


srmm 

[private finance]

maritime
economy



Financing sources and tools of shipowning companies

SRM's Observatory on the Maritime Economy publishes – in the “Private finance” collection and by courtesy of d'Amico International Shipping – a project work coordinated by the shipowning company within the sixth edition of the “Master in shipping, logistics, finance and business strategy” held by I.P.E. – Istituto per Ricerche ed Attività Educative. The project focuses on the financing tools and sources used by the operators in this field and analyses in depth the case study concerning the tutoring shipping company.

This study hereby translated into English is a summary of the Project Work “Financing sources and tools of shipowning companies”. The full Italian version is available at www.srm-maritimeconomy.com

Business tutors:

Francesco ROTUNDO – d’Amico International Shipping

Giovanni BARBERIS – d’Amico International Shipping

Authors: I.P.E Master’s students (in alphabetical order)

Giuseppe Valerio AGOVINO, Eugenio BIANCUCCI, Vincenzo Gregorio DEL SORBO, Alessandra LAUDATI

Graphic design and publishing development:

Marina RIPOLI

The following publication shall not bind or represent the thoughts or opinions of the founding and ordinary members whatsoever. The present study can be reproduced in whole or in part only upon authorisation by SRM. The quotation of the data here contained is only allowed with a specific mention.

Table of contents

Introduction 5

Features of shipowning companies 6

Debt instruments 13

General features and IPO 21

Bank financing 27

Vessel purchase simulation 33

INTRODUCTION

Over the last twenty years maritime transport market's changing conditions and needs have engendered a strong mutation of both its internal composition, and of the relationships on which the trade relations between the operators in the sector are based. Among these latter, the relation between credit institutions and shipowning companies has undergone a progressive transformation. To better understand the phenomenon in question it is necessary to highlight the criticalities which led to the credit crunch and led the shipping companies to use alternative funding sources. In this regard, "d'Amico Società di Navigazione", besides being one of the few Italian shipowning companies listed on regulated markets, it is exemplary in the sector as it uses a number of financing sources.

FEATURES OF SHIPOWNING COMPANIES

Shipowning companies just like the shipping market itself are highly peculiar. One of their first traits lies in the characterisation of the vessel assets which can reach 90% of their balance sheet. Unlike other plant assets, these ones are movable, and this favourably suits the high internationalisation degree of shipping companies along with the more and more influential globalisation. The vessels' value hence, because of their function, is subject to the same fluctuation of the real market being its direct derivate. The sharp fluctuations of developments in the real market, the continuous variation of the equilibrium points between supply and demand of transportation and their effect on the freight market have an impact on the value of those assets, normally estimated on the base of the discounted cash flows which they are expected to generate in the future.

For this very reason shipping companies have become 'capital intensive' i.e. companies requiring substantial financial resources of their own, and of third parties. Another peculiarity of this sector is the high use of the financial leverage which, over the years and because of the particular economic situation, has suffered a sharp drop. The diminishing confidence of the credit institutions due to the drop of freight rates, especially that of solid and liquid bulk segments, has led shipping companies to expand the search for financing sources sometimes using financing tools which are new to this sector. Another peculiarity of shipowning companies, and especially Italian ones, is a strong familial presence in the governance structure.

re which inevitably influences the companies' strategic choices and which, in certain conditions, might limit their growth. To date "D'Amico Società di Navigazione" is one of the most robust Italian companies. The decision to list the company along with the use of financing tools which are new to the shipping sector has allowed a great investment power right when the price of new assets were more favourable due to the downward trend in freight rates. This was possible only by changing the governance attitude: in fact shipowning companies, whose primary goal is their own survival and profit have to aim at being more appealing to investors that, albeit their lack of knowledge in the sector offer a precious source of financing. A new vision for shipping companies is hence required; as non-atypical companies they have to be considered as common businesses whose goals are the same as any other business and whose financial tools can be borrowed from other sectors.

DEBT INSTRUMENTS

The difficult credit market access conditions have led shipping companies, traditionally bound to bank funding, to look for new financing sources. Among these a viable alternative is the bond issue. In particular, besides the 'plain vanilla' type the company can also issue 'convertible bonds', that are bonds which allow the owner to convert his/her investment in a different form, usually into ordinary shares of the company issuing the bond, according to a formula of predetermined share swap. Furthermore, other complex tools entered the sector; from 'cover bonds' – guaranteeing the repayment of capital and interests thanks to the constraint of a slice of the total assets of the bank which is only intended to the remuneration and repayment of bond – to the issuing of 'sukuks' the so called Islamic bonds.

