Challenges and opportunities for ship finance

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The shipping industry is a capital incentive one and is expected to become even more so, based on our subsequent analysis.

Traditionally, shipping has been financed mainly by commercial banks. Additional capital has been provided by capital raised in the public markets, initially the US and then on a global basis. Over the last 15 years, we have observed a gradual decline in traditional bank financing, as a share of the industry's total ship financing requirements, to approx. $400 billion, which accounts for approx. 60% of the total (Graph). The departure of many committed European banks was primarily responsible for such decline, mainly following the 2008 Lehman's financial crisis and the since increasingly stringent minimum capital ratios requirements of central banks and the Basel accords.

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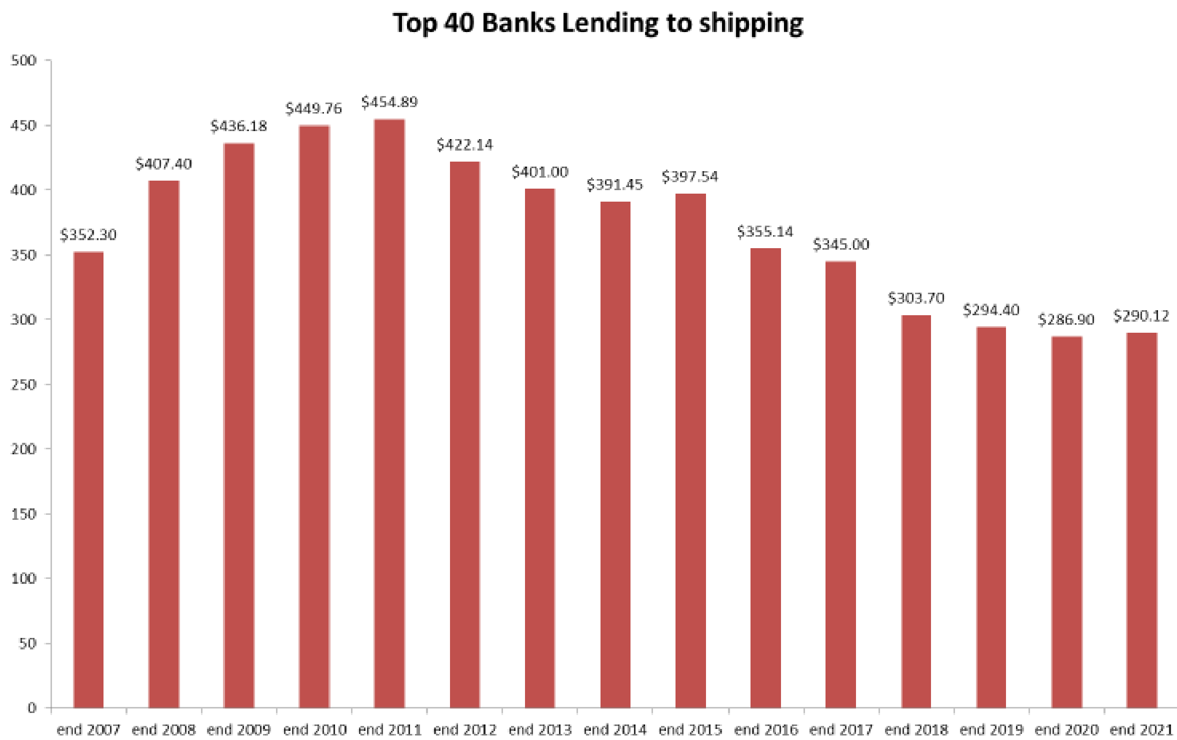
Graph: Top 40 Banks' lending totals in US$bn between 2007-2021



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In view of the shipping industry's continuous growth, the industry's increasing financial requirements were covered by Far East leasing, which included Sale and Leaseback transactions and by the development of Private Equity Funds (PEFs). Far East Leasing, primarily, consisted of Chinese leasing companies, often associated with banks and, to a lesser but still important extent, Japanese and Korean leasing. Such leasing was initially focused only on Far East owners but has increasingly spread out to European and notably Greek owners. Leasing terms are normally better than ship financing ones i.e. longer period, higher LTV etc. but often at a higher overall cost.

PEFs have grown enormously over the last 15 years. Being largely unregulated and able to offer more flexible terms, such funds have been increasingly active in traditional ship lending, leasing, as well as in providing investment funds over and above finance. However, PEFs would not normally lend and invest in the same transaction. PEF related costs are normally higher than leasing but they make up for it via tailor made terms and/or financing projects that would not fit in the risk profile of banks or leasing companies.

