The Great Eastern Shipping Limited
Q3 FY12 Results Conference call
(February 13, 2012)

Moderator: Good evening ladies and gentlemen. Welcome to GE Shipping Earnings Call on declaration of its financial results for the third quarter ended December 31, 2011. I now hand over the conference to Ms. Anjali Kumar, Head- Investor Relations at GE Shipping to start the proceedings.

Anjali Kumar: Good evening everybody and welcome to our Q3FY12 results conference call. As usual, our CFO, Mr. G. Shivakumar will present the highlights of the results and then will take you through the Q&A session.

G. Shivakumar: Good evening everybody. I presume you all would have gone through the results that we put out on Friday evening and the press release along with it which had analytical information as well. The information which was not included there is the net asset value as on 31 Dec'12 which is Rs. 431 per share on a consolidated level. We can now start the Q&A session so that we can go deeper into the results and into our outlook for the next few quarters.

Moderator: The first question is from Vikram Suryavarshi from Mumbai.

Vikram: What is the standalone NAV as on 31 Dec'11?

G. Shivakumar: Standalone NAV as on 31 Dec'11 is Rs.285 per share.

Vikram: So that has come down from Rs. 329 per share in Sept'11 to Rs. 285 per share.

G. Shivakumar: Yes, that is correct.

Vikram: Why has the Equity figure come down from Rs 6461 crs in Q3FY11 to Rs. 5942 crs in Q3FY12 in the consolidated numbers?

G. Shivakumar: The derivatives transactions that we have are under the hedge accounting i.e. the MTM's gain or loss goes to the hedging reserve and because of the movement in the Rupee/Dollar there was a MTM loss during the quarter which resulted in an increase in the hedging reserve which brings down the net worth.

Vikram: How many vessels were dry docked in Q3FY12 and how many are expected to be done in the last quarter?

G. Shivakumar: We had 6 dry docks in Q3 and around 5 vessels are expected to be drydocked in the last quarter of FY12.

Moderator: We have our next question from Mr. Bhavin Gandhi from Mumbai.

Bhavin: Can you first highlight as to in which asset classes have we seen correction in rates and also, what is the impact on that because of the exchange rate?

G. Shivakumar: The asset prices across the sector, be it in tankers and dry bulk have fallen between 12% to 20% from beginning of October and December end. On a year-on-year basis it has declined by 25% to 30%. So, it is not that any particular asset class has outperformed the others. Of course, the very modern assets have stood up a little better.

Bhavin: And has there been a significant impact because of the exchange rate?

G. Shivakumar: Yes, exchange rate would help to improve the NAV because all these are denominated in US dollars. On the other hand, of course, we have most of our borrowings which are dollar denominated. So, it is fairly balanced. We have not had any great positive or negative impact on account of the exchange rate on the net asset value.

Bhavin: Could I have the CWIP numbers for the shipping & offshore?

G. Shivakumar: Shipping CWIP as of 31st December is close to $160 mn. In offshore, it is about $85 mn.

Bhavin: What are the utilization levels in the offshore assets?

G. Shivakumar: The utilization was just under 94% for PSVs; 80% for AHTSVs; MPSSVs were 93%; ROVSVs at 96% and Rigs are 100%.

Bhavin: Even though we are seeing decent utilization levels for all our assets, why has the ROC been so low?

G. Shivakumar: That is including the work-in progress. So, we will be about 10% ROC without taking the work-in progress which will yield close to about 20% ROE.

Moderator: The next question is from Mr. Krishna Raj from Bengaluru.

Krishna Raj: My question is related to the Rs 600 odd crs debit balance that we added this year to the hedging reserve account and so that led me to understand the various derivative instruments that we use and how they get reflected in the financial statements. So, I went to the 'Annual Report' and then I saw that there are some JPY/USD swaps that we use. So, I wanted to know what was the purpose behind those swaps and whether we are protected against adverse movements in USD/JPY? And second was, I also saw some currency options. So I just wanted to understand what those currency options were and what were the cash flows items that are being hedged with these instruments?

G. Shivakumar: The first point we will take up is the JPY/USD. That is actually a pretty simple transaction. Money was available when we were looking to borrow. JPY funding was available and therefore it was borrowed in JPY. This is for acquisition of vessels. Our standard position is that we would like to borrow US Dollars, because our assets are US Dollar-denominated and our revenues are mostly dollar-denominated. So, we have borrowed in JPY but immediately swapped those into US Dollars and therefore ended up with the US Dollar exposure on the liability. So, that is the JPY/USD. We have no net exposure to JPY at all. So, that is one. Second is on the option. These are basically dollar sold positions where we have hedged our revenue inflows by selling forward using structured products and so, this is hedging our future revenue. Basically we have sold forward some of our expected future revenues.

