

Time to Put the Champagne on Ice; Choose Wisely When to Open It

Markets are on the up but the post-downturn landscape will be complex and nuanced, says Dr Adam Kent, Director of Maritime Strategies International.

As 2018 gets underway, the shipping industry can at last take heart from a range of more positive demand-side indicators. The Compound Annual Growth Rate for seaborne cargo was positive almost across the board over the period between 2013 and 2017, and will be equalled or bettered over the next four years for all sectors except crude oil and LPG.

Looked at more closely, what becomes clear is that this improvement comes with caveats: more complex and diverse trade routes, shifting bilateral relationships and national policies will impact front and backhaul business.

China's crude oil imports exemplify the shift; the trend is positive but exporting sources will be diverse, with the US taking market share from Middle East producers,

for example, while both China and Middle Eastern countries will gain market share in refining capacity over the next decade.

New trades, new rules

To illustrate the changes taking place, MSI used its proprietary models to rank significant bilateral trades by rate of growth in the last five years and the next five.

Looking ahead, the fastest crude trade route, in terms of volume growth, is Latin America-India, which has moved from 50th to top position. Sub-Saharan Africa-South East Asia, meanwhile, will jump from 90th place in the last five years to a top five position in the next five. Middle East-North Europe will be the fastest growing products route.

