PRC LEASE FINANCE OR TRADITIONAL DEBT FINANCE?

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INTRODUCTION

It is commonly accepted these days that PRC lease finance is a mainstream form of finance attracting reputable names within the global shipping community. The two main reasons behind the astounding growth of PRC lease finance within a relative short period of time are: firstly, the lack of ability of traditional ship financiers to meet the demand for finance in global shipping due to their withdrawal from, or reduced interest in, the sector and; secondly, the simultaneous increase in appetite of the Chinese leasing community to provide finance to reputable international tonnage providers. But why would one pick financing its ships or its newbuilding program by way of a Chinese-derived lease?

WHY LEASING?

The answer to this question certainly depends on the type of transaction and the identity/credit status of the lessee. A vessel which is subject to a long-term charter generating cash flow is, of course, a suitable asset. This doesn't mean that the Chinese lessors are not looking for quality vessels which would operate in the spot market, particularly at the bottom of a cycle in a low market value environment with good prospects. A solid deleveraged corporate guarantee or a strong group cash position would certainly help in this case. A newbuilding would also be appealing and would make its financing easier if constructed in a Chinese shipyard; however, one should note that Chinese leasing companies are not export credit agencies solely focused on promoting Chinese-built vessels. Quality ships constructed in South Korea or Japan have also been subject to such financings. Name lending is also very important for the Chinese leasing community and, even though a particular project might not be ideally tailored to such financing, the name, size and/or track record of a shipowning group constitute strong factors which would entice such financiers to offer competitive finance packages.

High financing leverage is also an important factor which could assist shipowners in uprising markets to generate cash by refinancing vessels acquired by asset players or to finance capital intensive projects. During the course of last year, which was particularly bad across the sector, we saw and documented sale and leasebacks entered into solely for the purpose of generating equity for new projects to either refinance debt or to assist major players in meeting their corporate demands. Banks are not able to compete with Chinese lessors in this respect; a capital intensive project would probably require a great number of banks showing interest and, as said previously, shipping at the moment is not banking's favourite sector. Strong capital adequacy regulations affecting banking make asset financing expensive and difficult to structure. Basel IV, as things currently stand (as the scope of the relevant regulation is not firm yet), makes the problem even greater as non-secured financing based on credit rating could be cheaper and more appealing than secured and asset financing. The problem faced is how many shipowners across the globe are credit rated?

Bank-affiliated Chinese lessors are regulated by the Chinese Banking Regulatory Commission ("CBRC") and, although they are subject to capital adequacy restrictions that aim to ensure that such Chinese lessors have adequate liquidity reserves, such restrictions are not as strict as those imposed post-credit crunch on banks. It should be noted that timing of entry into the shipping market has been key in this respect. Most sectors have been at the low end of their cycle; hence the values of the assets have also been relative low. Thus; currently; the main parameter that determines a Chinese leasing house's growth pattern is its balance sheet and not some external regulation by which it has to abide.

