

Prospects for the Shipping Markets in 2003 and Beyond

*Hong Kong Shipowner's Association
20th February 2003*

Dr Martin Stopford, Managing Director, Clarkson Research

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Contrary to everyone's expectations, the 1990s proved to be a very disappointing decade for shipping. However we are now into a new era, and some of the fundamentals have changed, producing a series of unexpected market spikes. The paper speculates on how the tanker and bulk carrier markets will develop as the business cycle moves forward. Will the pattern of unexpected booms continue or should we be preparing for a "Jam today, in a jam tomorrow" scenario?

Each Decade is Different in shipping

Shipping seems to have a different character in each decade. The 1960s was a golden age as shipowners helped rebuild the western economies and entrepreneurs like Pao, Tung, Onassis and Niarchos were handsomely paid for their efforts. Then in the 1970's there was the investment bubble, followed by the 1973 oil crisis. It was spectacularly exciting and profitable for any investors who managed to bale out in time. Then in the 1980s there was the worst recession in history¹. As the equity drained from the industry, operators here in Hong Kong and elsewhere went down like ninepins. Unpleasant, but not without compensations. In the closing years of the decade the survivors enjoyed the century's best asset play market. No wonder the industry entered the 1990s with high hopes.

In fact the 1990s was very disappointing, with weak markets and a poor return on capital compared with other investments. The fact that the stock markets were booming made shipping look even worse. The difference in performance is shown by Figure 1 which compares the return on \$100 million invested in 1990 in an Aframax Tanker (the area), a Panamax bulk carrier (the bars) and the Dow Industrial Index (the line)².

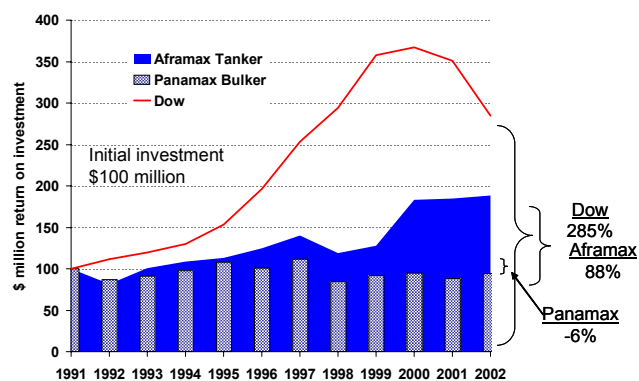


Figure 1 Stocks outperformed shipping in the 1990s

¹ This bold assertion is based on examining the length and characteristics of shipping cycles back to the 1870s.

² This is part of a 30 year analysis which takes account of operating costs, spot earnings and economic depreciation on a "typical" 10 year old vessel. The full analysis is unpublished, but is available on request.

By 1999 the Panamax investment had fallen to \$94 million, the Aframax tanker had increased to \$128 million, but the value of the Dow Industrial investment had increased to \$358 million. At this point the shipping returns were well below the cost of borrowing (LIBOR averaged 5.2% in the 1990s), so heavily leveraged investors were generating leveraged losses. No wonder that by the end of the decade shipowners were wondering if they were in the right business.

What went wrong in the 1990s?

So what went wrong? Demand was not really a problem. Seaborne imports grew by an average of 2.7% pa in the Atlantic and a healthy 3.7% pa in the Pacific. There were none of the appalling disruptions which caused so much trouble in the 1980s, though there were “normal” recessions in 1992-3 and 1998-9 (Figure 2). The real problem was on the supply side where expanding shipyard capacity and tanker life extension pushed up supply. Shipbuilding capacity, which had been cut back in the 1980s, grew faster than anyone expected, trebling from 14.8 m dwt in 1988 to 44 m dwt in 2000.

