OPEN SQUARE CAPITAL

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Dear Limited Partners,

We recently came across a funny Spotify ad campaign that suggested a play list if you're planning to move to Canada because of the upcoming elections. This is likely a trending option as voters now believe the best qualities of either Trump or Hillary is that they aren't Hillary or Trump.

What piqued our curiosity though was the song in the commercial. As the lady hauls her home away on a flatbed she starts rapping. Turns out the song "My House" is by Tramar Lacel Dillard, an American hip hop artist, better known as "Flo Rida".

We're delighted to discover two things about Flo Rida, or Mr. Rida. First, he's actually from Florida, hence his clever *nom de guerre* Flo Rida. Second, "My House" is actually a great commentary on the current state of the financial markets. The first fact is pretty self explanatory, but let's unpack the second one a bit. Flo Rida's song is ostensibly about inviting friends over for a party . . . .

"Hear the knock on the door
and the night begins . . .
Welcome to my house
Baby take control now
We can't even slow down
We don't have to go out"

Really though we think he's making a commentary about what professional investors are doing today. Let's take stock. The market is well off the lows it experienced in February, and now the S&P 500 index is up 3.84% as of June 30th. The past few weeks have seen even more gains since the debacle known as Brexit. The initial steep sell-off has been flipped 180 degrees. The U.S. stock market turned initial misery into euphoria and decided that: a) the world wasn't going to end because the economy may just be okay and b) maybe the central banks of the world will continue printing money, in which case we should probably just buy. Yet what started as one of the most hated or feared rally in awhile has morphed into real actual momentum. The "pros" are skittish, but they're buying.

Josh Brown from Rithholtz Wealth Management recently stated

> "[t]his is that moment where the underinvested professional begins to worry about career risk . . . . Everyone is (or feels) underinvested if a melt-up begins to take hold, which fuels the fire. $67 billion has come out of stock mutual funds and ETFs, on a net basis, since January 1st. This is not a "cash on the sidelines" argument, it's a . . . "we're gonna get fired" argument. If you work on The Street (or in Boston), you know how palpable this anxiety is and what types of behavior it will drive people to rationalize."

Interestingly the worst fear for investment managers isn't that they underperform when the markets are terrible. Quite the opposite, it's the fear of underperforming when markets are rising. It's similar to the idea that it's not how your investments performed that matter, but how your neighbor's did relative to yours. If you significantly underperform as compared to your benchmark (typically the S&P 500) and your investor base is fluid and prone to withdraw capital, you'll begin to lose clients, assets and eventually your livelihood.

It's not just reputational risk, but eventual career risk. So if this rally continues, investment managers who previously were heavy in cash, wary of investing in a "high" market will begin playing Flo Rida's "My House" song. They start looking to invite FOMO and TINA to their house.

FOMO and TINA in The House

Who're FOMO and TINA you ask? Well FOMO is the "fear of missing out" and TINA is "there is no alternative". They're the beautiful multicultural fun friends in beer commercials. The ones that can take a party to new heights on a rooftop deck and elevate your mundane parties and portfolio performance into something truly epic! Unfortunately, they're the same ones you regret inviting the next day, when too much fun leads to a failure to <u>make good choices</u>.

These friends are often the by-products of human emotions, Ubered to your house by fear and greed. Fear that your portfolio is underwhelming, and greed over missing out. Both emotions affect even the most professional of investment managers. If this sounds too implausible to be true, here are recent quotes from said professionals . . .

> "<u>There is truly no alternative</u> and if fund managers want to keep clients, they have to participate in this market, they simply can't afford not to . . . [y]ou can hate fundamentals all you want, but when price action is bullish, you need to stay invested." – Lance Roberts, Chief Investment Strategist at Clarity Financial

> "We continue to invest, somewhat cautiously and only in defensive stocks. We have to play this game <u>even if we don't feel very good about the market</u>." – Channing Smith at Capital Advisors

So it's not that the underlying asset is mispriced and that there's value to be had. Some investment managers are buying simply because FOMO and TINA have just showed up. So if this market were to grind even higher because of the Fed induced rally or negative interest rates get more negative, FOMO and TINA could potentially propel it much higher. That would require us to exercise extreme caution because investing based on FOMO and TINA is investing with the least conviction; it's investing scared and that fear swings both ways. The fear of losses can easily trump the fear of missing out (i.e., when selling begins it can quickly accelerate). So be wary of how assets are priced these days, be wary of why prices are going up, because if FOMO and TINA just showed up, we may want to lock the door.

