Dryships at the Height

Dryships, captained by George Economou, listed on the NASDAQ under the symbol "DRYS", is one of the great success stories of the drybulk markets. At the height of its valuation in 3Q 2007, its market capitalization exceeded $4.3 Billion, One of the earliest in a wave of IPOs, in early 2005, it built up its fleet, through shrewd timing on vessel sale and purchase, and, with a chartering strategy that emphasized a spot trading strategy during periods of a soaring spot market. Today, its 39 ship fleet includes 32 Panamaxes, 5 Capes and 2 Supramaxes.

In late 2007, DRYS turned in a new direction- beginning in its efforts to acquire Ocean Rig, a Norwegian specialist in ultra deepwater oil drilling ("UDW")- through purchases of 30.4% of the shares in Oslo- listed Ocean Rig. As described by DRYS, its intention would be to create a "pure play" business in the UDW sector, which would own six drilling units that can drill in waters deeper than 7,500 ft. Though not explicitly stated, such a business would likely be structured as a full payout partnership or a high dividend paying corporation.

Six months later, by mid 2008, DRYS had announced:

- George Economou was named Chairman of Ocean Rig and a new board elected
- DRYS would be entering into lengthy period charters on 14 drybulk vessels in its fleet.
- The Ocean Rig unit made known its interest in acquiring two drillships under construction by private Economou interests at Samsung
- Options were exercised to construct two additional drillships at Samsung
- Sometime in 2009, DRYS would be spinning off a new UDW business, as an independent sector "pure play" company, in a share offering.

This article will explore the implications of the shift in strategy and its potential impacts on both DRYS and other companies. These impacts touch on how companies are valued, and how they create further value through spinning off separate businesses.

"Those who don't pay attention to history are doomed to repeat it." In a nutshell, the juxtaposition of the record highs in the drybulk market, evokes memories of the Greek shipping titans of the late 1960s who were sitting with spot "supertankers" at the time of the Suez Canal closure. However, with the benefit of hindsight, it is easy to see that the shipping boom of four decades ago (an era of what is now labeled as a previous supercycle) turned to bust by late 1973 with the combination of an oil price shock, severe recessions and overbuilding in the tanker sector. Savvy shipowners diversified, mainly into property holdings in developed countries. In the public company context of 2008, the actions of DRYS are analogous, representing a diversification.

This time around, the dynamics are also different- with the shipping boom emanating from the drybulk side instead of tankers, based on the shipments of iron ore and coal, rather than oil. In spite of nearby demand weakness (the IEA recently lowered its 2008 demand estimate to 86.8 MBD, implying only 0.9% growth from the previous year) , the pent up demand for oil has already caused an upward explosion in oil prices, a trend likely to continue. One day prior to a historic price spike to $139/ barrel oil Morgan Stanley's noted shipping and energy analyst Ole Slorer issued a note predicting a $150/ barrel price for crude oil by early July, 2008. The team of Goldman Sachs analysts that had first suggested an oil price target of $100/barrel are now promulgating a view that $200/ barrel is possible. In early June, a top economist at the U.S. Department of Energy told a U.S. Congressional committee that, in 2009, oil prices are expected to be $126/ barrel. The shift away from oil dependence is a decades-long process, with "Alternative Energy" still the stuff of science fiction. Likewise, the untapped potential of the Arctic regions (where oil reserves have been estimated by the U.S. Geological Survey, and StatoilHydro to be at one-quarter of the world's remaining undiscovered oil and gas deposits) will also be exploited over decades, not years.

Oil production is heading into deeper waters. Consultants Douglas-Westwood Ltd have framed the bigger picture, saying: "Floating production has proved a cost-effective method of developing both marginal and world-class offshore fields worldwide."

