SPECIAL FEATURE

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Private equity becomes key

Barry Parker

Difficult times call for fresh approaches to financing transport businesses. Barry Parker reports on new sources of funding available to the sector.

As the maritime industry sets up for a possible move off its cyclical floor, the secretive world of private equity is becoming more visible. Likewise, deeper pocketed cargo interests and state entities - whether in the form of sovereign wealth funds or guises of "rescue" vehicles - are also watching the market cycles, preparing for entry into shipping markets ahead of an upturn.

History shows that such a turn is not a question of "if" but rather of "when" the market's lengthy curve will swing upward. Market analysts have a variety of views on the trajectory of a future move upward, with allusions to 'U' shapes, 'V' shapes and 'L' shapes and its timing. There are green shoots emerging - even for shipping - but it must be viewed in the context of overwhelming overcapacity.

Over the past few months, there has been a steady murmur of private equity massing on shipping's sidelines. A cross-section has been mentioned in Jane's, including investment teams at Greenbriar Equity Group, DVB Bank, JP Morgan, Seabury Group and within Germany's Dohle Group. A panel focusing on alternative financing at an upcoming conference in London contains a complement of senior executives from financial investors Castle Harlan, Kohlberg Kravis Roberts (KKR) and Fortress Investments. The panel is rounded out by shipping stalwarts from recently formed Finamar, Eurofin and Tufton Oceanic.

Nature of investments

Equity analysts have grown more bullish on the downtrodden drybulk sector in recent months. Whether one believes that the upturn is real or not, a central question for financiers and investors is: What is different on this trip through the cycle? Depending on the answers, the nature of investments going forward may be different.

The research team at New York investment banking boutique Dahlman Rose, noting a pickup in Chinese imports of steel-related iron ore and thermal (steam) coal, stated collectively to Jane's: "We believe ship values are set to increase on the recent strength in charter rates." The bank team, led by analyst Omar Notka, has been quick to emphasise the salutary impacts of a rising freight market on asset values - and possible improvement in loan-to-value (LTV) covenants.

The team added: "Based on implied returns from current spot rates, we believe drybulk vessel values could see increases of 20 per cent, with additional increases possible should the firming continue. Such a move would have a significant impact on the highly levered structures of many within the drybulk group, and would lead to much higher equity valuations."

Researchers at Morgan Stanley, led by Ole Slorer, are also positive on the sector, pointing to: "a series of data points suggesting improvements in the debt and credit markets, as well as positive sentiment on China-centric Asia".

The Morgan Stanley view echoes that of Dahlman Rose on the asset market. Morgan Stanley said: "The rapid rise in rates and forward sentiment has kicked the sale and purchase market into high gear." Debt

providers are also seemingly sharing such optimism; shipowner DryShips has now cemented additional covenant waivers, this time on USD86 million of debt from lender DnB Nor.

Naysayers have called the newfound optimism a "bear trap" - a rally that might prove to be without foundation and therefore short-lived. Forward freight rates (FFAs) from the Imarex market suggest an abundance of caution. Spot US dollar-denominated day rates for capesize, panamax and smaller vessels are all well above forward "settle prices" for the second half of 2009, 2010 and beyond.

Janos Koenig, chief financial officer of Eurofin Group, a boutique investment bank and adviser, provided additional perspective. "It's perceived by some to be the time for investment now, but it's not clear whether prices have bottomed out yet. Will the recovery come in 2010, or in 2011? Nobody can say with certainty."

A veteran of shipping markets since the 1970s, Koenig explained: "Based on the forward prices the market does not believe in the recovery yet, at least in drybulk. Yet, it has risen well off the bottom. In historical terms, the rates we are seeing now would have been good rates. Compared to those of a year ago, the current rates are a pittance - people became accustomed to much higher rates. In that context, prices have gone down."

He said that the large war chests built up by owners during the good times meant that they can continue to service debt; this, coupled with banks providing waivers (with increased margins), rather than taking decisive actions, has kept ship prices above distressed levels. He told Jane's: "For these reasons, I don't think we have seen a real bottom yet."