Our Quarter

We ended this quarter outperforming the S&P 500 by 0.02% year-to-date. Admittedly this was a very frustrating quarter as our oil stocks were outperforming quite nicely. Our portfolio notched an all time high by the first week of June, and then promptly reversed itself in the last few weeks, turning what was a cheerful quarter into one that we can only shrug at.

Date	Open Square Fund I Performance YTD*	S&P 500 Performance YTD*	Outperformance / (Underperformance)
January 1 – June 30	3.86%	3.84%	0.02%

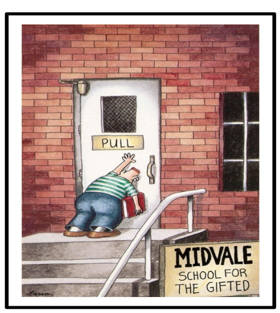
* Prior to fees. S&P 500 is using ETF: SPY, per Yahoo Finance

Last quarter we said we'd provide an update on our oil thesis, so let's do that first and then cap it off with a description of our oil investments.

Holding Firm

When the market slid in February, our energy trades fell as well. The portfolio then recovered in April and May as our energy positions propelled it to outperformance. Then last week the U.K. decided to break-up with the EU, and another worldwide downdraft swept us along, and then it recovered. So the roller coaster continues.

While the down days are difficult to stomach, how we react to them will be the most determinative for our portfolio performance. It's a never-ending battle, but since human emotion can be one of the greatest detractors to portfolio outperformance, we keep striving to mitigate the effects of our fallible psyche (e.g., documenting our thinking in calmer times and refraining from making investment decisions in emotionally charged times). We also strive to maintain a healthy dose of humility because some days it can feel a lot like this . . .



Our Oil Thesis Updated

For the past few months we've been trying to hold onto this thought.

> Give to us clear vision that we may know where to stand and what to stand for because unless we stand for something, we shall fall for anything. – Peter Marshall (1902–67) Senate Chaplain

It's a helpful quote since we're in the midst of election season, but it's also a touchstone when markets are volatile. When we started our investing adventure less than a year ago, we analyzed the energy sector and concluded that $50 for a barrel of oil was an unsustainable price. It's unsustainable because at that price oil companies don't earn enough to either pump oil or find oil. As the world uses up its reserves, the dearth of capital and long-term investments will come back to haunt us. We believed that last year and continue to think the evidence supports our view today. We've been trying to keep this in mind as the markets have swung wildly.

So what's happened since January for oil? Well a few things:

1. Oil Price Collapses (February) – oil falls from $50/barrel to $26 by mid-February, leading pundits to predict the inevitable fall to $10 and the imminent bankruptcy of governments and oil companies. Although some oil companies have gone bankrupt, many have continued to refinance their debt and sell stock.

2. Doha (April) – OPEC and non-OPEC producers convened an emergency meeting in Doha, Qatar to agree to cap oil production. Russia agrees to join, however, Saudi Arabia (the largest OPEC producer) scuttles the deal when it demands that Iran join the agreement. Iran, having recently emerged from international sanctions, refuses as it aims to increase production to pre-sanction levels. The "Doha" accord fails.

3. Demand – Even with all the turmoil in the markets, demand for oil continues to grow in 2016. Low prices spur demand, which steadily eroded the excess oil supply. Supply/demand begins to rebalance.

4. Saudi Arabia Vision 2030 (April) – Saudi Arabia announces a sweeping plan to lessen their dependence on oil revenues. More on this later.

5. Oil Rebounds (May) – oil rebounds to $50 by May, still more oil companies declare bankruptcies and continue to do so, and many governments are still shaky.

6. OPEC Meeting (June) – in a scheduled June OPEC meeting, the organization decided to continue with the status quo since oil has risen from $26/barrel to $50. OPEC agreed to not cap or curtail production, letting supply/demand rebalance organically.

7. Brexit (June) – will the uncertainty caused by Brexit reduce oil demand? In the U.K. most likely as its economy slows, however, this is a negligible amount as the U.K. consumes only 2% of the

worldwide oil demand per day. A slowdown in the EU would have a larger impact as the EU consumes 10% of the world's oil per day.

So things are different now, and yet the same. With oil having bounced off the lows at the beginning of the year (i.e., from $50 to $26 to today's $50), commentators and analysts have shifted their tone. Many again expect a pullback from the >90% gain off the lows, and maybe that will happen, who knows. What we do know is that things are becoming very interesting. We believe oil prices will continue rising in the short-term because of exogenous factors and the industry's self-inflicted wounds. In the long-term . . . Houston we have a problem.

Force Majeure Du jour

For those who read and write contracts, you'll no doubt be familiar with the *force majeure* clause. This French phrase means "superior force". It's a clause in contracts that frees you from liability and the duty to undertake an action in situations beyond your control (e.g., war, terrorism, riots, and "Acts of God" such as hurricanes, floods, earthquakes, etc.).

