EXAMINER'S REPORT

NOVEMBER 2021

SHIPPING FINANCE

Question 1

Answer BOTH parts of the question.

a) Explain the advantages and disadvantages to a shipowner of operating a vessel under a lease with a third party such as a bank, instead of owning it outright.

b) Briefly comment upon THREE obligations imposed upon a shipowner under a typical ship leasing arrangement.

This was a subject which a student would either know well or not at all: it was not a question which could be guessed at. Students were required to distinguish between the two main forms of ship leases, these being operating and finance leases. If a student was familiar with leases, then this would have been a straightforward and descriptive question: there was no requirement to apply principles to scenarios, which is usually the case for this paper.

Leasing is a vital part of shipping finance, and for professional as well as examination purposes, it is suggested that the list of main clauses, covenants, rights, and duties are learnt. Familiarity with the main advantages and disadvantages is also essential from a practitioner's perspective: this question required a set of bullet points for each and in this regard could have been one of the easier questions to answer on this paper. For completeness of this report, these are listed as follows:

Advantages.

Leasing company will pay for insurance and upkeep of the asset, depending on the lease terms.

Tax advantages in terms of rental payments.

Owner does not have a depreciating asset in its balance sheet.

There may be a right to substitute a new vessel for the leased vessel.

Balance sheet looks better because there is not a higher level of debt.

Owner may be able to raise short term cash during a recession by selling the asset and leasing it back.

Students should distinguish between operating and finance leases.

Disadvantages.

Lease rentals may be high, and it is not possible to extricate oneself from the arrangement.

Owner loses operational control over vessels as to where they can be traded.

Vessel cannot be used as collateral for future loans.

Balance sheet looks weaker because assets are not owned.

Leasing company may be able to demand confidential information.

This may be a more expensive form of financing than a plain vanilla loan.

Typical terms imposed on the lessor would include the following:

- Duty to insure
- To provide information
- To trade only on specific routes
- To maintain asset in a good state of repair
- To return vessel at the end of the lease in an acceptable pre-stipulated condition.

Question 2

'A shipping loan agreement represents a compromise between the need of the shipowner to keep capital expenses to a minimum and vessel trading freedom to a maximum, and the needs of the lender to be secure, fully informed, and with maximum rights following a default or borrower insolvency'.

With reference to specific terms and covenants in a typical ship loan, discuss the extent to which you agree or disagree with this statement.

This question was not amongst the most popular on the exam paper but of those who answered it, the results were very high, with all achieving pass marks. The answer required was descriptive, with no application of principles to scenarios. Those students who have revised a standard loan agreement, or have dealt with this in a practical context, would have been aware of the main covenants and how these impact upon the borrower's ability to run the business as it wishes, particularly in response to cyclical changes. Regarding this latter point, for example an owner may be prevented from disposing of assets at the peak when values are inflated, because of the usual restriction placed in the loan agreement.

This question reinforces the need, when preparing for this exam, to be fully familiar with standard documentation regarding ship finance, the three often examined agreements being leases, plain vanilla loans, and guarantees provided by a parent company in respect of a loan given to a subsidiary. For completeness of this report, the range of covenants which could have been discussed would include the following:

Discuss rate of interest, and tenure. Penalties for early repayment (which does not suit borrower). Restriction on borrower's rights to trade in certain areas. Duty to keep lender informed on a regular basis: this may be intrusive and reveal borrower's confidential future plans.

Restrictions on borrower's freedom to restructure the business, sell off assets, hive off assets into separate SPVs- lender will have to give consent.

Asset cannot be used as security to raise fresh debt because it is already secured by a mortgage.

Limitation of borrower's right to raise fresh debt, senior or subordinate.

Limitation of borrower's freedom to make dividend payments to shareholders.

Limitation of borrower's freedom to lay up or sell vessels. This is significant and prevents the borrower from reacting quickly to market changes.

