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Deep-sea fishing

The No. 1 offshore deepwater drilling contractor is based in landlocked Switzerland but functionally resides at the intersection of oil and debt. Transocean, Ltd. (RIG on the New York Stock Exchange) is the topic at hand. In preview, *Grant's* is bullish.

Or, rather, we say (thanks to reader Paul Isaac, whose depth of knowledge and curiosity set this analysis in motion), bullish with an asterisk. Heavily leveraged Transocean is a speculation, with the share price and unsecured credit rating to prove it (respectively, $3.86 and Caa1). Business is strong just now, and we expect it to strengthen. Given the balance sheet, it had better strengthen, although, on form, RIG is an unlikely candidate for insolvency. During the 2014–20 cull of the saltwater drillers, all those not named Transocean—Noble Corp., Seadrill Ltd., Diamond Offshore Drilling, Inc., Valaris plc and Pacific Drilling S.A.—succumbed to bankruptcy.

Transocean owns, in whole or in part, and operates, a fleet of 39 offshore drilling vessels, most self-propelled or "mobile." The fleet comprises 29 ultra-deepwater floaters, which can puncture the seabed up to 12,000 feet below the surface, and 10 foul-weather floaters, which can operate in 19-foot seas and at wind speeds of up to 55 miles an hour.

Shell or Chevron or some other major producer contracts with Transocean to drill an exploratory well—and, if successful, many more wells to delineate the size of the field. At length, a producer's Floating Production Storage and Offloading Unit will show up to extract and store the oil before a tanker appears to haul it away. It's nothing at all, in other words, like the whaleships in *Moby Dick*.

"The technology is incredible," as Darren Maupin, founder of Pilgrim Global Advisors, LLC, marveled at the latest *Grant's* Conference in reference to deepwater oil-drilling vessels in general. "Last cycle, a number of engineers moved from NASA to this industry because it was more challenging. These things cost more than $1 billion to build. They weigh more than an aircraft carrier. They have the thrust of a SpaceX Falcon 9 rocket."

That $1 billion price tag sets bulls' hearts to fluttering. RIG commands a $2.8 billion equity market cap, though a $9 billion enterprise value (i.e., net debt plus equity). "In a bull market," contends an investor we know, "you can ignore the debt, because it'll be gone. I mean, you're going to blink and it's gone. And so, at the end of the day, the only thing that matters is what is the market cap per rig."

If, our friend adds, the market comes around to valuing RIG at the replacement cost of its assets, $2.8 billion of equity market cap would mushroom to something like $40 billion. "A very rational number," he says of that very hypothetical figure.

Not everyone cottons to capital-intensive businesses, nor to oil, nor to the volatile mixture of oil and debt, and these aversions create the Transocean opportunity. No prudent fiduciary would invest in a company that's marked for extinction on environmental grounds, but there's another side to the ESG contention:

