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# PRIVATE EQUITY FUNDS AS A PROMINENT FEATURE ON THE SHIP FINANCE

The business of owning and managing ships is unique and therefore gives rise to unique approaches to control and management, capital contributions and exit strategies with which private equity firms new to the industry may not be familiar. Likewise, ship owners may not appreciate how different a private equity firm's motivations and objectives may be from those of banks lending on a secured basis. This briefing will focus on some of the competing objectives which routinely arise when setting up a joint venture between a ship owner and a private equity firm which, if identified and addressed early by the parties, can lead to a more straightforward and harmonious start to the new relationship.

The shipping market moves with considerable pace and ship owners need to retain the flexibility and freedom to run the venture in a profitable way. This contrasts with the cautious investment processes and careful and structured regulatory procedures with which fund managers are familiar. Where a private equity investment in shipping involves the exercise of investment discretion it is important to put in place clear investment procedures which consider both the time frame required for the private equity party to get comfortable, and the market pace of the shipping industry, which thrives on the ability of ship owners to act quickly and with flexibility. Ship owners are often reluctant to give up unilateral control of day to day operations of the venture as they, of course, are the party with the market knowledge and experience. However, it is often the case that private equity firms do not actually want to relieve the ship owner of this responsibility. Rather, they are more interested in ensuring transparency in the operations of the joint venture than wanting to take an active role in the management of the business. In this respect, it is about striking the right balance between allowing the private equity firm the appropriate level of negative control it needs to ensure the protection of its investment and the need to give the ship owner the freedom to operate the joint venture in order to achieve the maximum economic benefit for both parties. The ship owner will commonly seek to provide commercial and technical management of the vessels through a management company which is within the ship owner's group, but is external to the joint venture. Private equity firms may seek an equity interest in the management company itself as there is a perception that value may be created therein which can be realized separately from the main venture e.g. on an IPO; however this participation is often resisted by the ship owner. On the ship owner's side it will be important to ensure that the management company remains separate from the joint venture, the management of the vessels always remains with the designated manager and that the private equity partner's ability to terminate the management arrangement is limited. On the private equity side, it is important to ensure that the terms of the management arrangement are no worse than standard arm's length terms, provide transparent reporting and can be terminated in cases of serious or consistent underperformance.

Private equity firms usually require a first right of refusal for the joint venture for any opportunities arising within the relevant sector of business in which the joint venture is operating. This can be potentially burdensome for the ship owner as if this right is badly formulated in the joint venture agreement, it may require the ship owner to present every possible opportunity to the joint venture, even if it is apparent to the ship owner that it is an undesirable or inappropriate investment for the joint venture. Management of potential decision making conflicts will also need to be considered, particularly if there is an issue or dispute between the joint venture and the external ship owner associated manager or a potential overlap between the joint venture and the interests of either party outside of the joint venture. It is vitally important that such provisions are drafted precisely. In the event that a decision of the joint venture requires the consent of both parties, the failure to come to a decision one way or another can lead to a deadlock. The procedures to resolve a deadlock can vary ranging from consultation and escalation at one end of the spectrum to dissolution of the joint venture at the other. A ship owner will likely want to ensure that the deadlock resolution process disrupts the normal operations of the joint venture fleet as little as possible. The private equity party will likely want a process that they can remain in control of and which has a minimal impact on the return on its investment. Therefore special attention must be given to the deadlock procedures; especially at what stage (and after what initial steps) a deadlock will trigger dissolution of the joint venture. Often parties to a joint venture will seek restrictions on the change of both the direct and ultimate beneficial shareholding of the other party. This gives rise to unique issues with a shipping joint venture on the basis that ultimate control on the shipping side can be held by various members of the same family group and on the private equity side is held by various participants in one or more funds. Each situation must therefore be dealt with on a case by case basis, taking into account amongst other things, potential commercial conflicts, sanctions, regulatory issues, specific confidentiality concerns and other situations where a change in control may not be permitted or may give rise to undesirable legal or commercial consequences. As they are less familiar with the risks and rewards of a shipping enterprise, and because as regulated financial institutions they are subject to a much higher degree of direct oversight by the authorities, equity investors will often be more sensitive to possible breaches of applicable laws and regulations than ship owners are. Furthermore, non-shipping equity investors are often nervous about environmental liabilities that are the subject of various shipping specific laws and conventions which can “pierce the corporate veil” and potentially create a significant liability for parent entities higher up the private equity chain of ownership. Private equity investors therefore often insist on heightened regulatory compliance measures and a higher level of reporting than ship owners are used to. These can include extensive provisions relating to antimoney laundering, “know-your-customer” compliance, sanctions compliance, merger control and anti-corruption.

While some private equity firms look at investment in the shipping sector as a long term play, most are drawn to the sector by the opportunity to earn attractive returns on relatively short and medium term investments. As a result the investment horizon for a private equity firm is often a lot shorter than what is customary in respect of an investment by a ship owner in a vessel or fleet.