The development of Private Equity Funds (PEFS), the impact of the shipping crisis and some predictions as to their future involvement in Shipping

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PEFs are collective investment schemes used for making investments in various equity or debt securities and seeking high investment returns over a fixed term.

These "investments" can take various forms, including JVs with owners, direct ownership of vessels, mezzanine lending, preferred or direct equity participations in public and private companies and purchasing existing shipping debt from banks. Lately, there emerged financial institutions, who provide lending on a similar basis to banks but at a higher cost, taking advantage of the ship financing gap that has emerged over the last 8 years (post Lehman Brothers collapse). These financial institutions, often backed by large investment funds, provide alternative finance to owners, who do not wish to enter into an investment relationship with PEFs.

Competing both with PEFs and alternative financial institutions are the ship leasing companies, often subsidiaries of banks and usually based in China or the Far East. These, specialize either in long-term leasing or in Sale and Leaseback transactions, initially for local newbuildings and increasingly, lately, for modern vessels for publicly quoted or large privately owned shipping companies.

Returning to PEFs, they are becoming a prominent feature on the ship finance and shipping investment landscape. As they are less regulated and more commercial in approach, they offer much needed capacity and flexibility to the shipping industry. Moreover, such interest has developed at all stages of the shipping cycle with a bias for investments in sectors offering good prospects of a swift recovery.

You can observe their evolution via Graph 1 (Drewry's/MarineMoney/PetrofinResearch©). However, as many of their investments are shrouded in secrecy and they do not have to report their shipping exposures, estimates of current PEFs totals vary. For example, Drewry's estimate private equity investment for 2013/14 at approx. $19bn whereas Tufton Oceanic report that over $32 billion were invested by PEFs. As the value of their investments varies with the value of the underlying vessels or security, it is difficult to provide reliable and analytical data to the industry.

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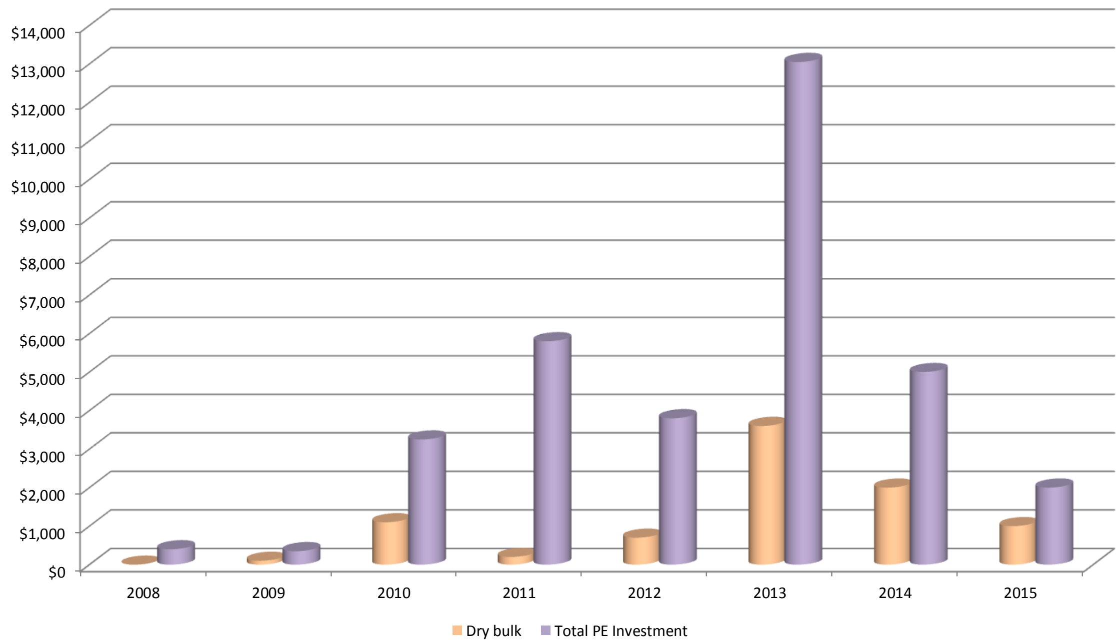
Private equity investment in Shipping
in US$m



Source: Drewry / Marine Money / Petrofin Research © November 2016

Readers may be familiar with some of the names often appearing in the shipping press, such as Apollo, Tufton Oceanic, RMK Maritime, Tennenbaum Capital Partners, Breakwater / Hayfin, Northern Capital and many others. Using just one year's published information and attendance in shipping fora, such as Capital Link, one would find in excess of 100 names.

Initially, PEFs were centered in the US, although there were some in the Far East, Continental Europe and London. A relatively recent trend has been for PEFs to open offices in London, which has become an active PEF center for shipping. We must not fail to mention the steady presence in Norway of a developed shipping investment market using the KS system, which has demonstrated consistently good results and which has become available to non-Norwegian companies, all but with some Norwegian link.

