Valaris Limited [NYSE: VAL]

Initiate at BUY at 2.5% | PT: $69.23

February 10th, 2025

CIMG Investment Research

Valaris Limited: Drilling Down to Upside

Valaris Limited (NYSE: VAL) is the largest offshore and well drilling contractor in the world. Headquartered in Houston, Texas, VAL operates a 53-rig fleet composed of 13 drillships, five semisubmersible rigs, 35 jackup rigs, and a 50% equity interest in ARO Drilling, a joint venture with Saudi Aramco. VAL's operations span six continents, with 24% of revenues coming from Brazil, 16% from the United Kingdom, 15% from the Gulf of Mexico, 14% from Australia, 11% from Angola, and the remainder from other countries (3Q24). Of last quarter's $643M of revenue, 59% was generated through floaters (Drillships & Semisubmersibles), 35% was generated through Jackups, and 6% through ARO Drilling. Using rough approximation, each drillship costs ~$1B to build, and each Jackup costs ~$250M. Thus, although no one would attempt to rebuild VAL's fleet, you wouldn't be able to do it for under $25B, making VAL's current $4.2B EV a curious anomaly for the long-term shareholder. Other investors found this curious too, with famous shipping investor John Fredrickson recently raising his stake to 9.4% ownership from 5% and the CEO of Tidewater Inc (NYSE: TDW) selling shares of his own company to buy $2M in shares of VAL. Additionally, the Maersk Family, long-time shipping magnates, recently purchased 3M additional shares of Noble Corporation (NYSE: NE), bringing their total ownership to ~19%.

Investment Thesis

The offshore drilling cycle is beginning to inflect, steadily increasing demand while capacity has been halved from a decade-long bear market. Beginning in 2014, offshore drilling began to lose meaningful market share to shale, an alternative method of extraction that promised a more economic and efficient delivery of the same oil quality. Combined with many investors believing that we were nearing the energy transition which would mean that peak oil consumption would be in the 2020s, offshore drilling quickly fell out of favor in the eyes of the market and Big Oil, where spending fell by 55%. In order to *stay afloat*, (sorry, I had to) many offshore companies had to liquidate equipment in order to meet their interest obligations. Additionally, as contracts began to become more and more sparse, it became uneconomical to renovate ships that had been moored for an extended period of time, leading to further retirements. In aggregate, 183 floaters were retired from 2014-2024, and much fewer were produced, bringing global supply from 313 rigs to 195, where it sits today. Conveniently, this brought VAL's market share from 5.7% to nearly 10%, since they were one of the few companies able to keep their ships steadily contracted out. As the market becomes more comfortable with the idea that globally, we are nowhere near reaching our energy transition goals and will be dependent on large quantities of oil for many years to come, contracts have been gradually returning to the offshore industry. To quote the Saudi Aramco CEO, "We should abandon the fantasy of phasing out oil and gas, and instead invest in them adequately." Additionally, throughout the "Shale Boom" of the last ten years, it is becoming increasingly obvious that shale executives, whether malicious or overly optimistic, overpromised and underdelivered in regard to the economies of scale associated with shale mining. Depletion rates are rising, and it is clear that all of the best (cheapest and largest) wells have already been drilled and what is left is much harder (and more expensive) to extract from the ground. All major remaining shale mines need ~$70/barrel to break even, but 85% of offshore projects have break-even points below that, with a majority of them operating at <$50/barrel break evens. With exploration, well, and offshore upstream capex growing meaningfully through the next 5 years, and the market getting used to the idea that peak oil demand is likely a few decades further away, it is clear that the tides are beginning to turn back in favor of offshore drilling. Furthermore, now that VAL represents the largest player in the offshore industry, higher demand while supply remains constrained should result in a material lift on day rates and eventually, free cash flow.

Industrials and Energy

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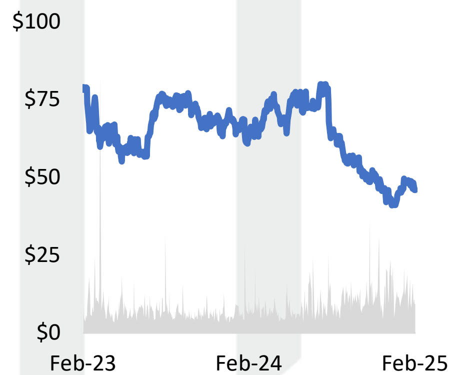
Figure 1: VAL 2 Year Stock Chart



Price	$45.87
Dividend Yield	-
PT	$69.23
Upside	51%
52-Week Range	$39.90-84.20
Dil Shrs Outstand	73.21 M
Mkt Cap	$3.38 B
Ent Value	$4.23 B
NTM P/E	9.83x
NTM EV/EBITDA	6.72x

