EXAMINER'S REPORT JULY 2020

SHIPPING FINANCE

General Comments.

This July's exam papers showed again that some students are continuing to read around particular topics they are revising and have been able to provide additional detail in their answers. This was particularly illustrated by students who were able to reinforce their answers with reference to case studies. For example, two of the questions raised the subjects of syndicated loans and initial public offerings: some students backed up their answers with reference to companies who have used these financing techniques and gained additional discretionary marks. Students deepen their answers when they show evidence of reading around a subject, although it is not necessary to give extensive detail in this regard. A mention of practical issues and case studies enhances the quality of answers.
On a minor note unrelated to the quality of answers. Students should be aware that if their handwriting is illegible to the examiner, their paper can be unmarked. If you have poor handwriting, and if it is very small, then you should take steps to improve its presentation in the exam. This may be for example by spacing out paragraphs. If your writing is small, then you must endeavour to write in larger form. When handwriting is illegible it is not fair to the examiner to expect the script to be marked, but it is also unfair to the student who may find that, because the script is impossible to read, points that he or she has made will be lost because they cannot be read. Grammar is not an issue: illegible writing is.

In summary, this is a details-based exam, and general unsupported statements in answers gain borderline marks. Issues of risks, procedures, and drawing from other topics in the syllabus, such as brief mention of covenants in mortgages or loan agreements, deepens an analysis. It is also vital to address the specific wording of a question, and to consider why a fact or set of facts has been provided in a scenario-based situation. Additional reading around topics being revised is highly recommended!

1 his was a very popular question with nearly all students attempting it. Marks were mainly centred around the higher grades: the overall quality of answers was good. Several students focused upon plain vanilla bonds, and this was fine, but those who scored higher marks proceeded to discuss the different types of convertibles, for example mandatory convertibles, reversible, co-cos. Again, this showed reading around the topic, instead of simply focusing upon one form of the bond. It was also surprising how many students failed to mention the two main advantages of convertibles: lower coupon, longer maturity. Regarding the former, a basis point spread saving of about 20 to 30 makes this attractive to issuers. Most but not all students mentioned the avoidance of equity dilution, whilst at the same time linking this in, briefly, to pre-emption rights in a company's articles which require an offering to be made to existing shareholders first, pro rata, to avoid the dilution risk. Investors of course hold a hybrid instrument with the possibility of participating in future share price appreciation as well as increased dividend payments relative to the coupon payable when it is held in bond form. The other side of the coin is that if the trigger price is not reached, then the bond will

be busted and the investor will have received lower coupon payments throughout the bond life than would otherwise have been received relative to a plain vanilla, because of the embedded equity sweetener.
The second part of the question required discussion of the relevance of hot and cold timing for issuance. Specifically, if the market is heading towards its peak and investor sentiment is high and probably unrealistic, then it is possible to issue a convertible with a high trigger conversion price. However, most students also explained that in an overheated market there is little upside potential in the share price, and possibly a market adjustment downwards is imminent. For this reason, the best time to issue is probably when share prices are low, since the upside potential is greater. But in a recession or depression when asset values, profits, ad share prices are very low, investors are wary to take positions in the maritime sector, and for this reason the bond pricing and conversion trigger will need to be generous. But sophisticated investors will recognise the upside potential as the shipping cycle begins to recover, and for this reason convertibles, privately placed, may have a higher likelihood of being taken up or subscribed in full. This part of the question required a linking of the cycle and consideration of what is happening to freight rates and asset values, with the issue of the best timing of a convertible issue in terms of upside potential.

2. This was a moderately popular question but of a type where a student either knew the subject well, or not at all. It was almost impossible to guess at an answer; this was a question about the usual terms in a guarantee given by a parent company in respect of a loan given to one of its subsidiaries. Students who had not prepared this subject did not gain pass marks; those who knew that this exam can ask about specific documentation such as mortgages and guarantees, or who perhaps also used such documentation in their day to day work, scored high marks. It was surprising that several students answered by discussing the nature of a guarantee, the procedural requirements, and the risks to the lender taking such an assurance from a 'straw man' or a company which does not have the cash or assets to effectively underwrite it and meet its obligation should it be called upon following default by the subsidiary. Discussion of these issues gained no marks: the question was specific and clear in wanting only a setting out and brief explanation of the main provisions in such a document. The lesson is this: answer a question as it is written, and not as you would have preferred it to be written. Students are reminded that questions can be set on finance documentation. However, awareness of standard terms and covenants can be very helpful in other questions; for example, if answering a question on types of loans, discretionary marks are usually awarded for brief references to some standard terms in the documentation, as well as consideration of the risks to the lender of providing such a facility. For example, that at the end of a moratorium loan the asset value may have fallen further, placing the lender in a worse position compared to that which would have existed if liquidation of the defaulting borrower had been done in the first place, and not delayed.

