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All ahead full

Over the transatlantic telephone from the landlocked Alpine ski village of Verbier, Switzerland, Darren Maupin was marveling at his saltwater shipping investments. "The prices are so wrong," said Maupin, founder and director of Pilgrim Global, "they are stupid."

Now under way is a survey of the opportunities in ocean-going shipping. Interest rates, bank credit, day rates, fuel costs, the relevance (and irrelevance) of trade wars and a looming regulatory upheaval are among the topics on the agenda. Genco Shipping & Trading Limited (GNK on the Big Board) and Eagle Bulk Shipping, Inc. (EGLE on the Nasdaq) are the micro-cap companies under the *Grant's* lens. We're bullish on both.

Receipt of Maupin's 2018 investor letter set this essay in motion. "The Fund's shipping investments are currently priced for global economic disaster," he writes. "We do not observe anything else in global markets approaching the pessimism and fear embedded in our shipping-stock prices. Or the asymmetry of the return profile."

Maupin, 42 years old, a native of Reno, Nev. and the husband of a Swiss wife, is the chief cook and bottle washer of the fund he characterizes as "not quite a one-man band." He is a connoisseur of the cheap and the contrary—Microsoft in 2011, Russia in 2014, shipping in 2016. He favors concentrated positions, never mind that that concentration will almost certainly lead to volatile returns.

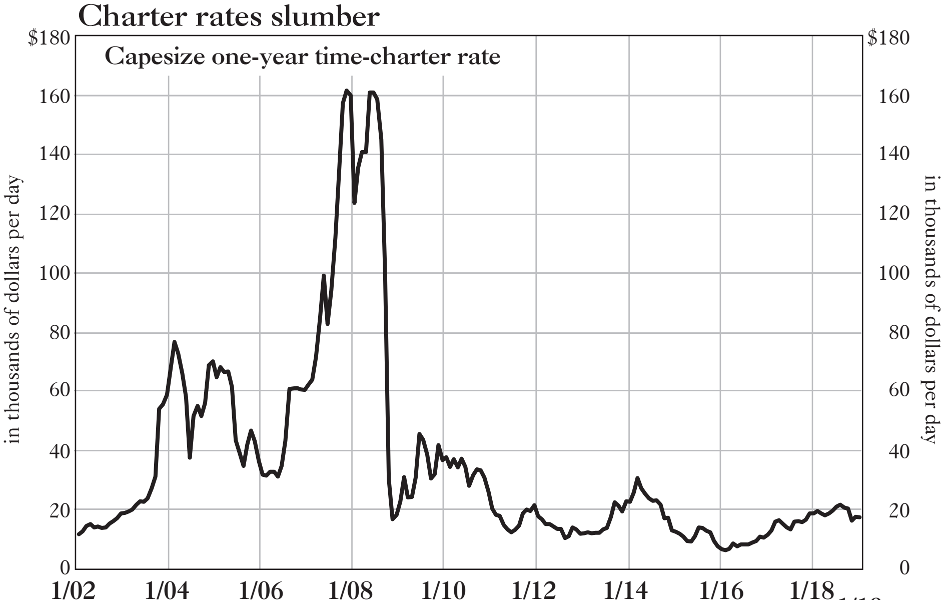
In his 2014 investor letter, for the benefit of new partners, Maupin laid out his rules to live by. There were six: "(1) borrowing and printing money does not create wealth, (2) buying overvalued assets is a long-term losing strategy, (3) volatility is not risk, but is a creator of opportunity, (4) price paid is the key determinant of risk, (5) areas with emotional pricing of assets is where the best bargains are found, (6) owning out-of-favor, undervalued assets around the world is a sound investment formula for compounding wealth over the long term."

Maupin says that, unusually for Pilgrim, the fund is currently fully invested. "The portfolio entered 2019 with eight stocks," he advises his limited partners, "the most expensive of which trades at four-times trailing earnings per share. Much of the portfolio trades at one-time normalized cash flow." Shipping accounts for more than half of it.

