EXPOSING THE "CREDIT CRUNCH" MYTH

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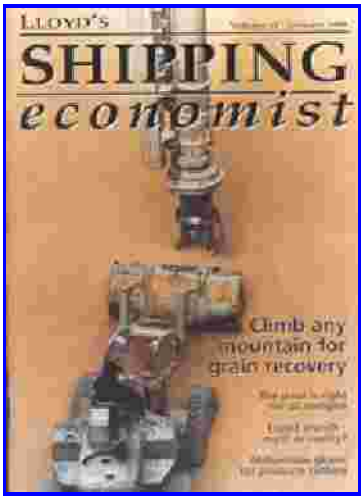

The Credit Crunch "myth" and the "Banking Consolidation scare" theories under the magnifying glass

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Every so often, shipping analysts report of a danger, which they call "the credit crunch". The theory in a few words is as follows:

- The demand for shipping credit is huge and growing qui kly in order to finance the extensive newbuilding program and the replacement of obsolete, over age and low quality tonnage, whereas,
- The supply of shipping credit is limited to a dwindlin mber of commercial Banks (more of US high yield bonds later) thereby creating a credit shortage for the shipping industry.

The recent mergermania (CITICORP / TRAVELLERS, DEUTCHEBANK / BANKERS TRUST etc. etc.) has added to the "credit crun " theory since the number of major Banks is dwindling and thereby (via this banking consolidation) exacerbating the problem.

Is there, however, any evidence of a "credit crunch"?

Does the merger of Banks in their quest to become Global players create conditions which lead to a "credit

crunch"?

Some answers and observations follow:

The shipping industry is a highly cyclical one. Shipping analysts have identified long-term cycles of 30 years or so, medium term cycles of 10-12 years and shorter-term cycles of 3-5 years.

Examples of a long term cycle is the VLCC / ULCC sector in the tanker industry which went into a cyclical low in the 1970's and has only begun to effectively recover in the 1990's.

Previous evidence

Medium term cycles are characterised by the drybulk crisis of 1983-1986 and the current shipping slump of 1997-1998 with respective cycle highs in 1989 - 1990 and 1995. Short term cycles can be identified in 91-1992 and 1996.

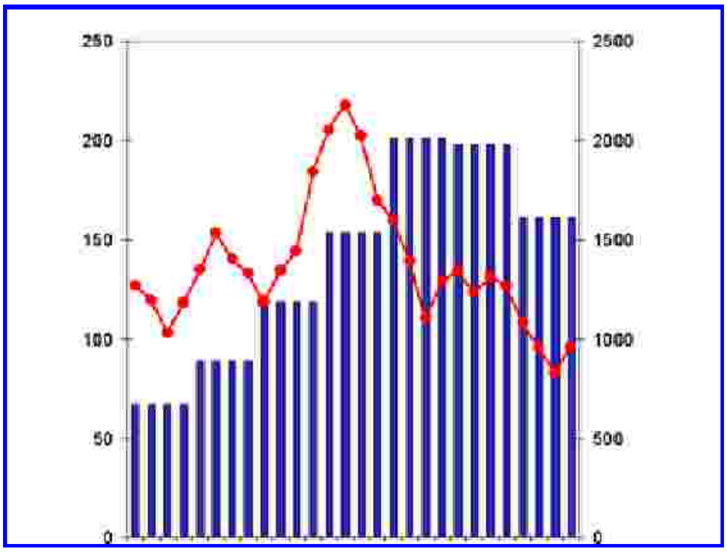
It is only natural for Banks to proliferate and engage in massive lending when market conditions and prospects are good, money is in abundance and when credit appetite by shipowners is high. Conversely,

when during slump periods the Banks' loan portfolios w aken, loan losses are incurred and the appetite and liquidity of shipown e low, it is hardly surprising that Banks reduce their lending or leave the industry altogether.

An example of the above observations can be demonstrated in the following graph showing:

1. The number of active shiplending Banks in accordance with PETROFIN's Research that has been carried out since 19 nd
2. The BIFFEX index over the period.

TABLE I: Comparison of the Number of Banks involved in Shiplending and the BIFFEX Index



As you will observe, during the period that shipping conditions and prospects were positive, the number of Banks grew and the position was reversed as the market begun to weaken.

