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Credit funds in the wake of departing shipping banks

Traditionally, the biggest provider of capital to the shipping industry has been shipping banks; European banks in particular have built upon long practices, relationships and core competencies over decades of lending to ship owners. The Royal Bank of Scotland (RBS), HSBC and Lloyds TSB in the U.K. were the prime bankers to the shipping industry, while Nord LB, HSH Nordbank, Commerzbank and Deutsche Schiffahrts were the dominating lending names out of Germany. Shipping banks in Scandinavia, Greece, France and Italy have also been instrumental at funding the shipping industry for several of the past decades. Independent ship owners with good track-records of performing on their shipping loans had typically few difficulties over the cycle to borrow and expand their fleets.

Since the financial crisis in 2008, many exogenous events have affected the banking industry as a result of titanic losses generated during the good years, and the ensuing crystallization that banks have a much bigger relevance for society than many other industries. The realization by 'Main Street' that banks are too important to be left to their own devices has brought, in turn, political and regulatory ire upon them. Just trying to quantify and put into perspective the state of the shipping lending market gives pause for thought. It has been estimated that shipping banks have had close to $100 billion of non-performing shipping loans out of a total shipping loan portfolio of $500 billion.

Based on such hard-to-justify figures, shipping banks have come to the conclusion that shipping may not be an 'average' industry after all. Cashflows from the freight market resemble the choppy North Atlantic Ocean in the winter and are certain to generate bad loans over the course of a business cycle.

All of the banks mentioned above have either already sold a substantial portion of their shipping portfolios or they are actively exiting the shipping industry by not originating new loans, not rolling over performing maturing loans, and offering to sell their loans at a discount back to their debtors. When one or two banks opt to re-prioritize the importance of an industry, the result can be bearable, even insignificant; however, when the prime movers are exiting en mass, the action can resemble an elephant stampede. To the dismay of many vulture funds, the elephant stampede never materialized in the form of 'fire sales' as the banks have been mindful of drastic moves that could further materially affect inversely their portfolios. On the other hand, the steady march of shipping banks away from shipping, has undoubtedly created a funding vacuum that many an entrepreneur have dreamt of benefiting from.

The effects of the funding gap are reflected in many aspects of the industry. Asset prices for ships have been less volatile and less correlated with the freight market; in the past, robust bursts to the upside in the freight market would lead to equally robust improvements in asset prices in the same direction with only a lag of a couple of weeks. Nowadays, many analysts are wondering what

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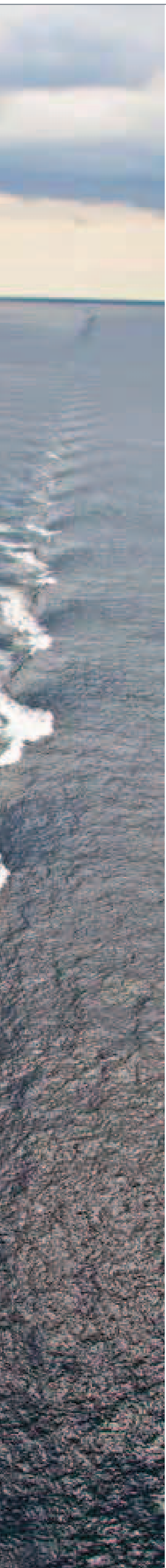

happened to tanker prices that have not budged even though average tanker freight rates more than doubled since last year.

Another indication of the funding gap in shipping is the age of vessels sold in the secondary market, and relative values along the age profile curve of certain vessel types. Ship owners with access to the capital markets prefer buying brand-new ships, while owners with cash but no access to debt opt to buy older vessels, fifteen years and older, as these vessels are valued almost at scrap and their purchase price is a small number in absolute terms. There is a so-called 'smile' in the asset pricing curve, as vessels in the middle of their economic life, around ten years, are not 'bankable'. Any bank still active in shipping definitely prefers lending against vessels that are not older than five years.

As a result the action is concentrated at the two ends of the spectrum of the smiling curve while the middle is lacking in activity.

The lack of debt financing in the shipping industry has acted attracted several institutional investors that aim to fill the lending 'need'. These 'credit funds' finance the industry via credit and lending, more or less in the same way that a lending bank could have done. However, institutional investors are not exactly banks (in terms of having a banking charter, funding, cost of funding etc) and accordingly credit funds have to have a business model modified to best suit their own capital structure and risk profile.

