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Returns to patience

Evan Lorenz writes:

The price of crude oil appears insensate. Saudi Arabia's surprise 1 million barrel-per-day cut to production on June 4 can't seem to raise it—nor did the aborted Russian coup d'état of June 25. What with Covid-era shutdowns, warm European winters and China's disappointing economic reopening, energy bulls seem forever destined to play Charlie Brown's field-goal kicker to Lucy's special-teams holder, the kind who snatches the ball away before a fellow can put his foot to it.

Nevertheless, the simple physics of energy extraction means that producing wells become depleted over time and even the prolific U.S. shale patch is starting to look long in the tooth. In preview, *Grant's* remains bullish on companies that enable offshore oil and gas production, including click-to-pick Transocean Ltd. (RIG on the New York Stock Exchange) and TGS ASA (TGS on the Oslo Stock Exchange).

Is the oil market in a surplus or a deficit? There's no easy answer. To start, it's impossible to get a real-time read on worldwide supply and demand, and estimated figures (the only ones there are to work with) are frequently revised. Inventory data are more reliable, Adam Rozenchwajg tells me—"You stick a dipstick in a tank, and you get a number"—but even they are subject to distortion.

According to the International Energy Agency (IEA), worldwide commercial stocks of crude oil totaled 2.8 billion barrels in April. One could observe that this is an 88 million barrel deficit relative to the five-year average or that it constitutes a big improve-

ment from the 295 million barrel deficit at the same point last year. If the latter, one might conclude that there has been a surfeit of supply relative to demand over the past 12 months. Then, again, crude stored in government inventories has declined by 201 million barrels over the same stretch, largely owing to sales from the U.S. Strategic Petroleum Reserve. Including government barrels, therefore, inventories are basically unchanged.

"In my logic, you would add those two numbers together and look at the combined inventory," says Rozenchwajg, one-half of the nameplate of the natural-resource investment shop Goehring & Rozenchwajg Associates, LLC. "Put another way, if—all things being equal—the market was balanced, and then all of a sudden you released oil from the SPR and it found its way into commercial inventories, is that market still balanced? I would say yes, it is. Nothing has really changed...but the market will treat the SPR as though it's a big new oil well that's come online."

Inventories have stabilized despite a bulge in production by the sanctioned pariah states. Over the past seven months, the IEA has boosted estimates for Russia, Iran and Venezuela by 1.3 million barrels per day (mmbpd). Iranian oil, for instance, Bloomberg reports, is making its way to China as the unsanctioned and politically unobjectionable product of Malaysia.

The green movement constitutes another exogenous force to be reckoned with. Witness, on June 15, the Dutch government's announcement of the permanent shuttering of the Groningen gas field, Europe's largest, by

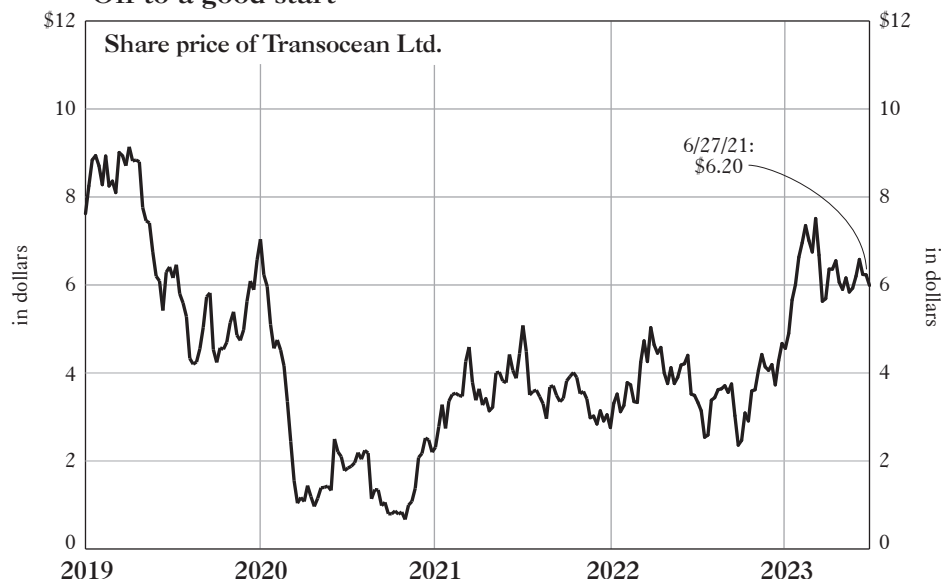
Oct. 1. This followed the German government's decision, in April, to close the last of Germany's nuclear power plants, thus boosting fossil-fuel consumption in Europe's largest economy.

