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Valaris Ltd. (VAL)

Q4 2022 Earnings Call

CORPORATE PARTICIPANTS

Darin Gibbins
Vice President-Investor Relations & Treasurer, Valaris Ltd.

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.

Christopher T. Weber
Chief Financial Officer & Senior Vice President, Valaris Ltd.

Matthew Lyne
Senior Vice President & Chief Commercial Officer, Valaris Ltd.

OTHER PARTICIPANTS

Gregory Lewis
Analyst, BTIG LLC

David Smith
Analyst, Pickering Energy Partners LP

Fredrik Stene
Analyst, Clarksons Securities AS

Edward Kim
Analyst, Barclays Capital, Inc.

Kurt Hallead
Analyst, The Benchmark Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the Valaris Fourth Quarter 2022 Results Conference Call. All participants will be in listen-only mode. [Operator Instructions] Please note, this event is being recorded.

I would now turn the conference over to Darin Gibbins, Vice President of Investor Relations and Treasurer. Please go ahead.

Darin Gibbins

Vice President-Investor Relations & Treasurer, Valaris Ltd.

Welcome, everyone, to the Valaris fourth quarter 2022 conference call. With me today, our President and CEO, Anton Dibowitz; Senior Vice President and CFO, Chris Weber; Senior Vice President and CCO, Matt Lyne, and other members of our Executive Management Team. We issued our press release, which is available on our website at valaris.com.

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 expectations. 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. As a reminder, this morning, we issued our most recent Fleet Status Report, which provides details on contracts across our rig fleet. An updated investor presentation and ARO Drilling presentation will be available on our website after the call.

Now, I'll turn the call over to Anton Dibowitz, President and CEO.

Anton Dibowitz

President, Chief Executive Officer & Director, Valaris Ltd.

Thanks, Darin, and good morning and afternoon to everyone. During today's call, I will start by providing an overview of our performance during the quarter. I will then provide commentary on the outlook for the offshore drilling market, highlight some recent contract awards and discuss our strategy for maximizing shareholder value during the unfolding industry upcycle. After that, I'll hand the call over to Chris to discuss our financial results and guidance.

I'd like to start by acknowledging the focus and efforts of the entire Valaris team, which resulted in us continuing to deliver excellent operational performance, achieving revenue efficiency of 98% in the fourth quarter and 97% for full year 2022.

This is commendable performance given we reactivated four floaters during the year. These projects required a significant amount of internal resources and attention. And we are extremely pleased to have maintained high levels of operational performance that our customers expect from us under these circumstances.

The safety of our offshore crews and onshore personnel is at the core of what we do as an organization, and we achieved some notable milestones during the quarter, including several rigs reaching two years and our Broussard Warehouse achieving six years without a recordable incident. These achievements are the result of our highly-skilled and dedicated workforce. We believe that our people are the most important element of our success and we recognize that a motivated, engaged and diverse workforce is essential to delivering high performance.

As a result, we continue to invest in our people, both onshore and offshore. Our bold leadership training for offshore supervisors was attended by approximately 650 personnel in 2022. We also recently completed two pilot workshops for our new onshore leadership program and will be holding more of these courses in 2023 to develop senior leadership throughout the organization. Development of our people is just one element of our ESG program. We are committed to making progress in our sustainability journey and we have a strong framework in place to advance our efforts. Our sustainability program is primarily focused on reducing emissions from our own operations and partnering with our customers on their ESG efforts. We have already implemented several solutions on-board our rigs to help lower emissions, such as engine optimization and SCR systems, and we will continue to make targeted investments in our fleet, where it makes economic sense to do so.

During the fourth quarter, we issued our latest Annual Sustainability Report, which was prepared in accordance with the Sustainability Accounting Standards Board, and we will be further enhancing our disclosures in the 2022 report. Following the release of our 2021 Sustainability Report, our ESG rating was upgraded by both MSCI and Sustainalytics, two of the leading ESG rating agencies. As a result, we now have the highest ESG rating amongst offshore drillers with both MSCI and Sustainalytics.

Moving to our financial performance for the quarter. We generated adjusted EBITDA of $54 million and adjusted EBITDAR adding back one-time reactivation costs of $75 million. Adjusted EBITDA and EBITDAR were in line with and higher than our prior guidance respectively, but were lower than the third quarter, primarily due to the ongoing weakness in the harsh environment jackup market, which I'll discuss in more detail in a moment.

During 2022, we successfully executed four major floater reactivations, with all four rigs returning to work largely on time and on budget. We are currently reactivating VALARIS DS-17 for a contract with Equinor offshore Brazil starting later this year and we're in advanced discussions regarding a further drillship reactivation for a multi-year project expected to commence within the next 12 months. The reactivation of VALARIS DS-17 and any additional reactivations will impact our financial results and cash flow in 2023, as we spend money to return rigs to the active fleet.

However, based on our contract profile, we believe that 2024 will represent an inflection point for earnings, with at least three drillships expected to complete legacy contracts and be available for re-contracting at market rates, along with meaningful contributions from VALARIS DS-17 and any additional rigs that we begin to reactivate in 2023.

We are optimistic about these repricing opportunities because the fundamental outlook for our industry remains constructive. Despite the macroeconomic uncertainty, demand for hydrocarbons continues to increase. The IEA forecasts that oil and gas demand will increase by 1.9 million barrels per day to approximately 102 million barrels per day in 2023, with nearly half the expected gain attributed to increased demand from China following the lifting of COVID restrictions.

Meanwhile, the IEA forecast supply growth to slow to 1 million barrels per day as compared to 4.7 million barrels per day in 2022, in part due to expected declines in output from Russia. A lack of investment in new sources of production over the past several years has contributed to a tight supply picture, while events over the past 12 months have brought the topic of energy security to the [ph] fore (00:07:37), and highlighted the importance of oil and gas in meeting the world's need for secure and affordable energy.

A significant increase in investment will be required to rebuild global supplies, with offshore production expected to continue playing an important role due to the scale provided by offshore reserves, attractive breakeven prices for most offshore projects and lower carbon intensity as compared to onshore oil and gas extraction. We believe that these factors, along with the significant reduction in the global rig fleet, especially floaters over the past several years, lay the foundation for sustained industry upcycle in which Valaris is poised to thrive.

