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Public and Private Equity Markets

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7.1 Introduction

The public and private equity markets constitute viable sources of ship financing alongside bank debt and other debt alternatives. Although a less traditional source of ship finance, the equity capital markets and private investors offer a plethora of opportunities as seen in Fig. 7.1, for both public and private shipping companies, albeit some solutions are more favored and applicable than others. As illustrated in Fig. 7.1, a private company may issue common stock in the public markets in a registered initial public offering (IPO), or they may choose to do an equity private placement. A public company may access additional capital in the public markets by pursuing a private investment in public equity (PIPE), a follow-on offering or through an equity-linked security such as convertible debt. Execution tactics are dictated by market conditions, investor appetite, structural considerations and trading dynamics. This chapter primarily focuses on the most relevant equity products available to private shipping companies with a particular emphasis on the benefits and drawbacks of being a public versus a private company, IPO structures and processes, as well as the role of private equity within the maritime sector.

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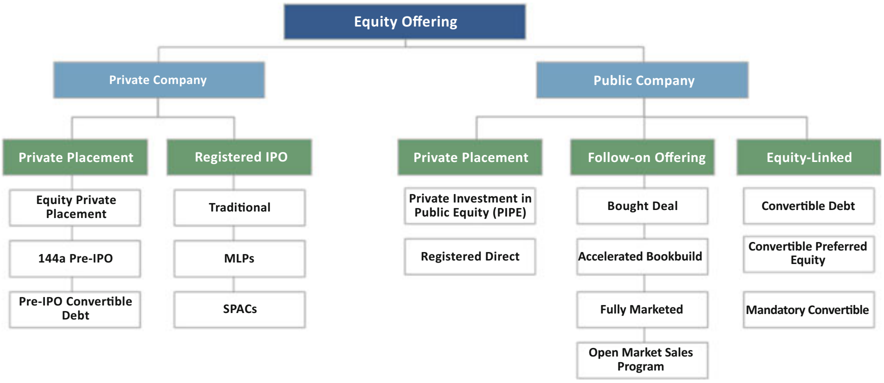

Fig. 7.1 Equity options available to public and private companies (*Source*: Jefferies)

7.2 Public Equity

7.2.1 Public Equity Overview

Public equity is an asset class of which institutional and/or individual investors can purchase ownership in shares of a company through unregulated and regulated public markets. Within the public equity asset class there are different types of equity, depending on the type of company that issued the equity as well as the seniority of the equity. In the shipping public equity landscape, the main types of equity available to investors are common and preferred equity (preferred equity is rated higher than common equity in liquidation) issued by C-corporations and units issued by master limited partnerships (MLPs).

C-corporations A C-corporation is a legal business entity that is taxed separately from its owners and is the most common structure for major companies. Shareholders of C-corporations own stock in a company which allows them to elect the board of directors, vote on certain strategic decisions and entitles them to a corporation's earnings, which are distributed through dividends unless reinvested back into the business for growth purposes.

Limited Partnerships (LPs) and MLPs An LP is another form of company structure, with an MLP being a type of limited partnership that is publicly traded. LPs are structured as pass-through entities and therefore avoid double taxation. The LP formation is often used by companies established to invest in industries linked to natural resources as well as real estate development. There are two categories of partners in LPs and MLPs: the limited partners and the general partner. The limited partner is an individual investor or a group of investors that provides the capital to the partnership; that is, the limited partner holds "units" and receives periodic income distributions from the partnership's cash flow. The general partner is responsible for managing the partnership's business and receives compensation that ideally is linked to the performance of the entity. To qualify, entities must satisfy the MLP qualifying income criteria requiring that the company must derive at least 90% of its gross income from real estate, mineral and natural resources (excluding renewable resources). Many MLPs are focused on the midstream sector of the supply chain as the qualifying income rule includes the storage and transportation of such resources but does not allow marketing these resources to the end users at the retail level. Pipelines and storage facilities are especially common MLP candidates as these companies' assets tend to have long-term contracts in place with stable cash flow outlook and visibility. However, MLPs are also common in shipping where vessels can be chartered out on long-term charter contracts. The advantage of the MLP corporate structure is that it combines the tax benefits and lower associated cost of capital of a limited partnership, as profit is only taxed when unit holders receive distributions, with the liquidity and flexibility of a publicly traded company. A comparison and overview of the MLP structure versus the C-corporation structure is laid out in Fig. 7.2. The tax benefits associated with MLPs are less important for shipping MLPs as shipping companies tend to be registered in jurisdictions with favorable tax regimes and therefore do not bear heavy tax burdens even if the entity is structured as a C-corporation or equivalent. This also gives shipping MLPs the advantage of only needing to file form 1099 for tax reporting purposes, as opposed to the more complicated schedule K-1 required for traditional MLPs. MLPs typically distribute a high percentage of their income through cash distribution policies or generous dividend payout policies compared to C-corporation entities, which causes the higher MLP dividend yield results. Strong investor appetite for yield, and the premium that is attached to yield-based valuation, have driven the wave of shipping MLP formations in the past few years.