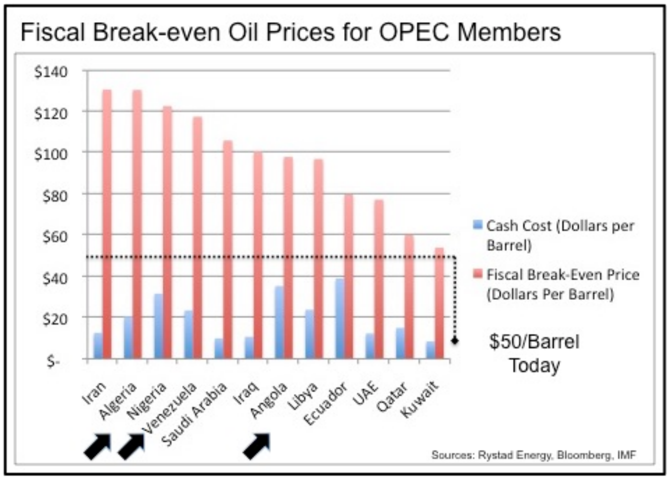
We've been calling our energy trades the *force majeur du jour* trade because lately a smorgasbord of *force majeure* events worldwide have reduced oil supplies. While some of the outages are caused by natural disasters, most are man made and symptoms of low oil prices.

As demand has soaked up excess oil, the supply/demand situation has recently been impacted by temporary outages caused by such events. A forest fire in Alberta, Canada temporarily removed 1M barrels of oil from the market, violence by militant groups in Nigeria and ISIS attacks in Libya have also impacted supplies from those countries (approx., 1M each). With oil prices so low, there was little "risk premium" priced into the commodity, and as outages reduce supply, the market began repricing this added risk.

The Resource Curse

You often get to witness the best and worst of mankind when you embark on the energy trade. When a country discovers oil, it can become the key to build true wealth or the chains to a cycle of poverty, violence and corruption. Much depends on how mature a country's political system is when the discovery occurs. Too often, it's the weak countries that make the find, which leads to corrupt officials pilfering the coin. Even when the treasury isn't stolen, it's squandered. This is why finding oil has been called the resource course because it can throw a developing country off track, and we can see it play out in Africa, the Middle East and Latin America.

For some context, take a look at the chart below. Oil is priced at $50 per barrel today, but Libya, Nigeria and Venezuela need > $100 per barrel to balance their government budgets.



Fiscal "break-even" is a crude measure as it's affected by many factors and can be decreased (e.g., austerity measures will reduce expenses), but like a family budget, if you're receiving $50 in income, but spending $120 to buy your kids' affection, this imbalance will eventually end.

Spending less isn't an option when politicians trade social programs for votes and social stability. Any violation of this social compact can quickly inflame the populace and lead to regime change. Sadly it's not surprising that the countries with some of the highest fiscal break-even points are experiencing social unrest. At least in the case of Nigeria and Venezuela, this is a direct symptom of low oil prices.

These are just some of the pictures of what Venezuela is like today.

Poverty in Venezuela is rampant because over 55% of the population is under the poverty line. For most voters, exchanging votes for government handouts seemed a practical bargain until collapsing oil prices curtailed the funding of these social programs. Falling oil prices have forced Venezuela to borrow staggering amounts of debt and burn through their foreign currency reserves (i.e., a country's savings account). A drought has added to the misery and reduced hydroelectricity production. In a bid to save electricity, the Venezuelan government has instituted a 2 day work week. Extended 5 day vacations sound lovely, but when 1/3 of the country's population works for the government and government offices, schools, etc. are closed for 60% of the workweek, productivity stops.

The Venezuelan bolívar has become worthless as inflation ran 275% last year and 750% this year (imagine the cost of a Big Mac rising from $3 to $62). This severe devaluation and cash shortfall has forced Venezuela to slash imports, creating food and medicine shortages. People now line up for hours to buy basic goods only to see empty store shelves when they enter. The resulting death, hunger, and abject poverty has led to riots and calls for President Nicolás Maduro's ouster.

Venezuela's oil production has fallen from 3.2M barrels per day to 2.6M barrels a day. This is largely conjecture though since recent estimates forecast a more severe decline because many US oil service providers (i.e., Schlumberger and Haliburton) have stopped providing services in Venezuela for nonpayment. Without such expertise, oil production will almost certainly decline even further. We anticipate this decline to last for quite awhile given the problems in Venezuela. Unfortunately, we think it'll get worse for Venezuela before it gets better.

