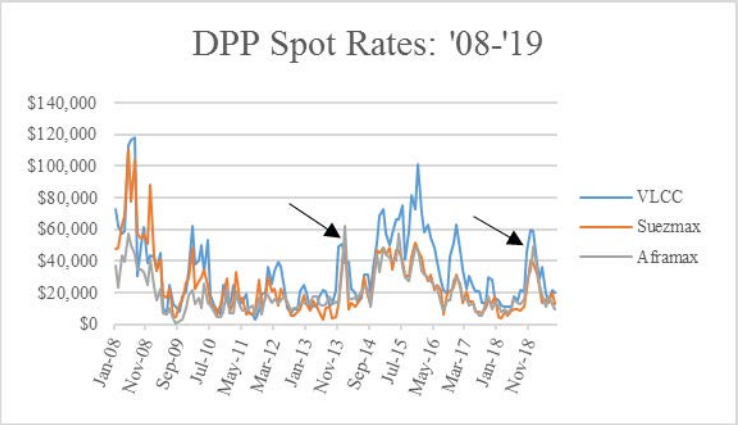
The Tanker Cycle

The tanker order book for 2019 never looked anything but daunting. But the amount of scrapping in 2018 went a long way toward convincing this market observer that owners might have found religion, so to speak, at least temporarily. If what began in 2017 and continued in earnest during 2018 could persist through 2019, fleet growth might have been sufficiently tempered to allow for some upward momentum in spot rates. Indeed, looking at rates in late 2013 suggests we might have been at a similar point in the business cycle to 5 years prior.



In late 2013, the dirty tanker markets had a decent run that lasted around three months during the Northern Hemisphere winter. That said, even though rates for all three segments spent time above $40,000/day, the scrapping of 2013 continued apace in 2014 after rates, by March '14, returned to levels mirroring the previous three years. Things had been so bad for so long at that point that tanker owners (in aggregate) probably deemed the spike little more than seasonality, and ended up removing more units than were delivered in 2014 (across all three DPP sectors).

Fast forward through the business cycle since and compare the four months from October '18 to February '19 with the same period 5 years earlier. In both cases, the winter spike appeared merely seasonal and came after an extended period of low rates. In fact, the spikes were probably the early returns from years of steady scrapping that served to partially offset the surge of ships ordered during the prior optimistic times. The point of divergence is that scrapping continued through the summer of 2014, whereas scrapping has more or less halted during the first eight-plus months of 2019. Deliveries have not. The table below gives a sense of how out of place 2019 looks in terms of scrapping, given the rates.

The numbers more closely resemble the up year of 2015 and its successor 2016 than the down years when scrapping was heavy. And while we've left room for more scrapping for the rest of the year, given the recent fall in scrap prices, it is increasingly likely that we won't hit the already-reduced targets.