Commodity prices remain at levels that are highly supportive of continued investment in offshore oil and gas projects. According to S&P Global, offshore exploration and production spending is expected to increase by 14% in 2023, following an estimated 18% increase in 2022.

In addition, offshore project approvals in 2023 and 2024 are expected to be at their highest levels in more than a decade, which should help drive capital expenditures for several years to come. The constructive macro environment and increased upstream spending have led to increases in contracting and tendering activity across both floaters and jackups. The number of contracted benign environment floaters has steadily increased from the lows in late 2020 and early 2021 and has nearly returned to pre-COVID levels.

Active utilization for drillships is currently above 90% and has been above 85% for more than 12 months, which has led to meaningful improvements in day rates, with leading edge day rates now pushing in the low to mid 400,000s. As of the end of 2022, rig years of open demand at tender or pre-tender stage for benign floaters were 14% higher than 12 months ago and we continue to see new opportunities coming to market, particularly offshore Brazil. Building on last year's eight rig tender, Petrobras has been actively seeking rigs for its BMS-11 and Búzios fields, and recently launched a new tender for up to four floaters on long-term contracts commencing in 2024. This is in keeping with reports that Brazil is seeking to double production by 2030. And with offshore resources that can deliver production at attractive economics, we anticipate that Brazil will be a significant driver of offshore demand over the next several years. We continue to see a mix of short term exploration and longer term development programs offshore West Africa, including in Namibia, which was estimated to have the world's largest offshore discovery in 2022.

The potential for this market is highlighted by the fact that one major IOC recently announced that 50% of their 2023 exploration budget is allocated to Namibia alone. New discoveries, along with a pickup in activity in other parts of West Africa could lead to increased rig demand for the floater market going forward. We have a strong footprint in the region and we're recently awarded a 330 day extension with Shell for drillship VALARIS DS-10, which will keep the rig working through March 2024 and is the final priced option under the rig's current contract.

We're also in discussions to fill some of the available time in 2023 for VALARIS DS-12. We also see opportunities in the Gulf of Mexico, both on the US and Mexican sites. On the jackup side of the business, the number of contracted jackups has increased by more than 15% from lows in early 2021, now are at the highest level since mid-2015. Most of this increase occurred over the past 12 months, primarily driven by demand from the Middle East. As a result, active utilization for jackups is above 90%, and day rates continue to trend upwards as demonstrated by our most recent contract awards at $125,000 per day or higher for work offshore Australia and Trinidad.

The outlook for jackups continues to be constructive with rig years of open demand at tender and pre-tender stage 20% higher at year-end as compared to 12 months ago.

While the benign environment jackup market has improved meaningfully over the past 12 months, the timing and pace of a recovery in the harsh environment jackup market is uncertain. As highlighted on our third quarter call, we do not expect opportunities to materialize in Norway until 2024. In addition, the outlook for the rest of the North Sea has softened, as we are now also seeing more projects delayed in the UK with customers citing the uncertainty created by changes to fiscal policy related to windfall taxes.

Our three Keppel FELS N-Class rigs, which are capable of operating in Norway, are all now located in the UK with only the VALARIS Norway partially contracted for the year ahead. The Stavanger is currently undergoing a special periodic survey, and we are actively marketing both the Stavanger and the Norway for projects in the North Sea, as well as further afield.

We do not see sufficient prospects over the next 12 to 18 months to keep all three of these rigs working. And as a result, we are preservation stacking the Viking in Dundee to reduce costs while the rig is idle. This uncertainty is expected to have a negative impact on our business in 2023, particularly in the first half. Based on customer discussions, we expect the market outside of Norway to begin improving in the second half of the year, although most of the opportunities we see at present are short-term in nature.

Moreover, given the role that hydrocarbons should play in ensuring European countries' energy security, we expect that demand offshore Norway, the UK, and other sectors of the North Sea will improve in 2024 and create a more balanced harsh environment jackup market in future years. Against this backdrop of a broadly constructive market environment and renewed optimism within our sector, I'd like to spend a few moments discussing our fleet strategy as we navigate the unfolding industry upcycle. We continue to employ a disciplined fleet management strategy with a focus on driving long-term shareholder value. Our priority is to ensure that the active fleet remains highly utilized, while having a large fleet means that we can pursue a portfolio approach to contracting with a mix of longer and shorter duration contracts, ideally with staggered rollovers. We also continue to regularly assess our fleet for retirement and divestiture candidates.

As part of our fleet strategy, we aim to have a critical mass of rigs in priority basins to benefit from economies of scale. Following the reactivation of VALARIS DS-17, we'll have three floaters operating at each point of the Golden Triangle. Our other two drillships in Brazil, VALARIS DS-4 and DS-15 are both expected to finish their current contracts in mid-2024, leaving them well-positioned to roll on to higher day rate contracts in a region where we expect to see continued growth.

We have proven our ability to win work for and reactivate our preservation stacked assets, and we see attractive opportunities to commence reactivation of additional drillships in 2023. We will remain disciplined in exercising our operational leverage by only returning additional stacked rigs to the active fleet for opportunities that provide meaningful returns over the initial contract.

Given the opportunities we see in the market today, we believe that investing in our fleet by reactivating our high specification stack drillships is an attractive use of our available cash as we expect that these investments would generate significant returns for our shareholders.

In addition to our stacked fleet, we have options to take delivery of newbuild drillships, VALARIS DS-13 and DS-14 by year-end 2023, for a shipyard price of approximately $119 million and $218 million, respectively. VALARIS DS-13 is attractively priced compared to recent market transactions for similar assets, while DS-14 is in line with recent transactions. Both drillships are amongst the highest specification assets in the global fleet and have two BOPs, which remains a preference for customers globally. We will continue to evaluate our options regarding these rigs as we see the market evolve over the course of the year.

The pool of available supply is shrinking as stacked rigs are absorbed into the active fleet when supported by demand. Following the recent announcement by a competitor to utilize one of their stacked drillships for non-drilling activities, we count only 14 competitive drillships remaining on the sidelines, 13 of which are owned by Valaris and two other major drilling contractors.

