Nautilus Marine Services*

26 April 2017

Ticker	NAUT
Price	15.5p
Target Price	n/a
Downside	n/a
Market Cap	£5.6m
Market	AIM
Sector	Oil & Gas
Net Cash	£9.1m
Shares in Issue	36.1m
Next Results	September - Interims

Share Price Performance

Source: Thomson Reuters

%	1M	3M	12M
Actual	+14.8	-4.6	-41.5
Relative	+14.6	-6.6	-49.9

Company Description
Production, development and sale of hydrocarbons and related activities in Colombia, South America

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Initiation of coverage: Metamorphosis

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Originally called Global Energy Development, the company was previously an upstream oil and gas explorer which divested the majority of its assets in Colombia in 2014. The company has now changed its name to Nautilus Marine Services and has recently acquired several offshore support vessels to be utilised in the service sector. We discuss the company's change in strategy and new focus on the offshore energy service sector.

- **Updated strategy**. Following the sale of its upstream assets in Colombia for US$50m, Nautilus was cash rich and seeking new opportunities. The company spent its time wisely, identifying and analysing new markets and strategies before selecting the offshore energy service sector as its new venture.
- **New and expanding portfolio.** Nautilus has recently acquired 11 offshore offshore service vessels and raised US$10.5m in new capital via two transactions for a fair value consideration of US$24.1m. The company plans to expand its portfolio further and is targeting additional transactions over the next 12 months. The acquisitions are likely to focus on value-add technology plays that are value accretive to the vessel portfolio.
- **Service sector poised to turn.** Due to the doubling of the oil price over the past 12 months, we are starting to see previously shelved projects being reactivated. In the US, the focus is on the Permian basin, where there has been a sustained increase in activity this year. However, we also expect to see more activity in the Gulf of Mexico, where Nautilus will initially be active, and we can therefore expect to see increases in demand for offshore services.
- **Outlook.** We are of the view that Nautilus's decision to move into the service sector is the right one as we are of the view that it will see greater gains in value than the E&P sector in the medium term. There are still a number of distressed assets and companies that could provide significant opportunities for Nautilus, not just in the US, but also overseas.

Strategy review

The company has evolved from being an upstream company active in Colombia, to a cash shell (since 2014 following the sale of its assets), to an offshore energy service company today. The disposal of the Llanos assets in Colombia for US$50m was driven in part by the fact that the company wanted to crystallise the value in the assets and to eliminate its outstanding debt.

Following the closure of the Colombian transaction, the company was cash rich and needed to identify options to put this cash to work. Nautilus reviewed the oil and gas supply chain and came to the opinion that the energy service sector was the most attractive option due to the availability of distressed assets and the potential to create value in a rising oil price environment.

The two recent transactions add multiple vessels and additional cash to the company's portfolio. Over the period 2013-16, demand for these sorts of vessels fell by 50% as offshore inspections, maintenance and compliance work was pushed back or cancelled due to low oil prices. However, this is not a sustainable option for the industry, primarily for regulatory and safety reasons. Whilst activity levels are forecast to remain low in 2017, they are expected to begin to recover in 2018 due to higher oil prices and cash flow generation. This should lead to increased activity by energy companies as well as an increasing need to carry out inspection protocols.

Costs in the oil sector can be split into two categories: capex (building, platforms, facilities and other infrastructure) and opex (inspection, repairs, maintenance and decommissioning). Whilst the recovery in capex will take time, the more opex types of activity are expected to recover quicker and this is where Nautilus will focus its efforts.

In terms of how the strategy will evolve over the next 12-18 months, Nautilus will continue to identify more assets to add to the portfolio. Its next transaction will likely be technology related, to enhance or enable the services to be provided through the company's portfolio.

How that value is created could be using commercialised technology to perform offshore regulatory requirements in a faster, more efficient and less expensive way for its future clients. It could also be a technology which can be used in multiple sectors such as telecommunications and renewable energy, not just oil and gas.

Valuation

Given the early stage of the portfolio and the company's ongoing assessment of the assets already acquired, we have decided not to include forecasts or a target price at this time. As the company's strategy crystallises, its portfolio matures and market conditions become clearer, we will be more able to provide meaningful estimates.

