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KNOP - Q2 2018 Knot Offshore Partners LP Earnings Call

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CORPORATE PARTICIPANTS

John A. Costain *KNOT Offshore Partners LP - CEO & CFO*

CONFERENCE CALL PARTICIPANTS

Benjamin Preston Brownlow *Raymond James & Associates, Inc., Research Division - Research Analyst*

Hillary Cacanando *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

PRESENTATION

Operator

Good day, and welcome to the Second Quarter 2018 Earnings Conference Call. (Operator Instructions) Please note, this event is being recorded. I would now like to turn the conference over to John Costain, CEO. Please go ahead.

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

Thank you. If any of you have not seen the earnings release or slide presentation, they're both available on investors section on our website. On today's call, our review will include non-U. S. gap measures such as distributable cash flow and adjusted earnings before interest, taxation, depreciation, and amortization, the EBITDA. The earnings release includes a reconciliation of these non-GAAP measures to the normal, directly comparable GAAP financial measures.

A quick reminder that any forward-looking 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 onto the presentation. KNOT Offshore Partners focuses on the shuttle tanker segment. Each vessel is usually built to an individual charter specification. Under non-volume-based contracts, we transport oil from the offshore production units to shoreside, in effect we're midstream mobile pipeline business. The chartered vessel forming an integral component of the charter supply chain. Shuttle tankers operate in a niche space. In our sector to date, there has been no speculative ordering of tankers by vessel owners. So given the solid growth outlook from the sector, the partnership should yield stable and sustainable revenues longer-term. Our sponsor Knutsen NYK has placed all their younger vessels in the MLP. All have long-term charters after construction, and all remain strategically important in their respective charters. Taken together with the partnership, the Knutsen Group has 29 shuttle tankers, numerically this equates to the largest fleet on the water. Our sponsor is a very experienced operator, having been involved in the design and construction of shuttle tankers for well over 30 years, including being involved with the development of the design in the pioneering days, growing their fleet organically over time.

Oil production is moving further offshore as new fields open particularly in Brazil and the Barents Sea, and these tankers, therefore, operate in a space, which is seeing substantial oil production growth. This should continue in the coming years in addition to much of the shuttle tanker fleet is aging and will need replacing in the medium term.

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. Since the partnership's initial product offering in April 2013, the fleet has grown 300% to 16 vessels, with an average age of just under 5 years at the end of June.

Slide 3, financial highlights. The partnership generated its highest quarterly revenues of $69.8 million, and its highest operating income of $32.1 million, and net income of $21.7 million. KNOT also generated its highest ever quarterly adjusted EBITDA of $54.4 million. The partnership estimated distributable cash flow of $27 million, and that with a coverage ratio of 1.5x.

We declared and paid cash distribution of $0.52 per unit for Q2 2018 on the 15th of July, 2018. Since our initial public offering in April 2013, we've declared and paid common unit distributions of $10.30, so our initial investors have received a total return of 49%.

Our current yield is stable distribution of 9.5%. In this quarter the fleet operated with a 100% utilization from scheduled operations, and 96.3% utilization considering the scheduled dry docking of Brasil Knutsen. In July, Shell exercised its option to extend the time charter of the Windsor Knutsen by one additional year until October 2019. In August, Eni agreed to amend the time charter on -- of the Hilda Knutsen. KNOT now has a further charter until 2022, July 2022 with 3 1-year extension options after. The partnership has agreed to enter into new $375 million loan agreements to refinance the credit facility, secured by Windsor, Bodil, Fortaleza, Recife, Carmen and Ingrid.

Slide 4, the income statement. Total revenues were $69.8 million for the 3 months ended June 30, Q2 compared to $68 million for the 3 months ended Q1. The increase in revenues is mainly due to full earnings from the Anna Knutsen as the vessel is included in results of operations from March 1, 2018, improved utilization on scheduled operations for the fleet in Q2, and 1 additional calendar day. The increase is partly offset by the reduced revenues from Brasil Knutsen because of the 53 days of hire incurred during Q2 for the vessel scheduled for a special survey drydocking. Vessel operating expenses for Q2 were $14 million, an increase of $0.8 million from $13.2 million in Q1. This is mainly due to higher operating expenses due to Anna Knutsen being included in the result of operations and bunker consumption in connection with the drydocking of Brasil Knutsen charge in Q2. This was partially offset by the reimbursed insurance claim in connection with propeller repairs on the Carmen Knutsen.

