ARE LARGE BULKERS MORE OVERSUPPLIED?

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Cargo movement shifts from one segment to another rather easily (except in some cases when cargo size and draft restrictions at ports play a role) in the dry bulk market compared to other sectors. So, an oversupply in one segment trickles down to other segments rather easily. Therefore, an oversupplied Capesize market will, in turn, impact Panamaxes in the long run, which will further go down to smaller segments.

The current nemesis of the overall dry bulk market finds its genesis into the huge oversupply built up in the excessive new orderings in the post 2007-08 period which were delivered during 2010-12. As a result, 2012 saw the worst dry bulk in its history where the BDI went down to its lowest level and it looked as if the only way forward is an upward journey. The market did move upward for two years. The market did look like it was coming back to good days of net profits, recovering towards the end of 2014 but the improvement was more because of a short-term supply crunch in 2014 when many dry bulk owners filed for bankruptcy and some of the vessels were not available because of legal tangles.

The oversupply again caught up and the BDI reached to fresh lows in 2015 going further down in 2016. The sustained low earnings brought in some structural changes and the new orders almost dried up, many yards got bankrupt which in return were unable to deliver any further vessels, owners became cash-strapped and reached a position where they became unable to take any further deliveries. Slippages increased and as young as 11-year-old Capesize vessels were sent for demolition; as a result, the fleet contracted for the first time in 2016. This paved the way for a genuine recovery and the market has started moving up, though at a very slow pace as the oversupply remains huge.

BDI IMPROVES IN Q2, 2016 SUPPORTED BY INCREASED LAY-UP ACTIVITY

Extraordinarily prolonged downturn in the dry bulk market has pushed shipowners and charterers (for long-term) past the threshold of their endurance and they are resorting to cold lay-ups. As the BDI fell to its historical low earlier this year, the reported lay-up activity has increased from 13 vessels at the end of 2015 to 151 dry bulkers by the end of June, 2016. Drewry believes this number is going to remain high over the next three to six months as more shipowners will crumble under the pressure of low freight rates and negative day earnings for a sustained duration. These lay-ups, along with other factors, such as iron ore restocking demand in China have supported freight rates to an extent. Drewry is of the opinion that while cold lay-ups might help owners to manage their costs and minimise their losses, even a marginal recovery in demand will keep the freight rates on the path of recovery. However, if demand doesn't improve, current oversupply in the dry bulk market is too wide a chasm to be bridged by lay-ups alone.

SLIPPAGES TO HELP CONTRACT OVERSUPPLY

Slippages have been historically high in the dry bulk sector, moving in tandem with dwindling earnings. Until the end of Q2, 2016, it has already touched highest ever recorded slippages at 50%. With most owners struggling to make profits with the existing fleet, a large number of orders have been cancelled, deliveries have been pushed back and many have been converted to tankers and other vessel types. As owners run into financial troubles, the Domino effect has led tofinancial troubles for the shipyards.

DELIVERIES UNDER RISK AS YARDS GO BANKRUPT

Shipyards continue to be stifled by newbuilding order cancellations, stringent financing policies by lenders and a rise in wages at Chinese yards. Over the past year, 20 yards have either gone bankrupt or have filed for bankruptcy. Despite Beijing's policies to promote shipbuilding, along with steps like transfer of direct benefits, the state-owned yards are still struggling and have started to file for bankruptcy. Wuzhou Shipyard, a subsidiary of Zhejiang Shipping Group, became the first state-run Chinese yard to file for bankruptcy in December, 2015, while another major shipyard Zhenjiang Shipping, a subsidiary of Sinopacific Shipbuilding, was declared bankrupt in 2016. Zhenjiang was a major state-run shipyard and was acquired and restructured by Sinopacific Shipbuilding in 2003. Sinopacific Shipbuilding is currently in a financial crisis and is closing down its Shanghai operations to cut costs.