Besides this is just Venezuela, Nigeria, Libya, Iraq and other less stable countries have also experienced unrest and decreasing oil production. The longer oil prices stay lower, the greater the unrest. Just remember that these are all OPEC oil producing countries, and OPEC produces 1/3 of the world's oil supply. If supply/demand is balanced, any outages means oil will need to be pulled from existing inventories. Inventory is now at an all time high so there's a giant buffer against oil price spikes, but oil demand and decline rates never sleep, and eventually this safety net will become increasingly threadbare.

Short-Term

By 2017 both the U.S. Energy Information Administration and the International Energy Agency forecast demand exceeding supply. Demand from the US, China and India has been increasing because of oil's low price and continued growth in the economy. In the short-term we think oil prices will continue higher because although most producers have survived the downturn, they've done so in a way that impacts their ability to ramp up quickly.

Many Wall Street analysts think that these companies can hire oil workers back and begin pumping again, we think different. Why? Three reasons:

1. Capital – with so many bankruptcies, devalued equities (stock and bond prices) many investors and banks are hesitant to invest or lend to oil and gas companies. As we've previously noted, capital always moves faster than fundamentals, and once burned, investors can be slow to return. It takes money to drill for oil, and if you need to show results before obtaining capital, the lag between showing positive results and receiving more capital to grow will slow supply and exacerbate the price swing.

2. Skilled Labor – the recent oil and gas declines have led to massive layoffs with over 100,000 jobs lost. Many of these skilled oil and gas workers have gone onto other occupations. If another boom occurs, it will take time to restaff oilrigs and service companies. We all know how hard it is to find good help, and 100,000 helping hands in the oil industry is very specific.

3. Balance Sheets – most oil and gas companies are heavily indebted these days. As oil prices rise, most will direct any extra cash to reducing debt and deleveraging before spending it on growing production. After spending a year in survival mode, companies now have a heightened awareness of how precarious heavy debt loads can be.

   Longer-term

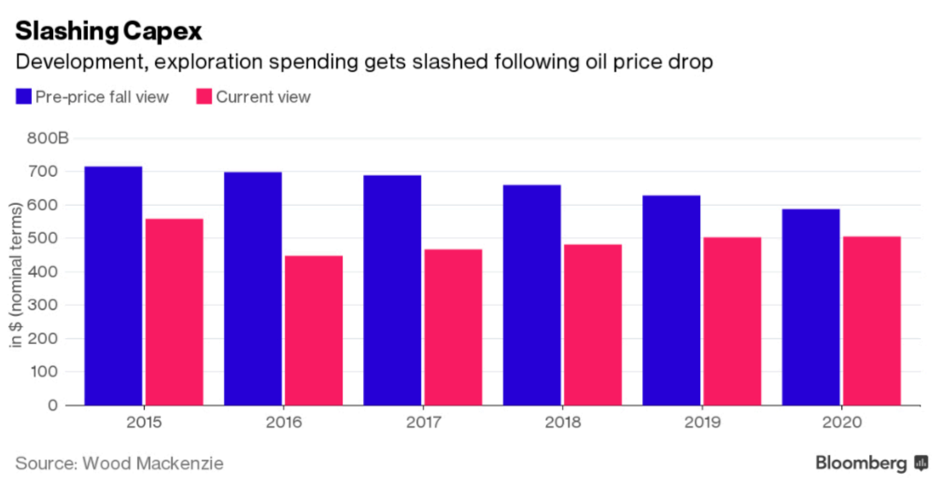
Looking out a bit longer, there's definitely an issue. In our Q4 2015 letter, we discussed the importance of capital expenditures (i.e., expenses incurred for long-term assets). In the oil and gas world, this means exploration and drilling. It means finding new reserves of oil to replace the oil you've drilled and pumped. We've known this has been declining, and in our Q4 letter we included this quote:

> "A big gap is forming in oil-industry investments. That will lead in two to three years an imbalance between supply and demand that will push prices higher." – Claudio Descalzi, Chief Executive Officer of Italian energy company Eni SpA

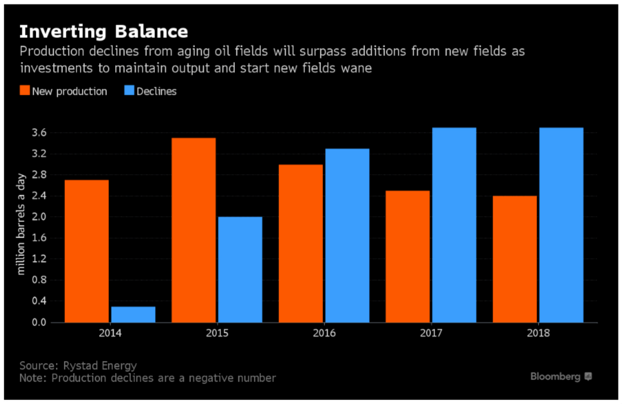
Although oil is now at $50 per barrel, at this price only a small portion of oil producers break even. Recall that as you pump you always have to keep finding or buying new oil reserves to replace what you've extracted. Yet these long-term expenditures are the first ones cut when you're trying to survive in the short-term. Eventually this "rob Peter to pay Paul" strategy will lead to a reckoning.

