



# ROAD TO RECOVERY

BIMCO's analysis on the recovery of shipping markets

October 2016: the wider impact of the dry bulk market crisis

## Foreword

In 2016 the dry bulk shipping sector experienced some of the worst market conditions in recent history. Many companies all over the world have been affected by these conditions. In response to this crisis, BIMCO produced a unique analysis model, named the “Road to Recovery”. It is designed to highlight the actions needed for struggling shipping markets to recover – and to track their progress.

The first piece of analysis on the “road to recovery” for the dry bulk sector prescribed a “zero supply side growth” scenario for the recovery of the dry bulk market. This requires shipowners to neutralise the delivery of new ships every year by scrapping an equal amount of capacity from the existing fleet. This analysis and the latest information on the recovery of the dry bulk market is available on BIMCO’s website. We will continue to update this throughout 2017 and beyond.

But the impact of the crisis in the dry bulk market is deeper and more complex than initial data alone can show. It has already begun to have a knock-on effect for many companies that do business with the dry bulk sector and will, in some cases, change the way they operate.

In October 2016 BIMCO produced the following report on the impact of the dry bulk market crisis – not only on shipowners but also on the wider shipping industry, including brokers, bankers and shipyards. It concludes that major changes are on the horizon. We are sending a copy of this report to each of our members as this issue could affect many of your businesses.

In 2017 we will extend this series of analysis on the “road to recovery” for shipping markets to look at the tanker sector and will keep you up to date with developments. You can always find the latest market analysis at [www.bimco.org](http://www.bimco.org).

### Angus Frew

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### How will the crisis impact the future of the dry bulk shipping industry?

#### Huge changes around the corner

In 2016 BIMCO published analysis on the “road to recovery” for the dry bulk shipping industry. The report highlighted the severity of the current crisis – and the likelihood that the sector will only return to profitability in 2019 if shipowners deliver “zero supply side growth”, year on year. This is where ship demolition is equal to or greater than deliveries. This is not an easy task, as the dry bulk shipping industry has only achieved zero supply side growth in three of the last 35 years.

Total dry bulk trade has grown by 40% since 2007, this was largely driven by developing nations in Asia. The demand for dry bulk commodities has peaked in advanced economies, for instance demand from Europe, North America and Japan has not returned to pre-crisis levels and is unlikely to in the future. The question is: how close to the peak are the larger developing nations in Asia that have driven dry bulk demand over the last 8 years? It is clear that the future potential for growth is focused on a few key countries.

Dry bulk shipping relies strongly on heavy industrial activity and the use of fossil fuels. The future growth of the related cargoes appears limited and uncertain. While China's economic growth has slowed, its focus is moving away from infrastructure, housing and heavy industry towards a consumer and service driven economy. This transition has already hit China's import of dry bulk commodities and will continue to play out in coming years.

Various countries have announced their will to end the use of fossil fuels and have started to close coal-fired power plants due to their declining political and social acceptability. It was recently reported that energy from coal hit zero for half a day in the UK for the first time since it opened its first coal-fired generator in 1882. Thermal coal imports to the UK were reported down 80% year on year in the first half of 2016.

As if this was not enough, the shipping industry as a whole is being required to invest heavily in equipment to satisfy up-coming environmental regulations on ballast water treatment, and NOX, SOX and greenhouse gas emissions. The new ballast water convention will enter into force in 2017 and will require more than 50,000 ships to be retrofitted with ballast water management systems costing up to USD 5 million per ship. This is another blow to the dry bulk shipping industry at a time when it can least afford it, and will force many owners to scrap their ships prematurely. While this will have a negative financial impact for many individual owners, it will be a positive move towards rebalancing the supply side of the market and hasten freight rate recovery in general.

#### What changes will the current multi-year crisis bring around for the dry bulk shipping industry?

This prolonged crisis is likely to have a significant impact on how dry bulk shipping business is conducted in the future, and many of the changes are likely to spill over to other shipping sectors as well.

#### “Fragmented ownership”: the current industry model for dry bulk shipping

The current industry model in dry bulk shipping is characterised by very fragmented ownership of the 10,800 ships in the global fleet. There are only four companies owning more than 100 dry bulk ships and on a DWT basis, the largest owned fleet represents less than 4% of the total fleet. This means that each individual owner has very little influence and bargaining power with its customers and is often reflected in low levels of mutual trust.