Question 3

Describe any FOUR of the following:

- **Mezzanine Finance**
- **Partly paid shares**
- **Cumulative preference shares**
- **Liability under the Sarbanes-Oxley Act of the Chief Finance Officer of a shipowning company for statements made in a initial public offering prospectus**
- **Private placements**
- **Gearing ratio**

This question was popular and answered by most students, the large majority of whom achieved good pass marks. This form of question has become typical in recent Shipping Finance examination papers, requiring students to discuss four topics out of six. Given that the overall mark for the question was 20, this meant equal marks of 5 for each description. A small point but each explanation should be of similar length. Additional marks were given when a student added finer detail for each point. For example, instead of simply describing partly paid shares. There should have been an additional discussion of the benefits and risks to the shareholder. For example, the benefit would be that the investor receives full dividends and full voting rights, notwithstanding that only part of the price has been paid. But the risk is that should the issuer become bankrupt, the investor will have to pay in the outstanding amount and then receive repayment after all other creditors have been paid (ordinary shareholders being paid last). Similarly with private placements: niche investors take up the shares and are better informed than ordinary investors and less likely to panic. They can recognise shares which are undervalued. Costs of prospectus are avoided. But these investors will be more intrusive and will demand information and influence at board level.

When answering a question which presents a list of possible subjects to be discussed, one or two sentences will not be enough: detail, particularly regarding risks to all parties, should be considered.

Question 4

Answer ALL parts of the question.

In each of the following scenarios and with full reasoning, identify which type of loan or loans would be appropriate for a shipowner which wants to make purchases to expand its fleet. In each answer you should also identify the risks to the lender, and how, if at all, these can be reduced through appropriate loan covenants.

- **i. A shipowner is trading its vessels during a recession in which revenues are insufficient to meet both capital expenses (CAPEX) and operating expenses (OPEX). The shipowner holds each of its vessels in one-ship companies registered in different jurisdictions.**
- **ii. A shipowner is trading its vessels during a boom in which revenues exceed OPEX by three times. It has existing high interest debt which was raised during the recovery period leading up to the present market situation. How should the shipowner make budgetary provision to meet the imminent downturn in the cycle.**
- **iii. During a recession a shipowner wants to make acquisitions of underpriced tonnage in the sale and purchase market.**
- **iv. A shipowner is trading its vessels during a period of gradual market recovery. Revenues are presently low but are expected to increase considerably during the short term as the market recovers.**

This question concerned the different types of loans which may be appropriate at different stages of the shipping cycle from peak, down to recession, to depression, and then up to recovery. The question was answered by most students and nearly all passed with high scores. Students were presented with four different scenarios and asked to explain which type of loan would be appropriate.

It was important that students identified the type of loan, and then the risks if any to the lender. For additional marks, a brief mention of covenants would have helped. Importantly, some of these scenarios, as in practice, can be answered in what at first may appear diametrically opposite ways. For example, during a recession it is conventional wisdom to use a back-ended loan or moratorium, but it could also be answered that a front-ended loan is appropriate if it means that debt is substantially reduced as the company heads downwards into recession. This could also be justified from the viewpoint that a company which has a small debt burden during a depression will be better able to borrow at that time to buy up distressed assets which are for sale because the owners (or banks if they have forced a liquidation) cannot sustain them or simply want to withdraw from the market. After all, the best time to buy assets is during a market downturn when prices have been pushed down too low rather than at the peak when they will have inflated values. It all depends on whether the borrower can find sufficient business to keep the fleet going during

a difficult time or can afford to lay up. This analysis illustrates the dynamism of shipping finance: there are rarely right or wrong answers, and for exam purposes it is all about understanding principles and then making out a logical case.

