DANMARKS SKIBSKREDIT

26 March 2018

Chairman's report 2018

“2017 was the first full year under our new ownership and with new members of the Board of Directors elected by the shareholders. As a natural consequence of the changed composition of the Board, with only the employee-elected members continuing after the takeover, the company’s strategy was reviewed in the early months of the year and an action plan was formulated for the years ahead.

The strategic review reaffirmed the foundation of Danish Ship Finance’s business model. Danish Ship Finance will continue growing its business based on a balanced approach to lending, focusing on reputable shipowners and transactions with high credit ratings. On the funding side as well, we will maintain our robust profile.

A number of areas were identified to which we are going to dedicate special focus in the years ahead besides our ongoing lending business. Allow me to name the most important areas:

We will focus on retaining the role of ship financing in the legislative frameworks. We have made a substantial effort in connection with the pre-legislative work in the European Union to ensure that ships continue to be equated to real estate. During the year, Boston Consulting Group prepared a report which confirmed that the risk profile of covered bonds secured by ship mortgages corresponds to that of covered bonds secured by mortgages on real estate. On 12 March 2018, the European Commission issued a proposal for revision of the relevant provisions of the Capital Requirements Regulation, and the status of ships in the proposal is unchanged, which is satisfactory. What remains now is to follow the proposal through by way of continued consultations with decisions-makers in Brussels. In this connection, we would like to thank the Danish Government’s Implementation Committee for its active efforts in safeguarding Danish maritime interests in this matter.

We will focus on diversification of the company’s funding, which is currently sourced in the Danish market only. The Danish bond market will remain the primary source of funding, but as the company’s bonds are priced on the basis of Danish mortgage covered bonds, a correlation exists which may be inexpedient in periods of financial turmoil. From time to time, the spread between Danish covered bond yields and swap rates widens, and such spread widening also impacts ship mortgage bonds. When that happens, the company’s competitiveness is reduced, as our competitors – which are mainly international universal banks – tap other funding markets. For this reason, it is desirable for the company to have access to markets other than the Danish market. The company’s base prospectus and various administrative systems were updated in the course of 2017 to allow for issuance of covered bonds in foreign currency and also in Danish kroner. So far, it has not been attractive to launch issues outside Denmark, but we are monitoring the market for opportunities.

We wish to pursue the opportunity to expand lending without straining the company’s balance sheet. This may be achieved, for example, by sharing ship loans with institutional investors, with the company still assuming part of the risk but handling the administration of the entire loan. We will intensify our efforts in this area for the remainder of 2018 and in the coming years. If we succeed in this effort, it will contribute to earnings and make the company even more relevant for the largest and most creditworthy customers.

The last point I wish to mention is that, in 2017, we intensified our efforts to make the company an even more relevant partner for discussions with our customers. In addition to the ongoing dialogue about loans, the company’s research function is increasingly involved in the dialogue with our customers, one of the main themes being digitisation of the maritime industries. This effort will be expanded further in the years ahead.

The shipping market
In general, 2017 was yet another difficult year for the shipping industry, but let me begin with a positive story.

Following a historical low in 2016 when the market touched bottom around the beginning of the year, the Dry Bulk market continued the recovery that began in late 2016. Average freight rates were 70% higher in 2017 than in the preceding year, and the surge in secondhand values that set in towards the end of 2016 continued and even accelerated slightly during the year, so that the market recorded increasing secondhand values for the second year in a row.

The Offshore segments continue to struggle with huge challenges. We again saw very low demand for supply vessels in 2017, which meant that many vessels are still stacked and an even greater number found it difficult to attract profitable employment. Towards the end of the year, there was an increase in the number of new offshore projects backed by final investment commitments. However, these projects have been under way for a long time and are not likely to have any serious impact on demand until a couple of years from now.

In the Tanker market, the general theme during the year was very low freight rates despite robust demand for oil and oil products. Freight rates were depressed due to the oversupply of vessels from the shipyards. Tanker shipowners increased scrapping activity during 2017 – a positive trend which appears to have continued into the new year.

The Container market is still seeing fierce competition, and the consolidation wave continued apace during the year. Demand grew considerably, causing a steady rise in box rates over the year, which was favourable for liner shipowners in particular. Because of the continued overcapacity in the market, many tonnage providers found it difficult to deploy their vessels at acceptable rates.

The Gas Tanker market was characterised by high fleet growth, which offset the otherwise strong growth in demand and kept both freight rates and secondhand values at historically low levels. Going forward, however, we expect decent growth in demand in the Gas Tanker segments.

The segment comprising ferries and Ro-Ro vessels generally had another good year, while the market for car carriers came under pressure. It is difficult to provide a general description of trends in this market, which differ significantly according to the regional situation and the shipping companies' market position.

All in all, we can conclude that the shipping industry has not yet emerged from the downturn that set in after the financial crisis a decade ago. On a positive note, however, a growing number of shipping companies are trying out various digitisation projects in an attempt to streamline their operations and, in some cases, even to expand their business areas. Generally, we do not expect freight rates to return to pre-crisis levels and we therefore find it positive that many shipowners are trying to adapt to what, we believe, will be the new reality.

Lending
As will be apparent from the review of the financial statements, lending measured in DKK declined. This was mainly a consequence of a plunging USD in the last few months of 2017. Measured in lending currencies, lending was only slightly reduced. Looking at the level of loan offers, the number of accepted loan offers more than doubled compared to 2016, and compared to 2015 as well. Issued loan offers totalled more than DKK 10 billion, which corresponds to over 25% of outstanding loans. This does not mean that the loan volume will increase dramatically as ordinary and extraordinary repayments on existing loans annually amount to some 15-20%. But it is a step forward in bringing total lending back within the range of DKK 40-45 billion, which is the company's overall target under current market conditions.

