POTEN TANKER OPINION

The Boom Before The Bust

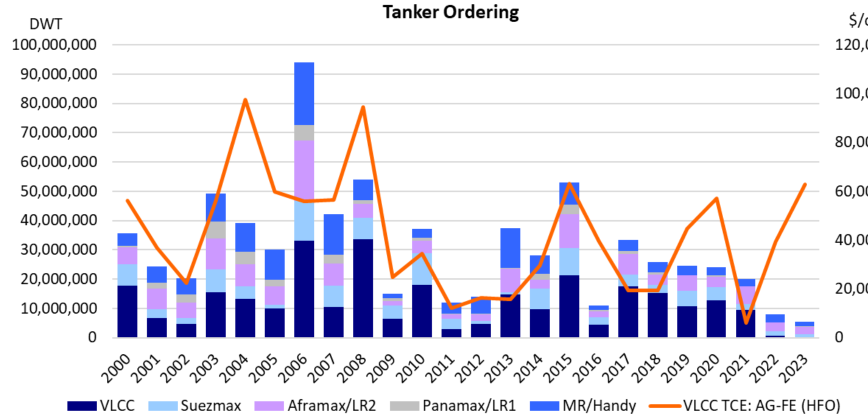
Strong tanker earnings are here to stay (for a while)

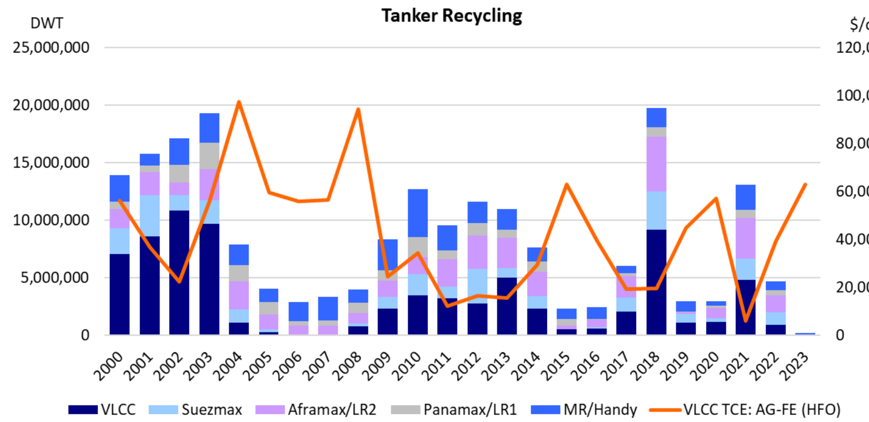
In most discussions about the future direction of the tanker market, the supply of tonnage (or lack thereof) is one of the key reasons that shipowners are generally optimistic about the next three to five years. Tanker owners are optimistic despite the challenges that are looming in the future such as tightening environmental regulations and peak oil demand. An unusual combination of circumstances, including geopolitical unrest, financial challenges and regulatory uncertainty have created a bullish market environment. In this Weekly Opinion we discuss the main drivers of this optimism.

The tanker market goes through cycles. Tanker demand is a derivative of oil demand and as such is highly dependent on global economic activity. Given the geographic location of much of the worlds' oil reserves, geopolitics also play a major role. In the past, conflicts in the Middle East have had a major impact on oil trade flows and tanker freight rates. More recently, the Russian invasion of Ukraine caused havoc in the markets. Black Swan events like the global pandemic also drove extreme volatility in the markets.

Tanker supply responds to market movements in a mostly rational fashion, although the highly fragmented nature of the industry and the long-life nature of the assets (20-25 years) makes the tanker industry prone to boom-bust cycles. Strong freight markets stimulate high levels of new orders, usually above and beyond what is needed to satisfy demand growth and fleet replacement. Delivery of all the new capacity frequently coincides with a cyclical economic slowdown and contributes to a market collapse. As a result, owners stop ordering new vessels and a period of poor earnings ultimately leads to an increase in tanker recycling, which balances the market and causes rates to start improving again. The charts depicting ordering and recycling activity since 2000 show the natural progression of a "typical" tanker cycle. High levels of recycling in the early 2000's as the last batch of single hull tankers were phased out, combined with the rapid economic ascent of China, set the stage for a strong cyclical upturn. Tanker ordering accelerated and the bulk of the new vessels delivered during the global financial crisis, and the market collapsed.

The current market situation is rather unique. Tanker recycling picked up during the pandemic as one would expect when earnings were very weak. This tightened market balances, especially since new orders had been gradually declining since 2017. At the same time global oil demand was staging a strong recovery from the depths of the pandemic. The only thing the freight market needed to ignite was a spark. This was provided by the Russian invasion of Ukraine and the reshuffling of trade flows that resulted from the sanctions imposed on Russian crude oil and refined product exports. Freight rates skyrocketed for both crude oil and product tankers.





Source: Poten & Partners

Under any "normal" scenario, this would lead to a significant increase in tanker ordering. Owners, flush with cash would want to put their money to work. However, this has not happened (so far). There are a number of reasons for the owners' reticence. Firstly, vessels are currently expensive: a newbuilding VLCC costs $127 million (33% more than two years ago). Secondly, shipyards are fully booked, mostly with other vessel types, like container ships and LNG carriers. This has extended delivery dates into 2026, creating significant market uncertainty. Thirdly, the myriad of ever tightening environmental regulations and the uncertainty around fuel availability and pricing makes it very difficult for shipowners to decide on a propulsion system. Should they stick to a conventional diesel engine, choose a (largely unproven) alternative or keep their options open with (more expensive) a dual or triple-fuel engine. Not surprisingly, many shipowners decide to sit on the fence and wait, especially since financing these assets has become much more expensive as well.

Ordering will pick up at some point. Some brave owners will dive in, and others will follow, but even when that happens, meaningful deliveries will only start in 2026. Owners are looking at an extended window of strong earnings.