KNOT Offshore Partners LP

Second Quarter 2017 Earnings Conference Call

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CORPORATE PARTICIPANTS

John Costain – *Chief Executive Officer*

Oystein Kalleklev - *Chief Financial Officer*

PRESENTATION

Operator
Good afternoon and good morning. Welcome to the KNOT Offshore Partners LP Second Quarter 2017 Earnings Results Conference Call. All participants will be in a listen-only mode. Should you need assistance please signal a conference specialist by pressing the star (*) key followed by zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question you may press star (*) and then one (1) using your telephone keypad. To withdraw your question, you may press star (*) and two (2). Please also note that today's event is being recorded.

At this time, I'd like to turn the conference call over to Mr. John Costain, CEO. Sir, please go ahead.

John Costain
Thank you. If any of you have not seen the earnings release or the slide presentation, they're both available on the Investors section of our website. On today's call, our review will include non-U.S. GAAP measures such as distributable cash flow and adjusted EBITDA. The earnings release includes a reconciliation of these non-U.S. GAAP measures to the most directly comparable GAAP financial measures. A quick reminder that any forward-looking financial statements made during today's call are subject to risks and uncertainties, and these are discussed at length in our annual and quarterly SEC filings. As you know, actual events and results can differ materially from those forward-looking statements. The Partnership does not undertake a duty to update any forward-looking statements.

And now, on to the presentation. KNOT Offshore Partners, KNOP's focus, is on the shuttle tanker segment. The asset is yield-specific and an integral part of the logistics supply chain and provides a vital service transporting oil from the offshore oil production unit to shoreside. In essence, a midstream mobile pipeline business. Shuttle tankers operate in a space which will see substantial oil production growth in the coming years. The vessels are built to charterers requirements and used on specific oil fields. They attract contracts which give them long-term non-volume-based revenue streams. Although our MLP is young, our sponsor is a very experienced operator having been involved in the design and construction of these type of vessels for over 30 years. Today, the Knutsen Group has more than 30 of these high-specification tankers, building the fleet organically during this period. And on each sector, there has been no speculative ordering, so the Partnership should yield both stable and sustainable revenues longer term.

Following on from the recent acquisitions of Raquel in 2016, Tordis in quarter one, Vigdis in quarter two, we are pleased to announce further additions to MLP fleet, the Lena Knutsen, for an acquisition price of $142 million. The vessel was delivered in June of 2017 and should commence a five-year charter to Royal Dutch Shell in September 2017. The acquisition by the MLP should then occur at the start of October 2017. Our sponsor, Knutsen NYK, is according to Clarkson Platou Research, part of the largest shipping group in the world, and NYK is a major company in the Mitsubishi family. At the end of the second quarter of 2013, just after the IPO, we had a fleet of four vessels with an average age of 3.25 years. In the space of four short years, the fleet will have grown 250% to 14 vessels with an average age of about 4.25 years.

Now turning onto the presentation, Slide 3, the financial highlights. The Partnership generated its highest ever quarterly revenues of $54.4 million, operating income of $26.1 million, and net income of $16.9 million. It generated its highest adjusted EBITDA of $43.5 million, distributable cash flow of $23.4 million, and we also report our highest ever distribution coverage

ratio of 143%. The fleet operates with 100% utilization for scheduled operations, including insurance receipts for the Raquel off-hire this quarter. On the 15th of August 2017, the Partnership will pay a cash distribution of $0.52 for the common unit with respect to Q2. The distributable cash flow of $16.6 million, we made a record $17.4 million distribution payment, including the recent common and preference units. Since our initial public offering over four years ago, we have declared and paid common unit distributions of $8.22. So, our initial investors will have received a total return of 39%. Our current yield has stable distribution of around 9%.

Slide 4, other events. On August 15th, the Partnership entered an agreement, as previously stated, to purchase the shares of the company which owns the shuttle tanker Lena Knutsen from Knutsen NYK Offshore Tankers, Knutsen NYK our sponsor.

On the 1st of June 2017, the Partnership completed the acquisition of the entity that owns the Vigdis Knutsen, completed the successful refinancing of the credit facility secured by Hilda Knutsen. The Hilda refinancing removed the next balloon repayment that fell due in August 2018. At the same time, we raised an additional $25 million, reducing the loan margin by 30 basis points. The cost of the facility was 1%.

