March 2015
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KIMMERIDGE Energy

LUV for Oil?

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Summary

- Current oil prices reflect the trough of a cycle. ROACE is at record lows, capital spending is being slashed, production growth is nonexistent within current cash flows and the marginal E&P operator is in need of capital to stay in business.

- Much of the recent collapse in oil appears to be the result of a deceleration in demand and a strengthening of the USD. History suggests that a recovery from this trough will be demand-led and supply-supported.

- Consensus expects a recovery in the second half of 2015. While this remains plausible, the risks appear to be to the downside, with a longer trough driven by a flood of new capital into the space and a weak macro backdrop.

- The increased volatility and low commodity prices are likely to be positive for long-term oil prices, lowering confidence in investment, lowering planning assumptions and instilling capital discipline in a sector where it has been lacking. This appears similar to the events of 1998, which led to a multi-year bull cycle.

Kimmeridge Commodity Outlook Framework

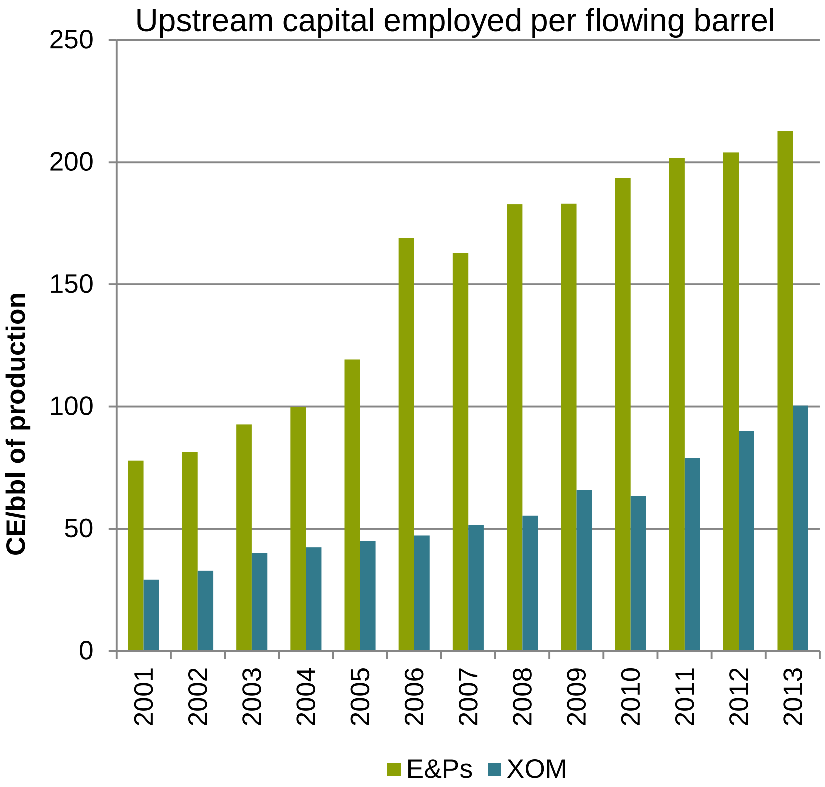
- Over the long term, oil and gas prices have trended in line with the capital intensity of the industry. Since 1998 the capital intensity of the industry has expanded circa 8% per annum on a per barrel basis, despite the shale revolution.

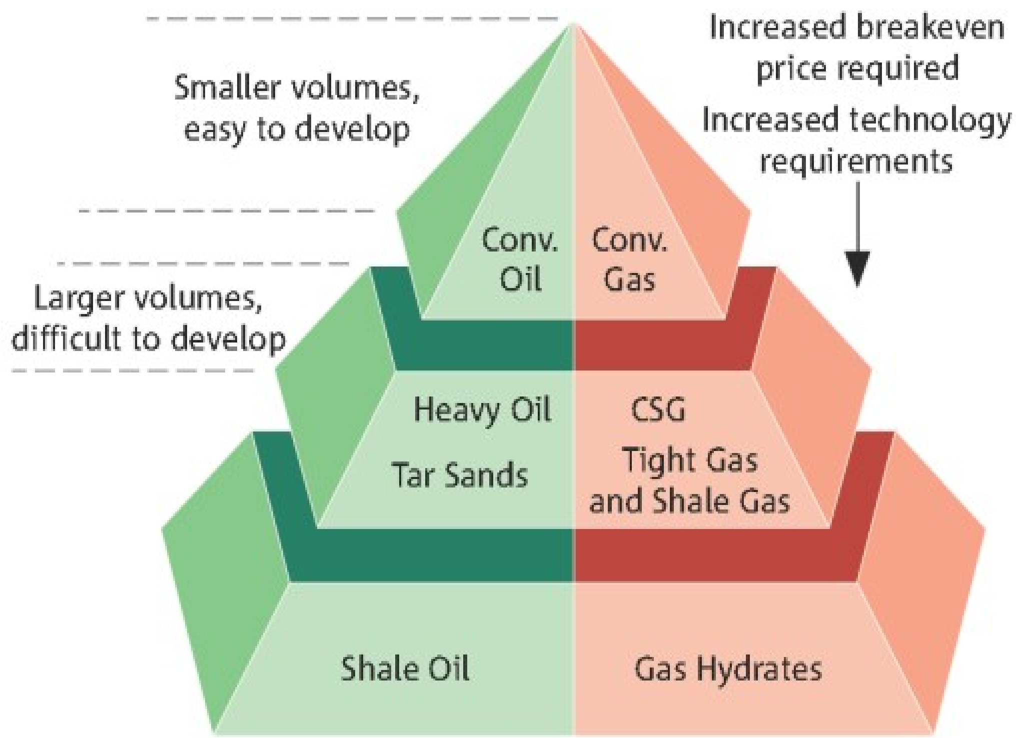
- While prices have trended with the marginal cost, they have also been reflective of near-term supply/demand trends, such that when spare capacity is tight, operators earn outsized returns and are incentivized to add production. In contrast, when demand is low, prices tend to trend below the marginal cost, leaving the high-cost players to reduce volumes.

- Today, oil and gas prices are trending below the marginal cost of supply, with prices having collapsed in the face of decelerating GDP and stable supply. Current pricing is unsustainable. However, the timing of a recovery is likely to be demand-led and later than consensus, driven by liquidity, lease dynamics and irrational operator behavior.

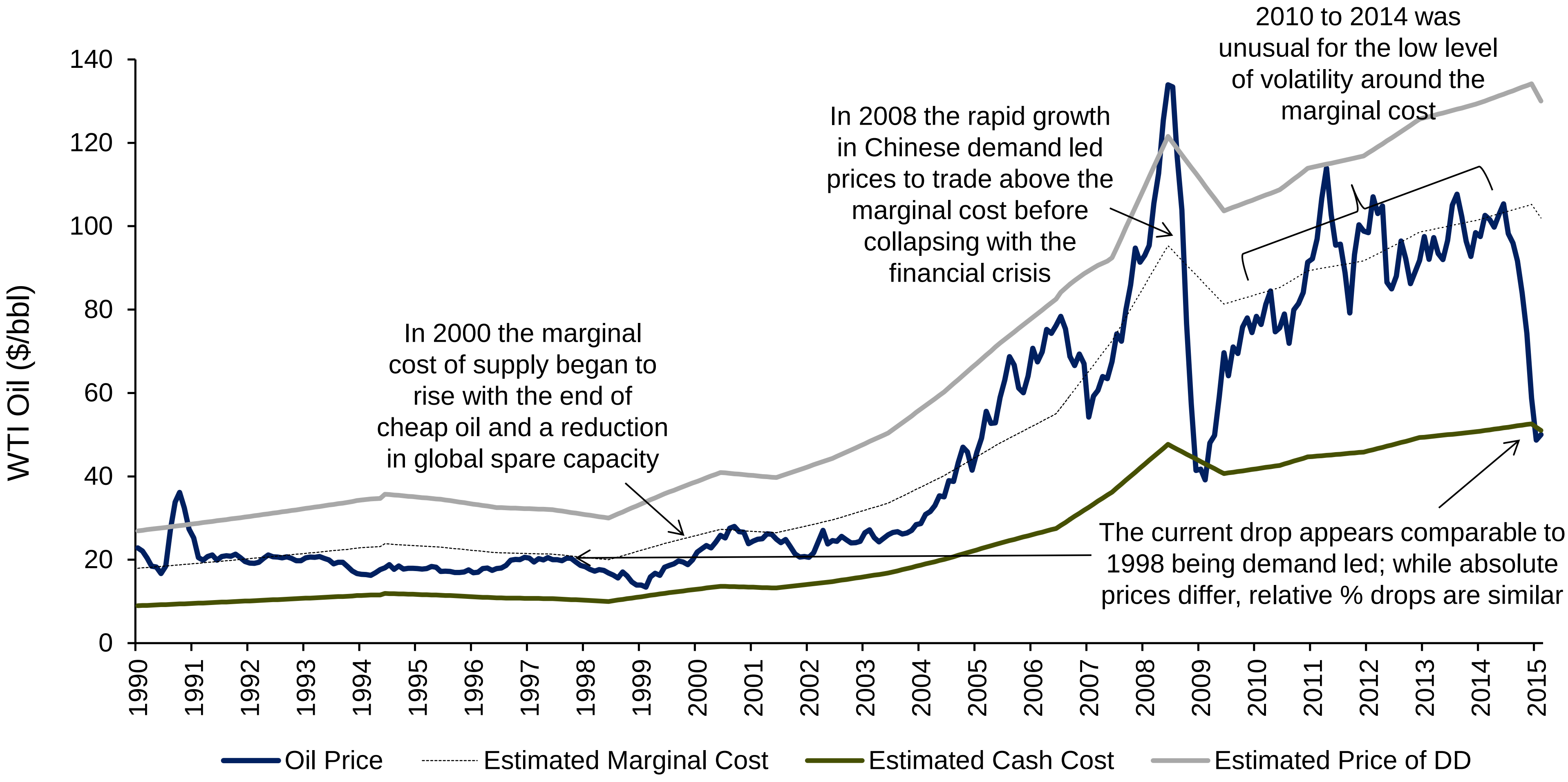
The Trend of Rising Capital Intensity Has Come from Moving Down the Resource Triangle

- Capital employed per barrel of production has expanded for all companies. While XOM's has risen from $30 per flowing barrel to $100 per flowing barrel, the US E&P group has gone from $78/boe to $212/boe.





