

The challenges and opportunities facing shipping public companies in the face of increasing market and financial turbulence

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Until last autumn, shipping was on a 'high'. Soaring freight rates and vessel values coupled with the abundance of both capital and credit had resulted in an unprecedented success growth story that seemed set to continue. Growth forecasts for China, world GDP and international trade, displayed a solid robustness that seemed capable of absorbing the increasing newbuilding order book at least for 2008 and 2009. Many pundits were calling for a 'new paradigm' for shipping where the success was likely to continue not only for years but indeed for decades.

For a while shipping investments were blessed with the 'Midas touch' and public company share prices soared.

As shipping companies, both public and private, displayed colossal returns, often exceeding 100-200% per annum, shipping attracted the real interest of public and private capital looking for extraordinary gains.

However, some of the investors represented institutions such as hedge funds that were looking for a 'quick buck' and had no interest in the long term benefits of investing in a shipping company. As such, as long as 'El Dorado' was on, they remained interested but their desire for shipping would quickly evaporate if harder time would be encountered when they would run for the first exit.

Aided by fee seeking investment banks, aspiring shipping public company entrepreneurs tapped into the emerging investment appetite for shipping. Greek owners were among the most active over the past 2 years.

As can be observed in the attached Table, there are currently 25 'Greek' shipping public companies in the US and London markets and there are a further 7 in the 'Hellenic' markets with a total market capitalization as of 8th February 2008 of \$21bn.



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	7th December 2007	Company Name	Market Capitalisation - 7th December 2007	Market Capitalisation - 8th February 2008	52 week high - share price	52 week low - share price	8th Feb 2008 - share price
1	Naadaq	Aries Maritime Transport Limited	189	190	10.45	5.75	6.5
2	NYSE	DANAOS CORP	1592	1530	40.26	21.55	28.3
3	NYSE	Diana Shipping Inc.	2378	2010	45.15	16.66	26.09
4	Naadaq	DryShips Inc.	3008	2600	131.34	17.22	65
5	NYSE	Excel Maritime Carriers	947	628	81.99	15.8	30.63
6	Naadaq	Navios Maritime Holdings Inc.	1453	1120	19.76	6	10.57
7	Naadaq/Singapore	Omega Navigation Enterprises, Inc.	258	190	24.74	13.3	15.31
8	Naadaq	Quintana Maritime Limited	1453	1310	29	12.21	21.82
9	AMEX	Star Bulk Carriers	447	450	15.85	8.66	10.58
10	Naadaq	StealthGas Inc.	351	330	20	12.05	14.59
11	Naadaq	TOP Tankers Inc.	222	160	8.4	2.02	2.74
12	NYSE	Tsakos Energy Navigation Ltd.	1352	1360	39.48	21.99	35.04
13	Naadaq	Freeseas	113	120	10.48	4.25	5.88
14	Private 144A	Paragon Shipping Inc	424	420	27.34	12.51	16.56
15	NYSE	Aegean Marine Petroleum Network Inc.	1577	1385	48	13.7	30.41
16	NYSE	Oceanfreight Inc	293	230	30.48	14.1	18.61
17	London	Goldenport Holdings Inc	602	469	GBP 515	GBP 254	GBP 343
18	AIM	Global Oceanic Carriers (GO Carriers)	102	86	GBP 164	GBP 68	GBP 109.5
19	AIM	Globus Shipmanagement (£3per share)	271.05	195	GBP 625	GBP 300	GBP 392
20	Naadaq	Capital Product Partners	522	450	32.5	17.52	20.13
21	OTCBB	Euroseas Ltd	432	330	21.52	8.33	11.24
22	AMEX	Oceanaut Inc	191	190	9.25	7.25	7.8
23	AIM	Hellenic Carriers	208	183	GBP 230	GBP 205	GBP 205
24	NYSE	Seasergy Maritime	272	270	9.67	9.26	9.37
25	NYSE	D/JS Torm	2839	2220	47.1	26.52	30.32
		Total market capitalisation - in mn\$	21,496	18,426			
26	GA	Anek Lines	505	502	2.85	1.13	2.11
27	GA	Attica Holdings	831	837	6	4.08	5.5
28	GA	Blue Star Maritime	587	491	4.28	2.85	3.06
29	GA	Maritime Co of Lesvos	162	104	1.3	0.51	0.61
30	GA	Minoan Lines	542	501	6.6	4.1	4.88
31	GA	Kyriakouli					1.36
32	Cyprus	Ocean Tankers Holdings	14	156	2.04	1.073	1.29
		Total market capitalisation - in mn\$	2,641	2,591			
		Grand total - market capitalisation	24,137	21,017			

Public company CEOs and CFOs too have been riding on the crest of a wave and the market offered them enormous opportunities to grow. Often companies would grow 3 and 4 fold in only a matter of months.

