

MARINE
M O N E Y

ACADEMY

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Ship Financing 101: a Practical Guide to Debt, Equity & Leasing

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INTRODUCTION

Ships tie up a lot of capital

- Container-ships & tankers could cost up to \$200MM each;
- LNG tankers could go for around \$250MM;
- Cruise ships could be +\$1B;

As a result, capital could account for 80% of the costs of running a bulk shipping company with a fleet of modern ships

Shipping has particular characteristics that make financing ships distinct from other asset classes

Lenders look for: predictable earnings, well-defined corporate structures, high levels of disclosure & well-defined ownership

Equity investors look for: consistent growth & high yield

This session: An overview of ship finance covering basic principles and common practices

SHIPS AS “ASSETS”

Positive Characteristics

- Hard Asset (Collateral)
- Unrestricted mobility
- Low obsolescence risk
- Fungible
- USD denominated
- Cyclical
- Liquid secondary market (50 vessels sold each week)

Challenging Characteristics

- Capital intensive
- Low returns = Temptation for Financial Leverage
- High operating leverage
- Volatile / Unpredictable
- Chronic overcapacity

DEBT vs EQUITY

Debt

- Capital that is borrowed and must be repaid
- 'Guaranteed' repayment, but typically without any upside
- Repayment is comprised of “Principal and Interest” (aka “P&I”)
- Primary source of financing for most shipping companies
- Debt can have different levels of security (collateral) - from fully secured to unsecured
- Principal Repayment - can vary from fully amortizing to balloon

LINGO ALERT: Credit, Leverage, Spread, Bonds, Notes, Revolver, Term Loan, Swap, Secured, Unsecured, Senior, Subordinated, Mezzanine ("Mezz")

DEBT vs EQUITY

Equity

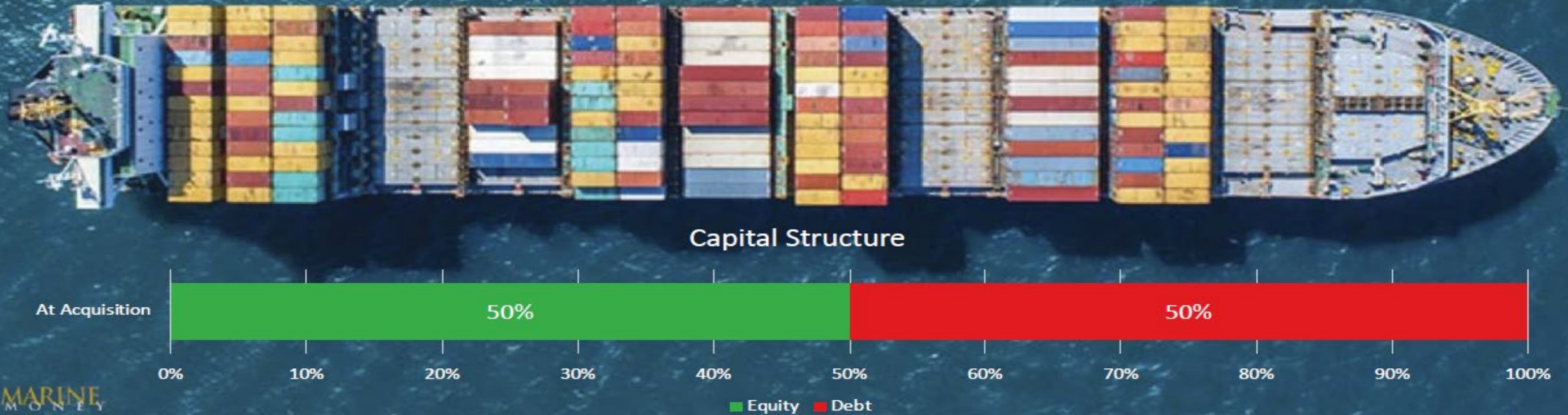
- The “Down payment” on the house
- “Enjoys” Ownership and Control
- Has most upside, but..
- Equity is the “first loss” source of capital
- All other sources of capital have priority of repayment ahead of equity
- Equity earns its return from free cash flow and residual value (hopefully)

LINGO ALERT: Public equity, private equity, financial sponsor, hurdle rate, carried interest, common, preferred, dilution,

