26 March 2015

Chairman's report presented at the annual general meeting of Danish Ship Finance A/S 2015

In my report, I will present the Board's views on the markets in which Danish Ship Finance operates. Of course, I will also be presenting the Board's views on Danish Ship Finance's current situation and outlook.

After my report, our chief executive officer, Erik I. Lassen, will review the annual report for 2014.

The shipping market

Let me start my review by making a few comments about the shipping market.

At last year's annual general meeting, my predecessor indicated that we had perhaps seen the first signs of the shipping crisis slowly abating. At that time, the dry bulk and tanker segments were both experiencing decent rates and rising ship prices. However, my predecessor also emphasised that shipping is a volatile industry and that the market could quickly turn sour again.

As the year progressed, it became clear that the shipping crisis was – and still is – far from over. The year brought highly volatile rates, especially in the tanker and dry bulk segments, and the upbeat sentiment from the early months of the year evaporated relatively quickly.

Towards the end of the year, it was evident that the tanker and the dry bulk markets were moving in opposite directions.

The falling oil prices in the final quarter of the year triggered stronger demand for crude oil transports, opening up the arbitrage market, which is an important factor in the product tanker segment. As a result of these developments, the tanker market experienced rates in the fourth quarter of 2014 that can only be termed satisfactory. I would also mention that product tanker

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freight rates remain at a decent level here at the end of March 2015, and consensus expectations are for quite a good year in 2015. While it would be nice if these expectations of a strong 2015 come true, we also need to point out that many ships are still being delivered to the market, and that many inventories are beginning to fill up. This indicates that developments may take a different path than the one we're all hoping for.

In the dry bulk market, only the large ships – the capesize vessels – experienced short periods of decent freight rates. All of the small vessel types had a miserable year. The low level of interest rates continued into 2015, and the dry bulk market has dropped to levels witnessed during the crisis in the 1980s. The slump was triggered by failing demand and a too high level of contracting both before and after the financial crisis broke out in 2008. Unfortunately, there is not much to indicate that we will see a sustainable recovery in the foreseeable future. Supply levels being what they are, we can only hope for a surge in demand or that scrapping activities are extended to cover younger vessels than usual. Otherwise, the dry bulk market will most likely experience a difficult period, although there will probably be brief periods of decent rates.

The container market remains split with liner operators on the one hand and tonnage providers on the other. In 2014, box rates fluctuated close to the 10-year average, and liner operators relied on strong positioning and a sound business model in order to land a profit. Tonnage providers still faced challenges in employing their vessels with the liner operators and had to settle for consistently low rates in the vast majority of the container segments.

The offshore market has recorded fair and stable rates for a number of years. However, the plunging oil prices will have a material adverse effect on developments in the entire offshore industry because oil extraction activities, particularly in deep waters, have become less profitable. The large oil companies have been quick to downsize their investment programmes, and this will impact the offshore shipping companies which are sub-contractors to the oil industry. For 2015 and onwards, we therefore expect much different results in the offshore segment, and the not so financially strong shipowners may face difficulty if oil prices remain low.

However, some shipping segments have recorded decent developments, and our customers in for example the LPG and ro-ro segments had quite a good year in 2014. Let me also mention that many shipowners benefit from the lower oil prices on account of lower bunker costs.

The image I'm trying to convey is that the shipping industry, in spite of many years of hardship, is not out of the woods just yet. Some segments will experience brief periods of buoyancy, and squeezed segments will experience periods of decent rates, but overall the next few years will remain challenging.

On this account, it is our assessment that Danish Ship Finance should retain its strategy of focusing on shipowners who, over time, have proved resilient to the volatility of the shipping industry. Even though shipping is a volatile industry, Danish Ship Finance has for many years proven that it is possible to run a sound and stable business based on lending to a volatile market. In the years before us, it will be up to the Board of Directors to ensure that the company can remain on the current path.

Competitive situation

After the onset of the financial crisis in 2008, a number of banks left the market, creating a more acceptable competitive environment. There has always been a core group of lenders in the market, one of them being Danish Ship Finance, but former and new players are now increasingly entering the market. Furthermore, export credit institutions in Asia are extensively backing their local shipyards.

We are currently witnessing a great appetite for lending to the most creditworthy shipowners, and lending margins are coming under increasing pressure. However, margins are still a fair bit above the pre-crisis levels, so even in the current market it is possible to obtain decent results in ship financing. In this context, I would like to remind you all that we have a good foundation on account of our low cost base, which allows for an acceptable net income from each loan.

Overall, we are seeing the contours of a sharper competitive environment. In that light, we are pleased that we were able to add a number of attractive new clients to our portfolio in 2014 while also serving our existing clients.

Lending and funding

As a result of the strong appreciation of the US dollar in the first quarter of 2015, Danish Ship Finance's loans measured in Danish kroner have already increased by a fair margin since the turn of the year. The Board is determined to maintain a capital ratio that is well above the minimum requirement. Consequently, we will remain focused on well-managed lending operations. Against that background, we expect slightly less loan offer activity in 2015 than in 2014, when we offered loans for about DKK 10 billion.

