

Contrarian Investments in the Energy Market

At Hotchkis & Wiley, we focus on finding securities we believe are trading at substantial discounts to their intrinsic value. When investor sentiment, emotions, or short term trends cause a security to deviate from its intrinsic worth, we see opportunity. Listen in to a recent conference call featuring Portfolio Managers Stan Majcher and Hunter Doble.



[▶ Full Presentation](#)

Transcript (Excerpt)

Operator: Greetings and welcome to the Hotchkis & Wiley Contrarian Investments in the Energy Market Conference Call. At this time, all participants are in a listen-only mode. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded. I'd now like to turn the conference over to your host, Mr. Christopher Roller. Thank you. You may begin.

Chris Roller: Thank you, Operator, and thank you to all of those who dialed-in today to join us on the Hotchkis & Wiley Contrarian Investments in the Energy webinar call. We appreciate your willingness to spend time learning more about our investment perspective surrounding current energy markets. The goal of today's call is to share our thesis surrounding energy, and the companies whose earnings are correlated to the underlying price of oil. The catalyst for this discussion is our firm's investment in both the equity and debt of oil exploration, production, and service companies. We hope today's call will create a transparency to our outlook on energy, and that our clients will gain a more in-depth understanding of our point of view.

Joining us today is Stan Majcher, our Portfolio Manager for the Mid-Cap Value Strategy and our Hedged Value Strategy. Also, joining the call is Hunter Doble, our Portfolio Manager for our Hedged Value Strategy and member of our Investment Team. As some of you might recall, we initiated a more interactive format on our most recent call in February. As a continuation of this enhanced call structure today, Hunter will interview Stan on a variety of issues related to the energy markets. Stan and Hunter will also touch on some of the recent questions we've heard from our clients, advisors, and consultants, over the recent weeks and months. Our hope is that this exchange of ideas and perspectives will lead to a productive call for our clients. At this point, I'll turn the conversation over to Stan.

Stan Majcher: Great. Thanks Chris. Energy is a very complicated area. On this call, we are trying to simplify a lot of the areas where we think are the greatest misunderstandings about the energy market and explain why we think it's actually a very attractive area to invest. Obviously, given the complex nature of the energy markets, we're not going to cover everything. We're not going to go into detail about all the facets of the energy market in terms of supply and demand, inventories, etc. There is a lot of areas to go into but what we're trying to do is simplify the areas we thought were the biggest misunderstandings and point out the opportunity for investing in the area.

Hunter Doble: That's great, Stan. Thanks. This is Hunter Doble. With that introduction, I thought we could start by providing some context for the valuation opportunity that exists in the energy sector.

Stan: Great. When you think about Hotchkis & Wiley, we're obviously value investors. We try to find areas that are out of favor and complicated, because in general what you'll find is that they are misunderstood and provide opportunities. I started at the firm 20 years ago covering energy, and what's interesting is people take a shorter and shorter time horizon to look at very complicated areas. They try to overly simplify things and make blanket judgements about the complex areas.

In general, energy is a capital-intensive business. It's a commodity business. When things are great, you really don't want to invest in commodity businesses because they tend to get over-supplied. Not too long ago, we were talking to our investors about why \$100 oil was unsustainable. It largely fell on deaf ears because people believed China was growing so rapidly that oil supply could never keep up with demand. Lo and behold, the returns became great enough that it became oversupplied. Today is the reverse. As you see on [Page 1](#), energy has been the worst performing sector over the last three years. We like to take a look at areas that have underperformed. If you look on [Page 2](#), the time to buy a capital-intensive commodity business is when it is out of favor, but it is important that you get the right valuations. If you look at price-to-book which is a good measure of the attractiveness of asset-intensive businesses, you will find that energy is one of the most inexpensive areas of the market on a price-to-book basis today as well as relative to its history over the last 20 years. It's at a significant discount, while other parts of the market are actually at pretty high valuation premiums. So, in an expensive market, energy is one of the few places that is very out of favor, trading at a reasonable multiple.

