Baltic Dry Bulk Investor Indices

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Gambler's Market: Newbuild Prices Ignore Freight Rates

In our December 2023 quarterly report, we discussed whether the stronger dry bulk freight rates being experienced at that time were a trend or a "head-fake". From what we see today, the freight rates experienced in the fourth quarter of 2023 (4Q23) appear to be the latter. Since that update, freight rates weakened, and remained relatively soft heading into Chinese Lunar New Year but have improved somewhat this past week. In addition, bulker asset values remained very firm in 2023 despite the generally weak nature of freight rates during the year. Importantly, dry bulk cargo ship newbuild prices firmed somewhat in 2023.

Are freight rates somehow less relevant to asset values? Is this the 'new normal'? Baltic Exchange Investor Indices (BII) have been tracking newbuild values since July 2022. It is generally counterintuitive to think that asset values are not dependent on freight rates and, given that the data set covers less than two years, we don't believe this is a new normal for the dry bulk sector. We remind readers that corrections to the mean in dry bulk shipping can be very painful.

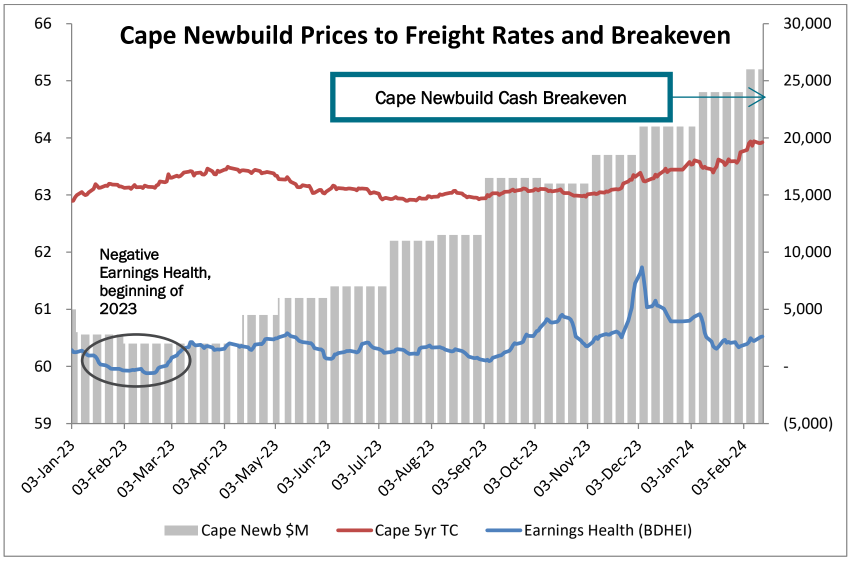
That said, what is driving the counterintuitive nature of newbuild prices having almost no recent correlation to freight rates? In our view, there are three core reasons. Firstly, the orderbook is low. Secondly, input costs for shipyards continue to rise. Thirdly, shipyard capacity is limited, with the longest lead-times in over a decade. It appears that investors who are willing to order dry bulk tonnage today are ignoring recent freight rate trends and are likely looking at the supply dynamics and betting that freight rates will rise to justify the newbuild prices they are paying.

Correlations appear counterintuitive

For the purposes of illustration, we will look at the Capesize and Supramax sectors.

Since the beginning of 2023, Capesize newbuilding prices have had a fairly steady trend upwards. While the Capesize implied five-year time charter rate has also improved over the same period, it remains below $20,000/day and has averaged about $16,000/day. The correlation between the implied Cape five-year time charter rate and the Cape newbuild price has been almost non-existent at 0.24x, with an R^2 (*the coefficient of determination*: with the charter rate being the independent variable, newbuild price the dependent) being effectively irrelevant at 0.06x.

Finally, the Baltic Capesize Health of Earnings Index (CDHEI) – a ratio of earnings against cost (with a negative number meaning earnings are below operating costs) – was negative for some of 2023 and is not particularly firm today.



