AS DRY BULK RECOVERS, HERE'S WHAT TO WATCH IN 2018

Overview

Dry bulk shippers specialize in transporting cargos, typically commodities, such as iron ore, coal, grain, and other materials around the world.

Companies with exposure to dry bulk include Diana Shipping, Inc. (DSX), DryShips (DRYS), Eagle Bulk (EGLE), Genco Shipping (GNK), Golden Ocean Group Ltd. (GOGL), Navios Maritime Holdings, Inc. (NM), Navios Maritime Partners L.P. (NMM), Scorpio Bulkers (SALT), Safe Bulkers, Inc. (SB), Star Bulk Carriers Corp. (SBLK) and Ship Finance International Limited (SFL).

Background

In January of 2016, I authored an article entitled 2016 Will Be Catastrophic For Dry Bulk where I stated that "the dry bulk sector is bracing for what could be the worst year ever, yes, ever."

That proved to be true as the Baltic Dry Index set an all-time low of 290 on February 10th of 2016. The Baltic Dry Index (BDI) is a composite of the Baltic Capesize, Supramax, Panamax, and Handysize indices. It is useful in determining the cost to move materials by sea and serves as benchmark for charter rates.

But a high level of demolitions, coupled with reasonable demand side increases, paved the way for a different headline in 2017 when I wrote Why Dry Bulk Shipping Could Look Very Different One Year From Now. Here, I noted that "the first signs of recovery may be emerging." I concluded that "that a correction appears to be on the horizon, and I am able to forecast, for the first time in years, that a recovery may be setting up in the long-run."

2017 saw a significant improvement in both the BDI and charter rates across all vessel classes.

In their week 47 report, Allied Shipping Research noted:

The Dry Bulk market has shown a remarkable recovery this year with the average earnings having increased by around 63% this year so far compared to the average earnings noted back in 2016. This strong increase has been in part a reflection on the improvement witnessed in terms of trade flows and the much better economic growth figures given by most of the major trading economies. At the same time and thanks to a considerable effort made within the industry the growth of the trading fleet had managed to remain relatively flat during 2016 and has held at a rate of just above 2% up until the start of November 2017. Both these factors helped to bring back a sense of balance in the market, allowing for freight rates achieved by owners to recover back to a sense of normality and away from the loss-making levels witnessed back in the Spring of 2016.

If we were to look at rates from last December, charter rates are more than triple what they were on a year-over-year basis.

However, let's put things into context. Following a downturn, especially a historic one, sometimes the percentage increases in earnings can look very impressive, but that's because we are starting from a very low base. But nevertheless, the recovery has allowed some companies to turn a profit for the first time in several quarters, even years.

So, the question, naturally, is can this continue?

On October 19th, Joeri van der Sman released an article entitled Bulk Shipping's Exciting Outlook where he offered a very detailed and accurate analysis of factors that should continue the recent bullish trend into 2018.

Instead of repeating much of what Joeri has previously discussed, I would like to take this time to review the supply side outlook in more detail and then spend a bit of time on factors to watch in 2018 that could derail this bull market.

Make no mistake, I am bullish on dry bulk in 2018. But when things are going badly, I'm cautiously looking for what could spark a turnaround. When things are going well, I'm far more focused on what could spoil the party. Right now, things are going well, and I feel it would be best to spend this time focusing on issues that I believe should be watched in 2018 that might negatively impact the market. So, instead of repeating much of the bull case I have detailed since February of 2017, along with Joeri's article, let's just take a moment to look at the other side of the coin.

After all, I would be remiss if I didn't bring up potential issues to watch, and I would hate, HATE, it if my readers thought everything was all peachy and then were caught off guard by bearish developments.

