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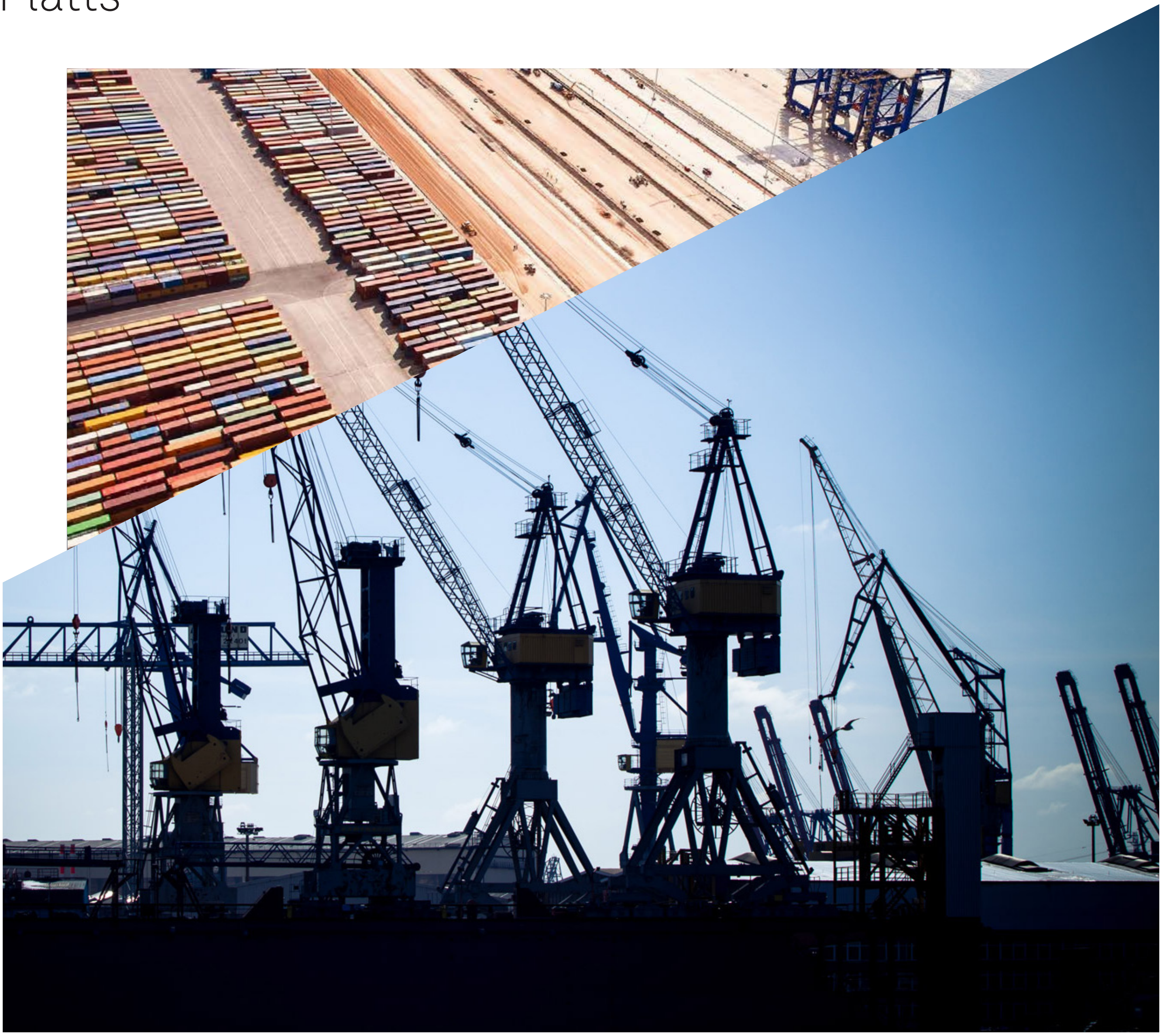

CONTAINER SHIPPING: WHAT NEXT FOR THE SMALLER TEU FLEET?

SHIPPING SPECIAL REPORT

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SHIPPING

Can the abandoned smaller TEU vessels become the workhorse for the customer focused container market?

The world is becoming an ever smaller place and the ability to conduct business with the most competitive companies globally is paramount for survival.

The emphasis on customer needs now provides competitive advantage, and in the case of the container market, this may present opportunities for smaller TEU vessels.

These containerships, which generally fall into the 1,000-4,999 TEU size range, were once pioneers laying a foundation for the modern behemoth of the container market. Later, when the focus shifted to their bigger and younger sisters and the economies of scale they provide, smaller vessels started to quickly lose their appeal.

