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ANALYST INTERVIEW

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Awaiting Service Cost Impact on E&P Sector

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PAUL GRIGEL, CFA, is an Analyst responsible for providing coverage of U.S. independent exploration & production companies at Macquarie Group Limited. He is based out of the Denver office and joined the company in 2011. Prior to joining Macquarie Group Limited, Mr. Grigel worked as a Senior Consultant at FTI Consulting advising both companies and lenders on multibillion dollar bankruptcy cases as well as performance improvement projects. Previously, he worked for Anschutz Investment

Company where he headed up fundamental research efforts for a leveraged loan and distressed securities portfolio. He has also worked for Lehman Brothers in investment banking focusing on equity capital markets. Mr. Grigel holds a B.S. in finance and a B.A. in economics, both with distinction, from the University of Colorado Boulder. He has earned the right to use the Chartered Financial Analyst designation.

SECTOR — ENERGY

(AGU802) TWST: Give us an overview of your coverage universe.

Mr. Grigel: I joined Macquarie just under six years ago now, and I cover both the large-cap U.S. E&Ps as well as the small and midcap U.S. E&Ps, so ranging from companies with a market cap of a few hundred million all the way up to almost \$60 billion, so running the full gamut from small producers to large producers. In total, right now we cover 25 different U.S. E&Ps.

TWST: How would you characterize 2016 for the E&P space? Were there any key themes or anything particularly noteworthy?

Mr. Grigel: Summarizing in one word, I would say volatility. Clearly we started the year off in a very tenuous position, a lot of very nervous investors as well as operators with the decline in oil prices at the start of the year and the quite rapid reduction in activity as well. A lot of firms moved to live within cash flow at very, very low oil prices. Oil has rallied, and OPEC has helped that as of late, but at this point in time I think the key story as we look back certainly is the volatility. But frankly, the resiliency of the

U.S. E&P sector has been quite tremendous, both on the stock front as well as on an operational front.

Highlights

Paul Grigel covers U.S. E&Ps. Mr. Grigel says 2016 was a volatile year for E&Ps; however, the resiliency of the sector has been tremendous on the stock front and the operational front. For 2017 he is looking at the back half of 2016, which had more favorable tailwinds with rising crude prices and service costs that had remained flat after declining earlier in the year. For 2017, is looking for some of those tailwinds to die down or even become headwinds, mainly service cost inflation starting to come back. He says that while there are a few select places you can find value, generally the E&Ps are looking more fully valued right now.

Companies discussed: Anadarko Petroleum Corporation (NYSE:APC); Devon Energy Corp (NYSE:DVN); SM Energy Co (NYSE:SM) and PDC Energy (NASDAQ:PDCE).

TWST: As we look to the new year, what are you expecting, and how are you gauging investor sentiment?

Mr. Grigel: On key themes for 2017 as we look ahead, we first look to the back half of 2016, which had more favorable tailwinds with rising crude prices and service costs that had remained fairly flat after declining earlier in the year. I think as we look to 2017, we look for some of those tailwinds to either die down or maybe even potentially become headwinds, mainly service cost inflation starting to come back and how E&Ps will deal with that. How will the U.S. as a whole respond to a more stable crude outlook, and what will the crude production growth be, and how much will that offset some of the recent OPEC cuts is a key theme.

And I think lastly, on investor sentiment, after what was a very, very strong 2016, the near term still appears to be favorable. Crude prices are still holding in there, and service costs haven't risen quite yet, but they appear to be rising soon. Is it a question that it's going to be a tale of

two halves, where it will be a first half of continuing this momentum and then as growth comes on, as some other constraints and service issues start to happen in the back half of the year, how will the E&Ps respond to that stress being put on to the system? I think this is the view that we take on the year right now, and I think investor sentiment is one of still trying to find value in a space that I don't think anyone would call cheap by any means. We think there are still a few select places you can find value, but generally the E&Ps are looking more fully valued than not right now.