Credit constraints

What is different about this cycle for shipping are the constraints on credit. Veteran shipping banker Bote de

Vries, now at the helm of consultancy Finamar, told Jane's: "At this point in the shipping cycle the interesting part is that equity is not the limiting source of capital. An impressive number of equity funds are active or in the process of becoming active. Most of them are in the USD100 million-plus range. The return requirements these funds target are mostly high in the 20 per cent to 25 per cent range."

Finamar's story reflects the retrenchment of bigger institutions, with de Vries commenting further: "Quite a few banks left shipping, and the main banks have a strong focus on their core clients. For equity funds, the room to get senior debt is very small. All equity funds are chasing a small group of banks these days and senior debt is the limiting source of capital for shipping."

Koenig explained: "There is a real need for finance. One of the roles we play is that we are an outsourced finance department and we talk to many banks. Right now, there is quite a lot of demand, especially from owners now looking around to raise finance for orders placed but not yet financed." In discussing the current situation in the Greek market (where Eurofin has an office), he added: "The banks still have severe liquidity problems. About 30 per cent of finance for the Greek market was done by three banks that now are pretty much at a standstill regarding new business - so there is a big requirement to find funding."

The actions of one well-placed investor, with connections at the highest echelons of business and government, provide an important signpost. Reports from downtown New York indicate that Mark Friedman, a specialist shipping banker from Merrill Lynch, will be moving to a senior role at Evercore Partners.

The firm is captained by Roger Altman, who has divided his career into stints at Lehman Brothers, Blackstone Group and, during the Carter administration, assistant secretary of the US Department of the Treasury, as well as deputy secretary in that department under the Clinton administration. Altman authored an article early this year in the prestigious journal Foreign Affairs, in which he wrote: "Much of the world is turning a historic corner and heading into a period in which the role of the state will be larger and that of the private sector will be smaller." Such views may signal the shape of future shipping deals.

Evercore's business segments encompasses both advisory - in which Friedman will be a senior managing director - restructuring and private equity, all with an international slant. The firm's transportation experience

to date has been limited; over the past two years, its advisory group assisted European Aeronautic Defence and Space Co (EADS) on the sale of two units, the Airbus cabin systems business at

Laupheim, which was sold to Diehl/Thales in 2008 and the Airbus Filton wing component business, which was sold to aerospace and technology company GKN in the UK in 2008. Besides its own private equity business, Evercore activities involve private equity heavyweights Blackstone, Bain Capital, KKR and Berkshire Hathaway, based on deals concluded in recent years.

State intervention

Altman's views should not be lost on financiers who will be devising new financing structures and funding sources as governments around the world become stakeholders in all types of businesses. Indeed, the US government is set to invest USD100 billion - combined with equity from the private sector - in a public-private bank that will invest in troubled financial assets. Templates being studied by US policy-makers include entities such as the Korea Asset Management Corporation (Kamco), a government-owned distressed asset aggregator and re-packager, born in the wake of the late 1990s Asian crisis.

Across transport modes, governments have already moved to the forefront, playing a greater role in financing. In Europe, the French government earlier this year offered up to EUR5 billion (USD7 billion) to assist credit-strapped customers in purchasing aircraft from Airbus through money raised by its Société de Financement de l'Economie Française, (SFEF) and then channelled through major French lenders. Quasi-governmental export credit agencies (ECAs) are also expected to step into the breach, assisting Airbus in Europe and Boeing in the United States.

Newbuild cancellations, which will have a profound impact on shipping markets, have now provided a lighting rod for state intervention. Koenig said that the supply side of shipping now poses great uncertainties. "A big question mark is the percentage of new vessel orders that will be cancelled. I don't think anybody has a good grip on what is happening; the percentage of orders that could be cancelled ranges from 10 per cent to 40 per cent," he said.

In Asia, shipyards are responding to large numbers of cancellations from buyers that have reassessed market prospects and/or have been unable to raise finance. Risk classification firm Det Norske Veritas (DNV) estimates that orders for nearly 500 vessels, mostly bulk carriers, have been cancelled so far, with China and South Korea hit particularly hard. However, the reluctance of both shipyards and buyers to publicise cancellations makes such estimates informed guesses, at best.

