

Another Perspective on Shipping call notes 18 February 2009 (5pm HK time)

A thanks to Tom Kim at Goldman Sachs for coordinating call with Matt Flynn (Worldyards and Transport Trackers) and Charles de Trenck (Transport Trackers) for GS and Transport Trackers clients.

Presentations & Call Takeaways (our conclusions):

- Close to zeroweight dry bulk and shipowners
- Underweight ship operators (but be constructive where possible)
- Valuation exercises still useful to identify deep value, and stand ready
- BDI no longer as relevant to reflect industrial activity
- China subsidies could draw out downturn in industry
- For containers, now with 1.1m TEU of fleet out of action, we are in middle of process...
- Scrapping will not have an impact on shipping industry in 2009
- Order cancellations will have zero impact in '09 and perhaps 30-40% effectiveness in '10
- Ships will also be sidelined due to credit issues (velocity of ship usage)
- Deep credit contraction for ship financing may help later in downturn
- More spectacular bank busts may prove better for the survivors

Call Q & A Sections

Question 1

Q: What is view on the supply of ships due to cancellations, delays and demolitions? ...And in light of “ship rescue plan”...

Matt:

- Talk of forward vessel scarcity back in [2007-08] was often erroneous...
- The concept of 2009 tonnage cancellations is a misconception (see comments from Worldyards prez)
- Most sectors will be over-tonnaged ... but where cancellations will come from is the big question...because owners and yards are not willing to cancel in most cases. ...Ie, 60% paid already
- Yards tend to continue building ships. Various scenarios exist as presented in Worldyards slides...



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Charles:

- That's why we need credit markets/ship loan facilities to fail on a large scale in order to reduce the number of ships coming on as radically as possible (ie, for 2010-11 crop...). We've been on about this for awhile...
- If we look at lessons from the 1980's and the scrapping of tankers, it took 5 yrs for the whole process of bottoming to get completed. If we use history as reference, it may take several years for bulkers to complete its scrapping process, though we know history does not repeat exactly

Question 2

Q1: Stories of ship cancellations (attempts to...) in Korea and in general prior to Chinese New Year..?

Q2: Credit by banks, how did ship-bankers deal with this?

M:

- Not many cancelations. The Koreans are digging in their heels. Many more are/were delayed than cancelled. China ships being delayed was again part of the misconceptions out there... Delays are common...
- There were "40% delays" at China shipyards...a concept embraced by some, but mistaken in 2008 and again in 2009...
- There are no medals for the few cancelations...

C:

- Clarksons weekly prices feed (used to feed) valuation models to bankers but in 4Q08 the process came to a halt. In addition to the vessel valuation process for second-hand ships being more difficult, that there was no live updates led to a process of freezing changes to loan to value exercizes...
- Discussion of covenants breach and debate when ignored or used to call to task by bankers
- Transfield in the press is an example that could be replicated many times over in coming year(s)
- BDI levels will generally dictate the extent of waves of renegotiations



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Question 3

Q1: How does BDI related to scrapping? (Earnings and scrapping relationships)

Q2: What is the world scrapping capacity each year?

C:

- BDI cash breakeven point is around 1,000 (the level at which one can continue operating before asset and debt cost of carry...)
- BDI's recent rebound up to 2,000 level was partly due to ships being locked up in charter daisy chains, as in a long series of charter-in, charter-out relationships... and that some of these vessels are being shunned by the market....
- Average age of bulk ships is now reversing after reaching new peaks during the boom, but debate on longer useful life of bulk ships. Ships are generally in better condition today, Matt points out....
- But take example of Precious Shipping that is scrapping and delivering new vessels at the same time...

M:

- Scrapping will not save the day...

Question 4

Q1: Financing, 2010 orderbook and cancellations (What is the % of 2010 in need of financing still?)

Q2: Which ships should a bank back?

M:

- Depends if you are listed or not
- If counter-party is going to perform or not
- If buyer defaults or not
- How long it takes to build a ship/stage of completion
- Q2: A cheaper ship – which will depend on the value quoted at the time of the order



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C:

- Another way is to break it down Ship types and Ship sizes. A super-post panamax [container ship] late 09 or 2010 is the last shiptype you'd want delivered....

Tom:

- Taking a stab, 60% of orderbook has been funded for 2010 deliveries and the problem lies on orders made from 2008 onwards (note: this requires more discussion)

Question 5

Q1: What is a "credit constrained" ship... and relation to BDI 2000 level?

