HERCULES OFFSHORE, INC.
Form 10-Q
April 26, 2012
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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, 2012

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

Large accelerated filer ¨	Accelerated filer x	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 23, 2012 158,450,839

HERCULES OFFSHORE, INC.

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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, 2012 (Unaudited)	December 31, 2011
ASSETS		
Current Assets:		
Cash and Cash Equivalents	$ 165,057	$ 134,351
Restricted Cash	13,261	9,633
Accounts Receivable, Net of Allowance for Doubtful Accounts of $12,187 and $11,460 as of March 31, 2012 and December 31, 2011, Respectively	139,256	153,688
Prepaids	8,516	16,352
Current Deferred Tax Asset	15,543	15,543
Other	30,747	20,435
	372,380	350,002
Property and Equipment, Net	1,600,530	1,591,791
Equity Investment	34,645	34,735
Other Assets, Net	33,767	30,176
	$ 2,041,322	$ 2,006,704
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Short-term Debt and Current Portion of Long-term Debt	$ 52,886	$ 22,130
Accounts Payable	58,635	49,370
Accrued Liabilities	60,248	70,421
Interest Payable	18,546	9,899
Insurance Notes Payable		5,218
Other Current Liabilities	25,849	18,366
	216,164	175,404
Long-term Debt, Net of Current Portion	771,002	818,146
Deferred Income Taxes	67,605	83,503
Other Liabilities	20,028	21,098
Commitments and Contingencies		
Stockholders' Equity:		
Common Stock, $0.01 Par Value; 200,000 Shares Authorized; 160,528 and 139,798 Shares Issued, Respectively; 158,451 and 137,899 Shares Outstanding, Respectively	1,605	1,398
Capital in Excess of Par Value	2,154,834	2,057,824
Treasury Stock, at Cost, 2,077 Shares and 1,899 Shares, Respectively	(53,089)	(52,184)
Retained Deficit	(1,136,827)	(1,098,485)
	966,523	908,553

	$ 2,041,322	$ 2,006,704

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, 2012	2011
Revenue	$ 143,319	$ 159,378
Costs and Expenses:		
Operating Expenses	111,237	106,381
Depreciation and Amortization	42,978	41,793
General and Administrative	17,674	12,826
	171,889	161,000
Operating Loss	(28,570)	(1,622)
Other Income (Expense):		
Interest Expense	(19,669)	(18,506)
Other, Net	1,009	(194)
Loss Before Income Taxes	(47,230)	(20,322)
Income Tax Benefit	8,888	6,679
Loss from Continuing Operations	(38,342)	(13,643)
Loss from Discontinued Operations, Net of Taxes		(576)
Net Loss	$ (38,342)	$ (14,219)
Basic and Diluted Loss Per Share:		
Loss from Continuing Operations	$ (0.28)	$ (0.12)
Loss from Discontinued Operations		
Net Loss	$ (0.28)	$ (0.12)
Basic and Diluted Weighted Average Shares Outstanding	139,208	114,906

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, 2012	2011
Cash Flows from Operating Activities:		
Net Loss	$ (38,342)	$ (14,219)
Adjustments to Reconcile Net Loss to Net Cash Provided by (Used in) Operating Activities:		
Depreciation and Amortization	42,978	42,911
Stock-Based Compensation Expense	1,487	1,158
Deferred Income Taxes	(16,872)	(18,027)
Provision (Benefit) for Doubtful Accounts Receivable	1,218	(5,021)
Amortization of Deferred Financing Fees	993	874
Amortization of Original Issue Discount	1,183	1,089
Gain on Insurance Settlement	(3,400)	
Gain on Disposal of Assets	(274)	(702)
Other	(972)	238
(Increase) Decrease in Operating Assets		
Accounts Receivable	13,214	(8,867)
Prepaid Expenses and Other	(9,606)	21,673
Increase (Decrease) in Operating Liabilities		
Accounts Payable	8,378	571
Insurance Notes Payable	(5,218)	(5,248)
Other Current Liabilities	4,451	21,221
Other Liabilities	(1,114)	11,461
Net Cash Provided by (Used in) Operating Activities	(1,896)	49,112
Cash Flows from Investing Activities:		
Acquisition of Assets	(40,000)	
Additions of Property and Equipment	(16,573)	(10,277)
Deferred Drydocking Expenditures	(3,213)	(4,124)
Cash Paid for Equity Investment		(10,000)
Insurance Proceeds Received	13,139	
Proceeds from Sale of Assets, Net	3,312	3,421
Increase in Restricted Cash	(3,628)	(1)
Net Cash Used in Investing Activities	(46,963)	(20,981)
Cash Flows from Financing Activities:		
Long-term Debt Repayments	(17,571)	
Common Stock Issuance	97,102	
Other	34	(1,831)
Net Cash Provided by (Used in) Financing Activities	79,565	(1,831)
Net Increase in Cash and Cash Equivalents	30,706	26,300
Cash and Cash Equivalents at Beginning of Period	134,351	136,666
Cash and Cash Equivalents at End of Period	$ 165,057	$ 162,966

