BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

May 29, 2020 | www.btnresearch.com

# A.P. Moller-Maersk (AMKBY)- EQ Review

| Current EQ Rating* | Previous EQ Rating |
|---|---|
| 4+ | na |

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

**We are initiating earnings quality coverage of AMKBY (the ADR in the US) with a 4+ rating indicating Acceptable and Improving.**

Maersk also trades in Copenhagen in Danish Krone as two classes of stock (MAERSK-A with two votes per share) and MAERSK-B that is non-voting. While the company does much of its business and reporting in USD, the shares trade in DKK. In recent years, the currency has been 5.5-6.0 DKK to the dollar, it is currently between 6.5-7.0 DKK to the dollar – so there the potential for about 15% return or loss simply from the exchange rate changing by 1.0 DKK to the dollar.

We thought this would be an interesting name for readers because it has faced many headwinds regarding fuel prices and levels of world trade. The company has gone through a multi-year restructuring to eliminate cyclical commodity-related businesses related to oil exploration, oil transport and dry shipping containers. What is left is a company with a huge footprint in the world container ship market that would be difficult to replicate. It also has improved its door to door model by bulking

up relationships with terminals, intermodal and air shipping and warehousing, and well as operating towing vessels in ports.

**While we are not going to delve into the COVID and trade issues in-depth for an EQ-report; we do believe the accounting has been conservative. Many areas that would flag for concerns turned out to be either immaterial to results, low risk going forward, and have good disclosure.**

This company still has exposure to fuel prices, the level of world trade on its utilization rates of ships, and the rates it can charge. Even with that volatility, the underlying business is seeing improved profitability and improvements to cash flow and the balance sheet:

- **Joint Venture deals look low risk for Maersk. We do not see evidence that these are being done off-balance sheet to hide leverage or operating costs.** In many cases, they are likely partnering with governments who are not willing to sell the full asset of operating the commercial activities of a port.

- **The Joint Ventures are only about 7% of book value and are part of the more profitable division at Maersk – Terminal operations. The profit and margins are rising.** The risk of having to cover minimum concession payments at these terminals with trade levels down looks minor in terms of dollar exposure vs. the EBITDA and liquidity at Maersk. It also uses a 13% discount rate to determine if impairments are needed which is conservative in our view.

- **Divesting many oil-related businesses improved the balance sheet. Disclosure has been great, gains and losses were run through discontinued operations and removed, and debt/EBITDA has fallen from 4.4x to 2.0x since 2016.**

- **The focus of using divested assets to retire debt and fund shareholder returns as dividends and share repurchases all helped. With this program of asset sales largely complete – the dividend may be paid at the lower part of the company's 30%-50% payout range going forward** – especially with COVID impacting current revenues.

- **The large 2017 acquisition also comes with very few issues for us. They bought a business in their industry where it's easier to achieve some synergies. They**

**didn't overpay at 7.9x EBITDA and have realized significant synergies already to lower that further.**

- **The acquisition accounting was also very conservative. Only 9% of the purchase price went to Goodwill. The other 26% intangibles will be amortized over 15-20 years and Maersk is not adding that back to adjusted earnings. The integration and restructuring costs have also been very minor and shown results.**

- **Earnings quality is very strong in our view too. For EBITDA, Maersk removes gains/losses and JV income. It also does not add back restructuring charges or dividends received on shares it held as one of the divestments. EBITDA is often below the reported cash from operations.** Plus, this company touts actual cash generated and kept and looks at EBITDA against capital spending too.

- **Income from Continuing Operations adds back gains/losses, impairments, restructuring charges, and transition costs. Most of those are minor. It does not add back amortization of acquired intangibles.**

- The pension assets exceed liabilities and the PBO discount rate is 1.9%.

- Leases have some risk or opportunity as about 12%-15% rolls over in most years. Maersk's revenues are largely variable, but the leases are largely fixed. COVID and trade issues may create the ability to renew leases at favorable or lower rates.

## Investments in Joint Arrangements and Associated Companies Have Risks that Appear Very Manageable

Often, this is an area we would expect to see red flags in the form of off-balance sheet leverage and contingencies or an area where a company is keeping expenses off the income statement such as interest expense, R&D, or marketing. We do not see many of those traditional risks in this area for Maersk.

