Key Development Consideration

Ship Acquisition in Nigeria

NIGERIA

Introduction

In recent times, there have been significant changes in the shipping finance landscape. Traditionally, shipping companies have often relied on bank debt and equity markets to finance acquisition and operations of vessels. The decline in the availability of bank finance has contributed to ship companies looking for alternative sources of financing increase including access to international bond markets through high-yield bonds, recourse to private equity (including preferred equity structures) and convertible debt.[8]

It goes without saying that ship owners need easily accessible cheap funds to finance vessel acquisition. Like all businesses, shipping requires credit facility with a competitive interest rate. Our research reveals that a large number of ship owners drown in repayment of debts to banks due to lack of special lending terms, despite shipping being an investment with long gestation period.

With Nigeria's total annual freight cost estimated at between $5 billion and $6 billion annually, there is no doubt that shipping is of great importance to the Nigerian economy and ship acquisition should attract increased finance.[7] However, inadequate financing for the acquisition of (new) vessels have brought about a huge gap in indigenous ownership of vessels in Nigeria.

It is against the foregoing background that this publication focuses on key issues that are deserving of attention when contemplating making a ship acquisition in Nigeria. Starting

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Ship Acquisition

There is hardly any effective discussion of ship acquisition without making recourse to ship finance. Ship finance is needed for financing the acquisition and/or operation of a ship (tonnage). The larger the ship, the greater the costs of acquisition and operation. The greater the costs of acquisition and operation, the greater the need for external finance which inevitably leads to higher financing cost.

Ship finance entails the finance of activities relating to ships and shipping (the ownership and/or operation of ships) where the ship is a central figure, both as the 'object' (directly or indirectly) of the finance transaction and, very frequently, as the principal or one of the main items of security in the transaction.[2]

Ship finance transactions involve a lender providing funding to a borrower for the purchase of a vessel (which is either a new-build vessel under construction or a vessel that already exists and which is being purchased by the borrower as a second hand vessel) or to refinance existing indebtedness already in place in respect of a vessel. The lender will look to put itself in the best possible position both in respect of the initial security position following the provision of finance and then in the subsequent operation of the vessel.

Sources of Ship finance?

Some of the sources of ship finance include the following:

⇒ owners' own funds;
⇒ institutional financiers (credit and financial institutions);
⇒ capital markets (IPOs, bonds etc);
⇒ investment funds;
⇒ private equity;
⇒ securitization vehicles;
⇒ venture capitalists; and
⇒ wealthy individuals

Forms of Ship Finance

In this section, a brief overview of categories of ship finance is provided. The three forms of ship finance discussed are namely: asset finance; corporate finance and equity finance.

Asset Finance

As the name implies, the main purpose of asset finance is the acquisition or operation of one or more assets. The asset in this context being a ship.

Corporate Finance

In corporate finance, the major goal is to inject liquidity into the borrower/the wider group of companies to which the borrower belongs in an attempt (albeit indirectly) to strengthen the borrower's (and, or its wider group of companies') balance sheet

Equity Finance

With respect to equity finance, ordinary equity which includes voting rights, rights to dividends, rights to appoint directors, amongst other are used to finance ship acquisition.

Key Legal Framework

Beyond the routine legal considerations in financing and ship acquisition in Nigeria, the following legal framework are deserving of mention, to wit:

⇒ Nigerian Maritime Administration and Safety Agency (NIMASA) Act 2007: NIMASA Act establishes NIMASA and saddles NIMASA with the responsibility of pursuing the development of shipping and regulating matters relating to merchant shipping and seafarers in Nigeria.

⇒ The Coastal and Inland Shipping (Cabotage) Act 2003: The Cabotage Act restricts the use of foreign vessels in domestic coastal trade (including carriage of good and passengers in Nigerian waters), promotes the development of indigenous tonnage and establishes a cabotage vessel financing fund. Specifically, the Cabotage Act precludes a vessel other than a vessel wholly owned and manned by a Nigerian citizens, built and registered in Nigeria from engaging in the domestic coastal carriage of cargo and passengers within the coastal territorial inland waters, or any point within the waters of the exclusive economic zone of Nigeria.

⇒ Merchant Shipping Act, 2007: This Act provides for merchant shipping in Nigeria and allows only registered Nigerian ships to operate commercially in the Nigerian to the exclusion of others except for statutory exempted cases.

⇒ Value Added Tax Act, Laws of the Federation 2004: This Act provides for five percent rate on all goods and services that do not fall within any of exemptions under the Act.

