TRANSOCEAN LTD. (RIG) 5.375% SENIOR SECURED NOTE DUE 05/15/23

COLLATERALIZED NOTE; STRONG DOWNSIDE PROTECTION; OVERWEIGHT RATING

10/10/2021

TRANSOCEAN LTD. (RIG)

OVERWEIGHT

COLLATERALIZED NOTE; DOWNSIDE PROTECTION; OVERWEIGHT RATING

OFFERING PRICE: $99.50

OFFERING YIELD: 5.516%

CURRENT PRICE: $96.50

SECURITY RATING: B-

(As of 9/25/21)

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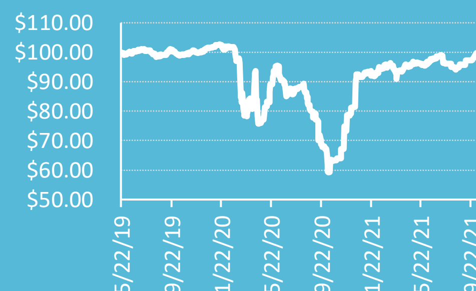
Rating	Overweight
Current Yield	5.57%
Tenor	19 months
Yield-to-worst	7.93%
EBITDA/Interest Expense	2.3x
Debt/EBITDA	6.7x

Transocean LTD. 5.375% Senior Secured Bond Price



THESIS

We are initiating an overweight rating on Transocean LTD.'s senior secured note due 05/23 and rated B-. For the 19-month tenor, the bond, offering a 5.375% coupon and YTW of ~8% has strong downside protection from the collateralized underlying oil rig assets. The short remaining time to maturity on the bond combined with very minimal debt maturing until 2023 suggests a strong likelihood of the firm's ability to repay.

KEY DRIVERS

Collateralized senior secured note.
This note sits atop the capital stack, subordinated only to the untapped low-interest rate revolver. The indenture that governs the note contains covenants that, among other things, limits the ability of the subsidiaries that own or operate the collateral rigs Transocean Endurance and Transocean Equinox to declare or pay dividends to their affiliates. The note is secured by a lien on each of the Transocean Endurance and the Transocean Equinox and certain other related assets. The note is fully and unconditionally guaranteed, jointly and severally, by the Guarantors on a senior basis.

Strong downside protection from underlying assets.
The going concern value of the assets securing this note would leave the senior secured claimants comfortably oversecured in the event of Chapter 11 bankruptcy. This ensures the noteholders' positions at the top of the recovery waterfall, and even their rights to receive post-petition interest payments. The "best interests" test requires that creditors receive at least as much under a proposed Plan of Reorganization (POR) as they would if the debtor's case were converted to a Chapter 7 liquidation (wherein the debtor's property would be sold and distributed to creditors). Based on a liquidation analysis done on Transocean presuming a Chapter 11 filing in 2023, the secured creditors would have a recovery rate of 92.8%. With that, the possibility of closing out the position with a negative yield is eliminated.

Minimal cash burn concern over the remaining life of the bond.
Transocean has cash (nearly $1.5 billion in liquidity from cash and accounts receivable) and is generating above-market contracts. Looking at the company's maturity schedule, maturing debt for the next few years up to the maturity date of our note (2023) is below $2 billion. Each year since 2016, the firm has been able to repay debt ranging from $1.3 billion to $2.3 billion which demonstrates a history of reliability. The years after 2024 see a massive rise in maturing debt but the bond's mid-2023 maturity date allows noteholders to avoid this concern.

COMPANY OVERVIEW

Transocean, together with its subsidiaries, provides offshore contract drilling services for oil and gas wells worldwide. It contracts its drilling rigs, related equipment, and work crews to drill oil and gas wells. As of July 21, 2021, the company owned or had partial ownership interests in and operated a fleet of 37 mobile offshore drilling units, including 27 ultra-deepwater and 10 harsh environment floaters. It serves integrated oil companies, government-owned or government-controlled oil companies, and other independent oil companies. The company was founded in 1926 and is based in Steinhausen, Switzerland.