Supply Side

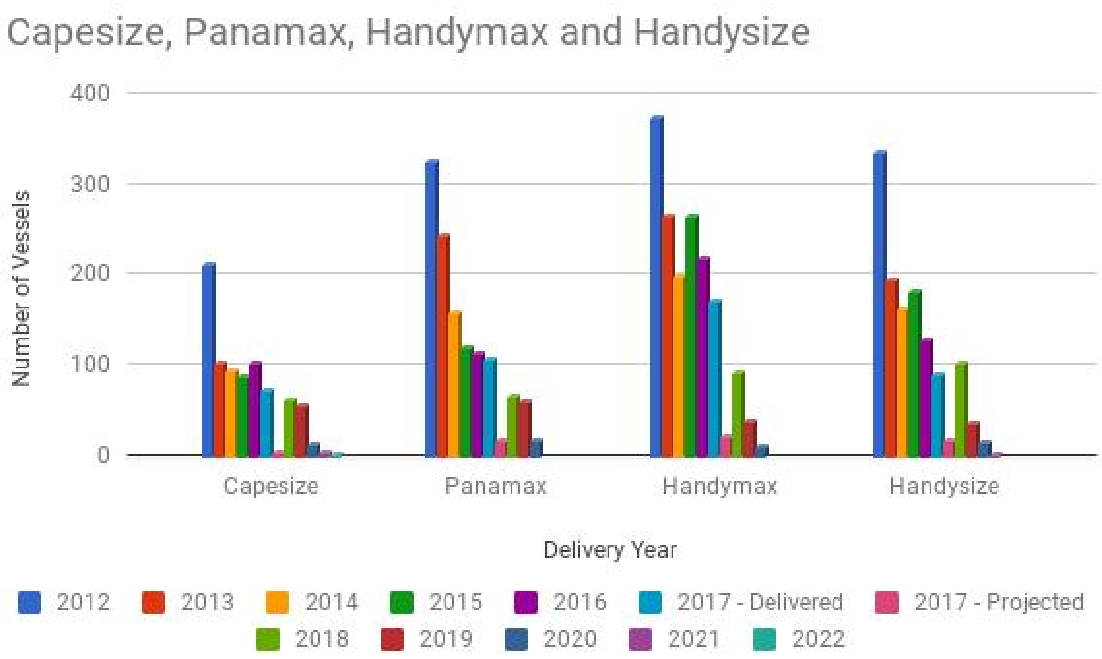
The vast majority of problems in the dry bulk market as of late can be traced to an oversupply of vessels.

In late 2008, the dry bulk orderbook peaked at 332m dwt, representing approximately 52% of the fleet at that time. But as these vessels hit the water, rates consequently plunged as a result of both vessel oversupply and the global economic slowdown. Forecasts of a prolonged downturn, low charter rates, and limited access to finance for many owners caused ordering of newbuilds to slow down. Today, we find ourselves in a drastically different situation. Currently, the dry bulk orderbook comes in just under 7% of the total trading fleet in terms of number of vessels and 9.2% in terms of total dwt capacity, which has broken a previous 20-year low of 7.2% (trading fleet) recorded in April 2002.

2017 is on pace for demand growth to outpace vessel supply, which has been a rarity since 2008. This has allowed for a badly needed rebalancing to take place, and this trend is set to continue in 2018 provided the demand side holds up its end of the bargain.

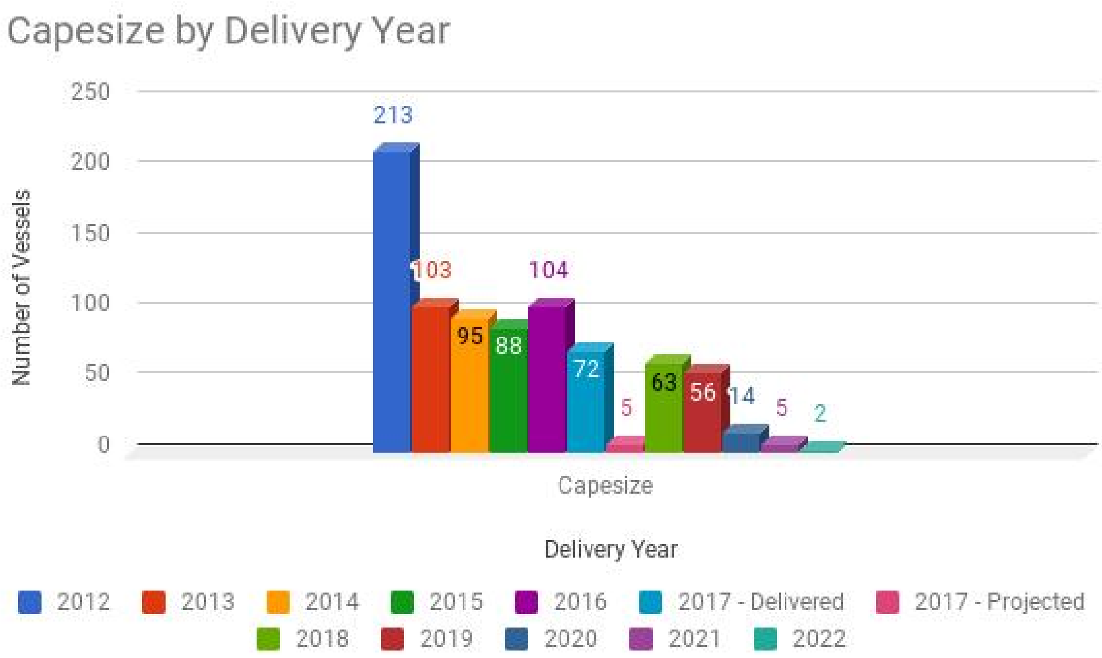
Though some headlines lately have noted that dry bulk orders have quadrupled in 2017 during the first 10 months, once again, some context is needed. 2016 saw the lowest number of orders in many, many years. So, the quadrupling represents just a total of 287 vessels, which is a drop in the bucket, given the over 11,000 dry bulk vessels currently on the water.

