Stena's Drill-Max IV Financing

A recent financing of a vessel costing in excess of USD 1 Billion shows that markets are still open for carefully crafted deals. At a time of disarray in both credit and commodity markets, a borrower tied to Sweden's Stena AB was able to raise USD 850 Million in a structured deal. Janes gained insight into the deal through conversations with deal participants and advisors. Citi was the Global Coordinator and one of four bookrunners (along with BNP, Deutsche Bank and HSBC) for the financing.

Watson, Farley & Williams (WFW) played a key role, advising the lending group-composed of nine banks. Janes spoke with Mike Vernell, Partner in the International Shipping Finance Group at WFW's London office. Vernell offered a broad view of the deal's innovativeness, telling Janes that "…some of the issues we faced went way beyond the purely legal realm. The deal was done at a time that the bank syndication market disappeared."

Commodity price declines (from highs of nearly USD 150/ barrel in Summer 2008) have also made caution a watchword in finance of any equipment used for production or transport of natural resources. With oil at USD 40/ barrel, bankers and strategists in the sector are sensibly taking a long view of the industry's cycle. A previous constructed by Stena, delivering in mid 2009, is set to enter a 5 year charter, with Hess, at a rate reported to be USD 520,000/day.

Analysts expect that a combination of demand growth (albeit after a likely dismal 2009), in conjunction with further reductions of supply, will push prices back upward. A recent Morgan Stanley (MS) analysis suggests that 2Q 2009 oil prices could reach a trough as low as USD 25/ barrel. Yet, the MS base case points to prices of USD 85/ barrel two years out, in 2011.

The commodities markets are factoring in such positive expectations. The crude oil market has been characterized by an unusual and large "contango", meaning that prices farther out in the future are above nearby levels. One consequence of this pricing structure has been a significant increase in tanker chartering activity beginning in late 2008, where vessels are chartered for floating storage of oil. Traders hope to hold the cargoes before reselling at higher prices. Futures prices for later 2009 oil deliveries reveal expectations of oil at USD 55/ barrel and above, and above USD 60/ barrel out into 2010. These same expectations are responsible for the rising jet fuel swap prices encountered by airlines for hedges on fuel purchases later in the year.

Stena AB, based in Gothenburg, is a large player with a presence in the tanker and oil exploration sectors. Its tanker business is conducted through Stena Bulk and Concordia

Maritime, and it participates in the oil exploration markets through Aberdeen-based Stena Drilling.

Cutbacks in oil exploration have received considerable attention in the media since the collapse of commodity prices last year, but deep resourced integrated oil companies (who may experience “breakevens” on big exploration projects at around USD 40 / barrel) continue to plumb the depths. The customers for Stena’s drilling subsidiary (and other independent equipment owners) are the large oil companies. Increasingly, exploration is occuring in offshore fields. In the words of Morgan Stanley’s global team of energy analysts, “…the structural bull run <in the oil markets> is not over.”

Company planners, along with financiers of exploration equipment, see a bright future once the near-term weakness has been overcome. Oil exploration in deepwater fields has been performed by semi-submersible rigs, and, increasingly, by drill-ships. Not surprisingly, there is a large overlap between the energy shipping and oil exploration sectors.

In the Drill-Max IV deal, Stena Drilling is constructing its fourth in a series of drilling ships to be built at South Korea’s Samsung yard. The vessels are used to explore for and then develop commercially exploitable oil deposits in fields as deep as 10,000 feet. Exploration has moved to deeper and more remote waters; the Drill-Max vessels are suitable for working in harsh environments, for example the Norwegian Sea and the Barents Sea.

From an economic standpoint, drillships (which can move rapidly between locations) offer an advantage over semi-submersible exploration rigs, which must be towed to the next assignment following completion of work. Previously built units are operating in the U.S Gulf of Mexico for Repsol, until early 2012, and through 2013 in the Shetland Islands for Chevron. The third ship, to be delivered in mid 2009 by Samsung, will go on charter to Hess through 2014. The new unit, with delivery scheduled for 2012, augments the features of the three earlier units with its certification to work in ice; its hull will attain a “Polar Class 5” designation.

The overall “ready for sea” cost of the new , dubbed “Stena Drill-Max Ice”, is slated to be USD 1.065 Billion, USD 850 Million of which is funded by US dollar denominated debt. The finance is structured with a 15 year “door to door” tenor- meaning that drawdowns occur during a three year construction period, followed by a twelve year repayment. USD 250 Million of the debt is sourced from Eksportfinans SA under Commercial Interest Reference Rate (CIRR) fixed rate funding. This amount represents the amount of Norwegian content in the vessel- in the form of topside and drilling equipment, provided by Norwegian vendor National Oilwell, Kongsberg and ABB along with several others and shipped to Korea during the construction period. Under CIRR, with interest rates published monthly by the OECD (tied to U.S. Treasury borrowing costs in the case of US dollar debt), repayment periods of up to 12 years are allowed. The Citi-led USD 600 Million of bank funded debt, tied to Libor plus a margin, comes from the four Bookrunners and five Scandinavian banks.

