Tanker markets will feel credit crunch bite

Basil M Karatzas assesses the present impact and future implications of today's credit crunch for the world's tanker markets*

The term 'treasure ships' is associated with China's Ming Dynasty of the 15th century, when vessels four times as long as Christopher Columbus' *Santa Maria* sailed as far as the east coast of Africa and Mozambique, the Red Sea and the Arabian Gulf. In the first decade of the 21st century, the term 'treasure ships' can metaphorically be applied to the ships that are ploughing the oceans carrying liquid and wet cargoes: these vessels are worth a 'treasure' in terms of asset valuation, and both the value of the cargoes transported by them and the freight revenue they generate today are the highest by any historical standard.

Asset prices for ocean-going vessels, and tankers specifically, have appreciated materially in recent years, as depicted in Graph 1. The appreciation of asset prices has been more acute since 2004, due to parameters that have affected both the revenue generation by tankers (freight markets, as in Graph 2) also the financial costs and conditions of acquiring the vessels.

The most notable variable in acquiring and possessing ships has, of course, been the state of the financial markets for shipping assets, and even more so for tankers. From 2004 until the early autumn of 2007, the worldwide financial markets had been very receptive to shipping projects after a lull of some seven years with anaemic freight rates and memories of the high-yield ('junk') bonds debacle still fresh.

Equity investors were willing to participate in new issues (IPOs) and were optimistic towards ongoing shipping concerns, even freshly established ones, and some of the best-performing equities in the US-equity markets in 2007 were shipping companies. Similarly, debt providers, awash with liquidity and with an optimistic view of the markets, were providing loans either through bond issuing or bilateral lending at extremely competitive terms.

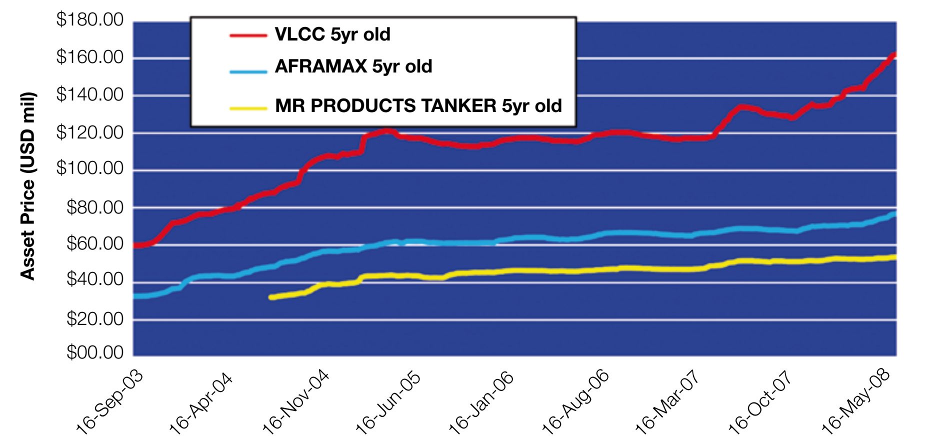
Reference names with a public listing were able to issue bonds at Libor plus 50 base points in early 2007, while brand name private owners were, in certain cases, able to receive 100 per cent advances at Libor plus 30 base points with zero amortisation and 10 years tenure (ie, 100 per cent financing of the value of the vessel at a 0.3 per cent above the lender bank's cost of money, with no principal repayment till maturity after 10 years).

Typically, the standard mortgage loan has been for a tenure of six-eight years with 25-35 per cent down-payment and a cost of at least 1-2 per cent above Libor with certain covenants. This contrasts with the last couple of years where mortgages have been somewhat 'covenant lite'. Then, from the autumn of 2007 until mid-2008, financial markets deteriorated.

What has caused equity investors and debt providers to re-assess their appetite for the shipping markets? The most obvious culprit has been the ripple effect from the fall-off in the US real estate markets, when sub-prime loans and collateralised debt obligations have affected major financial institutions worldwide (including financial institutions overseas which, strategically, would not have invested in such types of asset).

