Southampton SOLENT University

Global Maritime Weekly Digest

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*The **Global Maritime Weekly Digest**, based at **Southampton SOLENT University**, provides a regular flow of maritime news and analysis, of significance in a global context.*
Topics covered include shipping fleets and management, seaborne trade, ports, shipbuilding, ship recycling, maritime policy and regulations, and seafarers' labour.

Contents

Editorial comments

- This year, global ***ship recycling*** may reach one of the highest annual volumes ever seen, as shipowners decide to dispose of many uneconomic vessels.
- The ***key features*** of this large-scale maritime activity are discussed in item 2. Its salient characteristics, recent trends and the controversial topic of regulation, seeking to control environmental and human safety aspects, are reviewed.
- Plans to develop ***China's cruise shipping*** business are being closely watched (item 4). Currently, the country's burgeoning cruise market is served mainly by international operators, with China-owned ships contributing only a small proportion of total capacity, but changes are under way.
- What should the ***UK maritime sector*** do, after the Brexit vote? The UK Chamber of Shipping plans to strongly promote Britain's shipping industry in the new era (item 3), looking for new trade opportunities, seeking advantages for the revamped UK ship register, pursuing greater influence in the IMO and emphasising the need for free movement of people employed.
- Prospects for the very subdued ***bulk carrier market*** are evaluated in another report, which concludes that the outlook for the remainder of 2016 remains "extremely negative" (item 5) and that a solid recovery is still a long way ahead.

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editor (bulkshipan@aol.com)
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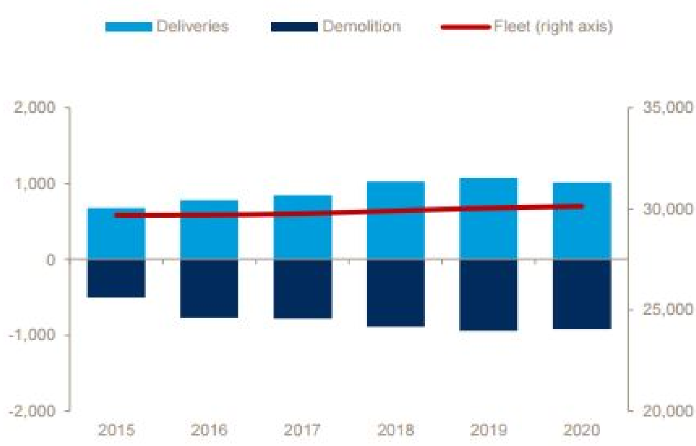
(1) Hellenic Shipping News, 30 June 2016/ Drewry Maritime Research

Light at the end of the tunnel faint and distant for multipurpose shipping

The demand outlook for the multipurpose fleet has not improved since the first quarter of 2016. The breakbulk and project cargo sector remain weak, with little suggestion that volumes will improve significantly until the end of 2017, according to the latest Multipurpose Shipping Market Review and Forecaster report published by global shipping consultancy Drewry.

On the other side of the equation, the supply of multipurpose vessels is under control, with an order book equivalent to just 5% of the operating fleet and growth estimated at less than 0.5% per year between now and 2020. However, it is the oversupply of the competing fleets that continues to erode the market share available to the multipurpose sector and in turn any positive growth.

Suggested MPV fleet development to 2020



Source: Drewry Maritime Research

Drewry believes that improvement in this sector is under way, but it is still some way off – and that is being optimistic. It is clear that the multipurpose shipping community can do little to improve the demand for these vessels, at a time when projects are being cancelled and steel production halted, but there is something to be done on the supply side. While it is true that most of the damage is being done by the oversupply of bulk and container vessels, there is still a view in the market that the problem is not 'ours'.