The firm currently has a market capitalization of $2.4 billion, enterprise value of ~$9 billion, and has earned revenues ranging from $2.7 to $3.2 billion over the last 5 years. As of June 2021, the firm has a current ratio of 2.0x, quick ratio of 1.2x, and a total debt to equity ratio of 66.5%.

MANAGEMENT OVERVIEW

Transocean. is led by Jeremy Thigpen, current CEO and President. Mr. Thigpen is committed to using new innovative opportunities to strive towards the short-term and long-term goals of Transocean. His 20+ years of experience of leadership in the oil and gas industry give him the credibility to lead Transocean as they continue to develop their business. To separate themselves from the competition, Transocean maintains one of the most versatile drilling fleets in the world, with highly advanced drill ships and semisubmersible floaters in support of offshore drilling activities and offshore support services on a worldwide basis.

Per Transocean's 10-K filed 03/01/2021, the management's discussion and analysis section places a strong emphasis on how the firm has distinguished itself as a leader in the industry and outlines the potential risks moving forward in a new economy with COVID-19 and highly volatile oil prices. Transocean believes their competitive advantage is established mainly through their industry-leading contract backlog. A high contract backlog demonstrates Transocean's ability to grow revenue and highlights the high level of trust that clients have in the firm. Management is focused on meeting customers' evolving needs in a changing market to grow this contract backlog by installing new technology on rigs such as Smart Equipment Analytics and Haloguard. Management has also expressed concern in their discussion on the impact of the pandemic and highly fluctuating oil prices. Despite the high risks that these impose on the business, management has made it clear that future developments and uses of liquidity cannot be predicted now and therefore cannot be dealt with now.

Management clearly outlines risks associated with generating future cash flow, such as uncontracted rigs, renegotiated contracts, suspended contracts, and potential failure to acquire funds for future capital expenditures. The effects of COVID-19 and volatile oil prices could impact the ability to generate future cash flows from operations while a substantial portion of current cash flows will be used to service maturing debt. Despite these risks, management expressed in the 2020 Annual Report to Shareholders that they expect cash flows to remain positive throughout the next year.

In the 2020 Annual Report to Shareholders, Mr. Thigpen and the Independent Chairman of the Board, Chadwick Deaton, showcase management's commitment to human rights, diversity, and environmental protection in a market where these factors have become increasingly important as seen by the rise of ESG investing. Overall, management appears to have the necessary experience, vision, and leadership to adapt to a changing global economy and work towards the long-term goals of the firm.

UNCERTAIN OIL ENVIRONMENT

Critical to the economics of a business operating oil rigs is the price of oil. As of early October, OPEC and a Russia-led group of oil producers agreed to continue increasing production in measured steps instead of opening the taps more widely, thus driving U.S. crude prices to their highest levels since 2014. Per oil-field-services firm Baker Hughes and the WSJ, the last time that domestic crude prices were so high, there were roughly 1,100 more rigs drilling for oil than the 428 at work presently. As a consequence of the coronavirus pandemic and the initial downward demand shock to oil, energy companies cut exploration budgets after investors pulled significant capital out of the energy sector. This is one of the potential causes as to why oil prices have surged more than 50% YoY but have not been met with any meaningful increase in U.S. oil production. Additionally, U.S. frackers, which normally boost output when prices rise, have been reining in their spending instead and thus firmly put OPEC in control of pricing at least in the short term. Saudi Arabia has privately signaled at related conferences that it is seeking higher prices now to make up for lost revenue last year.

However, there are also forecasts from OPEC economists suggesting oversupply in the oil market due to excess production occurring as early as December. Regardless, contract drilling companies like Transocean generally charge for their services based on the amount of time they work for an exploration & production company. Drillers do not generate revenue that is tied directly to oil and gas production but undoubtedly there is more favorable contracting at times when oil prices are high.

LIQUIDATION ANALYSIS

A liquidation analysis helps measure the recovery rate of the note in question in a worst-case scenario. The best interests test ensures that the recovery a creditor's class attains in any plan of reorganization is no less than what they would receive if the debtor was liquidated instead. Therefore, the recovery rate of the senior secured notes in a liquidation case can be a proxy for the minimum recovery they can expect in a worst-case scenario.

