



## **Ship finance trends in international shipping - AN OVERVIEW**

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FOR over eight years, (1987-1995), international shipping displayed a remarkable recovery and sustained growth. Supported by a robust OECD economic growth performance and a sound outlook, shipping, across almost all sectors, enjoyed a significant raise in earnings, values and newbuilding orders.

The confidence of owners was equally shared by banks that competed strongly among themselves to meet aggressive budgets. As such, for quality owners, shipfinance became an "owner's market" with many banks prepared to match and improve upon their bank's offers.

Research by Petrofin, recently published, shows that the number of banks involved in international shipfinancing rose in 1995 to 154 as compared with 119 in 1994 and only 67 in 1992 when the research first commenced. Whilst the number is still smaller than the over 200 banks active in the 1970's, it is clear evidence of the increased interest in international shipfinance. During the period, the "market norm" percentage of finance for quality names did rise from approximately 60% to 70% (on higher values) which represents an erosion of credit quality, especially since loan cashflows were based on higher anticipated earnings over longer periods.

In line with the weakening of credit terms and in order to be able to amortise high loan to value transactions, the average loan repayment period of loans did increase and most banks shifted the maximum age of vessels at the end of their loans from 15 years to 20-22 years, especially for dry cargo vessels up to handysize, general cargo and container vessels.

The latter relaxation, however, was only provided a) for owners with a demonstrable record of efficiently operating older vessels, b) where collateral vessels were of excellent quality (despite their years) and c) where vessels enjoyed an attractive specification and special survey position.

Increasingly over the years, as values rose, owners switched their purchases to older vessels with banks following suit. Owners did this in their search for acquisition, offering more attractive risk/reward characteristics and adequate anticipated cash flow. Focusing on yields over the period, these fell substantially in the face of keen bank competition from yields of over 200 basis points for quality names, to yields of between 100-150 basis points at present, representing a significant erosion of income to banks.

Many banks sought to offset the decline in yields by financing older vessels, offering higher percentages of finance and longer finance periods, foregoing personal guarantees and so on. Others focused on providing a variety of ancillary services and/or financial products such as derivatives. Some offered "hunting licenses" to their best clients against modest fees so that they could bid "outright" for their ship purchases.

As a general remark though, the traditional lenders refrained from aggressive lending, especially in 1995, thus allowing new bank entrants to obtain market share but on terms, which they may well regret. Instead, traditional lenders became very selective of clients, vessel type and condition and sought to offset higher percentages of lending either by requesting secured employment or structuring front-loaded repayment schedules of the provision of minimum cash balances.

## A change of picture

The outlook and confidence of banks and owners changed dramatically over the last nine months (Autumn 1995 onwards) as the BIFFEX index began a sharp fall, which admittedly caught most bankers and owners by surprise. Suddenly, everyone held their breath to see which way the market would go. Ship purchasers became very wary and held back, awaiting better opportunities. Sellers became more accommodating, values marked down vessel values, even though this was based initially more on market sentiment rather than on actual sales, and charterers held back cargoes hoping for lower fixtures.

The negative mood intensified in the first months of 1996 as the market continued to slide, especially for large dry cargo vessels. Values truly began to fall across all sectors, even though most sectors reacted in sympathy to the fall in the large dry cargo segment rather because of a fundamental change in their own segment demand and supply positions. As such, shiplenders (especially their credit departments) had become wary of new credits and have tightened on their offered terms. The excessive competition among banks abated somewhat in the first months of 1996 due to the poorer market sentiment on the one hand and a comfortable position among banks who had met their budgets for 1995 and were under less pressure at present. The bearish sentiment has not been helped by the Adriatic saga and other

problems such as Lykes, Regency Cruises, etc., which reminded banks of bygone years.

The recent stabilisation of market rates has provided an opportunity for owners and banks alike to reposition themselves and carry out new financings, or financing in anticipation of what the market will bring in the second half of 1996. We feel that international shipping is presently at a crossroads. Even though many analysts claim that the industry's fundamentals have not changed significantly, everyone is talking openly of a recession. This may well be premature because some market segments, such as tanker and container vessels, are showing robustness but undoubtedly the consensus is for lower freights and lower values.

Unlike the long and deep recession of the 1980's, the world's economic growth outlook remains positive with most analysts forecasting a rise in International trade volume for 1996-1997 in excess of 3%-4%.

