

Market seeks solutions for meaningful asset valuation

Barry Parker

Reliable values for vessels and, in alternative modes, aircraft and railcars, are an integral component of transport finance. Barry Parker reports

For shipping, the financial crisis that exploded in the third quarter of 2008 (3Q08) had the impact of choking off the supply of bank credit that would normally support purchases of second-hand vessels or resales of new ships about to be delivered from shipyards. Up until the market disruption, a steady flow of transactions provided the grist for asset appraisers - usually shipbrokers specialising in "vessel sale and purchase" - to steadily chronicle the ebb and flow of vessel prices. These values, in turn, would serve as the basis for periodic asset valuations used in measuring requisite coverage ratios for shipping loans, with the loan-to-value (LTV) ratio being the best known.

Although new lending activity contracted in late 2008, bankers were still faced with the task of monitoring borrower compliance with covenants in existing credit facilities. A number of brokers who had provided guidance on values of standard vessel types through market reports and client circulars ceased doing so around this time, although some were still providing values to their bank clients on a bespoke basis. On www.shipvalue.net, the online service of major broker Clarkson Valuations Ltd, a disclaimer reads: "Because of current market conditions we are having difficulty in monitoring values. The values in the system were last updated on 3 October 2008 and have not been updated since. Until we have been able to update our values as a guide to present values, please do not use the system."

The dislocations in vessel asset markets - or lack thereof - have figured prominently in companies' negotiations with banks. At the end of April, Global Ship Lease (GSL), a share-listed owner of containerships (with CMA CGM owning 45 per cent and investor George Soros holding 11 per cent) announced a two-month waiver with a lender group led by agent Fortis (Nederland) and with participation by five other banks, to submit valuations on its fleet of 16 containerships. GSL had been required to obtain valuations at the end of April to perform LTV tests on amounts outstanding under the company's USD800 million facility, which is in the process of being amended. As described by GSL in regulatory documents: "The charter-free market value of a vessel will be calculated semi-annually as the arithmetic average of valuations determined by two independent sale and purchase brokers acceptable to the agent."

According to Ian Webber, chief executive officer (CEO) of the GSL: "This agreement was secured in response to the current disruption in the containership sale and purchase market and resulting difficulty in receiving meaningful vessel valuations when many shipbrokers have suspended issuing such valuations." GSL, which has also suspended its dividend, will see an increased margin - to 275bp above Libor - on the facility, compared with margins originally ranging from 75bp to 110bp, depending on leverage, during the period to the end of June 2009. Original terms of the eight-year facility, agreed in late 2007, featured payments of interest only for the first five years, with repayment of principal outstanding at the end of the fifth year, then to be apportioned over the final three years.

Greater transparency

Slowly, more transparency is coming to the world of vessel valuations, still very much the province of specialised brokers such as Clarksons. London's Baltic Exchange, well known for its freight indices, in which rates are derived from polling industry panels, also provides weekly assessments of values for notional five-year-old oil tankers and bulk carriers but not container vessels, all charter-free. A Baltic Exchange spokesman told Jane's: "The Baltic didn't stop producing sale and purchase assessments at all last year." The spokesman provided a graphic (replicated, left) that indicated a dramatic fall-off in bulk carrier values in late 2008, along with a steadier slide in tanker values.

Where a vacuum of value information exists, those doing the talking are building an audience: the value assessments have led to more visibility for the Baltic Exchange. Consider a recent analyst report by investment bank Dahlman Rose & Co, which notes: "Asset values remain a concern in general for the tanker market." The report adds: "With rates for all vessel classes at depressed levels, tanker values have been assessed sharply lower by the Baltic Exchange. Its most recent assessment for a five-year old very large crude carrier (VLCC) of USD87 million represents over a 40 per cent decline from the 2008 peak." The report, in looking at General Maritime Corporation (GMR), goes on to describe a proactive stance by GMR to accelerate repayments on its debt, and to add an additional vessel to the collateral pool.

Questions surrounding valuations figured prominently in a recent ship finance seminar held at the downtown [New York](#) offices of law firm Seward & Kissel. Basil Karatzas, vice-president for projects and finance at Compass Maritime, a leading vessel sales and project intermediary, as well as a Baltic Exchange panellist, explained that, unlike some peers, Compass has continued to provide valuations of vessels, mainly in relation to LTV computations for existing vessels. In his view, up until 4Q08, "most valuations were done by looking at recent sales". Since that time, he added, "things have changed and the markets have become illiquid with big spreads between bid and asked, leading everyone to ask: what's the real price"? He said that an alternative method of valuation, looking at replacement cost, which is applicable for new vessels, has also been problematical, "because there have been no new orders over the past six months".

