The valuation of ships is of vital importance to all aspects of ship finance- from investors who look at Net Asset Value (NAV) as a guide-post for how shares should be priced, to lenders who need to assess the “loan to value” ratio- seeking comfort that the value of loan security exceeds amounts outstanding under credit facilities. Much of the recent news concerning listed companies centers around such valuation issues.

In early January, 2009, the shipping press was buzzing with news involving two private companies. A twelve year old Capesize bulk carrier, “Golden Wing”. had been sold for $27 Million from Far Eastern owners into the fleet of Greek owner Polembros. The transaction was newsworthy because it was thought to bode for a lower assessment on five year old Capes- pegged around $46 Million at the time of the rumoured deal. It also is illustrative of the bargain mentality that may ultimately buoy asset prices. On a market spike (were it to occur), a charter at $25,000/ day (only slightly above indicated FFA settles out through 2010) could throw off circa $7 Million per year. If such a rate held in the marketplace, the vessel could be paid off in four years, based on “cash on cash” flows.

In theory, asset prices should represent expected cash flows in the future discounted back to the present. Even in unexceptional times, when freight markets are flat, the vessel sales markets are highly illiquid, at best. But amidst unprecedented volatility in freight markets, where estimated earnings streams are little more than educated guesses, there has been no locus where buyers and sellers can agree on a long term basis- hence there are few transactions. As pointed out by Compass Maritime in a recent market report, drybulk S & P transactions have involved mainly older vessels. In late December 2008, the New York based S & P broker said: “Vintage early 1980's built tonnage has been sold in larger quantities so the benchmarks for older ships are more reliable than those of modern vessels.” This real world observation is consistent with economic models of capital asset pricing, where prices can be agreed on a shorter stream of higher probability cash flows.

With CFO’s and bankers unable to price assets properly, and with future earnings ability called into question, a handful of well known owners have actually cancelled orders for charter free newbuild tonnage. Back of the envelope estimates by equity analysts were pointing to negative company NAV’s in some cases. Existing vessels will continue to trade, but managements have some choices concerning units not yet on the water. Where contracted newbuilding prices vastly exceed estimated post-correction vessel values, the potential existed for debt advances during the newbuilding cycle to actually exceed the value of the vessels. For a number of the drybulk companies, the cancellation of higher priced vessels (as described in the previous issue of LSE), has nudged these NAV’s toward positive territory.

The experience of Eagle Bulk Shipping, a Nasdaq listed owner of Handymax and Supramax vessels (with symbol EGLE), is illustrative of the problems arising from aggressive expansion, and the ability to craft a sensible solution. Eagle, initiatlly backed by private investors in New York, began assembling its portfolio in late 2004, prior to its Initial Public Offering (IPO) in Spring, 2005. Debt finance was provided by Royal Bank of Scotland (RBS). By mid 2008, Eagle's newbuilding program consisted of nearly three dozen Supramaxes- all on order from yards within China's SinoPacific Shipbuilding Corporation.

By the 4Q 2008, after cancellations of newbuild orders by peer companies Genco Shipping & Trading, and Navios Maritime (see previous issue of LSE), the market rumblings had Eagle Bulk Shipping also set to cancel vessels within its ambitious new vessel construction program. And with valuations of vessels then in freefall, technical violations of loan/ value covenants were becoming commonplace and worrisome to both bankers and CFO's alike. By this time, a group of drybulk companies had either lowered or completely suspended their dividends. Credit agreements typically contain wording that prohibits payouts and distributions to shareholders when events of default have occurred, though the actual dividend suspensions were more in the category of proactive measures.

Eagle used adversity to strengthen its hand, choosing to face its various problems simultaneously. In a three pronged approach it reduced the number of newbuilds on order, reduced the size of its bank debt, and suspended its $0.50/quarter dividend to shareholders. Benefitting from a cooperative relationship with the bank and its shipyard, Eagle positioned these actions in terms of strengthening its operating position, and preserving its options for growth going forward.

The fulcrum driving the deal was a raft of newbuilds that had not secured forward charters. Eagle, with a mantra of secured coverage for its fleet, demoted eight newbuilding vessels that did not have charters around- turning those firm deals into options. The delivery on a ninth vessel, also charter free, was pushed back from 3Q 2009 to 4Q 2010. The eight now optional 58,000 tonners, originally slated for deliveries from Yanghzou Dayang Shipbuilding Co., between 4Q 2010 and 2Q 2012, were priced at $316 Million in the aggregate (just under $40 Million per vessel). A total of $47 Million that had been advanced as deposits on the eight vessels (approximately 15%) was credited, instead, as progress payments on the remaining firm newbuilding vessels. Strike prices on the options, priced at $55 Thousand each, mirror the original contracted prices, varying between $36.7 Million and $42.3 Million per vessel. The impact of converting the eight orders from obligatory to optional was to reduce Eagle's obligations for expending capital by $363 Million (the $316 Million savings, plus the credit for the $47 Million already paid in to the building program).

