Top Tankers- Lease Buyout

In heady markets for vessels of all types, high profile sales of assets, tied to leases back, have been enriching the coffers of companies. But this year, there has been a flurry of activity moving assets in the opposite direction- from lessors back into the hands of owners. In a move announced several weeks ago in late May, listed company Top Tankers (traded on NASDAQ under the “TOPT” symbol) announced that it would be buying four “Suezmax” vessels that it had sold, and leased back, only fourteen months earlier to companies set up to a K/S company in Norway.

Between 3Q 2005 through 1Q2006, TOPT had sold a total of 18 ships to various investment partnerships that including Norwegian K/S companies, as well as four Korean entities. With its fleet consisting of 24 – 25 vessels, a handful of its vessels remained owned. In these deals, the vessels were sold at tidy profits (reflecting the strengthed asset prices at the height of the tanker boom), and were chartered back on charters varying between five and seven years, under “bareboat” leases (where the lessee operates the ships). With its cash horde, TOPT paid two hefty special dividends in Spring, 2006,, amounting to USD 7.50 /share, to holders, and also pared down outstanding bank debt.

TOPT’s vessel sales in 2005 / 2006, which brought in USD 550 million and net cash proceeds of USD 240 million, may have seemed like a good idea at the time, but the leases turned into millstones. TOPT’fortunes were dragged down by expensive per diems , at a time when revenue earning capability flat-lined with the weaker than expected tanker market. Under the leases, bareboat charter obligations of individual ship operating subsidiaries were guaranteed by the parent.

Market sources suggest that the company will be paying USD52 million per vessel and possibly more, or a reported USD208 million in the aggregate, to reacquire the ships. The vessel re-acqusitions will be financed through operating cash, a drawdown on a new bank facility, and through a refund of a 10 % sellers’ credit. Each of the four vessels had been sold to the K/S company for USD 51.6 Million in a deal arranged by Norwegian powerhouse Pareto.

Consider the tanker “Limitless”, a 1993 built Suezmax originally leased to US oil major Chevron, sold by Mytikas Shipping (a Marshall Islands owning company) to the Norwegian K/S “Partankers III” in April 2006 for USD 51.6 million , and then chartered back at the bareboat rate of USD23,450/ day, for an 84 month period. The vessel was one of five collateral vessels securing a USD 180.6 Million loan to the purchasers from Nordea Norge ASA (the fifth “Partankers III” vessel, in a Liberian company, was not reacquired by the Sellers). The “Limitless” was being traded by TOPT in the spot market, along with one sister. The other two where on time charters at USD 36,500 and USD 37,000 daily through end 2008 and end 2010 respectively.

The “Limitless” bareboat charter does not explicitly specify buyout prices. One leading organizer of Norwegian K/S companies, Ragnvald Risan, of Ness, Risan & Partners (based in Oslo) told JTF: “Many of the vessels done in the past have been bought back by the charterers. In almost all transactions we have been able to agree on a price acceptable to both parties, ie also in the transactions where we have not pre-agreed purchase option prices.” A clue to the negotiatied buyout and deal economics for the TOPT Suezmaxes comes from an unlikely place, a schedule of Minimum Insured Values contained in the charter documents. For the “Limitless”, the market talk of a buyback around USD 52.5 Million, in contrast to the USD 48 Million minimum value, gives a hint that the K/S company booked a gain of several USD Millions above the tanker’s paid down value.

Twelve-monthly Period	Minimum Insured Value (USD)
0-12	51,600,000
12-24	**48,051,000**
24-36	41,923,000
36-48	35,794,000
48-60	29,666,000
60-72	23,537,000

Source: Clause 45.2, “Limitless” bareboat charter

Anecdotally, it’s cheaper to own than charter in. A recent presentation encompassing 4Q 2006 vessel costings at OMI Corporation (whose Suezmax fleet will be soon be absorbed into Teekay Corporation) provides useful perspective on TOPT’s financing costs and shows the cost advantages of owning, versus non tax driven leasing. OMI calculated the daily breakeven per diem on its owned Suezmaxes, mainly acquired in 2004 from Greek owners, is calculated to be USD 15,500/ day (with a financing component of only USD 6,500 daily, USD 4,800/ day interest and USD 1,700 principal, balloon assumptions not specified in the presentation). Data from consultants Drewry Shipping suggests that such vessels, only a year or two old in some cases, would have been worth USD 60 million individually, when acquired.

