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Full steam ahead

Evan Lorenz writes:

The world is reopening, inflation is percolating and big tech is wobbling. Is there an investment that suits the moment? Now under way is a bullish reprise of our 2019 analysis of a pair of seagoing transport companies, Eagle Bulk Shipping, Inc. (EGLE on the Nasdaq) and Genco Shipping & Trading Ltd. (GNK on the New York Stock Exchange).

With the end of lockdowns, we see the beginning of bottlenecks; for instance, the microchip shortage that has idled three North American General Motors Corp. factories. No sooner did the auto giant start canceling chip orders last year (who was going to buy a car in a pandemic?) than homebound consumers went on a digital buying spree, leaving Taiwan Semiconductor Manufacturing Co. Ltd., among others, racing to catch up. At least this particular misstep seems to be sorting itself out.

Copper is another story. Years of meager investment mean a paucity of new mines, commodity investors Goehring & Rozencwajg Associates, LLC point out in their fourth-quarter commentary. Meanwhile, demand for the metal is rising. Emerging economies continue to industrialize, and developed countries are pushing to build copper-intensive electric vehicles and green-energy infrastructure. No wonder the red metal is at its highest price since 2011, $4.21 per pound, up 100% from its March 23, 2020 nadir.

"The lack of massive new copper mining projects, coupled with an ever-accelerating copper mine depletion problem, means growth in mine supply should remain minimal over the next five years," say Goehring and Rozencwajg. "Global copper consumption exceeds copper mine supply and recovered copper scrap by about 500,000 tonnes per year presently and will get worse. Global inventories are experiencing sharp declines suggesting a structural deficit has now emerged."

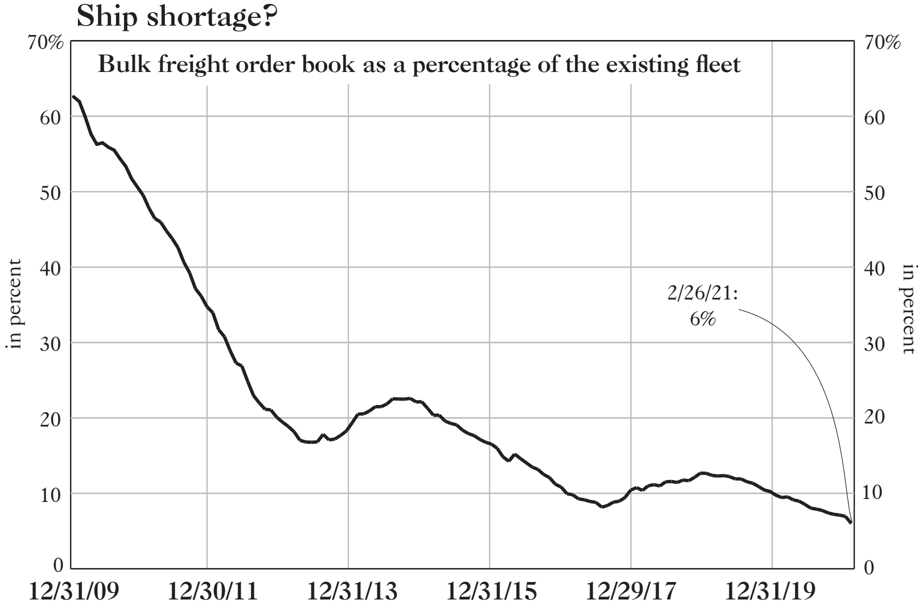
The bullish thesis for EGLE and GNK turns on the conviction that the supply and demand imbalance in dry bulk shipping more closely resembles the copper deficit than the microchip shortage.

Let it be said that the dry bulk sector of the shipping business is as famous for its busts as its booms. Eagle and Genco went in and out of bankruptcy in the mid-2010s on account of collapsing shipping rates and weakness in Chinese import volumes. It was one of the recurring demonstrations that, over the course of a shipping cycle, leverage and water are as ill-matched as oil and water.

