PROCEEDINGS —
Seventeenth Annual Meeting

Theme:

"Beyond The Bicentennial:
The Transportation Challenge"

October 28-29-30, 1976
Sheraton-Boston Hotel
Boston, Massachusetts

Volume XVII • Number 1 1976

T
R
F

TRANSPORTATION RESEARCH FORUM

I WOULD LIKE to preface my remarks this afternoon by saying that I felt somewhat apprehensive when I was asked to address this distinguished gathering. I was apprehensive for three reasons. The first was because I work on the international side of Scotiabank and consequently know very little about Canadian shipping. The second because the title of the meeting indicated very long term planning and 20 years in a rapidly changing industry—and there is none more rapidly changing in character and direction than shipping—is a very long time indeed. The third reason was that as applied to the Canadian maritime industry, sad to say, as the latter is so small in terms relative both to the Canadian economy as a whole and to world shipping, there was a danger, it seemed to me, of my assuming a role of a medical practitioner attempting to prescribe highly sophisticated and expensive treatment before the patient's illness has been diagnosed.

Accordingly, I felt that the bulk of what I had to say should be devoted to matters with which I was reasonably familiar, and where I could draw upon the considerable expertise of my Bank without necessarily going back into its archives to the days of sail in Halifax and other East Coast ports.

I have decided, however, to try to limit reference in my remarks to applications which may be of most interest and practicability in any emergent Canadian shipping policy. The Hedlin Menzies Report and our Chairman's excellent and lucid study on The Elements of an International Shipping Policy for Canada make reference to petroleum products, grain, coal, wood products and other dry bulk cargo as being those commodities most suitable for transport by a Canadian owned merchant navy. Beside the shipment of these heavy bulk commodities, of further interest are containers, and if the wheel was a revolutionary invention, containerization must also, in the context of shipping, represent a new step forward in the movement of goods with major implications not only for shipping and for ports but for rail and road transportation. It is, therefore, mainly in regard to the financing of, and to the existing market for, on the international scene, tankers, product carriers, OBOs, bulkers and container ships that I intend to confine myself.

In September 1973 the world fleet of tankers (including product carriers) in existence or on order totalled 378,732,400 deadweight tons, or 70.7% of the existing or ordered bulk carrier fleet. Combined carriers accounted for 49,614,500 tons or 9.3% and other bulk carriers (excluding lakers) for 107,094,000 tons, the remaining 20%. I do not have the figures for container ships. Included in the foregoing figures were 178,000,000 tons of tankers on order.

In February 1975, there were 138,000,000 tons of ULCCs and VLCCs on order and in the same month of 1976, the outstanding orders had been reduced to 72.4 million tons. An important element in the reduction of the tonnage outstanding were cancellations amounting to 32,000,000 in 1975 which figure has since risen to something in excess of 40,000,000. It is significant that the substitution orders which represented an important bargaining element in the cancellations consisted very largely of handy size bulk carriers (the Japanese yards generally seem to have been working on a ratio of one 38,000 ton bulker for each 100/125,000 tons of tanker). Prices of new tanker buildings have also fallen substantially—that of a 210,000 tonner in 1973 being quoted at $47,000,000 and at the end of 1975 $38,000,000—that is, if anyone wanted to order one. Bulker prices have also fallen—a new 30,000 tonner in 1974 quoted at $16,500,000 now being offered for around $13,500,000.

In second-hand tonnages, a 300,000 ton tanker built in 1971 or early 1972 at a cost of about $42,000,000 might fetch today approximately $18,000,000.

Some other figures which may be of interest to you relate to container ships and OBOs. As at February 1976 there were 69 OBOs on order around the world totalling 8,382,000 tons and 237 container ships totaling 4,376,000 tons.

Of all the above, one small tanker and seven bulk carriers were, according to the records available to me, on order for Canada.

I do not have precise statistics—or for that matter—any worthwhile statistics at all—as to how these immense shipbuilding orders have been financed. It is safe to say, however, that a very substantial percentage has been financed—at least partially, out of the Eurodollar market. The Canadian banking system—like that of our cousins to the South—has played its part along with the U.K., French, German and other banks—not always, unhappily as you will all be aware, without pain.

The sad state of tankers in today's world markets and the very sensitive position of bulk carriers which may well follow tankers—and indeed have shown every sign of doing so—is something with which you must all be familiar. Whether the banking community as a whole or the tanker operators or the

Ship Financing 1976 — from the Point of View of a Commercial Bank

*by Phil Dodd**

shipbuilding countries are to blame may now be academic. However, it is clear that easy availability in the Eurocurrency market combined with intense competition in the banking community, easy financing terms offered by yards and an abundance of shipowners eager and anxious to capitalize on a market temporarily short of shipping were the ingredients in a pot which was to be brought to the boil and spilled over by the OPEC embargo and price hike of 1973.

In the early 1970s, too many lenders rushed in where there had been a comparatively few specialized shipping lenders in the 1960s. Government handed out cheap building credits to create employment. Major tanker operators ordered without contracts or charters and bankers in many cases forgot their customary caution.