Q2: Who controls the cancellation process?

Q3: Subprime Crisis?

C:

- Chartering Chain and about owners/operators relationships
- LT Maturity charterer will charter out to ST Maturity charterer with a slightly higher price
- If one party in the chain failed... a ship will become questionable to operators..
- Operators prefer not to use doubtful ships
- Like changing the size of the pipe to run the water through

M:

- Banks certainly don't want to become shipowners
- There are still many unclear scenarios on funding and where \$200bn comes from
- This will play out toward the end as owners have to take ownerships and final funding has to be come from bank (About 2/3s of vessels are funded? (of \$200bn)

Question 6

Q: Back in 2005 example of tankers orderbook was high....Tanker charters fell. The market corrected. Then oil fell and tankers rebounded. Can there be a similar analogy for current bulk situation calling for a nearer term rebound?



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C:

- Bailout % of GDP for China if anything close to the US bailouts, and these start to work, then could be ok/good news for commodities. This potential scenario is always brought out, and is well known, but could be less like a tanker 2005 rebound scenario based on current outlook...
- For tankers, the destruction-rebound process is healthier...shorter cycles

Question 7

Q1: Vale to increase price and what was the impact on Chinese mines/mills? What impact does it have on the BDI?

Q2: Bankruptcy to Norwegian banks...

C:

- Need to consider the change from Australia to Brazil and hence the ton-miles, ore volumes, port volumes, the size of the mines/mills
- Please refer to a commodity/material analyst
- Hamburg/German banks and other other European banks have large exposure and Norwegians also as mentioned...(refer to HSH announcements 17 Feb 08 on portfolio downsizing)
- Dirty laundry may or may not come out. We need to see how this is handled

Two more questions followed, one on credit markets again and another on FFAs and BDI. Our notes fail us at this point, but we highlight a comment from Tom Kim on Australia to China cargoes and their recent speculative nature.



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Charles de Trenck main call presentation (separate from submitted slides)

Statement of assumptions/investment stance

Our disclaimer reads: “We have little faith in any forecast, including ours. We may have been a little bit right in the recent past. But we can be just as wrong or right in future. We want, rather, to focus on weaving in and out of the data we see in the recent past, the present, and the near future.”

Outlook: We are potentially around the middle of the downturn in shipping. Credit blow ups are still in process and restrict activity within the investible universe

We have supported looking for good companies/valuations to invest in since 2H08, though we also believe a trading approach is needed at times

A best long term case would be a continued meltdown. China bailouts risk dragging the process on for longer

A quick start with containers first

In 2008 a North America broker issued a report calling for soaring transport costs to reverse globalization of trade. A container move from Shanghai to the US West Coast was said to cost \$8,000, and to the US East Coast to cost as much as \$15,000 if oil was going to hit \$200/bbl. The report’s conclusions had some interesting points ... and some merit though we never believed the numbers cited.

Trade collapsed within a few months of this report – which I saw repeated on the pages of the Economist and the NY Times among other publications. But trade collapsed for very different reasons, as we know. And the impact of oil on cost changes was less important than the deceleration of just about everything in 2H08, and, of course, the deceleration of demand for Asia manufactured goods in face of growing supply for container ships.

Debates/ Discussions. The next section I want to touch on a few topics

- 1) **The end is nigh, or simply a deep correction**
- 2) **Velocity of ships**
- 3) **Credit/Trade Finance**



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The end is nigh, or simply a deep correction (certainly the worst seen since 1980s): We could cite in more length a debate of cyclical versus secular downturn. Maybe this discussion will come down to different starting points and drivers selected. Either way, the correction we have now is the worst since the early 80's for containers.

One chart I did a few years ago out of interest was Asia to US container volumes and Wal-Mart's share price – to be more fair we could take all the large retailers together. As far as I was concerned the era of big steps in growth was more the 1990s than anything we saw post 2000 – though not so for Asia-Europe. My view toward US consumers is similar to that popularized by Fukayama of Hegel's End of History concept during the Battle of Jena in 1806 in this respect. Long story short, containerization and demand for China made goods to the US reached a plateau about a decade ago.

