Year of severe difficulties

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SHIP FINANCE OVERVIEW

Nineteen-ninety-eight was a year of quiet desperation for lenders who saw the steady erosion of quality of their loan portfolios and their clients struggling with inadequate cash flows. Ted Petropoulos, Managing Director, Petrofin S.A., reviews both the international and Greek shipfinance scenes and comments on their main trends and prospects.

Most lenders saw the back of 1997 and the developing Far East crisis, in the expectation 1998 would witness the bottoming out of the shipping markets and the beginning of a modest market recovery, especially for the hard-pressed dry cargo sector.

Instead, as the year progressed, all shipping sectors nose-dived as investor confidence in the international economy collapsed, threatening a financial meltdown and worldwide recession. Indeed, for a few weeks in September / October of this year, banks and clients "held their breath" as they watched stock markets, hedge funds and international economies collapse and banks desperately "pulling the reins", announcing write-offs and redundancies, in an effort to stem their losses and adjust to the threatening international crisis. Shipping was thus hit once again and any prospects of a swift recovery were dashed.

However, as the year comes to an end, international financial stability seems to be returning, helped by the lowering of US interest rates, and the shipping markets seem to be stabilizing, although at very depressed levels.

Looking over the main events for shipping in 1998, we single out the following:

- *The deepening Far East crisis, intensifying structural and banking crisis in Japan, economic slowdown in China, collapse of Indonesian, financial instability of the whole region, slowdown in economic activity and international trade and especially imports into the region.*
- *The sudden collapse of Russia, near collapses of Brazil and the South American region and "flight to quality" among both investors and banks.*
- *After a very active period in the first half of the year, the shipping-related junk bond market paralysed as institutional money moved out of risky investments in high yield debt instruments and hedge funds.*
- *Worldwide patterns of trade changed, as previously 'strong legs' became 'weak legs'. In particular, the Atlantic region and cargoes to the Far East became weaker whilst outgoing rates from the Far East firmed, the latter due to an increase in long haul exports by the Far east ex-tiger economies, aided by their considerably lower currencies.*
- *Scrap prices fell and fell and approached $100/ldt at which levels the Chinese shipbreakers, in lethargy for over a decade, re-awakened and began to take in tonnage. Overall, scrapping volumes increased in line with the distressed shipping market as well as poor prospects and these volumes would have been even higher had scrapping prices held well.*
- *As the year progressed, vessel lay-ups increased especially for dry cargo and reefer tonnage. These laid-up vessels consist of primarily overage tonnage and are expected not to re-enter trading but to be holding out for higher scrapping prices in due course.*
- *The July 1 ISM deadline did have an effect on shipping as the need for compliance, coupled by the increasingly tighter regulatory environment, forced a great deal of the overage, poor tonnage out of the market via either scrapping or lay-up.*
- *Paradoxically, despite the poor market conditions, newbuilding orders especially for panamaxes, large tankers and container vessels continues to build up as owners were lured by falling newbuilding costs (especially at Korean shipyards) and expectations that the mounting pressure on overage and poor quality tonnage will drive it out of the market. Surprisingly, Greeks played a prominent role in placing newbuilding orders in what seemed to be a change of investment philosophy for them in preferring newbuildings to buying between them.*
- *As the year progressed, the wet sector began to fall and at year end, all shipping sectors were in uniform slump although maintaining sectoral differences between them.*

- *Vessel values continued to fall in reflection of poor vessel earnings and falling newbuilding prices. The falls were particularly prominent for older tonnage whereby 70s-built vessels were essentially valued as scrap. However, the expected rush of Far Eastern-owned modern tonnage being put up for sale at depressed prices has not materialised as owners are so far sticking on their prices and there still seem to be many keen buyers choosing the few modern quality units that are being sold.*
- *Vessel valuations became increasingly more difficult to obtain as the year progressed, not only due to the difficulties of the market and fewer sales being concluded but also due to the prominent law suits against certain valuers which frightened many valuers away or made their remaining colleagues more cautious.*
- *The deepening liquidity crisis in shipping was further exacerbated by a tightening of credit by all suppliers of goods and services who often resorted to ship arrests to press home their demands for payment.*
- *Charterers also took advantage of the market and owners' weak position either by pressing home their advantage and chartering – in at extremely low levels or in delaying payments for one reason or another.*
- *Owners, however, were cushioned to an extent by a strong US dollar, lower interest rates, low insurance costs and record low bunker levels.*

