



NO. 7 – A HERETIC IN THE HOUSE OF HYDROCARBONS

MAY 9, 2013

News headlines pertaining to the tanker market have been dominated by reports surrounding the positive sentiments of the clean tanker markets. On the back of this, orderbook activity has remained robust with the primary focus remaining on eco-design tankers. The dirty tanker segment meanwhile remains shrouded in a dark cloud that refuses to dissipate. This has been based on ample tonnage availability, shifting trade patterns and a tepid recovery in the global economy.

At the start of 2013, McQuilling Services published our Tanker Market Outlook and our research indicated that fundamentals in the clean and dirty tanker markets would move in the opposite direction than that which has actually transpired. This outlook was based on an uptick in the dirty tankers, driven by elevated exits on the back of reduced earnings, and a low orderbook. The clean tanker market was expected to be pressured by an increase in intra-regional trade an excess of tonnage, particularly for MR2 tankers and a shift to LR classed vessels.

The MR2 fleet, as maintained by McQuilling Services, consists of clean tankers and IMO 3 vessels (40,000-54,999 dwt), of which we recorded respective deliveries of 34 and 19 in 2011 and 2012. If we count IMO 2 ships, which are able to compete for cargoes, the MR2 fleet grew by a more robust 118 vessels during these two years.

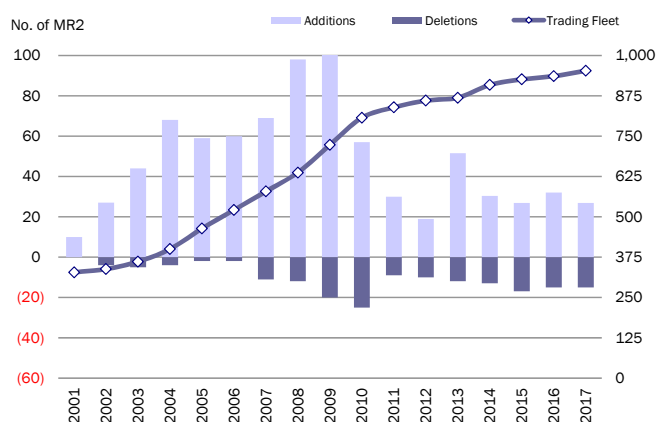
Throughout the current forecast period, we expect the MR2 fleet, excluding (IMO 2) to post a net growth of 96 vessels. This expansion can be viewed on Figure 1, and at the start of 2013 our methodology put the MR2 fleet at 869 vessels. This figure accounts for anticipated delivery delays from shipyards.

Further indicating that a supply imbalance could be on the horizon, 75 of the 121 new tanker orders that were placed since the start of the year were for MR2s (Figure 2), including IMO 2. Without considering delivery delays, these orders could boost MR2 tanker supply by 32 vessels in 2013 and 29 in 2014.

Our proprietary data shows that there are approximately 120 coated Aframax and Panamax vessels that are trading crude and residual products. If the clean market posts a rapid rebound, a portion of these tankers would likely be cleaned-up, further boosting available supply that can compete with the rising inventory of MR2 tankers.

Our ton-mile demand growth estimates show an annual average rise of 2% for clean products in the medium term. In 2013, we forecast that there should be some downward pressure, driven by reduced consumption by OECD nations, while downstream expansions in non-OECD countries support the trend of intra-regional trade. Over the medium term, we expect that the larger LR2 and LR1 tankers will find greater employment opportunities to export petroleum products.

