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Not the FANGs

Last Friday, the Brazilian government raised $1.9 billion by auctioning a half dozen offshore exploration blocks to the likes of Exxon Mobil Corp., Royal Dutch Shell plc. and BP plc. On the news—a most unusual glint of sunshine for the salt-water branch of the energy-development business—the leading offshore drilling stocks scarcely budged.

Now in progress is a survey of one of the few reviled segments of today's flyaway stock market. Transocean Ltd. (RIG), Ensco plc. (ESV) and Noble Corp. (NE; each is listed on the Big Board), the three largest U.S.-listed offshore drillers by assets, have declined by an average of 34.3% in the year to date, more than three times as much as the 9.3% in the S&P 500 energy sector itself. Nor are speculators betting on an early reversal. Short interest in the three averages runs to 20% of their respective floats. In preview, *Grant's* is bullish.

Think of the drillers, first, as a rank speculation, and one that could easily go pear-shaped. Think of them, second, as derivatives and the price of oil as the underlying element from which they derive their value. It was the plunge in oil prices in the summer of 2014 that sent petro-historians back to the early 1950s to find a comparably slack period of exploration activity. E&P companies won't go looking for oil just because wells deplete and demand grows (Elon Musk notwithstanding). They need higher prices.

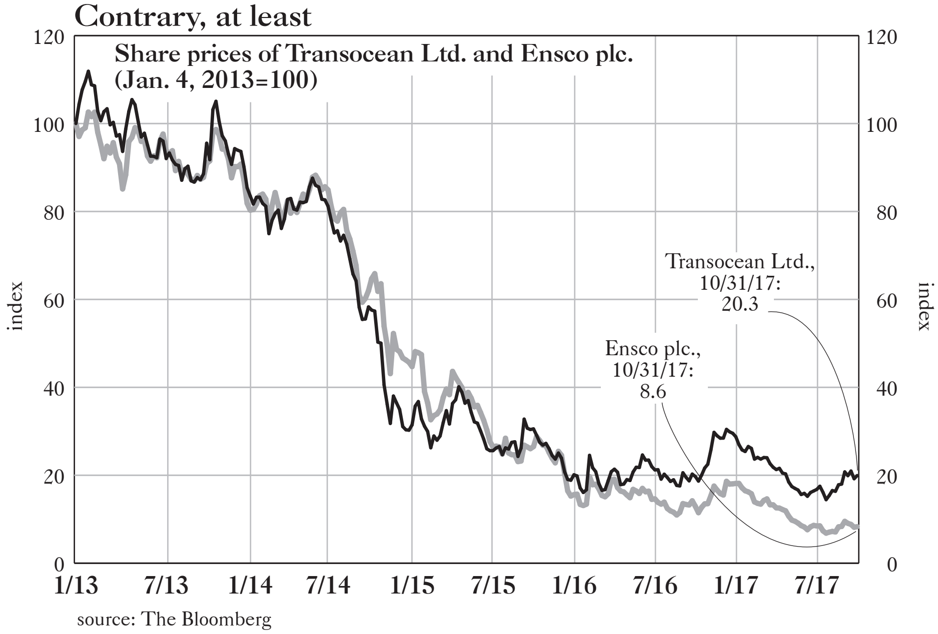
Still, they don't have them. The price of a barrel of West Texas intermediate, which trades at $54.67 today, has continued to shuttle between the mid-$40s and the mid-$50s. It has not been a profit-enhancing range for the speculation we proposed in the issue of *Grant's* dated March 10. Oasis Petroleum, Inc., a shale-oil producer that focuses on the Bakken formation in Montana and North Dakota and that, we said, would feast on higher energy prices, has fallen by 27%. The master limited partnerships about which we wrote in the July 14 edition—they own natural-gas and oil pipelines—have declined by an average of 8%.

Offshore drillers deploy two basic rig types: jack-ups and semi-submersibles. Jack-ups are platforms whose extendable legs reach the ocean floor. You use them for shallow-water drilling. Semi-submersibles are platforms that rest on top of hollow columns that float above a drill site. They're deployed for deep-water drilling. It's the semi-submersibles—the "floaters"—that interest us.

The bear case for offshore drillers begins with that 50-odd-dollar oil price. It's the reason, so the argument goes, that E&Ps will continue to focus on dry land, especially the rich shale plays in the Permian Basin in West Texas and New Mexico and the SCOOP/ STACK formation in Oklahoma. Big producers may commit to the occasional brownfield expansion of an existing offshore well (a "tie-back," as they say in the trade), but that alone will hardly cure the salt-water-drilling depression.

