Secondary Shares Article

James Christodoulou, the Chief Financial Officer of Oceanfreight Inc. (NASDAQ symbol “OCNF”), which launched its IPO in late April, 2007, told Lloyds Shipping Economist (LSE), "we have created a company that has a different relationship with the capital markets than many other companies. Our relationship is constant, dynamic and mutual. Rather than sit on big cash balances waiting to be deployed which we feel is inefficient, we reward our shareholders with immediate and hopefully growing dividends with the understanding that when we need additional equity to continue to grow that the capital markets will be there to support us.”

Christodoulou, who had prior high level experience on both the company side and the analyst sector, continued: “The markets would not have supported this type of relationship in the past. But as their commitment in the sector and knowledge about the sector continues to increase we feel that our business model is the most efficient use of capital for the Company and the investors."

The newly emerging paradigm, fueled by the combination of investor familiarity and comfort with the shipping industry, alluded to by Mr. Christodoulou, and good performance (where earnings rises more than counteract the dilutive impact of issuing additional shares) has certainly led to marked changes in the money raising environment over the past years. This phenomena was evidenced by the 3Q 2007, which saw a raft of secondary equity offerings.

Financial historians would find a precursor for this type of relationship with the markets in the Master Limited Partnerships (MLPs), exchange traded entities structured to pay out maximum amounts of available cash to partners, who hold “units” rather than shares. Though a handful of shipping MLP’s are trading, the preponderance of the MLP universe are pipeline operators- some with interests in maritime terminals. The first shipping MLP in U.S. markets was Maritrans Partners LP, formed in 1987 (after tax law changes expanded the definition of assets qualified for MLP treatment to include oil products transportation). After lackluster performance in the markets, the partnership was converted into a corporation in 1993- the same entity that was acquired by Overseas Shipholding Group in 2006. MLP’s are starkly efficient- they keep minimal reserves, and often “warehouse” vessels under construction which are dropped into MLPs when they are actually delivered.

“OCNF” is too new to have put its philosophy into practice. But, it is fitting that an actual MLP provides the most recent example of the new relationship of shipping companies with capital markets. K-Sea Transportation L.P. , a U.S. MLP operating barges and tugboats working in the U.S. coastal trades, had grown organically (meaning increasing earnings through growth in its existing business) and through acquisitions of equipment and mid-sized towing companies- with its largest deal prior to Summer, 2007 worth US $81 Million.

Historically, acquisitions had been financed through a combination of operating cash flows and draw downs on a revolving credit facility that lenders had expanded three times since its inception. EBITDA, projected for the year 2007 at US $90.6 Million, grew  from US $ 32.5 Million three years earlier. Following its January, 2004 IPO, it has now returned to the equity markets.

In August, 2007, K-Sea turned far more aggressive on the acquisition front, acquiring two entities, owning 11 tank barges and 14 tugboats, in the U.S. Pacific States (including Alaska and Hawaii) for US $203 Million. At around the same time, K-Sea entered into a contract for a newbuilding articulated tug barge (ATB), with 2009 delivery, for a price estimated to be between $68 and $70 Million. K-Sea has ten tank-barges under construction (deliveries 1Q 2008 thru 2 Q 2011), worth US $100 Million- with US $13 Million advanced through mid 2007.

K-Sea's US $430 Million balance sheet (at mid 2007) was already moderately leveraged, with equity of US $153 Million. Funded debt (including US $97 Million loan drawdowns) of roughly US $245 Million- vastly exceeded 2006 EBITDA of US $50.5 Million (and the US $64.2 Million of EBITDA projected before the 2007 acquisitions were factored in). When future capital needs were considered, it was clear that K-Sea would need to again raise additional equity. This would not be the first time for such an exercise. K-Sea had already been back, on a limited basis in 2005 (with the sale of an aggregate 1.45 million units, in two different raises).

To fund the new 2007 acquisitions, K-Sea borrowed on a bridge basis in August and raised additional equity in September. The existing senior secured revolving credit facility with KeyBanc (and others), which was originally capped at US $80 Million and then raised to US $120 Million, was upped, again, from US $155 Million, to US $ 175 Million, with its term pushed out from five to seven years. Additionally, a US $45 Million facility of just under one year tenor (364 days) and a US $60 Million three month bridge loan were also provided. The cash portion of the 2007 corporate acquisitions, some US $169 Million, was funded with debt.

