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The bitter medicine shipping must swallow

Changing management and dismantling outdated strategies is what is required if shipping is to recover

THE decline in freight rates from the dizzy heights of five years ago means many shipping companies are running at daily losses once operating expenses, overheads and debt service are taken into account. Worse, the values of ships have tumbled and yet still are not accurately reflected in most corporate balance sheets.

The solutions: changes at the top, aggressive moves against corporate overheads and reductions in fleet sizes.

The original rush by shipowners to the public markets came at the start of this century as the industry sailed out of the doldrums of the 1990s, blown by China's insatiable appetite for cargoes of all types that caused a shortfall in available space and a rush to shipyards to order new ships.

An abundance of demand met an expanding supply of risk capital looking for a home. It was newly formed companies, not the more established ones that would benefit the most.

Wall Street rose to the occasion, despite having been burned by shipping junk bonds a few years earlier. A rash of initial public offerings arrived. Share prices of these new companies rose rapidly as the freight markets soared on a dearth of available tonnage to meet primarily China's appetite for raw materials.

The dry cargo companies reaped this upswing best, despite historically being seen as a little dull. Building and operating a dry bulk ship was easier than a tanker and there were plenty of charterers, both primary and intermediate, ready to take on the new vessels.

The public markets responded with secondary offerings and other new companies in tankers, containers, gas ships and even tweendeckers emerged into the public arena.

Banks encouraged owners to go public and supported them with increasing amounts of debt and funded large orders for new ships. Established public companies rode the euphoria, enlarging their fleets and building large corporate structures.

Out of the public eye, the large private companies also climbed on the bandwagon by ordering new ships in batches with options, some from yards that did not yet exist. By the end of 2006, the industry had the largest orderbook in its history and all to deliver by the end of the decade.

The public markets had provided billions of dollars of new money for the industry and loosened the banks' purse strings to add billions more to both the private and public companies' spending capabilities.

Private placements of equity also emerged with hedge funds and some private equity funds joining the game and funding shipping ventures around the world without the onus of having to report publicly. Some investment banks even bought their own fleets as hedges against their commodity trading.

Ship prices rose dramatically on the back of huge orders and reached a point in 2008 that could only be supported if the extraordinary freight rates of the previous couple of years were sustained throughout the ships' lives.

It was a classic bubble that no one wanted to recognise and like all bubbles it collapsed faster than it inflated.

China's slow down, charterers' reaction to excessive freight rates and finally the global recession and the collapse of the global banking system all contributed to the crash of the shipping markets.

Nowhere was this more obvious than in the publicly quoted shipping companies whose market values disintegrated. The private companies faced all the same issues but they were mostly hidden from the eyes of the public.

OSG had dreamed of being the first to boast of a $100 shipping share in mid-2007 when its shares peaked at $90, only to be overtaken by upstart DryShips whose shares hit $123 in late 2007. Since then OSG's market value has declined by 70% to $2bn and DryShips by 66% to $1.8bn.

In search of a rescue remedy: DryShips, OSG, Seanergy and TBS are just some of the companies that have taken strain in the past few years. *Shutterstock*

"Selling ships that are draining cash flow and focusing on maintaining and operating reduced numbers of ships is vital for survival"

Most of the public dry and wet bulk companies such as Omega, TOP Ships, Seanergy and NewLead have seen their values crash and some have reached such low levels that they no longer are relevant indicators of shipping market values. Even at those levels they are still overvalued and will struggle to survive if markets remain as they are.

They are unable to attract further equity capital unless provided by the original sponsors or management, as in the case of TBS International, and are equally unable to raise any more debt even from the junk-bond markets.

Many of the medium-sized companies such as Seanergy, DHT, Global Ship Lease and OceanFreight are too seriously undercapitalised to have any growth potential and will struggle to survive as their cash reserves drain away with charter income barely covering expenses and funds being borrowed to pay dividends.

Even the new entries of last year — Baltic, Crude and Scorpio — have fallen sharply from their issue prices and the Tsakos-sponsored Tsakos Energy Navigation is trading below $10 down from a high of $38. Why does it remain public?

The expenses of quarterly filing and meeting Sarbanes-Oxley requirements are a constant drain of cash and many public shipping companies should seriously consider delisting.

Even the largest public companies, such as OSG and Teekay, have had to undergo major financial restructuring, seriously diminishing their so-called war chests but not their excessive overheads. They'll have to continue to resort to rights issues or other secondary offerings of equity to get through the next three years.

The fact that many of these companies are managed by the original sponsors is the main reason why there have been no significant management changes and the shareholders seem reluctant to force any.

In other industries facing such a destruction of values, there would have been takeovers, mergers and wholesale management changes. For the reason expressed above and the banks' reluctance to force change, this has not happened in shipping despite an underlying fear that there is worse to come.

Freight markets will not rebound to the dizzy heights of five years ago and the values of most of the new ships that have been delivered since then will have to be sharply written down, which will further reduce equity values.

If the present markets continue through 2011 auditors will be forced to assume permanent impairment of asset values, causing equity values to completely disappear and widespread debt defaults as loan to value covenants are breached.

It is these facts, among others, that help to explain why Lloyds Bank has been unable to sell off its shipping loan portfolio, as reported by Lloyd's List some two weeks back. In fact, we have not seen any bank's shipping loan portfolio sold off, and the banks are being forced to provide greater risk analysis and more cash reserves to cover these risks.

The challenge for all shipowners today is how to exit from uneconomic businesses and reduce their exposure to further losses, until the markets show permanent signs of recovery.

Management and the banks need to be reminded that they are dealing with public companies and issues of fiscal responsibility, asset transfers without shareholder approval and payments to related parties all loom large.

Shareholder lawsuits are beginning to emerge — witness the deal late last year that saw American Commercial Lines bought out by Platinum Equity — and the auditors will increase their concerns over financial statements they are asked to sign off on.

Changing management and dismantling outdated strategies along with drastically reducing overheads are the medicines for recovery. Selling ships that are draining cash flow and focusing on maintaining and operating reduced numbers of ships is vital for survival.

This may not appeal to the companies that pay large management fees and commissions to their private sponsors but perhaps leaving these funds in the company would certainly improve the picture. ■

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