30-Apr-2020

Valaris Plc (VAL)

Q1 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to Valaris Plc's First Quarter 2020 Financial Results Conference Call. All participants will be in a listen-only mode for today's call. [Operator Instructions]

I would now like to turn the conference over to Mr. Nick Georgas, Vice President of Investor Relations and Corporate Communications, who will moderate the call today. Please go ahead, sir.

Nick Georgas

Vice President-Investor Relations & Corporate Communications, Valaris Plc

Welcome everyone to the Valaris first quarter 2020 conference call. With me today are President and CEO, Tom Burke; and Executive Vice President and CFO, Jon Baksht. We issued our press release which is available on our website at valaris.com. For today's call as will be discussed in more detail, we will not have a question-and-answer session at the end of our prepared remarks.

Any comments we make today about expectations are forward-looking statements and are subject to risks and uncertainties. Many factors could cause actual results to differ materially from our expectation. Please refer to our press release and SEC filings on our website that define forward-looking statements and list risk factors and other events that could impact future results. Also, please note that the company undertakes no duty to update forward-looking statements.

During this call, we will refer to GAAP and non-GAAP financial measures. Please see the press release on our website for additional information and required reconciliations. We issued our most recent Fleet Status Report which provides details on contracts across our rig fleet on April 22 and filed our 10-Q earlier this morning.

Now, let me turn the call over to President and CEO, Tom Burke, for his remarks.

Thomas Peter Burke

President, Chief Executive Officer & Director, Valaris Plc

Thanks, Nick, and good morning, everyone. Welcome to the call, and thank you for your interest in Valaris. During today's call, I will briefly discuss the macro and industry environment that has developed over the last two months. I will then provide an update on how these events are impacting the demand for offshore drilling services and Valaris' operations. Finally, I will speak to the cost reduction initiatives that we have underway. Following my comments, I will hand the call over to Jon for his remarks on the first quarter financial results.

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The coronavirus pandemic has affected businesses and people around the world, creating a global economic crisis of which we are all acutely aware. In response, world leaders and policymakers have deployed fiscal stimulus programs, aimed at limiting the impact of this downturn. While it is uncertain how effective these programs will prove in jumpstarting the global economy, it is clear that travel restrictions, quarantine orders and the altered consumer behaviors have had a dramatic impact on the demand for hydrocarbons.

We expect commercial and consumer restrictions to be lifted soon in countries around the world. Still, we anticipate that it will take time for consumer behaviors to return to normal. Therefore, there is a highly uncertain picture of hydrocarbon demand particularly in the near-term. Unfortunately, in the face of these demand challenges, the energy industry has been simultaneously facing supply surpluses with competition for market share among producers over the last several weeks. This competitive intensity appears poised to subside following agreements by several oil producing nations to reduce production, although it remains to be seen if this planned supply contraction will be sufficient.

Collectively, these supply and demand pressures have created an excess of hydrocarbons to the point that there are storage capacity concerns and operators are choosing to shut in production. In turn, front month Brent crude prices declined from nearly $60 per barrel in late February to less than $20 per barrel earlier this month. In light of this challenging backdrop, customer demand for offshore drilling services has fallen swiftly over the last two months. We were receiving about 20 new inquiries per month in late 2019 and early 2020. We expect that the majority of these requests to lead to work for rigs in the global fleet.

Over the past month, we had received a total of nine such inquiries and we anticipate that fewer than half of these inquiries will lead to work for Valaris or its competitors. Not surprisingly, with several rigs in the global fleet having come off contract over the past several weeks without follow-on jobs and a shortage of new opportunities, we've already seen global rig utilization drop. This challenging environment is also impacting existing contracts for offshore drillers, as operators move to cancel and delay well programs, along with asking for pricing concessions and other modifications to contract terms.

Most of our customers have asked for some kind of change to current contract arrangements. We have had four contracts terminated and agreed to modify several others. One of the contract terminations we received was for the Valaris DS-8 which had been operating offshore West Africa when the rig's blowout preventer became disconnected following a non-drilling incident. At the time, this contract had approximately $150 million of revenue backlog remaining.

As previously disclosed, we have an insurance policy that we expect will largely offset the loss of backlog associated with this contract. In addition, we recovered the BOP from the seabed over the past weekend and we'll now mobilize the rig to the Canary Islands for repairs. However, with the exception of the DS-8, challenging market conditions, and logistical challenges with our customers, drilling and completion programs have led to these contract modifications and we expect that this trend will continue.

