HERCULES OFFSHORE, INC.
Form 10-Q
April 29, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2015
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission file number: 0-51582

HERCULES OFFSHORE, INC.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	56-2542838 (I.R.S. Employer Identification No.)
9 Greenway Plaza, Suite 2200 Houston, Texas (Address of principal executive offices)	77046 (Zip Code)

(713) 350-5100
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, par value $0.01 per share	Outstanding as of April 24, 2015 161,424,250

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

HERCULES OFFSHORE, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except par value)

	March 31, 2015 (Unaudited)	December 31, 2014
ASSETS		
Current Assets:		
Cash and Cash Equivalents	$218,172	$207,937
Accounts Receivable, Net	108,053	166,359
Prepaids	8,571	19,585
Current Deferred Tax Asset	4,461	4,461
Other	2,557	5,955
	341,814	404,297
Property and Equipment, Net	1,568,485	1,574,749
Other Assets, Net	23,156	23,361
	$1,933,455	$2,002,407
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts Payable	$46,424	$52,952
Accrued Liabilities	54,296	66,090
Interest Payable	39,132	32,008
Other Current Liabilities	12,177	13,406
	152,029	164,456
Long-term Debt	1,210,981	1,210,919
Deferred Income Taxes	4,403	4,147
Other Liabilities	7,479	7,854
Commitments and Contingencies		
Stockholders' Equity:		
Common Stock, $0.01 Par Value; 300,000 Shares Authorized; 164,400 and 163,540 Shares Issued, Respectively; 161,423 and 160,818 Shares Outstanding, Respectively	1,644	1,635
Capital in Excess of Par Value	2,180,650	2,179,838
Treasury Stock, at Cost, 2,977 and 2,722 Shares, Respectively	(56,939)	(56,765)
Retained Deficit	(1,566,792)	(1,509,677)
	558,563	615,031
	$1,933,455	$2,002,407

The accompanying notes are an integral part of these financial statements.

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HERCULES OFFSHORE, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended March 31, 2015	2014
Revenue	$122,619	$256,734
Costs and Expenses:		
Operating Expenses	99,599	140,752
Depreciation and Amortization	37,218	40,083
General and Administrative	15,760	18,227
	152,577	199,062
Operating Income (Loss)	(29,958)	57,672
Other Income (Expense):		
Interest Expense	(24,960)	(22,901)
Loss on Extinguishment of Debt	—	(15,158)
Other, Net	420	150
Income (Loss) Before Income Taxes	(54,498)	19,763
Income Tax Benefit (Provision)	(2,617)	153
Net Income (Loss)	$(57,115)	$19,916
Net Income (Loss) Per Share:		
Basic	$(0.35)	$0.12
Diluted	$(0.35)	$0.12
Weighted Average Shares Outstanding:		
Basic	161,057	160,070
Diluted	161,057	161,883

The accompanying notes are an integral part of these financial statements.

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HERCULES OFFSHORE, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended March 31, 2015	2014
Cash Flows from Operating Activities:		
Net Income (Loss)	$(57,115)	$19,916
Adjustments to Reconcile Net Income (Loss) to Net Cash Provided by Operating Activities:		
Depreciation and Amortization	37,218	40,083
Stock-Based Compensation Expense	820	2,400
Deferred Income Taxes	(278)	(4,616)
Other	(243)	3,089
(Increase) Decrease in Operating Assets -		
Accounts Receivable	58,779	(3,834)
Prepaid Expenses and Other	11,439	9,879
Increase (Decrease) in Operating Liabilities -		
Accounts Payable	(6,528)	1,887
Insurance Notes Payable	—	(9,568)
Other Current Liabilities	(7,573)	(16,119)
Other Liabilities	54	(2,472)
Net Cash Provided by Operating Activities	36,573	40,645
Cash Flows from Investing Activities:		
Capital Expenditures	(30,740)	(40,665)
Insurance Proceeds Received	2,418	—
Proceeds from Sale of Assets, Net	1,984	1,679
Net Cash Used in Investing Activities	(26,338)	(38,986)
Cash Flows from Financing Activities:		
Long-term Debt Borrowings	—	300,000
Redemption of 7.125% Senior Secured Notes	—	(220,072)
Cash Designated for Debt Retirement	—	(79,928)
Payment of Debt Issuance Costs	—	(2,961)
Other	—	108
Net Cash Used in Financing Activities	—	(2,853)
Net Increase (Decrease) in Cash and Cash Equivalents	10,235	(1,194)
Cash and Cash Equivalents at Beginning of Period	207,937	198,406
Cash and Cash Equivalents at End of Period	$218,172	$197,212

