UPGRADES+DOWNGRADES

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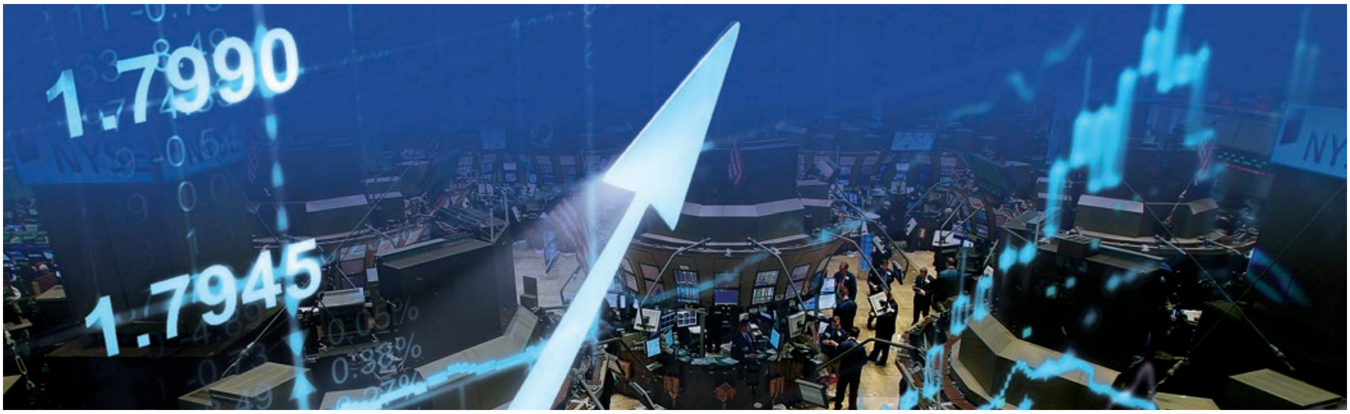

Can Private Equity Save Shipping?

Back at the turn of the century I was working for an offshore company that was coming out of Chapter 11. The new owners were private equity investors. They had gobbled up the debt of the "old" (pre-Chapter 11) company at thirty cents on the dollar and exchanged it for equity in the "new" (post-Chapter 11) company. They installed new management but generally adopted a "hands off" policy when it came to operating decisions. Five years later they sold the company to a bigger rival and walked away with a handsome profit. So did the company's shareholders. Employees benefited too. They were now employed by a firm that was bigger, better financed, and more secure. And no one, except a few members of senior management, lost their jobs.

The moral of the story? There are two, really. First is that private equity investing in shipping is not new – it's been going on for at least a dozen years and maybe more. Only it's gotten a lot more common and visible and important lately. And second is that not all PE investors are Gordon Gekkos. Sometimes deals work out the way they're supposed to – without mass layoffs and unnecessary pain and suffering and benefitting employees and shareholders alike. That's what happened in my case. But not always.

THE BOOM IN PE

Last year alone more than $3 billion was invested in shipping assets by PE firms, and more than $4 billion has been invested over the last three years. According to Basil Karatzas, a ship finance advisor and CEO of Karatzas Marine Advisors, that's just the tip of the iceberg: "We are still in the early stages of PE's attention to initiating investments in the shipping industry. Right now shipping presents compelling investment opportunities because asset values at today's prices are competitive from an historical point of view and certain pockets of private equity are prepared to take the longer view of the market without requiring an annual cash yield." Karatzas says he is aware of an additional $4 billion in committed capital that is earmarked for investment in shipping in the not-too-distant future.

He is not alone in his thinking. Peter Shaerf, Managing Director of AMA Capital, a ship finance and advisory firm, says "Purchasing opportunities have never been better." He points out that "It's tough to make money just from operating vessels," and that the real money in shipping is made from the buying and selling of vessels. Echoing the late Gus Levy, the legendary Goldman Sachs' senior partner, he adds that "An asset well bought is already half sold," and

The influx of funds over the last two years has been nothing short of phenomenal. Can it last?

– as we all know – PE investors don't like to hold their assets for more than five years or so, and selling is always on their mind.

Why all the fuss? Simple. Shipping has been in a funk since 2008. Except for a few niche sectors – offshore and LNG come to mind – freight rates on most major routes are at or below cash breakeven levels. There's a glut of vessels everywhere you look, and more newbuildings to come, so the markets aren't going to get better anytime soon. Maritime bankruptcies are becoming more and more common. And fewer and fewer banks are making shipping loans as the Great Recession drove a number of them out of the business entirely and forced others to cut back sharply. So what's a poor shipping company to do if it needs funding?

SEEKING CAPITAL

John Cartner, Managing Member of Cartner & Fiske, a practice focusing on maritime law, says that "The IPO market has dried up, and one must be creative and know where relationships are in order to find money and get it as inexpensively as possible." This is particularly true for small, private companies. The big public players are not impacted as much, although one need look no further than Genmar and OSG to see that they're not immune to the economy either.

Cartner says that the U.S. effectively owns the second largest fleet in the world after the Greeks and that it's headquartered in Greenwich, CT. He means PE investors, of course, as well as banks, and he explains that it's not U.S.-flagged but sails under other registries and mainly that of the Marshall Islands, a near-captive flag of the U.S.

