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Costamare Is Well-Positioned For Dry Bulks Recovery

Nov. 14, 2021 5:58 AM ET | Costamare Inc. (CMRE) | 10 Comments | 6 Likes

Summary

• Costamare performed well throughout the year until it peaked in mid-September - since then, the stock has lost >20% off high.

• This is primarily because the company now has a fairly large fleet of dry bulk carriers and the Baltic Dry Index has fallen sharply since early October.

• I believe that the current decline in BDI, as well as its parabolic rise from September to October, is unsustainable due to ongoing inflation.

• Since CMRE charters its vessels at short-term rates, the stock has a chance to reverse the current downward trend when the market conditions change.

• In addition, the company will see a fairly steady demand for its services over the long term, even with limited steel production in China.
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Investment Thesis

Costamare (NYSE:CMRE) performed well throughout the year until it peaked in mid-September - since then, the stock has lost >20% off high:
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This is primarily because the company now has a fairly large fleet of dry bulk carriers and the Baltic Dry Index has fallen sharply since early October:
Source: TradingEconomics.com, author's notes

I believe that the current decline in BDI, as well as its parabolic rise from September to October is unsustainable due to ongoing inflation. Since CMRF charters its vessels at its services over the long term, even with limited steel production in China.

The Baltic Dry Index behavior

It is generally accepted in academia that the BDI is a leading indicator of inflation growth - when the index rises sharply, inflation follows with a small lag. Some researchers try to predict economic growth using the BDI as an example of the United States - the results of such studies seem to be logical. On this basis, at the moment, some economists who observe a sharp decline in the BDI, claim that this is a sign that "the worst is over" (meaning inflation in the US and the rest of the world):

"The decline in the Baltic Dry Index may be signaling that some of the overheating in the economy that has been taking place is reversing itself," Gus Faucher, chief economist at PNC Financial Services, told CNBC in an email. The drop "is an indication that perhaps the worst of this is over, at least for goods that are traded internationally."

Source: CNBC

I cannot say that I entirely agree with this. I think some part of the price increase is indeed transitory, as stated earlier by Mr. Powell, and when the supply chain recovers we will most likely see "saturated" demand satisfaction. But I think it's wrong to use the BDI alone to reassure everyone about inflation.

First, another key index - HARPEX - is completely ignored. And it's important to note that it has been predicted to fall sharply for many days, and it has not happened - the index is sliding much more slowly than the same BDI.

Data by YCharts
Why is that? Because supply chains do not recover as quickly as journalists would have us believe - it's a pretty lengthy process given the limited supply in the market (most of the ordered containerships will hit the market in 2023 - the very year some executives

the coming quarters - an unconditional signal that the current sharp decline in BDI is an overreaction, not caused by the reason the media is trying to "sell" us.

Secondly, we must understand that BDI is not just an indicator of the dry bulk shipping costs, but also an important barometer on the volume of worldwide trade and manufacturing activity. There is only one reason why it has fallen so much in the last few weeks - a drop in demand from China, which started with a rise in the prices of key raw materials (iron ore, coal, etc - transported by dry bulkers). This background was overlaid by the situation with Evergrande and the doubts about the development of the Chinese economy because of all that was happening in general.

I believe iron ore prices have corrected too much - this commodity is now trading in the lower pre-Covid price range (2019).

Source: TradingEconomics.com

For all its "green initiatives", China cannot ideologically fall face down in the dirt and see a decline in GDP growth, much of which depends on steel production. Now that the iron ore price is so low and falling further, this is the ideal time for China to rebound in steel production. But of course, the earlier production levels are no longer possible as winter approaches and the energy crisis has not yet been resolved. Nevertheless, I think that the demand for dry bulkers' services will recover in the coming quarters and the BDI will stop falling at some point.

Thirdly, the weakest argument, which nevertheless cannot be ruled out, is the technical picture of what is happening. In recent years the BDI has had both sharp rises and equally sharp falls, succeeded by less volatile periods. However, one fact cannot be ruled out - a rapid decline is always followed by rapid growth and vice versa; moreover, this always repeats itself two or three times (in a row):
Source: TradingView.com, author's notes

Of course, there must be an economically fair reason for this - perhaps it is in everything I have described in the first two parts above.

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been proven several times and is now used by CNBC as the basis for conclusions, then given the unsolved supply chain and energy problems the United States and other countries are having at the moment, I do not rule out adding another "transitional" turn to what we are observing.

Campbell Harvey, the leading economist/professor at Duke University, has no doubts about even "more inflation to come":

Source: LinkedIn

If he's right, then the next leap in BDI will predict that surge in inflation.