General and administrative expenses were $1.4 million for the second quarter compared to the $1.3 million in the first quarter. Depreciation was $22.3 million in the second quarter, an increase of 0.7% from $21.6 million in the first quarter due to the Anna Knutsen acquisition in March.

As a result, the quarter -- this quarter, the partnership reported highest operating income of $32.1 million compared to $31.9 million for Q1.

Interest expenses for Q2 was $12.5 million, an increase of $1.9 million from Q1. The increase is mainly due to additional debt incurred with the acquisition of Anna Knutsen, higher LIBOR rates on average, and increased leverage because of the refinancing of Hilda and Torill Knutsen.

Gains under derivative instruments were $2 million compared to $10 million in Q1. This noncash unrealized elements of the gain was $1.8 million for Q2 compared to $9.2 million for Q1. All unrealized gains in 2018 were because of an increase in the U.S. dollar interest swap rate. As a result, net income for the second quarter of 2018 was $21.7 million compared to $30.7 million in this first quarter.

Slide 5. Adjusted EBITDA. In Q2, the partnership generated adjusted EBITDA of $54.4 million compared to $53.4 million of Q1. Adjusted EBITDA refers to earnings before interest, taxation, depreciation and amortization and is a proxy for cash flow. Adjusted EBITDA, of course, is a non-U. S. GAAP measure used by our investors to measure the partnership performance for the wasting asset like a vessel, younger fleet tend to produce lower EBITDAs for every dollar invested. The annuity effect reduces the annual loss in the early years, which is factored into the replacement CapEx calculation for the distributable cash flow.

At the end of Q2, the KNOT fleet had 16 vessels, with an average age of about 5 years, compared to the rest of the industry average for around 10 years, without KNOT.

The formation -- since the formation of KNOT, we have had very high levels of vessel utilization, on average around 99.6% for scheduled operations. Financial risk translates into a continually high and increasing predictable revenue, adjusted EBITDA and discounted cash flow as more vessels are added to the fleet.

Slide 6, distributable cash flow. Another non-U. S. gap measure to estimate distribution sustainability. Quarterly distributable cash flow was $27 million in Q2, this compares to $27.9 million in Q1. We maintained our distribution level for Q2 at $0.52 per unit, equivalent to an annual distribution of $2.08. The distribution coverage ratio for the quarter was 1.5X. It has been improved significantly in the first 2 quarters with the acquisitions of Brasil and Anna Knutsen. A coverage ratio of more than $1.4 million for the full year in 2018 is expected as the second half results will be impacted by the drydocking of Hilda, Torill and Ingrid Knutsen. The vessels will go of higher and positional bunkers will be expensed.

We are seeing rising interest rates in U.S. in 2018 and '19, together with increasing replacement CapEx provisions charged on our vessels as they get older. Our coverage should be significantly better for this year and in 2019.

KNOT has a significantly elevated yield compared to most MLPs and we continue to remain focused on firstly building coverage and then deleveraging when not making accretive investments. The higher coverage ratio gives the partnership a little bit more flexibility regarding our capital base going forward.

Slide 7, the balance sheet. At the end of Q2, we had cash and cash equivalents of $45.1 million and an undrawn credit facility of $13 million. We have a predictable cash flow and a healthy liquidity position.

Slide 8, long-term contracts by leading energy companies. The Windsor Knutsen has been on charter to Shell since October 2015. However, the exercise the latest 1-year option, the vessel remains committed to Shell until October 2019. It has further 4 years of extension options.

The Bodil Knutsen, our largest shuttle tanker operating in the North Sea, is ice class and on charter to Ecuador, formally named Statoil AS until May 2019. There are 5 further years of options to extend.

