

Oil States International: A mid-cycle slowdown is priced as if we had lockdowns

Company:	Oil States International (OIS)	Market Cap:	\$280mio
Industry:	Oil and gas equipment	Net Current Assets:	\$330mio (+\$135mio debt)
Country:	US, worldwide	Revenue:	\$782mio
Date:	26 th June 2024	Operating cash flow:	\$70mio
Dividend:	-	Free cash flow:	\$40mio*
Entry:	\$280mio	Target:	\$400mio (+47%)

*Estimated guidance as of Q1 24

Why Oil States International?

- Equity value is below net current assets
- At this valuation, the company likely buys back shares and part of the convertible bond at a discount
- A war between Hezbollah and Israel is more and more likely
- Iran sanctions are enacted in October
- Both, a Trump and Biden Presidency, will likely result in tougher sanctions for Iran, Russia and Venezuela, as neither needs to fear re-election risk
- US shale faces mid-cycle slowdown, but not a Covid-like disruption
- US SPR will buy more oil back at \$70-80/bbl

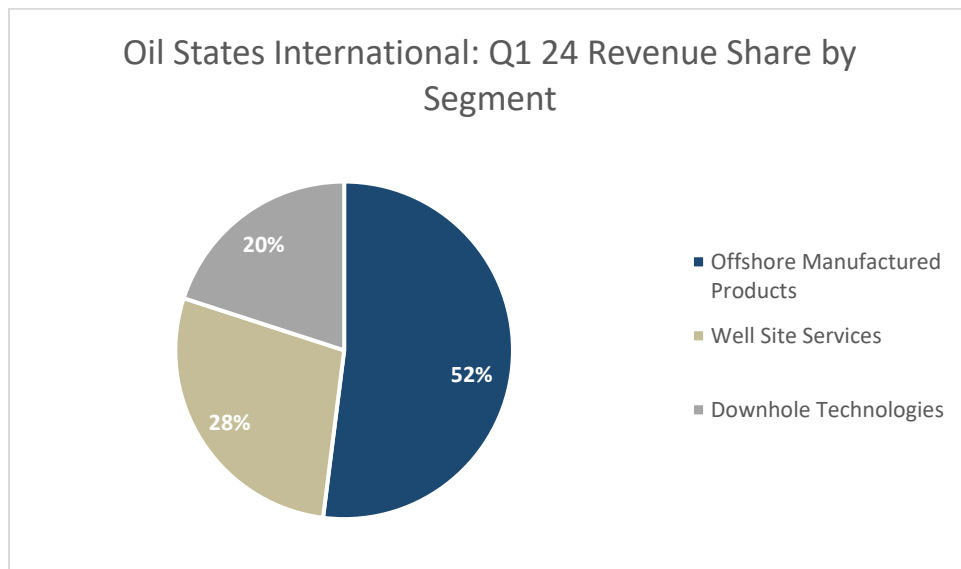
Risks

- Peace in the Middle East
- China slows down further
- US shale consolidation and further US shale slow down

- Biden will do everything to keep oil prices low ahead of the US election in November...
- ...Venezuela elections on 28th July could lead to a recognition of Venezuela (although it could also lead to the opposite)
- While hurricanes in the Gulf of Mexico are positive for oil prices, they can be negative for Oil States International due to no oil and gas activity in this important region

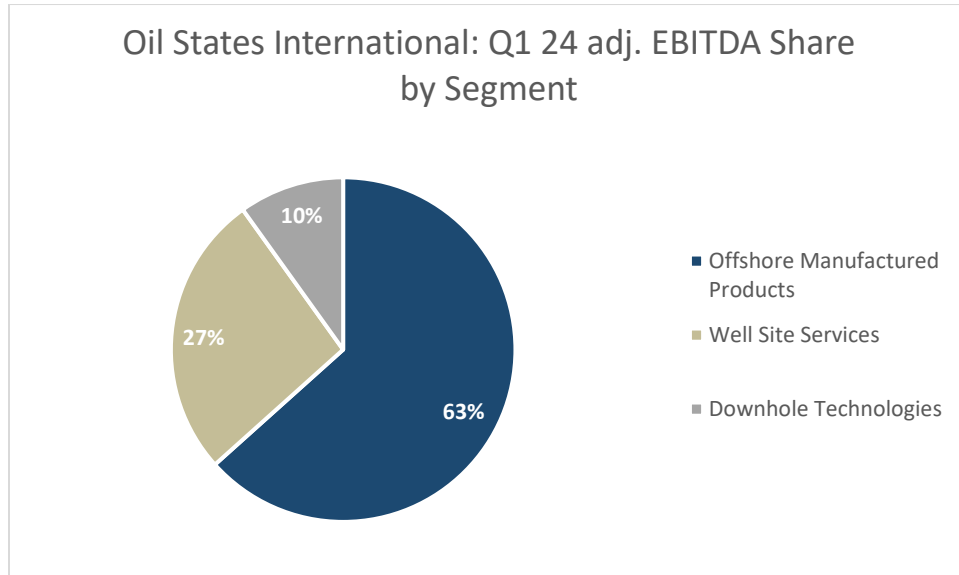
Introduction to Oil States International

