Capital: a blessing or a curse? A fresh look into capital in the light of renewed interest by Greek shipping companies into the US .

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In a shipping venture, capital represents the monetary contribution of shareholders and represents a liability towards shareholders by the company involved.

The other major liability of a shipowning company is towards a bank if it has borrowed funds in the form of a bank loan. Bank debt is normally secured by a first preferred mortgage as well as various other assignments and guarantees. As such, in the allocation of funds generated from the vessel's operations over time as well as from its sale or loss (via insurance proceeds), bank debt has to be satisfied first and in accordance with the loan agreement before shareholders can receive either dividends or their capital back.

The above two forms of liability represent the near total of a company's total liabilities. There are, of course, some liabilities to creditors, crew, etc. but these are usually of relatively small amounts and generated in the course of trading of a vessel. In most cases these trade related liabilities are unsecured and rank behind the bank but ahead of capital. Crew related liabilities, however, do have a certain priority often ranking ahead of a bank through the rights of a crew in possession.

The cost of capital

Let me explain straightforward that capital is very expensive. Despite a popular misconception that capital is passive and costs little, the truth is that entrepreneurial capital is very expensive. The higher the envisaged risk of an investment the higher the anticipated return needed to attract capital.

Whereas in manufacturing returns of 5-10% per annum on capital employed may well be attractive in the long run, in shipping, due to the cyclical nature of the industry and inherent risks, the required envisaged returns are considerably higher and would normally be between 15-25% per annum.

The level of returns required to justify shareholders does vary from time to time. It is influenced by the type, age and prospects of the vessel involved. It is also influenced by the timing of the investment in the shipping cycle and the prospects over the next years and beyond. It is also affected by the presence of secure employment as well as the track record of an owner which although does not provide a guarantee as to future performance, it does, however, demonstrate how an owner has handled in the past market crises, employment decisions, as well as the timing of vessel purchase and sale decisions.

In an environment where bank loans can be secured for a cost of say about 4% p.a. today, owners would have an incentive to maximize on “cheap” bank debt and minimize on their own “expensive” equity. It is precisely this that shipowners have done for decades reaping huge returns when their investments end up positively. After all, if one could keep capital down to 10-20% of the whole investment and in some cases near zero, then all the profits would accrue to the owner that had committed little capital and would have enjoyed immense returns for his investment.

Should, of course, the investment have turned out badly in cases involving high leverage (high bank debt to equity) the result would be ship arrests, possible bankruptcies and, invariably, some losses to banks. It can be said, therefore, that where banks allow owners to over-leverage on their investments, they are unwittingly entering into the area of capital risk without though enjoying the high returns of shareholders if the investment would succeed.

Banks, therefore, have an incentive to minimize on their loans and stay close to what they perceive as being safe lending assuming market conditions would deteriorate and vessel values and earnings would fall. At the same time banks are in business to lend money and to enjoy all the ancillary benefits of a bank-client relationship. As such, they need to be competitive and not over-cautious to the point where their client would prefer a loan from another bank.

How much capital?

Traditionally, banks have lent between 50 to 80% of the value of a ship and most of the times between 65-70%. Without going into all the factors that would affect the percentage of lending that a bank would feel safe to lend, the key factors relate to

- *the quality of the borrower,*
- *the borrowers / Group’s financial position,*
- *the age, type and prospects of the vessel involved,*
- *the point along the shipping cycle and how do vessel values compare in relation to the long term averages,*
- *the prospects of the shipping sector / market, and*

- *the presence of secure employment,*
- *the availability of guarantees and / or other security.*

In an ideal world, the above factors would be considered rationally and a result would emerge. However, like everyone, banks too are affected more by the market today than the market of a few years ago or a possible market into the future.

Let me provide an example. A 5-year old, 73,000 DWT panamax was worth $17m in 2002 and $44m today. If a bank had lent 80% in 2003, i.e. $13.6m, the loan would have been reduced to say $9.5m 3 years later (i.e. today) and would represent a debt / value of only 22% today. One could argue that a safe loan of 65% today for a young panamax, i.e. $28.6m is historically extremely high. Owners, however, would argue that earnings today are a multiple of what they were in 2002 ($37,000 versus $8,000 for a 1-year t/c) and, hence, their inherent risk (and that of the bank) is not higher. They would also argue that on the demand side, China should continue to support shipping for many years to come. Even the high newbuilding prices and absence of newbuilding slots until well into 2008 with only a couple of good years trading their risk would be reduced to very low levels, even by historical standards.

