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Baiting a hook

One of these days—perhaps as early as Dec. 12—Petrobras, the troubled Brazilian state oil company, will release its unaudited third-quarter earnings. What horrors await the reader of this long-delayed document is anyone's guess, though the holders of Petrobras debt seem not especially anxious. The oil giant's dollar-denominated 7 7/8s of 2019 ($2.75 billion is outstanding) change hands at 109 to produce a calm and collected yield of 5.47%.

Panic, or the lack of it, is the subject under review. Because confession is good for the soul, your editor will touch on a notable *Grant's* miscalculation for the year 2014. Yet—onward!—he will not wallow, certainly not on account of a certain oil-producing pariah state whose major equities trade at half of book value and yield 4 ½% or 5% and command multiples of price to fast-dwindling earnings of between three and six times. But enough about Russia, for whose reviled stocks and shredded ruble he continues to carry a torch (and personally to own, let the record show).

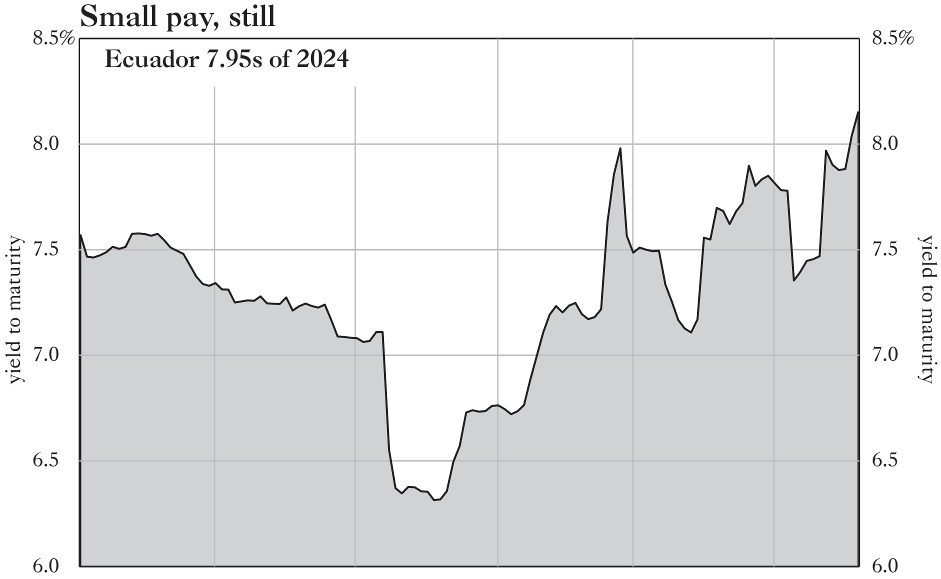
"Speculate like you mean it" is the message of this unfolding analysis. "Invest like you mean it, too," is the corollary. If you mean to be bullish on oil—for ourselves, we don't have a view as to whether the current price is the right or wrong one—there are vehicles that would give you a fighting chance if WTI did return to the T. Boone Pickens's targeted level of $100-plus per barrel. Other vehicles, too, are available.

Foremost among these others, we class the sovereign debt of some of the "frontier" oil exporters, including the Kingdom of Bahrain, which, in September, raised $1.25 billion in 6% bonds due in 2044. On Sept. 10, the deal date, Brent crude fetched $98. Today, with Brent trading at $66.84, the bonds are quoted at 98 cents on the dollar to yield 6.15%. As for Ecuador, about which *Grant's* said its bearish piece in the issue dated Oct. 17, the 7.95s of 2024 have fallen to 95.82 from 104.16 at the time we went to press. Still, today's yield—8.60%—hardly seems adequate to compensate an investor for the risks attached to a country with a record of willful default.

We judge that Bahrain and Ecuador have ridden the coattails of the 2014 boom in frontier-government borrowing. Only last month, the B1/BB minus-rated Socialist Republic of Vietnam raised $1 billion in 10-year securities priced to yield less than 5%. Only last week, B1/B-rated Ethiopia borrowed $1 billion with an issue of 6 5/8s of 2024; the underwriters, led by Deutsche Bank and J.P. Morgan, could have sold $1.6 billion more, the *Financial Times* reported. Concerning the shortening list of poor countries that have not tapped the bond market lately, *The Wall Street Journal* quoted a London buyer of the Ethiopian paper, thus: "We're running out of new names that can issue."

