They Paved the Port and Put up a Parking Lot

Quote
"I think that shortages are now the biggest theme out there." – Louis-Vincent Gave

Introduction
Back in June, this newsletter touched on one of the unexpected, world-defining events of the past year: the global shortage of semiconductor chips. The Covid-19 pandemic, trade sanctions, poor supply chain planning, and natural disasters have created strains on the production of these all-important chips. Additionally, skyrocketing demand for electronics and connected devices has continued to rise, pushing up prices in the process.

This week, we are presenting an expanded viewpoint on the global supply chain from someone who intensively studies supply-chain dynamics, Charles de Trenck. Charles is a long-time maritime industry expert and is part of Evergreen's unofficial research network. He and the other members of this group helped alert us early in 2020 about Covid-19 and their input is a key reason we took protective measures for our clients before the pandemic rocked markets.

As you will read, one of the key themes he highlights is the long-lasting nature of shipping bottlenecks. Supporting his view, this week, UPS announced that the logistics industry does not see 2022 as having any less disruption in supply chains than 2021. This could cause inflation to be less transitory than the Fed hopes. Please enjoy this thoughtful and enlightening article on the global supply chain and potential long-term market implications.

They Paved the Port and Put up a Parking Lot (and Turned Ships into Warehouses) by Charles de Trenck
We've all noticed the broken refrigeration units in supermarkets waiting to be replaced, roofers who reschedule work for a month out due to a lack of workers or tiles, and the shortage of air conditioning units. This is not to mention low new car inventories and crazy used car prices due to semiconductor shortages.

Shipping and supply chain industry professionals saw these challenges coming months before consumers did when the Covid craziness first saw its green shoots* in mid-2020. This was when consumer demand first began its rebound.

The importance of container vessels and the global supply chain popped up on people's radar – out of the blue for many – after the Suez Canal grounding of a 20,000TEU Evergreen vessel, the Ever Given, in March 2021. Fast-forwarding to the summer of 2021, the industry shifted into full crisis mode as ports became congested due to Covid-19 cases from seamen onboard vessels in China, while ports along the West Coast of the United States became overcrowded.

*Green shoots is a term used colloquially to indicate signs of economic recovery during an economic downturn.

A Long-Term Problem
The break in steady flow of goods on container ships, and to a certain extent bulk ships, is a deeper problem which will likely go on for years. The supply chain will be broken through 2023 and perhaps beyond. One of the main problems is that as long as China and Asia maintain strict protocols on vessels entering ports, and as long as concerns about under-vaccinated seamen remain, vessel asset turnover will be slower than usual. This will effectively reduce vessel

capacity while global demand remains firm.

Covid protocols have clobbered sailing schedules and turned ports into parking lots and vessels into warehouses. More ships are needed. But they are not coming in any significant quantities until 2023.

This implies that vessel asset values, especially container ships, will see multi-decade highs due to multiple chokepoint issues:

1. **Shipyard construction ramp up/vessel capacity** is coming off of a multi-year consolidation base, so vessel deliveries may be bunched a bit more at the back end (in addition to initial reticence by bombed out shipowners and banks to build up fleets, especially bulk ships). Decarbonization and vessel efficiency issues will also rear their heads as soon as capacity and supply find an equilibrium – which could occur around 2023.
2. **Higher charter rates (and higher input costs) will imply firmer Discounted Cash Flow (DCF)/Net Present Value (NPV) and higher price levels for ships**. For instance, a mid-size container ship that used to renew at $25,000 per day or less, may get a long-term charter for $50,000 per day or higher in 2022 and moving into 2023 (spot rates are currently over $100,000 per day and even as high as an unheard of $200,000 per day). Keeping charters firmer for longer will be a once-in-a-fifty-year industry event, creating a mega-cycle. Additionally, vessel and financing pipelines were still being muted in the first year of this mad ramp- up. After multi-year crackdowns on vessel owners with small down payments, there has been a greater focus on balance sheet control for large shipowners. Also, while the supply of vessels will take time to come back online, asset turnover will remain slow and volume demand firm. Therefore, ship operators will need to secure long-term tonnage, either by making sure to retain good long-term charters or diving into the second-hand market (and driving up prices for older, used tonnage).
3. **The supply chain itself (the catalyst) will remain fractured for longer**. Eventually a rise in reshoring of some industrial production will have an impact in certain markets. But reshoring textiles and furniture may prove a gargantuan feat, even without considering labor issues and high costs in North America or Europe. A complete reworking of the "Global Village" will be needed. Of course, anti-China rhetoric will continue to play in the background, and efforts will be made to continue to relocate factories outside of China. But lessons from Vietnam's Covid-19 port crisis, and the experience of high Covid-19 rates in many Southeast Asia countries, will benefit nations like Mexico (as well as enhance the role of the North-South rail in North America).

