Vessel value

Basil M Karatzas looks at the valuation of vessels – and the value of reporting

A few years ago, in the booming days of the super-cycle, the London interbank Offered Rate (LiBOR) was primarily mentioned in shipping circles as a prefix to a number, preferably a two-digit number, or the "spread", at which rate a borrower/ship owner was able to borrow funds.

For example, "LIBOR + 75 basis points" was indicating a rate of 0.75% above LIBOR, the rate that banks can borrow funds from each other for a very short period of time; the borrower, ship owner in this case, had to pay a rate related to LIBOR plus the spread as total (floating) cost for their debt financing. LIBOR has been produced under the auspices of the British Bankers' Association (BBA) by polling daily market banking participants, computing an average rate (based on a standard formula and calculation) and reporting the average rate.

The necessity of a LIBOR number is, of course, of paramount importance since numerous aspects of daily life are settled based on such rates (from car loans to house mortgages to credit card rates to commercial loans). It is estimated that $350tn of financial contracts are benchmarked or settled against the LIBOR rate, that is, for each basis point (bp) or 0.01% change in LIBOR rates, the nominal impact from the settlement of financial contracts is worth $35 bn.

Since the early post-Lehman days, it has been reported in the business press that the LIBOR reporting and calculation has not been as straightforward as it seemed and that there were observed unexplained discrepancies in the marketplace.

Most obviously, weak banks were under-reporting the rate at which they could borrow overnight in the middle of the financial typhoon, in order to conceal their cost of funds and alter the perception, provided to the market, their counter-parties implicitly placed on their credit risk.

However, in a more recent full blown investigation in the matter, it seems that certain financial institutions (or at least their agents) were purposefully mis-reporting market data, given that even a small aberration on the LIBOR rate could translate into serious money for the settlement of contracts, especially when the reporting party has an open position in the market. Again, for every change of LIBOR by just 1 bp, the nominal translation on settlements could be $35bn;

Overhauling the process

Recently, the International Organization of Securities Commissions (IOSCO) produced a circular aimed at overhauling the process of reporting energy prices. Similar to reporting on interest rates in the form of LIBOR, daily data in the energy markets are produced, published and used for settlement in the energy markets. Of course, there are clearing houses and exchanges in the energy markets and their closing prices are fairly well accessible.

However, there are several more energy numbers on less liquid contracts that are collected, tabulated and reported by the Price Reporting Agencies (PRAs), primarily Platts, Argus Media and ICIS; for instance, Platts oil prices are typically utilised for bunker pricing in the shipping industry. It is estimated that 60-70% of the over-the-counter (OTC) swaps and options in the energy markets are settled against the prices of these three PRAs. IOSCO's overhaul of the price reporting has been triggered by signs that certain numbers may have been 'manipulated'.

Our daily lives are strongly interweaved with the worlds of finance and energy, and price reporting in these two industries affects our lives whether we are aware of it or not. As with any reporting, it is expected that there is always a certain degree of bias involved, certain judgment, certain inaccuracy. After all, there are more colours than just black-and-white in our lives, and there is sometimes a very fine line that separates facts.

And, of course, facts do not always happen in a timely, predictable fashion or in a conspicuously observable manner and transactions in certain markets can be very, very infrequent. Sometimes, a "judgment call" or a "guestimate" or a "professional opinion" has to substitute for the lack of data points in order to produce a time series. Therefore, it is to be expected that there is always a certain imperfection in reporting. It's just human nature. And, when the stakes are so high and the value of the contracts are so monumental, besides the "honest" error and expected "inaccuracy", one may also expect that there might be a motivation for a deviation in the price reporting to reflect a bit more than just "human error".

The shipping industry, at the whirlpool of the financial and the energy markets, in a post-Lehman world of constrained liquidity, and anaemic economic growth compounded by the Damoclean sword of a series of sovereign crises in Europe and possibly an insipient political crisis in China and ensuing economic and banking deterioration, has been facing several

challenges, not least of them, a very illiquid market for the sale and purchase of vessels, and a yawning gap in "bid" and "ask" for shipping assets. In general, the second-hand market for shipping assets has been fairly subdued in the last year, reflecting weak freight rates, a substantial overhang of newbuilding deliveries, lack of debt financing, and an overall lack of conviction ("buyers' strike" may be called) from the part of the buyers; from the part of the sellers, any sale at today's "perceived" market levels will entail loss of some or all equity investment, a short sale and, quite possibly, a loss for the lenders.

