Funding options

As bank debt continues to be in short supply, Barry Parker examines whether other finance sources can come to the rescue of shipowners

At the recent Morgan Stanley (MS) Shipping & Commodities Conference in New York, Akis Tsirigakis, president and ceo of Nasdaq-listed Star Bulk Carriers described the current interaction of shipowners and shipyards as: "Expect more agreed delays."

The shipping industry may have cancelled orders, or pushed them further out into the future as Mr Tsirigakis suggests, but funding will still be needed. Historically, ship finance has been heavily dependent on bank debt. But the jury is still out on whether other forms of finance might play a more important role for shipping borrowers as banks continue the cautious stance which has led major institutions to pull back from maritime lending.

At the end of the first quarter 2009, according to LR Fairplay statistics was about 560m dwt (see page 36), though it is impossible to establish the exact impact of cancellations with any clarity. Dimitri Vranopoulos from Marine Plus SA estimated the value at approximately $533bn.

Assuming that half of the orderbook has already obtained finance, a reasonable estimate for the amount of equity that must be invested into shipping assets is of the magnitude between $50bn and $100bn over the next three years. Requirements for incremental debt issuance, beyond what has already been arranged, would likely be double the needs for equity, i.e. in the order of $100-200bn.

PRIVATE EQUITY

There has been considerable attention given to Private Equity at this low point in the cycle. LSE recently talked with veteran private equity investor Marcel Fournier, senior managing director at New York-based private equity firm Castle Harlan. The firm is best known to maritime financiers through its ownership of Horizon Lines earlier in this decade, with an exit through its IPO and subsequent share sales. Its wide ranging portfolio has also included Statia Terminals, later sold to Kaneb Pipeline (now part of Nu Star Energy, formerly Valero). Current holdings include consumer businesses such as restaurants, as well as industrial holdings in diverse businesses including drilling fluids and packaging. Mr Fournier told LSE about Castle Harlan's investment philosophy and its long-term view of markets. "Things will recover, but it may take a while. It's always painful, but the recovery will happen. But there must be some adjustment first."

Mr Fournier's views on timing, investment style and financing were tied to questions of how the current economic malaise differed from previous experiences. "During the period from October 2008 to early 2009, people were wondering if we were experiencing another depression that would last for years and years. There was clearly a near panic. But now that panic has receded, we're seeing some small bright spots," he said. Mr Fournier cited the ongoing investment by China in infrastructure as an example: "It's a bad recession, but now that things seem to have stabilised to some extent, people can start to deal with this crisis just as they have dealt with other recessions in the past."

The steep downward trajectory that occurred and the severity of this cycle, will make the adjustment harder, but he felt, "…this alignment creates an opportune time for patient, medium-term investors such as ourselves. We can't say exactly when the bottom may come, perhaps in six or nine months, but it's shaping up to be a good time to position for the pattern of cyclical upturn. Any businesses with a sizable fixed asset component… are seeing depressed earnings, much lower multiples and depressed asset values. This applies to shipping in particular," said Mr Fournier.

Revealing Castle Harlan's views on acquisitions of maritime companies, Mr Fournier told LSE: "We are looking at transport generally and certainly at shipping businesses." He described banks as "naturally conservative in this environment" and following a natural tendency of pulling back, dealing with people they know and trust, and only considering loans for amounts they can keep on their own balance sheets, rather than syndicating. He said: "Now is of course a difficult time, but the situation will eventually resolve itself. Banks will gradually revert to being able to structure deals in a reasonable, conservative way."

Regarding Castle Harlan's potential re-entry into shipping, Mr Fournier was able to synthesize these diverse cyclical, strategic and financial considerations for LSE. He stressed, "It's important to buy at the right time. The cost of capital will be with you for a long time and this has direct implications for your competitiveness down the road. Going forward, those who have bought good assets at an attractive price will be the most competitive. They'll have a base to build from in the future." He added that if you don't buy at the right time and if you overpay "it's very difficult, usually impossible, to recover." He noted the likely attractive pricing as ship operators can make deals with shipyards in the wake of potential cancellations, or where an original buyer can't obtain financing. "There's a big overhang now, there's a lot of choice," he said.

Mr Fournier told LSE: "You can't always get in at the absolute bottom, and we don't need to. But, from day one, it's important to partner with a company that's making money, even if the amount is substantially reduced compared to the higher points of the cycle." He talked about Castle Harlan's desire to "grow and prosper" with the right partner. He stressed: "We don't want a turnaround situation, we can't fund a business that's losing money but we can offer a platform for a company's growth, or perhaps aid in restructuring a balance sheet."

The jury is still out on whether other forms of finance might play a more important role for shipping borrowers as banks continue the cautious stance

A business with a positive cash flow and able to support a conservative amount of bank debt, will then have the staying power necessary to weather the downturn even if that downturn lingers longer than anticipated. Mr Fournier told LSE: "If the business is making money, if it has bought its assets at the right prices and costs have been lowered proportionally, then it can weather the downturn. When the cycle does turn up, even if it takes longer, we are well positioned. It's important for us to be backing good operators, and people who have the ability to be successful."

