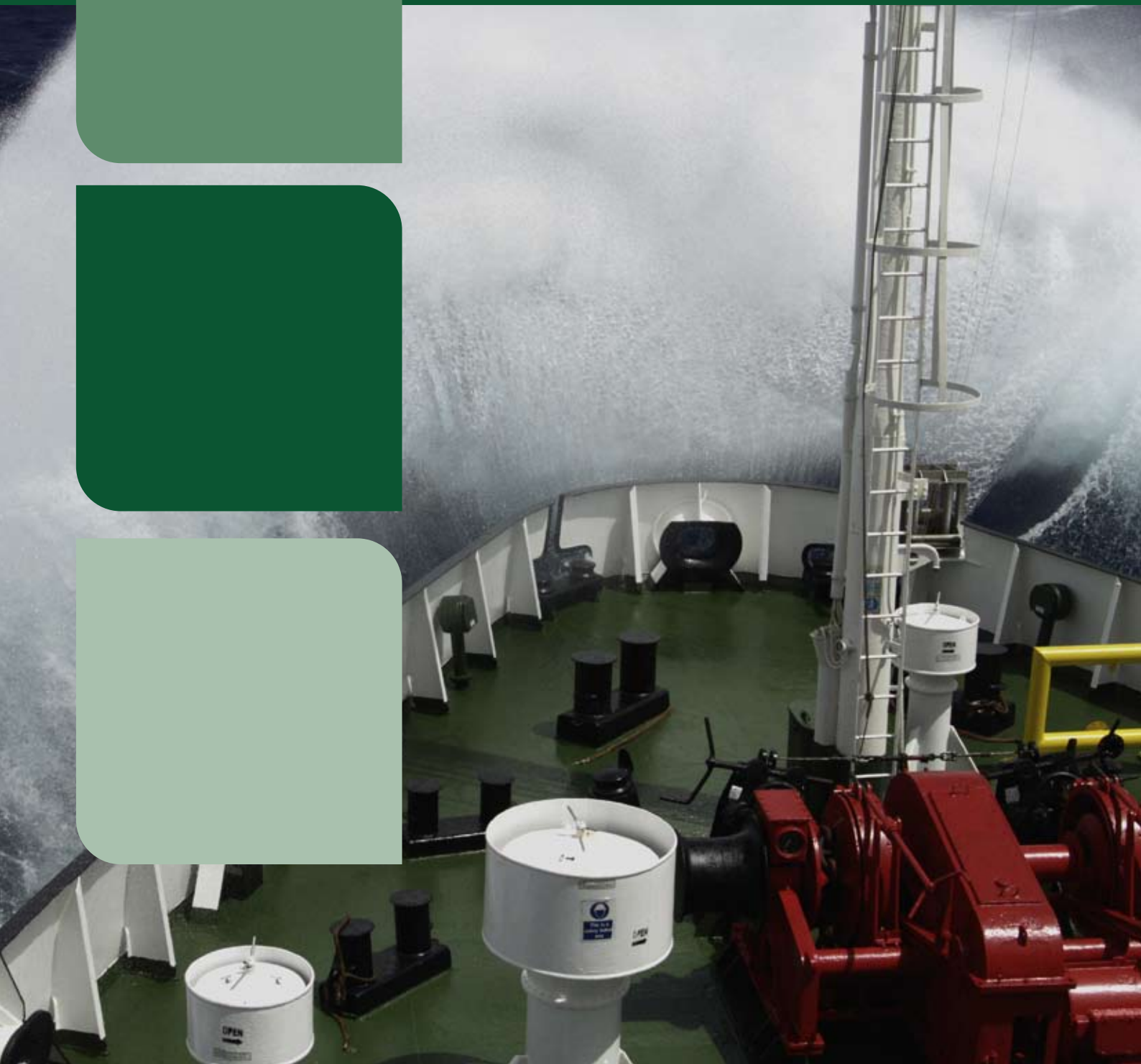




Safe passage ahead

Is the shipping industry unsinkable?