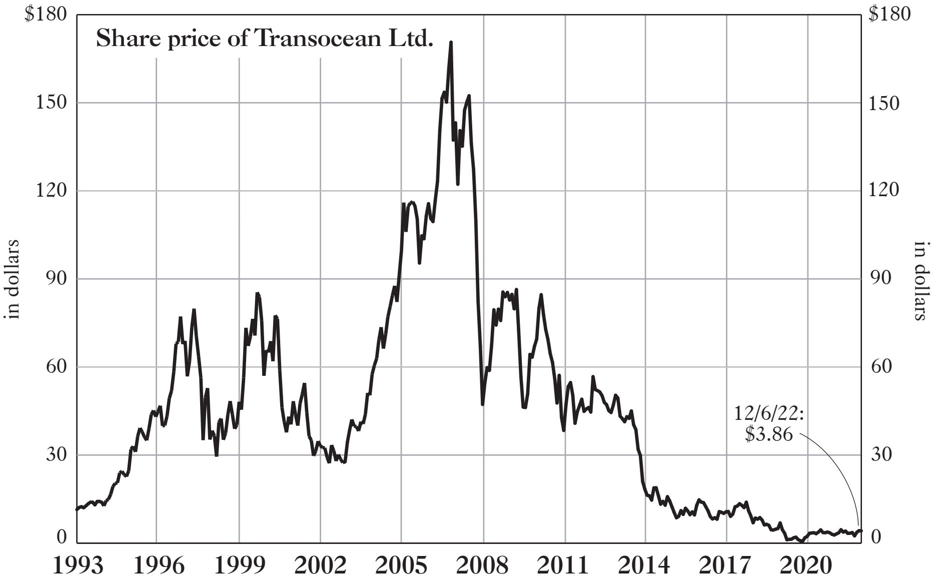
> In the mid to long term, demand for all sources of energy will continue to grow, and it's imperative that new sources of supply are discovered and developed to meet this demand. And while hydrocarbons will undoubtedly, over time, lose market share to renewables in the overall energy mix, most believe that volume-metric demand for oil and gas will continue to increase. In fact, Rystad Energy recently estimated that 63 million barrels per day of new supply are needed to avoid a shortfall in 2030. This cannot be accomplished without significant investment in additional exploration and development, including in the offshore basins requiring our assets and expertise.

That was Jeremy Thigpen, CEO and executive director of Transocean, on the Nov. 3 earnings call, talking his book. According to another interested party, Mark Mey, executive vice president and CFO, "day rates are now above levels necessary to generate cash flows that help support deleveraging our balance sheet."

Moody's Investors Service, however, is not so sure. "Although Transocean's credit metrics are improving," analysts led by Sreedhar Kona allow, "they still remain weak, making the company highly reliant on continued strengthening of offshore drilling fundamentals for its capital structure to become more sustainable. The company's high debt levels and complex capital structure increase the potential for future transactions that could be viewed as distressed exchanges, particularly if industry fundamentals or investor sentiment changes."

Moody's does not exaggerate when it talks about capital structure "complex-

Soon to make waves



source: The Bloomberg

ity." Transocean's debt obligations, listed in descending order of seniority as of Sept. 30, include $2.3 billion in debt with liens secured directly against specific drilling ships; $1.2 billion of senior-priority guaranteed debt that is backed by Transocean and its subsidiaries; $1.8 billion of junior-priority bonds, which are guaranteed by Transocean and its subsidiaries but are junior to the senior-priority bonds; and $1.6 billion in unsecured notes.

Transocean, a triple-B-minus-rated credit when the bottom fell out of the energy markets in 2014, owed not one dollar of secured debt, a fact that gave comfort (false comfort, as it turned out) to the unsecured lenders. As noted, RIG successfully fought to retain its equity and avoid bankruptcy, but victory made it few friends in any part of its capital structure.

New equity issuance, from year-end 2013 through Sept. 30, 2022, boosted the share count to 722 million from 371 million. Yes, shareholders would likely have been wiped out in a bankruptcy proceeding, but solvency didn't treat them much better. Over the 8¾-year span, they bore a 94.2% loss against the 128% return banked by holders of the S&P 500 (reinvested dividends, if any, included).

Not a few bondholders are likewise aggrieved. Over the past eight years, many have been "primed," i.e., subordinated versus more senior claimants, including holders of the so-called junior-priority and senior guaranteed debt. A 2020 coercive debt exchange was the provocation for a lawsuit by Whitebox Relative Value Partners, L.P., which ended without satisfaction to the plaintiff. The Sept. 30 Transocean balance sheet shows a ratio of net debt to trailing Ebitda of 6.84:1; trailing 12-month Ebitda covered interest expense by a ratio of 2.37:1.

