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# Hornbeck Offshore Services, Inc. (HOS): Navigating Difficult Waters

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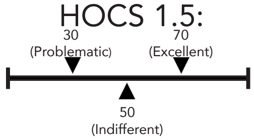
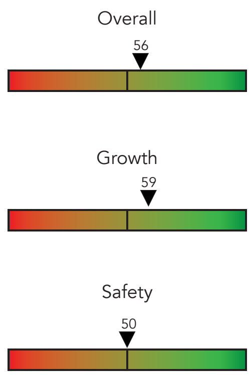
**HOS**

1.5% 2019/09/01
Price (Bond) = 83.50
Stock = $21.21
YTM = 6.04%
Premium = 112.0%
HOCS-Overall = 56
HOCS-Growth = 59
HOCS-Safety = 50

As of June 26, 2015

**HOCS 1.5:**




Time flies. It really does. Almost one year ago we published our first Ugly 20 list. It quickly became a handy guide to convertible bond avoidance for our clients. In the inaugural Ugly 20, Hornbeck Offshore was number 16 to avoid. In fact Hornbeck spent several weeks on the list until oil fell out of bed. Since then, the bond's optics have improved dramatically—at least for yield-oriented investors. While Hornbeck hasn't made it all the way to the HOCS 20, it is a well-managed company that yield seekers may want to consider.

Remember, being a member of the Ugly 20 doesn't mean that the company has failed to execute or that its prospects are not satisfactory. Rather, it means that the traditional convertible bond price cushion is not available, while the premium may substantially limit upside participation, or worse.

Hornbeck proves the point. After the price of oil began to drop late last year, things went bad for both the Hornbeck stock and the convert. On August 21, 2014, the bond and stock traded at their respective highs of 116.58 and $43.95/share. Today, the convert is trading at 83.50 against a stock price of $21.21/share. That means the price of the convert has fallen 28% and the stock fell 52%. The convert dropped a full 55% of the stock price. Much more than the convertible "one-third" rule of thumb. This, in fact, is why we created the Ugly 20: to give convertible investors a better sense of what they are, and aren't, getting.

But that was then and this is now. And now that the price of the HOS 1.5% convertible has fallen, it should behave a lot better. As a busted convert, the bond turns some potential buyers away with its high conversion premium of 112.0% and its relatively high debt load. Still, investors know what to expect from the bond - a 6.04% yield and a tailwind if the price of oil rebounds strongly.

## Recent Performance

Hornbeck finds itself at the height of its new ship-build program in a soft commodity price environment. Despite those obstacles, Hornbeck turned in a credible Q1 2015 performance report, missing consensus estimates on the top line, but beating them soundly on the bottom.

*Revenue in $ millions*

| | Actual 3-31-15 | Consensus Estimate 3-31-15 | Percent Difference Act. V. Est. | Previous Year Actual 3-31-14 | Percent Change Y-O-Y |
|---|---|---|---|---|---|
| *Revenue* | *$134.6* | *$136.7* | *(1.5%)* | *$136.5* | *(1.4%)* |
| *Adjusted EPS* | *$0.42* | *$0.28* | *50%* | *$0.31* | *35.5%* |

Source: Hillside Advisors, SEC Filings

While revenue stumbled slightly, Hornbeck's cost-saving measures in the face of the industry downturn paid off. The company's operating margin was 25% for the quarter after adjusting for gains on asset sales. That was up from 18% in the first quarter 2014 and 23% sequentially. Adjusted EBITDA remained strong at $62 million during the quarter, compared to $69.65 million sequentially and $54.3 million in the first quarter last year.

There were a couple of factors responsible for the relatively stable results in the face of a steep industry downturn. The average day rate for the first quarter was $26,705, down $900 sequentially, but essentially the same as first quarter 2014. The company was successful in selling the services of its newer, larger ships to enhance its product mix. Hornbeck has also undertaken an aggressive "stacking" program to take its smaller ships out of service. Hornbeck has stacked 18 smaller OSVs (offshore service vessels), up from 12 in the beginning of Q1 and zero in Q1 2014. While stacking penalizes asset utilization, the program significantly cuts expenses for crews, etc. Hornbeck reports that its cost savings measures have reached $80 million on an annualized basis, $60 million from stacking alone.

Hornbeck's HI-Spec MPSV (multi-purpose service vessel) adjusted day-rates of $77,200 for the first quarter of 2015 were roughly $24,300 lower than the previous quarter, but within the low-end of the company's guidance. Hornbeck has been adding MPSVs, allowing them to improve product mix. However, management reported that clients are coming to Hornbeck to renegotiate term contracts, so day-rates are under pressure. Cost containment is key going forward.

