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INVESTORS TREAD WHERE ANGELS FEAR TO GO

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Traditional shipping investors, reared on the motto of "buy low – sell high" will have few doubts about what they should be doing next. Quite simply, they should stay put until the freight market and vessel values subside to more attractive investment levels.

Shipping cycle theory and practice over the last 50 years can solidly demonstrate that market peaks do not last long (from a few months to about one year), whereas the troughs last considerably longer. Excess demand conditions have been quickly returned to equilibrium status and more often to recession by a rush of

newbuilding over-ordering to yards with considerable spare shipbuilding capacity. Consequently, since the runaway market, which commenced in late summer of 2003, broadly across all markets, (dry, wet, container, LPG etc.), is now just past its one-year anniversary, the way forward should be crystal clear, or is it?

I must apologise to these traditional investors and say that not only nothing is clear but that investment decisions are at this moment extremely complicated and fraught with both risk and opportunity.

Let me explain myself further.

There are certain factors in today's market, which have not been present in previous market highs. I shall address the main ones as follows:

a. China There has been no China factor before. The unprecedented 2004 high growth rates of China (10% GDP growth, 16% industrial production growth), her voracious appetite for raw and industrial materials (e.g. 600% higher steel imports between 2000-2004), her enormous investment drive, her low cost, hard working and relatively flexible work force, her exports and sheer commitment to become a world economic giant in the shortest time imaginable, are some elements of this growth story. China simply sucks in an enormous part of world shipping.

b. High international growth The International Monetary Fund estimates world growth for 2004 at 5% per annum, the fastest in over 25 years. Japan too and increasingly India, show signs of increased economic activity. The same applies for the whole Far East, the US and even for lethargic Europe. Readers should be aware that international trade grows at a faster percentage than economic growth and the ton/mile requirements even more as centres of production are away from centres of raw materials and demand. Coupled with China, demand for shipping exceeded available supply thus driving freight rates (and vessel values) even higher. The outlook for world growth in 2005 is still a very credible 4.3% p.a. and in the event that oil prices were to decline from today's $50 per barrel, this growth may be exceeded.

c. Finite supply The good market across all levels, as well as, the drive for double hull tankers has filled shipyard capacity until 2007. As such, for every sector, supply increases (even assuming little scrapping) are defined and not as threatening as in previous cycles. Of course, new Chinese, Indonesian and Vietnamese shipbuilding capacity is coming into stream, essentially from 2007 onwards but the supply side is still rather inflexible compared to similar occasions in the past. Undoubtedly, with shipbuilding prices having risen 35% in the last 2 years, Japanese and Korean yards are working flat out. However, the main effects on shipping supply shall be felt from 2006-2007 onwards.

d. Cheap borrowing US interest rates may be rising but they are still at record low levels for the last 35 years. For a capital-

intensive industry borrowing 2 – 3 times its own capital, low interest rates is a real blessing.

e. Shipping's investment returns Real shipping long term returns in the 1970's, 80's and 90's have not been exciting. Although they differ from sector to sector, on the whole they had ranged between 5% - 7% per annum. Timely purchases / disposals often multiplied the above returns for short periods. However, vessel operating profits were low and often insufficient to service bank debt, hence the increased emphasis on sale and purchase derived profit instead of long-term operating profit. Compare the above situation with that of today whereby one-year charters allow for annual net cash inflows often exceeding 30-40% per annum. In the event that vessel prices would depreciate by only 5% - 10% in one year, the annual return on vessel values today would be equivalent to between 25-30%. This is equivalent on average to the average equity committed by owners for their purchase, i.e. an annual return approaching or exceeding 100% in one year. Hence the interest by investors.

f. Uninspiring alternative investments Compared to the above high potential (but high-risk) investment returns, likely returns from stock markets appear decidedly dull. Deposit rates are so low as to be uninteresting. Bonds are suspect at a time of rising interest rates and expected to decline. Real estate appears overbought without going into deeper analysis.
Shipping is increasingly being regarded as a real industry with real (tangible) assets. It, therefore, represents a good story especially in view of the fact that it is now generating exciting cash flows and capital appreciation. Hence the rush to invest.

g. Attitude of time charterers The confidence in the short term (1 – 2 years) strength of the market is shown by charterers' appetite for such period charters. Even more importantly, we have seen an increase of long-term (3-5) period charter rates to levels that are considerably higher than before. Assuming that charterers are closer to detecting future demand conditions (and not simply speculating) the shift in confidence is striking.

The above factors, as long as they continue to apply, do explain why the markets are so high and why this cycle high may have more life in it than traditionalists expect. The $64bn question is how high and how long?

