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BTN Research

Ocean Yield
(OCY NO, OYEIF)

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Executive Summary- Ocean Yield (OCY NO, OYIEF) is a Norwegian ship-leasing company with a dividend yield of over 8%. The company has posted a mid-teens dividend growth rate for the last several years. Management is strongly committed to the dividend which consumes only 50% of cash flow. The company grows over the long-term by adding new ships to its fleet. Near-term growth will be boosted as charters on newly-acquired ships drive year-over-year results. Debt repayments are declining, and cash flow needs are limited by "bareboat" charters under which customers pay all operating expenses associated with the boats. The company's end markets have gone through difficult times in recent years, but there are strong signs that conditions are improving. All but two of the company's thirty-seven boats are under long-term contracts. While dividend growth may moderate given there are no new boats currently scheduled to be added to its fleet, we believe the company is more than capable of sustaining dividend growth in the 5% range for the foreseeable future.

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Company Overview

Ocean Yield (OCN NO, OYIEF) charters its vessels to major shipping companies for use in transporting containers, chemicals, refined products, and cars. The fleet is predominantly under 3 years old with the average charter length of more than 10 years remaining. Ocean Yield is adding more ships, with an emphasis on new or young ships. The current average age is less than 3 years with average useful lives of 20-30 years. Ships are purchased primarily with debt and a cash down payment and subsequently leased over 12-15 years under "bareboat" deals whereby the customer covers all operating, maintenance and insurance costs (similar to the triple-net lease concept.) Payments made by the customer cover the interest, amortize part of the debt, and provide for cash flow towards the dividend and financing the next deal.

Dividend Growth Drivers

Dividend Yield Is a Big Component of Company Philosophy

The company name is not the only give-away that Ocean Yield is focused on dividends. The company labels itself on the front page of its website as "The Dividend Yield Company." The stock currently yields 8.2% and has increased the dividend quarterly for every period since 3Q13.

Table 1

	Annual Dividend Growth
2014	15%
2015	16%
2016	13%
1H 2017	10%

Cash Flow Is Growing and Sustainable

Table 2 below shows dividend coverage data for the last three years:

Table 2

Dividend Coverage Data

	CFO+ Lease	Dividend	Cash Cushion	LT Debt Net of cash	Net PP&E	EBITDA	Debt/ EBITDA
2015	$200.0	80.7	119.3	1,041.2	1,232.5	235.0	4.4x
2016	$220.7	96.0	124.7	1,388.3	1,243.8	291.3	4.8x
12m 6/17	$241.5	106.0	135.5	1,428.1	1,361.1	320.5	4.5x

Three points to keep in mind when reviewing the above numbers:

- There are only 37 vessels in Ocean Yield's fleet, so each additional boat is a material boost to LT Debt and PP&E on day one, but the cash flow comes in over time. Many of the figures above thus understate the true cash flow being generated, as a full year's cash flow on new ships is not being reflected yet.

- Capital spending is only required if Ocean Yield buys another ship. Nearly all the vessels have purchase options for the customer at the end of the lease, and ships have useful lives of over 20 years with a residual value remaining at the end.

- The backlog of charters is currently $2.9 billion over 11.4 years. That does not include any provision for charter renewal for the 5-10 years remaining on the useful life of each ship. It also does not include backlog for charters that are in place but become variable rate in the future. Ten years of dividend is $1.06 billion, ten years of interest is about $700 million, meaning Ocean Yield could fund that and retire all but $300 million of debt over 10-years with no charter extensions. In addition, the salvage value of the ships is likely $300-$400 million.

Key Risks for Ocean Yield:

The company has few variables on day-to-day operations given the long-term nature of the charters. Ocean Yield also seeks to diversify the industries where it has exposure. However, maritime industries have periods of extreme cyclicality. We will examine these in detail and the current status of each market segment in this report.

- Counterparty risk – the charters signed with Ocean Yield are essentially rental agreements with rent paid the by the customer. If the rates earned by the customer do not exceed the payments made to Ocean Yield, it can eventually weaken the counterparty and force renegotiation.

- A weak market for charter rates can reduce the carrying value of ships and also lead to reductions in salvage value. That may influence how much debt Ocean Yield can carry.

- Charter renewals may come at time when the market is weak and older ships often must accept lower rates compared to newer vessels.

- Bareboat Charters are commonly used by Ocean Yield when it charters its ships. Norway is looking to change the ability of charter companies to have long-term charters that are bareboat, and those changes are likely to occur. That headline risk for Ocean Yield will probably appear in the news in the coming weeks. We believe the company can easily overcome this by reflagging ships to other countries, or changing terms to time-charters with separate agreements to manage the crews (who hires the crew is the primary difference between a bareboat and time charter.)

- The *Dhirubhai 1* is a vessel whose 10-year charter concludes in 2018 and represents roughly 40% of revenue and EBITDA at Ocean Yield. If this vessel does not get a renewed contract, it could materially impact Ocean Yield's results. The vessel has a longer useful life, and the current job it is working on still has more production potential beyond next year. The customer is also investing in other projects in the area that will require vessels like the *Dhuribhai* as well. Until something is resolved on a new contract, this remains a risk for Ocean Yield.

Investment Summary Conclusion

The company has already seen several key markets and customers go through very tough times that included some restructurings. Ocean Yield survived with few financial hits and continued to expand its fleet and grow its dividend. Growth is driven by adding new ships to the fleet. The goal is to invest a minimum of $350 million annually in new ships – a goal that is normally exceeded. Many of the company's end markets are now seeing improvements which should help reduce counterparty risk and salvage value risk. It should also make new investments in additional ships a profitable source of growth. Ocean Yield has accelerated debt repayment and it appears to us that the company has unresolved issues on only 2 vessels out of the 37 in its fleet (*Dhrubhai-1* and *Lewek Connector*). There are 15 new vessels that arrived after 2Q'16 and have not posted a full year's results yet. Thus, that represents higher cash flow and true annualized EBITDA as those ships simply reach 12 months of operation. We do believe the dividend will continue to grow, but the growth rate may moderate to closer to 5%. Faster growth will require the purchase of more ships and currently none are announced.

Summary of Investment Points

- **Ocean Yield grows by adding new ships** and targets growth of about $350 million per year. It has added about 30% to annualized EBITDA in the last 5 quarters with recent ship deliveries.

