SHIPPING MARKET REVIEW

GENERAL REVIEW AND OUTLOOK - MARCH 2012

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GENERAL REVIEW AND OUTLOOK

WORLD TRADE VOLUMES HAVE BECOME HIGHLY DEPENDENT ON ASIAN DEMAND. TRADE PATTERNS HAVE CHANGED DRAMATICALLY AS THE GROWING GLOBAL IMBALANCE HAS WIDENED. THE SUSTAINABILITY OF THE FUTURE DEMAND GROWTH PATTERN IS SUBJECT TO CONSIDERABLE UNCERTAINTY.

ASIA CONTRIBUTED 86% TO GROWTH IN IMPORT VOLUMES

Global seaborne import volumes increased by 24% from 2005 to 2011. Higher Asian imports constituted a massive 86% of the volume increase whereas European import volumes hardly budged and US import volumes fell 10%. Latin American and African import volumes surged during the period, contributing 16% to the increase in seaborne import volumes.

Asia imported 53% of world seaborne import volumes in 2011. 54% of Asian imports were transported in Dry Bulk carriers, 33% in Tankers, 9% in Containers and the remaining 4% in General Cargo. 40% of all Asian imports were bound for China.

LOWER THAN EXPECTED GROWTH IN 2011

In 2011, the world economy initially performed better than expected, but it gradually weakened as the year unfolded. Emerging economies were not left unaffected by the deterioration of the world economy in general or of European economy in particular. Nevertheless, growth rates in emerging economies remained high and continued to become more important for world economic performance.

SOVEREIGN DEBT CRISIS BACK WITH A VENGEANCE

The crisis surrounding European sovereign debt worsened in 2011. Several European countries have reached unsustainable levels of sovereign debt. International investors have become anxious about the risk of their government bonds and are less willing to finance government deficits. This is aggravating the situation and the initial response from European leaders has been to throw out a lifebuoy to the hardest hit countries in order to prevent the situation from getting worse. Subsequently the focus has shifted to cutting budget deficits and reducing debt burdens which will have the immediate effect of reducing stimulus to the ailing European economy.

WORLD GDP UP BY 3.3% IN 2012

According to the IMF, world GDP growth is expected to slow to 3.3% in 2012 (down from 3.8% in 2011). Economic growth in emerging markets is expected to continue to outpace growth in developed countries. Emerging markets are expected to grow by 5.4% in 2012, down from 6.2% in 2011 and developed countries are expected to drop from 1.6% in 2011 to 1.2% in 2012.

GROWING GLOBAL IMBALANCES

The dynamics of the global economy have changed substantially during the past decade. Emerging economies have expanded and become important players in reshaping the global economic landscape. The direct contribution of emerging economies to global growth has continued to increase over time and was further accentuated during the financial crisis while the reverse has been the case for advanced economies. During the financial crisis the emerging economies orchestrated significant changes to the formation of world economic growth. Emerging economies accounted for 86% of world GDP growth during 2008–09, while the contribution of advanced economies was 6%.

An essential issue to consider is whether what we have seen is the emergence of an additional main engine powering the world economy or simply a temporal boost to world GDP. Certainly, these transformations presented extraordinary growth opportunities for world trade over the decade, but they have also increased the dependency on emerging economies in general and Asia in particular. In the following, we will introduce a few key points that illustrate the greater risk that has been building up alongside the rise of emerging economies.

SIGNIFICANT CURRENT ACCOUNT SURPLUSES SUPPORT ASIAN GROWTH

It is important to understand a bit of the background for the emerging economies' increased resilience to the slowdown in the advanced economies. The key topic here is not complete macroeconomic de-coupling or a new economy. Rather, it is primarily the increase in trade and financial linkages among the emerging economies in combination with the relatively little dependence on foreign finance that have shielded the emerging economies as a group from the slowdowns seen among the advanced economies.

