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## Seaborne leverage

The stocks of Eagle Bulk Shipping, Inc. and Genco Shipping & Trading Ltd. (EGLE and GNK, both on the New York Stock Exchange) have been steaming in opposite directions since their featured appearance in the Feb. 22 issue of *Grant's*. A reappraisal of each as well as a brief survey of the oil-tanker business are the topics at hand. In preview, we remain bullish on the bulk carriers and sing the praises of a pair of tanker companies, Teekay Tankers Ltd. and International Seaways, Inc. (TNK and INSW, both on the Big Board).

Eagle, down 10% since publication, is our problem child, but the source of the disappointment has little to do with operating performance. July issuance of the unrated Eagle 5s of 2024 is rather the blemish, a \$115 million convertible issue placed mainly with Oaktree Capital Management, L.P. and Golden Tree Asset Management, L.P. on terms so strikingly favorable to the investors that they seemed to constitute a kind of corporate SOS signal. Even single-B-minus-rated Tesla, Inc. got away with a 2% coupon on its May convertible deal. Anyway, the Eagle share price dropped 18% as the terms of the financing hit the tape.

But there was no SOS—management raised the funds to buy more ships, a cheerful use of proceeds. As it is, Eagle's fleet is worth some \$669 million, according to VesselsValue, which indicates a net asset value of \$5.48 per share, a 22% premium to the \$4.48 share price.

In the ESG world, shipping stocks are only slightly more reputable than cigarette makers and arms dealers. For one thing, the ship owners tend to

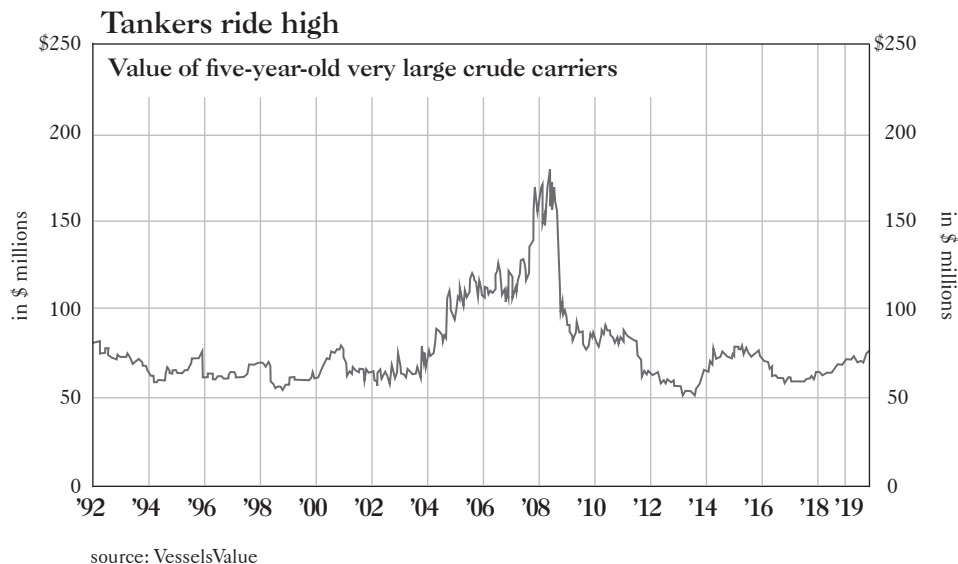
score low marks on governance, though Eagle ranks No. 1 in the 2019 Webber Research Shipping Corporate Governance Scorecard (and Genco places No. 9). For another, a standard container vessel emits sulphur oxide gas at a rate equivalent to that of 50 million idling diesel car engines. Hence, the International Maritime Organization's mandate for ships worldwide to drop sulphur content in fuel oil to 0.5% from the current 3.5%. Whatever the ukase may do for the environment, it promises to redound eventually to the competitive benefit of the operators that can bear the cost and manage the timetable to greener steaming; by such criteria, Eagle and Genco both stand to gain.