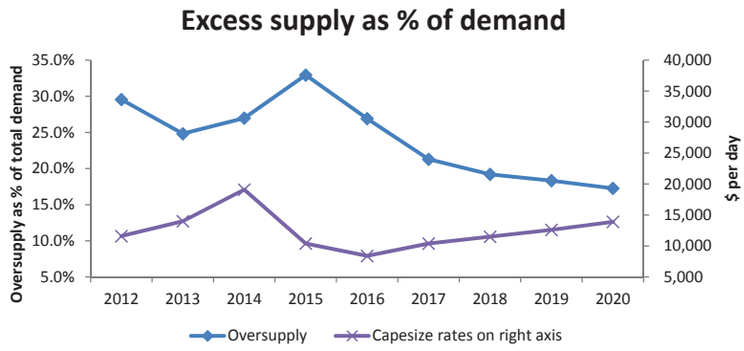
Meanwhile, in the dry bulk market, apart from the 30 Valemax orders placed at the Chinese yards, all other orders in 2016 have been placed at Japanese yards. Four Handysize vessels and two Panamax vessels were ordered at Oshima Shipbuilding Corporation. It is now pushing for the 2019 slots as the yard is occupied for the next couple of years.

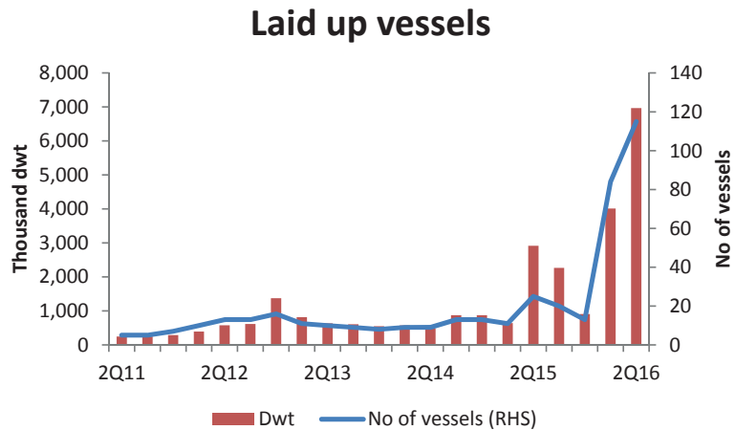
SHIPS AT RISK AT KOREAN YARDS TOO

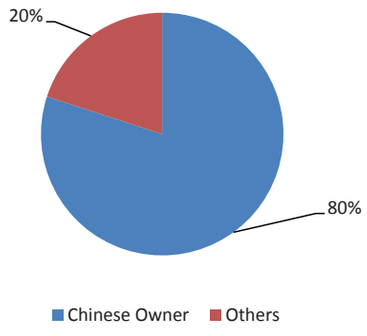
The top three Korean yards - Daewoo Shipbuilding & Marine Engineering, Samsung Heavy Industries and STX Offshore & Shipbuilding Company went into heavy losses as demand for their product portfolio took a heavy biting. The lenders are scared of financing the shipyards as they are running into losses. South Korea's Korea Development Bank (KDB) decided to avoid handling out large loans to single company or single industry. The bank will reduce the ratio of loans heavily focused on the troubled local shipping and shipbuilding sectors as part of its risk-management efforts. KDB is the main creditor bank of the three shipbuilders placed under court receivership. KDB and Korea Export Import Bank (KEXIM) have more than 50% of their exposure to shipbuilding sector.