Special Purpose Acquisition Vehicles (SPACs) A SPAC, often referred to as a "shell company" or a type of "blank check company", is a development stage company that has indicated that its business plan is to acquire another company with the proceeds of its public offering. SPACs typically have an 18–24 months deadline to complete an acquisition that must satisfy specified

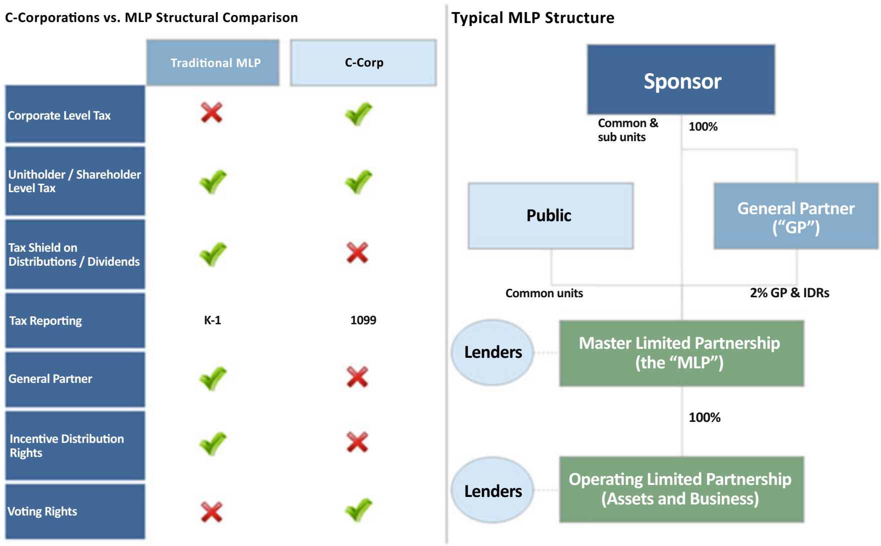

Fig. 7.2 US C-corporation structure vs MLP structure (*Source*: Jefferies)

requirements. If the SPAC is unsuccessful in making an acquisition, the proceeds—plus interest earned—must be returned to investors. SPACs are often used as vehicles in reverse mergers in order to facilitate the process of taking the private purchasing entity public. Reverse mergers allow private companies to become public without raising additional capital.

Advantages and Disadvantages of Being a Public Company Being a public company offers a range of advantages and disadvantages that shape the key decisions surrounding the corporate structure and various financing options (see Fig. 7.3).

Advantages:

Higher Company Valuation Public companies tend to have substantially higher market values than any of their private counterparts. The market liquidity of the company is a key factor in boosting a public company's valuation as investments in them can be easily bought, sold or traded, whereas trading investments in private companies usually go through a much more time consuming and costly process. Besides market liquidity, proper governance structures, easy access to audited financials, compliance with regulatory standards, transparency, preferential access to deal flow and market opportunities, and access to the capital markets are also factors that drive higher valuation premiums for publicly listed companies versus privately held ones, *ceteris paribus*.

Advantages

- Higher company valuation
- Ability to fund growth
- Increased liquidity, improved access to capital and reduced need for alternative financing options
- Better economics for raising capital
- Ability to use stock as currency for acquisitions and assets
- Human resources
- Exit and retirement strategy for founters, investors, and shareholders
- Public credibility

Disadvantages

- Extensive listing requirements
- Business transparency
- Costly process
- Pressure from market to focus on short-term results and hit earnings estimates
- Increased scrutiny of management
- Risk of takeover and loss of control by founders and management

Fig. 7.3 Advantages and disadvantages of going public (*Source*: Jefferies)

Ability to Fund Growth The process of going public can inject meaningful cash to fund various business initiatives and acquisitions, making it potentially easier for a company to execute on its growth strategy.

Increased Liquidity, Improved Access to Capital and Reduced Need for Alternative Financing Options Access to public equity creates another option for company financing. Private equity may at times be difficult to obtain and various debt structures unviable, but by being public a company is able to cast a broader net for financing providers. This gives the company greater flexibility with diverse options to finance growth, thereby increasing its bargaining position and strengthening its balance sheet.

Better Economics for Raising Capital On average, the cost of capital has historically been lower for publicly traded companies, especially with respect to equity. Investors are more willing to purchase smaller pieces of equity in a public company, which is liquid and easy to trade, than in the equity of a private company. This essentially lowers the cost of capital for public companies. Additionally, because public companies have higher valuations they would have to sell less stock to raise a certain amount of capital and thus realize less ownership dilution.

Ability to Use Stock as Currency for Acquisitions and Assets The ability to use stock as consideration in merger and acquisition deals once again provides a public company with greater flexibility than its private counterparts. This ability makes growth via acquisitions a less costly and easier process whilst preserving the company's cash position.

Human Resources A public company is able to use its public equity as a method of creating employee incentive packages that could attract talent and improve retention. Although a private company could provide employees with equity in the private business, it would be much more difficult for employees to potentially monetize that equity due to the limited liquidity.

