

Market Commentary

An Investor Looks at the Space

As an industry insider, we perhaps think too much or maybe not. We focus more on the micro - looking at the shipping markets, commodity driven demand and supply. In our world, the macro is beyond our ken and will take care of itself. We are part of the shipping industrial complex and for that reason we are somewhat jaded in our views. We have sat through innumerable investor presentations and wondered what are the investors thinking? How do they look at our world? What attracts them and where are the opportunities? And, most importantly, how and why do they invest?

In an attempt to answer these questions or at least understand the mindset of an investor, we were fortunate to have the opportunity of talking with a private equity investor, **Gregory Prata** of **Gotham Private Equity Partners, L.P.** (“Gotham”). Gotham is a private equity firm, which focuses on middle and lower-middle market companies. Backed by a network of high net worth families, Gotham is focused on originating, executing and managing proprietary private equity transactions and providing strategic advisory services. Gotham invests in leveraged buyouts, buy-and-build strategies and special situations and provides capital to growing companies in various industries. The firm is comprised of a team of professionals who have been investing in private equity together since 2001. Gotham was formed this fall.

Public Equity

As private equity investors focused on the dry bulk segment, Gotham has its own peculiar view of markets and investment strategies, which is clearly differentiated from investors in the public markets and Mr. Prata’s wide-ranging discussion highlights these differences which mainly relate, in our view, to the differing perspectives of a long-term investor and a short-term investor/trader.

In Mr. Prata’s view, a public equity investor may not really know what he or she is getting into. In general, the market views shipping as a China play while downplaying the fact that shipping itself is a commodity risk. This is best exemplified by the fact that while the

Chinese economy boomed, everyone failed to note the uptick in the orderbook in 2007 and the impact it would subsequently have on supply and therefore rates.

The investors in the shipping IPOs were sold on the China play and were blinded by high yielding dividends that were expected to last. When the markets collapsed and dividends were suspended institutional investors sold. Today, dry bulk shipping company shares are now mainly owned by retail investors, which does not provide much investor stability and following.

Private Equity

As a team, the principals have been looking at shipping since 2003. During that year, they worked on a tanker deal, which subsequently fell apart. According to Mr. Prata, “we were new to the shipping industry and we just did not move fast enough to get a deal done in a very fluid market.” That did not dissuade them and their interest continued. They continued to research the tanker and dry bulk markets and more importantly meet ship managers, bankers, brokers and industry experts – putting to good use the most important lessons of shipping, which is that business is based upon building relationships and credibility. Although it sounds good to show up with a \$100 million check, the reality is that both parties must know and trust each other for a deal to get done. Finally in early 2007, the group concluded its first shipping deal, **Supernova Shipping LLC**, which focused on panamax and handysize bulk carriers. During that year, the group purchased and sold two panamax vessels and purchased and held three handysize vessels.

For private equity investors, shipping is a very different animal from the leveraged buyout transactions they are accustomed to. Typically, PE investors and their investment committees have sufficient time to engage in full due diligence, negotiate specific terms of a deal, line up the debt financing and close on an investment.

This model does not work in shipping, where one has to be quick and nimble, and the process must lead to quick execution. “Vessels

are bought and sold very quickly. PE investors are just not familiar with making quick decisions without full blown due diligence. It took us a long while to get comfortable and to convince ourselves and our committees to make an investment in this industry.”

In addition to the deal process, Mr. Prata comments that another significant hurdle for PE investors is the future value of the vessel. “I’ve spoken with a lot of private equity investors and they all ask the same question – what is my ship going to be worth when I am ready to sell.”

This is an unanswerable question and one that trips up many investors. Unable to answer what a ship would be worth in three or five years, the partners attempted to structure around this risk by utilizing conservative leverage and locking in long-term, fixed time charters with a high quality counterparty. The partners were taking a calculated bet that after the time charters expired, their vessels would have repaid sufficient debt so that operating and fixed costs, mainly debt service would be at manageable levels -- even for a down market. “Our goal was to ensure that we had a bullet-proof capital structure coming off those time charters in order to weather any down market to allow us to stay in business. As long as you have given yourself the

ability to wait seven to ten years for a good market to come back, you can ride out the cycle. You may not make the return you were hoping to make but you should not lose your investment.”

For these reasons, the typical private equity fund with a 10-year life with a 7-year investment period cannot wait out the cycle. The right investor for shipping is a family office, like a George Soros or a Michael Dell or a Gotham, or an investment subsidiary of a bank, like Morgan Stanley or Goldman Sachs who have the patience and ability to wait for 10 to 15 years if they have to.

So what does Gotham think about the market today? In their estimation, the market is open, but it is still early. Asset prices still reflect an artificial run-up and should correct as the orderbook eventually gets delivered, inflated long-term time charters expire into lower rates and the inevitable effect of the banks acknowledging the true values of the assets underlying their loans. That’s when the opportunity will arise and Gotham will be there as long-term investors.