However, we do feel that the company is ideally suited to take advantage of low asset valuations whilst the market remains soft in 2017. We are of the view that the services market will pick up again in 2018 as the upstream sector re-evaluates opportunities to bring new production onstream.

Nautilus will not want to operate vessels un-profitably hence it focussing on expanding the portfolio during 2017 and then moving into operations in 2018 as the market recovers.

Future share price drivers

So far, Nautilus has successfully completed the initial two transactions and raised US$10.5m of new funding as part of its new strategic direction. It has also established dock facilities in the Gulf of Mexico.

Over the next three to six months the company hopes to:

- Acquire or invest in commercial, niche offshore technologies;
- Fully assess and enhance current vessels; and
- Identify other assets at attractive prices owned by banks and distressed companies.

Over the next six to twelve months the company hopes to:

- Add operational personnel and increase in-house expertise;
- Seek acquisition of or strategic partnership with offshore service companies;
- Make further acquisitions, either more vessels and/or remotely operated vehicles; and
- Become a specialised service provider.

Transaction details

The recent acquisition of the support vessels comprised two transactions, both of which were appraised independently to be fair value as part of the due diligence process.

Transaction A

In this transaction, Nautilus acquired three vessels from Everest Hill Group Inc. The consideration comprised:

- Forgiveness of US$8m of the outstanding principle amount of existing loan notes owed to Nautilus;
- Reduction of the loan note interest rate from 12% to 8% as well as extending its maturity to 14 September 2018; and
- Contingent consideration equal to the lower of US$5m or 75% of the net cash inflows (including capital improvements) for 18 months post closure.

Transaction B

Nautilus has issued US$31.6m of nominal value (US$16.1m fair value) convertible notes in return for:

- Eight subsea vessels, a barge and other equipment through the purchase of shares; and
- US$10.5m of new cash.

Convertible note terms

These comprise three levels of notes:

Level A

- Nominal value of US$10.5m
- 10-year term
- 50p conversion price
- Non-compounding interest. Payable at maturity or conversion at 8%
- Payable in cash upon maturity if not converted
- Subject to terms, Nautilus can force conversion

Level B

- Nominal value of US$6.1m
- 12-year term
- 160p conversion price
- Non-compounding interest. Payable at maturity or conversion at 6%
- Payable in cash or shares upon maturity if not converted
- Subject to terms, Nautilus can force conversion

Level C

- Nominal value of US$15m
- 15-year term
- 225p conversion price
- Non-compounding interest. Payable at maturity or conversion at 6%
- Payable in cash or shares upon maturity if not converted
- Subject to terms, Nautilus can force conversion

Transaction summary

Item	Value (m)
New cash	$10.5
Vessels and equipment	$13.6
Fair value of assets	**$24.1**
In exchange for:	
Fair value of convertible notes	$16.1
Forgiveness of debt	$8.0
Fair value of consideration	**$24.1**

Source: Company reports, finnCap estimates

The return of the oil service sector

Last year saw the oil price effectively double as high-cost production was shut in, reducing the oversupply, and OPEC finally agreed to cut production. As much as the industry may hope, we are unlikely to see the oil price double again in the short term, although we do expect it to strengthen further in 2017 to an average of US$60/bbl. With oil prices sustainably above US$50/bbl, life for the sector improves. When prices get above US$60/bbl, life is considerably better in terms of cash-flow generation, leading to energy companies to increase their activities in capital projects.

Oil services are the first thing to be cut when the oil price falls, and the last to be picked up when the price rises. Consequently, the service companies have not had a good couple of years during the downturn, with contracts being cut and margins squeezed. However, we are of the view that as the oil price improves and balance sheet pressure eases, we will start to a sustained increase in activity.

E&P budgets cut during downturn

Global E&P saw a capex decline of 40% in 2016 over the recent peak in 2014. Capex is forecast by WoodMac to increase by 3% to US$450bn in 2017, with the expectation that costs will continue to fall during the year as the sector continues to focus on efficiency. 2018 is expected to be the turning point for the oil sector as a leaner, more focused industry begins to crystallise.

We expect the oil price to continue to strengthen as global inventories are drawn down and supply and demand are brought back into balance. Crucial to this process will be the ongoing and rigorous compliance with the OPEC/Russian production cut.

