The Chairman's Report 2021

2020 was an unusual year. The promising start to 2020 took a dramatic turn in the first quarter when the Covid-19 pandemic spread across the world. A series of health-motivated restrictions on social and economic activity, trade and travel brought consequences that we all had to deal with.

Danish Ship Finance was also affected by Covid-19 and for large parts of the year, the organisation had to adapt to new, largely virtual ways of working as the majority of our employees worked from home. I am proud to say our it-systems and the employees of Danish Ship Finance made the transition easy. On behalf of the Board, I would like to take this opportunity to thank the employees for their efforts not just during these unusual times, but in general for the hard work they continue to do for Danish Ship Finance, its clients and stakeholders.

In addition to the organisational adaptations, the effects of the global Covid-19 crisis on financial markets and our clients also directly affected our result: severe turmoil in financial markets in March-April led to a significant full-year investment loss of DKK 99 million. This was followed by disruptions to oil markets, which led to increased loan impairments in the Offshore segments.

A significant positive in this challenging period was that credit quality outside Offshore held up well; no loans defaulted during the year and more clients than usual chose to prepay their loans in part or in full. This does once again, despite the negative side effects on our short-term earnings, confirm the robustness of our client selection.

The shipping industry is accustomed to volatility, and at the same time, vessel newbuild activity was very limited, making the industry well placed to sustain profitability while managing future changes in global trade. This resilience stems from the shipping industry's ability to swiftly adapt to new circumstances. I will comment on the performance of the individual ship segments later in my report.

If we zoom out from the immediate consequences of the Covid-19 pandemic, which after a year still holds the world in a bit of a deadlock, the overall strategic direction of Danish Ship Finance remains unchanged. Our objective is to finance reputable shipowners while adhering to a prudent credit policy and optimising our low-risk loan portfolio, and our vision is to be the obvious choice in ship finance for all our stakeholders.

Despite the unusual working conditions we made good progress with our strategic focus on improving internal processes to optimise our business, support commercial priorities and facilitate the implementation of new regulatory requirements during the year. In particular, we took steps to further strengthen our data, investment and risk management infrastructure.

Our top strategic priority for 2021 is to re-establish the strong momentum in our lending business and resume the growth trajectory that we enjoyed up to the global Covid-19 outbreak. It is encouraging that market activity increased towards the end of 2020, as evidenced by a strong pipeline of lending transactions, and we remain optimistic about the 2021 outlook.

Sustainability is another strategically important focus for us, and we build on the momentum we have gained in the past years. I would like to highlight a few key results from 2020 in this area: 1) It was our first full year with internal client sustainability ratings, and these have proved a valuable tool in our credit decision process and our dialogue with clients, 2) we granted the first new loans with pricing linked to clients' ability to reduce carbon emissions from their fleets, and last, but not least 3) we concluded our first annual Poseidon Principles reporting – a milestone in our work with the initiative after joining as one of the initial signatories in 2019.

Shipping markets

Examining the shipping industry and how it weathered the Covid-19 outbreak and the waves of regional lockdowns in 2020, the direct impact on the industry varied greatly between segments. Shipping is accustomed to volatility and the overall impact was not as severe as many may have expected. In the aftermath of the financial crisis of 2008-09, shipowners increased their use of lay-ups and slow steaming to balance supply and demand. Many of the same mechanisms were brought into play during 2020. Some segments even recorded periods with earnings at high levels not seen for years.

In the Container markets, due to strict capacity management by liner operators, the initial stroke was limited. Box rates increased in the latter part of 2020 as demand picked up. Timecharter rates suffered when the lock-downs were initiated, but managed to regain the lost territory in the second half of the year and is now benefiting from a strong market.

In the Dry Bulk market, demand for vessels came under pressure in 2020 due to a sharp decline in coal and minor bulk volumes. On the supply side, the fleet continued to expand rapidly, driven by a large inflow of Capesize vessels. The outlook for the smaller vessel segment is more positive, while a large orderbook and a blurred demand picture may challenge the Capesize segment.

