THE GROWTH OF THE JOLCO STRUCTURE

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INTRODUCTION

The Japanese Operating Lease with Call Option (JOLCO) in its current structure has been a valuable and reliable source of financing for nearly two decades. The product has historically been and continues to be predominantly prevalent in the aviation sector. While there have been JOLCOs in the maritime sector for many years, it is only recently that the vessel JOLCO market has started to thrive. The structure has a proven track record and provides a number of benefits to all the participants involved.

BASIC STRUCTURE

The basic structure of a JOLCO is set out in Diagram 1.

In summary, the Japanese equity arranger will set up an SPV in Japan, with the equity portion of the asset acquisition cost being invested by Japanese investors. The Japanese SPV, as borrower, will enter into a loan agreement with the lenders, pursuant to which the lenders will provide the debt portion of the asset acquisition cost of the vessel to the Japanese SPV. The Japanese SPV will then use the equity portion and debt portion to acquire the vessel. At the time the acquisition occurs, a bareboat charter between the Japanese SPV and the shipping company will commence. The bareboat charter will contain a purchase option in favour of the shipping company. As security for its obligations under the charter, the shipping company will provide security to the Japanese SPV over, amongst other things, its interest in the vessel insurances. The Japanese SPV will, in turn, provide the usual vessel security to the lenders over the vessel and its rights relating to the ship, including a vessel mortgage and assignment of its rights in the insurances, as well as an onward assignment of the charterer's rights in the insurances. In order to protect the structural integrity of the transaction, the charterer does not provide direct security to the lenders to secure the obligations of the Japanese SPV under the loan agreement. The Japanese equity arranger will provide limited support for the obligations of the Japanese SPV, usually in the form of two letters of undertaking: one in favour of the lenders, and one in favour of the charterer. The loan agreement that the banks will enter into will be limited recourse against the Japanese SPV, and there is typically no share security provided by the Japanese SPV's parent company in favour of the lenders.

The limited recourse nature of the loan agreement is unlike many Chinese leasing structures and other full recourse lessor financing structures, as the lenders' main recourse is to the shipping company rather than the owner group. As such, it is important that the loan agreement and the charter dovetail to ensure that there is no mismatch between the Japanese SPV's payment obligations under the loan agreement and the shipping company's payment obligations under the charter.

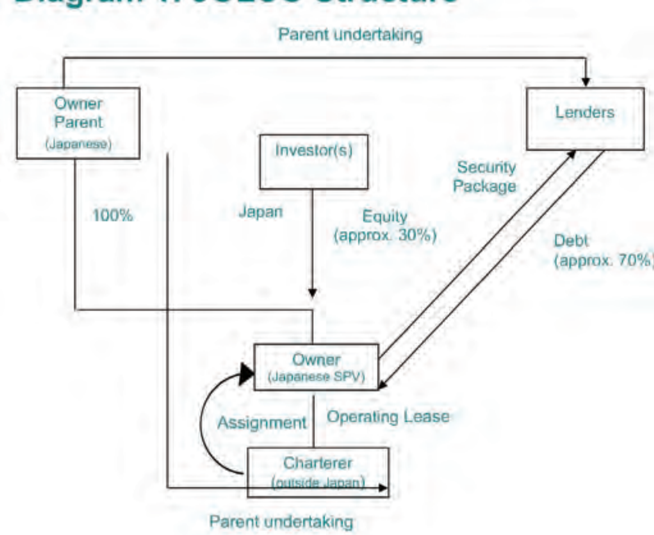
GROWTH OF JOLCOS

The discretion of Japanese investors makes it hard to put an exact figure on the number of JOLCO financings taking place, but leasing companies continue to report significant increases in the appetite for JOLCO financings. Figures from a reliable source indicate the value of vessel financings by way of Japanese Operating Lease (including JOLs and JOLCOs) during the period 2011 to 2017 has increased by 174%.

Given the savings glut in Japan, Japanese investors are looking at alternative ways of investing given negative domestic interest rates, which has resulted in this niche product becoming more mainstream.

Typically, the Japanese investors will be profitable small- and medium-size enterprises in Japan. Based on the figures from the Ministry of Finance's fiscal 2016 Financial Statement Statistics of Corporations, there are approximately one million SMEs in Japan that can be targeted to purchase equity from the tax leasing arrangement business, and the aggregate recurring profit from these Japanese SMEs was approximately JPY 30 trillion. As such, there is huge

Diagram 1: JOLCO Structure



potential equity market to be tapped for potential equity investment.

