AlixPartners

2020 OFFSHORE REPORT

RESTRUCTURE RETIRE CONSOLIDATE

The offshore drilling sector’s path to recovery

The narrative that has been unfolding in the offshore drilling industry since the price crash of oil in 2014 is rapidly approaching a climax. To an already toxic mix—composed of stubbornly low crude prices, a chronic oversupply of drilling rigs, unsustainable capital structures, and furious operational cash burn—has been added the global COVID-19 pandemic, which has further weakened demand and day rates while imposing tight constraints on offshore drilling operations. The harsh market environment has driven drilling operators and their creditors to finally bite the bullet and undertake major restructurings, including, in some cases, Chapter 11 bankruptcy protection. More operators could follow suit.

After operators and investors perform the necessary financial surgery, the offshore drilling sector could look very different than it does today, but it will likely still labor under the burdens that have weighed on it since 2014. Although most if not all of the sector's more than $45 billion in cumulative debt could be converted to equity, operators will still have to retire a significant portion of their drilling assets—and the sector will have to consolidate. Absent such drastic measures, operators may never regain pricing power or generate returns that exceed their (very high) cost of capital. As potential new shareholders, current creditors—especially bondholders—could be key facilitators of a consolidation wave.

Paradoxically, the operators that currently enjoy the largest contract backlogs and soundest balance sheets could soon find themselves at a competitive disadvantage to their more-troubled peers. If the stronger players do not restructure, retire assets, and aggressively lower their cash breakeven points, they could wind up losing business to rivals that have already slimmed down and could be left on the sidelines of any consolidation wave. But no matter how the competitive reshuffle shakes out, the offshore drilling sector as we have long known it could be approaching its end. The sector that emerges to replace it will likely be shaped by the critical moves that operators, creditors, and investors make—or don't make—today.

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A DIMINISHED PRESENT, A DARKENING FUTURE

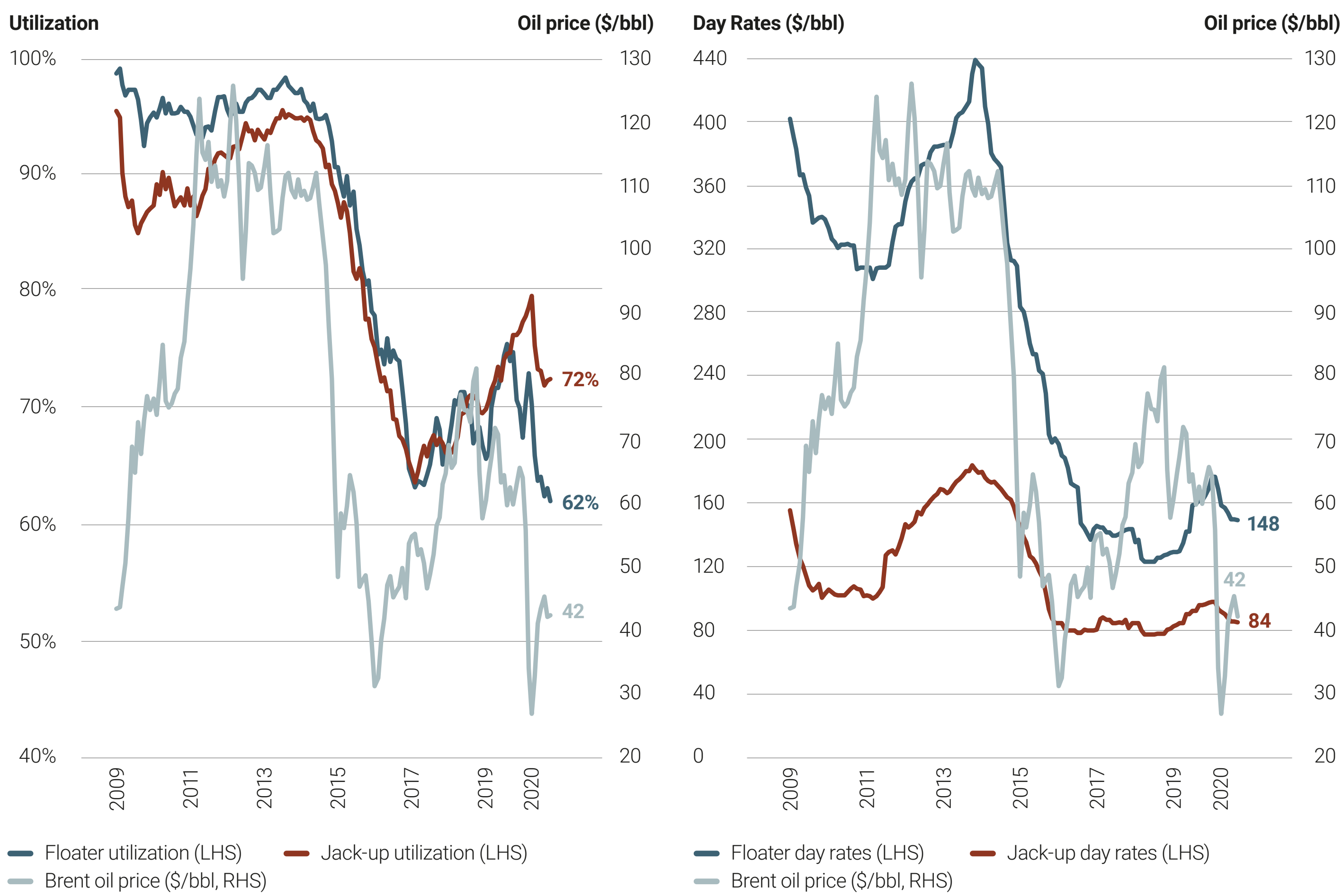
The macroeconomic and market conditions prevailing today are as unfavorable as any the offshore drilling sector has ever had to confront (figure 1), and they render the case for restructuring—as a first step back to financial health—more urgent than ever. The sector expanded significantly from the early 2000s to the mid-2010s, during which drilling operators took on substantial debt to finance the construction or rebuilding of a significant number of rigs. Since then, oil prices have fallen sharply from the highs reached earlier in the 2010s. That decline, driven in part by strong growth in US onshore production and accompanied by a sizable increase in the supply of offshore rigs, led to an industrywide supply–demand imbalance and an extremely challenging environment.