TWST: With fourth-quarter calls and reports coming up starting in January, what will you be looking at most closely? What kinds of questions will you be asking?

Mr. Grigel: I think clearly the guidance is going to be key for a lot of firms. Most companies put out guidance alongside the fourth-quarter results, so there will be a lot of focus on looking ahead at 2017 and how fast the production response will be. I think the number one question that we want to know, and not to keep harping on what I said before, but it's really, what is happening with the service costs? Are the firms able to mitigate some of the increases? How significant will the increases be?

I think any time you get into a business where your input costs start to move, that's something you want to keep a very close eye on, and not only under the assumption that they're building into the budget, but what momentum are they seeing, and then more specifically in what areas of the business are they seeing the increases? There are some areas that have a larger oversupply than others, and there could be areas that have a tighter supply/demand balance, creating a more difficult pricing situation for the E&Ps. Those are all issues that can step in the way of not only margins and actual profitability, but also in terms of what's called operational flow and operational momentum as well, especially if you have to alter the drilling program in response.

TWST: What are you expecting from the incoming Trump administration and his Cabinet nominees in terms of potential shifts in both tax and energy-related policy?

Mr. Grigel: For the E&P group as a whole, I think it's obviously far more regulation than taxes in terms of what really impacts them. I think everyone sees the nominees that are out there, and it says this is going to be an administration that is more supportive, generally speaking, of drilling than the past administration. The one area we caution is to maybe not get as focused on that. Really, the key driver — this is still a global oil market. Obviously over the last few weeks we've seen the impact that OPEC can have in terms of helping — or if it had gone the other way, hurting — supply/demand balance. So ultimately crude price is where we remain focused.

From an E&P perspective and a drilling perspective, I think the regulations being altered — for a lack of better term, we will have to see what the exact details are when they come out — but their being altered is something that probably is favorable. But at the end of the day, this is also an industry that remains aware of the fact

that it still needs to be a responsible and pragmatic corporate citizen. Being based in Colorado, we've lived through a lot of that over the last couple of years, and I think the firms are very clear that they still need to do things safely and still need to reach out to the community, even if things are more balanced from their point of view on the regulatory front.

TWST: What are some of your top stock recommendations right now and why? What sets them apart?

Mr. Grigel: Post the OPEC decision, what we've really been looking at in terms of stocks is what we're calling "flywheel" names. And by that we mean names that get a one-time boost of momentum here from the higher crude

oil price, but that creates a positive feedback loop into the corporation and can actually help drive growth faster and faster and faster. So the top pick for us right now in the space is **Anadarko** (NYSE:APC), and we strongly feel that they are the quintessential candidate for the flywheel. They started to show this even last week in their release with closing the Gulf of Mexico acquisition and the additional cash flow that they get from that and being able to grow their long-term growth rate now at 12% to 14%, up from 10% to 12% previously.

They can really focus in on increasing the activity in the core of the Delaware Basin moving up to 14 rigs, a situation where they look to be able to take it to another level and do what they've termed "uncoil the spring." They've been building up this very large potential energy, and they really want to turn that into actual production moving forward, and they've been working on the infrastructure; they've been working on a lot of the well designs and are really able to unleash that. And that's all driven by the cash flow that they get from the low-decline assets in the Gulf of Mexico, where also service cost inflation is likely to be far more constrained than it will be in U.S. onshore.

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1-Year Daily Chart of Anadarko Petroleum Corporation



Chart provided by www.BigCharts.com

The other name that fits our flywheel thesis is **Devon** (NYSE:DVN). Similar kind of concept in the sense that they have their Canadian oil sands project that is also not likely to be subject to much service cost inflation, but also a very low-decline, high-

oil asset that creates a lot of cash flow at these levels, and they are able to reinvest that cash flow into two core areas, one the Delaware Basin and the second in the STACK down in Oklahoma. In doing that, they can really create a better and more sustainable long-term growth as that cash flow that comes from the U.S. onshore starts to grow faster; it then feeds back and continues that flywheel prospect. So those are the names where we see the most value and continue to focus investors in that regard, at least in the larger-cap names.

