

SURVIVING THE PRESENT SHIPPING CYCLE: A SHIPBROKER'S PERSPECTIVE

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Who ever would have thought that shipping in 2008 would have been replete with pyrotechnics? While the fireworks at the Beijing Olympics in late August were definitely epoch defining, they were also eerily symbolic for the spectacular growth of shipping in recent memory. The minute the Olympic flame was extinguished, it seems the breath of the markets has gone with it. The freight indices, the broader Baltic Dry Index (BDI) and the narrower Baltic Capesize Index (BCI), both hit all time highs in late May and June 2008, but by early December 2008 both indices recorded all time lows, both indices down more than 90% from the peak.

While a slow down in shipping was widely expected by virtue of the fact that freight rates and asset prices were too high to be sustainable in the long-term, few people could have seen that we would experience such a summer-winter inversion with an almost calendar precision. We are not sure what the exact cause of the present turmoil was, but the following could all be logical explanations: reduced demand after the Olympics-induced super-boom in China; reduced demand due to recessionary pressures worldwide;

sub-prime loans and real-estate speculation; commodities inflation and speculation; lack of trade finance; de-leveraging of banks' balance sheets; lack of financing (debt and equity); excess tonnage supply; the overextended state of the consumer worldwide; the high cost of raw materials; excess of liquidity and easy credit that caused asset inflation, commodity inflation and over-supply of tonnage.

While the economists are working on the causation sequence and allocation of blame share for each factor in the current turmoil, it is for certain that the shipping landscape has changed fundamentally. In general, the booming years of the cycle have been exceptionally generous to the main (owners, etc) and ancillary (brokers, etc) market players, but the lean years now seem at hand. For those statistically inclined, the market is reverting to the mean, where asset pricing, freight rates and financing costs will be within a certain degree (standard deviation) of the historical average. It has happened in the past, and it is happening now; just another case of history repeating itself.

In previous cycles however, reverting to the mean entailed primarily disposing of (liquidating or laying-up) the excess supply of tonnage that was created during the euphoric stages of the cycle. This time though, the situation is different indeed: we are reverting to the mean when the 'standard' shipping correction of excess tonnage is interweaved with the tectonic changes taking place in the financial sector (Easy credit, lack of liquidity and historically low cost of funds have annihilated structured finance. Financial institutions desperately need to de-leverage, and a lack of liquidity and confidence has so deeply permeated the financial sector as to affect even trade finance and trading). Although these two corrections are taking place in parallel trajectories so far in two distinct industries (finance and maritime), there is a strong chance that they might be on a crash course. When the freight indices are presently recording their lowest levels, defaults to commercial lenders cannot be far behind. Similarly, when asset prices have corrected more than 50% in a matter of months, loans with covenants tied to Fair Market Value (FMV) of the underlying secu-

rity cannot remain unaffected forever. Thus, the correction, the reverting to the mean, will be more severe for there will be the combined reaction from two different industries trying to cut out excess capacity. While eventually the market will settle around the historical mean, there is a fair chance that there might be an overshoot first in the near term before the final judgment ('rubber-band reaction'). So far, the market has all the characteristics of a buyer's market, and probably in the near term, it will be getting more favorable to the buyers' with patience and good old hard cash.

The precipitous decline of the freight rates and shipping assets taking place simultaneously with cataclysmic changes in the financial landscape is a major distinguishing factor from previous cycles. In this cycle there will be a higher than usual representation of sellers who are not the 'standard' operating ship-owners but rather financial / passive owners. There will be sales of vessels by private equity and hedge funds, leasing companies, and other equity participants. But mostly, there will be sellers who are debt holders (commercial lenders) since there are already loan

defaults tied to loan collateralization (drop in vessel prices) and there will be defaults due to non-payment of loans (the present freight market does not even cover vessel daily operating expenses (variable cost)). While certain financial buyers had the 'luxury' to make shipping acquisitions / financing on the strength of their inexpensive financing and high leverage, their de-leverage likely will take place in an unfavorable market. By definition, passive owners lack operational ability and established infrastructure to actively participate in the shipping market.