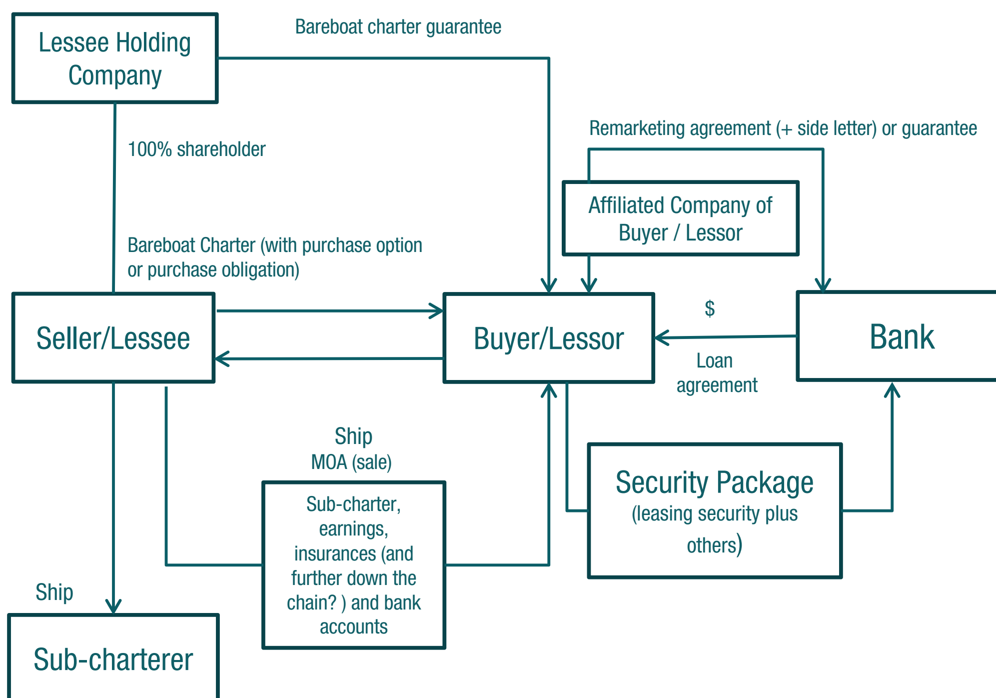
The most important reason why one should contemplate leasing, at least in the author's point of view, is that international shipowners, no matter how spoilt they are in terms of still being able to have access to cheap funding from banks, should at least have some of their vessels financed by Chinese lessors. The benefits of

following this route are multiple: a proactive approach against any risk of more traditional ship financiers not being able to finance their fleets, adding more options as part of the quest to find the ideal financing model well suited to their needs and, last but not least, establishing relationships with such financiers. The last point is particularly important not only from a financier's point of view but also culturally wise in Asia. Long standing relationships and well documented positive track records are of paramount importance and could unlock highly competitive financing packages and opportunities for repeating business.

STRUCTURE

Sale and leasebacks: This is the basic form of leasing structure. Such a lease can be in the form of an operating lease with a purchase option at the end of the charter period. This could be useful from an accounting point of view, as operating leases are off-balance sheet items at least until 1 January 2019, the date on which IFRS 16 becomes effective, whereupon all leases will be on-balance sheet items. Since the residual value risk lies with the lessor in operating leases, the cost is predictably higher than that found in a financial lease. Financial leases are, of course, preferred by Chinese lessors, as the residual value risk lies with the lessee. Leverage varies from 60% to 100% of the value or contract price of the relevant vessel, although most transactions hover between 80% and 100%. Call options are usually available in both forms of leases, albeit often not from the commencement of the charter period and with a prepayment fee being payable. Below is an illustration of a standard sale and leaseback/on delivery lease structure.

The vessel is bought by an SPV of the leasing house by way of an MOA documented usually in a Saleform. The vessel is then chartered back on a demise basis to the seller. The bareboat charter is a combination of a Barecon standard bareboat charter adapted to the fact that the lessor is a financial lessor and not a real tonnage provider, and a set of additional clauses in which the financial elements are included. One should not be surprised by the similarities between a standard bilateral loan facility and the additional clauses in such leases. The charterhire payments contemplate principal payments and interest payments either in the form of variable hire (margin + LIBOR) or a fixed sum if interest rate is fixed. Charterhire is usually payable monthly in advance, but we have also seen quarterly in arrears payments. The balloon payment is the purchase price payable at the

