EXAMINER'S REPORT
MAY 2019

SHIPPING FINANCE

General comments.

The quality of answers in this year's exam was generally very good. Students showed an appreciation of two realities concerning shipping finance as a distinct exam topic, and also as a practical issue of vital relevance to the prosperity of ship-owners. First, the subject is about detail; answers which were generally correct but too brief in analysis gained borderline pass marks. Now this is fine if answers in a student's script are all borderline passes because this should result in an overall borderline pass, which we all want to achieve! But if there are material errors in one answer, then the overall mark will dip below a pass mark and become a fail. The second reality which most students taking this paper reflected in their answers is that there is often no definite right and wrong answer to a scenario-based question. For example, in a recession a ship-owner will probably try to negotiate a moratorium loan; in this way payments can be suspended for up to two years, giving breathing space to at least cover OPEX. However, one could equally argue that if an owner has the cash flow to do so, even at a struggle, it may be advisable to try for a front-ended arrangement. In this way a loan can be paid off as quickly as possible, leaving the owner better-able to buy up distressed assets as the sector emerges from the slump and banks are now forcing through sales at significant discounts. So, students can argue for both types of loan in response to the same state of the cycle, and both answers will be correct if justified correctly.

Students continue to overlook the issue of cost of arrangements: there is no free lunch when it comes to requesting innovative finance from banks. So, if a moratorium is requested, then the bank will be taking a risk in deferring enforcement of rights if there has been a loan default. This may mean that in two years' time the company is still forced into liquidation but at this later time the lender receiving even less on the sale of assets than would otherwise have been the case if the sale had taken place earlier. It is important that students always bear in mind the risk to all parties concerned, and how this is priced into facility fees. If the bank is being asked to defer its rights and to suspend payments, then this will be reflected in either a significant facility fee or a higher rate of interest being charged when the owners is able to resume payments at the later date.

Question 1.

Identify and discuss the types of loans which would be best suited for a ship-owner in ALL of the following situations.

In each scenario explain the risks to all parties involved and the typical covenants which would be included by a lender.

a) An owner is trading vessels during a recession in the shipping market. Although the owner is presently trading its vessels in the spot market, an anticipated upturn in freight rates will result in charterers being willing to enter into medium term charter parties in the near future. The owner is looking to raise a loan to accommodate both its short term weak trading position and the expected increase in earnings following availability of charter parties for its vessels in the near future.

b) An owner is trading vessels in a booming spot market which has reached its peak. Earnings are currently high but are expected to weaken as the market cools. The company already has a significant level of fixed interest debt in its capital structure and is looking to refinance this.

c) An owner is currently struggling to service a high level of floating rate debt in its capital structure at a time when interest rates are expected to begin rising sharply. The company is finding it difficult meeting its operational expenses (OPEX) and there is doubt as to whether it can survive in the short term. However, if the market improves as expected, asset values should begin to increase over the next two years.

This question was well-answered with nearly all students gaining a pass, and several a very high mark. This question was about detail, as mentioned in the general comments earlier. Students all managed to correct apply the different types of loan, including moratorium or back end (a), bullet or back end or revolving (b). Scenario (c) could have been a moratorium or back end, but some students also noticed that the owner had floating rate debt in its capital structure at a time when rates were about to rise. This required mention of a fixed to floating interest rate swap.

Does it matter if the same type of loan is mentioned in two scenarios? No; if the student uses the same facility but justifies it by referencing the specific facts of each scenario, and recognising any differentiation which may arise, then full marks will be given. Remember, scenarios may differ in terms of the risks presented, the cost of the facility, and the different covenants which will be required by the lender. This is where a student can use the same loan facility, but distinguish it on the basis of different contexts. In loan-type questions, discussion of costs, facility fees, risks, and covenants are what distinguish a borderline pass from a full marks answer.

Question 2.

Describe and explain the main duties of a borrower, and the powers of a lender, under the terms of a typical ship finance mortgage.

It was apparent that several students had full practical working knowledge of ship mortgages, and accordingly this question, which was entirely descriptive in nature, resulted in some very high marks. Now, it would be impossible to reproduce all duties of a borrower and powers of a lender in an answer to a question like this: it would simply take too long. For this reason, students could be selective in which duties and powers they decided to discuss upon. But in essence the answer required was a 'broad and brief' style rather than 'deep and focused' one. By this it is meant, students who provided just a few of each but discussed these in great detail achieved lower marks than someone who listed a good number, almost in bullet point fashion, and gave very little explanation of each. This latter approach could be termed the 'wide and shallow' style of answer. Students should be careful when approaching such questions: if a number of points need to be raised by the terms of the question, then just raising a few and discussing them very well and in great detail can necessarily only result in half marks at best.

