Why do publicly quoted shipping companies increase or reduce their share capital?

By
Ted Petropoulos
Head
Petrofin Research©

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Many of you may have invested in public shipping companies and / or are interested to follow their development, as a matter of interest.

Although, the opportunities for new initial public offerings (IPOs) are still limited, there has recently been a spate of public companies that either offer new shares to their shareholders to raise capital or proceed via secondary offerings to brokers, who in turn acquire and dispose such shares in due course, usually at a discount to the prevailing share price.

Admittedly, one of the main benefits of being a shipping public company is to be able to raise capital in order to buy assets e.g. ships, using shares as opposed to cash. The same could apply if another shipping company is bought via shares. The above is best achieved when the share price of the offeror is above the Net Asset Value per share (NAV) and at the same time, the proceeds are used to boost the company's income stream. Whether the earnings per share (EPS) of each share (old and new) shall rise will depend on the contribution of the new vessel, as a percentage to the total fleet, prior to and after the new share issue. The same would apply if a shipping company was to be bought (provided sellers accept whole or part payment in shares), as to whether the resultant NAV and EPS are diluted or not.

In shipping, however, all public companies have share prices at a discount to NAV. For pure shipping public companies (not engaged in other activities or services other than those of running their fleet), the discount arises because such companies tend to have higher administrative and reporting costs as well as disclosure issues and other complications. Furthermore, the share price is also influenced by the volatility and prospects of the shipping market. Often, such a discount is substantial. Under such circumstances, by definition, an increase of the company's share capital will be dilutive for existing shareholders. As such, the value of each share, the ownership of the company they represent and their voting power may diminish in time. This applies even more in case shareholders do not take up their rights or such shares are "placed" with brokers at a deep discount to the share price and NAV.

So the question arises, why do public companies issue new shares at a discount to the share price which is itself at a discount to NAV, if this results in a dilution of their shareholders' NAV and a fall in the share price? Such practice may, on the surface of it, be contrary to the company's and their shareholders' interests.

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Further questions may arise if the share issue is underwritten by the major shareholder and the major shareholder ends up having acquired most or all of the newly placed shares at a discount, boosting their ownership of the company.

In this article, we will seek to present some simple explanations and observations (without delving into capital structure theory) that apply for shipping and which, readers may find useful in their selection or assessment of shipping public companies and their management policies and practices. As potential shareholders, such investors might wish to take into account how public companies treat their shareholders.

We should add that in addition to the NAV and EPS considerations, the value of a share may also reflect its earnings' expectations, dividends policy, quality and reputation of its management, its ability to have well timed investments taking advantage of shipping cycles, as well as its capital and debt structure and resiliency of earnings, via long term charters. However, in shipping the NAV factor remains the most important one, as over time a successful company should see its NAV rise through sound management, investment as well as financial and share capital policy .

Share capital and debt decisions, which are not dilutive, might involve the company buying part of its own issued share capital, if the discount of share price to NAV is substantial. In this way, the remaining shares should have a higher NAV and EPS. The above can be done if the company believes that investment opportunities are limited at a particular time and the cash to be used to purchase stock (Treasury stock) represents surplus cash. Another way to improve EPS, and consequently NAV, is to buy back issued bonds or repay expensive borrowing, which carry a high cost to the company, often in excess of 10% or even more. By reducing its debt servicing costs, EPS rises.

Diana Shipping represents a good example of a public company that has used effectively both the above methods, to the benefit of its shareholders. Another justifiable reason for a share issue may lie in management's belief that vessel prices represent an attractive investment opportunity. In such case, the purpose of the new share issue is to expand the future NAV and EPS of the company, should the decision turn out to be correct. Investors should be aware that, by definition, such purchase is likely to take place in a weak market, where NAV, EPS and share price are likely to be low and the dilution effect significant. However, at least in such cases, the purpose of the share issue is for investing in the company's business. Nevertheless, there have recently been shipping public companies, which have increased their share capital, often by deep discounts to the share price (let alone NAV) and without a pre-determined use of the cash proceeds. Such practices resulting in over-dilution of the existing shareholders'

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position raise serious questions. The questions multiply if such issues are repeated many times over a short period of time of, say, 1 year, which may cumulatively decimate the interest of shareholders, especially if no assets are acquired. Such repeated share issues may also seriously impact on the ownership structure of the company, depending on who will the new shareholders be and especially, if they happen to be associated with existing shareholders holding leading positions or interests in the company. Presumably, shareholders owning such stocks should seriously consider to sell their positions or not to increase their holdings, so as to reduce their downside risk in case they find the company's decision unconvincing or unclear.

The manner in which companies treat their shareholders is very important.

Shareholders, who see a deeply discounted share issue, may wish to consider whether the funds raised are urgently needed to meet a company's negative cash flow or are needed to meet lenders' financial covenants. In this case, such an issue would represent a warning sign of financial strain and troubles ahead.

Another practice that has become popular is to offer share warrants together with each share being issued. Such warrants have no cost but do give the right to their owner to convert into shares or sell the warrant when the price of the share and / or warrant rises. Should these warrants also have voting rights, they become vehicles of exercising ownership to their owners and reduce the effective ownership of existing shareholders.

The issuance of warrants may be very popular with Wall Street, investment bankers and brokers but might be a questionable method for the interests of the shareholders. Such warrants, if they represent a significant part of the potential ownership of a company, do act, in some cases, as "poison pills" against a takeover and certainly, put a lid or slow down EPS growth, due to their presence and possible conversion into shares.

It is not the purpose of this article to stigmatize any particular company as each case is different but instead to make readers aware of the need to look into a company's history, in respect of new capital issuance and how existing shareholders are treated as well as critically assess the company's announcements and share Capital increases. Recently, there has been a backlash against frequent increases of capital especially without a specific purpose or to be used for purchasing new assets, for companies with share prices well below NAV's. This has occasionally resulted in a company announcing that there would be no additional capital increases for a specific period of time and other measures designed to comfort shareholders.

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Issuing shares for the purchase of ships at a low point in a shipping cycle is eminently reasonable and shareholders may wish to back the judgment of the company's management. Raising additional cash, via a share capital increase, with no defined purpose and at a deep discount and/or the issuance of warrants, may indicate a company facing acute financial issues with its lenders or other potential issues for shareholders. Potential investors should therefore be wary and form their own judgment in each instance.

The key consideration behind a shareholder's decision, as to whether to buy shares or participate in an increase of capital, is to determine how the company treats its shareholders and if its policy is consistent with the shareholder's goals as to EPS, dividends and stock price appreciation. Share capital increases do render such assessment more difficult, without a clear explanation provided to shareholders by public companies.