Janes: Protecting the Downside

Summer holidays did not come to the drybulk shipping markets, as listed companies were announcing one blockbuster deal after another. So, the turmoil in the asset backed credit markets seems not to have impacted the availability and pricing of secured shipping finance. In an environment where most vessel purchases are tied to forward chartering commitments, one deal in particular, for Nasdaq listed Eagle Bulk Shipping ("EGLE") shows a very creative approach to handling counterparty risk.

During July, **Genco Shipping & Trading**, listed on the NYSE ("GNK"), announced that it would be acquiring nine Capesize newbuildings (wth seven yet to be delivered) from Swiss owner Theodore Angelopoulos (Metrostar Management). Four of the units, two of which are now on the water, have already been fixed on timecharters.

The Genco financing strategy includes a new 10 year US 1.4 billion revolving credit facility, with lender DnB NOR- serving as Lead Arranger, Book Runner and Administrative Agent. DnB has had a relationship with GKN, participating, along with along with Nordea and Citibank, in previous lending. Borrowings under the new loan will be priced at LIBOR plus 0.80% through the fifth year, and, thereafter, at an 0.85% margin. Genco's stated dividend policy of paying out all available cash, less appropriate reserves, remains unchanged.

The abundance of caution surrounding GKN's financial dealings can be seen from its management of interest rate risk. In addition to the notional US 406 million of interest rate swaps between GKN and counterparty DNB, the two parties entered into two new swaps, commencing March, 2008 with four year tenor and an aggregate notional value of US 150 million. The rates are effectively fixed at just over 5 percent, plus the applicable margin, or roughly 5.8% all in on US 150 million that will be drawn under the new facility.

Within a week of the Genco announcement , EGLE announced that it would be acquiring 26 Supramax drybulker newbuildings put on order by privately held Greek owner, Anemi. **Eagle** said that 21 of the vessels, set to deliver during 2008- 2012, would be fixed out on long period charters. The lengthiest deals will extend out to 2018; many of the charters will have a floor rate with upside profit sharing. Eagle said that it would be entering into a new $1.6 Billion 10 year revolving credit, to be led by its long-time banker Royal Bank of Scotland (RBS), replacing the present US $500 Million facility with RBS (at 0.75% - 0.80% depending on loan/value calculations).

Eagle's CEO, **Sophocles Zoullas**, is a financial markets veteran. In his remarks to equity analysts after the 26 vessel acquisition was announced, he stressed that Eagle would be looking to use a "portfolio approach" in managing charter lengths, but he indicated an interest in medium to longer term contracts. Zoullas stressed the company's comfort with profit sharing revenue determination (a device borrowed from the tanker business, where such arrangements are common), where the known revenue provides significant accretive cash flow and is sufficient to pay down debt tied to the new vessels. By way of comparison, the longest commitments in Genco's roster of charter contracts on its newly acquired vessels extend out four years from their dates of delivery- shorter than the tenor on its debt.

In its announcement to the marketplace regarding its acquisition deal, CEO Zoullas also revealed that Eagle was protecting its existing revenues, through 2010, with a unique form of credit insurance- an indemnity policy against loss of hire due to a charterer default. With its revenues secured, Eagle said that it would moving toward a stable $0.50/ quarter target dividend, in line with recent quarterly distributions.

Janes interviewed Thomas Brown, CEO of UK based Seacurus, a UK based marine credit sepecialist insurance broker that packaged Eagle's policy, branded "CharterSeacure". Brown explained that the policy was placed with one of the World's largest credit insurers, rated A by Standard & Poors (S & P) and A2 by Moodys - through the intervention of the London office of placing broker "Arthur J Gallagher" (NYSE symbol "AJG"). Seacurus acted in the capacity of a broker- with exclusivity on the CharterSeacure wording.

By way of comparison with a much different type of protection, the "monoline insurers" increasingly perform the function of a financial guarantor in asset finance and structured transactions. One such provider, XL Capital Assurance, played a pivotal role in the BNP Paribas "Vega" securitized containership transaction, in Feb. 2006. In the US 810 Million financing for "Vega", a special purpose issuer, for up to 12 container vessels (1700 TEU to 5100 TEU), to be operated by CMA-CGM, the funding was broken out into three components. These consisted of a "Class A" Note, a syndicated bank loan ("Class B", not rated), and a subordinated "Class C" note issue (purchased from "Vega" by CMA CGM). The US 253.7 million of 5.562% Class A Notes maturing in Feb. 2018, with the XL credit enhancement, received an "AAA" rating from S & P.

Seacurus Director Nick Maddalena told Janes: “The insurance in the Eagle transaction was bought from a dedicated credit insurance company- this is not the same as monoline coverage such as in the BNP Paribas deal with the function of a complete credit wrap. In Eagle’s case, the coverage is triggered by a credit default by a charterer.” His colleague Thomas Brown chimed in: “CharterSeacure responds to a credit default only.”

Brown added that, “CharterSeacure has no deductable. If a charterer defaults, the policy will cover the difference between the old <default> and the new <re-fixed> charter rate. The policy will also pay unpaid hire for the period of time a vessel is laid up awaiting re-fixture.” Such insurance differs greatly from “loss of hire” insurance, which generally covers physical breakdowns of the vessel- and pays out only after a deductable, typically two weeks or three weeks, has been exhausted. Brown added that a shipping bank can be named as a “loss payee” under the CharterSeacure policy, similar to more familiar insurances. Brown and Maddelena stressed that “Eagle’s was the first deal to provide fleet wide coverage and they know that their revenues are protected for three years.”

