Shipfinance: at the crossroads

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The shipfinance industry has come a long way from the bleak days of the mid 80's when shipfinance was considered to be almost synonymous with reckless lending and huge losses.

The sustained economic growth conditions that have prevailed over the last decade, have provided a solid platform of growth for international trade across all sectors. Srong demand has proven to be the main source of comfort and confidence to owners and lenders alike. Furthermore, the outlook for international trade over the next years appears, if anything, to be more positive than had been anticipated in the past. Almost all major economies across the world are expected to show increased economic growth, lower inflation and enhanced financial stability.

Shipowning returns on investment have been positive over the last decade and this has not only provided the necessary financial strength and incentive for owners to expand but has also provided the necessary conditions for a return of confidence to the industry by banks.

International, as well as local banks, therefore, seeing the shipping industry's robustness and enhanced outlook, drawing comfort from the sustained growth and good prospects of international trade, finding shiplending yields attractive and having an enormous capacity and appetite to lend, have all flocked back to shiplending. This is why the number of shiplending banks has grown from 67 in 1992 to 201 in 1996 (PETROFIN research, OUTLOOK DEC. '96).

At this point, we must make an important observation; namely, that the unusual or noteworthy aspect of shiplending is not the (high) number of shiplending banks at present, but how few these were in the past and how few they still are in comparison to other capital intensive sectors. Bearing in mind the importance of shipping as the largest mode of cargo transportation, it is remarkable that in a world consisting of tens of thousands of banks, only so few are involved in shiplending. Please disregard the well published protests by shiplenders alleging that there are too many banks as rather crude examples of a wish to preserve their own banks' interests and shiplending returns.

The answer to the still relatively small number of shiplending banks lies primarily in two factors:

- *the volatility / risk perception of the industry, and*
- *the need to invert in specialised personnel and develop the necessary «lending know-how» to handle the complex requirements of a shiplending portfolio.*

It follows therefore, that should the above factors be addressed, then shiplending should become a more «normal» activity for banks, the number of banks engaged in shiplending would increase exponentially and shiplending would lose some of its «exotic» nature. Under the above circumstances, it would be newsworthy if banks would not be involved in shiplending just like it would be newsworthy if banks were not engaged in property lending or foreign exchange or consumer lending. Please note that the above is not a forecast but merely a reasoned argument of how shiplending might evolve if its special factors are addressed and its risk / rewards begin to approach those of other forms of mainstream lending.

Let us now examine in detail if the above two factors, namely «risk» and «know how» shall be successfully tackled in shipping, the answer to which will provide to us a clearer vision of the future.

In order to overcome the volatility / risk perception of the industry, shipping must be able to clearly demonstrate a long and sustained period of sound economic performance over a longer period than has been seen thus far in the aftermath of the deep shipping recession of the 80's. Alternatively, shipping banks must be able to show that despite the industry's volatility, their loan losses were in line with those of other industries. It would be preferable if this resiliency to loan losses would be demonstrated during periods of adversity rather than only during periods of prosperity.

Here lies the crux of the matter; will the banks and/or the shipping industry find a way to keep volatility and losses down to acceptable levels so that the shipping industry can «come of age» and join the ranks of all other types of lending? Furthermore, will it attract healthy long term funding in the form of both loans and equity and will it attract the support of institutional and long term investors?

The title of this article is focusing on entirely these questions. The shipping industry is truly at a crossroads, not just as part of its short term expected performance which is of limited value from the long term perspective point of view but more significantly in terms of its ability and long term outlook to break out of its «exotic» and «high risk» perceived nature which has (deservedly) plagued the industry over the last 50 years.

The answer to the above questions lie for the most part on the supply side of the industry. In order to illustrate the point, reordering of VLCCs in the early 70's and bulk carriers in the early 80's have played a large part in explaining the ensuing shipping recessions, also assisted by weak demand at that time.

Turning our gaze to today's conditions, we can note the following observations affecting the supply side:

- *Overordering in the handymax/Panamax sectors certainly played its part in bringing about an abrupt reversal in the dry bulk market in 1996/97, despite continuous growth in demand.*
- *The gaze of investors has shifted over the last year to the tanker side, supported by positive forecasts for the sector as a result of which orders of Aframax and Suezmax vessels have accelerated and the overordering danger is now a clear one.*
- *Although container demand has been growing at extremely healthy rates, overordering in this sector (the current overbook stands at 35% of the total) has severely affected the container market and its prospects over the next few years appear very poor indeed.*

There are counter arguments made by those supporting the current order books, for tankers and bulkers, namely:

- *The advanced age of the world fleet.*
- *Stricter standards forcing out older/obsolete/poor condition tonnage i.e. restrictions by class, port inspections, salvage, ISM etc.*
- *Greater inefficiency of vessel operations i.e. congestion's, delays inspections, arrests etc.*
- *Higher costs and difficulties in operating, insuring and financing older tonnage.*

Bearing in mind the above, should the flow of new orders slow down then the outlook for the tanker and dry bulk sector may improve given the robust demand conditions. However should orders continue to flow, then the industry will once again have «shot itself in the foot» and created surplus supply conditions that will undermine values, freight rates and of course returns on investment.