Governments have responded aggressively; this month, a buyback vehicle of Korea Development Bank (KDB) is slated to begin operations with approximately USD800 million available for buying ships and leasing those assets back to financially distressed local owners. Recent reports suggest that KDB is teaming up with Kamco in its efforts, which might provide as much as USD4 billion. KDB's announcement of the bail-out comes several weeks after an announcement that two government agencies, Export-Import Bank of Korea (Kexim) and Korea Export Insurance Corporation (KEIC) would make amounts of USD16 billion available during the year. The aid will come in through a mix of actual loans and guarantees. Although applicable to both new and existing orders, analysts expect that existing orders would likely benefit from the support.

In China, the government has indicated an intention to support state-linked shipyards through a mechanism of pushing funding out through banks and to buy back vessels from yards where buyers have defaulted. According to Koenig: "It is likely that ship orders from new, 'greenfield' yards will likely disappear, with one estimate suggesting that this would amount to about 23 per cent of the orders."

These two countries' measures have catalysed a defensive response by Japan, once the world's shipbuilding leader - but now eclipsed by South Korea and China - which has threatened to lobby Organisation for Economic Co-operation and Development (OECD) for new guidelines on shipbuilding credit, arguing that industry support by its neighbours represents hidden subsidies. Long-time shipping market observers are quick to point out that political gambits dominate in recessionary markets, when the full effects of the industry's overcapacity are realised.

Debt market drivers

Where a government is not a participant in financing, the debt markets are now driving structures, unlike in earlier cycles where the market vacillated based purely on supply-demand interactions.

One investor told Jane's: "Debt is the new equity. Up until the credit crisis began, debt was easily obtainable. Now it is the opposite in that debt is difficult to get. Even existing clients with close bank relationships can only get 40 per cent to 50 per cent advance rates on second-hand tonnage."

De Vries expanded on deal structures and provided further colour on the constraints facing ship financiers: "Even if you assume a huge increase in ship values, funds are only able to make these returns (the 20 per cent to 25 per cent return previously alluded to) if there is an element of leverage by senior debt available. Senior debt is, however, very scarce these days. It is not so much the pricing thereof [which today easily reaches Libor plus 350 bp] but the availability."

Koenig echoed similar thoughts and stressed: "This lack of liquidity and traditional bank finance are creating the opportunities for private equity and for mezzanine finance. But they want a significant return."

Mezzanine debt has been referred to as quasi-equity, combining the debt element - albeit with a secondary position - with equity elements such as participation in sales proceeds, or option-like devices for an investor to gain control of an asset. Market participants have suggested that return parameters on mezzanine debt overlap with those demanded by equity.

In spite of the uptick in short-term rates, longer-term hires in drybulk - and in other sectors, if long-term employment even exists - are likely to be insufficient to cover debt service.

De Vries explained: "The issue with asset-backed investment these days is that the charter rates are so low that the cashflow out of the charters is not able to service the capital expenditure on an asset-backed deal. An investor in an asset-backed deal needs to accept no return on his capital until the market improves and then he is depending on the specific asset only."

There are various flavours of investment funds, some looking at companies and some looking specifically at vessels. De Vries offered a comparison of prospects: "The asset-backed deal is still a better deal than a company transaction as most shipping companies that were active buyers over the last two to three years are under water and have negative equity on a real asset value basis."

Round in circles

Both Koenig and de Vries took a view of market cycles in context. De Vries said: "As is applicable for the general economy, a finance-driven recession is very bad. On top of this, we have a tremendous high order book for newbuilding vessels outstanding, and this combination is painful and historically unique. Let us hope that this crisis is a blessing in disguise whereby the lack of capital kills the order book so that the supply and demand balance in shipping can come back quickly."

Koenig told Jane's: "In some ways, it is a bonus that the credit crisis happened when it did; this is not a shipping crisis, per se. If it happened a year later, it could have been much worse, with many more ships."

