Valara
Capital Management, LLC

6/23/15 - "Drilled", But Opportunity Developing

If there is a more hated group in the market today, we can't find it. The offshore drilling stocks have been among the worst performing groups for two years running now, and even amidst almost daily record highs in the stock market still can't get out of their own way, with many of the stocks trading below prices seen over twenty years ago. And why not? With the ink barely dry on the industry's dismal year end 2014 results, there remains seemingly no end in sight to the ugliness, as asset impairments, earnings estimate downgrades, and dividend cuts roll on. By now, it is becoming fairly well understood what is behind the industry's travails; 1) an epically mistimed and massive capacity expansion 2) the fracking boom, that led to a doubling of US production in the past 5 years and diverted significant capital that historically might have gone into offshore activities, and 3) a commodity price collapse that is creating a global retrenchment in energy capital spending as we write this.

So how bad is it? At present, the industry has approximately 675 rigs in the global fleet, of which about 20% are not working. And there is another 25% to come by the end of 2017 in the form of news orders and rigs presently under construction. And to make matters worse, with oil producers cutting budgets in the wake of the 2014 price collapse, new drilling contracts are virtually non-existent. The near term prospects for the industry's major players are indeed downbeat. We expect 2015 to be another tough year in terms of earnings, with the industry's difficulties likely spilling over into 2016 as well.

Are there any silver linings? We think so. Managements have begun to recognize the severity of the downturn, and are rationalizing at an accelerating rate. Since the middle of last year, the industry has retired or stacked (idled) approximately 70 rigs – a good start. We believe there could be as many as an additional 50-75 rigs retired/stacked this year. This would put a pretty hefty dent in the industry's overcapacity problem. There is plenty of negative commentary from the Street on this group (much of it justified), but one thing that we don't believe gets sufficient attention is the issue of obsolescence. As ill-timed as the capacity expansion of the past few years has proven, it has not radically changed the age profile of the industry's assets. We estimate that even with the new rigs on order (many of which could be cancelled if poor drilling conditions persist), roughly 20% of the industry's fleet will be at least 30 years old by year end 2017. To us, this means the new assets were always going to be needed, they just got ordered and built at the wrong prices. This issue is now being dealt with in the form of write downs, and earnings and balance sheet re-sets across the industry. Not surprisingly, stock prices have adjusted downward accordingly. When the eventual cycle bottom comes, we envision there will be several companies whose fleets will be young, technologically capable and well positioned when a new cycle unfolds. In the meantime, recognizing cheap could certainly get even cheaper, we believe value has now been firmly established.

We do not have a strong sense of when this down cycle will run its course and a new upcycle will begin, but we suspect it is not as far off as the stock prices of the industry's major players suggest. Until the asset base of the industry is fully cleansed of recent excesses and drilling activity levels begin to stabilize it is impossible to determine what a normalized level of earnings for this industry will look like. But with the stocks now trading at relative price lows not seen in the past 20 years, it now appears to us that a margin of safety has developed. We believe investment risk/reward now skews favorable for many of the industry's stronger players and would expect those companies to dramatically outperform the market in the years ahead.