Krishna Raj: The other question that I had was, for all practical purposes the functional currency on the business is US Dollars. That is my understanding. And free cash is mostly held in INR and that leads to exposure to adverse fluctuations. So I wanted to understand whether my thinking is right and what is the rationale if the functional currency basically USD but free cash is held in INR?

G. Shivakumar: You are right. Our base business currency is US Dollars but the free cash because of regulatory requirements can't be remitted out in dollars. We can only remit out for specific purposes. So if we have a surplus in the Rupee account, we cannot just convert it to dollars and keep it in dollars. What you are pointing out is correct, there is a mismatch in that case but we cannot do anything about it because we are not allowed to take it out except for specific purposes. So, for instance, if we borrowed money in the local market, that money will be placed here till we can find the utilization for it and remit it overseas.

Krishna Raj: And my last question is that I presume bulk of the movement in hedging reserve account would be on account of the USD/INR to swap your Rupee liability to dollar liability. Is my understanding right?

G. Shivakumar: That is perfect. A lot of that of course has changed in the last month, month-and-a-half.

Moderator: The next question is from the line of Abhishek Ghosh from B&K Securities.

Abhishek: What is the coverage in Shipping across both the segments in FY13.

G. Shivakumar: Overall, we are a little under 20% where it is lower for Dry Bulk around 10% and a little over 20% for Tankers.

Moderator: We have our next question from Mr. Trilok from Birla Sunlife Insurance.

Trilok: If you could just give us your broad outlook in both of your businesses, and also, what are the number of assets you are going to add in the offshore business in the next 12 months or so?

G. Shivakumar: First, I will give you the number of assets which are going to be added. In Shipping, of course, we have nothing which is pending in the order book. In offshore, we have one rig and three ROV Support Vessels which will be delivered within the next 12 months. That is the order book in the whole group. Now, coming to the outlook and when you said both businesses, I think you mean Shipping and Offshore. For Shipping, overall the outlook is not looking very good. The supply position for 2012 seems to be very strong in terms of number of ships that are getting delivered and even taking substantial amount of slippages into our calculations we believe that fleet growth could easily be in double-digits on the Dry Bulk side. And on the Tanker side, maybe a little less than that but still quite a solid number. So, we expect maybe 6-8% growth in the crude fleet in this year, in the products segment a little lower and in Dry Bulk definitely in the double-digits. We have not seen much scrapping take place. In Dry Bulk this year we have about 20% of fleet additions if all the deliveries go through. Last year was a big year for scrapping for Dry Bulk, but still only 20 million dead weight which is about 3% to 3.5% of the fleet was scrapped and therefore we expect a pretty solid increase in the fleet capacity in this year. As a result we do not expect earnings to be strong in this year. In Tankers, at least we have seen some scrapping happening. We have seen older vessels drop quite rapidly in value. And by older I am not talking of 20-year vessel, I am talking about the vessels which are in the age group of 10-15 years, so built in the late 90s. The drop in the values of those has been quite stunning from the middle of last year and so, we have seen quite a few of vessels going for scrap. Based on the oil demand projections which is running at anywhere between 1.3% and 1.6% for Calendar 2012, probably the growth in demand for cargo carriage maybe 3%-4% and we expect that fleet growth might be a little higher than that and therefore we do not expect earnings to be much higher than the previous year.

Trilok: Do you believe given the fact that you have already seen a substantial drop in the charter rates, there is further scope for downfall in the asset prices?

G. Shivakumar: Dry bulk charter rates have seen a bad market only for the last maybe two to three months. Before that the Dry Bulk market was pretty decent especially for the smaller bulkers where we operate between 40,000 and 80,000 tonnes. We have already seen a drop in the value of some of these assets. So, I would not say with confidence that these values have bottomed out. There are two things; one is the earnings, the second is a lot of it comes from the selling itself, which is when ship owners are unable to meet their obligations and banks take over and sell the assets to enforce a security. That can cause a drop as well. We have seen a couple of those cases happen though they have not had so much of an impact but if that accelerates then we could have an issue. As the market remains bad we will see people probably defaulting on their payments and therefore more of the enforcement or security happens and ships getting sold. That could lead to further step down in asset value. The other thing which has happened is that very modern assets have held values, especially on the Tanker side,

Trilok: What is the scenario in the Offshore business?

