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SHIPPING

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Shipping companies still dodging the financial bullet

The shipping industry has avoided a number of pitfalls and, for the most part, the gavels of auctioneers. But for how long can this carry on? Barry Parker reports

Echoing a recent report published by credit rating agency Standard & Poor's (S&P), speakers at the Marine Finance Forum in New York - representing the commercial banking, investment banking and legal sectors - debated whether financiers, vessel operators, owners and shipyards are in denial over the current economic crisis, refusing to take needed - albeit painful - measures to put their respective houses in order.

The S&P report addressing the North American transportation market, although focusing mostly on the air, rail and trucking modes, presented the same conclusions reached by maritime financiers.

A team led by Philip Baggaley, managing director and senior airline credit analyst at S&P, offers in the report the view that demand has stopped falling and a glimmer of hope for recovery can be found in some sectors, but that the "ride up may be slow and unsteady".

S&P notes in the report that, for airlines - the mode whose performance has most closely mirrored that of shipping - the focus is on liquidity, that is, having enough cash to meet obligations.

Unresolved battle

With the maritime mode, cashflow is paramount. Speaking at the forum, Chris Weyers, managing director at FBR Capital Markets, points to "an unresolved battle among shipowners, banks and shipyards".

The backdrop of oversupplied maritime markets in each of the drybulk, tanker and container sectors, provides context to the denial theme.

Quite simply, more bad news is likely to be on the way for industry cashflow generation. The bank market is limited in what it can provide and, therefore, asset prices must move lower for the markets to properly clear.

Keynote speaker Art Hogan, equity product manager and chief market strategist at investment bank Jefferies & Co, maintains that the equity markets are "facing a wall of worry" with the latest round of earnings for the third quarter.

In his view, the dichotomy between the recent strong performance of equity markets, versus the actual prospects for listed companies in general, will cause analysts to look closely at whether optimism is warranted.

The optimism, in Hogan's view, will come from observers and investors responding to top-line gains rather than cost reductions that have boosted earnings across the broad business spectrum and which, for maritime companies, have contributed to cash conservation.

Hogan talks about a bridge that financial markets must cross in 2010 as those markets become self-sustaining, after what will have been two years of economic stimulus and other governmental support.

This theme impacts shipping as well: Hogan conjectures that, in China, such a transition might result in a snapback in demand to normalised levels - translating into more shipping demand, including demand for mainstays such as ore and coal.

The view is borne out by another speaker, Arlie Sterling, president and co-founder of consultancy Marsoft, who describes a V-shaped trajectory in demand recovery, maintaining that China is "back on track".

Commodity market dynamics are more complicated and linked to policies of the US Federal Reserve. Hogan suggests that the US dollar is likely to weaken further, fuelling commodity price increases until the Federal Reserve begins to raise interest rates. Sterling identifies vessel supply, which interacts with demand, as the real bogie in projecting drybulk market developments.

Sterling, who studied at Massachusetts Institute of Technology under Nobel Prize-winning economist Franco Modigliani, paints a picture of commodity movements that had grown 2.4 per year from 1980 through 2002 and then at a 6 per cent annual clip from 2003 through mid-2008.

One important irony is not lost on Sterling, who maintains that, perversely, the stronger than anticipated rate environment of the second quarter of this year and early into the third quarter led to fewer vessel scrappings and less in the way of cancelled orders than might otherwise have been the case.

Looking into his crystal ball, Sterling prophesies that vessel prices in the drybulk segment, but also in tankers and the container segment, would need to further adjust downward to properly price in market risk, including on the newbuild front. Hogan reaffirms this view, saying that a precursor to economic recoveries across many businesses and asset classes, were "market-clearing prices".

One paradox emerging is that another bout with a bad economy might be good for spot tanker rates. Ole Slorer, maritime and oil analyst from Morgan Stanley, espouses a commodity-tinged viewpoint that has a "peak oil"-driven scarcity leading to high oil prices, which, in turn, provokes another bout of severe recession.

After a continuation of the current two-year weak tanker market, he predicts a strengthening of tanker freights, as lowered oil prices - brought on by the recession - provide a renewed incentive for oil "carry" trades, with vessels used for storage.

