Algoma Central

Profundus Research

Executive Summary

Algoma Central (TSE: ALC) is a Canadian Marine Shipping Company. They have a long history of profitable operations. In this analysis, a forward P/E ratio of 9.13, and an intrinsic value of $477,370,000 is assigned to the company. Healthy long-term operations and high barriers to entry make this an attractive investment, but limited growth and a competitive industry limited profits to consistent but unremarkable levels. Strong operation results in the past three years have placed the company in a healthy position, and they have rewarded shareholders with special dividends. The company can increase their intrinsic value by increasing market share in the Great Lakes and St. Lawrence Seaway, or by adding international operations.

	2022 Year End Result (Thousands CAD or as otherwise stated)
Revenue	$677,942
Net Income	$119,996
Profit Margin	17.7%
Total Assets	$1,365,697
Current Assets	$255,330
Liabilities	$639,673
Current Liabilities	$150,828
Long Term Debt	$397,157
Shareholders' Equity	$726,024
Debt to Equity	0.55
Market Capitalization (03/21/2023)	$595,540
Free Cash Flow	$99,192
ROE	17.6%
ROA	8.7%
ROIC	12.55%

Fig. 1 *Algoma Central Summary of 2022 Results/Financial Position*

Introduction

Algoma Central is a shipping company with a focus on the St. Lawrence Waterway and the Great Lakes. They are based in Canada. They also have their own international shipping operations, and joint interests in international operations. They provide operational management for four ships they do not own. They are organized into six segments:

- **Domestic Dry Bulk**: Consists of their dry-bulk carriers operating in the Great Lakes and the St. Lawrence Seaway. Typical payloads are iron, steel, cement, aggregates, building materials, and agricultural inputs and outputs.
- **Domestic Product Tanker**: Consists of liquid petroleum transporting vessels.
- **International Self-Unloaders:** Ocean going vessels, with crane like conveyor belts on board that rotate to offload cargo beside the ship.
- **Global Short Sea Shipping:** Specialized operations, including owned ships, managed ships, and chartered vessels. This is a 50/50 venture with Nova Marine Carriers, each entitled to 50% of the net income.
- **Investment Properties**: largely defunct, the last property in this segment was sold in 2022.

Corporate History

Despite the lackluster appearance of the company now, Algoma has a rich 124-year history. For its first 96 years, it was also a railway company, before spinning off their railway and focusing on shipping. They acquired imperial oils shipping operations in 1997, with imperial realizing that these were best managed by Algoma, who in turn prospered from the growth in their operations. In their years as a railway, they owned 1.6 million acres of land, which were sold two years after the railway was spun off. They also acquired, developed, and sold urban land in the Great Lakes region, but since the late nineties, they have focused on shipping while offloading their unrelated lines of business.

The significance of dominance (not a monopoly, but an oligopoly) on the St. Lawrence Seaway might not be understood until you look at the geography of the area surrounding the northeastern U.S border with Canada. Before the railways spanning the continent were build, it was the easiest path to the heart of the continent. Chicago, Detroit, Toronto, Buffalo, Cleveland, and Milwaukee would certainly not have become the cities they are (or were) without this geographical feature.

Fig. 2: A map of the Great Lake and the St. Lawrence Seaway

Customers and International Markets

Algoma’s business is dependent on commodities, but it is not a commodity business. They have remained profitable every year for over 50 years. They have long term relationships with customers:

Cargill	Over 80 years
Richardson	Over 80 years
Compass Minerals	Over 55 years
ArcelorMittal	Over 50 years
LafargeHolcim	Over 30 years
ExxonMobil	Over 20 years

Fig. 3: Algoma's long-term customers

Their international joint venture targets regional markets with the goal of becoming the shipper of choice in these markets. They have operations in Asia, Northern Europe, the Mediterranean, Central America, and the United States. These operations have become Algoma's primary mechanism to invest and expand with excess capital.

Management

The CEO has over 30 years of industry experience. His discussion and analysis is boilerplate and there are no videos of him on the internet. It is hard to get a read on management, so we must let the numbers speak for themselves. Shareholders are rewarded generously with a 4.7% dividend yield plus special dividends in recent years. Management has achieved historically strong returns:

	2022 Value	Average since 1997
ROE	17.6%	10.82%
ROA	8.7%	6.24%
ROIC	12.55%	9.02%

Fig. 4: Management's ratios

Key Risks

The prosperity and competitiveness of those operating along this route is more questionable than their predecessors that predate the railways. Profitability of shipping the route's target commodities, as well as historical trends, comparative consumer costs/wait times, and barriers to enter/exit shipping contracts with Algoma Central must all be analyzed against competitors and rival shipping methods.