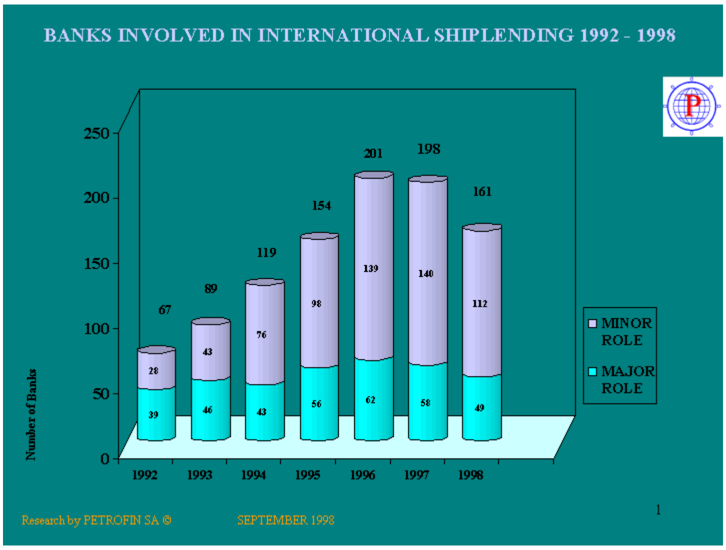
Effects of the above international, financial and shipping factors on shipfinance banks

These were significant. With the exception of newbuilding finance, traditional shipfinance ground to a halt as the year progressed and banks spent most of their time assessing their loan risk and dealing with their weaker credits / clients.

A number of banks, primarily in the Far East left shipfinance. Others disappeared through mergers which have begun to dominate the international banking scene as banks race to join the elite bank of global banks that is destined to dominate banking in the 21st century.

Latest Petrofin research, published this autumn, reveals that the number of shipfinance banks fell in 1998 to 161 banks compared to 198 in 1997 and a peak of 201 in 1996.

Banks involved in international shiplending 1992-1998



As shipping experienced the effects of a 'credit squeeze' and in view of losses sustained in other sectors and banks tightening their lending policies, lending margins hardened. More so, however, financial covenants and other borrowing terms simply declined credits they would have, in previous years, not only accepted but also keenly competed with other banks to secure.

On the whole, shipfinance banks responded responsibly and constructively to the shipping crisis. Restructuring loans became commonplace as banks recognised the need to adjust repayment schedules to reflect the actual cashflows of the vessels in their loan portfolios. Often, banks had little choice but to do so since vessel values to loan ratios had declined considerably and often banks found themselves underwater, especially in loans involving dry cargo vessels.

Not all banks, however, have responded in a uniform manner. First National Bank of Maryland, for example, has hit the headlines on numerous occasions due to its involvement in disputes and vessel arrests involving mainly Greek owners. DnB, too, has also hit the headlines over extensive provisions against its Greek loan portfolio coupled with changes in the bank's senior management. Bank of Scotland has also been featured on occasion due to its involvement in lending against older vessels, which have been the hardest hit during the crisis. Other banks have also been featured on occasion, which is not surprising given the adverse state of the market. Other banks such as RBS, Nedship, Midland, Indosuez, the German banks have adopted a low profile and have taken care of any problems in a low key and discreet manner.

The question, however, does arise of how long can banks continue to restructure debt and allow vessels to become older. Moreover, in most cases, the banks' boards and / or credit committees have been following closely the performance of their respective shipping departments and have often been asking for more effective action.

Shipfinance banks have switched their attention to non credit-related services, advisory services, investment banking, derivatives, personal banking, credit card promotion, cash management, computerised direct operating accounts, foreign exchange and so on, in an effort to boost their fee-related income

In the case of Far East banks, their predicament is that they must consolidate their lending as well as their numbers through mergers and acquisitions. As a result, increasing pressure has been placed on their clients to sell vessels despite low vessel values. Indeed, over the last few weeks, the number of vessels being put up for sale has increased, often accompanied by time charter back offers in an effort to keep vessel sale prices high.

