

## Equities

13 February 2011 | 7 pages

# Oilfield Services & Equipment

## Petrobras Commits to Deepwater Rig Construction in Brazil

### ■ Industry Overview

- **Event: EAS Awarded Seven New builds** — Petrobras (PBR) has awarded a \$4.64 billion contract to Estaleiro Atlântico Sul (EAS) for the construction of seven ultra-deepwater drillships. Sete Brasil S.A., an entity to be funded 10% by PBR and 90% by Brazilian pension funds and banks, will own the rigs. We believe this news furthers the investment case for RIG (1H) to reach our \$88/sh price target, among other stocks.
- **Supports Our Industry Thesis** — Inasmuch as this development expands Petrobras drilling program in deepwater, it represents a positive sign for the various groups of oil service companies in our coverage that will cater to the national oil company's needs: those that would build and outfit the drilling rigs and production infrastructure (including NOV, CAM, FTI, DRC), those that would provide rigs to meet subsequent tenders or manage the new drilling contracts (RIG, DO, NE, and others), and those that would provide the ancillary services to support its exploration and development efforts (SLB, HAL, BHI, WFT).
- **First Rig Delivery Expected in 2015** — Petrobras indicated in a filing that the first rig would be delivered in 2015, a one-year pushback from the original 2014 target. The admission only confirms a delay widely anticipated in the industry. We reiterate our belief that Petrobras will launch more international tenders starting in 2011 in order to have sufficient rigs for its 2011-2014 drilling program.
- **Premium of 10% for "made in Brazil" Rigs** — The \$4.64 billion purchase price implies an average cost of \$662M per rig, which is about 10% higher than the \$600 million price tag today for a high-spec drillship from a Korean shipyard. This local premium is substantially smaller than was widely predicted and it demonstrates the bargaining power of Petrobras as the world's largest deepwater exploration company. But since the EAS shipyard has never built a drilling rig, there is a significant risk of cost overruns on the seven-rig package.
- **Sete Brasil Structure Offers Advantages** — We believe setting up a separate entity to fund and manage the rig-building program is favorable because it reduces the risk that excessive debt levels could disrupt PBR's ongoing drilling budget. The prudent risk management scheme improves the likelihood that PBR will need rig kits, FPSO infrastructure, supply vessels, etc. sooner rather than later.
- **PBR Milestones Are Indicative of Future Sector Revenues** — We can analyze the details of this contract and parse the company's statements, but the fact is that Brazil represents the single largest source of non-OPEC supply for the next 10 years. The bigger question for the oil service companies is whether financial or political developments will impede or delay efforts by Petrobras to proceed with its \$224 billion investment program to develop Brazil's deepwater reserves on an aggressive schedule. So far it appears to be on track.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

## Additional Background

- Estaleiro Atlântico Sul (EAS), the initial low-bidder, was awarded the seven-rig construction program as expected. The company is made up of Brazilian contractors Queiroz Galvao and Camargo Correa, with smaller stakes owned by Brazilian shipyard group PJMR and South Korea's Samsung Heavy Industries. The purchase price of \$4.64 billion was determined when EAS was the lowest of nine bidders for the seven-drillship order.
- The initial bid called for the construction to take place at the EAS yard in Pernambuco. Industry sources indicate that the lack of a previous track record on a major construction operation at this facility increases the likelihood that the project will run late even beyond the modified first-rig delivery target of 2015. The Pernambuco yard is designed to eventually be one of the most automated shipyards in the world, with input from Samsung Heavy Industries in the design. Reports from a few months ago have indicated, however, that previous projects for a tanker and a semisubmersible production platform hull had fallen behind schedule.
- Sete Brasil S.A will be 10%-owned by Petrobras and 90%-owned by local pension funds and banks, including Santander and Bradesco. It was previously reported that Petrobras directors were creating a holding company to charter the rigs, and the formation of Sete Brasil had been announced last month. Petrobras never intended to operate all of the rigs built in Brazil, although it may do so for a limited number of them.
- One of the major advantages that Sete offers, in our opinion, is that Petrobras can avoid putting excessive leverage on its balance sheet to fund rig construction projects. Sete should also align incentives by offering equity stakes to rig operating companies on a rig-by-rig basis. Drilling companies may be invited to invest in Sete if they are chosen to manage the rigs after they are built.

## Transocean Inc

(RIG.N; US\$77.23; 1H)

### Valuation

We derive our \$88 RIG price target by averaging P/E and EV/EBITDA methodologies. Our target is based on historical analysis of RIG and group multiples.

Our P/E derivation generates a price target of \$83 by applying an 10.0x multiple to our \*forward 12-month EPS estimate of \$8.30. The multiple is below the 28.2x peak RIG multiple reached in the most recent downturn and is above the 3.4x trough reached at the peak of the last upturn. The multiple is based on historical analysis of RIG and relative market multiples and is within the 4.5x–47.0x historical range where the average of offshore driller stocks traded over the past ten years. The median group P/E multiple was 13.1x in the most recent cycle.

