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Offshore drilling requires a strategy, especially in today's environment where the wrong move can be more costly than ever. That's why the first move should be to look for a company with worldwide capability and experience. And that's Transocean.
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Special Report: Service Sector Stocks

Getting In on the Ground Floor

It seems the bulls and the bears disagree about the oilfield service and supply industry's prospects for 2003 and beyond. Whenever that happens, we say this must be a buying opportunity. Jitters about the Middle East, the economy and the stock market in general have obscured the excellent fundamentals of the energy industry. These support a new and higher floor price for natural gas, coupled with growing deliverability challenges that can only be solved by more exploration and development drilling in North America. That in turn means exploration and production companies will have better economics and drill more—and that means service companies stand to benefit soon thereafter.

The only remaining challenge is to determine exactly when this chain of events will kick in. It takes these companies some time to bring their geological prospects to a drill-ready state and line up appropriate drilling partners. "For 2003, our view is that oil service stocks will outperform the S&P 500, as they have in six of the past eight years," says analyst Kurt Hallead of RBC Capital Markets.

He reminds us, however, that stock selection is the key. "In our view, tubulars, land drillers, midcap service stocks and gas-sensitive offshore drillers should outperform."

The Philadelphia Oilfield Service Index (OSX) has returned an average 30% from January through May since 1998. The tubular companies have returned 48%, land-drilling companies have returned 42%, and the midcaps, 40%, he says.

Who can argue with returns like these? Hallead envisions a different outcome for service stocks in 2003 than occurred after the Gulf War in 1991. First, the stocks have decoupled from high oil prices and more important, oil and gas fundamentals support much higher commodity prices now than in 1991. U.S. crude inventories are at historical lows and gas storage is at a five-year low.

Finally, U.S. companies will increase drilling in this year's second half and in 2004, thanks to the historically robust cash flows they are now enjoying. Some analysts say activity may go up by 4% to 6% in the U.S. In Canada, operators are predicted to drill a record or near-record number of wells this year. RBC now estimates the U.S. rig count will rise 18% this year.

The bottom line? Many experts believe we are at the beginning of an upturn in U.S. and Canadian drilling. That translates into a boost for service company activity and backlogs—and earnings power.

—Leslie Haines

Service Buys

The oilfield-service sector offers some hidden investment opportunities.

Article by Nick Snow

Signs of an impending increase in demand for oilfield services—from the drilling of wells to supplying specialized services and equipment to stimulate and maintain production—have been in place for several months. Overseas supply uncertainties created by civil unrest in Venezuela and possible war with Iraq have pushed crude oil prices. Key members of OPEC have the capacity to replace any lost Venezuelan or Iraqi production, but consuming countries' crude and product inventories are so low that many experts believe strategic petroleum reserves will have to be tapped before the end of 2003.

Meanwhile, natural gas prices have retreated from midwinter spikes, but consumers and producers face the prospect that they won't fall very far—in the wake of declining production and little significant new drilling during 2002.

Leading oilfield-service observers are viewing demand-recovery prospects carefully. "It's one of the few times in history when oil-service stocks haven't moved up with commodity prices," observes J. Marshall Adkins, who follows the sector for Raymond James & Associates Inc. in Houston. "Clearly with these commodity prices, particularly with natural gas, which we think is more sustainable, you're going to see more activity."

Early-March rig counts for North America were much higher than expected, says Geoff Kieburtz, who leads Salomon Smith Barney Inc.'s oil services research group in New York. "However, this outperformance was generated in the less profitable U.S. land and Canadian markets, with offshore

Bernard Duroc-Danner, chairman, president and CEO of Weatherford International Inc., says the U.S. oil-service markets are "in the early stages of coming alive."

markets well below expectations," he adds. "Moreover, in international markets, the year started out well below our forecast, particularly in Latin America and Africa."

Michael E. Wiley, chairman, president and chief executive officer of **Baker Hughes Inc.**, says, "The market was more difficult than we expected in 2002." But, meanwhile, "we improved our oilfield focus with our sale of Eimco and our pending sale of West African oil and gas properties.

"We introduced new technology at every division. In fact, our new product revenue rose to 21% of total revenue from 15% in 2001. We extended our presence in growing markets. We continued to build on our high-performance culture, based on our core values," says Wiley.

In 2003, he anticipates natural gas to continue to dominate North American drilling. "The inventory deficit compared with last year continues to grow. We believe current drilling is insufficient to meet necessary production levels." The company expected drilling would increase in second-half 2002. "It didn't. It's hard to predict when the recovery will occur, but it will have to in order to replace falling inventories. We expect this to happen by the second half of 2003."