Now, after the opening of the new Panama Canal locks, they no longer hold their main advantage and many believe they are facing a maybe slow, but certain extinction.

However, their fate might not be as dire as all that. With big liner services and the largest ships mostly serving the big hub ports, smaller vessels may still embrace their advantage of flexibility and concentrate on the more niche trades.

The opportunity lies in the fact that logistics costs for the end client do not end once the containers are dropped at the port of delivery. What usually follows is a long inland leg via trucks or trains. And this part of the journey is costly. It is especially so, in the hub ports, where huge demand for carrier services may often inflate the price.

Smaller TEU vessels can sometimes be a cost-saving solution, if they take the side street and deliver the required volume of cargo to an alternative port, which is smaller and potentially cheaper in terms of final logistics expenses.

They also may provide a better service for niche arbitrages in commodities like sugar, scrap or petrochemicals. Using smaller container vessels in such cases may allow a leaner, just in time delivery of an entire cargo to a nominated port instead of waiting for a scheduled liner service.

However, such opportunities are not usually frequent and should be grasped early, so the smaller TEU vessels still represent the value-adding cog in the supply chain machine.

FLEET DYNAMICS

The smaller TEU vessels have struggled to find a logical home since the Panama Canal expansion as logistics companies are utilizing the neo-panamax gauge for economies of scale. A similar case in point was captured in S&P Global Platts' recent dry bulk survey.[1]

The findings showed that 50% of shipbrokers who responded said that shippers will shift focus to larger vessels for economies of scale. From the charterers' camp, 28% felt that the focus will shift to larger vessels for economies of scale and will decrease ton-mile demand. The shipowners sounded less enthusiastic, with 32% saying the focus will shift to larger vessels.

Key to this is that nearly 55% of world trade is exported or traded within the Far East and Oceania region. Danish Ship Finance estimates this to be nearly 80% of container trade when measured in TEU miles.[2] The new alliances, coming into effect from April, should control the lion's share of these trade routes with neo-panamaxes along with even larger vessels, typically 13,000-20,000 TEU.

This leaves the 1,000-4,999 TEU fleet fighting for the leftover grasslands for employment. MDS Transmodal estimates that of the 217 vessels deployed on the Far East – North America East Coast trade lane in 2015Q4, 50 (equating to 23% of the total) were in layup during the same quarter of 2016. These vessels contribute approximately 230,000 TEU. Therefore the smaller TEU shipowners face the continued conundrum of meeting their commitments to their financiers through vessel employment revenues or, failing that, selling those vessels for scrap.

Danish Ship Finance recently said that within the container market "more defaults are to be expected, particularly centred around small tonnage providers."[3] This should mean further consolidation and further vessels being scrapped. In 2016 the seeds were sown by slaughtering a steady flow of workhorses reducing the overall size of the herd. Yes, there remains an inherent oversupply but this should not prevent the 2017

1 S&P Global Platts Dry Bulk Market Survey 2016
2 Danish Ship Finance – Shipping Market Review – December 2016
3 Danish Ship Finance – Shipping Market Review – December 2016

container market leaving the Southern Ocean's rough seas and sampling the calmer Mediterranean morning waters by focusing on meeting customer needs and providing a focused, flexible approach.

'Keith Gaskin, Group Commercial Director, SEKO Logistics believes "It's not always a case of bigger being better. Reviewing customers' needs and being nimble enough to react to them can show the way to sustainable profitability."'

CUSTOMER FOCUS

The time is indeed good for a major shift towards customer focus as there is yet more pressure to mount upon the smaller container ships segment. As the new alliances strive to cut costs through economies of scale and reducing their counterparty risk they may not renew their chartered in vessel contracts for some of the smaller TEU vessels. With the potential of extra ships in a free roam mode, finding new solutions for employment would get even more challenging.

Part of the solution may lie in dedicated trade routes for specific commodities, like petrochemicals or sugar, where a direct and quick delivery of a full batch on a smaller ship may save costs and make the supply chain leaner.

Keith Gaskin, Group Commercial Director, SEKO Logistics believes "The lines have to be nimble and recognise opportunities that aren't always met by the largest carriers and the largest vessels. By deploying vessels into the smaller ports, it satisfies the need for cargo delivery points that aren't near the main ports for inbound and outbound volumes. By servicing the smaller ports nearer where the client's facilities are based, it is a more eco-friendly option by reducing the road haulage journey and also stripping out cost.

