BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

November 8, 2018 | www.btnresearch.com

# Ocean Yield (OCY NO, OYIEF) 3Q18 Update
# Changing to NEUTRAL from BUY

Ocean Yield (OCY NO, OYIEF) did not renew the contract on its FPSO vessel with Reliance in India. Liquidity remains strong and the company is forecasting no dividend cuts. Management is pursuing multiple opportunities and believes the FPSO will have a new long-term contract in the first half of 2019. The vessel is debt-free and we have noted that with the focus on retiring its debt faster – cash flow from the FPSO was not fully available to cover the company's dividend in recent years.

The fleet growth in other areas continues with Ocean Yield now at 57 ships and we only see one more problem regarding its customer Solstad with two oil support vessels. The nearly 10% yield is attractive and there appears to be enough cushion to support the dividend much longer than it should require to resolve the FPSO situation. **We will go a NEUTRAL rating until we see what Solstad does as that does represent a new issue.**

- FPSO is finishing clean-up issues and preparing to receive customs clearance to move. Ocean Yield reserved $28 million for demobilization already. A cash infusion is expected as final receivables are paid. Management sees a new contract in 1H19.

- FPSO cash flow is not necessary to pay the dividend. A new contract should provide room to grow the dividend in 2H19.

- Annualizing cash flow from recent new ships should boost results further. Outlook for stronger results for the Connector should also help 1H19.

- Solstad is looking to boost liquidity and charters two ships from Ocean Yield. It is possible Ocean Yield will not be approached because it already restructured its Solstad charters in 2017. However, a write-down in the stock received from Solstad in 2017 is likely and it's unclear how extensive Solstad's activities may become.

**We believe the company has adequately planned to support the dividend during the period when the FPSO is without a contract. However, it will likely need to hit its forecast to sign a new long-term contract in the first half of 2019 or sell the FPSO to maintain the current dividend level beyond 2019.** Solstad represents about $8.8 million in EBITDA per year. That is a meaningful amount if Ocean Yield needs to waive charter revenues for 3-6 months. It is not close to the level of the idle FPSO – but that situation has been addressed and planned for during the last three years.

## FPSO Situation:

The 10-year contract was completed on September 19. That it was not extended is not surprising because the contract price exceeded current market rates. Also, the field was unlikely to operate more than a few more months had it been retained. The vessel is now free from hookups in the field and is ready be cleared by customs and moved to a new site.

As part of settling up remaining payments, there is $53 million in receivables from the prior charter customer – Reliance Industries. ($4.2 million has come in since the end of 3Q.) Ocean Yield expects this remaining receivables and payments for miscellaneous end-of-the-deal activities to be resolved in November and that should release a large amount of cash into the company.

Ocean Yield recorded a provision already of $28 million to demobilize and move the vessel. That will turn into a cash outlay in 4Q18 and 1Q19 and includes some operating expenses while it is still in India.

The company sees increased interest in the FPSO for several reasons: 1) there is a better outlook for developing oil/gas fields, 2) there is no longer a purchase option with Reliance, which kept many potential charterers away as they didn't want to do the preliminary work on suitability if there was a chance they could never get the vessel, and 3) there are discussions ongoing with several parties simultaneously at this time.

The company could still sell the vessel but believes it is more likely to have a long-term contract in the first half of 2019. It is possible there will need to be some modification to the vessel depending on the potential project and location. More than likely, any modification would occur after a new contract is signed and a cash flow stream can be forecast. Ocean Yield still sees the vessel as having a 20-year life. It is debt-free so any cash flow that comes in from either a sale or contract will be fully available to shareholders or additional company growth. The carrying value is $255 million and given the projected range of future cash flows, management does not expect to record an impairment. However, to be conservative, they have given a range of $0-$50 million for any potential impairment taken in the next couple of quarters.

