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Perfect Storm: *Shipping Recovery & IMO 2020*



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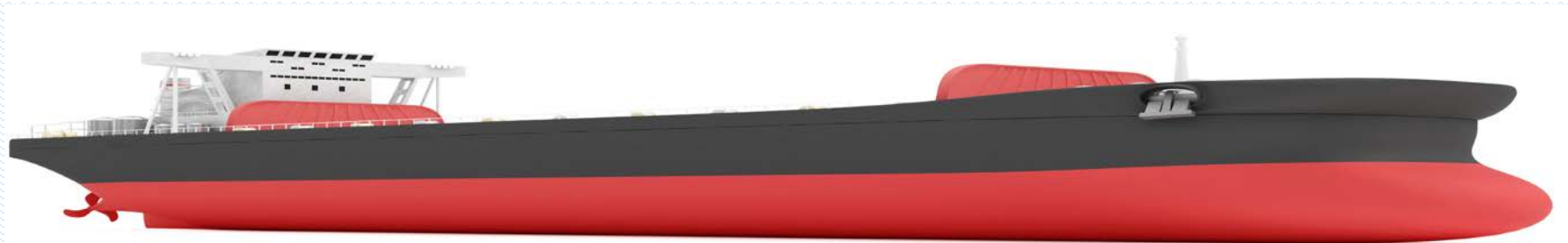
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Who were are

- **BlueShore** runs a concentrated deep-value global equity fund
- Our portfolio: 3 to 5 investments
- Our holding period: 2 to 7 years
- Our focus: general industrial, real estate and commodities



Investment thesis: Perfect storm

- Marine shipping is entering recovery phase of cycle
 - Highly cyclical industry exiting from long downturn
- **Low supply:** Orderbook at historical lows
 - Roughly two-year building time for commercial vessels
- **Strong demand:** Synchronized global recovery
- **Undervaluation:** Vessels are nominally cheaper than late-1980s
- **Perfect storm:** International Maritime Organization (“IMO”) 2020 sulfur rules to shock tightening market

Types of vessels

Dry bulk carriers¹



- 25,000 to over 400,000 tons per ship of bulk commodities
- Each about 1/3 of global cargo: iron ore, coal, grain and minor bulks

Tankers²



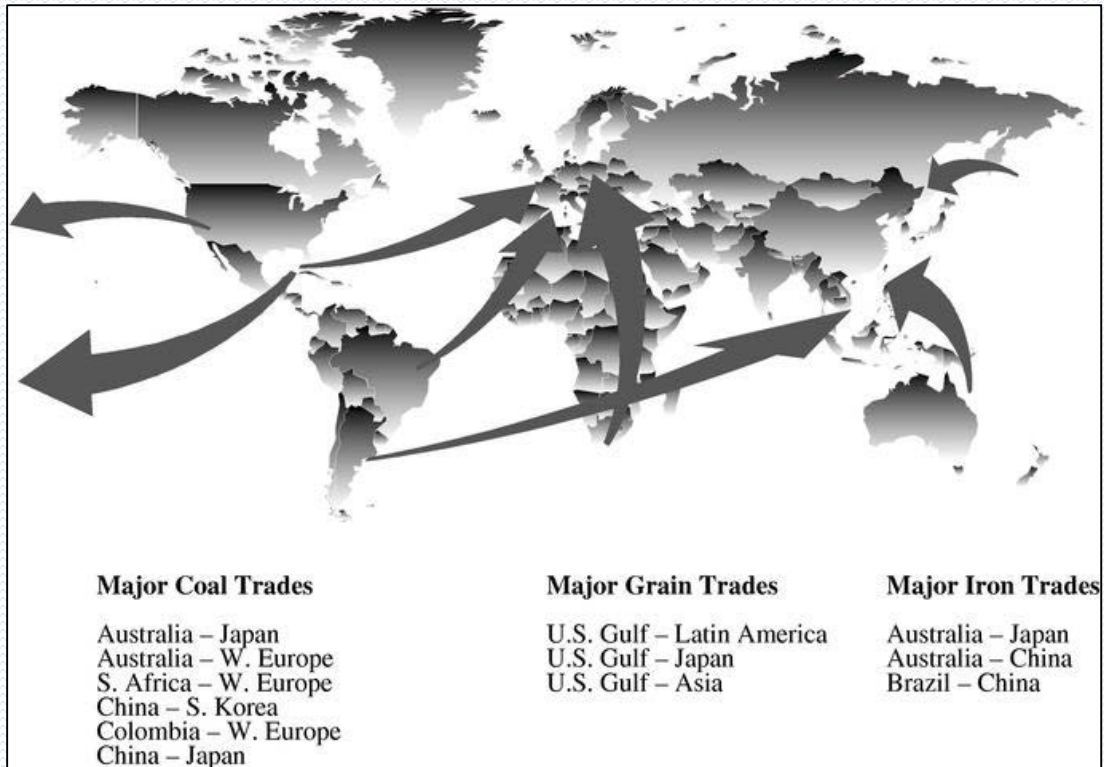
- Crude tankers: 0.5 to over 2 MM barrels of crude oil
- Product tankers: 0.1 to over 0.5 MM barrels of refined oil products
 - Coated tanks to prevent contamination and corrosion