Over the Long Term, Oil Prices Have Cycled Around the Marginal Cost



Source: SCB, Kimmeridge

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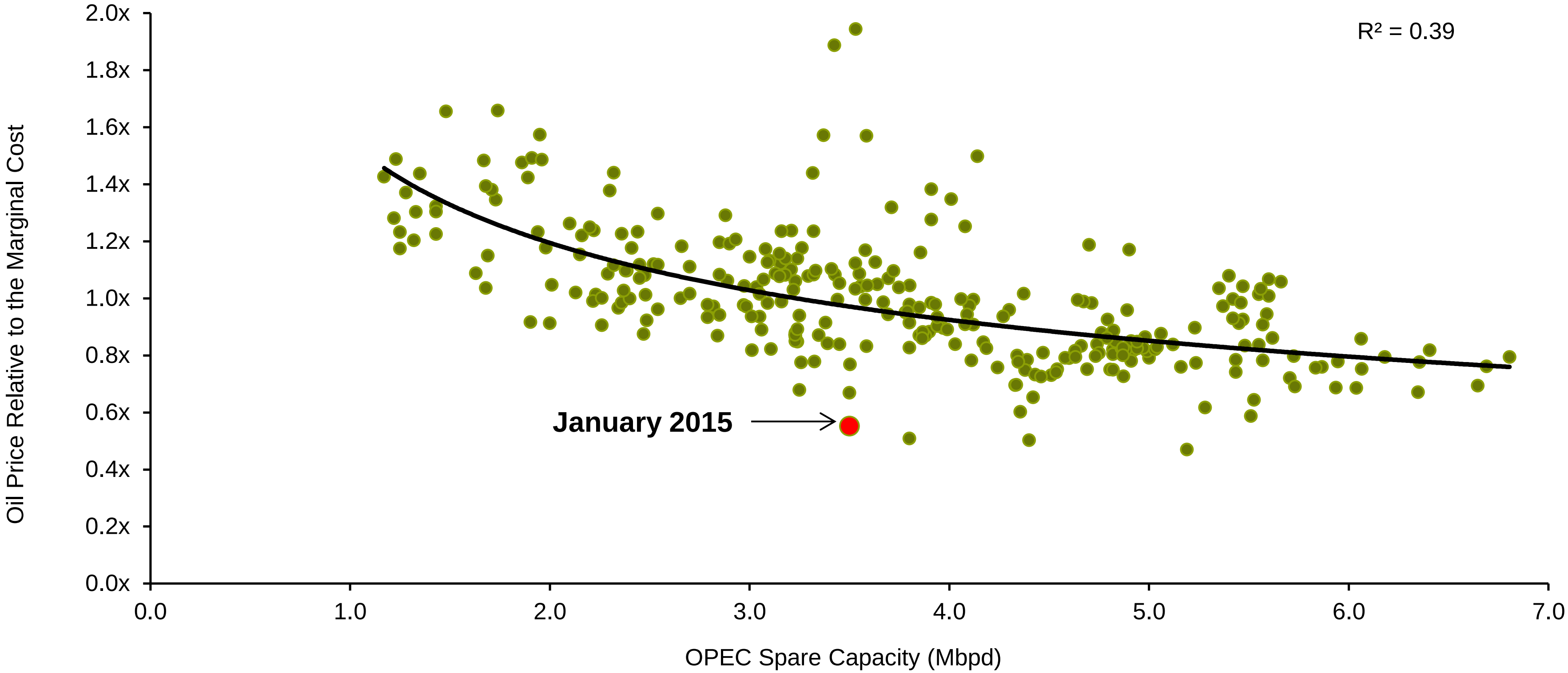
Oil Prices Relative to the Marginal Cost

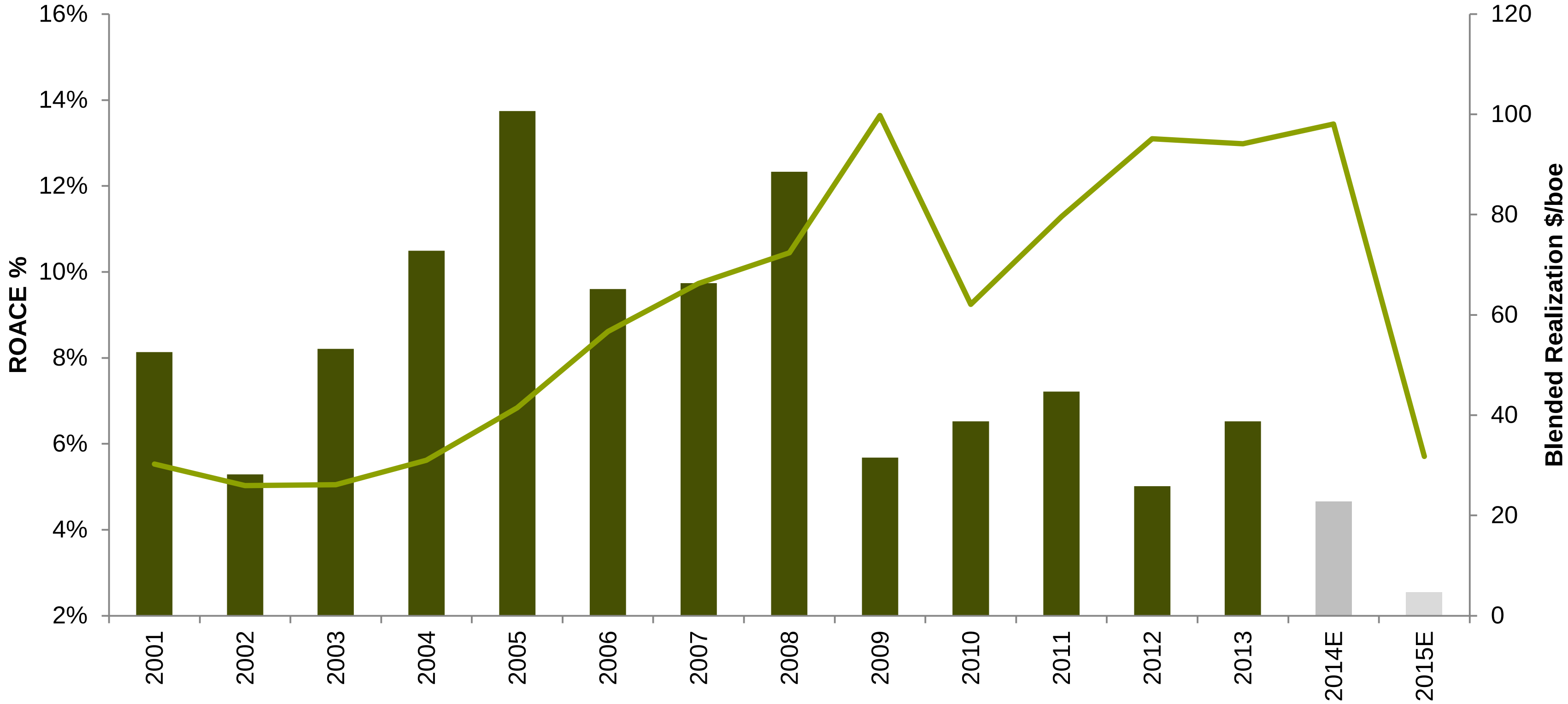
- Oil prices have continued to trade around the marginal cost (adjusted for supply/demand). However, as fears grow about a deflating marginal cost and growing spare capacity, prices have trended below the line.



Source: SCB, Kimmeridge

The Rising Marginal Cost has Meant that Higher Prices have not Led to Higher Returns

- If current pricing persists ($50/bbl and $3.5/mcf gas), then 2015 ROACE would be lowest for the peer group in 20 years, indicative of a cyclical trough.



Supply: Summary

- While investors have focused on US supply growth as the cause of the collapse in crude prices, the reality is that total global supply growth is not abnormally high, due to weak non-OPEC/non-US supply.

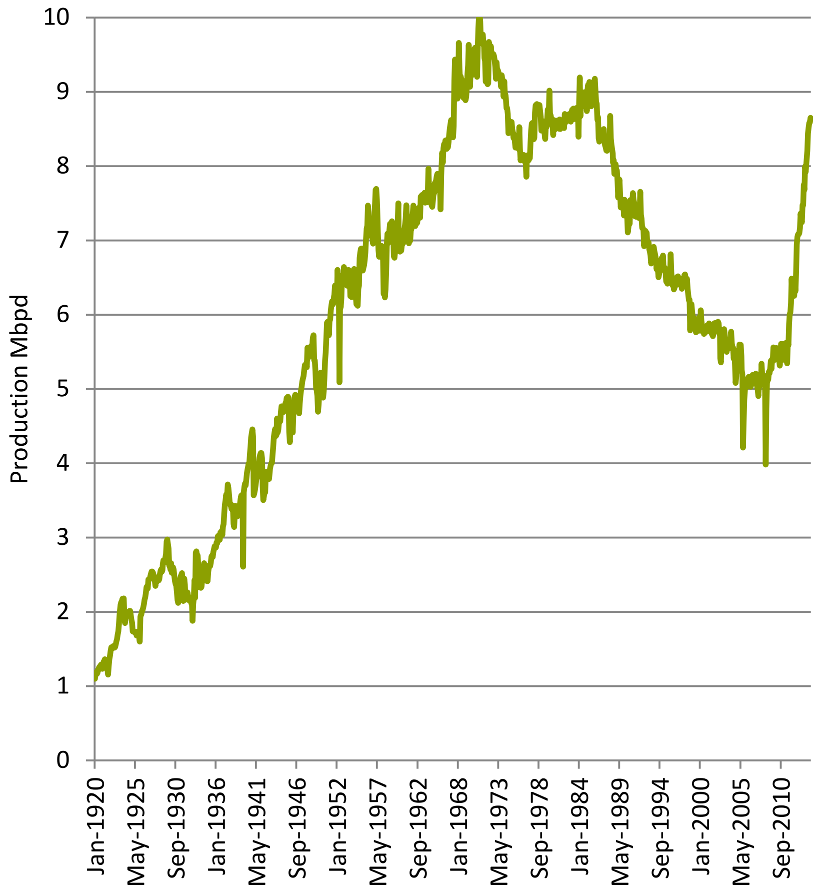
- The growth in US supply and the inability to export does however create the potential for significant “local” dislocations, including the risk that US inventories will become effectively full, putting pressure on WTI cash pricing.

