Signs of renewed buoyancy

The recent upturn in vessel sale and purchase activity is evidence of a thaw in a shipping market that had seized up until late 2009. Barry Parker reports

As an indication of the new optimism within the shipping market, shipping services provider Clarkson's is said to be resuming valuations of second-hand vessels, which the company ceased providing in late 2008.

A recent market letter from New York broker Compass Maritime Services identified ship acquisitions by Far Eastern buyers and multiple-listed companies. These included the Navios group (which recently sold two vessels from its flagship unit into its limited partnership); Seanergy Maritime Holdings; Diana Shipping (which is entering the containership sector); and STX Pan Ocean. At the end of January, Compass reported: "The news of a dead market for the acquisition of modern tonnage at strong prices seems [to have] been greatly exaggerated."

The upturn, certainly in tanker values, comes at a time when bank credit still remains tight for many borrowers; Peter Georgiopoulos, chairman of three New York Stock Exchange (NYSE)-listed companies in the tanker, dry and bunkering sectors, speaking at a seminar presented at the stock exchange, said: "People who have invested in shipping are cautiously optimistic."

'False bottom'

Throughout his remarks, Georgiopoulos, whose flagship company General Maritime Corporation was founded with private equity backing, bemoaned the seeming paucity of investment opportunities in shipping - an unintended consequence of government intervention that had lent buoyancy to asset values. "One of the problems is that the market has not been allowed to find its level," he said, referring also to a "false bottom supporting shipping, real estate and all businesses". He noted further: "That's why you have not seen the type of washout that you might have seen 20 or 30 years ago."

The Compass report referred to "an epigrammatic S&P [sale and purchase] event of the week, [which] is the acquisition of two prompt resales of very large crude carrier [VLCC] tankers at about USD96 million each, and, in a different transaction, that of two 2008-built suezmax tankers at about USD65 million each". According to Compass, both transactions involved private Greek companies - Capital Ship Management and Goulandris respectively - that were paying prices approximately USD10 million per vessel higher than the market's consensus on what such ships were worth.

Insufficient returns

An impact of the bottom on assets - artificial or otherwise - is that private equity investor calculations do not show sufficient returns. Georgiopoulos cited private equity investors as seeking returns of more than 30 per cent, where projected returns on various deals have been in the single-digit range. He noted: "Maybe more companies will survive, but we are not seeing many 'home run' opportunities." With the types of buyers identified by Compass, which reportedly financed their purchases largely with internal equity, Georgiopoulos' observation rings true.

From the investor vantage point, the same views were borne out by ship finance lawyer Jonathan Campbell, a London-based partner specialising in shipping and banking at Holman Fenwick Willan. Campbell told Jane's: "In the past three or four months, we have had approaches from a number of big US- and London-based private equity investors. We've had a few term sheets, but they have not moved forward on deals they were looking at." He added that investors had seen big money made, especially during the 2000-08 period, "and now [that] they've seen the collapse they are looking at acquiring distressed assets, and also at picking up distressed debt. But I think they are still waiting for a bottom, and looking for some big collapses before dipping their toes".

In discussing rates of return, Campbell suggested that high net worth individuals investing in funds - possibly through partnership structures - who have aligned with shipowners in partnership-type deals might look for returns of 8-10 per cent. "This may be better than returns they are seeing on other alternatives," he said. In such structures, which might be open-ended or closed, the fund itself would demand a much higher return. Campbell told Jane's that he did not see future structures being significantly different than those with which investors are already familiar.

Concerning possible exit strategies, Campbell opined that potential public offerings were on the minds of private equity packagers. He added, however, that "the advice I give is that they cross that bridge when they come to it. I would not change any advice about structuring now, based on what might happen later; these days shipowners are aware of the regulatory and accounting disclosures that they would need to make if they were to do an initial public offering [IPO]".

Georgiopoulos, whose General Maritime had completed a USD300 million high-yield issue due in 2017 and priced at 12 per cent, when commenting about high-yield bonds described their role as "a tool in a toolkit", adding: "I don't think it is a very big part of the toolbox and I don't think that it's going to replace traditional financing sources." He had remarked on the same subject in November 2009, saying: "It's expensive; it's something that [only] some companies can access."

General Maritime's unsecured bonds were part of a financing package that saw margins on its bank debt increase. Part of the bond proceeds were slated to pay down bank debt. Commenting on the bank debt environment, Georgiopoulos said: "Standards [for lending] will start tight, and, as things get better, will work their way down." He continued: "We've seen companies raising equity to shore up their balance sheets - hopefully that will translate into more bank lending. Maybe we'll see that in a while, but we have not seen it yet."

