Sealift, SeaDrill, SeaProduction- New Value Creation at the Front of the Line

Company valuation is part science and part art- and the real test of beauty may be in the eyes of beholders, ie what investors will pay. Norwegian owner Frontline's (NYSE and Oslo "FRO") financial strategy has advanced way beyond rewarding investors through its distributions tied to earnings of its tankers, following the axiom of "the parts are worth more than their sum when companies are busted apart." Shareholders have gained value as FRO has spun out a financial holding company and a drybulk shipholder. It has launched an FPSO operation. Now, Frontline, often at the leading edge of financial and business strategies, 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.

The moves in the directions of heavy lift and FPSOs are at the intersection of multiple currents. Energy company exploration and production (E & P) budgets have ballooned with the price of oil in recent years; rigs need to be moved around. Among investors, energy investments command a premium over shipping, an inequality well known to financial alchemists, and also, it seems, to naval architects. Later in the decade, hundreds of single hulled oil tankers will come against mandatory phase-out rules enacted by the International Maritime Organization. In anticipation, shipowners have been seeking alternative uses for these assets. Conversions to FPSO's (for use in offshore oil production) have provided one alternative, and now, heavy lift conversions have joined the list.

In terms of valuations, a soon to be phased out tanker, bought on the cheap, is worth far more, even after conversion cost, as an integral link in an energy supply chain. Where Teekay has gobbed entire players in the offshore sector, Frontline's modus operandi has been to develop selected businesses, and, when self-sustaining, spin them out as independent companies, what can be called "Some of the Parts".

Teekay Offshore Partners, a Master Limited Partnership, was spawned with similar considerations in mind. Like Frontline, Teekay's mentality has moved away from that of a traditional owner, to that of the "asset manager" with fee and charter revenue income earned from operating assets owned by others. Teekay said in a recent presentation: "Fixed rate cash flows have a higher value to investors". In addition to the higher multiples and equity valuation afforded partnership structures (due to their tax

efficiency), an asset manager, a/k/a a General Partner, numerous fees and arbitrage profits. One leading analyst, Mr. Urs Dur, at Lazard Capital Markets, points out in a recent report that, in spite of the theoretical appeal of "Sum of the Parts", Teekay's fortunes are still heavily dependent on the traditional tanker market.

At Frontline, the expanded multiples of EV/EBITDA, in the energy sector (compared to shipping) imbue the spinouts with potential to create value for investors. The propensity toward 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 Frontline's fledgling FPSO business. Indeed, last Autumn, a Norwegian innovator in the FPSO market, Sevan Marine, was able to raise $120 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, though mainly an operator of vessels, has a book value in excess of $700 Million, and a market capitalization of $2.5 Billion, based on recent share trading. In addition to its quarterly dividends (most recently, $2.50/ share reflecting a strong 3Q 2006), it has also enriched shareholder by dividending shares in spun off and de-merged companies. After gaining the reputation as fierce consolidator, its first carve up took place in 2001, when Golar LNG was formed. In late 2003/ early 2004, Frontline created Ship Finance Limited (SFL), a financial holding company that bought 47 oil carriers from Frontline and chartered them back. Frontline shareholders were rewarded with 25% of the equity in the new entity. Frontline, though not a "General Partner" in a legalistic sense, is effectively performing that role.

Now, nearly 89% in SFL, a $1.7 Billion (market value) entity listed on the NYSE has been placed in the hands of Frontline shareholders since the first partial spin off in June 2004 (NYSE "SFL"). Magnate John Frederiksen maintains a 37.58% position through his Hemen Holdings (in addition to Frontline's piece). Shipping companies lamenting an uninspiring share price/ NAV ratio should remember Frontline's solution- move the assets somewhere else, ie into SFL, and then lease them back.

In late 2004, Frontline spun off the steel-making raw materials specialist Golden Ocean (GOGL), which had a market capitalization of $131 Million at the end of 3Q 2006 (retaining a significant stake for itself). Golden Ocean has recently been creating value of its own, with recent acquisition of Capesize newbuilding contracts for ships under construction in Korea. GOGL sold the contracts at a profit to SFL, and will charter the vessels back over fifteen years (supported for the first five years by charters in the market by Goldbeam/ Jinhui), commencing upon delivery in 2008/ 2009. Coal and iron ore, often moving in contracts, are an eminently suitable base for securing freight contracts that, in turn, buttress yield type shipping business and their higher multiples. As evidence of such thinking by financiers, industrial shipping specialist Navios (now moving to the NYSE) announced its purchase for $161 Million of privately held Belgian owner and operator Kleimar- active in Capesize and Panamax sectors. $85 Million will be financed by a drawdown on its revolver with HSH Nordbank and Commerzbank AG.

On the liquid energy front, the FPSO activity will be handled by SeaProduction, a company still organizing its finances. Its first asset will be the FPSO “Front Puffin” ex “Gerrita”, a single hulled post-Aframax purchased by Frontline in 2006, and presently being converted to an FPSO at Singapore’s Keppel Shipyard. If all goes according to plan, it will deliver in mid 2007 into a contract with Australian E & P company AED Oil at the Puffin Field, in NW Australia. The new company, SeaProduction, then agreed to acquire both the vessel, and the organization that Frontline has been building, for $210 Million (with $150 Million allocated to the actual unit). In early February, the new company then announced that it succeeded in capitalizing the new entity, completed a private placement of $180 Million through Pareto, SEB and Nordic rising star Glitnir Securities ASA. Keppel Shipyard has garnered 5% of the new equity, and Frontline 28%.

