Investing in newbuildings today - a folly or an opportunity

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Whereas in previous decades newbuilding orders were the prerogative of a small elite e.g. Livanos, Niarchos etc., the 90's and increasingly the early 2000s, witnessed a dramatic rise in newbuilding interest by a much wider body of Greek owners. Currently, Greek newbuilding orders account for about 15% of the world's total in Deadweight terms, which is an all time high.

Why, though, the explosive interest? The answer lies in two types of factors. Those that "push" owners towards newbuildings and those that "pull" owners towards newbuildings.

Examples of "push" type factors are the increased regulatory environment, double hull construction, new (technical, construction and safety) requirements, charterers', bankers' and insurers' preference for new vessels, the attractiveness of operating quality safe and modern vessels and the preference of office and crews towards new vessels.

“Pull” type factors have been the low newbuilding prices offered in the early 2000s by shipyards in the Far East and especially China, the attractiveness of developing a standardized, homogeneous fleet, the high percentage of finance offered by shipping banks, the record low rates of interest and the opportunity to achieve high profits from resales on the basis of only a 10% - 20% newbuilding down payment to yards.

The explosive rise in freight rates and vessel values over the last six months has come as an unexpected surprise to all. Whereas most analysts and owners anticipated stable to good economic conditions, no one expected this unprecedented rise of the shipping market.

To illustrate the market rise, the Baltic Panamax Index, which hovered around the 1,000 mark in early 2002, rose to 1,500 – 2,400 in the first half of 2003 and to 4,000 – 5,500 in late 2003 / early 2004.

All vessels across all sectors have risen in value with tankers and containers by 50% on average over the last two years and bulkers by over 100% over the same period. In addition, the older the vessel the larger the rise as evidenced by 20 year old Panamaxes quadrupling in value. Owners with prompt newbuilding deliveries are also enjoying enormous profits either by selling such vessels at more than twice the newbuilding cost, providing them with returns of 400% - 600% over their invested equity, or by locking in 2 to 3 year time charters, which are capable of repaying the newbuilding cost in full over such a short period!!

Despite the record number of newbuildings, the appetite for prompt new second-hand vessels is currently enormous. It stands to reason that for every successful owner there are many that have missed the opportunity altogether or found themselves with few vessels or had sold early and have subsequently regretted their decision. The purchase interest has now shifted from the Greeks, who until recently virtually monopolized purchase interest, to Far East buyers who are closer to cargoes and longer term employment of vessels and who may have missed the opportunity to acquire vessels at lesser prices.

The main thrust of this article is aimed at those owners who find themselves with smaller fleets than they would wish to own / operate whilst they have the liquid resources and banking relationships to acquire either newbuildings or second-hand vessels.

The predicament they face is precisely those enormous prices asked by sellers of such vessels and the inherent risk they face that a possible market fall would leave them exposed both from the financial and investment points of view.

The question, therefore, is what risk is one running by buying a newbuilding with 2007 delivery and beyond or a second hand vessel at 3 or 4 times the price levels of 1-2 years ago?

Apparently, the downside is high, but is it? The main questions being asked by everyone are:

- *How long will the good market last, and*
- *How far may it fall?*

The answers do vary and are to a large extent subjective, as decision makers are asked to evaluate international factors and variables over a 3-5 year period. However, it is possible to create 4 opinion subgroups, as follows:

a. The cycle followers

Those who believe that the recent market is just another short and sharp cyclical high, which will quickly come off. It is true that all previous shipping cycles, since WW II, have followed the same pattern, consisting of cycle highs lasting, approximately, 6 – 12 months at best. However, is the recent enormous rise just another cycle high? Supporters of this theory believe the answer is yes but on the whole they are a significant but rather small minority.

b. The structuralists

This second sub-category consists of believers that the shipping cycle has been dramatically and permanently affected by the emergence, development and importance of the Chinese economy and the subsequent emergence of other shipping hungry markets, such as India, the remaining Far East countries, South America etc.