Follow up IPO issues became commonplace and it seemed for a while that there were no bounds to what could be achieved in the quest for growth and economies of scale.

As the champagne flowed and market capitalization, cashflows and liquidity grew, it is only natural that attention to cost control waned. Moreover, as public companies must have a blemish free performance, money was poured to bid and secure competent crews (an increasingly scarce commodity) and at keeping vessels in a pristine condition. Consequently, vessel operating expenses grew by over 20% in the last couple of years and drydocking expenses skyrocketed, as China adopted, much higher pricing in the light of too many ships chasing a limited vessel repair capacity.

As with all parties, at some point the music stops. This has occurred over the last two months when shipping has become increasingly affected by international events. I am referring of course to the subprime crisis, which has started off a series of chain reaction events each affecting shipping directly or indirectly. To this, we have recently added the risk of non-performance by the credit insurance giants, such as MBIA, AMBAC, etc., which collectively cover over US\$2.4tr of credit risk. One dreads to think, to even contemplate, the potential adverse effects to banks and other financial institutions of such a failure.

The first effect of the above is the increasing slowdown in the US economy with most analysts forecasting a relative short and shallow recession aided by US interest rate cuts and an expansionary fiscal policy. Unfortunately, the US 'flu' has had an effect on Europe, as well as the rest of the world economy leading to forecasts of slower growth for 2008 but a bounce back in 2009.

The huge bank losses have created high instability in the markets which became nervous of which bank would report record losses next. Banks stopped lending to each other and this exacerbated the liquidity problems which lead to central banks providing unprecedented liquidity to the interbank system.

Banks facing insufficient capital adequacy problems, as a result of over-lending and / or losses had to slow down or even stop their lending. Examples for the shipping industry are HSH and RBS, two of the leading shipfinance providers.

The developing credit crunch affected all market participants (public and private alike) as credit became more difficult to obtain, large syndications became harder to effect, and mergers and acquisitions harder to finance. Banks started to view their dwindling lending capacity as a valuable resource that had to be allocated prudently to selected clients at better terms. Consequently, we have observed not only increased client selectivity by banks but also an increase in pricing by at least 25 basis points, higher fees, tighter covenants, reduced lending percentages and an even greater reliance on secure income flows and evidence of corporate liquidity in anticipation of harder times.

Some banks (Scandinavian and Greek) having no sub-prime exposure and no losses from structured products, have actually capitalised on the credit gap created by the slowdown and cessation of lending by many banks that had been until then the most aggressive lenders.

The above turbulent events had an impact on shipping which had become rather over-extended.

Whether as a short term correction or a reflection of the changing international environment, shipping freight levels, especially in the dry bulk market, fell massively. The BDI fell from a high of 11039 on the 13th November 2007 to 6353 on the 8th February 2008, i.e. a 42.45% fall.

Many say that charterers are behind this fall, as they have withdrawn cargoes for as long as they can to drive freights lower. This appears to be true to some extent and as such, it cannot last for long. However, there can be no doubt that there are other more solid reasons for the change in sentiment that may have so far affected freights and not vessel values but will no doubt also affect the latter should adverse conditions persist.

In addition to the effects on shipping mentioned (slowdown in international growth and credit crisis) above, the shipping industry had become over-extended.

According to Clarkson's, at the end of 2007, the world order book stood at over 500,000,000 DWT as against an average of about 100,000,000 DWT during the 90s. Indeed, in one year alone it had grown by over 55%.

Drybulk was the champion in orders as the order book grew from 77,000,000DWT in 2005 to 223,000,000 DWT in 2007 with most of the orders coming in 2009 onwards.