'Underwater portfolios'

Georgiopoulos added: "I think that a lot of banks that are in the [ship finance] business are not open for business now .... Some of the banks' portfolios are so underwater [that] nobody wants to admit it; that's why they are not lending. It's going to take a while to work its way through the system; that's why you haven't seen many distressed opportunities either."

Richard M Lemanski, who was previously a top finance executive at Stolt-Nielsen where he was involved in a successful restructuring, and, more recently, chief financial officer at Eastwind Maritime, which was put into liquidation in June 2009 after a series of protracted negotiations with lenders, offered a different opinion. "Private equity has been sniffing the shipping space for some time now, seeking to emulate the success stories that private equity firms had with their investments in the late 1990s down-cycle. Many private equity firms are now expressing frustration [about] the lack of movement on the part of banks in terms of dealing with the problems in their portfolio. In other words, the banks do not appear to be discounting enough yet for private equity firms to make big enough returns."

Lemanski added: "Some of the better-capitalised banks are taking the view that at least a portion of their loan is an equity position so why should someone else get the upside of this equity?"

With repayment of Royal Bank of Scotland (RBS) bank debt on his mind - one reported use of a portion of General Maritime's recent high-yield bonds - Georgiopoulos asked rhetorically whether a committee at "a bank in England that's been taken over by the government" would choose to lend to "a Liberian corporation managed out of Greece, with ships trading in the Far East", or to "a homebuilder in Manchester". Recent General Maritime filings show that USD229.5 million of the company's RBS debt that came with its Arlington Tankers acquisition (coming due in early 2011) is swapped out (also with RBS). The interest rate under the swap is fixed at 4.98 per cent - the highest rate among multiple swaps on the books. The filings further state: "As a result of this swap, Arlington has effectively fixed the interest rate on the term loan agreement at 6.2325 per cent per annum." If taken out by the new bonds, maturity is moved six years further out, to 2017.

Campbell, in commenting on the interplay between the new government in Greece and the shipping industry, said: "A lot will depend on how the banks in the UK handle things and whether they decide to retreat from international lending - which is under discussion but by no means a certainty. If RBS pulls out [of Greece], that would be a big hole in the market." He pointed out that RBS has already apparently sold off parts of its Greek portfolio to Aegean Baltic Bank, and conjectured that "they might sell debt on, as distressed debt, or maybe ask their clients to buy debt back at a discount to its value".

Campbell continued: "Some of what happens will be tied to the upcoming UK elections; there is a perception that the Conservatives would be more business friendly [while] Labour might be more restrictive." Lemanski then added: "Other banks - primarily German banks - are dealing with significant problems elsewhere in their portfolios and appear to be hamstrung in focusing on issues within their shipping portfolios."

Also speaking at the NYSE seminar, Duncan Niederauer, chief executive officer of the exchange, said that companies in many industries were "suffering from not being able to get access to traditional sources of capital. You saw [previously] a lot of money that would have been invested in traditional equities go into the high-yield markets. Now the pendulum has swung back a little".

Niederauer, a one-time stock trader at Goldman Sachs, defended the equity mode: "Equity capital can be a pretty inexpensive alternative to debt." He suggested that, in late 2009, the high-yield bonds of established companies - in shipping and across a broader business spectrum - looked attractive compared with other interest-paying investment opportunities. He pointed out that issuers, including many from the maritime sector, rather than being enticed by the market, simply did not find the availability of debt from conventional channels. Like Georgiopoulos, Niederauer worried about "certain regional or global banks becoming local again".

n repayments into the future, thanks to a strong bond market - Niederauer's "pendulum" notwithstanding. The mid-January bond market did see a USD450 million high-yield deal sold by Teekay Corporation, rated BB by rating agency Standard & Poor's. The 10-year senior unsecured bonds, carrying an 8.5 per cent coupon, were slated to refinance approximately USD177 million of bonds, due in 2011, through a cash tender offer, and to take out a term loan coming due in August, priced at Libor plus 80bp, along with revolving credit debt coming due in late 2017, priced at Libor plus 55bp.

With its massive USD9.7 billion balance sheet at the end of the 2009 third quarter, Teekay Corporation had more than a dozen term loans outstanding and a comparable number of revolving credits. A heavy crush of balloon payments, due in 2011 and totalling USD450 million, had been a concern for Teekay - a concern that has now been allayed.

Economic cycle

Bankers, like investors, always try to determine where we are in economic cycles. One view of the longer-term price path comes from Randee Day, managing director and head of maritime activities at Seabury Group, who discussed the likely actions of banks in a recent Capital Link event held several hours prior to the

NYSE seminar. Day, also a director of Double Hull Tankers, which owns vessels all leased out on period charters, offered a view: "I think we have a significant erosion still to go on the second-hand values of modern tonnage. It has been anticipated by private equity funds and opportunity funds. They are hesitant to enter into [transactions] because they are hesitant to enter into a sector where they would essentially have to warehouse ships in certain categories because there is simply no current return. They don't want to have a negative carry."