The business unavoidably experiences seasonal fluctuations in their operations. The St. Lawrence Seaway freezes every year to halt operations for at least one quarter. Algoma is also exposed to changes in the water level in the St. Lawrence Seaway and other canals in the Great Lakes: if the water level is too low, they are forced to reduce cargo weight, and if levels are too high, the clearance height is raised and may render some bridges impassable. Water levels fluctuate between the two extremes of 71-74 meters, but climate change could make these values even more volatile, forcing Algoma to modify its fleet to accommodate to the new water levels.

The economy of the Great Lakes region is vital to Algoma's existence. Ontario, Quebec, Minnesota, Wisconsin, Illinois, Indiana, Michigan, Ohio, Pennsylvania, and New York all have coasts along them. The region accounts for 50% of trade between Canada and the United States. 200 million tons of cargo moves through the region, and the area has a GDP of 6 trillion. The population of the surrounding provinces and states is over 100 million. Over 50% of the cargo moved across the Great Lakes is Iron ore. This high exposure is a vulnerability. If demand for iron decreases, it would systemically change trade in the region and could threaten Algoma's business if they cannot adapt.

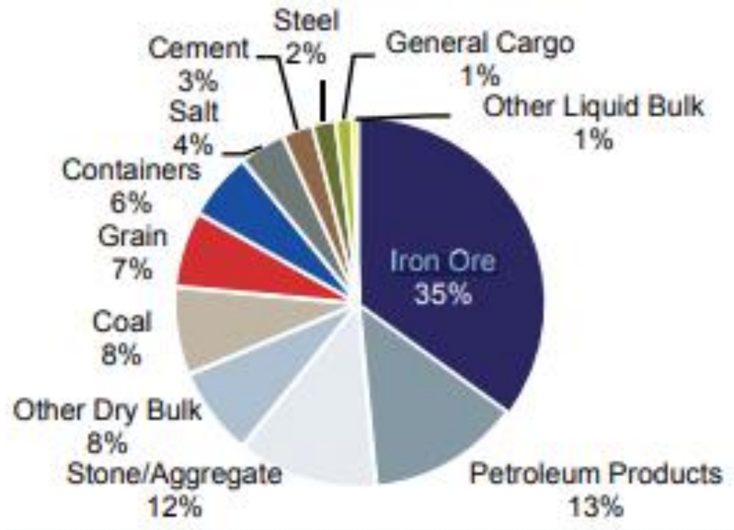

Fig. 5: Breakdown of cargo in the region

Quantitative Factors

The underlying economics of this business are easy to understand. The company is chartered to ship cargo, with a focus on term contracts of 5 years. Their major costs are maintenance and fuel, as well as capex in fleet renewal. Rising fuel costs are passed through to the customer via surcharge, mitigating direct risks associated with volatile fuel prices. Algoma has shown that they are focusing on what they know by spinning off businesses unrelated to marine shipping while expanding their primary business of regional commodity shipping into different parts of the world.

The company has been buying back shares slowly, reducing the shares outstanding from 38.9 million to 37.8 million since 2016. They pay a generous 4.7% dividend yield and have paid out much larger dividends to distribute excess capital.

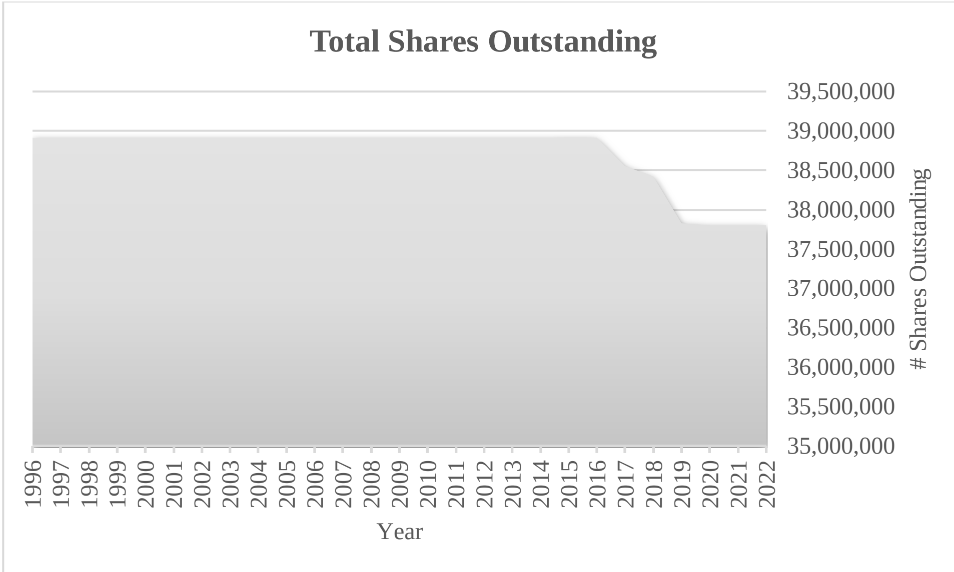

Fig. 6: Shares outstanding since 1996.

