PROGRESSIVE CAPITAL PARTNERS

SHIPPING

A NICHE ALTERNATIVE SEGMENT ABOUT TO GET BACK INTO FAVOR, BIG TIME

IN A NUTSHELL:

- From a generalist investor's perspective, shipping looks broadly un-investable. For the last 12 years, the industry has been in a downward spiral.
- When looking beyond the surface, however, one is in for a surprise. The shipping cycle might face a jump-start it has not experienced for decades.
- In this paper, we argue that the supply side is about to tighten, while demand for shipping will remain relatively stable in comparison. We examine the impact of IMO 2020, a new marine emission standard that is expected to have wide-spread ripple effects, and be a catalyst for shipping as an investment theme. Finally, we look at options to capitalize on the possibilities. In doing that, we zoom in on tankers, a sub-segment that, we believe, exhibits a particularly favorable risk-reward profile in light of the developments ahead.

"GOD MUST HAVE BEEN A SHIP-OWNER. HE PLACED THE RAW MATERIALS FAR FROM WHERE THEY WERE NEEDED AND COVERED TWO-THIRDS OF THE EARTH WITH WATER."

- ERLING NAESS, NORWEGIAN SHIP-OWNER 1901-1993

FOR THE LAST TEN YEARS, SHIPPING HAS BEEN A DISTRESSED ASSET THEME

Overcapacity in the wake of the global financial crisis led to a dramatic erosion in ship prices, charter rates, and shipping stocks. Equity valuations are among the lowest levels in ten years, and those who survived the consolidation are busily propping up their share price through share buy-backs.

SHIPPING – USEFUL FACTS

- Old and established asset class
- The market is divided in tankers, bulkers, containers, special ships
- The average ship has a 20-25-year lifespan before being scrapped
- More than 70,000 commercial vessels are in operation today
- Shipping is the most polluting industry in the world: one ship emits as much sulphur as 15,000 cars!

Specialized shipping banks have either gone belly up, were restructured, or were acquired by the big global banks. The latter, in turn, have been forced to act as sellers of distressed debt as risk capital requirements (Basel III/IV) forced them to offload the exposure to volatile shipping debt from their balance sheets.

Finally, global recession fears and long-lasting trade disputes that have recently turned hot did not precisely alleviate the concerns of generalist investors.

HOW SHIPPING GOT ONTO THE RADAR OF A NICHE ALTERNATIVES SPECIALIST

Assets that seem un-investable because they are out of favor are one of Progressive Capital's sweet spots. We look for complex investment challenges that are bottoming out of a cycle.

Around two years ago, we began to look into the segment with determination. We had observed specialist market participants acquiring ships from German banks and chartering them out for three to four years. With no leverage involved, such transactions resulted in after-fee returns of 10-12 percent annually and a 7.5% dividend payout. Naturally, this piqued our interest in times where high-yield bonds would routinely provide less performance.

SHIPPING – PERFORMANCE DRIVERS

- Shipping is capital-intensive with a long and volatile business capital cycle
- Over-supply is driving down returns while under-supply is driving returns (and asset prices) higher
- Demand factors have been of lower importance in determining long-term investment returns
- Key to returns in all segments of shipping has been the significant historic fluctuation in the supply of vessels

As of today, Progressive has executed two private transactions and seven listed equity investments in the segment.

SUPPLY TO DRY UP, TRIGGER A NEW STRONG UP-CYCLE

Let's first dive into the supply side for shipping. It is fair to say that the constellation is probably the best the market has seen for the last 15 years. We believe that this opportunity window may last for the next two to three years.

WHAT IS NEWBUILD PARITY?

A 32% DISCOUNT TO NEWBUILD PARITY MEANS THAT THE PRICE FOR A TEN-YEAR-OLD SECOND-HAND VESSEL IS 32 PERCENT BELOW THE IMPLIED VALUE OF A NEW SHIP AFTER TEN YEARS OF (LINEAR) DEPRECIATION.

First, the number of shipyards (traditionally a determinant for the potential to add capacity quickly) is down from 550 in 2007 to currently around 50 after a massive consolidation, with tonnage capacity down 40%.

Second, the discount to new-build parity forces owners away from newbuilds. Today, for example, sellers are offering 10-year old dry bulk ships at a 32% discount, and 15-year old vessels at 46%.

Third, there is little cheap money to fuel new shipbuilding, despite low interest rates globally. As outlined above, the flow of both debt and equity into shipping is currently at the lowest level in decades.

