DIAMOND OFFSHORE SENIOR UNSECURED NOTES

INVESTMENT REVIEW | DISTRESSED DEBT

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MASSIF CAPITAL, LLC | CHARLOTTE, NC

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Investment Thesis and Expected Return

Diamond Offshore (DO) is an offshore oil field services provider, specializing in contract drilling services. On April 27, the firm filed for bankruptcy. At the time of filing, the company had $499 million in unrestricted cash, an aggregate contract backlog totaling approximately $1.4 billion, and a fleet of offshore drilling rigs consisting of 11 semisubmersibles and four ultra-Deepwater drillships, vs. total liabilities of ~$3.0 billion. On a GAAP basis, the resulting book value of the firm is $2.3 billion.

An analysis of the multiple reorganization scenarios implies that New Diamond (ND), assuming yearly EBITDA of $50 million a year and trading at an EV/EBITDA multiple of 6.5x, which is well below that of industry leader Transocean (current EV/EBITDA of 9x) but in line with the firms historical EV/EBITDA ratio at healthier times for the firm but still a stressed market environment, would result in a firm with a new equity value of $656 million. Investors in the senior unsecured notes, currently trading at between $0.10 and $0.12 on the dollar, would recovery 33% of the face value of the bonds in new equity. In this recovery scenario, bond investors can expect a return of is 173%, limited downside risk, and a favorable investment timeline.

Bankruptcy Filing Context

A combination of three unprecedented events has created a situation in the oil and natural gas industry that will generate numerous bankruptcies and distressed investment opportunities. The first was the growth in relatively expensive and capital-intensive shale oil. Since 2008, the world has been flooded with shale oil out of the United States, produced by innovative North American E&Ps that, despite their production success, have failed to create any value for investors. The result has been an increasingly tenuous oil price environment that has suffered from extreme volatility and increasing fragility.

The second is the spread of the COVID19 virus, which has brought economies throughout the world to a grinding halt in a way investors have never seen before. With the halt in economic activity has come significant oil and natural gas demand destruction that has threatened the fragile edifice upon which much of the new oil and gas production brought into operation over the last twelve years in North America was built.

Finally, in the presence of an already weak demand environment, Saudi Arabia and Russia decided it was time to end their always tenuous détente and begin a price war with both parties announcing their intention to flood the already swamped oil market with more barrels then the world can consume or store.

Although many had hoped that the end of that price war would bring a rebound in the price of oil, the demand destruction and economic punishment meted out by the COVID19 virus have extended the historic sell-off beyond the rapprochement of Saudi Arabia and Russia. Oil and natural gas investors must now come to grips with the fact that investing in the sector will require either catching falling knives or purchasing distressed assets. We are still in the early days of the industry shakeout, and only two significant publicly traded industry participants (WLL, DO) have filed for bankruptcy, but DO is just the first of possibly many significant distressed opportunities.

Diamond Offshores Distressed Situation

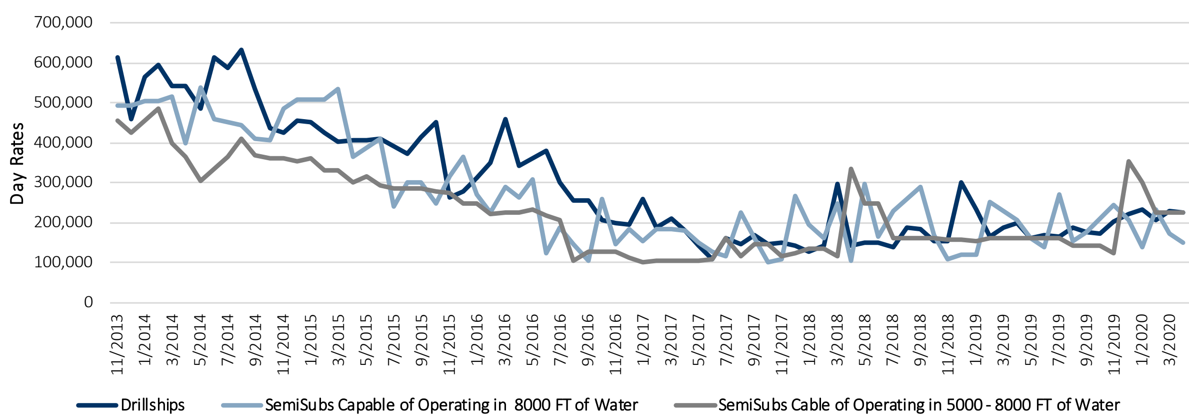
Diamond Offshore is an offshore oil field services provider, specializing in contract drilling services to the oil and natural gas industry globally. On April 27 of this year, the firm filed for bankruptcy. At the time of filing, the company had $439 million in unrestricted cash on hand, an aggregate contract backlog totaling approximately $1.4 billion, and a fleet of offshore drilling rigs consisting of 11 semisubmersibles and four ultra-Deepwater drillships, vs. total liabilities of roughly $3.0 billion. On a GAAP basis, the resulting book value of the firm is $2.3 billion. At face value, this appears a relatively stable position, and when one takes into account the maturity profile and quality of assets, the position of DO appears even more robust.