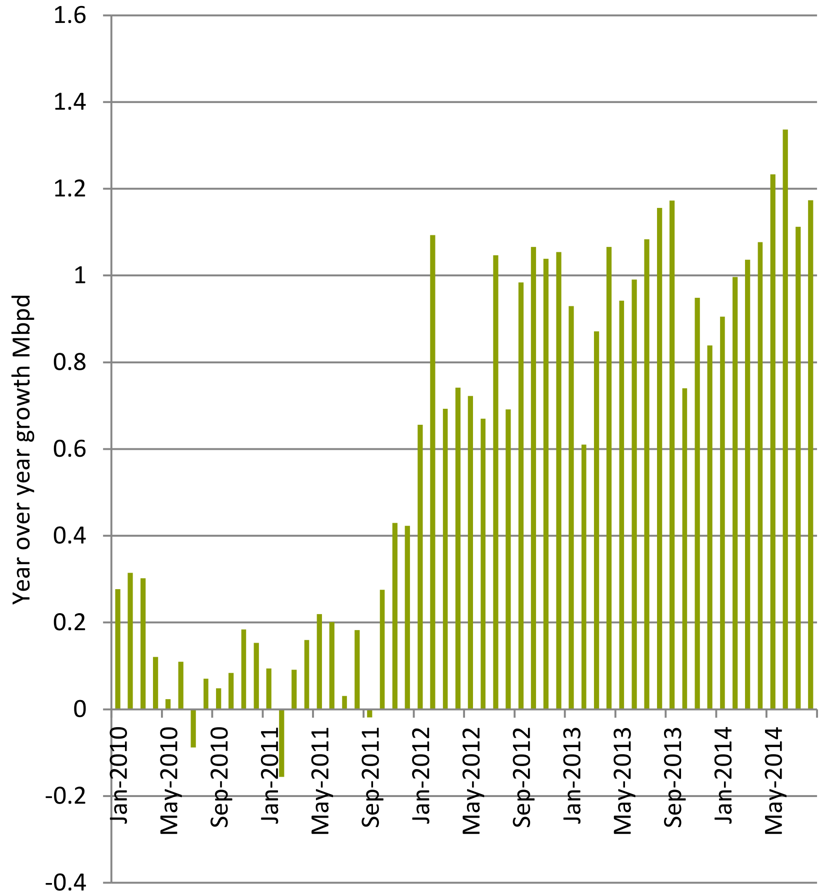
- OPEC growth has been significant, driven by the return of Libya. Risks exist on both sides of this equation with more supply likely in the event of an Iranian resolution and less supply possible due to political unrest in Libya/Iraq/Nigeria/Venezuela.

- Long-term supply is likely to be negatively impacted by the return of volatility to the crude market. This was a meaningful outcome of the 1998 downturn and we would expect it to be repeated.

The US Flood

- Investors are concerned about US volume growth for good reason.

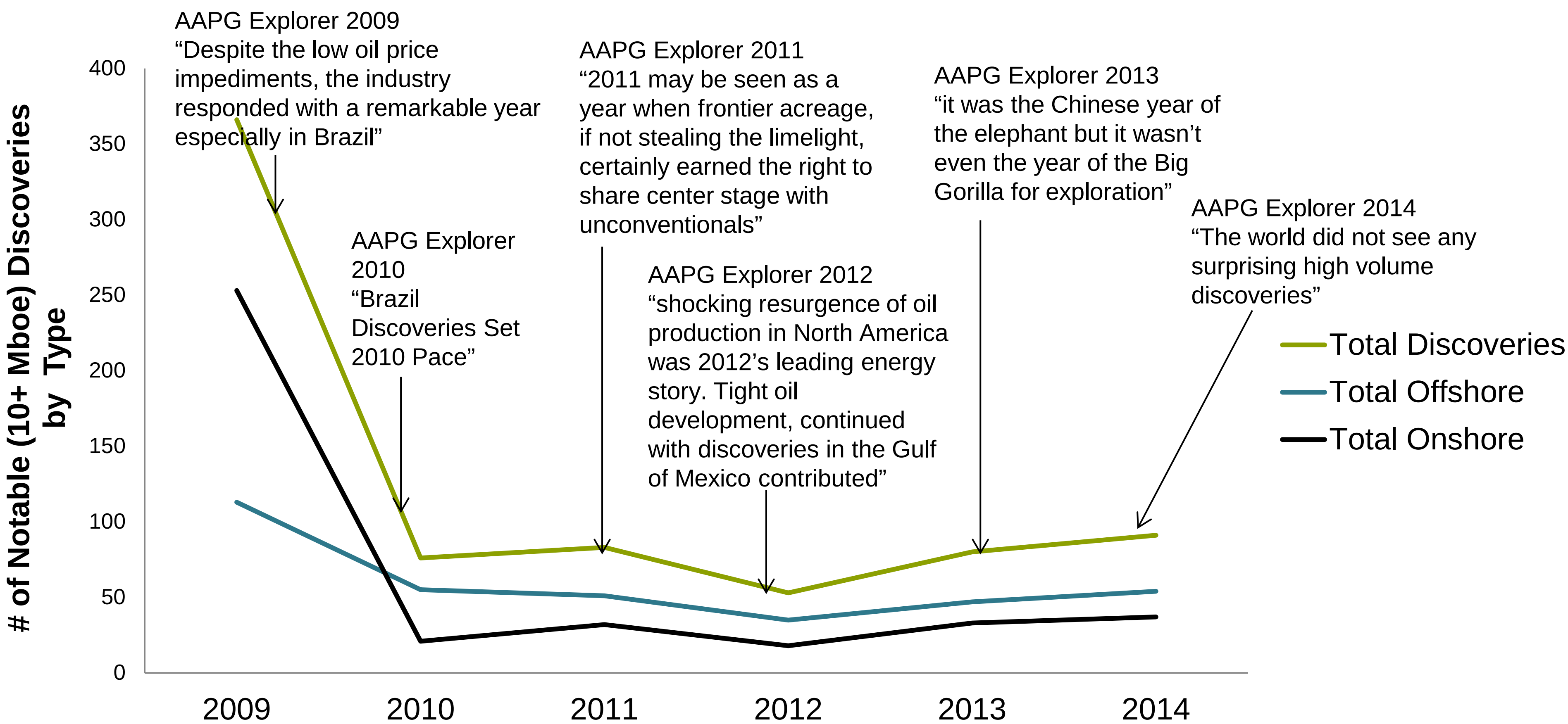




Source: EIA

The International Drought

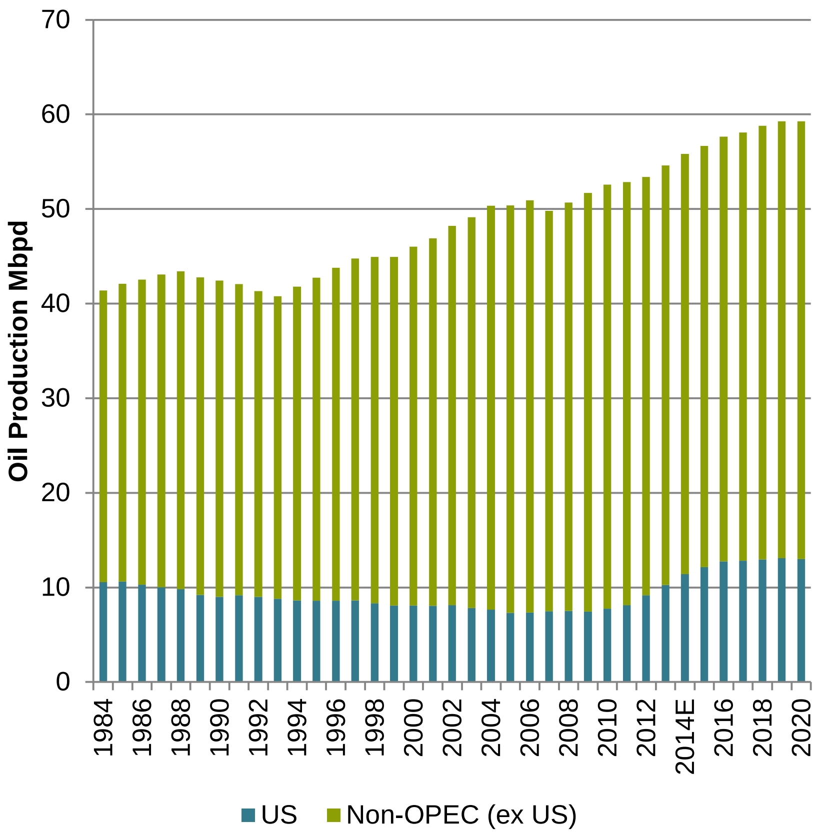
- Outside of the US, new exploration has been extremely limited.

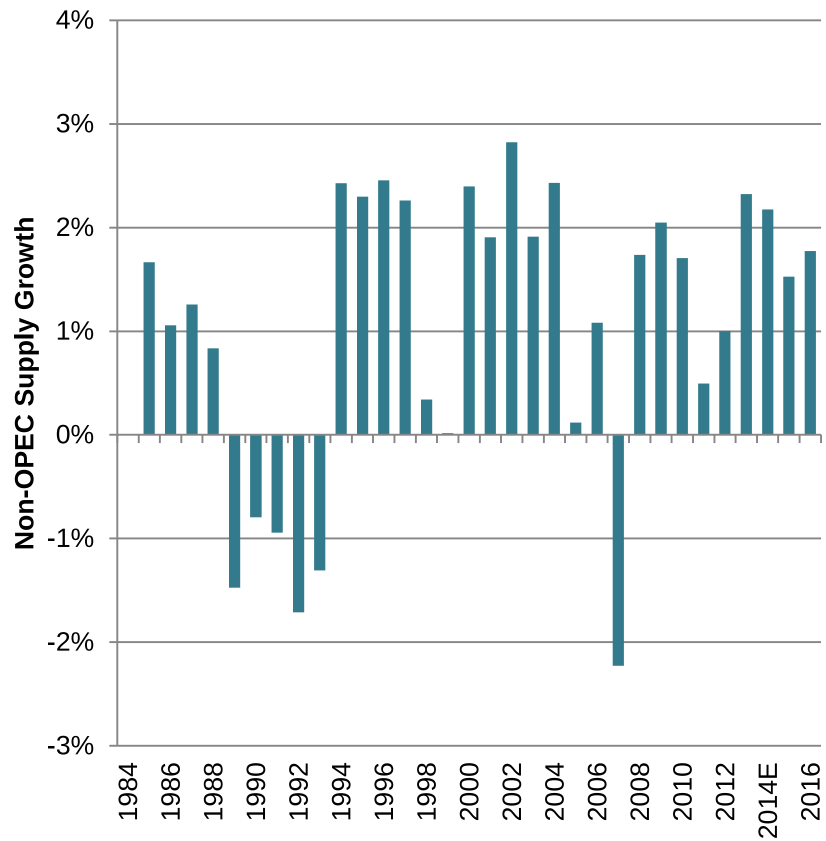


Source: AAPG, IHS

The Combined Non-OPEC Effect

- However, overall, non-OPEC supply growth has been in line with history due to limited international growth.