With the type of disruptions described by Karatzas, long-standing practices related to valuations are now being contested. Harry Theochari, a partner specialising in ship finance at law firm Norton Rose in [London](#), told Jane's: "Up until very recently we saw little evidence of borrowers challenging valuations. However, as the market has worsened and certain banks have issued reservation of rights letters, we have begun to see borrowers challenging valuations." Such disputes have no doubt figured prominently in discussions between GSL and its lenders, and played a part in the resultant two-month moratorium.

The income method

Karatzas described a third appraisal method - the income method, which answers the question of what can be earned from an asset; the method has seen more usage lately. But he cautioned: "It is not an exact science; it is a theoretical exercise and just because the value is x today, it may be different tomorrow." In discussing the approach, he said that appraisers were using rational but low expectations of the freight markets going forward. He added that the risk of charter default was an issue with the methodology, "particularly where the current charter is significantly above the present market rates".

The income method of appraisal is becoming more established as a benchmark. In February, the Hamburg Shipbrokers Association (HSA), a 100-year-old organisation in one of the world's leading shipping centers, opined that the 2008 crisis "has caused a virtual standstill in the main segments of the ship sales and purchase market". HSA added that another implication of the crisis is that transactions that have been reported might well be unreliable as a basis for proper valuation "because they were forced sales". In context, the fortunes of the container trades are critical to the health of the [Hamburg](#) market in which many containerships are owned by KG companies. Unlike the tanker and bulk carrier sectors - in which large shipping banks have so far been working with borrowers to amend covenants - the smaller containership market is often characterised by ownership in the hands of smaller investors. KG funds, starved for liquidity, have indeed pursued fire sales of the assets rather than putting the funds into bankruptcy.

Forced sales

KGs without deep-pocketed parents or investors willing to meet additional calls for equity capital have already been forced to sell vessels under distress conditions. For KGs facing restructuring, lengthy periods of unemployment for vessels that typically trade in multi-year contracts have forced packagers to make

tough choices. In the unfolding saga of three-ship KG Fund No 38, with more than USD5 million of equity investment raised by the vessel and real estate packager Fondshaus Treuhand, linked to Germany's Ahrenkiel Group, one 3,398-teu box carrier has been without employment since late 2008. The KG sought to bridge the shortfall by taking a USD15 million loan from Ahrenkiel, which has subsequently taken the ship back from the KG. In another well-documented case, investors in a KG fund packaged by Gebab watched the prices on offer for a 1997-built, 2,900 teu, KG-owned vessel dip in value to levels below those needed for investors to pay taxes due. Rather than de-accessioning the vessel at a distress price, investors voted for a capital infusion of approximately EUR4.5 million (USD6.1 million) that would cover a final debt service cost and anticipated costs for vessel layup.

In response to the paucity of transactions, the HSA has promulgated an alternative mechanism for assessing the long-term asset value (LTAV) of vessels. The association's proposed methodology, applicable to containerships but also to tankers and bulk carriers, is one familiar to business school graduates: the DCF (discounted cashflow) approach. The HSA, in offering its guidelines for appraisers, states: "In dysfunctional/irregular market conditions, may these be excessively high or low markets, this evaluation can be used to obtain representative figures." Even though DCF has been around for decades, the broker group breaks new ground in seeking to delineate the conditions that exactly define such a market.

Of course, the devil is in the details; the broker group offers its guidelines through a formula, in equation format replete with Greek symbols, for calculating the LTAV of a vessel over a 10-year timeframe. In spite of the seeming precision of the approach, much is left to individual judgement. Suggestions for deriving two very important components of the calculation - operating costs and residual value - point to long-term averages. The top-line charter rate should be derived from an existing charter, and then, upon expiry, a long-term average rate, with consideration of freight measures such as the Baltic Dry Index or the Contex, an HSA measure of hires for feeder containerships.

