# **Energy Investing is Really NOT a Commodity Story**

As an energy investor, one ignores the outlook for commodity prices at one's own peril. However, while a fundamental understanding of the macro forces shaping supply/demand and price outlook is an important part of our investment process, we believe that other forces beyond price will be more significant in the next several years and favor investing in energy equities over commodities.

In fact, our energy outlook is really NOT a commodity story, but a story of seeking out those companies best positioned to deliver differentiated growth and returns on investment by capitalizing on major industry developments driven by changes in technology, trade flows, infrastructure needs, and capital intensity. We believe our focus on change, growth, and the long-term differentiates our investment process and investment outlook from those of our competitors.

## "Change is the law of life and those who look only to the past or present are certain to miss the future." – John F. Kennedy

This quote from President Kennedy has perhaps never been as true for the energy industry as it is today. We are in the midst of great changes, so much so that the words "revolution" and "renaissance" are frequently used by analysts, politicians and the media to describe these changes and the impacts they are having on the industry, our society and the investment landscape.

Evolutionary developments in the use of horizontal drilling and hydraulic fracturing technologies in recent years are now enabling the production of large quantities of oil and gas from

unconventional geologic formations, the most common of which are shales. Shale rock sequences have been well known source rocks for conventional hydrocarbons for over a century, but producing directly from these tight, impermeable rocks has been a huge challenge. With the use of improved technologies, this challenge is now being met, reversing decades of U.S.



JAMIE STONE PORTFOLIO MANAGER

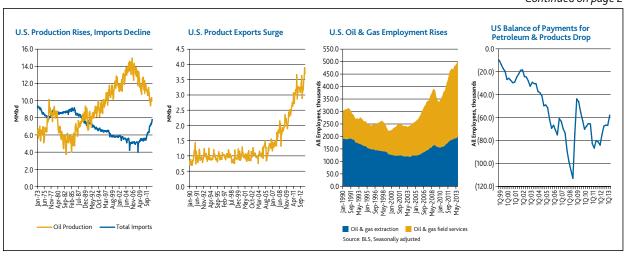
production declines, rising imports, and competitive disadvantages. This major shift has the U.S. on its way to eliminating the need for imported oil from the Middle East and becoming one of the world's lowest cost manufacturers of hydrocarbon based products. Eventually, we believe this shift will lead the U.S. to being a leading exporter of hydrocarbons rather than an importer.

This is a good thing for our economy, our national security, and investors who have focused on the companies driving and capturing this growth.

#### Oil Supplies Rise on Rising Investment

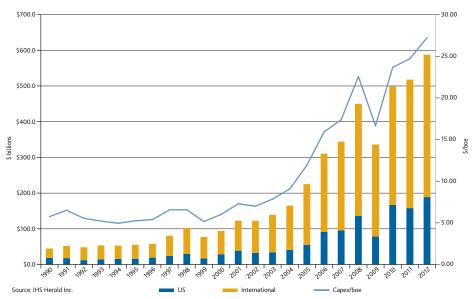
As can be seen from the charts below, U.S. oil production is surging while oil imports are falling, and refined product exports are rising. As a result of these shifts, domestic employment levels in the oil industry have doubled, and the U.S. balance of payments in petroleum products is narrowing.

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#### **Global Upstream Capital Spending and Capital Intensity Climb**



Although some Wall Street analysts question whether the growth in North American oil production will drive prices sharply lower for a sustainable period of time, we do not believe this will be the case. Instead, we believe the price levels and range of the last several years are likely to persist. Although technology has enabled the growth in production of new resources, without these higher prices, these resources would not be economically viable for the industry writ large. Even as cash flows have risen with the price of oil and gas, the industry has needed higher prices to generate the capital required to exploit the resources (shales, deepwater, oil sands) that are driving production growth and offsetting declining productivity from conventional reservoirs. In fact, in the past 15 years, the global reserve replacement cost per barrel has quadrupled and the annual capital investment to find and replace reserves and grow production has increased six-fold (see chart). Thus, while the industry has figured out how to grow supply, we believe this growth cannot be sustained in a price environment that is materially worse than what we have experienced in the past several years. If anything, we continue to see evidence in project and corporate data that capital intensity remains on the rise.

Finally, in the past five years, most of the growth in global production is from North

America and the rest of the world has lagged. This is a change from the previous 20 years, and it can be directly linked to a shift in capital allocation back to the U.S. and Canada and away from the rest of the world, as oil industry investment is something of a zero-sum game.

