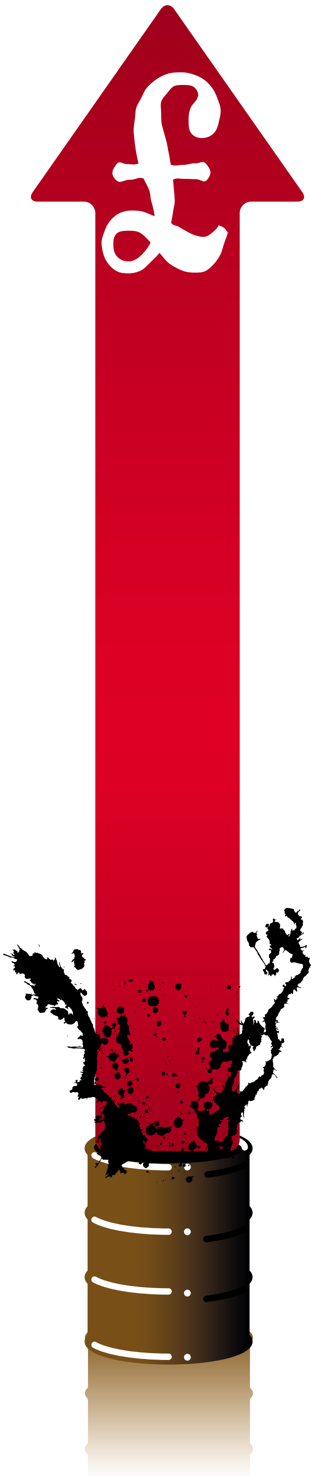
GUSHING DIVIDENDS

The autumn oil sell-off has dragged down oil services shares and left many offering huge dividend yields – **Chris Boxall** asks whether this represents good value or a value trap



While the FTSE 100 index was only marginally lower over the summer months and the third quarter of the year and the S&P 500 index in the US actually registered a very small positive return, it was a different story for the oil price. Brent crude tumbled 16 per cent in the third quarter and West Texas Intermediate fell 13 per cent as oversupply cushioned crude markets from the fear of supply disruptions emanating from the troubled area of the Middle East. The weakness has also continued in the final quarter of the year with Brent hitting its lowest level since June 2012 in October.

The crude sell-off has also supported an equally pronounced sell-off in the energy services arena, with the US-based Philadelphia Oil Services Sector (OSX) down 14.5 per cent in the third quarter of 2014. The OSX is composed of only 10 constituent US-listed entities and therefore only offers a glimpse of the weakness across the global energy services sector as a whole, with certain sub-sectors of the energy services space experiencing a much more pronounced fall.

While Saudi Arabia, Opecs largest producer, has so far resisted a production cut, several members of Opec are pushing for action on oil prices, with the next meeting of the cartel on 27 November 2014 set to be more interesting than usual. With these factors in mind, now might be an opportune time to go bargain hunting in the oil services sector – and when bargains come to mind, an appetising dividend yield is often top of the agenda for many investors.

The energy services sector hasn't been a traditional hunting ground for yield; however, recent crude market gyrations have changed all that, with even the likes of UK-listed **Amec (AMEC)** and **Petrofac (LSE)** currently offering up forecast yields just over 4 per cent.

Prospective investors might be worried about the sustainability of these dividend payouts but it's worth remembering that the big oil and gas groups generally commit to very long-term projects offering the providers of key equipment and services good visibility of earnings over the medium to longer term.

While several UK-listed groups look more attractive from a yield perspective, the real bargains are on offer overseas – and with many UK stockbrokers now able to facilitate trading in overseas shares it's now easier than ever for small investors to access these equities – bearing in mind, of course, that international dividends are often subject to withholding taxes higher than in the UK. That said, given the elevated yield on offer at present it could be worth the inconvenience.

Drill for yield

With offshore drilling activity at all-time highs it will probably come as a surprise that the share prices of many leading offshore drilling groups are at or around three-year lows. This share price slump has arisen largely due to the fear that too many new rigs will enter the market over the next few years with the result that it will be tough for the older rigs to secure new contracts and that the high day rates enjoyed over the past few years ($500,000-plus per day) will no longer be achievable. Day rates for ultra-deepwater rigs recently hit a new official low, with **Noble Corporation's (US: NE)** Danny Adkins rig fixed at $317,000 (£197,000) a day for 200 days. Even the hitherto more resilient jack-up rig sector is starting to feel the strain, with utilisation now at 92 per cent, compared with 96 per cent in March 2014.

As rates fall further the big oil and gas groups will be drawn back to the market with the more optimistic suggesting rates rebounding by early 2016, and the more cautious view that a rebalancing of supply and demand will only occur in 2017. In the meantime, investors should be able to pocket some attractive dividends.