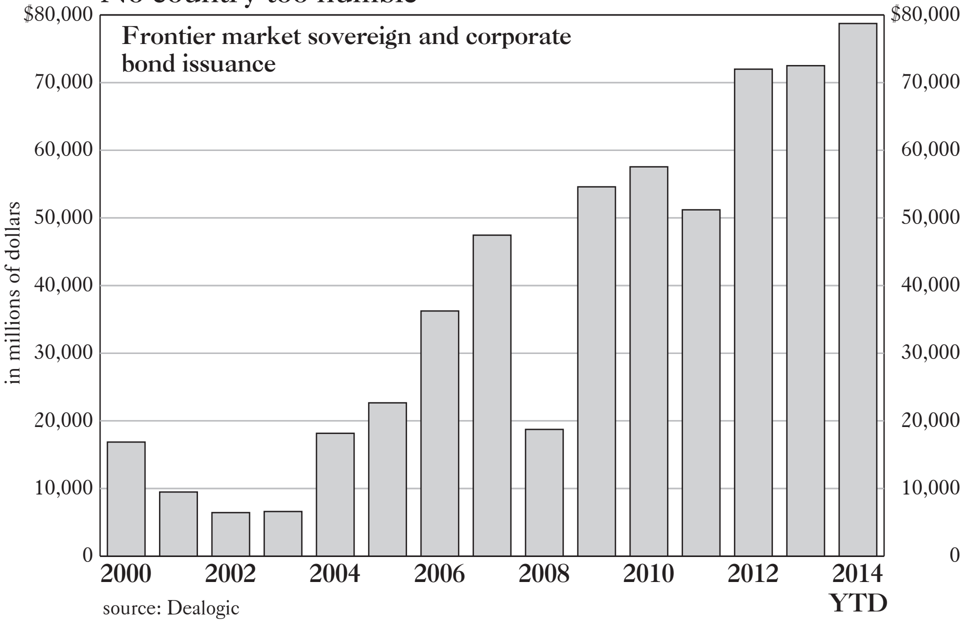
On the one hand, because the world is getting richer, the list of creditworthy nations ought to be lengthening. On the other, observes colleague Charley Grant, "a look at

Small pay, still



source: The Bloomberg

No country too humble



source: Dealogic

data from Dealogic shows that the lift-off in issuance corresponds neatly with the plunge in interest rates. In 2000, frontier governments borrowed $15.8 billion. From 2001 to 2008, they raised no more than $9 billion in new money in any one calendar year. Since 2009, they have borrowed no less than $22.3 billion in any 12 months (2010 was that lean year). In the year to date, they have already borrowed $40 billion."

On, now, to North Atlantic Drilling Ltd. (NADL on the Big Board), the leveraged, harsh-environment offshore driller on whose sub-$2 share price this publication was bullish at prices as high as $10.62 (*Grant's*, Sept. 5). We liked it for its technological prowess (which the lower oil price has rendered academic) and generous dividend (now suspended). We compared an investment in NADL to the purchase of a fully leased, fully tenanted office building in one of the better neighborhoods of Manhattan. The analogy still stands, except for the detail that our figurative office tower is facing significant lease rollover risk and that the mortgage lenders are worried.

The collapsing share price has left North Atlantic with a $412 million market cap. On Sept. 30, the balance sheet showed interest-bearing debt of $2.7 billion and book equity of $938 million. At this writing, the unrated North Atlantic 6.25s of Feb. 1, 2019 change hands at 65 for a yield to worst of 18.7%—a properly speculative yield for a shaky credit. In the third quarter, the company generated $168 million of EBITDA and $111 million of operating profit. In the fourth quarter to date, 95% of its fleet—semi-submersibles, jack-ups and drillship—was busy and earning its keep, down from 99% in the third quarter.

One can almost read the market's worry list. North Atlantic may raise equity at a dilutive price. It may bust a covenant and be forced into bankruptcy. The price of crude may spend years below the level at which the company's *West Navigator* drillship and *West Venture* semi-submersible rig can be profitably operated.

Thus, the threshold question: One year hence will oil companies have developed enough confidence in prospects for the out-year oil price to justify drilling in the North Sea? (The petroleum thereby produced would not be hitting the market until 2018 or 2019.) A return to say $80 a barrel would likely quell concerns about the long-term idling of the big rigs. It would similarly push aside worries about the balance sheet.

A speculation on any part of the North Atlantic capital structure is therefore a speculation on rising oil prices and forbearing creditors. In view of the potential rewards, we judge the bonds and the equity each to be reasonable gambles. Flyers—gambles—they are, of course. Such is the way of disappointing investments. Many dollars cheaper, they become hopeful speculations.

Give us a portfolio of hopeful speculations over a collection of 6% speculative-grade sovereigns quoted at a price to yield 6.15%.

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