Even a casual market observe could rightly ask, if the asset position is so strong (and we will demonstrate below that it is), why did the company file for bankruptcy? The answer to that question is also the source of the challenge in determining the outcome of the current bankruptcy. From a pure solvency perspective, DO appears to be in modest shape, from a liquidity perspective though the firm has issues. There are three primary reasons for this. The first is the erosion of day rates in the offshore drilling industry, which can be seen in the chart below:

Distressed Investing

The basic problem faced by distressed company is that the firm financial value is less than the debt/liabilities component of the capital structure. There are two possible solutions to this problem. Management can increase the asset value of the firm, or they can attempt to reduce the amount of liabilities to better reflect the current asset value. Although increasingly the asset value is a desirable solution it is rarely one that can be pursued. As such, a restructuring is generally the path taken by most firms.

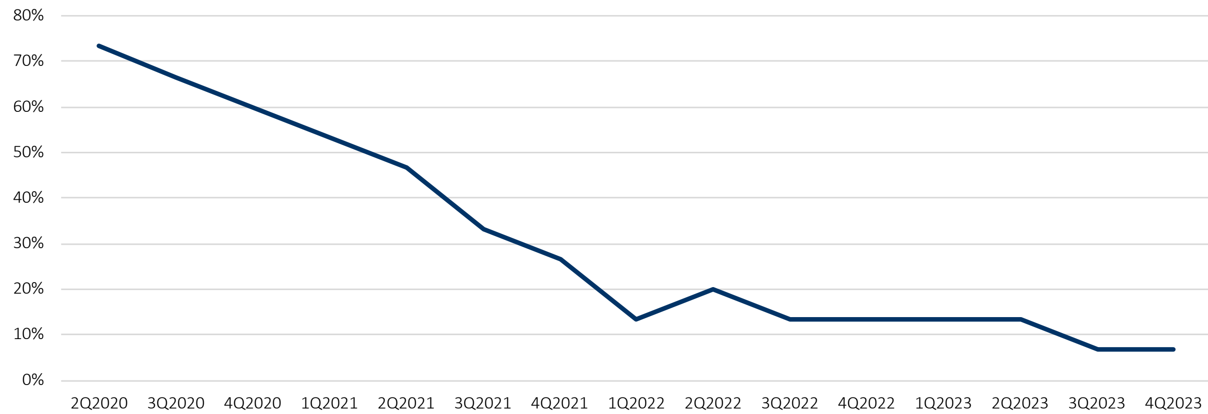
Distressed investors are search for an investment opportunity in the process of resizing the capital structure of the firm. This means distressed investments are found in a careful consideration of a firms existing balance sheet within the context of multiple of new capital structure scenarios. Assets on the current balance sheet can be thought of as clay, and the liabilities as constraints on the eventual shape one can form the clay into. It is worth noting that the bankruptcy code also provides structure as it defines the negotiating leverage of various parties



