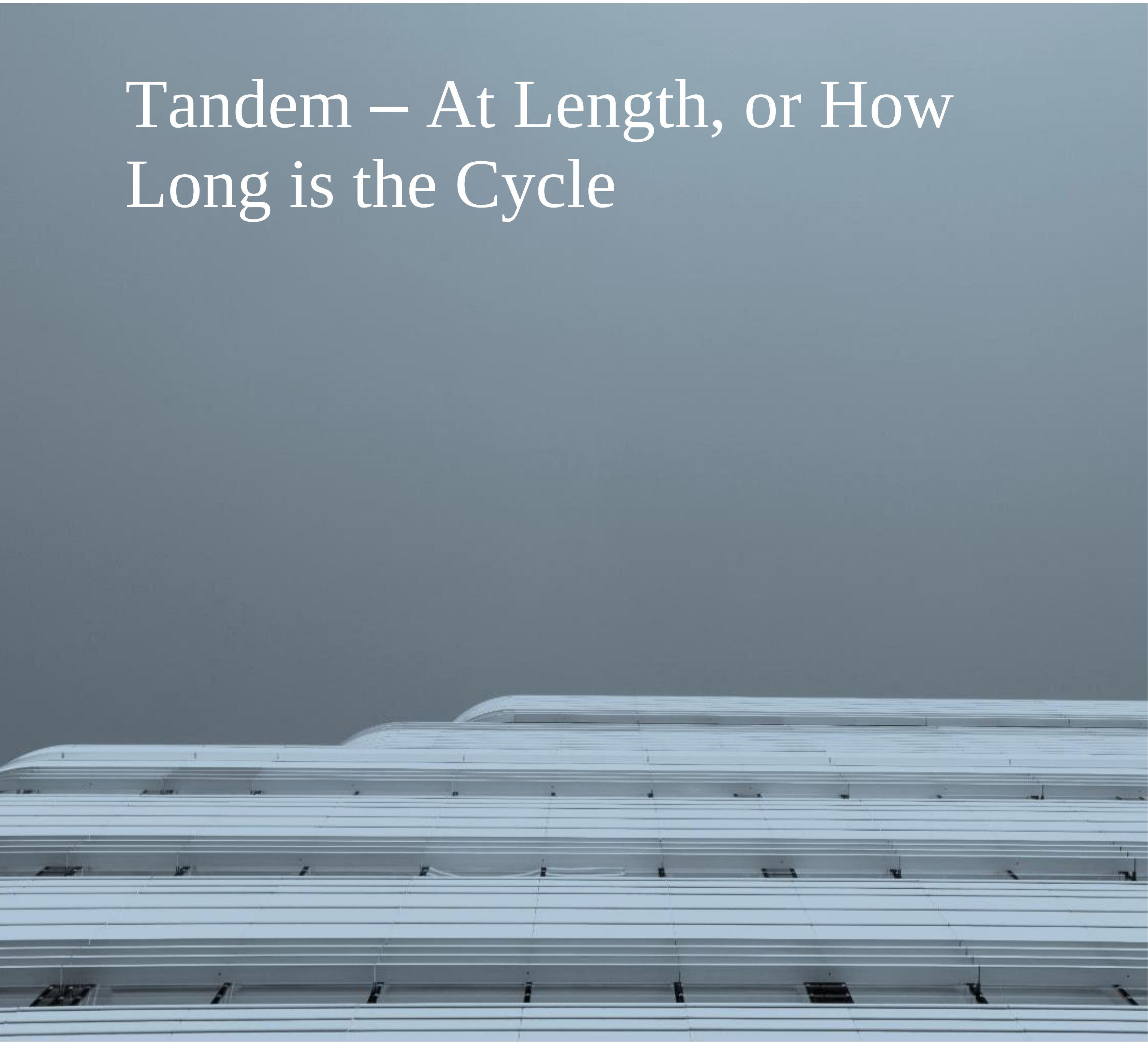
Hosking Partners®

Hosking Post

Tandem – At Length, or How Long is the Cycle



As we write, in the final quarter of 2021, the world is waking up from Covid-induced lockdowns, global leaders are meeting at the COP26 Conference, and newspaper headlines are dominated by the twin topics of supply chain disruption and energy price spikes. The inside pages meanwhile are engaged in endless debates about inflation - what it means, how to measure it and whether it is "transitory" (as Federal Reserve Chair Jerome Powell puts it) or longer lasting.

