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Container Freight and Charter Markets and Their Impact on Secondhand Valuations

Improving charter rates are driving up second values while struggling freight rates indicate a broader slowdown could be at hand.

By James Frew

The container shipping markets continue to emit contradictory signals. In its Q1 report, MSI opened an overview of containership earnings and prices with a comparison of freight and charter markets, and noted an ominous divergence in their fortunes. As in 2011 and 2015, charter rates were marching upward at the same time that freight markets stagnated. Our concern was that, just as in 2011 and 2015, this trend would precede a downturn in charter earnings.

In the intervening period this divergence has widened further. While the speed of charter market increases has slowed recently, the gains made in the interim have been impressive. Freight markets, meanwhile, remain lackluster and most major liner companies have announced losses in their Q1 2018 financial results.

Reconciling a changing Market

On the face of it, the different paths of these two markets is tricky to reconcile. We ask, 'why do liner companies pay increasing amounts to hire vessels when they can only run them at a loss?' However, there are some factors at play which imply that this is not quite as contradictory as it appears.

First, one major factor behind liner company losses is the increase in the fuel price, which has yet to be fully passed on to customers but which will not deter liner companies from launching new services.

Secondly, liner companies may choose to counter losses by seeking to increase market share rather than cut capacity, which if anything would imply greater demand for charter market tonnage.

The tone of any review of freight rates is inevitably set against the backdrop of profitability. While liner company results for 2017 were firmly in the black, Q1 2018 has been a lot more mixed, with industry bellwethers such as Hapag Lloyd (a loss of EUR 34.3 Mn) and CMA CGM (down $77 Mn) demonstrating that the industry remains under pressure.

This pressure has not been distributed equally. A recent divergence across freight markets shows that north-south trades saw plummeting rates over Q1 and have seen limited recovery, while mainlane trades experienced a similar plunge before recovering their ground. The most striking element is instead the extent to which intra-Asian freight rates have broadly held their ground amidst the gyrations of the longer-haul trades, suffering a minor slump in Q1 before recovering the entirety of the lost ground by April.

In part this is likely reflective of the strength in intra-Asian volumes, but it may also reflect the fact that intra-Asian liner companies have been more effective in passing the increase in fuel prices on to their clients.

The charter market meanwhile has continued its renaissance since the turn of the year, with MSI's indicator for a Panamax vessel having picked up from below $8,000/day at the end of 2017 to sit at above $12,000/day by May. This improvement has been across the board, but once again those assets which act as the marginal capacity suppliers to the industry – namely the old Panamax and Post-Panamax tonnage – have seen the greatest upside.

The evolution of earnings for old Panamax and Post-Panamax class assets against the wider charter market is tracked by the MSI T/C index (which is weighted by the number of fixtures in each vessel class) showing their role as marginal suppliers of capacity – and thus seeing the greatest upsides and downsides in earnings.

Typically rates for larger vessels do exaggerate the movements of the wider charter markets, with the two spikes in the differential between >3,900 TEU earnings and the overall T/C Index markets seen in April and September 2017 reflective of a broader pick up in the charter market.

Overall though, we believe that the signals from the freight markets imply that the charter markets will come under some pressure, particularly in Q4. The MSI Base Case is that there is limited further upside to charter rates over Q3, before Q4 sees a retrenchment in earnings.

Nevertheless, the risks are increasingly weighted to the downside, both from the current divergence in freight and charter rates together with the risk of a downturn in trade growth. Chart 1 plots the divergence between freight and charter rates, using the Howe Robinson Container Index to map charter rates against the Shanghai Containerized Freight Index.

Secondhand Prices

The recovery in containership earnings has inevitably provided a strong fillip to second-hand prices, and as Chart 2 shows, values have been on a strong upwards trajectory since the end of 2016 (with the strengthening scrap price serving to push up older vessel prices even as more modern ships remained marooned in Q1 before following a recovering earnings profile).

Last quarter, we underlined how we believed that the recovery which had taken place was driven by fundamentals, and the increase in activity in the sale and purchase market was reflective of those same improved fundamentals rather than in itself engendering the price increases. As the chart shows, we feel that the price recovery is reaching close to its near-term limits, with 2019 representing a year of consolidation before 2020 sees prices kick on further upwards.

