Dedication may pay off

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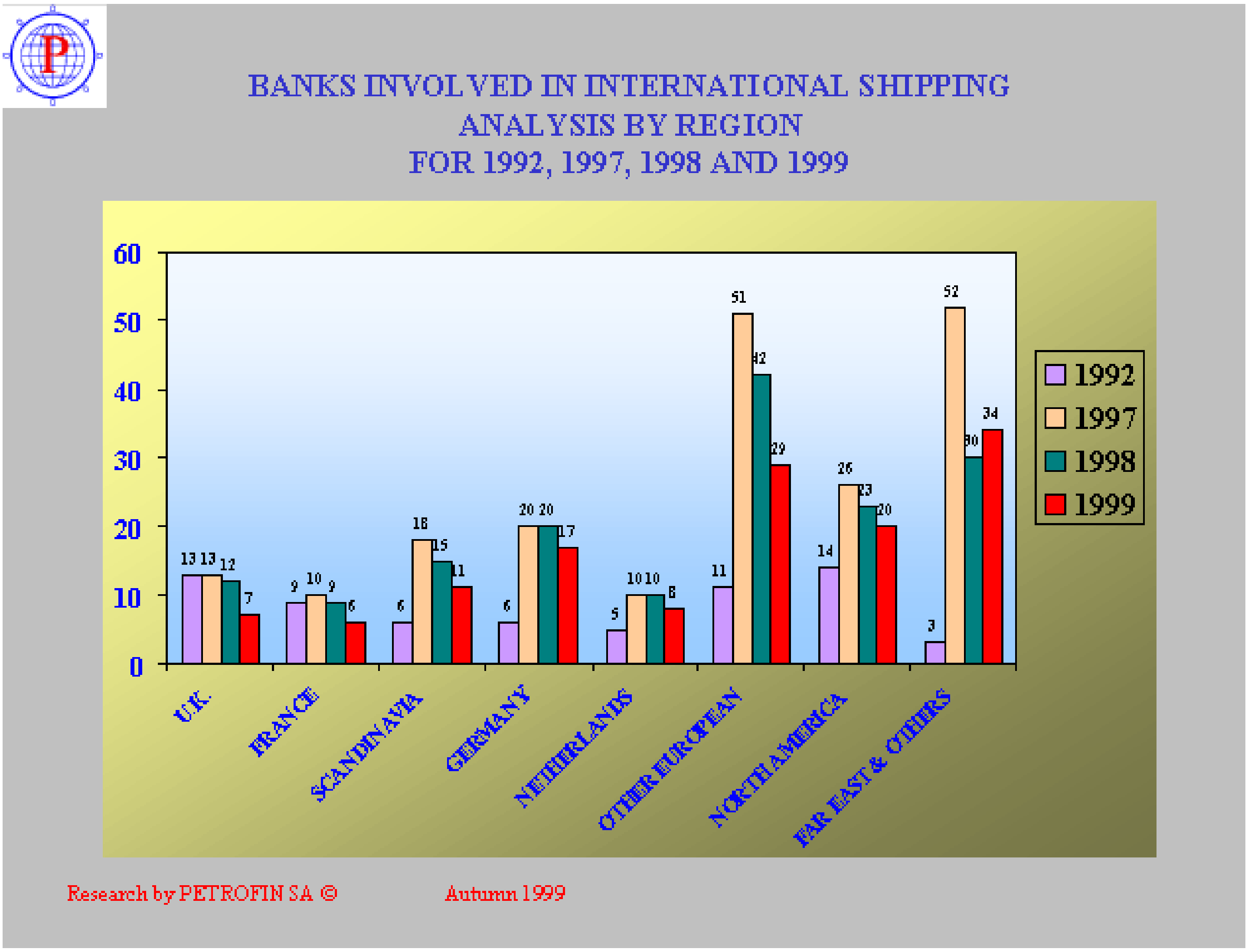
The general belief that the shipping cycle has reached its lowest pint has prompted a significant amount of optimism at banks with dedicated shipping departments

London has traditionally been the capital of the shipping industry, with many owners choosing to locate their operations there in order to be in the proximity of the Baltic Exchange, large and competitive brokerage networks and the comprehensive range of mortgage and so-called "relationship" banks located there.