Rising day rates only occur if capacity stays constrained. Why wouldn't companies just build more rigs? Despite the fact that oil demand's right tail is extending far beyond many scientists' predictions, the oil industry still has valid terminal value concerns. Primarily, it is hard to justify the extremely large capex spend to build a new fleet when *eventually*, the energy transition will occur. However, it is not unheard of for company executives to spend irrationally when facing large increases in demand for their product, so instead of focusing on why executives ***won't*** build more rigs, let's instead explore why they ***can't***. In the past, oil rigs have been rendered obsolete every decade or so, due to increases in technology that allow new ships to drill deeper, safer, and faster. After the deepwater horizon accident (5th generation rig), the industry moved to the 6th generation, which makes up two-thirds of global capacity today. As we entered the most recent bear market for offshore drilling, the 7th generation rigs were invented, but only 57 (1/3 of global capacity) of them exist, primarily due to some players in the industry not being in the financial position to upgrade. Unlike the offshore industry, (which nearly ground to a halt from 2014 to 2023) technology continued to progress, and we are now on the 8th generation of vessels. There are three 8th generation vessels in the world, and unfortunately for manufacturers, it looks like that number will remain at three forever. An 8th generation rig costs 3 years and ~$1 billion to build, which from an IRR perspective, only makes economic sense at $1 million / day rates (reminder: we are currently ~$500k / day and peak inflation-adjusted day rates from the last cycle are $750k-$800k). As a result of this, 7th generation vessels are effectively the cream of the crop, since 8th generation vessels are too expensive, and operators are hesitant to upgrade 6th generation vessels as they become increasingly obsoleted by 7th generation rig efficiency gains. Now feels like a good time to remind you that VAL is in possession of 12 (21%) of these 57 7th generation rigs, the most of any offshore company. Therefore, there will be no new supply entering the space, and VAL seems particularly poised to benefit from rising demand. In the six-sigma event that day rates hit record figures and construction of 8th generation ships becomes an economic reality, then companies like VAL would generate obscene levels of free cash flow on the way up, and during the 3-4 year construction period.

VAL currently trades at a meaningful discount to fleet value, despite representing ~20% of the world's remaining high-quality drillship supply. Assuming that jackups cost ~$300M to produce, semisubmersibles cost ~$600M, and drillships cost ~$1B, it would cost ~$26.5B to recreate VAL's fleet assuming you started from scratch. At a valuation of ~$26.5B, assuming no change in shares outstanding, (which management is actively repurchasing) VAL shares should be worth $362/share. After falling nearly 40% in the last six months, VAL currently trades at $47/share, implying 670% upside. However, reflecting back on previous peak points in the last cycle, businesses like this sometimes trade *above* replacement value, making the upside case even more extreme. Our math yields meaningful (100%+) upside if VAL trades at even 25% of replacement value, let alone >100%.

Valuation

The committee modeled VAL by calculating NAV through projecting market values of their equipment and subtracting depreciation, and then applying a multiple on that NAV. As to not stray too far from CIMG's roots, the committee also did a 3-statement model, driving future cash flows primarily with increased utilization and day rates, and discounting those future cash flows to reach a terminal value. Assigning 80% weight to NAV and 20% to the traditional DCF, we arrived at a projected share price of $69.23 five years out, representing an IRR of ~17%.

Company Overview

Valaris Limited (NYSE: VAL), is the world's leading provider of offshore contract drilling services. VAL operates in nearly every major offshore market across six continents and serves a diverse client base of nearly all national major and supermajor oil and gas companies. The company currently owns 53 rigs, including 12 7th generation drillships, one 6th generation drillship, four semisubmersible rigs, one moored semisubmersible rig, 35 jackup rigs, and a 50% equity interest in ARO Drilling, an unconsolidated joint venture with Saudi Aramco, which owns eight additional jackup rigs and is contracted out to build 20 more in 2025. VAL was founded in 1975 when John Blocker bought Choya Energy, a then six-rig contract drilling company, renaming it Blocker Energy. Blocker Energy IPO'd in 1980, where it traded until being renamed to Energy Service Company (Ensco) in 1987. After numerous acquisitions to build fleet size, Ensco merged with Rowan Companies and changed its name to Valaris plc. Shortly after in August 2020, Valaris plc. filed for Chapter 11 bankruptcy protection. The company emerged from bankruptcy as Valaris Limited, eliminating $7.1B of debt, and began trading on the New York Stock Exchange under the VAL ticker. Part of the restructuring involved a replacement of the core management team, introducing Anton Dibowitz as CEO (former Seadrill CEO) and Chris Weber as CFO (former Haliburton CFO).

Industry Overview

VAL operates in the offshore drilling industry, which plays a key role in the global energy market. As of October 2024, offshore accounted for 27% of global liquid fuel production, a number that is expected to increase to 29% by 2030. While this may seem insignificant, that 2% increase represents ~5M barrels per day. Primarily driving this increase is a rebound in deepwater drilling activity due to worsening shale economics. The Permian Basin, Marcellus Formation, and Utica Shale represent some of the only remaining large shale reserves in the country, and over the last decade, the best shale wells have already been drilled, creating a more difficult and expensive process to obtain new resources. While shale was rising in popularity, the offshore drilling industry has consolidated meaningfully over the last 10 years. Out of the 53 active 7th and 8th generation drillships in the world, 48 of them are owned by VAL, NE, Seadrill Ltd. (NYSE: SDRL), and Transocean Ltd. (NYSE: RIG). All four of these companies have comparable balance sheets, with the exception of RIG, which currently has a 7x net debt/EBITDA ratio. Virtually all revenues in the offshore business are generated through long-term contracts with fixed day rates, meaning that another important variable here is renewal dates. VAL has a large portion of its contracts up for renewal in the next four to six quarters, creating an additional opportunity to reset the day rate to a higher base.