

Portfolio Intelligence Report (PIR): 01.21.2023

"Know what you own and why you own it." - Peter Lynch

Happy Saturday!

I'm traveling to Pensacola, FL, for a wedding and will have to keep this week's note on the shorter side ... In this note, we update our Tidewater (TDW) thesis and explain to newer Collective members why we have such high conviction in the company and the offshore drilling industry.

Tidewater (TDW): Still A Long Way To Go ...

I'm almost done reading Bruce Greenwald's classic book, *Competition Demystified*. It's a must-read for any investor that wants to up their company analysis game. Greenwald is a master at taking seemingly complex ideas (like valuation and competitive analysis) and distilling them into simple yet powerful realizations.

Take competitive advantage, for example. Morningstar has five (or six) moats. Michael Porter devoted his entire life to the subject. If you're not careful, the subject can get way more complicated than it needs to be.

Competition Demystified has a simple definition of competitive advantage: **Any business with strong barriers to entry or customer captivity.**

Barriers to entry include network effects, fixed cost scale advantages, geographic dominance, etc. In other words, they're things incumbent businesses have that new entrants can't easily replicate.

However, when investors hear "easily replicate," they sometimes assume "differentiation." A company's product or service must look, feel, and act differently than its competitors. Greenwald dismisses this notion in the book (emphasis added):

"Differentiation may keep your product from being a generic commodity item, but it doesn't eliminate the intense competition and low profitability that characterize a commodity business...the damage to profit persists because the problem is not lack of differentiation, but the presence of barriers to entry."

Said differently, what makes a commodity business isn't the widget it sells or the service it provides. Rather the ease with which competition can enter the space, compete on price and destroy returns.

That brings us to Tidewater (TDW).

On the surface, TDW operates in a pure commodity business. They provide offshore drilling vessels to assist oil and gas E&Ps (exploration and production companies) in extracting oil from the ocean floor. TDW charges "day rates" for their vessel services, which range between \$10K - \$25K. The other important metric for TDW is the **Utilization Rate**, which is the percentage of their total fleet actively working.

You can check out a snapshot of their 165-boat fleet below.

Fleet Overview



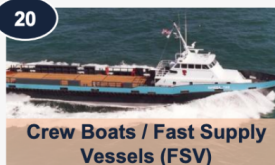
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Platform Supply Vessels (PSV)

- Specially designed to supply offshore oil and gas platforms
- Transport variety of cargoes incl. fuel, water, drilling fluids, cement or mud in below-deck tanks
- Carry material such as casing, drill pipe, tubing and misc. deck cargo on open deck

20



Crew Boats / Fast Supply Vessels (FSV)

- Specially designed to transport as many as 150 personnel from shore bases to offshore rigs, platforms and other installations at high speed and in comfort
- Capable of carrying moderate quantities of cargo

59



Anchor Handling Towing Supply Vessels (AHTS)

- Specially designed to serve offshore rigs in mooring and towing operations
- Capable of all types of towing, anchor handling activities, and varied subsea operations

5



Offshore Tugs

- Used to tow floating drilling rigs and barges
- Assist in the docking of tankers, pipe laying, cable laying and construction barges

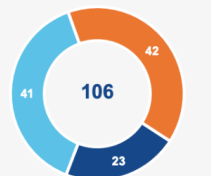
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Specialty Vessels

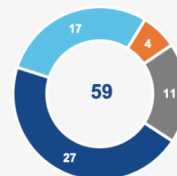
- Support offshore well stimulation, construction work, subsea services, and/or serve as remote accommodation facilities
- Equipped with a variety of lifting and deployment systems, including large capacity cranes, winches or reel systems

PSVs by Deck Size



▪ <700m2 ▪ 700 - 900m2 ▪ >900m2

AHTS by Bollard Pull



▪ 4 - 8K ▪ 8 - 12K ▪ 12 - 16K ▪ >16K

Note: Vessel counts as of June 30, 2022.

8

tdw.com

At a high level, we can think of TDW's end markets as a simple supply/demand equation.

High-Level Overview of Demand

Demand is a function of oil prices, global inventories, and global production. E&Ps want to drill when oil prices are high because they can make more profits per barrel (as most costs remain fixed). So the higher the oil price, the greater the profits, and the stronger the desire to drill.

This means **greater demand for TDW's vessels and higher average day rates** as E&Ps compete for the marginal vessel bringing TDW to full utilization.

Next, there are inventories and production. Consumption draws down oil inventories, which puts a "floor" on demand as countries replenish their stores.

If there is one, the goldilocks zone for oil demand is a price that's not too expensive to purchase but not too cheap for E&Ps to drill it, a tightening of global inventories, and a high level of global consumption/production.