Many shipowners in dry bulk shipping today have highly leveraged fleets and are focused on the asset play (buy low, sell high) rather than acting as logistics providers focused on return on capital employed. The asset play is a high risk business model especially when it is combined with a high proportion of ships on the spot market.

There are owners who are more conservative and had a strategy of running many of their ships on long term charter. They have been caught out by the length and severity of the downturn with most, if not all, of their long term charters now expired. Today, when the dry bulk shipping market is scraping the bottom, locking ships into loss making time charters is not an attractive option for the owner.

There is consolidation going on amongst the dry bulk shipping customers, many of whom are already very large global players. So while the dry bulk shipowners remain highly fragmented, their customers are ever-increasing in their influence and bargaining power. Right now many dry bulk customers are spoilt for choice in the shipping market: there are too many ships to choose from and, as a result, freight rates are firmly in the gutter. Dry bulk shipping is in fact a good example of what economists call an oligopsony: a market with a limited number of buyers and a large number of sellers.

Due to the small size of many owners' businesses, today a very large part of dry bulk chartering continues to be done via brokers. This means that the relationship with the shipping customer is effectively owned by the broker, further weakening the negotiating capability of the owner.

Since 2011, 34 giant valemax ships have been launched (380,000 DWT or more). It was announced in March 2016 that a further 30 valemax ships have been ordered for delivery in 2018 by three Chinese owners for a combined USD 2.5 billion with back-to-back 25 plus year contract of affreightments (COA) with Brazilian mining giant Vale. Once these orders have been delivered, the valemax fleet will be able to carry over 50% of Brazil's current iron ore export volume, eating into the business currently carried by the existing capesize fleet.

Today the financing of ships comes largely from banks – with the bank able to dictate the terms to the small ship owner. European banks have cooled their interest in increasing their exposure to the shipping industry. At the same time, more finance is now entering the industry from Asian banks. Global ship financing was heavily reliant on banks before 2008 and, according to Petrofin Research, this reliance has dropped markedly since then as the proportion of non-bank finance sources has grown. The gap is made up by alternatives such as export credit agencies, bonds, public and private equity. Further declines in bank financing are likely as existing and future banking regulation will make lending to shipping more expensive.

Currently there is far too much ship building capacity. Government backed export credit agencies financing new buildings has contributed to the unsustainable level of new ships hitting the water. State support for the yards could be for a number of diverse reasons, such as to create/retain employment in some countries and/or attain leadership in the global transport system.

### **Consolidation and risk management: the new industry model for dry bulk shipowners**

Consolidation is the natural consequence of a prolonged and deep shipping recession. Less well capitalised owners will be forced to sell their ships, and some owners will wish to withdraw their capital from the dry bulk sector. Their ships will be bought at bargain prices by better capitalised competitors and new entrants to the market.

While the existing business model is set up to service the requirements of the smaller shipowner, there are a number of significant benefits from size and scale for larger shipowning companies:

- Larger owners will seek to develop long term direct relationships with major customers without the requirement of an intermediary or broker. They will have the resources and capability to deliver creative, flexible and value-adding logistics solutions. The larger owners will eventually develop more balanced and trusting long term relationships with these customers and, as a result, have more power at the negotiating table.
- At the same time, major shipping customers will want to work directly with fewer shipowners, each of which can provide a significant part of their shipping transport requirements. This is seen in the Brazil China iron ore trade with Vale recently signing long term COAs with Cosco, China Merchant Group and ICBC.

The key stakeholders in large shipowning companies, both debt and equity providers, will require a more sophisticated business model with a greater focus on risk management. We will see them adopt risk management in a number of ways:

- Through the availability of better quality information, with a deeper knowledge of the market and improved forecasting capability. This will help companies achieve a deeper understanding of customers and the market, and ultimately support better resource allocation and asset purchase/disposal decisions.
- Putting a charter portfolio strategy in place. Owner companies will wish to have a large part of their fleet on longer term charters to ensure a steady cash flow to maintain the business through down cycles. They will also want to ensure there is not too large an exposure to any one single customer.
- Shipowners will seek to control their commercial risk better via forward freight agreements, currency and bunkers hedging, and counterpart checking among others.
- Larger owners may also wish to reduce risk and capital requirements by operating a fleet of pooled ships alongside their owned fleet.