The financing mix is also cyclical. Koenig pointed out: "In the old days, you might have had a structure with 60 per cent debt, and maybe 20 per cent of mezzanine tranche. In the good market of 2006 into mid-2008, you had banks willing to provide up to 80 per cent leverage at very attractive spreads over Libor. There was no role for mezzanine finance during that timeframe. Now, it has a place again."

In the tanker sector, joint ventures with customers, especially where the partner is a well-resourced oil trader or refiner, provide another channel for funding shipping businesses, ratcheting several levels up from traditional profit sharing on charters.

Nasdaq-traded Omega Navigation, a niche player in the product tanker sector, announced that it has formed a company outside its corporate balance sheet that will own a newbuild in a 50/50 venture with commodities giant Glencore. The vessel will, in turn, be chartered to ST Shipping, a separate entity within Glencore, for five years at an unspecified rate, but enough to fully cover operating expenses and debt service.

Omega will fund its half with equity and by drawing on a previously secured bank facility.

Financial input from the equity partner enables Omega to stretch limited amounts of cash and bank debt still available. In early 2008, Omega restructured its USD295 million debt facility with an HSH Nordbank-led syndicate into a package that will be non-amortising until the second quarter of 2011, taking out a portion with a subordinated junior facility, non-amortising until the same time.

At the time of the debt restructure, with USD284.2 million outstanding, which was subsequently pulled back to USD242.7 million, Omega reported: "The non-amortising facilities, which will free up approximately USD15 million of cashflow in 2008 and about USD41.4 million until the maturity, will allow the company to reserve more cash for potential acquisition opportunities."

Omega, although not in violation of any covenants, has now succumbed to the need to conserve cash and has suspended its dividend.

Another player in the product sector, d'Amico Tankers, is financing a sizable newbuild programme through joint ventures with both Glencore and Mitsubishi, which has opened up debt finance sources with Japanese lenders.

Joint ventures with state companies, sometimes a feature of shipping markets even in good times, may see renewed interest with debt constraints. New York Stock Exchange-traded Tsakos Energy

Navigation, another tanker owner, has close relationships with state-controlled natural resources producers in Brazil, Ecuador, Mexico and Venezuela. These relationships have included sales of stakes on two panamax tankers to the company's Ecuadorian partners, consistent with the company's strategy of booking profits through asset sales, when appropriate.

If the vision of Altman and other experts who see an economic pendulum swinging towards more state involvement with business is correct, deal packagers may well be looking towards government investment entities.

In previous shipping cycles, the locus of the transport world rested with Japanese "shikumisen" deals, in which privately owned steel mills - benefiting from Japanese government regulatory largesse - controlled transportation through long-term charters, usually matching a shipowner's repayment period on finance.

In the mid-1980s, the Japanese government assisted in restructuring the debt of shipowner Sanko, which had greatly overbuilt. This time through the market pendulum, maritime transport has already seen a taste of state involvement through the shipyard supports described, and also through ties with state companies. China's raw materials buyers - the large state-linked steelmakers - have flirted with stakes in mining companies, which, in turn, control shipping.

History repeating

Peering into the future, it is a safe bet that history will continue to repeat itself. This time though, given bank constraints which may linger for a while, there is room for state companies to play a greater financing role.

When the time comes for Kamco and others to sell vessels, one must wonder whether shipowners will repurchase their vessels the old fashioned way, with bank debt.

It is entirely possible that a savvy new breed of private equity investors might play a role, using debt sourced at least partially with governmental assistance, if traditional lenders continue their cautious stance on new business.

Market indicators in the shipping sector

Clues to the direction of any market can be found by comparing its forward market or futures market - where one exists - to prices for spot transactions. Currently, traders are not looking for great leaps upward.

A swap market exists in both the drybulk and tanker shipping sectors, providing market-determined forward price guidance that can then be compared against estimates of spot rates sourced from spot market brokers. For containerships, the situation is more jumbled, with forward market information available, but no spot benchmark to compare it against.