Market Implications
Implications for stocks within the supply chain are far reaching, and find themselves running parallel to the "Inflation Trade":

1. **Transport assets and transport infrastructure are being upwardly revalued in a way not seen in 50+ years.** This favors asset-heavy players over asset-light supply-chain specialists. It is hard to imagine asset-heavy players facing a 50-year run such as we saw with asset-light companies, but I believe the trend will last longer than most thought in mid-2021. In other words, this short-term trade may become a longer-term investment opportunity – with certain conditions attached.
2. **The inflation trade has its own modalities within transport infrastructure**. The core of the inflation trade is that low interest rates encourage wasteful overproduction and

consumption. However, currently, blockages at every level of transport requires us to pay attention to players that have been forgotten since the early 2000s China commodity boom ran out of steam: shipbuilders, port operators, stevedores, seafarers, ship managers, shipowners, truckers, rail operators, and warehouses. On the other side of the trade, supply-chain middlemen have had their world upended.

3. **Asset-light operators have not seen business run this way since forever**. Taking a look back in time, the 1920 Jones Act encouraged shipowners to leave the US over several decades. As decades went by, operators entered into a series of shorter-term access rights to keep cumbersome assets off of their balance sheets. However, with a revaluing of assets upwards, the implication is that asset-light players will have to renegotiate access to longer-term assets!
4. **As a result of the above trends, we have seen successive buying waves of the shares of container ship owners, dry bulk vessel owners, LNG transport operators, and most owners of transport networks**. Air cargo rallies during the beginning of the Covid-19 pandemic was merely the first wave of easy-pickings. Oil tankers are the only ones that have not benefitted directly due to lower shipped oil volumes (although I believe they will benefit indirectly eventually).

A Conclusion of Sorts

In some cases, we have seen shipping shares – which previously were valued close to bankruptcy – rise nearly 1,000% over the course of one year. More often, we have seen 300-500% rises. It's important to keep in mind that these shares were trading at deep discounts to book value following a decade of death by a thousand cuts. Currently many shares are trading at discounts to forward net asset value (NAV). But the challenge for long-term investors is to determine how much higher forward NAVs can be revalued.

Detective work will be required, but, as a sector, market pullbacks may provide opportunities for investors. A decisive negative catalyst would be if the COVID-19 crisis magically disappears. However, more than likely, we should be on the lookout for partial solutions to the ongoing Covid nightmare (such as forced vaccination for harbor operators and seamen and how quickly productivity is improved as a result).

Longer term, the key problem for the global supply chain may be a dearth of workers and production challenges in Asia, while productivity at US ports remains sub-par. In the scenario where grey area solutions are applied, investors will need to assess at what level long-term shipping rates might stabilize after initial corrections. We may see the apex of shipping rates in the fourth quarter of 2021. However, if rates remain high into 2022-2024, longer term investors may experience payouts in the form of special dividends, share buybacks and takovers if they are able to acquire shares at reasonable (not overbought) levels.

Investors should also bear in mind that oil tankers are the single core sector in shipping that remains in the penalty box. A pickup in oil shipments and refined products volume could prove counter-cyclical to other shipping shares.

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QUICK CHEATSHEET: **Container ships** rely on high optimization levels of ship, port, truck and rail networks. Larger 15,000+ twenty-foot equivalent units (TEUs) vessels trade mainly East – West and rely on larger container vessel berths at key global ports. Volumes are driven by consumer demand**. Bulk ships** are for more diverse cargo and are driven by developing economy cargoes such as iron ore, coal, as well as bauxite, grain. At the margin, some bulk ships can carry containers, and this helps to influence dry bulk ship rates in some instances. However, the main driver for rallies in bulk recently has been congestion at bulk ports as well as strong demand for some cargoes. Some of this demand has also been expressed in terms of longer ton-miles due to China import restrictions and shifting global production patterns. **Tankers** are not so much a sector in shipping but a separate industry altogether. Demand for gas tankers has been firm while demand for oil and refined products has been weak. Bear in mind, there are also some elements of the offshore drilling sector that are closely related to tankers and shipping.