Against this backdrop, DRYS has chosen to follow a diversification path towards the UDW sector, as the optimum way of providing value to its shareholders (with Economou-linked companies holding nearly 30% of DRYS common shares). The move has not been without rancor and criticism, with some investors expressing displeasure with the move away from drybulk. One prominent shipowner best known for his tanker business, but with an entirely separate drybulk entity considered to be a peer with DRYS, suggested that creating a completely distinct entity would have been more appropriate, with investors free to invest in it, or not.

The premise for investing in the UDW sector is compelling, as detailed in a late April 2008 presentation made by DRYS as it launched a tender offer for outstanding shares in Ocean Rig. Present demand (and, unlike drybulk shipping- the projected demand going forward) is outstripping a limited supply of rigs capable of drilling for oil in the ultra-deep depths, generally defined as deeper than 7,500 feet. A March 2008 presentation at a Baltic Exchange seminar, using International Energy Association and Merrill Lynch data, suggested that: "…New projects to develop non-conventional production require long-dated crude oil prices above $60/bbl…", with ultra deep drilling included. By any measures, we are well passed that tipping point. At a time that the July 2008 futures contract on NYMEX has been trading in the region of $137/ barrel, the forward curve out as far as December 2016 is virtually flat, ie "long dated" eight year swaps are priced in line with spot, at more than double the $60/ barrel threshold referred to.

By late April, 2008, DRYS had accumulated more than 55% of the outstanding shares of OceanRig, including the 30.4% stake acquired in late 2007 (at a cost of $405 Million). Under the rules of the Oslo Stock Exchange, within four weeks of gaining a foothold of more than 50%, the acquirer is required to tender for the remaining shares. DRYS began its tender in early May and by early June announced its acquisition of nearly 94% of issued shares and would be initiating a compulsory acquisition of the remaining shares. The acquisition price for 69.6% (which does not include the initial 30.4% holding) was pegged at $1.07 Billion, based on a price of NOK 45 per share, funded by $500 Million of company cash, and $572 Million of bank debt sourced from several banks, after DRYS was able to amend its existing facility with HSH Nordbank (and others). DRYS says it has paid a price in line with comparable companies and acquisition metrics- albeit at a price in the upper portion of the range. The approximately $1.5 Billion acquisition price works back to a 7.9x multiple of Enterprise Value (EV)/ EBITDA, based on estimated 2009 EBITDA of $273 Million. EV measures market capitalization plus debt in place.

The mainstay of DRYS's additional financing is a USD 800 Million loan from Nordea, with a two year maturity, specifically for the purchase of Ocean Rig shares (including refinancing of late 2007 borrowings put in place when the share-buying commenced). Presumably, proceeds from the share offering of the UDW business, expected sometime in 2009, would go towards repaying amounts outstanding under this bridging facility.

The new financing arrangements also include a vessel-secured bridge facility for as much a $183 Million, and pre-payment flexibility. During the three month period from March through May, 2008, DRYS negotiated a seven year borrowing with Piraeus Bank for $ 130 Million, a seven year $ 90 Million loan from Dresdner Bank and an eight year $125 Million credit, from Deutsche Schiffsbank.

DRYS, with its financial firepower, is not the first shipping entrant into UDW. Other shipping names involved in the UDW sector have created separate drilling businesses, most notably John Fredriksen's Seadrill. The "West Polaris", a Seadrill newbuild (from Samsung), being commissioned in 3Q 2008, will go on a charter to Esso Exploration, for $504,000/day, for three years, with a fourth year at $602,000/day. Seadrill sold this unit to Ship Finance Ltd, in a deal valued at $850 Million, against a 15 year bareboat charter back to the sellers. Seadrill's "West Taurus", a Fifth generation semi-submersible, will deliver to Seadrill in 1Q 2009 from the Jurong Yard, into a six year charter to Petrobras at $630,000/ day. The "West Orion", a similar unit, will deliver in mid 2010, also into a six year Petrobras charter, at $600,000/ day.