Hunter: It clearly it looks like that Stan, thanks. Obviously, these slides point out the attraction that the sector's valuation has at the moment, but every time I turn on the TV or open the journal, all I hear or read about is the pessimistic outlook for crude oil prices and that the world is awash in the commodity and, in the near term at least, the markets are going to remain loose and prices will decline. So, can you talk a little bit about supply and demand and your outlook on supply/demand for crude?

Stan: Sure. So, on [Page 3](#) we try to paint the bear picture, which is the consensus picture for supply and demand, and point out why someone would be bearish on the commodity. In general, someone would be bearish because prices have dropped fairly significantly. Oil used to average around a \$100, today it is less than \$50. So, prices are half what they were not too long ago.

The consensus outlook isn't that great. When you look at why someone would be bearish, they point to OPEC being ineffective. They have cut production but inventories really haven't cleared much. The U.S. is poised to grow very rapidly; the rest of the world really hasn't declined and while demand is growing actually fairly significantly, we could still end up with an oversupplied market in 2018.

What we'd like to point out as a counter to all of this is that those are all point estimates. People take what they think of as their best guess as where things will be and they put that into their supply/demand model, and really there is a distribution around those assumptions. We think that distribution is actually skewed lower for each of those areas. When we think about what could happen, what is likely to happen, we think about all of those three groups that we've segregated on Page 3 could be too high in terms of supply.

Each have their own risks to supply not being as robust. When you add those all up and look at how significantly over-supplied the market is, it's really not wildly oversupplied. It's 0.7% of the market oversupplied. So, if things as we believe are skewed to the downside, you can have a significantly undersupplied market instead of what the market is expecting as a slightly oversupplied market.

We break the market into three groups: OPEC which in this case on this chart will include the natural gas liquids, the U.S. and the rest of the world.

In the case of OPEC, they ramped up production at the end of the year and then they cut from those very high levels. In general, in consensus models, people have OPEC cuts expiring in March and then coming back to where they were producing at the end of last year. We think there are some risks around that scenario. One, that's higher than they've produced on an annual level. Producing on an annual level is much more difficult to do than producing for a very short period of time. Additionally, they're not spending a lot of capital on their own capacity. So, there are risks that they won't be able to fully come back to where they were, and keep in mind that these geographies are also politically very risky. When you look at these countries, they're really not on a fiscal basis earning money. They're burning cash. OPEC is comprised of countries like Venezuela, Angola, Nigeria, Algeria, and in the Middle East, Iraq, Iran, Saudi Arabia, all of which have their own risks and they're not generating a lot of cash today. We think of those countries as, while it might be economic to add a new well, there is not a lot of capital there to actually increase capacity and when you do, it takes a long period of time for that capacity to come on stream.

The U.S. would be the second area where we think there are some risks on supply. It is generally predicted that the U.S. will grow rapidly and it has grown very rapidly in the past. It is easier today to grow rapidly than we think it normally is: One, the decline rates have shallowed out because there was a recent production decline. As you go forward, the decline rates become more significant. Additionally, we think what happened this year was that companies spent money to grow because they were expecting \$55 crude oil in combination with low oil service and drilling costs similar to 2016 when oil prices were in the low \$40s. What they've got in 2017 is actually a price in the low \$40s but the oil service and drilling costs have increased fairly dramatically and we think that this is putting a pretty negative hit to their cash flows and that will become even more significant in 2018 as their hedges roll off.

Lastly, for the rest of the world, the rig count has dropped fairly precipitously. Eventually that production will start rolling over. We think all three of these groups if they have a minor change to assumptions, could see significantly lower output than people expect.

Hunter: So Stan you said, analysts are using a point in time estimate. It represents the consensus view which you could include in a category of being a bearish view about supply and demand. I'm curious, when you look at inventory levels and then changes in inventory levels, let's say the last few months, is this dynamic in fact playing out in the daily consumption or inventory figures. Can you talk about the inventory situation, how do you think that compares to our view?

Stan: Sure. When you think about inventory simplistically, if you demand more than you supply, inventory should decline. If supply is more significant than demand, your inventories increase. We look at inventories to judge how accurate is the supply/demand model. When you look at 2016, inventories were relatively flat which would indicate that most people's supply and demand models were overly conservative in assuming that supply was actually greater than demand. Year-to-date, we've actually seen some declines. They've actually accelerated recently to where it looks like in 2017 we're actually under-supplied relative to history, which makes sense given the OPEC cuts.

