The Great Eastern Shipping Co.Ltd
Q2FY14 Results Conference call
(November 11, 2013)

Moderator: Good evening ladies and gentleman, thank you for standing by. Welcome to GE Shipping's earnings call on declaration of its financial results for the quarter-ended September 30th 2013. I now handover the conference to Ms. Anjali Kumar, Head of Corporate Communication at GE Shipping to start the proceedings.

Anjali Kumar: Good evening and welcome to the conference call. As the results were declared on Friday, I am sure that all of you had enough time to go through it. I now handover the call to Mr. Shivakumar, our group CFO to start the proceedings.

Moderator: We have our first question from Mr. Bhavin Gandhi from B&K Securities.

Bhavin Gandhi: If we look at the offshore EBIDTA, i.e. consol. EBITDA minus standalone EBITDA, that seems to have gone up by about 21% sequentially. Rupee depreciation was one part. Could you explain for the balance part?

Shivakumar: That is correct. A large part of it was on account of rupee depreciation. There was no significant change in the realization or in revenue days because we did not add any new asset in this quarter.

Bhavin Gandhi: Going forward, if the operating days were to remain flat and the exchange rate remains at where it is right now, would the operating profits in the offshore business remain stable in the coming quarters?

Shivakumar: Generally we do not give any guidance but one thing that I should point is that we have a big survey coming up on one of our rigs, which just completed a contract and will be going on to another contract. So that rig will have some downturn before she goes on to the next contract. Therefore, apart from the revenue loss for that period, there will also be a significant cost of doing that survey.

Bhavin Gandhi: Are the equipment costs/ modifications which we need to do in the survey for this particular rig built in into the next contract price?

Shivakumar: That is right, we built in the costs when we are tendering the rig. The equipment that is being put in just for the contract will not be expensed out. The survey expenses will be expensed out and the equipment will be written of over the life of the contract.

Bhavin Gandhi: The forex gains during the quarter were also down on a sequential basis?

Shivakumar: It is basically a difference between the opening and the closing of a quarter. Last quarter we had a five rupee difference, whereas in this quarter we had only three rupee difference. That is why it is down from last quarter.

Bhavin Gandhi: Will the depreciation on the dollar borrowings be capitalized?

Shivakumar: That is correct. It will reflect in higher depreciation.

Bhavin Gandhi: What are the un-hedged dollar borrowings that we have on the balance sheet?

Shivakumar: All our dollar borrowings are un-hedged. We have approximately $1.1 bn, or approx. Rs 6900 crs of debt on the books. We also have a dollar denominated cash of close to $350 million in the group.

Moderator: We have our next question from Mr. Vikram from Antique Stock Broking.

Vikram: What is the standalone and consol. NAV for this quarter? Also, why has the other income on the consolidated basis gone down so significantly?

Shivakumar: As on 30 Sep'13, the consolidated NAV is Rs 532 per share and standalone NAV is Rs 284 per share. In case of other income, the treasury income dropped drastically during the quarter broadly due to movement in the yields.

Vikram: How many ships were dry docked in the second quarter?

Shivakumar: None of the vessel was dry docked in the second quarter.

Moderator: We have our next question from Mr. Sachin from Lucky Investment.

Sachin: Congratulations on a good set of numbers. If you see the operating EBITDA of shipping business, it is almost flat as compared to June quarter. I thought the spot rates for the dry bulk were slightly better in Q2 and since we were not fully covered, the margins should have been slightly higher. Secondly, if you could give us a broad outlook on shipping & offshore segments going forward?

Shivakumar: Thanks Sachin. There was an improvement in the dry bulk spot rates in the month of September. However that improvement did not come in time to affect this quarter's results and those voyages which were fixed at a higher rate will reflect in the October-December quarter. Apart from that, even in the tanker segments, the rates were little lower than in the previous quarter.