Chart 1: Seaborne Cargo Growth

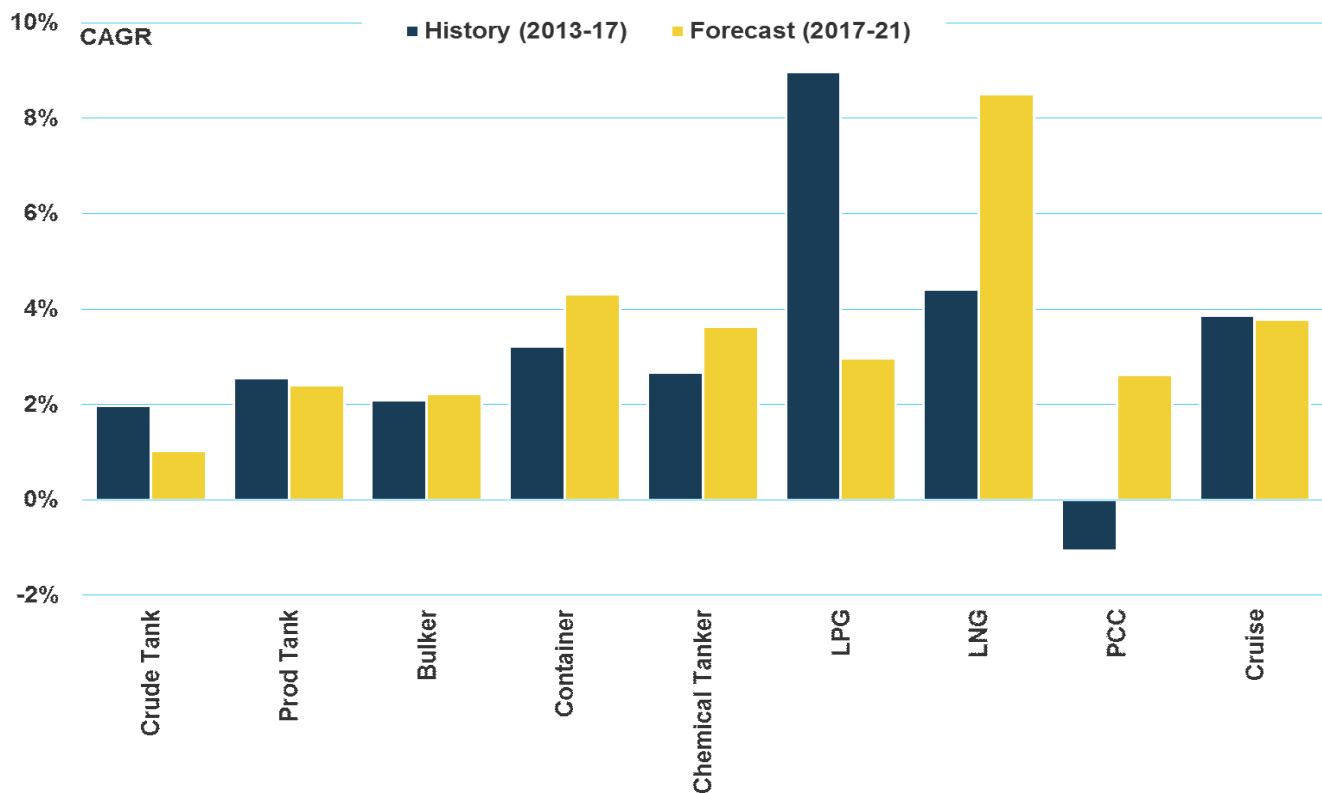
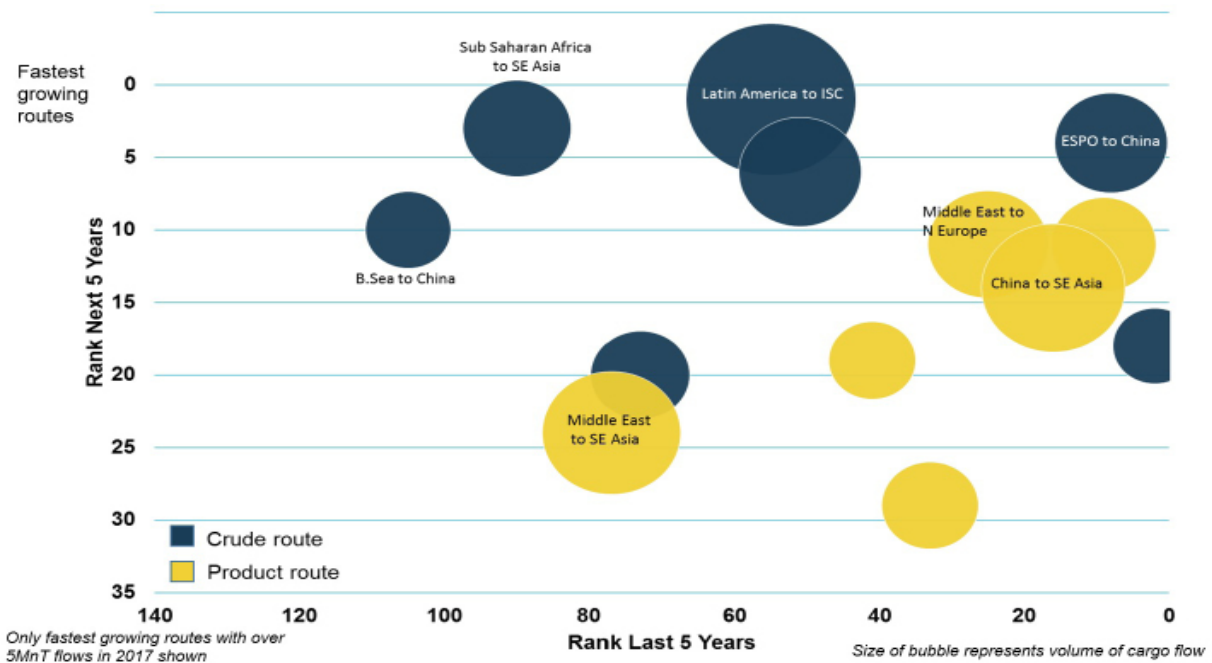