We started the year with inventories growing which led people to conclude that the market was over-supplied. We would argue that there were some timing issues as well as shifting inventories geographically in that. So, when we look at inventories or any indicators of supply and demand, we think the market is actually tighter than most people think.

As an aside one other area of misconception related to inventory we would point to is that the U.S. on a weekly basis, there is the number that is distributed by the EIA in the United States for U.S. production. We would highlight that that is not the actual weekly production. It's not a sample of wells in the United States. It's an econometric model based on a number of factors that they believe are correlated with what production should be. When the monthly numbers of actual production, which are surveys from producers, come out, they've generally shown recently that those weekly numbers are overstated. So, we think that that might be a contributing factor as to why the supply/demand models might be more favorable than they look.

Hunter: Can you talk about the three different sources of supply OPEC, U.S., Rest of World, highlighting the fact that each of these has perhaps some risk to the forecast and at the end pick the distribution around how they may skew to the downside? Can you go into that a little bit next?

Stan: Sure. On [Page 4](#), we show why it has taken longer than we would have expected for the market to clear. We've seen a lot of what we call one-time increases. Generally, when you think about capacity additions, they happen when capital is spent and then production comes on. It varies in time with the shortest lead time being the United States. Projects take longer as you go internationally. Some players also had excess capacity that was brought into the market. For example, when you think about Saudi Arabia historically, they've held back production. They've put that production on the market. They really can only do that once. The same is true of Iran which had political sanctions that went away. They've brought their excess capacity on the market. Libya, has seen a reduction in the risk around their geopolitics which allowed them to flow more barrels, and then Iraq is somewhat a hybrid of both. They had some infrastructure

issues that cleared as well as a lot of the capacity that was added post the war which increased production. So, we think that that these one-time additions have delayed the rebalancing of the market.

The U.S. supply has been less of an impediment. Everywhere else is actually slightly lower than the ending supply which is actually a slight oversupply. If you look at those one-time issues and take them out, thinking that they will most likely not happen again going forward, we think that the market actually clears in a relatively balanced approach in the future.

If you turn to [Page 5](#), we talk about OPEC. We show where they ramp up to. You can see how much they ramped up right before the cut. In general, cuts can be a political issue. We think that they ramped up to cut from a higher base. We think most consensus observers that model supply/demand take production back to the peak, assuming that OPEC will come all of the way back. As I mentioned before, there are some risks around that actually happening, whether they can sustain those rates for long periods of time.

On [Page 6](#), we show a couple of anecdotes about the non-U.S. or non-Shale parts of North America and internationally. On the top, is the rig count in the U.S. Gulf of Mexico. Development wells and explorations wells have declined fairly dramatically. So, what you've seen is the U.S. Gulf of Mexico has been growing and that should slow down as those projects have come on stream. It takes a number of years for those projects to come on stream. Internationally, we've seen the rig count drop fairly dramatically. Again, those are long lead time projects that have come on stream and are coming on stream still, but as time goes by if you don't replenish those, you'll eventually see declines internationally. And then lastly, projected oil sands growth, again, capital was spent when oil prices were at the \$100 a barrel. That is coming on stream. Eventually that slows down.

On [Page 7](#), the part that really no one tries to predict and people will generally carry forward what is going on in the current market is disruptions to supply. We did see a number of disruptions in 2016 going back to what we would consider more normal levels. Now those are relatively low. Libya is back on stream. Nigeria has brought crude oil back on stream. But in general, what you will find is that either geopolitical disturbances or national disasters can lead this up and that helps the supply/demand balance.

Hunter: Yes, that's very interesting. I wanted to ask a question about U.S. shale production. That's obviously a key element of the bear case around the price of crude oil today. It's certainly a place where there's been a big increase in drilling activity. You read a lot about improving efficiency in new technology making shale economic at low prices and that this unique improvement in technology and efficiency will allow the U.S. to meet world demand for many years. What do you think about those claims and how can the price of oil climb meaningfully in the face of rapidly growing production from U.S. shale?