On the assumption that the oil market is stabilising, and that costs have been cut to a point where cash can be generated at oil prices in excess of US$55/bbl, what does that mean?

Last December, BP gave its Final Investment Decision (FID) for the Mad Dog 2 development in the Gulf of Mexico. This project is important as it illustrates how the sector has been forced to embrace the lower oil price and excessively high cost base that has blighted the sector for too long.

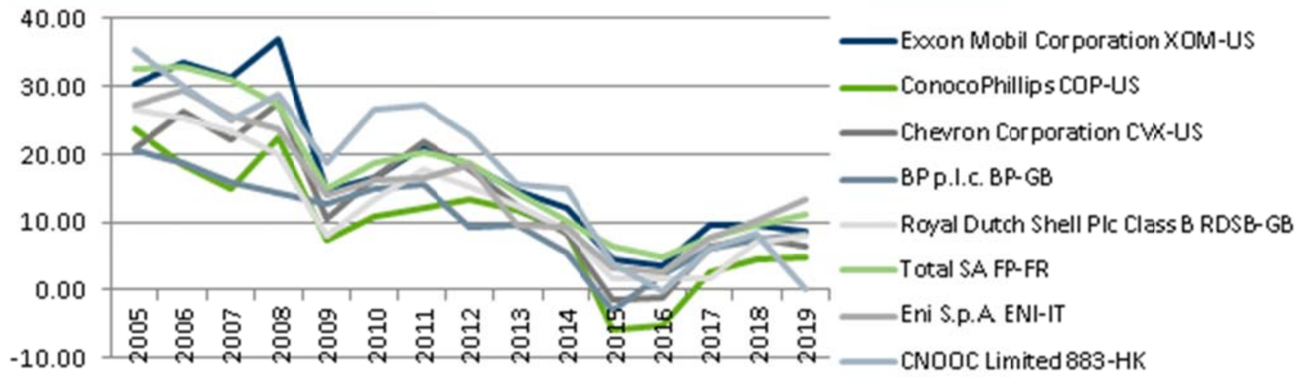
In 2013, the project was estimated to cost US$20bn, which – given the company's stretched balance sheet post-Macondo (rather than foresight as to the impending oil price collapse) – caused the company to shelve the project pending re-evaluation. As a result of this process and new emphasis on cost-cutting and maximising margins at low oil prices, Mad Dog 2 will now be developed for US$9bn – a 60% reduction on the original estimate.

It is examples such as this which are becoming more common as shelved projects are re-examined in the current environment. The lack of focus on return on capital, and the reduction of investment hurdle rates for projects more generally, has been an increasingly forgotten method of benchmarking oil and gas companies over the past 20 years.

Back to basics: Why benchmarks are important

We mentioned earlier that the sector has been blighted by falling rates of return on capital (ROCE) and reducing internal rates of return (IRR) for projects. Since 2005, we have seen a steady decline in ROCE, which accelerated during and subsequent to the financial crisis in 2009.

ROCE



Source: Factset. Calculated on an EBIT basis

The Chevron-operated Gorgon LNG project is a classic case study when looking at ROCE and IRR in the sector. The project gained Final Investment Decision in 2009 with a proposed budget of US$37bn in what was a strong LNG market. The project eventually came onstream in January 2016 (before quickly being shut in again due to technical issues) at a cost of US$54bn in a substantially weakened LNG market.

Such budget blow-outs for large-scale projects are common and were perceived more as an annoyance that the sector tolerated rather than an issue that must be resolved. As a result, both ROCE and project IRRs were negatively affected, and this is a change that the sector will need to embrace in future.

As the table above shows, the industry and the capital markets have been tolerating single-digit ROCE for most companies for several years. Looking at IRRs back in the early 2000s, 15% was the absolute minimum before a project was signed off. Today, the average project IRR is 9%, with a significant proportion of projects unable to reach an IRR of 15% even at an oil price of US$60/bbl.

Which areas will see investment?

In 2016, only nine major projects (more than 50mmboe) made it to FID, and this is forecast by WoodMac to increase to more than 20 in 2017. However, this is still about half of the average number of projects to reach FID over the period 2007 to 2014. So where are companies looking to develop?

