Pareto Alternative Investments AS

# Pareto World Wide Offshore AS

4th quarter report 2015

*Link: http://paretosec.com/pai-reports.php*

# Executive Summary

NAV PWWO NOK 45/share
NAV POK NOK 21/share
(as of 31 December 2015)

The offshore oil services markets are very distressed with no places to hide. Asset utilization and valuations are coming down fast and has a big impact on the risk profile and valuation of the Fund. The NAV is down sharply from June 2015 as a result of the BassDrill Alpha now being marked at zero value based on broker value indications and the trading of the company's bonds. PWWO has significant capital requirements this year, as it is uncertain how and if this can be financed. Worst case, this could lead to a forced sale of certain assets in the portfolio, with a corresponding negative impact on NAV.

## Market Development

The oil price reached new lows in January and remains exceedingly volatile. Inventories continue to build as global production levels appear immune to the falling price. Increasing worries about global economic growth and concerns about financial stability are adding to the woes.

With earnings and cash flows at depressed levels, most industry players are having a hard time servicing debt. We have already seen the first bankruptcies take place in oil services, as well as several debt restructurings. We expect this to represent the flavour of the year. It is a time to reset the pricing of both debt and equity to conform with the new reality.

## Portfolio

The portfolio has 26% contract coverage and is thus very exposed to the weak market conditions in the offshore oil services markets. Both of the two largest investments have their units in lay-up and have significant challenges relating to their funding. The Fund Manager is actively engaging in negotiations with the creditors in these two projects in order to achieve a solution that preserves the viability of the operations and minimizes the upfront capital needs.

The BassDrill Alpha has been marked down to zero value following market value indications from rig brokers and the current trading of the outstanding bonds in the company, which is currently at 20% of par value, implying a market valuation of the debt at USD 14m.

## The way forward

The term of PWWO was extended to July 2019 at the Annual General Meeting in June 2015. This was in recognition that it is exceedingly difficult to realize meaningful value in the current markets, particularly with the portfolio so skewed towards two large investments.

PWWO will refrain from investing further for the remainder of its lifetime, save for follow-up investments in existing projects, if required.

It is estimated that the portfolio has capital requirements of NOK 70-90m in the next 12-18 months. PWWO only has a cash position of around NOK 14m and no real prospects of material incoming cash flow this year. As a result, it will not be able to fund its share of the capital requirements. The Fund Manager is working towards reducing the requirements as much as possible, as well as exploring the possibility of getting new investors to the Fund. Failing this, PWWO should expect to be significantly diluted in several of the projects or alternatively will have to sell or liquidate certain parts of its portfolio. The impact on NAV is expected to be negative in any case.

# Portfolio News

PWWO is invested in a broad range of offshore projects, which implies a diversification across different asset types and market segments. This section provides an update on the quarter's most important news flow related to the underlying investments.

### BassDrill Alpha Ltd

The rig is semi-warm stacked in the Congo with no immediate prospects for employment. The company has a good cash position which, assuming no debt service, should be able to fund a lay-up until mid-2017.

### Neptune Subsea IS

The project is engaged in a constructive dialogue with the banks regarding an extension of the maturity of the current loans beyond Oct '16, as well as "pay-as-you-earn" structure. This will nevertheless require a major capital call during Q2'16. Both ships are in lay-up. Vessel values have come down, and so also the valuation of the project.

### Vestland Seismic IS

The vessel is still idle, although there have been some developments regarding a new charter. The project is 100% equity financed and the cash burn is insignificant. The value has been marked down further.

### Master & Commander IS

Charter hire is paid punctually, while the seismic market is weak. Both counterparts are in reasonably good shape. The vessel valuations have been lowered, which has a negative impact on the residual value expectations. The lenders are very reluctant in approving dividends (requires significant e.o. repayments on the debt) so the future dividend schedule is subject to uncertainty

### Asian Offshore III IS

The average day rate for the six vessels was USD 2,800/d during Q4'15, down 29% on the preceding quarter. The receivables collection issue is shared with its pool partners (including AO I), but an agreement has been struck with the banks for a full amortization holiday through to the maturity of the loan, which is October 2016, as well as waivers on some reserve account requirements. A re-financing solution will carry maximum priority this year.

