Hosking Post

What Shall We Do With The Drunken Sailor?

What shall we do with the drunken sailor?
Put him in the long boat 'til he's sober?

Early 19th century shanty

More attentive observers of the Hosking Partners portfolio may have remarked on a gathering collection of shipping companies among the 400-odd stocks we invest in. Names such as AP Møller Mærsk and Pacific Basin have had a berth in the portfolio since inception, but more recently they have been joined by Diana Shipping, Scorpio Bulkers, Scorpio Tankers, D'Amico International Shipping and Golar LNG coming on board. Combined, this cluster of positions (covering the container, dry bulk, product tanker and LNG sub-sectors) currently represents 1.25% of the portfolio.

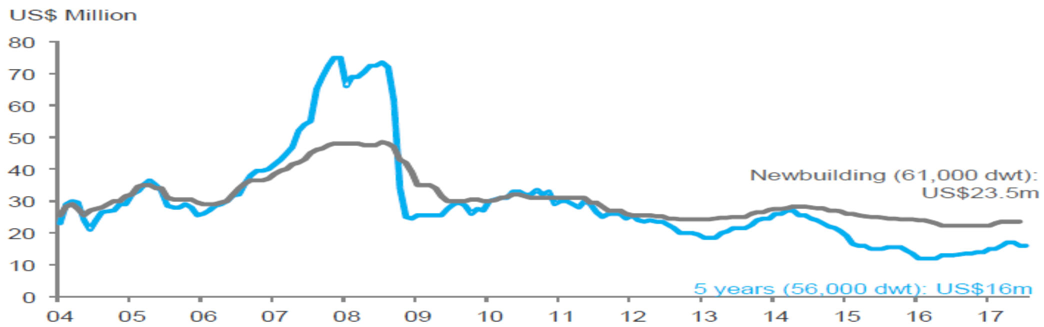
The shipping industry has been characterised by over-capacity for at least the last decade, as supply has consistently grown faster than demand. At times the supply growth has been justified by strong demand: to take the example of the container sub-sector, activity has grown at 2.5x the rate of global GDP growth for the half century leading up to the global financial crisis. However, the fall in demand growth since then, combined with the time lag between ordering a ship and its delivery, has resulted in large and persistent over-capacity and very poor industry returns. The Baltic Dry Index, the index of freight rates in the dry bulk sub-sector, is today one tenth of its level ten years ago, and the price for shipping a container from Shanghai to Europe is about half what it was in 2014. The advantages of scale – in what is largely speaking a commoditised industry – mean that rational behaviour at an individual level results in sub-optimal outcomes for the group. Even in the last five years, gross investment in the container sub-sector globally has totalled more than US$400 billion annually, calling to mind the wanton profligacy of a sailor on shore leave. Looking beyond containers, the three big Japanese shipping companies (Nippon Yusen KK, Mitsui OSK Lines and Kawasaki Kisen Kaisha) have generated negative cash flow for 11 of the last 12 years, a cumulative ¥3.5 trillion, as a result of which their combined market capitalisation has fallen 80% since 2007.

Guessing when this state of disequilibrium will reverse is tough. At Hosking Partners, we do not regard ourselves as having a more accurate forecast of economic conditions than anyone else and anyway, our multi-counsellor setup is expressly designed to avoid the sort of groupthink that may come with a top-down macro house view. Regional, let alone global GDP predictions are not what we do, and working out future grain exports from Latin America, coal imports into China, the global steel price or oil inventories in North America is simply beyond us. What we can do, however, is observe the change in supply and capacity growth into an industry, as that provides a rough but fairly reliable indicator of future returns, independent of estimates of demand. We are students of the capital cycle. Eventually, economic rationality must be restored, the powerful but silent force of mean reversion must assert itself, and the conditions which supported the over-capacity must come to an end. Governments at some point tire of subsidising bankrupt industries, banks give up making loans which do not get repaid, shareholders either rein in profligate managements or else find themselves wiped out. The only question is when.