#### **Demand Growth Makes a Comeback**

When thinking about prices, it is always important to consider demand as well as supply. We believe that the outlook for demand is improving. Following the rise in prices in 2007-2008 and the global recession, oil demand growth slowed materially. However, in the past year or so, it appears that the negative effects of both the price spike and the recession have begun to fade. Despite structural forces that will likely restrict demand growth over the long-term, the rate of growth has shifted from around 0.8% to 1.3-1.4% per annum. Even that small a difference can be meaningful in terms of keeping the market in balance.

## Natural Gas – Light at the End of the Tunnel

As for domestic natural gas, we think that prices are going to remain pretty subdued for a couple more years. In the near term, we think demand growth can be readily sated with incremental volumes from certain key shales and associated gas. However, toward the latter

half of this decade, we do see a potential significant upward shift in U.S. gas demand, driven by pending LNG export facilities and proposed increases in petrochemical, fertilizer and other large industrial gas users. Based solely on projects we are tracking with a high probability of being built, U.S. gas demand has the potential to increase by 30-40% more than the average demand level for 2013. However, to bring these facilities on line, the industry will first have to ramp up investment in new drilling and infrastructure to accelerate the growth of domestic production.

Our conclusions on the current outlook for oil & gas prices are as follows:

- 1. Energy commodities are likely to be relatively non-inflationary in the next several years.
- 2. Oil prices will remain volatile but within a range of perhaps \$80 to \$110, which is similar to the range of the past several years.
- 3. Continuing the trend of recent years, U.S. oil prices will remain structurally below global prices for the next several years, due to improved local supplies and a reduction in light oil imports. However, this could change if the U.S. lifts the 40-year-old crude oil export ban, allowing the free trade of crude oil.
- 4. U.S. natural gas prices will also remain seasonally volatile, but constrained by the industry's ability to grow supply at the current price point until there is at least a significant change in domestic demand.
- 5. Since most of our valuation work already incorporates the forward prices embedded in the futures strip which is pricing in a sharp decline in the forward price of oil our long-term views incorporate pricing at the lower end of our expected range.
- Current global exploration and development economics necessitate that prices remain around the current level. Over time, this level is likely biased higher in contrast to the futures curve's direction.

## Investing in a Price Neutral Environment

Our view that commodity prices will be

non-inflationary in the next several years is based largely on our belief that supplies can grow, and that numerous companies can grow their businesses in this environment. As a result, we think the environment for investing in the energy industry remains attractive. This is an environment that favors equities over commodities, and should also favor stock picking over indexing. To support this conclusion, we point to the bifurcated performance among domestic natural gas producers in the last several years. Despite weak commodity prices, companies with superior assets delivered strong shareholder returns and outperformed numerous peer companies that lacked these advantages. We have also seen decreasing correlations between commodity prices and increased dispersion among share prices and equity returns across the energy spectrum. We believe this is the type of environment in which our investment process, driven by bottom-up research that focuses on long-term investment in companies with competitive growth advantages, great assets, financial sophistication, and strong capitalization, will produce superior returns.

Our energy outlook is a story of seeking to find the growth brought about by changes in technology, trade flows, infrastructure investment, and capital intensity. A number of companies in this mature industry are in the midst of an exciting growth phase driven by technological advancements in drilling, completions, reservoir analysis, materials science, data analysis, manufacturing and many other areas. These advancements are helping to unlock new reserves and production from unconventional (mostly shale) resources and ever deeper waters across the world's oceans, which is benefiting energy producers. At the same time, it is also creating a virtuous cycle for equipment suppliers, infrastructure providers, engineering & construction companies and a host of other businesses. This is where we are focusing our attention, and in doing so, differentiating ourselves from our competitors.

We have focused the majority of our energy investments around three key themes:

1. Unlocking the production potential from unconventional reservoirs.

- 2. The move into deeper water around the globe.
- The need for increased investment in the infrastructure to support the changing supply/demand landscape.

#### **Exploration & Production**

We believe the technical revolution in unconventional resource development and deepwater is having its greatest impact on the exploration and production sector. In this area, we typically look for companies with competitive advantages related to land positions, technical and operational capabilities, capital allocation strategies, and of course, management. These advantages tend to be the key drivers of differentiated growth and returns on investment, which in turn drive share price performance. We also tend to focus on small-to-mid-size companies in this area, as economies of scale are not as important as growth rates and the potential durability of that growth. Our favorite companies in this sector are Concho Resources, Inc., SM Energy Co., Bonanza Creek Energy, Inc., and Oasis Petroleum, Inc. All of these companies own favorable acreage positions in key shale basins/plays, such as the Permian, the Eagle Ford, the Niobrara and the Bakken, and all are run by excellent management teams with proven track records of resource growth and wealth creation.

