„The Art of Restructuring of Ship Finance Loans“

How can a ship owner benefit from a smart restructuring?

Hamburg, 08 January 2013
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7. Summary
Background

- Maritime law since 2002 (Law of the Sea)

- Joined HSH Nordbank AG in 2007 in ship finance:
  a. New Business of up to USD 450m syndicated loan
  b. Restructuring cases of up to USD 3bn debt per owner.

- Lawyer in Ship Finance Restructuring since 11/2011
  Finished: USD 200m,
  Ongoing: USD 2,2bn
1. Background

1. German lawyer (banking)
2. Banking procedures
3. Bespoke liability restructuring
4. Ship financing expert

∑ Effective, cost-efficient and unique!
Background. Procedure

- Commercial terms of restructuring
- Legal documentation of an agreed deal

- Central restructuring departments with senior experts
- Centralized legal departments with senior lawyers

- Usually owners alone
- Usually owners alone

- Owners together with an expert

Standard situation approach

Professional approach
Background. Procedure

Handling of restructuring (factory)

Basel II / III

Legal in ship finance

Strategic growth

Ship operations

Handling of restructuring (factory)

Basel II / III

Legal in ship finance

Strategic growth

Ship operations

Owner & expert

Bank

Owner
2 Restructuring

Q: What is restructuring?

A: When debt service can not be done or vessels are arrested

Q: Correct?

A: Lehmann!

Q: BDI-charts? Oversupply?
2 Restructuring

Conclusion:

Irrespective of industry sector and country, a restructuring situation occurs when management faces problems which they did not sufficiently prepared for.

Reason were:

a) reality changed (weak skills) or
b) internal skills deteriorated or
c) both happened simultaneously.
Success of Restructuring is measured by:

- not only compliance with DS & covenants
- but broadening of technical skills of management (management philosophy)
- to be prepared for „known“ or „unlikely“ or even „unknown“ risks
- permanent business optimization and **risk-control-culture**!

*Not cost leaders but leaders in innovation survive the best in recession periods!*
2 Restructuring / Horizon

- FS
- accounts balance (daily?)
- next repayment and charter income?
- next 12 months?
- DS, covenants and all business model risks of next 3 to 5 years! (5Y+H)

plus
with tools how to react on risks!

ideally 5-year horizon

past present future 5Y+H time

regardless of industry and region

awareness's level
2 Restructuring / Methodology

OWNER
1. cost of capital
2. management success

OWNER & Bank:
Rating Optimization

OWNER & Bank:
Cycle?

SUCCES
is determined by

OWNER:
Debt Capacity

OWNER:
Financial Model
1. to prove past &
2. to extrapolate
3 RC / Costs of Debt

Lender is driven by:
1. risk appetite &
2. yield expectation:

Relevance:
- collateral quality,
- documentation work,
- flexibility (dd & repayment),
- publicity requirements,
- rating requirements,
- investor expectation,
- Lender’s influence.

Lender’s class:
- insurances,
- wealthy families,
- investors (WR),
- inexperienced natural persons (INP)

- equity
  private/public
- bonds
  secured/unsecured
- mezzanine
- commercial papers
- bonds
- secured
- loan
  bank/SY/EXIM

quality of finance (risk-aversion)

yield expectation

high

low
over-ordering
over-tonnage
freight rates drop
scrapping
fleets shrink
(demand increases)
excess of ship builders
ship prices fall
ordering
yards reopen
freight rates recover

selling
buying
not public
3 RC / Shipping Cycles

Unique capabilities of shipping banks:

- Cycle, capital reservation mechanisms, organization

But:

- bread & butter business only!

Figure 3.1
Seasonal, short and long cyclical components
Compiled by Martin Stopford from various sources

Dr. Martin Stopford, Maritime Economics, 2008, p. 95.
3 RC / Shipping Cycles

Figure 3.5
Dry cargo shipping cycles (mainly coal), 1741–2007
Source: Based on Appendix C.

Dr. Martin Stopford, Maritime Economics, 2008, p. 105.
not public
3 RC / Model & Extrapolation

A model is not a science, it’s an art!

