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ALTERNATIVE INVESTMENT REPORT

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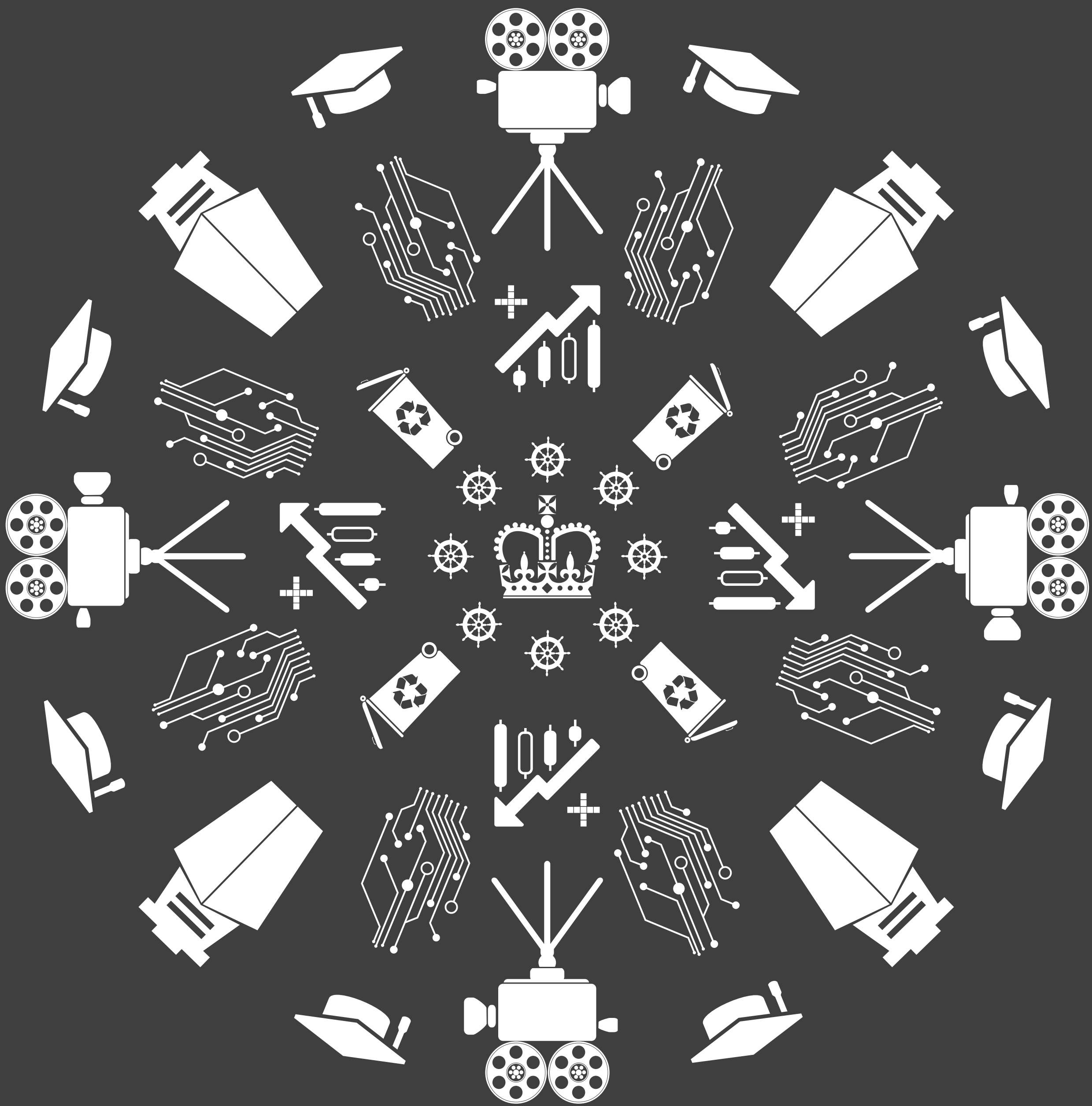

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DRY BULK SHIPPING 2015/2016

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Welcome to the first industry report focused purely on Dry Bulk shipping.

Shipping is an industry which can be traced back thousands of years. As a method to both facilitate and stimulate early international trade, its historical importance is clear, but its current significance is also indisputably huge: world trade is largely dependent upon the availability of adequate shipping[1] with some estimates suggesting that over 90% of global commodity movements are carried out by ocean-going vessels[2].

Dry Bulk shipping is an essential shipping sub-sector providing a worldwide distribution method for a range of vital commodities such as iron ore, coal, grain, timber and steel which are transported in "bulk" form loose within cargo holds, as opposed to carried in containers or other unit loads.

As a result, it is influenced by world and regional economic and demographic conditions, as well as supply and demand of vessels and cargo. This affects charter prices, producing cyclical trends. The development of emerging nations has a considerable influence on market movements within Dry Bulk shipping. China has been the most notable of these for the last decade, but other Asian nations and a global population which is predicted to increase by almost a billion within fifteen years, to create increasing Dry Bulk shipping demand in the next five years[4].

Weak market conditions in Dry Bulk shipping have combined to cause a major fall in vessel prices. This has led some experts to believe that lucrative investment opportunities now exist given the proximity of second hand vessel values to their scrap value. The typical two-year time frame for delivery of new ships and a historically low order-book suggests the possibility of limited availability of vessels when market conditions improve. This will cause an increase in charter prices and consequent rises in vessel values.

However, the sector has experienced significant volatility of both charter rates and shipping values over recent years, and whilst this provides the possibility for high returns, if the cycle is judged accurately, the presence of downside risk is also an important factor requiring specialist consideration.

The sector offers a tangible, alternative investment opportunity, but the high cost of capital has historically tended to preclude smaller investors.

This report is intended to inform advisers, intermediaries and sophisticated investors about the potential risks and benefits in Dry Bulk shipping investment.

Guy Tolhurst
Managing Director
Intelligent Partnership

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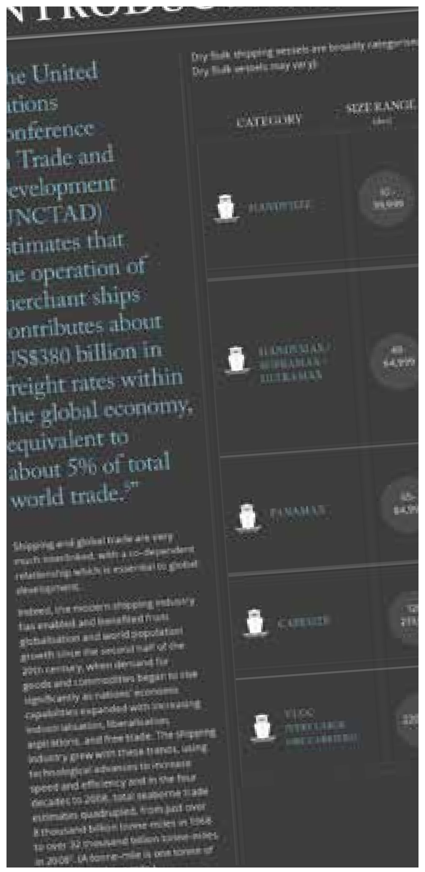

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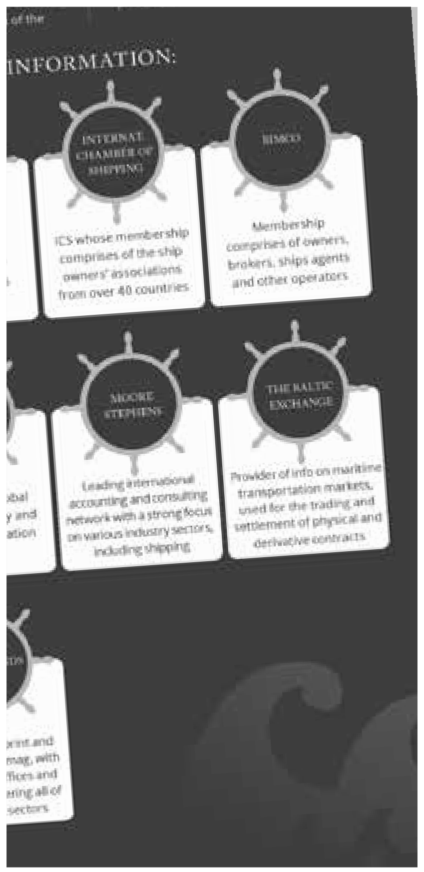

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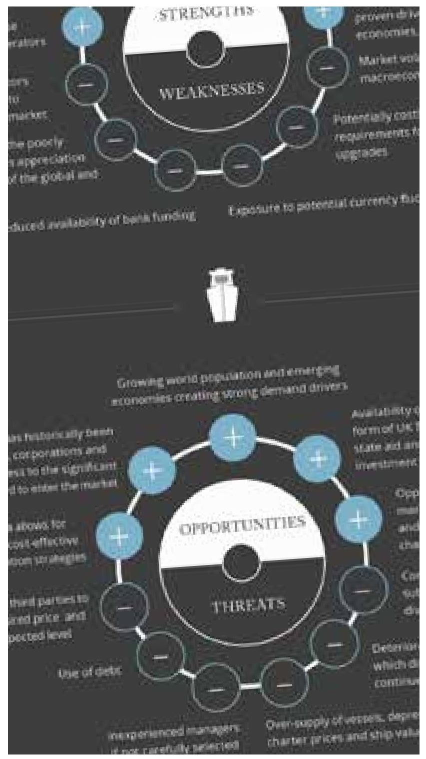

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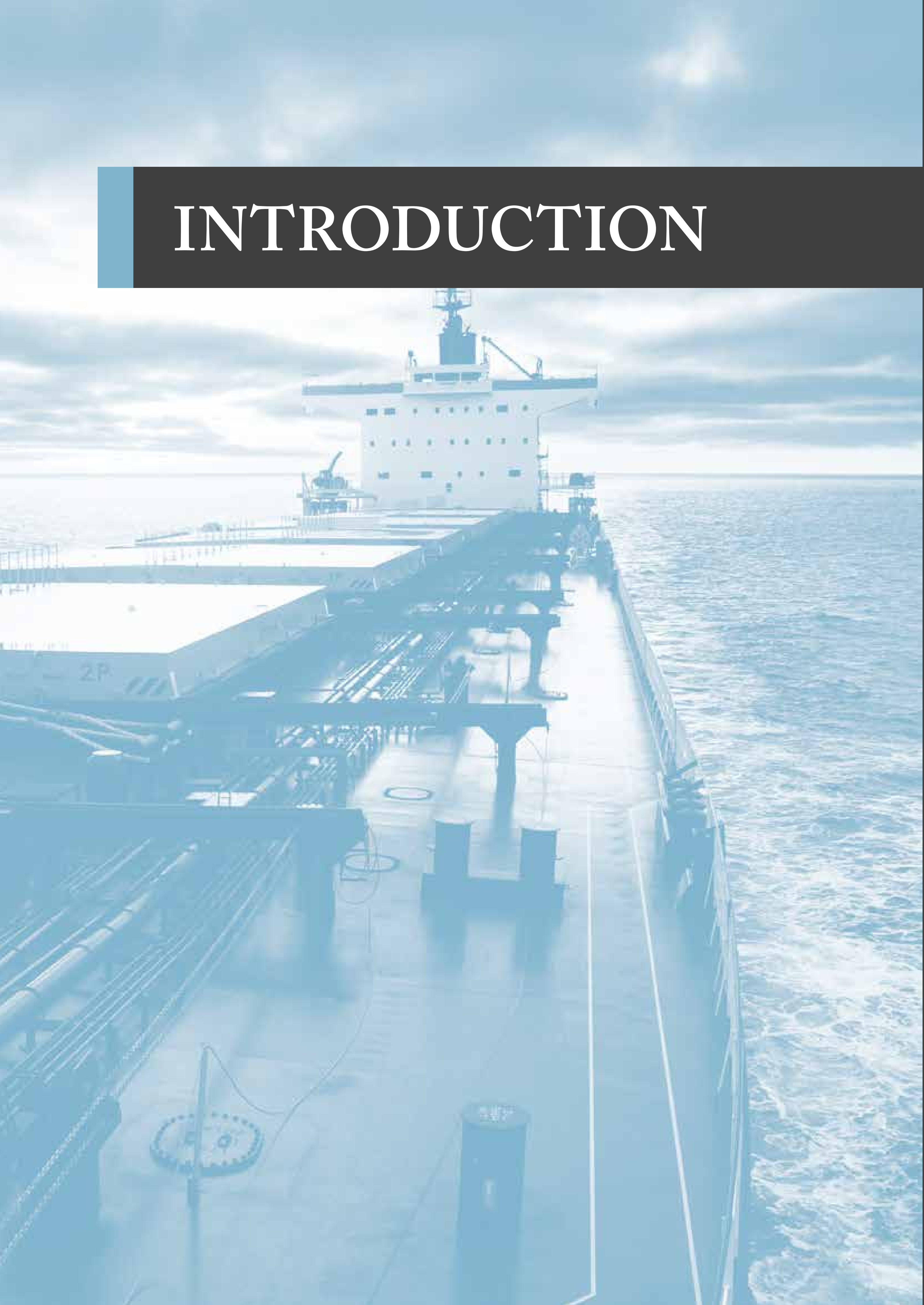
ALTERNATIVE INVESTMENT REPORT

* Please note: unless otherwise stated, all charts and graphs have been provided by Intelligent Partnership



INTRODUCTION

"The United Nations Conference on Trade and Development (UNCTAD) estimates that the operation of merchant ships contributes about US$380 billion in freight rates within the global economy, equivalent to about 5% of total world trade.[5]"

Shipping and global trade are very much interlinked, with a co-dependent relationship essential to global development.

Indeed, the modern shipping industry has enabled and benefited from globalisation and world population growth since the second half of the 20th century. At this time, demand for goods and commodities began to rise significantly as nations' economic capabilities expanded with increasing industrialisation, liberalisation, aspirations, and free trade. The shipping industry grew with these trends, using technological advances to increase speed and efficiency and in the four decades to 2008, total seaborne trade estimates quadrupled, from just over 8 thousand billion tonne-miles in 1968 to over 32 thousand billion tonne-miles in 2008[5]. (A tonne-mile is one tonne of freight shipped one mile.)

Dry Bulk shipping vessels are broadly categorised as follows[9] (sizing categorisations in Dry Bulk vessels may vary):

CATEGORY	SIZE RANGE (dwt)	USEAGE
HANDYSIZE	10 - 39,999	Carry widest range of cargos in Dry Bulk fleet. Cargo-handling gear gives them access to ports without their own land-based cargo-handling equipment and those which cannot receive larger ships/lack their own gear.
HANDYMAX / SUPRAMAX / ULTRAMAX	40- 64,999	**Handymax** size (40,000-49,999 dwt) **Supramax size** (50,000-59,999 dwt) **Ultramax** size (60,000-64,999 dwt) Versatile and hardworking, they are also geared with cranes for ease of cargo movement. They carry a range of cargo types, including iron ore, but are largely responsible for transporting grains and minor bulks, e.g. bauxite, fertilizers, cement, forest products and steel.
PANAMAX	65- 84,999	Able to transit the Panama Canal. Mainly carry coal and grain cargos, although they also participate in a number of other trades (including iron ore, bauxite and fertilizers)[11]. Size limits the number of ports they can access.
CAPESIZE	120- 219,999	Almost exclusively deployed on the iron ore and coal trades, which benefit most from their large capacity.[11] Size limits the number of ports they can access.
VLOC (VERY LARGE ORE CARRIERS)	220,000+	Comparatively new to the sector, built to exploit economies of scale on long-haul iron ore routes.[9] Size limits the number of ports they can access.

Source: Drewry

'In 2014 Drewry calculated 45% of seaborne trade was in the Dry Bulk sector. Some commentators expect this to be over 50% in 2015'

World trading activity is closely correlated to global GDP levels and consequently, as with all industrial sectors, shipping is susceptible to macroeconomic trends, including economic downturns. As a result, following several years of extremely strong shipping markets, the contraction in trade following the 'credit crunch' in 2008 inevitably, severely and suddenly, reduced shipping demand.

Recovery has been slow and patchy, with current market conditions incredibly challenging for ship owners and operators. Nevertheless, the longer-term outlook still remains positive. The continual rise in the global population, emerging economies providing new demands for goods and raw materials and the position of shipping as a safe and efficient carrier, as well as the most fuel efficient and carbon friendly form of commercial transport[5] all stand in the industry's favour. Indeed, even in the midst of the market difficulties, after the world economic recession of 2008 and beyond, the world's ships have carried record volumes of cargo, with 10.8 billion tonnes predicted for 2015[6] and the world fleet now standing at approximately 55,000 vessels of 1000+ deadweight tonnage (dwt)[7].

The main shipping segments are dry bulk, crude oil tankers, product tankers and containers – each with their distinct market drivers and volatility, not necessarily correlated with each other. According to Drewry research, in 2014 45% of seaborne trade was in the Dry Bulk sector. Some commentators expect this to be over 50% in 2015.

The late 1960s saw the emergence of Dry Bulk shipping as a separate sector from conventional general cargo, driven initially by relatively low value, high volume commodities – especially iron ore and metallurgical coal, as well as the major food and feed grains (these are known as major bulks, whilst minor bulks are made up of steel products, forest products, bauxite or alumina and cement, and fertilisers)[8]. The massive increase in the volume of thermal or steam coal in the 1970s secured the position of the sector and trade volumes continued to grow steadily in the 1980s and 1990s. The Chinese trade boom from the mid-2000s brought extraordinary increases in seaborne trade in commodities such as iron ore, as well as further expansion of the Dry Bulk fleet[9].

