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Turn of the tide?

In a March 19 press release, Herbjorn Hansson, chairman and CEO of Nordic American Tankers Ltd. (NAT on the New York Stock Exchange), planted the seed from which has sprouted the following oil tanker-themed essay. "Are we now at a turning point?" rhetorically inquired Hansson. To judge not only by his words but also by his deeds—viz., the Hansson family's purchase last month of 50,000 shares of NAT at a price of $10.50 apiece—the answer might conceivably be "yes."

"No" would be the answer that reflexively springs to mind. Seaborne oil transportation companies have generated net losses since 2011. The industry is fragmented and given to uneconomic decision-making. And the idea has gained currency that tanker demand will fall along with American oil imports. "If any asset has not been lifted by quantitative easing," observes John Authers in the *Financial Times*, "it might be shipping."

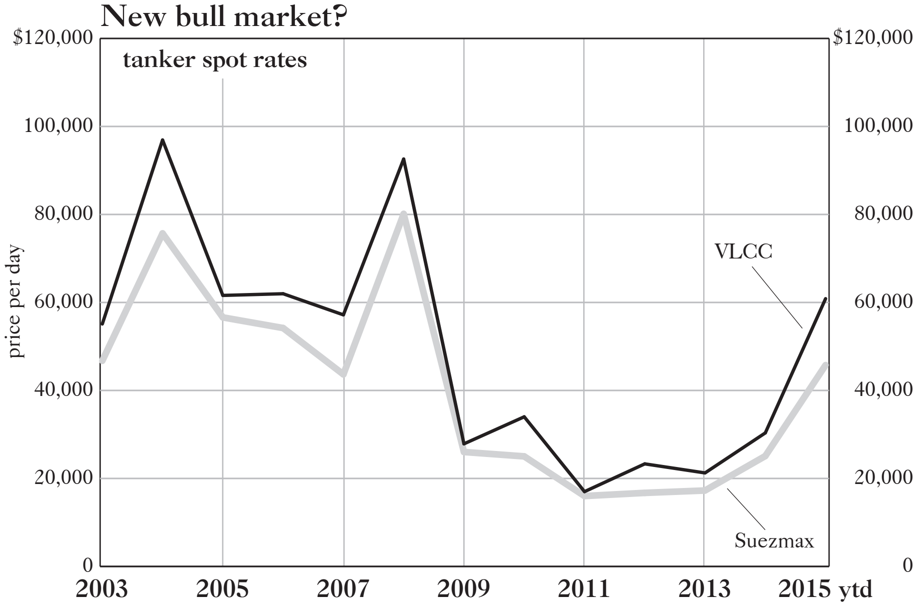
Then, again, a funny thing happened on the way to insolvency. Fifteen months ago, day rates turned up, and they have continued to rise even as shares of the leading tanker companies have continued to languish. The aforementioned Nordic American Tankers, Euronav NV (EURN on both the NYSE and the Euronext Brussels exchange), and Frontline Ltd. (FRO on the NYSE) constitute the principal flotilla of oil-tanker investment opportunity. All trade at net asset value or a slight premium to it.

To begin at the beginning, the bear market for crude is bullish for shipping. It's not so counterintuitive a proposition, though the average investor seems to doubt it. "One immediate impact of the recent fall in oil prices," says the Euronav prospectus for its U.S. IPO in January (the company had been listed exclusively in Europe), "is that it makes the purchase of oil more attractive and it leads to stockpiling and increased demand for tankers. The other factor to bear in mind is that the fall in oil prices is taking place during the winter months in the northern hemisphere, when demand for oil is generally higher. Overall, falling oil prices are generally a positive factor and normally lead to increased demand for oil, although their impact in the short term is likely to be felt more through activities such as storing oil at sea."

