WHITE & CASE

# Restructuring & Beyond: The marine industry's routes to safety

**Survival strategies and new opportunities for companies, banks and investors in the marine sector**


# Shipping has its fortunes anchored to the health of the global economy.

As long as supply exceeds demand, there will be companies at risk of failure. More than four years into the industry's downturn, market equilibrium is still some way off: There are simply too many vessels for too little trade.

Despite this bleak scenario, maritime industries remain intrinsic to international commerce and have no substitute. They will survive and become healthy again. In this paper, we assess the state of the sector and discuss the strategic and practical measures companies under threat might take to preserve their future. We look at ways for lenders and investors to support companies during difficult times while also protecting and managing their own exposures. And we examine new opportunities for yield and growth.

Although 2013 was predicted by some to be the year in which wide-scale recovery would pick up pace, the experts who kindly contributed to this paper have mixed views as to whether this will come to pass. But each could spot reasons to be positive about the industry, despite its continuing difficulties.

While there is no easy fix for those marine companies and their backers in trouble, there are often routes to safety. And further opportunities may be opening for new sources of capital and enhanced yield and growth across the sector.

We hope you enjoy this paper, and welcome the opportunity to discuss these subjects with you in greater depth.

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# Status update

The downturn had three root causes: The first was slowing global demand as world economies contracted; the second was the huge amount of oversupply of new builds on the order book and in the water; and the third was the crisis in the financial markets which saw banks retreat from normal lending practices. Each of these factors is still troubling the industry.

Although shipping is cyclical, and financial peaks and troughs have been periodic over the decades, there is something special about this case. Macroeconomics, market behavior and politics are conspiring to extend the downturn.

## Recovery in global trade is slow

Certain indicators of recovery are good, but progress is disappointing. In April, the IMF revised down its 2013 global growth forecast 0.2 percent to 3.3 percent and kept the 2014 forecast constant at 4 percent.

The eurozone remains problematic, with several countries requiring financial aid, and even the likes of the United Kingdom, France and Germany failing to show significant improvement.

China's growth has slowed. The IMF has cut its growth forecast in successive months, from 8.1 percent in March to 7.75 percent at the end of May. Now the world is watching in the hope that domestic demand picks up and policy announcements have an impact on trading activity.

While positive US employment figures and rising share prices offer some encouragement, the macroeconomic outlook is still offering little in the way of a real impetus for shipping.

## Ships are still being built, despite overcapacity, and rates are low

Looking at the entire sector, current new build is outpacing scrappage. In 2012, shipyards built a near-record 152m dwt, according to Clarksons. And, although total orders for new ships were down during the year, significant deals are still being struck. Industry veteran Paul Slater, Chairman of First International, is concerned that the market is spending too freely: "I was hoping at the end of 2012 we were starting to move on. Yet with a thousand container ships laid up, companies are still buying. In a service industry that only makes money when it is carrying stuff, that cannot make sense." Slater argues that the desire for new build—whether to attract investment, to bring down fuel bills or just for show—is contributing to the shortening life of ships in service. Maintenance on ships just a few years old, he says, has dropped to marginal levels—meaning the plunge in their rates and resale value is accelerating.

## Looking at the entire sector, current new build is outpacing scrappage.

### Many financial institutions hold underperforming portfolios

There are no definitive figures on the scale of shipping bank debt: "Hundreds of billions of dollars" was as far as our experts were prepared to approximate. Even against the backdrop of a recession so long and deep that nine-figure losses became mundane, such exposure to a single industry stands out. Contractions or withdrawals in lending have occurred, and more are expected.

Alternative capital sources previously tested, such as German KG funds, have been widely affected. Decisions must be made by the financial institutions supporting these funds as to whether to hold assets or to sell at prices that may result in less than full returns.

The net consequence is becoming clearer: In the future, a significant portion of the industry's sources of finance will be found elsewhere—including from private equity and, potentially, the capital markets—and several banks will have retrenched.

### Governments and regulators are acting to protect the industry and curb lending

Governments and export credit agencies (ECAs) have stepped in where jobs and "the national interest" have been in play. For those looking at financing a new build from a Chinese or Korean yard, for example, ECAs can provide a foundation for the deal. Such activity can be helpful in isolation, but widespread intervention is suggestive of systemic ill health. Furthermore, it can be seen that one instrumentality of government has the potential to undercut or limit the positive impact of another. ECA-related loans could, for instance, be prevented from achieving zero-risk weighting by the introduction of Basel III standards.

