The Outlook: May 12, 2018

Transocean's corner of the big picture: small, but instructive.

We often talk about seeing the "whole picture," rather than just a small corner of it. But sometimes a small corner can be pretty interesting, and instructive. A few days ago, an oil-rig-industry newspaper told the following story:

> Altogether, 88 new oil-exploration drilling units are being docked along Chinese coastlines—without drilling contracts. Most of these rigs were ordered during 2013 and 2014 with upfront payments (from the buyers to the Chinese shipbuilding companies) of less than 10% of their price. In some cases those down payments were as low as 1% of the price, so that the Chinese shipyards (mostly owned by the state) had to take bank loans to finance almost all of the multi-year costs of construction—before hoping for payment in full from their buyers, once construction was complete. But now, with rental rates for drill rigs down 50% to 80% from their 2014 peaks and a major glut of drill ships around the world, the buyers aren't showing up, since most of them desperately need to preserve cash. The same Chinese shipyards which aimed, back in 2013 – 2014, to take over world leadership in drill ship construction from the world's established yards in Korea, Norway and elsewhere, are now facing the likelihood of years of financial losses.

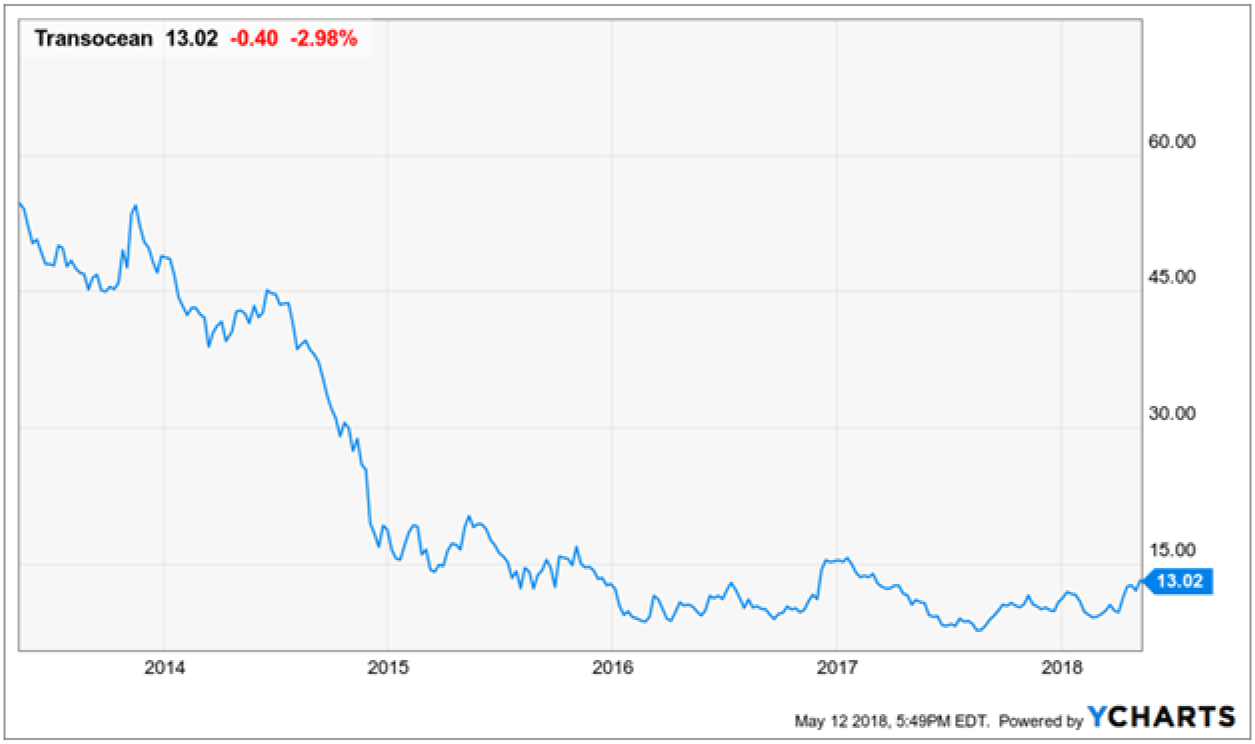
Outlook was not following the oil rig industry and companies like Transocean back then. The oil market was sky-high, hence the stock market's valuation of Transocean (and most other companies scattered broadly across the oil industry) was optimistic—which means, of course, "dangerous." That changed in a hurry as oil plunged from 2014 to 2016. As oil itself dropped to "end-of-the-world" lows, so did the market's valuation of Transocean (and Conoco, Shell, Schlumberger and many others)—and they became mighty interesting indeed, as well as much safer. But we would bet a good deal that back in 2013 – 2014, as those Chinese shipyards went all-out to take leadership of the global industry, the investment world was impressed.

It was impressed in exactly the same way it's been awed by China's recent announcements that it means to knock the world's memory-chip leaders off their perch. A good many Wall Street analysts, displaying aerial photographs of gargantuan chip factories under construction in China, have been so awed by the power and determination of the Chinese government that they've advised would-be investors in Micron Technologies (an Outlook core holding) to back off, or at least tread with great care.