What is the optimal size of a shipowning company? In June 2016 at the TradeWinds Shipowners Forum in Posidonia a number of owners stated that running an efficient shipping company requires a certain number of ships under its control. Some said around eighty to a hundred ships although there was little coherent justification for limiting the size to a hundred ships. It should be noted that on a pure ownership basis, there are only eleven companies that currently own eighty or more ships.

In summary, in the future there will be many larger dry bulk shipowning companies whose business will be as logistics providers to the commodity giants with a focus on risk management and Return on Capital Employed (ROCE). The asset play will be a subsidiary benefit to these businesses rather than the number one business goal.

What will this mean for the dry bulk shipping sector as a whole? It will be a demand-driven industry with most ships purchased against long term charters by large and sophisticated businesses that are better able to forecast future market demand. This will ensure that supply and demand are much more closely linked in a mature market where large and unforeseen trade fluctuations are rare. Ultimately this will mean a less cyclical industry where the peaks and troughs are dampened, leading to steadier and more predictable ROCE for the larger companies.

This is a real risk for the small shipowner, many of which are family run businesses, as the business model will become less attractive over time for many reasons:

- Finance will be harder to find, requiring a higher proportion of equity, and be more expensive than their larger rivals who are able to demonstrate a lower risk business model.
- As a stand-alone company, small owners will not be able to participate on the major routes for the major commodity sectors. They will mostly be limited to niche trades arranged through brokers, alternatively they may place their ships in a pool operated by a larger shipowning company.
- The large and frequent shipping cycles that made the asset play so profitable in the past will be dampened in intensity and reduced in frequency. This will make the asset play a less attractive business model in the future.

Dry bulk shipping has the least sophisticated ships requiring low levels of crew specialisation. This means there is a low barrier to market entry and therefore small dry bulk shipowners generally struggle to benefit from their experience and reputation.

These changes are not expected to happen overnight but will accelerate over time, particularly if the current recovery is delayed. There are already some larger shipowning companies acting as logistics providers to the commodity giants with a focus on risk management and ROCE.

### **Broader range of services: the new industry model for shipbrokers**

Brokers are already facing challenging conditions due to the supply demand imbalance across almost all shipping sectors and the resultant low levels of charter rates, spot freight rates, resale values and newbuilding prices.

Consolidation will mean bigger shipowners in all the major shipping sectors. Owners of big dry bulk fleets will want to deal directly with larger customers for major commodities on the major trade routes. They will want to own the customer relationship and reduce the cost of doing business by eliminating broking commissions. The larger organisations will have the scale and resources to manage their key customer relationships directly. Maybe these larger owners will also have the resources to deal directly with shipyards and ship breakers in the future too?

There is also pressure from the shipping customers to eliminate brokers from their supply chain with Vale having recently put in place very long term COAs for over 50% of the Brazil China iron ore trade from 2018 onwards. It is only a matter of time before there will be similar moves to control the Australian iron ore and coking coal trades.

On standard fixtures it may be difficult for brokers to add value, and that is where digitalisation may gain the first foothold into an otherwise reluctant industry. For instance, where a large exporter frequently ships under standard terms to the same discharge port, a digital portal for tenders and offers may facilitate doing business without the assistance of a broker. Also, it is possible that the resale of ships and ship breaking could be handled through online auctions.

In summary, shipbrokers that add value to a deal will always be in demand in the shipping market and will continue to bring together shipowners and dry bulk shipping customers for niche trades and for minor trade routes. Whilst this is the case, the existing model for shipbrokers is already under severe strain, and consolidation of shipowners and digitalisation will add further pressure.

Shipbrokers are already broadening their commercial offering to what they describe as their full service client offer, seeing themselves more and more as advisers. Brokers are offering services such as consultancy and data provision to a broader range of clients and will need to continue to expand these offerings to survive. For

example, a leading broker has recently announced a strategic investment in a company focused on leveraging knowledge.

### **Basel drives up the cost of finance for shipping**

While banks are expected to continue to provide the majority of finance for ships across all the major shipping sectors in the coming years, there will be a need for alternatives such as export credit agencies, bonds, and both public and private equity.