Stan: We think one of the most misunderstood parts of the energy market is the real efficiency gains in shale or unconventional U.S. production. We see on a daily basis news articles, research reports, highlighting how productive the U.S. has become and we do believe that there have been efficiencies but we think they're misunderstood. We think in a lot of cases, the wells have become bigger and more complex and part of the reason for that is, in a falling cost environment,

you can use more physical inputs and they won't cost as much as they did. Now, we believe a lot of those physical inputs were at prices that were cyclically depressed and as the price goes back up, the economics actually deteriorate, which make it more difficult for producers to add a lot of capacity.

We do think the U.S. can grow but what's important is they need the returns and the cash flow to do it and we don't think that at the current commodity prices that that's sustainable. One analogy that I would give on wells becoming bigger and more complex. It's not an easy idea to grasp for some people that aren't familiar with energy. The way I would describe it is, a well is building something below ground. If you use the analogy of building something above ground, it might be easier to understand. If you thought about building a two-story building and you did it on a piece of property; it has one front door, one parcel of land for a two-story building. If the construction materials were to fall precipitately in price, you could build a larger building on a similar piece of land and you'd still have one front door. But going from a two-story building to a four-story building, if prices fell in half, they would both cost about the same amount. This is economically more efficient but there is not much physical efficiency.

If you think about the analogy with an oil well, you're doing the same thing. More stories were added but it's not costing you as much because prices fell. If those construction materials go back up in price because they were cyclically depressed, there is really not a lot of economic efficiency that you've gained. So, we do think physically the wells have become more efficient, that operators have become more efficient, but we think a much, much larger component is cyclically depressed oil service and drilling costs and we show on Page 10, we start to walkthrough what is commonly believed and then really how we view things.

So, this is the most common chart that we see which is on [Page 9](#). This shows oil production per rig. We don't think this a great way to look at it. So, a rig will drill a well. Drilling is generally not a very large piece of the well cost and what you do see is more production per rig. People assume that this is just going to keep getting better and better over time. What we would say ask is if companies are drilling larger and larger wells, "what are the economics?" "Are these wells getting better economically and is it sustainable?" We think it's not necessarily indicative of the economics looking at how much is coming out per rig or per well. We think what makes more sense is to look at: where should well cost normalize and can they generate a return.

So why has efficiency improved per rig or per well? One, as the rig count drops you high grade, you move closer to the core or best acreage. You're using a better rig, a rig that drills faster with a better crew, on better geology. If you drill in the core of a play versus the periphery, you're going to get better results. As the rig count moves towards better plays as the rig count drops, you're drilling your best prospects with the best rigs with the best equipment. As that rig count rises, you should see some productivity actually decline.

On [Page 11](#), we also like to point out what a company showed the improvements they've had in their recent wells as recently as 2015 going into 2016, 2017, and the new version of the wells. We think it's indicative of what's been going on in the industry. So, production has improved about 22%.

When you think about that per well or a per rig number, it is improving. You're getting more production out per well and the cost really hasn't gone up much, this shows costs going up 6%. So, we would say that is actually economically efficient. The question we would have is: are those costs sustainable? We think that there are some other data points that provide indications that they may not be. What we did was anything better than 22%, we put in green which means more efficient, anything worse than the 22% as a part of the well we show as red. If you look at that performance, the lateral length, the distance drilled horizontally went up 12%. So, you're still getting some benefit in the well versus production. The amount of proppant or sand use is similar. So, we think proppant and fluid usage which they used 39% more fluids to frac the well. The number of stages which is how closely you will break apart the horizontal drilling has gone up dramatically, 68%. The number of clusters which is the amount of perforations within the well, 124%.

So, when you look at all of those things we believe, if your cost weren't falling because of cyclically depressed costs, we think a well like this normally would cost more than just 6%. So, we are not sure of the efficiency gains from a capital perspective are sustainable.