- **The dividend is sustainable, and growth looks solid**. The dividend has been raised every quarter since going public in 2013. The payout is cushioned by consuming only 50% of cash flow. The dividend has to compete with debt repayments, but those are declining. The company also has over a full-year's cash flow of cash and liquidity available.

- **Offshore oil servicing is a big market for Ocean Yield**, largely as that was its original market. Offshore was 63% of EBITDA in 2Q'17 with the FPSO unit (floating, production, storage, and offloading) comprising 38% by itself. This is a market that has seen significant drop-off in investing from 2014-2017 as oil prices declined. The market appears to be bottoming at this point, and the company has already restructured two deals. It appears the worst is over and Ocean Yield's counterparties are stronger. The company recently added two more ships to serve this market. The two ships with some remaining overhang are in this segment, but both appear to have strong potential for favorable outcomes.

- **Container ships are a new area for Ocean Yield** via an equity investment which generated 9% of EBITDA in 2Q'17. This market was overbuilt for several years, but it also appears to be turning higher and the customer base has consolidated. The company appears to have solid growth potential in container ships and strong counterparties as demand growth is again exceeding supply growth.

- **Chemical, refined product, and oil tankers represents another new area for the company,** accounting for 12% of EBITDA in 2Q'17. Older vessels are being scrapped in these markets and Ocean Yield's newer ships should be profitable for its customers to operate. This industry has also seen consolidation which should boost credit quality of counterparties. The focus on refined product and chemical carriers also gives the company exposure to markets growing much faster than oil.

- **Gas carriers may represent an area for additional growth** for Ocean Yield. The markets for carrying liquified propane and ethane are growing as the supply from US shale is rising rapidly. The company added its first ship here in 2016 and a second this year.

- **Car carriers were 13% of EBTIDA in 2Q'17 and Ocean Yield appears to have solid counterparties** in this market. One vessel is moving to an Asian route, but the future looks stable here. There are signs that growth from Asian markets will accelerate.

- **New ships are in demand in the majority of Ocean Yield's markets**. These ships have lower maintenance costs, better fuel efficiency, and meet increasing pollution standards. The company's fleet is very young, and its ships are often the youngest in its customers' portfolios. That bodes well should any customer run into problems, as Ocean Yield would likely be able to re-charter the ship in a worst-case scenario.

The History of Ocean Yield and Aker

The company was formed by acquiring several offshore assets from Aker in 2012. It was taken public in 2013 and Aker Capital still owns about 66% of the stock in Ocean Yield. Aker management is also represented by two of the five board members including the Chairman of the Board. Aker is involved in several businesses such as Aker Solutions, the oil services and production unit, Aker BP, a 50%-50% venture with British Petroleum for oil development offshore, Kvaerner, an engineering and construction company, and BioMarine which harvests krill for fish oil and salmon feed.

It is important to remember that Aker set up Ocean Yield as "The Dividend Yield Company" and it continues to do new business with Ocean Yield. In 2017, it sold the company two new support vessels and signed long-term charter agreements, so Aker is still supporting the basic operating structure of Ocean Yield. Aker operates in industries and in a country where large dividends are very common - oil exploration, oil equipment, and Norway. All of that leads us to believe that there would be little pressure from Aker to ever change the Ocean Yield dividend model. Also, Aker looks unlikely to sell a significant stake in Ocean Yield and pressure the stock price. Aker is in expansion mode again with British Petroleum and its own businesses are bouncing off cyclical lows with higher oil prices.

Bareboat Charters:

A relatively new and important development in the Norwegian shipping market is the advent of bareboat charters. A bareboat charter is a long-term charter for a ship in which the customer is responsible for providing a crew and paying all expenses related to fuel, port fees, maintenance and insurance for the ship, as well as deciding the ship's route/planned cruise.

Another common feature in the company's charters is known as the "Hell or High Water" clause. This simply means that the customer pays the day rate regardless of circumstances such as a storm preventing the ship from sailing for a week or maintenance work taking the ship offline. In addition to providing easy, predictable cash flows, bareboat charters currently offer some tax shield in Norway for the ship owner.

Norway is proposing new rules to limit bareboat charters to 50% of a carrier's fleet and limit the terms to 5-years. The current laws were extended to the end of 2017 while discussion continues, and there will likely be some transitional time for any changes imposed. As news and ideas are floated, it may move Ocean Yield's share price. Regardless of outcome, it is not expected to have a material impact on the company's results. Ocean Yield noted that under a worst-case scenario, it would pay corporate tax of 23% in Norway, but the heavy depreciation shield of so many young vessels should delay tax payments for years - 9-10 years by the company's estimate on the 2Q,17 earnings call.

Other options are available as well. The company could set up ownership of the bareboat ships in other areas of the world, removing them from Norwegian jurisdiction. Second, the bareboat contracts could be converted to time-charter deals. A time-charter works almost exactly the same as a bareboat charter, except the company would hire the crew and report wages on the income statement. The charter rate would also rise to compensate for this. The CEO of Ocean Yield, Lars Solbakken noted in the 2Q17 conference call,

> *"One way (to adapt to the new regulation) is to do new transactions on time charter basis, and then you can outsource operating costs back to the counterparty. So there is not often that big of a difference between a time charter and a bareboat charter."*

The Growth Story:

Ocean Yield essentially buys ships and charters them for 12-15 years to other companies. Rarely does the cash flow per ship grow over that time other than via debt payments resulting in lower interest expense. There are some variable options on a few ships after 5-years for new extensions of the charter. For the most part, however, the company sees growth from only three avenues:

- Buy more ships and charter them out. This is the primary growth source.
- Benefit from the balance sheet growing on day one of delivery, while the cash flow takes a full year to arrive – so newer ships demonstrate growth.
- Buy ships cheap and get longer life out of them, then forecast or enjoy a higher residual value than originally forecast – all of which means more cash flow to redeploy.

Obviously, the first and second avenues are the easiest to achieve and would have the greatest impact, but we will discuss some aspects of the third too.