There are signs that this is now happening in shipping. The picture varies across the various sub-sectors, given the different end markets they supply, but some common factors are becoming observable. Shipyards in Korea and China, who may be likened to the sellers of hooch to our drunken sailor, are starting to close. The bankruptcy of Korean container liner Hanjin in 2017 was evidence that Korea has finally given up subsidising its shipping industry, having wasted billions of dollars bailing out shipyards such as Daewoo. Financing which was previously available on tap to shipping companies is drying up: governments are giving up as we have seen in Korea, European banks have pulled back from shipping loans, and alternative funding sources such as German KG limited partnership structures have shown that the tax tail should not be allowed to wag the commercial dog. Regulatory issues are playing their part: the International Maritime Organisation (IMO) has set a deadline of 2020 for reducing emissions of polluting sulphur oxides from 3.5% to 0.5%. This means that for dry bulkers over 15 years old, future outlays on retrofit, dry-docking and testing can be as much as two times the residual value of the ship, making scrappage a more attractive alternative. There are similar pressures from the IMO's ballast water management regulations which come into force in September 2017. Other regulatory measures impact financing: accounting rule changes require long-term charters to be capitalised on balance sheet, making life more difficult for non-operator owners (NOOs) who have contributed to historic over-capacity, and increased risk weights for shipping loans make it less attractive for new players to take the place of the retreating European banks. The low oil price is making the benefits of ordering new more fuel-efficient ships less clear, as well as providing the threat of an effective capacity increase if slow steaming were to end in response to lower oil prices.[1]

The effects of these changes are visible. As shown in the chart below, a gap has opened up between the price of a second-hand dry bulker (five years is the benchmark reference age) and a new-build. In a balanced market second-hand prices tend to track new-build prices, as the newness of the latter is offset by the need to wait two years for delivery and the risk that economic conditions may change during that period; in bull markets the price of second-hand vessels is up to twice that of a new-build. Immediacy comes at a premium.

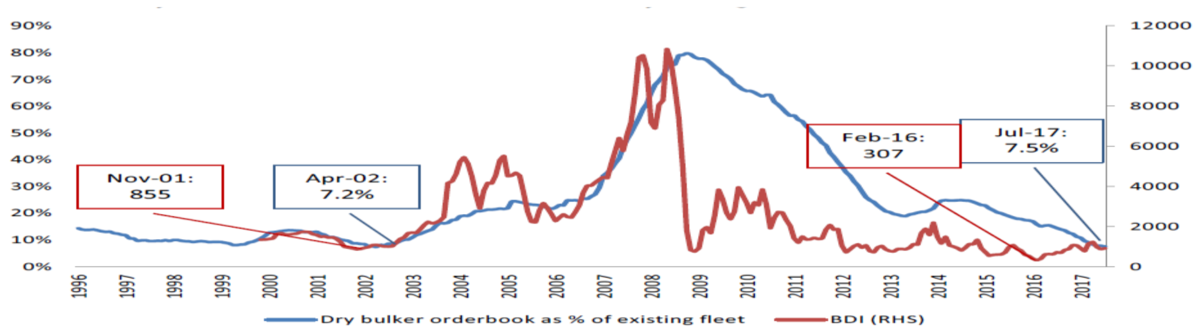
Dry bulk: Handymax Vessel Values



Source: Pacific Basin, Clarksons Platou

Lower second-hand prices reduce the attractiveness of ordering new ships. Sure enough, order books are at record low levels: according to Morgan Stanley, the dry bulker orderbook/fleet ratio in July 2017 was just 7.5%, its lowest level since April 2002 when it reached 7.2%. The chart below shows the historic orderbook/fleet ratio, as well as the correlation with the Baltic Dry Index, a concrete example of the importance of focusing on supply:

Dry bulk orderbook/fleet ratio vs. monthly average BDI



Source: Clarksons, Morgan Stanley Research

[1] Slow steaming results in higher capacity utilisation due to the extra time required for each voyage.

