NOTOS NEWS | TANKER MARKETS

The market recovery scenario for large crude tankers is quite appealing at the moment, fueled by a strong trade demand growth combined with modest fleet growth.

RECOVERY UNDER WAY - OR JUST WISHFUL THINKING?

When OPEC and other oil producers decided to restrain oil production in 2017 to get rid of surplus oil inventories and support oil prices, which had collapsed to less than USD/barrel 30 in early 2016, the tanker market was left high and dry - and charter rates collapsed. Now, after 18 months of miserable tanker earnings, rates have started to stabilize and even increase. Many hope for earnings to improve further in the next months.

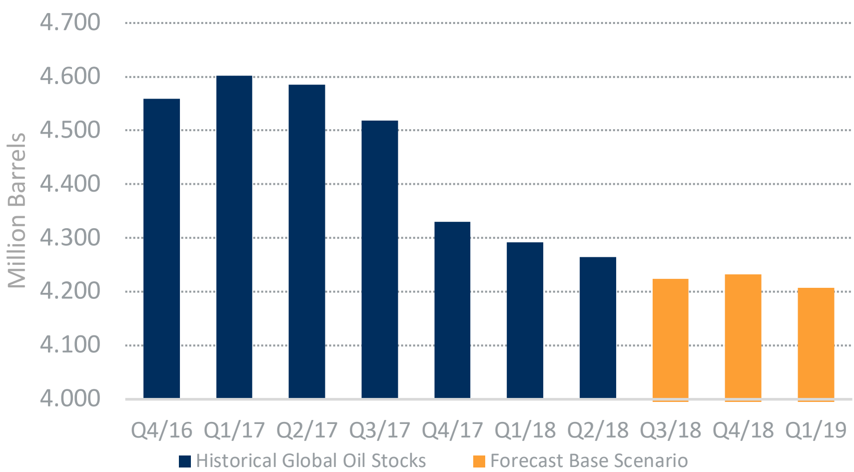
Sceptics, however, point to the overcapacity in the market and continued expansion of US shale oil which, to a large extent, has been consumed locally without much demand for shipping.

FUNDAMENTALS SUPPORTIVE

A closer look at the fundamentals, however, presents some strong arguments that a recovery is building behind the scenes, waiting to unfold over the coming months:

- Global oil stocks are on ‘neutral’ levels, meaning that after several quarters of stock draws - as shown in the graph below - or balanced oil supply and demand, additional growth in global oil demand has to be covered by increasing oil supplies or stock draws which would push oil prices even higher.
- Oil demand growth is robust with IEA and EIA predicting 1.4-1.6mbd annual growth in world oil demand in 2018 and 2019 which is likely to support similar annual increases in oil production going forward. Such increases in oil supply would be a significant break from recent supply patterns where global oil production posted a meagre 1mbd gain over the six quarters from Q4/2016 to Q2/2018.

GLOBAL OIL STOCKS ON A REDUCED LEVEL



Source: AAA 09/2018

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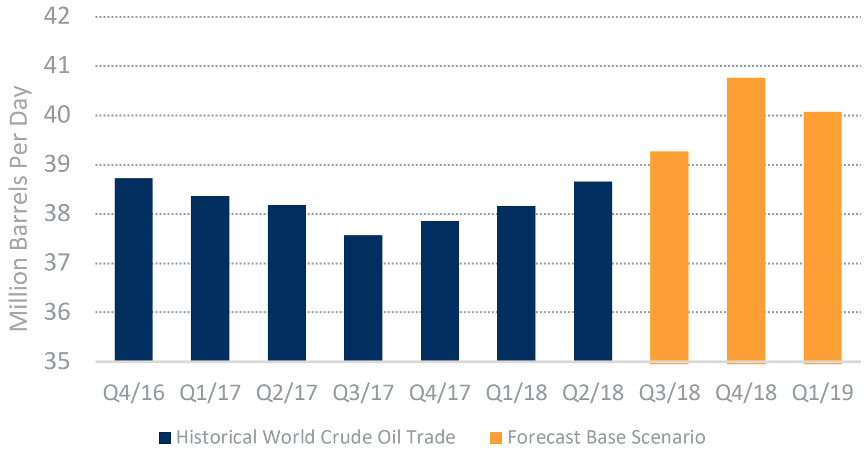
ZERO GROWTH IN WORLD CRUDE OIL TRADE IN Q4/2016-Q2/2018 COMES TO AN END



Source: AAA 09/2018

- World seaborne crude oil trade was even worse off with no or ‘zero’ growth over the same period as the majority of increase in oil production came from onshore US shale formations instead of coming from more tanker dependent OPEC suppliers (see graph to the right). However, we expect that the trade growth will accelerate in the quarters to come.
- US crude oil exports is a new and rapidly expanding factor in the crude tanker market. US crude oil exports have increased from around 0.6mbd last summer to some 1.8mbd over the summer months this year, considerably contributing to the increase in world oil supply despite OPEC’s production cuts (see graph below). Further growth in US crude oil exports is foreseen, contributing positively to tanker demand.

