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Oil and water

Evan Lorenz writes:

Not every company can boast 101% year-over-year top-line growth, but, then again, not every stock commands Nvidia Corp.'s 37 times price-sales multiple. For those who prefer to deal in ratios of price to *earnings*— and who'd gag at even a 37 times P/*E* multiple—there are alternatives. In preview, *Grant's* is bullish on Tidewater, Inc. (TDW on the New York Stock Exchange), the No. 1 owner and operator of offshore service vessels (OSVs).

Admittedly, the customary auguries of a rising oil price are nowhere to be found in China's burgeoning debt crisis (see page 9) or in the downbeat August purchasing managers' reports for Germany, France and the U.K. However, weak economies don't necessarily presage low oil prices.

Recall that Japan's economy downshifted shortly after the Nikkei peaked in December 1989. Yet Japanese oil consumption actually rose, to 5.8 million barrels per day (mmbpd) in 1995, from 5.3 mmbpd in 1990. The end of China's world-beating growth may or may not spell disaster for the Oil Patch.

As far as that goes, balancing the market in hydrocarbons may require slower economic growth. As noted in these pages before, the prolific Permian Basin, which straddles Texas and New Mexico, may be reaching peak production (*Grant's*, July 28). It's hard to exaggerate the importance of the Permian, which accounted for 74% of incremental oil production worldwide between 2015 and 2022. If that gusher is subsiding, the world will need to find new sources of oil, including offshore.

"Global oil-market balances tightened further in June to the most undersupplied level since summer 2021 on fresh, record-high demand—and that's before Saudi production cuts hit the tape in July," Rory Johnson, the founder of Commodity Context, informed his clients last month. In June, global oil supply summed to 101 mmbpd, a shortfall, relative to global demand, of 3.5 mmbpd. "Moreover," Johnson added, "it's notable that the large deficits observed in May have been revised even larger on stronger demand and despite upward revisions to supply: 2.7 mmbpd vs. an initial estimate of 2.3 mmbpd noted in last month's report."

Draws on inventory continue in the meantime. Energy-analytics firm Kpler estimates that, in the four weeks ended Aug. 23, global stocks fell by 60 million barrels, to 3.37 billion barrels, near a six-year seasonal low.

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Tidewater's fleet of offshore service vessels is the world's biggest, a collection comprising 142 platform supply vessels (PSVs), the pickup trucks of the offshore energy industry that ferry people, equipment and supplies to and from drill sites; 57 anchor-handling towing supply (AHTS) vessels, which, as the name suggests, tow, position and handle anchors for drilling rigs; and 29 crew boats, maintenance vessels and tugs.

Tidewater focuses on the larger, more highly specified vessels that can bear extra-large loads in extra-choppy waters; 65% of the company's PSV and AHTS boats fall into this category. The median age of Tidewater's fleet is 11.3 years, 7.8 years below the industry average.

The travails of the OSV sector recall those of the offshore drillers (*Grant's*, Dec. 9, 2022). The boom in offshore drilling seemed like it would go on forever as the price of Brent crude surpassed $115 in June 2014. Taking advantage of low interest rates and easy credit, OSV operators placed orders for new boats equivalent to 20% of the existing fleet. That summer, Saudi Arabia, in effect declaring war on U.S. shale production, flooded the market with oil, but shale output kept right on growing, and crude prices sank to $27.88 on Jan. 20, 2016.

As oil gushed from onshore shale basins, exploration companies reduced offshore spending. Tidewater's day rates, which peaked at $19,415 in the three months ended Sept. 30, 2014, collapsed to an average of $9,809 in 2018. Now bankruptcy filings gushed, including Tidewater's own (the company exited Chapter 11 in 2017), along with the widescale scrapping of idle vessels. It's a mark of the fury of the liquidation that the worldwide OSV fleet is about 30% smaller than it was nine years ago.

Well recalling that bust, operators are unlikely to add much supply over the next several years. For one thing, day rates aren't high enough to justify new orders. Tidewater reckons a rate of at least $38,000 to justify the purchase of a new OSV at an assumed 15% cost of capital. In the second quarter, Tidewater itself was earning an average of $16,042 per day.