Whereas there are some valid arguments that some of these orders, especially at smaller Chinese green site yards, may turn out to be paper orders and concerns over the lack of main engines and the possible cancellation of options, the sheer size of the drybulk order book is causing increasing concerns.

As period charter rates plummeted and banks increasingly requested charter cover, the number of potential new shipfinancing transactions slowed as the numbers simply did not work out, unless lending was restricted to 50-60%. Clearly, owners did not wish to lock in such relatively low charter rates expecting a market recovery and this has resulted in a slowdown in potential new shipfinance transactions at the same time as banks became increasingly concerned about adding to the shipping risk. A real problem has arisen as owners sought to obtain committed finance for their huge new order books. Such was the exuberance of owners and their expectation that the abundant cheap credit conditions would continue, that less than 1 in 4 owners had secured credit before credit conditions worsened. Indeed, most new vessel deliveries for 2010 and nearly all for 2011 onwards have not been financed.

As owners run for cover, the banks became increasingly selective as well as concerned to lend against an asset that might not be delivered for another 4-5 years, when shipping conditions could not be anticipated.

Consequently, whereas mostly pre-financing at low levels has been secured, many owners have not secured their post-delivery finance.

Whereas the shipping markets still have the capacity to surprise and freight rates are expected to stabilise and the ratio of income to vessel value return to average levels, the odds of shipping maintaining the recent history of 2007 are rather slim.

Consequently, most analysts are now anticipating a slowdown in shipping but hardly a catastrophe, with freights and values stabilising at higher levels than those prevailing a few years ago. Some are even suggesting that an industry shakeout may even induce higher scrapping to take place and the slowdown / cancellation of many newbuilding orders which would help the industry overcome rapidly this corrective phase. They are supported by a longer term return to high global growth and the recovery of the banking system which will (as they maintain) refuel both the US and global economies.

Certainly, as the shipping industry is primarily a US Dollar borrower, the recent fall in US interest rates is helping the industry at a time of falling operating incomes.

How have shipping public companies fared thus far amidst such turbulence?

As can be seen in the table provided, shipping stocks are substantially lower than their 52 week highs. Such highs were established in most cases last October, November 2007. The falls vary widely depending on the relative shipping sector for each company. On the whole, though, most companies are trading at between 40-50% of their share highs, having already come off their recent lows.

Moreover, whereas most companies were trading at levels substantially over their NAVs per share and often up to 140-150%, their share prices have now come down to levels well below their NAVs.

According to Bear Stearns, the dry bulk sector is now trading at approximately 74% of NAV, whilst the tanker sector at approximately 82% of NAV.

The share price falls have been more severe than anticipated. Moreover, as most shipping companies have secured earnings for 2008 and many for 2009 and beyond, large positive cashflows, low leverage, good liquidity and sufficient committed credit lines, the magnitude of the fall is surprising.

Examining such falls further and as these companies' profit and loss expectations over the next few years remain largely intact, it would seem that investors have instinctively reduced their expectations of future vessel values (after period charters run off). If this is correct then it would imply a massive shift in sentiment and market expectations as to values and earnings for 2009 and beyond.

However, there may be other factors at play here. Part of the fall may be linked to shipping stocks being downgraded from their exorbitantly high levels as their growth potential and anticipated performance in the light of worsening market conditions are reduced.

Another factor may be linked to the falls in stock markets across the world with investors realising profitable stocks to finance their worsening positions or to shift resources to other

more promising or defensive sectors. There is also a tendency to reduce holdings in peripheral stocks (such as shipping) in favour of main line stocks.

For most shipping companies, the residual vessel values after secure employment are substantially lower than recent vessels values and represent a defensive quality for such shipping stocks. In addition, such period charters, often established at lower levels, had acted as a brake to NAVs and share prices rises in the past and as the market differences now reduce from current charter levels, this should act as a cushion and a prop to NAVs per share.

The share price falls may also be linked to a flight to safety and / or liquidity by concerned investors. Let us not forget that most of the public float (not linked to the original owners / stocks / managers) has been held by institutions and not private investors. These institutions may be concerned with being locked into an industry whose fundamentals may be changing. In addition, they may be facing their own internal pressures as their own investors may be bailing out concerned about immediate economic prospects. As such, institutions become sellers and there are few parties prepared to buy shipping stocks, unless they see value for money opportunities. Indeed, analysts of shipping stocks have issued strong messages that share prices are oversold and are expected to recover.

