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Chowgule Steamships Ltd

A no brainer at 80% discount to NAV!

On the back of unprecedented boom in dry bulk shipping, Chowgule Steamships Ltd (CSL), a ship owning company, performed spectacularly well in FY08 and will repeat the feat in FY09 based on already entered into charter agreements. The cash-rich company is in a position to capitalize on available & emerging opportunities with seeds of long term growth already planted.

NAV Rs.248-269 | Current Price Rs.49 | FY08 P/E 2.2x | FY09E P/E 1.3x

Despite an almost assured spectacular 66% PAT growth in FY09E, the company is currently available at mere 1.3x FY09E EPS and an unbelievable 80% discount to NAV. As ships are highly liquid and have a ready market, NAV is the most appropriate valuation method.

Key Data	
Market Cap	Rs.1.77bn US$41.3mn
Shares Outstanding	36.3mn
Yearly High-Low	Rs.105 - 25
Average Trading Volume 30 Days 365 Days	No. of shares 57,600 153,600
BSE Scrip Code	501833
BSE Group	B
Reuters code	CHWG.BO
Bloomberg code	CHOW IN
Shareholding %	**31 Mar 08**
Promoters	66.91
Institutions	0.29
Others	32.79
Multiple Valuation	**FY09E**
EV/ EBIT	1.4x
Market Cap/Rev	0.7x
P/E	1.3x
P/BV	0.4x
P/NAV	0.2x
Key Ratios	**FY09E**
RoE	36.5%
D/E	Nil

Key Investment Points

- Record high dry bulk shipping market and timely addition of a panamax enabled CSL to perform spectacularly in FY08.
- Renewal of charters at improved rates will enable another spectacular growth in FY09 despite reduction in tonnage. CSL currently has two panamax, one handymax and three coastal dry bulk vessels.
- One panamax is due for renewal in Jul/Aug-08 and we estimate 50% plus rise in day rates.
- Judicious utilization of significant surplus cash can be catalyst for growth beyond FY09.
- For long term growth, CSL has already placed orders for seven new-built handysize vessels and is investing in a port-cum-ship repair project.

Value Kickers

- Delays in new-building delivery schedules, as a quarter of these vessels are being built by new inexperienced shipyards.
- Less than contracted conversion from VLCC to VLOC can significantly take pressure off capesize market. Given the strong undercurrent in VLCC market, this cannot be ruled out.
- If reduction in ship cruising speed to save on bunker cost takes place, this can significantly absorb rising vessel deliveries in later years.

Points of Concern

- Forex risk on forex debt. At present, naturally hedged.
- Volatility in shipping earnings (freight rate / charter rate) and ship values. Investors need to closely monitor and distinguish between noise factors and cyclical factors.

Introduction

Chowgule Steamships Ltd (CSL) is part of 92-year old Goa-based Chowgule group with interest in a range of industries including iron ore mining & pelletization, shipping, shipbuilding, automobile distribution, real estate development, explosives, breweries, industrial salt & gases, education, and machine fabrication.

CSL has a wholly owned subsidiary (WOS) called Chowgule Steamships Overseas Ltd (CSOL) incorporated in Guernsey. CSOL has three WOSs called Sunshine LLc, Fairweather LLC and Blue Ocean LLC. These three step-down WOSs are incorporated in the Marshall Islands. All references to CSL henceforth in this report mean the consolidated CSL entity including its subsidiary CSOL and its three step-down subsidiaries.

CSL is a ship-owning company and currently has a small fleet of three ocean-going & three coastal dry bulk vessels. These vessels are chartered out (given on hire) on spot or time period basis for movement of dry bulk cargoes like iron ore, coal, grain, bauxite, fertilizers, etc. Among the ocean-going vessels, it has two panamax vessels and one handymax vessel. It has seven ocean-going (handysize) vessels on order. CSL does not ply ships on its own.

There are various categories of ships depending on the cargo they move. Key categories are Tankers (for transporting wet cargo like crude oil & petroleum products), Dry bulk vessels (for transporting dry cargo like iron ore & coal), and Container ships (ships that carry cargo in truck-size boxes that help in intermodal transport). Then, there are specialized ships to carry niche cargo.

