Article by Ted Petropoulos
for Nafs
February 2012

Equilibrium? Where art thou, Equilibrium?

Living through the worst dry bulk shipping market that most can remember is affecting confidence. Owners, having gone through a prolonged phase of over-exuberance and talking of a 'new paradigm' and believing in the long term robustness of shipping, fuelled by China and longer ton-mile distances, splashed heavily in new building orders. Now, with demand having slowed down and net tonnage supply having reached unbelievably high levels, a huge tonnage surplus has materialized whilst the order book still looms large.

As if the above was not sufficient, we also face an unprecedented banking crisis, affecting all western banks, but most heavily, the European banks that make up 90% of ship lending.

Banks, the shipping industry's partner, have been slow fox-trotting along owners for 3 years in anticipation of a recovery which has not yet materialised. To the contrary, market conditions, freights and values have gone from bad to worse. Banks, who face their own uphill struggle to achieve capital adequacy and absorb sovereign debt and bad loan provisions, have started to show their uneasiness and they too are considering how long will it be that they will need to support owners, restructure debts and forgive covenant infringements.

I have, however, good news to both banks and owners. This crisis will pass and a market equilibrium shall return. No doubt at all about this. The only questions that still remains is 'when?'!

It is the answer to the fundamental question of 'when?' that will determine the fate of many owners and the losses of many banks.

As neither the banks not the owners know when the market shall recover, they are both trying to 'survive'. Until now, such survival has, on the whole, been achieved via co-operation. Owners focus on liquidity, cost cutting, maximizing revenues, spinning off all non-core assets and activities as well as by contributing further own resources to the extent that they can do so.

Banks have been patient and have provided loan restructures in return for higher margins and evidence of owner commitment. However, to both banks and owners, time is beginning to run out, as all the easy solutions have been utilized and the situation is grimmer than before.

The 'credit crunch', whereby fresh bank credit is low, difficult and expensive, is actually helping the shipping industry. It discourages further newbuilding orders and throttles existing commitments. Owners with vessels on order, have the chance of either walking away, or postponing the order or committing more capital. Thus far, they have mainly chosen the route of postponement, thus spreading out the order book. This slippage,

however, has not resulted in a reduced order book and in occasions where owners have walked out, the vessels were still eventually built for another owner.

As the market situation worsens, there will be more layoffs, scrapping and cancellations / defaults. Shipbuilding capacity has already started to be reduced primarily in China and to a lesser extent in South Korea and Japan.

However, all the above is ‘evolutionary’ and not ‘immediate’ in effect.

Having laid out the basic parameters in the issue of where the dry bulk market is, I wish to concentrate on the fundamental question of ‘when’, i.e. ‘when’ will the market equilibrium be reached and ‘when’ will the current surplus be absorbed?

The general consensus is that the market will take a long long time to absorb surplus capacity. However, rather than providing unsubstantiated beliefs and crystal ball gazing, I will seek to present reasoned analysis of where we are going.

The difficulties associated with ‘forecasting’ in that is depends on the collective actions of both owners and banks, as well as the global economy and world trade which in turn depends on global sentiment, confidence, central bank and state actions.

Let me begin then. Please see Graph 1 by Platou. This shows demand and supply for the dry bulk fleet over the last 10 years. The key to reading this chart is by reference to the utilization rate. As you will observe, the utilization rate crossed the 90% mark in mid-2003 and stayed about this rate until the end of 2008, when the banking crisis began.