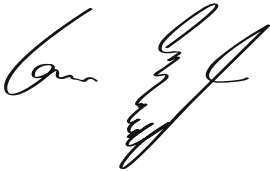
Foreword

February 2010

Last year was every bit as tough for the shipping industry as predicted: most large carriers have posted losses, many ship owners have seen equity wiped out and new-builds have slowed. Although the wider economy is showing signs of stabilisation and even recovery, the outlook for shipping remains dark. Primed for steep growth before the credit crunch and global slide in trade, the industry is still dangerously exposed. With a global excess of capacity, cash running out and rates at a sustained low, 2010 promises little comfort.

So far, mass failures have been averted primarily through cost-cutting measures and renegotiations of loan terms. But the extended period before likely recovery means that further aggressive restructuring strategies will be needed by many stressed companies. The coming year will see closer-than-ever negotiation between owners, operators and banks. Innovation and urgency will be required as more pressure is put on both the lenders and the industry as cash dries up.

This report examines the shipping sector's passage through a turbulent period and plots its route to recovery. Expert insiders give their analysis of lessons learned and progress made – and propose measures to minimise long-term harm.



Lars Westpfahl

Partner

T +49 40 36 90 62 51

E lars.westpfahl@freshfields.com

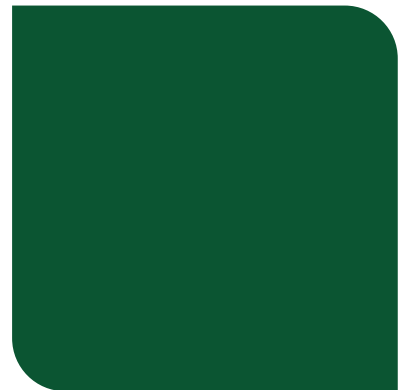
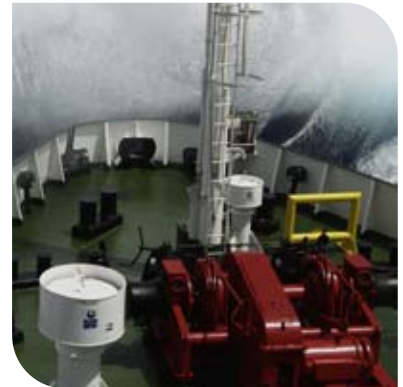


