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TRANSPORTATION & INFRASTRUCTURE

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2016 dry bulk shipping outlook: already–troubled waters get rougher

At A Glance

1 Rough seas ahead

- After treading water in 2013–14, the dry bulk shipping industry will likely continue struggling this year.
- According to our inaugural study of industry performance based on an analysis of the major dry bulk shipping companies,[1] industry revenues for the global group fell 18% from 2014 to 2015.[2]
- Even more troubling: the collapse in EBITDA within this group, dropping from $169 million to minus $115 million: a staggering, 168% decline.

2 Conditions may worsen in 2016

- Industry consolidation and vessel scrapping remain well below the levels needed to generate a meaningful rebound in pricing.
- Even companies that restructured a few years ago are struggling, and at this point, the majority of companies in our 2016 Dry Bulk Shipping Outlook are at risk of bankruptcy.

3 The path forward

- The industry should embrace increased consolidation and scrapping, and individual companies should improve operating cash flow.
- Management should proactively contact lenders and other creditors regarding potential problems.
- Earlier is better than later: company stakeholders are in the same, listing boat.

1 The AlixPartners 2016 Dry Bulk Shipping Outlook 2016 surveyed a market basket of 15 to 17 large dry bulk shipowners whose public financial information is available.

2 2016 AlixPartners' Dry Bulk Shipping Outlook. The Outlook is an annual update on the state of the industry and the latest thinking on trends that may shape the coming year. All references, facts, and opinions contained in this article can be found in the 2016 Outlook.

After a somewhat stable 2013–14, the dry bulk shipping industry began a deep downturn in 2015. Industry financial performance declined markedly from 2014, and compared with 2013, the drop in operating performance has been staggering. The unbalanced supply-and-demand equation means pricing won't rebound meaningfully while too many vessels keep chasing too few shiploads.

The beginning of 2016 was equally rough: despite a modest bounce in pricing at the end of the first quarter, the outlook for the remainder of the year remains extremely negative. Although vessel demolitions in 2016 are expected to hit a record high of 40 million deadweight tons (DWT), that won't offset the 50 million new DWT expected to enter the fleet.[3] Virtually every company in the industry is at risk because of uncertainties about overall global economic activity and trade, coupled with reduced demand for iron ore and coal from both China and India.

ROUGH SEAS WORSEN AS PRICING COLLAPSES

During the Great Recession, from late 2008 through 2010, six large dry bulk carriers filed for some form of court protection worldwide, according to The Deal's database of filings. Many others pursued out-of-court restructurings when the drop in worldwide demand for goods became compounded by expanding capacity as new vessel builds arrived. Then pricing crashed from the stratospheric heights of 2007–08. Comparatively, during that earlier period, tanker and container ship operators together accounted for only four filings. But the postrecession pricing relief those companies expected never arrived, and filings continued at high rates from 2011 to 2013.

By 2014, the dry bulk sector appeared to have stabilized, and it looked like companies had positioned themselves to take advantage of any market rebound, protecting themselves against further market erosion. Unfortunately, that stable state broke down in 2015, when four companies filed for protection and many others sought out-of-court restructurings.[4] Market pricing— reflected in the Baltic Dry Index, which charts the costs of shipping raw materials globally—sank once again as increased industry supply met diminished global demand (figure 1). These unbalanced fundamentals continue to hobble the industry in 2016 and show no signs of abating anytime in the near future.

A DISTRESSING TALE

The industrywide decline can be explained by a fairly straightforward equation that few companies have managed to solve: Weak Pricing + Costly Operations + High Debt Loads = Distress. Shipowners' financial performance in the past few years reflects the harsh proof of that equation (figure 2).

FIGURE 1: BANCRUPTCY FILINGS VERSUS BALTIC DRY INDEX, 2008–2016

Dry bulk filings — Baltic dry index

Filings represent shipping companies with more than $50 million in estimated liabilities

Source: Deal Pipeline, World Maritime News, AlixPartners

[3] "Dry Bulk Shipping: A Miserable Start to a New Year, Where the Market Struggles to Grow at All," BIMCO corporate Web site, January 22, 2016, accessed May 10, 2016, https://www.bimco.org/Reports/Market_Analysis/2016/0122_DrybulkSMOO_2016-01.aspx.

