Marine Investments Financing Forum
Shipowners versus capital providers "a tango for two"
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Setting the Scene, Identifying the Objectives

Fifty years of ship finance

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1. Introduction

It is a particular pleasure to be making this presentation in the famous and historical shipping center of Amsterdam. Shipowners and bankers have been "dancing a tango" here for at least 500 years, so whatever conclusions we reached during our discussions today, the weight of history says that solutions will be reached and the ships will be financed.

I will divide my talk this morning into three parts. Firstly I will make some remarks which I hope will set the scene for the debate. The point I want to make is that the relationship between shipowners and bankers changes depending on the commercial circumstances, and to illustrate this I will work through a brief overview of the last 50 years for ship finance. Secondly I will present some estimates of financing needs for the next five years, indicating how much investment will be needed and in what sectors. Finally I'll make some very general comments about the future and the scenarios which might occur.

2. Setting the scene

Bankers and owners have had to deal with many changes in the commercial environment over the last 50 years. This is illustrated in Figure 1 which shows the freight rates for tankers and bulk carriers since 1960, along with a few comments about the commercial environment. We had a golden age of growth in the Sixties, a bubble in the Seventies, followed by an oil crisis and a deep recession in the 1980s. Finally the 1990s was extremely volatile,

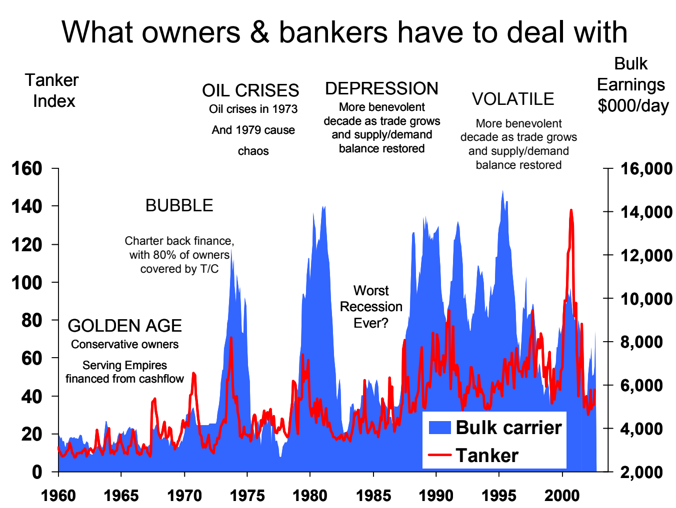

Figure 1 Changes in shipping's commercial climate

though less life threatening. Perhaps the most interesting point is that with each of these commercial developments, the characteristics of ship finance changed.

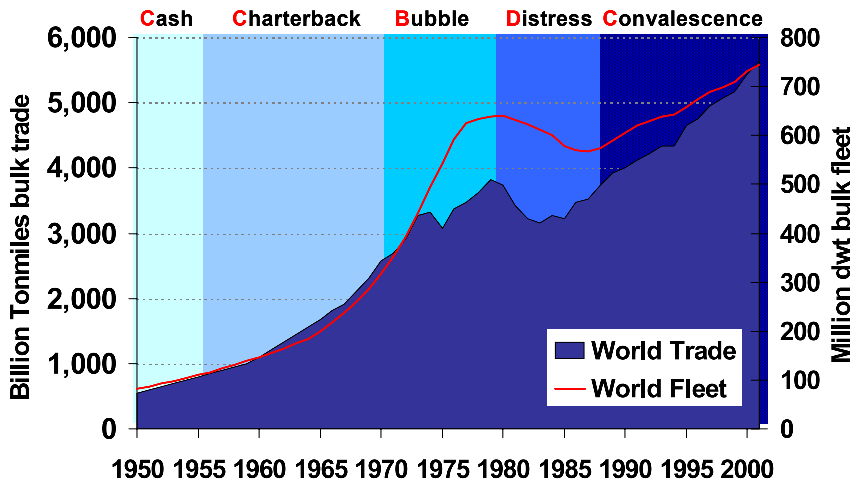

Figure 2 Five phases of ship finance

Five phases of ship finance

The five phases of ship finance are illustrated by Figure 2, which shows the shipping market fundamentals during the 50 years since 1950. This graph compares the growth of trade and the growth of the fleet. In the background I have identified each phase with a title.