Drybulk rates have received considerable attention lately. Spot assessments of how much a capesize bulk carrier can earn on a timecharter trip of less than two months duration have risen with renewed market activity in recent weeks. At the dawn of the late May bank holiday weekend, a composite of four such trips suggested that large bulk vessels were commanding a daily rate of USD45,000, based on components of the Baltic Capesize Index. This same four-voyage composite was worth far less in forward markets, based on data provided by Imarex, the Norwegian financial intermediary. Imarex settle prices for full-year calendar trips encompassing 2010 and 2011 were pegged at around USD25,000 per day.

Panamax vessels, another important category, have seen less of a runup. The Baltic Exchange, which also publishes a panamax index, values a composite of four-trip timecharters at just above USD18,000 per day. Yet traders on the screens of the Imarex network have valued 2010 and 2011 panamax hires at USD13,650 daily and USD14,450 per day respectively. Supramax vessels show a spot value around USD19,000 per day but see a big discount in future years, with traders pricing daily hires at around USD12,000.

The tanker markets have proved disappointing during May. Similar to drybulk, tanker market expectations can be discerned from forward markets. The timecharter value on very large crude carriers (VLCCs), in spot voyages from the Arabian Gulf to Japan, was worth little more than USD5,000 per day in late May. For later in 2009, Imarex settle prices have clustered around a daily rate of USD25,000, with expectations of a move to per diems of USD28,000 for 2010 and 2011.

Financial security packages have been linked to receipts in forward freight transactions, in which an owner agrees to receive a strip of payments at regular intervals at an agreed upon rate. More likely, an assignment of an actual timecharter will feature in banking arrangements. The forward settles - rather than the spot quotes - will often provide a good proxy for the value of timecharter transactions concluded around the same time. Online fixture data provided by brokers RS Platou reveals one two-year drybulk physical transaction, on the modern capesize vessel Cape Brittany, agreed at USD26,000 per day rate, very close in line with the forward rates for financial transactions traded on the Imarex.

Actual transactions - whether in the physical or the "paper" markets rather than expectations - are what counts. The futures settles may provide clues to directionality, but they shift around dramatically. In May 2008, when the capesize timecharter composite stood above USD200,000 per day, forward settles for May 2009 pointed correctly towards a downward move. But the downward values for the second quarter of 2009 (at that time, one year out) stood at around USD120,000 per day. When May 2009 actually rolled around, actual capesize rates were substantially lower - in the USD30,000 per day neighbourhood, and moving above USD40,000 late in the month.

Government assistance

In the United States, the transport sector is not immune from participation by a new shareholder - the government. To date, American International Group (AIG), parent of giant aircraft lessor International Lease Finance Corporation (ILFC), has been beneficiary of USD182.5 billion of direct and indirect US government assistance.

Market rumblings have suggested that Troubled Asset Recovery Programme (TARP) funding might be an inducement to attract buyers for ILFC - which is high on AIG's list of units to be sold to raise cash for repaying the US government's largesse.

There is further evidence in the motor freight sector to back up Altman's assertion. Trucking powerhouse YRC has been mentioned in the trade press and by credit rating agencies as a potential recipient of US government money to fund its pension and health-care programmes, with funds emanating from TARP.

YRC, a major employer of unionised labour, is struggling to fund its requisite annual contribution to both pension and health-care schemes.

Standard and Poor's has noted: "In 2008, YRC paid pension expenses totalling USD554 million and health and welfare benefits totalling USD532 million."

Private equity helps state sector

At the intersection of state ownership and private equity, a story more closely linked to the battered container sector is unfolding. In this case, funds may be flowing to a state-linked investor from the private sector.

Reports have been circulating that the government of Dubai, majority owner of port operator DP World Ltd through state-linked holding company Dubai World, is in discussions regarding a possible private investment.

Abraaj Capital, a large private equity investor in the Middle East - and already a transportation sector investor player through interests in Aviation Fund Holdings, which operates a range of businesses including the Al Khayala luxury shuttle and charter service, low-cost airline Nas Air and Jordan Aircraft Maintenance - has been tipped as a possible acquirer of at least 15 per cent of DP World Ltd shares. The rumoured potential deal would have DP World sell down a portion of the majority interest it holds in DP World Ltd.

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