Source: Massif Capital, Riglogix

Figure 1: Offshore Rig Day Rates Over Time

The erosion of day rates has significantly impacted the firm's revenue, compressing margins, and reducing both EBITDA and free cash flow generating ability. Since 2013, day rates have collapsed between 45% and 69% depending on the rig type. DO management may have been about to navigate this situation if contracting had held up, but fixtures for offshore rigs have been few and far between and DO is approaching a cliff in its currently contracted status, as the chart below shows:

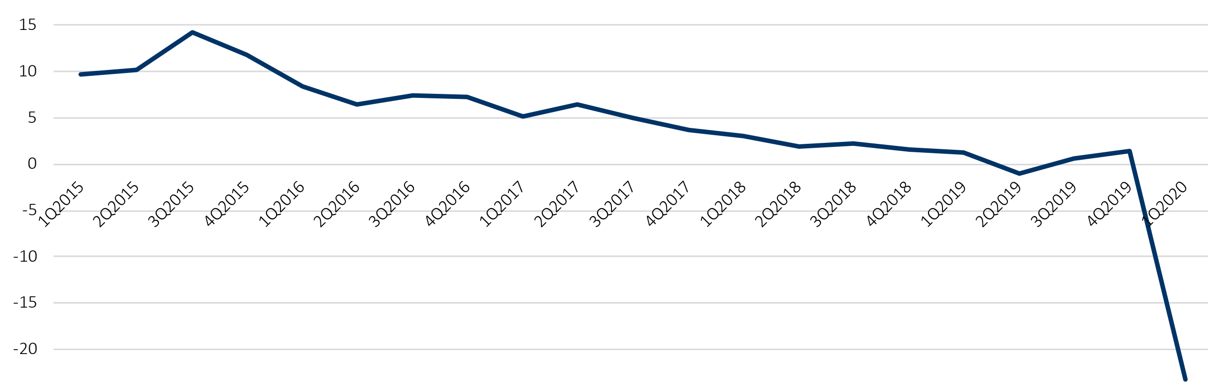


Source: Massif Capital, DO Filings

Figure 2: Percentage of DO Rig Fleet Contracted by Quarter

The combination of collapsing day-rates and reduced re-contracting both drivers of revenue have eroded in recent years. This is highly problematic for a capital-intensive business with high fixed costs and significant working capital requirements. In general, the solvency of the firm has held up because the asset value of offshore rigs has held up relative to the firm's liabilities. The reason for this is that offshore rigs remain expensive to build, and the value of secondhand rigs has placed a floor under the asset value that is more than an owner's potential going concern value of the rig. Put another way, the NPV of a project utilizing a secondhand rig vs. a project that uses a new rig is sufficiently higher than in a secondhand open market transaction the rigs sale price is based to a greater degree on replacement value than operating value to the existing owner. The result of this somewhat odd situation (which is usually only possible in highly cyclical industries) is that while DO appears to have a reasonably strong balance sheet; it has a deteriorating liquidity situation that is aggravated by the fact that the prospects for future borrowing are limited.

How bad is the current debt servicing situation?



Source: Massif Capital, DO Filings

Figure 3: EBITDA/Interest Coverage Ratio

Pretty bad, not only has the historical EBITDA/Interest coverage ratio deteriorated significantly but the outlook, in the absence of signing significant new contracts, is equally bleak. Assuming the firm signs no new contracts through the end of 2023, an admittedly pessimistic assumption but not one that is out of the question, the firm will not be able to cover interest expenses out of operational cash flows in any quarter between now and the end of 2023.

Unlikely in many bankruptcy situations in which management has driven the company into the ground, DO's management team has not done that but has also not been able to extract value from its asset base. In some respects, management has done everything one would ask of a cyclical company's management team. DO management husband resources, invested in their fleet counter-cyclically[1], innovated where possible[2], and operates the fleet at the highest rig operating standards in the industry[3]. The innovations the management team has put in place, combined with the high operating standards, could even be pointed to as significant sources of unrealized value creation. This is especially true of the high operating standards which create an institutional memory within the rig operation teams of best practices for operating the rigs at a high tempo.

Despite these positives, when operating in a highly cyclical industry, with significant operating leverage, and a generally commoditized revenue stream, there are substantial limits to the ability to realize value via innovation and better service as premium pricing has limitations due to the market structure. Complicating matters is the fact that revenue appears to be either approaching or roughly at the operating cost of the assets. In such a situation, there is little that management can do. Add to this a dire macro-economic backdrop for the global economy, and the oil industry and trouble is inevitable.