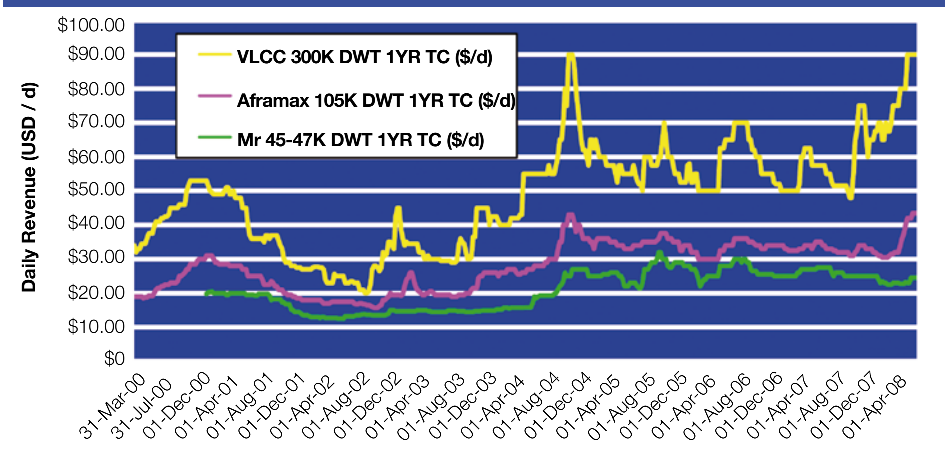
Some of the affected financial institutions have held sizable shipping portfolios (which traditionally are considered a step child to mainstream banking business), and when the balance sheet of the parent bank-company has come under pressure, shipping loans were the first areas to be affected. Secondly, part of the present reluctance to sanction shipping loans might be linked with 'strategic' corporate transactions in the banking sector itself, such as the acquisition of ABN AMRO. This acquisition has proven to be more complicated than originally thought, and at least one of the acquiring banks (Royal Bank of Scotland with major shipping interests and about US$11.5 billion in write-offs for US sub-prime real estate investments)

TANKER VESSELS ASSET PRICES



Graph 1. Changes in tanker asset value prices over the last five years

TANKER VESSELS FREIGHT RATES - 1 YR TC



Graph 2. Fluctuations in freight rates since March 2000

is understood to be looking for fresh equity to strengthen their balance sheet.

Thirdly, the nature of modern investing, with heightened volatility in the share pricing of financial companies and uncertainty over the full impact of the sub-prime mess (yet to be quantified), has persuaded banks to adhere to the 'cash is king' philosophy, on the balance principle that cash (capital preservation) could prove to be more important for the survival of a financial owner *per se* than generating profits by extending loans. Finally, the velocity and ferocity of the collapse of Bear Stearns has underlined that, in uncertain times, liquidity and credit can never be appreciated enough.

While all eyes had been focused on the issues related to lenders and the financial markets overall, the shipping markets have continued to move to completely new latitudes. Never-before-seen freight rates drove asset prices to all-time highs. As Graph 1 depicts, the price of a five-year-old VLCC, as provided by the Baltic Exchange Sale & Purchase Assessment Index (BSPA), of which the company I work for, Compass Maritime Services, is a panel member, has appreciated from US$117 million in the last week of July 2006 to US$134 million in July 2007, and US$162 million at present. This represents an approximate 40 per cent appreciation overall or 20 per cent annually.

By means of comparison, the one-year TCE rate for a modern VLCC was US$65,000 *per diem* at the end of July 2006, US$50,000 in July 2007 and US$90,000 at present. From July 2006 to July 2008, the newbuilding cost of a VLCC has appreciated by only 25 per cent or 12.5 per cent annually. Therefore, commercial lenders have to justify to their credit committees the robust asset appreciation, especially when compared with the building cost of the 'hard' asset.

The differential between the newbuilding contract and the modern vessel with prompt delivery is considered the 'time premium', which financial lenders are less willing to finance. Accordingly, the advance payment or down payment has solely increased to compensate for the time premium or goodwill (hot air) over the hard asset. Thus, with everything else being equal, if a bank required 35 per cent equity for a US$117 million five-year old VLCC in July 2006, equalling US$41 million, the same down payment today represents only 25 per cent of a comparable vessel's fair market value.