Offshore

Investment in offshore upstream projects is beginning to return. Given that the emphasis is now on high-margin, capex-lite projects, we expect to see expansion projects (such as Mad Dog 2 in the Gulf of Mexico) to be the first to be sanctioned. We also expect a modular approach to developments, with capex being spent in discrete blocks of production onstream rather than the previous model of building out 100% of infrastructure and capacity upfront.

Deep water projects will very likely be a focus in the coming years. Deep water exploration has yielded world-class discoveries, and certainly recent exploration success offshore West Africa continues to prove up new discoveries. Given the scale of the resource base of such prospects, there is the ability to drive down unit costs in order to increase returns on capital. There is the perception that deep water projects need high oil prices to be commercial, but the industry has addressed this issue by re-setting the cost base, and we are of the view that many of these projects will be commercial above US$60/bbl.

In mature regions such as the North Sea, we are starting to see new partnerships being developed in order to reduce costs. Helicopter and support vessel sharing and new approaches to accessing infrastructure are already making an impact.

How is the service sector evolving?

We have discussed technological advances in previous editions of *The Joy of Techs* and *Support Group* quarterlies. The ‘Internet of Things’ is not just limited to fridges ordering your milk when you run out, or lifts determining when they need to be serviced rather than a technician coming once a year on a scheduled basis. The Internet of Things (IoT) is becoming an important feature in the oil sector too, with a number of drivers accelerating this process.

One of the key barriers to the implementation of the IoT has been the ability to transfer and monitor data from an offshore to an onshore location. The installation of fibre optic cables has made this process easier to manage and use in a constructive way. There are a number of key drivers that have accelerated its adoption.

The first casualty of the downturn was discretionary capex such as exploration drilling; the next casualty was staff. The oil sector was already suffering from an aging work force, and it was also struggling to attract the next generation of workers due to certain negative perceptions of the industry, particularly post-Macondo. As a result of the declining pool of workers, inevitably the sector needs to become more automated.

Safety is another key issue. As we saw with the Exxon Valdez disaster and other terrible industrial accidents, human error is frequently a key factor.

There is an old ‘joke’ which talks about the local oil refinery and its only two occupants: the foreman and a dog. The foreman’s job is to call the fire brigade if something goes wrong. The dog's job is to bite the foreman if he touches any of the instruments. This farcical scenario, whilst mildly amusing, does illustrate to an extent how by removing or minimising the human element, processes can become more efficient and – more importantly – safer.

Retro-fitting these new technologies will be difficult in already installed facilities, but certainly we feel that in greenfield projects they will increasingly become the norm. In EY’s recent oil field services report, there was an interesting statement: it reported that we are now at the point where it is cheaper to make and install a ‘smart’ bit of kit than it is to install its ‘dumb’ equivalent and maintain it.

Asset overview

We provide some details on the vessels acquired in the two transactions.

Transaction A vessels

Built in 1983, the Mystic Viking is an offshore supply vessel, fitted with a SIMRAD Dynamic Positioning System (DP) and is currently set up to support Remotely Operated Vehicle (ROV) programmes in the Gulf of Mexico. The Mystic Viking is equipped with a 50-ton Hydralift crane, a helideck suitable for a Bell 212 helicopter and has accommodations of up to 57 berths. The vessel is currently flagged in the Bahamas and the port of registry is Nassau, Bahamas.

The Mystic Viking is currently held in a newly-created entity NMS Viking Inc. (incorporated and registered in the Marshall Islands) and is docked at Berwick facility in Louisiana which has access to the Gulf of Mexico.

Mystic Viking

Source: Company data

Built in 1975 and refurbished in 2011, the Midnight Star is fitted out as a diving support vessel featuring a six-man saturation diving system depth rated up to 300 meters (1,000 feet). The Midnight Star is equipped with a 31-ton EBI crane, has a four-point mooring system for diving operations and has accommodations of up to 42 berths. The vessel is currently flagged in Vanuatu and the port of registry is Port Villa, Vanuatu.

The Midnight Star is currently held in a newly-created entity NMS Star Inc. (incorporated and registered in the Marshall Islands) and is docked at the Berwick facility in Louisiana which has access to the Gulf of Mexico.

Midnight Star

Source; Company data

Built in 1974 and refurbished in 2013, the Cal Diver 1 is a four-point diving support vessel and is currently flagged in the United States and registered in New Orleans, Louisiana, US. Cal Diver 1 has been in an extended period of cold lay up and would require more extensive work and investment than the Mystic Viking and Midnight Star to return to service.