We believe that our demonstrated track record of successfully reactivating rigs leaves Valaris well-positioned to benefit when the right opportunities present themselves. There are a further eight newbuild drillships remaining at South Korean shipyards, including VALARIS DS-13 and DS-14. We expect these rigs to come to market in a staged manner when demand supports incremental supply and likely only if these rigs are in the hands of established international drilling contractors.

Importantly, we currently believe that it is unlikely that we will see another floater newbuild cycle, given high build costs, long lead times and limited shipyard availability. Therefore, we anticipate that the current rig fleet will form the basis of supply for the foreseeable future. A large portion of demand growth in the jackup market over the past 12 months has been driven by the Middle East, particularly Saudi Arabia. Valaris has significant exposure to this market through ARO Drilling, our unconsolidated 50/50 joint venture with Saudi Aramco. And ARO was recently awarded multi-year contracts with Aramco for VALARIS 76 and 108, which will be leased to ARO following completion of their existing contracts.

2023 is expected to be an important year in the growth of ARO, with two newbuild rigs due to be delivered. As a reminder, each of the newbuilds will be backed by an initial eight-year contract with Saudi Aramco at a day rate set to achieve a six-year EBIDTA payback on the total price of the rig. Following the initial contract, each newbuild will be contracted for at least eight more years in aggregate, with pricing set every three years utilizing a market pricing mechanism. We see significant appetite in the local market for financing the newbuilds and we expect funding to be secured prior to delivery. Importantly, we do not expect that Valaris or Aramco will need to provide any additional financing to ARO to fund the newbuild program. Furthermore, there is significant investor interest in the Middle East for drilling businesses.

Last year, a local driller with both onshore and offshore rigs successfully completed its IPO, raising more than $700 million in a substantially oversubscribed offering at an attractive valuation. We remain focused on highlighting what we believe is the significant value inherent in ARO and recent asset transactions and IPOs in the region helped to support this view.

I will conclude by reiterating some of the key points from our prepared remarks. First, we continue to deliver excellent operational performance, as demonstrated by achieving 98% revenue efficiency in the fourth quarter and 97% for 2022. Second, the fundamental outlook for our industry remains highly constructive, with offshore exploration and production spending expected to increase over the next several years, which is anticipated to drive increased demand for our services. And third, we will continue to exercise our operational leverage in a disciplined manner by returning our high-quality stacked rigs to the active fleet for opportunities that will generate meaningful returns. And we see attractive opportunities to commence reactivation of additional drillships in 2023, including one for which we are in advanced discussions.

In summary, we will continue executing our focused, value-driven and responsible strategy, and we believe that our strategy will drive meaningful earnings and free cash flow during the unfolding industry upcycle.

I'll now hand the call over to Chris to take you through the financials.

Christopher T. Weber

Chief Financial Officer & Senior Vice President, Valaris Ltd.

Thanks, Anton, and good morning and afternoon, everyone. In my prepared remarks today, I will provide an overview of fourth quarter results as well as guidance for the first quarter and full year 2023. In addition, I will briefly review our financial position and capital structure. I will also highlight our fourth quarter results press release, which includes our trailing five quarter results, as well as various supplemental data and our latest Fleet Status Report that we published this morning.

Moving now to the fourth quarter results. Adjusted EBITDA was $54 million compared to $76 million in the prior quarter and adjusted EBITDAR, adding back one-time reactivation costs was $75 million compared to $94 million in the prior quarter. Revenues were $434 million compared to $437 million in the prior quarter. Excluding reimbursable items, revenues decreased to $413 million from $416 million, primarily due to lower utilization and lower average day rates for the harsh environment jackup fleet, but partially offset by an increase in utilization for the floater fleet. Jackup revenues decreased primarily due to VALARIS Stavanger completing its contract offshore Norway and idle time between contracts for VALARIS 123, 144 and 115. This was partially offset by more operating days for VALARIS 118 and 92, following a contract start-up and a special periodic survey, respectively.

Floater revenues increased primarily due to higher revenue efficiency across the floater fleet and a full quarter of revenues for VALARIS DS-4 and DS-9, which commenced contracts early in the third quarter,. Contract drilling expense was $353 million compared to $337 million in the prior quarter. Excluding reimbursable items, contract drilling expense increased to $333 million from $316 million, primarily due to an increase in operating days for the floater fleet, which have a higher per day operating cost, as well as higher reactivation cost which increased to $21 million from $18 million.

Moving to our shore base costs. General and administrative expense increased to $24 million from $19 million in the prior quarter, primarily due to higher personnel costs and professional fees. Onshore support costs, which are included within contract drilling expense in the income statement increased to $33 million from $30 million, primarily due to higher personnel costs. The sum of these two items provide our total onshore support costs, which increased to $57 million from $49 million in the prior quarter.

Depreciation expense increased marginally to $24 million from $23 million in the prior quarter. Other expense was less than $1 million compared to other income of $30 million in the third quarter 2022. Other expense in the fourth quarter included foreign currency exchange losses, primarily related to revaluation of balance sheet accounts of $13 million as it compared to gains of $10 million in the third quarter. Third quarter other income also included non-cash interest income of $15 million related to the write-off of the discount attributable to the $40 million of shareholder notes receivable repaid by ARO. These items were partially offset by higher cash interest income and a small gain on sale associated with the rig sold in the prior year. Tax expense was $10 million compared to $14 million in the prior quarter. Adjusted for discrete items, tax expense increased to $13 million from $12 million.

Moving now to our first quarter 2023 outlook, we expect total revenues will be in the range of $410 million to $420 million as compared to $434 million in the fourth quarter. Revenues are expected to decrease primarily due to lower activity for harsh environment jackups in the North Sea and planned out of service days for floaters completing contract-specific requirements in BOP recertification.

