U.S. Shipping by Sterling Investment Partners — Buyouts Article

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Few things are guaranteed in life, and even fewer in the world of buyouts, mergers and acquisitions. But Sterling Investment Partners managed to ink a deal in 2002 that comes as close as possible to securing a guaranteed stream of revenue.

Last September, Sterling purchased the product tanker business of Amerada Hess Corp. for $198 million, including fees. The armada, now part of the newly created U.S. Shipping LLC, consists of six sister tankers, management, crew (approximately 250 personnel in total) and ancillary assets. Also included in the deal is a support agreement with Hess.

This support agreement is one of the main factors that sets this deal apart from the other 200- plus deals in the “small market” category (LBOs with a purchase price no greater than $200 million). It’s essentially an assurance from Hess that guarantees minimum revenue on all six vessels through 2007. The way it works is if U.S. Shipping can’t find any customers — as its vessels come off of existing or future charters — Hess is obligated to reimburse the company in an amount equivalent to the projected market rates over the next five years.

“Of course, neither Hess nor U.S. Shipping expects that to happen,” said Bill Macey, a co-founder and managing partner at Sterling. “Our expectation is that the backstop payments will not be needed or utilized.” The only noticeable downside to this arrangement is that if U.S. Shipping has a customer that backs out of its contract to charter one of the vessels, Hess is not on the hook to make up for the lost revenue. Currently, five of the vessels are under charters of varying duration with major oil companies to transport petroleum products between U.S. ports.

“This deal creates a rational, predictable market for the services these ships provide,” said Allan Vartelas, a managing director at Aetna Life Insurance Co.,a co-investor in the transaction. “Also, the existing management and the ships themselves have a great reputation in the industry.”

U.S. Shipping paid approximately 5.5 times pro forma EBIT-DA for the six tankers. Financing for the deal includes a $10 million five-year revolving credit facility and a six-year $130 million term loan from CIBC World Markets, and a $29 million senior subordinated note retained by Hess. Sterling’s co-investors in the $40 million equity stake include Aetna, PPM America Capital Partners, Landmark Partners and Massachusetts Mutual Life Insurance Company.

According to Macey, U.S. Shipping currently maintains the fourth-largest market share among comparable vessels, and by 2007, “our market share will jump to number two.”

Pro forma revenue and EBIT-DA, for the Hess support agreement and existing charters, exceeds $67 million and $36 million, respectively. “This allows us to pay back nearly all the senior debt within the first five years, based on a revenue stream that is assured in nature.” said Macey.

“This transaction is for the patient investor,” said Doug Newhouse, Sterling’s co-founder and a managing partner with the firm. “This deal will make a lot of money, but over the long term. We expect to have a fairly long holding period, and while we predict a very positive IRR, the cash-on-cash returns should be even more appealing. We structured the deal so we can provide liquidity by distributing cash flow once debt has been paid down. This allows us to pay out to our LPs without going through a traditional exit.”

One of the people Sterling can thank for the deal is Paul Gridley, a veteran of the shipping industry and longtime friend to Macey and Newhouse. Gridley brought the deal to Sterling and will run U.S. Shipping as chairman and CEO. Gridley ran Marine Transport Lines for 12 years and, with the help of Macey and Newhouse, privatized the company in 1989 in a transaction valued at $140 million. In 1998, Gridley sold MTL, gaining a 12-to-1 return of invested capital, with an IRR in the low 20s. “Paul had a non-compete clause, but when that ended in 2000 he brought Hess to our attention and identified the potential opportunity,” said Newhouse.

According to Pat Callahan,a tanker broker and analyst with Mallory Jones Lynch and Flynn, there are approximately 70 tankers that compete directly with the vessels in the U.S. Shipping fleet. The silver lining behind all these regulations is that every year, five of these competing ships must be de-activated or dry-docked, either to be scrapped or retrofitted. A retrofit can cost up to $50 million and take six months to complete, while building a tanker from the ground up can cost $100 million and take three years to finish. With such staggering costs involved with either option, it’s likely many of those tankers will end up being scrapped.

Conversely, the vessels acquired by Sterling will not come under the thumb of these regulations for at least 10 years from the purchase date, allowing Sterling ample time before being forced to decide between performing a retrofit, or scrapping the ships altogether.

In addition to the Jones Act, established by the federal government in 1920 to monitor and protect coastal trade between U.S. ports, the oil shipping industry is also subject to the U.S. Oil Pollution Act of 1990, which mandates all tankers shipping petroleum products to and from U.S. ports must be double-hulled (bottom and sides) by 2015. All six of the tankers bought from Hess are double-bottomed, and are some of the newest ships in this sector. The OPA dates for these six vessels range from 2012 to 2014, according to Callahan, and the regulations “will substantially diminish the total number of ships that compete with U.S. Shipping’s vessels.”

“This is a significant barrier to entry, and another advantage of this deal,” said Newhouse. “We believe charter rates could rise significantly by the end of five years, resulting in even higher returns,” he continued. These ships also contain “redundent propulsion“; thereby allowing a crew to conduct maintenance on one engine system while a second system keeps the ship in operation, “substantially reducing unexpected dry-docking.” According to Newhouse, this is another distinct advantage over many competing ships in this sector. None of the six ships is scheduled for routine dry-dock maintenance until 2005.

Sterling is a private equity partnership focused on investing in and enhancing the value of middle-market companies. Sterling maintains a broad industry focus including outsourcing and business services, niche manufacturing and industrial growth, and transportation and logistics.