

## Insights

### Offshore Drilling Upcycle

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Our preferred type of investment is to purchase high-quality businesses with good growth potential and own them for a long time. However, on occasion opportunities arise for us to do some short-term active trading, which can be centered around industry tailwinds/headwinds, fundamentals or momentum, to name a few. After nearly a decade of difficult market conditions, we believe the offshore drilling industry today presents such an opportunity.

#### Brief history of offshore drilling

To understand where we are in the industry today, we must first understand where we came from.



Source: Investing.com

#### Upcycle from early 2000s to 2014

The early 2000s to 2014 were undoubtedly the golden years of the oil and gas industry. Up until 2008, oil prices were extremely constructive, and offshore exploration and production (E&P) was showing significant potential, especially in deepwater due to the emergence of the “Golden Triangle” of West Africa, Brazil, and the Gulf of Mexico. This led to a strong pickup in offshore E&P investments. At this time, the industry was significantly supply-constrained, and hence drilling contractors enjoyed high dayrates rates and rapid payback periods. This also triggered the start of a major newbuild cycle for rigs.

The Global Financial Crisis and subsequent decline in oil prices merely paused the investment cycle, as oil prices swiftly recovered. With the rise in oil prices from the 2009 bottom, day rates experienced a corresponding upturn, and the building momentum resumed in 2010/2011, particularly for deepwater assets such as drillships, underpinned by speculation that oil majors would need an ever-growing fleet.

#### Signs of oversupply starting to emerge

The first tangible signs of oversupply in the offshore rig market emerged in late 2013 as shareholders became increasingly uncomfortable with the diminishing returns of deepwater E&P investments. In turn, International Oil Companies (IOCs) blamed high dayrates for the poor performance, and offshore investments started to decelerate. The oversupply of rigs started to build up until mid-2014. Leading edge dayrates fell 30-40%, from \$600,000/day at its peak to

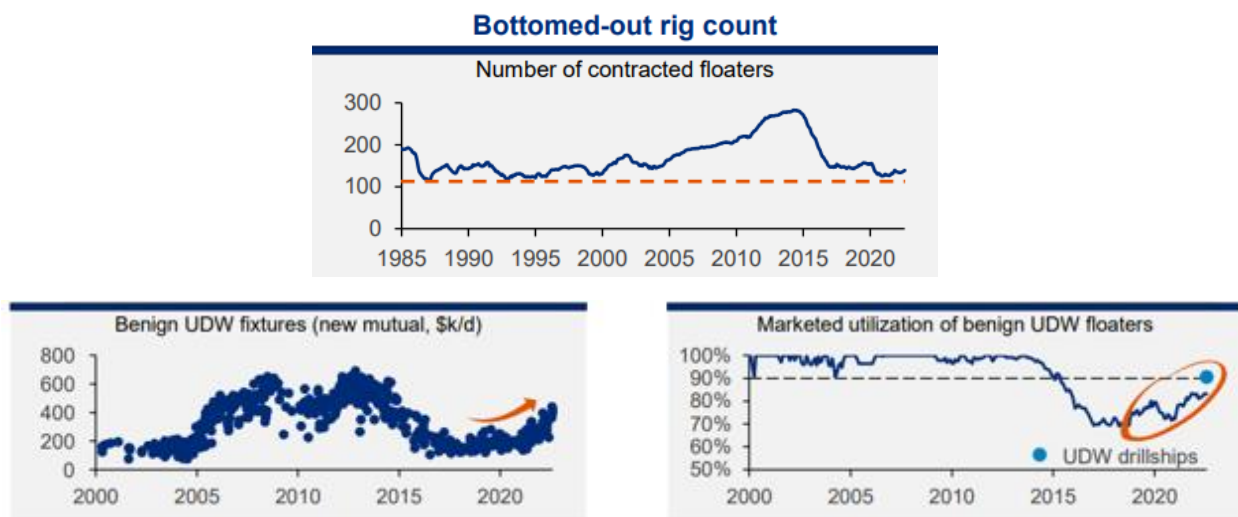
under \$400,000/day. At this point, very few new contract fixtures were being announced for newbuilds entering the market, in stark contrast to prior years where it was common for newbuilds to be contracted up to a year in advance.

### Downturn from 2014 - 2021

The downturn got into gear in late 2014 when oil prices crashed. Shareholders came to the realisation that despite the exceptionally high oil prices, the expected returns on their investments did not materialise. Consequently, they demanded E&P companies to curtail their investments and return more capital to them. Thus, less capital was available to service providers, including offshore drillers. To make matters worse, this coincided with an influx of newbuilds into the market that were ordered during the 2010-2013 upcycle. This double whammy of reduced demand and increased supply resulted in a significant demand-supply imbalance, causing dayrates and utilisations to plummet.