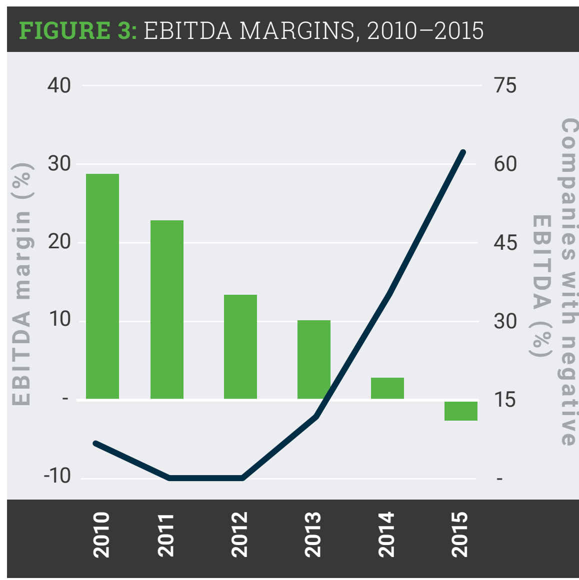
[4] AlixPartners Analysis, Deal Pipeline, accessed May 5, 2016, http://pipeline.thedeal.com/. Filings represent shipping companies with over $50 million of estimated liabilities.

FIGURE 2: DRY BULK INDUSTRY FINANCIAL RESULTS, 2010–15

	US$ millions						Year-over-year change				
All companies	2010	2011	2012	2013	2014	2015	2011	2012	2013	2014	2015
Revenue	6,093	5,905	5,316	5,667	5,893	4,839	-3%	-10%	7%	4%	-18%
EBITDA	1,773	1,364	721	581	169	-115	-23%	-47%	-19%	-71%	-168%
EBIT	1,207	713	61	-49	-437	-1,014	-41%	-91%	-181%	790%	132%
Cash from operations	1,753	1,073	624	306	267	59	-39%	-42%	-51%	-13%	-78%
Net income	1,073	-42	-969	-542	-234	-2,828	-104%	2,207%	-44%	-57%	1,109%

Sources: AlixPartners analysis, S&P Capital IQ, Yahoo! Finance, company filings. (When full-year 2015 data was not available, data from the previous 12 months for the most recent period for 2015 was used).

