JANE'S TRANSPORT FINANCE – NOV 26, 2009

Brazil flexes its muscles

Latin America - in particular Brazil - will play an increasing role as both a commodity provider and a shipbuilder. Barry Parker reports

Economists are undecided as to whether the success of developing countries is predicated upon that of developed economies; most measures show that standalone growth in the former - which include Brazil and China - greatly exceeds that of the latter.

Politics plays an important role in Brazil, which - like China - has great shipbuilding ambitions. Brazilian President Luiz Inácio Lula da Silva touched on the strategic importance of his country's nascent shipyard industry in a recent interview for the UK's Financial Times. "We want to develop a strong oil industry and a strong shipbuilding industry together. We want to build our own drilling rigs, our own offshore platforms and our own ships," he stated.

Lula added: "We are endeavouring to make oil companies around the world develop partnerships with us in building shipyards with drydocks so that we can build things in Brazil."

A huge ordering programme tied to energy giant Petrobras - which includes tankers and offshore service craft and, in the future, drilling rigs currently being built in South Korean shipyards - is set to revitalise Brazil's shipbuilding industry. In anticipation of an infrastructure boom in the country, international financial and legal providers are therefore beefing up their presence.

Over-ambition?

However, significant questions surround the country's ability to mobilise yard capacity in a timely manner. Brazil is not ready to usurp the entire global shipbuilding industry - at least, not yet - although there has been talk of ambitious plans for Brazilian yards to build both small supply vessels and gargantuan drilling rigs.

At a recent ship finance conference in Miami, John Gellert, president of the offshore marine unit of Seacor Holdings, spoke of plans to build 146 support vessels in Brazil. He added, however, that "the lack of facilities and the [slow] pace of activity means that you are paying a premium for Brazilian-flagged vessels. These vessels would not be competitive on the international market".

The Brazilian cabotage trades - and those of Mexico, where Seacor also operates - are analogous to the US Jones Act trades, which require locally built and operated vessels.

The chokepoint is not restricted to smaller vessels. Orders have not yet been placed for the majority of the 28 deepwater oil exploration units that Petrobras is expected to contract up to and including 2017. Those orders, worth as much as USD700 million per unit, are likely to go to shipyards in Singapore and South Korea. Lately, however, there have been suggestions that Brazilian shipyards, including a number that have not yet been constructed, should pre¡sent drillship designs to Petrobras.

Thomas Kellock, Houston-based head of consulting and research at ODS-Petrodata, agreed that these 28 'floaters' (drillships and semi-submersible rigs that will explore for oil in water from 7,500-10,000 ft [2,290-3,050 m] deep) would not be built in Brazil - although with price tags app¡roaching USD1 billion per unit this contract is big business.

"Most of the contractors that I talk to are not leaping at the opportunity to build in Brazil," Kellock said, adding by way of explanation: "If you are going to build in Brazil, it will be expensive and not really economical at today's day charter rates." He pegged these rates at USD500,000-USD600,000 per day for deepwater and ultra-deepwater floaters, noting that, "in spite of the fluctuations in oil and gas prices, this market is holding its own".

Across the divide

One company straddling both drybulk shipping and offshore energy is DryShips, which has benefited from the positive sentiment towards the energy sector. With most of the company's drybulk vessels now locked into period charters, analysts and investors are focused on DryShips' oil market exposure, described by one analyst as "an oil-drilling play with some shipping exposure". Two existing semi-submersibles are under charter, including one entering a three-year deal with Petrobras at an estimated USD575,000 per day. Four drillships are on order from South

Korean yards for deliveries in 2011. Talk suggests that DryShips is in advanced negotiations on at least one of these drillships, consistent with pronouncements from the company.

DryShips, which has now secured covenant waivers from a trio of German lenders - Commerzbank and WestLB on USD70 million in total and Deutsche Schiffsbank on USD117.5 million - is in the final stages of raising USD400 million of senior unsecured convertible debt. The debt carries a low interest rate - in this case, 5 per cent, per the recent pricing of the Deutsche Bank-led issue - in consideration for investors being given the opportunity to convert their debt into shares priced at USD7.19 each, versus a 20 November trading price of USD6.29.