Yet the Chinese ship yards are in a world of long-lasting pain, today—because, at bottom, they didn't know what they were doing. They took wild financial risks at the very top of their market, as if there was no such thing as the Golden Rule that both high prices and low prices always cure themselves (especially in commodities.) Now they are paying, and the government which owns them is simply shrugging, more or less, and embracing its next opportunity to absorb the same hard lesson.

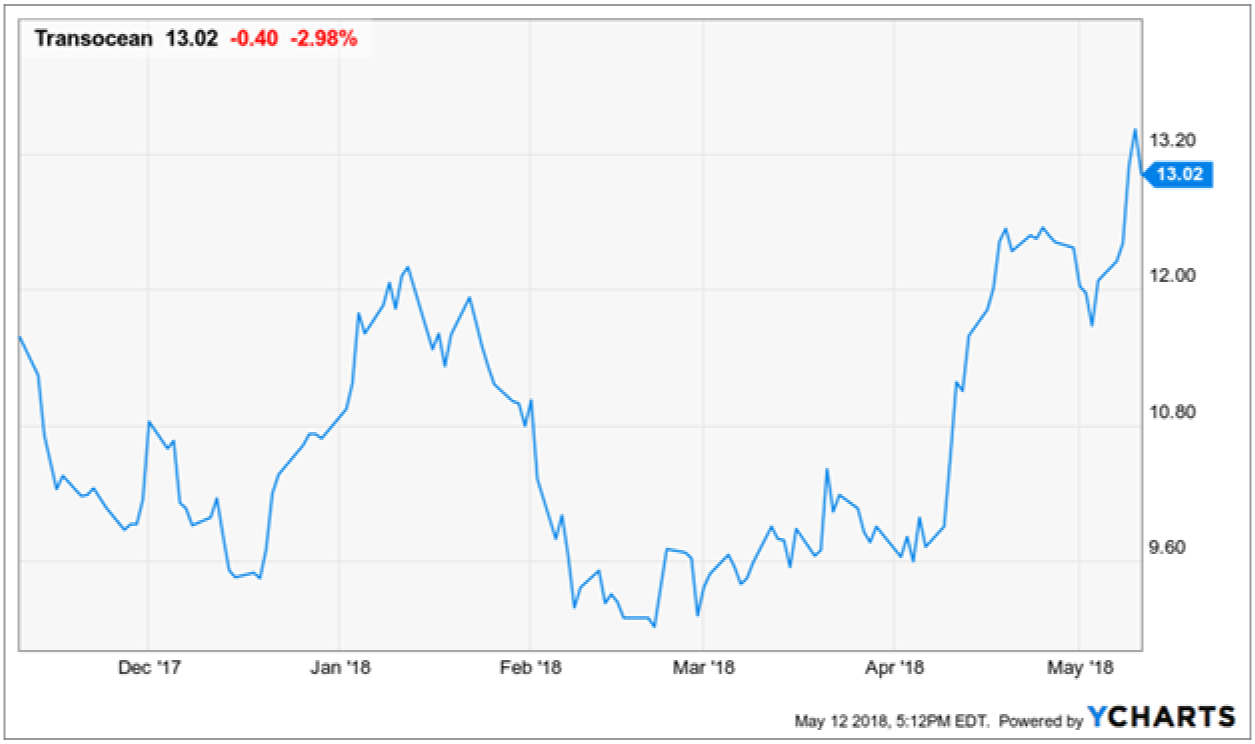
That's the nature of governments, of course . . . but it's not the nature of private-sector companies, accountable to their owners for results.   Let's glance at Transocean before wrapping up the instructive part of this little corner story.

Transocean: 5 Years



An awful plunge indeed, these past 5 years. Transocean was not a customer of those Chinese shipyards, but companies like Transocean are precisely the buyers running away from those 88 new, idle drill ships stacked up along the coast of China. We can see why.

The 5-year chart doesn't quite capture the market's current love-hate relationship with Transocean, but this 6-month chart does.



The latest pop up (at the far right) was the market's reaction to the President's destruction of the Iran Nuclear deal, because it's another straw on the camel's aching back (with the camel being any chance of flat-or-down oil prices in the years ahead.)

Transocean surely has a considerable wait ahead, before oil explorers give in to mounting pressure to resume deep water exploration, and before rental rates on the company's fleet of ships begin to recover those 50% to 80% losses. (Transocean is seeing the first small steps in that climb, but most of the mountain still lies in front.) But the company's leadership moved a couple of hundred percent faster than, for example, the Chinese government moved in reaction to the destruction of its shipbuilding dream. Costs were slashed; the oldest and least-desirable half of Transocean's fleet was scrapped or sold; and the company used its industry-leading financial strength to buy more deepwater drill ships at good prices. When the oil explorers come back with cash in hand, they will find Transocean dominating the business of deep water and harsh environment drill rigs, with the most modern and productive equipment in the world by a long shot.

The market knows that Transocean's oil-exploring clients must come knocking on the company's door again, and they'll come faster, the sooner oil prices go up. Neither the market nor Outlook knows just when that will happen—<u>only that it will happen</u>. The market's reaction to that truth will be endless buying and selling of Transocean on each whiff of news. Outlook's reaction, on the other hand, will be to hold firmly, and keep looking for chances to buy more.

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