In a market where supply is constrained, the UDW company would control the following units, assuming that two drillships ordered by Cardiff are woven into the DRYS entity:

NAME OF THE UNIT	**YEAR BUILT**	**DESCRIPTION**	
Leiv Eriksen	2001	Fifth generation semi-submersible	Capable to drilling to 7,500 feet
Eirik Raude	2002	Fifth generation semi-submersible	Capable of drilling to 10,000 feet
Cardiff order hull#1837	4Q 2010	Drillship $660 Million (unit)	Capable of drilling to 10,000 feet, Samsung
Cardiff order hull#1838	1Q 2011	Drillship $660 Million (unit)	Capable of drilling to 10,000 feet, Samsung

TBN option exercise, hull#1865	3Q 2011	Drillship $800 Million (delivery cost)	Capable of drilling to 10,000 feet, Samsung
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Ocean Rig's semi-submersible, "Leiv Eriksen", presently on charter to Shell at $512,000/day until September, 2009, is one of the few UDW units available for charter in 2009, while its "Eirik Raude" will be entering into a three year contract with UK independent oil company Tullow at $637,000/day, commencing in 3Q 2008, followed by two one year options.

Analysts and students of DRYS' strategy will see parallels with its vessel acquisition strategy, where promptly available tonnage has commanded a premium over the price of newbuildings with delivery several years out. In October, 2007 DRYS stepped up and paid the then un-heard of price of $147 Million for a Capesize resale from Golden Ocean, set to deliver in 2Q 2008, from a Korean yard (Daehan). More recently, in May 2008, DRYS again showed its willingness to pay premium prices for a nearby position, in announcing deals to acquire a 170,000 tonner built in 2004 to be named "Flecha" (reported to be Alcyon Shipping's "Nightflight") for $ 158 Million to be delivered charter-free in 3Q 2008. Additionally, DRYS announced that it would be acquiring a 177,000 dwt Capesize vessel for $ 153 million to be named "Daytona" which will be delivered in 4Q 2008 / 1 Q2009 (reported to be one of two Geden vessels being built at China's Waigaoqiao yard. In May, DRYS took delivery of a 2001 built unit, renamed "Capri", purchased in November, 2007 at a price of $152.3 Millon. The premium for a nearby delivery can be seen by a comparison with prices for newbuildings delivering in 2011. Brokers Compass Maritime recently put such a price at roughly $93 Million, contrasted with a prompt newbuilding worth $164 Million and a prompt five year old ship worth $153 Million.

But, drybulk shipping may now have become too expensive. When investment opportunities in core sectors are not readily available for shipowners, they have pursued a variety of financial strategies. Analysts can also see parallels in DRYS with the dilemmas faced by tanker owners who have had difficulties finding deals where asset prices were seemingly over-priced in relation to discounted earnings expectations. Owners have taken the shareholder friendly tack of paying out special dividends to shareholders. Most famously, General Maritime Corporation (GMR) paid out a one time special dividend in early 2007, paid out a one-time special dividend of $15.00/share after paring down its fleet through sales of single hull tonnage. Once widely thought of as a consolidator, GMR cautiously began acquiring vessels in 2Q 2008, announcing the purchase of two Euronav-owned Aframaxes, both built 2002, for an aggregate price of $137 Million. Another strategy has been the share buybacks most recently associated with Overseas Shipholding Group (OSG), which instituted a fresh $250 Million buyback program in early June, after completing an earlier initiative, worth $200 Million. Since mid 2006, OSG has spent more than $600 Million on buybacks.

Thus, “diversification” is an alternative to shareholder friendly dividend payouts or share buybacks, in the drybulk sector, where continued firming in the markets has been reflected in asset pricing. DRYS is not the only Greek owner eying the drillships marketplace. Metrostar (a shrewd asset trader best known as the seller of tankers to GMR, and, more recently, of bulk carriers to Quintana Maritime and Genco Shipping and Trading) has recently placed two orders for drillships. Both orders, priced at $668 Million, and $652 Million, with Hyundai, have been reported with 2011 delivery. Metrostar, unlike DRYS, is a private non-listed company.

