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2 Oil-Drilling Stocks That Offer Value

By
Robert Robotti



Photo of the Seven Borealis from Subsea 7, used with their permission

Has the rebound in crude oil run out of bounce or is it just getting started? If you're a value investor, as I am, it doesn't matter much. Whether oil pops or drops in the coming weeks, valuations of some of the best run companies in the energy industry remain at extremely attractive levels as investors believe oversupply of oil is the new norm.

Before we discuss equity opportunities, let's put the bouncing ball of crude oil prices in perspective. The wild volatility in the energy complex that sent crude tumbling from more than \$100/barrel in 2014 down to \$26/barrel in February has been driven as much by emotion as fundamentals.

Recall \$140 oil in 2008? It's a market dislocation that has created opportunity for value-seeking investors. News reports describing the world being "awash in oil" are simply inaccurate; we are not reliving the 1980s when supply vastly outweighed demand by as much as 20 percent. Today, daily global supply of crude exceeds demand of 94 million barrels by less than 2 million barrels/day, an adequate reserve margin that can absorb swings in both supply and demand. The need for crude oil continues to grow, albeit at a slower pace than a year ago, which means producers will keep pumping petroleum out of the ground. What seems to be

forgotten today is that oil wells are productive for only a limited period; they get depleted. Meanwhile, capital investment to replace that production continues to rapidly decline. The simple fact is that demand is growing while supply is declining, so whether it'll be next month, next year or even later, at some point the price of crude oil will be substantially higher than it is now.



The price collapse has squeezed businesses throughout the petroleum industry, and we are still in the middle of the shakeout. So, rather than wondering what the price of crude will be tomorrow, investors should be asking, "Who will be the survivors?" and particularly, which companies will be best positioned when a sustained energy rebound is on the horizon?

Major integrated oil companies, including **ExxonMobil (XOM)** and **Chevron (CVX)**, and oil field service leader **Schlumberger (SLB)** are certain survivors, of course. Their shares should outperform the market. But for investors willing to look further and assume a bit more risk, there are deep values in deepsea drilling and the engineering services that support it.

Currently, the offshore drilling business is lousy, the outlook worse. Day rates for deepwater drillships are half what they were in late 2013. Many offshore rigs are sitting idle and the older ones, including some owned by the leading players, Transocean and Diamond Offshore Drilling, likely will never return to service.

So why this industry? First off, the retiring of rigs will have a lasting effect, eliminating significant supply. More importantly, deepwater represents the greatest opportunity to replenish gas and oil reserves for the majors.

A survivor in the group is **Atwood Oceanics, Inc. (ATW)**, the offshore drilling contractor with the best financial performance in the business over decades, an industry leading safety record reflecting its technical and execution prowess, and great stewardship through its close relationship with Hemlrich & Payne since the '70s. Atwood has a small modern fleet, just 11 rigs, far fewer than its better known competitors. That's not a problem, because in deepsea drilling there are no economies of scale; each rig is a business unto itself. As with the entire industry, Atwood has been driving costs down, to help ride out the downturn and position itself for recovery. The company eliminated the dividend last month, part of its effort to maintain financial flexibility. We believe Atwood has ample liquidity through FY 2018, when it will need to renew its revolving credit facility. So it has 2.5 years before much more significant decisions would have to be made should industry conditions fail to improve. That's not our expectation, given the age profile of the industry fleet, our expectation of stable and rising oil prices, and the number of known deepwater discoveries waiting to be developed in a stable price environment. Trading at a price-earnings ratio of only 1.3 (that's not a typo, slightly more than 1 times earnings) and less than 20% of tangible book value, the stock is on the bargain table! Atwood earned \$6.65/share in the fiscal year ended September, 2015 and should be able to at least replicate that performance in the next cycle. Once investors realize the offshore business is not going away, the stock should return to the \$60 neighborhood it inhabited in mid-2013.

Another undervalued stock is a deepwater services company based in Norway, **Subsea 7**, the global leader in seabed to surface engineering and construction services to the offshore industry. The American Depository Receipts trade here under the symbol **SUBCY**. Subsea 7 is in a highly specialized niche business, employing some of the finest engineering talent on the planet, a strong competitive advantage and a real barrier to entry in a sector that is critical to successful oil drilling. The company has only two serious competitors, the French firm Technip and Italy's Saipem. Subsea 7 Chairman Kristian Siem, who controls the company, owns 21% of the stock, so we know his interests are well aligned with those of shareholders and Kristian has a proven money making record.

Recognizing today's tough environment, Subsea 7 has built its cash position up to \$947 million, a significant increase from last year, and far greater than the entirety of its debt at just \$524 million. Now that's what I call a fortress balance sheet! Adjusted EBITDA last year was \$1.2 billion on revenues of \$4.7 billion. Compare that to its market capitalization of \$2.25 billion. Yup, less than 2x EBITDA. The ADRs appear even cheaper when compared to the company's enterprise value of only \$1.8 billion.

Now of course there are headwinds. The major oil companies continue to defer their commitments to the long list of deepwater projects in planning. Petrobras is a big customer, so the corruption scandal engulfing the company and Brazil's political leadership is a concern, even though oil revenues remain vital to the country. The likely outcome is that some of Subsea 7's very significant backlog of work will be cut, or at least delayed. These are known facts. The company has dramatically responded through a significant downsizing. If need be, it will do so again.

Our long history of investing in cyclical businesses at depressed points in those cycles enables us to appreciate the benefits that accrue to the winners in an industry downturn as competitors wither. The standing of the survivors improves, and with it, their earnings power. For Subsea 7 that is clearly the case. For example, Ceona, a Goldman Sachs backed competitor, was placed into insolvency in the UK last year. Its assets have gone unwanted. Other competitors continue to retrench. Meanwhile, Subsea's balance sheet positions it very well to capitalize and Kristain Siem has a record of opportunistic expansion in similar downturns. In conclusion, when, not if, the energy business turns, Subsea 7 should be able to enjoy a long runway of significant business growth. The plunge in oil has led the market to value Subsea 7 as a commoditized business, which is not at all the case. In a healthy drilling environment, Subsea 7 should be able to easily out earn its 2014 results of \$2.40/share. With a modest PE multiple of 10, the ADRs would trade at \$24, more than triple their current value of \$7. Even if it takes 5 years, that's better than a 25% annual return, not bad in a 1% interest rate world.

Robert Robotti is president of Robotti & Company Advisors, a money-management firm based in New York. Currently, his firm has positions in shares of Atwood Oceanics, Subsea 7, and Chevron.

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