Earnings of the offshore sector have been halved, or worse, since the peak, and they will continue to fall, the case for the opposition continues. Transocean, the biggest of the drillers by assets, is

Contrary, at least



source: The Bloomberg

a case in point: RIG's adjusted earnings before interest, taxes, depreciation and amortization (EBITDA) declined to $1.8 billion in the 12 months ended June 30 from $3.8 billion in 2014. Earnings today are supported by long-term contracts with day rates for deep-sea floating rigs of more than $500,000 per day. Those contracts are coming to an end and spot rates are closer to $150,000 per day. In consequence, Transocean's EBITDA will likely halve again, to $959 million, in 2018.

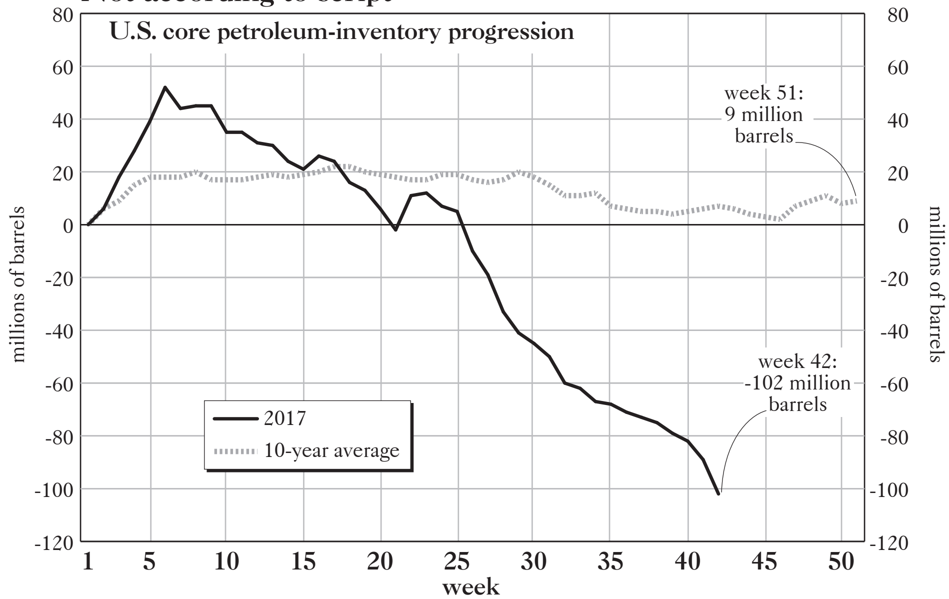
"Unfortunately," concludes an Oct. 25 bulletin by SRSrocco Report which was reposted on ZeroHedge, "mainstream energy analysts do not believe the ultra-deep-water rig industry will recover until at least 2020 or more realistically by 2024."

Some of the bears go further, insisting that the offshore sector will never recover—in fact, the entire oil market is doomed. The introduction of electric cars and renewable energy may obviate the need for hydrocarbons, they say. Innovation will ultimately do to fossil fuels what fossil fuels did to whale oil.

"'Ultimately?' Maybe," comments colleague Evan Lorenz. "'Quickly,' meaning soon enough for a speculative payoff? Unlikely. According to IHS Markit, there were 264 million light-duty vehicles registered in the United States in 2016. Over the last 12 months, car sales totaled 17.2 million, meaning that to replace today's fleet at current sales rates would take 15.3 years—assuming, of course, that costly electric vehicles could fill the breach. For reference, Tesla, Inc. sold 101,193 units worldwide in the 12 months ended June 30. To produce even that many electric cars, manufacturers would need massive supplies of lithium and cobalt (at presumably much higher prices), materials which they are struggling to secure even at today's anemic sales rates."

When he's himself, Mr. Market can see over the horizon. Thus, Transocean's stock price peaked on Feb. 14, 2013, at $59.30 a share, 16 months before oil topped out at $107.26 a barrel—investors intuited the surplus in offshore-drilling rigs well before the price of crude tumbled. It's bullish indeed, as our friend Arjun Divecha remarks, when a horrible situation becomes, not necessarily good, but only less horrible.

Not according to script



source: Goehring & Rozencwajg Associates, LLC

"There are early signs that things are getting less horrible for the offshore operators," Lorenz points out. "E&P companies have slashed costs and taken out overhead in the three-plus years since the top in oil prices. Statoil ASA, the state-owned Norwegian producer, has talked about some of its offshore fields breaking-even at prices as low as $27 per barrel (e.g., the Kayak field in the Barents Sea) vs. the mid-$40s pre-crash. The Scandinavian penny-pinching has led to a green shoot that few seem to notice. Utilization of high-end floaters that can stand up to harsh weather on the Norwegian Continental Shelf is approaching 100%, according to an Oct. 24 report by Fearnley Securities. As a result, day rates for high-end rigs in Norway have increased to around $240,000 today from around $145,000 at the start of the year. And, as far as temperate climates go, two Tuesdays ago U.S. Interior Secretary Ryan Zinke announced that 77 million acres in the Gulf of Mexico, an area about the size of New Mexico, will become available for exploration in March."