3. This was not a popular question, with significantly less than half of students attempting it. However, for those who had revised syndication as a topic, this was a straightforward question. For example, it asked for the main costs to the issuer: this was simply a matter of listing, with perhaps a single sentence in explanation. The main costs would be the margin, probably LIBOR-referenced, arrangement fee, commitment fee, and legal fee. Part (iv) required a diagram: a syndicated loan diagram does not have many participants to it and is relatively straightforward when compared to a securitisation structure. Regarding corporate structural changes, these are often required in typical plain vanilla or complex loans. If a company holds most of its assets registered in different jurisdictions, then the risk is that they cannot be arrested following default by the borrower because

of the principle of separate legal personality. Lenders also do not like opaque ownership structures: they rightly ask, why is the borrower doing this, if not simply to conceal assets and protect itself against claims for, for example, pollution incidents? All assets should be re-registered in one place which has a jurisdiction and legal system, including recognition of the power of arrest, which is acceptable to the lender. Again, this is an issue which should be mentioned by students when answering questions about types of loan generally, if appropriate on the facts.

4.
This was a popular question with several high scores and nearly all students who attempted it gaining passes. As with question 3, this was a topic which students either knew or did not know: uninformed guessing does not gain marks. However, many of the clauses are common sense and should be identifiable by students: for example, the duty to pay on time, not to dispose of assets, not to move assets into other subsidiaries within a group, to obtain regular valuations of assets (to meet the loan to value coverage covenant), to give timely information when required by the lender, to maintain the vessel in class. So, students should be able to have a go at a question like this, even if they have never seen a mortgage, because many of the clauses could be anticipated as being natural stipulations by a lender. As a tip: put yourself in the position of the lender, whether answering a question like this or a more general loans question, and ask yourself what risks you face and how you could reduce these by inserting relevant clauses in a mortgage or loan agreement (although of course the former will be in standardised format).

5. This question was attempted by most students and all passed, several with high grades. Answers were very good in terms of identifying why investors were sceptical about investing in shipping including perceived secrecy of owners, the risk of disappearing assets, volatility of asset values (although this can also provide a speculative play during an upturn, and not just an unrealised loss during a recession). Some students also mentioned the risk of environmental pollution at a time when international rules are becoming evermore demanding in terms of compliance obligations. However, answers were weaker regarding what can be done to allay these concerns, or this scepticism. Principal ways would include having a transparent corporate structure and not hiding assets in separate entities or jurisdictions, possibly re-registering all vessels in one acceptable jurisdiction, maintaining the fleet in a good state of repair and in this way reduce the risk of mechanical breakdown, and arranging medium to long term charterparties to assure investors that the company will be able to meet its CAPEX obligations as well as OPEX, assuming that the latter does not increase unexpectedly in the short term, in a spike. The company should constantly work to retain trust, because this is what has been lacking in some shipping companies in the past and hence leading to wariness on the part of investors. Full disclosure of asset values, risks, and future plans should ensure that investors feel engaged in the company, instead of feeling like irritating external stakeholders who can be ignored once they have handed over their equity investment!

6. This question was answered well by most students who attempted it, with several achieving high marks. It was surprising, however, that several students failed to comment on the significance of the question's geographical context. A major risk would be a possible outbreak of armed conflict in the Middle East, and the consequences for a company which transported oil out of the area. Risks would be market, currency (although of course all contracts would be denominated in US dollars), political, jurisdictional. The question specifically referred to the New York Stock Exchange; several students

gained additional discretionary marks by identifying how the Sarbanes-Oxley Act would be applicable to prospectus disclosures, and the potential criminal consequences if these proved to be false or misleading. Some students also mentioned shipping as a derived demand: if the world economy enters a recession, then this will affect quantity transported under the long term charterparty. Opportunities would include asset plays regarding the tankers but there would also be the risk of deterioration here, and the high maintenance costs which would need to be disclosed. The charters with state entities are a definite plus in terms of opportunities for the future; these provide the issuer with certainty or stability of earnings over an extended period from which to meet CAPEX, if there is any, and OPEX.

7. This was a very popular question, with nearly all students attempting it. Marks were generally high since the requirements were largely mechanical and descriptive: students were asked to describe relevant forms of security which would be requested by the lender, give the specific facts in the scenario. Students all identified assignment of earnings as a form of security, but several did not then proceed to mention that, in the question, these were seasonally affected, and this would be of concern to the lender. Other security included an assignment of insurances. A few students also did not pick up on the fact that one of the vessels had been involved in a collision but liability had yet to be determined in court proceedings; this could result in the vessel not being available as security for the loan. Mortgages on the older vessels could also be of limited interest to the lender given their propensity to break down due to mechanical defects. In summary for this question, student scored well by describing the forms of security and, importantly, briefly mentioning the procedures for taking them. Those students who scored particularly well did so by discussing the more detailed facts of the question, such as the issue of the age of some of the vessels, and the collision which was still under court consideration. Scenario-based questions should always be read carefully to ensure that principles are correctly applied to the specific facts given.

8.This was not a popular question and was generally not answered well. Several students failed to discuss a range of Islamic financial instruments; instead, they simply focused on leasing (ijara), or sukuk, when there were others which should have been considered including musharaka and mudharaba. Security cannot be taken over assets since lenders are precluded under Shariah from taking this. No personal guarantees can be demanded: this will protect the owners of the company. Regarding disadvantages, students could have discussed short termism of the lending decision, whereas shipping requires long term financial commitment, lenders are more at risk and therefore require more information and, possibly, representation at board level, residual value insurance is not permitted which presents risk for repayment of principal, or meeting balloon payment commitments. Generally, products also lack liquidity.