DEBT vs EQUITY

Debt and Equity - Baseline

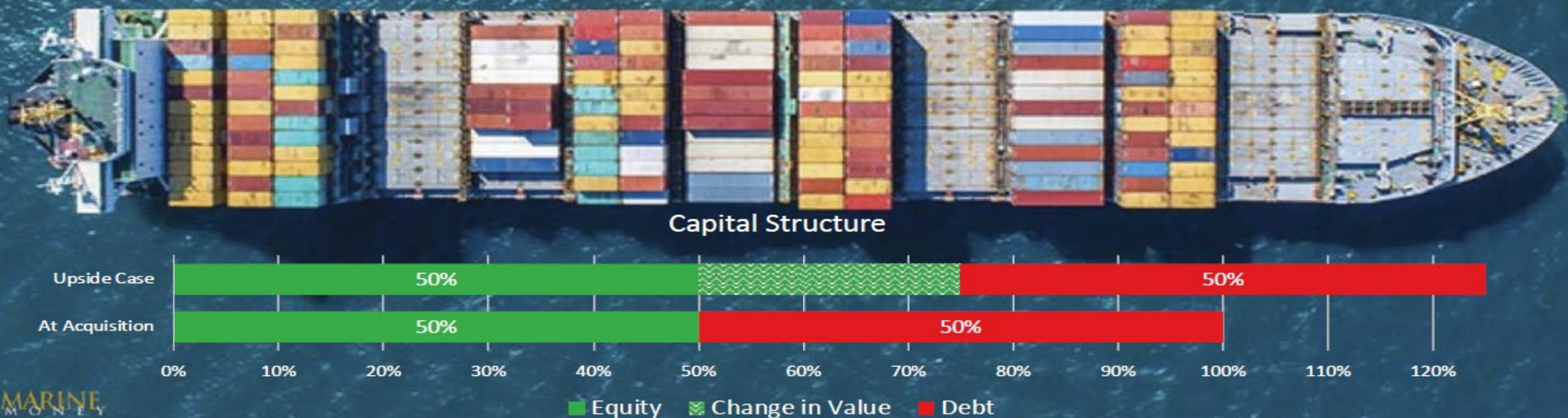
- \$20mm purchase price
- 50% Debt (red)
- 50% Equity (green)



DEBT vs EQUITY

UPSIDE Scenario

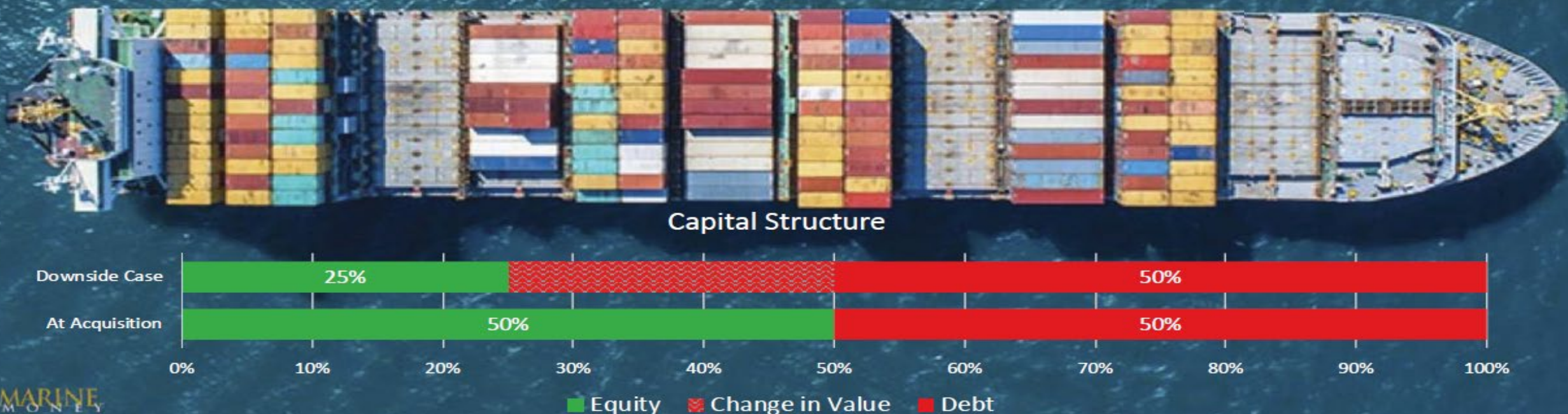
- Vessel's market value increases by \$5mm from \$20mm to \$25mm
- Debt balance remains \$10mm
- Mark-to-market equity value now equals \$15mm $(\$25\text{mm asset} - \$10\text{mm debt} = \$15\text{mm equity value})$