Emerging economies, on average, were net exporters of capital during the past decade. Asian emerging markets, especially China, have run significant current account surpluses in recent years, reducing their dependence on foreign finance. In combination with changes in the composition of capital inflows (away from debt and toward foreign direct investment and equity investment) emerging economies have reduced their vulnerability to swings in capital flows. Obviously, other emerging economies — especially those in Europe — were also running large current account deficits before the crisis. This latter group proved most vulnerable to the crisis because credit booms in these countries were financed largely through foreign capital rather than domestic savings.

COMMODITY EXPORTING COUNTRIES SHIELDED FROM SLOWDOWN

The strong growth in the emerging markets has shielded commodity-exporting countries from the slowdowns among the advanced economies. For example, China's rapid growth continued during the crisis fuelled by a surge in investment. In turn, this has boosted demand for commodities from emerging markets, such as Brazil and Chile, increasing demand for other raw materials and intermediate inputs from other Asian emerging markets.

GREAT RISK ATTACHED TO THE CHINESE GROWTH MODEL

The growth engine of emerging economies went up a gear as the previous main engine of the world economic locomotive sputtered. Accordingly, the transformation of the global economy during the past decade could easily be considered a great success. And it might be. We definitely would not argue otherwise. What we will argue, on the other hand, is that there is great uncertainty attached to the sustainability of the future growth path. Take China as an example. China's growth model has resulted in it having the lowest share of private consumption to GDP in the region and the lowest rate of employment growth relative to GDP growth. Investment-driven economic growth is hardly a sustainable long-term strategy if underlying fundamentals are not improving. Risk is building up. Currently, we begin to see warning signs of a potential return of non-performing loans on a large scale in the Chinese banking sector. Local governments are currently at the epicenter of the challenge. Debt-financed infrastructure investments have created an environment that draws local governments into a leverage trap. The central government is currently in the process of taking over the responsibilities.

LARGE IMPACT ON TRADE VOLUMES

The rise of emerging economies and the growing global imbalances have been major drivers of the increase in seaborne trade volumes. Distance-adjusted demand for the world fleet is basically a product of world trade volumes and travel distances. The growing regional imbalance reduces the productivity of the world fleet as ballast legs become longer. Therefore, the growing imbalance is basically amplifying the impact of trade growth on world fleet utilization. A less attractive consequence of the global imbalances is that distance-adjusted demand for the world fleet becomes significantly less resilient to economic shocks impacting Asian demand.

Rebalancing growth in emerging Asia is an important component of the overall global rebalancing effort that will be required to stabilise the world economic system in the years to come. Hopefully, such rebalancing effort will not dramatically impact future world trade volumes.

For a detailed segment analysis, see our latest Shipping Market Review.

GENERALLY SPEAKING, EARNINGS ARE UNDER PRESSURE AS RATES ARE LOW AND BUNKER PRICES ARE RISING. EXTENSIVE SCRAPPING AND A LIMITED INFLOW OF NEW VESSELS IS REQUIRED. HOWEVER, THE OPPOSITE APPLIES IN A NUMBER OF (SUB)SEGMENTS: EARNINGS ARE HIGHER, THE FLEET IS OLDER AND THE ORDERBOOK IS THINNER. IN TODAY'S MARKET, IT IS IMPORTANT TO LOOK CAREFULLY AT THE DETAILS BEFORE DRAWING A CONCLUSION.

INCREASED GAP BETWEEN SUPPLY AND DEMAND IN 2011

The supply surplus widened further in 2011 as growth in world trade volumes levelled off during the year. By the end of the year, world trade volumes had on average increased by 5.5% and was 6% above the pre-crisis level. Tonnage supply continued to accumulate in many segments. The world fleet grew by 9% (120 million dwt) in 2011 and by year-end it had grown to a size 25% larger than in 2008.