The challenges of ship finance in the next decades

The inherent risks in ship finance relate to changes over the life of a loan or transaction in the vessel's income and/or collateral value. These changes relate to the various market cycles, which in shipping can be very pronounced. Hence, lenders need to assess such risks and offer a loan with terms that are not likely to run into default during a market trough. Lenders consult with market forecasting companies to assist them but also rely on historical data and their own risk/reward appetite.

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In order to augment a loan, additional support is provided by corporate (holding company) and/or occasionally personal guarantees. In addition, liquidity adequacy is examined as to its ability to cope with cash flow issues, in case of market troughs. An owner's performance, management qualities and charters are also determinants of ship finance across all lenders.

Interest rate hedging and/or period chartering does provide further support, where deemed necessary.

Additional challenges to the ship finance industry

Although market change is the norm in shipping, we have seen lately an exacerbation of such risks. I will seek to highlight some of them, below.

Aside from the usual market cycles, we have witnessed lately, an increase in geopolitical risks and challenges, arising from conflicts, sanctions and restrictions to trade. These, rather political risks, have altered the patterns of trade and the demand-supply of the industry across all sectors. The recent Ukrainian war is but an example of far reaching consequences.

The covid pandemic also affected global growth and shipping costs and rendered ship utilisation less efficient.

The recent rapid rise in interest rates has also impacted on owners' cash flows and banks' existing loan portfolios, as well as the appraisal of new loan and the survivability of many banks e.g. Credit Suisse.

However, by far the most significant and far reaching change, which represents an enormous challenge to both the shipping and ship financing industries, has been the commencement of the transition by shipping towards reduced emissions by

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2030, leading up to zero emissions by 2050. The changes in regulatory emissions and goals have been far reaching, requiring the shipping industry to adopt. DNB's Jam Ole Huseby pointed out in this year's NOR shipping that annual investments in clear energy need to reach $4.4 trillion annually by 2030 (TradeWinds – 16th May 2023) and the annual investment in the last 5 years was only $1.2 trillion.

Whereas regulations have been set and additional ones are expected, the required technology is not yet available nor is its cost known. Various devices leading to reduced emissions and reduced fuel consumptions are being investigated but none so far represent a technological breakthrough. As such, there are heightened risks, as to technological changes and their costs, as well as the risk of obsolescence of the existing overage fleets.

The ship finance industry needs to factor in all the above additional challenges in its lending model. There are also issues related to future charter hires and charterers' views towards eco, non eco vessels and total eco (reduced and/or zero emission vessels) be able to recoup their investment costs without passing the risk on to lenders. The scrubber debate is still an issue.

One major observation has been the overall buoyant shipping markets across all sectors. Admittedly, some sectors, e.g. containers, have subsided but they had been very strong for prolonged periods. All in all, the industry has been earning robust incomes, which have assisted both cash flows, liquidity accumulation and the reduction of leverage, via prepayment of loan facilities. Consequently, at a time of upheaval, the industry's financial health is solid. It will need to be in order to find the enormous capital required in the future.

A major development has been the emphasis placed by all lenders on financing "green" vessels with low emission/consumption characteristics. The Poseidon Principles amongst lenders has expanded to 30 top banks. Although, technology

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has not matured yet and "green" e.g. dual fuel etc. vessels, account only for 0.2% of the current fleet and 5% of newbuilding orders (Clarkson's WFR), lenders are keen to expand their ESG footprint and are willing to offer favourable terms and lower margins for such vessels. In the offshore sector, vessels built for the wind renewables sector and offering the latest specifications are very much in demand.

There are many PEFs, which lend only to green shipping and it is expected that finance for older technology vessels may become increasingly difficult.

The opportunities for ship finance lenders

At a time of reduced global bilateral loans, lenders have come to appreciate shipping's vast capital requirements and favourable risk/reward characteristics. The industry has demonstrated a good performance with relatively low defaults and owners' ability to meet the challenges over the last decade.

Ship finance has become a global industry, extending to ship finance platforms and other innovations. Owners have ample choice and ability to raise loans. Bank finance still represents the lowest cost source but many owners value the increased LTV offered by alternative lenders, despite the higher cost, as it reduces their capital requirements.

As outlined earlier, uncertainty and geopolitical risks have grown but, thus far, these have been absorbed by the shipping industry, without impacting on the quality of loan portfolios. The outlook for the ship finance industry remains bright, challenging and rewarding.