Exit and Retirement Strategy for Founders, Investors and Shareholders The superior flexibility and liquidity of a public company is especially important when considering exit strategies for its founders and investors. Exit windows will be more readily available and more viable for public companies.

Public Credibility Going public is in many ways a "branding event" bringing added public awareness of the company as analysts begin covering the company and thereby improving its visibility. This sense of improved credibility can lead to better supplier and customer contracts and also potentially attract and retain talented senior management who seek prestige, credibility and professional growth in their employment opportunities.

Disadvantages:

Extensive Listing Requirements Public companies need to comply with the reporting requirements established by the regulating bodies governing the public exchange on which the public company is traded. These listing requirements may be extensive as well as expensive to adhere to.

Business Transparency The listing requirements may also necessitate sharing sensitive information with the public that may reveal trade secrets, as well as competitive and confidential information. More readily available information could potentially lessen a company's bargaining power by revealing to clients and suppliers its contracts and earning position.

Costly Process The process of going public is expensive and time-consuming with costly fees related to the necessary administrative, legal, accounting, filing, printing and underwriting aspects. Additionally, there is also the risk that an IPO offering may not be successful—meaning that all fees and expenses incurred during the roadshow will, for the most part, not be recoverable.

Pressure from Market to Focus on Short-Term Results and Hit Earnings Estimates Public companies may increase the focus on short-term results instead of long-term growth strategies, as a response to pressure from the market to meet or exceed current earnings estimates. Public investors often have short-term investment objectives, sometimes at the cost of curtailing long-term opportunities, thus putting pressure on the company's management for immediate positive results that will drive the stock price higher as opposed to valuing meaningful long-term strategic decisions that may have a negative impact on the immediate earnings. Private companies on the other hand are guarded from this public analysis as financial results are not publically distributed.

Increased Scrutiny of Management Along with evaluation of earning results, public companies are also subject to increased scrutiny of management. Increased transparency facilitates public scrutiny of management's role, actions and compensation. Additionally, there is a higher risk of exposure to civil liabilities for the public companies and the management and directors for any false or potentially misleading statements made. The elevated risk as well as the more focused market and media attention may also cause the management to spend less time dealing with the operational aspects of running a company that could positively impact on its financial results, and instead spend more time on public relations and responding to market pressure.

Risk of Takeover and Loss of Control by Founders/Management Public companies are exposed to hostile takeover attempts through tender offers and may suddenly find themselves sold against their will. A variety of preventive measures such as golden parachutes, supermajority rules, a staggered board of directors, dual class stock and poison pills may be instituted to guard against hostile takeovers, but are not always entirely effective and take time and effort to implement successfully.

7.2.2 Public Shipping Equity

Shipping Equity Landscape Evolution (2000–15) Traditional merchant bank loans continue to be the most popular source of funding for shipping companies; however, the last decade has seen the funding universe widen. Public equity played a minimal role in the shipping industry up until the early 2000s with IPOs few and far between. The booming freight rates and robust global trade fundamentals, especially the industrialization of the Chinese economy that drove strong demand for raw materials, supported high charter rates and boosted shipping asset values higher, which in turn drove favorable company valuations. The strong fundamentals provided shipping companies with the ability to promise investors high dividend yields and potential for capital appreciation. As the shipping industry's relationship with the public equity market has developed, the composition and characteristics of public shipping companies has evolved alongside it. In the early 2000s, shipping companies with small fleets, often with a vessel count below ten, found enough traction to go public. In the past couple of years, the shipping equity landscape has altered and mainstream shipping companies operating in dry-bulk, crude oil tankers or the container shipping segments find that the potential for extensive scale economics is viewed as essential. Therefore, a larger fleet of on-the-water vessels and/or contracted newbuildings is often critical to launch successfully in the public equity markets. Also, in the past couple of years, the only IPOs that have launched successfully without scale have been for specialized shipping companies operating in niche markets such as liquefied petroleum gas (LPG) and liquefied natural gas (LNG), which, for the most part, attracted strong initial investor interest, above-range pricing and robust after-market trading; such investor interest was not directly for the shipping companies per se but their "proxy" value in the energy markets (oil, shale, gas, etc.).

Shipping Markets/Exchanges Shipping capital market activity is found in both over-the-counter (OTC) markets as well as stock exchanges. The most active stock exchanges for shipping companies are the New York Stock Exchange (NYSE), the NASDAQ, Oslo Børs (OB), the London Stock Exchange (LSE), the Tokyo Stock Exchange (TSE) and the Stock Exchange of Hong Kong (SEHK). Each exchange tends to cater for their regional shipping companies; for example, most Scandinavian shipping-related public companies are listed on OB while Asian public shipping companies are listed on the TSE or the SEHK.

NYSE/NASDAQ The NYSE and NASDAQ cater for American shipping companies but also international companies that are looking to access the American extensive and well-developed capital market. The US Securities and Exchange Commission (SEC) governs the publicly traded companies listed on the NYSE and NASDAQ stock exchanges and requires that these companies comply with an extended list of standards. These requirements include comprehensive public reporting requirements, minimum financial standards, such as minimum share price or number of shares, as well as other transparency and maintenance standards. For shipping companies who have traditionally operated in a comparatively opaque cross-border business environment and kept the majority of any company information confidential, the SEC's transparency standards can be challenging to accept. It is often a key deterrence in keeping a company from pursuing an IPO on a regulated exchange.

