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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Investing in Oil Service & Equipment Providers

L. FARRELL CRANE, JR. is a Managing Director of Energy Opportunities Capital Management, LLC, and a Portfolio Manager and Director of Research at Orleans Capital Management Corporation. Farrell has more than 11 years of investment management experience managing both fixed income and equity allocations, and has served as the portfolio manager of the firm's Energy Opportunities strategies since their inception in 2000. The Energy Opportunities strategy has received a number of professional accolades, including spending 8 consecutive quarters as a Pension & Investments magazine's Top 10 Equity Manager and most recently being named a Top Gun Manager by PSN in their All Cap Growth, All Cap, and US Growth Universes. Before joining Orleans Capital, Farrell spent 13 years as a corporate lawyer, managing financial restructurings of both publicly and privately held institutions and developing an extensive background in the review and analysis of securities. He was formerly a partner with Kirkendall & Isgur, LLP, and Of Counsel with Fulbright & Jaworski, LLP, in Houston, Texas. Farrell holds a Bachelor's degree in Economics from Austin College and a J.D. from the University of Texas.

SECTOR — GENERAL INVESTING

TWST: Would you give us a bit of background on Energy Opportunities Capital Management, including its history and your role there?

Mr. Crane: Energy Opportunities has grown out of the relationship that began in 2000 between Orleans Capital Management, a registered investment advisor, and Simmons & Company International, a premiere energy investment banking and research firm in Houston, Texas. The strategy really started as an investment idea between Louis Crane — the Chairman of Orleans Capital — and the late Matt Simmons — who was the Founder of Simmons & Company. The idea focused on an investment opportunity created by an intransigent set of supply and demand fundamentals that began to emerge in late 1990s and 2000, primarily driven by exceptional demand growth from the developing economies of the world and supply challenges that we thought the world would face going forward.

Our thought was to create an investment product that would capitalize on that set of dynamics. Early on, very few agreed with our hypothesis that energy supply would be challenged going forward and would require increasing levels of capital spending. But that has now become more of a consensus view given the facts that have emerged in terms of supply and demand. Originally the strategy was managed by Orleans Capital with Simmons & Company acting as a research provider and subadvisor. I've been the Portfolio Manager on the strategy since its inception in October 2000. In 2008, Simmons and Orleans decided to form Energy Opportunities Capital as a standalone registered investment advisor to take that strategy forward. One of the benefits of that was to have Scott Gill, formerly the Co-Head of Research at Simmons, come from Simmons over to Energy Opportunities to serve as Co-Portfolio Manager on the strategy.

TWST: Last year you said your investment strategy focuses on oil service and equipment providers as opposed to large integrated companies like BP. Why do you think the oil service and equipment providers are the best ways to play the sector?

Mr. Crane: I think a couple of things. First is that our strategy starts with a focus on the evolving global supply and demand dynamics, and the corresponding reality that global economic growth must be coupled with a corresponding increase in energy demand growth. At the same time, the world is facing a growing number of supply challenges. Not necessarily that the world has reached peak oil, but that the era of cheap, easy-to-access oil is over. These dynamics create a pressing need for significant increases in global capital expenditures by the world's exploration and production companies in an effort to meet the supply and demand challenges.

Our strategy is designed to focus on the sector and companies within the energy industry that are the beneficiaries of that capital spending. These are primarily companies within the oil service sector who have an opportunity to enjoy both volume and pricing growth as global capital expenditures increase. At the same time, the fundamental outlook for the large integrated majors is markedly different. If you look at the data over the last few years, these companies have significantly increased capital spending, but have frankly not been able, despite that spending, to increase production. There are some additional challenges related to the access to reserves that impact the integrated oil companies as well, but the underlying challenge of increasing costs and declining production differentiates them from the oil service sector. So within the energy space, we see the outlook for the oil service group as much more compelling.

TWST: In your Web site, you wrote most investors are underweight in energy. Why is that, and why do you think they may be making a mistake?

Mr. Crane: Simmons has historically prepared an analysis using the 13F filings of the institutional investment community to assess where institutional ownership of energy stands versus its weighting within the S&P 500. It's very interesting to look at the data because prior to 2005, institutional ownership was very close to the weighting of energy as a percentage of the S&P 500. During 2005, institutional ownership began to come down to a level that was meaningfully underweight and has remained underweight since then. What's interesting is that the underlying fundamentals for the energy sector since 2005 have remained strong and the energy sector has been by far the best-performing sector since 2005.

I'm not sure I can answer the question as to why the institutional investment community has underweighted energy during this period of significant outperformance, but my guess would be that the institutional community still sees energy as a highly cyclical investment that must be managed by adherence to an aging set of valuation metrics. And after the energy sector produced superior returns in the 2004-2005 period, investors reduced their positions thinking that the cycle had run its course. So I suppose it was driven by looking at the charts and the technicals instead of digging into the underlying supply and demand fundamentals. Our view is that the energy sector has lost the historic hypercyclicality seen in prior periods, given the intransigent supply and demand fundamentals. Finally, I think it is difficult for investors to think outside their own experiences. The energy story is simply an outcome of a generational shift in economic power from the developed countries of the world toward the emerging economies, which means some of the old paradigms that are applied to energy investing are no longer valid.

Highlights

Farrell Crane discusses Energy Opportunities Capital Management's investment thesis and strategy. Mr. Crane says global energy supply will grow slower than demand, and he focuses on oil service and equipment providers. Mr. Crane begins his stock-selection process with a top-down macroeconomic analysis, and he selects companies in line with the key investment themes in the sector. When selecting the individual stocks, he uses a bottom-up traditional, qualitative assessment of the companies' fundamentals, and he pays special attention to metrics like asset makeup, revenue, earnings growth and valuation metrics.

