PRIVATE EQUITY FIRMS IN THE SHIPPING SPACE:

A LOOK BACK AND FORWARD

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Over ten years ago now, the global financial crisis hit the shipping sector particularly hard, beginning in 2008. The financial crisis produced a slowdown in overall world economic activity and trade, causing vessel earnings to fall precipitously in many cases as a result. At the same time, problems within the global banking sector, where the crisis originated, severely constrained the availability of vessel financing sources. Falling revenues and constrained liquidity financing caused severe disruptions for many shipping companies. These conditions, in turn, led to significant changes in the way shipping companies raise capital, finance their activities, and even the composition of their investors. In many ways, the impacts from the downturn have not yet run their full course.

Now, the global Covid 19 pandemic and continuing concerns about global trade tensions raise the prospect that the shipping sector again faces a likely, but at present uncertain, slowdown in overall world economic activity and trade. In assessing the potential fallout from these new developments, many industry participants are seeking to draw parallels and distinctions from how the industry developed out of the 2008 financial crisis. While such analysis is likely to produce useful insights to guide predictions about future trends, it will be important to keep in mind the changes that have already taken place in the industry.

One difference to consider is the potential impact private equity fund sponsors and other asset managers (PE Firms) who have invested heavily in the space over the last decade still have. The early years following the global financial crisis saw a significant increase in PE Firms investing capital in the shipping industry through both debt and equity investments. As the market potentially enters a new downturn, understanding the way PE Firms operate and how their incentives are structured will be helpful in assessing how these relatively new participants in the space will respond to another disruption.

The typical PE Firm raises capital through one or more co-mingled investment vehicles or funds. The PE Firm and its third-party investors, typically pensions and other institutional investors, would each have commitments to make capital contributions to the fund in specified maximum amounts. These capital commitments remain available for drawdown by the PE Firm over investment periods generally ranging from 3 to 7 years. Investors make their capital contributions to the funds from time to time, usually on an as-needed basis rather than upfront. After the investment period, any unutilized capital commitments would typically no longer be available for further new investments, although they often are available to support existing investments. After the investment period ends, the PE Firm seeks to exit the fund investments profitably over several more years. Importantly, investors have no rights to get their capital back until the fund exits its investments which provides a firm secure capital base. Funds may have investment mandates focused on debt or equity, or have broad flexibility to invest in both. Some funds focus on particular sectors such as shipping, or even particular sub-sectors such as dry bulk, while others have the ability to invest in any sectors and sub-sectors.

The PE Firm sponsoring a fund will have sole responsibility for identifying and evaluating investments, monitoring investments, and pursuing sales or other exit strategies. In return for its services, the PE Firm is paid a management fee by the fund, and would ordinarily receive a share (typically 20%) of the profits (the "carried interest") generated for the investors through a "waterfall" mechanism.

Essentially, in the common structure, the PE Firm keeps 20% of every dollar generated after investors have gotten their invested capital back and minimum return. The structure is designed to allow the PE Firm to make higher risk, long-term investments without having the pressure to return capital at investor demand. The carried interest provides the PE Firm a strong incentive to generate returns and minimize losses.

Coming out of the financial crisis, many of these PE Firms became interested in pursuing investments in the shipping sector, both on the equity side by acquiring vessels and vessel owning companies, and on the debt side by financing vessel owners and operators. While the precise investment theses varied, at a high level, the PE Firms concluded that, despite the market dislocations at the time, key fundamental growth drivers of the shipping sector would continue to fuel demand for seaborne transportation going forward. At the same time, they believed that traditional investors in the space would be unwilling or unable to return to new investment activity quickly due to weak balance sheets, aging fleets, and other legacy issues from the crisis. As a result, they believed there were excellent opportunities to acquire vessels or vessel owning companies that would provide attractive current income to investors, with the possibility of obtaining additional gains upon the ultimate liquidation of the underlying investment program.

On the finance side, PE Firms sought to fill the gap as historical sources of capital to the maritime sector such as banks reduced their capacity for exposure to the industry due to, among other factors, capital restrictions and new regulations (e.g., Basel III and IV). As some traditional financing sources reduced their activity and others exited the market entirely, PE Firms began increasingly to set up funds able to invest in a variety of maritime financing transactions such as sale-leaseback arrangements, first lien loans, second lien loans, revolving credit agreements, and other similar structures backed by vessels. These PE Firms often focused on the financing side, focusing mainly on financing privately owned, small-to-middle market companies in the maritime sector that were most hurt by the pull back of traditional lenders.