Chart 2: Tanker Fastest Growing Routes



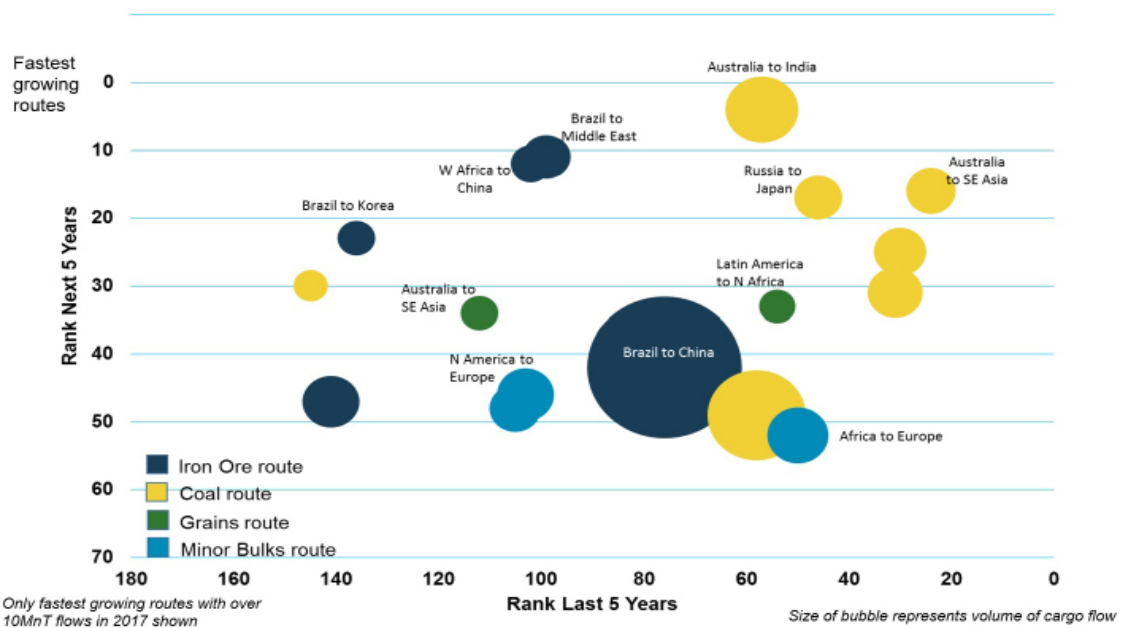
In dry bulk, and focusing in on coal in particular, there is a tension between the drive towards cleaner, more efficient energy and demand for more electric power.

While some governments are moving fast towards renewables, others are opening bigger coal-fired power plants. So while coal consumption is due to peak, coal

trade itself will not because of the mismatch in coal producing and consuming countries.

In ranking terms, Australia-India coal trade is the fastest-growing bilateral dry bulk route and MSI expects to see iron ore movements from Brazil to China continue to grow but, as is the case for other commodities, both products will be moved on an increasing range of routes.

Chart 3: Bulker Fastest Growing Routes



In the container market, 2017 was the first year since 2013 that the industry witnessed significant growth, in terms of incremental required carrying capacity, on all four trade lane groupings. The good news is that the sector will continue to see growth across the board in the coming five years. What is more striking, however, is that none of the mainlane trades feature among the fastest growing routes in the next five years.

Instead, the fastest growth will be seen on Non mainlane East-West and North-South trades such as North America-Middle East and Indian Sub-Continent routes, as well Far East-Middle East trades.

Across all shipping sectors China remains critical to the demand side equation over the next 15 years but politics and policy are likely to play an increasing role. China watchers will be looking for more than just auspicious GDP growth numbers and will instead pay attention to the impacts – positive and negative - of policy shifts.

Supply side under control

In terms of newbuilding supply, China's role looks likely to follow the recent trend with a return of the 'Phantom Chinese Orderbook' - ships contracted but never delivered - identified by MSI last year.

Of the 15 Mn CGT scheduled to be delivered in 2017 actual deliveries were closer to 10 Mn CGT, and of the 15 Mn CGT scheduled for 2018 delivery from Chinese yards MSI expects to see a similar volume of 10 Mn CGT delivered. Partly as a result of this shortfall and with robust scrapping, the supply side generally looks highly favourable in 2018 and beyond.

MSI predicts fleet growth rates close to or less than 2.5% over the next 2-4 years, providing good news for market balances.

Shipyards continue to manage underutilised capacity and with deliveries outpacing contracts there was a further retrenchment in the number of yards taking orders over the course of 2017. However, viewing 2017 in isolation only provides part of the picture as Japanese yards, in particular, are awash with keels contracted in 2015, just before the Tier III NOx regulations were in effect for newbuildings, some of which are only coming to light today.

The NOx compliance issue has a significant impact on vessel construction costs - up to \$2m for a VLCC - but regulation may have a smaller impact on newbuilding prices than it does on scrapping volumes.

