The Chairman’s report 2020

I feel compelled to start this year’s report by addressing the severe issues that the global community is facing as the COVID-19 pandemic spreads across all continents. The authorities have thankfully taken the threat very seriously and have put substantial efforts into limiting the spread. At Danish Ship Finance we have done the same, and over the past weeks a substantial part of our employees has been working from home. The ones who have had to work from the office, to make sure operations run as smoothly as possible, have had to comply with extra strict rules regarding hygiene, lunch routines, keeping a distance etc.

While the past couple of weeks have brought about unprecedented challenges, it has been encouraging to witness how the organization has managed to regroup and continue the work amid unfamiliar circumstances. On behalf of the Board, I would like to take this opportunity to thank the employees for their efforts not just during these challenging times, but in general for the hard work they continue to do for Danish Ship Finance, its clients and stakeholders.

The pandemic is not just affecting how we run our business, it is to a much larger extent affecting our clients. The shipping markets are dealing with the effects of lower global economic activity which is causing a temporary decline in global seaborne trade volumes. The significant drop in oil prices has had a slight rebalancing effect on the overall market in the form of lower bunker costs, but we still expect the pandemic to leave a mark on the shipping markets’ performance in 2020, on some segments more than others. That said, we do expect global seaborne trade volumes to rebalance and resume the growth trajectory once the effects of the pandemic subside. Shipping is an industry accustomed to volatility and demand shortfalls, and it has various means at its disposal for limiting supply in response to declining demand – more scrapping, less ordering/delayed delivery and slow steaming. I will go more into the performance of the individual ship segments later in my report.

Although we expect no one to be immune to the consequences of this pandemic, we find some comfort in our careful approach to client selection and believe that our clients are better positioned to weather a prolonged period with lower seaborne trade volumes. However, if it becomes necessary, we will do our best to support our clients through these difficult times.

If we leave the current situation for a bit and look back at 2019, I can report on an active year that brought about promising lending growth, a healthy development in credit quality, but unfortunately also an unsatisfactory result from investment activities. Hence, the result ended lower than expected, but the development on the lending side leaves us cautiously optimistic for 2020 although the current state of affairs has made forecasting extremely challenging.

Our overall strategic direction has remained unchanged over the past many years. Our objective is to provide competitive ship financing to reputable ship owners while adhering to our prudent credit policy and optimising returns on our low-risk loan portfolio. We have a vision of becoming the obvious choice in ship finance for all our stakeholders.

Three strategic focus areas are guiding our work: 1) Strengthening the core, 2) Operational excellence and 3) Diversification. Despite entering 2019 with a very long list of strategic and operational projects, we managed to execute on many of them and will continue this work in 2020. We will especially focus on strengthening the core business even further and improving internal processes and systems to ensure we can continue to add more clients in a sustainable and efficient way in the years ahead.

Sustainability has been a strategically important subject for us the last couple of years and our efforts were ramped up in 2019. Some of the initiatives that I would like to highlight are our commitment to the Poseidon Principles, which we joined as an initial Signatory, and the Getting to Zero Coalition. We also introduced a first version of sustainability ratings on all our clients, and these are now becoming an integrated part of the credit approval process. We are very aware of the responsibility we bear as a lender to an essential, global industry with a substantial carbon footprint, and we will do our utmost to support the transition to a more carbon-neutral industry. We will maintain a strong focus on this in 2020 and beyond.

Shipping markets

Looking at the shipping industry as a whole, it saw fundamentals improve during 2019 as the orderbook continued to decline and seaborne demand grew. The global orderbook came down to just below 9% and global seaborne trade managed to grow by 1% despite the uncertainty created by geopolitical tensions and trade conflicts. Although we expect 2020 to become a challenging year for shipping, the industry has time and again proved capable of steering through crises.

The Dry Bulk market saw both ups and downs during 2019. The smaller vessel sizes generally experienced a slight positive development over the year, benefitting from being more flexible and serving a more versatile group of commodities, whereas the larger vessels, especially Capesize, struggled with absorbing relatively high fleet grow. The lower industrial activity in China caused by the COVID-19 pandemic has especially affected the larger vessels and combined with the global climate agenda and the global push for more circular material flows, it has created a difficult employment outlook for the young and expanding fleet.