You can have low prices and bad news or high prices and good news, but you can't have low prices and good news, is a saying that Maupin has quoted to his investors before. It has certainly fit the dry-bulk shipping market for most of the past decade. Between 2008 and 2016, the Baltic Dry Index, a proxy for the cost of shipping such cargo as iron ore, coal, soybeans, steel and fertilizer, fell by 98%. And while it did bounce, it has plunged by 50% since the start of the year.

"Too many ships" is the short version of the immediate cause of this long-running bear market. Ultra-low interest rates and easy credit are the remote causes. Nor must you stretch your imagination to visualize a future time of trouble. China, the world's

Charter rates slumber



sources: Clarksons Shipping Intelligence, Pareto Securities A.S.

great importer of iron ore, coal, soybeans and other dry cargoes, is likewise the world's all-time greatest debtor. One of these days, the People's Republic might finally yield to the crisis that we have long predicted for it. Or, perhaps, today's trade skirmishes may turn truly warlike. Each threat is clear and present, though it can't be said that Eagle or Genco is priced for anything but high winds and heavy seas. The bullish case on the stocks boils down to a conviction that good things happen to cheap securities, let the macroeconomy do what it will do. As neither company has earned a full year's GAAP profit in any of the past five years, their cheapness is stamped on their respective balance sheets. Each trades at half of liquidation value, Maupin calculates, "meaning the companies could sell their fleets, pay off the debt and equity holders would double their money."

The dry-bulk trade, in which Eagle and Genco ply their vessels, relies, to start with, on iron ore (29% of estimated 2017 tonne-miles), coal (24%) and grain (10%). These mainstays are called "major bulk." Miscellaneous other cargoes—steel, bauxite, forestry products, fertilizer, cement—are known as "minor bulk," and they contributed 37% to 2017 dry-bulk demand. According to Maritime Analytics, Chinese demand constitutes 41% of the dry-bulk market, non-Chinese Asian demand another 37%.

It can't be a good sign for the major bulk market that, according to *Nikkei Asia Week*, some 65 million apartments sit vacant in the People's Republic—it would seem that China has just about all the high-rise residential construction it needs in place already. Nor is "peak population" a promising augury for future Chinese purchases of iron ore from distant Brazil. Last year's 1% decline in Chinese iron-ore imports may flag 2017 as the top—at 1.075 billion tonnes—of a world-shaking secular growth cycle. In any case, the iron-ore stockpile in Chinese ports, measured at 140 million tonnes, is nearly twice the 80 million tonnes level registered at the end of 2015. You could spin a similar story about risks to the coal trade, although Chinese coal imports continue to surprise by their strength.

When you think of ships, you may think first of trade, second of tariffs, third of trouble. But trade conflict may not, after all, pose an existential risk to the dry-bulk shippers. For one thing, a ship is a 20- or 25-year asset; nobody has a clock on trade disputes, but the politicians who fight them eventually leave office. For another thing, tariffs are like roadblocks. Lengthening supply chains, they push up the cost of transportation—not a bad thing for ship owners. Anyway, Eagle estimates today's tariffs affect less than 2% of the world bulk trade.

The demand for vessels is not nearly so volatile as the supply of vessels. It's the paucity (or excess) of ships in relation to the demand for ships that accounts for the recurrent typhoons in charter rates. The shipping business boomed and busted in the 1970s. It boomed from 1988 till early 2008, when peak one-year charter rates for large capesize vessels reached $160,000 a day. The ensuing crash took that rate down to $20,000 late in 2008 and to $10,000 by 2016. It's quoted at about $20,000 again in what may prove to be the start of a new upswing.

