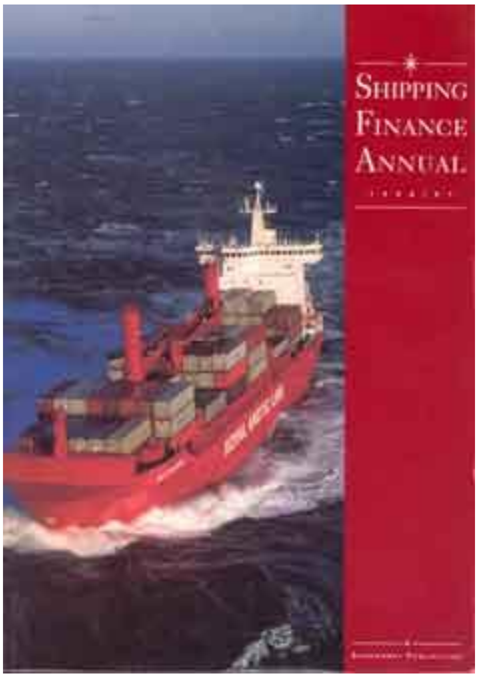
Shipfinance trends in International Shipping

1996/1997 - AN OVERVIEW



by Ted Petropoulos

For over 8 years, 1987-1995, International Shipping displayed a remarkable recovery and sustained growth. Supported by a robust OECD economic growth performance and a sound outlook, shipping, across almost all sectors, enjoyed a significant raise in earnings, values and newbuilding orders.

The confidence of owners was equally shared by banks that competed strongly among themselves to meet aggressive budgets. As such, for quality owners, shipfinance became an "owner's market" with many banks prepared to match and improve upon their bank's offers.

Research by PETROFIN, recently published, shows that the number of banks involved in international shiplending rose in 1995 to 154 as compared with 119 in 1994 and only 67 in 1992 when the research first commenced. Whilst the number is still smaller than the over 200 banks active in 1970's it is clear evidence of the increased interest in international shipfinance.

During the period, the "market norm" percentage of finance for quality names did rise from approximately 60% to 70% (on higher values) which represents an erosion of credit quality, especially since loan cash flows were based on higher anticipated earnings over longer periods.

In line with the weakening of credit terms and in order to be able to amortise high loan to value transactions, the average loan repayment period of loans did increase and most banks shifted the maximum age of vessels at the end of their loans from 15 years to 20/22 years, especially for dry cargo vessels up to handysize, general cargo vessels and container vessels.

The latter relaxation, however, was only provided

- *for owners with a demonstrable record of operating efficiently older vessels,*
- *where collateral vessels were of excellent qualify (despite their years) and*
- *where vessels enjoyed an attractive specification and special survey position.*

Increasingly over the years, as values rose, owners switched their purchases to older vessels with banks following suit. This owners did in their search for acquisition offering more attractive risk/reward characteristics and adequate anticipated cash flow.

Focusing on yields over the period, these fell substantially in the face of keen bank competition from yields of over 200 basis points for quality names to yields of between 100-150 basis points at present, representing a significant erosion of income to banks.

Many banks sought to offset the decline in yields by financing older vessels, offering higher percentages of finance and longer finance periods, foregoing personal guarantees and so on. Others focused on providing a variety of ancillary services and/or financial products such as derivatives. Some offered "hunting licenses" to their best clients against modest fees so that they could bid "outright" for their ship purchases.

As a general remark though, the traditional lenders refrained from aggressive lending especially in 1995, thus allowing new bank entrants to obtain market share but on terms which they may well regret. Instead, traditional lenders became very selective of clients, vessel type and condition and sought to offset higher percentages of lending either by requesting secured employment or structuring front-loaded repayment schedules of the provision of minimum cash balances.

A change of picture

The outlook and confidence of banks and owners changed dramatically over the last nine months (Autumn 1995 onwards) as the BIFFEX index begun a sharp fall which admittedly caught most bankers and owners by surprise. Suddenly, everyone "held their breath" to see which may the market would go.

Ship purchasers became very wary and held back awaiting better opportunities, sellers became more accommodating, valuers marked down vessel values, even though this was based initially more on market sentiment rather than on actual sales, and charterers held back cargoes hoping for lower fixtures.

The negative mood intensified in the first months of 1996 as the market continued to slide, especially for large dry cargo vessels. Values truly begun to fall across all sectors, even though most sectors reacted in sympathy to the fall in the large dry cargo segment rather because of a fundamental change in their own segment demand and supply positions.

As such, shiplenders (especially their credit departments) had become wary of new credits and have tightened on their offered terms. The excessive competition among banks abated somewhat in the first months of 1996 due to the poorer market sentiment on the one hand and a comfortable position among banks who had met their budgets for 1995 and were under less pressure at present. The bearish sentiment has not been helped by the Adriatic saga and other problems such as Lykes, Regency Cruises etc. which reminded banks of bygone years.

