**Shipping Finance Exam May 2017. Examiner's Report.**

**General overview.**

The May 2017 exam saw a very good set of results, with a significant number of candidates gaining marks in the 70s and 80s. Many scripts indicated that candidates had 'read around' the topics they had revised, with references to cases in the news and latest trends in particular aspects of shipping finance. This exam is above all else a details-based subject; candidates often lost marks, not because of a lack of understanding of a subject, but a lack of precise and specific explanation of principles. It was as if some had assumed that, since the Examiner knows the subject anyway, there was no need to go into any meaningful degree of detail. This is the incorrect approach; it is essential to answer questions on the basis that the Examiner does not know anything about the subject and in this way the 'easy marks', if there is ever any such thing, will not be lost and an exam script submitted which is light on detail. A further observation regarding problem-based questions: it is important to proceed through a question coherently, dealing with each issue at it arises. Some scripts approached problems in a disorganised way and in so doing, missed minor issues which would have added to their overall mark.

**Question 1.**

Results for this question were mixed, with most candidates gaining good pass marks. The main reason for a few failed marks was a fundamental misunderstanding or misreading of the question. Several students failed to discuss the risk of dilution of the owner's control of the company if ordinary shares are issued to outsiders. Some answers failed to address the issue of the existing capital structure within the company; if it already has a high level of debt, this must be serviced from profits before any dividends can be paid to shareholders (dividends, unlike loan repayments and interest, are discretionary). When answering this kind of question, it is always important to consider the implications of the existing structure; debt can be a heavy burden, and accordingly may deter new shareholders from coming in to the business.

With regard to equity, it was surprising how many candidates failed to discuss the different types of shares, and when each would be appropriate given the needs of both the owner, the shareholders, and future anticipated profits of the business. Several candidates also did not even discuss the issue of a private placement, what this means, and how it compares to a traditional ordinary share issue. With regard to this, it is the sophistication of the shareholders which is a distinguishing factor, but also their usual requirement to have greater influence in the business.

With regard to keeping embarrassing charterparties quiet, this brings in a discussion of Sarbanes Oxley. Good candidates were able to cite individual sections, which demonstrated a reading around the subject.

**Question 2.**

This question was generally well answered although there were several fails, including two zero marks. The main reason for some low marks was a lack of detail; the question specifically asked for a discussion of the relevance of each type of loan to the particularly phases of the shipping cycle, and yet some answers discussed this latter aspect in a very brief way. Shipping is a highly cyclical industry, and for this reason it is vital for candidates to understand the behaviour of lenders and borrowers, owners and charterers, at each phase. They should also be able to contextualise this within the economic qualities of a derived demand, and the lag. These factors can be brought in to other topics in the course since they are so fundamental. This is the sort of detail which gains higher marks. Also, with regard to each type of facility, it was surprising how many candidates failed to discuss the risks to the parties concerned. For example, if there is a balloon payment at the end of a loan, or if there is a moratorium, the risk is that asset values will have fallen by this time, preventing the borrower from being able to make the payment. Also, the higher the risk to the lender, the more one would expect to see this reflected in the facility fee. This question should have been answered well since it was mainly descriptive in what it required; however, it was the lack of detail which let down some answers.

**Question 3.**

This was a good question because there were no right or wrong answers, just a requirement that candidates think about the issues and provide coherent analysis. Despite being specifically asked not to, some students still discussed operational reasons for failure, and gained no marks for having done so. This resulted in there being more very low fail marks for this question than should have been the case. It is vital to always read the wording of a question and answer it as written and not as you would like to have seen it written! In this answer candidates could have discussed in detail the consequences of having too much debt in the capital structure, and how this will cause strain and difficulties in servicing at different phases of the cycle. Different types of loans could also have been discussed, for example front and back end, bullet. With regard to bonds, the question arises as to which benchmark the interest rate is referenced against; is it fixed, floating above LIBOR, or above freight rates? With regard to existing debt, is it possible to swap out of fixed into floating, or vice versa, depending on how interest rates are anticipated to move in the near to medium future? What would be the cost of the swap? Would a swaption be an alternative? Again, would the facility fee be too expensive? This question saw several candidates gain a maximum mark; although they may have missed some issues, they compensated for this by raising others which were equally relevant. The number of candidates failing this question was very low compared to the other questions.