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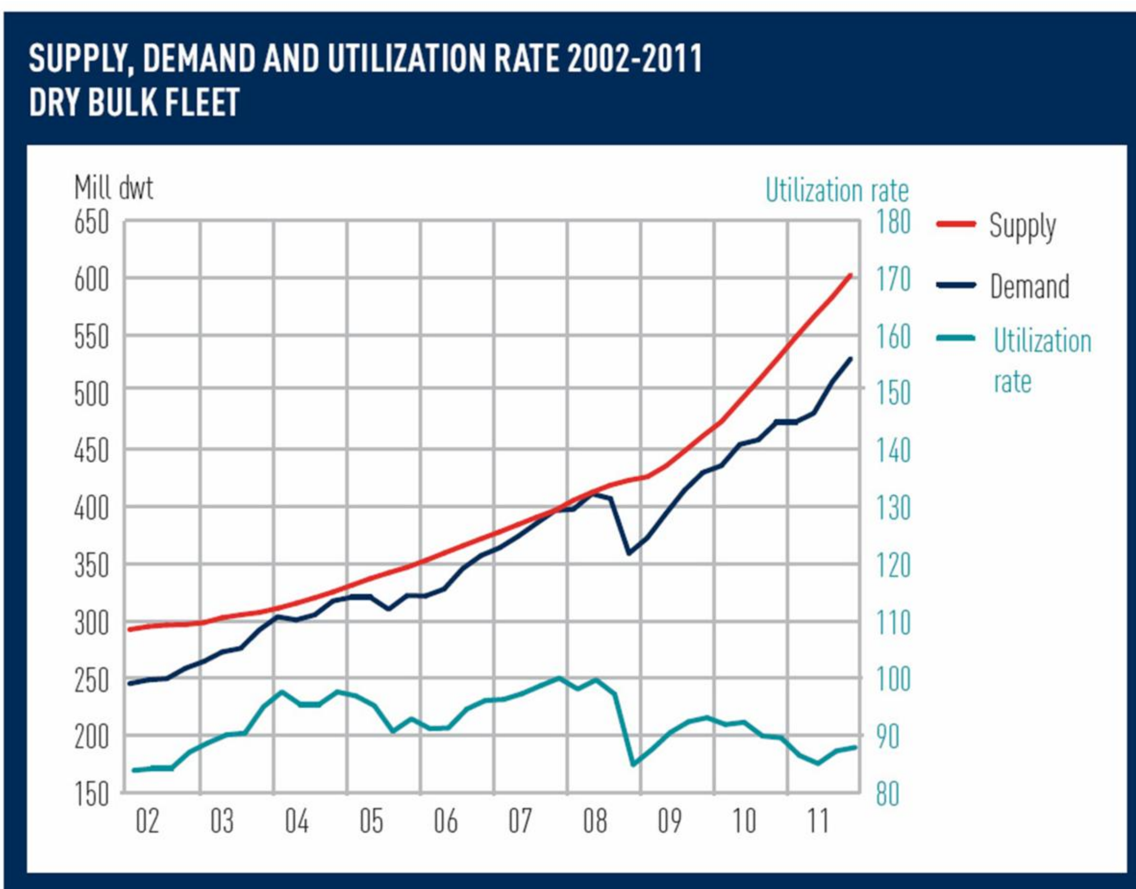
Graph 1



As the rate approached 100%, shipping experienced very bullish market conditions, which led to over-ordering and created the current problem.

The utilisation rate movements explain why we enjoyed a reasonable market in the second half of 2009 and the whole of 2010, but have been sliding in 2011 and early 2012. In answering the fundamental question of 'when', we need to see when the utilization rate will cross the 90% rate. Currently, we are at approximately 85%, where the 15% surplus has driven rates down to operating expense levels.

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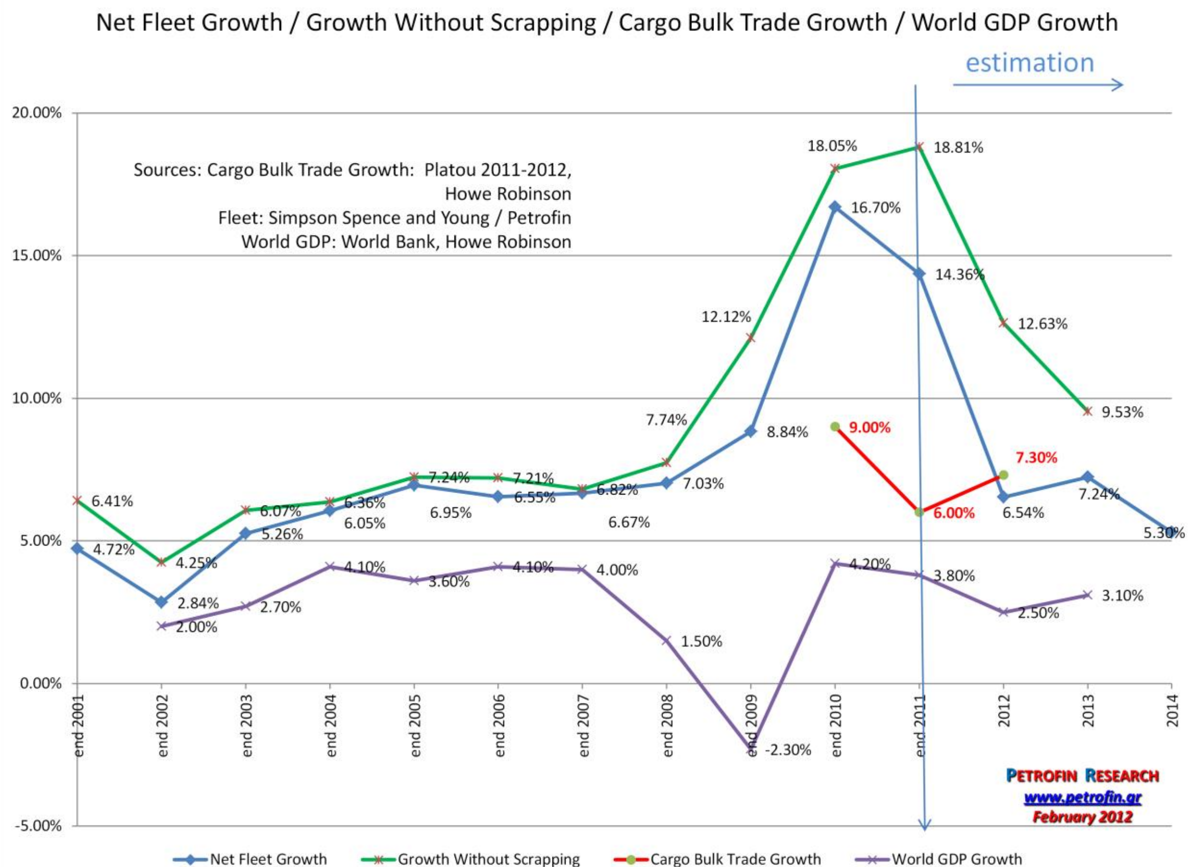
To provide a reasonable prognosis to the key question, I refer readers to Graph 2. Please bear with me, as I go through it.