Though a detailed analysis of the supply side was done this past August, here is an update on the delivery schedule.



Source: Data from Clarksons Research with chart by James Catlin

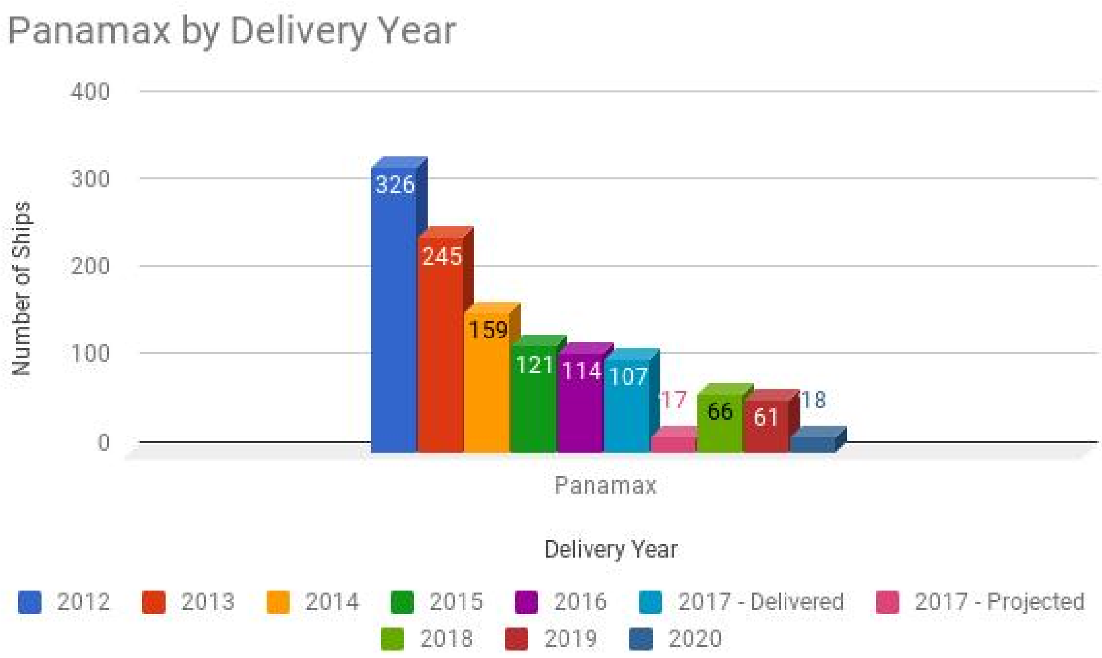
The graph above already shows a very positive situation developing with vessels hitting the water decreasing significantly. But let's take a look at each class individually starting with the Capesize class.



Source: Data from Clarksons Research with chart by James Catlin

There are currently 1,692 bulkers above 100,000 dwt (classified as Capesize here for simplicity) with five more set to hit the water by the end of the year. With 63 set for delivery in 2018, this comes out to about 3.7% of the total fleet. But if we account for slippage and expected demolitions, this number will likely be closer to 1.5% net total fleet growth. An easily manageable number if we can maintain the approximate 4% overall trade growth I expect 2017 will show.