Dry bulk encompasses the seaborne export and import of such items as iron ore, coal and grain. Each year, 5.3 billion tons of goods move around the world in this fashion. Since the demand for shipping tracks global GDP, and since the world is (we hope) mending, shippers should enjoy a bounce-back in 2021.

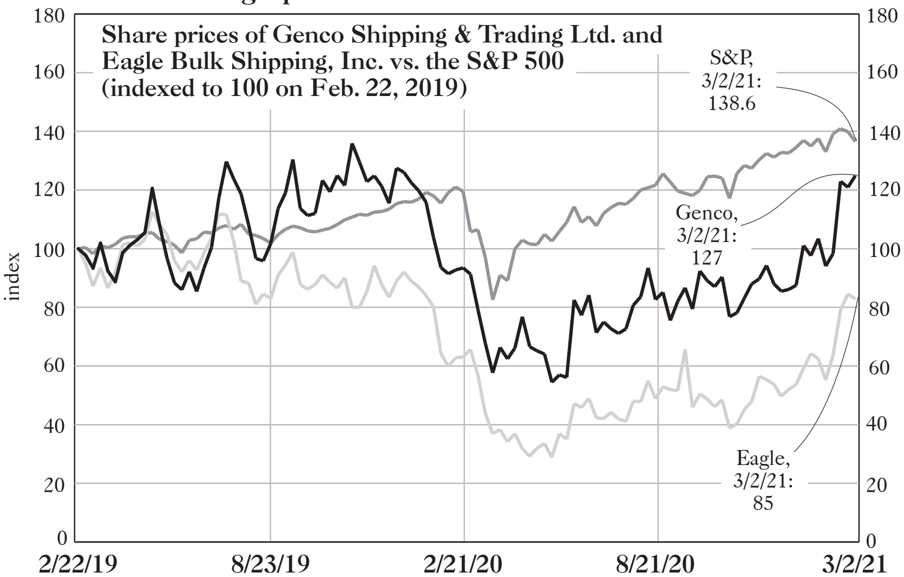
Bulk cargo falls into two categories, denoted major and minor. Leading majors consist of iron ore (29% of total shipments), coal (24%) and grain (9%). Leading minors include steel (8%), forest products (7%), fertilizer (3%) and bauxite (2%). China accounts for one-half or so of major bulk shipments and

Ship shortage?



sources: The Bloomberg, company reports

Still catching up



source: The Bloomberg

slightly less than one-fourth of minor bulks. And while China's debt-fueled investment model may one day blow the global economy to smithereens, Beijing last week outlined plans almost to double the size of its railway system by 2035 and add 162 airports. They won't be built without commodities.

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Order a new ship, and you wait two years for delivery, which means that the near-term supply of vessels is relatively fixed. As we go to press, the order book sits at just under 6% of the existing fleet, the lowest reading in modern history. At the same time, 6% of that fleet is 20 years or older, not far from the typical freighter's useful service life of 25 years. Netting out expected scrapping, Clarksons Research projects the fleet will grow by 2.6% in 2021 and 0.6% in 2022 (in the bad old days of 2012–16, it was expanding at annual rates as steep as 7%). It seems a tailor-made setup for high, and rising, shipping rates.

As the first quarter coincides with the Chinese New Year, the shipping business tends to be slow out of the blocks. Yet, through February, rates for capesize vessels (which, with capacities of 110,000–200,000 deadweight tonnes, are too large to traverse the Panama Canal) were the highest for a first quarter since 2014; for the supramax vessels (48,000 to 60,000 dwt), rates have had their best start to a year since 2010.

What drove this unseasonal spike? I put the question to Poe Fratt, who rates EGLE and GNK as buys for Noble Capital Markets, Inc. "There's been a little bit of a trade tension between Australia and China," he replied. "China stopped allowing [some] imports of Australian coal and iron ore." Buying, instead, from Brazil stretched shipping routes and effectively reduced dry bulk capacity. Notably, this tightening happened with most of Europe still in lockdown.

At the end of 2010, the new-vessel order book swelled to 50% of the existing fleet, ushering in a decade of low returns. A repeat tsunami, however, appears unlikely. Let the operators flood the shipyards with orders, no new vessel would be ready for service until 2023 at the earliest.

