Potential longer term benefits to shipping from a market correction

Nafs – July 2005

Ted Petropoulos, Petrofin S.A.

Shipping in all its sectors, has been through, in the last 2 years, the strongest market in living history. To highlight this statement may I give some examples from Clarkson's statistics. VLCCs daily earnings went from $20,000 in June 2003 to $220,000 in November 2004. Over the same period, clean product tankers from $16,000 to $66,000, Capesize bulkers from $32,000 to $104,000 and 1700TEU Containers from $15,000 to $28,000.

Vessel prices too, responded to the above as well as to the positive outlook for shipping, to the 'China growth' story (and fact) as well as the positive effects of low investment rates. Over the same period, VLCC prices rose by 130%, 45,000DWT double hull, 10-year old product carriers by 70%, 5-year old capes by 78% and 1700TEU container vessels by 120%.

In consequence to the above, shipping became a high performing, glamorous industry capable of providing exciting investment returns and attracting the attention of investors both from within and outside the shipping industry as well as from the public markets.

The rush into newbuildings took place across all sectors and this gave the opportunity to shipyards to increase their prices by an average of 40% although a good part of the above is due to rising steel costs and labour costs.

Due to the shortage of immediate newbuilding berths and owners' unwillingness to consider late deliveries for 2008 and beyond, 'prompt delivery' newbuildings and second-hand vessels began to command enormous premiums. To give but one example, the value of a prompt delivery 69,000DWT 15-year-old Panamax at $20m approached the 2002 newbuilding cost of a 75,000DWT Chinese built vessel.

At a time of market disequilibria such as the one experienced in 2004 and early 2005, where shipping demand exceeded supply, it is quite usual to observe such excesses.

In addition, it is worth pointing out some characteristics of a market living through its cyclical highs. Sellers of prompt tonnage become almost arrogant in their attitude towards buyers. Often, they would demand excessive premiums over the 'last done' high vessel prices. In order to buy vessels, buyers began to buy them 'without inspection' and often on an 'as is' condition. The high prevalent earnings and low interest costs would justify almost any price provided the strong earnings flow could be projected for a long enough period.

China alone was deemed sufficient to 'guarantee' the new style of market where many believed vessel earnings would remain high until 'the Chinese Olympics of 2008' at the very least. As the rate of newbuilding orders and deliveries began to grow and scrapping virtually disappeared, maintaining the same optimistic scenario necessitated the inclusion of additional growth stories such as India, growing port congestions, etc.

Whereas it is clear that vessel earnings topped in late 2004, vessel prices carried on rising until March / April 2005 on the back of an enormous demand for vessels as a result of the enormous monies generated by IPOs and public companies in the public markets as well as private equity capital continuing to be drawn into shipping.

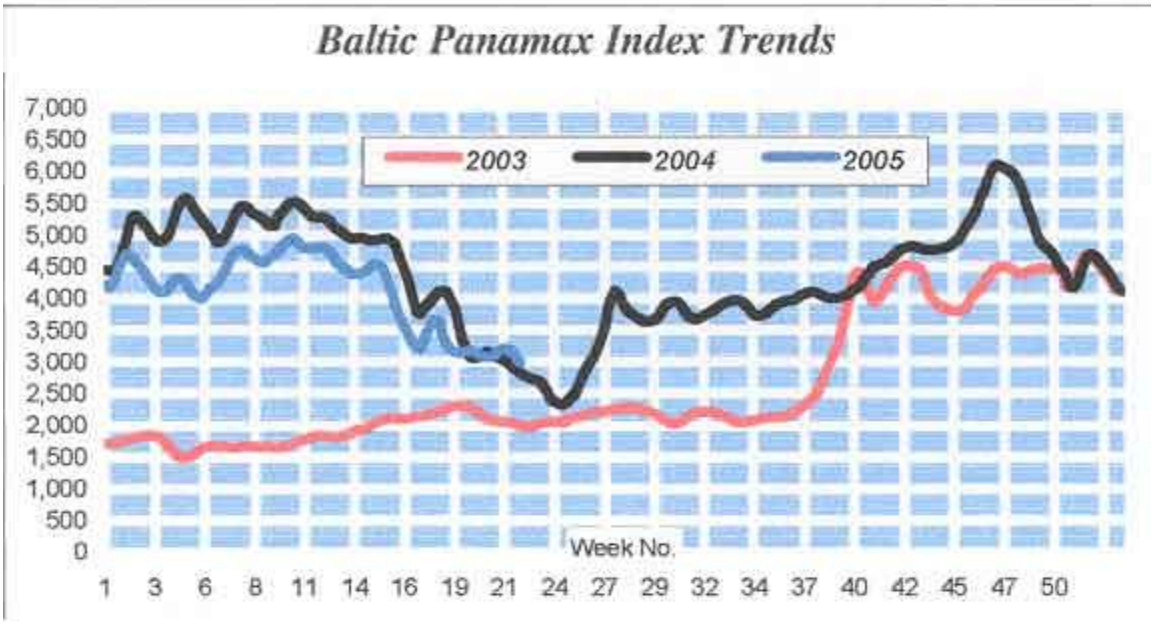
It is inevitable, though, that every 'hyper' market shall come to an end sooner or later. It is remarkable that in the shipping industry, very few had the courage, interest and vision to caution market participants of the dangers of excessively high vessel prices. It was as if to do so would be seen as 'undermining' the shipping market. After all, why spoil the party when everyone benefits? If inexperienced investors would 'lose their shirts' it was countered by such flippant responses as 'too bad' or 'they should have known better' or 'they are paying for their greed'. The freight market sentiment, however, began to change in March of this year. As is often the case, it is not one factor but the simultaneous action of a number of factors which combine to turn market sentiment.

