

Driller merger sparks talk of new wave of consolidation

Two deals last week came as no surprise: at the high end Pride International was swallowed up by EnSCO, while at the low end Seahawk sold out to Hercules



BARRY PARKER — NEW YORK

IN THE offshore drilling business, it was plain back in April 2010 that further consolidation was on the way.

At that time, after the Deepwater Horizon accident, SEB Enskilda drilling analyst Lukas Daul and his Oslo-based team issued a note stating: "Events in US Gulf set up mergers and acquisitions stage." This analysis proved to be extraordinarily prescient.

Last week a merger deal was struck between drillers EnSCO and Pride International. If the transaction succeeds, the merged entity would own 21 deepwater rigs, including two Pride-ordered drillships still to be delivered from Samsung Heavy Industries and 47 jack-ups. It would create the industry's second largest driller behind Transocean, which owns 71 deepwater rigs and 66 jack-ups.

The merger would be worth a total of \$8.6bn-\$7.3bn in equity, divided into cash and new EnSCO shares issued to Pride's shareholders, with the balance representing \$1.3bn of outstanding Pride debt that EnSCO will assume.

Nordea Markets equity analyst David Bhatti told clients: "The industrial logic seems sensible, as they will gain in scale and scope." The combined company will have an enterprise value of around \$16bn and a backlog of some \$10bn, he said.

Pride's story, culminating in the purchase proposal from EnSCO, shows the fruits of a good strategic plan, where the

\$8.6bn

Estimated value of merger deal

burgeoning deepwater and ultra-deepwater sectors were identified as targets for company activity.

Pride has made a big bet on its relationship with Petrobras. Its *Deep Ocean Mendocino*, the third of five drillships being built at Samsung, is mobilising for delivery on a five-year contract with Petrobras, drilling in the deepwater US Gulf.

Mr Daul of SEB Enskilda told Lloyd's List that a hefty amount of rig capacity was being built speculatively. However, because there were only a handful of transactions, "not everybody could get financing".

He added: "In line with our M&A thesis, Pride was thought to be a target, especially after Seadrill had built up a 9.5% stake. Other possible buyers were Noble, Rowan and EnSCO. After Noble (Frontier rigs) and Rowan (Skie acquisition) did other deals, it was really between Seadrill and EnSCO."

"Any buyer needed to do a friendly deal, to avoid poison pill provisions. EnSCO had the money and, being in Europe, had some tax advantages in taking over Pride."

Within days of the EnSCO/Pride announcement, Seahawk Drilling filed for Chapter 11 bankruptcy. In conjunction with the filing, it will transfer a fleet of shallow-water jack-ups to rival Hercules

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David Bhatti, Nordea Markets

Offshore for a combination of cash, and Hercules stock. This will be worth an aggregate \$105m, including \$25m of cash that can be used to off down Seahawk's outstanding debt as it reorganises.

It was a coincidence that the announcements came within days of each other, but the two developments are intertwined through a trail of events that began in summer, 2009, when Pride chose to concentrate on international deepwater rigs and high spec jack-ups.

The decision led to the spin-off a division owning 20 1970s- and 1980s-built, mat-supported jack-ups, used mainly in drilling for gas and suitable for the soft mud of the US Gulf. That entity, which was then christened Seahawk Drilling, owned



Pride's deepwater drillship *Deep Ocean Ascension*: the vessel was delivered last year as one of the quintet being built by Samsung Heavy Industries.

Rig values indicate high bid premium

A DETAILED analysis of the EnSCO/Pride merger comes from Egle Domataite, oil service analyst at Terra Markets in Oslo, writes Barry Parker in New York.

"We find the bid for Pride to be somewhat expensive. The transaction indicates that buying a company is more expensive than buying rigs," she told Lloyd's List.

She explained that some premium can be justified due to Pride's experience and well-known name, complementary geographies and expected synergies that will result in cost savings, but that "relative to EnSCO's valuation in the market, the bid price looks too high".

Using a detailed financial model, Ms Domataite explained that an estimated \$879m implied value of Pride's deepwater rigs, based on values of February 11, was derived from the bid price, using estimated earnings before interest, taxation, depreciation and

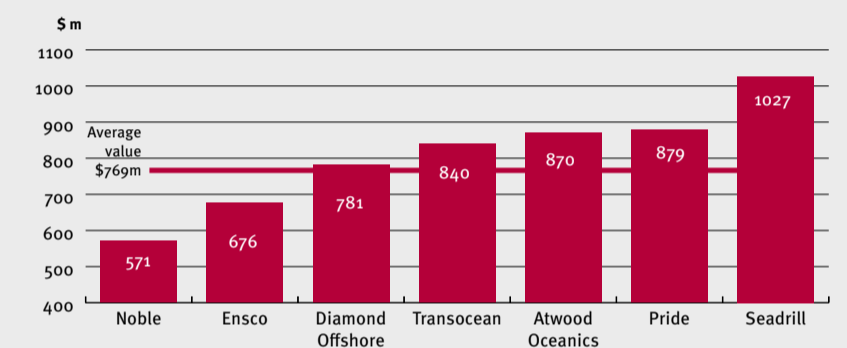
the 20-rig fleet now going to Hercules.

