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Joint Venture finance

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Joint ventures between companies in the developed world and in the developing world are being mooted as a prime means of satisfying the maritime aspirations of the Third World (and resisting pressures from Unctad). A major obstacle to the establishment of joint ventures, however, is the availability of finance.

Mr. Ted Petropoulos, Head of Transportation, Energy and Project Finance at the Algemene Bank Nederland, enumerated the criteria banks would use to evaluate such proposals at a conference entitled 'Maritime Joint Ventures', held in May and jointly organised by Lloyd's of London Press and the International Chamber of Commerce. Mr Petropoulos admitted that, at present, Joint Venture finance comprised a minute proportion of banks' shipping portfolios.

The first consideration to a lender is: to whom are we lending? Banks believe that they are primarily financing ship owners rather than vessels and look into an owner's management, operating experience, track record, reputation, fleet diversification, employment position, policy and, last and currently most important, liquidity prior to examining the terms of a specific proposal.

With a Joint Venture **(JV)** client, a bank has to critically assess not only the two or more parties involved separately using the above mentioned criteria but also to critically examine the JV itself.

These points would be covered:

- *The JV's track record (if any).*
- *The clarity of objectives and scope of the JV.*
- *The nature of the JV, i.e. north/south, north/north, south/south.*
- *The ownership split of JV.*
- *The relative strengths and weaknesses of each partner and what they each bring into the JV.*
- *The existence of a clear demarcation of responsibilities, what constitutes major collective decisions, the complementarily and working rapport of the partners and the establishment of mechanisms for the settlement of disputes.*
- *The relative commitment of each partner to the JV, i.e. management, operational and financial support.*

- *The legal and management structure of the JV as well as physical location of the JV's management and its partners. Is there a separate JV management responsible for the JV? Are its members drawn from the partners or hired from outside?*
- *The strength of the financial base of the JV and its access to additional equity funds plus adequate financial auditing controls.*
- *The effect, if any, political/governmental policy changes may have on the ability/willingness of either party to fulfil its obligations — the potential instability factor.*
- *The probability of survival of the JV at least as long as the term of the finance involved.*
- *The partners' knowledge of the home country market (the market in which the JV will operate).*
- *The effect of cargo preference allocations, low bunker prices, berth preferences, subsidies etc. on costs and revenues.*

How are JVs being approached in general

Banks are aware that JVs often fail and their loans are adversely affected, not because of the market and security consideration, but more due to the imperfect set-up of the JV itself. Specifically, a JV often lacks its own relatively independent management.

Often the temptation is to allocate one person from each JV partner to represent the interests of the partners and to co-ordinate work performed by each partner's established organisation. It is important to have a JV management, committed to the JV and controlling such work performed by each partner outside the JV management itself.

Often, the partners themselves have not established the working rapport and mutual respect required to succeed. Grey areas of responsibility and potential conflict exist and insufficient effort is made to fully understand each other's decision-making and working modes.

What is required?

A strong financial base is required to enhance the JV's survival, especially when there is insufficient additional commitment to the JV by the partners who may consider that the JV should stand or fall on its own.

An overall bank assessment of the quality, financial strength and survivability merits and drawbacks of the finance itself. This requires considerable time, effort and keen judgement. In many important areas, the bank is likely to be unable to make a judgement until a JV is seen in operation. Many banks feel hesitant to fully commit themselves until the JV can be seen to be working smoothly for an initial period.

The next step has to do with the analysis of the loan proposal itself.

Financial details

Firstly, we look into the JV's prepared cash flow and check out the reasonableness of the assumptions used, i.e. projected earnings in line with forecasted demand/supply for the sector, operating and interest expenses, working days per year etc.

The ability of the project to withstand major changes in the above variables is tested by a sensitivity analysis. Even where vessel employment has been assured at fixed rates, the lender will do a market analysis to determine the degree of reliance of the project on such fixed employment in case the JV were to fail and the vessel had to be redeployed elsewhere.

It is to be expected that JV finance proposals will display favourable cash flow characteristics since the employment factor is often the underlying reason behind the formation of a JV. Bankers, however, become uncomfortable where JV-obtained rates are significantly higher than market rates and a high percentage finance is requested in line with such high rates.

Types of vessels involved in a JV

Secondly, the vessel or vessels are considered from the collateral point of view. Collateral desirability and value depend on the following factors:

Type of vessel

The more specialised and sophisticated a vessel is, the smaller its relative market will be from the sale and purchase, employment and number of participants aspects. As such, for specialised vessels, in good markets substantial premiums may be paid to secure such vessels, especially if needed for a specific project.

In depressed times, however, sale prices have to drop to extremely low levels to attract one of the few potential buyers/users of such vessels. The latter is very important to banks since it would be under such depressed conditions that asset disposals often take place.

