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Summer boom for drybulk

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The drybulk shipping markets did not relax over the summer holidays, as listed companies announced one blockbuster deal after another. Barry Parker reports

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, demonstrates a very creative approach to handling counterparty risk.

During July, New York Stock Exchange-listed Genco Shipping and Trading announced that the company would acquire nine capesize newbuildings - with 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, bookrunner and administrative agent.

DnB has established a relationship with Genco, participating, along with Nordea and Citibank, in previous lending. Borrowings under the new loan will be priced at Libor plus 80bp through to the fifth year and, thereafter, at an 85bp margin. Genco's stated dividend policy of paying out all available cash, less appropriate reserves, remains unchanged.

The abundance of caution surrounding Genco's financial dealings can be seen in its management of interest rate risk. In addition to the notional USD406 million of interest rate swaps between Genco and counterparty DnB, the two parties entered into two new swaps, commencing in March 2008 with four-year tenors and an aggregate notional value of

USD150 million. The rates are effectively fixed at just over 5 per cent, plus the applicable margin, or roughly 5.8 per cent all-in on the USD150 million that will be drawn under the new facility.

Within a week of the Genco announcement, Eagle Bulk Shipping announced that it would acquire 26 supramax drybulker newbuildings put on order by privately held Greek owner Anemi. Eagle said that 21 of the vessels, set to deliver between 2008 and 2012, would be fixed on long-term 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 enter into a new USD1.6 billion 10-year revolving credit, to be led by its long-time banker Royal Bank of Scotland (RBS), replacing the current USD500 million facility with RBS, which priced at between 75bp and 80bp depending on loan-to-value (LTV) calculations.

Sophocles Zoullas, Eagle's chief executive officer (CEO), is a financial markets veteran. In his remarks to equity analysts after the 26-vessel acquisition was announced, he stresses that Eagle will be looking to use a "portfolio approach" in managing charter lengths, but he indicated interest in medium- to longer-term contracts.

Zoullas stresses the company's comfort with profit-sharing revenue determination - a device borrowed from the tanker business, where such arrangements are common - in which known revenue provides significant accretive cashflow 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 delivery dates - shorter than the tenor on the company's debt.

Protecting revenues

In announcing the vessel acquisition plan to the marketplace, Zoullas also revealed that Eagle was protecting its existing revenues, through to 2010, with a unique form of credit insurance: an indemnity policy against loss of hire due to a charterer default. With revenues secured, Eagle said that it would move toward a stable 50 cents per quarter target dividend, in line with recent quarterly distributions.

Jane's interviewed Thomas Brown, CEO of UK-based Seacurus, a marine credit specialist insurance broker that packaged Eagle's policy, branded CharterSeacure. Brown explains that the policy was placed with one of the world's largest credit insurers, rated A by Standard & Poors and A2 by Moody's Investors Service, through the intervention of the London office of placing broker Arthur J Gallagher. Seacurus acted in the capacity of a broker on the CharterSeacure deal.

By way of comparison, with a very different type of protection, 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 February 2006 Vega containership -securitisation.

In the USD810 million Vega deal, which covered up to 12 containerships to be operated by CMA CGM, the funding was broken out into three components: a Class A note, a Class B unrated syndicated bank loan, and a subordinated Class C note that was purchased from the Vega special-purpose vehicle by CMA CGM. The USD253.7 million of 5.562 per cent Class A notes maturing in February 2018, with the XL credit enhancement, was awarded a triple-A rating by S&P.

Nick Maddalena, a Seacurus director, tells Jane's: "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 [Vega] with the function of a complete credit wrap. In Eagle's case, the coverage is triggered by a credit default by a charterer."

Brown says: "CharterSeacure responds to a credit default only. CharterSeacure has no deductible. 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 breakdown of a vessel and pays out only after a deductible, typically two weeks or three weeks in length, has been exhausted.

Brown says that a shipping bank can be named as a loss payee under the CharterSeacure policy, similar to more familiar forms of insurance. Brown and Maddalena stress that "Eagle's was the first deal to provide fleet-wide coverage and they know that their revenues are protected for three years".

Regarding the Eagle example, with its current book well diversified among multiple charterers, Brown tells Jane's: "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 says that underwriters review all charter terms prior to confirmation.

The CharterSeacure policy recognises 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.

Maddalena tells Jane's: "Regarding substitutions, it is 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, Maddalena replies: "If the shipowner chooses to fix a vessel with a charterer not on the list, the insurer may or may not approve a limit."

Although Eagle is covering its existing fleet with its present employment, many of the big blockbuster deals involve forward deliveries of vessels. Credit insurance could also be applied to situations with forward delivery.

According to Brown: "By paying underwriters a commitment fee, it is possible to reserve capacity for a future date. However, such a commitment would be subject to there being no material adverse change in the creditworthiness of the charterer."

Where new vessels come into the fleet, Brown tells Jane's: "There will be a new declaration. Once for each attachment to the policy, the insured is required to submit a completed proposal form and sign off on a separate declaration. Terms and pricing will be indicated on a per declaration basis."

According to Alan Ginsberg, Eagle's chief financial officer: "The cost of the premium amounts to about one-and-a-half days' hire per vessel per year." Using a rough average of USD25,000 per day for Eagle charter revenue, this cost translates into approximately USD37,500 per year per vessel in Eagle's fleet.

Another way for shipowners to protect the revenue downside, where vessels are employed predominantly in spot charters rather than longer-period timecharters, is the freight derivatives market.

Transactions typically involve forward freight agreements (FFAs) that 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 extending out as far as three years. With each lot being equal to revenues attached to one timecharter day, or to 1,000 tonnes of cargo, depending on charter terms, turnover from dry-market FFAs was roughly USD12 billion to USD15 billion in 2Q 2007. The majority of trades are handled over-the-counter (OTC), without intermediation other than brokerage.

Integrated relationship

Jane's spoke with Douglas Garnsey, who manages the corporate risk solutions shipping group at RBS in London. Garnsey explains that RBS has integrated freight derivatives into the bank's overall relationships with 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 tells Jane's "As a matter of course, RBS puts an ISDA [International Swaps and Derivatives Association] master agreement and accompanying schedule in place with all of its ship finance facilities."

He says that FFA contracts are then executed under ISDA terms, falling under the same master agreement originally put in place for handling interest rate exposure. He adds: "We structure our ship finance facilities such that the debt security package also secures all liabilities under the prevailing ISDA master agreement."

Garnsey says 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 adds: "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 cashflow during the initial two- or three-year period."

But to the RBS team, there may be times that paper hedges are more effective than physical timecharters. Garnsey said: "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 cashflow protections using European options, for example, on widely watched composites of Baltic timecharter rates.

RBS seeks to provide clients with the ability to hedge with FFAs, although it is not a requirement. While clients can choose between physical and paper hedges, the timecharter 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 Garnsey, who distinguishes RBS' current role as credit intermediary from that of 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 FFA offset sold either over-the-counter or possibly cleared on exchange. Garnsey tells Jane's: "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."

According to statisticians at London's Baltic Exchange, transactions cleared through LCH Clearnet, which is owned by a consortium of large banks and exchanges, or Imarex, which is tied to the Norwegian Futures and Options Exchange, account for approximately 25 per cent of FFA turnover.

Garnsey says 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 says that an OTC via a credit intermediary and cleared trading "achieve the desired end goal of reducing the credit exposure in the transaction".