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

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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, Inland, Domestic Liftboats and International Liftboats segments (See Note 12). At March 31, 2012, the Company owned a fleet of 43 jackup rigs, seventeen barge rigs, two submersible rigs, one platform rig, and 58 liftboat vessels and operated an additional five liftboat vessels owned by a third party. 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 to present fairly the Company s Consolidated Balance Sheet at March 31, 2012, Consolidated Statements of Operations and Consolidated Statements of Cash Flows for the three months ended March 31, 2012 and 2011. Although the Company believes the disclosures in these financial statements are adequate to make the interim information presented not misleading, 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, 2011 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, 2012 are not necessarily indicative of the results expected for the full year.

In preparing financial statements in conformity with accounting principles generally accepted in the United States, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenue and expenses during the reporting period. On an ongoing basis, the Company evaluates its estimates, including those related to bad debts, investments, derivatives, property and equipment, income taxes, insurance, percentage-of-completion, employment benefits and contingent liabilities. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates.

Recent Rig Acquisition

In March 2012, the Company acquired an offshore jackup drilling rig, the *Hercules 266* (formerly known as *Ocean Columbia*) from a subsidiary of Diamond Offshore Drilling, Inc. for $40.0 million. The Company has entered into a three-year drilling contract with Saudi Aramco for the use of this rig with an option to extend the term for an additional one-year period. The Company expects to spend approximately $45.0 million for upgrades and other contract specific refurbishments to the rig and to mobilize the rig from the Gulf of Mexico to the Middle East. The Company expects the rig to commence work under the contract in December 2012.

Recent Common Stock Offering

In March 2012, the Company raised approximately $96.7 million in net proceeds, after adjusting for underwriting discounts and expected offering expenses, from an underwritten public offering of 20.0 million shares of its common stock, par value $0.01 per share at a price to the public of $5.10 per share ($4.85775, net of underwriting discounts). The Company also granted the Underwriters a 30-day option to purchase up to an additional 3.0 million shares of the Company s common stock on the same terms as the 20.0 million shares sold by the Company, but it was not exercised. The Company used a portion of the net proceeds from the share offering to fund a portion of the purchase price for the acquisition of the *Hercules 266* and intends to use the remaining net proceeds for general corporate purposes as well as the costs associated with the upgrade and mobilization of *Hercules 266*.

Investigations

On April 4, 2011, the Company received a subpoena issued by the Securities and Exchange Commission (SEC) requesting the delivery of certain documents to the SEC in connection with its investigation into possible violations of the securities laws, including possible violations of the Foreign Corrupt Practices Act (FCPA) in certain international jurisdictions where the Company conducts operations. The Company was also notified by the Department of Justice (DOJ) on April 5, 2011, that certain of the Company s activities were under review by the DOJ.

On April 24, 2012, the Company received a letter from the DOJ notifying the Company that the DOJ has closed its inquiry into the Company regarding possible violations of the FCPA and does not intend to pursue enforcement action against the Company. The DOJ indicated that its decision to close the matter was based on, among other factors, the thorough investigation conducted by the Company s special counsel and the Company s compliance program.

HERCULES OFFSHORE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

UNAUDITED

The Company, through the Audit Committee of the Board of Directors, intends to continue to cooperate with the SEC in its investigation. At this time, it is not possible to predict the outcome of the SEC s investigation, the expenses the Company will incur associated with this matter, or the impact on the price of the Company s common stock or other securities as a result of this investigation.