For definition – Joint Arrangements are where Maersk has joint control of the entity above 50%. They are considered Joint Ventures if the investments are separate legal

entities and rights are limited to the net assets. They are considered Joint Operations if there are unlimited rights of the owners to the assets and liabilities.

For definition – Associated Companies are entities where Maersk has significant influence through controlling 20%-50% of voting rights but does not have controlling influence.

The list of these companies shows that they are primarily terminals, port operations, and storage operations in places such as China, Hong Kong, Brazil, Bermuda, France, etc. There is some intermodal operations and storage as well. These operations are part of Maersk's efforts to be able to handle shipments beyond just ocean travel and be able to charge higher fees and boost total profits. Much of the terminal and port operations involve loading and unloading ships to and from ground transportation.

There are several reasons we say there the risks appear lower than what we have seen from other companies in this area:

- The size of these deals is a small part of total equity:

| | 2019 | 2018 | 2017 |
|---|---|---|---|
| Joint Arrangements | $1,204 | $1,333 | $1,394 |
| Associated Co's. | $937 | $754 | $963 |
| Equity | $28,837 | $33,380 | $31,425 |
| % Book Value | 7.4% | 6.3% | 7.5% |

- Liability during COVID-19 could come from minimum volume commitments at some ports where Maersk would need to pay some port authorities to cover times when shipment volumes are lower. That would seem to be a short-term item and not likely to trigger an impairment. However, the variables in assessing future cash flow in this unit are the volume of movements and profit per move. So, volume is likely to be down in 2Q.

- The terminal and towage unit has been earning a margin that exceeds the business as a whole and it has been seeing growth:

| Terminal/Towage | 1Q20 | 2019 | 2018 | 2018* | 2017* |
|---|---|---|---|---|---|
| Revenue | $911 | $3,894 | $3,772 | $3,772 | $3,481 |
| EBITDA | $276 | $1,107 | $978 | $778 | $639 |
| EBITDA % | 30.3% | 28.4% | 26.5% | 20.6% | 18.4% |
| Co. EBITDA % | 16.3% | 15.9% | 13.0% | 9.8% | 11.4% |
| T&T JV Income | $71 | $206 | $164 | $164 | $187* |
| Co JV Income | $85 | $229 | $1 | $56 | $60 |

2018 and 2017 with * are before the changes in lease accounting

The 2017 JV income added back $265 million of impairments related to lower volumes in several West African ports and difficulty in repatriating some local currencies

Our conclusion on this source of income from associated companies and joint ventures is that the income stream will likely continue although it should be lower in 2Q and perhaps 3Q also. The carrying value of the assets is very low as a percentage of book value as well.

On potential negatives (or sign of conservatism) – Maersk uses a 13% discount rate in evaluating Terminal and Towage assets for impairment. That could trigger an impairment later this year. Also, the minimum volume commitments to some ports could cause a cash payment. For all of 2019, the concession fees at all ports were only $249 million. Volume is not going to be zero and Maersk has $9.2 billion in liquidity.

## The Divestitures Improved the Balance Sheet

Maersk had several companies in its portfolio for decades that were highly cyclical – and largely tied to oil prices. The company set out to transform away from that and focus more on its transport business that has some cyclicality to it but for the most part has more inherent growth.

- Conservative Point for Accounting – Maersk immediately classified each unit as Discontinued Operations. Gains and Losses impacted Discontinued Operations.
- Conservative Point for Accounting – Each transaction is broken down into gains/losses, proceeds received, any future proceeds are called out, each is easy to find for impacts on income and cash flow. So, Disclosure is great.
- Conservative Point for Accounting – The Maersk Supply Services which primarily supplies offshore oil drilling activity was unable to be sold in a

reasonable amount of time and Maersk moved it back into continuing operations and the carrying value was written down.

What may be the largest material change was the company devoted much of the divestiture proceeds to paying down debt:

| Debt Picture | 1Q20 | 2019 | 2018 | 2017 | 2016 |
|---|---|---|---|---|---|
| Net Interest-Bearing Debt | $12.0 | $11.7 | $15.0 | $15.0 | $11.4 |
| EBITDA | $6.0 | $5.7 | $5.0 | $3.5 | $2.6 |
| Debt/EBITDA | 2.0 | 2.0 | 3.0 | 4.2 | 4.4 |
| Liquidity | $9.2 | $10.5 | $10.3 | $9.6 | $11.8 |

Net Interest-Bearing Debt = Financed Debt + Leases – Hedging Assets – Cash
Liquidity = Cash on Hand + Undrawn Credit Lines

In 2017, Maersk made a $4.2 billion acquisition that boosted debt.

