

Cash flow is crucial in debt finance ratings

Credit rating agencies must be responsive to changing dynamics when evaluating bond debt of offshore drilling firms



BARRY PARKER — NEW YORK

CREDIT rating agencies, which evaluate bond debt, play an important — though sometimes overlooked — role in the offshore drilling industry, which typically has hefty capital requirements.

The numbers are staggering. The \$36.8bn balance sheet of Transocean, with the largest fleet of semi-submersible vessels, drillships and jack-up rigs totalling 138 units, includes a relatively conservative \$11.1bn of debt — mainly long-term — with maturities exceeding one year.

The \$17.6bn balance sheet of soon-to-be second largest player EnSCO, with 76 units once the company's acquisition of Pride closes, is anticipated to show \$5.2bn of debt when its deal is completed.

Included in this total is \$2.5bn of bond debt — divided into \$1bn of five-year notes paying 3.25%, and a further \$1.5bn of 10-year notes priced at 4.7% interest — raised by EnSCO in mid-March. The price for acquiring Pride is pegged at about \$7.7bn, of which \$2.9bn will be paid in cash, and the balance paid through newly issued EnSCO shares.

The new bonds, along with cash on hand, will be used to fund the majority of this cash component, with the remainder paid out of EnSCO's substantial cash reserves. Bond markets are sometimes unpredictable; as a backup, EnSCO had entered into a \$2.75m bridge loan commitment from Deutsche Bank/Citigroup in early February, but cancelled it after the successful bond offerings.

Rating agency Standard & Poor's rates EnSCO as BBB+, which is in the lower tier of investment grade borrowers. However, the rating agencies must be responsive to changing dynamics. In an industry Credit Outlook published just prior to the bond offerings, S&P qualifies its rating by adding "negative implications".

S&P stated: "We expect that debt leverage could increase as a result of this transaction."

In fact, in a proxy filing addressed to shareholders who must vote on the Pride acquisition, EnSCO said: "The level of consolidated indebtedness of the combined company will increase by the amount of the

debt financing incurred to fund the cash component of the merger consideration and by about \$1.86bn of Pride's debt that will remain outstanding after the merger.

"The combined company's increased indebtedness and higher debt-to-equity ratio in comparison to that of EnSCO on a recent historical basis may have the effect, among other matters, of reducing the combined company's flexibility to respond to changing business and economic conditions, lowering credit ratings."

Lawrence Wilkinson, director at S&P, told Lloyds List: "In the offshore sector, we see weakness, centring on the issue of oversupply. As we move through the ordering cycle, we will see 120-130 rigs being delivered over the next three and a half years, split between jack-ups and floaters."

"When you look at the overall supply equation, you try to line it up with demand. Supply will be outstripping demand."

In discussing the state of the markets, Mr Wilkinson stressed the bifurcation between high-end and lower-specification units in both the floating and jack-up segments,

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Lawrence Wilkinson, S&P director

point out that drilling units with older equipment would be less competitive.

"As the newer rigs come to market, the higher specification units will find work — deepwater will push down into mid-water; some rigs will be pushed out of the market," he said.

When S&P calculates debt issuers' ratings, the ability to meet debt service obligations — interest payments and sometimes amortisations of principal amounts — is paramount.

Mr Wilkinson explained that two of the most important measures when examining drilling units were the ratios of "total debt/earnings before interest, tax depreciation and amortisation [a measure of cash flow]" and "funds from operations/total debt".

He said: "Over time, difficulties in generating cash, when compared with the overall debt burden, have been reliable indicators of default, especially for those rated BB or better. When you get into weaker ratings, then overall liquidity — including cash on hand, cash from operations and funds available through bank revolvers — becomes the most important consideration." ■

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Owners seek spin-offs to boost asset returns

ONE consequence of the divide between the high and low ends of the rig spectrum, where the best equipment earns outsized returns, has been the recent rash of spin-offs by players including Seadrill, Aker and Sevan, writes Barry Parker.

Standard & Poor's director Lawrence Wilkinson offered a multi-faceted perspective on these transactions, explaining that strategy formulation involves considerations that are not always obvious. "We frequently have conversations with debt issuers about spin-offs. The challenge comes down to a question of what the returns are," he told Lloyds List.

"What do you do with the lower return assets?" he asked.

Such lower-end assets might be left behind if high-end rigs are grouped into a new entity, or, alternatively, might be spun out into a separate business.

The experience of Seahawk Drilling, now being absorbed into Hercules Offshore after a bankruptcy filing — once a part of Pride International before its August 2009

spin-off — shows the perils of the latter strategy. Most of Seahawk's mat-supported jack-ups had been idled as charters expired at the time of the US drilling moratorium.

Mr Wilkinson also highlighted another reason for housing multiple fleets under one corporate umbrella. "Some of the drillers that we talk to see the benefits of having multiple touch points with their oil company customers — they can offer a variety of equipment types," he explained.

