Downwards price correction looms but how far will demolition rates fall?

An increased supply of ships for recycling is inevitable but there are many factors at play influencing the demand side of the equation

SHIPPING analysts have warned for a couple of years that owners should sell vessels for demolition sooner rather than later and take advantage of higher prices before everyone floods the market with tonnage and scrap rates fall.

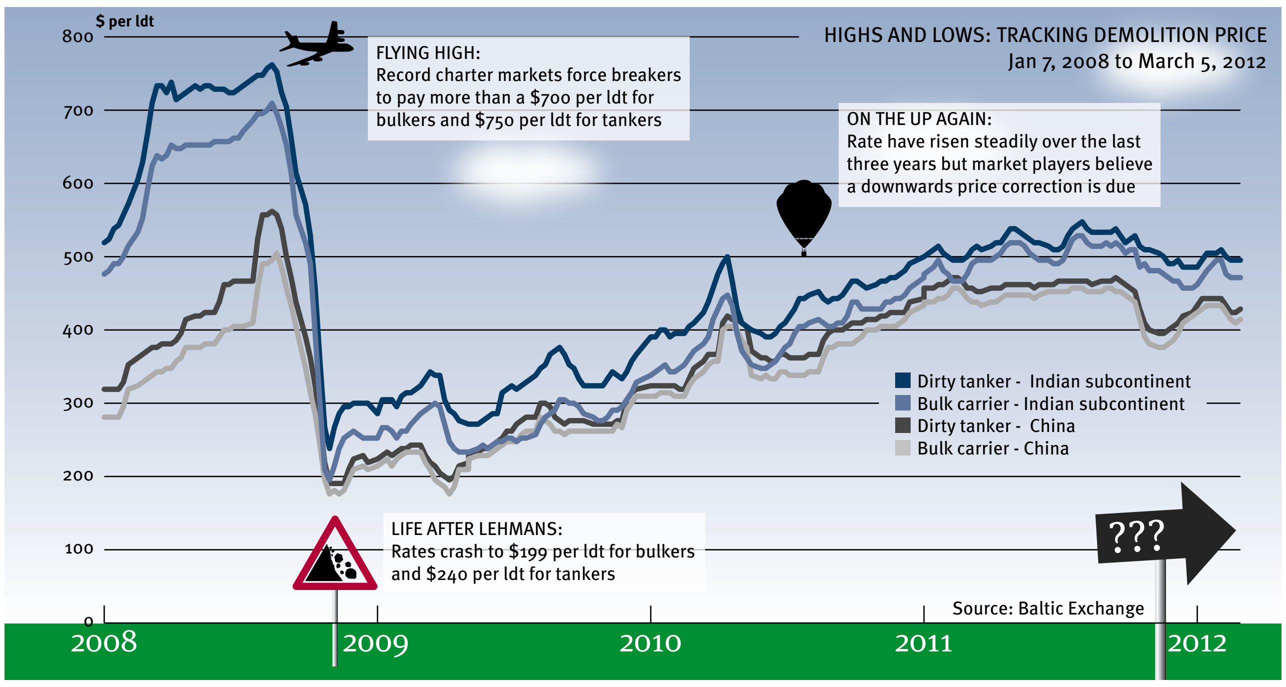
Clearly some people listened, as the significant volume of tonnage sold in the last couple of years shows, but breakers and cash buyers warn that the industry is on the cusp of a downwards price correction.

Sanjiv Agarwal, the chief executive of Indian green ship recycling company MJR-One describes the volume of tonnage being marketed for sale as "relentless".

"There is a huge oversupply of vessels and therefore the prices are going down," he says, adding that Indian yards simply cannot buy and beach all the ships being offered.

"Steel prices are strong at the moment so that will create a floor but prices could go down by another $20-$30 per ldt."

His forecast matches that of Billu Khetan, the chief executive of Singapore-based cash buyer Wirana Shipping Corp. He says that a price correction of 5%-10% can easily be expected.



This week, the Baltic Exchange reported its weekly demolition assessments — with estimates provided by shipbroker panellists — at an average $497.50 per ldt for tankers and $475.50 for bulk carriers on the Indian subcontinent.

> *"There is a huge oversupply of vessels and therefore the prices are going down"*
> **Sanjiv Agrawal, MJR-One**

"People talk about how much money they are losing but in reality the prices at the moment are excellent," says Anil Sharma, president and founder of cash buyer GMS that has offices in the US, Dubai and Shanghai.

When freight rates and asset values plummeted in the fourth quarter of 2008 — as frozen trade credit caused chartering markets to come to a virtual standstill — scrap rates came under serious pressure and reached extremely weak levels compared with today's prices.

Having topped $700 per ldt for bulk carriers and $750 for tankers in August 2008, as shipowners raking in cash from the record-high chartering markets were reluctant to sell and forced breakers to bid extremely high prices to secure vessels, prices then came crashing down following the collapse of Lehman Brothers.

Less than three months later in early November 2008, the freight indices provider was reporting average prices of $199 per ldt for bulk carriers on the Indian subcontinent and under $240 for tankers.

Prices steadily increased over the following three years and reached a recent peak of $530-$550 per ldt in August last year.