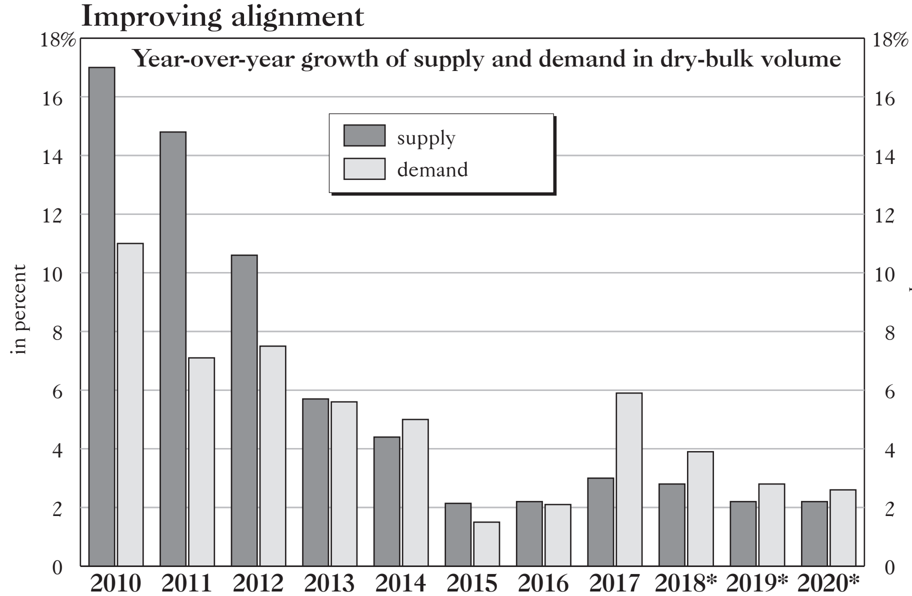
Twenty years ago, Ted Petropolous, managing director of Athens-based shipping research firm Petrofin S.A., wrote a research report on the monetary and financial sources of the 1970s shipping bust. Aggressive lending, excessive leverage and inflationary central-bank policy bore much of the blame, he said. By the time the cycle ended, the number of banks engaged in ship finance had shriveled to 25 from 500.

The names change but the narrative remains the same, observes colleague Fabiano Santin. The €13 billion taxpayer bailout of HSH Nordbank in 2009 was testament to the overgenerosity and miscalculation of what was by then the No. 1 shipping lender (bailed out, HSH was nonetheless uncured; private-equity sponsors Cerberus Capital Management, L.P. and J.C. Flowers & Co. rode to second rescue in November). The next largest shipping lender of the cycle, Deutsche Schiffsbank AG, merged in shotgun fashion with Commerzbank AG in 2012. Waves of bankruptcies have taken down shipping lenders and shipping borrowers alike, including in the latter category both of our picks to click, Eagle and Genco, in 2014.

Today's shipping lenders are appropriately, cyclically prone to say no. "It is tougher to get access to capital," Wilhelm Flinder, equity research analyst at Pareto and himself a one-time ship banker, tells Santin. "We're seeing less of the speculative type ordering. . . . Also, there are new [Basel IV] bank regulations that have to take into consideration the volatility of the value of the asset that is financed, and, as you know, shipping is super volatile. So that is also contributing to less availability of credit."

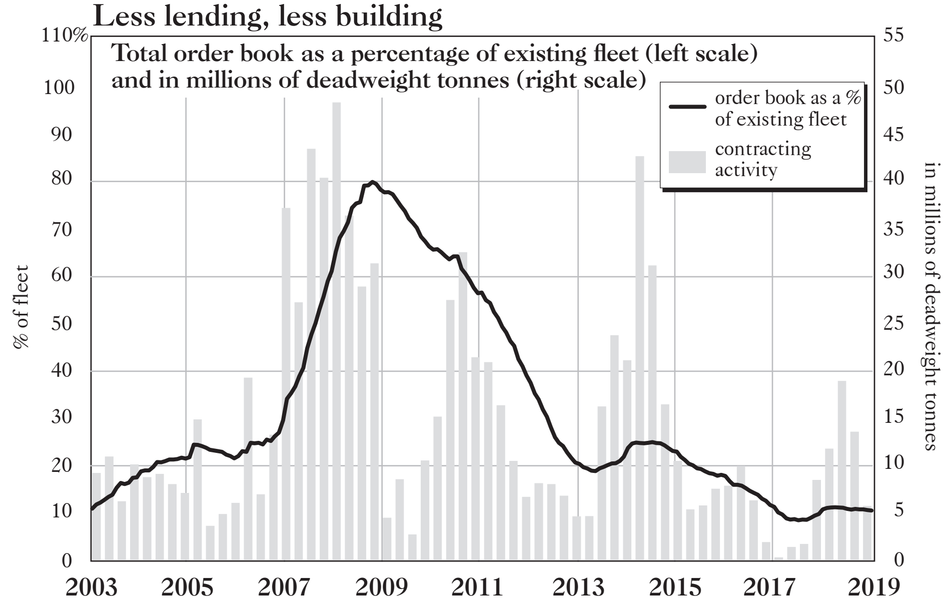
Once upon a time, ship lending was a European preserve. That changed with the entry in force by Asian lenders, especially China's, in the wake of the Great Recession. From a roughly 5% market share, the newcomers have come to command a 40% share (or had by 2017, when figures were last tal-