These believers hold that China will sustain the markets until well after their 2008 Olympics, resulting in a new shipping cycle on a much higher freight rates plane. In short, they believe the market has changed structurally, will remain strong and that any falls will be down to levels that are higher than those of previous shipping peaks, thereby rendering the new high vessel prices sustainable in the long run.

The notion of a structurally changed shipping industry has fuelled orders well into 2007 / 8, has prompted yards / sellers to ask for ever increasing prices and has induced shipyards to create new shipbuilding capacity.

c. The short-term structuralists

These owners believe that there has been a structural change due to China that will impact shipping positively over a longer period than the cycle followers, i.e. 3-5 years but that as China slows down and / or newbuilding capacity increases, the structural change will reverse into a period of longer-term market weakness approaching but not falling down to previously low points.

d. The optimists

The fourth sub-category consists of owners who believe that we have not yet seen the market high and that the demand – supply in shipping will result in much higher vessel prices and earnings. These optimists rely not only on China and the other emerging nations but also on the lack of newbuilding spaces for all Far East shipyards, which will keep shipping supply relatively low over the coming years. They also combine their expectations with those of a longer-term favourable climate for the world economy and international trade.

The preponderance of charterers wishing to take on tonnage for long periods of up to 5 to even 7 years indicates that the believers in this sub-category are not so few, although it is fair to say that charterers may be offering charters on the back of real contracts.

Clearly, the market now is dominated by owners with views akin or close to b) and d) above, rather than a) and c). The latter, especially a), have already withdrawn from the market, as buyers and may represent the sellers of tonnage in this market.

Irrespective of which sub-category one supports, there is no doubt that the dominant factor that will shape the market is CHINA. As such, readers will permit me to concentrate on this factor, to analyse the position now and attempt to make some predictions.

China's economic growth (GDP) rose from 7.3% in 2001 to 8% in 2003, 9.1% in 2003 and at 10% in the early months of 2004. However, this is only part of the story, as the Chinese economy is export-lead with exports growth being a multiple of the above growth, with importation of raw materials, including oil, showing year-on-year growth of over 50% and with annual investments in production capacity exceeding 50%. Such rates of growth are not sustainable over the long-term as there are clear signs of overheating. The pressure on the banking system is enormous, the ability of the banking sector to absorb and channel correctly all these investments is in doubt, corruption abounds, the economy is unable to develop in a balanced manner, the infrastructure is wilting under the enormous production and investment pressure and the rigid economic and political system is being strained. A Chinese bubble is in the making and, although few expect it to burst in the same way as the Asian tigers in the late 90s, the risk is definitively there.

In recognition, therefore, of the above pressures, the central bank of China recently tried to drain some monetary liquidity, curb bank exuberant lending, slow down state spending on infrastructural projects, raised interest rates and tried to soft-land the economy back to long-term, more sustainable GDP growth levels of 7% per annum.

Readers are aware of how difficult is to attempt a soft landing for an exuberant economy. Moreover, China still has one of the lowest per capita incomes in the world and there is increasing disparity between the backward farming communities and the large industrial centres near the coastline. The population is expecting its income to rise significantly every year and any slowdown may bring some internal inter-regional strife that will test the strengths of China's rigid political system.

Pressures on China for a revaluation of its currency, especially from the US are increasing and, no doubt, if the first regulatory measures do not bring the economy back to track, a revaluation may well do it. The question though is once revaluation expectations shall be realised, can the currency be pegged again??

My personal view is that China will continue to manage growths that are well above the world's annual growth of about 4% now expected for 2004 for the foreseeable future. The slowdown, though, may take the edge off the shine of the shipping market, as the year-on-year demand for raw materials begins to slowdown.

Looking at the wider picture, although the world economy is growing steadily, and this augurs well for international trade, the rise in the price of oil and the prospects of further rises, may result in a slowdown. Already Goldman Sacks revised their own 2004 world growth figures from 4.6% to 3.8%. As China's appetite for oil is expected to quadruple in just 10 years, together with the rise in world GDP and associated demand for oil, the price of oil is expected to increase further and acting as an economic dampener over the years. Coal, as the competitive fuel, though, should benefit and so should dry bulk at the expense of tankers.