Two weeks ago, the secretary general of the United Nations, António Guterres, accused the oil industry of "trading the future for 30 pieces of silver," while the Church of England, just last week, announced plans to divest oil and gas holdings whose managements do not "protect God's creation." Never mind bulls versus bears. In the fossil-fuels business, it's infidels versus saints.

Meanwhile, the Permian basin, the giant, famously productive shale reservoir that straddles Texas and New Mexico, seems to be losing its mojo. The March 8 *Wall Street Journal*, citing data from Novi Labs, reported that the average well in the Permian produced 6% less in 2022 than in 2021. According to an analysis in Goehring & Rozenchwajg's first-quarter letter, the problem runs deeper. The decline in productivity, they predict, presages an absolute decline in output, not merely a deceleration in the growth of output. Other major shale plays, the partners point out, e.g., the Bakken and the Eagle Ford, have already peaked.

This would be no small thing, if true. According to the U.S. Energy Information Administration, the world will consume 101 mmbpd this year, of which the Permian is currently producing 5.8 mmbpd. Since 2015, the 86,000 square-mile sedimentary basin has accounted for 74% of the 7.3 mmbpd global increase in oil production. If, in fact, the Permian has peaked, the

Off to a good start



source: The Bloomberg

market will need to scramble for new sources of hydrocarbons, including those situated offshore.

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Ultra-deepwater drill ships, which can pierce the seabed up to 12,000 feet below the surface, are complex and formidable works of technology, but the U.S. shale boom, along with the 2014 energy-price collapse, left them high and dry. Bankruptcies felled Seadrill Ltd., Diamond Offshore Drilling, Inc., Valaris plc and Pacific Drilling S.A., among others. Over the past nine years, roughly half of the worldwide drillship fleet went to the knacker's yard, reducing the number of such vessels to a post-2004 low.

Nor is there much prospect of new supply coming back any time soon. It would take at least three years for a shipyard to build a new deepwater drillship—that is, if you could get one to take the order. Liquefied-natural-gas ships, for which there is plenty of demand, are not so daunting to build as drillships, and the yards have understandably lost patience with their insolvency-prone drillship customers. Besides, says Darren Maupin, founder of Pilgrim Global Advisors, LLC, day rates would have to double before drillers would even consider placing new orders.

If, as and when energy companies ramp up spending on offshore exploration, therefore, something will have

to give; maybe it's already begun. Our Transocean analysis, dated Dec. 9, noted that day rates had risen to \$343,400 from a low of \$159,000 in 2017. "[W]e've observed a marked increase in day rates for ultra-deepwater drillships, which are now predominantly between \$400,000 a day to \$450,000 per day across the global fleet," Transocean CEO Jeremy Thigpen told his dial-in audience on the May 2 earnings call. "Sixth and seventh-gen drillship utilization remains at nearly 100%...by the end of the year, we expect leading-edge rates to exceed \$500,000 per day," a target that Nobel Corp. CEO Robert Eifler also called out two days later on his own earnings call.

On May 10, Transocean announced

the signing of one of its vessels to a contract for 300 days at a total value of \$137 million, "implying," noted a Barclays report, "a day rate of \$457 k/d, marking the highest day rate secured for a harsh-environment semi since the 2014 downturn."

"Everything's playing out the way you would expect," Maupin tells me. "We knew that the last thing that would happen before the market really gets exciting is that the cold-stacked and stranded new-builds would be bought and reactivated and then put to work. That's what we're seeing right now. We're seeing those assets bid into contracts. And we're seeing those assets win long-term contracts. After that, there's nothing out there."

Maupin is doing his part to help the cyclical process along by purchasing, in company with a group of Norwegian investors, a trio of stranded new-builds, i.e., deep-sea rigs ordered by drillers that subsequently went broke. While a new drillship may cost \$1 billion-plus, an orphaned vessel could be yours for \$300 million—\$200 to \$250 million or so for the cold iron and about \$70 million to make it operational.

