The impact of private equity in shipping; does this represent a threat to Greek Shipping?

By Ted Petropoulos

December 2014 – for Nafs

Head of Petrofin Research ©

It would assist readers if we split private equity into "institutional private equity" (IPE) and "private equity" (PE).

The latter (PE) has been a feature of the development of Greek shipping, especially after WW II. Many prominent Greek names commenced their shipping business on the basis of the support of a multitude of private investors. These were usually known to be management with family and / or common origin roots and some were among their management staff and at times supplier or associates.

The lure of "rags to riches" and the successful reputation that Greek shipping soon developed, led to an ever growing trend towards shipping PE. Especially in the last 10 – 15 years, many Greek industrial names diversified into shipping either via PE participations or by instigating their own shipping companies. As Greek shipping became more international, numerous non-Greeks also became private investors in Greek shipping. The development of Greek publicly quoted shipping companies also attracted PE into such companies, via share acquisitions, offering both anonymity and the ability to exit at will (subject to the prevailing share price).

Due to the confidentiality that prevails in PE, it is difficult to estimate the exact amount of PE capital generated over the years and outstanding today. Based on our experience and knowledge of private and public companies over the years, we would estimate the percentage of PE in Greek shipping to be approximately 15%-20% total capital.

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The development of IPE has been a relatively modern phenomenon. In the 1970's and 1980's, investment in shipping was seen as rather exotic and frowned upon by investment institutions.

Scandinavia and Northern Europe was an exception, as shipping companies were closed to institutions and banks and as such, investment in shipping became more common place. The development of KG and KS investment schemes assisted both PE and IPE, to develop in Germany and Scandinavia, whilst Holland, too, has examples of IPE, now well into their second decade.

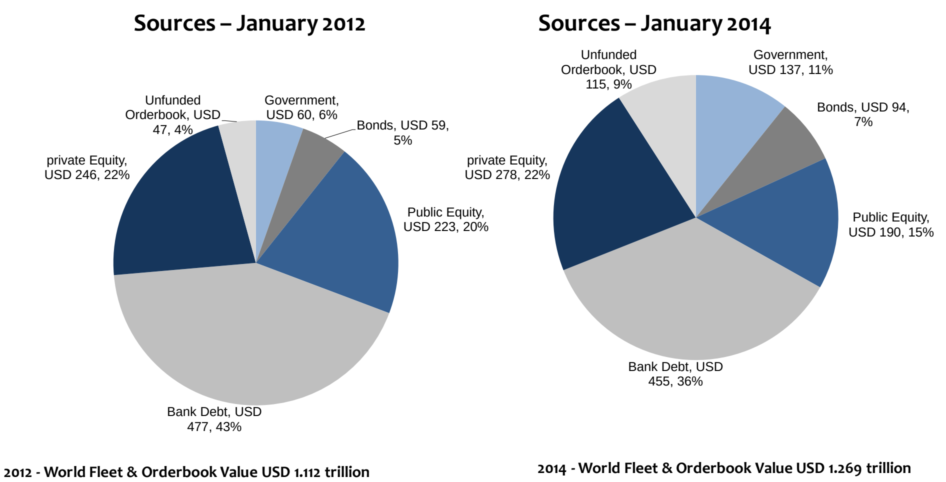
The "game changer" came with the development of US IPE. Following the financial crisis of 2008, the collapse of the interbank market, the de-leveraging by banks, quantitative easing and low deposit rates, a great exodus of liquidity was channeled into US IPEs. Such was the abundance of money that it became increasingly difficult to find attractive investments that offered a satisfactory mix of risk versus reward. Shipping caught the eye of an increasing number of major IPEs, many of which had participated in US listed shipping public companies i.e. Oaktree, Blackstone, York, Monarch and others.

There was, also, a crisis lead, rapid development of "distress funds". These are IPEs looking for distress situations that may arise either in bank's lending portfolios or in shipping companies.

In the last few years, the IPE phenomenon spread to outside the US, with separate institutions springing up in London, Germany, Norway and elsewhere. For the first time, similar interest appeared in the Far East, with Singapore, Hong Kong and other shipping centres developing a number of IPEs. In addition, leasing companies expanded their financing role by entering into shipping investments, if projects justified it. There has, also, been a resurgence of the "Norwegian investment model", with substantial IPEs being drawn to this market, with an emphasis in offshore shipping.

In Graph 1, you will see the changes that have taken place in the sources of funding from international shipping in only 2 years, 2012 and 2014. Bank debt declined from 43% to 36%, on account of the reduced appetite and ability to lend by shipping banks. Private equity (IPEs) maintained its share at 22% but the amounts involved grew from $246 bn to $278 bn. Interestingly, public equity funds fell from 20% to 15%, over the two-year period.

