Capital Link Shipping Conference Keynote Speech

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We first invested in shipping four years ago and have learned a lot from the recent traumas. We now know that ship owners are like real estate developers. If they can get the money they will build the next project, whether it is really needed or not. Also, unlike most industries, shipping cannot influence the overall demand for its services. No shipper charters an extra vessel because rates are low. Price cutting just causes losses. However, the industry's extreme fragmentation makes it impractical to balance supply and capacity the way other cyclical industries do. Aside from these peculiarities, it is a great industry.

There has been consistent, but modest demand growth except for a small dip in 2009, and the range of new build orders as a percent of the fleet remained between 10% and 15% from the 1990's through 2003 but then rose to an absurd peak of 61% in 2008. It took until 2013 to get the ratio down to 20%, still a huge percentage. Scrappage has been only a partial offset, peaking at 4.1% of the fleet in 2012 before dropping back to 2% last year. This surprisingly low 2% implies a 50 year average life and therefore is too low to be sustainable. Gyrations in net incremental supply are why rates and vessel values are so volatile.

Because of these factors, total fleet growth exceeded 6% per annum consistently from 2003 through the first quarter of 2013 and peaked in excess of 10% in both 2011 and 2012. We are still paying the price for this irrational exuberance, but in some sectors the outlook is improving.

Shipping's fragmentation makes it very difficult to idle capacity when supply exceeds demand. For example if there is a five percent capacity excess and your fleet is fewer than 20 vessels you cannot moderate capacity proportionately. Instead owners cut their rates to protect utilization. A partial solution to this problem is slow steaming. But this practice simply offsets part of the lower rates by consuming less bunkers. It does not stabilize prices.

This brings up another strange aspect of marine transport. There is virtually no price elasticity of demand. Charter rates are a small percentage of the delivered price of cargo, so no shipper charters another vessel simply because rates have come down. Therefore all that happens when rates are cut is that the shipping companies lose money. If, as we believe, the industry does undergo meaningful consolidation during the next few years, rates will become less volatile because the larger entities will find it more economical to lay up a small portion of their fleet rather than to endure a rate reduction on the whole fleet. This is how other industries function. Shipping's structural problems can only be cured by means of massive consolidation.

Despite the problems, prices of both new builds and second hand vessels bottomed out early in 2013. Just when our Transportation Recovery Fund started taking over new builds for delivery late in 2015 through early 2017. We now have more than $1 billion of commitments on 126 vessels plus $800 million of orders placed by our Navigator and Diamond S companies. Our theory is that somewhere in that time frame rates and values will recover and that low priced eco vessels purchased with cheap financing will do especially well. Our earlier investment in Diamond S was structured similarly in that we had product carriers on long term charters to offset the volatility of spot rates in the Suezmax fleet from the purchase date through most of 2015. That structure enabled us to service our debt easily through the recent bad periods for suezmaxes. Now the Suezmaxes are quite profitable and the challenge will be trading the MRs as their charters run out. Navigator is our other investment and has performed very well from inception to the present even though the stock is back down around its IPO price. David Butters is at this conference so I will not talk about LPG, but instead will make a few more macro observations and then go into the outlook for our tankers and dry bulk carriers. Last year only half of the companies in Bloomberg's shipping index were profitable but 75% expect profitability in 2015. Their stock index declined 15% last year and is up only 0.5% this year, leaving most of them trading at or below book value. Last year, consolidation of shipping started and we believe will accelerate this year, with M&A volume two or three times the 2014 level. This will be especially true in the spot market segments. A larger fleet there improves the chances of getting the first call and that superior intelligence improves your ability to triangulate. There also are G&A and purchasing synergies, and the ability to bring in house formerly outsourced functions.

Let's turn to our forecast for oil. We believe that over production and excessive inventories will last well into 2016. Rig count in the U.S. is down 40+% but production is actually up so far this year. This is because the shift from vertical fracking to horizontal is continuing and is much more productive so it will take a while for production to decline. Second, E&P companies are renegotiating costs with their service suppliers, cutting costs by as much as $10 per barrel, so they can survive as companies through present low prices. We expect that prices eventually will level at somewhere in the range of $60 to $70 because that seems to be the range at which there will be enough incremental supply to offset the decline curve and meet demand increases. But it will take a while to get there. The Saudis not only have not cut production but actually have been increasing their production somewhat to push prices down. They appear to have both economic and geopolitical reasons to hold the price down for an extended period. Letting it go back up quickly would encourage short lead time shale production and would reduce the pressure on the Saudis' enemies, especially Iran and Russia. Meanwhile the U.S. is running out of storage capacity because of record breaking inventories of 450 million barrels. Excess supply is not just a one shot thing. It recurs every day. This is why inventories increase each week. The good news for shipping is lower bunker costs for a long period and the probability that lower prices eventually will trigger modest elasticity of demand. But most developing country governments have cut or ended their previous subsidies of petroleum products, so their consumers will only benefit partially from the reduction. Probably the extra global demand increase from low prices will be only 500,000 to 700,000 barrels per day, a fraction of one percent relative to 92 million barrels per day of crude. But global ton miles of crude and petroleum products will grow faster because of the increasing refinery capacity in China and India, much of which will be for re-export. President Obama's veto of the Keystone Pipeline will increase U.S. demand for seaborne heavy crude, but most of the Canadian oil sands output will be carried by rail to the U.S., just as it is today. If sanctions against Iran are lifted, there will be some incremental exports but the amount will not be huge because the sanctions already exempt the country's three major oil customers, China, India, and Japan. The reduced pump prices have boosted the sales of larger less fuel efficient cars in the U.S. but this is small relative to a global market of 92 plus million barrels per day. Prospects for exporting crude from U.S. are not good. The Energy Secretary seems to be quite negative on the idea. This administration simply doesn't like hydro carbons. There also is heavy lobbying by American refineries and the chemical and plastics industries against expanding exports of either crude or LNG. Meanwhile, the low prices of oil and the unfavorable terms proposed by the Mexican government will retard the expansion of Pemex and Petrobas’ expansion will be delayed by the corruption scandal in Brazil. The biggest danger to seaborne hydrocarbons is the potentially slower growth in the emerging markets because they have been the incremental drivers of demand.