Revenue Recognition

Revenue generated from the Company s contracts is recognized as services are performed, as long as collectability is reasonably assured. For certain contracts, the Company may receive lump-sum fees for the mobilization of equipment and personnel. Mobilization fees received and costs incurred to mobilize a rig from one market to another under contracts longer than ninety days are recognized as services are performed over the term of the related drilling contract. Amounts related to deferred revenue and deferred expenses are summarized below (in thousands):

	Three Months Ended March 31,	
	2012	2011
Revenue deferred	$ 120	$ 24,533
Expense deferred	11,127	1,349
Deferred Revenue recognized	2,966	5,232
Deferred Expense recognized	1,603	586

For certain contracts, the Company may receive fees from its customers for capital improvements to its rigs. Such fees are deferred and recognized as services are performed over the term of the related contract. The Company capitalizes such capital improvements and depreciates them over the useful life of the asset.

The balances related to the Company s Deferred Costs and Deferred Revenue are as follows (in thousands):

	Balance Sheet Classification	As of March 31, 2012	As of December 31, 2011
Assets:			
Deferred Expense-Current Portion	Other	$ 10,192	$ 3,811
Deferred Expense-Non-Current Portion	Other Assets, Net	6,795	3,652
Liabilities:			
Deferred Revenue-Current Portion	Other Current Liabilities	7,617	8,461
Deferred Revenue-Non-Current Portion	Other Liabilities	11,294	13,296

Percentage-of-Completion

The Company has a construction management agreement and a services agreement with Discovery Offshore S.A. (Discovery Offshore) with respect to each of the two new-build rigs under construction for Discovery Offshore (each Rig or collectively Rigs). Under the construction management agreements, the Company is planning, supervising and managing the construction and commissioning of the Rigs for which it received a fixed fee of $7.0 million per Rig in February 2011. The Company is using the percentage-of-completion method of accounting for its revenue and related costs associated with its construction management agreements with Discovery Offshore, combining the construction management agreements, based on a cost-to-cost method. Any revisions in revenue, cost or the progress towards completion, will be treated as a change in accounting estimate and will be accounted for using the cumulative catch-up method. As of March 31, 2012 and December 31, 2011, $9.7 million and $11.2 million was outstanding as deferred revenue, respectively. The Company recognized $1.5 million as revenue during the three months ended March 31, 2012, under the percentage-of-completion method of accounting. Additionally, $1.3 million in cost was

HERCULES OFFSHORE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

UNAUDITED

recognized during the three months ended March 31, 2012, under the percentage-of-completion method of accounting related to activities associated with the performance of contract obligations. There was no revenue or cost recognized during the three months ended March 31, 2011 under the percentage-of-completion method of accounting as there were no activities associated with the performance of contract obligations during the first quarter of 2011.

Other Assets

Other assets consist of drydocking costs for marine vessels, a derivative asset, deferred income taxes, deferred operating expenses, financing fees, investments and deposits. Drydocking costs are capitalized at cost and amortized on the straight-line method over a period of 12 months. Drydocking costs, net of accumulated amortization, at March 31, 2012 and December 31, 2011, were $4.4 million and $5.2 million, respectively. Amortization expense for drydocking costs was $4.0 million for the three months ended March 31, 2012 and $3.7 million for the three months ended March 31, 2011.

Financing fees are deferred and amortized over the life of the applicable debt instrument. Unamortized deferred financing fees at March 31, 2012 and December 31, 2011 were $8.6 million and $9.1 million, respectively. Amortization expense for financing fees was $1.0 million for the three months ended March 31, 2012, and $0.9 million for the three months ended March 31, 2011, and is included in Interest Expense on the Consolidated Statements of Operations.

2. Earnings Per Share

The Company calculates basic earnings per share by dividing net income 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 option and 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. Stock equivalents of 6.0 million and 6.8 million were anti-dilutive and are excluded from the calculation of the dilutive effect of stock equivalents for the diluted earnings per share calculations for the three months ended March 31, 2012 and 2011, respectively.