CSL owns only Dry bulk vessels. There are various types of dry bulk vessels depending on the size of the vessel:

Ship type	Capacity dwt	Cargoes
Capesize	>100,000	Iron ore, coal, grain
Panamax	60-100,000	Iron ore, coal, grain, bauxite, phosphate
Handymax	40-60,000	Grain, coal, steel, cement, Potash, rice, Sugar, Gypsum,
Handysize	10-40,000	Forest products, scrap, sulphur, NFM Ores, Vehicles, Salt

As mentioned earlier, CSL has two panamax and one handymax at present. It has ordered seven handysize vessels.

Buying & selling ships (vessels) is a more or less regular activity with most ship owners depending on their market outlook. In FY08, CSL bought a handymax in April-07 and sold a panamax in Jan-08.

Shipping is a highly cyclical business. Managing shipping cycles by adding assets (ships) at early stage of the cycle and selling assets near the peak of the cycle are the key and most important success factors. As new ship building takes time (currently three years for a dry bulk vessel), ordering of new ships has to take place much in advance for the assets to be ready for plying in time to benefit fully from the cycle.

Chowgule group, the promoters, owned 67% of CSL at the end of Mar-08. Their holding remains unchanged since Sep-2002. Institutional investors' holding was negligible at end Mar-08.

Key Investment Points

Unprecedented boom in dry bulk shipping continues unabated

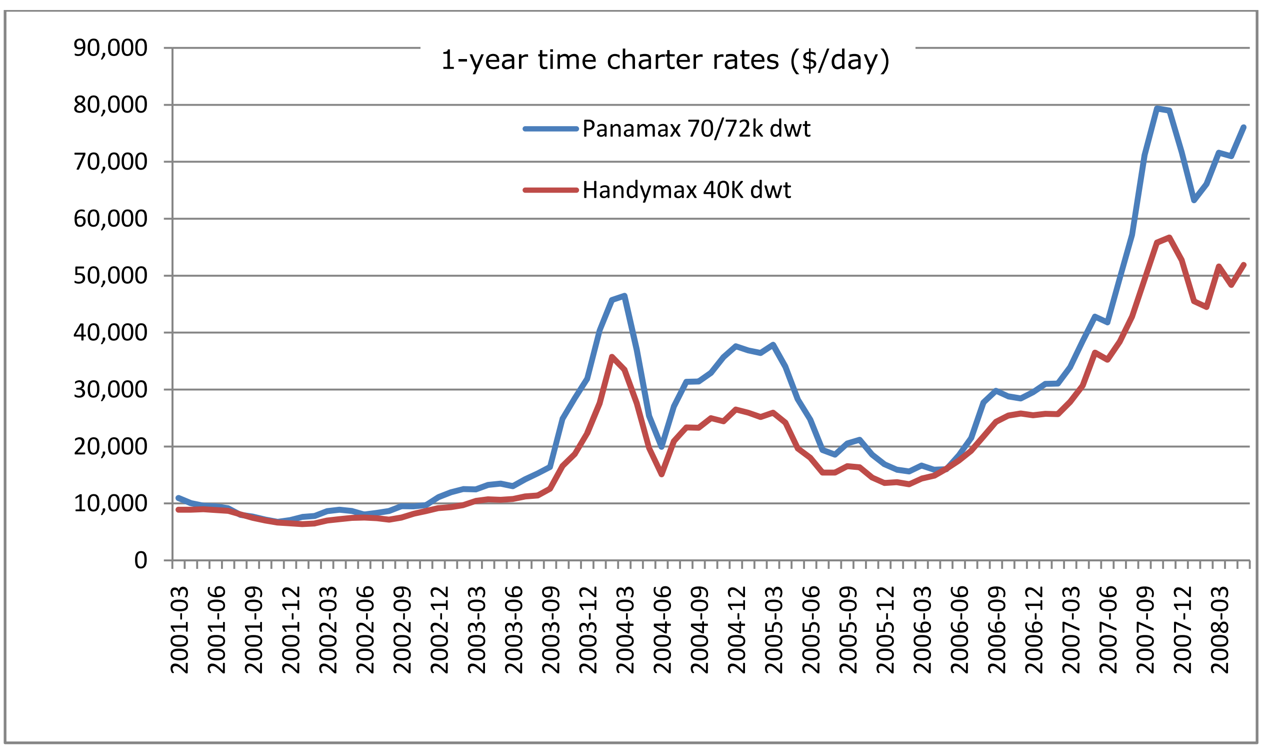
Dry bulk shipping segment has been on a cyclical upswing since 2003, though with significant volatility in the interim. Iron ore & coal import by China, steel export by china, thermal coal & met coke import by India have been but some of the drivers of dry bulk trade growth globally. Supply side has been constrained by years of under investment in dry bulk ship capacity, as dismal performance of the segment prior to 2003 dissuaded investment in the segment. By the time, the sustainability of growth in global dry bulk trade was realized; ship building yards' capacities were booked by tankers. Driven by twin impact of demand explosion and supply constraint, both ship values and ship earnings have reached record levels. These figures achieved their highest levels so far in the month of Nov-07. Though there has been a decline from these levels post Nov-07 especially in the capesize segment, these are still higher than a year ago period and previous record peak in 2004.

