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BTN Thursday Thoughts

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Deepwater Drilling – Deep Value Play?

Following the comments from Mark Mobius about the commodity cycle still seeing solid demand growth, but now suffering from years of underinvestment – we saw Diamond Offshore's (DO) earnings this week. This industry was in great shape until early 2014. Within a year of the financial crisis, oil was back to $80 in 2009 and stayed between $80-$100 into the summer of 2014. Offshore drilling was a huge moneymaker, charging over $600,000 per day for many rigs and more rigs were coming online. However, 2013 marked the end of rising capital spending for major oil companies as it peaked for ExxonMobil, Royal Dutch Shell, Statoil, BP, Chevron, Petrobras, and Total. With falling investment, the deepwater rig companies saw demand for their rigs evaporate and the rates charged fell 50%-70% for those that did find new work.

Oil demand continually rises. For all the talk of Tesla and windmills, the world consumes about 97 million barrels of oil per day and that daily demand rises about 1.0-1.5 million barrels every year. Growth in China, India, and Africa continues to drive this. The supply of oil is also basically about 97 millions per day. A big part of the equation for drilling is existing wells decay and production falls over time. Total decay is about 6%. So, doing some rough math, the production side has to replace 7 million barrels per day every year – 6% decay + 1% growth. That data comes from the U.S. Energy Information Administration (EIA).

Offshore drilling is one of the biggest boom-and-bust commodity-based industries there is. Every project is very expensive and new ones can be delayed or cut if oil prices are falling. Also, an offshore rig is a very expensive and technical piece of equipment that costs several hundred million dollars and takes years to build and be delivered. What made this downturn worse for companies like Diamond Offshore was equipment ordered was arriving as oil companies were cutting back on drilling. Thus, demand was falling as very expensive new rig supply was coming online. On top of that, high oil production drove oil in storage into the billions of barrels, so the decay curve of existing wells was offset by drawing down inventory to meet demand. Thus, the offshore drillers geared up for a typical 2-year drop in capital spending by their customers. However, they found that customers cut spending for a record 4 years in a row! Plus, the cuts were over 50% for some companies.

There are signs that this industry may be starting to turn around. Now we want to be clear – these are not for faint-hearted people. Companies like Diamond Offshore (DO), Seadrill (SDRL), Ensco (ESV), Noble (NE), and Transocean (RIG) used to pay hefty dividends and they have all essentially eliminated them. There is debt here, including moving some of it off balance sheet by doing sale-leasebacks of equipment with other companies. In addition, joint ventures for several rigs exist to cloud what is really on the balance sheets. Debt modifications have been necessary in some cases. Asset impairment charges have been substantial and profits difficult to find in several years. Diamond Offshore even promised another restructuring charge for 1Q'18 and its balance sheet is fairly clean. However, here is some evidence that things may be improving:

First, the industry is consolidating. Maersk (MAERSK DC) sold its offshore oil equipment to Total (TOT) in August 2017. Ensco bought Atwood (ATW) in October 2017. Transocean bought some rigs from Songa Offshore (SONG NO) in February 2018. Seadrill is also in bankruptcy looking to improve its balance sheet as it waits out the downturn. The result should be fewer and stronger companies in the industry to negotiate with the oil companies.

Second, the industry has been pulling rigs offline and cold stacking them. It has gone further and started to scrap many too. In February 2015, Diamond Offshore had 28 active rigs, 4 in cold storage, and 2 under construction. In February 2018, the company has 12 active rigs and 5 in cold storage and zero under construction. Transocean in January 2015 had 12 rigs under construction, 33 active, and 1 in cold storage. In October 2017, Transocean is only waiting on 3 more rigs in construction, 28 are active, and 13 are in storage. Noble in February 2015 had 29 active rigs, 3 in storage or undergoing modification, and 1 under construction. In January 2018, Noble has 13 active rigs and 13 in storage. Seadrill is a wildcard as it in bankruptcy and finding full information is a little more difficult. What we know from their last fleet report in August 2017 was there were 54 active rigs and 18 idle ones. Of the active rigs, 12 were completing their contracts before the end of 2017 and 12 more were completing contracts in the first half of 2018. Some of those would likely have had extensions at possibly lower rates and others may now be idle. Also, Seadrill had 14 rigs under construction that had already been delayed. In bankruptcy, it is possible to reject contracts and they may have cancelled some of the new rigs.

