Slater on Money

Charter rates are not going to get back to anywhere near the boom rates of the last decade and that means a large number of new ships will remain uneconomic

Paul Slater

Companies have used too much money to buy too many newbuildings and are unlikey to get a return on their investment as charter rates continue to fall. *Bloomberg*

A bleak outlook for shipping

THERE is much discussion these days about the outlook for shipping over the rest of this decade as the results for 2011 continue to reveal that companies in all sectors are continuing to lose money and the equity values of most of the public companies are at all-time lows.

I have long felt that the shipping industry needs to get back on course and return to the great service industry that is the lifeline of world trade.

When shipping started to emerge with public debt issues in the 1990s and then public equity issues in the last decade I expected to see large shipping companies develop with substantial equity bases and strong cash reserves. After all, ships are expensive assets that are relatively short-lived compared with other industrial assets.

The largest shipping companies today are still mostly privately owned with the exception of many Asian companies. This means that the majority of operating information is also privately held and a large percentage of charter contract details are also private.

The new public companies have failed to attract institutional or other long-term investors and are today owned by traders and hedge funds.

Furthermore, the shipping banks have grossly overlent to the industry, with billions of dollars funding 75% or more of the cost of new ships even though they cost 30% more than identical ships ordered only two years earlier.

These loans were also mostly made without any charter cover, and in many cases with little or no construction supervision or any real clue as to where the ships would trade when delivered. Options on further ships became the norm and it was not uncommon for orders to be made for a dozen ships.

The results of the boom years of the last mid-decade were used to entice equity from investors, who were mostly ignorant of the shipping industry, and the stock market value of most companies soared as more and more ships were ordered.

Not only in New York was shipping madness rampant, but in Germany the KG funds and the German banks combined to order more ships of all types in a three-year period than the total of the previous 20 years. These orders were particularly vulnerable as the KG managers charged outrageous upfront fees and excessive management costs, and the bankers were inexperienced. This combination has created the largest group of shipping losses, which could well reach $100bn between the banks and the KG investors, compared with $35bn of market value losses in the US public companies.

The problem is that the ships do not disappear like the money. Today the industry is riddled with over-priced ships and excess capacity, and is now facing reduced demand which is likely to continue for many years.

Falling iron ore imports, particularly in China, means reduced demand for ships to transport it.

Macro-economic issues, world trade and the uncertainty of regional and global politics all affect the

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demand for shipping. Unfortunately, the shipbuilding industries of Asia do not focus on these issues but continue to build ships and stimulate orders with subsidised financing and lower prices, adding to the already over-tonnaged markets.

This not only depresses ship values, but also continues to undermine any recovery in charter rates that today barely cover operating costs and make no contribution to debt service.

The reality is that charter rates are not going to get back to anywhere near the boom rates of the last decade and that means a large number of new ships will remain uneconomic and their loans will be unserviceable. The equity value of most of the public companies will not recover either and unless the banks restructure their loans and write them down to levels that the ships can service, they will end up owning them and face the same cash flow problems as the present owners.

Meanwhile, there are a number of reported factors that need to be considered in looking ahead at the outlook for shipping.

The first and most important one is China, which was the fundamental reason for the last boom and the subsequent massive orderbook for new ships.

China is about to begin a new 10-year government with a new president and a new prime minister. Already they have indicated that the next 10 years will be a period of consolidation, with a greater focus on internal Chinese affairs than external ones.

Growth projections will be 7.5% or less and the yuan will be allowed to float in the currency markets, albeit not immediately.

Imports of iron ore and coal are already down and China is now importing increasing amounts of oil from the Russian Sakhalin Islands and will aim to grow this through the construction of pipelines.

The depressed economies of the US and Europe have created reduced demand for goods manufactured in China and elsewhere in Asia, compounding the problems of the container sector, which is over-tonnaged and has a large orderbook.

Brazil's economy is slowing down and it is looking to build more ships locally for its growing oil trades. The Greece mess is far from over and the euro remains threatened by further defaults of sovereign debt in Portugal, Spain and Italy.

France is facing a tough election and Germany has huge problems with its major banks that need further capital to meet the new Basel rules and to cover the losses they have suffered from the Greece default.

Globally we see a reduced demand for crude oil, with both the US and Europe using less gasoline. The global demand for iron ore and coal has stalled at levels way down from the peaks of the last decade.

Shipping has too many ships and the youngest fleet in 50 years, in most sectors, while the orderbook continues to cast deep shadows over any recovery in the near term. Once again we see major intermediary charterers in the dry cargo sector defaulting and trying to renegotiate charters as their underlying business declines sharply.

Perhaps owners and bankers will be more careful before accepting charters from companies that have little or no control over the cargoes being carried. It is time for the cargo owners to step up and charter ships directly.

There are many unconfirmed rumours of billions of dollars sitting in the hands of Greek shipowners waiting to pounce on cheap ships when they determine the markets have bottomed out.

This may be true, but similar rumours in previous bad markets have proved to be false.

One thing is certain: the public companies will not be bought, but their assets may.

More likely is the progressive ordering of new, cheaper ships with

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greater fuel efficiency and not at the extremes of size. This could result in a large number of existing ships becoming uncompetitive and possibly facing early scrapping.

Public and private equity will remain scarce and debt financing will remain elusive for several years to come.

The next three to five years will see shipping return to its base as an industrial service industry in which modest returns are made but ships are maintained to last longer. New ships will be ordered to replace older ones and not to expand fleets to the levels of self-destruction. ■

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