Spurred by low demand and falling prices, many oil & gas exploration and production (E&P) companies de-emphasized offshore programs in favor of less-capital-intensive onshore opportunities—most notably in US shale. Offshore rig utilization rates plunged in consequence, and competition for contract awards became ferocious. Drillers' pricing power all but evaporated, and operators were forced to accept contracts with day rates and terms substantially lower than they anticipated when they made their rig investments.

FIGURE 1: MACRO HEADWINDS AND UNFAVORABLE SECTOR DYNAMICS PROVIDE SIGNIFICANT CHALLENGES TO SHORT-TERM AND LONG-TERM OUTLOOKS

Global average working utilization (percent)

Global average day rates ($000/day)



Sources: Clarksons Offshore Intelligence Network, AlixPartners analysis

Demand for drilling services turned around and steadily increased during the latter part of 2019 and the early days of 2020 — to the substantial benefit of contract durations and day rates in all geographic markets. But late in the first quarter of 2020, the global COVID-19 pandemic struck, and commodity prices tumbled, slamming the brakes on the sector's comeback. Production disputes among major oil-producing countries added to the downward pressure on prices, and the resulting oversupply has had a dramatic impact on energy markets: a stunning drop in oil demand of 17 million barrels (bbl) per day in the second quarter, a peak stock build of 1.4 billion bbl, and generational lows in oil prices. At one point, Brent fell below $20/bbl, and West Texas Intermediate briefly turned negative for technical trading reasons. Brent now trades in a narrow corridor of $40/bbl to $45/bbl.

Against that backdrop, oil companies have slashed E&P spending by 25% to 30% this year—and by as much as 60% in shale—and many upstream operators say they expect little improvement in 2021. Only $34 billion of new offshore-project capital expenses has been sanctioned so far this year, thereby reducing the medium-term pipeline of work. It's difficult to see energy producers sanctioning 2020 capital investment of more than $45 billion—down sharply from $105 billion in 2019. Those actions have adversely affected the near-term market outlook, reversing 2019's positive trends. How long those reductions and sanctioning delays will persist is not clear.

The offshore drilling rig market, which had seemed set for a fourth successive year of moderate demand improvement, is now in a pronounced downturn. Only 460 rigs were active as of October 2020, down 12% from the beginning of March. Floater utilization fell 11 percentage points to 62% in that time, retreating to the lows touched during the 2014 downturn; and jack-up utilization fell 6 points to 72%. Clarksons estimates that floater and jack-up utilization rates will settle at 61% and 71%, respectively, by year end. Accordingly, day rate levels have softened since mid-2020, with global average jack-up rates sinking to $84,000/day—down 8% from March—and global average floater day rates declining 12% to $148,000/day. At the same time, logistical difficulties associated with the COVID-19 pandemic have pushed operational costs higher. Many drilling contractors, for example, have had to resort to private charters in areas where travel restrictions are in force.

Although structural efficiency gains achieved by the offshore oil & gas industry in the past six years have materially improved the economics of offshore development projects compared with shale production, the transition to renewable-energy sources has not faltered. Even if offshore reclaims its status as the marginal barrel, energy transition poses an existential long-term threat to offshore-drillers' business model.

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VANISHING CONTRACTS AND BACKLOG

As demand for crude has ebbed, the number of contract terminations, suspensions, and renegotiations has grown to historical highs since the 2014 price crash. Drilling contract volumes could fall by as much as 10% in 2020 and 2021, according to estimates by research provider Rystad Energy, for a combined revenue loss of $3 billion. Already in 2020, 98 contracts have been canceled or revised compared with 49 in 2015 and only 9 in all of 2019. The sector's forward contract coverage—applicable to contracts of 12 months' duration or more—has fallen to 16% from 21% (figure 2). And additional cancellations could be in store.

As backlogs have thinned, so have cash flows. With little prospect of a recovery in 2021, offshore drillers are under heavy financial stress. The annualized sector EBITDA run rate collapsed to about $3 billion as of June 2020—down from more than $18 billion in 2015. During that same period, net leverage (net debt/EBITDA) soared to an unsustainable, 12x from about 3.3x. Some drilling operators—such as Diamond Offshore—have resorted to Chapter 11 filings to forestall any further contract cancellations and safeguard short-term cash flow visibility. More such protective filings could follow.