Chart 1: Freight versus Charter Rates

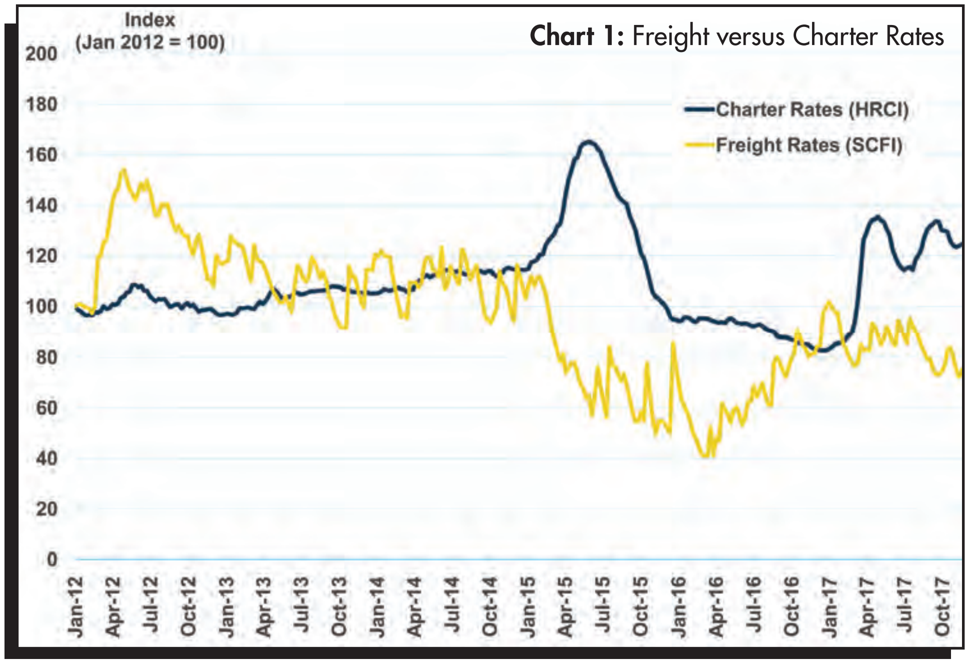
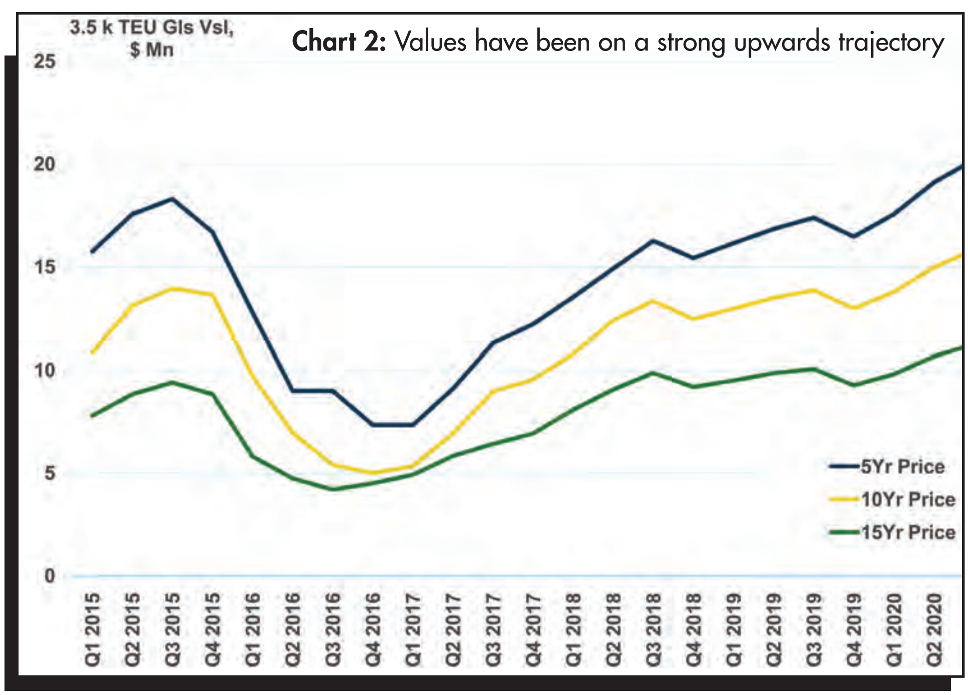


Chart 2: Values have been on a strong upwards trajectory



Container Shipping: **Finance**

It is worth trying to untangle something of what is underlying this price stabilization. MSI traditionally has seen second-hand vessel prices as being influenced by four factors: newbuilding prices, scrap prices, earnings and depreciation.

Life expectancy is to a large extent a function of the earnings environment and challenging to quantify, but since the global financial crisis of 10 years ago it has been rare that newbuilding prices, scrap prices and earnings have combined to give a sustained boost to asset values.

The brief surges in earnings in 2011 and 2015 were at least partly undercut by falling newbuilding prices, while the newbuilding price and earnings rally in 2015 was partially offset by falling scrap prices.

However, the scale of the earnings recovery in 2017 was sufficient to overcome stable newbuilding prices, while 2018 offers the rare prospect of solid fundamentals underpinning all three drivers of asset values.

Looking forward into 2019 and 2020, the interplay becomes more complex. In essence, we believe that containership prices have risen sharply, with sentiment and acquisitive buyers snapping up distressed assets at a speed which has meant that rather than lagging the fundamentals, prices have stayed strictly in line with where the market recovery suggests they should be.

Chart 4 attempts to demonstrate this, plotting the NPV of vessel cash flows over a 10 year period (based on current charter rates, OpEx and a 10% discount rate – if anything, this is an overestimate as OpEx will increase and earnings decline as the vessel ages).

