

Nirvana and marital bliss in ship finance

Comparing financial data provided by shipping companies is a complex affair. Here, Barry Parker discusses what investors want and need

Was this a good deal? Is that company on solid financial footing? The present wave of consolidations has brought with it a stream of announcements from tanker companies, and commentary from analysts.

Students of these announcements have probably wondered what, exactly, is the meaning of "accretive", EBITDA, debt/ equity and any number of other arcane terms. As the pile of bulletins mounts on our desks or email inboxes, the jargon gets thicker and takes on a life of its own. Over the past few months, professional dealmakers have stitched together two groundbreaking acquisitions- Teekay's \$800m acquisition of the Navion fleet, and General Maritime's \$525m combination with Metrostar (Angelopoulos). While both deals involve operating synergies at the respective companies, the biggest variable, often imponderable, is the knotty question of how investors will view a particular transaction.

ACQUISITIONS AT A GLANCE

	<u>TEEKAY</u>	<u>GENENERAL MARITIME</u>
Acquirer	Teekay Shipping	General Maritime Corporation
Acquired	Navion ASA	Assets of Metrostar Management
Ships Acquired	10 owned, 36 in charter	14 Suezmax, 5 Aframax
Dwt. Acquired	5.1m dwt	2.67m dwt
Acquirer Fleet After	147 vessels	19 Suezmax, 28 Aframax
Acquirer Dwt After	15.9m dwt	5.6m dwt.
Price	\$800m	\$525m

Even the professionals find themselves politely disagreeing on the prospects for the tanker stocks sector, and on investors' perceptions of particular deals, as I discovered at a recent Ship Finance panel, moderated by JP Morgan Chase's shipping supremo Peter Evensen, at the Norwegian American/ Hellenic American Chamber of Commerce conference in New York, now in its ninth year.

As background, perfect objectivity is elusive in ship finance, making it hard to compare one transaction with another or one set of company books with another. Standards for reporting on shipping company earnings and balance sheets are far from uniform as finance intersects with varied accounting rules in shipping centres in New York, London, Oslo, elsewhere in Europe and the Far East. However, concern about "cash flow" permeates all aspects of ship finance, mainly because tanker companies are typically leveraged (that is, employing debt to finance their vessels and their operations). Simply described, cash flow is the excess of freight income minus cash outflows during the same approximate time period. This quickly becomes confusing, because some number crunchers subtract only operating costs, while others may look at "free cash flow", which adjusts for capital investing and sometimes for drydocking/ special surveys, a major cost item where funds are sometimes actually placed into a restrictive account, while at other times merely accrued.

Through this thicket, the measure closest to an objective yardstick of cash flow is EBITDA (earnings after subtracting operating costs but not subtracting interest, taxes, depreciation and amortization), which analysts use to compare shipping pricing, and bankers use as an input in calculating measures of overall debt service, or interest coverage. Reported earnings and actual cash flows are not always the same thing. In asset intensive companies, published accounting numbers may deviate

significantly from the more critical ledger of cash in/ cash out. Whatever your measure of choice, analysts on the Norwegian/ Hellenic panel, and around the world do agree that, unfortunately, shipping shares command lower multiples than their brethren in more corporatised transportation and logistics businesses.

Revealing some of the differing viewpoints in the listed equity markets, Jeff Pribor, senior vice president at Det Norske Bank pointed out that US and UK investors are looking at the earnings and cash flow measures, Norwegian (a big factor in the equity markets) investors focus on "Net Asset Value" (NAV) per share - a measure that considers fluctuating ship values minus debts owing. Perhaps, this reflects the Norwegian climate where companies are flipped around with some regularity. If the company is a pure shipping play, just a constellation of vessels and little else, then the breakup value of the company is tied to asset values. The analysts on the panel did lament shipping shares' poor comparison with other logistics companies, even asset based, which traded at higher multiples of both earnings and EBITDA. Financial nirvana, it seems, is to be perceived as a very stable ongoing industrial business.

At road shows and conference calls for listed companies, the talk always comes around to earnings per share, which is irrelevant in the world of private equity that still predominates tanker ownership structures. In this age of consolidation, share investors are concerned about whether a particular acquisition is accretive (increases earnings on a per share basis) or dilutive (reduces earnings on a per share basis). Architects of both Teekay-Navion and General Maritime- Angelopoulos, solved this problem by financing the purchases with debt finance in the form of term loans from syndicates of banks.

Teekay's January 2003 shelf registration provides for the possibility of issuing shares, and in mid February 2003 Teekay announced its intention to sell some \$125m of Premium Equity Participation (PEPS) units- a combination of debt convertible into equity two years out. Add another acronym to the list! The good news is that earnings per share (EPS) rise when all debt structures are utilized, as no additional shares are issued. The bad news, according to some of the analysts, is that investors may not like the extra leverage. Anthony Argyropoulos, Senior Vice President at Jefferies and Company, says that "leverage tempers advances in a stock," citing the absence of a pop upward in the stock price after Teekay's announcement, even though predicted earnings per share, post combination, were substantially higher.

A slightly different view on leverage was expressed by Jill Evans, a seasoned equity analyst who follows shipping shares for JP Morgan Chase. Noting that the Teekay announcement came during a market downdraft, she said that investors will tolerate a higher gearing if the overall deal is perceived as promising. Ms. Evans cited General Maritime, a company she is recommending partly because of its large spot exposure at a time of a strong market, which rose \$1 per share after its January 2003 announcement of the Metrostar transaction, in spite of leverage moving up from 40 % to nearly 60 %.

Questions came up about the likely development of share prices during the year, which saw the panel divided. Jim Dolphin, from American Marine Advisors, stressed the high correlations of tanker share prices with the movement in the price of oil. The talk turned to war scenarios- with nobody willing to commit on what might happen. Mr. Dolphin also pointed out the share prices may become out of synch with company earnings because actual rates may (and earnings) move around rapidly, while investors may be pricing shares in reaction to reported earnings in the last quarter.

Investors have also responded to chartering strategies, shifting their company preferences to respond to the market outlook. Ms Evans suggested that in the weaker tanker market in evidence throughout most of 2002, defensive stocks like Stelmar, with a high proportion of tonnage committed on time charter, were good

performers. As the tanker rates showed signs of upward movement, companies like Teekay and Tsakos Energy came into favor, because of what Ms Evans described as "50/50 strategy", where potentially risky exposure to spot WS and hire rates is balanced against the stability of time charter and contract cover. Her positive views on General Maritime stem in part from its high proportion of spot tonnage (although the company said in its January conference call it will be easing into more period coverage, albeit at extraordinarily good rates).

The consolidation wave, reflected in acquisitions or mergers, is always on the minds of the analysts and the investors, but may be shifting amplitude and direction. At a time of few public deals being shown around throughout the marketplace, many private conversations are taking place. DNB's Jeff Pribor asked the question "...how can you do a hostile take-over in an industry full of family businesses?" Clearly, other factors are at work in creating willing sellers. In previous articles, we have asked the question about whether increasing demands of regulation and transparency may drive traditional owners to sell out, so one might look for arranged marriages instead of shotgun weddings. In combined companies, marital bliss means that operating costs can be spread over more ships, creating economies of scale and bolstering the case for earnings growth and increased size.

Corporate decisions to divest out of shipping, or to hive off a tanker fleet, are another source of deals. Teekay, General Maritime and possibly others are looking at American Eagle Tankers (part of Neptune Orient Lines), now prettied up following the second quarter of 2002 \$18m acquisition of MTL Petrolink's lightering business in the US Gulf.

As fleets grow, can that elusive financial nirvana be far away?