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MarineNews

ISSN#1087-3864 USPS#013-952
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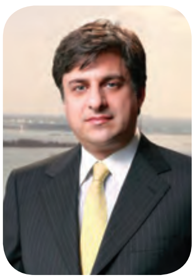
POSTMASTER: Send address changes to ***MarineNews***, 850 Montauk Hwy. #867 Bayport, NY 11705.
MarineNews is published monthly by Maritime Activity Reports Inc. Periodicals Postage paid at New York, NY and additional mailing offices.

Lending & Financial Markets

A new seascape for domestic owners & a new course line for brown water credit.

Basil M Karatzas, CEO of Karatzas Marine Advisors & Co.



U.S.-based institutional investors have raised more than $750 billion in committed funding and have been looking for investment opportunities in several industries. Likewise, in an environment of exceptionally very low interest rates, U.S. lenders are hard at work seeking for good opportunities to lend to. Seven years after the collapse of Lehman Brothers, it seems that the financial world has come to a full circle, and liquidity and access to capital is plentiful and competitively priced.

It would seem that for many small businesses in industries that are capital intensive, like, for example, 'brown water' shipping asset owners and operators, these are the times to feel robust, strong and swimming in money. With each passing day, the story of shale oil reaches deeper into national conscience that it's a solid opportunity for the long term, despite the growing pains, and companies in the domestic shipping business and inland transport / 'brown water' would be exploiting the plentifully available capital to expand their fleets and their businesses.

Sea Change

Unlike the international water transportation industry that has experienced a sea change of epic proportions (first, by having the industry proxy index Baltic Dry Index (BDI) dropping from 13,000 in May 2008 to below 1,000 points by the December of that year and presently only around the 1,200 mark, and also the international shipping banks 'abandoning' the industry since then), the domestic shipping industry only experienced mostly seasonal variations. The shock of the financial crisis in 2008 was softened domestically by several factors, including the statutory privileges of the Jones Act nature of the business, and the providentially well-timed discovery of shale oil helped to a more expedient recovery. It would thus appear that domestic owners came out of the crisis rather unscathed and in ship-shape form to benefit from the availability of capital.

If only the markets were so easy to benefit from!

Talking to investors and lenders, on the other hand, one gets a diametrically opposite assessment of the market; lenders, and financiers in general, see a highly fragmented market, a market dominated by local, family-owned companies with little competitive advantage in terms of market expertise, critical mass, and strong ambition to get on a national level, or even 'do things different' in the new, different market environment. And, indeed, it's a different market environment: the events that followed post-Lehman typically made big financial players bigger (that is, for those who survived the shock of the crisis), diluted market expertise and loosened up client relationships, while, on the other hand, increased regulation and hurdles for providing financing, and the boxes to be checked for any transaction.

Super-banks such as Bank of America, Wells Fargo and J.P. Morgan got to absorb several of the smaller players, some of which had exposure to domestic shipping and 'brown water' industry. 'Too big to fail' offered them the implicit assistance of the government as systemic institutions; however, the monstrous balance sheets now can afford opportunities only big national players who have the capacity to seek financing to the tune of $100 mil or more at a time. Again, when a super-bank's balance sheet can now exceed a trillion, deals have to be of certain size in order to move the needle, as they say, which automatically excludes many qualified borrowers who lack scale.

National banks and banks at a local level may have not received all the benefits of the super-banks, but in general, they were found with larger balance sheets and lower cost if funding after the crisis as well, but also higher hurdles of doing business. Larger balance sheets may imply higher number of transactions, but often lead to a need for larger-sized transactions. Thus, their target market of local borrowers has had to be upped in size. Documentation and due diligence for transactions in the new order of things became of paramount importance, which leads to a higher cost for originating and administering transactions; since such costs are typically 'fixed' with minimized incremental cost for the size of the transaction, even for smaller banks, size of a transaction has come to matter.

There are the so-called ‘Five C’s of Lending’:

Credit (ability to repay), Capital (amount borrowed), Collateral (quality of mortgaged asset), Character (track record) and Conditions (covenants). **These Five C’s have always been crucial, and the changing market conditions at present don’t erase any of them.** Instead, it merely shifts the relative weighting during the financing process.

