

From the Weeds to the Trees

A look down from the treetops reveals some of the bigger picture dynamics currently impacting shipping, while a dig into the weeds turns up specific sectors and sizes where opportunities exist.

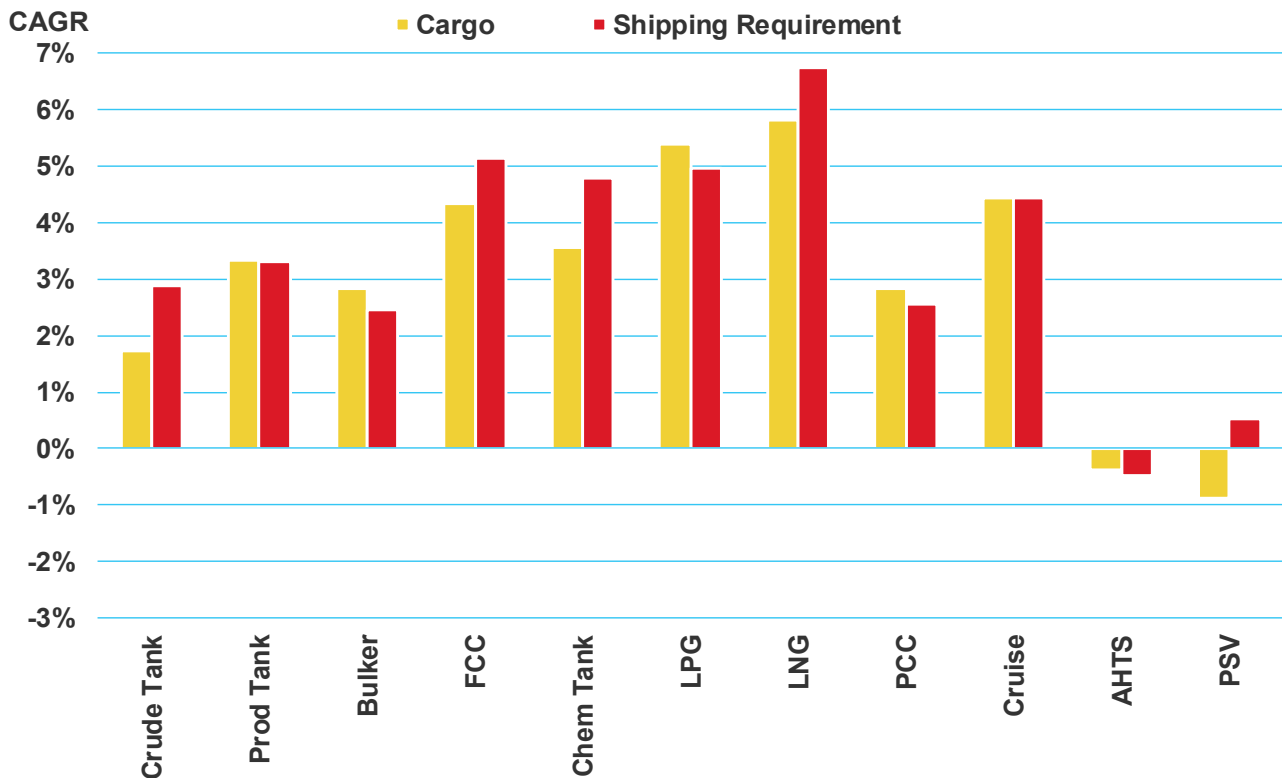
First the good news. From a demand side perspective, the outlook for shipping over the next five years isn't too bad, especially compared to the last five years. Looking at Compound Annual Growth Rates based on MSI's assessment of demand in a number of shipping sectors, crude tankers, containers, chemical tankers all have better prospects over the next five years.

Cargo growth only tells one side of the story though, and if we convert this into growth in shipping requirements, factoring in distances, speed, port times, waiting time, ballast ratio etc, the picture becomes even more positive for crude tankers and containers, chemical tankers and LNG carriers.

Getting into the detail, we can see a favourable outlook for the long haul product tanker story. Middle East product exports will continue to grow, driven by new and expanding refineries in Saudi Arabia, Oman, UAE, Qatar and Turkey. Whilst Europe and non-OECD Asia are forecast to remain the primary destinations of Middle Eastern products exports, we expect (mostly east) Africa and Latin America share to grow. OECD Asia sees stable imports with growth focused on non-OECD regions in Asia.

Another sector we expect to see improvements is for 8,000 TEU containerships. These have been sucked into the liquid charter market and are therefore witnessing earnings at levels only marginally above those of vessels that are a quarter of their TEU capacity. However, we don't expect this to last and it will be the 8,000 TEU sector that shows signs of improvement first.