1. Diana Shipping Inc., Form 424B1, March 18, 2005

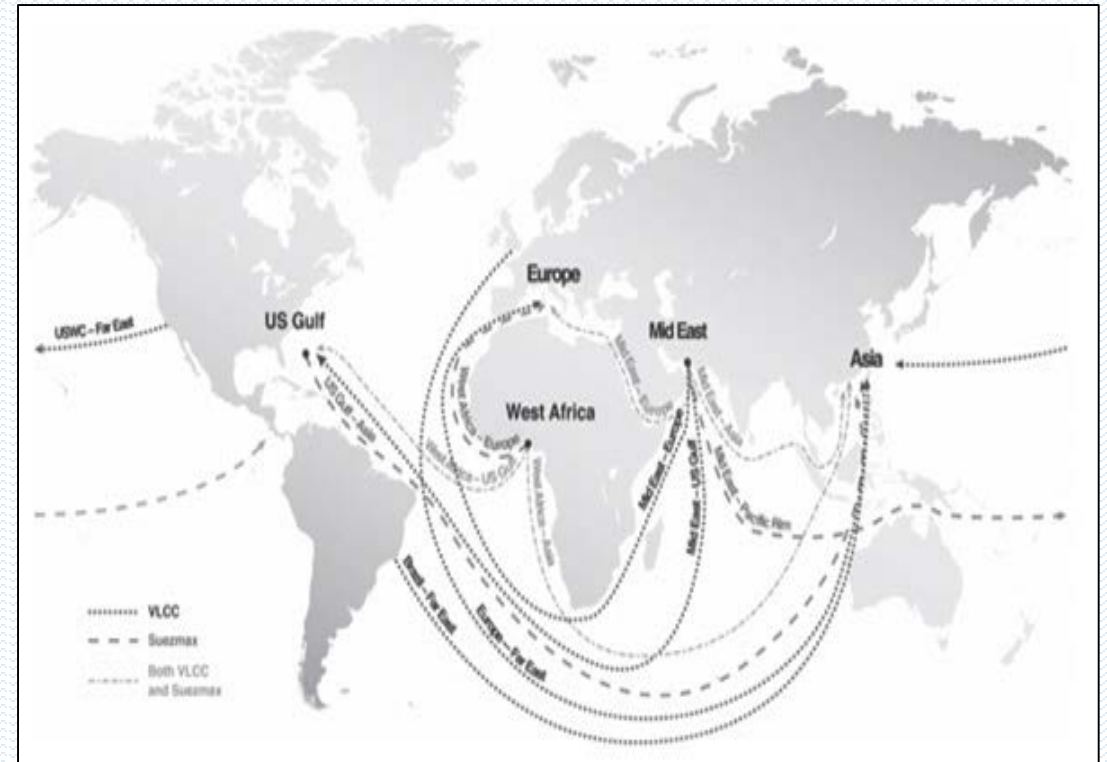
2. Euronav NV, Form F-1, Sept. 18, 2014

Major sea routes

Dry bulk trades¹



Tanker trades²

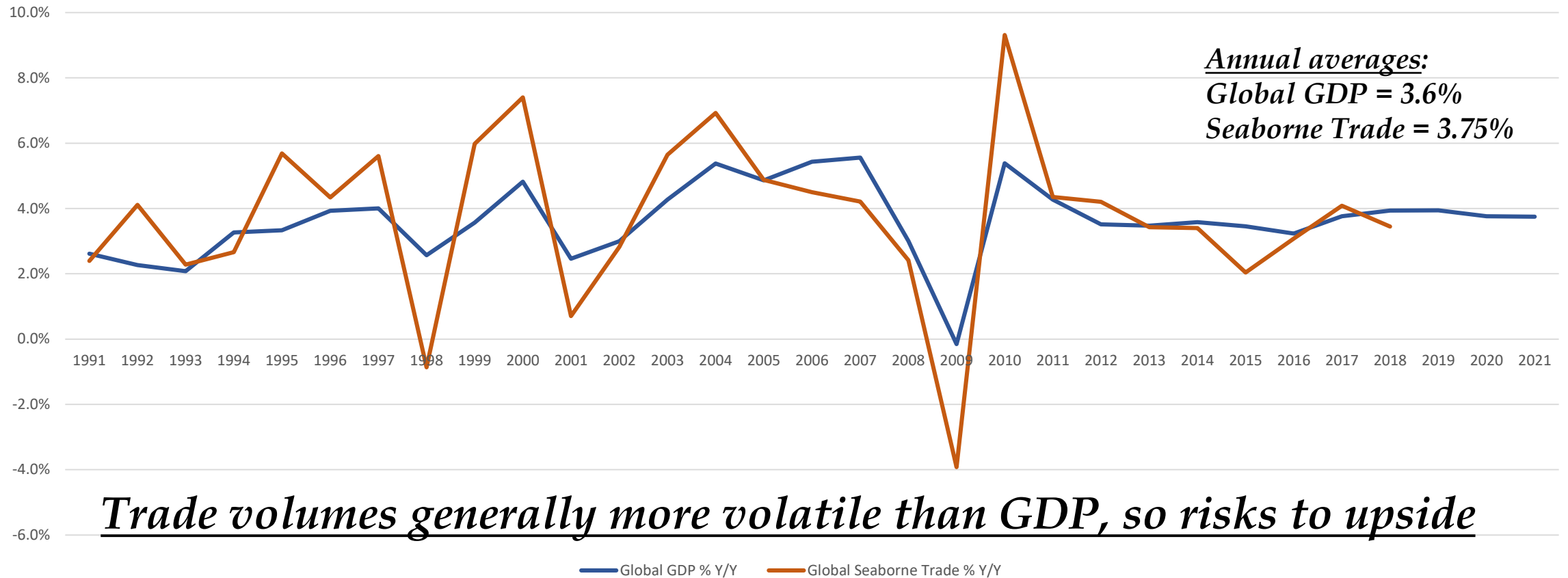


