Examiners' Report November 2016

Shipping Finance

General Comments

The November 2016 paper was done well by most students, with a number of distinctions. There were a few fails but these appear to have been because of lack of preparation and/or timing difficulties in the exam room. Shipping Finance is an exam where students have to assimilate and understand, in the context of some of the case-based questions, a wide range of facts and scenarios in a short period of time. There is a need to write quickly and succinctly. Before proceeding to specific comments on individual questions, it may be useful to make some general overarching observations.

In some case-based questions where students are given a range of divergent facts, it is often true that there is no set answer, with a number of alternative solutions which will gain maximum marks if well-argued. Students may be required to give well-informed advice and guidance regarding possible options, usually in the form of a report to the Chief Executive Officer or Chief Finance Officer, based on an understanding of the topic AND the agendas of all parties concerned. For example, raising finance via an equity issue may appear to be the best advice, but if the company owner does not want to dilute his or her control of the business, or does not want to comply with higher corporate governance requirements particularly regarding disclosure of strategy, then this equity route would not be correct in the particular circumstances.

This is a details-based exam: answers which are vague lose marks as a result. For example, returning to the last point, if a student suggested an equity issue and then left it there, he or she would lose marks because this answer begs the question: what type of equity? Are we talking about an ordinary mainstream issue? Or preferred stock? Or convertible preference shares? And in the context of each, why are you proposing this, given the company's circumstances and the owner's strategy, and not some other form of equity? Should there instead be a private placement with sophisticated niche investors who understand the cyclical nature of the shipping business? If there is to be a public placement, are there legislative considerations to take into account, for example the Sarbanes Oxley Act?

Shipping finance presents risks to the borrower and to the lender. This may be for example that at the end of a loan which has a balloon payment, asset sales in a depressed market may not raise sufficient money to meet it. Or that in a loan which has been raised against a long term charter, the charterer is found to be a 'man of straw'- a weak company- which subsequently becomes bankrupt, leaving the owner unable to continue servicing interest payments. It is not enough to have a charter in place: it's the quality of the charterer which also presents a significant risk. If the loan is being raised by a company which comprises many one ship companies within its structure, this presents legal and jurisdictional risks in the event that it becomes necessary to arrest a vessel following loan default. In these circumstances, will it be possible to 'pierce the corporate veil'? This issue of risk can be factored into most answers, and discretionary marks will be awarded for raising what is in effect a 'fair point'; the examiner does not adhere rigidly to a marking scheme so anything different, which is well argued, will be rewarded with additional marks. This is, after all, the nature of shipping finance: it is dynamic, with many different solutions to one central problem.

Shipping Finance overlaps significantly with Legal Principles of Shipping Business. For example, students need to know, even if briefly, the types of clauses which are included in standard ship loans. There is always merit in referring to specific covenants and clauses, just to show the examiner that you know how the parties protect their positions in the documentation. There was also a question about mortgages in November's 2016 examination, and yet few students referred to legal aspects or gave some maritime caselaw to support or illustrate the basic principles. This legal aspect goes to the root of enforcement, and should not be overlooked.

Question 1

A general shipping company operating through one ship companies, registered in several different jurisdictions, owns and operates bulk cargo carriers built in the 1990s. It also owns several specialist chemical carriers built between 2012 and 2014. The Chief Executive Officer (CEO) of the company wants to raise a loan to purchase new specialist vessels, mainly gas carriers, whilst at the same time raising part of the capital through disposals of existing older vessels. He has approached a ship finance bank for a loan.

In your capacity as Chief Loans Officer at the bank, identify and describe those issues which should be taken into account when appraising the loan application by the company. You may want to discuss, but without being restricted to, the following aspects of the business:

- **The age profile of the company, and the borrower's intention to raise part of the finance needed from disposals of existing vessels;**
- **The legal structure of the company;**
- **Jurisdictional issues.**

This was a scenario-based question and nearly every student who attempted it gained a pass, but with a lack of high marks. The question required discussion of the legal risk presented by a company which has registered its assets in several jurisdictions. This required a discussion of enforcement, and also the difficulty of obtaining a true view of the company's overall strengths and weaknesses. As a solution to the facts of the question, the lender could require all vessels to be re-registered in one, recognised jurisdiction. There was also an issue as to whether the prospective borrower had been 'sweating the assets', or overworking the older vessels, reducing their value as a consequence. This issue is vital in terms of collateral value appraisal.

