<u>The Outlook: Sept. 11, 2018</u>

What investing is all about: Transocean's story.

We shall tell the story of Transocean, today. It's a story which teaches us what investing is all about; and it also reminds us how so few people—so very, very few—seem to understand "what investing is all about." The tidal waves of daily buyers and sellers who set stock prices (and company valuations) in the short term do <u>not</u> understand; but if we wish to invest well, we must.

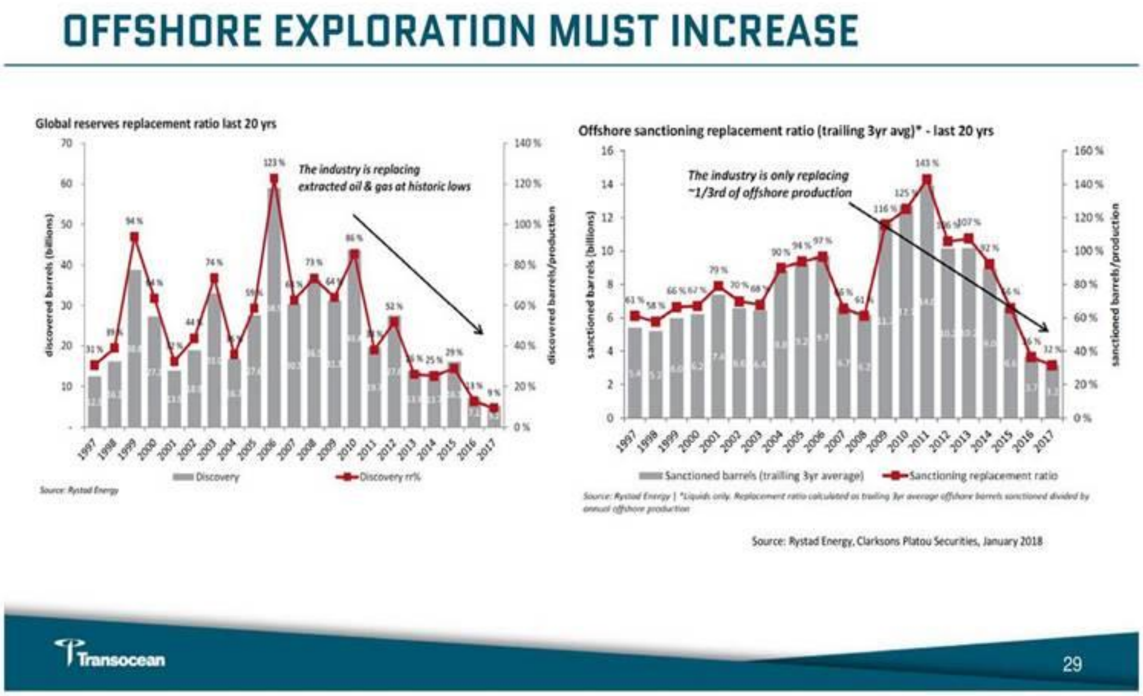
The first chart below might be called "Transocean's 5-Year Train Wreck." Yes . . . a 77% drop in value since the oil market (and Transocean's rental income from its deep-sea oil drillships) peaked in 2014, then plunged like Wile E. Coyote off a cliff. The price of oil fell about 75%, and so did Transocean's stock price, as oil-exploration companies around the world slammed the brakes on every dollar of spending they could possibly cancel, or postpone.

Next we'll zoom in on the far right corner of that chart: last week.

Alongside the "5-Year Train Wreck," last week's 11% plunge does seem almost trivial—but the story behind that latest plunge is the diamond in the coal pile, so to speak, for investors who'd like to understand what investing is all about.

Transocean's CEO, Jeremy Thigpen, announced that his company would buy one of its competitors: Ocean Rig. That was all the market needed to hear, because its opinion of Transocean is perfectly expressed in the 5-Year Train Wreck chart at the top: essentially, "A better future for this company is so far away—if it even exists—that we have no interest in it." And that brings us to the most profound point in the art of investing: *"Whose judgment is right: the market's, or Mr. Thigpen's?"* There is no room for compromise or "balance," here. We will all find out, eventually, that one of the two—the market, or Mr. Thigpen—was absolutely right; and the other was dead wrong.

We know the market's reasoning: "Bad present, questionable future . . . who cares?" So let's consider Mr. Thigpen's reasoning, in making his deal for Ocean Rig, expressed in some of the following slides. First, his judgment that the oil explorers must return to drilling offshore, and must return in a big way.



