McDermott International USD 8% 1 May 2021 second lien bond

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Issuer

McDermott International (MDR) provides integrated engineering, procurement, construction and installation (EPCI) services for upstream oil and gas field developments worldwide. The service offering includes fixed and floating production facilities, pipeline installations and subsea systems for offshore oil and gas projects, and relies upon MDR's fleet of marine vessels, fabrication facilities and engineering offices. MDR's operations span across approximately 20 countries, with a presence in most major offshore oil and gas producing regions throughout the world. The company reports its financial results under three reporting segments, according to geography. These segments are: AEA (Americas, Europe and Africa), MEA (Middle East) and ASA (Asia). MDR's customers include various national oil and gas companies, as well as major integrated and other oil and gas companies. For example, INPEX Operations Australia, Saudi Aramco, PEMEX, Petrobras, Chevron, and Exxon Mobile were reported as some of MDR's significant customers from 2013 to 2015 (MDR Annual report, FY15). MDR's contracts are typically operated on a fixed price basis, which exposes the company to risks of actual costs on fixed price contracts exceeding those originally expected by the company (see "risks").

Recent price falls and subsequent volatility seen in global oil prices have contributed to much of the trading price volatility of MDR bonds. By way of comparison, MDR USD 8% notes traded to a low price of USD63.5 in February 2016, having been issued at USD100 in April 2014, and WTI Crude fell to USD26/bbl from USD104/bbl in the same period (a 75% correction). Since then, MDR bond prices have recovered back to around par, supported by two main factors: 1) offshore and brownfield services, which account for more than 50% of MDR's revenues, have been less affected by lower energy prices; and 2) MDR has implemented various cost saving initiatives in an attempt to recover margins in the face of a falling revenue pipeline. However, the outlook for oil prices in the medium term remains uncertain, and McDermott will continue to be inherently exposed to a very cyclical and competitive offshore Engineering & Construction energy services sector. As at 30 September 2016, the company reported an order backlog valued at USD3.9bn, compared to USD4.2bn as at FYE15. According to MDR's estimates, approximately 57% of backlog as at September 2016 was attributable to Saudi Aramco. The decline in the reported backlog is attributable to major projects being completed and rolling off during the period. The current backlog of orders provides some stability to earnings, but such a backlog does not necessarily represent guaranteed future revenue, and pricing pressures will remain as the large global oil and gas companies maintain cost discipline amidst future price uncertainties.

For the last twelve months (LTM) ended 30 September 2016, MDR reported total revenues of USD2.7bn, adjusted EBITDA of USD331.2m, and net debt of USD541.9m (including FIIG's adjustments*). Net leverage as at the end of 3Q16 stood at 1.6x. However, it is worth noting that whilst unrestricted cash and cash equivalents at the end of 3Q16 was reported at USD500.5m, this high cash balance is the result of a capital structure that the company put in place in 2014 in order fund new and existing projects for the subsequent two or three years, and as such the degree of total debt leverage is also important to take into consideration. Total debt leverage as at the end of 3Q16 stood at 3.1x. MDR has access to a USD450m Letter of Credit (LC) facility which expires at the earliest on 15 January 2019 and is subject to certain restrictive maintenance covenants, including a minimum fixed charge coverage ratio (reported to be 2.86x as at 3Q16, versus requirement of 1.15x or above), maximum total leverage ratio (2.15x as at 3Q16, versus requirement of no more than 4.5x), and maximum secured leverage ratio (0.66x as at 3Q16, versus requirement of no more than 2.0x). As at 30 September 2016, the LC facility had USD95m of availability. The LC facility forms part of the Credit Agreement which includes a USD225m term loan maturity in 2019. MDR voluntarily repaid USD75m of the term loan in May 2016, reducing the outstanding face to USD225m from the original USD300m.

