Hosking Partners®

Hosking Post
Offshore drillers: Tangible assets strike back

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www.hoskingpartners.com | info@hoskingpartners.com | +44 (0) 20 7004 7850 | 11 Charles II Street, London, SW1Y 4QU

OFFSHORE DRILLERS: TANGIBLE ASSETS STRIKE BACK

"Scarcity is the most important law in economics… What makes the painting valuable is not the canvas or the paint, but the fact that there's only one." Anthony Deden

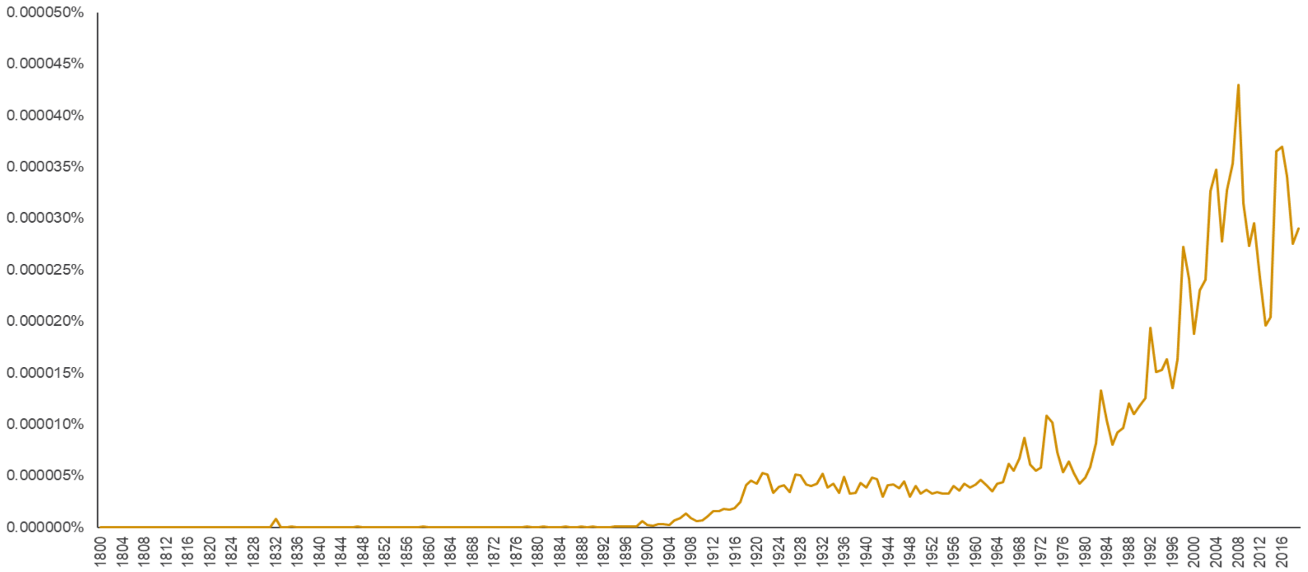
Over the past decade all-time low interest rates - overlaid with a dose of extrapolation bias - have prompted market participants to form bold views on the recasting of business models, terminal growth rates, and 'capitalism without capital'[1] (the latter may be one of our favourite oxymorons). It has been the age of the intangible asset. This exuberance has been coupled with a distinct apathy towards asset-heavy business models, in part driven by an oversimplistic, growth-oriented assessment of corporate asset bases. Looking at the world through a capital cycle lens, empowered by a go-anywhere approach, and fuelled by a contrarian spirit, at Hosking Partners we have used this opportunity to establish positions in a collection of overlooked 'tangible world' sectors that we believe offer strong potential returns. The offshore driller sector represents one such area. This sector – which represents c.2% of the Hosking Partners' portfolio – provides an attractive upside opportunity due to the supply constraints on available vessels and the resultant prospect of significant profit and Free Cash Flow ("FCF") generation as scarcity value increases. A margin of safety is derived from the high barriers to entry inherent in the asset intensity of operations. This Hosking Post unpacks our attraction to this overlooked sector.