The financial regulations on liquidity and capital maintenance in Europe have been pre-empted by banks, and shipping loan books are being trimmed. The phasing-in of Basel III standards should make the banks more resilient. But the cost to them of meeting these improved requirements is already being reflected in the pricing of loans (which have historically been low for vessel financing when compared to other sources of capital). There has been shipping-specific action too: For example, BaFin has ordered a review of loans to the sector in Germany, forcing banks to take affirmative steps to deal with exposure.

### The outlook

Low prices and ongoing changes in the sector's financing mean there are attractive prospects for investors who can deploy capital quickly and have a view on the cycle. New private equity is moving into the sector, and Greek money is coming back strongly. Meanwhile, China has expressed its ambition to emerge from the recession as the shipping capital of the world, and is looking to consolidate financing, infrastructure, shipbuilding and fleet control. And the global capital markets represent an intriguing potential new source of finance if appropriate credit profiles can be brought to market with structures that conform to expectations and practice.

While lethargic global trade growth is likely to keep many box-ships and bulkers laid up, there is more optimism regarding tankers. Shipment of liquid natural gas, industrial growth in non-OECD countries and moves by energy and other companies to own or manage their own vessels will help speed recovery. Related port and offshore infrastructural projects are likely to benefit proportionately. And the offshore rig business continues to demonstrate strength.

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# The evolution of bank financing

If shipping companies have had an uncomfortable few years, so have the financial institutions that have historically provided the mainstay of the sector's financing.

The boom that pushed Capesize day rates above US$100,000 and sent the world into a ship-building frenzy caused traditional lending multiples and loan-to-value ratios to swell. When the credit crisis struck, loans were left looking impossibly generous as asset values retracted and earnings capacity dwindled.

What remains is an industry looking, for the first time in the modern era, outside traditional bank lending for its core capital requirements. Meanwhile, some financial institutions have made it clear they are reappraising their commitment to the sector, and new money is working out how to get involved as recovery picks up.

Banks in Europe are not acting en masse, despite circumstances and regulatory pressures being common to many. Some have openly committed to the sector, despite having a large portfolio of investments under strict management. Others have made efforts to shrink, sell or wind down their loan portfolios.

Though new bank lending is hard to come by, it can still find a way through. That is not necessarily good news, according to Erik Nikolai Stavseth, an analyst at Arctic Securities. "The overall environment for commercial debt has cooled considerably. But the shortfall is partly being filled by enhanced capital allowances and export-import finance orders, and by government support for the industry. This represents a risk to recovery, as most segments need to have their access to additional capacity constrained." In other words, an absence of cheap money might be helpful to the industry as a whole. One senior director at a bank choosing not to grow its shipping portfolio said that rock-bottom prices offer institutions "good opportunities." But he suggested that leverage would be conservative, most likely between 50 and 60 percent loan-to-value.

Stavseth sees certain European banks' strategic withdrawal as typical in a down cycle and has already spotted those looking for fresh opportunities. Whether banks stay committed, turn their backs on the sector temporarily or quit in perpetuity is yet to be seen, but Albert Stein, managing director at AlixPartners, senses lasting change: "The new banking regulations look pretty permanent. American banks got out of balance sheet lending 15 years ago, and European banks may do the same."

By any reckoning, the sector has offered poor returns to banks and their shareholders over time. Paul Slater feels the asset class can sometimes be misunderstood: "There is occasionally inadequate recognition that ships depreciate. Too often they are treated in the same way as real estate. But they will only ever see a fleeting uplift in value. In the long run they lose value until they are scrapped, and that should never be forgotten." Slater equates the flood of money into shipping in the boom—from banks, KGs and other sources—to 1980s Wall Street, fueled in this case by dreams of unstoppable growth in China and other emerging markets. He and others who have watched the industry over decades from a steady frame of reference are entirely unsurprised by what has unfolded.

"The new banking regulations look pretty permanent. American banks got out of balance sheet lending 15 years ago, and European banks may do the same."

**Albert Stein, AlixPartners**

Banks sticking by their long-term clients have good prospects, if they can be flexible. A senior banker in the sector was confident that "those [banks] that can afford to be patient should see asset values and rates lift high enough for debts to be repaid in full."