There are over 600 vessels trading that are over 25 years old, which is 20% of the operating fleet in number terms (13% in dwt terms as the majority are less than 10,000 dwt). Although these vessels generally only compete in the breakbulk trades, that is where the cargo is at the moment, and so, they compete across the majority of the fleet. Susan Oatway, lead analyst for multipurpose shipping comments: "This competition will impact rates across the sector as high spec project carriers will need to carry any cargo to fulfil their investors' requirements."
Source: Drewry Maritime Research

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(2) Hong Kong Shipowners Association, June 2016

The Responsible Recycling of Ships

Article by Dr Nikos Mikelis in HKSOA Yearbook 2015-2016

http://maritimecsr.com/files/misc/The_Responsible_Recyling_of_Ships.pdf

This article, by one of the world's leading experts on ship scrapping, provides a very useful discussion of global ship recycling activities. It outlines basic characteristics and recent trends, together with coverage of the Basel Convention, the Hong Kong Convention and European Regulation.

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(3) Lloyd's List, 1 July 2016

UK shipping sets out plans to safeguard top maritime status

- Friday 01 July 2016, 13:44
- by Janet Porter

Update: Free movement of people essential for shipping as industry leaders prepare ifor ntensive lobbying campaign to ensure maritime activities can thrive outside EU

BRITAIN's shipping industry leaders are already working on a manifesto setting out their vision for a future outside the European Union, and will be lobbying the government in support of policies designed to preserve the country's status as one of the world's most important maritime nations.

In particular, they are looking for the opportunities that could arise in terms of trade, along with greater influence at the International Maritime Organization. They will also be stressing the importance of maintaining the free movement of people in an industry that constantly needs to move personnel around the world.

Although the UK is a member of the IMO, EU countries are expected to follow the lead of Brussels. Once the UK leaves the EU, it would have the freedom to pursue a different agenda if it wishes, said UK Chamber of Shipping chief executive Guy Platten.

That could be turned to the UK's advantage, he believes, and may prove a bonus for the UK Ship Register, which has embarked on a major expansion drive following recent restructurings within the Maritime and Coastguard Agency.

"Those reforms could not have been better timed," Mr Platten told Lloyd's List.

Whether or not the UK flag will benefit from Brexit remains to be seen, but the maritime community is now looking for the positive message to promote around the world after last week's shock vote to leave.

With Britain unlikely to quit the EU for at least 30 months, Mr Platten said there was time to consider the implications, do some deep analysis and then decide how to turn the situation to the industry's advantage.

The UK Chamber and other maritime associations will be getting together to see how they can present a united front in lobbying the government as the UK starts negotiating EU exit terms.

"We want to make the UK the most competitive place to do business," said Mr Platten.

"I don't think government will ever be listening to the shipping industry as much as they are going to be over the next few months."

That reflects the fact that shipping is about trade. "We want free trade and free movement of people, and that is what we want the government to achieve."

As an international business, "shipping wants to be able to rotate people around, we do not want barriers to that," Mr Platten told Lloyd's List.

The UK Chamber of Shipping plans to make that case very forcibly, he said.

"We want to make the UK the most competitive place in the world to do business. If we are outside of the EU but on the outskirts why can't we be the champions for free trade around the world?" Mr Platten asked.

"We were a major maritime nation last week, and we are major maritime nation this week. We have the world's best lawyers. the world's best maritime business services, world leading maritime education estabishments and some great shipping companies, and those fundamentals are still there."

Mr Platten said the UK Chamber of Shipping was now working on a manifesto that will be published within a couple of months, and which will set out more clearly what the industry hopes to get out of negotiations with the remaining EU countries. Trade deals, how to make tonnage tax more attractive once outside the constraints of EU state aid rules, and corporation tax, are all likely to feature.

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(4) Clarksons Research, 30 June 2016

China Steers Towards Cruise Ownership

The rapid growth in China's cruise market in recent years has encouraged major international cruise operators to race to accommodate the burgeoning demand in the region. So far, the presence of domestic Chinese shipowners and operators has remained relatively limited, but with China aiming to play an increasingly active role in the cruise industry, is China's cruise ownership set for a shake-up?

