



Chairman's report

13 April 2010

Chairman's report presented at the annual general meeting of Danish Ship Finance A/S, 13 April 2010

I would like to start off by saying that Danish Ship Finance achieved a decent financial performance in 2009. The year was marked by the crisis in the financial markets and the shipping markets. In light of what was an unusually turbulent year, the Board of Directors finds that Danish Ship Finance made it through the year with satisfactory results in 2009.

Our company reported a profit of DKK 263 million and a solvency ratio of more than 14%.

The profit includes an additional reserve of just under DKK 900 million for potential future losses. As we now have nearly DKK 1.9 billion in contingency funds for potential future losses, Danish Ship Finance is well bolstered in case the shipping market crisis drags on.

1. The shipping markets

The crisis in the shipping markets would probably be the natural topic for me to start my report. I will refrain from giving you a detailed review of each individual segment and instead refer to our annual report and the publication entitled "Shipping Market Review", which will be published on our website within the next few days.

Most shipowners encountered severe difficulties in 2009, both on account of plummeting freight rates and declining ship prices.

If we look at our loan portfolio, the value of the mortgages underlying the company's lending declined by 26% on a weighted basis relative to the end of 2008. This drop in value reflects a substantial fall in rates for nearly all segments.

The substantial fall in rates and values has still not resulted in any material losses. In this context, I would like to remind you of the importance of distinguishing between impairment charges and losses.

The reason why we managed to avoid being impacted any more than what was the case under the difficult market conditions is partly our relatively conservative lending policy during the economic boom, when we retained our focus on providing loans to shipowners who we expected would be able to withstand a potential downturn. The fact is, of course, that there will always be ups and downs in shipping, even though the current downturn admittedly has been unusually severe.

Naturally, we have ships in our current portfolio with a high loan-to-value ratio because of the drop in values. However, a high LTV ratio does not by itself imply a loss. The source of payment of interest and loan instalments is the cash flow from the customers' **combined** operations – not only the ships that we finance.

Our current client portfolio generally ranks among the strongest in the sector. We may have a few loan cases in which we have financed ships whose drop in value have resulted in a high loan-to-value ratio, but the shipowners' combined cash flow and funds saved up during the boom years are in almost all cases sufficient for the shipowners to repay their loans on a timely basis.

We have identified breaches of loan covenants in respect of 17% of our total lending. These cases typically involve a higher LTV ratio than the minimum set out in the loan agreement: For example, the residual debt must not account for more than 80% of the tonnage value.

In most of these cases, the loan covenants allow us to request the shipowner to provide additional collateral or to reduce the loan. After discussing the issue with the shipowners in question, we have found mutually acceptable solutions for nearly all the cases.

This is also reflected in note 37 to our financial statements, which shows that 95% of the carrying amount of the loans are secured within 80% of the ship price. This level is unchanged from the end of 2008, despite the afore-mentioned value decline of 26%. We believe that these figures serve to illustrate our possibilities of responding to and acting in a market of declining ship prices. We are able to respond and do so fairly and consistently.

A few of our clients have requested an extension of their instalments. They represent only a moderate proportion of our total lending and a much lower share than one might have feared given the quick and strong decline in global trade.

Finally, we incurred actual credit losses of DKK 3.5 million in 2009 as we were compelled to request a forced sale of a ship at an auction. DKK 3.5 million is a relatively modest amount compared with our total volume of lending, and we expect additional and higher credit losses in 2010.

The present state of the freight markets might tempt us to conclude that the worst part of the crisis is nearly over. However, the order books remain very thick, and the delivery of a large number of new vessels may squeeze earnings in all segments. This also applies even if many

orders were to be cancelled or postponed. Therefore, we cannot rule out the possible need for additional impairment charges.

Moreover, the situation on the demand side is also somewhat shaky. The growth of the global economy is fragile, but let us hope that the current buoyancy persists and that there will be no more setbacks.

Danish Ship Finance is prepared if the situation deteriorates from the present state, and we believe that we have a good and prudent buffer by way of impairment charges and a comfortable solvency ratio.

2. The financial markets

I will now briefly describe the situation in the financial markets, which, fortunately, was gradually returning to normal.

During the first half of 2009, we suffered under the lack of market efficiency. Lack of access to even the most simple and common interest rate hedging instruments had a huge impact on bottomline results. This phenomenon now appears to have blown over, and with the current market conditions, we do not expect to see the same bottomline effect in 2010.

However, the afore-mentioned additional costs were more than offset by positive value adjustments of the securities portfolio. The positive developments in the financial markets, including normalised credit spreads, benefited mortgage bonds in particular and helped us to record the profit for the year.

We have not at any point been under liquidity pressure.

Because we apply the balance principle, we hedge the cash flows for our loans until the loans expire.

We have consistently had ample cash and have been able to make loan offers with no uncertainty as to whether we would be able to fund the loan until maturity.

The balance principle – or more precisely what is termed the specific balance principle and the way it is managed – is one of the cornerstones of our robust business model.

3. Competition

Let me now turn to competition in our industry, which brought many changes in 2009. Until the middle of 2008, there were many players – including many new operators – and competition for every single transaction was very intense. The financial crisis, and since the fourth quarter of 2008 also the shipping crisis, changed this picture dramatically.