Massive Supply-Side Barriers To Entry

Today's supply-side barriers to entry result from the challenging 2012-2014 period in offshore drilling. Judd Arnold of Lake Cornelia Research explained that period on Andrew Walker's *Yet Another Value Podcast* (emphasis added):

*"Twelve to fourteen, it didn't blow up until 14 when OPEC, effectively stopped defending price. You think about offshore versus onshore. **Offshore is a long cycle. If you and I own an E&P company, we're drilling off Guyana or wherever, we're making a 5, 6, 7 year-bet on prices.** At that board meeting, the board deck is, this is a 5 to 10-billion-dollar commitment. Once this thing's built, it's going to flow a huge fixed cost, very low variable, and so forth. You think about Shale, it's the inverse of that, which is the wells used to be 10 million bucks a pop. Now, they're 7 to 8 or probably going back to 10, but with onshore cost inflation. But you get back all your capital within, I don't know, 2 months.*

*Then you've got this really big tail, and huge decline rate, what have you. **What you saw in 14, once OPEC stopped defending and Shale became ascendant is every board made the rational decision of, "Heck. I don't know where pricing is going, but there is no way. I'm making a multi-year bet,"** which is not. This was one offshore which had sort of a crescendo. So, right before the OPEC buzz and Shale, you want a new build order book that was 30% of the existing fleet. So, it wasn't just that existing assets got [decayed] like, you were just dead, right? **It was over like, it was going to take or what I thought was more than a decade to sort itself out.***

*What turned out was a lot of these guys came out of bankruptcy in '17, '18, '19, and then it was still crap. You look at the supply and demand, you're like, this math makes no sense, and **COVID really was the accelerant that just destroyed the last vestiges of hope,** and you really rationalized all these fleets."*

Offshore companies saw \$100/barrel oil, the E&Ps drilling, and flooded the market with new supply to capture outsized economics. The problem is that all that supply destroyed the returns by slashing day rates and lowering utilization rates.

Then oil prices collapsed below \$50/barrel, which dampened demand as E&Ps operated at breakevens/losses. This put further pressure on offshore vehicle (OSV) day rates and utilization.

To make matters worse, the offshore companies loaded up on debt to finance the increased supply.

Eventually, they all went bankrupt. I like how Judd Arnold describes it (emphasis added):

"What happened was these guys lost on 2 metrics, right? Utilization went from - you can't really run an OSV more than 90% of the time because there's dry docks and the crew changes, and all the other stuff. Same thing for a Deepwater rig.

But utilization, I think round numbers for the industry went from low 80s to 50. Day rates went from, for really good stuff went from 28,000 to 12. No, actually 10. I'm sorry. So, you just got

slaughtered on everything, and then you dumped a bunch of new boats into it, and none of this cap,