Regarding the outlook, the one bright spot which was there as of last year was the product tanker market which seemed to show some signs of strength. However, it has not been as strong as a lot of people expected in this calendar year. Though there are still reports out there talking of much stronger calendar 2014 and an even stronger calendar 2015.

Sachin: To add on to that, is the market already pricing in some sort of recovery in Europe and US or if this recovery were to continue then the rates probably could start to improve further?

Shivakumar: The market is not necessarily pricing in European economic recovery. Basically, the market is pricing in poor refining margins in Europe & OECD countries and new refining capacity emerging in the developing economies, especially Middle East and China in particular. Therefore, shutting down of OECD refineries in Australia, Japan & Europe will happen which will then be substituted by movement of refined products from the developing countries. That is expected to give a boost to the product tanker trade. However, people have seen this coming in and already have ordered a lot of ships in this year which will cause a little bit of an issue with regard to the sustainability of the recovery or even whether that recovery can hold for much time.

In case of crude tankers, the market has been very weak for the last 2 years. Again mainly because US domestic shale oil production, which has reduced crude oil imports by 2-3 million barrels a day and that continues to be so and that is removing demand for imports of crude. So, that market still seems weak but we see some spurts in the rates from time to time. VLCCs are currently earning $35,000 per day, but still people do not expect much from the VLCC trade going forward. New ordering has also been at a very low rate, which is at least a good sign for the crude segment.

Coming to dry bulk segment, demand growth has been very strong backed by strong Chinese imports of iron ore and coal. On the supply side, fleet growth is expected to be somewhere around 6%. So, supply side is still strong. New ordering has been massive on the product tanker and on the dry bulk side. For instance, in Calendar 2012, 25 mn dwt of dry bulk ships were ordered. Whereas in 9mCY13, 46 mn dwt of dry bulk vessels have been ordered. So, that is the kind of ordering which is happening and if we annualize this 46mn dwt, we are talking of 61 mn dwt being ordered in the full year which would be the 3rd highest on record, including the boom years 2005 to 2007. So it is looking like recovery will be short lived or somewhat muted.

Sachin: This is quite surprising because in between we had reports wherein lot of orders are getting cancelled because of issues with some of the tier 2 yards as well as some of the shipping owners who were facing financial problems.

Shivakumar: A lot of the orders never got cancelled. They actually got postponed. So, owners might have cancelled their orders but other owners went and took up those orders because the yard sold off those slots. They were half constructed or had the equipment and therefore the yards sold at a discount. The ships actually got delivered late but they still got delivered. And now what is happened is that people are seeing just the relative value. They are seeing that ships prices are at 50% below peak levels and shipowners are saying that let us go and place order because it can go up from these levels. Then, there is a lot of new money coming in and chasing ships. Capital markets have been very strong and very favorably inclined towards shipping. Lots of money has been raised from private and public equity in shipping, especially, in the last 9 months and this has triggered this big run of orders.

Also, what has happened is that because of the weakness in the market, some yards have shut down. So yard capacity has decreased and all this money is going only into the top tier or second tier yards. People are not going to the unknown yards like they used to go in 2007. And so the pricing power is still there for the yards and therefore prices have moved up.

Sachin: Can you give outlook on the offshore business?

Shivakumar: On the drilling side, demand seems to be fairly strong. People are expecting E&P spending to come down next year, i.e. about 4-5% increase as against an increase of 8% in this year and 10-11% in last year. But we will have to admit that this year and last year were really massive years in terms of E&P spending. But even a 4-5% increase is still a very strong number. This is in addition to a replacement demand for all the old rigs. In the last 15 months many Chinese Shipyards have got into buildings rigs and they have taken as many orders as a Singaporean Shipyards have taken and these are all first time yards. They have not been able to provide a steep discount but what they do is that they have been giving very favorable payment terms and have been taking orders. So that is a little bit of a concern. But having said that, we will have to see how the delivery record develops. It is not too easy to build a rig so let us see how the delivery happens as against the schedule. But it is still not over-supplied because of the big overhang of old rigs which are still there in the system which needs to be removed. And there are 250+ old rigs which still needs to be removed from operation and we are talking of an order book of about 110 jack-up rigs and the delivery capability is maybe for 45-50 in a year. So there is still a long time to go before you even replace the old tonnage.