With the present chaotic state in the tanker market which will probably last into the 1980s and a looming oversupply of bulk carriers, what is the likely attitude of lenders today and how are and will new orders be financed?

The ingredients for eligibility for banking assistance are traditionally the three Cs, capital, capacity and character. While the ship operating industry has some major differences with regard to industry in general when you come to examine its balance sheets, and cash flows, nevertheless recent events have demonstrated that the three Cs have equal application to this important industry, notwithstanding some differences in interpretation and application.

The overbuilding which has resulted in the major oversupply situation today has seen several operators (some very highly esteemed names among them) go to the wall or at best make compromises of a kind they would not have conceived as possible three years ago. Those operators with limited capital on which to draw and with a heavily overlevered position without assured cash flow have failed or are struggling against failure. Those with relatively secure cash flows from charters agreed before newbuildings were ordered or delivered are generally surviving—and must be breathing deep sighs of relief with their bankers—because many of these were in highly over-levered positions in terms of debt vs. equity.

I have used the term "relatively secure" because the value of a ship, as you are all aware, most often lies in the value of its charter and if a charterer fails today, the penalty for a tanker owner is likely to be severe.

The second and third ingredients of capacity and character are still to be found in the shipping world in generous numbers. The events of the last three years will have reminded them, and many needed no reminding having been schooled well in a trade with its ups and downs—that the unexpected must be guarded against. Shipowners recognize that this is a time in which to exercise discretion and also one wherein may lie valuable opportunities.

As in the U.K. property market, the shakeout will result in good buys for those in a position to put the property to work and to return, in a reasonable period, a reasonable profit. Certain types of ships remain reasonably attractive both to the owner and lender.

The shipbuilding world, national governments, owners and bankers have reacted to the current liquidity problems in shipping in a variety of ways. For those fortunate owners with sufficient capital resources and/or assured cash flows from firm and profitable charters, there has been little need for extraordinary action. For those, however, less fortunate some intuitive thinking has been evident in stalling off or avoiding bankruptcy in certain cases, while at the same time orders which would otherwise have been cancelled have continued through the construction stage to delivery by innovative support given by bankers, yards and governments. Some of these are likely to be of interest to you.

- The substitution of a different class of vessel or vessels for the original order. As indicated previously, many substitution orders for tankers have been bulk carriers which orders in themselves promise a dangerous oversupply of this class of vessel in 1978 and later. In such cases the predelivery and post delivery financing have often seen some change from the original conceptions. Banks providing post financing by way of guarantee of notes or direct loans have

**Assistant General Mgr.-International Operations, The Bank of Nova Scotia.*

strengthened their security or the yards have assisted with the provision of somewhat more favorable terms in some cases taking second and third mortgage positions over longer payout periods.

● By way of government assistance, as an example, the Norwegians have established their Guarantee Institute primarily to prevent the sell off of their ships to foreign owners. At present this Institute appears to have some limitations as to its capabilities and it is not yet clear how it will effectively help certain Norwegian owners.

Norwegian shipping needs are very substantial and the scope and size of the Institute's operations may have to be enlarged.

● Other governments have provided major assistance to shipowners and yards by direct or indirect assistance or by guaranteeing consortia bank loans to the builders, the proceeds of which have been flowed through to the ship owners in term finance form.

● In the private sector the banking community involved in ship financing has been engaged in intensive efforts to prevent some owners from going into bankruptcy. Such efforts concern themselves with short term and long term rescue programmes. The short term efforts are persuasively aimed at having owners sell off assets to meet immediate cash demands, to cancel or renegotiate orders and to phase down operations; the long term assistance representing in return extended payouts, and or moratoria on payments. In all of this the banks are to some extent working on a best guess basis of an estimated turn around date for tanker and bulk carrier markets.

Unfortunately, crystal ball gazing is not always infallible and it remains to be seen whether the shipping market has reached its bottom in all the sectors which are affected or are going to be affected. By bottom, I do not mean a floor in the sense of freights and charter prices but from the owner's point of view, the crucial point when neither he is able to nor his bank in good conscience can continue to generate sufficient funds to keep the owner going.

In many cases, loans still current may go into default and while in numerous such cases it is possible now to predict the crisis point when cash resources, generated from operations or sell off programmes, fail to meet outgo in servicing debt, it is not possible to predict with any great assurance the point of balance in the market where demand will once again begin to push rates up to more economic levels.

Apart from the difficulties created by the oversupply in shipping, there are, from the lending banks' point of view, the further imponderables insofar as the independent shipping operator is concerned, of the impact of the centrally controlled shipping lines of the Soviet Union, other Eastern bloc countries and the emerging National Lines of South America, OPEC countries and so on.

It is clear that the Soviet Union is determined to emerge as a major force in the shipping world for reasons other than purely economic. What the combined efforts of such countries will be has yet to be determined but can well be imagined.