### Iceman IS

The vessel had an excellent period in the spot market in December and January, where the average day rate in December was NOK 541k and the utilization 65% (January not confirmed). As a result, the project looks to possibly avoid having to raise additional capital from the shareholders during H1'16. The longer term outlook continues to be bleak, however.

### Bukit Timah Offshore DIS

Charter hire is paid punctually, but vessel values have come down sharply. As a result, the project has resolved to make an extraordinary debt repayment, using existing cash holdings, to avoid potential MVC covenant breaches. The value of the project has been marked down due to lower vessel values.

### 3B Offshore IS

Bareboat hire is paid punctually, the project is on track. The vessel valuations are lower and there is a potential MVC breach to be handled, which means that there will be no dividend distributions in the near term.

### Project sales

PWWO has not made any divestments during Q4'15.

### Payments to and from projects

During Q4'15 PWWO had to inject a total of NOK 15m of equity into two more projects (Asian Offshore III and Neptune Subsea) to support the projects due to the adverse market conditions.

# Portfolio

The characteristics of the portfolio has changed drastically in the past year due to the charterer bankruptcy in Neptune Subsea and the termination of BassDrill Alpha's contract. Contract coverage has dropped to 26% and the weighted average charter length is only 1 year. Hence, the portfolio risk has increased meaningfully and there will be less visibility on incoming cash flows than before.

### Investments and capital

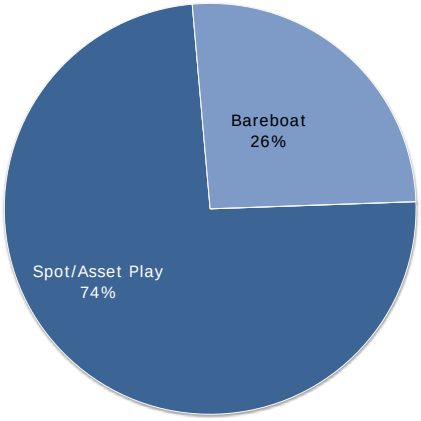
PWWO's portfolio consists of 8 projects which owns stakes in 19 units. The average contract length is 1.0 year and the contract coverage is 26%.

The gross nominal value of the contract backlog is roughly NOK 100m. The backlog is primarily made up by two solid counterparts.

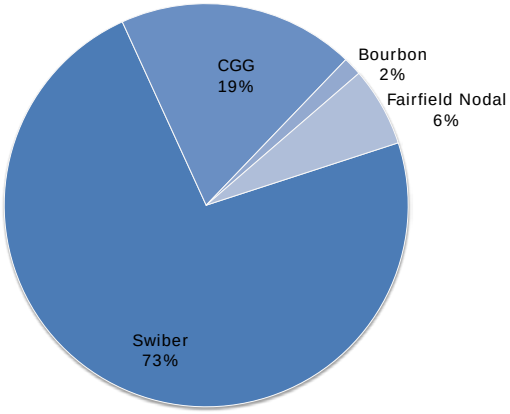
PWWO had a cash holding of NOK 14m as of 31 December 2015. There may be additional capital calls in in the coming quarters, so cash is being preserved to be in a position to follow up such calls.

The life cycle of PWWO has been extended through 30 June 2019.

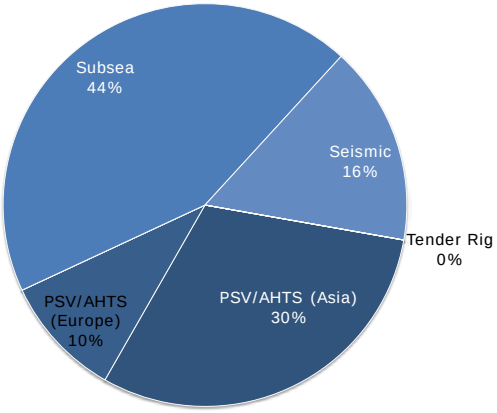
Charterparty Distribution based on NAV+commited




