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Danmarks Skibskredit A/S

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Danmarks Skibskredit A/S

SACP	bbb
Anchor	bbb+	
Business Position	Weak	-2
Capital and Earnings	Very Strong	+2
Risk Position	Adequate	0
Funding	Below Average	-1
Liquidity	Strong	

+

Support	0
ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

+

Additional Factors	+1

Issuer Credit Rating
BBB+/Negative/A-2

Major Rating Factors

Strengths:

- Very strong capitalization.
- Sound risk management with conservative underwriting and prudent provisioning.
- Superior funding metrics and strong liquidity buffer.

Weaknesses:

- Business and revenue concentration.
- No access to central bank for funding needs.

Outlook: Negative

The negative outlook on Danmarks Skibskredit reflects the current difficulties in the international shipping and offshore markets and the potential for deterioration in DS' asset quality metrics over our two-year outlook horizon. In our base case, we assume DS will maintain its conservative risk profile, report low realized loan losses, and demonstrate high-quality underwritings at this low point in the shipping cycle. Furthermore, we believe new ownership could expand the group's funding profile outside Denmark, but will not affect the conservative risk management. Given the conditions in the shipping market, we intend to review the entity in a less-than-yearly cycle. Our next review is planned for the third quarter of 2017, following the entity's mid-year results and an update on the shipping industry, including ongoing restructuring cases in the sector.

We could lower the ratings if a longer period of stress and further worsening of operating conditions in the shipping industry lead to materially higher provisions for DS. Furthermore, a significant weakening in DS' funding and liquidity metrics or change of prefunding strategy could lead us to remove our positive adjustment for the institution's superior performance relative to peers, leading us to lower the rating.

We could revise the outlook to stable if operating and structural conditions in the shipping industry improved the outlook for DS' customers, resulting in a stabilization of DS' asset-quality metrics.

Rationale

Our ratings on Danmarks Skibskredit, internationally known as Danish Ship Finance, reflect its anchor of 'bbb+', its weak business position, very strong capital and earnings, adequate risk position, below average funding, and adequate liquidity, as our criteria define these terms. The stand-alone credit profile (SACP) is 'bbb' to which we add a one-notch upward adjustment, reflecting its superior funding position compared with peers, to derive the 'BBB+' issuer credit rating.

Anchor: 'bbb+' for banks operating predominantly in Denmark

Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a commercial bank operating only in Denmark is 'bbb+', based on an economic risk score of '3' and an industry risk score of '4'. In recent years, DS has diversified its lending to different countries and reduced its exposure to Danish counterparties. We assign an anchor of 'bbb+' by combining the weighted average economic risk of the countries where it lends, which we calculate as 3.3, with the industry risk score of 4 for Denmark.

Our assessment of economic risk for Denmark reflects the high-income, open economy with mature political and institutional settings that promote fiscal discipline and growth-stimulating policies. Although it has decreased in terms of GDP, household debt remains high and a constraint to our assessment of economic risk. Problem loans from the previous credit cycle are falling. We expect credit losses to fall below 10 basis points (bps) annually through 2018. Consequently, we expect Denmark's economy and bank performance will remain stable, supported by a balanced fiscal policy, strong external position and improving profitability of the banking sector.

We view the regulatory environment in Denmark as in line with that of other EU countries. We observe an overall improvement in the banking sector's profitability that, in our view, will continue through further cost efficiency measures, decreasing credit losses and higher mortgage margins. This should enable the sector to report improvements in return on equity (ROE) despite a negative central bank deposit rate weighing on deposit margins. We note the continued stability and strong track record of the Danish covered bond market and we expect individual banks' ongoing efforts, as well as restrictions imposed by the regulator, will maintain the reduced share of short-term financing.

Table 1

Danmarks Skibskredit A/S Key Figures

	--Year-ended Dec. 31--				
(Mil. DKK)	**2016**	**2015**	**2014**	**2013**	**2012**
Adjusted assets	62,621	64,873	69,374	67,222	83,002
Customer loans (gross)	42,328	45,128	45,321	45,454	49,248
Adjusted common equity	8,944	9,955	9,955	9,568	9,496
Operating revenues	974	729	1,057	912	1,045
Noninterest expenses	122	114	99	99	95
Core earnings	188	413	1,568	477	314

DKK--Danish krone.