The initial PEF investment returns experience has been mixed. The keenly expected recovery of dry bulk shipping in 2015 / 2016 failed to materialise, with vessel values collapsing and cash flows turning negative. During this time, there have been some well publicized "PEF" takeovers e.g. Excel Maritime by Oaktree, in June 2014, Eagle Bulk by Oaktree, in March 2015 and recently, the removal of Peter Giorgiopoulos at Genco by Apollo, Centerbridge and Strategic Value Partners.

For many PEFs experiencing increasing losses, the liquidation process was made in an orderly fashion without undue publicity. For many, though, especially those who enjoyed close relationships and confidence with owners, it was more a question of waiting for the recovery and adjusting their positions through the sale of vessels or switching their interest into other types of investments. An example at hand is Oaktree with Starbulk, where the adjustment process seems to have run its course, in anticipation of better recovery prospects for 2017 and beyond.

The tanker industry did offer in 2014 and 2015 an opportunity for above average investment returns and some PEFs had a positive experience. Lately, vessel values and incomes have fallen significantly though and, as such, the exit window has receded. Nevertheless, it would appear that unless the fall continues, it would be a matter of waiting and finding a better exit opportunity.

The other sector which affected a lot of PEF involvement has been the offshore sector, where investors had been lulled into overconfidence over the years and which, on the back of the fall in the oil price and reduced exploration, fell to calamitous levels with long lists of idle ships in the North Sea and elsewhere.

If one might venture an opinion, it would be correct to say that the anticipated high returns hoped for by PEFs have not been realized, with some notable exceptions.

PEFs have adjusted their strategy in the face of their recent experience. Although some have departed shipping, many new names have begun looking at fresh opportunities, especially in the dry bulk sector. Their investment models have begun to factor in different time frame scenarios and most PEFs have been looking for positive and convincing signs of a recovery before jumping in. Another trend has been to focus away from direct equity investments and more into preferred equity or mezzanine investments, offering a shift of risk away from PEFs and into owners. Given the severe lack of traditional bank ship finance and the perceived risk / reward opportunities offered by the dry bulk sector, many owners started to flirt with such high cost form of lending with effective borrowing costs jumping to 8% - 10% per annum or even more. In order to accommodate such high borrowing costs, some PEFs agree to a repayment moratorium over the first 2 or even 3 years, as well as providing finance of 60%. A key here is the timing of the recovery, as the owner's 40% equity is vulnerable, in case of a market recovery delay. For PEFs, such "equity cushion" is deemed sufficient for their risk / reward investment models.

Looking into the future, the traditional bank lending appetite does not appear to be returning soon. Although, Far East shipping banks have largely covered most of the gap created by the declining European ship finance industry, conditions for a recovery in overall ship finance appear poor. Increasing bank regulations and the imposition of Basel IV criteria, the anemic economic growth in Europe, the non-existence of the interbank market and lack of liquidity continues to plague European banks. In addition, the fear of bail ins and bank collapses has made depositors weary of bank deposits, especially as recently such deposits have attracted negative rates of interest. Moreover, the development of FATCA and the exchange of personal UBO

(Ultimate Beneficial Owner) information and assets owned among over 80 leading countries have acted as a dampener to many investors, as they involve a lot of paperwork on top of the current negative interest rates.

During this increasingly regulated environment for banks, it is not surprising that would be depositors are turning to PEFs, which are currently more flexible and which offer the prospects of positive investment returns.

There are many PEFs whose capacity to invest has grown exponentially in just a few years and which now have considerably higher budgets than many well known shipping banks.

Moreover, PEFs have an infinite ability to “tailor make” their products, to meet the requirement of owners instead of relying on a singly lending concept of shipping banks. The recent losses suffered by prominent European ship lenders has highlighted to all that traditional ship lending is not immune from extreme shipping sector falls and that shipping banks should re-appraise their margin policy and / or the timing of their loans. The above adverse conditions for banks do present huge opportunities for PEFs to make further inroads into ship finance and equity over the next years.

A recent example of how PEFs have learned from previous errors is the absence of support for fresh newbuilding orders. Having been accused of fueling the excessive dry bulk newbuilding program over the last decade, it is interesting to observe a new note of caution and constraint. In so doing, coupled by the dearth of new orders by shipping companies, the recovery prospects for dry bulk (as well as most other affected sectors) have improved.

Shipping conditions over the last years have not supported a high borrowing cost in the region of 8% - 10% per annum. Coupled with the lack of traditional bank lending at levels in the 2.5% - 4% margin level, further investments in shipping would rely increasingly not on long-term income generating investment models associated with newbuildings but increasingly on short-term investment, involving existing tonnage.

The laws of economics and the forces of demand and supply are affecting the shipping industry and the prospects of an equilibrium for a sustained recovery over the next few years. No one can discuss, however, investment exuberance returning at some stage but as long as banks are shedding both loans and distress vessels and such vessels are being picked up by owners (often supported by PEFs), the prospects both for the shipping industry and for the PEFs themselves appears positive.