

The financing of newbuildings

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1. Introduction

Any consideration of newbuilding finance as opposed to the financing of second-hand tonnage must examine a combination of financial, commercial and political factors. For many years, shipbuilding played a significant role in the economies of many of the world's industrialised nations, and the decline of traditional 'heavy' industries in the Western world, coupled with the advance of technological developments and the availability of cheap and increasingly skilled labour in the Far East, led many governments to look at ways of subsidising or otherwise supporting domestic shipbuilding activity. This has been particularly true of those nations whose poor-performing shipyards have been located in areas of economic deprivation where unemployment is high and traditional industrial activity has declined.

Many governments have considered it politically desirable to take steps to support their domestic yards, and any owner wishing to have a new vessel built was wise to consider the possible availability of some form of governmental support, either directly or indirectly, for the financing of his project. In the late 1980s and 1990s Western governments sought to provide governmental financial support in various forms to prop up their ailing shipbuilding industry. In the new millennium Far Eastern governments began to recognise the benefits of export credits. Of course, there are many other important factors which a buyer will have to consider, not least the technical expertise available in any particular yard, the reputation of that yard for reliability and punctuality, and the stability of the political regime in the country in question, but the effect of governmental or quasi-governmental support either on the price or the payment terms on offer has been and will continue to be a material consideration.

This chapter will give an overview of the shipbuilding market during the last three decades and will consider the types of financing available to owners today, as well as the range and nature of the subsidies and other support available in certain of the principal shipbuilding nations of the world.

2. The shipbuilding market today¹

The obvious trend in the last two decades is the rise of Asia in world shipbuilding, as graphically illustrated in Table 1. This table shows, for five-yearly intervals from 1980

* The publisher acknowledges Dora Mace-Kokota as co-author of the previous edition.

1 Sources for statistics in this section: Lloyd's Register/IHS Word Fleet Statistics/Lloyd's List Intelligence. For more information visit www.info.lloydslistintelligence.com.

to 2015, the world's five largest shipbuilding nations by gross tonnage (gt) completed. The decline of shipbuilding in Western Europe is clear: only Germany survived from the 1980 table into the 2010 table (but not into the 2015 table) and Germany's figures were certainly boosted by reunification and the inclusion of the yards of the former East Germany, which received substantial government aid after reunification. China, South Korea and Japan have been the dominant nations for the last 17 years; the People's Republic of China now being the largest shipbuilding nation in the world, with South Korea not far behind.

Table 1: Vessels completed (ranked by gross tonnage (gt))

1980 gt (in millions)		1985 gt (in millions)		1990 gt (in millions)		1995 gt (in millions)	
Japan	6.09	Japan	9.50	Japan	6.82	Japan	9.31
Germany	0.72	South Korea	2.62	South Korea	3.46	South Korea	6.22
United States of America	0.56	Brazil	0.58	Germany	0.36	Germany	1.12
United Kingdom	0.43	Germany	0.56	Republic of China (Taiwan)	0.67	Denmark	1.00
Spain	0.39	Spain	0.55	Yugoslavia	0.46	People's Republic of China	0.95

2000 gt (in millions)		2005 gt (in millions)		2010 gt (in millions)		2015 gt (in millions)	
South Korea	12.22	South Korea	17.63	People's Republic of China	36.49	People's Republic of China	25.44
Japan	12.00	Japan	16.48	South Korea	31.70	South Korea	23.61
People's Republic of China	1.48	People's Republic of China	6.27	Japan	20.22	Japan	12.80
Germany	0.98	Germany	1.21	Germany	0.95	Philippines	1.86
Poland	0.63	Poland	0.79	Italy	0.63	Vietnam	0.72

Very similar general trends appear if one considers the comparative figures for the actual number of vessels completed, as opposed to gt. Here, when compared with Table 1, the dominance of the Far East in building larger vessels is even more pronounced (see Table 2). These figures illustrate the continued use of domestic yards to build short sea or coastal vessels or vessels used on inland waterways, but that the yards of Asia have secured the lion's share of newbuilding work for major ocean-going tonnage, with cruise being one exception.