Charter hire backlog by counterpart




Segment Distribution based on NAV+commited




| Project / company | Segment | Contract | Charterparty | Charterer | Proportion of NAV |
|---|---|---|---|---|---|
| Bassdrill Alpha Ltd | Tender Rig | | Spot/Asset play | | 0.0 % |
| Neptune Subsea IS | Subsea | | Spot/Asset play | | 39.5 % |
| Bukhit Timah Offshore DIS | PSV/AHTS (Asia) | Jul-20 | Bareboat | Swiber Offshore Marine Pte | 17.0 % |
| Asian Offshore III IS | PSV/AHTS (Asia) | | Spot/Asset play | | 11.8 % |
| Vestland Seismic IS | Seismic | | Spot/Asset play | Albatross Shipping Ltd. | 9.2 % |
| Iceman IS | PSV/AHTS (Europe) | | Spot/Asset play | | 7.7 % |
| Master and Commander IS | Seismic | Aug-18 | Bareboat | CGG/Fairfield Nodal | 6.8 % |
| Neptune Subsea SHL | | | Spot/Asset play | | 4.2 % |
| 3B Offshore IS | PSV/AHTS (Europe) | Nov-17 | Bareboat | Bourbon | 2.0 % |
| Asian Offshore III IS SHL | | | Spot/Asset play | | 1.7 % |

# Net Asset Value Development (PWWO)

Net asset value was down 51% in H2'15. The stronger USD vs NOK has had a positive impact of 7%. Adjusted for this, the NAV was down roughly 56% during H2'15. The main explanation is the reduction in value of BassDrill Alpha, which made up 30% of the portfolio six months ago, but all other projects are also valued significantly lower due to reduced vessel valuations from brokers.

### NAV development

In USD, the value of PWWO declined 56% during H2'15. A stronger USD vs NOK resulted in NAV ending up at NOK 45 per share at the end of Q4'15, down 51% from Q2'15.

PWWO makes semi-annual NAV calculations. Accordingly, the next NAV will be published as of 30 June 2016 and will be reported to investors in the report for the second quarter of 2016.

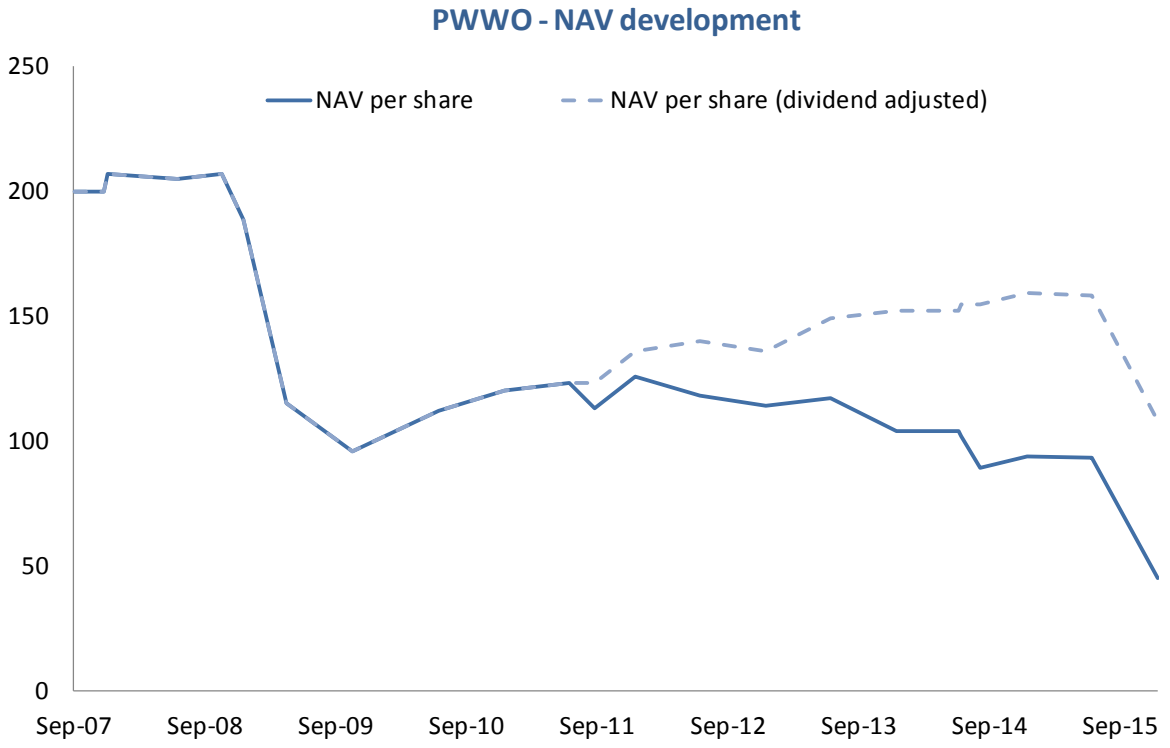
NAV is down 45% since inception in 2007. This poor return reflects the cyclical timing of PWWO's inception, with the fund having experienced both the financial crisis as well as the ongoing oil price collapse. This is reflected in the fact that oil service stocks on the Oslo Stock Exchange are down 56% in the same period.

