



Are the world's bankers right to let US business just sail away?

THERE have been almost no loan-to-value breaches among Jones Act borrowers. Yet international lenders — never big fans of bankrolling overpriced US-built ships — have now deserted the Jones Act scene even more completely.

These minor snapshots depict the big picture of Jones Act lending, and how this niche market fits within the tattered tapestry of global ship finance.

There is much confusion, or even an abject lack of knowledge, about the Jones Act market. Even reputable international bankers have been heard to express reservations about venturing into this space.

The biggest question remains whether the Jones Act itself would survive. Under President George W. Bush, the possibility of it being repealed frightened quite a few people — even though Mr Bush's actions always belied such fear mongering.

With President Barack Obama now in power, and his avowed support to — and from — trade unions, this danger is said to have receded.

Against this backdrop, is it worth an international banker's time to view the Jones Act market as a business prospect?

Interviews with a cross-section of experts indicated that the answer is far from simple.

The Jones Act requires that ships that ply cabotage trades be US-built and US-flagged, and operated and controlled by US citizens.

For reasons related to economics and politics, US-built ships cost much more than similar models produced in Asia.

A medium-range product tanker, for example, would cost \$100m to build in America, when South Korea might manage it for \$40m and China potentially less.

Assuming a 75% loan ratio, a typical bank loan against such an asset would run to \$75m.

The banker would wonder whether, in the event of a default, it was a wise move to advance \$75m on a ship that would fetch no more than, say, \$30m in the global secondhand market.

Traditionally, European banks such as DnB Nor, Fortis and DVB have had at least token exposure in the Jones Act market. Most of these banks are now said to have curtailed, if not abandoned, their activity in this space.

Joseph Markey, managing director of transport and logistics at KeyBanc Capital Markets, said fears over increased defaults, already ingrained in foreign bankers' minds, have come to a head in the recession, and practically all foreign banks have abandoned Jones Act lending as a result.

"It is understandable if a banker with a \$75m loan on a \$100m ship sees the asset as under water even before a default, because of its international resale value," Mr Markey said.

For KeyBanc, with 90% of its modest ship lending portfolio of \$500m comprising Jones Act loans, this mass desertion is good news, in that it reduces competition.

However, Mr Markey leads a chorus of industry experts who say fears over underwater Jones Act loans are massively overblown.

A major reason why Jones Act lending must be seen in a different light is the fact that this market has far fewer headaches when it comes to an oversupply of ships, partially because of the high cost of building them domestically.

The Jones Act market could be the safest haven for traumatised international lenders looking for reliable borrowers right now. Yet this group is least likely to enter this space. **Rajesh Joshi** reports

In the case of tankers and tank barges, the Oil Pollution Act 1990 phase-outs of single-hulled ships, which kick off in 2011, have added another dimension to the ship supply-demand equation.

US charterers of tankers, i.e. oil majors, are also supportive of Jones Act companies whose ships they charter in, Mr Markey believes.

Downward pressure on Jones Act charter rates "is happening", he said. Still, Jones Act charter renewals are faring far better than the complete collapse seen in renewals in international sectors. This has helped asset values remain much more stable than in the overall world fleet.

"Time charter cover provides a reliable indication of cash flows, and since most of our charter renewals have come in at similar levels to the expiring charters, we have reasonable confidence that the ships against which we have lent have not lost much, if any, of their value," Mr Markey said.

Basil Karatzas, managing director for projects and finance at Compass Maritime, said that that even in the absence of an active sale and purchase market, Jones Act ships provide "a better handle" for valuation purposes. Jones Act asset values also tend to fluctuate much less than ships in international trade.

"It is true that a new MR tanker would cost about \$100m to build in America and \$40m in South Korea,"

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Brett Esber
Ship finance attorney
with Blank Rome

Mr Karatzas said. "However, over a 10-year window, the Asian-built ship even as a secondhand asset could see a price as high as \$60m and as low as \$10m.

"The Jones Act ship, on the other hand, is not likely to go to \$150m, nor will we see it at \$50m. Without pinpointing a range, it is safe to say it will remain stable in value."

Compass, one of the few shipbrokers left today that still provide valuation services, has represented Jones Act interests in product tankers built in shipyards in Philadelphia and California.