Income Statement

The company is mature and does not achieve significant organic growth in its historical operating regions. If you were to look at their financial performance since 2016, you would tell me otherwise, but in looking at longer term financials, the cyclicality of the business is clear. Revenue in 2022 was $678 million, in 2016 it was $295 million, and in 2010, it was $520 million. This is an attestation to Algoma's exposure to macroeconomic industrial trends, but consistent profitability proves that they are capable of operational and financial stability in all conditions. The company experienced financial losses in 2008, attributable to foreign exchange losses, but operations improved, showing operational resiliency to unrelated economic conditions.

Because fuel costs are passed to customers, lower fuel prices decrease revenue. The lousy mid 2010's are attributable to lower volumes of iron and steel production. Looking forward, it would be nearly impossible to predict changes in these raw commodities markets that are subject to geopolitical and economic activity worldwide. It would be wiser to assume that downturns in the market would produce results like those experienced in the mid 2010's. Two forward looking analysis of operations will be created, one that predicts an economic downturn, and one that assumes operations will not experience significant changes.

	25-year average
Profit Margin	8.8%
Revenue Growth	6.3%
EV/EBIT	10.5
P/B	0.9

Fig. 7: Long term average metrics

Earnings Per Share:

2022	$2.00
2021	$1.73
2020	$1.01
2019	$0.79
2018	$0.82
2017	$0.70
2016	$0.43
2015	$0.18
2014	$1.01
2013	$0.95
2012	$1.14

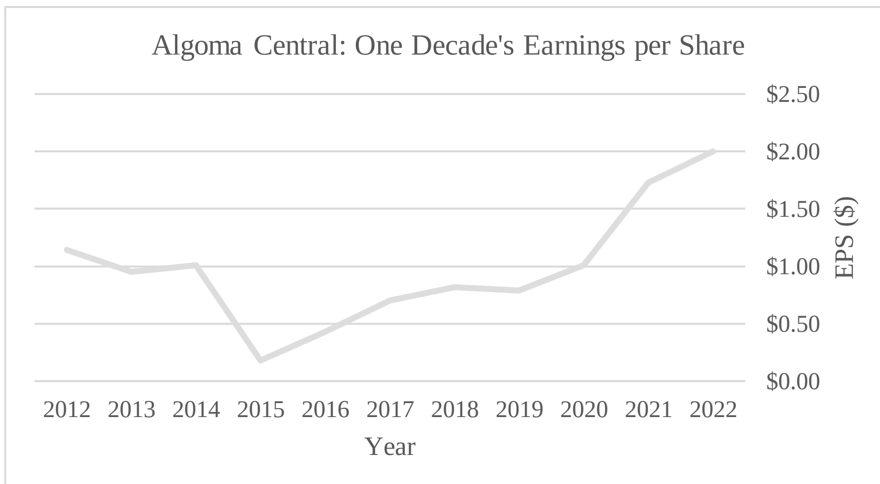

Fig. 8: Ten years of earnings

The company's ability to maintain steady operations is a strong indication that earnings will not fluctuate significantly. However, the rising cost of borrowing in its operating regions will inevitably reduce earnings, resulting in the company ossifying operations and taking whatever business they can. A 15% drop in earnings, like the difficulties in a tight 2012-13 housing market would not be an unreasonable expectation. This would cut earnings per share to $1.70 and yields a forward P/E of 9.13.

Balance Sheet

The company has a strong balance sheet, with $1.37 in assets, $141 million in cash, and $640 million of liabilities. PP&E is easily the most significant asset at $850 million. Because every ship has its own nuances, it is not possible to determine exactly how much each would go for at an auction, but we can make estimates based on ships currently for sale. There are four types of ships Algoma operates: Domestic Dry-Bulk, Domestic Product Tankers, Ocean Self Unloaders, and Global Short Sea Shipping.

The average fleet age is 20 years, which is old based on their depreciation schedule of 25-30 years. They have a diverse fleet with operations in four continents. Algoma decommissions ships at a rate of 1.6 per year, and assuming this must be reciprocated from the other end, they must incur constant capital expenditures associated with building new vessels at a rate of 1.6 per year.

Within Domestic Dry-Bulk, there are Self Unloaders and Gearless Bulk Carriers. There are self-unloaders with similar specifications to Algoma's average 210-meter LOA in the market for $13/million per ship. Algoma has 11 of these ships, totaling a $143 million liquidation value. Algoma's gearless bulk carriers are slightly larger, and similar ships are on auction for $15 million. Algoma owns 8 of these, which adds $120 million to our liquidation value.