Several of the large international lenders have either pulled out of the market or scaled down their shipping operations. This was also the case in the Danish market, where our customers only to a very limited extent engaged with international banks.

A similar trend was witnessed in the Nordic market. Many banks opted to focus on their natural domestic market.

There is still great demand for loan capital, and in step with the decline in supply of mortgage loan capital from the banking sector, a number of other options have arisen. Recently, a number of our clients have utilised opportunities in the bond market, and the shipyard nations in Asia – China in particular – have opened up for government participation in the funding of vessels built in local shipyards. Also the export credit institutions of the various shipyard nations have made substantial contributions on the funding side with respect to newbuildings.

Credit margins remain high in the shipping industry. To some extent, the higher credit margins underline the fact that prices of long-term funding have gone up. However, the trend also involves an actual increase in net interest margins. This increase should be seen against the backdrop of a very low level of credit margins just before the crisis commenced in 2008. We believe that, to a greater extent than previously, the new higher credit margins reflect the underlying risk.

However, we need to prepare for a return to a slightly sharper competitive environment in the segment where Danish Ship Finance usually operates; lending for the most creditworthy shipowners. As the financial crisis abates, margins will probably edge down in this segment.

However, we do not expect that the credit margins will return to the very low pre-crisis levels within the foreseeable future.

In 2010, we will remain focused on our existing clients, especially Danish shipowners, a segment with which we obviously have a special affiliation. We will also have the capacity for and a need to provide loans to foreign shipowners, and in this regard we should expect that, despite the growing competition for the most prestigious clients, we will be able to enter into some attractive deals.

4. In-house developments

Looking at our company from within, a few matters require special mention.

First of all, we opted to raise hybrid tier 1 capital under The Second Bank Package. In April, we applied for the maximum amount of approximately DKK 2 billion, whilst announcing at the same time that, in the course of the year, we would decide on the size of the actual loan amount. In December, we raised a loan for DKK 900 million, which we believe will be

sufficient to secure the continued development in lending and for us to cover our share of Danish shipowners' demand for loans in the years ahead.

The effective coupon on the loan of 9.49% is at the high end of the scale. Although the interest rate is high, we believe that it will still be possible to increase lending profitably on the basis of the hybrid tier 1 capital.

We expect to be able to repay the hybrid tier 1 capital when this becomes possible after a period of three years.

The second event was Moody's decision in July 2009 to lower its rating of our company's bonds from Aa3 to A2 with a negative outlook. The downgrade was made after we had held an Aa3 rating constantly since 1998. We have noted that Moody's has changed its view on shipping and that they are generally concerned about developments in the sector.

From our point of view, the security of the bond owners has not changed. In spite of the crisis, the quality of our loans remains strong owing to many years of conservative credit granting, and with a combination of appropriate impairment charges, which presently amount to DKK 1.9 billion, and a solvency buffer of more than 6% at the end of the year, we do not share Moody's concern with respect to our own situation.

In this context, it should be mentioned that Danish Ship Finance does not apply the so-called advanced method for credit risk mitigation, which means that our absolute equity relative to actual lending remains high.

Thirdly, we should refer to the many new statutory rules that may have a direct or indirect impact on our business.

At the beginning of the year, the Danish Act on taxation of profits was amended and the term minimum coupon bonds was abolished with respect to new issuance. The tax rules contained a number of provisions that made capital gains tax exempt for private investors provided the so-called minimum coupon was achieved. The new rules introduced symmetric taxation for private investors.

And why am I telling you this? The reason is that Danish Ship Finance was one of the many issuers of bonds with a coupon equal to the minimum coupon. The tax treatment has allowed for an attractive yield for both the private investor and the issuer. The amendment of the rules will most likely lead to a small increase in the company's funding costs, but we believe that this will be more than offset by the increase in credit margins.

Many new national and international rules governing the financial sector are underway. A number of these new measures could potentially affect our operations. Therefore, we maintain a dialogue with the authorities and affinity groups concerning the drafting of the rules. We have still not seen any fundamental impact on our business model, among other things because we have always maintained strong liquidity and a high equity relative to lending,

whilst at the same time closely monitoring legislative initiatives and regularly assessing the potential consequences.

In this regard, we are particularly attentive to bills under which the capital charge etc. of our bonds risks being determined by external rating agencies' ability to assess the security underlying our bonds.

Our bonds currently carry a low standard risk weighting because we comply with the strict regulatory requirements for issuing gilt-edged bonds. We would feel most comfortable if the public authorities remain the body that ranks financial institutions. The fact is that the authorities are in a good position to assess individual institutions as they have full insight into every aspect of an institute's operations.

5. Management remuneration

The Danish Act on State-Funded Capital Injections introduced a requirement that the chairman of the board must report to the shareholders in general meeting on the remuneration of the management in the preceding financial year and the expected remuneration in the current and upcoming financial year.

With respect to the remuneration in 2009, I refer to note 8 of the financial statements. I would like to add that no bonus was paid to the management in 2009.

The basic salary of the Management Board for 2010 has been raised by 4% for Erik. I. Lassen and by 3.2% for Per Schnack, and in 2011 we expect to adjust the management's salary by a rate conforming to market standards.

6. Final comments

Closing by report, I would like to conclude that Danish Ship Finance navigated reasonably well through 2009 and that our present loan portfolio, robust liquidity and comfortable solvency ratio make us well-prepared to meet a challenging 2010.