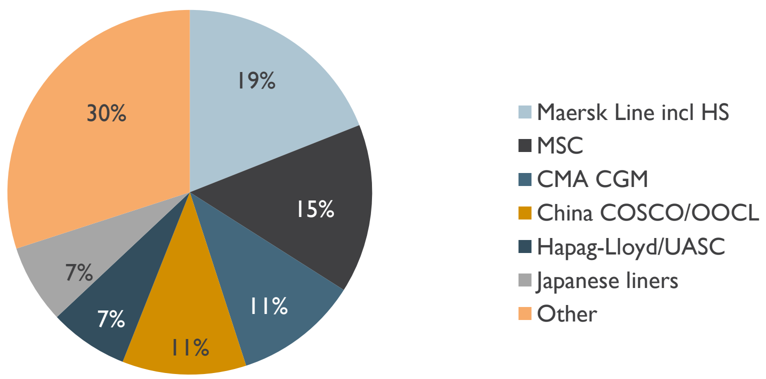
Another consequence of the lower second-hand prices is an increase in second-hand transactions. Dry bulk shipping companies Pacific Basin and Diana Shipping have been buying second-hand vessels this year (as opposed to chartering in ships or ordering newbuilds). Although both companies have raised some equity to fund the acquisitions, part of the consideration has been funded from existing cash on the balance sheet, which in net terms has resulted in the departure of capital from the sub-sector.

In the container sub-sector, the pressure on freight rates from industry over-capacity has resulted in either bankruptcy (for example, in the case of Hanjin Shipping) or consolidation. Indeed, it is likely that the disruption caused by Hanjin's bankruptcy may act as a catalyst for further consolidation: after it filed for receivership in August 2016, there were instances when Hanjin's vessels would not dock for fear of seizure by creditors, and ports denied Hanjin's vessels entry for fear of not getting paid. The resulting disruption suffered by Hanjin's customers would have made them wary of the weaker survivors. With this catalyst in mind, it is interesting to note the following announcements of M&A activity within the container sub-sector since 2014:

Announcement date	Parties
April 2014	Hapag-Lloyd, CSAV
December 2015	CMA CGM, Neptune Orient Lines
December 2015	China COSCO, China Shipping Container Lines
June 2016	Hapag Lloyd, UASC
October 2016	NYK, MOL, K-Line
December 2016	Mærsk Line, Hamburg Süd
July 2017	China COSCO, OOCL

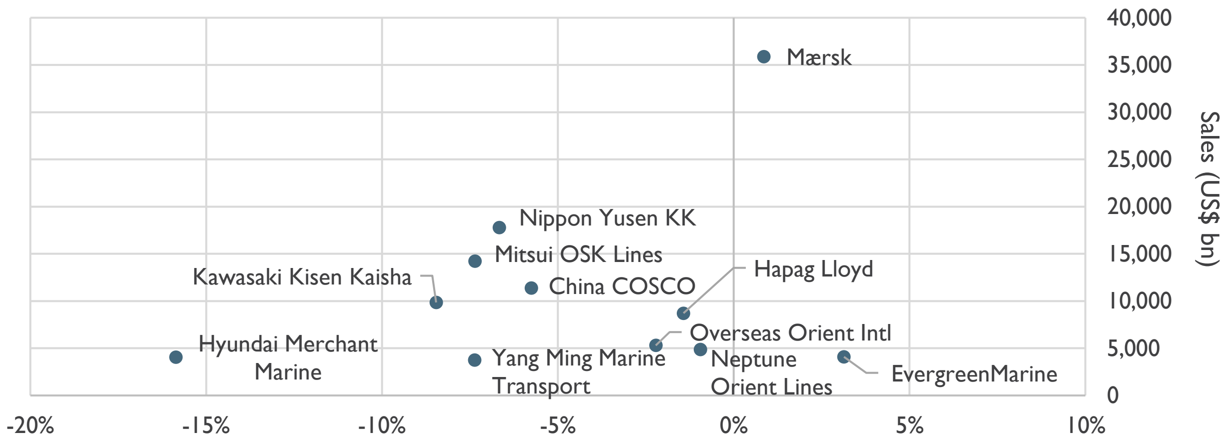
Containers may be the shipping sub-sector most advanced in its progress around the capital cycle. 70% of the market is now controlled by the top six players, the largest of whom is AP Møller Mærsk (Mærsk for short). Mærsk exhibits a number of characteristics we find attractive: family ownership to enable it to chart a course to a more distant horizon however choppy the waves are in the short term; a moat provided by scale and network effects which allows it to keep prices low and maintain its competitiveness; and counter-cyclical capital allocation which has allowed it to invest in and harvest non-core activities such as banking and food retailing with good timing. Like other companies which dominate their industries (Taiwan Semiconductor in foundry comes to mind), Mærsk accounts for more than 100% of the profit pool, and it has used that position to keep pressure on its competitors to expand market share and drive continued sector consolidation.