It is perhaps not illogical to conclude that the day of the independent operator as we have known him is over, notwithstanding Mr. Reksten's assurances to the contrary. Is it perhaps the case that the present disastrous situation in tankers and bulk carriers has merely accelerated the day when the ownership of large bulkers will be changed out of all recognition? And perhaps also it will not end there as again, the Soviet interest is clearly to penetrate deeply into the liner and passenger trades.

If I appear unduly gloomy I hope that you will forgive me, but it is apparent that more is involved in the current state of world shipping than merely an oversupply in certain types—and some of the implications are indeed disquieting.

For all of this, ships are going to be around for a long time and in increasing numbers. The pattern and form of lending by banks will change but the need and opportunity for participation will remain. The worst kind of lending risk must be avoided. Undiversified business activities, vessels operating in the spot market without the owner having adequate financial strength in the background, uncancellable building contracts, newbuildings without charters, charters to companies without adequate financial strength or assurance of continuing in being, over leveraging and owners sensitive to political or punitive tax changes, etc.

The objective of any lending bank in today's market must be to lend on a sound basis. The criteria to be applied where the security rests in the vessel, should include—

● full knowledge of the affairs of the borrower. This has not always been forthcoming in the past. Borrowers, especially owners of fleets, each component vessel of which is in a one ship company, must be prepared to 'open up the safe' and satisfy the lenders.

● consolidated cash flows, capitalization, debt structure, employment of vessels, charter rates are a pre-requisite.

● assured charter income sufficient to fully service the debt to be undertaken, over the life of the charter—in other words, establish capacity from cash flow to ensure repayment.

- the charterer's financial position must be sound and his ability to perform, unquestioned.
- the owner's record, expertise and proven ability to operate ships must clearly be established.
- the security to be provided will, of course, need to be properly documented and beyond attack before advances are made.

You will note that I have not made mention of the percentage of cost of a vessel which may be financed, nor interest rates. These will, of necessity, vary, the one a product of the debt service capability arising from income to be earned (after proper allowance for inflation if a time charter or contract of affreightment), the other a variable depending on the market place. Due allowance in the debt service capability must be made for date fluctuations.

During the last two years, Eurodollar rates have moved from highs in the double figures to the present low levels —themselves reflecting U.S. fiscal and monetary policies. Allowances must also be taken into account of the currency of the charter and the group's (if a group is involved) exposure to foreign currency debt differing from the currency or currencies of the charter parties.

Some ship lending agreements will provide for multi-currency clauses to allow the owner to borrow in cheap currencies. All such clausing will, of necessity, be subject to availability of the alternative currencies and if not available, to cancellation of the agreement and immediate repayment.

One further point on load agreements in Eurocurrencies. These will, as specific requirements, include reserve clauses allowing the lender to recover any additional cost from the borrowers arising from the imposition of reserve requirements and additional taxes and where withholding taxes are in effect, the agreement will probably call for such tax to be met by the owner or waived by the government of the borrower's country so as not to reduce the earnings of the lenders. It must be borne in mind that withholding taxes are payable on the gross interest paid, whereas the margin of gross profit available to the lender is a relatively thin one, usually 1½ to 2% over the cost of the London Interbank Offering for U.S. dollars available to the lending bank, commonly known as LIBOR.

The particular circumstances leading to a bank's participation in a shipping loan vary, of course, from case to case.

Finally, national governments will today support their shipping companies in the national interest to a greater extent than heretofore and, of course, when a nation owns its major shipping companies, it will unhesitatingly provide its support by way of its own sovereign guarantee or arrange for either Central Bank or government-controlled commercial bank guarantees to be available. Such financing then become a sovereign country risk and is beyond the scope, in general, of this talk.

As regard the Canadian scene, I have made it clear that I cannot speak with any degree of knowledge or confidence on the subject. However, given the present state of world shipping, and the relatively small participation in deep-sea movement of goods that Canadian ship owners and operators have, one cannot help speculating that it will be difficult today to persuade private ship owners to make any substantial investment particularly with borrowed funds in this turbulent industry. One has got to wonder why they have not previously become more deeply involved. After all, Canadian maritime history is indeed a long one of which Canada and Canadians should be very proud. No country for the size of its participation played a more distinguished naval role than Canada in 1939 to 1945. As an employer, as a strategic implement, in a policy of conservation of foreign exchange and indeed in the earning thereof, it should hold high priority. Have the openings for Canadian investors in other directions been too easy or should one look deeper for more fundamental reasons such as high taxation, inadequate provisions for depreciation, union attitudes, lack of general subsistence or a combination of all the factors?

Clearly, Canadian Government revenues are not in receipt of any substantial contributions from Canadian-owned maritime shipping. Given this situation, and the interests to Canada of having a sizeable maritime fleet, cannot a case be made for strong and substantial tax incentives for investment in Canadian shipping, thus leading to the maximization of profitable opportunities for the investor, the generation of worthwhile profits, the retention of revenues and foreign exchange earnings and in turn, a satisfactory but indirect contribution to the Federal Government and the country?