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SUSTAINED LOWER OIL PRICES HAVE OSV COMPANIES RUNNING OUT OF OPTIONS

Offshore supply vessel (OSV) owners have been navigating rough waters for many years. As oil prices continue to hover at $50 per barrel, exploration and production (E&P) companies have drastically reduced their rig counts, causing demand for OSV services to plunge. Excess rig capacity affects many different types of vessels in the OSV market, but it hits platform supply vessels (PSVs) and anchor-handling tug supply (AHTS) vessels the hardest.

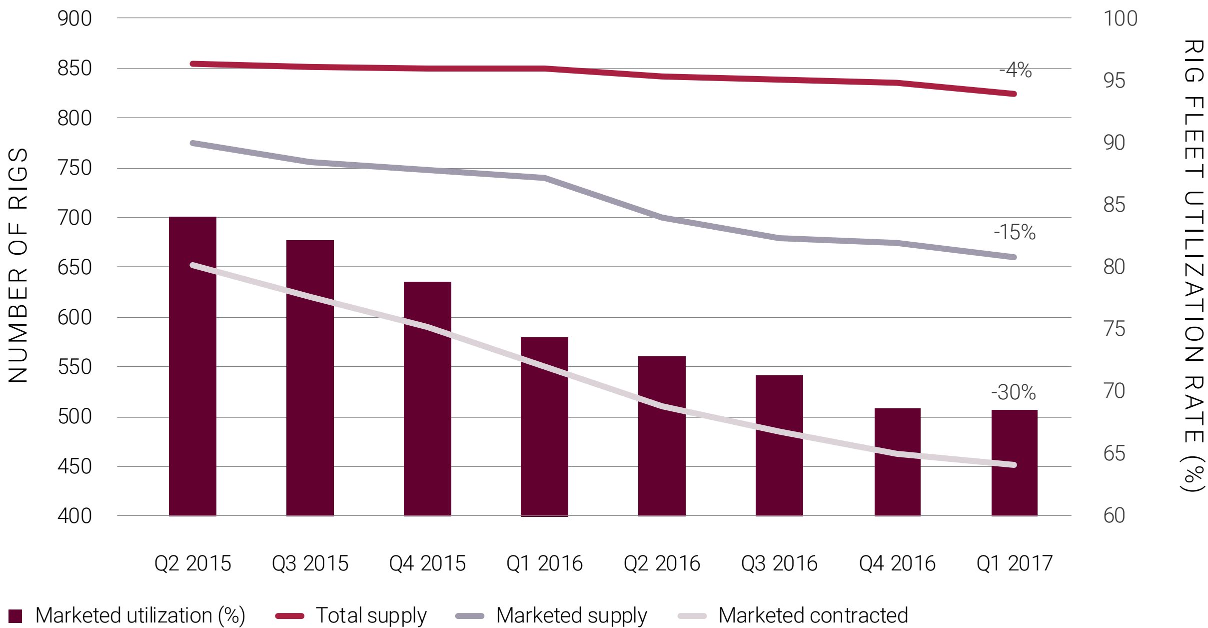
2017 could be one of the worst years in decades for OSVs. Our 2017 offshore supply vessel study of 44 major companies in the OSV sector highlights their rising debt burdens. Their growing debt makes it increasingly unlikely that most of them will be able to maintain positive cash flow, because debt-servicing costs are consuming greater and greater shares of already declining earnings. The industry thus faces grave financial pressure, which is clear from recent bankruptcy filings and distressed mergers.

For the next few years, OSVs will have to confront their new reality: lower demand, shorter charter contracts, and reduced day rates.

OFFSHORE RIG DYNAMICS

During the past two years, total rig count declined by only approximately 4%. Marketed vessels declined by nearly 15%, and owners have tended to stack rigs in lieu of scrapping. However, the number of contracted rigs declined by more than 30% during the same time period, with fleet utilization levels hovering between 65 and 70%. Rig utilization and day rates are two major components that drive revenue for OSV operators (figure 1). With fairly fixed near-term and midterm cost structures, operators continue to see precipitous falls in operating income as day rates and utilization remain at depressed levels. Further, because rigs are either working or not, it is an all-or-nothing revenue game for operators.

