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Ocean Yield (OCY NO, OYIEF)– 3Q'19 Update
Maintain NEUTRAL

We are maintaining a Neutral rating on Ocean Yield. It was a fairly busy 3Q. As the company promised, if it did not appear to have the FPSO contract situation resolved by the end of 2019, they would reduce the dividend in 1Q20. The cut will be from 19.1 cents to 15.0 cents per quarter. On the current price, that would still be an 11% yield and save the company approximately $26 million in cash flow per year.

Also, in the current 4Q, the seasonality of offshore oil projects tends to slow down. That makes it tough to sign new contracts for the Connector vessel and the two supply vessels operated by Solstad. The Connector has been on short term deals and Solstad has deferred payments on the two supply vessels for 2019 and that that deferral is now extended until the end of 1Q20.

There remain several reasons to be positive as well. However, it may be three more quarters until it is clear how some of the variables will play out regarding the FPSO, the Connector, and Solstad. Ocean Yield did raise $125 million in a hybrid perpetual bond at the end of the quarter that brings the total cash balance to $176 million. The issues to still focus upon remain:

- The FPSO has several options for future employment. The most promising remains with Aker, which is developing a field in Ghana and owns 61.7% of Ocean Yield. However, nothing may be decided before 3Q20. The FPSO will be producing minimal if any cash flow in 2020. But keep in mind, it remains debt-free and the rapid paydown of debt in 2017 and 2018 effectively made it a zero for net cash flow during those years too.

- The Solstad restructuring is continuing to focus on deferring interest and debt payments until the business cycle strengthens for offshore oil work. There is evidence of improvement from several companies. This could see cash flow rise at Ocean Yield from the two Solstad vessels and the Connector in 2020 and 2021.

- EBITDA is growing with new vessels coming online. The smaller dividend adds some cushion, but interest expense and debt payments are rising. The company already operated without oil-related vessels discussed generating much EBITDA in 2019. Cash inflow/outflow will still be tight going forward.

- Aker is a key player here as it owns 61.7% of Ocean Yield, 20.1% of Solstad, and developing the field in Ghana. Also, Okeanis which has a lease on the four VLCC oil tankers from Ocean Yield has given notice to reacquire them. That is in dispute but could result in Ocean Yield receiving about $64 million in cash.

We Still See the FPSO, Connector, and Solstad Vessels as Call Options for the Stock

The delays in getting a new FPSO contract and short-term nature of work for the connector have hurt the stock price. At the same time, the Solstad revenue deferral that has been extended is not a positive either. The issue at this point is, what is the downside?

These vessels have contributed only modestly to EBITDA in recent quarters versus past results:

FPSO	3Q19	2Q19	3Q18	2Q19	2018	2017	2016
EBITDA	$0.6	$1.5	$26.3	$29.7	$63.6	$115.9	$114.5

We have talked about talked about the FPSO situation in prior reports. In the years when its contract was finishing, the company aggressively retired the vessel's debt and thus the EBITDA of $115 million resulted in essentially no cash flow to the company overall. The contract ended in 3Q18 and the drop-off has been severe. An option with Aker is the current source of quarterly EBITDA that may well disappear in December. However, the FPSO is debt-free and on the books for $150 million after a write-down of $68.4 million in 3Q19 based on the projected delay into 2H20 for a resolution to the next contract situation.

The FPSO could still produce above $20 million in EBITDA plus a return on any capital on improvements/modifications that may be required.

The Other Oil Service vessels contain the Wayfarer on a long-term contract, the SBM Installer on a long-term contract, and two platform supply vessels on contract that are all paying and producing EBITDA. The Connector has been on a series of short-term charters or idle since early 2017. The two Solstad vessels have not produced EBITDA since December 2018.