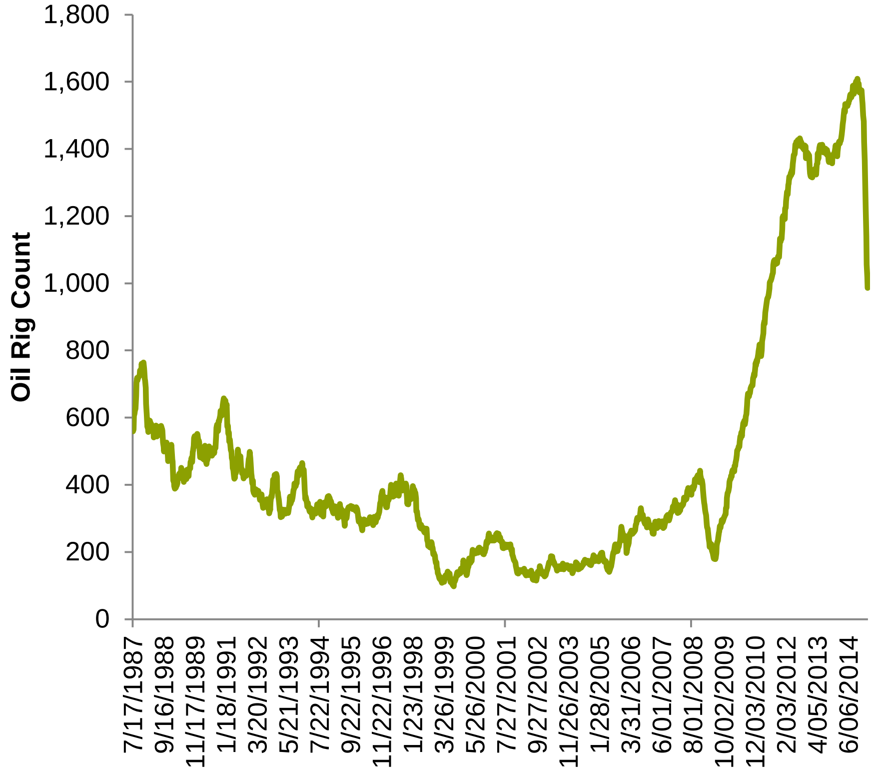




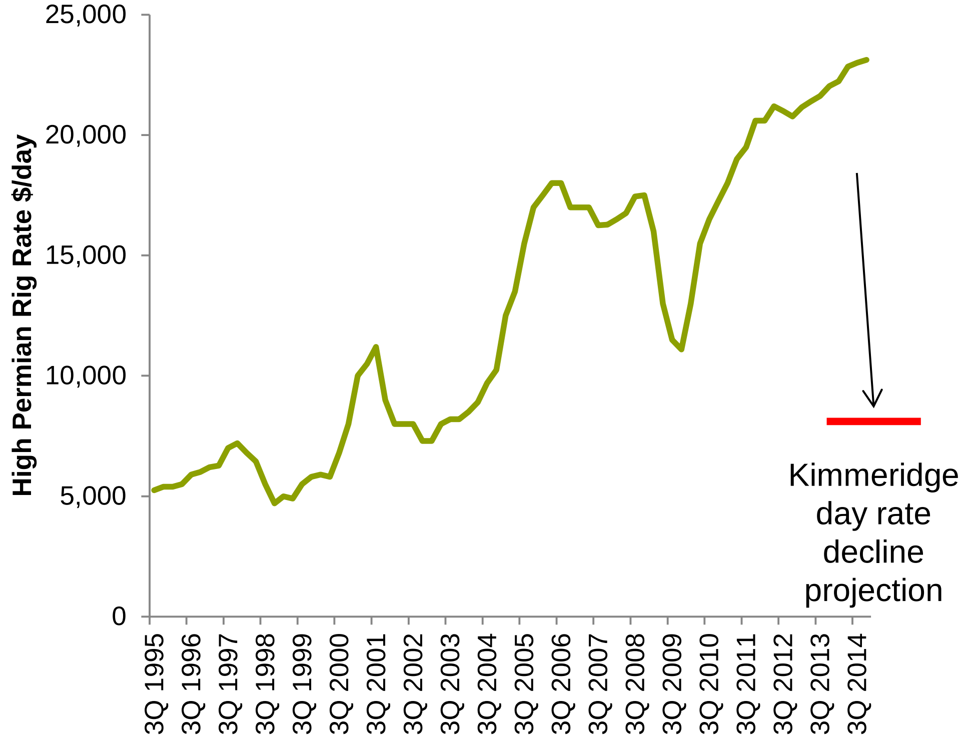
Source: EIA, SCB, Kimmeridge

The Near-Term Reaction to Price is Being Felt

- The economics of drilling have been rapidly felt in a peer group with limited access to new cash flow sources. As a result, the rig count has collapsed and rates will follow supporting a 20% reduction in F&D.



Source: Baker Hughes

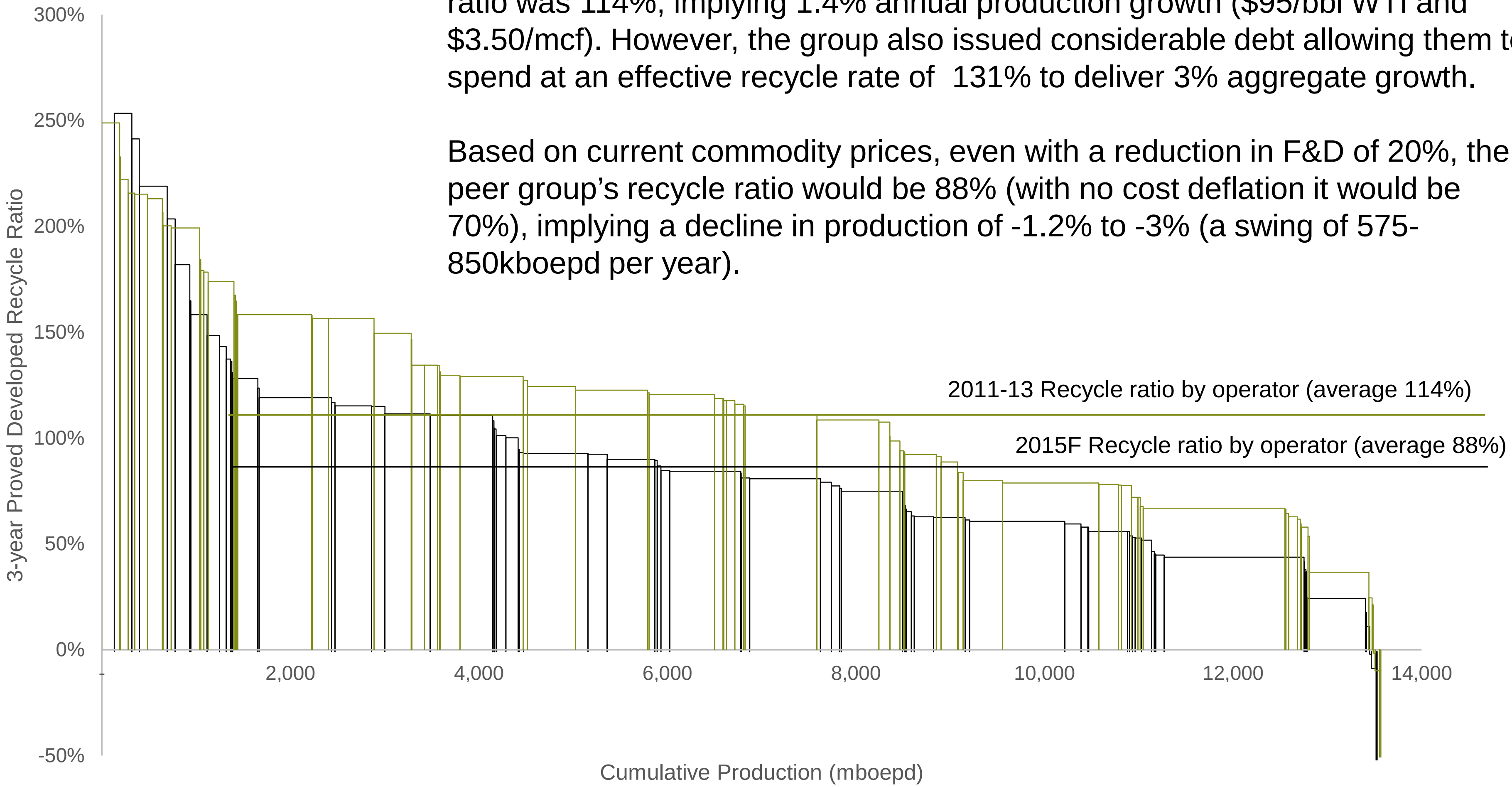


Source: Citi, Kimmeridge

How Much Can the US Grow When Living Within Cash Flow? Zero.

From 2010-2013 (2014 data has yet to be reported) the peer group's recycle ratio was 114%, implying 1.4% annual production growth ($95/bbl WTI and $3.50/mcf). However, the group also issued considerable debt allowing them to spend at an effective recycle rate of 131% to deliver 3% aggregate growth.

Based on current commodity prices, even with a reduction in F&D of 20%, the peer group's recycle ratio would be 88% (with no cost deflation it would be 70%), implying a decline in production of -1.2% to -3% (a swing of 575-850kboepd per year).