1. Diana Shipping Inc., Form 424B1, March 18, 2005
2. Euronav NV, Form F-1, Sept. 18, 2014

Global demand is accelerating

IMF forecasts above-trend global GDP growth through 2021

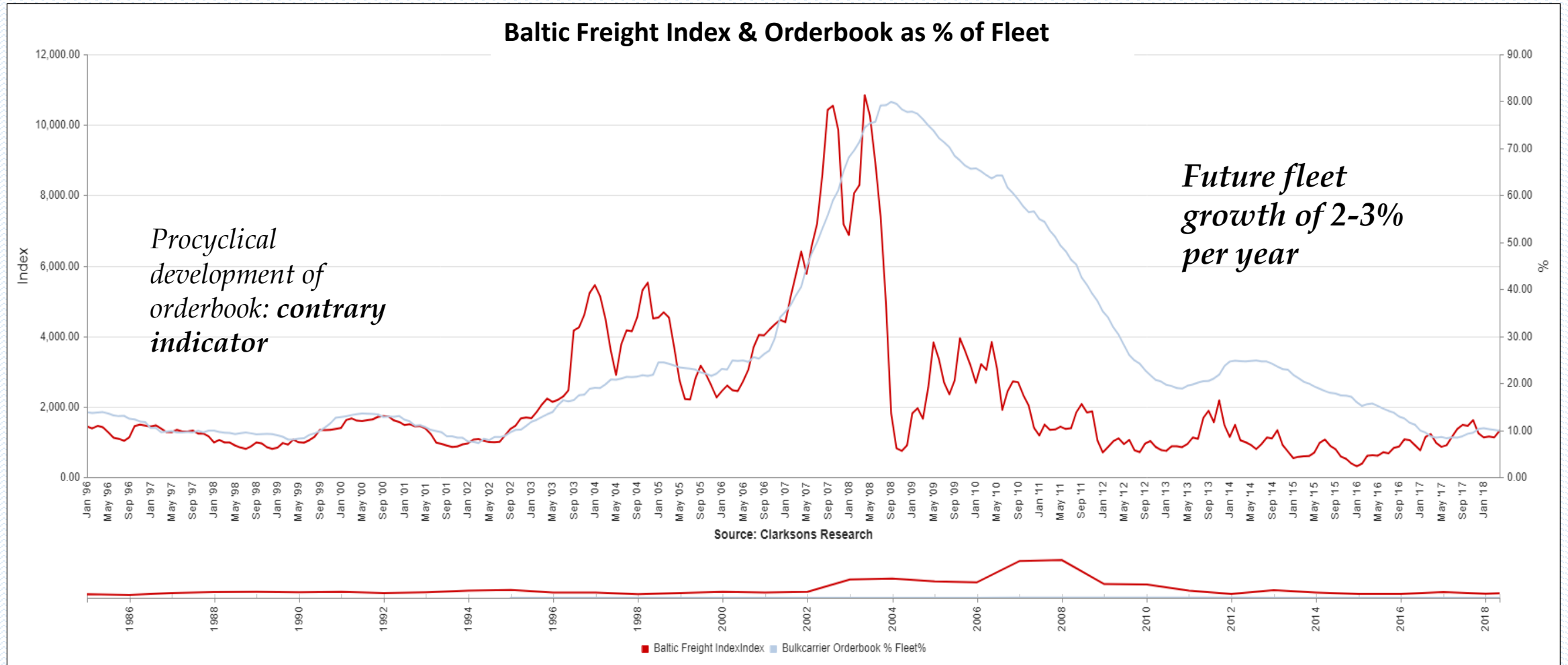
Annual change in Global GDP & World Seaborne Trade



