Cruise control: investors celebrate consolidation

Takeovers and acquisition of huge ships in the cruise sector are keeping bankers busy. RCCL's latest mega-deal leads the way. **Barry Parker** *reports*

Capital intensity and cruise shipping have long been synonymous, as giant behemoths carrying 3,500 passengers can easily be priced in the USD800 million to USD900 million range, vastly exceeding that for other commercial shipping assets.

Over the past decade, the three giants of the cruise sector — Carnival Corporation, Royal Caribbean Cruises Ltd (RCCL) and Malaysia-based Star Cruises — have also grown bigger, consolidating their positions through acquisitions of smaller players or gaining greater market share as traditional shipping players shed their leisure assets. Carnival's growth has included the Cunard Line and Princess Cruises acquisitions from P&O, while RCCL acquired Celebrity Cruises from tanker giant Overseas Shipholding Group (OSG) and partner Chandris Lines.

Financial resources

The continuing consolidation trend requires financial resources to affect these acquisitions. In mid-January, Miami-based RCCL completed a European roadshow to promote its EUR1 billion (USD1.3 billion) offering of seven-year senior notes. The notes, which carry a 5.625 per cent coupon, were issued in January priced at 99.638.

At the end of January, 10 days after pricing, the bonds were trading at between 99.9605 and 101.1485, working back to a yield of 5.63 per cent to 5.60 per cent. The privately placed RCCL bonds, issued only two months after rival Carnival Corporation's EUR750 million issue in November 2006, were priced at the low end of the 145bp to 150bp anticipated range over the midswap curve (the average of bids and offers) for comparable seven-year maturities. Goldman Sachs International, Citigroup, JP Morgan and Morgan Stanley were the underwriters leading placement of these unsecured and unsubordinated instruments.

RCCL is rated BBB- by Standard & Poor's (S&P) and Ba1 by Moody's — at the top of sub-investment grade. Those ratings contrast with the well-below investment grade ratings of high-yield debt issued by US Shipping Partners, Britannia Bulk and Navios Holdings last year. Investors were clearly enthusiastic, as RCCL upped the size of the offering from the EUR500 million initially proposed. Brian Rice, RCCL chief financial officer, told *Jane's*: "We are very pleased with our eurobond offering and the interest shown in our company and our future."

The investor enthusiasm bubbling through the bond markets is not surprising. At a recent S&P seminar, New York University Professor Edward Altman, inventor of the Z-score model for predicting bankruptcies, said: "We are in a period that is very attractive to debt investors; this is one of the most uniquely benign and forgiving credit markets over the last 25 years." Altman also noted low default rates and high recovery rates in bond markets, adding that "a company's optimal rating, in overall terms to shareholders, may be BBB/BBB-". Another speaker, Jim Grant, of *Grant's Interest Rate Observer*, offered that "leverage is fabulous now", and commented that bond spreads are narrow in historical terms.

Proceeds of RCCL's massive oversubscribed eurobond offering are earmarked for repayment of a bridge loan used to finance RCCL's November 2006 acquisition of Spanish regional cruise specialist Pullmantur, valued at USD430 million, and repayment of roughly EUR270 million of Pullmantur debt. RCCL drew down the bridge loan to fund its purchase. Rating agency Moody's said that it considers the new note issuance to be a credit positive because "it reduces RCCL's near-term debt maturity requirements. Additionally, the size of the note issuance is large enough to materially boost RCCL's projected 12-month liquidity cushion…". Regarding timing of the bond offering, Greg Johnson, who handles investor relations at RCCL, told *Jane's*: "It is coincidental that we came to market only a few months after Carnival Corporation. We might not have done what we did without Pullmantur."

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>
> **Professor Edward Altman,** New York University

Construction costs

RCCL's capital requirements to fund construction are still enormous, pegged by S&P at: USD1.3 billion in 2007; USD1.8 billion in 2008; and USD2 billion in 2009. The comparable number for 2006, when the new *Freedom of the Seas* vessel was delivered, stood at USD1.2 billion. A company regulatory filing suggests potential year 2010 expenditures of USD1 billion.

Using consolidated financials, RCCL's USD12.2 billion balance sheet — with nearly USD11 billion of existing property/equipment, net of depreciation on the asset side, including the first Freedom-class ship — included at the end of the third quarter of 2006 long-term debt of just under USD4.2 billion, and a current portion of USD300 million. Reflecting its transformation into a global brand, the euro-based offering joins a roster of debt issues that includes: USD900 million of unsecured dollar-denominated bonds issued in 2006, comprising a USD550 million issue carrying a seven per cent coupon with a 2013 maturity, and a USD350 million issue carrying a 7.25 per cent coupon due in 2016. Additionally, RCCL has borrowings under a USD570 million term loan and a USD1 billion revolving credit facility, with USD800 million available. Those facilities were led by joint lead arrangers Salomon Smith Barney and Nordea as well as DnB. The revolver, originally for

USD500 million, was upped to USD1 billion in late 2004, and amended in 2005 to expire in 2010 rather than 2008. Pricing was also amended to Libor plus 100bp, down from 175bp. One vessel, *Brilliance of the Seas*, is financed through an operating lease with UK-based Halifax Leasing.