For Gas Carriers, the market conditions weakened in 2020, with supply outpacing demand significantly as the Covid-19 pandemic lowered consumption of gas commodities. Freight rates declined accordingly during the year but recovered strongly during the fourth quarter. Uncertainty over future demand and large fleet growth have reduced expectations for rates and values for the coming year.

The Tanker markets were heavily impacted as global oil demand crashed in the first half of 2020 as a result of the Covid-19 restrictions, while OPEC+ embarked on a price war that flooded the market with excess oil. Vessels were used for storage, which caused freight rates to spike. While most vessels have returned to the market, demand remains low and freight rates have softened. Persistent Covid-19 restrictions are keeping vessels in surplus.

The Offshore sector was expected to begin a slow, long-awaited recovery at the end of 2019 and early 2020. However, Covid-19 and the oil price shock in the first half of 2020 have delayed the recovery further into the future. Offshore projects are being postponed and cancelled, lowering vessel demand and exacerbating the oversupply.

Car carriers saw a significant drop in demand in 2020, leading to extensive lay-ups of ships and increased scrapping. European ferry routes also saw a sharp drop in demand due to travel restrictions. For both segments, we expect the Covid-19 effects to be temporary. Notably, demand increased in the second half of 2020.

In general, the market conditions in the major shipping segments continue to be mixed, but the supply side is becoming more manageable with a low orderbook and consolidation in the yard industry. Still, average fleet utilisation declined during 2020, since global seaborne demand shrank while the fleet continued to grow. We expect 2021 to be a year of recovery with few new orders placed and more vessels scrapped. Seaborne trade volumes are expected to regain much of the lost territory, although the outlook in some segments is shrouded in uncertainty. The impact of the vaccine roll-out, geopolitical tensions, weakening macro conditions and technologies transforming the underlying industries are all elements that could impact seaborne trade volumes significantly in the years to come.

The strategic outlook is also changing in tandem with the unfolding climate agenda. The call to decarbonise the shipping industry is intensifying even though the regulatory side remains largely unsettled. No clear pathway to fully zero-carbon fuels has yet been identified. But shipowners are devoting significant resources to lowering emissions of existing vessels, and many are placing the issue of how to make decarbonisation a reality at the top of their agendas.

Lending

We are pleased that we were ready and able to fully support our clients through a challenging year.

New loans of DKK 6.5 billion were disbursed during 2020 and new loan offers accepted equalled DKK 6.6 billion (at year-end exchange rates). Loan offers were made at slightly better net margins than the average margins achieved in 2019. As at 31 December 2020, our loan book equalled DKK 33.6 billion, 19% lower than the year before. The decrease was primarily due to DKK 4.5 billion prepayments from clients, DKK 3.5 billion FX adjustments due to a declining USD and DKK 0.8 billion in net write-offs.

Net income from lending declined by DKK 44 million year-on year, as loan balances decreased and non-accrual Offshore loans weighed on income, while net margins remained resilient. At year-end 2020, the loan book was collateralised by a total of 792 vessels.

The competitive situation

The ship finance market in 2020 was severely impacted by the Covid-19 pandemic. In the first half of 2020, margins generally increased due to banks experiencing higher wholesale funding costs. During this period, large numbers of clients sought more flexible funding to ensure ample liquidity in case of a prolonged crisis. In the second half of 2020, the market stabilised and we saw more normalised competitive patterns being re-established in ship finance. Margins returned to levels only slightly above those of the pre-Covid-19 period.

European banks to a large extent provided the flexibility to clients demanded throughout 2020, but overall continued the trend of reducing their shipping exposure. We expect many banks to increase focus on core clients in their home regions.

Chinese leasing companies were less visible during the first half of 2020 but appears to have resumed their aggressive growth in the second half of the year, primarily acting as lessors in leasing transactions with ship owners.