Regarding the North Sea, we expect five rigs to be idle for at least part of the first quarter The VALARIS Stavanger and Viking have both been moved to the UK from Norway following completion of contracts in November and January respectively. The Stavanger is currently undergoing a special periodic survey in Dundee and is actively being marketed for work. Given the uncertain near-term outlook in Norway and the rest of the North Sea, our expectation is that the VALARIS Viking will be idle for at least 12 months, and therefore, we are preservation stacking the rig in Dundee to reduce costs while the rig is idle. In addition, the VALARIS Norway was idle for the first half of the quarter before it recently started its contract with Centrica. Finally, VALARIS 121 and 247 are undergoing special periodic survey work during the first quarter in advance of their next contracts.

We anticipate that contract drilling expense will be in the range of $380 million to $390 million as compared to $353 million in the fourth quarter. The increase is primarily driven by three items. First, higher repair and maintenance costs, as we expect to have four jackups undergoing special periodic survey projects in the first quarter. As a point of comparison, we effectively had just one jackup undergo a special periodic survey during the fourth quarter. Second, higher offshore compensation costs driven by wage adjustments that were implemented earlier this year. And third, higher reactivation costs primarily due to the continued reactivation efforts on VALARIS DS-17 in advance of its contract commencement later this year.

Reactivation costs in the first quarter are expected to be approximately $25 million versus $21 million in the fourth quarter. General and administrative expense is expected to increase to $25 million to $27 million from $24 million in the prior quarter, primarily due to higher professional fees and higher compensation costs.

Adjusted EBITDA is expected to range from breakeven to positive $5 million compared to $54 million in the fourth quarter. And adjusted EBITDAR is expected to be $25 million to $30 million compared to $75 million in the fourth quarter.

I will now provide preliminary financial guidance for full year 2023. Consistent with our past practice, this guidance does not account for any incremental reactivation for contracts that have yet to be executed. Therefore, it does not assume any additional contracted reactivations other than the completion of the DS-17 project. Based on reactivation lead times of approximately 12 months for floaters, if we were to reactivate additional drillships in 2023, it would have a negative impact on EBITDA and CapEx, but would increase expected earnings and cash flow in future years. 2023 revenues are expected to be $1.8 billion to $1.9 billion, up from $1.6 billion in 2022. We anticipate that revenues will increase primarily due to higher average day rates; VALARIS DS-17 commencing its contract later this year following its reactivation; and the full year impact of four floaters that were reactivated during 2022. This was partially offset by lower utilization for harsh environment jackups in the North Sea.

Contract drilling expense is anticipated to be $1.43 billion to $1.53 billion as compared to $1.38 billion in 2022. This year-on-year increase is primarily due to more operating days for the floater fleet resulting from a full year impact of 2022 reactivations and a partial year of DS-17 operations following the expected completion of its reactivation project midyear. Higher compensation costs for offshore crews and associated support personnel and higher planned repair and maintenance costs driven by six special periodic survey projects for jackups. This is 2 times the number of projects completed in 2022. Of the six projects planned in 2023, five are scheduled to occur in the first half of the year with four occurring in the first quarter and one in the second quarter. The projects are front-loaded in the year in order to take advantage of idle time between contracts and due to class requirements. And they will have an outsized cost impact on the first half of year financial results, especially the first quarter. These increased costs versus the prior year are partially offset by lower reactivation spend, resulting from fewer rigs returning to the active fleet in 2023 compared to last year.

Moving to G&A expense, we expect $105 million to $110 million of cost for the year, up from $81 million in 2022. This increase is mainly due to the company transitioning into a more normal level of G&A cost, as we build out corporate infrastructure following our relisting in May 2021. In 2023, we will have a full year of a complete executive management team and an additional year of long-term incentive plan awards that are granted annually.

Since these awards vest over three years, this component of compensation costs is expected to reach full run rate in the second half of 2023. In addition, G&A will be impacted by a full year of our new sustainability and new energy function, higher compensation costs as we have reinstated some employee benefits that were eliminated in the last downturn, and higher professional fees.

When combined with $135 million to $140 million of support costs included within contract drilling expense, this provides total onshore support costs of $240 million to $250 million. The sum of these items provides adjusted EBITDA of $240 million to $280 million and adjusted EBITDAR, which add backs one-time reactivation costs of $280 million to $320 million.

We expect first quarter EBITDA will be the low point for the year and for EBITDA to increase sequentially each quarter thereafter with approximately 80% of 2023 EBITDA generated in the second half of the year. Second quarter EBITDA should improve relative to the first quarter as jackup rigs begin returning to work following their surveys or other idle periods, further utilization improves due to lower out-of-service days and reactivation expense moves lower as the DS-17 project nears completion.

In the second half of the year, we expect EBITDA to move materially higher as the DS-17 starts its contract with Equinor in Brazil, rigs complete legacy contracts enrolled to higher day rates, utilization for our North Sea jackups improves and we execute just one special periodic survey project versus five in the first half of the year.

Moving now to capital expenditures. Fourth quarter CapEx of $53 million was in line with the prior quarter. Fourth quarter CapEx included $20 million for maintenance CapEx and $33 million for enhancements and upgrades, primarily for reactivation, contract-specific upgrades on reactivated rigs and steel replacement for the VALARIS 92. Full year 2023 capital expenditures are anticipated to be $260 million to $300 million, compared to $207 million in 2022. Maintenance CapEx is expected to be $120 million to $130 million versus $69 million in 2022. This increase is primarily due to an increase in the number of BOP re-certifications and overhaul cost for drilling and well control equipment due to more floaters working during the year, plus an increase in the number of jackup special periodic surveys that I mentioned earlier.

We are also restocking capital spares following several floater reactivations that have depleted our levels of long lead equipment. Enhancement and upgrade spend is expected to be approximately $140 million to $170 million, including approximately $80 million to $90 million of reactivation and associated contract specific CapEx, primarily related to VALARIS DS-17. The remaining enhancement and upgrade costs in 2023 are largely related to life enhancement work for VALARIS 72 before continuing its contract with Eni, well control and drilling equipment upgrades on VALARIS 76 ahead of its five-year bareboat charter with ARO and the purchase of an MPD kit.

