# DryShips, Inc. (DRYS)

*Proceed with Caution*

*Rating:* **HOLD**

**DryShips, Inc.**
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## DRYS RESEARCH REPORT:

**Published June 19, 2014**

***COMPANY OVERVIEW:***

DryShips, Inc. (DRYS) is an international provider of ocean transportation services for drybulk and petroleum cargoes through their ownership and operation of drybulk carrier vessels and oil tankers. The company also engages in offshore drilling services through their majority-owned subsidiary Ocean Rig UDW (ORIG), which specializes in the ultra-deepwater and harsh-environment segment of the offshore drilling industry. DryShips operates among three reportable segments: Drybulk Carriers, Tankers and Offshore Drilling.

Within the Drybulk Carrier Segment, DRYS owns a fleet of 38 drybulk carriers comprised of 12 Capesize, 24 Panamax and 2 Supramax vessels, which have a combined deadweight tonnage (dwt) of approximately 4.1 million dwt and an average age of approximately 9.7 years. Additionally, the company also owns ten oil tankers, comprised of 6 Aframax and 4 Suezmax tankers, in their Tanker Segment; and 8 drilling units in their Offshore Drilling Segment through ORIG.

DryShips generates revenues by actively managing the deployment of their assets. For example, through the chartering of their drybulk fleet, DRYS distinguishes between long-term time charters and bareboat charters (which can last up to several years), and short-term time charters or spot charters (which generally last from several days to several weeks). As of February 14, 2014, the company's 38 drybulk vessels were evenly split between time charters and spot charters.

***BUSINESS SEGMENT MARKETS AND OUTLOOK:***

Overall, the international shipping and offshore drilling industries are highly competitive, fragmented and capital-intensive. For the most part, trends and the state of the global economy heavily influence the markets for drybulk carriers, tankers and offshore drilling. For example, the demand for drybulk carriers is determined by the underlying demand for commodities transported in drybulk carriers, while the demand for oil tankers is driven by the demand for crude oil and petroleum products.

Meanwhile, the offshore drilling industry is influenced by a number of factors including the global demand for oil and natural gas. Further, as the international drilling market has seen an increasing trend towards deep and ultra-deepwater oil and gas exploration in recent years, overall demand for companies operating in this space has increased as well.

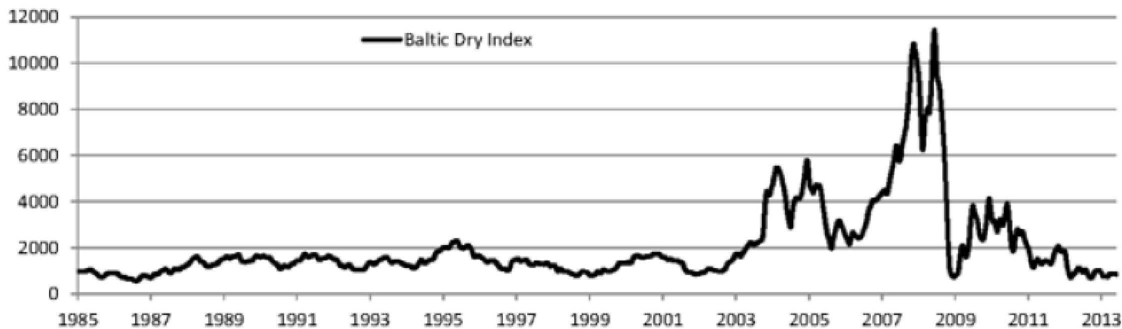
*DRYBULK:*

Drybulk commodities include major bulks (coal, ore, grain, etc.) and minor bulks (steels, sugars, cements, etc.), and are shipped across the world in large, unpackaged amounts. In 2013, approximately 4.3 million tons of cargo was transported by drybulk carriers with iron ore, coal and grains representing 27.8%, 25.9% and 8.6% of the total drybulk trade, respectively.[1] Due to the adverse effects an in-

transport accident can have on the environment, the transportation of drybulk commodities is highly regulated.

The company competes with other owners of drybulk carriers in the Capesize, Panamax and Supramax size sectors, which have carrying capacities of 110,000-199,999 dwt, 60,000-85,000 dwt and 45,000-60,000 dwt, respectively. It is estimated by DRYS that there are approximately 1,600 independent drybulk carrier owners who all compete for charters on the basis of price, vessel location, size, age and condition of the vessel, and reputation as an owner and operator.

Within the drybulk industry, the Baltic Dry Index (BDI) is used to price shipping worldwide and is employed by logistics teams to calculate costs. The index is also used by macro traders as a leading indicator of macroeconomic strength as moves in the index tend to be demand-driven. As demand increases for shipping, the index and shipping prices increase as well. Currently, the index sits around 867, down dramatically from its peak of almost 12,000 in 2008 and only up around 34% from its 25-year low of 647 in February 2012.