POSITIVE TON-MILE EFFECT EXPECTED

Increasing crude oil production and trade are not the only factors expected to support the crude tanker market going forward, the ‘distance effect’ is likely to play a significant role as well.

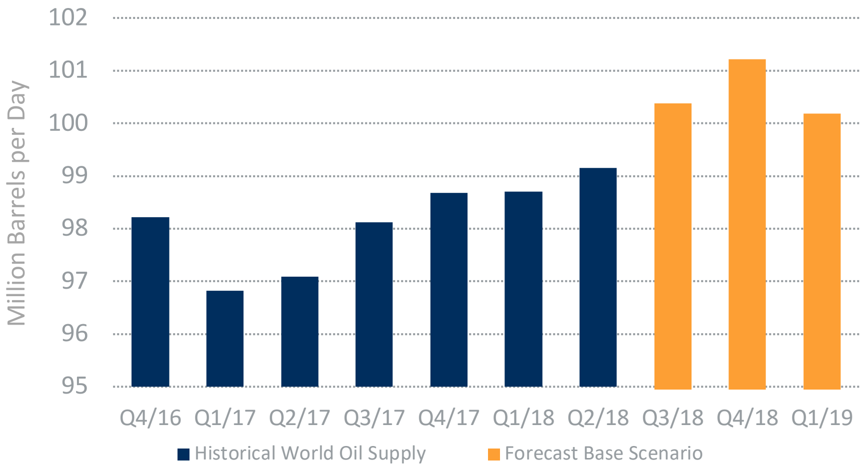
Although crude oil shipped from the Arabian Gulf to Asia is by far the biggest or main source of demand for the largest tankers, shipping crude oil from Atlantic Basin suppliers like Nigeria in West Africa or Venezuela in the Caribbean to customers in Asia are important trades as well. These volumes have traditionally been dwarfed by shipments into the Atlantic Basin from the Arabian Gulf and the smaller volume ‘west to east’ shipments were usually carried out by available tonnage on the return leg from the Atlantic.

SOARING US SHALE OIL PRODUCTION

The shale oil revolution in the US has seen US oil production recover rapidly over the past few years to reach all-time highs. The US is currently pumping 11mbpd of crude oil which is more than every other country in the world, also leaving Russia with 10.4mbpd behind. The bounce in US oil supplies has a number of consequences for tanker markets:

- One effect that in particular may contribute to push crude oil carriers into the comfort zone arises from the fact that oil flows in-and-out of the Atlantic Basin now have become more balanced compared with the old days when VLCCs normally returned empty to the Arabian Gulf.

US EXPORTS FOSTER WORLD OIL SUPPLY GROWTH



Source: AAA 09/2018

▪ On the contrary, VLCCs sailing empty all the way from Asia into the Atlantic Basin to pick up cargoes have become much more commonplace (at least seasonally). The number of VLCCs taking on this long journey - sailing empty all the way from Asia to pick up cargoes in the Atlantic Basin and return - are likely to see a pronounced upswing over the next months and onwards into 2019 based on current forecasts for further growth in US oil supplies.

▪ Hauling crude oil from West Africa to North Asia (e.g. China, Korea) adds three to four weeks of sailing time for a round voyage compared with the benchmark Arabian Gulf to North Asia trade. Picking up US or Brazilian cargoes in the same manner would involve some of the longest sailing distances viable for commercial shipping and potentially add two months of sailing time for a round voyage.

One should caution here that although the base case scenario clearly supports a boost in ton-miles demand stemming from the above-mentioned trade, the fundamentals supporting this scenario are fragile by nature - involving oil supplies from Venezuela and Libya to mention some.

NEGATIVE NET FLEET GROWTH CLOSE AT HAND

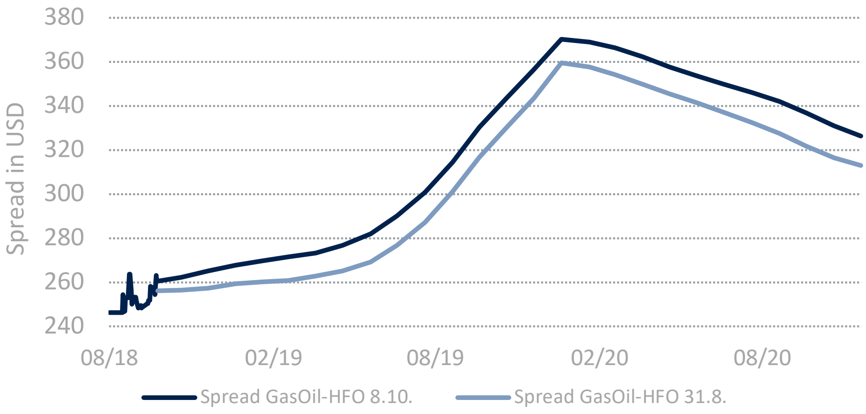
The number of VLCCs, the largest in numbers and dwt of the main three crude tanker vessel classes, are expected to swell by 110 units by 2020, with the majority expected to hit the water already in 2019.

