Lloyd's List Events

Sale & Purchase of New & Second Hand Tonnage Seminar

PIRAEUS

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Alternative Sources of financing the Purchase

presented by

Ted Petropoulos

MD

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Topics

- **Trends in international ship finance**
- **Financial insurance products**
- **Shipping Venture Funds**
- **Shipping Tax Driven Investment Schemes**
- **Bareboat hire purchase**
- **Deferred credit and charter back deals**
- **Alternative sources of finance for the smaller Owner**

Trends in International Shipping and Shipfinance

- **The world economic situation is, at the moment, quite unstable**
- **The imminent Iraqi war is negatively affecting stock markets, the dollar, oil prices, consumer and business confidence and immediate economic prospects**
- **Shipping, however, has not been affected and confidence is still going strong**
- **Shipping is anticipating a strong economic revival post-war in the near future (2003-2004)**
- **This is evidenced by the rising vessel prices and the relative ease with which charterers offer t/c backs for 1 –2 to 5 years**

- **Demand for shipping is continuing to rise, especially in the Pacific. We could predict that this growth will be accelerated by the middle of the year.**

- **Demand for bulk is forecast to grow around 3.5% *(Martin Stopford – 2003)* - always on the assumption that there is some background scrapping.**

- **In terms of tonnage supply and demand we note from *Clarkson's* that the orderbook for bulkers is down to 11%, tankers at 20% reflecting the demand for double-hulls, containers down to 20% , which is relatively low for this sector.**

- **We note, therefore, that deliveries are waning and the balance is being tilted in favour of shipping.**

Trends in International Shipping and Shipfinance

- **Low interest rates are an enormous benefit / bonus to shipping, which is a capital intensive industry.**
- **Shipping banks continue to show their confidence in shipping through higher shiplending limits**
- **Emphasis on young, well managed assets, backed by period employment, continues**
- **Clear preference towards corporate clients**
- **Low interest rates, secure employment and positive prospects have lifted loans to asset value terms from 65-70% to 70-75%**
- **Low interest rates allow for higher shipfinance loan yields**

Financial Insurance Products

- ✓ **Shipmortgage Indemnity Products (top-up)**
- ✓ **Credit enhancement insurance products**
- ✓ **Residual Value Insurance**

Provided by specialised insurance brokers (MFR (Heath Lambert), Centre, Rattner Mackenzie) in conjunction with selected banks

Financial Insurance Products

- ✓ Applicable for new and second-hand vessels
- ✓ Insurance covers risk of loss caused by borrower's inability / default up to a certain amount
- ✓ Insurance normally up to 7 years
- ✓ Insurance guarantee may raise loan-to-value up to 85% or higher
- ✓ Indemnity usually up to $10m per vessel or $50m per risk

Financial Insurance Products

- ✓ Insurers work with selected banks to offer joint finance to the borrower
- ✓ Client of the insurer is the bank and not the client
- ✓ High “due diligence” requirements
- ✓ Costs vary but for a 5-7 year loan involving a 15-20% top-up range between 20 to 30 basis points per annum on the whole loan for the applicable period
- ✓ Scheme replaces need for mezzanine finance
- ✓ Non-refundable fees

Financial Insurance Products

Example

- ✓ Product carrier worth $37m
- ✓ Bank willing to finance up to 65% or $24.05m
- ✓ Insurance indemnity up to 85% or $31.45m by providing a $7.4m indemnity over 7 years
- ✓ Single premium of 7% or $518,000. Assuming an average loan during the 7-year period of $24m the indemnity costs 31 basis points on the whole loan amount
- ✓ Policy covers loss up to $7.4m during the period
- ✓ Policy pays upon liquidation of loan the bank's loss up to the insured amount

Financial Insurance Products

- ***Pros***
- **Relatively inexpensive**
- **Fixed premium / cost**
- **No equity risks**
- **Does not require other security**
- **Standard product documentation**

Cons

- **Scrutinization**
- **Selectivity**
- **Limits potential banks**
- **Under extreme circumstances may encourage lenders to call in a loan secured by policy, thus eradicating owner's equity / involvement**