If you go to [Page 12](#), we actually took a typical well and tried to break it into its various parts. We looked at how much is being consumed in wells today versus history and changes to prices. We think in 2014, drilling that same well would drop about 34% in cost in 2016. That creates higher returns. So, when you think about companies that have said, "we used to earn a return at \$70 or \$80, today we only need \$40." We think a significant piece of that is because service costs have declined. We've heard anecdotal comments. When we go through our thesis with a number of companies, we do about 100 management meetings a year, and we've had companies respond back who are in the service business and they say, "companies would tell us pump more sand, use more pressure pumping, pump more fluid because the costs were so low, why not." In other words, higher oil prices will be needed to offset these costs if the U.S. wants to grow rapidly.

Hunter: Stan, what gives you confidence then that these costs will have to go up? Obviously, it fell when people's utilization of the industry declined during the price declines of about a year and a half ago but what will necessarily give you the confidence that these increases then have to come back up?

Stan: When you look at what's been going on in the U.S. drilling and completion market, there are a lot of rigs. We have plenty of rigs. People just assume that since we have plenty of rigs, we have plenty of completion equipment, etc. But, these wells are getting so big and completion intensive. While rig usage is nowhere near the peak, in 2018, we should be through the peak for a lot of other things like sand, fluid, pressure pumping, etc. The issue has been that the oil service companies, when prices dropped so precipitously with such a large drop in volume, they weren't making any money. We think in most cases they're really not earning enough money to add the amount of equipment needed to grow production. So, when you think about it, if in 2013, 2014, you were using less than you will be in 2018 or 2019, but there is less equipment available, particularly for that completion end to frac the well. The industry is going to need more equipment and if there is not an economic incentive for oil service companies to add that profitably, they're unlikely to do it.

Hunter: So you're saying that today the returns that the service companies earn are inadequate for them to justify investment in more capacity?

Stan: Exactly. So, we think you need higher returns and higher prices. On [Page 13](#), we show that the returns actually aren't that great for the E&P companies at the current commodity prices. So, what we did is we showed what is commonly referenced in the media or sell-side reports, the returns that companies make. In general companies will say "we earn 40% to 120% returns on our wells at these very low commodity prices." Those returns generally don't include the cost of the land and the mineral rights, the transportation costs, corporate overhead, taxes, anything that you would typically associate with a capital-intensive business. If you exclude all of those things you can get really theoretically high rates of return. In some sense, it is an incremental return but it's really, you've taken a lot of the capital out that which overstates returns.

When you look at the ROEs of these businesses, they do not compare to these high stated returns. We think in some cases, in a lot of cases actually, the ROEs are a bit understated for reasons that are a little more difficult to go into. But in general, what we see is, in order to grow rapidly, what you need is high levels of profitability not only from the oil service companies to incentivize them to add the capacity that is needed to rapidly grow U.S. production. but, you also need greater returns and greater cash flows to the E&P companies themselves. We don't think that because their stated well economics are purported to be good that it is enough to generate the returns and the cash flow that they need to actually grow rapidly.

Hunter: So your feeling is that given how low the ROEs of these companies are and the high expectations that people have for growth that unless people lent them more money or they had access to additional capital, they don't have enough ability to retain earnings on their own to grow production as quickly as is assumed by many.

Stan: Yes. We think that they could have grown rapidly if oil prices were higher and/or oil service costs stayed very low. So, the budgets made sense at the beginning of the year. If you're expecting \$55 oil and you're expecting depressed service costs, you can generate pretty good returns. But that combination is probably unsustainable. We don't think that returns were high enough to be significantly above the cost of capital on a corporate basis to grow rapidly in the longer term. But, what the companies ended up with is \$45 oil, hedges have helped them somewhat, but their oil service costs have gone up fairly dramatically. So, we think what we're going to see is companies being forced to pull back on their growth in the U.S.

If you go to [Page 14](#), we show some other qualitative issues that could prevent the U.S. from growing as rapidly as what many think. One, the ROEs are low, the cash flow isn't high. Again, going back to expanding outside of the core, you have to overcome some areas where you might have diminishing returns. So, you have to drill on lower quality acreage as you move out of the core and your next crew or frac spread or rig should be less efficient than the last. The more wells you drill in an area, take the Permian for example, wells are being drilled, there in some cases you drill one well to show how much you can get out of the acreage and then you try to sell it to somebody else. The ability to produce diminishes as you try to develop on a bigger scale an area because there will be interference between wells so you're forced to shut-in wells. As well as, if you frac a well too close to another you can cause interference and the production from both can suffer.