Route Checks

By the start of June 2016, 15 cruise ships of c.37,000 berths were deployed on routes calling at Chinese ports, accounting for 7.3% of the global cruise fleet, up from 0.4% three years ago. The Chinese market is dominated by international cruise operators, with less than 3,000 berths accounted for by domestic Chinese owners, representing 7.1% of total cruise capacity calling in China. There are four domestic Chinese cruise operators, with small to mid-size secondhand ships. Following HNA's recent scrapping of the 30-year old "Henna" due to age limits, and once Suzhou Taihu's "Glory Sea" is operational, the Chinese market will comprise three domestic ships.

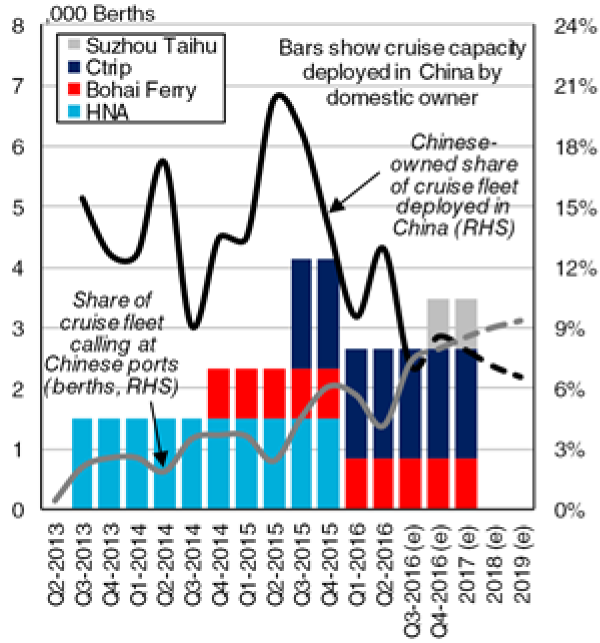
Far From Smooth Sailing

While Bohai Ferry is a major Chinese ferry operator, the remaining three owners – HNA, Ctrip, and Suzhou Taihu – are travel agencies with no historical experience in operating cruise ships, and have recently struggled to make profits. A lack of product differentiation and issues relating to the "charter sailing" ticket selling model have also had an impact, with greater competition between travel agencies new to the cruise market contributing to low ticket prices. In addition, difficulties in securing young tonnage from international competitors has undermined Chinese owners' attempts to build their brands. The competition seems to be getting tougher, with a number of global cruise operators planning to increase deployment of large, modern ships in the Chinese market in coming years, which would diminish China's domestic share barring any new investment (see graph).

Graph of the Month

China's Domestic Cruise Owners Starting Out

The bars show the domestic-owned cruise ship capacity in terms of passenger berths deployed in China at the start of each quarter (left hand axis). The grey line shows the share of the global cruise fleet accounted for by ships calling in China, while the black line shows the domestic-owned share of total cruise deployment in China at the start of each quarter (right hand axis). Projections for future months and years based on expected delivery trends and reported deployment plans by international operators only.



Source : Clarksons Research, Industry Sources

Moving Upwind

However, for domestic investors, the vast opportunities in the Chinese market seem to outweigh the challenges. The central government is encouraging the development of China's cruise industry, through new terminals as well as greater vessel operation, ownership, design, construction, repair and maintenance. A number of Chinese companies are understood to be looking into investing in cruise ships, including a number of travel agencies, terminal operators and state-backed funds, with local governments keen to benefit economically from the development of new terminals. In the shipbuilding industry, SWS is targeting delivery of the first Chinese-built cruise ship in 2020, whilst the Fujian government has established an investment company with a view to order three ships at Xiamen S.B.

In For The Long Haul?