In a time where consolidation between carriers is becoming ever greater, I feel the shipping lines that are nimble and can react quicker to customer requirements are in a better position to increase their customer base and their margins. It's not always a case of bigger being better. Reviewing customers' needs and being nimble enough to react to them can show the way to sustainable profitability."

Such a customer focused approach offers clients reduced sailing times compared to the traditional liner services. The knock-on benefits could streamline the company's overall supply chain costs through reductions in terminal, port, customs and inland trucking costs. This could afford both parties a competitive advantage that brings more certainty from a pricing standpoint as well as maintaining the required agility.

POLYETHYLENE

A good example is the Polyethylene (PE) industry, which relies on the container market to ship its goods globally. For 2016, MDS Transmodal projects that US exports of PE moved in containerships could grow by some 20%, with cargo moved to North Europe & Mediterranean, major importing market, expected to report an increase of approximately 35% compared to 2015.

For US PE exports, the Port of Houston is one of the main hubs. And as such it sometimes suffers from a bottleneck of a very important resource – empty containers. When there is a lack of those, the agile delivery of goods becomes problematic.

Ensuring empty containers are in the right place to load goods in a cost efficient way may seem simple to the outsider but is causing the PE producers a logistical headache as this is their means of support to ship their PE products globally.

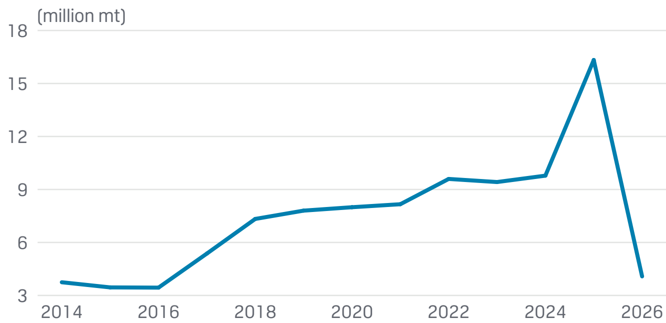
One of the logistical solutions to that may be provided by the smaller TEU vessels that can berth in shallower ports. This creates alternative destinations for the inland trucking and rail networks thereby assisting PE producers in scheduling their export programs more efficiently. In particular the ports of Charleston, Savannah, or New Orleans normally have adequate levels of empty containers.

Such a move could also ensure some relief in road congestion as trucks would be sourced to different locations.

The US shale gas phenomenon has meant that PE producers are among the most competitively priced globally. The planned expansion program is expected to increase by more than 2 million mt in 2017[4] leaving the PE market in ample oversupply and potentially exasperating the empty container situation.

The liners are reportedly working towards the planned timeframes for when additional capacity comes on stream, but

NORTH AMERICAN PE NET SUPPLY AND DEMAND BALANCE



Source: Platts

4 Platts Analytics 10-year forecast

the bigger ships might not provide the best solution for all of the interested importers. The main buyers would be around the UK Continent, Brazil, South Korea and China.

For example, Far East buyers, in this case, may sometimes be better served by smaller vessels, considering relatively modest volumes on this arb and the fact that such ships can do a quick delivery via the cheaper old Panama Canal locks.

It is not about chasing the lion's share of the business, but being agile enough to provide solutions to PE producers quickly when additional capacity appears and a potential arbitrage opportunity presents itself.

This comes into specific focus since OPEC's December decision to curb oil production. The oil price has rallied and could provide further arbitrage opportunities as this extra capacity comes on stream.

SUGAR

A similar opportunity may present itself in the EU sugar market.

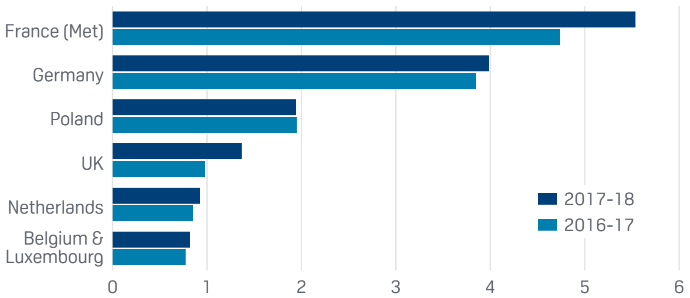
A recent change in the EU's Common Agricultural Policy to end the sugar quota system on October 1, 2017 could lead the EU to become a net exporter for the first time since 2006.

Before the quota system was introduced the EU sugar market averaged exports of around 5 million metric tons white value (mtwv) a year.

