

EQUITY NEWS

Merrill's Neptune deal ends up in court

By Anette Jönsson, | 28 May 2007

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The high-profile deal between shipping company Neptune Marine and a group of investors introduced by Merrill Lynch, hits an unexpected legal roadblock.

Two-and-a-half months ago, when founding CEO Idar Iversen bought control of drill-ship owner and operator Neptune Marine Oil & Gas with the help of financing arranged by Merrill Lynch, it appeared the investment bank had pulled off yet another privately placed and company-transforming deal.

Merrill brought nine investors into the deal, which was put in place in a record six weeks, and also committed its own money through two separate entities.

But since then the \$185 million transaction has hit a snag, and on Tuesday (May 29) Merrill Lynch will find itself in a Cyprus court room defending a case brought by four of Neptune's minority shareholders, which together hold 39.3% of the company. The shareholders, which are all hedge funds, want Iversen's acquisition of the shares that boosted his stake from 10.7% to above 50% to be declared void because they feel the transaction was not done in the best interests of the company and that it violated Cyprus company law.

Specifically, they object to the fact that company assets and cash flows were to be used as security for the highly structured financing and to pay the interest on the loan obligations issued by a company wholly-owned by Iversen – a type of financial assistance which is illegal in Cyprus.

According to allegations made by the four shareholders, the financing puts Neptune in breach of a previous loan agreement to the extent that it could end up defaulting on \$125 million of floating rate notes. And they claim that Merrill Lynch colluded with Iversen and two other companies owned by him to defraud Neptune and its shareholders.

Damages are also being sought against Merrill Lynch for unjustly enriching itself through the commission it received for arranging the financing and against Iversen for breaching fiduciary duties that the plaintiffs claim he owes to all of Neptune's shareholders as a director and CEO of the company.

The case is being brought in Cyprus, which is where Neptune is incorporated. However, the company's operating subsidiary is based in Singapore, it is run by a team of Norwegians and it is traded over-the-counter in Oslo. This is important since the defendants argue that it is the excess cash flow at the Singapore subsidiary that will be pledged as a security for the financing and such financial assistance is permitted under Singapore law, provided that a so called "whitewash" procedure has been carried out.

In their view, Cyprus company law has no relevance in this matter.

Representatives for Merrill Lynch declined to comment on the basis that this is an ongoing case, but sources close to the bank say it feels the claims made by the minority shareholders are without merit.

Iversen meanwhile counters that it is his belief that the case is brought primarily because of a desire by the minority shareholders to make more money for themselves out of his takeover of the company.

All minority shareholders were offered to sell their shares to Iversen at the same price he paid for the shares that gave him majority control, but the four plaintiffs all agreed that this price was too low and consequently decided to hang on to their respective stakes. These four were also offered to participate in the new financing put in place by Merrill, but snubbed this on the basis that it would offer only capped upside to the equity story, compared with the full upside they get from holding the shares.

Many of the minority shareholders had bought into the company at the same time and price as Sector – the Norwegian private equity firm which was selling a 35% stake, and triggered the transaction.

Iversen also claims that the four plaintiffs don't have the right to bring this case in the first place since they are in fact not registered shareholders of the company (the shares are held through a Norwegian trust). With regard to the alleged breach of the loan agreement, he notes that Neptune is not party to the financing transaction and therefore not bound by it and is not incurring any debt as prohibited by the relevant loan agreement – but merely facilitating its Singaporean subsidiary in providing security for the (financing).

While Merrill and Iversen may feel that the case will be thrown out due to a lack of merit, the law suit has already managed to delay the completion of the financing transaction, which has yet to be approved by Neptune's board of directors. Worrying that the board would go ahead and do this before the case could be heard, the minority shareholders earlier this month sought and received (by the same Cypriot court) an injunction that explicitly prohibits the company and its board from ratifying the deal. The court order also prevents Iversen and his two holding companies from taking steps to remove or replace any of the current directors on Neptune's board or to appoint new ones.

As a result, the entire financing, which was put in place using collateralised equity-leveraged loan securities (or CELLS for short), currently hangs in limbo. If the board cannot ratify the deal, or if the whitewash procedure (which typically requires a signed statutory declaration by the directors to confirm the solvency of the business) it could result in an event of default with regard to the CELLS.

Indeed, whatever the eventual outcome of the law suit, it does highlight the risks involved in these kind of privately-placed transactions where typically the arranging investment bank puts its own money to work alongside its hedge fund clients, adding a degree of comfort that the issuer is a good one.

The April issue of *FinanceAsia* looks at these transactions (which we call "syndicated investing") in greater detail and market participants interviewed for this article all say this is a rapidly growing part of investment banking. Because of the private nature of most of these deals it is difficult to determine the size of the market, but Teall Edds, a portfolio manager with Stark Investments, one of the biggest hedge fund players in this area, estimates there could be \$3 billion of "syndicated investing" deal volume this year, versus almost zero in 2003.