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HERCULES OFFSHORE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

UNAUDITED

3. Equity Investment

The Company has a 28% equity investment in Discovery Offshore of $34.6 million and $34.7 million as of March 31, 2012 and December 31, 2011, respectively which is included in the assets of our International Offshore segment. This investment is being accounted for using the equity method of accounting as the Company has the ability to exert significant influence, but not control, over operating and financial policies. The Company reviews its equity investments for impairment whenever there is a loss in value of an investment which is considered to be other than temporary. The Company was issued warrants to purchase up to 5.0 million additional shares of Discovery Offshore as additional compensation for its costs incurred and efforts expended in forming Discovery Offshore, that, if exercised, would be recorded as an increase in the Company s equity investment in Discovery Offshore.

4. Business Combination

On April 27, 2011, the Company completed its acquisition of 20 jackup rigs and related assets, accounts receivable, accounts payable and certain contractual rights from Seahawk Drilling, Inc. and certain of its subsidiaries (Seahawk Transaction).

The unaudited pro forma financial information set forth below has been compiled from historical financial statements and other information, but is not necessarily indicative of the results that actually would have been achieved had the transaction occurred on the dates indicated or that may be achieved in the future:

		Three Months Ended March 31, 2011
		(In millions, except per share amounts)
Revenue	$	184.6
Net Loss		(28.9)
Basic loss per share		(0.21)
Diluted loss per share		(0.21)

5. Discontinued Operations

The results of operations of the Delta Towing segment are reflected in the Consolidated Statements of Operations for the three months ended March 31, 2011 as discontinued operations.

Operating results of the Delta Towing segment were as follows (in thousands):

		Three Months Ended March 31, 2011
Revenue	$	6,868
Loss Before Income Taxes	$	(964)
Income Tax Benefit		388

Loss from Discontinued Operations, Net of Taxes	$	(576)

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HERCULES OFFSHORE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

UNAUDITED

6. Debt

Debt is comprised of the following (in thousands):

	March 31, 2012	December 31, 2011
Term Loan Facility, due July 2013	$ 435,338	$ 452,909
10.5% Senior Notes, due October 2017	293,874	293,676
3.375% Convertible Senior Notes, due June 2038	91,165	90,180
7.375% Senior Notes, due April 2018	3,511	3,511
Total Debt	823,888	840,276
Less Short-term Debt and Current Portion of Long-term Debt	52,886	22,130
Total Long-term Debt, Net of Current Portion	$ 771,002	$ 818,146

Recent Notes Issuances and Changes to Existing Debt Balances

On April 3, 2012, the Company made the following changes to its debt structure:

Issued $300.0 million aggregate principal amount of 7.125% Senior Secured Notes due 2017;
Issued $200.0 million aggregate principal amount of 10.25% Senior Notes due 2019;
Entered into a new Credit Agreement that provides for a $75.0 million senior secured revolving credit facility, with a $25.0 million sublimit for the issuance of letters of credit;
Terminated its prior credit agreement dated July 11, 2007, as amended to date, which included an undrawn $140.0 million revolving credit facility and a term loan (prior secured credit facility) balance of $435.3 million as of March 31, 2012;
Repaid in full all outstanding indebtedness under the prior secured credit facility, and the liens securing such obligations were terminated; and
On April 3, 2012, and in connection with the aforementioned notes issuances and the repayment of the prior secured credit facility, the Company s secured indebtedness was reduced below the defined threshold (as established in the indenture governing the 10.5% Senior Secured Notes), whereby, all the liens securing the 10.5% Senior Secured Notes were released (10.5% Senior Notes).

Senior Secured Credit Agreement

The Company had a $575.3 million credit facility, consisting of a $435.3 million term loan facility and a $140.0 million revolving credit facility as of March 31, 2012. As of March 31, 2012, no amounts were outstanding and no standby letters of credit had been issued under the revolving credit facility. The interest rate on the amount outstanding under the term loan facility was 7.5% and the annualized effective rate of interest was 7.86% for the three months ended March 31, 2012 after giving consideration to revolver fees.

Under the prior credit agreement, as amended, which governed the prior secured credit facility, the Company had to, among other things, make certain mandatory prepayments of debt outstanding under the credit facility. Accordingly, in addition to its scheduled payments, in January 2012, the Company used the net proceeds from asset sales to retire $17.6 million of the outstanding balance of the Company s term loan facility as required under the prior credit agreement.