Ship Acquisition

The traditional model for ship finance transactions has often been in the form of **asset finance**. Over the past years, however, it can be best described as a **hybrid of asset and corporate finance.** Not least because account is taken of and emphasis placed on the overall financial situation of the borrower and the wider group of companies to which the borrower belongs

Asset finance

In ship acquisition, asset finance is often provided by institutional financiers.

Ship finance and acquisition can take any of the following form, to wit:

⇒ acquisition of tonnage (new or second-hand) secured by real security over the ship which is the focus of the ship acquisition and finance;

⇒ financing of shipping operations towards improving the ship owner/ship operator's working capital secured by the ship which is the object of the acquisition; and

⇒ re-financing existing facilities secured by the ship which is the subject of the finance

In ship finance, the debt servicing hinges on the ships being operated profitably, efficiently and continuously. To achieve profitability and efficiency, the ship must continue to be operated by its owner or designated operator, which can be the owner or an approved charterer or manager and the ship must remain in the possession of such party.

Lender's risks

Some of the risks that a lender in a ship finance would consider in assessing whether or not to grant a facility include:

- credit default risk (customer's solvency, history and credit rating);
- market/structural risk (overall assessment of costs of bunkers, costs of labour, geopolitical issues, specific issues depending on the type of ship and geographical scope of activity);
- risk of asset value impairment;
- risk of increased cost of borrowing;
- risk of erosion in real value of return (interest payments);
- risk of arrest or detention of the secured assets; and
- risk of loss of the secured assets

Security in Ship Acquisition and Finance

In a typical ship acquisition and finance, security will include one or more of the following:

- Guarantees (corporate and collateral);
- Mortgages (real security) on ships and related deeds of covenants;
- Assignments of earnings;
- Assignments of rights under contracts of insurance;
- Pledges or other charges over shares/securities;
- Pledges or other charges of earnings accounts

Key Issues in Documentation

Some of the key issues in documentation for ship acquisition and finance are addressed below:

- Negotiating the term sheet containing: Definitions; Commitment; Purpose; Availability period; Borrower's and security parties' warranties and representations; Conditions for drawdown (CPs); drawdown mechanics; amongst others.
- Facility Agreement (creating the underlying principal obligations of repayment etc) + other Security Documents;
- Payment of interest (usually based on LIBOR and interest periods;
- Repayment and prepayments;
- Borrower's positive and negative covenants;
- Insurance undertakings;
- Environmental undertakings;
- Increased cost (including breakage costs);
- Asset protection (Loan to Market Value Ratios);
- Regulatory restrictions imposed upon the Lender, for instance, liquidity and own funds ratios (by measures such as Basel II and Basel III);
- Events of default;
- Transfer and syndication provisions (where applicable);
- Governing law;
- Dispute resolution; and
- Miscellaneous provisions such as providing notice

Matters Arising in Ship Financing

It is worth noting that ship financing is an arrangement that uses vessel charter fees as the principal source of repayment, while various forms of collateral structured around shipbuilding and charter agreements are assigned to mitigate credit risk.

Security in Ship Financing

Generally, a first priority mortgage is often used as security over the vessel but depending on the particular transaction, the lender may also demand all or some of the following types of security:

- assignment of insurances
- earnings and requisition compensation;
- parent company guarantee;
- charge over shares;
- charge over a deposit account.

In the UK, a legal mortgage over a ship is created by the execution of a form of statutory mortgage by the owner which is then registered with the Registrar. Notably, priority in respect of registered mortgages is determined by the order in which they are registered. Additionally, priority will be given to a registered mortgage over an earlier mortgage that has not been registered.

Operation of the vessel

More often than not, the lender will be concerned about the protection of its position in respect to the operation of the vessel, the earning capacity of the vessel and repayment of the loan.

As such, there is usually a charter-party which is an agreement concerning the use or employment of a vessel, or some part of it, for a voyage or series of voyages for a specified time. The agreement is ordinarily put in place in relation to the carriage of particular goods or cargo although it can also relate to passengers, towage and salvage.

