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Stormy weather

The interest-rate environment may be cruel, but it's sweetness and light compared to the North Atlantic drilling environment. To lift oil from beneath the freezing waters of the North Sea or the Norwegian Sea, to say nothing of the Barents Sea or the Kara Sea, you need a special kind of rig. North Atlantic Drilling Ltd., a 2011 creation of Seadrill Ltd., happens to own a fleet of such custom units, which bear the understated designation HE, for "harsh environment."

North Atlantic Drilling—on which, to jump the gun, we are bullish—is a bit of a special situation. Highly leveraged, 74%-owned by Seadrill and Bermuda-headquartered, the company is not your standard NYSE-listed, red, white and blue industrial. The company's 227.6 million shares change hands on the Norwegian OTC list; in America, they can be found in the Pink Sheets (the American ticker is NATDF). Cumulative daily volume here and in Norway amounts to about 150,000 shares. At Tuesday's price of $8.74, the stock yields 10.3%, and presents a market cap of slightly less than $2 billion.

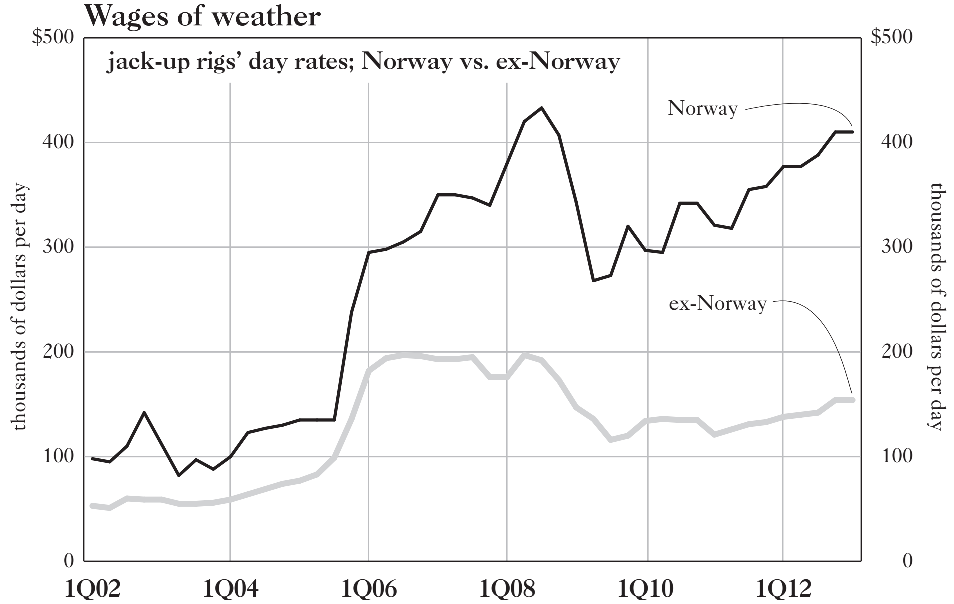
While there's much to like about this curious amphibious enterprise, widows and orphans should now avert their eyes. Risks include the obvious—oil prices and drilling day rates, for instance—as well as the more nuanced, e.g., the Norwegian krone-dollar exchange rate. Then, too, the investor in North Atlantic Drilling must content himself with the role of a very passive, very outside and very minority holder. At the helm of the controlling organization stands Oslo-born John Fredriksen, age 69, holder of the 87th spot on the *Forbes* 400 rich list and practiced user of debt. "I wouldn't necessarily want to be a creditor of Fredriksen," a North Atlantic stockholder tells colleague David Peligal. Neither, necessarily, would we.

Before enumerating the strong points of the situation, a few lines of description are in order. North Atlantic's fleet numbers nine, each unit outfitted for the kind of climate you won't find in the Gulf of Mexico. Four semi-submersibles, one ultra-deepwater drill ship and a pair of jack-up rigs constitute the fleet in place, while two additional drilling rigs are under construction. The vessels on order include *West Linus*, slated for delivery by the end of the year, and *West Rigel*, due in the first quarter of 2015. *West Linus* will do business in up to 450 feet of water, *West Rigel*—a sixth-generation, semi-submersible job—at depths of up to 10,000 feet.

Needless to say, exploration and development companies didn't go searching first in the most forbidding places on earth. They started in the friendliest. But, as temperate waters gave up their mysteries, the drillers repaired to colder, stormier and more remote regions.