> "There is still an ominous investment gap building up in the oil industry that might, depending on how quickly today's record high oil stocks are eroded, create the conditions for sharply higher prices over the medium term." – IEA Oil Market Report July 13, 2016

Wood Mackenzie has projected that over $1 trillion of capital expenditures have been cut from the 5 year plans made in 2014 when oil was at $100 a barrel.

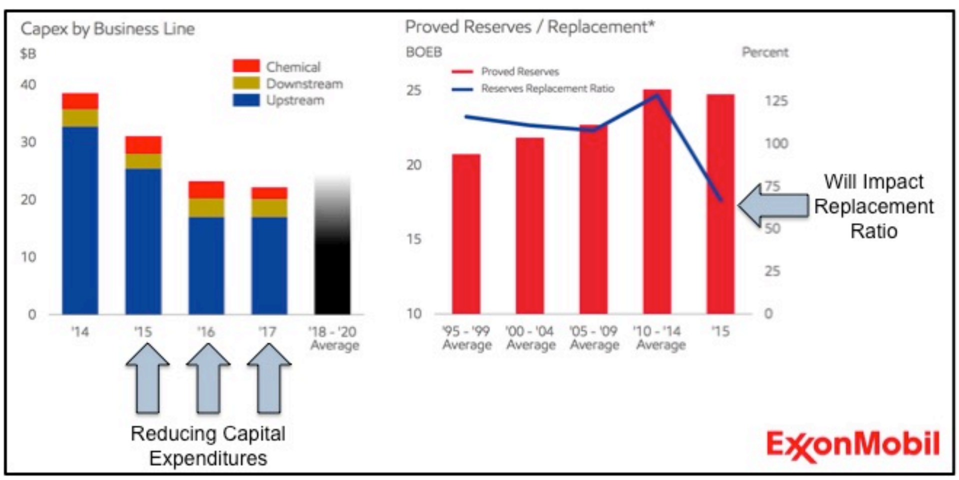


Most projects have been shelved or placed on hold at today's prices, and cutting capital expenditures will almost surely do two things: 1) accelerate the decline rate (the production on older wells decline faster as they age, more so when you skimp on maintenance) and 2) lead to an oil shortage as you fail to replenish the oil you pump with new oil. So what happens? Well this.



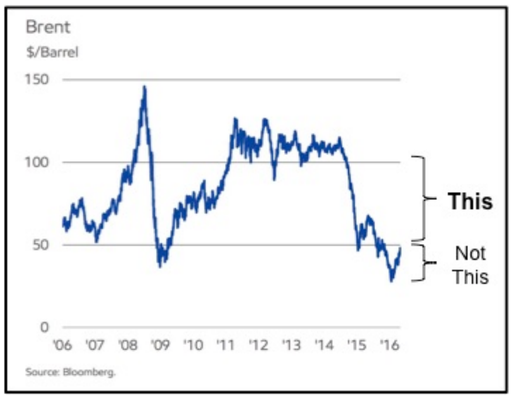
The red bars represent new oil production whereas the blue bars represent the oil declines from older oil fields. When blue overtakes red, declines are happening faster than our ability to pump new oil, and since you've just cut $1T, you better believe that blue will continue to rise.

Even on a company level this is happening. Take a look at ExxonMobil's latest presentation, which shows that they've only replaced 67% of the oil that they've pumped in 2015 (i.e., its replacement ratio).



While this may be temporary and not foreshadow a melting ice cube, what's certain is that reducing capital expenditures will almost surely impact every company's replacement ratio in the long-run. It's important to note that reserves are what you can economically produce so a lower oil price really reduces the amount of reserves you have (i.e., some of the oil you own can't be pumped profitably at these prices, so your “inventory” falls and your replacement ratio starts trending down). Having said that it’s also true that oil isn’t easy to find these days, and 3 years of reduced capital expenditures doesn’t mean we can spend 3x more in 2019 or 2020 and quickly find what we’ll need.

