The bankers' view

The opinions of those financing shipping on market prospects are revealed in a survey carried out by **Ted Petropoulos** of ***Petrofin Bank Research***

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Forecasts for what is likely to happen to shipping markets in 2006 are plentiful and there are also widely diverging views in some respects. Most of these predictions have come from brokers, analysts and consultants, but what do those who provide the finance for shipping investments think will happen? This survey of 40 leading shipping banks gives an insight into their opinions of how shipping may shape up in the coming year and beyond.

Shipping, across all sectors, has enjoyed two very successful years in 2004 and 2005 with freight rates and vessel prices rising to unprecedented heights. Although it has been a bumpy ride with freight rates, exhibiting enormous short-term volatility, the yearly freight averages for 2004 and 2005 bear no resemblance to those in the previous years of 2001 to 2003.

Ship values for all vessel types, sizes and ages have enjoyed even better performance over the last two years. Aided by the abundance of ship finance, owner liquidity and, most importantly, higher freight rates, as well as a soft interest rate environment and limited newbuilding capacity, used vessel prices doubled or even tripled, whereas newbuilding prices increased by an average 605 over the period. The recent statistical performance of shipping was largely unexpected, especially in relation to the magnitude of its peaks.

This survey concentrates on the outlook and prospects for shipping in general for 2006 and beyond. Most market participants, owners, charterers and bankers are apprehensive about the future. Classical cycle theory dictates that every period of boom is followed by a period of slump.

The newbuilding orderbook compared with existing capacity is running at about 20% for bulkers, 25% for tankers, 50% for containerships, 30% for LPGs and 85% for LNGs, while scrapping has slowed to one-fifth of the levels of 2001-2003. The supply side of the equation therefore looks rather heavy.

On the demand side China, India and other fast developing countries are still showing solid year-on-year growth, apparently unperturbed by high oil prices. Japan is at long last coming out of its chronic recession and deflation cycle, while the US continues to display a solid economic growth performance well ahead of Europe. In consequence, even though 2006 growth expectations have been slightly reduced, largely as a result of oil prices, the overall demand side still appears quite healthy. So, we have a classical race between rising demand trying to absorb rising supply. In this tug-of-war most analysts anticipate a period of excess supply of vessels leading to reduced freight rates and, correspondingly, vessel prices.

Is it possible that the analysts will, once again, be proved wrong? This is quite possible as the forecast excess supply may easily evaporate should oil prices fall from the record $60-70 per barrel to a more benign $40-50 and should world trade in fact continue to grow at the same rates as in 2003-2005. The anticipated excess shipping capacity supply could be largely absorbed by just a 1% increase in anticipated GDP growth, which is within the realm of possibility. Equally, there may be unexpected shocks to the international economy that further widen the gap between demand and supply in the short-term. This poses a question as to what investment and finance decisions should be made amid such uncertainty.

Market participants can be broadly split into three categories. Firstly, the pessimists/traditionalists, who believe that the recent shipping boom is a 'flash in the pan' and that freight rates and vessel values will return to their much lower long-term averages. This group refrains from buying new vessels having sold large parts of its fleets. Bankers in this group will lend only against solid charters, down to the residual historic value after expiry of the time charter.

Secondly, there are the structuralists, who believe there has been a fundamental shift in vessel values and freights to a higher plane that is considerably higher than historic averages. They anticipate a turbulent ride but at a higher overall level. In short, they believe in the presence of a super-cycle, which will positively impact shipping for the next couple of decades. Consequently, owners in this category continue to buy new tonnage when presented with relative opportunities. Bankers lend more competitively by relying on higher loan break even and vessel values over the life of new loans.

Finally, there are the optimists who believe that given the restricted newbuilding capacity and an over-age fleet, due to limited scrapping, the demand for shipping will outpace such limited supply for the next few years. They base their optimism on the momentum of China, India and other developing nations, a robust international economy and trade and the easy supply of finance, as well as investment funds attracted into shipping that will keep ship values high. In their view the freight peaks of 2004 and early 2005 are nothing but an indicator of better things to come. They argue that vessel prices will, due to the abundance of money, good shipping performance and higher newbuilding costs, continue to hold, and indeed may rise further as trading ships are seen as valuable commodities. Although there are few bankers among the optimists willing or able to lend aggressively, there are a number of owners that continue to invest for market growth in 2006 to 2008 and seize every opportunity to do so.

Whatever individuals believe, a key factor in the continued good performance of shipping rests on the shoulders of its commercial bankers. Almost all vessels purchased and most newbuilding orders require the support of commercial banks. Consequently, their views and opinions, as to the future of ship finance, are of major importance in shaping the decisions that determine its actual performance. For example, if all bankers believed that markets were about to collapse and either refrained from financing vessels or lowered their percentages of finance and tightened their terms, the effect would be felt immediately in the market and ship values would plummet. Lending on an asset with uncertain income over the next 10 years is an act of faith by banks in owners.

To determine the current attitude of the world's leading banks towards shipping and ship finance Petrofin conducted research by asking 40 shipping banks 15 questions during the period from mid-October to early November, 2005. The banks involved are mostly based in Europe but account for a significant portion of the world's ship finance industry on the basis of their collective shipping loan portfolios. Their collective opinions are therefore important and interesting.

Do you expect the shipping freight market across all sectors to be higher, the same, or lower in 12 months' time and three years' time?

Reflecting current expectations by most analysts and the market at large, not surprisingly 85% of bankers anticipate lower freight rates for shipping as a whole after 12 months, with just 5% expecting it to be higher. Some expected the tanker sector to outperform dry bulk and especially the container sector. Interestingly, bankers' expectations were more evenly divided as to the outlook for three years' time. The largest number, 45%, still expected rates to be lower, but 30% believe rates will be higher in three years' time. This reflects the widely held view that a short-term correction will be followed by a further period of relatively good performance in shipping.

