Shipping Finance Exam, May 2023.

1. Answer **ALL** parts.

a) Explain the differences between senior debt and mezzanine financing from the perspectives of lenders and shipowners. Advantages and disadvantages of each form of financing should be discussed.

Answer.

Senior debt is more secure than mezzanine in terms of being paid prior to it on the insolvency of the borrower. It gives a lower rate of interest because of this prior entitlement to payment. It is secured on assets: in the case of a shipowner, the vessel. It is paid prior to equity on an insolvency. The advantage from the borrower's perspective is that it does not have a right to dividends and does not afford voting rights to the lender. Mezzanine is below senior debt on an insolvency and is paid after it but above equity. It contains an equity trigger which is activated by non-payment on maturity, hence the reason why it is viewed as debt by the borrower but equity by the lender. It is a hybrid form of finance. It is short term and expensive relative to other forms of debt.

b) Describe the characteristics of following types of loan, relating the suitability of each to the different phases of the shipping cycle.

Back ended loan

Interest is postponed to the end of the loan. It is suitable when freight earnings are low but expected to pick up in the short term.

Moratorium loan

This is a suspension of interest and principal payments for up to two years. But when payment is restored, it is usually for a wider basis point spread over existing market rates, to compensate the lender for having foregone payment.

Bullet repayment loan

This pays interest on an escalating basis towards the end of the loan, as well as principal.

c). Identify FOUR covenants which are included in a standard loan to a shipowner intending to expand a fleet with new tonnage.

To keep the vessel insured

To provide regular information

To pay interest on the loan

Not to move jurisdiction

Not to undertake a corporate restructuring

To give the lender notice of pending legal proceedings

To abide by environmental regulations

Not to trade the vessel illegally

Not to dispose of the vessel without the lender's consent.

2. **Explain the main forms of security, other than a mortgage, which may be taken by a bank from a shipowning company in its corporate capacity, and its owners in their personal capacities, in respect of a loan to the business. In the case of each, discuss the applicable procedure, and the risks to lenders and the continuing obligations, if any, of the borrower.**

Answer.

Assignment of earnings. This may be a problem if the borrower is trading in the spot market. Notice of assignment to the charterer should be mentioned in the answer. Continuing obligation of the borrower: to inform the lender of any material changes in its earnings, for example if the market declines or vessels are off hire or involved in an accident or arrested.

Assignment of insurances.

Notice of assignment to the insurer to be discussed. Risk to lender: that the borrower will lapse in payment of premiums. Risk that the borrower may not have made full disclosure of all material facts to the insurer, with the result that the insurance is voidable and worthless (the lender will not have been privy to the discussion between insurer and insured and will not know of the quality of the disclosure).

Borrower has the continuing obligation to maintain premium payments and to comply with the terms of the insurance policy, for example not trading in certain waters (where there is war risk) and maintaining the vessel in class.

Guarantee.

Need to comply with section 4 of the Statute of Frauds 1677. The guarantee is only as good as the parent which gives it; this is a risk to the lender since it cannot know of the changing circumstances of the guarantor. Continuing obligation of the borrower; to maintain loan payments and to do nothing which undermines the guarantee, for example selling assets or relocating location of registration.

Share pledges.

Risk to lender: the shares may fall in value, undermining them as security for the loan. Registration of ownership issues. Borrower may be required to add fresh collateral if the value of the shares falls below a certain level.

3. **Answer BOTH parts.**

a) **Briefly explain the factors considered by a lender when appraising a second-hand vessel for its suitability as collateral for a loan.**

Answer.

Type of vessels to be bought, and existing and anticipated market conditions

History of the vessels

Age

Valuation

Insurance

Employment

Condition: new or old, and the risk of being off hire for maintenance

Speed consumption and emissions, including ability to comply with environmental regulations

Class and registry: enforcement of loans, and jurisdiction issues

b) Identify the issues which a lender will take into account when appraising a new customer's suitability for a loan to purchase a vessel to be traded in a niche shipping sector (such as chemicals, dangerous substances).

Answer.

Type of borrower

Track record

Experience

Opaqueness of ownership

4. Answer BOTH parts of the question.

a) Describe the characteristics of a typical convertible bond and explain why it may be suitable for a cyclically driven sector such as shipping.

Answer.

Students should define the characteristics of convertibles, but with discretionary marks given for identifying that the issuer may force conversion (instead of the investor being the sole holder of this right), and the consequences of a busted convertible in terms of negative market signalling. Issues such as the trigger exercise price need to be discussed in detail, and whether they are date restricted or open in terms of conversion.

b) Discuss the advantages and disadvantages of convertible bonds for both issuers and investors.

Answer.

