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# SEA VIEWS

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# SHIP FINANCING: SURVIVING THE STRESS TEST

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*Nazery Khalid, Senior Fellow at MIMA's Center of Maritime Economics and Industries outlines the impacts of the credit crunch emanating from the financial crisis on ship financing. Despite the gloomy outlook for the shipping sector in the near term, he emphasizes that a long term perspective is needed to evaluate the worth of the shipping industry as an investment potential*

### Squeezed by the credit crunch

The Wall Street meltdown has had a massive domino effect on major industries worldwide. The ensuing financial crisis cuts deep and wide across the global economy. It has clipped the wings of growth of many business activities and industry.

Being an activity that transports much of the world's trade, the shipping industry has not escaped the crippling effects of the global recession. Despite the fact that certain shipping trades appear to have weathered the storm well, the industry in general has inevitably felt the pinch of the credit squeeze arising from the 'financial mess in the US'. There is growing concern that the crunching effect of the crisis will choke the growth of this capital intensive industry that depends much on the fluid, trans-boundary flow of capital. Below are some of the implications – observed and projected - of the financial fiasco on the shipping industry and ship financing :

### *i) Less debt financing available for shipping*

The credit squeeze following the financial crisis will make banks more cautious to lend to the shipping sector. Traditional players in ship financing will no doubt continue lending, but will do so more conservatively and prudently. Banks not familiar with ship financing might stay on the sideline altogether and concentrate on their mainstay areas of lending to generate revenues. We can expect banks which count ship financing as their forte to trim their exposure to shipping and reduce their single client borrowing limit. This will sharply reduce the loan-to-value ratio of ships as the cost to finance purchase of ships increases and less money is available to purchase vessels. In addition, the tight financial markets will heat up competition among various industries to borrow money from banks. Shipping will be faced with greater rivalry from other industries in raising debt financing.

### *ii) More expensive cost of borrowing*

The less debt financing becomes available, the more stringent banks will become in disbursing loans, hence making it more expensive for shipping companies to raise debt financing. Banks will charge higher fees for the cost of underwriting debts, shorten the tenure of loans, and demand more collateral from borrowers. Intervention by central banks to pump in more liquidity into financial markets is not expected to have a dramatic impact on the cost of borrowing money in the short term. Despite getting new funds from rescue packages, banks will be reluctant to lend amid the uncertainty and volatility of the financial markets and global economy. Interbank lending rates are poised to remain at high levels, hence the overall cost of bank borrowing is expected to be more expensive. This can be off-putting to shipping companies looking to embark on major fleet expansion and asset acquisition programs which require huge capital.

### *iii) Declining margins among ship financing banks*

As banks affected by the financial crisis become less liquid, they will have less appetite to undertake 'big ticket' deals. This will affect ship financing, especially the financing of new buildings and purchase of large, sophisticated vessels. As a result, bilateral deals, which provide the main pillar of debt funding in ship financing, will see a reduction in quantum and number of deals. Such a situation will not be desirable for ship financiers as cash-rich shipping companies will be in a good position to partly finance their fleet expansion programs using internal funds and hence need to borrow less from banks. The combination of less bank lending and more internal funding by shipowners will send the margins of ship financing banks on a downward spiral.

### *iv) Greater focus on alternative financing / non-debt borrowing*

As a direct result of banks reducing their exposure to shipping, shipowners will seek financing from alternative sources beyond 'plain vanilla' debt financing. They will explore more intensively alternatives such as bond financing, shipping trusts and Islamic financing to raise funds. Ship financing outfits will also increasingly offer structures incorporating asset securitization, sale and leaseback and derivatives and hedging structures in structuring ship financing deals. Such alternative and more innovative structures should continue to attract good response from shipowners looking to ease off dependence on debt financing and investors looking to spread out their investment to a wide range of asset classes.

### *v) Greater focus on risk management by banks*

As banks reel from the aftershocks of the crisis, they will enter into ship financing deals more cautiously and will seek whatever means to minimize their risk exposure and protect their lending. Expect to see more syndicated loans or club deals instead of outright loans by a single party, and also more structured finance elements being incorporated into ship financing deals. Banks will increasingly use advanced hedging techniques and cutting-edge hybrid financial structures in managing the risks of shipping loans. They will strive to minimize risk on their end by 'transferring' the risk to the borrowers' end.

### *vi) Banks preferring to lend to shipowners with strong credit*

When the going gets tough, businesses need capital badly but banks become more choosy. With the slice of the debt financing pie shrinking, banks will tend to favor companies with strong asset base, track record and credit standing over smaller companies. Shipping companies with those qualities will have the comparative advantage to borrow money from banks over companies without strong assets in terms of value and which cannot put up strong collateral or contracts to provide comfort to the bankers.