Continued commitment

DryShips has pared down its debt-to-total-capital ratio through a series of equity raises, and began following in the steps of acquisitive drybulk peers after the last debt waiver was in place. The company's continuing commitment to shipping - in spite of the analyst's characterisation - is shown by its mid-November purchase of two modern panamaxes (built in 2006 and 2007) for a total price of USD75.8 million.

A booming market in Brazil for offshore oil - which has buoyed DryShips and other operators - is hardly a guarantee of success for local shipbuilding. Gellert, talking about supply craft, said: "Investing in shipyards has its limits - it takes a long time to come, and happens at a high cost."

Kellock explained plans at Petrobras and what he called "a massive newbuilding programme as oil exploration moves into deeper waters", adding that "there are new contractors appearing, changing the dynamics of the offshore drilling markets."

He noted that, of 22 floaters currently under construction throughout the world, 19 are destined for Brazil, where Petrobras controls most of the activity, and three are to be used in Mexico, where Pemex dominates. Kellock added: "The plans and actions of Petrobras are the wild cards that will impact day rates and asset values."

Kellock suggested two possible scenarios regarding the 28 floaters: either day rates in the market will go up or "Petrobras could flood the market. Of the 28 rigs, some will be out there in the sub-let market." He added: "For now, the market is under control; there is no reason for rates to go lower unless there a massive newbuild programme. The sub-lets we've seen have been at or near the original rates fixed in."

The potential for delays at Brazilian yards is not lost on the policy-makers and executives. After months of rumours, South Korea's STX Offshore & Shipbuilding Co confirmed that it had succeeded in gaining a contract worth KRW1.02 trillion (USD900 million) to build eight very large ore carriers (VLOCs) that would be used to transport iron ore from Brazil to China.

This piece fits nicely into a puzzle that saw its sister company, shipowner STX Pan Ocean, agree to fund a portion of the vessel purchases with the proceeds of a USD200 million convertible bond issue. Previously, STX Pan Ocean had announced its agreement to a 25-year charter contract on the vessels - which are to be delivered during 2011-12 - with Brazilian ore producer Vale. The price tag on the eight ships reflects the dramatic impact of the drybulk slide that started in the third quarter of 2008 (3Q08). Similar vessels had been ordered by Vale from the Rongsheng yard in China for USD140 million each at the market's height, around the time of the 2008 Olympics in Beijing.

Nevertheless, investors have confidence in debt issues tied to Brazilian natural resources. In early November, BBB-minus-rated and mostly state-owned Petrobras issued USD4 billion-worth of bonds, with a 10-year issue yielding 5.875 per cent and the 30-year issue yielding 7 per cent. Market-watchers noted that purchasers of the Petrobras issue - which eclipsed a USD3.75 billion bond issue by Vale in 2006 and is now the largest in a dec¡ade - were mainly US and European investors that were enthusiastic about prospects for successful exploitation of Brazilian offshore oil discoveries.

Renewed confidence

The Goldman Sachs-led STX Pan Ocean bond, which has a conversion premium of 25 per cent - meaning that bondholders can convert into shares priced 25 per cent above the share price at the time of issue - mat¡ures in five years and is priced at 4.5 per cent. The issue reflects renewed confidence in the drybulk sector. The composite rate for capesize bulk carriers (180,000 dwt - smaller than the 400,000 dwt ore carriers) had increased to USD76,000 per day by mid-November - up from USD50,000 per day at the beginning of the month.

The drybulk sector's rosy glow, tied to a belief in renewed increases in Chinese steel production, provides further fuel to the Brazilian growth machine. Vale has seen its stock price more than double in the past year. A testimony to the bright prospects of Vale - which is effectively a growth engine for the drybulk trade with more than two dozen large ore carriers set to join its owned fleet or committed for charter, according to shipbrokers - can be seen from its own recent financings. In 3Q09, Vale logged its highest-ever quarterly iron sales to China, aggregating some 39.8 million tonnes.