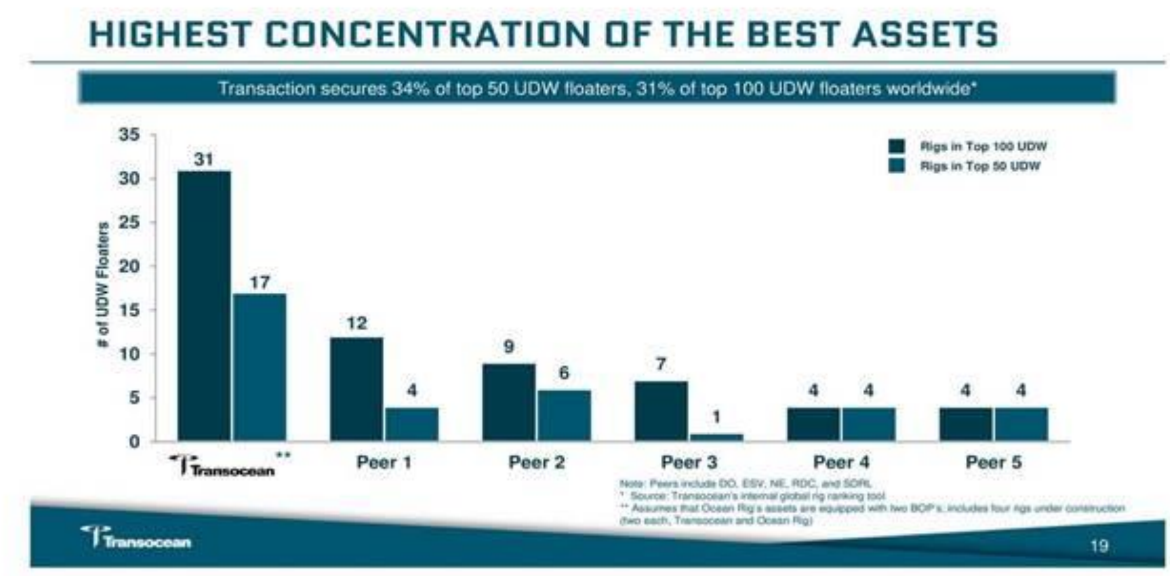
The left-hand chart is enough. In 2006 the oil industry discovered enough oil to replace <u>123%</u> of the oil it sucked out of the ground and the ocean floor. Last year it replaced <u>9%</u>. The 12-year plunging arrow of "new oil compared to used-up oil" is, in fact, the disaster it looks like. It is a terrible picture of global supply eventually falling far short of global demand . . . unless by a miracle of wind power, solar power and electric vehicle usage, global demand for oil also falls off a cliff. There are certainly quite a few voices, in the political world and in the investment world, predicting or calling for exactly that outcome. The problem for those voices is simple: there is no sign at all to suggest the slightest chance that such energy alternatives can stop the annual growth in oil demand, <u>any time soon.</u> Oil is just too cheap, too reliable, and too entrenched as an energy source for any sudden reversal toward "alternative energy" to be practical.

Free Cash Flows at the Oil Explorers

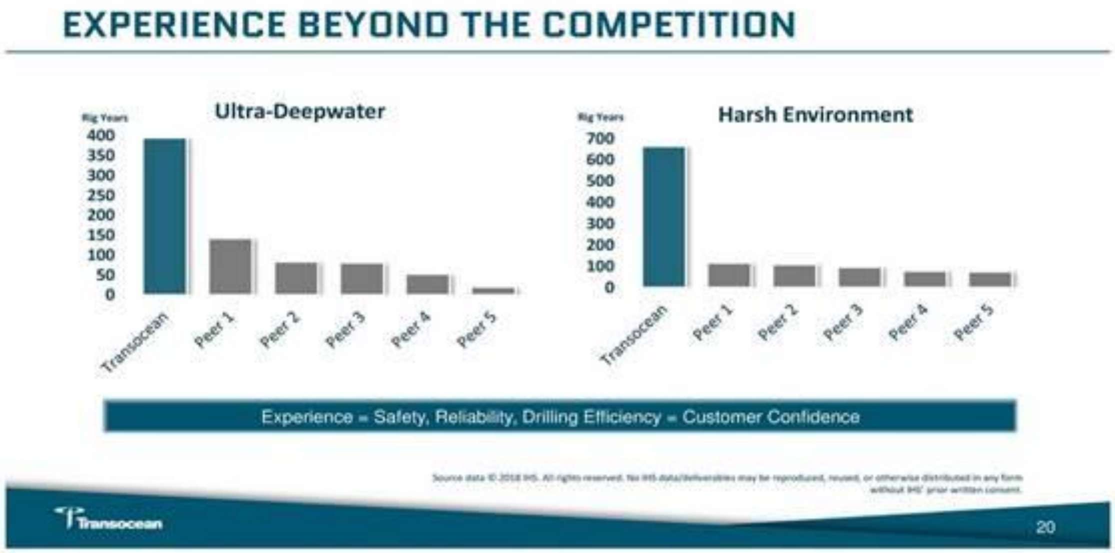
First we looked at the "need" to return to heavy spending to find more oil. Next comes the question: "Can the oil explorers afford it?" That upward-exploding arrow, above, says "They sure can." The oil industry did what it had to do when prices plunged in 2014; and it did so with the speed and effectiveness we almost always see in companies which must compete in free markets, and which are run by people who are personally accountable for results. Production costs and debt were cut, dramatically; profitability virtually exploded, with companies like Shell earning more cash at $60 oil than they had at $100 oil; so "free cash flow" (meaning, roughly, incoming cash above and beyond the levels needed to pay all the bills) also exploded. The oil explorers can afford to spend, again, to begin to solve the long-term crisis shown a couple of charts above: new discoveries replacing only 9% of annual oil production.