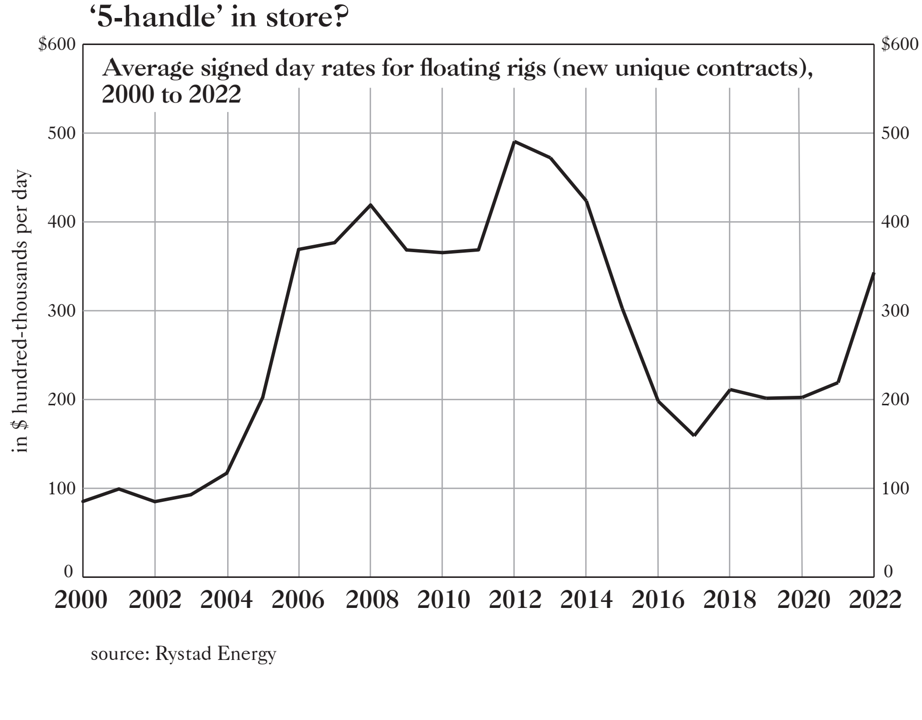
"As technologically dazzling as Transocean's seagoing collateral undoubtedly is," observes colleague James Robertson, Jr., "the market value of those vessels is highly sensitive to the economics of the drilling business, macro and micro alike. Thus, in 2020, the year when oil briefly went sub-zero, some rigs sold for as little as $65 million, down from as much as $900 million in 2012. Based on current estimated drilling-contract trends, Barclays analysts value the fleet today at $10.3 billion. Putting to one side the ships encumbered with $2.3 billion of first-lien bonds leaves a fleet worth $5.8 billion covering $4.6 billion in unsecured creditors."

Transocean today counts 24 rigs under contract, 3 awaiting contracts and 12 stored in dry docks or "cold-stacked." Reactivation would cost between $70 million and $150 million per mothballed vessel.

Across the market for floating rigs, average day rates climbed by 57% in the past year, to $343,000, according to Matthew Hale, lead analyst of energy services at Rystad Energy. Compare and contrast the low of $159,000 set in 2017. Transocean commands the highest average day rate among the deepwater drillers: $343,400 versus $222,000 for Valaris and $212,958 for Noble—evidence, some say, of RIG's steely skills of negotiation.

Averages hardly do justice to the buoyancy of the market. In the second quarter, Transocean signed a two-year contract for *Deepwater Conqueror* at $440,000 a day. "And if we look at the third quarter of 2020," Thigpen told last month's earnings-call audi-

'5-handle' in store?



source: Rystad Energy

ence, "the average drillship fixture was $184,000 per day. Last quarter, the average was $393,000 per day, an increase of 113%."

According to Barclays analysts led by J. David Anderson, Transocean snagged most of the recently signed $400,000-plus contracts, and a third of its contracted rigs (8 of 24) will "come off contract next year with the opportunity to reprice higher."

