THREE STEPS OFFSHORE DRILLERS MUST TAKE NOW

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The recent plunge in global oil demand, coupled with the collapse in prices, has dealt a painful blow to the oil and gas sector. Few businesses have suffered more than offshore drillers, many of which were already in dire financial straits heading into the crisis and now find themselves facing an existential threat. For drillers, weathering the storm and positioning themselves for a recovery will demand bold moves, including significant fleet rationalization—both capacity reduction and industry consolidation. It will also demand an extensive revamping of their operating model, performance, and value proposition.

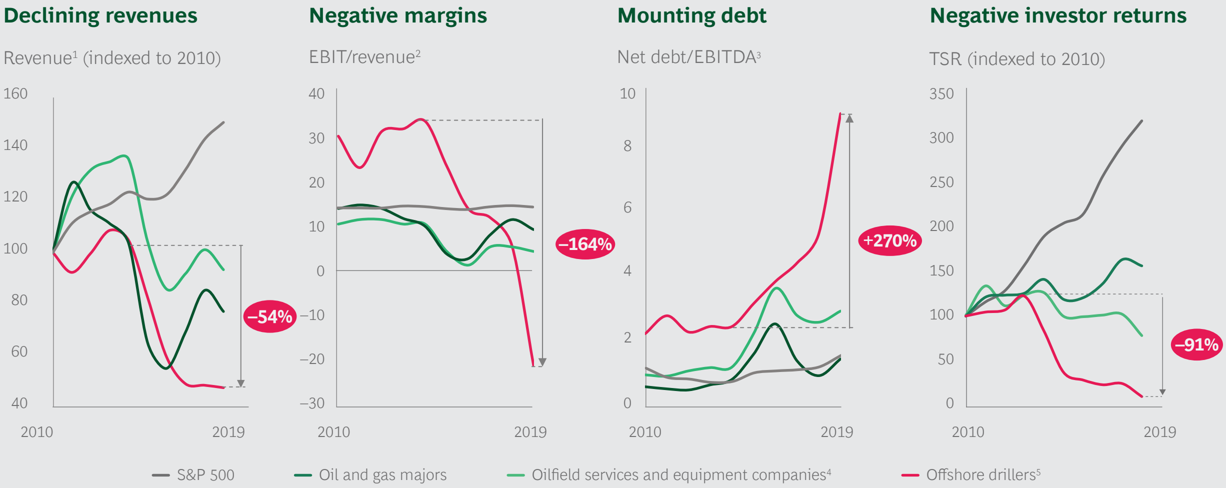
Major drillers took steps to overhaul their business following their last severe test, the oil price plunge of 2014. Unfortunately, they didn't go far enough. This time, companies will need to do more—in fact, much more, given their less-robust financial state, the potential for protracted weakness in oil prices, and mounting pressure from shareholders and creditors to act. Given the industry's current operating model and challenges, sustainable value creation will be difficult to achieve. But players that are willing and able to fundamentally change the way they do business could emerge in a relatively strong and sustainable position when the clouds finally lift.

A Perfect Storm

The numbers tell the story. The oil market recently saw a 70% price decline within a period of three months, its steepest slide in three decades. In response, major oil and gas companies have pulled back sharply on spending plans. The ten largest players by market capitalization have already announced $130 billion in spending cuts, roughly half of which had been earmarked for capital expenditures—hitting offshore-drilling contractors hard.[1]

Offshore drillers are ill-equipped to deal with this challenge. Between 2014 and 2019, they saw dreadful performance, with revenues falling by half, debt doubling, income and margins turning negative, and shareholder value falling by 90%. (See Exhibit 1.)

Exhibit 1 | Offshore Drillers' Performance Has Suffered Since 2014



Sources: S&P Capital IQ; BCG analysis.
[1]Average revenue in each sector.
[2]Average EBIT/revenue of all companies analyzed in each sector.
[3]Average net debt/EBITDA of all companies analyzed in each sector.
[4]Analysis includes 50 oilfield services and equipment companies.
[5]Top public offshore drillers by 2020 fleet size that have complete historical financial information since 2010.

