31 March 2016

Chairman's report presented at the annual general meeting of Danish Ship Finance A/S 2016

I will be presenting the Board of Directors' views on Danish Ship Finance's current situation and outlook and will also touch upon the situation in the shipping markets and other selected areas.

After my report, our Chief Executive Officer, Erik I. Lassen, will review the annual report for 2015.

Danish Ship Finance

I would like to start my report by emphasizing that Danish Ship Finance had a satisfactory year in 2015.

Earnings from lending were more or less in line with those of 2014, and loan impairment charges were moderate.

Our asset management operations yielded a small profit, although interest income from our bond portfolio, primarily mortgage bonds, was largely offset by negative market value adjustments.

Lending was unchanged, and our capital ratio was a solid 17.3 at the end of 2015.

All in all, a fairly good year.

As mentioned before, I will let Erik provide a more detailed account of our financial statements and instead focus on the events and trends that influenced our results in 2015, and not least on factors expected to affect Danish Ship Finance in the years ahead.

Rating

Let me start with the areas of rating and regulation.

In previous years, we have often expressed regret that the rating assigned to Danish Ship Finance was relatively low in view of the company's robustness and good loan loss history. This year will

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be different, however, for as most of you know, we have succeeded in obtaining a new and better rating that better reflects the security supporting the company's bond issuance.

For some time, we have worked intensely with Standard & Poor's to explore the possibilities of finding an alternative to Moody's. The outcome of these endeavours was a covered bond rating of A, which we announced in early February of this year. The rating covers all of the company's listed bonds.

In addition to bringing the rating more in line with the so-called 'market implied rating' and creating opportunities for a more diversified investor base in the longer term, the change was beneficial in that bonds with an A rating qualify for inclusion in the LCR of financial institutions.

The Board of Directors will continue its dedicated efforts to safeguard the company's funding possibilities, and we still have more ground to cover. We are very pleased with the support we get from the Danish fixed income community. We intend to retain and safeguard this base of support. However, seeking diversification is sound business conduct, and going forward, we intend to explore the possibilities of selling our bonds outside of Denmark. The new A rating will facilitate these efforts.

I would also like to say a few words about regulation. Like all other financial institutions, we monitor regulatory developments closely. Although Danish Ship Finance is governed by its own regulatory framework, we are exposed to the same regulatory challenges as all other financial institutions in all significant areas.

We have a solid foundation with a low leverage ratio and portfolio level match between lending and bond issuance. However, many new initiatives are underway that Danish Ship Finance must also spend time and efforts preparing for. The Board of Directors believes that Danish Ship Finance is well-prepared to face regulatory developments and to meet new requirements. However, the regulatory challenges should not be underestimated. And we don't.

The shipping market

Let me now turn towards the shipping markets and the everyday lives of our customers.

All sub-segments suffered in the aftermath of the financial crisis. Ahead of the crisis in 2008, order books were too big in all shipping segments, and the following years were characterised by excess capacity. It would have been beneficial if the oversupply had been absorbed before new waves of newbuildings flooded the market, but as shipbuilding is a priority industry in some countries and benefits from ample funding, unfortunately the supply of vessels has far exceeded demand.

Since 2008, the dry bulk markets have experienced short periods of acceptable rates, but the inflow of new vessels has eroded the market, and rates are now at their lowest since the 1980s.
As a result, freight rates do not cover operating costs and values are historically low. Many vessels are being scrapped, but the low interest rate environment probably prevents a repeat of the extensive scrapping activity of the 1980s, when interest rates were higher. In other words, it will probably be some time before the market truly starts to recover. We can only hope that a lesson has been learned and that a slight recovery in freight rates does not spark a boom in newbuilding.

Obviously, the developments in the dry bulk segment affect our customers. If freight rates remain low, we cannot rule out the possibility that we may have to grant forbearance to more borrowers than we do today, but overall we have a strong loan portfolio, so helping shipowners in financial difficulty through the crisis is the right thing to do in the present situation. We expect to benefit from that strategy in the long run, while of course taking every step necessary in each specific case.

The drop in oil prices – or the extent of the drop at any rate – had not been foreseen and it has had a major impact on the tanker market and the offshore industry in particular.

If we start by looking at the positive aspects, the low oil prices triggered a stronger need for transportation in both the crude oil and product tanker segments. This meant that shipowners operated in a decent market and recorded fair earnings in 2015 – a trend that seems to continue into 2016 and has been warmly welcomed after years of hardship.

On the other hand, the falling oil prices weighed hard on the offshore market. This market had also witnessed a strong inflow of newbuildings expecting oil prices to remain high and consequently a rise in demand for equipment to extract oil offshore. When oil prices plummeted and oil companies started to slash their investment budgets, the market suffered from an oversupply of tonnage.

The production of offshore oil, maintenance of installations and oil exploration activities have not grinded to a halt. However, until the oil price rises above the current level of roughly USD 40 per barrel, oil companies are expected to be reluctant to launch extensive investment programmes.

