CAUGHT IN A SEA CHANGE

Shipping finance is facing turbulent times, says **Basil M Karatzas**, CEO of Karatzas Marine Advisors. So what is the way ahead for shipowners?

The traditional form of financing the acquisition of vessels has been through first preferred ship mortgages where the shipowner contributes 20-30% equity and the lender provides the balance of the purchase price in the form of a loan secured with an asset as a collateral. Variations on the theme have been utilised for the changing times and accommodating the circumstances, for example the extent of equity required, the "spread" on the interest charged, the strength of the loan covenants demanded and whether fixed contract employment was required as an additional security for the loan. Obviously, a great deal of emphasis was placed on trust and the prior track record on performing on loans by the debtor.

At the top of the market in 2007, about $130bn of new loans in shipping and offshore were originated according to Marine Money (see graph 1). It is estimated that by the end of 2007, the bank loans in shipping and offshore were standing at approximately $480bn, implying $120bn invested in the industry in the form of equity, with $25bn of the equity invested in shipping in 2007 though the capital markets. All in all, no small numbers by any measure, but to put it into perspective, in August 2012, Apple, as the most valuable company in the world then, stood at about $630bn, and presently at about $380bn. The maritime market is big business, but it seems Its importance Is never "big enough to matter" – unless there are noticeable shortages of merchandise on supermarket shelves or fuel at the petrol station.

Anyone who has even casually been perusing the newspaper headlines since 2007 can attest to the fact that there has been a sea change in many markets and realms, with the banking and the shipping industries not the least affected the course of events.

In banking, several of the shipping banks that mattered in 2007 are now owned and controlled by the state and several smaller players have declared bankruptcy or been forced to be absorbed by other financial institutions in order to avoid bankruptcy.

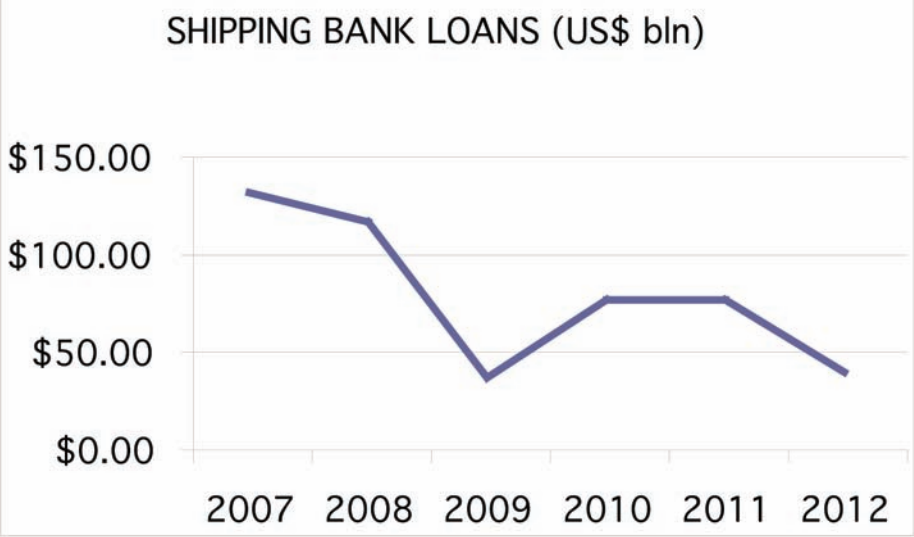
In shipping, as a matter of perspective, the Baltic Exchange Dry Index (BDI), the proxy for the shipping market, topped on 20 May 2008 at 11,793 points and bottomed on February 3rd, 2012 at 647 points, with a present value of 760. In more realistic terms, freight rates for VLCCs have collapsed from about $200,000 pd to even negative rates (when properly calculated at cruising speed) and for capesize vessels from $200,000 plus pd to as low as $4,000 pd; vessel prices have been halved in most cases since the top of the market (see graph 2).

The sea change produced by the tectonic shift of market, fiscal, monetary and political shifts has been having a tremendous impact on shipping and shipping finance. Anyone in shipping who has had a casual discussion with a shipping banker recently can attest that banks rarely lend any more and when they do – as infrequent as this may be – the terms of the loans have no relevance to the pre-Lehman days. On average, loan amounts are smaller in absolute terms and lower in relative terms to value of the asset, covenants are featured prominently and the basic "four Cs of lending" are back in vogue (Capacity to borrow, Credit, Collateral, Character.)