U.S. dollar interest rates are still on near record-low level and the dollar remains undervalued. The weather - related seasonal problems in North America and parts of Europe experienced in early 1996 have abated and having, driven rates lower, charterers need to fix tonnage, in order not to be caught "on the hop."

The supply side of the picture is less supportive. Whereas the combo, reefer and tanker orderbooks showed the newbuildings orderbook standing at 2.9%, 3.2% and 7.4% of the total respectively (Clarksons). For bulk carriers the total is 15.5% and for capesizes in particular the figure rises to 20%. The position is even more worrisome for container: where the overall figure is 33.8% and a staggering 56.2% for container vessels of 3,000 TEU capacity and above.

Thus, it is mainly the supply side that is causing concern and the change of sentiment. Despite this, the rate of newbuilding orders has not slowed down while the new building price index has fallen over the last four years. Banks are visibly showing their discomfort at financing new building orders especially in the dry bulk sector but new building financing is still being somewhat provided to enable the rate of newbuilding orders to continue.

Many analysts believe that the decline in the market shall continue and shall indeed stabilise at the 1,200 to 1,300 level range. If this should happen in the second half of 1996 then international shipping will begin to suffer in earnest. At such levels, net operating margins shall be at a fraction of those of the last years since vessel operating costs have also risen substantially. As such, not only have crew costs and insurance costs risen substantially over the last few years but repairs and maintenance costs have exceeded all expectations. The combined effects of stringent classification, flag, insurance and bank requirements on vessels' condition, have

pushed up vessel operating expenses substantially and the costs of special survey, dry docking and condition surveys dramatically.

### **The outlook for international shipping**

The abrupt change of sentiment has already affected the attitude of all banks towards shiplending. Whereas it is early to talk of banks leaving the industry, it is fair to say that all banks are presently reviewing thoroughly their credit portfolios and are conducting sensitivity analyses on all their credit in a market with reduced sale and purchase activity, new shiplending opportunities have been reduced. Lending to new clients has been dramatically curtailed unless involving "prime" names.

Already, most international banks have reduced their percentage of finance from an average of 70% to 65% and increased their resiliency to lower loan spreads and fees. At the same time, banks have been increasingly focused on their clients' liquidity reserves, vessel maintenance and survey positions and in bringing the clients' files up to date. Although, no bank has stopped fresh lending, especially to established clients, it is fair to say that all new credits are being thoroughly researched and decisions are both slower and involve harsher conditions.

Owners, too, are quietly re-evaluating their positions and adjusting their strategies and there has been some "flight to quality" in their own bank selection where they can reduce their exposure to inexperienced lending banks and in an effort to reduce their loan repayment obligations, especially over the next two years. The industry's ability to attract capital via the international stock markets, private placements and/or investment institutions has also been affected. The industry has had a poor record in this area anyway and as such most fresh equity has been raised privately rather than publicly.

Nevertheless, awaiting the market's next move, the plans for new flotations and issues have been temporarily shelved. Should the market's decline turn into a prolonged recession, it is inevitable that international shiplending banks will face problem loan situations. Already most are prepared for this and have identified clients or loans, which have been put into the "watch list". Lenders are committed not to repeat the mistakes of the 1980's and to tackle problem loans with coolness and self-control. Smooth recoveries via "controlled" sale of vessels will be the name of the game in loan recovery, especially since there is such a plethora of liquid clients with the financial strength and appetite to "sweep up" such vessels at attractive prices and finance terms. Banks have also turned their all attention to the quality of their collateral assets by stepping up vessel inspections.

Another key area of interest is the extent of "market" credit enjoyed by owners (bunkers, lubs and paints, general creditors,

etc.) An undue reliance or exposure to market credit by owners may indeed lead them to cashflow problems, since unsecured credit is the first to be cut at times of recession, thereby shifting the burden via the owners to the banks for additional support.

As the market continues to slide, or as long as it remains in a "bearish" mode, banks will increasingly tighten their control on existing clients and their terms for new business. Many bankers believe that this has been long overdue, since the industry had overheated, and a mild recession would restore shiplending terms and conditions to much more acceptable (to banks) levels as well as cleanse the industry from recent aggressive lenders, who may well lack the ability to last the course.

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