Trade volumes generally more volatile than GDP, so risks to upside

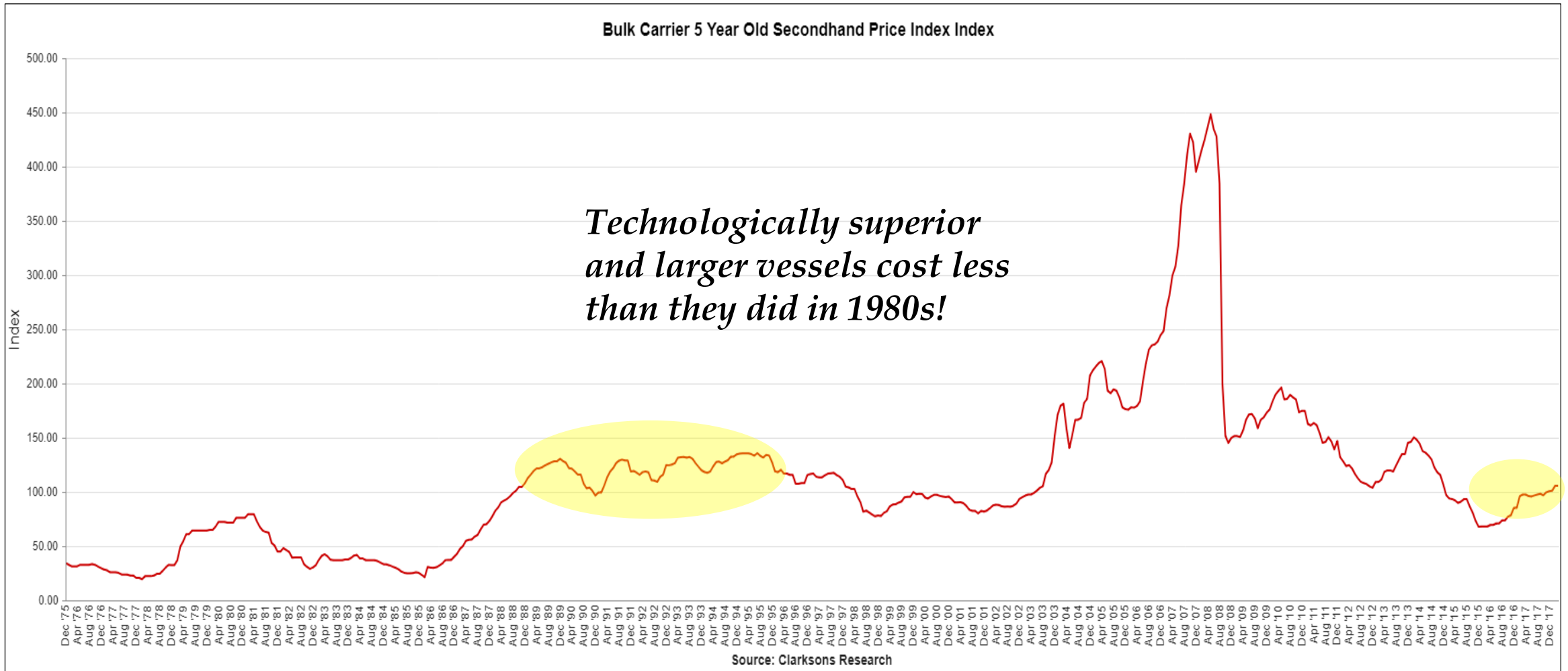
Vessel oversupply is ending

Orderbook at historical low of 10% of fleet



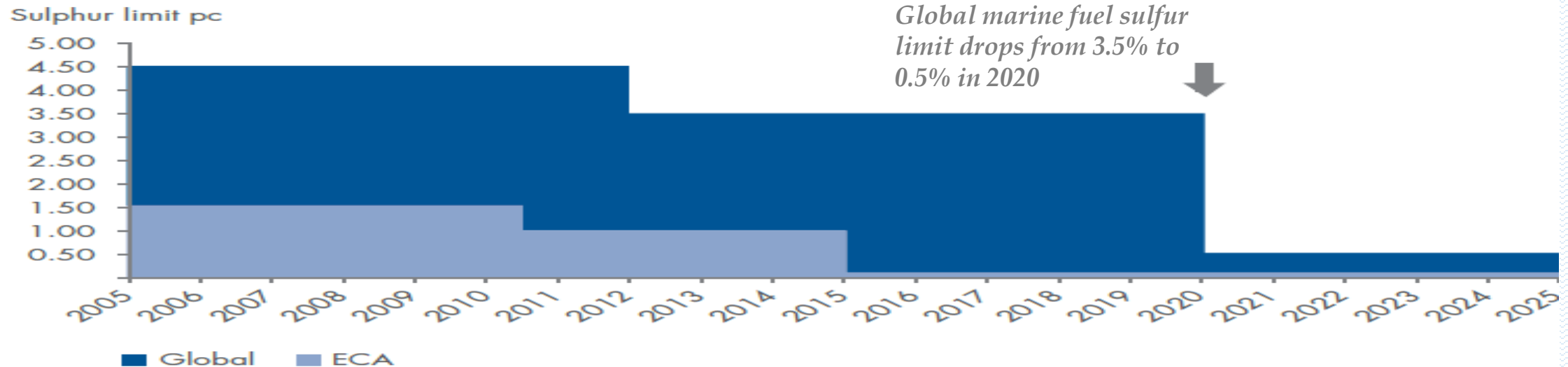
Vessels are cheap!

Bulk carriers are nominally cheaper than late-1980s!