On balance, we believe that tanker ton miles will rise 3% in 2015 and 3.5% in 2016. With a slim order book for VLCCs and Suez Maxes, the outlook for both utilization and charter rates, or even more is good. Another $10,000 to $20,000 in VLCC and Suezmaxes rates would not be surprising.

Let’s turn now to dry bulk. China is of course the wild card for most parts of shipping. It is the largest importer of oil, coal, iron ore, copper and nickel and the largest exporter of containers. Despite strong demands, dry bulk has been burdened with over capacity. Rates dropped by about 5% last year from already low levels. Only two of the 10 companies in Bloomberg’s dry bulk index were profitable last year and that group of stocks is down another 5% this year after a 15% decline last year despite slight increases in shipping equities over all. Yet, Bloomberg last week forecast a 27% rate increase in 2015 despite a 6% net increase in capacity. We have 22 Ultramaxes and two capesizeds on order for delivery though 2017 but have none on the water now, so I hope that the Bloomberg report is correct. They are bullish on the demand for seaborne cargo mainly because of India and China. Those two accounted for 85% of growth in seaborne dry cargo demand growth since 2008 and India now roughly equals China in total demand. Jefferies foresees a 13% increase in India's thermal coal demand, to 160 million tons this year. Coal generates 60% of India's electricity and the Supreme Court there cancelled domestic coal mining permits for captive use. Jeffries also expects that Japan will continue to idle nuclear reactors and this will increase Japanese coal imports by 3%. As to iron ore, Bloomberg expects Australia's exports to rise by 65% due to expansion of mines in the Pilbara region. But there may be some displacement of Brazilian shipments to Asia and Brazil is three time as long a voyage as Australia, so that is a negative trade for shipping. There also is some confusion over the extent to which Vale's sale and lease back with Cosco might permit Valemax vessels to enter China. I am skeptical about the outlook for China's steel industry as the economy's growth rate slows and the mix of the GDP swings away from capital expenditures and toward less steel intensive consumer goods and services. Because of slack domestic demand China increased its steel exports last year by about 80 million tons. Consequently, many steel dumping cases seeking countervailing tariffs have been brought against China. For example, the European Commission will impose tariffs on €620 million of cold rolled stainless steel imports from China and Taiwan of 25% and 12% respectively. Jeffries estimates that the growth rate of seaborne iron ore will drop from 12% in 2014 to slightly over 6% this year and recover to about 7.5% in 2016, despite nominal growth in Chinese steel production. Morgan Stanley forecasts 4.6% growth this year to 1.43 billion. Both expect seaborne iron to gain market share from domestic miners. Arctic Securities on Friday forecast a 5% growth rate and a 73% market share for seaborne iron ore. Perhaps coincidentally capesize charter rates rose for the third consecutive day. Last year ore imports rose by roughly the same 100 million tons as consumption of domestic iron ore declined. China's steel industry consumes 70% of seaborne iron ore and about 40% of industrially mined commodities on average. Separately, Indonesia's ban on raw material exports will cause China to buy more nickel from Philippines. This ore has a 35% lower nickel content than Indonesian nickel ore and therefore will require a similar increase in tonnage imported. Just one 30,000 ton per year project, the Tsingshan/Bintang Deplan venture is likely to come on stream in 2015 in the Philippines. It will ramp up next month. Meanwhile, Chinese inventories of nickel peaked at more than 15 million tons in November and now are less than 11 million. By June those inventories hopefully will be sufficiently low that incremental demand will need to be met by seaborne supply. Similarly, China is ramping up its exports of aluminum. The government had put a tariff on exports of raw aluminum in order to hold down the consumption of pollutive electricity, but Chinese aluminum producers have devised a semi-finished form which is exempted from the tariff and also benefits from the partial VAT rebate on exports. This semi-finished aluminum is then shipped to a wholly owned facility in Vietnam and re-exported as finished goods. This export maneuver will cause more bauxite to be imported from Australia, India and Africa.

Despite analysts' optimism, second hand dry bulk vessel prices have dropped by 39% from their February 2014 peak and supply increases of 5+%

have exceeded the 4% increases in demand. Hopefully, the gradual absorption of capacity will result in a more favorable environment by the time our vessels are launched.

To end on a happy note, the forty percent decrease in bunker cost since June 2014 to $380 per ton is a welcome reduction in operating costs and if our forecasts for the price of oil are correct, a high proportion of these savings will continue throughout the next few years. Perversely, this will reduce somewhat the economic advantages of the new eco vessels but those still will benefit from the new limits on sulfur effective January 1 in emission control areas. To the extent that owners of older vessels have to switch to higher cost distillates, they will give back most of the discount in the base price. As is usual with marine transport both the questions and the answers are complex and complicated by multiple intervening variables moving in divergent directions. But, there also is one eternal truth. The ship owner community survives despite lurching from one crisis to another and the people who time their purchases and sales correctly make high rates of return. Since we believe we are generally headed in the right direction, we intend to increase selectively our exposure to the space. The outlook for rates is generally good and where else could we meet so many larger than life entrepreneurs?