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Energy firms' spending cut takes a toll on offshore drillers

by Victor Liu

As the crude oil price began a drastic downward trend from June 2014 onwards, struggling energy companies have rushed to reduce their investment in exploration and development activities. The organic capital spending by sector-wise energy companies decreased sharply to USD 133bn in 2014 from USD 437bn in 2013. Furthermore, a large number of energy behemoths, such as Shell, Chevron, and BP, have all recently decided to pull back on their capital expenditures in 2015. As a result, offshore drillers, whose main customers are energy companies, have been hit hard due to fewer business contracts and a falling drilling day rate.

The dropping oil price lowered the break-even point for energy companies, resulting in sluggish demand for drilling service as well as a lower day rate for renting rigs. The day rate for deep-water rigs has tumbled from a peak of USD 650,000 two years ago to nearly USD 375,000 now. Accordingly, offshore drillers had no choice but to stack or scrap their idle rigs, which could help to decrease operating and administration expense, but also could affect their long-term core competency. It is expected that the number of stacked or scrapped deep-water rigs will grow to a two-decade high in 2015.

With these business challenges ahead, the offshore drilling industry has performed poorly since crude oil prices began dropping at the end of June 2014. As shown in Figure 1, the Bloomberg Global Offshore Drilling Valuation Peers Index, which shows the stock performance of offshore drillers in the world, fell to 43.44 on Feb 27, 2015 from 109.51 on Jun 30, 2014, while the RMI aggregate 1-year Probability of Default (PD), which is a simple median, of 24 offshore drillers increased to 54.83bps from 7.38bps during the same period.

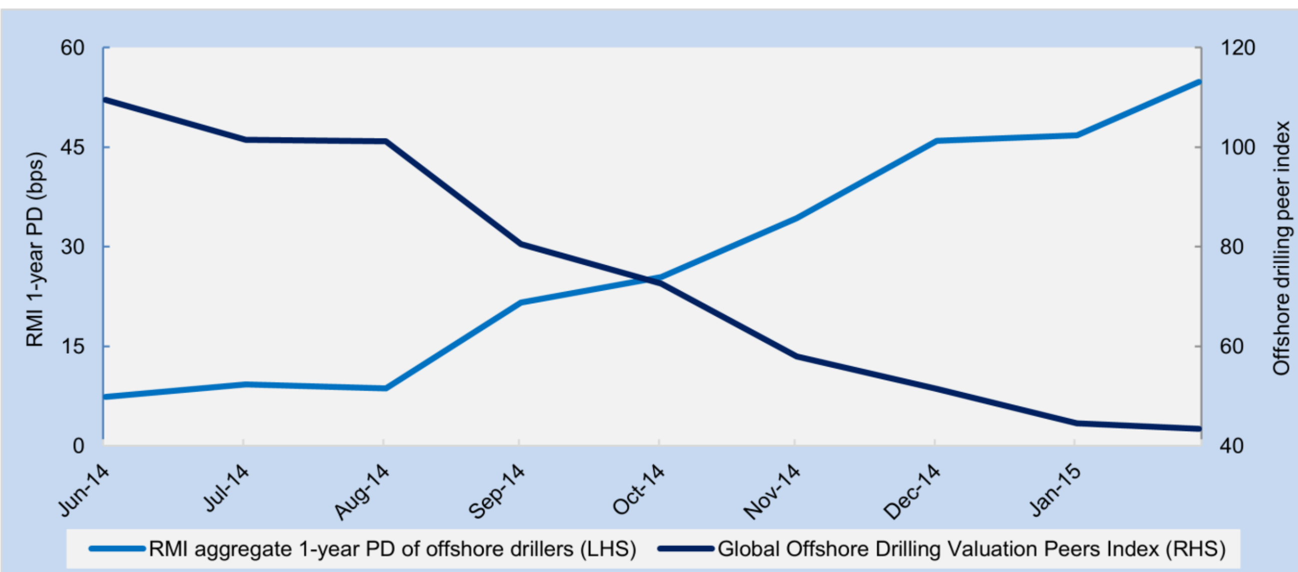

Figure 1: RMI aggregate 1-year PD of offshore drillers versus Bloomberg Global Offshore Drilling Valuation Peers Index. *Source: Risk Management Institute, Bloomberg*

Switzerland-based Transocean, which owns the world's largest fleet of offshore drilling rigs, has suffered particularly seriously from the oversupply problem with many of the company's rigs becoming idle. Its utilization rate slid to 72% in Q4 2014 from 78% in Q2 2014. In February 2015, 8 of Transocean's 29 high-specification ultra-deep water rigs, which are its most lucrative assets, were idle without contracts. According to an investment bank analyst, 8 idle rigs would cost the company USD 728mn per year or USD 320mn per year if the company cold-stacks them. What's worse is that the company had made heavy capital spending commitments over the past few years just before oil prices dropped. Transocean still has 12 rigs under construction now. Considering the bad timing, the company has postponed the completion date by 6 months.