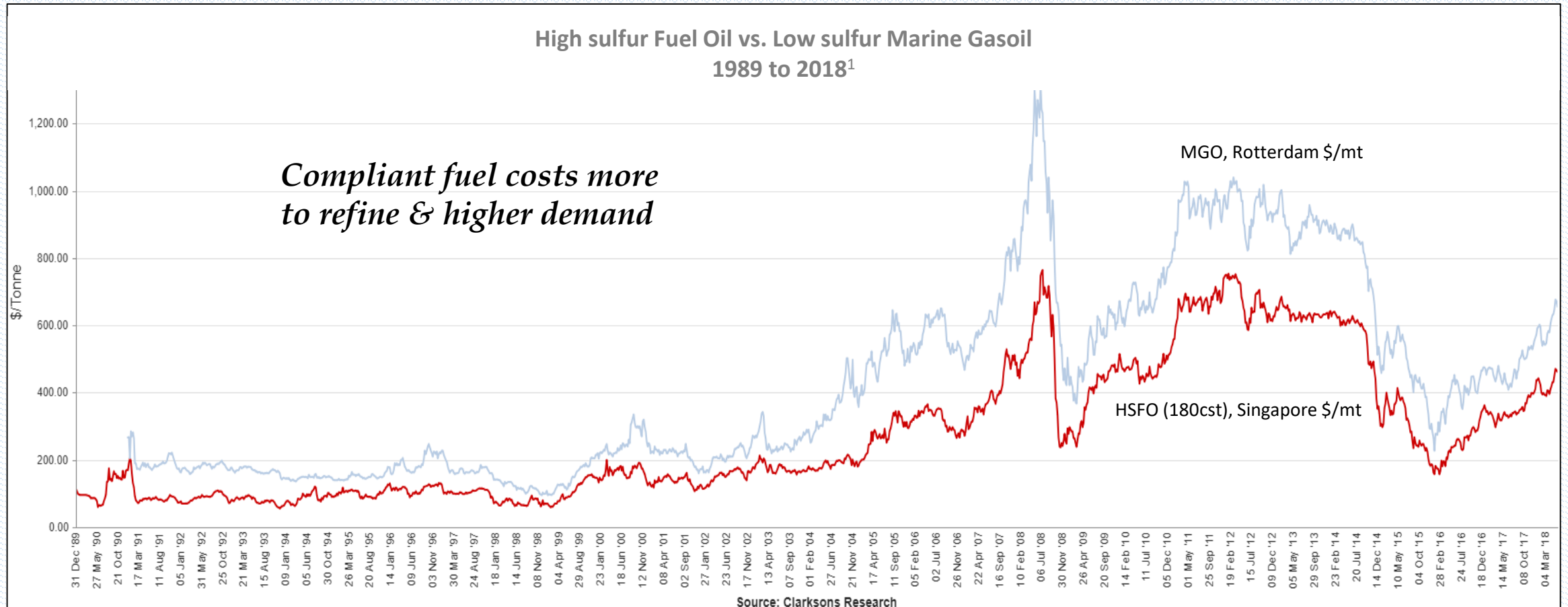
Market shock: IMO 2020 sulfur cap

- IMO regulates marine pollution
- October 2016: Enacted global sulfur cap in marine fuel
 - New limit of 0.5% sulfur from current 3.5%
 - Applies to ~70,000 commercial vessels
- Sulfur cap **effective on January 1, 2020**



IMO 2020: Fuel cost spike

Compliant fuel is always more expensive



IMO 2020: Bunkers are 'bottom of barrel'

Shipping uses ~5% of oil barrel – most of this fuel is no longer compliant

Total Daily Global Oil Product Consumption¹ =
96.6 MMBD (2016)

Light Distillates: 31.7 MMBD 33%
Middle Distillates: 34.6 MMBD 36%
Others: 22.2 MMBD 23%
Fuel Oil: 8.0 MMBD 8%

- HSFO is low-value residual product
- Consumed by ships & power plants
 - 70% of bunkers are HSFO²
 - HSFO Bunkers = 3.5 of 8.0 MMBD
- Trades at significant discount to cleaner products
- Low value: HSFO negative crack spread
 - Trend toward higher value production
 - Global output: 7.7% (2006) to 5.2% (2014)

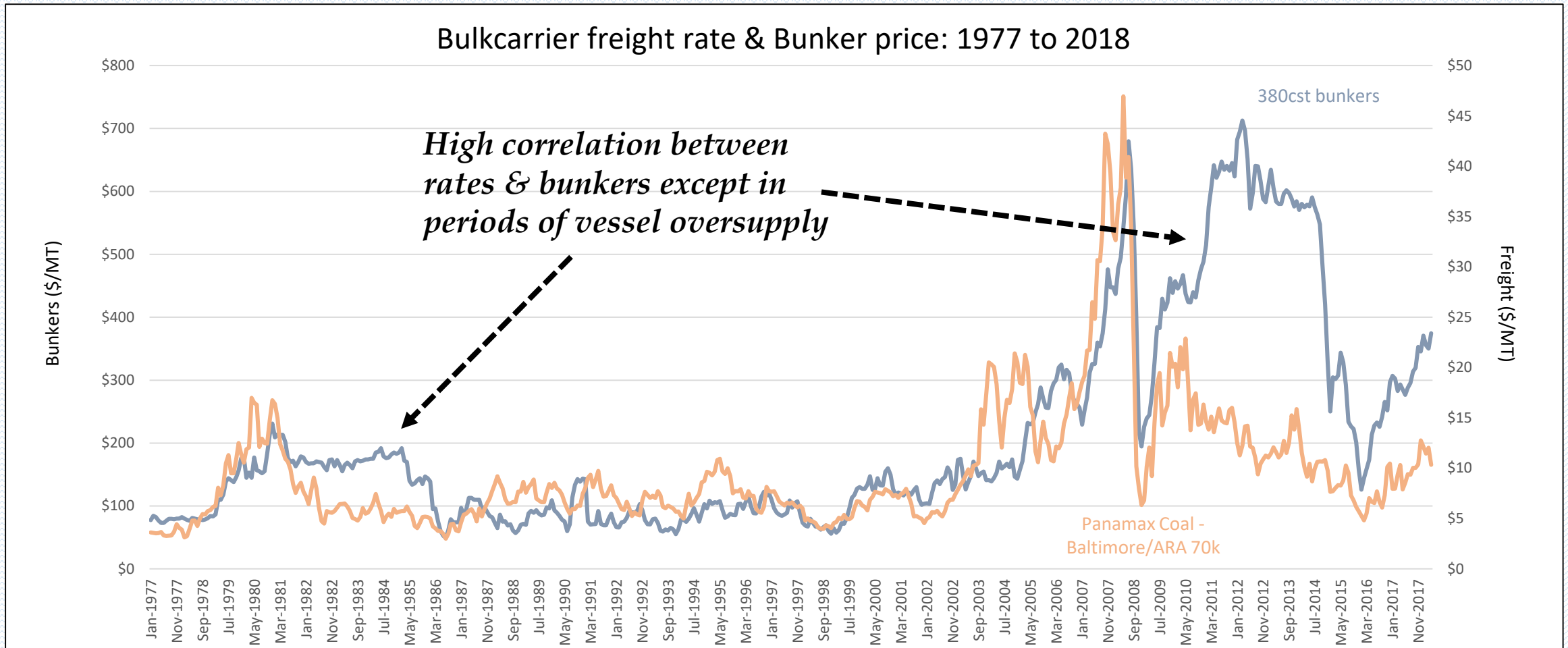
Ships use 5 MMBD but 3.5 MMBD is low-value & high-polluting HSFO²

