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The image of Aristotle Onassis in his expensive double-breasted suits and tortoise-rimmed glasses has come to glamorize the era of the magnificently successful daredevil independent shipowner where his seed capital was used to finance his vessels, along with loans from shipping banks.

A changing seascape

in shipping finance and the capital structure of vessel ownership

The shipowner's equity was first leveraged through loans from banks with the vessel as collateral (first preferred ship mortgage), and Onassis took it one step further, with more and cheaper leverage by collateralizing both the vessel and the long-term contract he had obtained to transport crude oil from Saudi Arabia to the U.S.

Shipping loans, whether asset-based finance or based on cash flows or a combination thereof, have been the traditional way to obtain financing in shipping for several decades now.

There were certain variations on the theme, such as export credit finance (loans guaranteed by the government of the exporting state), and financing through alternative sources of capital, such as leasing, which were conditioned on risk differentiation or market-specific criteria, whether strong counterparty signature (low default risk) or risk appetite for residual value exposure of the shipping assets or tax considerations (mostly in the USA and the Jones Act market).

However, the ship mortgage with approximately 30-40 percent equity and 70-60 percent bank loan has been the traditional way of financing ships for the last several decades, whether through bilateral loans or club deals and syndications. In 2008, the shipping lending market had been estimated to be larger than $500 billion in the western world.

In the last decade, there was an increased effort to access the equity capital markets primarily for smaller, newer shipowning companies; Hong Kong, Singapore and London have their stories to report, but the New York stock exchanges had the most success attracting new companies. Greek shipowners had been especially adept, and in the five years preceding the financial crisis, more than 10 pure shipping companies were listed on the NYSE or Nasdaq boards.

Fast forward five years after the collapse of Lehman Brothers and the financial crisis, the seascape in shipping only marginally resembles a "normal market."

First, as a result of the financial crisis, banks do not have the lending capacity or appetite, especially for shipping. Appetite to lend in shipping is even more curtailed when one looks two years forward to expected new banking regulations and especially Basel III, which makes asset-based lending – just ship finance – more onerous than other industries in terms of reserve ratios, etc.

While the future doesn't look too promising for bank lending to finance shipping, the mirror image still has to improve and become more visible: shipping lending is dominated by European banks and several major institutions have taken minimal accounting losses and write-offs in shipping for their bad loans.

A lot of accounting fudging has been rumored and some believe that accounting losses in shipping loans could exceed $50 billion. There has been a collapse in asset pricing (ship values) – in general 30-40 percent from the top of the market in 2008 until now. In addition, technological obsolescence, poor craftsmanship and shipping market dynamics will force some of modern tonnage to have shortened commercial lives. The problems in shipping industry itself, including anemic freight rates, have further caused many shipping loans to go bad, since borrowers were unable to service interest payments and amortization.

The second reason of the drastic change of seascape in shipping is the crisis in the industry itself: the Baltic Dry Index (BDI), a gross proxy of the overall shipping markets, which is based on level of freight rates, peaked in late May 2008 at just below 13,000; ever since the end of that very same year, the BDI has been trading around 1,000, on several occasions re-establishing new lows around the 650–700 baseline. In short, freight rates are very low, actually too low to service existing shipping loans, or support new

shipping loans at today's pricing. Often, shipping freight rates are at levels that do not allow for the shipowner to finance vessels' crewing, insurance, and maintenance from operations but from cash reserves, if any. Freight rates have been low because world economic growth has been weak, but freight rates are also depressed because too many ships were built based on easy credit and speculation; and a lot of these ships are new (thus have a long time till their natural end of their lives), and they are expensive (which makes it even more painful for the lenders to deal with them). Worst of all, one-quarter of the world fleet, is on average, still on order to primarily Asia shipbuilding countries. All in all, shipping is not a too promising industry to deal with, unless prices reflect an increased premium for recovery.