To make matters worse, despite the hardening sentiment against old ships after the Exxon Valdez incident, most tankers traded longer than expected. For example in 1989, just a few weeks after the Exxon Valdez, I gave a paper speculating on how long the 1970s fleet would last. I outlined three life extension scenarios for the 1990s – and average life of 19 year (Case 1), 22 years (Case 2) and 25 years (Case 3)³. In fact the average life turned out to be closer to a 28 year! All of this increased supply side pressures. However the real *coup de grace* was the fall in asset values. During the decade new prices for tankers fell by 30% and bulkers by around 25%. Instead of making asset play profits, many owners faced capital losses. The Panamax bulk carrier delivered for \$30 million in 1990 was worth \$11.8 million in December 2000, a 60% fall in ten years. A shock for shipowners who had been used to selling the ship after ten years for as much as they paid for it!

Prospects for the 2003 and Beyond

Will the next decade be any better? Let me start with the two key fundamentals, the world economy and the shipbuilding industry, since these two variables that will set the economic framework for shipping in the next five years. In fact the message the statistics tell looks pretty good in the short term, but there are a problems bubbling away in the background – it is a classic “Jam today, in a jam tomorrow” scenario!

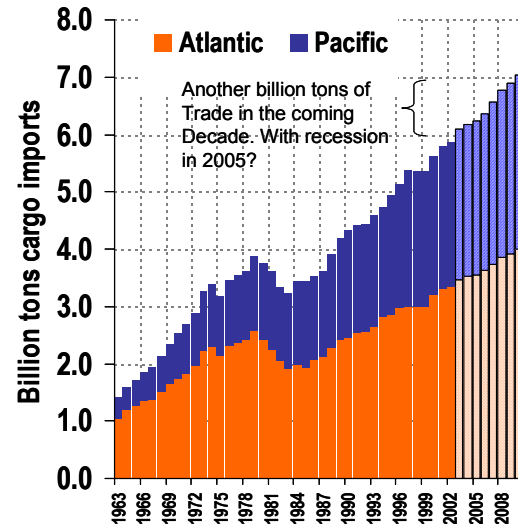


Figure 2 No big trade shocks, but regular cycles

³ “Problems & Prospects of Ship Investment for the 1990’s”: paper to the Hong Kong Shipowners Association, 4th April 1989

Prospects for the world economy

In the short term despite all the gloom in the newspapers, there are clear signs that the industrial economy, which is the one that drives shipping, is heading for a reasonably good year in 2003. Of course there are many political worries, but to date the statistics, shown in Figure 3, tell a positive story. After an appalling year in 2002, when industrial output in the Pacific declined by 8%, this region has bounced back and is now growing very strongly at around 6% pa. The

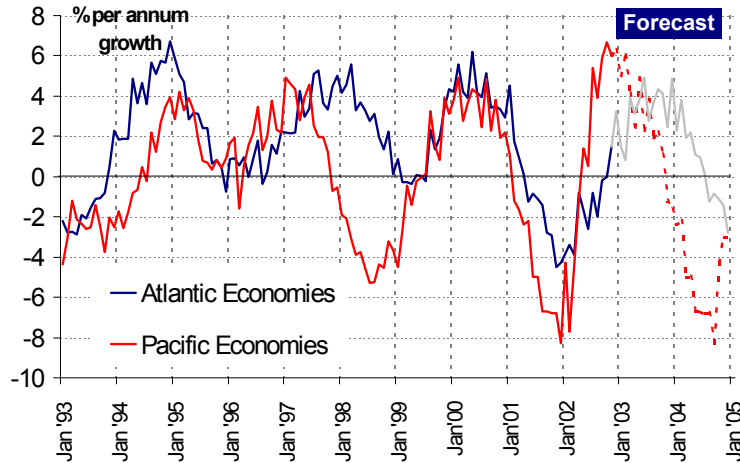


Figure 3 Industrial business cycle has picked up in the Pacific

The Atlantic economies, which seemed to be lagging, have now moved into positive industrial growth, reporting around 2% growth for end 2002. So we started 2003 with a solid base of demand growth. My guess is that, disasters aside, this improving trend will continue, with the Pacific economies peaking out later in 2003. Hopefully by that time the Atlantic will have caught up, helping to support trade in the closing months of the year. So, political uncertainties permitting, we have a positive demand outlook for 2003, extending into 2004.

