27 March 2017

Chairman's report 2017

2016 was an eventful year for Danish Ship Finance in a number of areas.

New majority shareholders

Let me start by talking about the changes made to the company's group of owners. In June 2015, Danish Ship Finance informed NASDAQ Copenhagen that it had initiated a so-called strategic review of the company's future ownership. A number of interested parties approached the company, but after a long and thorough process, the company announced at the end of September 2016 that a consortium consisting of PFA, PKA and Axcel had signed an agreement to take over the majority of the shares in Danish Ship Finance A/S. Specifically, the agreement was to take over the ownership interest of 72% of the A shares held by the four previous majority shareholders. An offer was submitted to take over the A shares of the remaining shareholders, the vast majority of whom agreed to sell. As a result, the consortium now holds 86.3% of the shares of Danish Ship Finance A/S. The shares are held by Danmarks Skibskredit Holding A/S, which is owned equally by the three consortium members.

Den Danske Maritime Fond still holds 10% of the company's shares in the form of B shares. The B shares still entitle the holder to preference dividend of 15% of the company's profit after tax.

Naturally, the ownership changes gave rise to changes to the board composition, and all six shareholder-elected board members were replaced by six new board members in November 2016. I was elected chairman of the Board, and Peter Nyegaard of Axcel was elected deputy chairman.

Since the takeover, the Board has reviewed the company's strategy, working to identify areas in which it may be possible to strengthen operations. The new Board concluded that Danish Ship Finance A/S has a unique and well-functioning ship financing business model. We will seek to improve the company's earnings in a few specific areas, but the strategy of focusing on the most creditworthy part of the shipping industry, basing lending operations on bond issuance according to the balance principle, remains unchanged. Customers and investors alike should therefore still regard Danish Ship Finance A/S as a stable lender to the industry.

Change of rating supplier

An important event in 2016 was the February announcement that Danish Ship Finance had terminated its rating agreement with Moody's Investor Services (Moody's) and entered into an agreement with Standard & Poor's (S&P).

S&P has developed a model that recognises the value of the structural strength of Danish legislation on the issuance of ship mortgage bonds, which in key areas is similar to Danish legislative rules on issuance of mortgage bonds. The model allows for a higher bond rating than the Issuer Credit Rating (ICR). In February 2016, S&P assigned an ICR of BBB+ to Danish Ship Finance A/S, and the issued ship mortgage bonds were assigned a rating of A with 'stable outlook'.

As a result of the takeover of the majority of the shares in the fourth quarter of 2016, the outlook was changed from stable to negative, primarily due to the technical aspects relating to the capital structure of the new group. The company aims to retain its A rating and regularly monitors that the relevant threshold values are not exceeded.

The shipping market

The offshore industry and the dry bulk market had difficult market conditions in 2016.

Recent years' falling oil prices from levels above USD 100 per barrel to below or around USD 50 per barrel have caused an abrupt slowdown in oil company investments. A lower level of capital expenditure had a direct impact on suppliers of rigs and supply vessels, which had in fact positioned for growth, receiving and placing orders for a large number of vessels in the preceding years. Already in 2016, many reputable shipowners with short contract coverage initiated discussions with their creditors about more lenient repayment conditions. Under the rules of the Danish Executive Order on Financial Reporting, forbearance will always constitute objective evidence of impairment, and this can be seen in the net profit for the year of Danish Ship Finance A/S. The offshore crisis is expected to drag on because of the long-tail effects from the time new offshore investments are approved until they have an effect on demand.

The dry bulk market experienced the worst conditions for decades in the first quarter of 2016, although it did recover somewhat towards the end of the year. It is estimated that ship prices bottomed out in early 2016, and in the intermediate period we have seen ship prices rise by 20-30%, albeit from a low starting point.

The tanker market generally had a good year, although it weakened towards the tail end of 2016 especially due to the many new vessels being delivered from the shipyards. Although renewable energy like solar and wind power is rapidly gaining a foothold, demand for fossil fuels is still not expected to have peaked. It is important for tanker shipping companies to adapt to the new reality and to a drop in demand at some point in the lifetime of newly contracted vessels.

The container market remains highly competitive, but multiple consolidation steps were taken in 2016 that would hopefully lead to more stable rates than in recent years. This consolidation will initially benefit liner operators, as non-operators will probably have to wait a while longer before time-charter rates start to recover.

Many new vessels were supplied to the gas tanker markets, with the large segments generally experiencing low spot rates, while the small segments only saw a small decline in rates.

The segment covering ferries, Ro-Ro vessels and car carriers generally had an acceptable year in 2016. There is no single label to fully describe developments in this segment because earnings largely depend on the individual shipowner's position, fleet composition and routes. As such, earnings differed considerably from one shipping company to the next.

