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GRC NEWSLETTER 02 | 2018-07-29 | OUTPERFORMANCE

For the month of June 2018, the Fund generated a return of 27.6%, after the deduction of all fees and expenses, while the Fund's benchmark, the MSCI ACWI, declined by 0.5%.

While I had initially planned to write about our meetings with various listed companies in Asia, this outperformance requires an explanation.

AWILCO DRILLING

Most of the outperformance is attributable to the Fund's participation in a rights issue by a Norwegian listed offshore oil drilling company called Awilco Drilling ("Awilco").

Offshore oil drilling contractors such as Awilco own and operate rigs which they contract to integrated oil companies such as Shell for exploration, development and production.

The offshore drilling industry is very cyclical – company earnings fluctuate widely, in line with the industry cycle, and their stock charts often look like the Alps with sharp peaks and deep troughs.

The best time to buy a cyclical business is at the bottom of the cycle and those who have a thorough understanding of the industry have an advantage in determining the bottom. This requires detailed research and we believe that successful investing is 90% hard work.

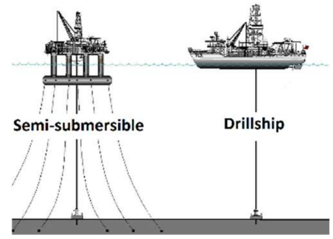
We have been following the offshore oil drilling industry closely since the oil price collapsed in 2014. We have regular calls with listed operators in the North Sea and Norwegian Sea and I met face-to-face with the management of one of Awilco's competitors in Norway in 2016. What they have been telling us recently is consistent – the offshore drilling cycle is turning up.

Oil companies have more free cash now and their capacity for spending is growing. Tendering activity has increased sharply and so has the number of approved plans for development and operation. Many of the older 3rd generation rigs have been scrapped and there is more scrapping underway.

The market dynamic in the Norwegian Sea is most attractive because there has been relatively more scrapping there, resulting in an undersupply of rigs. Furthermore, the Norwegian market is protected from the oversupply of rigs from other regions because it is very expensive to move rigs to Norway which have been built for other regions.

The Norwegian market has the strictest regulations ensuring that important components such as the blow-out preventer do not fail, reducing the risk of industrial disasters such as the Deepwater Horizon Blowout in the Gulf of Mexico. Rigs from many other regions would not be able to comply with the strict Norwegian regulations without substantial cost.

Moreover, the Norwegian Sea is a harsh environment with big waves thus a drillship cannot be used there because it would be too expensive to stabilise it. Enhanced semi-submersibles are required.



While the utilisation of old rigs in Norway is still low (~ 30% in use); almost all the modern (6th generation) rigs are fully booked, reflecting the undersupply of modern rigs in the region. Utilisation levels influence day rates (customer prices) and modern rigs receive higher day rates because they are more reliable and efficient than older rigs.

Awilco has a history of deploying capital wisely – they acquired two mid-water semi-submersible drilling units in 2010 at bargain prices from Transocean who were forced (by the regulators) to sell the units following Transocean's merger with GlobalSantaFe. Awilco has done very well, paying out substantial dividends despite the severe market downturn and they are the only contractor in the region with a net cash balance while several competitors are facing bankruptcy.

Acknowledging the current undersupply, Awilco ordered a new 7th generation rig with the lowest environmental footprint. They purchased it at a bargain price because the production yards in Asia are desperate for work – Awilco is the first to place an order for the Norwegian Sea since the oil price crash. New rigs are expensive – usually costing around US$ 0.5 to 0.7 billion. Awilco ordered theirs for US$ 0.4 billion. It will take a few years to build the new rig, while day rates for undersupplied modern rigs will likely continue to rise.

THE RIGHTS ISSUE

To raise capital for the new rig, Awilco issued shares in a private placement for majority shareholders in February and then in a subsequent repair rights issue for minority shareholders in June. This is where it gets interesting.

Awilco management, driven by the founding majority shareholder, were making the most of the cycle-low and the subscription price was set at NOK 29 per share. The market reacted to the announcement and the share price rose over the following months to around NOK 45 – 50 leading up to the subsequent repair rights issue.

Only existing shareholders were eligible to participate in the rights issue, while a few strategic investors were contacted in a market sounding to participate in the private placement. The Fund was not contacted in the market sounding but was eligible to participate in the rights issue.

We called Awilco and learnt that: (1) shareholders in the rights issue would be allocated disproportionately fewer shares than shareholders in the private placement, relative to each groups' respective pre-existing shareholdings; and (2) the subscription rights would not be transferable.

Unsatisfied, we sent letters of enquiry to the Norwegian Financial Authority, the Oslo Børs, the UK Ombudsman, the UK Financial Authority (since Awilco is a UK company listed in Oslo) and Awilco management.

Interestingly, the Oslo Børs had recently issued guidance notes to issuers relating to carrying out repair rights issues to rectify the dilutive effect of private placements and the regulator warned against increased use of criteria and methods to disadvantage certain shareholder groups.

We used some of the content of the guidance notes in our letters, citing that Section 5-14 of the Norwegian Securities Trading Act requires issuers to treat shareholders on a non-discriminatory basis and that a basic prerequisite when carrying out a repair issue is that it should ensure the largest degree of equal treatment possible.

The Norwegian regulators acknowledged our enquiry and their duty to review the rights issue prospectus while Awilco responded with rebuttals in a signed letter, noting that rights issue participants would have the benefit of additional time and certainty of pricing which has a positive option value.

In the end, Awilco did not increase the number of shares allocated in the rights issue but they did allow eligible shareholders to oversubscribe for shares that other shareholders would not or could not take up.

By the time the repair rights issue prospectus was approved the share price was ~ NOK 45, while the rights issue price was NOK 27.35 (after adjusting for a post private placement dividend distribution), allowing rights issue participants to make a potential instant profit of around 65%.

The final kicker was that shareholders resident in the US (and in many other countries) were restricted from participating, per the prospectus, because the share issue was not registered under the US Securities Act. This meant that many existing shareholders would not be eligible to participate in the rights issue. Furthermore, Awilco operates in an out-of-favour industry; is small, unfollowed and is listed on a small exchange. It appeared likely there would be an oversupply of unutilised rights.

We knew that we would have to sell other listed companies the Fund owned to make room for a larger Awilco position. We evaluated the risk reward profile. In the worst-case scenario, the oversubscription application would not be approved, and the Fund would be left with a large amount of excess cash and we would have to buy back the other listed companies which would result in increased transaction costs. In the best-case scenario, the entire oversubscription application would be approved, and the Awilco shares bought could be sold immediately in the market for a ~ 65% profit.

The risk reward profile seemed very attractive, so we decided to apply for as many rights as the Fund could accept. Pressed for time, and on our return to Cayman after visiting several listed businesses in China and Japan, we quickly evaluated the Fund's portfolio and made room for a short-term overweight position in Awilco.

The oversubscription was successful and, even though the Fund was only allocated about half the Awilco rights applied for, the investment produced most of the Fund's 27.6% net return for the month. We immediately realised substantial gains by selling shares in modest volumes until the oversized Awilco holding was reduced to a comfortable level. We continue to believe Awilco is well placed to benefit over the long-term from the upturn in the cycle.

CONCLUSION

While the Fund's recent performance has been exceptional, we will continue to work hard and remain focused on long-term investment outperformance.

Opportunities with extraordinary risk reward propositions, such as the Awilco rights issue, are rare and we shall continue to pursue them; however, while our annual goal is to have over 100 company meetings and to read over 400 financial statements, there can be no guarantees in the results of our research.

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