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Shipping eyes new funding

One of the themes of 2009 was the maritime industry's search for alternative funding in the wake of constraints at finance banks. Barry Parker reports

As 2009 closed out, two listed shipping companies offered glimmers of the way forward. Nasdaq-listed product tanker owner Omega Navigation Enterprises and Nasdaq-listed ¡Euroseas, an owner and operator of drybulk carriers and container vessels and provider of seaborne transportation for drybulk and containerised cargoes, both announced partnerships with entities that will bring in funds from different parts of the investment sector. These are both smaller outfits: Omega has a market capitalisation of around USD50 million; and Euroseas has a market capitalisation of USD124 million, based on current share prices.

The Omega deal, a newly announced joint venture dubbed Megacore, continues a relationship that has been evolving since Omega launched an initial public offering (IPO) in early April 2006. In a deal hailed by analysts at investment bank Jefferies & Co as "a game changer for Omega", both Omega and commodity trader Glencore are now contributing vessels under construction to the new joint venture. Jefferies has mentioned "concerns related to capital requirement [that] needs now [to be] effectively resolved" as the newbuildings find a path off the balance sheet.

Omega had already experimented with Glencore in a 2008 deal in which Omega took a 47,000 dwt product-carrying vessel - then under construction in South Korea - off its books through the sale to the 50/50 joint venture. Two vessels, the joint venture ship and a sister ship that stayed on Omega's books, were put into evergreen charters (ongoing unless terminated) with ST Shipping, a unit of Glencore, at rates that covered debt service plus operating expenses. Importantly, with this precursor to the Megacore deal, debt was moved from Omega to the one-ship joint venture.

Prior to the Megacore announcement, both entities were separately building 37,000 dwt MR1 vessels at Hyundai Mipo shipyard; ST Shipping was already Omega's largest customer. Now, each entity will contribute five vessels. Omega will provide technical management of the vessels and ST Shipping will manage them commercially. The aggregate vessel order, in which deliveries were heavily skewed to 2010, will be time-shifted, moving vessel availability out to 2011 and 2012. A lengthened capital expenditure programme dramatically reduces pressure on cashflows. One vessel, to be delivered in 2010, has already agreed a three-year charter with a Japanese operator. The two partners, noting that small product tankers have been a poorly performing sector, have switched seven vessels to 75,000 dwt long-range (LR) vessels, capable of carrying crude oil. One firm order has also been switched to a vessel on option.

From a financial perspective, capital expenditures are not only stretched, but the joint venture medium dramatically lessens the expenditures that Omega needs to make. According to guidance from analysts at investment bank Dahlman Rose: "We estimate Omega's capital expenditure requirements to have dropped from USD180 million to USD70 to USD75 million." Analysts at Jefferies, in estimating Omega's capital needs going forward, suggest that no outside equity raises will be needed as the big newbuilding programme can be funded with cash on hand, financing already arranged, and cashflow from operations - even assuming a lacklustre tanker market with no inflows from the lucrative ¡profit-sharing component.

Vessel values

Erosion of vessel values, a concern throughout shipping sectors, is addressed in a late December report by tanker broking specialist Poten. The New York-based broker describes 2009 as follows: "What did materialise this year was a sharp drop in the value of both modern and secondhand tonnage." So, upsizing the vessels to longer-range tonnage is a strategy for clawing back much of the depleted value in a way that only marginally increases shipyard costs. Jefferies estimates the revamped order to be worth approximately USD420 million - slightly below the bank's approximation of the contract price at USD450 million - versus a USD350 million value of the vessels in the old order. Dahlman Rose comes up with a price of USD420 million for the nine firm ordered vessels. At the end of the third quarter of 2009, Omega had roughly USD23 million of cash on hand.

Dahlman Rose, with a more cautious view than Jefferies, raises the question of refinance on Omega's current debt, a nearly USD250 million facility with HSH Nordbank, priced at 90bp to 110bp after an early 2008 modification and expiring in the second quarter of 2011. The owner needs to maintain fair market value of 120 per cent to 135 per cent, compared to outstanding debt; in the battered product tanker market, vessel values are hovering at levels that put the borrower at the low end of the range. Nevertheless, refinancing will remain an issue. Dahlman Rose raises the spectre that Omega might need to tap the bond market in 2011 if refinance is not available. Estimates are that a spread of about 800bp above Libor, compared to the current low spreads, would cost USD1.30 per share, well in excess of the company's likely earnings-per-share (EPS).

Profit share structures are prevalent on charters in the product tanker trades on longer-term commitments such as multi-year timecharters. Particularly where owners are listed companies, such as Omega and Italian Stock Exchange-listed container, dry cargo and tanker operator d'Amico International Shipping, financial considerations have dictated that period timecharters - in effect, commitments of six months or longer - cover minimum costs. But rates in the "clean" products sector, such as gasoline and jet fuel, are highly volatile, with neither owners nor charterers willing to commit to longer tenors. Thus, both sides have viewed profit share arrangements as a way to garner potential upside optionality and operating leverage. From a business standpoint, partners can scale commercial or technical management capabilities over a fleet larger than otherwise possible.