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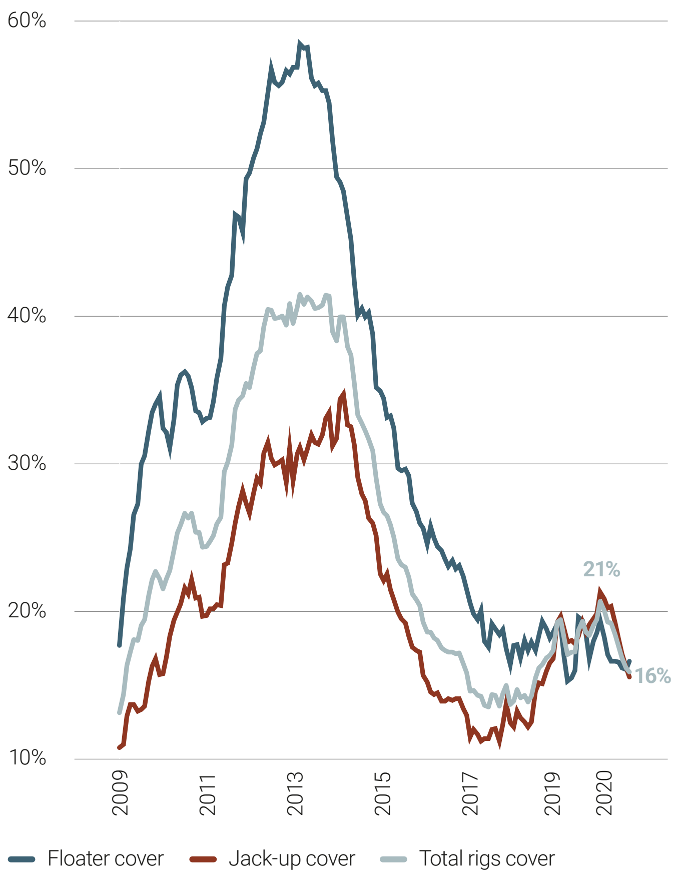
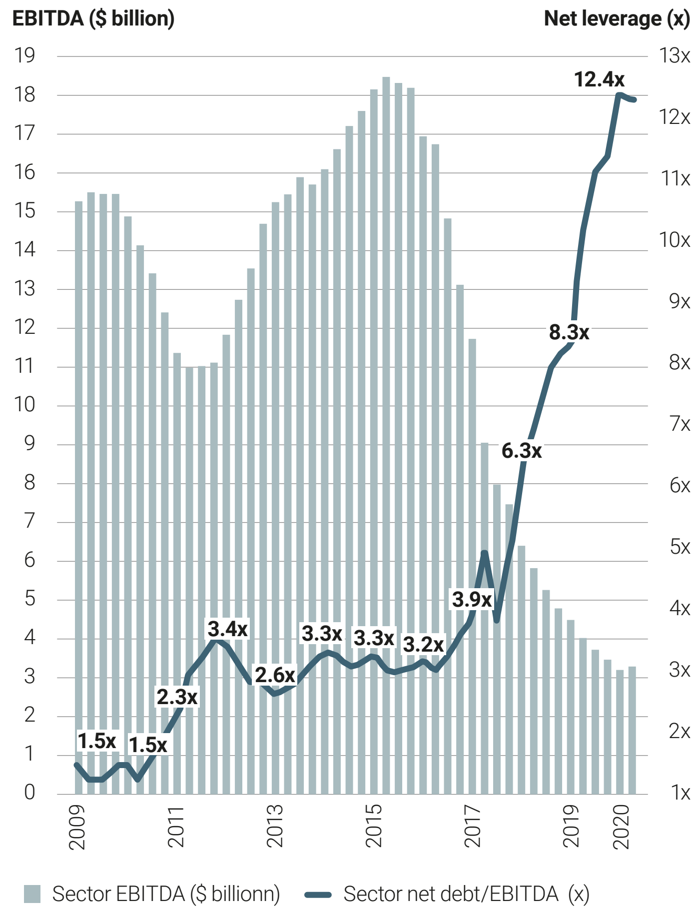
FIGURE 2: ERODING BACKLOG AMPLIFIED BY CONTRACT CANCELLATIONS PUTS FURTHER PRESSURE ON ALREADY CHALLENGED SECTOR FINANCIALS

Global average contract cover (percent, more than 12 months)



Drilling sector financials (12 months rolling)[1]



Sources: Clarksons Offshore Intelligence Network, S&P Capital IQ, AlixPartners analysis
1. Based on 21 publicly listed and 5 no-longer-active (M&A or bankruptcy) offshore drilling companies

PERSISTENT RIG OVERCAPACITY

To return to financial sustainability, drilling companies will have to drastically downsize their portfolios of rig assets once they've completed their restructurings. The oversupply of drilling rigs remains one of the sector's most-pressing issues, and the oil price crash that hit in March 2020 has only aggravated the problem (figure 3). The global rig supply stands at 841 units (that total comprises 65 rigs on order, 114 cold-stacked units, and 662 marketed rigs); 460 of those rigs are currently in operation. The estimated sustainable demand for rigs is in the 430 to 510 range, implying an overcapacity of 210 to 290 rigs, or 25% to 35% of total supply. The estimated excess capacity of floaters, at 30% to 45%, is more severe than that of jack-ups, at 20% to 30%.