We expect to receive customer reimbursements for capital expenditures of approximately $27 million in 2023 related to customer-specific upgrades on VALARIS DS-17. This represents the second customer reimbursement for capital expenditures on this project as we previously received $27 million at the end of last year. This CapEx guidance does not include any assumed expenditures for exercising our options to purchase drillships VALARIS DS-13 and DS-14. As a reminder, we have the option to purchase these rigs for $119 million and $218 million, respectively, through the end of 2023. Given recent drillship contract economics and comparable asset transactions, DS-13 is a very attractive option and DS-14 is priced in line with recent transactions for comparable assets.

First quarter CapEx is expected to be $65 million to $75 million, comprised of $25 million to $30 million for maintenance CapEx and $40 million to $45 million for enhancements and upgrades, including $25 million to $30 million of reactivation and associated contract-specific CapEx primarily related to VALARIS DS-17. The remaining spend on enhancements and upgrades is primarily related to contract preparation costs for VALARIS 115 in advance of the rig commencing a multi-year contract with Shell in Brunei as well as the VALARIS 72 life enhancement work.

Now, I'll move to the fourth quarter results as well as the first quarter and full year 2023 outlook for ARO Drilling. Our 50/50 joint venture with Saudi Aramco. As a reminder, ARO is not consolidated in the financial results of Valaris. ARO EBITDA increased to $29 million from $17 million in the prior quarter, primarily due to higher utilization as certain rigs returned to work following out-of-service days for planned maintenance.

ARO's first quarter EBITDA is expected to decrease to $21 million to $23 million from $29 million in the fourth quarter, largely due to higher planned maintenance costs and higher expected bareboat charter expense in the first quarter. ARO's full year 2023 EBITDA is expected to be approximately $110 million to $120 million as compared to $99 million in 2022. The expected EBITDA increase is largely due to the startup of newbuild rigs 1 and 2 which are expected to be delivered this year.

As Anton mentioned earlier, we expect both rigs to receive financing prior to their delivery and we do not expect to provide additional financing to ARO to fund the newbuild program.

I'll now provide a brief overview of our financial position and capital structure. At the end of the fourth quarter, we had cash and cash equivalents of $724 million, plus restricted cash of $24 million. Our total liquidity increased by $104 million during the quarter, primarily due to positive cash flow from operations of $155 million, partially offset by CapEx of $59 million. Included in cash flow from operations was a $55 million refund payment from the IRS related to the CARES Act. In January, we received an additional $45 million payment related to the CARES Act and we still have a further $19 million outstanding. However, the timing of this receipt is uncertain. On a full year 2022 basis, our total liquidity also increased by $104 million, primarily due to positive cash flow from operations of $128 million, which included the $55 million CARES Act refund I just mentioned. Net asset sale proceeds of $150 million, primarily from the sale of jackups VALARIS 113 and 114 and the $40 million of shareholder note receivable repaid by ARO, partially offsetting these positive cash inflows was $207 million of CapEx, which included a $117 million of reactivation and associated contract-specific CapEx.

Looking to 2023, we expect to be cash flow positive, assuming no further reactivations and no spend on the DS-13 or DS-14 newbuild options. Regarding our capital structure, we have only one tranche of debt, our $550 million senior secured notes due in 2028 that has a first call in April 2023. As a reminder, the cash on our balance sheet is our only source of liquidity, as we do not currently have a revolving credit facility. Ideally, we would like to implement a new capital structure that includes a revolver in a more regular way high yield note. Putting in place a revolver with attractive terms would improve the cost and efficiency of our capital structure, while the extra liquidity would allow us to hold less cash on the balance sheet over time and give us more flexibility when making capital allocation decisions.

However, in contrast to many of our offshore drilling peers, we are in the fortunate position of not having to do something. We plan to be opportunistic and only execute a revolver and refinancing of our existing note, if the size, pricing and terms are attractive and do not significantly impact our operational and strategic flexibility in both strong and weak market environments.

Now, I'll hand it over to Anton, who will make a few closing remarks.

Anton Dibowitz

President, Chief Executive Officer & Director, Valaris Ltd.

Thanks, Chris. I want to wrap up the call with a few comments on capital allocation priorities, including shareholder returns. We have ongoing discussions regarding capital allocation as a management team and with our board, and we are all aligned on the priorities for our cash. The first of these priorities being to execute the operational leverage in our business in a disciplined manner in order to create long-term shareholder value. We have three stacked drillships and purchase options for two newbuild drillships and we are currently actively pursuing contracting opportunities for these rigs. With drillship day rates in the $400,000 per day range, we're able to generate meaningful returns on the reactivation investment over just the initial contract and we are able to generate significant earnings and cash flow.

We are constructive on the market. However, we cannot predict with precision the timing or terms of new contracts. We could have several reactivation projects in one year or they could be spread over a longer period of time. Similarly, we may enter into contracts where material portion of upgrades and reactivation costs are reimbursed upfront, or contracts where a more significant portion of the upgrades and reactivation costs are recouped in the day rate over the initial term, but which are nonetheless attractive opportunities. These variables lead us to be somewhat conservative from a cash planning and capital allocation perspective today, because most importantly, we want to be able to execute on all attractive contract opportunities.

The second priority for our cash is pursuing strategic growth opportunities. The offshore drilling industry has benefited from the efficiencies enabled by prior combinations and Valaris has been a major driver of those efforts. However, there are opportunities for additional consolidation, whether it is at the corporate or asset level, and we want to help drive it further as long as the transaction is value enhancing and accretive to our shareholders. We believe having cash available to fund all or a portion of a transaction depending on its size is valuable. Our priority for any excess cash is returning it to shareholders. With a positive long-term market outlook ahead of us, we are focused on transitioning Valaris into a consistent cash generating and yielding investment for our shareholders. While our first priority is putting our stacked rigs to work for attractive returns, there may still be catalysts for opportunistic return of capital like value accretive rig sales or a significant dislocation in our stock price.

Looking forward, we expect 2024 to represent an inflection point in our results. As legacy drillship contracts roll to market rates, we get a full year benefit of the DS-17 contract and expected recovery in the North Sea takes hold. Rig reactivations depending on their timing could further improve our results in 2024 or beyond. We expect that as we complete reactivations and the active fleet has rolled to market rates, we will generate meaningful free cash flow, providing the ability for us to shift from an opportunistic to a consistent and structured return of capital program.