For DRYS, the economics of large semi-submersibles and drilling ships, where purchase prices are balanced against potential cash flows and earnings, suggest that UDW equipment acquisition and deployment will be accretive to earnings. An estimate by analysts at Jefferies & Company put the value of the spinoff at between $35 and $54 per DRYS share. Jefferies assumes day rates of $637,000/day on the two semi-submersibles, and $525,000/day on the drill ships The variability in determining a target price, basis 2012 value, stems from uncertainty in the multiple to 2012 estimated EBITDA in a public offering, as detailed in the table below.

BACKING OUT SHARE TARGET	The “Low” Case	The “High” Case
Estimated EBITDA (2012)	$858 Million	$858 Million
The Multiple	EV = 4x EBITDA	EV = 5x EBITDA
Enterprise Value projection	$3.431 Billion	$4.290 Billion
Subtract: DRYS guidance re net debt in 2012	($1.967 Billion)	($1.967 Billion)
UDW entity Capitalization	$1.464 Billion	$2,323 Billion
Divide by 42.440 m shares	$34.51 / share	$54.72 / share

The multiple for drilling companies observed in the marketplace, comparing EV with estimated 2012 EBITDAs, is presently 5.3x to 5.5x, according to DRYS and Jefferies. Multiples on IPO’s are always discounted, initially, from entities with a trading history. With a large proportion of floated shares likely remain in DRYS hands, it would benefit from the gain in the UDW entity’s value.

A DRYS investor presentation regarding the UDW business, using analyst consensus estimates for 2009, demonstrated the accretive aspects of the acquisition, even after adjusting for costs of financing its drill ship construction programme:

2009	DRYS	Ocean Rig	DRYS	
	Projections	Projections	Pro-Forma	Adjustments
EBITDA	$607.5 M - $14.66/sh	$273.0 M	$880.5 M - $21.27/sh	Na
Cash Flow	$486.1 M - $11.72/sh	$224.7 M	$710.8 M - $17.17/sh	($19.0 M) – ($0.46/ sh)
Net	$429.0 M - $10.35/sh	$162.6 M	$591.6 M - $14.29/sh	($70.2 M) – ($1.70/ sh)

Income				

Not so coincidentally, DRYS' announcements detailing its tender offer for Ocean Rig shares coincided with disclosures that DRYS had agreed to charter out eight Panamaxes and six Capesize vessels on to period charters ranging from four years (on three Panamaxes and two Capes) to ten years (on three of the Capes). The exact specifics of vessels and charterers are guarded, but the timing appeared to be prescient, preceding a monumental drop in the drybulk markets (in mid June) by several weeks.

But, the longer term chartering strategy is deeply intertwined with DRYS' financial contours on a number of levels. Indicative hires for vessels reported fixed on long periods as the market prior to the market's drop have included Genco's fixture of its newly deliverying (4Q 2008) "Genco Hadrian" for five years at $65,000/day, and a Nordcap TBN Capesize vessel delivering in a forward position- Feb 2010 from Hyundai, into a five year charter at $51,000/day. A five year deal was struck on the 2006-built Panamax "Alexandra" at $42,500/day giving delivery to charterer Mittal in late 2008/ early 2009.

Up until its 2007 foray into acquisition of newbuilding resales DRYS built up its fleet through S & P activities in the second hand market. Not surprisingly, asset values had appreciated greatly, causing the inverse of NAV, debt to total capitalization, to shrink. In mid May, DRYS estimated that its ratio of debt to capitalization (adjusted for the market values of vessels) had shrunk to 27% (compared to the debt to non adjusted capitalization of 53% at end March). A trade-off will emerge as higher price prompt delivering assets move onto DRYS balance sheet, cash flow may be bolstered but the "vessel appreciation differential" will likely shrink.