FIGURE 3: EBITDA MARGINS, 2010–2015

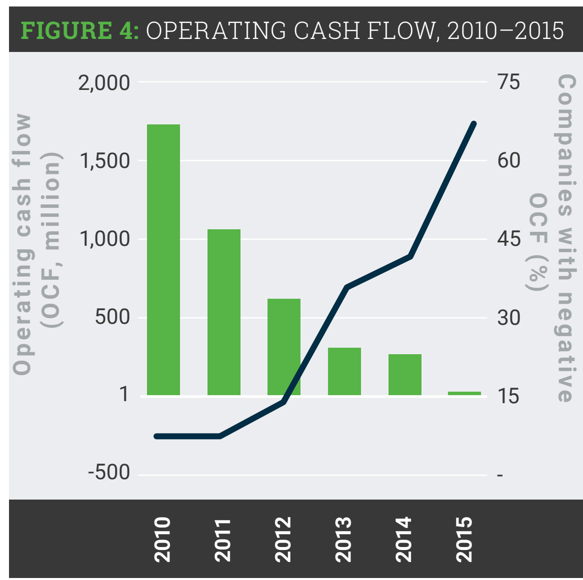


EBITDA as rercentage of revenues

Percentage of compaines reporting negative EBITDA

Source: Bloomberg, Clarksons Research, Morgan Stanley, AlixPartners

FIGURE 4: OPERATING CASH FLOW, 2010–2015



Operating cash flow

Percentage of companies reporting negative OCF

Source: Bloomberg, Clarksons Research, Morgan Stanley, AlixPartners

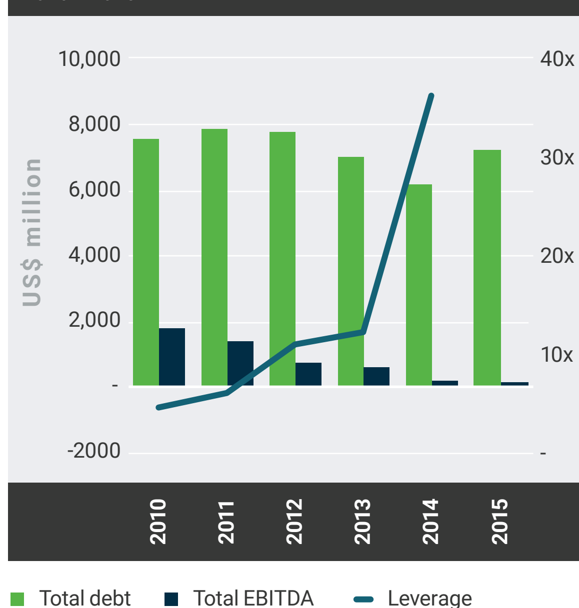
The first part of the equation—weak pricing and costly operations— shows that industry revenues fell by more than a third from 2014 to 2015, with less than 15% of the companies surveyed showing revenue growth during the period. Bottom-line operating performance was even worse, as overall EBITDA turned negative.

The declines in EBITDA margins and operating cash flow are especially troubling because few companies have been able to sustain positive results for either. A majority of companies surveyed had negative EBITDA last year compared with less than 15% in 2013 (figure 3). In addition, two-thirds of companies in our study had negative operating cash flows (figure 4) compared with just over one-third in 2013.

The severity of the slide is best shown by comparing 2015 results with those of 2013, when dry bulk new ship contracting was on the rise. Industry revenue dropped 15%, but EBITDA slid 120%—into negative territory. Income losses went from $542 million in 2013 to $2.8 billion in 2015. The grim numbers illustrate the collapse and pinpoint the challenges the industry faces in projecting demand accurately enough to pace supply.

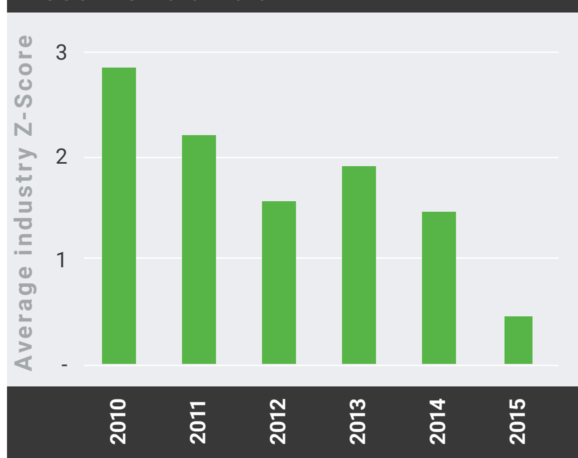
Weakened operating performance becomes especially critical with regard to these companies' significant debt loads. Leverage is common in the industry; indeed, it usually forms part of a company's operating model. However, as their performance faltered, companies found themselves struggling to generate the cash flow needed to sustain their leveraged models (figure 5).

FIGURE 5: INDUSTRY DEBT VERSUS EBITDA, 2010–2015



Source: Company filings, AlixPartners analysis

FIGURE 6: AVERAGE INDUSTRY ALTMAN Z-SCORES: 2010–2016



Source: AlixPartners analysis, S&P Capital IQ Altman Z-Score calculations

This means that almost every company in our study is in the zone of distress, with the average Altman Z-score for the sector dropping below 1.00 (figure 6). A score below 1.80 is generally accepted as indicating a high probability of financial distress, and the 2015 average was 0.46 compared with the 2013 average of 1.91. With substantial restructuring activity already in process in 2016, it's expected the industry will see even more activity as the year proceeds.

THE PERILS OF PLUNGING ASIAN DEMAND

Although demand is only part of the pricing equation—the part that shipowners have the least short-term control over—it makes a tangible impact on the industry. China's economic slowdown remains the most obvious culprit causing reduced demand for dry bulk shipping because it makes about half the world's steel,[5] and iron ore and coal make up a majority of dry bulk shipping. In Q1 2016, Chinese GDP dipped to 1.1% annual growth from Q1 2015—the weakest figure since data collection began in 2010.[6] In 2015, the Chinese economy grew 6.9%—its slowest pace in 25 years.[7] Chinese demand for coal and iron ore for domestic steel production continues to slow: in 2015, China produced approximately 24 million fewer tons of steel than in 2014—a 3.1% dip—marking the country's first annual decline in 20 years. And the trend continues: through April 2016, production was down an estimated 1.8% from 2015, and it remains well off 2014's highs.[8]