Oil States International is a US based oil and gas service and equipment manufacturer. The company generates around half of its revenue and nearly 2/3 of its profits in offshore manufactured products, which includes technology that is needed for the extraction of oil, gas and minerals in the oceans, including deepwater capital equipment, military and industrial applications and also provides services, including inspection, repair and maintenance of offshore rigs and vessels. Just over ¼ of its revenues and profits are generated from well site services, of which 76% of the revenue is focused on US shale (Q1 24) and 24% in the Gulf of Mexico and international markets (Q1 24). Last but not least, around 20% of revenue and 10% of profits are being generated by downhole technologies, such as perforating systems. In this latter segment, Oil States International competes with Hunting, DMC Global and Core Laboratories, and has the smallest market share amongst the four of around 14%¹.



Source: Oil States International

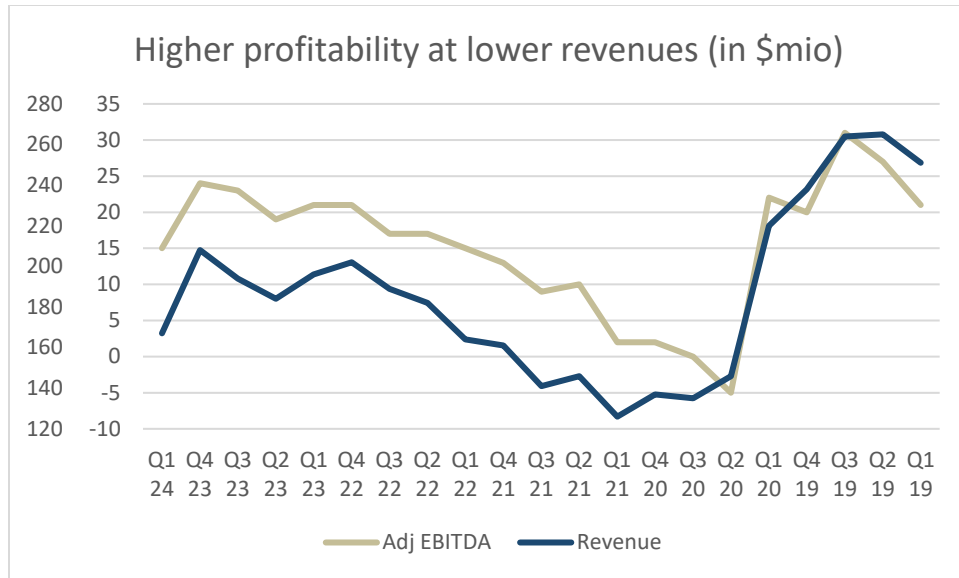
¹ <https://www.aozorastep.com/reentry-hunting>