Against this backdrop, a number of stocks in the Hosking Partners portfolio have enjoyed some long-awaited strong performance. In particular this applies to capital intensive companies, whether those in "old economy" industries or, similarly reliant on their balance sheets, banks. They include names such as Pacific Basin and Diana Shipping (both in dry bulk shipping), mining names such as Teck, Freeport, First Quantum and Alcoa, oil stocks such as ConocoPhillips, Apache and Canadian Natural Resources as well as a collection of companies in such disparate areas as car rental (Avis Budget even before its meme explosion) and silicone (Ferroglobe). Among our banking exposure, Bank of America and Wells Fargo have made strong contributions.

There might be a temptation to reach for today's news topics of inflation (transitory or not), disruption from the energy transition or logistics bottlenecks to provide the reasons why these stocks have done well, but as students of behavioural finance we should be alert to the false allure of availability bias. Rather what all the aforementioned stocks have in common - whether they sit within shipping, mining, oil and gas or banking industries - is that they have suffered long periods of poor returns on capital. This has led to investment being turned off, and now those returns on capital are picking up sooner, to the surprise of the market. This can all be foreseen by rudimentary capital cycle analysis.

Briefly described, the capital cycle framework predicts that an industry with high returns on capital attracts new entrants, enticed by the prospect of enjoying those high returns. The consequence of this is that the rising competition causes returns to fall, eventually in some cases to below the cost of capital; investment declines, capital stock becomes obsolescent, firms consolidate, withdraw or close down. In time, an improving supply side causes returns to rise above the cost of capital and the cycle begins again. At the same time, the equity market is tracking its own cycle: investors are optimistic when returns are high, but share prices fall as industry returns suffer from rising competition, reaching a nadir as returns bottom and capital exits, and finally share prices pick up in anticipation of rising returns again. The opportunities for capital cycle investors arise in two broad areas. Firstly, where the market anticipates the high returns of certain companies will turn down sooner than in fact they do. Secondly, where the market underestimates the likelihood of returns recovering in beaten up industries, when the supply side is already improving.