On April 3, 2012, the Company entered into a new Credit Agreement, which governs its new credit facility (the Credit Agreement), which provides for a $75.0 million senior secured revolving credit facility, with a $25.0 million sublimit for the issuance of letters of credit. In connection with these events, the Company terminated its prior credit agreement dated July 11, 2007, as amended to date. On April 3, 2012, the Company repaid in full all outstanding indebtedness under the prior secured credit facility, and the liens securing such obligations were terminated. There were no termination penalties incurred by the Company in connection with the termination of the prior secured credit facility.

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HERCULES OFFSHORE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

UNAUDITED

The Company may prepay borrowings under the new revolving credit facility at any time without premium or penalty (other than customary LIBOR breakage costs), subject to certain notice requirements. The Credit Agreement requires mandatory prepayments of amounts outstanding thereunder with the net proceeds of certain asset sales, casualty events, preferred stock issuances and debt issuances, but these mandatory prepayments do not require any reduction of the lenders' commitments under the Credit Agreement. All borrowings under the new revolving credit facility mature on April 3, 2017.

Borrowings under the Credit Agreement bear interest, at the Company's option, at either (i) the Alternate Base Rate (ABR) (the highest of the administrative agent's corporate base rate of interest, the federal funds rate plus 0.5%, or the one-month Eurodollar rate (as defined in the Credit Agreement) plus 1%), plus an applicable margin that ranges between 3.0% and 4.5%, depending on the Company's leverage ratio, or (ii) the Eurodollar rate plus an applicable margin that ranges between 4.0% and 5.5%, depending on the Company's leverage ratio. The Company will pay a per annum fee on all letters of credit issued under the Credit Agreement, which fee will equal the applicable margin for loans accruing interest based on the Eurodollar rate, and the Company will pay a commitment fee of 0.75% per annum on the unused availability under the Credit Agreement.

The Credit Agreement contains covenants that, among other things, limit the Company s ability to:

- incur additional indebtedness or issue certain preferred stock;
- pay dividends or make other distributions;
- make other restricted payments or investments;
- sell assets;
- create liens;
- enter into agreements that restrict dividends and other payments by restricted subsidiaries;
- engage in transactions with affiliates; and
- consolidate, merge or transfer all or substantially all of its assets.

In addition, during any period of time that outstanding letters of credit under the Credit Agreement exceed $10 million or there are any revolving borrowings outstanding under the Credit Agreement, 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 as follows:

Period		Maximum Secured Leverage Ratio
April 1, 2012	September 30, 2012	4.25 to 1.00
October 1, 2012 and thereafter		3.50 to 1.00

The Company s obligations under the new revolving credit facility 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.

The Credit Agreement contains customary events of default. The Credit Agreement also contains a provision under which an event of default on any other indebtedness exceeding $25.0 million would be considered an event of default under the Credit Agreement.

7.125% Senior Secured Notes due 2017

On April 3, 2012, the Company completed the issuance and sale of $300.0 million aggregate principal amount of senior secured notes at a coupon rate of 7.125% (7.125% Senior Secured Notes) with maturity in April 2017. These notes were sold at par and the Company received net proceeds from the offering of the notes of approximately $293.8 million after deducting the initial purchasers' discounts and estimated offering expenses. Interest on the notes will accrue from and including April 3, 2012 at a rate of 7.125% per year and is payable semi-annually in arrears on April 1 and October 1 of each year, beginning October 1, 2012.

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HERCULES OFFSHORE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

UNAUDITED

The 7.125% Senior Secured Notes are guaranteed by each of the Guarantors that guarantee the Company s obligations under its new revolving credit facility that was executed on April 3, 2012. The notes are secured by liens on all collateral that secures the Company s obligations under its secured credit facility, subject to limited exceptions. The liens securing the notes share on an equal and ratable first priority basis with liens securing the Company s credit facility. Under the intercreditor agreement the collateral agent for the lenders under the Company s secured credit facility is generally entitled to sole control of all decisions and actions.