Overseas, the company anticipates a record year in Russia this year "because of our ability to put people on the ground there. We see some products like electrical motors doing particularly well."

Doug Rock, chairman and CEO of **Smith International Inc.**, identified another negative force that reduced service and supply demand last year. "We found that in the second half of 2002, several major oil companies began to switch their E&P strategies from growth to balance." Royal Dutch/Shell Group restructured its E&P operations, and BP Plc rationalized many of its upstream assets.

"From past experience, when there is restructuring, there is uncertainty in the affected groups, particularly among managers who aren't sure they'll be continuing their jobs," he adds. "On the other hand, asset dispositions usually are good for the oil-service industry because new owners customarily drill more aggressively. In the long run, they do this because they have to increase production. However, there usually is a time lag between when the sale closes and when drilling resumes."

Independent producers expect the major domestic and multinational oil companies to bring a nearly record number of properties onto the market, according to Rock. He doesn't anticipate many more deals of the magnitude of BP's $1.3-billion sale of legacy North Sea and Gulf of Mexico assets to Apache Corp. in January, but adds that there certainly are a large number of properties being evaluated. Nevertheless, he does not anticipate a demand improvement for oilfield services until 2003's second or third quarter.

"I have more confidence in a second-half 2003 gas-drilling increase than in a second-half 2003 worldwide oil-drilling pickup, but I think both could occur," he says.

Bernard Duroc-Danner, chairman, president and CEO of **Weatherford International Inc.**, also considers BP's sale of such a large block of assets significant because Apache will be more aggressive in developing them. "The U.S. markets are in the early stages of coming alive," he says.

"If historic trends hold, we expect a rise in U.S. business in May or June. A 10% rise in volume should be enough to trigger a price increase. Canada, which is 15% of our revenue base, is very strong. We see the international markets growing for the industry 4% year-on-year, with Weatherford experiencing a 10% increase. Much of that increase will be facilitated by our technology footprint."

Research and development (R&D) has traditionally been a primary component of the company's strategy (4.2 % of revenues, one of the sector's highest percentages, according to Duroc-Danner). "We anticipate R&D will flatten in 2003 at [about] $82 million. In 2003 and 2004, it should be less of a burden and start to deliver earnings because there will be more 'D' than 'R.' R&D does not include continuous technology changes occurring in Weatherford's core businesses, which we regard as a competitive necessity," he adds.

Choosing a stock

Oil-service executives haven't been content to simply stand by and anticipate a rebound in demand. While changing oil and gas prices make the drilling, service and supply sector inherently cyclical, many companies' managements have worked hard to reduce the negative effects of downturns and continue to grow. Those are the companies to watch, maintains L.E. Simmons, president of SCF Partners, a Houston-based investment group that specializes in oilfield services.

"We've found that the best strategy is to

L.E. Simmons, whose SCF Partners makes private-equity investments almost exclusively in oil-service companies, suggests watching for oil-service stocks that are on sale "but that's not all. A company needs to offer growth."

pick an area where there are consolidation and market-growth opportunities, and then execute that strategy over a longer period," he says. "We look at situations over periods up to five years. Consequently, we expect the outlook to look bad for two of those years, average for another two and good for one.

"You should worry less about being opportunistic and selling at high prices. It's better to choose a good company you can live with for three to five years, and then be ready to sell. We certainly watch for companies that are less expensive, but that's

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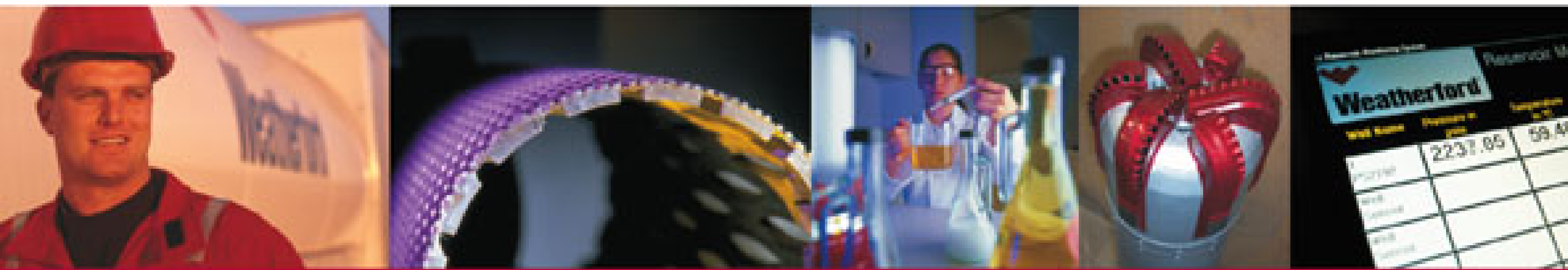