The Neptune transaction also highlights how highly structured these deals need to be to attract outside investors and make them comfortable that the rewards are on par with the risks.

The structure of the CELLS used in the Neptune transaction is similar to a convertible bond, with a basic bond-like return of Libor plus 900bp and equity upside on top. As the deal is subordinated, the equity component carry much more weight than the credit element, which is obvious as the investors will have access to the potential equity upside for up to 10 years even though the maturity of the bonds is only two years.

Under the deal terms, the equity upside will be realised through either an initial public offering, a high-yield debt recapitalisation scenario or through a trade sell. Merrill Lynch bankers involved in the deal say the structure is such that the investors should be able to achieve an internal rate of return of at least 20%. The proportion of the equity upside that investors will get will also increase gradually from 25% in the first two years to 30% after two years and 35% after four years.

The CELLS were issued by Primepoint Holdings, which is indirectly wholly-owned by Iversen.

The buyout came about after Norwegian private equity firm Sector, which at the time was the single biggest shareholder of Neptune, informed Iversen in December or January that it intended to sell its entire stake of about 35%

over the next few months. A couple of competitors of Neptune Marine expressed interest in buying these shares as well as the rest of the company, but Iversen believed it would be in the best interest for Neptune to “maintain its independence in order to grow its business with the current management and employees.”

When Merrill Lynch proposed to Iversen that it could raise the financing needed for him to buy Sector's shares himself and regain control of the company he had set up two years earlier, he was understandably keen – especially since the company was showing clear signs of being undervalued at an enterprise value to Ebitda ratio of 3-4 times. Most of the comps in the sector trade at 7-9 times EV/Ebitda.

The bank got commitments from the investors for a \$300 million financing, but as several of the minority shareholders chose not to sell, the final deal size stopped at \$185 million.

The acquisition of Sector's shares was done through Primepoint at NOK143 per share, which was equal to 10 times the private equity fund's entry level and represented a premium of about 30% to the market price at time of around NOK110. Primepoint also bought a 5% stake held by Merrill Lynch at the same price, which together with Iversen's original shares left it holding 51.7% of the company as of mid-March. The subsequent offering to minority shareholders raised that stake to 55.4%.

The acquisition allegedly took the four plaintiffs – Millennium Global, Ore Hill, VR Global Partners and Luxor Capital Partners - by surprise as they say they were at that time in the process of negotiating a different solution with Iversen and the company chairman of how to acquire the Sector shares and prevent the other interested buyers from becoming shareholders of the company. That solution would either have involved Neptune buying the Sector shares with the help of external financing or a sale of all shares in Neptune to an outside buyer at a price significantly higher than NOK143.

Rather than buying the shares himself, they argue, the CEO should have been working to structure a buyout by Neptune of Sector's shares. If he wanted to become the majority owner himself, he should have used his own money rather than the company's, they say

“This is really an opportunity for all shareholders or for the company that the CEO should bring to the attention of the board,” says Susheel Kirpalani, a New York-based Partner at Quinn Emanuel Urquhart Oliver & Hedges and legal counsel to the minority shareholders.

The plaintiffs' view that the initial offer price was too low, stems from the fact that only one of the company's two drill-ships are currently in operation. When the refurbishment of the second ship finishes at the end of July and starts operating it is expected to result in a sizeable increase in the value of the company, the plaintiffs say.

Iversen has tried to reach a settlement with the four minority shareholders since his initial acquisition, including offering them more than NOK200 for each of their shares – an offer that they were inclined to accept. However, they were also unhappy with the commission that Merrill Lynch had made on the transaction and wanted the bank to pay it back. According to a press report, the fee may have been as much as 8% of the total transaction. Not surprisingly, the parties on the other side of the table were not about to agree to this and the settlement came to naught.

Neptune's business plan is to buy old drilling ships cheap, refurbish them so that they become state of the art vessels and then lease them out to oil companies on a full-service basis, with crew and all. Its first ship is in service with a Vietnam unit of Russia's Gazprom, while the second one will be rented out to India's Reliance Petroleum under a three-year operating contract. The company is also currently looking at another acquisition project.

By buying old ships instead of commissioning new ones Neptune is able to shorten the usual three-year delivery time by about half, which means it can start to earn revenues much earlier. It bought its current two ships for about \$14 million (when they were about 30 years old) and spent a couple of hundred million dollars to do them up and fit them out. They now have a combined market value of \$500 million to \$600 million.

Neptune's share price jumped 17.6% to NOK127 in a single day in mid-February after the company announced it had been approached about a takeover. It then rose further to match the offer price. Since early April it hasn't moved from NOK143.

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