An Insight into a Non-Correlated, Undervalued, High-Optionality Industry Group

The dry bulk shipping industry is one of the most depressed sectors of the world economy. A good way to measure it is by perusing the Baltic Dry Index (BDI), which is calculated by the Baltic Exchange. BDI is not a measure of stocks; it aggregates shipping rates from a variety of brokerage agencies and compiles an index based on this information. On May 20, 2008, the Index reached a record of $11,793. On June 30, 2009, it closed at $3,757, for a total loss of 68.1% during the 2008-2009 credit crisis. Other segments of the marine and shipping industries show a similar history. The World Container Index (Drewry) shows the average price paid per Forty Foot shipping container; it fell 75% between May 2012 and March 2016.

BDI is a volatile index. This volatility is rooted in the price variability of the cargo, which is primarily composed of commodities, the prices of which can swing wildly and unpredictably, which in turn impact consumption demand. A dry bulk shipper is beholden to this price volatility, since vessel charters do not generally allow for long term commitments (i.e., over 10 years, as can be the case in other shipping categories). As a result, with direct exposure to short term market rates, this is truly a business marked by feast or famine.

Another cause of the Index crash is an excess supply of dry bulk ships. The only remedy is a decline in the number of vessels, because there is no possibility of increasing freight traffic to a level that could absorb the capacity. In order to understand why, it is useful to glance at the dry bulk carrier tonnage statistics shown in the accompanying table.

Bulk Carriers in Deadweight Tons ('000s)

Year	Tons	Year	Tons
1980	181,880	1999	274,690
1981	184,501	2000	274,445
1982	193,217	2001	280,323
1983	204,631	2002	294,780
1984	212,915	2003	296,140
1985	218,518	2004	308,935
1986	227,551	2005	325,666
1987	226,967	2006	349,721
1988	223,659	2007	367,542
1989	222,432	2008	391,127
1990	223,619	2009	418,356
1991	230,028	2010	456,623
1992	236,143	2011	547,192
1993	234,697	2012	624,022
1994	236,843	2013	686,635
1995	250,142	2014	730,296
1996	261,169	2015	762,322
1997	271,702	2016	779,289
1998	280,055	2017	796,581

Source: United Nations Conference on Trade and Development (UNCTD), http://unctadstat.unctad.org

For instance, in 2000, there were 274 million tons of vessels. By 2008, that figure rose to 391 million tons, which is a considerable increase. As large as that increase was, it was insignificant in relation to what followed. From 2008 to 2017, the deadweight tonnage rose from 391 million tons to 796 million tons.

So despite the fact that freight rates cratered in late 2007 and mid-2008, and have only modestly recovered since, the supply of bulk carrier tonnage grew 8% (annualized) from late 2008 to mid-2017. There is no other example of an industry losing so much value while gaining supply at an even greater rate.

The reason for the huge supply increase is that once the ships are ordered, they will be delivered, even if the original customers do not accept delivery. They will simply be sold to someone else; they are going to be in the market. The reason for the orders was that in 2007 and 2008, the various industry

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participants were wildly optimistic about the prospects for world trade in general and the emerging markets/China trade in particular. It is worth knowing that it is so expensive to mothball a cargo vessel that it is actually more economical to have it ply the oceans and earn some revenue—even at a loss—than to mothball the fleet.

What is clear, though, is that the shipping industry is not going to go away, given its importance to global trade. When it does emerge from its current cycle, the strongest players will be more dominant, having acquired competitors and having streamlined their businesses. One would not expect the now 10-year depression to improve much for the next few years, but certain companies have positioned themselves well and, we believe, will likely emerge stronger than ever.

Leasing Rates for Dry Bulk Carriers per Day
(Monthly Averages)

	2007	2016
Capesize	$126,945	$9,429
Panamax	$62,404	$6,905
Handymax	$52,231	$7,351
Small Handy	$36,408	$5,372

Source: Mitsui O.S.K. Lines

Contrary to most capital intensive industries, shipping is actually a high margin business. Vessels are leased to a variety of customers, which include both commodity producers and wholesale/trading companies. The shipping company is typically responsible for the transport–crew's operating costs, vessel insurance, maintenance and repair, and port fees. However, the lessee pays the daily shipping rate, as well as fuel costs, the latter often being the largest expense component of ship transportation. Thus, not bearing responsibility for fuel (bunker) costs, the shipping company is in a position to earn a considerable margin. In a normal or robust market, a shipping company can often earn an operating margin in excess of 60%. Of course, since the cost of operating a ship is fixed to a large extent, a decline in shipping rates or revenues can lead to severe margin erosion—this is a business with extreme operating leverage.