It is evident that a great deal of Sale & Purchase (S&P) transaction in the new environment will be 'forced' transactions where there will be one unwilling participant; there is a strong chance that quite a few of these transactions might involve the court system where foreclosures and arrest of assets will happen in order to discharge debts. Therefore, the standard Sale & Purchase (S&P) transaction we all got used to, based on the standard Norwegian Sale Form (NSF 93) with 10% down-payment and the balance payable on delivery, in some cases might not be applicable at all.

Whether a shipping professional is trying to survive the current market as a ship broker or s/he is in the market shopping for the services of a shipbroker, we are reminded of 'The functions of a corporate director' by the late Chairman of Goldman Sachs, John Weinberg, in 1949, when in his seminal speech tried

to encapsulate the principles of corporate directorship at a time when corporate governance was in its infancy. We believe the services of a shipbroker to the ship owner are an extenuation of the services of a director to the company, of course with a few 'logical amendments' as brokers would say. In the same way that an outside corporate director has the fiduciary duty to advise, guide and direct a company without ever managing the business, it is equally the duty of a ship broker to advise, guide and direct the sale and purchase transaction without ever becoming a 'manager' of the vessel.

SCOPE OF SERVICES

In such market environment, it's apparent that a great deal of the transactions will involve abilities, knowledge and skill of far more of what had been expected during a standard Sale and Purchase transaction. Also, it is highly likely that at least one player in the transaction might be lacking shipping expertise in terms of logistical and managerial support. The shipbroker should be ready to step in and substitute for a financial owner by providing services beyond the scope of brokerage such as crewing services, custodian and husbandry services, and mainly ensuring that the vessel remains at all times within class with valid trading, statutory and regulatory certificates. Choosing Port A versus Port B for a vessel arrest might primarily be guided by the legal jurisdiction of preference, but if the port expenses in one location are

prohibitively higher, especially in circumstances when the vessel might have to remain for an extended period of time, the ultimate savings will be low. While a vessel inspection might be as simple as flying an in-house port engineer to location for a traditional ship owner, a financial owner cannot afford to look up an inspector in the yellow pages the last minute for an inspection of a multi-million dollar piece of equipment. Probably there will be instances where the vessel might have to be repositioned and possibly remain at lay-up for a period of time before the actual sale eventually takes place. Again, having placed vessels in the past at lay-up and knowing the company, the people, the location, the costs and the procedures involved, it adds value to the services of a shipbroker.

Transactions involving a dual ownership-management structure are usually complicated by their own nature, even in good markets and pleasant times, as the interests of the owner (not to be confused with the registered owner, owner-trustee, disponent owner, etc) and the manager are not necessarily coincident. In good times, when the profit was enough to go around, a lot of problems were solved with money. In harder times, there will be an absentee / passive owner who shows up to claim the asset, with minimal shipping experience, and try to physically gain control of the asset (the captain and the crew onboard, certificates, etc). How co-operative will the manager of a vessel be to the representatives of the

owner? How co-operative will the manager be in arranging inspection for a third party when the manager by definition has a vested interest in (acquiring) the vessel? Past experience has shown that even when the manager had no vested interest in the vessel, even in good times, the change of ownership was treated disinterestingly, as a chore.

The principal service of the shipbroker still remains that same as in the past, that is to put together transactions and 'make a market', in a sense. No one expects shipbrokers to be able to perform all types of services, but shipbrokers with established and tested relationships with service providers will be a tremendous value-added service. In an industry where assets are valued at millions even at bad times, and daily costs and expenses are running in the thousand of dollars, for a shipbroker to deliver ancillary professional services to support a client will be of paramount importance.