We entered into an agreement for a new $25 million unsecured revolving credit facility in order to further strengthen the balance sheet and increase financial flexibility.

On June 30th, KNOP successfully completed a private placement of 1.66 million additional Series A preferred units at a price of $24. The net proceeds were around $38.8 million. Subscribers to the instruments are largest international firms located in three different continents. The placement will enable the Partnership to acquire the Lena Knutsen on the 1st of October, subject to a satisfactory agreement to Shell. There are no preemptive rights with this preference issue, which are quite common to such agreements, and this is to the detriment of the issuer.

The expansion of the issue is evidence that KNOP is proactive in finding other sources of capital-accretive terms when constrained by our equity markets. The private preferred perpetual convertible equity instrument carries a fixed coupon of 8% allowing KNOP to continue to go through accretive acquisitions. It is not subject to adjustments and is convertible into common equity after two years at an adjustable strike price, which is dependent on the development of the book value of the Partnership. The original issue had a strike price of $24, and today the variation is less than 0.0025%.

On 5 July, 2017, Knutsen NYK acquired from Chevron the Brazil Voyager, a DP2 Suezmax class shuttle tanker built in 2013. The vessel, which is located in Brazil, is not currently under contract. The vessel has been renamed Brasil Knutsen, and Knutsen NYK is seeking to secure a long-term time charter for it with a view to placing it in the MLP.

Slide 5, income statement. Total revenues were $54.4 million for the three months ended June 30, 2017, compared to $45 million for the three months ended March.

Q2 revenues were positively impacted by increases in time charter earnings. These were positively affected by: Windsor Knutsen being fully back on hire after completing its 10-years special survey in dry-docking at Brest yard, France, during the first quarter; Raquel Knutsen being fully back on hire following completion of repairs to its controllable pitch propeller; Tordis Knutsen being included in the results of operations from 1 March 2017; and Vigdis Knutsen being included in the results of operations from 1, June 2017.

Vessel operating expenses for the second quarter were $9.4 million, a reduction of $900,000 from $10.3 million in the first quarter. The reduction was mainly due to the Raquel Knutsen claim adjustments in the second quarter and also some savings on OpEx driven by foreign exchange savings. The NOK is low compared to the US dollar.

General and administrative expenses of $1.5 million in Q2 were in line with the previous quarter. Interest expense for Q2 was $7.3 million compared to $6.2 million for Q1. The increase was mainly due to additional debt incurred with the acquisition of vessels Tordis and Vigdis Knutsen. A higher LIBOR rate has also had a small impact.

Interest rate swap agreements totaled $536.7 million. The Partnership received interest based on LIBOR and paying a weighted average interest rate of 1.65% with an average maturity on these instruments of 4.1 years.

We also have foreign exchange forward contracts. These are economic hedges for vessel operating costs and total $40 million against the NOK at an average rate of 8.31 per US dollar. The financial results are impacted by the changes in the market by these instruments and realized and unrealized losses in Q2 were $1.5 million compared to a gain of $0.5 million in Q1.

As a result, net income for Q2 was $16.9 million compared to $11.4 million for Q1.

Slide 6, adjusted EBITDA. In Q2, the Partnership generated adjusted EBITDA of $43.5 million. It compares to $33.2 million for Q1. Adjusted EBITDA refers to earnings before interest, taxation, depreciation, and amortization. It provides a proxy for cash flow. Adjusted EBITDA is a non-US GAAP measure used by our investors to measure the Partnership's financial performance.

With a wasting asset like a vessel, younger fleets in theory should produce lower EBITDAs for every dollar invested. The annuity effect reduces the value loss in early years, which is factored into the replacement CapEx calculation for the distributable cash flow. At the end of Q2 the KNOP fleet of 13 vessels has an average age of 4.3 years compared to the rest of industry average for shuttle tankers including KNOP of around 12 years.

In general, since the formation of the MLP, we have had very high levels of vessel utilization, on average around 99.7% for scheduled operations. Financially, this translates into continually high and increasing predictable revenue, adjusted EBITDA, and discounted cash flow as more vessels are added to the fleet.