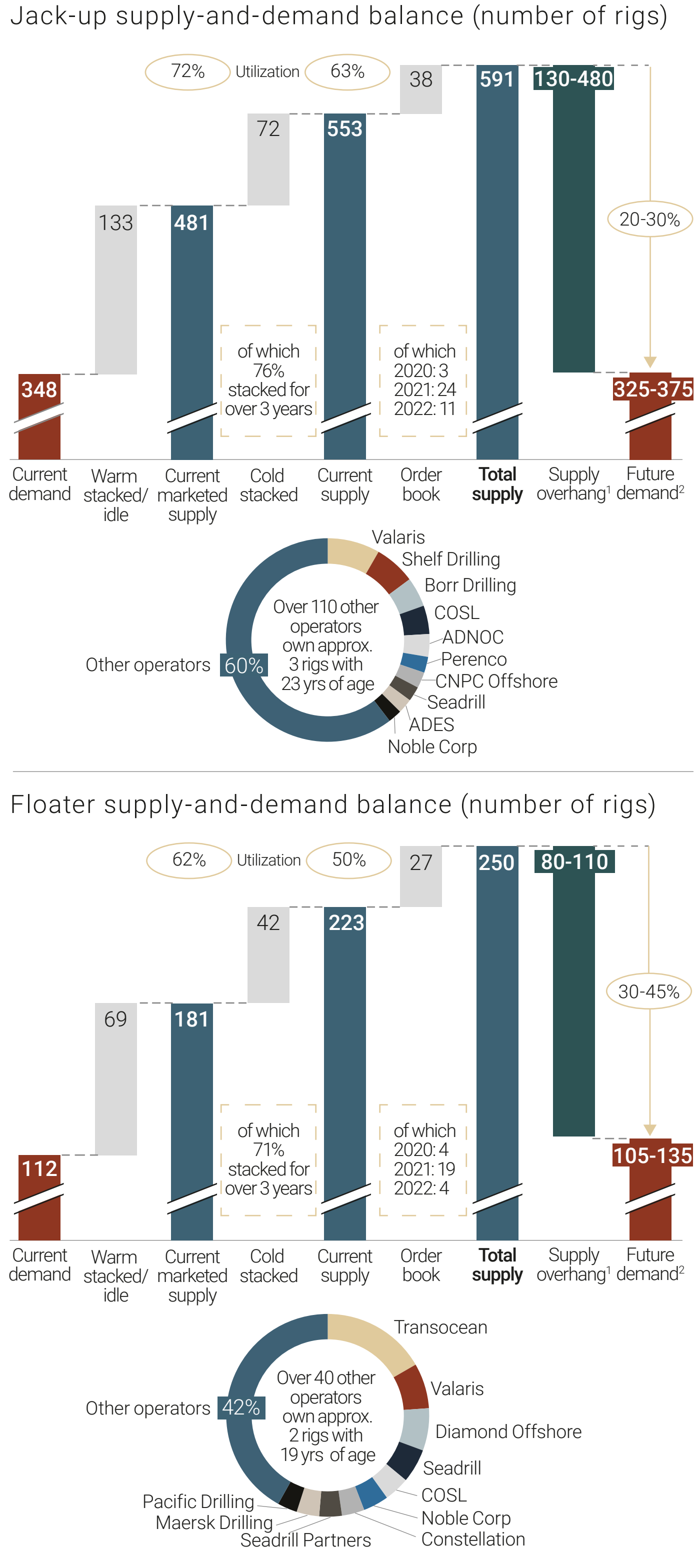
Rigs on order

The weak market conditions have amplified the problems that yards face in delivering units, and multiple owners have sought to defer newly built deliveries and attendant stage payments to protect their balance sheets. Borr Drilling, for example, has delayed until 2022 the delivery of all newly built jack-ups. Awilco Drilling in June canceled its order with Keppel FELS for the Nordic Winter, originally due for delivery in 2021. Keppel is disputing the termination. Excluding the current order book of 65 rigs, estimated overcapacity stands at 140 to 220 rigs, or 20% to 30% of total supply, including 90 to 140 jack-ups (an overhang of 15% to 25%) and 50 to 80 floaters (a 25% to 35% overhang).

Stacking

The number of cold-stacked rigs has continued to increase since the oil price crash in March 2020. The count now stands at 114 units: 72 jack-ups and 42 floaters; 75% of those rigs (55 jack-ups and 30 floaters) have been cold stacked for more than three years. In addition, the number of idle and warm-stacked rigs increased significantly in recent months—to 202 units (133 jack-ups and 69 floaters)—in the expectation that many of those idle or ready-stacked units could be cold stacked in the short to medium term. According to Rystad Energy, reactivation costs for floaters that have been warm stacked for a relatively short time can range from \$20 million to \$30 million; costs for rigs that have been cold stacked for longer periods can run anywhere from \$40 million to \$100 million. Demolition maybe the only viable option for the owners of many of those units.

FIGURE 3: OVERSUPPLY AND HIGH LEVELS OF FRAGMENTATION REMAIN THE BIGGEST DRAGS ON THE SECTOR

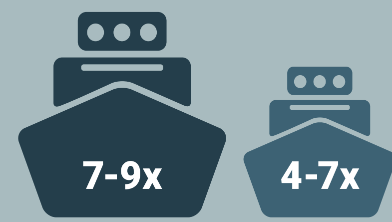


Sources: Clarksons Offshore Intelligence Network, S&P Capital IQ, AlixPartners analysis

1. Supply overhang assumes 85% utilization
2. Based on Clarksons, Rystad, IHS Markit estimates

Scrapping

The oversupply of rigs is concentrated in vessels stacked for three or more years and/or older than 15 years and generally viewed as uncompetitive. Because many even older units were scrapped during the 2014–18 downturn, rig owners have few options but to scrap more-recently-built assets. Scrapping those uncompetitive rigs would return the market to equilibrium, and restructuring and bankruptcy filings would likely accelerate the process. As of November 2020, multiple drilling operators have launched Chapter 11 proceedings, and others are restructuring, thereby spurring an increase in sales for demolition. From March to October 2020, 32 rigs, including 20 floaters, were removed—equivalent to an annualized year-over-year increase of 22%. Seven of those scrapped floaters were built after 2005.



Even with the acceleration in scrapping, seven to nine times more scrapping activity than the current rate (or four to seven times more if the current order book is excluded) would have to occur to effectively remove the supply overhang.