Question 5

Answer ALL parts of the question.

a) Discuss the main covenants in a typical ship mortgage.

b) Explain the main powers of the mortgagee, and the duties of the mortgagor, in a typical ship mortgage.

c) Why would a mortgagee be hesitant or reluctant to enforce its powers, even if the mortgagor has been in breach of the mortgage terms

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This was a popular question with most students answering it and achieving high passes. The question was entirely about ship mortgages: students who had revised a typical document or dealt with one in practice would have scored high marks because this was essentially a descriptive question. For completeness of this report, the main covenants in a typical ship mortgage include:

To insure the vessel and keep it seaworthy
To conduct all necessary repairs
To provide regular information and management accounts to the lender
Not to use the vessel as security for future loans
Not to change the flag
Not to be involved in illegal activities
To make regular payments on the loan
Not to do anything which undermines the lender's security
Not to be in breach of environmental regulations
To give the lender notice of actual or pending legal proceedings which affect the security.

Regarding part ii, powers of the mortgagee and duties of the mortgagor, these were again very descriptive, resulting in students achieving full marks. These would include:

Power of arrest

Power of sale

Power to demand the vessel be delivered to a nominated port where it can be arrested

Power to call in the loan early following a default

Power to insure the vessel following default

Duties:

To pay interest and principal upon maturity.

To provide information

To keep vessel in good state of repair.

Part iii of the question was a useful non-descriptive element and, in this regard, required critical thinking by students. The points which were expected were:

Lenders do not want to hold deteriorating assets in their balance sheet- it adversely affects the capital asset ratio.

Banks are not shipowners and lack the expertise to trade vessels. Better to come to an agreement with the borrower and a business plan, and in this way keep the vessel trading and at least generating some revenue.

Lender may have to take possession in an unfamiliar location or enforce the mortgage in an unfamiliar and unpredictable jurisdiction.

Question 6

Answer ALL parts of the question.

a) Explain the roles of the participants in a syndicated loan agreement.

b) Briefly comment on the fees which are charged in a syndicated loan agreement.

c) If you were a shipowner looking to appoint a financial institution to lead-manage a syndicated loan issue, which factors would you consider when deciding between banks competing for the appointment?

This descriptive question required discussion of a typical syndicated loan agreement, the main participants, and the fees charged of the borrower/issuer. Some students answered based on a bilateral loan agreement between borrower and a group of banks, whilst others answered using a financing arrangement which results in the issuance of plain vanilla bonds which provide a coupon for investors and can be traded on public markets. Both approaches were equally valid and gained the same marks.

Regarding fees, these would include:

Margin fee

Facility fee

Arrangement fee

Legal fee

Commitment fee.

Regarding factors which would be considered when appointing the lead, these would include:

Cost.

Placement power (if a bond is to be issued).

Financial resources.

Complexity of the issue.

Investor base.

Have the parties dealt with each other previously?

Ability to put a management group together.

Reputation in the market.

Regarding participants in a syndicated loan agreement, some students provided a diagram:

this was acceptable and gained marks, provided each participant's role was briefly described.

Question 7

'The amount of debt a shipowner takes on is irrelevant. Leverage is irrelevant. All that matters is the ability of the company to service its obligations'.

To what extent do you agree with this statement? In your answer you may want to refer to shipping companies which have failed because of flaws in the debt-equity strategy.

This was a critical thinking question which could be approached in a wide variety of ways. There is no single solution: students can agree or disagree with the statement and still be correct either way. In essence the question required discussion of the debt-equity balance and how this should be adjusted at each stage of the shipping cycle. Such a question should not be avoided: it gives freedom to draw from across the syllabus and to put forward a rational, coherent, logical answer based upon principles which will not necessarily be right or wrong: it all depends on how it is argued and presented.