In the UK, shipping is not only vital to our commodity supply as an island nation, but is also an important income generator. In 2013, shipping contributed around £1.8 billion to the UK's trade balance, whilst around 95% of goods that the UK imports and exports are transported by sea, including about 40% of our food and about a quarter of our energy[10]. The UK's proud history as a sea-faring nation may have witnessed the near decimation of its ship-building industry in the last few decades, but Lord Mountevans of the Department of Transport asserts that, "we continue to provide services to the world that support their charter, insurance, sale and purchase". This is evidenced by the fact that UK firms account for 30-40% of the global Dry Bulk chartering ship broking business and Lord Mountevans sees "a once in a lifetime opportunity to exploit the expected growth in world trade to help create jobs, increase the export of our maritime services and encourage maritime-related investment across the country. This is a sector rich in SMEs and innovation and one that, with the right conditions, can contribute to enterprise, productivity and both national and regional growth in the UK."[10]

As a result of the differing sizes and uses of the Dry Bulk vessel types, the value of the vessels varies and charter income can also differ. For example, in August 2015, it was reported that rising iron ore shipments from Australia and Brazil to China have led the Capesize rates to beat the overall Dry Bulk sector in recent months.[12]

Vessel age, speed, and fuel efficiency in addition to cargo size, where larger

DRY BULK SHIPPING VESSELS CHARTER TYPES

CHARTER TYPE	DESCRIPTION
LONG-TERM CONTRACT / TIME CHARTER	Arrangements between producers and consumers of key products – normally industrial raw materials. The buyers want security of supply guaranteed and some certainty on price over a known period. The charterer takes the ship on hire for a designated period (for example, 12 months). The freight rate agreed between the ship owner and charterer is at a daily hire rate (in US$), rather than as a US$ per tonne figure. The vessel owner meets the ship's operating and capital costs, with the charterer paying all variable voyage expenses (mainly fuel costs, plus port and canal dues)[13].
	Bareboat Charter gives the charterer responsibility for all crew, fuel and operational costs for the duration of the charter period. (EIS investments are excluded from entering a bareboat charter as this is akin to asset leasing which is not permitted as a qualifying trade under the EIS regime).
SPOT CHARTER	**Single Voyage** involves the hire of a vessel for just one stipulated voyage, carrying a designated quantity of a named commodity.
	Voyage/Trip Charter generally lasts from 10 days to three months. The ship owner pays for vessel operating expenses, including crew costs, provisions, deck and engine stores, lubricating oil, insurance, maintenance and repairs and for commissions on gross revenues. The ship owner would also be responsible for each vessel's intermediate and special survey costs.

"This is a sector rich in SMEs and innovation and one that, with the right conditions, can contribute to enterprise, productivity and both national and regional growth in the UK"
Lord Mountevans, Department of Transport

loads benefit from economies of scale and generally receive a lower rate per tonne than a smaller one, can also affect value and charter rates. Charter rates are generally available on the basis of a long-term contract or a spot rate.

Spot charters expose ships to the immediate volatility of market sentiment, whilst long term contracts involve committing the vessel over a period in return for a fixed level of revenue. In periods of weakening charter rates and / or market uncertainty, the time charter is viewed as the more secure option, whilst a rising market may encourage ship owners to accept short term spot rates to enable them to take immediate advantage of price increases.

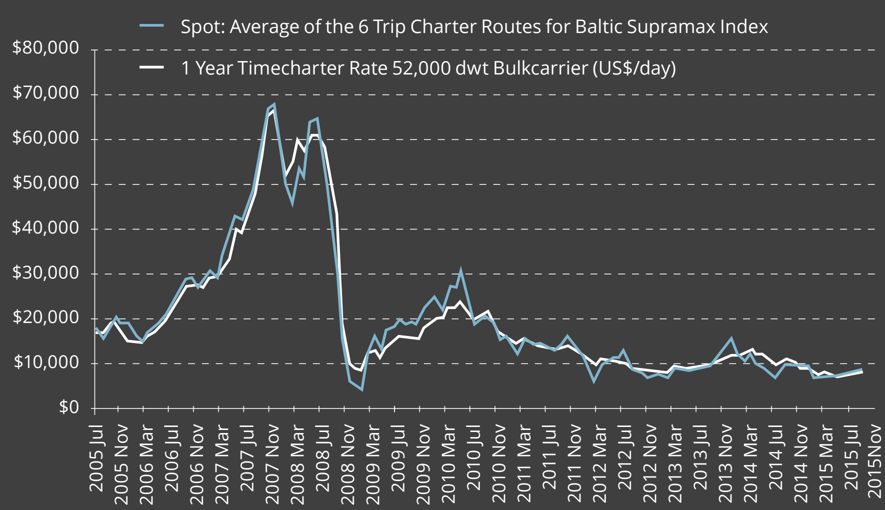
Charter price fluctuations are also highly influenced by supply and demand factors, based on the supply of vessels and the demand generated by trading conditions and international commodity prices and requirements. New ships are generally ordered when owners judge a shortage in supply, and/or an increase in demand, (although the price of new or second hand vessels is also a consideration, as is the price available from scrapping existing vessels which are to be replaced). The supply and demand curve is heavily affected by the two-year lead time required to build new ships, providing both a lag and market expectation for the delivery of new tonnage, which eventually pushes down charter prices when supply of vessels outstrips supply of cargos.

Consequently, historical data demonstrates a cyclical market, marked by rises and falls.

The Baltic Dry Bulk Index ("BDI") is an index of daily charter rates issued by the London-based Baltic Exchange. It provides an average index for 23 shipping routes measured on a time-charter basis of current freight rates for Handysize, Supramax, Panamax, and Capesize Dry Bulk carriers, carrying a range of commodities including coal, iron ore and grain.[15]

The cyclicity of the sector as can be seen in the BDI graph has contributed to substantial volatility with the BDI reaching a peak of 11,793 in 2008 and all-time low in December 2015 of just 471. This suggests the possibility of sizeable future rises in the index[16], and even the mean monthly average from January 1985 to September 2015 (excluding the extraordinary highs of 2007 and 2008) of 1,657[17], indicates the real possibility of gains.

TIME CHARTER VS SPOT RATE



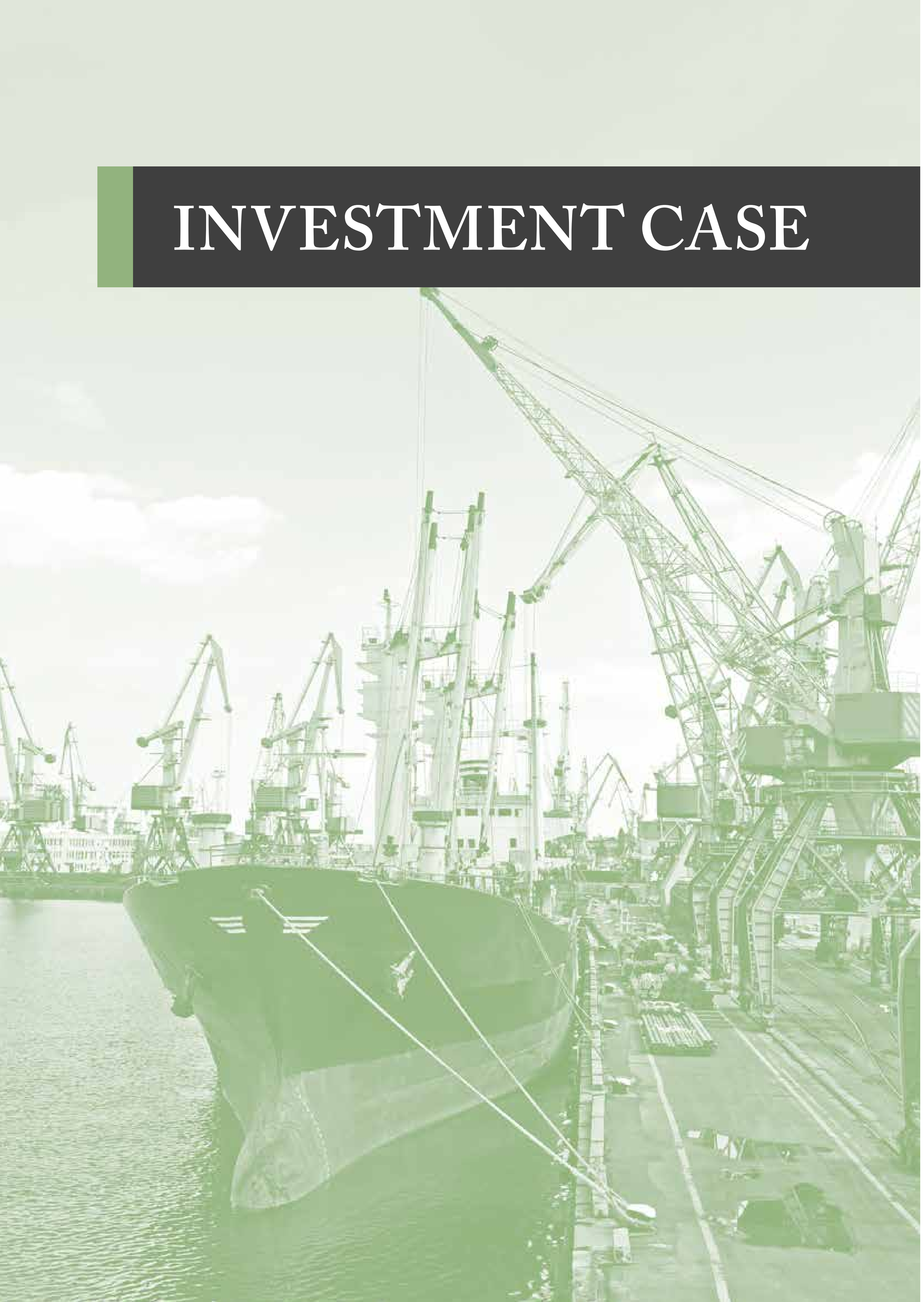
Source: British Marine

Dry Bulk is a fragmented investment sector, in which, unlike other specialised areas of the world shipping fleet, there are approximately 2,000 different owners and the largest 50 owners account for only around 36% of the fleet in terms of deadweight carrying capacity[13]. This has the effect of allowing smaller players into the market.

The traditional investment routes of public and private shipping companies, including Greek shipping families who have a history of decades and even centuries in the industry, other corporate vehicles, ultra-high net worth families and family offices, are losing their monopoly. According to Hedge Fund Journal, "The global bulk shipping industry is currently undergoing a fundamental change. It has been and continues to be mostly dominated by principal-led, family-owned companies, funded mainly by commercial banking. However, following the financial crisis and the extended downturn in charter rates, vessel values and traditional bank lending, alternative sources of finance – particularly private equity and hedge funds – have become increasingly prevalent in the sector."[2]

The report's sponsor, TIME Investments (a part of Alpha Real Capital Group, a global co-investing fund manager with over £1 billion of assets under management) manages an EIS service which looks at new and interesting investment sectors on which to overlay EIS benefits for smaller investors. The TIME:EIS service aims to allow investors who are looking for better growth for their funds than the returns offered by banks and orthodox routes, to access the Dry Bulk shipping market via EIS companies using the expertise of an experienced vessel owner and operator, to acquire, operate and eventually sell a Dry Bulk ship and target a profitable investment realisation.

Whilst there is not universal agreement, many market commentators are now suggesting a recovery to the Dry Bulk shipping sector in around three to five years' time. It is that forecast which is making it timely to look at the investment sector now, taking into account the current low pricing of vessels and the time required for market entry and preparation for the improving charter price outlook, driving up asset values.



INVESTMENT CASE

THE INVESTMENT CASE

A fundamental part of world trade, Dry Bulk Shipping's growth potential is strongly linked to the global supply and demand of commodities and other shipped goods.

SUPPLY AND DEMAND

CRITICAL SECTOR OF GLOBAL ECONOMY

In just a few decades, Dry Bulk shipping has become a critical sector within not only the wider shipping market, but also in world industry, something not underestimated by Intercargo; "The importance of the Dry Bulk industry is that without the estimated 500 million deadweight tonnes of Dry Bulk shipping, global trade, industry and ultimately our current lifestyles, could not be maintained. The international steel industry, for example, could not function without an efficient and cost effective maritime industry transporting the raw materials, coal and iron ore, as well as the means to ship the finished product around the world."[18]

The international movement of large volumes of commodities carried by Dry Bulk vessels is essential, with Australian, American, South American and Russian grains now feeding the world and Indonesian, Australian and South African coal supplying many of the world's power stations[7]. In fact, Dry Bulk shipping has enabled free market forces to play out on a global scale, giving international consumers access to the best value commodities, however painful that may be for some producers. Most notably, there have been recent issues in the UK steel market where Chinese imports have undercut UK pricing and led to the closure of much of the UK's remaining steel industry.

MACROECONOMIC DRIVERS

The strong long-term historical growth in the market has been driven by powerful underlying global drivers that have created sustained and ongoing demand; there is certainly no suggestion of the world's population growth stopping anytime soon, virtually guaranteeing the continuing and increasing requirements for the movement of food and building materials. The expanding middle classes establishing themselves in developing economies are also forecast to stimulate a greater demand for electricity and the fuel that produces it.

This means that, in spite of the short-term effects of maturing markets such as China, where growth rates have slowed, the general trend is for rising demand. It should be noted that, in October 2015 China announced that it was relaxing its one-child policy rules to allow couples to have two children, with 90 million couples becoming eligible for the new two-child policy[19].

LOW ENVIRONMENTAL IMPACT

Environmental factors also place Dry Bulk shipping at the forefront of demand for the transportation of essential commodities as a result of its low environmental impact compared with other transportation methods such as road and air. In an increasingly carbon footprint aware world, thanks partly to economies of scale, the World Shipping Council has stated that, "there is little if any dispute about the fact that shipping is the most carbon-efficient mode of transportation. According to a recent report of an IMO [International Maritime Organisation] expert working group, international maritime shipping accounts for just 2.7% of annual global greenhouse gas emissions. According to analysis by the Swedish Network for Transport and the Environment, shipping also produces fewer exhaust gas emissions - including nitrogen oxides, hydrocarbons, particulates, carbon monoxide and sulphur dioxide - for each tonne transported one kilometer than air or road transport."[20]

CYCLICAL MARKET

Such over-arching demand factors do not escape underlying fluctuations in international, national and regional economies, and it is this which leads to fluctuations in the supply of vessels to meet the requirements of charterers looking to move their commodities. High demand for shipping can result in there being an under-supply of vessels available to transport goods, leading to higher charter prices and giving existing ships, whether new or second hand, greater value. This increase in income and asset value encourages ship owners to acquire more ships to take advantage of the beneficial market. However, new ships take two years to deliver, by which time market conditions may have changed, particularly if more ships have flooded into the market from earlier orders, having the effect of shifting the supply and demand balance back in favour of charterers, reducing charter prices, income and vessel values.

Nevertheless, this cyclical process can be particularly profitable to those who have the expertise to assess it correctly as it can provide windows of opportunity thanks to the presence of undervalued vessels because of over-supply of tonnage at the current stage of the sector cycle. This can lead ship owners to scrap more vessels that are no longer as economically viable at current income rates and to delay or cancel new ship orders, weakening both new and second hand ship prices. Those that time market entry well, so that ship acquisition coincides with low prices, whilst delivery (two years later for new ships) coincides with lower tonnage availability in comparison to an upturn in demand factors, are likely to benefit from a lucrative positive price volatility, which could be significant.

"There is little if any dispute about the fact that shipping is the most carbon-efficient mode of transportation ... international maritime shipping accounts for just 2.7% of annual global greenhouse gas emissions" **World Shipping Council**

'Tax regimes on maritime activities in many worldwide jurisdictions are particularly low and this is also the case with UK shipping'

Some commentators believe that current market conditions suggest that the cycle is now in such a position, with newbuild prices having continually fallen and Deutsche Bank predicting in their September 2015 Industry Update on Dry Bulk shipping, that 2016 will be a transition year characterized by slow and steady improvement, giving way to a sharper recovery in 2017. In fact, some owners, such as Seanergy, which acquired seven vessels from Restis Group at $183 million in September 2015, are already taking advantage of low asset prices to expand their fleet, gain market share and replace their old tonnage.[21]

GROWTH POTENTIAL

Although there are many old shipping companies that rely on the potential of the industry as a long-term income generator, for smaller investors this is largely a speculative investment focusing on capital appreciation in the shorter term, with the aim of avoiding the volatility of multiple market cycles. It is therefore not surprising that a number of private equity products are focusing on the sector, looking to buy assets cheaply and to take advantage of markets and management to increase their value in a short period. This is currently very much aided by the presence of undervalued companies as well as distressed assets.

MARKET FRAGMENTATION

The growth potential is also assisted by the fragmentation of the market, making entry for new or smaller owners possible as they do not face massive, consolidated competition with the ability to control pricing to their advantage. However, this lack of control of pricing also explains some of the volatility in the market, with charterers wielding significant power in depressing pricing when so many smaller entities exist and are keen for business during difficult periods. That said, some owner/operators have attempted to mitigate this by pooling their vessels to give them better negotiating power in certain charter agreements, with the earnings shared on agreed terms between those vessels.

In times of lesser supply of vessels, pricing power switches firmly back to the owners and their prices are then only restricted by what the market will pay. Such pricing issues would suggest the potential for difficulties whilst over-supply and negative macroeconomic factors play out, as is currently the case, but asset appreciation when supply shrinks and improved macroeconomics come into play, as is widely predicted in the next several years.

At such times, the demand for second hand vessels is strong. Ship values generally follow earnings trends so that, where charter rates have increased, second hand values have shown a corresponding increase, and vice versa.

TANGIBLE ASSET

The investment sector benefits from being a tangible asset, where investments are generally based on the value of ships, meaning that, unlike a money market instrument, there is usually no risk of complete devaluation overnight. Having said that, like the majority of real assets, particularly those which work to earn their keep, the advent of newer models and the traditional financial markets/economic conditions do affect the value of Dry Bulk ships, although the rate of devaluation will depend on the original asset, with Japanese and Korean vessels currently attracting a premium versus Chinese built vessels because of superior quality, value and longevity.