### Direct yield

A total of NOK 66 per share (33% of par value) has been paid out during the past two and a half years, of which NOK 17.50 came during 2014. All distributions have been repayments of paid in capital. Further distributions of capital cannot be expected until further project realizations.

| | Last 6 mths | Last 12 mths | Last 24 mths | Since inception |
|---|---|---|---|---|
| **PWWO** | **-51.4%** | **-51.2%** | **-37.9%** | **-44.7 %** |
| Oslo Stock Exchange | -3.2% | 5.4% | 11.1% | 22.1% |
| Offshore Index * | -18.6% | -22.6% | -47.6% | -55.8% |

* Based on OSE101010 Energy Equipment & Service



# Net Asset Value Development (POK)

NAV in the feeder company Pareto Offshorekapital ASA («POK») declined by 51% during H2'15. POK currently has more than 1,600 shareholders and the company acts as the main marketplace for second hand transactions for small, non-institutional investors.

### NAV development

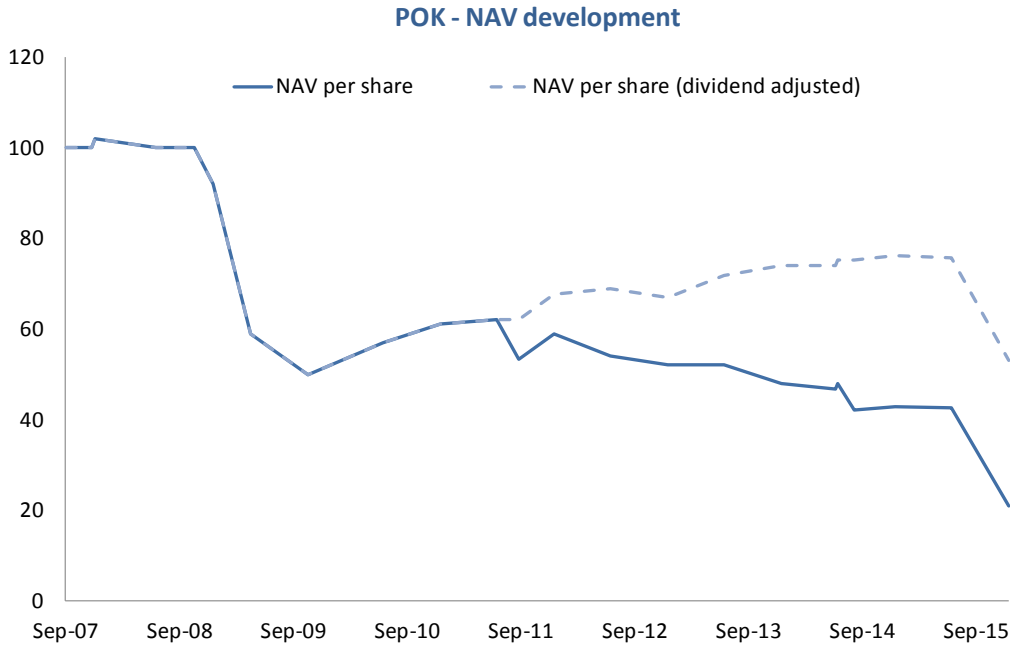
NAV as of 31 December 2015 was NOK 21, down 51% on the previous NAV as of 30 June 2015 and down 51% for the past year, both adjusted for the repayments of capital made to shareholders.