The key take away from this discussion should be that although DO has filed for bankruptcy, the balance sheet contains significant asset value that, if given time and paired with a right-sized capital structure, could produce a viable business. As such, there is a range of Chapter 11 outcomes that can that result in significant value creation for investors in the senior unsecured bonds, especially given that the senior unsecured bonds are currently trading at levels that imply that there is no viable future business and less than $240 million in asset value on the balance sheet.

The rest of this report will demonstrate that not only is there significantly more value on the balance sheet than $250 million but that the senior unsecured bonds represent a significant opportunity. To illustrate this, we will walk through several hypothetical "plans of reorganization," but before that, we will briefly look at the capital structure and the priority of DO's various liabilities.

Capital Structure

DO has a relatively simple capital structure that makes for a more straightforward analysis than many distressed opportunities and, hopefully, will make for an easier plan of reorganization. The firm's principal non-contingent liabilities consist of a partially drawn revolver and four unsecured notes that have a total outstanding principal amount of approximately $2.4 billion. The liabilities below are arranged in order of overall priority, the exception being any potential critical vendor payments and or trade claims.

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[1] Management significantly upgraded multiple rigs last year, spending $176 million on rig upgrades.

[2] Management has deployed two innovations to rigs in recent years: Pressure Control by the Hour and Sim-Stack. Both innovations are related to the Blow Out Protector or BOP, and keeping the BOP operating, BOP downtime is the number one cause of rig downtime. In the 1st Qtr of this year, deployed innovations resulted in the firm operating rigs with Pressure Control by the Hour and Sim-Stack 100% of the quarters potential revenue earning hours, most firms operate between 90% and 95%.

[3] Last year the firm drilled three of the four most cost efficient wells in the history of offshore drilling in the Gulf of Mexico, all in ultra-deep water.

Revolver

A senior 5-year revolving credit facility, maturing in October of 2023 with a maximum amount of borrowings available of $950 million. The firm is free to use the revolver for general corporate purposes, including investments, acquisitions, and capital expenditures. Any debts incurred under the revolver are guaranteed by various subsidiaries of DO but is not otherwise secured by liens on the DOs assets, including any cash collateral. According to court filings, no other security interests have been granted to the credit facility lenders, and all the borrowers and guarantors named in the indenture are debtors in the Chapter 11 case. In March of this year, DO borrowed a total of approximately $436 million on the revolver as a precautionary measure to increase its cash position and preserve financial flexibility considering the uncertain market conditions. As of the Chapter 11 filing, DO had approximately $442 million of borrowings and L/Cs outstanding under the Revolving Credit Facility.

The revolver does include restrictions on borrowing if additional borrowing would result in the firm having available cash in excess of $500 million, this is likely the reason management did not fully draw the revolver.

The revolver is the only bank debt[4] the firm has, and it represents only a modest percentage of the capital structure relative to the long-term unsecured debt.

Notes

- $250 million principal amount of 3.45% senior notes due 2023, the notes require semiannual coupon payments, are not guaranteed and are unsecured.
- $500 million in principal amount of 7.87% senior notes due 2025, the notes require semiannual coupon payments, are not guaranteed, and are unsecured.
- $500 million principal amount of 5.7% Senior Notes due 2039, the notes require semiannual coupon payments, are not guaranteed, and are unsecured.
- $750 million principal amount of 4.8% Senior Notes due 2043, the notes require semiannual coupon payments, are not guaranteed, and are unsecured.

At the current time, the notes are all trading at extremely distressed levels, generally in the 10 to 12 cents on the dollar range, resulting in the $2 billion in face value having a mark to market value of $200 to $240 million.