**A quick summary for the FPSO is it should be resolved in 1Q or 2Q of 2019 – either a new contract or sale. Moving the vessel could involve cash costs of up to $30 million, but $28 million has already been expensed against earnings. There is $53 million of receivables owed on the prior contract and that should result in a large cash flow in 4Q18.**

## The Dividend Does Not Rely on the FPSO Operating in the Next Year

We have talked about this before. Here are cash needs for Ocean Yield for the next twelve months ending September 30, 2019:

> $36 million for expected capital spending. This is for 1 Suezmax that was delivered on October 25, two chemical tankers delivered October 29, and 4 VLCC tankers coming in 2Q and 3Q 2019. The $36 million is net of $322 million of financing already in place.
>
> $96 million in interest expense. 3Q18 interest was $22.1 million, which we annualized and then added some additional interest expense for the loans on the new ships – which will be more backloaded for the VLCCs arriving later in 2019.
>
> $109 million for scheduled debt maturities over the next 12 months.
>
> $122 million for the dividend over the next four quarters.
>
> $30 million demobilization outlay for the FPSO to be moved.

That totals $393 million in cash needs. The company remains very liquid with $173 million in cash plus available credit of $37 million. Also, it will receive some portion of the $53 million in FPSO related receivables this month.

**Let's use round numbers and say Ocean Yield has $250 million in cash and near-cash against $400 million of cash needs to fund the dividend, growth, debt payments, and movement of the FPSO.** Obviously, they will not use all that cash and liquidity for the dividend. However, the company will generate EBITDA as well. Last quarter was $100.4 million with $26.3 million from the FPSO. So, adjusted down for the idle FPSO, it's $74.1 million. **Again, round numbers $300 million over the next 12 months from EBITDA.**

On top of that, there will be the full quarterly results for the 3 Suez tankers and 2 chemical tankers. That should add to the $300 million. The new VLCCs will all arrive in 2Q and 3Q and start producing EBITDA too. If the target is to have a new long-term contract for the FPSO in the first half of 2019, the FPSO may start producing EBITDA again before the end of the 12-months. The Connector is also on contract into mid-November with an option to extend to the end of December. Interest in the vessel is improved for post-winter 2019 for more consistent cash flow results with a longer contract, rather a series of 2-4 month engagements.

**After the next 12 months, Ocean Yield will not have the $36 million in capital spending, the $30 million in demobilization cash outlay, and cash needs become essentially $320 million per year** for interest, debt maturities, and the dividend (Unless it adds more ships which in turn add more EBITDA). The FPSO was producing almost $115 million in EBITDA per year. The new contract will come in lower than that – maybe even less than half that, but the vessel is debt free and with the new ships and the FPSO operating, the company looks likely to cover all cash needs without refinancing debt or tapping liquidity.

We also want to point out that Ocean Yield spent recent years prepaying the FPSO's debt to $0 and that was consuming the bulk of its cash flow. In 2016, EBITDA from the FPSO was $115 less interest expense and debt retirement of $75 million – so only $40 million was available for other corporate cash needs. In 2017, FPSO EBITDA of $116 million paid $84 million in interest and debt retirement leaving only $32 million from the FPSO. **So, the FPSO can come in at a much lower contract price and may still produce more than $30-$40 million in cash for general corporate purposes annually.**

**A quick summary here** – the company is targeting a flat dividend until the FPSO situation is resolved. Cash and near cash are about $250 million at the moment and $300 million of EBITDA is likely in the next 12 months assuming nothing from the FPSO. Management sees that and knows it has $400 million in cash outlays too which includes the dividend. They are willing to spend cash in the short term to maintain the dividend until the FPSO is working again. If that doesn't happen for some reason or it is delayed for an excessive amount of time – then they will need to either cut the dividend in our view or sell the FPSO and reinvest that cash in other ships.

