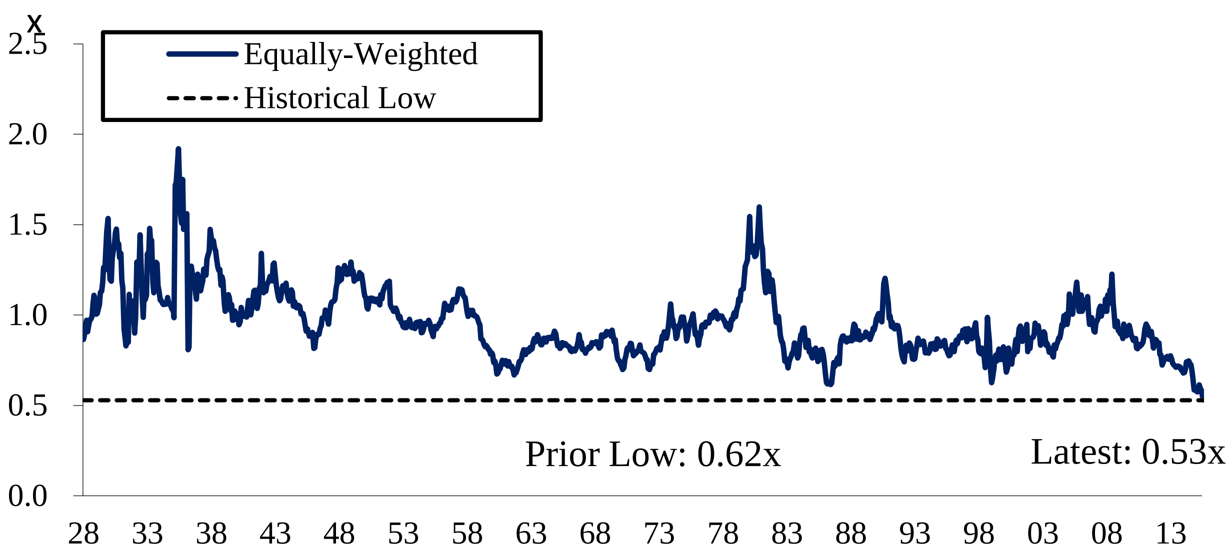
THE ENERGY OPPORTUNITY TODAY

Introduction

Crude oil fundamentals are challenged near term as the market remains in an oversupplied situation. However, sentiment is far too negative on the potential timing and magnitude of an inevitable oil price recovery. This pessimism has pushed relative Price/Book valuations to 90 year lows [Exhibit 1]. As contrarian value investors, we view this as an excellent investment opportunity and are following our VMER process to selectively build a diversified Energy exposure within our broader portfolios.

We are seeing definitive signs that a recovery in oil prices is underway, while acknowledging that trying to call the bottom is a fool's game. The two main drivers of oil prices are demand, which is growing, and supply, which is beginning to respond to lower oil prices. Global oil is a ~95 million barrel per day market, where production naturally declines by 5%+ each year unless new capital is added. The drop in oil prices has led to significant capital spending reductions rather than additions. This decreases future supply. With ongoing demand growth, the price of oil will need to rise in order to incentivise required investment. Once again proving that the cure for lower oil prices…is lower oil prices.

Exhibit 1: Price/Book Valuation



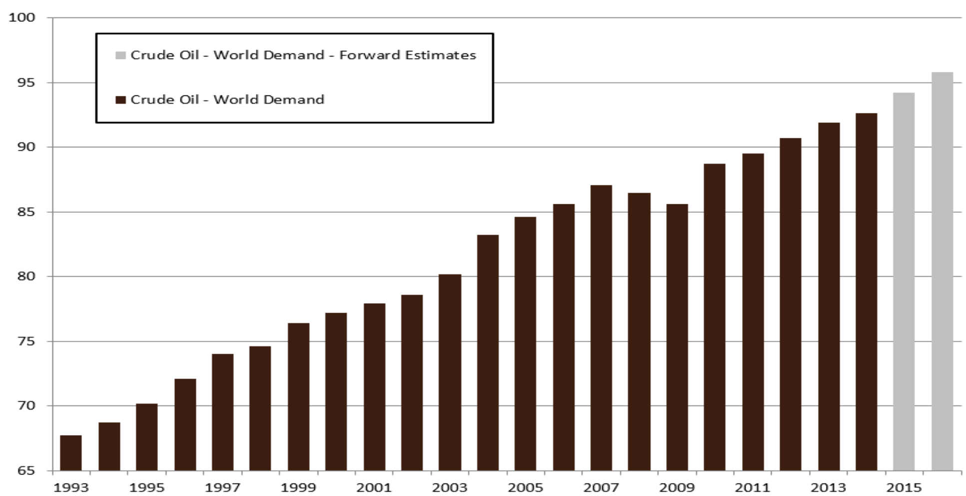
Source: Empirical Research Partners, As of September 30, 2015