***Source: Seeking Alpha[2]***

Additionally, the drybulk carrier segment has been known to exhibit seasonality – more so than the tanker and offshore drilling segments. Typically, the demand for vessel capacity has been stronger in the fall and winter months in anticipation of increased consumption of coal and other raw materials in the northern hemisphere during the winter months.

*TANKERS:*

Generally, seaborne crude oil transportation services are provided by two main types of operators – major oil company captive fleets (both private and state-owned) and independent ship-owner fleets. Competition, like in the drybulk carrier market, is based upon price, location, size, age, condition and acceptability of the vessel and its manager. In addition, competition is also driven by the availability of other size vessels to compete in the trades in which the company engages. Charters are often brokered through international independent brokerage houses whose task is to find the optimal ship for a particular cargo based on the criteria above. While some seasonality may still exist (oil demand is usually higher in the winter months in the Northern Hemisphere), it has moderated over time as other uses for oil and oil products have developed and demand over the summer months have increased over the years (i.e. air conditioning, more travel in motor vehicles, etc.).

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*OFFSHORE DRILLING:*

Although the drilling industry has experienced consolidation over the last several years, the market has many participants with very few representing a dominant share. As of January 2014, offshore drilling contractors had approximately 203 existing deepwater and ultra-deepwater (i.e. 3,000 feet or more) drilling units worldwide. While the majority of undiscovered offshore reserves in ultra-deepwater fields are primarily located in the area between West Africa, Brazil and the Gulf of Mexico, as well as in the area between East Africa, Australia and Southeast Asia, competition takes place on a global basis. Since these drilling units are mobile, they may be moved from one region to another, thereby allowing competing contractors to adjust to supply and demand in the area.

In general, drilling contracts are subject to intense price competition. However, other factors such as unit availability, location and suitability, a drilling contractor's operational and safety performance record, and condition and suitability of equipment come into play as well. Meanwhile, seasonality does not usually affect the offshore drilling market, but the occurrence of adverse weather conditions during certain times of the year (i.e. hurricane season in the Gulf of Mexico, the winter season off of Norway and the monsoon season in Southeast Asia) could impact operations.

Finally, following the *Deepwater Horizon* accident in the Gulf of Mexico in 2010, the risks associated with offshore drilling have been featured more prominently as of late. Drilling contractors and oil companies alike have shown a preference for more modern drilling units to better deal with these challenging environments. Not to mention the increased scrutiny and regulations within the industry that came as a result.

***MUCH MORE THAN JUST A DRYBULK SHIPPING STOCK:***

Perhaps the biggest thing most investors do not realize about DRYS is that its name is something of a misnomer. While the company is certainly one of the larger players in the drybulk and crude oil shipping markets, its approximately 57% ownership in Ocean Rig UDW (ORIG) is both its main advantage and disadvantage.

At a time when most of its competitors such as Diana Shipping (DSX), Navios Maritime Partners (NMM), Baltic Trading Limited (BALT), Star Bulk Carriers (SBLK), etc., are struggling due to lower shipping rates, oversupply and a still-depressed Baltic Dry Index, DRYS has managed to differentiate itself from the pack.

For example, in 2013, the Offshore Drilling Segment accounted for an astounding 79% of DRYS' total revenue. Not only that, but that percentage has grown sequentially over the last several years by 34.6% and 25.3% in 2012 and 2013, respectively. In looking at the company's revenue breakdown by segments from 2011, 2012, and 2013, it is easy to see that DRYS' so-called bread and butter – drybulk shipping – has continually accounted for less and less of the company's total revenue, while its offshore drilling segment has grown dramatically over the same time frame.

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| ***Revenue Breakdown (in millions)*** | **2013** | **2013** | **2012** | **2012** | **2011** | **2011** |
|---|---|---|---|---|---|---|
| Drybulk Carrier Segment | $191.00 | 12.8% | $227.10 | 18.8% | $365.40 | 33.9% |
| Tanker Segment | $120.70 | 8.1% | $41.10 | 3.4% | $12.70 | 1.2% |
| Offshore Drilling Segment | $1,180.30 | 79.1% | $941.90 | 77.8% | $699.60 | 64.9% |
| *Total* | *$1,492.00* | *100.0%* | *$1,210.10* | *100.0%* | *$1,077.70* | *100.0%* |

***Source: DRYS Form 20-F***

| ***YoY Revenue Change*** | **2013** | **2012** |
|---|---|---|
| Drybulk Carrier Segment | -15.9% | -37.8% |
| Tanker Segment | 193.7% | 223.6% |
| Offshore Drilling Segment | 25.3% | 34.6% |

In addition, this growth and revenue breakdown is likely to continue as it was reported that at the end of the first quarter of 2014 this Offshore Drilling Segment had an order backlog in the neighborhood of around $5 billion.