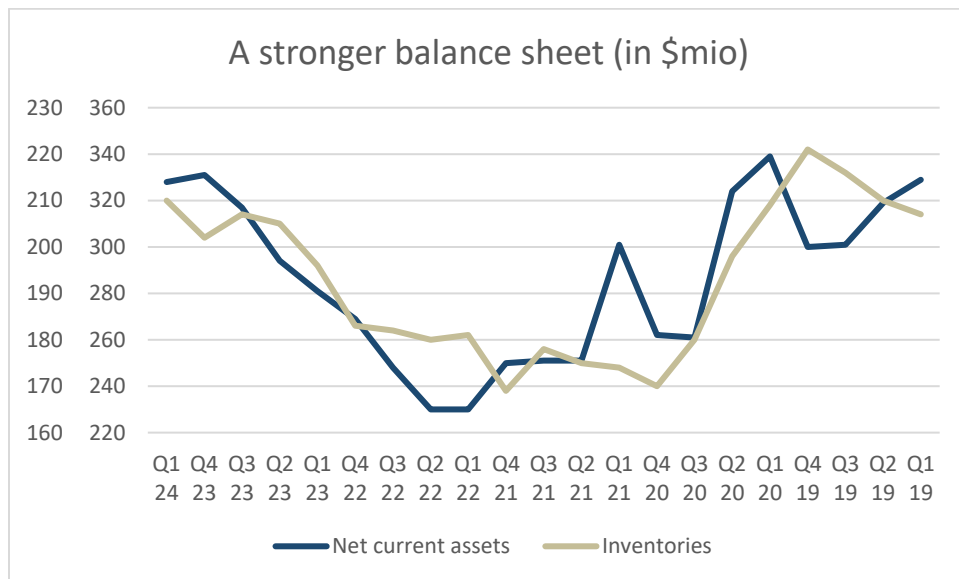
Source: Oil States International

A near record low valuation that matches the Covid lows

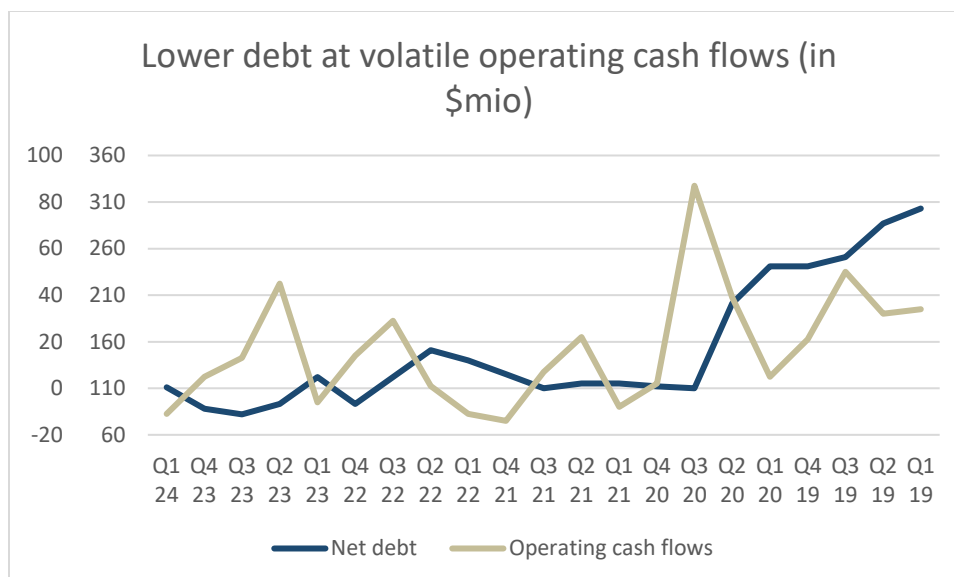
What gives me the most comfort in having a concentrated position in Oil States International is the very strong balance sheet. The enterprise value is currently matching the lows of the Covid Pandemic, when Oil States International had around \$240mio net debt and a \$125mio equity valuation. This low valuation didn't even last for more than 1-2 months during this unprecedented time during Covid. Why is the valuation so low currently then? This is mainly due to the decline in the US rig count, which is to a large degree due to lower natural gas prices and producers cutting production because of this, as well as consolidation amongst producers, which leads to fewer holes, rigs, but longer laterals. Overall, this has led to lower demand for oil and gas services and most of their products. However, Oil States International has confirmed in their Q1 24 results call that free cash flow is expected to be \$40mio for the year, which can be used to buy back shares or part of the \$135mio outstanding convertible bond.



Source: Oil States International (timeline & chart to be read from right to left)



Source: Oil States International (timeline & chart to be read from right to left)



Source: Oil States International (timeline & chart to be read from right to left)

Macro factors: The price of oil

There are quite a few variables that influence oil prices at the moment. On the demand side, we have record jet fuel and gasoline demand², China seems to be recovering³, but manufacturing remains in the doldrums in the Eurozone⁴. Much more important is the supply side. While Guyana has increased production to 645k boepd from 450k boepd last year⁵, most other output growth of around 100k boepd more year-to-date has come from Iran (3.5mio boepd) and Venezuela (950k boepd) each. Both, Venezuelan and Guyana's oil is likely mostly refined in the US. Saudi Arabia has curtailed some offshore projects⁶, but recently awarded \$25bn in contracts to progress its gas fields⁷. However, one of the main macro factors that influenced me to enter a position in Oil States International, is the deteriorating situation in Northern Israel & Lebanon, which appears to be moving closer to war. Biden will of course do whatever it takes to keep oil prices low, and hence allow Iranian and Venezuelan oil to reach its buyers.

