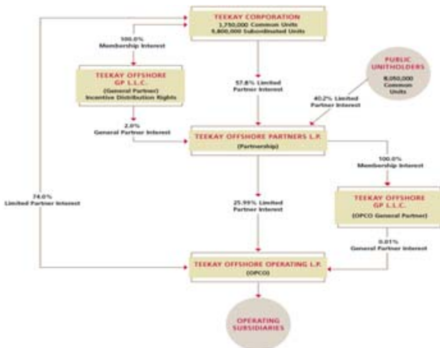
Unlocking Hidden Value



An important development, in recent years, as freight rates have risen and contracts have lengthened, is that shipping companies' valuations have emphasized cash flow. Indeed, some analysts have contended that Net Asset Value (NAV- a measure which reflects company equity based on market value of vessels) was now a less appropriate guidepost than earnings and cash flow measures for valuing companies. Omar Notka, Shipping Analyst at New York's Dahlman Rose offered the following: "It's interesting, the shipping equities have always seemed to be valued on cash flows rather than NAVs as evidenced by the way disparity in P/NAV multiples across the board."

In the natural order of things, as shipping companies grow, they will invariably move into market sectors differing from their original business. Analysts and CFO's have long debated the benefits of diversification and the virtues of "standing on two legs" instead of one. As the asset base was muddied by investments across ship types, in various charter models, a number of major companies expressed the viewpoint that the marketplace was not properly pricing their shares, based on ratios of Price / (NAV), per share.

Where these twin problems of valuation and diversification have converged, some managements, believing that shareholder value would be enhanced by listing individual businesses on the stock markets, have initiated flotations of business units. The spinoffs have taken the form of Master Limited Partnerships (MLP), with listings of limited partnership units, rather than shares. MLP's, a structure where all available cash (after reserves for debt service and operating costs) is distributed directly to partners, are thought to offer a lower cost of capital than conventional equity, and, in turn, a higher valuation.

"Unlocking hidden value" has been a concern of Teekay Corporation (NYSE "TK"), which built up a portfolio of business as it positioned itself as a "Midstream Service Oil Services Provider" in the energy transport chain. In April, 2003, TK completed its $774 Million acquisition of the "Navion" shuttle tanker business from Statoil, adding to a suite of businesses that included a stake in U.S Gulf lightering specialist Skaugen Petrotrans (SPT).

In a Jan. 2004 Investor Presentation, TK lamented that: "Historically, tanker companies have been valued based on 'steel value' alone. Teekay is an integrated logistics provider, and not just a conventional tanker company." At a time that its shares were trading at approximately $62/ share, TK's analysis was indicating that TK's shares should be valued at $78.53/ share. Its methodology, where the company was divided into two segments (Fixed rate- 3 or more years of employment, and Spot- under 3 years), was as follows:

42 million TK shares	FIXED RATE SEGMENT	SPOT SEGMENT
Annualized EBITDA	$285 Million	Na
Multiple (inherent multiple)	9x	Na
Enterprise Value	$2.565 Billion	Na
Book Value: Spot + JVs	Na	$1.365 Billion
Multiple	Na	1.6 x
Adjusted Price/ Book (based on peers)	Na	$2.183 Billion
Subtract: Debt Allocation	-$0.787 Billion	-$0.663 Billion
EQUITY VALUE	**$1.778 Billion**	**$1.520 Billion**
Per share value	**$42.33/ share**	**$36.20/ share**

TK set out to realize the hidden values of the gas business. In 2005, it sponsored Teekay Gas Partners LP (symbol "TGP"), an MLP initially built around a core of LNG's and Suezmaxes that Teekay acquired from

Naviera Tapias in 2004. Gas transportation is characterized by long contracts, sometimes of 25 years duration. The strong credits and stable cash flows are ideally suited for suited for MLPs. In 2006, TK sponsored Teekay Offshore Partners LP (symbol “TOO”), an MLP controlling “OPCO”- an entity that operated shuttle tankers, floating storage units and conventional Aframax tankers.