The main types of charter are:

⇒ **voyage charters** under which the owner of the vessel allows the charterer to use it for a defined voyage or series of voyages between a specific port of loading and a port of discharge;

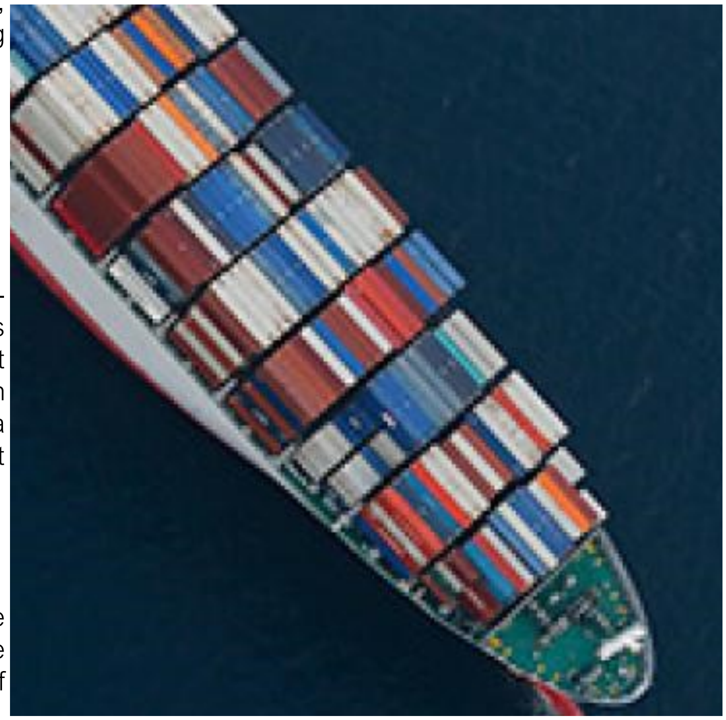
⇒ **time charters** where the vessel will be hired by the charterer for a specific period of time; and

⇒ **bareboat charters** under which the vessel is leased by the owner to the charterer without generally providing a master and crew and where the charterer is responsible for all operating expenses.

Ship Acquisition and Finance in International Context

The understanding of the nature of the structure of a typical shipping transaction where the vessel, lender, borrower, any parent company and the ship registry are often located in different jurisdictions will leave no doubt that international issues are great relevance.

For one, lenders, borrowers and practitioners will need to understand and specially consider choice of law and jurisdictional issues, tax aspects which are likely to have a major impact on how the entire transaction is structured and practical issues such as legal opinions, currency risks and the completion process.



Standard form documentation

Standard form documentation in relation to shipbuilding contracts have developed globally, such as the Shipbuilders' Association of Japan and the Baltic and International Maritime Council).

The most common standard form used for the purchase of second hand vessels is the Norwegian Sale Form (NSF). This is the Norwegian Shipbrokers' Association's Memorandum of Agreement which was originally adopted in 1956. It has since been revised.

The parties may agree to negotiate the terms of the agreement from scratch although the NSF is used in the majority of cases as the starting point and is then amended in each case to meet the needs of the parties. The NSF covers the following main subjects: parties, price, condition and inspections, delivery and cancellation.

The main contractual terms are found in the shipbuilding contract itself and the specific plans, drawings and technical data. The main provisions covered under the contract include: price, title, supervision and trials, delivery and termination.

Options for Ship Acquisition

Ship can be acquired in one or a combination of the methods described in this section.

The principal method of owning a ship is the purchase of a new or existing ship. The options for the purchase of vessels are to either buy a new vessel or a second hand vessel.[4]

A ship can also be acquired through the sale of ship done pursuant to an Order of Court.

Acquisition of a New Vessel

A prospective buyer can place an order with the shipyard for the construction of a specific type and size of vessel. Contracts for shipbuilding is usually expressed on Standard Forms which incorporate internationally accepted terms such as the Shipbuilding Contract of Shipowners Association of Japan.

In the case of existing vessels, parties express their agreement in the Memorandum of Agreement (MOA) which incorporates standard terms like the Norwegian Sale Form.

A buyer may negotiate the terms and his chances of success are subject to the amount of work the shipyard has.

Shipbuilding Contract

A shipbuilding contract defines rights and obligations of parties and also allocates risks to be borne by the parties. Some of the salient issues in a typical shipbuilding contract are considered below.

Obligation of Builder: The Builder is expected to build the vessel to specification for a fixed price and to deliver the vessel on time.
Obligation of Buyer: The Buyer is expected to pay the price which is usually a fixed price and to accept delivery if the vessel is built to specification and delivered on the agreed time.
Allocation of risks: (a) market risks: price fluctuation, charter rates costs of labour and materials (b) technical risks: may cost more to achieve specification and to meet timely delivery poor performance after delivery risk of physical loss or damage accident in yard or during trials etc. (d) non performance Ancillary contracts specification is set out guarantees, refund, guarantees to refund of installments, performance bond to cover installmental payments, amongst others.