Ocean Yield's growth plans specifically involve expanding the fleet, and it has a goal of spending an average of $350 million per year on new ships. OCY has been hitting that goal:

Table 3

	Capital Spending
2013	$255.5
2014	$367.8
2015	$182.7
2015	$492.1
1H'17	$267.9

The timing can be off between signing deals, ordering ships, and when the cash is actually spent on them – but over 4.5 years, they are right at an average annual investment pace of $350 million. We will explore in later sections of this report that several end-markets are seeing better revenues and

demand, which should enable the company to add more ships going forward. As to the second aspect of growth, simply having new ships be delivered – since June of 2016, Ocean Yield has added 17 ships to its current fleet of 37 vessels. Only recently has the company had investments in containerships, chemical/product tankers, and gas carriers. Looking at recent quarterly EBITDA, investors can see the growth generated by new ships contributing to the fleet for a full period. Table 4 below shows EBITDA and the number of ships at the end of each quarter by segment:

Table 4

Quarterly EBITDA by Vessel Segment (number of vessels in parenthesis)

	2Q'16	*3Q'16*	*4Q'16*	*1Q'17*	*2Q'17*
Container	-	$1.8 (3)	$4.9 (4)	$5.3 (5)	$6.5 (6)
Tanker	$4.7 (7)	$6.1 (10)	$8.4 (14)	$9.0 (14)	$9.1 (15)
Gas	-	-	$1.4 (1)	$2.6 (1)	$3.0 (2)
Total	$4.7	$7.9	$14.7	$16.9	$18.6

Often, new ships arrive near the end of the quarter. For example, the most recent Suez class oil-tanker arrived on June 30, 2017 (the last day of 2Q17) and a new gas carrier that was added on June 16, 2017. EBITDA is further understated because the containerships are owned in a JV where Ocean Yield only recognizes a percentage of net income. That net income is penalized by financing costs and depreciation and thus does not represent EBITDA.

We will discuss each of these deals in more detail later in this report. Once all these ships post a complete quarter, Ocean Yield should be getting about $21-$22 million in quarterly EBITDA from the recent expansion in these areas. Compare that to the reported quarterly EBITDA:

Table 5

	EBITDA +Lease Rev.
2Q'16	$69.3
3Q'16	$75.6
4Q'16	$82.8
1Q'17	$79.1
2Q'17	$83.1

In 1Q'17, the company had some issues with one vessel, the *Lewek Connector,* that we will discuss later in this report. It is one of the two ships that needs a new long-term contract and currently is

operating on a series of 30-90 day contracts. But, these new segments have already become over 20% of the cash flow and have contributed to much of the recent growth. There are many reasons to be bullish on the future plans to add more containerships, chemical tankers, and gas carriers.

Dividend Sustainability and Growth:

At the moment, Ocean Yield does not have more ships on order. Orders are also lumpy. Management is committed to continuing to grow its fleet and with the container ship, gas carrier, and tanker market improving, there should be more opportunities.

Lars Solbakken, Chief Executive Officer 2Q'17 Conference Call:

> *"Looking at the outlook, respect to new investments, we feel that with the liquidity that we have available and quite strong balance sheet, this gives us capacity to continue to invest going forward without raising any new equity. Also, looking at the different shipping markets, although earnings may not be that good, values have come down to levels now where we think it is attractive to invest."*

The current dividend has some cushion as well to continue growing. Table 6 shows information regarding dividend payout for the last six quarters:

Table 6

Quarterly Dividend Payout Ratios

(per share amounts in NOK cents)

	1Q16	*2Q16*	*3Q16*	*4Q16*	*1Q17*	*2Q17*
Div/share	16.75	17.25	17.75	18.25	18.50	18.75
EPS/share	21.28	23.21	23.94	24.66	22.34	22.41
Payout	79%	74%	74%	74%	83%	84%
CFO/share	28.75	45.47	47.50	37.15	43.70	37.76
payout	58%	38%	37%	49%	42%	50%

The earnings in Table 6 are adjusted for non-cash charges and as reported by the company. The *Lewek Connector* is a ship that we will discuss in more detail later in this report. However, in summary, the counterparty for that ship is reorganizing and the charter was mutually cancelled. It has had some short charters in 2017 at lower rates and that is the primary reason for drops in EPS in 2017. In addition, to finance the containership deal, the company issued approximately 10 million shares of stock. That happened before the cash flow and earnings from those ships started fully coming in. That dilution cost the company about 1.85 cents per share.

On cash flow, one of the biggest expenses for Ocean Yield's earnings is non-cash depreciation. The customers have to pay for any maintenance on the ships and there is essentially no capital spending that is not related to growing the fleet. Thus, the cash flow payout ratio is even lower than the earnings ratio. When Ocean Yield finances new ships, it does use equity for some of the payment. Thus, the company does like to retain some of its internally-generated cash flow to pay for growth. Also, Ocean Yield uses some of the internally-generated cash flow to service vessel-related debt. Many of these financings are payable over 5 years with a balloon payment or on a straight-line basis over 12-14 years. In some cases, a vessel's debt also has prepayments tied to excess cash flow.

In general, the goal is to keep the debt below the value of the current market value of the ship and below any purchase option levels that the customer holds. However, when the value of the ship exceeds the debt and/or when a balloon payment is due, refinancing is likely to occur if the customer does not buy the ship. Often, Ocean Yield ends up paying debt ahead of schedule. Prepayment also happens with non-vessel related debt or asset sales. Consider the simple cash flow history for Ocean Yield in Table 7 below:

Table 7

Ocean Yield Cash Flow History

	2013	*2014*	*2015*	*2016*	*1H17*
Cash Ops	$157	$183	$189	$195	$104
Leases	-	4	11	26	17
Total Cash In	157	187	200	221	121
Dividends	56	69	81	94	55
Sch. Debt Repayments	112	127	142	184	87
Net Cash	-11	-9	-23	-57	-21

The table shows the scheduled debt payments listed for the coming 12 months (for 2017, half a year's scheduled debt repayment is $87 million). Thus, the payment for 2016 was the amount listed on December 31, 2015 as current vessel debt maturities. The dividend growth rate would have been even higher had the company not had these debt payments. Also, prepayments and refinancing with cash flow from asset sales (other ships and investments) have allowed the debt payments to exceed these listed minimums. Some ships like the *Dhirubhai* are almost paid off at this point, and the minimums going forward are lower. On June 30, 2017, the 12-month vessel maturities were only $98.6 million compared to $184 million coming into 2016. That will rise when they buy more ships. However, looking at less than $100 million in payments, the company is showing good coverage on the dividend going forward as cash flow rises with the cash flow from recently-added ships annualizing.

