SPECIAL FEATURE

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Shipping stays on course

Despite the credit crunch, shipping companies appear to be able to access the debt markets. Barry Parker reports on the sector's ability to tailor funding mixes

Over the past nine months, attention among ship finance participants has shifted to various manifestations of the debt spectrum, encompassing both secured bank debt and unsecured corporate bonds.

Despite dire predictions about the unavailability of credit going forward to fund newbuildings delivering in 2009 and beyond, reports continue to emerge of companies accessing bank funding.

Maritime companies have the ability to tailor funding mixes to respond to market conditions.

Corporate acquisitions in a sometimes robust merger environment have prompted maritime companies to utilise the bond markets, with some issuing high-yield debt to support asset purchases.

A widely visible trend since credit instabilities erupted in 3Q07 has been an overall lowered level of interest rates across the entire curve - particularly at the short end.

One US shipping company, Horizon Lines, in announcing the April 2008 implementation of an interest rate swap to fix its costs, says: "Over the last nine months, we have been able to reduce our blended cost of debt from 8.8 per cent to 4.6 per cent as a result of our August 2007 refinancing and the structuring of our senior credit facility borrowings to take advantage of falling interest rates."

In the aforementioned August 2007 transaction, which came on the heels of a ratings upgrade, Horizon Lines began what may soon be viewed as a trendsetting transaction. Horizon retired high-priced debt, including USD193 million of 9 per cent senior notes and USD289 million of 11 per cent senior discount notes. The company refinanced the debt through USD330 million of five-year convertible notes, attractively priced at 4.25 per cent to reflect possible conversion of the debt to equity. In the refinance move, the convertible paper was supplemented by drawdowns under a previously agreed revolver and term loan, currently priced at Libor plus 150bp based on the current ratio of debt-to-EBITDA. Following the recent swap transaction, which fixes the cost on USD122 million of the August 2007 debt at 4.52 per cent, Mike Avara, Horizon's new chief financial officer, says: "The interest rate swap locks in improvement in interest rates on a substantial portion of our debt."

John F Parker, high-yield bond analyst at Jefferies & Co, tells *Jane's*: "Shipping companies are flush with both cash and cheap financing options after five consecutive years of global economic expansion above 4 per cent."

Dynamics of cheaper funding

Concerning the dynamics of cheaper funding, he explains: "It is not surprising, therefore, that with three-month Libor currently at 2.7 per cent, high-yield bond issuers, who can access the bank market at Libor plus 100bp or even plus 200bp levels (or 3.7 per cent to 4.7 per cent as an all-in cost) are looking at calling in high-yield debt and replacing it with bank debt.

The dynamics referred to by Parker explain the recent actions of Overseas Shipholding Group (OSG), which announced that the company will redeem USD176.1 million of 10-year 8.25 per cent senior notes issued in 2003 at a redemption price of 104.125 per cent of principal value. The earliest that these unsecured bonds could be called was March 2008, five years after issuance, with the bond documents specifying a schedule of redemption prices declining to 100 per cent in March 2011. Previously, in 2006, OSG repurchased USD23.9 million of these notes through purchases in the open market.

Although OSG has not made any explicit statements on refinancing, the hefty cash on the company's balance sheet - USD502 million at year-end 2007 - offers ample liquidity for the redemption. Were OSG to then releverage with bank finance, an estimated USD1.2 billion was available under the company's USD2 billion of available bank credit, principally from a USD1.8 billion seven-year facility entered into in 2006. OSG filings indicate that the average rate paid on floating debt in 2007 was 80bp, for an average rate of 5.9 per cent; a lower Libor-based structure prevailing in 2Q08 would imply all-in costs certainly below 4 per cent. Parker elaborates further, telling *Jane's*, "Net annual interest savings, assuming that OSG uses its revolver and not its cash, would be USD8.4 million in the current interest rate environment, even after accounting for the 4.1 per cent increase in total debt due to the call premium."

OSG's corporate ratings had been cut from BB+ to BB by Standard & Poor's (S&P), whose caution was aroused late in 2007 by large cash expenditures for share buyback - not considered friendly to debt interests - and by OSG's large chartered-in fleet, which is mainly off-balance sheet but an obligation nevertheless. The BB+ rating was at the upper edge of non-investment grade ratings. Following the redemption, USD85 million of 8.75 per cent debentures, also due in 2013, will remain outstanding at OSG, along with USD150 million of 7.5 per cent senior notes due in 2024.

The timing of OSG's call option and the company's strategy proved to be a good match. The first allowed date for optional redemption on OSG's 8.25 per cent paper was 15 March, coming five years after issuance. That date fell exactly five days before Frontline and private companies controlled by John Frederiksen announced the acquisition of OSG shares.

Analysts could speculate that a connection may exist between Frontline's share purchase and OSG's redemption. In the continuing battle between appearing to be either shareholder or debt friendly, the company may hope to remind the debt markets that it will not spend all of its cash and liquidity on share repurchases and dividends, after Frontline has taken a 10 per cent stake in the company.

Acquisitions may stretch finances, leading to ratings downgrades. For OSG, acquisitions of businesses, notably product tanker specialist Stelmar for USD742 million in early 2005 and US-based Maritrans in 2006 for USD444.6 million, prompted S&P to move OSG's rating down a notch.

Berlian Laju Tankers (BLT), a rapidly expanding product tanker owner based in Indonesia, has raised money through conventional bank debt but also through bond markets. S&P downgraded BLT from B+ to B in early April after the company ran afoul of a leverage covenant in an Indonesian rupiah-denominated bond issue.