Assets

On the asset side of the balance sheet, DO has $439 million in cash, $273 million in accounts receivable, and a 15-rig fleet with a March 31, 2020, GAAP balance sheet value of $4.32 billion. Note that these numbers come from the 1st Quarter 2020 10Q, issued on May 5, a week after the firm filed for bankruptcy. DO did write the value of its rig fleet down by $774 million in the most recent 10Q, but it

[4] The greater the amount of bank debt the less likely it will be that non-institutional open market participants can easily engage in the reorganization as bank debt does not trade in readily accessible markets. Additionally, a large overhang of bank debt limits the range of reorganization options. Bank debt usually has all-encompassing covenant packages and rigorous security. Furthermore, although the automatic stay that goes into place once a company enters Chapter 11 prevents a bank from seizing collateral, the bank is still protected by the concept of "Adequate Protection."

did not write down the value to less than $240 million, which is what the firm's mark to market value of debt is. The current market value of debt implies that not only is the rig fleet worth very little, and substantially less than reported in SEC filings a week after filing for bankruptcy but that the accounts receivable and contract backlog are worthless.

If we assume a liquidation scenario, which is the minimum return scenario demanded of a Chapter 11 filing, then investors in the senior unsecured debt will make money (considering a purchase price of $0.12 on the dollar) as long as more the balance sheet has more than $640 million in value (100% of the value of the drawn component of the revolver plus the marked to market value of the senior unsecured notes). The question for an investor is thus, can we find more than $640 million in value on DO's balance sheet?

<u>Cash</u>

As of March 31, DO had $499 million in cash on its balance sheet. It is worth noting that at least $150 million of it is already allocated to necessary CAPEX associated with the execution of existing contracts. As a result, the firm has $349 million in cash that is unspoken for or roughly 54% of the necessary minimum value for a breakeven investment gives the current mark to market value of the senior unsecured notes.

<u>Accounts Receivable</u>

As of March 31, DO had accounts receivable worth $274 million. If we assume the firm is only able to recoup $0.50 on the dollar, the AR are worth $137 million, which gets us 21% of the way to the minimum recoverable asset value that makes an investment in the debt at the current time breakeven.

50% recoveries on accounts receivables seem appropriately conservative, and so we will assume that level of recoveries in our base case. It is worth digging into DO's customers to evaluate whether or not we can expect higher or lower recoveries. During 2019, 2018 and 2017 DO had 12, 13 and 14 different customers, the most significant of those customers where: Hess, Occidental, Petrobras and BP. Although Occidental and Petrobras are having struggles, and the entire industry is suffering in general, these are not necessarily the worst creditors to have. The firm's other significant customers include Apache, Posco Daewoo, Shell, and Woodside. As a back of the envelope approximation of the risk to the recovery of DO's AR we can look at the 1-YR default probability which suggests that although Occidental, Petrobras, and Apache have elevated credit risk, none of the principal creditors appears likely to be incapable or unwilling to pay, especially as most are still clients.

% of Annual Consolidated Revenues

	2017	2018	2019
Hess	16%	25%	28.90%
Occidental (formerly Anadarko)	24.90%	33.80%	20.60%
PetroBras	18.90%	15.80%	19.50%
BP	15.80%	10.50%	3.10%

Source: DO 2019 10K

1-Yr Probability of Default

Hess	0.71%	Shell	0.30%
Occidental	3.77%	Woodside	0.19%
Petrobras	5.21%	Apache	3.42%
BP	0.40%	Posco Daewoo	0.27%

Source: Bloomberg

On this basis is it is also reasonable to assert a 75% recovery of accounts receivable, which we do in our high return scenario. Under this scenario, AR are worth $205 million to DO creditors and get us 31% of the way to the minimum value necessary to make an investment in the debt at the current time break even.

Rig Fleet

In the three plans of reorganization, we present below, we account for the value of the fleet via a going-concern valuation, focusing on a variety of forward-looking EBITDA scenarios paired with several EV/EBITDA ratios. We do this because in filing for Chapter 11, DO management has drawn a line in the sand and told the market that they want, and believe themselves capable, of emerging from bankruptcy as a going concern. As such, the post-bankruptcy capital structure needs to fit the operating requirements of the business. Despite this choice, it would be a mistake to overlook the resource conversation[5] value of the rig fleet.