For a student who has 'question spotted' only to find that chosen topics are not on the exam paper, such a question presents an excellent opportunity to gain a high score by 'thinking outside the box' and presenting a sensible line of reasoning. For completeness and to indicate what the Examiner was looking for, here are some of the issues which could have been raised:

Describe what is meant by debt. Distinguish between senior and subordinate. Debt is manageable when the market is booming but becomes a problem when earnings fall; leverage is relevant in a cyclical issue, and therefore the statement is incorrect. Debt also affects the credit rating of the company as assigned by S&P or Moody's, regardless of the state of the market, and this will impact on the cost (interest rate) on future borrowing. Debt can deter investors in equity because it must be serviced first before any dividend payments are made to them. Debt can provide tax advantages in terms of deductibility of interest payments which is not the case for dividends. Debt puts assets at risk in terms of the tight of lenders to arrest vessels following default: this power is not available to shareholders if dividends are not paid (they are discretionary).

Discuss shipping company failures of students' choice (for example, Hanjin).

Briefly discuss Modigliani Miller debt irrelevance hypothesis.

Question 8

You are the Loan Application Officer at a niche ship finance bank. Recently you received a loan application from a Bahamas-registered privately-owned shipowner. The company has the following structure.

i. **It operates through a series of one-ship companies registered in several different jurisdictions, some of which you recognise as being efficient and effective, others being renowned for taking a lenient attitude to enforcement of international conventions regarding crew safety and environmental protection.**
ii. **It took out a loan several years ago with another bank: this contained a covenant prohibiting the future raising of debt of senior ranking, and a limitation on the value of future subordinate debt relative to the value of the fleet.**
iii. **One of the vessels is deployed in the spot market but is old, and essential repairs are now urgent.**
iv. **Several vessels are leased in on long leases from another shipowner on terms which were negotiated during a previous cyclical boom in which rates were particularly high.**
v. **The company board comprises of members of the Chief Executive's family, and no non-executive directors have been appointed.**

Your Head of Department has asked you, as Loan Application Officer, to evaluate this application, focusing on the facts disclosed by the potential borrower. In your report you should also identify steps, if any, which you would require the owner to take as a prerequisite to being granted a loan.

This question drew together principles and financing techniques studied across the syllabus, and then asked how these would be applied in a range of scenarios. There were five scenarios in total, all carrying equal marks. Types of risks presented to the lender in each situation should have been discussed. The principle of separate legal personality as applied to one ship companies was also tested, this being a major concern to lenders since it can restrict or prevent the capacity to arrest ships in the fleet following default by the parent. The status of senior debt was also questioned in scenario ii, and corporate governance and the use of non-executive directors in scenario v. For completeness of this report, the issues which were required to be considered were as follows:

i. It operates through a series of one-ship companies registered in several different jurisdictions, some of which you recognise as being efficient and effective, others being renowned for taking a lenient attitude to enforcement of international conventions regarding crew safety and environmental protection.

This is unacceptable: vessels cannot be arrested following default because of the principle of separate legal personality. Also, rights of mortgagee may not be certain in some jurisdictions. Solution: re-register all vessels in one company in an acceptable jurisdiction.

ii. It took out a loan several years ago with another bank: this contained a covenant prohibiting the future raising of debt of senior ranking, and a limitation on the value of future subordinate debt relative to the value of the fleet.

New debt cannot be taken on in which the lender has seniority. But even if subordinate debt is issued, this must relate to the value of the fleet and is restricted. The bank must check that any loan does not breach these requirements but in all probability it will. Solution: borrower should try and renegotiate terms of existing loans with other providers or set up a new company to which the loan can be granted.

iii. One of the vessels is deployed in the spot market but are old, and essential repairs are now urgent.

This is a lender risk. There may be no point in arresting this vessel following default elsewhere because it may have limited value. Also, the insurance premiums will be high. This is a weak source of loan collateral.

iv. Several vessels are leased in on long leases from another shipowner on terms which were negotiated during a previous cyclical boom in which rates were particularly high.

This is the Hanjin problem. The burden of these lease payments will be high and may reduce the borrower's ability to meet payments on new debt. Solution: try and renegotiate existing lease terms or terminate if possible.

v. The company board comprises of members of the Chief Executive's family, and no non-executive directors have been appointed.