Table 2: Vessels completed (ranked by number)

1980 Number of ships		1985 Number of ships		1990 Number of ships		1995 Number of ships	
Japan	943	Japan	817	Japan	663	Japan	717
USA	205	Germany	135	South Korea	110	South Korea	177
Germany	155	South Korea	115	Spain	97	People's Republic of China	159
Netherlands	82	Spain	58	Germany	97	USA	109
Norway	80	Poland	44	People's Republic of China	46	Germany	92

2000 Number of ships		2005 Number of ships		2010 Number of ships		2015 Number of ships	
Japan	427	Japan	469	People's Republic of China	1413	People's Republic of China	818
South Korea	197	People's Republic of China	420	Japan	580	Japan	440
People's Republic of China	101	South Korea	326	South Korea	526	South Korea	363
Netherlands	96	Malaysia	108	Vietnam	144	Malaysia	90
Spain	91	Spain	77	Indonesia	141	Turkey	79

Table 3 shows completions by number and gt in the top three countries and globally between 2013 and 2016. While the numbers in the two older Asian shipbuilding nations (Japan and South Korea) are relatively consistent, there has

been a decrease in the number of completions in China which has, nevertheless, the highest number of completions despite (arguably) not being as technically advanced as its neighbouring countries. South Korea remains at the top of the chart in terms of gt and has for some years been outsourcing some of the work to cheaper Chinese subsidiaries. Finally, it is interesting to note that Japan and China are breaking into the cruise ship market, traditionally the stronghold of European shipyards.

Table 3: World completions (over 100t)

		2013				2014				2015				2016			
		No.	%	Gt (m)	%	No.	%	Gt (m)	%	No.	%	Gt (m)	%	No.	%	Gt (m)	%
Completions	Japan	442	14	14.5	19.6	441	15.6	13.5	20.6	440	16.7	12.8	18.6	414	19.1	13.3	19.9
	S. Korea	383	12	24.5	33	343	12.2	22.9	35	363	13.8	23.6	34.4	364	16.8	25.8	38.6
	China	1033	33	28	37.8	831	29.4	22.6	34.5	818	31.1	25.4	37	653	30.7	21	31.4
	World	3125	100	74.2	100	2823	100	65.5	100	2629	100	68.7	100	2171	100	66.8	100

At the time of writing this chapter, certain commentators suggest that the shipbuilding industry is reaching the bottom of the ordering cycle. After the ordering boom and a peak in the number of deliveries in 2010 and 2011, there has been a gradual fall in worldwide deliveries (34% between 2010 and 2014), many orders placed during these two years having now been delivered. The current estimates are for an 18% fall in shipyard output in 2018. The year 2016 had the lowest number of new orders but overcapacity continues to be a prominent issue, with many vessels (including newbuildings) being laid up.

As global trade slowed down, many Asian shipyards encountered difficulties and underwent bankruptcy proceedings or restructuring schemes. The ‘Big Three’ Korean shipyards (Hyundai Heavy Industries Co, Daewoo Shipbuilding & Marine Engineering Co and Samsung Heavy Industries Co) all posted losses in 2016 amid delivery delays.² The deteriorating credit quality and value of the shares of these shipyards has also spilled over to state-owned lenders with a high exposure to shipbuilders. While more consolidation or internal restructuring is inevitable in the years to come, some Asian shipyards are starting to recover and the world’s largest shipbuilder, Hyundai, reported a profit in August 2017 with increasing new orders for oil tankers and natural gas carriers.

While full recovery is probably still some way ahead, it is foreseeable that many of the older vessels will need to be replaced over the next years, especially in the light of technical advances (eg, increased speed and lower fuel consumption) and new, stricter, environmental and safety regulations. A large proportion of these

2 Example of source: www.straitstimes.com/business/companies-markets/after-20000-job-cuts-worlds-biggest-shipyards-brace-for-more.

newbuildings will require third-party financing and buyers are likely to look at traditional and alternative methods of financing.

3. The traditional financing options

Both the builder and the buyer are likely to require financing.

As far as the builder is concerned, the shipbuilding contracts will normally provide for the buyer to pay for the construction and delivery of the vessel in instalments over the duration of the contract. Payments of the contract price will fall due at specific contract milestones. This will allow the builder to finance part of the project.

The buyer, for its part, will be entering into a very significant financial commitment in paying for a new vessel, but will not be able to start to recoup its investment until the vessel has been completed and is trading. There have been two sources of traditional finance for a buyer. Either the buyer obtained finance to pay for the vessel in full on delivery (and/or to refinance its payment of the pre-delivery instalments) ('buyer's credit') or the buyer agreed to purchase the vessel on deferred payment terms with credit provided by the builder ('seller's credit').

3.1 Buyer's credit

(a) Basic features

The majority of shipbuilding contracts currently employed worldwide are financed on buyer's credit terms. Payments of the contract price made before delivery are treated as advances under the shipbuilding contract.