Although it is improbable there is a large market, or perhaps any market at all at the current time, for a fleet of 15 offshore drilling rigs, we can estimate the potential sales value of the fleet based on the following variables: category of the rig, age, current status and various operating capabilities (Deck Load, Propulsion, Tubular handling, etc.). Our estimated fleet values are as follows:

Rig Name	Low (Mil USD)	High (Mil USD)	Years in Scv	Design	Status
Ocean BlackHawk	200	221	2014	GustoMSC P10000	Drilling
Ocean BlackHornet	196	217	2015	GustoMSC P10000	Drilling
Ocean BlackLion	200	221	2015	GustoMSC P10000	Drilling
Ocean BlackRhino	200	221	2015	GustoMSC P10000	Drilling
Ocean America	2	4	1988	ODECO Odyssey	Cold stacked
Ocean Apex	123	135	1976	ODECO Enhanced Victory Class	Drilling
Ocean Courage	123	135	2009	F&G ExD Millennium	Drilling
Ocean Endeavor	28	36	1975	ODECO Victory Class	Drilling
Ocean GreatWhite	409	452	2016	Moss Maritime CS-60 E	Warm Stacked
Ocean Monarch	8	12	1974	ODECO Victory Class	Drilling
Ocean Patriot	31	39	1983	Bingo 3000	Drilling
Ocean Rover	2	4	1973	ODECO Victory Class	Cold stacked
Ocean Valiant	31	39	1988	ODECO Odyssey	Drilling
Ocean Valor	129	143	2009	F&G ExD Millennium	Drilling
Total	1,682	1,879			

Source: Massif Capital Estimate, Riglogix and Bassoe Analytics

This fleet valuation is significantly less than the GAAP reported value of the fleet, but we believe it is more accurate and does not change the overall story. DO's assets remain significant and higher than the firm's liabilities. Should the fleet need to be liquidated, we are not confident that these are the values that will be recovered, not because the rigs are not serviceable but because the market is currently full of serviceable rigs. As such, we consider the following a more feasible liquidation value of the fleet[6]:

[5] We view businesses as having going concern value, the value of a business as an operating entity, and as a resource conversion entity, which means we view the firm as a business with a balance sheet of resources that can be converted into cash in various ways, only one of which is as an operating entity.

[6] It is worth noting that the scrapped rigs, based on recent transactions, appear likely to have a few million dollars in value each rather then zero, this is just a supposition though, for which we have only recent history as guide.

Rig Name	Low (Mil USD)	High (Mil USD)	Haircut to Value in Sale	Low Value	High Value
Ocean BlackHawk	200	221	50%	100	110.5
Ocean BlackHornet	196	217	50%	98	108.5
Ocean BlackLion	200	221	50%	100	110.5
Ocean BlackRhino	200	221	50%	100	110.5
Ocean America	2	4	Scrap	0	0
Ocean Apex	123	135	Scrap	0	0
Ocean Courage	123	135	10%	12.3	13.5
Ocean Endeavor	28	36	Scrap	0	0
Ocean GreatWhite	409	452	60%	245.4	271.2
Ocean Monarch	8	12	Scrap	0	0
Ocean Patriot	31	39	Scrap	0	0
Ocean Rover	2	4	Scrap	0	0
Ocean Valiant	31	39	Scrap	0	0
Ocean Valor	129	143	10%	12.9	14.3
Total	1,682	1,879		669	739

Source: Massif Capital Estimate, Riglogix and Bassoe Analytics

Reorganization Plan Outcomes

As previously noted, one of the primary differences between distressed investing and equity investing is the recognition that the outcome for the investor is going to be the result of a negotiation between various interested parties, but principally the creditors with the highest priority in the capital stake. In the case of DO, the principal participants in the negotiation are going to be the bank/banks who have provided the firm the revolver and a bondholder committee. DO has already started the process of engaging with these stakeholders and did so as early as April 20.[7] Because a negotiation will determine the eventual return on investment, rather then a "pure" market process, we present three possible scenarios below, our base case, a low scenario, and a high scenario:

[7] DO began sharing financial and other information with creditors on April 20th, and it has been reported that the revolver agent is represented by the law firm Bracewell and advised on financial matters by FTI consulting. The noteholders are represented by Milbank and Evercore.