It's the company's conviction, and ours, that HE is a growth field. "The recent years' exploration success in Norway, in particular in the Barents Sea in which we saw three out of a to-

Wages of weather



source: RS Platou Markets AS

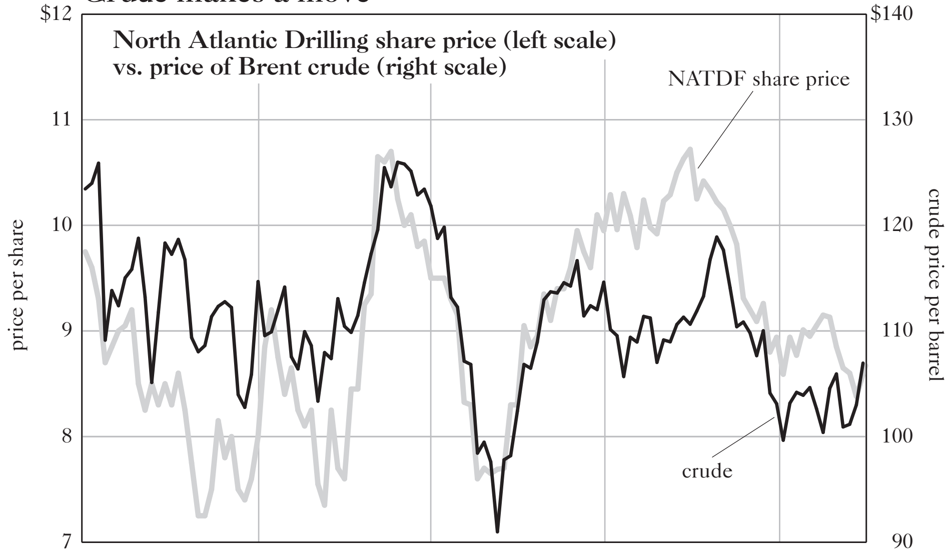
tal of 13 discoveries being made last year, supports the board's optimistic view for the Norwegian continental shelf for the years to come," says North Atlantic Drilling's first-quarter report, dated May 28. "The discoveries already made will lead to further appraisal drilling and subsequent development drilling if the fields are found economically viable to develop by the big oil companies." Four weeks ago, in the 22nd licensing round on the Norwegian continental shelf, some of those very heavyweights—e.g., Eni S.p.A., Statoil, Rosneft and Lukoil—were among the winners of licenses to poke around for oil in the Barents Sea. "The North Sea is the most mature of the harsh environments today," Peligal observes. "The Kara Sea and the Barents Sea are the up-and-comers."

Meantime, North Atlantic Drilling is poking around for what the first-quarter report terms "potential strategic partners." The idea, the board continues (for it's the board that signs the document), "is to position the company better for the high growth in activities, which is expected in harsh environment areas like the Barents and Kara Sea." Evidently, the board was in a mood to fish or cut bait, as it wound up this particular segment of its first-quarter message by saying that it expected "to announce the final outcome and details of the process with the new potential shareholder before the end of the second quarter," i.e., almost two weeks ago. However, the authors hastened to add that, come what may with these negotiations, they were "fully committed" to completing the preliminaries required to list the shares on the New York Stock Exchange. The second quarter has come and gone without any news on the M&A front.

For the income-starved investor, the dividend might be the most interesting part of the North Atlantic Drilling story. It's currently paid at the rate of 90 cents per share against free cash flow of $1.50 a share, for that 10%-plus yield. Still more interesting for the security analyst is what supports the dividend. Two things do: the economics of the business and the equity-mindedness of the parent's chairman, John Fredriksen.

"As to the first," Peligal says, "not just anybody can compete with companies like North Atlantic Drilling. The heavy investment and expertise required to fit a rig for operation in northern waters creates a barrier to new entrants. You can infer as much by comparing the day rates prevailing in Norwegian waters with those quoted elsewhere."

Crude makes a move



source: The Bloomberg

Thus, in Norwegian waters, for a day's use of a jack-up rig—one of those self-elevating platforms equipped with legs that stretch down to the ocean floor—you paid $420,000 in the second quarter of 2008. Then the bottom fell out of Lehman Brothers. In the same Norwegian waters 12 months later, you paid $268,000 a day, a decline of 36%. But Norwegian rates today are back within a few percentage points of the old highs, and utilization rates in those same waters remain at about 100%, where they have been for 11 years.

Outside of Norwegian waters, for a day's use of a jack-up rig—an ordinary platform, with no special customizing to stand up to the northern elements—you paid $200,000 a day in the second quarter of 2008. Twelve months later, the rate was $120,000, a decline of 40%. But jack-up rates outside Norway are still 25% lower than they were at the pre-Lehman top, and utilization rates stand at 95%, not 100% (having dropped as low as 88% in 2009).

The average North Atlantic Drilling shareholder, we would guess, is not quite satisfied at this point. Their Pink Sheets-quoted shares are more than 20% cheaper than they were in January, and one of the parent's HE rigs, *West Mira*, wound up being sold not to North Atlantic Drilling (at what would have been accrued cost plus fees) but to another offspring of the Fredriksen family, Seadrill Partners, a master limited partnership (the MLP having outbid North Atlantic Drilling for the prize).

Peligal invited Jeffrey Schwarz, a North Atlantic Drilling holder and co-founder of New York-based Metropolitan Capital Advisors, to unburden himself.