Torill and Hilda Knutsen operate on the Goliat, the first field developed in the Barents Sea, and it currently represents the world's most northerly offshore development. It is estimated that the Barents Sea contains nearly half of discovered oil reserves in the Norwegian shelf.

Starting production in 2016, the estimated lifetime in the field is 15 years. It has an estimated recoverable reserves equivalent of about 178 million barrels of oil. Hilda and Torill are 2 or 3 specially designed shuttle tankers built to operate in this arctic environmental. Our vessels are heavily winterized, allowing the crew and hence the vessels to operate safely in temperatures down to minus 30 degrees Celsius.

Hilda Knutsen finished her first special survey drydocking in August and Torill will commence a similar docking in September. Having reached their 5th anniversary, the initial 5-year term charters on both vessels will have expired in August, Eni trading and shipping, SPA Eni agreed to amend and extend Hilda time charter for 4 years with a further 3 annual extension options.

For Torill, we expect Eni to lift the first of 5 annual extension options in the original time charter in October. Today, many charters like this annual option type agreement, both for commercial flexibility and because the imposition of more unrisked financial disclosure requirements, there is a much lower impact on the accounts of the charterer for the MLP, this mix of short and long-term charters in the portfolio is useful because as well as tailoring solutions for charterers wishes, we believe asset prices could firm and a market will tighten in the coming years.

Given the size of our fleet and therefore commercial footprint, some measure of contract flexibility is desirable. 4 of our vessels are on long-term charter bareboat to 2023 with Petrobras Transporte. These vessels are amongst the youngest in the Petrobras fleet delivered between 2011 and '12 and are heavily utilized. Dan Sabia and Dan Cisne are a unique size and Fortaleza and Recife shallow drafts with lots of thruster capacity.

Delivered in 2013, Carmen Knutsen is on charter to Repsol Sinopec until 2023. The Ingrid was delivered in December 2013, and is operating in the North Sea on a time charter for Standard Marine Tønsberg, a Norwegian subsidy of ExxonMobil. The vessel will commence its first special drydocking and renewal of class in Q4 2018. The initial charter will expire in the first quarter of 2024 after the second scheduled docking. The charter then has options to extend the charter for 5 1-year periods.

The Raquel Knutsen was delivered in March 2015 and operates under a charter that expires in the first quarter of 2025 with Repsol Sinopec in Brazil.

There are options to extend them till 2030.

The Tordis, Vigdis and Lena are on 5-year charters, to Brazil Shipping 1, a subsidiary of Shell. These will all expire during 2022, and the charter has options to extend the 2 additional 5-year options totaling 15 years.

The Brasil and Anna Knutsen are on charter to Galp Energia until 2022 with options to extend until 2028.

The KNOT fleet has an average remaining fixed contract durations of 4.1 years with an average 4.4 years in charterers' option, after they complete the main period.

Whilst we currently have no further drop-down candidates, which means no near-term equity requirement, given the market outlook, we will expect to be able to grow the MLP in the coming years.

Debt maturity profile, KNOT have agreed to enter senior secured credit facility on the refinancing of the vessels Windsor Knutsen, Bodil Knutsen, Fortaleza Knutsen, Recife Knutsen, Carmen Knutsen and the Ingrid Knutsen. The facility consisting of a term loan of $320 million and a $55 million revolving credit line, this will refinance previously existing term loans totaling $320 million and replace the $35million credit -- revolver credit facility secured by the vessels, these were due to mature between December '18 and June 2019. The new term loan will be repayable in 20 consecutive quarterly instruments with a 20-year profile giving a balloon repayment of $177 million at maturity. The facility will mature in September 2023 and bear interest at LIBOR plus a margin of 2.125%. There is a commitment fee of 0.85% payable on the undrawn portion of the revolving credit line. The facility is guaranteed by the partnership and secured by mortgages on the vessels.

As of June 2018, the facility vessels have an average age and remaining contracts of 7.1 years and 3.7 years, respectively. We've managed to increase our leverage by $20 million through credit line increase, retaining an attractive margin and stretching the profile from 19 to 20 years. The refinancing gives the partnership a 3-year run rate on next loan balloon payment.