Arguably, the Seahawk bankruptcy and rig sale represent an "I told you so" moment for critics of the Obama administration, who have bemoaned the slow pace of permit issuance for new exploration.

But the real answer is far more complicated. Pemex, which had accounted for 74% of Seahawk revenues between January and September, 2009,

ENTERPRISE VALUE/DEEPWATER UNIT

2012 estimate



Source: Terra Markets, using InFinancials and estimates

amortisation likely to be generated by the rigs in 2012. The model assumes an average day rate of \$500,000, with 95% utilisation, and operating costs of \$150,000 per day.

Two different comparisons were done, but both arrive at the same answer of a price that is too high.

First, the Terra analyst looked at the average implied values of deepwater rigs owned by six large peer companies and arrived at \$794m, using a similar methodology. Including Pride's rigs, the

figure would be \$769m (see graph above). Using a different methodology, Ms Domataite adjusted the \$600m price of a rig ordered now by adding in the "opportunity" cost of waiting for delivery in 2012, which works back to \$208.3m based on foregone estimated free cash flows.

The result is the same: the \$879m per rig implied by the EnSCO bid still greatly exceeds the \$808.3m that each Pride rig ought to be worth, even without the age adjustment. ■

failed to renew contracts on multiple rigs, and the newly independent Seahawk cold-stacked 10 of its jack-ups.

Prices for natural gas, after a modest rally in late 2009, softened throughout 2010. New permitting activity ground to a halt, even in the shallow waters, after the Deepwater Horizon accident on April 20.

Seahawk's bankruptcy announcement last week came after more than \$100m of losses since the August 2009 spin-off out of

Pride. The announcement was not a complete surprise — it had announced previously that it was exploring strategic courses of action.

It had attempted but failed recently to sell its jack-up Seahawk 2505 (ex Pride Oklahoma) out of the US Gulf market to Essar Oilfield Services, subject to its winning a tender with India's Oil Natural Gas Corp, for \$14.55m. ■

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Analysts divided over deal's strategic implications

SOMETIMES, a marquee merger will precipitate other deals in a sector, but it remains unclear whether the EnSCO/Pride deal is the start of a merger wave, writes Barry Parker in New York.

SEB Enskilda's Lukas Daul said: "The market is more fragmented than it was five years ago, and strategically it would make sense. But I am not sure it will be a massive trigger."

His reticence is based on a spate of recent orders for ultra-deepwater rigs at the \$600m price point. He told Lloyd's List: "You have to pay up in a corporate transaction — we estimate an implicit price of \$850m for the Pride ultra-deepwater units."

A more bullish view came from Janne Kvernland, at Argo Securities in Norway. She expressed her firm's view that there will be more consolidation. She pointed out that with fewer players in the market, "there is a smaller probability that the market is oversupplied by speculative players or others".

Ms Kvernland stressed that "size matters", drilling down on the importance

of pricing power — "the greater the size of the player, the more likelihood of having pricing power" — and financial balance sheet strength.

She pointed to the fallout from last year's Deepwater Horizon calamity: "The incident illustrates the importance of being a company with a balance sheet

"Strategically [a merger] would make sense. But I am not sure it will be a massive trigger"

Lukas Daul, SEB Enskilda

strong enough to be able to survive if an incident should occur."

She added: "None of the smaller players would have survived as a company following an incident like that," referring to multi-billion dollar lawsuits and damages claims.

Kjetil Garstad at Arctic Securities was very matter of fact, telling Lloyd's List: "We

think consolidation is high on the agenda in the ultra-deepwater market. In a supply/demand-driven industry like drilling, controlling the supply side is extremely important, especially for down cycles,

"One year ago Transocean and Seadrill, the two largest ultra-deepwater players had a combined 50%-plus market share in the segment. Including the ordered newbuildings their combined market share will fall to less than 30%."

Mr Garstad explained that Transocean had now built up a disproportionate share in stacked midwater and jack-up units. He cited approximate shares of 12% globally in jack-ups but ownership of 23% of global stacked jack-ups. "As such, we think it is unacceptable for Transocean to control only 19% of the ultra-deepwater fleet in 2014."

Bjorn Thoresen, Oslo-based senior equity analyst at First Securities, shared Mr Garstad's views on the direction of possible deals, which will be driven by fleet renewal and segment exposure. "The EnSCO/Pride merger underscores the

current industry focus on fleet renewal and expansion.

"While considering jack-up contractor Rowan a likely target for the large integrated contractors including Seadrill, we see few other likely targets among the large-cap drillers.

"We believe the main focus will be on

"The EnSCO/Pride merger underscores the current industry focus on fleet renewal and expansion"

Bjorn Thoresen, First Securities

growth through newbuildings and mergers and acquisitions involving smaller scale contractors with newbuilding rigs."

Mr Thoresen puts Prospector Offshore Drilling, Standard Drilling, Vantage Drilling, Ocean Rig, Aker Drilling, Pacific Drilling, Metrostar and Odffell Drilling on his list of potential targets.

Analyst Janne Kvernland from Argo