Suspension of Eagle's $2.00/share ($0.50/quarter) annual dividend was an additional cash saving move- one that also pleased its bankers who had seen loan covenants come under pressure at Eagle (and elsewhere) . Based on roughly 47 Million shares outstanding, and the annual dividend of $2.00/share, some $94 Million of cash generated from operations is freed up annually.

Charter coverage, a hallmark of Eagle's strategy, is closely intertwined with the ability to service bank debt. Since its inception in 2005, Eagle had maintained a close relationship with RBS, with its credit facility expanding over time to meet Eagle's continued needs to support fleet expansion. By the middle of 2008, the credit (a 10 year deal, interest only until mid 2012) allowed borrowings of up to $1.6 Billion to support Eagle's massive newbuilding deal. Eagle had taken over contracts for 26 vessels originally ordered by another Greek owner- Anemi Shipping (Dushas family). At end September 2008, Eagle's balance sheet showed that $742 Million of long term debt outstanding had been drawn down, including a total of $427 Million tied to Eagle's newbuilding program. The nearly $600 Million still available under the RBS credit should be in line with further capital requirements for the remaining newbuild expenditures.

Due to a good relationship with its bank, Eagle was able to amend its revolving credit facility, reducing its size and subtly shifting the covenants to reflect present market realities. The analysts at New York equity brokers Dahlman Rose assessed Eagle's situation as follows: "We believe RBS has made several concessions to Eagle in hopes for a turnaround in operations rather than face a massive foreclosure." The RBS credit facility, now re-sized to $1.35 Million in line with lessened vessel expenditures, remains interest only until mid 2012, but margins are increased substantially, from Libor plus 0.95% to new pricing of Libor plus 1.75%. The "security ratio" (the minimum ratio of vessel value to the outstanding loan under the facility), which had been 130%, was now reduced to 100%. The borrower's minimum net worth requirement was lowered to $75 Million (from $300 Million), a number which will subject to annual review.

The Eagle case may be a precedent setter, according to the analyst team at New York based Cantor Fitzgerald, who wrote that: "…we suggest this agreement between EGLE and their lenders could be a bellwether arrangement for other companies in the sector."

John Parker, High Yield Analyst at Jefferies & Company, who closely follows the debt side of maritime companies, explained to LSE: "A number of shipping companies, especially in the dry bulk sector, are facing potential loan to value covenant violations on their bank facilities….More likely a lot of the covenants will be amended to use cashflow based covenant measures rather than ship value based measures." Echoing the views of the Dahlman Rose on Eagle, Parker, in describing the overall landscape, said: "For the good operators with solid charter coverage on their ships, the banks are not interested in forcing the sale of ships into a very soft S&P market."

The swings in Supramax prices have been comparable to those for Capesizes and Panamaxes. For example, the Baltic Exchange assessment of a five year old Super Handy (a "Tess 52" type slightly smaller than the majority of Eagle's newbuildings) has fallen from $75 Million, at the height of the market's frenzy in early Summer 2008, down to around $24 Million. Newbuild prices are less volatile. S & P brokers Compass (a Baltic Exchange panelist) were estimating that newbuild prices for a Supramax vessel have declined from around $47 Million (in early June, 2008), to $37 Million.    Part of the bank's willingness to work with Eagle can likely be attributed to the borrower's relatively good timing on the majority of its 2007 vessel purchases. Still, analysts were wary of further downside in ship values. In discussing the prospects for Eagle shortly after its announcements, researchers at Wachovia Capital Markets cautioned: "…we note that as vessels deliver, they will likely be marked-to market, which may add incremental downside to EGLE's market-value-to-loan value if vessel values remain at current levels."

Though calculations of net asset value (NAV) always involve a subjective element, the Dahlman Rose team was suggesting that lowered vessel prices were already impinging on Eagle's NAV. Their late 2008 research report suggests that Eagle's "net worth" would be close to $200 Million (equating to a security ratio of 115%), if the remaining newbuilds are valued at cost. However, in a hypothetical "mark to market" scenario, the Dahlman Rose analysts suggest a "net worth" around $40 Million (working back to a security ratio of 105%- and in compliance with the amended credit covenant).

Eagle was not alone among peers in suspending its dividend, a capital-raising move that also feeds a war chest that could potentially be used for acquiring tonnage offered by distressed sellers. Anticipating a future time of rising asset values (and intimating at the strong influence of RBS), Eagle said that future dividends were tied to the company maintaining a minimum "security value" of  130%.  Analysts at Cantor Fitzgerald have noted that dividend paying shipping stocks have been favored by value investors; they commented: "We believe a suspension of the dividend to conserve capital is a prudent decision, however, we suggest the share price may be impacted over the near-term as income oriented investors could cycle out of the stock."