Jan-Holger Arndt

Partner

T +49 211 49 79 244

E jan.arndt@freshfields.com



Contacts

PARIS

Amir Jahanguiri

Partner

T +33 1 44 56 54 19

E amir.jahanguiri@freshfields.com

HAMBURG

Michael Schäfer

Partner

T +49 40 36 90 61 26

E michael.schaefer@freshfields.com

HONG KONG

Bruce Cooper

Partner

T +852 2846 3417

E bruce.cooper@freshfields.com

LONDON

Ken Baird

Partner

T +44 20 7832 7168

E ken.baird@freshfields.com

HAMBURG

Lars Westpfahl

Partner

T +49 40 36 90 62 51

E lars.westpfahl@freshfields.com

LONDON

Richard Tett

Partner

T +44 20 7832 7627

E richard.tett@freshfields.com

HAMBURG/DÜSSELDORF

Jan-Holger Arndt

Partner

T +49 211 49 79 244

M +49 172 24 50 972

E jan.arndt@freshfields.com

LONDON

Presley Warner

Partner

T +44 20 7832 7653

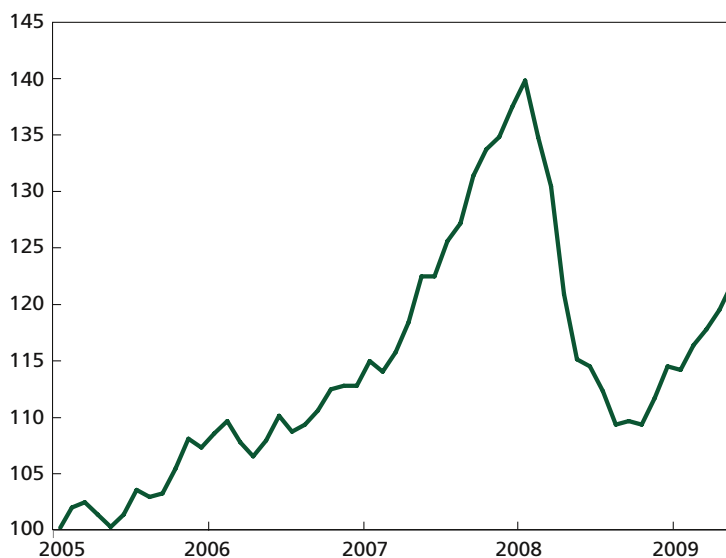
E presley.warner@freshfields.com



A rough year, survived by most

When we published our report *Surviving the storm* at the German Ship Finance Forum this time last year, it was clear that the industry was confronted by some of the fiercest challenges in its history. Recent years had returned only growth to liners, ship owners, ship builders, ports and other associated parts of a sprawling, global sector. But the world economic collapse hit hard and weakened each link in the shipping supply chain. The reversal in world trade trends (see graph below) had a near-immediate effect on the need for transport to move goods around the world and prices tumbled as a consequence.

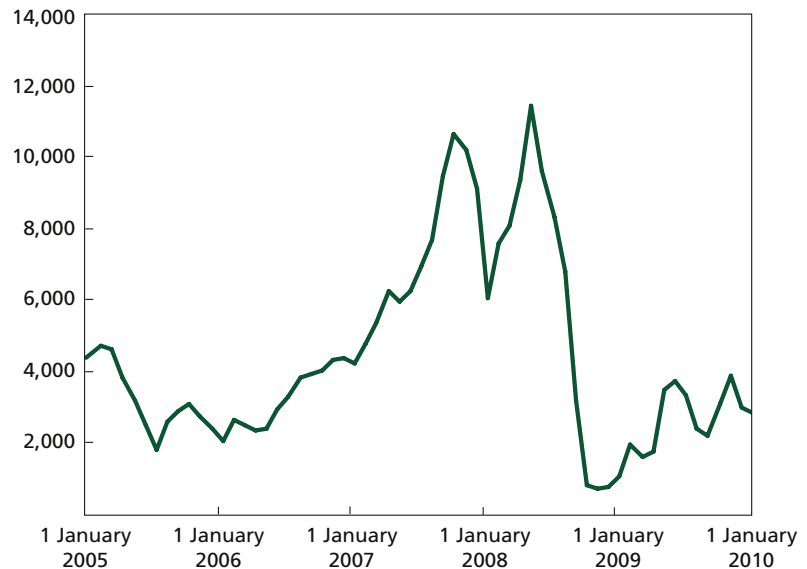
Picking up: index of world trade



Source: CPB

The shock waves rocked the industry all the harder for the fact that it was gearing itself up for continued steep growth: decline or even stasis had previously been unimaginable and therefore had not been widely planned for, even by the most risk-averse players. So, as world demand evaporated, the industry became burdened with unneeded capacity (see graph on next page) and the unwelcome prospect of brand new ships being readied for launch. As 2008 ended and last year began, the maths started to look pretty frightening. Both freight rates and charter rates slumped into loss-making territory. For owners, ships ordered just a couple of years back for, say, \$50m might by last year have been worth \$25m. For banks, assets were threatened and for investors, forecast returns were looking like fanciful dreaming in retrospect.

Progress in 2009: Baltic Dry Index



The BDI index assesses the cost of moving raw materials by sea

Yet the industry sails on. The catastrophic failures that were looking so distinct a possibility as the economic world stumbled did not materialise. No major carrier fell in 2009 and no bank imploded because of its exposure. Of course, that forms only part of the story... Although the shipping sector has shown its inherent strength in making it through the year with some semblance of completeness, there have been horror stories.

For liners and ship owners, 2009 was almost universally a year of loss. Although many shipping companies are private, those publicly listed reveal that the damage caused was significant. There have been pockets of comfort: ports, for example, have remained in a solid position and certain offshore companies even made a profit last year. For the majority of dry-bulk, container and tanker shipping, though, there was really only one direction.