The fall post Nov-07 record peak has largely been due to noise factors that cause significant volatility in shipping earnings. These noise factors are often temporary supply side factors that cause temporary peaks & troughs. The unexpected fall post Nov-07 was due to two such noise factors:

- An accidental closure of a Brazilian iron ore port.
- Farmers' strike in Argentina, which is a large exporter of agricultural cargo.

Due to these two incidents, many vessels were suddenly released in the spot market causing freight/ charter rates to plummet.

The record high ship earnings & values enabled strong financial performance of CSL in FY08 and strengthening of its balance sheet. Timely acquisition of Providence, a handymax vessel, in Apr-07 helped too. We expect a significantly stronger performance in FY09.



Analysis of FY08 Financial Performances: A spectacular performance

Consolidated

Rs.mn	Jun-07	Sep-07	Dec-07	Mar-08	Mar-08	Comments
No. of months	3	3	3	3	12	
Operational Months for vessel						
Messenger	3	3	2	3	11	Dry-docked in Dec-07. Renewal in Jan-08 at significantly higher rate
Providence	3	3	3	3	12	
Coastal vessels-3	3	3	3	3	12	
Explorer	3	3	3	1	10	Sold at the end of Jan-08 for $35.2mn
Triumph	3	3	3	3	12	Renewal from end of Aug-07at higher day rate
Revenues	424	442	507	556	1,928	
Manning & staff cost					170	
Brokerage, Agency fee					117	
Fuel oil, lubricants					45	Cost of fuel (bunker) to run ships is borne by charterers and not by ship-owners
Stores & spares					46	
Insurance					47	
Other Expenditure					111	
Dry docking exp					165	
Depreciation					288	
EBIT					940	
Other income					110	Rent on properties, Interest on surplus fund
Interest					123	Largely on Fx debt in Indian company
PBT	166	170	195	396	926	
Extra ordinary Income	82	30	11	733	857	Fx gain in the first three quarter. Fx loss & profit on sale of ship in the fourth quarter. Fx gain/loss relates to Fx debt only.
Tax	-36	- 26	- 5	- 55	- 123	Co opted for regular tax and not tonnage tax. It pays regular tax on income of Indian vessels and no tax on vessels (Explorer, Triumph) in the subsidiary.
Tax/PBT %	14.6%	13.2%	2.5%	4.9%	6.9%	
PAT	212	174	200	1,074	1,660	
Adjusted PAT	130	144	190	341	803	
Equity Capital					363	
Annualized EPS (Rs)	14.29	15.81	20.88	37.52	22.13	
Adj PAT Margin (%)	30.6%	32.5%	37.4%	61.3%	41.7%	

Renewal of a panamax is due in Jul/Aug-08: We estimate 50%+ rise in day rate

Global Triumph, a panamax vessel, is due for renewal in Jul/Aug-08. This vessel accounts for 36% of CSL's total capacity at present. The vessel is currently deployed at $51,500/day on a one-year time charter, which come to an end in Jul/Aug-08. The recent one-year time charter fixtures for similar vessels have taken place at around $80,000/day. This implies a likely rise of about 55% in day rate for 36% of the capacity. We estimate that this would add an additional Rs.320mn to the company's consolidated PAT.