## Business Summary

Hornbeck's business is providing support ships to drillers, primarily in the Gulf of Mexico. The fleet includes smaller OSV's (offshore service vessels) and larger MPSVs (multi-purpose service vehicles). While Hornbeck designs all of its ships to be as flexible as possible in the types of services it can offer, the MPSVs have 2.5 to 6 times the deadweight tonnage capacity of the smaller, more specialized OSVs. The MPSVs can act as supply ships or tankers and undertake subsea construction – the company calls it cradle-to-grave service. The larger MPSVs are also able to operate in more adverse weather conditions, reducing downtime for customers. The OSVs are smaller and typically more specialized, providing supply services with tanks for holding chemicals, drilling mud, water and other liquids necessary for drilling operations.

The company has grown dramatically over the last fifteen years. In 2000, Hornbeck had ships with a deadweight tonnage of 13,366. That figure totaled 55,324 in 2005, 161,812 in 2010 and will reach 291,912 in 2016. Hornbeck is adding to its advanced fleet with 18 new Jones Act-qualified OSVs under construction and six Jones Act-qualified MPSVs under construction. That will preserve the company's position as having one of the youngest fleets in the industry with a current average age of seven years.
The company provided the following chart regarding its current new-build program.

| | 2015 | | | 2016 | | | | Total |
|---|---|---|---|---|---|---|---|---|
| Estimated In-Service Dates: | 2Q | 3Q | 4Q | 1Q | 2Q | 3Q | 4Q | |
| 300 class OSVs | - | - | - | - | - | - | - | - |
| 310 class OSVs | 1 | 1 | - | - | - | - | - | 2 |
| 320 class OSVs | 2 | - | - | - | - | - | - | 2 |
| Total OSVs | 3 | 1 | - | - | - | - | - | 4 |
| 310 class MPSVs | - | - | 1 | 1 | 1 | 1 | - | 4 |
| Total new builds | 3 | 1 | 1 | 1 | 1 | 1 | - | 8 |

Source: Company Filings

Hornbeck is focused on the high-end of the OSV market. The company is the third largest Hi-Spec OSV operator worldwide and the second largest Hi-Spec OSV operator in the Gulf of Mexico. Hornbeck has an even larger share of the Ultra-Hi Spec market. There are 207 Ultra Hi-Spec vessels worldwide (including 52 vessels under construction) and 74 Ultra Hi-Spec vessels (including 27 vessels under construction). While the higher performance ships can command a premium, margins may still take a hit due to the large number of new ships under construction as they enter the market.

OSV size has increased as wells have been drilled to deeper depths further offshore. Deepwater drilling, much like shale related oil & gas, is a trend enabled by continually advancing drilling technology. These trends favor the larger OSV and multi-purpose vessels. According to Hornbeck statistics, the average depth of wells in the Gulf of Mexico doubled from about 10,000 feet to 20,000 feet from 1976 to 2013. That average has leveled off as the shale oil revolution has taken hold, but the trend is intact. Deepwater wells are further from shore and have a more complex infrastructure, favoring Hornbeck's fleet.

Hornbeck is strategically diversified by geographic market to take advantage of its Louisiana headquarters location. The company provides services in four major markets including the Gulf of Mexico, Latin America (Brazil), West Coast United States, and East Coast United States.

The Gulf of Mexico is by far Hornbeck's largest market and it provides strategic barriers to entry against foreign competitors. The Gulf of Mexico is regulated by the Jones Act (1920), which promotes the US merchant marine by providing that goods transported between US ports carry a US flag, be constructed in the US, be owned by a permanent US entity and be crewed by US citizens. The Jones Act makes it difficult for foreign entities to support drilling activity in the Gulf, particularly when the foreign operators tend to be highly fragmented, offering only one or two ships in the Gulf of Mexico. So while foreign MPSV ships have relocated to the Gulf during the latest downturn, they are not viewed as a fully dependable partner compared to a US-based supplier such as Hornbeck.

Also in the plus column, there have been no new domestic orders of Hi-Spec ships since 2013 according to Hornbeck, so the market should not see any new supply until 2018 or 2019. While no one can call the current down cycle with total confidence, Hornbeck is looking for two down years.

### Leverage

Liquidity remains strong with $279.5 million in cash and a $300 million undrawn revolver which was recently extended to 2020. Hornbeck boosted cash by selling four ships to the Navy for an aggregate sale price of $152 million and a total gain of $44.1 million. The sale of three of the ships closed in the first quarter for an aggregate gain of $33.1 million and the fourth sale is expected to close before the end of the year. Management has stated that it expects to have enough cash to get the company through the current new-build program without drawing down on the revolver.

During the industry downturn, stacking (idling with minimal crew) will play an important role in conserving cash. Management plans on a significant number of vessels to remain stacked until the cycle turns up.

