CREDIT ENHANCEMENT FOR SHIPPING FINANCE

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INTRODUCTION

The bank market has traditionally been the financing market of choice for the shipping industry. However, the combination of the ongoing aftermath of the global credit crisis and the increased capital and liquidity costs being imposed on banks has resulted in the shipping industry increasingly looking to the capital markets. Whilst this is nothing new, capital markets instruments favoured by owner/operators tend to be at the more traditional end of the spectrum: vanilla corporate bonds, convertible bonds, baby bonds, Norwegian bonds and high yield bonds. These instruments are typically on-balance sheet transactions for general working capital or capital expenditure purposes. Whilst first ranking ship mortgages may be granted over a specific asset or assets, it is rare to see any more sophisticated credit enhancement features.

There are a variety of financial structuring technologies which have been developed by the structured finance market and other industries which could be utilised in the shipping industry. Sophisticated, off-balance sheet financings are seen within the shipping sector, but these tend to be the preserve of owners whose business it is to lease or charter assets to third parties. Container lease receivables securitisations and charter hire portfolio transactions which use well established techniques to leverage a portfolio of assets and their associated revenues are familiar transactions. However, it is significantly less common for owner/operators of capital assets to utilise structured finance techniques.

WFW has considerable experience structuring financings, assisting owner/operators, lessors, lenders and investors in the shipping, aviation and transport industries and understands the nuances of each asset class and the particular challenges that they present for investors in those assets. This article considers some of those structuring techniques, particularly in the aviation industry, and the extent to which they may be utilised to raise funding for shipping owner/operators given the current constraints on traditional banks.

Structured finance instruments tend to be tailored to meet not only the company's funding requirements but also the investors' requirements. An investor's credit analysis of a structured, asset backed financing will focus on three distinct elements: (i) the nature of the asset(s) and sustainability of associated revenues, (ii) the susceptibility of the structure to "external" events and (iii) the ease and speed of enforcement over the asset and realisable capital value on a liquidation.

An issuer's ability to secure a favourable credit rating is a key element in its ability to raise capital. Many investors are limited by mandate to investing in, for example, investment grade paper. One of the principal advantages in using structured finance techniques is that credit enhancement techniques may be used to give debt, backed by a particular asset or portfolio of assets and the associated receivables, a higher credit rating than that of the originating or operating company. In the airline industry it has been possible for airlines with no or poor credit ratings to issue investment grade debt through the use of "enhanced equipment trust certificates". EETCs have many interesting features that we consider could be exported to the shipping industry.

REVENUE RELIANCE

The key principle of any asset backed financing is that revenues derived from the asset(s) must be capable of servicing the debt without looking to any wider corporate cash flows. Revenues must be predictable, regular and able to withstand measured levels of distress from within the portfolio.

The creation of a portfolio of assets is a fundamental feature of structured asset backed deals in the capital markets. Absent any macro-economic factors which could create a close correlation of default probability within an entire asset class, the theory is that the larger and more diverse the portfolio the less susceptible that portfolio is to the default of a single asset. In traditional securitisation structures, there may be hundreds (CDOs/CLOs) or thousands (RMBS/CMBS) of assets in a single portfolio. Owner/operators of shipping assets are unlikely to be able to achieve these levels of scale, but even a small portfolio could create a very different profile to a single asset financing. The airline industry regularly packages multiple aircraft into EETC structures. Asset management features may also be added, giving the operator the ability to substitute assets (whether they be distressed assets or assets nearing the end of their useful life) to preserve the integrity of the revenue or to add additional assets as their operations grow.

For similar reasons, securitisations and structured transactions generally package assets generating receivables from a diverse set of third party "obligors" (eg lessees, charter parties, facility borrowers) and impose strict requirements on the number and diversity of those underlying obligors. The wider the diversity, the lower the risk to the financing of a single obligor default. It may be difficult to replicate this from an owner/operator perspective since, although structures can be devised to create multiple synthetic on-loan, lease or charter receivables between structural SPVs, there are no third party obligors and the ultimate obligation to service that debt remains solely that of the owner.

Structured transactions typically provide for several tranches of debt and contain detailed requirements for the distribution of revenues on each periodic payment date ("pre-enforcement waterfall"). This prioritises the payment of the senior tranches and may provide for the lock-up or diversion of revenues when agreed cash flow tests fall below certain thresholds. In such circumstances, the junior ranking tranches will be prevented from collapsing the structure even if they are not being paid, enhancing the continued ability to service the senior tranches.

Other common techniques for stabilising asset revenues include the provision of super senior ranking liquidity facilities to fund short term cash flow shortfalls and currency and interest rate swaps to manage exposures to those customary risks.

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STRUCTURAL ROBUSTNESS AND BANKRUPTCY REMOTENESS

It is critical in structured transactions to insulate the revenue generating asset(s) from "external" events, in particular, the risk of insolvency of the originator. This is primarily achieved by transferring those assets to an SPV (in a favourable insolvency and tax efficient jurisdiction) by way of "true sale", a transfer which cannot be set aside on the insolvency of the transferee, and other techniques to ensure there would be no reasonable likelihood of substantive consolidation of the assets of the SPV with those of the originator in the event the originator were to become a debtor in bankruptcy.