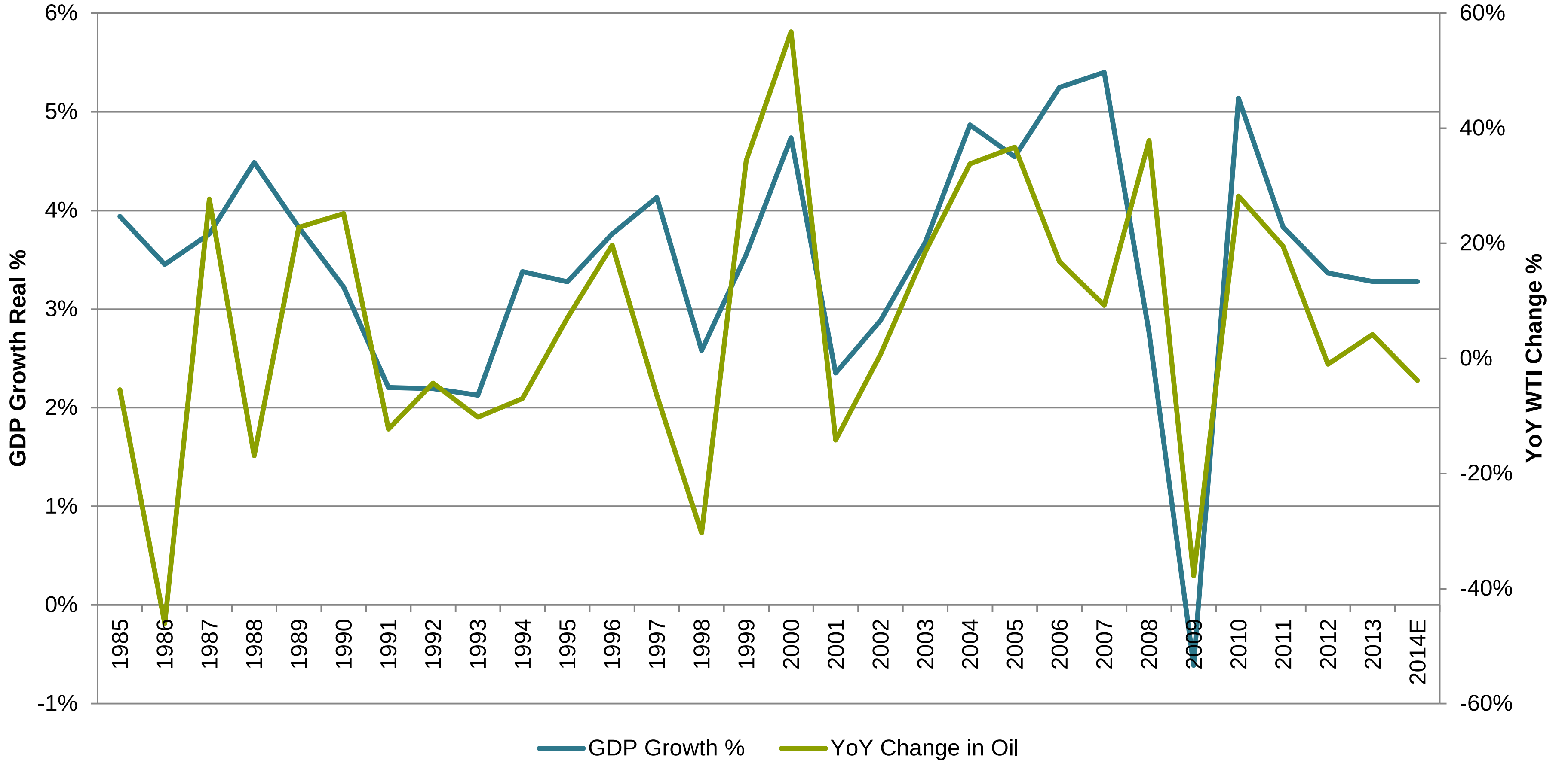


Demand: An Uneven Recovery

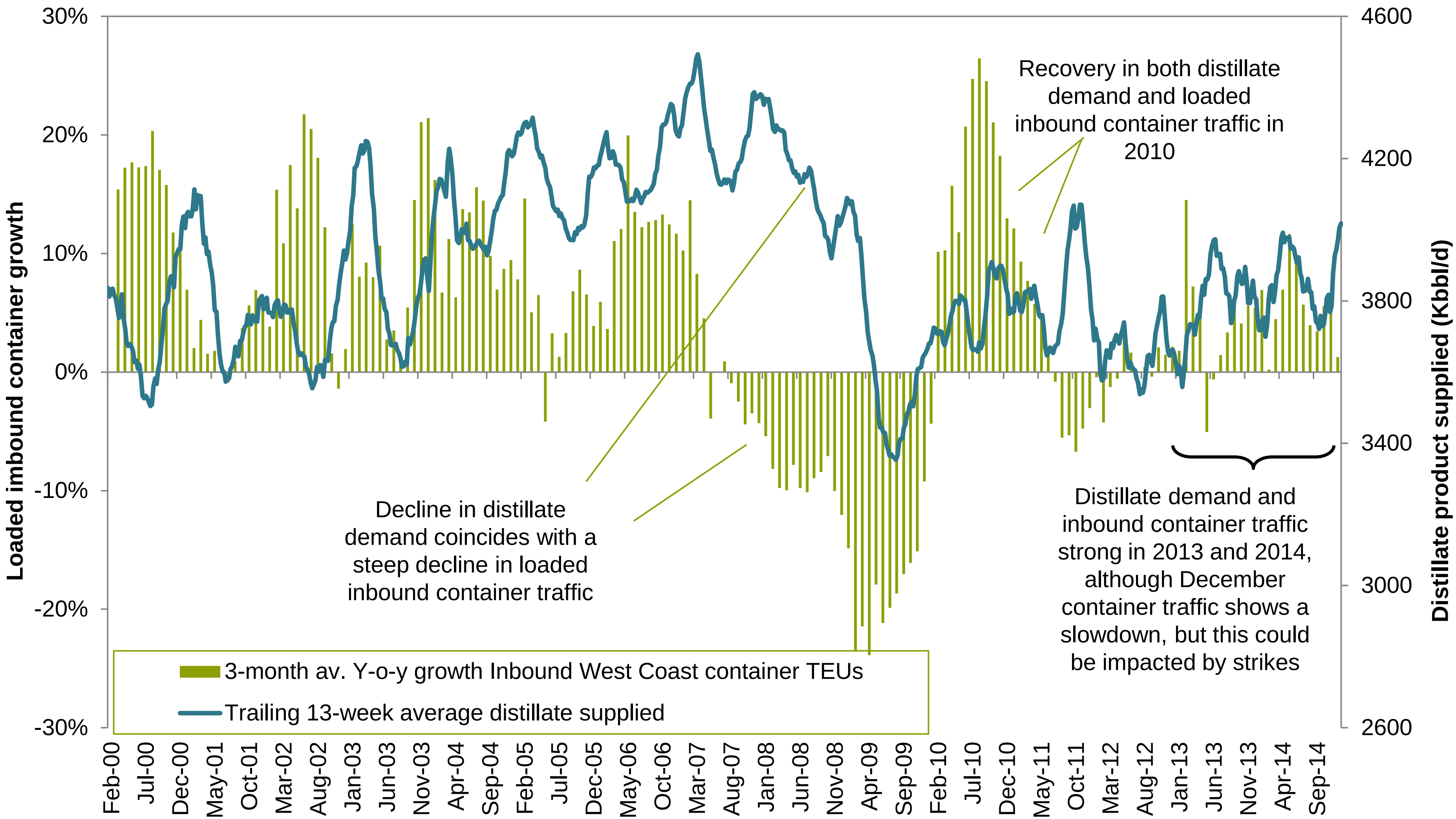
- While the focus has been on US supply, the directional change in oil prices in 2014 appears to have been demand related, which has seen negative revisions since mid-year.
- The IMF now expects global GDP growth to edge up only slightly from 3.3% last year to 3.5% in 2015. That is down from a 3.8% forecast for 2015 in its World Economic Outlook published in October. It forecasts growth picking up only slightly next year and cut its 2016 forecasts from 4.0% to 3.7%.
- Historically (only one in nine times), have oil prices risen with GDP below 3%. For a material appreciation, yoy GDP growth has averaged 4%+.

Global GDP and the Demand Problem

- Historically, oil prices have correlated closely with GDP growth with the exception of 2007 when prices dropped steeply in the face of strong growth.

