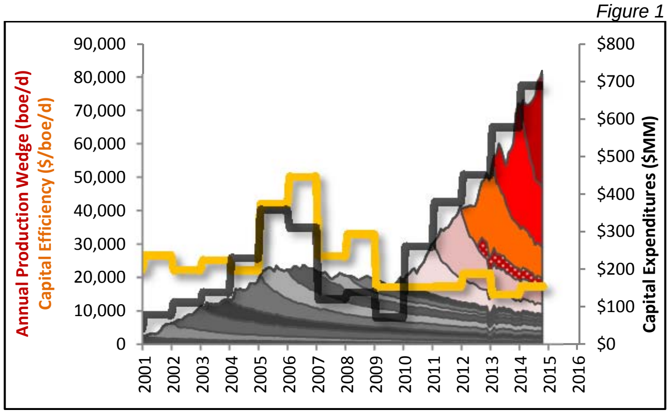
Peyto Exploration & Development Corp.
President's Monthly Report

November 2014 — From the desk of Darren Gee, President & CEO

Geopolitical conspiracy theories abound when it comes to explaining the latest drop in crude oil prices, whereas natural gas prices are at least explainable with the more mundane weather and inventory predictions. A drop in both commodity prices is, however, constructive to Peyto's counter cyclical investment strategy which is designed to take advantage of lower activity levels and lower service costs to deliver higher returns on invested capital. And this is a good time of year to be feeling bullish about the future environment. We're busy putting together our plans for next year, which at this point are looking extremely opportunistic.

Figure 1 shows how aggressive we've been. Deploying $2.3 billion over the last 5 yrs at a time when the cost to add new production (and the returns we can generate on that capital) are some of the best in our history. Personally, a few more years of this would be just fine by me.

Figure 1



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).

Capital Investment*

2013/14 Capital Summary (millions$ CND)*

	Q3	Q4	2013	Q1	Apr	May	Jun	Q2	Jul	Aug	Sep	Q3
Land & Seismic	3	2	11.9	7	1	0	7	8	0	0	0	0
Drilling	86	60	253.0	80	22	22	24	68	28	30	24	83
Completions	54	47	151.7	36	16	14	18	48	17	14	15	46
Tie ins	14	12	48.2	16	4	3	3	10	3	4	4	11
Facilities	24	34	112.2	40	6	4	7	16	11	16	13	40
Total	**181**	**155**	**578**	**179**	**49**	**43**	**60**	**151**	**60**	**63**	**57**	**180**

Production*

2013/14 Production ('000 boe/d)*

	Q3 13	Q4 13	2013	Q1 14	Q2 14	Jul	Aug	Sept	Q3 13	Oct
Sundance	41.5	47.4	**42.6**	49.3	51.6	55.1	58.0	58.3	57.1	59.6
Kakwa	2.6	2.5	**2.9**	2.4	2.4	2.3	2.4	2.4	2.4	2.4
Ansell	9.9	13.9	**10.8**	15.7	14.2	13.2	14.5	15.3	14.3	15.7
Other	2.4	3.6	**3.1**	4.8	3.9	3.5	3.7	4.0	3.7	4.0
Total	**56.5**	**67.3**	**59.3**	**72.3**	**72.1**	**74.1**	**78.6**	**80.0**	**77.5**	**81.7**

This is an estimate based on real field data, not a forecast, and the 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 Outsiders

I've recently finished a book sent to me from a long time Peyto shareholder entitled "The Outsiders" by William Thorndike (no, not the one we all read in school). This one is about "Eight Unconventional CEOs and Their Radically Rational Blueprint for Success". It was apparently #1 on Warren Buffett's 2012 recommended reading list (naturally he endorsed it, since he's in it). In it, the author chronicles the business successes of:

1. Tom Murphy – Capital Cities Broadcasting
2. Henry Singleton – Teledyne
3. Bill Anders – General Dynamics
4. John Malone – TCI
5. Katharine Graham – The Washington Post
6. Bill Stiritz – Ralston Purina
7. Dick Smith – General Cinema
8. Warren Buffett – Birkshire Hathaway

And other than Warren Buffett, most of these are/were not household names. However, what was interesting was how successful all of these eight were at delivering spectacular returns to their shareholders during their tenure as chief.

The common theme that I took away was that in every case, they recognized an opportunity to buy or transform a low margin business and turn it into a high margin business. Then they did it again and again, usually by being incredibly frugal. And when the market didn't reward them for what they'd done or could do, they invested in their own stock as a way to compound the returns they were confident they could create.

As an interesting aside, there was little credit afforded to all the people that worked for these CEOs. As if it was the top guy that was really doing all the work to convert those low margin businesses into high margin ones. Obviously that was and is never the case.

