MACRO OPS
TRADE - LEARN - EVOLVE

August 30, 2023

# Equity Note: Product Tankers (HAFNIA.OSL)

*A write-up on an exciting/actionable company or investment situation …*

Shipping and tanker stocks are a meme in the MO community. Mention a shipping stock in Slack, and you'll see what I mean.

This is for good reason. Shipping and tanker stocks have destroyed shareholder capital over, well, forever… In fact, shipping is the lowest value-creating industry in history… I remember seeing a study a few years ago that showed shipping has returned net $0 real dollars over the last 100 years… So it's a date 'em and not marry 'em kind of market.

HAFNIA, a stock we're pitching today, is a bit different. The company is a product and crude tanker operator that globally delivers things like wheat, corn, soybeans, and energy products like oil, gasoline, and diesel fuel. HAFNIA makes money by the spread between its "day rate" to deliver goods and its daily operating costs to run the ship.

HAFNIA is a Trifecta Setup:

- ➢ **Fundamentals:** HAFNIA trades at <3x earnings, 30% of NAV, and returns 60% of its cash flow to shareholders via dividends
- ➢ **Technicals:** The stock is within 6% of all-time highs and boasts the highest relative strength in its industry
- ➢ **Sentiment:** HAFNIA gets lumped into the hated shipping/tanker industry, and everyone's worried about China/European/US recessions.

That said, the stock doesn't offer the return profiles we demand in our portfolio (a minimum of a double over a 24-month period).

However, the industry has a ton of medium-term tailwinds that could vault a name like HAFNIA into our return hurdle, and it never hurts to expand our circle of competence.

## Why The Opportunity Exists

There are three main reasons this opportunity exists:

1. Product/Crude tankers ship OPEX, not CAPEX goods
2. Day rates are strong and will continue to surprise to the upside
3. The supply/demand environment provides a 2-3 year window of excess profits

Let's start with the first reason, which we can consider through a family budget.

Families generate a certain amount of income per month. They use this income to buy necessities and/or luxuries. Necessities are things like gasoline, the monthly mortgage payment, and groceries. Luxuries include spa treatments, Netflix subscriptions (although my wife would argue this is necessary), and the Peloton membership.

HAFNIA delivers NECESSITIES to countries. This is different from other shipping-related companies that transport LUXURIES, which is what most investors think when they hear the words "shipping stock." Another way to think about it is via OPEX versus CAPEX.

The distinction between OPEX and CAPEX-driven demand creates a mispricing opportunity, and here's why.

Everyone is focused on China's recession, Europe's pending recession, and the US's Q1 2024 slowdown. And when countries contract, they drastically reduce spending on luxury (i.e., CAPEX) items like new cars, purses, and other widgets.

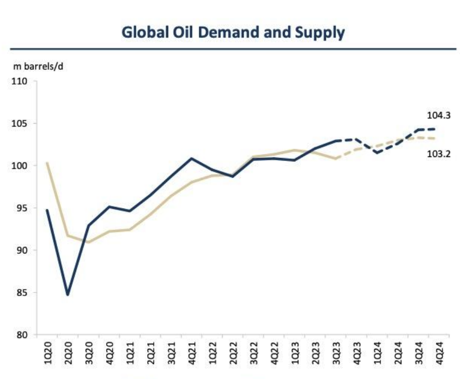
But they don't massively reduce their spending on OPEX items like gasoline, agriculture products, and cooking oils. These countries still need these things to survive despite a recession. It's like how parents keep buying food for their kids even if they lose their jobs.

OPEX-driven demand leads to higher sustaining day rates, around $27K/day as of writing. The most important question is how sustainable the current rates are and where they'll be in the next 12-18 months.