In conclusion, I remain excited about the outlook for Valaris. We will continue executing our strategy of being focused, value driven and responsible and believe that our strategy will drive increased earnings and meaningful free cash flow during the unfolding industry upcycle. We've now reached the end of our prepared remarks.

Operator, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] And today's first question comes from Greg Lewis with BTIG. Please go ahead.

Gregory Lewis
Analyst, BTIG LLC

Q

Yeah. Thank you. And good afternoon and good morning, everybody. And, Anton, thanks a lot for the prepared remarks. Super helpful. But I was hoping to get just a little bit more color around the rig reactivations and the newbuilds, and your comments around capital allocation. I guess, I'll just ask a few questions at once. As we think about the ability to reactivate rigs, realizing that there's a lot of customer demand, as we think about re-certifications and supply chain and crewing, is that more of the hindrance? And realizing that if the market looks pretty firm and there could be opportunities to reactivate and take delivery of the newbuilds in a compressed window, is that really – is that possible, given all of the things I just mentioned?

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.

A

Good question. Absolutely, Greg. Look, what I will say is one of the true prowess of this organization is the ability to effectively reactivate rigs. There's a demonstrated track record. We've reactivated four rig last year, and as importantly as bringing those rigs to market largely on time and on budget, on average is the fact that as an organization we delivered 97% revenue efficiency over the year. So it's as important to execute the reactivation project as it is to have those rigs operate at the same level as the rest of the active fleet when they get back to work.

We have extended the duration that we expect a new reactivation. So on the [ph] 17 (00:45:50) for example, that project is a year versus nine months before. But this is an organization that has great control of executing operational delivery. For us, it's more -- if I go back to the strategy of being focused and disciplined, it's about finding the right opportunities as the constructive market continues and those incremental demand comes to market to find the right opportunity to bring those rigs back in a measured pace. And we see that those opportunities are there. I think we had made some comments about being in advanced discussions for at least one more drillship to go back. And I'm optimistic about 2023 in general that where there will be additional opportunity.

So it's not -- I wouldn't say, there's a constraint because of the project. I think it's more about being focused and disciplined and finding the right timing and the right opportunities to bring those rigs back.

Gregory Lewis
Analyst, BTIG LLC

Q

Okay, great. Super helpful. And then realizing that the focus has been on – the focus of that conversation is around the floaters and realizing and understanding that, one of the N-Class rigs has been idled. As I guess we look around our other basins like West Africa and let's say the Golden Triangle area and even in Asia, we still do have some stacked jackups. As we think about the next 12 or 18 months, do you see a scenario where we could see some of those rigs go back to work or at least in the near term the focus really is on just bringing floaters that are on the sidelines back into the working fleet?

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.

A

Now, there's certainly been an improvement in a more constructive benign jackup market driven largely by what's happened in the Middle East with a lot of rigs being relocated to Saudi in particular. There are opportunities for jackups, but again, for us, it's about the capital allocation decision. And if you call it the investment return we get on those reactivation economics. So today, given the fact that floater day rates, if you look at drillships of, in essence, doubled from 200s to the 400s over the last couple of years, jackups have improved kind of from the 70s north of 100. We've executed some contracts in certain markets above 125. But on the absolute, looking at it on a capital allocation basis, the economics of allocating capital to a reactivation of a drillship is superior to that of doing a jackup today. That's not to say that those opportunities aren't there. And we continue to look for attractive opportunities for our jackups. And if we find one, we'll absolutely execute on those. It's just a great priority on where we get the best returns.

Gregory Lewis
Analyst, BTIG LLC

Q

Okay. Understood. Thank you for the time and have a great day.

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.

A

Thanks. Appreciate the questions.

Operator: And our next question today comes from David Smith of Pickering Energy Advisors. Please go ahead.

David Smith
Analyst, Pickering Energy Partners LP

Q

Hey, good morning and thank you for taking my questions.

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.

A

Good morning.

David Smith
Analyst, Pickering Energy Partners LP

Q

In your prepared remarks, Anton, you mentioned there may be catalysts for opportunistic returns of capital. You mentioned rig sales as a potential catalyst. Would you consider the CARES Act refund to be a catalyst for opportunistic returns?

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.
A

Yeah. Let me let Chris start and just kind of update everybody on where we are on our CARES Act refunds and then I'll come back and cover your question after.

Christopher T. Weber
Chief Financial Officer & Senior Vice President, Valaris Ltd.
A

Yeah. So from a from a CARES Act refund perspective, we got the $55 million in the fourth quarter. We got $45 million in January, and we've got $19 million remaining. As we think about these CARES Act refunds, these aren't surprises to us. These obviously, we've been waiting for a long time for them. They've been in our in our planning models. So we don't necessarily consider them a catalyst or found money from that perspective.

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.
A

Yeah, Dave, I'd reiterate kind of some of my prepared remarks, I mean, we have, ongoing discussions in the management team and with our board about capital allocation and our focus again is following the strategy of being focused and disciplined and investing capital to create long-term shareholder value. And for us today, including that CARES Act refund, it's about allocating capital to attractive economics on reactivation, particularly of our drillships. There is some opportunity for M&A and we want to have cash available if those attractive opportunities are available, but our priority is to return any excess cash to shareholders.

Today, that means – today, that means being opportunistic in the case of dislocation and stock price or if we do have some opportunistic rig sales. And that's largely driven by the fact that our first priority being return of drillships to the market for attractive economics, I can't tell you exactly what those contracts are going to look like. In a [indiscernible] (00:50:55) in the high-class scenario, we have multiple reactivation of our remaining drillships, all going on this year, right? Heading to that -- increasing that inflection point in 2024 where we're generating even more significant cash and return and can get to a structural return scenario of returning cash. If the market has -- as it develops this year, it becomes a little more spread out, and those reactivations are over a greater period of time and/or we have to enter into contracts where we're recovering those reactivation economics over the term of the contract, but it's still a great attractive opportunity.