Some companies ultimately did not survive: between 2014 and 2019, nine drillers filed for bankruptcy and six were acquired or merged. The remaining players entered 2020 with little financial cushioning. Their near-term growth prospects also looked shaky; relative to 2014, these companies' project pipelines were thinner and their backlogs and contract terms less attractive. Since the start of the COVID crisis, at least five other major drillers have filed for bankruptcy or indicated their intention to restructure financially.

Offshore-drilling contractors also continue to face significant structural headwinds. These include the likelihood of prolonged low oil prices, which will have a dampening effect on industry capex; customers (exploration and production companies) with alternative capital deployment options, including increased spending on low-carbon energy sources; investors' retrenchment of capital; and regulators and subcontractors whose demands and expectations have not adapted to the industry's current circumstances.

Finally, drillers are wrestling with the realities of their high-fixed-cost business model and a fragmented and oversupplied market. And they have had to contend with the effects of a high degree of pricing volatility, reflected in sharp swings in day rates.

Given this confluence of challenges, even large drillers run the risk of exhausting their cash reserves in the near to medium term. As a result, most will need to substantially restructure.

A Missed Opportunity

Against this backdrop, it's clear that the period following the 2014 plunge in oil prices was a missed opportunity. To their credit, offshore drillers tried to improve their business, with an emphasis on cost cutting and on digital and other technology investments. But these efforts were insufficient to produce a level of performance that matched precrisis levels—or even to achieve a standard that was sustainable. The measures also fell short of the types of actions needed to fundamentally transform the industry, such as substantial reductions to fixed costs and capacity. And they failed to create differentiation among contractors; no business emerged a materially more efficient company than its competitors.

The lack of bold moves reflected management's optimism that the crisis was temporary and that customer demand and the industry's pricing power would quickly return to where they stood before the crisis. Drillers were also confident that the financial cushion from their pre-2014 contracts, supplemented by the reestablishment of easy access to capital, would provide them the ready means to resurrect their business.

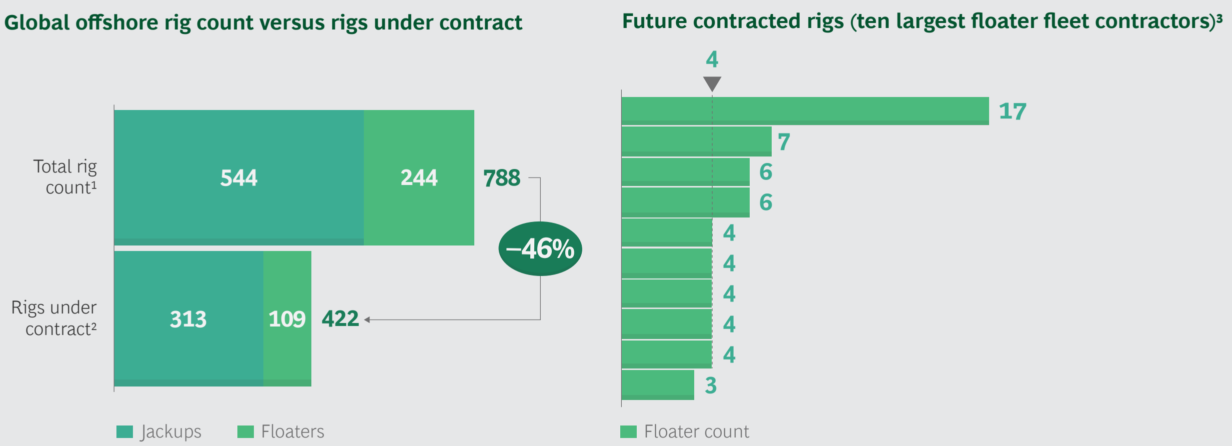
But this optimism ultimately came at a cost, with contractors finding themselves ill-prepared to withstand today's market turmoil. Many drillers still operate very inefficiently on multiple fronts. Some have support costs that are too high—with roughly twice the optimal number of onshore support staff per rig, for instance. Other drillers have made ill-advised technology investments. Post-2014, many went on a technology investment spree, thinking it would differentiate them from their peers. But they did so without determining exactly how those investments would deliver commercial value. Now these companies find themselves with a portfolio of technologies that don't make a meaningful impact on the top or bottom line.