Another question raised by the New York analysts concerns the feasibility of an additional capital raise. Effectively, company managements can raise cash through dividend reductions or cancellation of orders, which they may find preferable to raising dilutive shares at prices near cyclical lows. In the Eagle case, Dahlman Rose highlights the dilemma, noting that Eagle does not plan to raise equity at this time, but then opining that: "…additional equity would add a substantial buffer to the company as asset valuations remain at risk to the downside."

An Eagle peer company, Dryships (Nasdaq "DRYS"), has been wrestling with issues similar to those faced by Eagle, including that of a possible further capital raise. In November, 2008, with its stock down significantly from its 3Q 2007 and 2Q 2008 highs, DRYS still filed with the U.S. Securities and Exchange Commission for a potential issue of  25 million shares. Such a move could bring in some additional outside liquidity, as well, But, a further share issuance would also reduce the ownership percentage of existing holders (including company founder George Economou).

Nor has Dryships been immune from the same NAV issues bedeviling its drybulk peers. In the very eventful 3Q 2008, Dryships entered into two sets of transactions with entities represented by a related privately controlled company- Cardiff. In a deal announced in

July but subsequently cancelled, Dryships was set to acquire four Panamax vessels for $100 Million each. After lodging deposits ($13 Million each vessel) but failing to secure longer term finance for these acquisitions, Dryships cancelled the acquisition. The penalty provisions, where Dryships paid the erstwhile sellers an additional $105 Million ($26.3 Million for each vessel), in return for options to acquire these vessels at $40 Million each, were viewed as excessive by some analysts. In contrasting Eagle's ability to avoid a penalty for canceling its newbuild orders, Oppenheimer & Company analysts said: "This compares to the recent cancellations of six newbuilds by Genco and four vessels by Dryships, in which both companies were required to forfeit their down payments ($53 Million and $55 Million, respectively), with DRYS also paying a penalty/option fee of $105M."

In a further deal, announced in October, Dryships announced another deal with Cardiff-linked sellers, in which it would acquire four existing Capesize vessels and five newbuildings for a total consideration of $1.168 Billion. The existing vessels (including one of late 1980's vintage), and one of the newbuilds were set to earn hefty hires in multi-year period timecharters, extending as far as six years into the future. Dryships has intimated that it was working towards a cancellation of the nine ship deal, but there had not been any firm announcements. Within the nine ship purchase, the four charter-free newbuildings are almost certainly candidates for cancellation. With newbuild Capesizes now estimated to be worth circa $70 Million, versus agreed purchase prices circa $120 Million, these vessels would be "under-water" (with debt likely exceeding vessel cost) at their day of delivery.

The situation with the other five vessels- all with charters, is less clear, depending on a mélange of factors including continued charterer appetite for the vessels, Dryships' success (or not) in securing bank finance for vessel purchases, and the severe dropoff in the market for offshore drilling. Dryships has invested heavily in six ultradeepwater oil drilling units, with plans to spin off a separate company owning the energy exploration assets.

Dryships' deal involved second hand vessels as well as newbuilds. In November, 2008, the London listed Hellenic Carriers Ltd. had cancelled its acquisition of a second hand, 2001 built Supramax, forfeiting a nearly $7 Million deposit (and paying a $1 Million penalty fee).

Another issue that will be faced frequently throughout the markeplace in 2009 is what is politely called re-chartering risk; that is, what hire rates can be expected on newly fixed charters, after the expiry of period timecharters, fixed at high rates in 2006 through early 2008. Eagle has nearly a dozen vessels coming off charter within calendar 2009. Diana Shipping (NYSE symbol "DSX") has re-chartered two vessels post market correction. Most recently, its Panamax "Clio" (2005 built), coming off a $27,000/day timecharter with Cargill, is being rechartered, in direct continuation, at $11,000/day, for one year. In early 2009, its 2001 built Panamax "Dione" was set to begin a 17-20 month employment with Louis Dreyfus Corporation, at $12,000/day. Its previous employment, at $82,000/day had begun in early 2008 with Chinese charterers Jiangsu Shagang Group Co.

Uncertainties abound concerning shipping markets, equity markets, and the markets for debt finance. Perhaps confirming the optimistic predictions of Cantor's analysts following Eagle's success in crafting a cooperative arrangement with its bankers, another listed company, Oceanfreight (Nasdaq- "OCNF"), announced that it had obtained an important waiver from its lenders. Oceanfreight, operating a fleet of mainly drybulk carriers all on multi-year charters, said that it had agreed with lender Nordea on an amended collateral maintenance requirement. Earlier, in December 2008, Oceanfreight announced that it too was suspending its dividend.

Oceanfreight's $325 Million senior secured loan facility (bifurcated into two tranches- a revolver and a term loan), agreed in late 2007 and successfully syndicated in early 2008, included a minimum ratio of vessel fair market value to debt outstanding under the term loan tranche, of 140%. Though the amended value is not disclosed, we can guess that it's close to the 100% benchmark set by EGLE with its bankers. As Cantor Fitzgerald's prediction is borne out, we may see more announcements of this kind.