Seadrill (No: SDRL) is the world's largest offshore driller by market capitalisation (not rig fleet) and is dual-listed in Oslo and New York. Founded in 2005 by current chairman John Fredricksen, it has a modern fleet, either operating or under construction, of 34 drillships and semi-submersible rigs and 34 jack-up rigs, and it has always sought to reward shareholders through an appealing dividend. The recent share price slump means that the shares currently yield over 14 per cent and trade on a multiple of around eight times 2015 forecast earnings per share. With the forecast dividend not fully covered by forecast earnings there are clearly fears that this cannot be sustained. But this has always been the case with Seadrill and its modern efficient fleet is attractive to the large oil and gas groups, with contract coverage of 87 per cent for 2015 and 64 per cent for 2016. Following recent management changes, Mr Fredriksen's Hemen Holding vehicle also recently boosted its holding to 115.1m shares by acquiring a further 2m shares.

'Super' yield of 27 per cent

For a really eye-watering yield one need look no further than Aberdeen-based but Oslo-listed **Awilco Drilling (No: AWDR)**. This small offshore drilling group, valued at a market capitalisation of $472m, operates just two semi-submersible drilling rigs which operate in the North Sea and were acquired from **Transocean (US: RG)** in January 2010 at what turned out to be bargain prices; although major expenditure was subsequently incurred to update the rigs. The group has committed to distributing all free cash flow above a minimum cash buffer which supports a current year 2014 annualised yield of 27 per cent, with the shares trading at a meagre four times estimates for 2015. The share price reached a high of Nok161 (£15) in July 2014 but have since tumbled over 40 per cent on fears that the company will have trouble securing contract renewals in 2016 and 2017, the cost of future upgrades potentially impacting cash flow from December 2015, and their ability to maintain the rich payout. More recently, two founder shareholders also significantly reduced their stakes. But with contract coverage at 100 per cent in 2015 and a solid contract backlog of $598m, there is significant downside protection and it's worth pointing out that since the first quarter of 2013 the company has already paid out $195m to shareholders, equivalent to 36 per cent of the current market capitalisation. While the company's two rigs were built in the early 1980s the remaining fatigue life for both is 17 years, with both benefiting from enhancements in 2011. And while the founder shareholders sold 2m shares they still retain a 53 per cent stake. So, even if the dividend gets cut in half, 12 per cent could still be quite appealing.

The offshore limited partnership

One company's share price has proved more resilient than the rest of the offshore drilling sector: New York-listed **Seadrill Partners (US: SDLP)**, the limited partner (LP) offspring of larger Seadrill, which LP structure demands that it pays out substantial dividends. SDLP listed in October 2012 at $22 a share (current price $29) and has increased its distributions by an annualised 40 per cent since its IPO, most recently declaring a payout of $0.5075 for the first quarter of 2014, which equates to an annualised 7 per cent. SDLP has an interest in nine rigs in operation, comprising four semi-submersible rigs, two drillships and three tender rigs operating in Canada, the US Gulf of Mexico, Ghana, Nigeria, Angola and Thailand. For those of a more cynical disposition there is evidently quite a bit of financial engineering going on between the two Seadrills, with 'parent' SDRL selling rigs to SDLP based on projected cash flows from long-term contracts, which in some cases are almost double the rig's book value, and SDRL saddling SDLP with significant debt to reduce its own indebtedness. In mitigation, SDLP's distributable cash flow in the second quarter of 2014 of $51.9m represented a coverage ratio of 1.22 times (adjusting for new shares).

'Alternative' rig exposure

Another sector battered by fears of oversupply and a reduction in short-term visibility in the North Sea market due to oil companies' focus on capital spending cuts is the offshore accommodation sector. Oslo-listed **Prosafe (No: PRS)** is the world's largest listed provider of offshore accommodation rigs and has a market capitalisation of $1.3bn. It currently owns 11 semi-submersible accommodation vessels and two vessels under construction that will be ready for operations in 2015 for Norwegian waters, and two further vessels for worldwide operations excluding Norway that will be ready for operations in 2016. Prosafe is very much a yield story, with significant dividend distributions made over the past few years. Shares in the group fell dramatically in August on news that management is considering reducing dividend payments for a period – however, dramatically reduced dividend estimates still suggests a yield of just over 5 per cent for 2015, covered over three times by earnings.

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Contrarian offshore play

Northern Offshore (No: NOF) is a small and unusual Oslo-listed group with a current market capitalisation of approximately $260m, offering a 13 per cent dividend yield, supported by a variety of different aged assets that generate strong cash flow. The company currently owns a drill ship, a semi-submersible drilling rig, a harsh environment jack-up rig and a floating production unit operating in the North Sea. In addition, it has two high specification jack-ups under construction with options for two more. The key asset in terms of cash generation is the floating production unit called the Northern Producer, which is operating in the North Sea under a Life of Field contract with UK-listed **EnQuest (ENQ)** and currently 'producing' revenue of approximately $90,000 a day. With EnQuest planning new wells that will be tied back to the Northern Producer and expected to be producing for nine years, NOF is considering divestment alternatives available to unlock value from the Northern ▶

▶ Producer, including a sale or a potential spin-off. In the meantime, shareholders can bask in the glory of a well-covered dividend and lowly forward multiple of approximately five times forecast 2015 earnings per share.