Students were also required to comment on the potential attitude of the bank to the fact that the CEO's plan depends in large part on the disposal of older tonnage; what if this is not possible, or if they are in bad condition? Would the bank be content to finance a strategy which can only be partially implemented? The question raises the importance of discussing, not just the applicable principles, but also the case facts and the agendas of all concerned- both the borrower and the lender.

Students were also required to identify the stability and reliability of the charterparty income of the borrower; if this is unstable, then how will it be possible to meet interest payments throughout the loan term?

A point missed by many students: is the company able to provide financial statements for recent years hich have been properly audited?

Question 2

Answer BOTH parts of the question.
a) Describe the factors which are taken into account when making a customer analysis for a loan.
b) Briefly identify the main elements which make up the pricing of a ship loan.

This was a popular question for students, but with a few fails because of a failure to read the question and answer its specific requirements. The question asked for a customer analysis, and NOT a vessel analysis: several students seemed to combine the two, and gained low marks because of issues they failed to mention. The question required, amongst other matters, the borrower's track record, existing relationship with the lender, financial projections, capital reserves: nothing was required regarding the state of the vessel, whether it was well maintained, and so on.

The second part of the question was not well answered by a number of students, although its requirement was straightforward. Students should have discussed the loan margin, legal fees, survey costs, fees relating to mortgages. This was just a list of points and there were a number of students who gained full marks because they kept to this narrow requirement and did not go off at a tangent into considering issues such as quality of the borrower, or strength of charterparty income.

Question 3

Discuss in detail the factors which are taken into account by a potential lender when making a vessel analysis.

This was a very popular question, with a number of students gaining full marks (20 out of 20) for their detailed answers. Issues to be addressed included type of vessel, valuation (several students missed this point), class and registry. Most students mentioned speed and fuel consumption, but did not raise the point of compliance with international or EU anti-pollution regulations. Breach of these can lead to arrest or being barred from trading in certain waters, and accordingly should have been mentioned in the answer. The Shipping Finance exam often has a 'list and briefly explain' question, but the danger for students is to write on a few points in great detail, but at the expense of missing other highly important points. So, the end result is perhaps half the marks available, even though the student has written extensively and eloquently about the few points which he or she has raised! Students should make sure they know their list of points for the topics where such an approach may be required.

Question 4

Answer BOTH parts of the question.

a) Compare and contrast legal and equitable mortgages, and the significance of the difference for lenders in terms of security and interest rate payable on loans.

b) In the context of arrest following default on a loan, describe the procedural differences between an action in rem and an action in personam.

This question was about legal and equitable mortgages. The legal differences had to be discussed in depth, and students were also required to identify applicable statutory provisions (including MSA 1995). Several students mentioned caselaw in illustration of the principles, and gained extra marks for doing so. If a student intends revising this important topic, which is one of the basic forms of bankers' security, then it would be wise to do a quick Google search for illustrative caselaw. Students were also required to give some indication of standard clauses in legal mortgages, as well as discussing basic issues surrounding registration. The question also required a discussion of procedural issues, particularly regarding the difference between actions in rem and in personam. Students who missed out on this 'nitty gritty' part of the question lost some valuable marks, although nearly every student who attempted it passed it (only one failure although it was not a popular question, possibly because it's the sort of subject which you either know or don't know- there is no in-between!). Students were also required to recognise the fact that the higher the mortgage in terms of registration, as well as in the context of a secure legal mortgage compared with an equitable mortgage, ceteris paribus this should be reflected in the interest rate paid on the loan to which that mortgage relates.

Question 5

Identify and discuss in full, in terms of purpose, the main standard clauses and covenants in a typical ship finance loan.

