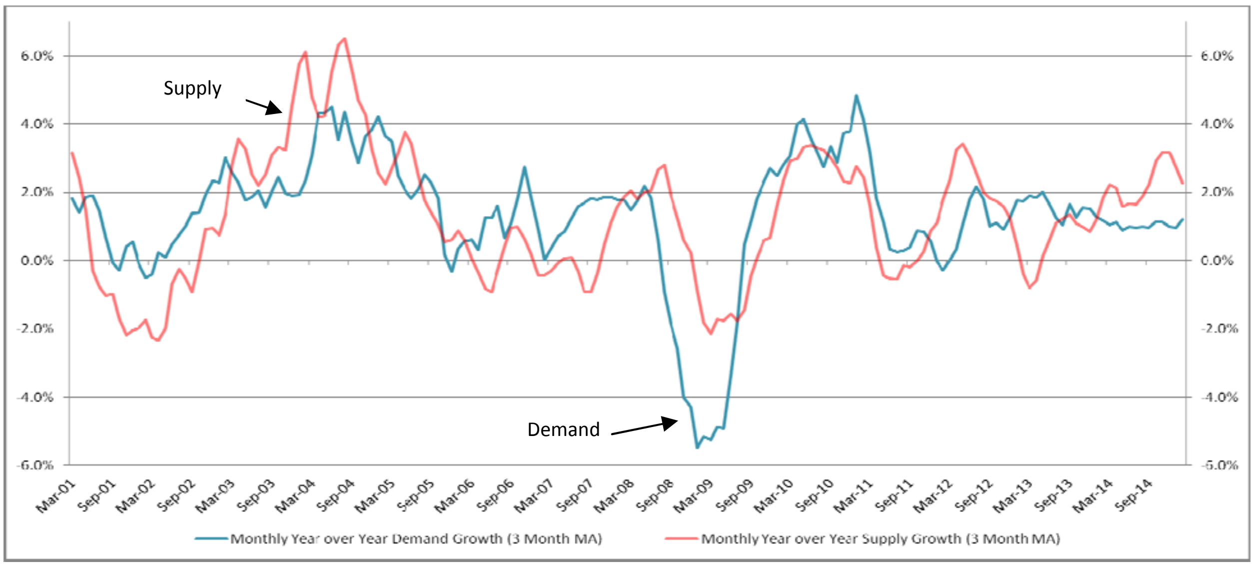
# SeaBridge Core Strategy

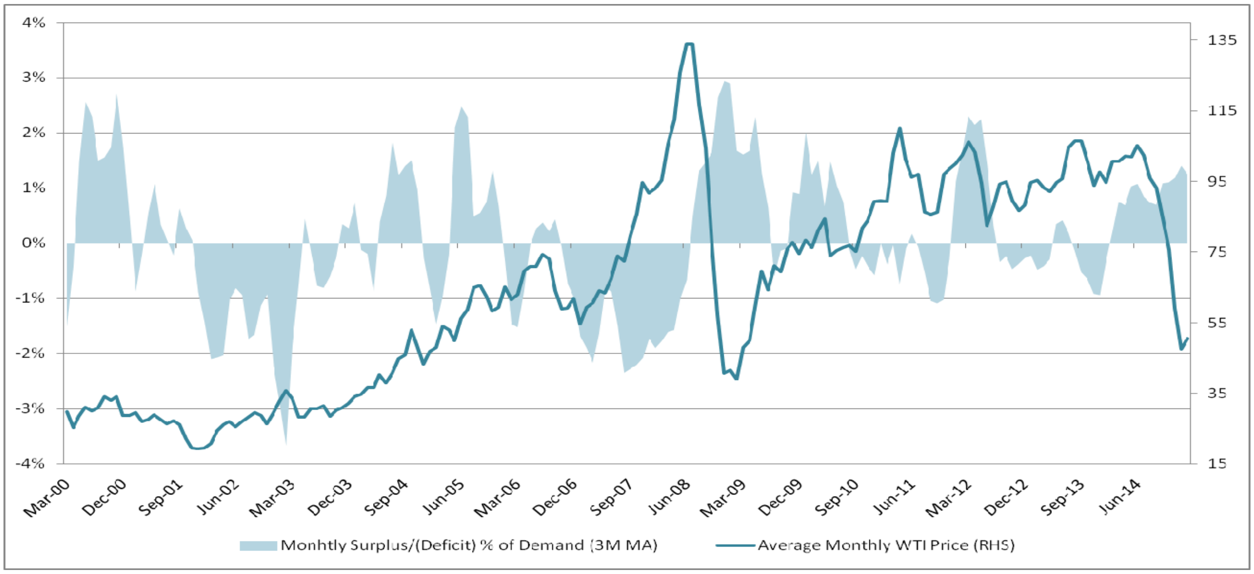
First Quarter 2015
Commentary

The current imbalance in the oil market has led to a 55% decline in the price of oil since June 2014. In contrast to the 2008/2009 period, the current sell-off appears to have been caused by surging supply rather than collapsing demand. In 2014, strong production growth from the US and Canada led to a 2.3% increase in global supply while global demand grew just 1%. Growth in demand was attenuated by weakness in Europe and Japan, which together represent approximately 19% of global demand.