Why would a shipping company want money anyway? Lots of reasons. To fund expansion, for one, although in today's environment that's not likely. More likely is the need to service its debt, and here's where PE can come in handy in exchange for a piece of the action. Examples are abundant, a recent one being Anchorage Capital's 38 percent stake in DHT Holdings (the former Double Hull Tankers) in exchange for a much-needed cash infusion.

Speculation abounds that the Anchorage investment could turn into another Oaktree Capital/Genmar home run. You remember that one, don't you? As Genmar's fortunes fell last year along with the tanker market, Oaktree invested $200 million to prop it up, but it wasn't enough and Genmar filed for Chapter 11 anyway in November 2011. Then Oaktree added another $175 million to enable Genmar to exit bankruptcy this past May and now is the proud owner of 98 percent of the company, whose prospects are much brighter as a result of the restructuring. It's a formula that has been proven in countless other industries.

"GOING CONCERN" VS. "GRAVE DANCING"

There are at least two different varieties of PE investment. The first is the "going concern" approach, which invests because the target company has excellent prospects, is well managed, and is privately held or part of a public company. Examples include The Jordan Co.'s purchase of Louisiana-based Harvey Gulf in 2008. Harvey Gulf was family-owned and operated one of the largest and newest deepwater fleets in the Gulf of Mexico. Its vessels were high-spec and commanded premium day rates in the fastest growing segment of the offshore market. That investment is still paying dividends.

Another is J. F. Lehman & Co.'s purchase of a portion of Seacor Environmental Services earlier this year. The firm, founded by former Secretary of the Navy John F. Lehman, is no stranger to maritime investments. Among its previous holdings were Sperry Marine, Hawaii Superferry and Atlantic Marine shipyards, and it currently owns Drew Marine, a well-known supplier of water and fuel treatment systems and fire, safety and rescue products.

Far more common, however, is the "vulture" or, to use my friend Basil Karatzas's phrase, "grave dancing" approach. With many marine assets priced at or near salvage value, they present a golden opportunity for PE investors to pounce. And pounce they have. Among the big names with investments in shipping are Apollo Global Management, the Blackstone Group, the Carlyle Group, and W. L. Ross & Co., run by the billionaire turnaround expert Wilbur Ross.

Last year Ross teamed up with former OMI Corp. CEO Craig Stevenson and six other investors to form Diamond S Shipping, which promptly purchased 30 product tankers for $900 million from Hong Kong-based Cido Tanker Holding Co. Two months ago he purchased a 34 percent stake in gas tanker operator Navigator Holdings for just north of $100 million. Combined with an earlier investment in Navigator, that gave Ross controlling interest. The Navigator purchase was a bargain because the company had been part of Lehman Bros. bankrupt brokerage arm.

Ross, whose previous turnaround exploits in steel, textiles and automotive are the stuff of legend, has become a big proponent of shipping investments, and there may be more to come from W. L. Ross & Co.

THE RIGHT COMBINATION

Hamish Norton, the well-known head of the global maritime practice at Jefferies & Co., says "The best deals involve private equity investors and a knowledgeable management team that invests along with them." He cites Kelso & Company's 2005 investment in Eagle Bulk Shipping and Eagle's going public shortly thereafter at a big multiple as a good example of what he means. And indeed that formula – private equity + knowledgeable management – could be applied to many of the combinations already mentioned in this article – Anchorage and DHT, Blackstone and American Petroleum Tankers, W. L. Ross and Diamond S Shipping, although none of these companies have gone public. But you can be sure they will when the timing is right.

Perhaps the greatest PE investment of all time, pointed out by both Norton and Karatzas, was the late Larry Tisch of Loews Corp.'s investment in Majestic Shipping in 1984. The deal involved six ULCCs (Ultra Large Crude Carriers), which Tisch purchased at the bottom of the shipping cycle for $30 million total, and then laid up until the market turned, which it did three years later. In 1989 Tisch sold a 51 percent interest in the six vessels, which were then worth about $40 million each, for about $120 million. So in the space of five years he had quadrupled his investment and retained a 49 percent stake in the vessels without any future oil spill liability to worry about! And while not technically a PE investment, it was an example of using cash (corporate cash, in this case) to acquire distressed assets. Karatzas calls it "the asset play of the century."

THE SHIPPING MAN

How long will the PE window stay open? As long as the market remains depressed, say all the experts, and most agree it could get worse before it gets better. Meanwhile, the pressure is building on all sides. How long can owners hold out with low rates and high operating costs before they file for Chapter 11 or hold a fire sale? How long can the banks hold loans that are technically in default but have been granted one covenant waiver after another – a practice Peter Shaerf dubs "extending the runway"? And how long can private equity firms wait while sitting, according to a recent article by Andrew Ross Sorkin in *The New York Times*, on $1 trillion in uninvested funds? Yes, that's trillion with a "t" in dry powder that they need to invest before time runs out and they have to return it to their investors. Expect to see more deals in the future and at a faster pace than ever before.

In his wonderfully comic novel, *The Shipping Man*, Marine Money's Matt McCleery describes the escapades of a private equity investor who sets sail on the high seas of shipping. From New York to Oslo to Hamburg to Piraeus, the picaresque tale touches on all the right locales and all the right players, and in the process the reader gets a complete and painless education in the esoteric world of ship finance. Best of all, the book captures the romance and glamour of shipping and why it has appealed to so many for so long. It's a hymn to the marriage of private equity and shipping – a combination that's hard to beat. **Mar**Ex