Coming to the supply vessels, Chinese threat is much more tangible because they have been able to discount very heavily in the supply vessels business and they are selling at maybe a 30-40% discount to other Asian yards. These vessels come in cheap and compete in some markets like, the Indian market and are bringing down prices and therefore the final realizations. That is a little bit of a threat but overall demand here also remains strong. The only worry is about people bringing in the low capital cost assets and competing and bringing down rates.

Sachin: So, is it fair to assume that the charter rates should be higher in the support vessel side as we go forward?

Shivakumar: I do not expect significant rate hike in the support vessels because we have a heavy order book here, especially on the PSV. The order book is currently at 25% for PSVs and growing. Charter rates are already extremely profitable especially in international market. They are not so much in the Indian market because of the cheap ships which are competing.

Moderator: We have our next question from Mr. Sumit from Standard Chartered.

Sumit: Charter rates in the shipping segment were down in Q2 as compared to previous quarter i.e. Q1FY14. What was the reason behind the same?

Shivakumar: We got some good fixtures in the previous quarter, especially on the product tanker side and therefore we outperformed substantially in the last quarter. This quarter has been a little weaker and therefore the rates are lower. On the dry bulk side, I think the rates were marginally lower than they were in the previous quarter. So it is not a big change, but it is just a seasonal movement of markets between the months. So it is not a trend, but one thing I would point out is that the product tanker rates were exceptionally strong in Q1FY14 and not really a repeatable number.

Sumit: The revenue days have also gone down on a sequential basis

Shivakumar: This is purely because of incomplete voyages. Basically the way we account for voyages is that they get accounted when complete. So if a ship has started a voyage and on15th September and she discharges on 2nd October. Those 15 days are not counted in revenue of the September quarter. So in some quarters there can be a big swing in the revenue days due to this.

Sumit: You earlier mentioned that one of the rig has completed its contract and will be going on to the new one. How many days will the rig lose in the survey and entire remobilization process?

Shivakumar: We will probably lose a month. It depends on how much the work gets generated. Basically, you are doing a full survey, so a lot of the equipment needs to be overhauled.

Sumit: You said that you have factored the cost of this refurbishment in your bid. So does that mean we can see a higher day rate on the same?

Shivakumar: We see prices down from the previous contract because the new contract is a 3 year contract as against an earlier contract of 18 months.

Sumit: As you mentioned, the outlook for the product & the dry bulk segment does not look to encouraging because of the supply overhang. How would you position yourself in this kind of market? Would you be buyers, sellers or just sitting at where you are?

Shivakumar: It is a function of the price. We are buyers and sellers in most markets and it depends on the price. If we are offered a strong price to sell our ship even if we are pretty bullish, we would sell that ship and vice versa. Talking about the current market condition, we are still in net investment mode. We are still think that they are in the bottom quartile of the asset prices for a few of the segments and probably will tend towards buying rather than selling.

Sumit: The Company had plans to list the offshore business. Is there any further thought on that side?

Shivakumar: No as of now there are no plans to list that company.

Moderator: We have our next question from Mr. Ashish Jain from Morgan Stanley.

Ashish: For the standalone business, the other expenses and the fuel cost is down quite sharply both year on year and sequentially. How should one read that?

Shivakumar: Fuel cost depends on how much you have on time charter and how much you have on voyage charter. Fuel cost moves in line with the price of crude oil, so that has come down a bit in the quarter. So that is the change.

Ashish: Why has been the other income down?

Shivakumar: It is basically because of the treasury investments in debt funds which have suffered due to increase in yields in the last quarter. These could get reversed. Lot of it is MTM. So you have to recognize MTM losses whereas you cannot recognize MTM profits.

Ashish: What is the total amount of capex going forward?