Chart 1: Trade versus shipping requirement (2015 - 2019)



The reason we believe this to be the case is that the sector and deployment of containerships continues to evolve and we are still of the opinion that the container cascade will remain efficient. In 2011 these vessels were primarily servicing the Far East–Europe and the Transpacific lanes only; today they are operating on a large number of trades and increasingly on North-South routes.

The rapid evolution in port infrastructure developments, an area that MSI monitors in some detail, has to be included to accurately forecast future cascade developments and through this process we believe 8,000 TEU vessels will be calling at a lot more ports over the next couple of years.

Some of the best opportunities from a demand perspective can be found in the specialist sectors. For example, looking at the aggregated demand for NE Asian chemical imports, we are forecasting significant growth of shipping demand requirements over the course of next few years for organic chemicals (increasing 45% in 2019 versus 2015) with growth also exhibited by inorganics and vegetable oils.

Supply Side Questions

Now, the slightly worse news. The supply side is the source of most problems and despite some recent corrections, the orderbook still casts a long shadow over most sectors. Across all the main commodity sectors the orderbook significantly outstrips the ageing fleet with MPP, Ro-Ro and PCTC the only sectors where there is a better balance of replacement tonnage requirements.

Ro-Ros have been left out in the cold for the last decade with newbuilding prices and the cost of bunkers preventing owners ordering new ships, though with these restraints lifted we are finally beginning to see some orders.

However, we do not think all vessels in the orderbook will materialise. Currently over 25% of the 2016 orderbook is set to be delivered by Tier 2 or Tier 3 shipyards, falling to nearer 20% in 2017. We are forecasting that these yards will see significant volumes of cancellations.

Indeed, if the same analysis is repeated purely on dry bulk carriers over 50% of tonnage scheduled to be delivered this year will come from Tier 2 and Tier 3 shipyards. However, for once the industry is trying to help itself. There has been very little ordering in the first half of 2016, when compared to 2015. Apart from 30 VLOC orders booked this year, most other sectors have seen little or no contracting in 2016.

We have also seen the average age of vessels scrapped being reduced. The average age for bulkers scrapped in 2016 to date is now at a historical low based on 1990 to 2015 data. Average age at scrapping for containerships has also fallen considerably from the median and there is evidence to suggest other sectors are also following by scrapping younger tonnage as the markets turn and sentiment becomes more negative. We also think that the up and coming ratification of the BWM Convention, coupled with rising scrap prices in 2017 onwards will force the hand of some owners.

The Earnings Cycle

So where are we in the current earnings cycle? We think that tankers have passed the peak of the market and are currently on the downward slope, with LPG leading the way. We think that the offshore sector still has a little way until it reaches the bottom of the current earnings cycle.

Then we have a number of vessel types that are at or near the bottom of their respective earnings cycles. On the upwards trend we have chemical tankers and at the top RoRos. But of course what goes up must come down and the picture in three years will look different, with RoRos past their peak and crude near the bottom of its cycle.

We think that OSVs will have finally found their floor with almost all other sectors either at the foothills or climbing up the upward slope of the next earnings cycle with chemical tankers towards the top of the cycle.

It will come as no surprise that shipyards are having significant difficulties. Based on scheduled orderbooks and maximum historical output the three main shipbuilding nations are currently looking fully utilised

in 2016, however in 2017 their utilisation drops to around 70% in Korea and Japan and is close to 50% in China.

Looking out to 2018 highlights the recent dearth of orders with Korea and China currently having only around 20% output when compared to the historical maximum. It is our belief that yards need around two years' orderbook forward cover to give them pricing power, any lower than this and that power switches to the owners.

Even the big three Korean shipyards are feeling the pain this time, with HHI and Samsung's current scheduled deliveries for 2018 at exceptionally low levels, although DSME's orderbook is bolstered by healthy LNG cover.

Based on MSI's contracting projection we do not think there will be a significant upturn in contracting levels at any time soon. Contracting will see a nadir this year but then there will be only a gradual increase in ordering levels over the course of the next three years – not enough to offer shipyards immediate salvation.