OTC Exchanges Of the OTC markets, the Norwegian OTC market (NOTC) is the most active in the shipping sector. For most issuers, time is money, and with short windows available for a potential IPO/follow-on offering, the speed to market and ease of execution are very important factors. The NOTC provides an issuer with a few key advantages to a stock exchange like the NYSE or OB. Being an OTC exchange, the NOTC imposes fewer regulating requirements. For example, the NOTC does not require quarterly filings. Comparatively fewer regulatory barriers and maintenance requirements expedite the process substantially. An additional advantage of the NOTC is that the associated listing costs are lower than those of stock exchanges. OTC exchanges can also be considered as an attractive entry point into another market. For example, the NOTC would provide a company with access to the Norwegian investor base, which has historically been very focused on the maritime industry due to its key role in the Norwegian economy. However, if the OTC listing is a company's sole public listing location, the company's management often plans to shift to a regulated stock exchange with time. This is primarily due to the less liquid profile of OTC listed companies, which can pose significant limitations.

7.2.3 Initial Public Offerings (IPOs)

The process of taking a company public is demanding, time consuming and involves cooperation with several parties such as lawyers, accountants, investment bankers, company management and board of directors (see Fig. 7.4). The process can be divided into four main phases:

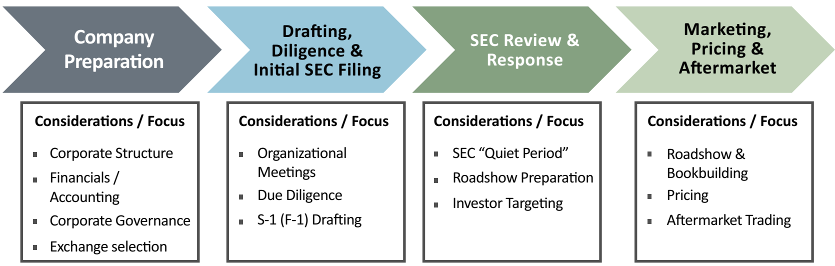

Fig. 7.4 IPO process on a senior exchange in the USA (*Source*: Jefferies)

1. company preparation;
2. drafting, diligence and initial SEC filing;
3. SEC review and response;
4. marketing, pricing and aftermarket.

Company Preparation A key component of the company preparation phase is to analyze the company to determine the most appropriate corporate and capital structure for it. It is not necessary, but most often recommended, that a company is structured as a C-corporation prior to beginning the IPO process. If the company therefore has to convert from another entity form, such as an S-corporation, adjustments need to be made and the resulting taxes covered (S-corporations do not pay corporate taxes but pass this burden onto shareholders instead). Authorized equity capital should be adjusted to reflect the required number of shares of common stock for the IPO. This first phase also includes preparatory accounting work, which means having historical audits prepared if not already assembled, and preparing specific presentations as required by regulations like Sarbanes-Oxley. The SEC requires that companies report specific segment data that are consistent with how management evaluates company performance both internally and externally. Pitfalls can occur when the company unintentionally presents itself as having different reporting segments. Auditors will often provide guidance on the best method to report their revenues and expenses before they file with the SEC, so as to minimize the requirement to report in segments. Employing an accounting firm that is familiar with the IPO process is often a helpful start to the process and can provide a company with meaningful guidance. Additional key decision points in this phase include selecting the most appropriate exchange for the company to be listed on, revisiting and refreshing key management contracts with incentive and compensation elements in place and a general corporate governance structure, and creating organizational documents which will be requested for legal and business diligence. The company must also select an investment bank to be the lead bookrunner and potential additional bookrunners and co-managers. Key factors that companies consider when selecting bookrunners include previous IPO and equity transaction experience of firms, relevant research analyst coverage, industry experience, investor relationships and distribution platforms, and how much capacity the firm has to focus on the company. The number of bookrunners is usually determined by the relative size of the offering to be distributed, and with the aim of achieving an optimal level of control and accountability whilst instilling some sense of competition in respect to performance. Co-managers on the other hand are primarily used for aftermarket support and can be helpful in providing incremental retail distribution.

Drafting, Diligence and Initial Filing The second phase centers on the working group reviewing due diligence materials, determining the final structure and timing of the deal, as well as preparing valuation and marketing materials. The working group typically includes the company, company counsel, underwriters and underwriters' counsel. The due diligence performed spans the business, legal and financial aspects of the company and is a critical element in the offering process as it helps to ensure that disclosure documents provide a complete and accurate picture of a company's operations, financials and future prospects. The company and the underwriter's counsel will draft a preliminary prospectus called an S-1 registration statement for US companies or an F-1 for non-US issuers, to be filed with the SEC, which can be filed on a public or confidential basis depending on the management's preferences. The Jump Start Your Business (JOBS) Act, which became effective in April 2012, provided companies that qualify as emerging growth companies (EGCs) with regulatory relief which allows for confidential filings as well as other benefits such as the ability to test the waters and go on non-deal roadshows. The law was designed to create more jobs by facilitating smaller, high-growth companies with easier access to capital markets.