The accompanying notes are an integral part of these financial statements.

HERCULES OFFSHORE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
UNAUDITED

1. General

Hercules Offshore, Inc., a Delaware corporation, and its majority owned subsidiaries (the “Company”) provide shallow-water drilling and marine services to the oil and natural gas exploration and production industry globally through its Domestic Offshore, International Offshore and International Liftboats segments (See Note 8). At March 31, 2015, the Company operated a fleet of 33 jackup rigs, including one rig under construction (See Note 9), and 24 liftboat vessels. The Company’s diverse fleet is capable of providing services such as oil and gas exploration and development drilling, well service, platform inspection, maintenance and decommissioning operations in several key shallow-water provinces around the world.

The consolidated financial statements of the Company are unaudited; however, they include all adjustments of a normal recurring nature which, in the opinion of management, are necessary for a fair presentation. Certain information relating to the Company’s organization and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted in this Form 10-Q pursuant to Securities and Exchange Commission rules and regulations. These financial statements should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2014 and the notes thereto included in the Company’s Annual Report on Form 10-K. The results of operations for the three months ended March 31, 2015 are not necessarily indicative of the results expected for the full year.

Recent Events

Demand for the Company’s oilfield services is driven by its exploration and production customers’ capital spending, which can experience significant fluctuation depending on current commodity prices and their expectations of future price levels, among other factors. The recent decline in the price of crude oil has negatively impacted dayrates and demand for the Company’s services. In addition to the oil price decline, the consolidation of the domestic customer base has negatively impacted demand for jackup rigs in the U.S. Gulf of Mexico. Internationally, the new capacity growth expected over the next three years could put further pressure on the operating environment for the existing jackup rig fleet. Although activity levels for liftboats are not as closely correlated to commodity prices as the Company’s drilling segments, commodity prices are still a key driver of liftboat demand. Demand for liftboat services in West Africa has been volatile, which the Company believes has been driven by budgetary constraints with major customers primarily in Nigeria.

On February 25, 2015, the Company received a notice from Saudi Aramco terminating for convenience its drilling contract for the Hercules 261, effective on or about March 27, 2015. The Company received a subsequent notice from Saudi Aramco extending the effective date of termination to April 30, 2015. The Company is in the process of seeking a basis for continuing the Hercules 261 contract. There will be no termination fee payable to the Company under the contract as a result of such termination.

The Company’s immediate capital resources to fund and grow operations come from cash on hand, cash from operations and availability under its revolving credit facility. The Company has taken numerous actions to mitigate the effects of the decline in activity levels, including but not limited to: (i) cold stacking nine rigs over the past several months to significantly reduce operating expenses, (ii) significantly reducing its capital expenditures planned for 2015 and (iii) significantly reducing its workforce, both onshore and offshore. The Company continues to monitor its operating environment and will respond to further activity level declines as appropriate. The Company believes these steps will enhance its liquidity and further believes, based upon the current business environment and activity levels, it will have adequate liquidity to fund its operations through December 31, 2015; however, the Company cannot predict how an extended period of low commodity prices will affect its operations and liquidity levels.