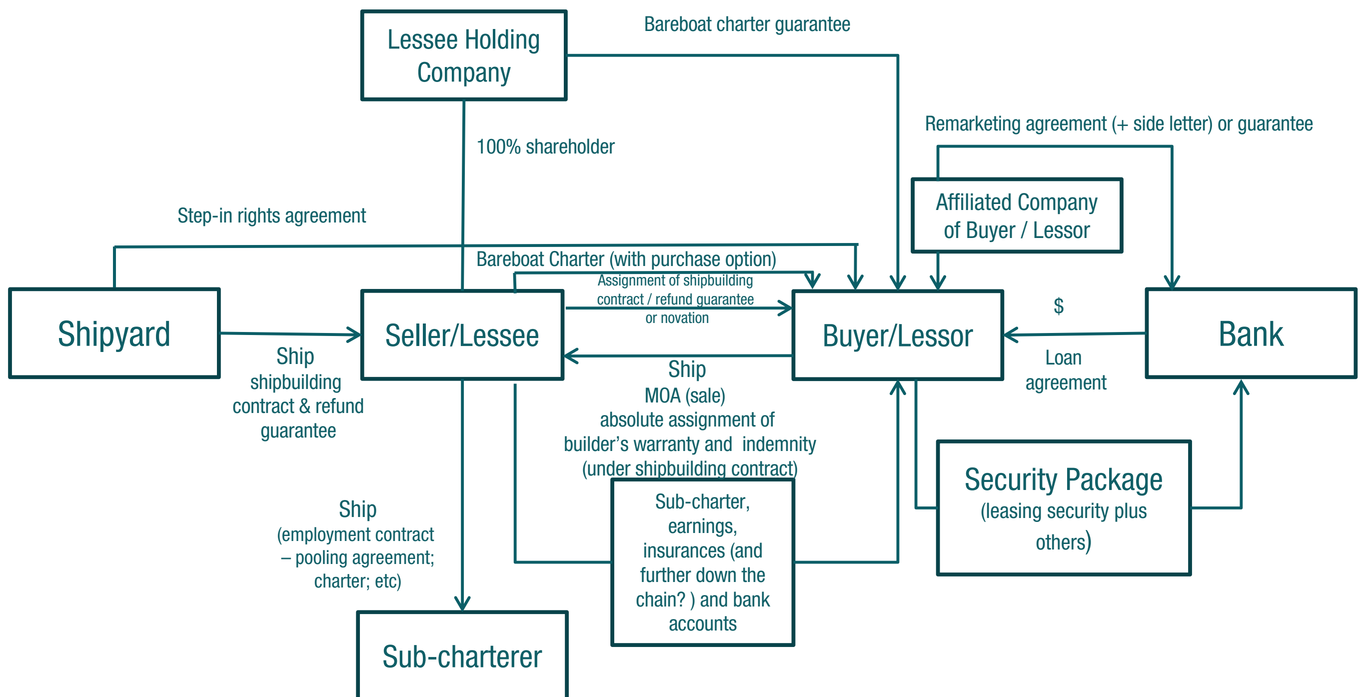


end of charter period, the payment of which will result in the vessel being bought back by the lessee. In operating leases, the charterhire payments are usually fixed and not variable, and they are structured in conjunction with the call option price payable at the end of the charter period in a manner that will ensure the residual value risk incurred by the lessor will be as low as possible.

The security package is similar to that given in bank loans: corporate guarantee from lessee's parent, charge over the shares in the lessee (important "step-in" tool if there is a valuable sub-charter and no direct relationship between the lessor and the sub-charterer being possible which would grant the lessor step-in rights - note intragroup liabilities which would make enforcement of such security risky as liabilities would be assumed by the chargee upon enforcement), manager's undertaking, subordination of shareholder's loans, charge over the vessel's operating account and an assignment of insurances, requisition compensation and earnings as well as any long term sub-charter. If such sub-charter exists, lessees should expect that the lessors would demand a direct agreement between themselves and the sub-charterer which will grant the lessors "step-in" rights in case the lessee defaults either under the lease or the sub-lease. Financial leases will be structured around such sub-leases and the lessees should be alert when negotiating the terms of the sub-lease to ensure that such tools are available to their financiers.

The right side of the structure depicts the back funding loan facility. In most cases, such leases are funded by way of a bank loan; this is why they must be drafted in a "bankable" form. Hence the resemblance between a bilateral shipping loan and the additional clauses we see in a financial lease. LTV requirements, insurance covenants, ship operating covenants (sub-chartering, manager appointment change, flag, name of vessel, surveys etc.), operating covenants (financial statements, financial covenants etc.) increase costs provisions, and FATCA provisions are usually found in the additional clauses, and drafted in a manner which would ensure that any demands from the lessor's financiers would be passed on to the lessee.