The recovery estimates in Figure 1.0 were based on the liquidation analysis attached to the approved plan of reorganization for Diamond Offshore Drilling, an offshore drilling company that emerged from bankruptcy six months prior to the publication of this report. Diamond Offshore's rigs were severely

underperforming compared to those of Transocean making the figures in Figure 1.0 reasonably conservative estimates.

If the filing takes place before the first major maturity wall in 2023, the liquidation analysis yields a high-end recovery of ~$1.95 billion. The $2.1 billion senior secured class's claim sits above any remaining claim, meaning the senior secured notes would have a recovery rate of 92.8%. Since, as it was in Diamond Offshore's case, the high-end figure would be used to conduct a best interests test, the 5.375% senior secured note is expected to have a positive yield even in a worst-case scenario, especially considering that the bond trades at a discount to par value.

Figure 1.0: Liquidation Analysis

Liquidation process	Pro Forma Value	Recovery Estimate % Low	Recovery Estimate % High	Recovery Estimate $ Low	Recovery Estimate $ High
Gross Distributable Value					
Current Assets					
Unrestricted Cash at Conversion	300	100%	100%	$300	$300
Administrative expense Account	81	100%	100%	$81	$81
Accounts receivable	530	53%	72%	$281	$382
Inventory	430	12%	32%	$52	$138
Other Current Assets	156	5%	13%	$8	$20
Total Current Assets	**1497**	**48%**	**61%**	**$721**	**$920**
Non Current Assets					
Rigs & Spare Equipment	16900	2%	8%	$338	$1,352
Long Term Investments	139	70%	85%	$97	$118
Other Long Term Assets	774	1%	3%	$8	$23
Total Non Current Assets	**17813**	**2%**	**8%**	**$443**	**$1,493**
Gross Distributable Value	**19310**			**$1,164**	**$2,414**
Less: Liquidation Adjustments					
Post-Conversion Cash Flow				($192)	($246)
Estate Wind Down Costs				($75)	($75)
Retention Costs				($21)	($27)
Severance Costs				($21)	($21)
Professional Fees				($12)	($33)
Ch. 7 Trustee Fees				($14)	($66)
Total Liquidation Adjustments				**($335)**	**($468)**
Net Distributable Value				**$829**	**$1,946**

COLLATERAL VALUATION

The rigs acting as collateral for the notes, the Transocean Equinox and Transocean Endurance, are semi-submersible harsh environment floaters. Transocean came to own them three years ago after acquiring Songa Offshore, who built the rigs relatively recently in 2015.

At the time of the acquisition in 2018, when crude prices were only ~6% lower than they are now, the rigs were valued at $200-$300 million each on a charter-free basis, and $675-$775 million each including their (above-market) contract values.

Since the company will argue to maintain use of these assets in the case of a Chapter 11 bankruptcy, the rigs will be valued as going concerns. This puts the conservative estimate for the rigs' combined values well over $500-600 million, which comfortably covers the $347 million claim of the notes and even allows for the collection of post-petition interest.

COVENANTS

Although the bonds are redeemable in whole, dates before November 15, 2022, require a premium. Redemptions before May 15, 2022 must be done at 102.688% of face, and those after must be done at 101.344%. The covenants further dictate that $31.5 million of principal per annum must be redeemed at face on November 15. This amounts to 9% of the bond's current outstanding amount. Both provisions create capital appreciation gains, due to the current purchase price sitting at $96.50.

Moreover, the collateralized rigs are secured with negative pledges. This ensures that the bonds will not be primed by another lien in the future. It is also stated in the covenants that the assets cannot be sold off without compensating the bondholders as well, thus eliminating the risk of getting asset stripped.

PREDICTABLE FREE CASH FLOW

Investigating the ability of the company to repay debt involves the analysis of its Free Cash Flow. Transocean's financials and management presentations reveal a firm with predictable Free Cash Flow. In 2022 FCF is negative as the company will experience a significant increase in CapEx due to payment for the Deepwater Titan in May. Despite this, the firm demonstrated strong and relatively stable cash flow during the last 5 years and its 2023 FCF is expected to be generate ~$1.07 billion. Overall, the company is well positioned to meet their debt obligations especially given projected liquidity of ~$2 billion at the end of 2022 and a contract backlog of ~$7 billion.