At a time when financing in the maritime sector is still in recovery, the JOLCO is becoming an increasingly popular financing structure.

REASONS FOR POPULARITY

100% financing

One of the main reasons for the rise of the JOLCO is the reduced availability of direct bank lending, which has led to an increase in lease financing generally, of which JOLCOs make up a relatively small but important portion. Both internal compliance and externally imposed regulatory requirements have impacted financiers' ability and flexibility to lend, and amounts available for funding have dropped. Today, lenders often require LTV ratios of up to 70%. Additionally, the pool of lending banks is also smaller, with a number of traditional shipping banks — even those that are used to the cyclical nature of the shipping industry — withdrawing from the maritime sector and selling their shipping portfolios. JOLCOs structures can fill this 'lending gap' as they typically offer 100% financing to ship owners; this is roughly split 30% equity and 70% bank debt.

Cost of equity

The Japanese equity investors, via the Japanese SPV, opt for a double declining balance sheet depreciation method in their accounts, which gives rise to accelerated losses for the Japanese SPV (by way of costs from depreciation of the vessel, interest payments on the loan, and management fees owed to the Japanese SPV). Each individual investor is then able to offset its tax benefit from depreciation of the vessel and its share of the other losses from the Japanese SPV against the taxable profits of its main business, and thus defer taxes.

In common with many other forms of tax-based leasing products, a portion of the tax benefit derived by the equity investors is passed on to the charterer. In addition, since repayment of the equity is mainly 'back-ended', the rentals paid during the charter term are used primarily for paying interest and principal on the senior debt. Consequently, for the shipping company, not only does a JOLCO offer 100% funding, in addition it usually also offers cheaper blended funding over the term of the transaction than pure bank debt on a typical loan/mortgage structure.

The financiers' perspective

The JOLCO structure offers a proven structure for lenders and gives them access to clients with good credit ratings that they may not otherwise be in a position to lend to directly.

OTHER KEY FACTORS IN DOCUMENTATION

There are various factors that will impact the transaction documents involved in a JOLCO. The nature of the operating lease will depend on the terms of the financing documents required by the lenders involved in the loan, all of which will be impacted by factors such as the predicted residual value of the asset, the leasing period, and the interest rates. Additional factors include the credit status of the shipping company, interest rates in the market at the time of the charter, the investors' expected return, and other costs including, for example, arrangement fees.

Additionally, the charter will be structured so, if there is an early termination of the transaction, the amount payable by the shipping company will defer depending on the reason for the termination.

JOLCOS NOT FOR EVERY TRANSACTION

Despite the benefits, Japanese operating lease structures are not necessarily as accessible as other types of lease financing. Firstly, the Japanese equity will be looking at a certain calibre of owner. That is not to say that only first-class shipping companies will be considered, as the pool of potential JOLCO candidates definitely seems to be growing. It also comes down to a matter of the asset in question and how core that asset is to that shipping company's ongoing business, as there is an expectation that the shipping company will exercise the purchase option in the charter. In order to be attractive to the Japanese investors: (i) newbuild vessels usually require a special depreciation certificate, and (ii) second-hand vessels need to be of a certain age and will require a certain advance rate. Finally, it is also worth noting that JOLCO structures are not as flexible to refinancing as typical loan/mortgage structures.

FUTURE OF JOLCOS

Changes to accounting principles pursuant to IFRS 16, which comes into effect on 1 January 2019, will eliminate nearly all off balance sheet accounting for lessees. Whilst this may remove some benefit of the operating lease structure unlike other operating lease structures, in the case of the JOLCO, there are sufficient remaining upsides for the structure to remain popular.

Japan is one of the world's largest export economies, and a lot of the profits generated by the SMEs that invest in JOLCOs derive from exports. A global "trade war" would likely have a negative impact on the profits of these SMEs which, in turn, would reduce the requirement of those SMEs to defer taxes.

Finally, it should be borne in mind that new tax rules are announced in Japan every couple of years, and the next revision, due at the end of this year, will be applicable from April 2019. Whether these changes affect the tax treatment of JOLCOs will be closely watched.

CONCLUSION

The JOLCO has a strong pedigree. While the tax regime in Japan remains the same, interest rates remain low in Japan, and Japanese SMEs continue to make impressive profits. Thus, the demand and availability of this product in the maritime sector will continue to blossom.