DEBT vs EQUITY

DOWNSIDE Scenario

- Vessel's market value decreases by \$5mm from \$20mm to \$15mm
- Debt balance remains \$10mm
- Mark-to-market equity value now equals \$5mm ($\$15\text{mm asset} - \$10\text{mm debt} = \5 equity value)



DEBT vs EQUITY

“Happy Happy” – Benefits of 50% Leverage

OWNER HAPPY

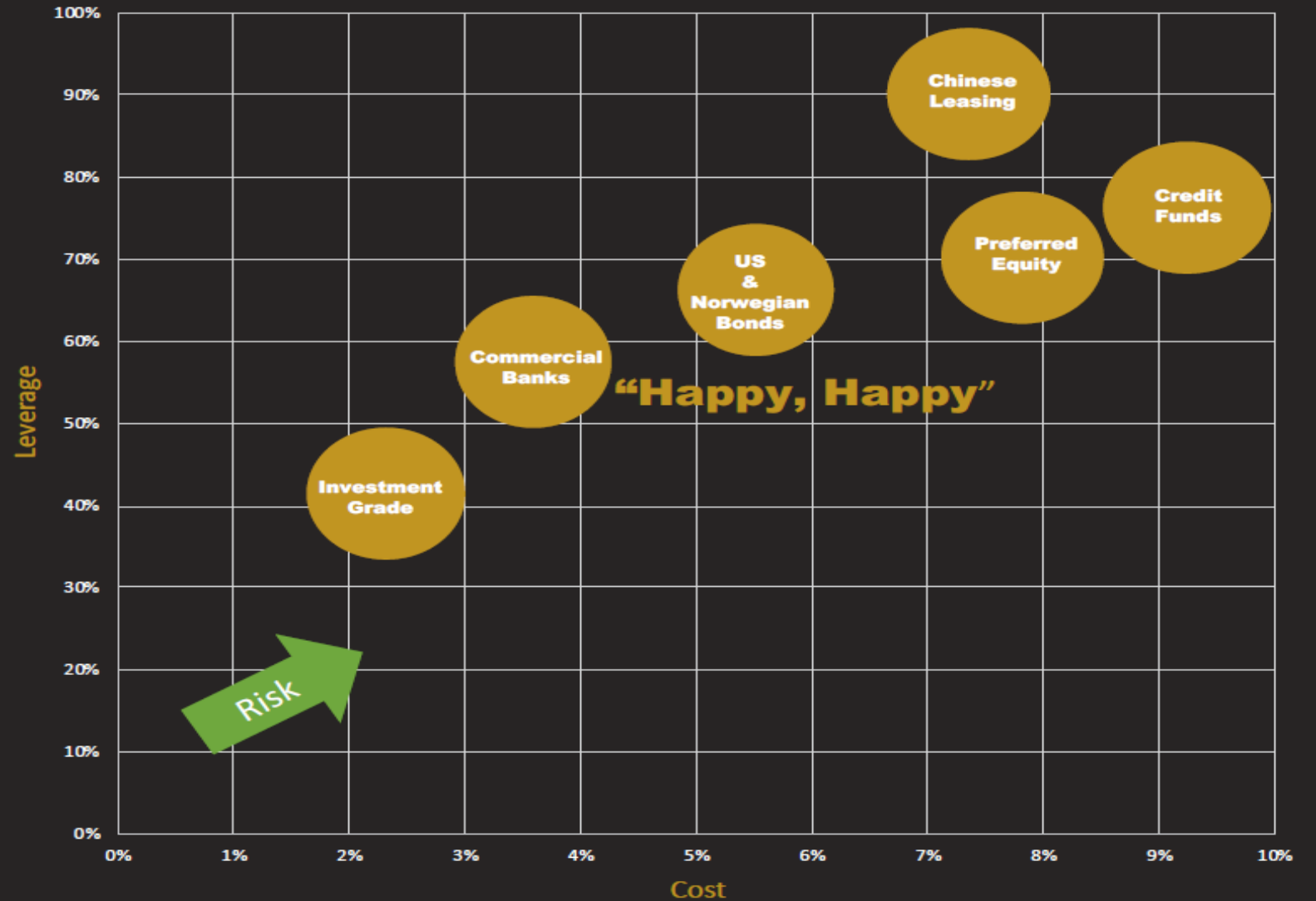
- Uses someone else's money
- Conserves precious liquidity (cash)
- Debt Capital Cheaper than Equity
- Boosts Return on Equity
- Creates Manageable daily breakeven
- Allows free cash for maintenance
- Allows free cash for weak markets
- Make money selling ship (hopefully)