But what does "being patient" involve? At a minimum, a company that cannot pay its debts to the bank must negotiate new terms or risk adverse action. The downturn has seen players on both sides in near-constant negotiation, with contracts extended further and further. Such voluntary flexibility is often the best option for lender and borrower alike. Banks tend not to want to seize assets and surrender any chance of their debts being repaid in full. Companies, meanwhile, have a mission to keep trading by any reasonable means.

If the repayments are not affordable in the long term, and the assets remain below the value of the loan against them, restructuring a company's entire financing can be the last hope. No two restructurings will be exactly alike: The relative bargaining power of the creditors, the nuances of the capital structure and other factors (such as the jurisdictions involved and the possibility of maritime arrest actions) can significantly affect the dynamics of the process and the solutions proposed.

# The evolution of bank financing

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### Restructuring in detail: TORM—a consensual approach

TORM A/S is a Danish ship owner and operator that enjoyed steep growth after the turn of the millennium.

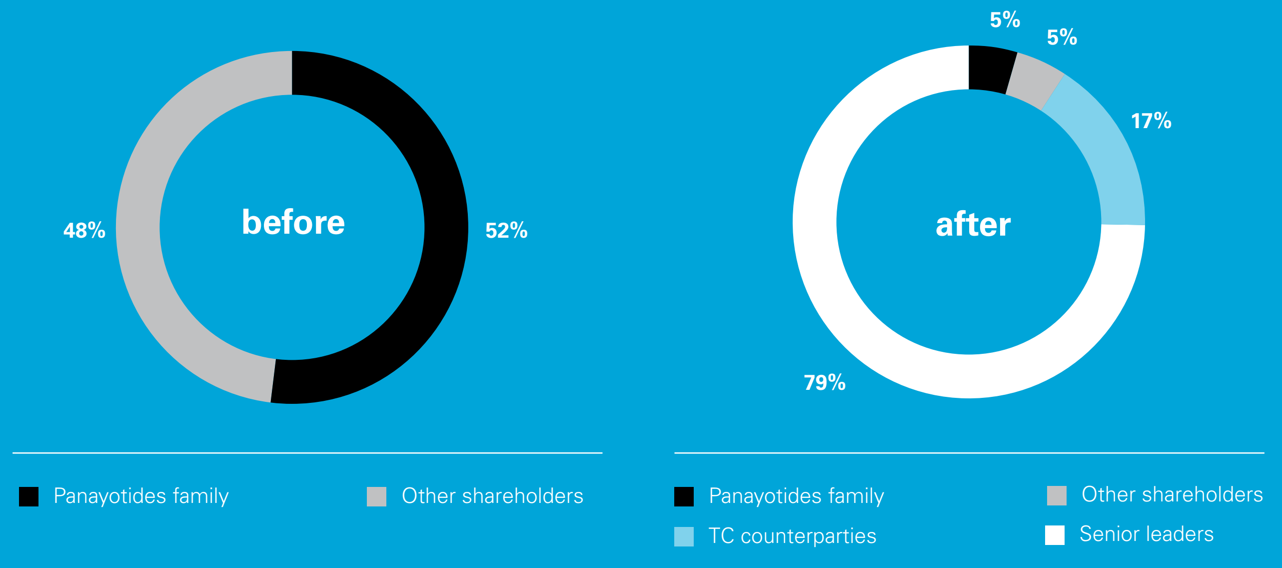
To service customer demand above and beyond its owned capacity, TORM leased vessels through time charter (TC) contracts. As the economy faltered, and demand and rates fell, TORM remained locked into TCs negotiated when rates were far higher. The drop in income left the company vulnerable and unable to service its contracts long term and with dwindling cash reserves.

White & Case was appointed by the secured creditors to explore the options. Partner David Manson, who advised on the restructuring, describes the criticality involved: "In the interests of all parties, the main objective was for TORM to remain a going concern. To avoid bankruptcy and stabilize the business, additional financing would be required. Improvements to cash flow would also be sought, with the existing debt and TCs the main targets for renegotiation."