The company also has significant liquidity at the moment. The quarterly dividend is about $28 million at the current rate. There is currently $127 million in cash on the balance sheet, $58 million in available credit lines, $51 million of bonds available for sale that Ocean Yield owns plus about

$10 million of stock available for sale that the company has acquired. That amounts to $246 million of liquidity and there is only $286 million in corporate non-vessel related debt.

Detailed Review of OCY's Fleet and Markets

Offshore Oil Market

Offshore oil is a big part of Ocean Yield's business. It is also an area where some risks remain. Since the summer of 2014, the offshore business has been crushed because their contracts were finishing and not being renewed. Oil companies had started slashing capital spending in 2013, a trend which continued to accelerate in 2015 and 2016. It was the first time in history when capital spending was cut for more than two years in a row. However, there are signs that conditions are beginning to turn around. We reviewed the 2Q'17 earnings discussion and guidance for 7 of the largest oil companies in the world. Our findings are detailed in Table 8 below:

Table 8

Annual Capital Spending History and Forecasts for Oil Majors

Company	*Ticker*	*2012*	*2013*	*2014*	*2015*	*2016*	*2017e*
ExxonMobil*	XOM	$34.3	$33.7	$33.0	$26.5	$16.2	$22
Royal Dutch Shell*	RDS	$32.6	$40.1	$31.8	$26.1	$22.1	cut $2*
Statoil	STO	$16.3	$19.6	$19.5	$15.5	$12.2	$11
BP	BP	$23.2	$24.5	$22.5	$18.6	$16.7	$16-17
Chevron	CVX	$30.9	$38.0	$35.4	$29.5	$18.1	down
Petrobras	PBR	$41.1	$45.1	$34.9	$21.7	$14.2	$19.8
Total S.A.	TOT	$25.6	$29.7	$26.3	$25.1	$18.1	$16-17

-figures sourced from Bloomberg and 4Q'16 conference call. Spending amounts in billions

** Royal Dutch Shell (RDS) merged with BG Group and gave guidance for the total combined company to cut spending by $2B this year*

Some of the major oil companies are starting to boost capital spending plans. ExxonMobil was spending $34b a few years ago, and it fell to $16b in 2016. For 2017, XOM is on course for $22b in spending and sees $25b annually going forward in addition to highlighting several offshore projects. Chevron spent $38b only 4 years ago and that fell to $18b last year. The company will come in at $19b in 2017 and as much as $22b next year. It also mentioned offshore. Royal Dutch Shell is coming in at the low point of guidance between $25-$30b (this is the budget for the combined RDS and BG Group), but thinks that could increase within that band going forward. Shell made another good point, that is being echoed by others, that companies are being more focused on cost control. At the same time, drilling costs are falling. Thus, spending $25b now is the equivalent of spending about $31-$32b in prior years.

Other oil companies such as Statoil, British Petroleum, Petrobras, and Total are at least seeing the declines in capital spending stop and expect to see higher spending in 2H17 with guidance for at least flat spending in 2018. Total recently bought the offshore assets owned by Maersk this summer and Petrobras announced in September 2017 it is now partnering with other oil companies to further develop its own fields. So, the oil companies have not returned to the free-spending days yet, but total spending seems to have turned up. Nearly every 2Q'17 conference call included discussion about companies having the flexibility to expand spending if oil prices increase.

Also, a look at the 2Q'17 earnings for the various offshore oil rig companies reveals that several reported extensions for working rigs and even a few cold-stacked rigs are being reactivated for new work in 2018. Since taking office, President Trump has also opened up more parcels to offshore drilling, and with Brazil being opened to non-Brazilian companies for development, it should mean more work for offshore drilling. Finally, Seadrill, one of the largest offshore rig companies, has struggled with debt and fewer contracts. Seadrill reached a restructuring agreement in mid-September 2017 to reduce debt loads and delay other debt maturities for 3-5 years until the forecasted cyclical bounce is well underway.

With the backdrop of offshore oil production showing several signs of improvement off the lows seen in the depression the last few years, let's look at Ocean Yield's exposure to the market:

Offshore - *Dhirubhai-1* is a Floating, Production, Storage, and Offloading (FPSO) vessel that is used like a hub for offshore oil and gas. Essentially, other wells and drilling platforms in the area are attached to the FPSO which collects and stores the oil and gas produced by the wells. Other ships or the FPSO itself can then transport the oil and gas to port, which eliminates the need for pipeline construction. FPSOs are cheaper to build than pipelines and can be moved, making them perfect for use in smaller and shorter-lived fields. Risks for FPSOs include other FPSOs cutting charter rates, and relying on customers to maintain production on existing oil/gaw fields and/or developing new ones to stimulate demand when contracts are expiring and the FPSO is looking for a new job.

The *Dhirubhai* is under contract with Reliance Industries through September 2018 when it will complete its first 10-year charter. This is one exception to Ocean Yield's bareboat charter terms, as it does have crew and operating expenses for this vessel and the company does not earn lease revenue during downtime.

This ship has a material impact on Ocean Yield's results:

Table 9

Dhirubhai-1 Contribution to Results

% of Operations	*% of Revenue*	*% of EBITDA*	*% of Net Profit*	*% of fixed PP&E*
1H 2017	43%	39%	n/a	23%
2016	47%	43%	40%	28%

OCY has been aggressively paying down debt on the *Dhirubhai-1* and at the end of 2Q'17, only owed $30 million on the ship. It expects to pay that debt in full before the current charter ends. But what happens then? There are several options:

- The oil/gas field where the ship operates now is expected to still be viable and need the services of an FPSO vessel past September 2018. An extension of the existing contract is very possible.

- Reliance and British Petroleum have announced plans to expand production in the same area with 3 new fields. The *Dhirubhai* is under consideration for that work too, and the feasibility reviews are being done in 2H'17. Thus, there may be much more work for the ship. Both Reliance and BP are large investment grade companies, so counterparty risk should be low.

- Reliance has a purchase option to buy the ship in September 2018 for $255 million. According to *Offshore-mag.com*, in August 2017, about half the FPSOs in the world are owned by the production companies and half are leased out to production companies. An outright purchase of *Dhirubhai-1* would certainly not be an odd-occurrence. That would remove the revenue stream from Ocean Yield's books in a year, but would also free up capital to purchase more ships to replace the revenue and cash flow.