***CRUSHING DEBT LOAD:***

Despite the significant revenue growth that DRYS has enjoyed from its investment in ORIG, the company's biggest disadvantage can also be seen in the fact that the majority of its crushing debt load comes from this same investment (discussed below). Moreover, this large and increasing debt burden is one of the oft-cited reasons why analysts, money managers and investors advise against an investment in shares of DRYS.

Just recently, Genco Shipping & Trading (GNKOQ) filed for bankruptcy protection in April 2014 as a result of their excessive debt burden combined with decreased charter rates and continued volatility in the shipping market. In light of Genco's recent fate, many investors are questioning whether DRYS might be next as the company has continued to grow their debt burden over the past decade. Judging by the figures below related to DRYS' debt to equity (D/E) ratio, long term debt to equity ratio and working capital, it appears as though they are right.

| ***ANNUAL*** | **2004-10** | **2005-12** | **2006-12** | **2007-12** | **2008-12** | **2009-12** | **2010-12** | **2011-12** | **2012-12** | **2013-12** | ***AVG*** |
|---|---|---|---|---|---|---|---|---|---|---|---|
| D/E Ratio | -47.00 | 1.55 | 1.59 | 1.29 | 2.75 | 1.07 | 1.08 | 1.74 | 2.12 | 2.87 | *3.09* |
| LT Debt/Equity | -22.50 | 1.17 | 1.30 | 1.02 | 0.61 | 0.35 | 0.59 | 1.21 | 1.15 | 1.50 | *1.36* |
| Working Capital (Deficit) | (29) | (117) | (102) | (86) | (1805) | (715) | 130 | (171) | (670) | (988) | *(455)* |

| ***QUARTERLY*** | **2011-12** | **2012-03** | **2012-06** | **2012-09** | **2012-12** | **2013-03** | **2013-06** | **2013-09** | **2013-12** | **2014-03** | ***AVG*** |
|---|---|---|---|---|---|---|---|---|---|---|---|
| D/E Ratio | 1.74 | 1.77 | 1.92 | 2.03 | 2.12 | 2.36 | 2.33 | 2.67 | 2.87 | 3.01 | *2.28* |
| LT Debt/Equity | 1.21 | 1.21 | 1.23 | 1.37 | 1.15 | 1.21 | 1.27 | 1.59 | 1.50 | 1.60 | *1.33* |
| Working Capital (Deficit) | (171) | (299) | (128) | 203 | (670) | (782) | (679) | (394) | (988) | (949) | *(486)* |

***Source: Morningstar***

Moreover, the company's declining interest coverage ratio over the past several years further emphasizes DRYS' growing debt problem. Calculated as earnings before interest and taxes (EBIT) divided by interest expense, it helps measure how easily a company can pay interest on its outstanding debt. The lower the ratio, the more the company is burdened by its debt. In general, a ratio under 1 indicates the company is not generating sufficient revenues to satisfy interest expense, while companies that are barely able to cover its interest costs may fall into bankruptcy.

In the case of DRYS, the company's interest coverage ratio has been under 1 for the last two years, with 2013 registering 0.47.

| | 2004-10 | 2005-12 | 2006-12 | 2007-12 | 2008-12 | 2009-12 | 2010-12 | 2011-12 | 2012-12 | 2013-12 |
|---|---|---|---|---|---|---|---|---|---|---|
| Interest Coverage Ratio | 20.00 | 6.55 | 2.31 | 8.82 | -0.12 | 0.59 | 5.40 | 1.19 | 0.08 | 0.47 |

***Source: Morningstar***

Considering the company continues to grow its debt balance – mostly through contracts for the new construction of drybulk vessels and seventh generation ultra-deepwater drillships – over the course of this year and next, the risk of not being able to cover their interest payments increases.

Currently, DRYS' long term debt obligations amount to over $6.1 billion as of the end of the first quarter of 2014. What's more, roughly 29% of that total is due within one year.

| | *For the twelve months ending* | | | | | | |
|---|---|---|---|---|---|---|---|
| | **3/31/2015** | **3/31/2016** | **3/31/2017** | **3/31/2018** | **3/31/2019** | **3/31/20 & Beyond** | ***TOTAL*** |
| Long Term Debt Obligations Due | $1,765,891 | $145,687 | $145,687 | $945,687 | $832,345 | $2,295,500 | ***$6,130,797*** |
| | *28.8%* | *2.4%* | *2.4%* | *15.4%* | *13.6%* | *37.4%* | ***100.0%*** |

***Source: DRYS Form 6-K, 31 March 2014***

However, it should be noted that the overwhelming majority of this crushing debt burden (nearly 74%) comes from the offshore drilling segment (i.e. ORIG). As such, DRYS' investment in ORIG is responsible for both their growing revenues *and* their crushing debt. If you were to look at each company separately, DRYS' balance sheet might improve, but their growth potential and diversification benefits would diminish significantly.