Additionally, in a downturn, you end up with excess infrastructure. If you're growing rapidly, which the Permian is expected to do, you're actually going to have to add greenfield infrastructure. So greenfield is much more expensive than using existing infrastructure in the area. Additionally, given that the quality of crude oil in the Permian is very light and sweet and that's generally not what U.S. refiners need. They're generally set up for a lower quality crude. So, you really have to export it. So those export costs can rise and again, you need more service capacity to handle the amount of activity that producers are expecting.

Hunter: Stan from an industry perspective, obviously the energy sector is a very competitive industry, whether you're talking about service companies or producers, could you talk about how you think the industry's cost curve affects the potential returns of the various players and then how that filters into investment decisions in the sector?

Stan: If you think about a normalized market, where supply and demand eventually get back in balance, the advantaged producer should earn at least their cost of capital if not more. So, we think when the market balances, advantaged producers should be able to earn superior rates of return. We focus on areas where the company should generate high rates of return. So, if you think about it, the U.S. unconventional is a very small piece of the world production. So, it's roughly 5 million barrels a day on close to a 100-million-barrel market. So, you're talking about 5%. So, adding a million barrels a day means that you have to grow at 20% or so a year.

In order to do that, you need high rates of return and so we think the U.S. is advantaged in that it can bring on oil wells relatively quickly. But, they should be generating high rates of return to do that. We think more marginal areas, disadvantaged producers, should see low rates of return which should cause their production to eventually decline, given that they are a very large part of the world market outside of OPEC and U.S. unconventional. That should provide a lot of ability for U.S. producers to grow at high rates of return.

Lastly on [Page 16](#), in summary, we think that the supply/demand balance is better than people expect. We think that there is risks to the downside for supply if you take more than just point estimates. If you look at the distribution, of how things are likely to unfold, we think in some of the worst-case scenarios, it lasts for a year but as time goes by economics should work out.

We think the economics of U.S. shale are misunderstood. We don't think that they can grow at high rates of return at the current commodity price level.

We think there are a lot of opportunities to invest in companies where they can take advantage of the downturn. They have good assets that should earn high rates of return as the market normalizes.

We also believe that adding capacity in the U.S. won't be economic unless these returns do normalize. OPEC cuts should expire, but once they do we think the globe will be really producing full out and we will be exposed to any supply shocks if they happen. Typically, they do. So we do take a long-term approach looking at the market and we think the next five years looks very good for supply and demand even though there are some questions on 2018.

Hunter: Yes, just one question on that. We have talked a lot about supply but how about demand? We hear a lot of increasing adoption of electric cars or hybrid vehicles, more efficient automobile fleets, industrial users becoming more efficient, how has demand held up and what's your expectation for there?

Stan: We think that demand grows relatively slowly. It's a commodity business where people are constantly innovating. There are efficiency gains; this is nothing new. In general, we look for a little over 1% growth. Demand has been very strong for the last few years, partially because oil prices have been low. All of the things that are negative for demand will take a while to really have a significant impact. So, when you think about the innovations in electric vehicles, there are a number of bottlenecks associated with the rapid development of that; the most significant of which is the overall turnover of the car fleet. It takes a while for that to happen and to have a significant effect on overall usage.

Hunter: In closing, could you highlight a couple of areas that you think best represent how we're finding opportunities in the sector, to put it into context of valuation and what you think the opportunity is.

Stan: Sure. To highlight each of the three areas that we're focused on; we own U.S. exploration and production companies with high quality acreage. What we find is the Permian stocks generally tend to be a bit more expensive than we're willing to pay because it's widely regarded as the best play. We think there is a lot of risk around growth there. We think the inflation there might be more significant than people think. If you go outside of that play to other areas like the Bakken we can find high quality E&P companies with great acreage. If you have a lot of very good acreage in the Bakken, your economics can be as good if not better than the Permian and you have lower risk of significant inflation or bottlenecks in the area.