Slide 7, distributable cash flow, another non-US GAAP measure to estimate distribution sustainability. Today, we report our highest ever quarterly distributable cash flow of $23.4 million in Q2. This compares to $15.6 million in Q1.

We maintain our distribution level for Q2 of $0.52 per unit equivalent to an annual distribution of $2.08. The distribution coverage ratio for the quarter is again, our highest ever reported at 1.43 times.

The coverage ratio has increased primarily due to the equity overhang being removed. The common unit issuance $54.9 million and the preference unit $48.6 million made in our first quarter funded the acquisition of Tordis (February 1st) and Vigdis on June 1st. The preference issue $38.8 million approximately in second quarter will be used to help finance the equity required for the Lena acquisition on 1st of October.

The outlook for the third quarter should improve further as the Vigdis Knutsen will be on hire for the full quarter.

The MLP has an elevated yield compared to most MLPs, and therefore, we have rather focused on firstly building coverage and then de-leveraging when not making accretive investments. There is little benefit to this MLP in the short term paying yield much over 9%. We have raised funds of between $21 and $29 per unit and many of our common unit holders have remained loyal, so we do not want to dilute and we see double-digit distributions as a signal that investors would rather prefer increased coverage through investments and secondly de-leveraging rather than increasing dividends.

The coverage ratio of 1.43 in Q2 gives flexibility with regard to our capital base and also there is room for an increase in the distribution.

Slide 8, balance sheet. At the end of Q2, we had a very solid liquidity position with cash and cash equivalents of $64.5 million and an ongoing undrawn credit facility of $5 million. The credit facility is available until June 2019. In addition, the Partnership have accepted an offer of an unsecured revolving credit facility from NTT Finance in Japan. The amount is for $25 million for a period of two years from 30th of August, 2017, a margin of LIBOR plus 180 basis points with a commitment fee of 50 basis points. There is no arrangement fee.

We have a predictable cash flow, and we do not have any loan maturities before the second half of 2018, primarily the Torill Knutsen with currently $75.6 million outstanding. We are looking at this with a view to refinancing before the end of the year. The total interest-bearing debt outstanding was about $906 million. This has increased due to the acquisition of Tordis and Vigdis Knutsen.

Annually, we currently have scheduled repayments of $65 million. This compares to a current annualized replacement and maintenance capital expenditure charge of $40 million when computing distributable cash flow.

Slide 9, Pending – the Lena drop-down. We announce the latest addition to the MLP fleet. Built by Hyundai Heavy Industries in Korea and delivered in June of 2017, the Lena Knutsen, sister to Tordis and Vigdis, is a Suezmax class enhanced DP2 shuttle tanker operating under a time charter that expires in the third quarter of 2022 with Royal Dutch Shell in Brazil. There will be options to extend until 2032.

We have agreed with our sponsor Knutsen NYK to acquire the vessel for $142 million with delivery effective from the start of October 2017. The purchase price for Lena is $142 million, which is $5 million less than the purchase price for Tordis and Vigdis, the sister vessels. This is despite the vessel being a bit younger than the other two vessels that dropped down.

The 3.4% lower purchase price reflects the reduced TC rate of about 3.4% over the sister vessels Tordis and Vigdis. When the Lena time charter was entered into, interest rate levels were a bit lower and the US dollar a bit stronger compared to NOK, which gave a benefit on the future capital and operating costs. These were passed on to the charter.

The purchase price therefore reflects the slightly lower present value of the Shell charter compared to Tordis and Vigdis. The vessel is a sister with be same technically advanced features.

The vessel will be part financed by a commercial debt of around $92 million and partly with cash

from the preference debt equity around $39 million. The senior loan has a margin of 190 basis points with an annual repayment of $5 million.

The net charter rate will yield around $7 million in net income and approximately $15.8 million of EBITDA for the first year from October 2017. The charter has an escalator in of about $600 per day applicable annually, $200,000 on the EBITDA. As with the other sister vessels, the vessel comes with an attractive loan, a 19-year profile, and a margin of 190 basis points above LIBOR.

With this acquisition, which again demonstrates our sponsors' strong support and commitment to the MLP, our fleet will have grown 250% since the IPO in April of 2013.