In September, K-Sea raised $138 Million in a "follow-on offering" of 3.5 million Limited Partnership units, priced at $39.50 each, with proceeds earmarked for paying down US $132 Million of the debt recently piled on (and more if the "greenshoe", an option for the underwriters to increase the deal size by another 15%). Lehman, Citi and UBS were "joint book-running managers" for the offering.

The chart below, adopted from a K-Sea regulatory filing, shows the impact of the offering on the right side of K-Sea's balance sheet. The "Actual" column shows accounts as of June 30th. The middle column adjusts those numbers as though the acquisition, supported by additional lending (but not the equity raise) had occurred on June 30th. The right-hand column then adjusts the capital structure for the equity raise- which is used to pay off the Bridge Loan, the 364 day loan, and a portion of the Revolver. The chart does not consider the impact of the "greenshoe"- which would net an additional US $16 Million- that would go towards further repayment of the revolver.

K-SEA CAPITAL STRUCTURE

| | As of June 30, 2007 | | |
|---|---|---|---|
| | **Actual** | **Pro Forma** | **Pro Forma As Adjusted** |
| Long-term debt, including current portion: | | | |
| Bridge loan | $ — | $ 60,000 | $ — |
| 364-day loan | — | 45,000 | — |
| Revolving facility | 97,071 | 162,225 | 135,105 |
| Term loans and capital lease obligation | 147,216 | 177,322 | 177,322 |
| **Total long-term debt (A)** | **$ 244,287** | **$ 444,547** | **$ 312,427** |
| Partners' capital: | | | |
| Common unitholders | $ 127,722 | 135,634 | 267,754 |
| Subordinated unitholders | 23,722 | 27,219 | 27,219 |
| General partner interest | 684 | 910 | 910 |
| Accumulated other comprehensive income | 525 | 525 | 525 |
| Total partners' capital (B) | $ 152,653 | $ 164,288 | $ 296,408 |
| Total capitalization (A+B) | $ 396,940 | $ 608,835 | $ 608,835 |

Source: K-Sea filing with U.S. Securities and Exchange Commission

With its successful follow-on offering, K-Sea is facing a new challenge- dilution. Common unit-holders will now hold 9.5 million units (68.6% Limited Partner interest) versus 6 million units (58% Limited Partner interest). With 4.2 Mbbl of tank barge capacity (a 22% jump following the recent purchases), has had a successful track record since its early 2004 IPO, with steady rises in its quarterly distributions from pro-rata $0.50/unit to $0.70/unit. Its unit price of $39.50, determined in NYSE trading, was up from the $23.50 IPO price, although down from 3Q highs at $48.50. K-Sea holders were considering that the free cash flow available to fund distributions (though growing as capacity is bolstered) must now be spread over many more units.

In K-Sea's case, the dilution is a high class problem to have. With an additional 777,000 barrels of capacity coming into the fleet, much of it tied to term contracts, revenues will quickly flow in. In addition, equipment on order will be delivered starting in early 2008; capital payments due will likely be funded by additional revolving debt. The ample dry powder, in the form of borrowing power on the revolver, could also be used to fund distributions temporarily, if necessary.

* *

K-Sea is a unique case, operating in the protected Jones Act markets. But, because of its partnership structure, with the inability to retain big cash balances at the non-existing corporate level (other than those needed to conduct day to day business). A number of the drybulk and container drybulk IPO's have also been redefining their relationship with investors- going back to the well to draw more.

A highly successful equity offering, where shares were sold, was recently completed by drybulk specialist Genco Shipping & Trading (symbol "GKN"). Though Genco has sold off several older vessels in the past few months, it too faces the need to raise expansion capital- to buy neer vessels, as the anticipatory wave of  dry strength continue to move forward. Like K-Sea, it is faced with the problem of balancing leverage concerns (how much can be reasonably borrowed to fund acquisitions) against the potential dilution of issuing more equity (used to pay down the debt).