Mr. Thigpen believes completely in the story behind those charts; and he has bet his entire company that the story is indeed the absolute truth about global oil supply and demand, and the industry's need to spend heavily again to find new supplies.

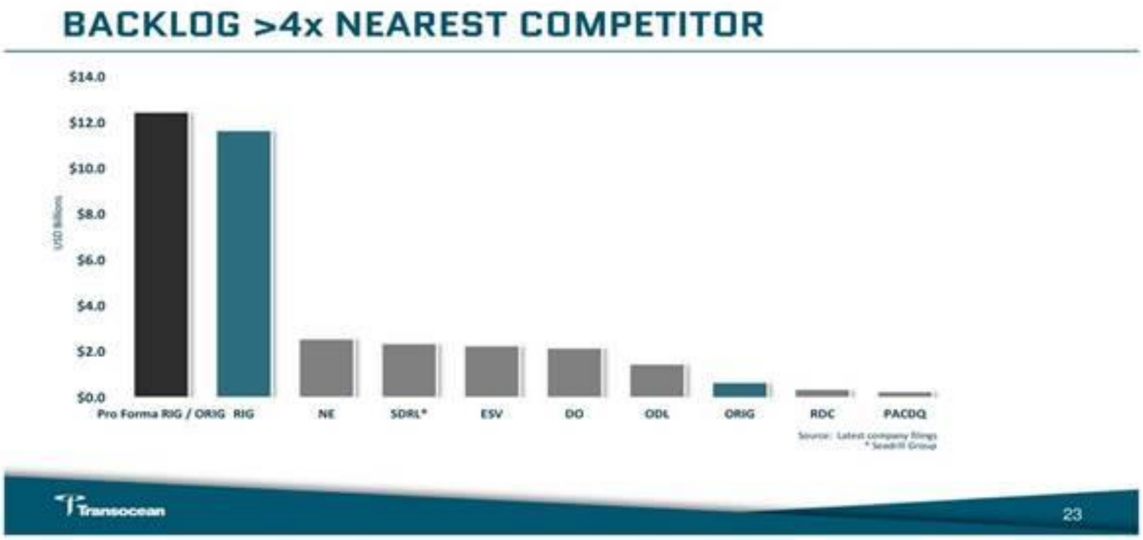
Over the last couple of years, Transocean bought a fair-sized drilling company named Songa, which owned a fleet of fairly modern drill ships and a solid backlog of future contract commitments from major oil explorers; sold off or junked a great many older, somewhat antiquated drill ships; and now has bought another, somewhat smaller drilling company named Ocean Rig—because it has a handful of modern ships in the deep-water and "harsh environment" category (which is Transocean's total focus) and because those modern ships could be bought cheap, right now. In that process, Transocean also—ahem—eliminated 2 competitors from the deep-water industry, ensuring that when the oil explorers do return to spending, they'll have virtually no choice but to deal with Transocean—because it has become the 10-ton gorilla in its business. Here's a look at the strength of the gorilla:



The bars at the left are Transocean's share of the world's best (most modern, most capable) deep-water ships—including the ships gained, last week, in the Ocean Rig purchase. They do tower
over the competition, don't they?



And above, the bars at the left are Transocean’s rig-years of experience in deep water and harsh-environment drilling. Those towers are even higher, versus the competition.



And finally, the two left-hand bars are Transocean's current backlog of contracts: that is, the contractual commitments among explorers to rent Transocean's drill ships, over the next several years. Those are the most impressive towers of all, and they reflect the company's great financial staying power, as it waits for the exploring industry to spend heavily enough to require Transocean's full fleet of outstanding equipment at rental rates much higher than today's.

Last week the market trashed a stock which had already been trashed, for 5 years. Its reasoning, if we must use that word, amounted to displeasure that Mr. Thigpen slightly weakened the strong financial position of his company in order to make Transocean the sort of kingpin which will make a great deal of money when that long-awaited resumption of ocean drilling finally shows up. The market never believes in "long-awaited" benefits on the way for companies which it has placed in its "disbelieve" category. But it endlessly believes in such benefits for companies which it has placed in its "believe anything" category. Companies never stay in either category: the "disbelieved" don't stay, because their people act to build better futures; and the "believe anything" don't stay, because their people can't possibly do the endless, fabulous things the market expects from them.

It is Mr. Thigpen's job to act, to build his company's future. When he, or his fellow CEO's, do that job exceptionally well, they always act with courage. They bet their whole companies they'll be right; then they work like the devil to prove it. That is what leading a company is all about. It is what good investing is all about: placing our money with exceptionally tough, determined people who will fix big problems, and in the process show us that the market's "reasoning" is not just wrong, but wrong on a galactic scale. We think we'll eventually make money on a fairly galactic scale, with Transocean; so we hold, and we buy more.

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