The list of divestitures:

- The sale of Maersk Oil in 2018 to Total. The company received $4.95 billion in Total stock which they sold over 2018 and 2019. Some of the proceeds from the stock sales were paid as dividends to Maersk shareholders. The deal also included $2.5 billion in cash. The sale generated a $2.6 billion gain – which appeared in income from discontinued operations.

- Maersk has a parent company that holds 51.45% of its A-shares and 41.51% of total shares. That parent bought the Maersk oil tanker business in 2017 for $1.17 billion in cash. That cash went toward debt reduction. It produced a $453 million loss that also appeared in discontinued operations.

- Maersk Drilling was spun off as a dividend to shareholders in 2019. It also took about $1.1 billion in net debt with it. It recognized a $553 million loss on the transaction.

Given that shareholders have received some sizeable dividends in recent years as a result of these divestitures and asset sales and also the dividends received on Total shares – it worth mentioning here that this program is now largely complete.

Maersk intends to pay dividends of 30%-50% of income and currently it expects to be near the lower end of that range. It has been repurchasing shares with excess cash

flow, but the dividend has remained flat for 3-years. Last year, it even noted that half the dividend was to be paid from sales of Total stock. Given COVID issues now, we would not count on a dividend increase in 2020.

## Acquisitions Also Are Not Creating A Red Flag

Maersk made a sizeable deal in 2017 when it bought Hamburg Sud. That helped consolidate the industry of containership vessels – so it was in their wheelhouse. We also do not think they overpaid. The deal cost $4.4 billion and the stand-alone company had EBITDA of $554 million – so the cost was 7.9x. Also, Maersk forecast synergies of $350-$400 million from the integration and every $100 million achieved, lowers the cost to 6.7x, then 5.8x, then 5.2x. There has been some evidence of margin gain in the Ocean segment as some synergies are unlocked. Maersk claimed it realized $420 million in synergies related to more volume running through terminals operated by Maersk, better schedule optimization, and better procurement.

It is also refreshing to see an acquisition where only 9% of the purchase price was allocated to goodwill. Another 26% was allocated to intangible assets that will be amortized over 15-20 years for brand-names and customer-relationships and 3-5 years for software. The remaining assets went to PP&E which will be depreciated over 12 years for containers and 20-25 years for ships. While EBITDA adds back depreciation and amortization – Maersk is not adjusting for amortization of intangibles and adding that back to adjusted earnings.

## Earnings Quality Is Also Strong

Maersk reports two metrics – EBITDA and Income from Continuing Operations. As noted above, we are already impressed that it does not add back the amortization cost from an acquisition, and it expenses the bulk of the purchase price as either amortization or depreciation. We are also impressed that the company also talks about capital spending both for growth and replacement levels and how much of EBITDA it actually retains.

Maersk continually sells older equipment too and minor assets that generate small gains/losses as part of normal operations. These are removed from both EBITDA and Income from Continuing Operations:

| EBITDA Calc. | 1Q20 | 1Q19 | 2019 | 2018 |
|---|---|---|---|---|
| EBIT | $552 | $230 | $1,725 | $409 |
| Add D&A | $1,073 | $1,082 | $4,287 | $4,756 |
| Less Gains | $19 | $18 | $71 | $166 |
| Less JV Income | $37 | $24 | $93 | $116 |
| Less Ass Co. Income | $48 | $34 | $136 | -$115 |
| EBITDA | $1,521 | $1,236 | $5,712 | $4,998 |
| Cash from Ops | $1,216 | $1,482 | $5,919 | $4,492 |
| Capital Spend | $310 | $778 | $2,035 | $3,219 |

EBITDA is subtracting the gains on minor asset sales. It is also subtracting all the income from joint ventures and associated companies. Within depreciation, impairments are added back but none of the company's restructuring charges are being added back. The company is not even adding in the cash income from the Total dividends that was received. That is netted against financing charges and would not be part of EBIT.

Most companies we follow, would not adjust EBITDA to remove JV income or ignore dividend income and would certainly add back restructuring charges. The net result is EBITDA is arguably understated at Maersk. It is also higher quality because compared to Cash from Operations, CFO is often larger than EBITDA or at worst – very close to it.