The first phase of ship finance is called "**Cash**". In the 1950s European shipowners and many established Greek families stuck firmly to a policy of finance based on retained earnings. Debt was regarded as a sign of commercial weakness and was not used by "blue-chip" companies. The British owners were a typical example. In 1969 the UK Rochdale Committee on Shipping found that only £160 million out of £1 billion of capital employed by British owners was represented by loans, a 16% gearing rate! It was a defensive policy by shipowners with mature fleets and plenty of cash, with no real need to borrow. Their problem was finding profitable investments.

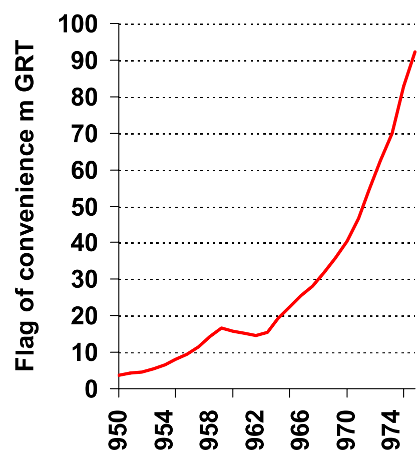

Figure 3 Flag of convenience fleet

The second phase of ship finance, which ran from the mid 1950s to the early 1970s, is entitled "**Charter back**". This was a period when cash would not work. As the European and Japanese economies started to expand in the 1950s and 1960s, trade grew rapidly and this triggered a revolution in ship finance. Large corporations with rapidly growing cargo volumes desperately needed bigger ships and were willing to give long term charters to get them. Independent owners used the charters as security to finance new buildings, which they registered under low cost flags of convenience. Bankers, who now had access to the expanding Eurodollar market, were happy to offer very high advances against the security of a timecharter and the mortgage of the ship.

So a new banking partnership was forged and bankers came to play an increasingly prominent part in dictating the commercial structure of the shipping market[1]. Soon charter back credit became the preferred means of financing fleet expansion for the period of very rapidly expanding trade and the impact it had on shipping is evident from the growth of the "flag of convenience" fleet, which by 1975 had reached 90 million grt (Figure 3). The system of "back to back" credit achieved its most sophisticated form in the Shikumi-sen arrangements developed between Japanese charterers and Hong Kong shipping entrepreneurs such as YK Pao. By the end of the 1960s about 80% of the Independent tanker fleet was on time charter and very highly leveraged!

The third phase is entitled "**Bubble**". In the late 1960s many shipowners found the time charters restrictive. Inflation was eroding the tight margins and as the conservative TC owners lost money, prominent shipowners such as Hilmar Recksten were making a fortune on the spot market. As trade grew ever faster, many owners believed that they should order ships on their own account, so that they could enjoy the profits or spot market booms. Unfortunately before long bankers had reached the same conclusion, taking the view that the ship itself was sufficient collateral, and no time charter was necessary. This change of banking strategy broke the link between it supply and demand, and orders escalated to 120 m. dwt of tankers in 1973 (Figure 4). This was a genuine bubble, and we are still living with the consequences 25 years later. The bubble was "pricked" by the 1973 oil crisis, and the 1979 oil price hike, shown by the line in Figure 4. The combination of over-production and collapsing demand set the scene for the worst depression in shipping history.