So, China seems to be embarking on a long voyage to build up its domestic cruise fleet, despite a number of headwinds. Against a backdrop of firm expansion by major international cruise lines in the fast-growing Chinese market, it will be interesting to see whether Chinese owners can keep pace and eventually take a more dominant role.
Source: Clarkson Research Services Limited

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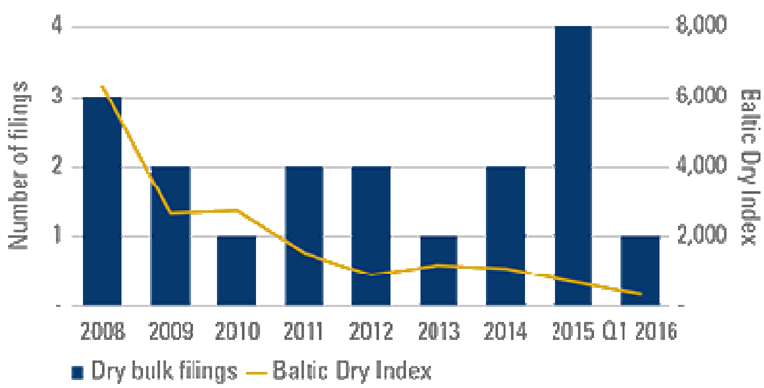
(5) Hellenic Shipping News, 2 July 2016/ AlixPartners

2016 Dry Bulk Shipping Outlook

After a somewhat stable 2013–14, the dry bulk shipping industry began a deep downturn in 2015. Industry financial performance declined markedly from 2014, and compared with 2013, the drop in operating performance has been staggering. The unbalanced supply-and-demand equation means pricing won't rebound meaningfully while too many vessels keep chasing too few shiploads. The beginning of 2016 was equally rough: despite a modest bounce in pricing at the end of the first quarter, the outlook for the remainder of the year remains extremely negative. Although vessel demolitions in 2016 are expected to hit a record high of 40 million deadweight tons (DWT), that won't offset the 50 million new DWT expected to enter the fleet.1 Virtually every company in the industry is at risk because of uncertainties about overall global economic activity and trade, coupled with reduced demand for iron ore and coal from both China and India.

Rough seas worsen as pricing collapses
During the Great Recession, from late 2008 through 2010, six large dry bulk carriers filed for some form of court protection worldwide, according to The Deal's database of filings. Many others pursued out-of-court restructurings when the drop in worldwide demand for goods became compounded by expanding capacity as new vessel builds arrived. Then pricing crashed from the stratospheric heights of 2007–08. Comparatively, during that earlier period, tanker and container ship operators together accounted for only four filings. But the postrecession pricing relief those companies expected never arrived, and filings continued at high rates from 2011 to 2013.

FIGURE 1: Bankruptcy filings versus Baltic Dry Index, 2008–16



Filings represent shipping companies with more than $50 million in estimated liabilities

Source: Deal Pipeline, World Maritime News, AlixPartners

By 2014, the dry bulk sector appeared to have stabilized, and it looked like companies had positioned themselves to take advantage of any market rebound, protecting themselves against further market erosion. Unfortunately, that stable state broke down in 2015, when four companies filed for protection and many others sought out-of-court restructurings.2 Market pricing— reflected in the Baltic Dry Index, which charts the costs of shipping raw materials globally—sank once again as increased industry supply met diminished global demand (Figure 1). These unbalanced fundamentals continue to hobble the industry in 2016 and show no signs of abating anytime in the near future.

A distressing tale
The industrywide decline can be explained by a fairly straightforward equation that few companies have managed to solve: Weak Pricing + Costly Operations + High Debt Loads = Distress. Shipowners' financial performance in the past few years reflects the harsh proof of that equation (Figure 2).