Other drillers made poor portfolio decisions. Most contractors, for example, have maintained fleets that are too large, incurring significant costs for the stacking (that is, the temporary deactivation) of rigs that should have been retired as part of a broader capacity reduction. Finally, drillers have shown an absence of discipline in M&A. They paid excessive premiums on rigs not fit for current markets, underestimated integration costs, or inherited unprofitable contracts, resulting in deals that have delivered only a fraction of the expected value.

As a result of such decisions, the industry continues to be largely oversupplied and fragmented. (See Exhibit 2.) At the end of August 2020, roughly 370 (about 45%) of global offshore rigs were idle, stacked, or among the 65 new builds underway. More than 40 drillers owned the current industry's 220 floaters and nearly 100 drillers owned its more than 500 jackups, an average of only about five rigs per company for each category.

Heading into 2021, most drillers will also lack scale in their core market segment or region. Even the largest fleet owners in the two rig categories could soon end up running a subscale operation. Based on a recent count, by the end of the first quarter of 2021, the ten largest owners of floaters could hold a median of only four rigs with firm contracts, while the ten largest owners of jackups could hold a median of only nine rigs with firm contracts.

EXHIBIT 2 | Offshore Drilling is Highly Oversupplied and Drillers Lack Scale



Sources: RigLogix; BCG analysis.
[1]Comprises rigs that were stacked or under construction on August 25, 2020.
[2]Rigs that had firm contracts as of August 25, 2020.
[3]Rigs that had firm contracts as of August 25, 2020, and will be active by March 31, 2021.

Pressure from Multiple Sides to Change

The offshore-drilling industry thus finds itself at a crossroads. It must act boldly, overhauling its value proposition, operating model, and performance. Merely repeating the financial restructuring and other actions that it took following the oil price plunge of 2014 will leave it far short of what's needed to avoid sliding toward sunset industry status.

In fact, the industry has no option but to act soon and decisively. Pressure to act will come from multiple directions. Boards, cognizant of the prevailing risks, will be far less likely to accept "wait it out" plans from executives. Instead, they will demand schemes that minimize cash burn and emphasize such measures as mergers and the retirement of assets—as well as performance improvements and the professionalization of drillers' business models. Drilling executives will need to demonstrate tangible results quickly.

Investors will also apply pressure. After watching the industry's protracted slide, they are skeptical and their confidence is at an all-time low. These investors include former bondholders who were sold on earlier debt-for-equity schemes that typically didn't pay off, so it's no surprise that they are now more demanding. This time they will significantly lower the value assigned to rigs—and significantly raise their required return on investment. The industry is also likely to see a growing concentration of owners and investors, players who have proportionately more at stake and are thus increasingly committed to seeing the industry build a sustainable future.

Shifting priorities among exploration and production companies will also pressure drillers to change. E&Ps are increasingly redeploying their capital toward short-cycle investments and low-carbon energy sources. In conjunction, they are taking a short-term approach to drilling activities and planning. This orientation results in high volatility in drillers' revenues and margins—and makes it that much more imperative for drillers to alter the way they manage these relationships.

A Three-Pronged Plan of Attack

To achieve the degree of change required—one that results in improved net earnings and returns on invested capital and leaves the industry genuinely transformed—drillers will need to move on three key fronts. Each is necessary but not, in itself, sufficient.

