Dry Bulk market; what is in store?

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At some time, both the fundamentals, as well as technical factors, involving tonnage supply, shall clearly point towards a meaningful and sustainable recovery. In our opinion, we are not there yet. This recovery shall come but there are no reasons to believe that it is around the corner.

Time will tell.

Earlier this year, on the 10th February 2016, the BDI reached an all time low (since BDI was created) of 290, and it lingered there for the following day too. At these levels, all dry bulk vessels were earning far below their operating and voyage cost levels. Many of those that still enjoyed higher earnings via period charters found themselves being re-negotiated or defaulted upon.

A year to two earlier, dry bulk shipping had been basking in the limelight of attention by primarily US equity funds, who believed in the classic 'rags to riches' story and who had invested heavily in the dry bulk potential story. Moreover, supported by high bunker prices and the appeal of eco ships, owners (public and private) competed with each other in placing huge orders for the latest eco designs.

Many analysts, myself included, had serious misgivings about the shipbuilding spree and where it might lead, as the writing was on the wall for all to see. In table 1, below, we are comparing annual dry bulk demand and supply over the last 10 years, in order to highlight what information was publicly available and ignored by investors. As you will see, supply outpaced demand, thus creating a huge tonnage surplus.

In the buildup of dry bulk overcapacity, the orderbook reached 140.5m DWT by end June 2015 and 126.6m DWT by December end 2015 (Clarkson's World Shipyard Monitor). Many owners still clung to the offsetting benefits of port congestion, slow steaming and delivery delays to restore somewhat the mismatched demand and supply sector.

The factor that brought the house of cards down was not only the slowdown in international trade, as witnessed by successive downward revisions in global growth but the fall of Chinese demand for commodities and, most notably, coal, as China shifted away from a commodity hungry, infrastructural and capital construction growth and towards satisfying internal, as opposed to the weakening external, demand. Please see tables 2, 3, 4, 5 and 6.

As commodity buyers found both inventories high and prices falling, all orders stopped and world trade slowed to zero growth and, for some commodities, such as coal, into negative territory.

Owners, seeing their cash flow turn decisively into the red, reacted en masse by slowing down or stopping their payments to all, including their banks and shipyards, in an effort to slow down their rate of "cash burn". Banks tightened their reigns but found their clients unwilling to cover both their loans, as well as their operating shortfalls. Consequently, a number of vessels were abandoned or laid up, in an effort to stem the bleeding. Quickly, the until recently unused Far Eastern, Greek and other layup anchorages, saw a dramatic influx of applications for layup. Moreover, scrapping accumulated with the first 3 months recording 14.1m dwt dry cargo vessels out of 778.6m tons or 1.8% of the total dry cargo capacity, according to Clarkson's. In addition, unwilling to face ruinous spot fixtures and with period charterers unwilling to commit themselves, the 'employment' utilisation of the dry bulk fleet fell, as numerous vessels remained idle awaiting new orders. With the Far East overwhelmed by surplus tonnage, many owners decided to ballast to the Atlantic, only to find falling earnings opportunities and little to justify their courageous decisions.

However, through this 'holocaust', the dry bulk market started a recovery and the BDI stood at 539 on 8th April, i.e. an 85.86% increase from the low point. During this period, according to research conducted by Clarkson's, 208 out of an estimate of an orderbook of over 870 dry bulk vessels for the whole of 2016 were delivered, representing 23% of 2016 total. In that period over 170 vessels have been scrapped, amounting to over 14m tons DWT.

Following the acceleration of scrapping and the slowdown of newbuilding deliveries, the three-month increase of dry bulk supply fell to 0.3% in dwt terms, a far cry from earlier rates of growth with BIMCO forecasting a 1.3% increase in 2016.

We, therefore, see clear evidence of market forces at play on the supply side. However, the demand fundamentals remain weak and despite predictions of rising global growth for 2016 – 2017 by the World Bank, IMF and others, there is little in the way of hard facts to support even a partial return to higher levels of demand. Additionally, whereas GDP growth is still at 3% + levels, dry bulk demand is at a standstill.

