Buoyancy level

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With growth in the LNG market showing few signs of abating in the short term, it looks like business as usual for LNG ship financiers. In 2004, LNG production reached a record level of 134.8 million tpy (million tonnes per year). This year a further 10.8 million tpy is forecast to come on stream, with a further 21.5 million tpy in 2006.

Concurrent with the surge in LNG demand, LNG ship orders have increased steadily year-on-year for the past three eyars. In 2003, 152 LNG vessels were in service, while 34 were on order. In 2004, these figures had increased to 174 vessels in service with a staggering 113 on order. By 2007 it is expected that 30 vessels will be delivered, a first for the number of deliveries to take place in one calendar year.

Qatar will be at the forefront of vessel purchases. Qatari LNG production is expected to hit 77 million tpy by 2012, which will make Qatar the largest global LNG producer. Earlier this year, energy minister Abdullah bin Hamad Al Attiyah announced that Qatar would invest around $15 billion to create the world's largest LNG fleet.

The highest profile operator – part of an overall $10.65 billion package that includes new LNG trains, terminals and ships for Qatargas II – is Qatar Gas Transport Company (QGTC). The Doha-based company – which closed a $660 million IPO earlier this year – is looking to become the world's largest LNG carrier, having won the mandate to manage the Emirate's shipping needs.

Shipowners are mandated on the basis of tender specifications and the lowest daily tanker rate. In turn, QTC forms a joint venture with the mandated shipowner, which then sources the debt/equity package from the banks. So far five joint ventures have been formed: two JVs will charter eight vessels to Qatargas II and the remaining three will serve the RasGas II project.

Manufacturing boom

Daewoo Shipbuilding & Marine Engineering, Hyundai Heavy Industries and Samsung Heavy Industries have all been selected as preferred bidders to build 44 LNG carriers by the end of the decade. It is expected that Daewoo and Samsung will split the 40 carriers between them, though they have secured minimum orders of 15 vessels respectively.

By the end of the year, an initial order of 12 LNG vessels will be placed. In order to cope with the increase in orders, both Daewoo and Samsung will increase plant capacity to build 14 vessels per annum by 2008. At present, both shipbuilders have the capacity to build up to 10 LNG vessels per year.

And while the increase in LNG demand has been marked, the increase in the price of newbuilds has not. Competition, coupled with the narrow availability of building slots, has tempered a sharp rise in prices. Korean shipyards continue to dominate the market, constructing 75% of all vessels. Nevertheless, Hyundai has declined to take any further orders and is said to be concentrating on more profitable business streams. Both Daewoo and Samsung continue to invest in LNG construction.

Given the increase in LNG demand mirrored in newbuild orders, ship financiers will have their work cut out. And yet while the appetite for transactions has increased, there is still a lack of innovation in relation to financings. The financing options continue to be clear-cut: corporate, project or asset finance, or, in certain creative circumstances, a hybrid of the latter two.

For the major energy players traditional financing is no problem – they have the creditworthiness to get very cheap debt.

But the lack of innovation severely reduces the financing options for independent operators to get into the market.

Lending margins are also tightening. According to Gaurav Seth, head of global LNG shipping finance at SG Corporate and Investment Banking, "All aspects of LNG have become very competitive, so financing has to keep pace as well."

According to bankers there are three to four deals in the pipeline that will be interesting in terms of margins. But overall the business is not producing the margins it used to, which may become a deterrent to entry for new lending sources.

However, to date there is little evidence of lack of lending appetite. In March, 12 potential mandated lead arrangers (MLAs) submitted bids for financing two LNG carriers to be chartered by Oman Shipping Company (OSC). The estimated $240 million deal is expected to be backed by the Export-Import Bank of Korea (Kexim). Societe Generale is acting as financial adviser. It is rumoured that a number of bidders put in low bids in order to clinch the mandate, only to fall wide of the mark.

Growing ECA role

ECAs are playing a growing role in the market and, like the banks, are becoming increasingly competitive.

Late last year ANZ and Kexim signed a $253.8 million limited recourse loan facility to finance the purchase of two LNG vessels. Structured as a limited recourse financing, the facility comprised a $152.3 million Kexim tranche and a $101.5 million top-up commercial loan tranche, split 60/40. Kexim has provided its tranche from its own account, whilst ANZ has fully underwritten the commercial tranche.

Nigeria LNG Limited (NLNG), a natural gas liquefaction project sponsored by the Nigerian National Petroleum Corporation, Shell Gas, TotalFinaElf Nigeria LNG and Agip International, will charter the vessels. The shipowners are two Bermudan special purpose companies sponsored by Nippon Yusen Kabusiki Kaisha, a Japanese shipping specialist. The vessels will be chartered to NLNG for a period of 20.5 years from delivery.