The rapid paydown of debt is important. In a conference call with investors, CEO George Economou explained the dual rationale for contract cover- taking advantage of strong rates, but also the ability to pay down asset purchase prices very quickly. He told investors that he was "happy to keep growing the fleet on the back of deals that provide a full payout during the time we are doing them." Of course, as it comes time for DRYS to source "take-out" longer term finance for its orderbook of nine drybulk vessels, revenue visibility, and stable long term cash flows, will enable likely enable the most advantageous terms.

Another reason, simply put, is that companies with contracts in place are more respected in the markets than their spot-minded peers. Listed entities in the oil exploration, production and drilling sectors, where contracts and "revenue visibility" are commonplace, have achieved better valuations than many shipping businesses. In certain cases, where permitted by tax considerations, they have taken the form of partnerships- where the corporate layer is completely eliminated and free cash is distributed directly to investors, who hold "partnership units" rather than "shares". Shipping has seen a number of "full payout" entities, including the partnerships.

DRYS's spot market style has contributed greatly to share turnover, unfortunately- much of trading activity has been driven by "momentum" investors who jump aboard an upward, or downward trend without regard for the underlying company fundamentals. A recent Jefferies analysis points to a superior Price / Earnings (PE) ratio for a group of peer companies with a time charter (as opposed to spot) orientation- 9 to 10 times 2009 projected earnings and 7 to 8 times projected cash flow. The new strategy may help narrow the gap with DRYS, at 6 -7 x projected EPS and 5 -6 x projected cash flow.

A different side of defensiveness can be labeled as "Plan B"- what if the contemplated spinoff of the UDW business is not viable in 2009, due to broader economic uncertainties, or specifics within the energy and/ or shipping sectors of the equity markets? As shown previously, DRYS projects that the acquisition of Ocean Rig (with its two semi-submersibles) would be accretive to 2009 earnings and cash flow (in the absence of a spinoff). But if market vagaries delayed or prevented the spinoff, DRYS management would be seeking to finance four drillships that DRYS (rather than an independent entity), would have on order.

There are a number of other permutations on the disposition of the UDW business, all of which auger for a chartering dynamic that could help support financing requirements of circa $3 Billion, on a delivered cost basis, worth of UDW assets. One possibility might be a partial spinoff, initially of the two UDW semi-submersibles only, with the drillships under construction "warehoused" by DRYS until they are suitable for the UDW company.

Yet another possibility could be a spinoff entity consisting of the rigs under construction along with one or more drybulk vessels under long term charter contracts. Such a structure is based on the rationale that cash flows of an inchoate UDW company would be buttressed by drybulk vessels earning steady revenues on contracts spanning the three year timeframes for construction and mobilization of the four drillships. As a precedent in ship finance, one can point to Teekay LNG Partners (TGP), which (in spite of its name) at the time of its 2Q 2005 IPO, offered a fleet of four LNGs and five Suzemax tankers acquired from Naviera Tapias. In late 2005, TGP bought three additional Suezmaxes from Teekay Corporation (TK). Three years after its IPO, a 2008 TGP regulatory filing states: "We view our Suezmax tanker fleet primarily as a source of stable cash flow as we seek to expand our LNG and LPG operations."

TGP, like TK's two other spinoffs (Teekay Offshore and Teekay Tankers), OSG America, Capital Products Partners and, on the dry side, Navios Maritime Partners, relies on an established sponsor entity for warehousing, ie construction and finance of vessels as well as negotiation of period charters. Then, usually upon delivery of the vessel (in the case of newbuildings), the vessels are "dropped down", sold into the partnership entity, where they begin service, usually under period timecharter contracts.

Energy still has an appeal that shipping does not. Though valuations of shipping have improved in the past few years, the "Energy Exploration and Drilling" sector has routinely achieved higher valuations than shipping. The P/E multiples based on estimated 2008 earnings of the big offshore drillers are all in the double digits, ie 10x or more, exceeding the multiples for the contract minded shipping companies- a fact not lost on George Economou.