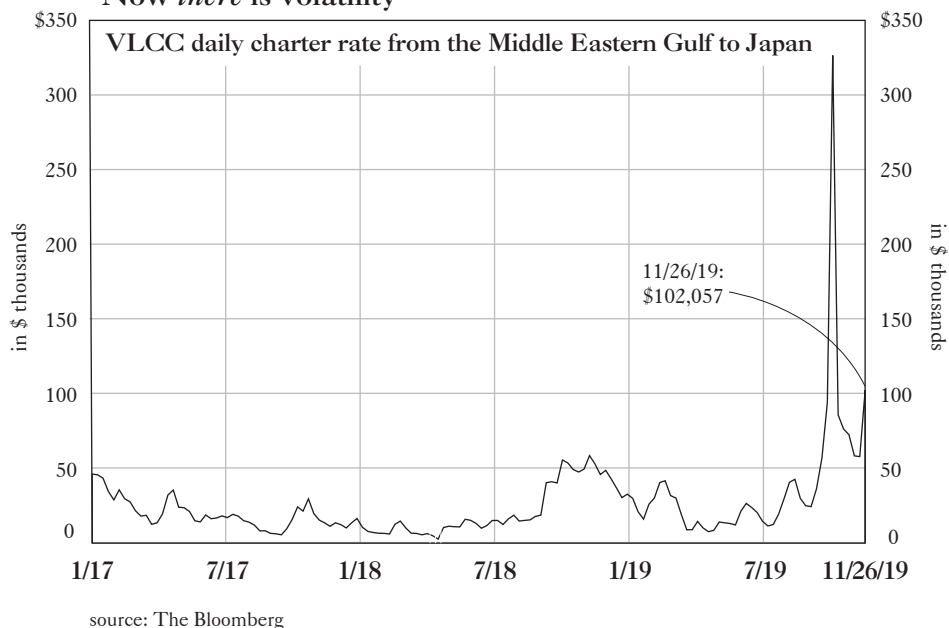
On Nov. 6, Genco spiced up the announcement of lackluster third-quarter results with news of the initiation of

a regular quarterly dividend of \$0.175 a share, the first since 2008—and the declaration of a special \$0.325 dividend. And it's no small thing that, at least for the time being, these are tax-free payouts, "a nontaxable return of capital to stockholders to the extent of their basis in our common stock and then as capital gain," to borrow from the press release.

As to operating results, Genco missed sell-side earnings estimates—the Vale dam disaster in Brazil reduced iron-ore volumes, and environmental remediation meant more ship days "off water"—but management projected high utilization next year, when the costs of the green fixes are behind it.

John Wobensmith, CEO of Genco, tells colleague Fabiano Santin that the demand for dry-bulk vessels has come to meet and, as he views the market,



**Now there is volatility**

exceed the supply. More than that, the new-ship orderbook represents “about 10% of the overall dry-bulk fleet, and you’ve got a situation where 7% of the dry-bulk fleet is 20 years old or older. So you’ve got a—from a historical standpoint—very little orderbook and a pretty high potential for scrapping over the next few years. You continue to have a lack of financing, particularly from banks.”

Genco’s fleet is worth \$799 million, says VesselsValue, meaning (as we do the figures) a NAV per share of \$12.31, which is 19% above the last quoted stock price of \$10.37.

“It’s impossible to tell whether dry-bulk stocks will be tomorrow’s big winners,” writes Santin. “Volatility, a source of risk and opportunity, is widely available in a different market. Thus, over just two months, September and October, the daily spot rate for oil tankers surged tenfold, to more than \$300,000, setting a new record. And as daily rates have risen, so have the prices of tankers. Indeed, a 10-year-old very large crude carrier can fetch in excess of \$50 million, well over the \$47.6 million long-term historical median, according to VesselsValue.”