Nevertheless, one can identify shipping and marine companies that, despite a decline in pricing and/or order volumes that would devastate most industries, have both remained profitable and have maintained well-ordered balance sheets – that is to say, they have staying power. That is a powerful combination if they trade at prices that are not reflective of any recovery, because it means one can hold, effectively, a long term call on what will typically be a large-magnitude set of increases that can be multiplicative in their impact on the share price in recovery mode: i.e., order increases, price increases, margin increases and valuation multiple expansion.

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AP Moller-Maersk ("Maersk Group" or "Maersk"), based in Denmark, is the largest container shipping company in the world. When it first attracted our attention, we believed that the earnings of the Maersk Line container shipping segment, which had already experienced a cyclical decline, were robust enough to justify the valuation of the entire company. This would allow shareholders to generate a significant return once the shipping business recovered, or when the market recognized any value for its other struggling energy businesses, such as Maersk Oil and Maersk Drilling.

In September 2016, Maersk announced that it would restructure the company into two segments: Transport & Logistics, consisting primarily of Maersk Line, which would be the ongoing operations; and Energy, for which it would seek strategic alternatives. Since then, three transactions have been announced:

- In December 2016, Maersk Line announced plans to acquire Hamburg Sud, a German container shipping line, bolstering its transportation and logistics business, and increasing its global market share by 3%.
- In August 2017, Maersk entered into an agreement to sell its Oil and Gas business to Total S.A. for $7.45 billion. Part of the consideration was paid in Total shares originally valued at $4.95 billion, which gives the company continued exposure to oil prices. This is expected to close by March 2018.
- In September 2017, the company's Tanker business was sold for $1.17 billion to APMH Invest A/S, a 100% owned subsidiary of A.P. Moller Maersk's controlling shareholder.

The prices paid for these assets relative to Maersk's total enterprise value supports our original investment thesis: the market capitalization of the company, adjusted for the value of these transactions, gives little credit to the normalized earnings potential of the company, which is significantly higher than current results indicate.

It should be noted that despite its enormous size and breadth of businesses, Maersk, which has over $30 billion of annual revenues – quite a bit more than McDonald's, Abbott Labs or Union Pacific – is barely included in global equity indexes, hence absent from most investment managers' portfolios. Part of the reason is that well over 50% of its shares are held by the founding Moller family. As well, only 18 Danish companies are included in the standard international developed market stock index, the MSCI EAFE Index. One of them has to drop out – all formulas involve trade-offs.

Over the long term, the newly installed CEO is emphasizing revenue growth initiatives. The low valuation multiple likely reflects several variables, including the depressed average freight rates and the low growth outlook for freight volumes. Though these are showing some signs of recovery, neither appears poised for significant imminent improvement. However, as a well-capitalized industry leader, Maersk stands to benefit from further industry consolidation amongst more weakly capitalized peer companies. Over a full business cycle, we believe it is highly likely that Maersk will increase its cash flows and, thereby, be awarded a higher valuation multiple. Should the company experience an increase in freight

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rates and volumes on par with what it typically sees in a healthier shipping market, it could easily generate $10 billion a year in EBITDA. The current enterprise value of Maersk is approximately $40 billion. In other words, at a multiple of just 8x these higher cash operating earnings, the shares would double in price, with other incremental gains reflecting the company's debt reduction and dividend distributions.

In addition, the pending divestiture of its Energy assets, which should occur by the end of this calendar quarter, is a significant achievement that appears to be overlooked by the market at present. In short, Maersk is poised to complete its transformation into a Transport & Logistics company, which is a business that has stabilized and is generating positive free cash flow, while, we believe, possessing an earnings potential that is much higher than the company's share price would seem to indicate.

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Stolt-Nielsen is a Norwegian shipping company operated by the Stolt-Nielsen family, who own just over 50% of the shares. It provides transportation, storage and logistics services related to its particular segment of shipping: bulk liquid products, ranging from edible oils to industrial acids, as well as clean petroleum products (gasoline, jet fuel, naptha and certain condensates).