"Higher," to judge by the transcript of the Transocean call, is the analytical consensus of opinion. In response to a friendly analyst's question—"Congratulations on strong performance this quarter," he said before asking when the first "5-handle" day rate will be signed—Thigpen replied that such a $500,000-per-day toll is on the way. "Our customers feel it," he said. "They know it's coming. And so I'm not going to give you a date by when we would see a 5-handle, but we're definitely moving in that direction."

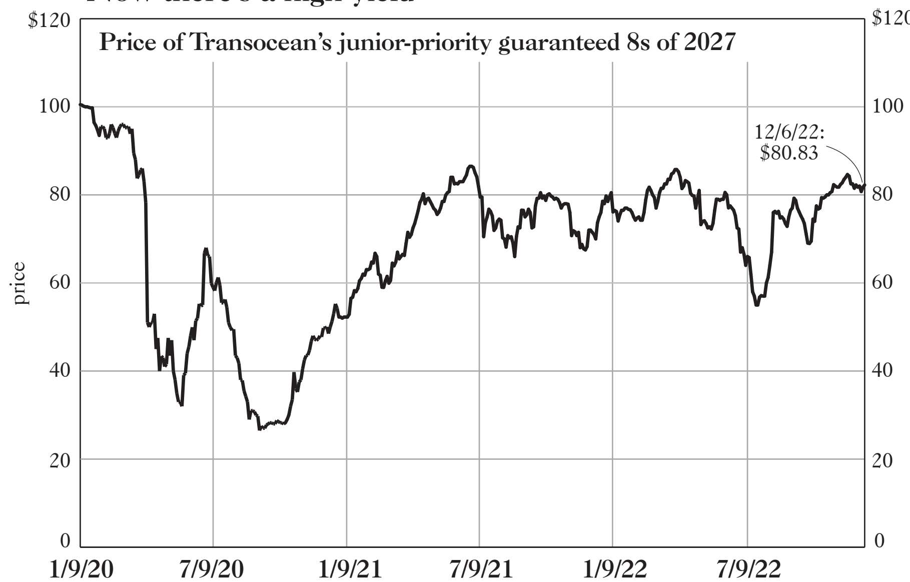
As important as the day rate is, the length of time that that rate is in force is perhaps even more telling of the state of the market. Multiyear contracts at today's rates are very attractive; a rush to sign them would be the upside catalyst that at least one bull we know is looking for.

Outsiders, ourselves assuredly included, can't quite make out the personality of the Transocean front office. Management, which declined to come to the phone, can project supreme self-confidence, for instance, in 2017, by moving to shed its shallow-water jackup rigs, while adding the deepwater kind. It was virtually a declaration that the bottom of the oil market was in, which it indeed proved to be until the price of crude sliced through the zero bound on April 20, 2020.

"This potential transaction," Thigpen said on the sale of the 10 jackups not then under contract, "is consistent with our strategic goal of remaining the industry's undisputed leader in ultra-deepwater and harsh-environment markets, where our high-quality assets, unmatched operational experience and trusted customer relationships provide us with a clear competitive advantage."

The extreme leverage of today's balance sheet might be construed as another expression of bullish conviction—management is actually betting the house. Yet the same management itself owns just 4,639,882 shares, 0.64% of the 722 million RIG shares outstanding. In the past 12 months, officers and directors were net sellers of 277,118 shares for proceeds of $1.47 million dollars.

Now there's a high yield



source: The Bloomberg

Thigpen, who earned $13.7 million in salary, bonus, stock, stock-option and non-equity awards, owns some 2 million shares outright, worth $7.6 million. He has neither bought nor sold (nor exercised options) since March.

The only substantial owner of RIG on the board or in the executive suite is Frederik W. Mohn. His firm, Perestroika A.S., owns 46 million shares, including 2 million shares purchased in the past 12 months.