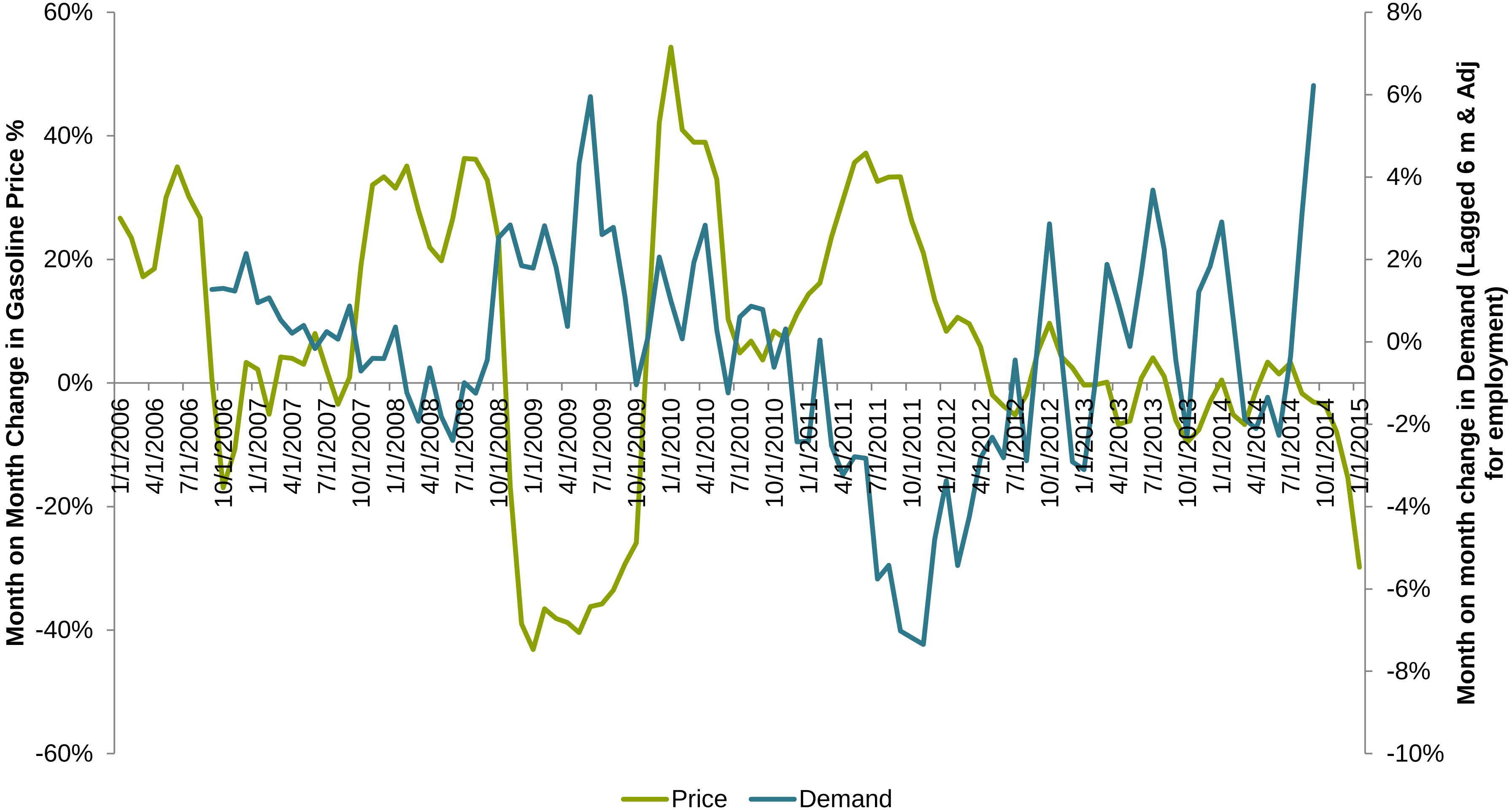


US Demand Remains Strong Driven by Strong GDP



Source: US Dept. of Transport, EIA

And Falling Prices/Higher Employment



Source: EIA, Bureau of Labor Statistics

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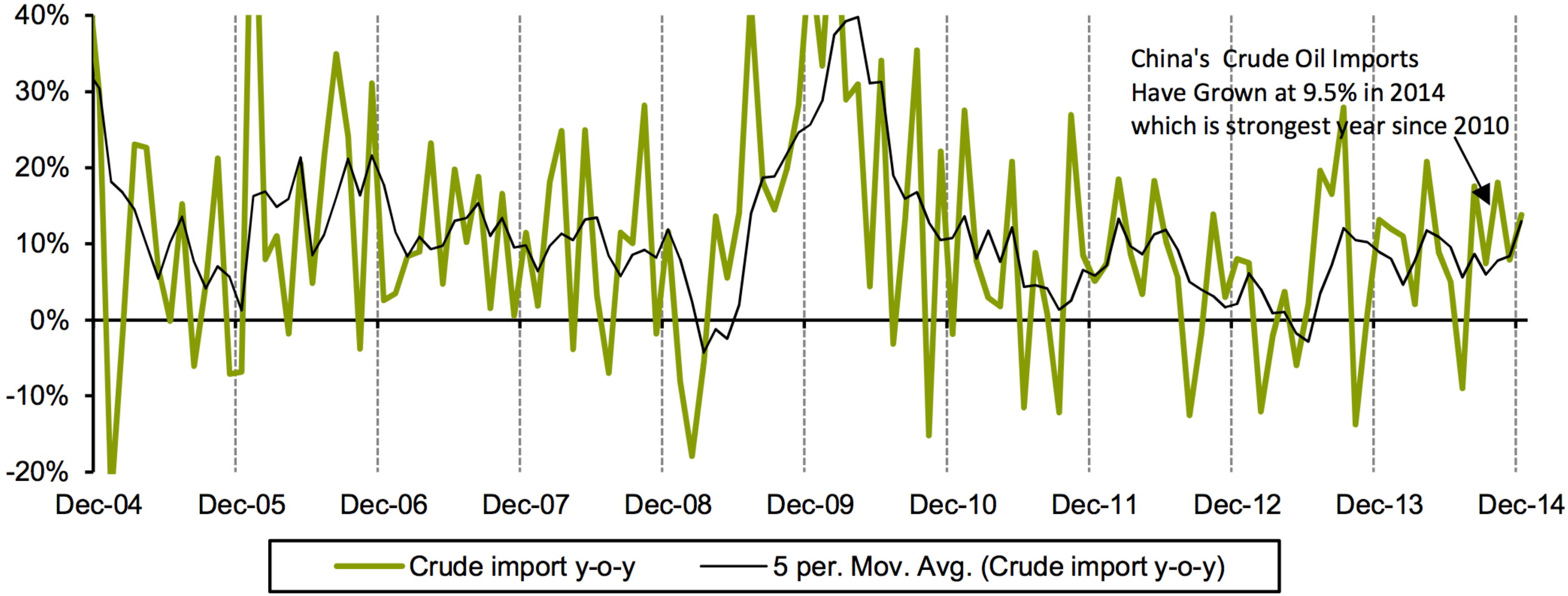
International Demand has Decelerated

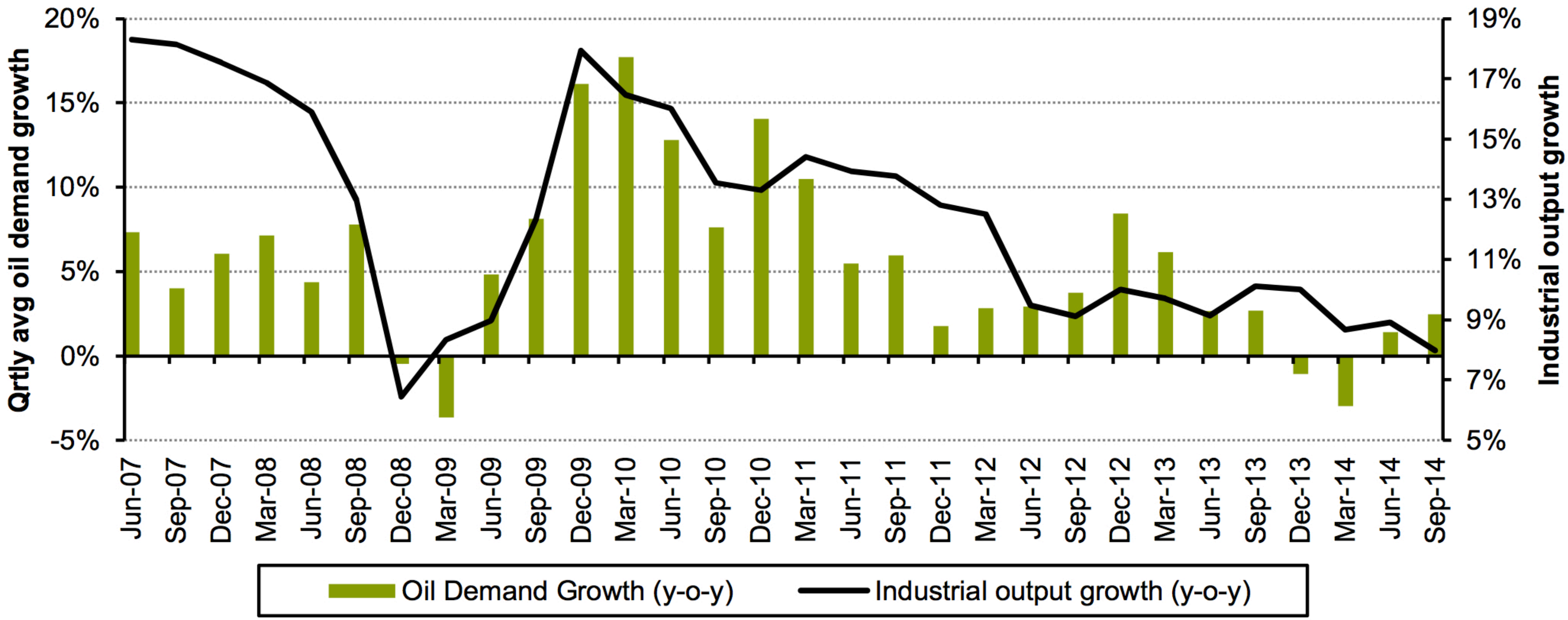
- China Imports have been robust, up 10% or 600kbpd, but this is largely a result of storage growth.



Source: Source: China NBS, Bernstein analysis and estimates

China Underlying Demand has Been Weak (Up just 2-3%)

- Last year China added 75-100mmbls to storage (200-300kbpd) supporting imports.
- 2015 demand is forecast at 4.0%, suggesting that if inventory build slows, imports could drop circa 100kbpd (yoy). January imports were weak (flat yoy and down 8% on December).

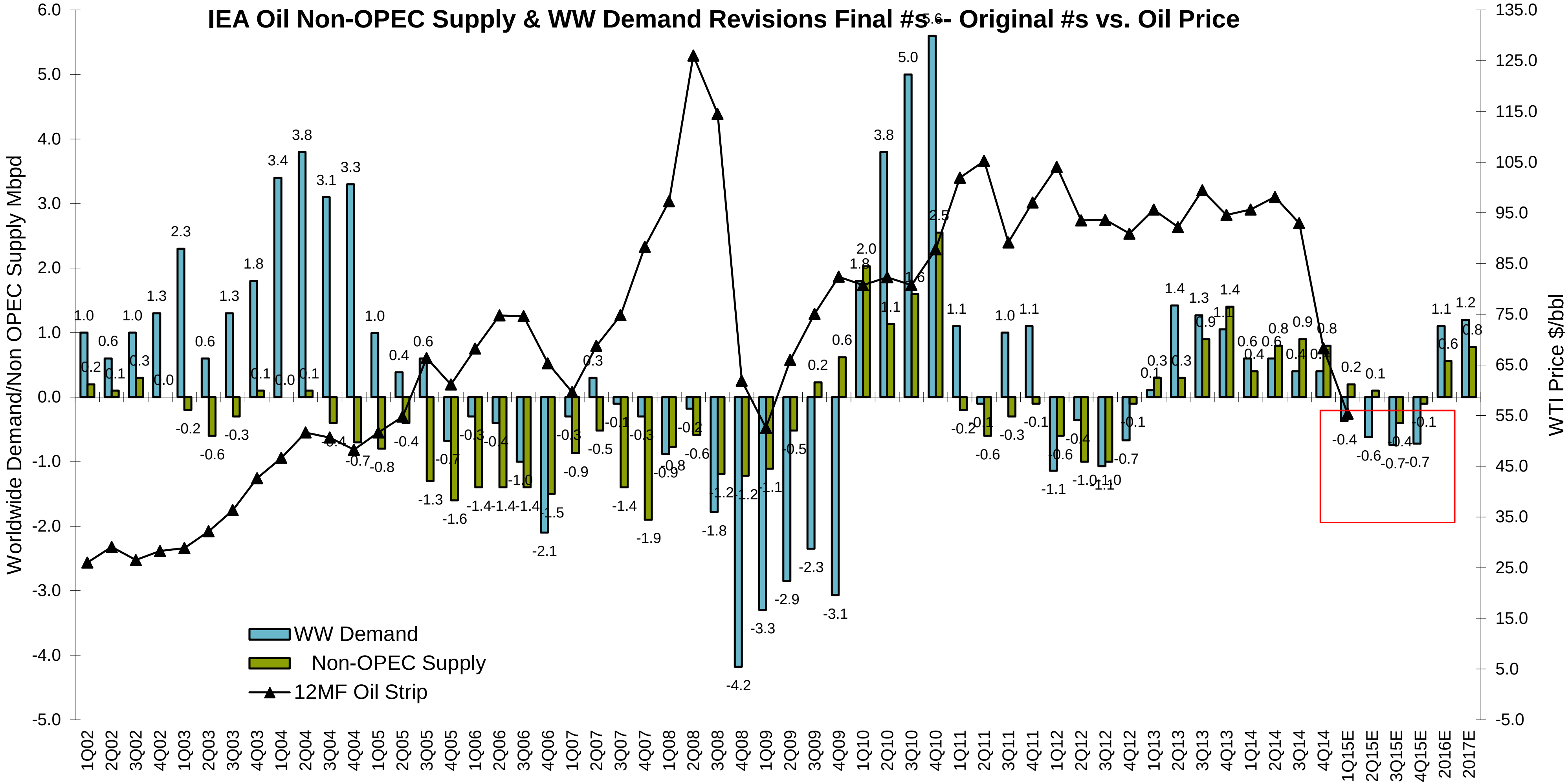


Note: Chinese oil demand is defined as crude runs plus net product imports plus adjustments to oil products inventory