The company's primary assets are a fleet of over 150 tankers (including new-builds) with a capacity for nearly 3 million deadweight tons. The company also has an extensive terminal business, with a bulk-liquid chemical capacity of 4.5 million cubic meters, and handles approximately 12 million cubic meters per year. The company's tank container business has 35,000 tanks in its fleet and provides "door-to-door" shipments of many bulk-liquid products, which its other businesses transport. Finally, it has a smaller interest in sea farms, as well as a joint venture in liquefied natural gas supply chains.

Despite the dramatic declines in global shipping volumes and pricing, Stolt-Nielsen has achieved, remarkably, rising revenues, operating income and earnings. It has been profitable in each of the past 10 years, and has recorded higher operating margins in the most recent fiscal year than during the shipping boom prior to the global financial crisis. However, perhaps due to the wider malaise of the global shipping industry, the shares trade at only 11.5x 2017 run-rate earnings (which are down considerably from 2016) and at 52% of 2017's beginning book value. Additionally, it has paid a dividend in every year since 1988, now amounting to over $0.75 USD, or a yield of 5.9%.

We believe that Stolt-Nielsen is one of the most well managed shipping companies in the industry, as evidenced by a consistently profitable business model that has endured and even prospered amid the depression in shipping prices. It is an example of a relatively low-risk way of investing in a recovery in the shipping industry. The investor isn't required to assume undue balance sheet or liquidity risk, collects a 5.9% or higher annual dividend yield, and owns the optionality on higher cyclical earnings and a possible re-valuation vis-à-vis the large discount to book value.

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Subsea 7 is a different type of participant in the cyclically depressed shipping and offshore drilling sectors. The company is one of the world's leading engineering, construction and services contractors focused on the infrastructure for deep-water oil and gas developments. As the name suggests, the company is retained to both construct, inspect and repair substantially all of the drilling infrastructure that connects wellheads on the seabed to surface facilities such as platforms and drillships. Subsea 7's clients comprise supermajor, multinational and sovereign oil companies. It operates in a highly specialized market, with considerable barriers to entry, in the form of personnel qualifications, technology, assets, and local presence and relationships.

The company is 21%-owned by Siem Industries, which is operated by its founder and Chairman Kristian Siem, known as the Warren Buffet of Norway for his long record of astute deep value investing across the marine commercial sector. He is the chairman of Subsea 7 and controls nearly 80% of Siem Industries through personal holdings and the Old Yard Trust Company Ltd.

Unsurprisingly, as oil prices fell in 2014 and 2015, so too did demand from oil companies for new well development, with many projects suspended or delayed. New exploration activity effectively stopped as low oil prices made the development of wells cost-ineffective. As a result, revenues in 2016 were almost 50% lower than in 2014. Nevertheless, in the interim, the company generated considerable high margin recurring revenue from highly specialized subsea inspections, and from maintenance and repair contracts on existing wells. It generated over $1.2 billion in adjusted cash operating earnings (EBITDA) in 2015, and $1.1 billion in 2016. Moreover, Subsea 7 maintains a quite liquid balance sheet: total debt of $647 million at September 2017 was exceeded by cash of $1.52 billion.

As the oil industry has begun to recover, Subsea has been able to secure new orders of $3.4 billion in 2016, leading to a backlog of over $5.3 billion as of September 30 2017. At year-end 2017, the company traded at approximately 0.9x Q3 2017 book value, despite having a net cash balance.

Subsea 7 provides essential services to the offshore oil and gas industries and appears poised to remain an industry leader. Though the valuation has recovered somewhat in the past year, there appears to be significant upside remaining if and as the oil industry continues its recovery. The fact that Subsea is primarily traded in Norway (although US ADRs exist) and is owner operated are no doubt non-financial contributors to this deeply discounted valuation.

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Navigator Holdings is the world's largest owner and operator of small and mid-size liquefied petroleum gas (LPG) vessels. LPG, which primarily includes propane and butane, is a byproduct of oil refining and oil/natural gas exploration that has several consumer and industrial uses. Naturally, the massive increase in North American shale exploration has greatly increased the supply of LPGs, leading Navigator to more than double its vessel fleet since 2013. Moreover, the company has partnered with Enterprise Products Partners LP to construct a large LPG shipping terminal near Houston to accommodate the rising supply.