He also pointed to the portfolio effects of differing asset categories. "The diversification of the assets, in a cyclical business, is a positive," he said.

"The jack-ups are weaker than a few years ago, but there's a sense that maybe they've bottomed out. There is pressure now on the floater side."

When asked whether Maersk was considering any transaction with the impact of spinning off its drilling unit, Claus Hemmingsen, chief executive of Maersk Drilling, provided Lloyds List with a very simple answer: "No." ■



Maersk Drilling's two new drillships will be able to drill in water depths of 12,000 ft and be capable of drilling wells of more than 40,000 ft.

Maersk pushes the boat out with \$1.3bn deepwater drillship order

AMONG this year's marquee deals is Maersk Drilling's new order, at Samsung, for two ultra-deepwater Dynamic Positioning System-equipped drillships, with delivery scheduled for the second half of 2013, writes Barry Parker.

Able to drill in water depths of 12,000 ft, they will be capable of drilling wells of greater than 40,000 ft. In a Maersk announcement, a price tag of \$1.3bn overall, or \$650m each, was indicated.

Claus Hemmingsen, chief executive of Maersk Drilling, and also a member of the group executive board at parent AP Moller-Maersk, when asked about the cost of the drillships, told Lloyds List: "We believe that we have acquired a high-quality product at a good price."

After noting that the new units will feature optimised health and safety performance, higher capacities — useful in regions with limited logistical support — and efficiencies, for example, a higher speed to support quicker mobilisation, and a dual derrick, he said: "We do invest extra in high-performance equipment that will benefit the customers."

Mr Hemmingsen explained that the drillships were being built speculatively. "With the strong market outlook, we are confident that they will find employment prior to their scheduled deliveries at the end of 2013," he said.

He added that Maersk Drilling's deepwater units were being targeted at "the golden triangle" of Brazil, Gulf of Mexico and West Africa, but are suitable

for drilling offshore Australia, Southeast Asia, or in the Mediterranean/Black Sea.

In taking a broader perspective, where growing demand will offset additional rig supply, he said: "The era of easy oil is over and global discoveries are shifting to deeper waters. Consequently, we will see the deepwater segment drive exploration and development drilling over the coming decades."

"One of the reasons that we have confidence in deepwater rigs, where we have three existing now, is that we see a decline in oil production in areas such as the North Sea and the Gulf of Mexico."

"Looking out 20-30 years from now, we see that new oil must be found on a scale equivalent to four to six times that which Saudi Arabia is producing now. Offshore oil will make up for much of that increase in demand," he added.

When asked about the bifurcation in the markets for rigs, Mr Hemmingsen provided additional nuance, particular in the jack-up arena.

Referring to Maersk Drilling's recent order at Keppel FELS for two jack-up rigs capable of working in the ultra-harsh environments of Norway and eastern Canada, he said: "These are high capability units, but they are aimed at a small part of the market."

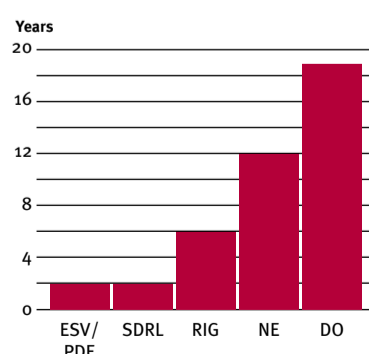
"These rigs are purpose-built for ultra-harsh environments of up to 150 m water depth only and will not be competitive in other areas. However, we have strong faith in the segment they're built for, in



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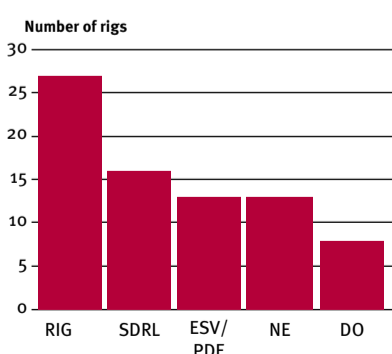
Claus Hemmingsen, chief executive, Maersk Drilling

AVERAGE AGE OF ULTRADEEPWATER FLEETS



Source: EnSCO

FLEET SIZES- ULTRADEEPWATER FLEETS



Source: EnSCO

particular the Norwegian and other North Sea arena."

He characterised the overall jack-up market as one where ageing equipment would drive the dynamics. "In general, by 2020 almost 60% of the current jack-up fleet will reach 35 years of age. A large part of the fleet will become relatively old," he said.

He agreed that high-specification units would see high utilisation as commodity rigs were pushed out, but said: "In the jack-ups, it's really about the age profile and fleet renewals."

In the market for semi-submersibles and drillships — the floaters — he said: "The deepwater rigs being built now are high specification. If there is some slack, these will push out the mid-water rigs." ■

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