Figure 1: MR2 Additions, Deletions & Trading Fleet



Source: McQuilling Services

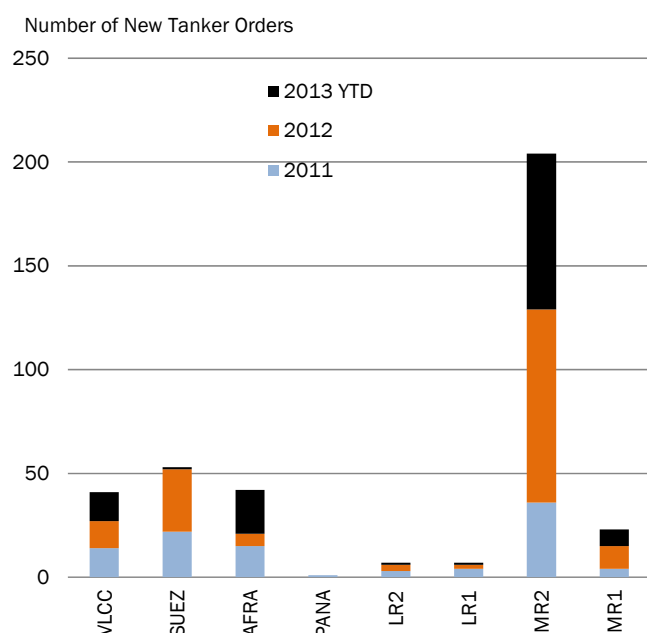
One of the traditional clean tanker markets, Caribbean to the US East Coast, is fading further. On top of the closure of the 350,000 b/d Hovensa and 235,000 b/d Aruba refineries in 2012, the shuttering of the 335,000 b/d Curacao refinery in the Caribbean is also being discussed. If this transpires, it will all but eliminate product movements from the Caribbean to the US Atlantic Coast. These units could be turned into storage depots, providing a greater benefit to parcels sourced from further afield on larger tankers.

Additional strain for MR2 demand is likely to stem from industry consolidation in Europe, which according to JBC Energy, witnessed the closure of 1.6 million b/d of downstream and terminal capacity since 2009. At present, the consultancy estimates that some 880,000 b/d are proposed to be sold, and it would be reasonable to anticipate at least a small portion may be closed. Flows from the United States to Europe will remain present, but Russia's development of its downstream sector should provide another source of primarily land based supply.



In the longer term, as rail and pipeline delivery capacity expands, the spread between WTI and Dated Brent should narrow. This will erode the pricing advantage that has allowed utilization levels and product exports to remain elevated. Although the plan is still being considered, the Colonial Pipeline, which spans from Houston, Texas, to Linden, New Jersey, is mulling expansions that could add as much as 600,000 b/d of capacity. This has the potential to erode demand on the basis of TC2 by about 45 vessels per year or about four a month.

Figure 2: Tanker Order 2011-2013 YTD



Source: McQuilling Services

Our optimism, particularly for larger crude and residual tankers, was rooted on massively reduced ordering activity (Figure 2) and relatively robust exit profiles. The VLCC sector recorded a net fleet growth of 34 vessels in 2012. This, combined with the previously low orderbooks in recent years, yielded a comparatively low net fleet growth of 34 vessels through 2017. Our data shows that the VLCC fleet expanded by an average of 5% 2010-2012 and is forecast to slow to 2% from 2013. There have been 14 VLCC orders placed this year, but given the origin of some, at present we remain skeptical if they will be built (Figure 2).

Despite these seemingly positive fundamentals, rates for crude and residual fuel transport have languished since the start of the year and are well below our 2013 forecasts.

Nevertheless, we remain optimistic that some support could be around the corner. Between January and May, roughly 1.4 million b/d of refining capacity was scheduled to be offline in the US and Asia-Pacific. These deep turnarounds, combined with global economic uncertainty, reduced demand for crude oil during the first four months of the year. The recent fall in commodity prices in the wake of souring sentiment towards the global economy have the possibility to support the dirty tanker segment.

The boon could come from end-users, traders and governments elevating oil purchases to capitalize on market plays or to store up strategic and/or commercial crude inventories. These activities could help alleviate some of the excess tonnage through fixtures and even the potential for storage.

In summary, we see a laundry list of arguments against a bullish view for MR2 tankers:

- Growing orderbook
- Lackluster deletions
- Competition from IMO 2 MR2s, LR2, LR1 tankers directly and through cleaning up
- Surplus capacity unlocked from slow speeds (~10 vessels per knot) as market improves
- Long hauls favor LR class over MR2s
- Market events such as potential Colonial Pipeline capacity increase or Brazil product demand could alter CPP ton-mile demand

We currently find ourselves in sparse company regarding these views, favoring a stronger performance in the dirty tanker sectors and pressured MR2 rates. At present, the market does not support us, but what if we are right?