POTEN & PARTNERS

August 19
2016

HOUSTON / NEW YORK / LONDON / ATHENS / SINGAPORE / GUANGZHOU / PERTH

POTEN TANKER OPINION

That Sinking Feeling …

Will vessel prices continue their relentless slide?

Sometimes it is good to remind ourselves that we are involved in an unusual business. When a regular business owner evaluates if he should invest in new production capacity, he will consider the cost of the investment relative to the income that he can generate with the new production facility. Since investment costs do not typically fluctuate much in the short- to medium-term, the timing of his investment will largely be determined by the long-term outlook for the products or services he sells. In the bulk shipping industry it is different. For a shipowner, there are usually a few twists to the traditional capital budgeting process.

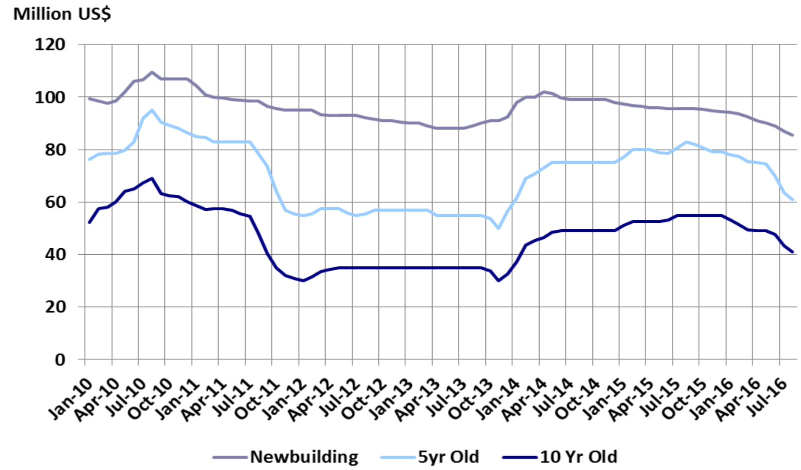
A shipowner that is deciding whether to invest in new capacity has at least three other factors to consider: (1) his production facilities (i.e. the vessels) are not only used to transport commodities, the vessels are commodities themselves, i.e. there is a liquid secondhand market for vessels of all sizes and ages; (2) the location of a shipowners' production facility is not fixed, it floats and (in theory) competes with vessels all over the world; (3) vessels, even though they can cost well over $100 million to build, have a limited lifespan. There can be a stark difference between commercial and technical obsolescence, vessels don't last much longer than 25 years.

For many years, the Holy Grail in shipping was to buy a vessel at a low point in the cycle, generate significant earnings while the market recovers and sell the vessel for a hefty premium at a high point in the cycle. Obviously, executing this "buy low, sell high" strategy is easier said than done (especially doing it more than once!) and the shipping industry has destroyed a lot of capital in the process of trying.

For a variety of reasons, prices of vessels, both newbuildings quoted by shipyards and secondhand vessels transacted in the sale & purchase market, have come down significantly in recent years (new) and months (second hand). This begs the question: are we getting close to the right time to invest in the market? And, if so, should an owner order a newbuilding or try his luck in the secondhand market? It depends to some extent on an owners' client base and employment strategy. Also important are access to financing, market timing and liquidity (in particular in the secondhand market).

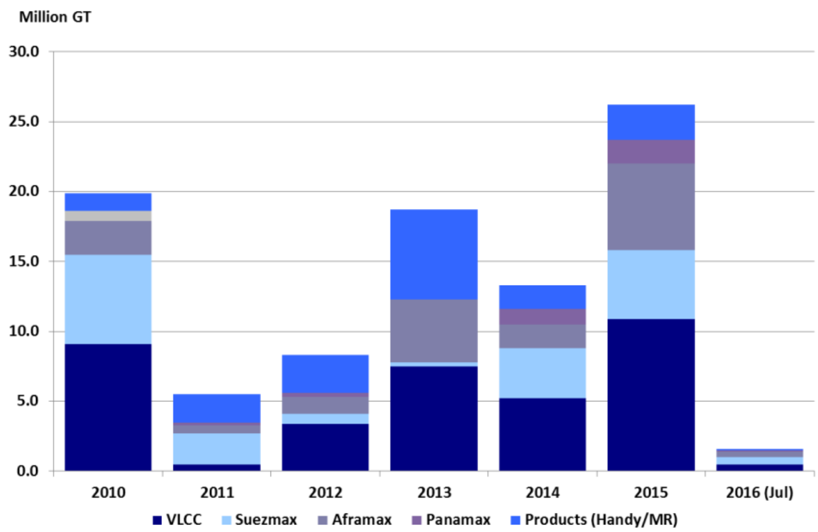
The shipbuilding industry is in dire straits at the moment. Yards all over the world are facing a dearth of new orders on top of attempts by owners to cancel or at least renegotiate existing contracts. These challenges were initially created by the dismal state of the dry cargo, container and offshore markets, but more recently the downturn has spread to the tanker market and orders have slowed down materially across the board (Fig. 2). Newbuilding prices were already under pressure due to the low utilization rates of the shipyards, but falling freight rates in the crude and product tanker markets are now also pushing secondhand prices down. Ship finance is only available for the best credits and it is no surprise that overall market psychology is quite negative.

Fig. 1: VLCC Prices 2010 – 2016 YTD



Source: Poten

Fig. 2: Tanker Contracting 2010 – 2016 (Jan-Jun)



The shipbuilding industry is in the middle of a perfect storm with all major shipping segments facing a downturn at the same time. As a result, the shipyards are restructuring. Several shipyards (mainly in China) have gone out of business and the large Korean yards are restructuring; closing facilities and reducing their workforce. However, it takes time for capacity reductions to have an impact and newbuilding prices will likely remain under pressure until one or more of the shipping markets recover.

The secondhand market reacts more quickly and may provide better investment opportunities. Low newbuilding prices will cap the upside of tanker values, in particular modern ones. The downside for secondhand vessel prices remains significant as long as freight markets stay under pressure. Prices may continue to slide and the secondhand market could present serious buyers with attactive options over the next 6-18 months.