Demand

Oil demand has consistently grown over the past 20 years and remains strong today [Exhibit 2]. The International Energy Agency (IEA) expects demand growth of almost 2% in 2015, or 1.8 million barrels per day, the largest increase in five years. Expectations in 2016 are for demand to grow by 1.2 million barrels per day, another strong year. Lower oil prices are stimulating demand, a basic requirement to reduce currently high oil inventories.

- China's oil demand is unlikely to decline, even in the event of a "hard landing" ~ *Wall Street Journal*
- "Crude oil demand in the coming months should continue to improve and, thus, gradually reduce the imbalance in oil supply-demand fundamentals." ~ *OPEC Report, August 2015*

Exhibit 2: Crude Oil Demand

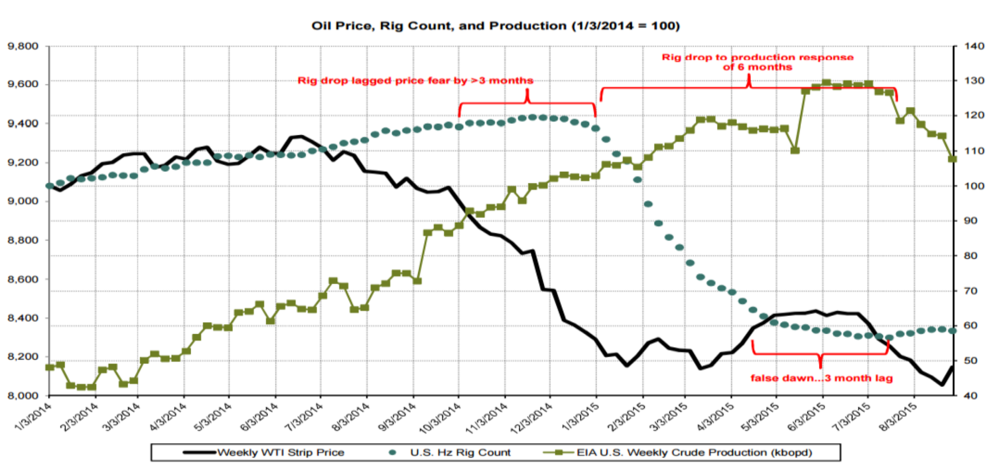


Source: International Energy Agency (IEA)

Supply

The supply response for US shale typically lags the price of oil by roughly nine months; we believe this lag in the system is most often overlooked by investors. A US supply response was never going to occur in tandem with the oil price decline, but it is happening now. Companies came into this year well capitalized and well hedged, allowing them to maintain existing drilling budgets. In short, companies had cash from the strength of oil prices in 2014 and they spent it. The market is extrapolating the supply levels seen in the first half of 2015 as evidence that oil prices will remain lower for longer. As shown in Exhibit 3, this view ignores the fact that it takes at least six months for a drop in the rig count to actually impact production. The rig count is dropping, supply is rolling over and oil producers are facing steep "decline rates" – the natural speed at which wells are depleted – setting the stage for the market to become balanced in the months ahead. Through the start of October, the US rig count is down 59% from its peak, one of the most severe declines in history even exceeding that seen during the oil bust of the mid-1980's.