According to Vale, its budgeted vessel investments are in addition to a USD59 billion capital investment programme for 2008-12, with USD8.9 billion of capital expenditures in the first three quarters of 2009. Within Brazil, Vale says it is investing in rail infrastructure - longer trains and more efficient locomotives linking inland mines to ports - to fine-tune its logistics chain.

Drawing a Vale

Taking advantage of the worldwide boom in the capital markets, in early November Vale Overseas offered USD1 billion of 30-year unsecured bonds, guaranteed by the Brazilian parent company, which sold at just under 7 per cent through a bank group led by Deutsche Bank, HSBC and JP Morgan. Vale, the world's largest iron ore producer, is rated BBB+ by rating agency Standard & Poor's (S&P). In mid-2009, Vale issued USD1 billion of 10-year debt and a further USD940 million of convertible debt. With pro forma adjustments for the new issue, Vale's USD81.5 billion balance sheet includes USD22 billion of long-term debt, including a current portion of USD2 billion.

Further evidence of Brazil's attractiveness is the bond market activity of domestic construction contractor Odebrecht, which has gone to the market twice in 2009: first in April with USD200 million of five-year notes that were yielding 9.625 per cent at the time; and, more recently, with USD500 million of 10-year bonds yielding 7.25 per cent. The issue, illustrating investors' excitement about the 2016 Olympics Games and a host of other upcoming construction activity, was rated BB by S&P.

Odebrecht has ordered two drillships from South Korea's Daewoo Shipbuilding and Marine Engineering Co (DSME), with a funding package of nearly USD1.7 billion, including USD335 million of equity and USD770 million of commercial bank finance, independent of bond issues. Both Norwegian and South Korean export credit agencies (ECAs) played a role in the drillship finance, with a USD274 million loan from Norway's Eksportfinans, backstopped by Norwegian guarantor GIEK; and USD300 million from Export-Import Bank of Korea (Kexim).

The drillships are set to enter into 10-year charters to Petrobras, which has been a charterer of Odebrecht equipment since the 1990s. Of the 28 drilling units to be deployed by Petrobras, nine will be owned by a group of local operators that includes Odebrecht.

Catching up

Laila Johnsen, senior vice-president at Eksportfinans, told Jane's: "We have seen a progression from European shipping companies like Stena, Awilco and Seadrill [tied to Frontline], among others, which made the move into the drillship business from the middle of this decade onwards." She continued: "Now it is the

Brazilians; they may be small players compared with the better-known names but they are advancing quickly and are very vibrant."

Johnsen added: "There are six drilling companies in Brazil. In May 2008 Petrobras awarded 12 10-year contracts. Petrobras had already gone to [South] Korean yards with the specifications, [but] local drilling companies and other companies got the contracts. 2012 is the year that these rigs will be delivered."

Local owners include Odebrecht, which will build two units at DSME, as well as Delba, Etesco, Petroserv and Schahin Group. Johnsen said: "We have worked with Odebrecht and Etesco; we are now working on a structure with Schahin." She also stated that Delba will build at least three units in China and probably two in South Korea.

Bookrunners for the commercial bank finance, with a two-year construction period and 12-year repayment from time of delivery, are Banco do Brazil and Banco Espirito Santo. Johnsen told Jane's that the 12-bank syndicate included "big international Dutch, German and French banks, plus the two Brazilian banks". She stressed the important role that pro¡ject sponsor Odebrecht played in getting the deal done, with roadshows and a continual juggling of institutions "in response to a banking landscape that was very dynamic at the time they were trying to line up the syndicate".

ECAs come to fore

The growing role for ECAs can be seen when reviewing the evolution of recent financings undertaken by the Schahin Group, another large, but still family-owned, Brazilian player rooted in the construction business but operating various rigs for Petrobras since the early 1980s. Fernando Schahin, chief financial officer of the group, noted that the company's oil and gas business was spun off earlier this year into a separate company, with the sole customer being Petrobras.

The ECAs are filling an important gap, Schahin said, as "the capacity of lenders is slowing down". Schahin Group is currently working through financing arrangements - part of the company's Black Gold project - which will include Norwegian and South Kor¡ean ECA components in addition to commercial bank participation for two drillships to be built at South Korea's Samsung yard and to be used for drilling in an offshore field.