Travel restrictions and quarantine requirements have also created significant challenges to deploy our global workforce to our offshore rigs and supply these rigs with necessary materials, often in remote locations. That said, I'm pleased to report that despite these challenges, we've been able to keep our rigs crewed and operating. This performance is a testament to our employees, to the fantastic efforts of our operations, supply chain, and human resources teams, as well as our travel partners.

I'm especially proud of our offshore crews, many of whom have had to work over for extended periods. They've done so dutifully despite being away from their families during such an uncertain time. In response to this

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challenging backdrop for the offshore drilling sector, we're taking action to rationalize our fleet, right-size our support costs, and structurally lower our operating expenses. As I've mentioned before, I want Valaris to be the industry cost leader. I believe that the offshore driller that offers safe and reliable operations at the lowest cost is best positioned for success. To minimize our costs, we intend to preservation stack several of our competitive rigs, including three drill ships, a semisubmersible, and five jackups. By putting these rigs into a lower state of readiness, we expect to realize more than $50 million of annualized cost savings beginning in the latter half of this year.

In addition, we will retire three sixth generation modern drill ships, the DS-3, the DS-5, and the DS-6, and four benign water semisubmersibles, the 5004, the 8500, the 8501, and the 8502. We believe that given the age and capability profile of the global floater fleet, only the most capable modern rigs will be competitive going forward. Given the combination of these rigs' technical capabilities and amount of time they've been out of service, we do not believe that the necessary economics to reactivate these rigs and make them competitive will ever occur. So, we plan to retire these assets.

We will also retire four jackups. Collectively, the decision to scrap these 11 rigs will save the company more than $30 million in stacking costs annually once sold. Jon will discuss the impairments we've taken on these assets in a moment. We're also rightsizing our shore base support to better reflect expected fleet utilization levels which aligns well with the final phase of the merger synergy process that I mentioned on our last conference call.

At the end of the first quarter, we achieved a run rate of more than $175 million of combinational synergies, exceeding our $165 million pre-merger target, nine months early. Today, our run rate of shore base support is approximately 65% of the two legacy organizations' shore base support costs immediately before the merger closed, inclusive of G&A expense as well as operational and local support that is within contract drilling expense. We expect to further reduce shore base support costs in the future, lowering them to less than half of what they were in early 2019. While savings through fleet management and shore base reductions are significant, the most meaningful opportunity to sustainably improve our cash generation potential is by lowering rig operating costs.

To address this, we have several initiatives underway including optimizing manning levels and improving operational and supply chain processes to safely lower repair and the maintenance spend. We anticipate that these efforts will help us structurally reduce our daily operating costs. While the savings from these initiatives will depend on rig utilization, we expect to benefit regardless of activity levels. Lastly, we are reducing our capital expenditures for full year 2020 to $120 million, a 25% decrease from our prior estimates and we continue to scrutinize this spend carefully.

With market conditions expected to remain challenging, we're focused on what we can control, providing safe and reliable operations to customers and actively managing our cost base. By delivering efficient services and high levels of uptime, we best position the company to win the limited opportunities for new work that arise and keep our rigs utilized, provided they are economically viable contracts for Valaris. And through the rightsizing of our marketed fleet and overall rig footprint, along with our operating and support costs, we preserve cash as we navigate the industry challenges.

And with that, I'll turn it over to Jon.

Jonathan H. Baksht

Chief Financial Officer & Executive Vice President, Valaris Plc

Thanks, Tom, and good morning, everyone. We issued a press release yesterday that provides detailed explanations of our first quarter 2020 results on a sequential quarter basis. Therefore, my commentary today will

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focus on more significant items included within our results along with our cost reduction efforts and capital structure.

Starting with our first quarter results, we reported an adjusted EBITDA of negative $40 million. From an operational perspective, our first quarter financial results were negatively impacted by the following. First, as Tom mentioned, we had a non-drilling incident on Valaris DS-8 where the rig's BOP became disconnected. And as a result, the rig did not earn a dayrate for most of the month of March. In addition, we incurred some extra costs associated with remediating the situation. In total, this incident negatively impacted first quarter results by approximately $15 million, mostly in revenues.

In addition, first quarter contract drilling expense included $14 million of higher repair and maintenance costs, inclusive of contract preparation and startup costs for jackups in the North Sea. Lastly, contract drilling expense also included a non-cash charge of $5 million to write off a receivable from a customer impacted by the drop in oil prices.