The company mentioned in an analyst meeting when discussing its Q4 2014 result that the day rate and utilization remained under pressure and the challenging conditions might continue for 1.5 years, which indicated that the value of its drilling business would fall substantially. It explains why Transocean witnessed a huge net loss in both Q3 and Q4 of 2014. As Table 1 shows, the company reported a loss on goodwill and other assets of USD 2.8bn and USD 1.2bn in Q3 2014 and Q4 2014, respectively, to update the value of its contract drilling business and the value of its assets held for sale. In accounting, goodwill is the premium that the acquiring company pays over the acquired company's fair value in an M&A. After the recognition of impairment loss, the goodwill, which Transocean accumulated from all its acquisition activities in the past, became zero.

	Q2 2014	Q3 2014	Q4 2014
Goodwill	2,987	1,014	0
Impairment loss on goodwill and other assets	0	2,768	1,210
Net income	597	(2,263)	(766)

Table 1: The impairment loss on goodwill, goodwill balance and net income of Transocean (USD mn). *Source: Risk Management Institute*

The huge net loss incurred by the impairment loss on goodwill and the dim prospects for Transocean's future revenues has weighed on its stock performance. The market cap of Transocean has plummeted by 64% since the end of June 2014, while the RMI 1-year PD climbed to 56.03bps from 0.44bps during the same period, as shown in Figure 2.

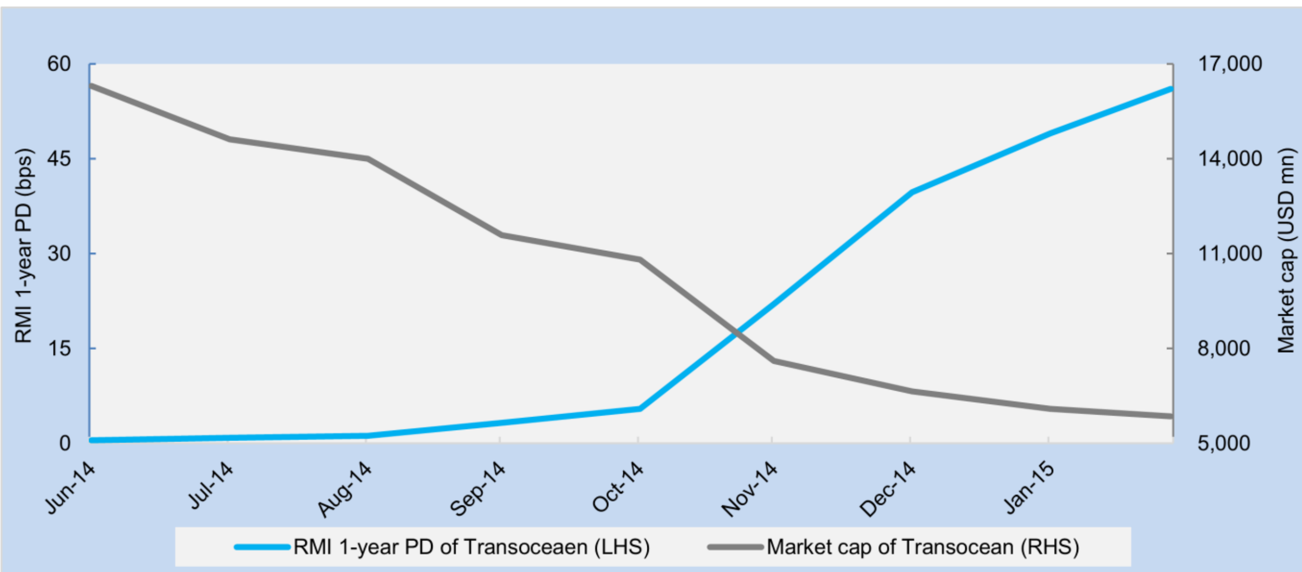

Figure 2: RMI 1-year PD of Transocean. *Source: Risk Management Institute, Bloomberg*

Foreseeing the difficulty in running its drilling business, Transocean has slashed its annual dividend by 80% so that it has ample cash to repay debt maturing in 1.5 years. On Feb 25, 2015, Moody's downgraded Transocean's corporate rating to junk, expressing concern that the rapid drop in oil prices in late 2014 and early 2015, together with the company's large capital commitments for the construction of new drilling rigs, has significantly increased the credit risk to Transocean's bondholders.

To relieve investors' worry, the company has pledged to reduce cost by disposing non-core rigs as well as downsizing its capital expenditure. Nevertheless, it remains to be seen if the cost reduction strategy would take effect and help the company weather the oil price slump.