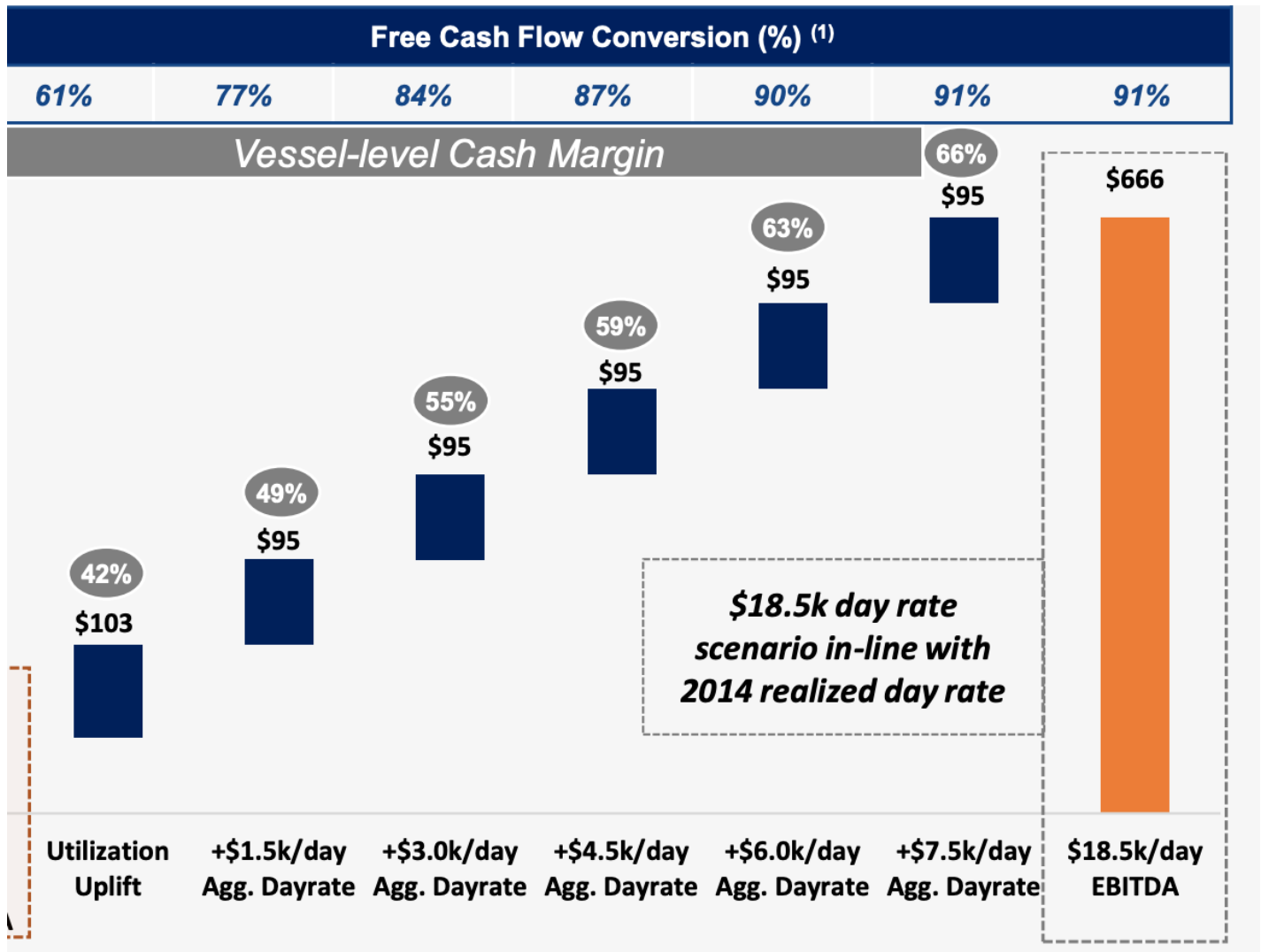
*they financed all the new build obviously with a ton of debt. All these guys had a ton of debt. It just was like a **game set match, goodbye.***

Here's why that history is important: **Nobody has built a new boat in over ten years.**

The entire offshore value chain has had PTSD since 2014. Judd explained on the podcast that there are no shipyards to build ships. They all went bankrupt. And the ones that didn't, they're demanding 40-50% upfront deposits and guarantees (pre-2014, you'd get ~10% upfront deposit).

Plus, the cost of building new boats has increased since 2014. TDW's latest investor presentation suggests it costs around \$60-\$70M to build a new vessel, which brings us to another critical aspect of the supply-side barrier to entry: **New Build economics.**

Companies like Tidewater must earn an attractive return on their investment to justify the cost of investment. TDW makes money at ~\$13K day rates and ludicrous amounts at anything above that. Check out the breakdown of returns below from TDW's presentation.



TDW makes \$600M+ in EBITDA with a 90%+ FCF conversion rate at \$18.5K day rates. Remember that number.