Graph 2



The green line until 2011 shows the net dry bulk fleet growth without scrapping. As you will see, it peaked at 18.81% in 2011. For 2012 and beyond, the green line represents orders that will be delivered in each year after estimated postponements, cancellations and new orders placed with deliveries in each year. The blue line shows the net dry bulk fleet growth after scrapping with the difference between the two lines representing scrapping. Due to scrapping in 2011, the actual net tonnage growth was 14.36% as opposed to pre-scrapping of 18.81%.

The purple line at the bottom of the graph shows World GDP growth per annum, whereas the red line since 2010, shows the cargo bulk trade growth. It is this red line, together with the blue line that determine if there is a minimal surplus.

As you will see, in both 2010 and 2011, net fleet after scrapping increases have been 16.7% in 2010 and 14.36% in 2011, clearly rates that could never be matched by cargo growth

which remained at 9% and 6% per annum. Hence, there was a surplus in each of the above years resulting in a fall of the fleet utilisation rate.

For astute readers, I should hasten to add that there are other factors that affect the supply side, such as congestion, slow steaming, lay-up and weather. As such, to some extent, the large surpluses have been cushioned by the above factors, though not eliminated, hence the increasing supply and utilization rate falls.

Let us now move to the world of 'reasoned prognosis'.

The 2012 green line forecast shows an estimated pronounced fall in the pre-scrapping net fleet growth to 12.63% after cancellations, postponements and on account of a slowdown in new orders in accordance with our analysis. As you will see, the gap with the blue line is increasing due to record scrapping forecasts for 2012. To give readers a better idea, the scheduled newbuilding deliveries for 2012 are 132.6mDWT (Clarkson's Fleet Register – February 2012). This figure after postponements, cancellations etc, as well as scrapping and due to the bad market conditions, is expected to fall to a net 40m DWT fleet increase. Hence a considerable market induced adjustment.

The result, if our assumptions as to the above parameters hold true, is for a net fleet growth after scrapping of only 6.54% for 2012. This, should it materialize, would be very good news. For 2013, the net fleet increase is estimated at 7.24% falling to 5.3% in 2014.

Although world GDP growth for 2012 is expected to slowdown from 3.8% in 2011 to 2.5% per annum, Cargo bulk trade growth according to Howe Robinson, is expected to rise in 2012 to 7.3%. This compares well with the 6.54% net fleet increase, which shows for the first time, since 2008, a more balanced market. However, what is needed is not only for demand growth to match supply growth, but for the current surplus to be reduced and for utilisation rates to rise.

Although the adjustment process shall be slow and the danger of further orders is always present, should the above prognosis materialise in 2012, we should see a rise of the utilisation rate to levels above 90%, hence a recovery in 2013 and 2014 to at least 2010 market conditions. The recovery of the utilisation rate shall not be smooth but erratic. However, as 2013 and 2014 dry bulk growth expectations are for higher growth than 2012, it is forecasted that the current fleet surplus shall slowly absorbed.

A rush of new orders can and will delay the market recovery whilst a pick-up of Chinese and global growth will shorten the period until the current surplus shall be absorbed.

In conclusion, as the current order book works through the ship building system, demand / supply conditions should return to near equilibrium from 2013-2014. However, what is needed is the current supply to be reduced by a period of demand exceeding supply and the utilisation rates rising to 90% and above. This will require considerable new order restraint

by owners and banks, a lot of postponements, reduced shipbuilding capacity, continued scrapping and fleet inefficiency, as well as pick-up in demand. The above pre-conditions for a robust recovery may appear daunting but not improbable. For owners and banks, surviving the next 1-2 years will remain their main goal. For those that survive the famine years, the future, once the market shall recover, looks very promising.