It can be viewed as a relatively liquid asset, with a number of global Sale & Purchase shipbrokers (such as Clarkson Platou plc, Braemar ACM Shipping and North South Maritime) providing agency services for ship owners looking to expand or reduce their fleet, but an added benefit of ships is that they have a scrap value which can be accessed as an exit safety net, meaning that it is very unlikely for there to be total loss of investment. Scrap prices are determined by steel prices and vary with supply and demand and between the nations which undertake this work; they include Bangladesh, India, China, Pakistan and Turkey[23]. The price is calculated per ldt (lightweight dead tonne) and according to figures from September 2015, the average value of a Handymax bulker was $3.07 million, at $330/ldt[24]. The proportion of the original vessel purchase price offset obviously depends on the purchase price, but the October 2015 pricing for a ten year old second hand Handymax was around $10 million whereas a fifteen year old Handymax was around $6 million[24]. Such a vessel would have five to ten years working life left and, depending on movements in scrap value, up to 50% of its asset value guaranteed by the scrapping option.

Bear in mind also the room for the value of such a ship to rise with market improvements, as the price of a fifteen-year-old Handymax was at $13.5 million as recently as February 2014, $22.5 million in June 2010 and $50.5 million in the heady times of April 2008. The attraction of buying an asset at $10 million which could bring in income to at least pay its costs and potentially more, whilst its value potentially increases by a third, or doubles, or more, thanks to a rising market, is clear.[24]

INVESTMENT HORIZON

For individual investors, given the nature of this market and the risks of volatility, the most sensible investment horizon would certainly be a short-term one mirroring the typical private equity or Enterprise Investment Scheme exit at three to five years. There is a concentration risk involved with investing in one specialised sector like this, so it would perhaps not really be suitable as a first foray into investments and is probably better as an addition to an existing portfolio.

The investment case suggests a modest allocation as a short-term commitment, within a balanced portfolio, is justifiable for the investment sector which is closely correlated to wider economic markets and factors, but also with potential for substantial gains. This allocation might form part of a diverse satellite portfolio of EIS, VCT and other investments into unquoted companies.

TAX BENEFITS

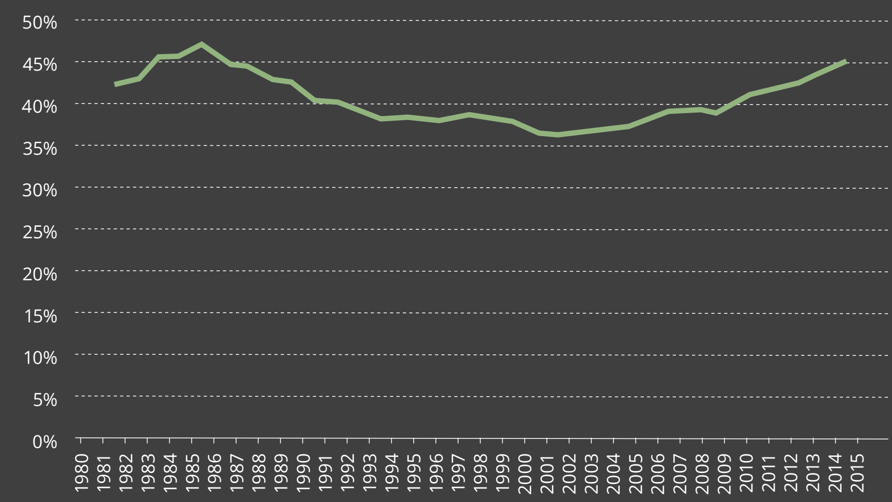
Tax regimes on maritime activities in many world-wide jurisdictions are particularly low and this is also the case with UK shipping, thanks to the UK Tonnage tax, which is "a ring-fenced regime allowing ship-operating companies to have their taxable profits from shipping activities determined at fixed rates, according to the carrying capacity (tonnage) of the ships in their fleet. These, rather than the actual profits, are then subject to corporation tax in the normal way, producing a low tax charge that is competitive in the international shipping markets. Introduced in 2000, this system reflects the norm in many other countries throughout the world and is explicitly approved under the EU's state aid policy. "[25]

This means that Dry Bulk shipping, as a part of the international shipping fleet, is not an industry which is subject to significant taxes on its profits, leaving a larger element of funds for the successful upkeep of its vessels, running of its businesses and preservation of their capital reserves.

From 2000 to 2011, there was remarkable growth of shipowners and operators within the UK. The UK-owned fleet grew by almost three times, and the UK-registered fleet – albeit from a very low base – grew by more than six times[25]. This has been of major benefit to the UK economy.

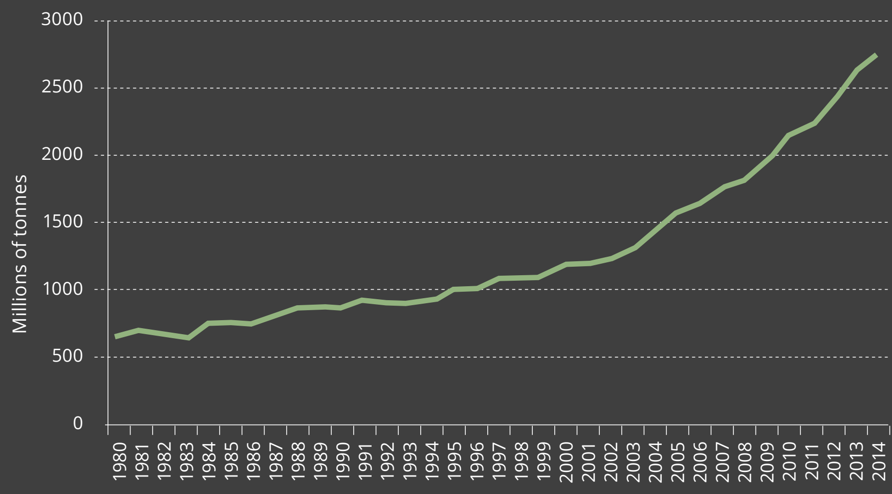
The eligibility of Dry Bulk shipping for tax efficient investment wrappers such as EIS and VCT, is also advantageous.

DRY FREIGHT % OF WORLD SEABORNE TRADE (1980-2015)



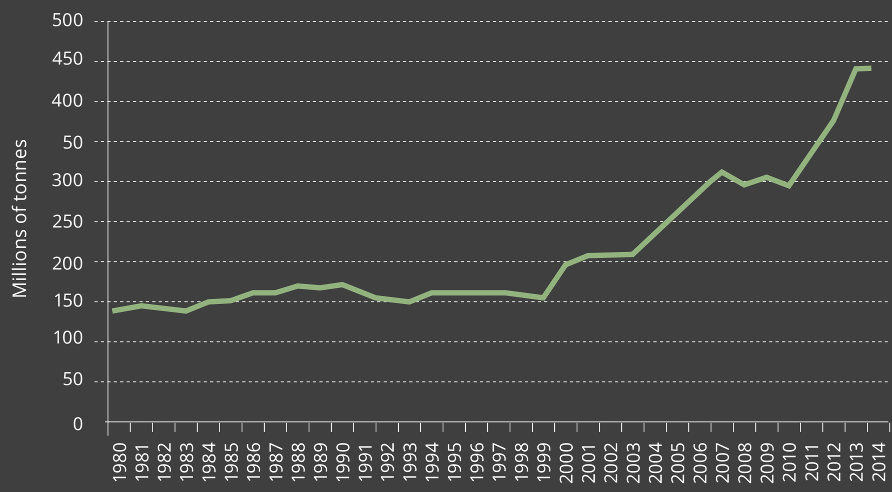
Source: Drewry Research[9]

TOTAL DRY BULK MAJOR BULKS SEABORNE TRADE (1980-2014)



Source: Drewry Research[9]

TOTAL DRY BULK MINOR BULKS SEABORNE TRADE (1980-2014)



Source: Drewry Research[9]

MARKET UPDATE

In November 2015, Frank Dunne (a partner at Watson, Farley and Williams, who undertakes a broad range of ship finance work and commercial shipping transactions for major international shipping finance lenders and shipowners) summed up his thoughts on the Dry Bulk sector; "We appear to be at a ten-year low in the value and freight rate cycle for dry cargo. If so, now is a good time to buy, so long as leverage is low and the further investment in a carry cost is available. Market sentiment is that values and freight rates are unlikely to improve significantly for the next couple of years. The fleet is young so it will take time for over-capacity to be worked out. Much depends on China and growth. Also restraint by Shipyards to avoid adding capacity as soon as conditions start to improve."

OVER-SUPPLY

There is no denying that the Dry Bulk shipping market has experienced very tough times since the effects of the world economic recession took hold in the sector in late 2008. Pricing was hit hard: as an example, one-year time charter rates were at their highest for the Supramax vessels in 2008, reaching over $60,000/day and have since struggled to recover, and in late 2015 were sitting at well below $10,000.[9]

The Baltic Dry Bulk Index hit an all-time low in 2015, but, although reduced, there is still trade growth within the sector, with expected total Dry Bulk trade growth in 2015 at 1.2%, compared to 8.4% in 2014[26]. This indicates that there is increasing demand to move commodities by sea, albeit affected by demand-side issues, and highlights the huge importance of supply-side factors in terms of the Dry Bulk fleet. It is these supply-side issues which have had the greatest influence on the market in recent years, with the Financial Times commenting that, "Most shipping sectors remain in deep financial trouble. Delivery of the glut of vessels ordered before the financial crisis has driven down earnings for dry bulk carriers, most tankers and container ships."[27]

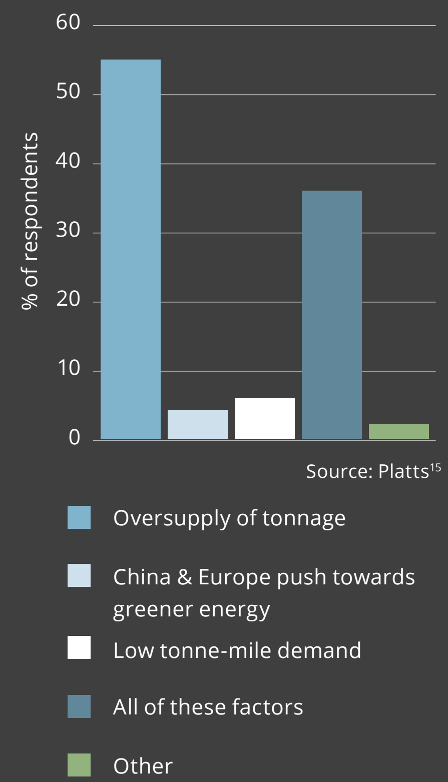
Owners, operators and analysts are fully aware of the cycles experienced by this sector and according to Platts Dry Bulk Market Survey August 2015, "55% [of bulk market participants] indicated tonnage oversupply as the main issue for the dry bulk market."

This recognition of the contribution of vessel over-supply to the weak market has led to action in the form of a reduction in the number of new ships ordered, coupled with high levels of demolitions (scrapping of ships); Bimco, the world's largest international shipping association was positive about the trend for market improvement in October 2015, citing the marginal year-to-date growth of the dry bulk fleet of just 2.1%, made up of the inflow of 39.7 million dwt offset by demolition of 23.8 million dwt. In terms of new orders, Clarkson's orderbook statistics showed only 84 new contracts recorded at the end of August 2015, in stark contrast to less than two years ago when capacity equal to the year-to-date amount in 2015 (4.7 million dwt) was contracted in just 16 days.[28]

In fact the delivery of previously ordered new vessels, at a time when the market outlook was stronger, is part of the problem and a further 36.3 million dwt of Dry Bulk vessel capacity is expected to hit the water by the end of 2015[29]. This is made up of 118 Capesizes, 139 Panamaxes, 300 Supramaxes (155 ships last year) and 217 Handymaxes. However, delay, cancellation or default on newbuild orders should also be taken into account, with a number considered doubtful for delivery; Drewry expect 7% of Handymax orders and 17% of Supramax orders to be cancelled. Furthermore, a number of Chinese shipyards are in trouble or have filed for bankruptcy protection while Korean yards are also burdened with high debts.

When demolition is taken into account, Bimco predicts that 2015 fleet growth will be at a 10-year low of 2.5%[28]. Dryships Inc. puts this figure at only 2.4% in 2015, followed by a 4.0% increase in 2016[30].

MAIN ISSUE FOR THE MARKET



Source: Platts[15]

> *"Most shipping sectors remain in deep financial trouble. Delivery of the glut of vessels ordered before the financial crisis has driven down earnings for dry bulk carriers, most tankers and container ships."*
>
> **Financial Times**

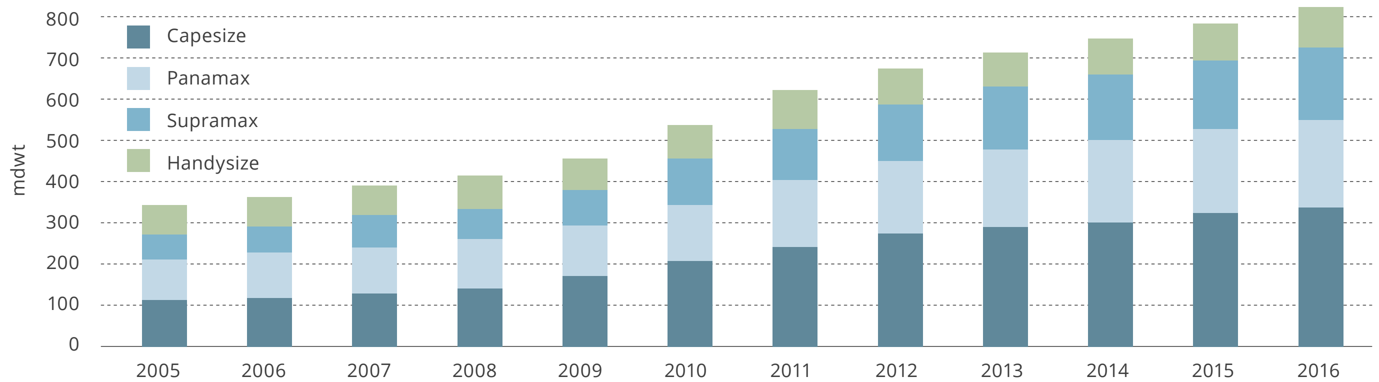
For the year to September 2015, Drewry figures put fleet growth at around 3%, bearing in mind the overall fleet size of 10,237 vessels of 747 mdwt in September 2014, compared with the September 2015 numbers. Previous years' increases have been much more significant, with Intercargo putting the 2012 Dry Bulk fleet at 8,141.

Of course, these statistics mask variances for different vessel types, which in turn have an impact on the market. For example, Panamax and Supramax fleets are expected to increase by 1% and 4% respectively[31] in 2015. Such variations are a mark of the differing markets in which the various

NUMBER OF VESSELS AT DEC 2015: (TOTAL 10,689 VESSELS)		
1633	CAPESIZE	309.6 mdwt
2467	PANAMAX	196.4 mdwt
3323	HANDYMAX	179.3 mdwt
3266	HANDYSIZE	92.3 mdwt

Source: British Marine

FORECAST DRY BULK FLEET DEVELOPMENT (2005-2016)



Source: Market Realist

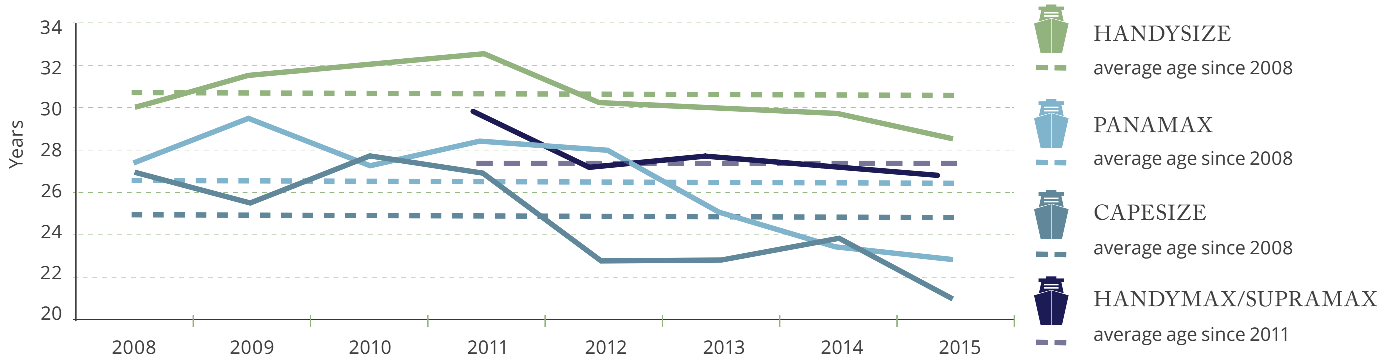
vessel types operate. Drewry's 3Q 15 Forecaster noted that delivery numbers have remained consistent for Supramax and Capesize vessels in the third quarter, with shipowners still taking deliveries of Supramax vessels as grain trade was seen flourishing in the ECSA region in the third quarter with growth anticipated in the Black Sea grain shipments in the last quarter of 2015.