In April 2007, after the Teekay family of companies had grown with the two successful flotations, an updated “sum of the parts” analysis was presented - this time with three inter-related prongs (encompassing “TK”, “TGP” and “TOO”). With TK’s stock price just under $55 / share, the company was advising investors that its true “value” was $72.02 / share- or, 33% above TK’s market price. TK’s rationale is summarized below.

74.56 million TK shares	**TOO / OPCO**
OPCO EBITDA forecast (2007)	$278.4 Million
TOO EBITDA multiple	12.5x
Implied EV for OPCO	$3,471.7 Million
Subtract: Net Debt	-$1,189.4 Million
EQUITY VALUE	$2,282.3 Million
TK ownership (adjusted for public owners)	$2,031.6 Million
Est. value of GP end March, 2007	$ 13.0 Million
Total	**$2,044.6 Million**
Per TK share	$27.42

74.56 million TK shares	**TGP**
Units outstanding	34.97 million
Price per unit end March, 2007	$37.58/ unit
Total Market Cap	$1,314.2 Million
TK ownership (adjusted for public owners)	65.8%
EQUITY VALUE	$864.7 Million
Est. value of GP end March 2007	$ 62.9 Million
Total	$927.6 Million
Per TK share	$12.44

74.56 million TK shares	**TK**
Fair market value of owned fleet	$1,550 Million
Add: Petrojarl investment (adjust for min. interest)	$ 819.1 Million
Subtract: Net Debt	-$772.5 Million
Est. equity value of in charter fleet	$ 168.1 Million
Subtotal - before additional items	$1,765.7 Million
Add: In the money amount - Newbuilds	$177.1 Million
Add: Installments to date- Newbuilds	$315.3 Million
Add; RasGas3 installments (LNGs)	$140.5 Million
Total	$2.397.6 Million
Per TK share	$32.16

During 2Q 2007, Teekay announced that it would be spinning off its "Conventional Tanker Business" which it includes TK's traditional Aframax franchise, but also additional holdings in the Suezmax and MR (Handymax) products sector. Not by coincidentally, the announcement coincided with news that TK would be gaining additional vessels through its acquisition of OMI Corporation, jointly with Torm. In answering analysts' queries at the time, TK referred to a "critical mass" of tankers and its management talked about an "MLP-like" structure. Another large owner, Overseas Shipholding Group (OSG) has now filed preliminary regulatory documents for "OSG Americas", an MLP populated with US flag assets.

Teekay is in the process of a transformation to a holding company, owning stakes in independent businesses, now describing itself as a "Global asset management company focused on the marine midstream space." In a mid August investor conference call, TK management indicated that it was actively working on the "Teekay Tankers" project, and hoped to file for an IPO during the second half of 2007.

At end July, 2007, the potential fleet for its new entity consisted of 41 owned vessels in the "Spot" segment and seven owned vessels presently owned in the "Fixed Rate" segment. Chartered in vessels consisted of 40 in the spot segment plus an additional pair in the fixed category. These include assets acquired from OMI, consisting of seven Suezmax tankers, three Medium Range product tankers and three Handysize product tankers, plus OMI's in-charters of six additional Suezmax tankers but excluding vessels managed, in the "Gemini" pool. TK has said: "…it is expected that Teekay Tankers will grow through the acquisition of conventional tanker assets from third parties and from Teekay, which may include vessels to be acquired by Teekay from its planned acquisition of 50 percent of OMI Corporation…" The OMI chartered in vessels could suitable for inclusion in the new company (depending on in-charter term) because they are suitable for multi-year outcharters.

How much might the new entity be worth in the marketplace? Teekay's own presentations provide a multiplicity of approaches for valuing companies and investments. However, bankers valuing an ongoing business will often compute an implied Enterprise Valuation, adjust for debt, and arrive at the base case for the potential value of an independent Teekay Tankers. For this article, Lloyds Shipping Economist (LSE) developed a simple model for evaluating an entity resembling a hypothetical "Teekay Tankers" under various scenarios. Methodologies follow those used in Teekay presentations, supplemented by guesswork and inferences. The actual legal structure of TK's "MLP-like" offering will likely differ from that shown here.