Figure 2: Dry bulk industry financial results, 2010-15

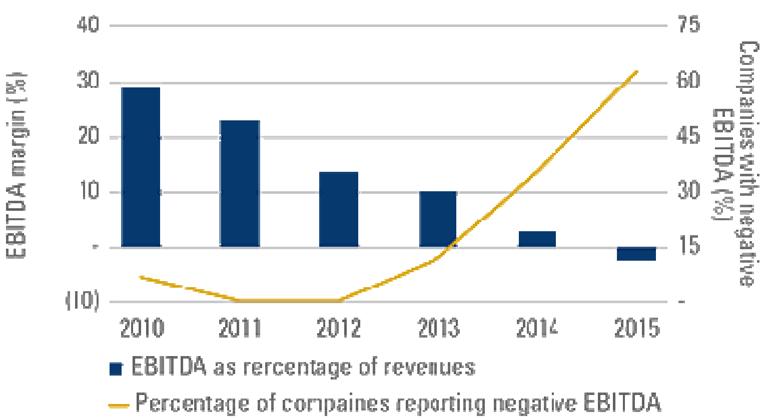
	US$ millions						Year-over-year change				
All companies	2010	2011	2012	2013	2014	2015	2011	2012	2013	2014	2015
Revenue	6,093	5,905	5,316	5,667	5,893	4,839	-3%	-10%	7%	4%	-18%
EBITDA	1,773	1,364	721	581	169	-115	-23%	-47%	-19%	-71%	-168%
EBIT	1,207	713	61	-49	-437	-1,014	-41%	-91%	-181%	790%	132%
Cash from operations	1,753	1,073	624	306	267	59	-39%	-42%	-51%	-13%	-78%
Net income	1,073	-42	-969	-542	-234	-2,828	-104%	2,207%	-44%	-57%	1,109%

Sources: AlixPartners analysis, S&P Capital IQ, Yahoo Finance, company filings. (When full-year 2015 data was not available, data from the previous 12 months for the most recent period for 2015 was used)

The first part of the equation—weak pricing and costly operations— shows that industry revenues fell by more than a third from 2014 to 2015, with less than 15% of the companies surveyed showing revenue growth during the period. Bottom-line operating performance was even worse, as overall EBITDA turned negative.

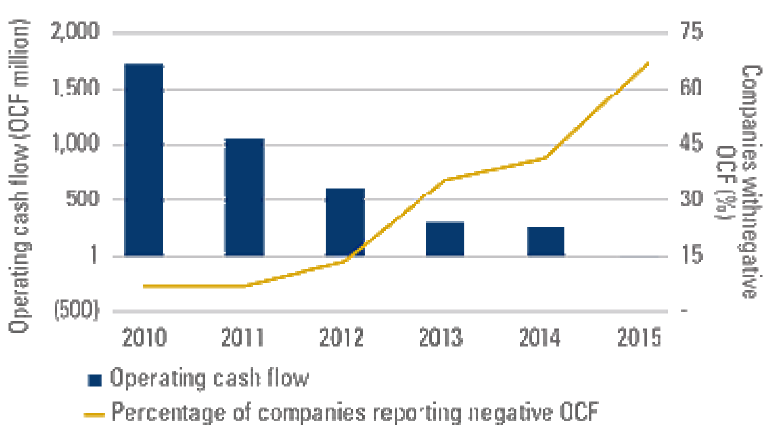
The declines in EBITDA margins and operating cash flow are especially troubling because few companies have been able to sustain positive results for either. A majority of companies surveyed3 had negative EBITDA last year compared with less than 15% in 2013 (Figure 3). In addition, two-thirds of companies in our study had negative operating cash flows (Figure 4) compared with just over one-third in 2013.