As for the method of share placement, the public placement represents the principal formula of allocation of bonds on the market. This procedure is definitely the most complex and costly for the issuer. The main limitations lie in the necessity of a business plan developed with scientific mechanisms by consulting firms, in the attribution of one or more ratings (generally from Moodys', SP and Fitch), to the listing and the minimum size of the issue. In fact such size shouldn't be less than 500 million euro, in view of the prerogatives of the investment made by large investors and the expenses for the issuing procedure. In addition, the public placement generally imposes covenants like the negative pledge, limitations on indebtedness (EBITDA/debt ratio) and a minimum equity.

Contrariwise, with the private placement the issuers offer newly issued financing tools which are placed to a limited number of investors; institutional investors such as mutual funds, Italian and foreign banks and financial intermediaries, trust companies or high standing individual investors. This placing mechanism is generally used for limited size issues and can be also adopted for capital increases of unlisted companies. The issuer agrees with a limited and selected circle of investors the volume, the price and the conditions of the issue. Often the private placement represents the first step for a subsequent access to regulated financial markets. Private placement is able to finance companies at a lower cost compared to that of a public placement. In addition it allows a greater control over the entire process: it allows more flexibility with the extent and the type of financing and allows companies to choose their own investors and the prior agreement with the investors can quicken the realization times and can ensure the total placement of the securities. However, such decisions need an accurate due diligence and a careful evaluation of risk factors: the bonds sold through private placement in fact, are not listed on an exchange and accordingly they are less liquid. Therefore, the investments in private placement require a higher tolerance to risk, minimum liquidity problems and the possibility of long-time commitment; essentially, investors have to be capable of supporting the loss of the entire investment.

Besides the above mentioned characteristics, the advantage of the private placement procedure lies in the possibility to issue a smaller size compared to a public bond issue. As a matter of fact, the issue can vary from 50 million to a maximum of 250-300 million euro. To carry out the issuing procedure a certified rating is not required as it is, instead, for public issue. In fact, unlike this latter, in private placement there is no public offer thus eliminating the risk of execution, i.e. the risk that the total amount of the bond offered for subscription at a certain rate of return, doesn't meet the investors' favour and therefore will not be acquired for the whole.

GENERAL FEATURES AND IPO

The financial sources of debt have always been the principal type of financing for Italian ship owners used to expand their fleet. Only a few shipowning companies, among which "d'Amico Società di Navigazione", have taken up the challenge offered in recent years by the IPO – i.e. initial public offering.

Nevertheless, this is by no means a low risk strategy, in fact before acquiring an IPO the company has to undergo high cost of internal transformation in order to attract outside investors. In this regard, it is fundamental for the company to prepare updated business plans containing information about the activities it intends to carry out and to strengthen financial communications which are directed externally in order to keep the outside investors up to speed on company's financial health and solidity on the market place. The aim of such an operation is to spread the shares in the public thus creating a free float. D'Amico group launched its IPO in 2007; when a share amounted to € 3.50, in the following years share value of the company suffered due to the crisis in the sector with the drop in freight rates, touching its lowest in 2012 in which a share was worth about € 0.20.

By the end of the same year the governance decided to start a courageous operation to increase the company's capital; an operation that generally can be performed either with the increase in the nominal value of the securities issued and by the issue of new shares. This latter operation determines an increase of shareholding and a dilution of the division of share ownership in the hands of individual shareholders. As a result of this process which was carried out in two stages, the listed company of d'Amico Group has recorded its best performance in the stock market in 2013 with a growth of 170%. This has been possible thanks to an effective financial communication policy started by the company and which has led, in March 2014, to a share price of € 0.70. This operation permitted the financing of the fleet renewal by purchasing twelve ships with a sustainable design, in a moment when it was crucial for a shipping company to renovate itself and when the prices of the ships were more attractive. The whole operation has had a positive impact on the company's image too. Despite the strong internationalisation of the group, the goal of the d'Amico family is to own at least the 51% of the company.

Another capital source is represented by private equity funds which are an alternative formula to provide risk capital to companies through intermediaries specialised in promoting the development of the company. The job of these professionals is to invest in significant shareholdings of companies, including non-listed companies, aiming to increase the value of medium-term shareholding to achieve a substantial capital gain when the shares are sold.

