A year of anxiety and consolidation

Winter 1997

by Ted Petropoulos, MD, Petrofin S.A.

The year ending 1997 has been a challenging one for both shipowners and shiplenders. The main event that overshadowed all others was the collapse of the Far East economies that revealed inherent weaknesses and excesses that had been hidden in the past behind the 'facade' of a high- investment/high-growth performance.

The agility of the economic system of the area, the speed and magnitude of the collapse, the chain reaction and psychological effects felt throughout the world economy, caught everyone by surprise.

Drybulk and container shipping, that had been holding their own during a year of intense newbuilding activity, took fright by year end, and ship values, that had been remarkably resilient throughout the year, began to soften noticeably. All sectors have been affected and the only comfort prop has been the 'wet' sector, where values and earnings have remained strong.

Towards the end of 1997, increased newbuilding activity in the tanker sector has also begun to cast shadows over the sector's ability to maintain this robust performance and many analysts have begun to voice their increasing concerns.

Although shipping has the tendency to 'outfox' all analysts and to bounce back when least expected, bankers are influenced by facts and trends and the whole mood in the shipfinance sector has become very pensive.

The credit qualities of banks' loan portfolios declined in 1997 and together with a number of notable shipping group failures, as well as all the signs of liquidity strain, banks were forced to increasingly concentrate on intensively monitoring their client base and dealing with the numerous restructure requests that arose from market, technical and operational factors.

Competition for the top names continued unabated since new loan production targets had to be met.

However, there was considerably more lending restraint shown by banks during the year and a greater tendency to cooperate in club deals and syndications rather than play the 'owners" " 'game' of pitting one bank against the other.

With asset values and cash flows on the defensive, the propensity by owners to use new buying opportunities in order to refinance upwards their loans with fresh banks largely declined. As such, bank loan portfolios were less volatile and subject to fewer prepayments during the year.

The year witnessed a slowdown in the decline of the fees and margins which remained largely unchanged. The tendency to lend for longer periods that would stretch loans, to well beyond the 20-year 'rule of thumb' upon loan maturity, also abated and most lenders would wish for the 'balloon payment' to kick in by the 22nd or the 23rd year. Multipurpose vessels and container vessels tend to be viewed more leniently by lenders whereas high tensile steel built and/or large vessels are viewed more rigidly.

Covenants dealing with leverage, minimum liquidity and minimum loans interest cover have begun to re-appear in loan structures. In general, bankers have begun to re-appraise some of these 'early warning' covenants which have fallen to wayside as a result of competition.

Most banks have also begun to focus on the implications of ISM/ISO compliance and how this will affect the ability of their collateral vessels to trade. ISM related clauses have been inserted in loan documentations and more importantly the progress of accreditation has been closely monitored by banks.

Combined effects of ISM, port authority inspections, renewed class and P&I inspection vigour and increased selectivity by charterers and insurers alike, have taken their toll on older, sub-standard vessels. Banks have become increasingly more reluctant to finance older and/or substandard vessels.
The direct consequence of the above has been that owners in search of finance for vessels older than 20 years have had a frosty reception by banks. In the absence, therefore, of other supporting

factors such as time charters, owner's substance and liquidity of borrower, excellent special survey positions, specialised nature of vessel etc, the number of banks prepared to lend to owners supported solely by overage tonnage has declined considerably.

As a result of the lack of finance for overage vessels, their values and 'saleability' have declined, thus exacerbating the problem. The flight to quality which has been self-evident over the last year has been further supported by a flight to size. As most shipping professionals know, economies of scale play an increasing role in shipping and this has been adopted as an additional yardstick by banks seeking to further protect their lending portfolios and, as such, concentrate on the top thirty large names.

The traditional two-tier finance market has been replaced by a ‘one and a half’ tier market whereby unless an owner is in the selected list, finance on previously flexible and inexpensive terms has become harder. It is a relative rather than an absolute observation.

The year has been marked by a great deal of activity primarily in the US capital markets where shipping has become 'flavour of the month'.

In terms of the total size of US investment funds and activity, the combined shipping totals fail to make an impression. However, following a long period of inactivity, public issues, IPOs and high yield debt issues have not only caught on but also brought back the smile to both the shipping services industry and the faces of some major shipowners.