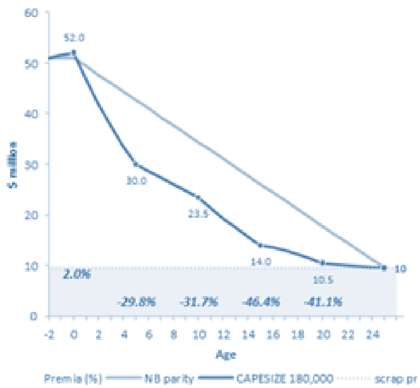


FIGURE 1 - NEWBUILD PARITY FOR CAPESIZE 180,000; SOURCE: CLARKSONS PLATOU SECURITIES AS

NOW OR NEVER – THE TIME TO CONSIDER SHIPPING AS AN INVESTMENT HAS RARELY BEEN MORE INTERESTING

THERE IS OFTEN DOUBLE UPSIDE POTENTIAL

We believe that the unique combination of the secular supply/demand cycle, fueled by impending regulation that will act as a catalyst for far-reaching changes in the shipping landscape, has resulted in a compelling investment thesis.

There is often double upside potential, for example in the case of a container company whose ships are valued at a discount (i.e., below newbuild parity), in addition to its equity trading at an additional 20-30% discount to book value.

THE OIL & SHIPPING MARKETS COULD BE MASSIVELY UNDERESTIMATING THE IMPACT IMO 2020 WILL HAVE ON THEM

Fourth, and most crucially, the imminent regulation by the International Maritime Organization (IMO), as a United Nations specialized agency, to reduce the sulfur content of marine fuel by January 1, 2020. IMO 2020, as it is called, should significantly tighten the market balance almost irrespective of what happens to the regular supply-demand changes. We expect that the fleet adjustment represented by scrubber installations should continue to support charter rates over the next 18 months.

IMO 2020 AND HOW IT IMPACTS SUPPLY

- Global cap on the emission of Sulphur in marine fuel
- Cap of 0.5% sulfur emission vs. 3.5% in the past
- Sulphur emission filter (so-called scrubber) retrofit costs USD 2-5 m per ship, and in addition to increasing the cost base, puts a ship out of service for 1-2 months
- Approx. 15% of all vessels will have scrubbers installed by the end of 2020
- The remaining approx. 85% not compliant by the end of 2020 will have to buy more expensive low-sulfur fuel, and, consequently, steam slower to compensate cost
- Owners of older, less efficient ships with higher operating costs and fuel consumption may consider scrapping their ships earlier

THE SPEED OF A VESSEL IS A FUNCTION OF FUEL COST AND THE CHARTER RATE. AS FUEL COSTS INCREASE, SHIPS SLOW DOWN TO PRESERVE THEIR OPERATING MARGIN. SLOWER SHIPS TRANSLATE INTO LESS SHIPPING CAPACITY.

There is already an acceleration of ships going out of service to be retrofitted amounting to 1-2% of the overall fleet on average for the remainder of the year.

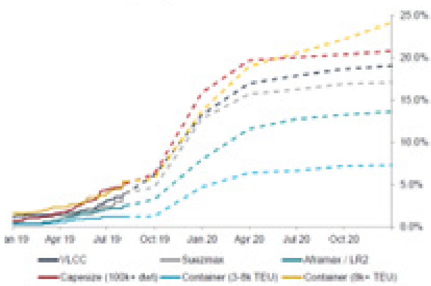
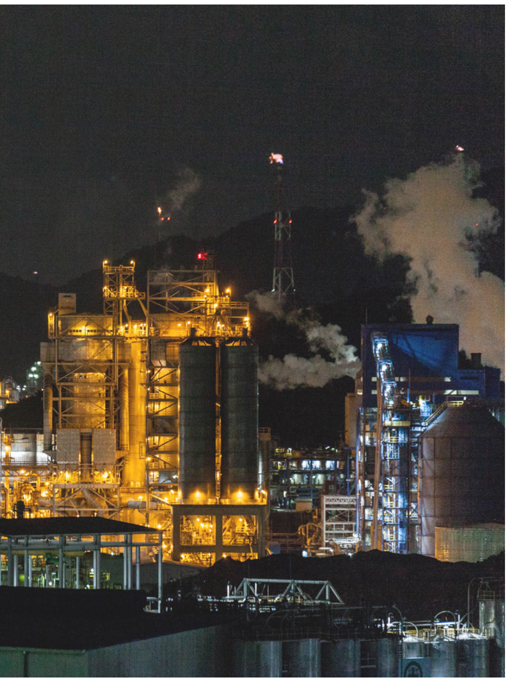


FIGURE 2 - RETROFITS AS PERCENTAGE OF CAPACITY; SOURCE: CLARKSONS RESEARCH, CLARKSONS PLATOU SECURITIES AS



IMO 2020 WILL NOT ONLY INFLUENCE THE SUPPLY SIDE OF SHIPPING BUT ALSO HAVE A FUNDAMENTAL IMPACT ON THE OIL INDUSTRY

Depending on which side of the trade you are on, this might be perceived as either a virtuous or vicious cycle.

