

Deal making at Frontline

Although Norway's Frontline is closely watched by the industry and media it can still offer surprises that ensures it remains a leading player in its field. Barry Parker considers the companies latest moves

In shipping every trend reverses sooner or later, so perhaps the consolidation fad has now over-reached and will then shift to a mode of selected deconstruction. Throughout the summer, Frontline, which truly invented the "urge to merge" tanker companies since the mid 1990's, has been making noises about unleashing value while making its stock as attractive to investors. This trendsetter has made another dramatic move, and we are wondering whether other companies may follow. Frontline (FRO) has built a large entity through the strategy of artfully combining businesses, sometimes on hostile terms. Shareholder value, ie the market capitalization of a listed shipping company, is enhanced through economies of scale (ie fixed overhead spread over more units and lowered variable cost through volume purchasing) and through more control over marketing (higher concentration, ability to substitute similar vessels in contract business).

However, in a bigger company, the financing cost and structure have both explicit costs and implicit opportunity costs. So, now, Frontline, always a trend-setter, is looking at how to create further value by restructuring the company- which now controls almost 70 relatively modern vessels, mostly VLCCs and suezmaxes, aggregating 16.4m deadweight. Such size comes with the price-tag of a huge exposure to interest rate volatility, and a somewhat lesser buffeting by foreign exchange swings - mainly in the Japanese yen tied to the acquisition of Golden Ocean tonnage several years ago. The liability side of FRO's \$3bn balance sheet included \$1.445bn of interest bearing debt at the end of 2002. Of this, a staggering \$1.425bn was priced at floating rates (offset by \$352.7m of interest swaps where Frontline can receive variable flows). Capital leasing obligations (long and short term portions) comprised an additional \$273m.

Frontline's stock price on the New York exchange has just about doubled between April 2003, when it was trading at \$10 per share, and early September- when it surged ahead along with the entire tanker peer group. Indeed, as recently as October 2002, it was trading down near \$3. Though its pricing happily reflects the general upward thrust of the tanker market, and interest expense came down sharply in 2002, non shipping variability has still crept in. In 2002, the company booked a foreign exchange loss of \$10.9m, and took a charge of \$8.6m for "other financial items", principally market adjustments on interest rate swaps.

In August, Frontline took the first steps in its transformation to becoming a quoted company where investors can focus on tanker rates- rather than the vagaries of the yen and bond markets. After paying a dividend of \$1.10 per share in September (coming on the heels of the second quarter results) and moving its Suezmax OBO's into the Capesize dry trades, FRO sold two VLCC's to the KG companies organized by the German investor Dr. Peters GmbH, and then leasing them back for a 12 year term with sellers garnering repurchase options.

This follows a deal done late in the second quarter of 2003, where Front Symphony and Front Melody, two modern units built 2001, were similarly sold and chartered back. Such deals raise instant cash, and, when done at firm prices, generate a profit to the income statement. In the case of the Suezmaxes, \$39 of cash was generated along with an income gain of \$8m (which will be taken over the 12 year charter period in accordance with rules for accounting for Capital Leases).

At some point, isolated transactions emerge as part of a bigger plan. The first two sales to KG companies were done in 1998, followed by five additional transactions

during 1999- 2002. So far, in 2003, Frontline has done 4 such deals. Now, following a series of recent presentations at banking conferences, FRO has investors salivating over the prospect of selling an additional 9 VLCC's to German KG companies, and refinancing the debt on Suezmax vessels. Such a plan could free up an estimated \$332m of cash, leaving FRO with a comfortable cash cushion once the market cycle turns downward. According to Frontline's Chief Financial Officer, Mr. Tom Jebsen, "...this could take some time, perhaps a year."

The trade-off in such a strategy is evident by looking at the increased required freight rates (RFR), sometimes described as the TC breakeven. In the case of Frontline, cash breakevens on the VLCC's could rise from \$20,500 per day up to \$22,900, while Suezmax cash breakeven could rise to \$15,300 from a per diem of \$14,300. In context, even the increased breakevens are still on the low side. Daily VLCC timecharter equivalents averaged \$29,400 from 1990 thru August 2003, still significantly in excess of the breakeven.

Due to its fixed nature, a KG lease involves higher daily capital costs than a more typical template of 30 % equity / 70 % bank finance. Analysts suggest that for a notional 2002 built VLCC, the TC breakeven (capital cost plus operating cost) might be circa \$27,000 - \$28,000 per day under a KG type lease. In the current low interest rate environment of LIBOR plus a margin, the TC needed in a more traditional banking structure could be as low as \$18,000 per day. However, with a sharply upward yield curve, swapping the variable debt into what becomes synthetic fixed rate debt (with a 7 year tenor) will narrow the gap, causing the required TCE to be up in the \$22,000 range.

At Frontline, Mr Jebsen indicated that he was studying possibilities beyond simply gearing up, telling Tanker Operator, "We have been looking at several future paths for the company, including the regular releverage exercise and the split in two," into an arrangement where ownership and ship operating are done by separate and distinct entities. Such structures are well known in the airline industry, where leasing companies are structured to optimize financial benefits. The lessors then charter their assets out to carriers, who are insulated from interest rates, depreciation, and yen/GBP cross-rates.

The split strategy could involve creating a vessel holding financial company that charters the vessels out to a reconstituted and more shipping market- responsive FRO. One possible structure that bears investigation is that of a Master Limited Partnership (MLP) in dealmaker parlance. Popular in the hotel business, and among oil producers and pipelines, the MLP facilitates a "pass-through" of financial flows to investors. In the shipping context, the stock price will track per share earnings that, in turn, represent the net inflows from shipping market operation, untainted by a layer of corporate items that might move share prices out of synch with earnings from operating vessels.

The shipping industry will soon experience an MLP transaction first hand, with the upcoming IPO of K-Sea Transportation which is expecting to be raising some \$73.5m (3.5m units, priced at \$21) to repay debt and add to its operating funds. Assuming that enough cash will be available to fund annual distributions to investors of \$2.00, the yield to investors from this operator of small tankers and barges in the US coastal trades will be a hefty 9.5%.