We expect the offshore crisis to last for a few years and will focus on helping our customers through the challenging period. We have remained focused on providing loans to the strongest shipowners, but due to the severity of the transition, we must be prepared to offer more lenient repayment terms, including forbearance, to some shipowners for a certain period of time. We have stayed away from project companies and similar organisations, so we expect our customers to emerge unscathed from the crisis. Against this background, we do not expect any noteworthy write-offs in the offshore segment, although it may prove necessary to temporarily offer more lenient repayment terms. However, we cannot avoid loan impairment charges in the offshore segment.

The container segment has also experienced low freight rates, but the financial standing of the company's portfolio has not given rise to concern with respect to this segment.

Other segments are performing decently. I would like to mention the ro-ro segment, which comprises ferries, trailer ferries and car ferries. Trailer ferries are primarily a European segment in which our customers have performed well in terms of adapting capacity and routes to demand. We have also noted decent trends in the market for car ferries.

On another positive note, the LPG and, to some extent, the LNG market had a good year, with our customers in the latter segment experiencing good contract coverage.

The shipping market is notorious for delivering surprises – be they positive or negative. Given the current situation and despite progress in the tanker segment, we must prepare for an increase in the number of problem loans because loans, regardless of the underlying risk of a loss, must be classified as problem loans when borrowers are granted full or partial forbearance. It is not unusual for a lender in a volatile industry to grant forbearance. Although this policy may result in losses in the longer term, we are not seeing any indications that our fine loss history will be tainted by developments in the coming years. Should the market situation deteriorate dramatically, the Board of Directors can vouch that Danish Ship Finance can absorb the losses via its loan impairment losses.

In this report on markets, I should remember to mention that, in spite of the somewhat dismal outlook, we are still seeing a borrowing requirement among reputable shipowners with a good financial standing.

Competitive situation

There have been no major changes in terms of competition. A number of banks are still winding up their ship financing activities, and the number of active banks has not changed to any noticeable extent.

We were reluctant to make new loan offers in the first part of 2015 because the USD appreciated by about 20% against the DKK, as a result of which our loans in DKK terms rose by nearly as much. In light of the USD appreciation, we scaled down our lending operations a bit. However, our lending capacity has been restored, and Danish Ship Finance is prepared to offer loans to customers with a good financial standing.

However, we have noted that shipping customers have not been hit by the widening credit spreads that have generally characterised the credit markets. This means that credit margins are currently attractive to customers considering the costs incurred by banks to obtain funding with matching maturities. However, such is the competitive environment we operate in. Some transactions seem to be priced too low, and we have therefore turned down more business opportunities than usual.

We do not expect an increase in lending in the years ahead, and unless earnings increase from the current levels, in the upcoming period we will focus on maintaining lending at the present level. This may also prove difficult with loans for DKK 7-8 billion being settled each year and considering the historically low ship prices.

Strategy considerations

In 2015, the Board of Directors asked consultants McKinsey & Company to perform a strategic review of Danish Ship Finance. The strategy has worked well so far, but the Board of Directors found that it would expedient to have an in-depth review performed of all aspects, especially with a view to identifying any opportunities we might have failed to notice. A number of extraordinary board meetings were held, and our Executive Board and many of our employees of course took active part in these endeavours.

The analysis confirmed that we have selected a good and prudent strategy and also that Danish Ship Finance enjoys a good reputation among its customers. The risk profile will not be adjusted, and in the coming years we will therefore pursue our current strategy of focusing on strong funding and low credit risk in lending operations.

In June 2015, we released an announcement because of rumors about a potential imminent sale of part of the company's shares. In the announcement, we confirmed that work had been initiated to identify any possibilities of facilitating the continued development of our ship financing operations and improve the share liquidity. We also announced that the analysis included the possibility of an initial public offering or a sale of shares. I do not at this point have anything new to add. We will issue a new announcement when required or when conditions warrant it.

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 2015, I refer to note 8 of the annual report.

As set out in our remuneration policy, the next adjustment of the remuneration of the Executive Board will be on 1 April 2016. I can inform you that the Board of Directors has still not fixed the level for the period from 1 April 2016 but that we will find a level that reflects the Executive Board's efforts and performance.

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

Conclusion

In closing my report, I wish to emphasise that the Board of Directors is pleased with the developments in Danish Ship Finance. We recognise the great effort put in by our employees to keep abreast of and implement new rules and procedures. These include COREP, KYC and other ongoing sector initiatives.

We still believe that our business model has proven to be sustainable after having been subjected to quite severe stress testing in recent years. This has now also been confirmed by a recognised group of consultants. We must prepare for new challenges, but also new opportunities, and I am confident that we are capable of handling such challenges and exploiting the opportunities that may arise.

Finally, I would like to take the opportunity to thank the Executive Board and all of the company's employees for their strong and loyal efforts in 2015.