EXAMINER'S REPORT NOVEMBER 2018

SHIPPING FINANCE

General comments.

Candidates lost marks by providing answers which 'lack depth'; they were too basic, and did not provide the degree of detail required to score well.
A number of candidates showed evidence of having read around topics by providing actual case studies in illustration, such as real syndicated loans and securitisations by shipping companies. These real life case studies deepened answers and gained additional discretionary marks.
Candidates are advised to adopt this approach in their preparation, and also to consider phases of the cycle which affect all aspects of shipping finance and should be integrated into answers where relevant, even if not specifically raised in the terms of a question.
In this latter context they are also advised to consider at all times the issue of types of risks which are faced by parties when negotiating with each other, for example regarding a particular type of loan such as a moratorium, or types of shares.

1. How can securitisation be used to raise finance to purchase new vessels? Explain the requirements for securitisation, and if a company's cashflows can be suitable for use in the process. Are there ways to reduce the interest rate spread on the bonds which will be issued?

Most students of shipping finance knew in broad terms what is meant by securitisation, and this came through in the answers where very few gave incorrect answers by not correctly explaining the technique. However, some candidates failed to mention the three requirements of cashflows (stable and predictable; legal right to assign to third parties; of the same source or homogenous).
It is also important to put arrows in diagrams to show the direction of payments (coupons) and investment from buyers of the bonds.
The constituent parts of a securitisation should also have been explained, and their status. For example, additional marks were awarded for those students who mentioned that a special purpose vehicle is an integral part of the arrangement, but then went on to explain that it has separate legal personality the purpose of which is to protect investors (because it is bankruptcy-remote from the issuer), and also the originator (the shipowner) against legal actions brought by investors.
This was a question which required detail to gain high marks; for example, instead of saying that a bond is issued, candidates should have mentioned that this is usually a floating rate note, with the coupon linked to a benchmark such as LIBOR. Some candidates missed the ways in which the basis point spread can be narrowed; this can be a guarantee from a wealthy parent company, or the transfer of ownership of assets (vessels) to the SPV if this is possible (it will not be possible if there are outstanding mortgages on the vessels).
So, general answers tended to gain borderline passes, but in questions such as this it is possible to gain high or full marks by providing the extra detail regarding finer points.
Candidates should always remember to not only identify the constituent parts of an arrangement such as a securitisation or syndication, but they should then progress to discuss the functions of

those parts.

2. Explain the characteristics of convertible bonds, discussing the advantages and disadvantages of such bonds from the perspectives of both issuers and investors.

Candidates scored well on this question in describing the broad characteristics of convertibles, although some simply guessed that it was an instrument which by definition allowed conversion from one medium (debt) into another (equity). However, candidates who gave higher detail scored well.
For example, most candidates simply described a plain vanilla convertible with an embedded equity option; better answers included a very brief discussion of other types of convertibles such as mandatory, reverse, packaged. This showed evidence of reading around a topic.
Also, there was a small number who then proceeded to give actual examples of convertibles issued by shipowners, and this gained higher discretionary bonds.
This information is not difficult to find; for example, a simple google search for 'shipping companies, syndication', or 'shipping companies, convertible bonds', will find actual case studies with the names of the issuers and the basic terms of the issue. This additional detail gains discretionary marks because it demonstrates that the candidate is able to take a particular technique or instrument and show how it has been applied in a practical situation.
Candidates are accordingly advised to read outside the materials they have, and find case studies which can be very briefly mentioned in answers.
Some candidates failed to mention the main risk of convertibles from the viewpoint of investors: that they can become busted with no prospect of the trigger share price being met, so the bond remains unconverted for its life. This is a major drawback since the investor will have sacrificed a handful of basis points vis a vis an alternative purchase of a plain vanilla bond, in exchange for the equity sweetener, but this has turned out to be worthless.

The list of advantages and disadvantages of convertibles from both sides' perspectives was well done by students, since it is simply a matter of 'list and explain'.
A list of bullet points here was sufficient to gain full marks for this part of the question.
A brief mention of exchanges on which convertibles are traded, and how pricing is linked to share price and wider issues of liquidity, increased marks.
No candidate mentioned how, with some types of convertibles, the warrants can be stripped from the host and traded separately.