The implementation of IMO 2020 will directly impact four million barrels of marine fuel per day. Two million barrels per day less will be required of the 3.5% Sulphur type that has been used by ships in the past.

Instead, one million barrels per day more will be in demand of the 0.5% sulfur type fuel, and an additional one million barrels per day of 0.1% sulfur, both of which will allow conforming to IMO 2020.

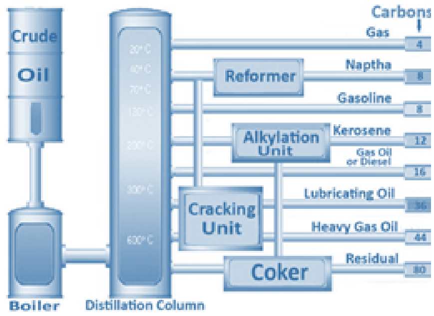


FIGURE 3 - SCHEMATIC ILLUSTRATION OF THE FUEL DISTILLATION PROCESS; SOURCE: CLARKSONS PLATOU SECURITIES AS

Unfortunately, the industry cannot merely switch from low-margin 3.5% to the higher-margin 0.5% fuel. Additional processes (employing so-called cracker and coker units) can upgrade around 700,000 barrels per day. And no matter how much effort one puts into the distillation and upgrading processes, there will always remain a residue of lower grade heavy oil or residual tar.

THERE IS NO WAY AROUND USING MORE CRUDE OIL TO OBTAIN MORE SO-CALLED MIDDLE DISTILLATE.

In short, there is no way around using more crude oil to obtain more so-called middle distillate. With the ratio being 1.8 to one barrels, we estimate there will be an additional demand of anywhere between three to five million barrels per day, which translates to 5% of global crude consumption.

AS IF THIS WERE NOT COMPLEX ENOUGH, NOT ALL CRUDE OIL IS THE SAME

80% of the new crude produced comes from west of Suez and goes to the Eastern hemisphere. 80% of new consumers live there. 75% of the distillers who are best suited to refine that supply are located in the far East / China. It is those refineries which can process US low-sulfur shale oil cost-effectively; US refineries are better calibrated to refine more sour crude oil.

Other factors playing into the situation:

1. The transport across the Suez line to the Far East takes about twice the tonnage mile compared to a destination in the Middle East
2. US oil exports are expected to add another one million barrels of transport per day

Finally, there is always the risk of a disruption in the oil supply due to political and military events, such as the tense situation in the Strait of Hormuz.

Or the recent strikes on Aramco's oil facilities which, according to CNN, happen to be the world's largest oil processing facility and crude oil stabilization plant. While incidents like these can regularly leave their mark in the short term, they don't put the overall investment thesis for shipping in question.

SOMEWHAT COUNTER-INTUITIVELY, THE DEMAND SITUATION IS INTACT

No amount of supply tightening would make for an attractive opportunity if there was no demand. Maritime transport is essential to the world's economy as over 90% of the world's trade is carried by sea, and it is by far the most cost-effective way to move en-masse goods and raw materials around the globe.

That being said, we believe that neither an escalation of the trade wars nor a cooling of the world economy would be able to cause a massive long-term effect to the demand side of shipping.

LIFT THE ANCHOR OF THE TANKER!

The same order-cycle circumstances that will be responsible for trimming the supply for the shipping industry, in general, will be effective in the tanker market as well, except that tankers have the least question-marks about demand in the whole shipping industry.

THE TANKER SUB-SEGMENTS

- Crude tankers (a.k.a. dirty tankers)
- Product tankers (a.k.a. clean tankers)
- Chemical tankers

Of all shipping sub-segments, we believe that tankers show the clearest demand picture, and therefore exhibit the most attractive risk vs. reward ratio.

PROGRESSIVE'S FOCUS IS ON CRUDE TANKERS AND PRODUCT TANKERS

Order books for new ships are at two-decade lows in general. This also applies for tankers (orders are 10% of the overall fleet, on average 4% of ships are being retired every year).