	VLCC			Suezmax			Aframax / LR2			Panamax / LR1			MR2		
		Present:	767		*Present:*	548		*Present:*	1,020		*Present:*	449		*Present:*	1,739
		Total Orderbook:	81		*Total Orderbook:*	35		*Total Orderbook:*	91		*Total Orderbook:*	26		*Total Orderbook:*	136
		% of fleet on order:	*11%*		*% of fleet on order:*	*6%*		*% of fleet on order:*	*9%*		*% of fleet on order:*	*6%*		*% of fleet on order:*	*8%*
Breakdown of deliveries & removals	***Deliveries***	***Removals***	***Growth***	***Deliveries***	***Removals***	***Growth***	***Deliveries***	***Removals***	***Growth***	***Deliveries***	***Removals***	***Growth***	***Deliveries***	***Removals***	***Growth***
2013	30	-17	2.16%	17	-8	2.14%	18	-27	-1.01%	10	-8	0.49%	78	-15	5.08%
2014	24	-17	1.14%	8	-9	-0.23%	16	-25	-1.02%	4	-5	-0.25%	83	-10	5.60%
2015	20	-3	2.58%	9	0	2.10%	28	-6	2.52%	3	-9	-1.48%	107	-2	7.63%
2016	47	-3	7.06%	26	-1	5.71%	53	-9	4.92%	18	-1	4.25%	91	-13	5.27%
2017	50	-24	3.81%	51	-12	8.42%	63	-33	3.20%	21	-6	3.60%	62	-16	2.95%
2018	39	-29	1.98%	31	-20	4.78%	50	-44	0.93%	13	-8	2.31%	57	-30	4.80%
YTD 2019	50	-5	6.23%	25	-3	4.18%	45	-2	4.40%	9	-2	1.58%	67	-10	3.39%
Remaining 2019p	*22*	*-4*	*2.35%*	*4*	*-2*	*0.36%*	*11*	*-5*	*0.59%*	*8*	*-3*	*1.11%*	*41*	*-6*	*2.01%*
Full-Year 2019p	*72*	*-9*	*8.73%*	*29*	*-5*	*4.56%*	*56*	*-7*	*5.02%*	*17*	*-5*	*2.71%*	*108*	*-16*	*5.47%*
2020p	45	-25	2.55%	18	-15	0.55%	31	-25	0.58%	10	-11	-0.22%	74	-36	2.14%
2021p	12	-23	-1.37%	13	-18	-0.90%	37	-40	-0.29%	8	-4	0.88%	18	-55	-2.04%
2022p	2	-37					9						2		
2023p	0						3						1		
Net present through end-2023p	***81***	***-89***	***-1.04%***	***35***	***-35***	***0.00%***	***91***	***-70***	***1.76%***	***26***	***-18***	***1.78%***	***136***	***-97***	***2.19%***

Expectations Surrounding IMO 2020

So where are we now? Looking back at 2014-15 as a reasonable analog, we would have expected this coming winter to be the beginning of an upcycle. Indeed, across all tanker asset classes we cover, rates have been better so far in 2019 than they were to this point in 2018. While it is still September, the whole year appears to be well-positioned to outperform 2017 too.

So, without the IMO 2020 regulations, all else equal, we would have expected an improving rate environment going into Q4 '19 and 2020. But that, to some degree, would have depended on the scrapping that hasn't, in fact, occurred. And the extent to which that scrapping *hasn't* happened is the extent to which any upturn will be partially capped or entirely stymied.

But since we live in a world that will indeed face the IMO 2020 regulations, we have to layer that issue on top of our expectations. Indeed, there's a feedback loop at work here. The regulations are feeding higher spot rate expectations, which has led to stronger TC rates in the face of still-depressed spot rates, which has led to less scrapping, which, finally, all else equal, must mitigate to some extent the actual appearance of higher spot rates.

$/day	VLCC	Suezmax	Aframax	LR2	Panamax	LR1	MR	Handy
Q1 2017	**$34,781**	**$19,357**	**$19,112**	**$13,590**	**$11,579**	**$10,635**	**$11,935**	**$11,575**
Q2	**$25,352**	**$12,203**	**$11,342**	**$9,379**	**$6,714**	**$7,906**	**$11,391**	**$8,226**
Q3	**$15,985**	**$8,413**	**$8,482**	**$13,194**	**$5,641**	**$10,655**	**$9,137**	**$8,350**
Q4	**$25,117**	**$15,380**	**$13,466**	**$13,664**	**$8,457**	**$10,142**	**$9,974**	**$10,775**
Q1 2018	**$12,709**	**$5,563**	**$9,846**	**$11,850**	**$7,257**	**$9,149**	**$11,809**	**$10,566**
Q2	**$13,255**	**$8,052**	**$10,919**	**$10,579**	**$6,261**	**$9,228**	**$7,452**	**$6,769**
Q3	**$19,045**	**$9,579**	**$14,263**	**$10,625**	**$6,750**	**$8,150**	**$5,496**	**$4,705**
Q4	**$55,469**	**$34,064**	**$37,087**	**$19,584**	**$16,593**	**$15,410**	**$14,772**	**$11,459**
Q1 2019	**$37,886**	**$21,357**	**$28,338**	**$22,724**	**$18,378**	**$18,864**	**$15,043**	**$15,521**
Q2	**$18,783**	**$16,465**	**$13,784**	**$17,205**	**$12,282**	**$14,786**	**$13,212**	**$11,845**
Q3	*$27,000*	*$15,000*	*$13,500*	*$17,000*	*$11,000*	*$15,000*	*$11,750*	*$8,000*

