ENERGY UPDATE

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STAR CAPITAL

ENERGY UPDATE

EXECUTIVE SUMMARY

TWO BLACK SWAN EVENTS HIT AT THE SAME TIME

U.S. SHALE PRODUCTION TO CORRECT SIGNIFICANTLY

WE EXPECT DEMAND TO RECOVER OVER TIME

A Black Swan is an extremely rare, surprise event. The impact of a black swan is severe and far reaching, with the consequences going far beyond what would normally be expected. Black Swan events are often characterized as obvious in hindsight.

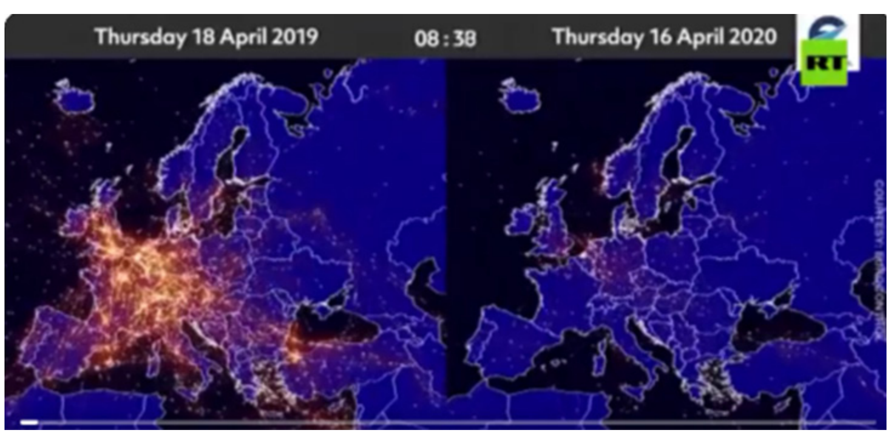
Two black swan events hit in one month: Coronavirus and temporary dissolution of OPEC+ supply constraints.

Ironically, OPEC was founded with the mission of price stability during demand fluctuations to avoid underinvestment in down cycles and over investment in strong pricing cycles which would perpetuate never ending “boom and bust” cycles. The cartel failed in this mission.

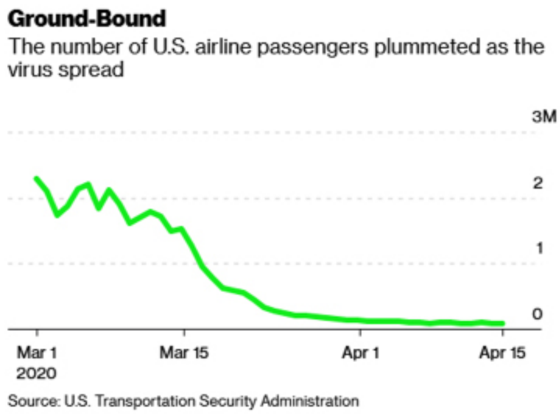
A cycle of long-term underinvestment was already in play and is now sealed. If demand recovers, we believe the latest series of events will increase likelihood of materially higher oil prices. Most likely natural gas prices as well.

This graphic posted by *RT@RT_com* comparing European air traffic before and after Coronavirus lockdowns sums up how dark global transportation markets have gone.