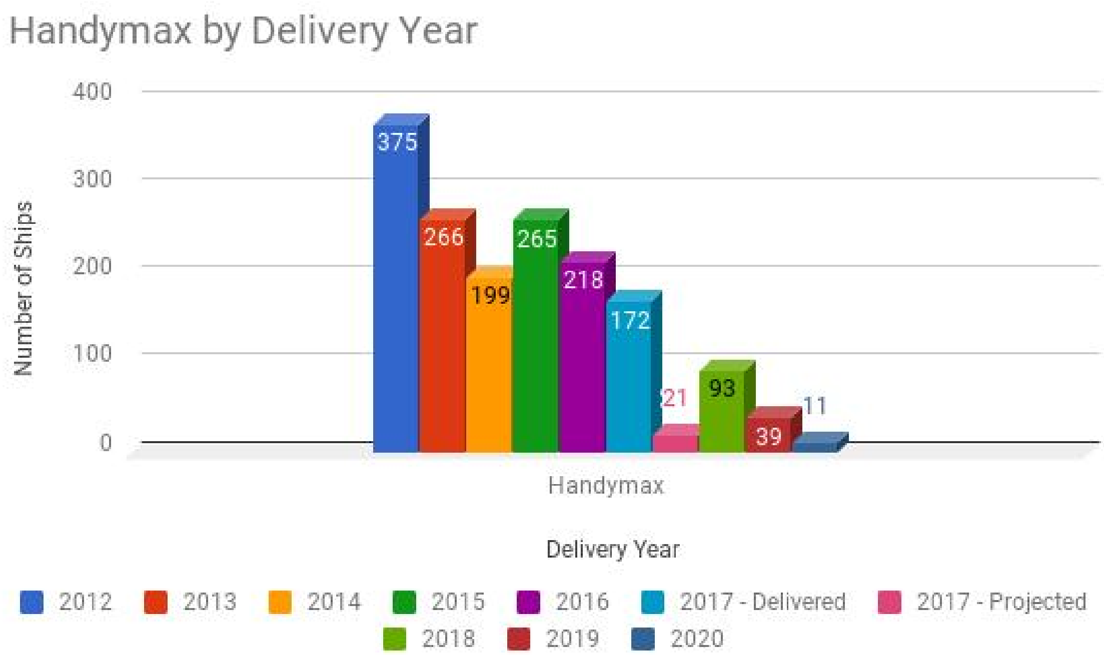
Here is the Panamax delivery schedule.



Source: Data from Clarksons Research with chart by James Catlin

The Panamax segment, representing vessels between 65,000 and 99,999 dwt, has a total of 2,506 vessels on the water with 17 more set for delivery by the end of the year. With 66 set to hit the water in 2018, this comes out to approximately 2.6% of the total fleet. With expected slippage and demolitions, we will see net fleet growth likely below 1%.

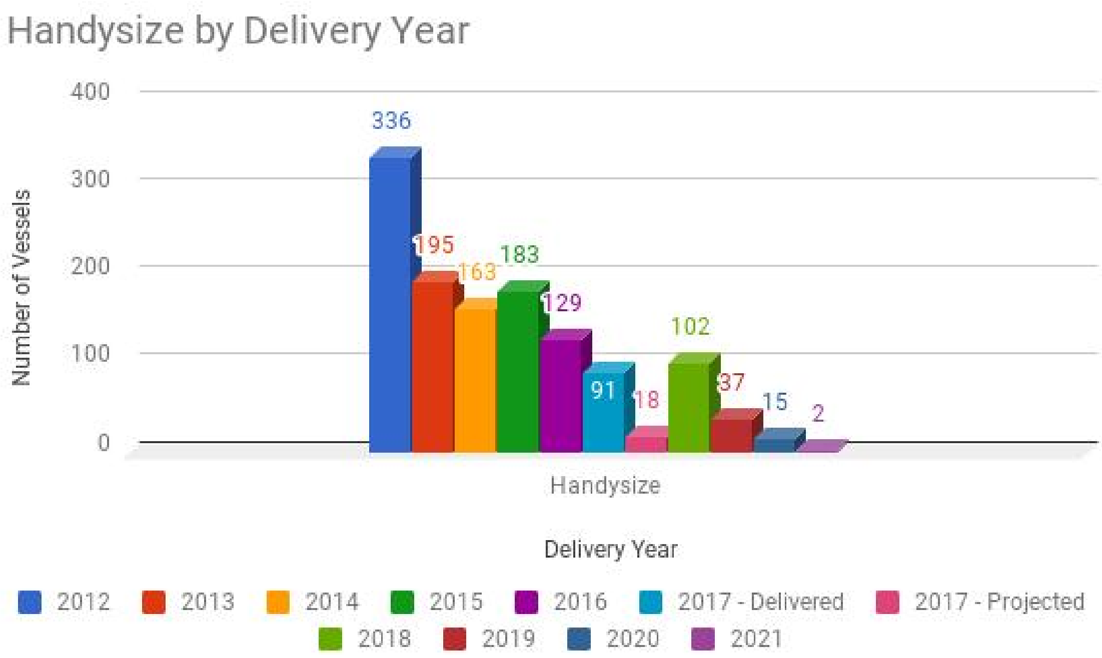
Next, the Handymax.