Improving alignment



sources: Clarksons Shipping Intelligence, Pareto Securities A.S. *estimated

Less lending, less building



source: Pareto Securities A.S.

lied). Even so, advises our friend Logan Wright, director of the Rhodium Group in Hong Kong, deleveraging remains a priority of Xi Jinping. This would seem to imply that the state-controlled Chinese banks won't be throwing their weight around the world's credit markets as they used to do.

The supply of, and demand for, dry-bulk vessels is becoming more favorable to the ship owners. Consider the number of new vessels delivered to the world's fleet. Subtract vessels condemned for scrapping and vessels laid up in dry dock for refitting and repair. On net, according to Clarksons Research, the global bulk fleet will increase by just 2.2% this year. If so, it will be the third consecutive year in which the growth in demand for deadweight tonnage will have overtaken the growth in the supply of deadweight tonnage.

As for the overhead supply of new ships, the dry-bulk ship order book stands at 11% of the current fleet, less than half of the percentage at the start of 2015 and only marginally higher than the 16-year record low registered in 2017. For this relative scarcity of new orders, you may thank, among other maritime actors, skittish bankers and a bellicose American president, says Petropoulos.

Dry-bulk vessels are surprisingly liquid assets, more readily valued and traded than certain classes of debt instrument you could name. The secondary market is deep, and prices are transparent.

"In line with freight rates," Santin reports, "the value of newly built ships hit the lowest level since 2003 in the second half of 2016. It has subsequently risen by 21%, though Flinder thinks this is mostly owing to higher shipyard costs (wages and steel) rather than a sign of demand for vessels. Nevertheless, 10-year-old capesize vessels trade at a 23% discount to the depreciated value of newly built ships. Taking into account the low order book and better prospects for charter rates, the current seasonally driven slump notwithstanding, the low price of secondary vessels flags the pessimism in the market—and the opportunity for investors."

If there's a catalyst in sight—check that; if there were a catalyst in sight, why isn't the next bull market already catalyzed? Let us rephrase: A potential catalyst for our projected bull market could be an order by the International Maritime Organization. Starting Jan. 1, 2020, the IMO will enforce a cap on the sulphur content of the bunker fuel that powers dry-bulk ships: It will fall to 0.5% from 3.5%.

Bunker fuel is what remains in a barrel of oil after refiners have extracted the gasoline and diesel and other light-carbon products. As Wiki says, "It's literally the bottom of the barrel." It's gooey, poisonous and smelly.

"If you can't burn the dirty cheap stuff, then you've got to burn something that is less dirty and less cheap," Maupin says. "It looks like a fairly significant hike in fuel costs." If the IMO directive accelerated the scrapping of older vessels, or otherwise trimmed the size of the fleet, few owners would object.

Not that the ship owners pay for fuel in most charter contracts. The ship charterers do. To economize on fuel costs, a charterer might direct the owner to steam slowly, since fuel intake rises as speed increases. Slower speeds effectively remove capacity from the fleet. It would be as if every New York City taxi observed the speed limit—there would effectively be fewer cabs for hire.