Shivakumar: On a consolidated level, we have 4 vessels and one rig to join the fleet which will cost about $300mn in total.

Moderator: We have our next question from Mr. Himanshu from M3 Investments.

Himanshu: My first question is on jackup rig market. We ordered this jackup rig in this quarter but what I can recall from the previous conference calls is that we were slightly cautious on the offshore market. What has been the overall thought process behind this purchase?

Shivakumar: We do not expect the market to weaken substantially from here. If you just look at some numbers, there are 250 old rigs which need to be removed in the next few years. 45-50 new jackup rigs are expected to get added every year. So just to replace old rigs will take 5 years plus of production. Also, every year additional requirement for jackup rigs is generated because of new demand for more drilling in existing fields. There are very few new shallow water fields but old shallow water fields still requires a lot of work. So overall there is this replacement demand which is equal to 5 years of production capability backed by new demand which is coming for the new age jackup rigs. Therefore, we still remain reasonably optimistic on that market and think that it will provide decent returns but because of the number of new yards getting into it, those gains may get capped.

Himanshu: Can you explain the reason for not providing the name of the shipyard where the rig has been ordered?

Shivakumar: That is because of the confidentiality requirement in the agreement..

Himanshu: Have you already chartered this new jackup rig? Is it necessary to have a rig in place before getting the charter from the charterer?

Shivakumar: If you are asking whether we need to have a rig in order to get a contract, yes, you certainly need to have either an existing or an under-construction rig in order to get a contract. In case of our rig, we do not yet have a contract for this rig but we have bid in tenders and hope to get a contract sooner or later..

Himanshu: Does the cost of operating offshore assets differ in different geographies? The Company has mentioned in the FY12 annual report that Brazilian operations had certain issues. Can you please help us understand, what are the difficulties when you go outside Indian markets and what differences are there in the contract specifications?

Shivakumar: Talking about our activities in Brazil, it is a very specialized operation that we are doing there. We had to spend some extra time to understand the complexity of the operations and therefore took us sometime to settle down. We have now settled down and are proud that we managed to do that. That is why we made that statement. For instance, we operate our assets all over the world. We have vessels in Africa, Middle East, South East Asia and we are perfectly fine operating there. It is only in this specific Brazil contract that we had a little bit of teething trouble and so it took a lot of effort for us to settle down there and that is why we specifically mentioned in our Annual report. We have not mentioned that with regard to any other contracts.

Coming to your question on jackup rig operating cost, it is not the same type of rig which operates here and in the North Sea. There are different types of rigs which operate in the North Sea. The one statement I can make in general is that, costs in India are lower than they are overseas but that is also a function of us being Indians operating in India. So if you were a foreigner operating in India, the cost would be higher because there are local taxes which foreign ships operating in those jurisdictions have to pay and there are local operating requirements which they have to meet. So generally yes, costs are higher in overseas jurisdiction than they are in India but that is because we are specifically an Indian player. And the numbers would be different for different jurisdictions. So in some countries, they are extremely high like Australia or in Brazil.

Himanshu: How have the asset prices moved in the offshore business from the beginning of the year?

Shivakumar: Assets prices have broadly remained flat in the offshore segment. In term of charter rates, they have also not changed much from the beginning of the year. The market has been flattish at profitable levels.

Himanshu: The Company has contracted to buy a second hand gas carrier with scheduled delivery in next year. Is there any specific reason for taking delivery in the next year and not in immediate future?

Shivakumar: The seller normally delivers his vessel after completion of the ongoing charter. So it is generally known upfront what the delivery is. When the owner circulates it for sale, he says that this ship is available at a particular date. So it is not very unusual to find such transactions happening because ships are on charter and still the owner wants to lock in a certain price based on his view.

Moderator: We have our next question from Mr. Amit Dalal from Tata Investment.

Amit Dalal: You spoke about the next 2 years where you see a surge in ordering of ships taking place in both dry bulk and tanker and the yields on that are not that high. So when you decide on remaining net buyer of ships what type of an IRR do you model into your investing?