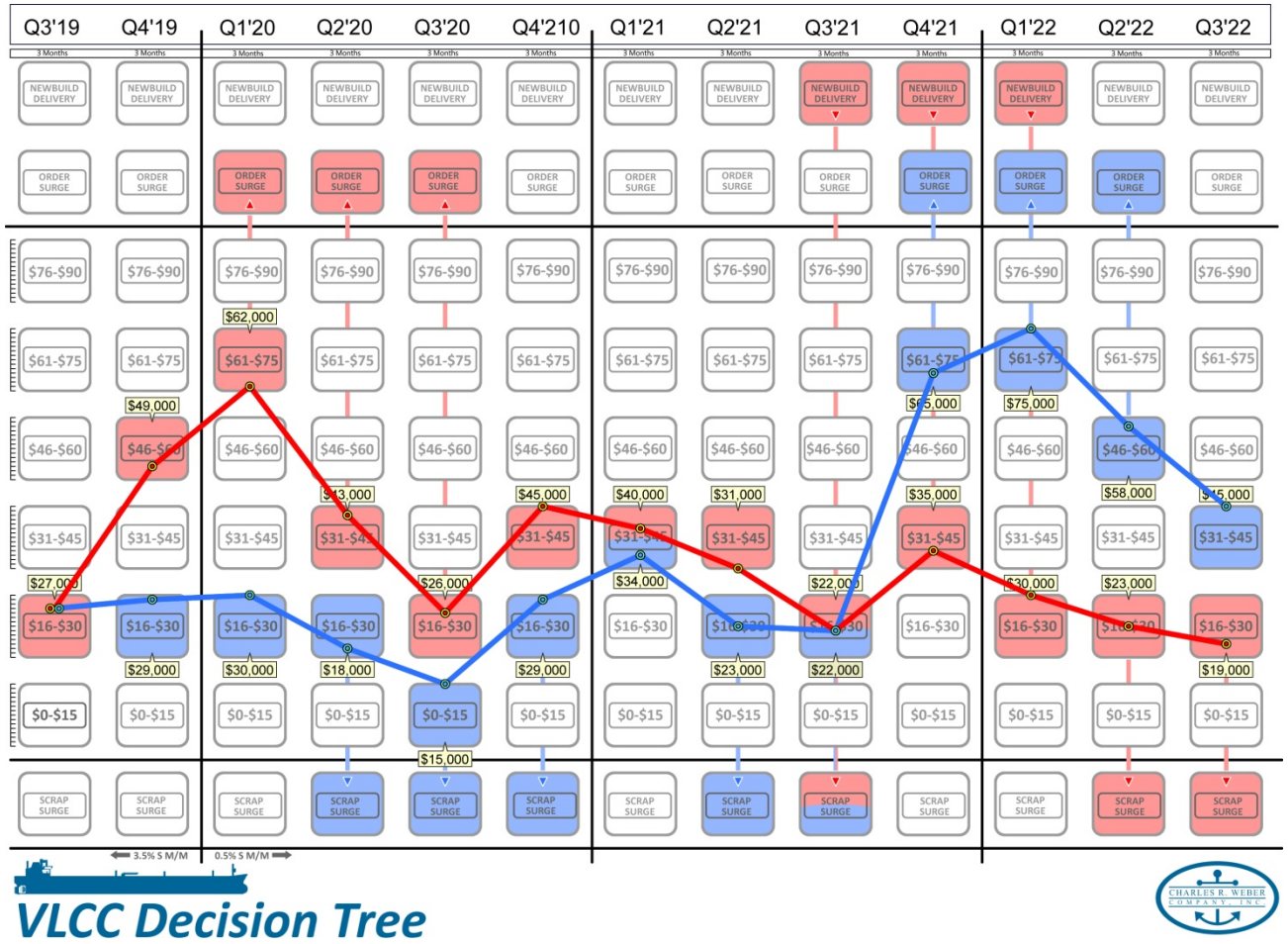
This is not to say that we don't see a stronger Q4 '19 and FY '20. We do. The business cycle aside, we think that short-term systemic inefficiencies will increase demand for tankers in 1H 2020 as the new IMO-compliant fuel finds its way to all the bunker ports calling for it. We also believe there is a decent chance that an unusual number of ships will head to the yard to be fitted with scrubbers if the spread between HSFO and VLSFO turns out to be compelling. Flows of this kind should dampen the supply of ships, if sporadically. We hear anecdotally that scrubber fitting is taking longer than expected, and is not always working as expected. Indeed, we had heard that one vessel's engine room flooded because of a scrubber malfunction. That rumour now appears to have been confirmed by a viral video purporting to show the event.