So, we need a couple of those pieces to fall in place for us to get to that place of structural return. But the CARES Act kind of just goes into our basic numbers and we'll see how the rest of the year as some of these pieces fall in place.

David Smith
Analyst, Pickering Energy Partners LP
Q

Very much appreciate it. And if I can ask a quick follow-up, Chris.

Christopher T. Weber
Chief Financial Officer & Senior Vice President, Valaris Ltd.
A

Sure.

David Smith
Analyst, Pickering Energy Partners LP

Q

Going back to your comments about the interest in a new capital structure, a revolver and high yield note. Wanted to kind of gauge your optimism and outlook for -- is that something achievable this year? What do you need to see happen before you would hope to get that in place?

Christopher T. Weber
Chief Financial Officer & Senior Vice President, Valaris Ltd.

A

Yeah, I mean, we've been pretty vocal for a while talking about our desire to get a regular way capital structure in place, which includes a revolver. And then obviously to do that, we need to refinance the note given the terms of the note. And so that's been on the table for a long time. We'd like to be able to execute that this year. I think, there could be opportunities to do that. We are talking to our banks about that. But I think it's really important for us is that we don't have to do that. And so if we -- we don't like the terms, the size of the pricing that we see, we don't have to do it. And so for us, this is opportunistic, if we can find something that allows us to do that, and we want to be able to execute on that. But again, it needs to be on size, pricing terms that makes sense for us and it doesn't overly restrict us from an operational or strategic perspective.

David Smith
Analyst, Pickering Energy Partners LP

Q

Appreciate it. That's it from me.

Operator: Thank you. And our next question today comes from Fredrik Stene with Clarksons Securities. Please go ahead.

Fredrik Stene
Analyst, Clarksons Securities AS

Q

Hi, Anton and team, and thanks for the comprehensive remarks today. Super helpful. I think a few of my questions have been answered already, but I wanted to pivot a bit into ARO on your plans there. You mentioned financing of the two newbuilds with the local money, if not ample, at least available. And then you talked about the different IPOs that have been done in the Middle East for these local drillers. So I think, right now, ARO, it's a growth story and for some time, maybe the market has kind of neglected a bit what could happen there. So I was wondering, if you envision going the route of an IPO with that asset, do you have any timeline in mind? Do you have any kind of events that would need to happen before you do something like that? And if you do some sort of IPO or strategic divestment on that side, what do you think will happen with the rigs that you lease into ARO? Would that -- likely that those will be part of such a transaction or do you think you'll continue to lease them into that, if you're kind of fully letting it go? So any thoughts that you can spare would be super helpful.

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.

A

Absolutely, Fredrik. It's a great question, because I think the value of ARO is a strategic asset to Valaris is somewhat underappreciated by many people because we don't consolidate it. What I will say, at a high and macro level, this is a 50/50 joint venture with the biggest user of 9 jackups in the world in a market where some could say colloquially, the last well in the world will be drilled. 15 rigs operating today. We recently announced two contracts of rigs that will transition, plus two newbuilds this year. This will be 19 rigs operating once that process happens.

I think there are some -- I'm not going to get into details of kind of what the thinking is at ARO, but I think there are some natural kind of timing points where it may make sense to look at more strategic options for ARO as far as value realization. And that is particularly the two newbuilds. The newbuild story with 20 rigs being built in ARO and the last 18 in Kingdom is an important part of ARO's growth story. And what those first two rigs being delivered this year, getting on contract, demonstrating that contract model with the first contract eight years with six-year EBITDA payback, and along with that committing to the additional rigs in the newbuild cycle is an important milestone for ARO and the venture. And I think, although we continue to have discussions at that at the board level and in ARO, that would be a natural point for us to start looking at what's next. So I don't want to comment more than that.

Fredrik Stene
Analyst, Clarksons Securities AS

Q

That's very helpful. Thank you so much. That's it for me.

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.

A

Thanks. Thanks, Fredrik.

Operator: And our next question today comes from Eddie Kim at Barclays. Please go ahead.

Edward Kim
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. Just regarding the cold stacked assets that you're in, in advance discussions on reactivating, you noted this was a program expected to commence within the next 12 months. We've heard from NOV that it would take around that long to complete a reactivation. And I believe you also mentioned 12 months lead times in your prepared remarks. So I'm just curious about your confidence level and being able to reactivate that rig in time for this this contract's commencement date. And separately, what would be your estimate of the reactivation cost for this particular cold stacked drillship?

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.

A

Yeah. I think I answered in one of the earlier questions, Eddie, one thing this organization has a demonstrated track record of with 4 in the last year and the 17 project going on, which is on pace and largely on budget, is the ability to reactivate rigs on the timing and on the budgetary numbers that we say we're going to do it. So we are in advanced discussions and I'm confident in the team that they can execute that project and have that rig reactivated in the timeframe that we need it to be and as expected by the customer.

As far as the budgetary estimate, we're in a discussion and are very optimistic and constructive on us closing out that contract here in the near future. And when we do, we will update the market, including the adjustments to our numbers as a result of adding in that additional reactivation. We said $65 million to $75 million for the DS-17. I think you can be looking at numbers towards the top end of that range if we're looking at additional reactivations today. But we will certainly update the market as we go through that process.

Edward Kim
Analyst, Barclays Capital, Inc.

Q

Got it, understood. And we'll be looking forward to learning more about that. Anton, secondly, you mentioned eight newbuild drillships currently stranded in Korean shipyards and that you expect these rigs to come to market in a staged manner? What headline rate do you think would be required to bring one of those drillships out? Is it 500 or 550, or [ph] would you argue we're (00:59:27) even close to it now in the mid-400's, depending on the contract structure? And what might you expect us to see an announcement about one of those rigs coming into the supply stack?

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd. A

Look, there are quite a few discussions going on. The market and the incremental demand that keeps coming to market is making it more realistic for those rigs. What I will say, I expect them largely to come to market in the hands in some way, shape or form of kind of established prudent drillers. When you look – I don't want to get into day rate speculation on what others may do. But I will say, with market clearing prices to take up, we have two options, one at $119 million, the other at $218 million.