EUROPEAN AIR TRAFFIC BEFORE & AFTER CORONAVIRUS LOCKDOWNS

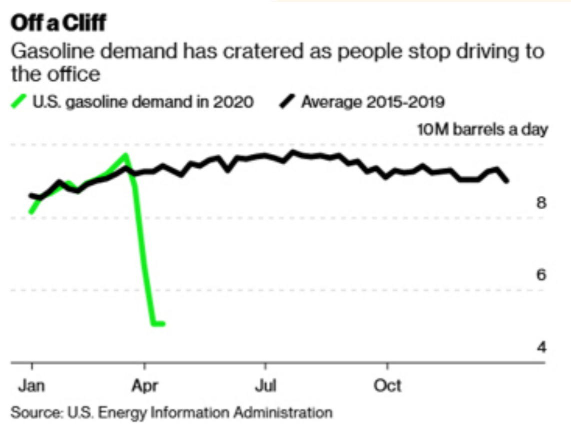


U.S. airline passengers have plummeted thus sending jet fuel demand down 70%



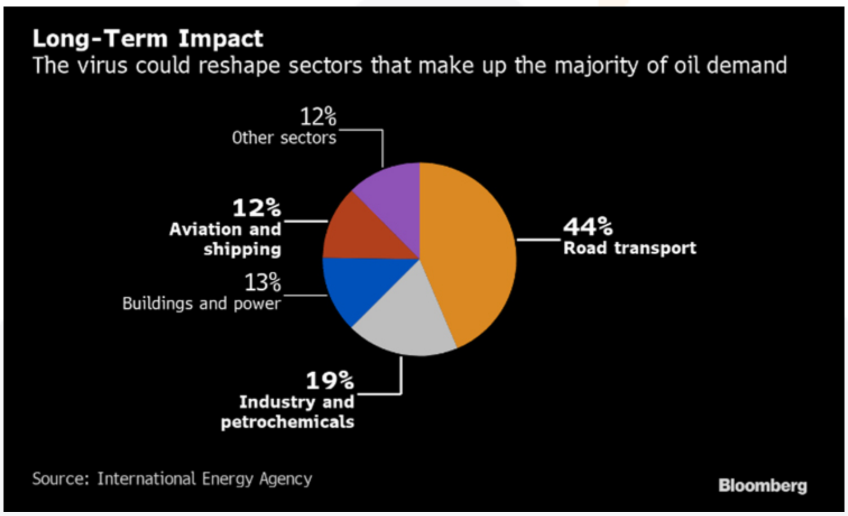
Source: "The future of oil demand is being reshaped by virus lockdowns", Bloomberg News April 23, 2020

U.S. automobile traffic has fallen off a cliff.



Source: "The future of oil demand is being reshaped by virus lockdowns", Bloomberg News April 23, 2020

These dynamics are important to crude markets as transportation markets are the most important end users of oil.



Source: Bloomberg

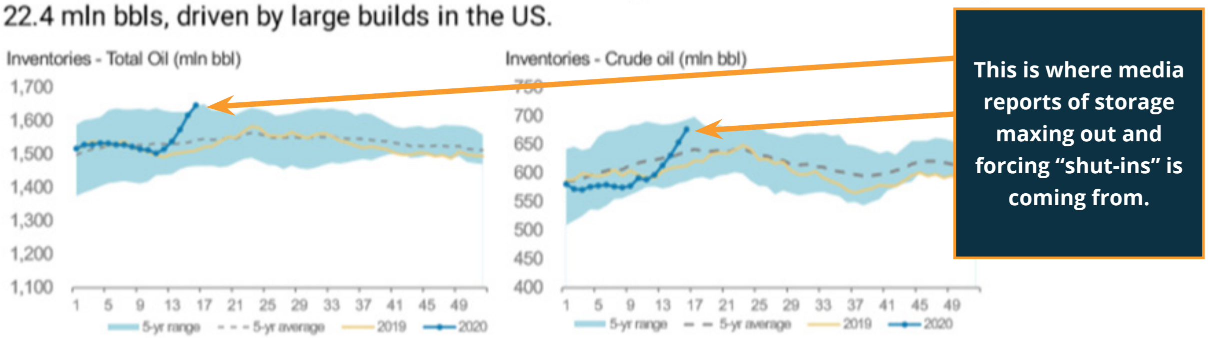
This demand hit has been unprecedented in history. It is estimated that Coronavirus has impacted global crude consumption by about 30% or 30 million barrels per day (bpd). The best way to put the magnitude of this collapse into perspective is to compare it to the demand collapse during the financial crisis, one of the worst recessions since the Great Depression. The reduction in demand during the financial crisis cost oil demand 3-5 million bpd.

In early March, as Coronavirus was spreading Internationally, OPEC+ could not come to an agreement on how to offset falling demand. In response, Saudi Arabia took a scorched earth approach and flooded European markets with oil.

This move meant to bring the holdout, Russia, back to the table. In reaction to the next leg of free-fall in oil prices, OPEC+ (at the urging of President Trump) met again in early April and agreed to cut production.

The damage was done. Inventories are still rising and storage will soon be maxed out.

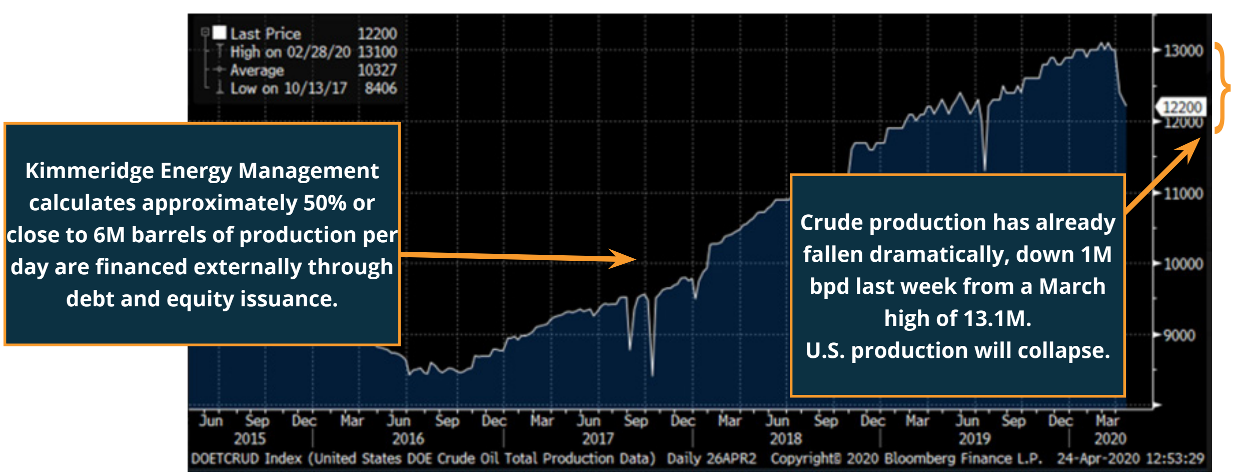
Exhibit 1: Total oil stocks (crude + products) built by 30.1 mln bbls. Crude built by 22.4 mln bbls, driven by large builds in the US.