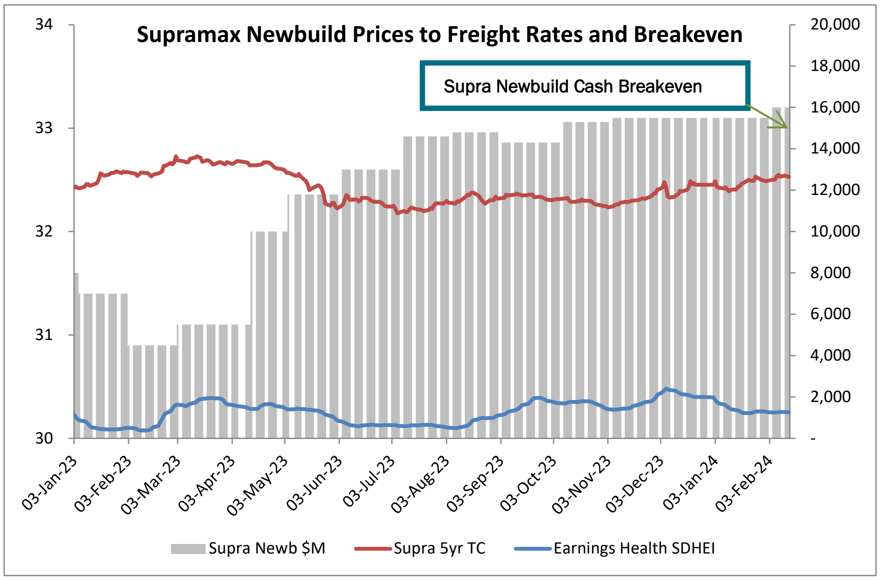
The Capesize newbuild price in in February 2024 is an estimated $65.2 million, indicating a cashflow breakeven of approximately $23,500/day. [1] Therefore, Capesize freight rate trends support ordering a Cape at today's prices.

Supramax sector appears slightly more rational.

Supramax newbuild prices have been more responsive to freight rates. However, with a correlation of 0.55x and an R^2 of 0.31x, the relationship is not firm and may well be tenuous. For example, Supramax newbuild price of approximately $33.2 million in 4Q23implies a cashflow breakeven of $14,600/day[2], yet Supramax spot rates have averaged $11,400/day since the beginning of 2023. For some consolation, Supramax newbuild prices have been relatively stable for the last nine months and the Supramax Health of Earnings Index has been positive since the beginning of 2023.

[1] Assumes current Capesize newbuild price of $65.2 million, OPEX of ~$6,100/day, G&A of $750/day, 65% leverage, 17 year loan profile, 8.75% interest)

[2] Assumes current Supramax newbuild price of $33.2 million, OPEX of ~$5,300/day, G&A of $750/day, 65% leverage, 17 year loan profile, 8.75% interest)



The rationale behind ordering today (hint, it is not historical freight rates)

Investors have fairly clear information on the supply side of the dry bulk ship equation and that data appears bullish.

Firstly, the dry bulk fleet orderbook is near the lows of 2002, which preceded the historic bull-run in dry bulk freight rates. The outlook for fleet growth appears to be slower than historical average demand growth for the coming years. Further EEXI/CII and other carbon emission restrictions are expected to slow older, less efficient ships, constricting supply further. Offsetting this are the current economic challenges in China, whose demand may not be nearly as supportive of freight rates as it was two decades ago.

Secondly, shipyard input costs have continued to rise. In our view, decisions regarding newbuild propulsion type has delayed orders due to the constantly evolving nature of modern propulsion systems after decades of relative stability. If an investor has decided on propulsion and knows input costs are going up, accepting today's newbuild price may make a lot more sense than accepting tomorrow's newbuild price.

Finally, the number of active shipyards globally is approximately 150, the lowest since 2005. Furthermore, the lead time for vessel delivery is more than three years, the highest since 2010.[3] There are large caveats to this data as many of the roughly 150 yards are not relevant to certain cargo types and we have seen dry bulk ships ordered recently with lead times of 30 months. However, if an investor believes in the supply-side story and expects newbuild input costs to rise then lead times may increase in the coming quarters. Ordering now makes some sense.

[3] Clarksons Shipping Intelligence Network

Gambler's market

While there is a rationale to order at today's dry bulk newbuild prices, freight rates are not yet one of them. Investors must make an educated gamble that freight rates will react to supply constraints and, if that is the case, the earlier one has a ship, the better. However, for hypothetical instance, should Chinese demand fall on a deep recession, freight rates may stay well below cash breakeven for some time and asset values will drop accordingly. As this is shipping, to reverse a phrase from the film Casablanca, we are not at all shocked to find there is gambling going on in this establishment. Yet, it remains a notable gamble.