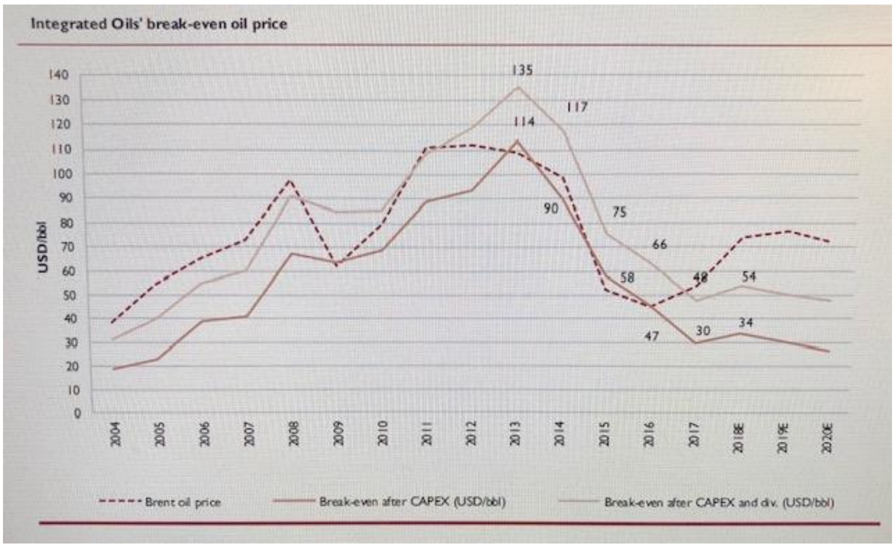
SEADRILL (ODFJELL) – SIFTING THROUGH THE RUBBLE

Even oil is under Trump`s thumb now. That must be the conclusion following this fall`s rollercoaster ride. With some help from the Saudis, admittedly, in setting the stage for the crash as the Khashoggi murder dealt him an enviable hand in controlling the rhetoric on not only sanctions on Iran but also on the swing producer Saudis control of production.

Meanwhile, the underlying supply/demand balance in oil markets continues to tighten on the heels of the last few years investment drought following the 2014/15 oil price crash with spare capacity probably down to less than 2pc of annual production now. Over the next 5 years, the outlook for production is a decline of more than 13mbd (since 2010 the decline rate has been around 3mbd annually, according to IEA) while demand looks set to increase with around 6,9mb (1-1,1mb annually from 2020). Thus, the oil industry needs to come up with around 20mbd of additional volume– or around 20pc of current production. With a couple mb spare production as we speak… Let`s hope IEA`s projected decline rates prove too fast. Or maybe everyone nervous about the rapid increase in US shale rather ought to beg for it to increase even faster? Sure, shale may be enough to supply this years – and next – global demand increase of 1,2-1,5mb/year. And lead to continued wobbly oil markets as those numbers are reported. Thereafter, something`s gotta give.. For anyone willing to look out more than 2 years the threat is not an oversupplied oil market, but rather the opposite; a sharply undersupplied market unless oil companies start to ramp spending and bring on new capacity. On top of that, in only a few months, there is IMO2020 (see report 10/14/18). Don`t be surprised to see investor sentiments around everything oil swing sharply upwards over the next few weeks and months. Either oil prices stabilize at a level allowing new volumes to be found now, or they stay down until we get an even tighter oil market later with a subsequent overshoot forcing new capacity on stream.

On that note, and ahead of next week`s OPEC meeting, time has come to start sifting through the oil rubble following the last few weeks debacle. Before doing so, it may be worth taking note of the following; whenever oil prices swing (which they do all the time – 50pc up or down is actually the norm), panicky investors seem to forget that oil services companies don`t actually sell oil. Right, they sell services. So, while it is fully understandable that the share prices of the E&P companies correlate closely with oil prices, oil services investors ought to be more concerned with the growth/recession line in the industry than the ups and downs of Brent spot. For US shale, that line is currently around $55/b all-in. WTI is now below that level, which in itself ought to spur some buying. Offshore has that line a lot lower on new projects following the last few years massive cost cuts. Large, new projects like Johan Castberg have seen costs axed by 50pc or more, several are now profitable even at $20 oil, and Equinor now report a breakeven oil price on its entire portfolio as low as $27/b. 27 dollars! Investors may have forgotten the 2016/17 breakeven mantra of the offshore players. That breakeven is far lower than the +/-60`s prices seen currently, as illustrated below:



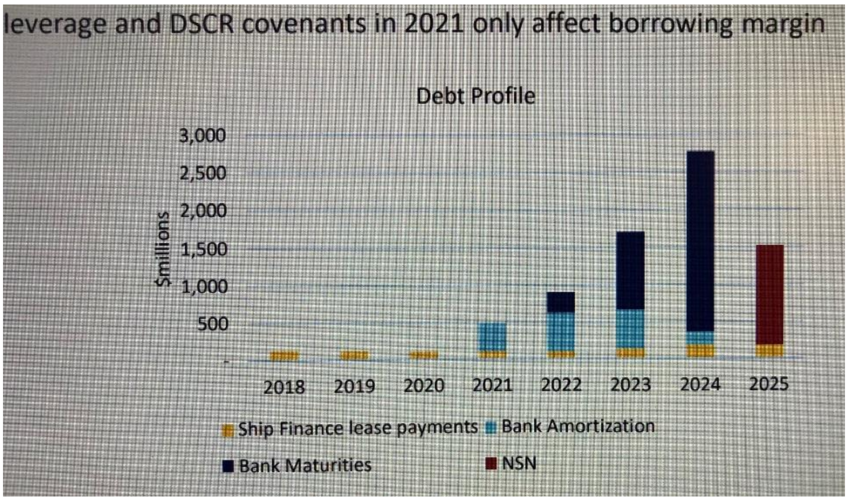
Source: Carnegie Research

The chart above is from Carnegies Oddvar Bjørgan. My interpretation is that as long as we stay above $54 Brent the recovery ought to continue. That leaves enough for planned capex and the huge dividends the industry is planning for ($20/b!) Importantly, «Saudi Inc» currently runs with a breakeven in the vicinity of $70. In conclusion, I think it is hard to argue for any «better» oil prices than the ones we are witnessing today. WTI < 55 slows down shale while 55 < Brent < 70 keeps OPEC+ on its toes while at the same time providing ample cash to grow spending for the offshore E&P`s. Ironically, in the midst of the panic, it seems Goldilocks may have arrived.

Oddvar`s quarterly update on the IOC`s furthermore shows that the IOC`s will have «excess» cashflow of $38bn, 52bn and 51bn for 2018-20 assuming Brent at 56, 60 and 63, respectively. After capex and dividends. And buybacks. That is a hefty 40pc of total capex, and 12pc of current global upstream capex as reported by IEA. Providing sufficient headroom to ramp sorely needed upstream spending whenever they decide to do so, even at modest Brent assumptions.

Which brings me to Seadrill. The ultimate operational and financial leverage on a recovery in offshore spending. The most immediate pushback you`ll get on Seadrill as a long is that it has fallen less than its peers. In EV terms. I.e. while the non-levered oil service players are down 30pc, Seadrill assets may be down only 15 pc or so. What these investors seem to forget is that relative repricing can happen in down as well as up markets. Seadrill was on it`s way to being repriced vs peers while going up before the crash, and has continued that repricing during the drop. What matters in my mind, is not relative performance but relative value. Seadrill is still by far the cheapest way to get exposure to the drilling recovery already well underway. I see mainly 3 reasons for the discount;

1) Complex structure and a large debt load, at around 2x the closest peers rel to mrk cap. However, debt servicing costs are only marginally above those of ESV and RIG and any liquidity shortfall (assuming no mrk recovery) is the same as ESV and RIG, ie 2021 (incl RCF). No bank maturities until 2022. Actually, with the liquidity runway provided, one may argue that the leverage offered adds an element of optionality not found in its peers, adding to the stock`s attractiveness.



Source: Seadrill

2) Lack of coverage. Only 12 analysts have so far gotten around re-initiating on Seadrill after the company came out of ch 11. All with a buy. It used to be 30+. I expect another 18+ to initiate on it over the next few months.
3) Non-core assets; co holds around $1,1bn in non-core assets. I expect these to be divested as soon as feasible, further reducing net debt.