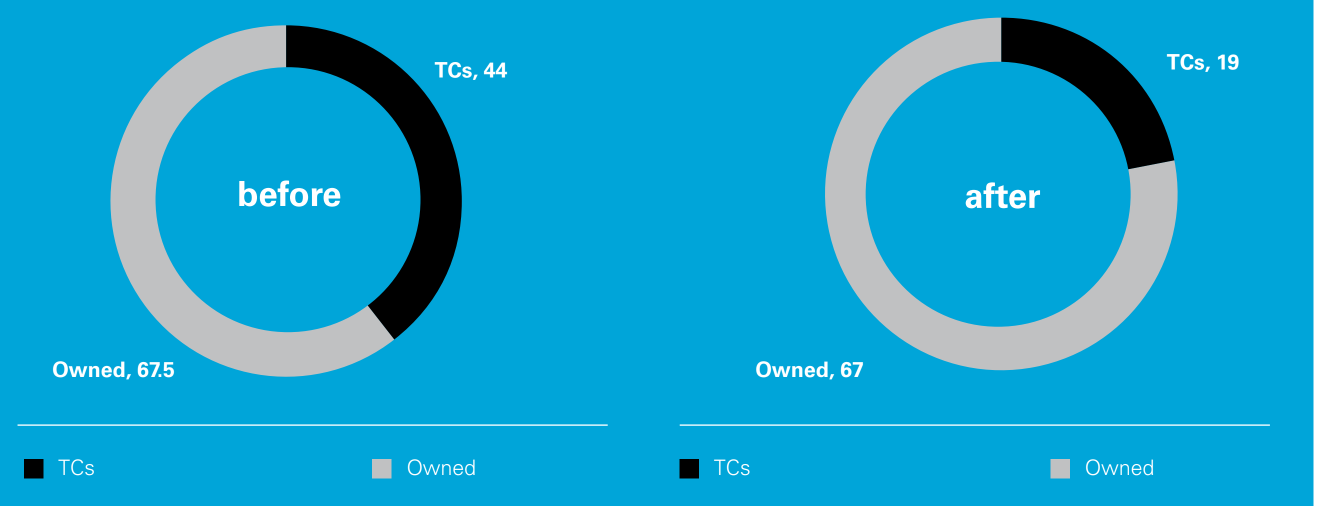
After a number of options were considered, a consensual out-of-court restructuring was the chosen route. This strategy avoided an insolvency process, so TORM could continue trading as the same legal entity, and maintain its public listing and liquidity in shares. It also allowed for the renegotiation of debt and TCs to occur with minimal disruption to normal business operations.

The major difficulty with this kind of restructuring is gaining the approval of all stakeholders. But in this instance, an acceptable compensation model was found and agreement reached. In return for their support, the banks and TC counterparties would now hold 90 percent of the equity, with the existing shareholders retaining 10 percent of the company. It was through this compensation offer to the TC partners that the loaned fleet was reduced significantly, creating an immediate improvement in cash flows and a US$270 million rise in TORM's mark-to-market value. The banks received their equity stake in return for deferring the maturity of their debt and restructuring their secured indebtedness, and approving a new US$100 million capital facility.

**TORM equity profile: Before and after restructuring (percentages)**




**TORM fleet composition: Before and after restructuring (numbers of vessels)**




Source: TORM

# Protecting investors and shareholders; bankruptcy proceedings

## Fundamental restructuring of insolvent companies—in any sector—is a fight for survival.

Given the global nature of the industry, it is perhaps no surprise that shipping companies and their advisors have sought appropriate court protection to alleviate creditor pressure and a possible break-up of the business where a consensual restructuring is not possible.

Since mid-2011, various surviving shipping companies have filed for chapter 11 bankruptcy protection. Central to chapter 11 is the belief that an operating business is worth more than the sum of its parts, and a carefully constructed filing can offer benefits to investors and the company alike.

The need for some meaningful measure of stakeholder consensus to achieve an effective and swift restructuring through chapter 11 proceedings is often misunderstood.

Without such consensus, especially where the value of the underlying assets is exceeded by the amount of indebtedness secured thereby, a chapter 11 proceeding can pose risks to the debtor. In such circumstances, it can be very difficult to achieve a successful outcome. This lesson is illustrated by recent failed chapter 11 reorganizations filed by small shipping companies without any creditor support.