Product & Service Leadership
Global Market Reach
Step Change Technologies

Weatherford is a leading company in the worldwide oilfield services industry, with market leadership in core products and services and a manufacturing and distribution system that provides global leverage. Weatherford also has established itself as a leader in step change technologies, including expandable tubulars, intelligent completions, drilling with casing and reservoir and production optimization systems. Our main goal is to provide shareholders with above average returns on their investment through income growth and asset appreciation. Although not a prediction of future performance our historical relative stock price performance is illustrated below:

Weatherford Relative Stock Price Performance
(as of 12-31-02)

	WFT	OSX*	S&P 500
1 year	+7%	-0.5%	-23%
3	+50%	+1%	-40%
5	+16%	-24%	-9%
10	+1,114%	—	+102%

**Philadelphia Oilfield Service Sector Index, established 1997* not all. A company needs to offer growth. It needs a differentiated product or service that makes it unique. And it needs a management team that can optimize investment opportunities efficiently, given the cycles.

"I think that capital allocation often makes or breaks these companies. They need to be aware of savings opportunities through the business cycles as well as acquisitions that have a strategic fit. The formula is simple. The discipline is difficult."

A basic tendency is to overpay when markets are strong and expect better deals at fair values when they are weak, Simmons continues. But it involves more than simply adopting a contrarian strategy, he adds. Oil-service investments work best over longer periods within specific, predetermined parameters. That's what has helped SCF Partners achieve consistent results over 14 years with more than $8 billion of acquisitions, divestitures and financings, according to Simmons.

"Beyond that, we've found that it's not just what you buy, but what you do with what you buy. When we've bought a company, controlled the strategy and executed it, our returns have been more than twice what they've been when we've simply bought an interest and haven't controlled the strategy," he says.

"We like companies that are relatively small and have a high market share in a very narrow market. More often than not, we have avoided companies involved in well construction because Baker Hughes, Schlumberger and Halliburton have consolidated that market very heavily. We don't differentiate a lot between service and manufactured products. I think the ideal is where a company offers a proprietary product that requires service."

Natco Group Inc.'s membrane-replacement services, in connection with the systems it sells to separate carbon dioxide at the wellhead, might fit into that category. "We manufacture them and ship them to domestic or international sites," says Nathanial A. Gregory, chairman and CEO. "In the Gulf of Thailand, for example, membranes that were installed several years ago will need to be replaced in 2003. If you look back over five years, if the Asian financial crisis hadn't developed, we would be replacing even more."

The company is focused, both in EOR and other applications, to build and operate membrane operations and replace parts and services with an ongoing operations monitoring contract. "Right now, we're negotiating with one U.S. customer to replace a membrane with something that would be smoother and more regular for him—and for us." He anticipates quarterly fluctuations in revenues should decrease as such applications increase and more producers contract to replace CO2 separation membranes regularly.

Offshore drillers

Pride International Inc. uses a similar approach with its technical-services division. "We expect it to diversify income in the long term," says Paul A. Bragg, president and CEO. "We don't make a lot of money from the construction, but they lead to operating agreements once they're deployed. The first of these five contracts will be operational late in 2003, with the others due in 2004 and 2005. We're building stable long-term cash flows without additional capital investment. Our customers will own the rigs, and we'll operate them on a contract basis.

"It's not completely unique to us. We're fairly early in the development of these offshore properties that are being completed at the surface instead of the subsurface. We received a disproportionate share of the contracts, but it's an area we targeted and

Holder of the world records for ultradeepwater drilling and setting a wet tree in the deepest water depths, the Transocean *Deepwater Spirit* drillship operates in the Gulf of Mexico under a long-term contract for Unocal Corp. It and two sister rigs—the *Discoverer Enterprise* and *Discoverer Deep Seas*—have a patented dual-activity process with two drilling systems in one derrick. Two wells can be drilled or serviced at once.

Transocean's *Sedco Express* features the Tri-Act derrick. The rig and two sister units—*Sedco Energy* and *Cajun Express*—feature penetration rates, streamlined logistics, extensive mechanization and parallel tubular handling operations that are supported by a transparent integrated well construction center.

Until the offshore-rig market improves, Transocean Inc. is working on areas it can control to increase value, says Robert L. Long, president and chief executive officer.

approached. We're geared up to do more of those contracts."