This was a relatively popular question, with all students apart from one passing it. Again, standard covenants and clauses in a ship finance loan is a topic you either know or don't know- it is very difficult to guess at it and gain enough marks to pass. The marks were average passes with very few scoring well. The reason for this was that students tended to focus on just a few covenants and discussed these in depth, when the question required students to discuss 'narrow and shallow' or in other words, raise many clauses but only give a brief explanation. Notification of litigation, provision of information covenants, negative pledge, and maintenance of status, were some of the clauses which were omitted from several answers given by students.

Question 6

Define and discuss ALL of the following.
a) Amortising term loans
b) Revolving credit facilities
c) Hunting licences
d) Bridging loans

This was a very popular question, with many students achieving high marks. There were several students who seemed to go for this question as a 'last resort' because they had exhausted the topics which they had revised; accordingly there were uninformed guesses, particularly regarding hunting licences and bridging loans, which gained some students no marks at all because the answers were completely incorrect. The lesson seems to be, don't attempt very specific questions if you have run out of options, but instead go for questions, particularly scenario-based, where you at least have a chance of identifying relevant issues and putting forward well-informed solutions, perhaps based upon your working experience. With regard to revolving underwriting facilities, the commitment fee should have been discussed. Also, the amount available for drawdown usually decreases during the life of the facility to protect the lender's position.

With regard to hunting licences, importantly, although the vessel to be purchased has not yet been identified, lenders usually impose conditions relating to, for example, age, survey, and classification, so it is not a 'blank cheque' given to the borrower. With regard to bridging loans, these are usually secured with a mortgage on the vessel concerned.

Question 7

Answer BOTH parts of the question.
a) If a shipping company is described as 'highly leveraged', what does this mean, and how might this be altered through adjustments to the capital structure?
b) In a highly volatile interest rate environment, what are the implications for both borrowers and lenders of high leverage?

This was not a popular question, possibly because it had theoretical dimensions. But those students who did attempt it achieved very good marks, and higher than the spread of marks accruing to the other questions for this paper. Students were required to discuss the burden of interest for a highly leveraged company, and how this becomes difficult to service in a declining shipping market where earnings are diminishing and redeployment to the spot market has become necessary in the absence of long term charterparties. Borrowers are already finding it difficult to cover OPEX at this time, and it will become increasingly difficult to service loans, opening the possibility of default and, if the lenders so choose, bankruptcy petition. Students should also have briefly mentioned that the ratings agencies, for example Moody's and Standard and Poor's, will usually downgrade a company which has taken on too much debt which has the paradoxical effect of raising the interest rate demanded by lenders on any future loans (because perceived risk is greater). Students could also have briefly mentioned the Modigliani Miller irrelevance hypothesis, and its abstract (unrealistic) assumptions about perfect markets. In a volatile interest rate environment, borrowers will try to fix the rate by swapping out of floating rate debt. With regard to lenders, they will ask for more security from borrowers in the form of fresh collateral such as a parent company guarantee, which may not be possible if the borrower is already highly geared with nothing left to pledge.

Question 8

Identify the characteristics, for example in terms of freight rates, of the main phases of the shipping cycle, describing how borrowers, lenders, and equity investors behave at each turning point. If the shipping cycle lags behind the wider economic cycle, what are the consequences of this for each of these groups?

This was a deliberately vague question which gave students plenty of areas for discussion and for raising interesting perspectives. It was very popular, with almost all candidates passing, and with several very high marks gained. An important requirement of the question was to specifically discuss and identify each stage of the shipping cycle: behaviour of parties such as owners, charterers, lenders at each stage was where students could give their informed opinions. Shipping Finance requires a thorough understanding of the cycle, and how parties behave for example at the zenith and the nadir. This subject cannot be neglected by students studying for this exam because it comes into so many other topics in the syllabus, such as bonds, equity, vessel appraisal, and so on. It is also important to have an awareness of how the newbuilding market behaves at each stage. The layup or scrap decision, and the factors which drive it, must be known in detail, and many students answering this question were able to list and briefly describe these. Students who had exhausted the subjects they had revised and were looking around for the last question to answer would have been well advised to try this question, given that it gives plenty of opportunity to think, to reflect, about what the shipping industry and its accompanying cycle are all about.