TWST: Any small or midcap names you'd highlight?

Mr. Grigel: Yes, on the small and midcap side the two names that have similar theses for us are **SM Energy** (NYSE:SM) and **PDC Energy** (NASDAQ:PDCE). Both of those names made acquisitions in the back half of 2016 in the Permian Basin. For us it's a risk/reward trade that we look at, that in moving to the Delaware Basin the names can not only expand and enhance their drilling inventory, but the stock can also start to be rerated on a more favorable basis for both of those names.

Clearly both of them have risk in the execution of the program, so by the nature of the small and midcaps they are a little bit more risky. But with the crude support, especially driven by OPEC here, there's a bit more clear line of sight to those, and we still think there's a favorable risk/reward in those, **PDC** being a bit more conservative than **SM**, but with the risk tolerance being higher on **SM**, the ultimate risk/reward is still favorable in our mind for that name.

TWST: What are you most cautious about? What are your areas of concern?

Mr. Grigel: It's going to be a beating of the same drum, but the service cost inflation is something that really matters to us, and we don't want to undersell that. I know a lot of people will look at it and say yes, we know it's going to go higher. But the reality is, as we look at the world, the most favorable time to be an E&P is when oil prices are rising and service costs haven't. This is a big change when and if service costs start to change, and it appears to be more of a when, as every day passes, rather than an if. That's a very material change to the business, and that really structures the business differently, especially as firms start to increase activity in that regard.

The other one that we really focus in on that has less to do with costs is more of the logistics. For the last couple of years, generally it's been a period of decreasing activity or very low activity in many of the basins. With activity ramping recently and the rig count rising, we see an area of the business that could start to face constraints. That could be on pressure pumping, that's completion crews; that could be on sand and getting your sand on time to a well; it could be water handling; it could be takeaway capacity, being able to get your oil to market. When a large number of firms go from a very low level of activity to ramping to a much higher level

of activity very quickly, they can, for lack of better term, start to bump into each other a little bit, and everything doesn't go quite as smoothly as everyone might think it's going to. So we're keeping a very close eye on those logistical elements as well, rather than just assuming that the extreme high efficiencies that have been seen here can continue without any hiccups going forward.

TWST: Are there any topics we haven't talked about yet that you think are important for investors to keep in mind?

Mr. Grigel: The one we haven't touched on — is natural gas. In the near term, the weather has, after a late start, come around to a cold December, as most of the U.S. has quickly realized. And in doing that, as we look at the outlook for winter, but even really more so into summer and the fall and winter, there's a very large debate going on: Will the Northeast and the Marcellus be able to respond and meet the demand that is necessary? And by that, we mean with the takeaway, with pipelines, are they going to be able to get the pipelines that they need to be approved in order to get the gas to market?

The gas is clearly in the ground. It's very economic; it's generally low-cost. But the challenge really is getting it to market. And so there is a very large debate right now, and we'll have to see how this pans out over the next few months as winter evolves. But also, as we get more into 2017 and with some of the administration changes and as things evolve on various fronts, can natural gas really continue to work at higher prices, or is it likely to be met on the supply side with fairly material growth and push prices back down a little bit more? So that's an area where there's a lot of investor debate, there's a lot of investor focus, but one that frankly still needs a little bit more time before there's more clarity into how we end up on that one.

TWST: Do you want to wrap up with any final thoughts?

Mr. Grigel: It's been a wild year, and I suspect that 2017 will at least start equally as exciting, but hopefully there's a little more stability over the course of the year than we had this year.

TWST: Thank you. (MN)

Note: Opinions and recommendations are as of 12/19/16.

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