Seismic dividends

The offshore seismic sector was first to bear the brunt of the oil companies' spending cuts and recent oil price weakness has also negatively impacted sentiment. Several of the leading vessel owners have seen their share prices decimated over the course of 2014 as oil companies are reluctant to commit to new surveys and expanded fleets are under-utilised. Oslo-listed **Petroleum Geo Services (No: PGS)** owns 16 offshore seismic vessels and is one of the giants of the sector. For the year ending December 2013 it generated revenue of $1.5bn and net income of $238m. Since the beginning of 2014 the share price has fallen by over 50 per cent, which results in the shares trading at just under eight times revised consensus estimates for 2015, leading one leading analyst to comment that the shares "offer a valuation not seen since the post-Lehman depression". PGS has a strong balance sheet and has committed to retiring old vessels, holding back on capital expenditure and committing to a dividend of at least Nok2.30 for 2014, which results in a more than twice covered forward yield of approximately 7 per cent. With the seismic sector often the first to recover on improving sentiment, it could indeed offer an opportunity for 'seismic' returns over the coming years.

14.5%
The fall in the Philadelphia Oil Services Sector index in Q3 2014

Onshore accommodation

The provision of accommodation and related services to onshore oilfield operators, notably those supporting oil sands, suggests a certain consistent and predictability of returns and high dividend payouts. The attraction of the 'camps' sector to long-term income-seeking investors was highlighted in 2013 when **Oil States International (US: OIS)**, a diversified oilfield services group, announced the intention to spin off its camps business to a separate real-estate investment trust (Reit), pushing its share price up significantly. The camps business subsequently spun out of OIS is called **Civeo Corp (US: CVEO)** and owns 18 lodges and villages in Canada and Australia, with a total of more than 21,000 rooms. Having attracted shareholders with the promise of high distributions (a requirement for a Reit to maintain its beneficial tax status) investors weren't pleased when Civeo Corp recently announced that it planned to move its headquarters to Canada and no longer intended to convert to a Reit. Management credibility was further undermined with the news that revenue and margins in 2015 would be lower than 2014 levels on expectations that demand will remain weak. The market wasn't impressed, cutting the share price of Civeo Corp in half, which also impacted the share prices of two other Canadian-listed camp providers **Black Diamond (Ca: BDI)** and **Horizon North Logistics (Ca: HNL)**.

North Logistics experienced installation problems earlier in the year and the recently released third quarter results and outlook were disappointing, pushing the shares down significantly. The share price collapse appears to be a bit of an overreaction with the result that the one-year forecast yield is now close to 10 per cent, suggesting that many don't believe the dividend distribution can be maintained. The more adventurous income seeker might consider this a buying opportunity.

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Floating production, storage & offloading

BW Offshore (No: BWO) is an Oslo-listed provider of floating production services to the oil and gas industry with a fleet of 14 floating production, storage and offloading platforms (FPSOs) and one FSO. It has a current market capitalisation of approximately $900m.

FPSOs are floating vessels used by the offshore oil and gas groups for the production, processing and storage of oil. They generally operate in frontier offshore regions as they are easy to install and do not require a local pipeline infrastructure to export oil. In their simplest form (if you could call it simple), they are often converted oil tankers as opposed to being specifically built for the purpose. A vessel only used to store oil (as opposed to processing it as well) is referred to as a floating storage and offloading vessel or FSO.

Contracts for these costly floating giants are typically of long-term duration, which results in excellent visibility of earnings and cash flow. To illustrate this, for the second quarter of 2014 revenue of $320m resulted in pre-tax profit of $112m and a net cash flow from operating activities of $144m. Needless to say, these long-term cash-generative assets facilitate high levels of debt, with net debt $1.5bn equating to net gearing of 130 per cent. But the cash generation supports high dividend payouts, with BWO having distributed $255m since it introduced a quarterly dividend in 2011, equivalent to Nok 2.30 a share or 30 per cent of the current share price (Nok7.51). Despite the high debt load the group has plenty of headroom in its current debt facility, supported by a huge order book of $9.6bn, of which $4.6bn are firm contracts with blue-chip clients. The projected dividend payout equates to a yield of approximately 9 per cent, well covered by earnings and cash.

Contributed by Christopher Boxall, manager of SF Fundamental Energy Fund (www.fundamentalasset.com/energy-fund), which invests in the global providers of equipment and services to the energy sector and holds shares in some of the companies mentioned in this article.