Source: China NBS, Bernstein analysis and estimates

The Deceleration in GDP and Demand has Led the Decline in Oil

- Change in global GDP outlook will drive the recovery of the oil price, not supply reductions.



Source: IEA, Bloomberg

Currency, Interest Rates and Free Money

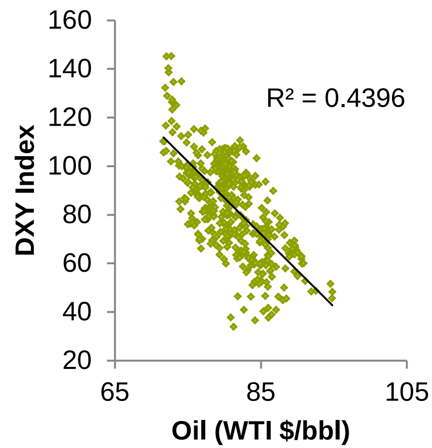
- While historical and future oil prices are likely to be driven primarily by the marginal cost of supply and spare capacity (i.e. supply/demand), historical data suggests that currency/interest rates are an additional variable.

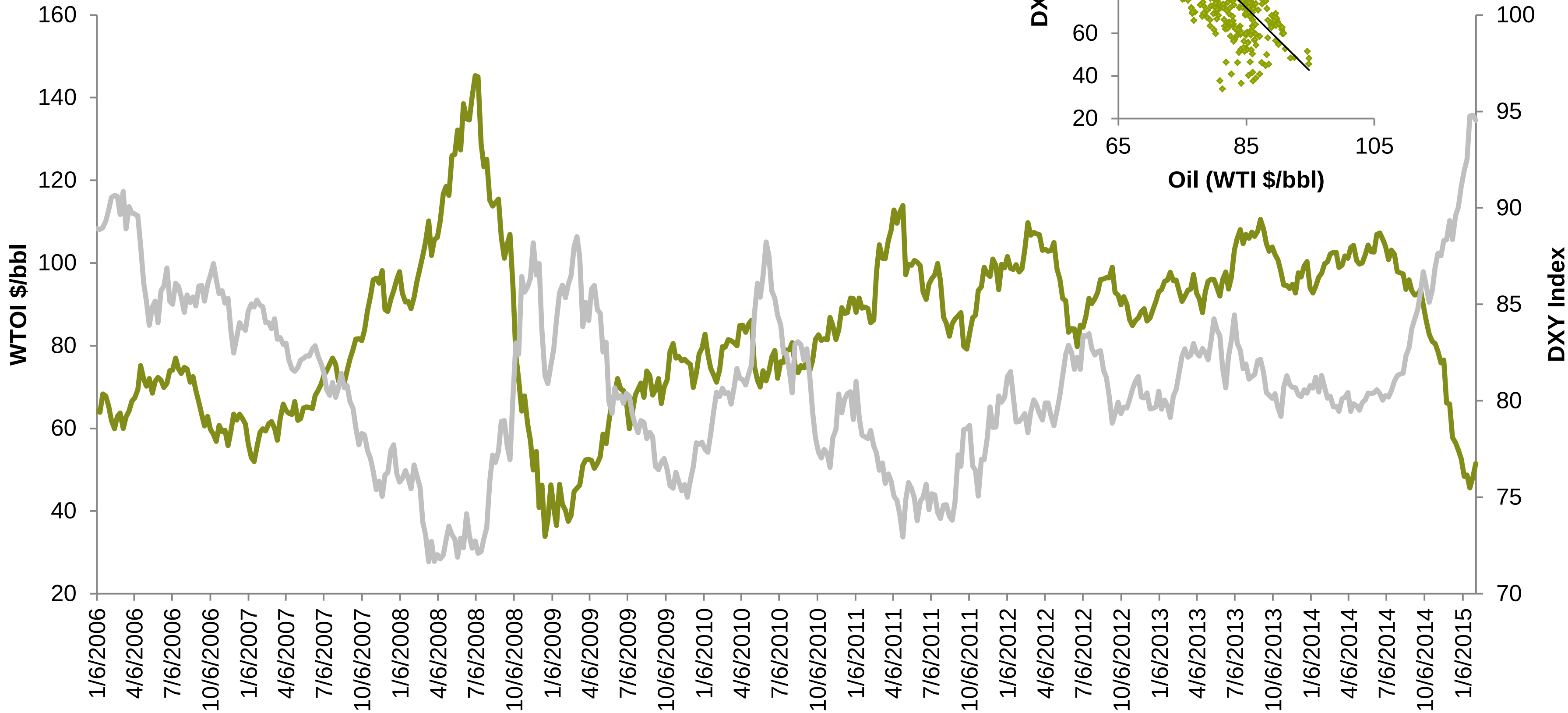
- A leading factor in the crude downturn was the reversal from an accelerating GDP world (1H2014) to a decelerating one (2H2014). At the same time, the relative interest rate and exchange rate outlook for USD/EUR and USD to other currencies also reversed.

- In the near term, dollar strength appears likely given the indications that the Fed will raise rates (at least a quarter this year). However, job and inflation data suggest that a moderation of this position (to no rate rise or further easing) isn't impossible, which in turn may lead to dollar weakening and a modest recovery in crude.

Relationship of WTI to the DXY Index (2006-Present)

- While the correlation is moderate, there is a clear directional relationship between currencies and crude.