That is the positive message. On a gloomier note, a continuation of this cyclical pattern is likely to bring a downturn in 2004-5. The normal pattern of business cycles makes this likely, but the pace of development in Asia reinforces the case. Developments in China recently have moved so fast that there is bound to be a reaction, and the same is probably true in the Atlantic, though this will be influenced by the outcome of the campaign against Iraq. If there is a war this will be very expensive with budgetary consequences.

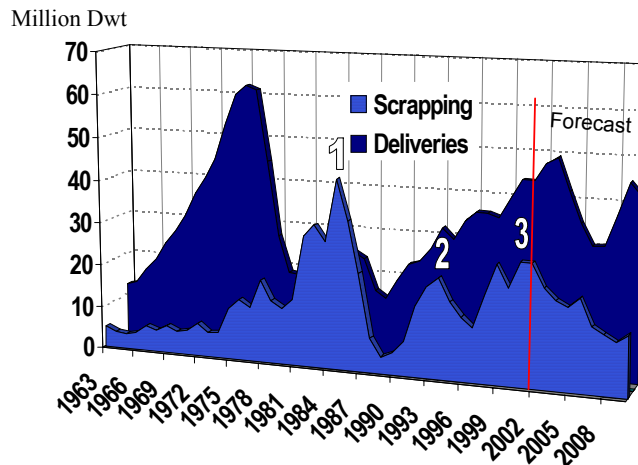


Figure 4 Shipyards at the peak of replacement cycle in 2003

Outlook for shipbuilding & scrapping

On the supply side, shipbuilding capacity is another reason for caution. As mentioned in the first paragraph, the shipyards are now at the peak of the 1970s fleet replacement cycle (Figure 4). With an orderbook of 118.9 m

dwt on 30th January 2003, shipbuilding deliveries are likely to reach 50 m dwt in 2003, the highest since 1976. Although regulators pressing to phase out the remaining 53 m dwt of Pre MARPOL tankers may welcome the prompt delivery of these ships, for the tanker market it raises problems. The April 2001 IMO Regulation 13G amendment gives owners a fairly relaxed phase out program, stretching through to 2007, and so far they are taking their time. Although the latest EU proposals are more draconian, calling for Pre-MARPOL ships to be phased out by 2005 that is not yet law. So there is a great deal of uncertainty in the short term. In the longer term, once this phase of scrapping is over replacement demand is likely to fall from the recent level of 25-30 m dwt pa to 12-15 m dwt pa in five years time. The projection in Figure 4 suggests that this will lead to a fall in the demand for shipbuilding capacity over the next five years.

The Tanker Market in 2003 & Outlook

Turning to the tanker market, we are now enjoying the third tanker market spike in seven years (Figure 5). This is a very significant development. Funds permitting, shipping investment is driven by sentiment and three spikes in a row generates a lot of positive sentiment, not to mention the cash to do something about it. The last time this happened, between 1967 and 1973, the third spike created an investment bubble followed by a long recession, so we are in dangerous territory! By definition you can never reliably predict what investors will do, but now is the time to watch the orderbook very carefully.

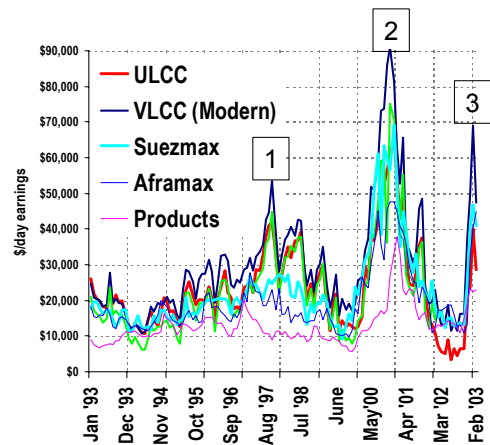


Figure 5 Tanker earnings - 3 spikes in 6 years!