Question 3.

A general shipping company is a subsidiary of a cash-rich parent which is quoted on the New York Stock Exchange. The shipping company has a fleet of five ships, two of which are new builds, the other three are older vessels which have recently been breaking down, resulting in them being off-hire for extended periods of time. The older ships are free of debt, but the new ones are secured with mortgages. The company has medium-term charter parties for the new builds with a reliable Middle East-based state oil company. The older vessels are traded in the spot market which is presently booming but expected to enter a downturn within the year. The shipping company holds shares in the parent company.

The Chief Executive Officer of the shipping company now wants to raise a loan for the company and asks you, as the Chief Finance Officer, to advise on the different types of security the company may be able to offer to potential lenders. Write a briefing report to the CEO.

This again was a highly descriptive question. Those students who simply listed the types of security which could be offered by the borrower gained a pass mark. However, those students who related their knowledge of types of security to the facts of the question scored higher marks. For example, the two new builds will be the best form of security, but the vessels which are breaking down will be of lesser value. Given that the older vessels are traded spot, and rates will decline within the year, their value as security will decline in a short period of time. Residual value insurance will not be available, or at least not at an acceptable premium, given the risk that would be taken on by the writer of the policy. The medium term charter parties are strong security, and need to be assigned to the lender. Some students mentioned the procedural points: payments would have to be made into an account controlled by the lender, to avoid default or jurisdictional risk. The parent is cash-rich: it was surprising how some students missed the possibility of a parent guarantee here. Those who also said there would have to be compliance with the statutory requirements- section 4, Statute of Frauds 1677 which provides that they must be in writing - scored additional discretionary marks. Several students missed the point that the borrower owned shares in the parent; these could be subject of a legal assignment to the lender, but with a brief discussion of the risks associated with this type of security (the value of shares can decline as security).The answer should have been presented in a briefing report format: there is no set template that the examiner is looking for here, just that the student understands who he or she is representing, and to whom the report is to be presented, and the nature of the subject addressed in its title or heading.

__Question 4__.

You are the marketing director of a ship finance bank. You have been invited to 'make a pitch' to a large ship-owner for the mandate to lead-manage a syndicate to raise a substantial bond issue. The Chief Executive Officer of your bank has asked you to prepare a briefing report, addressing the following issues;

a) **The factors which you will include in your pitch to win the mandate.**
b) **The costs the bank will charge to the ship-owner.**
c) **The nature of the relationship between the bank, the management group it will put together if it wins the mandate, and the underwriters. Use a diagram to support your answer.**

In your briefing report, you should also explain the role of the trustee or fiscal agent in the syndicated loan arrangement.

This question was well-answered with nearly all students gaining pass marks, and many at the high end. Answers could easily have been presented as a series of bullet points with brief explanations, rather than in essay format. Both styles would gain the same marks. Factors to be included in a pitch was a useful practical aspect to this question because it arises when banks are trying to win new business. These would include, but not be limited to, the complexity of the issue; the placement power of the bank (its network of investors); pricing of the deal; geographical target for placement of the issue; size; the parties may have dealt with each other on previous occasions; the reputation of the bank. Students should have mentioned in the second part of the question the power of the trustee to waive minor deviations on behalf of investors: for example, failure to make a coupon payment on precisely the required day, but will be made a few days afterwards. The diagram required arrows to show collaboration and control between parties.

Question 5.

Describe and explain any THREE of the following:

a) **Mezzanine finance.**
b) **Sinking fund.**
c) **Loan to value maintenance clauses.**
d) **The Modigliani-Miller capital irrelevance theory.**
e) **Kommanditgesellschaft or KG financing.**
f) **Private placements of shares.**

Students scored well in this question, with nearly all gaining a pass mark and a number very high marks. In such questions students need to first explain or define a concept; for example, how loan to value clauses work. But they then need to say why they are used (purpose), the weaknesses or risks involved, and what happens when such clauses are omitted. The same applies to the sinking fund option in the question.