There are two interesting points to be drawn out of this chart. The first is that both the Panamax and the Handysize containership are priced below where the net present value of the cash flows over the next 10 years would suggest they should be. The 6,600 TEU vessel is priced within spitting distance of this theoretical value, whilst the 8,500 TEU vessel meanwhile rests slightly above this level but not egregiously so.

It should not be surprising then, that the Panamax is priced below the theoretical value for a "buy and hold" investor given there is so much uncertainty surrounding their life expectancy, whereas for the 1,700 TEU vessel we actually regard the disconnect as something of a buying signal. The 8,500 TEU does present a greater risk, particularly given

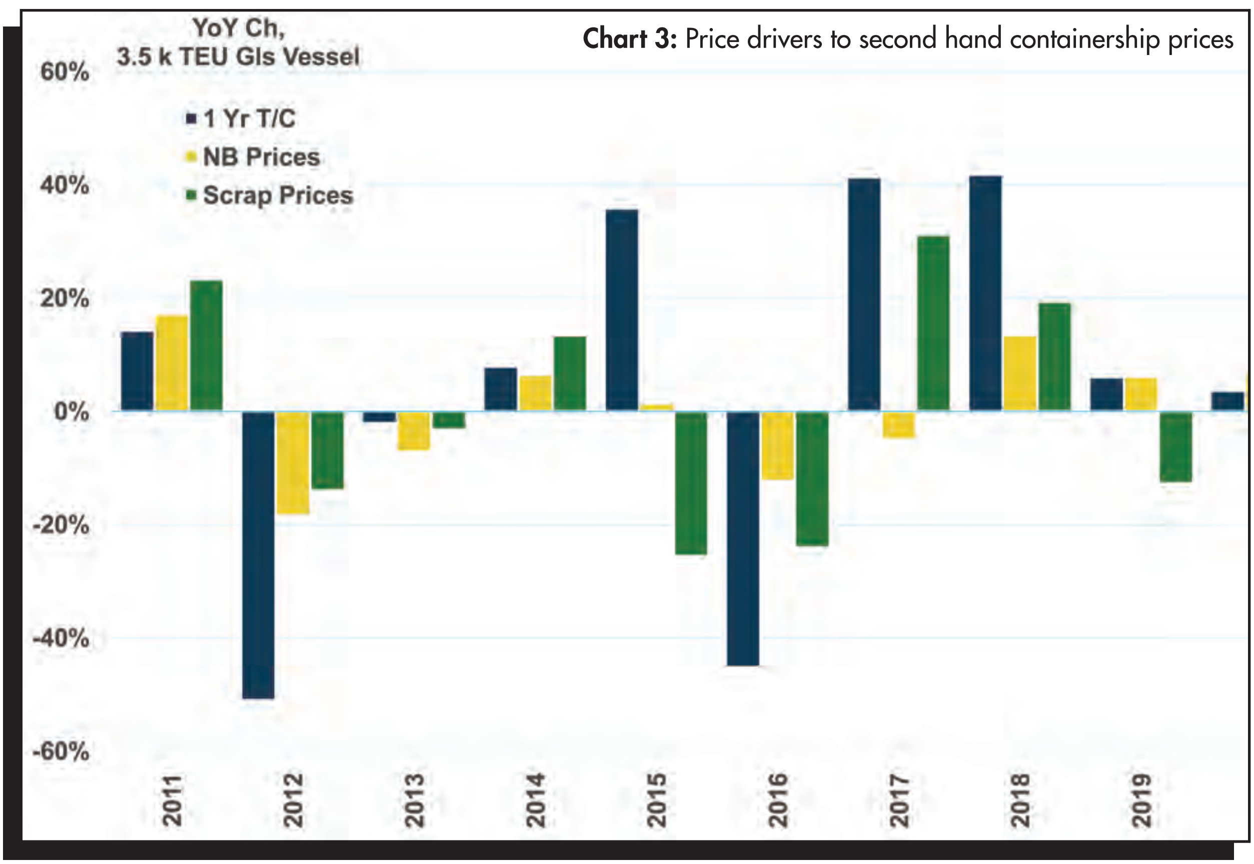


Chart 3: Price drivers to second hand containership prices

the limited liquidity in the market hindering price transparency. Taking the price discrepancy at face value however, we would posit that buyers are in part paying an 'illiquidity premium' while at the same time also hoping for greater upside on the earnings.

The second point relates more to the future outlook. The fact that second-hand prices and underlying values are generally aligned implies that, given earnings will broadly move sideways for the next 18 months, it will be challenging for asset values to make much further headway over that period.

This is where the other element of the pricing jigsaw comes in, in the form of newbuilding prices. Although earnings growth through 2019 will be muted - and in our view that will suppress further heavy investments in the sector as well as asset value appreciation – the fundamentals around asset pricing will continue to move upwards, dictated by the newbuilding price.

A further factor anticipated to suppress asset values in 2019 is the uncertainty surrounding the introduction of the 2020 sulphur cap. 2020 will see these concerns resolved, and even though earnings growth will remain steady rather than exciting, we expect to see prices adjust further upwards in response to the improved fundamentals.

The Author

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Chart 4: Net Present Values versus 10 year-old values