The indenture governing the notes contains covenants that, among other things, limit the Company s ability and the ability of the Company s restricted subsidiaries to:

- incur additional indebtedness or issue certain preferred stock;
- pay dividends or make other distributions;
- make other restricted payments or investments;
- sell assets;
- create liens;
- enter into agreements that restrict dividends and other payments by restricted subsidiaries;
- engage in transactions with affiliates; and
- consolidate, merge or transfer all or substantially all of its assets.

The notes provide that the Company may, at its option, redeem all or part of the notes, at any time prior to April 1, 2014 at a redemption price equal to 100% of the aggregate principal amount of the notes to be redeemed, plus the Secured Applicable Premium as of, and accrued and unpaid interest, if any, to, the applicable redemption date. The term "Secured Applicable Premium" means, with respect to any note on any applicable redemption date, the greater of:

- 1% of the principal amount of such note, and

- The excess, if any, of:

(a) the present value at such redemption date of (i) the redemption price of such note on April 1, 2014 plus (ii) all required interest payments (excluding accrued and unpaid interest to such redemption date) due on such note through April 1, 2014, computed using a discount rate equal to the Treasury Rate as of such redemption date plus 50 basis points; over

(b) the principal amount of such note.

On or after April 1, 2014, the Company may redeem all or part of the notes at the redemption prices set forth below, together with accrued and unpaid interest, if any, to the redemption date, if redeemed during the 12-month period beginning April 1 of the years indicated:

Year	Optional Redemption Price
2014	105.344%
2015	102.672%
2016 and thereafter	100.000%

HERCULES OFFSHORE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

UNAUDITED

If the Company experiences certain kinds of changes of control, holders of the notes will be entitled to require the Company to purchase all or any portion of the notes for a cash price equal to 101.0% of the principal amount of the applicable notes, plus accrued and unpaid interest, if any, to the date of purchase.

The indenture governing the notes contains customary events of default. The indenture governing the notes also contains a provision under which an event of default by the Company or by any restricted subsidiary on any other indebtedness exceeding $25.0 million would be considered an event of default under the indenture if such default: a) is caused by failure to pay the principal at final maturity, or b) results in the acceleration of such indebtedness prior to maturity.

10.25% Senior Notes due 2019

On April 3, 2012, the Company completed the issuance and sale of $200.0 million aggregate principal amount of senior notes at a coupon rate of 10.25% (10.25% Senior Notes) with maturity in April 2019. These notes were sold at par and the Company received net proceeds from the offering of the notes of approximately $195.8 million after deducting the initial purchasers discounts and estimated offering expenses. Interest on the notes will accrue from and including April 3, 2012 at a rate of 10.25% per year and is payable semi-annually in arrears on April 1 and October 1 of each year, beginning October 1, 2012.

The 10.25% Senior Notes are guaranteed by each of the Guarantors that guarantee the Company s obligations under the Company s new revolving credit facility that was executed on April 3, 2012.

The indenture governing the notes contains covenants that, among other things, limit the Company s ability and the ability of our restricted subsidiaries to:

incur additional indebtedness or issue certain preferred stock;

pay dividends or make other distributions;

make other restricted payments or investments;

sell assets;

create liens;

enter into agreements that restrict dividends and other payments by restricted subsidiaries;

engage in transactions with affiliates; and consolidate, merge or transfer all or substantially all of its assets.

The notes provide that the Company may, at its option, redeem all or part of the notes, at any time prior to April 1, 2015 at a redemption price equal to 100% of the aggregate principal amount of the notes to be redeemed, plus the Senior Applicable Premium as of, and accrued and unpaid interest, if any, to, the applicable redemption date. The term "Senior Applicable Premium" means, with respect to any note on any applicable redemption date, the greater of:

1% of the principal amount of such note, and

The excess, if any, of:

(a) the present value at such redemption date of (i) the redemption price of such note on April 1, 2015 plus (ii) all required interest payments (excluding accrued and unpaid interest to such redemption date) due on such note through April 1, 2015, computed using a discount rate equal to the Treasury Rate as of such redemption date plus 50 basis points; over

(b) the principal amount of such note.