Potential Reorganization Plans	Low Valuation Low Leverage *(0.5x Debt/EBITDA)* Low Asset Recovery *(25%)*	Medium Valuation Medium Leverage *(2.0x Debt/EBITDA)* Medium Asset Recovery *(50%)*	High Valuation High Leverage *(4.0x Debt/EBITDA)* High Asset Recovery *(75%)*
Valuation of Rigs in Operation			
Valuation EBITDA (USD Th)	50,000	50,000	50,000
Valuation Multiple	4.0x	6.5x	8.0x
Going Concern Value of Rigs	200,000	325,000	400,000
Assets			
Cash	82,138	157,138	157,138
Accounts Recievable	71,316	142,632	213,947
Prepaid Expenses & Other Current Assets*	14,917	29,835	44,752
Other LT Assets	51,070	102,140	153,210
Going Concern Value of Rigs	200,000	325,000	400,000
Total Assets	419,441	756,744	969,047
Liabilities & Equity			
New Revolver	25,000	100,000	100,000
New Senior Unsecured Debt	0	0	100,000
New Equity Value	394,441	656,744	769,047
Total New Liabilities and Equity	419,441	756,744	969,047
Expected Senior Unsecured Investor Return	**64%**	**174%**	**262%**

Allocation of New Value to Creditors

Scenario		Claim	Recovery	Recovery %	% Cash	% New Debt	% Equity
Low Valuation Low Leverage (0.5x Debt/EBITDA) Low Asset Recovery (25%)	Revolver	442,000	442,000	100%	94%	6%	0%
	Senior Unsecured Debt	2,000,000	394,441	20%	0%	0%	100%
	Equity		0	0%	0%	0%	0%
Medium Valuation Medium Leverage (2.0x Debt/EBITDA) Medium Asset Recovery (50%)	Revolver	442,000	442,000	100%	77%	23%	0%
	Senior Unsecured Debt	2,000,000	656,744	33%	0%	0%	100%
	Equity		0	0%	0%	0%	0%
High Valuation High Leverage (4.0x Debt/EBITDA) High Asset Recovery (75%)	Revolver	442,000	442,000	100%	94%	6%	0%
	Senior Unsecured Debt	2,000,000	869,047	43%	0%	12%	88%
	Equity		0	0%	0%	0%	0%

The base plan outcome is our expected outcome for several reasons. The quality of the DO's fleet is good, and when combined with the fleet backlog suggests it deserves a modest valuation but not a valuation as high as the industry leader, Transocean (currently trading at an EV/EBITDA of around 9x). The low case valuation is also particularly pessimistic and appears unlikely, in our opinion, to be a viable operating business given that the balance sheet does not robust enough the support the operation of the company. The high case valuation, an EV/EBITDA, is possible, but given the current market sentiment around the industry, a favorable market reception is more likely at a lower valuation.

In terms of leverage, we have chosen a 2.0x leverage ratio as a likely target outcome because:

1) It appears the minimum revolver size necessary to facilitate the business; for example, the low case leverage ratio results in a revolver that is too small to allow for the proper functioning of the business given the working capital requirements of the business.
2) 2.0x is also the leverage ratio (Debt/EBITDA) that Seadrill exited its 2018 bankruptcy with, which is the reason we believe it is more likely than the 4.0x ratio in the high case.

Although we expect the firm to exist bankruptcy with something around 2.0x leverage ratio, it is worth noting that at 2.0x, the firm would be under levered vs. industry peers by several times. As such, it is possible that senior unsecured creditors could achieve higher recoveries via a mixed outcome in which some of their debt is rolled into new debt, and some of it is swapped for new equity. In terms of asset haircuts, we have chosen 50% out of an abundance of caution, find 25% improbable, and recognize the possibility of 75% but see no reason to stretch.

Despite these caveats, all three cases produce a positive return for investors in any of the four tranches of senior unsecured debt at the current prices. As previously noted, the debt is trading at between $0.10 and $0.12 on the dollar, implying a total value for the debt of $200 million and $240 million. Assuming $240 million value, the above scenarios result in a low and high return potential of between 74% and 303% and a likely return (via the base case) of 173%.

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