In a traditional securitisation, the SPV may then appoint the originator to service and manage the assets at arm's length. On an insolvency of the originator, the financed pool of assets is itself insulated from the insolvency, the servicing arrangement could be terminated and the SPV could appoint another entity to service the assets. The contractual structure would be different where an owner/operator financed its vessels. Rather than entering into servicing arrangements, the SPV could charter the vessel back to the owner/operator, which charter would be terminable on a default by or insolvency of the owner/operator, leaving the SPV able to re-charter the assets to a third party, theoretically, without defaulting the financing.

Similar to standard ship finance transactions, the activities of SPVs are tightly controlled, limited to the issuance of the bonds, the ownership of the asset portfolio and ancillary activities. In particular, SPVs are prohibited from having any employees or incurring any other indebtedness or other liabilities. Furthermore, all creditors and agents of the SPV agree that their recourse is limited to the realisable value of the collateral assets and that they will not take any action to wind-up the SPV.

Securitisations of some types of assets can be achieved without asset transfers, relying instead on special statutory regimes to achieve effective ring fencing. The US airline industry benefits from specific treatment under Section 1110 of Chapter 11 of the US Bankruptcy Code ("Section 1110") which affords creditors of underlying aircraft favourable rights to enforce against aircraft collateral notwithstanding an ongoing automatic stay. A number of other jurisdictions also benefit from Section 1110-style protections through their ratification of the Cape Town Convention and the related Aircraft Protocol. Although EETCs are issued out of bankruptcy remote trusts, because of these statutory rights, EETC structures do not necessarily require a transfer of the aircraft to an off-balance sheet SPV. As noted below, the shipping industry generally does not benefit from any such statutory regimes.

LIQUIDATION AND ENFORCEMENT

In the event that a financing defaults and the assets need to be liquidated, investors look to the realisable capital value of the assets to redeem the principal amount of their debt. As with any other ship financing transactions, over-collateralisation based on the net present values of the assets is the simplest way to ensure repayment of the debt. The greater the extent of over-collateralisation, the less susceptible investors are to asset value declines. This is of particular importance where the assets are, by their nature, depreciating assets such as vessels. Net asset value triggers can be incorporated to trigger an early redemption before the value declines to a critical level.

The tranching of debt into different classes of seniority, with the entitlement to enforcement proceeds governed by a "post-enforcement waterfall", creates another level of overcollateralization enhancing the relative credit of the senior tranches. Typically, the most senior "A" tranche under an EETC will have a loan to value ratio of about 50% and an investment grade rating. The subordinated "B" tranche will typically have a loan to value ratio of about 65% and a sub investment grade rating.

In order to maximise the benefits of cross collateralisation within a portfolio of assets, there should be full cross default provisions between the contractual arrangements for all of the assets comprising that portfolio.

In a liquidation, it is critical that creditors can be assured a quick and efficient enforcement over the assets. The jurisdiction of incorporation of SPVs are carefully chosen for their "creditor friendly" bankruptcy regimes. Enforcements against assets which continue to be held on the balance sheet of an operating company are inherently more susceptible to complex bankruptcy proceedings. As mentioned above, the airline industry benefits from key exemptions under Section 1110 which gives airline creditors, amongst other things, rights of enforcement against the aircraft assets after 60 days regardless of an ongoing automatic stay. Although US flag vessels do benefit from the same Section 1110 protections, creditors of non-US flag vessels do not. As many international vessels are non-US flag vessels, creditors of those vessels are more concerned to avoid any nexus with the US (which nexus has proven, in the recent shipping downturn, relatively easy to achieve) in order to prevent the shipping assets becoming part of a Chapter 11 automatic stay. Shipping deals should therefore be structured carefully in order to limit the opportunity for forum shopping and to ensure certainty in the insolvency regime(s) which will be applied.

Due to the mobile nature of both aircraft and shipping assets, the process of enforcement creates additional legal and practical issues. The ability to effect an enforcement and the rules applicable to maritime liens which would rank ahead of a ship mortgage, will be heavily dependent on the jurisdiction in which the vessel is physically located at the time of enforcement. The airline industry is again ahead of the curve, and a number of key jurisdictions (including the US, Canada and the UK) have adopted the terms of The Cape Town Convention under which those jurisdictions have agreed that they will recognise the enforceability of the foreign security over aircraft assets.

Absent equivalent international conventions, investors in the shipping industry need to look to more practical ways to ensure that enforcement over vessels is not unduly frustrated. This may mean that certain types of vessels which are by operational necessity tied to specified routes through "creditor friendly" jurisdictions and less able to be diverted off those routes (for example, cruise liners and container vessels), may lend themselves more naturally to structured finance deals. We have been involved in the negotiation of bespoke covenant packages with both investors and, perhaps more significantly, rating agencies in order to create a greater degree of certainty of the ability to enforce.

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In any event, the process of enforcement over material capital assets, such as aircraft and vessels, will inevitably take considerably longer than enforcements over more commonly securitised asset classes. EETCs employ liquidity facilities to enable the issuer to continue to service interest payments following a default and whilst the underlying aircraft are repossessed and sold, typically for a period of up to 18 months.

CONCLUSION

Due to the nature of shipping assets, including their mobility and therefore the potential extent of complex jurisdictional enforcement issues, any asset-backed bond financing of a portfolio of vessels by an owner/operator is likely to be highly bespoke and tailored carefully to, amongst other things, the particular company, the nature of the fleet and the geographies (and therefore jurisdictions) of their operation. Nevertheless, many (if not necessarily all) of the techniques and structures touched on above may potentially be utilised to help enhance the credit of an owner's principal assets and open up additional efficient sources of funding.

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