1. BP Statistical Review of World Energy 2017

2. Rats, Martijn; Countdown to IMO 2020: Not Plain Sailing; Morgan Stanley; May 15, 2018

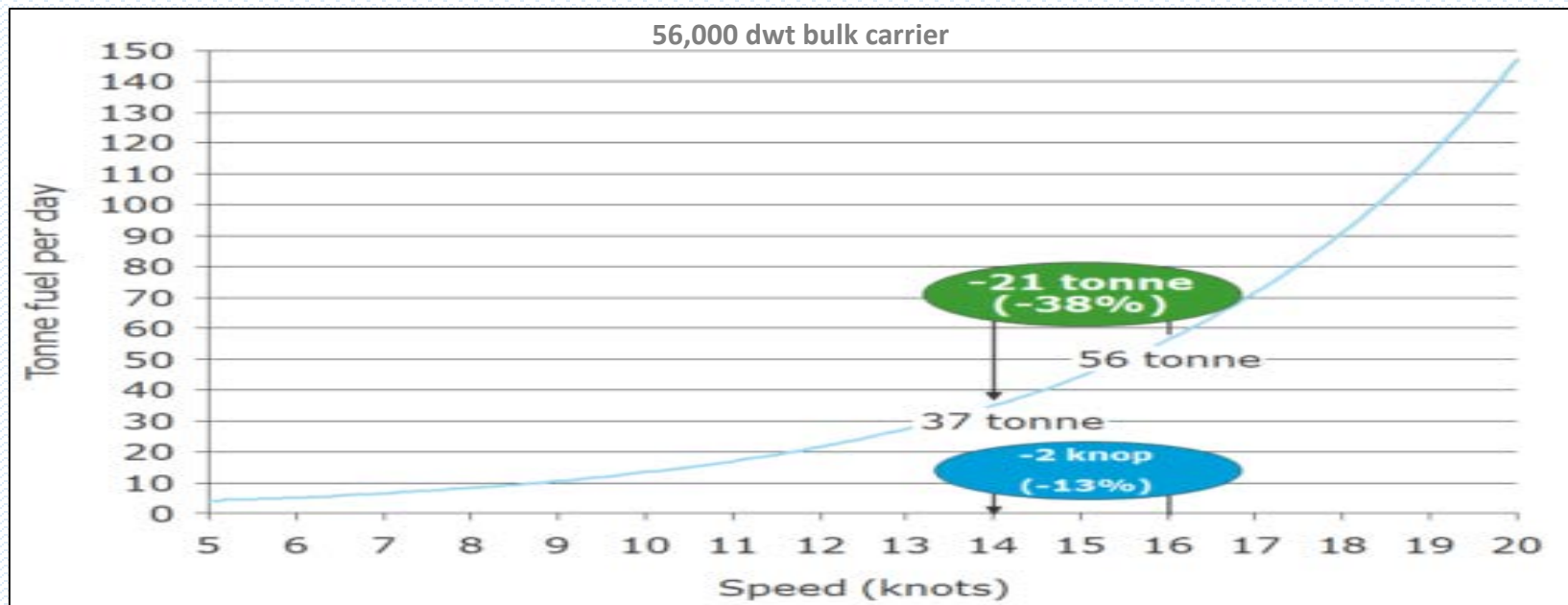
Rising fuel costs = Rising freight rates

Fuel costs are main component of freight rates - up to 60% or more!



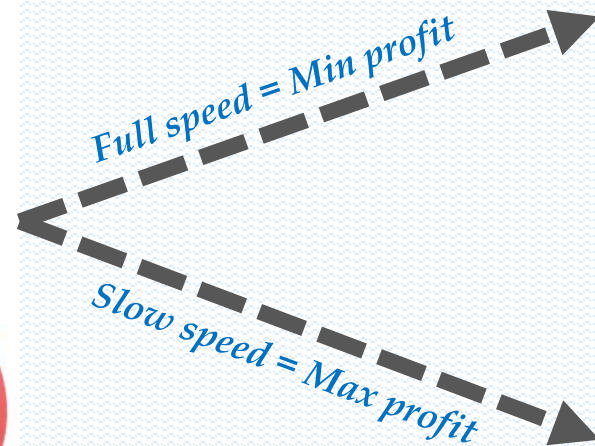
Small slowdown = Big savings

- Higher speeds = exponential increase in fuel consumption
 - Rule of thumb: (10%) speed = (27%) daily fuel consumption



Lower speeds => lower fuel consumption =>
lower fuel costs

Fuel price rises = Global fleet slows!