Tanker demand outlook

In the short term the outlook for tanker demand is promising. World oil demand, which grew at around 1.2 m. bpd/year in the 1990s, ground to a halt in 2001-2, so it is no wonder the tanker market had a bad time last year. However in 2003 oil demand is forecast to increase by 1 m bpd and tanker demand is being topped up by the strike in Venezuela which started on 2nd December 2002. Lack of short haul Venezuelan crude is forcing US importers to go to longer haul sources, increasing tanker demand by 2-3%. Looking further ahead I estimate trade to grow by another 7m bpd by 2010⁴. This projection would generate demand for an additional 45-65 m dwt of tankers, depending on where the oil comes from (Figure 6). The low forecast takes a positive view of exports from Russia, the Caspian and various new developments in Indonesia, West Africa, Brazil and the Gulf of

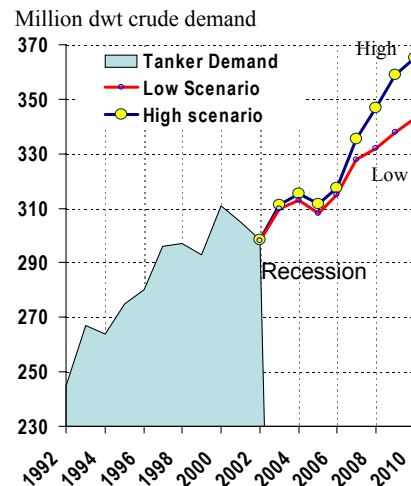


Figure 6 Tanker demand forecast – with bumps!

⁴ In fact the IEA in its latest forecast in October 2002 predicted much higher growth

Mexico. The two scenarios will generate demand for about 6-10 million dwt of extra tankers each year, but note that the forecast builds in a dip in tanker demand in 2005. This ties in with the recessionary cycle discussed above. Predicting the timing of these events is not really possible, but we do know it is unlikely that the growth path will be smooth.

Tanker Supply

On the supply side, the current orderbook of 61.9 m dwt tanker is enough to replace the Pre MARPOL tanker fleet, which is now down to 53m dwt. Deliveries are currently running at 3 m dwt/month and the major issue, looking ahead, is the timing of scrapping relative to deliveries. On the present schedule the pre MARPOL ships will not be completely phased out until 2007, but the orderbook will be delivered over the next two years – the timing problem is clearly visible in Figure 7. Proposed EU legislation in response to the *Prestige* sinking would speed up the phase out, by making it more difficult for owners to hang on until the last possible moment permitted by the IMO Regulation 13G phase out programme. However bitter experience in the 1990s when, contrary to all expectations, tankers traded past 25 years plants a few seeds of doubt urges caution is making this assumption.

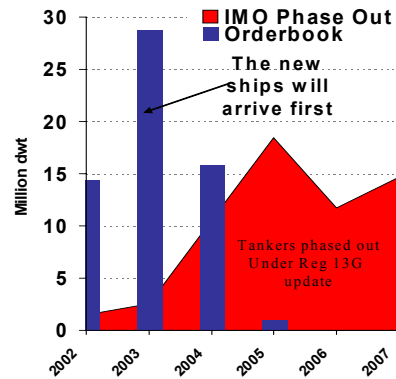


Figure 7 Orders delivered before IMO phase out

In the longer term the level of investment in new tankers will need to drop. Tanker investors ordered 28 m dwt in 2001 and 36m dwt in 2000 but the forecast indicates a requirement for no more than 10-16 m dwt pa of new orders in five years time ⁵. Given the high shipbuilding capacity, and the fact that this is the third tanker “spike” in a row, over ordering seems a very real possibility, especially in the early period when it would be most damaging.

Which brings us to the market forecast (Figure 8). For tankers, I suspect that this is as good as it gets. In the short term the tanker market has peaked and is likely to wind down over the next year. Looking further ahead, we have many of the ingredients for a fairly long recession. The forecast indicates a dip in tanker demand in 2004 or 2005, and with falling replacement demand, sluggish scrapping and a surge of short haul

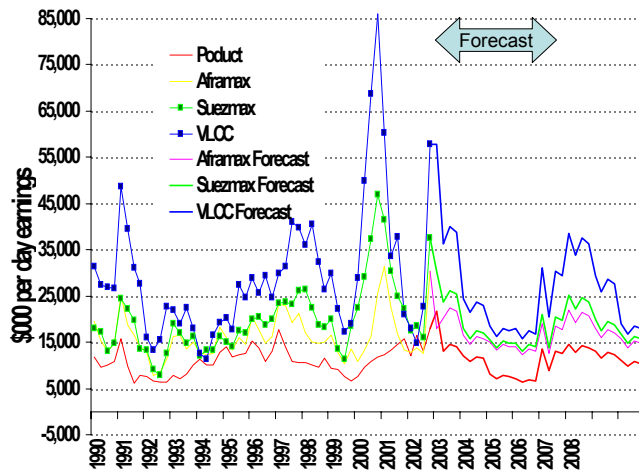


Figure 8 Tanker freight forecast – boom & bust?