Given the relatively young age of the dry bulk fleet, on account of its prolific growth over the last decade, it is difficult to believe that the elimination of the market surplus could be achieved only via scrapping and the slowdown of newbuilding orders. A large percentage of previous newbuilding orders may be delayed but will still be delivered and as such, the new orders tap may have been shut but there will still be sizeable deliveries to come in the next couple of years. As of 01/04/2016, the newbuildings' order book consisted of 1,326 vessels of 111.7m DWT, representing 12.75% of the fleet. Even allowing for failed shipyards and some non-starts of newbuildings, as well as for some conversions into tankers and other types of vessels, we

Table 1

Year	Dry bulk World Seaborne trade (m tons)	Annual growth/ deficit	Active fleet (m DWT)	Annual growth
2006	-	5.7% compound annual growth	372.8	
2007	-		398.5	6.9%
2008	-		422.5	6%
2009	-		461.4	9.2%
2010	-		540.3	17.1%
2011	-		618.5	14.5%
2012	-		686.4	11%
2013	4,502		725.6	5.7%
2014	4,718	+4.8%	757.8	4.4%
2016	4,708	0%	773.1	2%
2016	4,719	0%	783.15	1.3%* (forecasted by BIMCO)
* Estimated annual trade fleet growth			Source: Clarkson's, BIMCO	

Table 2 – Newbuilding outstanding orders – Dry bulk (no of vessels)

Year	No of vessels
2010	1380
2011	549
2012	321
2013	1249
2014	783
2015	256
2016*	208
* By 1/4/2014 Source: Clarkson's World Fleet Register	

Table 3 – Demolitions – Dry bulk (m DWT)

Year	m DWT
2010	6.4
2011	23.2
2012	33.7
2013	23.1
2014	16.3
2015	30.6
2016*	14.1
* By 1/4/2014 Source: Clarkson's	

believe that at least 80% of this huge order book will 'hit the water', or approximately 90m DWT over the next 2 years up to 2018.

So, whether the overall supply will grow or not will largely depend on the rate of scrapping over the next 2 years, as well as the level of layups, the level of additional newbuilding orders, as well as the actual newbuilding that shall be delivered.

To put it in number terms, the scrapping rate of the first 3 months of 2016 will need to be sustained over the next 2 years, in order to drive approximately 90-100m DWT of dry bulk vessels out of the market. This should match the estimated new bulkers that shall be delivered over the next two years. Is this sustainable? In addition, such prolific scrapping would only manage to keep shipping tonnage at a standstill and not to reduce the current surplus. The only way for high scrapping rates to be achieved and for new ship building orders to remain low, in our opinion, is for vessel earnings to remain at / or below operating and voyage cost levels. Hence, as the market recovers and approaches breakeven levels, scrapping will slow down and laid up vessels shall be reactivated. In addition, for owners to scrap their vessels, as opposed to laying them up, scrap prices would need to remain at reasonably attractive levels. In the first quarter of 2016, we saw dry cargo scrap prices fall to approximately US$225 per ldt, which is a very depressed figure and reflects not only the number of vessel scrap candidates but also the fall in the price of steel.

Furthermore, in order for the rate of scrapping to be maintained at the required high levels, increasingly younger vessels will need to be scrapped i.e. vessels at the age of 20 or below. So far, we have witnessed a fall in the age of scrapped dry bulk vessels by 4.29 years since 2014 to an average of 23.26, but we remain far from the levels needed to maintain the scrapping rate (Source: Allied Shipping Research)

Owners are renowned for their resiliency and ability to survive. This notable attribute in general, is a drawback in a bad market, as it makes owners reluctant to layup and / or scrap vessels. The motto of 'hope dies last' has its best application in shipping, where owners have slowed down their layup enquiries and those in layup are itching for the opportunity to secure even a short voyage that will take them out of layup. Already, there are signs, as to earnings are approaching breakeven levels, that owners are taking vessels out of layup. In so doing, the forces that have assisted the shipping market to recover thus far this year from the abyss, already show signs of weakening.

So,what is in store?