Source: Data from Clarksons Research with chart by James Catlin

The Handymax class, representing vessels between 40,000 dwt and 64,999 dwt, has 3,547 vessels on the water with another 21 anticipated by the year's end. The 93 set for delivery in 2018 represents 2.6% of the total fleet, and once again, with expected slippage and demolitions, total net fleet growth is likely to be under 1%.

Finally, the Handysize class.



Source: Data from Clarksons Research with chart by James Catlin

The Handysize class, representing vessels from 10,000 to 39,000 dwt, has 3,363 vessels on the water with another 18 anticipated before the end of the year. With 102 set for delivery in 2018, this comes out to 3% of the total fleet. Once again, with expected slippage and demolitions, we should see approximately 1-1.5% total net fleet growth.

In that aforementioned August supply side update, the bullish impact of this shrinking orderbook was discussed even further if you care to explore this situation further, including age of ships and therefore demolition potential. So, aside from this bullish setup, let's move ahead to another important point about the orderbook which could be consequence of this situation.

Despite increased ordering so far in 2017, the bulk carrier orderbook has continued to shrink. But this shrinking orderbook can't last forever. The fact is that owners are reactionary. So, as charter rates improve, more orders will likely be placed. Let's also not forget that with increasing charter rates comes an increase in asset values altering the debt/asset metric leaving more room for owners to leverage up (purchase more assets). Currently, the industry average D/A ratio already allows for some increased leveraging as asset prices have climbed significantly over the past year. In fact, 5-year old Capesize, Panamax, Supramax, and Handysize asset values have increased 42%, 63%, 36%, and 42%, respectively, over the past year.

Remember the historic low for the dry bulk orderbook came in at just 7.2%, and the current orderbook is close to that level. But I anticipate that 2018 will see an uptick of orders meaning that the current orderbook is likely near or even at a cyclical bottom. Some rough math shows that if 2018 orders replicate the past six-month average the orderbook could reach between 9%

and 10% by the end of 2018 taking into account expected deliveries and slippage. If 2018 orders coincide with some of the more recent heavy ordering months such as May or September, we will most likely end up around 12%-13%.

Therefore, while a shrinking orderbook will provide a catalyst for an improving market and may capture the most headlines in 2018, the real story could turn out to be how owners react to this situation regarding new orders placed.

Demand Side

As we can see from the supply side, above all, we really need is for global trade growth to maintain at least 2% or above for the bullish trend to continue. Over the past decade, only 2009 and 2015 came in under 2% growth.

So far, forecasts have reached a fair consensus placing total dry bulk demand growth for 2018 between 3.5% and 4.5%. This bodes well for demand growth outpacing net fleet growth and even gross fleet growth. So, already things are looking bullish.

These projections seem more than reasonable if the global economy remains on track. But with increasing skepticism surrounding the prolonged bull market, the potential for a global economic slowdown can't be ignored. So, instead of getting all swept away in the euphoria of this apparently never-ending bull market, let's discuss a few demand side factors we should watch in 2018.

The majority of dry bulk demand revolves around coal and iron ore, with China being the key customer. So, let's spend a bit of time on that subject.

First, it might be important to know what caused the lackluster 2015 growth and if a repeat is possible.

The main factor which affected the trade during 2015 and into 2016 (leading to additional lackluster growth that year as well) was the weakening coal imports of China, totaling a drop of 30%, that resulted in a drop of the global seaborne coal trade by almost 7% in 2015 and 2% in 2016, respectively. The coal market is the main segment that softened during these two years, but it wasn't the only one as iron ore demand growth came in at just 1% for 2015 as well before normalizing in 2016 to 4%.

In the week 47 report, Allied Shipping Research stated:

A shift away from this current model and any decisions such as those noted back in 2015 with regards to coal could just as easily send the market back into a momentary tail spin.