The November 2006 Pullmantur bridge loan, for up to EUR700 million, with a term of up to one year from closing and tied to the euribor rate, was led by Citibank North America, with equal participation by affiliates of the same quartet tapped to underwrite the eurobond: companies within Citibank, Goldman, JP Morgan and Morgan Stanley. The facility margin is tied to RCCL's credit rating; based on BBB-, it would be set at 0.625 per cent. Covenants include prohibitions against net debt-to-capitalisation being more than 0.625 to 1, fixed charge coverage ratio — defined as cashflow divided by dividends, including dividends on preferred stock — and principal payments being less than 1.25 to 1. Covenants also require RCCL's net equity to be at least USD4.15 billion plus 50 per cent of net income during 2006. The unsecured bridge facility contains numerous negative pledges against additional liens on assets.

Unlike industrial shipping enterprises, for example in the liquified natural gas (LNG) sector where financing may be tied to inflows from long-term charter contracts, a cruise ship business depends on a combination of good economic conditions and high disposable income in developed countries, along with many ephemeral factors. So, estimates by trade group Cruise Lines International Association for continued passenger growth in 2007 have not been lost on investors. Nor did the precipitous decline in oil prices in late 2006 go unnoticed by investors. Unlike industrial shipping, where fuel price risk is transferred to lessees under most timecharters or where a dollar/tonne bulk charter or dollar/teu box contract may have a bunker surcharge provision, cruise companies must build the fuel component into their pricing. RCCL said that 40 per cent of 2007 fuel requirements have been hedged.

Market trend

Other industry watchers have noted a continuing market-wide trend away from A ratings into the B area, with BBB- at the bottom of the investment-grade region. Indeed, it has been suggested that companies may manage their balance sheets, where possible, to maintain a credit rating around the 'optimal' BBB/BBB- levels, perhaps offering a partial backdrop to RCCL's attaining the distinctions of both 'rising star' and 'fallen angel' during 2006 in lists compiled by S&P. In January 2006, RCCL's rating was raised one notch upward from BB. But in late August 2006, 'negative implications' were added amidst waning consumer confidence and after fuel prices had reached historic highs.

Similarly, Moody's had pushed RCCL's speculative grade liquidity (SGL) rating one notch downward in late 2006 as the rating agency noted mounting debt maturities for 2007. This has now been reversed, with a move up to SGL-2. S&P described RCCL's liquidity position as "solid" but continues to express concern about the integration of Pullmantur — which will involve juggling some vessels with the Celebrity brand — and the huge shipbuilding overhang. S&P was also closely monitoring the all-important ratio of EBITDA-to-overall-debt, adjusted for operating leases and obligations for port facilities, currently in the low- to mid-4x "but expected to trend below 4x during 2007". For RCCL, the choice of the eurobond market was predicated on Pullmantur's underlying cashflows. According to RCCL's Johnson: "We bought a company that operates in the European market, and its revenues are denominated in euros. Matching cashflows provides an element of stability."

Stability of a different form — that of company ownership — has been important to financial markets. Although exchange-listed, a significant minority of ownership in RCCL still rests in the hands of three founding families: the Pritzkers, who are also active in real estate and hotels and have owned stakes in vessels through the years; the Ofers, also owners of the private Zodiac Maritime and leading investors in Zim Lines along with the Israeli government; and the Wilhelmsens, Norwegian shipping magnates currently very active in the offshore energy service area.

An important feature of RCCL's bond, as well as the late 2006 Carnival issue, was a clause restricting a change in control. Typically, such language allows a bondholder to sell his investment back to the issuer were a leveraged acquisition to occur — in the case of RCCL, at a price 101 per cent of the principal value under this repo feature. Although Carnival, boasting a balance sheet of USD28.4 billion and a market capitalisation of approximately USD28.4 billion, would almost certainly be too large to be digested in a private equity deal, RCCL's valuation of USD9.45 billion is a stretch, but not outside the realm of possibility for buyout funds. The RCCL bond also limits the amount of secured debt that can be incurred, as does the bridge loan that has now been taken out.

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High-yield issues

Although the RCCL eurobond and the recent euro issue from Carnival dwarf the smattering of high-yield shipping issues during the second half of 2006, some observers have predicted a return of shipping companies to the bond trough in capital markets that can only be described as awash with money. Insiders note the dramatic impact of hedge funds coming into the financial markets as lenders that are integrally involved in structuring transactions. The activities of these funds are increasingly indistinguishable from those tagged as private equity, and have great similarities to the proprietary trading activities fuelling profits at Wall Street firms. The case of RCCL highlights the continuity of the financial solution, beginning with the Pullmantur acquisition in 2006 through to the recent eurobond deal.

Consider that Goldman Sachs Credit Partners LP, an investment partnership providing funds to support buyouts, played an important role in the RCCL bridge loan, acting alongside Citibank. Not surprisingly, the Goldman Sachs entity is no stranger to the transportation markets, having funded the restructuring of oil refiner Tesoro — which had considerable marine activities around the US Gulf — in 2003, and the 2005 acquisition of naval shipyard UDI by a US subsidiary of UK defence contractor BAE Systems. The partnership is also providing debt in a private equity-backed management buyout of US-based freight forwarder and logistics provider EGL. ■

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