The effect of Bank Consolidation on Ship Finance

HOW DOES INTERNATIONAL BANK CONSOLIDATION AFFECT THE SHIPFINANCE INDUSTRY IN GENERAL AND ITS APPETITE FOR ASSET - BASED SHIPFINANCE?

ANALYSIS, VIEWS AND TRENDS

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Over the last decade, the process of Bank mergers and takeovers has gathered pace. This consolidation has taken place both within the boundaries of each nation, as well as, internationally.

It is believed that bigger size brings with it the opportunity to:

- *Dominate the market, either nationally or internationally;*
- *Enjoy economies of scale both in Bank operations, as well as, in marketing, technology and efficiency;*
- *Be able to geographically diversify across regions, states or continents;*
- *Be able to develop worldwide products and services on a standardised basis;*
- *Be in a position to cross-sell such products and services to each and every Bank customer and*
- *Develop greater earnings per share and increasingly higher returns to shareholders.*

Time will tell whether the aspired higher returns shall materialise.

However, improved IT technology, telecommunications, the use of the Internet, internationalisation of Banking products, the breakdown of boundaries in the flow of capital and funds, as well as, the undoubted success of the western capitalistic system (based on the principles of a free global economy) have all contributed to this process.

How do small and large Banks view the consolidation race?

No Bank wishes to remain a small player whilst trying to cover all the Banking requirements of its clientele. Their management feel that sooner or later they shall be absorbed by larger Banks who shall offer the shareholders of the smaller Banks "an offer they could not refuse".

Furthermore, it is believed that small Banks cannot efficiently compete across all services with the larger Banks since this requires a great deal of capital and commitment to human, as well as, technological resources.

As such, small Banks have 3 choices, **either**

- *become small "niche" players,* ***or***
- *allow themselves to be absorbed,* ***or***
- *join the race themselves.*

Large national Banks too, no longer feel safe. As such, they either also join the race or build up strategic alliances with other large National Banks via exchanges of shareholdings or acquiring minority stakes.

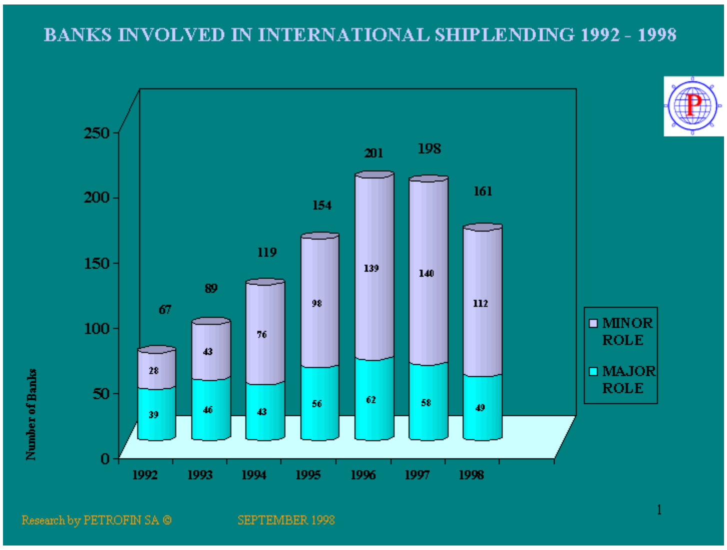
How does all this consolidation affect the shipfinance industry?

Will shipfinance become easier or increasingly more difficult? Will certain shipping nations or type of shipping companies benefit whilst others may lose out through this process? What steps can the industry and each shipping company take to meet the challenges and opportunities of this consolidation process?

We will now attempt to provide some answers to the above.

Already, as a result of both the above process, as well as, the effects of the shipping slump, the number of Banks involved in shiplending has declined dramatically. We present below **PETROFIN's** published research since 1992 covering the number of Banks engaged in shiplending either in a major or in a minor role.

Banks involved in international shiplending 1992-1998



As you will observe, the overall number of Banks has declined since its peak of **201** in 1996 to **161** in the fall of 1998 when the last research was published.

Since then, the process of consolidation has accelerated whilst the shipping industry has continued to show a poor performance across all sectors. This has affected the appetite of all Banks towards fresh lending and has motivated some to leave the industry altogether e.g. **PARISBAS, HAMBROS BANK, GUINNESS MAHON** etc.

Although the 1999 research shall be published in the fall of 1999, it is believed that the number of shiplending Banks has continued to fall and presently stands at approximately **150**.

When Banks leave the industry, their capacity, i.e. ability to lend, is lost. Whereas appetite for shiplending may return to those Banks that remain in the shipfinance industry, this does not apply for departing Banks who need a considerable period of time to consider re-entering the market.