Only a small number of national UK banks have shipping interests (Midland, Bank of Scotland and Royal Bank of Scotland) and it is the international players which have carved up the shipping mortgage market between them.

European banks active in the shipping business as a whole have declined with the fall skewed towards French and British lenders, while the Germans and Dutch have remained strong players in the sector. Recent research by **Petrofin** shows that the total number of European banks has fallen from 32 major banks in 1998 to 26 this year and from 76 minor banks to 44.

Banks involved in international shipping - Analysis by region



This decline, to some extent, marks the exit of the "fair weather" banks which stampede into the shipping industry when the market is near the top of cycle, tempted by the high loan margins they perceive. They normally withdraw with their fingers burnt, leaving the industry in the hands of a few long-term players which fully understand the volatility and cyclical nature of the industry.

The banking community believes much of the "fair weather" withdrawal has now taken place. **Petrofin managing director Ted Petropoulos's research**, however, did show a serious decline in the number of northern European and Scandinavian banks lending to the shipping business as loans were being usurped by national banks seeking to get into the industry.

Despite the decline in the amount of shipping activity being performed at the southest Asian banks at the moment, he believes that the long-term structure of the ship mortgage business is changing as the national banks take more of an interest in the local shipping community and pull business away from international centers such as London.

Citibank optimises the "relationship" bank insisting that it lends money not against the asset as collateral security, but on the overall strength of a company's balance sheet. The structure of the transactions depends on the view the bank takes of the company's overall financial strength and this means that if the client is sufficiently rated by the bank it may lead without any security in the asset but with a set of financial covenants on the company's overall business.

Citibank, with its focus on blue-chip clientele, is inherently conservative and boasts that it has never repossessed a vessel. However, this conservatism means that it does not generate the returns a less risk averse bank can. Those accepting the biggest risks and taking the greatest exposure to the industry's volatility are the aforementioned "fair weather" banks.

No more fair weather

Lesley Jones, head of northern European ship finance at Citibank said: "I am not aware of any these banks in the market now, but I do anticipate that certain portfolios may be adjusted for return reasons as much as for credit. This does not mean the automatic firesale of portfolios as there are other techniques, such as credit derivatives, that banks can employ for managing their balance sheet exposures.

"Citibank has had a very active year, but most of the activity has been in the structured finance or equity capital markets arena, not in the syndicated loan markets. We have been focusing more actively on balance sheet and tax management."

Another London banker spoke with less confidence in the ability of banks involving themselves in the industry without expertise: "There will always be banks who find returns available on shipping deals more attractive than in other sectors and who are prepared to lend on shipping deals without fully understanding the risks or the speed at which values and earnings can change."

He reported that there were banks in the market which were looking to exit the industry and that this offered good opportunities for those committed to ship lending.

Banks, without dedicated shipping departments and expertise in the business, show little tolerance to owners and can often become the reason behind the downfall of that company, although the cash flow shortage was never going to be irrevocable.

Bankers in the know will tell you that they assume, during a typical eight-year loan tenure, that the industry will pass through at least one cycle during this time. They know that recovery will come, even though no one can pinpoint exactly when. If the transactions have been structured correctly, the borrower should have been left with sufficient cash balances and a long enough period for the amortisation of principal to weather the storm.

The principal catalyst behind a loan entering difficulty is when a bank has lent money to a small company, with vessels financed against a first priority mortgage with the right to call for a cash sum. When the value of the vessel begins to fall, the bank will exercise the "top up" clause asking the owner to insert additional equity he does not have.

The banker, having little expertise, panics and decides he cannot watch the asset values tumble further and so will take the decision to repossess. Credit committees are often accused of being overly clinical in decisions to call for asset repossession, despite the fact if the bank sat it out for the upturn it could recover all its money in full.

The level of repossessions and loan work-outs remain high in London, although only a small number ever surface to embarrass the banker. DnB suffered a range of high profile losses, particularly to Greek clients, while Bank of Scotland has also had a series of high profile loan defaults and repossessions as a result of the aggressive way it entered the market.