Companies include: BP plc (BP) and National Oilwell Varco (NOV).

TWST: What macro factors are creating opportunities for energy investors right now?

Mr. Crane: Well, our investment approach is very macro-oriented, and is focused on the opportunities created by the global supply and demand situation. The primary investment opportunity lies in the desperate need for increasing levels of capital spending to meet these supply and demand challenges, and in particular, accelerating decline rates which have put us on what we call a capital spending treadmill — the world spends more and more on exploration and production but doesn't get supply growth. By way of example, if you look at the capital spending of the five largest integrated oil companies over the last six or seven years, we've seen roughly a doubling in capital expenditures and yet a decline in their oil production by as much as 10%. So what we're seeing is that it costs a lot more money and is a lot more difficult now to maintain supply and grow supply. So the best opportunities today are based upon that set of supply and demand fundamentals and the growth in capital spending around the world.

TWST: Would you walk us through your stock-selection process?

Mr. Crane: We are very fundamental, qualitative investors, and unlike folks who manage energy within a broad market portfolio, we have the luxury of really focusing on the fundamental drivers of our thesis and on a much smaller universe of names. Our process starts with a top-down macroeconomic analysis focused on energy supply and demand fundamentals and the related implications to the various segments of the upstream energy business. That analysis leads us to our thematic investment allocations within the various subsectors within the energy industry, such as oil service. We then look to identify the superior investable themes within those sectors, which may be defined geographically or by the underlying nature of the particular business — including, for example, North American services, international services, deepwater equipment providers and energy infrastructure companies. So our top-down analysis defines and identifies those themes and sectors that we believe will be outperformers over the midterm and longer term. After making thematic allocation decisions, we then employ a fundamental, bottom-up

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analysis looking closely at the various companies that participate in those favored sectors. Security selection is then driven by a traditional, qualitative assessment about which companies we think will add superior value, focusing on metrics like asset makeup, management team, as well as traditional assessments of revenue and earnings growth and valuation metrics.

TWST: Would you give us a few examples of some of your top holdings that are representative of your investment approach and embody the characteristics you look for in a stock?

Mr. Crane: Today, one of our largest holdings is **National Oilwell Varco** (NOV), a capital equipment provider to the energy industry. It's a company we've had in the portfolio for a long time and has been an exceptional performer. One of the things we've liked about **NOV** is a steady increase in the construction of new, higher-spec rigs and equipment. So if you start with a macro view that the supply and demand fundamentals will create a need for an expansion of deepwater drilling and an increase in the number of deepwater rigs, particularly those that can drill in more difficult environments, it leads you to look at those companies that produce and supply the equipment necessary for that effort. And in fact, there have been a number of announcements regarding the construction of new deepwater drilling rigs. **NOV** is the dominant provider of specialized equipment used on deepwater and other drilling rigs. All of that leads us to consider the underlying fundamentals of the company, and it's a company we want to own as a significant part of our portfolio.

1-Year Daily Chart of National Oilwell Varco

Chart provided by www.BigCharts.com

In addition, we have recently been adding to companies that fall within the North American services segment, service and equipment providers that are involved in North American natural gas and oil exploration. Over the last year or so, the exploration and production companies have begun to apply the technologies and techniques that were successful in advancing natural gas shale exploration and production to efforts for producing oil from oil shales. So we've seen expansion in oil-directed horizontal drilling in the Bakken, the Eagle Ford and a number of other areas around the United States directed at oil production, which has caused us to look for companies that have specialized products and services related and necessary to oil-directed drilling in these various shale plays.

TWST: What are the risks to investing in energy right now — particularly the sectors you focus on — and what's your risk-management strategy?

Mr. Crane: I think for us the primary risk to our strategy does not lie within the fundamentals of supply and demand, as we don't expect a significant risk on the supply side. We do believe that the era of cheap, easy-to-access oil is over, and so it is becoming increasingly difficult for the world to grow oil production to meet global demands. So the real risk to our thesis is a demand-driven event caused by a global macroeconomic downturn. So systemic concerns about the global macroeconomic growth story pose the primary risk to our thesis, which is the same risk that applies to all equities. But I do think one of the things that investors get wrong is a very U.S.-centric focus when considering energy fundamentals, given that virtually all of the increase in global energy demand now comes from the developing nations and economies.

TWST: What differentiates your firm from other managers who also focus on energy?

Mr. Crane: A couple of things come to mind. First, we have a unique team of people that come from different backgrounds and bring some unique ways of looking at the investment world. I came to the investment business from practicing law and bring an aspect of critical analysis with respect to our fundamental investment process, all the way from the macro picture down to company-specific levels. In addition, Scott Gill comes not only from having been the Co-Head of Simmons' research team for a number of years, but also having worked in the energy industry for a number of years before that. So I think this combination helps us make good investment decisions on a very common sense level, as opposed to being caught up in a multitude of quantitative data points. Scott also brings with him a number of relationships with company management that he has developed over the years, which give us a unique capacity to generate internal proprietary research that is additive in terms of understanding the company level dynamics. We are passionate students of the world of energy and we rely on a much more fundamental, qualitative analysis than others managers. We're very interested in understanding the macro picture, understanding the themes that we invest in and understanding the details of companies that we invest in on a fundamental basis.

TWST: Thank you. (MES)

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