SHIPPING INVESTMENTS

Shipping financier Bote DeVries, a former banker, now runs the financial consultancy Finamar. His experience of hammering out vessel transactions affords him a unique perspective in linking the structures of shipping investments to questions of where we are in the market cycles. His process is analogous, though not identical, to the private equity investment approach.

Asset players buy ships and private equity investors buy ongoing businesses. Both require debt and benefit from a well-timed entry point. Mr DeVries, based in the Netherlands, told LSE: "You could argue that there are only limited times to invest in shipping. Only when asset values hit an all time low are massive investments worthwhile. If you read the cycle correctly you will have huge capital gains and fantastic returns. If the cycle works out differently you can have huge losses as well. Past performance does not give a guarantee for future performance and there is no benchmark for the bottom of the market."

At the MS event, bankers and company cfos offered their views on the state of ship finance banks. One time banker Christopher Thomas, now cfo of Paragon Shipping, said that credit is available in limited amounts from the banks. "It's become easier over the past few months," as bankers are "a little more open to our industry right now." Others offered a more sanguine view. Eagle Bulk Shipping's cfo, Alan Ginsburg, told the audience: "Ship finance is still very difficult now…maybe the banks have the money, but they are not making loans…" A senior MS shipping banker added: "There is still a scarcity of finance" and that alternative modes of finance might support transactions. But Mr Ginsburg, putting the role of the banks into context, said: "The shipping banks have been very supportive of listed companies."

DnB Nor's Nicolai Nachamkin said that "So far, there have not been many casualties, the banks prefer to deal with problems internally." However, he suggested that later in the year, bankers collectively could potentially re-evaluate what provisions to take. Mr Nachamkin said that even though private equity packagers had been assembling funds to pick up the pieces of distressed situations, the influx had not happened yet and the banks had so far not looked in that direction. But he cautioned that, depending on the course of the markets, "if the problems become too time consuming for banks to solve, or the banks are simply not able to deal with them, then the banks might look towards the restructuring experts."

He suggested: "Perhaps, shipowners might first look to the capital markets, and then, to their traditional funding sources, banks - if banks are still encountering difficulties later in the year."

Reflecting on why most shipping company finances were withstanding some of the current difficulties, Mr Nachamkin pointed to robust structures created during the high markets. "The policies of the banks up to the third quarter of 2007, especially in fashioning non-amortising debt structures, may actually have helped companies stay out of trouble in 2009."

Janos Koenig, managing director and cfo of Eurofin, offered: "I do not believe that private equity is a substitute for plain vanilla financing. There is still a great need for straight bank financing. The situation has not improved appreciably, although there are indications that some banks are there to support their good clients." Speaking to LSE, Mr Koenig added: "There is a market for small deals with existing clients."

Mr Koenig, with a boutique investment bank that pays close attention to financial structures that include a Mezzanine component, sits with a unique vantage point on both the debt and equity camps. The news is not all rosy. His observations on the attitude of banks added colour to the views of company cfos. Mr Koenig told LSE: "In another rather disturbing development, we are seeing banks with committed facilities that are looking at ways of getting out of some transactions. In general a great number of banks, including some heavily involved in shipping, have to reduce their portfolios because of capital adequacy ratios. As such, one way of achieving the goal is by withdrawing commitments for real or imaginary reasons.

"If they [banks] can see a way out, they will probably take it. A year ago, they may not have dared to put these reasons forward. In effect, they are reducing their exposures"

Mr Koenig cautioned that: "If they [banks] can see a way out, they will probably take it. A year ago, they may not have dared to put these reasons forward. In effect, they are reducing their exposures. This is a trend that makes it difficult for owners if there are things to be changed in an existing commitment."

PUBLIC DEBT

The public debt market, in the form of bonds, has also been a source of capital for shipping, but maritime deals have been structured or linked to governmental incentives in some cases. The market has taken on a distinctly Asian tinge. In China, hard hit by the potential for order cancellations, the government has stated an intention to support state-linked yards, using a mechanism to push funding out through banks, and to buy back vessels in cases where buyers have defaulted. The government has also indicated an intention to assist yards by purchasing vessels and by initiating trade finance to support vessel exports.

In mid-May, a buyback vehicle of the Korean Development Bank (KDB) is slated to begin pumping approximately $800m toward buying ships and then leasing them back to financially distressed local owners. It was reported that KDB, teaming up with KAMCO, might provide as much as $4bn. KDB's announcement came several weeks after an announcement that two government agencies, the Korea Export-Import Bank (KEXIM) and the Korea Export Insurance Corp (KEIC) would make available amounts of $16bn during the year. The aid will come in through a mix of guarantees and actual loans. Though applicable to both new and existing orders, analysts expected that existing orders would likely see the greatest benefit from the support.

