EXAMINER'S REPORT NOVEMBER 2019

SHIPPING FINANCE

General Comments

Detail is the key to success in this subject. For example, if a question asks about types of ship financing loans a candidate may discuss, for example, front and back ended loans, but the student who gains a higher score will then discuss the risks associated with each type. A moratorium loan means that the lender may wait for up to two years for servicing of the loan to be resumed; during this time the asset value may have declined, the borrower may have become insolvent, or freight rates may not have sufficiently recovered to meet the above market new rate which will apply later to compensate the lender for having 'waited'.

An additional discretionary mark would be awarded for briefly mentioning a loan covenant which may be included in the arrangement. Further, students should mention that these arrangements are not a free lunch: there will nearly always be a facility fee charged by the lender which will be added to principal.

Students gained higher marks for answering the question as it was written, and not how they would prefer it to have been written. For example, question 4 was about the use of convertible bonds in the shipping sector; some students treated this as a general discussion of convertibles but without application to the phases of the cycle, and lost marks as a result.

Some questions required a breadth of discussion of several issues, rather than focusing on just one or two. Question 1 was a good example of this. Some students focused on just a couple of balance sheet weaknesses when the question required a good range to be identified and discussed. Even if the two points are discussed in excellent detail, if there were four or six or whatever points to be discussed, then the answer will fail. As will be discussed shortly, several answers to question 1 gained fail marks for this very reason. It is very important that if a question, on careful reading, indicates that a range of issues needs to be discussed, that the candidate does not focus on just a couple of points. Presentation in bullet point form, with a brief explanation under each point, will be acceptable, but the risk being brevity of answer in which case marks will be lost.

Q1. Identify the main components in a shipping company's balance sheet that a lender should pay particular attention to when deciding whether or not to make a loan. Identify possible weaknesses and how these may be reduced or managed.

This was a straightforward question in terms of what it was asking for, but several candidates failed this because they focused on perhaps two or three balance sheet items when a wide-ranging approach was required. Most students knew that asset values as recorded in the balance sheet would be the first and foremost item of concern to a lender.

The additional issue here was also whether the value was made on a market or historical valuation, the latter being less reliable in a volatile market. Other major items would be whether there is already a high level of debt in the capital structure, and whether this is of a fixed or floating nature. It is surprising how many candidates continue to refer to 'interest' payable on debt, but not following this through by questioning what type this would be. If it is fixed, then the borrower will know what the month on month exposure is- the sum payable will known. If it is floating, the worst case scenario for the borrower is that just as freight receipts are falling in a declining market, or perhaps as operational expenses are rising, interest rates of a floating nature begin to rise, adding further stress to the capacity to meet monthly expenses.

Candidates should also have mentioned OPEX and how these have been changing over recent years. If earnings are stable or predicted to fall, a rising trajectory In OPEX will be of concern to a lender because it raises the question as to whether the borrower will be able to service additional debt.

The issue of remuneration of board members was missed by candidates, and yet this is very important. If the profits of the business are being extracted by the board, or even worse if there are no profits and yet the board continues to be well rewarded, then this will be unstainable from the viewpoint of the lender. It points towards a company which is being plundered, leaving little left over to meet capital expenses.

Most candidates missed the second part of the question which asked for cost management strategies. These could have been presented in bullet form, with brief explanation. Points to consider would be a sale of underperforming assets, assuming an acceptable price can be achieved, layoff of employees or outsourcing provided this doesn't make the vessel legally unseaworthy, and briefly, hedging of bunker costs.

This was a question which could have been well-answered but generally wasn't because of a lack of breadth and too narrow a focus in answers. Read the question!

Q2. You are the marketing director for an Islamic bank looking to develop its client base in the shipping sector. Prepare a proposal to a Middle Eastern-based oil tanker owner, explaining the principles underpinning your business, and the specific instruments which may be suitable for its line of business. You should also explain the advantages the company may achieve from doing business with you compared with a non-Islamic bank.

Some students didn't provide specific examples of Islamic financing techniques, such as ijara leasing, musharaka, mudharaba, and sukuk. Students who mentioned these, and the basic characteristics of each, were already on course for a high mark. But the question also asked about the main principles underpinning Islamic finance.

Candidates should have discussed the prohibition against interest (riba), which is a commonly known principle. They should also have mentioned that security cannot be taken over the asset or from the borrower by the lender. This links in to the word 'marketing' in the question: an Islamic bank will state that the personal assets of the borrower will not be at risk, which is often the case in a non-Islamic context where personal guarantees are often required by lenders. The Islamic approach is derived from the principle that risk rests with the lender and not the borrower.