FIGURE 3: EBITDA margins, 2010–15



Source: Bloomberg, Clarksons Research, Morgan Stanley, AlixPartners

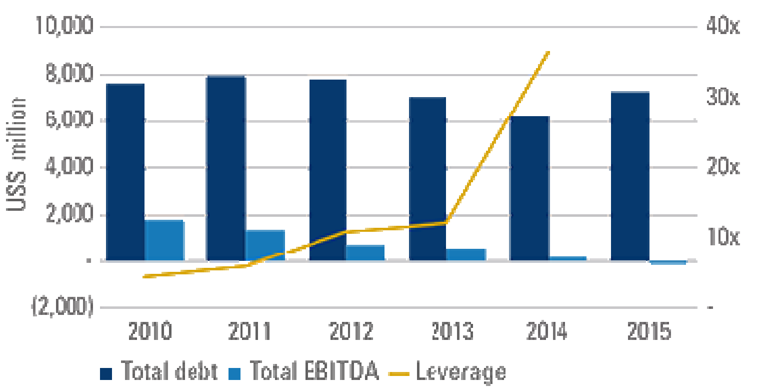
FIGURE 4: Operating cash flow, 2010–15



Source: Bloomberg, Clarksons Research, Morgan Stanley, AlixPartners

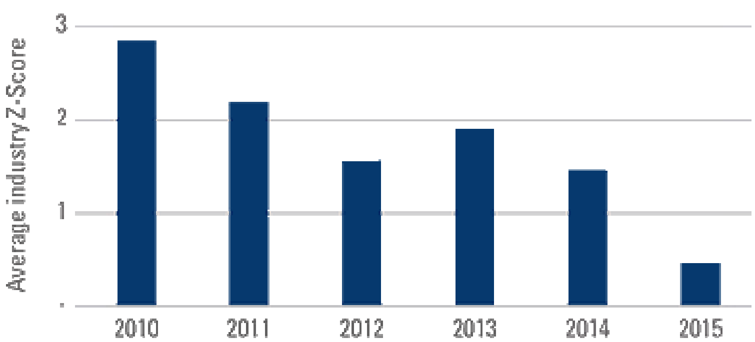
The severity of the slide is best shown by comparing 2015 results with those of 2013, when dry bulk new ship contracting was on the rise. Industry revenue dropped 15%, but EBITDA slid 120%—into negative territory. Income losses went from $542 million in 2013 to $2.8 billion in 2015. The grim numbers illustrate the collapse and pinpoint the challenges the industry faces in projecting demand accurately enough to pace supply.

FIGURE 5: Industry debt versus EBITDA, 2010–15



Source: Company filings, AlixPartners analysis

FIGURE 6: Average industry Altman Z-Scores: 2010–16



Sources: AlixPartners analysis, S&P Capital IQ Altman Z-Score calculations

Weakened operating performance becomes especially critical with regard to these companies' significant debt loads. Leverage is common in the industry; indeed, it usually forms part of a company's operating model. However, as their performance faltered, companies found themselves struggling to generate the cash flow needed to sustain their leveraged models (Figure 5).

This means that almost every company in our study is in the zone of distress, with the average Altman Z-score for the sector dropping below 1.00 (Figure 6). A score below 1.80 is generally accepted as indicating a high probability of financial distress, and the 2015 average was 0.46 compared with the 2013 average of 1.91. With substantial restructuring activity already in process in 2016, it's expected the industry will see even more activity as the year proceeds.

The perils of plunging Asian demand

Although demand is only part of the pricing equation—the part that shipowners have the least short-term control over—it makes a tangible impact on the industry. China's economic slowdown remains the most obvious culprit causing reduced demand for dry bulk shipping because it makes about half the world's steel,4 and iron ore and coal make up a majority of dry bulk shipping. In Q1 2016, Chinese GDP dipped to 1.1% annual growth from Q1 2015—the weakest figure since data collection began in 2010.5 In 2015, the Chinese economy grew 6.9%—its slowest pace in 25 years.6 Chinese demand for coal and iron ore for domestic steel production continues to slow: in 2015, China produced approximately 24 million fewer tons of steel than in 2014—a 3.1% dip—marking the country's first annual decline in 20 years. And the trend continues: through April 2016, production was down an estimated 1.8% from 2015, and it remains well off 2014's highs.7

Even with that decline, though, iron constitutes 29% of global dry bulk freight, and coking coal, about 5%, with thermal/ steam coal accounting for an additional 19%.8 China's impact on those markets can't be overstated: annual low points on global steel production figures correspond to the Chinese New Year, which generally comes in the middle of the first quarter. Plus, after falling for much of 2015, Chinese stockpiles of iron ore increased from approximately 80 million tons to more than 90 million. The mix of larger stockpiles and reduced production mean it's unlikely Chinese iron ore imports will grow enough in the near term to make a material difference for dry bulk shipowners.

Indian demand for coal may help offset China's reduced appetite—the International Energy Agency's World Energy Outlook observes "India moving to the center of the world energy stage"9—but India's power plants built up significant stockpiles of coal in 2015, and domestic production soared 13% in January 2016 compared with the previous year.10 This meant a 15% decline in coal imports for April to December 2015 compared with the same period in 2014.