Deep down I believe the US will see a secular decline in demand and this should have started in 2000 if not for Greenspan, but some parts of the world should see a continuation of the cyclical theme after this deep correction. ***Containerization is a more efficient means of transport and has more mileage ahead despite the current setback from a global perspective.***

Put another way, containerization has two or three long term engines of growth. The US engine experienced engine failure a while back (more recently, one can also see the real decline in demand in Asia to US began at least a year before the mid-08 deceleration in Asia to Europe) – thus the secular decline. And now the Europe engine may experience its own failures – but if East Europe recovers in a few years we can get back to a cyclical pattern though for now perhaps the risk is leaning toward secular.

Other markets will likely get back to a cyclical pattern as well following this deep correction. But this will be impossible in the short term – unless global policy responses to the crisis start to impact the consumer positively in the coming few months.

As an interesting sidenote on US demand, we noted an update from **Welling** and **The Liscio Report** that US Marginal Propensity to Consume (MPC) has now fallen to levels lower than the low of the series in the 1950s in terms of short term indicators and the 1980s at the current stage of the long term trend.

East- West trade will thus face a crisis not seen since tankers in the 1970s/1980s. That will be bad news for super post-panamax container ships and ship owners that are exposed toward the higher end of ship prices. My industry mission in 2006-07 and then with more urgency in 2008 was to spread this message wherever possible.



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We had put out a forecast of 2-3m TEU of capacity would be sidelined in this crisis in Sept/Oct '08, and it appears we are getting about 50% there now, after having gone from 0.5m TEU around X-mas to 1.1m TEU as of yesterday, according to Alphaliners.

The silver lining is the more spectacular the failures the better the recovery can be. We've postulated at least two scenarios. Ultimately, I am less negative now than pre- mid-08 from an investment perspective – although we have to monitor how bad the downturn continues to unfold and be willing to trade.

But if asked where we are in the downturn I have to say we are we still somewhere in the middle of the physical correction. I am not too far apart with some of the views of Tom Kim.

Velocity of ship assets

I don't want to stay too long on the BDI. But something we saw in recent weeks was a BDI recovery for some of the wrong reasons. No one really knows where the BDI will end up. But now that we are moving to the other side of the crest of ship deliveries this matters less.

The concept of the drying up of velocity of money due to global credit contractions applies to ships too, especially in dry bulk. This is more linked to bank finance and more important an issue than the Letter of Credit breakdown issue cited many times in 4Q08, we think.

HK operator Transfield's public problems with Armada as well as so many others, as we have seen recently, remind us of how careful we have to be with shipowners and their charter-in and charter-out relationships. One can imagine when an owner has a vessel inside a daisy chain of charters how easy it is for something to go wrong.

Credit and ships

We've seen a piece in Lloyd's List last week talking about a need by German KGs (German finance houses) to finance \$30bn of new ship orders. And we recall the estimates of several hundred of billions of ships that need financing for 2010 – 2013. Matt Flynn will have more to say here.

A typical comment we got from European ship brokers, at the same time, was Hamburg is bust. No issues there. But honestly, this was also the case 6+ months ago. It was the case the minute steel prices broke down, which of course was linked to the period last fall when many correlations all went to 1.

We think the turning off of credit for ships will prove a healthy development for the industry. But our concern has been that potentially a few too many ships slip by in 2009 and that these vessels still result in a system overload. The debate/discussion continues.