"On the NYSE listing," said Schwarz, "it's been quarter after quarter of delay, and that's disappointing. That said, at the end of the day, we don't care so much about the liquidity that might come from a listing, but we do care about what we expect to be an improvement in valuation by accessing a broader, deeper pool of potential investors. If you believe the story, which I do, that there will be attractive growth opportunities in the harsh environment—and that was the reason we made the original investment—because we think that people mistakenly look at the whole oil services sector as one monolithic group, and it's anything but that. We want to be in the places where there is going to be growth in demand vs. a shrinkage in demand. If I owned a little crappy mat-drilling rig that could only work in shallow waters of very benign environments, all of that oil has been found. At some point in time, you don't need that rig for anything."

Two Mondays ago, North Atlantic Drilling disclosed the welcome news that it had executed a sale and leaseback transaction totaling $600 million for the aforementioned HE jack-up drilling rig, *West Linus* (the one that's due in the fourth quarter). The news removed any suspense over how North Atlantic was going to pay for its acquisition; the stockholders would have been hugely disappointed if management had chosen to raise the funds in a disadvantageous equity offering. Then, too, the news underscored the fact that North Atlantic Drilling is a John Fredriksen company. Not that that fact needed much underscoring: The press release disclosed that North Atlantic's counterparty on the sale leasebacks, Ship Finance International Ltd., is also a John Fredriksen company.

Schwarz told Peligal that he applauded the deal—it will allow the ordering of more new vessels—and more generally, he is happy with the condition of the North Atlantic balance sheet. Yes, there's $2 billion of senior bank debt with a six-year tenor priced at Libor plus 2%, and, yes, half of the principal is being amortized quarterly, which will leave a $1 billion balloon payment at maturity. But even before the *West Linus* starts to earn its keep in a five-year contract with ConocoPhillips, Schwarz contended, the company is generating on the order of $325 million to $350 million of annual free cash flow, i.e., earnings after taxes, after maintenance capital spending and after interest expense.

"I think of the company, trading at an equity market cap of six times to 6½ times that free cash flow as a cheap price with growth prospects beyond," Schwarz continued. "I acknowledge I'm playing a little fast and loose by only including interest expense and ignoring debt repayments when defining free cash flow. But given that I feel that the average useful life of their fleet is probably another 20 years, I'm not so worried about debt repayments. I feel they'll be able to refinance that without any difficulty because they're still going to have assets that are high quality with a long useful life and good utilization. . . . I believe that when the time comes, they'll essentially roll that debt over."

Peligal had a theory to try out. "In some ways," he proposed to Schwarz, "North Atlantic Drilling can be thought of as an investment in a fully leased, high-quality-tenant commercial office building. The landlord charges premium rents, though—an admitted difference—a 30-year lease on West 57th Street in midtown Manhattan is arguably a more stable source of cash flow than a five-year contract on a drill rig."

Schwarz warmed to the analogy. "For the business as it sits today, I don't see it as being highly leveraged," he said. "If we owned eight commercial office buildings that were fully occupied, people would look at it and say, 'Your assets are probably worth $4 billion and you've got $2 billion of debt.' I don't think anyone would say, 'That's highly leveraged.'"

Certainly, the stock market isn't taking off many points on account of perceived financial weakness. At 6.7 times the 2014 consensus estimate of earnings before interest, taxes, depreciation and amortization, North Atlantic Drilling trades with the top half of the public driller universe. Then, again, not one of the trio of Rowan Cos. (RDC on the New York Stock Exchange), Atwood Oceanics (ATW, also New York-listed) or Ocean Rig UDW (ORIG on the Nasdaq) pays a dividend; they trade at EBITDA multiples of 6.0, 6.9 and 5.7, respectively. Seadrill, North Atlantic's parent, changes hands at 9.1 times the EBITDA estimate and yields 8.5%; Fred. Olsen Energy ASA (FOE in Oslo), trades at 5.0 times the EBITDA forecast and yields 3.9%.

On form, Fredriksen is the kind of chairman who gives the creditors their due, no more, and who uses debt in an opportunistic fashion to pay the stockholders. We suppose you wouldn't expect a shipping magnate who, in his risk-taking youth, earned the moniker "Big Wolf" to eschew debt financing entirely. "I would be hard-pressed to point to an example where Fredriksen did wrong by his shareholders, where he treated himself in a fashion that was superior, whereas I would not have a hard time pointing to countless other investors whom I would not invest alongside," Schwarz said. "In that regard, although Fredriksen is willing to play with more leverage than some people find comfortable, I think that's a choice where some investors feel comfortable with that risk, while others might prefer not to have it. But if you can feel comfortable with that type of leverage, he's a good guy to have steering the ship. He's not going to head for the rocks, and then bail out on his private launch with his pockets lined."

Peligal offers, on behalf of himself and *Grant's*, a more pleasing scenario: "The company lists on the New York Stock Exchange in a few months and it trades down to an 8% yield. That's 20% on your money. You make 10% on the dividend. That's 30%. Not to mention the realistic possibility of growth, and not to mention those high barriers to entry."

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