McQuilling Services, LLC
Marine Transport Advisors

Tankers

Suezmax Tankers: The Real Winner?

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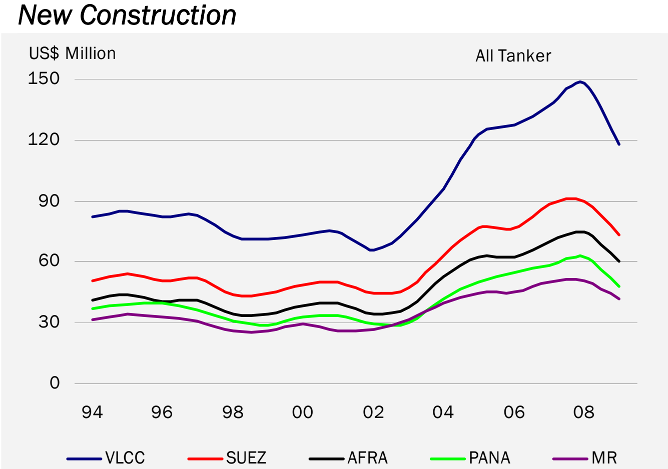
The recent strength in the Suezmax freight markets as compared to other tanker sectors encourages one to ask: "What tanker project represents the best investment?" Of course, if we had the answer to that question, it's likely we wouldn't be writing these notes. We can, however, look back a few years and evaluate how investments in competing tanker projects have performed.

As our basis we selected 1995 as the year to invest in a tanker newbuilding project. At that time a VLCC could be contracted for about US$ 85 million, a new Suezmax tanker for US$ 54 million, an Aframax tanker for US$ 44 million, Panamax tankers for US$ 39 million and Medium Range product tankers for US$ 34 million. During this period asset prices were relatively stable (Figure 1). We assumed a 24 month delivery period from the shipyard meaning that the vessel would begin trading in 1997. Our project would carry through until present, a period of 12 years, when we assumed the assets would be sold at the appropriate second hand prices.

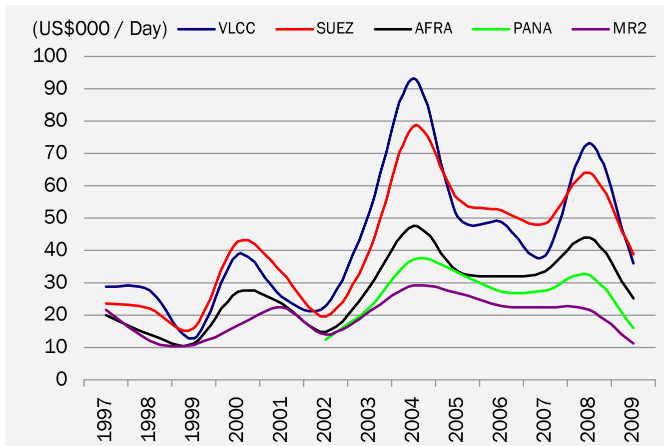
Figure 1 – Tanker Asset Prices
New Construction



We assumed that the vessels would trade in the spot market earning time charter equivalent revenues on a round trip basis in the bellwether trades for each vessel class (Figure 2).

As can be seen in Figure 2, during several periods in this timeframe the TCE revenues of Suezmax tankers were actually higher than those for VLCC tankers.

Figure 2 – Tanker TCE Revenues
1997-2009 YTD



For the analysis we assumed operating costs escalating at about 5% annually. We first excluded financing, preferring to look at the overall project economics rather than investment returns that had been optimized by a financing structure.

The results yielded some interesting observations. Table 1 reveals the net cash flow, the net present value (NPV) of each tanker project at 10% hurdle rate and the project rate of return (IRR). Cash flow figures represent the initial amounts in 1997 before operating cost escalation.

Table 1 – Tanker Project Investment Performance
No Financing

	VLCC	SUEZ	AFRA	PANA	MR2
Cash Flow [1]	36,200	36,100	24,600	21,300	11,500
NPV [2]	7.8	38.9	18.5	15.0	(4.7)
IRR (%)	11.4	20.2	16.1	15.6	7.9

[1] – TCE Revenue less 1997 operating cost basis with about 5% annual growth (US$/Day)
[2] - US$ Million

Project cash flows with no financing are substantial, representing a large cash flow cushion for periods of market weakness. This is typical however, of projects without financing. Excess cash flows need to be evaluated against a much larger capital contribution in order for investment attractiveness to be assessed. Using a 10% hurdle rate, all projects except MR2 tankers generated positive NPVs. A Suezmax tanker project was the clear winner in terms of project investment attractiveness with an internal rate of return of 20.2%, substantially greater than the rate of return of an investment in second-place Aframax tankers at 16.1%. MR2 tanker projects faired poorly, generating just under 8% return while VLCC projects represented a return of 11.4%

Therefore, from an overall project economics perspective, and with the benefit of 20/20 hindsight Suezmax tankers were clearly the preferred investments in 1995. This is primarily due to the fact that on average Suezmax tankers earned only about US$ 1,000 per day less than VLCCs in the market over the project time period while their acquisition price in 1995 was about 36% less than that of a VLCC.

Next we applied a financing structure of a 60% loan-to-value (LTV) note at 7.5% fixed interest rate with a 7-year tenor and payments in arrears. A 20% non-amortizing bullet payment was also assumed. We used an annuity basis for calculating the periodic loan payments instead of a constant-principal basis to simplify the math. The methodology created a slightly higher loan payment amounts initially and lower amounts towards the end of the loan period but overall does not affect the relative results of the analysis (Table 2).

Table 2 is illustrative of the effect of financing on an investment project. As can be seen, the available cash flows for each tanker project are drastically reduced – in the case of MR tankers almost to zero. Conversely, the rate of return on investment across projects has soared. This result is a good illustration of the risk-reward trade-off that comes with external financing of projects. Higher returns on invested capital are achieved but with lower available cash flow there exists a greater risk of default if market conditions take a turn for the worse.

Table 2 – Tanker Project Investment Performance
Financing Structure

	VLCC	SUEZ	AFRA	PANA	MR2
Cash Flow [1]	9,500	19,200	10,700	9,000	800
NPV [2]	17.5	45.0	23.5	19.5	(0.9)
IRR (%)	15.4	33.5	24.5	23.5	9.4

[1] – Cash flow during financing period equals TCE Revenue less financing costs less 1997 operating cost basis with about 5% annual growth (US$/Day)
[2] - US$ Million

The relative attractiveness of projects has not changed however, and we see clearly that the vessel class of choice in 1995 was the Suezmax tanker. This result is especially meaningful for us – while we have looked repeatedly to the Suezmax class over the years to differentiate itself as the next workhorse of the tanker fleet we were never able to confirm our expectations. In our 2004 sector analysis for the Suezmax fleet, we closed with: *"In summary, this sector seems to remain challenged by its own fundamentals. Too small to compete effectively against VLCCs and too large to be as flexible as Aframax tankers, this sector has never really distinguished itself."*

The results detailed in this brief distinguish Suezmax vessels as the tanker investment project of choice over the last decade. It will be interesting to see if their comparative attractiveness in this area continues into the future.

Please contact us to further discuss investment attractiveness in the tanker sector or other areas of your business that may require directed research and/or commercial advisory services

Tel: +1.516.227.5700
Fax: +1.516.745.6198
Email: services@ mcquilling.com