shipping feature

Adding up value: what are investors willing to pay?

Company valuation is both a science and an art, so the real test of beauty may be in the eyes of beholders. Barry Parker *reports*

The financial strategy of Norwegian owner Frontline has advanced far beyond rewarding investors through distributions tied to the earnings of its tankers, following the axiom that the sum of the parts is worth more than the whole when a company is broken up.

Shareholders have gained value as Frontline has spun off a financial holding company and a drybulk shipholder. Frontline has also launched a floating production, storage and offloading (FPSO) operation. Now Frontline is carving out a niche in a new market — the 'heavy-lift' sector, where vessels with flat decks and submerging capabilities transport oil rigs and modules for far-flung projects, usually for oil or minerals exploration and production (E&P). The move into the FPSO and heavy-lift sectors comes two years after Frontline gained control of driller Seadrill and listed the company in Oslo.

Energy company E&P budgets have ballooned with the price of oil in recent years, meaning rigs need to be moved around. Among investors, energy investments command a premium over shipping. Later in the decade, hundreds of single-hulled oil tankers will come up against mandatory phase-out rules enacted by the International Maritime Organisation (IMO). In anticipation, shipowners have sought other uses for these assets. Conversions to FPSOs for use in offshore oil production have provided one opportunity. Now heavy-lift conversions have joined the list of alternative uses.

Functional shift

A soon to be phased-out tanker purchased on the cheap is worth far more — even after conversion costs — as an integral link in an energy supply chain. Where Teekay Shipping has swallowed up entire players in the offshore sector, Frontline's approach has been to develop selected businesses, and, when self-sustaining, spin them out.

Teekay Offshore Partners, a master limited partnership (MLP), was spawned with similar considerations in mind. Like Frontline, Teekay's mentality has been to transform from being a traditional shipowner to an asset manager, with fee and charter revenue earned from operating assets owned by others.

In addition to the higher multiples and equity valuation afforded tax-efficient partnership structures, an asset manager, also known as a general partner, receives fees and earns arbitrage profits. Urs Dur, an analyst at Lazard Capital Markets, points out in a recent report that, in spite of the theoretical appeal of valuation based on the sum of its parts, Teekay's fortunes are still heavily dependent on the traditional tanker market.

At Frontline, the expanded multiples of EV (enterprise value)/EBITDA, in the energy sector — compared to shipping — imbue the spinouts with potential to create value for investors. The propensity for project-type financings in energy production, where finance is tied to flows from a project — and will not tie up Frontline's borrowing resources — is particularly suited to its fledgling FPSO business. Indeed, last autumn, as reported in *Jane's*, Sevan Marine, a Norwegian innovator in the FPSO market, was able to raise USD120 million of limited recourse project finance through GE Capital and ANZ Investment Bank to take out secured bond debt raised in the Norwegian market.

Frontline itself, although mainly an operator of vessels, has a book value in excess of USD700 million and a market capitalisation of USD2.5 billion. In addition to its quarterly dividends — most recently USD2.50 per share that reflected a strong third quarter (Q3) of 2006 — Frontline has also enriched shareholders by dividending shares in spun-off and de-merged companies.

After gaining a reputation as a fierce consolidator, Frontline's first carve-up was accomplished in 2001 when Golar LNG was formed. In late 2003 and early 2004, Frontline created Ship Finance Ltd (SFL), a financial holding company that bought 47 oil carriers from Frontline and chartered them back. Frontline shareholders were rewarded with 25 per cent of the equity in the new entity.

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Fluid assets

Now nearly 89 per cent of SFL, a New York Stock Exchange-listed USD1.7 billion entity (based on market value), has been placed in the hands of Frontline shareholders since the first partial spin-off in June 2004. Shipping magnate John Frederiksen maintains a 37.58 per cent position in SFL through his Hemen Holdings. Shipping companies lamenting an uninspiring share-price-to-net-asset-value ratio should remember Frontline's solution: move assets elsewhere. In Frontline's case, the assets were moved to SFL and leased back.

In late 2004, Frontline span-off steel-manufacturing raw materials specialist Golden Ocean — meanwhile retaining a significant stake — which had a market capitalisation of USD131 million at the end of Q3 2006. Golden Ocean has recently created value by acquiring capesize newbuild contracts for ships being constructed in South Korea. Golden Ocean sold the contracts at a profit to SFL and will charter the vessels back over 15 years, supported for the first five years through charters in the market by Goldbeam/Jinhui, commencing on delivery in 2008–09.

Coal and iron ore, often moving in contracts, are a suitable base for securing freight contracts that buttress a yield-type shipping business with higher multiples. Industrial shipping specialist Navios, which is moving to the New York Stock Exchange, has announced its USD161 million purchase of privately held Belgian owner and operator Kleimar, a company active in the capesize and panamax sectors. Of the purchase price, USD85 million will be drawn from a revolving credit facility with HSH Nordbank and Commerzbank.

In terms of liquid energy, Frontline's FPSO activity will be handled by SeaProduction, a company still organising its finances. Its first asset will be the FPSO *Front Puffin* — a single-hulled post-aframax vessel purchased by Frontline in 2006 and currently being converted at Singapore's Keppel Shipyard. The FPSO is due to be delivered in mid-2007 into a contract with Australian E&P company AED Oil at the Puffin Field in northwest Australia. SeaProduction has agreed to acquire both the vessel and the organisation for USD210 million, with USD150 million allocated to the actual FPSO unit.