In the meantime, Pride has tried to deploy its rigs where they'll generate the most revenues. "What we've done differently than most of our peers is that we recognized or suspected that the downturn would be fairly prolonged. We spent most of the last year repositioning the fleets to better markets and contracting them on a longer-term basis," Bragg notes.

"The area where that doesn't fit is the Gulf of Mexico jackup fleet, where there isn't an opportunity for long-term contracts. We have redeployed some fleets from there to other markets as a result. We have tried to position ourselves to prosper, to a degree, during the downturn and retain potential upside from a U.S. Gulf of Mexico rebound, with 16 jackups and 19 platform rigs."

To help smooth the cycles, the company has sought long-term work agreements—contracts between three and five years. "We still have a large fleet, with a number of rigs in markets where that's not possible."

A major competitor, **Transocean Inc.** leverages its position as the world's largest offshore drilling contractor to provide marketing and operational advantages regardless of commodity prices. "Because we operate in virtually every major offshore-drilling market as the largest or one of the largest offshore drillers, we know the local conditions as well as or better than anyone. We have operated in these regions for years—including 15 continuous years in India and longer in Brazil, the U.S. Gulf of Mexico, the North Sea, West Africa, Egypt and Southeast Asia," says Robert L. Long, Transocean president and CEO.

"In addition to our critical mass of rigs, Transocean has the leading global position in deepwater floaters, and our technical expertise is second to none. We provide 34 drillships and semisubmersibles that can work in water depths greater than 3,000 feet, or about 35% percent of the global capacity in this market. That's more than twice as many deepwater rigs as the nearest competitor.

"Also, our 12 fifth-generation drillships and semisubmersibles are providing clients with the most efficient and overall cost-effective tools for offshore exploration and production. These advanced rigs include our patented dual-activity Enterprise-class drillships, the Pathfinder series drillships and the Express-class Tri-Act-derrick semisubmersibles."

When demand truly grows, Transocean expects to command higher dayrates and longer-term contracts. However, the offshore drilling contractor, while it expects to see some improvement for jackup rigs in those respects during 2003, is not anticipating similar conditions this year for international floaters.

"Until the market does improve, we are working on areas that we can control to increase value," Long says. "Those areas include efforts to significantly improve our safety performance and reduce downtime as well as developing incentive contracts that will allow us to capture some of the value we can create with the tremendous efficiencies of our new fifth-generation rigs."

Land-drilling

Operating versatility—specifically, the ability to move rigs easily from place to place—has become a vital onshore drilling component too. "In a business when you

"If you have your own trucking fleet and hands that can manage it, you can have a rig moving on Friday night and start generating revenue on Saturday."

Mark S. Siegel, **Patterson-UTI Inc.**

Proven strategies for growing shareholder value.

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rent a rig, how fast you can put it on a well site and get it running is important," says Mark S. Siegel, chairman of **Patterson-UTI Inc.** "Our management lives with the rigs. They are not absent, in some office tower, but close to the yard. If you have your own trucking fleet and hands that can manage it, you can have a rig moving on Friday night and start generating revenue on Saturday.

Patterson-UTI also has become more efficient as it has grown to become the country's second-largest onshore driller. "Growth is great, but shareholders often wonder if it dilutes the value of their holdings," Siegel adds. "In December 1995, it took 340,000 shares to buy a rig. Today, it takes 245,000 shares. We also improved the depth and quality of those rigs."

