The Dilemma of Sailing Beauty Limited

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The Director Finance of Sailing Beauty Limited, a shipping line company, is urgently summoned by the Chairman in the evening of 17 August,2001. The Chairman told Mr. Vora, the Director, “ Vora, we have only two months to decide about our future investment plans in the LNG joint venture. The lenders have really put us in tight spot. We have to take decision as to whether to make additional investment in the project or just forget about the investments already made. I personally feel the JV has great future. You go through the notes and give your quick comments”. Mr. Vora said, “ I had earlier prepared a note on this issue, if you recall sir. I still believe that our company should not invest any further in this project considering the uncertainty with Kajol Power Corporation (KPC). My calculations show that the JV would not be in a position to yield the hurdle rate.” The Chairman responded by saying, “Please for heaven’s sake, do not always take decisions on the basis of numbers alone. You have to consider other strategic factors as well. We want to be in LNG business. Even the Government wants us to be in this business. Hence you look into the project more objectively and give your observations within next 48 hours. I have to put up a note on this matter in the next Board Meeting”

The Board of Studies has decided to launch case study based pedagogy for the benefit of students at Professional Education (Course-II) and Final Levels. This case study is relevant for the students of Final course. More such cases are under preparation.

Case Studies and replies will also be hosted on our web site. You may send your responses to this Case Study by e-mail to ssuneja@icai.org with the subject line `The Dilemma of Sailing Beauty Limited' by the end of June. The best reply will be awarded a certificate and cash prize of rupees one thousand.

Background

Newfield Holding Company Limited (NHCL) was initially set up as an incorporated joint venture (JV) between Mitsui OSK Lines (MOL), Japan and Atlantic Commercial Finance Inc. (a subsidiary of Evon) in 1998 to construct, own and operate an LNG tanker for KPC (Kajol Power Corporation) project. KPC, a mega power corporation, was promoted by Evon Development Corporation, GE and Bechtel in a western province of India. The power generation capacity of KPC is divided into two phases- Phase I (installed capacity 1826MW) and Phase II (installed capacity 1624MW). The commercial production of Phase I have already started in May 1999 and the expected date of completion of Phase II was December 2001. KPC is currently using Naphtha as fuel and has plans to shift to LNG as and when it becomes available. A LNG receiving terminal was set up to import 5MT (Million tonne) of LNG per annum. An agreement has been entered into with Qatar Gas Corporation for importing LNG. 1.6MT of LNG will come from Oman Gas, 0.5MT from Abu Dhabi Gas and 2.6MT from Petronas of Malaysia. NHCL has been formed to import the LNG. 2MT of LNG per year will be used for the project and the rest will be sold to other companies.

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The Union Government of India thought that LNG, as a fuel for power plant, would be a new experience for India and hence decided that an Indian company should get involved in the JV to operate LNG transportation. As a result of Govt.’s persuasion the JV has agreed to induct the Indian company Sailing Beauty Ltd.(SBL) as the third partner in January 2000. SBL had initially sought a stake of 10% of NHCL. This was, however, increased to 20% later, at the behest of the Government, to enable SBL exercise the requisite Indian control. But due to the delayed entry into the project, SBL had to accept all the terms and conditions in various contractual documentation such as the Loan Agreement, Time Charter Party, Shipbuilding Contract, which have by then already been negotiated and finalised by the original promoters with the shipyards, lenders, KPC etc. SBL has paid US$8 million as contribution towards its equity stake in 2000. Of course, it has to pay US$5 million more as the balance amount of equity contribution in 2001.

The Problem

Initial project cost was US$220 million to be financed in 3:1 debt-equity ratio. A loan agreement was signed in February,1999 between NHCL (borrower) and ANZ banking group and others (a consortium) for a loan of US$165 million at an interest rate of 9.85% per annum. However, as the project has since accumulated cost overrun of US$10 million (contributed largely due to increase in soft cost), the project cost has been revised upward to US$230 million. The Loan Agreement had a clause that in the case of Vessel Default the consortium would have the right to ask for prepayment of the loan or possess the vessel for realisation of the loan. The entire KPC project is now in standstill due to the litigation between Evon and Indian Government. The construction of Phase II of the project is indefinitely suspended. There is a move by Evon to move out of KPC by selling its stake in KPC to Indian Government or any Indian company. There is also a move by the Domestic Financial Institutions (DFI) in India to arrange for financing the balance amount in order to complete the project and operate it thereafter with the assistance of consultants. The consortium of the lenders is of the opinion that the default clause should be invoked due to the occurrence of a *political force majeure* event under the PPA (Power Purchase Agreement).

The Consortium has threatened the NHCL that if the impasse (as mentioned above) were not cured within 21 days from the date of receipt of the notification (the notification was sent on 15 May,2001), the Banks would have the ability to take such steps to enforce their rights as they deem appropriate. But the impasse could not be rectified within the allowed 21 days. However, according to the Project Coordination Agreement (PCA) entered between KPC and NHCL with the lenders during May 1999, the borrowers were to be allowed a *standstill period* of 90 days from the day of default. As per the notice sent by the consortium to NHCL, the 90 days *standstill period* commences from 24 July 2001 and would be valid 20 October,2001. During the *standstill period* the lenders cannot exercise their acceleration/enforcement rights under the Loan Agreement and the borrowers are required to cure the default during this period. The vessel is scheduled to be delivered on 15 November,2001. Since the *standstill period* expires on 20 October,2001 there is a gap of around 25 days and in case the cure is not achieved, the lenders can take the vessel and recover their loan with interest by selling the vessel either prior to delivery or after deliver.