There is another, green impediment to fleet expansion. A rule to slash the sulfur content of bunker fuel worldwide, to 0.5% from 3.5%, took effect on Jan. 1, 2020.

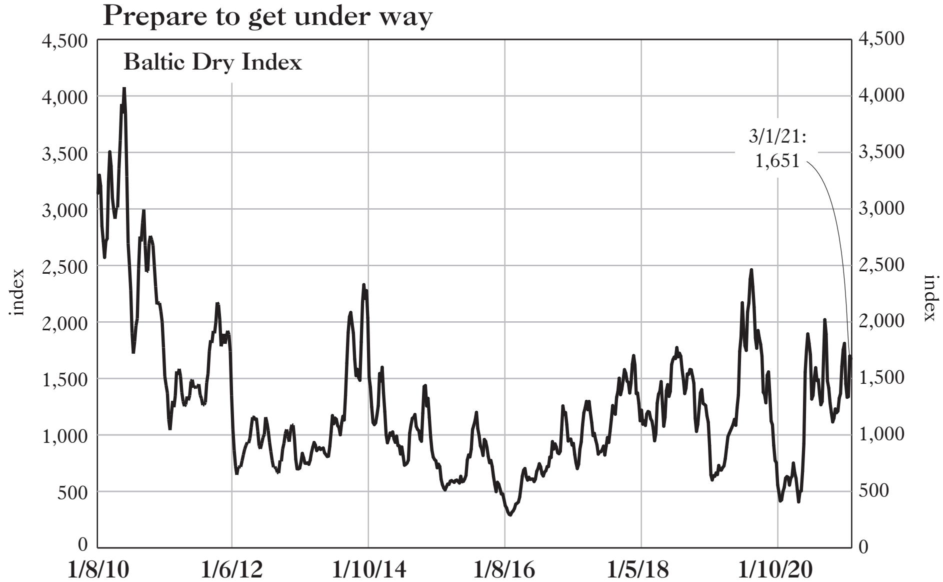
Bunker—which takes its name from the ship compartments where coal was stored—is the fraction of a barrel of oil that's left over after the refiners have extracted gasoline, diesel and other lighter fuels. It's among the cheapest, and dirtiest, sources of energy available.

For the privilege of burning bunker, operators must install scrubbers at a cost of $2 million per ship. Most operators have switched to lower-sulfur fuel. They likewise reduce speed when spreads on more environmentally friendly fuels rise. Steaming more slowly has the side effect of shrinking global fleet capacity.

The International Maritime Organization, author of the 2020 bunker rule, says it's planning to enact a more stringent emissions standard in 2030, and the imagined diktat is already exacting a cost. Would you, Mr. or Ms. Fleet Manager, place an order to build a ship today for 2023 delivery when you can only guess what that asset might return for 18 of its hypothetical 25 years of service?

Never mind that you might not find a builder to order from. "Shipyard capacity is reduced, and a lot of shipyards have closed," Randy Giveans, who rates EGLE

Prepare to get under way



source: The Bloomberg

and GNK as buys for Jefferies Research, tells me. "Access to capital is lower. European banks are lending less. Owner balance sheets have been stressed in recent years, so there is not a ton of surplus cash going around."

Perhaps we bulls will look back with gratitude at the banks that didn't lend and the shipping managements that didn't build. Joakim Hannisdahl, who rates GNK a buy (and EGLE a sell) for Cleaves Securities, sees the situation in this light. "We think we will have a more normalized market [this year], and then, because the fleet growth is so low, we will have an overshoot and a peak cycle period from 2022–23," he tells me. "We think that will continue because there is no transparency on the technology side. We think you could see a super cycle developing because of the lack of investment. It's not our base case, but it is something we are paying more and more attention to, and the odds of that scenario are increasing each day."

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In the issue dated Feb. 22, 2019, *Grant's* laid out the bull case for Eagle Bulk Shipping and Genco. Of course, we didn't anticipate the impact that the Jan. 25, 2019 collapse of Vale S.A.'s iron-ore tailing mine in Brumadinho, Brazil would have on global shipping routes. Nor did we foresee the Covid-19 pandemic and subsequent economic lockdowns, which crushed demand for bulk commodities worldwide.