FIGURE 1: CHANGE IN OFFSHORE RIG COUNT AND UTILIZATION



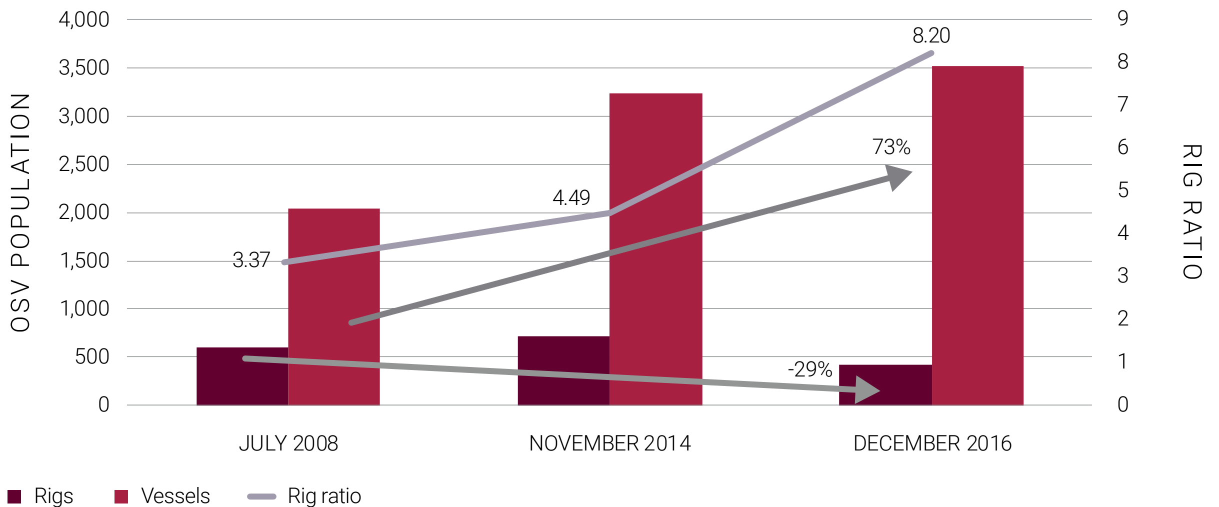
Source: HIS Markit RigBase, 2017

IMPACT ON THE OSV SECTOR

An analysis of some of the largest offshore E&P companies shows that CAPEX has decreased 53% from 2013 through the last 12 months (LTM), which is one of the reasons the OSV-to-rig ratio more than doubled.[1] Figure 2 shows the OSV-population-to-working-rig ratio, and it's easy to see that that ratio exploded by almost two and a half times from July 2008 to December 2016. The rig count reduced (as noted earlier), whereas the vessel population increased 73% to 3,510. Those dynamics caused the ratio to go from 3.37 in July 2008 to 8.2 as of December 2016. And until the working-rig-to-OSV ratio drops back to a healthy level, we will continue to see an ample oversupply, which puts pressure on day rates and utilization. Rates are down 60 to 65% in some markets, and utilization is down 40%.[2] Total global E&P spending on OSVs declined from $18.1 billion in 2014 to $14.8 billion in 2015 and $11.9 billion in 2016.[3] That's a staggering, 34% decline in just two years.

IHS Markit reported that as many as 1,000 vessels have to be scrapped or permanently removed from service—including vessels under construction or on order—in order to achieve market balance by 2020, yet the current scrap rate is only about 13% of what's needed.[4]

FIGURE 2: OSV/RIG RATIO



Source: ODS-Petrodata and Tidewater presentation

1. AlixPartners analysis: Capital expenditures of 15 companies from 2013 to last 12 months
2. OSV Market Outlook, Pareto Securities, September 22, 2016
3. Ibid
4. This implies that as many as 200 vessels per year for the next five years would have to be scrapped compared with an average of 25 vessels per year scrapped in recent years. IHS Markit says cold stacking of vessels would not have the same effect as scrapping—and would actually delay industry recovery and balance

REGIONAL ROUNDUP

GULF OF MEXICO

The Gulf of Mexico has been a brutal place in which to operate. Significant E&P CAPEX cuts have contributed to two recent Chapter 11 filings: Tidewater and GulfMark Offshore, both of which had been publicly traded. Both filings include prearranged agreements with the majority of their respective creditors to convert the majority of existing debt to equity and allow the companies to emerge from bankruptcy with much-improved financial leverage. This is likely to put additional pressure on other OSV players that still have significant debt to restructure their balance sheets to remain competitive.