Our lending capacity is the smallest early in the year, but it will gradually recover in the second half of the year and into 2016 as instalments are paid on existing loans.

We have maintained our strategy of prefunding our loans, which means that we borrow funds in the bond market well in advance of loan disbursements. In this way, Danish Ship Finance retains a robust cash position, and our funding still has longer average duration than our lending. We are very comfortable with this situation.

Our competitive strength hinges on our continued access to the capital markets, and we will continue to prioritise this policy. In the fourth quarter of 2014, Moody's finally changed our outlook from negative to stable, and Danish Ship Finance subsequently holds a Baa2 rating with a stable outlook. In light of the company's performance since the first downgrade from Aa3 in 2009, it is difficult to see any good reason why the company's rating should remain at the present level. However, Moody's has its methodologies, and all we can do is keep up the good work and hope that they will eventually recognise that they have been too harsh in their rating of Danish Ship Finance.

Our viewpoint on the Board is emphasised by the fact that the company's loans remain comfortably secured by the underlying mortgages. During the past five years, our ranking in the mortgages has gradually been improved. At the end of 2010, 89% of loans after impairment charges was secured within 60% of the market value of the mortgaged vessels. At the end of 2014, this figure had risen to 95%. This means that only 5% of our loans – or about DKK 2 billion – are in the 60%-and-above range of the mortgage value. This figure should seen relative to the company's equity of nearly DKK 10 billion. On the Board, we believe that these figures indicate a robust business.

Earnings and capital structure

In a moment, Erik I. Lassen will review the annual report for 2014 in greater detail.

I would like to say, however, that our profit for the year was dominated by a quite substantial reversal of impairment charges. The large reversal was solely due to the fact that we managed to settle a few large loan issues in full or in part, and it was therefore not caused by any change in principles for calculating impairments. In the specific loan cases, the value of the mortgage covered the outstanding debt, allowing us to reverse the impairment charges. The large amount of the reversal is due to the fact that, in the impairment calculations, we assume that the ships in question will be sold at a discount to the current market value. So in cases where we succeed in using the market price as the basis for the prepayment, it obviously has a positive bearing on our impairment charges.

A look at the overall earnings pattern clearly reveals that earnings from lending operations now represents a greater source of income than income from the securities portfolio. The reason is that it has been possible to increase income from lending operations– without changing the risk profile – while low interest rates make it difficult to grow the income on our bond portfolio when it is placed in low-duration Danish mortgage and government bonds. We should probably prepare for a persistently low income contribution from the securities portfolio in the coming years.

The capital ratio was 16.4% at the end of 2014, well above the minimum requirement at the end of the year of some 8.5%. We aim to have a comfortable capital ratio that will allow us to withstand large negative impacts without jeopardising the timely repayment to the bondholders. The ongoing appreciation of the US dollar is an example of such an impact. In 2015 to date, the dollar appreciation has reduced our capital ratio by some 1.5 percentage point. However, we maintain an ample buffer relative to the statutory requirement, and we always have the possibility of strengthening our capital ratio by aligning our lending operations to capacity. Like I said earlier, current loan instalments will relatively quickly strengthen our lending capacity because instalments reduce our risk-weighted items and, by extension, increase our capital ratio. Nevertheless, we intend to maintain a fair capital buffer so that bondholder security is never jeopardised.

I would also like to emphasise that we serve the interests of our shareholders by maintaining a high degree of bond market confidence in our operations. Only by maintaining competitive funding will we be able to retain a fair level of earnings and thus remain able to pay dividends.

To sum up this review of earnings and capital structure, I would like to say that the bulk of our loans are denominated in USD and that our allowance account is therefore practically speaking also in USD. As a result, an appreciation of the USD will generally result in an increase in the allowance account measured in Danish kroner. A number of other factors also affect the impairment charges, but if we look exclusively at the impact of the appreciating US dollar, it will have a negative effect on impairment charges in 2015.

Management remuneration

The Danish Financial Business Act stipulates that the chairman of the board must describe at the general meeting 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 for 2014, I refer to note 8 of the annual report.

The salary increase at 1 January 2015 represents 4% for the Management Board, which has accepted that salaries will henceforth be adjusted at 1 April, which means that the next adjustment will be at 1 April 2016.

The rules stipulate that I must express an expectation for next year's adjustment; next year, we expect an adjustment of management board remuneration that will reflect market conditions.

Conclusion

In closing my report, let me emphasise that the Board of Directors is pleased with the developments in Danish Ship Finance, which achieved the highest profit in the company's history. Going forward, we should expect earnings to normalise. However, we believe that our business model has proven to be sustainable after having been subjected to quite severe stress testing in recent years.

I would also like to take the opportunity to thank the Management Board and all of the company's employees for another great effort in 2014.