GEAR ENERGY

Monthly Update

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Vol. 6 Issue 7

FROM THE DESK OF INGRAM GILLMORE, PRESIDENT & CEO

We regularly include the following data populated with estimated monthly results:

Capital *

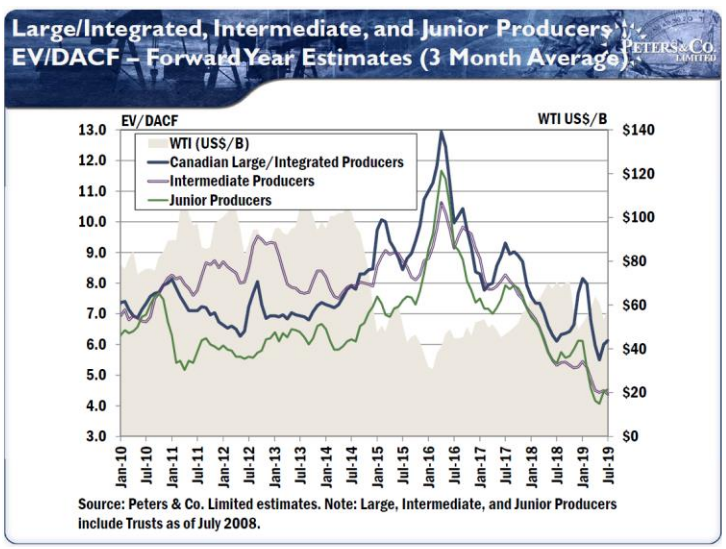
($k CAD)	Q1 18	Q2 18	Q3 18	Q4 18	**2018**	Q1 19	19-Apr	19-May	19-Jun	Q2 19	**2019 YTD**
Drill & Complete	3,624	3,451	14,936	5,596	**27,607**	6,112	190	-66	1,694	1,818	**7,930**
Facilities	3,742	2,742	3,490	5,137	**15,110**	2,676	708	485	465	1,658	**4,334**
Land & Seismic	2,766	282	39	34	**3,121**	671	11	9	11	31	**702**
A&D	390	10	65,471	301	**66,172**	-1,038	-25	21	-158	-163	**-1,200**
Other	-889	-90	285	-1,285	**-1,979**	-207	67	114	-354	-173	**-380**
TOTAL	**9,633**	**6,395**	**84,220**	**9,783**	**110,032**	**8,214**	**951**	**563**	**1,658**	**3,172**	**11,386**

Production (boe/d) *

Sales	**6,522**	**7,025**	**6,747**	**6,847**	**6,786**	**6,877**	**7,600**	**6,859**	**7,035**	**7,161**	**7,020**
Field	6,810	6,532	6,729	7,030	6,776	6,649	7,201	6,824	6,918	6,979	6,815

** Estimates based on field data, actuals will vary from estimates due to accruals and adjustments. Such variances may be material.*

Two weeks ago, WTI oil prices traded above US$60 per barrel. Typically, in the past, strengthened oil prices would catalyze energy investor enthusiasm. However, these are not typical times. After five years of volatile oil prices and ongoing domestic political uncertainty, it apparently is more difficult to encourage investors to get excited about the Canadian energy space. This is despite the fact that public energy company valuations have never been this low since Gear started operations in 2010. (Chart courtesy Peters&Co)



The valuations are listed on the left as EV/DACF, which equates to enterprise value divided into debt adjusted funds from operations, and the history of WTI oil prices are shown on the right. Gear would fit into the Junior Producers category and as the chart shows, even though oil prices have recovered from the 2015/2016 lows, the valuations for junior and intermediate (mid-cap) energy companies have never been as compressed in Gear's history.

For almost two years, WTI oil prices have spent the majority of the time trading between $50 to $70 per barrel. For most Canadian producers, this is likely a range that supports maintenance of the business, or even a reasonable element of growth. Notwithstanding the intermittent volatility in differentials and egress restrictions, one might argue that the fundamentals of the business are relatively stable. They have certainly been much worse at times over the last five years when WTI oil prices were struggling to stay above $40 per barrel. The conclusion here is that there is a drastic misalignment between the business fundamentals of Canadian energy producers and their respective trading valuations, most notably for the junior and mid-cap space.

There are limited opportunities available to either rectify or take advantage of this valuation misalignment beyond diligent capital management and continued patience and perseverance. One strategy that a few producers have employed to try and create value in this market is to direct some of their funds from operations away from debt reduction or growth-oriented projects to instead invest in purchasing their shares back from the open market. This buy-back strategy is a relatively rare occurrence in the Canadian energy space with only a handful of peer operators engaged in the activity over the last couple of years. In fact, among the 38 junior/mid-cap producers that Gear typically monitors, only 5 of them have recently executed on a common share buy-back program. Those companies are Paramount Resources, Prairie Provident Resources, Razor Energy, Tamarack Valley Energy and Whitecap Resources.