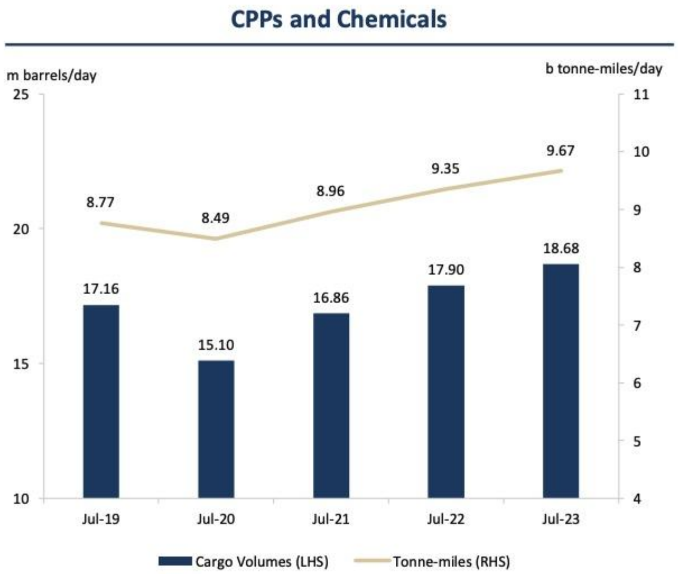
## Why Day Rates Will Remain “Higher For Longer”

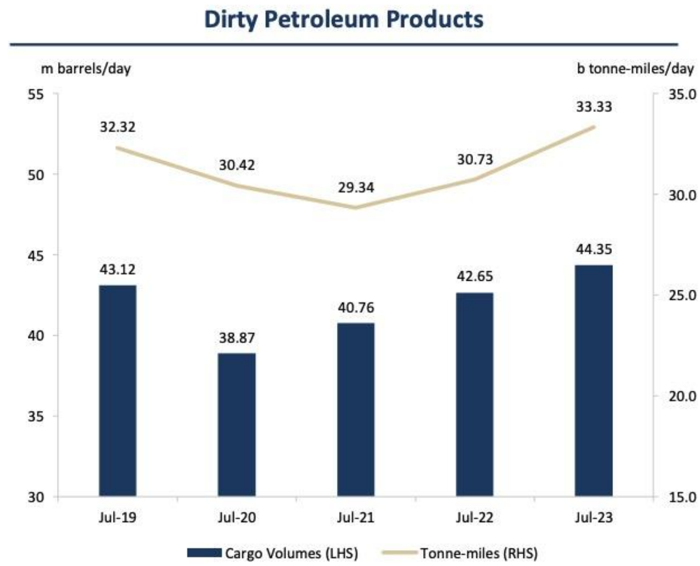
Summer is usually the slowest/weakest season for product tankers. Yet they're still generating above-average day rates. There are a few reasons to explain the seasonally high prices.

1) **Global energy demand is at an all-time high. Countries still need their OPEX goods despite recessionary fears.**



2) **The Russia-Ukraine war mangled old trade routes and forced tankers to take longer, alternative paths to deliver high-demand OPEX goods** (note the increase in tonne-miles below).