Contemporary obsession with asset-light companies is, unsurprisingly, reflected in the language we use. Employing the technology of Google NGram – a digitalised library of more than 5 million books published since the 1800s and empowered by word search functionality – we can observe the rapidly growing attention paid to intangibles since the 1990s. There are good reasons for much of this: in a 2021 follow-up to his seminal work on base rates, Michael Mauboussin highlighted the transformative impact intangible assets have had on corporate growth.[2] "Commonly cheap to produce and share," intangible assets "enjoy strong economies of scale." In a period where the cost of capital has been all but eradicated, it is not surprising that the unstoppable growth of intangible-first companies (i.e. Big Tech) has captured the market's imagination. However, equally apparent in the NGram data is the decline in frequency of use of 'tangible world' terminology – for example, book value – over the same period. This linguistic 'either-or' misrepresents the mutual dependence of one on the other – the tangible on the intangible, and vice-versa. After all, there is no cloud storage without data centres. There is no e-commerce without fulfilment capacity. There is no AI without semiconductor chips

[1] Haskel and Westlake
[2] The Impact of Intangibles on Base Rates by Michael Mauboussin

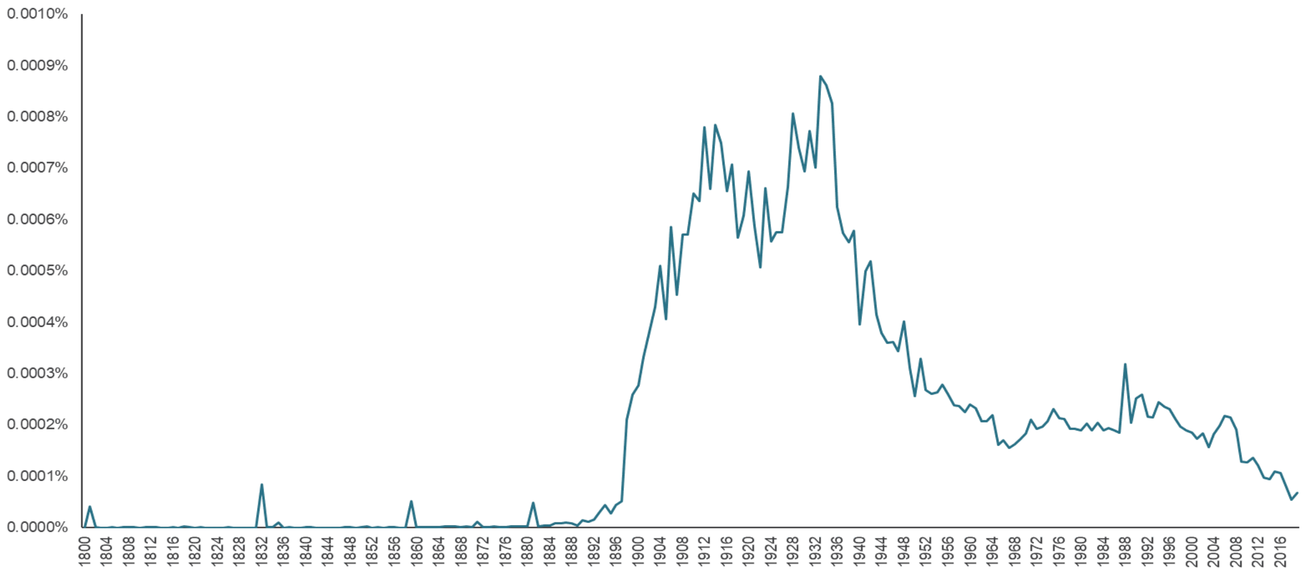
fabricated in vast foundries. As Django Davidson discusses in our recent podcast with Material World author Ed Conway, whether it is in extracting hydrocarbons or harnessing wind power, there is no human progress without the countless tons of steel necessary for energy capture and transmission. Any analysis that fails to accurately identify – and commensurately value – the interdependence between intangible and tangible assets risks being idealistic at best, and superficial at worst.