SEC Review and Response The SEC typically takes approximately four to six weeks to perform their initial review of the filed S-1 or F-1. Once the registration statement is filed, there are usually two to three rounds of SEC comments and responses prior to launching the roadshow. The SEC's main objective during the review process is centered on company disclosure and fair representation to the public and not on whether the offering represents a "good investment". This phase is often also referred to as the "quiet period" (or "waiting period") as it is important that all company communications continue to be "normal course" and refrain from commenting publicly about the IPO whilst the SEC finishes its review process and declares the registration statement as effective. Any failure to comply with the federal communication limits during this period is referred to as "gun-jumping" and will have various consequences depending on the type of company in question. For example, if a quiet period violation occurs, the SEC may impose a "cooling-off" period, impose fines and rescission rights may be exercised. At the end of this process, prior to the roadshow launch, the S-1 or F-1 will have its final amendment, which will include the filing price range and the number of shares offered.

Marketing, Pricing and Aftermarket In the fourth and final stage of the process, the management and bookrunners will undertake a roadshow covering key geographic regions where potential investors are located. Bookrunners will receive investor feedback and consolidate indications of interest. The final pricing is dependent on overall investor demand and picking a price point that assures strong aftermarket trading performance. For shipping IPOs, an important factor in selecting an underwriter and bookrunners involves considerations revolving around their knowledge and experience in the shipping industry, experience in addressing shipowners' concerns about the process and fulfilling listing requirements, as well as established relationships with targeted shipping investors.

Aftermarket Trading of IPOs As illustrated in Fig. 7.5, MLPs and companies focusing on the LNG and LPG sector have performed the best in the aftermarket out of the shipping IPOs in the past few years. It is important that a company performs well in the aftermarket in order to facilitate any secondary offerings down the line. If aftermarket volume traded is poor, investors will likely be wary of investing in any follow-on offerings due to value depreciation and liquidity concerns. A fine balance should be targeted with a moderate IPO discount of approximately 10% of equity value to keep investors content with the result whilst securing an appropriate valuation for the company. Along the same lines, sufficient public float is also important to attract investors and reduce stock price volatility. "Public float" refers to the shares outstanding not held by insiders, directors or shareholders who control 10% or more of voting power. In a traditional IPO, the public float is typically 20–30% of the equity value.

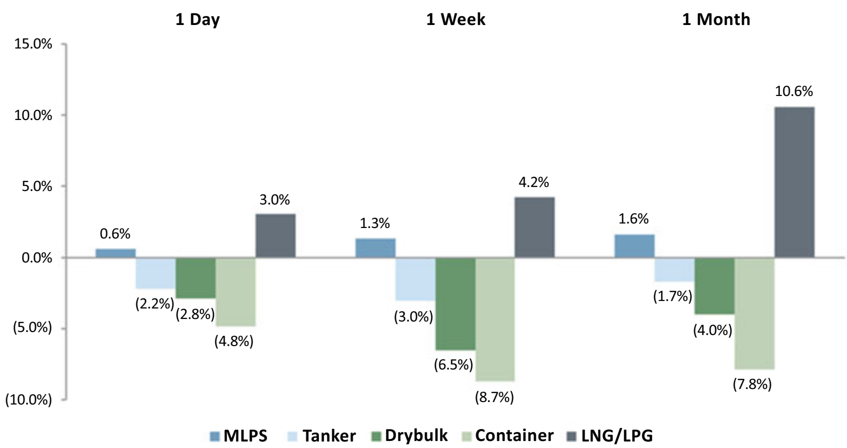

Fig. 7.5 Aftermarket trading: shipping IPOs 2008–14 (*Source*: Bloomberg)

What Makes a Good IPO? An ideal IPO couples a good IPO candidate company with an efficient, streamlined process resulting in a favorable outcome. Good IPO candidates typically have certain common traits. For example, a well-respected senior management team with a solid track record as well as experience in dealing with investor concern and media attention tends to add integrity to a company going through an IPO process. A company with sponsor backing also increases investor appetite as financial sponsors are considered to represent "smart money", which typically strengthens investor confidence in the company and its underlying operational capabilities and financial savviness. Secured newbuilding contracts and options and/or second-hand acquisition deals at beneficial contract prices are also advantageous characteristics as investors favor companies with a strong growth profile that can set the path to capital appreciation. Another good IPO candidate trait is related to the make-up of the company's counterparties. A diverse group of well-known counterparties ensures that investors have more protection against the adverse effect of one counterparty defaulting on its charter agreements. Additionally, investors generally prefer shipping companies with clear chartering strategies, a strong reputation as a counterparty and a willingness to be transparent.

