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Research Update:

Odfjell Drilling Rated Preliminary 'B+'; Outlook Stable; Proposed Bond Rated 'BB'

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Rating Action Overview

- Oslo Stock Exchange-listed offshore drilling company Odfjell Drilling Ltd. has launched an offering for a $390 million five-year senior secured first-lien bond and plans to use the proceeds to partly refinance its existing debt instruments.
- The planned bond issue, together with the extension and refinancing of the bank facilities for the Deepsea Stavanger and Deepsea Nordkapp rigs, will fully refinance all of the company's interest-bearing debt.
- We assigned our preliminary 'B+' long-term issuer credit rating to Odfjell Drilling.
- We also assigned our preliminary 'BB' issue and '1' recovery ratings to Odfjell Drilling's proposed $390 million senior secured first-lien bond. The '1' recovery rating indicates our expectation of very high (90%-100%; rounded estimate: 95%) recovery of principal in the event of a payment default.
- The stable outlook reflects our view that Odfjell Drilling's credit measures will remain commensurate with the ratings over the next 12 months, with debt to EBITDA below 3x, supported by a continued gradual pick-up in offshore drilling and robust cash flow visibility over the coming years.

Rating Action Rationale

Odfjell Drilling will likely remain a small-scale driller with significant asset concentration. With only four rigs of its own, along with four managed rigs, we see Odfjell Drilling as exposed to risks arising from its dependence on a high share of EBITDA from each unit. This is a key negative consideration for Odfjell Drilling compared to its larger peers, since unforeseen events that hampered Odfjell Drilling's ability to operate one or more rigs would have a material impact on its cash flows.

Above-average operating efficiency and profitability support the ratings. While Odfjell Drilling's fleet is small, we believe that it is very well managed, with an overall utilization rate of close to 99% over the past few years. This, combined with the rigs' high technological specifications, allows the company to contract the rigs more often and at higher day rates than peers. This supports Odfjell Drilling's superior profitability, with EBITDA margins over 40% on average.

Activity in the drilling markets continues to pick up. We expect that the current commodity prices, supply and demand fundamentals for crude oil, and a renewed focus on global energy security will support a continued gradual increase in offshore drilling spending and activity. Over the longer term, we believe the energy transition will challenge the offshore drilling sector because customers may become less willing to commit capital to multi-year greenfield projects due to the risk of waning oil demand. However, with operations in Norway largely encouraged by the state, we believe Odfjell Drilling is in a relatively strong position.

With a backlog of $2.3 billion, of which $1.7 billion is firm, we think that Odfjell Drilling can generate EBITDA of about $350 million in the coming two-to-three years. This will provide ample headroom for capital expenditure (capex) and potential dividends. Odfjell Drilling's strong customer relationships, notably with Equinor and Aker BP, lead us to believe that the company has a superior ability to contract the rigs, even at low points of the cycle.

Odfjell Drilling takes a prudent approach to its balance sheet in the context of high industry volatility. Despite drilling being a boom-and-bust type of industry, Odfjell Drilling is less prone to great EBITDA variations, thanks to its long-term contracts with clients, as well as the harsh environmental conditions in Norway, which limit the number of rigs that can work there. Odfjell Drilling went through the previous industry downturn without experiencing a default or distressed exchange. We therefore believe that its prudent leverage target of net debt to EBITDA of 2.5x over the cycle, and the absence of dividend payments if debt to EBITDA is above 3.0x, support the rating.

Outlook

The stable outlook reflects our expectation that Odfjell Drilling will reduce its leverage amid supportive market conditions, providing it with the scope to face headwinds at lower points in the cycle. We believe that Odfjell Drilling's fleet of rigs will continue to achieve above-average utilization and efficiency rates. We anticipate debt to EBITDA in the 2x-3x range, which is commensurate with the 'B+' rating.

Downside scenario

We could lower our ratings on Odfjell Drilling if we anticipate weaker credit measures, such as debt to EBITDA consistently above 3x or funds from operations (FFO) to debt below 30%. This could occur if:

- Weaker commodity prices impair demand for offshore drilling services, making it more challenging for the company to re-contract its rigs at favorable day rates; and
- Odfjell Drilling adopts a more aggressive financial policy on dividends and capital spending.

Upside scenario

We view rating upside as limited in view of Odfjell Drilling's asset and geographic concentration.

Such upside is linked to increased scale and cash flow generation, with less dependence on individual assets. Rating upside could also arise if the company's financial policy targets were to become much more stringent, for example, with a capital structure that was close to being free of net debt so that debt to EBITDA would be below 1.5x at all points of the cycle.

Company Description

Founded in 1973, but with roots dating back to 1914, and headquartered in Aberdeen, Scotland., Odfjell Drilling owns and operates mobile offshore drilling units in Norway and Namibia. As of Dec. 31, 2022, the company employed 1,358 people. Through its various subsidiaries, Odfjell Drilling has eight rigs in total, four that it owns and four that it operates under management contracts.

The company operates through two main segments, Own Fleet and External Fleet. The drilling operations and management of Odfjell Drilling 's own rigs reflect contracted day rates and additional incentives. Odfjell Drilling only offers operational management to the owners of the rigs in the external fleet, for which it receives a management fee. Although limited, the customer base mostly consists of tier 1 exploration and production companies like Equinor, Aker BP, Exxon, and Shell.

Odfjell Drilling is a publicly traded company with all its ordinary shares listed on the Oslo Stock Exchange. Its majority owner is Ms. Helene Odfjell, who holds more than 60% of the publicly traded shares through Odfjell Partners Holding Ltd. No other shareholder owns more than 2.5% of the shares.