2. Supplemental Financial Information

Consolidated Balance Sheet Information

Other current liabilities consisted of the following:

	March 31, 2015	December 31, 2014

	(in thousands)	
Other Current Liabilities:		
Deferred Revenue - Current Portion	$5,088	$9,439
Other	7,089	3,967
	$12,177	$13,406

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3. Earnings Per Share

The reconciliation of the numerators and denominators used for the computation of basic and diluted earnings per share is as follows:

	Three Months Ended March 31,	
	2015	2014
	(in thousands)	
Numerator:		
Net income (loss)	$(57,115)	$19,916
Denominator:		
Weighted average basic shares	161,057	160,070
Add effect of stock equivalents	—	1,813
Weighted average diluted shares	161,057	161,883

The Company calculates basic earnings per share by dividing net income (loss) by the weighted average number of shares outstanding. Diluted earnings per share is computed by dividing net income by the weighted average number of shares outstanding during the period as adjusted for the dilutive effect of the Company’s stock options, time-based restricted stock and performance-based restricted stock awards. The effect of stock option and restricted stock awards is not included in the computation for periods in which a net loss occurs, because to do so would be anti-dilutive. The Company's diluted earnings per share calculation for the three months ended March 31, 2015 excludes 6.0 million stock equivalents that would have potentially been included if the Company had generated net income but are excluded as the Company generated a net loss. The Company's diluted earnings per share calculation excludes 1.2 million stock equivalents for the three months ended March 31, 2014 due to their anti-dilutive effect.

4. Debt

Senior Secured Credit Agreement

On April 3, 2012, the Company entered into a credit agreement which as amended on July 8, 2013 (the "Credit Agreement") governs its senior secured revolving credit facility (the "Credit Facility"). The Credit Agreement provides for a $150.0 million senior secured revolving credit facility. As of March 31, 2015, no amounts were outstanding and $7.0 million in letters of credit had been issued under the Credit Facility, therefore the remaining availability under this facility was $143.0 million. During any period of time that outstanding letters of credit under the Credit Facility exceed $10 million or there are any revolving borrowings outstanding under the Credit Facility, the Company will have to maintain compliance with a maximum secured leverage ratio (as defined in the Credit Agreement, being generally computed as the ratio of secured indebtedness to consolidated cash flow). The maximum secured leverage ratio is 3.50 to 1.00. As of March 31, 2015, the Company was in compliance with all covenants under its revolving credit facility.

The Company's obligations under the Credit Agreement are guaranteed by substantially all of the Company's current domestic subsidiaries (collectively, the "Guarantors"), and the obligations of the Company and the Guarantors are secured by liens on substantially all of the vessels owned by the Company and the Guarantors, together with certain accounts receivable, equity of subsidiaries, equipment and other assets.

Retirement of 7.125% Senior Secured Notes

In 2012, the Company issued $300.0 million of senior secured notes at a coupon rate of 7.125% ("7.125% Senior Secured Notes") with maturity in April 2017. On March 12, 2014 the Company commenced a cash tender offer (the "Tender offer") for any and all of the $300.0 million outstanding aggregate principal amount of its 7.125% Senior Secured Notes. Senior secured notes totaling approximately $220.1 million were settled on March 26, 2014 for $232.7 million using a portion of the proceeds from the $300.0 million 6.75% Senior Notes due April 2022 ("6.75% Senior

Notes") issued on March 26, 2014. Additionally, on April 29, 2014, the Company redeemed all $79.9 million of the remaining outstanding 7.125% Senior Secured Notes for approximately $84.2 million using the remaining net proceeds from the 6.75% Senior Notes offering, together with cash on hand.

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Loss on Extinguishment of Debt

During the three months ended March 31, 2014, the Company incurred the following charges which are included in Loss on Extinguishment of Debt in the Consolidated Statement of Operations:

- In March 2014, the Company incurred a pretax charge of $15.2 million, $15.2 million net of tax, consisting of a $12.6 million call premium and $1.4 million of unamortized debt issuance costs related to the redemption of the 7.125% Senior Secured Notes, as well as $1.1 million of bank fees related to the issuance of the 6.75% Senior Notes.

5. Fair Value Measurements

Fair value measurements are generally based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company’s view of market assumptions in the absence of observable market information. The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. The Company uses the fair value hierarchy included in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 820-10, Fair Value Measurements and Disclosure, which is intended to increase consistency and comparability in fair value measurements and related disclosures. The fair value hierarchy consists of the following three levels:

Level 1 — Inputs are quoted prices in active markets for identical assets or liabilities.