Ngram analysis: "Intangible asset"



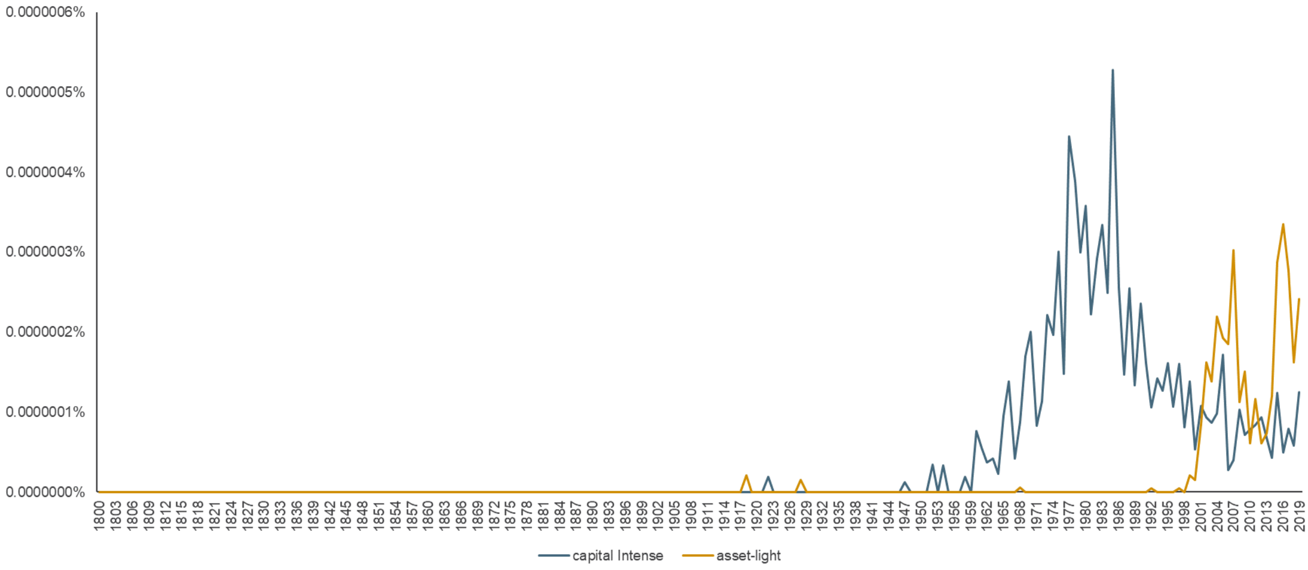
Source: Google Ngram

Ngram analysis: "book value"



Source: Google Ngram

Ngram analysis: “capital intense” & “asset-light”



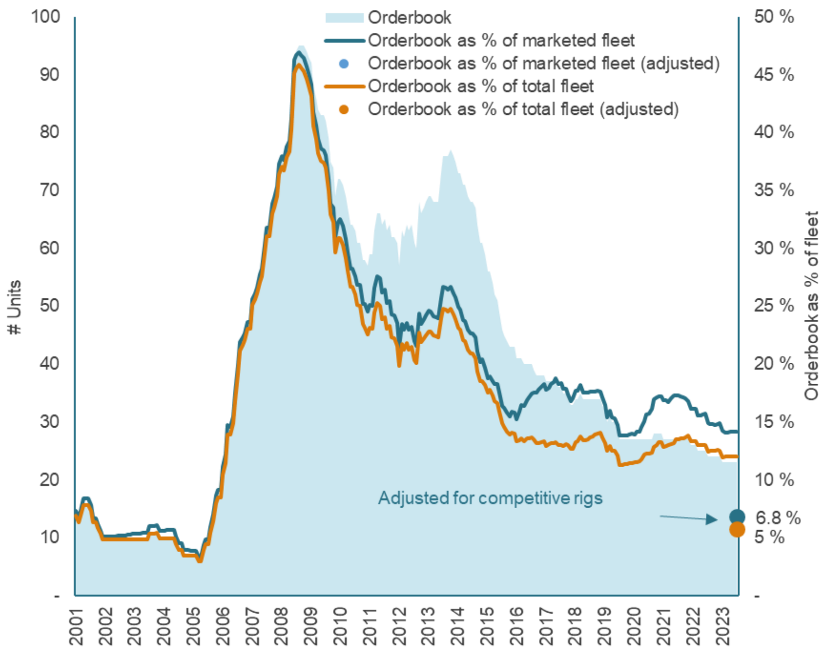
Source: Google Ngram

As Maboussin goes on to acknowledge, one lesser discussed characteristic of intangible assets is their risk of obsolescence due to the emergence of newer, competitive alternatives: “once an operating system software is replaced… the old one is of little relevance or value.” Comparably, there is a direct relationship between the sheer mass and durability of the physical world (i.e. tangible assets), and the barrier to entry they consequently represent to competitive supply. The larger, more complex, and more expensive an asset is to produce, the harder for incremental competitive supply to emerge.