The *Dhirubhai-1* only went into service in 2008 and was operated at 99.8% utilization for 2Q'17 so its useful life should last longer than September 2018. We also know from Diamond Offshore, a company that charters ocean drilling rigs, that customers prefer rigs that do not have to go through a long set-up phase and find new crews to begin work – these are referred to as "hot rigs." Marc Edwards, Diamond Offshore's CEO, has talked about this several times in recent conference calls:

> *In 4Q16, "Our clients have a strong preference for rigs that have recently completed other work, in other words, rigs that are hot. They do not want to take the financial or time risk of qualifying a rig, which has been stacked for a lengthy period. We are already seeing some tenders illustrate a strong preference for rigs that are hot."*

In 2Q'17, "we believe that the incremental cost of re-contracting a long-term cold-stacked drillship will help pricing recover for hot rigs, in what will be effectively a bifurcated market between those rigs that are working and those that are cold-stacked."

Offshore-mag.com concurred when discussing the FPSO market in August 2017. It noted that there are 178 active FPSOs by the end of 2017 and 19 are looking for a contract:

"Depending on the selected field for reuse, a stacked vessel needs to be thoroughly inspected and found structurally and commercially suitable with its existing mooring, accommodations, topsides modules, and anticipated turret loads. Altering these components can lead to significant expenditures and installation delays.

Other issues can hamper the cost of refurbishment and re-introduction of an out-of-service vessel. Reservoir characteristics of a new field could impact the effectiveness of the topsides facilities. Fluid viscosity, pressures, temperatures, and suitability of current gas compression and dehydration can require replacement or addition of upgraded capabilities."

In our opinion, Ocean Yield is likely to have a positive outcome here. Another multi-year charter appears likely, and it should be announced in the next 6 months. The fact that the existing job would still need an FPSO and that more development is likely to happen in the area supports this belief. In addition, offshore rig companies are starting to see modest gains in terms of new contracts, indicating a bottom may be forming for offshore drilling. On 2Q'17 conference calls, Diamond Offshore, Seadrill, Ensco, Transocean all reported new contracts in their results and are reactivating some drilling rigs as the market may start growing again. Total also bought Maersk's offshore oil assets in the North Sea in August 2017. If the offshore market is starting to recover, demand for FPSOs should also increase.

Also, keep in mind the *Dhirubhai-1* will be debt free when the contract is up. Any cash flow from a new contract or from the ship being purchased will flow 100% into the pool available for dividends and funding future growth. EBITDA is running about $28 million per quarter right now, and the company paid the debt down on the FPSO division from $100 million to $30 million in the first half of 2017.

Offshore - *The Aker Wayfayer* is a construction, subsea equipment vessel. It was modified and upgraded in 2016 for a contract with Petrobras. The vessel is chartered to AKOFS Offshore through 2027 under a bareboat deal. AKOFS will do the work with Petrobras. That contract is for 5-years starting in late 2016 with Petrobras having an option for another 5-year extension. We view this situation as improving. AKOFS, as an offshore support company, suffered from poor business conditions in recent years as offshore oil drilling was more subdued and another one of its vessel's contract was canceled. However, the company sold some assets and has boosted liquidity. It also entered a JV with some shipping companies to jointly own and hire the ship that lost its charter in 2014, and that vessel is now on a 5-year contract. AKOFS reported last quarter that it had a net debt of NOK 1.7b and still had NOK 1.6b of cash and available credit on hand. The company still

has one other idle ship, but the long-term cash flow stream from Petrobras for the *Aker Wayfeyer* and the second ship JV along with the liquidity should make this a sustainable situation. Also, with Brazil looking to add more offshore development, the odds of the 5-year extension on *Aker Wayfarer* look promising, as does the chance that AKOFS can find business for the 3rd vessel.

Offshore - The *NS Orla* and *NS Frayja* were added to Ocean Yield's fleet in June 2017. Both are supply vessels for offshore operations and are chartered for 15 years to AkerBP. It is important to note that these two vessels have had essentially zero impact on reported results so far, other than to add to the debt at the end of 2Q'17. They will add $12.6 million in EBITDA vs. $320.5 million or about 4% growth. AkerBP was recently formed by combining assets of Aker's offshore and BP's Norway business in 2016. It is 48.8% owned by Aker and 36.6% by BP. It is a large offshore exploration company with a net debt to EBITDA ratio of only 1.1x. The company is also seeing business and results increase. In addition, new developments are scheduled to come online over the next several years. All of these parties have high credit quality and seeing improving business conditions.

Offshore - The *SBM Installer* is another offshore support and construction vessel with a contract through 2026. The vessel was modified and upgraded before entering its latest deal and is jointly owned 75% by Ocean Yield and 25% by SBM Holding, who is also the charterer. SBM has reported that it expects to see sporadic work for the *SBM Installer* given the downturn in the market. However, SBM is also reporting new contracts for other assets, cash flow has more than doubled in 2017 vs 2016 thus far, it has increased its dividend, and the balance sheet is not very leveraged with debt/equity of 1.4x and debt/EBITDA of 5.5x and falling.

Offshore - *FAR Statesman* and *FAR Senator* are two more offshore supply vessels that are chartered to Farstad Shipping. Earlier in 2017, Farstad merged with Solstad Offshore and Deep Sea Supply. Those two companies were largely owned by stronger parent groups and viewed consolidation within the industry as a good option. As part of the merger, Aker and Hemen will own the majority of the new company's stock and will buy new shares to put capital into the deal. Farstad debt was converted into equity as well to improve the balance sheet.

Ocean Yield also participated in the deal, as it reduced the daily rate of the charters from about $31,000 per day to about $13,000 per day for 5 years. (We are converting these from NOK to USD). Ocean Yield will also participate in a profit sharing arrangement should the two ships be earning more than the $13,000 per day. In 2022 and 2023, the charter rates will rise to about $27,200 per day for each ship. The company also received 316 million shares of Farstad, which became 8.8 million shares of the combined company and worth about $15 million when the deal closed. In addition, Ocean Yield will receive a balloon payment of $33 million in 2023. That amount would be reduced by any amounts paid to the company early via the profit sharing arrangement. Thus, Ocean Yield

gave up $70 million in payments over 7-years in return for $48 million in stock and balloon payments that may appreciate or be paid early as the industry recovers.