Source: U.S. Energy Information Administration

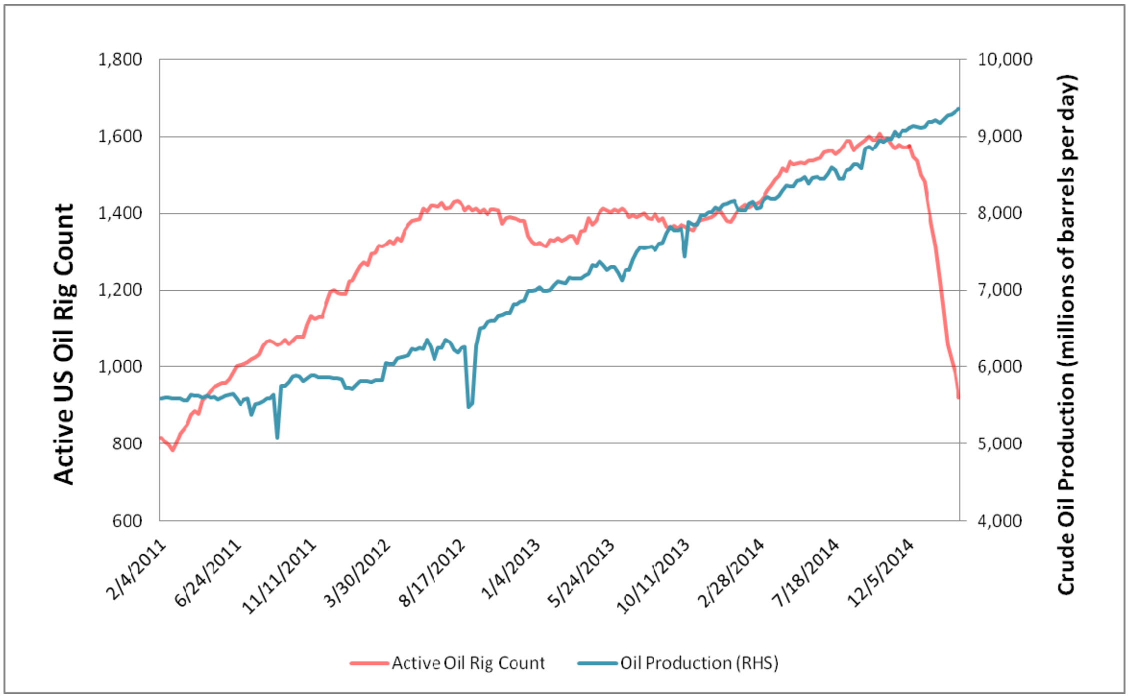
The oil market experiences frequent periods of imbalance as demand tends to be more volatile than supply, which is compounded by oil's inelastic short-term supply curve. Over the past 15 years, the oil market has entered into 14 distinct periods of oversupply. On average, these periods of excess supply have lasted 6 months, and the longest period spanned 13 months. As of February 2015, the current period of oversupply reached 13 months matching the duration of the 2008-2009 period.