The fall in Bank numbers begun to be steeper in 1998 as a result of the Far East, as well as, worldwide economic crises and the po ings, values and immediate prospects for recovery of the shipping industry.

In my opinion, the above phenomenon is not only a natu e but does not add any strength to the "credit crunch" theory, since during shipping slumps the demand for shipping finance is also reduced. Deman for shipping finance is the direct result of interest in vessel purchases by shipowners.

The recent Sale and Purchase statistics add overwhelming support to the slowdown in new finance. Admittedly, there has recently been a proliferation of newbuilding orders. In these, commercial Banks have played a key role.

Readers, however, should recognise that these loans have not been drawn yet as deliveries are scheduled for 1999, 2000, 2001 and beyond. As such, they represent contingent loan volume rather than actu volume. Moreover, as new finance activity slows down, overall evels of finance are reduced via the gradual repayment of existing shipping s.

The shipping finance market is highly vulnerable to a "flight into quality" syndrome that has been experienced over the last few m ths in the wake of the Far East, Russian, Latin American and worldwide econom rises.

As investors and depositors run for cover, Banks were subjected to massive loan provisions or losses in the countries that until recently had been "evergreen lands of credit opportunity". Coupled by losses and a crisis in the hedge funds, Banks were rudely awakened by these multi le shocks and had to pull in their reins in fact, as well as, to be seen o be doing it. Banks, therefore, reacted by increased credit controls and a slowdown in fresh lending / exposure whilst at the same time pressing for loan redemptions by clients in the affected countries.

Nowhere was this truer than in the Far East where Bank ave been fighting a fight of survival just as their country economies were doing. Shipping, being a capital incentive industry and directly in the "eye of the storm", could not and did not escape.

All Far East Banks, being relatively fresh shiplenders (with the exception of the Japanese) stopped all lending and begun to press their clients to sell assets. Witness to this is that most vessels being put p for sale are coming from Far Eastern owners.

However, the above does not constitute a "credit crunch" since it is a cyclical and not a structural phenomenon. For a "credi crunch" to exist there must be fundamental long term and structural changes affecting the shipping and ship finance industries, something which, in my opinion, does not exist at present.

I believe that as soon as investors' and depositors' confidence shall return, a number of Far Eastern Banks will return to life and wi ce again recommence lending to the shipping industry. After all, the higher loan margins, which have almost doubled for Far East loans, will be a factor they will not be able to ignore for long. It is true that after a period of trauma, Banks tend to seek their survival by huddling together to weather the storm.

This is often described as "consolidation" or more elegantly "mergers and acquisitions". As such, although the number of Banks and potential shiplenders will weaken as a result of this "consolidation", the surviving Banks shall be stronger and thus able to remain in or re-enter shiplending. Once again the cyclical process in the markets are being mirrored in the banking sector and consequently in the shipfinance sec r.

Where there are more grounds for structural changes is in the "consolidation" of very large Banks in their effort to become Global players. This Globalmania is not new. Seasoned observers will recall similar moves by US Banks (CITIBANK, BANK OF AMERICA, CONTINENTAL etc.) in the 1970's which ended in dismal failure. Already, the markets are beginning to react to the latest moves such as, DEUTCH BANK's acquisition of BANKERS TRUST and are starting to mark down the shares of the bidding Banks.

This expresses the doubt in the investors' minds that is strategy will be successful as seen from their eyes, which are looking for earnings per share growth and enhanced shareholder value.

Size done does not guarantee success and all too often is the largest Banks that display loose credit controls and massive losses i.e. UBS. Nevertheless, should this trend continue and Banks feel that only via size can they effectively compete as equal terms against each other, then there will have occurred a structural change in the banking sector.

Even if this is correct, however, how does this "Globalmania" adversely affect shiplending? The answer to this is trickier. Sh ld both Banks involved in a merger have active shipping departments hich consolidate their lending, then undoubtedly the merger does bring about a reduction in the number of major shipfinance lenders.