Shipping Investment Funds

- ***Low interest rates and low stock market indices have caused restlessness among investors.***
- ***There is a lot of money that is waiting to be invested and it has been accumulating since the rapid drop in interest rates started over a year ago***
- ***A change in attitude towards shipping is noted as shipping shows solid performance and good prospects in these difficult times***

Shipping Investment Funds

Venture Capital Funds including Mezzanine Finance

Examples:

- ***DVB / NNI (NFC Shipping Funds I+II)***
- ***AMA***
- ***Tufton Oceanic***
- ***Great Circle Capital***
- ***Fortis (Maas Capital) backed by NIB/GATX)***
- ***Citicorp***
- ***Astrolabe (shelved)***

Shipping Investment Funds

Venture Capital Funds including Mezzanine Finance

The Funds' point of view

- Lower returns can be accommodated if there is relative project stability
- Shipping is still not that attractive due to its inherent cyclicality
- The vessel, however, is a real asset
- If there is a floor and cap in the transaction returns then it is more attractive
- Fund Investors can be willing to accept some of the downside if there is a share in the upside too

Shipping Investment Funds

Venture Capital Funds including Mezzanine Finance

From a Shipowner's point of view

Cons

- Costs – 15 to 20% p.a. returns demanded by the fund (mezzanine 10-15%)
- Although not set on stone – employment helps
- For mezzanine: higher breakeven costs for project
- Profit sharing. For mezzanine: equity kickers
- Time intensive
- Intense structuring required

Pros

- gets the deal done
- more investments made possible
- develops relationships between institutional bodies and owners for future mutual advantage

Shipping Tax Driven Investment Schemes

Types:

- ***KG – Germany***
- ***GIE – France***
- ***KS - Norway***
- ***CV – Netherlands***
- ***UK Tax Lease***

A good source of analysis of the above schemes can be found in *Marine Money – February 2003*

Shipping Tax Driven Investment Schemes

The KG German system

- **This pool of funds has been exploited by shipowners since 1995**
- **An impressive $8bn of equity has been raised since then for investments into vessels which together with the usual 60% of bank finance amounts to $20bn in total investment in shipping.**
- **Despite reduced tax benefits, KG still attractive to investors**

Shipping Tax Driven Investment Schemes

GIE – Groupement Interet Economique – France

This is a scheme that is considered by the tax authorities on a project-by-project

French tax authorities are aware of foreign shipowners who look for tax-free or low-tax projects

Shipping Tax Driven Investment Schemes

The KS Norwegian system

- **Severe drop in projects since the early 1990s due to tax law changes and bad shipping markets**
- **Deals have been flowing in again the last few years**
- **Prospects are considered good for the forthcoming years**
- **A KS transaction can be put together quickly and sometimes involve less than 5 investors, identified by a small shipowner.**

Shipping Tax Driven Investment Schemes

The CV system - Netherlands

This is another system that lost its popularity after tax law reform since the year 2000.

Again, coupled with a low in the shipping cycle, investors' interest waned

The recent introduction of the tonnage tax allowed an in principle tax-free dividend.

Plans are to make it attractive again, like the year 2000 when it peaked with approx. $200m invested.

Shipping Tax Driven Investment Schemes

Tax Lease - UK

The UK is the biggest leasing market in Europe (current annual volume: $5.5bn

Ships account for 50-60% of the above equity investment

Tax benefits are derived from the availability of 25% p.a. 'Writing Down Allowance'

Ocean going vessels can be depreciated by 25% rather than 6% p.a.