Outside of core bulk steel inputs, the picture—especially in China—looks equally dim. The China Coastal Bulk Freight Index, a broad proxy for the country's maritime shipping activity, is at all-time lows and even well off its 2011–15 average.11 This may reflect new norms, as the National Bureau of Statistics of China lowered its 2016 growth target to 6.5% to 7.0% and reduced the five-year growth rate to 6.5%.12

The Capesize challenge

The Chinese slowdown affects most acutely operators of Capesize vessels. Capesize vessels, too large to pass through the Suez Canal and the existing locks on the Panama Canal, had the worst first quarter of all dry bulk vessel classes, with spot rates declining 65% to 80% (Figure 7)

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FIGURE 7: Dry bulk vessel segment spot rates, 2010–16

Spot rate ($000/day)	2010	2011	2012	2013	2014	1Q 2015	2Q 2015	3Q 2015	4Q 2015	2015	1Q 2016*	QoQ D	YOY D
Capesize (172k DWT)	33.2	15.7	7.7	14.9	13.7	4.6	4.6	11.5	6.8	6.9	1.5	-78%	-67%
Panamax	24.9	13.9	7.7	9.5	7.7	4.8	5.2	7.6	4.5	5.5	3	-33%	-38%
Supramax	22.4	14.4	9.4	10.3	9.8	6.5	6.8	8.8	5.7	7.0	3.8	-33%	-42%
Handysize	16.4	10.5	7.6	8.2	7.7	5.4	5.1	6.3	4.6	5.4	3.4	-26%	-37%

Sources: Baltic Exchange, Clarksons Research, Peter Döhle, Poten & Partners, Morgan Stanley, AlixPartners
Note: * 2016 rates through March 25, 2016.

Because of their size, Capesize vessels haul—almost exclusively—iron and coal from South America and Australia to large Asian ports that have the equipment necessary for their loading and unloading.

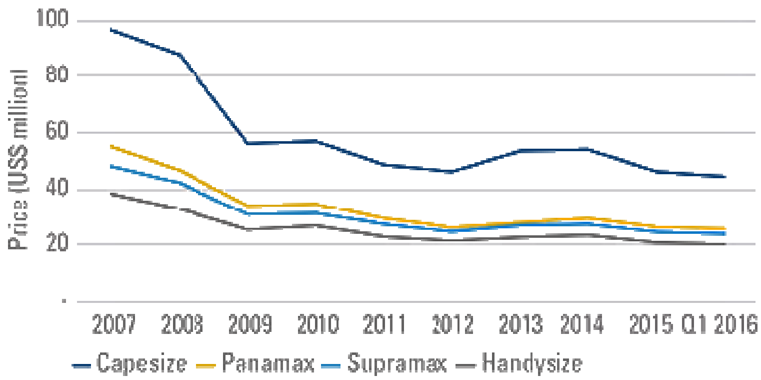
Because operators' fortunes are inexorably tied to core bulk commodity shipments, Capesize operators' vessels have historically experienced the greatest volatilities in charter rates.

But despite such volatilities—and being limited to routes servicing a small number of large ports—the Capesize fleet composes about 40% of dry bulk capacity, the largest of any vessel class.13 Reliance on Asian markets, particularly China, sent the Baltic Capesize Index dwindling more than 57% for the year to date through the first quarter and 55% in the past 12 months. The broader dry bulk market declined 48.1% and 32.1% for the same periods, respectively.14 Underscoring its potentially dramatic volatility, the Baltic Capesize Index followed a dreadful first quarter with an April 2016 surge, when the index more than quadrupled from its March close. As deliveries have kept pace with demolitions, the price recovery appears driven by increased demand rather than reduced supply.

