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His highest praise

The cyclical gods may be starting to smile on the clapped-out deep-sea oil drillers. Last week Maersk Drilling A/S, the offshore-drilling subsidiary of the world's largest shipping company, signed a four-year contract with Tullow Ghana Ltd., the first such commitment to span more than three years since the mid-2014 break in oil prices. In the past two months Transocean Ltd. inked two shorter-term contracts at higher-than-recently-customary day rates. Last week came news of the scrappage of two more deep-sea vessels, bringing the number of retired platforms to around 100, or one-third of the pre-crash fleet.

Politics, too, is extending a hand to the bulls. By executive order, President Barack Obama prohibited oil exploration in 94% of the U.S. outer continental shelf, defined as the area between state coastal waters and the open sea. Last week, the Trump administration moved to return some of that territory to drilling (though not Florida, at the request of the governor of the Sunshine State).

Since *Grant's* laid out the bull case for deep-sea drillers (see the issue dated Nov. 3, 2017), the price of Brent crude has rallied by 11% to $69.14 from $62.07. Over the same period, our two clicks-to-pick, Transocean (RIG) and Ensco plc (ESV; both on the Big Board), have risen by 11% and 29%, respectively. We write to freshen the driller story and to highlight a pair of fetching bonds.

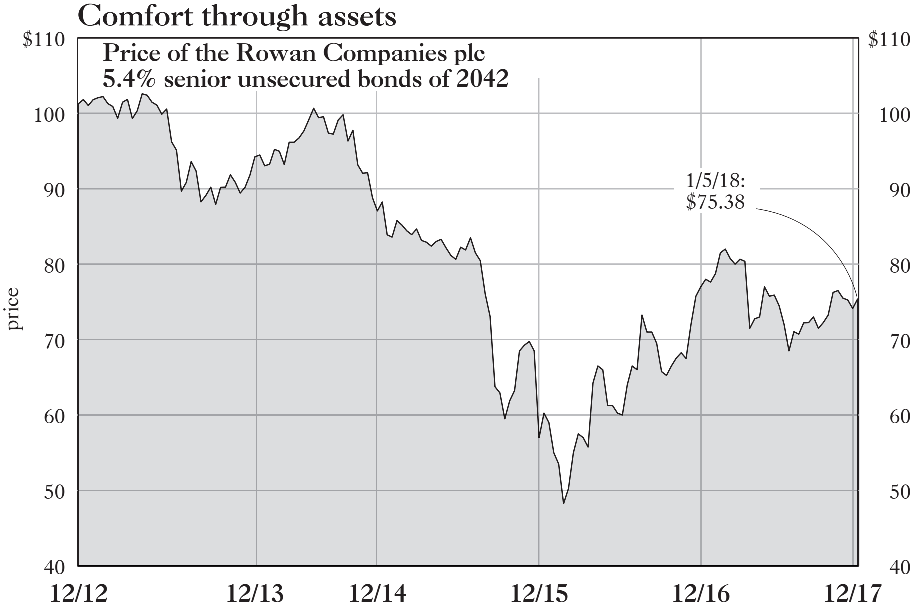
Offshore drillers, you'll recall, deploy two basic rig types: jack-ups and semi-submersibles. Jack-ups are platforms with extendable legs and stand on the ocean floor. Semi-submersibles, a.k.a. floaters, are platforms that rest on top of hollow columns that float above a drill site. They're used for deep-water drilling. Floaters are the specialties of the house at Transocean and Ensco.

Contagious, our bullishness is so far not. Short interest in Transocean and Ensco weigh in at 22.5% and 16.4% of their respective floats. Of the 37 analysts who cover RIG, just 16 say "buy"; with Ensco, it's 16 out of 32. Typical of the ruling sell-side skepticism is a Jan. 4 bulletin from Jefferies LLC, which reckons that contracted semi-submersibles will decline to 142 in 2018 from 150 last year. While an additional 20 rigs, the analysts say, will be cold-stacked or scrapped by year end (out of an overall fleet of 200 or so), drillers will begin to raise day rates in 2019 and then "only (very) modestly."

"With Brent prices where they are, I would say the exact opposite," Adam Duarte, managing partner of Sears Point Capital Management, a hedge fund focused on the energy sector, tells colleague Evan Lorenz. (Duarte kindly contributed his bullish views to our Nov. 3 analysis.) "Given the cost reductions and efficiencies that every single E&P company has undergone in the past three years, all their offshore projects are more economic than where they were three years ago. So, all their break-evens have come down at a time when crude is going up and capacity is going out of the market.

"All else being equal, 2018 will be better than 2017," Duarte continues. "Even if crude oil goes down $10 a barrel, there are still incremental rigs com-

Comfort through assets



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ing out of the market. Your supply picture is getting better no matter what."

While the common stocks of RIG and ESV appear attractive, there are also opportunities at a higher level in the capital structure. A pair of bonds of the Rowan Companies plc—the 5.4s of 2042 and 5.85s of 2044—constitute one such option. Each security is senior unsecured in status, single-B-plus in rating. Trading at 75.38 and 80, respectively, each is priced to yield 7.6% to maturity, a return that, if realized, would hit the hurdle rates of pension-plan sponsors everywhere.

Rowan, unlike Transocean and Ensco, primarily operates in shallow waters. Of the company's 26 rigs, only four are deep-sea floaters. In addition to its fully owned fleet, Rowan is part of a 50/50 joint venture with Saudi Aramco called ARO Drilling. The enterprise owns and operates four jack-ups (three furnished by Rowan and one by Aramco), for which Saudi Aramco is the sole contracted customer. By the end of 2018, Rowan will present two more jack-ups to ARO (Aramco will make an equivalent cash contribution). The partners plan to order another 20 vessels over the next dozen years.

While Rowan has good assets and a solid JV partner, management did the stockholders no favors during the oil crash. The company took delivery of those four floaters in the bleak years of 2014 and 2015. Yet, after making final payments for the rigs in the first quarter of 2015, Rowan has generated positive free cash flow in every subsequent quarter.

As of Sept. 30, Rowan's debt footed to $2.5 billion vs. a cash balance of $1.2 billion. That balance will grow later this year upon Rowan's delivery of the two jack-ups to the Saudi JV. The floaters are state-of-the-art assets, known in the trade as generation 7. Richard Rubin, paid-up subscriber and founder of the deep-value fund Hawkeye Capital Management, LLC, tells Lorenz that units similar to Rowan's four semi-submersibles have traded at between $250 million and $350 million in recent M&A transactions. At $225 million apiece—let's be conservative—the four rigs would be worth $900 million.

As for the JV, Rubin estimates its value at $1 billion based on the free cash flow that the six rigs will likely produce. As Rowan owns half of the JV, its stake is worth $500 million. Adding cash, plus the four floaters and the JV (and not giving Rowan credit for the 20 jack-ups that the JV plans to buy over the next decade), Rowan has $2.6 billion in identifiable assets—or more than total debt outstanding.

Rubin confers his highest praise: "This is the largest position in our fund."

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