Following this approach, we developed an estimate of the likely EBITDA for an entity consisting of the 22 owned vessels and six in-charter vessels, including owned and chartered ships acquired from OMI. TCE's used in the base case are above those seen by TK during the first half of 2007, reflecting TK's stated position that tanker rates ought to move up sharply in 2H 2007 with increased liftings tied to the "call on OPEC". In practice, where the sponsor can choose among vessels for placement in an MLP, strong cash flow (ie higher rates for longer periods) will be an important criterion. If recent drybulk developments are a guide, charterers fix longer periods in stronger markets.

Simplified MLP Model for **Hypothetical** Large Tanker Spinoff		
Top Line Net Revenue (TCE)	$ 372.8 Million	Based on Portfolio Fleet
Op Costs (and charter hire)	-$ 100.8 Million	Based on Portfolio Fleet
G & A Expense	-$ 35.9 Million	Estimated
EBITDA for entity	$ 236.2 Million	
Multiple	11x	High end of peer range
Implied Enterprise Value	$ 2.6 Billion	
Subtract Applicable Debt	-$ 0.8 Billion	Estimated debt allocation
Overall Equity Value	$ 1.8 Billion	
Sponsor share (82%)	$ 1.47 Billion	Estimated control

Fleet Value	$ 1.50 Billion	Estimated fair mkt value

Rate and Operating Cost Assumptions for Hypothetical Tanker Spinoff				
	Suezmax	Aframax	Large/ Med Prod	Small Prod.
Asset price	$90 Million	$70 Million	$50 Million	na
Rate, onhire days	$42,000 - 362	$38,000 - 361	$28,000 - 360	$16,000 - 360
Op. Cost/day	$6,600	$6,500	$5,500	$5,000
Owned	6	8	8	na
In-Chartered	6 @$24,100/day-355 days			

Analysts arrive at the "Implied Enterprise Value", once an annual EBITDA (similar to an operating cash flow) has been determined (after adjusted by S,G &A) by applying the appropriate multiple to the annual cash flow. Multiples of the Enterprise Value to annual EBITDA, based on peer comparisons, are by their nature highly subjective. A recent research report from Jefferies & Company, with EV based on recent market prices, showed a range of multiples for seven high payout tanker companies ranging from a low of 7.7x (Aries Maritime) to 12.5x (Arlington Tankers), with an average of 10.1x. TK itself garners a multiple above the average for a peer group of regular dividend payers.

The partnership's equity can then be valued by subtracting the debt attributable to that business unit from the Implied Enterprise Value. In the MLP template, the sponsor retains control, through holdings of subordinated Limited Partner (LP) units, and ownership of the General Partner (typically 2% of all units). Outside investors end up with a minority interest. In our simplified base case, the sponsor contributes vessels worth approximately $1.5 Billion, ultimately equal to 82% of the equity value.

Assets controlled in MLP's, and MLP-like structures (shipping companies distributing cash) have generally been owned. Modern vessels controlled under bareboat charters are also appropriate for inclusion into MLPs. Consider that TGP currently operates a handful of Suezmax's (originally in the Naviera Tapias fleet), on bareboat in-charters, financed through long term (capital) leases- with purchase obligations due to be exercised in 2007- 2011. These five ships are listed in the TGP "Owned" category in the April 2007 "Investor Day" presentation.

Similarly, the asset base in a newly announced tanker MLP, the "OSG Americas" transaction (currently in the registration phase) is set to include six product tankers controlled by OSG under bareboat arrangements. Two have delivered into charters in 2007, with four more set to deliver into oil company charters later this year and in 2008. During 2007, Teekay has reported that it had sold and leased back four older Aframaxes under bareboats of four- five years duration.

As a practical matter, owned assets can be easily placed into longer term charters. In pure MLP's, U.S. investors are able to gain tax benefits from the partnership's equipment ownership, adding to the attraction of the investment. But, operational control (without tax ownership) can also be achieved through such bareboat in- charters of vessels by MLPs.