People forget that there was a reason why just a few years ago we were drilling heavily in the Artic, North Sea and other exotic locales when oil was $100 a barrel. Even with the boom in shale technology and the abundant US shale oil and gas, the worldwide demand for oil continues to creep up and decline rates keep accelerating. Eventually, once the stored inventory of oil is reduced (i.e., our current buffer), we may end up experiencing a shortage. So while the pundits focus on the bounce from the low, we’re focused on something else . . .



The Saudi Put and Vision 2030

One last item on oil. Did you hear that Saudi Arabia (“SA”) has decided to get out of the oil business? SA produces over 10M barrels a day, or 10% of the 95M barrels a day the world needs. Like Flo Rida and a new album, Deputy Crown Prince Mohammed bin Salman’s (“MbS”) dropped his new Vision 2030 for mass consumption in April and it was as Trump says . . . “Yuge”.

Vision 2030 is a strategy shift, and represents an attempt by the government to tackle its dependence on oil revenues and tack away from a future where its main product is no longer desired. With King Abdullah’s death early last year, and the ascension of Prince MbS’s father King Salman, Prince MbS now appears to have *carte blanche* to begin implementing his reforms. Consequently, we think that SA’s Vision 2030 plans can help serve as a guide to interpret SA’s oil strategy going forward.

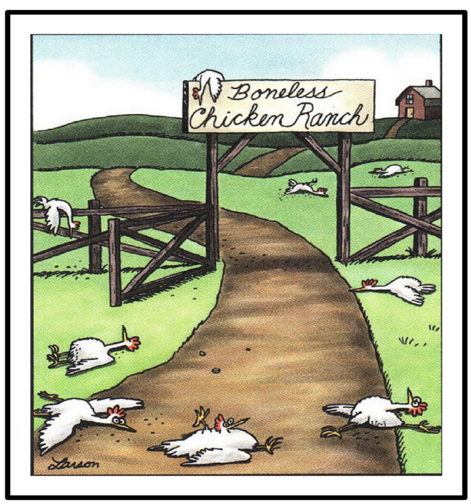
A cornerstone of SA’s Vision 2030 program is the listing of 5% of SA’s oil company Aramco on multiple stock exchanges in 2017. A listing is an initial public offering (“IPO”), and an IPO of Aramco for all its hoopla is essentially a sale, a sale of a piece of the business to public investors. Prince MbS plans to use the proceeds to grow SA’s sovereign wealth fund, and invest in other non-oil local industries so that when SA eventually runs out of oil or the world moves onto cleaner energy, the country can survive.

So in addition to the supply/demand issues we highlighted above, our oil thesis is piggy-backing off of SA's ambitions. Just as homeowners stage and paint their houses to obtain a better price, we believe SA has been laying the groundwork to beautify the landscape. Overproduce oil so oil prices fall. Force weaker competitors into bankruptcy. When supply/demand rebalance and oil prices rise, sell your business for a premium. While painful in the short-term, SA's strategy is necessary if it wants to begin exiting the business. Selling shares of an oil conglomerate when oil is above $70 a barrel would certainly garner a higher valuation than oil at $40, and it would also give the sovereign wealth fund a more valuable asset to leverage to invest in the transformation of SA's economy. This, however, doesn't mean that SA will need to dramatically engineer an artificial price pop prior to the IPO event; we think SA is taking the long-view. Exiting the oil business can't happen overnight, as oil revenues need to be slowly replaced with non-oil revenues. SA needs higher oil prices over a longer period, so its oil strategy has to complement its reform plans.

As the rebalancing accelerates, oil prices will inevitably rise, and SA, the largest producer will no doubt be the cheerleader, if not orchestrator, of a higher oil price environment. It's self-interest, and if the biggest oil producer and de facto leader of the OPEC cartel needs higher oil prices to realize its dreams, we're happy to align our interests with theirs.

Oh by the way, Kuwait, another OPEC member, announced last week that it's also planning to sell a portion of its oil companies. Fun, more coattails to ride.

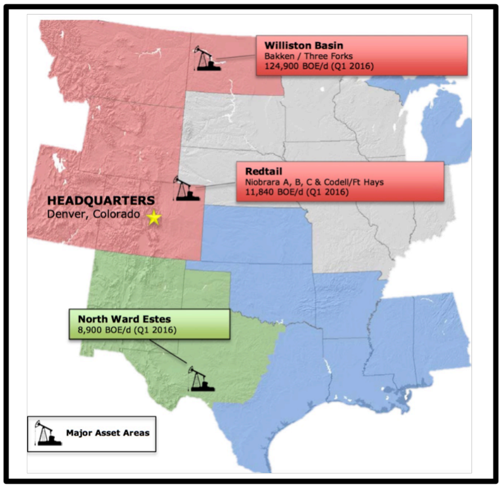
So that's our oil view and thesis updated. As much as we believe we're on the right path we're still well aware that it will be volatile. The biggest threat to our thesis has always been the overall economy, a slowdown could lead to a slowdown in oil demand. So it's always good to update and challenge our thesis, and make sure that we stand for something so we don't fall for anything, lest we wind up like these chickies.



