



SHIPPING FINANCE

INTRODUCTORY REMARKS

This year's answer papers evidenced an excellent standard, with a good number of students scoring in the high 70s and 80s. A general observation and criticism of those papers scoring close passes, or in the low 50s, would be a lack of detail in some of the answers. Some students did not contextualise their answers, for example within the wider shipping cycle or borrower-lender behaviour; or the fundamentals explained before passing on to the substance of the question; the Examiner will know this detail, so why, they seemed to reason, is there a need to explain it in the answer? This approach is incorrect: of course the Examiner knows the material, the question is, does the student? Easy marks were lost, and answers provided too superficial, because of this lack of detail.

It is important that students do not assume any knowledge on the part of the Examiner; and in this way they will not lose relatively easy marks. For example, it would be insufficient to describe KG finance without first contextualising it within its historical background, but also following this through by at least briefly referring to the current, poor state of KG funds, and the negative impact upon the normal market mechanisms whereby demand and supply return to balance. The shipping cycle phenomenon, which can be raised throughout the topics in the course to gain discretionary marks, where relevant.

Another example would be a discussion of types of loans; for additional marks, risks to both lender and borrower, and possibly covenants or other clauses which might be incorporated within documentation, would be a very useful way of 'painting the bigger picture' before proceeding to the specifics of the question set. Shipping Finance, both in terms of the exam but also in the practical world, is all about detail and specifics: broad generalisations, and a lack of explanation, can have severe consequences in both contexts.

I. Abacus Shipping Corporation is the parent company of a group of shipping companies registered in various jurisdictions, including Panama, Cyprus and the British Virgin Islands. As parent, Abacus Shipping holds all shares in each company. Some of the vessels held by each company are owned outright by that company, and there is no debt remaining or mortgage. Some of the vessels are still mortgaged to various 'boutique' ship finance banks. Several of the companies have long term charter parties arranged with high quality charterers, including well-known commodities transportation companies. However, several of the vessels are trading spot, in the absence of charters. Abacus is looking to raise finance for expansion of its fleet and is considering securitisation as a possible means of achieving this.

Answer all parts:

- a. What is meant by securitisation, and which assets may be used to collateralise an issue by Abacus?**
- b. Discuss the structure of a typical securitisation (you may use a diagram).**
- c. What are the reasons for incorporating a special purpose vehicle within a securitisation structure?**
- d. In the context of Abacus's plan, which practical issues need to be addressed before the securitisation can proceed? (In this context, you may wish to consider the structure of the company).**

This question was generally well-answered, with some very good diagrams, although it must be pointed out that in the context of any diagram, it is essential to indicate flows of interest payments using arrows. Some students did not provide this, but instead merely put lines within the structure which did not show the transfer of funds, payments of coupons to investors- this lost marks. Several students did not set out precisely the three main qualifying conditions for cashflows before they can be suitable subjects for securitisation. A number of students also did not explain precisely that the SPV is set up because it has a separate legal identity from both the originator and the investors. In this regard its purpose is to protect the former against claims for default by the latter, and the latter against possible insolvency of the former, because the cashflows belong to the SPV, and will not fall 'into the pot' of assets created by the liquidator to meet the claims of creditors. With regard to practical issues, there were a range of answers to this part of the question, all of which made sense and gained full marks. In other words, there was not a definitive answer required here. However, the question did raise the issue of assets held by one-ship companies registered in different jurisdictions: this would cause concern to prospective investors due to enforcement issues, as well as possible court process questions; for this reason the originator would probably be required to re-register vessels in one jurisdiction, and in this way give greater transparency to the structure. This was a highly detailed and focused question: general answers gained borderline passes.



SHIPPING FINANCE

2. Answer all parts:

- a. What is meant by the shipping cycle? In what ways does it lag behind the wider economic cycle?
- b. Discuss the main reasons why niche ship finance banks and shipping companies are adversely affected by the negative phases of the shipping cycle.

Identify and discuss the main strategies which may be pursued by niche ship finance banks and shipping companies to prepare for the downturn in the shipping cycle

It was surprising how many students failed to discuss basic economic aspects of the shipping cycle in the context of this question. Specifically, the principle of derived demand, and the concept of the lag between the cycles. Students who briefly discussed individual sectors such as commodities, coal, iron, consumer goods, integrating these within the concept of the cycle, gained additional discretionary marks.