"As crude oil supplies fill up at places like Cushing, Okla.," observes colleague David Peligal, "floating storage takes on a greater role. In its Feb. 9 earnings report, Nordic American said that the fourth-quarter plunge in the oil price had resulted in traders taking advantage of a commodity in contango, i.e., one in which forward prices are higher than spot. 'In recent weeks we have also seen a return of the contango trade where oil traders, from time to time, buy oil, store it in tanker vessels and sell it for future delivery at a profit, normally in one operation,' the company added. 'This is taking transportation capacity out of the tanker market and is, in turn, increasing rates.'"

The ships are behemoths. Very large crude carriers that can haul as much as 320,000 tons of crude, equivalent to two million barrels each, are bigger than the USS Ronald Reagan. Some-

New bull market?



source: RS Platou Markets AS

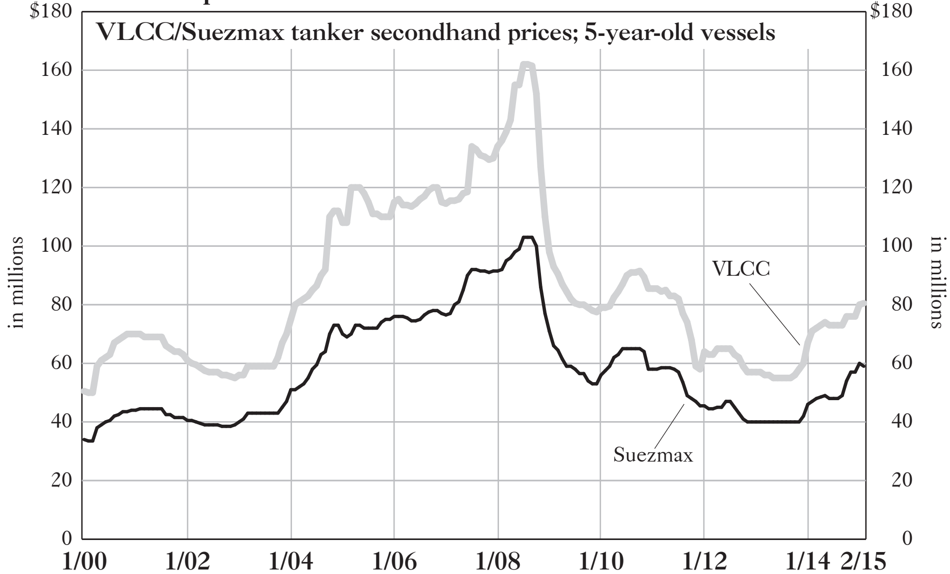
what less monstrous are Suezmax vessels (they can slip through the Suez Canal) and Aframax vessels (which are used for shorter regional trade). At the end of 2014, 632 VLCCs made up 35.3% of the worldwide 1,791 oil tanker fleet by number, 57% by carrying capacity. Suezmax tankers, with an oil cargo carrying capacity of around one million barrels each, made up 26.9% of the fleet by number and 21.8% by capacity. And Aframax ships, which can haul 500,000 barrels each, make up 38% of the fleet by number and 21.3% by capacity.

Capacity utilization in the tanker business is both fixed and flexible. You can't just order up a VLCC on a 3-D printer; construction can take two years. What you can do is order your captain to change speeds in accordance with market conditions. At a static estimate, tanker utilization today stands at 87%. At a functional estimate, depending on how fast the fleet is steaming, utilization could be higher or lower. Ships move faster in response to good rates, slower in response to low ones—at 12 knots, say, when there's money to be made, at 10 knots in slack times.

"In a rising freight rate market like today's," Peligal notes, "companies that are spot oriented—as opposed to those who employ their tankers via a time charter—will receive the biggest benefit. How have tanker spot rates trended over the years? In 2008, when tanker utilization was close to 91%, according to data provided by Oslo-based RS Platou Markets AS, day rates for VLCCs and Suezmax tankers stood at $92,600 and $80,126, respectively. There ensued a collapse in 2009 to $27,869 and $26,014, respectively. As for 2015, the second year of the unsung recovery, spot day rates for VLCCs and Suezmax tankers are quoted at $60,685 and $45,767, respectively. In general, investors are content to wait and see. They'll believe it when it lasts. Make no mistake, though—tankers are making money today.