² <https://www.reuters.com/business/energy/us-jet-fuel-output-rises-pre-covid-levels-demand-soars-2024-06-21/>

³ <https://www.pmi.spglobal.com/Public/Home/PressRelease/dbf0d2731415453f99fac0d7826e16ea>

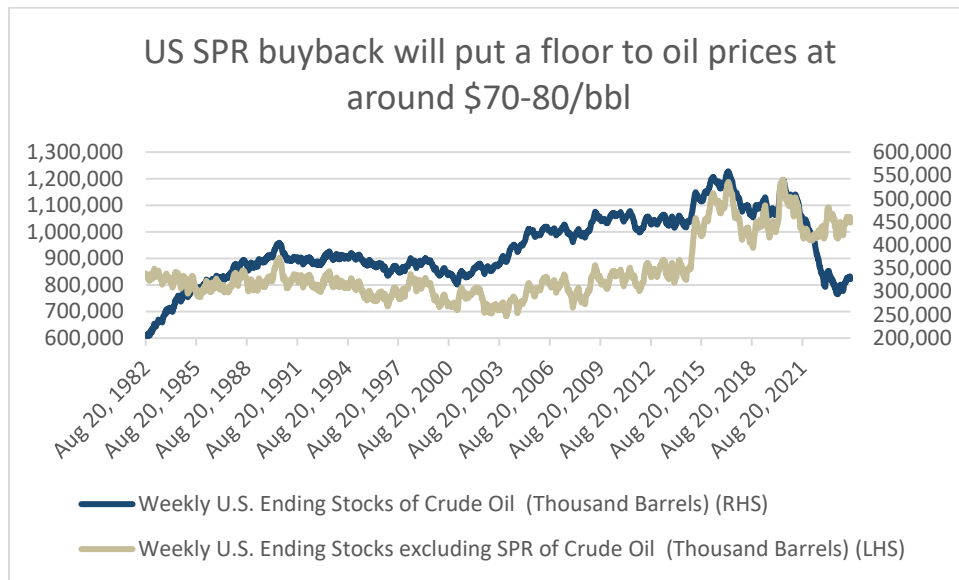
⁴ <https://www.pmi.spglobal.com/Public/Home/PressRelease/b8ebd597eb8d475ab7ec04250bb31e1e>

⁵ <https://www.reuters.com/markets/commodities/exxon-raises-guyanas-oil-production-about-645000-barrels-per-day-2024-02-06/>

⁶ <https://www.oedigital.com/news/512760-middle-east-18-drilling-rigs-believed-to-be-suspended-by-aramco-so-far>

⁷ <https://www.aramco.com/en/news-media/news/2024/aramcos-strategic-gas-expansion-progresses-with-25bn-contract-awards>

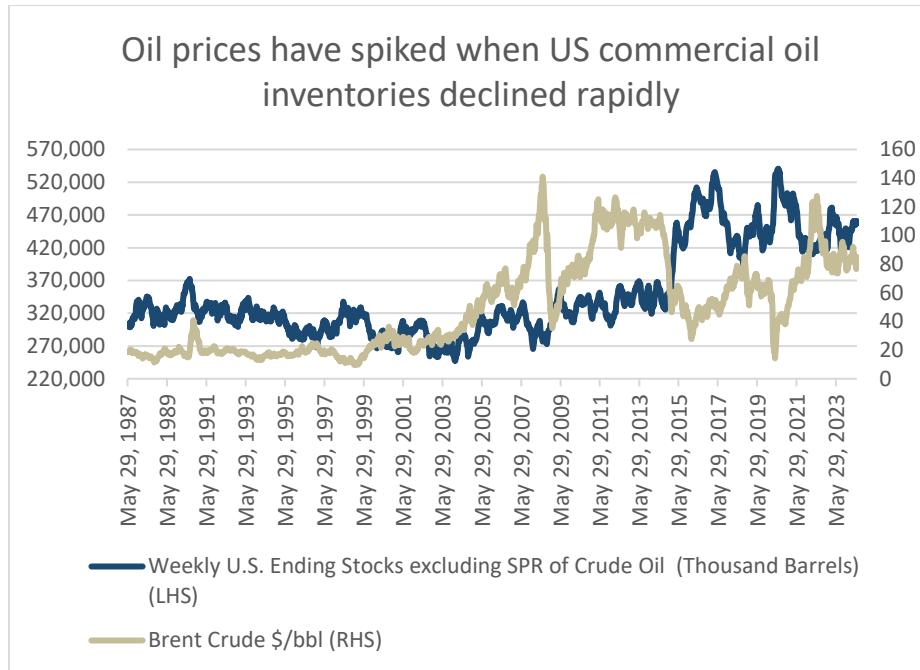
But with the Israel Hezbollah conflict and Venezuelan elections on 28th July, there is a lot more uncertainty whether Biden will have to enact stricter sanction compliance⁸. Last but not least, the US rig count keeps falling. Although this is negative, the laterals keep getting longer, which should be beneficial for some of the equipment Oil States International sells. The key is that Biden also doesn't want oil prices to crash and hence buys oil for the SPR when prices go down below \$80/bbl⁹. We remain between 2-300mio barrels below pre-pandemic SPR levels.