| | |
|---|---|
| Drybulk secured debt[2] | 625.5 |
| Tanker secured debt[2] | 295.4 |
| Ocean Rig debt[2] | 4,510.0 |
| Convertible bond[2] | 700.0 |
| Total debt | 6,130.9 |

***Source: DRYS Q1 2014 Earnings Presentation, 31 March 2014***

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Furthermore, in May 2014, ORIG declared it would issue a quarterly cash dividend of $0.19 per common share, which equates to roughly $15 million per quarter that DRYS will receive for their 57% ownership in the company. While this is but a drop in the bucket, these funds will certainly go towards DRYS' enormous interest payments, and might help any debt renegotiations that may take place between now and the end of this year.

***MACROECONOMIC RISK AND POSSIBLE REBOUND:***

As mentioned earlier, the industries in which DRYS operates are exposed to a significant amount of macroeconomic risk, especially from China. In recent years, China has been the biggest driver of shipping rates considering the country accounts for 70% of the world's iron ore imports. If the Chinese economy cools, the impacts to the shipping industry and therefore DRYS could be significant.

Since the Great Recession, the shipping industry has been hit hard with many people predicting an eventual rebound. In fact, DRYS' Chairman and Chief Executive Officer (CEO) George Economou and several other CEOs including Michael Bodouroglou (of Paragon Shipping), have supported this idea of a rebound. One of the ways that Economou and DRYS are poised to take advantage of this rebound in charter rates is to have its fleet operate more on daily spot rates rather than fixed-rate contracts. If shipping rates rise, as they are expected to do, DRYS will be able to generate more revenue and profits, ultimately allowing the company to meet or eliminate some of its debt obligations.

In a recent report from Clarkson Capital Markets, they estimated that Capesize vessel rates will reach $24,301 per day in 2015 – a significant jump from recent rates in May around $8,400.[3] Additionally, rates of Panamax vessels are also expected to jump at least 65% over the same time frame.[4]

Furthermore, a Thomson Reuters report from February 2014 further supports Economou's belief in a rebound, projecting an end to the years of overcapacity and depressed freight rates since the end of the shipping boom in 2008. Drybulk operators are expected to see the strongest recovery as the growth of iron ore and coal will outpace the supply of new tonnage for the first time in seven years.[5] According to Barclays Research, the global dry bulk seaborne trade is forecast to grow 5.8% in 2014 to 4.37 billion tonnes, outpacing a 5.3% rise in the global merchant fleet to 753 million deadweight tonnes.[6] In addition, tanker rates are also expected to rise as fleet growth is slowing and strategic oil reserve projects in China and India are expected to contribute to increasing demand in Asia.

***ADDITIONAL DILUTION:***

At the beginning of this year, it was announced that DRYS would resume its previously announced program of issuing $200 million worth of common stock in an at-the-market (ATM) offering. The reinstatement of this program opened the door to further dilution, which will inevitably hurt existing shareholders. Over just the first quarter of 2014, the weighted average number of common shares grew roughly 7% to almost 410 million. However, it is expected that the proceeds from this offering – almost $90 million raised in Q1 2014 alone – will go towards reducing the company's debt burden, which should ultimately prove to be a positive outcome for longer-term shareholders.

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***BOTTOM LINE:***

DryShips is more than just a shipping company. Its exposure to the high growth offshore drilling market has already helped contribute to the firm's top and bottom lines. As the trend continues to move towards deepwater and ultra-deepwater more and more, DRYS and its subsidiary Ocean Rig will continue to benefit as well. Meanwhile, the company's drybulk carrier and tanker segments are poised to gain should the coming rebound in shipping rates and volumes finally take hold.

With the company's diversification away from their sole reliance on the global shipping industry, the biggest risk to DRYS' success is its debt-laden balance sheet. The company's chief test will come over the course of the remaining months of 2014 as almost 30% of DRYS' debt obligations are due by March 31, 2015. In the meantime, the company is growing revenues – mostly through their offshore drilling segment – and increasing their cash position in an effort to shore up their balance sheet and adequately prepare to meet their debt obligations. While I would certainly proceed with caution, shares of DRYS look more attractive now than they did at the beginning of this year – having fallen over 30% from their highs.

***SOURCES:***

[1] DRYS Form 20-F. 31 December 2013. Page 53.
[2] http://seekingalpha.com/article/2259783-dryships-dont-give-up-at-the-bottom
[3] Adnan Riaz. "DryShips: A Buy or a Sell?" *Seeking Alpha*. 13 May 2014.
[4] Ibid.
[5] Wallis, Keith. Shipping industry Sees an End to Five-Year Downturn." Thomson Reuters. 7 February 2014.
[6] Ibid.

**Disclosure**
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