There's an inkling of much-needed offshore consolidation, too. On May 30, Ensco announced it would acquire Atwood Oceanics, Inc., in an all-stock deal valued $1.6 billion (the transaction closed on Oct. 6). On Aug. 15, Transocean committed to buying Songa Offshore in a cash and stock deal worth $3.4 billion. There may be other such tie-ups in the works. Ocean Rig UDW, Inc. (ORIG on the Nasdaq) emerged from bankruptcy on Sept. 22 with net cash of $175 million, a mostly new fleet of 11 floaters and two floaters on order for delivery this year and next. What ORIG lacks is long-term contracts. Activist investors Elliott Management Corp. and BlueMountain Capital Management own 31.3% of shares outstanding. Seadrill Ltd., while under the protection of a bankruptcy court, entered into a restructuring agreement with 97% of its secured lenders on Sept. 12. It's a sign that Seadrill may soon emerge from reorganization proceedings with a much-improved balance sheet.

Excess capacity is on the chopping block, too. Since that 2014 top in the oil price, according to the Fearnley report, 93 floaters have been consigned to the scrapping yards. The floater fleet now consists of 298 rigs, a figure which includes another 38 newbuilds. Then, again, second-quarter demand tallied only to 148 floaters—at 50% utilization, the offshore drillers would appear to be set for years of pain.

"However," Lorenz points out, "this overstates supply. A total of 82 semi-submersibles are stacked, i.e., moored in calm waters in hope of better times. Many of the stacked rigs are old and lack such modern, must-have features as dual drilling capability and the space to carry a second blowout preventer (beyond the mandated one). And, as most idled rigs have been out of commission for 18 months or more, they would require a substantial investment to reactivate—an investment not supported by current day rates. Earmark, then, another 60 or so rigs for the knacker. Most of the 38 newbuilds were ordered on speculation and are not yet fully paid for. At current economics, Fearnley estimates, only five newbuilds will enter service through 2019. So, overcapacity is not so daunting as it first appears, and, based on earnings reports from offshore drillers, it looks like demand for semi-submersibles has bottomed."

Nor is shale production, that abiding bogeyman of the offshore business, quite so menacing as it seems. "In North America land," Schlumberger Ltd. chairman and CEO Paal Kibsgaard said on the company's Oct. 20 earnings call, "where the E&P companies have added significant capex over the past year, the production growth is so far falling short of expectations, driven by supply-chain inflation, operational inefficiencies and the need to step out from the tier 1 acreage. This has led to a moderating investment appetite, where the previous pursuit of production growth is now being balanced out with an equal focus on generating solid financial returns and operating within cash flow.

"This moderation can be seen in the flattening trend of the U.S. land-rig count [in fact, 46 rigs have left service since a 2017 peak of 934 on Aug. 4] during the third quarter, and it is also reflected in our customers' 2018 activity outlook," Kibsgaard continued. "The more tempered activity outlook for U.S. land, combined with the short-cycle nature of the business, has an immediate impact on the outlook for production growth, which, for 2017 and 2018, has been revised down by 100,000 and 500,000 barrels per day, respectively. This clearly has a material impact on the global supply and demand balance." For reference, the IEA forecasts growth in U.S. production in 2018 of 1.1 million barrels per day (mbpd).

The weakening growth of shale production is reducing the once-daunting oversupply of oil. This year, through the week ended Oct. 20, commercial-crude inventories (i.e., excepting the government's stockpile) have fallen by 102 million barrels. It's an anomaly. In the 10 years before 2017, such inventories tended instead to build, by an average of 6.9 million barrels, through the 42nd week of the year. The decline this year has come despite the government's sale of 23.7 million barrels from the Strategic Petroleum Reserve. While soundings of global inventories are less frequent and less statistically dependable than the Department of Energy reports, the drawdown would seem to be a worldwide phenomenon.

Inventories will continue to fall so long as demand grows. China bears—we're certainly one of them—must stop to weigh the possibility that the validation of their long-held doubts about Xi Jinping's over-leveraged economy will change the world in unpredictable ways. It may or may not be relevant that Japanese oil consumption actually rose in the half decade following the peak in the Nikkei index on the last day of December 1989. Deep-sea bulls would be properly grateful if China—which is expected to consume 12.4 mbpd this year, second only to the forecast 19.9 mbpd consumption for the United States—followed the same benign script.