Seadrill holds a young and attractive fleet at an avg age of 9 years vs 15 for ESV and RIG. It is also most levered to the emerging upturn, with only 5pc of its floaters contracted YE 19 vs 9pc for ESV and as much as 35pc for RIG. That`s exactly what investors should look for at this point of the cycle. You don`t want to own a driller having already locked in subpar rates when heading into the recovery. While rig utilisation has improved for more than a year and fixture activity is back to previous highs, contract duration and day rates are still lagging. Importantly, the drillers Q3 calls not only reflected much of the same sentiment; when commenting on the market recovery, the generally upbeat mgmt teams also indicated that we may see more contracts at higher day rates in the near future. While share prices have crashed, earnings estimates 2 years out have remained stable or even increased somewhat, as exemplified by the most representative deep water player, Transocean:

Source: Bloomberg

At this early stage, investors ought to focus on asset values rather than earnings, though. Over the last few months there has been quite a few transactions confirming pricing levels in some categories. The analysts are for some reason fond of using these and implied peer pricing, to calculate implied pricing levels for other rig categories within the same company, setting up peer relative implied values. I prefer looking at absolute values as it eliminates the moving parts in the implied pricing models. Doing so for Seadrill is a quite a stretch, though, given lack of broker quotes in some segments and a complex structure, forcing any calculation to be at least partly earnings based. Supported by Pareto`s diligent work on the company, I`ve got the following net asset and replacement values:

SEADRILL			
		Shr count	100000000
No of rigs	35	USDNOK	8,55
		mid-cycle	replacement
Harsh env	5	1150	
Floaters	14	4400	
Jackups	16	1900	
Sum fleet		7450	11300
Non-core		1100	1100
Gross		8550	12400
net debt YE 18		-5400	-5400
NAV		3150	7000
NAV/shr		**31,5**	**70**
NAV in NOK		**269**	**599**

The mid-cycle calculations here are around 10-15pc above values where broker quotes are found; assuming the same on the whole fleet would take NAV down by 5-10 USD. Recalculating the mid-cycle approach (e.g. HE rates at 60pc of new build parity, which I don`t think is aggressive at all) across the whole fleet returns an EBITDA around $1400m, implying an EBITDA multiple of 6 on a $30+ target. Assuming these rates will be achieved within 3 years (ref discussion above) and assuming a cash flow neutral position until then, SDRL currently is fairly priced at $21-25 – or 50-80pc up from here. Thereafter, who knows.. Despite coverage in popular media pointing to the death of hydrocarbons, the base load effects are such that demand will continue to increase for the foreseeable future, and beyond. Assuming the offshore industry ever goes through another replacement cycle, rates need to go up another 80-100pc to justify new buildings. In case, investors may be well advised to buckle up as any replacement orders would take SDRL up 5x or so from current levels.

In conclusion; this autumn`s Trump-induced fall in oil prices has created a temporary set-back in an industry well underway to recovery. Everybody I talk to is struggling to regain their footing and conviction on what will happen next, turning to myopic staring at current oversupplied markets by a few hundred thousand barrels here and there, worrying about the next weekly DOE number and its impact on oil prices. As if that will provide them with the answer. «Glut» is now a word in fashion. Meanwhile, the most attractive equities in the space have crashed and burned, leaving investors who have the ability to lift their view and look beyond the crash scene, with an unusually attractive buying opportunity. When the crowd returns, the underanalyzed, undervalued and unpopular just-out-of-ch-11-complex Seadrill provides the most upside.

For those who dare.

Source: Bloomberg

Investors with less demand on size and liquidity (free float less than $300m) may want to take a look at Odfjell Drilling. As prices on everything has come down, even the HE segment again offers some upside, with Odjell the highest quality way to play that. HE North Sea is already a balanced market with Odjell`s earnings beginning to reflect that. Net debt to EBITDA is already down to a comfortable 3x levels on next year's contracts, and looking out to 2020 with around 60pc of the capacity already sold the stock trades at less than 6x EBITDA with further upside on rates, with an estimated NAV north of NOK 40/shr. A low risk option to wait in.

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