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Opportunity in confusion

At first glance, the junk-bond market is an oasis of peace and prosperity. A second glance is more informative. Now begins a survey of risk and opportunity, post the energy bust.

In preview, we judge that this is the time for security analysis. Some energy-related bond yields are too high, others are too low. In a few cases, Mr. Market has distractedly assigned incongruous yields to different securities of equal standing within the same capital structure. Halcon Resources, Transocean Ltd., Paragon Offshore, FTS International and Goodrich Petroleum are the companies on the analytical agenda.

Public policy provides the analytical back story. In the 12 months through September, speculative-grade borrowers defaulted at the rate of just 1.6%. Over the long sweep of time, they have defaulted at the annual rate of 4.4%. The yield famine is the underlying source of this cosmetically impressive showing. Sub-investment-grade corporate debtors don't fail at the standard rate because the super-hospitable bond market won't let them.

Low, low borrowing costs have had their effect in the Oil Patch, too. Along with commensurately liberal covenant terms, rock bottom hurdle rates have sped the investments that produced the energy that arguably sank the oil price. A new Deutsche Bank analysis finds that capital expenditures by American energy companies over the past four years averaged 150% of EBITDA against capital outlays of over the same span averaging two-thirds of EBITDA for non-energy borrowers—EBITDA being defined as earnings before interest, taxes, depreciation and amortization. In June, Bloomberg quoted a sell-side analyst on the tendency of small drilling companies to spend more than they earn and to finance the difference: "Theoretically, it can continue forever. It's generally not seen as a major issue by investors."

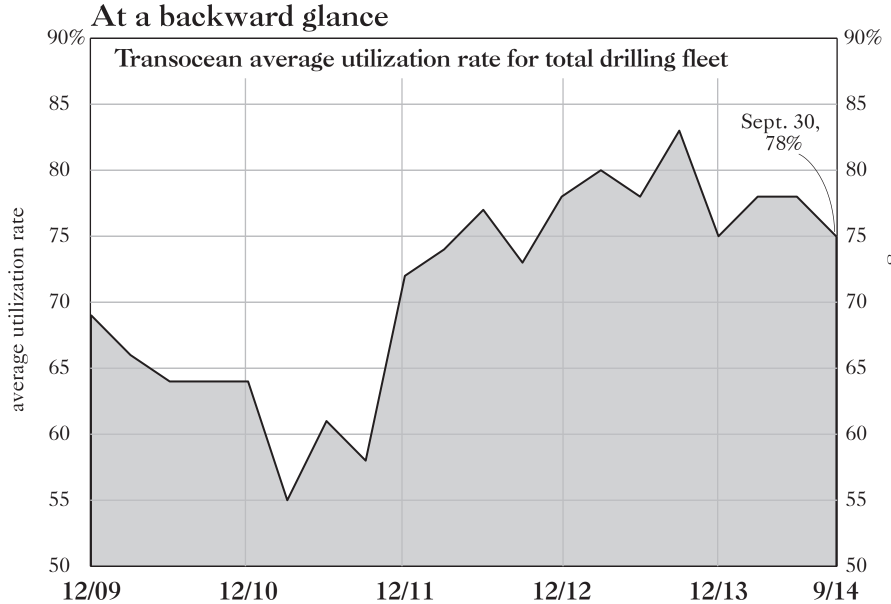
The Volcker Rule adds a final public-policy fillip to the narrative. Absent the usual big-bank market makers, corporate debt trades in fits and starts. The posted bid for a certain not overlarge corporate issue might be, let us say, 85—that is, until a seller shows up with a million dollars worth of securities, at which time the bid pulls back to 78 or 80.

Accounting conventions put their stamp on the boom. Once upon a time, right-thinking people denounced EBITDA. It was paid-up subscriber Michael Harkins who observed that the very people who seemed most adamant about excluding depreciation from calculations of corporate cash flow were the ones who were divorcing their first wives.

Now comes EBITDAX, under which, as colleague Charley Grant relates, "a company can add back to EBITDA the impairment of proved reserves, exploration expense, non-cash stock compensation expense and unrealized losses on derivatives, among other seemingly similar basic debits. Anadarko Petroleum, Continental Resources and Penn Virginia are among the companies that avail themselves of this accounting `X' factor."

Of course, not even the most cre-

At a backward glance



source: company reports

ative accounting can lift the oil price or materialize the income with which to service fixed charges. According to the Deutsche Bank analysis, a sustained $60 oil price would imply a 15% default rate for high-yield energy companies, which, in turn, constitute 15% or so of the junk bond universe. "If this scenario were to materialize," relate Deutsche Bank analysts Oleg Melentyev and Daniel Sorid, "U.S. energy Bs/CCCs would have to trade at spreads north of 1,800 basis points, about 1,000 basis points away from its current levels. Such a spread widening translates into a 40-point drop in the average dollar price from its current level of 92 points for energy Bs/CCCs." There have been some pretty vertiginous drops as it is. The CCC+/B3-rated Samson Investment Co. 9 3/4s of 2020 last week traded as low as 66.37 to yield 20.5%; sold last summer in the amount of $2.25 billion, they were quoted at par as recently as Sept. 8.