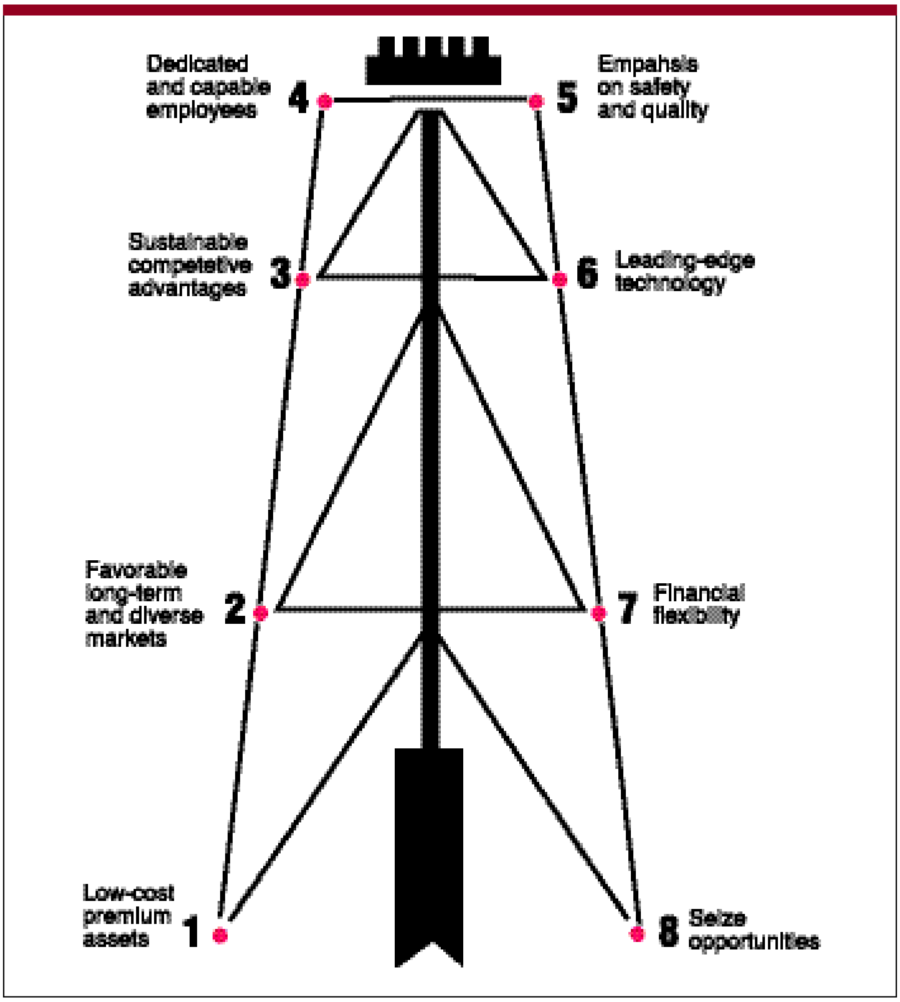
Sixty percent of the company's revenues come from independents, 34% from large independents and 6% from multinationals. "Our customers react faster to changes in the marketplace. They don't have budgets; they have bankrolls. They decide when it's opportune to go to work, and we have a sales force that can respond and put rigs to work quickly."

The land-drilling industry offers the investor significant advantages, he adds, with the top three companies accounting for 60% of the business. "That's in contrast to offshore drilling, where there are many operators."

The largest domestic land driller, **Nabors Industries Inc.**, uses its workover and well-servicing business to complement its primary services. "In the U.S. land business, we're probably about 25% of the market overall and about 50% of the high-end market." Offshore, the company has about 30 boats, 10 of which are high-premium boats it acquired from Pool Energy Services and have stayed fully utilized at good margins, says Dennis Smith, director, corporate development and investor relations.

"We have some manufacturing and data-management businesses that are integral with our core businesses," he adds. "Of necessity, we're in the trucking and hauling business, which is lousy. But we do it for the service of our customers."

He suggests onshore drilling is on the verge of a gradual market improvement. "Utilization is coming up. It's between 50% and 60%, which is close to the inflection point. When you get north of 60%, you hit another inflection point, and above 80%, it becomes hyperbolic. We've seen our rig count in the U.S. land business come up from 92 to about 120 in mid-March.



Houston, Texas-based drilling company Nabors Industries Ltd. (Amex: NBR) uses this graphic with its mantra of several points toward success.

"We were at loggerheads with some well-service customers who tried to cram some onerous contracts down our throat. All of a sudden, at the beginning of the year, demand began to grow and they began to accept traditional contracts. We're at the cusp of an improvement of the market."

Francis D. John, chairman and CEO of **Key Energy Services Inc.**, considers now to be an exciting time for well-servicing companies. Key is now approaching midcap size, with about $1.4 billion of market capitalization. A well-service rig completes a well, does all the maintenance over five to 25 years, and plugs and abandons it. From the time a well is drilled to when it's abandoned, a well-service rig is involved. It provides a gateway in and out of the well.

Key's strategy has been to be the full-service supplier. That lets a company like ChevronTexaco, ExxonMobil or Anadarko pick up the phone and call one company that provides consistent services and quality. "Other than Baker Hughes or Halliburton, there's no oil-service company that has more locations across the U.S."

Key and Nabors are the U.S. well-workover leaders, according to John. "There have been virtually no workover rigs manufactured since 1985. The capacity to service the industry continues to decline, which works to our advantage."

During the last three years, Key has refurbished more than 400 rigs at its facility in Midland, Texas, and has more than 900 rigs operating. "We always have tried to find ways to make our company more efficient and effective. In the last few years, Key has shown pricing and leverage discipline," he says.

"During the last year, while drilling rig rates dropped between 30% and 35%, well-service rates dropped by only 7%. This reflects the continuing decline in well-servicing capacity. Key is in a good position to move rates up during the next downturn, of which we're already beginning to see signs." ☐