Source: U.S. Energy Information Administration

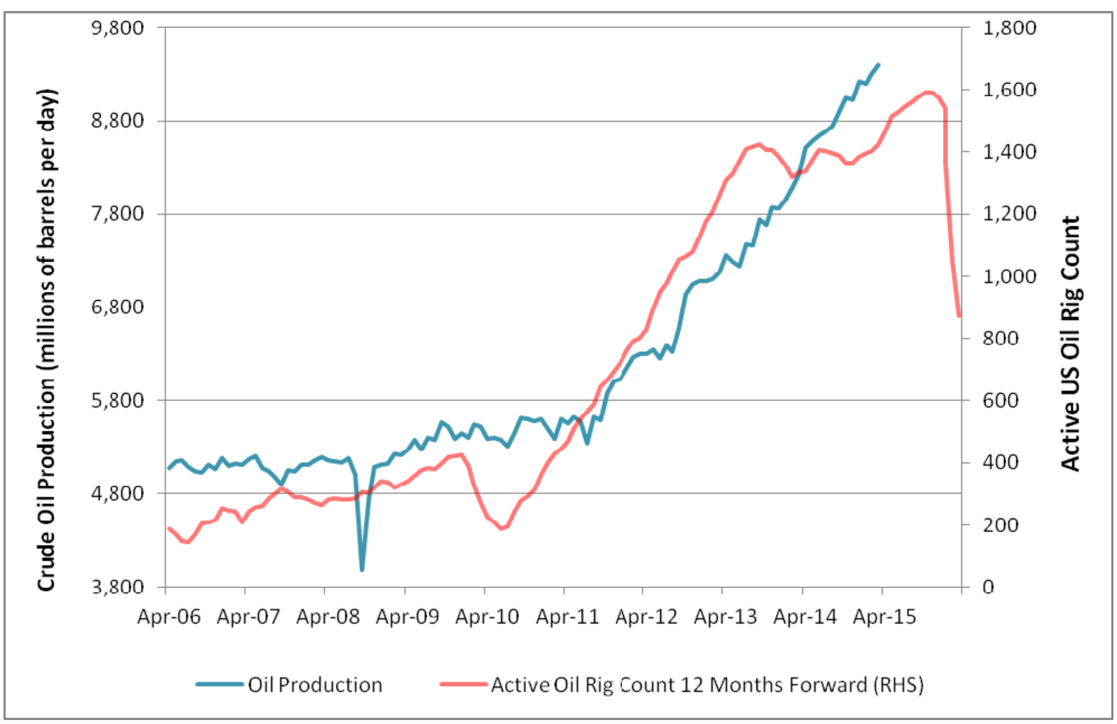
The oil industry is beginning to experience a supply-side response as producers begin the process of returning the oil market to balance. A leading indicator of US oil production is the number of oil rigs actively drilling wells in the United States. The recent decline in oil prices has caused a significant decrease in the number of rigs actively drilling for oil. Since the rig count peaked in October 2014, there has been a 50% decline in the number of active oil rigs currently drilling new wells. There have been sharp decreases in active rigs across all major basins including the Bakken, Eagle Ford, Permian, and Niobrara formations.

It should be noted that a producer must drill new wells each year to replace declining production from existing wells due to the inherent rates of decline in production of existing wells. The global decline rate is estimated to be between 2.5% and 6% of global production depending on the source of the estimate. These rates of decline are especially high for unconventional wells, such as fractured shale wells, which can experience decline rates as high as 70% in their first year of production. As the proportion of shale wells increases in the overall production mix, the rate at which new wells must be drilled to keep production stable increases.




Source: U.S. Energy Information Administration & Baker Hughes

Oil production from the reduction in rigs is slow to respond initially because as producers begin to curtail drilling activity they generally start by taking the older less efficient rigs offline first. This leaves the more productive rigs that can drill wells much faster continuing to operate. Over the long run, rig count appears to exhibit a correlation with domestic oil production. Since 2005, the active rig count exhibited a high positive correlation to US oil production when production data are lagged 12 months relative to the rig count.




Source: U.S. Energy Information Administration & Baker Hughes

This finding is consistent with industry comments relating to the domestic oil production outlook. Recent comments from Scott Sheffield, CEO of Pioneer Natural Resources (PXD), deliver the point well:

"I had been surprised and pleased with the amount of cuts that the industry is delivering, even though I've been bearish short-term, I'm bullish going into 2016 and 2017, simply because U.S. production, if it stays at $60 or less, most companies are going to have declining production going into 2016. U.S. production is going to peak in third quarter. It may be flat, it may roll over a little bit, but there is only 2 million barrels a day of [Saudi Arabia] excess capacity, it's going to be used up in the next 18 months. In the world, I think demand is going to get better around the world for the product, and essentially in 18 months we could be faced, [with] the fact that we have no excess supply in the world. So, I think we'll get restored somewhere back to at least $70 a barrel sometime in 2016. It could be higher short-term with a spike, but $70 a barrel is where we – is the mid-point of where we see the next five years, between $60 and $80."

We believe our three oil & gas exploration (E&P) holdings (Pioneer Natural Resources (PXD), Laredo Petroleum (LPI), and WPX Energy (WPX)) are well positioned to weather the downturn in energy prices. In 2015, the companies are reducing capital expenditures by an average of 54%, which demonstrates the advantage of developing a short cycle asset, such as shale wells. PXD and LPI are expected to grow production in 2015 relative to 2014 but daily production levels should be essentially flat compared to Q4 2014 production rates due to the significant reduction in drilling activity.

In this environment, we have focused our energy investments in companies that have a low cost advantage driven by their unique drilling prospects relative to their domestic and international peers. We believe these companies have the balance sheet capacity to weather the downturn while also benefiting from their robust hedging programs. These programs should allow them to maintain flexibility in 2015 as most of their expected production was sold forward in the first half of 2014 locking in prices at attractive levels. With development and operating expenses expected to fall 20% in 2015 due to excess capacity within the oil services industry, we view the potential reward favorably vs. the risk among our E&P investments. It is difficult to predict when the price of oil will return to balance given complexity of the market, but we believe our portfolio companies are well positioned to capitalize on a potential recovery in the price of oil.

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