The Cal Diver 1 is currently held in a newly created entity NMS CD1 Inc. (incorporated and registered in the Marshall Islands) and is docked at the Berwick facility in Louisiana which has access to the Gulf of Mexico.

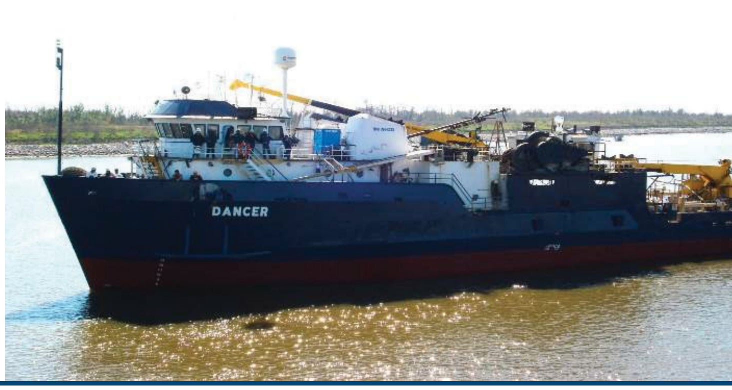
Cal Diver 1

Source; Company data

Transaction B vessels

Built in 1977, the DC Dancer is a four-point diving support vessel that supports surface diving operations. The DC Dancer is equipped with a 30-ton EBI crane and has accommodations of up to 36 berths. The vessel is currently flagged in the United States and the port of registry is in New Orleans, Louisiana. The DC Dancer is docked at the Berwick facility in Louisiana which has access to the Gulf of Mexico.

DC Dancer



Source; Company data

Built in 1967, the DC Star is a four-point diving support vessel that assists surface diving operations. The DC Star is equipped with a 20-ton HydraPro crane and has accommodations of up to 32 berths. The vessel is currently flagged in the United States and the port of registry is in New Orleans, Louisiana. The DC Star is docked at Berwick facility in Louisiana which has access to the Gulf of Mexico.

DC Star

Source; Company data

Built in 1969, the DC Fred is a four-point diving support vessel that assists surface diving operations. The DC Fred is equipped with a 25-ton Coast crane and has accommodations of up to 36 berths. The vessel is currently flagged in the United States and the port of registry is in Morgan City, Louisiana. The DC Fred is docked at the Berwick facility in Louisiana which has access to the Gulf of Mexico.

DC Fred

Source; Company data

Built in 2000, the DC IV is a four-point diving support vessel that assists surface diving operations and offshore inspections. The DC IV has accommodations of up to 21 berths. The vessel is currently flagged in the United States and the port of registry is in Morgan City, Louisiana. The DC IV is docked at the Berwick facility in Louisiana which has access to the Gulf of Mexico.

DC IV

Source; Company data

Built in 1983, the DC Polo is a four-point diving support vessel that assists surface diving operations and offshore inspections. The DC Polo has accommodations of up to 19 berths. The vessel is currently flagged in the United States and the port of registry is in Morgan City, Louisiana. The DC Polo is docked at the Berwick facility in Louisiana which has access to the Gulf of Mexico.

DC Polo

Source; Company data

The DC Triumph, Victory, and Sterling are currently out of service and would require extensive work and investment to return to service. As a result the Company has salvaged these vessels.

Built in 1995, the Rider Barge is a non-propelled pipelay barge. It features pipe laying equipment and can support air diving operations. The Rider Barge has accommodations of up to 88 berths. The vessel is currently flagged in the United States and the port of registry is in New Orleans, Louisiana and is in laid up status. The Rider Barge is docked at the Berwick facility in Louisiana which has access to the Gulf of Mexico.

Rider Barge

Source; Company data

Berwick dock facility

Global has signed a one-year lease with Hellenic, LLC. for exclusive use of the docking facility in Berwick, Louisiana. Lease of this facility provides 24-hour docking services. The company has also contracted for on-site 24-hour security for the vessels. The facility also includes office space and adequate area for storage of equipment.

The lease is for an initial period of one year at a rate of $10,000 per month and has an option for a further two years at $12,000 per month.