Moving to other income. We repurchased $13 million of discounted 2021 maturities in early March prior to the significant decline in oil prices, which generated a $3 million gain in the first quarter. We reported a $152 million tax benefit for the quarter, primarily due to a $164 million benefit from discrete tax items. These discrete items occurred due to the release of certain liabilities as we received a favorable outcome on an uncertain tax matter, along with the benefit from the recently completed internal reorganization.

However, the largest item in our first quarter results was a $2.8 billion non-cash impairment to adjust the book value of several of our rigs. As Tom mentioned, industry challenges over the past two months have negatively impacted customer demand for offshore drilling services. This led to an impairment for three drill ships, three semisubmersibles, and seven jackups. The vast majority of this impairment was to adjust book values for six modern floaters to scrap.

In anticipation of a multi-year downturn, we are also taking decisive action by preservation stacking several competitive rigs, including three drill ships, one semi, and five jackups. In doing so, we expect to realize significant annual savings as compared to keeping these rigs in a warm-stacked state. While reactivation costs vary depending on asset type and duration of the stacking period, in general, we believe that the decision to preservation stack an offshore drilling rig breaks even in a little over two years. Given our outlook on the market and other rigs in our fleet that are currently or will soon be without contracts, we believe these are prudent decisions. We will reactivate these rigs when dayrates and contract durations can justify it. But as evidenced by our actions, we do not expect this will happen for at least two years.

Additionally, as further rigs come off contract, given the current environment, we'll evaluate quickly moving them to a preservation stacked state. To be clear, we are shifting our marketing approach from what we have done over the past several years including during the prior sector downturn. We will not be keeping many rigs particularly floating rigs available to pursue short-term work at near breakeven levels. That approach has more cash flow variability and is only successful at the rig level when high utilization was achieved. However, a non-working available rig can be a material cash liability. Without meaningful cash flow being generated from our backlog and with our high cost of capital, we can no longer take the risk of keeping rigs available to pursue short-term work with the hopeful view on the near-term recovery. Therefore, these rigs will remain stacked until market conditions become more favorable and contracting terms return to levels where we're able to lock in the necessary return on capital to justify a reactivation. These cost management actions, including efforts to right-size our support cost base and optimize rig operating costs that Tom spoke about earlier, will benefit our liquidity position going forward.

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As of March 31, we had $185 million of cash on the balance sheet and outstanding balance in our revolving credit facility of $329 million, leaving Valaris with approximately $1.3 billion of available revolver capacity. In total, available liquidity from cash and the remaining revolver capacity was approximately $1.5 billion. We remain in compliance with our debt covenants under our revolving credit facility including our debt-to-capitalization ratio which stood at 52% at the end of the quarter and we continue to draw on our revolver as a source of funding, having drawn approximately $30 million earlier this week to bring our outstanding revolver balance to approximately $410 million.

While we continue to have access to liquidity, the associated challenges presented by lower energy demand and an oversupply of hydrocarbons had meaningfully impacted demand for offshore drilling services. These challenging market conditions have led several customers to defer, suspend or cancel offshore projects. And in turn, we have seen the majority of the rig contracting opportunities we are pursuing get deferred or cancelled. As a result, we expect to continue to report losses and negative cash flows throughout the remainder of the year.

As we are taking rapid measures to address the financial impact of the challenging market conditions, we are also analyzing the costs to support our capital structure. With more than $6.5 billion of debt and outstanding balance on our revolving credit facility, annual interest expense of approximately $400 million is our largest non-operating cost by a wide margin. Therefore, we are evaluating various alternatives to address our capital structure and annual interest costs. To facilitate the evaluation of these alternatives, we are engaged in discussions with our creditors and their advisers around these alternatives including, without limitation, a comprehensive debt restructuring which may require a substantial conversion of our indebtedness to equity.

Given the sensitivities surrounding these discussions, we will not be providing further comment on the matter or holding a question-and-answer session at the conclusion of today's call and would refer all inquiries on the company's capital structure to Lazard in their capacity as Valaris' financial advisor.

Before I close today's call, I would reiterate Tom's comments around our cost control focus. It is clear that there are challenges ahead. And to better face these challenges, we must lower our costs to operate and support our rig fleet, while continuing to provide safe and reliable operations to customers. Cost efficiency will be a key differentiator for offshore drillers going forward irrespective of activity levels and we are determined to make Valaris the industry cost leader. I believe that this combined with strong capital discipline will position Valaris well for the future. This concludes our prepared remarks.

I'd like to thank you for your interest in Valaris and will now hand it back to our operator to close the call.

Operator: This conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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