Having an ideal IPO candidate alone doesn't guarantee a successful IPO. Various aspects of the IPO process and market dynamics are often instrumental in driving favorable outcomes. A window of opportunity for a shipping IPO to launch successfully is not something that is available at any time of the year or at every point of the economic cycle. There are certain market dynamics that need to be in place. Variables such as the number of comparable companies launching IPOs at the same time and general economic trends affect investors' appetite for investment. Appropriate pricing is also essential for an IPO to be deemed successful, which can be assessed by the stock's after-market trading. An issuer aims for positive after-market trading in order to drive interest in any future follow-on equity issuances while avoiding such trading from becoming too steep, which would indicate that the company has left money on the table. For MLPs in particular, whose growth is often dependent on future equity offerings to finance drop-downs to provide the growth investors are expecting, positive after-market trading is essential for their growth prospects.

The Shipping IPO Market As with any sector, a shipping IPO cannot launch without an open window of opportunity, which depends on various sector-specific trends, such as current freight rates and the freight rate projection trajectory as well as worldwide macro-fundamentals related to general economic cycles and international trade. The public equity markets will often experience shipping companies operating within a certain sector wanting to access the public equity market at the same time due to favorable market dynamics and sector-specific fundamental drivers. For example, roughly half of the shipping IPOs launched in the USA between July 2013 and July 2015 (including MLPs) were in the gas transport sector.

Investor appetite for shipping stocks has historically been limited due to a basic lack of investor understanding of the industry's fundamentals and its opaque traditions and business dynamics. Additionally, investor understanding of shipping companies has also been hampered by the sheer shortage of equity analyst coverage to enhance investor comprehension. In the past couple of years this trend has slowly been reversing as more equity analysts begin to cover the space, giving investors not only access to relevant research, but also providing a greater breadth of opinions and outlook on the sector. The JOBS act has also bolstered IPO activity by reducing regulatory requirements.

Pitfalls to Avoid When a company is evaluating its profile and the industry dynamics, in order to determine if it fits the profile of a good IPO candidate, there are pitfalls that the company should seek to avoid. Drawbacks such as having a mediocre industry position and high customer concentration make the company especially vulnerable to investor scrutiny. Pending material litigation, messy financials and auditor issues also make for a less than ideal IPO candidate.

7.2.4 Shipping Equity Valuation

While the scope of valuation metrics for publicly traded shipping companies is fairly limited, the key metrics primarily depend upon the company's legal formation, asset type and business model. Generally, limited liability companies and C-corporations that operate in shipping sub-sectors in which the assets owned/operated are highly liquid (e.g. dry bulk and crude oil) will be valued on an asset basis. Limited liability companies and C-corporations that operate in shipping sub-sectors in which the assets owned/operated are less liquid (e.g. containerships, LNG, LPG, drillships, platform supply vessels) will typically be valued on an earnings basis. MLPs, which often have business models that center around long-term charters to provide EBITDA visibility, are typically valued on their respective dividend yield.

Net Asset Value (Method 1)	
OTW Fleet Value	$ XXX,XXX,XXX
Newbuilding Fleet Value	
Less: Remaining Capex	
Gross Asset Value	$ XXX,XXX,XXX
Charter Adjustment	
Adjusted Asset Value	$ XXX,XXX,XXX
Less: Debt	
Less: Minority interest	
Plus: Cash	
Net Asset Value	$ XXX,XXX,XXX

Net Asset Value (Method 2)	
OTW Fleet Value	$ XXX,XXX,XXX
Contruction-In-Progress	
Contract Value	
Gross Asset Value	$ XXX,XXX,XXX
Charter Adjustment	
Adjusted Asset Value	$ XXX,XXX,XXX
Less: Debt	
Less: Minority interest	
Plus: Cash	
Net Asset Value	$ XXX,XXX,XXX

Fig. 7.6 Net asset calculation (*Source*: Jefferies)

Net Asset Value (NAV) As previously mentioned, limited liability companies that own/operate vessels that are highly liquid, such as dry-bulk and crude oil vessels, tend to be valued on an asset basis or NAV for that matter. While the calculation to derive NAV varies depending on the inputs used, the definition remains the same: the liquidation value of the company.

As illustrated in Fig. 7.6, there are two generally equal methods to calculate the NAV of a shipping company. The first method consists of totaling the market value of the on-the-water fleet and newbuilding fleet, less the remaining capital expenditures for the newbuilding fleet, plus charter adjustment (the difference between the charter rate and the current market value of the charter, discounted by a rate commensurate with the charter party default risk), less debt, plus cash. The second method entails summing the market value of the on-the-water fleet, plus construction-in-progress payments made, plus change in contract value (the difference between the market value of the newbuilding fleet and the purchase price), plus charter adjustment, less debt, plus cash. Quite possibly, the most closely followed ratio in shipping equity valuation, price/NAV, shows whether the associated equity value trades at a premium or discount to its asset equity value. If a public shipping company is trading at a premium to NAV, it could have the ability to acquire ships or other shipping companies by using its shares as consideration instead of cash.

Forward Earnings: EBITDA Another valuation metric followed by investors in shipping equities is forward earnings, more specifically forward EBITDA. Investors will usually assess forward EBITDA on an enterprise value/forward EBITDA (EV/EBITDA) multiples basis. In order to assess whether a specific equity trades at a high or low EV/EBITDA multiple, investors must compare it to its respective comparable companies. Typically, higher multiples are a sign of companies that encompass higher growth, while lower multiples are a sign of little or no growth.