Competitive situation
The competitive situation is slowly improving, albeit with no noticeable effect so far on the credit margins on the best customers. The reason for our cautious optimism on this point is that several, but not all, of our European competitors are still scaling down their lending to the shipping industry, which should make for business opportunities in the short and, perhaps particularly, medium term as the consequences of the proposals of the Basel Committee, also known as Basel IV, are incorporated into legislation. The rules are intended to take effect from 2022 with a phase-in period until 2027. Those of our competitors who will have to reassess the weighting of shipping loans for capital requirement purposes, are expected to start organising their lending activities according to the future rules well before they enter into force.

We have noted that Chinese leasing companies are pursuing a rather aggressive strategy to enter the market of international ship financing, which could have a significant impact on the future competitive situation.

Bond issuance
On the funding side, 2017 was a good year. Issuance of long-dated bonds totalled just over DKK 19 billion, and buybacks of shorter-dated bonds amounted to about DKK 15 billion. The average maturity of the funding thereby increased by just over two years. Moreover, bonds were issued at increasingly better spreads to CIBOR, which is the benchmark against which we measure our DKK funding. Towards the end of 2017, we issued bonds at a spread to CIBOR that nearly matched the level observed before the onset of the financial crisis in 2008. As most of our loans are issued in USD, the trend in our funding denominated in DKK combined with a slightly falling price of what is known as the basis swap, which in simple terms 'swaps' our Danish kroner into US dollars, resulted in an increasingly favourable funding position in USD.

Changes to the Executive Board
In December 2017 we announced that Michael Frisch would join the Executive Board and had been appointed Head of Customer Relations. Michael will join us on 9 April 2018. After the end of the financial year, we announced in March 2018 that the CFO Per Schnack will leave his post by the end of June. He will be succeeded by Lars Jebjerg, who will join the company as our new CFO on 1 July at the latest. I wish to take this opportunity to thank Per Schnack for his substantial and dedicated service for the company.

Management remuneration
The Danish Financial Business Act stipulates that the Chairman of the Board, in his report at the general meeting, must account for the remuneration of the management in the preceding financial year and the expected remuneration in the current and upcoming financial years.

With respect to the remuneration for 2017, I refer to note 8 of the Annual Report.

The remuneration of the Board of Directors and the Executive Board for 2018 is specified in our remuneration policy for 2018, which is available on the company's website. It can be seen from the remuneration policy for 2018 that the remuneration of the Board of Directors is unchanged from 2017. The annual remuneration of the Executive Board was adjusted with effect from 1 January 2018. Before the general meeting in 2017, the Executive Board received a retention bonus in the form of equity-like instruments with a view to incentivising the long-term value creation in the company. The instruments comply with the requirements 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 Executive Board remuneration that will reflect market conditions.

I will now briefly present the income statement and the main balance sheet items.

Income statement
Net profit for the year was DKK 342 million, which was a rise from the DKK 200 million achieved in 2016.

Net profit for the year was affected by lower lending activity and loan impairment charges. Measured in DKK, the loan portfolio decreased by just over 13%, which had a negative impact on earnings from lending.

Loan impairment charges totalled DKK 122 million in 2017, against DKK 610 million in 2016. Loan impairment charges in 2016 were exceptionally high as a result of the crisis in the Offshore and Dry Bulk segments. Net write-offs were largely unchanged and at a low level, which was ascribed to the loan impairment charges made in preceding years.

The securities portfolio yielded a satisfactory return of 3.1%, which was marginally lower than in 2016. The company recorded a decline in interest income from finance activities and a rise in capital gains on finance activities.

Total capital gains dropped from DKK 124 million in 2016 to DKK 37 million in 2017. The drop in capital gains in 2017 should be seen in the context of a negative effect of DKK 151 million from buybacks of previously issued bonds at prices above the carrying amount. This expense is expected to result in largely similar, positive contributions in the coming years.

Total net interest and fee income declined from DKK 849 million in 2016 to DKK 655 million in 2017.

Costs increased to DKK 141 million from DKK 120 million, in part as a result of a number of strategic initiatives.

Balance sheet
As mentioned, lending decreased in 2017. At the end of 2017, loans after loan impairment charges totalled DKK 34.5 billion, against DKK 39.8 billion at the end of 2016.
A minor decline in lending was expected, but total lending at the end of the year was somewhat lower than expected on account of the weaker USD versus the DKK. In foreign exchange terms, lending maintained the level recorded at the end of 2016.

Total assets fell to DKK 58.2 billion at the end of 2017 from DKK 62.6 million at the end of 2016.

The lower USD reduced the size of the loans measured in DKK, with an ensuing positive impact on the total capital ratio, which rose to 19.7% at the end of 2017, compared with 17.2% at the end of 2016.

The company's liquidity and capital position remains very robust.

Conclusions
All in all, we delivered acceptable results in 2017 in a shipping market which continued to be difficult. The company gained new customers, and we are cautiously optimistic on a number of shipping segments. Against this backdrop, and combined with the ongoing improvement in the competitive situation, the company is well prepared for expansion of its lending capacity in 2018 onwards.

In closing my report, I would like to thank the company's employees for their great and dedicated efforts. The Board of Directors is well aware of the great effort put in by the employees in their everyday work. We perceive the organisation as working well and having a high level of employee satisfaction, which we on the Board are pleased to note."