3. Discuss the advantages and disadvantages of a private placement compared to an initial public offering (IPO).

This was another question where discretionary marks were available to those candidates who very briefly gave some actual examples of private placements and IPOs by shipping companies. This was a descriptive question but only a few candidates mentioned how private placements avoid the cost and legal obligations of the prospectus rules associated with an IPO. Some candidates correctly discussed, even if tangentially, statutory provisions governing IPOs, for example Sarbanes Oxley in the US.
High marks were awarded to those candidates who managed to incorporate reference to the shipping cycle in this answer. For example, during a boom there will be high demand for shipping shares, and an IPO should be successful with all offered shares being taken up.
However, during a slump this is not the case. Here, it is only sophisticated investors who are able to make an informed view as to the immediate and medium term direction of the cycle, and how this will impact upon share prices and asset values.

Although the wider public will be sceptical about shares during a downturn, sophisticated investors may see this as an opportunity to purchase under-priced shares.
This is where a private placement becomes a good option for shipowners. However, such investors tend to be more demanding for information, and more intrusive in the running of the business, than uninformed investors. Candidates who also discussed pre-emption rights in the context of private placements- that share must first be offered to existing shareholders before they can be offered to outsiders- scored higher marks.

This also briefly enabled the issues of dilution of control and earnings per share to be mentioned.

4. The Chief Executive Officer (CEO) of a general shipping company wants to raise equity capital via a new issue of shares but is concerned. The prices of shares have declined in recent months (the general view is that prices should improve over the next year). The CEO is also confident that a series of new charterparties will result in an increase in profits over the next five years, enabling a significant increase in dividend payments to shareholders.

As the Chief Finance Officer, write a marketing strategy for a possible equity raising round and the types of shares that could be offered to existing investors, bearing in mind anticipated changes in general market conditions as well as the company's short term trading performance.

The types of shares, including plain vanilla, partly paid, cumulative, preference, were identified in most answers, gaining an immediate pass. However, several students did not then proceed to discuss the finer detail, or to link the types to different phases of the shipping cycle, which is a major driver of investor sentiment and behaviour. For example, during a slump it is not easy to raise the full amount of a share from an investor, but asking for part payment, as is the case with partly paid shares, still looks attractive despite the current state of the market.
Candidates were also required to discuss risks attached to the different types, and how ability to pay dividends is directly correlated to trends in the cycle. For example, when rates are booming then it becomes easier to raise equity but also to pay dividends to it.
During a slump, the issue of a lack of liquidity becomes relevant, and previous holders are more likely to bail out than to see the price fall even further, which itself becomes self-fulfilling with further falls following.
With regard to marketing strategy, some candidates correctly discussed in their answers the 'upside', in terms of the prospect of share price improvement and rising dividends.
However, they did not then give a balanced answer by explaining the risks, which is a requirement in all listing rules and should be specifically set out in the prospectus.
Again, some reference to Sarbanes Oxley would have helped here, even if a very brief one, for additional discretionary marks. It is vitally important in shipping finance, and certainly for this exam, to consider the risks to, objectives of, and behaviour of, all parties, whether this is shareholders, bondholders, or lenders.
Shipping finance often sees different groups negotiating with each other, but with different goals and risks. For example, owners and charterers negotiate with different strengths and power at different stages of the cycle.
In a boom, the owner has the whip hand because of the scarcity of tonnage, but conversely, in a slump there is too much tonnage and charterers can drive a tough bargain, particularly if the spot market is always an alternative to locking in to rates in a medium term charterparty (although of a course a wise charterer will know that there is only one course of direction at the height of a boom, and that is downwards, and accordingly it is good strategy to fix at this time, locking in attractive rates offered by desperate owners struggling to cover OPEX).

5. Identify the principal participants in a syndicated loan, and the functions of each. Use a diagram to support your answer.

This question was answered very well, with candidates providing excellent diagrams which identified all participants to a syndicated loan. It was surprising, however, how several students omitted the underwriters.
Discussion of functions was reasonably well done, although there was weakness in some papers in discussing the role of the trustee or fiscal agent. Regarding the latter, for small discretionary marks there should have been mention, briefly, of minor deviations which can be waived, such as late payment of a coupon.
The overwhelming number of candidates who attempted this question passed it; there was no critical thinking or application required, just a discussion of functions. Again, a few candidates gave brief mention of actual syndicated loans by shipping companies, including the term and coupon, which was particularly commendable (and gained marks) because it demonstrated a reading around the subject.

6. Discuss the characteristics of THREE of the following types of loans, including the potential risks to the lender, and how these might be reflected both in the fee payable, and covenants in loan documentation.
i) Moratorium loans
ii) Bullet repayment loans
iii) Balloon repayment loans
iv) Back/Front ended loans
v) Revolving credit facility loans.