Slide 10, long-term contracts backed by leading energy companies. The Windsor Knutsen has been on a two-year contract from 13th of October 2015 with Brazil Shipping I, a subsidiary of Royal Dutch Shell, with a further six years of extension options. In July '17, the first option was lifted taking the firm charter period through October 2018.

The Bodil Knutsen, the largest shuttle tanker operated in North Sea, is ice class and on charter to Statoil until May 2019. There are further five single-year options to extend.

Four of our vessels are on long-term bareboat charter to 2023 to Petrobras Transporte. These vessels are amongst the youngest in the Petrobras fleet, being delivered between 2011 and 2012, and are heavily utilized. Dan Sabia and Dan Cisne are of a unique size and Fortaleza and Recife Knutsen have shallow drafts with lots of thruster capacity.

Delivered in 2013, the Carmen Knutsen is on charter direct to Repsol Sinopec until 2023.

The Ingrid Knutsen was delivered in December 2013 and is operating in the North Sea on time charter to Standard Marine Tonsberg, a Norwegian subsidiary of Exxon Mobil. This will expire in the first quarter of 2024. The charterer has options to extend the charter for five one-year periods.

The Raquel Knutsen was delivered in March 2015, and it operates under a time charter that expires in the first quarter of 2025 with Repsol Sinopec in Brazil. There are options to extend until 2030.

The Tordis Knutsen is on a five-year time charter to Brazil Shipping I, a subsidiary of Shell. This will expire in the first quarter of 2022. The charterer has options to extend two additional five-year options to total 15 years. The sister ships of Tordis, the Vigdis, and Lena Knutsen, are on similar time charters to Shell expiring in the second and third quarters of 2022, again, with options to extend a further 10 years.

Slide 11. Significant growth since the IPO. With the latest acquisitions, which again demonstrates our sponsors' support and commitment to the MLP, we have already added nine, soon to be 10 ships to the fleet. Since the IPO, this represents a 250% increase in 4.5 years.

Summary. KNOT Offshore Partners is in essence a midstream mobile pipeline business with fully contracted revenue streams.

Since being awarded its first two contracts in 1984, Knutsen has grown organically for over 30 years as the business has been built into a sizeable fleet of these tankers; currently 31 units, including orders.

We have a solid and highly profitable contract base generated by our modern fleet, which by the end of June will have an average age of 4.25 years.

The fleet has delivered the MLP's best ever performance for EBITDA, distributable cash flow, and distribution coverage ratio.

Since the formation of KNOP, we have a very high level of vessel utilization, on average around 99.7%. Financially, this transforms into high and increasing predictable revenue streams, adjusted EBITDA, and discounted cash flow as more vessels are added to the fleet.

This year, we have so far completed the acquisitions of Tordis and Vigdis Knutsen and have entered into a share purchase agreement to acquire the Lena Knutsen.

In the year-to-date, to finance those acquisitions, we have raised both $145 million of new equity and $100 million of long-term debt, together with $25 million of credit facilities, all on attractive terms.

No one has more experience in operating these sophisticated shuttle tankers than Knutsen Offshore, and we operate these vessels with real expertise.

Today, supply is tightening and the market is expanding, and with tenders back soon, the sponsor expects to build a further drop-down inventory. We have a supportive sponsor and we remain an attractive value proposition with a quarter distribution of $0.52 per unit, around 9% distribution.

Thank you, and if anyone has any questions, I'm happy to take them now.

QUESTIONS AND ANSWERS

Operator
Ladies and gentlemen, at this time, we will start the question-and-answer session. To ask a question, you may press star (*) and then one (1) on your telephone keypads. If you are using a speakerphone, we do ask that you please pick up your handset before pressing the keys to ensure the best sound quality. To withdraw your question, you may press star (*) and two (2). Once again, that is star (*) and then one (1) to ask a question. We will pause momentarily to assemble the roster. And our first question today comes from Hillary Cacanando from Wells Fargo. Please go ahead with your question. (20:58)

Hillary Cacanando
Hi. Thanks for taking my questions. Recently one of your competitors ordered 2 DPT shuttle tanker new builds with LNG propulsion technology. I was just curious is this technology, I guess, to be able to use LNG as a fuel, something that you expect will be included in the shuttle tanker new builds going forward? Would this be a normal or is this kind of like a one-off do you think?

