Pareto Offshoreinvest AS

1st quarter report 2016

Link: http://paretosec.com/pai-reports.php
Executive Summary

The adverse market conditions continue to be very challenging and we are witnessing further reductions in vessel valuations, which will ultimately filter through to the Fund’s NAV to be reported next at the end of June. The Fund is keeping its powder dry and is preparing for a very difficult 2016 and 2017, in which investors should not expect any dividend distributions.

Market Development
The oil price has jumped by ~60% from the bottom in January and is now trading at around USD 47/b for Brent. The reason is that we have finally started to see production levels coming down outside of OPEC, particularly onshore US, while oil demand continues to be firm. As a result, most observers now see the re-balancing of the oil market strengthening during H2’16 and there is an increasing confidence that the oil price will head towards USD 60/b. During the next 9-12 months, we are therefore expecting to see some improvement, but probably not material until 2017.

That being said, earnings and cash flows remain at depressed levels and most industry players are having a hard time servicing debt. We are seeing an increasing number of bankruptcies in the industry and many more debt restructuring efforts that appear to have an uncertain outcome. Some default-induced forced asset sales have also taken place, some at extreme discounts to a more normalized newbuilding parity. The Fund has had its share of default events during the quarter.

Portfolio
The portfolio consist of shares in 8 projects with a total of 16 vessels. The contract coverage is 94% with a weighted contract length of 3 years.

POI has distributed NOK 70 per share (70% of par) to its investors since the inception. Further distributions will depend on running dividends and project realizations.

NAV as of 31 December 2015 was NOK 59 per share, down 23% from the last reported NAV as of 30 June 2015. Since inception, NAV is up 29% including dividends distributed. The Fund will next report NAV as of 30 June 2016 and investors should expect a further decline, based on lower vessel valuations we are currently witnessing.
Portfolio News

POI is invested in 8 offshore projects, which implies a good diversification across different market segments. This section provides an update on the quarter’s most important newsflow related to the underlying investments.

**Master and 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.

**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.

**Azur Offshore IS**
The project has made an agreement with its lenders to postpone the increased MVC covenant until Dec’ 16 against an extra ordinary debt instalment. The charterer has also approached the project with a proposal to lower the charter rate against a longer duration of the BBCP. Negotiations around this are ongoing and will also require consent from Azur’s lenders.

**Norseman Offshore IS**
The charterer, Viking Supply Ships AS (VSS), has defaulted on its obligations to pay charter hire since March. VSS is currently in a restructuring process with all its creditors (banks, bondholders and Norseman) to seek a long term solution for the company. So far, this has not been concluded, meaning that the outcome for Norseman is highly uncertain.

**Far East Offshore**
The project continues as planned with bareboat hire paid punctually. The project is hoarding cash, which will be utilized to handle potential MVC breaches and/or funding requirements when the current bareboat charter ends in February 2017. The value of the project is down due to lower vessel valuations.

**PSV Invest II IS**
The vessel is on a contract to Apache in the UK at an acceptable day rate through to October 2016, however, with a 3-month stint in the spot market in Q4’15. The market for high spec PSVs is extremely difficult at the moment.

**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.

**Asian Offshore IS**
The average day rate for the four vessels was USD 3,700/d during Q1’16, up 6% q-o-q. Receivables collection has picked up and provided some relief in terms of covering operating expenses. AO I has approached the bank with a proposal to solve the near term liquidity risks, but has so far been unable to conclude. AO I has, together with its co-investors in RK Offshore Holdings decided to sell RK Offshore Management to Navig8, which will also be taking over the management of the RK Offshore International Pool. This will provide more stability for the operational platform and provide AO I with some much needed liquidity. Vessel valuations have dropped significantly, implying a significant mark-down of the NAV.

**Payments from projects**
During Q1’16, POI received NOK 0.7 of dividend payments from the portfolio.

**New investments**
POI will only make follow-up investments in existing projects, if required.
Portfolio

The portfolio continues to be characterised by a high contract coverage (94%), despite the market volatility. The average charter length 3 years, which is still robust. We expect the portfolio to continue to produce a decent cash flow for the Fund, but the situation now is that this cash is trapped in the projects due to restrictive banks, rather than becoming available to the Fund.

Investments and capital

POI’s portfolio consists of 8 projects which owns stakes in 16 units. The average contract length is 3 years and the contract coverage is 94%.

The gross nominal value of the contract backlog is roughly NOK 65m. The backlog is evenly distributed among solid counterparts.

POI had a cash holding of NOK 10.4m as of 31 March 2016. Capital calls for projects should not be ruled out. Until the situation is more clarified, the Fund plans to retain its cash position.

The life cycle of POI has been extended to 30 June 2017. It goes without saying that it will be difficult to make project realizations at good prices with the current market conditions. Hence, if the markets do not improve within such a time frame, further extensions should be expected.