The Dahlman Rose analyst's views on valuation, expressed in a general context, also help explain why the Teekay MLP would probably be based on a high multiple. Teekay's share price was estimated to be 90 % of NAV in the same recent Jefferies report that examined EV/EBITDA. The high asset values (which have deviated from their historical relationship with freight levels as rates slumped during 2007) work to the advantage of asset sellers- selling "metal rather than shares". Where the sale of the ships (to the MLP) is achieved above 90 percent of the NAV, value is unlocked for TK shareholders. The vessel portfolio modeled here is worth on the order of $1.5 Billion.

Provided that the MLP is able to arrange for accretive charters with terms of typically three years or more, the yield based pricing enables the MLP to pay up. Dahlman Rose's Omar Notka told LSE.. "**So in**

essence, investors are willing to pay this NAV premium because of the cash flows. MLPs today are buying assets at 10% yields that investors value at 6%, again boosting NAV multiples". A major key to unlocking value is this arbitrage alluded to by Mr. Notka- multiples move inversely with the yield (a measure of distributable cash available per partnership unit as compared with the market value of the units). Ships are worth more when they generate regular distributions; which is precisely what MLP's do.

The same arithmetic applies to dividend paying corporations (MLP-like entities paying out cash, but organized in corporate form). On these companies, Notka said: "investors today are willing to buy certain equities with high dividend-paying structures that yield in the 8% to 10% range. At the same time, these companies can acquire assets at NAV that yield roughly a 12% to 15% yield. In other words, a company can buy a vessel for a 12% yield and in a dividend-structure that same vessel would be valued at 8%, which means a significant premium to NAV."

By way of comparison, TOO has been yielding 5% in recent trading, based on annualized distributions of $1.40/ unit, while TGP's annualized distribution of $2.12 (based on a recently increased payout) has produced a yield of 6.2%. Both are attractively priced compared to the benchmark 10 year U.S. Treasury yield of roughly 4.6%, and compared to the big energy MLPs. As guidance, the new OSG MLP is aiming for an initial yield of 7.0%.

In practice, and possibly differing from the model here, the MLP will likely include the vessels with longest charters and those generating the most cash flow. The arms length, albeit friendly, relationship between the Sponsor and the MLP enables the MLP's portfolio (and hence, valuation) to be optimized. In practice, a Teekay MLP could begin with perhaps fewer than 22 owned vessels, supplemented by a handful of in-chartered ships (as modeled here).

A useful paradigm for future transactions between sponsor and MLP has been set by Capital Products Partners L.P., an April, 2007 IPO. The MLP has options on six additional MR's (four 51,000 tonners from STX and two 37,000 tonners from MIPO) on order by its sponsor, privately held Capital Maritime. The options can be declared, ie the MLP will have the right to buy the vessels from the sponsor entity, but only if the MLP first obtains accretive charters.

Similarly, TK has "warehoused" projects for TGP- for example, two recently delivered LNG's, that have now delivered into RasGas III charters. TK has a 33% stake in four LNG's for delivery in 2011 into an Angola project- and TGP presentations inform that: "Teekay Corporation is obligated to offer Teekay LNG Partners the opportunity to purchase these vessels." In announcements regarding the OMI vessels, TK said: "Teekay and Torm will continue to hold two Medium Range product tankers jointly in OMI, as well as two Handysize product tanker newbuildings scheduled to deliver in 2009. The parties intend to divide these remaining assets equally in due course." Quite possibly, these will be sold to the conventional tankers MLP if and when accretive charters are put in place. TK also has ten conventional Suezmaxes on order for delivery during 2008 – 2009, which, analogously, could be sold into the "Teekay Tankers" entity later on- when attractive charters are put in place.

All of the Sponsor/MLP pairings must walk the fine line between the interests of sellers (seeking the highest price possible for their assets) and buyers (seeking to buy at the most attractive prices possible). Where the Sponsor is a listed company (such as TK, and, now, OSG), analysts' eyes are on both buyer and seller; historically, TK has a good record of navigating these narrow straits with its other MLPs.

An actual IPO will likely be smaller than the entity modeled here. Capital's IPO netted $270 Million (including the Underwriter's Overallotment, or "Greenshoe"), and OSG is aiming to raise $150 Million. In practice, additional capital can be raised in follow on offerings as TGP and TOO have done.