LENDER HAPPY

- All the same reasons as owner
- Security of asset
- Big ticket
- Generates a return + fees
- Low risk if done properly
- Participation in great industry
- Consistent annual need for capital

SOURCES OF DEBT CAPITAL

Credit Alternatives: Leverage and Cost



SOURCES OF DEBT CAPITAL

Key Sources Include:

- Commercial Banks (Funding: depositors, other banks, bonds)
- Non-Banks (Credit Funds) – (Funding: Private equity, Investors)
- Institutional Investors - (Funding: Pension Funds, Endowments, Insurance companies)
- Leasing Companies – (Funding: Equity Investors, Commercial Lenders)
- Governments – (Funding: Export Credit Agencies (“ECAs”))

Loans, Private Placements & Bonds

ECA Loans / Guarantees

SOURCES OF DEBT CAPITAL

Export Credit Agencies:

- Government institutions
- Mandate to support domestic industries (shipbuilding or trade)
- Primarily available to finance newbuildings
- Direct lending
- Sovereign guarantees on performance of commercial loans

SOURCES OF EQUITY CAPITAL

Key Sources Include:

- Ship owners / Private Business
- Public Equity Investors
- Private Equity Investors
- Leasing Companies

SOURCES OF EQUITY CAPITAL

Ship Owners:

- Most significant source of equity
- Long-term investment horizon (permanent capital)
- Traditional family or private corporate businesses
- Generational investments
- Lifestyle
- Concerned with more than short term economics
- Ships as storage place of wealth

SOURCES OF EQUITY CAPITAL

Public Equity:

- Invest in publicly listed companies
- Comprised of: Retail investors, Hedge Funds and “Long Only” Institutional Investors
- Permanent capital in theory, BUT high investor turnover, short term trading
- Challenge of Long Term Investing in a Cyclical Industry
- Opportunistic (i.e. fickle) with regard to shipping equities - discounts
- History of dilution by listed companies periodically closes public markets
- Valuation relative to ship values and other public companies

SOURCES OF EQUITY CAPITAL

Private Equity:

- “Smart Money”
- 3-7 Years Holding Period
- Professional investors
- Funding Source for non-banks
- Buyers of Discounted Shipping Loans
- Strategies: Distressed, Special Situations

VESSEL LEASING: BLENDING DEBT & EQUITY

Vessel Leasing:

- Tool for extracting equity
- Leasing company buys ship for 80 - 100% of value
- Rents ship back to owner for fixed period
- Leasing company uses its equity and borrows debt
- At end of lease, owner may have right to buy it or leasing company might keep it
- China, Japan, Korea

VESSEL LEASING: BLENDING DEBT & EQUITY

Vessel Leasing (Con't):

- Most levered form of equity
- Fixed term capital, typically tied to vessel age or length of contract employment
- Emerged as significant source of capital for shipping assets from both Asian leasing companies and from credit-oriented private investors
- Successfully leveraged lease depends on cost of capital arbitrage between lessor and lessee such that residual cash flows provide reasonable return to equity

SECURITY, SHIP MORTGAGES & MARITIME LIENS

Secured Lending:

- Unsecured loan: lender relies on borrower's general financial condition, profitability and cash flow;
- Secured loan: lenders takes these factors into account, it places heavy reliance on particular assets of the borrower as a source of repayment;
- In a secured loan, the borrower grants a *security interest* to the lender in certain assets which gives the lender (aka secured creditor) rights in the collateral which take *priority* over claims of other creditors;
- In ship financing transactions, the key collateral is the ship, but other collateral is also typical (eg, earnings, insurance proceeds, stock, etc.);
- The result is that upon a default by the borrower of its obligations under the loan documents, the secured creditor is granted the right to take possession of, and sell, the collateral in order to satisfy the debt;
- *first priority security interest*: depends on (among other things): (i) consensual agreement and (ii) “perfection”

SECURITY, SHIP MORTGAGES & MARITIME LIENS

Ship Mortgage:

- In a typical ship financing transaction, a lender obtains a security interest in the ship (as well as its earnings, insurance proceeds and any requisition proceeds)
 - Consensual security interest
 - Applicable law may confer lien rights on certain classes of creditors; these are not consensual and will often prime a consensually granted security interest