Perhaps the officers and directors are more the fixed-income types of investors. They might pick up some of the 8s of 2027, for instance, quoted at 80.83 to yield 14.3%. These are the junior-priority guaranteed callable 8s of 2027, of which, in November, according to TRACE, $74.3 million were bought and sold. The junior-priority guaranteed 8s are not to be confused with the senior unsecured 8s, also of 2027, which are quoted at 75.6 to yield 15.552% and which are noncallable and nonguaranteed.

Or perhaps the officers and directors prefer secured debt to the "guaranteed" variety, the type resembling the railroad-trust certificates of yesteryear or the airline-trust certificates of today. RIG's first liens against *Deepwater Poseidon*, the B-minus-rated 6.875s of 2027, are quoted at 98 to yield 7.46%.

Transocean's debt maturities are spaced fairly evenly over the next three years, at an average of $760 million per annum. They bulge to $1.6 billion in 2027, the year the 8s fall due.

The high-yielding RIG bonds are a high-yield market anomaly. The Bloomberg U.S. Corporate High Yield Index is priced to deliver 8.62%, a not-commanding premium to the October CPI. "The" junk-bond market is really two markets in one, Craig Carlozzi, principal and portfolio manager at Longfellow Investment Management Co., LLC tells Robertson. There's the liquid, "flow-name" portion, "which is obviously tied to every word Jerome Powell says and the opinion of the market as to whether there'll be a pivot or not." And then there's everything else, comprising idiosyncratic names with real balance-sheet problems, Transocean included. The question, of course, is whether RIG's balance-sheet problems are soluble.

Certainly, we conclude, barring unscripted events. Peace, prosperity and falling interest rates would, of course, be helpful, as would a reasonably high oil price. However, as to this last point, again to cite Rystad Energy, the deepwater drillers break even, before debt-service costs, at around $40 a barrel. They are among the cheaper options, on land or sea, for lifting oil.

Transocean stands to take delivery of two advanced vessels this year, including the first drillship of the so-called eighth generation, *Deepwater Atlas*, which set sail in June. A second ship of its class, *Deepwater Titan*, is due in the fourth quarter of 2022. Transocean's new ships can drill wells where no ships have drilled before, including down to the reaches where well pressure can build to up to 20,000 pounds per square inch.

The size of the modern drillship fleet has fallen by 50% since 2014, according to CreditSights. Of that reduced remainder, Transocean owns 35%. "Now what's interesting is, Transocean has the most rigs," Gregory Lewis, managing director and energy and infrastructure analyst at BTIG, LLC tells Robertson. "In other words, Transocean is arguably the swing incremental rig provider to the market. What I mean by that is Noble has one or two rigs that, as the market tightens, they could put into the market. Valaris has got a couple of rigs they could put into the market as the market tightens. Diamond's got a rig. Seadrill's got a rig. Transocean has a lot of rigs."

The excellent team at CreditSights declares itself bullish on RIG: "In light of the strong results and continued strong outlook, we maintain our buy recommendation across the capital structure," they opined last month. Of course, one must explore the downside case, too, and Peter Sakon, senior analyst for special situations at CreditSights, approaches it this way.

Assume an adjusted Ebitda of $1 billion, up from $995 million in 2021, he says. This would put the recovery rate of the senior guaranteed issues at 100% and that of the junior guaranteed bonds at 66%. The recovery rate of the juniors would rise to 91% and 100%, at assumed Ebitda levels of $1.1 billion and $1.2 billion, respectively. "Generally, we believe that value breaks between the junior-priority guaranteed and unsecured layers of the capital structure," Sakon says.

There will be some—perhaps, even one day, members of the Transocean executive suite—who choose the highest-risk, highest-reward option for this interesting opportunity. For the information of those bold non-widows and non-orphans, RIG changes hands at a price-to-sales ratio of 1.02, versus 3.21 for Valaris and 2.48 for Noble. Out of the 17 analysts on the Transocean case (never mind the fence-sitters), six say buy, four say sell.

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