Second, the borrower and lender should share in the profits of the venture. In other words, if the tanker owner does not make a profit, then the lender will not receive anything. This contrasts with the conventional model in which the lender must be paid regardless of whether or not the borrower has made a profit.

Third, capital must be used for socially productive purposes. So, the lender will not be able to treat the loan as simply being made on the profit maximisation, risk minimisation principle found in conventional finance: there must be a moral or ethical underpinning to the arrangement. The question did not ask for the negatives arising from Islamic finance such as short termism, intrusiveness in the borrower's business by the lender: the question asked simply for the advantages which would be put forward in the pitch.

Islamic finance is growing at a significant rate, in general finance but also in shipping finance in the Middle East, and for this reason is a fair topic to be examined in a shipping finance paper.

Q3. Answer ALL parts of the question.
Advise an owner with regard to the most appropriate type of loan to refinance existing debt in ALL of the following circumstances. Risks to the lender should be discussed in the context of each type of loan proposed.

- **a) Earnings are presently low and it is only possible to meet operating expenses. An upturn in the market is expected in two years' time.**
- **b) Earnings are currently booming but rates are expected to decline soon.**
- **c) The market is in depression and there are under-priced vessels for sale due to corporate failures. The owner wants to buy up vessels but interest rates are presently high.**
- **d) The owner has high levels of floating rate debt in its capital structure: interest rates are expected to rise in the immediate future.**

The reason for the success of nearly all who attempted this question was because they approached it with plenty of detail. Candidates identified the applicable type of loan, but then also discussed the risks from the lender's perspective and the additional costs in the form of facility fees which may be chargeable to the borrower.

Most students missed the minor point in 3 d), this being that an interest rate swap could be used to hedge against anticipated future increases in interest rates. In this case it would be wise to swap out of floating rate debt and into fixed, although the cost of the facility may be higher the further out the debt goes in terms of duration. If the borrower would prefer to see how interest rates go over the next year then a swaption may be an alternative, this being an option on a swap.

Q4. Explain the characteristics of convertible bonds, describing the advantages for borrowers and opportunities to investors, and the risks to all parties concerned. In which ways could convertibles be suitable for a shipping company borrower, taking into account share price behaviour at the different stages of the shipping cycle?

It was a highly descriptive question with the bulk of marks going to an explanation of the main characteristics of convertible bonds. In this context future candidates should however be aware that although they may focus upon a basic plain vanilla convertible, those who are able to go the extra step and discuss variants such as contingent convertible bonds or CoCos, mandatory convertibles, reverse convertibles, and foreign currency convertibles, will achieve maximum marks. This extra detail indicates that a candidate has read around the subject and will gain additional discretionary marks.

An important part of the question which was missed by some candidates was a requirement to discuss how convertibles could be used at different stages of the cycle. For example, at the peak investors believe (incorrectly) that share prices will continue rising indefinitely and accordingly are very interested in equity linked hybrids, which is what a convertible is. However during the slump, when share prices are low, investors are wary of shipping company stock and accordingly tend to steer clear of such products.

Q5. Describe the forms of security which a lender may take in respect of a loan made to a cashrich parent company which owns all the shares in several one ship subsidiaries registered in different jurisdictions.

The answer would include assignment of charterparty earnings and insurances, mortgages over vessels, parent guarantee in respect of a subsidiary, charge over shares.

Procedure included registering charges in appropriate registries, notifying charterers and insurers of assignments, compliance with section 4 Statute of Frauds 1677 in respect of guarantees. Risks would be declining value of assets (consider residual value insurance), vessels held in different one ship companies (to avoid arrest); consider requiring borrower to re-register all vessels in one company, in an acceptable location. Non-payment of premiums on insurance by borrower (consider requesting insurer to notify lender if this happens).

Q6. Answer ALL parts of the questions.
You are the Chief Finance Officer of a shipping company which intends making a syndicated bond issue. The company already has a high level of debt, and most of its vessels are old:

a) **Discuss the functions of all participants in a syndicated bond issue, with the aid of a diagram.**
b) **Describe the typical factors a ratings agency will take into account when assigning a rating to the bond which will be issued.**
c) **If potential investors are concerned that the company will be unable to meet repayment of principal on maturity, and that the value of the vessels may have fallen by this date, what measures could the company take to address these concerns?**

Although the syndication part of the question was well answered and dealt with in detail by candidates, some were not able to answer the question concerning the role of the ratings agencies, such as Standard and Poor's and Moodys.