It's therefore clear that shipping is experiencing a mandatory "soul searching" that is likely to be a catalyst for change in the industry. Certain changes have already been apparent and more are expected to present themselves in due course.

Private equity funds and shipping

So far, a major new factor has been the involvement of institutional investors and especially private equity funds with shipping. In the past, institutional investors, primarily hedge funds, preferred liquid investments in shipping, such as buying shares of shipping companies in the public markets, and resulted in the success of IPOs in the last decade. With a weak freight market at present, IPOs in commodity shipping (tankers, dry bulk, containerships) are a completely uninspiring market, and thus there has been limited involvement and success. On the other hand, private equity funds have been much more active investing in shipping, in both debt and equity.

With the banks exiting shipping or preferring corporate clients and balance-sheet lending, to the extent that they still lend, there has been a dearth of lending to finance shipping, in particular for smaller owners, a "vacuum" that credit-oriented investment funds have been trying to fill.

Funds have to meet much higher investment return hurdles than banks and they have been focusing on opportunistic niche markets for now, like smaller owners (non-strategic to the banks), older vessels (non-desirable for the banks) and vessels in immediate need of financing (time pressure) for working capital, dry-docking and maintenance. Funds usually charge 8 percent interest for simple ship mortgages, while banks used to and still lend at 5 percent or lower than that.

Funds usually have more flexibility in extending credit and structuring deals as they are much less regulated than banks; and funds can extend riskier types of credit that banks are not allowed to engage in, such as second lien financing, mezzanine financing, junior loans and preferred equity.

Some private equity funds have occupied the space vacated by shipping banks (KKR is a well–known example), while certain funds with a banking license have entered the market and other investment companies are seeking a banking license to provide lending (Merchant and Maritime). It is difficult to estimate the size of the business opportunity available as funds would never be able to cover the whole market and lend at low-interest rates and compete for corporate credit, but the exit of just three banks from shipping – RBS and Lloyds in the U.K., and Commerzbank in Germany – have created a nominal lending vacuum close to $100 billion.

In addition to providing credit, private equity funds have been active equity investors in shipping by acquiring shipowning companies, vessel management companies, and shipping assets (whether at distressed pricing for "legacy transactions" or prevailing market prices), and by co-investing with shipowners and managers to order new vessels at the shipyards. By some accounts, private equity funds have made approximately $30 billion in equity investments in shipping since 2009, representing 3 percent of the overall size of the shipping market in the western world.

Private equity has been attracted to shipping recently since the industry is in dislocation, experiencing stress factors of severely curtailed financing, tonnage oversupply, low freight rates, and with traditional lenders in shipping still having to face write-downs and negotiate a new strategy in this new market place.

Private equity funds, in general, have investment return hurdles higher than 15 percent for equity investments and an investment horizon of five to seven years, which forces them to view shipping through a very specific prism of relatively elevated expected returns in a timeframe that is much shorter than the shipping business cycle.

Whether private equity funds will meet their objectives and investment targets in shipping is to be determined, the truth of the matter is that they have brought a certain, "institutionalized" approach to investing in shipping and corporate governance in shipping; the daredevil approach of the "buccaneer" independent shipowner has been replaced with decisions by committees and a bona fide board of directors.

Given that the investment horizon for private equity funds is rather short and an exit strategy has to be devised for them to monetize their investments, through M&A or sale to another buyer or primarily through an initial public offering (IPO), the "institutionalized" approach to shipping from the private equity funds may be the most enduring result of the present changing seascape in shipping.

There will be winners and losers from the changing outlook, ranging from adaptations to business models in shipping specific to certain markets, like the Kommanditgesellschaft (KG) in Germany or heavily dependent on asset-based finance in Greece, to opportunities in new jurisdictions that traditionally have not been extremely active in shipping. Given that a large number of private equity funds are domiciled in the Cayman Islands, the changing seascape will hopefully be beneficial to Cayman and the Cayman registry to the extent that companies are going to be incorporated in Cayman.

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