NORTH SEA

The North Sea market remains depressed, which is unsurprising, because the North Sea is the most expensive area worldwide from which to extract a barrel of oil. The vast majority of Norwegian owners are in debt-restructuring talks with their creditors and bondholders, and some consolidation is afoot. For example, Farstad, Solstad, and DSS are merging to create one of the biggest OSV operators with a fleet of 157 vessels this year. Notwithstanding the structural oversupply issue, operators with the will to survive could have to withstand a cash burn for the next three or four years, because expert consensus does not expect a recovery in utilization until 2020 or later.

BRAZIL

The Brazilian market remains subdued as key driver Petrobras continues to deal with a corruption scandal and financial problems. Charter risk has been high for foreign OSV operators. And circularization rules, which permit owners of Brazilian-flagged vessels to challenge contracts issued to foreign-flagged vessels, continue putting lucrative term contracts and non-Brazilian vessels at risk.

SOUTHEAST ASIA

Since Q3 2014, E&P activities in this region have declined. Reduced demand for OSVs has led to fewer buyers, as supply started to move beyond demand. Furthermore, drops in daily rates and utilization mean that the chartering of OSVs as a revenue source is no longer a viable option.

OSV oversupply continues to persist. The 2017–2018 order book shows a 10% increase in global fleet size.[5] Utilization for both AHTS and PSV has dropped to less than 60%, which is an approximately 30% drop since July 2013.[6] This downward trend in utilization rates has put pressure on OSV firms in Southeast Asia and led to an unprecedented number of bankruptcy filings by such firms as Ezra, EMAS Chiyoda, Perisai Petroleum Teknologi Bhd, and Swiber.

Given the less-than-bullish tone of oil prices, reductions in chartering rates, and new builds coming to market from China, we expect to see more bankruptcy filings in the next 12 to 18 months. The deleveraging of existing balance sheets and the streamlining of operations to keep costs low should be operators' main focus going forward.

Notably, the Singaporean government has taken proactive steps to help the ailing offshore marine sector. A government agency under the Ministry of Trade and Industry introduced the Bridging Loan for Marine & Offshore Engineering[7] in late 2016, and a different agency introduced the Internationalization Finance Scheme[8] to help the sector with alternative financing options. Pacific Radiance became one of the first firms to use the available financing schemes by borrowing $85 million this past June.

MIDDLE EAST

The Middle East is the only region where OSV demand is holding relatively steady because of favorable oil economics. Break-even prices are relatively low; the national oil companies continue to dominate the region; and OPEC members remain committed to maintaining oil production in line with market share. What the market has not been able to escape is downward pressure on rates, because new contracts have attracted tonnage into the region.

5. https://issuu.com/rivieramaritimemedia/docs/offshore_support_journal_may_2017?e=15860807/47853471
6. DBS, Offshore Support Vessels report, August 19, 2016; https://www.dbs.com/aics/templatedata/article/industry/data/en/ GR/072016/Offshore_Support_Vessels.xml
7. https://www.spring.gov.sg/Growing-Business/Loan/Pages/Bridging-Loan-for-Marine-Offshore-Engineering-companies.aspx
8. https://www.iesingapore.gov.sg/Assistance/Global-Company-Partnership/Access-to-Financing/Internationalisation-Finance-Scheme

HOW CAN OSV FLEET OWNERS NAVIGATE THE STORM?

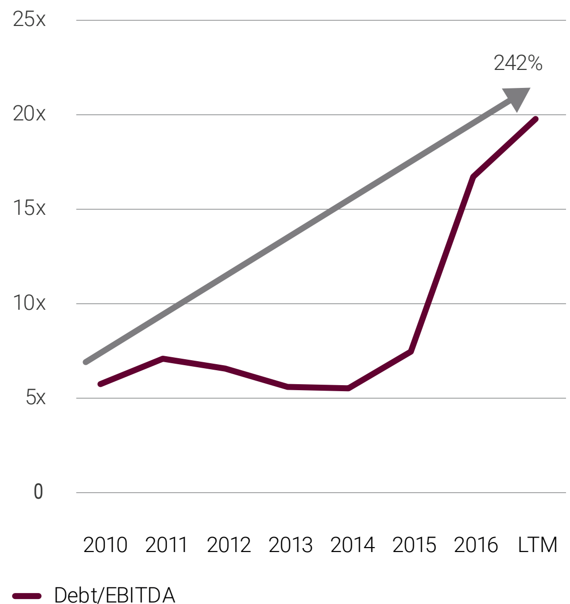
OSV companies have so far responded to falling oil prices by cutting general and administrative expenses, by stacking, and by scrapping. The 44 companies we studied—which averaged $220 million in revenue in the 12 months through May 2017—now have an overall debt load that is up 24% from peak economic conditions in 2011, for a total of $25 billion. The $5-billion increase over approximately five and a half years will play a major role in determining which companies survive the downturn, which falter, and which get absorbed by competitors with stronger balance sheets.