G. Shivakumar: On the Offshore business the activity levels remain strong and are widely expected to get stronger. The E&P budgets we see from different surveys are going to be up this year from previous year by about 10% to 12%, which is a very strong number. And the good thing about offshore is that the yard capacity or the supply of ships is not very high, and therefore, we do not have the supply overhang that we have in shipping, which is the worry in shipping over even the longer-term after this order book goes. In offshore it is not as much of worry. And in offshore, the other thing is that such a large part of the fleet is very old that. Replacement demand forms a bit of a safety net when you are running modern assets. And the first assets to go will be the ones in a weak market will be the 1970s and 1980s built assets and our assets will remain relatively insulated from a poor market.

Trilok: What is the incremental investment can we expect in the Offshore business?

G. Shivakumar: As of now we have no plans. We have an order book of about $260 mn. We have nothing planned as of now. The impact of the financial crisis we believe has not been fully felt in a lot of the markets, including Shipping. As I mentioned that one is that banks enforcing security, the other is that there is actually a lack of funding for people to take delivery of assets. We are a top-rated name, so we are still in a position to raise financing in the ship finance market. But a lot of companies are having difficulty doing this and that is another factor which will really add to the pressure on asset values and therefore we are adopting a 'Wait and Watch' attitude. As you would have seen we have a fairly light balance sheet, we have leveraging capability, we have substantial amount of cash sitting in our balance sheet and therefore, we are in a position to commit to further investments but we are being cautious about that.

Moderator: We have our next question from Ms. Pallavi from CRISIL.

Pallavi: I wanted to know at what price are the jack up rigs been chartered?

G. Shivakumar: We are not allowed to give out that information.

Pallavi: What is the proportion of spot and time charter contracts in shipping?

G. Shivakumar: For this quarter we have 80% covered as of now. But that is because we have already gone through almost half the quarter and there is very little left of the quarter to cover. So, this quarter we have covered 80% of the operating days and for the next year we have a cover of little under 20% on the overall shipping fleet.

Moderator: We have our next question from Mr. Janakiraman from Franklin Templeton.

Janakiraman: Given the fact that coverage for fiscal '13, appears to be on the lower side, will the effective day rates come down quite sharply?

G. Shivakumar: It depends on what happens to spot market. What has happened is that we can lock in by fixing out on charter now but time charter rates as they are today and as they have been for the last few months are very low and therefore, we are not putting any risk by time chartering out a ship. This is not a normal situation for us as you would know that we go into a year with only a 20% cover. Some of the contracts are annual contracts which get down with effect from 1st April which is the financial year and therefore we expect that as we go into the financial year we will be closer to 25-30% but the point is that we will not be going to a large number on the time charter because we do not see a value in it and we believe that it is actually reducing our yield because by operating the ships well on the spot market we have actually outperformed the time charter rates in the last year.

Janakiraman: Will you be able to replicate his strategy in FY'13 as well?

G. Shivakumar: We have been able to do that in the last year, year-and-a-half. What has happened is that banks have been putting pressure on some of the weaker borrowers to put away the ships on time charter so that the banks are protected and that is one of the reasons for time charter rates going down. And we do not want to get into a situation where we are competing with these people who are forced to time charter out, which we believe are unremunerative rates.

Janakiraman: Just a hypothetical question, as per the current time charter rates, will they cover the cash opex and interest payments?

G. Shivakumar: They will cover opex and maybe just about cover depreciation, but not really. Even if you buy the ship at today's depressed values you would not cover your book breakeven. So, if you had to buy a ship today and time charter it out for a year you would be making a loss.

Janakiraman: Given the prospects of a slightly more sticky oversupply situation in the shipping market, would it be fair to assume that even if asset prices come down from the current lower levels, you would be very hesitant to commit more capital into shipping?

G. Shivakumar: We are not too hesitant to commit capital. We believe that this is a decent opportunity to invest in shipping and build up a fleet for the long-term, The only thing is that what we like to really ascertain is that whether there is a structural downturn or whether it is cyclical and because that changes our returns in a big way. So if we invest now and the market remains low for the next five years then our return is basically hit. Our investment approach is similar to funds investment approach in that way. Therefore, we are trying to get it closer to where the recovery could take place and therefore that is what we are trying to get some handle on and some confidence on and then we will go out and commit. So far we have not yet got that. As we said, we have been saving of for this opportunity, so then we will be happy to grow the business but not until then.