A typical payment profile for a buyer's credit would be as follows:

Milestone	Percentage of contract price
Signing	15%
Steel cutting	15%
Keel laying	10%
Launching	10%
Delivery	50%
Total	100%

If the builder fails to complete the construction of the vessel in accordance with the shipbuilding contract by the contractual delivery date, or if he is otherwise in breach of the shipbuilding contract so as to entitle the buyer to terminate the shipbuilding contract, the buyer will be entitled to terminate the shipbuilding contract and require repayment of the pre-delivery instalments of contract price.

Where the building contract provides for payment in full by instalments on or before delivery, the buyer will commonly finance the second and subsequent instalments of the contract price by bank debt (or equivalent). Here, the lender will normally require the buyer to pay the first instalment of the contract price from its own resources, advancing the balance by way of a pre-delivery loan. In this structure, the loan (and the loan agreement) will substantially follow their equivalents in second-hand financing, except only that the loan will be made available for drawing in tranches to meet the later building contract instalments as they fall due, and the lender will require, as a condition precedent to each drawing, evidence from the builder that the instalment to be financed by that drawing has become payable coupled with a certificate from the classification society that the milestone event (eg, keel laying) has occurred. It would be common for the loan not to become repayable until after delivery, when the vessel's earnings come on stream, and sometimes a borrower can persuade the lender to allow interest to be rolled up (or capitalised) in the meantime.

(b) *Security*

Mortgage over a vessel under construction: Lending in order to finance vessel construction causes lenders particular security problems. This is because in many jurisdictions it is not possible for the lender to take a mortgage over a vessel under construction. In any event title to the vessel will frequently, by the terms of the building contract, remain with the yard until delivery, so that the vessel under construction will not be an asset of the buyer over which the buyer can grant security. Even if, as is sometimes the case, title to materials used in the construction of the vessel passes to the buyer as the materials are appropriated to the vessel, the builder will retain a lien on the vessel until payment (or delivery if a seller's credit is to be provided) and any form of security which the buyer could grant its lender (eg, by way of a fixed and floating charge over its assets generally) would be of limited value. This position should be contrasted to that where the lender advances monies on delivery of the new vessel, either simply to finance the delivery instalment or to re-finance earlier instalments paid by the buyer from other sources. A mortgage over the vessel in the usual way is then perfectly possible, and financing techniques and documents are almost identical to those used in the financing of second-hand tonnage.

Under English law, a registered mortgage over a vessel under construction is an impossibility, even to the extent that title has passed to the buyer. A statutory mortgage can only be taken over a registered vessel and, to be eligible for registration, a vessel must be "used in navigation"³ and, as a precondition to registration, a builder's certificate must be produced.⁴ This inability to take a registered mortgage during construction is not limited to the United Kingdom, but is relatively common throughout the world, although with exceptions such as Germany, where the builder will frequently mortgage the vessel under construction to its lender until delivery,

3 Section 313(1) Merchant Shipping Act 1995.

4 Regulation 28 of The Merchant Shipping (Registration of Ships) Regulations 1993.

making it important for a buyer and its lender to ensure that any mortgage granted by the builder is indeed discharged on delivery. As a result, a lender will generally need to look elsewhere for security, perhaps to guarantees and to security over other assets of the buyer or of its parent or associated companies.

Assignment of the shipbuilding contract: One form of security commonly taken by ship finance lenders financing the construction of a vessel is an assignment of the benefit of the building contract and refund guarantee. This will enable the lender, in the event of the buyer's default, to continue with the construction of the vessel, take delivery, and then sell the vessel to satisfy the outstanding debt. It is not an entirely satisfactory security for several reasons. First, while the assignment will not of itself make the lender liable for unpaid instalments of the contract price, in practice, if the buyer defaults, the lender will have little option but to continue to pay those instalments from its own resources in order to complete the construction of the vessel. The lender may be able to negotiate a price reduction with the builder but it will still be tying itself to a possibly substantial ongoing commitment, all the time relying on the market for the type of vessel concerned staying sufficiently firm to allow it to sell the vessel on completion for a sufficient amount to satisfy the outstanding debt.

Second, enforcing its rights as assignee after default creates ongoing administrative and operational difficulties for a lender. While before default the lender will normally be content to allow the buyer and its representatives to supervise the construction of the vessel, after default – when co-operation from the buyer is likely to be limited or non-existent – the lender will not normally have the technical expertise necessary properly to supervise the construction and will have to rely on employing (and paying) outside advisers. There may be ongoing insurance obligations, and pending delivery the lender will have a non-performing asset on its books and an increasing debt. The only way out is for the lender to find a third party prepared to take a further assignment of the contract – in effect, to sell the contract.

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