#### Oilfield Service and Equipment

The rising capital intensity of the global oil & gas business has been, and should continue to be, a favorable tailwind for the companies that supply producers with the "picks & shovels" and technical know-how and innovation. In this area, we tend to focus on companies that are exposed to the markets where we think investment is growing the fastest, and are best positioned to capture those investment dollars. We also like companies with capital discipline that can balance investing in growth with returning cash to shareholders. Many of our holdings in this area are exposed to varying degrees to all of our key growth themes. For example, companies such as Halliburton Co., Core Laboratories N.V, and Forum Energy **Technologies, Inc.** are benefiting from growing investment in unconventional resources and deepwater, while companies such as Flotek

**Industries, Inc.** and **CARBO Ceramics, Inc.** are providing niche products/technologies that enhance well productivity.

#### Infrastructure-Related

The unconventional resource revolution and the growing investment in deepwater production capabilities are opening up significant new geographies to the production of hydrocarbons and changing the flow of trade in the industry. In almost all instances, these new fields and regions lack adequate processing, storage, and transportation infrastructure to move product to market. We are targeting companies investing in infrastructure, as well as those providing the engineering, equipment, and construction services to put these assets into place. Right now, the former set of companies interest us the most since we believe these companies will ultimately generate streams of highly visible and growing long-term cash flows. Most of these investments are structured as master limited partnerships (MLPs). When investing in MLPs, we focus more on growth in distributable cash flow and distributions and less on yield to generate our expectations for total return. One area we are targeting is MLPs that own refined product and oil logistics assets such as Tesoro Logistics L.P. and Western Refining Logistics, L.P. In addition, we often prefer to own the general partners (GPs) of certain MLPs, as these companies will often generate better returns than the underlying MLP. Two of our top investments among GPs are Atlas Energy, L.P. and Targa Resources Corp.

#### Conclusion

The outlook for pricing will always be an important factor to understand when investing in the energy sector. However, we think that over the next several years, other forces at play will be more important and will favor investing in energy equities, particularly the types of companies that we tend to favor at Baron. The energy industry is undergoing major changes that, in turn, are producing exciting growth opportunities. We seek to capitalize on the growth themes we have identified by finding the companies best positioned to deliver differentiated growth and returns on investment within these themes

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Non-diversification can increase volatility of the portfolio's returns and expose it to greater loss at any given time. Energy industries can be significantly affected by fluctuations in energy prices and supply and demand of energy fuels, and resources industries can be affected by adverse global geo economic and political events.

Top ten holdings and securities mentioned in this newsletter as a percentage of net assets as of December 31, 2013 are as follows: Baron Growth Fund – Core Laboratories N.V. (1.7%), Targa Resources Corp. (1.3%), CARBO Ceramics, Inc. (0.5%), SM Energy Co. (0.4%), Oasis Petroleum, Inc. (0.1%); Baron Small Cap Fund – Core Laboratories N.V. (1.5%), Targa Resources Corp. (1.1%), Forum Energy Technologies, Inc. (0.7%), Tesoro Logistics L.P. (0.5%), Flotek Industries, Inc. (0.5%), Bonanza Creek Energy, Inc. (0.4%), CARBO Ceramics, Inc. (0.4%), Oasis Petroleum, Inc. (0.4%), Western Refining Logistics, L.P. (0.4%); Baron Asset Fund – Core Laboratories N.V. (1.6%), Concho Resources, Inc. (1.1%); Baron Opportunity Fund – Concho Resources, Inc. (1.4%), CARBO Ceramics, Inc. (1.3%), Oasis Petroleum, Inc. (1.2%); Baron International Growth Fund – Concho Resources, Inc. (4.9%); Baron Energy and Resources Fund – Concho Resources, Inc. (3.8%), Bonanza Creek Energy, Inc. (3.8%), Oasis Petroleum, Inc. (3.5%), Atlas Energy, L.P. (3.4%), SM Energy Co. (3.3%), Flotek Industries, Inc. (3.2%), Halliburton Co. (3.0%), Forum Energy Technologies, Inc. (3.0%), Tesoro Logistics L.P. (2.7%), Western Refining Logistics, L.P. (2.4%), CARBO Ceramics, Inc. (2.3%), Core Laboratories N.V. (2.0%), Targa Resources Corp. (1.9%).

#### \* % of Long Positions

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We offer thirteen mutual funds\* in Retail as well as Institutional Share Classes, Separately Managed Accounts, Sub-Advisory Services\* and an Offshore Fund.

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