The following reasons can be highlighted for the above change as:

1. *Lower estimated international growth predictions for 2005 and 2006,*
2. *realisation that year on year ton/mile growth was virtually dependent on Chinese growth*
3. *appreciation that all the 'positive' market factors had already been taken into account by the market whereas potentially negative or shock factors had been largely discounted*
4. *actual slowdown of rates of individual growth in Asia as well as combined for US, Europe and Japan*
5. *realisation that it was highly unlikely that demand growth would match supply growth for the second half of 2005 and for the whole of 2006*
6. *a pronounced slowdown of Europe*
7. *the undermining effects of high oil prices remaining at $50 per barrel and above levels*

8. *the huge US debt and balance of trade imbalance and*
9. *increasing dangers of protectionism and barriers to trade.*

Interestingly enough when freight earnings began to slide in March – April, most owners (especially vessel sellers) attributed it to seasonal factors. Many used as an excuse for them to continue believing in the 'continuous high market theory', the uncanny resemblance of the market fall to that of last year (for example the BPI chart). As such, they were lead into the mistaken belief (as far as the writer is concerned) that the fall in freights was nothing but a short-term correction with the market about to rebound as strongly as last year in the 3rd and 4th quarter. Although markets often have the capacity to surprise, in this instance the odds are stacked heavily in favour of the case for a fall in vessel prices.



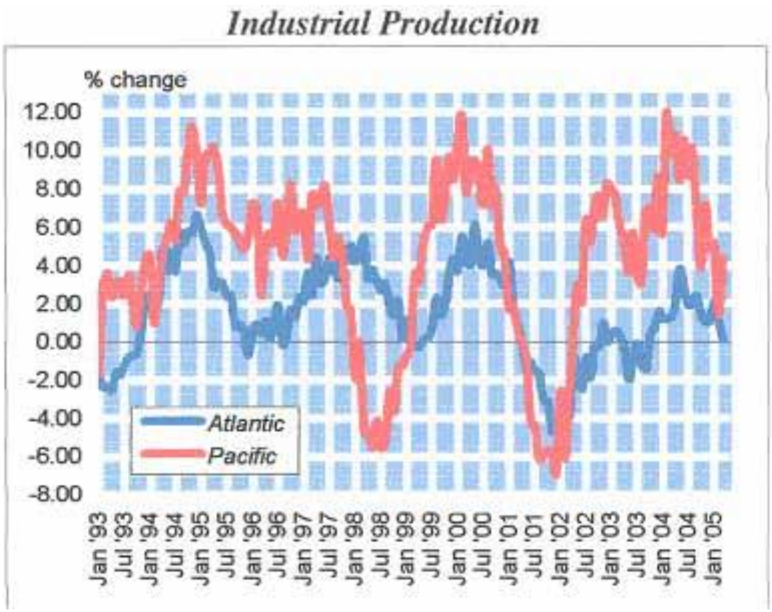
from Shipping Intelligence Weekly – 10-Jun-2005

In addition to the factors already highlighted above, some more recent 'developments' have come to upset the sensitive demand/supply equilibrium. China recently announced measures whereby Chinese only vessels would be allowed to carry iron ore and steel products in/out of China. Although this has been subsequently refuted, this is seen by many as just the opening salvoes of a protectionistic war between Europe and the US on the one hand and China on the other. At best a compromise shall be reached. At worst the problem lies ahead of us with measures and counter-measures being taken. Let us not forget the increasing problems of unemployment in Europe (and in my opinion soon in the US) and the 'unfair' competition arguments raised against cheap Chinese products undermining jobs in countries whose population have begun to feel increasingly insecure. In the event that China does not revalue its currency and continues to display ‘self only’ tendencies, international trade will suffer and shipping will feel its effects.

A second factor is consumer confidence. Already in Europe we have witnessed the first signs of consumer concern over economic policies and the threat of unemployment. The recent ‘NO’ votes to the EU constitution by France and Holland may have been the result of numerous factors but it is unlikely that the same result would have taken place had both countries had buoyant economies with low unemployment rates.

