

# Alternatives in ship financing

*Is the KG model about to disappear, as the industry has debated since the financial and economic crisis? German shipowners search for alternative options such as partnerships with family offices, private equity firms and pension funds. By Dr. Dirk Lammerskötter*

Many shipping companies are currently examining alternative sources of capital, since the old models have recently become less competitive. Up to now, the KG model (Kommanditgesellschaft, limited partnership) for ship financing has dominated in Germany. According to the German Association of Closed-End Funds (VGF), about 440,000 private investors participate as limited partners in German KG ships via closed-end funds. Since 2009, however, the number of investors who are willing to risk this entrepreneurial investment has been dwindling. The 2011 overall market study by Feri EuroRating Services indicates that only 1.34 billion € was placed in the »ship« asset class in 2010 – the lowest fund volume since 1993. The VGF reports a similar picture for the second quarter of 2011. Its members were only able to raise 77.1 million € in equity capital for ship investments during this period, 39% less than in the second quarter of 2010. In addition, a large part of this funding (38 million €) went on equity capital increases rather than being used for new projects.

It is therefore not surprising that private investors and distributors are currently staying well clear of ship investments. There is still no upturn in investor sentiment in sight, too. At present, the risks of ship funds, not their strengths, are the key element in the general public's perception. Until the market for closed-end ship funds regains its former level, many shipping companies are faced with a substantial gap in their financing to implement new projects.

The perspectives for shipping companies are nevertheless not as gloomy as many private investors believe. Market participants continue to describe economic prospects for the next twelve months as relatively good, as revealed for example by a survey of German shipowners conducted on behalf of PricewaterhouseCoopers (PwC), published in June 2011. The survey reports that the order books are full and vessels are operating at 86% capacity. There has been a fall in short-time working, while investments and new hires have been planned. As a result, the worst seems to be over, and the industry is looking to the future with cautious optimism.

## Conservative models on the rise

Amongst others, it is the rising cost of finance that is putting a strain on companies. Almost two-thirds of the shipowners surveyed by PwC reported rising costs for their credit commitments in the past twelve months. So it is not only private investors who are now more hesitant, but also the banks providing finance for ships calculate



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their credit decisions more conservatively. External capital for German shipping companies has become significantly more expensive due to the stricter equity capital requirements that the banks must comply with. A higher proportion of equity capital is also becoming increasingly important. In the case of single-vessel companies without collateral beyond the asset itself, the required equity capital element is currently about 40–50% of the amount invested. The money must also be available right at the start – bridge financing that would allow shipowners to raise equity capital during the building phase is rarely offered these days.

Although more favorable credit terms are occasionally available from Chinese banks, getting external capital from China is too much for some medium-sized shipping of-

ices to cope with. In addition, the Chinese banks have not gained the expertise, networking, and long lasting experience of European ship financiers, yet. Their market share is also quite limited. Ultimately, the question whether shipowners can receive capital from Chinese banks invariably depends on the political will in Beijing. As a result, alternative forms of finance are required. Prospects include mezzanine capital, ship financing in conjunction with a family office or other institutional investors, or through private equity (PE).

## Alternative forms of finance

Forms such as mezzanine models are popular: Provided that the shipowners contribute their own equity capital and have already received a loan, funds or banks supplement the external capital up to 80–90%. In return, they receive a yield of 10–15%. This model is a reasonable option, particularly for ships that are already operational. The risk inherent in this structure is that, if the mezzanine capital provider does not receive the payments, he will seize the vessel, and the shipowner's capital will be reduced or even lost entirely. As in all other forms of finance, the success of this model depends on the revenue generated by the vessel.

It is also possible to involve a family office as financier. In this case, investors benefit from the option of transferring assets within the family and from tax advantages. The return expectation is also moderate, about 5–10%. The search for potential partners is not quite as easy, however, since investing in ships is not an asset class typical of family offices. They must firstly be persuaded – and investors in this situation often have the same reservations as private investors. Some offices also do not become involved in alternative investments.