Bareboat Hire Purchase

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- **Not a widely used method**
- **B/b entails:**

✓«Leasing out» of a vessel normally by a large/sophisticated corporate shipping company, who thoroughly vets the proposed b/b charterer

✓Obligation to buy at the end of the bareboat period

✓Bareboat hire is paid out in monthly in advance and it includes interest at predetermined rates

✓A residual amount is normally left at the end of the bareboat period, which is well short of the vessel's residual trading life

Bareboat Hire Purchase

- ✓ **The b/b manager manages the vessel taking full responsibility for its performance**
- ✓ **Owner has right to inspect vessel throughout the b/b period and ensure proper maintenance**
- ✓ **Insurance terms and quality specifically set/approved by owner at cost of b/b charterer**
- ✓ **Vessel price normally higher than market value by 5-10%**

Bareboat Hire Purchase

- ✓ **The bareboat charterers will incorporate the interest in the whole amount which needs to be worked out as there is a tendency to inflate it. There have been cases where the interest was calculated at 15% p.a. but nowadays it is closer to 4-6% per annum or variable**

- ✓ **Down payment is normally less than the equivalent requested for bank finance, i.e. 15-20% of vessel's underlying price**

- ✓ **Documentation is based normally on a Barecon A or other Bareboat agreements adjusted to reflect the individuality of the transaction**

Bareboat Hire Purchase

✓ The option to purchase at any point during the bareboat term can be negotiated. This means that the vessel can be bought off at any suitable moment.

✓ As bareboat schemes increase the fleet and vessels thus acquired tend to be of younger and more bank-acceptable age, there is the possibility that the owner may be rendered financeable and, thus, obtain bank finance in due course in order to repay the residual. The ability to manage the vessel will have already been proven to the Bank

Bareboat Hire Purchase

Important!

✓ **Bbhp's are more likely during periods of market slackness when sellers cannot achieve their sales at prices they have selected.**

✓ **Bbhp has been often used by banks seeking to recover their loan exposure after foreclosure whilst keeping "ownership" of the vessel(s)**

Deferred Credit and charter back deals

- ✓ **Where buyer is unable to raise sufficient finance, sellers are often induced to offer deferred credit terms of up to 1, sometimes 2 years, in return of a) achieving the sale and b) a higher price**

- ✓ **Deferred credit can be more elegantly structured through charter-back deals, whereby the deferred credit is reapid via approximately lower charter-back rates**

- ✓ **Deferred credits for the benefit of the buyer have higher interest costs**

- ✓ **Deferred credits for the benefit of the seller is achieving a higher sale price than market value, usually have lo or no interest costs**

Loan Transfer

- ✓This involves the substitution of one owner for another utilising the same bank.
- ✓It does, however, still call for new loan documentation and credit approval

Loan Transfer

Advantages

- ✓**Facilitates a vessel's sale by a seller and its purchase by a buyer**
- ✓**Since it does not involve an increase in loan exposure, bank approval can be easier to obtain**
- ✓**There is often a loan reduction as a bank sweetener**

Loan Transfer

Disadvantages

✓Full documentation cost which may be prohibitively high for a small loan residual transaction

✓Tends to be short-term and thus onerous for new owners

✓Seller may request a premium

✓Some banks require the continuance of personal guarantees of the sellers

Engine Manufacturers' Finance

Example: Caterpillar Finance Services

- ✓*Up to 75% of new vessel cost*
- ✓*Up to 75% of used vessel acquisition and conversion cost*
- ✓*Up to 12 years*
- ✓*Fixed or variable interest rate loans*
- ✓*Standard documentation and security including first preferred ship mortgage*
- ✓*Collateral vessels must have MAK or Caterpillar engines*
- ✓*Competitive pricing*

Overall Conclusions

- **A combination of a robust and promising shipping industry. low interest rates and a shift towards real investment assets have redefined the attractiveness of shipping investments**

- **In addition to classic ship mortgage lending, new financial and investment products and services are being provided by financial boutiques, venture capital funds, investment banks and special tax-driven schemes**

- **International and Private investors are being attracted into the shipping industry via shipping equity funds**

- **Mezzanine lending, Bareboat Hire Purchase and other forms of credits and structures have begun to re-appear as net operating incomes generated by vessels increase.**

Conclusions

- **Shipowners can no longer ignore the benefits of alternative sources of funding, especially as capital commitments towards newbuildings have increased**

- **The cost of alternative sources of finance have fallen whilst period employment opportunities have increased, thus opening an exploitation gap for many owners**

- **Lastly, for all the above alternative sources of finance or equity, a clear presentation with spelled out strategy, analysis and full credit and performance background of owner is a <u>must.</u>**