**Question 4.**

Nearly all candidates who answered this question gained a pass mark, with several high marks and just a few fails. There were some obvious issues which required discussion, and all candidates spotted them. For example, the company's intention to trade its dirty vessels in EU waters would not be possible because of recent environmental directives which ban such vessels. Also, the cost of modification would probably be prohibitive. There has also been a previous collision at sea, but with the outcome as yet unknown in terms of whether a payment will be due. Candidates should have discussed the implications of this, for example in terms of a possible undischarged liability and also the risk of future arrest of the vessel if a judgment has not been paid. Candidates were also required to discuss the fact that the vessels have been 'sweated'. This means that their value as collateral or security may have diminished in recent years. There is also the added risk that they are more likely to break down, be off hire, and accordingly not earning anything. A lender would be concerned about this risk. This question gained the highest number of maximum marks on the paper; candidates identified all the points, including the issues of insurance, registry (some vessels are registered in politically unstable countries. Enforcement of loans may be problematic, and lenders will require them to be re-registered in one stable jurisdiction before any loan is made); employment (there is a long term charterparty in place with a reliable agricultural company). Overall a very well answered, descriptive, detailed question.

**Question 5.**

This was a straightforward descriptive question in terms of its requirements, and there were many high marks, including some at the maximum. Candidates should have discussed type of borrower, track record, management experience, and any existing relationship with lender. With regard to character, candidates should have discussed the fact that behaviour should not change according to the phase of the cycle; if a borrower is to establish a reputation for honesty with lenders, then this should be consistent during periods of boom and depression. In fact, a borrower who prioritises lenders' interests above his or her own during a downturn or depression is more likely to be able to raise finance later, because lenders will be assured on the basis of behaviour during previous difficult times. Character doesn't change with the winds of the economy; in many ways it is more important than the value of vessels being financed. This raises the practice of 'lending to the name' rather than to the company. Candidates should also discuss capacity to meet loan or interest payments during a downturn when just meeting OPEX may already be proving difficult. Capital and reserves are also run down during a downturn as owners struggle to meet OPEX from falling or non-existent earnings. However, capital may also be run down during an upturn as owners who have survived the recession are now looking to make acquisitions at 'bargain basement prices' from owners who have decided they cannot survive and are now looking to quit the business.

**Question 6.**

This was a descriptive question in terms of its requirements but marks were mainly around the mid-range or just fail. A number of candidates gained zero for the negative pledge part of the question; it was one of those questions which you knew completely, and gained a maximum mark, or not at all, and gained nothing. Candidates should look at the following link for an initial definition, which would need to have been expanded upon in the exam;

https://uk.practicallaw.thomsonreuters.com/2-107-6875?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1

The purpose of the clause is to prevent a borrower from taking on fresh debt ranking above or at the same level as existing debt holders. This makes sense; a lender would not want its place in the queue on the insolvency of the borrower to suddenly fall behind that of a newly taken on debt holder. Even if the new debt is lower ranking, a lender may try to prohibit this because it increases the risk of corporate failure, and is also a further strain on existing cashflow. With regard to events of default, some candidates gave just a single example; the question required discussion of a few. Provision of information, for example audited financial statements, profit forecasts, details of incidents at sea such as collisions, was also answered inadequately, with most candidates failing to provide the degree of detail for a high mark. In this type of question, often answered by students who have exhausted the topics which they have 'question spotted' in their revision, it is vital to be able to provide the degree of detail for each part. There is a maximum amount which can be awarded for individual sections, so there is no point in writing a large amount for the single topic you know, but then nothing for several others which you have not revised. There can only be a quarter of the marks awarded if one out of four has been answered, even if that particular answer is in great detail and gains the maximum mark.

**Question 7.**

This was not a popular question, with fewer candidates answering it than for the other questions. Students who did answer it lost many marks (there was a significant failure rate for this question) because they did not give the breadth of provisions required but instead gave just a few which were discussed in great depth but still gained low marks. This type of question requires answers to be broad and shallow, rather than narrow and deep. If the question specifies that a number of points need to be made, even if in bullet form, then there is no point in just giving a few clauses or terms or covenants and writing about these to the exclusion of all else. If candidates intend revising ship mortgages, or terms of a loan, then they need to have a comprehensive knowledge and not just familiarity with a few main terms.

**Question 8.**

This question required candidates to 'think outside the box', and consider issues of the debt-equity balance, cyclicality, lags, and derived demand. The ratio has to be adapted to meet present earnings as well as anticipated shifts in these. If they are expected to decline, then perhaps it's better to reduce debt in favour of equity. But if they are expected to rise, it becomes easier to raise equity finance as investors get caught up in 'exuberance', driving up share prices and company values. Candidates who briefly discussed the MM hypothesis, its assumptions and weaknesses, gained high marks. This was a popular question but with marks either being very high or very low, with very few hitting the middle range. Candidates who discussed the drivers of investor sentiment at different phases of the cycle gained high marks.