It is very important that future candidates for this paper do not overlook the role of ratings agencies since they have a major impact in the pricing of bonds including convertibles, as well as syndicated issues. The agencies should be mentioned, even if briefly, when answering questions involving these topics. In allocating a low rating to a bond this reflects greater risk to investors and accordingly will inevitably result in higher borrowing costs. With regard to investor concerns that the syndicated bond issuer will not be able to repay principal upon maturity, this part of the question required brief mention of the setting up of a sinking fund, which should be defined, or possibly the taking out of residual value insurance should the borrower intend selling vessels at maturity to meet this payment.

Q7. A family-owned shipping company headquartered in a developing country is exploring the feasibility of raising equity finance on the New York Stock Exchange. It has several long term charterparties with the state-owned oil company of the country in which it is based, but most of its vessels are otherwise employed in local markets in East Africa, regularly sailing between Eritrea and Tanzania, through the Gulf of Aden and into the Indian Ocean. The shares are owned by the family, and the board is dominated by relatives of the company's founder. The company has several outstanding high interest-bearing loans in place, and made a seven year bond issue five

years earlier. Apart from a few recent acquisitions of newbuilds, the fleet is old and repair and maintenance costs have been escalating.

Prepare a briefing report for the founder, identifying the risks and opportunities which would need to be disclosed in a prospectus should the company want to raise equity on the New York Stock Exchange. You should also briefly discuss the legal framework (the statute or law) which applies, and the liabilities of officers.

The question required candidates to look at the facts in the scenario and to identify risks. This was as much a matter of common sense as it was of financing principles. For example, the company regularly sails vessels between Eritrea and Tanzania, through the Gulf of Aden and into the Indian Ocean. The obvious and immediate risk would be of piracy and will be reflected in higher insurance costs.

The company has high levels of pre-existing debt: the risk is that it will find it increasingly difficult to service this if it is of a floating rate nature and rates begin to rise. The shares in the company are owned by the family and it is dominated by the founder: this raises the risk of possible poor corporate governance, a lack of transparency or accountability to shareholders. The fleet is old, raising the risk of future mechanical breakdown or even vessels falling out of class in the future, and breaching loan and insurance covenants.

The opportunities would include the guaranteed earnings from the long term charterparty with a state-owned oil company. The company will also be acquiring newbuilds: these should be technologically advanced, will reduce fuel consumption, and will be of greater appeal and competitive position when it comes to negotiating new charterparties. Regarding legislation, candidates were required to discuss the Sarbanes Oxley Act, and specifically section 404. The CEO and CFO, amongst others, will have civil and criminal liability in respect of false statements made in the prospectus.

Due to its straightforward requirement to consider the facts in the scenario in terms of risks and opportunities, this could have been of more appeal to those candidates who were towards the end of the exam and running out of questions to answer based on question-spotting (which is always a risky strategy).

Q8. What information is held by each of the following, and how might this information affect a financial institution's decision whether or not to make a loan to a shipowner?

a) **Marine insurance companies**
b) **Classification societies**
c) **Port state authorities**
d) **International Transport Workers Federation**

Information held by each of the organisations mentioned in the question relates to their line of business. For example, a marine insurance company will have details of how premiums have increased or decreased in recent years, indicating how safe or risky the assured's business has become over a period of time. It will also show the record of claims made by the assured. If these have been increasing, it points to either a declining quality of the fleet, mismanagement, or increased accidents at sea. This last point is of concern to lenders if these are attributable to the negligence or poor technical quality of the vessels insured.

Classification societies will hold information on the compliance record of the borrower. The lender will be concerned about this if vessels have perhaps temporarily fallen out of class and have had to incur costs to remedy these. If a vessel has fallen out of class then insurance cover may also have been withdrawn; even if this has been temporary, it will be of concern to the lender.

Port state authorities will have information on the borrower's compliance with local laws, accidents whilst in local waters, possibly barring of vessels from those waters because they present a pollution risk. All of these factors point towards a mismanaged fleet comprising vessels which are likely to cause accidents or pollution, and possibly become subject to arrest at a later date.

The ITF will have information on how crew has been treated, strikes, late or non-payment of wages, and whether a vessel has been arrested as a result. The union will be particularly interested to see that vessels do not present a danger to seamen while at sea.