The Container markets continue to be characterised by an inflow of large vessels which causes surplus capacity to be cascaded down to smaller vessels' routes. Some vessels are caught in the middle, being too big to be cascaded any further. Vessels with high bunker consumption are increasingly likely to be scrapped during the next few years. When the COVID-19 virus broke out in China it decreased production of containerized goods partly due to quarantines of workers. The following outbreak in Europe and increasingly also in the US seems to be decreasing demand for containerised goods as spending has slowed. Hence, the Container markets will be feeling the pressure of the pandemic in the short to medium term.

The Tanker markets enjoyed increasing freight rates in 2019 despite a slight contraction in seaborne volumes. Longer travel distances combined with a number of temporary factors have kept fleet availability low and kept demand ahead of supply growth. Even with the temporary boost generated by the significant drop in oil prices, the COVID-19 pandemic is expected to lower oil demand in the short to medium term as air travel, transportation in general and industrial production slows down.

The Gas markets experienced strong demand growth for both liquified natural gas (LNG) and liquified petroleum gas (LPG) products in 2019. Low commodity prices increased end-user demand and created artificially high seaborne gas demand and higher freight rates. The effects of COVID-19 are expected to be limited on these segments although they will be negatively affected by a period with lower or no economic growth.

The Offshore sector has not yet recovered from the severe downturn starting in late 2014. There is still a significant supply surplus in the industry, but market activity slowly began to pick up in 2019 and vessels were returned to service. The significant drop in oil prices is however expected to reverse some of the positive trends in the market and move a meaningful recovery of the industry even further into the future.

Lending

Turning to the lending side, the loan book continued the upward trajectory that started in 2018, and by year-end 2019 it reached DKK 41.4 billion before loan impairment charges. This equaled an increase of DKK 1.8 billion or 5% compared to 2018. New loans of DKK 7.3 billion were disbursed over the year and five new clients added to the portfolio. Although new lending activity was marginally below the high level observed in 2018, new loan offers of DKK 7.0 billion were accepted at reasonable margins and with a good credit quality.

We find ourselves in a good position to grow the loan book further in the coming years.

The competitive situation

I have previously reported on how the competitive landscape for ship financing is shifting towards Asian lenders and how a number of European lenders are scaling back their shipping exposures. This trend continued in 2019 and we expect it to do so going forward, intensified by the anticipated changes in capital requirements for IRB institutions brought about by Basel IV.

We see ourselves maintaining a strong competitive position in this landscape. Our strong focus on building long-term relationships with our clients and leveraging our broad sector knowledge is still highly valued by clients. This was evident in the results of the annual client survey. That said, a number of difficult years for the shipping markets have forced many lenders to focus on the top tier names and competition has been fierce for this target group. This will, however, not cause us to change our focus. We will remain dedicated to the most reputable ship owners and maintain our high credit standards.

Bond issuance

At the last general meeting in March 2019, I had the pleasure of announcing that we had just issued our first Euro-denominated ship covered bond. This was a top priority in relation to the strategic focus area Diversification as it enables us to diversify our funding sources. Since then we have made another Euro issuance, and by the end of 2019, our Euro covered bond program accounted for 16% of total outstanding bonds.

Our credit story resonated well with the European investors we met with on the two deal-related roadshows completed during 2019. In order to familiarize even more investors with our business model, we have increased our Investor Relations efforts and will work to expand the investor base even further in 2020. As outlined in our Annual Report, the Danish bond market will continue to be our primary source of funding.

We issued a total of DKK 13.9 billion last year at healthy spreads and had DKK 47.7 billion of outstanding bonds at year end with an average maturity of four years, slightly longer than the average maturity of the loan book.

Our ability to issue bonds at attractive spreads in both DKK and EUR were strengthened in August when S&P announced that our rating outlook would be upgraded to 'Stable' after more than two years with a 'Negative' outlook.

I will now present the 2019 results and the main items of the balance sheet.

