The massive capital influx from German banks and private investors, who at one time invested around EUR 20 billion every year in the country’s shipping industry, has come to an end. However, the arrival of private equity funds seems to be a far from painless process.

"On top of that the banks behaved very stupidly."

Dagfinn Lunde, former President and Head of Shipping at major bank DVB.

The capital stream from hundreds of KG companies – organised by KG houses, as they are typically referred to – and from banks has now stopped, and today German shipping is looking at a completely new reality with close ties to several American private equity funds. These funds eye solid business opportunities in acquiring bank loans and ownerships of fairly new ships through joint ventures with some of the country’s biggest shipping companies, including Rickmers Group, Peter Döhle Schiffahrts, Bernhard Schulte, Claus-Peter Offen, and many others.

Dagfinn Lunde has more than 30 years of experience in the maritime industry. In 2014 he replaced his old job as Vice President and Head of Shipping at major bank DVB with a new job as Chairman of Singapore-based Exectuve Ship Management.
“The KG system is not a bad system. It’s still an amazing investment opportunity for investors, as investments in shipping – under German tax laws – are tax free, and the investments can deliver far bigger returns than what you find elsewhere. So the KG scheme will continue to be attractive in terms of new investments, but some of the conditions were sidetracked and crashed,” says Dagfinn Lunde, former President and Head of Shipping at major bank DVB. He is current a member of the Executive Board of the new Oslo-based shipping bank Maritime & Merchant.

One error after another
“The KG houses and the banks made two crucial errors. One was that each individual KG house would typically establish several companies within a complex corporate structure, which would be well paid and also lead to several conflicts of interest as responsible for the commercial operation of the ships, technical and crewing operations thus trust and accounting functions. Combined, these various fees could increase the operating cost of a ship by up to 40–50 percent, and this was in many ways a kind of abuse of investors’ trust,” says Dagfinn Lunde, who also believes that many German banks acted downright foolishly.

Dagfinn Lunde describes it as a game of cards: “On top of that the banks behaved very stupidly for two reasons. Not only did they do very badly structured pre-delivery financing to the yards, but they also did equity pre-financing. So a lot of these projects never had equity, because the banks said we’re willing to pre-finance the equity, while you go to the market to raise the capital. “

Many projects never managed to resolve in the equity market.

Today many German companies and banks are heavily involved in complex negotiations with, especially, US equity funds, which in addition to negotiating with the individual KG house also risk having to negotiate with anywhere between 20 to 2,000 investors.

According to Dagfinn Lunde, German documentation and legislation – and thus many of the loan agreements – are legally weak in comparison to the Anglo-American systems, as German banks are particularly subject to numerous restrictions in terms of their freedom to act.

Dagfinn Lunde expects that it be another year or so, following a three-year downturn, before the financial situation in German shipping stabilizes and banks have performed the necessary impairments. He predicts a high level of insolvent KG companies in 2014 as well – like in 2013, where he predicted that around 200 KG companies would become insolvent; a prediction that has now been proven correct.

The new collaborations
When the market peaked, the KG companies raised approx. EUR 10 billion in equity every year, of which some 50–60 percent was placed in shipping. With EUR 5–6 billion in equity, geared up to around 70–80 percent in individual projects, the annual investment volume in shipping comes to approximately EUR 20 billion, he says.

Several eyed a fantastic business model in developing investment projects, where they had a trustee function, the KG houses, and in addition to this, many of the houses established ship management companies – commercial as well as technical – companies that are now known as shipowners. A misleading description, as they are not actually shipowners. Rather, they work solely as ship managers or administrators, with the ships being operated by other entities.

Major companies and shipowners such as Peter Döhle Schifffahrts KG, Claus-Peter Offen, Bernhard Schulte, E.R. Schifffahrt (Erck Rickmers), Rickmers Group (Bertram R. C. Rickmers), and others have invested in ships themselves, though these players today are looking for capital mostly outside traditional shipping loans from the banks or equity from the KG market.
For instance, Rickmers Reederei has formed a joint venture with US equity fund Apollo Global Management in order to invest up to USD 500 million in second-hand tonnage.

Also, in 2012 Rickmers and Oaktree Capital Management formed a strategic partnership aimed at investing in newbuild container vessels and the cooperation is said to be moving fast.

Bernhard Schulte collaborates with JP Morgan, and Peter Döhle Schifffahrt had also secured US capital in the past.

But the list of equity fund interests is far more comprehensive than just the names that are frequently named in the public.