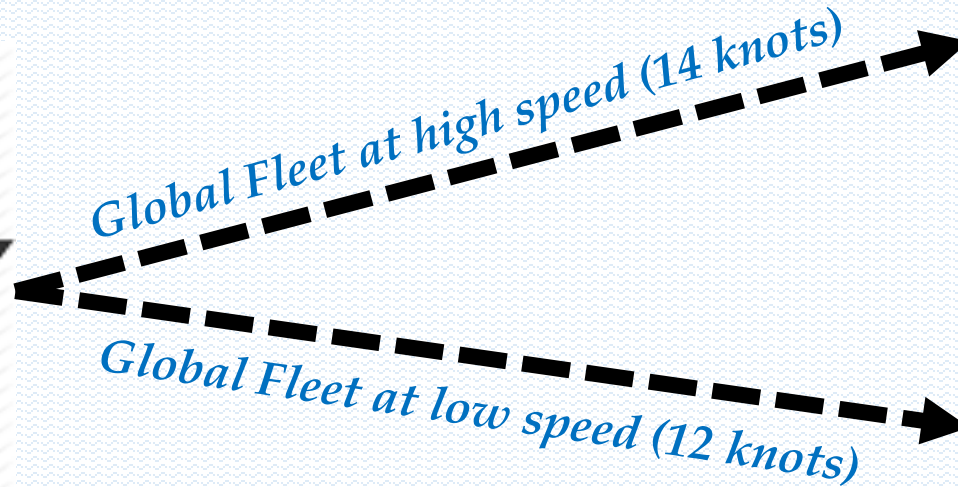
If fuel price jumps, shipowner's costs rise if she travels at same speed

If fuel price jumps, shipowner's costs rise less if she travels at lower speed

All shipowners optimize for fuel price spike so entire global fleet slows down!

Slower fleet = Lower vessel supply

*100 MM tons of iron ore
from Brazil to China*



*77 days per
round trip: 108
ships needed*

*86 days per
round trip: 122
ships needed*

Rise in fuel price leads to an immediate shortage of vessels

Lower supply = Higher freight rates



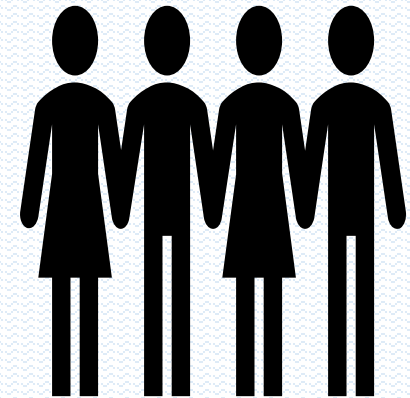
Commodity producer
Perfect competition so
price-taker of freight
costs

Commodity producer
Aims for maximum
volume at minimum
cost



Post-fuel price spike
Freight costs must rise to
incentivize faster speeds &
increase effective vessel
supply so commodity
producer can deliver
targeted production

Market balance
Higher freight rates
needed to maintain
pre-fuel price spike
supply-demand
balance



Shipping & commodities are perfectly-competitive markets

Freight rates: How high & how long?

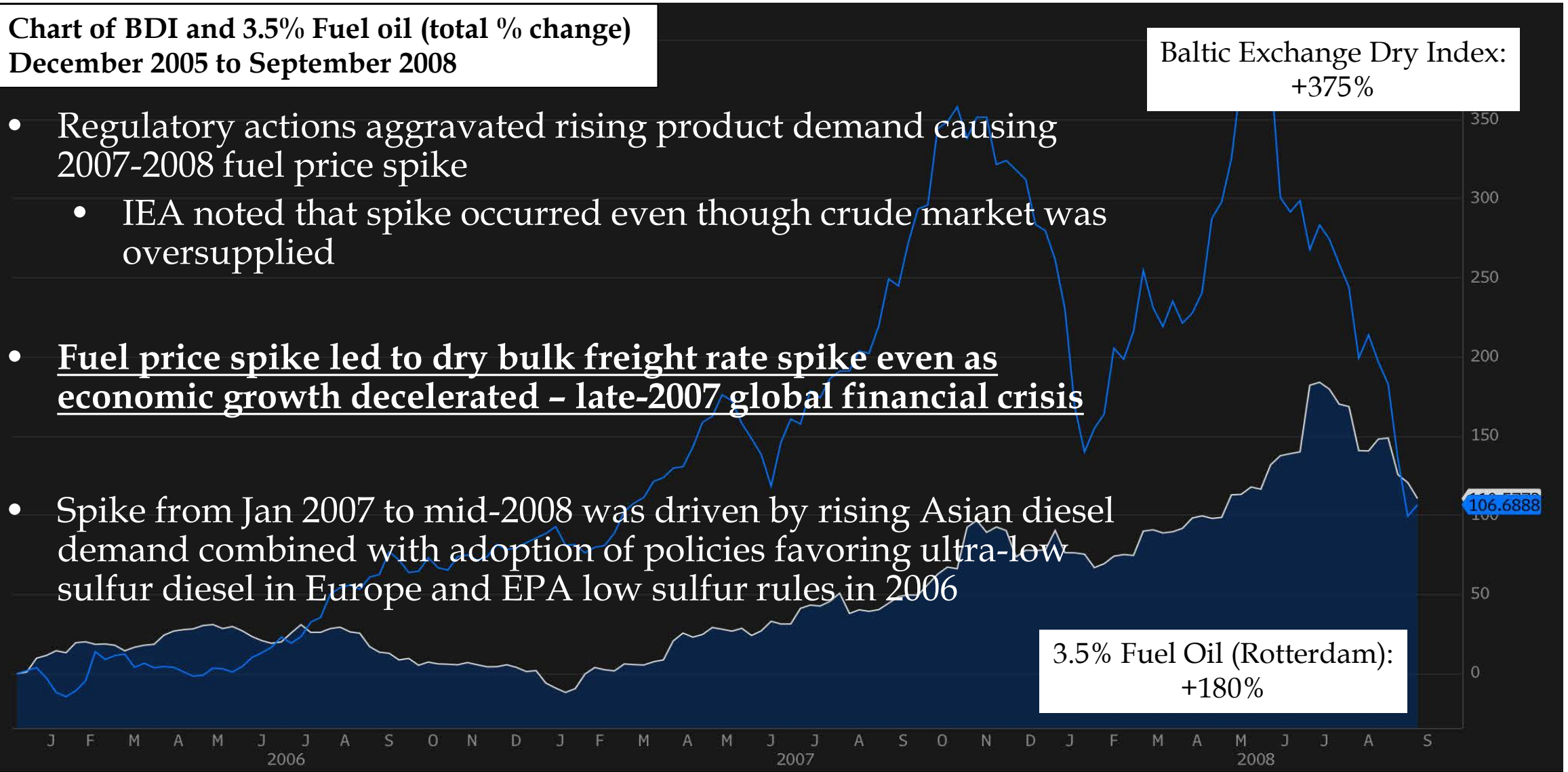
Tightening market balance meets IMO 2020 = Sustained rise in rates