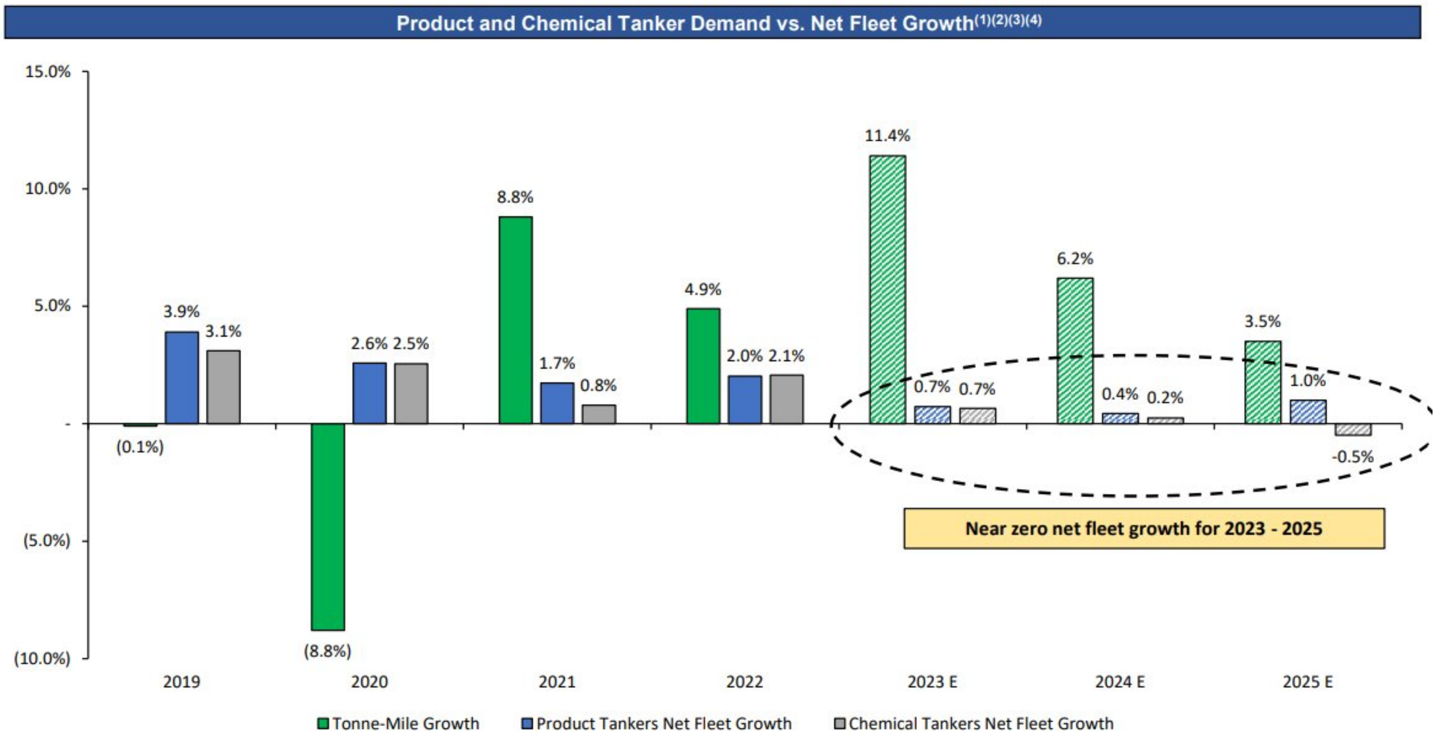




Longer trade routes mean higher prices, longer wait times and more complex logistics schedules. All these things make it more expensive (and challenging) for tankers to deliver products. Which leads to increased prices.

Moreover, when you account for the added tonne-mileage growth from trade disruptions, the supply-side response looks even more muted (see below).