In summary, KNOT Offshore Partners is a midstream business with fully contracted non-volume-based revenue streams. We've had another very good quarter with strong financial performance including a further increase in revenues, operating income and EBITDA, following on from a substantial increase in the previous quarters. This is no surprise as successes have been added to the MLP in the 6 months. KNOT has very good access to financing. After executing equity transactions and refinancing in the last year to facilitate these special acquisitions, this quarter the partnership has raised a further $375 million of long-term debt including $55 million of credit facilities all on attractive terms.

On the commercial side, we continue to see high demand for our vessels with charterers and charters extended on Hilda and Windsor Knutsen, in this quarter. This translates into very high levels of vessel utilization on average around 99.6% since the formation of KNOT.

Financially, this has enabled the partnership to achieve higher and increasing operating results, adjusted EBITDA and discounted cash flow as more vessels have been added. KNOT is well-placed to compete in future tenders. We have a solid and profitable contract base, generated by our modern fleet, which by the end of Q2, have an average age of around 5 years.

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

Today, supply is tightening and the market is expanding, we have a supportive sponsor, and we remain an attractive value proposition with a quarterly distribution of $0.52, around 10% distribution.

Thank you, and that concludes a narrative for the slides. If anyone has any questions, I'll be happy to take them.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Hillary Cacanando of Wells Fargo.

Hillary Cacanando - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

So you have a healthy target distribution coverage ratio and you've been saying that you're focusing on increasing your coverage ratio and deleveraging first, before perhaps increasing your distributions. What does the target -- like what are the ratios that you are looking for, I guess, for you to start feeling comfortable (inaudible) distribution?

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

I think we need to -- I mean, first of all, today, with the MLP operating, we actually don't need to refinance it for 3 years, and we are -- we can pay this recent cash flow (inaudible) without looking to releverage or do anything. I mean that's the first objective, to make it easy, for the MLP to function. And that we have had to refinance a fair bit to pull all these ships in, and now we've done that. We've got good coverage ratio. I see the -- I mean, this is a sizable business with lots of people involved and I want to keep it stable and going forward, it has to be a long-term investment. So we are happy to build the coverage. We see -- I mean, once we -- once -- I mean, there's a lot of questions over the inventory that we don't have, but that will come. And obviously, the market has changed a lot, and we have another competitor in the market who has been very aggressive, and has won a lot of tenders lately. But the market is there and we -- we're back in and talking to people. So that -- in the interest of time, that will happen. I think as far as the distribution change goes, I don't think the policy will change until we have a bit more clear view of where we're going with the business and how the contracts have accreted the arm, and the sponsor, how he's doing. I'm not -- I don't have a primary goal to push the distribution at all. I think, at the current year, and the current unit price, I'd like to keep it all very stable, and keep the distribution very comfortable. I think, it's working for us. And don't forget the shipping market generally, in the last 10 years, we've seen quite a fall in asset prices, and it's difficult to make a case when in a falling asset price environment to increase distributions in the shipping MLP because you have a weakening -- slightly weakening charter position just inherently given the Windsor market because the newbuilds are a little bit cheaper. What is interesting with interest rates going up is actually second hand tonnage costs have become more competitive value wise because the cost of a new build significantly increases compared to an older vessel. So -- but today, I'm happy with where we are. I think, $150 million is sensible amount of coverage. I think, ideally a bit more, and it's going to be weaker in the next 2 quarters, these (inaudible). Next year again, we have a nice relaxed position. And people, again, pay a very good (inaudible). I mean, we are a growth MLP, so it's just a phase at the moment. We didn't -- we haven't won many contracts. We were expected to have -- basically been -- had to had more announcements to make from the sponsor by now, but that hasn't happened, and we are clearly aware of that and that's really why we haven't -- we just want to keep it very stable, taking over, good coverage, paying down and keeping a good footprint. You can see the quality of the contracts, because there is no problem with bank refinancing, that's the reality. So I feel fairly confident. I mean, obviously, you've got to weigh the risks and the opportunities with this MLP. But I think today, we're doing -- the way we're running it is we're not -- I wouldn't -- I'm not going to be -- I'd be dishonest to say we're going to push the distribution. I mean, we could do that, but I also look at it and think we've got preference issues in this and that's 10%, 15% of the capital base. And when you've got that in there, you've really got to think about -- paying too much distribution because also (inaudible) common unitholders against you know we've got quite a lot of leverage and preference unit holders, you want a longer term investment for them. So that's really how I see it.