Students would first describe a sinking fund: what are its characteristics, including funding and ring-fencing? They then need to explain what they are used for, and the benefits. For example, they may be used to provide a lump sum to meet principal repayment on maturity of a bond.

This means that, even if the underlying collateral (the vessel itself) has declined in value and will not realise enough if sold to repay principal, there will still be the contents of the sinking fund. It should be ring-fenced to prevent the borrower from 'dipping in' to it for other purposes. Given this additional form of reassurance to investors, this should be reflected in a marginal reduction in the rate of interest the borrower will have to make in the form of coupon payments to bond holders. So, although the list of topics to be discussed looks easy as question, it can be seen that simply describing is not enough: the question requires a deeper degree of analysis.

Question 6.

Answer ALL parts.

a) **Discuss the three requirements for cash flows to be securitised. Which cash flows in a shipping company meet these criteria?**
b) **Using a diagram to support your answer, identify the participants in a typical securitisation, and discuss their roles.**
c) **If the special purpose vehicle (SPV) in a securitisation is collateralised by the cash flows assigned to it, explain how the basis point spread (the interest rate) payable on the bonds issued may be narrowed or reduced (consider the additional assets which a ship-owner may pledge or assign to the SPV).**

This question was very well answered by students, principally because it was descriptive in nature, with a diagram to be provided in support. Part c) caused some problems for students. The SPV is essentially a shell company- a 'man of straw' - which is set up because it has separate legal identity and protects investors against the possible future bankruptcy of the issuer. To narrow the basis point spread, the asset held by the SPV - the cash flows - should be augmented by, for example, a parent guarantee from the issuer, or transference of ownership of some of vessels to the SPV via a mortgage.

Question 7.

With reference to the shipping cycle, explain with full reasoning the suitability of each of the following types of shares for each stage of the cycle.

Discuss the characteristics of each type, and its potential appeal to investors at each stage;

a) **Ordinary shares.**
b) **Partly paid shares.**
c) **Rights issues.**
d) **Cumulative participating preference shares.**

Question 7.

This was a question which had mixed results, with some scoring well but others failing to deal with one or more of its requirements and gaining low marks as a result. The question required, first an explanation of each type of share. For example, partly paid means that the full amount is not paid 'in one go' by the shareholder, but in stages. Second, it required identification or discussion of the individual stages of the shipping cycle: for example, peak through to depression. Third, it required integration of both of these issues to identify investor sentiment at each stage. So, if the market is booming, investor sentiment is strong and it is easier to sell shares to them; the (incorrect) assumption is that share prices and dividend payments will increase year on year, regardless of the certainty that the cycle will move into recession at some future point. In a recession investors 'get cold feet', and accordingly there has to be some incentive to draw them in to buy shares in a company which is perhaps struggling to meet OPEX in difficult market conditions. The incentive may be giving priority over existing shareholders in terms of future dividend pay-outs (cumulative participating preference shares), or not asking them for the full amount in one go- partly paid shares. The latter would be interesting to investors because they will receive the entire dividend even though they have only paid perhaps a third of the price. They also receive full voting rights. But of course the risk is that if the company becomes bankrupt, they will have to pay any amount outstanding on their shares. Students who addressed all three aspects gained full marks.

Question 8.

You are a ship-owner operating in the oil transportation business between the Middle East and Europe, and you are preparing a prospectus to have shares listed on the New York Stock Exchange.

Describe and explain the risks and opportunities which would need to be disclosed to potential investors.

Answer:

This was a well-balanced question which required students to discuss risks and opportunities in the oil transportation business. Given the geographical focus of the question, risks would include political and/or the possibility of military conflict in the region. Other standard risks would be:

exposure to oil price volatility; exposure to wider economic trends (shipping being a derived demand); exposure to the shipping cycle; risk of vessel deterioration; risk that the EU may bring in new anti-pollution regulations; risk of new international regulations concerning safety at sea; risk of competition from other carriers; risk of mechanical breakdown; unavailability of charter parties; crewing difficulties. Opportunities would include: increasing demand for oil as the wider economy improves, driving up rates; increased dividend payments to shareholders as the sector recovers; opportunities resulting from political agendas to increase oil supply to interfere with world prices (OPEC); technological and carrying capacity advantages of the fleet. Students who briefly mentioned the legislation applicable to such listings, principally Sarbanes Oxley, scored additional discretionary marks.