Where there are quality period charters, banks can support the above argument and lend even higher percentages. Where owners, however, do not wish to commit to period charters, being lured by even higher spot market freight rates, then the risk shifts from the owner to the bank and the bank would justifiably provide a reduced loan, thus calling for greater capital by the owner.

Owners could justify the higher capital by considering the enhanced returns to be secured by spot trading.

In conclusion, therefore, we can deduce that capital acts as a safety cushion for banks. The presence of adequate amounts of capital makes loans “all weather” and renders loans as well as investments safer even in adverse conditions.

Owners seeking to maximize long term returns should commit sufficient capital not only to satisfy the banks but also to ensure their investment survives.

Alas, the temptation of high returns on a minuscule capital are too great and are particularly in force today when vessel values are near their all time highs and the risks of a market fall even greater.

Today’s capital paradox

One would expect that raising capital to be injected into shipping ought to be easier during a shipping slump than at the top of the market as the recovery prospects would, by definition, be higher. Historically, the reverse would apply. In conditions of a shipping

slump, few capital providers have the appetite to buy greater shipping risk as the prospects appear in the short term quite dull. On the contrary, when the market is riding high, owners can put forward a very attractive case of rising values and freights and high capital returns. On the basis, therefore, of the past, they are able to entice easily impressionable providers of funds lacking the shipping knowledge and experience to see markets as they truly are.

The US market has enormous capital resources. Institutions managing capital funds, generated by a variety of pension funds, investment funds and private monies, need badly companies into which to invest. There is simply too much money chasing too few investments.

In addition, there is a whole investment banking industry geared for "packaging" these new investments, i.e. making them presentable.

What does this mean in practice. It means US style GAAP accounting, a story, some period employment (though not always necessary), credit agency ratings, due diligence road shows and off we go! It also means a cost of $5 to 10m but it all comes out of the capital being raised anyway.

At times of plenty with exuberance guiding the pocket one even gets 'blind' investments whereby there is no specific commitment as to what type of assets would be bought.

Often the new public company consists of a few old vessels and a short history. Is this enough? Should it be enough?

Shipping investments like all other investments have rules and ignoring a basic rule such as not over-investing at market highs is risky. Let me make it clear that for owners going "public" it is a major exercise and if they get it right would propel them to the big time. Once public, the future is open and it is possible that they may even make it in the longer term and indeed become the exception to the rule. My concern is for the investors who are investing into such "public companies" in an industry at its highs where the risk/rewards are not particularly attractive.

Even if these investments involving a great deal of equity do not go belly up, investors do face prolonged periods of low or even negative returns. As such, one way or another they risk not obtaining the rewards they feel should be made out of investing in a shipping public company.

Cynics may say what does it matter if a few US institutions and / or private investors get it wrong. The answer, though, is that it does. Greek shipping needs the public markets to raise capital continuously and consistently and not only opportunistically. Greek shipping failures would only increase the required capital returns needed to attract capital into shipping for other shipping companies

with a more long-term attitude to investment and respecting private shareholders.

For Greek shipping to continue to grow and raise the vast capital required to compete as a world class leader it is necessary to treat markets and shareholders with respect. Unless we see a number of prominent Greek owners approaching the US markets with sound prospectuses, the current flirtation between Greek shipping and the US markets is likely to turn into a repeat of the junk bonds disaster of about 5 years ago.

In conclusion, capital is necessary to cushion and protect the inherent risks of a cyclical industry such as shipping and by reducing it an investor multiplies the risks involved and courts a financial disaster. At the same time too much capital makes an investment inefficient, the likely returns for shareholders low and the shipping company involved lazy and slow.

Striking the right balance for a private or public company shareholder is not easy. However, investment analysis using historical and future prospects can assist in quantifying the risks involved and striking a better balance.

Private investors should treat this latest shipping “gold rush” with caution and look for safety and survivability first rather than fantasizing about mythical returns should the market stay as today’s for the considerable future.

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