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Why Wall Street overvalues shipping

Volatile nature of industry means long-term investors have mostly left, to be replaced by hedge funds and traders who distort valuations — so values of most public shipping companies bear little relation to their true value

INVESTORS have struggled to understand shipping's business models since the 1980s when privately owned companies came to Wall Street in search of 'other people's money' to expand their businesses.

The original institutional investors with a long-term view have mostly left and been replaced by hedge funds, wealth funds and stock traders who like what they see as volatility in shipping, underlining the view that it is a cyclical business.

This view of the world means analysts pore over freight reports and indexes to establish where a company is in the cycle. Such efforts result in false expectations and distorted valuations.

Shipping markets are directly affected by the fluctuating demand for shipping services. The bigger factor, however, is that they are dominated by the supply of the vessels, both those in the water and the enormous willingness of Asian shipbuilders to supply new ships quickly and in large quantities.

This is dramatically evidenced by the huge expansion of the South Korean and Chinese shipyards, which could, statistically, replace the existing world fleet every seven years. Looked at another way, shipping capacity could rise by more than a sixth annually assuming that the average operating life of a ship is 25 years.

Shipping is also fungible, a global industry with few localised restrictions and where ownership, place of registration or nationality of crews rarely impede potential for business.

There are no real barriers to entry, apart from money, as all the operations can be sub-contracted out to third parties.

The trading is enabled by highly efficient chartering markets run by shipbrokers around the world and documented by well-tested standard forms of charter parties that enable the trading. This means new business can be executed quickly whether it's for period time charters or spot fixtures.

Accounting for the business

Ship operating expenses, including insurance, occur continuously whether the ship is chartered or not, as do general and administrative costs. These, together with interest and principal payments on debt, are pre-determined and combine to form the cash expenses of the business, with the variables of repairs and drydocking costs added in periodically.

On the other side of the ledger, however, income is only derived from operating the ships under the terms of their various charters and even with time charters this income is rarely received for the full year, as off-hire days need to be taken into account.

The spot markets hold higher risk because vessels here are exposed to much longer periods of off-hire, sometimes as much as 100 days a year. This is relevant in weak markets with ships competing for fewer cargoes or, as we currently see, too many newly delivered ships entering markets already reeling from a surfeit of vessels.

Thus in valuing a shipping company its revenues and expenses must be projected forward. A lot of attention is lavished on the outright cost of a ship, mainly in relation to its owner's debt level, but it really only matters twice: the day it is purchased and the day it is sold. Charterers broadly don't care about ship values as they are only renting them.

Bow of a newbuilding: ship supply is a big factor in the ups and downs of the shipping industry. *Bloomberg*

Unlike some industries, shipping has a highly liquid sale and purchase market for its fixed assets, the ships, that fluctuates constantly on pure supply and demand factors, again facilitated by a highly efficient shipbroking industry. This can include everything from buying and selling newbuilding contracts to selling the ships for scrap.

Valuation

Most private shipowners are primarily interested in cash flow, which can include the proceeds of selling a ship. Their balance sheets are only relevant when dealing with their bankers.

It is different for public companies. The investment banks and the investors they sell shares or bonds to are focused on balance sheets, net asset values and earnings before interest, taxes, depreciation and amortisation and pay little attention to the revenue statements. They do not have any forward projections to assist them, a bizarre situation given that the entire financial industry is built on forward risk.

Many analysts, who mostly work for banks with a vested interest in the companies they cover, deploy metrics that are based on general and not specific information and invariably compare the subject company with another composed of an entirely different fleet.

In shipping, one size will not fit all.

This 'intelligence', such as it is, is conflated with the unknowable — weather events, strikes and revolutions — and fed to investors or sewn into the strategies of the short-term traders that dominate the shareholder mix today.

The first consequence: shipping share prices constantly move, a dynamic loved by the short-termists and detested by those with long-term investment strategies.

The second consequence: the market values of most public shipping companies bear little relation to their true value.

It becomes almost impossible to differentiate between a good and a bad company or to look at potential values longer term. The balance sheets are no help, as net asset value bears no relation to the true value of the assets.

Answers

There are solutions. Auditors need to insist on marking the ships to market as they are so easily traded and their depreciated book values have no bearing on their market values. An additional note to the accounts should reflect the charters of the ships and where relevant highlight large exposures to named charterers.

If this were done today then most public shipping companies would show a negative net asset value because their debts would exceed the asset values, making the equity worthless.

The Hamburg attempt to create a new method of valuing ships is simply about creating the pretence that the equity in the KG companies has some value. The reality is it has none.

Most experienced shipping bankers follow ship market values closely and also analyse the revenue streams and operating expenses with the benefit of seeing the pertinent chartering information.

Investors have no such access but should push companies to follow Genco Shipping & Trading's example and file all their charter details, rates, periods and charterers' identities quarterly.

Shipping is not a cyclical business. Its ups and downs are more driven by the activities of owners and not charterers and it is the supply of ships that causes the swings, not the demand for their services. ■

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