John Costain
I think, with the North Sea, it's likely to be more prevalent because there are emission criteria.

They are basically restricting the greenhouse gases in that area of operations. I think it was quite prudent for them to do that, looking at the shipping legislation going forward and what they're replacing. But it's not really; it's down to what the charterer specifies when he orders the vessel as to what we build. Generally, in Brazil, there's no requirement to build dual-fuel ships. And they are more expensive, basically, we will build to what the charterer requirements are, not what we

think we need to do. It stands with the charterer to make the decision on how he designs the vessel to that level, because basically a dual system, it adds significant amount of additional expense.

Hillary Cacanando
Okay, got it. Thanks. That's helpful. And then just I know your next, I think your next maturities are, I guess, due in October 2018 and December of next year, and I know you've been able to tap attractive bank financings, but I was just curious, just wanted to get your thoughts on your capital structure plans? Would it look fairly traditional with bank finance, bank refinancings or would you look at different refi options? I know we've seen lot of like sale-leaseback transactions and stuff at different MLPs as well, so just wanted to get your thoughts on your capital structure plans?

Oystein Kalleklev
If you want me to jump in, I…

John Costain
Yes. You can, Oystein. Yeah, why not?

Oystein Kalleklev
Yeah, first just to mention on the refinancing, of course we've taken out the first facility that matures for Hilda Knutsen, and of course two of the sister vessels. we are looking into doing something similar in terms of financing Torill, and as John mentioned in his presentation, we aim to put something in place by year's end before the loans turn into our current portion in our balance sheet. And then of course there are also maturity on the Ingrid loan but that is very small loan because most of that loan is actually an export credit loan that matures in 2025 and it's only a small commercial bank transaction that matures at end of 2018. But that we will also refinance. we will see whether we put that together with some other loan or how we actually do it. When you do have a time charter with extra options in 2024, that's not really an issue doing the refinancing. it's more about finding the alternate solutions.

When it comes to, sale-leasebacks, it could be feasible, but we do think that we have so good access to bank financing that going to some other leasing company in order for them to kind of finance it through the banking system, it doesn't make that much sense for us because we have a very good access to bank financing, our plan is to do this fairly simple, finance our vessel with mostly bank financing and then of course relying on the equity market for risk capital.

And so far we haven't done any bonds and the reason is the fact that we have already new fleet and we have a good backlog so that gives us good access to bank financing. And rather than doing bonds we have decided to do the preferred equity. We think that is more financially prudent. We have a debt maturity tenor on that instrument and we have the take option and it has a fixed yield of 8%. And if you're doing a bond, it wouldn't be that much cheaper and you would probably have a 5 to 7 years' tenor on those loans. we think, but of course we are flexible. If there are some good financing opportunities we might take benefit of it and I think we just proved it with the facility we did with Nippon Telecom in this quarter that we are open to look at all those structures if we find an attractive and of course unsecured loan at LIBOR plus 180, we do think it very attractive.

Just to mention also when it comes to this LNG fuel, of course the two Statoil vessels are the first to be built with LNG propulsion in the shuttle tanker market. This is not only related to shuttle tankers, you see the same discussion in the container segment, where also people are

considering whether to go for LNG fuel or [Statoil], so this is something we will of course monitor. I think for the Statoil vessels, they were highly specialized with a contract length up to 20 years and of course with Statoil then maybe sticking with these vessels until 2039. I do think that they want to have the security of having the right kind of technology in terms of the propulsion system. And also, it's related to the emissions systems in the Norwegian sector. But of course, it's costly, so it can typically cost $10 million, $15 million extra to add this feature to the vessel.

Hillary Cacanando
Thanks for the detailed answer. That's it for me. Thank you.

Operator
Once again, if you would like to ask a question please press star (*) and one (1). Our next question comes from Nick Raza from Citi. Please go ahead with your question.

Nick Raza
Thank you. Really quick, John mentioned new tendering activity and potentially, or the possibility of rebuilding the backlog. Could you just speak a little bit more about where this tendering activity is, North Sea versus Brazil? And then how the new tendering activity is coming out in terms of rates and just give us your initial thoughts on that?