MSI traced timeseries data back to the 1990s looking for other regulatory spikes impacting construction

Chart 4: Chinese Pivotal Policies – Demand Breakdown Risks

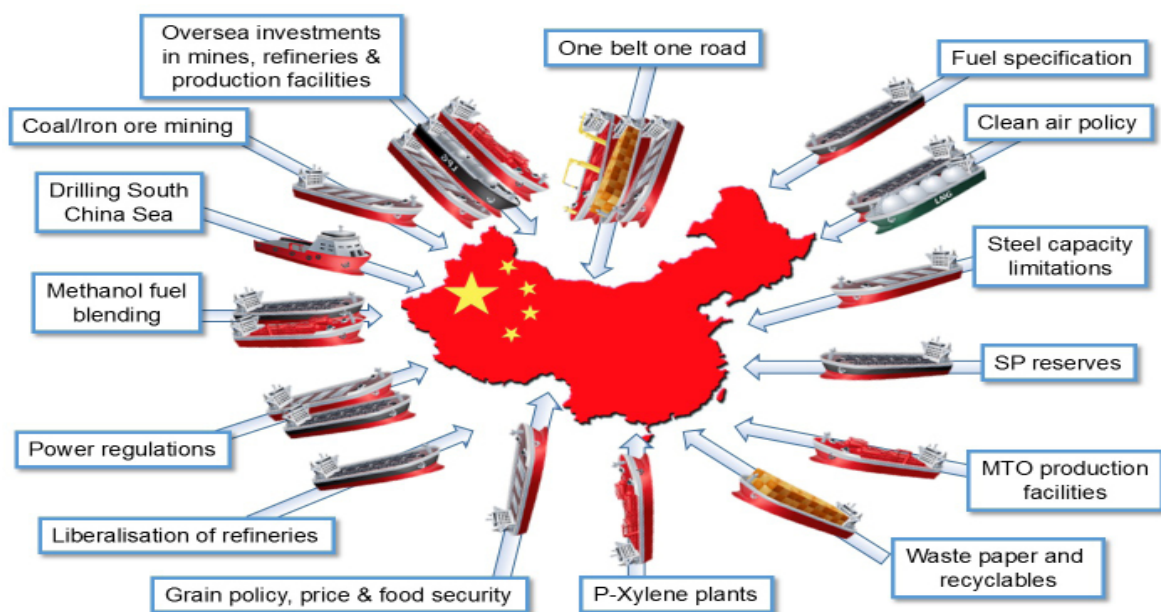
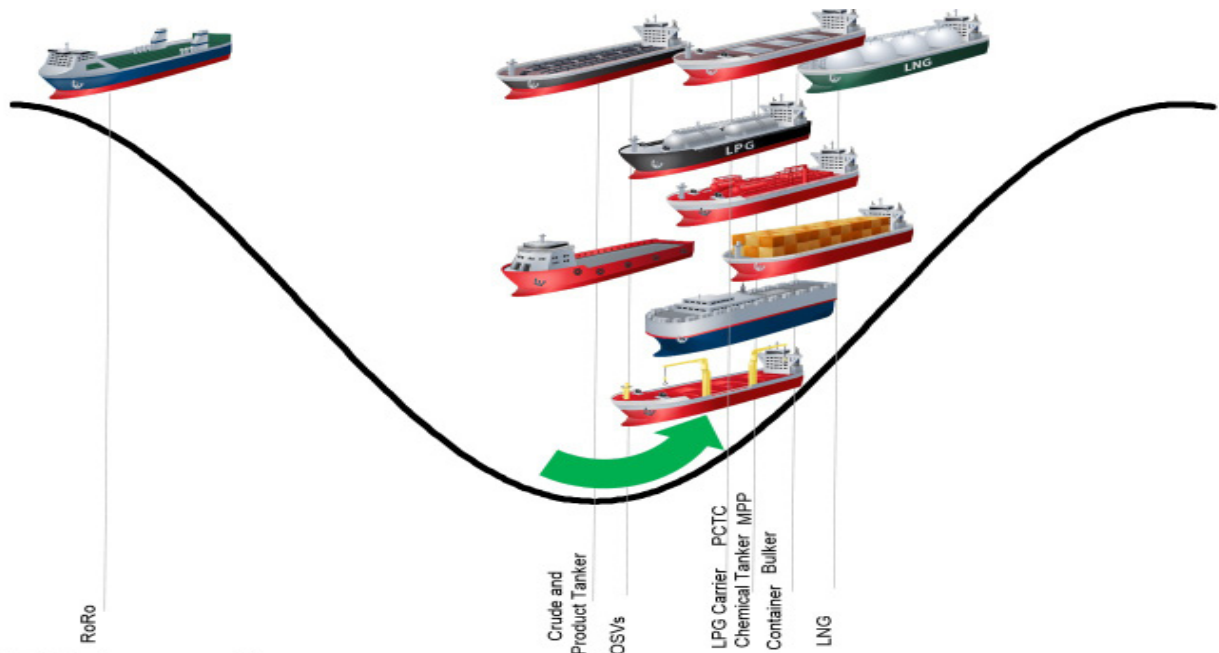


Chart 5: Where on the Earnings Cycle Are We?