Critical to the success of proceedings—for both creditor and debtor—is stakeholder consensus and professional and swift preparation and implementation. Paul Slater returns to the relevance of the financed assets' depreciating value: "Chapter 11 proceedings can drag on. If negotiations take two years, the vessels being protected may have shed another 10 percent of their price." So in some cases, an expedited exit can be vital. Albert Stein sees chapter 11 as a good thing in principle, but notes that it can be abused, adding: "If you put a Ferrari in the hands of a teenager, do not be surprised if it gets wrecked."

### The global power of US bankruptcy law

Chapter 11 of the US Bankruptcy Code can grant organizations in financial distress protection from creditors, and the "debtor in possession" principle means that the current managers an stay in their roles during the proceedings (in contrast to administration or rehabilitation laws in many other countries that provide for a court-appointed professional stepping in to replace management). And, as many companies in this sector and others are finding to their advantage, a US incorporation or listing is not required to enter chapter 11 proceedings: Under the right circumstances, a single office or US bank account may be deemed sufficient.

Once entered, chapter 11 is a powerful tool for companies in global industries such as shipping. Its "automatic stay" applies worldwide—meaning no secured lenders can enforce their claims or recover possession of the underlying assets without leave of the court, or they risk being held by the US Court in violation of the chapter 11 moratorium. Established "debtor in possession" financing techniques and banks being prepared to fund in a chapter 11 case means companies can be permitted to incur further debts to finance and stabilize their operations to protect going-concern value.

Where companies have sought local protections, the existence of US assets or US governing law instruments of indebtedness raises the possibility of an application for US recognition of such foreign proceedings under chapter 15 of the US Bankruptcy Code. Last year, embattled Japan-based Sanko Steamship listed assets and debt of more than US$500 million in a chapter 15 petition in New York (seeking recognition of its Japanese insolvency). This helped allow the company to keep operating, and offered it additional protection needed to reorganize its financial affairs and maximize recoveries for all stakeholders.

## Protecting investors and shareholders; bankruptcy proceedings

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### Chapter 11 up close: General Maritime

Chapter 11 can be entered into in a number of ways. The "traditional" approach sees a company file prior to negotiations with its creditors. But insufficient preparation can lead to a "free-fall," causing material harm to a debtor's business while risking liquidation and a fire sale of assets.

But there are alternative routes available. The recent case of General Maritime illustrates the potential benefits of a pre-negotiated bankruptcy filing, whereby creditors agree to a proposed reorganization or restructuring before a petition is filed.

General Maritime was providing seaborne transportation services for petroleum products, operating in 70 countries with a fleet of 30 vessels. But the ongoing pressures on tanker rates meant that cash flow was becoming constrained, and its ability to honor debt obligations was diminishing. In 2011, it determined that a renegotiation of its US$1.3 billion of debt would be needed to mitigate these risks.

White & Case partner Thomas Lauria, who leads the Firm's Global Financial Restructuring and Insolvency Practice, explains the motivations: "To ensure the preservation of business value, and increase the likelihood of a speedy exit from bankruptcy protection, General Maritime sought agreement from its creditors for a company reorganization. We acted on behalf of Nordea Bank and other senior lenders to negotiate a plan to keep the company afloat and protect their positions."

By the time General Maritime entered chapter 11 in November 2011, a Restructuring Support Agreement with a strict timeline was in place. To bolster cash flow, the lenders agreed to an amortization "holiday" until June 2014 and an initial US$75 million debtor-in-possession financing in cash, with more to follow if required. Creditor Oaktree Capital also agreed to provide US$175 million of new equity investment and to convert all of its pre-petition secured debt to equity.

The result saw General Maritime emerge from bankruptcy protection after just six months, having continued normal business operations throughout. The reorganized company had substantially less debt and significantly more liquidity, granting the potential to enhance its position as a leader in its class. The agreement reduced the risks of default for the creditors and increased the likelihood that their investments will be returned in a realistic timeframe.

# Sources of capital

## As certain banks in Europe lick their wounds, certain investors are licking their lips.

Richard Haines, a shipbroker at Howe Robinson, sees activity picking up: "Banks are still in the game, but they want quality. A first-division company with a good track record could still expect to get 60 percent financing on new builds. But there are increasing amounts of private equity coming in. And the Greek owners are making a conspicuous return." Haines sees seasoned investors—many of whom accumulated cash in the boom and sold vessels as prices fell—buying back into the market and gaining a head start on newcomers.