<table>
<thead>
<tr>
<th>Project / company</th>
<th>Segment</th>
<th>Contract</th>
<th>Charterparty</th>
<th>Charterer</th>
<th>Proportion of NAV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Master and Commander IS</td>
<td>Seismic</td>
<td>Aug-18</td>
<td>Bareboat</td>
<td>CGG/Fairfield Nodal</td>
<td>34.2 %</td>
</tr>
<tr>
<td>Azur Offshore IS</td>
<td>PSV/AHTS (Asia)</td>
<td>Jun-23</td>
<td>Bareboat</td>
<td>Ezra Holdings</td>
<td>21.1 %</td>
</tr>
<tr>
<td>Norseman Offshore IS</td>
<td>PSV/AHTS (Europe)</td>
<td>Dec-20</td>
<td>Bareboat</td>
<td>Viking Supply Ships AS</td>
<td>10.6 %</td>
</tr>
<tr>
<td>3B Offshore IS</td>
<td>PSV/AHTS (Asia)</td>
<td>Nov-17</td>
<td>Bareboat</td>
<td>Bourbon Maritime</td>
<td>10.2 %</td>
</tr>
<tr>
<td>Far East Offshore IS</td>
<td>PSV/AHTS (Europe)</td>
<td>Feb-17</td>
<td>Bareboat</td>
<td>Sanko Steamship Ltd</td>
<td>8.9 %</td>
</tr>
<tr>
<td>PSV Invest II IS shareholder loan</td>
<td>PSV/AHTS (Asia)</td>
<td>Sep-16</td>
<td>Timecharter</td>
<td>Apache UK</td>
<td>8.4 %</td>
</tr>
<tr>
<td>Vestland Seismic IS</td>
<td>Seismic</td>
<td></td>
<td>Spot/Asset play</td>
<td>Albatross Shipping</td>
<td>4.9 %</td>
</tr>
<tr>
<td>Asian Offshore IS</td>
<td>PSV/AHTS (Asia)</td>
<td></td>
<td>Spot/Asset play</td>
<td>Apache UK</td>
<td>0.7 %</td>
</tr>
<tr>
<td>PSV Invest II IS</td>
<td>PSV/AHTS (Europe)</td>
<td></td>
<td>Timecharter</td>
<td>Apache UK</td>
<td>0.5 %</td>
</tr>
<tr>
<td>Asian Offshore IS shareholder loan</td>
<td></td>
<td></td>
<td>Spot/Asset play</td>
<td></td>
<td>0.5 %</td>
</tr>
</tbody>
</table>
Second Hand Market and Liquidity

As of 31 March 2016, POI had 851,877 shares outstanding. Pareto Securities AS (“PSec”) aims to facilitate an active second hand market for shares. The last trading price was NOK 30 per share in March 2016, which implies a 49% discount to the YE’15 NAV (of NOK 59 per share). Investors who wish to buy or sell shares should contact their advisors or alternatively PSec directly.

<table>
<thead>
<tr>
<th>Date</th>
<th>Share price</th>
<th>No. of shares</th>
<th>Volume (NOK)</th>
</tr>
</thead>
<tbody>
<tr>
<td>06/08/14</td>
<td>82</td>
<td>4,129</td>
<td>338,578</td>
</tr>
<tr>
<td>25/08/14</td>
<td>65</td>
<td>1,000</td>
<td>65,000</td>
</tr>
<tr>
<td>23/01/15</td>
<td>35</td>
<td>5,000</td>
<td>175,000</td>
</tr>
<tr>
<td>27/04/15</td>
<td>45</td>
<td>2,000</td>
<td>90,000</td>
</tr>
<tr>
<td>04/03/16</td>
<td>30</td>
<td>2,065</td>
<td>61,950</td>
</tr>
</tbody>
</table>

Number of trades since establishment 43
Volume traded since establishment (NOK) 8,173,723
Average volume per trade (NOK) 190,087
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.

Non-OPEC oil production has started its decline

US onshore oil production has finally caved in and started on a downward trajectory. The 80% drop in the US onshore rig count suggests an additional decline of about 0.5 mb/d by Q3’16, implying a total decline of nearly 1.2 mb/d from the peak in March 2015. The lower production levels are also starting to show up in the weekly inventory numbers, adding further evidence that the inventory correction cycle is indeed underway.

At the same time, OPEC is maintaining its high production levels. Iran has raised its production faster than expected, following the removal of sanctions, up 0.7 mb/d from October ‘15. This has been balanced out by Saudi Arabia and other OPEC producers, leaving OPEC-12 production within the same 32-32.5 mb/d range we’ve seen in the past year.

Worries over China appear to have abated somewhat, with crude imports at strong levels and the leading indicators, such as the PMI, now levelling out and even showing some improvement.

Finally, the USD has weakened due to reduced expectations of interest rate hikes in the US. This is typically good for all commodities, oil and gas included.

Oil price bounces back strongly

The oil price is up by more roughly 60% from its trough in January this year, in response to the factors above. While this may appear to be an outsized move, it only reflects a move back to the levels seen as late as November ‘15.

Such a sharp move necessarily leaves the oil price vulnerable. The move is based on forward expectations, as the market fundamentals so far do not warrant such a large reacation. Hence, we need to see a continued strengthening of the inventory correction cycle, and disappointments in this regard may lead to a downward correction.

That being said, it is hard to see why the oil price should not continue its upward trajectory during the remainder of the year as the inventory correction cycle is bound to strengthen. In the medium term, it will be interesting to watch the production levels from conventional oil plays, which is bound to have been negatively impacted by the cut-backs in E&P spending. That could provide an upside surprise.
**Oil services, continued**

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. Any recovery in the oil price is unlikely to have material impact until next year, as the budgets for 2016 are more or less fixed.

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 back to 2009 levels, and as such similar to what we saw post the financial crisis – a drop of 28% from the 2014 peak. This is less than the 43% drop in E&P spending from peak and reflects that an important part of the reduction in the oil industry’s capex spend is coming from pricing declines.

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 are witnessing an increasing number of bankruptcies in oil services. The result of this will likely be a string of forced asset sales, which will set new benchmarks for asset pricing. The latest one being set by the 2011-built UDW drillship Cerrado, which fetched USD 65m in an auction, about 10% of its original construction cost.
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