Even with that decline, though, iron constitutes 29% of global dry bulk freight, and coking coal, about 5%, with thermal/steam coal accounting for an additional 19%.[9] China's impact on those markets can't be overstated: annual low points on global steel production figures correspond to the Chinese New Year, which generally comes in the middle of the first quarter. Plus, after falling for much of 2015, Chinese stockpiles of iron ore increased from approximately 80 million tons to more than 90 million. The mix of larger stockpiles and reduced production mean it's unlikely Chinese iron ore imports will grow enough in the near term to make a material difference for dry bulk shipowners.

Indian demand for coal may help offset China's reduced appetite—the International Energy Agency's *World Energy Outlook* observes "India moving to the center of the world energy stage"[10]—but India's power plants built up significant stockpiles of coal in 2015, and domestic production soared 13% in January 2016

[5] David Stanway, "China's steel glut: years in the making, years to resolve," Reuters, April 13, 2016, http://www.reuters.com/article/us-china-steel-overcapacity-idUSKCN0XA033.
[6] "China GDP Growth Rate," Trading Economics, accessed May 12, 2016, http://www.tradingeconomics.com/china/gdp-growth.
[7] Mark Magnier, "China Lowers Growth Target to 6.5%-7% Range This Year," Wall Street Journal, March 5, 2016, http://www.wsj.com/articles/china-sets-economic-growth-target-of-6-5-to-7-for-2016-1457137605.
[8] Monthly crude steel production 2010 to 2015, World Steel Association, accessed May 13, 2016, https://www.worldsteel.org/statistics/statistics-archive/steel-archive.html.
[9] Corrine Png, "Dry Bulk Shipping," Singapore, J.P. Morgan Asia Pacific Equity Research, April 1, 2016, p. 7.
[10] World Energy Outlook 2015, International Energy Agency, November 10, 2015, p. 9, http://www.worldenergyoutlook.org/media/weowebsite/2015/151110_WEO2015_presentation.pdf.

FIGURE 7: DRY BULK VESSEL SEGMENT SPOT RATES, 2010–16

Spot rate ($000/day)	2010	2011	2012	2013	2014	1Q 2015	2Q 2015	3Q 2015	4Q 2015	2015	1Q 2016*	QoQ D	YoY D
Capesize (172,000 DWT)	33.2	15.7	7.7	14.9	13.7	4.6	4.6	11.5	6.8	6.9	1.5	-78%	-67%
Panamax	24.9	13.9	7.7	9.5	7.7	4.8	5.2	7.6	4.5	5.5	3	-33%	-38%
Supramax	22.4	14.4	9.4	10.3	9.8	6.5	6.8	8.8	5.7	7.0	3.8	-33%	-42%
Handysize	16.4	10.5	7.6	8.2	7.7	5.4	5.1	6.3	4.6	5.4	3.4	-26%	-37%

Sources: Baltic Exchange, Clarksons Research, Peter Döhle, Poten & Partners, Morgan Stanley, AlixPartners
Note: * 2016 rates through March 25, 2016.

compared with the previous year.[11] This meant a 15% decline in coal imports for April to December 2015 compared with the same period in 2014.

Outside of core bulk steel inputs, the picture—especially in China—looks equally dim. The China Coastal Bulk Freight Index, a broad proxy for the country's maritime shipping activity, is at all-time lows and even well off its 2011–15 average.[12] This may reflect new norms, as the National Bureau of Statistics of China lowered its 2016 growth target to 6.5% to 7.0% and reduced the five-year growth rate to 6.5%.[13]

THE CAPESIZE CHALLENGE

The Chinese slowdown affects most acutely operators of Capesize vessels. Capesize vessels, too large to pass through the Suez Canal and the existing locks on the Panama Canal, had the worst first quarter of all dry bulk vessel classes, with spot rates declining 65% to 80% (figure 7).

Because of their size, Capesize vessels haul—almost exclusively—iron and coal from South America and Australia to large Asian ports that have the equipment necessary for their loading and unloading. Because operators' fortunes are inexorably tied to core bulk commodity shipments, Capesize operators' vessels have historically experienced the greatest volatilities in charter rates.