"There are other bullish factors," Peligal goes on. "On the demand side, changing oil-trading patterns are making for longer voyage distances. A VLCC's voyage from West Africa to the U.S. Gulf takes 35 days, a trip from West Africa to China takes 61 days. And who knows? A repeal of the 1975 ban on the export of crude from the United States might open up a new source of demand for ocean-going

In the depths



source: Drewry, company documents

oil transportation. On the supply side, a declining tanker order book and increased scrapping activity over the past few years have led to only moderate growth in vessel supply. The Euronav prospectus, which sourced data from Drewry, an independent maritime advisor, notes: 'Lower levels of new ordering combined with cancellations have resulted in a declining vessel order book. At its peak in 2008, the VLCC and Suezmax tanker order books were each equivalent to 50% of the existing fleets, respectively, which led to high levels of new deliveries in both sectors between 2009 and 2012. However, with low levels of new ordering in 2012 and 2013, as of Dec. 31, 2014, the total crude VLCC and Suezmax order books were equivalent to 14.9% and 12.6% of the existing VLCC and Suezmax fleets, respectively.'"

You couldn't blame a bear for rolling his eyes at the recital of these bullish possibilities. Shipping managements don't just shoot themselves in the foot. They torpedo themselves amidships (for instance, by building new ships at exactly the wrong times). Dead-in-the-water share prices are one expression of this pervading skepticism; the soft market in secondhand vessels is another. Five-year-old, secondhand values peaked in August 2008 at $162 million for VLCCs and $103 million for Suezmax types. By the end of 2013, quotations had dropped to $60 million and $42 million, respectively. While climbing for over a year now—in fact, as of February 2015, Drewry estimates that five-year-old secondhand prices are $80.5 million for VLCCs and $59 million for Suezmax tankers—they still figuratively remain in Davy Jones's locker.

Nor has it exactly lifted investor sentiment in the saltwater space that the Baltic Dry Index, quoted at 10,000 in mid-2008, registers 599 today (following last year's failed rally to 2,000). The iron ore and coal shipping business is a far cry from the crude oil shipping business, but bad PR is contagious.

How to profit from an anticipated upturn in the industry's fortunes to a state of pretty good from one of downright terrible—or, rather, from a widespread recognition of the improvement that has already taken place? Euronav, a $2 billion market-cap company, tops the *Grant's* list of picks to click. Its merits include, No. 1, the largest and youngest fleet (27 VLCCs and 18 Suezmax tankers, aged six years and 11 years, respectively) and No. 2, a management farsighted enough to expose 86% of the fleet to the buoyant spot market in 2015. A third appealing point is that Peter Livanos and Marc Saverys, respectively chairman and vice chairman, own a combined 23% of the company. Finally, the balance sheet looks reasonable. It's not so easy to form a financial judgment. Complicating matters are the aforementioned January IPO (in America) and the manner in which the company accounts for joint ventures. Balance sheet vital signs feature assets of $3.2 billion, debt of $1.5 billion and equity of $1.7 billion.

"This is using the proportionate method of accounting," Peligal comments, "which is not exactly what International Financial Reporting Standards would have the company do—it would point management toward the equity method—but it's the easiest way to think about what their balance sheet looks like. So leverage, or gearing, is 46%. Despite these positive characteristics, the valuation is reasonable; the stock trades right around its estimated NAV. According to a Stifel weekly shipping report dated March 29, Euronav trades at a 2016 EV/EBITDA ratio of 6.5 times. Finally, Euronav seems transparent enough—this should help the company attract an American following."