Unfortunately, with the steady decline in trading multiples shown on the chart, the results to date of these programs have not been very encouraging. In fact, Gear's relative share price performance has been better than the average of these peers since the inception of their respective buy-back programs.

Specifically, one company outperformed Gear, two essentially matched, and the remaining two underperformed. In addition, the current share prices of each of these peers is on average over 40 per cent lower than the average cost of the purchases made under their respective buy-back programs. Notwithstanding these results, the potential for share buy-back programs should not be instantly dismissed. It is still early days in our peer's programs, and with a potential shift in investor sentiment, those historical transactions may look better in the future.

So, would Gear consider initiating a share buy-back program?

Gear's primary goal is to create shareholder value, and we measure our performance by focusing on growing funds from operations on a debt adjusted per share basis. Achieving this performance requires consistent successful reinvestment of the company's capital, (funds from operations, debt and equity). The big choices of where to invest this capital are simplistically limited to only four options:

1. Invest in growth
2. Strengthen the balance sheet
3. Buy-back shares
4. Issue dividends

Each of these options are influenced by their own variables and intricacies, which are discussed below, except dividends, we will save that for another letter sometime in the future.

Investing in Growth

This is the typical path that Canadian energy companies have pursued for decades. Traditionally, success in this regard would be rewarded with strong growth in funds from operations and a commensurately healthy share valuation. However, as previously mentioned, these are not typical times. Continued uncertainty in price volatility, egress, differentials and political support for Canadian energy have changed the landscape. Companies with the luxury of strong balance sheets are finding themselves considering moving some of their focus away from their historical growth strategy to the other three potential options. In fact, the term growth may not even be correct in this case, as many companies over the last five years have not invested sufficient "growth" capital to offset natural declines.

Exclusive of the macro challenges, the advantages of a growth strategy can be compelling. Returns on capital of individual projects should be strong as long as they exceed investment hurdles. And if the individual value adding projects are of a significant enough scale in relation to the fixed costs of the business, the full cycle predicted returns should also be strong.

In Gear's case, the 2019 capital budget is estimating that production additions will be accomplished for approximately $19,000/boe/day on an IP365 basis. As an added benefit, that new production comes on with low operating costs, low royalties and helps to maintain or reduce total corporate costs on a per boe basis, thus improving the total corporate portfolio. In isolation, the returns of a successful organic drilling program should rank strongly against the other investment options. However, growth does not come without its risks. Actual returns on investment can be variable. Volatile prices and executional missteps can diminish the predicted returns on invested capital. Also, growing aggressively into a market subjected to egress restrictions adds incremental risks. Furthermore, when you move to the acquisition side of the business, the costs for additions will typically be much higher as you will be paying up front to expand your future inventory of opportunities and extend and improve the future growth potential of the company.

The strategy at Gear is to invest a healthy portion of capital towards growth projects, currently targeting the maintenance of current production and reserves levels, with possible enhancements in value as a result of an increased weighting towards higher netback light oil opportunities.

Strengthen the balance sheet

If the last five years in the energy space have taught us anything, it's that the balance sheet is key, especially as a junior energy company with a reserves-based lending structure. Ongoing price volatility, increased scrutiny of future abandonment obligations and limited options for new capital have continued to amplify the importance of maintaining a healthy balance sheet.

But what is the right amount of debt? There are two key debt metrics that Gear likes to focus on; the first is the ratio of net debt to funds from operations, and the second is net debt as a percentage of the enterprise value.

On the first metric, Gear's target is to have the net debt to funds from operations ratio below 1 times at strip pricing. If WTI oil prices average $60 for the rest of 2019, we should be very near to that target for 2019. However, the current outlook is a little different for 2020 with forward curve estimates showing WTI dropping a couple of dollars, heavy oil differentials expanding from approximately 24 per cent of WTI in 2019 to around 38 per cent of WTI in 2020 and light oil differentials expanding from approximately 10 per cent of WTI to over 16 per cent of WTI. You may argue that the forward curve seems too pessimistic, but it is the only data that we have to work with. To meet our target, continued focus on investing capital into strengthening the balance sheet is going to be required under the current forward strip estimates for oil prices.

On the second metric, the targets are more like guidelines. Notionally, we believe that net debt should ideally range between 25 to 50 per cent of the total corporate enterprise value. Above 50 per cent and the debt holders own more of the company than the shareholders, and below 25 per cent is likely an under-utilization of the company's ability to leverage high return projects against the low cost of debt. Using first quarter numbers the net debt was approximately 42.5 per cent of the enterprise value. With Gear forecasting to underspend funds from operations through the second quarter, that number is anticipated to fall below 40 per cent. Which is good, but we are still likely to be closer to the upper end of our target than the lower end.