"You can contract them today at roughly \$450,000 a day for three to five years," Maupin continues, "which works out to \$70 million to \$85 million per year of cash flow. So, you've got a three-to-four-year payback on the assets, but you're contracting them with a major or national oil-company credit risk on an asset at a quarter of replacement cost. We like that."

Unusually within the offshore drilling industry, Transocean did not shuck

Transocean at a glance

all figures in \$ mns except per share data

	<u>TTM*</u>	<u>2022</u>	<u>2021</u>	<u>2020</u>	<u>2019</u>
sales	\$2,638.0	\$2,575.0	\$2,556.0	\$3,152.0	\$3,088.0
Ebitda	883.0	843.0	961.0	1,264.0	823.0
net income	-911.0	-621.0	-592.0	-567.0	-1,255.0
earnings per share	-1.27	-0.89	-0.93	-0.92	-2.05
shares outstanding	717.3	699.0	637.0	615.0	612.0
cash	747.0	683.0	976.0	1,154.0	1,790.0
debt	7,342.3	7,347.0	7,170.0	7,807.0	9,261.0
total assets	20,194.0	20,436.0	20,681.0	21,804.0	24,105.0

* For the 12 months ended March 31, 2023.

sources: company reports, the Bloomberg

off its debt in bankruptcy during the long drought in exploration spending. And for that reason its balance sheet bulged with a net debt balance of \$6.9 billion on March 31, an amount equal to 7.3 times the Street's estimate of 2023 Ebitda and 4.5 times the guesstimate for 2024.

Operational leverage, too, is a Transocean calling card—none of its competitors is more exposed than RIG to the cadence of offshore energy business activity. The Transocean fleet comprises 39 seagoing drillships, of which 29 are ultra-deepwater floaters and 10 are foul-weather floaters, which can operate in 19-foot seas and gale-force winds. Twelve out of the 39 are cold-stacked, i.e., stored in calm waters in anticipation of the good times on which Maupin and we are banking, including 8 out of the world's remaining 13 unutilized sixth- and seventh-generation floaters.

Adding the \$6.9 billion in net debt to Transocean's \$4.8 billion market cap yields an enterprise value of \$11.6 billion. Admittedly, at 12.3 times this year's estimated Ebitda or 7.7 times next year's guess, RIG hardly looks cheap. It would look a lot more fetching if energy producers continued to boost their outlays on offshore drilling activity and those dozen fallow assets returned to work. In those happy circumstances, strong cash flows would permit a program of debt retirement. Investors are currently paying \$122 million in market cap for each Transocean ship while the cost for a new-build tops \$1 billion.

Business indicators, at least, continue to move in the right direction. "Transocean's backlog has trended much higher since bottoming in June 2022 at \$6.1 billion," said CreditSights, which is bullish on each of RIG's bond issues. "We believe that for most businesses and Transocean in particular, orders are the main drivers of stock and bond prices. For 2022, orders were roughly 1.8x revenue. For 1Q 2023, orders were slightly higher than revenue. Backlog is currently \$8.6 billion."

Since we had our say in December, Transocean's stock price has soared by 66.2% versus an 12.3% bump in the S&P 500. Over the same span, the junior-priority guaranteed callable 8s of 2027, which are rated triple-C-plus, have rallied to \$88.36 to yield 12.1% from \$80.83 and a yield of 14.3%.

Of the 19 Wall Street analysts on the

TGS ASA at a glance

all figures in \$ mns except per share data

	<u>TTM*</u>	<u>2022</u>	<u>2021</u>	<u>2020</u>	<u>2019</u>
sales	\$757.6	\$716.6	\$518.7	\$319.5	\$585.6
operating income	91.7	132.0	-72.3	-264.2	129.0
net income	58.0	87.7	-76.0	-188.6	113.4
earnings per share	0.50	0.75	-0.65	-1.61	1.05
share outstanding	125.2	118.9	117.8	117.1	109.4
cash	208.0	188.5	215.3	195.7	323.4
debt	45.0	44.7	0.0	2.5	2.8
total assets	1,866.5	1,838.9	1,629.8	2,015.4	2,199.7

* For the 12 months ended March 31, 2023.

source: company reports

case, eight rate RIG shares a buy, four a sell. Short interest sums to a whopping 20.9% of the float, although some of these sales may be tied to hedging Transocean's \$618 million in convertible bonds rather than expressing an outright bearish view on the stock. If the insiders are bullish, however, they are expressing that sentiment in words alone: In the past 12 months, they have sold a net 171,122 shares for proceeds of \$1.3 million.