Exhibit 3: Rig Count and Production Lag



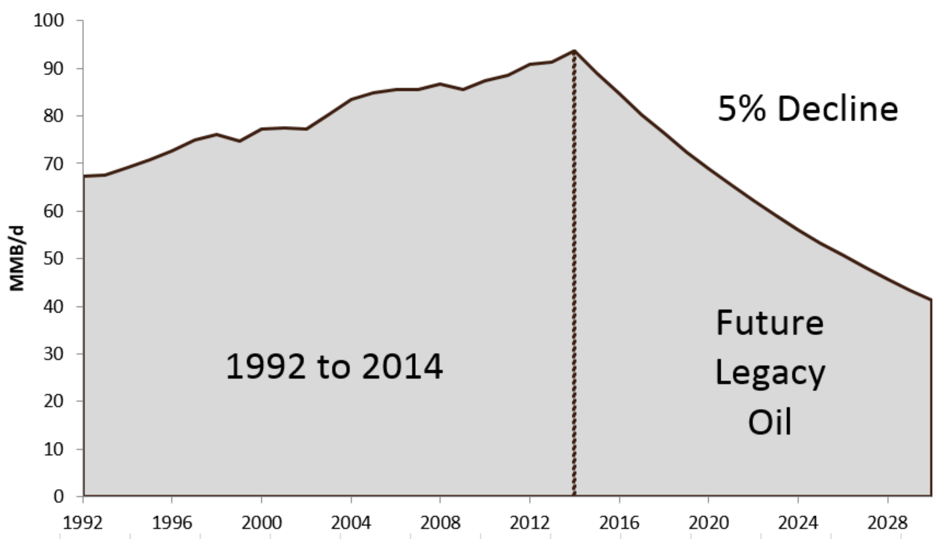
Source: Bernstein Research, EIA, Baker Hughes, and Bloomberg

While OPEC members Saudi Arabia and Iraq have been increasing supply, the oil cartel's spare capacity is at multi-year lows. This has historically been a bullish signal. The market is also concerned about the potential impact of Iranian sanctions being lifted, despite legitimate questions around Iran's ability to even return to pre-sanction levels of production. However, this supply will ultimately be absorbed given continued demand growth and therefore only delays the oil price recovery rather than prevent it.

While supply has been resilient from North America and OPEC, the market tends to ignore that the rest of the world (RoW) accounts for ~40 million barrels per day of supply. This RoW production has likely peaked and faces potentially serious declines given the massive reduction in capital investment. A certain level of capital investment is required just to maintain flat production, otherwise global decline rates of ~5% naturally reduce supply [Exhibit 4]. We believe this dynamic is underappreciated by the market. The longer oil prices remain low, the more investments are deferred, setting the stage for a sustainable recovery.

- Russia's Deputy Prime Minister said oil production could fall up to 10% if prices stay low ~ *Reuters*
- Mexico's oil industry is in decline as lower prices have thwarted its plans ~ *Wall Street Journal*

Exhibit 4: Impact of Decline Rates



Source: Tetrem Capital, Data from IEA

Portfolio Approach

Tetrem's portfolios offer diversified energy exposure, owning the more defensive, well-capitalized companies, as well as those more levered to an eventual oil price recovery. Energy equities have been uniformly shunned as investors overlook the competitive differences between the individual companies. Our approach remains focused on owning those companies best equipped to emerge from the downturn more competitively advantaged, while also owning those with exceptional risk/reward characteristics to a minor recovery in oil prices. Examples of our portfolio holdings are:

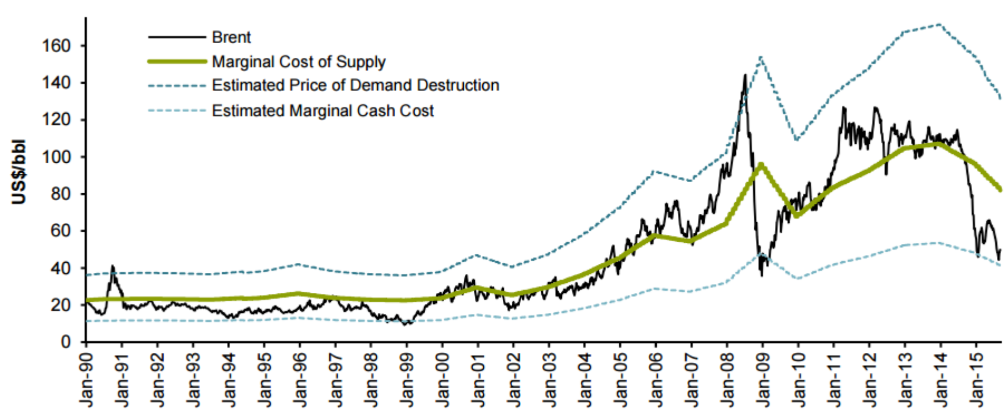
- **Suncor Energy** (SU) has one of the strongest Free Cash Flow profiles in the industry and one of the most profitable downstream operations in North America. The company is aggressively reducing costs and making permanent productivity improvements. They are well positioned to emerge from the downtown stronger. SU's base oil sands cost per barrel in Q2/15 was only $28 (down 18% y/y) and they raised their dividend 4% while other companies cut theirs.

- **Tourmaline Oil** (TOU) is a low cost gas producer with leading production growth and a pristine balance sheet. The drop in oil prices is leading to service price concessions for TOU, allowing them to drill for less. TOU is using the downturn to consolidate key resource plays at attractive prices, enabling them to emerge competitively advantaged.
- **Vermilion Energy** (VET) offers unique exposure to highly profitable European gas. Gas prices in Europe are 3x higher than in North America. The ramp of an offshore natural gas asset over the next year should provide a step change in cash flow that will increase financial flexibility. Vermillion offers a 5.3% dividend yield which they are capable of increasing even in a lower for longer oil price environment.
- **Paramount Resources** (POU) has tremendous asset and infrastructure value that is being ignored by the market. Paramount's crown jewel is their condensate operation, which has yet to hit its stride but has great potential. Management's interests are aligned with investors as insiders own ~50% of shares outstanding – the highest level of insider ownership within our energy universe.
- **EOG Resources** (EOG) offers the best combination of resource and management quality. They are the highest quality US Shale E&P, a top ranked operator with immense scale in the most desirable shale basins, and one of the lowest cost producers. EOG has historically led productivity gains and is best suited to outperform under a variety of oil price scenarios.

Our base case scenario, which uses conservative oil price assumptions, offers upside of over 50% for our Energy holdings. This equates to a 5:1 upside/downside ratio. With a dire scenario already priced into the stocks, as evidenced by trough relative Price/Book valuations, not much is needed to achieve significant outperformance.

We acknowledge the headline-grabbing bear cases out there, such as one prominent sell-side firm's worst-case scenario of $20 oil. However, even they assign a low probability to this case. We are confident that $20 oil is unsustainable as this would destroy supply by forcing uneconomic wells to "shut-in" creating a rapid supply response. [Exhibit 5].

Exhibit 5: Marginal Cost of Supply



Source: Bernstein analysis and estimates

Conclusion

Global oil supply is ~95 million barrels per day and naturally declines by 5%+ each year. Demand remains strong and is growing by 1-2% per year. It really does not take much to bring the market into balance. Of course there are various wildcards, like Iranian supply, which has pressured oil, but this is why we probability-weight our scenarios. Then again, oil has traditionally been priced with a geopolitical risk premium and that is now gone. This could return at any time; it is not as if peace has broken out in the Middle East. Equities within the Energy sector are far from discounting the marginal cost of supply and do not reflect the positive developments that should drive a sustainable recovery in oil prices. There is no denying that the Energy sector offers an excellent value opportunity.

About Tetrem

Tetrem Capital Management is an employee-owned investment management firm that specializes in managing large cap, value-oriented portfolios. Tetrem offers Canadian and U.S. Equity Value strategies as well as Canadian and U.S. Dividend Growth strategies.

Tetrem's talented team of eight investment professionals works collaboratively to employ a bottom-up, fundamental research process focused on finding value opportunities within the large capitalization segment of the market. We are contrarian value investors in the purest sense.

For more information about Tetrem Capital Management please visit our website, www.tetrem.com.