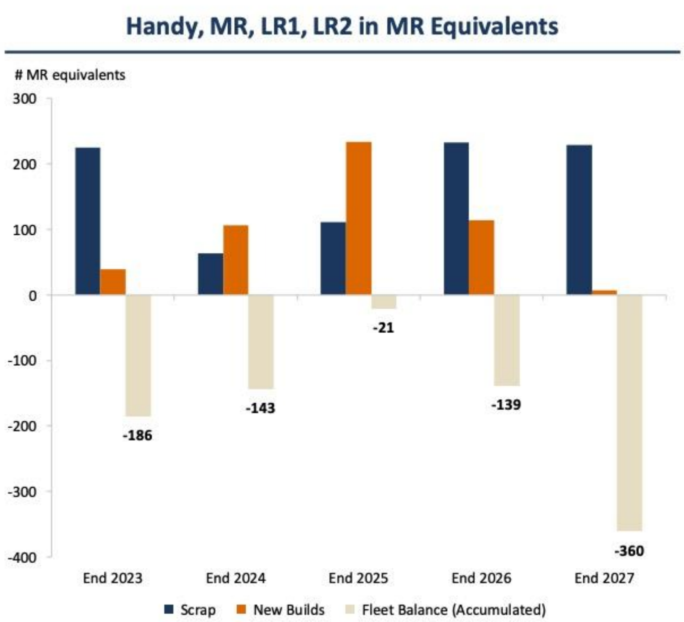
 

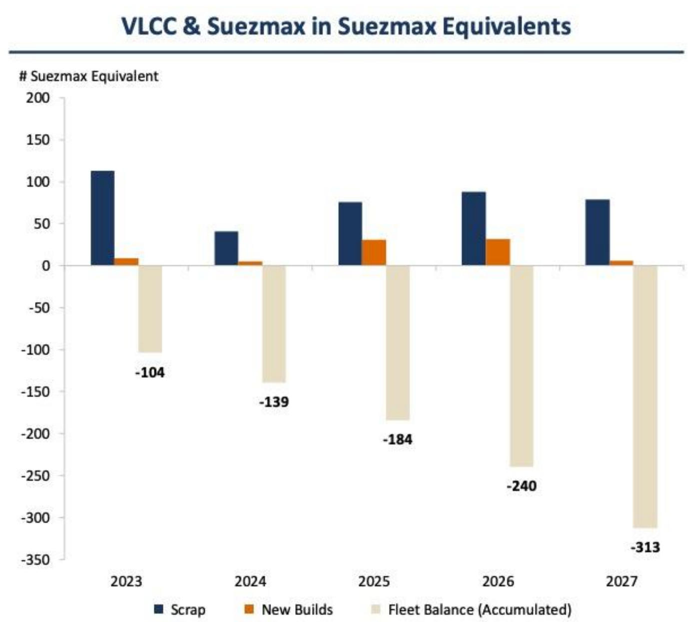
**Negligible net fleet growth combined with increasing tonne-miles supports market fundamentals**




This brings us to the third and most important factor for higher day rates going forward.v

3) **There are only a few product/crude tankers on the water, and future supply (i.e., order book) remains constrained until 2026+.**




Like our OSV thesis with Tidewater (TDW), shipyards are still recovering from the previous tanker boom-bust supply cycle. But even if they wanted to build new ships, cost curves have inflected so high that it's not economical at current rates.

Then there's the ESG regulations which reduce vessel speeds, making trips longer and more expensive. ESG even impacts financing. No European bank wants a product tanker loan on their books because it would damage their ESG score.

So you've got increasing demand, stunted supply, and jumbled trading routes that increase daily costs for the entire industry. That's a cocktail for higher day rates over the next 18-24 months.

There are four reasons why we chose HAFNIA out of all the available product/crude tanker stocks:

- **Youngest fleet in the industry at 7.9 years**
- **Strongest balance sheet in the industry (30% LTV)**
- **Highest capital return policy (60% of cash flow historically that moves to 70% in 2024)**
- **One of the cheapest names on cash flow and NAV basis**

Let's discuss valuation and downside protection.

## Thinking About Valuation

HAFNIA trades at a $2.9B market cap and a $4.3B EV. As of last quarter, the company's NAV stood at $3.5B.

NAV should grow over the next two years as limited supply increases the value of existing fleets, especially younger fleets like HAFNIA.

In a bull market, product/crude tankers usually trade around 1.25-1.5x NAV, giving us **~$4.5B in potential NAV.**

The company should generate nearly $900M+ in annual profits on elevated day rates and industry-low operating costs. Shipping research firm Clarkson's recently put out a bullish update on Dry BUlk & Product Tankers, which highlighted:

- **Slim European diesel supply cushion coupled with rising diesel prices**
- **Low fleet growth**
- **An average of $35,000/day rates over the next 12 months**

HAFNIA will eventually share 70% of those profits with shareholders via dividends (I think we see 70% in Q4 or Q1 2024).

There's also a chance we see $1B in profits should the supply/demand imbalance decline further and day rates reaccelerate beyond $30K.

## Wrapping Up: Heads I Win, Tails I Don't Lose

HAFNIA is a "Heads I win, tails I don't lose" bet.

Our downside is capped at NAV, which will grow over the next few years, given the supportive supply/demand imbalance and high day rates.

Our upside is a bull market NAV valuation of $4.5B and substantial shareholder returns of 20%+ over the next 2-3 years with a call option on $35K+ day rates.

Product Tankers are in the early innings of a strong bull market. One that will last longer than people think. While everyone's concerned about a global recession, product tankers like HAFNIA will generate outsized profits and return 70%+ to shareholders.

The industry (and HAFNIA specifically) trades like demand will fall off a cliff or that supply will magically come to the rescue. But as of now, none of those things seem likely.

To summarize, the opportunity exists because:

- **Everyone hates shipping/tanker stocks**
- **Recession fears are clouding investors' understanding of where product tankers are in their business cycle**
- **Supply/demand imbalance + global energy demand will remain elevated longer than people think**