Brett Esber, senior Washington-based shipfinance attorney with law firm Blank Rome, said that there was a "symbiotic partnership" between US-based charterers and shipowners, which kept charter rates and hence ship values more stable.

"In the Jones Act there are fewer players and a greater appreciation of the need for both owner and charterer to benefit from the commercial relationship. This perspective is often missing in the international market," he said.

Nonetheless, Mr Markey, Mr Karatzas and Mr Esber all stressed that this so-called "stability" in the Jones Act market only goes so far.

Mr Esber pointed to the massive amount of tonnage laid up in the Jones Act product and crude oil transport trades, and the drastic decline in the spot market.

This environment has contributed to the demise of the venerable US Shipping Partners, which today is fighting its way out of Chapter 11 protection. Companies such as OSG America are suffering too, with ships laid up and revenues and profits badly affected. Mr Karatzas added that articulated tug-barges, which are economical alternatives to product tankers because of smaller crews, have not escaped the downturn either.

"The recession has slowed business for every sector, whether tankers or ATBs," Mr Karatzas said.

He said operating expenses are an important element in Jones Act trading, as these remain the same even in a recession.

"A typical Jones Act product tanker has daily operating expenditure of about \$20,000, versus \$6,000 for a typical modern foreign counterpart," he said. "Under these circumstances, even a modest decline in charter hire would have a bigger impact on the US company."

Mr Markey said KeyBanc clients with a larger proportion of their fleet on the spot market, or larger fleets of single-hulled ships, have been more vulnerable to market vagaries.

"Clearly, a company's philosophy — whether it believes in reliable long-term charter coverage or relies more on the spot market upside — makes a dif-

ference in a downturn," Mr Markey said. "Our clients' performance and ability to service their loans follow a spectrum that closely reflects these realities."

Still, Mr Markey said asset values and charter rates have held up so well among the bank's Jones Act borrowers that KeyBanc has not had a single loan-to-value default this year.

The bank has had to repossess only one ship — which was promptly scrapped — but this involved an international flag operation.

Mr Esber, who in his capacity as ship finance lawyer helps shipowners agree loan terms with banks, said that there were practically no loan-to-value defaults in the Jones Act.

However, he said another reason for this might be that in the heady days of 2002-2007, when the sky seemed the limit, many loans were agreed without a loan-to-value clause at all.

Jones Act banks now have started insisting on such a clause in loans that come up for refinancing, or in new loans on the table, Mr Esber said.

Despite such technicalities, if all experts agree that the Jones Act market is a more stable environment for doing business, a double-headed question arises. Are foreign banks reluctant to dabble in this market right now missing a brilliant counter-intuitive opportunity? Conversely, would lenders such as KeyBanc, with loan capacity to spare and a very good reputation, try to exploit cash-starved foreign markets to maximise their interest income with relatively low risk?

The answer to both questions is no. Mr Esber had the best explanation among all three commentators. "It is a question of knowing your sweet spot and sticking with it," he said.

Mr Markey said: "For a small Midwestern boutique investment bank headquartered in Cleveland, Ohio, the prospect of looking to foreign markets is not very appealing."

"We want to remain focused on an area where we can be meaningful. We have a good portfolio of borrowers, and are very happy with our disciplined approach of targeting the middle market of predominantly private shipowners who are not big enough for public markets and who do not want to go public, yet who have solid ambition to grow their business and need financial backing for that purpose."

Mr Karatzas added: "For a US bank, the very fact that it knows that its collateral asset is floating somewhere within the country, and can be repossessed in a generally predictable manner, is a big plus."

"They certainly do not want to be chasing their ship around the world, not when the world itself is in recession. Also, the debtor, by definition, is a US-based entity, which simplifies legal matters."

Mr Esber provided the counter-point: "For a foreign lender, the fear is always there that the Jones Act might be done away with suddenly. I personally do not believe this is going to happen — I think the Jones Act is here to stay — but we are dealing with market psychology here."

The Jones Act market is, in theory, a much safer haven for the more wary international lender, while cash-rich Jones Act lenders could make a killing if they decide to diversify into international lending.

However, to paraphrase Kipling, when it comes to lending to shipowners, America is America and the world is the world, and never the twain shall meet.