### Direct yield

NOK 33.20 per share has been paid out to POK shareholders during the past two and a half years. All distributions have been repayments of paid in capital. Further distributions of capital cannot be expected until further project realizations.

| | Last 6 mths | Last 12 mths | Last 24 mths | Since inception |
|---|---|---|---|---|
| **POK** | **-50.9%** | **-51.3%** | **-40.0%** | **-45.9 %** |
| Oslo Stock Exchange | -3.2% | 5.4% | 11.1% | 22.1% |
| Offshore Index * | -18.6% | -22.6% | -47.6% | -55.8% |

* Based on OSE101010 Energy Equipment & Service



# Second Hand Market and Share Liquidity

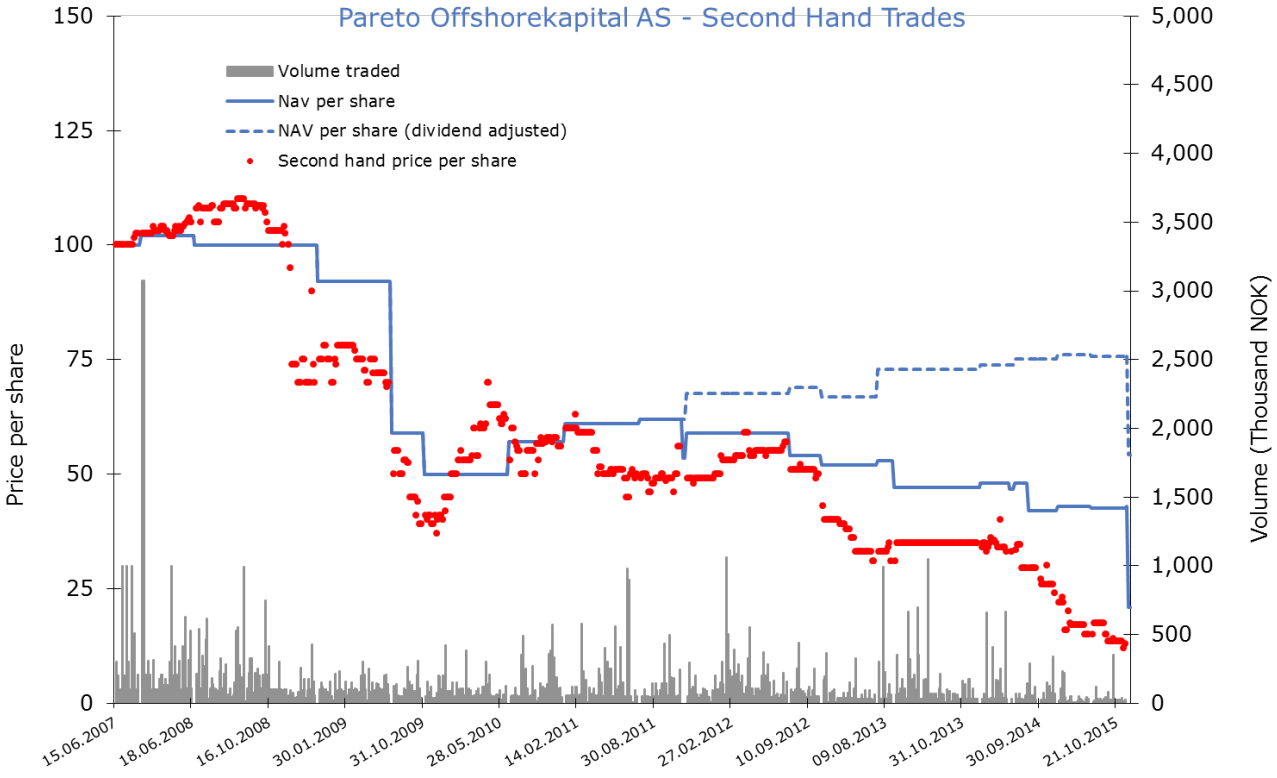
As of 31 December 2015 PWWO had 4.37m shares outstanding. Pareto Securities AS ("PSec") strives to facilitate an active second hand market for shares. The last trading price in PWWO was NOK 62 per share (29 October 2014). Investors who wish to buy or sell shares should contact their advisors or alternatively PSec directly.