CHINA'S WIN-WIN STRATEGY

On the other hand, the ordering of 30 VLOC's and strong buying interest of Chinese owners in secondhand market when the freight rates struggle at their bottom level shows the country's strategy to gain in the current tide. Last year CMES purchased four Valemaxes from Vale and agreed a COA with the company that expects the ships to carry six million tonnes of iron ore from Brazil to China each year for 20 years, plus an optional five-year extension period. VMM has also acquired four second-hand VLOCs and secured a COA from Vale. The COA, which covers a period of 27 years, will see the company transport about 16 million tons of iron ore for Vale each year. China will benefit from economies of scale as transporting from world's largest ship reduces cost of transportation. If shipping costs are low, China can drive a hard bargain and if the price of ore falls Vale absorbs the losses because after the capital costs are sunk the marginal revenue takes priority. Either way, China wins. This will also force the other suppliers like Australia to cut their iron ore prices in order to stay in the competitive market where the bargaining power has shifted to the giant buyer i.e. China. While Brazil still has much to gain from the upside of a future tough ore market, they also have much to lose from the downside. China, on the other hand, has insulated itself from the downside under normal market conditions, but at the same time demonstrated a willingness to play hardball in pursuit of absolute gains from trade.

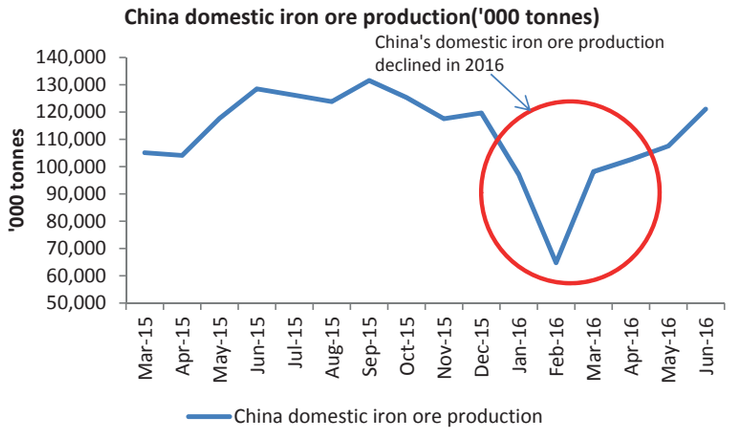


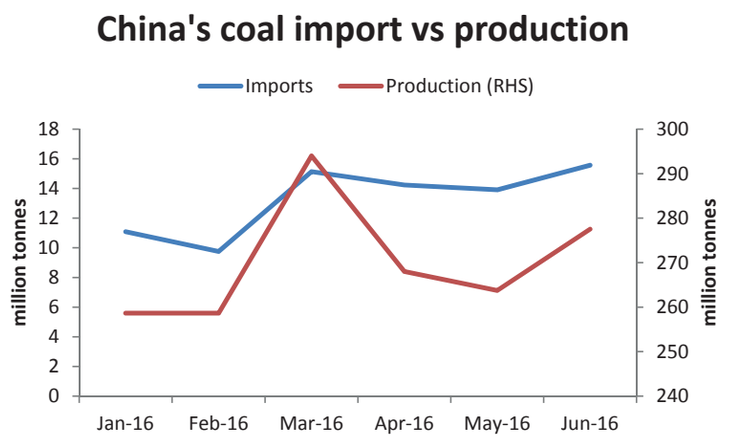


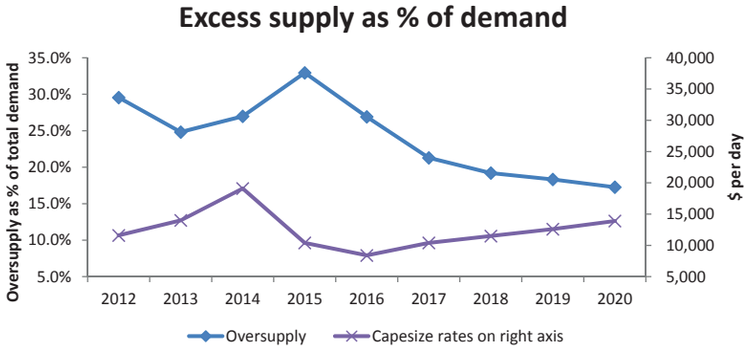


CHINA'S IRON ORE STORY

China's fresh iron ore appetite might revive other bigger vessels too. The sad story of China's iron ore imports took a positive turn as the country's imports started to pick up which has given some relief to the struggling Capesize segment which is evident by rise in Baltic C3 and C5 rates (Australia-China and Brazil-China iron ore route). But what led to the rise in China's iron ore imports despite shrinking steel production? Firstly, the fall in domestic iron ore production was due to strong competition by the cheap imported iron ore as the price in the world market slumped as a result of oversupply and weak demand. Secondly, it was not feasible for the domestic iron ore producers to survive at negative margins as the cost of domestic iron ore production increased steeply due to rise in labour cost and high cost in iron ore production from low grade iron ore. China's iron ore imports increased by around 10% this year so far while steel production has actually contracted compared to last year which is due to replacement of domestic iron ore production by imports. The increase in imports due to falling domestic production will result in increased employment of Capesize and VLOC vessels on Brazil-China and Australia-China route and improvement in freight rates on Baltic C3 and C5







route as the supply of vessels remains in check. The freight rates on the Brazil-China route for Capesize and VLOC vessels are expected to rise more compared to freight rates on the Australia-China route as the imports from the distant location is expected to be high. However, the comeback of laid up vessels in the picture might bring some disturbance in the improvement path of the Capesize segment.