Our overall conclusion is that, nearly ten years after the onset of the financial crisis, shipping as an industry has still not fully emerged from the downturn. Short periods of excessive investment appetite in the various segments have extended the crisis as demand has actually risen steadily over time.

On a positive note, the order book as a percentage of the operating fleet is now at less than 10% for the first time in many years. We can only hope the shipping companies will refrain from investing too heavily on speculation and will instead place orders based on the need for fleet renewal and a de-facto increase in demand from their customers.

Lending

As described in our annual report, we remained cautious in our lending operations in 2016, submitting loan offers for an overall amount that was lower than the annual loan repayments. On a satisfactory note, we managed to add a handful of new customers. Our objective for 2017 is to increase momentum in our lending and thus to stop the downward trend in lending volume. As already mentioned, we will remain focused on shipowners with a good financial standing.

Competitive situation

There have been no major changes in terms of competition. New capital requirements and a general slump in risk appetite is expected to lead to a lower supply of loan capital from commercial banks.

However, there is still ample capital available to the most creditworthy shipowners, our main target group, and competition thus remains unchanged from prior years with a small increase in credit margins over the course of the year.

Bond issuance

Opportunities for issuing bonds remained strong in 2016. Danish Ship Finance issued bonds for DKK 6.3 billion with an average maturity of 4.4 years at satisfactory spreads, and the company bought back shorter-maturity bonds with an average maturity of 1.3 years for DKK 6.9 billion. The weighted maturity of funding was thus still longer than the weighted maturity of lending. To this should be added the liquidity reserve in the form of the company's equity, which is placed in investment grade bonds. In other words, the liquidity situation remains quite robust.

Management remuneration

The Danish Financial Business Act stipulates that the chairman of the board must describe at the general meeting the remuneration of the board of directors and executive board of the preceding financial year and the expected remuneration in the current and upcoming financial year.

With respect to the remuneration for 2016, I refer to note 8 of the annual report.

The remuneration of the Board of Directors and Executive Board for 2017 is disclosed in the remuneration policy for 2017, which is available on the company's website. The remuneration policy for 2017 shows that the Board remuneration has been increased. The annual remuneration of the Executive Board was adjusted effective 1 November 2016, and no further adjustment has been made for 2017. In 2017, members of the Executive Board have been granted equity instruments intended to retain the Executive Board and ensure long-term value creation in the company. The instruments comply with the provisions of the Danish Financial Business Act.

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

I will now briefly account for the net profit for the year and the principal balance sheet items.

Net profit for the year

Comprehensive income for the year amounted to DKK 200 million, which was a decline from DKK 413 million reported for 2015.

The net profit for the year was influenced by a significant increase in loan impairment charges. Loan impairment charges amounted to DKK 610 million in 2016 as compared with DKK 46 million in 2015. The increase was primarily driven by developments in the offshore segment. Write-offs remained at a low level on account of loan impairment charges made in prior years.

The securities portfolio generated a satisfactory return of 3%. There was a decline in interest income from finance activities, but this was more than offset by positive market value adjustments of DKK 124 million, against negative market value adjustments of DKK 177 million in 2015.

Lending fell by just under 10%, adversely affecting income from lending.

Total net interest and fee income fell from DKK 906 million in 2015 to DKK 849 million in 2016.

Expenses rose to DKK 120 million from DKK 113 million.

Balance sheet

As mentioned above, Danish Ship Finance recorded a drop in lending in 2016. Lending less loan impairment charges fell from DKK 43.2 billion in 2015 to DKK 39.8 billion in 2016. The decline in lending was due, among other things, to the company's cautious approach to lending on expectations that the net credit margin will increase in the coming years.

Total assets were largely unchanged at DKK 62.6 billion at 31 December 2016 against DKK 64.9 billion at year-end 2015.

In December 2016, the company made an extraordinary distribution of DKK 1 billion to the shareholders to adjust the Group's capital structure. After adjustment for expected dividends, the capital ratio at the end of 2016 was 17.2%, against 17.3% at the end of 2015. In other words, the company's capital situation remains robust.

Conclusion
Overall, 2016 was a difficult year for the shipping market, and the company reported an acceptable profit given the market conditions. As the new ownership has not resulted in any changes to the company's risk profile and liquidity situation, the capital structure remained solid at the end of the year.

Finally, I would like to take the opportunity to thank all the company's employees for their committed efforts at a time when the new ownership has naturally made many of you think about the company's future direction. This process has now been completed, and the company can continue its strong performance, so on behalf of the Board of Directors, I would like to thank you for your patience. We look forward to developing Danish Ship Finance together with the Executive Board and the employees.