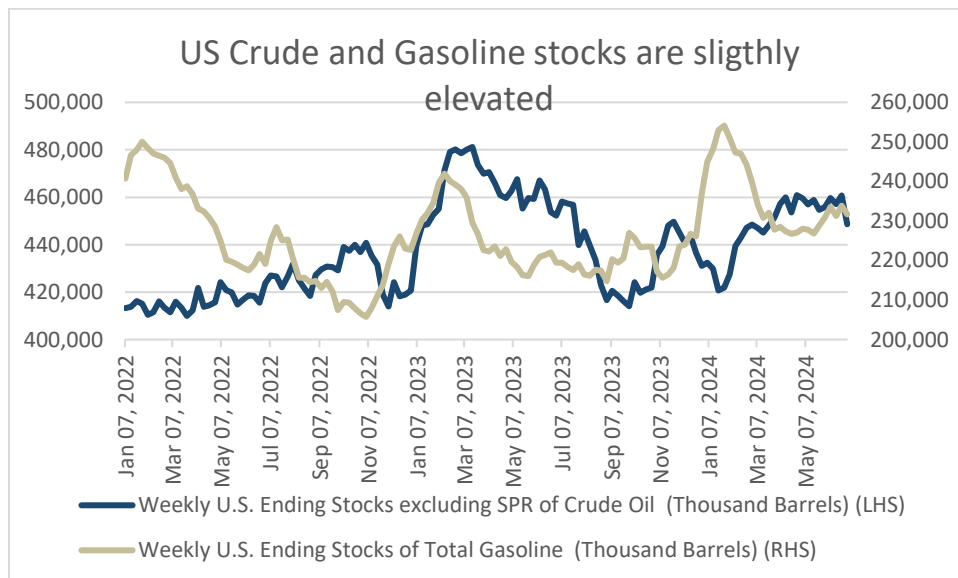
Source: EIA

⁸ <https://oilprice.com/Energy/Crude-Oil/US-Targets-Iranian-Oil-Exports-with-Latest-Sanctions.html>

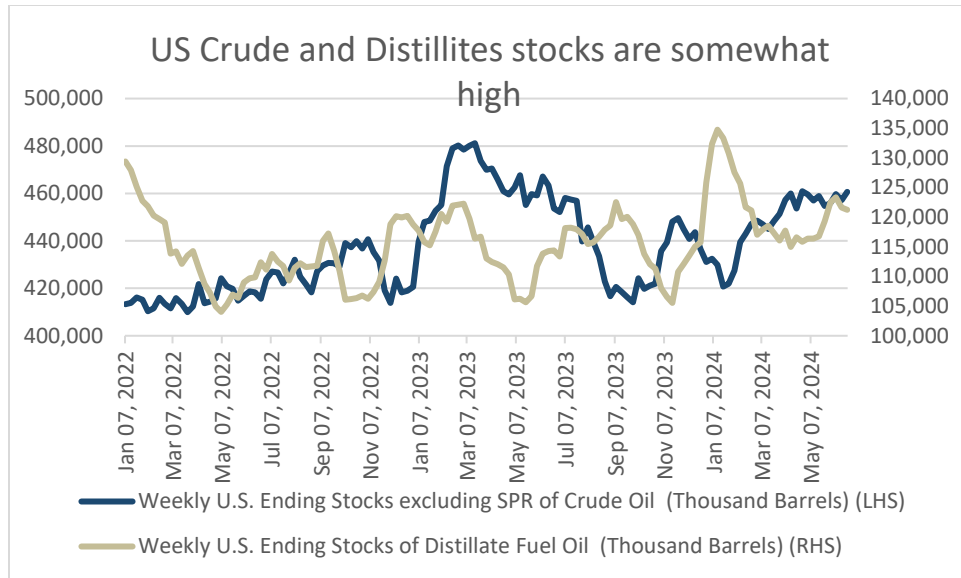
⁹ [https://www.reuters.com/business/energy/us-buys-3-million-barrels-oil-strategic-petroleum-reserve-2024-06-03/#:~:text=WASHINGTON%2C%20June%203%20\(Reuters\),largest%20sale%20ever%20in%202022.](https://www.reuters.com/business/energy/us-buys-3-million-barrels-oil-strategic-petroleum-reserve-2024-06-03/#:~:text=WASHINGTON%2C%20June%203%20(Reuters),largest%20sale%20ever%20in%202022.)