"We're not worried particularly about the squiggles in supply and demand," Maupin tells me about the offshore drillers. "Whether it takes a year, two years or five years to play out, based on the near-term path of the global economy, that's okay for us. We think these assets are available at prices where you're paid to wait."

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Drilling isn't the only hollowed-out branch of the offshore-services industry. Seismic survey analysis, too, has been through a rough patch. No Transocean ultra-deepwater ship goes poking holes in the seabed without some scientifically sourced conviction of what lies beneath.

To identify promising subsea real estate, a seismic survey vessel will traverse a patch of ocean while streaming long arrays of seismic sensors in its wake (think of a huge tractor pulling a massive plow across the flat Illinois earth). To generate signals for the sensors to detect, the survey ship shoots short bursts of compressed air at the sea floor every 5 to 15 seconds. How the energy from these bursts is reflected back from

the sea floor to the sensor arrays on the surface tells the seagoing seismologists about the underlying geology.

For marketing purposes, seismic data come in two forms, off-the-shelf, or "multiclient," and bespoke, or "contract." The customers, mainly exploration-and-development companies, may choose one or the other, or both.

In the energy-starving time of 2012–22, the number of companies shooting multiclient data declined to 4 from 11, according to TGS, the largest surviving multiclient specialist. According to PGS ASA, which owns the second-largest seismic fleet, behind Shearwater GeoServices Holdings A.S., the number of vessels available to gather seismic data of any kind has dwindled to 17 from 60 in 2013.

In the recovery phase of the offshore drilling cycle, E&P companies typically spend first on multiclient surveys. "It basically starts with exploration and then moves into production," PGS's vice president of investor relations, Bård Stenberg, tells me. "This time we see the opposite in terms of it starting with production and a recovery in the contract market before exploration and a recovery in the multiclient market."

"We think it is due to the energy transition and the fact that oil companies during 2020 and 2021 focused a lot of resources on producing fields and on extracting more from producing fields to get a quick return on their investments," says Stenberg. So the multiclient portion of the recovery is still to come.

TGS owns no boats and, as a rule, does not directly employ seismic crews. The strategy paid off during the prolonged

downturn in oil and gas exploration.

For one thing, it preserved an unlevered balance sheet; as of March 31, TGS showed a net cash balance of \$163 million or 9.6% of the current market cap. For another—directly related to the first—it afforded the financial flexibility that allowed for continued dividend payments and the periodic repurchase of shares; since 2010, management has returned \$1.4 billion to shareholders versus a current market cap of \$1.7 billion. And, finally, the capital-lite model gave TGS the wherewithal to acquire companies and to buy seismic-data libraries while competitors like PGS worked on balance-sheet repair.

In two transactions over the past eight months, TGS purchased Magseis

Fairfield ASA, a seismic company with a specialty in ocean-bottom nodes. Placed directly on the sea floor, such nodes generate more, and more-detailed, data than streamers do.

Magseis is a bit of a departure from TGS's capital-lite model as the newcomer owns thousands of sensors and employs crews on the company payroll. (TGS currently describes itself as "relatively asset-light.") However, TGS now commands two-fifths of the \$1 billion ocean-bottom-node market. While OBN is five times as expensive as a legacy seismic survey, it's much in demand in areas with complex geology or basins that house existing wells (whose concrete and steel components can interfere with seismic signals). This opens

up fresh opportunities for TGS to shoot new and valuable data in basins where multiclient seismic maps already exist.

TGS does a green kind of business, too. Whether you want to place a windmill offshore or store carbon in a depleted well, you need to know the geology under the sea floor. In the first quarter, such work delivered 7% of revenues.

Of the 10 analysts who cover TGS, 8 say buy and 1 says sell. The stock changes hands at 28.2 times trailing earnings but at just 6.6 times the 2024 guess; the dividend yield is 4.1%. Over the past 12 months, one insider has purchased 1,200 shares at a net cost of \$20,383 (give that loyalist a raise!), while no one has sold.

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