The lack of market activity in the sale and purchase market is even more accentuated for modern tonnage younger than five years reflecting the high cost basis of the assets. It does not come as a surprise then that there are few data points in the sale and purchase market, and a great deal of the existing data points, especially for modern tonnage, are neither "transparent" (mostly bi-lateral, off-market deals) nor "clean" (vessel employment or soft financing or "compulsion" to sell may be involved).

Several investment banks, research and advisory firms, ship brokerage houses, and so on produce regularly asset value tables. In a similar manner, the Baltic Exchange produces the weekly Baltic Exchange Sale & Purchase Assessment (BSPA) index for five-year old vessels only in certain asset classes. In active and liquid markets, all these data points more or less converge to the same numbers and, quite often, accurately reflect the market itself. However, in the present illiquid market, often the tables produced from different sources show strong aberrations, and sometimes transactions take place well beyond any level of normalcy that such reports would predict.

Given that the shipping industry consists of a small atoll in the ocean of the industries of finance and energy, any inaccuracies in reporting vessel asset prices are of little importance to the broader markets. Despite BSPA's popularity, there are no standardised contracts (that is residual value guarantees, and so on) settled against any vessel price indices or broker reports. Whether we like it or not, as consumers we have to live with LIBOR (that is check your credit card statement, your mortgage note, and so on) and energy prices as reported by the PRAs (that is, check your heating oil bill, and so on). However, in shipping any inaccuracies in presenting asset values, whether inadvertent due to the bias of the reporter or purposefully due to cognizant error, are only pertinent for discussion and academic purposes.

For instance, where vessel valuations are required,such as by banks for loan documentation purposes and loan-to-value clause testing, rarely is there a reference to a certain index (such as the BSPA) or standardised tables, but each time the banks require fresh vessel valuations, specific to each vessel, from recognised valuators. And once again, there is a very limited derivatives market in shipping or contractual obligations on asset prices that are normally settled again indexed prices. And unlike the LIBOR and PRA numbers, with which we have to live, standardised vessel asset prices are quite often irrelevant even to shipping market participants; it only takes one buyer and only takes one seller at one point of time to agree on the price for the physical exchange of the shipping asset. At times when buyers can exert most pressure during a transaction, whether in a weak or strong market, they end up with a better value proposition. At times when the seller can resist the buyer's pressure, or, even better, incite a bidding war, whether in a weak or strong market, a strong asset price can be achieved.

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Although a price reporting mechanism in shipping, similar to LIBOR and the PRAs,may be a good thing to have, we doubt that such a system will ever be widely recognised or followed, or even be considered consistently accurate and dependable. And, as a reporting asset price mechanism in shipping, it will be hard to attract the scrutiny of regulators and investigators for its accuracy or lack thereof.

First of all, the shipping markets are just too small to matter, as compared to the finance and energy industries. After all, there are no standardised underlying assets (all vessels are different, even sistership vessels – just take a look at modern Chinese vessels ordered at the top of the market).

Second, the market for shipping asset prices is too parochial to even attract a derivatives market. The derivatives market doesn't seem to have worked exceptionally well in the more liquid freight market and the Forward Freight Agreements (FFAs). Third, in a very illiquid market such as at present, supplementation of actual data points based on actual sales with "professional estimates" may be an event of little consequence. Finally, no two transactions are identical – the nature of the buyer and the seller and the circumstances of each transaction are very important, or even more important, we may dare say, than the asset per se.

As proof, take a look at how fortunes were made (and lost) in shipping in the past decade(s): by taking a position against the indexed, the standardised, the consensus opinion one can find in the papers. After all, indexed prices are good for historical information and contract settlement, but that's not how money is made.

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