FY09 performance to be significantly better than that in FY08

CSL has already sealed bulk of the FY09 performance through long term period charters at attractive day rates. As long term charter agreements are in place, CSL's earnings are largely insulated from changes in dry bulk market in FY09. We estimate CSL's Revenues to grow 25% and PAT to grow 66% in FY09. This is despite sale of Explorer, a panamax vessel, towards the end of FY08.

Consolidated Rs.mn	FY08	FY09	YoY
Revenues	1,928	2,419	25.5%
PAT Adjusted	803	1332	65.9%
EPS (Rs.)	22.13	36.70	65.9%

Key drivers of growth will be renewals done at higher rates in FY08 for Triumph & Messenger, renewal of Triumph in Jul/Aug-08, absence of any dry-docking & special survey in FY09. Dry docking/special surveys have dual adverse impact on revenues and profits:

- For the duration of dry docking/special survey, the vessel does not earn any thing
- Dry docking/special survey, which happens every two and a half years, implies large lumpy repairs & maintenance expenditure in the period in which it takes place.

Judicious utilization of surplus cash & leveraging capacity to determine growth beyond FY09

CSL sold Explorer, a panamax vessel, at the end of Jan-08 for $35.2mn. This coupled with strong earnings in FY08 enable it to have surplus funds of $35-38mn at year end after paying $8mn advance towards two handysize vessels. It has forex debt of $28.5mn out of $30mn it borrowed to fund acquisition of Providence, a handymax vessel, in Apr-07. This debt is repayable over a period of eight years. CSL, which is net cash positive and has a net-worth of Rs.3.2bn (as on 31/03/08) has substantial unutilized leveraging capacity and surplus cash to be deployed gainfully for driving growth beyond FY09. Part of the surplus cash has been committed towards acquisition of seven to-be-built handymax vessels including the two contracted to be built in FY08.

CSL has been in coastal shipping for long and has a small presence with three small vessels that earned it an estimated revenue of Rs.100mn in FY08. These were deployed with Ultratech Cement on the west coast. With the onset of monsoon, these vessels are now deployed on spot. Coastal shipping holds immense potential in India, as India has long coastline dotted with many major and minor ports; and water transportation is significantly cheaper than road/ rail transportation. Despite the potential, it could not be capitalized due to lack of adequate infrastructural support (port connectivity, navigational facilities, etc) by state and central governments. Yet, CSL seems to be hopeful and plans to add a couple of coastal vessels to its fleet. It does not want to ignore coastal shipping having been in this segment for long.

Judicious use of available cash & leveraging capacity is important and can go a long way in determining its financial future. We shall evaluate its plans on this count as and when these are known.

Two initiatives taken towards Long-term performance

- Placed Order for new building of seven handysize vessels
- Approved investment in a port-cum-ship repair project

Placed Order for new building of seven handysize vessels

CSL placed orders for seven handysize vessels over the last six months with Japanese shipyards. These will be of 32-37,000 dwt capacity and each of these will cost $40-42mn. An advance of 10% has already been paid and balance is payable in installments as per progress in ship building. These new-building acquisitions are normally funded with 70% debt component. These ships are scheduled to be delivered between Oct-2010 and 2013. This implies that the company will require a cumulative funding of $86mn ($41mn*7*30%) by 2013 besides debt funding. Of this, about $29mn has already been paid. The balance $57mn can be paid out of internal accruals, as we estimate it to make an after-tax profit of $31mn and cash accruals of $37mn in FY09. It has $15-18mn in cash. After making repayment of $3mn towards debt, it still will have about $49-52mn to be paid towards seven handysize vessels at the end of FY09 itself. Then, there is always the option to sell under construction vessels if prices shoot up over the contracted price. Currently, there is not much difference in the contracted price and the price at which these under construction ships can be sold, as they have just been ordered. However, given the scarcity of berths at shipyards, there is a possibility that these vessels can command premium even during construction going forward. This brings forth two points clearly:

- It will not have to resort to dilutive equity funding.
- As only part of the cash accruals of FY09 will be utilized towards paying for seven handysizes (part being used out of FY10-FY13 cash accruals), there will be enough cash accruals to fund other growth drivers.