But just as their world was rocked, so it can be seen that others have sought advantage. A shift in the way bulk markets work has been noted by Tim Jones, chief executive of international ship broking firm Barry Rogliano Salles. He points to businesses for which 2009 represented an opportunity for strategic manoeuvres: 'A suppliers' market has emerged. Forty per cent of the capesize fleet was chartered to deliver iron ore CIF [cost, insurance, freight] by the mining companies Vale, Rio Tinto and BHP Billiton.' Freight as a commodity has become integrated into industrial processes. And although there may still be dry-bulk capacity sitting idle and to be delivered, he points to the huge increase in China's import of steel and coal in 2009 as an indicator that the sector remains active.

Elsewhere, Jones notes the prescient actions of certain carriers, particularly Oldendorff – a company that sold ships and weathered the downturn

with an increased reliance on chartered vessels, remaining poised to take advantage of cheaper assets as values fall in line with the reduced charter returns.

Though rare success stories are there to be found, tales of woe are abundant. Shipping newspaper *TradeWinds* continues to publish its 'Crisis watch' section – and there has been no shortage of content. Jan-Holger Arndt, a Freshfields partner who has advised banks and shipping companies throughout the recession, sums up the damage: 'There have been some total failures. In Germany alone, 13 one-ship companies have gone under. Companies with critical mass have fared better, but losses have been counted and debt has grown fast.' Arndt notes that the crisis has been a leveller – with the biggest liners and owners seeing fortunes sink in unison. But he is quick to speak up on behalf of the industry. 'We see an industry in crisis because of the global recession. The situation is as it is because of the behaviour of the market, rather than poor strategy.'

The clean-up operation, though, is a necessity regardless of the origins of the problem. 'We have seen impressive efforts on behalf of both the industry and the financial institutions to ensure that the storm is weathered,' he adds, 'and both sides have shown intelligence and resilience in defending themselves from collapse.'

Keeping the industry afloat

At the forefront of initiatives to survive the dual effects of increased capacity and decreased demand has been operational adjustment. Early in 2009, freight rates bottomed out. Since then, they have bounced back up – with the big carriers making a concerted move to slow-steam and withdraw ships to reduce capacity and restore higher prices. As the year ended, those companies with a balanced cost structure were trading at break-even or better. Of course, with capacity lying idle, it is inevitable that there are those who will see the downside of the industry-wide move to increase freight rates – and charter rates remain low. It is a point noted by Jesper Kjaedegaard, partner at Mercator International and chairman of Maritime UK: 'The huge drop in volumes in 2008 and 2009 paired with a significant new building programme has led to around 12 per cent of the world's container ship tonnage being laid up. As it tends to be favourable for the big carriers to keep their own vessels in operation, there are owners unable to charter out their vessels and who are suffering as a consequence. The German KGs have been particularly badly hit – and much of their capacity is lying idle off Singapore.'

Elsewhere in operations, the future shape of fleets has been modified in reaction to shrunken demand. Flamboyant ship-building plans have been revised across the board – with companies looking to alter timings or costs or even to scrap new-build plans.

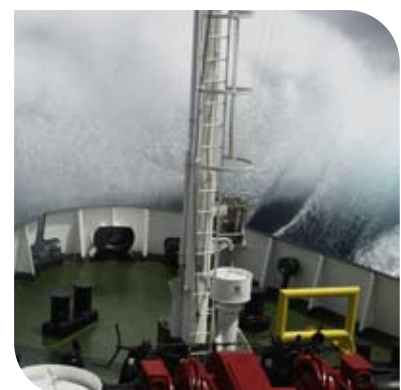
Stories of sharp contract negotiations abound – as is typical in an industry fighting for its very survival. In many cases, the detail of an original contract has been overruled for a 'best-case scenario' price – and one doesn't have

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to look far to find examples of ship owners chartering their assets out at a discount from what was promised. After all, it is easily argued that covering costs is better than tying a vessel to a harbour wall on principle.

