

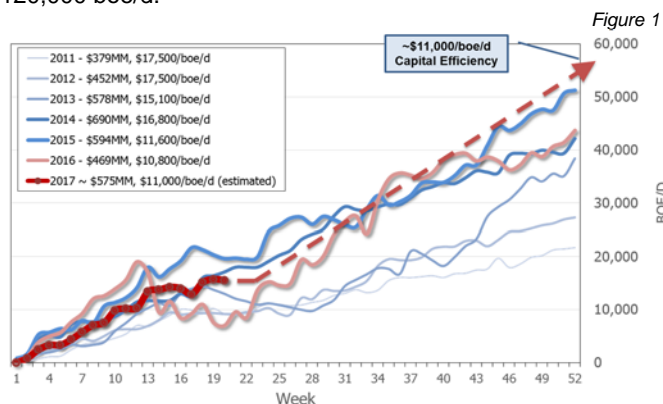
# Peyto Exploration & Development Corp.

## President's Monthly Report

June 2017

From the desk of Darren Gee, President & CEO

We have been slowly chipping away at our backlog of drilled but uncompleted wells (DUCs), despite the wet spring conditions. As soon as we can get back in the field to complete the rest and tie them all in, we should start to see this accumulation of production potential materialize (still currently over 10,000 boe/d). Between the start of April and end of May we were only able to bring on a dozen net wells. Still, looking at a comparison of past years and the build of new production expected for this year (Figure 1), 2017 looks to be similar to 2015, when we built 50,000 boe/d with \$594 million. The plan this year is 55,000 boe/d with \$575 million, which when combined with the base production that is forecast to be around 65,000 boe/d at year end, should have us exit the year close to 120,000 boe/d.



Source: Peyto

As in the past, this report includes an estimate of monthly capital spending as well as our field estimate of production for the most recent month (see Capital Investment and Production tables below) as well as any production deferrals.

### Capital Investment\*

2016/17 Capital Summary (millions\$ CND)\*

	Q1 16	Q2 16	Q3 16	Q4 16	2016	Jan	Feb	Mar	Q1 17	Apr
Acq.	28	0	5	1	34	0	0	3	4	0
Land & Seismic	4	1	1	4	9	8	0	1	9	1
Drilling	63	30	64	63	219	22	25	20	67	10
Completions	33	8	27	37	105	11	13	13	36	4
Tie ins	12	3	13	14	42	3	4	6	13	2
Facilities	37	9	4	11	60	9	5	11	25	9
<b>Total</b>	<b>176</b>	<b>50</b>	<b>114</b>	<b>130</b>	<b>469</b>	<b>53</b>	<b>47</b>	<b>54</b>	<b>154</b>	<b>25</b>

### Production\*

2016/17 Production ('000 boe/d)\*

	2015	Q1 16	Q2 16	Q3 16	Q4 16	2016	Jan	Feb	Mar	Q1 17	Apr	May
Sundance	59	61	54	58	59	58	59	59	59	59	58	55
Ansell	17	25	20	21	22	22	21	21	22	21	20	19
Brazeau	7	12	11	14	17	14	19	18	17	18	18	20
Kakwa	2	2	2	2	2	2	2	2	2	2	2	2
Other	2	2	1	1	1	1	2	2	1	1	2	1
<b>Total</b>	<b>86</b>	<b>101</b>	<b>88</b>	<b>96</b>	<b>102</b>	<b>97</b>	<b>102</b>	<b>100</b>	<b>102</b>	<b>101</b>	<b>100</b>	<b>98</b>

\* This estimate is based on real field data, not a forecast, and actual numbers will vary from the estimate due to accruals and adjustments. Such variance may be material. Tables may not add due to rounding.