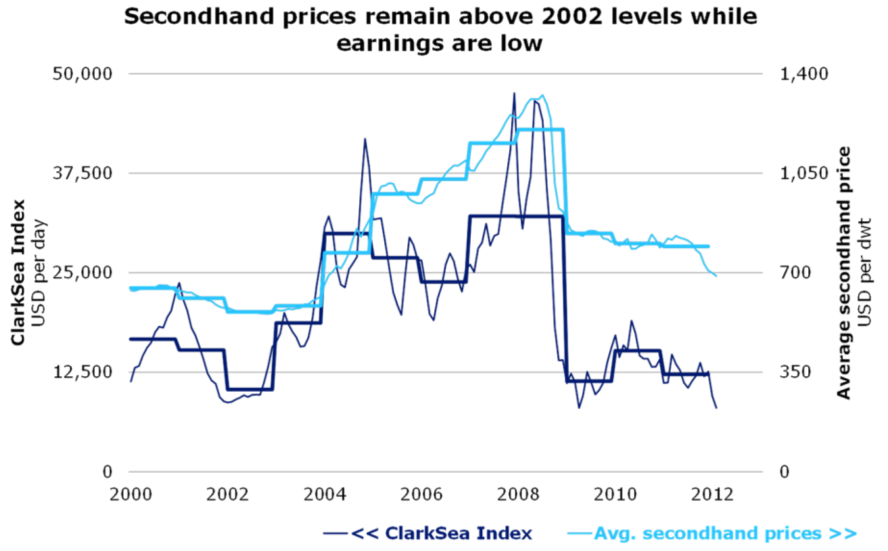
RATES DECLINED ON AVERAGE BY 20% IN 2011

Even before the crisis, it seemed likely that owners' appetite for new vessels could outstrip the short-term potential for world trade volumes. Still, few had imagined the devastating shortage of demand in 2009. Evidently, demand growth returned strongly during 2010 and recovered the lost ground. Nevertheless, many segments have been over-supplied by tonnage delivered in 2009 and 2010. The effect of the supply surplus has been eased by slow steaming, growing trade imbalances and to some extent longer travel distances, but rates and values have remained under pressure. In 2011, the ClarkSea Index dropped 20% while average secondhand prices remained fairly stable (fig. 1). By February 2012, the indices had declined a further 36% and 3% respectively (year-to-date).

BUNKER PRICES INCREASED ON AVERAGE BY 37% IN 2011

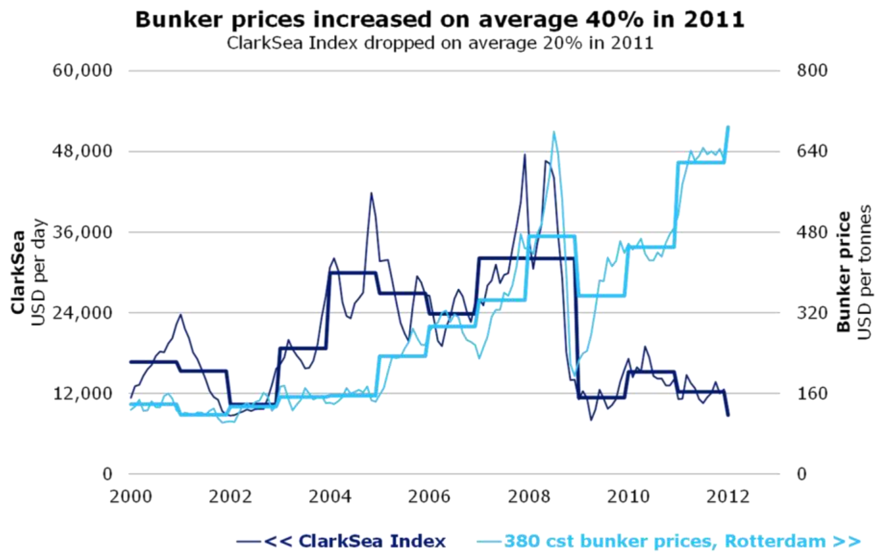
Bunker prices have recovered from the drop in 2009. In 2011, average bunker prices increased by 40%. At February 2012, bunker prices traded at a record-high of almost USD 700 per tonne (fig. 2). The combination of record-high bunker prices and low freight rates may eventually create financial difficulties for

Figure GRO.1



Sources: Clarksons, Danish Ship Finance

Figure GRO.2



Sources: Clarksons, Danish Ship Finance

some owners. Accordingly, in today's market cash flows are at least as important as profits. This dilemma adds further the pressure on rates as many owners may accept lower rates in order to secure cash flows.