Our Base-Case Scenario

Assumptions

- Revenue of about $700 million-$800 million per year in 2023-2024.
- The execution of the current rig contracts and options, with 95%-100% utilization of Odfjell Drilling 's own rigs.
- All-in day rates of about $400,000 in 2023-2025.
- EBITDA margins of 40%-45% in 2023, improving slightly in 2024.
- Capex of about $75 million in 2023 and $100 million in 2024; and
- Dividends of $0 million-$50 million in 2024 and 2025.

Key metrics

- Average FFO to debt of 35%-40% in 2023 and 2024;
- Average debt to EBITDA of about 2.0x-2.5x in 2023 and 2024; and
- Positive free operating cash flow of $140 million-$160 million per year over the next two years.

Liquidity

We assess Odfjell Drilling 's liquidity as adequate and expect sources of funds to exceed uses by more than 1.2x over the next 12 months. In addition, we expect that sources would exceed uses even if our projected EBITDA figure were to decline by 15%. The proposed refinancing is in line with our liquidity assessment, which is limited by qualitative factors such as the company's limited ability to absorb high-impact, low-probability events without refinancing and its satisfactory standing in credit markets.

We assess liquidity using Odfjell Drilling's pro forma balance sheet values as of Dec. 31, 2022:

- The proposed $390 million senior secured bond;
- The $197 million senior secured term loan facility for Deepsea Nordkapp;
- The $285 million senior secured facilities for Deepsea Stavanger, with a $160 million revolving credit facility tranche and a $125 million term loan tranche; and
- The repayment of $551 million in senior loans, $100 million in junior loans, a $95 million loan from Aker BP, a $51 million credit facility from Samsung Yard, and $20 million of seller's credit from oil services company Akastor.

Principal liquidity sources

- Cash and cash equivalents of about $157 million, of which $50 million is not available for debt repayment because of a minimum liquidity covenant;
- FFO of about $190 million-$200 million over the next 12 months; and
- Total new debt of $872 million that Odfjell Drilling received in the second quarter of 2023.

Principal liquidity uses

- Debt maturities of $848 million, including the repayment of the existing debt and the amortization of the new debt;
- Capex of about $75 million over the next 12 months; and
- No working capital requirements or dividend distributions over the next 12 months.

Covenants

The proposed bond and term loan in Odfjell Drilling 's pro forma debt structure have the following covenants:

- An equity ratio of 30% or more, with minimum equity of $600 million;
- A leverage ratio of 5.0x or less (the ratio is currently above 1.0x); and
- Free liquidity of $50 million or more.

We expect Odfjell Drilling to have ample headroom under these covenants over the next 12 months.

Environmental, Social, And Governance

ESG credit indicators: E-4, S-2, G-2

Environmental factors are a negative consideration in our credit rating analysis of Odfjell Drilling due to our expectation that the energy transition will reduce the demand for offshore drilling rigs and services, as accelerating adoption of renewable energy lowers the need for fossil fuels. In view of Odfjell Drilling's exposure to the offshore drilling market, the company faces higher environmental risks than onshore rig contractors due to its susceptibility to operational interruptions and damage to its equipment in its harsh operating environments. However, we believe that Odfjell Drilling's operational track record in Norway partly mitigates these risks. Social factors are a neutral consideration in our ratings on Odfjell Drilling thanks to the company's safety record and presence in very low-risk countries, notably Norway. Governance factors are a neutral consideration for Odfjell Drilling due to its historically conservative approach to leverage and long track record of successful operations.

Issue Ratings--Recovery Analysis

Key analytical factors

- We assigned our preliminary 'BB' issue rating to Odfjell Drilling's proposed $390 million senior secured bond due 2028.
- The preliminary '1' recovery rating on the senior secured bond indicates our expectation of very high (90%-100%; rounded estimate: 95%) recovery of principal in the event of a payment default. This recovery rating leads us to apply a two-notch upward adjustment to the 'B+' issuer credit rating to arrive at our 'BB' issue rating.
- Our hypothetical default scenario contemplates a prolonged deterioration in cash flow as capital spending on offshore oil and gas exploration and production declines significantly and demand for offshore drilling services decreases.
- We value Odfjell Drilling using a discrete asset-based approach, which is consistent with our treatment of other contract drilling companies. We assume a 5% annual depreciation rate and a 50% realization rate on the company's drilling equipment, based on third-party valuations.

Simulated default assumptions

- Simulated year of default: 2027
- Insolvency jurisdiction: The company is headquartered in Aberdeen, Scotland, U.K., which we rank in Group A
- Simplified waterfall
- Net enterprise value (after 5% administrative costs): $714 million
- Obligor split between A/B/C: 50%/26%/24%
- Total collateral value available for the secured debt: $450 million

- Total senior secured debt of obligor A: $231 million*
- --Recovery expectation: 90%-100% (rounded estimate: 95%, capped)

*All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating	B+(prelim)/Stable/--
Business risk:	Weak
Country risk	Very low
Industry risk	Moderately high
Competitive position	Weak
Financial risk:	Aggressive
Cash flow/leverage	Aggressive
Anchor	b+
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	b+

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings , Oct. 10, 2021
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments , April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers , Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments , Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers , Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology , Nov. 19, 2013
- General Criteria: Methodology: Industry Risk , Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions , Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities , Nov. 13, 2012

Ratings List

New Rating	
Odfjell Drilling Ltd.	
Issuer Credit Rating	B+ (prelim)/Stable/--
Senior Secured	BB (prelim)
Recovery Rating	1(95%)