Over the next few years, activists, politicians, investors, financial institutions, and certain communities increasingly began advocating for an energy transition away from hydrocarbons. Thus, E&P companies now directed their investments into renewable, lower-carbon energy sources, which translated into even more diminished investments in oil and gas.

Due to a significant lack of demand during this downturn, many rigs were idled and cold-stacked, and a significant number of older vessels were scrapped or retired.



Source: Seadrill Investor Presentation (8 Sep 2022)

During this downturn, offshore drilling companies worked hard to reduce project costs for delivering wells. According to Transocean, the cost-per-barrel break-even was reduced from \$75/bbl to well below \$45/bbl, depending on the geographic market.

There was a brief rebound in late 2018, due to improved project economics and higher oil prices, which led to increased utilisations and dayrates. This rebound turned out to be short-lived as the pandemic hit, which led to another rough year for the industry in 2020.

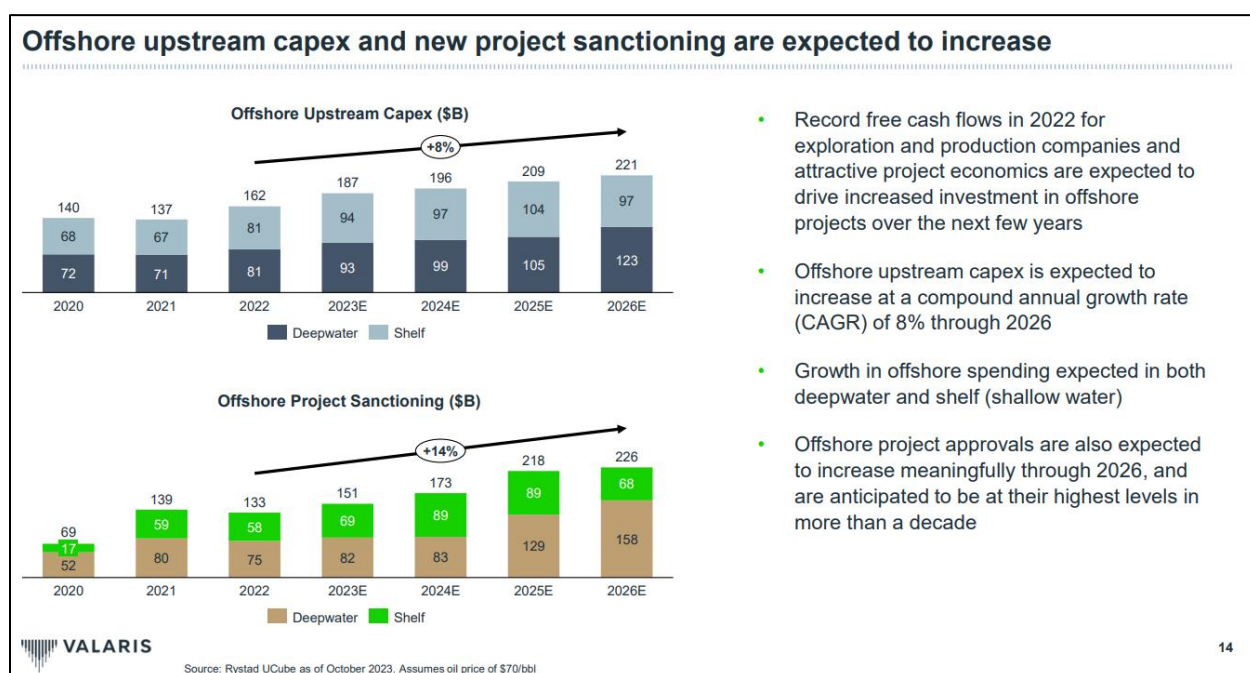
2014 to 2021 were tough years for the offshore drilling market. Falling utilisations and dayrates led to a significant decline in profitability and cash flows for drilling contractors. Many filed for

Chapter 11 Bankruptcy as debt levels became unsustainable. Dayrates remained low for a large part of this period, and companies were struggling to even survive.

### After 8 years of pain, the industry seems to be in a multi-year upcycle

After pandemic-related restrictions eased, economic activity rebounded quickly. Demand for energy returned to pre-pandemic levels, and the draw on crude oil inventories started to raise supply concerns. This was exacerbated by Russia’s invasion of Ukraine, which severely disrupted oil exports from Russia and further tightened supply. Suddenly, talks of energy transition quickly shifted towards energy security and diversification. Increasingly, people started to recognise the reality that the transition to green energy is not something that can happen overnight, and that a substantial amount of our energy needs still have to come from oil and gas during this transition.