Further FPSO related asset acquisitions were also in the works. Frontline announced that it was in discussions with Seatankers (a Frederiksen controlled company) regarding the disposition of two Aframaxes suitable for conversion into FPSOs. These were reported acquired for $18 Million each. SeaProduction announced the $90 Million acquisition of the FPSO “Crystal Ocean” from another family entity in the Frederiksen sphere, SeaDrill (which has grown through acquisition of assets from Smedvig, Mosvold and others), after the termination of a contract of the Indian coast. Market rumblings have SeaDrill, linked last year to US $ 1.2 Billion bridge loan with Nordea and DNB (in connection with Smedvig acquisition), looking at a loan facility as big as NOK 50 Billion with these two Nordic giants, as well as Danish and German banks.

SeaProduction, with its $336 Million of purchases, will be financed through the private placement, a small amount of Sellers’s credit, and through an upcoming bond placement of $130 Million in the Norwegian Alternative Bond market (ABM). Its equity will be listed in the Norwegian OCT market. The dayrates for FPSO’s can easily exceed $100,000/day; recent research by Pareto Securities suggests that the ratio of Enterprise Value (EV) to EBITDA on recently awarded FPSO contracts (with equity and debt reflected 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/ EBTIDA ratios for six firms at an average of 14.9x.- nearly the double the ratio for most tanker companies. Two aspects of alchemy are at work here; first, single hull tankers are worth more as FPSOs, and, secondly, FPSO startups can be attractive as they appreciate in value; an early trading discount compared to more established players may disappear as investors gain confidence and jump on the bandwagon.

The Heavylift arena is also part of the energy production chain. Another Norwegian, Oslo traded Awilco Heavy Transport, showed that tanker conversions were viable. In late 2006 into January 2007, Sealift, Frontline’s heavylift entity, announced that it also raised $180 Million privately from Scandianavian investors- including $60 Million from Frontline. Sealift is also planning on raising $110 Million in the ABM. By mid 2008, Sealift will have six “heavylifters” under its control. Four single hulled Suezmax tankers are

presently owned by SFL (four are on charters to Frontline; one is presently undergoing a conversion process begun after the vessel was damaged in an explosion last June). In addition to these, two additional vessel acquisitions from Frontline are in the works, for $38 Million apiece, with conversion, at COSCO Shipyard, expected to cost $40/ $45 Million each. Frontline will have complete responsibility for the vessel conversions, and is providing Sellers credit to the Heavylift entity as part of its financing package, with repayment timing tied to completion of the conversions. Sealift has hired a team of Dutch heavylift veterans to manage the units, worth nearly $100 Million each all in, when completed.

The deals include a significant “related party” component. As contemplated, SFL will sell the vessels to Frontline for gross proceeds of nearly $184 Million- en bloc, of which SFL kicks back $62 Million to Frontline as reimbursement for “charter termination”. Delivery to Frontline is expected during the 1 Q 2007. After netting out $14.2 Million of outstanding bank debt on the vessels, SFL coffers grow by $107 Million- with SFL’s stated intention of investing the proceeds into equity of new projects.

The calculations between SFL and Frontline, concerning replacement of chartered in tonnage under changed market circumstances, are not detailed in publicly available information For perspective on the economics of “charter terminations”, the arrangement with respect to the recent $38 Million sale by SFL of the 1989 built “Front Transporter” (similar to the vessels going into Sealift) is revealing. In this one-off deal, SFL will pay $15.4 Million to Frontline as compensation for early termination of charters where Frontline would have been chartering the single hull Suezmax (once it reached 18 years of age) for $15,348/day, and then at $7,500/day beyond 2010.

Discounting to the present with a simplifying assumption of comparable cost structures between early 1990’s and modern Suezmaxes, the implied charter cost over a seven year period works back to the low $20,000s/ day. The fine print in Frontline’s charters with SFL provides 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 $15.4 Million discount back to the upper $20,000s/ day. Broker sources suggest that modern replacement tonnage in the charter market would be in the region $38- 40,000/day for a three year charter; intuitively, a replacement over seven years (assuming a 25 year ship life) would see a much lower hire rate. Happily for perspicacious investors, the Frontline/ SFL charter termination black box appears to be conservative with respect to hire assumptions.

The capital costs for construction, and day rates earned in the market, are lower for heavylift vessels than for FPSO’s. With the daily hires in the $40,000/ day - $60,000/ day range that can be expected, analysts on a comparable deal have estimated an all-important EBITDA/EV

startup value to be around 4.5 x to 6.5 x (depending on the day rates). Though fewer heavylift "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- where "mobilization costs" are small in relation to the overall transaction. Consider for example a recent multi-year deal that could be worth up to $580 Million, announced for the 2008 delivery of the Seadrill ultra deepwater rig "West Hercules" to a field off the Chinese coast, at a day rate that works back to $510,000/day. With such room to raise prices, and numerous rigs to move, company promoters would look for the valuation multiple to expand as market capitalization booms outward and the trans-mutation takes hold.