Very low global interest rates played a role in causing increased levels of debt to EBITDA (aka leverage). Rising oil prices pushed up earnings—blunting some of that financial effect–but since 2011, leverage increased during the five years ended December 2016, putting it at 16.7 times (figure 3). In the last 12 months, the leverage ratio further increased to an astounding level of 19.8 times. From 2010 to LTM, leverage increased 242%.

OSV operators' operating expenses have risen as a percentage of revenue, growing from 73% in 2010 to 87% in LTM (figure 4), or 18% higher. Those OSV operators must continue to trim operating expenses wherever possible because in the face of declining revenues and shrinking balance sheets, they will have to become more aggressive about cutting those expenses going forward.

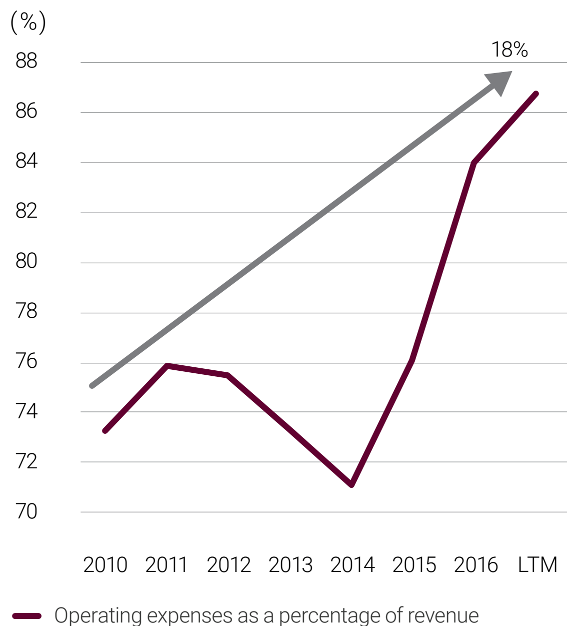
The combination of shrinking revenues and lower EBITDA levels means many OSV companies will likely have to struggle to make interest and amortization payments. In addition, an AlixPartners Altman Z-score analysis[9] of those companies showed that 28 out of the 29 companies we analyzed had scores of less than 1.8 in the last 12 months ended May 2017, indicating a high probability of bankruptcy if they do not take significant financial measures. The LTM average Z-score across the 44 companies was 0.19,[10] which was an approximately 52% drop from the tabulated Z-score for Q4 2016, underscoring the rate of financial deterioration.

FIGURE 3: OSV LEVERAGE TRENDS



Source: AlixPartners analysis

FIGURE 4: OPERATING EXPENSES AS A PERCENTAGE OF REVENUE



Source: AlixPartners analysis

9. A formula for predicting the likelihood of bankruptcy based on a number of metrics found in a company's public statements
10. For which Altman-Z-score-analysis-related data is available (29 of the 44 companies)

Here's the bottom line: with excess shipyard capacity, excess numbers of OSV operators and OSVs, and too much debt, companies will have to be diligent and take radical steps to survive.

- Companies need to be disciplined about capacity management and do everything they can to reduce excess tonnage—preferably through scrapping.
- They must explore more-radical or innovative ways of reducing overhead costs and of adjusting their operating structures in light of the current market reality of lower day rates projected until at least 2020.
- They must develop liquidity plans with sufficient runway based on realistic market assumptions.
- They must vigorously identify and address key risks to that liquidity while bearing in mind the possibility of a prolonged market downturn.
- They must aggressively seek to de-lever and trim their balance sheets in order to remain competitive and position themselves for opportunities to consolidate.
- They must become realistic about priorities by identifying and ranking their own projects and then cutting out all spending that would not generate sufficient cash-on-cash returns.

That said, a couple of positive trends could also factor into OSV operators' fortunes. Some OSV operators have made significant strides in reducing their costs across the board, and M&As that generate opportunities for additional synergies—and, potentially, greater capacity discipline—are on the rise. In addition, low oil prices will not last forever, and another sign of hope is that many experts still see a positive environment for oil prices in the longer term, which will eventually lead to increased demand for OSV services. But until then, as they say, the cure for low oil prices is low oil prices.

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These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

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