- IMO 2020: permanent jump in marine fuel costs
 - Global refinery sector will take years to upgrade
 - Two-year construction time for new vessels
- Minimum two to three years of higher freight rates
 - Assumes steady global GDP growth
 - Tight supply-demand conditions in 2020
- Rates are at historical lows – substantial room for rise
 - Baltic Dry Index: -90% from 2007
 - Baltic Dirty Tanker Index: -75% from 2004
 - Baltic Clean Tanker Index: -70% from 2005

Has this happened before: 2008 spike

Chart of BDI and 3.5% Fuel oil (total % change)
December 2005 to September 2008

- Regulatory actions aggravated rising product demand causing 2007-2008 fuel price spike
 - IEA noted that spike occurred even though crude market was oversupplied
- Fuel price spike led to dry bulk freight rate spike even as economic growth decelerated – late-2007 global financial crisis
- Spike from Jan 2007 to mid-2008 was driven by rising Asian diesel demand combined with adoption of policies favoring ultra-low sulfur diesel in Europe and EPA low sulfur rules in 2006



What's the upside?

- Potential one year returns on a ten-year old Capesize – **\$25 MM current**¹:

Freight rates	TCE (\$/day)	Unlevered CF ²	One-year ROIC
Current 1yr TC	\$18,500	\$4.3 MM	17%
1990-2017 Average	\$28,000	\$7.6 MM	30%
2003-2008 Average	\$70,000	\$22.1 MM	88%

- Nominal average price of 10-year old Cape: **\$31 MM** (1993 – 2017)
 - Range: \$12 MM to \$116 MM

<u>Buy at \$25 MM and sell in 1yr</u> (\$MM)	Year ₁ cash return	Average 10-year price less \$1MM depreciation	Total Return	1y ROE with 50% leverage
Recovery	\$7.6	+ \$30	= \$38	+100%
Boom	\$22.1	+ \$30	= \$52	+220%

1. Vessel value and one year average/time charter rate estimates from Clarkson Research
 2. Unlevered returns based on \$6,000 daily all-in cash operating costs and 345-day operating year

Risks: Shipping supply-demand

- Supply risks are minimal
 - Low orderbook & two year build time
- Demand risks:
 - Sharp global slowdown in short-term
 - Global trade war leads to drop in commodity demand
 - Counter point: may lead to domestic stimulus
 - Aggressive monetary tightening
 - Collapse in oil prices

Critically, must invest in companies with the liquidity to endure unexpected short-term economic weakness

- **Implementation risks: *Kicking the can?***
 - Legally, cannot be changed now: “no possibility of delay” (IMO, 5/18/18)¹
 - IMO-commissioned study (CE Delft July 2016) confirms 2020 fuel availability
 - July 2017 MEPC 71 session reaffirmed implementation date
 - Financial: Concentrated benefits and widespread costs
 - Health & environmental: Small unit cost increase but global benefits
- **Compliance and enforcement risks**
 - Enforcement at port level – 60% of bunkering at 7 nations
 - HSFO Carriage ban; experience of ECA rule enforcement
 - Reputational risks for lobbying against or breaking environmental rules
 - 75% of fleet controlled by large international companies (Maersk)
 - Insurance declares “unseaworthy”

Historical analog: fuel price spike in 2007-2008 did not lead to rule change

Risks: Shipping stock investment

- Small public sector - most less than \$1 BN in equity value and sub-\$3 BN EV
 - Low investment bank coverage
- Complex capital structures
 - High leverage sector due to asset heavy nature
 - Bank loan dependent – covenants are key
- Concentrated ownership
 - Family-controlled or PE-controlled
 - Historic treatment of minorities
- Management and governance issues – self-dealing risks
 - Management history and reputation is critical

Random diversification not prudent – Shipping requires careful stock selection

Summary: Perfect storm is coming!

- Following an extended downturn – shipping is recovering
 - Supply and demand is tightening
 - Orderbook is low
 - Global growth is strong
- Vessels are very cheap versus history and earnings power
- IMO 2020 will lead to marine fuel price spike
 - At higher fuel prices, higher freight rates are needed to incentivize full speed to balance market



Perfect storm: Fuel price spike meets a tightening market

For further information...

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Thank you for your time and consideration.