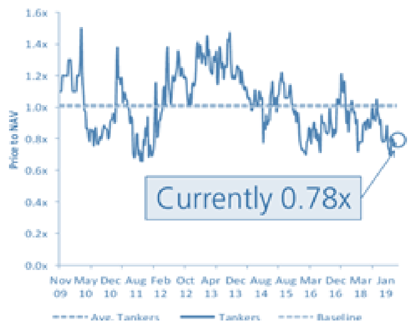


FIGURE 4 - SHIPPING STOCKS ARE TRADING AT A DISCOUNT TO NAV; SOURCE: CLARKSONS PLATOU SECURITIES AS

All the other factors affect tankers as well, i.e., few active shipyards, vessels trading at a discount of newbuild parity, and shipping stocks trading at 0.7 – 0.8x below NAV or book price.

What makes the proposition even more attractive for tankers is that capacity utilization is already tighter than in other shipping segments (for VLCCs, the largest crude tanker category, the utilization rate has increased from 85% in 2018 to 87% in 2019 and is projected to rise to 89% in 2020).

At around 90% utilization, charter day rates start to spike. An example of this was the highest ever registered capacity utilization of 91% in 2008. At the time VLCC charter day-rates spiked above USD 200,000!

The tanker companies we look at are valued around 50% debt to assets and trade at break-even or slightly cash flow positive at the current rates. At the projected charter day-rates we expect them to trade anywhere between three and six times earnings in 2020.

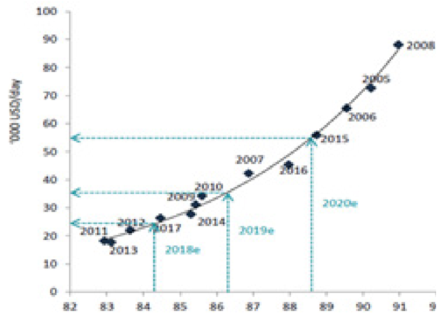


FIGURE 5 – UTILIZATION VS. VLCC CHARTER RATES; SOURCE: CLARKSONS PLATOU SECURITIES AS

As outlined in the section on the oil industry spill-over effects, the IMO 2020 specific impact for tankers translates into additional tanker demand. This is needed to satisfy the increased transport requirements of crude and products to and from refineries due to increased demand in crude oil, and the fact that the United States is becoming a net exporter to crude oil, mostly to Asia.

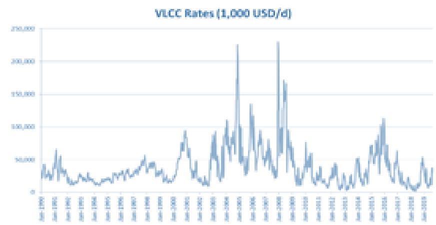


FIGURE 6 – VLCC DAILY CHARTER RATES; SOURCE: CLARKSONS PLATOU SECURITIES AS

Additional tailwind for tanker demand will be the slow steaming and off-hire for scrubber installation, and the increased floating storage demand for out-of-favor high sulfur marine fuel until further usage.

> SLOW STEAMING – REASONS AND IMPACT
>
> The speed of a vessel is a function of fuel cost and the charter rate. As fuel costs increase, ships slow down to preserve their operating margin. Slower ships translate into less shipping capacity.

CONCLUSION

Shipping is by far the most cost-effective and efficient way to move goods and raw materials across the globe. It should be no surprise that over 90% of the world's trade is carried by sea.

After a decade of bloodshed in the industry that decimated shipyards and specialist lenders, and left equity valuations, ship prices, and charter rates at rock-bottom, we believe shipping is well-positioned for a recovery.

By further tightening supply while demand will remain stable, the imminent IMO 2020 regulation has the potential to kick-start the shipping cycle and thus provide various opportunities for investors to add a performance boost to their portfolios.

THE AUTHORS

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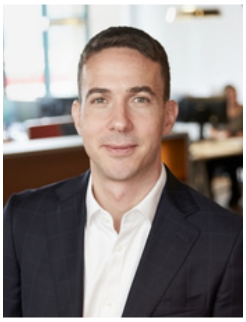

Werner Brönnimann is an Investment Analyst at Progressive Capital Partners. Before joining Progressive, Werner worked four years at PWC Switzerland as the Head of banking, trading and finance in the Data Analytics and Modelling team. He was responsible for a number of forensic investigations where he led teams of data scientists. Prior to that, he worked for eight years at JPMorgan in London and Singapore. Werner has in-depth experience across all asset classes. He is experienced with different accounting standards and their respective strengths and weaknesses. Werner holds an MA in financial economics from the University of Zurich, and the Certificate in Quantitative Finance (CQF) from Fitch Learning.

We at Progressive Capital Partners would be delighted to be your partner on your journey into the Niche Alternative world. We would be honoured to be able to contribute to the quality of your overall asset allocation.

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