⁵ That is based on 4-8 m dwt per annum to expand the f

supply from the FSU and elsewhere, the risk of a pretty long trough is significant. Just what the regulators need to drive out the last of the pre-MARPOL ships!

The Dry Bulk Market 2003 and Outlook

The bulk shipping market had a dismal first half to the year in 2002, weighed down by delivery of the massive orderbook contracted in 2001/2. Panamax rates slumped to \$6,000/day, and at one stage Capesizes were almost as low. Although there was a general expectation that things would improve in 2003, the sudden surge in September 2002 took everyone by surprise (Figure 9). Rates climbed rapidly to around \$20,000/day for a 1990s Capesize and around \$10,688 for a Panamax and continued this way into early 2003.

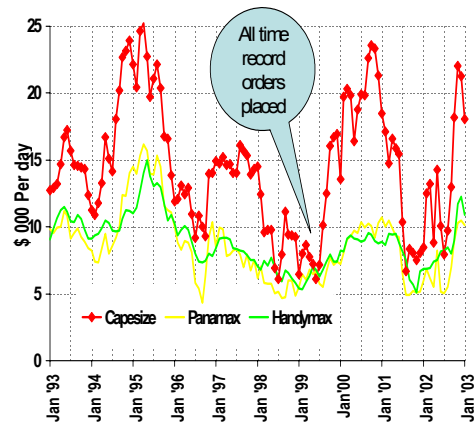


Figure 9 Bulk earnings picked up in Sept 2002

Bulk carrier demand

Bulk carrier demand is behaving pretty well at present. After a massive 6% growth in 2000 it increased by 3% in 2001 and 2% in 2002, a remarkable performance considering the depth of the industrial recession last year (see Figure 10). Demand is benefiting from the recovery in Asia, always a major cargo generator, and a pickup in the steel industry, but the real driving force has been China. Total dry trade is expected to grow by 4% in 2003, but there is likely to be a backlash as the world economy slows in 2004, and this is reflected in the forecast in Figure 10 which shows a small dip (but big enough to unsettle the market).

The impact of China is particularly great in the *iron ore trade* which grew at 5% in 2002 and is expected to grow by 9% in 2003. Virtually all of the growth is in Chinese imports, which are forecast to increase by 32 million tons in 2003. When combined with the Pacific industrial upswing hopefully followed by the Atlantic later in the year, bulk carriers will have a good year, especially Capesizes, though it raises real questions about whether there will be a reaction in 2004 as the market has to soak up all the new capacity.

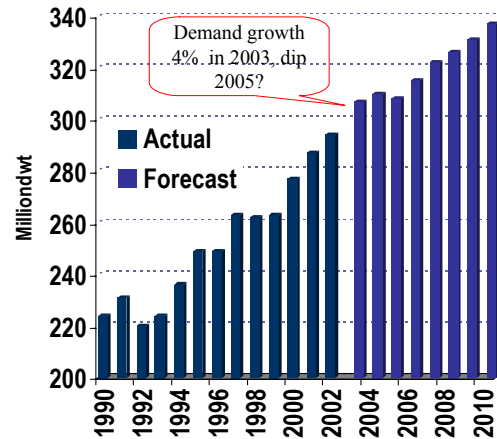


Figure 10 Bulk carrier demand & forecast

The outlook for the *coal trade* is also positive in 2003, with coking coal predicted to grow by 3% and thermal coal by 4%. In the thermal trade Japanese imports are a key issue. The temporary closure of nuclear power plants has triggered increased coal imports and current thinking is that the nuclear power stations will not be back on stream until the autumn. This is not a problem at present, but when air-conditioning is more heavily used during the summer it will boost electricity

demand and coal imports. There is also congestion in Australian coal ports. The grain trade is set to hold its own compared with 2002, and we are predicting that the minor bulks will grow at 2% in 2003, up from 1% in 2001. Overall the major bulk forecast increases trade at 4% in 2003, 1% in 2004 and -1% in 2005.