**Standard**: All in one excel file, 5YH, with all liquidity streams of the group, quarterly basis.

**Advanced**: Equity injected, debt capacity, ROE, all covenants included, forecast of vessel values, depreciation, monthly, different scenarios, budgeting deviation etc.
not public
3 RC / Model & Horizon

Horizon matches model and vice versa!

DS, covenants and all business model risks of next 3 to 5 years!

(5Y+H)

plus

with tools how to react on risks!

ideally 5-year horizon

DS, covenants and all business model risks of next 3 to 5 years!

(5Y+H)

next 12 months?

next repayment and charter income?

accounts balance (daily?)

FS

regardless of industry and region

awareness's level

past

present

future

5Y+H

time

horizon matches model and vice versa!
$pv = \frac{pmt}{i} \times \left[ 1 - \frac{1}{(1 + i)^n} \right]$

$pmt = FCF$
$mode = \text{end}$
$payment \text{ p.a.} = 1$

$pv = \frac{100}{5\%} \times \left[ 1 - \frac{1}{(1+5\%)^7} \right]$

$pv = 578,64$

Multiple of 5,8 of FCF in order to repay 100% in 7 years at 5% p.a.!
## 3 RC / PV-Examples

<table>
<thead>
<tr>
<th>i% p.a.</th>
<th>pmt</th>
<th>pv</th>
<th>fv</th>
<th>n</th>
<th>n/y</th>
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<td>-100</td>
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<td>0</td>
<td>7</td>
<td>1</td>
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<td>-25</td>
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<td>7</td>
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<td>0</td>
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<tr>
<td>4</td>
<td>-25</td>
<td>?</td>
<td>0</td>
<td>18x4</td>
<td>4</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>1.279</td>
<td></td>
</tr>
</tbody>
</table>
1. Collection of all data:
   - Quantitative Factors
   - Country and Industry Data
   - Qualitative Factors
   e.g. Management and Investment Skills, Market Position, Legal Issues

2. Choosing 200+ criteria:

3. Result:
   - AAA
   - AA
   - A
   - BBB
   - BB
   - B
   - CCC
   - Default

(Note: simplified presentation)
3 RC / Interest / Rating Method.