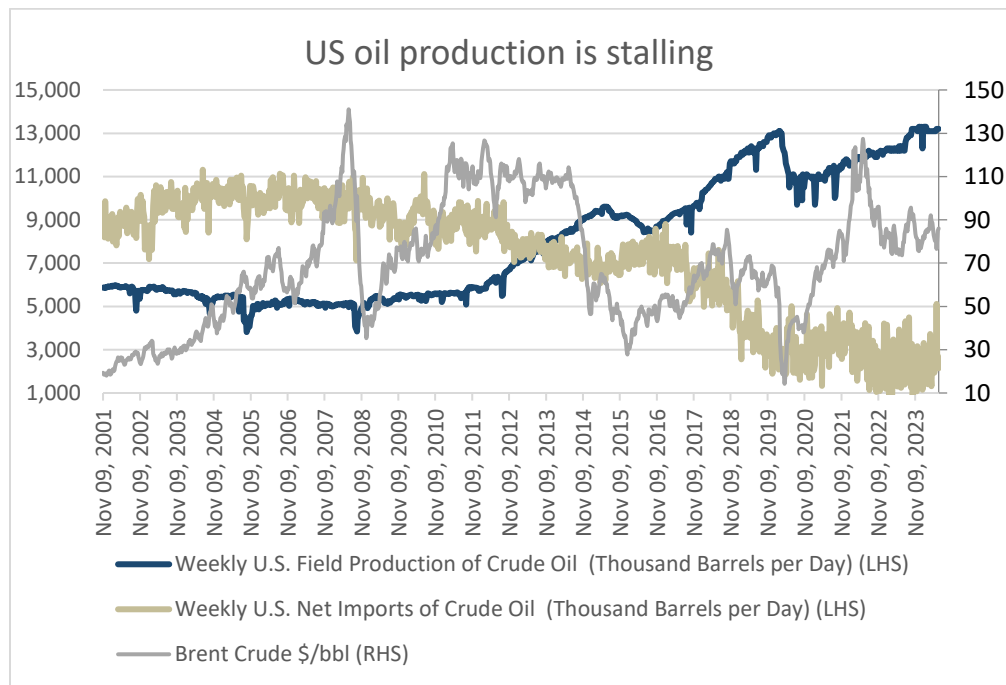
Source: EIA, FRED St. Louis



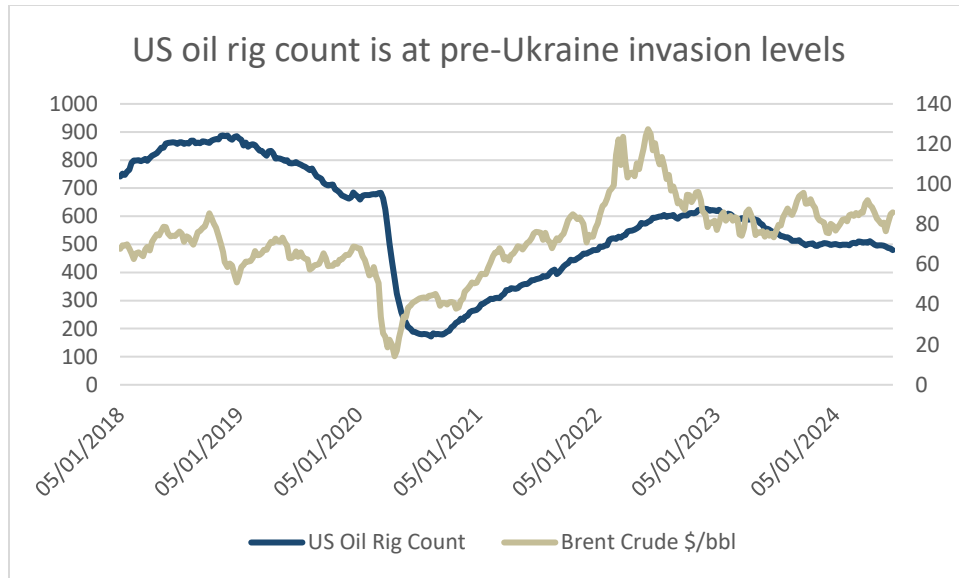
Source: EIA



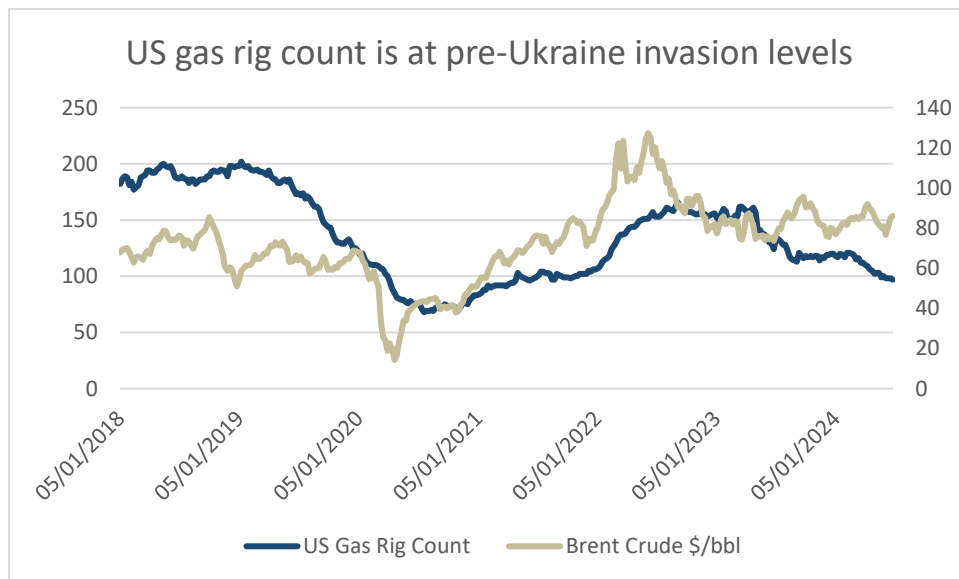
Source: EIA



Source: EIA, FRED St. Louis



Source: Baker Hughes, FRED St. Louis

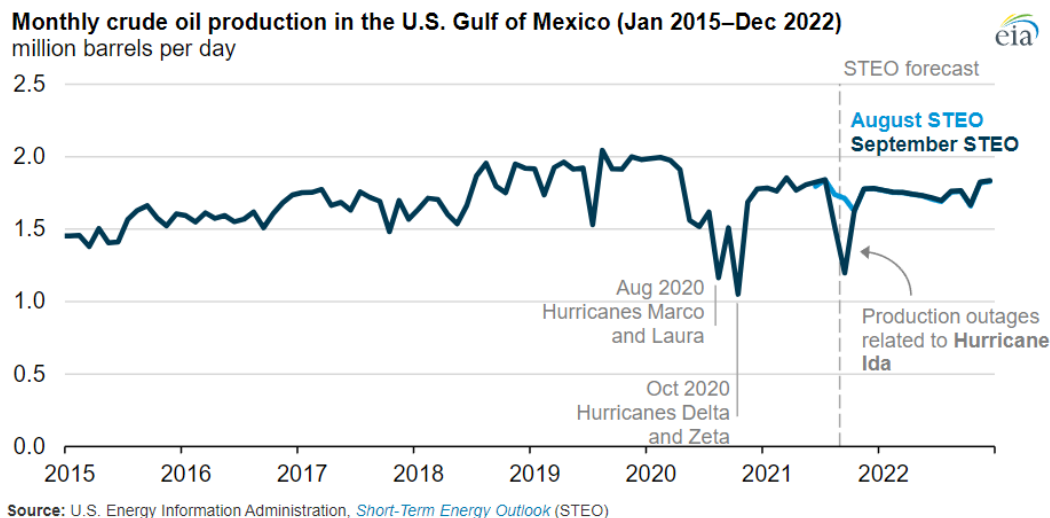


Source: Baker Hughes, FRED St. Louis

What about Hurricanes?

Over the last few years there have been a few hurricanes that caused production outages in the Gulf of Mexico, mostly in 2020 and 2021¹⁰. Hurricane Ida caused Q3 2021 revenue and EBITDA reduction for Oil States International of \$5.9mio and \$3mio respectively¹¹. Although this seems to be negative for Oil States International, the drop in production, and even the fear of a drop in production, could add a few \$ to the price of oil. Overall, this could end up being positive for Oil States International. This year's hurricane season is expected to be very strong, given that Beryl is the earliest hurricane of the season on record¹², around 5 days earlier than hurricane Dennis in 2005¹³. 2005 was one of the worst hurricane years on record with 4 major hurricanes and damages exceeding \$104bn¹⁴. Hurricane Beryl is expected to knock out some oil and gas production in Mexico, and possibly in the US.