For once, Wall Street likes what we like, with the sell side virtually unanimous in its bullishness toward the tanker stocks. According to Bloomberg—“The Spike in Oil Tanker Rates May Be Over, But a Boom is Coming”—the analysts project VLCC rates to average

\$51,000 in 2020, 34% higher than the \$38,000 average penciled in for 2019.

The insiders are another story, sellers of their own shares, for the most part, and maybe they know something we don’t know. Or perhaps, sick and tired of their own long-languishing industry, they can’t imagine a turn for the better.

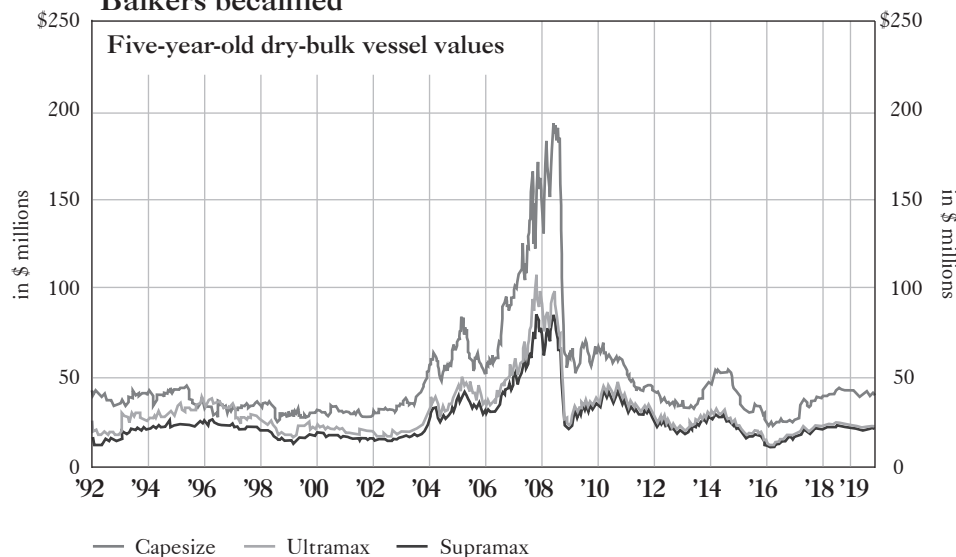
Don Cox, investor and portfolio manager, knew the mindset when he said of another set of bearish insiders at the bullish turning point of another commodity cycle, “Those who know it best, love it least, because they’ve been disappointed most.”

The October spike in tanker rates was partly owing to U.S. sanctions against China’s state-owned COSCO Shipping Tanker Co. Ltd., the world’s largest owner of oil-tanker fleets. As many ships are laid up for the repairs required to meet the IMO’s Jan. 1 green deadline, shipping capacity has remained tight.

A ship owner turns his vessels green by fitting them out with devices that permit the continued use of cheap and dirty fuel; such “scrubbers” render the bunker oil acceptable to the IMO standard-setters. As it’s done with bulkers, the retrofitting has tightened the supply of tankers. Because, according to Clarksons Research, only 8.9% of dry bulk and 10.7% of oil-tanker capacity passed environmental muster on Nov. 1, the dry docks will likely keep busy for the next two years.

Un-scrubbed vessels may, in fact, operate, but only with the added expense of burning low-sulphur fuel. The greater the cost of that fuel, the greater the tendency of the unfitted vessels to reduce speed. Slower speeds translate into cheaper costs for the operator and tighter supply for the market.

“Although shipping rates have already risen and are expected to remain high throughout the next two years,” Santin relates, “the opportunity lies in the future. The market expects spot rates to fall once this one-off event peters out. For instance, VLCC rates are estimated to drop to \$33,500 a day in 2022, 12% below the \$38,000 projected for 2019, and 34% lower than 2020 ex-

**Balkers becalmed**

pected levels, analysts tell Bloomberg.”

But if the size of new-vessel order-books is any indication, the up cycle could prove longer than many expect. UK shipping broker Gibson estimates that the tanker orderbook stands at 7.6%, lowest of this century.