Rating-scales

<table>
<thead>
<tr>
<th>Moody's</th>
<th>S&amp;P</th>
<th>Fitch</th>
<th>Description</th>
<th>Master-scale (Landes-banks)</th>
<th>Probability of Default (Landes-banks)</th>
<th>Other German Banks (IFD)</th>
</tr>
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<tbody>
<tr>
<td>Aaa</td>
<td>AAA</td>
<td>AAA</td>
<td>Prime (Triple A)</td>
<td>1 (AAAA)</td>
<td>0.01 %</td>
<td>0.00 %</td>
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<tr>
<td>Aa1</td>
<td>AA+</td>
<td>AA+</td>
<td>High grade</td>
<td>1 (AA+)</td>
<td>0.02 %</td>
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<tr>
<td>Aa2</td>
<td>AA</td>
<td>AA</td>
<td></td>
<td>1 (AA)</td>
<td>0.03 %</td>
<td></td>
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<tr>
<td>Aa3</td>
<td>AA-</td>
<td>AA-</td>
<td></td>
<td>1 (AA-)</td>
<td>0.04 %</td>
<td></td>
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<tr>
<td>A1</td>
<td>A+</td>
<td>A+</td>
<td>Upper Medium grade</td>
<td>1 (A+)</td>
<td>0.05 %</td>
<td></td>
</tr>
<tr>
<td>A2</td>
<td>A</td>
<td>A</td>
<td></td>
<td>1 (A)</td>
<td>0.07 %</td>
<td></td>
</tr>
<tr>
<td>A3</td>
<td>A-</td>
<td>A-</td>
<td></td>
<td>1 (A-)</td>
<td>0.09 %</td>
<td></td>
</tr>
<tr>
<td>Baa1</td>
<td>BBB+</td>
<td>BBB+</td>
<td>Lower Medium grade</td>
<td>2</td>
<td>0.12 %</td>
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<tr>
<td>Baa2</td>
<td>BBB</td>
<td>BBB</td>
<td></td>
<td>3</td>
<td>0.17 %</td>
<td>0.30 %</td>
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<tr>
<td>Baa3</td>
<td>BBB-</td>
<td>BBB-</td>
<td></td>
<td>4</td>
<td>0.26 %</td>
<td></td>
</tr>
<tr>
<td>Ba1</td>
<td>BB+</td>
<td>BB+</td>
<td>Non Investment-grade speculative</td>
<td>5</td>
<td>0.39 %</td>
<td>0.70 %</td>
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<tr>
<td>Ba2</td>
<td>BB</td>
<td>BB</td>
<td></td>
<td>6</td>
<td>0.59 %</td>
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<tr>
<td>Ba3</td>
<td>BB-</td>
<td>BB-</td>
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<td>7</td>
<td>0.88 %</td>
<td>1.50 %</td>
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<tr>
<td>B1</td>
<td>B+</td>
<td>B+</td>
<td>Highly Speculative</td>
<td>8</td>
<td>1.32 %</td>
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<tr>
<td>B2</td>
<td>B</td>
<td>B</td>
<td></td>
<td>9</td>
<td>1.98 %</td>
<td>3.00 %</td>
</tr>
<tr>
<td>B3</td>
<td>B-</td>
<td>B-</td>
<td></td>
<td>10</td>
<td>2.96 %</td>
<td></td>
</tr>
<tr>
<td>Caa1</td>
<td>CCC+</td>
<td>CCC</td>
<td>Substantial risks</td>
<td>11</td>
<td>4.44 %</td>
<td>8.00 %</td>
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<tr>
<td>Caa2</td>
<td>CCC</td>
<td>CCC</td>
<td>Extremely speculative</td>
<td>12</td>
<td>6.67 %</td>
<td></td>
</tr>
<tr>
<td>Caa3</td>
<td>CCC-</td>
<td>CCC-</td>
<td>In default with little prospect for recovery</td>
<td>13</td>
<td>10.00 %</td>
<td></td>
</tr>
<tr>
<td>Ca</td>
<td>CC</td>
<td>CC</td>
<td></td>
<td>14</td>
<td>15.00 %</td>
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<tr>
<td>C</td>
<td>D</td>
<td>D</td>
<td>In default</td>
<td>15</td>
<td>20.00 %</td>
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<tr>
<td>/</td>
<td>DD</td>
<td></td>
<td></td>
<td>16</td>
<td>100.00 %</td>
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<tr>
<td>/</td>
<td>D</td>
<td></td>
<td></td>
<td>17</td>
<td>100.00 %</td>
<td></td>
</tr>
<tr>
<td>/</td>
<td></td>
<td></td>
<td></td>
<td>18</td>
<td>100.00 %</td>
<td></td>
</tr>
</tbody>
</table>


2 Relationship PD and Rating

3 PD determines equity-allocation

4 Basel II: \( \frac{\text{equity}}{\text{risk}} \geq 8\% \)

5 Basel III: \( \frac{\text{equity}}{\text{risk+liq.buffer}} \geq 8\% + \text{buffer} \)

(simplified) 24
**3 RC / Interest / Rating & Interest**

- **Equity allocation and margin**
  - Rating optimised project: 2.00%
  - Project risk: 3.00%
  - Partially unknown risk (to be priced): 3.60%

**Spread of 1.60%**
3 RC / Interest / Rating Factors

1. Transparency
2. Business Model
3. Management Skills
4. Strategic Growth
5. Multiple Channels
6. FS-Quality
7. Quick & Professional
8. Multiple Borrowings
9. Profiles & Liquidity Reserves
10. Deferrals
SUCCESS is determined by

OWNER:
1. cost of capital
2. management success

OWNER:
Debt Capacity

OWNER & Bank:
Rating Optimization

OWNER & Bank:
Cycle?