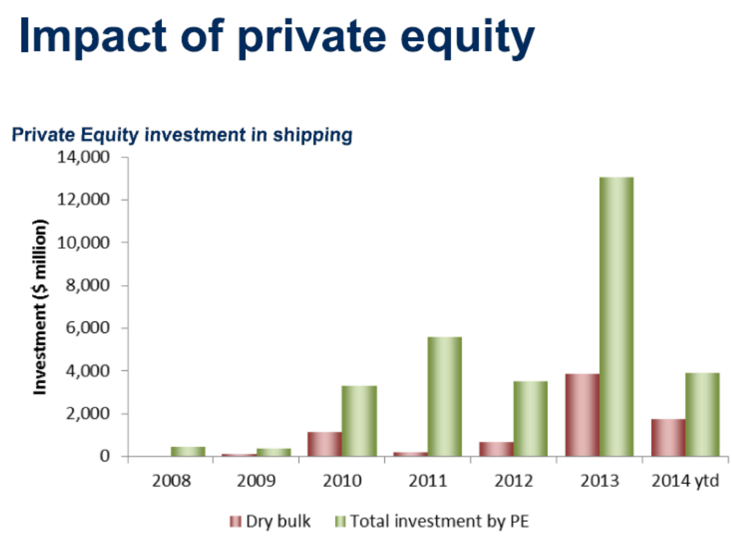
Graph 1



Source: Tufton Oceanic data

A clearer indication of the growth of IPEs is shown in Graph 2. You will observe the growth in total private equity investments. This is linked to IPE and not to PE, whose overall figures and annual investments are relatively unknown. With an unfunded order book of approx. $115 bn, there is room for substantial more investments by IPE providers.

Graph 2



Source: Drewry – November 2014

Although dry bulk shipping and the container sector have failed, as of today, to fulfil IPE expectations, other shipping sectors, such as tankers, appear more promising. As a consequence of the previously poor shipping market, there has been a slowdown in IPE shipping activity, in recent months. However, in the light of low vessel prices, interest in finding IPE has grown, as many owners consider investing at this time, as a relatively low risk and sufficiently attractive to take on board the complications of symbiosis with an IPE.

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Does the growth of IPE represent a threat to Greek Shipping?

Whilst both PE and IPE are looking to maximise investment returns, there are fundamental differences between them.

PE normally involves minority participations in the capital of vessels, whereas IPE normally takes a majority position. IPE wishes, thus, to control / strongly influence the investment and is more active than PE, which tends to be passive. IPE wishes to control the exit of the investment as well, via time deadlines for the sale of vessels or when minimum investment returns shall have been achieved. On occasion, where they are dissatisfied with the management's performance of the managers, IPE may appoint new managers.

IPE is, also, actively involved in the monitoring of an investment and willing, (as well as legally able) to terminate its involvement whenever it has reasons to do so.

PE tends to have a longer investment horizon than IPE and often would provide funds to all or most of an owner's projects. IPE, instead, is highly selective on the projects it wishes to invest in and will proceed only with those that strictly meet its exacting criteria, as to envisaged rates of return, quality of partner and timing.

IPE has no fundamental wish to be involved in shipping at all times and will do so only in the rare occasions it believes such involvement offers extremely attractive risk / reward ratio. PE, instead, tends to be more committed to shipping and to an owner over a longer timeframe.

IPE has the resources to add further amounts in an investment and, if necessary, to buy out a partner or an underlying bank loan. As such, its options are wider than those of PE.

PE tends to be more patient in awaiting for a market recovery, when an investment turns sour, whereas IPE, having a shorter investment horizon, may look for earlier exits to "cut its losses". Taking a loss is of an issue for IPE, as it relies on diversification.

Lastly, a key difference lies in the target investment returns sought by IPE. These are usually a minimum of 15% per annum and often targets over 20% per annum are sought. These are extremely high targets and can only be sought for relatively short-term opportunities, when an imminent market recovery is both expected and finally materialises. PE has less rigid expectations and tends to look for longer-term opportunities.

Needless to say that there are big differences in the approach and handling between IPEs and the same applies for PE. However, on the whole, the above characteristics are those that characterise the differences between PE and IPE.

Shipping is a highly volatile and cyclical industry. The long-term returns of shipping, based on academic studies, show an average long term return of closer to 5% over a timeframe of 20 years. This rate may change if the period covers prominent troughs or peaks.

Consequently, in order to make the minimum returns sought by IPE, an investment has to be initiated at the right point in the cycle. As all readers know, this is far from easy and there are often exogenous factors that affect shipping cycles.

Should IPE and PE get the timing of entry / exit right for each investment, then the results are expected to be very satisfactory. Should, however, the market fail to provide the envisaged recovery / rise, things become more complicated.

IPE, faced with the non-realisation of their targets, will need to adjust their strategy. This adjustment may be either to close out the investment or wait for a while longer for a better exit time or, possibly, add more investments at better vessel prices i.e. averaging down.

The danger to Greek shipping lies in IPE losing faith in the investment and wishing to sell the vessels in an already depressed market. Such a distress sale would not only add downward pressure to already low vessel prices but would result in the disposal of "Greek" vessels. Consequently, such forced sales would, also, largely eliminate the capital provided by Greek owners, together with IPE. To the extent that many Greek owners have funded their extensive vessel purchases and newbuildings with IPE, a forced sale by IPE would put a large part of Greek shipping in danger.

There is, however, also, a contrary view; namely, that many Greek owners may seek to exploit the above situation and buy out the IPE at what may well be advantageous prices.

Thus far, the disappointing dry bulk market has not resulted in a mass exodus of IPE from shipping. This situation may well change, should the market fail to pick up, in the next 1 – 2 years.

IPE in shipping is going through a fast learning curve. As such, it is expected that IPE will adjust its interest in shipping and further define the methodology it shall use. It is, also, possible that IPE will seek to consolidate its investments into a fewer number of “Greek owners”, based on its experience. Consequently, I do not regard IPE as “easy prey” in the event of a poor market, as it still holds most of the cards and has the capacity to take decisions to protect its interests.

For Greek owners, who have used OPM (other people’s money) and have realised their wish to grow via IPE, my comment is “be wary of what you wish for”.