We own service companies with exposure to pressure pumping in the United States. We can find companies with very little debt trading below replacement costs. So, we can buy service companies below replacement cost at a low multiple of normal earnings where regardless of what goes on in the short run for oil prices, there still should be a lot of demand as a lot of that capacity is getting used up today. Lastly, we own international explorers. Once a company discovers oil or natural gas internationally in deep water, the go forward economics are very good and in many cases, as good if not better than U.S. unconventional returns.

So, we like international explorers. They tend to have very good balance sheets, net cash on the balance sheet. We can buy them for below the discovered assets and they generally will have hidden assets that really are being accorded no value by the market.

Hunter: One last question. As you look at where the price is today, you think about the kind of price you think the market needs to see in order to incent adequate exploration and production to meet demand, do you have any sense around the timing for that normalization in price? Is that a function of current inventory levels being drawn down to more normal levels? Any thoughts on how long this might take?

Stan: Sure. We think it actually could be relatively short-term. Predicting timing is very difficult in almost anything particularly in something that's out of favor. We think there are a lot of things that have prevented the normalization in the past that shouldn't repeat to as great a degree going

forward. The OPEC cuts we think those will come back on. But once they come back on, we don't think there is much in a way of excess capacity. There's very small amounts of OPEC capacity that's offline, the neutral zone might be one of them but it's relatively small in the grand scheme of things. Libya is back producing at high levels, Nigeria is also. Outside of the U.S. we don't think even if oil prices spike dramatically, you can bring much on in the short-term basis.

We don't think that there is much many more surprises left than we've already seen. In fact, we think it could go the other way and then what we think happens in 2018, 2019 non-OPEC, outside of the U.S. production should start declining and that puts more pressure on OPEC and the U.S. unconventional to grow. So, we think in the next year and a half, if things are not tight currently which we think they might be tighter than a lot of people currently believe but within the next, call it two years, things could become very tight.

The issue becomes if you get a tight market, how can the world respond and it might actually be very different than people expect. So, it takes a long period of time outside of the U.S. and even in the U.S. outside of the shales for capacity to be added. If you look at the Gulf of Mexico as a proxy for deep water, it can take five to ten years for a discovery to come on stream. So, if there was an under supply after the OPEC cuts, after the U.S. ramp, it's very difficult to grow and we could see significantly higher prices. So, we think things are skewed to the upside and we think it should normalize in a reasonable time frame.

Hunter: Okay, well that's great Stan. Thanks.

Stan: Great and just in conclusion we hope that this was helpful. We obviously didn't cover all of the topics in energy. If you have additional questions, please forward them along to us through our sales representative. Hopefully this was helpful and that's the conclusion of our call.

Chris: Thanks Stan, thanks Hunter. We appreciate all the energy market insights you shared today. Just a few closing observations before the Operator ends our call. First, as you mentioned earlier, I think it would be fair to say that the energy market landscape is complex and multilayered. So, there is definitely a learning curve to interpreting all the data that you shared with us today.

But with that said, you raised a number of very interesting questions surrounding the sustainability of current global oil production levels and those sustainability issues have big implications for future oil supply and storage volumes. What's also noteworthy is that the questions you raised are reminiscent of the questions our firm has asked about other industries and companies that were experiencing environments that we believe were neither normal more sustainable.

It feels like the market has a tendency to take a current condition like the growth of U.S. shale oil production that you referenced, for example, and extrapolate that circumstance far out into the future, almost assuming a new normal if you will, whereas our experience tells us that it's critical to identify whether the new condition is in fact a permanent change to the backdrop or is it simply an unsustainable temporary situation. And, if we identify that the circumstance causing the concern is temporary and that the market has mispriced a security as a result of that concern, then we take advantage for our clients of that dislocation. Clearly, our positioning within energy

now is a strong example of exactly this type of active investing and our value investing roots and in-depth research has convinced us that certain energy companies have been mispriced by the market and we believe those securities represent value for our clients.

So, for all of you that dialed-in to join our call today, thank you for your continued interest in our firm. We look forward to our next call with you and Operator that does conclude today's discussion.

Operator: Great. Thank you, everyone. Thank you for joining today's teleconference. You may disconnect your lines at this time. Thank you and have a nice day.

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