Stamford-headquartered Eagle Bulk owns and operates so-called supramax and ultramax dry-bulk vessels, midsize ships that hold 50,000 to 65,000 in deadweight tonnage. They carry any and all dry-bulk cargo, from iron ore to cement and timber. Since the vessels are equipped with their very own cargo-handling cranes and grabs, they can call on any port that can accommodate their 43-foot-high drafts (unlike the capesize behemoths that carry only iron ore and coal and are restricted to ports that can both handle their size and offload their cargo). Happily for the Eagle shareholders, the industry-wide order book for supramax and ultramax stands at 7% of the current fleet, a 20-year low.

Like the Pilgrim Fund, Eagle is heavily concentrated. In Eagle's case, that concentration takes the form of a single-minded focus on midsize vessels and on the so-called minor-bulk cargo category, which made up 59% of the third-quarter cargo mix. Coal (28%), grain (9%) and iron ore (4%) furnished the balance.

"China is over 40% of major bulk demand but is about 14% of minor bulk demand, which is the majority of our cargos, so clearly China is an important customer," Gary Vogel, CEO of Eagle Bulk and old-salt alumnus of the U.S. Merchant Marine Academy at King's Point, tells Santin. "But there is a big difference between approximately 14% and over 40%. Our demand base, because we carry so many different cargoes, is more diversified. Not just country-wise but in terms of commodities as well, so it tends to be less volatile." He says that Eagle's vessels called in more than 450 ports last year, not excluding Bata, Equatorial New Guinea and Manaus, capital city of Amazonas, in northern Brazil. "So that gives you an idea of how broad our trading array is."

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The fleet consists of 46 vessels with 2.7 million deadweight tonnage capacity and an average age of 8.6 years. The shares change hands at $4.77 each for a $338 million market cap, down 22% from $6.11 a share on June 22. An average of 366,000 shares trade daily, or $1.7 million at the current price.

Total debt stands at $322 million and cash on hand at $92 million for a net debt of $230 million, or 3.0 times the past 12 months' adjusted earnings before interest, taxes, depreciation, and amortization. Interest coverage is adequate with adjusted EBITDA covering interest more than 2.8 times. Maupin calls the nonrated, first-lien Eagle Bulk Ship Co.'s 8¼s of 2022 ($196 million are outstanding), which came to market last year and are priced to yield 8.5%, "one of the most mispriced bonds in the world."

"The Eagle fleet is worth $643 million, based on VesselsValue estimates on Feb. 14," Santin relates. "The fair market value per vessel comes out to $14 million, which more than covers $5 million in net debt per vessel for a loan-to-value ratio of 36%. After paying down debt, $9 million would theoretically remain, 22% above the current market cap.

"More exposed to China but offering a bigger discount, and perhaps upside, is the New York-based Genco, the third largest U.S.-listed dry-bulk shipowner," Santin proceeds. "Its current fleet comprises 58 vessels diversified according to the market share of each type of vessel (capesize, panamax, ultra/supramax and handysize) with 5.1 million deadweight tonnage capacity and an average age of 8.9 years."

The stock changes hands at $8.02 a share for a $333 million market cap, down 60% from $19.77 a share on June 8; turnover averages 259,000 shares a day, or $2 million at the current price.

Total debt weighs in at $568 million and cash on hand at $166 million for a net debt of $402 million, or 4.3 times the past 12 months' adjusted EBITDA. It's not as high as it looks considering asset coverage. Interest coverage seems adequate with adjusted EBITDA covering interest more than 3.2 times.

Genco's fleet is worth $1 billion by the reckoning of VesselsValue. The value per vessel comes out to $17.3 million, which more than covers $6.9 million in net debt per vessel for a loan-to-value ratio of 40%. After paying down debt, there would be $10.4 million left over for shareholders, which is nearly double the $5.7 million in market cap per vessel assigned by the market.

"But [the discount to net asset value] understates the attractiveness," Maupin contends. "The real story here is mean-reversion of cash flows. These companies would earn their entire market caps in approximately one year of normalized cash flow. And if history is any guide, they will likely earn multiples of their market caps in a single year. We don't know when of course, but with capital scarce and the largest regulatory change in at least 50 years less than 12 months away, it's an unusually compelling situation."

And it would be helpful if China didn't blow up.

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