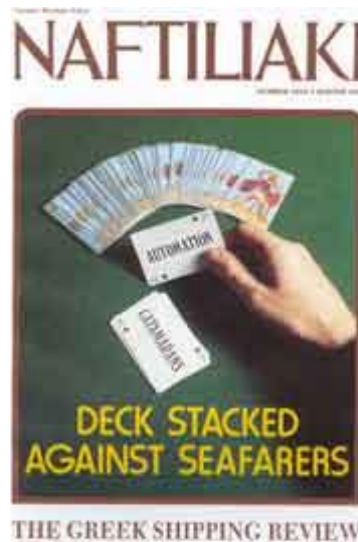
Reducing the Pain of a Credit Squeeze

Winter 1990



Ted Petropoulos takes a closer look at the Banker / Shipowner relationship at a time when problems are looming for both sides, and he offers some recommendations on how to steer clear of divorce. Mr. Petropoulos is Joint Managing Director of Piraeus-based PETROFIN, which offers a comprehensive range of financial, advisory and management related products and services.

The shipping industry is capital intensive and requires the provision of long-term credit by Banks to secure and maintain the world fleet, as well as, the provisions of working capital finance by Banks and other industry participants such as suppliers of goods and services.

It is a characteristic of the industry that the credit made available is reduced during a declining shipping market. Thus, at a time when vessel values fall and most importantly, their net earning power is dramatically reduced, the industry faces a credit contraction, which further exacerbates its financial difficulties.

At the same time, fresh capital for the industry from new public issues, investment schemes and other private sources dry up, since adverse short-term investment considerations outweigh attractive longer term ones.

As such, there is a forthcoming credit squeeze. However, the key questions that must be addressed are: a) how severe will such a

credit squeeze be this time around, and b) what step can be taken by shipowning interests to lighten the impact of such a credit squeeze.

The International Situation

To answer the above questions, we must begin by looking at the international picture. There are a number of factors, which point to a particularly negative underlying position. There can be no doubt that the world has entered into a recession due in part to the political, economic and investment uncertainty and higher oil prices as a result of the Gulf crisis. We have observed the classic early signs, e.g. declining US auto production, increased lay-offs and unemployment, slowdown in corporate earnings, calls for reduced interest rates, erosion of business confidence, slowdown in new investments, stock market falls etc.

In addition to the usual factors and the effects of the Gulf crisis, there are, however, certain additional important factors that have to be taken into account.

Firstly, the world's economic growth powerhouse that has been the Far East economies in general, and Japan in particular, are slowing down. In addition, cracks have begun to appear in Japan's well-lubricated and confident economy, underlying the loss of confidence by Japanese industrialists and the Banks.

Secondly, the world's banking system is going through a particularly severe liquidity and profitability crisis. In addition to the problems of third world debt and energy, commercial Banks have problems in the traditional growth areas, such as property and consumer lending. Furthermore, there are huge debts by industries such, aviation and shipping and the high risks involving junk bonds and leveraged buy outs (LBOs).

Furthermore, commercial Banks have to increase their share capital as a percentage of total liabilities in accordance with the "Cook Recommendations" at a time when their share prices and profits are depressed and the cost of such an exercise is high in terms of equity dilution.

As a result of the above, Banks will have no choice but to reduce their balance sheets though a reduction in lending and other liabilities. This reduction, which has already commenced by US Banks is being extended to European Banks. Most hard affected, however, are expected to be the Japanese Banks, which have tended to over-expand on the back on an ebullient economy, unrealized stock market and property appreciation profits both of which have gone into reverse.

As always, there will be an overreaction in terms of credit contraction until equilibrium is reached or until the international economic and political picture changes.

In conclusion, the underlying economic, political and Bank conditions are negative and undermine the attitude of commercial Banks towards shipping. In particular, the negative banking factors are more significant this time than those prevailing during the 1980's. Whereas the 1980's were marked by the market withdrawal of one or two big US Banks, such as, CONTINENTAL, the 1990's will see the initial retrenchment of most commercial Banks.

Banks' attitudes

Having established the above negative factors, it is important to examine the current and envisaged attitude of shipping Banks. On the positive side, the Banks involved in shipping and their personnel are more experienced and able to cope with a shipping downturn. The lessons of the last shipping crisis are still fresh in their minds and their attitude so fas has been one of caution, concern but not of over-reaction.