There remain the 'optimists' who view current dry vessel prices, as a unique opportunity to acquire historically cheap tonnage and make enormous capital gains, when the market shall recover. They cite a number of factors, in support of their view. To give you some examples, there is the Indian story, whereby India will take over from China, as the dry bulk champion. Although India is important and growing, it hardly compares to the explosive growth of China, which propelled the dry bulk boom. They also cite the rising global growth estimates and the eventual resolution of all dispute and sanction areas e.g. Iran, Syria, Ukraine, Russia etc. They also cite the swift reaction of the dry cargo supply statistics (outlined ear-

Table 4 – GDP Growth (IMF, OECD, The Economist, Clarkson's)	
2013	3.3%
2014	3.4%
2015	3.1%
2016*	3.4%
2017*	3.6%
* Estimate	

Table 5 – Steel production (m tons)				
	China	Japan	EU-27	Total Steel Production
2013	815.4	110.6	166	1091.9
2014	822.7	110.7	169.3	1102.7
2015	803.8	105.2	166.2	1075.2
2016*	786.9	103.5	156.6	1047
* Estimate	Source: Clarkson's			

Table 6 – Coal trade imports (m tons)				
	China	India		
2013	264.9	175.3	186.1	123
2014	239	216	183.2	128.3
2015	163.8	209.9	184.8	133.4
2016*	144.1	207.8	184.4	139.7
* Estimate	Source: Clarkson's			

earlier), as evidence of a recovery ante portas. What works against their case is the fact that dry bulk finance by banks has virtually stopped and that vessels will need to be financed by cash. Moreover, should the current market recovery falter, vessels are unlikely to show any positive cash flow over the next years and buyers may find themselves with loss making vessels that are also growing older. Seeing it in this context, the very low prices that vessels attract nowadays, may be seen as a 'buyer's trap', with buyers' patience being tested in the years to come. Of course, it is possible that seaborne trade may save the day, if it shall begin to grow at levels of 3% and above that had been the case in previous years. However, international trade is showing signs of slowdown, with increased trade restrictions, regulations and quotas outweighing measures that promote trade.

Another argument lies with commodity prices. The argument runs along the lines that falling commodity prices reduce international trade, which, however, will resume its growth, once commodity prices shall stabilise and grow. There is truth in this argument but we do not see the drivers that will propel commodity prices to grow in the immediate future. In conclusion, we believe that buying at this time in the expectation of a swift continuation of the market's recent recovery off the bottom, still carries risks mainly associated with the need to subsidise such vessels until a recovery shall occur. In short, the risk of buying vessels today is high but so are the rewards if buyers' expectations shall be realised. They should know, though, that the probability of the market recovery in a 'V' manner is not high and they should allow for sufficient cash reserves, in case the market's meaningful recovery shall be delayed.

Another band of owners (admittedly, the minority) believe in a market that will crawl along the bottom over the next years. We call them 'the flat liners', who expect little. They do not see a meaningful recovery, for at least a few years, and their aim is to stop their cash flow hemorrhaging and keep their ammunition dry until the market's fundamentals shall recover. History may prove such flat liners to be 'shrewd' and good tacticians. However, they face the overwhelming evidence that shipping is a cyclical industry with a demonstratable record of booms and busts.

What shipping is experiencing now is not a 'new paradigm' but another crisis brought about by overbuilding and the expectation that seaborne trade (and China) would continue to grow. These flat liners are also risking not to being able to buy when the turn will come, as sellers' expectations often change overnight and they may well miss the train, for which they would have been waiting for so long. It is a fallacy to deny the ability of a market in recession to recover, as there are already economic forces at play that are reducing the market supply surplus with a view to reaching equilibrium status, over the next years. We view this approach as one that may allow buyers to time purchases tactically but not to expect that the market will not turn until 2020 or beyond is unlikely to materialize.

So, what are we left with? Our view is that the market will not be able to keep its current recovery momentum and will show erratic movements for this year and 2017. There will be a number of false dawns and aborted rises, only to be followed by falls that test everyone's resolve. During this period of to and fro, there will be some profitable S&P opportunities but hardly the ability to record monumental gains. Overall, we see the next 18 months as periods of weak earnings, as shipping seeks to contain and reduce the tonnage surplus.

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