Business position: Significant revenue and business concentration

We view DS' business profile as weak, reflecting its small size, narrow franchise, and concentrated business model (based on first-lien mortgage lending to the Danish shipping industry and select international shipping companies). This is partly mitigated by DS' successful operational track record and very strong efficiency in a highly volatile industry.

With total assets of Danish krone (DKK) 62.6 billion (€8.42 billion) at Dec. 31, 2016, and a 1% global market share in shipping, DS is a small, specialized lender to the shipping industry that services a selection of very large clients by financing vessels against a first-lien mortgage. The largest share of lending is to shipping companies in Denmark (32%) and Norway (16%). The loan portfolio is highly concentrated, reflecting the company's chosen strategy of working primarily with the best shipping companies, with diversified fleets--for example, shipping operators able to manage difficult markets and adjust operating capacity. DS has approximately 70 clients, for which it finances over 50 vessels, exposing the institution to significant revenue concentration risk in a highly cyclical sector. Although we recognize that client concentrations are decreasing, we still view them as very high. The 10-largest customers represented 45% of the loan book in 2016, versus 66% in 2009.

Partly counterbalancing its narrow business franchise, DS has shown a strong operational track record and performed robustly in the 2009 downturn in global shipping markets. We also recognize DS' strong operating efficiency, as reflected by cost-to-income ratios between 10% and 15% for the last five years, significantly outperforming the peer average of nearly 50%. This creates, in our view, a sound first line of defense against severe dislocations in the cyclical shipping industry and enables DS to maintain a conservative provisioning policy.

DS changed its ownership in late 2016. A consortium consisting of the private equity fund Axcel and the pension funds PFA and PKA now own approximately 33% each of 86.5% of DS's shares, through a newly formed holding company Danmarks Skibskredit Holding A/S. Den Danske Maritime Fund still holds 10% of the share capital and has a claim on 15% of net profits. We believe that the influence of the pension funds will ensure the stability of DS' future operations. In particular, we anticipate that the three parties will have equal representation on decisions regarding the future of DS' stand-alone and consolidated capitalization, including the newly formed holding company. While we cannot rule out that partial financial sponsor ownership can lead to risks related to financial policy and risk appetite, we understand that the new owners intend to preserve DS' business model and conservative underwriting practices. We understand that the current business strategy will remain broadly intact and that the conservative management strategy and risk culture will stay in place.

The outlook for the shipping sector remains sluggish, with most segments suffering from overcapacity, even though fuel costs are low. While we expect DS will remain a small player within a volatile niche market, we see its position and revenue generation as relatively stable and anticipate that its prudent provisioning and funding policies will support it during the sector's current challenges, given its own reputation and assortment of solid, profitable ship-owners with diversified fleets.

Table 2

Danmarks Skibskredit A/S Business Position					
	--Year-ended Dec. 31--				
(%)	2016	2015	2014	2013	2012
Total revenues from business line (currency in millions)	974	729	1,057	912	1,045
Commercial banking/total revenues from business line	100	100	100	100	100
Commercial & retail banking/total revenues from business line	100	100	100	100	100
Return on equity	1.9	3.8	14.8	4.8	3.2

Capital and earnings: Very strong capitalization and earnings benefiting from superior operating efficiency

We view DS' capital and earnings as very strong, primarily based on our expectations that our projected RAC ratio, our main measure for capital adequacy, will remain well above our 15% threshold over the next two years.

We measure DS' risk-adjusted capital (RAC) ratio on a stand-alone basis to be 18.2% at end-2016, down from 20.0% in June 2016, due to the Danish krone (DKK) 1 billion (€135 million) extraordinary dividend paid to the holding company as part of the November acquisition. We anticipate the development of the loan book and dividend policy will work together to maintain stable RAC ratios of 18.0%-18.5% over the next two years. Our forecast takes into consideration minimal growth in loans and low earnings retention driven by high dividends.

While our focus is on the capitalization of the rated entity, we also review the consolidated capital situation, including Danmarks Skibskredit Holding A/S. At the consolidated level, we calculate the RAC ratio as 16.4% at end-2016. This includes the same portion of the tied-up capital reserve as is eligible in regulatory capital at the consolidated level. Including the remainder of the tied-up reserve would improve the capital ratio by 6.9 percentage points, which we see as supportive of our very strong capital assessment of the combined entity and meaningful for the combined view of risk and capital.