Besides providing opportunities for investors, Day looks for new deals that would be "getting some decent returns for the lenders". She expressed her opinion that: "Banks and mezzanine players should be eying the sector closely over the next year or so. They could enter into a very lucrative lending business to support the global shipping business from the latter part of 2010 on." Day, a shipping banker since the 1970s, added: "I think that the days of putting out money at 75bp over Libor were absurd to begin with; I don't think that you'll see a repeat of that."

Bank foreclosures were another topic discussed at the NYSE seminar. JP Morgan shipping analyst Jonathan Chappell said: "There was materially less availability of finance in the near term." He added that, with banks' own balance sheets stronger than they were in late 2008/early 2009, lenders "could be stricter on tanker owners than they were on drybulk and containership owners" in terms of foreclosing.

Day said: "Up until now, banks have been unwilling to mark to market" on ship values - another visage of the "false bottom" phenomenon and the state of denial identified by Georgiopoulos at the NYSE event.

A different viewpoint comes from Lemanski, addressing questions about the likely actions of auditors, regulators and banks. He said: "It is clear that many of the major European shipping banks will have issues with their shipping loan portfolios. What is not entirely clear is if these banks face the same type of auditor and regulatory pressure to address these issues as a US bank would."

Recently, shipping insiders have pointed to February and March as the time when the problems would become more evident as the banks move through their audit cycle, with the anticipation that the market would be seeing more distressed deals occurring.

U-shaped curve

If the overall economy recovers in the U-shaped curve predicted by some, there will be blowback onto maritime borrowers as costs rise. Chappell, in discussing rising interest rates, explained that, previously, rising spreads over Libor had been counterbalanced by a falling overall curve. "The actual overall blended interest rate has not had much of an impact up until now," he said. "Now, as Libor increases, and the spread stays at the same 200-300bp level, that will start to have a bigger impact on profitability going forward."

Day said: "For those people who have not swapped and covered, the risk of interest rates rising is an additional factor of uncertainty that could work against a rapid recovery in the sector." She questioned, with freight levels as they are now and some owners barely able to cover operating costs (for example, in the beleaguered product tanker sector), "how much of an increase in interest rates could be sustained?"

'Black hole'

In another Capital Link event, this time focused on tanker markets, David Saginaw, commercial director at maritime services specialist McQuilling Services, said that, when analysing the supply side of a fleet, "people are talking about

The question of how many orders get cancelled because of no financing is certainly a wild card".

He continued: "The industry often works things out; very few predicted train wrecks actually happen. Since we are at, or near, the bottom of the cycle, when we look at vessel acquisition projects our analysis can produce a favourable investment return."

Saginaw was careful to footnote his remarks, saying: "Such projects are for experienced players. You are going into projects that may show negative returns now; you need to have a certain appetite for risk. That's always a component of shipping investment."

Falling ship values have garnered much of the industry's attention. Jane's asked David Chopping, a partner at accountancy and advisory firm Moore Stephens in London, about the impact of rising values where owners have previously taken impairment losses: "IFRS [International Financial Reporting Standards] allow previous impairment losses to be reversed where it becomes clear that the situation has improved," Chopping said. "The treatment of such reversal depends on whether the company's normal accounting practice - that is, in the absence of impairment - is at depreciated historic cost or fair value. If the normal policy is cost, then reversals are taken to profit, but are limited to taking the value back to the amount it would have been had there never been any impairment."

Chopping added that: "If the company's normal policy is value, then reversals of impairment are treated as revaluations."

Market bubble

Views on asset prices are influenced by the perceived trajectory of the longer-term cycle. In her remarks about ship values, Day described the past decade - in which asset values went up by levels far more than were justified by freight rates - as "one of the greatest asset bubbles in the history of modern global economics". A market bubble is typically defined as a price run-up that turns out not to have been justified by underlying fundamentals of the market in question.

One academic analysis of ship prices, looking at data from the first half of the 2003-08 boom, arrived at a conclusion different from that of Day. The work was authored by Roar Adland, a portfolio manager at Clarkson Fund Management, and two colleagues; it was published in 2007 in the journal Maritime Economics and Logistics.

Using a vector error correction model (VECM), Adland and his team took the view that: "Our empirical results suggest that the second-hand market was closely co-integrated with the fundamental freight and newbuilding market, with no evidence of a short-term asset bubble." In other words, ship prices reflected underlying expectations of freight rates and returns to investors after deducting operational and financial costs.

When asked whether his findings would extend further into the boom years, Adland told Jane's: "I've not tested beyond 2007 since the paper on asset bubbles was written. But my guess is that the result would be largely the same - that is, fairly efficient if we ignore the charter default risk."