### *vii) More refinancing activities*

Since the financial meltdown began, some shipping trades such as the container and dry bulk trade have suffered declining freight rates and are faced with overcapacity of tonnage. If this prolongs, it will cause shipowners in these trades to be more cautious to commit to new loans to expand or modernize their fleet. They will look at their loan portfolio to trim down their interest payments, and this will result in an increase in refinancing of shipping deals. Expect to see sale and leaseback arrangements and bond issuance by several highly-leveraged shipping companies in the near future.

### *viii) Emergence of more private equity financing*

With less debt financing available in shipping, more private equity (PE) investors will make forays into the industry to pick up the slack left behind by banks and invest in ships to be chartered out. The entrance of more PE money into ship financing will reduce the debt ratio of shipowners and in the industry overall. Look out for several high-profile direct buyouts of public shipping companies funded by private investors. Don't be surprised to see PE investment from diverse background such as pension funds and insurance companies buying into shipping companies as they have done with ports.

### *ix) More mergers and acquisitions among shipowners*

The credit crunch is expected to add impetus to further consolidation in the shipping industry. Having already seen numerous mergers and acquisitions (M&A) exercises, the industry is poised to drive shipping lines to attain greater economies of scale. The small companies will get big while the big will get bigger. The mantra is for industry players to offer bigger asset base, greater market capitalization, better collateral and brighter growth prospect - to enhance their chances of gaining access to competitive financing from banks. This will spur more banks to set up dedicated M&A desks in major shipping centers such as Singapore, Greece and Hong Kong to reap the opportunities presented by the 'M&A mania' in the shipping industry. Investors will pay greater attention on the financial opportunities arising from these activities.

### *x) Delisting of shipping companies from bourses and delays in shipping IPOs*

With equity markets worldwide in the doldrums, listed companies will not be too pleased with their share prices languishing, their market capitalization eroding and their companies undervalued. It would therefore not be surprising to see listed shipping companies seeking to delist themselves and going private again. Shipping companies seeking to embark on an initial public offering (IPO) exercise will have second thoughts about their plans to go public. As more alternative financing options become available in ship financing, they will be tempted to tap into other funding sources which can offer better return than equity financing.

## What comes down must go up

Despite earnest attempts by the contrarian camp to spot the glitter amid the gloom, it is hard to put money on the shipping market turning around in convincing fashion n anytime soon. However, one should view the current crisis – albeit severe in its magnitude – in proper perspective. No market will remain in the doldrums forever, no matter how severe a beating it takes. There have been recessions before, and those who have been in the shipping market industry long enough should have seen several bouts of downturn in this cyclical business. They will also vouch that the industry will always recover once the economy gets back on an even keel and trade volume grows again. Global trade and economy will pick up steam again in due course, and shipping will be among the first economic activities to rebound.

If what goes up must come down, surely the reverse should also be true. Nations will continue to trade, industries to produce goods and materials, and consumers to demand products - albeit at lower volumes. The prognosis for the economy of China, which has almost singlehandedly fueled the global trade and economic growth in recent years, is positive, although it will not grow at the dizzying rate as it had done in the last decade. This alone provides promise for the shipping sector, which is a crucial facilitator of global trade, to perform reasonably well despite the ‘economic doom and gloom’. It would take an event a lot more serious than the financial fiasco – as dramatic as it is – to bring the shipping markets to a grinding halt, despite the significant blow already inflicted on certain trades.

Naturally, the financial crisis will make seasoned lenders and capital providers in ship financing to tread the ship financing market more cautiously, and newcomers into ship financing will be apprehensive to enter the fray. However, the underlying sentiment towards shipping, a crucial facilitator of global trade, should remain positive so long as the global economy does not collapse. Once the dust kicked up by the financial market‘s stampede for survival settles, ship financing institutions, capital providers and investors will focus less on the woes of the financial markets and more on the fundamentals of the shipping industry in considering their involvement in this crucial sector.

It should be emphasized that shipping is a long term play and a slow burner of an activity. It would therefore not do it any justice to assess its worth within a short term perspective. Market cycles notwithstanding, shipping as an investment opportunity demands a patient following over a considerably lengthy time line for its prospects to be truly appreciated.

No doubt, there will be some players and investors in the shipping industry falling by the wayside amid the violent waves of the global recession and economic contraction. However, those who remain standing after the waves have retreated should take opportunity of the breather and take stock to assess the way they do business. They should be more prudent, strive to attain greater efficiency, improve their competitiveness and utilize their resources in a more optimal fashion.

Shipping players who remain resilient amid these challenging times and stay the course to prepare for the impending recovery in global trade and economy will be the first to reap the fruits of their patient when things turn around.