Financial purists will note that a simplistic approach to determining the applicable discount rate is based on a weighted average cost of capital. In late February, the HSA arrived at a 6.6 per cent cost of capital, based on 70 per cent bank finance at Libor plus 137.5bp and 30 per cent equity costed at 7.63 per cent. While one can disagree with the specific numbers and brokers' assumptions, the methodologies underpinning the LTAV, which are said to have been developed in conjunction with the German finance community, may point the industry towards a more objective approach to asset valuation.

Theochari explained some of the problems with the current widely used methodology for vessels valuations. "The two main arguments that have been raised by borrowers are: firstly, that the valuations from brokers are so heavily caveated that they cannot be considered as genuine valuations; and, secondly, that as there has been limited, if any, sale and purchase activity in certain sectors, it is simply not possible to satisfy the valuation criteria in the loan agreements which require the valuation to be based on a 'willing buyer/willing seller' basis."

Market participants in [Germany](#) are still getting a handle on the LTAV concept, which is meant to guide rather than replace appraisers. Burkhard Lemper, a professor at the Institute of Shipping and Logistics in [Bremen, Germany](#), told Jane's: "My rough understanding is that it is just a normal net present value (NPV), calculated with specific assumptions. If data is available, it should also be applicable to other vessel categories such as tankers and bulk carriers." Hamburg-based shipping bankers contacted by Jane's would only say that they are studying the LTAV methodology.

Richard Howley, also a partner in Norton Rose's ship finance practice, spoke to Jane's about the possibility of using a pure formulaic approach to vessel valuations. Howley said: "In our experience, loan documentation always requires the use of one or more independent shipbrokers that are either appointed by or approved by the banks. Sometimes a panel will be scheduled to the facility agreement. The formula approach will also probably fail standard documentary requirements because valuations are usually predicated on a charter-free sale basis as between a willing buyer and a willing seller which would indicate that recent sale and purchase activity should be the appropriate input."

Aircraft valuations

In the aircraft sector, valuations still blend art and science but benefit from guidelines issued by the International Society of Transport Aircraft Trading (ISTAT), which also offers a rigid certification programme

for asset appraisers. Fred Bearden, CEO of Aircraft Information Services Inc, located in Orange County, California, said: "Commercial aircraft valuation has developed into a very complex business from very simple beginnings." He added that, prior to the ascendancy of the leasing giants, appraisals were primarily built around the value of the "last similar transactions". Bearden explained that the advent of professional operating lessors, financing their fleets with complex, often tax-driven financial instruments, demanded better appraisals.

In the current economic environment, where bank market financing rather than capital markets dominates, aircraft valuations mimic vessel valuations. In the maritime sector, listed lessors include GSL as well as Danaos Corporation and Seaspan Corporation. Privately held ship lessors include SeaChange Maritime LLC, which owns and operates a fleet of medium-size containerships to serve as a leading supplier of vessels to integrated liner operators worldwide.

Frozen market

In the aircraft sector, enhanced equipment trust certificates (EETCs) and the securitisation of lease portfolios have ratcheted up the importance of valuations and forecasts of future values. Although the EETC market has been frozen for the last several years, analysts are hopeful of a thaw in late 2009 or in 2010. Bankers suggest that one or at most two EETC deals could hit the market within that timeframe.

Fred Klein, an ISTAT director and president of Virginia-based Aviation Specialist Group, told Jane's: "It always helps to have a human being in the loop; good appraisers must have brains, experience and common sense." He explained that the first of two main methods used by aircraft appraisers is current market value - the price that would likely be agreed between a willing buyer and seller, without distress conditions. A second method - the "securitised value" or "lease encumbered value" - reflects the prevalence of operating leases for set periods where rentals are known in advance. According to [Klein](#): "You have known rents. You can forecast the likely residual value, and you can make a reasonable assumption on the discount rate." He added: "Operating lessors, investors, and hedge funds may well have a target rate of return. That forms the implicit basis for the discount rate."

Mindful of the ongoing discussions about charterer default or renegotiation in the maritime realm, Jane's asked [Klein](#) how appraisers using the securitised value method would apply to an analogous situation in the aircraft sector. He said: "You have to look at the actual terms of the deal. For example, they may have to put several months of rent into a security deposit." [Klein](#) explained that, typically, two months of rentals are held as a security deposit, with the precise deposit depending on bargaining power, deal risk and general market conditions. He added: "If there is a default risk, you can explicitly build that into the discount rate. With certain big national airlines, that risk may be less than with smaller outfits - but the risk is not zero. You have to be selective."