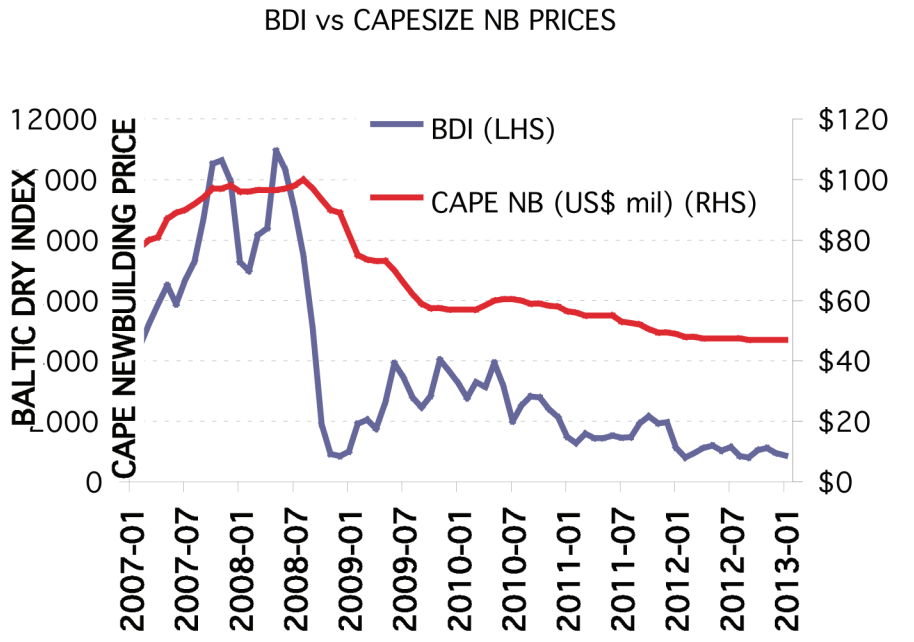
In 2013, preliminary tabulation of data suggests that bank loans barely topped $40bn in both shipping and offshore (compared with $130bn in 2007), and about another $40bn in equity was raised in the capital markets (compared with $15bn in 2007), implying a much lower tolerance for financial leverage.

For a capital intense industry like shipping, the lack of debt financing poses questions of strategic importance to many a shipowner.

GRAPH 1



GRAPH 2



Their fleet may be getting depreciated and technologically obsolete and thus in need of replacement sooner or later, while they cannot access financing in order to exploit the present weakness of asset pricing in both the second-hand and newbuilding markets.

Given that banks worldwide have been shifting to more risk-averse investments and industries in an even more accommodating monetary environment and also the fact that gradually shipping is perceived as a risky industry that needs to be properly priced, under the impending new rules and regulations, such as Basel III rules, the message in the bottle travelling the ocean is fairly clear: debt finance in the future will be much more limited (as a result of banks shifting away from shipping); it will be more expensive (to compensate for properly priced industry risk or beta); and the borrowers that will have higher priority accessing it will be companies that have their four C's in straight order, more easily represented in a consolidated corporate balance sheet.

> "Partners from complementary industries can be a strong arm to hold on to when times are bad and grow with when times get better"

In our experience as shipping finance advisors, we have seen just too many good, old-fashioned shipowners that founded their shipowning firms several decades ago and presently stand with a strong capital base with excess working capital and cash on the sidelines and modern fleets with reasonable cost bases and sustainable leverage, but in a clear bind in accessing their usual sources of debt financing, including the shipping banks that had been financing their fleets since their corporate inception.

As painful and frustrating the experience can be, especially since it is the result of no fault by the owner, it's a moment of strategic inflection and decision-making about the capital structure of shipowning. Well-informed market players believe that going forward, the traditional model of 20-30% equity from the private owner and the 70-80% asset-backed lending from the traditional lenders is not a viable model any more, with a strong probability that it may never again be a sustainable model. When shipping bankers, in private admit that their cost of capital has to be in the region of 600 basis points for the banks to justify the new loans under the new regulations, it can logically be assumed that traditional lending in shipping will never be what it used to.

The distribution of vessel ownership is heavily skewed with a long tail – meaning that despite the few major shipping tycoons we all have heard about, vessel ownership is dominated by a long list of shipowners with their individual ownership limited to a handful of vessels each. Although small owners have collectively comprise a very competent core of shipping market participants, this may be the type of the owner who is likely to be affected most adversely by the present shifts in shipping financing and in most need of using the present crisis as their inflection point. As the traditional lenders have been walking away from the industry, their limited lending or investing capacity will be reserved for the owners that have critical mass, strong balance sheets and core competencies; shipowners who will be able to sustain more competently strong waves of a bad market and will not be in trouble with the first local storm.

And again, it's never too late to start thinking that shipping financing is not necessarily limited to traditional debt financing that worked well 20 years ago (and conspicuously too well in 2007 and 2008 with 90% leverage and 100 basis points over LIBOR.) While major shipowners have access to more sophisticated financing and they are on the radar of investment banks and financiers, the present crisis is an optimal time for smaller owners to think outside the box in order to access alternative forms of financing.

What the smaller owners lack in shipping finance expertise they can make up on flexibility and agility, possibly at making the right, strategic partnerships with companies in other industries to whom they can offer a solution through their shipping expertise. These partners can optimally be in industries outside shipping, but complementary needs. Despite the weakness of trade, commodities have always been moved around as well as finished products. And, despite the risk aversion of the banks for shipping, there are alternative sources of capital that have a strong interest in entering shipping.

Partners from complementary industries cannot offer a panacea to shipping's present problems and they are likely to want to address their own mandates, whether that's transport of cargo or elevated returns on investment, but they can be a strong arm to hold on to when times are bad and grow with when times get better.

After all, an estimated 4.2 billion tonnes of dry bulk was transported over the oceans in 2012, representing an approximate increase of 6.1% year-over-year, and more than $11bn committed to shipping by private equity funds between 2008 and 2012, despite the 57% drop in the BDI in 2012.

As they say, a crisis is a terrible thing to waste. ■

Tel: +1 713 545 5990
Email: info@BMKaratzas.com

BASIL M KARATZAS,
CEO OF KARATZAS MARINE ADVISORS & CO.

FREIGHT focus

SPRING 2013

ON THE RISE

CHINA'S FFA MARKET CONTINUES TO DEVELOP

STRONG GROWTH IN IRON ORE MARKET

ENVIRONMENTAL REGULATION ON THE INCREASE

KARATZAS: TURBULENT TIMES IN SHIPPING FINANCE