



This time it's different

THE maritime transport industry is facing the largest and sharpest correction to its economic structure since the mid-1970s. But what makes this situation different from previous market downturns?

The two primary drivers of the shipping industry are demand for its transportation services and the supply of money to finance the capital cost of the ships and their operating expenses.

In the past several years, a huge supply of cheap new money has met a huge new demand for shipping services, neither of which had any historical precedents.

During the last 40 years, there have been many major events, which have suddenly changed the supply and demand equation of shipping services. These include the Vietnam War, the Japanese Industrial expansion in the 1970s, the Middle East War of the early 1970s and the financial crises of the early 1980s and early 1990s all of which have had major but temporary impacts on shipping's economics.

There have, however, been few if any economic issues that have affected the shipping industry as much as the Chinese 'economic revolution' of the last 10 years. Surprisingly, this Chinese revolution was unforeseen and yet its impact has been far greater and far more enduring than any of the other historical incidents.

More and more ships have been needed to move the raw materials and manufactured goods to and from China as its industries have sought to grab an increasing share of the developed nations' demands, for cheap manufactured goods of all types.

A vast supply of cheap labour met a transportation industry prepared to deliver all of the components needed to satisfy both sides of this industrial revolution. Shipping had after all provided the same services to Japan in the 1960s and 1970s that helped create its own economic growth.

For the shipping industry the Chinese industrial revolution has been a bonanza for the last five years, coming after some 15 years of mediocre returns.

But as with previous bonanzas the shipping industry, which is predominantly made up of privately-owned companies, has itself gone on a spending frenzy of unprecedented proportions.

Prices for newbuildings and secondhand ships have soared since 2000 as shipowners old and new bought or ordered ships of all types and sizes to meet a perceived ever increasing demand from China for shipping services.

This massive capital investment has been fuelled by extraordinary short-term charter rates and an abundant supply of cheap debt.

With annual expenditures of \$100bn a year on new ships and upwards of \$30bn a year in the secondhand markets, shipping is a huge consumer of capital.

The bulk of the funds have been provided as debt, mainly by commercial banks in the US and Europe, on an increasingly leveraged basis.

A mountain of cheap debt not only fuelled the shipping industry and the US and European housing markets but together with private equity pushed stock markets to record heights as bigger and bigger takeovers of public companies became a weekly occurrence.

Today, the newbuilding orderbook is more than \$350bn and prices of secondhand ships have doubled and tripled as owners fought to get ships delivered quickly to ride the waves of ever increasing short term freight rates.

From 2002-2006 the shipping industry experienced a boom in freight rates and secondhand ship prices of a magnitude never seen since the brief period in 1974 when the Middle East war disrupted oil supplies.

A new and unpredicted series of events began to unfold in the third and fourth quarters of 2007, which have had a dramatic effect on the other main driver of the shipping industry, the supply of debt capital.

The US housing market, which had experienced enormous growth from 2000 onwards fuelled by Alan Greenspan's cheap money, ground to a halt in late 2006 and by the middle of 2007 was showing in excess of 25% reductions in house prices in many areas of the country. This worsened in the first half of 2008.

With cheap debt no longer available and demand for shipping services at risk



from the downturn, the industry must brace itself for some turbulent weather, writes Paul Slater, chairman of First International Corp

Further panic in the capital markets was caused when it emerged that billions of dollars of house mortgages had been packaged and sold into the unregulated debt markets with little regard for their creditworthiness. These new mortgage-backed secu-

rities were widely sold to financial institutions and insurance companies all over the world.

By the end of March 2008, it became clear that US house mortgages were only part of the problem as the underlying values of a range of other debt securities began to be challenged and the hitherto secure area of debt guarantors came under review by the rating agencies with devastating effect.

Furthermore, most of the world's largest commercial and investment banks had to confess that their trading operations had gambled in the unregulated debt markets they had themselves created and lost hundreds of billions of dollars.

Today, the International Monetary Fund estimates that more than \$1trn has been lost by the banks and this figure does not include the losses incurred by pension funds, insurance companies, hedge funds and other non-bank financial institutions worldwide, which will likely add another \$1trn.

The recent collapse of Lehman Brothers, the enforced takeover of Merrill Lynch and the US government bail-outs of Fannie Mae, Freddy Mac and AIG, gave some idea of the severity of the crisis, but not the full extent.

However, a clearer idea of the extent of the crisis was provided by the US government's subsequent \$700bn rescue plan for the financial sector, which is designed to bring an end to the credit crunch.

The financial fall-out has by no means been limited to the US, with rescue packages for European banks such as Fortis and HBOS under way.

Adding to the gloom

OVER the last 12 months, says Mr Slater, the shipping industry has begun to feel the effects of the slowdown in world trade and the reduced demand for shipping services. "Now the industry faces the additional problems created by the collapse of the global debt markets and the exit of many equity investors from shipping. All this comes at a time when the orderbook for new ships is at an all-time high and shipyard capacity has grown to a level that it can now replace the world fleet in less than 10 years."