The combination of higher oil prices and expectations that demand for oil will remain strong in the near future has led to increased offshore investments in E&P from the oil majors (chart below).



- Record free cash flows in 2022 for exploration and production companies and attractive project economics are expected to drive increased investment in offshore projects over the next few years
- Offshore upstream capex is expected to increase at a compound annual growth rate (CAGR) of 8% through 2026
- Growth in offshore spending expected in both deepwater and shelf (shallow water)
- Offshore project approvals are also expected to increase meaningfully through 2026, and are anticipated to be at their highest levels in more than a decade

Source: Valaris Investor Presentation (Nov 2023)

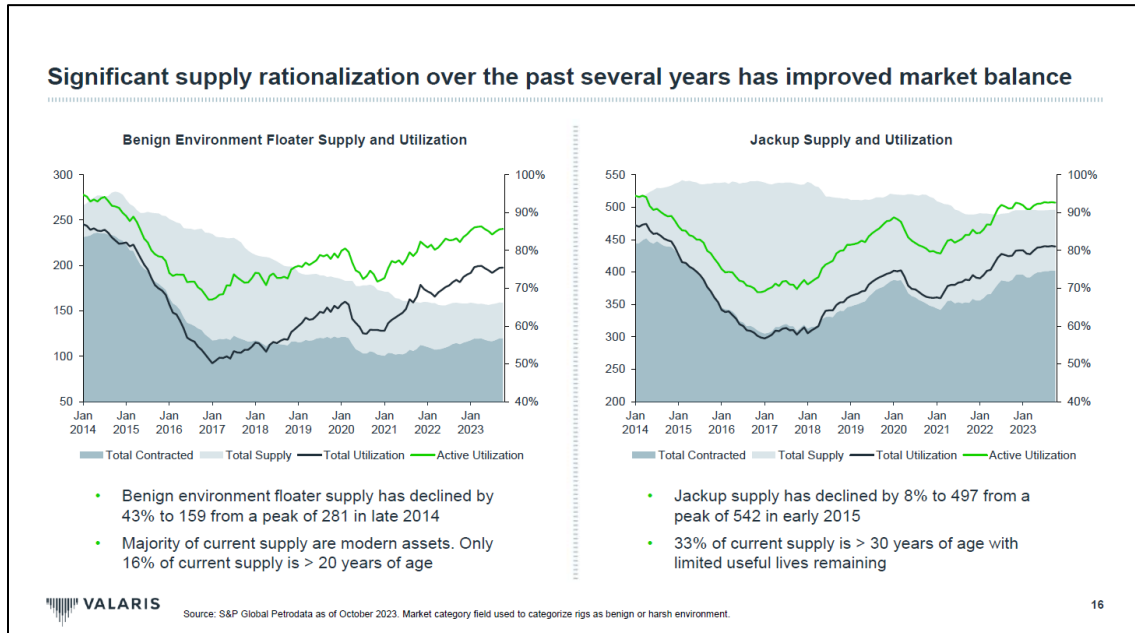
In essence, demand for offshore drilling activity has returned and is expected to remain strong in the coming years. All this bodes well for offshore drilling contractors.

That being said, what we perceive to be an even more important factor is supply in the industry. While demand may be robust, an oversupply, as witnessed during the 2014 downturn, can render the economics of the business unattractive. At present, the supply picture has improved significantly, resulting in increased rig utilisations and higher dayrates.