Another Kexim deal is for three LNG carriers for Greek shipping company Angelicoussis. The $480 million deal finances three 145,700 cubic metre tankers purchased from Daewoo Shipbuilding & Marine Engineering. Kexim is lending $288 million over 12 years, with repayments starting 6 months after delivery. Citibank, HSBC, BNP Paribas, and DNB NOR Bank are funding the commercial portion. The commercial loan is expected to be repaid after 10 years, increasing the average weighted life of the financing and aligning repayments with charter agreements signed by the shipowner.

Although established shipping companies have tried to get in on the LNG market, many have found its club-like set-up difficult to overcome. Angelicoussis is one of the few shipowners to have succeeded in joining new players such as independent power producers and utility companies.

Islamic finance

With one LNG shipping deal closed in the past three years, the future for Islamic financings does not look auspicious. Nevertheless, this dearth of successful deals belies a product that could rival the more traditional structures.

According to regional experts, some $300 billion of un-invested Islamic funds are presently looking for assets. "Islamic financing is asset hungry and ships and aircraft are ideal assets to underpin any Shari'ah-compliant financing. As the deals become bigger and the tenures longer, Islamic finance will become increasingly more attractive," says Neil Miller, head of Islamic finance at Norton Rose.

Although the appetite for assets is there – especially for real estate and equipment – Islamic financiers continue to be dissuaded by the long tenors of shipping projects. Islamic deals do get done – but not many.

In August 2002, HSBC closed a $100 million deal for Brunei Gas Carriers Sdn Bhd (a joint venture between the Government of His Majesty the Sultan and Yang Di-Pertuan of Brunei Darussalam, Shell Gas BV and Diamond Gas Carriers BV, a wholly owned subsidiary of Mitsubishi Corporation). The transaction was the first Islamic-financed deal for a LNG carrier.

Since 2002, deals have been very thin on the ground, though this may have had more to do with the immaturity of the Islamic banking market. "In the last five to seven years, Islamic banking really has been finding its feet and entering more mature types of transactions. There is a curve: in trying to understand how to put all this money to work," says Mark Mortimore, senior asset manager leasing at Arab Banking Corporation.

However, all this may change. In late April, Abu Dhabi Commercial Bank (ADCB), ABCIB Islamic Asset Management and ABC Islamic Bank agreed to act as joint underwriters and placement agents for a corporate Sukuk issue by Al Safeena I Ltd. The $26 million sukuk issue will in part refinance a VLCC (Very Large Crude Carrier) on charter to Vela International Marine, the tanker owning and operating subsidiary of Saudi Aramco. ABCIB acted as lead manager, while Norton Rose was the legal adviser.

The deal is the first transaction in the shipping sector to use an Islamic bond issue. The unquoted private issue employed an ijara (lease) sukuk arrangement through a Jersey-based issue vehicle. The Sukuk was supported by a lease financing of the VLCC.

According to Miller, "The investors are able to make their Islamically compliant investment via the purchase of Sukuk (Islamic notes) which give them a beneficial right in the use of the vessel. The benefit of this structure is that it did not interrupt the pre-existing leasing chain and also allowed conventional finance to continue to be taken by the owners. This type of transaction can be tailored to many types of shipping transactions."

With the success of this relatively small sukuk, larger transactions in the region of $100 million are expected to follow. It is even rumoured that certain Islamic banks are looking at setting up a fund to finance three or more vessels at a time. In time, once the market matures, LNG vessels may be a perfect fit.

Tapping the bond market

In an industry that has been traditionally conservative in its financing techniques, it comes as no surprise that the bond market has yet to be tapped.

"To date, we haven't seen utilization of the bond markets. If you have a look at the operators, a number of them are rated and they all rank among the strongest of the ship owners. They have enough of a good name to raise limited recourse project finance," says Richard Howley, partner at Norton Rose.

In addition, banks are now better placed to provide more flexible and competitive debt solutions, which mitigate the need for bond market finance. The fact that the bond market does not price construction risk efficiently has kept certain players away.

Nevertheless, some bankers believe that a market will arise through the private placement of bonds. According to one London-based banker, "I don't see why it shouldn't happen, but only on a private placement basis. With a rated company, say A-, it does stack up."

If this form of financing does come to fruition, banks will probably fund construction while project bonds take out the construction loan to fund the post-delivery period.

A competitive future

On the current wave of optimism, market analysts are predicting that the global LNG fleet will stand at 400 ships by 2030. Strong natural gas prices, liberalised energy markets and environmental issues have all contributed to the current buoyant market. Moreover, if the current trends are to continue, the number of LNG carriers will surpass VLCC and ULCC vessels.

Although traditional ship finance options like tax leasing look set to disappear, long–term chartered LNG carriers will always find funding in the debt markets and those forms of debt look set to become more diverse.

Nevertheless there is also a lot of interest, and concern, as to how vessels are going to be financed in the future and how much appetite and capacity ship owners (as opposed to the energy majors) have for LNG carriers. It is not solely innovation that needs to match the growth and competitiveness of the LNG business, it is the appetite for deals from independents.