An earlier pair of semi-submersibles (rather than drillships), with a total value of USD1 billion and also part of the Black Gold project, was placed with Chinese yard Yantai Raffles and financed using USD800 million of commercial debt and a USD100 million junior tranche, according to Schahin. The lender syndicate on the project financing, inked during the heady banking markets of late 2007, included HVB, Mizuho, Standard Char¡tered Bank and WestLB. Schahin indicated that the USD100 million junior portion was provided by Japanese lenders.

The financing consists of a 3.5-year construction phase and five-to-seven- year operating phase, during which the facility will amortise via charter payments from Petrobras. Market chatter has suggested that delays at the Chinese yard were necessitating renegotiation of the USD800 million credit. Schahin also described another earlier group of financings in which cash-rich Petrobras and its Japanese partners purchased rigs and placed them on 20-year capital leases to the operator, Schahin.

Transpetro, the shipowning arm of Petrobras, is continuing its expansive initiative for construction of several dozen deepsea crude product tankers and gas tankers in Brazil. The company recently sent out tenders for the technical specifications of an eight-vessel gas tanker construction programme, part of its fleet modernisation and expansion programme that could include as many as 86 tankers (owned mainly by Transpetro but also by independent owners) and all expected to be built in Brazil.

Shipyard nationalism

Realism has crept into such shipyard nationalism. Brazilian leaders had urged Vale to build vessels in Brazil rather than in Asian yards, delaying Vale's STX order for VLOCs that ultimately went abroad. Brazilian President Lula had said: "What I ask of Vale is that it should turn ore into steel in Brazil, and, at the same time, it should buy the machinery and ships it needs in Brazil."

In spite of the seeming concession by the Brazilian government as the Vale VLOC order went to South Kor¡ea, the jury is still out on the strategic importance of shipyards in Brazil.

Joseph R Edwards, managing director of private equity firm First Reserve, asked: "Does Brazil want to sidetrack fast-track production for nationalistic goals? Investors need clarity on this." He conjectured: "We will need to see massive investment in shipyards or relaxed Brazilian flagging standards for vessels."

Schahin added: "The first priority in the whole government plan for developing the pre-salt [offshore oil finds] is development of the country" - an advance hint that shipyard delays may become endemic to Brazilian ordering.

Lula's highly nationalistic views notwithstanding, and in spite of regulations proscribing a high percentage of local content, there are opportunities for foreign partners. In mid-

November Petrobras announced that it would work with 'large cap' partner BG Group Ltd on a joint venture to operate a vessel that will process and liquefy natural gas from Brazil's Santos Basin prior to loading it onto liquefied natural gas (LNG) tankers.

Edwards stressed: "Private equity has an important role to play in partnering with local companies." He pointed to First Reserve's early 2008 acquisition of Canadian oilfield services provider CHC Helicopters as an example, and mentioned terminals, tankers and shipyards as possible areas of interest.

Asked about the impact of Brazilian activity on tanker markets, Edwards said: "We have high hopes that the Latin American tailwind will carry over into shipping." However, he was quick to add that tankers are still likely to face a shake-out. "We are not investing in that sector," he stated.

Yet the star appeal of Brazilian pro¡jects - with construction in South Kor¡ea - is not to be underestimated.

Johnsen offered: "Since 2Q08 there has been a great deal of activity in creating finance for these rigs. Despite the financial crisis that erupted in 3Q08, these deals have gone ahead. Among the ECAs and the different banks it is a small community with a lot of co-operation rather than competition. We have sufficient capacity and good formulae for sharing risk.

"Each project has a slightly different structure. There is room for all of us," she concluded.

Are credit markets thawing?

At the Miami ship finance event, a group of bankers and providers of non-bank investments in transport equipment profferred their opinions and gave insights with a slightly Latin American slant.