As such, it is likely that the management of shipping Banks, branches or departments will be supportive of the industry and resist pressure from "the top", which may call for a quicker and more drastic action in case of non-performing loans. Already the drop in values has alerted Banks to a deteriorating asset cover position for most shipping portfolios but most believe that such facts may have been overdone and where the underlying assets are of good age and quality, Banks will adopt a more patient approach. At present, Banks are experiencing the first repercussions of their clients', tighter cash flows in the form of requests for loan repayment restructures. Banks resist such requests for obvious reasons. However, when faced with a good and co-operative client, who provides full information and has no alternative means (assets) of meeting the original loan repayment terms, it is difficult not to appreciate that market conditions have changed. The alternative way forward would be to insist on vessel disposals but in view of the illiquidity of the sale and purchase market and falling values this is not a realistic alternative, unless there are deeper concerns or difficulties in the Bank / client relationship.

Thus far most Banks have reacted with an understanding of their clients' problems but have firmed lending criteria for new business especially where it involves a new client. As a result, Banks have unwittingly added to the illiquidity of the S&P market by tighter lending criteria. This has had a more appreciable effect in the market for older vessels, where concern about vessel employment and falling scrap prices have added to the reluctance of Banks to provide finance.

The situation of drifting vessel values, employment opportunities and freight rates will continue until either: a) a major reversal occurs in the international scene, which affects the demand for shipping; or b) the supply of tonnage decreases through scrapping and lay up; or c) the industry attracts additional capital investment and/or Bank financial support. None of the above appears imminent but unpredictability has always been a feature of the shipping industry and for most owners and Banks staying in the market without serious upheavals, ensures a position to enjoy a market upturn.

The shipping industry has a weak financial structure in that capital has always been scarce and equity too little in relation to borrowings.

How is shipping faring then?

Shipping has tended not to attract wide investment support, the stock markets have been "fair weather" friends and private investments has been restricted, except for K/S tax driven interests. As such, the industry has produced a wildly fluctuating investment and banking profile, which has estranged numerous Banks that had entered the market without the necessary expertise in previous periods.

At present, even though shipping is highly leveraged, most prudent owners are entering the recession with more liquidity than at the same stage in the early 1980's, having in part anticipated the current market situation.

In addition, most owners too, have adapted their strategies to ensure maximum staying power and to develop policies that ensure the support of their Banks.

In short, to survive, both owners and Banks need to help each other in order to weather the forthcoming crisis until such time as the picture brightens. To do so, owners must plan for, anticipate and address at an early stage the cash flow and overall financial effects of a weakening market. Survivability can be tested through a sensitivity analysis using time, freight rates, employment efficiency, interest costs, initial and developing liquidity, ability of Bank and market credit and unforeseen contingency factors. Strategic decisions involving asset disposals, period employment, cost rationalization, loan extensions and additional capital must be taken or contingency planning made at an early stage. Where possible, owners should concentrate on their core businesses and weed out (even at a loss) all investments, which have negative or under performing cash flow characteristics since the whole world is experiencing a new bout of "cash is king"! Where owners have non-shipping activities and assets, it is important to consider some liquidation of such assets in order to bolster the resources available to shipping.

One major factor to stress bust be the need to keep Banks constantly advised of decisions and developments since Banks feel comfortable and supportive to owners that have a clearly laid out strategic plan, the ability to deal with contingencies, as well as, keep them fully informed. Where Banks have confidence in their clients and their ability to survive without the Banks entering into undue risks and exposures, it is those clients that will survive with their position largely intact and should be in a place to take advantage of the undoubted investment and market opportunities that will present themselves in the forthcoming period.

With every fall in vessel values, the industry's risk/reward investment profile improves and already certain shipping sectors have begun to represent much better value for money.

Despite the current bearish attitude, the shipping industry's longer-term economic fundamentals remain positive and will once again assert themselves. The fleet is aging; its replacement cost is enormous and freight rates must rise in the longer term to warrant economically viable new shipping investments. In the classic shipping mode, the rapidly deteriorating current position is laying the foundations to a realistic market in 2-3 years by which time the world economic outlook should have improved.

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