Increased demolitions are a symptom of a weak market and 2015 is likely to be a record breaking year in terms of vessels being sent to the scrapyards. This occurs when a ship reaches the end of its useful life at around 25 years, but in a depressed market, it is not uncommon for ships to be scrapped at 20 years. In the first six months of 2015, 19.5 mdwt were demolished, an increase of approximately 145% compared to the same period in 2014[30] and Drewry expects demolition to increase further as small players, particularly those burdened with debt repayments on top of standard opex, will find it difficult to to survive for long in the weak freight market and wish to avoid the costs of dry dock surveys. (According to international regulation, every sea-going vessel has to undergo two dry docks within a period of five years to allow for inspection to ensure the safety of the vessel. A ship in dry dock is a ship out of service and it is a complex process which is expensive and, depending on the number of days out of the water, represents ongoing loss of income.)[32]

The reducing age of vessels being scrapped in 2015 (with the exception of the largest vessels) indicates the growing pressure that low freight prices places on ship operators to cut their losses, particularly with older vessels incurring higher operating costs and thereby diminishing the scope for profit in poor market conditions.[33]

The average age reduction is around 4 to 5 years since 2011, with Handymax and Supramax falling from 30.6 to 26.6 years.[34]

DECREASING DEMOLITION AGE (YEARS) (2008-2015)



Source: Drewry[34]

DEMAND FACTORS

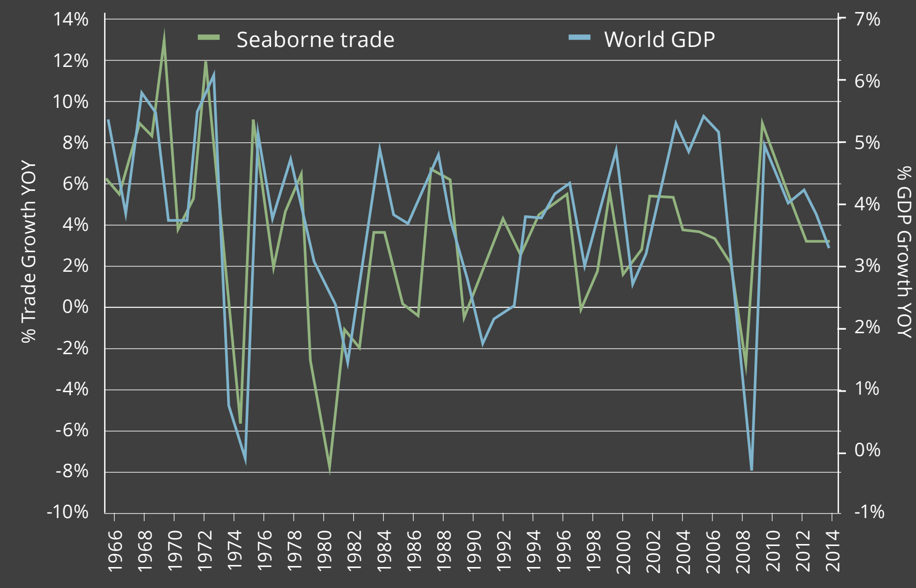
Demand is reliant on commodity production and distribution requirements and this is strongly influenced by macroeconomic factors and in particular their effects on commodity supply industries such as energy, manufacturing and construction[4]. In terms of commodities, iron ore and coal (both used in the production of steel) make up almost two-thirds of the Dry Bulk shipping industry and China is currently the biggest consumer of these two commodities.[35]

MACROECONOMIC ELEMENTS

The close correlation of world trading activity and GDP levels and the resulting effects on the Dry Bulk shipping market are well known; with the contributions of China, India and Brazil increasing as their GDP growth rates are significantly higher than those of developed countries. It is expected that trade between Africa and Asia and the Middle East and Asia will keep growing at a higher pace than the rest of the world as we approach 2020, with a positive effect on the Dry Bulk market[4]. Having said that, according to the IMF's April 2015, World Economic Outlook, "Global growth remains moderate, with uneven prospects across the main countries and regions. It is projected to be 3.5% in 2015. Relative to last year, the outlook for advanced economies is improving, while growth in emerging market and developing economies is projected to be lower, primarily reflecting weaker prospects for some large emerging market economies and oil-exporting countries. The International Monetary Fund outlook also points out that, "Asia's growth is forecast to hold steady in 2015, and the region is expected to continue outperforming the rest of the world over the medium term. While the Chinese economy is shifting to a more sustainable pace, growth is projected to pick up elsewhere in the region."

"The average age reduction is around 4 to 5 years since 2011, with Handymax and Supramax falling from 30.6 to 26.6 years"[34] Drewry Maritime Research, Dry Bulk Forecaster | 3Q 2015

CORRELATION BETWEEN GDP AND SEABORNE TRADE GROWTH



Source: ICS and UNCTAD

HISTORIC AND PROJECTED GDP GROWTH (% CHANGE PREVIOUS PERIOD) (2010-2016)

	2010	2011	2012	2013	2014	2015 (expected)	2016 (expected)
GLOBAL ECONOMY	5.2	3.9	3.5	3.1	3.1	3.5	3.8
INDUSTRIAL WORLD*	2.8	1.6	1.7	1.3	1.6	2.1	2.0
USA	2.5	1.8	2.8	2.2	2.1	2.8	2.3
EUROPE	2.0	1.7	-0.3	-0.4	0.8	1.2	1.7
GERMANY	3.9	3.4	0.9	0.1	1.4	1.5	1.8
FRANCE	1.7	2.0	0.3	0.4	0.4	1.0	1.6
JAPAN	4.7	-0.5	1.4	1.5	0.8	0.8	0.7
UK	1.7	1.1	0.3	1.7	3.1	2.7	2.5
EMERGING ASIA	9.7	7.9	6.7	6.1	6.0	6.3	6.5
CHINA	10.4	9.3	7.7	7.7	7.3	6.5	6.5
INDIA	10.3	6.6	4.7	4.7	5.3	6.3	6.8
KOREA	6.3	3.7	2.0	3.0	3.6	4.1	4.0
LATIN AMERICA**	6.0	4.6	2.9	2.5	1.1	1.9	2.8

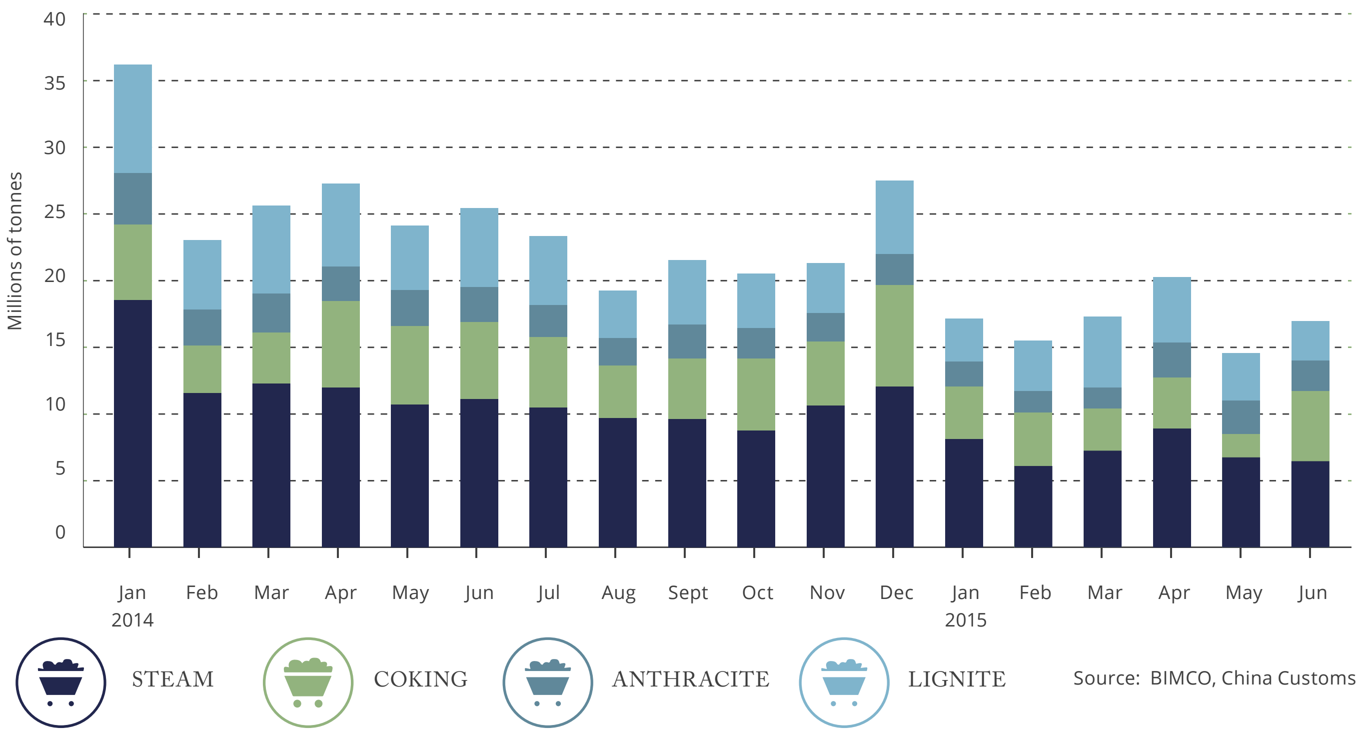
*G10 ** Latin America and Caribbean

Source: Drewry[21]

In recent years, China has been the most important macroeconomic driver of demand in Dry Bulk shipping and the slow-down in its economic growth has therefore been a significant negative influence on the sector; China has experienced sharp corrections in its equity markets, weak manufacturing output and reduced growth rates since 2013. The country is targeting 6.5% annual growth[97] for the next five years, which would be the country's slowest growth pace in the last 25 years[36]. This slow-down has reduced building rates and additionally, in recent years, the Chinese government has worked hard at implementing more renewable energy sources such as hydropower, thereby reducing its reliance on coal, which has traditionally generated 70% of China's energy[37].

'Other Chinese imports are continuing to grow, e.g. soya beans – China is the world's largest importer, with soya bean imports for the 2014/15 harvest predicted to reach a new high of 76 million tonnes'

CHINESE COAL IMPORTS BY TYPE (2014-2015)



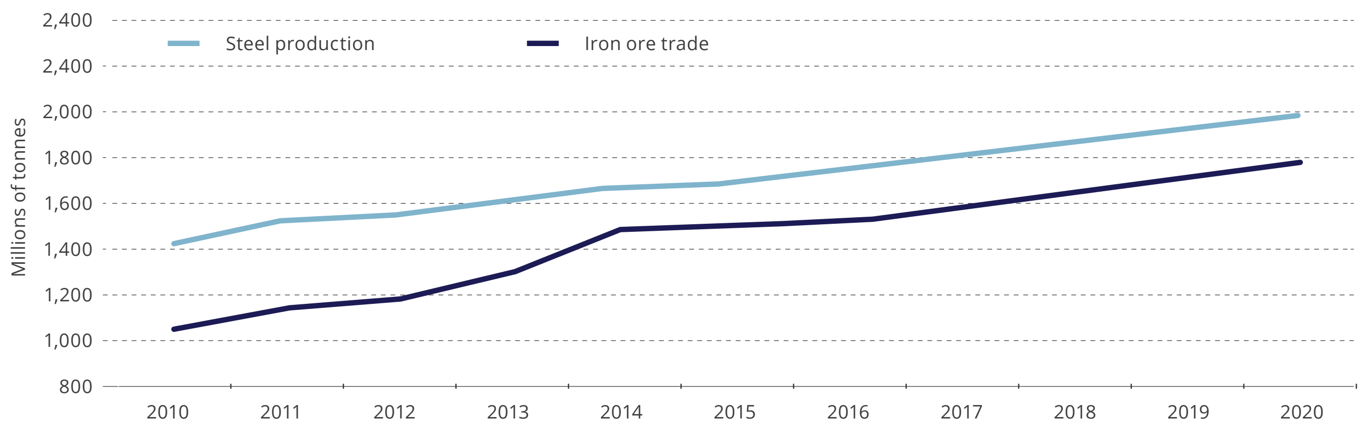
Source: BIMCO, China Customs

This has led to a levelling off of iron ore demand and diminished demand for coal, and since China's consumption of coal accounts for just over 50% of global use[37], and it imports almost two-thirds of the world's seaborne iron ore, the Dry Bulk shipping market is presently very vulnerable to changes in China's demand. The scale of the problem is noteworthy: e.g. in the first six months of 2015 China imported just under 100 million tonnes of coal in total, a reduction of more than 38% compared to the same period in 2014.[37]

In September 2015, Deutsche Bank described Chinese coal imports as being at a new normal and iron ore imports not growing but steady.[38] In the same month, Australia & New Zealand Banking Group Ltd (ANZ) stated, "While we still see steel demand recovering mildly in the later part of the decade, in line with a less sluggish housing market, we now forecast that peak-steel consumption occurred in 2014."[39]

However, other Chinese imports are continuing to grow and a country with such a massive population will always command significant demand in one area or another, particularly as globalisation continues. Soya beans are an example. China is the world's largest importer, with soya bean imports for the 2014/15 harvest predicted to reach a new high of 76 million tonnes, and the volume for 2015/16 forecast at 77 million tonnes[40]. Dry Bulk carriers, especially smaller vessels such as Handysize and Handymax/Supramax, also enjoy in excess of 400 million tonnes of the 1 billion tonnes of cargo of all kinds which is transported between Chinese ports by sea[9] and there are positive moves

GLOBAL DEMAND DRIVERS (HISTORIC AND PROJECTED FIGURES) (2010-2020)



Source: Drewry Maritime Research

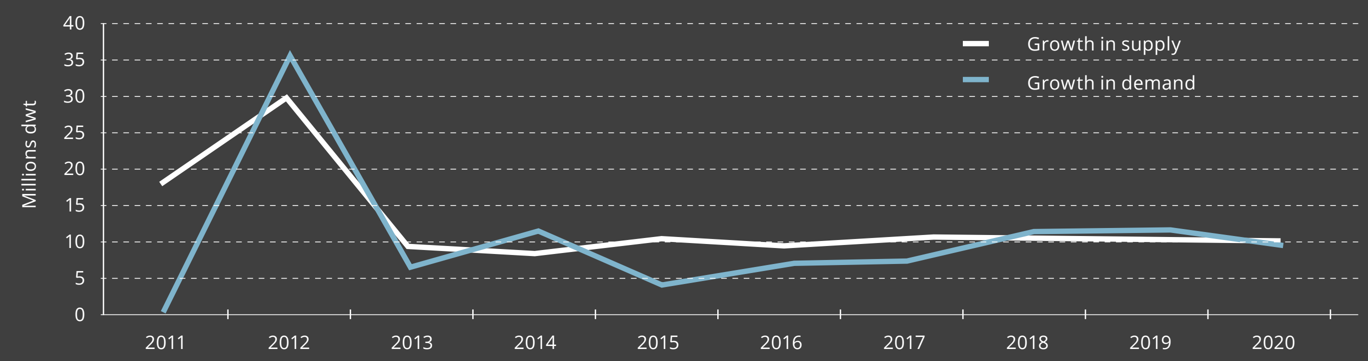
'The Bulk Shipping market is presently very vulnerable to changes in China's demand, although a country with such a massive population will always command significant demand in one area or another'

being made by the government, with the Chinese central bank cutting interest rates, improving bank lending tools to boost economic activity, introducing new stimulus measures to fund construction projects and devaluing the yuan to increase export competitiveness.[41]

Whilst the knock-on effects of economic and political movements in China have proved to be an unwanted and frankly huge drag on the Dry Bulk market, it is certainly not the only country to impact trade, with India filling a meaningful portion of the demand gap for coal left by China[33] and the growing requirements of both developed and developing nations, including Japan and Vietnam[34], for increasing amounts of electric power. For coal, the main exporters are Australia, South Africa, Russia, Indonesia, United States, Colombia and Canada. The main importers are Europe, Japan, South Korea, Taiwan, India and China.

Indeed, the supply of ships versus the demand for the movement of commodities is predicted to show demand outstripping supply by 2018 for some Dry Bulk sectors.

HANDYMAX HISTORIC & FORECAST SUPPLY/DEMAND GROWTH (2011-2020)

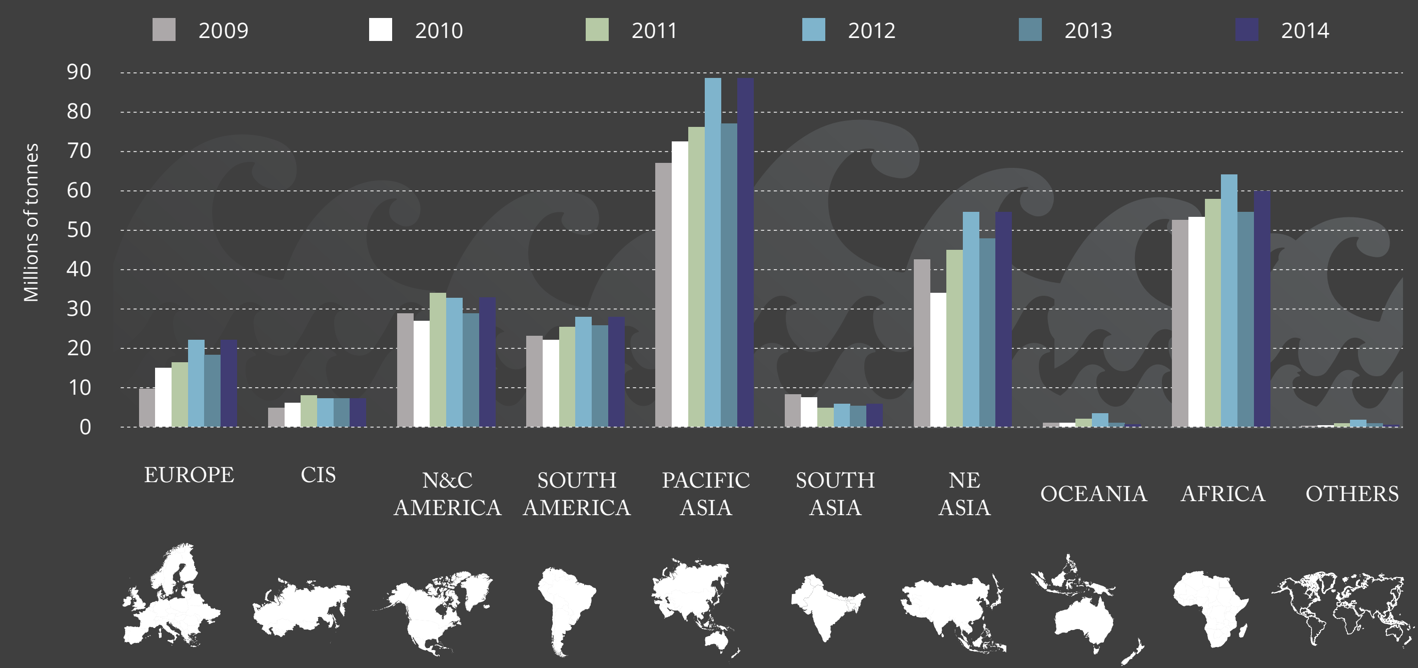


Source: Drewry Maritime Research[34]