## POK

As of 31 December 2015 POK had 5.3m shares outstanding. The last trading price in POK was NOK 13 per share (28 December 2015) and the previous five trades are displayed in the table below. Second hand prices have been dropping in line with a weaker market outlook for oil services, with the discount to NAV at 38%, as illustrated below (red dots). Investors who wish to buy or sell shares should contact their advisors.

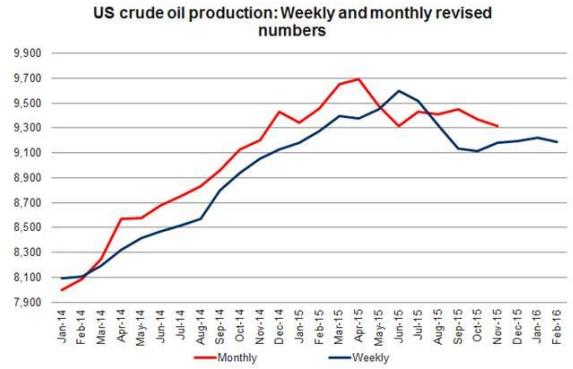
| Date | Share price | No. of shares | Volume (NOK) |
|---|---|---|---|
| 09/11/15 | 13.5 | 2,000 | 27,000 |
| 10/11/15 | 13.5 | 1,000 | 13,500 |
| 13/10/15 | 13.5 | 3,000 | 40,500 |
| 20/11/15 | 12.0 | 1,000 | 12,000 |
| 28/12/15 | 13.0 | 2,000 | 26,000 |

| | |
|---|---|
| Number of trades since startup: | 618 |
| Volume traded since startup (NOK): | 94,516,900 |
| Average volume per trade (NOK): | 152,940 |

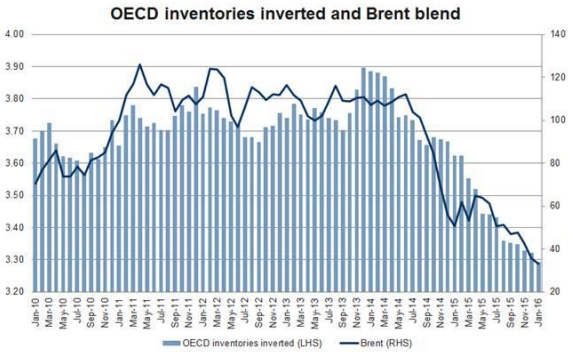


# The offshore oil services market

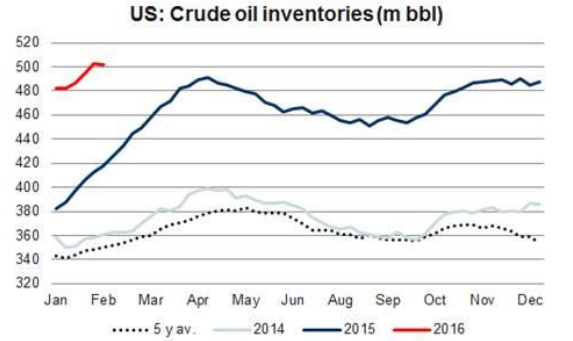
The oil price reached new lows early this year and continues to exhibit strong volatility. The inventory build is continuing, while worries about the health of the Chinese economy is adding gloom to demand side projections. We expect this pattern to continue to the next 6-9 months and do not expect any upwards traction for the oil price until after the summer. All in all, this means that the likelihood of any meaningful recovery in 2017 is slim.