Hurricane Ida disrupted crude oil production and refining activity



¹⁰

<https://www.eia.gov/todayinenergy/detail.php?id=49576#:~:text=On%20Sunday%2C%20August%2029%2C%20Hurricane,as%20a%20Category%204%20hurricane.>

¹¹ <https://oilstates2023ir.q4web.com/Press-Releases/news-details/2021/Oil-States-Announces-Third-Quarter-2021-Results-of-Operations-11-01-2021/default.aspx>

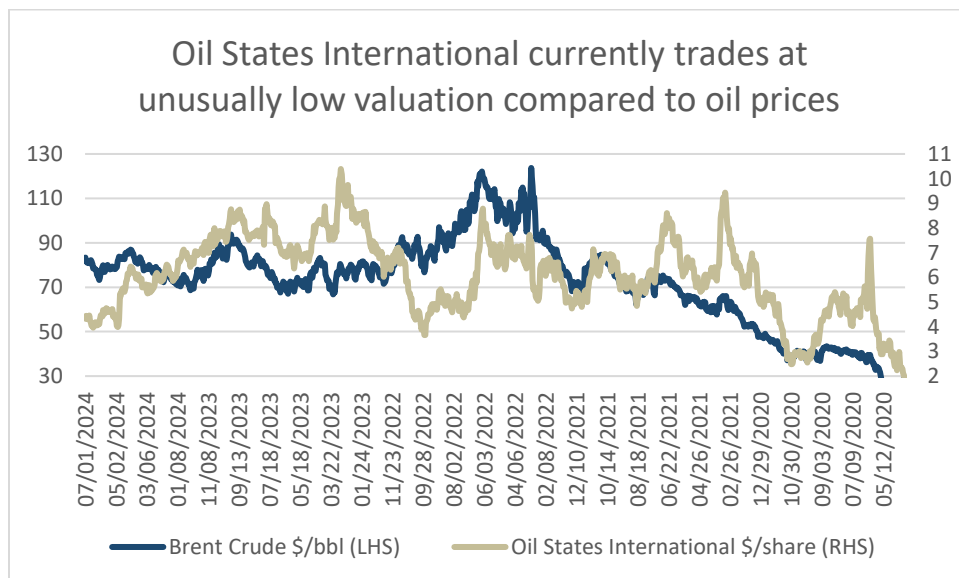
¹² <https://www.ft.com/content/de03e6fe-cb77-4fe2-b00a-ad2ae790824b>

¹³ <https://www.nhc.noaa.gov/outreach/history/>

¹⁴ <https://www.nhc.noaa.gov/outreach/history/>

Dejavue?

The chart below shows that Oil States International is highly correlated to oil prices, and that the Oil States International's share price is currently trading at the lowest level compared to oil prices since September 2022. Within less than two months, the share price then doubled in 2022, as the following quarterly results surprised to the upside and the company delivered a share buyback programme. Right at the bottom of this 2022 level, I arranged a call with management and didn't buy any shares, because it was not UK listed. Today, I see many similarities to 2022, and although the return profile is less compelling today than it was in 2022, Oil States International appears wrongly priced at current valuations with net current assets exceeding the equity valuation by over \$50mio. Even including the \$135mio convertible debt, the company could easily survive another Covid lockdown as it happened in 2020, and emerging stronger from it. This is how attractive the current valuation really is.



Source: Investing.com (timeline & chart to be read from right to left)

Relative Value

Last but not least, Oil States International is not only in deep value territory, but also provides the most upside compared to its competitors. One of its competitors, DMC Global, recently received a takeover proposal, which is still pending. Oil States International is the only player in this field that hasn't rerated, yet, while Hunting is up 42% YTD, Core Laboratories +17%, and DMC Global down -20% compared to Oil States International down -35%.

Share price performance year-to-date: Oil States International vs. competitors



Source: TradingView



Legal Disclaimer

The contents of this publication have been prepared solely for the purpose of providing information about AozoraStep Capital LLP and the services and products it is intending to offer, which are targeted for professional investors only. The opinions and views expressed are those of AozoraStep Capital LLP, may change without notice and should not be construed as investment, tax, legal or other advice. AozoraStep Capital LLP does not guarantee the completeness and accuracy of the information provided and all content can become out of date. Products or services mentioned in this publication are subject to legal and regulatory requirements in applicable jurisdictions and may not be available in all jurisdictions. Accordingly, persons are required to inform themselves and observe any such restrictions. In respect to investments described in this document, past performance is not a guide to future performance. The value of investments and the income of any financial instruments mentioned in this document may fall as well as rise and may have tax consequences. The performance of the investment strategy of AozoraStep Capital LLP is based on a personal track record of its managing partner and approved by Sedulo for the time period Q1 2019 - Q1 2021 and by HiCloud Accounting for the time period 2020 - 2023, only with further examinations being done on an occasional basis. AozoraStep Capital LLP is currently not authorized and regulated by the FCA, and therefore, is not allowed to provide financial products and services. AozoraStep Capital LLP is registered in England and Wales with registered number OC436835. Registered Office: 21 Knightsbridge, London SW1X 7LY, United Kingdom. Reproduction or distribution of any materials obtained in this publication or linking to this publication without written permission is prohibited.