HAVING YOUR CAKE AND EATING IT TOO
EQUITY-LINKED DEAL OF THE YEAR

Transaction: Ship Finance International Limited $225 Million Convertible Note Offering
Winners: Jefferies, Morgan Stanley, ABG Sundal Collier, Clarksons Platou, Seaport Global Securities

In the world of shipping where simplicity is over-reaching, convertible securities are an anomaly. Seemingly purpose designed for the geniuses inhabiting hedge funds, these securities are among the most complex extant. A magician is required to structure them and a translator to explain them. For that reason nominations are typically infrequent. Thus we were pleasantly surprised when we received two nominations in the equity-linked category this year. Both were highly structured transactions which met the desired goals of achieving the lowest possible cost (coupon) while minimizing the risk of conversion into dilutive common equity.

Returning to the private placement market, KNOT Offshore Partners LP (“KNOP”) issued $50 million of Private Preferred Convertible Equity (“PPCE”) at a price of $24.00/unit, resulting in the issuance of 2,083,333 Preferred Units, representing limited partner interests. The PPCE is perpetual, pays a fixed coupon of 8%, a 15% discount to the common units’ current yield, and is convertible into common units at a strike price of $24, which represents a ~14% premium over the 30-day average VWAP.

After two years, the PPCE will be convertible, at the option of the holders, into common units at the then applicable conversion rate. As of the closing date, the conversion rate will be one-for-one and will be subject to adjustment under certain circumstances. Specifically, the partnership developed a new mechanism to adjust the strike price that is similar to the concept used in a K-1 MLP filing. Essentially, the strike price is adjusted every quarter depending on whether there is a return of capital or not. The PPCE also has forced conversion options for the partnership and several redemption options. The PPCE can be redeemed by the partnership from the second anniversary until the tenth anniversary with the redemption price falling linearly from 130 to 100 per cent of par during this period of time. The PPCE holder will also have the option of putting the PPCE back to the issuer after year 10 at a discount to principal investment. In such an event, KNOP will have the option of settling the PPCE either in cash at 70 per cent of par or in new units at 80 per cent of par. The partnership has thus no cash obligation as it can settle the put option with a payment in kind by issuing new common equity to the PPCE holders. Based on the structure of the deal with no cash obligation, KNOP expect to be able to book the PPCE as equity in its balance sheet.

The benefits of this particular instrument are numerous. While valuations in the MLP space have recovered, KNOP’s yield remains elevated in comparison to the Alerian MLP Index. In addition, the cost of issuing new equity in the space is still fairly expensive due to a lack of demand for new units with significant discounts having to be offered to new investors. Typically in today’s market the all-in costs of a common unit raise can comfortably be in double digits taking into account both discount and investment bank fees. This contrasts with the attractive coupon, strike price, and significantly cheaper issuing costs of the PPCE. Most critically, the PPCE enables the partnership to raise equity at a running cost of 8% allowing KNOP to continue to grow through accretive acquisitions. This transaction had winner written all over it, but then along came the offering from Ship Finance International which raised the bar.

Life is good, if you happen to be a seasoned issuer with a shipping business that is diversified across multiple sectors that provides long-term contracted or stable cash flow. If you meet those criteria, you may have access to the convertible bond desk with its substantial pool of institutional money ranging in size from $25 to $50 billion annually. Convertible investors include hedge funds and long-only funds. The latter are fewer in number but place the larger orders. A mix of the two is ideal. There is a subset of investors in this category which by their investment criteria are required...
to hedge their exposure. For these, a share borrowing agreement is structured which provides them with shares that can be shorted to provide the necessary hedge. Although a small subset of the hedge fund universe, this tool facilitates their participation and expands the investor pool.

Convertible investors are credit orientated but also understand and appreciate the company story. They are attracted not only by the coupon but the equity component and are willing to trade some of the former for the latter and thereby offer highly competitive rates. In exchange, borrowers have access to form of junior unsecured capital that is among the most unrestricted available. Largely covenant free, there is little a borrower can’t do so long as it makes its payments.

The coupon is a function of volatility and dividend. Volatility speaks for itself with the more stable companies being preferred. The dividend drives the value of the option. Somewhat counterintuitive, it turns out that the higher the dividend the less the value of the option. A company that does not pay a dividend is reinvesting its cash flow in the business driving growth. Mathematically, in that instance, there is a better chance for investors to be in the money. But even in the case of a dividend paying company, there is still an opportunity for appreciation.

Back in October, Ship Finance International Limited announced that, subject to market and other conditions, it intended to offer $200 million aggregate principal amount of Convertible Senior Unsecured Notes due 2021. This announcement sounded unusually tentative to us and was likely a reflection of the market having been left fallow for a while. But this is a great company that has survived this difficult period carefully managing its risks while working with the support of its largest shareholder.