A third factor that has arisen is the imbalance between vessel prices and earnings. Using Shipping Intelligence Inc statistics, a very interesting observation arises whereby over the last 6 months bulk carrier prices (basket of 15 various size vessels) have risen by about 14% whereas 6-12 month t/c earnings fell over the same period by over 40%. In simple terms, a potential buyer on June 1st 2005 would have had to pay on average 14% more for a vessel than six months earlier whilst enjoying 40% less earnings. No wonder, therefore, that vessel prices have begun to slide over the last fortnight as potential buyers easily see that their cashflow and net present analysis are no longer supportive. In the writer’s opinion vessel prices have one way to go and that is down! The capital locomotive propping high vessel prices, namely a) high cashflow returns and b) public markets, have slowed down. Already the window of opportunity in the US for IPOs is narrowing. US interest rates are rising and the freight market continues to slide. The BDI index has already fallen through the 3000 mark from a high of over 6200 in December 2004 and is heading even lower.

A fourth factor lies in the slowdown in the rates of growth of the industrial production in both the Atlantic and Pacific economies (see chart) and lastly a fifth factor lies in the slowdown of the growth in ore imports into China. Although this is still doubted by many, if confirmed it will provide future ammunition in favour of a Chinese rate of growth slowdown with all its implications for international trade and shipping.



What of the future

The freight market have sent to all market participants a clear signal and ignoring such a freight market fall to about 50% of the highs would be a folly. A freight trading range of 2000 to 3500 for shipping would hardly be disastrous. The freight market only went through the 2000 level in the spring of 2003 and did not rise significantly until the fall of 2003. Seen historically, today's freight levels may not justify today's vessel prices but they still represent extremely attractive earnings for vessels on a historical basis. Already recently both tanker and bulker prices have begun to fall by about 10% and unless the freight market would stage an unexpectedly large recovery, further falls of 10-20% are on the way.

However, with shipyards full for a further 2-3 years and the newbuilding cost having risen substantially (chart below), it is difficult to see newbuilding vessel prices falling significantly in the next year or so. This factor should underpin second hand values and help it stabilise. In addition, although China may be in danger of a slowdown, it still represents and will continue to be an enormously positive factor that should underpin the whole shipping industry as well as global growth.

from Shipping Intelligence Weekly – 10-Jun-2005

My expectations are therefore of a significant but relatively short term correction for the shipping industry. Let me elaborate. I consider a slowdown in the rate of growth for the world economy not as bad news. Growth rates of 4% p.a. are historically high and not far removed from the 5.5% p.a. growth of 2004. The benefits of the brief slowdown are numerous. It puts less strain to production, inflation and commodities prices. It should allow for a fall in oil prices to levels in the $30 per barrel range which would reduce the negative impact of the $50 per barrel plus prices to inflation and economic growth. Furthermore, it would enable China to slow down a little and achieve a soft landing to still robust growth annual rates of 7-8% p.a. The slowdown, therefore, is seen as significant but helpful in allowing the world economy to continue to grow at strong rates which will benefit the shipping industry.

A revaluation of the Chinese currency together with a slowdown in Chinese exports would also enable the western economies to try to tackle their own problems of uncompetitiveness and should reduce (but not eliminate) the acute problems being faced by uncompetitive industries. A slowdown would also assist the US balance of trade and would also allow Europe to carry out necessary structural changes to improve its competitiveness. It is important for the western economies to attract capital and enhance employment by investments in areas of comparative advantage. Defying basic economic laws and competing with China in industries where labour costs dominate is a mistake. Emphasis should be given on R&D and technological competitiveness where the US and Europe can compete.

For shipping, a market correction of 1-2 years following the excesses of 2004 are also welcome. It would allow for a healthier balance between vessel prices and earnings. It would also address the excesses we witnessed over the last year. More importantly a market correction would slow down newbuilding orders and would reduce as time passes the high shipbuilding orders overhanging the market. Fortunately, because of the simultaneous strong market across all sectors, shipbuilding capacity has been well dissipated across all vessels types. Consequently, a 1-2 year slowdown in orders would assist the industry to restore the balance between demand and supply.

Of all the market sectors, I believe the dry bulk sector may well be the least affected. The reasons lie in the higher age profile of the dry bulk fleet which should allow for some scrapping of extremely old vessels over the next couple of years as freight rates decline. In addition, the bulk carrier orderbook represents 21.2% of the current fleet as opposed to 26.4% for tankers, 57.6% for containers and 77.8% for LNGs. Moreover, bulk carrier orders are concentrated in 2005 and 2006 and reduced thereafter. Consequently, a slowdown of newbuilding orders for 2008 and beyond may well improve the sector's future outlook following an initial fall in line with all sectors in 2005 and 2006.

To summarise, therefore, it is my belief that a continuation of the good market for a longer period would have resulted in a hard landing for shipping which is not in the interest of either owners or banks. A softer market for the next 1-2 years would provide a much needed breathing period where the demand, supply and the dynamics of shipping shall be improved fundamentally and would ensure a) that the market correction shall be relatively short-lived and b) that the longer term positive outlook for shipping shall remain intact.

From Nafs- July 2005 Issue