Like the new vessel's innovative design, the Drill-Max IV financing broke new ground in a number of ways, building on the structure of the three previous drillship deal arranged by Citi for Stena-operated drillships built at Samsung. Citi's Anders Henckel told Janes that: "Compared to the other three financings, this financing was more straight-forward in some ways. This time, we had full recourse- with guarantees from Stena AB. We realised that market realities had changed, and that it would be necessary to propose a more conservative credit structure to banks that would limit the capital that they would be required to allocate to this lending. There was also an appreciation that, notwithstanding a compelling credit profile, availability and cost of bank funding was a key factor in determining institutions' appetite for new financings. " He explained further that the borrower was an SPV wholly owned by Stena AB, with the vessel to be operated by Stena AB's subsidiary Stena Drilling.

Citi's Henckel added that: "In the credit environment of late 2008, when everything was being finalised, it would have "very difficult" to achieve a financing replicating the earlier deals which were executed under a limited recourse structure and included both senior and junior commercial bank debt. This was one of the reasons for the move to this structure."

The latest drillship deal, saw the Korean Export Insurance Corporation (KEIC) guarantee of the drillship financing (its largest ever and first drillship), contrasted with KEIC's business of providing guarantees re financing of conventional vessels having far less complexity (and less construction risk). This was the first drillship financing that KEIC had supported. In the new financing, a KEIC guarantee was utilized, instead of actual funding from Korean Export Import Bank (KEXIM) as had been the case previously. Here, KEIC;s insurance policy on commercial and political risks covers 95% of the debt amounts. Citi's Henckel explained to Janes: "The funding from Eksportfinans was a very important structural element given the difficult bank market conditions at time of distribution and contributed significantly to the success of the financing and its competitive pricing. The structure provided the banks with an unfunded risk participation pro rata with the bank funded portion, something that was very helpful in mitigating the increased funding costs the banks were facing". As is customary in shipbuilding deals, Samsung was required to post Refund Guarantees, covering progress payments made to the yard.

Though the structured deal has elements of both asset based and project finance, the corporate element in the funding, in the form of recourse to the parent of Stena Drilling, is important. The Drill-Max IV does not yet have a charter; Anders Henckel said: "The financing for the previous units was also arranged prior to them having a charter in place." Once a charter is agreed for the new vessel, the lenders will benefit from the additional security, mirroring conventional asset based ship finance.

WFW's Vernell was candid in describing difficulties in developing a new structure at a time that credit markets around the worldwide were imploding. He commented further, "We had quite a chunk that needed to be funded by commercial banks, and we were putting together two export credit agencies that had not worked together previously. It is an incredible achievement, and a testimony to the professionalism of this group that it hung together at this time of extraordinary tension in the markets."

For the foreseeable future, Export Credit Agencies (ECAs) are likely to play an important role in equipment finance. WFW's Mike Vernell said: "Work with ECA's has always been a part of our ship finance practice. We think deals that are funded or supported by ECA's will be a key element in the finance market in 2009 / 2010." Citi's Anders Henckel concurred, saying: "The banking market is suffering from severely constrained access to funding and very limited capital. ECA support can mitigate these issues through the provision of insurances or guarantees and, on occasion, funding. As a result ECAs will continue to be important in supplementing and enhancing bank capacity, and our team is focusing on it. There's a big increase in demand for ECA financing; for vessels, such as the drillships, the 15 year term <a construction period of three years, with a 12 year loan with repayment starting at the time of delivery> is attractive compared to other financing alternatives."

Several ECA's have been involved in Stena's recent deal, and the three previous transactions. Norway's Eksportfinans, owned by the Government and banks, operates an export finance program in Norway. To support the significant amount of Norwegian content in the South Korean built drillships, it has been a participant in all four of the Stena . Eksportfinans's balance sheet included USD 22.8 Billion of loans outstanding, at end 3Q 2008. Roughly one third were devoted to ships and other capital goods. In the three previous Drill-max deals, the South Korean ECA, Korean Export Import Bank (KEXIM) provided a portion of the actual credit package, in conjunction with insurance from a Norwegian guarantor- the Guarantee Institute for Export Credits (GIEK). Instead of actual finance from KEXIM on Drill-Max IV, a key deal piece was the guarantee on 95% of the debt, instead, from another agency, Korea Export Insurance Corporation (KEIC), a provider of credit insurance for both political and commercial risks.

A positive that is underscored by the success of the Drill-Max IV financing is the vital role that governments can play in keeping the flow of finance open. In late November, 2008, shortly after the much heralded G-20 meetings in Washington, D.C., the OECD issued a statement supporting coordinated action to keep the arteries of export finance free from blockages. Its communication stated: "Official export credit support and finance play an enhanced key role in counterbalancing instability in periods of economic uncertainty and risk averse behaviours of economic players, by helping to fill the gap where market capacities are temporarily limited… these OECD Member and Non-Member governments are determined to maintain their export credit support and ensure that sufficient capacity is available with the aim of supporting international trade flows…"

Ekportfinans borrows heavily from international capital markets to fund itself, principally in US Dollar, Euro and Japanese Yen. With USD 39.9 Billion of commercial paper and bond debt outstanding (at end 3Q 2008), its credit ratings are crucial. Storm clouds had been on the horizon since early 2008. After several loss making quarters, Moody's outlook on the institution's credit rating had turned negative by mid year. At that time, Moody's noted that: "In the prevailing turbulent market conditions Eksportfinans has maintained access to market funding although cost of long-term funding has increased notably." In early January 2009, the Eksportfinans credit rating was actually downgraded by Moody's (from Aaa to Aa1) and Fitch (from AAA to AA), with both raters citing liquidity issues surrounding some of its securities holdings.