Security enforcement and restructuring is good business and several banks have established "work out" departments, where they claim they offer services to that rare bird, the bank with a problem loan.

Bankers, at the end of the day, are just that and will often employ shipping specialists to assist companies such as Tufton Oceanic or Fairwind with an asset repossession or difficult restructuring.

In terms of the amount of deals being done, 1999 has been a far quieter year in the debt market for Citibank. Ms. Jones explained the reasons behind the lower level of activity in the "plain vanilla" loan market.

"This has much to do with the state of the bank market as with the depressed shipping markets. During 1998 we saw a significant increase in interest margins to all borrowers, regardless of quality. There is little incentive in these circumstances to go out and refinance one's debt at higher margins," she said.

Conversely, others in the market claim that 1999 has proved busier. "Activity has picked up in the last 12 months," another London-based "relationship" banker reported. "This has been driven by the ordering of new ships as a result of low newbuilding prices and perceived improved prospects in the dry bulk market. We prefer to write new business at low points in the cycle when values are low."

Counter-cyclical loans

Not all banks will do counter-cyclical lending, although the ones that are willing to do so report that it is hard to get deals done for older tonnage and that loan terms have tightened. London has typically been changed resistant when new financial techniques and products are developed. However, one new ship mortgage indemnity can make a riskier counter-cyclical loan more palatable.

In terms of the type of tonnage the banks are looking to finance there has been a marked shift away from older second hand tonnage after a number of banks, most noticeably DnB, found itself caught out by the massive drop in dry bulk values. As the vessels financed were old, they would have been out of their trading lives by the time of the upturn in the market, so repossessions became necessary.

It is now very difficult to get financing for this type of tonnage in London. However, while banks prefer a modern fleet, a fleet with a broad mix of ages will be considered acceptable, though there may be some restrictions on the age of the individual vessels in the security documentation, such that if a single ship exceeds the age threshold during the loan's life, the loan has to be paid pro rata or additional collateral security provided to the bank.

What has also proven significant in the current climate is that the pressure on shipping departments to pump money into the high margin industry has dropped somewhat as losses in the Far East, investment portfolios and general economic uncertainty have taken their toll on credit committees.

"Banks are becoming increasingly picky about the deals they are prepared to go in to and there is no question that they are now very focused on a more equitable return for the risk that is obviously there," Ms. Jones pointed out.

Despite the number of banks active in the market tailing off in the last year, most bankers claim that there is not a dearth of lending capacity at the moment for good projects modern tonnage for quality owners. The syndicated market, however, has shrunk, some bankers reported to LSE.

Low point

The general consensus among the banks is that the shipping cycle has reached, or will soon reach, its low point and there is a significant amount of optimism in the market because of this. One banker commented that despite the turn in the dry bulk sector the banks were not out of the woods yet.

He said: “The improved trading conditions for dry bulk ships and the increase in values will ease the situation for banks which have over lent in the period 1995-1997, but there could continue to be problems in other sectors where the prospects are not quite so favourable. There have been less defaults than one may have expected, bearing in mind the severity of market conditions in most sectors.”

Although the “fair weather” banks have, more or less entirely, pulled out of the shipping market dogged by problem loans, the spreads on “quality” loans to blue-chip clients remain thin. “We have seen so-called relationship banks walks away form deals purely and simply because they feel the transaction is thinly priced and they feel there is little earnings upside in the short to medium term,” Ms. Jones commented. “Borrowers are beginning to get the message that a relationship is a two-way street and their relationship banks have shareholders too.’

A two-tier market has emerged, with large corporate clients or privately owned companies with substantial balance sheets and record of business having a distinct advantage in the market over the “one-ship operators”.

One of the principal reasons behind this trend is that these clients will require a more comprehensive range of business including “add on” fee-driven opportunities, shush as treasury management, foreign exchange, derivatives etc., which can lift the overall spread on the loan for the bank and compensate for thin margins.

In addition the provision of these services does not affect the balance sheet of the bank. In addition it is likely that the company will return for financing for additional vessels. If no additional products can be sold to the owner, it is often the case that the bank will reject the deal as the spreads on the loan may be too thin to adequately compensate the bank’s risk.

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