Shivakumar: There is no specific way of reasonable modelling that one can do in this because the market is very volatile. The way that we are looking at it is, and the reason why I said we are a net buyer is, because we are still, in historical terms, at a pretty low part of the cycle in terms of the asset values, even if they have come up, maybe 10% from the bottom of the market. Now, at any point, except at the top of the shipping cycle, you would not have got a current yield of more than 12% on any ship that you bought. The shipping markets generally priced that into the asset values very quickly. So it is tough to make that kind of return and therefore your returns generally, that you can price in at any time is not more than 6-8% in dollar terms. Then you have to play for the blips and you have to say that if I am buying in the low part of the market, I will get at some point a strong market and therefore that will improve the return beyond that. That is the way we are approaching investments and basically saying that broadly market is at a low point, let us invest in good ships and at some point the market will recover and we will make money on these.

Amit Dalal: If you were to sell any of your ships that you have already in your fleet, what is the opportunity cost in terms of loss of income in yield basis that you would have?

Shivakumar: This is on a current yield?

Amit Dalal: Yes.

Shivakumar: On a current yield, most of the ships are not making much money, which in turn is reflected in our results also. We expect freight at some point in time to recover because we do not want asset values to go up without freight markets going up. We would like freight rates to go up and therefore our running yield go up. But yes, that is the entire idea and we are saying that we are going to invest in the low part of the cycle where there does not seem to be much profitability happening and we have seen most of our profitable investments have come by doing counter cyclical investing. The most profitable investments have been counter cyclic and as well where we sold when ships were earning 15% current yield. That is when we have actually made most of our money.

Amit Dalal: How much of the buyback have you been able to complete?

Shivakumar: As of now, we have managed to get about 15 lakh shares in the buyback.

Moderator: We have our next question from Mr. Rohan Jain from Quantum Advisors.

Rohan: You told that 46 mn dwt in dry bulk has been ordered YTD. So what would be the comparable figure in the tanker segment?

Shivakumar: It is 17 mn dwt in the tanker segment as against 14 mn in the last calendar year. Ample money is coming into the market. Be it by way of private equity or equity markets.

Rohan: What has been the scrapping YTD?

Shivakumar: Scrapping has been lower than the previous year, especially on dry bulk. Last year in dry bulk we had 33 mn dwt scrapped. This year in the first 10 months we had 18 mn dwt scrapped. So we are expecting to finish up by close about 22 mn dwt. In tankers, we had approximately 12 mn dwt scrapped last year. This year we are going at a run rate of about 11 mn dwt.

Moderator: We have our next question from Mr. Sachin K from Lucky Investments.

Sachin: Can you give us the net debt as of 31st September?

Shivakumar: On a consolidated basis, the net debt is close to Rs 2900 crs.

Moderator: We have our next question from Mr. Ashish Jain from Morgan Stanley.

Ashish: From a next 12-18 month's perspective, would you believe that product tanker is still the best place within the 3 segments of shipping?

Shivakumar: Dry Bulk probably will do substantially better than this year, because of a lower base. Hence, in terms of percentage increase, dry bulk will do better than product tanker segment. But on an absolute basis, product tankers may be the most profitable.

Ashish: You said that 5-7% of new order book will be delivered in CY14 in the dry bulk segment. Do you expect commodity demand growth to be higher than this supply growth?

Shivakumar: We do anticipate demand to grow at a steady pace. New supply will result in lower prices of commodity. For e.g. If iron ore becomes lower than a $90 a ton, it results in more imports into country like China where the local produced iron ore is not able to compete on FE content and therefore improvement in trade. So, this is mainly a call on improvement in quantum of trade.

Moderator: As there are no more questions, I would like to hand over the call to Ms. Anjali Kumar.

Anjali Kumar: Thank you very much for joining us today. We will have the transcript of this call on our website in a couple of days. In case you have any more queries, please feel free to contact us.