## Solstad Offshore Is a Possible Unforeseen Issue

Solstad is a company that charters a number of ships for offshore support to the oil and gas industry. Jon Fredrickson who owns Seadrill owns a large stake in Solstad. In early 2017, the company was looking to restructure some of its charters due to softness in the market. The view was the offshore market would improve within five-years and in return for a lower day-rate early on, a company like Ocean Yield would receive shares of stock, a potential cash sweep if day rates on the vessels exceeded targets and a balloon payment.

Ocean Yield took the deal and cut its rates on the two ships to about $12,000 per day (we are converting NOK to USD at current levels) or $4.4 million per year through 2021. ($8.8 million for two ships.) They will increase to $25,000 per day in 2022-23 and there is a total balloon payment of over $30 million after that. If the market recovers, the $30 million balloon can be prepaid with cash sweeps through a profit-sharing arrangement. And they received stock worth about $15 million at the time that was subsequently written down to $6.5 million and is now valued at $5.3 million given the state of current Solstad.

**Solstad is approaching creditors and customers to boost liquidity again during the coming winter when business is seasonally slower. Also, the market has not turned as fast as forecast. The CEO told Reuters in late October, *"We were all too optimistic about when the recovery will happen." 2019 will probably be a bit better, but we will need to wait until 2020 or 2021 to see the rates rising to reasonable levels."***

**We do follow the offshore market a bit and we have seen some similar comments from rig operators – essentially, they are winning some new contracts, business seems to be turning up, but it's not recovered yet.** It's much better than late 2016 and early 2017 when Solstad restructured last time. But, pricing has not fully returned. **Marc Edwards the President of Diamond Offshore commented this week on what it is seeing in offshore drilling:**

> *"We believe the day rates in the floater (type of rig) market have bottomed, and although we are unsure as to the velocity of any recovery, we believe day rates will generally improve from here on in."*

*"We believe the moored (another type of rig) market has hit bottom. We have previously stated that there has been tightening in the North Sea, but is not limited to just that region. We are seeing it in non-harsh markets as well, where we are attaining incremental price increases as a result. Customers are looking to lock in capacity for 2020 and beyond as they see the coming strengthening of this asset class."*

*"We also believe the DP market has bottomed, but the question remains what type of recovery we will have. We do not expect day rates to recovery rapidly; however, we do believe the rates have found a floor and there is more upside than downside from her forward."*

*"Now moving to our contracting activity, recall that in the second quarter Diamond was able to secure an additional five years of backlog with three major operators: Shell, BP, and Anadarko at rates significantly above the prevailing market. In the past quarter, we are announcing three additional contracts, one in the North Sea and two in the Australasia region."*

The recovery may be near and new activity is more widespread. We have commented before about the level of reduced investment by the oil companies was unprecedented after 2013, which has set up the offshore market for a rebound as current wells decay and production declines.

So Solstad is looking to sell vessels, raise money from equity holders, or defer payments with creditors. The focus is to get through the next two quarters and it may not be as major of a restructuring as before. Also, with the Ocean Yield charters already reworked, the focus may be on ships with higher lease payments with other counterparties. We do not think that some percentage of lost revenue from the $8.8 million current charter upends the Ocean Yield cash flow forecasts. Any negative news from Solstad will likely flow to its counterparties' stocks.

However, there are potentially larger risks if Solstad looks for a more extensive restructuring and tries to cull some of its fleet. It is likely the Solstad stock owned by Ocean Yield may see an impairment and a further reduced day rate (or waiver period on charter revenue) could offset some of the growth in cash flow from the new Suexmax tankers that have not had a full impact on results yet. If it became worse, it would be a bigger issue if Solstad defaulted on the charters and there was a longer period of time without charter revenue. That is worst-case as Solstad has deep pockets behind it and it should be easier to do some minor restructuring with the market showing signs of recovery than it was in 2016. **However, we will go to a NEUTRAL rating on Ocean Yield as this situation plays out.**

## Disclosure

*BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.*

*The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.*

*This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.*

*Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.*