In early February, the new company announced it has succeeded in capitalising the entity by completing a USD180 million private placement through Pareto Securities, SEB and Nordic rising star Glitnir Securities. Keppel Shipyard has garnered five per cent of the new equity and Frontline has 28 per cent.

Frontline has announced discussions with Frederiksen-controlled Seatankers regarding the disposition of two aframax vessels suitable for FPSO conversion. The vessels were acquired for an estimated USD18 million each.

SeaProduction announced the USD90 million acquisition of FPSO *Crystal Ocean* from Seadrill — another Frederiksen family entity — which has grown through the acquisition of assets from Smedvig, Mosvold and others, after termination of a contract on the Indian coast. Market rumblings have Seadrill, linked last year to a USD1.2 billion bridge loan with Nordea and DnB in connection with the Smedvig acquisition, looking at a loan facility as large as NOK50 billion (USD8.1 billion) with the same banks as well as Danish and German banks.

Cheap conversion

SeaProduction will raise finance through the private placement market, a small amount of sellers' credit and an upcoming USD130 million bond placement on the Oslo Alternative Bond Market (ABM). Equity will be listed on the Norwegian OTC market. Dayrates for FPSOs can easily exceed USD100,000; recent research by Pareto Securities suggests that the ratio of EV/EBITDA on recently awarded FPSO contracts — with equity and debt reflecting the low cost of a vessel conversion — worked backwards to 4.7x.

But businesses with contracts in place take on higher numbers. Pareto evaluated 2007 estimated EV/EBITDA ratios for six firms at an average of 14.9x — nearly double the ratio for most tanker companies. Single-hull tankers are worth more as FPSOs — and FPSO start-ups can be attractive as they appreciate in value. An early trading discount compared to more established players may disappear as investors gain confidence.

The heavy-lift arena is also part of the energy production chain. In mid-January, Sealift Ltd, Frontline's heavy-lift unit, said it had raised USD180 million in a heavily oversubscribed private equity placement from Scandinavian investors, including USD60 million from Frontline. Sealift also plans to raise USD110 million on the ABM.

By mid-2008, Sealift will have six heavy-lift vessels under its control. Four single-hulled suezmax tankers are currently owned by SFL. Four vessels are on charters to Frontline while another is undergoing conversion after being damaged in an explosion in June 2006. Two additional vessel acquisitions from Frontline are in progress, costing USD38 million each, with conversion cost pegged at USD40 million to USD45 million per vessel. Frontline will have complete responsibility for the conversions and is providing a seller's credit to the entity as part of its financing package, with repayment timing tied to completion of the work. Sealift has hired a team of Dutch heavy-lift veterans to manage the units, which are each worth nearly USD100 million at completion.

The deals include a significant 'related party' component. SFL will sell the vessels to Frontline for gross proceeds of nearly USD184 million, of which SFL will kick back USD62 million to Frontline as reimbursement for charter termination. Delivery is expected during Q1 2007. After netting out USD14.2 million of outstanding bank debt on the vessels, SFL coffers will swell by almost USD107 million, with SFL intending to invest proceeds in new project equity.

SFL and Frontline calculations concerning replacement of chartered-in tonnage under changed market circumstances are not detailed in public documents. For perspective on the economics of charter terminations, the arrangement with respect to the recent USD38 million sale by SFL of the 1989-built *Front Transporter*, which is similar to the vessels going to Sealift, is revealing.

In this one-off deal, SFL will pay USD15.4 million to Frontline as compensation for early charter termination. Frontline would have chartered the single-hull suezmax, once it reached 18 years of age, for a daily rate of USD15,348, decreasing to USD7,500 a day beyond 2010.

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Discounting to the present with a simplifying assumption of comparable cost structures between early 1990s and modern suezmaxes, implied charter cost over a seven-year period works back to the low USD20,000s per day.

Discount trading

The fine print in Frontline's charters with SFL provide the charterer with the option to terminate deals on single-hull suezmaxes after year 2010. Over a four-year term, assuming termination at the end of 2010, implied charter rates from the USD15.4 million deal discount back to the upper USD20,000s per day. Broker sources suggest that modern replacement tonnage in the charter market would be in the region of USD38,000 to USD40,000 per day for a three-year charter; intuitively, a replacement over seven years, assuming a 25-year economic life for a ship, would see a much lower hire rate. The Frontline/SFL charter termination appears conservative with respect to hire assumptions.

Capital costs for construction and day rates earned in the market are lower for heavy-lift vessels than for FPSOs. With the daily hires in the USD40,000 to USD60,000 range that is to be expected. Analysts working on a comparable deal have estimated an all-important EV/EBITDA start-up value to be about 4.5x to 6.5x, depending on day rates. Although fewer heavy-lift comparables exist, the universe of higher energy services ratios provides a benchmark of the potential for higher valuations, exceeding those of scrapping a phased-out vessel in 2010.

The sector offers considerable price elasticity in which 'mobilisation costs' are small in relation to the overall transaction. Consider, for example, a recent multi-year deal that could be worth up to USD580 million for the 2008 delivery of Seadrill ultra-deepwater rig *West Hercules* to a field off the Chinese coast at a day rate that works back to USD510,000.

With such room to raise prices — and numerous rigs to move — Sealift's promoters would look for the valuation multiple to expand as market capitalisation booms outward and transmutation takes hold. ■

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