During late 2008 and into early 2009, a similar "contango" (upward sloping) pricing structure caused oil traders to lease as many as 60 large oil tankers, creating artificial demand for vessels.

Brent Dibner, president of consultancy Dibner Maritime Associates, also a peak oil proponent, cautions that tanker demand would stagnate over a longer term, as technological inroads will reduce demand for gasoline and diesel fuels.

Dibner, who correctly forecast a glut of US Flag Jones Act tanker capacity in 2006 and 2007, offers that "the world has changed, the existing double hull fleet is adequate under any reasonable demand scenarios".

Return to healthy cashflow

The financial landscape mirrors the weak markets. Mark Friedman, senior managing director with restructuring boutique Evercore Partners, describes the yearlong saga of the Eitzen Group, a shipping company concentrated in the product tanker and chemical sectors, where breaches of value maintenance covenants led to debt rescheduling, leading to the group's potential acquisition by Indonesian stalwart Berlian Laju Tankers (BLT).

Container shipping specialist Nicholas Bailey, director of privately owned drycargo and containership broking house Howe Robinson & Co, offers a desultory view of a market where supply and demand would equilibrate, with favourable growth in trade flows in 2013.

Under slower growth recessionary scenarios, Bailey's models pinpoint a return to healthy cashflow generation well into the middle of the next decade.

For example, beleaguered containership owner Zim Integrated Shipping Services will receive more than USD500 million in new financing from Israeli and foreign banks in 2009/2010. This funding will be scheduled for repayment over more than 10 years and enables the company to finalise its purchase of new vessels from South Korean shipyards in the coming years, the company says.

The delivery dates of most of Zim's newbuildings have already been deferred by periods of two-to-five years. Zim had reached agreement with bondholders, owed some USD1.5 billion, to defer principal payments out to 2016. Bailey, bemoaning likely problems in the container trades, maintains: "This will likely cause headaches for German banks and KGs." Tobias Konig, managing partner at investment packager Konig & Cie, amplifies that stance. "We will see a restructuring of both banks and liner companies," Konig maintains.

Konig, a veteran of the German shipping scene, predicts: "Banks will weed through the orderbook; they will see where they can get out of deals." In discussing the Zim deal, he says: "Holding off on delivery until 2015 makes sense - that is when the vessels will be needed. If you postpone, you have a chance of the vessels coming into a better market."

In describing the German market, he says: "Equity is the problem, rather than the debt," explaining that many of the nearly 600 containerships ordered by German KGs had already obtained financing. He is quick to add: "Don't expect any new financings [from German banks]; they are very busy helping out their existing customers."

Konig estimates that EUR160 million of equity was raised for shipowning KGs in the first half of 2009, compared to EUR3 billion annually from 2003 through 2007.

Yet challenges for some companies represent opportunities for others. News has been emerging linking Norwegian owner John Fredriksen to a startup venture in the box trades, preliminarily dubbed The Container Line. Although speculation about the company's likely business model has been wide-ranging, cheap acquisition of distressed assets is a thread running through all versions.

In the drybulk sector, Peter Georgiopoulos and the team behind Genco Shipping & Trading filed preliminary documents presaging an initial public offering (IPO) of newly formed Baltic Trading Ltd, possibly raising USD230 million together with a USD70 million stake to be funded by Genco. Baltic's objective would be the acquisition of attractively priced vessels to be operated in spot charter markets.

Real distress of the type that would whet the appetites of Fredriksen and Georgiopoulos has not occurred yet. Richard Christopher Whalen, senior vice-president and managing director of consultancy Institutional Risk Analytics, picks up on the themes identified by Konig and other speakers, describing the banking industry's attitude as "extend and pretend".

Referring to predictions by Sterling and others that asset prices could move lower, Whalen maintains that banks "don't want to recognise losses; they don't want to close out and liquidate". In offering a prospective view, he states: "You need to ask, where's my financing?"

Speaking particularly about US banks - but also mindful of the problems faced by German institutions - he adds: "We are turning our banks into REITs [real estate investment trusts] that are operating assets that they can't sell."