Do you anticipate newbuilding prices across all types of vessels to increase, remain the same, or decline in the next 12 months?

Although the majority, 65%, of bankers believed newbuilding prices would fall, most of them immediately qualified their answer by stating that such reductions would be relatively little, as rising newbuilding costs do not allow for significant reductions in prices. In addition, most bankers added that they anticipated newbuilding orders would continue, thus reducing pressures on shipbuilding yards for further reduction to secure future orders.

Do you expect average modern ship prices across all types of vessels to increase, remain the same, or drop in the next 12 months?

Once again, most bankers displayed a consistent attitude with 80% expecting prices to fall over the next year. However, there remained a view, held by 20%, that prices would stay the same or even increase.

Do you expect prices for over-age vessels (15-20 years) to increase, remain the same, or drop in the next 12 months?

Here the outlook is overwhelmingly against older vessels being able to maintain their values with 90% expecting their values to fall and none that they would increase. To a large extent bankers feel that, to maintain their values, freight levels will need to be high in relation to vessel values. However, the contrary applies currently as freight rates have fallen by considerably more than ship values since the peaks of early 2005.

Do you expect scrap prices to increase, remain the same, or drop in the next 12 months?

In line with short-term market expectations, 65% expect lower scrap prices and only 10% that they will be higher. However, many added that such price reductions would be largely limited while a considerable number expected no significant change. Their argument is that scrap prices are still supported by relatively high steel prices and that, as long as over age vessels earned more than their operating costs (taking account of special surveys and high maintenance requirements), there is still limited interest in scrapping.

Do you expect the international regulatory environment to be harsher, the same, or more relaxed in 12 months' time?

Interestingly, no one expected a more relaxed environment, but bankers were split between those believing that the trend towards a harsher regulatory environment is a one-way process in the short-term (55%), and those that felt it is 'bad enough' and there is no room for even harsher regulations.

Do you think oil prices will be higher, about the same, or lower in 12 months' time?

Currently, 60% of banks are of the view that oil prices will fall, which, if proved correct, may act as a stimulant to the world economy and growth in international trade. Just 10% said that oil prices will be higher.

Do you expect China's economic growth, currently running at about 9%, to climb further, stay about the same or reduce in 12 months' time?

Most bankers, 45%, believe that the Chinese economy has a steady momentum and its growth will continue at the same pace. Some 15% anticipate yet higher growth, whereas a solid 40% expect some degree of slowdown. All expect that China holds the key to the demand/supply position for shipping in the next year.

Do you expect the overall global ship finance loan portfolio to be higher, about the same or reduce in the next 12 months?

Anticipating lower newbuilding prices and secondhand prices, many bankers believe that the shipping loan book will stabilise or even fall with 10% expecting a reduction. The remainder are equally split between those expecting it to stay the same and those forecasting an increase. Some 45% anticipate a continuous increase, even though at a reduced pace, citing that there are considerable newbuildings still to be delivered that required finance. On the other side, as US interest rates increase, more owners may be willing to use their considerable cash reserves in pre-paying loan facilities.

For your own institution, do you expect your ship finance portfolio to

be higher, about the same, or lower in 12 months' time?

It is fascinating that despite the prevalent caution about the market and vessel values and freight rates, 80% expect their own loan book to grow and only 10% that it would fall. This underlines the continuous competitiveness of ship finance and faith in the longer term prospects and performance of shipping and banks' shipping clients.

Do you expect spreads to increase, remain about the same or drop in the next 12 months?

Most bankers believed that loan margins had fallen to the lowest level possible, with 30% expecting a rebound, especially if shipping were to go into a mild recession. A smaller number, 15%, believe that competition will drive margins even lower.

Do you expect that the number of banks involved in ship finance internationally will increase, remain about the same, or decrease in the next 12 months?

Many bankers felt that shipping had performed well and despite the relatively low margins, more banks would join the ship finance ranks, with some 45% expecting the number of shipping banks to rise. An equal number felt that there is little room for more banks as the competition is still intense and banks involved in ship finance needed to have a clear commitment to the shipping industry in order to develop.

Do you expect the average loan to value financing to increase, remain the same, or drop in the next 12 months?

Despite the anticipated volatility of ship values and earnings, the majority – 75% – believe that the usual yardstick of about 70% financing would remain the industry norm, with 15% suggesting it would increase and 10% that it will fall.

What is, in your opinion, the probability of a severe shipping crash i.e. massive falls in vessel values and freights, in the next 12 months?

Despite an overall bearish sentiment, 80% of bankers believe that the risk of a crash is small, at 0-20%. Only 5% rate the chances of a crash at higher than 50%. Most add that they expect a mild correction that will leave their loan portfolio intact and their clients largely unaffected.

Will shipping IPO activity will increase, remain the same, or drop in the next 12 months?

Despite the recent difficulties faced by some new IPOs, there is no overwhelmingly sentiment that there will be a slowdown. A firm 30% anticipated continued activity at 2005 levels and 15% an increase, although a majority did expect activity to fall. Reasons cited for continued activity were the considerable number of owners still queuing for an IPO, or some for tapping into the capital markets and the continuous interest in shipping by investment banks and the investment community. All, however, predicted a further tightening of terms as investors grew more selective and demanding.

Conclusions

Overall, the survey indicated increased caution on the part of banks over the near term performance of shipping, but no reason for any major concerns. In consequence, bank competition is expected to remain intense, but banks are likely to become even more selective.

The belief in the long-term performance of shipping is widely prevalent and, overall, there is confidence that any correction will be relatively shallow and brief.

This is an edited version of a paper presented by Ted Petropoulos at the LSE Ship Finance Conference in London in November