### Vastly improved supply picture

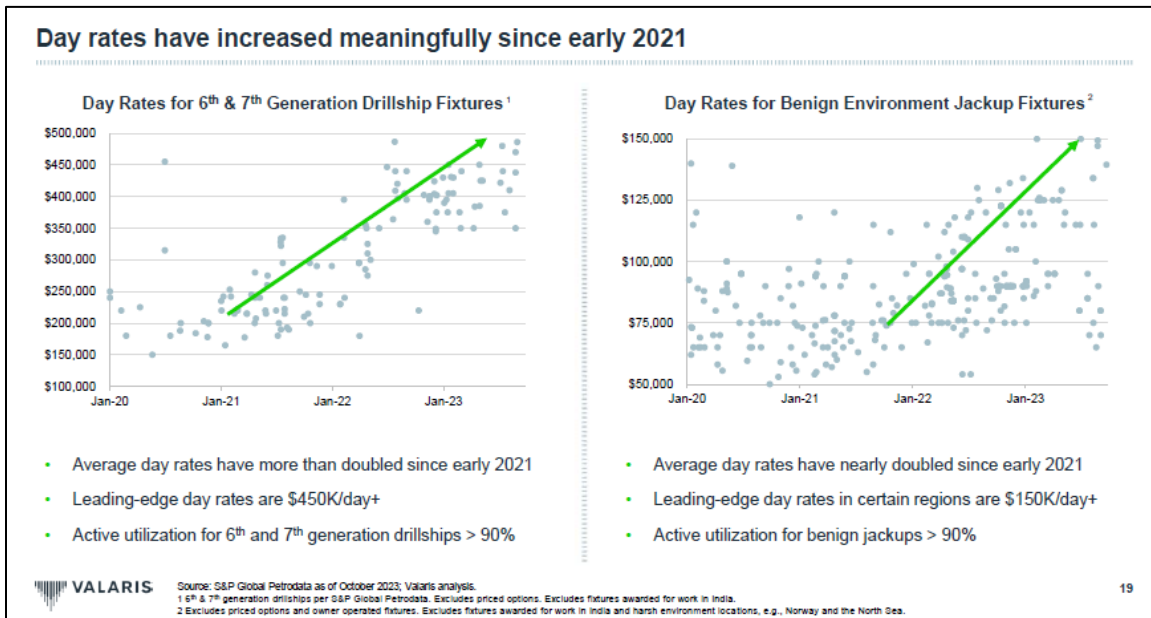
As highlighted earlier, the downturn forced many companies to retire or scrape old rigs, while newbuild orders were scarce. As a result, the supply of offshore drilling rigs has fallen significantly compared to 2013/2014 levels, as illustrated in the chart below.

The floater (drillships and semisubmersibles) fleet size has decreased from 281 in 2014 to 159 today, whereas the jackup fleet size has decreased from 542 in 2015 to 497 today.



Source: Valaris Investor Presentation (Nov 2023)

Due to this scarcity in supply, drillships, semisubmersibles and jackups have all witnessed a steep rise in utilisation since 2021. As reported by Westwood Energy, as of October 2023, marketed utilisations for these rigs stand at 96%, 84% and 92%, respectively. Effectively, nearly all the available rigs in today's market are contracted. This has led to significantly higher dayrates, approaching levels last seen during the peak of the previous upcycle in 2013/2014.



Source: Valaris Investor Presentation (Nov 2023)

## **Supply unlikely to increase meaningfully**

With demand expected to remain strong, concerns would be regarding the supply of rigs coming back too quickly. After all, if supply consistently outweighs demand, utilisations and dayrates may, at best, remain at current levels or, at worst, trend downwards. Encouragingly, we do not foresee this scenario unfolding due to the following reasons.

### Overbuilding/newbuild orders from contractors unlikely to materialise

Historically, amid recovery or upturns, contractors in the industry have been prone to overbuild and add too much supply too quickly, which was what played out during the last upturn. But this time, we, and all the companies who we follow, believe that a newbuild floater in the next 5 (or even 10) years is unlikely.

Today, costs of floaters are too high (~\$850m-\$1bn today) and lead times too long (at least 3yrs) for contractors to underwrite such an investment, especially with concerns around oil demand peaking sometime in the 2030s. Estimates by Westwood Energy suggest that companies require dayrates of \$650k-700k for a five-year initial term to even consider building a new unit.

Even if contractors wanted to build one, it may be hard to find a shipyard willing or able to do it. Shipyard capacity has fallen since 2008, and shipyards today favour other vessels such as FPSOs and non-drilling units, where there is lower risk of non-payment from the counterparty (many of these shipyards suffered heavy losses from offshore rig orders during the last upcycle that were later abandoned).

### Stranded newbuilds/cold-stacked assets available

Additionally, there remains many undelivered rigs (stranded newbuilds) in shipyards that were ordered from the last newbuilding period, as well as many high-quality cold-stacked assets in the fleet that can potentially be reactivated. RigLogix estimates that there are still ~22 newbuild floaters and ~30 cold-stacked floaters globally.

The more rational approach for contractors is to prioritise the reactivation of stranded newbuilds or cold-stacked assets before they even consider ordering a newbuild. Moreover, the fact that there are still so many stranded newbuilds and cold-stacked assets today despite supply tightness is a strong indication that contractors are exercising discipline and caution in introducing new supply.