Making the hard choices

Picking up on the theme of denial, Whalen, who worked at both investment bank Bear Stearns and at the Federal Reserve Bank of New York, maintains that "rather than just muddling along, the other choices are to make the hard choices", which he characterises as nasty and painful.

Hamish Norton, managing director at Jefferies & Co, continues to sound the drumbeat for high-yield debt, underscoring its use since early 2009. "This could also be true for shipping - every credit has its price."

He adds: "High-yield bonds are the only source of debt capital that is easily available."

Norton describes a dynamic in which commercial banks that also operate capital markets arms have been pushing borrowers to refinance bank debt, suggesting that 90 per cent of junk bond issuance has been driven by such refinancings.

Friedman points to the pace at which companies have been issuing equity to refinance debt, which may have been at least partly driven by government involvement in the banks.

Norton offers data demonstrating what he terms as "spreads that have normalised" to pre-3Q 2008 crisis levels, as illustrated by the spreads between BB rated paper - which is just below an investment-grade rating, as defined by S&P - versus B grade bonds.

For the broader bond market, in early October, Norton pegged BB bonds at 8.0 per cent versus 9.7 per cent for B grade debt, a differential actually narrower than that just prior to the crisis which carried coupons of 8.3 per cent and 10.2 per cent respectively.

A good deal of the Jefferies banker's presentation is devoted to explaining differences between the present environment and that of 1997 to 1999, when the majority of some two dozen high-yield issues defaulted.

Norton takes the view that, unlike the stronger markets of 1997 and 1998 - with their considerable downside risks - the shipping industry is at "near a cyclical low", adding: "It can look like equity, under bank debt."

Friedman, mindful of the gloomy presentations of other industry participants at the forum, asks the rhetorical question: "Can [debt issuers] get through the next 18 months, before an upturn?"

Matthew Thomson, head of shipping for North America at Bank of America Merrill Lynch, adds prophetically: "When the high-yield market does open up for shipping, it will be characterised by highly secured issues, where investors feel comfortable."

On 22 October, almost coincident with the forum, Navios Maritime Holdings and Navios Maritime Finance, a wholly owned subsidiary, issued USD400 million of 8.875 per cent senior secured first priority ship mortgage notes due in 2017.

The issue was rated BB- by S&P. The notes will be secured by first priority ship mortgages on 15 drybulk vessels aggregating approximately 1.1 million dwt by certain subsidiary guarantors.

The bonds, issued privately to institutions under an existing shelf registration through Bank of America and JP Morgan, will be "guaranteed by all of the subsidiaries that provide a guarantee of Navios Holdings' existing 9.5 per cent senior notes due 2014". The new issue complements an existing USD300 million issue of 9.5 per cent senior notes due in 2014, rated B+ by S&P.

In late June, Navios Maritime topped up its equity through a USD165.2 million convertible shares issue to be held by a South Korean shipyard and tied to the purchase of four capesize vessels, three of which are from companies controlled by Commerzbank. The German lender also provided a 10-year credit facility for up to USD240 million.

Navios, in announcing the new high-yield issue, said: "The net proceeds are intended to be used to repay borrowings under certain of Navios Holdings' existing credit facilities, as well as to provide additional financing to complete the purchase of two new vessels expected to be delivered in late 2009 and early 2010 [which will then become part of the collateral securing the notes]."

As explained in an S&P report defending the issue's BB- rating, USD105 million will be applied towards the two new ships.

Although Navios has gained a strong following from professional investors, Thomson says of shipping's junk bond market in general: "It is difficult near-term to see institutional investors piling in." But, in the case of Navios, they did: the issue was upped to USD400 million from an originally intended USD375 million.

John Parker, a high-yield analyst at Jefferies, tells Jane's: "Navios is a very innovative company. I think that this is the first of many deals of this type. They are taking out bank debt, basically a term loan led by HSH Nordbank. The new issue will be senior secured paper with no amortisation. Each year, they can save roughly USD20 million compared to the amortisation on the bank debt. It builds up their war chest and lets them reinvest their profits in the business."

Thomson emphasises the new climate of cash conservation, maintaining that "the dividend model has gone out of the market". Nevertheless, he says that 2009's spate of mainly small-size shipping equity deals "by companies with good brand names", is "largely driven by the retail investor".