Students who discussed locking in to medium term charterparties, where these are available, in anticipation of the downturn, gained additional marks, since such security of income translates across into continuing ability to service loan obligations and as such is very welcome by banks which have made loans to clients who are now experiencing squeezed earnings.

Other strategies discussed in stronger answers included renegotiation of debt, for example, moratorium, switching existing convertibles into equity if there is an issuer trigger available, sale of ageing assets, and taking advantage of government schemes where these are available. For example, to protect employment and similarly banks may require additional security, guarantees given by owners in private capacities or from sister companies.

Generally, all students who answered this question passed it, but the higher marks were gained by more detailed discussion of drivers of the cycle, and specifics about the dynamics of the owner-charterer negotiation and who has the advantage at different stages of the cycle in terms of bargaining strength.

3. Answer all parts:

- a. Describe the main features of a typical Kommanditgesellschaft or KG structure (you may use a diagram).
- b. Discuss the main benefits of the KG policy to the German shipping industry. To what extent has this policy distorted normal market mechanisms in the shipping sector?

This was a very specific question which candidates either knew or did not know: there was no scope for generalisation or bluffing! Several candidates gained high marks for discussing the qualifying criteria for KG status, and a detailed discussion of the applicable, tonnage-based taxation regime. Students who were able to give a detailed analysis of the current, very distressed state of KG funds, and how the policy has distorted the market, gained additional marks. This was a good example of the necessity of reading around a subject; questions can be passed through textbook-based revision, but for stronger marks some additional perhaps internet-based reading and research should be undertaken to back up understanding of individual topics and add crucial depth to the answer.

4. Answer all parts:

- a. Discuss the functions of all participants in a three tier syndicated bond issue (you may use a diagram).
- b. Describe the main factors which can lead to an increase or decrease in the level of syndication activity in the shipping sector.
- c. Identify the jurisdictional and asset security issues which may be of concern to investors in a syndicated bond issue by a global shipping company.

This question was well answered by students who attempted it. There were some good diagrams, although several were untidy without explanatory cashflow arrows. When students provide a very small, untidy diagram there is a danger that they will miss a point or leave out a participant completely: as a rule, diagrams should be large enough for all events within them to be easily read. A number of students linked the level of syndication activity to the stages of the shipping cycle, underlining the fact that when the market is depressed, investors may be reluctant to take up bonds, whereas during a boom investor 'psychology' may result in short-term exuberance when bonds are over-subscribed. The issue of the serving of debt was also raised by the same students in this context. Now, there are arguments for the opposite hypothesis but this is not the point: the point was that these high-scoring students showed a willingness to contextualise the subject-matter within the wider context of what happens in the cycle, and for this reason were given higher marks for thinking outside the box and looking at the practical dimension.

The jurisdictional part of the question related to the problem of bond issues by what may effectively be one-ship companies. This has enforcement aspects in terms of, for example, arrest of vessels following default. Re-registration of vessels within a single jurisdiction, and transference to a single issuing company, was a solution advocated by some students, and this sensible suggestion gained additional marks.



SHIPPING FINANCE

5. Identify the main clauses, including covenants and undertakings, in a typical ship mortgage deed and discuss the importance of jurisdiction in the context of registration of a mortgage.

This question was highly descriptive and detailed in terms of the answer required. Students who approached it by setting out very general issues dealt with in a ship mortgage scored poorly and would have done better by setting out, item by item, specific clauses and covenants. It was one of those questions where a student either knew it well and accordingly scored well, or did not know it at all, guessed at the mortgage components, and scored a borderline fail as a consequence. The lesson seems to be, do not attempt a highly specific question unless you have revised the topic in detail, or have a knowledge of it from practice or work. The jurisdiction part of the question raised the issue of international registries and was generally well-answered.

6. Answer both parts:

(a) With full reference to the Modigliani-Miller capital financing theory, discuss the extent to which the debt-equity mix in a shipping company is irrelevant, if at all, bearing in mind the cyclical nature of the shipping industry?

(b) Discuss the implications to banks of loans to shipping companies from a Basel Capital Adequacy perspective.