Candidates were well-able to describe each type of loan chosen, but failed to discuss issues of risk and covenants. With regard to the former, for example a moratorium loan can leave the lender holding security of less value than when the loan was initially made and the shipowner was already distressed. So, the borrower has gone into liquidation, and giving an extra two years for things to be sorted out was fruitless and only postponed the inevitable.
However, in the meantime the underlying security has collapsed, leaving the lender in an even bigger mess than was originally the case.
To overcome the risk there could be residual value insurance but this is impracticable because of the cost or premium, assuming that it would be given in the first place, which is unlikely.
The same applies for back ended loans- this may be putting off the inevitable, and if prices decline then the lender is in a worse position. Some candidates rightly briefly mentioned sinking funds as a way to offset in part the risk of asset value deterioration under a moratorium or back ended loan. Certainly, this gives a measure of reassurance to lenders but at the same time, if the borrower is already stretched to meet OPEX, there may be no cash left over to pay into a sinking fund, which would be ring-fenced and hence the decision to set it up in the first place should be carefully considered.
Future candidates are advised to make sure they have a list of covenants at hand, and can be found through a basic google search. Covenants would include, for example, to pay interest, not to take on additional loans, not to secure assets with further debt, not to make assets disposals, to keep assets insured, not to reorganise the comp[any or sell of parts. But there are many others: the question was not prescriptive in requiring a specific set of covenants, and candidates were free to use whichever they wish. In reality a good candidate of shipping finance should be able to identify a set of common sense covenants, even if he or she has never seen standard loan documentation, since the aim of these is to protect the lender’s position, and to set out the mutual obligations of lender

and borrower.

7. Discuss specific instruments found in Islamic finance which may be suitable for the shipping sector, referring to the basic principles which differentiate this form of finance from conventional financing techniques.

Islamic finance is the fastest growing area of finance in the world today, albeit from a very small base, and is having a major impact on ship purchase in the Middle East.
Centres such as London and Luxembourg are vying for this lucrative business, and accordingly it cannot be ignored by students of shipping finance.
Students had complete freedom as to which instruments or arrangements to discuss, with some discussing ijara, musharaka, mudharaba.
In essence this is joint venture or partnership finance, with the main differentiating feature from mainstream finance being the prohibition of interest or riba. With regard to principles, these would include the interest prohibition, the prohibition against speculation, and enforcement of the nemo dat quod non habet principle (you cannot give or sell that which you do not first own).
Structures of these joint ventures should have been discussed in depth, and some candidates failed to do this. No candidate who attempted this question provided a case study in illustration of a technique, which was a minor omission but one which would certainly have deepened the answer. Again, a basic google search will find such case studies.

8. In the context of a failing shipping company which owns diverse vessels which are traded in a range of sectors, discuss items in the balance sheet and in the debt-equity structure which would attract your attention when designing a turnaround or recovery strategy. You should also take into account wider shipping cycle considerations where you think these may be relevant.

This was a 'think outside the box' question, with candidates given freedom as to how they integrated issues of risk and balance sheet composition into a wider discussion of phases of the cycle. In terms of the theoretical underpinnings, some mention, even if very brief, of the Modigliani Miller capital structure irrelevance hypothesis, and its assumptions, would have gained more marks.
Answers tended to be too generalised, with candidates discussing focusing on asset values and their volatility, and whether or not they should be sold and leased back to gain short term liquidity.
Outsourcing of functions such as crewing, administration, chartering, were also considered by some candidates, as ways of reducing balance sheet stress.
Disposals of older vessels, good use of asset depreciation and write-downs, were also well discussed.
Holding of high inventory should also have been addressed.
With regard to the debt equity structure, several students rightly raised the issue of whether interest was fixed or floating, in an environment in which rates were volatile.
Some briefly and correctly mentioned that an interest rate swap (fixed to floating, or vice versa) would be considered to at least ensure that the interest burden was stable and predictable. Types of loans could also have been discussed; several candidates did this, discussing moratorium and back ended loans, and were correct to do so.
With regard to equity, again some discussion of types of shares could have been given here, notwithstanding that this subject had been tested elsewhere in the exam paper (at question 4).
This question was a good illustration of how candidates should feel free to roam across the syllabus, drawing upon a range of topics in order to provide a balanced and comprehensive answer.