There is, however, a counter-argument whereby such Global Banks are financially stronger and therefore, better able to withstand shipfinance cycles and able to be more committed to the industry. Similarly, such Banks may find it useful to expand their range of services i shipping and thus develop into key shipping Shipfinance Banks covering all their clients' requirements from loans, to mergers and acquisitions, equity and commercial paper and so on. This increased commitment shipping and ability to provide all services from one Bank is of value to clients and the shipping industry.

Similarly, as the average size of Banks involved in sh plending increases, there will no doubt be opportunities for "niche" players to take advantage of the gap created by the big "elephants" which are looki g after the big clients. It is the writer's opinion that as soon as sh ing market prospects improve the number of Banks shall once again begin to climb and it will more than surpass the previous peak of 201 Banks reach in 1996.

A new source of shipfinance was "discovered" in 1997 and the first half of 1998 in the form of high yield debt or as is commonly called Junk Bonds. For a while, this new instrument for shipping became t e only "game in town" and commercial Banks begun to create products to compete with these bonds that took away their clients and reduced t eir loan portfolios. The "flight into quality" by investors and the dismal performance of most of these issues have put a stop to new issues by the second half of 1998.

Readers, though, should be weary of writing off Junk Bonds too easily, since investors' appetite towards higher risk will return with a vengeance once conditions stabilise in 1999. In addition, lower S and International interest rates are leaving investors desperate for hig er yield investments and vulnerable to being enticed once again into the sh ing Junk Bond frenzy.

The departments that have been set up will not be dism tled overnight and the industry's appetite for these instruments will ret rn. No doubt, both investors and the investment Banks will be more weary of shipping for a while but both are characterised by anemic memories.

"Greed" will once again overcome "fear" and most issuers that had aborted their decisions, will dust off their aborted prospectu d will once again re-consider Junk Bonds. After all, when US interest rates a yield of 9% was acceptable and 11%+ prohibitive. When US rates fall to 4% a Junk Bond yield for a better quality issue of 8% need not f ghten issuers who will, no doubt, have faith in the ability of the shipping industry to recover from its slump. High yield shipping paper will once ag return to prominence and convince the last believers of the "cre crunch" theory.

Where the writer believes that there is greater eviden f a "credit crunch" is in two sub-segments of the shipping industry, namely:

- The overage vessels' sector and
- The small shipping company.

"Quality sector"

Unlike other cycles, there is a uniform view being developed by Banks that size equals quality.

As such, most lenders have identified the top 40-50 or so "quality" names of the industry and are still falling all over themselves trying to lend to this small band which accounts for less than 1% of the numb shipping companies in the world and less than 20% of fleet size.

Account officers and their respective credit committees feel safer with a major name. Certainly, there would be less criticism if one of these would go wrong. It requires, however, a brave decision to lend to a small and relatively unknown name. Fortunately, this attitude is not universal yet and Banks, which have a serious and committed long-term presence in the industry, do recognise credit quality in smaller owners.

Nevertheless, obtaining a loan in this market by a smaller client is a rather uphill task, as small owners shall discover to their surprise and disappointment when they would feel ready to buy tonnage once again over the next 1-2 years.

Similarly, overage vessels (mainly late 70's) have fallen from favour by shipping Banks. They see that these vessels are fighting for survival, are being shunned by charterers, increasingly scrutinised by port authorities, classification societies and insurers and have demonst ed the largest fall in relative vessel values over the last year. The low scrap prices do not help either.

A table showing vessel values falls for various vessel types and ages follows below. It clearly demonstrates this point.

TABLE II: Examples of Falls in Vessel Values $m

Research by: Petrofin S.A.
Source : Clarkson Research

The overwhelming majority of shiplenders will not support a small owner wishing to acquire overage vessels even where the clients' credit record, liquidity and equity may justify the loan.

To conclude therefore, the only evidence of a "credit crunch" is for the small owner with overage vessels. For all other sectors any difficulties are a reflection of the shipping market slump, difficult int ational economic conditions and the uncertain prospects.

Even the much talked about Bank "consolidation" theory may not have drastic long term effects as new Banks will move into iplending when the risk / reward criteria shall favour their re-entry.

Lastly, the presence of an active investment banking i terest in shipping will continue to act as a powerful provider of long term fu ds, as well as, equity for shipping. In other words, if the client and the project are sound, getting the money is child's play. No doubt, owners and Banks are looking forward to re-entering the playground soon.

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