Advantages include a lower borrowing cost to the issuer, and longer-term funding than a normal bond, whilst the investor is given a speculative play between debt (giving a guaranteed rate of interest) or equity (the opportunity to participate in the profits of the issuer through dividend payments in the future). Candidates should also discuss the dilution implications of conversion from debt into equity, and the fact that when made, this election cannot be reversed by the investor.

5. The Chief Executive Officer (CEO) of a general shipping company is looking to raise fresh capital via an issue of shares but is concerned about the possible reaction of prospective and existing shareholders. Share prices across the sector have declined in recent months, but the general view is that these should improve within the 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. The CEO has asked you, as the Chief Finance Officer (CFO), to advise on an equity-raising strategy for the company. The CEO is interested in the types of shares he could offer to existing investors, bearing in mind anticipated changes in general market conditions as well as the company's short term trading performance. He asks you to explain the factors, positive and negative, which should be included in a marketing strategy for a series of 'road shows' for institutional investors.

Prepare a briefing report to the CEO, addressing his objectives and concerns. explain whether he should consider listing the company's shares on several international stock exchanges.

Answer.

Students should discuss merits of straightforward ordinary shares issue. Payment in full is received, but usually the shares have voting rights which may dilute the owner's control (but shares can be issued without voting rights), and lead to dilution of earnings. A fresh issue may be subject to pre-emption rights in which event existing shareholders have first right of refusal, depending on the articles of association.

If the market is cautious, consider issuing partly paid shares. These do not require payment in full and can be called upon for the next tranche of payment later. The advantage to an investor is that full payment does not have to be made straight away, but there is still entitlement to an entire dividend payment- this is the incentive. The risk is that if the company becomes insolvent, the shareholder must pay over any amount still outstanding of the shareholding. Preference shares may be an alternative as a way of encouraging cautious investors to take shares in the company, since they will have prior entitlement to dividend payments. Students may also discuss cumulative preference shares in this context.

Good factors to be explained in the road show would be the potential increase in freight rates, asset values, and reduced risk of default in loan repayments, leaving more of earnings to be distributed as dividend payments. Share prices should increase as market optimism improves. Regarding negative factors, the market slump may continue longer than expected. Laid up tonnage may be brought back into play, as well as the beginnings of deliveries of newbuilds, which could weigh down on any market and asset recovery. Markets are also routinely sceptical about shares in shipping companies (students may briefly mention factors which cause this), and accordingly prices may remain underpriced relative to asset values, even if the latter are recovering. If the market is deemed understandable only to sophisticated or well-informed investors, then a 'rising tide' in the general marketplace may be slow to filter through.

The reasons a company may list its shares on more than one stock exchange include the following:

To gain access to a wider group of potential investors

To raise a greater amount of capital, at a lower cost than would be the case if it was raised in one market

To avoid dilution implications

To issue different classes of shares

To avoid making too many issues in one market in too short a time frame

Exchanges:

New York Stock Exchange

Oslo Bourse

Tokyo Stock Exchange

6. Answer ALL parts of the question.

a) Which factors are considered by a borrower when deciding which of several competing banks should be awarded the mandate to lead a syndicated issue?

Answer.

Fee structure

Geographically location of issuer and intended investors

Have the parties previously dealt with each other?

Technical capabilities

Placement power

Reputation

Capital resources.

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

Answer.

Students should discuss the roles of the following participants;

-Issuer;

-Trustee or fiscal agent;

-Investors;