When all the vessels were working under contract and being paid in 2016 – the EBITDA from these ships was $90 million per year or about $23 million per quarter. In mid-2017, the two platform supply ships were added on a 15-year charter paying $12.6 million per year. When everything is working and getting paid, this division should have EBITDA of over $100 million. Before the Solstad standstill, EBITDA was about $90 million with the Connector on short term deals. After the standstill, EBITDA is running about $60 million per year.

Even if Ocean Yield takes a haircut on the Solstad charters – EBITDA will still increase going forward. Based on how similar companies such as Seadrill restructured and what Solstad's goal has been – the primary part of the deal is to delay debt payments until the market turns up again. That seems to be the blueprint at work here now. The potential may be for a return of $20-$30 million of EBITDA in this division.

Total EBITDA is running about $320 million per year now plus the addition of a few new ships. In our view, simply resolving the FPSO, the Connector, and Solstad charters could add 10%-15% to EBITDA.

Offshore Market Is Showing Some Improvement

The fact that Ghana is working with Aker to develop an offshore field is evidence that the offshore business is improving. Looking at conference calls from the various offshore rig companies shows universal gains too.

- Transocean reported that it signed new contracts in 3Q19. Day rates are increasing from the lows. It is seeing customer interest at a 5-year high and is starting to reactivate rigs that have been stacked.

- Diamond Offshore said rates are rising off the bottom. Each new contract is showing a higher rate than the last one. It is also starting to reactivate rigs.

- Noble has reactivations starting. It is reporting new contracts and contract extensions on existing deals.

- Varalis (formerly Ensco and Rowan) said rates have been rising steadily since early 2018. It believes that as rates increase, customer interest will also increase as they want to avoid booking rigs at peak prices like in 2008.

- Seadrill has not reported 3Q results yet. It has listed new contracts in Brazil for 3Q. In its 2Q results, it saw day rates recovering in all segments. Longer-term contracts are also starting to see higher rates and the market is seeing forward pricing increase.

- ExxonMobil announced five significant deepwater discoveries in 3Q19 and Petrobras is focusing on deepwater and ultra-deepwater exploration on its 3Q19 call.

This is the market that is important for Ocean Yield's major idled vessels. It's also why we believe the Solstad issues will be worked out. That company is even signing new contracts in Brazil and Mexico. It saw EBITDA rise y/y in 2Q19 and reported an increase in activity. Solstad's goal is to now build cash and let business demand grow as it reaches the spring of 2020.

Where Does This Stand?

EBITDA is $320 million a good estimate without the FPSO, Connector, or Solstad ships. The new dividend is $96 million and interest expense will be about $128 million with the new bond. That's $224 in cash outflow. This company operates like a triple net lease REIT with bare boat charters and financing leases. It has roughly $100 million in cash flow after interest expense and the dividend.

There is $176 million in cash. Capital spending is essentially for growth and at this point is fully covered with financing. Debt is high at just under $2 billion. Much of that is related to assets on lease with customers where the debt retirement is built into the payment. The remaining vessels have Loan-to-Value ratios of under 80% of depreciated value. The company retires debt with the remaining free cash flow and refinances any balloon payments due. The recent bond offering covers much of those scheduled payments as the EBITDA is depressed with several of the oil-related assets not producing steady cash flow.

We believe there is the potential for an additional $30 million+ per year in cash flow to return in 2020. At the moment, that missing cash flow is the difference from being able to retire 6% of vessel debt per year and nearly 10%.

There is also a contract on some recently placed VLCC oil tankers with Okeanis. That company is trying to exercise a purchase option to reacquire those ships. Ocean Yield is disputing that at the moment, but the two outcomes are the company continues to receive payments or it will receive $64 million in cash and remove the debt from the balance sheet.

Ghana, where Aker is working to develop a new field and could employ the FPSO, has asked for more accelerated development from Aker. Those plans are in the works and will need approval from the government, but it appears that could result something positive in 2020 for Ocean Yield. Also, we anticipate the Solstad vessels will resume generating positive cash flow in early 2020 as well. Aker as the largest holder of Ocean Yield and a large player in Solstad has incentives to clarify that situation.

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