Which brings us to the clarifying investment question: Is the market dealing as efficiently as it might with the oil-price break? Not in every case, we think. Not from what we can see—nor from what we can learn from the knowledgeable Eric Hoff, managing director of FOC Partners, formerly Feingold O'Keeffe Capital, Boston-based manager of $2.5 billion in distress and high-yield assets. What's lacking, Hoff observes, is differentiation between highly leveraged and less than highly leveraged borrowers on the one hand, and between bank loans and bonds on the other; and between the stock and the bond markets, on the third hand (this one proverbial): "It's just kind of the baby with the bathwater."

Hoff identifies Halcon Resources as an example of a speculative baby. Triple-C-plus-rated Halcon is an E&P company with operations in North Dakota, Texas and Louisiana. Though it shows net debt to EBITDA of 4.5 times, the company is not so vulnerable as it seems. Some 75% of its fourth-quarter production (using the third-quarter run rate of 43,554 barrels of oil equivalent a day) and 80% of its 2015 production (assuming the same run rate) will be hedged at prices in the upper $80s and lower $90s, management relates; 40% of 2016 production is likewise hedged. In the third quarter, EBIT alone covered interest expense by less than two times. EBIT combined with the net

Tide rushes out

source: The Bloomberg

gain on derivative contracts, however, covered interest expense by six times. "So," says Hoff, "if oil is due to rise, or simply stop falling, Halcon is likely to be able to service their debt well into 2016. If oil falls further and stays there for an extended period, maybe that's another story." Halcon's three public debt issues, which combine to $2.9 billion of par value, fall due in 2020, 2021, and 2022. Their yield to worst ranges between 12.9% to 13.6%. We rate them highly speculative with a better than fighting chance to prove money-good.

As to bathwater, the oil service companies—e.g., owners of the big offshore drill rigs—fill the bill. When good things happen to the oil price, better things happen to the servicers, and vice versa. Some recent remarks from the Halcon front office underscore the risk to the industry that's positioned at the end of the whip of the oil market. "[Our 2015] outlook is driven by our view that the service cost side of our business is out of sync with crude oil prices," CEO and Chairman Floyd C. Wilson was quoted as saying in Halcon's third-quarter press release. "As a result, we are electing to reduce spending next year while still preserving our ability to grow production year-over-year. While we are substantially hedged through 2015 and into 2016, we believe that the precipitous drop in crude prices calls for conservatism." Halcon had expected to operate 11 rigs in the coming year, now it says five.

"Now, with oil at $74 and all of these guys under pressure," says Hoff of the offshore servicers generally, "you're seeing the demand side fall off. So you've got the perfect storm for these guys."

Which will serve to introduce Transocean, its 79 offshore mobile drilling units (with a dozen more under construction) and its $10.4 billion of BBB- public debt. The debt is unremarkable at a backward glance; at the end of the third quarter, it amounted to 2.8 times EBITDA. Looking forward is another matter. The stock market, which makes its living by attempting to look forward, has sawed the Transocean share price in half this year.

One would expect that if the oil bear market persists, more and more E&P companies will follow Halcon's conservative lead. If so, Transocean will be idling some of its currently employed ultra-deepwater, deepwater and premium jack-up rigs. As it is, 75% of the fleet is employed, three percentage points more than the five-year average utilization rate of 72%. The average, though, masks a certain amount of business drama. In the first quarter of 2011, during the BP/Transocean disaster in the Gulf of Mexico, utilization plunged to as little as 55%. It snapped back to 72% by the fourth quarter of 2011, but the damage to the company's credit metrics was done. By the second quarter of 2012, the ratio of debt to trailing EBITDA reached 11 times, up from just about where it is now—the aforementioned 2.8:1—at the end of

2010. What would happen in a setting in which capacity utilization rates fell further or rebounded less quickly than they did in 2011-12?

We ask because the bond market seems not to be raising the question. At least, no Transocean bond trades lower than 88 cents on the dollar. The highest yield to worst is that of the 7.5s of 2031, at 7.69%. One issue, the 7 3/8s of 2018, trades as high as 111.44 to yield 3.73%. This publication concurs with Hoff, who says of Transocean: "We see it getting cut to junk, and we see these guys burning a lot of cash and we think the bonds are still substantially overvalued."

As far as that goes, the investment-grade debt of the big oil service companies generally leaves us cold. The world is either deflating or inflating. The oil bear market will linger or it won't. If deflation is in our collective future, the bonds to own are Treasurys. If inflation is the prognosis, the bonds to own are the deeply discounted, speculative-grade debentures of the likes of Halcon. In a twilight world like today's, the investment-grade bonds of Halliburton (which is tying the knot with Baker Hughes) and of Schlumberger will likely continue to deliver their 1.5% to 7% yields. However, we think, one could do better—as well as worse.

