A sinking feeling

BOOM AND BUST CONTINUES TO AFFECT THE SHIPPING INDUSTRY, RAISING QUESTIONS OVER THE FUTURE OF GLOBAL SHIP FINANCING. **GRAHAM BUCK** REPORTS.

Global ship financing is experiencing its biggest shake-up in decades, claims a report issued last month by KPMG. According to Ship Financing in Flux – Searching for a New Course, sector stakeholders are looking for new means of financing vessels, and some of those new means require major changes to the way that shipping companies are run and how they raise finance.

The Ship Financing in Flux report comes shortly after a prediction from Norway's DNB Bank, a leading arranger of shipping loans, that the shipping industry will be exhibiting a funding gap of $100bn by 2015 as European banks scale back their lending in response to a slump in maritime transport.

"The money exiting the shipping and offshore space is a mind-blowing number," said Dag Thomas Michalsen, senior vice president at DNB Markets, speaking at the Scandinavian shipping and ship finance conference in April. "Clients will have to look elsewhere for ship financing, such as the bond markets."

Michalsen said that US lenders had increased their commitment to ship financing and he also expected Asian firms, which typically charge less than their European peers, to step up their lending to the industry in future. However, neither would fully make up for the funding gap.

DNB currently ranks as the second-biggest bank source of shipping loans after Germany's HSH Nordbank, which provides a total of $42bn, and ahead of Commerzbank and Sweden's Nordea Bank. Both German banks are already reducing their lending to the industry.

"Many Western banks were highly active in ship finance and helped to drive the market, but a huge number have now departed or are sharply reducing their exposure," says Jake Storey, chief risk officer at shipping company Gearbulk (UK). "Those that remain are increasingly selective and lending only to core customers. During the boom they would offer 10-year loans with margins of less than 100 basis points; now five to seven-year loans at 200bps or much more is the norm. And whereas they would lend 80% to 85% of a vessel's market value, the figure now is often no more than 50% to 70%."

Storey adds that since 2008 there has been much discussion on the possibility of private equity entering the shipping finance market, but the returns that private equity typically seeks have been unavailable for several years and are unlikely to return soon – barring a major event such as closure of the Suez Canal.

KPMG's report focuses in Germany, which is a key market for maritime capital and is based on opinions from local shipping companies, with survey participants collectively representing around 43% of German tonnage in merchant shipping. The companies represented own a total of 1,600 ships, or 42% of the German fleet, which is the world's third-largest after Greece and Japan.

Of these respondents, 90% agree that although Germany's traditional Kommanditgesellschaft or "KG" model will remain relevant, alternative forms of financing are vital for Germany to maintain its status as a key market for maritime capital. KG is a German form of legal incorporation suitable for a limited liability investment partnership.

Under the KG model, intermediaries have traditionally solicited investments from the public to buy ships that are then chartered out. In recent years, it has become more difficult to attract small investors and one in three respondents regards the KG model as under threat.

Nearly two in three respondents (62%) believe that the "transparency of company structures" will become an increasingly important factor in sourcing finance, while 59% regard "economic stability" and 49% the "consolidation of

shipping companies" as key factors in determining the market's future direction.

John Luke, KPMG's global head of shipping, says: "Everyone involved in shipping will be aware of the impact of the credit crunch on the sector, either indirectly via suppressed demand from developed economies or directly via the tightening of credit. The banking sector's current imperative to reduce its own balance sheet only exacerbates the depressed prospects for shipping in this context.

"Many maritime lenders in particular appear to want to vote with their feet and exit the sector completely – if only they could. The demand for capital in the sector – to fund the order book and refinance existing borrowings – appears to far outstrip the supply from either operations or from the traditional sources of maritime capital. Our research tries to identify how some of that gap may be bridged."

Other findings from KPMG's survey include:

- 64% of respondents have already taken steps to access new sources of equity capital (apart from funds) and 47% to procure new loan capital sources (apart from German banks);
- 80% of respondents expect ratings and/or growing capital requirements to become a more significant factor in future financing agreements; and
- 80% anticipate increasing competitive pressure from China, although only 50% believe China has a strong influence in the area of ship financing.

Ron Widdows, a US executive who formerly headed Singapore's Neptune Orient Lines and took over as CEO of Hamburg-based Rickmers Holding in April, agrees that new financing sources are vital. He was recently quoted as saying that banks were becoming "more aggressive in dealing with the non-performing ships", after several years when many German shipowners have seen vessels either lying idle or losing money and have been unable to raise new finance.

Widdows is confident that Rickmers – which, like many other German shipowning companies, is privately owned – is one of several operators that will survive, helped by its diversity of business, expertise and relationships with potential financing partners. However, he warns that there will inevitably be casualties.

Unlike the German participants canvassed by KPMG, Widdows also believes the KG model has no future. Funding is "going to be around other people – sovereign wealth funds, private equity and asset management", he says.

Ship financing will also become more reliant on import-export banks set up to support shipbuilding in China and Korea. "The centre of growth in financing of the business certainly begins to look more Asia, maybe US, than Europe as you look further out."

In China, the world's biggest shipbuilder by volume, government intervention and easy credit have been used to try to maintain production, says Storey. Chinese premier Wen Jiabao has also acted to shore up Greek shipping companies, announcing a $5bn Sino-Greek shipping finance special scheme when he visited Greece in October 2010. The first loan facility, for $122.6m, was signed between China Development Bank and dry-bulk carrier and tanker operator DryShips in February this year.

However, a sharp fall in orders and government efforts to cool China's economy mean that credit is now drying up and many shipyards are threatened with closure.

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The profitability of shipping companies has been eroded through a combination of oversupply of vessels, declining freight rates and sharply higher fuel costs, while lenders face more demanding capital rules. Many companies ordered new vessels shortly before the economic downturn four years ago and the new capacity became available just as demand for goods and commodities fell sharply.

Despite tougher conditions, the order book for new vessels is still very high, says Storey. For example in the dry-bulk sector new vessels equivalent to around 30% of existing fleet capacity are on order. For Panamax bulk carriers the figure is about 40%, raising the question of if and how the market can absorb such additional capacity.

"There is no doubt that the combination of the enduring suppression of shipping rates and broader economic woes of maritime lenders means that the KG model is, for now at least, no longer effective," writes Luke in the KPMG report. "However, that is not to say a headlong rush to wind up every non-performing single-ship KG will prove a solution. Instead the market must seek more sustainable and beneficial long-term alternatives, perhaps such as warehousing multiple ships in portfolio-based solutions."

Luke adds that KPMG's survey reveals that many ship-owners are already actively exploring new financing sources. "The future belongs to those shipping companies which come to terms with the new environment, find new business models and actively incorporate them into their operational trade."

The industry's woes have also served to create opportunity for a few individuals. Norwegian-born oil tanker and shipping tycoon John Fredriksen last month revealed that depressed prices had enabled him to purchase a dozen new and more fuel-efficient tanker vessels in recent months.

Fredriksen indicated that he might make further purchases, as the crisis was set to continue for a further two to three years and drive more shipping companies and shipyards out of business. The survivors would be those with low levels of debt, backed by long-term owners with liquidity and an established name.

Greece's shipping companies borrowed from the international banking market rather than locally, so have not been significantly affected by Greek banking problems, says Storey. "Many were astute and got out when the market was at its peak. They are now gradually using their cash reserves to re-enter the shipping markets and take advantage of opportunities from the much lower vessel values, which have fallen by as much as 40% to 50% since the 2008 peak."

Graham Buck is a reporter on The Treasurer.
editor@treasurers.org