The cost of finance for shipping from banks will undoubtedly continue to increase as a result of the raised quantity and quality of capital levels required by banks due to the Basel III regulations being phased in from 2013 through to 2019. There are further regulations being discussed by the Basel Committee, termed Basel IV. These proposed regulations focus on customer credit risk which, if adopted in their current form, will further increase the cost of bank finance for shipping.

There will undoubtedly be a much greater focus by banks on customer credit risk. A leading European bank recently stated that in future they prefer to provide finance to customers with a larger fleet size. Top tier companies will get all the financing they want, while smaller companies (say ten to fifteen ships) could get access to money but it will be more difficult for them and at a higher price. In general, it must be expected that banks will provide lower cost financing and higher debt to equity ratios to businesses that demonstrate scale, have a solid business risk management system in place, and a robust business model able to withstand future down-cycles in shipping.

Smaller ship owning companies without an established relationship with a bank will struggle to raise bank finance for the purchase of ships. If successful, the finance will be expensive and the owner will be required to fund a higher proportion of the purchase price with equity. Smaller owners may be forced to seek alternative forms of ship finance; private equity might be an ideal solution, both for shipping companies who need money, and for investors who need a return.

### **Diversification: the new industry model for shipyards**

The fundamental business model for shipyards may not change as much as so many jobs are supported by ship building and therefore state sponsorship is unlikely to entirely go away. Overall capacity could be expected to be reduced as governments recognise that shipping across all sectors is forecast to grow at a much slower rate in the future.

Many yards will close through bankruptcy or state-sponsored rationalisation. Others will seek alternative or specialist work. On a brighter note, there will be a need for substantial yard capacity to retro-fit equipment required by environmental regulations including ballast water systems, and possibly SOX scrubbers once the global SOX cap is enacted.

Over the next few years, it is essential that shipowners and other investors shy away from “early-bird discounts” and other “attractive” offers from the shipyards - otherwise the road to recovery may never be found. The result will be a much reduced ship building capacity and a more consolidated industry with intense on-going competition between China, South Korea and Japan.

### **And then what?**

This report focuses on what is likely to happen as a result of the prolonged and deep recession that is currently gripping the dry bulk shipping industry. The predicted outcomes are realistic and based on experience in other shipping related markets.

The underlying model for BIMCO's Road to Recovery Report returns the industry to profitability in 2019 assuming 2% per annum trade growth. This growth prediction may well be too optimistic meaning that the recovery could be delayed well into the 2020s. The shipping economist Olaf Merk, in his well-known blog, talks about the three reasons why global maritime trade will reach its peak. These are:

1. peak in consumption
2. peak in trade and
3. peak in fossil fuels.

Merk summarises: "Shipping and ports both live in a bubble: there is huge overcapacity of ships and terminal capacity. It might take a decade or more to reach a more balanced situation. The possibility of the three simultaneous peaks highlighted here should make anyone wary to add even more capacity".

What has not been considered in this report nor fully understood by all shipping stakeholders are the disruptive prospects of the Sharing Economy (where the utilisation rate of physical assets increase) and the Circular Economy (where more resources are recycled).

Even if trade growth of 2% is achieved, shipowners must scrap ships in far greater numbers than has been seen to date. The other key metric to the recovery in 2019 is "zero supply side growth" which if not achieved will delay the recovery into the 2020's.

Danish Ship Finance in their recent shipping market review made a prophetic comment: "Based on past experience, some seem to view low secondhand prices as a good investment opportunity. In some segments, however, we argue that the low secondhand prices are just as likely to represent an industry in transition in which overcapacity needs to be addressed and value creation needs to be re-thought."

## **Conclusion**

It is difficult to have an optimistic outlook for the coming years in dry bulk shipping. The industry is in charge of its own destiny, each and every shipowner must take tough decisions to help deliver, at a minimum, year on year "zero supply side growth". This is where shipowners stop ordering new tonnage, and there are at least as many ships demolished as delivered, something achieved in the dry bulk industry only three times in the last 35 years.

Not only must the dry bulk shipowners resolve the supply situation, they must also face up to the substantial changes needed to their business in a rapidly evolving macro-economic environment affecting future demand. This may well be intimidating for those involved, and many may choose to take their dwindling capital elsewhere.

While this report deals specifically with the dry bulk shipping industry, many of the outcomes will be the same for the tanker and container industries.