These are some of the key developments that Mr Slater highlights in his speech:

- inflation is rising rapidly in the US and the major European countries while economic growth has stagnated and is declining in most of these countries. Inflation is now in double digits in China while its economic growth has dipped below 10% and is projected to go lower;
- steel production in China is down sharply partly because of the Olympics and is not expected to return to anything near its previous capacity as the demand for steel, both domestically and for export, has declined. The cost of iron ore has doubled this year and is set to rise further as the Brazilians and Australians continue to adjust their prices upward;
- China has been losing money in its steel mills for the past couple of years as the rising costs of imported iron ore have had a big impact. These losses have been subsidised by the government but this is likely to end and China's steel production will focus on domestic demand and less on export markets;
- containerised cargoes from Asia to the west coast of the US are down by 8% per month since January 2008 compared with 2007;
- the container rates from Asia to Europe have collapsed as volume demand continues to fall. Some companies are laying up tonnage to bolster rates;
- many tanker companies are reducing their ship's operating speeds to conserve fuel and reduce the impact of an oversupply of ships and

charterers will no doubt seek compensation;

- many commercial banks are seeking to delay or cancel commitments on newbuildings unless period charters are in place;
- medium-term charters are being fixed in both the wet and dry bulk markets at rates that produce minimal returns for investors after debt service, excluding profit sharing bonuses, which themselves look doubtful;
- ship-operating costs continue to climb as the demand for skilled crews and the costs of maintenance, repair and insurance have risen sharply in the last two years. Fuel costs have soared over the last two years and show no sign of reversing;
- the orderbook for new ships remains historically high despite cancelled orders and delayed deliveries;
- shipyards are showing signs of concern about future markets and the shortage of debt financing. Recent predictions have suggested that as much as \$30bn of orders will be cancelled in the next year. Meanwhile, new shipyards continue to be developed in China and elsewhere without the skilled personnel to run them;
- most commercial lenders to the shipping industry have sharply reduced their lending activities and some have stopped altogether;
- private-equity investors have mostly moved away from shipping and the public markets are effectively closed to new initial public offerings and will remain so until the debt markets open up again;
- companies that have already taken or are expecting delivery of expensive new ships but have no charter cover, face spot and period markets that barely cover capital and operating costs, leaving little or nothing for investors;
- many public shipping companies are propping up their share price with dividends from charters concluded months ago, thereby diminishing their cash reserves;
- and the cushion that the sale and purchase markets have provided in the past has disappeared for new ships as values are in many cases below cost and new orders are being offered at a discount.

The knock-on effects for the global economy of these dramatic events will be enormous as debt will become scarcer and more expensive and remain so for several years to come.

Shipping has always been highly leveraged along with most other capital intensive service industries.

When the cost of ships rises sharply in response to perceived demand for ocean transport services the debt demands also increase significantly.

The time delay between ordering ships and taking delivery has always been a factor for those gambling on the spot markets and this period has now extended beyond three years because of shortages of machinery and available berths.

This may well shorten if there are a significant number of cancellations of orders but the current newbuilding orderbook is at record levels at a time when the outlook for demand is grim.

Unfortunately for shipping, there are no technical issues, such as double hulls, and there is no new "China" to provide new demand, which would mitigate the over-supply of ships.

The industry will need to seriously retrench and downsize in order to re-energise the freight markets, but this will take several years.

Meanwhile, we could well see significant lay-ups of ships and further cancellations of newbuilding orders.

China may well pick up some of the slots from cancelled orders and build simpler and cheaper ships for its own purposes.

It is already building ships that do not meet international standards and is operating them under the Chinese flag.

The Chinese central government has already said that it wants the majority of raw material imports to be carried in Chinese ships, which will further diminish the demand for foreign shipping.

Finance for shipping will be in very short supply for several years, and many of the existing deals will need to be restructured to meet the new circumstances with more equity being required and stricter covenants being reintroduced.

The dry cargo markets look very vulnerable in all sizes and we are likely to see rates weaken significantly and remain there for several years.

Ships delivered in the last year and those due for delivery in the next two years will struggle to meet their debt service and will earn no profit for their owners.

The tanker markets also look weak as rates have come off significantly from the heights of 2006 and 2007.

The consumption of gasoline in the US is down and likely to remain there even as the oil price drops. Demand in China is also down and the government is pushing to reduce oil imports further.

Tanker companies will find it difficult to make any real profits. Many have spent their cash reserves on dividends and new orders so we will see a number collapse in the next year or two.

The container markets are already weak and the orderbook will only make things worse as traffic volumes decline in the wake of the weakening global economies.

Hopefully there will be a slowdown in the shipbuilding industry but probably not before the bulk of the present orderbook is delivered.

There is a lot of stormy weather ahead in both the financial and shipping markets, which will continue for several years.

Shipping has only just begun to feel the effects of the crisis with the downturn of world trade and the collapse of the banking system.

There is an inbuilt delay as the time between fixing charters and completing the voyages can be as long as six months while the time between ordering and delivery of new ships can be two or three years.

Shipping's downturn has only just begun and, as we have seen in other markets, when reality sets in there are no limits to the levels to which prices and values can sink.

* This is an extract from a speech Mr Slater will make on October 9 at a Financial Times shipping conference in Athens.