Level 2 — Inputs are quoted prices for similar assets or liabilities in an active market, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable and market-corroborated inputs which are derived principally from or corroborated by observable market data.

Level 3 — Inputs are derived from valuation techniques in which one or more significant inputs or value drivers are unobservable.

Fair Value of Financial Instruments

The carrying amounts of the Company’s financial instruments, which include cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities and other current liabilities, approximate fair values because of the short-term nature of the instruments. The fair value of the Company's cash equivalents are Level 1.

The fair value of the Company’s 8.75% Senior Notes, 7.5% Senior Notes, 6.75% Senior Notes, 10.25% Senior Notes and 3.375% Convertible Senior Notes is estimated based on quoted prices in active markets. The fair value of the Company’s 7.375% Senior Notes is estimated based on discounted cash flows using inputs from quoted prices in active markets for similar debt instruments. The inputs used to determine fair value are considered Level 2 inputs.

The following table provides the carrying value and fair value of the Company’s long-term debt instruments:

	March 31, 2015		December 31, 2014	
	Carrying Value (in millions)	Fair Value	Carrying Value	Fair Value
8.75% Senior Notes, due July 2021	$400.0	$119.5	$400.0	$191.0
7.5% Senior Notes, due October 2021	300.0	85.1	300.0	135.8
6.75% Senior Notes, due April 2022	300.0	84.2	300.0	132.8
10.25% Senior Notes, due April 2019	200.0	62.1	200.0	111.4
3.375% Convertible Senior Notes, due June 2038	7.5	6.6	7.4	6.5
7.375% Senior Notes, due April 2018	3.5	1.1	3.5	1.9

6. Long-Term Incentive Awards

Stock-based Compensation

The Company’s 2014 Long-Term Incentive Plan (the “2014 Plan”) provides for the granting of stock options, stock appreciation rights, restricted stock, restricted stock units, dividend equivalents, performance awards and other stock-based awards to selected employees and non-employee directors of the Company. At March 31, 2015, approximately 5.5 million

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shares were available for grant or award under the 2014 Plan. The Company’s 2004 Amended and Restated Long-Term Incentive Plan (the “2004 Plan”) remains in effect only as it relates to outstanding awards previously granted under that plan.

During the three months ended March 31, 2015, the Company granted the following equity awards:

- Time-based awards — The Company granted 1.6 million time-based restricted stock awards to certain employees which vest 1/3 per year. The grant-date fair value per share for these time-based restricted stock awards is equal to the closing price of the Company's stock on the grant date, which was a weighted-average grant date fair value of $0.55 for the awards granted in the three months ended March 31, 2015.
- Objective-based awards — The Company granted additional compensation awards to certain employees that are based on the Company's achievement of certain Company-based performance objectives as well as the Company's achievement of certain market-based objectives. These awards cliff vest three years from the date of grant and are payable in cash, subject to vesting requirements, after the completion of all performance periods with 20% of the award being achievable based on a one-year performance period, 30% being achievable based on a two-year performance period, and the remaining 50% being achievable based upon a three-year performance period. The CEO’s award also contains an equity component that is earned, in addition to the cash, up to a total amount of 400,000 shares if minimum levels of performance are achieved. The fair value of all awards requiring share settlement is measured at the fair value on the grant date, while those requiring cash settlement are remeasured at the end of each reporting period.

The Company accounts for awards, or the portion of the awards, requiring cash settlement under stock-compensation principles of accounting as liability instruments. The fair value of all liability instruments are being remeasured based on the awards' estimated fair value at the end of each reporting period and are being recorded to expense over the vesting period.

The awards that are based on the Company's achievement of market-based objectives related to the Company's stock price performance as compared to certain peer groups as defined in the award agreements are valued using a Monte Carlo simulation. The Company uses various assumptions to estimate the fair value of the Company's objective-based awards. The Company uses the historical volatility of its common stock as well as that of certain peer groups as defined in the award agreements to estimate volatility while the dividend yield assumptions are based on historical and anticipated dividend payouts of the Company as well as that of certain peer groups as defined in the award agreements. The risk-free interest rate assumptions are based on observed interest rates consistent with the approximate vesting periods and the stock price used represents the closing price of the Company's common stock, as well as that of certain peer groups as defined in the award agreements, at the valuation date.