7% OF ORDERBOOK CANCELLED IN 2011

The global orderbook shrank by 26% (128 million dwt) in 2011 with 160 million dwt leaving the orderbook and new orders of 65 million dwt being added. The orderbook was further reduced by 33 million dwt. This figure indicates that up to 7% of the orderbook could have been cancelled during 2011.

LARGE FLEET GROWTH IN 2012 AND 2013

At January 2012, the orderbook was approximately the same size as in 2007 and the orderbook/fleet ratio had declined to 25%. A declining orderbook/fleet ratio does not necessarily indicate that the worst is behind us. It simply reflects that the fleet has increased. And it is not so much the size of the orderbook as it is the pace of delivery that is worrying. The lion's share of the orderbook is scheduled for delivery in 2012. In 2012, the world fleet is scheduled to increase by 16% assuming that no vessels will be scrapped and that the nominal orderbook for 2012 is delivered. However, we do expect to see extensive postponement and scrapping activity.

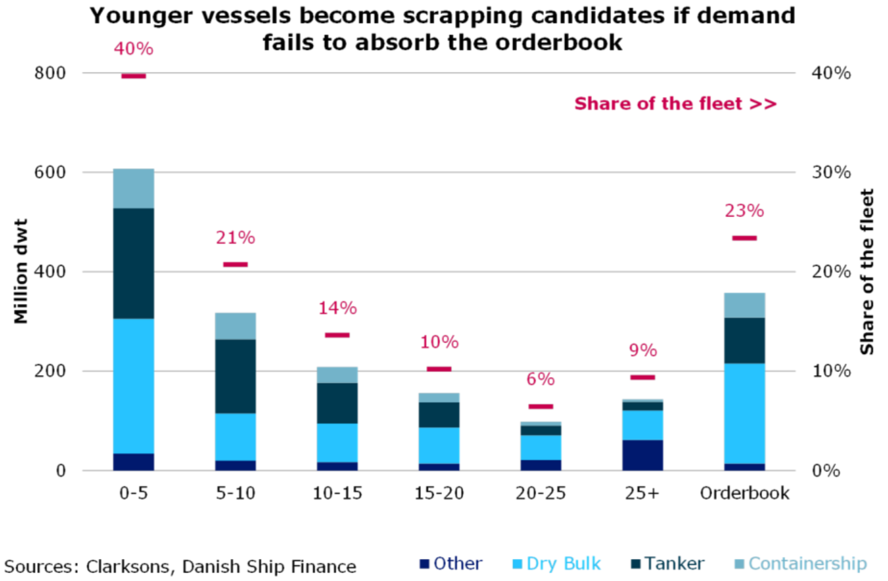
15% OF THE FLEET IS OLDER THAN 20 YEARS

The age distribution of the world fleet displays a gloomy scenario for fleet replacement. 40% of the fleet is 5 years old or younger and only 16% of the fleet is 20 years old or older. The orderbook is currently 2.5 times larger than the part of the fleet that is older than 25 years. Consequently, in some segments younger vessels need to be scrapped for supply and demand balance to remain at current levels (fig. 3). Otherwise, further use of slow-steaming (where possible) and lay-up of tonnage may be the only chance to balance supply and demand.