BLT had seen its earlier BB- rating from S&P lowered to B+ in late 2007, when the company announced plans to acquire Chembulk Tankers from US-based private investors for USD850 million. Chembulk's sellers who, in turn, had purchased the company from its Singapore-linked owners earlier in 2007, included a US-based private equity consortium, former GE Capital executive Bob Burke, and a fund packaged by AMA Capital Partners. The acquisition more than doubled the size of BLT's controlled fleet to 820,000 dwt. After a fresh downgrade to B on the S&P scale, BLT remains on Negative Creditwatch, where the company was placed after ratings were initially lowered by S&P in 3Q07.

Unlike OSG's good fortune, BLT's 3Q07 USD850 million purchase of the tanker operator provided an example of a 'must-have' strategic opportunity becoming available when the financial markets were not co-operating - with the implications still emerging nine months later. To cement the purchase, BLT put in USD100 million of cash, which was supplemented by USD750 million of bank debt, including USD250 million of unsecured bridge debt due in November 2008 and USD500 million of mortgage debt provided at the Chembulk level. From the outset, with the addition of the secured bank debt provided by DNB, Fortis Bank, ING and NIBC, expansion-minded BLT had been aware of the necessity to keep debt levels manageable. However, credit market woes conspired with a soft environment for chemical tankers to throw BLT's finances slightly off-course.

In late 2006, rapidly growing BLT was the darling of investors as the company raised USD117 million equivalent in a Singapore and Jakarta IPO. Following the IPO, BLT raised USD400 million through a 7.5 per cent seven-year bond issue due in 2014, and, with shares now gaining value as currency, USD125 million in a group of convertible bonds due 2012. These issues supplement the company's already outstanding Indonesian bond debt of IDR1.3 trillion (USD140 million), spread over four issues. On more than half of this debt, issued in in July 2007, BLT pays a fixed interest rate of 10.35 per cent over a five-year term.

BLT's debt-to-equity ratio reached 3.5 times at the end of 2007, putting the company in breach of covenants on its four Indonesian rupiah bonds, which require the company to keep its gearing at no more than 2.5 times. The company was given 120 days to remedy the situation from 17 March.

To get its debt-to-equity ratio back in line within the allowed 120-day cure period, BLT has also been in discussions about redeeming some IDR400 billion of Indonesian bonds and the company continues to pursue sale/leaseback transactions that would bring in cash. BLT is no stranger to using leasebacks to free up liquidity. A trio of BLT's newly delivering chemical tankers were sold for an aggregate USD135 million to First Ship Lease - predecessor of Singapore-listed FSL Shipping Trust - and taken back via 12-year leasebacks during 2006.

Signals from the banking sector continue to suggest that known credits with growth needs will be able to raise funds. Another one of three listed Singapore shipping trusts, Rickmers Maritime, announced that the company had arranged USD627 million of fresh credits through two facilities.

In a top-up to a credit arranged at the time of its early 2007 IPO, HSH Nordbank, DBS Bank and Citibank announced a USD130 million top-up on Rickmers' USD360 million revolver, priced at Libor plus 70bp. A further USD497 million in three facilities to fund vessel deliveries has now been agreed with groups led by BNP Paribas, Nordea and Commerzbank, priced at Libor plus 95bp to Libor plus 120bp.

Shipping entities that funded with bonds but have good access to commercial banks might look to follow the examples of Horizon and OSG. One company closely tied to Frontline is B+ rated Ship Finance Ltd (SFL), formed originally at the end of 2003 as a vehicle for Frontline to unbundle its market-responsive tanker business from the more stable business of shipowning. Although more than half of SFL's 72 owned vessels are oil tankers and energy-related assets leased back to Frontline or other Frederiksen companies, SFL has also diversified, carving out a third-party business leasing 13 container vessels. Within the USD2.3 billion of debt on its USD2.9 billion balance sheet, SFL has USD450 million of 8.5 per cent senior notes outstanding, with the approximately USD1.8 billion balance comprised of floating-rate bank debt.

To date, as company disclosures reveal, SFL has used the open market to buy back roughly USD139 million of high-yield debt, with purchases funded through what Jefferies' Parker describes as a "bank-sponsored bond-swap line". He explains that SFL is already realising annual savings of around USD6.4 million because, assuming the paper was purchased at par "the bond-swap line reduces the interest rate to Libor plus 100bp". As for further redemptions, Parker says: "We think it is possible that they will call the remaining notes that they do not control at their December 2008 104.25 call and replace the entire issue with debt at Libor plus 100bp levels."

London-based Britannia Bulk, rated B-, issued USD185 million of 11 per cent five-year senior secured debt as the company expanded its fleet in late 2006. Britannia Bulk has now tapped the bank markets, initially with a short-term transaction to test the waters. In early February, Britannia Bulk raised USD30 million through a secured bridge facility from Lloyds TSB at Libor plus 200bp.

Purchasing power

Proceeds of this loan, maturing in November, are earmarked to partially fund the purchase of two handysize bulk carriers worth an aggregate USD70 million, in conjunction with funds set aside in a vessel acquisition account from the 2006 debt issue in which USD17.5 million remained available at the end of 2007, supplemented by cash. Excellent conditions in the dry markets enabled Britannia Bulk to build up a cash balance exceeding USD55 million.

Parker explains: "Britannia Bulk has a T-plus 50bp make-whole call provision for the life of its 11 per cent senior secured notes, which means they must pay the price that will make the yield on the bonds 50bp higher than the current yield on a reference treasury bond."

Parker maintains that Britannia Bulk could substantially reduce annual interest expense by calling in the bonds now, fully funding the bond purchase with bank debt. He adds: "Even with a 17 per cent increase in debt, a Libor plus 200bp bank loan would reduce annual interest expense by more than USD10 million."

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