Some concern arises from future CapEx of the company which is expected to jump to $670 million in 2022 – calculated as the sum of the 5-year average CapEx and expected incremental CapEx for Deepwater Titan. FCF being negative in 2022 indicates an even larger negative value after mandatory debt repayment. To cover this shortfall, the firm will have to dip into its cash balance. The large debt paydown in 2022 releases the security interest on the underlying collateral and offers an opportunity for additional debt to be issued using that same collateral should liquidity concerns present themselves. The firm is expected to generate significant enough FCF in 2023 and even if FCF falls short of expectations, the company will still have ample liquidity to pay down its ~$870 million debt balance.

Figure 1.1: Free Cash Flow Expectations

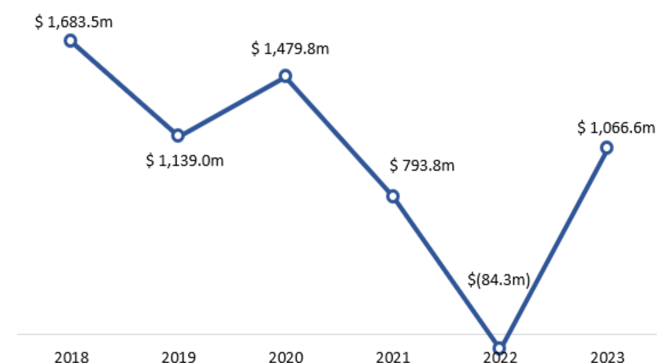


Figure 1.2: Liquidity Projection (2022)

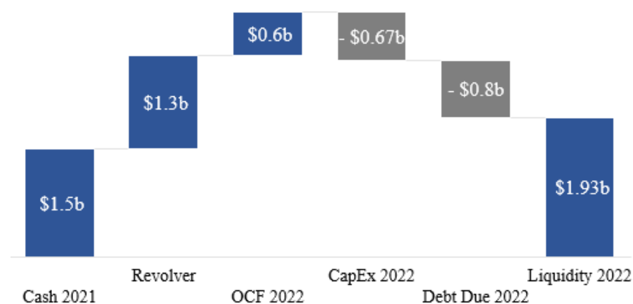
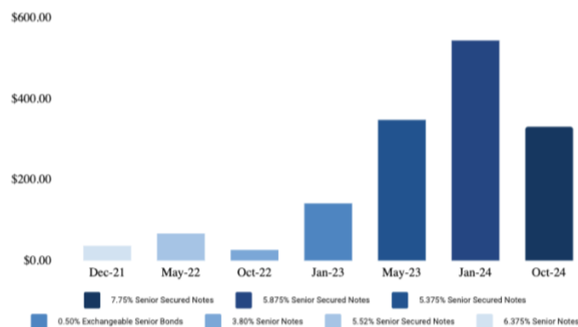


Figure 1.3: Senior Debt Maturity Schedule



RELATIVE VALUE ANALYSIS

These three bonds were selected because they are in similar industries, and possess similar tenors, solvency ratios, and credit ratings. Although two of the comparables are also senior secured, one is unsecured. This is due to the lack of secured notes that fit the above criteria.

Out of the set of comparables, Transocean has the lowest debt/EBITDA ratio, net debt/EBITDA ratio, and debt/equity ratio. Transocean also has the strongest EBITDA/interest expense ratio. Also, it has the second shortest tenor, making it more protected against interest rate risks.

In addition to Transocean's financial metrics looking superior to comparables, the 5.375% note also offers the highest YTW. All of this implies that this note offers a superior risk/return ratio within its industry, supporting the overweight rating given to the note.

