Leverage in shipping in the times of a pandemic: a blessing or a curse?

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"We're recovering, but to a different economy," Jerome Powell, the Federal Reserve Chairman, said few days ago during a virtual panel discussion at the European Central Bank's Forum on Central Banking.

The post-Covid-19 economy will require different management tools for each firm and will be characterized by volatility. The effects of the pandemic are widespread across the shipping industry. Crewing, technical, operations, finance, are some of the main aspects of shipping that are affected. In this article, we will concentrate on the effects of volatility upon shipping, focusing on the issue of leverage.

Leverage arises the moment that bank or other debt is obtained for the purchase of a vessel. If, for example, the purchase price of a vessel is $10m and the debt and capital used for its purchase are $5m respectively, then the leverage is 1. As the debt increases, so does the leverage. Leverage is usually measured at the ship-owning company level, which may also include additional capital, retained earnings etc. or at the consolidated Group level, in case of a number of ship-owning companies with a holding company comprising a Group.

As the use of debt is designed to increase the earnings per share of a company / Group, in the current uncertain climate, it is possible that debt is burdened by prospective losses. Until now, the way debt worked was that by reducing the required capital, even allowing for the borrowing costs, provided that there is net income above the cost of the loan capital, the earnings per share were expected to increase. In the event that the markets were strong, the use of leverage could result in very impressive earnings per share. That is, in the event of a strong market, the higher the leverage, the better. Even under conditions of a medium market, the use of a moderate leverage should enhance earnings per share. However, the volatility of shipping markets has an impact on what is deemed to be safe leverage levels in shipping.

Under strong market conditions, therefore, the use of controlled leverage is normally a blessing. The same, though, cannot be said in conditions of a poor or volatile market or when events unduly affect shipping income e.g. pandemic, breakdown, disputes etc. Under these conditions, the net cash flow of a vessel is insufficient to service the interest and the repayment of the loan.

In addition, banks often require that the expected income of a vessel or of a Group should be higher than the Group' obligation, i.e. operating and voyage expenses, loan debt service, dry-docking costs etc. If such expected income is below the Group's obligations then the bank may ask for additional security. Furthermore, the banks always require a minimum asset cover ratio, whereby the value of the asset should exceed the loan outstandings by, say, 120%, as a minimum, and 130% - 150% as a useful minimum average and this level is determined on a loan by loan basis.

It is easy, therefore, to imagine that a shipping venture may well run into trouble of either breaches of financial covenants and / or payment defaults, due to market volatility. Often, shipping companies experiencing cash flow problems are also pressed to reduce technical maintenance and / or allow the buildup of unpaid creditors, which may further jeopardise the survivability of a shipping entity and unsettle lenders.

This leads to the very important question of what may constitute a "safe" leverage in shipping and what measures may an owner take, to protect his / her shipping venture and ensure its survival during a pandemic.

Traditionally, safe lending at the ship-owning level is 50% - 60% of the vessel's value. Leverage of, say, 3 i.e. 75% is deemed very unsafe. The current "rule" is, for a standalone loan, that 50% is the starting point of a discussion with banks and this might rise in case of a period time charter that would underpin the cash flow or other supporting factors. Banks, also, require some cash collateral for "safety" and this is normally equivalent up to two loan installments. In order to obtain higher loans, additional security or the support of a strong parent company would be needed.

The above may constitute “safe” lending for banks but this does not mean that such loans may not experience difficulties in the Covid-19 era.

During the 2009 Lehman crisis and its aftermath, the global financial collapse led to a diminution of value for dry bulk vessels of 80% -90%. As such, the 50% model did not work during such extreme periods. Recently too, during the first phase of the pandemic, dry cargo charter rates collapsed and owners had to rely upon their cash reserves. Fortunately, the market, since then, picked up but our point is that relying on standard 50% - 60% finance does not necessarily constitute safe borrowing, from an owner’s point of view. In other words, what constitutes safe borrowing varies over time and is dependent on the shipping markets and any / all supportive factors and varies from borrower to borrower.

Debt needs not be bank debt only. It may involve bonds or other debt investments or leasing or sale and lease back (SLB) transactions with Funds or other non-bank lenders.