Rationalize the fleet. This will likely entail both capacity reduction and industry consolidation. Trimming capacity to optimal levels demands a clear understanding of a company's target state and will entail hard choices regarding the asset segments, customers, and regions on which to focus—there is no point in being a jack of all trades but master of none. Those choices will inform subsequent decisions. A driller that chooses to play in the deepwater market, for example, can't follow the conservative stacking and rig preservation strategy that prevailed in the wake of the 2014 crisis. Today, the company's tier 2 and 3 floaters coming off contract should immediately be put out of service.

In parallel, drillers should explore opportunities to consolidate. Owners of large contractors will need to take the lead here—it's unlikely that consolidation will be driven by small players. We can envision a scenario in which the industry's total floater capacity is roughly half of what it is today and is controlled by only two or three major players.

Getting the timing right on acquisitions, alliances, and asset divestment will be critical to maximizing value realization. BCG's analysis of more than 50,000 deals over the past 40 years revealed that deals made in a weak economy typically create more value for buyers than those made in a strong economy, for example. Drillers must identify and assess prospective targets and align stakeholders (management teams, investors, customers, and regulators) early regarding potential moves so that the company is positioned to strike boldly and quickly when opportunity knocks.

Optimize the company's operating model and performance. Our recent client work suggests that many drillers have the potential for substantial improvements in efficiency (up to 40% in some areas) through deployment of operational, organizational, and cost excellence levers. (See Exhibit 3.)

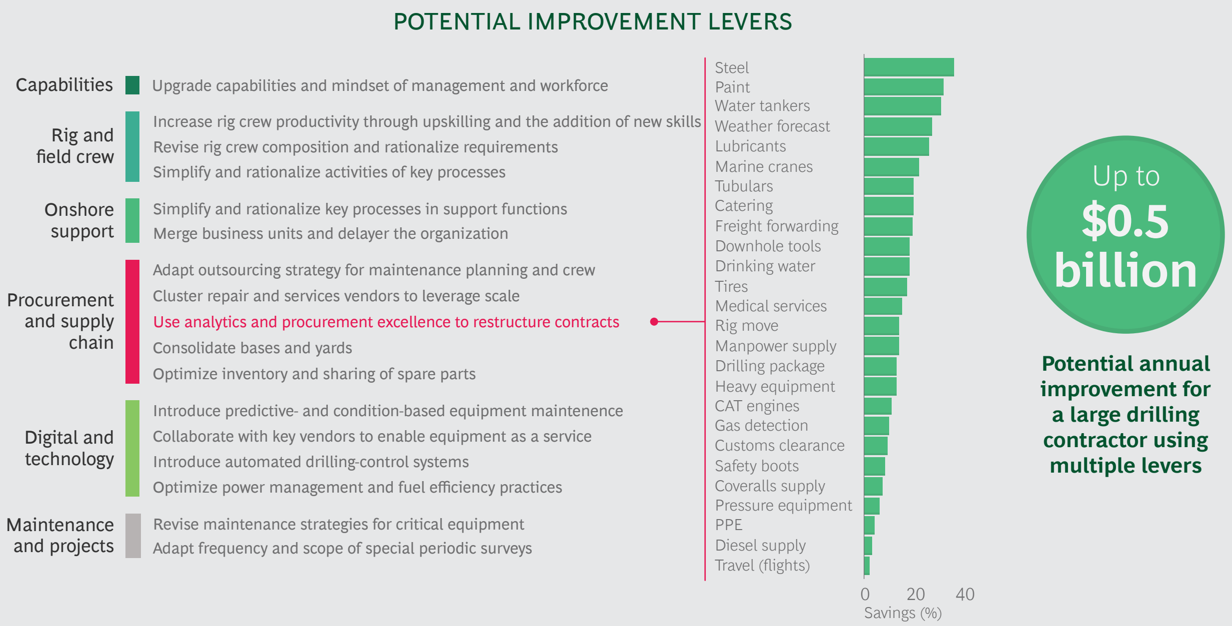
We suggest that drillers focus on talent, capabilities, and management teams. The attitudes of management teams should be reoriented from "we've seen it all before" to "we're ready and willing to do what it takes to win." In parallel, drillers should upgrade the company's talent to align with the demands of the new operating model. Talent, capabilities, and management will be key differentiators among companies with similar fleets and assets, especially given the speed at which change is coming.