Note: underlined text highlight revisions made on March 4, 2015

Credit News

Greece may need third rescue

Mar 3. European Commission Vice President Valdis Dombrovskis has expressed concern that Greece could need a third bailout when the program expires in June. Last month, euro area finance ministers pledged a total of EUR 240bn to Greece, on condition that the newly elected government meets the demands of its international creditors. The negotiations between Greece and the EU finance ministers have created a flight of capital from Greece, which created financial instability within the country and in the banking system. Depositors withdrew their savings from the banks and the market value of Greek companies dropped significantly. In April, the IMF, European Commission and the ECB would decide if Greece is sticking with its commitment and implementing the necessary reforms and whether Greece would require further financing. (Bloomberg)

Foreign banks brace for Fed stress tests

Mar 2. The Fed will publish its stress tests' preliminary results on Mar 11, which are expected to find some shortcomings in risk management at the US units of some foreign banks, including Deutsche Bank AG and Banco Santander SA, according to people familiar with the matter. The foreign banks are finding themselves tripped up not by capital requirements but by what the Fed sees as flaws in how they measure and predict risks and losses at their sprawling operations. This has set off a scramble among foreign firms as they staff up and revamp operations to meet the central bank's rising expectations. (WSJ)

Taiwan hottest place to raise RMB bonds

Mar 2. Taiwan has become the hottest place for international issuers to raise renminbi this year, while renminbi bond issuances in HK has slumped as costs at a record high. According to Dealogic, RMB 1.84bn worth of dim sum bonds had been offered since the start of the year and up to Feb 25, down nearly 70% YoY. Meanwhile, RMB 943mn of yuan-denominated bonds were issued in Taiwan, triple the amount in the same period last year. Analysts say lower costs and an easing of regulations are the main reasons encouraging foreign issuers to flock to the Taiwan renminbi market. On average, it is 10 to 20 bps cheaper to issue bonds in Taiwan than in Hong Kong. (SCMP)

Russian banks may see over 20% of loans go bad this year

Feb 26. According to Standard & Poor's, the bad loans may rise to 17-23 percent of the loan portfolio within Russia's banking system in 2015 from around 8% last year. This, along with banks' lower profits, has resulted from the economic crisis which is deepened by Western sanctions over Moscow's role in the Ukraine conflict and lower oil prices. In response, Russia has been forced to support banks with capital injections and other measures, and the banks may be forced to set aside around RUB 2.5tn (USD 41bn) to cover potential bad loans. (Moscow Times)

Korean household debt notches largest ever quarterly gain (WSJ)

Genworth raises red flags over 'Material Weakness' (Bloomberg)

E*Trade to cut debt by USD 340mn in restructuring (CNA)

Regulatory Updates

EBA advises the European Commission on Credit Valuation Adjustment risk

Mar 3. The European Banking Authority has published sixteen policy recommendations relating to the EU calculation of capital requirements for Credit Valuation Adjustment (CVA) risk. The changes have been proposed after the EBA sampled 32 banks across various European countries. Some of the recommended policy changes include expanding the scope of the CVA risk charge to exchange traded derivatives, harmonizing the treatment of securities financing transactions and conducting a yearly effort to monitor the impact of transactions exempted from the CVA risk charge. The EBA also recommends re-aligning the CVA risk charge with the actual CVA risk to better reflect banks' internal practices. (EBA)

Banks flag risk of wider RMB trading band as PBOC eases policy

Mar 3. The risk that China will widen the yuan's trading band is increasing, raising the prospect of further declines in the currency as deflationary pressures build. The currency is allowed to trade up to 2% on either side of a daily fixing set by the PBOC and has closed within 0.03% of the weak end of its range in each of the last six sessions. The band could be widened to 3% within weeks if it remains under pressure. (Bloomberg)

China to open banking sector more widely to private firms

Mar 1. China is taking steps to facilitate private firms to access the banking industry by simplifying approval procedures. According to the chairman of the China Banking Regulatory Commission, private firms will be encouraged to join the restructuring of "high-risk" city commercial banks, rural credit cooperatives and non-banking financial institutions. They also will be encouraged to set up banks in small towns and villages and to hold a bigger share in such financial institutions. Existing shareholders in these small banks are encouraged to cut their stake to allow more participation by private firms. (Reuters)

US regulator questions banks about dividend arbitrage trading

Feb 27. The US CFTC is examining if banks are conducting dividend arbitrage trades to minimize or avoid taxes. Dividend arbitrage trades are transactions in which banks help clients avoid paying withholding taxes on stock dividends. The transactions were designed to reduce tax bills on company payouts by exploiting the differences in tax rules among countries. Such trades tied to US stock dividends were banned after the government investigated the banks in 2007. In Europe, German and English prosecutors are also studying the tax revenue impacts of such strategies. New rules could be imposed on banks which would reduce their revenue from such transactions. (WSJ)

Biggest global banks shrink under pressure from regulators

Feb 27. Rather than making the biggest banks safer as expected, the dozens of rules issued by global regulators led to another result some wanted: making them shrink. HSBC is considering "extreme solutions" for some of its units; RBS is reducing its US trading staff and getting out of two-thirds of the countries where it operates; JPMorgan is closing branches, raising fees on some institutional deposits and looking for ways to shrink its trading businesses. Because of increasingly strict capital rules, lenders have become unable to use borrowed money to fund many of their businesses and have cut profitability targets. (Bloomberg)

Nomura said to be discussed for costly U.S. systemic-risk label (Bloomberg)

European banks' reciprocity draws scrutiny (WSJ)

Europe's big banks will need to raise capital warns ECB (FT)

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