Helmerich & Payne (HP)

Share Price:	$63.27	Revenue:	3,720	P/E:	9.7
Market Cap:	6,865	EBITDA:	1,578	P/TBV:	1.4
Enterprise Value:	6,584	EBIT:	1,055	EV/EBIT:	6.2
Cash:	361	Net Income:	709	Net Debt/EBITDA:	(0.2)
Debt:	80	FCF:	166	EBIT/Interest:	226.6

Background

Tulsa, Oklahoma-based Helmerich & Payne (H&P) engages in contract drilling of oil and gas wells with operations in three different segments: U.S. Land, Offshore and International Land. U.S. Land accounts for 84% of FY 2014 revenues. It drills wells on behalf of oil and gas producers, by providing drilling rigs, equipment, and personnel on a contract basis.

The Company is the leader of the U.S. onshore drilling market with one of the most modern and capable land drilling fleet. 93% of its 353 U.S. rigs are its proprietary AC drive FlexRig, recognized as one of the most efficient land drilling rigs. The Company owns over a third of the AC drive rig submarket, and 16% of the overall U.S. land rig market.

Thesis

1. **Share price has almost halved from all-time highs due to recent oil price decline, but long-term contracts and strong financials significantly protect the Company in a low commodity price environment.**

Although share price has declined in line with the recent oil price decline, the Company has strong fundamentals that will provide resilience for a sustained period of low commodity prices.

Although rig utilization and spot rates are both expected to decline with oil prices, the Company still has ~52% of its U.S. Land fleet (which accounts for 84% of FY2014 revenues) under long term contracts as of January 2015. The contracts average 3 years and are fixed rate per day. In revenue terms, these contracts provide a strong backlog (defined as the expected future revenue from executed contracts with terms over one year) of $5.0 billion, $1.8 billion of which is expected to be recognized in 2015; this is around half of 2014 revenues of $3.7 billion. Importantly, contracts are generally protected by early termination and delivery delay penalties. The Company's customers are financially strong with 75% of them in investment-grade with most of them being oil majors and large exploration and production companies. As such, although pricing and utilization may stay low, the Company's cash flow has a significant downside protection.

The Company is well positioned to weather even a protracted downturn in oil prices with virtually no risk of insolvency or illiquidity in the near term with its strong balance sheet. It has long-term debt of $80 million against $360 million cash as of September 30 2014 with access to $260 million of revolving credit.

2. **The Company's technological competitive advantage in FlexRigs gives it a favorable position in the secular trend of replacement of old generation mechanical and SCR rigs to new generation AC rigs.**

The drilling rig industry is undergoing a secular trend of replacing older generation mechanical and SCR rigs, to newer generation AC rigs, which include the Company's FlexRigs. The shift to AC rigs in the U.S. has been aided by the trend towards horizontal drilling, which requires the high horsepower, precise control, and reduced downtime, attributes that only AC rig technology can provide. As a result, AC rigs have continued to take market share from mechanical and SCR rigs, from ~15% in October 2008 to the current ~43%, as shown in the below chart. Despite its impressive growth, AC Rigs are still far from fully penetrated.

On a micro level, the Company is one of the pioneers of building new generation AC rigs. Its proprietary FlexRig, which it designs and builds in-house, is widely recognized as a premium rig with greater efficiency than competitors'. FlexRigs generate savings of $265K/well/day compared to peer AC rigs, which would equate to $5.3 million over a year. As a result of such higher efficiency, the Company is able to charge a premium on its rigs while enjoying higher utilization. As further evidence of its competitive advantage, the Company's ROIC at 14% has consistently been almost double that of its peers.

The long term trend towards horizontal drilling in the U.S. will mean a secular tailwind for the continued replacement of old mechanical and SCR rigs to new AC rigs. The Company, given its competitive advantage with FlexRigs, is in a particularly favorable position to benefit from such tailwind.

A low commodity price environment may spur the process, as producers become even more focused on efficiency. Highly efficient AC rigs are poised to take market share from less efficient mechanical and SCR rigs; while FlexRigs, the most efficient AC rigs, are poised to take market share from less efficient AC rigs. As illustration, in the 2012 down cycle when oil price declined ~25%, AC rigs gained ~8% market share from mechanical and SCR rigs, while the Company captured a significant portion by growing its share of the drilling rig market from 12% to 15%.

With the uncertainty of commodity prices, utilization and day rates may further decline in the short term. However, the impact is much more pronounced on mechanical and SCR rigs, and if history is any guide, it may be an opportunity for the Company's superior product to further gain market share.

3. **Management is a prudent and opportunistic capital allocator. Company has a strong balance sheet, well positioned to increase long term shareholder value in difficult times like today.**

The Company has an adroit history of share repurchases, making purchases following sharp share price declines in 2006/2007 (2.0 million shares at average ~$23), 2012 (1.7 million shares at average ~$44), and recently after September 2014 (0.4 million shares at average ~$78), without ever purchasing shares during times of high valuation.

With share price at over 50% off its highs, coupled with a strong balance sheet as discussed above, the Company has indicated that it may engage in further share repurchases with authorization to repurchase up to 4 million shares, representing almost 4% of shares outstanding in any calendar year.

4. Currently trading at historical low valuations

While it is impossible to forecast where oil price will end up, it appears that the low oil price has been priced in. At 9.6x LTM earnings and 1.4x tangible book value, shares are trading near historical low valuations. Given that the Company continues to enjoy long-term tailwinds from the replacement cycle of legacy rigs, we expect that it will continue to gain market share and further its position as the market leader.

High volatility and lack of clarity has caused many E&P companies to sideline projects for the time being. In a base case scenario, even without a return to $90+ oil, stabilization in oil prices will encourage drilling activity and investor confidence to return. Using conservative back of the envelope assumptions, if the Company gains market share similar to the last cycle, using a FY2014's $3.7 billion revenue and a lower net margin at 18, and applying a 12x P/E, with 2 million share repurchase, shares could trade <u>above $75, a 21% upside from current share price.</u> In an upside case where we see further growth in market share and recovery in margins, using $4.0 billion and net margin of 20% with 14x P/E, shares could trade <u>above $105, or a 70% upside from current share price.</u>