Table 3

Danmarks Skibskredit A/S Capital And Earnings					
	--Year-ended Dec. 31--				
(%)	2016	2015	2014	2013	2012
Tier 1 capital ratio	17.2	17.3	16.4	17.0	15.1
S&P RAC ratio before diversification	18.2	18.0	19.4	19.9	16.0
S&P RAC ratio after diversification	11.3	11.9	11.8	3.9	5.1
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	83.9	118.7	77.6	97.7	84.8
Fee income/operating revenues	3.3	5.6	10.8	4.9	4.6
Market-sensitive income/operating revenues	12.7	(24.3)	11.6	(2.7)	10.0
Noninterest expenses/operating revenues	12.5	15.6	9.4	10.9	9.1
Preprovision operating income/average assets	1.3	0.9	1.4	1.1	1.2
Core earnings/average managed assets	0.3	0.6	2.3	0.6	0.4

Table 4

Danmarks Skibskredit A/S RACF [Risk-Adjusted Capital Framework] Data

(Mil. DKK)	Exposure*	Basel II RWA	Average Basel II RW (%)	S&P Global Ratings RWA	Average S&P Global Ratings RW (%)
Credit risk					
Government and central banks	1,127	642	57	34	3
Institutions	5,923	1,026	17	1,047	18
Corporate	41,367	41,520	100	38,644	93
Retail	0	0	0	0	0
Of which mortgage	0	0	0	0	0
Securitization§	0	0	0	0	0
Other assets	860	1,075	125	900	105
Total credit risk	49,277	44,263	90	40,625	82
Market risk					
Equity in the banking book†	14	27	200	98	718
Trading book market risk	--	4,356	--	6,534	--
Total market risk	--	4,383	--	6,632	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	1,725	--	1,983	--
(Mil. DKK)		**Basel II RWA**		**S&P Global Ratings RWA**	**% of S&P Global Ratings RWA**
Diversification adjustments					
RWA before diversification		51,004		49,240	100
Total Diversification/Concentration Adjustments		--		30,133	61
RWA after diversification		51,004		79,373	161
(Mil. DKK)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		8,781	17.2	8,944	18.2
Capital ratio after adjustments‡		8,781	17.2	8,944	11.3

*Exposure at default. §Securitisation Exposure includes the securitisation tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital.DKK--Danish krone. Sources: Company data as of Dec. 31, 2016, S&P Global Ratings.

Risk position: Concentration risks well balanced by conservative underwriting and prudent provisioning

We consider DS' risk position as adequate, reflecting our view that its loan concentration risks are balanced by a conservative underwriting and provisioning policy that has resulted in a very strong track record of actual loan write downs versus peers in the segment. In our view, DS' strong capital position and risk-management performance mitigate its concentration in a very cyclical and capital-intense segment.