A further uptick in demolitions is likely to follow in the short to medium term, as drillers scrap rigs unlikely to be viable postdownturn—particularly once the costs of cold stacking and reactivation have been factored in. Even with the acceleration in scrapping, seven to nine times more scrapping activity than the current rate (or four to seven times more if the current order book is excluded) would have to occur to effectively remove the supply overhang.

If overcapacity is the biggest drag on the sector, why has scrapping activity been subdued until recently? Three reasons: the enduring—and increasingly forlorn seeming—hope among all stakeholders for a rebound in offshore drilling; restrictive vessel liens that prevent the scrapping of certain rigs; and the sector's highly fragmented nature—especially in the jack-up segment, where the 10 largest owners represent only 40% of the market, the rest consisting of smaller, regional or local players.

But the status quo seems to be crumbling. Stakeholders, including some lenders, appear to have adjusted their expectations for oil prices and have resigned themselves to the prospect of lower-for-longer prices. That, in turn, has prompted them to enable comprehensive restructurings rather than amend-and-extend deals that simply defer the day of reckoning. Those restructurings may finally give drilling operators opportunities to address restrictive bank liens on drilling assets, to facilitate consolidation, and to rationalize the sector's fragmented ownership structure.

MASTERING THE MATURITY PROBLEM

A looming debt maturity wall further strengthens the case for restructuring as a prelude to the reconfiguration of the offshore drilling sector. Tier one drillers alone have more than $25 billion in debt obligations—or 61% of total debt outstanding—coming due in the next five years. Immediately available liquidity would cover no more than the debt coming due by December 2021. Because most offshore drillers are already operating at a loss and burning through cash, lower-trending oil prices not only impair liquidity but also make it necessary to restructure before debt maturing in 2021–22 comes due. Previously, most stakeholders believed that restructuring could be deferred until debt maturing in 2023–24 came due. Those maturities were the results of the sector's last period of intensive restructuring, in 2016–17, which featured mostly amend-and-extend deals that pushed debt maturities out to 2021 and beyond.

Creditor dynamics and potential restructuring outcomes will vary with the composition of companies' current debt structures. United States–based players tend to have more unsecured debt and exposure to bondholders than do their European counterparts, whose capital structures are in most cases dominated by secured debt, primarily bank borrowings. One of the main issues looming over the coming debt renegotiations is how creditors will handle maturities of 2030 and beyond, bearing in mind oil's ever-shrinking share of the global energy mix.

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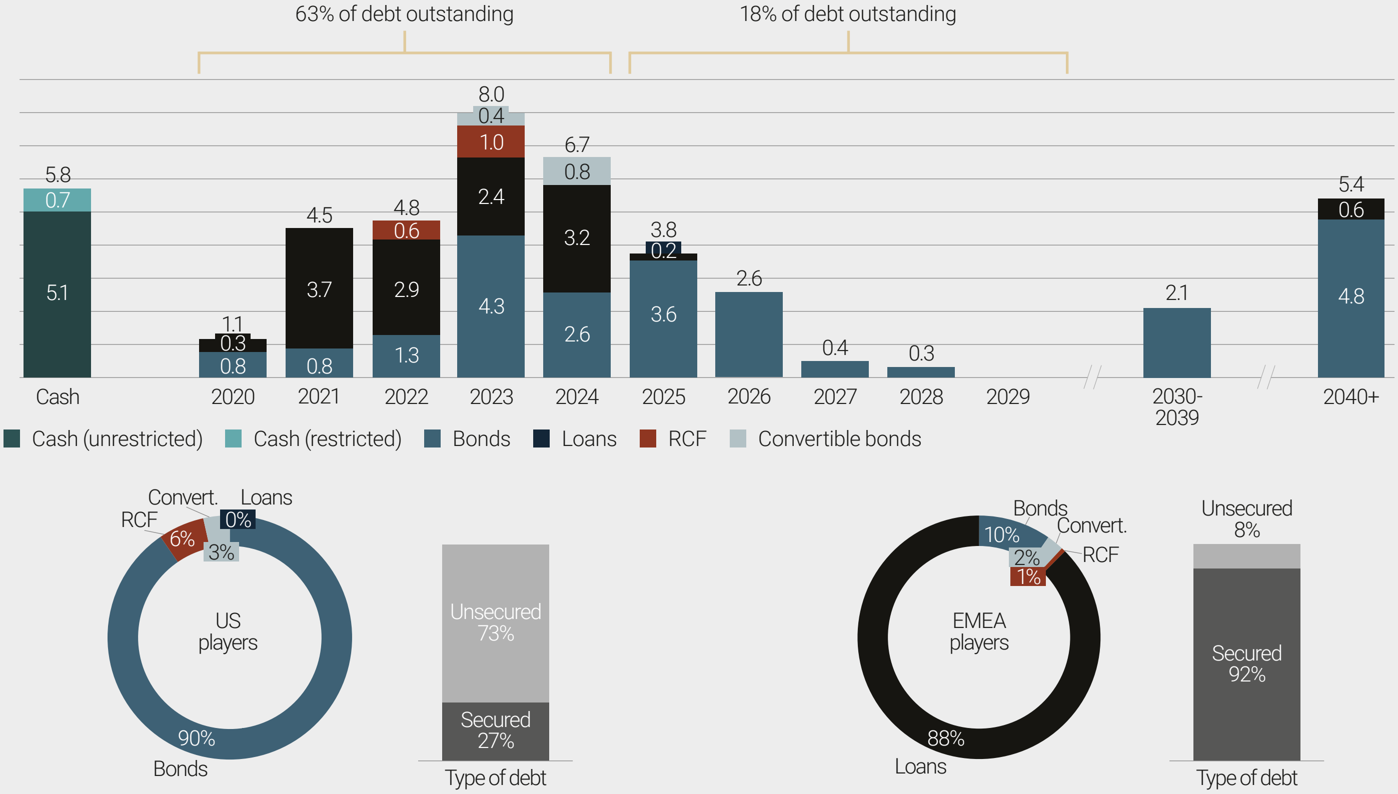
FIGURE 4: DEBT MATURITY WALL APPROACHING