Chart 1: The Capital Cycle

Source: Hosking Partners

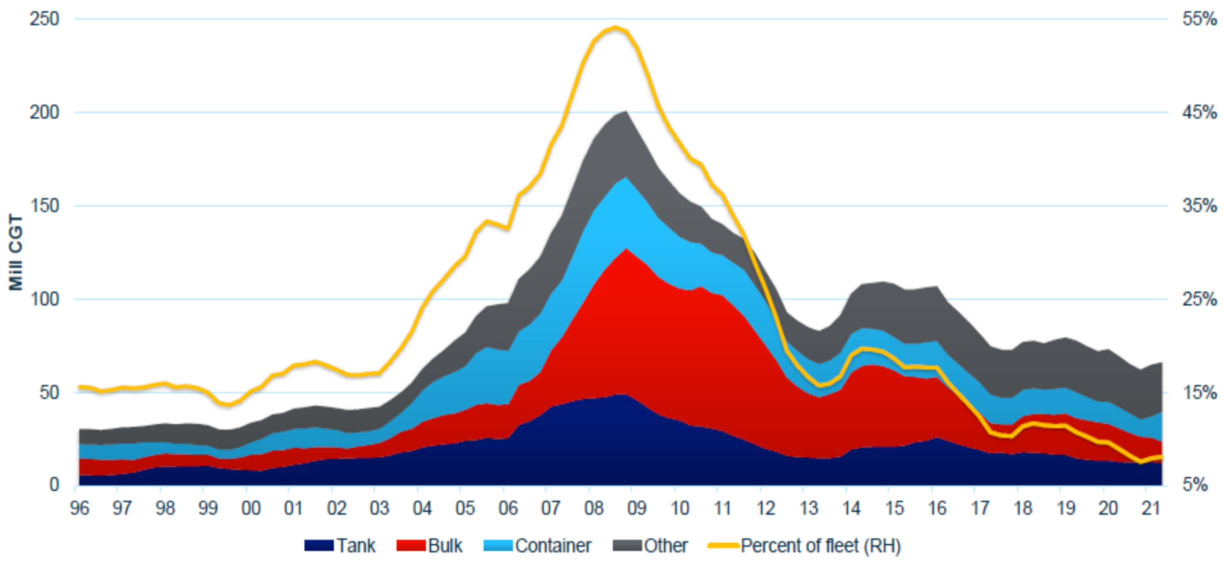
This chart highlights the two valuation anomalies which capital cycle analysis helps identify. We have started with the example of capital intensive industries surprising the market with attractive returns following historic underinvestment. While the Hosking Partners portfolio contains a greater share of such capital intensive stocks than is the case with many of our competitors, a glance at the largest positions in our portfolio will see names such as Amazon, Alphabet, Tinkoff Credit, Costco and TSMC, all showing higher and more stable returns. As any contrarian needs to be, we are foxes rather than hedgehogs[1]. What makes the capital cycle so versatile as a tool is that as well as providing a framework for investing in companies with low but volatile returns which are likely to recover sooner than the market credits, it also highlights the opportunity in companies with high and stable returns which enjoy barriers to the supply of new capacity which will mean that those returns will resist the gravity of mean reversion for longer than their share price suggests. What we are less good at is investing in companies without positive returns in the past and only the prospect of positive returns at some distant point in the future: we leave those to cleverer investors.

Considering the example of our capital intensive stocks which have recently performed well, the reasons for the historic poor returns on capital date back in many cases to the years before the Global Financial Crisis, when the combination of cheap and plentiful capital, the emergence of a China-driven commodity "supercycle" and wasteful capital allocation by many management teams led to massive overexpansion and the creation of excess capacity. This was later cruelly exposed by the ensuing worldwide recession. Asset lives are long: it may take a decade for a mine to receive necessary permissions and complete necessary capex before any revenues are generated, followed by decades of production, and at least a couple of years will pass between an order being made for a ship to be built and it being delivered, following which it will have a

Archilochus, via Isaiah Berlin: πόλλ' οἶδ' ἀλώπηξ, ἀλλ' ἐχῖνος ἓν μέγα - a fox knows many things, but a hedgehog knows one big thing.

useful life of 20 years. Shipping provides a vivid example of the length of time it has taken for the supply demand equation to have balanced: the size of the global order book for new shipping in relation to the scale of the fleet already on the water has been in decline for ten years (from a peak as high as 50%), but in absolute terms the size of the fleet has continued to grow, and it is only in recent years that new shipping has been growing at a rate which is the same or less than demand for shipping.

Chart 2: Orderbook for World Merchant Fleet



Source: Clarksons Research – in million compensated gross tons (CGT)

In other cases, overcapacity comes from state actors such as China prioritising investment as a strategic objective for reasons of economic self-sufficiency. Aluminium is the stand-out example, with the energy generated by stranded coal assets in Western China being converted into aluminium which can both be consumed locally and exported globally, destroying the returns on capital of international competitors for the past two decades. China's recent announcement that it is committed to CO_2 emissions peaking by 2030 and carbon intensity reducing by 65% over the same period provides some comfort that a turning point may be on its way. In the meantime, the energy crisis being experienced in China is providing a short-term benefit to Hosking Partners' portfolio constituent Alcoa, as less Chinese aluminium is dumped on world markets. Viewed through the capital cycle lens, however, it becomes clear that the China power squeeze is the result of longer-term underinvestment in traditional energy markets globally, in the mistaken belief that renewable capacity would be able to scale quickly to create replacement capacity more cleanly and with lower prices.