HSFO could also find its way into new trades. And hanging over it all is the increasing threat of violence in the Persian Gulf, which could reasonably be credited as one reason for the relatively strong VLCC performance so far this summer.

Deciding Where We Are

Still, the question remains, where are we now? Because the dearth of scrapping has thrown additional uncertainty into our place along the business cycle, we can't be sure. So this exercise posits a couple of scenarios that may prove useful for decision-making in the coming months. The upshot is that we should know by the middle of 2020 what impact the new regulations will have. And the impact on rates is likely to drive investment decisions for the tanker market in aggregate. That, in turn, will help to place us on the cycle.

To be clear, our Decision Tree to the right is not a prediction of absolute rates. Rather, it is meant to propose the different outcomes that we would associate with the current market environment prevailing at two different points on the business cycle. So, a scenario analysis, if you will…but a scenario analysis that posits two different opening gambits. And these are only guidelines. The degree to which actual outcomes differ from the scenario lines we have chosen (after two to three quarters forward) is the degree to which the feedback loop from building and/or scrapping may be amplified or muted by frictions from regulatory compliance, and the consequent rates driven higher or lower.



The Scenarios

1. If the lack of scrapping *doesn't* have an impact and the onset of IMO 2020 regulations does, rates are likely to surge again this winter. And if they do surge, and that surge lasts through the middle of the year, we would expect the ship-owning community to quickly and aggressively flesh out the order book for 2021 and 2022. The realization of that order-book, some twelve to eighteen months later, is likely to put an end to strong rates, if they even manage to persist that long. This is, of course, dependent on owners being able to finance such ordering. But a frothy rate environment often encourages the animal spirits that get such things done.
2. If the lack of scrapping *does* have an impact and the IMO 2020 regulations turn out to have only a brief and muted impact on the market, rates may be weaker than many have forecast. If Q2 '20 looks like Q2 '19, we would expect owners to lose much of their optimism. Special survey investments, ballast water treatment requirements, and, potentially, higher fuel costs may conspire to force older ships to the scrap yard. In this scenario, which might be the healthier one for the market, we would expect a large number of ships to scrap in 2020 and 2021. We would also expect the 2021 and 2022 order-books to grow more slowly than is typical.

(We've included a table here to give a rough feeling of how many tankers will be facing the need to invest for continued trading. The implication, of course, is the degree to which the tanker fleet may be rationalized in the coming years, the order book notwithstanding. We can't stress enough that the regulatory environment makes the investment decisions more acute this time around than they would otherwise be.)

Ship Count by Vintage

Built	VLCC	Suezmax	Aframax	Panamax	MR
2000	27	18	17	9	24
2001	20	14	12	4	18
2002	35	24	34	9	38
2003	36	21	73	20	71
2004	28	27	53	36	96
2005	31	23	61	45	87

Conclusion

These two scenarios suggest divergent alternative futures for the tanker market. If the coming winter brings a cyclical upturn that is amplified by disruptions from scrubber installations and other IMO2020 frictions, the likely inflation of the order book and the increased likelihood of ship-owners investing to keep older units in service may result in a vastly over-tonnaged market for years to come. However, if the industry smoothly navigates the regulatory shift and the cyclical upturn is muted this winter by deliveries and a lack of scrapping, the likely rush to scrap in 2020 and 2021 could rationalize the fleet to an extent that we haven't seen in quite some time.

We have endeavored here to communicate a concept that, while not overly complex, might provide a framework for industry participants to utilize as they wrestle with some of the current uncertainties. As ever, we here at Charles R. Weber are happy to answer questions, and to help guide and execute any actions our research might engender.

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