### The Cash-In = Cash-Out Fallacy

With the flurry of Q1 reporting and analysis now out, I was surprised to see just how much focus was on the concept of capital spending within cash flow or "free cash flow". This seemed to be something that the investment community was looking for and placing significant value on. Looking at Peyto, for instance, it was suggested that because our capital expenditures in 2017, plus our dividend, exceed our projected funds from operations, that this was, or is, a bad thing. That type of thinking struck me as illogical (much the same way that half-cycle economics do) and not just because leveraged returns can be very powerful but more because if you carry that thinking through to the logical conclusion, I don't think that's actually where investors want to end up.

It's not that investors are wrong to want businesses that can be successful (and profitable) without the constant need for external funding. Just look at Peyto's history, for example. We have invested a total of \$5.359 billion in capital over our entire history (to Q1/17) with funds from operations of \$5.026 billion and have profitably grown from a zero to 100,000 boe/d business. That's just \$333 million of net external funding to get here. More importantly, over that same time frame, we've generated \$2.2 billion in profit (earnings), and have an asset worth \$6.6 billion (2P NPV<sub>s</sub>, debt adjusted).

What's most important, however, is that the second part comes along with the first part. Firstly, that capital investments are ultimately funded from cash flows, and secondly, that material profits are generated. Spending your free cash flow to grow your business is only the first hurdle. The more important hurdle, and the more difficult one for most companies, is overcoming the next set of costs in order to generate a profit. Take a look at the example income statement on the next page (Figure 2).

Say you're a larger producer, with cash costs of around \$8/boe on revenue of around \$20/boe. That translates into a fairly average operating margin of around 57%. And if your base production decline is low enough, say sub 35%/yr, and your capital efficiency is good enough (say \$11,500/boe/d), you just might be able to offset your decline with your cash flow or funds from operations (0.35\*185,000\*11,500=\$745 million versus \$725 million).

But if you also have to cover a depletion charge (or replacement charge) of say \$10/boe (again, typical), you are unable to generate much profit (only 3%). Even if you are more efficient than the above example, or commodity prices are higher so you're generating a bit more cash flow (and more profit assuming your costs don't go up), if you're just investing your free cash flow, you're not going to be creating enough tax shelter to cover much income and you will be paying current tax as well as future tax.

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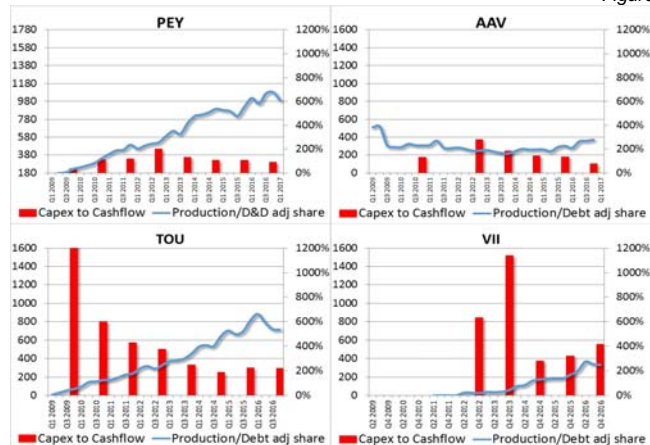
Figure 2

<b>Typical Income Statement</b>		
Production	185,000	boe/d
<b>Revenue</b>	( '000s)	\$/boe
Oil and Gas Sales	\$ 1,350,500	\$ 20.00
Royalties	\$ (67,525)	5%
Gain/Loss	\$ -	
<b>Total Net Revenue</b>	<b>\$ 1,282,975</b>	
<b>Expenses</b>		
Operating	\$ 270,100	\$ 4.00
Transportation	\$ 202,575	\$ 3.00
General and Administration	\$ 33,763	\$ 0.50
Interest and Financing	\$ 50,644	\$ 0.75
		\$ 8.25
<b>Funds From Operations</b>	<b>\$ 725,894</b>	<b>\$ 10.75</b>
	57%	
Stock based compensation	\$ 27,010	\$ 0.40
Accretion on asset retirement obligations	\$ -	
Depletion, depreciation & Amortization	\$ 675,250	\$ 10.00
<b>Total Expenses</b>	<b>\$ 1,232,331</b>	
<b>Income before Taxes</b>	<b>\$ 50,644</b>	
<b>Provision for Tax</b>		
Current	\$ -	
Deferred	\$ 13,674	
Total Income Taxes	\$ 13,674	
<b>Net Income (Profit/Loss)</b>	<b>\$ 36,970</b>	
	3%	