Okay, why Costamare?

I believe the company is little known to the general public (at least among Seeking Alpha readers) because:

a) No one has written about the company in over 3 months and

b) CMRE is in the middle of the list of "best" in the "Marine" industry in the "Industrials" sector:

Source: Seeking Alpha, author's notes

As you can see, "Profitability" spoils the whole picture - this factor grade stands at "D-". However, only 2 indicators are to blame - levered free cash flow margin and asset turnover ratio (both TTM):

Source: Seeking Alpha, CMRE, Profitability, author's notes
In my view, this is far from indicative of the quality of the company's profitability, as Costamare spent a lot of cash in the third quarter on expanding its fleet, particularly in terms of dry bulk carriers - hence CAPEX outweighed cash flow from operations, which

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Source: CMRE's recent 6-K

What can also alert investors is the company's increased debt load, albeit due to long-term debt:

Data by YCharts

This is a sensible warning, as most companies in this sector are trying to make the most of their unprecedented profits, and while there is such an opportunity to pay off as much debt as possible by reducing their financial leverage, the cycle does not last forever. Costamare has gone the opposite way - it is getting rid of old container ships, buying a bunch of relatively fresh dry bulkers, and loading them with debt at a lower rate (due to the appreciation in the value of the existing fleet - that definitely plays a role in determining the cost of debt capital).

Source: CMRE's IR presentation

Nevertheless, we cannot say that the company is in the red in terms of its debt burden - the amount of liquidity on the balance sheet and the relative debt cheapness due to the refinancing carried out leads us to understand that the opposite is the case.

Source: CMRE's IR presentation, author's notes

Costamare relies on dry bulk shipping - now the company's fleet consists of 9 container ships and 34 dry bulkers (3 more ships will be delivered by the end of 2021), with all of the dry bulkers tied specifically to operating in the spot market - since the end of the previous quarterly report (Q2) CMRE managed to fix 18 dry bulk vessels on fairly favorable terms, guaranteeing, together with previous contracts, long-term revenue of $3.3 billion (amid market cap of just $1.62 billion).
Source: CMRE's IR presentation

The growth in key financial indicators over the last 5 years in momentum is explained by strong demand and rising BDI after the stagnation of 2020

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The rather sharp decline in multiples that we have seen over the past year (P/E ratio is down >90%, YoY) is nothing phenomenal and does not in itself imply undervaluation - as in any cyclical industry, multiples are powerless in determining the attractiveness of companies because they take into account past performance and predict a decline shortly when the cycle ends. This was the case in the past when CMRE's key market multiples fell to similarly low levels relative to current ones:

Data by YCharts

The current multiples tell us that the industry is at the bottom of the cycle - EBITDA and net income are maxed out and unlikely to be higher in the next few periods. So why pay more now for something that will yield significantly less in the future? Therein lies the attractiveness of buying CMRE at current levels - multiples are unlikely to be lower (they have already fallen where they should have); EBITDA and net income, given the relatively high margins of Costamare's business compared to others in the industry, can very likely still grow if the BDI can recover based on the factors I described at the very beginning of this article. If so, the share price has no choice but to respond with a strong upward move.

Data by YCharts

**Bottom Line**

Of course, I could be wrong, and buying at current levels will prove to be a failure if the BDI continues its sharp correction. Also, I could be wrong in my assessment of CMRE's creditworthiness, as its strategy is still somewhat riskier than that of its peers, which are now actively repaying debt and paying out additional dividends.
However, I do not believe that all logistical problems have been solved and that the BDI can safely continue to fall to pre-Covid levels. Too many factors suggest that even if inflation has truly moderated, a new round is imminent, which by the logic of things

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a) High fuel prices as a result of a new rally in crude oil,

b) continued port congestion in China and globally, and

c) an extremely low order book, which more than anything indicates limited supply and ongoing supply chain issues.

In the long run, dry bulkers will also flourish, because

a) After the Olympics (February 2022) China might increase steel production again, and

b) even if the "green initiatives" were not dusty in the eyes of foreign investors / the general public, building new power plants to generate alternative energy, the construction of all the necessary infrastructure for this will take many months and, most importantly, thousands of tons of cement and other dry materials that will have to be delivered by sea (thanks to J. Mintzmyer for this idea, inspired by the recent webcast "Sleeper Stocks To Profit From The Supply Chain Disruption").

This will provide the lacking demand for dry bulk carriers, and given the freshness of Costamare's fleet, the company will gain a certain kind of advantage against the backdrop of limited supply in the market, as has been mentioned several times in this article.

Happy investing and stay healthy!

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This article was written by

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792 Followers

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