Paul Slater, meanwhile, sees "outsider" private equity activity talked about a lot, but seen only occasionally: "Traditional private equity looks for an exit before it invests. Where is the return from shipping in three years, or five years? Families, by contrast, can play the long game, and use industry insight to their advantage."

Despite words of caution from industry veterans, however, activity is picking up. To a certain type of investor, perhaps struggling to find yield in less troubled markets or looking for portfolio diversification, the sector is starting to look well-priced in the right circumstances. Howe Robinson describes the market as being "at five minutes to midnight." So a sharp uplift out of recession in the West, better-than-expected growth figures from China or further positive employment news from the United States might be enough to help advance the end of the drought for shipping.

Besides Oaktree Capital's partial TORM acquisition and further interests, there has been some notable activity: Costamare formed a joint venture with York Capital Management for investing in further box-ships; Delos Shipping and Tennenbaum Capital picked up majority control of German KG König & Cie; CHAMP and Headland Capital Partners have expanded their positions in Miclyn Express Offshore and Allianz and 3i are looking for a secondary exit on Scandlines, their ferry operation. PE bidders are reportedly lined up.

Views are mixed as to whether shipping is attractive to the wide variety of funding sources in both the capital and US private placement markets. Doubters point to yield deficiencies and risk aversion; believers point to the desirability of portfolio diversification and the opportunity, in the right circumstances, to satisfy yield and risk requirements. White & Case partner Christopher Frampton, who leads the Firm's Global Asset Finance Practice, explains: "Portfolio composition is evolving, and certain investors may be prepared to consider opportunities in shipping and related marine industries. This process could be accelerated if investors are presented with financing structures and creditor protection enhancements used in other transport sectors."

A bright spot for the equity markets is liquefied natural gas. Predictions are that investor interest will continue to grow, and that further IPOs look likely. Previous flotations—including Golar LNG Partners, Teekay LNG and GasLog—have seen stock prices perform well in the past 12 months, and certain competitors are thought to be considering public offerings.

## Sources of capital
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### Marine industry strategies in Asia

Developments in China in the next few years could represent the most significant catalyst for change in the marine industries. The country has as rich a maritime history as any other, and global trade wove its dynastic past. China's shipping credentials were lost for a handful of generations, but not forgotten. Its mastery of the modern shipping market may well be completed in the next five years. It is already the biggest shipbuilder, as well as the world's biggest exporter. And while China has only made tentative steps towards financing the marine sector beyond its own borders, the country's cash reserves and boundless ambitions mean it may become banker as well as builder for a significant portion of the industry. However, neighboring Japan and Korea will not yield their advantage in shipping unopposed: They have been looking to convince the market of their technical superiority in shipbuilding, while putting government weight behind the industry and its sources of finance. This globally dominant competitive region is likely to result in continually improving vessel quality and keen pricing for those looking for new builds.

As for those banks that remain committed to the sector, new loans are being written, many of which are innovative and structured:

- Greek tanker owner Aegean Marine Petroleum Network has secured US$800 million of loans to grow its business. Eight banks, led by ABN AMRO and BNP Paribas, are involved in the tranched, multi-currency revolving credit deal.
- DryShips took on a US$1.35 billion syndicated term loan facility for new builds, and an IPO in February 2013 raised US$123 million.
- Tradewinds reported in October 2012 that Credit Suisse, in a strategic counter-cyclical move, recently wrote US$2 billion of new marine loans.
- CMB signed a US$300 million senior secured reducing revolving credit facility with a group of banks led by DNB and Nordea.

Industry specialists talk of a "flight to quality." Banks are working closely with their long-term clients to find mutually acceptable terms that will help both sides back to growth.

The world of marine financing could look radically different in the coming years. Certain banks and owners no doubt face tense negotiations in the period ahead, and it seems inevitable that there will be further failures and high-profile exits from the market. But the industry will recover. In the meantime, investors looking afresh at the sector are likely to find opportunities, whether in the near term in particular circumstances or as economic growth returns and maritime businesses are restored to health.

"Portfolio composition is evolving, and certain investors may be prepared to consider opportunities in shipping and related marine industries. This process could be accelerated if investors are presented with financing structures and creditor protection enhancements used in other transport sectors."