Next up is Nordic American Tankers, a $1 billion market cap company that boasts a fleet of 22 vessels, all Suezmax, with two more on order. What makes Nordic American Tankers different from all the other tanker companies? We quote from the fourth-quarter earnings release:

"Nordic American has an operating model that is sustainable in both a weak and a strong tanker market. Accretive fleet growth, low debt per vessel and quarterly dividend payments are central elements of the strategy. . . . A homogenous fleet reduces our costs, which helps to keep our cash-breakeven down at about $12,000 per day per vessel, which is considered low for the industry. Net asset value (NAV) is a measure that is linked to the steel value of each individual ship, and has no relevance when it comes to valuation of NAT as an ongoing business." Well, yes, as to this last point, though the fact is that tanker companies do tend to trade in line with NAV over the long pull. Stifel reckons that NAT changes hands at a 2016 ratio of EV to EBITDA of 8.9 times.

Like Euronav, Nordic American is heavily exposed to today's spot market. Unlike Euronav, NAT pays a dividend—the shares yield 7.4%—and management regards the payout as an essential component of the corporate personality. Are dividends your cup of tea? Would they be your cup of tea in the knowledge that 10 of NAT's 22 ships were built before 2000 (the two vessels on order are expected to arrive in August 2016 and January 2017). Hansson, who, with his son, wrote a check for those 50,000 shares of NAT in March, owns 4.3% of the company. As an aside, Hansson also recently bought 50,000 shares in Nordic American Offshore (NAO on the NYSE), a $210 million market-cap platform supply vessel business in which NAT owns a 19% stake; since July of last year, the stock has plummeted to $9 from $20 as exploration activity in the North Sea has dried up.

Frontline, our third prospect, is smaller (with a $250 million market cap), more leveraged and more storm tossed than either EURN or NAT. Quoted at $38.85 in 2010, the shares fetched just $1.18 as recently as November; stockholders' equity was negative at the year-end statement date. Statistically, the stock is no screaming bargain—Stifel projects the 2016 ratio of EV to EBITDA to be 8.1 times. Sentimentally, the shares may be more appealing. As the sell side loves Euronav, so it has no time for FRO. The Bloomberg summary of sell-side opinion shows one buy, five holds and 13 sells. While Frontline may be just the stock for a truly cocksure shipping bull, that level of confidence far surpasses ours. We'll give it a pass.

What else might boost tanker returns? Speaking at the Ninth Annual Capital Link International Shipping Conference in New York on March 23, Wilbur Ross, the restructuring titan, called for consolidation: Fewer companies and fewer egos might prove nimbler at reducing capacity during times of weak pricing. Who could argue? Yet it was the private equity landlubbers who pumped an estimated $32 billion into the shipping business in 2012-14, the very time not to have brought on new capacity. Certainly, there's room for fatter margins; 7.5% is an estimate we've heard of what the industry pays for capital and 8% is what it's thought to earn on capital employed.

"One can make the assumption that all the private equity and hedge fund players who got involved in the shipping sector over the past years are working behind the scenes to encourage consolidation," Peligal winds up. "So when General Maritime and Navig8 Crude Tankers announced their intention to merge on Feb. 25 by forming a new company called Gener8 Maritime, it's likely that the new blood was at work. Per the press release, Gener8 Maritime will provide significant scale and consist of 46 vessels, including 21 VLCC new-buildings with near-term deliveries; the value of the combined fully delivered fleet will be in excess of $3 billion. Peter Georgiopoulos, General Maritime's chairman, remarked in the Feb. 25 press release: 'Together, Gener8 Maritime will be well-positioned to take advantage of improved market conditions and increasing average voyage lengths with one of the largest, youngest, and most efficient fleets in the industry. We are pleased to unite two high-quality investor groups, both of whom strongly support this transaction.' *Tradewinds* reported on March 6 that Oaktree Capital Management and BlueMountain Capital might have participated, and it quoted an anonymous source as saying: 'Some of these guys own $50 million to $100 million stakes in these companies. People can't get out of their positions very easily if it's a small-cap company. Companies need to be big enough and [have] enough shares float to allow different people to sell out at different times.' It remains to be seen when the combined company will go public; Navig8 trades on the Norwegian OTC market by appointment; General Maritime, having declared bankruptcy in November 2011, is closely held."

Anchors aweigh!

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