The industry seems to have made a conscious, if slightly uncomfortable, decision that tough times call for practical measures. There certainly seems little appetite to take negotiations to court. Even if that might make legal sense, the cascade effect is such that one company's potential failure very obviously represents a threat up and down the supply chain.

Beyond operational streamlining and contract negotiations, companies have had to look for innovative emergency measures to help them cope with increasingly daunting liabilities. The inevitably extended period of over-capacity – our expert contributors predict recovery of supply-demand equilibrium arriving as late as 2014 – means that even the biggest players and the most prudent companies have had to look at significant restructuring. To an industry so used to growth, this has been a steep learning curve. Freshfields partner Lars Westpfahl has seen increasing urgency on both sides of the equation: 'As the crisis deepened, banks quickly became aware that they were facing the spectre of borrower default. Initially this would be dealt with on a case-by-case basis. But as the recession deepened, and likely recovery moved farther into the distant future, it became clear that this was a systemic problem that would require global solutions.'

Banks have, in general, shown a willingness to help the industry renegotiate the terms of their loans. With analysts believing that shipping will likely make a good recovery as global demand resumes, it is clearly in the lenders' favour to avoid write-downs when their troubled assets may well be returned to health.

The sector has also seen salvation in the form of faithful shareholders and new investors on the capital markets. CSAV, the largest of the South American shipping companies, last year pushed through a three-phase capital increase to cope with financial losses incurred. It found a total of \$710m of new financing, initially from existing investors and other third parties, followed by further funds from German ship owners. Effectively a debt-for-equity swap, this robust series of moves – combined with operational adjustments – leaves CSAV in a strong position. In total, around 80 ship-owning entities were involved, showing just how wide-reaching such activities can be.



Pulling together

Shipping remains an area of concern to banks and, increasingly, to governments and regulators. Although wholesale governmental intervention has not yet occurred – there are isolated initiatives under way, such as Korea's ship purchase and finance programme – the industry is big enough in certain countries to ensure that its fate is of national concern. We have not yet reached the stage at which governments step in to prop up failing companies, as for the automotive sector, for example. But the industry is being watched. Regulators, too, in seeking to ensure banks are not

dangerously exposed, will increasingly become a consideration for the ship-financing sector. This year will likely bring closer scrutiny of banks' ship books.

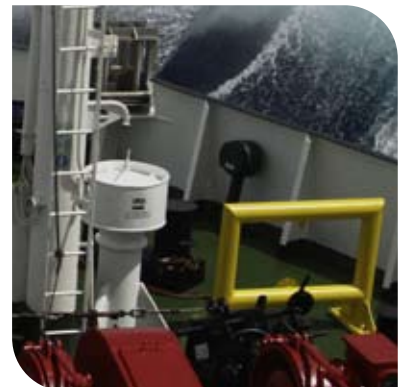
Westpfahl spots a change in relationship between banks and the industry over the past year: 'Some borrowers previously had a tendency for coldness towards the banks. But both sides have seen their risk increase and we are now witnessing genuine efforts to work collaboratively. It has been agreed that fire sales and liquidations can present greater risk to both sides than renegotiation of terms.' Where there is a financing gap that cannot be resolved through such adjustments, low asset prices have already started to interest new players – particularly in private equity. 'It is very likely,' adds Westpfahl, 'that the capital markets will become more involved in shipping over the next couple of years. This will lead to enhanced levels of transparency to meet the demands of regulators.'

A natural target for investment is the ship-building pipeline. New money will come to the aid of companies struggling to comply with contracts set before the recession. Ship prices are now looking attractive and could bring good returns when the sector returns to health.

The industry may yet prove able to guide itself out of danger with collective determination and practical protective measures. And, as Tim Jones points out, assets are now eminently affordable to those with the means. Although it is certain that many will have to fight hard to survive, and the shape of the sector may noticeably change as a consequence, new opportunity is starting to take the edge off the gloom.

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About us

Freshfields is a leading international law firm with a global shipping practice. The large, specialist team is drawn from experts in multiple disciplines, including: port development, shipping, M&A, restructuring, financing and fund initiation. The firm is uniquely positioned to offer counsel during the shipping downturn.

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