Why distress buyers may get bitten

Rates could stay at rock bottom as the cost of operating and maintaining ships soars

Paul Slater

NOW we have passed all the seasonal holidays from Christmas, the west's new year, Chinese new year, Passover and Easter, the various excuses for optimistic or pessimistic changes in freight rates are over for a while.

The fact remains that there are far too many ships in most sectors to support any lasting recovery in the freight markets. Moreover, most ships ordered between 2005-2010 were so overpriced and over-indebted that only the boom rates of 2005-2006 would fund them.

Bear in mind that the boom rates were not caused by war or national disaster but by mismanagement of the Chinese economy.

China channelled vast sums into manufacturing, infrastructure, construction and energy projects with little or no regard for lack of raw materials or energy products.

Buying these supplies was easy and moving them by ship was easy, provided that the arrival ports were built. More raw materials needed more ships to move the cargoes around in China's domestic markets.

Vast stockpiles of iron ore and coal were created and steel mills paid huge premiums to access them, as regional politics required these products to be moved around various domestic ports.

In practice, there is little difference between China's Communist government and the emperors and regional princes of centuries past.

Although central government, which has a 10-year life, sits in Beijing, sets policy and releases money through the banking system to the regions or states, there is no central control over regional government or city mayors' investment decisions.

The Chinese boom took some five years to grow and another five years to settle. Meanwhile the demand markets for Chinese finished goods in the US and Europe collapsed.

This is highlighted by the collapse in freight markets in nearly all sectors and the continued delivery of unwanted ships ordered in the boom years.

The opportunism of independent shipowners and the ignorance of US investors and German KG partners — on the advice of their respective bankers, brokers and other intermediaries — saw money thrown at shipping, regardless of the experience, quality or reputation of the shipping company or its principals.

Reality has now set in. Although demand for shipping services has returned only to levels seen in the early 2000s, fleet capacity has more than doubled.

A large percentage of the present fleet will never meet its debt obligations and will produce nothing for the equity owners except management fees for the companies' founders.

Large sums of money have been moved out of many of these public companies, the excuses ranging from inflated prices of ships bought from family related companies to absurd fees paid to some principals to cancel inter-family contracts.

Weak markets and eroded cash reserves have led to several bankruptcies, with more to come, although many will become insolvent first.

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Untouched by the external forces of investment banks, KG managers or lending bankers, the markets would have sorted themselves out, as owners always have, through the efficient sale and purchase markets.

Instead, we see arguments over assets and liabilities in the US courts or in major restructurings as banks try not to take the writeoffs.

Surprisingly, Germany has come out as the country with the worst shipping portfolio. Gross mismanagement of the once-revered KG investment system will cost the country tens of billions of dollars of bank debt and investor capital.

The German banks have refused to mark their portfolios to market and are even resorting to the fatuous Hamburg Ship Valuation System to hide the vast losses.

Thus thousands of ships will continue to trade, losing money every day, making nothing for their investors and not even servicing their debts.

The long-shot idea — that with accelerated scrapping and a reduced newbuilding orderbook, the markets would recover in a few years — has shattered.

First, the scrapping industry has its own market and will not expand its activities and depress its profits, particularly as demand for scrap steel has flattened.

More worrying, however, is renewed activity in the shipbuilding industry. The product tanker markets, for instance, have seen a relative flood of orders of ships cheaper than their predecessors and with new hull and engine designs that may well consign the boom-period ships to a secondary market, where they will have no equity value and will be unable to pay their debts.

It is interesting to see oil majors, directly or indirectly, returning to the market as long-term charterers or owners, although little activity of this type has been seen in the crude markets.

The container markets continue to flounder and the orderbook continues to grow, even with hundreds of ships laid up.

Economies of scale have seen ships outgrow port capacity and most serving the backhaul to Asia are sailing all but empty. With no sign of any real economic recovery in the US or Europe, the container lines face years of marginal growth in demand and shipyard prices continuing to decline.

The disappearance of most shipping banks and the lack of interest in shipping by most private equity firms means that the cash-rich traditional private shipowner will dominate the industry for many years to come.

Those investors that have entered recently on so-called distress buying expeditions may well find that they have found the bottom, but that is where rates remain, and that the cost of operating and maintaining the ships becomes an escalating problem.

Gas — both liquefied petroleum gas and liquefied natural gas — is probably the most exciting market as the US is now an exporter of LPG and could also export LNG in the near future.

Vast new finds in the Middle East Gulf and Russia, and the hint of more to come from Africa, could see gas replace crude as the world's primary energy resource.

This could be the end of the very large crude carrier and suezmax markets unless the Organisation of the Petroleum Exporting Countries slashes the price of crude to compete with gas.

Meanwhile, China continues to enlarge the fleet it controls, to fund shipyards to build more ships and to train large numbers of Chinese crew.

The political objective is to carry 75% of the country's imports and exports on Chinese-controlled ships by 2020.

Although this could embrace foreign owners such as Seaspan, through long-term charters or leases, the inevitable consequence is a shrinking of cargoes available for the spot markets, a drastic reduction in speculative ordering and a return to industrial shipping. ■

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