Hillary Cacanando - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

So there's really no target, distribution coverage or target EBITDA that we should be looking forward?

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

No, I think, it could go higher. I mean, we could go up. I mean, to me, I think it could get to -- I think go to [200%] maybe. I don't think that's possible at the moment. But it depends on how creative the contracts are. So the last thing with having -- with having this headroom, we can be in the market and contract vessels even directly into the MLP, if needs be. I mean, I think we need to grow the MLP because if we had a bit more liquidity in the units, so like, it was like 25% more liquidity would be in the Alerian and that would have been a natural improvement in the unit price just because you've got attractive funds in. You basically got -- I calculate probably about 400,000, 500,000 units would be in these sort of funds. Today we're already closed-end funds. And they're quite comfortable with what we're doing. So I've talked to a lot of them, I think, until you've got a clear pattern, what we can make some mathematical models as to what it's going to look like and how it's going to go. But you know, I think, I've looked at it quite closely on how we perform, and I think people do appreciate the stability of it all. And at the end of the day, there's a pension. And that we also have very big businesses. I mean, Knutsen is a sizeable organization and the accounts of the MLP don't really reflect that. Probably to shore side staff there. So it's important to keep it stable. -- a stable MLP which is our long-term future.

Hillary Cacanando - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

Yes, I mean, like on the topic of MLPs, I mean, we've seen a lot of -- I mean, it's been kind of been challenging in the last couple of years and we've seen lot of roll-ups and consolidations into the parent on the traditional energy MLP space...

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

Yes. We're not that flushed with cash.

Hillary Cacanando - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

Yes, on the viability of the MLP structure, in the Marine MLP space, I mean, is this something that you think will happen eventually as well? Rolling up to the parent and consolidations?

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

With our MLP, I'll be disappointed. I think, personally, I think, we should, we will -- I mean, we've raised a lot of capital last year, and it would be a shame to end it.

I think, it's got a lot of mileage, I mean, the MLPs are changing. But they are definitely changing their, the growth story, the distribution growth story and lots of the mature MLPs is out. I mean, almost -- except for Shell and 1 or 2 others, they basically are not really -- they're not many traditional growth story MLPs there.

And when we're paying 9.5%, it's almost dishonest to say we will be comfortable bumping that up and putting across. If you put a distribution, you're putting it across the full unit base. That is to stay stable and be really comfortable during distribution entries before you do one. So I think this is definite -- it's going to be a year or 2 really before we know what we're doing in MLP in terms of how it's expanding, how big it's going to get.

And I think it's got an attractive value proposition, but obviously we -- I mean, obviously, with the banks, if we go to Wells Fargo or someone and say we want to issue some units, then they'd say, well, we'd like to see an increase in distribution. So if you're doing anything in the market, it's dishonest to say why would you push the distribution, and weaken the MLP effectively. What we're doing, we're financially weakening that. I want to make a strong financial vehicle. And if we have to raise distribution to make it attractive to get units away, then maybe we do that. But today, there's no need. We look very stable, we can have fleet -- we can have vessels occasionally, there've been a couple of years of time, just to leverage that without raising the equity.

And today, if we're not achieving a lot of contracts then we could just be putting 1 or 2 ships into the MLP to maintain its position. There's, obviously, (inaudible) you have to watch ships occasionally even without raising equity and that should take you to a leverage par.

I mean, so that's -- and we're doing a bit of that already, if you do an ATM, I mean, that's possible. I look at our yield, it's fine, I'm comfortable with all. I talk to people both in the sponsors and in the investors. And I think, generally, people have got used to what we're doing. But yes, obviously, you've got over 200% cover or something, or the market recovers and you start winning orders and then the situation changes completely.