Pre-delivery finance structure: As from delivery of the vessel, the post-delivery elements discussed would apply here as well. During the pre-delivery period the lessor may choose to follow two routes: Assignment of the shipbuilding contract and refund guarantee or a novation of the shipbuilding contract together with a reissuing of the refund guarantee naming the lessor as beneficiary. The former was the standard form of security adopted



by banks when pre-delivery finance was possible up until the credit crunch. Given the higher financing leverage and risk incurred by the lessors, they usually demand a direct agreement to be entered into between themselves and the shipyard to ensure that if the buyer/lessee defaults under the lease or the shipbuilding contract during the pre-delivery period, the lessor would either have the right to cure the default or "step-in" to the shoes of the buyer/lessee and become a party to the shipbuilding contract. Novation of such contracts is commonly used, particularly in the case of vessels built in China. Such agreements provide for the substitution of the buyer/lessee with the lessors and a "step-out" mechanism whereby, if the lessee defaults under either the lease or the shipbuilding contract, the lessor would be entitled to serve a notice and trigger a renovation of the shipbuilding contract back to the lessee. Supervision of construction is, of course, carried out by the lessee as per the relevant provisions in the shipbuilding contract. On the preceeding page is an illustration of a standard pre- and post-delivery lease finance

LESSEE'S EQUITY

The first question lessees ask is "What about our money? How do we secure our position in case the leasing house's SPV defaults?" The obvious answer is to secure this amount by way of a second priority mortgage (as the senior back funding lender would certainly be the vessel's first mortgagee). The reality is that Chinese leasing companies have so far not shown willingness to accept this route. Another option is to include lessors' defaults into the documentation which would trigger a call option. If the lessee is not able to pay the call option price, the parties could structure a mechanism whereby the lessor would be obliged to procure the sale of the vessel in consultation with the lessee to ensure that the vessel is sold on the best available terms given the then current market conditions and, upon such sale, the sale proceeds would be applied in accordance with a waterfall similar to those found in facility agreements providing for the full repayment of the lessee's debt towards the lessor and the balance of the purchase price being paid back to the lessee. One thing to note in such structures is that, unless such waterfall or mechanism is built into the documents, a lessor is not obliged to return any part of the sale proceeds and can, in fact, treat the vessel as it deems fit following the occurrence of a charter termination event. Parent support from the lessors' parent is often requested and rarely given, certainly in the form of a guarantee. Letters of comfort are more common, and drafting is key in terms of determining the level of recourse (if any) the lessee would have from the lessors' parent.

QUIET ENJOYMENT

The last main point to address is a lessee's quiet enjoyment. Bareboat charterer's position at law provides strong protection in terms of its right of quiet enjoyment of the vessel for as long as it performs its obligations under the underlying lease. A bareboat charterer has possessory rights over the vessel and its mortgagee (which, in this case, would be the lessors' financier) and would only be permitted to enforce its mortgage if the security created under the mortgage is in peril. Despite the lessee's strong position at law, it would appear prudent to ensure that a quiet enjoyment agreement is demanded from the lessor's financier. It would, of course, most likely be given in exchange of "step-in" rights, but at least it would ensure that, no matter what happens upstream, for as long as the lessee performs its obligations under the lease it would keep possession of the vessel.

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CONCLUSION

Many consider that Chinese leasing is here to stay. Strategic planning of entering into the shipping market and of promoting the product, timing of entry, and the fact that it is not tax-driven are strong indicators that it will be a major player in ship finance in the long run. The rapid growth and impressive stats of the past 3-5 years are, of course, noteworthy but do not constitute firm evidence that leasing will substitute debt finance. Let's not forget that banks have taken serious hits both from regulatory point of view and from terrible markets which have not shown signs of recovery for a very long time (e.g. offshore). But who is to argue that banks will not come back in the future once the markets change? Even if this happens, Chinese leasing will no doubt remain a strong force in the ship finance space — I dare to say unaffected from a sudden recovery of banks in the sector. One should also note that the leasing community needs the banks and vice versa. Bank finance remains to this day the primary source of equity of the leasing companies, and international banks have shown interest in financing leasing projects on the back of the investment grade or credit rating of the Chinese lessors' parent, minimising in this way the impact the relevant asset would have on the capital position of the bank. So it's not about competing after all — it looks like a "win-win" scenario if played well on both sides of the fence.