In this way, the capital cycle and an ESG focus work together: industries are punished for poor historic investment performance in the former framework and they are also rationed for excessive emissions according to sustainability criteria. The result is the same - an extended period of higher returns. Restricted supply of reliable power generation meets recovering demand post-Covid, resulting in high returns for LNG and coal, as well as for what aluminium smelting capacity in developed markets has managed to survive two decades of dumping by Chinese competitors who have now been turned off (for a while at least). A similar dynamic is at play in silicone markets, expressed through our investment in Ferroglobe.

Faced with examples of such obstinate overcapacity it is no surprise that over the last decade capital has been attracted to opportunities in less capital intensive industries. Here, intangible assets cannot be replicated so easily and the prospect of increasing demand is enough to offset worries about capacity surpluses. Investment pundits may characterise this flow of capital as the triumph of “growth” over “value”, or of “quality” over “cyclicals”. In reality it is simply the punishment of certain industries and their management teams for squandering investors’ capital, and the rewards being handed instead to other industries which have either earned higher valuations through careful stewardship of capital, or at least the promise to do so.

Such punishment takes the form of starving the capital base of the investment needed to grow, or at least maintain, production in old economy industries. Equity valuations are depressed, and access to the capital markets is restricted as prospective returns on new investments are extrapolated from rock-bottom levels. The cure for low prices is low prices, however, and in time the structural underinvestment leads to higher returns for what capital that remains.

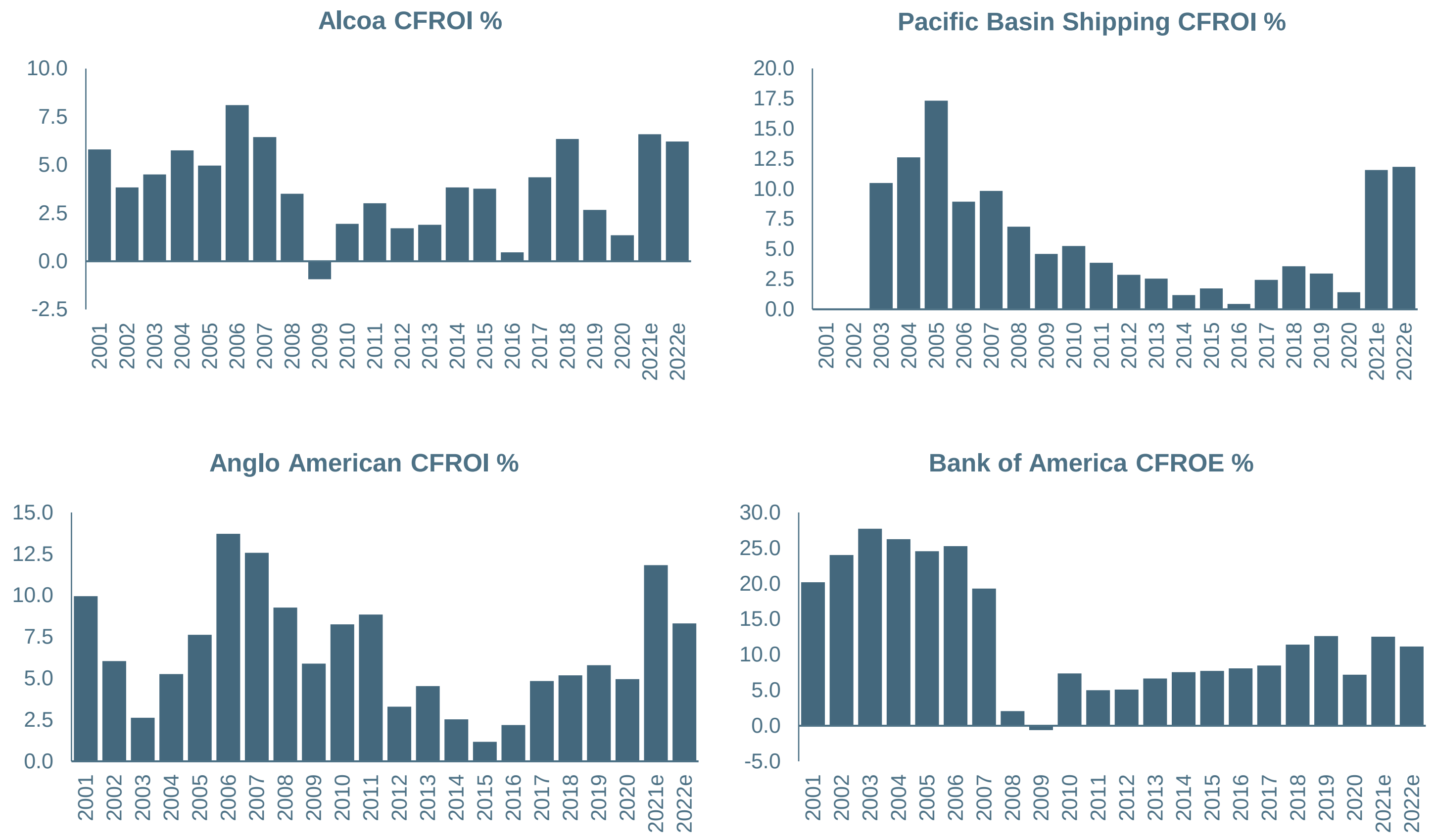
A key question for investors, then, is how long returns remain in the doghouse, in effect what is the (wave)length of the capital cycle? For Hosking Partners specifically, the question is whether and how quickly we should be taking profits in these winners, or how much further is there to run? The answer varies from industry to industry, depending in large part on asset lives, as the passage of time is needed for capital stock to be depreciated, but other factors can extend the time in the doldrums. In the case of shipping, for example, the arrival in the middle of the last decade of private equity investors trying to anticipate the inflection in returns resulted in a self-defeating wave of new capacity. This extended the downcycle by several years, the stocks continued to trade at a discount to replacement cost and the investment tap has only flowed at a trickle.