In addition, market valuations for such vessels vary considerably between valuers, with banks always having to take the lower valuations to be on the safe side.

Banks also assess the probability that a particular type of vessel may fall out of market favour.

All types of vessels could be involved in a JV although usually, developing nations have a preference to general cargo vessels for their main import/export requirements and tend to avoid (unless a specific project requires) very sophisticated expensive vessels

suitable for specific trades and requiring highly competent management/crew abilities as well as expensive maintenance.

Age of vessel

Young vessels provide banks and owners more flexibility in tackling problems as they arise. This has become acutely apparent during the current shipping recession. Hence, most financial institutions limit the age of the vessels they finance to current age plus the term of the loan, not exceeding 15 years.

However, certain vessels, e.g. passenger liners, with adequate maintenance do enjoy a considerably longer useful lifespan than the 20 years assumed on average.

Newbuilding finance is often arranged on a subsidised credit basis by a specialised ship mortgage and export credit institutions. As such, international commercial banks are less likely to be involved in the provision of finance.

However, due to the frequent shipping slumps, ship yard credits have often required that a percentage of the amount be covered on a second mortgage basis by bank guarantees.

It is the young second hand vessel finance requirement that international commercial banks cover and this forms the major share of their shipping exposure.

One of the main advantages of JVs, under present market conditions, is the relative inexpensiveness of second hand vessels as opposed to newbuildings. This has reduced the cost of entry into the shipping market by developing nations which often lack the necessary capital resources to commit to a newbuilding programme. This is partly offset by the subsidised, often "all on credit" newbuilding schemes offered directly to developing nations by "order hungry" shipyards at present.

On balance though, the second hand route is preferable from the cost and other benefits point of view to a newbuilding based entry or expansion in the market.

Country of registration/crewing

Country of registration is often the biggest obstacle to be overcome by commercial banks in financing JVs.

Most developing countries lack a well established maritime tradition, policy or legal framework and experience.

A bank’s security position is thus affected from the point of view of ranking and rapidity within which bank’s decisions can be legally implemented. Dual registration of vessels and permission to allow

local ownership of foreign flag vessels, can help overcome this problem.

Banks are also concerned with the competence of crews employed on the vessels and wish to be assured that the crew on board, irrespective of nationality, is up to standard. An insistence of one partner to utilise doubtful quality crew would be of concern.

Lastly, in this section, we must consider the problem of sovereign/country risk (also known as transfer risk or cross border risk). This is the risk to a loan, made in a freely convertible currency — dollar, sterling, deutschemark — normally at a major financial centre, to a borrower who is wholly or partly reliant on a local economy and/or generates local currency or foreign currency which must be repatriated to the local country and may require central bank permission to repay the loan.

As such, local market, political or foreign exchange problems may endanger a JV so that an otherwise healthy borrower cannot meet his obligations.

Other risks

Another element of risk may be in the difficulty encountered by a bank in successfully foreclosing in a country where one of the JV partners is of particular importance, e.g. state or state-controlled company etc., or in obtaining permission to remit/apply the foreclosure proceeds against the loan.

Banks look into the strategic and commercial importance of the JV to the sovereign risk country, to obtain an element of comfort where all or a large proportion of the loan is a sovereign risk.

All international commercial banks have country exposure limits and otherwise acceptable JVs may not be financed should they possess significant country risk exposure and that respective country risk limit is full. The third world debt crisis has increased this likelihood. The less poor country risk involved in a JV the easier it will be for a bank to provide finance. Innovation and flexibility in structuring the JV and its finance requirements are necessary.

Conclusions

It is clear that JV finance analysis is considerably more involved than the majority of shipping proposals a bank considers. The analysis requires additional time and cost to a bank which has to be reflected in the terms of the loan since considerable travel and numerous meetings with often geographically dispersed partners are involved. Following the granting of the loan, monitoring too is more time consuming and costly and should the JV be located where the bank has an inadequate presence, the bank will feel uneasy that the loan can be effectively monitored.

JVs involving at least one internationally experienced shipping group which may already be a customer of the bank will enhance the JV finance’s attractiveness and will positively affect all the bank lending criteria outlined earlier.

Often, the internationally established shipping group undertakes to prepare a feasibility study on a JV. In having more experience in banking relationships, such a group will be able to anticipate and cover a bank’s likely questions and difficulties.

In some instances, especially in JVs involving a high element of poor country risk, this partner will provide corporate guarantees or additional securities to the bank on a reducing basis to get the JV off the ground. Increasingly, though, as a result of mixed experiences with JVs, JV partners attempt to obtain finance based entirely on the financial and commercial strength of the JV rather than on partner support.

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