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While individual PE Firms generated varying results, it is fair to say that in many — and probably most — cases, the shipping investments made by PE Firms on the equity side have not gone entirely as planned. The long, slow recovery of the world economy over the last decade plus, and perhaps the excess of capital flowing into the space itself, among other factors, have prevented the strong rebound in the shipping space on which many of these PE Firms based their investment assumptions. As a result, even before the impact of Covid 19, it was these PE firms themselves now holding underperforming investments, many of them made during the period from 2011 through 2015 when PE Firms were particularly aggressive in moving into the space. Decisions made by these PE Firms will likely have a significant impact on how the maritime industry develops as it seeks to move past the Covid 19 disruptions.

Taking a look at these dynamics, it is possible to make several conjectures about how PE Firms will likely respond to current crisis.

As noted above, PE Firms make their investments using capital commitments made by investors to funds that have a relatively long life, typically in the 10 to 12 year range. As noted, investors cannot demand their capital back during the fund's life, which typically means that PE Firms have "patient" capital, and managers are not forced to liquidate investments and return capital to investors until a fund's stated life comes to an end. Further, many PE Firms still have substantial uncalled capital commitments available in many of these vehicles, and typically don't have long-term borrowings of their own to worry about repaying. Further, during the last financial crisis, PE Firms experienced few instances where their own investors defaulted on their commitments to contribute capital. Taken together, these structural features suggest that, where a manager sees the potential to ride out the current disruptions and ultimately make a profit on a troubled investment (and potential carried interest or at least minimize losses), he will often have the ability from both a duration of capital and liquidity perspective to finance their assets and wait for that turnaround. Similarly, on the finance side, these same factors often will allow PE Firms to work with their counterparties in times of distress in ways that a bank could not. Regulatory requirements, such as mark to market accounting, and related reserve requirements, often prohibit or disincentivize banks from continuing to hold troubled assets or extend further credit. PE Firms do not face these regulatory concerns, and the economic incentives for PE Firms, including crucially the carried interest, are based on the ultimate realized value on their assets and generally not interim mark-to-market valuations. These factors produce a strong incentive for PE Firms to take a close look at their assets and counterparties, so that they can separate out those investments and borrowers that are truly troubled and unlikely to survive from those that are facing liquidity issues brought on by pandemic. These incentives can differ markedly from those of banks, for instance, which often have regulatory and other incentives to clear distressed assets from their books quickly.

Over the last 2 to 3 months, we have seen this play out in several cases. Our firm has worked with several clients to restructure investments and raise additional equity capital from their existing PE Firm investors to shore up their balance sheets for the expected downturn. The PE Firms believed that, given time, these companies ultimately will be able to overcome the current dislocations and their structures allowed them to act accordingly.

While the full impact of lost revenues associated with the Covid 19 pandemic remains to be seen, we are also seeing finance-focused PE Firms begin to plan for distress among their counterparties. We are starting to see PE Firms taking a proactive approach. PE Firms with finance investments are beginning to review their finance transactions, and are anticipating an expected wave of defaults. Among the steps already being taken are: reviewing transaction documents for all outstanding financings, including assessment of covenants and remedies; checking-in with relevant counterparties and updating reporting information from them; conducting comprehensive collateral package reviews for each of their borrowers to update values and otherwise assess the collateral package; locating and tracking vessels serving as collateral and assessing their physical condition where possible; and reviewing technical requirements (legal filings, notices and statements etc.) required to perfect any security interests in the collateral. Through these reviews, the PE Firms are again seeking to identify which of their assets are likely to continue to perform, which are expected to struggle but are salvageable, and which ones are likely to produce losses or perhaps be written-off. At this stage, most PE Firms we've spoken to are focused on doing their homework and preparing to respond with flexibility on an asset-by-asset basis, rather than automatically seeking to press all of their available remedies against a distressed counterparty. In some cases, negotiations have already begun around things like term extensions, covenant waivers or modifications, payment holidays and similar remedial measures.

In summary, because the typical structure provides PE Firms with locked-in capital and, in many cases, callable financing from their own institutional investors, many firms will have the ability to support otherwise viable investments through periods of disruption. Further, the carried interest structure, combined with the often-significant exposure the PE Firm's management has to the funds they manage, provides a strong incentive for the PE Firms to take a flexible approach to their troubled investments on an asset-by-asset basis in an effort to preserve and enhance value where they can.

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