In contrast to these examples of excess capacity, supply constraints can cause returns to recover sooner than priced by the market and to be sustained higher and for longer. For example, a lack of suppliers to equip new entrants may hold back new capacity. As a case study: since the bursting of the US housing bubble and the collapse in demand for lumber, there are now only two manufacturers of sawmill equipment, resulting in long lead times for new sawmills to come on line. In Europe, paper manufacturers such as UPM-Kymmene have finally realised there is little point chasing volumes in the face of secular demand decline and have been closing down paper mills ahead of time.

Alternatively, the supply constraint may derive from funding being withheld. Depressed equity valuations rule out the issue of shares to fund expansion, while lenders have long memories and may restrict credit for expansion long after industry returns have recovered: in the case of shipping, many of the northern European speciality lenders who fuelled the pre-Lehman boom have gone bust while others have closed their shipping desks. Other stakeholders may impose supply constraints, particularly in the case of capital intensive industries which face emission challenges: governmental authorities' cancellation of oil pipelines in North America and imposition of restrictions on new drilling have held back oil production and brought on industry consolidation.

Even the prospect of future regulations can have an impact upon supply: shipowners are reluctant to order new ships if they do not know what future technology specifications will be needed to comply with changing emissions regulations over the course of their economic life. Geopolitics plays its part too: as tensions lead to local supply chain networks replacing global ones, capacity is reduced by such displacement.

<ins>Chart 3: Historic return on capital for selected capital intensive companies</ins>