This applies likewise to a lot of institutional investors, such as pension funds and insurance companies. These companies have relatively little experience in ship investments. There are also additional significant obstacles such as the project »Solvency II« by the EU that make it difficult for

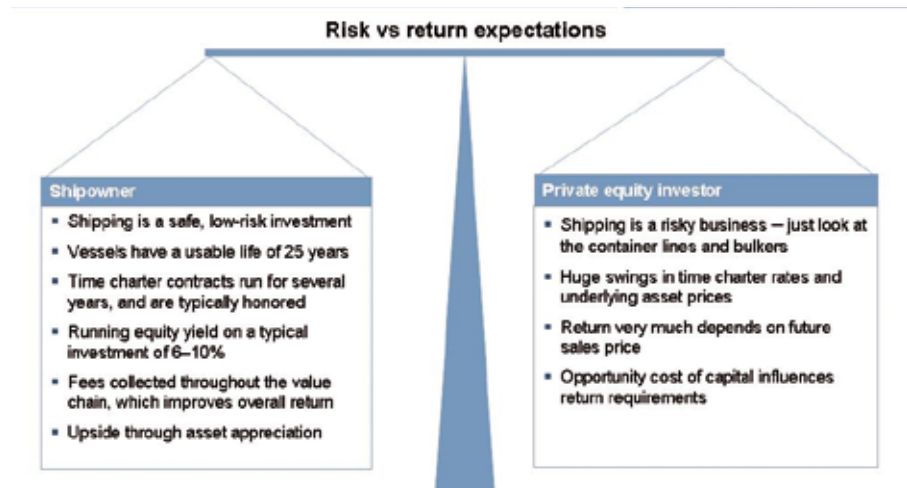
insurance companies and pension funds to make a direct investment in ships. The reliability of future revenue flows is also very important for this category of investors. Ideally, the charter should be very long-term and agreed with selected business partners. As a result, this route tends to be viable for shipping companies with good access to solid charterers.

### American capital for Germany

Although private equity and the maritime industry are not natural bedfellows, the involvement of private equity firms in the shipping market is not unusual. Not only American but also Arab and Asian money is invested in ships in various ways, mostly through asset platforms operated jointly with shipowners. In some cases they are also listed on stock exchanges. So far the focus has been primarily on the »dry bulk« and »tankers« asset classes.

Private equity is now also investing increasingly in the container segment. Our talks with investors, mainly from the American region but also from Asia, bear testimony to their increased interest in this segment. They assess the fundamentals as generally attractive in this respect. A prominent example is the joint venture between Tiger Investments from Hong Kong and the Carlyle Group from the USA, who intend to invest up to 5 billion US\$ in shipping. In Europe there is the Euromar joint venture between the Greek shipowner Aristidis Pittas and the American private equity companies Eton Park and Rhone Capital, which has acquired seven container ships since 2009. German shipping companies are also considered to be attractive partners, especially in the container segment, since they have a lot of experience with this asset class and are considered to be particularly reliable. Investors also hope to gain access to the major shipping lines through the German shipping companies.

Although investor activity is still at the initial stage in Germany, the first transactions have already been completed. An example from spring 2011 is the investment made by the American company Northern Shipping Funds in three ships operated by the shipping companies Bockstiegel from Emden and Hartmann from Leer. The investor plans to acquire up to fifteen container vessels. The Harren shipping company from Bremen has announced a partnership with Goldman Sachs relating to



Higher return expectation by private equity investors in shipping due to a higher perceived risk

special-purpose ships for offshore oil production. In other words, private equity is basically open to partnership with German shipowners. On the other hand, the negative example of Beluga is in no way representative from the US investors' point of view, and is seen as an isolated case.

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### High degree of transparency

Market entry by American private equity firms offers German shipowners a financing alternative to existing models. This does, however, have its price. Private equity firms and family offices too have shown themselves to be active, highly professional, and cost-conscious investors, who place great emphasis on clearly structured and detailed reporting, mostly on a monthly basis. This requires good organizational structures at the shipping companies and a high degree of transparency as far as the business figures are concerned. Based on current risk assessments, return expectations are 15 % or more per year. As a result, private equity firms also factor a rise in the value of the vessels into their budgets, since it is not possible to generate this level of returns from ongoing revenue. Furthermore, PE firms expect the shipping companies to invest their own capital – the more, the easier the negotiations.

It must also be borne in mind that private equity firms are always temporary investors. While their investment horizon is typically between three and seven years, they want to determine the exit period themselves in order to maximize profits. If ship prices have risen, it is highly likely that private equity firms will want to realize their gains. An exit could mean the sale of individual vessels or of the entire fleet that had been built up. It could also mean a stock market flotation for the shipping company if it comprises enough ships.

In summary: German shipowners are faced with the challenge of gaining new sources of equity capital in order to defend their market share, or even expand it through new projects. This could involve targeting family offices and pension funds in Germany or cooperating with private equity firms from the USA or Asia. Partnerships of this type may provide major opportunities for those German shipowners who meet the requirements of the new partners and can overcome cultural differences. In the next few months there will be an increased need to conceive new models and implement them together with new partners. As a result, in many cases the KG model could be supplemented quite soon by new corporate structures with new active partners.

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