But look at us today, since we've got no inventory. So why would you push the distribution? That's where I see is really. That's the way I see it, I'm not saying anyone sees it that way but...

Operator

The next question comes from Robert Favera of RE Favera and Associates Marine Surveyors.

Unidentified Analyst

My first question deals with the IMO 2020 sulfur content on fuel. Can you give us some color on how that may impact you?

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

Well, obviously, the vessels are time chartered, it's a charterer's expense, but the better vessels, with a more economic ships and newer vessels, will renew at a better rate because they burn less bunkers. I guess that's how it would impact us. In Brazil, we've done heavy fuel oil in Brazil, and the supply by the refineries in Brazil, it's almost -- it's 1%, sulfur content, it's quite low in South America.

So we -- I think that they -- a lot of the Brazilian refineries could get compliance with the 0.5 on heavy fuel oil. Because if they don't, the vessels will have to burn marine diesel, but that's a charterer's problem. But I think within a year or 2, the Brazilian fuels will be compliant because the fuel content -- the sulfur content is low down there.

In the North Sea, the SECA zone in Barents Sea is there have been quite onerous environmental requirements for -- since 2015, where they had -- I think it was (inaudible) knocks actually down to 0.1 or something from 1 in the harbor.

So basically, we've had to burn marine diesel on those vessels, or the charterer has. Basically it's a pricing issue, these ships are time charted, so if a vessel burns LNG and LNG becomes more effective, and they want to run it because it complies, then maybe they'll get a better rate.

But I suspect not, I mean, it's almost the Tier 3 compliance or Tier 2. We build ships at Tier 2 because actually, weirdly, ships with scrubbers are less efficient, and they've got more deadweight, they also discharge sulfates into the sea, which is not with an open-loop system, which is not totally desirable.

In fact, I think an open-loop system personally is a weak solution, because not only burning about -- it costs a lot to install it, you're burning 1 to 2 tons a day extra just to run it. And then because of the deadweight increase, you would use the capacity of the ship or you will increase the tonnage. So all in all, it's inefficient. And then if it's an open-loop system, you're actually discharging waste -- residual products into the sea, which is a lot of sulfate. So it's actually -- in some parts of the world, you can't use open-loop scrubbers because they add to the ocean acidity. So I'm not a big fan of open-loop scrubber. And also with the shuttle tanker, it has a lots of ancillary engines, so you would have the amount of fuel consumed at certain points quite a lot more, so it's more complex. It probably -- what AET and Teekay have done is build the dual-fuel ships, which we now see as quite sensible. But they are a lot more expensive. And in Brazil, I feel that it will be a diesel story for many years to come, or a fuel oil story. So we tend to build a Tier 2 which are a bit more efficient actually, they burn less fuel. The funny thing is with all these environmental filters, they actually increased the consumption of the vessel and increases its carbon footprints. So -- but obviously, IMO 2050 is also going to affect shipping quite heavily, if it comes in and there's a lot of climate change issues with vessels.

I mean, Hillary asked me quite a lot of questions on this before and I had to look into it. So you're not the first investor to ask me that either. But my stock answer is, it's not our problem, we time charter ships out. So it's a charterer's problem, but it's over simplistic because obviously a charterer will eventually look -- price -- look at the relative pricing of the ships.

There's no problem in our vessels being compliant, we just have to burn a more expensive fuel. I mean it's just down to pricing. But I think in the medium term, we're not going to be -- we're not exposed in 2020 with our fleet. And in the medium term, it will be a solution within 6 to 12 months, I think, because 90% of the our fleet will not have scrubbers on them, so they will have to be more compliant. So as that ramps up -- production ramp up, it will get cheaper. And it is a refinery problem rather than a shipment problem I would say, personally. (inaudible) refineries is that waste product.

Unidentified Analyst

Well thank you so much for the additional insight on. And I had no understanding of some of that. And you've spoken a lot about debt, okay? The total debt, et cetera, which we have increased a little bit because of the additional ships, et cetera. Now the market is, obviously, pricing us as a high risk operation since we're getting 9.5% based on the prices on stock and dividend, et cetera. And...