Janakiraman: Lastly, on the hedge reserve accounting, what is the notional value of the outstanding dollar sales that you take in 2007?

G. Shivakumar: It is not just dollar sales, there are different kinds of transactions there. The main kind of transaction which we have is when we borrowed Rupees and swap into dollars because we wanted a dollar liability. So, we borrowed in the long-term Rupee debt market through issue of non-convertible debentures. That is an underlying of about $360 mn. That is the one which is really affected the MTM and therefore the hedging reserve. Both went against our position and therefore the MTM as on 31st December was a pretty large number, which a lot of it has got reversed currently but that is the large transaction really which is affecting the hedging reserve.

Moderator: We have our next question from Mr. Chetan Kapoor from IDBI Capital.

Chetan: My question is regarding the cancellation the order at Mazagon Dock for a multi-purpose supply, which was further disputed by the yard. What would be the amount which was forwarded to the yard like the initial contract amount?

G. Shivakumar: It is a little over $10 mn.

Chetan: What would be te interest cost for the group?

G. Shivakumar: The interest cost is close 5% for the group as a whole.

Moderator: We have our next question from Mr. Ashish Jain from Morgan Stanley.

Ashish: My first question pertains to the response you made to an earlier question in terms of where would be thinking to buying assets given with the balance sheet flexibility we have. Is it right to assume that now from hereon we are looking more from a time correction rather than a price correction?

G. Shivakumar: There is also price involved. So, we believe the full impact of the financial crisis has not come through on prices of assets as well. So there has been a huge impact there; drop of maybe 60% to 70% in some cases. But we believe that maybe not the full impact has come through, but we are not yet ready to call the turn. So it is both price as well as time. We are not sure that it has hit that bottom and whether the turn will happen this year or next year.

Ashish: Secondly was on this reversal of the impairment of Rs 20 crs that we have done during the quarter. Could you just explain that a bit? Because I thought initially we had booked losses on the VLCCs. So in what context are we reversing this?

G. Shivakumar: Let us look at the notional number because I do not want to get into details on exactly how much it is. Let us say we repaid $10 million as an advance payment on the vessel and we had to revalue it on 31st of March. We had to take a hit of $2 mn on that which was a difference between the purchase and the sale price. So, d remaining receivable on that contract was $8 mn. As of 31st of March the exchange rate was little under Rs. 45 to the Dollar. Now, when you revalue the same $8 mn on 31st of December at the exchange rate of Rs. 53, you are going to receive higher amount in rupees. That different has been returned back because that is the amount that we will actually realize in Rupees.

Ashish: Then why was it not done in the previous September quarter?

G. Shivakumar: We have done it only for one vessel. As of end of September, we did not know what will happen to the exchange rate but on 1st of January we knew what would be the rate at which we would be accounting for the transaction which took place on 6th January and therefore, we reversed it based on that.

Moderator: We have our next question from Mr. Jehangir from Siddesh Capital.

Jehangir: What are your views on the demand growth rates in FY13 for Dry Bulk, Tankers as well as in offshore segment.

G. Shivakumar: Taking offshore first, 10-12% increase in E&P budgets will translate into approx 10% increase in demand for assets. On Tankers, approximately 1.5% increase in oil demand will result in maybe 4% increase in demand for cargo carriage on Tankers. On Dry Bulk it is very difficult to say because it is so much driven by China, but you need a huge amount of demand growth to keep up with the fleet growth. We are looking at a 10 percentage number on fleet growth. So, that is going to be pretty tough.

Moderator: We have our next question from Mr. Himanshu from M3 Investments.

Himanshu: My question is on the jack up rigs. What are the new realizations for Greatdrill Chetna, are they much different than the previous one? Greatdrill Chaaya has been chartered for five years. What is the view when chartering for five years?

G. Shivakumar: Both the rigs, Chitra and the Chetna were fixed in 2008 before the market really dropped and therefore the market has not yet come back to the levels that it was at in 2008. Chetna has got repriced but repriced at a lower number than she was earlier operating. And has a contract of 1.5 years. In case of Chaaya we have the risk management processes where we would like to put away as much of our capacity on charter as possible, especially with good signatures and therefore we looked for a long-term contract and put her on contract for a five-year period where she writes down a substantial part of her cost. It is not a commentary on how we expect the market to perform over this period but more as part of our risk management process where we would like to take some risk off the table. All these assets are close to $200 million and we believe that when we order these assets we should try to reduce the risks to some extent, and that also helps us to leverage and to grow.