Finally we come to the *minor bulks*. This important trade, accounting for over 700 million tons of cargo, is the mainstay of the handy bulk carrier business though it has hardly increased in volume since 1995. Although there was some growth in the Agribulks this has been offset by a decline steel products and metal industry materials. Forest products have been stagnant. So we need to be a little conservative in forecasting the smaller end of the bulk carrier market. After 1% growth in 2002, we are predicting a 2% growth in 2003, led by coke, manganese ore and the two big semi manufactures, steel products and forest products.

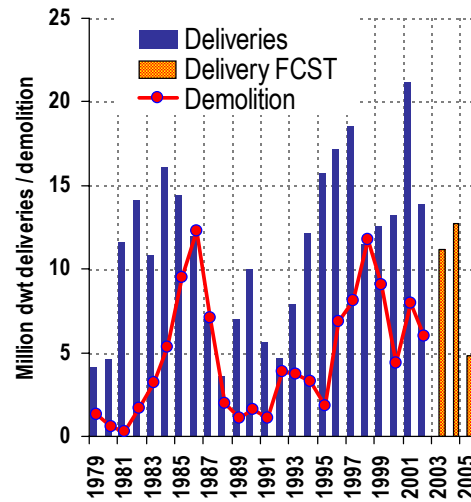


Figure 11 Bulker deliveries, demolition & O/B

Pulling all this together in deadweight terms the forecast indicates a demand increase of around 5% or 10 m dwt, an excellent prospect considering all the doom and gloom in the world today. However it is well above the trend growth projection of 1.7% pa, or about 5 m dwt pa, for the next seven years shown in Figure 10, so expect a reaction later.

Bulk carrier supply

Looking ahead to the remainder of 2003 there is really positive news for bulk carriers on the supply side. On the 1st Feb 2003 the bulk carrier orderbook stood at 32.7 m dwt, with just 11 m dwt scheduled for delivery in 2003 (Figure 11). This is the smallest orderbook for several years and the timing is good, with deliveries running down just as demand has started to pick up⁶. Scrapping has been running at 5-10 million dwt pa over the last five years, though low scrapping

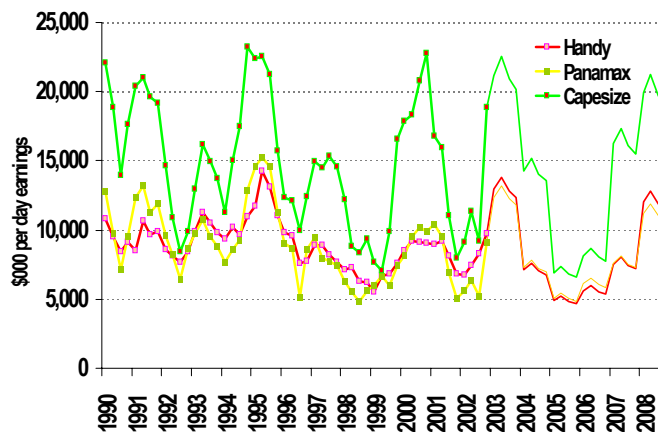


Figure 12 Bulker earnings – good 2003/4, then a trough?

over the last couple of months suggests that we may see a new low in 2003 if firm rates persist. But even if demolition slips to 4 m dwt in 2003, supply would still grow more

⁶ The cost of finance was based on the newbuilding price in each month, with 100% finance at LIBOR plus a 1% spread

slowly than demand. As far as the market segments are concerned, we have only 27 Panamax bulk carriers scheduled for delivery in 2003, compared with 110 vessels delivered in 2001. That is a big reduction and given a little growth of demand, Panamax rates should strengthen.