In late September, Genco came to market with 3.2 million shares of fresh equity, where proceeds would flow to the company, accompanied by 846,000 shares being sold by an early investor. Priced at $67/ share, Genco was raising approximately US $204 Million (or US $214 Million from a full greenshoe exercise), with its purpose clearly stated: "The Company intends to use its net proceeds from the offering to repay a portion of its outstanding indebtedness under its credit facility."

In late July, Genco had entered into what it described as a "US $1.4 Billion credit facility" for acquiring additional vessels, and re-financing a facility arranged two years earlier around the time of Genco's emergence as a public company. The additional vessels included nine Capesizes (three units aggregating US $330 Million already on the water, and the remainder under construction at Korean and Chinese yard for deliveries through early 2009 but requiring deposits of US $134 Million) purchased from Swiss owner Metrostar Management. In August, Genco announced a second blockbuster acquisition, with its US $336 Million purchase of three Handymaxes and three Supramaxes from private Greek owner Evalend (Kriton Lendoudis). All are expected to be delivered in the 4Q 2007- but deposits would have been paid prior to the share sale.

These purchases were complemented by an accumulation of Jinhui Shipping shares, with some US $ 77 Million splashed out during the first seven months of 2007- funded through a shorter term credit line put in place early in the year.  As it piled up its balance sheet with debt to finance the expenditures of US $930 Million, Genco faced the same calculus as K-Sea and others- it needed to raise equity to pay down the debt that facilitated the transactions.

The following chart, adopted from Genco registration documents, shows the mechanics, with the similar pro-forma treatment used by K-Sea. The first column shows the capital components of the balance sheet at mid year. The middle column layers in the additional debt needed to finance deposits and purchases (net of vessel sales) at the time of the share sale, bringing the debt/ total capital to an untenable 65%. The right-hand column reveals the impact of the share offering, with debt down and shareholders equity up, and a debt/ total capital ratio of 46.6%.

## Genco Shipping & Trading

| | As of June 30, 2007 | | |
|---|---|---|---|
| | Actual | As adjusted for indebtedness | As further adjusted for this offering |
| | (unaudited and in thousands) | | |
| **Total debt (current and long-term) (A)** | **$283,233** | **$ 720,083** | **$ 515,696** |
| **Shareholders' equity:** | | | |
| Preferred stock, $0.01 par value; 25,000,000 shares authorized; no shares issued or outstanding | — | — | — |
| Common stock, $0.01 par value; 100,000,000 shares authorized; 25,514,600 shares issued and outstanding, actual; 28,723,555 shares issued and outstanding, as adjusted for this offering | 255million shares | 255 mm. share | 287mm share |
| Additional paid-in capital | 308,259 | 308,259 | 512,614 |
| Accumulated other comprehensive income | 36,780 | 36,780 | 36,780 |
| Retained earnings | 42,520 | 42,520 | 42,520 |
| Total shareholders' equity (B) | 387,814 | 387,814 | 592,201 |
| Total capitalization (A+B) | $671,047 | $ 1,107,897 | $ 1,107,897 |

Source: Genco Shipping & Trading filing with U.S. Securities and Exchange Commission

The booming drybulk market greatly counteracts the dilution effects of the US $204 Million share issuance, enabling the companies to easily go back to the markets. The research arm of Jefferies, a finance house heavily involved in the shipping sector, had estimated 2008 vessel earnings of US $165.963 million- figuring in the new tonnage but not adjusting for the above re-capitalization (which was announced after the Jefferies' research report).

Over 25.5 million shares, 2008 estimated earnings per share, an important metric for shipping investors, works back to US $6.51/share- well up from the 2007 estimate of US $3.14/ share. With additional shares, the 2008 forecast earnings per share figure reduces to US $5.78/ share with the dilutive impact of the additional shares. Certainly, the same P/E multiple, applied across the diminished EPS, could result in a lower price target- but P/E's have been expanding with the rising rates. Two of the Supramaxes and three of the Handies expected to be delivered to Genco in 4Q 2007 have not yet been chartered.

Other listed entities have also followed similar strategies as Genco in this unprecedented drybulk boomtime- going to the well for more equity and paying down debt. Diana Shipping, another beneficiary of the ongoing drybulk surge, raised US $287 Million (including a full exercise of the "greenshoe") in a mid September secondary shares offering, priced at US $25.00/share. Diana, like a number of high payout drybulk peers, has utilized debt to fund capital expenditures, but always with the intention of raising additional equity to pay down debt. Originally concentrating on the Panamax sector, Diana has expanded into the Capesize markets in late 2006, taking delivery of one ship in 4Q 2006, two units in 2Q 2007, with a fourth Caper due to deliver in 4Q 2007.