In the short term, iron ore and coal shipments from China have actually been boosted by the slowdown in steel consumption within China, as mills have sought to find overseas buyers for their output[39] and in the longer term, the use of these commodities in the production of steel is an important factor, with Dr Edwin Basson, Director General of the World Steel Association saying that, "For the past decade, the steel industry was dominated by events in China. The evidence is that the steel industry is now entering a period of pause before undoubtedly picking up again when markets other than China drive new demand."[42]

For other commodities such as grains, international demand continues to be strong with wheat exports from the Black Sea countries projected at record levels in 2015/16, much of which is destined for the Middle East and North Africa.[33]

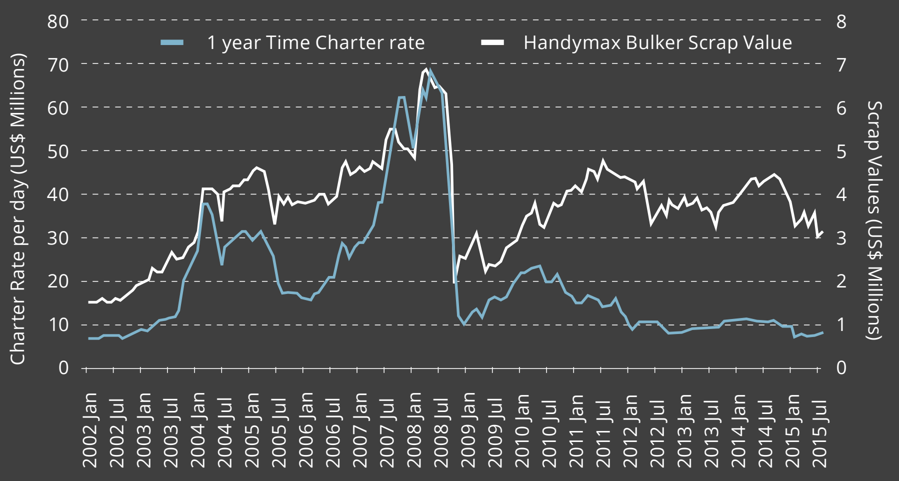
MAJOR GRAINS IMPORTS (2009-2014)



Source: Drewry Dry Bulk Forecaster 3Q 15[34]

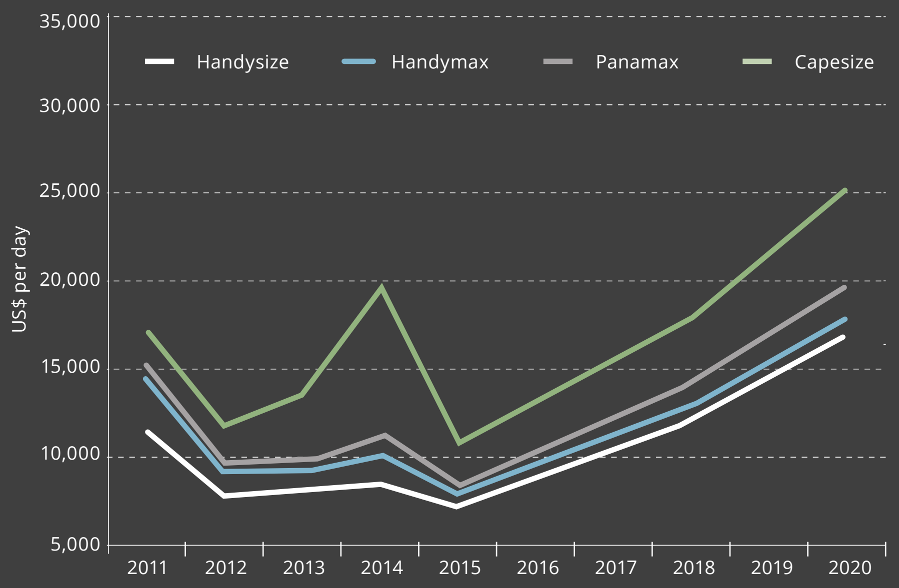
'Income earning potential for different classes of Dry Bulk vessels can differ greatly as they are exposed to differing supply and demand factors'

HANDYMAX SCRAP VALUES VS TIME CHARTER RATES



Source: Drewry[9]

HISTORIC & FORECAST PERIOD RATES (US$ PER DAY) (2011-2020)



Source: Drewry Maritime Research[34]

VESSEL VARIATIONS

"Ship demand is determined by the overall volumes of cargo moved and the distance that these are shipped (that is, tonne mile demand), as well as changes in vessel efficiency"[43]

Scorpio Bulkers Inc. 2014 Annual Report

VESSEL TYPES

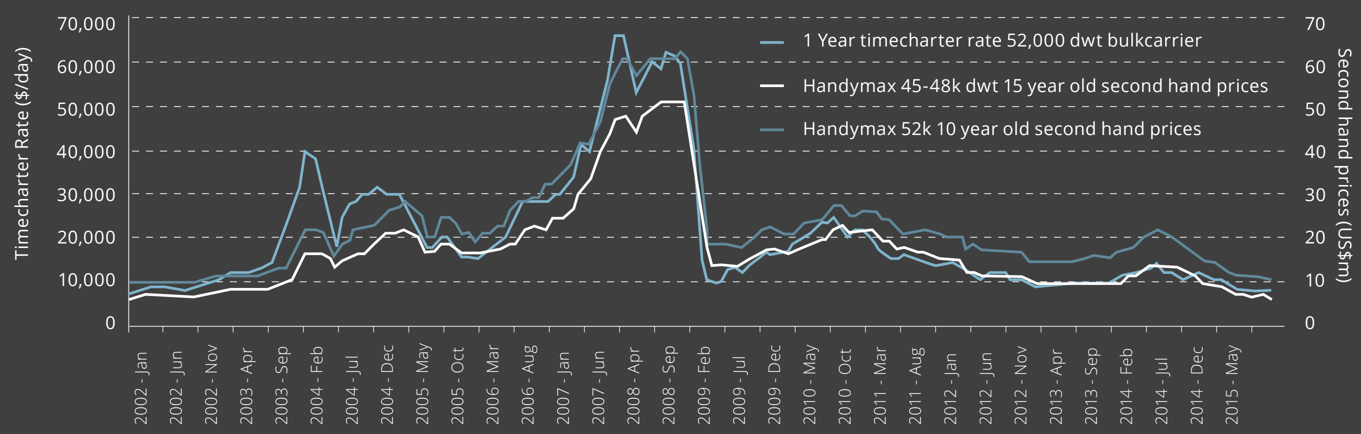
It is worth noting that income earning potential for different classes of Dry Bulk vessels can differ greatly as they are exposed to differing supply and demand factors, with more over-supply being experienced in some types than others and more or less reliance on certain commodities which may or may not be suffering demand dips.

For 2015, Supramax vessels have achieved the higher earnings within the sector, with September 2015 seeing Supramax average earnings for a single voyage of $9,228/day and tripcharter average earnings at $8,438/day[44]. However, with average running costs at around $5000 to $6000/day[45], that leaves narrow margins to cover unforeseen costs. It also means that operators with debt may not have sufficient margin to cover interest and fees on the debt.

CHARTER RATES

Whilst the volatility of Dry Bulk charter rates is clear, this applies differently

CORRELATION OF SECOND HAND PRICES AND CHARTER RATES (2002-2015)



Source: British Marine

'Whilst charter rates and therefore vessel values were at a market low in late 2015, the market expects a recovery in charter rates over the next three to five years'

to larger vessels than to smaller ones, with larger vessels exhibiting higher charter rate and vessel value volatility as a result of the larger volume of cargo shipped on board, their reliance on a few key commodities, and long-haul routes among a small number of ports[9].

Additionally, perhaps surprisingly given the current environment, Drewry reported in its Second Quarter 2015 Dry Bulk Forecaster that, following some research with ship owners in the Dry Bulk sector, barely 5% of their vessels were on long-term charters. This indicates a significant measure of vulnerability to day to day price adjustments, but also possibly some confidence in those adjustments being positive rather than negative. Interestingly, the Capesize owners had the highest proportion of Capesize vessels on long-term charters, at 11%.

Whilst charter rates and therefore vessel values were at a market low in late 2015, the market expects a recovery in charter rates over the next three to five years. Forecast rates provided by independent researchers Drewry suggest a recovery for the Handymax and Supramax to over twice their third quarter 2015 rates by 2019/20.[34]

NEW AND SECOND HAND VESSELS

Newbuilding prices are influenced by demand vs shipyard output, the cost of raw materials, freight markets and exchange rates. Newbuilding prices started to weaken in the second half of 2008 and although some increases were seen in 2013, by 2015 prices had dropped again and continued to be very depressed late into the year.

The second hand market is directly influenced by the newbuilding prices and charter market[9] and market sentiment towards them can vary, depending on market conditions, "Unlike newbuilds, buyers and sellers don't have to wait about two years to have the ships delivered. When newbuild prices continued to fall throughout much of 2009, due to uncertainty around a large backlog of orders placed before 2008 when rates were high, second hand vessels rallied."[46]

DIFFERENT OUTLOOK AND PERFORMANCE FOR VESSEL TYPES[21] (SEPTEMBER 2015):

CAPESIZE

The Baltic Capesize Index is expected to fall further as demand for Chinese iron ore is likely to decline with falling industrial output and falling steel demand and falling Chinese iron ore imports may depress demand for Capesize units.

PANAMAX

Bleak outlook with the fall in Chinese coal imports and its growing fleet. Coal imports to remain low following the stricter environmental regulations in China. Expectations are that freight rates will come down from their current level. However, the increased grain trade will provide some support to the falling Baltic Panamax Index.

HANDYMAX / SUPRAMAX

Baltic Supramax rallying as imports of thermal coal, petcoke and urea are likely to increase, whilst grain movements are strong.

HANDYSIZE

Market likely to continue to improve as the minor bulks trade will shore up. The increase in petcoke and urea imports by India is expected to support the earnings of Handysize vessels. Sugar exports from Brazil will also climb with improved production and currency depreciation in the country.

2015 OPERATING COSTS (US$PD)

Handysize	Supramax	Panamax	Post Panamax	Capesize	VLOC
$4,990	$5,460	$6,390	$6,670	$7,270	$8,160

HANDYSIZE SUPRAMAX PANAMAX POST PANAMAX CAPESIZE VLOC

OPERATING EXPENSES

Operating expenses (opex) are remarkably stable within the Dry Bulk shipping sector. Year on year, opex actually decreased by 0.6% to October 2015 and in the years from 2000 to 2014 it increased at a relatively low average of 3.9% per year[47]. Moreover, predicted increases over the four years following 2015 are not substantial.

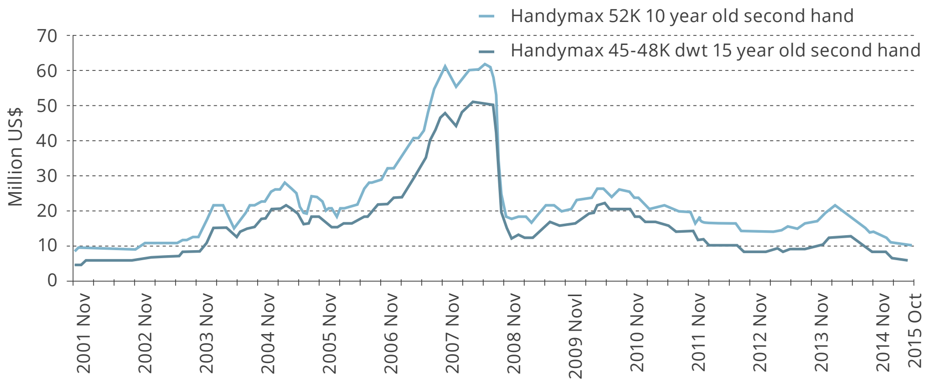
The highest proportion of opex is made up of crew costs, which account for almost 50%, almost four times as much as repairs and maintenance. The opex elements are crew, (around 48%), administration (around 16%), repairs and maintenance (around 13%), insurance (around 13%) and stores (around 10%). These vary by ship type[48]. The price of fuel is only for the account of the ship owner under certain charter types, with those who choose to charter their vessels under a time charter generally passing responsibility for the cost of bunkers (fuel in shipping terms) to the charterer.

SHORT-TERM OUTLOOK

In September 2015, Bimco[49] viewed charter rate increases from July and August as being of major assistance to dry bulk carriers, allowing them to achieve the break-even point and providing breathing room for companies with large newbuilding acquisition programmes. For some time before this, those companies had been operating their vessels at a loss. Consequently, in such a harsh trading environment, Bimco's cautious prediction for a return to profit is 2017. Nevertheless, the cycle is so sensitively balanced that even a suggestion of recovery could have detrimental effects by deincentivising ongoing scrappage, jeopardising the reduction in vessel over-supply and thereby delaying a more pronounced upturn.

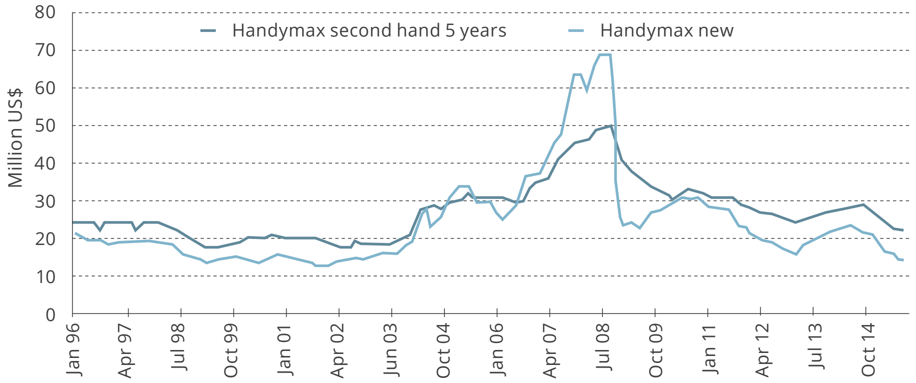
Drewry shares the forecast of 2017 as the year of recovery, stating in September 2015, that "The Dry Bulk shipping market will remain in recession

HANDYMAX SECOND HAND PRICES (US$) (2001-2015)



Source: Drewry[9]

HANDYMAX NEW AND 5 YEAR SECOND HAND PRICES (US$)



Source: Drewry[9]

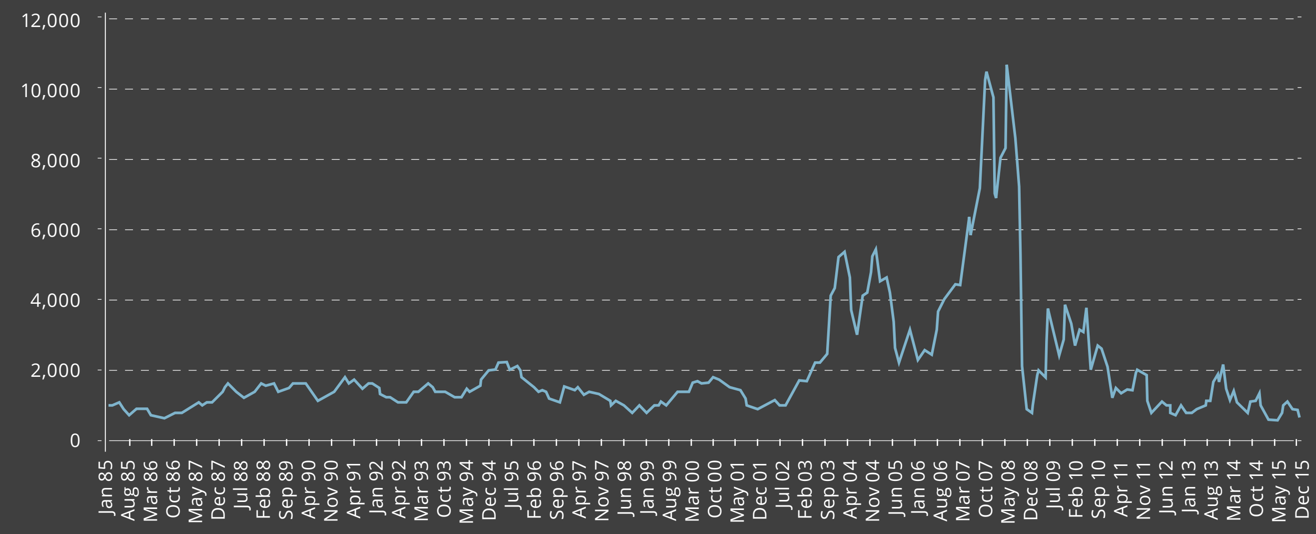
HISTORIC & PROJECTED OPERATING COSTS (US$ PER DAY)

	2013	2014	2015	2016	2017	2018	2019
HANDYSIZE (26-28,000 dwt)	4,880	4,920	4,990	5,080	5,190	5,290	5,390
SUPRAMAX (55,000 dwt)	5,380	5,410	5,460	5,570	5,680	5,800	5,870
PANAMAX (65-73,000 dwt)	6,270	6,300	6,390	6,500	6.630	6,750	6,870
POST PANAMAX (95,000 dwt)	6,550	6,570	6.670	6,780	6,930	7,060	7,170
CAPESIZE (140-160,000 dwt)	7,060	7,180	7,270	7,400	7,560	7,690	7,810
VLOC (220,000 dwt)	7,950	8,050	8,160	8,300	8,490	8,630	8,790

Source: Drewry Maritime Research[34]

"Since 2013, there have been billions of dollars in equity flowing into the industry, and the scary thing is that the reported number is not all of it. A lot of private placements don't show up on anyone's league table"[2] **Chris Weyers, Head of Maritime Investment Bank**

BALTIC DRY INDEX (BDI) (1985-2015)



Source: Baltic Exchange[14]

There is no doubt that the industry is at or near the bottom of a cycle, but commentators views on the short term progress of the cycle vary, although all agree that there is a lot of room for improvement: Starting 2015 at 771, the BDI dropped to 509 on 18 February 2015, rose to 1,066 in August and in December has slumped back to 471, setting a new all-time low.

due to contracting demand for iron ore and coal, and any recovery is not expected until 2017. Falling demand and over-supply has severely impacted commodity values, with iron ore and coal prices in virtual free fall.