In order to protect their position, owners need to look into the following areas, which may individually and / or collectively add additional strength and would enhance their survival. It is very important for each owner to always run “what if” exercises and test the robustness of their financings.

These are as follows:

1. Maintain sufficient liquidity / working capital at company level. A liquidity of approximately 10% of the loan amount was thought to be sufficient but this has now increased to levels closer to 20%, due to market volatility caused by the pandemic. Such liquidity would cushion short term cash flow differences and would provide comfort both to owners and lenders.

2. Maintain additional liquidity at Group level. This would apply, in case of Groups. This liquidity would constitute a central cash reserve to support those vessels / loans that faced the biggest difficulties. During this period of uncertainty, it would be prudent to keep this Group level cash reserve freely available for use and not restricted.

3. Maintain, if possible, some period charter cover at individual or Group level, in order to absorb short term cash flow shocks. This is especially important during the Covid-19 economy as the different pandemic waves will create periodic cash flow shortfalls. Many shipping entities maintain minimum 50%, 60% or up to 100% chartering cover rules. A useful test that can be done, at frequent intervals, is to take away the chartered days income from the total obligations (opex, voyage, debt service and d/d etc.) and divide the resultant shortfall by the number of unfixed employment days. The result per vessel / per day could be seen against current and potentially lower income levels for the unfixed days by 20% and 40% off current levels. Such sensitivity tests would also guide an owner's chartering decisions, as to spot or period charters.

4. Hedge loan interest and, if applicable, foreign exchange exposure.

5. Ensure that there are some unsecured assets available for possible use or arrange stand by lines of credit that could be used if and when required.

6. Sound their shareholders for a possible capital increase or provision of emergency shareholders loans and arrange such in good time.

7. Contact early banks, if required, with a clear analysis and plan for the restructure of some loans. This must be seen as a last resort, as restructuring loans is not an easy matter and banks would wish to ensure that all other available solutions had been exhausted.

8. Sell assets. This is the hardest decision, especially as it would be needed at a time when vessel values would likely be depressed. Another way would be in return for a loan restructure to undertake to sell assets at a defined date in the future at a minimum price. Banks, too, do not favour such "sale" decisions, unless the ratio of vessel values to debts remains high or the loan(s) situation is truly precarious.

9. Invite additional capital from fresh shareholders. Once again, this is not a simple matter as such a move could result in a significant dilution of existing shareholders position. This could be considered if existing shareholders are not willing or cannot raise additional capital.

10. Sell and lease back shipping assets. This method has been used widely and does achieve either the creation of much needed liquidity or an extended repayment schedule. However, such solutions tend to carry higher costs that are shared over a longer period of time and can provide immediate solutions to hard pressed companies.

There are many other variations and ways to overcome a temporary liquidity problem. However, should a shipping crisis like this pandemic last, then the result may well be that shipping companies only survive at the mercy of their lenders until a recovery takes place, at which point the lenders may seek to liquidate such loans.

The rapid emergence of Funds that provide equity or loans at high cost has been a notable feature of the last decade. Such costs are often punitive (10% - 15% p.a. all in) and for such ventures to work, they would require good markets that would absorb the higher cost of borrowing. Often, Funds require reduced loan repayment in the initial period to give these loans an opportunity to work and enable the borrower to seek solutions if the market is unsupportive. It is not surprising, therefore, that such loans have a higher default rate and need to be used cautiously.

Shipping is a volatile business with sharp fluctuations that require owners to build up their arsenal of how to resolve them when they shall occur. This volatility is enhanced by the pandemic. It is vital for owners in bad markets not to be the first to seek restructures but be amongst the last and only after having demonstrated the steps taken to structure their business in a safe manner and in anticipation of difficult times, as well as action taken to handle financial difficulties.

Our last advice is to be communicative with lenders and proactive and not being afraid to openly discuss difficulties encountered as a result of exogenous factors. Such approach builds up mutual confidence, which is a necessary ingredient for meeting crises both for owners and banks.

Thus far, banks have been understanding and supportive to owners facing pandemic-related difficulties and this has extended to agreeing to waiving temporarily financial convent breaches and / or providing some loan repayment relief in the expectation of improved markets post-pandemic. The above support has been provided to clients who have communicated their problems to the banks and have adequately explained the need for temporary support.