In the case of Eagle, with its current book well diversified among multiple charterers, Brown told Janes: “The underwriters will make a credit assessment on each and every charterer prior to offering terms, doing so on the basis of their market knowledge, financial reports and the assured’s prior payment experience with that charterer, if there is a prior relationship.” He said that the underwriters would review all charter terms prior to confirming terms. The CharterSeacure policy recognizes that the exact employment of vessels in Eagle’s portfolio may change during the coverage period, for example, where ships come off charterer and are re-chartered. Nick Maddelena told Janes: “Regarding subsitutions, it’s possible to have a pre-agreed list of charterers and a pre-agreed price. Provided that the shipowner is fixing a vessel with charterers on the pre-approved list, he can be confident that the insurer will approve a limit.” When asked about counterparties not on the list, Maddelena said: “If < the shipowner> chooses to fix a vessel with a charterer not on the list, the insurer may or may not approve a limit.”

Though Eagle is covering its existing fleet- with its present employment, many of the big blockbuseter deals involve forward deliveries of vessels. Credit insurance could also be applied to situations with forward delivery. According to Thomas Brown: “By paying the underwriters a commitment fee, it is possible to reserve capacity for a future date. However, such a commitment would be subject to their being no material adverse change in the credit-worthiness of the charterer.” Where new vessels come into the fleet, Brown told Janes, “There will be a new declaration. One each attachment to the policy, the insured is required to submit a completed proposlal form and sign off on a separate declaration. Terms and pricing will be indicated on per declaration basis.” According to Alan Ginsberg, EGLE’s CFO, “The cost of the premium amounts to about one and a half days’ hire per vessel per year.” Using a rough average of $25,000/day for EGLE charter revenue, this cost translates into approximately $37,500/year per vessel in EGLE’s fleet.

Another way for shipowners to protect the revenue downside, where vessels are employed predominantly in spot charters (rather than longer period time charters), is the freight derivatives marketplace. Transactions typically involve Forward Freight

Agreements (FFAs)- effectively swap contracts based on broker quotes for the daily values of standard vessels in the marketplace. Recent figures from London's Baltic Exchange suggest a 2Q 2007 dry cargo derivative market volume of 432,809 "lots" of varying maturities extend out as far as three years. With each "lot" being equal to revenues attached to one time charter day, or to 1000 tons of cargo, depending on charter terms, turnover in the dry FFA's was worth roughly US 12 – 15 billion in 2Q 2007. The majority of trades are handled Over the Counter (OTC), without intermediation other than brokerage.

Janes interviewed **Douglas Garnsey**, who runs RBS's Corporate Risk Solutions Shipping Group in London, who explained that RBS has integrated freight derivatives into the bank's overall relationships with RBS shipping clients, with his department handling interest rate, currency and commodity risk management. RBS has created the capability to "embed freight derivatives into our ship finance facilities."

Garnsey told Janes "As a matter of course, RBS puts an ISDA Master Agreement and accompanying schedule in place with all of its ship finance facilities." He said that FFA contracts are then executed under ISDA terms, falling under the same Master Agreement originally put in place for handling interest rate exposure, adding that: "…we structure our ship finance facilities such that the debt security package also secures all liabilities under the prevailing ISDA Master Agreement."

Garnsey explained to Janes that "in the current market, with extremely high asset prices, banks can often request some form of additional comfort when providing a debt facility." He went on to explain that: "In some circumstances, the bank may request that there is some form of period charter in place (with a good name) to provide certainty of cash flow during the initial two or three year period."

But in the minds of Garnsey and his team, there may be times that paper hedges are more effective than physical timecharters: "…we can and we do allow owners to transact the hedge using either a physical or a paper contract. If the facility in question is pre delivery finance, there is a period of time prior to delivery so it can be the case that a paper contract is the more flexible hedge for future charter income." The group also assists its shipping customers in building in cash flow protections using European options- for example, on widely watched composites of Baltic time charter rates.

RBS seeks to provide clients with the ability to hedge with FFA's, while not requiring it. Though clients can choose between physical and paper hedges, the time charter contracts are not "embedded"- they are assigned to RBS. But, in the paper markets, "the best way to get the 'assignment' is to be IN the contract," according to Douglas Garnsey, who distinguishes RBS's current role as a credit intermediary from that of a market-maker. In a typical scenario to protect a client's downside, RBS will buy the FFA swap contract from its ship finance customer (under the ISDA Master Agreement), and, will then cover its own position through an offset- through an FFA sold either over the counter or possibly cleared on exchange. Garnsey tells Janes, "There will be a small spread between buy and sell prices. RBS is taking on the credit risk of both sides of the transaction and the credit spread is our compensation for doing that." RBS's credit rating is staunchly investment grade- at Aa1 (Moody's) and AA (Standard & Poors).

According to the statisticians at London's Baltic Exchange, transactions cleared through LCH Clearnet (owned by a consortium of large banks and exchanges) or Imarex (tied to the Norwegian Futures and Options Exchange) account to approximately 25% of the FFA turnover. RBS's Garnsey told Janes that the mechanics of the OTC market, which does not incorporate the use of margining on a daily basis, works much more simply- "where the FFA is embedded in the debt facility, the OTC route is the cleanest. A key reason for this is that we are using the Mark to Market value of the FFA contract and bringing it into the security package. The mechanics of exchange margin calls would be difficult to embed into a finance package." He said that both OTC via a credit intermediary and cleared trading "achieve the desired end goal of reducing the credit exposure in the transaction."