Why Handysize?

If one has to invest in dry bulk segment, handysize segment appears to be the most sensible choice at the moment for the following reasons:

- The order-book size is the smallest in this sub-segment of dry bulk.
- Age profile of world handysize fleet is such that these will be the first ones to go for scrapping in sizeable numbers.
- These smaller vessels can go to all ports, as the draft depth required is small.
- These smaller vessels are versatile & adaptable, as these can carry all kinds of dry cargo. This is not the case with larger vessels.

These positives are countered by the only negative that the cost/unit of cargo carrying is higher in smaller vessels than that in larger vessels. However, looking at the order-book sizes and delivery & scrapping schedules of larger vessels particularly capsizes, handysize vessels' advantages outweigh the only disadvantage it has.

Approved Investment in a port-cum-ship repair project

Chowgule Ports & Infrastructure Ltd (CPIPL), a special purpose vehicle (SPV) co-promoted by CSL, recently signed a 50-year concession agreement with Maharashtra Maritime Board (MMB) for development of a minor port at Jaigarh (Dist. Ratnagiri). CPIPL will have two subsidiaries—one for port operations with two berths initially and another for ship repair facility. A ship lift facility, a better alternative to dry docking, is being planned here. Chowgule group will hold 51%, MMB 11% and strategic partner/s will hold the balance 38% stake in CPIPL. CSL's share out of Chowgule group's 51% is not yet known. The Rs.5bn project will be executed over next five years. Of Rs.5bn project cost, equity portion will be Rs.1.5bn. Chowgule group's equity investment will be to the tune of Rs.765mn ($18mn). Civil work is scheduled to start post monsoon and commissioning is expected after three years in phases. This is a long gestation project and we do not expect CSL's equity investment to be more than Rs.390mn ($9mn).

Throw-away valuation makes it a compelling investment

- Available at 80% discount to NAV (CMP Rs.49, NAV range Rs.248-269)
- P/E of 2.2x FY08 actual adjusted earnings and 1.3x FY09 estimated adjusted earnings

NAV Calculation				**Jun-08**	
Vessels	Vessel type	Cap (dwt)	Built	Value Range	
				US$ mn	
Messenger	Panamax	71,252	1995	65	70
Providence	Handymax	47,574	1995	50	55
Global Triumph	Panamax	72,870	1996	65	70
Courage	Coastal	2,053	1994	10	10
Crystal	ships	3,500	1997		
Coral		3,427	2000		
Value of Vessels				190	205
Cash in subsidiary				15	18
Real Estate (at book value as per Mar-02 revaluation, market value much higher)				4	4
Advance for 7 Handysize vessels				28	28
Total Value of Assets				238	256
Debt				29	29
Net Asset Value				209	227
Shares outstanding (Nos.)				36,308,425	
NAV per share (Rs.)				**248**	**269**
Current Market price per share (Rs.)				49	49
Appreciation Potential				**407%**	**450%**
Discount on NAV				**80%**	**82%**

Risks / Concerns

Forex risk due to INR/USD fluctuations –naturally hedged at present

CSL has $28.5mn forex debt in the Indian company. As per extant accounting requirements, change in the debt post conversion into INR due to fluctuations in INR/USD rate is adjusted in P&L account. CSL reported pre-tax forex gain of Rs.123mn in the first three quarters of FY08 on this debt as INR appreciated. It, however, booked a pre-tax forex loss of Rs.29mn in the fourth quarter of FY08, as INR depreciated marginally. It is likely to book a pre-tax forex loss of Rs.86mn in QE Jun08, as INR has further depreciated significantly. These are, however, notional gains & losses until the company is required to actually buy USD to repay debt. We have, therefore, treated these forex gains/losses as extra-ordinary and adjusted earnings accordingly.