However, the process of consolidation need not necessarily be feared by shipping. Through the process of larger Banks competing on a global basis, these Banks normally enjoy a greater capital base and the ability to commit greater resources to the shipping industry, which is still regarded as a "high risk" industry and requires greater capital resources than those required for other industries.

Although some initial streamlining may reduce overall capacity and the size of each Bank's shipping departments, consolidation in the medium to longer term shall not automatically lead to a reduction in shipfinance capacity.

To the contrary, there is a large number of major Banks that are not actively engaged in shipfinance. Via a merger with other Banks that have shipping expertise or wishing not to leave the field to competitors, it is believed that there is an opportunity for overall shipfinance capacity to actually grow despite the lower numerical number of Banks involved in the industry.

Will loss of players be compensated?

In short, what we believe will occur is that the actual number of major shiplenders will not decline in the medium to longer term since the loss of players via consolidation will be made up by new players wishing to compete in this sector.

The above process will take place once the shipping industry shall come out of its doldrums and its risk / reward profile from a banking point of view shall improve.

It is the major shiplenders that provide the necessary shipfinance capacity whereas the small Banks can either participate in syndications (as "participation fodder" or "stuffees" as they are sometimes arrogantly referred to by the lead Banks) or alternatively, they can become "niche" players. The number of minor shiplenders will invariably rise and fall with the performance and prospects of shipping.

Will consolidation lead to a change of Bank criteria in choosing Clients?

However, as Banks' size has increasingly become a key consideration so has client size also become a critical factor in a Bank's client selection. Bigger Banks are no longer interested in the smaller clients who do not offer them the ability to market the full spectrum of their services or may involve very small sums.

With the greater emphasis shown by the large Banks in non-risk products and services such as F/X derivatives, advisory services etc., it is the larger clients that shall be favoured.

The entry of shipping in the U.S. Capital Markets is also an opportunity that only larger clients can enjoy and only larger Banks can offer the required expertise, commitment and placing power.

A number of writers have drawn the conclusion that the U.S. Capital Markets may cross off shipping from their list of interest because of the negative performance of most of the recent High Yield issues. However, this is wrong since the financial needs of the shipping industry are prolific and the U.S.

Capital markets have a very good industry client for the generation of fees over the longer term. In addition, the fact that High Yield debt issues have not worked in the midst of a shipping slump does not rule out the majority of U.S. Capital market's other products and services i.e. equity placement, public floatations etc.

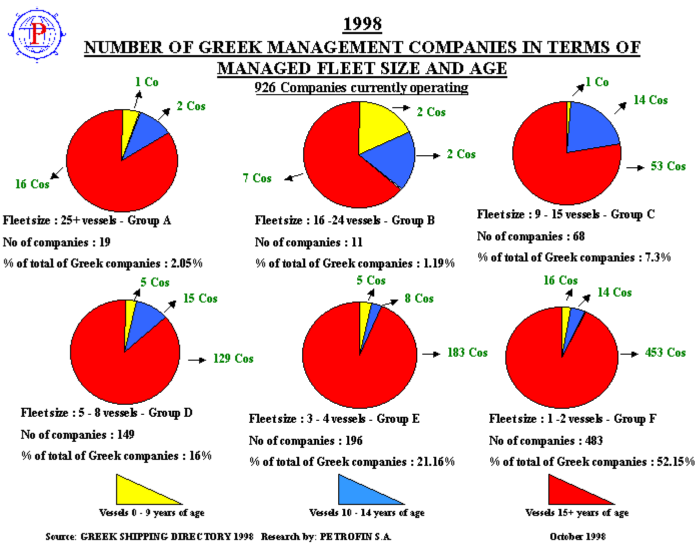
It is not my intention to dwell for long on this aspect. However, without a doubt, the increasing involvement of the U.S. and subsequently, the remaining International capital markets shall favour the larger Bank, the larger client and more importantly, clients with a corporate philosophy, structure and aspirations.

How is the small owner going to be viewed by large banking corporations?

In conclusion, therefore, Bank consolidation need not be feared by the large shipping companies especially those that operate in a corporate manner and are prepared to expand via a growing utilisation of their Banks' offered products and services.

However, worldwide shipping is highly fragmented. For example, in a recent PETROFIN research study published in September 1998 of the **926 Greek Shipping Companies** only **26.6%** had a size of 5 vessels or higher (see chart below).

Number of Greek Shipmanagement companies in terms of fleet size and age



Furthermore, the average fleet size per company was under 3 vessels. The consolidation of the Banking industry will undoubtedly adversely affect the ability of the small owners to obtain competitive finance or indeed any finance. Already, most Banks have developed strict policy guidelines as to the size and quality of clients they are prepared to consider as potential clients.