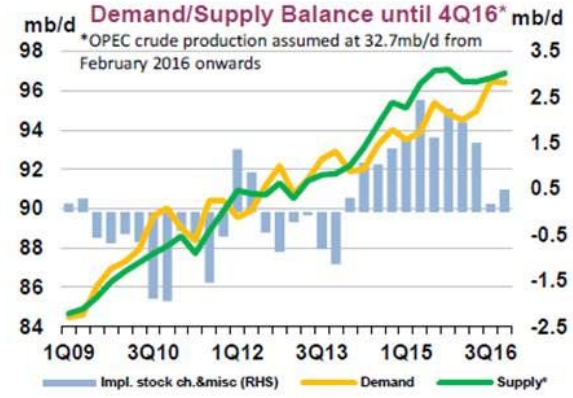

Source: EIA, Nordea Markets




Source: EIA, Nordea Markets




Source: EIA, Nordea Markets




Source: IEA

## Oil production looks immune to the price decline

While the US rig count continues to drop in line with lower oil prices, the US oil production levels appear relatively immune to this, which is resulting in continued inventory builds. In fact, the crude inventories are now so high that many worries that storage facilities will end up being full. If this happens, it is argued that the oil price will drop below USD 20/b in order to clear the market of excess volume.

At the same time, OPEC is maintaining its high production levels and we still have not seen the impact of Iranian volumes in the market yet. Granted, there have been some chatter about production cuts among producers, but we have little reason to read anything into it yet.

At some point, one would expect gravity to work. It would seem unreasonable to expect US oil production to maintain its current level with the significantly reduced drilling activity. Outside of the US, non-OPEC production will surely respond to the lower investment levels. But right now, it is anybody's guess as to when the inflection point will be.

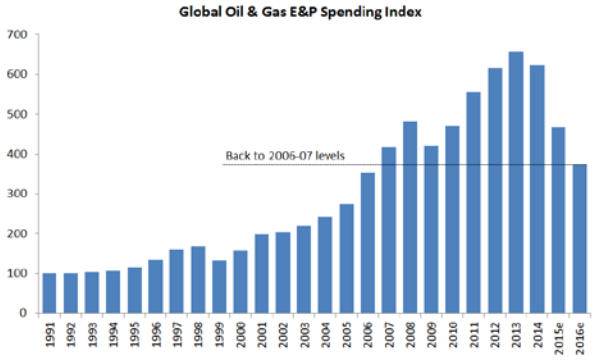
## China worries are mushrooming

There is a strong focus on abating Chinese economic growth at the moment. While apparent demand and actual imports have been stronger than expected recently, the feeling is that it will abate going forward and maintain a sense of bearishness surrounding the long term demand outlook in China, which has been by far the most important driver for oil in the past decade.

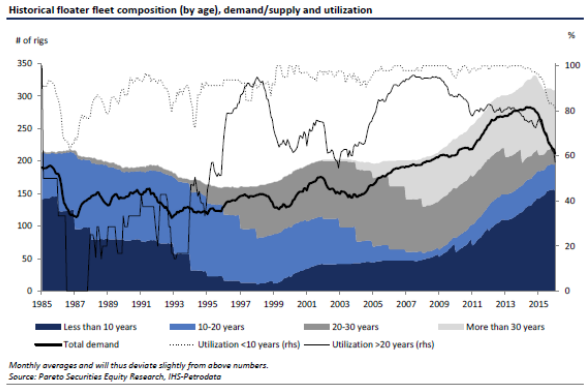
Financial markets are in a bearish mode about China, and there is a latent panic relating to the health of its financial system, which has expanded at the fastest pace ever observed in recent history. The overall sentiment is "risk-off", which is impacting everything with a strong link to emerging markets, particularly commodities.

In conclusion, it is hard to find any positive data points out there at the moment. Buckle up and prepare for a rocky ride this year!