Third, there is evidence of some recovery. Capital spending by oil companies is rising again for offshore projects. Marc Edwards, the CEO of DO, noted this week that the North Sea is seeing more demand, day rates are moving up, and contract terms are lengthening. In the last quarter, DO saw five rigs secure new contracts at positive levels with one getting a higher rate on an extension. DO also obtained the first new contract from Petrobras (PBR)

in two years as that company has continued to scale back drilling. Continuing the note on scrapping above, Mr. Edwards attributes some of the better rates in the North Sea due to heavy scrapping of older floating rigs:

> "Of the almost 100 floaters that have been scrapped since the beginning of this extended downturn, over 85 were in the moored class. This alone will help to incubate a recovery and utilization in a market segment that has started to tighten at current oil prices."

These types of rigs are used extensively in the North Sea and that helps explain why the North Sea is seeing better demand and pricing.

Areas of caution still remain and some may be overstated – we will need to see. The first is after being excited about the move in some parts of the market, even Mr. Edwards is quick to point out that these improvements are bouncing off some very deep lows and he expects it may be in 2019 and 2020 before this market sees signs of a more broad-based recovery. He expects significant recovery to occur between 2021-25. This also meshes with the timing laid out in the restructuring plan Seadrill filed.

There is also concern that stacked rigs and rigs under construction could come back into the market as well. Even Mr. Edwards offers some conflicting views. He sees an oversupply in the high-end rigs where 22 drillships and 11 high-end rigs are still in shipyards being built. Those could arrive during the recovery and dampen it. It is possible that some of these rigs under construction will not be completed. A large number are with Seadrill who is in bankruptcy. On top of that, there are many stacked rigs that would like to return to the market too. His belief is the high-end market may still need to see 60 rigs scrapped.

We said conflicting views because Mr. Edwards has also run the math to show that many of the higher-end idled/stacked rigs may never work again. His estimate is that reactivating a 6th generation rig is likely to cost $80-$100 million. The structure will need a complete survey and repairs, software and electronics need to updated and checked, and the whole rig has to be recertified and towed somewhere. A crew has to be found and trained. The blowout preventer and other subsystems have to be rechecked. By 2020, these rigs may have been stacked for 4-5 years. If the rig gets a contract for 2 years, $100 million in reactivation is $137,000 per day over a 2-year contract. Day rates are running below $300,000 per day now, so that doesn't work when adding in operating costs, interest expense and earning a return. And that rig being reactivated has to compete against a rig that has been working and coming off a contract. The customer doesn't have to wait for the working rig to get up to code. The rig company doesn't have all the start-up costs with a

working rig. The currently working rig has a big edge over a stacked one. It would take a very hot market for rigs to make many of the stacked rigs return. If the market is that hot – all these companies may be having some stellar years.

A final concern that investors should be aware of will be the news focus on US shale. The US has gone from producing about 4 million barrels a day on land to 10 million barrels with fracking tight oil. Offshore drilling produces over 25 billion barrels per day. Shale faces a problem in that the decay rate is about 25%, so the market has to drill and produce another 2.5 million barrels per day to hold production constant. Offshore fields tend to be much larger and the decay curve is about 8%. Energy Insights reported those figures in late 2016 and were highlighted in a Diamond Offshore presentation. Royal Dutch Shell noted when it cut back in capital spending following 2013 that it would focus more on offshore. The reasoning was the costs are minimal while waiting to drill, a short-period of heavy spending during drilling but they are experienced with that, and then minimal expense after drilling. That was versus continual spending to start and then maintain production. We do not think US shale can offset offshore given the decay curves, and the EIA is not projecting shale output to report much overall annual growth at this point because of that.

Our conclusions are that this industry is likely to see more impairment charges to write off stacked rigs, and even operating rigs may be marked down if they come off a high contract and get renewed at a lower fee. So, we would not put much faith in the book values here. Also, if the market does recover, there will be some stacked rigs that are reactivated and these companies would be reporting some sizeable cash outflows to pay for that. There should still be more lead-time between oil companies announcing they want to invest more and actual cash flow reaching these companies. With that said, there could be a significant turnaround given how deep the downturn was, and there are signs it is not getting worse at this point. The stocks are still selling for fractions of the peak prices.

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