The lenders have so far disbursed US$110 million and they have informed NHCL that in view of the present crisis, they would not release the final instalment of US$55 million. Therefore, to complete the construction of the vessel and to take its delivery, the promoters of the JV have to contribute proportionately the amount.

The two sponsors of the JV- MOL and SBL approached Atlantic Commercial Finance Inc. to contribute its share of US$55 million. But officials of Atlantic Commercial Finance Inc. flatly refused to contribute stating Evon's policy of not increasing its group's exposure in India. Considering the stubborn attitude of Atlantic Commercial Finance Inc. the other two sponsors of the JV have, in principle, agreed to share the burden of additional financing. SBL has expressed its keenness to support the project subject to the following three conditions:

(i) The lenders should not enforce security/take over of the vessel for a period of at least two years after delivery and should indemnify the shipping project against charterer's (KPC) default.

(ii) The tanker should be free to trade anywhere in the world.

(iii) The lenders should make concerted efforts for reduction in interest rate.

ANZ representatives were ready to consider the above conditions provided the sponsors were willing to contribute the balance amount of US$55 million as a subordinated loan along with their equity as the final payment to the shipyard. While ANZ did not commit on behalf of the other lenders, they assured that once the sponsors put in the required funds, they would strongly take up the case with the other lenders. In view of Evon's decision of not funding the loan component, it was proposed by MOL that MOL and SBL could contribute the amount on a pro-rata basis and accordingly MOL would take up 75% of US$55 million and SBL would take up the balance 25%.

Following the discussions among representatives of ANZ, MOL and SBL, a framework of understanding was prepared in the form of a "Revised Framework Agreement" (RFA) and it was decided that MOL and SBL would revert with their comments after internal deliberations. This agreement would be subject to following two conditions:

(a) KPC would not invoke the clause under the Time Charter Party under which it could postpone the delivery of the vessel by 9 months.

(b) Evon would agree to adequately compensate MOL and SBL for providing additional funds.

It was proposed that once appropriate internal approvals were obtained, the agreement could be executed by mid of September,2001.

From the draft agreement with the lenders, it is clear that the lenders would want the loan (of US$55 million) to be an interest free subordinated loan repayable in 20 equal annual instalments starting from the year 2008. If any part of the loan remains outstanding at the end of the expected life of the vessel, it would be paid out in full in that year.

Global Scenario of LNG

In view of suspension of work in Phase II of KPC and current impasse, it is quite unlikely that the charterer (KPC) would be able to employ the vessel after the same is delivered by the shipyard to NHCL on 15 November,2001. The sponsors of NHCL have to look for an alternative deployment of the vessel either in the interim or long-term basis. According to market reports, there is significant amount of development in the LNG market across the globe with new terminals being developed and expansion in existing terminals. There are considerable expansion plans in exporting countries such as Angola, Australia, Malaysia, Qatar, Oman, Saudi Arabia, Nigeria and Trinidad, and Tobago. In addition to the new markets of India and China, the LNG import is projected to increase in the existing markets of US, Europe and Asian markets of Japan, Korea and Taiwan. The actual spot trades of LNG during the year 2000 were around 4 million tonnes out of which 62% was to US. The estimated uncommitted LNG capacity throughout the world is to the tune of 9.5 million tonnes per annum. It is believed that with the increased growth in this sector and the change in the market away from the long- term deals, the spot trade is expected to grow significantly. The spot rates fluctuate widely depending on demand supply positions. For example, the spot rate for LNG was as high as US$100,000 per day in May,2001 and as low as around US$ 55,000 per day during October, 2000. The current long-term charter rates vary between US$ 60,000 to US$ 75,000 per day depending on ship prices and finance cost of the project.

If the vessel is chartered only for a shorter period, there is no guarantee that a suitable charter would be found after the short-term charter is over. If, for some reason, a suitable charter is not found, the entire additional investment would be at risk.

MOL has given a Performance Guarantee to KPC and if they are not in a position to provide the vessel, their obligation to pay KPC is to the tune of US$18 million per annum. There is no such obligation on the part of SBL, as SBL is not a signatory to the Performance Guarantee.

Table: Financial and other Details

Total Project cost (US$ '000)	220000
Loan from lenders (US$ '000):	
1999 (taken at the beginning)	15629
2000 (taken during the end)	55071
2001 (taken during the end)	39300
Operating cost per day (US$)	13000
Operating days in a year	357
Payment to Yard (US$ '000)	
1999	9450
2000	66150
2001	113400
Other capital costs (US$ '000)	
1999	11889
2000	7624
2001	21487
Operating cost escalation per annum (%)	3
Estimated scrap value of the vessel (US$ '000)	60000
Life of the vessel (year)	25
WDV rate (%) of depreciation	5.47
Tax rate(%)	35

The loans to banks are repayable in 20 principal equal annual instalments starting from year 2002. Interest on such loan is payable on the yearly average loan balance. The JV would pay out 70% of its profit after tax as dividend from the year it starts earning profit. At the end of the life of the vessel (i.e., year 2026), the cash available for equity shareholders will be distributed in full.

You are required to answer the following:

(a) What is the dilemma before the Chairman of SBL? (*Describe in a single sentence)*

(b) Build three scenarios from the case fact and suggest how to evaluate each scenario.

(c) Can you find out the project cost ? How much is it (in absolute value terms) at the end of 2001?

(d) What are the options available with the bankers?

(e) Could you estimate the annual hire charges and operating costs for first five years (starting from 2002)?

What would be your final recommendation?