But despite such volatilities—and being limited to routes servicing a small number of large ports—the Capesize fleet composes about 40% of dry bulk capacity, the largest of any vessel class.[14] Reliance on Asian markets, particularly China, sent the Baltic Capesize Index dwindling more than 57% for the year to date through the first quarter and 55% in the past 12 months. The broader dry bulk market declined 48.1% and 32.1% for the same periods, respectively.[15] Underscoring its potentially dramatic volatility, the Baltic Capesize Index followed a dreadful first quarter with an April 2016 surge, when the index more than quadrupled from its March close. As deliveries have kept pace with demolitions, the price recovery appears driven by increased demand rather than reduced supply.

One reaction to the depressed rates has been to imitate the alliances formed by the container shipping sector, such as 2M and Ocean Three. Capesize Chartering Ltd., the largest dry bulk alliance or pool, was formed in February 2015 between five shipowners that used the new platform primarily to share information and optimize fleet deployment with a view to reduce costs. Earlier this year, Capesize Chartering began a revenue-sharing program. Because it consists of only about 80 vessels, the alliance may not enjoy meaningful pricing power. However, the concept of finding ways to work together—without colluding—is an appealing response to an industrywide problem.

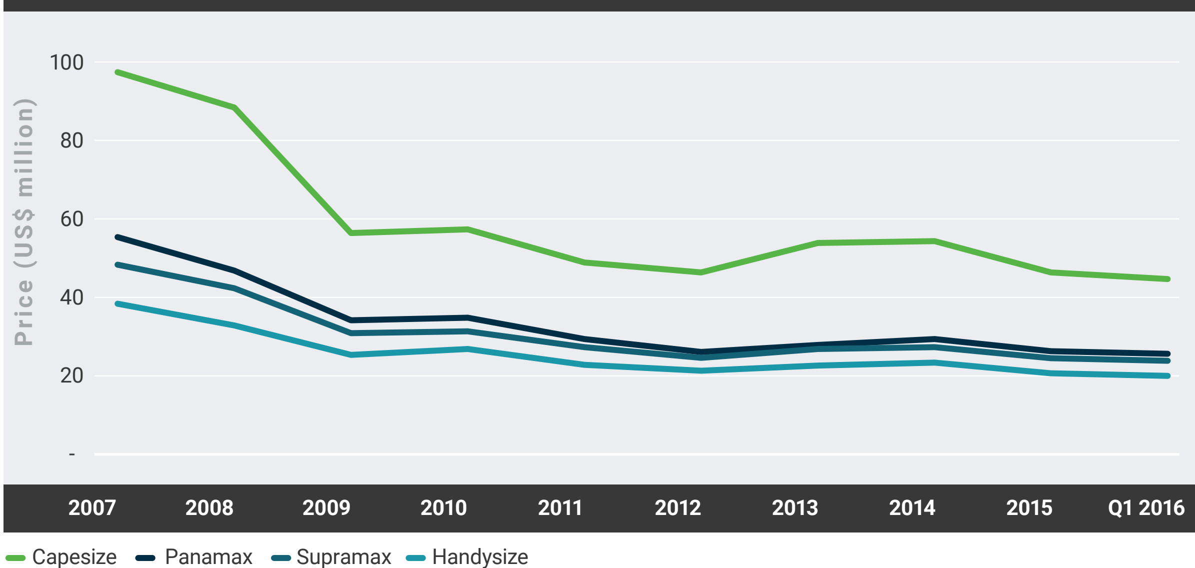
THE ALLURE OF NEWBUILDS

The industry order book finally began to decrease meaningfully in 2015, with contracting falling to 2.3% of the fleet. There is hope on the parts of some shipowners that orders will continue to stay low in 2016, keeping fleet growth minimal.[16]

Although individual companies sensibly view newbuilds as a negative, it's hard to resist the lure of cheap money and lower building costs, which