In 2018 so far, 29 vessels have been delivered and 33 units scrapped. This negative net growth of the fleet was the light in the gloomy market preventing earnings from a total collapse. In the years before we have seen 13 deletions compared to 50 deliveries in 2017 and 47 new units in 2016 with 2 vessels leaving the fleet that year.

PLENTY DEMOLITION CANDIDATES

Despite this moderate fleet growth there is plenty potential for further demolitions as 32% of the sailing VLCC fleet consists of units built prior to 2005. But when is a vessel due for scrapping or replacement? The costly surveys could be one of the main triggers determining whether a vessel is sold for scrap or dry docked for further sailing. Stricter regulations for ballast water treatment and IMO 2020 which involve considerable capital expenditure may brighten the outlook for the modest fleet growth to continue.

SPREAD GASOIL VS. IFO 380 IN ROTTERDAM

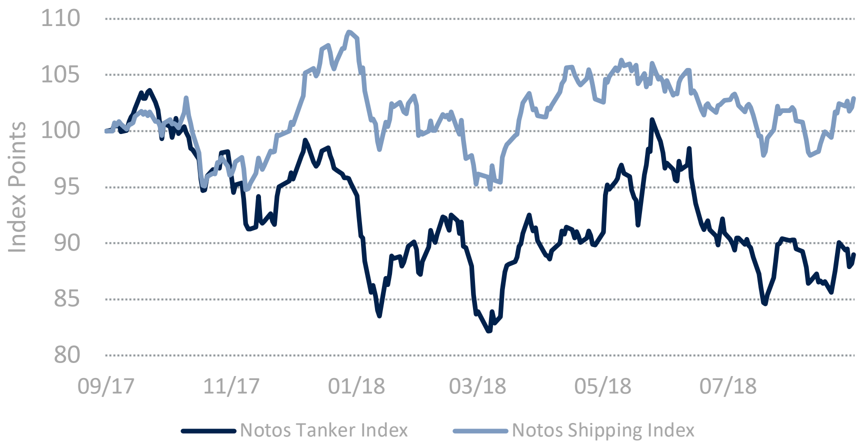


Source: Notos 10/2018

With regard to IMO 2020, scrappings may be affected by the spread between low sulphur Gasoil and traditional IFO 380. Currently, there is no future contract available for 0.5% low sulphur Gasoil. Therefore, we considered the spread between 0.1% Gasoil and IFO 380, both deliverable in Rotterdam. Although the current spread of USD 260 looks already impressive, the future contracts are trading at levels close to USD 370 and still rising, as shown in the graph above. If these spreads really materialize, non-scrubber vessels could face a serious drawback in the market leading to accelerated scrapping.

Given the aforementioned strong base case demand scenario and our scrapping expectations, we believe that the current orderbook is likely to be fully absorbed over the course of the next three years.

NOTOS TANKER VS. SHIPPING INDICES - 12 MONTHS



Source: Notos 10/2018

TANKER INDEX PICKING UP

Over the last years, the Notos tanker stock index has been rather suffering. However, since summer this year the index suddenly jumped by nearly 20%. It dropped, again, in autumn, but it did not reach the troughs seen in spring this year (see graph above). Our investment algorithm has already picked the crude sector to overweight and we would not be surprised if the product sector were to follow soon.

CONCLUSION: MORE THAN WISHFUL THINKING

1 | Sailing into the peak winter season, signs of a tanker market recovery remain fragile but VLCC spot rates have just risen to USD/d 25,000 and the market is starting to buy into a recovery scenario.

2 | Fundamentals are supportive for a strong and sustained recovery in the market for large crude oil tankers. Oil demand is growing and likely to lead to increases in oil production as well as oil trade going forward. Further oil production growth in North America is expected to boost trading distances related to shipping surplus oil out of the Atlantic Basin. An additional short- term boost - crude oil is usually freed up for export during the coming months as less oil is burned for power generation during the winter season in the Arabian Gulf.

3 | Modest fleet growth is expected to even turn into negative net growth taking expected scrappings into consideration. Likewise, tanker owners will thoroughly consider the costs and benefits of investments involved with the implementation of stricter regulations.

4 | IMO 2020 regulations may provide further tailwind for owners who decided to invest in scrubber technology. Current spreads between Gasoil and IFO 380 point to fast repayment scenarios for the investment.

Note: This article has been produced from a collaboration of AAA Aarskog Analytics and Advisory, Hamburg and Notos Consult, Hamburg.

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