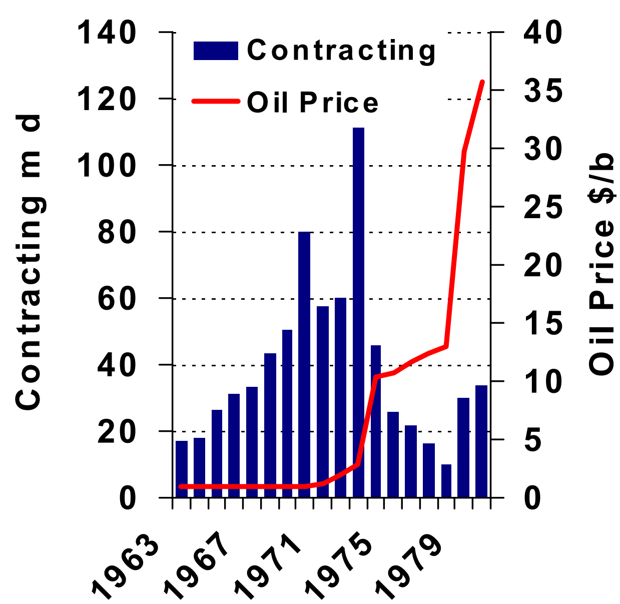

Figure 4 Tanker ordering bubble & oil prices

Phase 4 is entitled "**Distress**". All bankers know about the 1980s, a recession which changed the way the world banking community thinks about shipping risk, but let me remind you of some of the facts. Figure 2 shows the massive gap which developed between supply (the fleet) and demand (trade)

[1] This partnership between commercial bankers and shipowners had started in the 1940s, when exchange restrictions forced Norwegians ordering ships abroad to raise 100% dollar finance. Access to finance was greatly helped by five to seven-year charters available from oil companies at the time.

disrupting the fundamentals of the industry. The most visible indicator of the crisis was the volume of modern tankers in lay up, representing 25% of the fleet in 1984 (see Figure 5). From a banking viewpoint it was a disaster and the following statistics, though largely estimates taken from 1987 sorces, give an idea of what a severe recession this was.

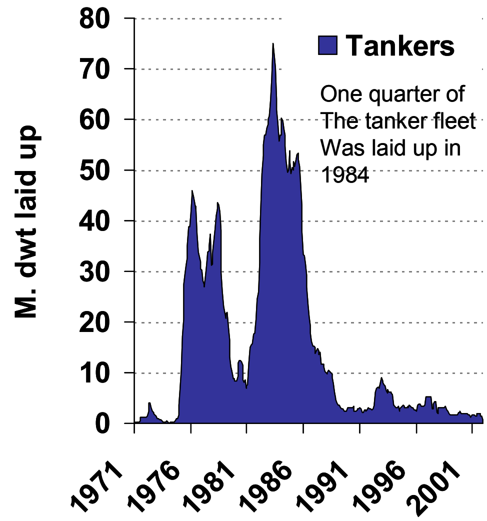

Figure 5 Unprecedented tanker surplus

- During the four years 1983 to 1987 borrowers defaulted on $10 billion worth of shipping loans

- The amounts written off the books by commercial banks and leasing companies because of defaults by shipping companies during this period was between $3 billion and $4 billion.

- Experienced ship financial institutions wrote off 1-5% of total commitments each year and others as much as 10%. Several banks disposed of their whole portfolio and dissolved all links with shipping finance

- Three Japanese banks wrote off $700 million loans to a single shipping company.

As these events unfolded, banking officers faced problems for which a career in commercial banking could hardly have prepared them. The struggle for survival was brutal on both sides. How many professional bankers expect to seize their customer's ships, or even threaten him with jail? So bankers were educated in the risks of financing ships in the most dramatic way possible.

Which brings us to the 1990s, a period of "**Convalescence**" for ship finance. The 1980s had upset all perceptions of how to conduct banking business in the shipping industry, and so owners and bankers had to go through the painful experience of "rehabilitation". During the decade shipping needed to raise about $200 billion to finance new investment and naturally there were worries about "where the money will come from". Step by step the financing techniques were taken out of the cupboard, dusted off and put into practice. Some worked, whilst others were not so successful.