Sector liquidity and debt maturity profile ($billion, pre-restructuring)[1]



Sources: Company data, AlixPartners analysis

1. Capital structures (including liquidity) as of June 2020, with exception of Transocean (Dec-19), Noble Corp. (Mar-20), Diamond Offshore (Mar-20), and Seadrill Partners (Dec-19) given their engagement in restructuring activities
2. Includes unrestricted cash and restricted cash for debt amortization but excludes available credit lines

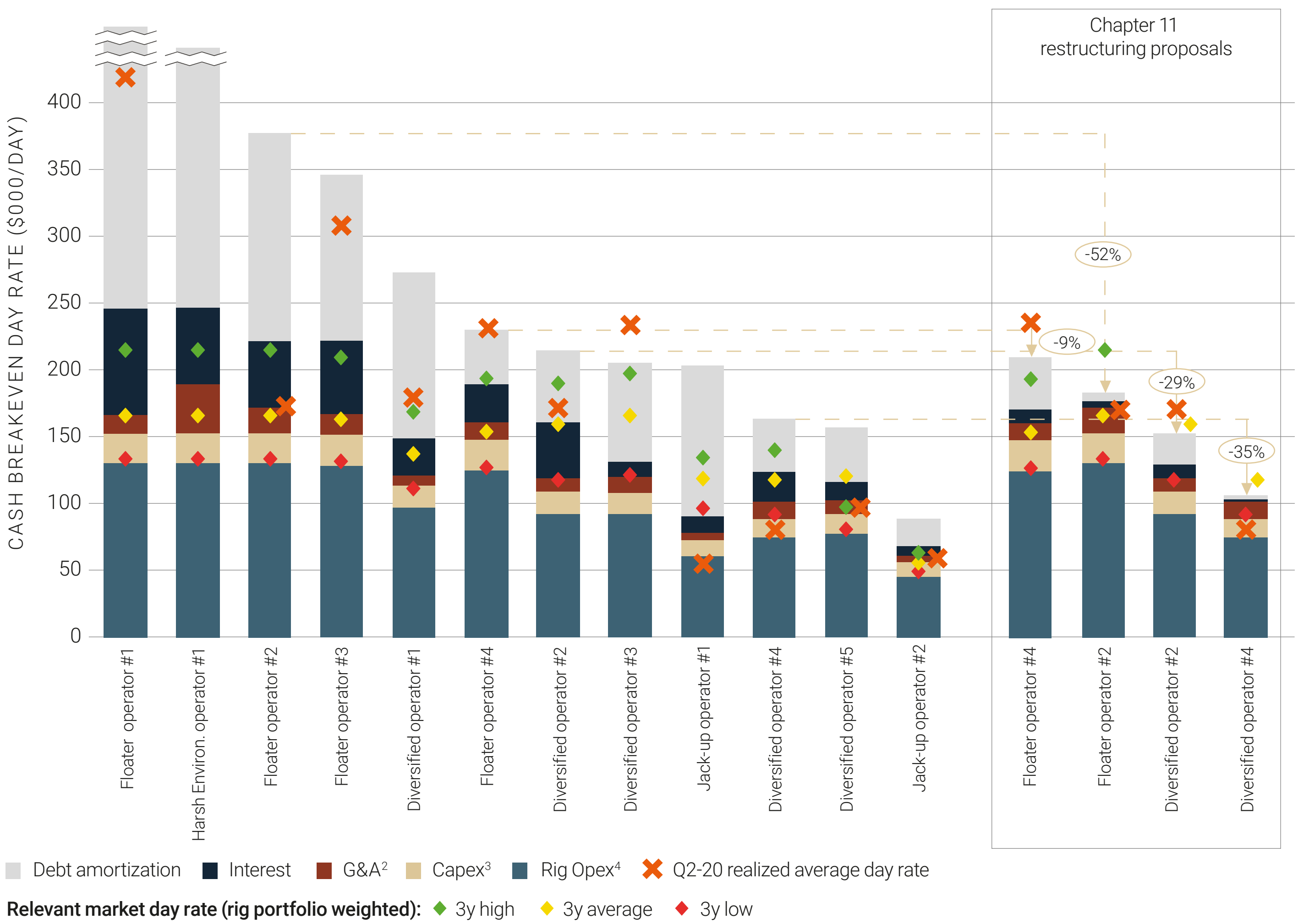
RIGHT-SIZING THE COST BASE

Companies that fail to restructure now risk saddling themselves with uncompetitive cost structures (figure 5). To assess the potential impact of restructurings on the competitive positioning of offshore drillers, we estimated what the cash breakeven day rates of the sector's largest players would look like if they maintained their present capital structures. For illustrative purposes, we assumed an 85% utilization of the current rig portfolio and no refinancing of current capital structures or debt facilities—in the recognition that new capital will be scarce and come at a high cost. Taxation and working capital were not considered.