Clearly pressure will remain on Hornbeck during the duration of the downturn and that's reflected in the yield of the convertible bond. The good news for convert holders is that the issue is the first to mature in the current capital structure. The undrawn revolver should give bondholders some further confidence, although Hornbeck must meet certain criteria under the revolver if it is used to pay off the convertible bond.

The waters are currently rough in the oil and gas services industry, but with Hornbeck, investors get decisive management with a well thought-out strategy for staying at the high performance end of the drilling service ship industry.

Credit Waterfall

| Hornbeck Offshore Services (HOS)<br>(Dollars in Millions) | 3/31/2015 | Total Debt (Cum. Bal.) | EBITDA Multiple | Net Debt (Cum. Bal.) | EBITDA Multiple |
|---|---|---|---|---|---|
| Current Share Price | $21.21 | | | | |
| Shares Out. (Millions) | 35.7 | | | | |
| Latest Twelve Months: | | | | | |
| EBITDA | 325 | | | | |
| Free Cash Flow | (169) | | | | |
| Cash & Cash Equivalents | 279 | | | | |
| Senior Unsecured Debt | | | | | |
| 5.88% Senior Notes (2020) | 375 | 375 | 1.2x | 96 | 0.3x |
| 5.00% Senior Notes (2021) | 450 | 825 | 2.5x | 546 | 1.7x |
| 1.50% Convertible Senior Notes (2019) | 251 | 1,076 | 3.3x | 796 | 2.5x |
| Total Debt | 1,076 | 1,076 | 3.3x | 796 | 2.5x |
| Equity Market Cap. | 757 | --- | --- | --- | --- |
| Enterprise Value | 1,554 | --- | --- | --- | 4.8x |

Source: Bloomberg & SEC Filings

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## Financial Summary

| HOS<br>(Dollars in Millions) | Fiscal Years Ended<br>31-Dec-10 | 31-Dec-11 | 31-Dec-12 | 31-Dec-13 | 31-Dec-14 | LTM<br>31-Mar-14 | 31-Mar-15 | Quarter Ended<br>31-Mar-14 | 31-Mar-15 |
|---|---|---|---|---|---|---|---|---|---|
| Revenues | 421 | 382 | 463 | 548 | 635 | 552 | 633 | 137 | 135 |
| Y / Y Change | ---- | -9.3% | 21.4% | 18.3% | 15.8% | ---- | 14.6% | ---- | -1.4% |
| Gross Profit | 147 | 89 | 163 | 223 | 223 | 205 | 230 | 39 | 46 |
| Operating Profit | 112 | 55 | 118 | 171 | 169 | 152 | 211 | 25 | 67 |
| EBITDA | 189 | 137 | 191 | 257 | 285 | 242 | 325 | 54 | 94 |
| EBITDA (Adj.) | 189 | 137 | 191 | 257 | 285 | 242 | 325 | 54 | 94 |
| Interest Expense | 55 | 60 | 58 | 47 | 31 | 41 | 34 | 7 | 10 |
| Income Tax Expense | 22 | (1) | 21 | 36 | 52 | 41 | 67 | 7 | 21 |
| Capital Expenditures | 62 | 74 | 258 | 543 | 409 | 579 | 358 | 129 | 79 |
| % Revenues | 14.6% | 19.3% | 55.8% | 99.0% | 64.4% | 104.8% | 56.6% | 94.7% | 58.6% |
| Free Cash Flow | 69 | (8) | (116) | (320) | (243) | (357) | (169) | (92) | (17) |
| Total Debt | 758 | 771 | 1,089 | 1,064 | 1,073 | 1,066 | 1,076 | 1,066 | 1,076 |
| % Total Debt | 9.1% | -1.0% | -10.6% | -30.1% | -22.7% | -33.5% | -15.7% | -8.6% | -1.6% |
| Gross Margin | 34.9% | 23.3% | 35.2% | 40.7% | 35.1% | 37.1% | 36.3% | 28.3% | 34.0% |
| Operating Margin | 26.7% | 14.4% | 25.4% | 31.2% | 26.7% | 27.6% | 33.4% | 18.3% | 49.7% |
| EBITDA (Adj.) Margin | 45.0% | 35.8% | 41.3% | 46.9% | 44.9% | 43.8% | 51.3% | 39.8% | 70.1% |
| EBITDA (Adj.) / Interest | 3.4x | 2.3x | 3.3x | 5.4x | 9.3x | 5.9x | 9.6x | 7.5x | 9.2x |
| EBITDA (Adj.) - Capex / Interest | 2.3x | 1.1x | -1.2x | -6.0x | -4.0x | -8.3x | -1.0x | -10.4x | 1.5x |

Source: Bloomberg & SEC Filings

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