In the case of offshore drillers, the assets involved meet each of these respective criteria. They are physically large, complex, and expensive. By way of example, the scale of Noble’s Invincible rig (acquired as part of the combination with Maersk Drilling) is humbling, with a platform height of over 200 metres – equivalent to two Boeing 777s – and drill depth capacity of over 12 kilometres, deeper than the Mariana Trench. Originally commissioned in 2014 at cost of $650 million, the vessel took two years to construct at the Daewoo shipyard in Korea. Immediately prior to delivery, day rates in the sector – the price at which offshore drillers rent their rigs to oil companies – had returned to prior cycle highs (>$500k/day), a reflection of the scarcity value of available vessels at the time.

Today – despite equivalent rates approaching the $400k-450k/day range for the largest, most complex vessels – significant barriers to new supply remain. The high price of a new vessel, the degree of consolidation in the industry, and the real risk of stranded assets given an uncertain demand duration and regulatory outlook for hydrocarbon extraction, mean that the incentive price (expressed in the form of day rates) has risen versus prior cycles. After all, if one is only able to have confidence that a rig will have a 10-year economic life rather than a 30-year life as in the past, higher day rates are needed in order to generate a positive return on investment. Exceptionally low shipyard capacity further exacerbates the challenging supply picture. As in prior upcycles – the late-90s, GFC/'08, and oil super-cycle ending in 2014 – this set of circumstances should result in increasing levels of active fleet utilization, rising day rates, and significant profit improvement for the offshore driller companies.

Historic newbuild floater orderbook relative to fleet (2001-2023)



Source: Clarksons, RigLogix, Clarksons Securities AS

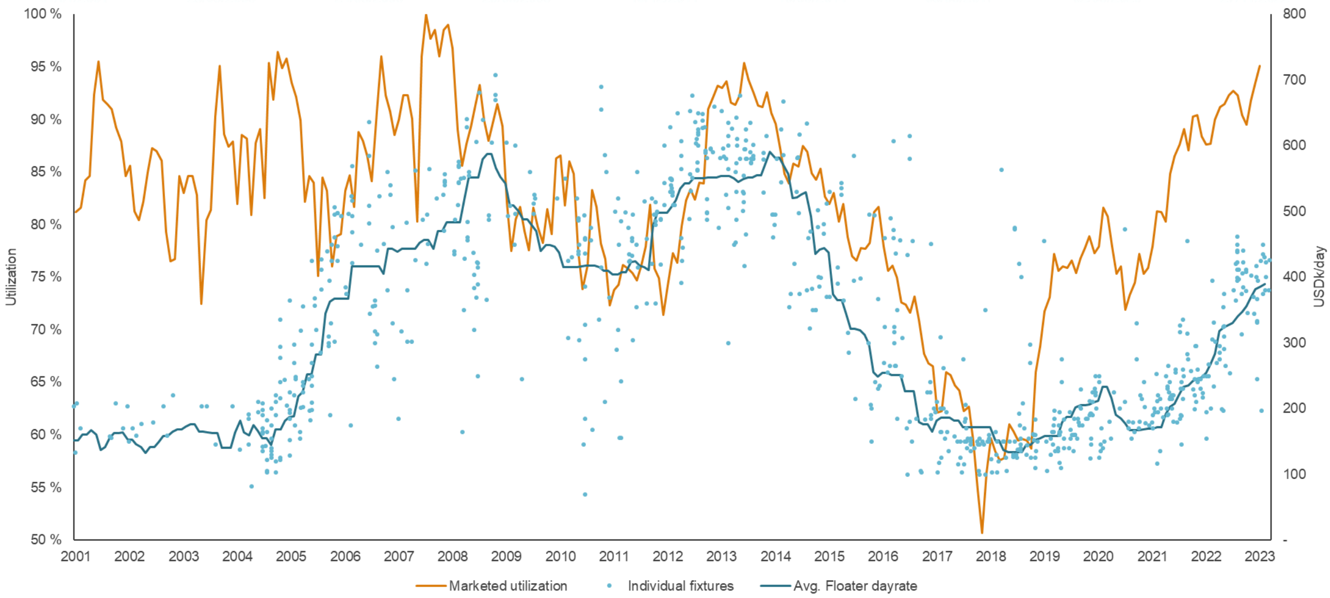
Encouragingly, the industry structure may also support an even more attractive upcycle than previously. Today, the majority of vessels (both floaters and jackups) are held in the largely consolidated hands of the seven listed players, with only a short list of assets owned by privately-held players and national oil companies, predominantly jackups. This compares to more than twenty vessel owners pre-GFC. In large part the consolidation reflects the financial stress and consequent restructuring processes that occurred in the wake of last oil super-cycle. Since then, the industry has undergone a sustained period of asset scrapping (60% of floaters scrapped), market consolidation (to today's seven listed players), and almost a full house of Chapter 11 restructurings (only Transocean and Shelf Drilling avoided the process). With over $50 billion of enterprise value destroyed in the period from 2014 to 2019, close to no new orders for an offshore drill rig have been placed for almost a decade. Furthermore, the number of rigs either on shipyard balance sheets (stranded) or not in active use (stacked) that could plausibly re-enter the market is limited and largely controlled by Transocean, the name with the highest indebtedness and most likely rationale to maximise profit and free cash flow. With ‘scar tissue’ from the previous cycle remaining in the form of industry executive management teams, and the significant price appreciation in the cost of a new vessel today (likely up to $1 billion), the behavioral incentive for capital discipline is significant.