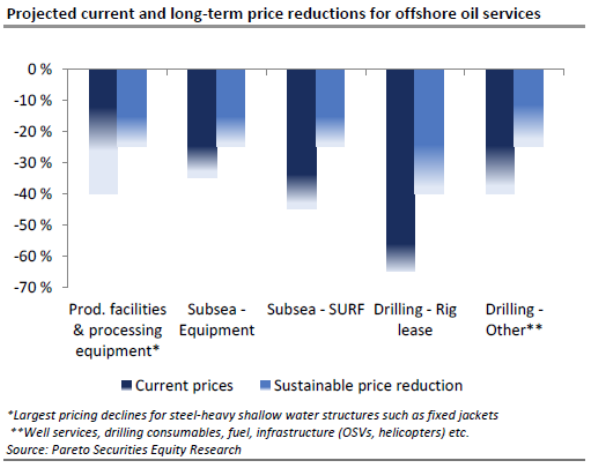
# Oil services, continued



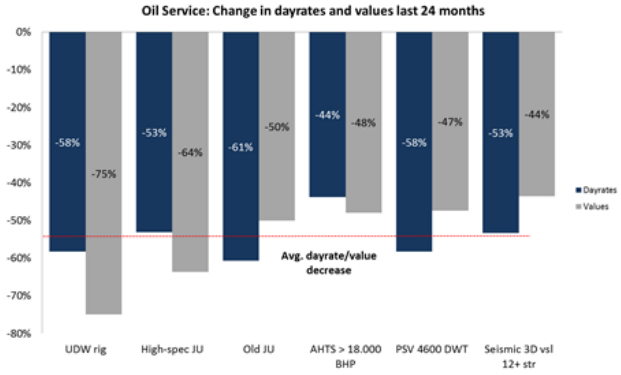

Source: Barclays Capital




Source: IHS, Pareto Securities,




Source: Pareto Securities, Clarksons Platou, Westshore




Source: Pareto Securities, PGS

## E&P spending expected down another 20% in 2016

Global E&P spending was down around 25% last year, the biggest decline in three decades. For 2016, the forecast is for another down-tick of 20%, meaning that 2016 will be even more difficult than 2015 on a global basis and that we are down to levels not seen since before the financial crisis.

## Activity levels are more robust

A reasonable measure for offshore activity levels is represented by the demand for floating drilling rigs. As seen by the graph to the left, activity levels have dropped to 2010 levels so far. Hence, a meaningful part of the decline in E&P spending is to be found in lower pricing. This is driven by utilization and the reason pricing is at historical lows is the significant capacity growth in oil services that has taken place during the past 5 years.

## Reduced pricing lowers break-even costs

The lower pricing on all oil services and equipment is resetting the break-even prices for new field developments and could, once the dust has settled, result in some recovery, even if oil prices were to stay low. The lower profitability experienced by the oil companies has also forced the oil industry into improving overall efficiency. As such, there could even be some room for pricing improvement, while retaining a permanently lower break-even price. Therefore, it should be expected that the required oil price recovery to facilitate a more material recovery in oil services is more limited now and that things could start moving upwards once (and if) the oil price climbs above USD 50/b.

## Asset valuations are at cyclical lows

Both day rates and asset values are down in excess of 50% during the past two years. Inflation adjusted, asset pricing is basically back to the 1980s level. While some may view this as a buying opportunity, it is creating significant headwinds for current owners. The cash flows from the assets are barely sufficient to cover operating expenses, little (if anything) is left over for debt service. This is leading to a high activity in terms of debt restructuring, which in turn also requires fresh equity to prop up the balance sheets. The lower valuations are also leading to LTV-covenant breaches. We have already witnessed a couple of bankruptcies in oil services and expect more to come. The result of this will likely be a string of forced asset sales, which will set new benchmarks for asset pricing. We would expect that the next data points will be lower, before they eventually start recovering.

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Historic returns and return forecasts do not constitute any guarantee for future returns. Returns may vary as a consequence of fluctuations in currency exchange rates. Investors should be aware that there is significant uncertainty related to valuations in the current volatile market. The valuation process is described in Pareto Securities' market report as per November 2015. Risks and costs are further described in the prospectus (information memorandum) produced in relation to share issues in the Company.

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