

## The Rise of “Shipbuilder Owner”

At the onset of the financial crisis, we advocated an approach to lighten the burden on the massive orderbook (see *A New & Radical Approach*, 24 November 2008). Our proposal was for the yards to reschedule the orderbook through collective renegotiation with ship-owners, which accommodated the interests of both shipyards and ship-owners. We anticipated that one-sided terminations by owners was simply not acceptable for the shipbuilders. Why shall a shipbuilder accept something which was against their contractual interest particularly when written under English law? Owners have to compensate the shipyard if they want to break the contract, that is only fair, and under such circumstances, there is a “mutual agreement to terminate” the contract with a freshly written set of legal documents that over-ride the original contract.

Development since then largely followed our predictions. Despite of much fanfare and publicity about a supposed evaporation of about 30% to 40% of the orderbook, the real “terminations” confirmed by us in the period from 1 January 2008 only amounted to about 6% of the orderbook<sup>1</sup>, which includes a large number of what we called “failed contracts” (ie, signed contracts which failed to become effective due to lack of a refundment guarantee). For a shipowner, the best case scenario is to capitalize on seller default allowing the shipowner to kill off the project without paying compensation. We can see there are two categories of poorly performing shipyards that will help an owner in their dream to avoid taking delivery:

- a) Shipyards which failed out for fundamental reasons, cash being the trigger or result of such problems. Such shipyards we classify as “failed ventures” and may or may not have had an effective order on their books, but their troubles shut their doors;
- b) Shipyards with delivery problems (many of these yards would have failed if not for the “assistance” rendered or directed by the Chinese and Korean governments). We know many yards that are 6/7 months late in construction in the current ships, and face the prospect that owners will exercise their contractual rights to cancel the order<sup>2</sup>. Owners have often been able to extract economic benefit out of these yards, by forcing the yard accept “terminations” of forward contracts in exchange for accepting delivery of the delayed vessel.

In other words, only orders in “problematic” yards have been terminated at no cost to ship-owners. The solid yards have held firm. They could accept rescheduling, modify payment terms, agree to change ship types, but 1<sup>st</sup> division shipyards that have met or will meet their contractual requirements, generally don't cancel<sup>3</sup>. In fact, the harder the owners press, the more motivation it gives the shipyards to complete construction of the orders at their own cost and account in order to prove the “damages” that the yards could claim against their client who defaulted payment, which is what the yards are entitled to do (and intend to do) under the shipbuilding contract.

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<sup>1</sup> Admittedly we don't know all main engine makers indicated around 10%.

<sup>2</sup> In the correct contractual sense – we insist that the term “cancellation” as commonly referred to is “mis-used”. Ship-owners or shipyards can only cancel a contract when strict contractual conditions are fulfilled. Otherwise they shall be called “termination by mutual agreement”.

<sup>3</sup> This is one of life's ironies – it seems to suggest that it is better to contract at “bad” yards...

We think in many cases “green shoots” are far worse than no recovery, to the extent that it encouraged “muddling through” mentality on the part of the ship-owners, banks, shipyards and the national governments which support the yards. Near death experience sometimes give the people involved a sense of invincibility as if they had been saved by divine intervention. Some may increase their bets. The recent surge in BDI (which we didn’t believe will last) surely played a part in the rumor that a large number of capsizes and panamaxes have been ordered in May. We speculate that this is part of the PR campaign to increase value of the firm as the yard in question was in talks to sell 50% of its shares. A large amount of shipbuilder financing have been injected into some “too-big-to-fail” troubled yards to make sure that they can complete what they have been contracted to build, and more.

That leads to the crux of our current comment. We foresee that increasing amount of shipbuilders will become ship-owners. That can’t be good news for pure ship-owners, or the shipping industry at large.

Shipbuilding owners are nothing new. Many Japanese shipyards practiced traditionally building “stockboats”. They often have ship-owning companies which contract ships at their own shipyards. Sometimes they sell to genuine 3<sup>rd</sup> party buyers at delivery. Sometimes they charter the ships out long-term at low rates until the market recovers. This started as a way to ensure minimal workload for the shipyards in depressed markets so it could continue as a going-concern. That is understandable. Some tax considerations also apply (notably for some offshore yards in Singapore).

However, during the past shipping boom, this practice has become “entrenched” as a business model for shipbuilding. Many owners had ventured into shipbuilding, and increasing number of shipbuilders were building ships for their own account (sometimes disguised as “3<sup>rd</sup> party”) for a variety of reasons. In China, many private yards are building “commodity ships” on the speculation that a foreign owner will eventually emerge to buy the newbuilding as resales. Some shipyards just do it for no reason rather than having too much money to play with; some shipbuilders are jealous of the large windfall made by ship-owners (especially the skillful resale players who managed to resell their slots even before they have to secure financing). Some shipowners invest in shipyards to gain “strategic” access to newbuilding or repair berths.

When newbuilding demand died off, we seen renewed interest in Japan to apply the ‘stockboat’ formula. We heard plans of many medium/big Chinese shipyards to form ship-owning companies to take over slots abandoned/terminated by shipowners or slots which have simply been “reserved”, in order to maintain production flow.

Even in a good market, we hardly think that such a horizontal integration is advisable. The trouble is that shipowning and shipbuilding are very different businesses. Shipowning is high-risk/high-reward, shipbuilding is a margin-plus business (for a general discussion on pricing structure of various shipping sectors and shipbuilding, see [On Oil Pricing Regime \(II\)](#) dated 22nd May 2009). The interests of a shipbuilder (highest price possible) are directly opposite of a ship-owner (lowest price possible). It is very difficult for anyone to wear two caps at the same time, lest one ends up spending much time mediating the conflicting interests of the two instead of trying to excel in either. The trouble with conglomerates is that it is very often “averaging down (in ROE)” rather than “averaging up”; unless it is organized as a very loose group controlled by the same

holding company (how many investors other than Warren Buffett could be happy when Wells Fargo refused to underwrite bonds for Berkshire Hathaway?). We can't see any evidence that even the best of yards with large shipowning interest come out ahead in the long run (we will revert to this point in a later comment).

What may not have worked well in the rising market as a sales strategy (or to avoid new regulations) will definitely not work in a bad market such as today. Shipbuilders becoming ship-owners is an absolutely terrible idea. It simply means that whatever was not wanted by the market (to the extent ship-owners represent the market) will be built, completed and delivered. It doesn't matter how high the BDI can be manipulated in the short term by cheap cargo (spot iron ore still cheaper than the new benchmark price agreed by Japan which was 33% less than last year), port congestion, and financial flows, there are simply too many ships on order. We are afraid that the actions (or lack of same) from both owners and shipyards so far are not shifting the supply-demand balance in the right direction in any meaningful way: ship-owners continue to wish that they can bully the yards to sacrifice their interests to let owners off the hook without compensation; shipyards - supported by government liquidity - form shipowning companies to operate the ships either contracted for own account or abandoned by owners who didn't pay as per contract.

The best advice we can give is still, as before, to sit down and reschedule the orderbook as far as practically possible. We have confirmed that some postponement is done, but not nearly enough. The shipbuilding capacity is simply gigantic. A great number of shipyards can deliver more than 50 ships each year. The last thing shipping needs is that more of them become shipowners.

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