Stranded asset concerns are another reason why the procyclical supply response seen in prior cycles will likely not materialize for some time in the offshore driller sector. Importantly, given the high absolute purchase prices of new supply, and the long useful asset life – both of which stand in stark contrast to the prevalent medium-term uncertainty for hydrocarbons and related ESG agenda – management teams have noted a shorter implied payback period is necessary to counterbalance the risk of rigs becoming stranded on company balance sheets (again). Whether it be the absolute level of day rates, pre-payment terms, contract duration, or a combination of all of the above, it is reasonable to think the burden of proof of need for new supply is firmly on the Exploration and Production customer (i.e. demand). Returning to the economic considerations of offshore versus onshore investment, the latter offers an average payback of one to two months, thereby only requiring a short-term commodity price view. Conversely, even shallow water projects, which are considerably less expensive than deepwater production, require a multi-year demand forecast. Unsurprisingly, the majority of offshore activity since 2014 has remained focused in the shallow water jack-up market, specifically in the Middle East, where state-backed National Oil Companies (NOCs) – with their atypically long time-horizon – represent around 70% of customers. While final investment decisions in offshore do gradually appear to be increasing – as articulated on Schlumberger’s recent quarterly earnings call – we remain some distance from anything approaching an ‘exuberant’ demand picture.

Furthermore, the number of shipyards that could reasonably build new vessels has shrunk. Hyundai Heavy Industries estimates global shipyard capacity has reduced by more than one third since 2008. What capacity that remains is predominantly found across Asia – specifically in Korea, Singapore and China – a matter that is geopolitically significant. A recent trip to the region by this author confirmed the limited inclination of Korean shipyards to support a revival of new orders for rigs. In the last cycle, the combination of excessively customer-friendly payment schedules and the subsequent customer defaults meant that shipyards sustained meaningful losses from offshore drill orders, with some yards subsequently carrying stranded assets on their own balance sheets for over a decade. Irrespective, the current strength in orders for other types of ships – such as LNG carriers – means yards are full and have limited spare capacity. Transocean noted on their most recent quarterly earnings call that a new offshore rig vessel ordered today would be unlikely to be delivered before three to five years (i.e. 2026-2028).

Despite these factors, in the spirit of Sir John Templeton: 'The four most dangerous words in investing are, it's different this time.' To believe we will never see new orders and additional competitive supply is to deny history and human nature. Were day rates to support an IRR of 15% earned over a long-term contract and with a significant pre-payment contribution towards construction, placing newbuild orders would be the rational course of action. But even a blue-sky scenario of $650k/day for the highest specification floaters – equal to an all-time high contracted price and requiring near 50% appreciation from current leading-edge rates – may fall short of such returns. In other words, we remain some way from such an inflection point.