TOPT is not the only player with expensive charterered in tankers. OMI, the company acquired by Teekay/ Torm for USD 2.2 billion, revealed that its chartered in Suezmaxes were breaking even of USD 31,100/daily- including time charter hire of USD 28,500/ day. Assuming that operating expenses (included in the time charter hire) were running at USD 6,000 daily, the financing component (bareboat equivalent) of USD 22,500 falls out- not very different from TOPT’s bareboat rates.

The buyback decision is not unrelated to the market context. The fifth Suezmax vessel, staying in the Norwegian K/S, is chartered out at a healthier USD 44,500 daily- until late 2008. Spot rates are around USD 30,000 equivalent; forward rates in the paper market for 2009 and 2010 equate to USD 32,400 and USD 34,900 daily on the bellwether West Africa/ Philadelphia voyage.

TOPT's stock had taken a battering as it ran into problems with its accounting for "10% sellers credit" in the 2006 sale/ leasebacK/S; the credit effectively played the role of a security deposit. TOPT re-stated its gains to reflect the deferral of the entire 10% credit until lease termination, rather than including it within the gain on the sale of the vessels, approximately USD90 Million- largely amortized over the respective lease terms (except for USD12.7 million booked in 2006). During 2006, TOPT's operating expenses were reduced by USD8.1 million as the deferred part of the gain was amortized (reflecting the restatement). The stock is now recovering.

In explaining its rationale for buying back the four vessels from the K/S company (in addition to a fifth charter termination- on a bareboat in-charter in where the lessor is selling the ship), TOPT's CEO hinted at the underlying conflicts between leasing and owning. These tensions are now driving the efforts to reduce daily costs, and increase earnings. In explaining how unwinding the five leases would benefit the company, going forward, CEO Evangelos Pistiolis pointed to several counteracting factors that, when netted out, would be accretive to earnings:

Accretion Factors	DIRECTION and (Earnings Impact)	USD Impact 2007 Earnings	USD Impact 2008-2013 Earnings
Lease payments	Reduced (+)	+$22.5 Million	+$38.5 Million
Amortization of lease gain	Reduced (-)	-$1.6 Million	-$3.1 Million
Depreciation	Increased (-)	-$9.1 Million	-$15.6 Million
Interest Expense on debt	Increased (-)	-$5.3 Million	-$7.1 Million
TOTAL Earnings	(+)	+$6.5 Million	+$12.7 Million
TOTAL Cash	(+)	+$17.2 Million	+$31.4 Million

Source: company press release dated May 29, 2007, and bdp1 Consulting Ltd

One transportation accounting expert with close ties to shipping companies told JTF: "A significant incentive for a ship operator to lease a ship is to obtain more favorable finance costs by passing on the tax depreciation to an 'owner' that can use them. Many shipping companies are in tax situations where no benefit is obtained from depreciation." In early June, 2007, a consensus of Wall Street analysts were viewing TOPT as likely to earn only USD 0.05/ share during calendar 2007, and could lose money during 2008, suggesting that TOPT would not benefit from the tax shield. Financiers assembling tax driven leases of short durations might look in the direction of the four Suezmaxes.