Source: Peyto

When E&P companies are fully taxable they generally don't trade on before tax cash flow multiples, they trade on after tax earnings multiples (aka Exxonmobil). But if you don't generate very much in the way of earnings, as illustrated in the example above, you won't be trading on much. So like I said, I don't think this is where investors actually want to end up. I suspect they would much rather companies continue to trade on before tax cash flow multiples, which requires tax shelter or pools that can only be generated from capital expenditures well in excess of cash flow. Thus the flaw in the concept of free cash flow only.

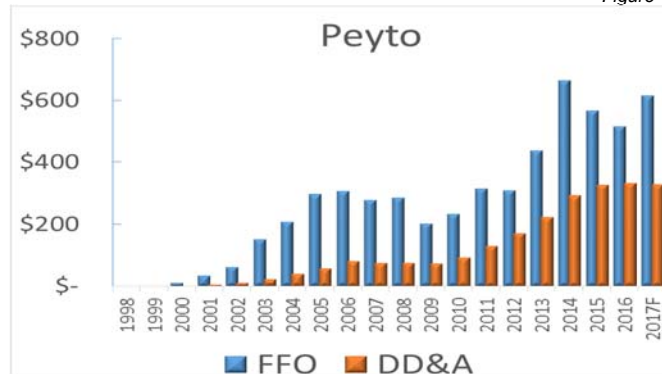
Figure 3



Source: Company Financials, Peyto

Historically, those companies that have invested multiples of their cash flow in order to grow their production (profitably or not) have traded on pre-tax cash flow multiples (Figure 3). But in order to change to a free cash flow only model, they would be first required to demonstrate an ability to generate significant earnings. The key to earnings, of course, as my example income statement shows, is to obtain or maintain a low depletion cost (DD&A), much lower than the funds from operations.

Figure 4



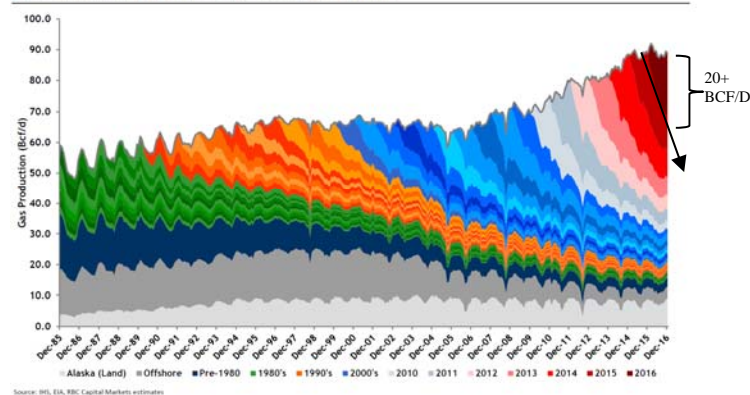
Source: Peyto

That's something that Peyto has always had (Figure 4) and continues to endeavour to maintain. But it's not so commonplace in the industry. Which is also why earnings are so rare. Thus the free cash flow fallacy.

### Activity Levels and Commodity Prices

Figure 5

Exhibit 16: U.S. natural gas production by age (month/year): 1985-2016



Source: RBC

RBC research put out an interesting graph on US gas production which showed the annual wedges of new production and the required build to offset decline. The 20+ BCF/d is a big number, basically 1.2 Marcellus shale plays is required to be found and developed every single year just to hold them flat. That's a big ask and something to consider when someone says we have cheap gas forever.