However, in 2014, LPG prices declined along with the erosion in oil prices. In addition, an increasing number of newbuild LPG vessels being placed into service ultimately created an oversupply in the market, causing a decline in voyage charter rates. For example, the company's current average daily time charter per ship is $21,170, which is 30% below the 2015 level.

As a result, Navigator's earnings have suffered. In 2015, the company produced $98 million in net profits. Through the first nine months of 2017, net income fell to an annualized $5.3 million. Based on the consensus forecast, Navigator will experience a modest improvement next year, perhaps earning $12 million. More importantly, even at the current low earnings level, the company should achieve almost $70 million in free cash flow this year, which is the relevant measure of earnings. This appears more than sufficient to service the $826 million of debt on the balance sheet.

Despite not posing a serious credit risk, the company trades at only 58% of tangible book value. In the simplest sense, even a valuation of 1x book value would produce a $17.21 share price, resulting in a 73% return, at current levels. However, there appears to be a far more intriguing scenario. At the most recent earnings peak in 2014, Navigator generated $3.5 million of net income per vessel. If this were applied to the current number of vessels, 38, the company would achieve a total profit of $134 million. At a 12x multiple, the share price would be $28.86, thereby, providing a 190% cumulative return. Stated differently, Navigator trades at only 4x prospective earnings.

In addition to this reversion-to-the-mean scenario, there is another attractive return outcome made possible by a low valuation and available cash flow to repay debt. Navigator, even at this depressed cash flow level, could repay roughly half of all outstanding debt over the next five years. This could create a situation in which the annualized share price return during this period would be 14.4%. This return would require no recovery to prior profitability levels, and no increase in the valuation multiple.

Such a depressed valuation is not entirely surprising. Based on the company's market capitalization of $556 million, its effective float is only $318 million, after subtracting the equity interests held by Wilbur Ross and Navigator's CEO, David Butters (both presumably long-term holders). Hence, this is essentially a micro cap company that has escaped the attention of the indexation community. Only in the domain of excluded and ignored securities can the investor find such opportunities.

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Clarkson plc is a global broker and financial services provider to the shipping and offshore industries. This business does not require ownership of any vessels and, therefore, Clarkson does not carry the balance sheet or operational risks of a typical shipping company. This model has allowed it to remain profitable throughout the current cycle, and its existing earnings and free cash flow, even in this depressed environment, arguably justify its market capitalization. Any upside earned as the market improves would be additive, particularly as a portion of the company's fees are based upon shipping lease rates. This optionality could be significant, as vessel earnings are still well below normalized levels.

The volume of global seaborne trade cargo has increased by more than 25% since 2008, yet, rates are down significantly over this period. The company has stated that vessel earnings would need to increase by nearly 40% to reach the average level experienced from 1997 to 2003, or by more than 150% to reach the average of the 2004-2010 period. Other facets of the industry, such as the number of newbuilds on order, are at multi-decade lows, which has pressured the finance portion of the business. A simple reversion to normalized, mid-cycle shipping activity, therefore, would be significantly accretive to Clarkson's earnings.

The company's earnings potential in such a market recovery is difficult to define, since the size of the shipping market (by tonnage and number of vessels), and Clarkson's share of it, have increased meaningfully since the last cycle. Fortunately, an investment in the company is justified based only on current depressed earnings and free cash flow. The current free cash flow yield (which is to say, the company's after-tax free cash flow relative to its stock market value) is estimated to be between 7% and 9%, which is an attractive absolute return for an asset-light, low risk business; this is equivalent to a Price/Free Cash Flow multiple of roughly 11x to 14x. On a more conventional basis, the shares trade at 19x the consensus 2018 earnings forecast, after adjusting the market capitalization for the £71.4 million net cash balance, which is roughly on par with its average earnings multiple over the last 10 years. Assuming price-to-earnings multiples remain constant going forward, any increase in profitability would generate the same rate of share price appreciation. The company has also increased its dividend in each of the last fourteen years and currently yields 2.3%.

Clarkson is clearly not immune to the cyclicality of the shipping market, but its strong balance sheet, negligible capital expenditure requirements and low fixed-cost business model, which have allowed it remain profitable throughout the current downturn, make it a safer means of investing in this industry. Shareholders might not enjoy the same degree of share price appreciation as might be found in a traditional shipping company that is currently facing financial distress (with shares priced accordingly), but the current earnings and upside optionality are attractive relative to its modest risk profile.

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