Dividend Yield The third key valuation metric for shipping companies that are incorporated as MLPs is dividend yield. In today's markets, MLPs have become attractive investment vehicles as long-term, fixed cash flows secured by companies are paid out to investors on a quarterly basis with management incentive programs incorporated so as to align company management and shareholders' interests. Dividend yield is assessed by investors on a forward basis and typically calculated as the most recent quarterly dividend annualized. Dividend yield is expressed as a percentage of the current stock price.

7.3 Private Equity

7.3.1 Private Equity Overview

Since the financial crisis of 2008 and the economic downturn, the shipping industry has experienced an unprecedented level of interest coming from financial sponsors; that is, hedge funds and private equity funds. Hedge funds are private investment funds that invest pools of capital in securities and other financial instruments. These funds typically engage in activities such as creative investment strategies based on active trading and combinations of long and short-term investments as well as borrowing money in an effort to increase investment gains. Investments in hedge funds tend to be fairly illiquid as restrictions ("gates") on redemptions that would adversely impact investors are often in place. Hedge funds are also typically only available as investment vehicles for individuals or entities with significant assets and are typically subscribed to by sophisticated investors.

A private equity (PE) firm is an investment management firm that makes investments in the PE of operating companies through a variety of investment strategies. PE firms usually raise pools of capital for a specific fund, which the firm then uses to fund the equity contributions for investment transactions that fit their given strategy. Typical investors include the PE firm's partners, ultra-high net worth individuals, institutions and sovereign wealth funds. PE funds tend to involve long-term investor commitments and even less liquidity than hedge funds. It may take a PE firm several years to invest all of a fund's assets and, with a PE investment horizon in any given company typically ranging from about three to five years, an investment may on occasions be locked up for as long as ten years.

7.3.2 Private Equity in Shipping

As opposed to public investors, financial sponsors make investments of various seniority levels across a company's capital structure, including investments in equity, junior equity, credit, convertible debt and mezzanine financing. The financial sponsors that have been most active within the shipping sector in the past couple of years are PE firms, or firms with specific funds that focus on distressed debt and/or special situations. The global downturn saw the shipping industry plummet from an unprecedented peak to a deep trough in the short space of a few months at the end of 2008. Many of the vessels were highly leveraged and with asset values falling, as illustrated in Fig. 7.7, much of the debt attached to these assets ended up under water and distressed. As a result, PE firms looking to gain eventually from the sector's anticipated bounce-back, as global trade levels recover and the vessel supply balance corrects itself, began buying up the debt and/or real assets. Additionally, the shipping industry has been appealing to PE firms and hedge funds with high volatility strategies. The industry is both highly cyclical and seasonal, allowing for ample opportunities for volatility plays.

Often, PE firms invest in the shipping industry by forming joint ventures (JVs) with existing shipping companies. This way, the PE firm has access to the commercial and technical shipping management abilities and resources of an experienced industry player. In other instances, PE firms will hire shipping professionals for the commercial business aspects, instead of partnering with an existing player. Shipping and PE JVs can generally be described as "bespoke" as each case is different. A key factor in determining the nature of the JV is how much capital is contributed by the shipping partner. Zero to minimal capital contribution makes a venture more difficult to create and, if

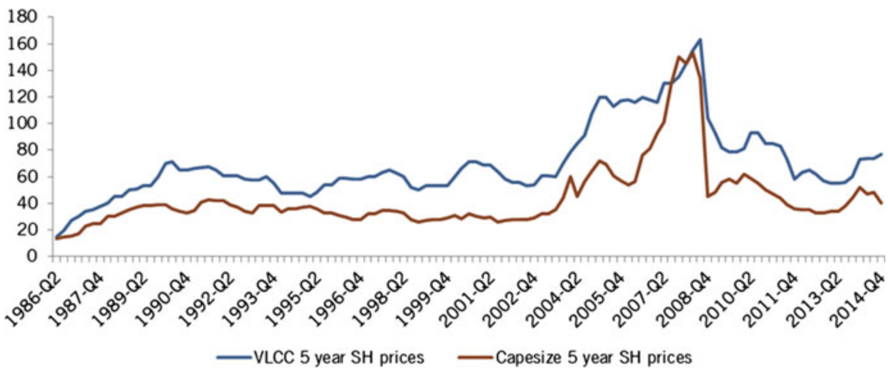

Fig. 7.7 VLCC and Capesize ~ 180,000 dwt dry-bulk second-hand prices (*Source: Clarksons)*

successful, the board and other control mechanisms will rest almost entirely with the PE partner. Another important factor is the robustness of the shipping partner's platform. If the partner is well-established and staffed with experienced individuals, creating a JV tends to be easier because of the enhanced industry know-how and reputation contributed to the venture by the partner.