These policy guidelines invariably leave out both the smaller owner, as well as, any fresh entrants into shipping. Furthermore, the smaller shipping companies are the ones that tend to lack the necessary sophistication and appetite for a Bank's services.

A final aspect to be considered is how Bank consolidation may affect asset-based shipfinance.

Due to its volatility in values and earnings, shipping has always been considered as "risky" lending by Banks. However, drawn by its relatively high loan yields and loan demand and propelled by the need to put to use the enormous deposits and liquidity of Banks over the last couple of decades, Banks found an outlet in asset-based shipfinance.

However, as loan yields have come off in the 90's and as greater margins were achieved in other areas and products (i.e. credit cards, fee related products and services), the appetite of Banks in asset-based finance has begun to waive over the years.

Banks have increasingly drawn the conclusion that strict asset-based finance yields of say 80-125 basis points are not sufficiently attractive to reward them for the entailed risk. Most Banks began to consolidate their balance sheets and overall leverage in line with the strict central Bank ratios over the last decade. As such, their interest in "blowing up" their balance sheets has evaporated.

The need to conserve capital has also played a key role since shipping is 100% "risk to capital weighted" by most central Banks.

Overcoming asset-based finance

A way to overcome asset-based finance's drawback has been for larger Banks to develop a lead role in syndications where they would also increase their earnings via transaction related fees. This trend has, however, once again favoured the larger and committed shipping Banks, as well as, the larger client. Once again, such syndications were focused on the highest quality shipping credits.

As most of the large corporate clients will increasingly turn to the investment capital markets for their requirements, the appetite for asset-based syndication finance by these larger players will decline. As such, we foresee a decline in the number of large asset-based shipping syndications and a shift to investment banking related transactions.

Smaller asset-based shipfinance will continue to be scrutinised and seen in a relatively negative light by most Banks. The process of consolidation and the relative unattractiveness of shipping's risk / reward characteristics will decrease Bank's appetite for small to medium asset-based finance.

As such, we foresee that such transactions will increasingly need to be priced higher than before and small to medium shipping companies looking for asset-based finance will have to accept such higher costs in order to secure the necessary finance.

More expensive loans for the small?

Although a number of "niche" shipfinance Banks may emerge over the next decade, the vast majority of Banks will have had a shift in interest as part of their overall strategy away from asset-based finance.

As such, traditional asset-based finance customers in Scandinavia and Greece, as well as in Germany under their "tax driven investment schemes" shall be most affected by this trend and will need to agree to higher margins with their Banks.

The process of consolidation in banking is also being mirrored in the World of Shipping. Increasingly over the next decade, shipping mergers shall continue to take place across all areas of shipping with the container and reefer sectors at the forefront and drybulk following.

As competition intensifies for shipping companies and the need to secure and reward capital, as well as, obtain competitively priced finance becomes a key parameter to their overall success, the process of consolidation will gather pace.

In the Greek sector, which has traditionally used asset-based finance, there is already clear evidence of consolidation taking place and we foresee that the number of shipmanagement companies over the next few years may well decline to less than half of those that were identified in 1998.

This process has been intensified by the slump in shipping that has adversely affected values and earnings. Furthermore, as smaller shipping companies tend to own older vessels, the trend away from overaged tonnage is impacting on their ability to acquire or even hold on to such tonnage.

What needs to be done?

In order to meet in the next decade both the challenges of the shipping market and the effects of Bank consolidation and reduced appetite for asset based lending, small shipping companies will need to adapt quickly. They should merge or enter into alliances or association with other small companies so as to generate the necessary size to attract interest from Banks.

In addition, they should:

- *Consider the benefits of developing a corporate structure and open information policy towards both the Banks and the markets, and*

- *Develop their interest and knowledge in the capital markets so as to take advantage of opportunities and products offered by the latter.*

The Banking Industry as well, could cover the void that is being created through the process of consolidation by the development of **"niche" Banks** and **"venture capital" financial institutions**. As such, the rising barriers to entry into shipping, as well as, the obstacles in the path of smaller shipping entities wishing to grow can be addressed.

In conclusion, therefore, the process of international Bank consolidation need not adversely affect overall shiplending capacity or interest by Banks in the shipping industry over the medium to longer term. The shift away from asset-based finance will continue and shall intensify.

The larger shipping companies shall be the least affected by such trend whilst the smaller companies will find it increasingly more difficult to obtain finance. The process towards corporate shipping structures and the U.S. Capital Markets shall also intensify, as the industry shall find long term funding and capital easier to obtain via the capital markets.

The emphasis on **quality and size** of shipping company shall also intensify and substantial consolidation shall also take place within the shipping industry.

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