Cash buyers are not confident the market will see these levels again anytime soon though, and say shipowners should factor price fluctuations into their planning.

"Supply and demand is fairly elastic. What we saw when the prices fell below $500 per ldt was a sudden reduction in the volume of ships. However, most breakers are making money when they buy a ship at $480-$500 per ldt so they want to keep the volumes up and carry on buying," says Dr Sharma.

"In contrast to what people like Greenpeace say, ship recycling has not been very profitable but the margins are probably better than they have ever been."

Unfortunately though, there are many moving parts that contribute to demand and these factors do not necessarily move in the same direction.

As Mideast Shipping & Trading general manager Steve Wansell says: "We've seen rain, hail and shine in the last three months. If it's not one thing it's another."

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Obviously the global economy impacts both owners looking to sell ships — increased growth and greater consumption leads to more cargo needing to be transported — and global steel demand, which creates need for scrap.

But, as detailed below, there are a number of factors that influence the supply-demand equation in ship recycling.

Supply factors

Owners selling ships

THIS side of the equation is quite simple; huge fleet growth from newbuilding deliveries that greatly exceeds cargo demand growth creates a surplus of ships in chartering markets and the older, more inefficient ships find it harder to secure employment, which in turn leads owners to market these vessels for demolition.

There is not expected to be any let up in supply over the coming year as shipping analysts forecast 2012 to be the worst year the chartering markets have seen in decades and an increasing number of companies are expected to face financial difficulty and bankruptcy.

While the number of ships being sold influences supply, the appetite for steel and currency fluctuations are among the factors that govern demand.

Demand factors

Ship recycling capacity

WITH the exception of China that could convert struggling shipbuilding facilities for recycling, the industry does not expect the capacity of yards on the Indian subcontinent to increase.

Even last year, global capacity was not fully utilised, says Wirana's Billu Khetan. He estimates that the four major Asian shipbreaking nations of India, Bangladesh, Pakistan and China have the capacity to dismantle a total of 12m ldt. By comparison, last year only 8.5m-9m ldt was sold for recycling, up from 7m-7.5m in 2010, he says.

Rival Steve Wansell of Mideast points out though that with such an inlux of ships coming in at one time, there is only so much tonnage that breaking yards can purchase. "With the Bangladesh market still unclear, and limited steel demand in Pakistan that puts a ceiling on how much it can take, India is creaking at the moment. That's when the brakes go on."

GMS' Anil Sharma says that although capacity is not going to run out, buying has become a lot more price sensitive.

"When the breakers give a price, that's it. If you sell you sell, if not they don't buy. I've been doing this for 20 years and there's negotiation involved. You see that less and less now. The word negotiation has been replaced by the word renegotiation," he says.

Steel demand and prices

FOR shipbreakers there is little point in purchasing vessels if they cannot sell the scrap to be remelted into new plate or rods. So steel demand in individual recycling nations has a direct impact on the volume of ships yards will be wanting to purchase to dismantle.

All five major shipbreaking nations are emerging economies and therefore the global economy has a knock-on effect— if construction and infrastructure projects slow down or pick up that in turn will influence steel prices.

Mr Khetan believes volatile steel prices will be the market's biggest challenge this year. "The economy is not doing so well around the world and even in local Asian economies it has not been as good as it was supposed to be," he says.

However, Dr Sharma argues that commodity market analysts forecast that steel prices will remain relatively strong this year, which should bring some level of stability to demolition rates.

Currency fluctuations

THE huge impact currency fluctuations can have on demolition demand has been demonstrated in the last two or three months, after the Indian and Pakistani rupee and Bangladeshi Taka weakened against the US dollar.

As Mr Wansell explains, many breakers do not hedge their positions against fluctuations over a 12-18 month period.

"They buy their ships in US dollars but they're dealing in Indian rupees. If they go to the bank they've got to exchange their local rupee into dollars to open a letter of credit and the rates go against them then all of a sudden their appetite dissolves as they see it as a foreign exchange loss," he says.

This is what happened to the market at the start of the year; even though steel demand was firm, foreign exchange rates saw prices become 10%-15% more expensive for breakers. However, this has somewhat subsided now and prices are getting back up to levels achieved in mid-2011.

Access to finance

THE lack of banks lending to each has created a squeeze on ship recycling, as so little money is moving in financial markets.

"It's a massive factor," says Mr Wansell. "When we sell a ship to a breaker we're selling it on a letter of credit basis, we don't get cash.

"If the money markets are squeezed and banks stop lending the discount rates go up and you will find it hard to find a bank that will be able to discount your letter of credit. That's an issue you've always got to keep your eyes on."

Bangladesh's ship recycling industry in particular though is suffering from a shortage of US dollars in the country.

"This is having an adverse effect on its ability to open a letter of credit as Western banks refuse to lend the country money. Unlike India where 180-day deferred letters of credit are used, in Bangladesh 'sight' letters of credit are used that require funds to be immediately available and this is not possible on a significant number of large ships at one time," says shipbroker Braemar Seascope.

Dr Sharma adds that even breakers that have been in business in Bangladesh for a long time are struggling to gain bank approval, which means cash buyers delivering ships into Chittagong are facing challenges and this is creating delays. ■

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