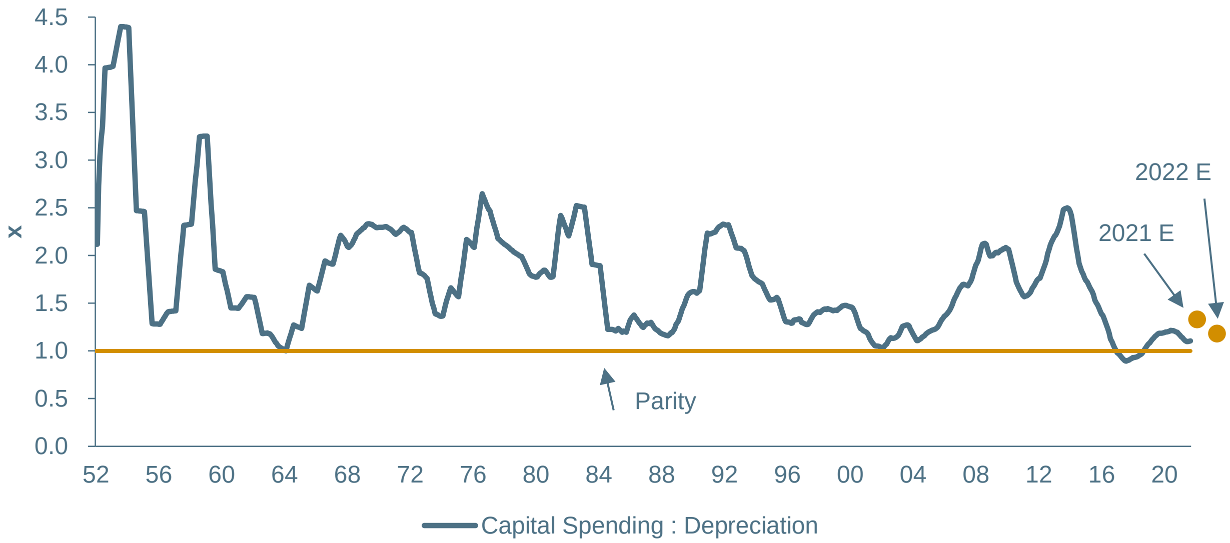


Source: Holt.

The key benefit of using the capital cycle as an analytical framework through which to view industries' returns and valuations is not only that it explains the link between supply of capital, future returns and asset valuations, but also that by doing so it creates the necessary confidence for us as investors to accumulate ownership positions in companies when returns are at trough levels. Being contrarian is by definition lonely, and being contrarian merely for its own sake leads almost inevitably to value traps. However, combined with a bottom-up approach, the capital cycle provides a rationale for making a bet against consensus just when the odds are most attractive <u>and</u> the course of play is about to switch. Of course, timing is never perfect (and anyway, perfect is the enemy of the good), but with respect to those commentators who say that to be right too early is to be wrong, we say that you will never own a stock at the bottom unless you are prepared to be early. Our diversified portfolio and our long-term performance fee help to provide scope for such behaviour and to reinforce the merits of focusing on the longer horizon.

Leading on from this, the capital cycle also gives us the confidence to say that while the high returns currently being enjoyed by these capital intensive companies are not permanent and will in time be eroded as new capacity is inevitably attracted in pursuit of those high returns, they may not be as short-lived as some valuations suggest. Market participants who measure their own performance over the shortest of time periods are quick to characterise the earnings power currently being enjoyed by these companies as a one-off blip due to the transient factors in today's newspapers (inflation fears, energy prices, port delays etc). At Hosking Partners, on the other hand, we have an eye on the bigger picture: what are the constraints on the entry of fresh capital and so what are the implications for capacity expansion? Analysts may try to estimate future demand to the last decimal point, but we are happy making broad estimates of supply based on more easily observed phenomena such as capital markets activity, capex projects and hiring announcements, all of which give forward notice of the arrival of new supply, or lack thereof.

Chart 4: Capital spending-to-depreciation ratio for developed market mining stocks



Source: Empirical Research Partners Analysis. Metals & Mining stocks - U.S. stocks used as a proxy for developed markets prior to 1987. Capital Spending-to-Depreciation - aggregate data smoothed on a trailing six-month basis.

The noise which results from false connections being made between daily price movements and companies' intrinsic values throws up opportunities. If profits really are one-offs then a low valuation multiple should be applied, which is why cyclical industries often experience tiny p/e multiples when profits are at their peak, and nose-bleed multiples when profits are lowest, if not actually losses. But if supply constraints (also known as barriers to entry) mean that returns will persist a while longer before they revert to the mean - and no doubt then overshoot to the downside - then a valuation anomaly is waiting to be exploited.

By way of vivid portfolio example, Pacific Basin, a dry bulk shipping company, is trading on a forward p/e of 3.2 and its chairman has just spent half a million dollars adding 9% to his existing ownership of the stock. This kind of insider behaviour should be catnip to the patient outside investor, and is to the four portfolio managers who own this within your portfolio.

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