CHINA REPLACING MORE DOMESTIC COAL WITH IMPORTS

China plans to raise environmental standards in the coal mining sector in order to control the pollution created by the sector. According to a draft published by The Ministry of Industry and Information, the coal mines that fail to comply with standards set by the government will be given six months to rectify and would be closed if they fail to make any progress. The companies that continue to pollute the environment despite warning will be fined on a daily basis and forced to shut down. This is going to further accelerate cost of domestic coal production in the country and increase the plight of the ailing coal industry. The cost of domestic coal production rose steeply in last few months with rise in wage cost which led to substitution of domestic coal with cheap imported coal, which in turn led to shutting down of many coal mines in the region. As these environmental regulations on treating waste is going to further add on to the cost of coal production in China, it will become more difficult for the domestic coal producers to survive in the market due to cheap imported coal that is available. However, this could bring some respite to the shipowners.

LA NIÑA EFFECT TO HELP RATES IN 2017

The El Niño effect, which brought warmer weather across the globe, is expected to be followed by its colder counterpart, La Niña, which is expected to bring heavy rains in some parts, including Australia as it has done in the past. La Niña was so severe that it hit 85% of Australia's coal production by severe floods. There was massive congestion disrupting coal supplies at Australian ports which squeezed vessel supplies. This made fewer numbers of vessels available at other locations helping rates to improve. A similarly strong La Niña in 2017 could repeat the devastation and make many vessels wait at the Australian ports and thereby help rates in 2017. If this becomes a reality, the impact of the Chinese New Year holiday, which is expected to bring rates down, might get neutralised to some extent.

Overall, it seems the dry bulk market has reached its bottom and the only way forward is to move upwards. This is another matter how flat the bottom is going to be. A lot will depend on how China's imports shape-up.

ABOUT THE AUTHOR

Rahul Sharan is the Lead Research Analyst on dry bulk shipping at Drewry. Rahul has an advance master's degree in International Economics from the University of Namur, Belgium. He has his post-graduate degree in Economics from Jawaharlal Nehru University, New Delhi. He has been working on shipping and economic research for the past 10 years. He has been the editor of Drewry's flagship monthly shipping insight. He has also been the editor of dry bulk publications – Dry Bulk Forecaster and Dry Bulk Insight.

ABOUT THE ORGANISATION

Drewry is one of the world's leading international maritime research, advisory and publishing organisations. Founded in 1970, the company has over 40 years' experience within the maritime sector, employing over 90 specialists across offices in London, India, Singapore and Shanghai. The company provides research reports and consultancy services with a brand renowned for its quality. Drewry reports are sold in more than 90 countries and consultancy services are commissioned by over 70 countries.

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