The Dry Bulk shipping sector has been a casualty of these developments with resultant impacts on vessel earnings. However, there is some optimism for small vessel employment, as the onset of El Nino weather conditions will increase demand in the long-haul grain trade."[50]

The Chief Executive of international Dry Bulk shipping company, Golden Ocean, cited over-supply could be a quicker process than some expect (but still up to 18 months). His reasoning was that over 50% of the current orderbook for new vessels is at Chinese yards and that the precarious financial status of such yards suggests a high proportion of these orders will simply not be delivered.[51]

It is certainly true that Chinese shipyards in particular have seen a number of newbuilding cancellations. Recently, after its yard allegedly failed to meet deadlines and deliver vessels, Dry cargo ship-owner Precious Shipping, cancelled two shipbuilding contracts for 64,000 dwt Dry bulk carriers due from Nanjing based shipbuilders, Sainty Marine[52]. In addition, in November 2015, a European buyer cancelled the construction of one 82,000 dwt bulk carrier due to be built at the Cosco shipyard in Dalian, China. The vessel was originally scheduled for delivery in the third quarter of 2016. Other Chinese shipyards are in serious financial trouble, with Rongsheng, once China's largest shipbuilder, on the verge of bankruptcy after orders dried up, with debts of 20.4 billion yuan in combined debt owed to 14 banks, three trusts and three leasing firms and allegations of exaggerated order books designed to make the company look stronger.[53]

Deutsche Bank is also optimistic about the short term for the Dry Bulk shipping sector – so much so, that in its September 2015 Industry Update on Dry Bulk shipping, it re-rated its stock recommendation on listed shipping companies such as Diana Shipping from Hold to Buy[54]. This was on the back of a trip to Asia, where, "Nearly everybody we spoke with was cautiously optimistic on the prospects for Dry Bulk rates, asset values and equities - the result of recalibrated demand expectations and scrappage-driven supply control. In particular, expectations were for a "Slow and steady improvement in 2016, translating to 15-20% year on year increase in spot rates after excluding the first quarter of 2015's weak levels".

However, Platts Dry Bulk Market Survey of August 2015 revealed a slightly longer projected period of recovery, citing 50% of industry respondents feeling the recovery of the Dry Bulk freight market was three to five years away. Presumably, the major European financial institution which provided Scorpio Bulkers with a commitment for a loan facility of up to $12.5 million in late November 2015, with a final maturity of five years from the date of signing[55], shares the view that there will be money to be made in the sector by then.

"With the Baltic Dry Shipping Index hitting a new all-time low in December 2015 and ship prices falling to a level where an EIS can purchase a ship without debt, this is a great opportunity for investors to enter a non-contentious sector that few have previously had access to, whilst taking advantage of all the tax benefits an EIS can offer" **Stephen Daniels, Head of Tax Products at TIME**

8 OF THE WORLD'S LARGEST CITIES WILL BE PORT CITIES

For the UK, the outlook is positive, with the Department for Transport's 2015 Maritime Growth Study, finding that, "The UK is ideally positioned to exploit these conditions and drive growth in the UK maritime sector. The evidence collected during the study demonstrates that the UK continues to be seen by the international market as a world-leading maritime centre. It also shows that the UK remains highly competitive."

LONG-TERM OUTLOOK

Demographic and economic factors are expected to increase international demand for resources and underpin longer term shipping demand. World population growth is projected to reach 8 billion by 2030, with 96% of growth coming from developing countries and India overtaking China with the largest population and the largest labour force in the world. Most of these people will live in cities: with massive shifts towards urbanisation in China, Southeast Asia, Bangladesh, Nigeria and Turkey, pushing the world's urbanisation to almost 60%. Eight of the world's 10 largest cities will be port cities. Global GDP could grow three times within 20 years. In 2030, the largest economies, by a long way, will be China, USA and India. The countries with the largest growth in per capita GDP will be China, Vietnam, India and Indonesia. Purchasing power in developing Asia will rise 8 times between 2010 and 2030. Massive growth in world GDP brings enormous opportunities to the marine industry and international trade is projected to continue to rise in line with economic expansion, leading to a potential doubling of seaborne trade to somewhere between 19bn and 24bn tonnes. Energy demand could increase by 40% by 2030 and China and India will be the giants in the world's coal consumption, with India likely to see the largest growth in steel consumption. China's steel consumption growth will slow, but it will remain the biggest steel consumer in 2030. India is also expected to become a giant driver of global trade in an order of magnitude similar to China[56].

MARKET ACTIVITY

The sector has certainly tested its owners/operators in the current Dry Bulk market downturn and most of the players in the Dry Bulk shipping space have lost value since the beginning of 2015. Most recent financials generally reflect the very difficult nature of the current market: at 26 October 2015 the share prices of most of the listed players in the Dry Bulk shipping space had fallen since the beginning of the year. DryShips (DRYS) fell the most by 82% YTD, Star Bulk Carriers (SBLK), returned -68%, Navios Maritime Holdings (NM), which forms 2% of the Guggenheim Shipping ETF's (SEA) holdings, and Safe Bulkers (SB) had fallen by 44% and 18%, respectively, YTD. Safe Bulkers took an additional hit to its share value in November 2015 when Deutsche Bank downgraded it from "buy" to "hold.[54]

Some corporate players, such as Scorpio Bulkers, have raised additional funding in order "to survive the toughest market conditions", with $74 million in retail bonds raised in September 2014 and $150 million in equity in November 2014 to withstand "the cyclicality of our markets"[11].

Additionally, Dry Bulk operator of mainly Capesize and Handysize vessels, Bocimar, owned by Compagnie Maritime Belge, reached losses of over $100m for the the first three quarters of 2015. In 2014, Bocimar posted a net loss of $24.9m for the first three quarters[57]. Even more regrettable is the receivership application of Japanese Dry Bulk giant Daiichi Chuo and its approval by a Tokyo court[58]. Bankruptcies can be problematic for the market as they can lead to banks flooding the market with vessels to sell to recoup losses.

This does, however, provide affordable assets for new market entrants, but also points to the use of gearing/borrowings by ship owners, which, in these challenging times of very depressed charter rates generating such low income levels, makes some of their businesses simply unsustainable. Fitch's Angelina Valavina recently said that small Dry Bulk lines look set to go bankrupt, "because banks have slashed their lending to the sector", and "there are few lines that could afford to take on any more debt".[59]

That said, whilst some of the larger players, as well as the small lines, have clearly overstretched their gearing, other companies have still managed to access bank funding, with a more successful story coming from Diana Shipping (DSX) which gained 6.80% YTD at 21 August 2015[60]. The company has since signed a $39.68m term loan facility with ING Bank and a drawdown of $11.73m. The term loan facility is designated to partially finance the acquisition of Medusa, a kamsarmax dry bulk vessel.[61]

In fact, the share value of Diana Shipping is a good indicator of the peaks and troughs of the sector and if we assume that the situation in late 2015 is near or close to the bottom of the market, there is certainly scope for appreciation. In November 2010 the share price was $13.16, by September 2012 it had dropped to $6.46 and by March 2014 it had climbed back up to $13.54. In early November 2015, it had dropped again to $5.92.

A Harvard Business School report which considered Dry Bulk shipping between 1975 and 2011 concluded that, "The annual returns to owning and operating a ship vary massively over time, from a low of -68% between December 2007 and December 2008 to a high of +87% between June 1978 and June 1979."[62]

In terms of mergers and acquisitions, the biggest market participants are investment firms, particularly from the USA. In 2013 they invested in over 75 vessels partnered with a number of private shipping companies, purchased significant amounts of debt from traditional shipping banks and participated in the five US shipping-related IPOs.

This, perhaps, reflects the opportunities which investors with sufficient funding have identified within the sector.

RISKS & DUE DILIGENCE

RISKS & DUE DILIGENCE

"The current entry price level is clearly de-risked from levels witnessed over the last five years … but the dry bulk sector today faces a major challenge with both supply and demand side economics working against it" **Andrew Hampson, MD of Asset Backed Investments, Tufton Oceanic Limited**

Andrew Hampson of Tufton Oceanic Limited, a fund management firm specialising in the maritime industry, stated in November 2015 that, "Currently charter rates are at an all-time low and prices at levels only seen on two occasions over the last 35 years. Whilst we might not quite be at the bottom of the market, the current entry price level is clearly de-risked from levels witnessed over the last five years. With such limited downside, if a regular employment can be found to cover costs then there could be some attractive asset plays in the right sub-sector". Nevertheless, he is also clear that, "The Dry Bulk sector today faces a major challenge with both supply and demand side economics working against it" and the following section looks at risks and mitigating factors which are associated with investment in Dry Bulk shipping.

GENERAL MARKET CONDITIONS

The correlation between general market conditions and Dry Bulk shipping, with its strong links to GDP and complex economic and political circumstances is clear and consequently, any recessionary events in the wider market are likely to have a negative effect on Dry Bulk shipping. This has been the case in the last few years, with very low global shipping rates and ship values, general market conditions under pressure from factors such as the Chinese economic slow-down and continuing struggles in Europe with economic conditions, it is hard to predict if or when improvements will take hold. So just relying on a rising market, within any pre-set investment horizon, is far from guaranteed. Of course, this does not mean that all Dry Bulk shipping would simply stop, as essential foods such as grains and fuel for electricity generation would still be required in nations and regions that do not produce them and the overall growth patterns expected for world populations and economies, as well as the historic performance of the Dry Bulk shipping sector, supports strong medium to long term general market conditions. Additionally, insurance is available against loss of hire/revenue and certain types of charter and strategy may be considered to be mitigated more than others against sudden general market shifts, including time charters where there is a fixed revenue stream for a known period of time that will be paid irrespective of fluctuations in the economy.

VOLATILITY

Longer term trends do not mask the high volatility of charter prices and vessel values in the Dry Bulk shipping market. The Baltic Dry Index hit a record high of 11,793 points on 20 May 2008. By 5 December 2008 the BDI had collapsed to 663 points and by December 2015 it had hit a low of 471. Even in the last few months this is evident with the August 2015 figure of 1,066 being more than double that of November[7]. This kind of unpredictability over where the market will bottom out is particularly difficult for those not experienced in this sector and has tested the most experienced companies in recent times. That said, some partial mitigations are available, with time charter rates being more stable than spot rates which are more representative of short term movements in demand and market sentiment[9]. Moreover, there is good availability of current and historical data and indices providing various industry benchmarks. Such information is of great importance to experts looking to chart the rise and fall of the Dry Bulk market and to judge the best times for investment entry and exit.

MARKET COMPLEXITY

The complex nature of predicting factors affecting the Dry Bulk shipping market makes judgements on its cycle particularly difficult. Geopolitical and macroeconomic issues have already been widely discussed in this report, but other items which can have a major and potentially unexpected effect on forecasts, both good and bad, include; weather patterns – from seasonal pressures impacting on the size of harvests to ice in ports and river levels - and market sentiment where market opinion affects the freight market just as much as the actual supply and demand of ships and cargos because much of the demand side is simply not known in a timely fashion[7]. The use of time charters in excess of 12 months again provides ship owners with some security against unforeseen circumstances since pricing is generally agreed for the entire period, insulating owners against negative consequences of inaccurate projections in the short term.

POLITICAL RISK

Since Dry Bulk shipping is an international industry, changes in government policy in one or more regions could affect it. Recent examples of this include the Chinese policy of focusing on greener energy, resulting in a drop in its coal imports and the Indonesian Government's decision in 2014 that it was not in the country's best interests to continue exporting bauxite and nickel ore, thereby substantially reducing global volumes available for shipping. The more versatile vessels in the Dry Bulk fleet, such as Handymax and Supramax, are equipped to mitigate such risks by having the ability to switch between different trade routes and commodities; for example, they could be on a Chinese iron ore voyage and then move to a Russia-Africa grain trip.

VESSEL SURPLUS/ COMPETITION

Whilst world and regional economic conditions have a significant role to play in demand for Dry Bulk shipping, the number of vessels available to ship commodities is an important factor on the other side of the supply and demand equation. Some research has suggested that individual firms underestimate the ability of the competition, leading to excessive industry investment during booms and low subsequent returns on capital as an over-supply of vessels eventually depresses charter prices and ship value[63]. Moreover, too much competition is likely to lead to under-utilisation of vessels. TIME research suggests a 90% level of utilisation of the vessel is the accepted standard in the Dry Bulk sector, with some operators reporting 95%, but under usage from lack of charters would reduce profitability for the vessel. Indeed, Bimco stated in June 2015 that there is reporting of 2015 levels of utilisation being at around 70%[64], although this will vary between vessel types. Additionally, in spite of the fragmentation of the Dry Bulk shipping sector, there are some very large companies as well as significant private equity backing of other entities in the market, with the funding to acquire further ships when they feel the time is right. That said, ship owners are keenly aware of the dangers of over-supply and this is demonstrated by the very high rates of demolition and delays in delivery of new ships in 2015, partly aimed at reducing the fleet size and addressing the current imbalance.

INDUSTRY REGULATIONS AND CHANGES

Shipping is subject to a host of international, national and local laws, treaties, conventions and regulations relating to health and safety and environmental protection. Compliance with these and other requirements may entail significant expense, including vessel modifications and implementation of certain operating procedures. Vessels are subject to both scheduled and unscheduled inspections and some of the inspection entities require owners to obtain permits, licenses, certificates and other authorisations for the operation of their vessels. Failure to maintain necessary permits or approvals could require them to incur substantial costs or result in the operation of one or more of the vessels being temporarily suspended[11]. As well as the current cost of compliance, it can be time consuming and costly, in relative terms, to implement changes to regulation in such a large industry, with expensive hardware and high costs for non-operation during modifications. An example of this is the Harmonised Common Structural Rules (HCSR) and International Maritime Organisation (IMO) Nitrogen Oxide (NOx) Tier III requirements which could add up to an extra $3m for a newbuild suezmax[65]. The upcoming Ballast Water Treatment regulations are also expected to impact costs. In addition, regulation in specific markets/sectors served by shipping can have wide ranging effects, as was demonstrated by the new Chinese import regulations on coal quality (sulphur and ash content) which were introduced in early 2015 and which contributed to the decline in imports to China in January.[66]

SAFETY FACTORS

Accidental damage and total loss of vessels and cargo does occur either through bad weather or other factors. In the 2014 Intercargo Bulk Carrier Casualty Report and the 2014 Intercargo Bulk Carrier Casualty Report noted that nine dry bulk vessels were either lost or involved in a serious casualty and that, to February 2015 there had been one significant casualty, that of the Bulk Jupiter, a vessel carrying bauxite that was lost on 2 January off the coast of Vietnam with the loss of all but one crew member[67]. The ship, operated by Gearbulk Norway, succumbed to one of the known safety issues – cargo liquefaction[68]. This demonstrates that shipping is not without physical risk, but whilst loss of life overrides any other considerations, the owner will insure the vessel as a standard precaution and the charterer is responsible for insuring the cargo, in order to limit financial loss. Nevertheless, such incidences have the potential to push up insurance costs and come with the possibility, as do conflicts, of affecting shipping routes, which may be narrow and easily blocked.

Piracy is also a very real threat to shipping in certain locations, particularly in the Indian Ocean, with vessels hijacked, crew taken hostage and the entire cargo and ship potentially lost. Again, insurance against this type of eventuality is available, but in addition, in October 2015 Intercargo announced in response to the ongoing containment of pirate attacks [through international cooperation] in the Indian Ocean that "the size of the High Risk Area for piracy in the Indian Ocean has been reduced and new advice has been issued to merchant ship operators"[69].

ONGOING COSTS

Operating expenses, including insurance and maintenance must be considered, otherwise expected financial outcomes could be significantly reduced. Standard marine perils such as mechanical and structural risks should be insured, with insurances including Protection and Indemnity insurance and hull and machinery insurance as well as loss of cargo (although this is the charterer's concern rather than the ship owner), pollution and damage to, or loss to the vessel.

Maritime legislation also requires the vessels to undergo a dry dock inspection and repair process approximately every two and a half years which carries significant costs for both the inspection and the resulting loss of revenue. That said, a good dry dock record, much like a good service record for a car, will assist with vessel value. Other operating expenses such as the crew, monitoring of the vessel's performance, and supervision of the maintenance and general efficiency of the vessel and arranging the supply of stores, spares and provisions are not insignificant. However, year on year, opex has actually decreased in 2015, has not suffered extreme increases in the medium term and is not forecast to be subject to significant elevation in the near future[47].

The cost of fuel is another consideration, although this is likely to be more problematic for spot charters than time charters; under a time charter, the charterers generally buy the bunkers on-board, at market price, on delivery of the vessel to them and would sell the bunkers - normally more or less the same quantity - back to the owners on redelivery from the charter at that same price regardless of the market cost of bunkers. This is not the case for spot charters, where the rate is offered by the owner on the basis of a flat $/tonne which would be calculated to include margin for bunkers as well as insurance, port charges and all other costs.

"Charter rates are at an all-time low but they're not expected to stay there forever; shipping is a highly cyclical industry" **Jim Everson, Former MD and Head of Shipping at ED&F Man Shipping Ltd**

The chartering manager works out where the vessel needs to bunker, the volume and cost and prices it into the $/tonne rate accordingly. However, once committed (charter agreed), there is a period before execution where there is exposure, although this can be hedged by the use of derivatives at a price[70]. Consequently, it is important to be aware of who is responsible for these items and how they affect the bottom line.

CURRENCY RISK

Virtually all trade and transactions in shipping are carried out in US Dollars. This presents a currency risk for non USD operators and investors who may be disadvantaged by currency movements, although under the right circumstances, other currencies may become cheaper to acquire with USD, making the currency fluctuation advantageous. One option to mitigate a negative outcome here is to employ hedging strategies.