It is difficult to predict how long this 'window of opportunity' shall remain open since investor sentiment is notoriously fickle. For the more conservative public company oriented owners, the process is a long and gradual one where long-term success is based on long-term performance. For the more aggressive high yield debt issuers the window may be a short-lived one, as shipping fundamentals may undermine this market and especially should US interest rates begin to rise and there is a flight to quality by the US investment community.

There is a great deal of criticism expressed by the banking community over high yield debt aimed at financing newbuilding. This debt is essentially expensive, and difficult to support by a cyclical industry such as shipping. However, it is long term and often without a sinking fund, both characteristics which improve the cash flow rather than the probability of the ventures themselves.

In the last analysis, the money can be described as 'OPMs' (other people's money) with all the associated reactions that this term generates. The respect with which such monies are treated in the long run will determine the use of this source of funding for shipping.

Shipping banks are generally hostile to this development since it takes away some of their largest customers and reduces loan volume. Other banks have moved in with the times and have begun to offer 'advisory' services to their large clients.

Turning to our specific report of shipping banks for 1997, readers are probably aware that the analysis into the number, nationality and role of banks involved in international shiplending has been published by Petrofin since 1992 and has been widely quoted and relied upon by banks and analysts alike in the shipping sector.

Major role banks in Europe and North America have stayed largely the same although the numbers for the Far East area have fallen. The main reason has been the declining interest in the shipping sector by Japanese banks who are facing numerous areas of concern at this point of time.

In the minor/local role category, although the overall number has stayed normally the same, there is a clearly discernible loss of interest by UK and French banks whereas the number of other European and Far Eastern banks has grown. It is fair to say that the recent financial turmoil in the Far East may well have dented the appetite of Far Eastern banks for shipping at this point of time and as such, the number may well have been reduced at this specific moment of rime.

The importance of European banks in general, remains very high, although the research shows that their overall contribution has fallen from 65.5% in 1995, to 62.7% in 1996 and 61.6% last year. It should be noted there has been an increased role played by Greek, both state-owned and private banks, in Greek shipping and that ship finance has begun to be of significant interest to all Greek banks.

Room at the top for major lenders is becoming harder to reach and more difficult to maintain in today's competitive environment. The relative growth of the major bank numbers has been much slower that that of the minor banks.

Interest by North American banks remains steady. However, shipping has thus far failed to attract the interest of the majority of US banks who still regard ship lending by a specialist, risky and capital hungry sector.

Petrofin believe the slowdown will continue over the next year but that the longer term trend of increased shiplending activity is still intact. In the absence of any major and sustained slowdown in shipping over the next decade, the number of major ship lending banks is expected to have grown in 10 years time to over 75 banks and the number of smaller banks to over 250, i.e. a total in excess of 325 banks. This should not unduly worry the major industry lenders since the growth will arise mainly in the smaller bank sector which will add significant and much needed capacity to the shipping market.

The needs of the shipping industry for replacement tonnage are enormous and lending demand shall continue to be strong. As the economic and regulatory pressures force out smaller shipping companies and overage vessels, the size, composition and numbers of international shipping groups will grow and this will allow the major banks to find room for growth even though a slice of their market shall be taken by investment banking products.

Most major banks have been increasingly focusing on non-lending products and services to enhance their yields. As shipping becomes increasingly a 'corporate' lending area involving larger and more sophisticated shipping groups, ship lending shall shift from being an area of mere asset play and shall evolve into a comprehensive range of inter-connected specialised services which together form a comprehensive service to clients by shipping orientated banks.

Specifically, Petrofin believe that over the next few years US banks will become increasingly more focused in shipping both in the investment, as well as, commercial fields and that' the presence of US banks will become increasingly felt in the shipping community.

Challenges and opportunities for banks in the shipping industry have never been wider and do offer room for growth for all banks. Banks that have developed the right and focused strategies in a timely and innovative manner, have built up experienced and sufficient well motivated shipping teams and devote financial and management resources to the industry, shall reap the benefits and the opportunities that are offered by shipping over the next decade, since the long term fundamentals for the shipping industry remain strong.

From NAFTILIAKI,
Winter 1997