CSL, however, has a natural hedge to forex risk. As its revenues are denominated in USD, any loss on debt is covered by a gain in revenues and vice versa. The Indian company is likely to have revenues of $32mn in FY09 as against forex debt of $28.5mn. The gain on revenue is, however, not disclosed separately and is an actual gain not a notional one.

The net change in its monetary assets in subsidiaries on conversion is taken directly to reserves without routing them through P&L account. The gain on huge cash balance that the subsidiary has at present due to INR depreciation will not be reflected in P&L but will go directly to reserves. In FY08, some losses would have gone directly to reserves as INR appreciated in FY08. The subsidiaries, however, did not have significant monetary assets in FY08.

Risk to ship earnings (time charter day rates) & ship values (NAV)

Cyclical volatility in ship earnings (freight/charter rates) & ship values takes place depending on how demand & supply are poised for ships in a particular segment and sub-segment. For dry bulk segment, demand is determined by volume of global trade in bulk commodities like coal, iron ore, grain, fertilizer etc and distances these have to be transported. Supply is determined by ship deliveries, ship scrapings, shipyard availability, etc. Lately, port congestion has sort of become a slightly longer term phenomenon to be included in cyclical factors rather than short term noise factors given the regularity with which it’s been happening.

Despite the US slowdown/recession, India & China are likely to continue to drive growth in dry bulk trade. India is likely to import record quantity of coal this year for its power plants. The rising interest of Indian businesses in overseas coal mines is an indication towards long term sustainability of this. There is no let up in growth in china’s iron ore imports this year so far. While Indonesia is likely to export more coal, South Africa may curtail coal export to retain more coal for its own power generation. Grain seaborne trade may be lower but maize & sorghum trade may rise due to EU’s imports from Brazil due to lower harvest in EU. Steel export from China is uncertain as China continues to increase export duty on steel to discourage exports.

Growth in supply in 2008 is likely to be at similar level as that in 2007. CY09 may, however, witness higher deliveries. A factor that may tilt the Capesize market from balance to negative is conversion from VLCC to VLOC (tankers to Capesize). We understand that actual conversions are likely to be much less than contacted and some of the delivery schedules are likely to be pushed back and these may help the market. About a quarter of all under-construction ships are being built in inexperienced greenfield shipyards. This increases chances of delays. High crude oil prices have led to high bunker (ship fuel, the dense residual product from crude refining) costs. Studies show that significant savings can be made in bunker costs if ship speed is reduced. The savings are significant even accounting for high cost of increased days for the same voyage. The magnitude of savings is enough incentive for reduction in ship speed. This will imply significant absorption of increased deliveries going forward. Clearly, there are more factors impacting demand-supply and new ones keep emerging in the increasingly dynamic world.

Investors, therefore, need to closely monitor (we shall endeavor to do it for our client-investors) freight & charter rates. Given the high volatility in these rates, it is important to distinguish between noise factors and cyclical factors causing the volatility before any investment or divestment decision is taken. The key to success lies in distinguishing between the two set of factors.

Conclusion

Last few years have been very good for dry bulk shipping. FY08 has been particularly strong year. We estimate CSL to do significantly better in FY09 on the back of already confirmed charter contracts. We notice that CSL is debt-free, cash positive and is therefore ready to capitalize on available opportunities as well as opportunities that may arise. It has already taken a couple of steps towards long term growth like ordering more vessels, investment in port & ship repair projects. It needs to do more to put in place growth drivers for medium term, particularly for FY10. As always, Investors need to understand, monitor and guard against risks.

The greatest positive for investors in CSL is very high margin of safety. It is currently trading at mere 2.2 times FY08 actual earnings (adjusted for one-time items) and a measly 1.3 times FY09 estimated adjusted earnings. NAV is a more appropriate valuation methodology for a shipping company, as its assets (ships) are highly liquid and reliable quotes are available. At the current price of Rs.49, CSL is trading at mere 20% of its NAV (NAV range Rs.248-269), a huge 80% discount! This, to our mind, is a no brainer.

Important Disclosure

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