SECURITY, SHIP MORTGAGES & MARITIME LIENS

Maritime liens:

- Created under maritime law and arise out of contract, status or tort
 - “secret lien”: (i) need not be registered in any public office, (ii) does not require possession by the claimant and (iii) enforceable despite a subsequent transfer of the ship to a bona fide purchaser for value;
 - In the US, maritime lien claims outrank nonmaritime claims against the ship, including tax liens and other governmental claims
 - In the US, a ship mortgage (meeting certain formalities) is a maritime lien and will take priority over other claims against the ship except preferred maritime liens (and court fees/costs)

SECURITY, SHIP MORTGAGES & MARITIME LIENS

Maritime liens:

- Created under maritime law and arise out of contract, status or tort
- Preferred maritime liens that receive priority over the mortgage:
 - (i) a lien arising prior in time to the filing for recording of the preferred mortgage or
 - (ii) a lien for:
 - damages arising out of tort;
 - for wages of a stevedore when employed directly by the owner, operator, master, ship's husband, or agent of the vessel;
 - for wages of the crew of the vessel;
 - for general average; and
 - for salvage, including contract salvage

TERM SHEETS & LETTER OF INTENT – SENIOR LOAN

FACILITY TYPE:	Senior Secured Loan
COLLATERAL:	M/V Big Papi
BORROWER:	Big Papi LLC (SPC formed to own M/V Big Papi)
GUARANTOR:	Fenway Holdco
LENDER:	Name of lending entity (Official name)
LOAN AMOUNT:	Lesser of \$12 million or 60% of Vessel Value
TERM:	60 months (5 years)
INTEREST RATE:	Term SOFR + 350 basis points = total interest payment
AMORTIZATION:	20 quarterly payments to a balloon repayment of [\$1,000,000]
UPFRONT FEE:	1.5% of draw down
COMMITMENT FEE:	1.00% of undrawn commitment
EMPLOYMENT:	Upon Drawn Down, Vessel To Be Time Chartered No Less Than 24 Mos
CHARTER RATE:	\$14,000 per day, net
SECURITY:	Ship mortgage, assignment of earnings & insurance, share pledge
INSURANCE REQUIREMENTS:	Borrower shall at all times ensure..
COVENANTS:	Value Maintenance Clause ("VMC"), Liquidity Reserve, Debt Service Coverage Ratio
LAW:	Transaction shall be governed by New York Law

TERM SHEETS & LETTER OF INTENT – PRIVATE EQUITY

SECURITY TYPE: Common Equity (or could be Preferred (preference in cash flow waterfall) or Convertible (can convert into common shares at pre-agreed price)

SERIES: Could have a Series such as A, B, C to describe how many funding events/dilution have occurred previously

ISSUER NAME: Big Papi Shipping, a company formed in the Marshall Islands, to own a vessel primarily engaged in the business of hauling freight by sea in the "tramp" market

AMOUNT OFFERED TO INVESTORS: \$10 million, representing 49% of the shares in vessel

CONTROLLING DOCUMENTATION: An Operating Agreement (Board of directors, Voting rights, etc.) for an LLC

USE OF PROCEEDS: Outlines what the money will be used for (Eg, Buy the Ship/s, Pay Down Debt)

PRE-MONEY VALUATION: What the issuer and investor agree is the value of the business before the new investment is made

CARRIED INTEREST: 20% of profits to Manager once Investor principal has been repaid + 10% annual return

OTHER: Pre-emptive Rights, Drag-along, Tag Along, Exit

TERM SHEETS & LETTER OF INTENT – VESSEL LEASE

STRUCTURE: Finance Lease (vs. Operating Lease)

VESSEL: Big Papi

TYPE: Container (5,000 TEU)

BUILT: Nice Times Shipyard

VESSEL VALUE: \$24 million

PURCHASE PRICE: \$24 million

LESSOR: Big Papi SPC

SECURITY DEPOSIT: \$1.5 MILLION

DAILY FIXED BAREBOAT CHARTER HIRE: \$11,250/day

LEASE TENOR: 6 years

PAYMENT TERMS: Monthly installments, payable in advance

UPFRONT FEE: 1.5% of Purchase price

BALLOON (PURCHASE OBLIGATION): \$8.5 million (vs. Fair Market Value "FMV")

GUARANTOR: Holding Company that owns vessel SPC

CONCLUSION

QUESTIONS?

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