In terms of capital spending, the company gives guidance over a 2-year period and expects to spend $3.0-$4.0 billion between 2020 and 2021. Some of that is growth with replacement spending on older assets estimated at $1.0 billion per year. So, the conclusion is EBITDA is high quality, a good proxy for cash flow, and the company's free cash flow is very strong for shareholders (or for enduring the COVID issues) considering debt/EBITDA is only 2.0x now.

For Income from Continuing Operations, Maersk does not omit the income from JVs and associated companies. It removes gains and adds back impairments like the EBITDA calculation. It also adds back restructuring:

| Income Cont. Ops | 1Q20 | 1Q19 | 2019 | 2018 |
|---|---|---|---|---|
| Reported | $209 | -$104 | $509 | -$755 |
| Less Gains | $19 | $18 | $71 | $166 |
| add Impairments | $7 | $21 | $29 | $757 |
| add transition costs | $0 | $31 | $78 | $78 |
| add tax adj. | $0 | $1 | $1 | $25 |
| Adj. Income | $197 | -$69 | $546 | -$61 |

Obviously, depreciation is a sizeable expense item as seen in the EBITDA table. The $757 million impairment in 2018 was largely the result of moving the Maersk Supply Service business back from discontinued operations to continuing in 2018 when the company decided it was not getting it sold in the near future. 2018 impairments also arose from closing container factories in China and Chile of $206 million and another business line for dealing with onerous contracts for tug vessels for $190 million. In total, we think Maersk is reserved for this type of issue at this point. It has an accrual of $1.0 billion for legal disputes and onerous contracts. Those issues may be getting smaller at this point as contracts expire and some of that reserve may be reversed back to income going forward.

We would point out that transition/restructuring charges are actually fairly low following a $4.4 billion acquisition at only $78 million for two years. It is also worth noting that income in 2018 benefitted by the dividends on Total stock of $239 million offsetting financing costs.

## Pensions, Debt, Leases

In the case of pensions – we see more conservatism. Maersk is overfunded on its pensions in total and is calculating the obligation with a 1.9% discount rate.

We addressed debt above, even adding the leases in as debt – Net Debt to EBITDA is 2.0x. Maturities are between $0.6-$1.0 billion for bonds and bank debt per year through 2023. The company has $9.2 billion in cash and liquidity.

Leases are largely related to the fleet. It has 307 vessels that it owns and 401 on lease. In general, many of the containership leases are multi-year in duration. In the last several years, the charter rates have been weaker than levels seen prior to 2008. This has been a combination of a growing supply of containerships with slow

economic growth from 2009-16 around the world. Then there has been increased concerns on tariffs and now COVID. The result has been a game of chicken between the operating companies and the landlords of these ships. Maersk wants to lock in longer-term leases at the lower charter rates. The landlords want to book shorter-term leases when rates are lower or get some degree of higher rates if the new lease is set for a longer-term. Often, the lease is a flat rate regardless of what Maersk earns by operating the ship. So, if freight rates rise, it's a windfall for Maersk. If they weaken, the landlord still gets paid a fixed lease.

About 12%-15% of leases roll over each year, in the current market there may be a chance to roll over some leases for a longer-term at favorable rates and help Maersk's earnings. Eventually, if demand strengthens for more trade – the rates could rise and that could become a headwind for Maersk. There are also scrubbers that are being added to some of the existing fleet – so they can burn historically cheaper high-sulfur fuel. While those investments are added, some of the fleet is idle and that helps the landlord push for higher lease rates too.

We just want to point out that many of the high-cost leases from 10+ years ago are now gone and the current market has seen more weak years than strong ones for leases rates. There are many variables, but it is possible Maersk sees higher lease costs over time than falling lease costs.

# Explanation of EQ Rating Scale

| Rating | Explanation |
| --- | --- |
| 6- "Exceptionally Strong" | Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises |
| 5- "Strong" | Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods. |
| 4- "Acceptable" | Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement |
| 3- "Minor Concern" | Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future. |
| 2- "Weak" | Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears. |
| 1- "Strong Concerns" | Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely. |

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

**Key Points to Understand About the EQ Score**

**The EQ Review Rating is much more than a blind, quantitative scoring method**. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

**The EQ Review Rating is not comparable to a traditional buy/sell rating**. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

# Disclosure

*Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.*

*The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.*

*This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.*

*Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.*