The Distressed Shipping Market Attracts Private Equity

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Since the collapse of Lehman Brothers, private equity has explored the distressed markets to find hidden value. With the decline in world demand, the workhorse of the transportation sector, shipping, is an obvious target. This article explores some of the risks in an investment in shipping.

For shipowners, private equity is hailed as the panacea for solving the funding imbalance of the overall uncommitted newbuilding order book. However, in the current financial crunch, tankers are the Rodney Dangerfield of all shipping sectors. Private equity investors are learning that the tanker sector has its own inherent risks; the wet market just doesn’t seem to get any respect.

These risks include cargoes viewed as inherently dangerous (sulfuric acid?), civil and criminal oil pollution liability (all ships can spill bunkers, but tankers have wet cargo too) and the public perception of irresponsibility. Financier and attorney can provide shipping investors with advice on reducing operational control and setting up an insulated corporate structure. Nevertheless, the idea of the ocean swallowing a boatload of grains seems inherently less problematic than a shipment of jet fuel.
Investment in distressed industries is among the most common investment strategies for private equity. Therefore, with the shipping indexes (think BDI — Baltic Dry Index) testing record lows and U.S. bankruptcy filings by international shipping companies on the rise, arguably, now is the perfect time for private equity investment in shipping. It is therefore no surprise to find a plethora of private equity investors combing the markets for investment opportunities. However, private equity investors seem to be put off by the intricacies of the shipping industry.

Inconsistencies among local, national and international regulatory regimes, the Oil Companies International Marine Forum and oil major strength, coupled with a highly cyclical business frighten the prudent strategist. Nevertheless, tales circulate about the Loews/Tisch tanker investment during the last major downturn in the 80s.

With calculated advice, Loews bought six ULCCs (ultra large crude carriers) for a total investment of roughly $30 million. While considerable expense went into maintaining each asset’s value and transaction structuring, in roughly 10 years, a half interest in the six ships was sold for $150 million. These are the stories PE firms live for.

Similarly, the markets eye with awe the Ontario Municipal Employees Retirement Fund’s recent investment in V.Ships (a Monaco-based ship management company) and Wilbur Ross’ investment in the Craig Stevenson (well known for the ship sale and U.S. SEC delisting of OMI Corp.) run Diamond S Shipping.

Private equity, in finance, is typically viewed as an asset class consisting of equity securities in operating companies that are not publicly traded on a stock exchange. According
to Jim Lawrence, the chairman of the shipping publication, *Marine Money International*, "The majority of ships are owned by independent privately controlled companies." This industry structure makes shipping a good fit.

In analyzing an investment, each private equity investor has its own set of goals, preferences and investment strategies. However, each strategy will need to provide working capital to the target company to foster expansion of the existing business model. Moreover, new forms of business (in the case of shipping perhaps different routes or alternative types of ship) or the restructuring of the company’s operations, management, or ownership are essential considerations.

The following typical private equity concerns also need careful examination.

**Structuring the Transaction: Tax and Corporate Efficiency**

With regard to structuring issues, as noted by our partners, Lennard K. Rambusch and Jovi Tenev, in "International Maritime Workouts," contained in *Business Workouts Manual (2d ed)* (Thompson Reuters/West: Boston, 2008), "A shipping venture may touch a number of countries and involve the laws of a number of jurisdictions. For example, a vessel may be owned by Greek principals through a single purpose Liberian owning company, flying the Panamanian flag, chartered to Danish charterers, mortgaged to a U.S. bank, be entered with a London protection and indemnity (P&I) club, and have hull insurance placed through the German insurance market … managed by owners, through a special-purpose corporation established to provide management services, or by professional managers … In short, the obligations and legal arrangements of a vessel and her owners may be affected by the laws of a number of
nations … " For the foregoing reasons, additional tax and corporate concerns are inevitable.

Maintaining Management Oversight

Often the technical operation of the new entity’s assets is controlled by the minority partner (the original shipowning interest). It is quite common that the expertise of the initial investors in the shipowning company will be used to technically and commercially manage the ship. While formal arm’s length agreements will negotiated for such services, PE oversight can be difficult. This requires a greater sense of trust with the operational managers.

Means of Repayment

Key to any PE investment is the means of repayment. In a shipping venture, repayment will primarily consist of income from a charter (the lease). A lease by any other name is a charter for a ship. This different terminology is but one of the factors that has had an adverse effect on the influx of actual investments in shipping by private equity interests.

Basically, there are three types of ship charters (never referred to as "leases") — the Time Charter, the Voyage Charter and the Demise (or Bareboat) Charter.

In a voyage charter the lessee (charterer) hires a vessel and its crew for a voyage between two ports. The charterer pays the shipowner on a per-ton or lump-sum basis. The shipowner is responsible for the payment of all the port costs (excluding stevedoring) as well as all fuel and crew costs. A time charter on the other hand consists of the hiring of a ship for a specific period of time. In a time charter, the shipowner manages the ship but the charterer selects the ports and
course of the ship. The charterer pays for all the fuel the vessel consumes, port charges, and a daily hire to the owner of the ship.

A bareboat charter or demise charter is an arrangement for the hiring of a vessel whereby no administration or technical maintenance is included as part of the agreement. The charterer obtains possession and full control of the vessel along with the legal and financial responsibility for it. The charterer pays for all operating expenses, including fuel, crew, port expenses and P&I and hull insurance. In commercial demise chartering, the charter period may last for many years; and it may end with the charterer acquiring title (ownership) of the ship. In this case, a demise charter is a form of hire-purchase from the owners.

Clearly the bareboat charter is the best means of establishing a payment stream to repay the private equity investor. In the case of time and voyage charters, the need to repair the ship or increased fuel or crew costs can alter the net income to the shipowner.

The private equity investor will also need to understand the shipping nuances related to the lease based (chartered back) financing. Important issues that have been getting a great deal of attention are those related to the recharacterization of a lease (the ship charter) as a financing instrument. In the context of the recent U.S. shipping bankruptcies, practitioners are closely examining whether charters can be recharacterized.

Assuming that a charter is a true lease, a debtor in bankruptcy has the option to assume, assume and assign, or reject the charter. Assumption (or assumption and assignment) of the charter means that the charterer (or its
assignee) agrees to perform the agreement in accordance with its terms unless the owner agrees otherwise. The charterer would also have to cure any pre-petition monetary defaults that may exist.

Rejection of a charter is deemed to be a breach of the charter. On the effective date of the rejection, the relevant charterer would be obligated to return the ship to the owner, but would not necessarily be obligated to comply with all of the return conditions specified in the charter. The owner then can assert a claim for rejection damages.

Assuming a charter is recharacterized as a financing, the ship will be deemed to be property of the charterer’s estate. The shipowner would be able to assert a claim against the charterer for amounts due under the charter that would be calculated in a manner similar to a claim for rejection damages. If the shipowner has not taken steps to perfect a security interest in the ship, it likewise would also be classified as a pre-petition, unsecured claim.

**Control and Planning of an Exit Strategy**

Finally, control and planning of an exit strategy can be difficult in a fragmented market largely controlled by entrepreneurs. The shipping industry has spent the last few years courting PE, trying to understand a need for 20% returns and three- to five-year exit strategies in a low-return, long-term, highly cyclical business. However in reality shipping is just another business.

While all private equity investments require careful analysis and market understanding, PE firms have quickly recognized that an investment in the shipping markets clearly has its own nuances. Nevertheless, investors seem willing to
address concerns related to exotic cargo blending issues, U.S. Office of Foreign Assets Control trade sanctions and even piracy.

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