General and administrative expenses in the past 12 months have been adjusted for nonrecurring items and announced cost-savings targets. We also applied typical industry rig operating expenses and capital expenses—for both annual maintenance and five-year special periodic surveys—for different rig classes and plotted realized day rates in the second quarter of 2020 (marked with an "x" in figure 5), along with the relevant low, average, and high market rates during the past three years. Market rates are weighted according to each company's existing rig portfolio.

FIGURE 5: OFFSHORE DRILLERS THAT DON'T RESTRUCTURE COULD END UP HAVING UNCOMPETITIVE COST STRUCTURES

Illustrative cash breakeven day rates for Tier One offshore drillers (no refinancing assumed | 85% utilization)[1]



Sources: Company data, AlixPartners analysis

1. Excludes taxation and working capital
2. LTM adjusted G&A expenses
3. Assumes annual maintenance capex of $5 million for Floaters & $2.5 million for Jack-ups, and SPS costs every five years of $10 million for Floaters and $5 million for Jack-ups
4. Assumes average rig opex for 6th/7th Gen Floaters ($130,000/day), other Floaters ($120,000/day), HE/HD Jack-ups ($70,000/day), premium/high-spec Jack-ups ($60,000/day), and Legacy Jack-ups ($45,000/day)

Our analysis reveals the ironic possibility that companies with healthier balance sheets and backlogs than their peers have could see their competitive positions erode over the long term if their rivals restructure before they do. It's a classic example of the winners' curse. Companies that do not restructure and that instead remain with debt on their balance sheets run two main risks: The first is that companies that succeed in equitizing their debt will have lower cash breakeven levels and could bid more aggressively on new work. The second risk is that companies carrying debt could be at a disadvantage in any consolidation wave, their obligations limiting their ability both to realize economies of scale and to acquire attractively priced assets or competitors.

To amplify that disadvantage, the cost of new capital, as suggested earlier, would likely climb steadily—if it is available at all—in coming years. A significant number of debt and equity providers have been burned in the past 10 years and have either retreated entirely from the sector or will commit new funds only in very limited circumstances. And as investors direct more and more capital toward companies with high environmental, social, and corporate governance standards, the offshore sector could fall further out of favor.

A SECTORWIDE RESTRUCTURING ON THE HORIZON?

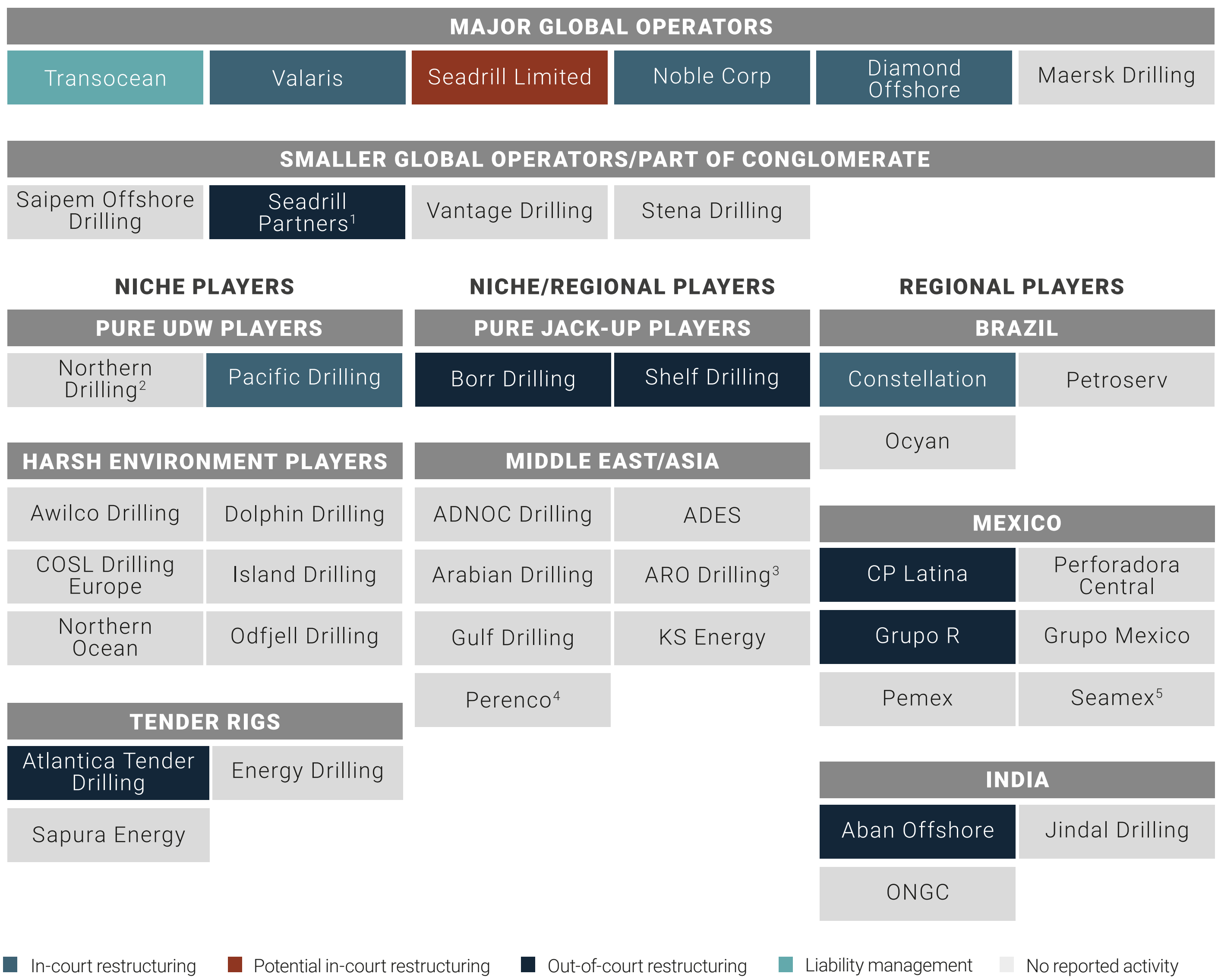
The majority of tier one drillers and some regional and local players have already entered liability management and/or restructuring negotiations or proceedings (figure 6). For the most part, the restructuring proposals submitted or reported to date aim to:

- Equitize a significant amount of debt so as to address deteriorating liquidity and looming maturities
- Reduce cash breakeven day rates to improve competitive positioning
- Remove stubborn overcapacity by relieving restrictive vessel liens
- Position drillers to acquire assets or companies—potentially at heavy discounts—in any future consolidation wave
- Re-establish pricing power

Four United States–based offshore drillers have already filed for Chapter 11—in large part to force debt-for-equity conversions that would wipe out more than $12 billion in borrowings. One other tier one operator has announced that it is preparing for a comprehensive restructuring which may involve the use of a court-supervised process. Three Europe-based players report that they reached out-of-court amend-and-extend agreements with their respective lenders. One major US driller is engaged in several public and private transactions, such as tender and exchange offers that are intended to reduce its debt stack by roughly $1 billion and push some $2 billion in maturities beyond 2026. Several other regional and/or niche players are reported to be actively involved in debt negotiations that fall short of full restructuring—at least for the moment. More-comprehensive measures are likely still necessary.

FIGURE 6: THE OFFSHORE DRILLING SECTOR IS POTENTIALLY HEADING TOWARD SECTORWIDE RESTRUCTURING

Current restructuring landscape (company-reported activities only)



Source: AlixPartners analysis

1. 46% owned by SDRL. 2. Rigs managed by SDRL. 3. JV Valaris/Saudi Aramco. 4. Diversified Jack-up player. 5. 35% owned by Seadrill Ltd (SDRL).

FROM CREDITORS TO SHAREHOLDERS, TO DEAL FACILITATORS

Restructuring and consolidation represent the straightest route to reducing the sector's intransigent oversupply of rigs and regaining the pricing leverage that drilling operators have lost since 2014. The industry is in dire need of fewer—but bigger—operators. News reports of potential mergers have already started to appear.

In a sectorwide restructuring that features material debt-for-equity conversions, creditors—especially bondholders—would be transformed into significant equity players. Their cross holdings could influence the course and pace of the sector's consolidation (figure 7). Our analysis of those holdings follows .

FIGURE 7: BONDHOLDERS — POTENTIALLY NEW SHAREHOLDERS — COULD ACT AS ENABLERS FOR CONSOLIDATION

Indicative bondholder overlap in Tier One offshore drillers[1, 2]

	DIVERSIFIED OPERATOR #4	DIVERSIFIED OPERATOR #2	FLOATER OPERATOR #4	JACK-UP OPERATOR #2	FLOATER OPERATOR #2	DIVERSIFIED OPERATOR #1	JACK-UP OPERATOR #1	DIVERSIFIED OPERATOR #5
FLOATER OPERATOR #3	45%	48%	50%	23%	19%	3%	16%	3%
DIVERSIFIED OPERATOR #4		32%	36%	11%	19%	–	12%	2%
DIVERSIFIED OPERATOR #2			43%	11%	18%	4%	12%	1%
FLOATER OPERATOR #4				15%	12%	1%	11%	1%
JACK-UP OPERATOR #2					2%	5%	13%	7%
FLOATER OPERATOR #2						–	–	3%
DIVERSIFIED OPERATOR #1							–	3%
JACK-UP OPERATOR #1								–

Darker color: larger overlap ■ ■ ■ ■ ■ ■ Lighter color: lower overlap

Sources: Bloomberg, AlixPartners analysis
1. Bond holdings extracted as of early October 2020
2. Bondholder overlap calculated as simple average of bond holdings across company pairs

Our bondholder overlap analysis is based on bond holdings reported by Bloomberg L.P. and covers roughly 44% of outstanding bond debt. Several drilling companies' capital structures feature large positions held by Allianz/PIMCO, JP Morgan, Capital Group, FMR Fidelity, and UBS, as well as other prominent asset managers.

The sector that emerges at the end of any consolidation phase might operate by models very different from those followed by today's drillers. A restructuring proposal offered by Valaris suggests that today's diversified model could give way to two predominant models: floater companies, focused on deepwater drilling and characterized by high risk and returns, and jack-up specialists, which would engage in shallow-water projects with relatively lower risk/return profiles. Variants of Seadrill's fleet management model, in which a contractor performs commercial and operational activities on behalf of rig owners, could emerge as well.

Consolidation and aggressive asset retirement could enable drilling companies to regain some measure of pricing power and earn rates of return in excess of their costs of capital.

CONCLUSION

As noted, some offshore drillers and their creditors are continuing their long-standing practice of negotiating amend-and-extend deals to relieve their debt pressures. But such temporizing measures do little to address the sector's persistent overcapacity of drilling assets, and they ignore the pressing need for drilling companies to improve their competitive positions by radically overhauling their cost and capital structures. Consolidation and aggressive asset retirement could enable drilling companies to regain some measure of pricing power and earn rates of return in excess of their costs of capital. The sector's bondholders, which would likely become shareholders in the aftermath of any restructuring, could facilitate consolidation through mergers, acquisitions, and asset sales. The process may be painful at times for all of those involved, but the alternative—a permanently ailing industry always on the verge of crisis—would be far more painful indeed.

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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.

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Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.