**FIIG's adjustments to debt include a total of USD288m of amortising unsecured debt (USD48m) and prepaid stock purchase contracts (USD240m) recorded as Tangible Equity Units (TEUs) in MDR's financial statements*

Please refer to the Investment Memorandum and full research report for full details on the company and transaction.

Guarantor/Credit Wrapper	Multiple subsidiaries pari passu with second lien priority guarantee level (see IM)
ISIN	USP64655AB20

Trading Information	
Minimum amount	USD10,000 (FIIG Restriction)
Denominations	USD1,000
Retail / Wholesale	Wholesale

Coupon	
Coupon Type	Fixed rate note
Rate	8.0%
Amortisation	n/a
Coupon Payment Frequency	Semi annually

Important Dates	
Issue Date	16 April 2014
Call Dates (Callable on and thereafter dates shown)	1 May 2017 @ USD104.0 1 May 2018 @ USD102.0 1 May 2019 @ USD100.0
Maturity Date	1 May 2021

Structure	
Type / Rank	Senior secured, second lien
Domicile	US
Currency	USD
Amount Issued/Outstanding	USD500m/USD500m
Issuer Credit Rating	B1/B+ (Moody's/S&P) Stable outlook
Issue Credit Rating	B2/BB (Moody's/S&P) Stable outlook
Australian W/H tax exempt	No

Strengths

- **Dampened exposure to energy prices:** Due to the recent corrections in energy prices, industry capital expenditure (capex) cuts have tended to impact new field (greenfield) and deepwater subsea activities. MDR's offshore and brownfield developments account for over 50% of total revenues, which have remained relatively unaffected by energy price related capex cuts, and have thus provided a degree of resilience to MDR's earnings. For example, for the two year period starting 1 January 2014 until 31 December 2015, the oil price as measured by WTI Crude fell by over 63.5%, whereas MDR's EBITDA was USD84.4m and USD301.2m for FY14 and FY15 respectively, having recovered from negative USD248.7m in FY13. However, it must also be noted that the sensitivity of earnings to oil prices is also dampened to the upside. For example, whilst WTI had seen a 31% recovery from YE15 prices to 30 September 2016, MDR EBITDA only grew by 13.4% for the nine month period versus the previous year
- **Strong orders backlog:** As at 30 September 2016, the company reported orders backlog totalling USD3.9bn in value. This is down from USD4.2bn as at FYE15 primarily due to major projects that have been completed and rolled off over the past year. The current backlog is 79% offshore and 21% subsea, and expected roll off timings are roughly 12.8% in 2016, 61.5% in 2017, and the remainder thereafter. The reported backlog consists of expected revenues from both contracts awarded and those that management anticipate to be awarded, with anticipated order activity forming a relatively small percentage of the overall backlog (c.6.5% as at FYE15). The mix of offshore versus subsea is provides continued resilience to future energy price volatility, and the expected roll off of backlog revenues provide support to FY17 expected earnings
- **Geographical diversification:** MDR has an operating presence in most major offshore oil and gas producing regions throughout the world. Financial reporting segments are split according to geography, including AEA (Americas, Europe and Africa), MEA (Middle East), and ASA (Asia). As at FYE15, 47.5% of revenues were generated in ASA, followed by 37.0% in MEA, and the remaining 15.5% in AEA. Australia (37.7%) and Saudi Arabia (29.3%) were the largest contributors to overall revenues. The current order backlog is split 64% MEA, 21% ASA, and 15% AEA
