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Is the equity capital window open to all? Chris Thorpe and David Hobbs discuss the issues facing marine transportation companies in choosing to go down the public - or private - equity route

Raising capital can be a daunting task for a new venture but well capitalised private companies may find the financing window wide open in the current environment. New shares are floated on a daily basis, often oversubscribed with orders from investors ranging from large mutual funds to private individuals. Private sales to private equity funds or direct investors are reaching levels seen before the 2008 crisis. In fact, 2014 may go down in history known as a seller's market. Conversely, raising public equity capital for the shipping and marine fuel sectors remains a challenge to all but a few companies that have demonstrated a strong track record for both profit margins and growth. The remaining majority have fewer attractive options. When it is time to sell, the question is whether it is preferable to choose public equity or remain private and attempt to find a financial buyer.

There is no 'one size fits all' approach to financing a business. It is truly a matter of market supply and demand, the potential growth of a company, a good story, seasoned management, and the life cycle of a business. During the start up phase a company relies primarily on private venture capital equity funding. As it moves on to later stages it may access bank debt or public debt to invest in property, plant and equipment. Other times, a company may raise equity capital to make an acquisition or simply invest in organic growth. All these factors contribute to financing decisions within the greater economic environment of interest rates and capital market dynamics. In some cases, markets will pay a premium for certain kinds of stocks, such as internet companies in the late 1990s and early 2000s. In more sober times, it could be next to impossible to float new shares, such as late in 2008.

The marine transportation industries are subject to their own set of financial market dynamics. Historically, shipping company finance was based on traditional debt financing of 70%-80% of the vessel construction or purchase value. Each vessel would have been separately mortgaged, giving the borrower attractive terms in exchange for pledging the vessel as security to the lender. However, since 2007 the amount of bank loans to the shipping industry has dropped by half, according to Bazil Karatzas of Karatzas Marine Advisors. Karatzas points out that debt has become more expensive and restrictive and vessel financing will require more equity than in the past which is a challenge for smaller independent owners. He adds that banks are now lending to shipping companies against their entire balance sheet versus on an individual vessel level.

Given the need for more equity and strong equity capital markets one may assume that now is a good time to issue new stock via an initial public offering (IPO). However recent issues in 2014, such as WL Ross & Co.'s Diamond S Shipping Group, failed to raise enough interest at the time of IPO issue on the New York Stock Exchange (NYSE) and were pulled abruptly from the market.

The company owner has said that he would not issue stock at a price 'equivalent to less than the market value of its fleet.' This may sound surprising when other issuers have come to market with rather strong debut pricing. In the case of Diamond S, the proceeds of the IPO were to be used to acquire 10 new vessels adding to the 33 in its current fleet. On the surface, raising capital to make an acquisition like this seems logical, fitting a growth strategy that would benefit current investors and would-be public share investors. However, negative sentiment in an industry can affect even a strong companies' potential to raise capital – despite their story.

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So what makes a successful public share offering? According to Ernst & Young, a successful IPO tends to depend on companies with relative strength in their industry when it comes to growth rates, sales performance, profitability and market share. Furthermore, it points out that the most successful have a credible management team, an outstanding

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product or service, a sustainable outstanding business model, a strong brand, a streamlined cost structure and an industry with high barriers to entry. Although WL Ross & Co. arguably has achieved a number of these criteria for Diamond S, the major challenges surround the business model and the industry itself. Depressed freight rates and overbuilding have plagued the marine freight industry for years and vessel values have suffered as a result. This has been both an opportunity for new investors, such as WL Ross & Co., and a curse in terms of financing in the form of debt or equity. For banks, public investors and passive mutual funds the investment thesis, or 'story', has remained too weak or risky given the industry fundamentals.

For the transportation industries as a whole, the volume of US exchange listed IPOs in 2013 was only 25% of those issued in 2005, according to Greenwich, Connecticut-based Renaissance Capital. More recent shipping issues are not reassuring of a change in investor appetite. Ardmore Shipping, a 13 vessel petroleum and chemical product tanker company, launched its IPO on the NYSE in August 2013. Since that time it has underperformed the broader market despite a relatively strong debut. Investors may look at a recent comparable such as Ardmore and question the likelihood Diamond S faring any better. Perhaps relative size of venue is the key. How does a company with a market capitalisation of $328 million (such as Ardmore) compare with companies as large as ExxonMobil and Apple with over $500 billion of market capitalisation, more than 1,000 times its size on the same stock exchange?

It may be better to be the big fish in a smaller pond. This is a key marketing point of smaller exchanges in Toronto, Oslo or Singapore. These markets garner more attention for small issuers because local investment banking underwriters can commit more resources to cover the companies and issue research further publicising the potential value of the company.

Since a public listing is based most importantly on the timing of both the company's life cycle as well as current capital market conditions, the benefits and drawbacks of being a public versus private company deserve careful review. The main benefit to owners of a public share issue is to create an exit strategy, provide partial liquidity for their investment or provide growth capital. By accessing the depth and breadth of investors both locally and internationally, private owners can often raise capital they may not otherwise. For example, a more diverse set of investors often will not discount a minority stake like a private investor would. Although large private equity funds do make minority investments, there is virtually no substitute for public markets when it comes to selling a minority stake of a large company.

Perhaps the biggest benefit of taking a company public is that public companies will often attract higher valuation due to more transparent disclosure and the market's perception of lower uncertainty. On the other hand, public listing requires company management to commit time and focus to reporting, compliance and investor relations. Additionally, underwriting fees (as much as 7% of capital raised) and ongoing expenses to external advisors needed to maintain a public listing can be a drag on company profits. For larger firms, these negative consequences are probably insignificant versus the benefits of access to greater capital pools that provide a tool for perpetual growth.

For small to medium size companies, the decision to go public is more complex. The expense of going public alone is a significant drawback for some whilst potential loss of control is the main concern of others. Those who have worked in a private company with a limited group of owners or a sole proprietor know that decisions can be made very quickly. Those who have had experience with a public company know that bureaucracy can impair or at least slow down decision making. As the officer of a public company, a manager must take more stakeholders into consideration and may often feel pressure from shareholders who want input in decisions and strategy. So-called 'activist investors', such as Icahn Enterprises and lesser known funds, increasingly launch public activist campaigns against listed companies in both the United States and Europe.

Despite strong market conditions for sellers, recent efforts to list shares by shipping companies have faced strong headwinds, likely a result of low freight rates and weak industry fundamentals. Whether current sentiment is positive or negative, investors must appreciate both the story of a company's potential profit and growth within its industry. Less profitable large companies such as Amazon are well received by the market since their outlook for growth is strong (at the time of writing Amazon has a market capitalisation of $133 billion).

For shipping and marine service businesses, growth is somewhat limited so profitability must be more heavily weighted. As a result, the option to use private equity financing is likely a more attractive route to provide current owners with liquidity or to fund organic growth and acquisitions. When the time is right, an IPO may be the obvious next step that could open doors that would otherwise remain closed.

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Prior to his current role, David Hobbs was a senior mergers and acquisitions investment banker at Citigroup and Compass Advisors. He has also traded fixed-income derivatives, primarily on a proprietary basis, at UBS.

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