First, the cost of capital for credit funds is much higher than that of banks. Banks are typically funded by customer deposits at a low cost of capital which is highly related to the official interest rates set by the corresponding central bank. Credit funds on the other hand are funded by institutional investors, private equity, endowments and family offices and their return expectations are significantly higher, even for investments with low risk profiles. Accordingly, although credit funds have a strong interest in exploiting the funding gap created by the banks, they cannot exactly fulfill a bank's role because of their return expectations.

Another major difference between banks and aspiring credit funds is the risk profile each is capable of handling. Banks as creditors are by nature very risk averse and preservation of capital is of paramount importance. Depending on the prevailing reserve ratio, banks are by definition levered multiple times. Thus even a small loss of capital can translate into big losses for the equity holders. Institutional investors, in turn, naturally despise loss of capital invested, but they are better suited for undertaking risk and eventually handling risk. Accordingly, credit funds can chase lending projects of higher risk in exchange of higher reward, since they can better tolerate a loss of capital and chasing credit projects of higher reward dovetails well with their higher cost of capital.

While banks are heavily regulated and can only underwrite credit risk within the regulatory environment, credit funds are largely non-regulated financial entities that theoretically can underwrite as risky credit projects as they wish, in terms of leverage, age of vessel, consideration for residual risk, possibly sovereign risk, etc.

For banks, each element of the transaction that dials-up risk translates into higher reserves, which in turn decrease return on equity, in a cycle that curtails the appetite for risk. For unencumbered credit funds not bound by banking regulations, riskier credit theoretically results in higher returns.

Another aspect of the regulatory environment for banks is that the only product they can offer is to extend credit in the form of a loan, while credit funds can effectively extend credit under many guises such as mezzanine financing, second lien financing, preferred equity (with preferred return on the 'loan') or convertible (whereby the loan can convert to equity under certain circumstances). Credit funds in theory can have much greater flexibility to participate in the non-equity part of the capital structure, while banks can only be in the pure debt of the capital structure. Although the weak freight environment is still marred by many legacy transactions, including loans that are under water, ship owners running out of working capital or owners in need of funding for drydocking and other unforeseen expenses, it seems that credit funds should have a ripe environment for selecting projects to extend credit to.

There have been several efforts by institutional investors to enter the debt market for shipping. The most visible among them have been KKR's Maritime Finance Company based in Bermuda and Bridgewater in the U.K.

An interesting case has also been Maritime & Merchant Bank in the U.K., backed by a group of former shipping bank officers, which is seeking to obtain a banking license in order to be able to have access to the inter-banking system and wholesale deposits.

In a similar and equally interesting development, the private and typically secretive Berenberg Bank has been fronting institutional investors looking for a platform to lend to the shipping industry. Besides these well publicized credit funds, there have been many more efforts on a more selective, discreet and opportunistic basis, including efforts to set publicly traded vehicles such as Business Development Companies (BDCs) in the U.S. Although Maritime Finance Company and Bridgewater are already well funded, Maritime & Merchant is experiencing difficulties raising funding and obtaining their banking license, whereas Berenberg Bank is well short of its ambitious $1 billion funding goal.

In theory, credit funds should make an ideal credit investor for shipping given the present state of the market and the lack of lending capacity from traditional banks; the fact that credit funds can be more flexible given lack of regulation for them would imply an even greater rate of success for sourcing suitable investments.

Empirical evidence suggests that very few credit funds have been managing sufficient credit opportunities in shipping. Based on our own experience, we typically see that credit funds have been looking for too high returns given the level of risk which they are prepared to undertake. Surprisingly, credit funds do not seem too keen to be flexible, and often end up looking for pure credit products at low double-digit returns, a rather usurious expectation, especially given that the freight market cannot support such a high hurdle.

Only a limited number of transactions have taken place in the primary market and some of the credit funds have been looking in the secondary market at shipping loan portfolios that can be acquired at a discount and likely to be able to satisfy the high return hurdle.

Given that banks most likely will stay out of shipping for the long term, credit funds will have fair prospects going forward. As long interest rates remain at historically manageable levels and banks keep shying away from shipping, there is little alternative to sourcing debt for the owners lacking a corporate balance sheet. However, present aspirations and expectations will have to be modified if credit funds were to have realistic prospects of lending to the shipping industry.

ENDNOTES

[1] http://www.compasscayman.com/cfr/2014/10/31/A-changing-seascape-in-shipping-finance-and-the-capital-structure-of-vessel-ownership/

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