These *FAR Statesman* and *FAR Senator* were both built new and were delivered only 4 years ago. Ocean Yield's backlog at the end of 2Q'17 reflects the new reductions in charter rates. This is also a good indication of how solid the company's customers are and how well the deals are structured. These ships were two $140 million deals. The counterparty went through a very rough cyclical downturn. The end result was Ocean Yield now has a much stronger counterparty, with less debt, greater market share, and two strong parent companies associated with it. The company gave up only about $20 million in future earnings in return for an equity stake and profit sharing arrangement that may more than recoup the $20 million lost as the industry recovers.

Offshore - *Lewek Connector* is another construction support vessel that also connects pipelines and other underwater work. It is the only vessel that Ocean Yield has without a long-term contract. It also has no impact on the backlog at the moment, and minimal impact on recent results. In February 2017, the company agreed with the counterparty, EMAS Chiyoda, to terminate the charter and let EMAS go through a bankruptcy organization. Part of the reorganization involved liquidating the Norway subsidiary, EMAS AMC, which worked with Ocean Yield. The vessel was thus kept out of the reorganization process.

EMAS Chiyoda was owned by Erza Holdings (which has financial problems) and Chiyoda Corp. (Chiyoda). In 2016, it sold 25% to Nippon Yesen. Both Nippon and Chiyoda are quality credits. EMAS Chiyoda filed for reorganization as it liquidated EMAS AMC, which should remove Ezra from the mix (or substantially dilute it). Chiyoda provided a credit line to EMAS, and another competitor, Subsea 7, has purchased many of the assets of EMAS with the goal of keeping the assets operating and the employees working. In September, the term sheet was finalized, and in October 2017, EMAS will be working to update its financial reporting with various stock exchanges.

Currently, Ocean Yield has put the *Lewek Connector* on short-term charters during 2017 while waiting for the situation with the customer to finish. The lease rate was reduced to $40,000 per day and is a reason why cash flow dipped in 2017 compared to 2016. In early October, Ocean Yield announced another continuation of *Lewek Connector's* short-term charter until mid-November with an option for another month. The company also noted that while it seems likely there is work for the vessel in the long-term, winter is normally a slower time in that business. Thus, the ship may go idle for a few months and then go on charter with a reorganized counter-party in the spring. This ship is not included in the backlog and has already missed time during 2017.

After coming through what appears to be the worst of the offshore downturn and seeing renegotiations of three vessels with Farstad and EMAS, the company only saw two fairly minor impairments. In 4Q'15, there was a $28.6 million impairment on goodwill related to the FPSO vessel. The vessel was nearing the end of its lease and the potential for either a purchase by the counterparty or new lease was being reviewed for future cash flows. The carrying value was also

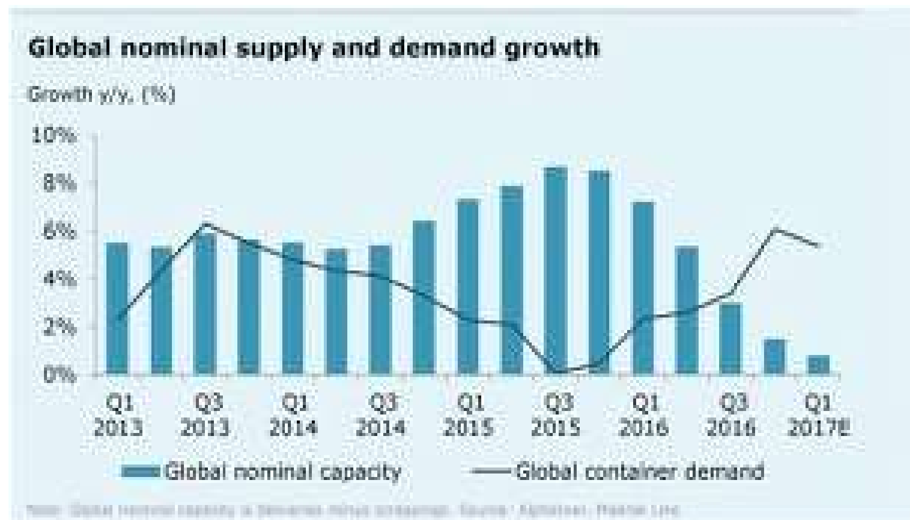
under review as the offshore market was still declining and future cash flows beyond September 2018 were being assessed. In 4Q'16, the negotiated loss of the *Lewek Connector's* long-term charter and replacement with a lower-priced short-term charter obviously reduced the forecasts for estimated cash flows for that vessel. The company took a $35.6 million charge to the value of that ship. There are reasons to expect both situations to improve in the near future as discussed above.

Container Ship Market

As noted above in the growth section, the container ship market is a new area for Ocean Yield which has 6 container ships coming online in late 2016-17. The ships are 49.5% owned by the company and 50.5% by Quantum Pacific Shipping. Ocean Yield raised $105 million of new equity in 2016 to invest in this venture that cost $162 million. All the ships are on charter with major transport companies for 14 years. The company accounts for this investment under the equity method on the income statement. Under the equity method, Ocean Yield is only reporting its percentage of net income on this deal. The EBITDA is understated as interest costs and depreciation would lower net income.

The containership market has considerable safety from counterparty risk and is another area we expect to see more growth for Ocean Yield. Container ships had a very rough time in the years prior to 2016. Essentially, the industry ordered many ships that began arriving in 2009-16 during a period of weak economic growth. Thus, supply growth for the industry was running about 6% for several years. Growth in world trade was below forecasts for several years, and bottomed at 0% growth in 3Q'15 after falling from about 6% annual growth. In addition, the way the shipping companies looked to reduce unit costs was using larger ships that carry more containers. The net result was falling shipping prices, which led to losses among many of the smaller competitors. One of the competitors in South Korea, Haijin, filed bankruptcy in September 2016 and liquidated. That market almost immediately started to show signs of recovery with supply of ships and demand swinging in more positive directions. Three trends are in play now.

First, scrapping of older ships accelerated and set a record in 2016 and likely for 2017. Removing older supply cut down on the number of idle ships. The world fleet had an idle rate of about 7%-8% in 2016. The scrapping in 2016 and 2017 removed about 3%-3.5% of the fleet each year, according to the industry firms Clarkson's and Alphaliner. At the same time, the number of new ships on order is at a record low. Costamare, another company that charters containerships, has noted that the orderbook looking out over several years is normally above 30% of the current world fleet and has been as high as 60%. In 2017, the order book was about 16% of the world fleet. Thus, supply is not growing even as demand growth has reemerged:



Second, several mergers have been announced with the goals of cutting fixed operating costs and boosting profitability. Three Japanese firms are merging: (NYK) Nippon Yusen Kabushiki, Mitsui OSK, and Kawasaki Kisen. Maersk is buying Hamburg Sud. CMA CGM acquired APL, while COSCO and China Shipping also merged. Hapag-Lloyd purchased United Arab Shipping. All of this was announced and completed in 2016 with the first two expected to close shortly. All these deals are expected to shore-up balance sheets and rationalize the capacity.