Valuations of the hypothetical new entity are, at best, "back of the envelope". But, the simplified model provides insights into the ways that value will likely be unlocked by TK's demonstrated financial wizardry.

SUPPLEMENT - THE OSG AMERICA FILING: While we can conjecture what the contours of an eventual Teekay Tankers might look like, OSG, another listed player with issues similar to TK- diverse businesses and a market valuation below NAV, has issued regulatory filings for an MLP. During the past three years, under CEO Morten Arntzen, OSG has grouped its business into four units- international crude tankers, international product tankers, an LNG business, and its US flag tanker business. The market has been harsh on OSG, valuing it at only 62% of its approximate NAV, so OSG is now taking action. Just as TK's acquisition of OMI may have set the stage for the upcoming conventional tanker spinoff, OSG gained a "critical mass" in its U.S. business unit when it acquired Maritrans Corp in 3Q 2006.

The new MLP, "OSG America L.P.", will own four older single hulled product tankers (from the OSG fleet), six double hulled product tankers and eight older ATBs (a unitized tug barge combination) that have recently undergone double hulling. OSG is also contributing a 37.5% ownership interest in "Alaska Tankers" (owned jointly with BP America and Keystone). Alaska Tankers controls five crude tankers (aggregate capacity of 6.3 Million) for the Alaska / US West Coast crude oil trades. The existing fleet includes two 46,000 ton product tankers already delivered into OSG bareboat charters from the Aker America (Philadelphia) Shipyard- one chartered to Shell and the other to BP.

Beyond the initial fleet, OSG has assigned the bareboat charters on four further product tankers under construction at Philadelphia for delivery later in 2007 through 2009, as well as two tugboats. OSG. Additionally, the new MLP has been granted OSG's options for purchasing up to six newbuildings from the Aker Yard

At the end of the day, public holders of partnership units will own 22.8% of the company. OSG, the Sponsor, controls the remainder of the partnership- divided into 75.2% of Limited Partner units (in turn divided between common- 26.2% and subordinated- 49%) and 2% through full ownership of the General Partner.

The IPO will raise $150 Million ($136.5 Million net). Projected cash distributions of US $45.99 Million, or $1.40 per partnership unit (over 32.85 million units overall, including those issued to OSG), works back to a 7% yield to investors, assuming a market value of $20/ unit. If the Underwriters exercise their "Greenshoe" (the 15% over-allotment option), then the total take will increase to $172.5 Million (before Underwriters fees).

The total capitalization of the MLP, post IPO, would be approximately $599 Million (based on the $136.5 Million net proceeds of the offering paid in by new investors, and other pro forma balance sheet assumptions spelled out in the initial filings). Using the forecast first year EBITDA of $86.4 Million, and a price of $20/unit, an initial EV/EBITDA valuation of around 9 x is implied at the time of the IPO. Typically, as the units rise in value in trading, the multiples increase.

In the first year forecasts, the MLP will reserve $15 Million for drydockings ("Maintenance capex"), and will set aside $15.9 Million for fleet replacement ("Replacement capex"), accounting for much of the difference between EBITDA and Cash Available for Distribution.

Impacts on OSG	
Cash (IPO Proceeds- net)	$136.5 Million
Common Units Issued to OSG Subordinated Units Issued to OSG	8,596,500 (26.2%) 16,096,500 (49%)
GP units issued to OSG America LLC	657,000 (2%)
Forecasts – Twelve Months ending June 30, 2008- all in $ Millions	
Revenues	**$203.522**
- Vessel Operating Expenses	-$76.072
- Bareboat Charter Hire	-$23.140
- Depreciation	-$51.075
- General & Administration	-$20.00
Income from Vessel Operations	**$33,236**
Add: Equity Income (Alaska Tanker)	$5.278
OPERATING INCOME	**$38.513**
- Interest Expense	-$10.078
NET INCOME	**$28.435**
EBITDA	**$86.374**
Cash Available for Distribution	$50.560
Distributions	$45.990
Excess Cash	$ 4.570