INDUSTRY VIEW

State of the shipping markets and the future of Chinese shipbuilders

Shipping is not an industry for the faint-hearted, as private equity has painfully discovered and experienced shipowners know only too well, while consolidation among Chinese shipyards is not the panacea some may be hoping for given the enduring nature of the current downturn, writes **Riaz Khan**, president and chief executive, Tavlon Commercial Enterprise

With the overall state of the shipping markets, especially in dry bulk, offshore, containerships, LPG and LNG, facing a shakeout in ownership, the obvious question is how many more companies will be forced to bite the bullet in the next year or two? The newbuild orderbook, despite being lower, is still too active and contributing to the continued imbalance in the supply of vessels. A clever yet mischievous year is in store in 2016 with the Red Fire Monkey (Chinese Year of the Monkey). It is said: "Monkey is a smart, naughty, wily and vigilant animal. If you want to have good return for your money investment, then you need to outsmart the Monkey."

Although currently the fate of many shipowners is mostly in the hands of banks, some banks are still reluctant to convert their loan loss provisions (LLPs) to actual write-offs as values have dropped even further. One major hurdle for the banks is the requirement to further increase their share capital should they call it a day on their loans. Other than banks, private equity (PE) and hedge funds are having heart palpitations at the state of their investments.

Clearly, the warning issued when PE firms started getting involved in shipping, to be wary of the wolves at the door, seems to have resulted instead in the wolves licking their own wounds. Many entered the markets too early thinking that they were at the bottom and had only one way to go; up. An entry to the shipping markets was a first for many PE firms and required the smart ones to acknowledge that, although asset prices had tumbled substantially, cash-flow support would be required for a minimum of two to three years, let alone for the period the downturn has lasted.

'DOUBLE-EDGED SWORD'

Some PE firms thought that if they went for scale, it would give them protection in market share. This has not succeeded in the past, with consolidation by owners, and is impractical just because of the sheer size of the number of vessels in each segment. It also ends up as a double-edged sword when the markets really tank, as they have for this long with no relief in sight. Precious Shipping's owner, quoting John Maynard Keynes, is very apt: "Markets can stay irrational far longer than you can stay solvent."

PE firms by now must have come to the conclusion, even with the ludicrous amount of liquidity that was burning a hole in their pockets, that shipping is not for the faint-hearted. Although to be a shipowner, one needs not only to be an optimist; one also has to have a gut feeling that does not come from reading a balance sheet or audited accounts or being counter-cyclical. Shipping requires a deeper understanding, with research done by experienced hands-on shipping people, with an understanding of market cycles, geopolitical issues, regional conflicts, commodity prices, yard forward cover, International Maritime Organization (IMO) rules — such as on ballast water treatment or scrubbers — currency fluctuations, protection-and-indemnity (P&I) and hull insurance, bunker prices, emission control area (ECA) rules, operating expenses and dry-docking/special survey (DD/SS), to name a few, and to be prepared, as best one can, for "Black Swan"* events.

As many banks in Europe still have government participation, the question arises: Is some latitude being allowed by certain central banks to continue to kick the can down the road? When booking an LLP one is required to "prove" to the auditors and regulators that an exit strategy exists for the impaired asset one is financing, or rather refinancing after default by the original client. Eight years down the road from the financial crisis of 15 September 2008, one continues to see non-viable assets running at operating expenses (opex) levels, if they are lucky, or, most likely below opex, without the ability to repay interest yet alone the capital. This prolongation in the downturn of asset values that caused an impairment are bundled up as a "new" loan. However, with the assets remaining in the market place, they act as a dragging anchor to the already oversupplied shipping markets, alongside decreased demand, which in turn acerbates earnings. A cleaning-out or culling, whichever term one wants to use, is overdue, especially as shipyards continue to build despite the orderbook dipping.

An interesting and surprising comment from HSH Nordbank (part owned by the Federal State of Hamburg and Schleswig-Holstein) board member Torsten Temp at Marine Money Hamburg was that if the shipping industry does not start to provide good returns soon he does not see any reason to continue financing the industry. It also seems that the bank is under pressure to sort out its losses from the states involved, yet they need to continue to support at least the German shipping community, if not international shipping.

On the shipyard side, the Chinese government will provide some relief, otherwise face protests and unrest from the large numbers of people who will be made redundant. With sizeable numbers employed in the shipbuilding industry, governments will weigh any decision very carefully. As usual, shipyards that are government-owned or quasi-government-owned/backed will most likely survive by some sort of bailout or consolidation. The vast number of "commercial" shipyards started at the peak of the boom markets have had the sword of Damocles hanging over them for some time and many have already faced the consequences. Some converted to became repair facilities. China is still a preferred location to carry out large repairs and DD/SS versus any European yards, other than possibly Turkey. Needless to say, the decision to head to either location by a shipowner requires calculating the cost of positioning to get to a yard, the time and cost for the repairs themselves and repositioning to pick up a cargo after completing DD/SS.

NOT ALL DOOM AND GLOOM

Chinese yards delivered over 700 vessels in 2015 out of a total of some 2,100 delivered globally, representing around 34%, retaining their top position among other countries. One shipping source monitors around 140 Chinese yards — with around 79 of them being independent, two joint ventures and seven foreign-owned. It is not all gloom and doom for the shipbuilding industry in China. State-owned enterprises (SOEs) and the large independent yards will benefit from government support, which will increase their market share.

The White List announced by the Chinese government is not a free pass, as yards need to qualify to obtain any tax rebates and bank credits. The main items in the checklist include yards having to prove A) they have a management structure, B) can be innovative in ship construction technology, C) have ship design capabilities and D) their energy consumption meets green credentials.

In 2016-2017, we most likely will see a wave of bankruptcies rather than consolidation, so long as the Chinese government does not intervene. SOE yards now have the consensus that the shipping market will not recover in 2016 or the short term — so consolidation does not provide a panacea. As to independent or foreign-owned yards in China, the same realisation that consolidation may not be a solution could require large cash injections or they too might have to scale down or wind up their operations.

* *After the book "The Black Swan: The Impact of the Highly Improbable" by Nassim Nicholas Taleb*

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