The Domestic Product Carriers transport petroleum. The average length for one of Algoma's ships in this category is 140 meters, and similar ships are on auction for about $16 million. Algoma owns 7 of these, adding $112 to the liquidation value.

Algoma's ocean self-unloaders are larger than the Domestic Dry-Bulk self-unloaders, but the auction prices are similar. So, for the ten Ocean Self-Unloaders, the liquidations value is estimated to be $130 million.

In Short Sea Shipping, Algoma only owns a 50% stake in the segment. Nova Marine Carriers owns the other half. In the event of a liquidation, Nova Marine would likely be offered these at a discount as Nova is already operating the ships, and they would be most willing to acquire them immediately. We can take a 25% discount off of the auction value. This fleet consists of 29 pneumatic cement carriers with an estimated discounted auction value of $15 million based on ships currently for sale, adding $174 million to the liquidation value after the priority claim discount to Nova.

Also in short shipping are 17 mini-bulkers and two deep sea bulkers. They average 130 meters LOA, and similar ships have sold for $7 million. The total liquidation value of Algoma's claim on these ships is $53.2 million.

The total liquidation value of the fleet is $732.2 million. This is a significant markdown to the $1.05 billion dollar value of these assets in their books. Thus, the "fire sale" book value of the company is roughly $320 million less in the event of a liquidation, or roughly $400 million.

Year	Current Portion of Long-Term Debt
2023	$5.2
2024	$78
2025	$0
2026	$0
2027	$27.1
2028 and after	$300
Total	**$410.3**

Fig. 9: Long-term debt repayments (in millions)

Cash Flows

The company has strong and consistent operating cash flows. In 2022, OCF was $133 million. This value is slowly increasing and does not fluctuate wildly year to year. Investing cash flows are forced up by the constant need for new vessels. This figure was negative $65 million in 2022, and over the long term tends to average around 50 million. The main expenditures in financing cash flows are the $25 million in dividends and $18 million in interest.

Average	2022	2021	2020	2019	2018
$43,359	$99,192	$134,378	$104,49	$-75,388	$15,252

Fig. 10: Five years of free cash flow (in thousands)

If we assume there is no growth, which is feasible considering the nature of the business, we could take the average of these with no growth and project them in our DCF. If we want to factor in a severe economic downturn, we could assume that the first two years in a DCF are zero, and the following are average. For a discount rate, we have seen that this company has exposure to economic volatility, but it does not have a material impact on the company's operations. As our interest rate, we could add a risk premium equal to the companies cost of borrowing, 5.5% to the current risk-free rate of 3.4%, giving us an 8.9% discount rate. We can also perform a more optimistic cash flow reflecting the past three years; however, this fails to consider higher costs of borrowing.

Sum of 10 years PV Free Cash Flow	$322,851
Sum of 10 years PV FCF except Year 0 and Year 1	$239,676.80
Optimistic, with low cost of borrowing but no growth	$869,581
Average	**$477,370**

Fig. 11: Upper, lower, mid, and average discounted cash flow model

Our average does not provide a margin of safety. Wishful thinking would only consider the more optimistic of projection, but it is not realistic to expect nearly zero interest rates over the next ten years, and the economic environment is already reflecting this.

Summary

Catalysts for growth in the future are dependent on the opportunities management sees in international markets, or changes in the shipping industry on the Great Lakes and the St. Lawrence Seaway.

Potential Catalyst: Long term international opportunities to expand operations become available.

Potential Catalyst: The opportunity to increase market share on the Great Lakes or the St. Lawrence Seaway arises.

The company is currently in a favorable position; however, the current cost of capital is impacted by higher interest rates and could prove to be a significant impediment to the company’s future growth despite fantastic recent operating results. This company has stable operations. If the future intrinsic value of the company ever exceeds the market value, this is a healthy company and could be an attractive candidate for investment.

Sources

Pitchbook

Algoma Website

Sedar

https://ijc.org/en/loslrb/watershed/forecasts

https://councilgreatlakesregion.org/the-great-lakes-economy-the-growth-engine-of-north-america/

Additional Figures

10-year discounted cash flow models:

All Values in $1,000's	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Present Value of Cash Flows	$43,359	$39,815.43	$36,561.46	$33,573.42	$30,829.59	$28,310.00	$25,996.33	$23,871.74	$21,920.79	$20,129.28	$18,484.19
Discount rate	8.90%										
Growth rate	0%										

All Values in $	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Present Value	$116,785	$107,240.59	$98,476.21	$90,428.10	$83,037.74	$76,251.37	$70,019.63	$64,297.18	$59,042.40	$54,217.08	$49,786.12
Discount rate	8.90%										
Growth rate	0%										