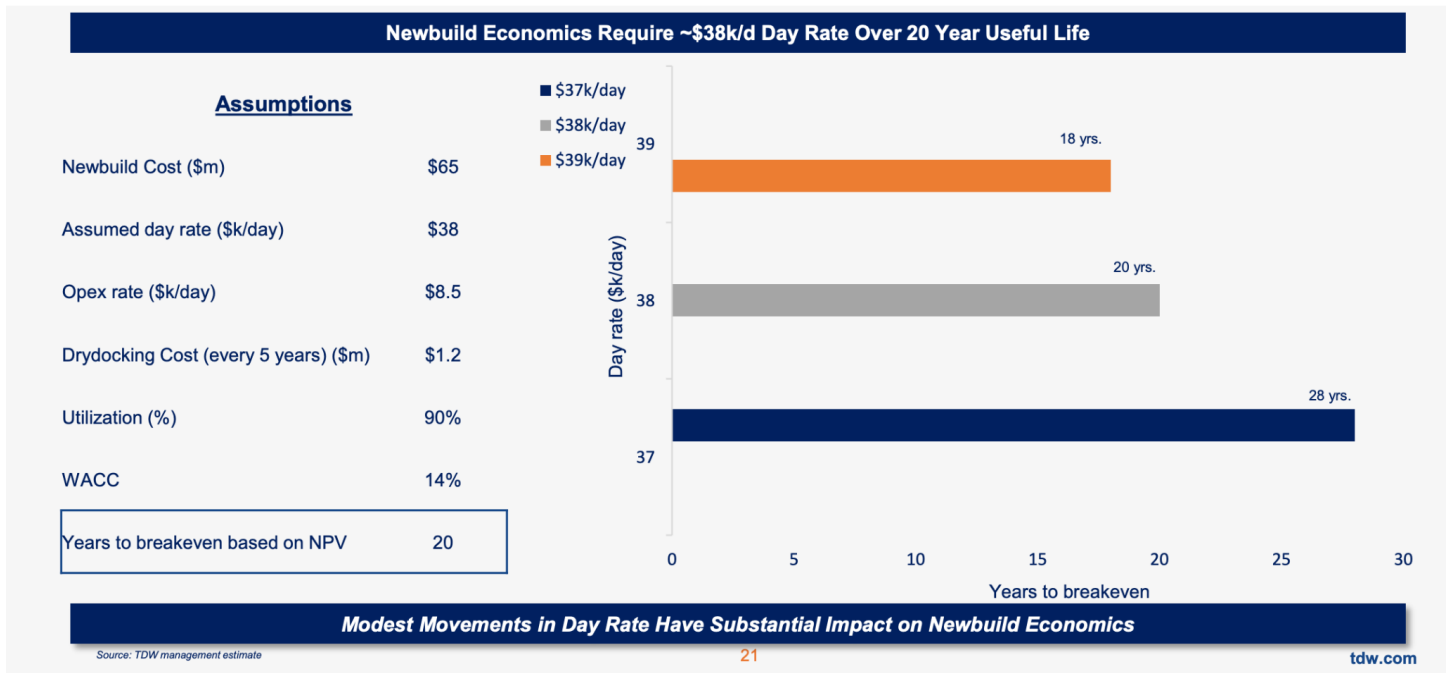
Suppose shipyards could build new boats. It would cost ~\$60-\$70M with higher upfront deposits, guarantees, etc. Even if a company wanted a new boat, it would take them **twenty years to break even at a day rate of \$38,000!**

I want to reiterate how wild this supply dynamic is for TDW. TDW is profitable at around \$13K day rates. And they make stupid money at anything above \$18.5K day rates.

But if a new ship wants to come online, it would need to charge \$38K day rates at 90% utilization for **twenty years** to reach breakeven.

TDW. On the other hand, it **would generate over \$1B in free cash flow at the current new build economic breakeven**. It's almost impossible to overemphasize how crazy this supply dynamic is for TDW.

Newbuild Economics Considerations



The offshore vessel space is a perfect example of Bruce Greenwald's **barriers to entry** in an industry that many write off as "shitco commodity space."

Structural/economic cost barriers to entry will enable TDW to generate outsized returns for the next 2-4 years. And if day rates keep inflecting, **the company can earn its entire enterprise value in FCF over the next 12-18 months.**

Summary: Early Innings of Demand/Supply Imbalance

I stopped in Atlanta on my way to Florida to divide the monotonous 15-hour drive (and to save my sanity). While I was there, I grabbed lunch with a hedge fund manager. He runs a \$1B+ L/S book with a value tilt.

I asked him what he thought about the oil/gas space and Tidewater. He responded, "Oh, you mean Turd-water? That thing is a shitco."

In a sense, he's right. Tidewater fumbled in 2014 by leveraging up to bring new supply to the market when oil prices collapsed. That doesn't look good. But the company has a new management team,

and more importantly, the entire structure of the demand/supply equation is ridiculously skewed in favor of companies like TDW.

I explained to him the logic of the demand/supply imbalance, how difficult it would be to bring new boats online, and why new build economics disincentivize building even if shipyards could do it.

His response was, “Look, Brandon. I just have too many scars from 2014-2016 from oil names. I don’t want to go through that again. At this point, I’ve accepted that I don’t want to get hurt like that again.”

Many investors feel like this, which is partially why the opportunity exists.

But as long as there’s strong supply-side barriers to entry, Moreover, the company has 165 offshore vessels. Even if we discount the value of those vessels by **75%** (for wear-and-tear, etc.), we get \$2.48B in asset value. That’s still 30% above the current stock price.

Management has said it will return most (if not all) capital to shareholders via dividends and buybacks. There are only 50M shares outstanding and no debt.

TDW is in the early innings of maximizing its supply-side barriers to entry with a fleet whose fair value is likely worth 2-3x its market cap on a conservative basis. Management has said it will return most (if not all) capital to shareholders via dividends and buybacks.

Portfolio Performance Update (as of 01/20)

- January: +7.52%
- Q1 2023: +7.52%
- YTD: +7.52%