Schematic for illustrative purposes only!

costs – double hulls, common structural rules or ballast water management – and found very little, if any, movement month-on-month in asset prices at the point of regulation implementation. The yards will, and have been shown to, absorb some of these costs, and this further highlights the importance of assessing an individual vessel's specifications rather than relying solely on benchmark timeseries data.

Earnings on the up

In terms of the earnings outlook a snapshot of the MSI forecast shows almost all vessel types at the bottom of the trough or moving up, with LNG carriers in particular leaping ahead in recent months.

But how owners will view prospects for 2018 depends very much on timing. An assessment of break-even levels when comparing buying a five year old vessel in 2012 or buying the same vessel as a 10 year-old last year shows that the better result was to be patient and buy later.

The generally rosy forecast comes with a warning, which is that for the recovery to continue the brakes need to stay on new vessel contracting. Earnings for tankers, bulkers and containerships will all show

marginal increases on an annual average basis this year, with sustained better rates for containers post-2018.

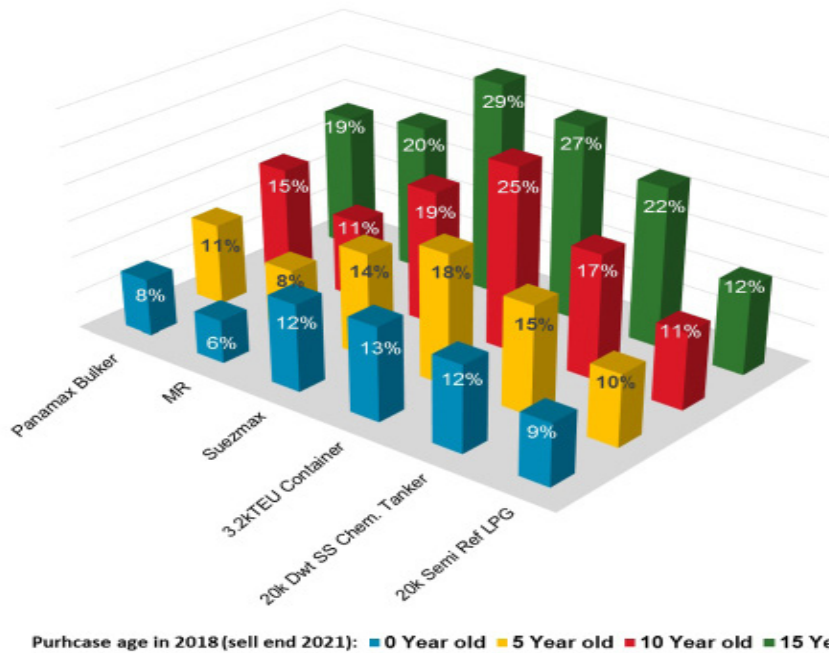
However, by assuming the same contracting run rate for newbuilds as was seen during parts of 2017, the uptick in earnings comes to an end as soon as 2019 or 2020 as new tonnage swamps the market.

In the meantime, second-hand prices will provide good opportunities in 2018. On the basis of a Net Replacement Value (NRV) depreciation methodology, the value of a typical Capesize bulker moved up progressively in 2017 and will continue to improve in 2018. Second hand prices will improve across the board in 2018, and at levels above their 2017 highs.

So what are the picks of the market in 2018? We ran valuations through the enhanced MSI Forecast Marine eValuator online service to forecast where the best returns will lie for a zero year-old, five year-old, 10 year-old and 15 year-old vessel purchased this year and sold in 2021.

Across the board the main shipping sectors all show a positive internal rate of return, and apart from a few areas all will see double-digit growth. With second-

Chart 6: IRR by Age by Sector



hand prices for older vessels currently the most discounted, buyers can expect to see the best returns here.

ordering could jeopardise the recovery within a couple of years and geopolitical factors will certainly play their part.

So, in conclusion, the current wave of optimism evident in the shipping markets appears somewhat justified, but this outlook is not without risks. A rush to over-

So while many owners will have the champagne on ice, when to open it will depend on the ability to judge the market correctly and capture the best returns.

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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