Container shipping: 70% now controlled by top 6



Source: Alphaliner May 2017 data

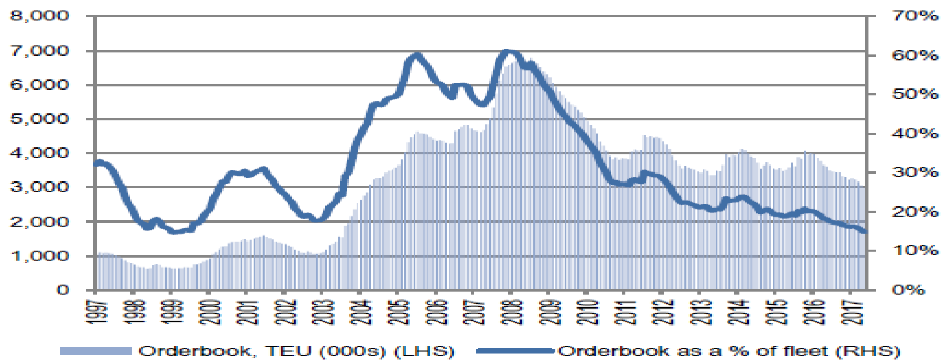
Container shipping: FCF/Sales vs Sales (US$ bn)



Source: Hosking Partners, Bloomberg

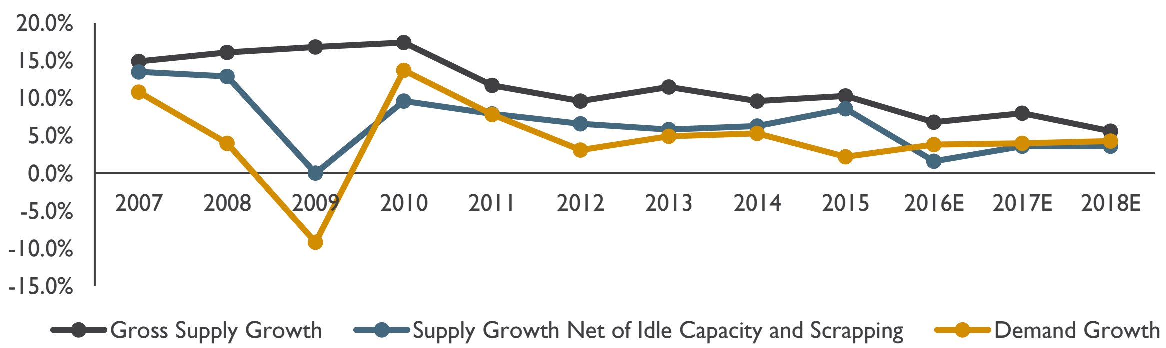
Despite the container industry having increased capacity by 50% over the last eight years to 20 million TEUs (twenty-foot equivalent units), there have been no orders of ultra large container ships since October 2015 as M&A and second-hand acquisitions have become more attractive alternatives. This means that the ramp-up in new capacity between now and at least 2020 is a known quantity due to the time lag between order and delivery. The container industry orderbook is currently at 14% of total fleet, the lowest level since 2003, having peaked at 70% in 2007.

Container shipping: The orderbook is down to 14% of the current fleet – lowest level in recent history