In addition to American, New York-listed Oaktree Capital Management, likely the most active equity fund in global shipping these years, and which in Germany is investing directly in ships through various funds – e.g. Oaktree acquired shipping loans backed by shipping loans from Commerzbank – there are names such as AMA Capital Partners, part of the Reederei Nord ownership circle, and First Pacific Advisors (FPA) through Soundview Maritime, a company established by Northern Shipping Funds at the onset of the crisis, along with several others.

Companies face new exam

This conversion or transformation of the ownership conditions in German shipping brings all new requirements for the German shipping companies.

“When things were going really well, there wasn’t a lot of focus on risk management and corporate governance, and today when professional capital comes in, these investors keep a close eye on whether these companies and their employees are capable of managing the capital and handling the investments. That’s why an emission house, which also has a trustee function, will typically be forced to make a significant co-investment in a project, or they won’t be allowed to just sit back and make money as a commercial and technical manager. If not, they could find themselves in an unfortunate dual-capacity that could lead to bad decisions. Maybe they don’t want to sell a ship when the market peaks if it means that the company in question loses its management fees,” one industry expert with extensive knowledge of the German market tells ShippingWatch, and like Dagfinn Lunde this consultant points to the complicated financial structure in German shipping:

“German banks today are left with some very big portfolios of shipping loans in highly inflexible structures, because these loans often involve independent companies, SPV’s (Special Purpose Vehicles), which in each case needs to be treated as an individual company, typically having between 150 – 1,500 investors, all of whom want to negotiate with the various parties, advisory boards, trustees, and others. And at the same time the banks have to navigate between ship management contracts – which are often non-cancellable – and which have zero interest in losing the ships.”

2. Built in 1872, the bark Deike Rickmers carried very special technology on board. A so-called ‘windmill pump’ had been installed between the main masts to help pump out any water the vessel might take on. PHOTO: E.R. SCHIFFHAFT
3. Albert Ballin (1857) took over his father’s business in 1874 and formed the shipping company Hamburg America Line – the world’s largest carrier at the time. Today Hapag-Lloyd. Ballin committed suicide in 1918, two days before the end of World War I. PHOTO: HAPAG-LLOYD AG, HAMBURG
4. PHOTO: HAPAG-LLOYD AG, HAMBURG
Like the past two years in particular, American institutional investors and equity- and hedge funds expect that 2014 could be another good year in terms of acquiring bank loans in shipping and vessels.

New York-based shipping finance advisory and shipbrokerage firm Karatzas Marine Advisors & Co expects that KG houses will be facing mounting problems and possibly having to file for bankruptcy during this year, just as several German banks could face difficulties when the European Central Bank takes over the supervision of around 150 banks in the Eurozone this coming fall.

Rating bureau Moody’s estimated a few months ago that eight German banks had combined loans of more than USD 136 million, and that one fifth of these loans were problematic, and that deferrals on losses would remain at a high level in 2014. The banks such as Commerzbank, DVB, HSH Nordbank, KfW IPEX Bank, and NordLB are particularly exposed to shipping.

But the American investors are picky and they bring demands. “The institutional investors usually have their own preferred way of structuring deals. Projects need to be adapted to their investment criteria, and equity funds have towering expectations for returns on their investments – often up to 20 percent, which makes it difficult for them to find suitable projects,” says Basil Karatzas, CEO of Karatzas Marine Advisors, whose work includes advising American equity interests in relation to Germany.

“Institutional investors typically prefer to buy shipping loans or provide financing or invest directly in companies rather than buying hard assets like ships. In short, they prefer paper and securities over physical assets. Some of the funds are only willing to take credit risk, but not market risk, and sometimes they don’t take into account the potential profits to be made in the market going forward.”

Basil Karatzas also believes that the business structure prevalent in German shipping has inherent conflicts of interest, which could make it difficult to deal with foreign investors. “There is a notable gap in investment philosophy and approach between German owners and private equity funds, as their views differ sharply on various aspects. The funds are used to doing things their own way, suited to their corporate structure, sometimes by sending term sheets on a ‘take it or leave it’ basis – and this is hardly a constructive approach dealing with ‘legacy deals’,” which means that many German banks and KG houses have been disappointed by the American equity funds, “says Basil Karatzas.

He estimates that more than one hundred equity funds are actively exploring the German industry in search of business opportunities, though he stresses the high uncertainty regarding the actual number of funds that end up doing business there.