A brief guide to shipfinancing options
for small to medium owners

By Ted Petropoulos
Head
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Readers will be aware of the phrase "to the victor belong the spoils". It was stated by Senator William Marcy in 1828. May I paraphrase it, though, and say that "in shipping, to the survivors belong the spoils"? In my view, the first and foremost aim for all owners, given the high volatility of ship values and freights, is to survive. Although the above applies to all owners, it is the small to medium dry bulk owners that face the greatest dangers, as their available options at raising capital are fewer. In accordance with the latest Petrofin Research ©, the number of Greek dry bulk owners, as of 2016, was 316.

The 2008 financial crisis, resulting in the collapse of dry bulk vessel prices, decimated cash flows and numerous bankrupt charterers, tested dry bulk shipping to the limit. It tested owners and banks alike and its aftermath is still being felt today.

Traditionally, a borrowing of, say, 50% on ship values has been viewed as relatively safe. However, even such safe borrowing, in the event of a radical drop in vessel values, will result in breaches in the loan to asset covenants prescribed under loan agreements. The ability to service the debt will also be impaired by falls in vessel earnings, often to levels as low as the running expenses, as was seen approximately 18 months ago.

The lower the leverage, the greater the available room for an owner before being forced to address covenant breaches with the banks. Moreover, the presence of substantial capital injected into the vessels would minimise both the extent of covenant breaches and the risks of bank foreclosure.

The absence of sufficient cash flow to meet the payment of loan interest and principal installments can be addressed by the availability of additional liquidity or access to fresh capital. Both a covenant breach and a loan service breach may also be overcome if an owner has access to unencumbered assets that can be provided to support either a loan restructure or a covenant breach waiver. The objective of the above would be to gain time and allow the opportunity for the market to recover.

Post the 2008 financial crisis, banks displayed great flexibility and permitted repayment restructures, aided by low interest rates. However, the banking climate has changed, due to regulatory pressure and capital adequacy restrictions, as well as losses with banks being less tolerant today. In addition, with so many commercial banks exiting shipfinance, owners' ability to restructure (without additional collateral) has virtually disappeared, as they have to provide for potential losses.

The third risk factor is that of the loan cost. Traditionally and upto 2008, bank margins were low, often under 1% for prime borrowers and 1% - 2% for most of the

small to medium owners. As a result of the 2008 financial and subsequent shipping crisis across most shipping sectors, as well as the increasing losses and provisions by banks, loan margins rose to 2% - 5.5%. The wide difference is due to the different risk credit rating of owners. These risk assessment models, which have been made tougher by regulatory authorities, have increased the minimum margins necessary to cover banks' capital adequacy requirements, as well as risk factors and processing / monitoring costs. As often is the case, it is small banks that offer loans to small to medium owners and the high margins reflect those banks' higher internal costs (as mentioned above), higher cost of obtaining deposits plus higher desired profit margins.

The fourth factor to identify is US Dollar interest rates. These, due primarily to QE (Quantative Easing), have been forced to be very low. Even though they have risen lately, as the US is trying to reduce its QE program, the cost is still a near historical low of 1 ½%, having fallen as low as 0.33% in 2014. These rates need to be compared to over 10% interest rates applicable in the early 1980's. The point to consider here is that there is little doubt that US Dollar interest rates are on the rise and, for shipping, this is bad news.

The most critical "survival" factor, therefore, is the availability of additional standby cash to smoothen out uneven cash flows and to demonstrate to banks prudency, commitment and ability to survive. In this way, banks will have an enhanced ability to support owners. Survival also depends on a low breakeven cost, as a result of low leverage and a low cost of borrowing.

As a result of the rapid exodus of western commercial banks from ship finance, owners are increasingly turning their attention to alternative financial sources. These, either provide a first mortgage finance of upto, say, 70% of a vessel's value or a "mezzanine" finance, covering the gap arising between a low commercial loan and the higher overall finance required. The cost (and risks) of such alternative loans is substantially higher and range from approximately 8% p.a. for, say, 50% finance to 12% - 15% for higher finance. The effect of such high cost and higher leverage is colossal to what is the key determinant of survival i.e. low breakeven. In order to partially offset such high breakeven, alternative finance providers often provide upto 2 years "interest only" loan repayments, with a 100% cash sweep (i.e. all net surplus earnings, if any, to be applied against the loan). Although, this factor helps to provide owners with an opportunity to survive, the cumulative higher cost of such expensive borrowing is enormous.

As a result, the chances of survival under such schemes are substantially less with the consequent loss of owners' capital. Only a strong / rising market would enable such loans to perform. A better structure would be for owners to pay, say, a lower cost of 7% - 8% per annum and provide some profit share to the lenders.

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Consequently, only in a rapidly rising dry bulk market with higher earnings would such high cost borrowings result in a "win – win" situation for both owners and lenders.

Alternatively, owners may wish to try some of the small new bank entrants to ship finance, who generally lend upto 40% -50% of vessel values at a cost of about 4% - 5%. This requires, though, a substantial injection of initial capital, some additional cash collateral and a long approval process.

Often, owners have no choice but to seek capital providers instead of loans in the form of private equity from friends and others or private equity funds. This may reduce an owner's "upside" but does provide a low breakeven and the ability to survive. Often, private capital would look for "exit" routes, say, in a couple of years, so as to maintain some control over the investment.

Another form of finance is leasing. Chinese and increasingly Japanese leasing companies have begun to look at ship leasing for western owners. Their interest is focused on medium to large owners but some smaller owners have also been successful. Leasing involves the lessor "acquiring" the vessel identified by an owner and leasing it back to the owner, having taken into account the owner's capital, which is often 25% - 35% of the initial acquisition price. The leases range from 5 – 10 years, depending on the vessel's age. The "implied" cost varies from 4% - 7%, depending on the leverage, size of the transaction and availability of corporate guarantees.

The advantage of this finance is that as long as an owner meets the lease payments, he / she can quietly enjoy the benefits of the vessel's performance. However, as the ownership of the vessel rests with the lessor, a missed payment would simply result in the lessor "taking over" the vessel and the initial capital committed by the lessee plus the payments upto the date of default being simply lost. Such leases often have obligations to buy at the end of the lease and are called bareboat hire purchase (BBHP).

To summarise, therefore, survival is best achieved by low or no leverage from low cost lenders, as well as the availability of spare cash liquidity. This was amply demonstrated in the period of 2008 – 2016, where dry bulk shipping produced poor cash flows able to cover only low leverages. It is something like the game of "hare and the tortoise". The hare risks its life. The tortoise slowly makes it to the finish line.