Paul Clifford, director and head of project finance for the Americas at Standard Chartered Bank, stated: "The credit markets are now unfrozen - things have eased." By one measure, the 'TED spread' (rates on three-month Libor less comparable US Treasury debt) has dropped to normal levels below 30bp. However, Clifford pointed out that capacity for project lending on equipment such as deepwater rigs has dropped because the approximately 40 banks lending to the sector two years ago have been pared down to 15 institutions - at a time when banks generally have husbanded capital and pulled back.

Guido Musso, director of project and export finance at HSBC, noted the growing importance of export credit agencies (ECAs). "When the credit crisis hit, the quality of clients turning to the ECAs improved," he said. Musso pointed out that currently about USD40 billion of ECA credit is outstanding, compared with USD23 billion two years ago. He estimated that around 25 per cent of this debt was related to shipping and offshore projects, with China, Norway and South Korea being the key players.

Geir Sjurseth, managing director and global head of the offshore support group at DVB Bank, said that the offshore market was being viewed favourably, "with good companies offering solid contractual support. It offers a good match between credit quality and leverage", he said. Sjurseth added that Norwegian guarantor GEIK is now offering guarantees on pre-delivery payment (PDP) finance.

Another consequence of the banking crisis and related reduced lending capacity was highlighted by Isaac Deutsch, deputy general manager and group head of Latin American structured and corpor¡ate finance at SMBC. He pointed to the increasing participation of local banks - most notably Brazilian development bank BNDES - adding that those banks lack expertise in addressing large projects. "BNDES does not take construction risks; they would likely be looking for completion guarantees," Deutsche said.

Given the uncertainties regarding Brazilian shipyards, such concerns are critical, although construction giants such as Odebrecht have a history of employing innovative solutions to move big projects forward.

Claus Hertel, executive director of capital markets, structured and corporate finance for Latin America at WestLB, said: "Certainly we need ECAs to plug the holes, but it's worth noting that the Brazilian banks have liquidity. They emerged from the serious crisis relatively unscathed because they didn't invest in things like CDOs [collateralised debt obligations]."

Looking ahead, Musso cautioned: "The ECAs are going to concentrate on the big guys like Petrobras and Vale; but ECA resources may not be enough - projects at smaller companies may be neglected."

Completing deals when there are constraints on available capital presents challenges. Clifford suggested developing finance as a hybrid of asset-based and cashflow structures. "If you are looking for access to the markets, you want broad appeal. You want to have both traditional ship finance bankers and project bankers looking at your deal," he said.

Hertel said that project documentation was more complex than ship finance, with reserves and escrows set up in response to oper¡ational and performance risks, such as asset price risk. He cited completion guarantees by a sponsor and over-collateralisation as part of a lengthy list of complexities, but stated that "construction risk remains paramount".

Hertel added: "The Brazilian operators have proven to be world-class. The contracts with Petrobras have been very good."

Clifford commented that project finance is flexible, which can help if a deal needs to be refinanced. "If needed, we think that deals in the sector can get restructured," he said, while Deutsch pointed to longer contract terms as an aid to reducing risk.

Bankers noted that the offshore sector has performed better than others in the shipping industry, with few major bankruptcies and few sales of companies or assets at rock-bottom prices.

Deutsch said: "We have not seen a lot of distress in the sector - maybe some one-offs." Sjurseth maintained: "We don't want to foreclose." Hertel agreed, saying: "If our clients have a shortage of liquidity, we try to work with them towards getting assets to where they generate cash. The last choice is to repossess the rigs."

Sjurseth asked rhetorically: "If this is the worst crisis of the last 80 years, where are all the bankruptcies?" In answering his own question, Sjurseth suggested two possibilities: "Either we have not yet seen the worst, or the banks are quietly doing deals, working in the background with their clients."

Peter Metzner, representing San Francisco-based equipment leasing specialist Cypress Financial, noted that identifying alternatives to scarce and costly bank debt has taken on new importance. "Our equity can complement that of existing investors," he said. Metzner noted that Cypress Financial, which has invested USD800 million through a retail broker network, has purchased assets through a pool of 26 funds.

He described numerous "opportunities to arrange structured equity transactions", as a pool of new asset sellers, including hedge funds and private investors, seeks to monetise positions and rebalance portfolios.

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