At a high level, the Omega deal casts the commodity trader into the role of intermediary banker to the shipping sector; Glencore, a leading commodity trader - and, by nature, very private - has taken steps toward a convertible bond offering, normally a device that is the preserve of listed companies. Glencore, launched in the mid 1970s, has raised USD2.2 billion in a convertible debt offering due in 2014; bonds, priced at 5 per cent, could convert into shares that have not yet been issued. According to analysts, Glencore's post-conversion value would be around USD37 billion.

Unlike the famed trading companies of the 1970s, Glencore has invested in hard assets in the metals and mining sectors. Most recently, Glencore negotiated an option to buy into Prodeco, a Colombia-based coal producer. Shipping, which is integral to energy supply chains, is now being added to the mix of hard assets.

The template

The Omega deal may offer the template for a similar arrangement at d'Amico, another company that has been closely allied with Glencore, whose Glenda International pool, in the same beleaguered petroleum products sector, was operating 28 vessels, with d'Amico having 10 vessels on order, two of which have, so far, been converted to longer-range vessels. Glenda is in the midst of a high-profile dispute with South Korea's SLS Shipbuilding, seeking to cancel four heavily delayed tankers under construction, with refunds of progress payments. A recent d'Amico presentation reveals that the company faces finance requirements on four product tankers on order from a Hyundai shipyard after having already financed five vessels with Commerzbank and Credit Suisse. The four ships could currently be worth about USD120 million in the aggregate, implying d'Amico's need for between USD85 million and USD90 million in finance.

Investors in the Glencore bond issue, squarely at the intersection of natural resources and shipping, include US private equity investor First Reserve Corporation, a specialist in the energy sector. First Reserve, known for launching coal-carrying specialist Quintana Maritime, which was subsequently merged into Excel Maritime Carriers, has formed a joint venture with Craig Stevenson, former chairman of crude oil and refined petroleum products specialist OMI Corporation, that hopes to acquire shipping assets on the cheap, most likely in the tanker sector. At the recent Marine Money conference in Miami in late November 2009, Joseph R Edwards, managing director at First Reserve, told attendees that the timing for acquisitions in the tanker trades was premature. The likely timing of a potential Glencore equity offering is also instructive; the commodity trader's announcement says that timing of a share flotation would be tied to likely moves upward in commodity prices, which would bring a higher valuation to Glencore shares. Through the indirect path, First Reserve will find its way into the product tanker sector, albeit not through the conventional distress route of acquiring foreclosed assets.

The roster of investors in the Glencore convertibles issue includes China Investment Corporation (CIC), a sovereign fund channeling equity investments on behalf of the government in China. Although CIC is well known for buying into financial services company Blackstone Group and investment bank Morgan Stanley at the top, it recently engaged in a further example of financial intermediation benefiting shipping, paying USD850 million for a 15 per cent stake in diversified commodities trading company Noble Group.

Noble, which like Glencore has invested in shipping in conjunction with its commodity transport needs, has also carved out a niche as a developer of drybulk port facilities.

Private equity

In contrast with the Omega joint venture, the private equity world offers a different entry trajectory through two newly announced link-ups with Euroseas. In late December 2009, ¡Euroseas outlined a joint venture with private equity investors Eton Park Capital Management and Rhone Capital. Broadly, Euroseas would invest up to USD25 million while Eton Park and Rhone would each invest up to USD75 million to form a joint venture to pursue investment opportunities in shipping. Management of acquired vessels would be performed by Euroseas.

The different structures of the ventures are dictated by the two companies' financial contours. Euroseas has beefed up its cache, USD43 million in cash at end September 2009 by trimming its dividend, and then boosted it to nearly USD50 sel sales. The company's ¡ratio of debt-to-market value of vessels, a common leverage measure, stood at below 50 per cent at that time, with the company pointing to net debt of almost zero.

Omega, on the other hand, had already booked orders - now set to move into Megacore - that would double its fleet size. When reporting third quarter 2009 results, Gregory ¡McGrath, the company's chief financial officer, commented: "As of 30 September 2009, the company had a ratio of net debt-to-net capitalisation of about 64 per cent, which we believe is modest for industry standards given our strong timecharter coverage and the young age and quality of our fleet."

But with USD330 million of existing long-term debt, Omega was sailing perilously close to the wind and nearing critical markers on vessel value covenants, the paramount concern being novation of debt related to its newbuildings, that is, moving the debt off-balance sheet.

The statements of Euroseas about the joint venture, still at a non-binding stage and offering the potential for greater scale, and the private equity mindset of buying businesses rather than individual assets, hint at future directions. The equity contribution to the joint venture, if cautiously leveraged up, could support the purchase of a mid-sized fleet with an ongoing business. Euroseas has talked about investments in the containership sector in which values have been battered.

In neither case does the traditional bank funding component disappear. But, with alternative deeper-pocketed finance, bankers' comfort levels are surely raised. Listed companies have struggled with questions of share value dilution when raising additional shares. Such worries among shareholders of Euroseas, which has an at-the-market offering in place, may be assuaged. Likewise, additional share raises, at a tough time for owners of smaller tankers, will figure less in Omega's financial toolkit. In both cases, the shipowners have "skin in the game", a critical factor in structuring joint venture deals.

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