What, then, is lacking from the LTAV approach? Very possibly, it is the mechanism for dealing with default risk, as elucidated by aircraft appraiser [Klein](#), who told Jane's that he had worked on shipping deals earlier in his career. In the shipping realm, the risk of charterer default or renegotiation is still very real, with shockwaves now emanating from the containership rather than the drybulk sector. The LTAV guidelines to ship appraisers may need more definition in treatment of defaults.

CSAV troubles

During April, the travails of Chilean containership line CSAV provided front-page headlines in [Hamburg](#), a centre for ship-owners and operators of vessels owned by KG companies. Hamburg-based Peter Dohle Schiffahrts-KG is reported to have more than two dozen vessels exposed to CSAV and is reportedly considering a CSAV proposal to reduce charter hire in return for equity in the Chilean liner operator. Gerry Wang, CEO of Seaspan, stated in a 1Q09 conference call: "We have advised CSAV twice that Seaspan is not interested in charter party negotiations."

In an amusing twist to the situation in [Germany](#), another arm of the Peter Dohle group is teaming up with packager HCI Capital to launch the HCI Shipping Opportunity fund. The stated mission of the newly formed vehicle will be to acquire vessel assets - not limited to the container sector - at attractive prices. Media reports have suggested an initial equity level of EUR20 million for the venture.

Appraisers report that another similarity has emerged across the modes: requests to value entire portfolios rather than individual vessels or aircraft. Neither mode has yet seen wholesale dispositions of entire asset holdings, but signs are pointing in that direction. Karatzas said: "We are now seeing requests from banks to value an owner's entire fleet rather than just one vessel for loan/value purposes," a statement that echoes a comment from [Klein](#) in describing "work we are doing for a big leasing outfit, valuing their portfolio". [Klein](#) also described differences from previous cycles: "This time, there is less of a willingness to drop to rock-bottom prices. Unlike a severe downturn that we had in the early 1990s, this time we are not seeing panicked sellers dumping planes onto the market."

Such thinking is consistent with the maritime mode - so far.

What makes an asset market dysfunctional?

The Hamburg Shipbrokers Association (HSA) has made an effort to define what constitutes a dysfunctional market.

- a) An uncharacteristically low number of sales candidates in comparison to the overall fleet with one category of vessel over a period of at least three months means that there is a severe imbalance between willing sellers and willing buyers.
- b) Transactions in which either seller or buyer are knowingly under time pressure, constraint or in urgent need to conclude a deal driven by personal or corporate distress. Prices do not reflect vessel characteristics.
- c) A difference of 30 per cent or more between current transaction prices and long-term asset value (LTAV) lasting for at least three months.
- d) An uncharacteristically low number of market participants, based on total number of parties within a market over a three-month period.
- e) Absence of essential, regular market conditions, such as the unavailability of debt financing for a large number of market participants.

How to appraise an aircraft

Jane's asked Fred Beardon, CEO of California-based consultancy Aircraft Information Services, about the finer points of appraising aircraft.

"We calculate the average sale transaction value of like aircraft and adjust for these differences. We calculate the present value of the lease stream and future value of every similar lease transaction and again adjust for differences.

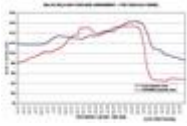
"We compare the value in a theoretical average market, called the 'base value' to the market value in the actual market, called the 'current market value' to assess market conditions. We compare transaction values of substantially differing aircraft using 'should be more than, should be less than' logic.

"We adjust transaction values for multiple aircraft because all accepted industry value definitions are for single aircraft, no hidden asset or liability, willing and knowledgeable buyer and seller, cash transaction, while most of our transaction data involves multiple aircraft.

"In a nutshell, a good appraiser uses every tool at his disposal and every scrap of information to narrow the range of probable values as much as possible.

The process is never-ending. We have developed means to account for more or less utilisation than average for actual conditions differing from the theoretical half-life condition, where every variable element is assumed to be precisely at a point that is one-half of its life or overhaul period.

"Future appraisals appear to be heading in a direction that puts more emphasis on future values so we are concentrating our efforts to improve our forecasting abilities."



Baltic Exchange: 1357357



Peter Dohle Schiffahrts-KG is reported to have more than two dozen vessels chartered to struggling Chilean containership line CSAV, which operates ships including the Rio Petrohue (seen here in its Safmarine Kei days). Ian Shiffman: 1167335