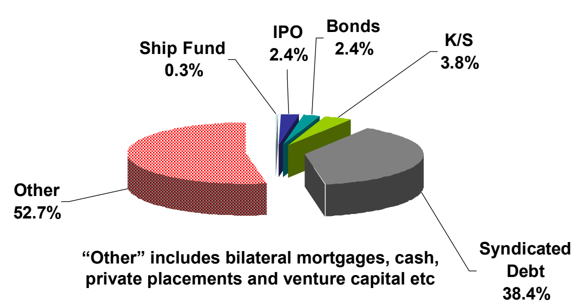

Figure 6 Guess at the split of ship finance by source in the 1990s

So how was shipping financed in the 1990s? I have made a very rough estimate of where the finance came from, and it is shown in Figure 6 (this is just an informed guess, so please treat it with caution!). As always debt accounted for the greater part of the finance raised, with the "Other" (i.e. cash, bilateral loans, shipbuilding credit etc.) accounting for about half of the finance raised. The volume of syndicated debt picked up over the decade, from around $2 billion a year in the early 1990s to over $10 billion a year towards the end of the 1990s[2]. By this time the syndications had become very large, and have proved in some cases difficult to manage. The remaining 10 to 15% of funds were raised from a variety of sources. Initial Public Offerings (IPOs) probably accounted for 2-3% and Bonds for about the same. However by far the biggest "catalysts" for ship finance were the K/S partnerships in Norway and the KG companies in Germany. The impact of the German KGs was massive, with the German banks building up a portfolio of shipping loans in excess of $50 billion by the middle of 2002 look (see Table 1).

Table 1: Shipping exposure of German Banks

Bank	portfolio volume in Million Euro 30.06.2002	31.12.2001	2000	1999	1998
Hamburgische Landesbank	**11,019**	**10,770**	8,445	7,576	5,861
Kreditanstalt für Wiederaufbau (KfW)	**9,206**	**9,405**	7,878	7,281	6,403
Deutsche Schiffsbank AG	**6,210**	**6,209**	4,457	4,044	3,384
Nord LB	**5,018**	**5,200**	4,076	3,486	2,752
Commerzbank	**6,000**	**6,000**	4,000		
Landesbank Schleswig-Holstein	**4,319**	**4,303**	3,229	2,714	1,919
SHL + Deutsche Bank	**2,800**	**3,200**	2,916	2,908	2,293
DVB Bank AG	**3,893**	**3,978**	2,865	359	k.A.
Bremer Landesbank	**2,088**	**2,131**	1,881	1,831	1,606
Vereins- u. Westbank AG	**3,000**	**3,000**			
Dresdner Bank AG	**1,000**	**1,000**			
Total	**54,553**	**55,196**	**39,747**	**30,199**	**24,218**

Source: Hansa, DVB Hamburg

In fact the ship finance business has emerged from the 1990s a much more sophisticated group of bankers, many of whom cut their teeth in the 1980s, and have all the experience of the volatile 1990s behind them. At Clarkson Research we keep a database of shipping institutions, and currently we have over 100 on file. Out of these 18 have very large portfolios, and another 14 fairly large portfolios. We also keep a database of public transactions, and it is interesting to note that although there has been much discussion about low spreads, the average pricing of the transactions we picked up in 2000/2001 was 160 basis points (see Figure 7). The average size of loan was $30.9 million, so we need to keep in mind that this is a very diverse business, with much more to it than the "Big ticket" syndications which attracted very low pricing.

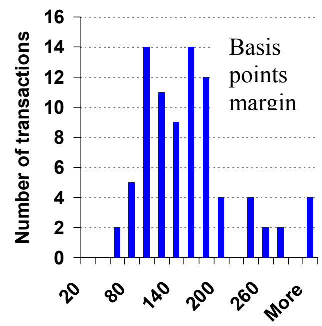

Figure 7 Sample of shipping loans 2001/2

3. How much finance will be needed?

I made an analysis of the requirement for ship finance over the next five years, and the results are shown in Figure 8. This analysis includes all types of merchant ships, and therefore it is not strictly comparable with the figures quoted for the early 1990s, which generally only referred to tankers, bulk carriers and