As to worse, Hoff names Paragon Offshore, the geriatric spin-off from Noble Corp. About a year ago, Noble decided that it wasn't getting the equity valuation it deserved. It assigned blame to the presence of 42 middle-aged rigs in the corporate offshore drilling fleet. Thirty years old and beyond, the jack-ups and ultra-deep-water rigs were serviceable but (so management judged) value depleting. "With technological advances post the Macondo blowout," says Hoff, "safety is of the utmost priority. The economics of an offshore development can vary with the price of oil, but an accident of the caliber of the Deepwater Horizon spill could be lights out for you. With each new innovation, these older rigs become less and less in demand, especially in an oversupplied market like this. If you're Total or Exxon or Shell, you really have your pick of any type of rig you want."

Day rates were beginning to come under pressure when crude still fetched close to $100. "Rates are likely to drop, but with a widening spread in day rates between older and new equipment," prophesied Rune Magnus Lundetrae, chief financial officer of Seadrill Ltd., in February remarks quoted by Reuters, ". . . and there is likely to be more idling for older rigs." What might Paragon say to all this? Lee Ahlstrom, vice president for investor relations, tells *Grant's* in an e-mail: "In an environment where oil prices have fallen, Paragon's fleet of well-maintained, safe, and cost-effective jack-ups continues to be in demand from our customers who are focused on matching asset capabilities with their particular needs. We have continued to secure contracts and extensions in our key markets, including the North Sea, Mexico, Middle East and India."

So far, the market sides with Lundetrae. Paragon, which debuted on the New York Stock Exchange in August at $12 a share, is quoted today below $5. A pair of Paragon debt issues, the 6.75s of 2022 and 7.25s of 2024 in the sum of just over $1 billion, rated Ba2/BB, are quoted in the 60s to yield upwards of 14%. Looking at current financials alone, you rub your eyes: Debt to trailing EBITDA is slightly less than two times. However, as Hoff observes, it isn't very hard to imagine a substantially—and suddenly—higher ratio of debt to EBITDA.

"Indeed," Grant adds, "a visit to the latest Paragon 10-Q shows that while 72% of available days are committed for 2014, that number drops to 41% in 2015, 10% in 2016 and 2% in 2017. The total backlog is just over $2 billion, $1.6 billion over the next three calendar years. At that, the figures may understate the bearish case, as roughly 13% of the overall backlog is attributed to contracts with Mexican state oil firm Pemex, which has the ability to cancel its drilling contracts with '30 days or less notice, without Pemex's making an early termination payment.' Ahlstrom reports that Paragon has expanded the backlog by roughly $580 million since Sept. 30, and that the 2015 committed days now exceed 50%. The fate of blended average day rates, which were up 17% year-over-year in Q3 to $150,548, remains to be seen."

Assume, then, that the oil price doesn't snap back, that drilling day rates remain depressed and that older rigs bear the brunt of the resulting shrinkage in exploration and production activity. Paragon generated $234 million of EBITDA in the third quarter. One can imagine it generating substantially less. In the worst case—with depressed demand for aging rigs complementing plunging energy prices—one can imagine it generating nothing at all.

Hoff wonders, and we with him, why different investor constituencies of the same corporation sometimes seem not to talk to each other. Houston-based Goodrich Petroleum Corp. (GDP is the Big Board equity ticker), an independent E&P company, provides a case in point. Goodrich develops and produces oil and gas in the southeast United States. It owns working interests in 392 producing oil and natural gas wells situated in 32 fields in eight states. It has financed itself, in part, with $275 million of senior unsecured notes, the 8 7/8s of 2019; 4.4 million shares of 10% callable preferred stock due 2029; and 44.4 million basic shares of common (not to mention a slug of convertibles).

So far, so unremarkable. What *is* remarkable is the disparate valuation of the various segments of the Goodrich capital structure. The common has rallied by 23% this month and by 39% from the lows, though it is still down by 40% on the year. At $10.12 a share, the company boasts an equity market cap of $448 million, from which one would suppose that Goodrich's solvency is a foregone conclusion.

Or not so fast. The 2019 bonds trade in the low 70s for a yield to worst of 18.6%. Solvent companies in a time of zero-percent interest rates don't generally borrow at 18%. Then, again, the preferred, quoted at $21.90 a share, is priced at a yield to worst of 11.9%. Considering that total debt is 29 times trailing EBITDA and EBIT has failed to cover interest expense since the third quarter of 2012, preferred shareholders might just be the somnolent ones.

Closely held FTS International—Temasek, the Singapore sovereign wealth fund, is the controlling shareholder—makes another example of seeming intra-capital-structure confusion. FTS specializes in well-completion services, such as pressure pumping, wire line and reservoir optimization technologies. It has a $500 million, 6.25% secured bond due in 2022, which is trading at 87 to yield about 8.65%. And it has a $480 million loan, as Hoff relates, "pari passu, same assets, same everything, which is L+475 with a 1% floor, so a 5.75% coupon. This loan trades at 96.50. It's a year shorter maturity, but that yield to maturity is 6.4%. So you have a 220 basis-point differential between a loan and a bond that should be trading exactly on top of each other."

Maybe there are fewer necessitous sellers in the loan market than in the bond market, Hoff speculates. Maybe the "flows" are different, one market to the other. Or maybe—this is *Grant's* talking—too many investors have left the hard work of investing to the index makers. Awake, we say, and read the footnotes!

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