Investors have also begun to look more critically at charterer quality and likely charterer defaults. The shipping industry has often seen charter failures and / or re-negotiations of charters during a slump and it is unlikely that this time around the industry will fare better.

Perhaps the most telling factor is a shift in expectations and confidence in the sector in the midst of market and financial turbulence.

Nevertheless, public shipping companies have been surprised by the severity of the share price falls and the increasingly difficult trading and credit conditions.

For one thing, as long as share prices are below NAVs, issuing fresh stock to acquire vessels make no sense and as such, it is not surprising that new IPO activity and follow on transactions have disappeared.

As investment bankers are quick to point out, the list of potential public company entrants is still very long. However, they have all temporised their interest as the market is not supportive of new entrants. Additionally, owners do not wish to see their assets sold to the public at a discount.

Indeed, many are arguing now that the attractiveness of being a public company has largely disappeared and they are lumbered by higher costs and reduced flexibility of action.

As public companies can hardly use their lowly priced paper to finance transactions nor raise new capital by issuing more stock at price below NAV, their options appear to be limited.

The challenges and opportunities facing shipping public companies

In order to address deep share discounts to NAVs, a number of shipping companies are announcing and certainly considering buying back part of their issued stock. This certainly improves NAV and earnings per share, but it does absorb liquidity. For companies with a high liquidity position and no immediate investment prospects, stock re-purchases are a useful tool.

Some companies may consider increasing their dividends as a stock price prop and as investment opportunities recede. However, with shipping stocks yielding substantial paid out returns via dividends of up to 13-14% per annum, the above step may appear unwarranted.

Certainly, shipping public companies used to drive in the fast lane may feel increasingly frustrated with the inability to grow via either the capital or finance routes. The prospect of leveraging the company at a time of a credit crunch and declining NAVs are very slim at the moment. So are the prospects of attractive substantially more investor support, unless stock prices were to fall substantially. However, at such levels, existing shareholders would be heavily diluted and may be not supportive.

For strong and liquid companies, however, there will be opportunities to acquire weaker companies at discounted prices. The recent Excel / Quintana acquisition has shown that a bidder would have to still offer a substantial premium to succeed. The situation may change, however, and a number of smaller public companies do not have the necessary liquidity or committed credit lines to face a deeper and more sustained market fall. As the stock prices of such companies may plummet and given the illiquidity of the market for such stocks, it is likely that investors unrelated to the original owners / management may well look for an exit.

There remains the possibility of selling some assets and still cashing in on the high asset prices. There is nothing wrong in doing so although few public company CEOs may be willing to go into a de-growth phase of development.

Opportunities may be presented to the original owner who sold stock at high prices at the time of flotation or later and who may well be required to buy back 'cheap stock'. This will no doubt be presented as a sign of commitment and support by the owner / manager.

There has been some talk also of companies de-listing. Although this is rather premature, it is quite probable that should stocks fall to substantially below NAVs and their public company prospects decline, the case for privatisation will add strength.

Investment banks are likely to attempt to earn fees by putting together merger and acquisition deals, as well as sales of substantial stock positions by institutions or other investors. They will certainly face an uphill task to make headway in a difficult market.

Whereas at the moment both the world economy prospects and those of shipping appear rather bleak, it is well possible that the position may change for the better over the next few quarters.

After all, once banks have addressed their capital adequacy positions and have covered their bad debt exposures, credit will start to rise rapidly once again. This will be supported by an easing of interest rates and an expansionary monetary policy by the Federal Reserve primarily and the remainder central banks to a lesser extent. As the US economy is 'kick started' to growth again and on the expectation that commodity and energy prices may fall in the interim, it is well probable that the current turbulent and negative climate shall change. As such, demand for shipping may well result in faster growth from 2009 onwards.

This would leave the oversupply issue as the main one facing the shipping industry. As such, the turbulence for shipping and shipping stocks is likely to last longer than that of the world economy.

Public companies that read the markets well and have the capacity to buy assets or companies during the coming difficult period may well come out of this uncertain period with a stronger position and even better prospects.

The eyes of the investing public and banks will be on emerging strategy that shall be formulated and executed by public companies during the next 12 months and the ability of their managements to succeed during uncertainty and adversity.