On or after April 1, 2015, the Company may redeem all or part of the notes at the redemption prices set forth below, together with accrued and unpaid interest, if any, to the redemption date, if redeemed during the 12-month period beginning April 1 of the years indicated:

Year	**Optional Redemption Price**
2015	107.688%
2016	105.125%
2017	102.563%
2018 and thereafter	100.000%

HERCULES OFFSHORE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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If the Company experiences certain kinds of changes of control, holders of the notes will be entitled to require the Company to purchase all or any portion of the notes for a cash price equal to 101.0% of the principal amount of the applicable notes, plus accrued and unpaid interest, if any, to the date of purchase.

The indenture governing the notes contains customary events of default. The indenture governing the notes also contains a provision under which an event of default by the Company or by any restricted subsidiary on any other indebtedness exceeding $25.0 million would be considered an event of default under the indenture if such default: a) is caused by failure to pay the principal at final maturity, or b) results in the acceleration of such indebtedness prior to maturity.

10.5% Senior Notes due 2017 (Formerly Secured prior to April 3, 2012)

The indenture governing the 10.5% Senior Notes provides that all the liens securing the notes may be released if the Company's total amount of secured indebtedness, other than the 10.5% Senior Notes, does not exceed the lesser of $375.0 million and 15.0% of the Company's consolidated tangible assets. The Company refers to such a release as a "collateral suspension." When a collateral suspension is in effect, the 10.5% Senior Notes due 2017 become unsecured. Following the closing of the recent transactions and the use of proceeds thereof to repay in full the prior secured credit facility, the liens securing the 10.5% Senior Notes were released on April 3, 2012. The indenture governing the 10.5% Senior Notes also provides that if, after any such collateral suspension, the aggregate principal amount of the Company's total secured indebtedness, other than the 10.5% Senior Notes due 2017, were to exceed the greater of $375.0 million and 15.0% of the Company's consolidated tangible assets, as defined in such indenture, then the collateral obligations of the Company and guarantors thereunder will be reinstated and must be complied with within 30 days of such event.

The 10.5% Senior Notes are guaranteed by each of the Guarantors that guarantee the Company s obligations under its new revolving credit facility that was executed on April 3, 2012.

The indenture governing the notes contains covenants that, among other things, limit the Company s ability and the ability of its restricted subsidiaries to:

- incur additional indebtedness or issue certain preferred stock;
- pay dividends or make other distributions;
- make other restricted payments or investments;
- sell assets;
- create liens;
- enter into agreements that restrict dividends and other payments by restricted subsidiaries;
- engage in transactions with affiliates; and
- consolidate, merge or transfer all or substantially all of its assets.

The indenture governing the notes contains customary events of default. The indenture governing the notes also contains a provision under which an event of default by the Company or by any restricted subsidiary on any other indebtedness exceeding $25.0 million would be considered an event of default under the indenture if such default: a) is caused by failure to pay the principal at final maturity, or b) results in the acceleration of such indebtedness prior to maturity.

3.375% Convertible Senior Notes due 2038

The 3.375% Convertible Senior Notes will be convertible under certain circumstances into shares of the Company s common stock (Common Stock) at an initial conversion rate of 19.9695 shares of Common Stock per $1,000 principal amount of notes, which is equal to an initial conversion price of approximately $50.08 per share. Upon conversion of a note, a holder will receive, at the Company's election, shares of

Common Stock, cash or a combination of cash and shares of Common Stock. At March 31, 2012, the number of conversion shares potentially issuable in relation to the 3.375% Convertible Senior Notes was 1.9 million.

The indenture governing the notes contains customary events of default. The indenture governing the 3.375% Convertible Senior Notes contains a provision under which an event of default by the Company or by any subsidiary on any other indebtedness exceeding $25.0 million would be considered an event of default under the indenture if such default is: a) caused by failure to pay the principal at final maturity, or b) results in the acceleration of such indebtedness prior to maturity.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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The Company determined that upon maturity or redemption it has the intent and ability to settle the principal amount of its 3.375% Convertible Senior Notes in cash, and any additional conversion consideration spread (the excess of conversion value over face value) in shares of the Company s Common Stock.