The bankers used a limited wall-cross process generating significant demand from existing convertible holders, blue chip long-only and arbitrage investors and top tier mutual funds, resulting in an oversubscribed order book at transaction launch. Overnight execution eliminated market risk for the issuer and locked in the conversion price. As a result of the strong demand the deal was upsized to $225 million and pricing was pushed tighter by 25 bps on coupon and 2.5% on conversion premium.

Maturing on October 15, 2021 unless earlier repurchased, redeemed or converted, the notes pay interest quarterly in arrears at a rate of 5.75% per annum. The notes are convertible, at any time prior to the close of business on the second scheduled trading day prior to the maturity date, into, cash, common shares, or a combination of the two at the company’s election. Subject to adjustment under the terms of the notes, the initial conversion rate will be 56.2596 common shares per $1,000 principal amount of notes, which is equivalent to an initial conversion price of approximately $17.77 per common share, a premium of 22.5% over the closing price before the announcement. The pricing was perfection as the bonds opened at 100.5% in the secondary market amid continued investor demand. The transaction allowed the company to opportunistically refinance its existing 2018 convertible extending its maturity by four years. Details of the offering are shown in the Guts of the Deal on the following page.

In conjunction with the offering and to facilitate the hedging capability, a subsidiary of the company will enter into a share lending agreement with affiliates of Jefferies under which it will lend it up to 8 million of the company’s common shares. Note purchasers may then separately sell up to 8 million of the company’s common shares that they may borrow, creating a short position, which will serve as a hedge for their respective investments in the notes.

One of the most intriguing questions raised and difficult to answer in this instance is why buy these notes when you can buy Ship Finance shares yielding 12% and have unlimited upside. The easy response is, of course, priority of and more certain payment while retaining some upside. For Ship Finance the question holds no relevance as they happily enjoy cheap capital paying less interest than a traditional bond, while suffering little dilution. In fact in the context of the conversion price of $17.77/share, it is worth noting that the company’s share price has rarely been above $18 over the last eight years. Moreover the company holds the option to pay the premium in shares, cash or a combination of both further mitigating the dilution effect. Lastly, the convertible provides true growth capital. The equity has a cash cost of 12% and it is nearly impossible to find a transaction today that can achieve that return and be accretive. Convertibles are a beautiful thing at 5.75%.

Not surprisingly the issuer was a big fan, comparing the transaction to peeling an onion with each layer revealing something new and creative about it. Among his multitude of comments, these two stood out:

“The structure on this convertible is highly unusual, yet very efficient in the market environment it was issued in. The fact that the conversion rate is only adjusted for the first 22.5 cents per share of quarterly dividend, currently representing 50% of the dividend paid, makes the implicit probability of conversion into equity very low, potentially in the single-digit 6% age range, depending on the volatility model applied. This feature is fantastic for the issuer, as it does get paid for the relatively high volatility in its share (=high payment), but at the same time pushes the initial conversion price
premium up from the seemingly 22.5% on the front page of the prospectus. At issuance, the dividend yield not compensated for by conversion rate adjustments represented ~6% per annum. The tenor of the paper is 5 years, so the conversion price premium is 6% x 5 = 30%, plus the initial 22.5%, a whopping 52.5% up from the share price at issuance! This makes the bonds’ economic features look more like a straight HY bond, whilst still paying a coupon much lower than what the issuer would have had to pay on an actual straight bond.

An important bit of a CB issue is share lending, the price and volume of it, in order to satisfy hedge funds trading out (hedging) the delayer and gamma of the warrant in the CB, to buy the CB in the first place. Most issuers provide sufficient share lending through lending out shares to the originators, who in turn do a placement of the shares in the market under a separate “cleansing” offering with adjoining prospectus(es) and full fledged filings to create a short position which can be offered to hedge investors through a CFD. This, normally quite large, sell off of shares overnight or over only a few trading days, creates a massive push downwards on the share price. Needless to say, a negative for both existing equity holders but also the prospective CB investors, as they’ll have to factor this into their delta positions. Ship Finance avoided this negative effect almost entirely, yet still managed to offer a ~10% of its market cap share lending facility through an innovative structure of providing short positions, to my knowledge not done on Wall street before. What they did in short, was to lend out “physical” shares to the CB investors itself, and list them as selling shareholders on a prospectus supplement. As each of them are borrowing a relatively small amount of shares and doing their own delta estimates, their sales pressure on the share is low, in fact, the SFL share traded up post announcement of the convertible bond issuance…. This way of sourcing inexpensive debt capital by making use of the value in equity volatility without much risk of dilution may be the biggest contribution to ship finance in years.

We surrender. You win.