Despite an explosive start to 2021 that has seen EGLE surge by 58% and GNK by 45%, the pair has underperformed the market: Eagle's stock price is down 15% over the past two years, and, while Genco managed a 27% gain, the S&P 500 generated 39%.

Still and all, the bull case continues to play out. Two years ago, the industry-wide order book footed to 11% of the existing fleet compared with the aforementioned 6% or less today. "The stocks we own entered 2021 trading at 70–80% of depressed private market asset values, less than 40% of book value, and at [about] 1.5x normalized cash earnings," reads the fourth-quarter letter to clients of Pilgrim Global. "The stocks are not in any indices, the business is non-correlated with other assets, and no mainstream institutions we know of are invested."

Darren Maupin, founder and director of Pilgrim Global, which holds positions in EGLE and GNK, is the author of those words. In addition to investing in publicly traded shippers, Maupin co-founded Anglo International Shipping Operations Ltd., a private bulk shipper that owns six post-panamaxes (109,200 dwt) and two kamsarmaxes (80,000 dwt). The prices of middle-aged ships "have been so depressed that we model them out, looking at, say, 7-to-10-year-old assets, at 20%-plus unlevered [internal rates of return] to scrap," Maupin tells me. "So that's from simply operating the assets and scrapping them. There's no exit multiple. There's no assumption that we're going to do something special with the asset. That's just the economics of those assets."

Of course, these are just Maupin's estimates of what a buyer of a used vessel would earn today. A sudden drop in global demand, a resurgence of a vaccine-resistant strain of Covid-19 or a crisis in China could cause demand and shipping rates to fall below his estimates.

"Over the past 30 years," Tony Mallin, the founder of STAR Capital Partners and a co-founder of Anglo International, tells me, "if you had no gearing [financial leverage], there wouldn't be a year where you wouldn't have positive cash flow in this sector over and above operating costs. And nobody has ever played this market without gearing."

You can blame the extreme cyclicality of the shipping business on many things, but hardly on taxes. Section 883 of the U.S. tax code exempts foreign shipping companies from most federal imposts since the ships do their work on the high seas.

Then, too, a ship owner's cargo is also his collateral. If a customer fails to pay in full and on time, the shipper can sell the iron ore or coal or bauxite to extract payment.

Mallin and Maupin say they intend to list Anglo later this year in London and apply the IPO's proceeds to paying off all the company's outstanding debt. It could be Mr. Market's first glimpse of an unleveraged balance sheet attached to a public bulk-shipping company.

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Shipping managements can control neither the weather nor the cycle, but shortfalls in corporate governance are their fault alone. On the first page of a February investor presentation, EGLE asks, "What differentiates Eagle?" It answers: "Industry-leading corporate governance structure and ESG focus with no related-party business/operational dealings; majority independent Board."

Eagle owns a fleet of 49 supramax and ultramax ships (50,000–65,000 dwt), 45 of which deploy the scrubbers that allow the consumption of cheap bunker fuel. At half the carrying capacity of a capesize, the Eagle ships may be small, but they are versatile and, with an average age of 8.6 years, relatively youthful. While capesize vessels handle major bulks and bauxite only, Eagle's can haul both major and minor bulk commodities.

The bulk-shipping industry is a mom and pop affair, with most owners operating five ships or fewer. As a result, many operators pool their vessels to earn the prevailing freight rate, less a fee to the pool operator. As an owner-operator, Eagle is typically able to earn rates in excess of the freight index. As most ship operators lack the scale to develop and negotiate hundreds of commercial relationships, this outperformance may be more deeply rooted, and prove more persistent, than it first appears.

"At the end of the day, the chartering desk is the main reason for our performance," CFO Frank De Costanzo tells me. In addition to negotiating freight for its own ships, Eagle charters third-party vessels for rental. "When you charter-in a ship, you have to give it back within a window," De Costanzo says. "So, if it's a one-year charter, you might have to give it back between 9 and 13 months. But that window at the end is always pretty wide." Eagle hedges the fixed part of these contracts using forward freight agreements and can generate extra profits if prevailing freight rates are higher than the pre-negotiated charter rate during the option period.