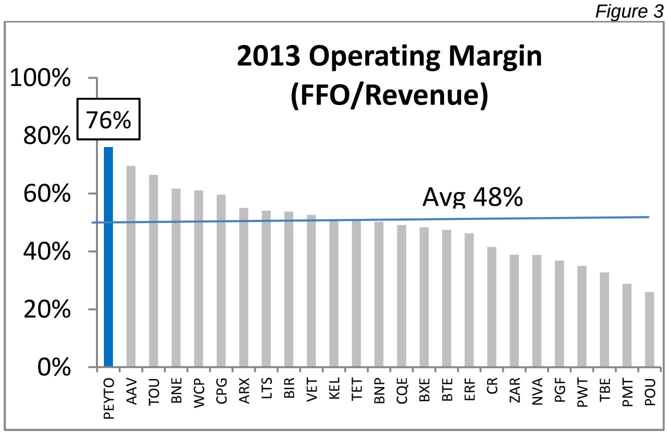
I found it interesting to compare those results to our own and contrast their business decisions to how we run Peyto. By comparison we have delivered returns to our shareholders that rival those depicted in Thorndike's review (Figure 2):

Figure 2

	CAGR	time (yrs)	S&P/TSX over same time	Index over same time	Value of $1 invested	Value of $1 in S&P/TSX
Tom Murphy – Capital Cities Broadcasting	19.9%	29	10.1%	13.2%	$ 204	$ 16
Henry Singleton – Teledyne	20.4%	33	8.0%	11.6%	$ 181	$ 13
Bill Anders – General Dynamics	23.3%	17	8.9%	17.6%	$ 30	$ 6
John Malone – TCI	30.3%	26	14.3%	20.4%	$ 933	$ 22
Katharine Graham – The Washington Post	22.3%	23	7.4%	12.4%	$ 89	$ 14
Bill Stiritz – Ralston Purina	20.0%	19	14.7%	17.7%	$ 57	$ 14
Dick Smith – General Cinema	16.1%	44	9.0%		$ 684	$ 43
Warren Buffett – Birkshire Hathaway	20.7%	47	9.3%		$ 6,265	$ 62
Peyto (Oct/1998 to Oct/2014)	**49.7%**	**16**	**6.0%**	**11.0%**	$ 637	$ 3

It was also interesting that all of these companies were acquisition focused, buying low margin businesses and making them high margin. As opposed to Peyto, that *builds* a high margin business from scratch – from our internally generated ideas. Figure 3 below illustrates how Peyto's business is much higher margin, at 76%, than the average in our industry, at 48%.

Figure 3



Source: Peyto, Company Financials

But just like all those CEOs, Peyto follows the same basic business principles which were boiled down to this:

- *Always do the math and invest for maximum risked return. Every company says it, but most rarely do it.*
- *The denominator matters. Maximize value creation per share.*
- *Have a feisty independence. Minimal advisory input.*
- *Charisma is overrated. Results are what matter.*
- *Have a crocodile-like temperament. Wait patiently for the right opportunities.*
- *With occasional bold action, when the time is right…*
- *Take a rational, analytical approach to all decisions.*
- *And a long term perspective. Ignore the noise on the street (Wall/Bay).*

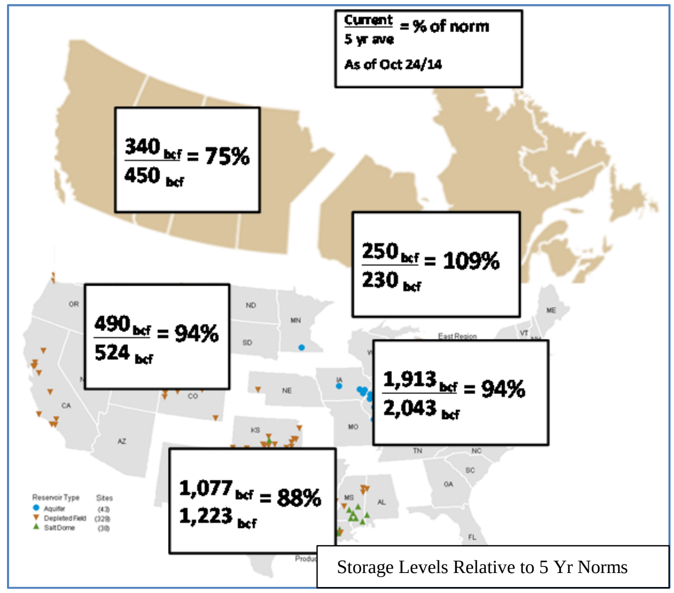
Ultimately, I believe Peyto's competitive advantage comes from the same place as many of these firms. We practice "radical rationality", and we (all of us at Peyto) take the approach of long-term investors and owners.

There was one simple quote in the book that I particularly liked, by David Wargo of Putnam Investments, which I believe epitomizes Peyto in every way.

> *"It's remarkable how much value can be created by a small group of really talented people."*

That's our entire team in a nutshell, which by no means starts and ends with an unconventional CEO.

Activity Levels and Commodity Prices



Source: Nexen, EIA *Figure 4*

How come it's traditionally the coldest place in North America that is the least prepared for winter when it comes to natural gas storage levels? You'd think it would be the reverse. Figure 4 above shows the volumes relative to the 5 year norms for the major gas storage basins in North America and clearly, going into winter, Western Canada is behind. We should be at 450 BCF and we're only at 340 BCF (as of Oct 21/14).

As a consumer, I suppose I don't need to be concerned. When the gas originates from here, I'm pretty sure I'll get my fill before the remainder will carry on either down east or down south. If we have a very cold winter, however, which is what the almanac is calling for, I'm not sure there will be much extra to ship out. I do recall last winter when the call for gas was so strong that on one day the Alberta price traded as high as \$24/GJ! I wouldn't count that out just yet.

Remember, the above levels are percentages relative to the norms. So in only one case are we at or above where we "usually" are. It's surprising then that natural gas prices are so weak considering that we really are behind in terms of normal storage fill up. Such an amazing confidence in supply seems foolhardy.

Interestingly, we always gauge these levels relative to the 5 year average. But with permanently increased demand, our "usual" is growing every year. Maybe we should just be comparing to this time last year as a more recent gauge of demand?