- **Barriers to entry:** The substantial capital costs and specialised capabilities required in becoming a global full service and fully integrated offshore EPCI contractor create a barrier to entry into the market. However, MDR is exposed to competitive pressures from regional and less integrated providers of certain EPCI services
- **Significant share in many targeted markets:** Whilst the offshore oil and gas services market faces competition from regional and less integrated companies, MDR's services are relatively niche, with the company reporting a high degree of customer reliance on the services MDR is able to provide. S&P notes that MDR commands a significant share in many of its targeted niche markets
- **Focus on cost:** MDR began various cost saving and turnaround initiatives in 2014, which has resulted in what management believes to be a better alignment of the overall cost structure to an expectation of a "lower for longer" oil price environment. Management also anticipates that order intakes will focus on markets where capital is available for investment, brownfield and producing basins with the lowest production costs, and national oil companies who are committed to production levels
- **DLV 2000 extends fleet capability:** Capex so far in FY16 has been relatively high due to the construction of the new derrick lay vessel 2000 (DLV 2000). Total capitalised costs associated with the construction of the DLV 2000 as at 30 September 2016 were USD433m, and MDR expects that a further USD15m cash obligation will be incurred in 4Q16. As such, most of the capex relating to the DLV 2000 has already been incurred. The DLV 2000 is the new flagship of the MDR fleet, and provides the capability of using this single vessel on projects which would typically require a combination of multiple vessels. The DLV 2000 is currently working on the INPEX Ichthys project, and is subsequently scheduled to work on Phase II of the Woodside Greater Western Flank project. Both projects are in Australia
- **Adequate liquidity position:** Following a broad refinancing in 2014, MDR's management put in place a new capital structure that allowed sufficient liquidity to fund large and potentially lumpy capex requirements for the subsequent two or three years. As such, current liquidity remains adequate, with over USD500m of unrestricted cash and cash equivalents reported on the balance sheet as at 30 September 2016, as well as access to USD95m of a USD450m Letter of Credit facility. Following various amendments to the Credit Agreement negotiated since 2014, MDR currently has no significant debt maturities until 2019
- **Relatively strong tangible asset coverage:** As at 30 September 2016, the total value of PP&E (net of depreciation) recorded on the balance sheet was USD1.7bn, which represents 1.6x total debt outstanding. The value of PP&E would need to fall by more than 38.3% for the debt coverage ratio to fall below 1.0x
- **Voluntary debt repayment:** Following the renegotiations of various amendments to the Credit Agreement, MDR decided to pay down USD75m of the original USD300m term loan in May 2016. Amendments to the Credit Agreement required that any proceeds from a potential future sale and leaseback transaction on the DLV 2000