Several factors explain the $38,000 calculation. Inflation is one. Since

2014, the cost of building a new OSV has leapt to $65 million from around $45 million. Another is the cost of capital, which has climbed to the aforementioned 15%. In 2014, Tidewater paid an average interest rate of 4.6% on its borrowings. As a footnote, the industry as a whole wasn't earning its cost of capital even in 2014, when everybody was building new boats.

The projected energy transition presents another pitfall for the likes of Tidewater. The average offshore service vessel has an economic life of 25 years. Will a boat ordered today find useful employment in the year 2040? The specter of stranded assets looms over many a board-of-directors meeting.

On top of this, the International Maritime Organization is ratcheting up emission standards with a goal of net-zero greenhouse gas (GHG) by 2050, with the next set of rules scheduled to take effect in 2030. "Given the long lifetime of ships of 20–25 years," a July 13 World Bank blog post explains, "this implies that ships recently put into service or being ordered now ought to plan for being able to run on zero- or near-zero GHG fuels in the not-so-distant future."

Currently, exactly no engine designs produce zero- or near-zero emissions. "If you're going to build a 25-year asset, you can't be seven years into your life and have to retool the entire engine room and propulsion equipment," Quintin Kneen, the CEO of Tidewater, tells me. "That's a deal-breaker."

Once-bitten lenders remain wary of the offshore oil-boat business. On May 3, unrated Seacor Marine Holdings, Inc., an OSV operator with 59 vessels, canceled plans to issue senior secured bonds, management not liking the indicative terms.

Tidewater, with a fleet of 228 vessels, was able to tap the credit markets to fund the $577 million purchase of 37 vessels from Solstad Offshore A.S.A. on July 5. Before the transaction, and despite the debt restructuring it underwent in 2020, Solstad showed a ratio of net debt to trailing Ebitda of 8.5 times; Tidewater's leverage ratio, including the debt to finance the transaction, stands at 1.5 times estimated 2023 Ebitda.

"What we wanted to do was to buy the assets for $577 million, and we were hoping that the banks who were already lending to Solstad would say, 'Okay, we'll lend the money to you, Tidewater, because you're a quality credit who will pay us back,'" Robert Robotti, the eponym of Robotti & Co. Advisors, LLC (the company's second-largest shareholder) and a director on Tidewater's board, tells me.

"Most of the banks said, 'No,'" Robotti continues. "There was only one bank who stayed in the financing, and they want out. They lent us $325 million, but $100 million has to be repaid the first year, $75 million the next year, and the balance will all be paid off in the third year, and they are charging us a floating rate that's close to 10%."

Unrated Tidewater funded the remainder of the purchase with $250 million's worth of senior unsecured bonds maturing in 2028 with a 10 3/8% coupon at a price of 99. The 10 3/8s today trade near 102 to yield 9.8%, a spread of 522 basis points over Treasurys, or 124 basis points wider than the average single-B spread. On the valuation evidence, then, investors have conferred their own rating on the apple of our eye—"deep junk" would be that implied verdict, the afore-quoted moderate leverage ratio notwithstanding. Perhaps the crowd will reconsider.

Even if Tidewater decided to place an order for a new service vessel today, it's not clear which shipyard would, or could, accept the order. The long years of trouble and retrenchment exacted their toll on the shipbuilding business, too, and many of the surviving builders are working off backlogs of orders for liquefied-natural-gas carriers. The best estimate of the elapsed time between order and delivery of a new oil-service boat is two years.

From a shipyard perspective, LNG carriers are a better business risk than OSVs. Buyers of LNG typically commit to multi-decade offtake agreements, which significantly lower the risk that the buyer of an LNG vessel will default on its obligations to the shipbuilder. While offshore service vessels can secure one-to-three-year contracts today, OSV customers typically have the right to cancel these agreements with 90 days' notice.

"What I'm least worried about right now is supply, which is very unusual," Kneen tells me. "That's what I'm accustomed to be always worried about." The biggest risks the Tidewater chief sees are a global slowdown that crimps demand for energy or a disaster at an offshore drilling site like the fatal 2010 Deepwater Horizon explosion.

