SEMPER AUGUSTUS
INVESTMENTS GROUP LLC

Important Disclosure about this Client Letter:

SEMPER AUGUSTUS
Investments Group LLC
CLIENT LETTER March 23, 1999

In This Letter:

Special Points of Interest:

- Historical Trends
- Capital Flows Into Sectors
- Industry Costs
- Investment Risk
- Stock Selection

Energy Stocks Today

What led Semper Augustus to the energy sector?

We saw a "cleansing" of the excesses of the past couple of years. The energy sector boomed in the late 1970s and into the early 1980s. Significant volumes of capital flowed into this sector as prices reached $40 a barrel and were projected to grow to $100 per barrel. Over 3,000 rigs were drilling for oil. With $12 oil came a massive exodus from the industry. The excesses created during the boom took almost a decade to work through, with assets coming out of production and on-going development plans proceeding in a more rational manner.

From 1994 to 1997, capital began to flow back into the sector as prices were stabilized and the large integrated oil producers expanded their capital spending plans. By late 1996 and into 1997, new drilling rigs were being constructed and excess profits were being achieved. This activity drove the stock prices of the oil companies, as well as the companies that serviced them, to all-time highs.

This capital spending program culminated in large additional reserves coming on line about the time that the Asian economies suffered a downturn. Result: falling demand and increasing supply dropped the prices of the commodity and the stock prices followed.

By January 1999, oil was hitting decade lows in prices, stocks of the oil companies and the oil service stocks were down significantly, capital spending budgets were being slashed, and contracts to drill for oil were being cancelled.

With the stock prices decimated, we began to forage through the remains in search of the survivors in the industry and those that would lead the next leg up. Oil, a depleting asset, is a necessary commodity in the world economy. Without additional exploration and work on existing fields, the amount of oil available will decline.

With this in mind, Semper Augustus focused on the oil service stocks that are highly leveraged to the price of oil and the exploration budgets of the energy firms.

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Stock Profiles

Diamond Offshore [DO/NYSE]

Revenues	$1.2 B
Net Income	$384 M
1998 wk hi	$54.625
1998 wk low	$20.688

Schlumberger [SLB/NYSE]

Revenues	$11.9 B
Net Income	$1 B
1998 wk hi	$86.75
1998 wk low	$40.06

Transocean Offshore [RIG/NYSE]

Revenues	$1.1 B
Net Income	$343 M
1998 wk hi	$58.94
1998 wk low	$41.50

Recent Discussions:

Energy/Energy Services

In This Letter:

Diamond Offshore

Schlumberger

Transocean Offshore

Oil service stocks comprise the various companies that provide support to oil companies' drilling efforts. One of the largest components is the contract drilling company, which owns the drilling rig and contracts with the oil company to actually drill the well.

The cost to locate and extract oil is determined by the supply and demand for the inputs. Once oil has been located, the costs to extract it do not change significantly. Therefore, as oil prices increase, a significant portion of the additional revenue is recognized as profit. As such, oil is a very profitable business at the margin. As oil profits are generated, the oil companies have a tendency to search for more oil. With a finite number of offshore drilling rigs (rigs capable of drilling in water up to a depth of 10,000 feet), the contract prices received by contract drillers are determined based upon the highest bidder. With a cost of $200 to $300 million and even as high as $350 million for a drilling rig, additional rigs are slow to help balance the supply. On the other hand, it is very expensive for a contract drilling firm to idle a rig and continue to pay the interest costs and depreciate that asset.

Our research visits to Houston and Tulsa confirmed that drilling rigs were being moved into storage and that the prices that the oil companies pay the oil drilling rig owners were declining as contracts expired. In addition, we worked to understand management's philosophy toward expansion and risk-management during this downturn.

Semper Augustus worked to balance the downside risk of further price declines and the risk of the stocks going nowhere until prices recovered. By focusing on the premier operators and working to understand their capital spending plans, we wanted to eliminate the risk of buying a company that would ultimately fail.

As prices moved to our price targets in February, we initiated positions in a handful of the oil service stocks. As planned production cuts were announced last week, the price of oil has recovered. Since the oil service stocks are highly leveraged to the price of oil, these stocks have moved up form 25 to 30 percent since our February purchases.

Oil prices will continue to move up and down as producers tend to increase production as prices increase and the demand moves as the economy changes. However, we believe that by owning premier operators and avoiding the temptations of greed, we can prosper in the current energy environment.

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