BANK FINANCING

Bank financing has always been the principal financing method for the shipping sector; this process is generally made of 5 different steps. First of all, the bank considers the value of the vessel being used to guarantee the loan. Secondly, an accurate cash flow forecast of financial assets has to be provided; in this regard a medium/long-term time charter (T/C) agreed with a charterer is an essential assessment element for the shipowner in order to obtain good financing conditions.

The course of action which is generally used involves a payment of 30% divided into three tranches; 10% at the signing of the newbuilding contract (SAJ form for Far East shipyards or AWES form for European shipyards), 10% at the time of “steel cutting”, 10% after 6 months and a final balloon amounting to 70% of the price.

The bank financing the shipowner operates during the construction of the ship, in fact during this period of time, as security for the loan granted, the bank requires the shipyard to release a bank refund guarantee for the contractual instalments paid by the owner and/or by the lending bank itself.

The due date for repaying the loan, generally signed about 24 months in advance, shall commence from the delivery of the ship to the client. A very common practice that aims to protect the borrower from fluctuating interest rates by fixing the rate through pre-hedging, even with another bank. This way the borrower neutralises the uncertainty of the cost of deferred financing which lasts, as previously said, 24 months. In ship financing, the guarantee instrument against the failure to perform, which safeguards the lending institution, is a first mortgage on the vessel, generally submitted to the common law. Besides that there is the possible assignment of the freights in case there are already existing contracts or more in general, the assignment of the proceeds resulting from the vessel's use.

Another guarantee instrument that safeguards the bank is the insurance guarantee which generally promises that the bank shall receive the insurance refunds in case of a total loss of the vessel or under other circumstances provided for in the contract.

Among the above mentioned instruments, with the exception of the refund guarantee, the registration of mortgage is certainly the most reliable. However, it should be noted that such an instrument proved inadequate to properly ensure credit in the period of severe recession in the industry. In fact, as just said, the vessel's value depends directly on the prospective cash flows that the vessel is able to generate.

As a consequence, after the drop in freight rates the assets value decreased and so did the mortgage guarantee which lost most of its original value: as a result the forced sale of the property was not able to pay off the debts of the client. To solve this issue, today there is now in place a widely used clause 'Loan to Value' which provides, starting from the date of the signing of the loan, a quarterly assessment of the market value of the asset.

The Loan to Value clause provides that this value must always be equal to 130/140% of the outstanding debt. If this condition is not met, the borrower should reintegrate the value through a refund of part of the loan.

VESSEL PURCHASE SIMULATION

After the description of the various peculiarities of the shipping sector and the strategies a company can take for its financing needs, we now illustrate a simulation of ship financing through the banking channel.

This simulation develops according to the methods used by d'Amico Group which represents a successful example in an economic and financial crisis in which many Italian shipping companies are in the necessary step of debt restructuring.

The vessel subject of this simulation is a 50,000 DWT Product Tanker Handysize type.

The newbuilding contract (SAJ form) which has been signed on 02.07.14 between the client and the shipyard (the most competitive of which are the South-Korean) provides for the following conditions:

- Vessel price: USD 35,000,000 (according to freight market prices provided to 2016 amounting to USD 17,000/per diem).
- Expected delivery date: 02/07/2016.
- Payment times in four *tranches* respectively on:

Date	Time (T1 = 1 month)	Amount (USD)	Reason for payment
02/07/2014	T0 Sign of SAJ Form	3,500,000	1 st advance payment 10%
02/01/2015	T6	3,500,000	2 nd advanced payment 10%
02/04/2015	T10 Steel Cutting	3,500,000	3 rd advanced payment 10%
2/07/2016	T24 Vessel delivery	24,500,000	Balance due 70% (from the financing bank)

After ordering the vessel to the shipyard, a first contract with the bank is signed (T1) and through it the financing¹ of 70% of the vessel's price is required. Such decision arises from the companies' choice to use its own funds until the vessel will be completed, in order not to expose the bank to the risk of non-execution. Thus the financing institution will be more inclined to provide more favourable contract conditions as it finances an asset which does not exist yet.

Moreover, for defining those conditions it is necessary for the shipping company to provide the elements and the indicators suitable to reach a certain status in order to obtain financing at more favourable conditions.

As just mentioned, the lender institution has to carry a detailed economic and financial analysis by assessing the principal indicators of the company's health status.² Other elements of great importance are the company's history, its management, its creditworthiness, and its reputation.³

According to these parameters, the bank assigns internal ratings, thanks to which it decides the spread to be applied in addition to the benchmark (benchmark upon which the cost of financing is calculated).