Source: Clarksons data

Container shipping global demand-supply growth

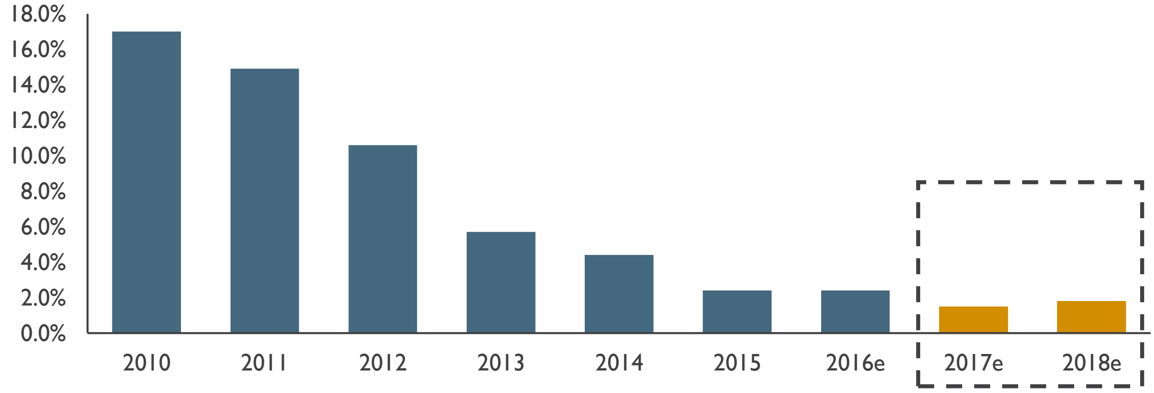


Source: Clarksons, Alphaliner, World Bank, JP Morgan

Against this backdrop, Mærsk has reduced its core cost per TEU by 20%-25% since 2014, although this is only half the drop in revenue per TEU it has experienced owing to the pressure it has imposed on rates. The potential operating leverage once supply and demand come into balance and pricing normalises is significant. Mærsk's cash flow return on invested capital today is just 1.4%: if it can raise this to its cost of capital (just 5.2%) there is 70% upside, even after the share has rallied over 60% since its low one year ago (since when we have added to our position).

The dry bulk sub-sector is not that far behind. We have already remarked that its orderbook, at 7.5% of the existing fleet, is at its lowest level since 2002. 2017 will be the third year of dry bulk limited fleet growth.

Dry bulk: Historical and project fleet growth



Source: Pareto Securities Equity Research, Clarkson Research Services

However, dry bulk is less consolidated than the container sub-sector, with the top 10 players in handymax and supramax accounting for half the market, and Hosking Partners' exposure is therefore less concentrated, being expressed via three names – Diana Shipping, Pacific Basin and Scorpio Bulkers. This is just as well: dry bulkers' capital discipline is nowhere near Mærsk's. Having timed the previous cycle to perfection by selling its fleet between 2007 and 2009, Pacific Basin squandered the opportunity to return cash to shareholders and instead pursued a strategy of diworsification, investing in Chinese real estate, roll-on roll-off ferries and towage vessels! More recently it raised equity via a rights issue in 2016 to ensure it had a strong enough balance sheet to take advantage of the long awaited upcycle, having been caught out by the industry's false start in 2013 when a number of players raised money from private equity or via IPO to take advantage of an anticipated turn which in the end failed to materialise, at least partly because of the same inflow of capital, a good example of reflexivity in action. As James Grant said "Successful investing is about having people agree with you ... later." Scorpio Bulkers is one example of the 2013 new entrants, and our position in that company was initiated in 2016 when the price was less than one tenth at which shares had been issued.

Having survived thus far, Pacific Basin has managed to reduce its overheads by one third in the last few years, and now has a strong balance sheet, a fleet of high-quality substitutable Japanese ships, and a global network which allows it to fill backhaul and thereby achieve an effective rate which is a 10%-20% premium over market rates. Most recently it has been acquiring second-hand ships at attractive prices.

Where and how might we be wrong? Our experience of investing in the airline space is one guide. Transport is an inherently lower quality industry than others which have higher barriers to entry (and lower ones to exit), and like airlines, shipping has had its share of visionary and charismatic managers who have succeeded in raising capital and expanding capacity with terrible timing. Both industries also feature state actors getting involved for strategic reasons, prolonging companies' ability to endure losses and acting as a brake on the wheel which is the capital cycle (in this respect, China COSCO's recently announced acquisition of OOIL is a development we will pay particular attention to). Nevertheless, a clear focus on the supply side tells us that the cycle has inflected and we are currently in an upcycle which is not yet fully reflected in share prices. It is unlikely to be all plain sailing, but we have the advantage of a longer time horizon and rather than waiting for one ship to come home we are backing a small flotilla.

Luke Bridgeman

August 2017

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