Thirdly, remaining players are also forming alliances designed to offer a wider footprint of routes to customers and improve scheduling efficiency. Think of this like airline partners, where you may book a flight to Japan on American Airlines or Quantas, but fly on a Japan Airlines plane and earn miles on any of the three partners you choose. It allows the three companies access to a larger fleet, more cities, and they don't have to spend the capital to build the capacity separately. For example, companies could look at a situation where they have 14 ships working a route, but the job could actually be done by 12. Two ships could be moved elsewhere with the expectation of creating higher volumes and prices on all the routes.

One such group is The Alliance which represents about 18% of the world fleet. It is represented by Hapad Lloyd of Germany and the three Japanese firms that are merging. Ocean Alliance has about a 33% market share with CMA CGM of France, China COSCO of China, Evergreen, and Orient Overseas. A.P. Moller-Maersk is merging with Hamburg and is already aligned in the 2M Alliance with MSC and will represent nearly 35% of the market.

This is an industry with a history of overbuilding in good times and suffering in bad times longer than it seems necessary. If essentially 85-90% of the companies are now merged or working together, perhaps the industry may be headed for a period of more rational expansion and lower cost structures. That also may help if world trade growth is running afoul of the "law of large numbers" and it is simply becoming tough to create consistent growth rates at historical levels.

New routes also absorb more capacity. The WSJ noted in October 2017 that the expanded Panama Canal can now handle large container ships. This allows many ships from Asia to travel to ports

along the Gulf and East Coast such as Tampa, New York, and Savannah. That skips using rail and trucks to move goods that were unloaded in Los Angeles. The longer routes occupy the ships for more time per voyage and effectively use up more capacity. Rising demand growth, as noted above, also absorbs more capacity.

The net result is the industry has restructured around its strongest players and become more rational in how it grows and views financial statements. So far, shipping prices have increased and appear likely to rise more. Ocean Yield's investment is chartered with the large containership lines such as Maersk, so the counterparty risk appears minimal and improving. This is why we expect the company to look to expand in this area going forward, which could provide profitable growth for the company and shareholders. Also, the value of very new containerships is likely rising at this point given the supply/demand situation. It is unlikely that the company would see a write-down of asset values or change in charter terms that would negatively affect results.

The Tanker Market

Ocean Yield has 15 tankers of various size. These are new to the fleet over the last few years. With one exception, all the product tankers were with Navig8, which was recently acquired by Scorpio Tankers. The other tankers remain with Navig8 Chemical Tankers. The leases are capital leases, so the end of the term in 9-12 years will likely result in Scorpio acquiring the ships and Ocean Yield recycling the capital.

Scorpio charters its ships out largely on the spot market. The prices can be very volatile based on supply and demand of other ships. Moreover, much of what Scorpio and the Ocean Yield ships transport is refined products like diesel fuel, gasoline, naphtha, jet fuel, etc. Refined product shipping is the fastest-growing area for tankers. According to Clarkson's, a shipping industry data supplier, oil exports have been rising at about 1.0% while refined product has been rising at 4.1% rate. Also, while cargos are rising, so are miles sailed, which have been increasing by 4.4%. The Middle East and Saudi Amarmco are also growing refined product output at a fast rate and much of that increase will need to be transported.

The tanker market has been oversupplied in recent years. Some of this was due to the extreme oversupply of drybulk ships leading to order for new drybulk ships being converted to new tankers. Some of this was the industry having a solid rate recovery a few years after 2009 and ordering more ships. And finally, some of this was due to poor scrapping rates of old ships. Given the demand picture continues to improve, fixing supply should drive up charter rates. Again, that doesn't change the return to Ocean Yield, but it does reduce its counterparty risk. Much like the container ship market, there simply are not many new tankers on order. Product tanker growth peaked at 5.7% and 6.3% in 2015 and 2016 net of scrapping. The growth rate is falling rapidly due to a lack of new orders. Clarksons predicts growth of 5.3%, 3.8%, 2.3%, 0.6% for 2017-20, and that is before scrapping of older ships.

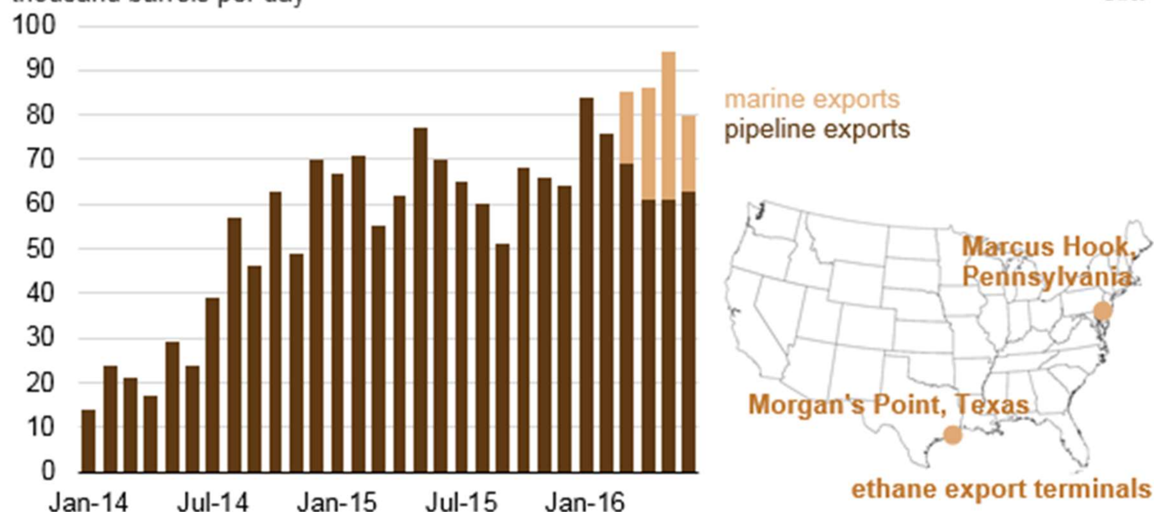
Fewer new orders will help balance the industry as demand for new product shipments and more miles sailed both increase. But, there is also a rising level of tanker scrapping that should reduce supply. Older ships require more maintenance, and environmental rules require them to be retrofitted with scrubbers. The ROI equation does not favor this higher spending on older ships because they do not have a long life remaining to earn back the new investment. Also, older ships often get a discounted charter rate, so it becomes even tougher to earn back the cost of new upgrades. Scrap prices have increased too. A crude oil tanker company, Frontline, walked through this formula in the 2Q'17 earnings call. After noting that older ships earn below-market charter rates, their value as a ship was still higher than the scrap value a year ago. Frontline gave the example that a 17-year old VLCC tanker (larger than what OCY and Scorpio use) was selling for $12 million as scrap or $20 million as a tanker – thus in 2016, there was little incentive to scrap old tankers. This year, those factors have changed. The difference in value has gone to essentially $0 as the older ship needs investment and the charter rates the ship can earn are lower because too many older ships remain afloat. This has led many to expect a rise in scrapping activity.