In this case, by virtue of the riskiness of the company, the institution shall draw up a contract proposal (term sheet) based on the needs of the customer, to the following conditions:

¹ Reliable companies are able to obtain more favourable financing terms by applying to institutions in northern Europe which are more competitive on the capital market. To date Italian banks are less competitive even though the latest capitalisations of the institutions have allowed an increased competitiveness of some of these (Banca Intesa).

² In particular, reference is made to the performance of leverage ratio and fixed assets coverage ratios.

³ Reputation means the professionalism of the subject to be funded based on its history, reliability and position in the shipping market, while creditworthiness means the subject's ability to repay his/her debts when due.

⁴ As for the method of refund they can be amortizing, bullet or mixed. In the first case, interest and principal are paid through instalments for the time being, while with the bullet mode the refund is paid in a lump sum. The mixed system, preferred by d'Amico Group, provides for both methods. In particular, it is provided the repayments to 15 years which leaves the option to the customer to return the remaining debt in full at the end of the seventh/tenth year, by paying a final balloon, so to proceed with the sale of the ship, still in the prime of its life, after the extinction of the loan and the cancellation of the mortgage on it.

⁵ For simplicity it has been reported in the table only the Loan to Value. Further covenants can be: minimum equity/debt ratio, EBITDA/debt ratio, minimum equity, negative pledge i.e. impossibility to register additional mortgages on company assets.

Amount of funding	24,500,000 USD		
Duration of loan (tenor)	10 years		
Method of refund ⁴	Mixed (ammortisation 9 instalments + final balloon)	10 annual instalments	Instalment profile 15 years
Ammontare n°9 rate:	1,634,000 USD (x9)	Baloon:	9,800,000 USD

As regards the choice of the funding benchmark upon which the contract hypothesis should be drafted, the client opts for a fixed rate by signing a swap as a hedge from the future change in interest rates and since the company has a bull market view on future rates, in fact at the date of signing they are at their lowest.

Benchmark	Mid Swap 10 years	1.5%	
Spread	280 BP	2.8%	(calculated according to the riskiness of the company, the industry average β and other parameters.)

The bank shall be due by the client, in addition to the remuneration of the pro-tempore credit, upfront and commitment commissions. The first, as preliminary one off fee, shall be paid upon signing the contract, while commitment fee shall be paid until the disbursement of the loan due to the inability of the bank to use the amount of money. Both are about 1% of the amount financed or 30% of the spread. In 2014, d'Amico succeeded in obtaining commissions equal to 0.8%, thanks to the constant work done over the past two years on the company's image.

Upfront	1 %	one off
Commitment	1 %	Biannual until 02/07/2016
Guarantees	Mortgage, surety of the parent holding	
Covenants: ⁵	Loan to Value	Mark to Market 135% of the residual debt

Following the issuance of the term sheet, between T1 and T2 negotiations take place, as a result of which the buyer is able to obtain the following more favourable conditions: spread 2.5%; upfront 0.8%; commitment 0.8% (32% of Spread); loan to value 130%.

Such conditions are subject to a future resolution of the bank (T3) and after another two months (T5) the financing contract shall be signed and the immediate obligation to pay the upfront sum of 24.500 USD shall arise. From this moment on the buyer has the burden of paying the pro tempore bank's commitment until the payment of the mortgage in T24. Concurrently with the delivery of the vessel, the financing institution shall pay the remaining 70% of the debt to the shipyard. From this date on the buyer which has been granted the loan shall pay the yearly instalments including principal and interest. By assumption, during the financing period the company receives a purchase offer for the vessel at a higher price than its market value. In case the company decides

to accept the offer this would lead to the need for an early repayment of the loan. If the funding had been granted at a variable rate, there would be no additional charges except for breakage costs, which are relatively low. In the present case, there is the need to pay the value of the swap at that time, according to its mark-to-market. Only in the event that the latter is lower than the capital gained from the sale, you can consider the operation convenient. Moreover, if the company decides not to sell its asset, it could then consider the possibility of placing the swap agreed in 2014 on an OTC market realising a possible capital gain/loss to be accounted for in the income statement. However it shall only be accounted after the granting of the loan by the bank, i.e. in the present case, only after the vessel's delivery. Conversely, the gain/loss shall not be accounted in the income statement if the swap is agreed in a moment that precedes the granting of the financing by the bank. The result would be the passage of the remaining debt from a fixed rate to a floating rate. The evaluation shall be carried out on the highest value between the gain realized from the sale of the instrument, and the higher cost of capital that has a variable interest rate.

maritime
economy