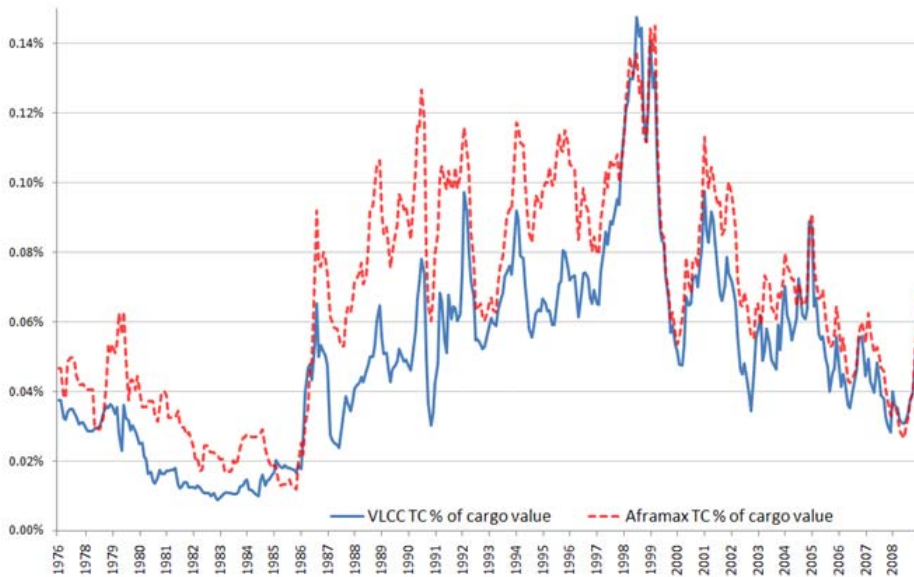


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Comments/observations on tanker transport costs % of value of cargo:

- For reference, these charts are big picture trend and capture cost/day and are not adjusted for total voyage cost, but capture the relative performance of the asset's daily revenue generating performance
- The percent cost relative to oil trended up 83 – 99 (ie, as the market bottom and peaks of scrapping started to come through 82-87), ending with a spike up...and then trended down from 99 with spikes up, etc, but in an overall downtrend
- One needs to disregard some aspects of continuity of data from pre-86 where the big VLCC over-hang resulted in owners significantly subsidizing the charterers
- The super spike in 1998 was the crude price drop from Asian Crisis which happened suddenly
- A major pollution incident with a SH tanker can spike rates for DH tankers
- 2001 onwards China likely played an increasing role when it comes to increasing demand of imports and propped up VL rates despite increasing newbuilding orderbook
- With the exception of 1997-2000 (impact of Asian financial crises) where trough to trough is 3 years the fluctuations from spike to spike is 2 years and spike to trough annual
- Oil majors, since they got out of shipowning, do not mind spikes in tanker rates they actually prefer it once in a while as it is invariably followed by over optimistic owners and over-ordering resulting in a poor market for several years

VLCC and Aframax TC \$/day as % Cargo Value ST Peaks Given Oil Price Downshift



Source: Transport Trackers



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Matt Flynn/Worldyards Presentation Extracts

Segment	2009 Newbuilding Deliveries (in CGT)			Market Share	
	Established Yard	Greenfield Yard	Grand Total	Established Yard	Greenfield Yard
Bulkers	10,665,534	3,800,406	14,465,940	73.73%	26.27%
Chemical Tanker	2,357,135	218,123	2,575,258	91.53%	8.47%
Containers	10,072,657	690,607	10,763,264	93.58%	6.42%
Crude Tanker	5,739,083	656,876	6,395,959	89.73%	10.27%
Heavy-Lift Cargo (Specialised Cargo III)		29,742	29,742	0.00%	100.00%
LNG (Gas I)	4,369,301		4,369,301	100.00%	0.00%
LPG (Gas III)	1,103,204	72,367	1,175,571	93.84%	6.16%
Offshore	390,932	92,002	482,934	80.95%	19.05%
Passenger Ships	1,242,433	67,670	1,310,103	94.83%	5.17%
Product Tanker	3,293,775	169,832	3,463,607	95.10%	4.90%
Product/Chemical Tanker	3,655,245	476,045	4,131,290	88.48%	11.52%
Semi-liner Tonnage	1,771,497	355,009	2,126,506	83.31%	16.69%
Specialised Cargo (Specialised Cargo I)	350,255		350,255	100.00%	0.00%
Specialised Tanker	19,900	41,833	61,733	32.24%	67.76%
Vehicles Carrier (Specialised Cargo II)	1,794,118	222,058	2,016,176	88.99%	11.01%
Grand Total	46,825,069	6,892,570	53,717,639	87.17%	12.83%

Source: Worldyards

Worldyards' Look at 2009 Capesize just for the sake of analysis:

Of the 148 capesizes that will be delivered, we note that there is a price range of \$65m to \$98m per vessel (note: mostly orders were placed between 2006-2007, with the 2007 deals few and expensive).

Of these ships, 122 will be delivered by established yards and 26 are scheduled to be delivered by greenfield yards. But the established yards have a fair share of low-cost units (life is not fair).

Average prices for 2009 delivery capes are about \$82m, a level at which yards are not likely to lose [as much] money. Owners have also likely paid two installments. This suggests that there is little hope that deliveries can be killed off to help 2009. The question is really, even if we assume that all ships from Greenfield yards are delayed or are killed off, can the market absorb this amount of tonnage?



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