7. Income Taxes

The Company, directly or through its subsidiaries, files income tax returns in the United States, and multiple state and foreign jurisdictions. The Company’s tax returns for 2008 through 2014 remain open for examination by the taxing authorities in the respective jurisdictions where those returns were filed. Although the Company believes that its estimates are reasonable, the final outcome in the event that the Company is subjected to an audit could be different from that which is reflected in its historical income tax provision and accruals. Such differences could have a material effect on the Company’s income tax provision and net income in the period in which such determination is made. In addition, TODCO income tax obligations from periods prior to its initial public offering in 2004 are indemnified by Transocean, the former owner of TODCO, under the tax sharing agreement, except for the Trinidad and Tobago jurisdiction. The Company’s Trinidadian and Tobago tax returns are open for examination for the years 2010 through 2014.

From time to time, the Company’s tax returns are subject to review and examination by various tax authorities within the jurisdictions in which the Company operates or has operated. The Company is currently contesting tax assessments in Venezuela, and may contest future assessments where the Company believes the assessments are meritless.

In January 2014, the Federal Inland Revenue Service of Nigeria commenced an audit of calendar years 2007 through 2011, which was completed in the first quarter of 2015. In February 2015, the Company has been informed that 2012 and 2013 will be examined as well. While the Company cannot predict or provide assurance regarding the outcome of these proceedings, the Company does not expect the ultimate liability to have a material effect on its consolidated financial statements.

During the three months ended March 31, 2015 and 2014, the Company recognized $0.9 million and $4.8 million of tax benefit as a result of the tolling of a statute of limitations in foreign jurisdictions.

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HERCULES OFFSHORE, INC. AND SUBSIDIARIES
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UNAUDITED

8. Segments

The Company currently reports its business activities in three business segments: (1) Domestic Offshore, (2) International Offshore and (3) International Liftboats. The Company eliminates inter-segment revenue and expenses, if any.

The Company's jackup rigs are used primarily for exploration and development drilling in shallow waters. The Company's liftboats are self-propelled, self-elevating vessels with a large open deck space, which provides a versatile, mobile and stable platform to support a broad range of offshore maintenance and construction services throughout the life of an oil or natural gas well.

In November 2013, the Company entered into an agreement with Perisai Drilling Sdn Bhd ("Perisai") whereby the Company agreed to market, manage and operate two Pacific Class 400 design new-build jackup drilling rigs, Perisai Pacific 101 and Perisai Pacific 102 ("Perisai Agreement"). Pursuant to the terms of the agreement, Hercules is reimbursed for all operating expenses and Perisai pays for all capital expenditures. The Company receives a daily management fee for the rig and a daily operational fee equal to 12% of the rig-based EBITDA, as defined in the Perisai Agreement. In August 2014, Perisai Pacific 101 commenced work on a three-year drilling contract in Malaysia. Specific to the Perisai Agreement, the Company recognized revenue and operating expenses of \$4.2 million and \$2.6 million, respectively, for the three months ended March 31, 2015 and \$1.3 million and \$1.2 million, respectively, for the three months ended March 31, 2014. These results are included in the Company's International Offshore segment. Perisai Pacific 102 is expected to be delivered by the shipyard by mid-2015.

Information regarding the Company's reportable segments is as follows:

	Three Months Ended March 31, 2015			Three Months Ended March 31, 2014		
	Revenue	Income (Loss) from Operations	Depreciation and Amortization	Revenue	Income (Loss) from Operations	Depreciation and Amortization
	(in thousands)			(in thousands)		
Domestic Offshore	$52,875	$3,830	$11,693	$143,265	$51,546	$17,371
International Offshore	51,648	(20,852)	20,339	80,938	14,642	16,626
International Liftboats	18,096					