Acquisition of an Existing Vessel

The processes involved in the acquisition of an existing vessel are somewhat different from that of a building new ship. As a matter of fact, contract for sale or purchase of an existing ship is usually negotiated by ship brokers acting as agents of both the buyer and the seller. After negotiation, agreed terms are written down in a Norwegian Shipbroker's Association Memorandum of Agreement for Sale and Purchase of Ships, being the standard form most widely used for the sale and purchase of old buildings. The entire processes comprise of three phases namely pre-delivery, delivery and post delivery.

Pre-delivery: At this stage, essential documents are collected from both seller and buyer by the brokers. Some of the other activities include: Drafting of the MOA; Buyer pays deposit (usually 10% of the purchase price); Inspection of the vessel; Timeline and sequence of closing is agreed upon; Seller makes arrangement to terminate insurance, discharge mortgages if any and arranges for deletion of vessel from existing flag; Seller gives advance notice of readiness for delivery of vessel by seller; Buyer makes arrangement for insurance, registration of vessel with classification society, crew, bunkers and registration of vessel.[4]

Delivery and Post Delivery: This entails physical delivery on board ship and documentary delivery ashore. The Seller has the duty to arrange facility for inspection. The seller has possessory lien on vessel if price is not paid.

Parties may agree to deliver in international waters to avoid sales tax at port or accepting delivery in a repair yard

Meanwhile, lawyers, agents, brokers and bankers meet ashore for the delivery of documents and final inspection of trading certificate and other documents ready to be handed over with the payment of purchase price for the ship by the buyer.

At this stage, title is transferred by the seller to the buyer; the seller then instructs his representatives on board to deliver the ship to the buyer.[4]

Other Options for Ship Acquisition and Financing

Debt Market

Given the tendency of banks tightening credit lines and taking or threatening enforcement action against defaulting shipping companies to repossessing the ship, there is a need to explore other sources of financing.

While the outlook for the shipping bank debt market does not look quite promising, bond offerings by shipping companies could sure be a possible way of raising funds for ship acquisition. Bond offerings by shipping companies involve small tranches and aimed to supplement large bank debt. Bond offerings, however, are not without their own challenges. For instance, the interest rates on bonds could be significantly higher than bank debt and the added interest costs may be untenable, Additionally, bonds are not prepayable for a number of years, which can be problematic if the bonds' interest rate is high. [6]

Private Equity Funds

Private Equity (PE) funds could be another way of financing ship acquisition. PE investors seeking to invest in asset financing could be sought through private equity firms. Generally, PE funds have substantial committed and undrawn capital.

In recent times, there has been some notable PE activity in shipping, and this could perhaps be a great indication of the potentials PE fund can offer in financing ship acquisition.

Typically, financial investors enter into joint ventures with shipping operators or acquire stakes in an asset acquisition.

Generally, in a PE investment, an investor will typically ask for preferred stock (with pre-emptive rights, registration rights and anti-dilution adjustments); significant board representation; close monitoring of the company's performance and veto rights over major decisions (for example, acquisitions, budgets and capital expenditure, dividends, debt incurrence); broad information rights (for example, regular financial statements, forecasts and management and board meetings); and control over the timing and form of exit (for example, tag-along and/or drag-along rights).[6]

Distressed investing can include "loan to own" strategies, which permit investors to emerge from restructuring controlling the company.

Rollup strategies by acquiring vessels, which could prove attractive due to currently depressed vessel prices, have the additional benefits of releasing investors from the burden of incurring the costs of a public company and assuming historical liabilities.

PE may experience some increased activity as shipping companies remain distressed and other financing sources remain limited. Banks may push shipping companies for an injection of PE as a precondition for providing waivers or otherwise restructuring.

Key Issues in PE Investment in Shipping

PE investment in shipping is not without its challenges.

First, from a fund's perspective, most PE funds are new to the industry, have limited operational experience and are mostly concerned about timing the downward point of the cycle.

From the perspective of shipping companies, it may be hard to accept that PE funds will have an active involvement in how the company is managed and the three - to five year exit strategy and finding the right balance.

Despite the challenges, opportunities abound for well-advised players. After all, nothing good comes easily and there is hardly any gain without a corollary pain.

Concluding Remark

In all, given the potential shipping has in boosting the Nigerian economy, one surely needs no soothsayer to come to the realization that increased funding for ship acquisition will go a long way in positing the country's economy.

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