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

Well, shipping generally because of the way the market has gone, it seemed quite high risk. The fact that we're probably -- we have some of the best contracts I've seen, certainly in tankers. Because they were actually contracts. They are fabulous contracts, but obviously, you still got the shipping industry risk a little bit, and the market has fallen a bit for vessels and people are always focused on the renewals. But while these ships are our long-term assets, (inaudible) we paid for them. And they've agreed a string of rates and options and that hopefully -- mostly, we basically get close to that, if not exactly the figure that we get in the charter. But it varies, and we intend to give them a little bit of a reduction, but not massive. Because, obviously, you have to build the ship and it's the cost of (inaudible). I mean these contracts are not massively profitable, so the leverage has to be there. The leverage is there by the banks. Because obviously, if you got 10-year excellent money on a time charter and it's a needed asset because you can't monetize the oil flow otherwise is a pipeline, you're going to get good financing in terms of just a consequences, the quality of the contracts you've got. You might as well take the bank to it. I mean, don't forget the sponsor on 25% to 26% of the units anyway. So you quite like our distribution. You're not going to sit down and say, well, I'm going to have it low leverage and low distribution. And you're going to say, I'd like to take some money out of it. So if you do, and that's why we, thus, end up where we are.

Unidentified Analyst

But one of the things I was concerned about is changing interest rates. We do have floating interest rates to go along with current LIBOR. And by the looks of it, more time is going to mean more higher rates for us. And obviously more cost on it.

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

Yes, but don't forget, it increases the entry cost of the new vessels coming in because the old ships are getting paid down. So actually, gives you a competitive challenge with an aging fleet. It's not all bad of a use. It's just a different use. But you are right. You are right, and it has an impact. We've covered -- we hedged about 4 years forward, that's why you see these big exchange -- we made these big profits on derivative contracts because we actually hedged around, about 60% on our debt coverage, but the rest of it isn't hedged. And we will be -- we've achieved lower margins a bit on the financings because part of the reason is because the LIBOR rate is going up on the banks. In a higher LIBOR environment, they're actually happier to take your money because they're getting more interest, so they actually lower the margins a little bit. So you see when we negotiate, we'd be doing that by 2.5% to 2.125% because you actually achieve the LIBOR fare.

Unidentified Analyst

The way of looking at -- that's the way I've been looking at it lately because the price is kind of stuck between $21.50 and $22. And the dividend is staying exactly the same. So it's a very stable thing, which is what you're trying to achieve. But the -- increasing the size of the business then, increasing the number of ships, if we're going to stay exactly the same in both price and dividend, what we're really doing is, increasing the benefit of the moneylenders and not the shareholders, particularly. So in the long run, is there any possibility that you can buy back some of the preferred, not change the regular dividend, but buy-in the preferred?

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

We don't want to buy in the preferred because after 10 years, there is a financial penalty on the preferred shareholder. I think he placed it at 70% of book. So you can't -- he wants his money back after 10 years, if it is still a preferred. Otherwise, it's a nice conversion. It's $24.67 now with strike. So actually he has to strike it per unit. It -- that preferred is a really nice stuff -- it's a really nice preferred, and I like it. But as I was alluding to in the call, if you've got preferred, then you should -- it's not the moneylenders are losing, because they know that they're going to get paid on these contracts. They are very, very good. If you pay a high distribution, just -- you're just hurting the common unitholders in the long run. You're just destabilizing the (inaudible).

Unidentified Analyst

I'm trying to understand the logic of why you don't want to buy back any preferred to reduce out $1.8 million per quarter?

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

Yes, because basically, there has to be cheap competitive common unit. And it's not part of the mechanism. The mechanism is that if we -- if they run out, then they take a discount on redemption quite significant. So they won't get paid out at the common unit rate. They get paid out significantly less. There is a discount on them. So it's not advisable for us to do that, and we've already won the preferred for 2 years now, is it? so...