The benefit to Scorpio is that it has a very young fleet, and all the Ocean Yield tankers are younger than 4-years old (only 2 are 2013 vintage and the rest are 2015 or younger). Those are the ships that should benefit as demand continues to rise and older fleets are scrapped. As it stands now, Scorpio boasts a very low-cost fleet to operate and most costs are fixed, so rising tanker rates will boost cash flow quickly. Also, its balance sheet has net debt-to-equity of only 1.2x, and the fair market value of the ships may be higher than what they are listed on the balance sheet. The spot charter rates are still above fixed costs and the company is cash flow positive. The same can be said for Navig Chemical Tankers which has a debt-to-equity ratio of 1.8x and net positive cash flow. All Navig8 ships are 2015 or younger.

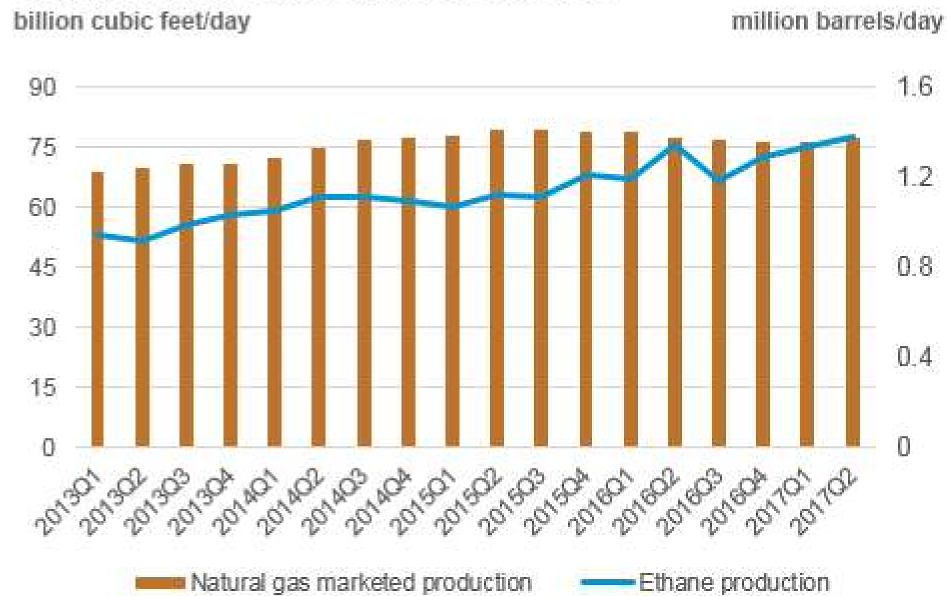
Chemical tanker demand is also expected to rise rapidly in the coming years according to *Fairplay*, an industry trade journal. The chemical tanker market has been hurt by too many tankers, as described above, as well the drop in shale production in the US 2014-15. However, both situations appear to be correcting well, and many new chemical plants are coming online (or already are). The result should be more long-haul routes for growing cargo volumes. For example, Brookfield Infrastructure, in its quarterly update in October 2017, noted that shale production in the US is back near peak levels. Also, the infrastructure to get the feedstocks from the field to the chemical plants continues to grow rapidly as well. Shell reported in its October 2017 presentation that it foresees chemical demand more than doubling from 2012-2030. That will be driven largely from Asian growth buying US chemicals, which are created with cheaper feedstocks.

Gas Carriers

Two of the newest ships in the Ocean Yield fleet carry liquid propane and ethane from the US primarily to Europe. This is a growing market, again due to low cost US shale. The fleet at Hartmann Group is also very young, and the two Ocean Yield ships are brand new. Look at how fast this industry is growing:



The exhibit is from the US Energy Information Administration in September 2017. The amount of ethane is rising rapidly and the amount being moved by ship is only recently starting to take off. The rest is moving via pipeline to Canada. Ethane, in a worst-case scenario, can be burned just like natural gas. It can also be processed into ethylene which is a feedstock for chemical plastics.



The amount of ethane and propane continues to rise with US shale drilling. In the past, much of this was flamed off because it had few routes to get to market. That has changed with the completion of many pipelines with more to come. The EIA expects ethane production to reach 1.8 million barrels per day in 2018. That's a 50% increase from 2015.

Car Carriers

Ocean Yield has 6 car carriers with Hoegh Autoliners. All are fairly new with 2 from 2010, 2 from 2014, and 2 from 2016. They should be desirable in the Hoegh fleet. Hoegh has 50 car carriers and only 14 are from 2010 or later, so Ocean Yield represents the youngest part of the fleet. Hoegh itself was formed in 1927, and almost 40% of it is owned by AP Moller Maersk, which is one of the largest and highest credit quality firms in shipping. AP Moller Maersk recently sold its offshore oil assets to Total, which boosted its liquidity and enables it to focus more on shipping, particularly containerships where it is a top player.

We believe Ocean Yield has a good credit quality counterparty in Hoegh. The market for transporting cars appears to be growing with China auto production increasing. China has been shipping products toward Europe, the Middle East, and Africa. These are new and growing routes for car carriers. Hoegh wrote about this growing change on its website, as well as helping to build Africa's middle class, thus stimulating more demand.

Disclosure

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