Himanshu: But will the charter rates be fixed throughout the tenure of 5 years?

G. Shivakumar: It will go at the same rate for five years. There is no repricing or options on it. There is a fixed rate contract with no variations and will go at that rate from when she is delivered which will be in end of this year or early next year and will go for the next five years at that rate.

Himanshu: What is happening in the AHTSV market because a lot of AHTSVs are on spot? Why are we not placing place them on longer term charter.

G. Shivakumar: What is happening is that we have ordered these modern assets and all these were built new by us. So, these are all the assets built 2008 onwards. They are all DP2 which is cutting edge for supply vessels and on the expectation that the old fleet would have to be replaced and that more and more charterers and oil companies would move towards that. However, our expectation on that has not been met and we have come into a situation where we have been competing with very old vessels in similar categories and tenders. So, we had a choice that either we could put away some of these vessels at very low term rate with vessels which was built in 1980's or decide to operate in the spot market and hope for an improvement in the market. We have decided that we will not take very low rates and we will look for markets that value the quality of the asset and the specification of the assets and therefore we are operating more on a spot market. It is just a question of time in our view when the market starts to pay more value for modern assets and where there is a clear 2-Tier market and once that happens then we are sure that these AHTSVs will outperform the market. So, it is a question of time. We have already seen it happening on the rigs side where there are tenders which come out specifically for modern rig, Unfortunately, the asset ticket size for investing in small AHTSVs is pretty low especially if you are buying a 25 or 30-year old asset and therefore the barriers to entry has been quite low in this market.

Himanshu: We are hearing a lot of news about the shutdown of refineries on American Coast as well as in European. What would be the impact of this on the product tanker market. What type of tonne mile demand growth are you expecting?

G. Shivakumar: Good question. So far we have seen announcements happening, but we have not yet seen necessarily the shutdowns happening as per the announcement. But if the refineries shutdown as per announcements, the direction should be that product movement increases. In terms of tonne miles I would not be able to give you a number. Directionally, there will be an improvement in demand for product tankers vis-à-vis crude carriers, but the number is not something that we have. The US in last year has become a net exporter of products which is the other thing which has changed the equation for product tankers. It is all in a bit of a state of flux. We are getting all unusual trading patterns.

Moderator: We have our next question from Mr. Ashish Jain from Morgan Stanley.

Ashish: Wanted to check on Rs 95 crs impact of currency on interest. Will all of that be reversed or there is something which has actually realized there as well?

G. Shivakumar: A small part of it will be realized. Probably somewhere around Rs10 crs might be a realized, but a large majority of it is on the mark-to-market. The way the accounting treatment does it is it treats each accounting year as a water tight compartment. For instance, we end this year March at say Rs 50 to the dollar, next year it goes back to Rs 45 to the dollar which is what it was in March '11. If March '13 ends at Rs 45 to the dollar, we will not reverse this. There is no provision to reverse it. That is a new year which starts. We will just not take any additional hit from Rs 50 to Rs 45.

Ashish: Will it be reversed in this quarter because rupee has moved from Rs 53 to Rs 49 a dollar?

G. Shivakumar: There are two things that you have to consider; one is the actual depreciation and the second is the differential in interest rates. So, let us say differential in interest rates between Rupee borrowing and Dollar borrowing is 4% per annum. The actual change in the exchange rate between March and December it went from Rs 45 to Rs 53. There is an 18% change in the exchange rate. So, you take the lower of the two, the interest rate differential is 4% but that is 4% per annum, so you have to take only 3% for the first three quarters and that is what is reflected in the accounts for the first nine months. So the part that really affects you is the first 4% in this example which I have given. After Rs.47 in the example which I have given, everything is irrelevant, I am just taking a very simplistic example to explain it to you.

Ashish: From P&L point of view, suppose Rupee moves to Rs 45 in Fiscal '13, you do not benefit, nothing changes basically?

G. Shivakumar: We do not benefit in P&L and in terms of the interest cost in the P&L, no. We will not benefit and if it goes back in Fiscal '14 from Rs 45 to Rs 50, we will take. So you will not take the benefit from Rs 50 to Rs 45, but you will take the hit again from 45 to 50.

Moderator: As there are no furthermore questions, I would now like to hand over the call to Ms. Anjali Kumar.

Anjali Kumar: Thank you everybody for joining in our call today. As usual, we will have the transcript uploaded on the website in a couple of days. Please feel free to contact us