PROFESSIONALISM

It is usually easy to transact (buy and sell) a vessel; the typical point of contention is usually the price. If the price swings enough toward one side, at least one party becomes extra motivated to have a deal. In a buyers' market, if the price drops enough, or the bids are 'guided' low enough, then you can have a sale. Although only the market can determine asset pricing, on average, it does not mean that the brokers cannot guide the transaction and the price through the bidding process for a particular asset. It has been a

sellers' market in the last few years, and there were very few forced sales. In a buyers' market and especially in an environment where there will be forced sales, the professionalism of the broker will be an important factor that cannot be ignored with impunity. To give a tangible example: in the near past, eight sister containerships came to the market for sale from three different financial owners. The owner of five of the vessels was represented exclusively by Compass Maritime Services. The owners of the other three vessels were represented by a different broker. All eight vessels, again sister vessels, were sold within a two-week period. Each vessel sold by Compass achieved approximately 40% premium over 'last done', while the other three sold at the then market levels. Compass didn't work magic for sure, but definitely drove a harder deal for their principals.

To take it one step further, independence of the shipbroker has to be sine qua non in shipping transactions in both good and bad times. Besides a loyal adherence to the interests of the principal in the transaction, it is difficult to serve two or more masters at a time. Certain ship brokerage offices are not stand-alone businesses but parts of bigger shipping conglomerates. Although no one can refute that there are synergies of scope, there is inherent conflict of interest when other parts of the business conglomerate have an interest in the transaction. In such cases, where do the interests of the shipbroker really lay deep down in their hearts?

EXPERIENCE & QUALIFICATIONS

Until a few short months ago when the freight market was at stratospheric levels and with plenty of money chasing deals, ship brokerage was a fairly straightforward exercise of putting (very willing) buyers and (money rich and willing) sellers together at a high asset price. Going forward, brokerage cannot be so simple anymore. It now requires additional skills and knowledge not only in the maritime sector, but also in fields related to shipping, including banking, finance and law. In short, shipbrokers will have to be fluent in all these areas in addition to bringing their shipping expertise to the table.

Future Sale & Purchase transactions might very well require brokers to testify in court, to be deposed, to provide well documented asset valuations, etc. In a market environment where asset prices are depressed and buyers are using every trick in the book to obtain even more favorable terms, it is not a time for the Sellers to be represented by newcomers to the market, unfamiliar with the legal system and, who, in general, require on the job training.

Where the sale and purchase of vessels will involve extensively financial players, and where the transactions will not necessarily be between a 'willing' buyer and a 'willing' seller, the change of ownership will not be 'transactional' but more elaborate requiring greater negotiating skills, strong business acumen, and an ability to 'see the bigger

picture'. It might not have always been true, but probably a deeper and broader academic background might make one a better shipbroker. Possibly advanced degrees in shipping, finance, management and law give the ability to a broker not only to be an integral part of the transaction but also to act as an advisor/consultant to the principals instead of just passing along information. And here the value of the experienced shipbroker comes to play. They say the 'devil is in the details' and this cannot be closer to truth in shipping. A seemingly innocent verbiage in a contract can have consequences, and thus another set of experienced eyes does make the difference.

For the transactions that will be outside the court system, experienced brokers with a bulging rolodex of worldwide contacts of solid market players, and especially in the major shipping markets such as in Greece, Scandinavia and Far East, can act decisively, save anguish and transaction costs and produce results in a timely fashion.

INTANGIBLES (REPUTATION & DEDICATION & SENSE OF MISSION)

Besides the tangible characteristics of the shipbroker, such as education and past experience, that can be documented, there are always those intangible assets that make the difference between a good and an excellent broker. It not only takes a hunting gun to shoot game, but also it takes a straight-shooting soul to brave the elements and

only shoot the game in season. The same applies to a ship brokerage, a service industry par excellence. The service has to be customer oriented, specifically targeted to provide solutions, and to do so in a manner that is dedicated, passionate, and adhering to high standards of legal, professional and ethical conduct.

To paraphrase Weinberg's observations of more than sixty years ago on the effective director, 'the influence of a shipbroker comes from their faithful, competent, and diplomatic performance of their duties and from their abilities and experience', and that 'a shipbroker must keep a broad outlook, high hopes, and believe in the future of their country; they must keep their feet on the ground but this need not keep them from looking off to the horizon.'

After all, we are only at the dark side of the perimeter of a business cycle of an otherwise great industry. Shipping has been the founding stone of building fortunes, empires and civilizations since antiquity. There are always bad times, but for professional players with a historical mission and an institutional approach to the industry, probably this is the time to work harder to build for the future.



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