Despite Gear having a strong balance sheet relative to peers, success in reaching both of Gear's debt targets is still in progress. As a result, this option for invested capital will remain a high priority. Reducing outstanding debt provides the company many benefits including; improving performance measures on a per debt adjusted share basis (essentially the same as buying back shares), reducing interest costs per boe which increases funds from operations per boe, maintaining protection from future commodity volatility, and providing optionality for future investment decisions.

Buying back shares

Investing capital to reduce outstanding shares when companies are trading at almost decade low price valuations is a valid strategic consideration. There are multiple factors to contemplate.

On the positive side, the returns on invested capital are essentially risk free. The repurchased shares would be removed and the performance of the company on a per debt adjusted share basis would improve, similar to reducing debt. There may also be some share price support through the increased liquidity of an active buy-back program, although to date Gear's peers who have engaged in share buy-backs have not exhibited much proof of that theory. An additional potential benefit of share buy-backs, is the possibility that valuations improve and the value of the repurchased shares inclines, thus improving the returns on that invested capital. One might argue that improving valuations would be associated with improving business fundamentals which would likely also boost the returns on growth capital. And of course, as we have seen in the past, the valuations can go the other way as well, so perhaps not as risk free as initially described.

One of the challenges to a share buy-back investment is that typically the predicted returns on the capital compared to the growth option are lower. And although the per debt adjusted share numbers are improved with buy-backs, all of the per boe benefits of investing in growth are eliminated. The additional challenge to share buy-backs is that if implemented with scale, any capital redirected from growth will decrease the percentage of funds spent on production adding opportunities in relation to the fixed costs of the business, thus eroding the overall capital efficiency of any growth investment.

All three of the discussed capital allocation strategies have tangible rewards that make them worth contemplating. And all of them are not without their associated risks. Any good corporate strategy should regularly consider all of them (and perhaps eventually dividends as well) as each can contribute in its own way to enhancing long-term shareholder value.

The first step towards any successful capital allocation strategy is to ensure that you are running a solid business. In Gear's case we would define that as; having a diversified asset base, having a deep inventory of future drilling opportunities, having a strong balance sheet, and having a low-cost structure. With these ingredients in place, a company is in the enviable position of being able to choose which mix of capital allocation options are most likely to deliver the best aggregate results.

Currently Gear is budgeting approximately two thirds of the 2019 capital budget towards investing in growth and the remaining one third towards strengthening the balance sheet. As we progress through 2019 and into 2020 and work to convert these forecasts to actuals, we will continue to evaluate all the potential capital allocation strategies. With price improvement, egress expansion, and balance sheet strengthening, there is every possibility that Gear's future strategy will be expanded to include the initiation of a share buy-back program.

Certain information in this monthly update is forward-looking within the meaning of certain securities laws, and is subject to important risks, uncertainties and assumptions. This forward-looking information may include, among other things, estimated production, expected cash flow and profit from certain assets of Gear, expectations of commodity prices and price differentials, demand for oil, capital expenditure budgets and estimates, royalty rates, operating costs, credit/debt requirements, and drilling inventory and locations. Readers should not rely on such forward-looking information to make investment decisions as the results or events anticipated or predicted in such forward-looking information may differ materially from actual results or events as a result of a number of factors including based on the risk factors as set forth in Gear's most recent annual information form (the "**AIF**"), which is available on this website and at www.sedar.com. Gear has based the forward-looking information on a number of assumptions including the assumptions identified in such monthly updates, which may not be realized. It has also assumed that the risk factors discussed in the AIF will not cause such forward-looking information to differ materially from actual results or events. The forward-looking information in this monthly update describes the expectations of management of Gear as of the respective dates of this monthly update and Gear does not assume any obligation to publicly update or revise them to reflect new events or circumstances, except as may be required pursuant to applicable laws. Readers should not rely on the views of management of Gear as set out in this monthly update to make investment decisions with respect to Gear or other companies in the oil and gas industry and should instead consult with their own investment advisors.

This monthly update may include certain key performance indicators to analyze financial and operating performance such as cash flow from operations, cash flow from operations per debt adjusted share, production per day per thousand debt adjusted shares, operating netbacks, corporate netbacks and net debt, which do not have any standardized meaning prescribed by Canadian generally accepted accounting principles ("**GAAP**") and therefore may not be comparable with the calculation of similar measures for other entities. For additional information on these non-GAAP measures, see Gear's most recent management's discussion and analysis which is available on Gear's website at www.gearenergy.com and at www.sedar.com.

Barrel of oil equivalent ("boe") used in the monthly updates have been based on a conversion ratio of 1 barrel of oil to 6 thousand cubic feet of natural gas. A boe may be misleading, particularly if used in isolation, as such conversion ratio is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.