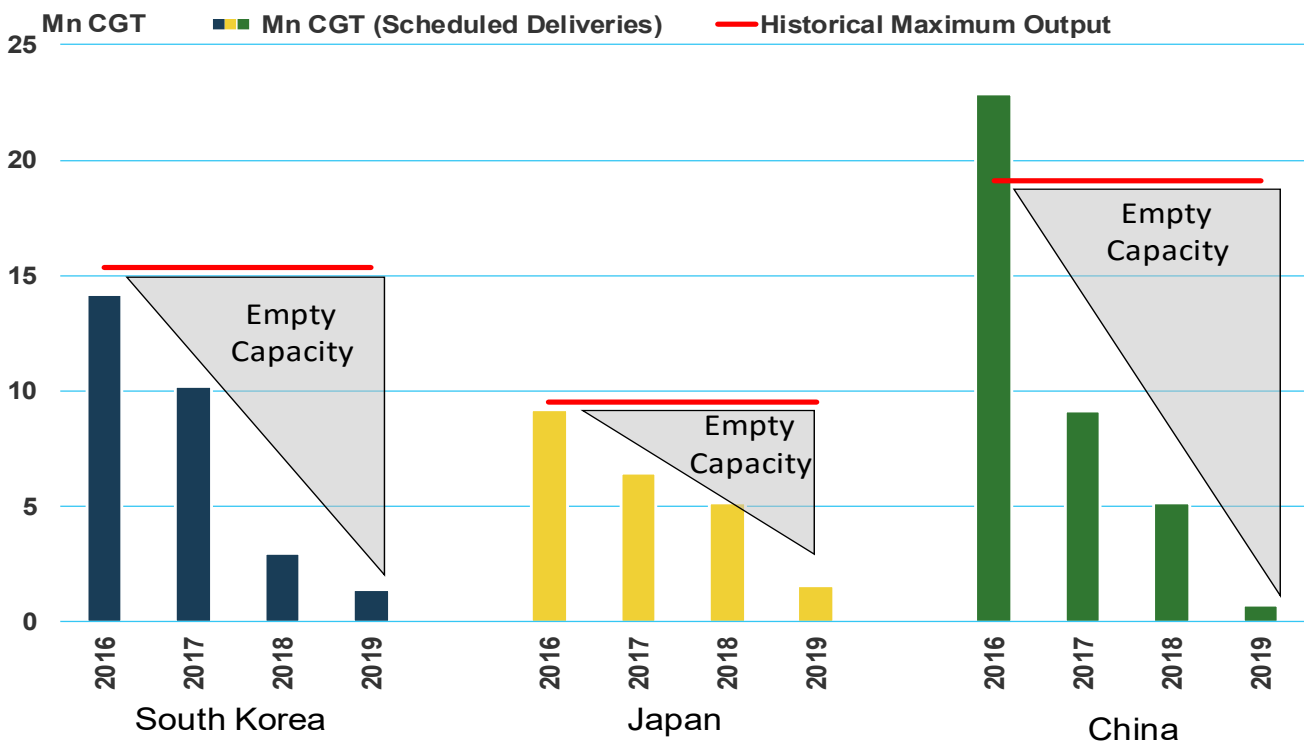
There is a strong relationship between yard forward cover and vessel prices. During the 1980s and 1990s yard forward cover sat between 1.25 and 2 years, however this had escalated to four years by 2008 with momentous consequences for newbuilding prices. Yard forward cover will fall to just over two years in 2016 and next year will drop to 1.75 years with 2018 forecast to be the bottom of the newbuilding price cycle at 1.6 years.

The other driver of newbuilding prices is yard costs, this will help pull newbuilding prices up in 2019. We do however expect newbuilding prices for commodity vessels to bottom out in 2017 and remain there on an annual average basis for 2018, with the specialised sector newbuilding prices only hitting the bottom of the price cycle in 2018.

Danger - Invasive Ships

We are currently in a situation where there is a glut of shipyard capacity, with many shipyards underemployed. The consequence of this is that if

Chart 2: Are the yards panicking yet?



any sector shows a sustained recovery the yards will be well positioned to take orders and deliver lots of ships promptly, within two years. This may mean that we are set to see a something of a structural change in the shipping cycles going forward, with shorter, sharper cycles with any bull run culled by the relative rapid delivery of legions of ships via the new dynamic shipyard capacity landscape.

The speed at which shipyard capacity is able to react to increased contracting volumes was witnessed during the eco ship 'boom' of 2013. After a rapid reduction in shipyard capacity, after the Chinese-led contracting explosion which ended in 2008, shipyard capacity was shown to be very elastic and responsive and increased again to meet the requirements of owners wanting to place new orders.