Despite these concerns, demand for offshore service vessels is booming. "Rystad projects that between now and the end of the current decade we're going to need almost 50 new FPSOs," says Jim Rollyson, who rates TDW a buy for Raymond James & Associates, Inc. "FPSO means 'floating production storage and offloading'; it's an offshore platform that floats. For every one of those FPSOs that get placed into service, according to Tidewater, that's somewhere in the neighborhood of three to five vessels' worth of demand."

"If we truly build the 48 FPSOs that Rystad is projecting here in the next six-and-a-half years," Rollyson adds, "you start doing that math—just call it four times—that's almost demand for an incremental 200 vessels on the PSV side, and we literally had, as of the last time

Tidewater, Inc. at a glance
all figures in $ mns except per share data

	TTM*	2022	2021	2020	2019
revenue	$786.6	$647.7	$371.0	$397.0	$486.5
operating income	95.6	26.7	-95.0	-186.8	-86.6
net income	49.3	-21.7	-129.0	-196.2	-141.7
earnings per share	1.06	-0.49	-3.14	-4.86	-3.71
shares outstanding	46.5	44.1	41.0	40.4	38.2
cash	171.3	154.2	149.0	149.9	218.3
debt	757.0	169.0	167.9	192.7	288.9
total assets	1,344.2	1,297.7	1,095.8	1,251.2	1,579.5

* Twelve months ended June 30, 2023.

source: company reports

I chatted with Tidewater, less than 60 idle ships in the large-vessel class."

Tidewater's results are beginning to reflect the rapidly tightening environment. In the three months ended June, day rates averaged $16,042, up from $12,544 in the second quarter of 2022, and new contracts signed last quarter averaged $23,498. As management expects the market to continue to tighten, Tidewater has kept the duration of its contracts short; just over one year is the length of its average charter nowadays.

"We think they'll do something like $600–$700 million of free cash flow in 2024 off of an average day rate blended across their fleet of $20,000–$21,000," says Darren Maupin, founder of Pilgrim Global Advisors, LLC, a 2022 *Grant's* conference speaker (he built a bullish case for Noble Corp. plc) and a shareholder of Tidewater.

With the Solstad acquisition, Tidewater's net debt sums to $585.8 million. "So, 12 months from now, they'll be close to debt-free," Maupin continues. "In 2025, based on a relatively modest rate increase to $24,000 per day, you have $1 billion in free cash flow." Tidewater's market cap is $3.2 billion.

Tidewater used its clean post-bankruptcy balance sheet to buy OSVs at a fraction of replacement cost. In 2018, it acquired GulfMark Offshore, Inc.'s 65 OSVs for $273.5 million, or $4.2 million per unit. Last year, it purchased Swire Pacific Offshore Holdings Ltd. for $215.5 million, gaining 50 boats at an average cost of $4.3 million. The aforementioned transaction with Solstad brought Tidewater 37 boats at an average cost of $15.6 million.

Top use for cash is to keep doing what it's been doing. "The banks are still holding on to a lot of debt," Kneen says, "because a lot of companies around the world don't have the benefit, if you'll allow, of the Chapter 11 process, so they can't restructure themselves. There's a bunch of debt that's still out there, especially in Northern European shipping banks, which normally provide capital for building.

"But, quite frankly, there's going to be more money than there are going to be acquisition opportunities," Kneen continues. "After that, it's returning money to shareholders. People have heard me say this a million times, but businesses are built to return money to shareholders. That's why we exist."

On Wall Street, five out of five analysts rate Tidewater a buy. Short interest is somewhat elevated at 6.7% of the equity float. Over the past 12 months, insiders—mostly Robotti and his firm—have net purchased 490,546 shares at a cost of $18.2 million.

"Quintin is doing an excellent job," says James West, who rates Tidewater a buy for Evercore ISI. "He's been very savvy with the acquisitions that he's made and very savvy with the capital structure that they have right now. I think that he'll continue to try to pick off high-quality assets at attractive valuations."

And if the oil market takes a detour to the downside? Tidewater has the balance sheet and the experience to weather a storm.

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