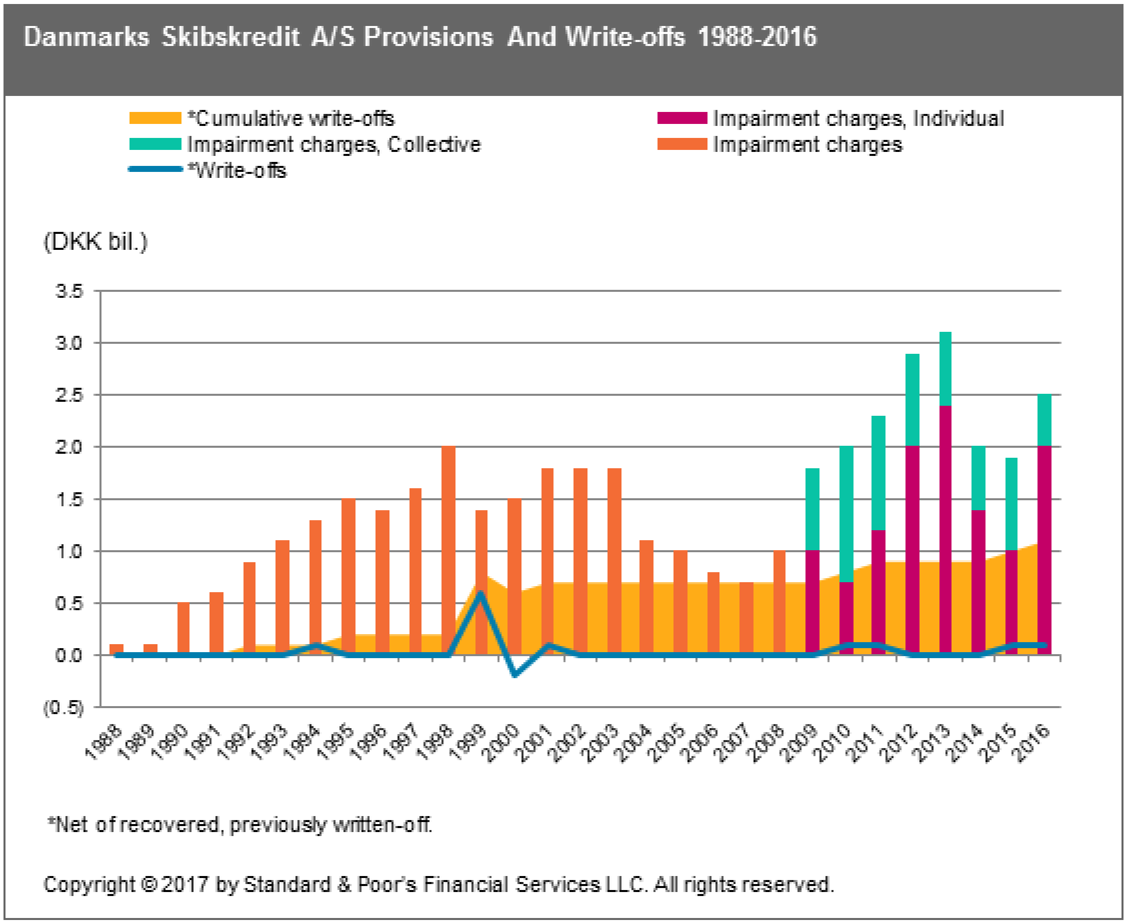
DS' lending is exclusively into ship financing, with 32% of the loans to Danish shipping companies, 16% to Norwegian, 14% to Greek, and 10% to German. We continue to view DS' loan portfolio as concentrated, with top-10 customers forming 45% of the loan book at Dec. 31, 2016 (although down from 66% at Dec. 31, 2009).

In spite of the increased risks associated with high concentrations, DS has demonstrated a stable track record of low impairment losses compared with peers'. For the year 2016, provisions increased to 1.4% of loans particularly because of the increase in problem loans in the offshore and dry bulk segments. Provisioning levels have averaged 10 bps in the last five years, which includes a large reversal of 243 bps in 2014. We expect provisioning will be around 1% of loans in 2017, considering the continued difficulties in the offshore segment. However, we acknowledge that DS is prudent in its provisioning by assuming stressed collateral values and 100% default probabilities for all customers showing evidence of impairment. Provisions averaged 65 bps of loans in 2010-2013 when the highly cyclical shipping industry, to which DS lends, had its worst historic downturn. The minimal impact on DS' realized losses results from what we believe to be very conservative underwriting standards, focusing on reputable counterparties with material fleet sizes.

We expect that lending will remain focused on a select niche of relatively strong clients in the shipping segment and that the allowance account, which was increased to 5.9% of loans from 4.3% a year ago (see chart 1), will remain a strong cushion for future write-offs associated with a deep and long-lasting stressed shipping and offshore environment.