OWNER:
Financial Model
1. to prove past &
2. to extrapolate

OWNER:

3 RC / Summary
not public
4 Ship Owner’s Strategy

Own Strategy towards Lenders

Fairness in Instruments and Contributions

Deferral Request (smart, sustainable)
(not by email)

Note: German Banks need to observe
a) German Insolvency Law, b) German Criminal Law,
c) new supervisory rules and d) profit expectations of bank’s shareholders.
not public
not public
### 12-Month Moving Debt Capacity

- **USDm**
  - Earnings p.q.
  - Debt Position (incl. SWAP)
  - Earnings after OPEX
  - Free CF p.a.
  - Earnings after OPEX, DD/SS etc. (= Free CF)
  - 6M-Moving Debt Capacity at 15Y @5% p.a.
  - 6M-Moving Debt Capacity at 18Y @5% p.a.
  - 6M-Moving Debt Capacity at 10Y @5% p.a.
1. operational measures (cost saving, mergers) and 2. financial measures:
Depending on business model and its current & future risks following instruments can be used for a sustainable restructuring package under German law with certain cash effects:

fairness

partially not public
## Example A / Stretching

### Ship Details

<table>
<thead>
<tr>
<th>Type</th>
<th>Aframax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Build</td>
<td>2007</td>
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<tr>
<td>Value</td>
<td>USD 35,000,000</td>
</tr>
<tr>
<td>Loan</td>
<td>USD 25,000,000</td>
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<tr>
<td>Interest</td>
<td>3.40%</td>
</tr>
<tr>
<td>Profile</td>
<td>12 years</td>
</tr>
<tr>
<td>OPEX</td>
<td>USD 8,000</td>
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</table>

### Financial Overview

<table>
<thead>
<tr>
<th>Year</th>
<th>T/C p.d.</th>
<th>Rating</th>
<th>LGD %</th>
<th>Bank’s Equity</th>
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</thead>
<tbody>
<tr>
<td>2009</td>
<td>USD 25,000</td>
<td>AA+</td>
<td>3.00%</td>
<td>USD 17,500</td>
</tr>
<tr>
<td>2010</td>
<td>USD 18,000</td>
<td>BBB-</td>
<td>3.00%</td>
<td>USD 606,500</td>
</tr>
<tr>
<td>2012</td>
<td>USD 11,000</td>
<td>B</td>
<td>3.00%</td>
<td>USD 6,834,500</td>
</tr>
<tr>
<td>2012</td>
<td>USD 11,000</td>
<td>BBB-</td>
<td>3.00%</td>
<td>USD 674,000</td>
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</tbody>
</table>

**Stretching 3Y+**

### Inflation of Equity Allocation

- **9 profiles & liquidity reserves**

**Margin increase risk!**
6 Example A / Libor & Swap

USD price index: 1.70% ⇔ 10Y-LIBOR

US0003M Index (BBA LIBOR USD 3 Month)
USSW10 Curncy (USD SWAP SEMI 30/360 10Y)
USSW5 Curncy (USD SWAP SEMI 30/360 5YR)
FEDL01 Index (Federal Funds Effective Rate US)
Example A / Libor & Swap

not public
6 Example A / Management

not public
not public
### 6 Example B / Equity Position

**6 quality of financial statements**

<table>
<thead>
<tr>
<th>FS shall present situation correctly</th>
</tr>
</thead>
<tbody>
<tr>
<td>some freedoms remain under IFRS. Intelligent structure!</td>
</tr>
<tr>
<td>very important for <strong>corporate guarantees</strong>!</td>
</tr>
<tr>
<td>prepared for bank’s purposes and for best achievable rating</td>
</tr>
<tr>
<td>on time, no contradictions, clarity, preciseness</td>
</tr>
<tr>
<td>highly rating-relevant, due to German law (§18 KWG)</td>
</tr>
</tbody>
</table>
Example B / Equity Position

not public
not public
Example C / Orderbook

not public
Example C / Orderbook

not public
not public
Example E / Omega

not public
not public
7 Summary

Using language called "Bankish"!

- banks’ interests
  - better rating & saving equity
  - debt capacity higher than debt
  - finding suitable instruments

- owners’ interests
  - securing vessels
  - strategic growth
  - finding cheapest instruments
7 Summary

1 Develop new skills in management!

2 Monitor *debt capacity* always!

3 React quickly, be prepared!

4 Speak „Bankish“!

5 Find arguments for fairness regarding restructuring instruments!
"When winds of change blow, some build walls, others build windmills."

Chinese Proverb

Thank you for your attention!

Mr. J. Kubilay Falkenberg, Attorney-at-Law
Address: Neuer Wall 54, 20354 Hamburg, Germany
office: +49 40 4149 6366, mobile: +49 172 722 8832
email: kubilay@falkenberg.pro