The process of bank consolidation will continue and, as such, it is expected that in the short term, the number of major as well as minor shipfinance banks shall decrease. Furthermore, the current shipping market and the international banking environment are hardly supportive for the return of those banks that have departed in the recent years.

Turning to the Greek market, shipfinance conditions do reflect those of the international market with some notable differences, namely:

- *There has been some retrenchment in the number of non-Greek banks active in the Greek market. Two niche banks, Hambros and Guiness Mahon, have departed the shipfinance scene. Credit Lyonnais having sold its branch presence in Greece, has refocused its shipfinance business out of Paris. Scandinavian banks that have marketed Greece have been notably absent and so too have all the Japanese banks.*
- *Non-Greek banks that remain active in the market (most with a local presence either in the form of a branch network or a representative office) have tended to be rather quiet over the last six months, with the majority of finance involving newbuilding-related credits. Exceptions to this are Nedship, BCV and RBS that remain quite active in the above as well as more traditional forms of finance for their clients.*
- *Main change in the market has taken place by the marked presence and commitment of the Greek banks. Headed by National Bank of Greece and Alpha Bank and closely followed by Eurobank, Greek banks have made substantial progress in this market. By adding loan volume in this depressed market, they have built up an impressive volume and quality clientele. Their strategic timing and commitment have been excellent, aided by the absence of problem loans at this stage of their evolution.*
- *All banks have stepped up their credit monitoring and internal reviews of shipping clients in an effort to stay on top of their loan books and to keep under watch sensitive credits.*

The vast majority of banks have turned a 'blind eye' to loan covenant defaults arising from falling vessel values provided original or restructured loan repayment schedules are being adhered to by their clients and their liquidity positions remain satisfactory. There is, however, considerable anxiety among banks of how long some of their clients can survive should the current market conditions continue for one or more years and how long their head offices or senior management will allow them to keep on restructuring loans.

There remains heightened speculation as to the long term commitment of some banks towards Greek shipping, especially as there as considerable pressures building up to cut out capital-intensive higher risk lending. However, the gap that may arise shall be covered by an increasing number of Greek banks that have discovered shipping (which is a major success story in Greece) and are keen to develop into major players.

In recent weeks, as junk bond prices have collapsed in the wake of credit warnings, there exists considerable speculation that banks shall assist their owners to buy back these bonds at a discount. Although there have been discussions between banks and owners n this direction, there are limited possibilities fo such deals since junk bond investors are no fools. However, should the credit markets go into a serious and prolonged recession and the flight to quality were to continue, then the chances of buyback arrangements shall be much greater.

The recent stock markets recovery and continuously good news from the US have tended to restore confidence in the financial markets that the worse may be over and that even if the world's economic growth slackens, we will see a 'soft landing'.

In 1977, world GDP grew by 3% and international trade by 9.6% according to the IMF and the German economic advisory council, whereas corresponding figures for 1998 are 2% and 3.5% respectively. IMF forecasts for 1999 are for a 2.5% growth in GDP and 4% growth in international trade. These are reduced growth figures but hardly represent a disaster scenario.

As the year turns to a close, the consensus of opinion is that following a poor but not substantially worse 1999 for all sectors, a mild recovery is expected from 2000 onwards. As long as the newbuildings' spree does not continue at the same pace, market equilibrium is expected by 2000/2001.

In the dry sector, supported by record low oil prices and falling interest rates, the shipping industry can look forward to the current slump being seen as no more than another cyclical low and not a structural problem. Readers should bear in mind that unlike the 1980s, owners are substantially more liquid than before and keen to acquire quality modern tonnage. This can be evidenced by the number of inspections that take place for any modern vessel that is placed in the market.

Although it is true that values are not as buyers would wish, Greek shipping does have the liquidity and underlying strength to make its presence felt when the risk/reward characteristic shall change and buyers decide that the time has come to buy again.

So that no one can say that we do not stick our neck out, our own ***Petrofin Research*** suggests that for dry cargo vessels, 1999 will be an excellent year for investment in good specification modern tonnage. Hopefully, the banks shall also be there to support the next phase of development and modernisation for the Greek fleet. If past experience is a guide to the future, then banks will once again more than rise to the challenge.

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