The most common sticking points for JVs tend to surround the control of investment decisions, day-to-day management issues and the control of the ultimate exit decision. For the most part, the PE partner controls the board unless the shipping partner's investment in the JV is at, or very close to, 50%. A situation where the shipping partner makes about 50% of the investment in a JV is rare to unheard of. The management structure of the ships and related feeds can be a common sticking point as many JV operators will want to manage the assets with an existing external management company and charge fees to the JV. Additionally, conflicts may occur when the PE partner wants the shipping partner to refrain from being involved in other shipping activities and investments outside of the JV. JV economics start with a relative contribution and are in most cases augmented by a "promote", also called a "carried interest", in which the shipping partner can get a preferential return. These terms are highly negotiable; however, a typical provision might involve a preferred return to the shipping partner after a minimum hurdle to the PE partner is met.

Typical exit strategies include IPOs, M&A and spin-outs into listed equities. Figure 7.8 lays out the effects of an IPO versus a sale process as an exit option.

Fig. 7.8 Monetizing investments (*Source*: Jefferies)

The decision to pursue one or the other is largely dependent on the expectations of the financial sponsor in what they are looking for, such as the level of liquidity desired, valuation and upside potential, as well as certainty and market risk exposure. In the past couple of years there have been several examples of PE-backed shipping companies going through various exit strategies.

Gordon and Amber Shipping[1] In 2010, Gordon, a PE firm focusing on the transportation industry, set up Amber Shipping, a ship owner and operator of fuel-efficient mid-range products and chemical tankers, in an attempt to take advantage of low asset values in the shipping industry. Amber was taken public in July 2013 with a USD140 million IPO and represented the first shipping IPO since March 2012 and the first growth shipping IPO since March 2010. Gordon selected a well-seasoned maritime management team lead by the former CFO of a well-known public maritime company, who has both extensive operational expertise as well as prior experience working for a public shipping company.

Watson's Investment in Noble Shipping[2] Deep-value investor Watson bought a majority stake in Noble Shipping in 2012, which was quoted on the pink sheet system and is the world's largest Handysize LPG carrier owner and operator. Watson took the company public on the NYSE in November 2013, in what was considered a highly successful IPO, at the high end of the pricing range and with the overallotment option exercised.

Oscar Private Equity/Opera Shipping/Sun Shipping[3] Oscar Private Equity, one of the most active PE investors in the world with more than USD40 billion of assets under management, has been particularly active within the shipping industry with interests stretching across several shipping sub-sectors that include dry bulk, tanker and offshore. However, Oscar's JV with industry veteran partners Opera Shipping represents one of the more interesting investments in the PE space due to Opera's ability to exchange the JV-owned assets for shares in Sun Shipping and receive a liquid currency, thereby allowing the JV to exit successfully its investment, provided they sell their Sun Shipping shares at a favorable price. Originally, Oscar and partners planned to take the company public in the first half of 2014. However, due to equity capital market conditions, which consisted of a strong backlog of IPOs on file and lackluster dry-bulk freight rates, Opera's opportunity to go public faded and forced the investors to consider other potential exits instead. In June 2014, Opera agreed to merge with Sun Shipping, a publicly traded dry-bulk company, of which one of the industry veteran partners was formerly the chairman of. The merger created the largest US-listed dry-bulk company with a fully delivered fleet of 69 vessels and one of the largest eco-fleets in the world. The merger consisted of Sun Shipping issuing 54.1 million shares of common stock to Oscar and partners at the transaction consideration. While an IPO would have been the preferred exit for Opera, the merger with Sun Shipping proved to be an optimal exit solution that provided Opera shareholders with a liquid currency and Sun Shipping shareholders with built-in growth, top-tier management additions (as the industry veteran partners stepped in as CEO and president) and an increased market capitalization.

7.3.3 Other

The Relationship Between PE Firms and Company Management PE investors are generally active investors, and as such the relationship between them and the company management is an important one to handle in order to ensure the success of an investment and potential exit strategy. Financial sponsors may seek to replace management team members or install operating partners in order to drive operational and strategic changes through which the PE firms look to provide the satisfactory return on their investment that they seek upon exit. The level of involvement in portfolio companies varies between PE firms and their preferred investment and operating methods. Additionally, a PE firm's funds have equity stakes in several different companies, which may do business with each other and that may result in a number of conflicts of interest. Fund operating agreements therefore tend to have specific terms related to how the sponsor is supposed to act if such a situation occurs and includes terms governing transactions related to affiliates.

7.4 Conclusion

The public equity capital markets and PE providers' roles in the maritime sector have strengthened over the past decade, but, as with so many things, timing is of the essence. Much of a shipping company's success in accessing public and private equity depends largely on the current point in the economic cycle and secular maritime fundamentals, the competitive market place and alternative investment opportunities, as well as investor confidence. In addition to handling the timing aspects, shipping companies must also carefully consider the implications and requirements that go along with being a public company and the involvement of outside investors before targeting either public or private equity as potential sources of funding.

Notes

1. "Gordon" and "Amber Shipping" are code names.
2. "Watson" and "Noble Shipping" are code names.
3. "Oscar Private Equity", "Opera Shipping" and "Sun Shipping" are code names.

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