DEPRECIATING ASSET

According to the Hedge Fund Journal, "Ships are depreciating assets with a non-linear profile determined by market activity"[2]. Dry Bulk carriers typically have a useful life of twenty five years and therefore theoretically, vessel values decrease steadily over time, although in times of low vessel supply and high commodity movement demand, such depreciation can slow, stop or even reverse; in June 2007, the average price of a five year old Handymax was $46.5 million. In July it was up to $48.5 million and by December 2007 reached $64.5 million. Whilst newbuild prices were appreciating at the same time, because of the immediate availability of second hand ships to meet immediate demand, in June 2007, the average price for these five-year-old second hand vessels was $5.5 million higher than a newbuild of the same class and in December of the same year, it was $19 million higher. The reputation and competency of the shipbuilder is also important in determining second hand values and future maintenance costs, so the builder, vessel selection and the timing of acquisition are crucial in controlling the loss of value of the asset over time.

OBSOLESCENCE

New innovations and developments require regular upgrades of machinery to stay efficient, to meet timelines, standards and remain profitable. This could have the effect of speeding up vessel depreciation. The Scorpio Bulkers 2014 Annual Report recognised this issue, stating that, "the charter hire rates and the value and operational life of a vessel are determined by a number of factors including the vessel's efficiency, operational flexibility and physical life. If new Dry Bulk carriers are built that are more efficient or more flexible or have longer physical lives than our vessels, competition from these more technologically advanced vessels could adversely affect the amount of charter hire payments we receive for our vessels once their initial charters expire and the resale value of our vessels could significantly decrease."

LABOUR CONSIDERATIONS

Intercargo has voiced concerns about the numbers of seafarers to meet the future needs of an expanding bulk carrier fleet and where these professionals might be sourced from. This is a medium to long-term consideration as the current rate of expansion is slow, but in addition the adequacy of the existing training regime for the modern safety conscious bulk carrier sector is under review[71].

UNCERTAINTY OF SCRAP VALUES

The principal markets for recycling are India, Bangladesh, Pakistan, China and, to a lesser extent, Turkey. Ship recycling offers a possibility to reuse significant parts and equipment of the ship and those parts and equipment have a value. At the end of their working lives, or sooner in times of very low charter rates making running of the vessel not commercially viable, ships can be sold for scrap. The scrap price for vessels, like any other commodity, fluctuates with demand and supply and this can provide a ship owner with a safety net to exit the market. The higher the scrap value, the better the safety net and the more limited any loss will be, but currently, low scrap prices and subdued demand for steel have forced ship owners to wait until the scrap market improves.[21]

LIQUIDITY

The liquidity available for any investment depends partly on the type of investment vehicle used, but in an EIS, for example, generally investors are locked in until exit at three to five years after entry with no interim returns as the assets grow (EIS tax benefits tend to enforce this). If investee companies are quoted, liquidity is much more readily available, although the underlying asset of the vessel is unlikely to be sold instantly in any circumstances. Having said that, the Dry Bulk carrier market is relatively liquid, with a number of London based Sale & Purchase shipbrokers, such as Clarkson Platou plc, Braemar Shipping Services and Howe Robinson as well as international brokers including Copenhagen based Maersk Broker and Oslo based Lorentzen & Stemoco[72], providing agency services for ship owners wishing to expand or reduce their fleet. Nevertheless, since there are no guarantees of prices or sales, mitigation against low liquidity is problematic, although scrapping is always an option. However, understanding the cyclical trends of the Dry Bulk shipping industry is really the only way to assess the strength of buyers in the market and this requires expertise for which most investors will need to rely on specialist advisors in the field. As a protection mechanism, a well-diversified portfolio across other shipping and non-shipping sectors is recommended.

'As a financial asset, there is an income stream for a ship and it has utility and therefore tangible value, which tends to track charter rate trends'

EXIT

As a financial asset, there is an income stream for a ship and it has utility and therefore tangible value, which tends to track charter rate trends. That said, the ultimate value depends upon there being buyers for these large, specialist, costly items and what they are prepared to pay. This is likely to limit the market for buyers and prospective investors need to take this into account, bearing in mind the current over-supply of ships and the uncertain timeline of the route back to balanced supply and demand for ships, both in terms of chartering and purchase prices.

CONCENTRATION RISK

A sensible investment option is to spread risk by diversifying across a range of sectors – some of which may be correlated and some uncorrelated to general market conditions so that losses in one section of the portfolio may be offset by gains in another. Investing solely in any single investment sector is a greater risk, although on the other side of the equation, it carries the potential of larger gains if the optimum conditions exist. This type of risk profile is very unlikely to be for inexperienced or non-professional investors.

Within the Dry Bulk sector, those ships which are most versatile and diversify across routes and commodities, provide some protection against changes which adversely affect the investment sector.

INEXPERIENCED MANAGERS

With so many complicated aspects to consider, including all of the risks in this section, as well as technical factors and international logistical imperatives requiring compliance and commercial and professional expertise, a sizeable risk lies in the persons and entities in control of the Dry Bulk shipping operation. Companies such as British Marine, Anglo Eastern Ship Management and Wallem Group can help to mitigate this risk, with their track records, experience and expertise.

DUE DILIGENCE

Key due diligence issues include the track record and expertise of the fund manager; the methods used by investment managers to assess the investments they make in such a complex sector; the issues examined in the acquisition of ships – such as the reputation/perception of the shipbuilder company to maximise second hand value (this may mean purchasing from a South Korean, Japanese or possibly Chinese shipbuilder), vessel size and type, with the aim of ensuring it meets current demands and has flexibility for cargoes, and opex costs versus current and potential freight rates.

SOURCES OF INFORMATION:

INTERCARGO
International Association of Dry Cargo Ship Owners

INTERNAT. CHAMBER OF SHIPPING
ICS whose membership comprises of the ship owners' associations from over 40 countries

BIMCO
Membership comprises of owners, brokers, ships agents and other operators

DREWRY
Independent global maritime advisory and research organisation

MOORE STEPHENS
Leading international accounting and consulting network with a strong focus on various industry sectors, including shipping

THE BALTIC EXCHANGE
Provider of info on maritime transportation markets, used for the trading and settlement of physical and derivative contracts

TRADEWINDS
Informative in print and online shipping mag, with international offices and journalists, covering all of the shipping sectors

HOW TO INVEST

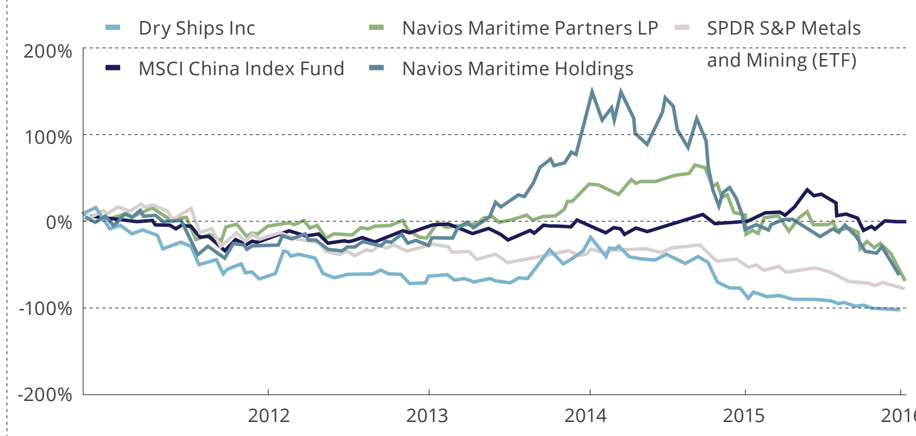
The typical owners of Dry Bulk vessels include public and private shipping companies, investment funds, ultra-high net worth families and family offices.

The high capital-intensive nature of the investment sector has generally meant that investments are reserved for institutional or large investors, with the exception of publicly held corporations. Nevertheless, more recently, the market has opened up with new investment money particularly attracted to the distressed nature of many shipping companies, loans and assets. Additionally, traditional sources of funding have become less enthusiastic about lending to shipping, primarily due to the increased capital adequacy requirements of banks, coupled with the high resourcing requirements and cyclical nature of the industry[2]. Hedge Fund Journal cites the stable medium-term fundamentals, contractual flexibility and the introduction of innovative structures as the enticement.

CORPORATE INVESTMENT

Historically, shipping companies are at the origins of investing in shipping and there remain private companies in the sector, for example Ceres Hellenic Enterprises, which is a large traditional Greek ship management company with family shipping interests that date back to 1824. Exposure to private shipping entities is difficult and likely extremely costly, although, interestingly, one of the company's divisions, DryLog Ltd., which makes investments in other companies involved in Dry Bulk shipping, as well as directly owning some ships, did sell some shares in an IPO in 2012.

DRY BULK SHIPPING PERFORMANCE 2011-2016



Source: Marketrealist

Still, the more accessible investment route is via listed shipping companies, of which there is a substantial number, listed on various international stock exchanges, providing liquidity benefits and the framework of regulations and governance applied to share issuing entities. These include Dry Ships Inc, Star Bulk Carriers Corp, both listed on the Nasdaq and Scorpio Bulkers, Navios Maritime Partners, Navios Maritime Holdings and Diana Shipping, listed on the New York Stock Exchange.

Performance figures over the last five years show the highs and lows associated with a cyclical sector where volatility is a symptom of finely balanced factors.

Buying and selling shares can provide investors with a low fee method to participate in potentially lucrative markets, but if investors are very active and make a number of trades looking for short term gains, dealing fees may become a problem. Also, without advice, investing in a complex investment sector in this way is not for the risk averse or those who cannot afford to lose their funds. In this arena, investors are relying on the expertise of the managers of their corporate entities and the structure of those entities, judging that they have the capacity to withstand the devastating market shocks which can occur. In addition, the right entry and exit time is of great importance if the investor wishes to avoid the hard times, or even to benefit from medium to long term trends, whilst attempting to ride shorter term fluctuations and this is likely to require significant skill and market understanding that anyone outside of the industry is unlikely to possess.

FUNDS

It is possible to gain exposure to various sectors of the shipping market through a number of different fund types including Exchange Traded Funds (passive investments mirroring a market or index and traded like individual listed stocks[73]), such as the Guggenheim Shipping ETF. However, currently, the most notable players in terms of fund investing into Dry Bulk shipping are private equity and hedge funds.

PRIVATE EQUITY

Private equity is finance provided in return for an equity stake in potentially high growth companies; private equity firms raise funds from institutional investors such as pension funds, insurance companies, endowments, and high net worth individuals and use these funds, along with borrowed money and their own commercial acumen, to help build and invest in companies that have the potential for high growth[74].

Private equity is suited to the Dry Bulk shipping sector because it is in a position to take advantage of opportunities whenever they are available as it can access funds at times when they cannot be easily sourced elsewhere. In this way, private equity firms have invested in debt-distressed businesses particularly affected by downturns. By taking advantage of

"Some of the U.S. hedge funds, often described as "vulture funds" as they buy assets cheaply before selling them on in a rising market, are eyeing portions of the €373 million ($406 million) debt of shipping firm Premuda" **Reuters**

adverse market conditions, private equity firms inject more capital to pay off a company's debts and finance expansion to take advantage of suitable investment opportunities. One example is US Private Equity firm Oaktree, which now controls a series of shipping companies including Genco Shipping and Trading Ltd, a Dry Bulk shipping company[75].

This explains the massive influx of private equity money into the shipping sector in the last two to three years. In 2013/2014, Bloomberg estimated $5 billion and rising being invested in that year alone by private equity and hedge funds[76]. It is not surprising that those with the cash are keen to take the private equity route, as growing evidence exists to suggest that private equity outperforms the public stock market over time; over the decade to 2013, its member funds generated an annual return rate of 15.7%, compared to 8.8% for the FTSE All-Share index.[77]

In addition, the regulatory protection of the FCA is available with private equity as all private equity and venture capital firms in the UK are regulated by the Financial Conduct Authority (FCA) and therefore the Financial Services Compensation Scheme (FSCS) applies[78]. However, entry levels are unlikely to be within the reach of ordinary investors; £200,000 or more, is a realistic figure[79], fees are high at around 2% annual management charge levied on the assets under management plus 20% of the fund's profits[77] and with no public market, it is an illiquid investment sector.

That said, whereas traditional ship owners tend to hold vessels for at least 20 years, private equity groups hope to turn a quick profit by listing companies or selling their vessels once charter rates and ship valuations recover[94]. The usual exit target is three to seven years.

HEDGE FUNDS

Like private equity firms, hedge funds have recently seen the value in investing in the shipping market and they are generally inaccessible to ordinary investors. Typically institutions, such as pension funds, university endowments and foundations, or high net worth individuals are the permitted investors, with the significant resources required to enter the market by this method.

Fees are similar to those in private equity, however, hedge funds generally invest in relatively liquid assets, purchase minority positions in company stocks and bonds for both long and short term investment purposes and have much greater liquidity than the standard private equity route of purchasing entire companies.

One of the most popular current methods of hedge fund shipping investment is purchasing the debt of distressed companies, for example, in August 2015, Reuters reported that "Some of the U.S. hedge funds, often described as "vulture funds" as they buy assets cheaply before selling them on in a rising market, are eyeing portions of the 373 million euro ($406 million) debt of shipping firm Premuda."[80]

ENTERPRISE INVESTMENT SCHEMES

Government backed schemes such as Enterprise Investment Scheme (EIS) are vehicles for much smaller levels of investment than that which is available through private equity, institutional or corporate players. The generous tax reliefs for investors, which were introduced to provide incentives for investment in small unquoted companies, with a perception of higher-risk, are very attractive. There is, however, a three-year period during which investors must hold their shares to access the tax benefits, which effectively constitutes a lock- in.

An individual company can apply for EIS status and investors are then invited to acquire shares in it, thereby taking some security over the assets of the company. A UK company can qualify for EIS status as long as it does not carry out certain restricted activities (whilst leasing or letting assets on hire is a restricted trade, certain ship-chartering activities are allowed) and meets other criteria to ensure that its size is limited.

The minimum investment is £500 worth of shares in any one company in any one tax year, although in practice, this minimum is set by the EIS itself and might typically be £5,000 to £10,000. Returns can vary considerably, with targets often high, taking into account the potential for small and sometimes young companies, to grow rapidly.

Exit from EIS is variable and is likely to be by way of sale of the underlying investee company(ies) or their unlisted shares after the three year holding period has elapsed and sometimes longer, depending on the optimum time to sell and interest of buyers.

All types of government sponsored investment schemes are vulnerable to changes in legislation and in last quarter of 2015, EIS underwent rule changes in order to comply with European State aid rules. As a result, the EIS now has a ten year sunset clause, so it will be reviewed again in 2025 and this gives the important advantage of giving the sector a decade of stability.

EIS TAX RELIEFS[81]	(2015/2016)
ANNUAL MAX. INVESTMENT	£1 million
TAX RELIEF	30%
HOLDING PERIOD	3 Years
ONE YEAR CARRY BACK	Yes
DIVIDENDS	Taxable
CAPITAL GAINS TAX	Gains exempt after 3 years
CAPITAL GAINS DEFERRAL RELIEF	Yes
INHERITANCE TAX EXEMPTION	BPR available after 2 years for qualifying investments[82]

"These moments of deep negative sentiment are often a good time to invest, especially if finance is in short supply" **Martin Stopford, non-executive President of Clarksons Research**

There is a history of EIS investment in this sector – through British Marine plc, a UK owned and managed ship owner and operator with a 14-year track record of successfully operating mid-size bulk carriers under the UK flag and Tonnage Tax regime. British Marine was originally set up in 1999 by CEO Alan Bekhor who personally invested the funds in its series of three EIS companies, which between them purchased seven vessels from 1999 to 2002. At the time of the merger of the companies in 2007 the accumulated cash and fair value of the vessels showed an IRR of 37% over a seven year period[83].

Asset backed EIS, London Shipping Ltd was also launched in 2014, although fundraising issues prevented it from progressing.

TIME Investments has recently introduced its own Dry Bulk shipping EIS and is also taking advantage of the expertise of British Marine. The project is looking to raise funds through EIS companies, which will each seek to raise £5 million in any 12 month period. This should generate sufficient capital to acquire a vessel outright without the need for gearing.

A three to five year holding period is anticipated for each EIS company to provide adequate time for a recovery in the shipping market and the targeted exit is for the acquired vessel(s) to be sold and the EIS companies liquidated at that time.

TIME Investments believes that there is a healthy market for second hand vessels as monitoring of the S&P market has shown. In November 2015 there were 40 Dry Bulk second hand vessels sold in that month alone.[24]

TIME Investments is well aware of the market dynamics and the variances between vessel types and returns and has focused on Supramax/Handymax class ships as its intended acquisition. This is unsurprising given Scorpio Bulkers assertion that a feature of the recent downswing in the freight market cycle was the relative resilience of earnings in the Handymax and Handysize sectors compared with the larger vessel sizes. This can be partly attributed to the greater trading versatility offered by the cargo gear on these vessel types[84].

Stephen Daniels, Head of Tax Products and Partner at TIME is positive about the company's Dry Bulk shipping EIS, asserting that, "With the Baltic Dry Shipping Index hitting a new all-time low in December 2015 and ship prices falling to a level where an EIS can purchase a ship without debt, this is a great opportunity for investors to enter a non-contentious sector that few have previously had access to, whilst taking advantage of all the tax benefits an EIS can offer".

To provide additional guidance on the shipping industry and specifically dry bulk operations, the EIS companies will also appoint an Independent Advisory Committee comprising experts with extensive industry experience, with the aim of achieving between £1.27 and £1.94 for each 70p (£1 net of tax relief) invested.

The EIS fees are not insignificant, but fairly typical of the EIS market, with a 3% transaction fee on subscription (this can be up to 5%)[85], up to 1.75% yearly services fee and a performance fee of 20% of the proceeds between £1.05 and £1.25 per £1.00 of net subscription, with all proceeds in excess of £1.25 per £1.00 of net subscription subject to a 40% performance fee. The second tier of this performance fee is higher than is generally the case, but is shared equally between TIME Investments and the Asset Manager, and reflects the specialist and complex nature of the investments and their ongoing management. However, unusually and in order to align the Manager's interests with those of the investors, TIME is not charging an annual management fee.