be applied toward further repayment of the remaining principal of the term loan, which would in turn reduce the degree of contractual subordination borne by bond holders of the 8% notes. Following the voluntary partial debt repayment in May, S&P upgraded its rating on MDR 8% notes to BB, from BB-, and anticipates recovery rates of 90-100% in the event of payment default

Risks

- **Exposure to energy prices:** Whilst the aforementioned exposure to brownfield and offshore projects provides MDR with a degree of insulation from energy price volatility, overall demand for oil and gas field services and construction on a global basis is still strongly tied to global energy prices. As such, continued low and volatile energy prices would increase uncertainty on the value and timing of new project awards and therefore on expected future revenue streams and cash flows
- **Exposure to certain political risks:** Many of the countries and jurisdictions in which MDR operates are in the emerging markets, and as such, operations are exposed to local and regional economic and political risks, including risks that may alter the tax and legal framework in which MDR conducts its operations
- **Risks of project cost uncertainty in fixed price contracts:** During 2013 the company suffered negative EBITDA of around USD250m. This was due to a combination of operational and commercial issues with various customers that affected MDR's estimates of costs at completion for several projects. Since then, MDR has implemented various turnaround initiatives that have supported a steady improvement in operational results. Nevertheless, with the majority of MDR's contracts subject to fixed price agreements, there remains significant exposure to the risk of cost overruns
- **Risk of changes to backlog:** Whilst the backlog is relatively conservatively reported by MDR, it includes a portion of expected revenues associated with change orders relating to ongoing contracts that have not been officially approved by the customer. At the end of FY15, the order backlog was USD4.2bn, of which USD277m related to such unapproved change orders. In the event that such change orders cannot be approved by the customers, MDR would record the loss of revenue as a claim
- **Customer concentration:** There is limited customer diversity, with INPEX Operations Australia representing 36% of FY15 revenues, followed by Saudi Aramco accounting for 28%. According to management estimates, of the USD3.9bn backlog as of September 2016, approximately 57% is attributable to Saudi Aramco. S&P expects that MDR's customer concentration will remain high. Mitigating this risk somewhat is MDR's focus on national oil customers who exhibit a strong commitment to certain production levels
- **Relatively high and likely increasing financial leverage:** Whilst leverage as measured by net debt to EBITDA is moderate, at 1.6x as of 30 September 2016 (including FIIG's adjustment for USD288m of obligations not reported as debt in MDR's financial statements), there is currently over USD500m of unrestricted cash on the balance sheet which MDR anticipates to use for various ongoing and new capex needs in the next one or two years (FY14 USD320m and FY15 USD103m). Therefore, total debt to EBITDA is important to consider when assessing leverage, which was 3.1x as of 30 September 2016. This degree of leverage is relatively high for a company exposed to a cyclical and competitive industry. Further, despite improving orders activity and backlog, management guides to slightly softer EBITDA forecasts for FY17 and FY18. Management forecasts imply that total debt to EBITDA would reach 3.8x by FYE17. S&P expects total debt to EBITDA to range between 4.0-4.5x for the next one or two years
- **Negative free operating cash flow:** Cash flow from operations has been volatile in recent years, related to energy price declines and volatility. This has been compounded by ongoing capex needs as well as new project capex requirements (e.g. DLV 2000), which has resulted in negative free operating cash flow. Whilst the bulk of the capex associated with the construction of the DLV 2000 has been incurred, free operating cash flow is likely to remain constrained in the face of softer earnings expectations from management. Mitigating this somewhat are signs of stabilisation in free operating cash flow, as well as an adequate liquidity position following successful renegotiation and amendment of the credit agreement
- **Significant exceptions to restrictive covenants:** The MDR 8% notes are subject to certain restrictive covenants which include limitations on incurring additional indebtedness, limitations on restricted payments and limitations on asset sales and the application of proceeds thereof. However, significant exceptions apply to these covenants, including a general additional debt basket of USD375m, and various exceptions to the restricted payments covenant of up to USD250m in total. In addition, the limitation on indebtedness is only subject to a fixed charge coverage ratio (FCCR) test of greater than or equal to 2.0x, and no ratio test on existing or pro forma debt leverage. The lack of more restrictive covenants limiting the incurrence of additional indebtedness exposes investors to the risk of being in a more junior position in the capital structure as a result of additional debt being incurred at a more senior level. Additional debt incurrence would also increase the risk relating to significant financial leverage, as well as the risk of potentially lover recoveries in a default scenario. Mitigating this to an extent are the existence of net secured leverage ratio tests for certain restricted payments, which may balance MDR's financial policy between creditors and shareholders

- **Duration risk:** The MDR USD 8% second lien notes mature in May 2021 and carry a moderate level of duration. Investors are exposed to a degree of interest rate risk on the bond. For example, a 1% increase in yields would result in about USD3.2 fall in the capital price of the bond, all other things being equal

Call Risk	McDermott has the option to call the bonds early at the call dates listed above. A decision to call the bonds ahead of the maturity depends on a number of factors, including the relative cost of entering new debt financing, the company's liquidity position, and the availability and attractiveness of new funding opportunities at the call date. Investors should examine the yield to worst, which may be the yield to call or the yield to maturity, when evaluating the investment opportunity
Interest deferral/Cancellation	n/a
Non viability trigger	n/a

Summary

McDermott USD 8% second lien bonds maturity 1 May 2021 provide investors with a US dollar high yielding opportunity in the oil and gas EPCI sector. The bond carries a degree of duration risk, which means that the capital price of the bonds can be sensitive to changes in underlying changes in interest rates, as highlighted in the risks above.