The first EU sugar production estimate post quotas for 2017-18 is seen at 18.32 million mtwv. Estimates of 2 million-3 million mt exports seem realistic for the 2017-18 crop year. The main producers and likely exporters are located within the UK Continent, as shown in the chart below.[5]

The incentive for exports is also boosted by high logistical costs to truck sugar across the EU, compared to the lower container freight rates within the UK Continent to importers

EU28 SUGAR (OCT-SEP): FIRST PRODUCTION ESTIMATE POST-QUOTAS (million mtwv)



Source: Platts

5 France, Germany, United Kingdom, Netherlands, Belgium and Luxembourg

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THE BARREL BLOG

What is the container market landscape going to be in 2017?

S&P Global Platts senior editor, Andrew Scorer, waxes lyrical about the global container market ahead of our Mediterranean Bunker Fuel Conference.

Read more here

such as North Africa and the Middle East, which are not really the busiest stops for the large liner service vessels. That means that smaller ships could yet again step up and offer such customers a quick solution for delivering extra European sugar, when extra volumes kick in.

Also, as the EU assumes the mantle of sugar exporter, its main suppliers, namely Mozambique, Fiji and Laos, could be forced to find alternative homes for their product. This may again create a small window of opportunity for flexible container ships that can call outside the liner trade highways on demand.

However, it is expected that imports of as much as 3 million mtwv could still be needed due to low stocks and increased export volumes. Whether the EU continues to import or resume exports it still could present an opportunity for smaller TEU vessels to provide the flexibility clients need to provide their competitive advantage and grow their market share.

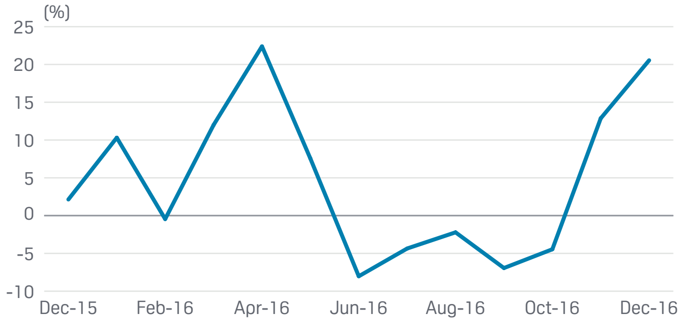
SCRAP METAL

Adaptability comes in many forms and being agile is essential for the US Midwest shredded scrap industry to ensure they take advantage of pricing arbitrages. During 2016 the month-on-month price change saw some big swings alongside increased scrap demand into Turkey.

Arbitrages open and close quickly as waiting for the scheduled liner service to load, and then stop off at numerous ports on the way, could be the difference between a profit and a loss. The typical lot size sold and shipped on containers is 40,000 mt, equivalent to roughly 1,500 FEU.

When required to do so by scrap buyers, smaller TEU vessels are capable of loading an entire cargo and sail direct to the nominated port, thereby allowing the intermediaries to pass on these potential efficiencies to their customers in their part of the supply chain.

US MIDWEST SHREDDED SCRAP PRICE M-O-M CHANGE



Source: TSI

TURKISH SCRAP IMPORT PRICES (CFR ISKENDERUN PORT)

Source: TSI (historical) and LME (forward curve as of 05-Jan-17)

The Turkish scrap import price (CFR Iskenderun port) for 2016 averaged US$234.89/t. Scrap prices are linked with iron ore and coking coal prices and there have been some negative fluctuations in these commodity prices in recent months. It remains to be seen if scrap prices will follow this trend in 2017.

The London Metal Exchange scrap forward curve as at January 5, 2017 stood above US$270/t for 2017. This could provide the springboard for smaller TEU vessels to once again drive this customer-focused approach.

CALMER WATERS

The shipping industry remains within the clutches of rough seas but the container market is showing signs of positivity to steer vessels away from the eye of the storm by scrapping ships under 10 years old and through mergers and acquisitions. This looks set to continue with more vigor in 2017 as countries and the major liners cease to flog the dead horse and form logical alliances to compete in the world arena.

Shipowners are always analyzing whether the best employment should be the spot or term market. Putting your faith in the right horse is more an art than a science but everyone has an opinion. This makes the industry exciting and players want to remain a part through thick and thin.

The smaller TEU vessels in particular have to take advantage of the commodities that require a reactive export or import program where the larger TEU vessels can't monopolize the trade routes. The lack of port infrastructure, shallower waterways or cheaper inland transport costs provide the opportunity to become the versatile workhorse businesses want to offer to their clients for a customer-focused approach. This could also ease the pressure not only on the banks but also the oversupply of shipping capacity and have a positive effect on freight rates.

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