7. Derivative Instruments

The Company was issued warrants to purchase up to 5.0 million additional shares of Discovery Offshore stock at a strike price of 11.5 Norwegian Kroner (NOK) per share which is exercisable in the event that the Discovery Offshore stock price reaches an average equal to or higher than 23 NOK per share for 30 consecutive trading days. As of March 31, 2012, Discovery Offshore s stock price was 10.5 NOK per share. The warrants are being accounted for as a derivative instrument as the underlying security is readily convertible to cash. Subsequent changes in the fair value of the warrants are recognized to other income (expense). The fair value of the Discovery Offshore warrants was determined using a Monte Carlo simulation (See Note 8).

The following table provides the fair values of the Company s derivatives (in thousands):

	Balance Sheet Classification	March 31, 2012 Fair Value	December 31, 2011 Fair Value
Derivatives:			
Warrants		$ 2,806	$ 1,758
Other Assets, Net		$ 2,806	$ 1,758

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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The following table provides the effect of the Company s derivatives on the Consolidated Statements of Operations (in thousands):

		Three Months Ended March 31,	
		2012	2011
Derivatives	**I.**	**II.**	
Warrants	Other Income (Expense)	$1,048	$ 155

I. Classification of Gain (Loss) Recognized in Income (Loss) on Derivative
II. Amount of Gain (Loss) Recognized in Income (Loss) on Derivative

8. 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) Topic 820-10, *Fair Value Measurements and Disclosure* (ASC-820-10), 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.

As of March 31, 2012 the fair value of the warrants issued by Discovery Offshore was $2.8 million. The fair value of the warrants was determined using a Monte Carlo simulation based on the following assumptions:

	March 31, 2012
Strike Price (NOK)	11.50
Target Price (NOK)	23.00
Stock Value (NOK)	10.50
Expected Volatility (%)	50.0%
Risk-Free Interest Rate (%)	0.74%
Expected Life of Warrants (5.0 years at inception with 3.85 years remaining)	3.85
Number of Warrants	5,000,000

The Company used the historical volatility of companies similar to that of Discovery Offshore to estimate volatility. The risk-free interest rate assumption was based on observed interest rates consistent with the approximate life of the warrants. The stock price represents the closing stock price of Discovery Offshore stock at March 31, 2012. The strike price, target price, expected life and number of warrants are all contractual based on the terms of the warrant agreement.

HERCULES OFFSHORE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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The following table represents the Company s derivative asset for the warrants issued by Discovery Offshore measured at fair value on a recurring basis as of March 31, 2012 and December 31, 2011 (in thousands):

	Total Fair Value Measurement	Quoted Prices in Active Markets for Identical Asset or Liability (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
March 31, 2012	$ 2,806	$	$ 2,806	$
December 31, 2011	$ 1,758	$	$ 1,758	$

The carrying value and fair value of the Company s equity investment in Discovery Offshore was $34.6 million and $33.9 million at March 31, 2012, respectively, and $34.7 million and $26.1 million at December 31, 2011, respectively. The fair value at March 31, 2012 and December 31, 2011 was calculated using the closing price of Discovery Offshore shares at each date respectively, converted to U.S. dollars using the exchange rate at each date respectively.

Fair Value of Financial Instruments

The carrying amounts of the Company s financial instruments, which include cash and cash equivalents, restricted cash, accounts receivable, accounts payable and accrued liabilities, approximate fair values because of the short-term nature of the instruments.

The fair value of the Company s 3.375% Convertible Senior Notes, 10.5% Senior Notes and term loan facility 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 two inputs. The following table provides the carrying value and fair value of the Company s long-term debt instruments:

	March 31, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
	(in millions)			
Term Loan Facility, due July 2013	$ 435.3	$ 434.5	$ 452.9	$ 442.0
10.5% Senior Notes, due October 2017	293.9	315.9	293.7	291.2
3.375% Convertible Senior Notes, due June 2038	91.2	94.7	90.2	84.7
7.375% Senior Notes, due April 2018	3.5	3.1	3.5	2.8

9. Long-Term Incentive Awards

The Company s 2004 Amended and Restated Long-Term Incentive Plan (the 2004 Plan) provides for the granting of stock options, restricted stock, phantom stock, performance stock awards and other stock-based awards to selected employees and non-employee directors of the Company. At March 31, 2012, approximately 5.8 million shares were available for grant or award under the 2004 Plan, as amended in May 2011.

During the three months ended March 31, 2012, the Company granted the following restricted stock awards:

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