Even if the world economy and China do slow down, though, the annual growth is still quite strong in historic terms. Many countries are holding back their own raw materials either for their own use or tactically in the expectation of higher commodity prices. This leads to an increase in the ton-mille requirements for shipping which is growing at much faster rates than world GDP.

In summary, despite the expected mild slowdown in world GDP and China, demand for shipping is expected to grow at a historically fast pace in excess of 6-7% per annum. Given the world fleet at 797m DWT as of 1/1/04, demand would absorb about 50-60m DWT per annum.

The 2004 world order book is 59.5m DWT and, although scrapping volumes are expected to decrease from an average of 26 to 28m DWT per annum over the last 3 years to about 15m DWT in 2004, it is self evident that for 2004 demand is expected to still exceed supply by a margin of about 5.5-15.5m DWT.

The actual figure, however, may indeed be much larger on account of significant port congestions and enforced vessel delays, which will continue in 2004, and which are reported to reduce the effective supply of shipping by up to 10%.

The position, though, may begin to balance from 2005 onwards especially as demand may slow down a little and more so from 2007 with expectations of higher new construction figures as a number of new shipyards and shipyard enlargement projects begin to result in significant higher volumes of new vessels being delivered.

The position for dry bulk itself is more favourable than for the market as a whole. The reason is the constrained newbuilding orderbook in relation to the total dry bulk fleet of 16.8%, as opposed to 26.2% for tankers and 45% for containers. In addition, the dry bulk fleet is older than the tanker and container fleets, allowing for more scrapping per annum. It should be noted, though, that double hull tankers may benefit from the 18m DWT of single-hull tankers which need to be phased out (Category 1) on 5th April 2005 as per IMO Reg13G and which may assist the tanker market for 2005 / 2006.

It would appear, therefore, that for the shipping market as a whole, equilibrium (demand equals supply) may be reached as early as 2005, whereas for dry bulk equilibrium may only be reached by 2006 or 2007 (depending on the growth rates of China and the world economy) and only when supply (increase in newbuilding orders) shoots up as is expected from 2007 onwards.

To summarise, therefore, there are economic forces at work that will tend to ease the current demand-supply disequilibrium that has generated the recent shipping market boom. These forces are working faster for the container in the next years and / or China manages not to slow down its voracious growth, the market equilibrium is expected as early as 2005 / 2006 for tankers / containers and as late as 2006 / 2007 for dry bulk. In these terms, therefore, my views are closer to sub-category c), ‘short-term structuralists’, than the other sub-categories.

Should the above expectations hold true (a rather big assumption), owners looking for investment opportunities should be wary. Deciding now on newbuildings, which shall be delivered in 2007 and beyond at prices 20-40% higher than those of only 2 years ago, appears a high-risk strategy. The market will need to stay strong for the next decade in order to justify such investments. In short, the views of sub-category b), 'the structuralists', will need to hold true in order make newbuilding orders a sound investment proposition.

The position for dry bulk vessels is more interesting as the demand-supply disequilibrium may allow for a number of years of gainful trading before the increased supply side shall assert itself. Prompt newbuildings are selling at a significant premium over historic or projected shipbuilding cost (often at more than double historical cost) and the associated risks are much higher. It becomes a race, therefore, until dry bulk rates shall subside in trying to claw back the premium paid upfront. Current period charters can go a long way to amortise most of the premium but no doubt a residual risk does remain.

To conclude, therefore, shipping investment decisions have become more difficult and the associated risks to owners and banks have risen. New containers and possibly tankers may not produce the necessary investment returns over the first years of their lives. New investments in dry bulk vessels may do so if a demand-supply disequilibrium persists for the rest of this decade and beyond, something that may be improbable but not impossible.

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