Funding

Even though traditional face-to-face investor meetings proved almost impossible to arrange for much of the year, we were delighted to see interest from existing and new investors alike. We are pleased that our extensive dialogue with investors across Europe endured and this proves that our strong credit story resonates well both in the Danish market and internationally. The Danish bond market continues to be our primary source of funding.

Bond issuance in the Danish market continued to efficiently support our lending business. Domestic DKK ship covered bond issuance accounted for total gross issuance of DKK 7.9 billion in 2020. We did not issue new EUR bonds during the year, having gone to market in late 2019. At year-end 2020, we had DKK 42.5 billion of outstanding bonds with an average maturity of four years, of which 18% were denominated in EUR.

Financial performance

I will now address the 2020 result and present some of the main items from the balance sheet.

Net profit for the year fell to DKK 117 million from DKK 227 million in 2019 due to the negative result from investment activities and loan impairment charges. Net interest income, including fee income, reached DKK 522 million, a decrease of 4% compared to 2019, largely attributable to a lower average loan book through the year.

Net income from investment remained subdued at negative DKK 99 million, a further decline from negative DKK 79 million in 2019. Interest income from financial activities fell quite sharply to DKK 41 million and market value adjustments were a negative DKK 150 million. This is not satisfactory, and we have implemented new measures to strengthen the investment setup during 2020.

The Offshore segments were increasingly challenged by an adverse business environment as mentioned earlier. This resulted in loan impairment charges for the year of DKK 100 million, compared to an income of DKK 2 million in 2019. Still, the credit quality of the shipping loan book remained good overall in 2020, with 98% of loans covered within 60% of the collateral market values of the mortgaged ships and the net NPL ratio constituting 4.2% of the loan book after impairment charges, compared to 6.3% at the end of 2019.

The Offshore crisis continues to tie up many resources and also resulted in significantly increased net write-offs. Net write-offs debited to the allowance account reached DKK 805 million in 2020, up from DKK 486 million in 2019. While numbers are elevated compared to previous years, they are manageable and remain well within the amounts previously provided for on the total ECL allowance account.

Costs decreased to DKK 158 million from DKK 166 million in 2019, a decrease of approximately 5% that mainly reflects the success of active cost control measures and temporary cost reduction from reduced travel activity related to client meetings. In addition, performance-based variable pay was also significantly lower in 2020, compared to previous years.

Balance sheet

Net lending ended the year at DKK 31.9 billion after loan impairment charges, down from DKK 39.1 billion at year-end 2019 and the balance sheet decreased to DKK 59.8 billion from DKK 66.8 billion.

The company continues to have a very robust liquidity and capital position. A side effect of the negative lending growth in 2020 was an improved capital ratio at 22.3%, significantly above the regulatory requirement of 12.0%.

Remuneration of the 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 the recently published Remuneration Report 2020, which is available on the company website for details.

The Executive Board saw a slight increase to the base salary in 2020. However, in light of the low net profit for the year, the Executive Board was not awarded incentive bonuses. Instead, the Executive Board was granted warrants in Danish Ship Finance Holding, which will acquire value only if the value creation in the company results in a rise in the share price materialising upon a sale of shares or upon expiry of a specified period of time.

This reflects a change to the Remuneration Policy. Incentive bonuses in general are now, to a larger extent than previously, tied to the return for A-shareholders. The updated Remuneration Policy was approved by the Board of Directors in February 2021.

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.

Policy on a healthy corporate culture

As the Chairman, I also have to mention our approach to ensuring a healthy corporate culture, originating from an amendment made to the Danish Financial Business Act. We support the objective and has consequently established a dedicated policy in 2019 which we adhere to.

Closing remarks

We are in overall terms not satisfied with our result in 2020, which was heavily influenced by challenging conditions on both the lending and investment side of the business. Despite this setback to our growth plans, we remain optimistic about the 2021 outlook and aim to regain the momentum in our lending business. However, despite successful vaccine roll-outs the Covid-19 pandemic still creates a level of uncertainty about the future, the development of the global economy and our everyday lives.