The above mitigating factors that prevail for tankers and bulkers do not exist for containers where the average age of the fleet is younger and the overordering will require a positive explosion in economic growth and containerisation that is clearly not-feasible. The ease of ordering and financing via K S structures has seriously undermined the container industry and a serious oversupply situation is upon us.

A weak container market will also adversely affect the multi-purpose trades and of course the performance of container bulker with further weakening effects on the dry bulk side upto the handy max sizes.

It would seem, therefore, that oversupply will adversely affect some shipping sectors despite healthy demand conditions.

The main question, however, is the following: does the shipping industry in general and the afflicted sectors in particular have the necessary liquidity and bank support to withstand the anticipated difficulties?

Shipping banks have thus far responded sagely to the reversal in the dry bulk side by granting restructures where needed to worthy but hard pressed clients. It is too early to observe the reaction of banks (mainly German) lending to the hard pressed container sector. However, should dry bulk rates continue to remain depressed, how long will banks continue to provide their support?

With vessel values still at levels higher than those justified by weak net cash flows, will the temptation to sell assets be one that would be too hard to resist?

Thus far the major shipping failures of the past (ADRIATIC, UNIMAR, BLUE FLAG, SILVER CARRIERS) over the past 18 months have not been directly linked to the market but to other factors such as over expansion and shareholder related problems. As such, any bank losses arising out of these situations can be attributed more to poor lending decisions, linked to poor client selection rather than to the change of direction of the market.

Clearly, if the shipping industry can overcome a temporary slowdown or recession without major losses for banks, as has been the case upto now, then the industry will have demonstrated its ability to effectively deal with adversity and the banks will have learned how to cope with shipping recessions without incurring substantial losses. Alternatively, should banks' patience waiver and panic set in, then we will all observe a repeat of previous crises.

The fundamental difference this time around lies in the much better «know how» that exists among shipping banks. The qualitative difference comes mainly from the following factors:

1. Quicker and better market information.
2. Enhanced market forecasting techniques and services available to banks.
3. Quicker, more accurate and better quality shipping client information provided to banks.
4. Highly educated, inter-active and specially trained shipping bank management.
5. Greater appreciation of the effects of shipping cycles to banks' shipping clients and the need to provide comfort and/or support where necessary, and
6. A wish to avoid errors of the past whereby banks sold vessels at the bottom of the shipping cycles.

The above list is not exhaustive but is illustrative of progress made in the «know how» part of our analysis.

In concluding, the main focus of this article is in pinpointing the fact that the shipfinance industry is at the crossroads with two possible future scenarios unfolding: the first scenario, one of a self-regulated shipping industry that displays regular but shallow cycles, linked to the prevailing demand and supply conditions, where owners would enjoy varying but positive long term returns to investment, where banks would remain largely protected in their loan exposures and can enjoy lower but more secure loan portfolio yields and where international and long term investors would be attracted to steadier returns of shipping and the second scenario where the shipping industry would demonstrate once again its deep cyclicality and inability to offer long term sustained positive returns on investments, shipping banks make huge losses and once again withdraw from the industry and long term capital is discouraged from considering the shipping industry as a stable long term investment.

The reader can form his own opinion and watch markets unfold over time and the reaction of shipping companies and banks.

Our own views are that as long as the demand side of the market remains intact, (container sector excluded) shipping cycles will remain abrupt but relatively shallow and the first scenario outlined above shall eventually prevail.

A DECADE OF CONTRIBUTION

PETROFIN S.A., the leading Greek based shipping finance consultants, are enjoying this year their 10th anniversary. PETROFIN's team provides financial consultancy services to owners and banks and has built up a most impressive and excellent professional reputation in this field and an enviable track record. Mr. Ted Petropoulos, Managing Director of PETROFIN S.A., has also made a significant contribution to shipping via numerous published articles and industry analyses over the last decade and has added to the knowledge of shipfinance via the worldwide published and quoted «PETROFIN RESEARCH» statistics on the number, size and nationality of shipfinancing banks. On our behalf we offer our congratulations to PETROFIN for its 10th anniversary and look forward to its continuous contribution over the next decade and beyond.

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