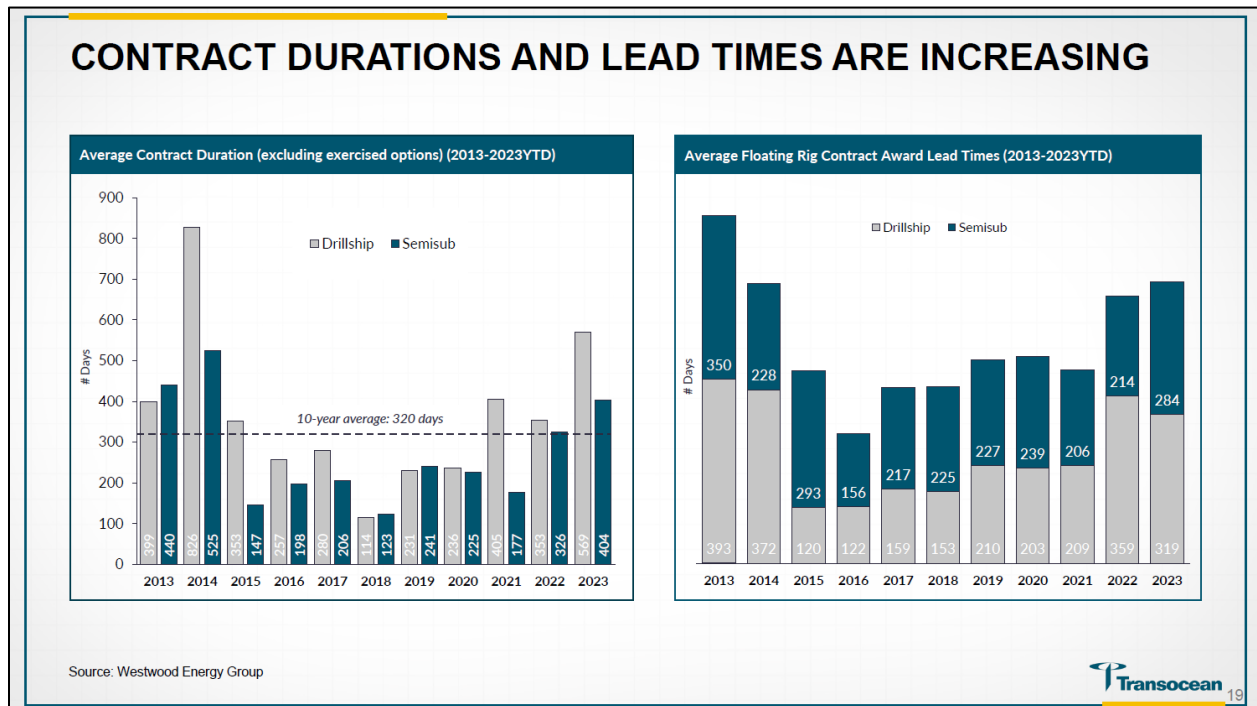
By way of example, Transocean owns the majority of cold-stacked drillships in the global fleet, but management has consistently reiterated that they will not reactivate these rigs unless they get an attractive contract that pays for the reactivation costs in full (~\$75-\$150 million per rig).

### Lack of capital

In the current economic climate, banks are also not as willing to lend in the oil & gas space compared to in the past. Unless offshore contractors get a 10 year contract from an oil major, the ability to get funding to expand capacity (newbuilds) is almost impossible. Contractors are not flush with cash either, many having emerged from Chapter 11 just a couple of years ago.

Given this combination of factors, we believe that incremental supply will not be significant in the near term. With the slow entry of incremental supply and persistent buoyancy in demand, we expect dayrates to trend higher over time. After all, if oil majors are seeking engage in E&P, they

have to secure these rigs for drilling. With utilisations nearing 100%, operators are increasingly tendering for longer term contracts, and increasingly securing contracts well in advance (chart below).



Source: Transocean Investor Presentation (Nov 2023)

We see this as a strong indication that operators recognise the scarcity of rigs that are available in the current market, and are looking to secure their supply earlier, and for longer.

### Multi-year upcycle

As long as contractors remain disciplined on the supply side, which we believe is the rational course of action, it is not unreasonable to think that the supply dynamic today will lead to significant dayrate appreciation. Higher dayrates will translate to improved margins, profits, and free cash flow generation. This, in turn, will enable companies to return capital to shareholders via dividends and share buybacks. On this front, we are encouraged that companies we monitor appear dedicated to capital return to its shareholders.

While companies in this industry may not fit our bill of high-quality businesses which we can buy and hold for a long time, we believe the potential of a multi-year upcycle presents an intriguing opportunity for active trading in the shorter-term.

AGT Partners  
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*Disclaimer: Nothing mentioned in this article should be construed as investment advice nor of recommending the attractiveness of the fund managed by AGT Partners.*