Our EV/EBITDA derivation generates a price target of \$93 by applying a 6.7x EV/EBITDA multiple to our \*forward-12-month adjusted EBITDA of \$5.37 billion. The multiple is below the 17.1x peak RIG multiple reached in the most recent downturn and is above the 3.8x trough reached at the peak of the last upturn. The multiple is based on historical analysis of RIG and relative market multiples and is within the 2.9x–15.6x historical range where the average of offshore driller stocks traded over the past ten years. The median group EV/EBITDA multiple was 7.6x in the most recent cycle.

\* Our forward-12-month estimate reflects the four quarters earnings stream beginning 12 months from the most recently reported quarter.

### Risks

Our High Risk rating on Transocean is based on projected financial performance, which is highly dependent on the level of oil and natural gas exploration and production (E&P) activity. E&P activity, in turn, can be significantly impacted by rising and falling oil and natural gas prices. Transocean's financial performance is particularly sensitive to both rig demand and day rates. We estimate that under conditions of strong rig demand and full utilization of its fleet, Transocean's earnings per share would change by \$0.13 for every \$1,000 change in its average daily revenue per rig. If the impact on the company from any of these factors proves to be greater/less than we anticipate, we believe the stock will likely have difficulty achieving our target price or could outperform it.

## Appendix A-1

### Analyst Certification

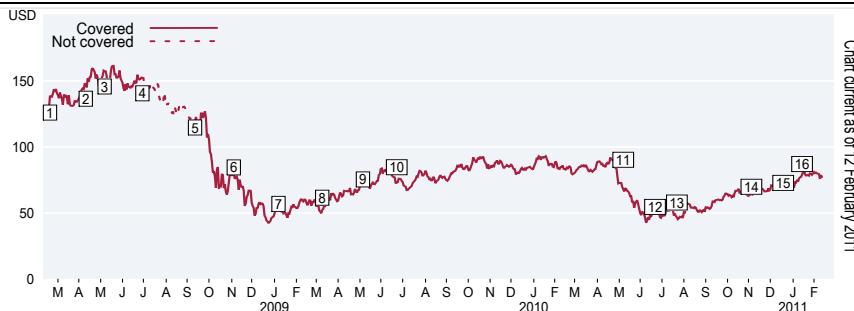
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##### Ratings and Target Price History Fundamental Research

Analyst: Robin Shoemaker  
Covered since September 12 2008



	Date	Rating	Target Price	Closing Price
1	20-Feb-08	1H	*165.00	138.73
2	10-Apr-08	1H	*179.00	147.41
3	7-May-08	1H	*197.00	157.40
4	30-Jun-08	Coverage terminated		
5	11-Sep-08	1H	*159.00	119.92
6	5-Nov-08	1H	*137.00	80.35

\* Indicates change

	Date	Rating	Target Price	Closing Price
7	7-Jan-09	1H	*107.00	54.91
8	10-Mar-09	1H	*98.00	52.30
9	6-May-09	1H	*102.00	74.59
10	23-Jun-09	1H	*100.00	72.98
11	7-May-10	1H	*98.00	68.01
12	22-Jun-10	1H	*72.00	52.49

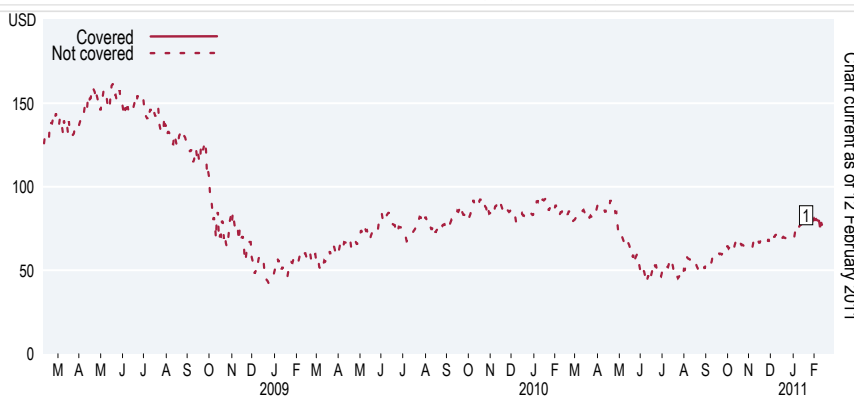
	Date	Rating	Target Price	Closing Price
13	22-Jul-10	1H	*69.00	46.67
14	4-Nov-10	1H	*80.00	64.21
15	19-Dec-10	1H	*90.00	69.34
16	14-Jan-11	1H	*88.00	79.01

Rating/target price changes above reflect Eastern Standard Time

#### Transocean Inc (RIG)

##### Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Robin Shoemaker  
Covered since September 12 2008



	Date	Rating	Target Price	Closing Price
1	20-Jan-11	*ADD MP	-	78.37

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