Oystein Kalleklev
Of course, predominantly the need for shuttle tankers are in Brazil, but right now of course we've seen four orders this year and all of them are for North Sea, and of course two of them are specialized for the Statoil fields in the Barents Sea and then of course Teekay when they have resolved their financial situation, they are finally now in a shape to renew the COA fleet which has aged quite a lot lately. But, so in general I think going forward I think we will see more activity from Brazil. In terms of rates they are fairly stable.

They are a bit dependent on the interest rate level, yard costs, and then of course the specification of the vessels. But from the sponsor's side, we have just acquired a vessel without any contract attached to it, and the reason for this is that we do see that there is a pent-up demand for vessels and we want to position ourselves for some of these charters. John, maybe you have something to add?

John Costain
No, that's pretty comprehensive. I think we would like to see a bit more growth in Brazil, it's been a bit slow. We expected it to have picked up more by now. Obviously, Teekay, I mean, I shouldn't mention them by name, no one else seems to, but they obviously have specific requirements for renewing their fleets and they are just ordering on the basis of they're in a position to now, and it's good to see that new orders are going in for shuttles again. we expect market to pick up. But it hasn't done yet. It's not evolved quite as quickly as we expected it to, but that's just how it is, you know.

Nick Raza
Okay. And then I guess in terms of the new vessel acquired by the sponsor, do you sort of have a sense of timing in terms of when it gets chartered and what the drop would look like?

Oystein Kalleklev
Of course, we can get shorter contracts, but of course if we order to put into the MLP, we will probably need a longer contract. it's a bit early to say how and when it might be feasible. We just took over the vessel. I think we will revert on the matter of the status of that contract, when

and if something happens.

John Costain
Yeah. And it can be placed into a modern charter fleet ship. It can be given the flexibility when negotiating with the clients about tonnage requirements. We've seen in the past where we've had to provide an intermediary solution before we can place an order and get delivery because it's quite a long lead time with these tankers, and sometimes it makes, you've got to acquire a unit early, and it gives you quite a lot of flexibility if you got spare tankers around. Basically, it's a competitive advantage.

Nick Raza
I gotcha. Okay. And then in terms of the distribution, I mean obviously you guys have used preferred equity in the recent past to sort of facilitate the dropdowns and they seem to be somewhat slightly, just slightly accretive to right about net even. But I mean in terms of what the equity investor could expect going forward in terms of distribution growth, John, I don't know, we've spoken about this in the past and we've discussed the difficulty of raising the distribution briefly, but any sort of color on that now that the shuttle tanker market is getting a little tighter, you might have tendering opportunities in the backlog?

John Costain
I obviously think when we have vessels and eventually we want to raise capital, the distribution will naturally go up. Today, we can elect to increase or keep it as it is, but it gives us rather more flexibility if we don't increase the distribution. It's not really my decision. Obviously we have the capacity to do it, to do an increase in the distribution, but we've obviously been refinancing, are still refinancing ships, we're doing charter renewals, and we just want to see how things fall out a little bit.

But obviously it does help to get interest in the unit by increasing the distribution. And a normal MLP you would expect and we would expect to run this way. We would expect 2% to 3% distribution increase per year because I guess an MLP is bit like a pension for a lot of people. But the reality is today, at 9% and the unit price is not going up too much, we're comfortable with the distribution level. If unit went up to $25, $26, then obviously we would definitely increase the distribution. I'm sure we would, because it would be, we have to be, we have to have a sensible yield on it, to make it attractive for people for purchase the units.

But today I feel the unit price, where the unit price is, it's a bit of a difficult, as you know yourself, but you don't lower the distribution too much, if you haven't got unit price to support it. I think the numbers will come through anyway because if we keep the cover we don't need to raise quite as much equity and the MLP naturally strengthens over time.

Nick Raza
Okay, that's great color. Thanks guys. That's all I had.

Operator
Once again, if you would like to ask a question please press star (*) then one (1). And at this time and showing no additional questions, I'd like to turn the conference call back over to management for any closing remarks.

CONCLUSION

John Costain

Thank you for your interest and coming to the conference call, and the questions we had were very good as usual. Appreciate the time you've taken, and if you like the sound of our story, go out and buy the unit. Thank you.

Operator
Ladies and gentlemen that does conclude today's conference call. We do thank you for attending. You may now disconnect your lines.