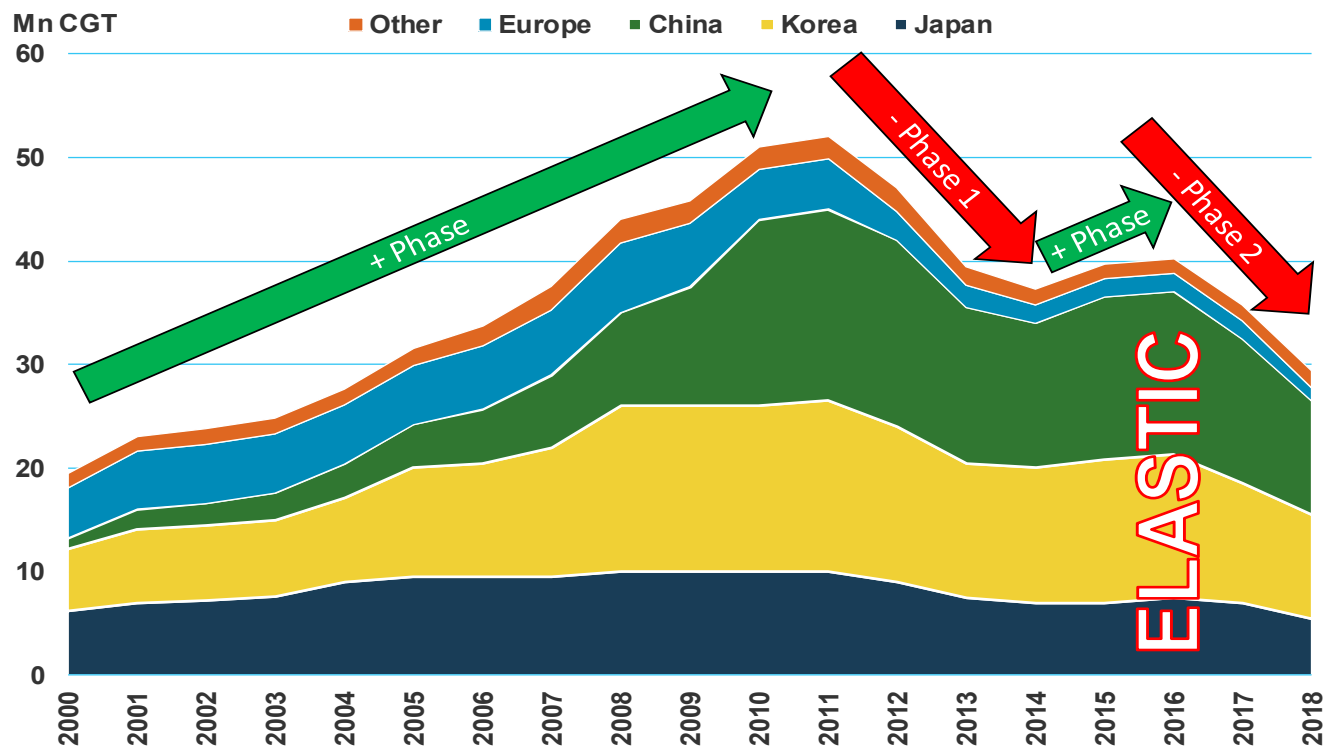
So what does all this mean to second-hand prices? The best way to capture the true relative levels in second-hand prices independent of newbuilding and scrap prices is to assess them in the context of Net Replacement Value depreciation (NRV).

This normalises second-hand prices for movements in newbuilding price and nets out the scrap steel value and enables us to capture the intrinsic value of the vessel and provides a very good correlation to earnings.

If the NRV is calculated for a number of sectors and ages it can clearly be seen how the shape of the depreciation curve varies in different earnings environments. Where earnings are strong the depreciation approaches a straight line – as recently seen in tankers and a number of specialised sectors. However, in weak markets the depreciation curve exhibits more of a convex shape and at the same time life expectancy is also reduced.

Looking forward, we expect the NRV metric to improve from today's position. Bulkers will see roughly a 20% improvement by 2018 versus today's position and containers increases of between 5% and 10%. Although we expect the tanker markets to soften over the course of the next two years the actual reduction in NRV will be limited to around 5%.

Chart 3: Shipyard capacity evolution



Where to plant your cash

One of the best ways to assess today's opportunities is to utilise MSI's new online forecasting tool, Forecast Marine eValuator (FMV) (www.msiltd.com/fmv). This enables you to plug in the specifics of a vessel online and generate a forward projection of newbuilding prices, second-hand prices, earnings and opex.

For this analysis we have assumed an investor has \$25Mn in cash to spend, ignoring any debt or equity considerations, and can buy today and re-sell in 2020. That amount would enable you to buy an ageing 6,500 CEU car carrier or a brand new Ultramax bulk carrier.

The first point to note is that across a wide range of merchant shipping sectors positive returns can be

expected. For sectors currently at the bottom of their respective shipping cycle buying vessels 'cheap' will eventually pay dividend. However, it will be a waiting game and with earnings only marginally above opex for some sectors (i.e. bulkers and small containers), investors focusing here must be prepared for the distinct possibility of further cash burn in the short term until an improvement in earnings gains traction.

The risks are more mitigated and the returns greatest for the specialised vessels based on MSI's latest forecasts. For example, small chemical tankers and LPG carriers can all expect IRR returns in the mid-teens. However, the relative winner is the car carrier sector. However, the problem then becomes both finding a suitable vessel and subsequently securing a charter.

MSI Foresight is a periodic series of articles on topical areas of interest across the commercial shipping spectrum. To find out more about MSI's analytical, consulting and vessel valuation services, please contact Adam Kent at MSI on Tel: +44 (0)20 7940 0075 or email: adam.kent@msiltd.com



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