In one Korean deal already announced, STX Shipyard said that it would be issuing the equivalent of $238m in one-year bonds, to be purchased by KDB. Among other Asian deals, PT Tunggaladhi Baskara, the parent of PT Berlian Laju Tanker (BLT), announced that it would be raising Rupiah 500bn through a series of bond issues. Though this deal attracted positive attention, given BLT's recent asset sales to reduce leverage incurred to fund its Chembulk acquisition, there is a deep pocket in the background.

The continuing attractiveness of maritime infrastructure provides indirect benefits to the shipping business. Hanjin Shipping is likely to benefit from a tax exempt bond issue of $110m for equipment at a new container terminal in Jacksonville, Florida. Though the deal had not been finalised, the port would borrow at its preferential credit rating. In contrast to raters' cautious attitudes about the container industry overall, the south-eastern region of the US is benefiting as ports develop intermodal distribution centres. Such financing, where available, should be looked at more in the municipal or public finance context, rather than as a maritime deal.

One major shipping company has taken issue with the ratings process that is part and parcel of public debt markets. CMA CGM announced that it would cease having its debt rated. In better times CMA CGM, raised $823m in its 2006 "Vega" vehicle. The innovative asset backed securitization (including $254m of notes with a monoline credit wrap and $283m of bond debt) had seen a series of downgrades as conditions worsened in the container sector. Rating agency Fitch downgraded the company's overall rating from BB+ to BB-, with a negative outlook. At issue are raters' methodologies, looking at a dreary overall canvas for the container sector, even though CMA CGM's businesses have continued to perform.

HIGH YIELD BONDS

At the MS conference, and elsewhere, bankers have pointed to below investment grade sold in public markets as a possible way to plug holes in shipping balance sheets and, on an aggregate basis, to provide a portion of the industry's requisite debt needs.

High yield bond markets saw a resurgence during April and May across a variety of businesses including oil and gas but also satellite and consumer industries. Jefferies high yield bond analyst John Parker said that bonds with less than investment grade ratings could play an important role in shoring up shipping company capital structures, "particularly where traditional bank finance has been curtailed." He told LSE: "Shipping deals could be done in the high yield space, where there is a strong security component, and certainly a long-term charter to a good name."

Not surprisingly, the high yield market encountered severe difficulties in late 2008. Mr Parker told LSE: "Some private equity companies took advantage of market turbulence to retire debt at steep discounts in the secondary markets." With high yield spreads at all time highs and with the prospect of better economic times ahead, $10.8bn has flowed into high yield funds up to the end of May. As an example of the increased risk appetite among investors, Parker cited Navios Maritime Holdings' Senior Notes. After trading at 51% of par in late February 2009, he told LSE that this issue has been trading in the low 80s during early June, adding that: "In addition, the new issue market has opened up in May after a long period of being essentially closed. If you need to refinance debt right now, you should be able to get it done. Eighteen high yield deals priced in the first week of June alone, and nine of them were increased in size, a good indicator of the demand for new issues."

Mr Parker was keenly aware of private equity interest in shipping and of the sometimes fleeting nature of financial windows. He told LSE: "The reopening of the new issue market has given a lot of private equity firms the opportunity to refinance debt that is coming due over the next year." In explaining the financing strategy of a spectrum of businesses looking at the sector, he said: "Given the fact that the new issue market was closed for so long, companies don't want to take the risk that it closes prior to the time of their debt maturity. Who knows if it will be open a year from now when the debt comes due?"

STRUCTURING OPTIONS

Where we are in the cycle clearly matters. As financiers explore alternatives to conventional bank finance, or, if the improved economic outlook provides sufficient comfort to entice shipping lenders back into the water, shipping market development is a key criterion. Mr DeVries suggested that "by using structuring techniques you can mitigate your risk and balance against the uncertainties. Only when you are very convinced you are at the bottom do you pursue pure asset play. If you are more uncertain you can take a 2-3 year charter enabling you to better time your exit. If you are uncertain about the market you will probably try to include coverage for your residual value positions like a put/call structure at the end of the charter."

Tasos Aslides, cfo of Euroseas, described its fleet renewal programme which began earlier this year. "When markets are depressed, it's the time to buy younger vessels." Conversely, "medium and older vessels make sense when markets are in full upswing," he said. He also explained the company's philosophy of paying down debt in times of stronger markets.

Mr DeVries offered a view about structuring in stronger markets, saying to LSE: "At a higher point of the cycle you still can invest but based on financial lease type of structures (long-term bareboat charter and purchase obligation at the end). Selecting your structure based on the cycle of the relevant shipping sub-sector enables you to invest profitably in shipping at many points in time."

For this to be effective, the banks and other funding sources must be of the same mindset and share the views of where we are in the shipping and finance cycles.

Deal intact

A banking deal that remains intact involves a Wachovia-led syndicate lending to Jones Act liner specialist Horizon Lines, following a mid-June settlement of a lawsuit related to price-fixing in one of the company's major trade lanes. Loan pricing was increased by 150 basis points across a grid linked to a leverage ratio. New pricing ranges from Libor plus 275 to Libor plus 350. Horizon also paid an amendment fee of 50 basis points.