Another area that drillers should focus on is staffing efficiency. The driller of the future will work with a multiskilled and lean offshore crew, one that is more than 30% smaller than today's standard. To achieve such efficiency, drillers will need to increase staff productivity. They will also need to make greater use of automation and remote-performance options that allow the company to shift as much work onshore as possible.

Drillers should also optimize their procurement and supply chain practices, which we believe are still untapped sources of value for many businesses. In addition to the use of analytics and core procurement levers, drillers should seek new collaboration models with suppliers, customers, and regulators that allow them to continue to meet regulatory performance standards without constantly needing to buy or inspect equipment.

Finally, drillers should think critically about their current and potential use of digital technologies, which can improve internal operating efficiency and help them meet the performance improvement targets of their customers. Drillers should aim to deploy these technologies aggressively but strategically, designing roadmaps that guide the choice of technology, define how the effort will be scaled, and specify how the value added will be measured and confirmed.

EXHIBIT 3 | Many Drillers Have Potential for Major Improvements in Performance



Source: BCG analysis.
Note: The levers highlighted are examples and do not constitute an exhausive list.

Revamp the company's value proposition. Drillers' commercial model is primitive and has never really evolved. Contractors offer rigs and crews on a day-rate basis, with pricing set by current market demand and supply. Drillers bear limited risk for the success or efficiency of drilling activities, with risk falling predominantly or solely on the client. This model, which rewards drillers simply for asset ownership, has been extremely lucrative historically. But amid a glut of rigs and falling oil demand and prices, it no longer fits today's reality. Drillers need to accept this, rethink their value proposition, and adopt a new model.

The model should address the need to exploit new sources of revenue, such as risk-based integrated drilling services and additional well-drilling and completion services—not as one-offs but rather as core parts of drillers' offering. In fact, these are precisely what growing numbers of E&P players are looking for today. Such services should add genuine value through the assumption of well or performance risk, the provision of a multiskilled rig crew, or vertical integration or alliances with providers of drilling and completions services. All this will move drillers away from a cost-plus model and toward a model that actually enhances value for the customer (and hence the driller).

The new model should also reflect a shift in mindset away from cyclical pricing toward pricing that is longer term and aligned with drillers' risks and rewards. As drillers take on additional risks and provide additional services, they need to make this explicit in their pricing model with respect to performance, incentives, and risk sharing. They can earn a healthy margin, but only by delivering legitimate value and doing so faster, more cheaply, and more efficiently.

In addition to expanding their offering to established customers, drilling contractors should review their longer-term options and explore how they can repurpose their capabilities to capture new markets. Well intervention services (for example, the provision of light intervention vessels) and decommissioning services (fit-for-purpose assets and capabilities) are two such potential opportunities; although drillers may need to reorient their operating model to exploit such opportunities, on balance they are well suited to such pursuits.

For established drillers, current market conditions also present an opportunity to add revenue by exploring alternative asset management models. This includes the operation of rigs owned by creditors or national oil companies rather than by drillers themselves. Such a model would allow drillers to lighten their balance sheet and start to deploy capital solely toward efficient operations.

THE NEAR-TERM PATH for most offshore drillers is rocky at best, and the days of outsized margins are likely gone forever. But by rethinking their business and being willing and able to make bold moves now, leading players can position themselves for healthy returns when the market finally stabilizes.

NOTE

1. Cuts are as of May 27, 2020. The companies are the ten largest by market capitalization as of the end of December 2019: Royal Dutch Shell, ExxonMobil, Saudi Aramco, PetroChina, BP, Chevron, Total, Gazprom, Petrobras, and Sinopec.

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