Even strong transport credits buy equipment out of leases, using bank lines. Earlier this year, NYSE listed Kirby Corporation (symbol "KEX") bought 58 inland waterway tank barges out of leases with two entities, Coastal Towing (bringing 37 barges, in a stock acquistion priced at USD 19.3 Million) and Cypress Leasing (21 barges, priced at just under USD 15 Million). Kirby, with an investment grade rating (Standard & Poors "BBB+"), sourced the USD34.3 Million through its unsecured USD 250 Million revolving credit facility that Kirby has in place with a syndicate of banK/S with JP Morgan Chase as Administrator (with further participation by Wells Fargo, Bank of America and several others). The facility is priced on a grid as a function of Kirby's credit rating; with its BBB+ rating from S & P (and Fitch), the margin is 30 bp (net of a 10 bp utilization fee). Prior to a spate of equipment acquisitions in 2006, the USD 250 Million credit was increased from USD 150 Million; language is in place to expand it to USD 325 Million, subject to participants' agreement.

The 15 barges bought from Cypress had been on lease since 1994- when Kirby bought out the barge fleet of Dow Chemical/ Union Carbide. Kirby has grown its balance sheet (with assets, principally tank barges and towboats, totally nearly USD 1.4 Billion at 1Q 2007) what it describes as "the successful integration of 26 marine acquisitions." The Coastal units had been under Kirby management since 2002.

Kirby, with a large institutional following and a conservative chartering policy- 75% of equipment on term contracts, is highly profitable. Its CEO, Joe Pyne, explained that "Kirby always prefers to own rather than lease whenever possible due to the tax advantages of ownership. We anticipate the two purchases will be slightly accretive to 2007 earnings per share." Pyne added: "EBITDA from these purchases for 2007 is projected at approximately USD11 million." By comparison, Kirby's EBITDA in 2006 was USD154 Million (more than 10 x its interest expense).

Another early 2007 buyback saw Tsakos Energy Navigation (NYSE "TEN") exercise a pre agreed purchase option in late 2006 on the Aframax tanker "Olympia", which had been sold to a German KG in 1999. The buyback, at USD 31 Million, was well below the vessel's market value, which the company pegged at USD 60 Million. Tsakos Energy will continue to operate the ship. Such a practice is also seen in Norwegian deals.

Though financiers such as K/S expert Ragnvald Risan strive to find middle ground, the tricky nature of pre agreed fixed price buyouts becomes most apparent where the advantage shifts strongly to the buyer (or the seller), if market dynamics have shifted. In the drybulk market, Navios Maritime transformed from an operator to an owner partly on the back of "in the money purchase options". The exercise of call options was an expressly stated likely use of funding for proceeds of the recent D'Amico IPO on the Milan bourse.

Danaos Corporation, an owner and lessor specializing in large containerships, recently delivered the "APL England" (5500 TEU) to APL- a unit of Neptune Orient Lines, for a price of USD 44.5 million (incurring a USD 0.2 million loss), and will be delivering two sisters, each at USD 44 million, over the next few months. The charterer holds call options on a fourth vessel, also priced at USD 44 million in Jan. 2008, and USD 39 Million two years later- in Jan. 2010. In talking about this last vessel, Danaos says:

"Although when negotiated the option exercise prices with respect to this vessel reflected market prices at the time the options become exercisable, which approximated the vessel's book value net of depreciation, we currently estimate that the $44.0 million and $39.0 million option exercise prices will be **below** the fair market value of the vessel."

In case where fixed price purchase options exist, shipping companies are able to buy out of leases, and the resell the assets at market prices. In early June, Golden Ocean Group, agreed to pay USD 11 million each, presumably per an existing arrangement, to acquire two early 1990's built Panamax bulk vessels taken under bareboat charters. In line with its business strategy of using sales proceeds to invest in fleet modernization, Golden Ocean simultaneously announced plans to sell the vessels on, for "net sale proceeds of USD 60 million in total," values consistent with estimates by ClarK/Sons Shipping Research- which pegged the prices for early 1990's Panamaxes at USD 36.5 million and strengthening. This transaction is a reminder of the hidden value contained in deals negotiated before a major market turn.

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The four suezmax tankers are Limitless (DWT 136,055 built 1993), Endless (DWT 135,915 built 1992), Noiseless (DWT 149,554 built 1992) and Stainless (DWT 149,599 built 1992).

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