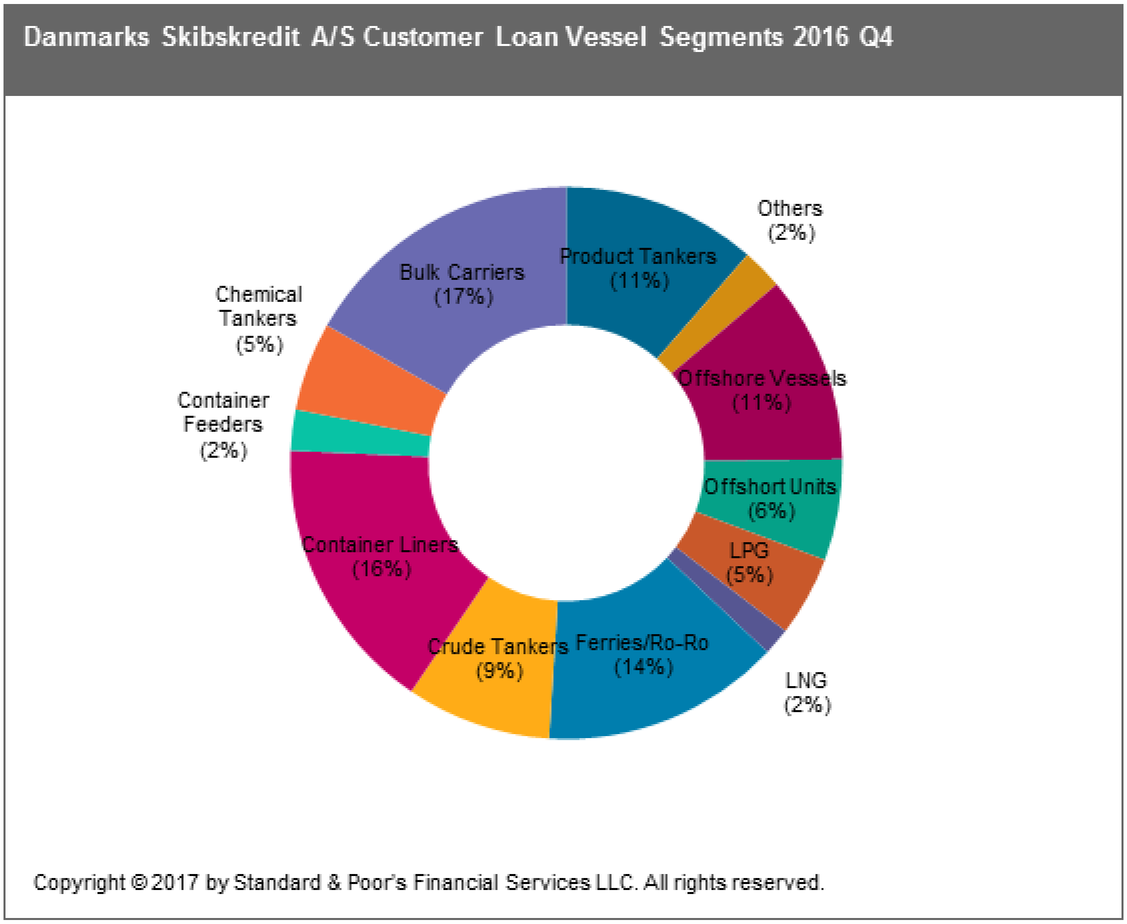
We note the historically actual write-offs for DS differ materially from the provision levels, with only 22 basis points of loans written off in 2016 compared to nonperforming loans of 16.5% (chart 1). However, current provisions are 2.3 times 30 years of cumulative write-offs, an indication that the current stress in DS' key segments is significant. In our view, this downturn has the potential to continue due to persistent oversupply concerns, low shipping rates, and offshore customers' continued low oil exploration and drilling activity.

Chart 1



DS has about 70 unique clients for which it finances over 500 vessels on first-lien mortgages across a wide variety of vessel types (chart 2). The average loan-to-value ratio after impairment charges was 66% at Dec. 31, 2016, up from 63% the previous year, due to reduced collateral values.

Chart 2



DS is exposed to market risks through changing interest rates, which affect the market value of its securities portfolio and through exchange rate fluctuations, primarily between the Danish krone (DKK) and the U.S. dollar, which is the preferred lending currency. These have translation effects on the financial statements and the issuer's capital ratios due to volatility in the value of loan exposures in DKK.

Table 5

Danmarks Skibskredit A/S Risk Position					
	--Year-ended Dec. 31--				
(%)	**2016**	**2015**	**2014**	**2013**	**2012**
Growth in customer loans	(6.2)	(0.4)	(0.3)	(7.7)	(0.1)
Total diversification adjustment / S&P RWA before diversification	61.2	51.1	64.2	415.5	216.6
Total managed assets/adjusted common equity (x)	7.0	6.5	7.0	7.0	8.7
New loan loss provisions/average customer loans	1.4	0.1	(2.4)	0.4	1.1
Net charge-offs/average customer loans	0.2	0.2	0.1	0.1	0.0
Gross nonperforming assets/customer loans + other real estate owned	16.5	9.2	8.7	15.1	13.7
Loan loss reserves/gross nonperforming assets	36.0	46.9	50.0	44.6	42.7

Funding and liquidity: Prefunding balances a narrow wholesale based funding model

We consider DS' funding as below average, since it does not have direct or indirect access to central bank funding. We view DS' liquidity as strong, reflecting its high level of liquid assets to adequately cover its short-term wholesale needs.