At the outset, Diana management always clearly stated their intention to operate with low levels of debt, and benchmarked US $150 Million, earlier this year, as a ceiling on debt. In a recent regulatory filing, Diana said: *Our current policy is to repay our debt, excluding construction pre-delivery financing, in excess of approximately $150.0 million from time to time with the net proceeds from equity issuances, although from time to time we may use the net proceeds from equity offerings to temporarily reduce our outstanding debt, excluding construction pre-delivery financing, to less than $150.0 million pending the application of such proceeds to vessel acquisitions or other uses.*

Following its prescient move into Capesizes, Diana had built up *"total debt outstanding of $124.8 million, including $24.1 million of construction pre-delivery financing"* at the end of August 2007, mainly under a ten year US $300 Million facility with RBS (six years non-amortizing), complemented by a 364 day US $200 Million credit, also with RBS. With the new equity offering, Diana will be able to fully pay down outstanding debt with RBS (though the pre delivery construction debt, with Fortis, may remain in place).

Shareholders, keenly aware of the potential dilution from new share issuance, did not seem bothered. Quite to the contrary- in the weeks following Diana's US $25/ share issuance, the price of the stock ratcheted upward, climbing to US $32/ share as charter rates reached above US $200,000/day on fronthaul trades for Capesizes, and nearby resale prices soared to US $147.5 Million.

Other participants in the sector, have also used the strong shares market as a chance to lower debt exposure. Eagle Bulk, in the news throughout the 3Q 2007 with blockbuster vessel acquisition deals (alongside Genco), sold secondary shares in September that were worth US $129.5 Million. Eagle is in the final stages of entering into a major debt facility, US $1.6 Billion, with RBS, to fund a major vessel acquisition program. Between end 2Q 2007 and mid September (the time of the equity offering), Eagle drew down an additional US $225 Million (presumably for deposits on the acquisitions) under its existing line of credit, also with RBS, butting up against a temporary increased existing facility size of US $550 Million, prior to the share sale. The share dilution, from 5 million new shares sold through Jefferies & Company, did not deter company CEO Sophocles Zoullas, from purchasing 300,000 shares for his own account.

Excel Maritime Carriers presents a different wrinkle, solving a similar problem. Excel, with mid aged fleet of Hanymaxes and Panamaxes, had recently entered into contracts to acquire two 2005 built high spec Supramaxes, for US $63 Million each, with expected delivery in 4Q 2007. Excel, with midyear 2007 debt of US $199 Million, 36% of total capitalization (US $564 Million), faced a similar dilemma- how to grow while walking the tight line between shareholders (wanting to maintain their stake) and bankers (wanting to keep leverage appropriate for vessel age and chartering strategy).

Its solution was the sale of 20 year maturity US $125 Million of convertible notes (plus the optional over-allotment). Interest on the notes is a very low 1.875% annual rate, reflecting the optionality of the convertible structure. Excel shares have seen a phenomenal performance, reaching a high of US $60/ share (versus US $11/ share at the beginning of 2007). Conversion is split into 10.9529 base shares and an incremental 5.4765 incremental shares. Taken together, the 16.4294 shares per US $ 1000 invested calculates back to a conversion price of US 60.87/ share- in spitting distance to recent share highs (making conversion very likely). However, Excel has the option to convert the notes into cash, shares or a combination of cash and shares. With a large cash horde after recent vessel sales (more than US $125 Million), Excel may be able to meet its funding needs, while moderating dilution (compared to a straight equity offering) if it chooses to effectively buy back the convertible notes with future cash inflows.

The 3Q 2007 will be looked upon on as a golden age for secondary offerings, across the sectors. It is too early for recent entrant Oceanfreight to be putting its "efficient use of capital" philosophy into practice. But, its peers (and companies like K-Sea in the MLP space) are creating a track that will be well traveled, at a point in the future, when it's James Christodoulou's turn to raise additional equity.