In Graph 3, we ran sample calculations, based on prevailing asset prices and financial terms and conditions, at the end of June in 2006, 2007 and 2008 available to a typical, well-established private owner for three asset classes in the wet sector (five-year-old VLCC, Aframax and MR tankers). The most noteworthy adjustments have been the shorter tenure of the loans (five years in 2008 versus eight years in 2006) and the leverage rate (50 per cent in 2008 versus 70 per cent in 2006).

TANKER VESSEL ASSET CLASS		5YR VLCC	
Calendar Year (End Of July)	2006	2007	2008
Purchase Price (In Usd Mil)	$117.00	$134.00	$162.00
Tenor (In Yrs)	8	8	5
Equity	30%	30%	50%
Libor	5.50%	5.40%	2.80%
Spread & Fees	1.00%	1.00%	3.50%
Interest Cost (Annual)	6.50%	6.40%	6.30%
Daily Finance Cost	**($37,364)**	**($42,626)**	**($53,851)**
TANKER VESSEL ASSET CLASS		**5YR AFRAMAX TANKER**	
Calendar Year (End Of July)	2006	2007	2008
Purchase Price (In Usd Mil)	$64.00	$69.00	$77.00
Tenor (In Yrs)	8	8	5
Leverage	30%	30%	50%
LiBor	5.50%	5.40%	2.80%
Spread & Fees	1.00%	1.00%	3.50%
Interest Cost (Annual)	6.50%	6.40%	6.30%
Daily Finance Cost	**($20,438)**	**($21,949)**	**($25,596)**
TANKER VESSEL ASSET CLASS		**5YR MR TANKER**	
Calendar Year (End Of July)	2006	2007	2008
Purchase Price (In Usd Mil)	$46.00	$52.00	$54.00
Tenor (In Yrs)	8	8	5
Leverage	30%	30%	50%
Libor	5.50%	5.40%	2.80%
Spread & Fees	1.00%	1.00%	3.50%
Interest Cost (Annual)	6.50%	6.40%	6.30%
Daily Finance Cost	**($14,690)**	**($16,541)**	**($17,950)**

Graph 3. Daily financial costs for five-year-old VLCC, Aframax and MR tankers

Our calculation is based on Libor rates plus prevalent spreads, without taking into consideration interest rate hedging/swaps and associated costs. The asset prices are once again based on BSPA. For the VLCC tanker market, which has been the most volatile asset class in the wet sector, the daily financial cost of owning such a vessel has jumped from less than US$40,000 to around US$54,000 since 2006.

In less dramatic terms, the daily finance cost of an Aframax tanker has jumped from US$21,000 to US$26,000, while the MR tanker vessel's daily cost has increased by around US$3,000 to approximately US$18,000 *per diem*. Of course, these calculations are based strictly on accounting costs without taking into consideration the required return on equity, daily operating expenses and bunker costs, and other corporate strategic considerations.

There is no question that the present credit crunch has had an adverse impact on the shipping markets. We have experienced it in the number of vessels sold and in the absolute monetary value of transactions concluded in the last six months, also the volume of transactions withdrawn because of failure to obtain debt financing at favourable terms.

Finally, we have seen it in the terms of caution, diligence, expediency and S&P transactions that have been taking place in the last six months. Whilst in 2007 potential buyers would agree on the terms of a sale and subsequently seek debt financing, in 2008 the mortgage bank is an active member in the acquisition decision making process from the early stages of the negotiation process.

What does the future hold? The financial markets will take at least a few years to absorb the financial excesses and losses, which are still not fully known. The shipping markets are closer to a 'new paradigm' in terms of asset valuations and freight revenue generation, and both are a few standard deviations from their historic averages (statistical uncertainty).

Probably, it will be a couple of years before solid land can be seen on the horizon. It is certain that significant equity participation and a solid balance sheet will command best terms for shipowners seeking finance in most types of financial markets, and definitely will provide a strong anchor to weather strong as well as weak freight markets. For shipowners with a clear strategic decision to stay in business, the current turmoil in the financial markets only provides an opportunity to strengthen their market position and their balance sheet. TST

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