One reaction to the depressed rates has been to imitate the alliances formed by the container shipping sector, such as 2M and Ocean Three. Capesize Chartering Ltd., the largest dry bulk alliance or pool, was formed in February 2015 between five shipowners that used the new platform primarily to share information and optimize fleet deployment with a view to reduce costs. Earlier this year, Capesize Chartering began a revenuesharing program. Because it consists of only about 80 vessels, the alliance may not enjoy meaningful pricing power. However, the concept of finding ways to work together—without colluding—is an appealing response to an industrywide problem.

The allure of newbuilds
The industry order book finally began to decrease meaningfully in 2015, with contracting falling to 2.3% of the fleet. There is hope on the parts of some shipowners that orders will continue to stay low in 2016, keeping fleet growth minimal.15

FIGURE 8: Dry bulk newbuild prices: 2007–16



Source: Bloomberg, AlixPartners analysis

Although individual companies sensibly view newbuilds as a negative, it's hard to resist the lure of cheap money and lower building costs, which have declined an average of 50% since 2007 (Figure 8). As long as shipowners keep falling for that tempting—and highly risky—proposition, it's difficult to put much faith in the industry's ability to rebalance itself in the short term.

Navigating troubled seas
Companies have limited control over the demand side of the equation. But they can control their own operating performances and—through careful work with all their stakeholders—their capital structures.
Oversupply remains the greatest industrywide problem. It's a real-life application of the prisoner's dilemma game theory problem: the best outcome for the group as a whole is achieved when no one entity acts in its own self-interest, but it will happen only if everyone acts selflessly, with owners scrapping or at least idling a proportion of their individual fleets to rebalance supply so as to boost demand. Owners would also have to stop building because even though new vessels may be more efficient and more desirable from a marketing perspective, the economics of adding capacity remain counterproductive in the current market. Practically speaking, we think it's unlikely that enough owners will, of their own volitions, behave in the industry's broadest interests to make a meaningful impact.
Fleet reduction will most likely happen through consolidation. Mergers—or newly formed alliances and pools—could lead to the termination of newbuild contracts in bankruptcy court or could result in increased idling and scrapping. However, challenges abound there, too. With companies in survival mode, few can finance acquisitions by using their balance sheets. And because lenders are actively limiting exposure to maritime shipowners, traditional mergers and acquisitions (M&A) seems an unlikely avenue for consolidation in the foreseeable future. Divestitures, too, are currently unattractive options, thanks to plummeting asset values; resale values of all dry bulk vessel classes slid sharply from 2013 to April 2016. For instance, Capesize vessels' resale prices declined 54% during that time.16
The structural handicaps that the entire industry faces do not mean shipowners can make no individual or collaborative response to the current, brutal market. The keys to success, or at least to effective damage control, are theoretically straightforward, though difficult to execute. Following are the steps to take.
-Work proactively and form close alliances with all company stakeholders—equity owners, creditors, vendors, and employees—to preserve cash and sustain a range of options. Companies that wait until liquidity runs out will have fewer options available.
-Minimize costs—at all costs. On an operating basis, costs represent the variable that companies can most control, but many companies may be missing opportunities to do so. Despite a glut of cheap bunker fuel, for example, the EBITDA margins and operating cash flows of most of the companies surveyed remain in negative territory. Companies' inability to trim fuel costs in a favorable pricing environment

suggests that despite the attention that companies pay to their cost structures, there’s room to improve both operating performance and applications of working capital.
-Stop building new vessels. The 2007–08 pricing run-up, fueled by the global commodity boom, was seen as a new normal, and hopes for sustained record-high pricing spurred sharp increases in newbuild orders. Despite the subsequent pricing roller coaster since the Great Recession, shipowners returned to their order books anytime a glimmer of stabilization appeared, encouraged in part by the availability of cheap money and eager shipyards. But even though newbuilds offer a number of advantages over aging fleets, vessel reduction should still be the paramount target. Continue scrapping or idling older or less efficient vessels to more aggressively manage supply.
-Seek opportunities to consolidate via M&A when feasible and via alliances or pools to more effectively manage fleet utilization.
Three years from now, demand may come back, but shipowners should focus on the next 36 months and act as though depressed demand is here to stay.
Source: AlixPartners

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