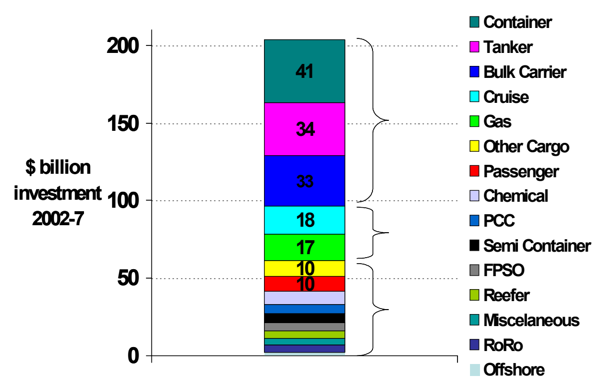

Figure 8 Forecast Investment 2002-07

[2] These statistics are taken from a paper by Fred Weening of ABN AMRO Bank iven at the LSE Ship Finance Conferene in 1997

containerships. The analysis suggests that there will be a requirement for around $207 billion of ship finance over the six years 2002-7, which will split as follows.

- About half (53%) of this finance will be for tankers, bulk carriers and containerships, each of which will require around $30-40 billion of funds. These segments have very different dynamics. The tanker and bulk carrier segments are expected to grow very slowly, only 1-2% per annum, but they are mature fleets, and will require heavy replacement. In contrast the container fleets will grow at around 6% per annum, with little replacement.
- Two very big segments, each requiring around $18 billion a year are LNG (8%) and cruise (9%). Both are expected to grow very rapidly, and so the sums finance are generally very large. This is the big-ticket business, and there will be much competition. It is also a business which lends itself to more innovative and highly structured finance.
- Finally the remaining 30% ship finance covers a host of different ship types, including passenger ships, chemical tankers, car carriers, semi containerships, reefers and offshore vessels. This is a complex and fragmented market, but it never less accounts for one-third of the total.

Shipbuilding Investment 2002-7

	$ million	%
Container	40,574	20%
Tanker	33,975	17%
Bulk Carrier	32,721	16%
Cruise	18,086	9%
Gas	17,034	8%
Other Cargo	9,975	5%
Passenger	9,949	5%
Chemical	8,043	4%
PCC	6,050	3%
Semi Container	5,717	3%
FPSO	5,301	3%
Reefer	4,920	2%
Miscelaneous	4,591	2%
RoRo	4,533	2%
Offshore	2,183	1%
Total	203,654	

Source: Clarkson Research

4. Objectives and options for the future

So now we are well into the 6th post war phase of ship finance. Each of the previous five decades had a distinctive character, and the challenge today is to decide what will characterize ship finance in the next 10 years. If my estimate of about $200 billion dollar investment requirement by 2007 is accurate, a considerable amount of funding will be needed. Where will it come from? And will it be provided in a way which will restore some of the "gravitas" the shipping industry lost during the financial stresses of the 1980s and the quality issues of the 1990s?

There are many hints thrown up by the historical review. What about cash? Should bulk shipping companies be relying more on internal funding, as in the 1950s? In a volatile industry like shipping, without charter cover, what is the right level of borrowing? The time charter regime of the 1960s may not return, but will owners will be able to forge stronger relationships with charterers that will improve creditworthiness, for example by the use of shipping pools or risk sharing agreements. What about derivatives? Will that market deepen? For commercial banks, is the future in bilateral debt or large syndicated structures? And how will this be reconciled with the changing position of the German banks and Basel 2? Can new approaches like synthetic securitisation help? Finally there are the capital markets. They provided less than 10% of ship finance in the 1990s, and the track record of bonds and IPOs has been disappointing. Will their market share increase in the next decade?

Mr. Chairman, ladies and gentlemen, these are a lot of questions. But I still have one task, and that is to identify the objective, which is a simple matter. Avoid foreclosure! It can be rather unpleasant, as the following 16th century cartoon of a Dutch banker foreclosing on his clients suggests[3].

Figure 9 Objective - avoid default at all costs!

So now it's over it to the distinguished speakers to tell you how to do this.

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[3] The picture by Frans Francken II (1581-1642) is a satire on speculation. The board on the wall reads "I shall not as for justice or injustice: will you drive the pig into the cauldron?"