Eagle was expected to report fourth-quarter earnings on March 4, right after *Grant's* went to press. As of Sept. 30, 2020, Eagle's balance sheet showed $83.4 million in cash and $497.3 million in debt for net debt of $413.9 million, on which is levied an annual interest cost of 6.8%. The Street estimates that EGLE will generate $100.7 million in Ebitda this year, which, if on the beam, means that the company is leveraged 4.1 times. In the depressed third quarter, operating income of $1.1 million didn't come close to covering $23.6 million of interest expense.

I invited Hannisdahl to explain why he's bearish on EGLE. "Our sell on Eagle is mainly a reflection of the high share price," he advised via email. "While we also have other companies priced at a similar [price-to-net-asset value] on buy, those companies have higher elasticity towards improving fundamentals."

To be sure, Eagle is more expensive then Genco. Some of that premium may stem from Eagle's greater exposure to small bulk freight, which is less vulnerable than major bulk to a plunge in Chinese demand. Even so, Eagle trades at just 4.1 times the estimates for 2023 earnings, a forecast which may come in for upward revision if the shipping supply/demand balance continues to tighten (or, of course, a downward one if the world has another 2020-caliber trick up its sleeve).

Eagle trades at 22.2 times the estimates for 2021 earnings. Over the past 12 months, insiders purchased 21,287 shares at a cost of $374,803. Of the nine analysts who follow EGLE, six say buy and only one—Hannisdahl—says sell.

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Genco takes a barbell approach to the composition of its fleet, with 17 capesize vessels and 22 ultramaxes and supramaxes. The capesize ships are scrubber-fitted, and the corporate fleet has an average age of 9.5 years.

Like Eagle, Genco directly negotiates with commodity producers and importers, which approach has contributed to results that, in most quarters since 2017, have topped those of the Baltic Dry Index. Unlike Eagle, however, Genco outsources the seafaring and maintenance sides of the business to Wallem Shipmanagment Ltd., Anglo-Eastern Group and Synergy Marine Group.

Another distinguishing feature of Genco is its balance sheet, the cleanest in the sector. The Dec. 31, 2020 edition showed a cash balance of $179.7 million and debt of $449.2 million, for net debt of $269.5 million. Analysts pencil in Ebitda of $113.5 million for 2021, which would yield a leverage ratio of 2.4 times. Adjusting for a non-cash impairment charge and a loss on the sale of a vessel, operating income covered interest expense by 2.9 times in the December quarter.

That until late last year 52% of Genco's shares were in the hands of Strategic Value Partners, LLC, Centerbridge Partners, L.P. and Apollo Global Management, LLC constitutes a reminder of what can go wrong with shipping investments. These investors had acquired stakes in 2016 as part of a debt refinancing and equity infusion following the 2014 bankruptcy. Since Dec. 11, 2020, the former majority-holding trio has reduced its stake to 32% of the shares outstanding, increasing Genco's float and whittling down an overhang of stock that had pressured the price of those shares.

On the Feb. 25 earnings call, CEO John Wobensmith agreed with Maupin that ships on the water are cheap: "[V]alues have moved up a little bit, but they still do not match the underlying fundamentals on freight rates.... I can't stress enough, I think asset values have ways to go." Joining talk with action, Genco swapped six vessels for three newer models in the last quarter in addition to selling older, less efficient ships.

Genco trades at 15.5 times consensus 2021 earnings and 2.1 times the 2023 estimate. In the past year, insider transactions consisted of a pair of sales totaling 11,362 shares for proceeds of $79,861 on March 4, 2020. All seven analysts who cover GNK rate the stock a buy.

"We think Eagle is the best operator," Maupin tells me. "They're the only fully integrated industrial shipping business, if you will, in public markets. And we think that Genco has the best balance sheet and the most liquidity amongst peers. It's the most defensive, and it's also probably the cheapest among public [dry bulk] companies."

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