Finally, let's turn to our oil investments and give you an idea of what we're invested in and why.

Whiting Petroleum (NYSE: WLL)

As Darren Gee, CEO of Exploration and Development Corp. describes it, there are four types of oil and gas companies. There's the "grow at any cost", "the pump and dumps", "the acquisition heavy", and "the return on capital focused". Oil executives will typically pick one or two of these business strategies and charge ahead. Whiting Petroleum ("Whiting") is definitely the acquisition heavy type. The Denver, Colorado based company is an independent oil and gas company engaged in the exploration, development and production of oil and gas fields in the Rocky Mountains (i.e., Colorado (Niobara) and North Dakota/Montana (Bakken)) and Texas (i.e., Permian).



The company has completed 21 acquisitions since 2003 and grew quickly, until 2014 when an ill-timed acquisition turned it into a heavily indebted company. In an effort to expand its reach in the Bakken, Whiting acquired Kodiak Oil & Gas Corp. In the go-go days when oil prices were higher this seemed sensible as growth was what Wall Street looked for. The acquisition would increase Whiting's oil and gas reserves by almost 40%, making the company a potential acquisition target for larger integrated oil companies. Unfortunately, the timing couldn't have been worse. When the deal was negotiated in mid-2014, oil prices were at $100/barrel, and when the transaction closed on December 8, oil had fallen to $63/barrel.

In hindsight the signs to cancel the deal were all there. To be fair many people expected a rebound back to $80/barrel so hindsight is 20/20. What's also clear though is the role of caution. Whether it's your daughter saying there's a monster in her room or you're the only one wearing a red shirt in a Star Trek episode, exercising caution amidst a steep oil decline seems sensible. Nevertheless, Whiting pressed ahead. The company paid for Kodiak by exchanging $1.8B worth of Whiting stock and assuming Kodiak's $2.5B in debt.

This effectively doubled Whiting's total long-term debt from $2.7B to $5.6B just when oil began its steep decent. Whiting's stock began to mirror the decent, and by February of 2016 Whiting had fallen to a low of $3.35 from a high of $88.

So what are we left with today? Well lots of oil, lots of debt and a very low share price. This is one of our largest positions because Whiting, Continental Resources, and Oasis Petroleum are in a class of oil drillers in the Bakken who need oil prices to exceed $60/barrel to breakeven and grow. The Bakken is a shale formation in North Dakota/Montana whose formations are oil and gas rich, so the potential is large. With their large debt loads though, $40-50/oil means these companies are essentially pumping to survive, and really it's just a slow march to bankruptcy or shareholder dilution. On the other hand we believe this represents an opportunity because our view is that oil prices will rise above $50/barrel, and if so, the marginal cost players like Whiting, will be worth more when this occurs.

We acquired our shares for $4.92. Our original thesis on Whiting was that we thought the stock could eventually recover to $30/share if oil rose above $70/barrel, and it was proving out. Whiting recently bounced from a low of $3.35 to $14 per share by early June, rising as the price of oil recovered. The stock is volatile because of the company's high debt levels and sensitivity to oil prices, but when oil prices rise this "torque" means Whiting's shares will increase dramatically. Torque (i.e., in the form of debt), however, can work both ways.

Much to our chagrin Whiting announced three weeks ago a plan to exchange 20% of its debt for equity. This along with an earlier share issuance will reduce Whiting's debt levels from $5.6B to a more manageable $4.1B, however, this recent share issuance was <u>extremely dilutive</u> as it increased share count by almost 80% and reduced our forecasted earnings per share by 40% (i.e., because the same amount of earnings are now divided by significantly more shares). The market agreed, as the stock fell from $12.50 (the day they announced the dilution) to $9.26 by June 30. The timing also couldn't have been worse as Brexit was announced the next day, and the share issuance and total amount of shares to be issued is dependent on a volume weighted average price of the stock over the next 25 days.

With little cash in the bank, a heavily indebted company like Whiting lives off of its corporate credit line (i.e., akin to a corporate credit card). The amount that banks are willing to lend them is "supposed to" be based off of their economic reserves (i.e., amount of oil and gas they have in the ground that they could pump profitably at today's prices) so oil prices and credit lines tends to rise and fall together. In reality, credit lines like credit cards are demand loans. Twice a year, the banks can "redetermine" the credit limit, and if they choose to rescind the credit line, you as a borrower are now on the clock to repay the loan.