For a variety of reasons, tension exists between the models and broker estimates. Chopping told Jane's: "While the projected value of future earnings [from a net present value (NPV) model] might be higher, banks are not shipping companies and are likely to be averse to taking and then operating the ships in order to obtain value."

Such discussions are far from academic following a year of banks waiving defaults as borrowers have breached loan-to-value (LTV) covenants. A group of brokers in the battered German markets have concocted a formula, dubbed "LTAV" (long-term asset value), which is meant to guide appraisers. With Hamburg brokers reluctant to talk about the methodology, some observers have viewed it as asymmetrical. Consultant Jonathan Feffer, president of JF Maritime, told Jane's: "I note that the Hamburg (LTAV) formula, approved by PriceWaterhouse, was formulated only when vessel values fell sharply and the breaching of loan ratio covenants became of serious concern to lenders.

"I view this as artificial and wonder why a similar system was not used when ship prices rose sharply in happier days."

The models' outputs may represent something different from what was intended. Chopping amplified his points, telling Jane's: "We were not aware that most bank documents specify that broker valuations must be based on estimates of currently realisable prices, but would speculate that this may well be because banks are aware that this is the basis that is used.

"There is certainly a logic in this basis of valuation being used by banks. A bank will want to know what the value of its security is. It makes sense for the bank to look at this in terms of what it could realise immediately."

In real life, charters may depress vessel values - even in strong markets. The fine print in Adland's analysis, with a focus on capesize vessels, offers valuable insights into the valuation of vessels, where broker estimates came in slightly below levels predicted by an econometric model, due, in part, to the risks of defaults on charters arranged at peaks in the market. Adland's statistical methodology was to tie values of newbuilds and second-hand vessels together with period time charters of one to three years' duration, showing that vessel values in the second-hand market could be closely tied to views of freight rates.

The researchers noted that "the apparent under-valuation of second-hand values during the initial stages of the drybulk supercycle [compared with the theoretical construct] may rationally reflect the default risk inherent in timecharter contracts".

Multitude of variables

In a second article, also in 2007 as the drybulk market was soaring, Adland and a colleague produced another study that stated: "Based on data from more than 1,850 individual sales of handysize bulk carriers from January 1993 to October 2003, we find that the second-hand value of a vessel can be well described as a partially non-linear function of three main factors: deadweight tonnage, age and the state of the freight market."

This time the methodology of non-parametric multivariate density estimation (MDE) was used, effectively side-stepping problems that creep up when broker estimates - in the absence of real transactions - are used. The results, employing one-year timecharter rates used to estimate the level of the freight market, were encouraging; but they showed that ship values incorporate more variables than economists' models can explain.

Adland wrote: "It is evident from the empirical results that even a three-factor model is not capable of fully explaining the observed vessel prices in the market. This is largely because several vessel-specific factors that an experienced shipbroker will take into account are excluded." Some of those factors, taken into account by brokers such as Clarkson's and Compass, include the type of engine, cargo gear and similar technical specifications.

Chopping shared observations about models in general. He told Jane's: "NPV models are allowed by accounting standards, as impairment is determined by reference to the higher of [either] the amount you could sell the asset for [or] the present value of the cashflows it is expected to generate in the future. All NPV models require estimates of future income and costs, and in a volatile industry such as shipping, making such estimates is always going to be difficult."

Yet Chopping, dealing with real vessels, and Adland, dealing with theoretical concepts, both come back to the quality of the lessee's credit. Chopping said: "Obviously the degree of uncertainty varies, so that a shipping company with a vessel on long-term charter to a financially secure charterer will be able to estimate future cashflows with greater reliability than a company trading spot. Generalised models, those that are developed for use by lots of companies and not for a particular company, will have all of the problems associated with all NPV models but will then add a few of their own, primarily that they will not take account of the specific factors affecting a particular company, such as the quality of charterers." The models meet reality when ships are bought without charters - and, importantly, without bank debt.

Questions and answers

In this context, the tanker purchases financed by Greek equity - where a banker, who would fret over the credit-worthiness of a charterer, is absent - can be reconciled. Brokers at Compass Maritime, taking a page from the commodity industry's risk management playbook, asked the following questions: "Does it mean that they gave up on the consequential pursuit of the distressed sales on a massive scale, which, by the way, have been conspicuously absent from the market to the disappointment of market gurus and cash-rich buyers? Or is just that these transactions are attributable to the strategic approach of establishing/doubling-down in the down-cycle?"

Evoking the complaints of owner Georgiopoulos and lawyer Campbell about higher lows on price charts, Compass says: "Only one buyer gets to buy at the absolute bottom of the market [which by definition is only known ex-post facto], and for shrewd buyers the strategy is of buying at several points of the down-cycle in order to establish a low entry point, on average."