The recent stabilization of market rates has provided an opportunity for owners and banks alike to reposition themselves and carry out new refinancings or refinancings in anticipation of what the market will bring in the second half of 1996.

We feel that international shipping is presently at a crossroads. Even though many analysts claim that the industry's fundamentals have not changed significantly, everyone is talking openly of a recession. This may well be premature because some market segments such as tankers and container vessels are showing robustness but undoubtedly the consensus is for lower freights and lower values.

Unlike the long and deep recession of the 1980's, the world's economic growth outlook remains positive with most analysts forecasting a rise in international trade volume for 1996/7 in excess of 3%-4%.

U.S. dollar interest rates are still on near record low levels and the dollar remains under valued. The "weather" related seasonal problems in North America and parts of Europe experienced in early 1996 have abated and having driven rates lower, charterers need to fix tonnage, in order not to be caught "on the hop".

The supply side of the picture is less supportive. Whereas the combo, reefer and tanker orderbooks showed the newbuilding orderbook standing at 2.9%, 3.2% and 7.4% of the total respectively (Clarksons), for bulk carriers the total is 15.5% and for capesizes in particular the figure rises to 20%. The position is even more worrying for containers where the overall figure is 33.8% and a staggering 56.2% for container vessels of 3,000 TEU capacity and above.

Thus, its mainly the supply side that is causing concern and the change of sentiment. Despite this, the rate of newbuilding orders has not slowed down whilst the newbuilding price index has fallen over the last four years. Banks are visibly showing their discomfort at financing newbuilding orders especially in the dry bulk sector but somewhat newbuilding financing is still being provided to enable the rate of newbuilding orders to continue.

Many analysts believe that the decline in the market shall continue and shall indeed stabilize at the 1,200 to 1,300 level range. If this should happen in the second half of 1996, then international shipping will begin to suffer in earnest.

At such levels, net operating margins shall be at a fraction of those of the last years since vessel operating costs have also risen substantially. As such, not only have crew costs and insurance costs risen substantially over the last few years but repairs and maintenance cost have exceeded all expectations.

The combined effects of stringent classification, flag, insurance and bank requirements on vessels' condition, have pushed up vessel operating expenses substantially and the costs of special survey, drydocking and condition surveys dramatically.

The outlook for international shiplending

The abrupt change of sentiment has already affected all banks' attitude towards shiplending. Whereas it is early to talk of banks leaving the industry, it is fair to say that all banks are presently reviewing thoroughly their credit portfolios and are conducting sensitivity analyses on all their credits.

In a market with reduced Sale and Purchase activity, new shiplending opportunities have been reduced. Lending to new clients has been dramatically curtailed unless involving "prime" names.

Already, most international banks have reduced their percentage of finance from an average of 70% to 65% and increased their resiliency to lower loan spreads and fees. At the same time, banks have been increasingly focused on their clients' liquidity reserves, vessel maintenance and survey positions and in bringing the clients' files up-to-date. Although, no bank has stopped fresh lending especially to established clients, it is fair to say that all new credits are being thoroughly researched and decisions, are both slower and involve harsher conditions.

Owners too are quietly reviewing their positions and adjusting their strategies and there has been some "flight to quality" in their own bank selection where they can reduce their exposure to inexperienced lending banks and in an effort to reduce their loan repayment obligations especially over the next two years.

The industry's ability to attract capital via the International Stock markets, private placements and/or investment institutions has also been affected. The industry has had a poor record in this area anyway and as such most fresh equity has been raised privately rather than publicly. Nevertheless, awaiting the market's next move, the plans for new floatation's and issues have been temporarily shelved.

Should the market's decline turn into a prolonged recession, it is inevitable that international shiplending banks will face problem loan situations. Already most are prepared for this and have identified clients or loans which have been put into the "watchlist".

Lenders are committed not to repeat the mistakes of the 1980's and to tackle problem loans with coolness and self-control. Smooth recoveries via "controlled" sale of vessels will be the name of the game, in loan recovery, especially since there is such a plethora of liquid clients with the financial strength and appetite to "sweep up" such vessels at attractive prices and finance terms. Banks have also turned their attention to the quality of their collateral assets by stepping up vessel inspections.

Another hey area of interest is the extent of "market" credit enjoyed by owners e.g. bunkers, lubs and paints, general creditors, etc. An undue reliance or exposure to market credit by owners may indeed lead them to cash flow problems, since unsecured credit is the first to be cut at times of recession, thereby shifting the burden via the owners to the banks for additional support.

As the market continues to slide or as long as it remains in a "bearish" mode, banks will increasingly tighten their control on existing clients and their terms for new business. Many bankers believe that this has been long overdue, since the industry had overheated, and a mild recession would restore shiplending terms and conditions to much more acceptable (to banks) levels as well as cleanse the industry from recent aggressive lenders, who may well lack the ability to last the course.

From SHIPPING FINANCE ANNUAL - EUROMONEY, 1996/1997