Source: EIA, PJK International, IE Singapore, PAJ, Genscape, FEDCom/Platts

These set of events are the "death nail" to U.S. shale production. As we stated in our February 2020 Energy Research report, U.S. shale was not cashflow positive when prices oscillated between $50-$60/ barrel for WTI in 2019. As pipelines and tanks fill, it will be the U.S. producers who bear the consequences.

U.S. OIL PRODUCTION SINCE 2015



Source: Bloomberg

Small oil wells – less than 100 bpd– accounted for 2.9M bpd production in the U.S. These “stripper” wells are high cost, low output due to lack of pressure and contaminated water. We expect most of this production to shut down quickly and likely not re-open until prices are materially higher. Removal of these wells takes U.S. production close to 10M bpd before bankruptcies, cap-ex reduction, and underinvestment in conventional oil development plays are factored into the supply market.

Furthermore, Kimmeridge Energy Management estimates half of domestic production is sustained by external financing - bond and equity issuance. Roughly 6 million barrels of oil production are vulnerable to the whims of the capital markets.

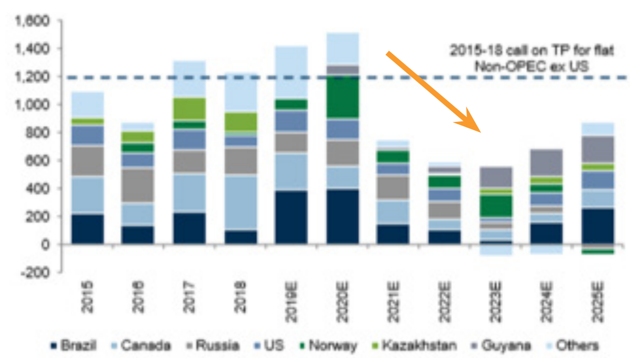
As hedges come off their books through the remainder of the year, bankruptcies are going to skyrocket.

Federal assistance will only prolong the process as these companies were extremely debt heavy going into the cycle with “all-in” costs much higher. Significant debt maturities are due in the coming years and it is hard to see any other scenario than massive bankruptcies.

Major producers like Exxon Mobile, BP, Royal Dutch, etc have cut capital expenditures by over $100B in recent weeks. This is at a point in time when years of underinvestment in conventional oil development is going to hit the supply-side.

Exhibit 2: From 2021, we expect long-cycle project additions to be insufficient to fill in decline rates, leading to c.0.5 mn b/sd net declines in non-OPEC ex-shale

Top Project (ex-shale) YOY oil growth kb/d



Source: Goldman Sachs Global Investment Research

Declining production trends were expected to emerge in the next few years before the Coronavirus implications were factored.

These dynamics portend a risk of structural supply deficits depending on where “normalized” demand levels emerge.

As with any commodity market, oil markets will adjust supply and demand over time. The world oil markets don’t work with anything under $40/barrel in our opinion. Expect a sharp supply correction. Russia requires over $40/barrel Brent to break even when considering fiscal expenses. Saudi Arabia needs $80/barrel or more.

The big question in our mind is, when does demand return to normal or near normal levels? This is a hard question to answer. The E.I.A. is currently estimating 2020 demand to fall 9.3 mb/d year on year. It is anyone’s guess at this stage.

One interesting phenomenon emerging in China is illustrated below. Commuters are switching from mass transportation to individual transportation to allow for social distancing. One question revolves around airlines that consume about 12% of Chinese crude oil demand. Airline traffic will most likely take years to recover.

Source: "The future of oil demand is being reshaped by virus lock-downs", Bloomberg News April 23, 2020

The years of underinvestment in traditional, low decline rate oil fields is now set to coincide with the collapse of high-cost shale production. Meanwhile, we believe demand will recover over time.

It is hard to see normalizing markets today but history tells us they will. During the Asian crisis in early 1999, oil prices fell to $10/barrel. After OPEC agreed to a third round of cuts, oil prices later that year rebounded to $25/barrel. Then in 2008 (8 years later), oil prices witnessed a super spike to $140/barrel on only a 1 -1.5M bpd shortfall of production relative to demand.

In summary, we remain optimistic on the longer-term outlook for select securities in the energy sector.

Please contact you advisor or Star Capital Inc. directly for a more comprehensive research report from February 2020 on the energy market or interest in Star's concentrated energy portfolio strategy. Contact us today for more information on our specific equity picks in the energy sector.

THANK YOU

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