Banks are really good about giving you an umbrella on sunny days, and then taking it away when it starts raining. Falling oil prices coupled with conservative bank lending have led to severe credit line cuts, which begets a cycle of reduced liquidity, further credit cuts, more reduced liquidity, etc., until finally an indebted company like Whiting is forced to deleverage.

While we believed that Whiting's debt level was unsustainable, indebted oil and gas companies have a few options. They can sell oil infrastructure assets to raise cash (i.e., gas processing plants, pipelines, land, drilling rights and noncore assets), reduce production and direct existing cash flows to paying down debt, refinance debts to extend maturities, issue convertible debt, issue preferred shares, and finally issue common stock. As shareholders our last preference is issuing common stock. The company chose the latter, and at a lower share price than we would've liked, but that's the reality of their situation.

At the same time though, the issuance will reduce the company's debt levels, which enhances its ability to survive in this challenged environment. We believe the company is still worth \$20/share in a \$70/barrel oil environment, however, we'll continue to watch it closely in the next few months. If we believe share issuances will continue, we could exit the position because if oil prices rise and shareholders in Whiting continue to experience dilution, our thesis will have proved correct, but we would have little to show for it. For now though, we are exercising patience.

Gear Energy (TSX: GXE)

If Whiting is the big brother in our portfolio, Gear Energy ("Gear") is the little one. Our position in Gear is small and more akin to a private equity investment because the stock is thinly traded on the Toronto Stock Exchange. Gear, headquartered in Calgary, Alberta, is a junior exploration and production company with a total enterprise value of about \$100M[1]. The company produces about 4,000 barrels of oil per day. With over \$50M in debt, the company was also heavily indebted. Banks had already reduced Gear's credit line from \$90M to \$60M, and was proposing to decrease it below \$50M, which meant any amount Gear had on balance over the credit limit became due. Much like Whiting, the company recently issued shares to bring debt levels down to \$35M (with the credit line set at \$50M), but this diluted shareholders by 33%. As a smaller company, Gear has less non-core assets to monetize, so a share issuance was really the only option.

An investment in Gear is essentially an investment in the leadership team of Don Gray (Chairman) and Ingram Gillmore (CEO). Both are focused on return of capital and prioritizing profitability over pure growth. Don Gray has a history of generating phenomenal shareholder returns as the former CEO of Peyto Exploration and Development Corp., and mentored by him is Ingram Gillmore, who has been running Gear using a similar game plan.

On two metrics that we pay particular attention to (capital efficiency and operational costs), Gear scores exceedingly well. The first tracks the amount of capital needed to maintain production constant and the latter tracks how efficiently operations are run. Gear has managed to reduce the capital costs to maintain flat production by over 60% from two years ago. The company has also managed to reduce operating

[1] Note that all amounts used when discussing Gear are in Canadian Dollars.

expenses and G&A by 30% and 38% respectively. A large part of this has been focusing only on its best locations, and some of these costs will increase once Gear expands beyond its core areas, but for now, living to fight another day is the focus.

In conjunction with the equity offering, the company announced a plan to merge with a similarly sized company, Striker Exploration Corporation. The merger is set to close later this month. We view the Striker acquisition as an asset acquisition as Gear paid only a slight 10% premium to the previously unaffected trading price, a 10% premium that it will recover when it eliminates Striker's G&A expenses post-close. The acquisition increases Gear's oil and gas reserves by 60% and production by 50%, and assuming some conservative oil/gas prices, will garner a recycle ratio (i.e., profit per barrel divided by the cost to find it, or in this case buy it) in excess of 2 to 1.

If oil prices were to simply hold at today's levels, we project Gear will generate an EBITDA of $50M by next year, enough to fund production growth and pay down the remaining debt. Trading at $0.61 on June 30th, we believe Gear is worth between $1.00 to $1.50 by early next year, and if oil prices were to go much higher, potentially +$2.00.

Parting Thoughts

After a tumultuous Q1 and an exhilarating Q2 that ended with a shrug, we're guessing the remainder of the year will be equally as interesting. We'll continue to stay rational and long-term focused and encourage you to do the same with your own portfolios. As always thank you for investing and please let us know if we can explain any of our ideas above in more detail.

Sincerely,

Nelson Wu

Nelson Wu
Managing Director

P.S. We know these letters are a bit long, and since we often write more on other topics than what's contained in these letters, we publish those writings on www.seekingalpha.com under the author name Open Square Capital. Feel free to search for us, and follow us if you'd like.