"Kool-Aid and Golden Eggs"

Contributed by
Barry Parker

Barry Parker is a financial writer and analyst. His articles appear in a number of prominent maritime periodicals including Lloyds List, Fairplay, Seatrade, and Maritime Executive and Capital Link Shipping.

With another equity market swoon- this time coinciding with the earnings season that's now upon us, the shipping stocks have moved into an uncertain phase and, dare I say it- driven by emotions. For active traders- who operate by sensing the collective psyche of the other guys in the room (which might be a virtual room, but never mind that), these are exhilarating times. For economists and analysts, including the tanker nerds described last week, who crave certainty, these can be maddening times.

In these columns (which are sometimes at odds the work of more credentialed analysts at name brand shipbroker and securities firms), I've made the case that the tanker market basically remains oversupplied. Yes, fleet supply growth, based on deadweight, has slowed, but second derivatives matter less than absolute tonnages- in calm economic waters, there are still too many ships. One great troika of tanker stocks, TNK, FRO and DHT, was clearly on a roll earlier this month, and TNP- which I watch closely, and NAT- which I watch a little bit, were also in the midst of upward turns. However, to the dismay of a number of investors looking to ride that tanker speedboat towards a sunny shore, the trajectory turned downward last week.

The overall market's worries, tied to the changing politics in Greece, slowing world growth, and energy company earnings that have disappointed, swamped gains of previous months, play a role While lower energy prices free up income for consumers (with consumer staples now actually a better performing sector of the markets), they also lead to announcements like those of oil major Shell- which, for example, cancelled a $6 billion petrochemical plant to have been built at Ras Laffan, in mid January. Powering against the current is hard work, even for tanker stocks- which have now come off more sharply than the broader equity indices.

Investors are very savvy about oil storage economics, and, quite simply, they are asking tough questions about how much freight market enthusiasm is justified by oil market developments. Such things, admittedly the province of tanker nerds, have direct impact on hires earned (a direct input into the denominator of that all important EV/EBITDA). Expected earnings then percolate, over a multi-month timeframe, into ship prices- the main ingredient of NAV calculations; for many investors, especially in companies prone towards active sale and purchase activities, decisions are driven by metrics of asset values.

As I look around at the markets, I am increasingly inclined to drink the oil storage Kool-Aid, taking the bet that prices will linger at the trough for a while. One prominent tanker broker- in its latest market report, hinted that as many as 80 to 100 VLCCs could be tied up in floating storage trades by June, 2015. Though, in full disclosure- and putting salt in my Kool-Aid, the same analysts (among the best in the business, in my opinion- they've been watching and opining on the forward curve since Q2 of last year!) said "We think it is unlikely that this stock building scenario will play out through the end of the year. At some point somebody will blink," alluding to the likelihood that a producer would pull back production, forcing a kick upward in the nearby end of the oil pricing forward curve. This is consistent, anecdotally, with shipping market participants (not nerds, but real on the market folks) who are looking for 6 – 9 months of sunshine. Is this enough time for NAVs to creep up and stay up? Maybe yes, maybe no.

One analyst who specializes in the interaction of ocean freight with commodity price arbitrages and spreads, Simon Jacques, author of the blog "The Trade, Shipping and Finance Wizard", views the question differently. Mr. Jacques, based in New Brunswick, Canada, cajoles readers with the observation that "…The Freight Market is fully pricing the storage optionality." In other words, and I am over-simplifying some very complicated risk/ reward concepts contained in his latest posting, the shipowners, who've done very well lately, are at the point of pricing charters right up to the edge of margins that make sense for oil traders. But shipowners are smart- they can do the same calculations as the traders, and, presumably, they will not want to kill the goose that delivered that golden egg called "contango".

How does this factor into forward earnings forecasts? It's something I will be spending more time on, as clients request viewpoints. We did one back of the envelope calculation, using a not so sharp pencil, for the wildly successful tanker IPO that was recently completed. Based on market appropriate metrics of EV/EBITDA for 2015, and the assumption of time charter equivalents (TCEs) averaging $60,000 during the year, you could have a stock worth nearly $20 /share. Yes, $60,000/day over a year is extremely aggressive, and beyond Simon Jacques egg-crushing contango kill-zone, but shipowners- through pools, have been able to optimize in the spot markets and earn upwards of $80,000/day. However, back to the Kool-Aid- if oil supplies don't dry up so quickly (maybe because they want to enjoy the fruits of a nearby rebound and therefore they keep pumping), then high TCE's may be supported. By the way the analyst mentioned earlier cited one set of forecasts, albeit unlikely, that 200+ VLCCs could be pulled into storage.

Readers have complained that I seem to have lost interest in the drybulk world- some even reminding me of my humble roots chartering and operating vessels hauling steel coils and scrap metal. But, not wanting to be Barry Bummer (the boyfriend of Debbie Downer), it's been tough to muster much enthusiasm for a group of trades where oversupply still dominates. Arguably, the excitement in the tankers- sparked by the falling oil prices (itself driven by commodity supply and demand) is possible because of the ability of underlying barrel flows to shift dramatically and quickly. While iron ore pricing has shifted in recent years from year-long contracts to spot pricing- which can float (mainly downward, lately) according to several established indices, land-side storage ore is not a constraint- as it may be on the tankers. Investors who are clued in to the shipping markets (just like the savvy owners- who do indeed create value by fixing vessels out on each peak) can make money in the drybulk shares with strategies of actively trading the stocks, literally buying on the whiff of upticks, and selling when non-shipping folks, upstairs in fancier offices, discover what's happening and bid up the share prices.

As I sip my tanker Kool-Aid, waiting for the next blizzard, I will keep a weather eye on those tanker fixtures and closely watch those oil price spreads on the screen.