So the bottom line for bulk carriers is a (long overdue) strong year in 2003. Thanks to the upturn in world economy, especially Asia, things are looking better than seemed possible six months ago. However there is a significant risk that this turns into a long trough as investment builds up, perhaps encouraged by some very low bulk carrier prices – so far the bulker newbuilding prices have not increased as much as tankers. The model forecast in Figure 12 is really quite encouraging in the short term, showing the firm market extending well into 2004! Let’s hope it is right.

A Final Word on Investment

A final word on the investment climate for the coming decade. Will the shipping industry appear more favorably to institutional investors than it did in the 1990s? I think that there is a good chance that it will. Over the last 10 years shipping has suffered from deflation with a 30%+ fall in asset ship values. One consequence of this is that today the cost of ships, by far the biggest item in the owner’s budget, is 90% lower than it was a decade ago. To demonstrate the size of the fall Figure 13 shows the cost of financing a new VLCC in \$000/day since 1990. The cost of the ship has fallen by 35% and the interest rate has fallen from 8.7% to 1.4%, reducing the finance cost from \$25,000/day in August 1990 to \$2,400/day today.

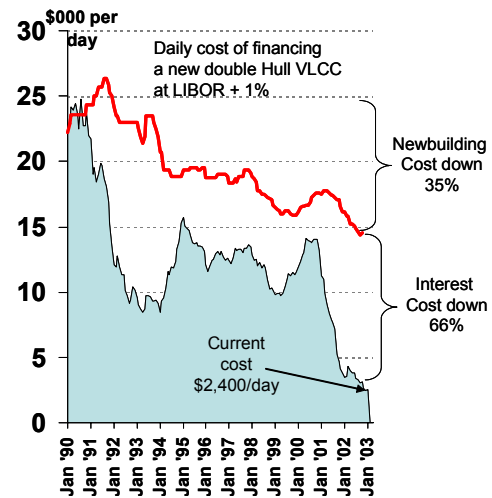


Figure 13 Cost of financing new tanker 1990-03

It is no exaggeration to say that if it lasts, this deflation will change the economics of shipping. If we compare the trend in capital costs with earnings during the 1990s, we see that things really have changed even more dramatically. In 1990 the earnings at the peak of the boom were just about enough to pay the \$8.5 million interest on a 100% loan. Today, or at least in 2002 the annual capital cost had fallen to \$1.5 million, leaving a much larger slice of cash for the equity owners.

\$ million	Interest	Spot
	Cost	Revenue
Total 1990	8,531,428	10,552,973
Total 2002	1,243,021	9,636,262

If this lasts, and some economists think that we may be in a deflationary age, it will have a major impact on shipping strategy. For example repairs suddenly look expensive compared with the cost of a new ship and trading new ships makes sense. So although the preferred strategy in the 1990s was to “Trade ships not cargo” maybe today we should forget about asset play and “Trade cargo not ships”. Such a change of strategic focus

might be welcomed by charterers, not to mention bankers and regulators. Well, think about it!

Conclusions

So let me pull all this together.

The world industrial business cycle is turning up and there is a good chance that by the middle of the year both the Atlantic and Pacific economies will be growing rapidly, always assuming there are no serious political developments. That coincides with a year of heavy Shipbuilding deliveries.

After two years of stagnation, tanker demand is projected to grow by around 3% in 2003, but deliveries represent almost 10% of the fleet. That leaves demolition to bridge the supply demand gap, and so far scrapping levels of very muted. This places the Tanker market close to a peak so expect a progressive falling away over the next 12 months. In the longer term reduced scrapping and the very heavy investment activity going on at present, or is likely in the near future, points to a fairly protracted downturn.

On the bulk carrier side, the fundamentals look much more robust. Demand is forecast to grow at around 3.5%, and in 2003 the order book is barely sufficient to meet this demand growth. So assuming there is some background scrapping, the short term prospects look pretty good. Two years ahead the outlook is less promising as the business cycle turns down.

So that's the scenario - "jam today, in a jam tomorrow". Luckily if interest rates stay at today's level, the jam tomorrow might not be too bad. Investors willing to cope with this volatility, may even find shipping quite an attractive investment in the coming decade.

Martin Stopford

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3,300 words

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