**Christopher Frampton, Partner, White & Case**

# Our global marine team

White & Case has an accomplished and broad-based global marine practice. Our lawyers have been responsible for handling the strategic legal work on some of the most prominent and complicated restructuring, refinancing and capital-raising transactions in shipping, ports and offshore infrastructure in recent years. Please contact us if you would like to discuss any of the issues addressed in this paper.

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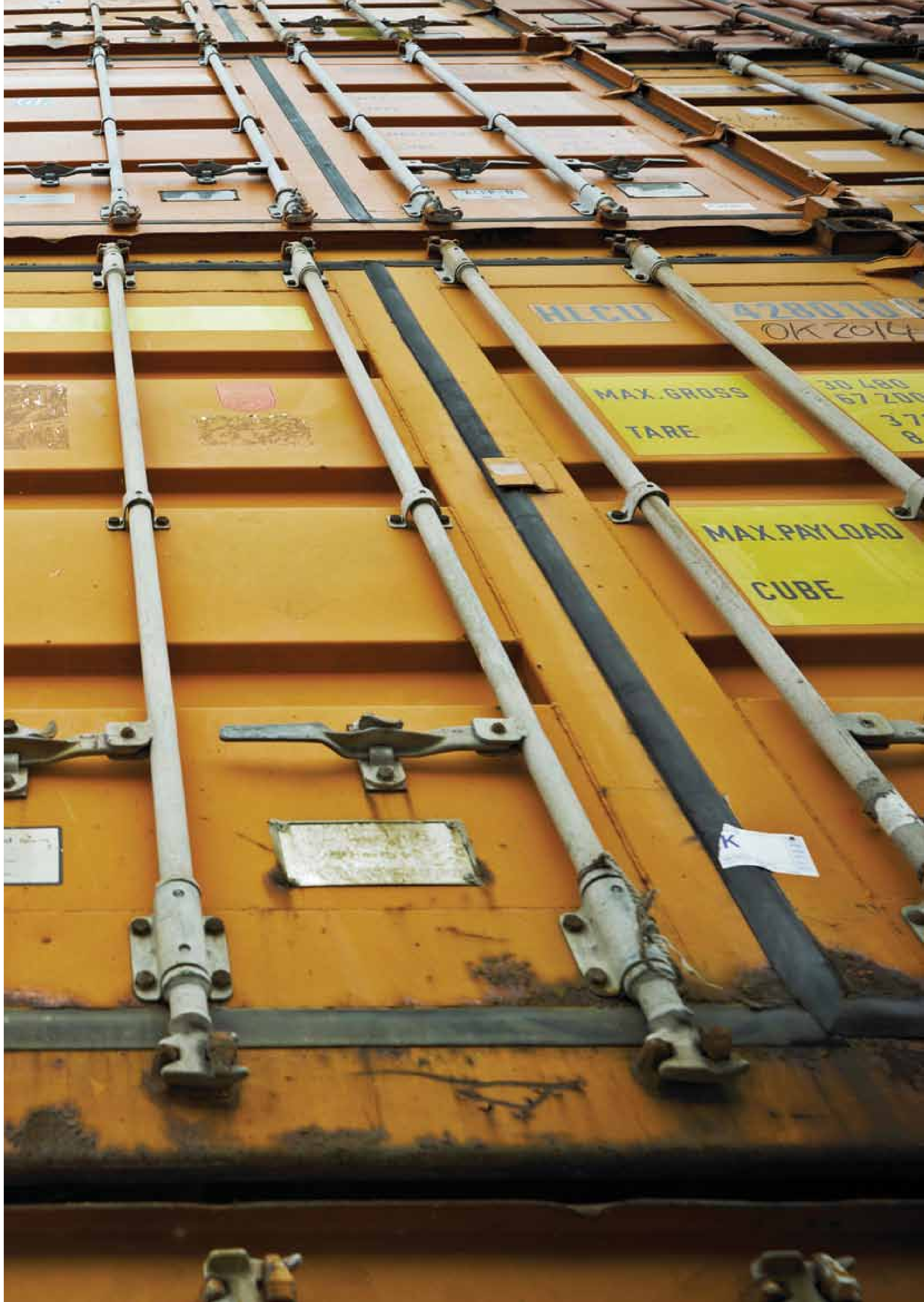

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