Private Equity Funds; an unfolding story

By Ted Petropoulos

Nafs

March 2014

Private equity funds (PEFs) have been increasingly making the headlines, over the past year. Driven by their abundant liquidity and strongly held perception that shipping presents attractive profit making opportunities, their shipping related investments have grown to unprecedented levels.

Whereas the precise level of PEFs investments in shipping are unknown (due to the secrecy surrounding such investments for competitiveness reasons), there have been estimates by various sources, ranging from $7bn to $10bn. I suspect, though, that the total numbers may well be higher, not only due to the inherent secrecy involved but, also, due to PEFs often investing in newbuilding orders, where their investment lies in the future. It is, indeed, this part of their shipping involvement that has raised the industry's eyebrows. It is feared that such investments will lead to excessive ordering and a chronic oversupply situation for shipping.

It is important here to distinguish between PEFs and hedge vulture funds. The latter are looking to buy shipping loans at a discount from banks (mostly European and in particular, German). These banks have been increasingly forced to contract their shipping exposure as a result of mounting regulatory pressure. The European Central Bank is currently assessing the systemic risk of about 130 European banks, under various stress scenarios. The pressure has been highest for banks with large shipping loan exposures (e.g. HSH, Commertzbank, Nord LB) and selling loan portfolios to hedge funds has been a way to reduce exposure. Moreover, the keen competition among hedge funds has driven up offered prices and reduced discounts to levels of only 10% - 15%, depending on loan quality. Many banks have turned this PEF appetite to their advantage. I will return with an article on hedge funds and their likely effect on shipping, later.

Returning to PEFs, in the table below, you will see some familiar names that have been active in the market over the last twelve months. What is the special attraction with shipping, though? The main reason lies with the widely held perception that shipping has come off from the

bottom in 2013 and is well on its way to a sustained and profitable recovery in 2014 and beyond. It is quite rare to see such uniformity of expectations, as to the recovery of shipping and its potential rewards. In addition, investing in shipping represents an investment in a real economic asset with an intrinsic value and cash flow.

Private Equity funds
Oaktree Capital
Monarch Alternative
Blue Shore Global Equity Fund
Far View Partners
Siguler Guff
Fortress
Apollo Global Management
Montagu Private Equity
Nordic Capital
Eton Park Capital
Hitec Vision
Global Hunter Securities
Maxim Group
National Securities Corporation
Breakwater Capital
Tufton
Warburg Pincus
Wilbur Ross
Solus Alternative Asset Management LP
Hartmann
Blabckstone
Elliot (US hedge fund)
Goldman Capital (private equity arm of Goldman Sachs)
Fearnley Securities

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Both shipping vessel values and incomes have risen substantially, in the last year, admittedly from a very low base. Using Shipping Intelligence Inc.'s statistics, over the last 12 months, dry bulk and tanker values have risen on average 49% and 4% and incomes have risen by 60% and 12%, respectively.

However, the newbuilding order book has started to rise substantially, as contracts last year tripled to 150 m dwt, the highest since 2010, according to Clarksons.

Believing in a shipping recovery in the years to come, PEFs have ascertained that shipping represents an excellent risk. Moreover, when involving newbuildings, with a 10% deposit, and often less, PEFs can hold an option in a super eco vessel, with delivery in 2015 and 2016. In the event that values would rise, the return on capital invested might be extremely attractive.

It is this growth in orders, lead in part by PEFs, that has caused alarm by many analysts, who fear that any sustainable shipping recovery will drop dead on its tracks, when all these vessels shall be delivered.

Although shipping demand is still growing at reasonably healthy 5% - 6% per annum, with China still being the leader, such demand may well not be able to match estimated annual tonnage growth rates of 8% - 10% per annum, in 2015 / 2016. Moreover, scrapping volumes have started to fall, as the market has recovered.

The recent recovery in shipping earnings has been the result of many factors, many of which could be temporary factors, such as slow steaming, congestion and a change of trading patterns. There is still an underlying shipping tonnage surplus across most sectors, as a result of the massive deliveries over the past 5 years and it is quite possible that any real recovery will be thwarted by a change in any one of the above factors.

In essence, the so called shipping recovery potential that PEFs have latched on to is lacking fundamental support and may well turn out to be wishful thinking.

In addition, the effect of PEFs on second-hand and newbuilding prices has been significant. Second-hand purchase opportunities have been few and far between and the prices commanded by quality modern vessels have been rising as PEFs outbid each other.

PEFs work alongside in an essential partnership with shipping companies, enjoying good operating, technical and chartering skills. PEFs provide the vast majority of funds and often bring in some first mortgage financial institutions e.g. CIT, whereas their shipping partners will normally commit between 5% - 15% of the overall equity. Control invariably rests with the PEFs but at least for now there is a good harmony that prevails in most such ventures. To their shipping partner, PEFs provide the opportunity to expand their managed fleet with "state of the art" super eco vessels with little investment on their part and enjoying all the benefits of a larger fleet under their management.

Such joint ventures / partnerships, involving PEFs, have yet to be tested by a market fall. As PEFs work with target investment returns of 15% - 25% per annum, it is obvious to see that shipping cannot provide long-term investment returns of this order. In fact, historic analysis has shown that overall shipping has not been (with rare exceptions) able to generate consistently long-term investment returns of the order required by PEFs. The only opportunity to do so would arise if investments could be made ahead of a market recovery and liquidated at a relatively high market moment.

So the questions is, will PEFs be able to enjoy and take advantage of such a rise and lock in profits in time?

An even bigger question is, what would happen if the market fails to rise, as expected by PEFs, and / or starts to fall? What is the exit strategy then? Would PEFs be willing to stick with their investments, aiming for a longer-term liquidation or rush at the door?

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All these questions are theoretical, as there have been little recorded examples of PEFs' behavior in a bad market. It might be consistent with their short-term investment approach that PEFs may cut and run, thus flooding the market with vessels for sale. Another way would be to seek to exit their position by selling their stake to the highest bidder. This may present an opportunity to their partners to possibly acquire the PEF shares at prevailing vessel prices.

Another question often posed is, whether PEFs are a positive or negative development for shipping?
PEFs provide capital to a capital intensive industry, such as shipping. This is useful per se in that it results in more capital and less borrowing. High leverage is the Achilles heel of shipping due to the industry's cyclicality. In addition, as our fleet research has shown, especially in the last 5 years, we have witnessed an increase in the world fleet, lower age profile across all segments and a rise in the average size of vessel (Petrofin Research ©) on the one hand and a reduction in the global loan totals on the other (Petrofin Bank Research ©). The availability of PEF allows the purchase of vessels that would not have been possible otherwise.

Although there are potential symbiosis risks and an investment profile mismatch between owners and PEFS, when PEFs invest in acquiring second hand tonnage, their presence is most useful.

The problem arises when PEFs assist owners in investing in newbuildings which add capacity. Here, as long as such investments are not excessive, PEF involvement is still viewed as positive.

An interesting development has been the gradual acceptability of PEFs co-investing with owners by banks who now view such joint ventures as a positive development in shipping.

We shall continue to monitor the evolution, performance and overall activity of PEFs in the years to come.

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