Perhaps investors want more production. One week ago, Exxon Mobil Corp. and Chevron Corp. reported better-than-expected third-quarter profits, and worse-than-anticipated production: 3.97 mbpd for Exxon vs. an estimate of 4 million, and 2.717 mbpd for Chevron vs. an estimate of 2.777 million. Despite stronger earnings per share, both stocks opened in the red.

You can't just set up a rig and pump oil. Shale production seems almost that easy, but big conventional projects take years to develop. And, as noted, years have elapsed—three, to be exact—since the top of the oil market. Notwithstanding the subsequent funk in exploration, the IEA predicts that non-OPEC/non-U.S. production will increase to 45.5 mbpd in 2018 from an estimated 45 mbpd in 2017. Adam A. Rozencwajg—he's managing director and one-half the eponym of Goehring & Rozencwajg Associates and our guest on the Oct. 2 *Grant's* podcast—says he doubts that this projected half-million-barrel rise is in the offing. "To give you a sense," he tells Lorenz, "when the IEA made their first estimate for 2017 non-OPEC/non-U.S. production growth (it was in the summer of 2016), they expected it to grow by 250,000 bpd. They have since revised it down to 189,000 bpd as of today (and counting)."

If the third quarter did, in fact, represent a low ebb, the 39-month decline from the market's peak would represent the deepest cyclical trough for the offshore sector. For comparison, the 1986 oil crisis bottomed out after 15 months. The crashes following the early 1990s recession, the Asian financial crisis and the decline following the Nasdaq bubble burst lasted 24, 21 and 27 months, respectively.

If this is the bottom—let us emphasize that many doubt it—the offshore drillers may offer substantial returns. "For Transocean," Adam Duarte—the managing partner of Sears Point Capital Management, a hedge fund focused on the energy sector—tells Lorenz, "you can actually value the backlog they have and figure out what you're paying for the residual value of the fleet. This is really back-of-the-envelope: The company right now, between Transocean and Songa, which they just bought, has a $14.3 billion backlog, the net present value of which is somewhere between $5 to $6 billion. If you back out the value of that backlog from today's enterprise value, you're left paying about $6.5 billion dollars for the residual value of the fleet, which comes out to about $115 million per rig.

"So you're saying RIG is worth a deep discount to the newbuild cost or even the used cost for these things," Duarte continues. "If you operate in a cyclical industry and the companies and the assets in the industry are basically wildly under earning what you might call their equilibrium economics, which is the case now, you are probably somewhere around the right time to buy it depending on what your investment time horizon is." If you plug in a $300 million residual value—a rock-bottom price for used rigs—instead of the $115 million residual value implied by the current share price, then you could justify a share price around $30, vs. the current stock price of $10.50, Duarte adds.

Transocean and Ensco have the modern fleets that are most in demand. Giving effect to the Songa acquisition, Transocean manages 55 floaters, of which one-fifth is suitable for service in a Norwegian-style winter. Ensco, pro forma for the Atwood acquisition, has a new fleet of 26 floaters (average age is five years) and 36 jack-ups.

While nobody would call the companies' assets junk, their liabilities are another story. Transocean and Ensco are both rated single-B-plus. Mitigating this obvious risk is that each company has availed itself of today's EZ credit to extend its debt maturities and secure liquidity. Thus, giving effect to the Songa acquisition, Transocean has $9.8 billion in debt against $2.2 billion in cash; maturities, through 2019, total $1.7 billion. Following the Atwood acquisition, Ensco has $4.7 billion in long-term debt against $2.9 billion in liquidity ($0.9 billion in cash and $2 billion in a revolver), against which loom less than $1 billion in near-term maturities prior to 2024.

"It's unusual that you get a group where the average stock is down 90% from its peak, trades at 60% discounts to replacement value, and 80 to 90% discount to the stated book value (although book value will be written down slightly)," Leigh Goehring, Rozencwajg's partner, remarks. "And you have ample liquidity in most of the participants in the area. It's a highly unusual situation."

The Street is lukewarm to Transocean (15 buys, 15 holds and 8 sells) and Ensco (16 buys, 12 holds and 4 sells), although analysts are beginning to lift recommendations. On Sept. 25, a team of UBS Securities analysts led by Angie Sedita upgraded the offshore drillers to buys: "We have reached the bottom in offshore utilization for both floaters and jack-ups and… compelling valuations under a broader, but still moderate, recovery in 2019-2020."

No Ensco insider has bought or sold shares in the last year. Transocean insiders sold a net 126,664 shares for proceeds of $1.8 million over the last 12 months. It may be noteworthy that selling turned into buying in August, a month in which insiders purchased a net 62,159 shares at a net cost of $455,964.

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