UDW floaters vessel utilization and dayrates (2001-2023)



Source: Clarksons Research Services td., RigLogix, Clarksons Securities AS

Of course, any discussion of an oil service provider would be incomplete without reference to the long-term demand concerns that weigh on hydrocarbons. We are generally humble when facing the challenge of predicting future demand. However, we note the undisputable data point that global oil demand reached an all-time high in 2022, despite political pledges and forecasts promising the opposite. As we have discussed at length in both recent Hosking Posts (Cosmo Energy, New World

Order) and Active Ownership Reports (A Diverse World, The Maze to Net Zero), moderate demand forecasts appear more convincing to us than extreme swings, at the very least out to 2030. The impact of EV adoption on the use of oil for transportation should not be underestimated, but the combined effects of emerging world development and sticky demand outside light transportation mean the Western consensus on the pace of oil's decline seems overstated. In any case, uncertainty around long-term demand for oil constrains new offshore supply, bolstering the capital cycle investment case we see today. Combined with declining breakeven costs in offshore production and a lower carbon intensity versus alternative production methods, the industry may well rationalise around offshore even as overall output begins to fall. In this context, a reduced capacity to build new vessels, day rates with payment terms that remain insufficient, and a consolidated industry structure, provide multiple obstacles to new supply and provide us both a margin of safety and the confidence to continue building our position in the near to medium term.

The sector offers a further margin of safety owing to relatively low valuations. While precise estimates vary by individual company - a function of fleet asset make-up, capital needs for respective projects, and balance sheet structure – at day rates of c.$600k/day and $250k/day for floaters and jackups respectively, the sector today trades at less than 3x EV/EBITDA. Furthermore, with the debt capital market transactions to refinance restrictive post-Chapter 11 debt terms already achieved by players such as Transocean and Odfjell Drilling, we are likely to see greater capital allocation flexibility for management teams, underpinning the prospect for substantial cash returns to shareholders.

A comparison of an offshore drill rig to a Hermes Scarf, a Louise-Vuitton trunk, or indeed a Ferrari Superfast V12 may at first appear misguided, not least given the close links between luxury brands and the ascent of intangible assets.[3] However, for each of these it is precisely the scarcity of the tangible asset that commands value. Just as we expect Hermes, LVMH, and Ferrari to remain disciplined in terms of curating availability for their customers, continued supply discipline from the offshore drillers at this point in the cycle is the rational and self-serving course. Just as we can observe that vintage editions of these luxury goods have appreciated with time, so too we think duration without incremental supply can results in higher day rates for rigs. Indeed, the observation from past cycles is that as available supply declines, securing capacity at all costs matters considerably more than the price you pay. It is not necessarily the quality of an asset that determines its price, but rather simply the (un-)availability of assets to contract. Acknowledging that this time is indeed likely not different – our base case – we think it is reasonable that sector supply dynamics

[3] The role of intangible attributes of luxury brands for signalling status: A systematic literature review, Fuentes, Vera-Martinez, Kolbe

result in significant day rate appreciation, translate into material profit improvement and FCF generation, enable improving shareholder returns, and consequently permit higher valuations to be attributed to the sector. The combination of these factors underpin the relative attractiveness of exposure to this sector in the current upcycle, and speaks to our broader faith in the coming renaissance for the ’tangible world.’

CHRIS BEAVEN

August 2023

Offshore Driller sector names owned

Name	Ticker	Weight %
Noble Corporation PLC	NE US	0.75
Odfjell Drilling Ltd	ODL NO	0.06
Seadrill Limited	SDRL NO	0.32
Shelf Drilling Ltd	SHLF NO	0.14
Transocean Ltd	RIG US	0.18
Valaris Ltd	VAL US	0.33
Diamond Offshore Drilling Inc	DO US	0.21
Total		**2.00**

Source: Hosking Partners, based on a representative portfolio as at 1 August 2023.

CONTACT DETAILS

Hosking Partners
11 Charles II Street
London SW1Y 4QU
Tel: +44 (0)20 7004 7850
info@hoskingpartners.com

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