Financial performance

Net profits for the year fell to DKK 227 million from DKK 262 million in 2018 due to the negative result from investment activities. Net interest income from lending developed positively reaching DKK 516 million, an increase of 8% compared to 2018.

Net income from investment fell to negative DKK 79 million from positive DKK 66 million in 2018. Interest income from financial activities fell to DKK 115 million and market value adjustments dropped to a negative DKK 197 million. The main reason was the falling interest rate environment, which made a large number of Danish homeowners refinance their mortgages at lower rates, generating market value losses on our portfolio of callable mortgage bonds. This is by no means a satisfactory result for us, and we have already implemented some new measures to strengthen the investment setup.

A general improvement in many of the larger shipping segments, except Offshore, resulted in a reversal of DKK 2 million in loan impairment charges for the year, compared to an expense of DKK 35 million in 2018. Hence, we saw the overall credit quality of the loan book improve and by year-end 99% of the loan book were covered within 60% of the market values of the mortgaged ships and the net NPL ratio had been reduced to 6.3% of the loan book, down from 8.4% in 2018.

However, the Offshore crisis continues to tie up many resources and it also resulted in an expected increase in net write-offs. Net write-offs debited to the allowance account reached DKK 486 million in 2019, up from DKK 298 million in 2018.

Costs increased to DKK 166 million from DKK 158 million in 2018, mainly reflecting a strong focus on implementing a range of strategic initiatives as well as new regulatory requirements.

Balance sheet

Net lending ended the year at DKK 39.1 billion after loan impairment charges, up from DKK 36.7 billion at year-end 2018 and the balance sheet increased to DKK 66.8 billion from DKK 62.3 billion.

The company continues to have a very robust liquidity and capital position. Despite strong lending growth, the total capital ratio remained high at 18.5%, markedly above the regulatory requirement of 12.5%.

Remuneration of Executive Board

According to the Danish Financial Business Act, the Chairman of the Board shall address the management's remuneration in the past financial year as well as expectations for the current and coming financial year.

I will allow myself to refer to note 8 of the recently published Annual Report for details on management remuneration in 2019.

The 2019 remuneration of the Board of Directors and Executive Board is specified in the remuneration policy, which can be found on the company website. It states that the base salary to the Executive Board increased slightly in 2019, reflecting a normalization of costs after the adjustments made to the Executive Board in 2018. The variable pay was reduced compared to 2018 to reflect the development in the underlying results.

According to the legislation, it is also my duty to express expectations for any adjustments in the remuneration for the next year. We expect to adjust the Executive Board's remuneration in line with prevailing market conditions.

On the agenda today is the approval of the remuneration policy. The content of the remuneration policy is basically unchanged although it has been clarified that all variable pay is granted on a discretionary basis. Furthermore, it has been adjusted with some additional explanatory text and information, following the new requirements in the Danish Companies Act. The Board of Directors recommends an approval of the remuneration policy.

Policy on a healthy corporate culture

In August 2019, the Board of Directors adopted a new policy on a healthy corporate culture, originating from an amendment made to the Danish Financial Business Act.

The objective of the amendment is to strengthen efforts related to avoidance of money laundering and financing of terrorism. The amendment included, among other things, a tightening of the rules related to the responsibilities of executives in financial institutions to ensure that the proper competencies and systems are in place in order to avoid money laundering.

We do not have to comply with the amendment, but we support the objective and has consequently established a dedicated policy. A draft for the executive order was sent in consultation in early 2020 and we will implement the outcome to the extent relevant.

The policy includes guidelines related to the prevention of money laundering, financing of terrorism and financial crime. It also addresses operational risk, reputational risk and handling of insider information. Moreover, we have set up a whistleblower scheme that allows all employees to anonymously report any misconduct directly to an external party.

Closing remarks

We are in overall terms very satisfied with what we achieved in 2019 on the lending side, and we plan to grow the loan book further this year. However, the COVID-19 pandemic will have an adverse effect on shipping and the financial markets, and it could potentially challenge our growth ambitions as we will not compromise on credit quality.

We will continue to follow the situation closely and securing the health of our employees and servicing our clients will remain our top priorities.