PRODUCT DEVELOPMENTS

Taking into account the environmental, regulatory, operational and economic challenges which face the Dry Bulk shipping fleet, the continuing development of new features, methods, products and processes to drive improvement is, in some instances, not just a promising development, but a necessity.

These include:

EMISSIONS REDUCTIONS

New regulations are currently pushing development in this area and these include the Harmonised Common Structural Rules (HCSR) and International Maritime Organisation (IMO) Nitrogen Oxide (NOx) Tier III requirements. The two main methods of compliance are exhaust-gas recirculation and selective catalytic reduction systems, both of which are still in development for slow-speed, two-stroke engines. The technology has to achieve a 76% improvement on the current Tier II levels[65].

Such improvements are likely to prove costly to existing vessels, although the Tier III regulations only apply to new vessels and engines, and potentially delay delivery of newbuildings. Nevertheless, according to the DNV Shipping Report, 2020, they will be worth it from both an environmental and cost perspective, "Newbuildings in 2020 will emit from 10% to 35% less CO2 than today's ships. The largest reduction will be experienced with tank, bulk and container vessels. Environmentally efficient designs will gradually improve throughout this decade and a newbuilding contracted in 2020 will, depending on type, emit 10-35% less CO2 than a current ship. Between one-third and one-half of this reduction will be motivated by cost-efficiency alone and would be implemented regardless of the EEDI requirements."[4]

The possible use of different fuels is already being explored, with a cross-industry collaboration of partners about to start research and ultimately aiming to realise the commercial and environmental benefits of using liquefied natural gas (LNG) as a shipping fuel for deep sea marine transportation. LNG is the cleanest of the hydrocarbon marine fuels.[86]

Biofuels and hydrogen are also amongst new methods being looked

"New generation vessels with fuel-efficient designs are an emerging feature of the market" **Drewry**

at for the powering of cargo ships, as a replacement for Heavy Fuel Oil. Such developments will require new propulsion systems, with the aim of creating a cleaner, more sustainable industry.[87]

Another emission related development is the Ballast Water Management Convention 2004 (BWMC), which is expected to come into force shortly. The Convention looks to implement methods to reduce the harmful effects of ballast water discharge, which is the estimated 0.66 billion tonnes of ballast sea water, taken on in one part of the world (to balance the vessel after cargo has been unloaded) and expelled in the coastal waters at the next port of call, where more cargo is loaded.

Ballast water discharge typically contains a variety of biological materials, including plants, animals, viruses, and bacteria. These materials often include non-native, exotic species that can cause extensive ecological and economic damage to aquatic ecosystems, along with serious human health issues.

Not only will the cost of compliance to shipowners be very high, with a ballast water treatment system costing from $500,000 to $5 million, but the use by the US of a different set of standards to the International Maritime Organisation which adopted the BWMC, along with almost a third of the tonnage of world shipping, is causing confusion and potential added expense for operators[88].

FUEL EFFICIENCY

With bunkering such a significant proportion of the operating costs across the Dry Bulk fleet, any developments in fuel efficiency are heartily welcomed by ship owners and charterers, as are the higher rates which can be achieved by modern vessels with superior environmental credentials, relative to older units.

Drewry, independent maritime advisor and researcher notes the trend, "New generation vessels with fuel-efficient designs are an emerging feature of the market. What has yet to become fully clear is how many of the advantages claimed are real as opposed to shipbuilders' hype. Improved engines and propulsion systems are a factor. There are, doubtless, other design and technological innovations. However, choices over hull coatings and anti-foulings also have an impact on fuel efficiency."[89]

Scorpio Bulkers states that recent ship orders have been "focused on new, more fuel efficient ship designs, where shipyard descriptions offer significantly lower fuel consumption compared with existing vessels through a combination of new technology main engines and refinements of hull forms"[11].

TECHNOLOGY

High level analytics, which allow for better and faster interpretation of ever increasing amounts of data, to accommodate the improved operation of vessels, are much in demand, with continual development sought after for optimal performance; "The industry requires advanced algorithms, huge data, innovative analytics and cutting-edge technology, while always being firmly grounded in commercial reality and application."[2]

In an industry in which the asset is often located almost anywhere in the world, other than where the owners and operators are, remote monitoring systems are crucial and becoming increasingly sophisticated, with web-based fleet management systems providing a desk, tablet or mobile-based voyage management solution for owners and charterers. The precise real-time location of ships in or near dangerous waters can be tracked via satellite[90]. This, and advanced communications systems, will have the added benefit of allowing port slots to be booked and enabling the ship to arrive just in time, with no waiting, no wasting of fuel and subsequently no effect on the efficient utilisation of the vessel.

Research into new materials, beyond steel is also taking place, with the potential to produce stronger and lighter vessels, thereby increasing fuel efficiencies. Ideas mooted for such new materials are the option of self-healing skin and embedded sensors which report real time information back to the bridge and owners, allowing clear information regarding the ship's condition and precisely tailored maintenance. All of this makes increasing the lifecycle of vessels by decades, a possibility.[91]

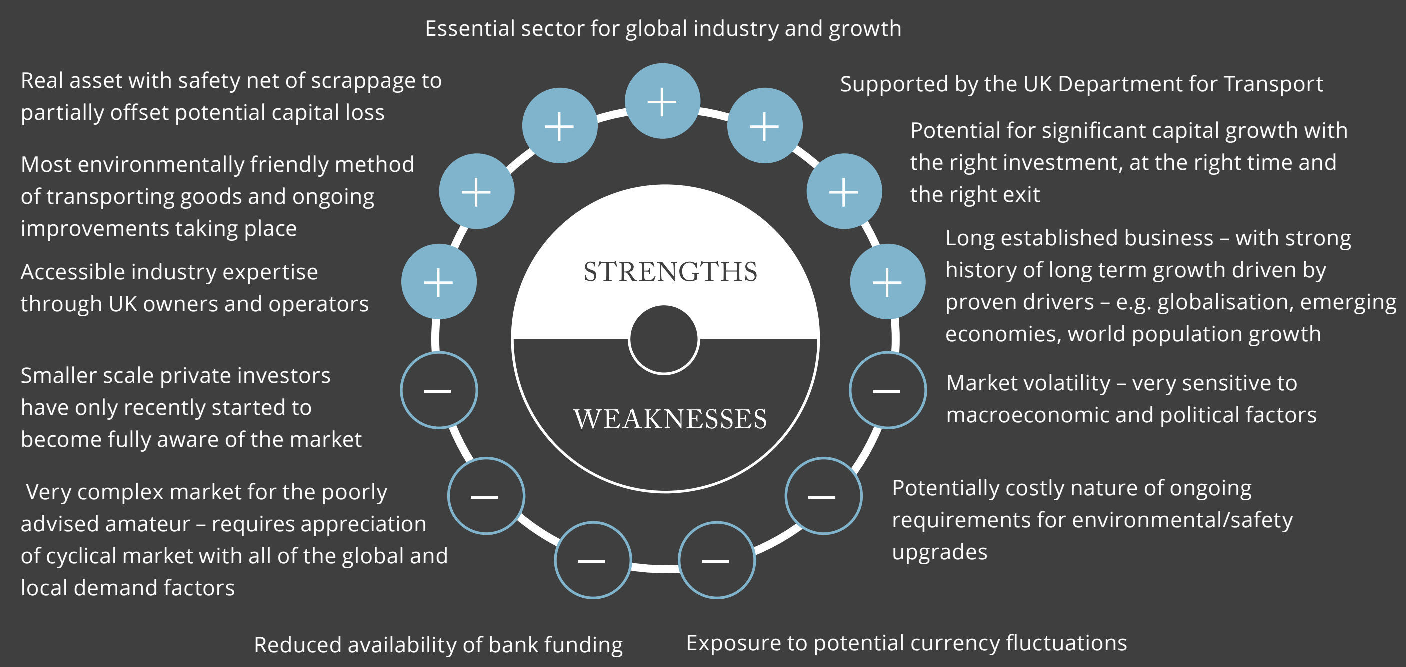
Recent progress in software engineering and advanced computing has also allowed for the creation of advanced virtual environments, in which ships can be built and tested under diverse conditions. This next generation emulation will provide the opportunity to adjust and correct the design, well before any actual work is ordered at the yard, optimising the design process.[92]

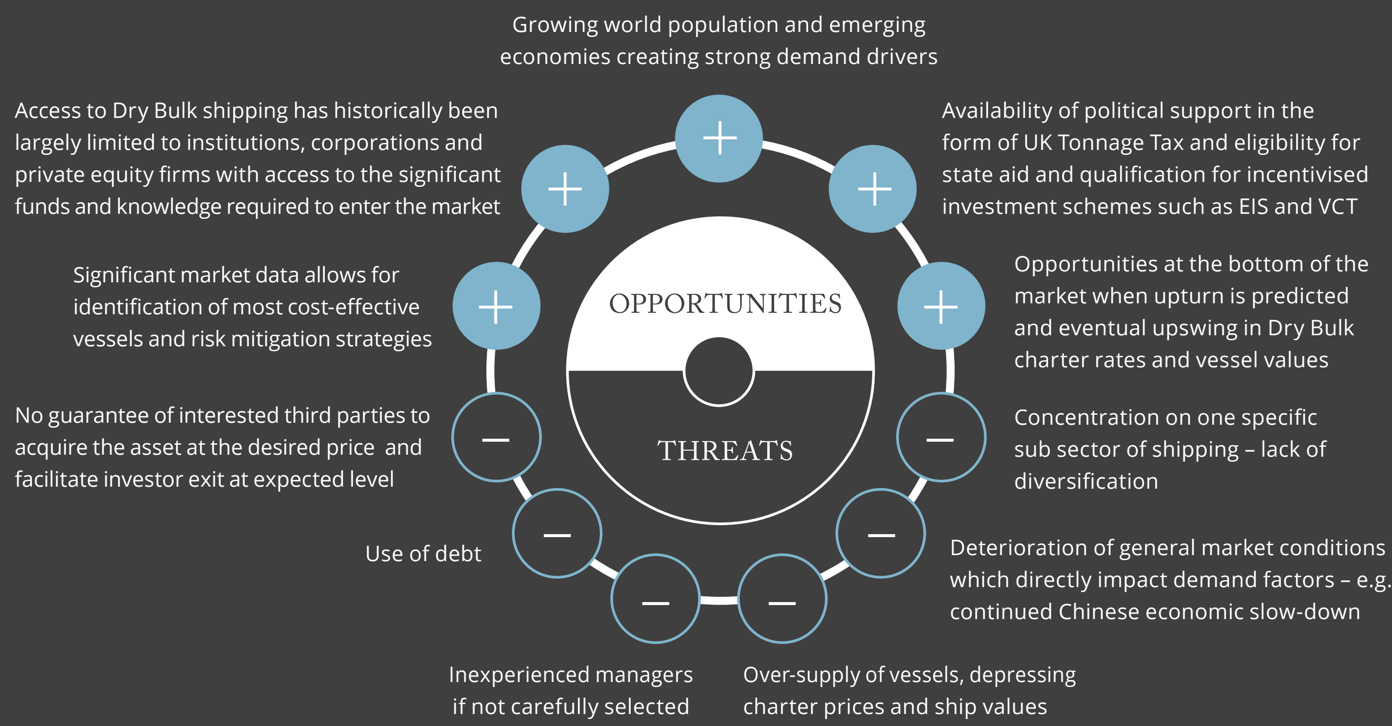
CONSOLIDATION

In February 2015, five of the world's biggest dry bulk carriers launched a common chartering platform for their biggest vessels in an attempt to overcome some of the issues caused by the fragmented nature of Dry Bulk shipping ownership. Capesize Chartering — consisting of Antwerp-based Bocimar International NV; Monaco's C Transport Maritime; Bermuda's Golden Ocean Group Ltd.; and Golden Union Shipping Co. and Star Bulk Carriers Corp., both of Athens — will combine and coordinate chartering services for a combined 80 capesize ships.

This move reflects the difficult times in which the Dry Bulk shipping sector finds itself, with a senior executive of one of the companies involved saying, "Sharing ports and ships is essential to cut costs and have some kind of a collective bargaining power with cargo owners although pricing will still compete in freight rates. I expect more companies to join Capesize Chartering going forward, or other such joint ventures being formed."[93]

SWOT ANALYSIS





SUMMARY

Dry Bulk shipping is fundamental to world trade and its success or otherwise both mirrors and enables international development and this makes its investors likely to be the beneficiaries of mid to long term gains, provided their ships can ride the waves of sometimes severe, shorter term pain which punctuate the good times. For the individual investor, the key to success in this sector is clearly in the timing of entry and exit and given the complexity of the factors instrumental in shaping the market, this is not easy and presents not inconsiderable risk.

Nonetheless, with expert advice, the potential upsides, even in the short term, could be significant if the market recovery takes hold as commentators have forecast. Whilst publicly quoted shipping companies have been battered by conditions for several years and have consequently posted major losses, those with short term goals and free from having to take on bank debt, could reap the rewards even if we have not yet reached the bottom of the market.

Accessing the market has certainly become easier in the last ten to fifteen years, with more corporate shares available and evidence of successful EIS qualifying investments. However, there have been casualties of the faltering and falling market since the credit crunch took hold in 2008/2009, with multi-vessel owning companies such as Copenship, Winland Ocean Shipping Corp, and Daebo International Shipping filing for bankruptcy in 2015 as they were simply unable to withstand the continuing harshness of the sector price environment making repayment of their debts unsustainable. Yet, in December 2015, Martin Stopford, the non-executive President of Clarksons Research, stated that, "These moments of deep negative sentiment are often a good time to invest, especially if finance is in short supply."[96]

Consequently, in a short term setting, as a small part of an overall portfolio, given the forecast for an eventual upturn in the market with a healthier balance of the supply of ships against required movement of commodities, individual investors who seek out well-informed and experienced guidance may well take the view that this is a good time to take a greater interest in Dry Bulk shipping.

"Whosoever commands the sea, commands the trade; whosoever commands the trade of the world, commands the riches of the world, and consequently the world itself."

Sir Walter Raleigh (c1552-1618)

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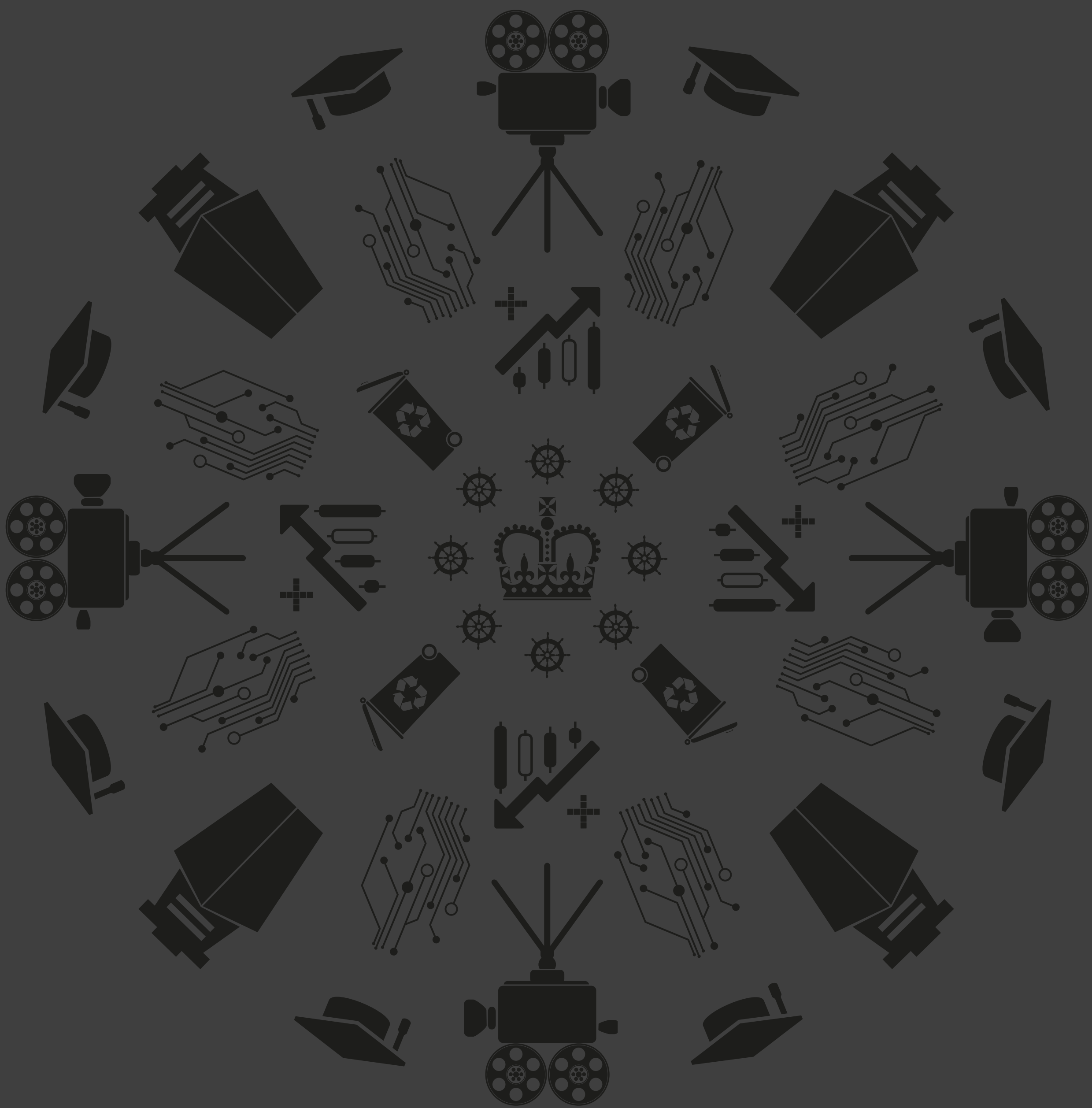
“ With expert advice, the potential upsides, even in the short term, could be significant if the market recovery takes hold as commentators have forecast”



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