In late January, 2009 Eksportfinans was able to announce that requisite approvals were now in order for a deal with the Norwegian government. In this deal, originally announced in late 2008, the Kingdom of Norway, which owns 15% of Eksportfinans (with DNB, Nordea and a group of Norwegian banks owning the balance), had agreed to provide funding to support new export credits.

Eksportfinans's Head of Oil & Gas Jørgen Hauge talked to Janes about the Drill-Max IV deal, explaining that standard OECD terms apply to its portion of the finance, with a 12 year semi annual repayment timeframe, with the CIRR rate based on the applicable tenor U.S. Treasury rate plus a margin of 100 b.p. In describing the deal environment, he offered that: "With the Korean involvement, we were able to put together a competitive package." He also cited the importance of three levels of guarantees, KEIC, the commercial banks, and Stena AB, saying: "The importance is quite simply, increased security." Implicit here is the ability to finance such an asset without a charter in place at the outset.

In reflecting on the highly positive outlook at Eksportfinans, Hauge told Janes: "We are experiencing a lot of demand lately, and we anticipate the GIEK and Eksportfinans support (the Norwegian ECAs) will be increasingly sought after, over the next few years. These ECAs will be potentially providing loans tied to Norwegian credit expected to grow further, especially services and infrastructure applicable in deep waters." He added that: "Energy will certainly be important."

Recent Eksportfinans deals show the interaction of ECA finance and guarantees. A late 2008 transaction saw financing raised for an FPSO delivering for a five year contract (with further options) in the North Sea. Oil driller Sevan Marine, the owner, worked with GE Commercial Finance, the leader of a USD 300 Million bank syndicate. With Norwegian topside and systems work (provided by Kanfa A/S, owned by Sevan) performed aboard the Chinese-built "Sevan Voyageur", GIEK provided a partial guarantee, with Eksportfinans funding the GIEK portion.

A recently reported but not finalized deal has Eksportfinans slated to provide finance to Siem Offshore- which operates a fleet of vessels serving the oil industry. Unlike the drillship or FPSO deals, the vessels will be built entirely in Norway. In a transaction still subject to completion, Eksportfinans could be providing up to 80% of the cost on 12 year terms, for a series of vessels to be delivered from a Norwegian yard, during 2009 and 2010. The financing commitment was made with the proviso of "…subject to suitable guarantees." These guarantees, initially on three vessels to be delivered in the first half of 2009, will then be provided by GIEK, "subject to participation by commercial banks on a parri pasu basis." According to the Borrower, "GIEK and a commercial bank have presented firm offers for such guarantees, and their relative share of such guarantees is 70% and 30% respectively. The guarantees are for 60% of the project cost for each vessel…”

For South Korea, the importance of KEIC is underscored by its insurance products covering 21.4% of the country’s exports, estimated to be worth some USD 371 Billion in 2007. Shipowners who have benefited from KEIC cover in recent years include China Shipping Container Lines (CSCL), UAE-based Fal Tankers (crude oil carriers), Stolt (chemical tankers) and Qatar Gas Transport, or “Nakilat” (LNG tankers). During early February, 2009, S Korean shipbuilding majors Hyundai, Samsung and Daewoo, will be delivering a total of ten “Q-Flex” and “Q-Max” LNG carriers to Nakilat- set to build a total of 54 LNG’s in Korean yards (25 of which will be wholly owned). The Samsung yard is the leader in the burgeoning market for drill-ships.

Complex financings of sophisticated vessels require steady hands at the tiller. WFW Partner Mike Vernell, talked candidly about the successes of the Drill-Max IV financing. He told Janes: “It helped here that we had a very strong group of arrangers, and lenders who were familiar with and comfortable with Stena. The banks were able to stick with tried and true techniques, and not trying to create novel ways to protect against all eventualities.”

Eksportfinans’s Jørgen Hauge was asked about the attractiveness of the Drill-Max IV project, given the cyclical nature of oil prices, and he offered that the market dynamics “…provided good long term project sustainability and commitment from commercial banks in this respect.” When asked for a big picture view on the inter-relatedness of the ECA finance with commercial bank finance, Hauge said: “ECA’s can not do it alone. Commercial banks’ risk appetite and long term commitment is strongly needed.”

WFW’s Mike Vernell summed the situation up as follows: “A clear message that we are getting from the larger banks, who are organizing deals with the ECA component, is that banks with capabilities to put such deals together will have a big advantage in the market.” The energy-related deals described in this article, being done in a tough credit environment, suggest that Vernell’s observation is correct.