The clearing price on those rigs is north of $200 million today. You need to think that on top of that, you would have another reactivation type expense, plus a mobilization. So call it another maybe, $80 million to $100 million all-in in order to do that project, that there needs to be kind of a robust day rate both in contract term and day rates in order to justify those economics. And I'd say we would be, at the rate levels we're seeing today or north of those rate levels. But I think the most folks' priority and definitely ours is to take priority to our active fleet, to make sure that that is highly utilized for us. Then secondly, to look at our reactive – our cold stacked -- preservation stacked ships and return those, and then to look at kind of newbuild options after that. And I think most folks in the market see it the same way.

Edward Kim
Analyst, Barclays Capital, Inc. Q

Great. Thanks, Anton. I'll turn it back.

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd. A

Thanks.

Operator: And our next question today from Kurt Hallead with Benchmark. Please go ahead.

Kurt Hallead
Analyst, The Benchmark Co. LLC Q

Hi. Good morning, everybody.

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd. A

Good morning.

Christopher T. Weber
Chief Financial Officer & Senior Vice President, Valaris Ltd. A

Good morning.

Kurt Hallead
Analyst, The Benchmark Co. LLC

Q

I appreciate the in-depth color. I'm kind of curious here, right? And as you look at the market tightness for the drillships, you mentioned that there were 14 idle assets with 13 of those with three companies, obviously, five of those being yours or at least three of those being yours, excuse me, not including the potential drillships. So when you think about your balance sheet, when you think about protecting your cash, what do you think about the demand factor for these rigs being activated, you mentioned some upfront costs being borne by the customer base order of magnitude of $27 million, seems like a very low percentage given still the capital risk and the balance sheet strength that your customers have.

So long winded way of getting around to my question, which is how are the discussion going with your customer base about them putting up more capital upfront to bring these assets into the market? Because at the end of the day, again, they're in limited hands, there's not too much competition out there as there had been and you guys just should be preserving capital, and making the customer base pay for it. So just kind of curious on how those discussions are evolving, if they've evolved and if you have some greater leverage going forward?

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.

A

No, I mean, you can see what we did on the DS-17 contract, but not all customers all the same, right? There's a great variety in customer and appetite and ability. And there's a -- ultimately there's a trade off in one way, shape or form. There's a market clearing price that a rig can be re-contracted at. And there are certainly some customers that we have discussions with who are more apt or to pay more capital upfront towards the reactivation in some manner that can be offset by the day rates that you're going to get under the contract. But there are other contracts, some point more to kind of national oil companies, let's say, where they have a very prescribed upfront mobilization or upfront payment mechanism because it's a very regimented contract structure. And then, our job is to make sure that we look at the economics and the ability to recoup those reactivation economics over the term of the contract. What I will say is the contracts that are available in the market, whatever flavor they are, whether it's recouping more of the – recouping more of that -- those economics over the term of the contract, with day rates north of kind of $400,000 a day and contract tenures in the three-year range, it's an attractive opportunity that generates cash under the initial contract, whichever form of contract that you're looking at.

So for us, your question about balance sheet and cash management, it's about understanding how those contracts will stack up as we recontract those rigs. So what is the timing of our liquidity and cash needs. But we've been very, very clear in being focused and disciplined. And for us, disciplined means, not taking on contracts where we are not generating return over the initial contract. That is what is most important to us.

Kurt Hallead
Analyst, The Benchmark Co. LLC

Q

That's great. Appreciate that. So my follow-up is on the North Sea market. You mentioned you expect improvement next year. Is that kind of your team's kind of forecast or perspective? Or is that coming from your customer base that basically saying 2023 is going to be what it is, but, 2024 will be in a much better position we plan to move forward on projects? So just wondering if its customer driven or just kind of your – your -- neither answer is wrong. I'm just trying to gauge whether it's coming from the customer or coming from your internal team?

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.

A

Yeah, let me let Matt start up with that question because he's having a lot of the customer discussions and maybe I'll cover up afterwards to give you some more color on the North Sea.

Matthew Lyne
Senior Vice President & Chief Commercial Officer, Valaris Ltd.

A

Hi there.

Kurt Hallead
Analyst, The Benchmark Co. LLC

Q

Hi.

Matthew Lyne
Senior Vice President & Chief Commercial Officer, Valaris Ltd.

A

So I think, if we dial back the clock and you look at where we felt in 2022 regarding the 2023 opportunities, we felt quite good about what the North Sea was bringing to the table on demand. There was obviously the fiscal change with respect to the windfall tax that added some headwinds to where operators have to take a pause to think about how they view going forward with projects. What I would highlight is that it's less about going forward and more about possibly delaying or digest the new economics. And I think that's what we're starting to benefit from. And what we see is visible demand in the second half of 2023 and into 2024, where a number of those projects that likely had short term delays are now being stacked into the next 12 to 18 months, and giving us a better outlook and a more positive outcome for that market.

So I -- to answer your question, it's largely driven by what we see demand coming from customer conversations on the ground in the North Sea.

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.

A

So what we see is more a question of timing. [ph] These are not (01:06:54) programs that have been taken off the table. It's a question of relooking at their capital allocation and the timing of them doing those projects. So [indiscernible] (01:07:05) snowplow and stuff, moving to the – to the back end of 2023 and then to 2024.

Kurt Hallead
Analyst, The Benchmark Co. LLC

Q

Okay. That's great. Really appreciate that color. That's it for me.

Anton Dibowitz
President, Chief Executive Officer & Director, Valaris Ltd.

A

Sure. Thanks.

Operator: Thank you. And ladies and gentlemen, this concludes today's question-and-answer session. I'd like to turn the conference back over to Darin Gibbins for any closing remarks.

Darin Gibbins
Vice President-Investor Relations & Treasurer, Valaris Ltd.

Thanks, Rocco, and thank you to everyone on the call for your interest in Valaris. We look forward to speaking with you again when we report our first quarter 2023 results. Have a great rest of your day.

Operator: Thank you. Today's conference has now concluded. We thank you all for attending today's presentation. You may now disconnect your lines and have a wonderful day.