New Normal

Higher documentation and due diligence hurdles also have meant that much of the information has to be in black-and-white, tangible and quantifiable, for origination purposes to begin with, but also, for auditing and second-guessing purposes, as well. The process is now more ‘transparent,’ at least as far as ‘optics’ are concerned, and the element of ‘relationship lending’ where a handshake and personal verbal promise to repay have moved lower on the totem pole of importance for receiving credit. As the process has become more quantifiable, with a grading system favoring certain types of transactions in terms of credit and size, the subjective element and personal relationship have been relegated a couple of notches lower.

Higher documentation and due diligence hurdles also have meant that preparation and access to the borrowers financials become imperative. Access to borrowers’ financials has been a typical prerequisite to lending, but now dependence on the ‘numbers’ becomes ever more crucial, with lesser personal discretion to work around the numbers. Also, bigger banks and higher standards have meant that lenders are now satisfied with purely accounting reports, but they want to see ‘vision’ and strategy, through a business plan or other proof for desire to grow with the market.

It’s not only how good the numbers are, but also financiers are asking themselves the question on whether they are financing a ‘winning horse’ player in the market; after all, financing two more tug boats or ten tank-barges requires the same effort whether for mom-and-pop-TX or mom-and-pop-LA, but the differentiating factor will be which company has a better plan to be a strategic player over time, to have stronger resources to withstand any market headwinds, and ultimately, that they will be players in the market when the loan matures and bring repeat business to the financiers (again, repeat business means lower costs to originate and administer financing, providing high probability of growth.)

Drivers

Zooming out and trying to see the domestic sea-transport industry from 10,000 feet, one can see that coal becomes less important source of energy domestically and globally (for whatever reasons, right or wrong) while shale oil and natural gas have been substituting it in the energy markets. As with the international tanker market, transport of oil and gas is a much more concentrated industry in terms of asset ownership, terminal and charterers, and also segment of the industry held to higher operating and regulatory standards.

For shipping asset owners and operators in the ‘brown water’ industry, in order to be successful, at least in the eyes of the financiers, they have to demonstrate that they operate on the ‘right side of the history,’ with larger, modern fleets that have critical mass and can offer full shipping solutions to the larger charterers. And these larger charterers are getting larger and more sophisticated themselves, even to the extent that they are large, well-established, institutional clients like the ever-more-active in the Jones Act market Kinder Morgan as a provider of transport solutions to their energy clients.

There are ‘fads’ and ‘trends’ in all industries all the time, and right now the ‘brown water’ industry faces a changing seascape brought onto them by structural factors but also variables in other industries, such as in the financial and banking industry. We are of the opinion that the present changes in the industry are more than just a ‘fad’ and require the attention of the owners and operators who would like to position their companies favorably in order to benefit from the new order of things. And, for such a capital industry, positioning favorably for the future requires competitive access to capital.

There is more than sufficient amount of capital at present looking for opportunities to get deployed, but such capital has only been prepared to be invested for the right opportunities, mostly for owners who can demonstrate that they have or prepared to have critical mass, can gear up to higher corporate levels than small family business. The vast majority of the 'brown water' players, despite their small size and local present, are great companies and they represent the backbone of industry.

The call for change doesn't not mean that these family business have been doing anything wrong; just that the nature of the 'scorecard' has been changing as these changes are reflected from the financial industry, and shale oil's 'game changer' nature.

Fundamentals

Some things never change. There are the so-called 'Five C's of Lending': Credit (ability to repay), Capital (amount borrowed), Collateral (quality of mortgaged asset), Character (track record) and Conditions (covenants).

These Five C's have always been crucial, and the changing market conditions at present don't erase any of them. Instead, it merely shifts the relative weighting during the financing process.

While 'Capital' has increased in availability, 'Credit' has become contingent on benefiting from the market rather than depending on 'Collateral' alone, while 'Character' and 'Conditions' have become more bureaucratic in nature. For successful companies, there is a clear need to be better prepared, advised and keen to think 'outside the box'.

KARATZAS MARINE ADVISORS & Co.

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