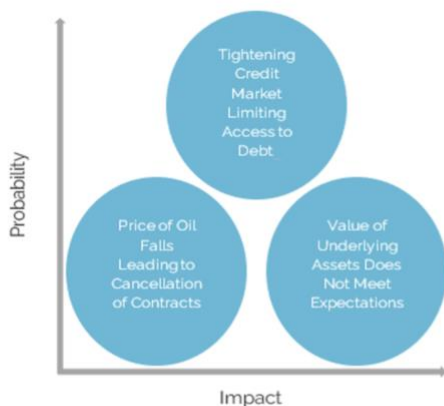
Figure 1.4: Relative Value

Senior Bonds				
	RIG	SM	MEG	MEDC
Description				
Company name	Transocean Ltd.	SM Energy Company	MEG Energy Bond	PT Medco Energi International
Mkt Cap	$2.181.30	$3.377.00	$1.819.00	$1.034.00
EBITDA	$818.65	$110.50	$376.00	$336.90
FCF	$778.00	$265.80	$265.80	$428.20
Credit Rating	B-	B+	BB	B+
Overall Credit Health				
EBITDA/Interest Exp	2.3x	2.0x	1.6x	1.5x
(EBITDA-CapEx)/Interest	1.9x	NM	0.7x	1.0x
Debt/EBITDA	6.7x	6.8x	7.7x	7.2x
Net Debt/EBITDA	5.8x	6.8x	7.3x	5.9x
Debt/Equity	67%	142%	87%	216%
Security Analysis				
Coupon	5.375	10.000	6.500	8.900
Maturity	15.05.2023	15.01.2025	15.01.2025	20.02.2023
Type	Senior Secured	Senior Secured	Senior Secured	Senior Unsecured
Trading Levels				
Mkt Price	$96.50	$111.50	$102.89	$101.93
YTW	7.93%	3.83%	1.89%	7.41%

RISK FACTORS

There are three main risks that could affect our investment thesis and subsequently the value of the investment. As illustrated in figure 1.5, we lay out the probability and potential impact of each risk.

Figure 1.5: Probability and Impact of Risks



The tightening of the credit market is a risk to Transocean because the potential for new debt issuances could be limited as a result of the company's high leverage. Based on the liquidity analysis, Transocean should not need more debt until the proposed senior secured notes mature. If a large expense were to come up that absorbed liquidity, Transocean might have to raise new debt at higher interest rates to pay down outstanding debt, however, this does not seem likely in the near term.

The transition from hydrocarbonaceous energy sources to renewable energy sources began accelerating a decade ago with major advancements in the solar industry. The COVID-19 pandemic showed the vulnerability of the market to systematic risks with the largest one on the forefront being climate change. According to McKinsey & Co., the pandemic served as a catalyst for the reallocation of capital into more sustainable energy forms which poses a risk for the long-term demand for oil. Although the global market supply of oil is currently increasing at a rate that does not match the post-COVID spike in demand, a forecasted oversupply of oil could be approaching the market in a few months which can have negative implications for its price. By taking a short-term senior secured creditor position in

the company, the macroeconomic industry implications will be largely mitigated.

Another risk to the proposed position is the value of the two semi-submersible oil rigs that secure the debt offering. The current rig fair values are roughly the same as they were in 2018 due to the fairly consistent price in oil which drives the price of their contracts. In terms of rig longevity and their operations, the two oil rigs are subject to usual hazards inherent to drilling and marine operations: the most severe of which include blowouts, fires, explosions, and sinking. The two main types of insurance that Transocean has are (1) hull and machinery coverage for structural and physical damage to the rigs and (2) excess liability coverage. The hull and machinery coverage has a $125 million deductible which could cause a substantial loss in capital if a significant amount of damage were to occur. The liability insurance covers losses up to $750 million. If a major disaster were to occur to one of the rigs and Transocean had to declare Chapter 11 bankruptcy, secured debtholders would receive an insurance payout. Additionally, newer rigs, like these, are designed and built with more advanced technologies that can mitigate physical damages in the event of a disaster. Given the short duration of the proposed bond, this is an important, but not likely risk to occur, to secured debtholders.

CONCLUSION

The significant downside protection of the note, stemming from the predictable short-term outlook of cash flows and the high recovery floor in a worst-case scenario, coupled with its superior relative value justify the overweight rating of the note. Although there are numerous risk factors like a secular decline in the oil drilling & energy sector and uncertainties in the oil market, the considerably short-term hold period and the values of the tangible collateral assets mitigate a lot of the risk exposure. All said, in an uncertain and low-yield market environment, this note offers an opportunity to extract an attractive risk-adjusted return.