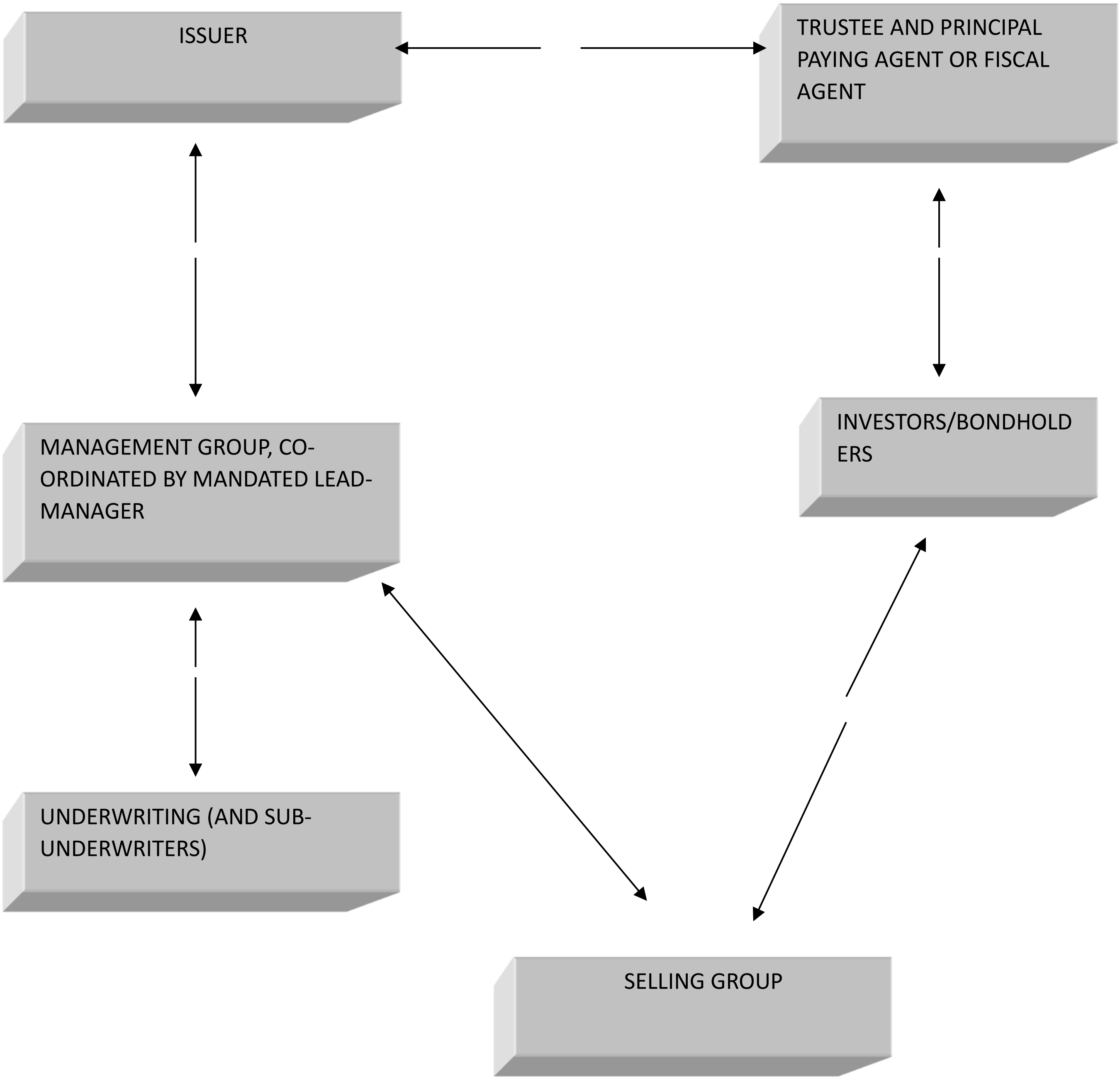
-Management group;

-Lead manager;

-Underwriters;

-Selling group.

UK/European three-tier syndication framework



7. **With reference to guiding principles, discuss THREE specific instruments found in Islamic finance which may be suitable for the shipping sector.**

Answer.

Principles:

Prohibition of payment or receipt of interest;

Prohibition against speculation;

Prohibited activities (alcohol, gambling);

Capital must be used for a socially productive purpose;

Security cannot be taken by the lender;

Risk rests with the lender and not with the entrepreneur;

The nemo dat quod non habet principle does not apply, so assets cannot be sold until owned.

Regarding instruments, students could use a wide range but would have probably restricted themselves to musharaka, Ijara, mudarabah, salam, istisna, zakhat.

8. Critically evaluate **ONE** of the following statements.

‘A shipowner which maintains a rigid capital structure will never be prepared at the peak and trough of the shipping cycle’.

Answer.

Discuss Modigliani Miller capital structure irrelevance theory

Debt is expensive when earnings are low

Asset values fall during a recession, making new loans more expensive

Equity can be raised cheaply at the peak because of investor dividend expectations

Equity in the capital structure during a recession is preferable to debt because it does not have to be serviced- dividends are discretionary, interest payment is mandatory.

Or

‘As Loan Evaluation Officer at a niche ship finance bank, I rarely look at a prospective borrower’s balance sheet: it is open to creative accounting and deliberate lack of transparency through the use of oneshipcompanies, depreciation policy, and off-balance sheet (leasing) transactions.

Answer.

Discuss the two methods of depreciation and the impact of both on the balance sheet.

Valuation of assets is usually historical; in shipping the market is volatile, meaning that prices can fall steeply but still be showing as of higher value in the balance sheet.

Companies use off balance sheet one ship companies to hive off vessels which are in bad condition.

Accounting dates can be manipulated between companies within a group to defer the reporting of bad results across the group.

Assets can be revalued using internal valuation methods, and without reference to market prices.