DON’T LET OVER-FUNDING STAND IN THE WAY OF A GOOD DEAL
STRUCTURED FINANCE DEAL OF THE YEAR

Transaction:  H-Line $31 million Mezzanine Investment
Winner:        Korea Development Bank

Depending, of course, on the eyes of the beholder, a well-structured transaction is magical and can often resemble a piece of art. Highly structured transactions, like project financings, are not traditionally seen in the shipping world, where bank debt and equity typically prevail. However where there is risk, there is a need to manage it and structuring provides one of the means to do that. That of course is not the only reason. Shari’ah law forbids the payment of interest requiring a secure and robust structure which provides a return to the lenders which is deemed compliant.

The National Shipping Company of Saudi Arabia (“Bahri”), along with its advisor, Standard Chartered, nominated Bahri’s 12-year $350 million syndicated Senior Secured Commodity Murabaha to partially fund the construction and delivery of five VLCCs in this category. Under this structure, the investors purchase commodities from brokers and sell them to Bahri on a deferred payment basis so that the company can finance the acquisition by reselling the commodities to the brokers. This transaction was Bahri’s first underwritten syndicated loan in a long time having more recently relied on club or bilateral deals. The loan was a great success. Not only was Bahri able to achieve its funding plan and target within the expected time frame, the transaction was oversubscribed, allowing for competitive pricing, while attracting new lenders allowing the company to diversify its funding sources.

With the right incentives any problem can be solved, which is evident in this year’s winning transaction. Part of the fallout from the Hanjin Shipping bankruptcy was a five-year old bulk carrier which it had acquired during the high market and was therefore burdened with too much debt. As part of the bankruptcy, the vessel was transferred to its new owner, H-Line Shipping, with the original debt intact, leaving it over-leveraged, which was made worse by the market downturn and the collapse of asset values. Traditional bank finance would only cover 60-70% leaving a substantial gap to be covered by the borrower. Unfortunately, H-Line had its own problems facing a liquidity crunch under its existing newbuilding program.

That left the KDB Ocean Value-up Fund to participate in the over-financing transaction. The $1 billion special asset fund was established by KDB Bank, who as the anchor investor committed $700 million, in order to invest in the marine and offshore industries. Investments are made through subscription to private bonds issued by the overseas SPCs, which own the vessels, or through investment in the contractual rights of SPCs. The fund targets a 6% return on an IRR basis.

While conventional lenders would only cover 70% of the vessel value, KDB and the investors concentrated on the cash flows from the 20-year (15 years remaining) consecutive voyage charter (“CVC”) with Korea’s South-East Power Co. (“KOSEPCO”), a 100% subsidiary of Korea Electric Power Corporation (“KEPCO”), which, in turn, is controlled by the Korean government, with its majority shareholding of over 50%. Based upon KEPCO’s ownership and support, the investors viewed the risk as the quasi-sovereign credit of the Korean government (AAA rated). With risk-off, the investors felt comfortable in adding the
present value of the cash flows from the remaining term of the CVC, to the value of the vessel, increasing the appraised value of the vessel. This approach was only possible because the charter and vessel are contractually linked with usage of the vessel limited to KOSEPICO. The sole benefit of the vessel having been ordered in a high market was the corresponding high charter rate associated with the CVC which was sufficient to cover a substantial portion of the vessel’s price.

The structure of the transaction is diagramed below. The new SPC, KOVF HL 1 S.A., owned by the Fund acquired the vessel from the old SPC for a total project cost of $44 million which consisted of a senior term loan from Bank of America of $13 million and a new mezzanine investment of $31 million from the Fund with a tenor of ten years and a put after seven years. The SPC bareboat charters the vessel to H-Line, which is a good quality corporate credit reflecting its stable business structure. With the bank secured by 1st mortgages and a primary interest in the collateral the Fund took a 2nd priority position in the collateral. To further mitigate the credit risk inherent in the junior tranche, the Fund arranged guarantee insurance with a coverage ratio of 95% from Korea Maritime Guarantee Insurance Company (“KMGIC”), who viewed the risk as a project financing secured by the CVC. With the risk mitigated by the insurance, the investors were able to provide higher gearing, while at the same time reducing the interest rate to a lower level more reflective of the risk, thereby reducing the overall financial cost from the higher proportion of more costly mezzanine debt.

The KDB Ocean Value-Up Program has a very flexible structure and can incorporate profit sharing schemes in order to adequately reward the fund for taking on the risk for a rather miserly cash return. At maturity should the appraised value of the vessel exceed the outstanding debts, the surplus amount is shared by the Borrower and the Fund.

Despite the topsy-turvy structure, with the junior debt representing 70% of the project cost, the bareboat charterer obtained 100% financing at a competitive rate, while keeping the rich CVC in place. Risk was carefully managed with the bank well secured by its collateral position including the priority lien on the CVC while the mezzanine lender reduced its exposure to 5% through the KMGIC insurance. “It’s magic you know”.

![Diagram of the transaction structure]