40 MILLION DWT SCRAPPED IN 2011

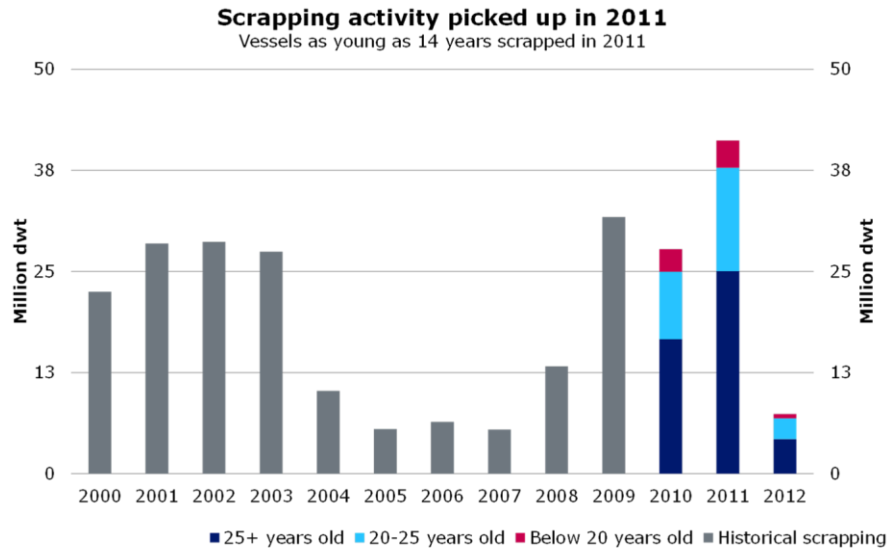
Scrapping activity continued to intensify in 2011 but was hardly a match for the massive inflow of new tonnage. It was the combination of high scrap prices, high bunker consumption of older less-attractive designs together with the sustained downward cyclical pressure on earnings that encouraged owners

Figure GRO.3



Sources: Clarksons, Danish Ship Finance

Figure GRO.4



Sources: Clarksons, Danish Ship Finance

to scrap more than 40 million dwt in 2011. Six out of ten vessels scrapped were older than 25 years, 30% were between 20 and 25 years old and 10% were less than 20 years old. Vessels as young as 14 years were reported sold for scrap in 2011 (fig. 4).

In the absence of an aggressive scrapping program several of the major segments will face massive supply side challenges in 2012 and 2013. Therefore, we expect that the trend of scrapping more and younger vessels will strengthen in 2012. However, whilst scrapping can help alleviate the difficulties facing the market and certainly hasten its eventual revival, it seems unlikely that it will absorb the entire orderbook.

A DELUGE OF NEW CONTRACTS IS REGARDED A MAJOR RISK

The large shipyard capacity and the quickly waning order cover might be a toxic blend that can further harm the supply and demand balance in 2012. Clearly, we do expect to see many yards campaigning for new orders in 2012. Yards will be offering vessels at lower prices and with lower bunker consumption and in some cases even supplemented with attractive financing of the vessel. Owners know that there is a risk of overcapacity (i.e. lower future asset values) but will be tempted to order anyway. The lower price and the lower bunker consumption will persuade many to conclude that they have done an attractive deal. But when should we conclude whether or not a deal is attractive? At the time of contracting or at the time the vessel is sold? Loosing less than your competitors is not a valid argument for placing new orders. We fear that a new contracting boom will harm both freight rates and asset values in the medium term, making it relatively difficult to make a return on the investment, not to mention the ability of some shipowners' to service their debts. However, we might be wrong, in which case, the strong arguments involving lower bunker consumption might justify the investment and force through the necessary early scrapping of existing vessels.

SHIPYARDS CAPACITY SET TO FALL

Clearly, a certain amount of new orders will be placed in 2012 and 2013, but we do not expect contracting activity to be strong enough to support the current yard capacity. We estimate that as much as 20% of the current yard capacity might be shut down within three years, with reductions expected mainly at less-advanced Chinese yards. Accordingly, we estimate that global yard capacity, by 2014, could be back at the 2008-level. On average, we forecast that newbuilding prices for less sophisticated vessels – or at least shipyard profitability - could decline by as much as 15-20% in 2012.

SHIP FINANCING INTO TURMOIL

Global ship financing has been hit hard by the financial market turmoil and, particularly, the European debt crisis. In combination with low freight rates, high bunker prices and declining asset values it seems inevitable that many – less creditworthy – owners' will struggle to raise debt. Shipowners' ability to take delivery of their newbuildings or to buy new vessels becomes highly constrained if access to debt markets becomes further limited. Therefore, for 2012 and beyond we expect to see an increasing share of the orderbook being postponed or cancelled. Still, cash-rich and well-established owners and/or owners with access to Export Credit Agencies (ECAs) or similar might be able to do some very good deals in the years to come.

OUTLOOK FOR 2012 AND BEYOND

We expect rates and asset values to remain low in 2012 although we do see a potential for some short-lived spikes in freight rates.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