[11] Tim Buckley, "Data Bite: India's Domestic Coal Production Surge Signals Lower Expectations for Imports," Institute for Energy Economics and Financial Analysis, February 3, 2016, http://ieefa.org/data-bite-indias-domestic-coal-production-surge-signals-lower-expectations-for-imports/.
[12] Fotis Giannakoulis, Ole Slorer, Sherif Elmaghrabi, Victoria Wong, New York, Morgan Stanley Research, March 28, 2016, p. 60.
[13] Magnier, "China Lowers Growth Target," op. cit.
[14] Giannakoulis et al., Morgan Stanley Research, March 28, 2016, p. 69.
[15] Png, J.P. Morgan Asia Pacific Equity Research, April 1, 2016, p. 2. First-quarter data through March 24, 2016.
[16] Star Bulk corporate presentation, March 1, 2016; Golden Ocean results Q4 2015, February 18, 2016; Genco Shipping & Trading Limited, Q4 2015 earnings call, May 10, 2016.

FIGURE 8: DRY BULK NEWBUILD PRICES: 2007–2016



Source: Bloomberg, AlixPartners analysis

have declined an average of 50% since 2007 (figure 8). As long as shipowners keep falling for that tempting—and highly risky—proposition, it's difficult to put much faith in the industry's ability to rebalance itself in the short term.

NAVIGATING TROUBLED SEAS

Companies have limited control over the demand side of the equation. But they can control their own operating performances and—through careful work with all their stakeholders—their capital structures. Oversupply remains the greatest industrywide problem. It's a real-life application of the prisoner's dilemma game theory problem: the best outcome for the group as a whole is achieved when no one entity acts in its own self-interest, but it will happen only if everyone acts selflessly, with owners scrapping or at least idling a proportion of their individual fleets to rebalance supply so as to boost demand. Owners would also have to stop building because even though new vessels may be more efficient and more desirable from a marketing perspective, the economics of adding capacity remain counterproductive in the current market. Practically speaking, we think it's unlikely that enough owners will, of their own volitions, behave in the industry's broadest interests to make a meaningful impact.

Fleet reduction will most likely happen through consolidation. Mergers—or newly formed alliances and pools—could lead to the termination of newbuild contracts in bankruptcy court or could result in increased idling and scrapping. However, challenges abound there, too. With companies in survival mode, few can finance acquisitions by using their balance sheets. And because lenders are actively limiting exposure to maritime shipowners, traditional mergers and acquisitions (M&A) seems an unlikely avenue for consolidation in the foreseeable future. Divestitures, too, are currently unattractive options, thanks to plummeting asset values; resale values of all dry bulk vessel classes slid sharply from 2013 to April 2016. For instance, Capesize vessels' resale prices declined 54% during that time.[17]

The structural handicaps that the entire industry faces do not mean shipowners can make no individual or collaborative response to the current, brutal market. The keys to success, or at least to effective damage control, are theoretically straightforward, though difficult to execute.

Following are the steps to take:

- **Work proactively and form close alliances with all company stakeholders**—equity owners, creditors, vendors, and employees—to preserve cash and sustain a range of options. Companies that wait until liquidity runs out will have fewer options available.
- **Minimize costs—at all costs.** On an operating basis, costs represent the variable that companies can most control, but many companies may be missing opportunities to do so. Despite a glut of cheap bunker fuel, for example, the EBITDA margins and operating cash flows of most of the

[17] Noah Parquette, "Maritime Industries: Shifting Tides," New York, Morgan Stanley Research, April 1, 2016, p. 5.

companies surveyed remain in negative territory. Companies' inability to trim fuel costs in a favorable pricing environment suggests that despite the attention that companies pay to their cost structures, there's room to improve both operating performance and applications of working capital.

- **Stop building new vessels.** The 2007–08 pricing run-up, fueled by the global commodity boom, was seen as a new normal, and hopes for sustained record-high pricing spurred sharp increases in newbuild orders. Despite the subsequent pricing roller coaster since the Great Recession, shipowners returned to their order books anytime a glimmer of stabilization appeared, encouraged in part by the availability of cheap money and eager shipyards. But even though newbuilds offer a number of advantages over aging fleets, vessel reduction should still be the paramount target. Continue scrapping or idling older or less efficient vessels to more aggressively manage supply.
- **Seek opportunities to consolidate via M&A** when feasible and via alliances or pools to more effectively manage fleet utilization.

Three years from now, demand *may* come back, but shipowners should focus on the next 36 months and act as though depressed demand is here to stay. **A**

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