Unidentified Analyst

Is that preferred -- is that preferred callable?

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

Yes, but we have to pay the spot price. And I got to check with the (inaudible). It's not advisable for us because if we call it, we have to issue common units effectively.

Unidentified Analyst

Have to replace that money?

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

Yes, yes. Because we are quite tight for cash, as you can see. And it's actually cheaper than common unit, and it has been nice -- I mean, as a quid pro quo, obviously this sits on top of the common unit holder. So while they've got these disadvantages, it's a nice -- it's a fair deal. I like the deal, it's a very fair deal because actually, they have residual risk as well. After 10 years, they did take quite a hits on those press. But they have to receive an 8% yield. I won't -- I mean, basically, you can turn any 10% yield to the common unit holder. And it does increase the risk levels. So -- and you can't look at the contracts. The quality of these contracts is very high, and you can't -- (inaudible) in the market and they are very aggressive because they want the business. It drives the accretion levels down if we want to do the contracts.

So even though there's so many ships that people will order different elements, we know the market very well. And we know what that will cost, and we know where we're comfortable going with charter rates. And if we see -- if we think it's over competitive, we're just staying out, and that's just how it is. But some are (inaudible) markets is very, very good. I mean, we've seen, I think, AET has won 7 contracts in the last year. And obviously, we've taken an order of 6 ships. We are talking to people, and they're quite keen, especially, the Statoil was very keen to give us some contracts, but it's going to be on the right terms.

And I can't say too much because of nothing been firmly agreed, if you know what I mean, but I'm not worried about it. I think, genuinely sometimes it's just better to sit out of it. There is only so many ships that people want to place with an owner and only so many berths they have to use and only ships they can construct. So sometimes you can go a bit aggressive into market,these happen....

Unidentified Analyst

But we don't see ourselves increasing our fleet at this point, right?

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

No. Because the sponsor has to order the ship, and it takes -- I'll be just honest, I've got ideas. We're obviously quite a large group of vessels. But I prefer personally to keep as a shuttle tanker business. And I think actually in view of NYK commencing today. But obviously, there are plenty of older vessels out there, and it just goes on to 6 to 12 months and they're not getting anywhere with anything, then we have to reappraise because we've sunk a lot of effort and time into building those MLT to where it is today. And it would be, not something that they would want to abandon, I don't think, you know what I mean. And that's basically what you're saying to close it out and move it down. Even then it's still a nice -- it's still got a nice -- it was not much risk to do that. It's not particularly sexy investment, but it's not a risk, you know what I mean?

Operator

The next question comes from Ben Brownlow of Raymond James.

Benjamin Preston Brownlow - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Just a few quick modeling questions. On the Hilda and the Windsor, the charter extension there, any meaningful change in the day rates with those?

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

No.

Benjamin Preston Brownlow - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Okay. And for the third quarter, it seems like the Torill, the 5-year survey was pushed up a little bit from the fourth quarter to I guess, towards the end of fourth quarter?

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

Yes, it's late September. It's going to be an investment delivered in November, mostly just at -- it maybe in early November when it was still (inaudible). So yes, it's probably a few. Will we continue? I don't know. It must have been the scheduling around but, obviously, it's not far off. Exactly in 5 -- it's 5-year dates (inaudible) whereas the Hilda has been on the 5-year dates, it has actually arrived. I guess, it just depends on when they have discussions with charterer, but you do have some latitude on when you dock these ships. I mean, you don't dock them on the anniversary dates, it depends on the yard availability and charterer. It is closed because the charter was delivered in November '13. So it's -- it possibly was early November 2nd or 3rd or something. But it has rolled it forward to that because of the 15- to 20-day docking. So yes, you're right, it's going to be late September, so probably 2 or 3 weeks early.

Operator

(Operator Instructions) This concludes our question-and-answer session. I would like to turn the conference back over to John Costain for any closing remarks.

John A. Costain - *KNOT Offshore Partners LP - CEO & CFO*

Thank you, operator. And thank you for your questions. It was very -- it's always good to have people on the call who listen to our business and I do appreciate it. Thank you very much.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.