Management

Mikel D. Faulkner – Chairman

Mikel Faulkner holds a Bachelor's degree in Mathematics and Physics and a Masters degree in Business Administration. His employment experience includes service as an officer in the United States Naval Nuclear Power Program, a member of the audit staff at Arthur Andersen & Co., a financial officer for American Quasar Petroleum, and Chairman at HKN, Inc. (formerly Harken Energy Corporation), where he served from 1991 to 2003 and has been the Chief Executive Officer since 1982.

Alan Henderson – Non-Executive Director

Alan Henderson is chairman of Smart Matrix Limited. He is a director of North One Garden Centre Limited and West Six Garden Centre Limited. He was previously Chairman of Forum Energy PLC, Aberdeen New Thai Investment Trust PLC, Aberdeen New Dawn Investment Trust PLC and Ranger Oil (UK) Ltd, and a Director of ADT Ltd and Ranger Oil Ltd.

David Paul Quint – Non-Executive Director

David Quint is a graduate of the University of Notre Dame from which he received a Bachelors degree in Modern Languages in 1972 and a Juris Doctorate in 1975. From 1975 until 1982, he was an attorney with Arter & Hadden in Cleveland, Ohio and Washington D.C. From 1983 until 1992, he served as the managing director of the London-based international financing arm of a US oil and gas company. In 1992, David founded RP&C International, Inc., an investment-banking firm with offices in London and New York. In 2016, RP&C International was acquired by Arundel AG, a Swiss company listed on the SIX Stock Exchange in Zurich which invests in assets and provides financial services on a global basis. He currently serves as a director of Arundel AG and as the chief executive officer of Arundel Group Limited.

Donald Zac Phillips – Non-Executive Director

Zac Phillips was elected to the Board of Directors in 2014. Zac holds a chemical engineering degree and a doctorate of chemical engineering from BP and the University of Bath. From 2006 to 2010, Mr. Phillips served as chief financial officer and founding director of Dubai World's Oil & Gas Business, DB Petroleum (formerly BSG Energy). He currently acts as an independent energy consultant to companies during periods of development and expansion, assisting with areas such as investment banking, assets valuation and capital market activity through Phillips Energy Consultants, a financial management firm he founded. He currently holds the role of non-executive director for Kairos Petroleum. He is also a member of the SPE and the Institute of Chemical Engineers.

John Payne – Director of Operations

John Payne has more than 30 years' experience in the international subsea sector. A qualified Master Mariner, Mr. Payne has held a number of senior business positions since coming ashore in 1999. He has gained his international experience within the subsea telecom, renewable and offshore subsea sectors and has held senior roles in Business Administration, Business Development and Service Delivery and more recently was Interim Chief Executive to Hallin Marine before taking a senior role with specialist chemical provider Aubin Ltd. He has qualified as a Chartered Director and is a Fellow of the Institute of Directors with experience in operating in USA, Europe and Asia.

Anna Williams – Director of Strategy and Business Development

Anna Williams formerly served as Finance Director of Global Energy Development PLC from 2010 to 2016. She served as Chief Financial Officer for HKN, Inc. (formerly Harken Energy Corporation), a US publicly-listed company, from 2000 to 2010 and as International Finance Manager from 1996 to 2000. Prior to that, Ms. Williams began her career in public accounting work at Arthur Andersen & Co. She has also served on the Board of Directors and Audit Committee of an independent Canadian-listed oil and gas company. Ms. Williams is a Certified Public Accountant.

Sarah B. Gasch – Finance Director

Sarah Gasch formerly served as Executive Vice President and Chief Operating Officer of HKN, Inc. and Chief Executive Officer of BriteWater International, Inc., a wholly-owned subsidiary of HKN from 2009 to 2016. During her tenure with HKN, she also served as Chief Financial Officer, Chief Accounting Officer, Corporate Secretary, and Controller. Prior to joining HKN, Ms. Gasch served as Vice President and Chief Accounting Officer for Green Hunter Energy, Inc., a public alternative energy company where she was responsible for the creation and management of the entire accounting and reporting organization from 2008 to 2009. Ms. Gasch also served as Financial Reporting Manager for Magnum Hunter Resources, Inc., a public oil and gas company from 2002 to 2005. Ms. Gasch began her career in public accounting.

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