From a company perspective, Thomson said that such fund-raising satisfied two important criteria: bringing in capital without losing control and building up war chests for potential acquisitions. On the other hand, two other objectives - bringing in low-cost capital and monetising existing assets - have not been met.

Parker notes that the Navios 15-vessel debt issue is secured by ships with long- and short-term charters. The company-provided appraisals on the collateral show charter-free and charter market values at USD504 million and USD668 million respectively.

When asked about the spread between the new issue, where market talk suggests pricing around 9.25 per cent versus the existing issue that is trading at around 10.75 per cent, he tells Jane's: "I would argue that the spread is too wide; holders of the existing issue are giving up security and a turn of leverage, but that issue matures in 2014, versus 2017 for the new one. That's worth something in the volatile shipping context."

Parker also addresses several of the structural considerations in the high-yield market, telling Jane's: "For Navios, this is very helpful. With more paper to trade there will be more investor focus on the name and that should help Navios' existing notes trade more, as well. Across the market, we would expect to see more deals like this as ship bank lenders are very constrained; the whole sector will become more liquid.

"What has happened is that shipping bonds have been penalised because of their lack of liquidity, especially after last winter when bondholders could not trade their positions. More liquidity can lower the yields facing issuers."

Chess game

Going forward, Thomson suggests that the metrics of company value would move to either enterprise value/EBITDA, or cashflow measures, in the absence of dividends (to fuel valuation models) and the impossibility of ascertaining ship values to feed net asset value (NAV) computations.

Former Chase Manhattan banker Peter Evensen, currently executive vice-president and chief strategy officer of Teekay Corporation, as well as chief executive officer and chief financial officer of Teekay LNG Partners, questions the rationale for perceived denial within the shipping sector. "The default position, for both bankers and shipyards is to stay with owners who are already there," he says.

But Evensen also applies a game-theory approach, wondering whether Greek shipowners who had ordered from greenfield shipyards were wrong, since these yards cannot build vessels. On the one hand those shipowners may have made good decisions, since yard non-performance means that payments will be refunded.

Evensen also offers: "The banks have not come to reality yet." Further explaining the asset sale dynamic in which financial institutions may need to face likely lowered asset prices, he adds: "It is about - 'what do you need?' [rather than] 'what do you want?' when contemplating prices that vessels would fetch at auction".

A further part of the chess game among shipowners and bankers is the legal implications of ship arrests.

Evensen, arguing in favour of the larger, consolidated entities, explains that vessel charterers might well seek to abrogate contracts if a bank were to arrest a vessel. As a result, the banks - similar to Greek shipowners - may also be in the driver's seat by not forcing issues. Evensen, citing Teekay's relationships with charterers such as Caltex and other oil majors, says: "Petrobras does not want their ship to be arrested".

Hans Petter Aas, chairman of Bermuda-based Ship Finance International, maintains that it is in the interest of banks to keep certain shipowners strong. He asks: "Who else would take on the operation of assets when weaker companies go down?"

Evensen hints that the tradition may continue: "We will do our share of restructuring. A big part of that is being the best vessel operator." Teekay was built on consolidating smaller fleets.

Friedman, synthesising the remarks of analysts and bankers, states: "Company earnings will be the biggest driver of how restructurings will go." He adds: "The pain will need to be felt" in the absence of syndicated finance and "Asian banks lending to Asian borrowers".

He suggests three possible option paths: modification of existing debt agreements, concessions by shipyards, and capital-raising exercises.

"Having a diversified financial structure has contributed greatly to the success of Navios," Parker tells Jane's. He adds: "In this down market, they have done a lot better than others who were overly reliant on bank debt.

"Having the USD300 million of senior unsecured debt in their capital structure has given them a lot more flexibility and covenant breathing room. While most of their peers were forced to eliminate dividends or raise equity close to the bottom, or both, Navios did not have to do either."

Reprising the Eitzen experience - which morphed from a covenant breach into the corporate combination now in the works - Friedman talks about a pending day of reckoning, saying: "Waivers may not be enough."

Navios Maritime Holdings and Navios Maritime Finance issued USD400 million of 8.875 per cent senior secured first priority ship mortgage notes in October 2009.
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