This answer was well-answered by some students, and very badly by others: there did not appear to be a 'half way house'. The question required a specific setting out of the Modigliani-Miller capital structure irrelevance hypothesis and, importantly, the ways in which its assumptions have been criticised. Students were then required to contextualise the hypothesis within the shipping cycle, in terms of a volatile industry in which cashflows and asset values are often erratic. It cannot be true that the debt-equity structure should be static in this context: it has to be altered to reflect prevailing or anticipated market conditions. Several students again introduced the shipping cycle into this context, and gained marks for doing so. With regard to the second part of the question, the Basel Capital Adequacy ratio, this followed on from the previous analysis, although it also required a precise definition of the difference in terms of implications between equity and debt. With regard to the latter, the various tiers of capital were discussed by a minority of students, with others also rightly discussing the issue of subordinate debt. It was also noted that several students introduced a brief discussion of these capital structure issues in answers given to other questions in the paper; this was excellent since it showed an ability to cross-reference issues and to connect what might at first be unrelated topics. Shipping finance must be, in practice, about drawing from a broad-based bank of knowledge: this examination reflects this practical requirement.

7. Discuss the characteristics of any three of the following types of loans. In the context of each, you should consider its suitability or otherwise, and cost, at each stage of the shipping cycle:

(a) Moratorium loans

(b) Bullet repayment loans

(c) Balloon repayment loans

(d) Back/Front ended loans

(e) Revolving credit facility loans

Again this was a descriptive question with students being required to identify the principal characteristics of a range of loans. A number of students provided this information but then lost marks by not considering the suitability or otherwise of each at the various stages of the cycle. In other words, the answers were too short, too descriptive, without this additional application which was specifically required in the question. With regard to the cost element, in simplistic terms if a company has highly unstable, perhaps declining spot-market related earnings, this will probably be reflected in a higher facility fee being payable, to reflect this additional riskiness. A small number of students briefly identified some clauses which may be included in such loans, reflecting the rights and obligations of borrower and lender; again this gained additional marks for thinking beyond the immediate issue in hand.



SHIPPING FINANCE

8. GoodSeas Shipping is a global shipping company which is currently trading in a depressed market. The Chief Executive Officer anticipates that the market will start to recover soon, and is anxious to take advantage of an anticipated rise in interest in the sector amongst investors. He believes that a share issue will not be possible for now, and is interested in exploring the bond markets. As Chief Finance Officer to the company you have been asked to prepare a briefing note for him describing the possible advantages and disadvantages of issuing convertible bonds at this stage of the cycle, from the viewpoint of both investors and the company itself, including potential implications of future bond conversion for GoodSeas. The CEO has also asked you to explain the function of a sinking fund. If the convertible is eventually converted, the CEO has raised concerns that this may have 'dilution implications'; you should address this concern in your briefing note.

This answer was generally not well-answered, with students not setting out in detail all of the relative advantages and disadvantages of convertibles. A number of students identified a couple of points for each, whereas a much more extensive and detailed list was required. This is also true in a practical 'real world' situation. All aspects have to be presented as a balanced report, as well as, of course, firstly defining the principal characteristics of the instrument, type of loan or share issue in contemplation. The trigger mechanism in convertibles, both from the investor's and issuer's perspective, required discussion forced conversion and its implications for bond valuation, required in the latter context. Several students rightly discussed the negative implications of an unconverted or 'busted' convertible in terms of perception of the issuer's future prospects from the viewpoint of the wider marketplace hence the need to incorporate an issuer right to force conversion in certain specified circumstances. Shipping cycle implications in terms of, for example, deteriorating share price during a slump and therefore a postponement of the right to convert being triggered, or the issuer needing to switch from debt to equity financing during a depression, since payment of dividends are discretionary, in contrast with bond servicing obligations which are mandatory, were addressed as issues by the majority of students, which was very good to see. Several students proposed the opposite hypothesis and behaviour, which was equally valid when well-argued. Most students were able to give a good, detailed definition of a sinking fund, and its purpose. The answer was required to be presented in the form of a briefing report: several students lost a couple of marks for not meeting this requirement and instead writing out everything they knew about convertibles, instead of relating this to the practical facts of the question.