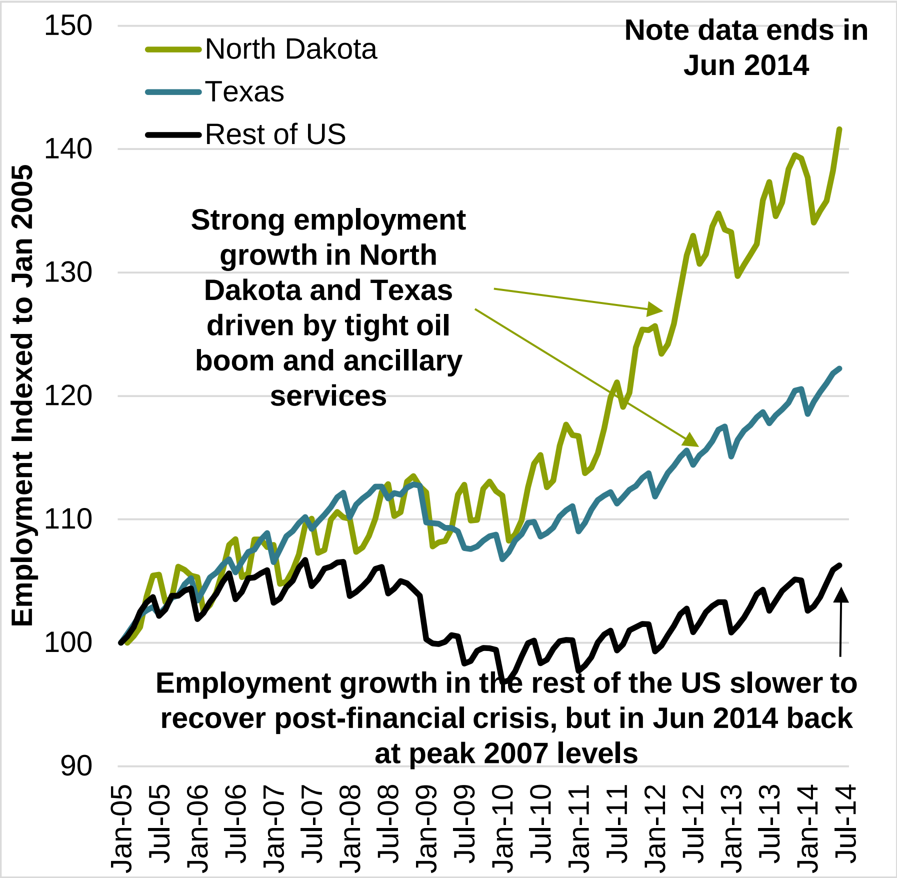


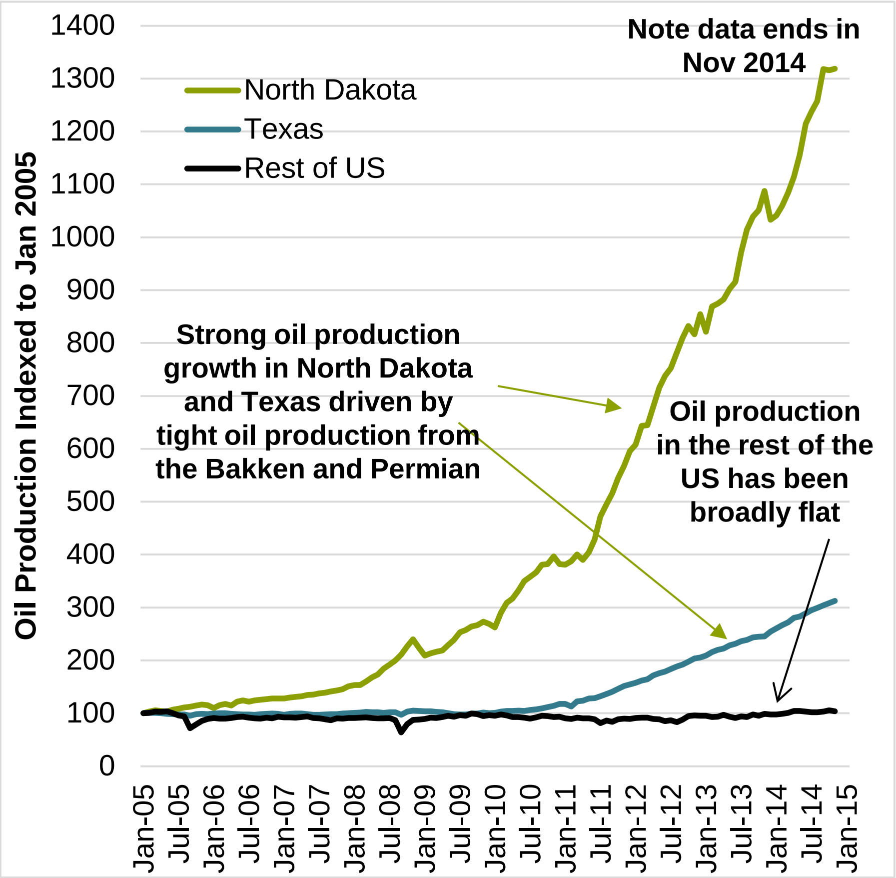


Source: Bloomberg

Jobs Data and Impact on US Rate Decisions

- The impact of the growing energy sector on the jobs market should not be underestimated and raises the possibility that the fall in unemployment stalls, further limiting inflation.





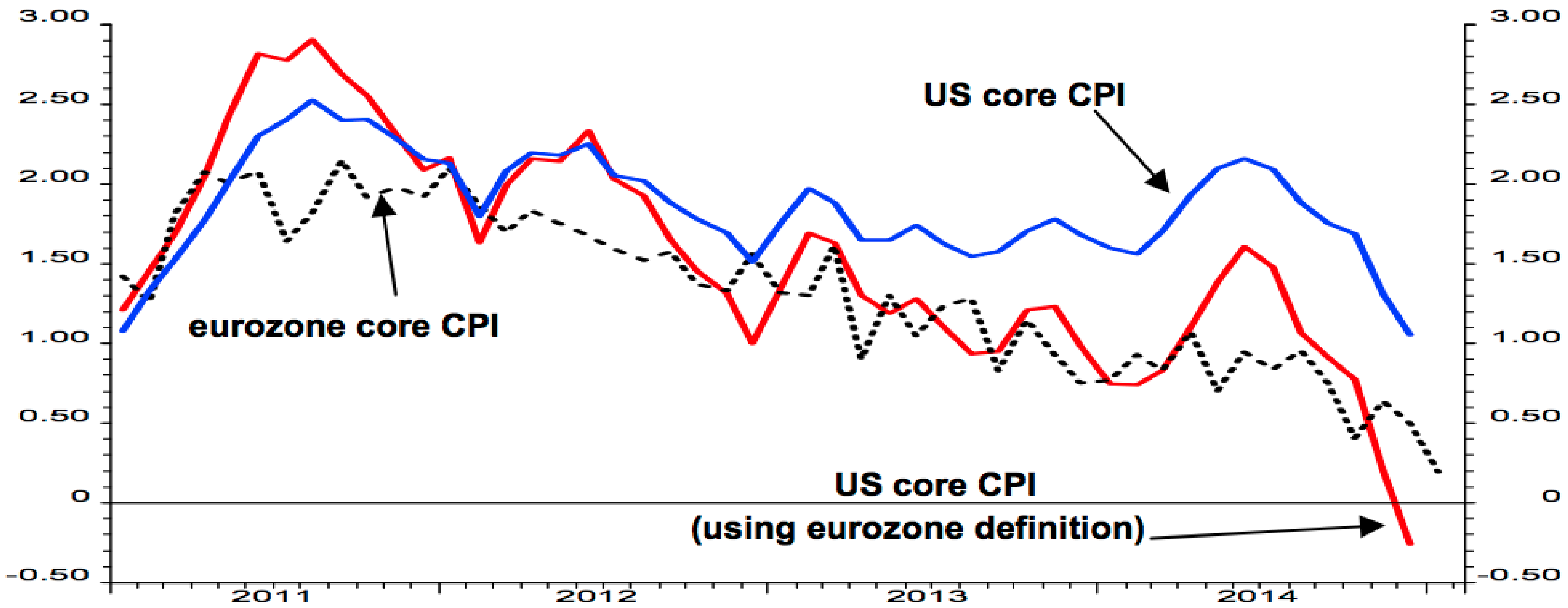
Source: Bureau of Labor Statistics

Source: EIA

What if Inflation Remains Non-Existent?

- If US inflation remains limited and unemployment stagnates, a single interest rate rise may be realistic, with future easing raising the potential of USD weakening.

US core CPI inflation negative for the first time ever (on eurozone definition and 6m% ann rate)



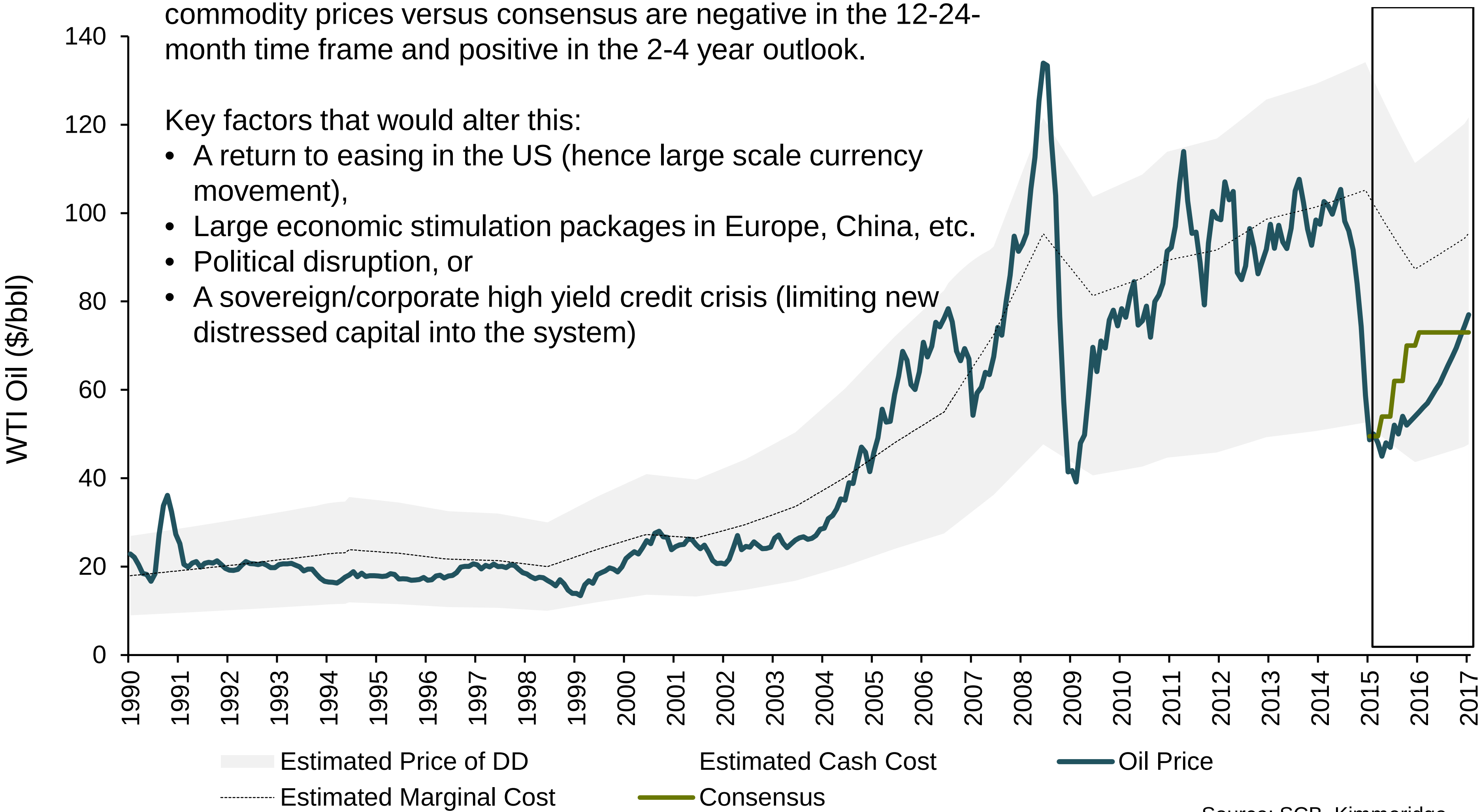
Source: Datastream

Summary & Conclusions

Based on current conditions, Kimmeridge believe the risks to commodity prices versus consensus are negative in the 12-24-month time frame and positive in the 2-4 year outlook.

Key factors that would alter this:

- A return to easing in the US (hence large scale currency movement),
- Large economic stimulation packages in Europe, China, etc.
- Political disruption, or
- A sovereign/corporate high yield credit crisis (limiting new distressed capital into the system)



Source: SCB, Kimmeridge

Summary of Positive & Negative Factors

Influence	Positive for Price	Negative for Price
Marginal Cost	Capital intensity continues to rise Service deflation bottoms Low ROACE continue	Material efficiency gains slowing impact of rig decline Deflation in services/materials Technological evolution to improve EUR/well
Supply Factors	Reduction in US rig count, operators live within cash flow Limited new liquidity (distress is the high yield market) Distress in sovereign bonds (Venezuela/Russia) Supply interruptions (Libya, Iraq, Nigeria, Venezuela) Non-OPEC, Non-US continued decline OPEC decision to act Export allowance/domestic growth (reducing WTI differential)	Iran nuclear deal Distressed capital flows into insolvent companies Stabilization in Iraq/Libya "Full" storage
Demand Factors	Recovery in Global GDP China and RoW Stimulus China SPR build Industrial base expansion (Chemicals)	Deceleration in US GDP Greek exit & Europe stagnation China deceleration and/or credit crisis Negative Petro State revisions Japanese stagnation
Macro	Dollar weakening US return to easing US deflation/rising unemployment	Dollar strengthening RoW rate cutting/weakening and negative interest rates

Source: Kimmeridge

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