“This could be the biggest boom ever in the history of tankers,” George Noble, paid-up subscriber, founder and chief investment officer at Noble Capital Advisors, tells Santin. The International Maritime Organization rules to take effect in 2020 constitute “just the first step in the decarbonization of the shipping fleet. As an aside, carbon emissions for the shipping fleet since 2008 have gone down by 20%, but they want to make the fleet greener. There is something coming up next called IMO 2030, which is to say that in 10 years there are going to be new regulations and we don’t know if you’ll still be allowed to use diesel, be required to switch to LNG, or use a different technology.

“Let’s say that you and I are in the shipping business,” Noble continues—he says he’s followed shipping stocks since his time as a Fidelity analyst in the 1980s—“and we want to buy a \$100 million new VLCC, or a \$60 million Suezmax. The asset is supposed to last 25 to 30 years. We know the rules of engagement for the first 10 years, but if the rules are going to completely change come 2030 . . . how do you go and order a new ship which is supposed to last 25 years when you don’t know what the rules of engagement are going to be post-2030? I’ve had two corporate managers tell me this. That puts an even bigger paralysis in the minds of shipowners, it makes them even more hesitant to want to order new vessels.”

Global demand for oil grows almost



every year. The world consumes about 100 million barrels a day, rising 1% to 2% annually with accelerating demand from the East and—thanks to America’s shale boom and persistent disruptions in Iranian and Venezuelan production—with accelerating supply from the West. The upshot is that oil demand, as measured in ton miles, is growing faster than oil consumption, as measured in barrels.

Thus, Clarksons expects demand for deadweight tonnage of crude tankers to rise by 4.8% next year, above the projected 2.3% growth in the fleet. Absent plunging shale production, tankers may retain the thing almost as scarce in today’s world as a decent yield. That rarity is pricing power.

Which brings us to a pair of our reader’s favorite tanker plays. Teekay deploys a large-vessel fleet of 30 Suezmax (1 million barrels of oil), 32 Aframax (750,000 barrels) and one VLCC (2 million barrels). It moves 5% of the world’s seaborne crude oil, and its ships are 90% exposed to the spot market, meaning that it will monetize increases in freight rates faster than companies running under time-charter contracts.

By Teekay’s reckoning of its own fleet value and NAV, the shares ought to trade at \$23.36 instead of Mr. Market’s \$18.74. Sell-side analysts esti-

mate that the company will generate \$358 million in free cash flow in 2020, or \$10.64 a share, implying the shares trade at 1.7 times 2020 free cash flow.

Judging that the cost of environmental remediation exceeds the benefit of that remediation, Teekay is choosing to pay up for fuel rather than to install scrubbers. The company ranks 17<sup>th</sup> in the 56-company Webber ranking of maritime corporate governance.

International Seaways’ 42-ship fleets include VLCCs, Panamax, Aframax, Suezmax and medium-range vessels. According to Clarksons Platou Securities, INSW’s net asset value stood at \$31.90 a share the other day, which is 18% above the last quoted stock price. Management, which on the Webber scale ranks No. 2, is either installing scrubbers or is planning to do so.

Then, should it be oil tankers or dry bulkers? Darren Maupin, himself a paid-up subscriber and the founder and a director of Pilgrim Global, tells Santin that he’s unloading some of his tanker exposure to focus on bulkers. Whereas VLCCs trade above their long-term median prices (the prior example of the 10-year vessel was \$50 million-plus), a comparable Ultramax dry-bulk carrier can be yours for \$14.4 million, 26% below the long-term Ultramax median of \$18.2 million.

“Likewise,” Santin observes, “if related to historically maximum levels, dry-bulk-carrying ships would appreciate by more than 400%, compared with 200% for VLCCs. These gains don’t include the additional profits that investors would recognize if the discounts of the shipping stocks to their respective net asset values narrowed or closed. In a bullish scenario, it could actually happen.”

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