Inevitably, the market will fall. This is a certainty. Disequilibria do not last for long. However, if this is after a few good trading years of good returns, the decision becomes a more difficult one because conceivably, vessels bought at even today's high prices may have been amortised down to attractively low levels. Should the market, though, not last for long enough, investors may find themselves having bought too expensively and facing the full impact of a bad market. The risks, therefore, are very high but so are the rewards if the market should last or if vessels are sold before the market falls. Who, however, can predict the market with such certainty?

Analysts are divided over this question and strong arguments are presented from both sides.

Wishing to clear the outlook a little, my personal thoughts are that we have entered into a higher platform of vessel values and freight rates. Quite simply, on account of the special factors I have outlined and as long as they continue to apply and impact the shipping markets (even at a reduced level), we should not easily see the previous freight rate ranges of the last 20 years but new higher ranges being established at considerably higher levels. Should this be correct, a good portion of today's high vessel values shall be retained establishing a floor. This may provide some comfort to investors. However, freight rate range volatility will not only continue but may increase, thus directly affecting vessel prices, even though on a higher general plateau than two years ago.

Newbuilding prices have risen and it is doubtful if rising steel and labour costs will allow historically low newbuilding prices to return, unless, of course, there shall be revolutionary technological or production changes. As such, newbuilding prices should also support part of current vessel value rises.

There are, of course, some scare stories that can affect international growth, confidence, investment trade and the shipping market. These are as follows:

a. Slowdown by China

The laws of nature, economic theory and common sense dictate that no nation can sustain such high, explosive growth rates for a very long time without extremely serious structural disfunctionalities in its economy, as well as monetary, social and political risks. In the short-term, however, China still has an enormous momentum that is expected to drive her for a good many years. Furthermore, growth rates are now based on ever higher GDP, which in physical terms can be year on year as high as before, even though they may be declining a little as a percentage. What is more important is that as China's economy grows, certain imports such as steel could be substituted by internal production. However, new requirements in energy and foodstuffs are expected to grow. Overall, for the next 2-3 years, China is still expected to be a strong positive factor. However, stay on the alert.

b. Energy prices

In the short term, higher Chinese and world demand for energy has coincided with production problems in Iraq, political concerns in Russia, Saudi Arabia and Venezuela, potential armed conflict in Nigeria and a tense geopolitical environment. There is a risk, therefore, of oil prices rising above $50 per barrel in the short term. In the medium term, though, of 2-3 years, the above short-term factors, especially on the supply side, may subside and a number of economists are predicting a fall to $25-30 per barrel.

c. US deficit and consumer spending slowdown

The new US administration (irrespective of who wins in November) will need to address the rising US deficit. They can do so by cutting down on spending and raising US interest rates which should adversely impact economic growth, employment, consumer confidence and spending, as well as investment. Unfortunately, a US slowdown will dampen economic growth levels. The effect, though, should be contained and not long lasting as this should be seen as a corrective short-term move rather than a long-term restraining policy.

There is no doubt, however, that the US government and the Fed shall apply their well known management skills at containing the effects of any slowdown to manageable levels.

Should the US government, though, commence to impose import restrictions and invite reciprocal action from other countries, such decision may have more significant effects on the high growing Far East economies and world trade as a whole. Thus far, there is more talk than action but potentially if there is a slowdown, the political pressure shall increase.

d. Collapse of investment real estate prices

Although the impact of such a scenario should be significant, especially for US and European consumer confidence, for the scenario to apply there must be at the same time a number of other negative developments. These will undermine the real estate market and not just the high prices of real estate, which can adjust by falling 10-20% or even staying the same for a few years, something that should address the problem.

Shipping investors, therefore, should watch for signs of a slowdown in international trade growth, GDP forecasts and Chinese growth, as early signs of an imminent slowdown, as well as the price of oil and rising US interest rates. Massive orders beyond 2007 may affect shipping expectations but not the physical market in the short term. The same applies for green site newbuilding yards being developed in China and the wider Far East. The strength of the US dollar is important, as it affects international stability, confidence and growth, as well as, the level of US interest rates.

Owners should spend more time conducting sensitivity analysis in using different freight rates scenarios and seeing how it impacts on their ability to repay bank debt. Most owners enjoy both high liquidity and healthy cash flows at present, so it is quite easy to be lulled into a false sense of security.

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Lastly, as usual, when the market fall shall occur, older vessel values shall fall faster than newer vessels. Consequently, selling older

vessels over the next year or at least putting them into period charters down to their scrap levels, should be seriously considered. For those that cannot simply sell and wait for better opportunities, the best advice is to buy some vessels, but not too many young age, in case the good market does last longer than most would predict, maintain strong liquidity in case it does not, stay focused and alert to changes in market sentiment and market fundamentals and keep analyzing your fleet breakeven levels beyond the next 12 months.

Shipping has always had the capacity to surprise. Owners, as well as, banks should be ready for all weathers. In the meantime, enjoy the exhilarating ride.

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