DS is entirely wholesale-funded through bonds. It has a match-funded lending book fully backed by the issuance of wholesale mortgage bonds, based on the balance principle that requires strict matching of interest rates and currencies. This results in a stable funding ratio of 118% as of Dec. 31, 2016, which is significantly better than all its domestic peers. However, DS' bonds are, since April 1, 2015, no longer eligible for repurchase transactions with the central bank. The central bank's motivation is to decrease its administrative burden; Danish banks also have substantial mortgage bonds eligible for repurchase transactions with the central bank. We understand that no other direct or indirect access to the central bank is currently available to DS, which leads us to view DS' funding position as below average as prescribed by our methodology in cases where there is no central bank access as a lender of last resort in times of stress.

Despite this, we regard DS' liquidity as strong, based on generous buffers of good quality liquid assets. At year-end 2016, the company had DKK20.8 billion liquid assets in the form of bank deposits and liquid securities, almost exclusively consisting of repo-agreement-eligible 'AAA' rated covered bonds. The ratio of broad liquid assets to short-term wholesale funding stood at 2.3x at Dec. 31, 2016, with a five-year average of 2.5x in 2012-2016. DS could withstand a scenario where 30% of the portfolio is lost and make timely payments on outstanding debt for eight years without accessing wholesale markets. This is due to cash flows coming from performing loans and bonds that are fully matched, as well as the sizable liquidity portfolio amounting to DKK19.7 billion (31.5% of the balance sheet; €2.6 billion) on Dec. 31, 2016. The regulatory liquidity coverage ratio was 631% for DS at end-December 2016.

Table 6

Danmarks Skibskredit A/S Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	**2016**	**2015**	**2014**	**2013**	**2012**
Core deposits/funding base	0.0	0.0	0.0	0.0	0.0
Long term funding ratio	84.0	90.3	77.7	89.7	77.2
Stable funding ratio	118.3	122.6	114.3	135.6	128.0
Short-term wholesale funding/funding base	19.1	11.8	26.9	12.1	26.0
Broad liquid assets/short-term wholesale funding (x)	2.3	3.4	1.7	3.3	1.8
Short-term wholesale funding/total wholesale funding	19.1	11.8	26.9	12.1	26.0
Narrow liquid assets/3-month wholesale funding (x)	2.6	3.4	2.4	3.3	2.3

Support: No uplift to the SACP, as no extraordinary support assumptions considered

We do not factor in any external support to DS' SACP. We consider DS to have low systemic importance in Denmark and, following the implementation of the bail-in provisions in the Bank Recovery and Resolution Directive in June 2015, we view government support as uncertain for senior unsecured creditors. As such, we do not add any notches to the issuer credit rating for government support.

Additional rating factors: One-notch uplift due to superior funding metrics

We add one notch of uplift to DS based on its superior funding metrics and resilience to stress or lack of market access to funding, even though it doesn't have access to the central bank for its funding needs. We expect that DS will continue to manage its funding and liquidity risk far more conservatively than most direct peers, exemplified by fully matched loans and bonds. Similarly, we expect DS will continue demonstrating superior metrics and a stronger resilience to abrupt market dislocations, which partly offsets our concerns about lack of access to the central bank.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions, Dec. 6, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Denmark-Based Danmarks Skibskredit 'BBB+/A-2' Ratings Affirmed; Outlook Remains Negative Due To Sector Pressure, May 23, 2017
- Danmarks Skibskredit Outlook Revised To Negative On Ownership Transfer Plan; 'BBB+/A-2' Ratings Affirmed, Sept. 28, 2016
- Denmark-Based Danmarks Skibskredit Rated 'BBB+/A-2'; Outlook Stable, Feb. 4, 2016
- Banking Industry Country Risk Assessment: Denmark, Dec. 19, 2016

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	**3**	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	**bbb+**	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of June 27, 2017)

Danmarks Skibskredit A/S	
Counterparty Credit Rating	BBB+/Negative/A-2
Senior Secured	A/Negative
Counterparty Credit Ratings History	
28-Sep-2016	BBB+/Negative/A-2
04-Feb-2016	BBB+/Stable/A-2
Sovereign Rating	
Denmark (Kingdom of)	AAA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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