Shipping sector on choppy waters following the Covid-19 impact on global trade and supply chain; tanker market likely to buck the trend in the near term

March 2020

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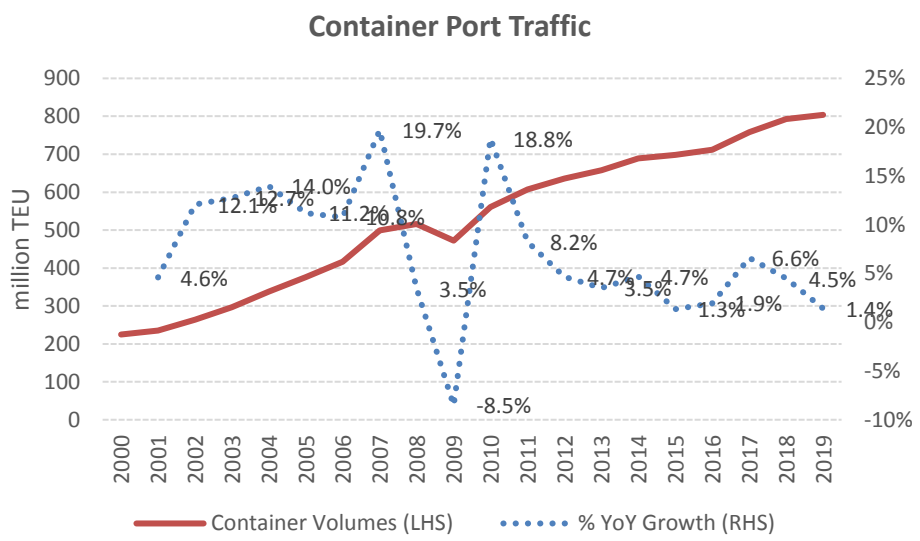
Global container traffic witnessed sharp slowdown in CY2019 and is expected to remain subdued in the near term

Growth in global container traffic slowed down in CY2019. Outlook subdued in the near term

EXHIBIT 1: Global container port traffic



Source: UNCTAD, Industry data and ICRA research

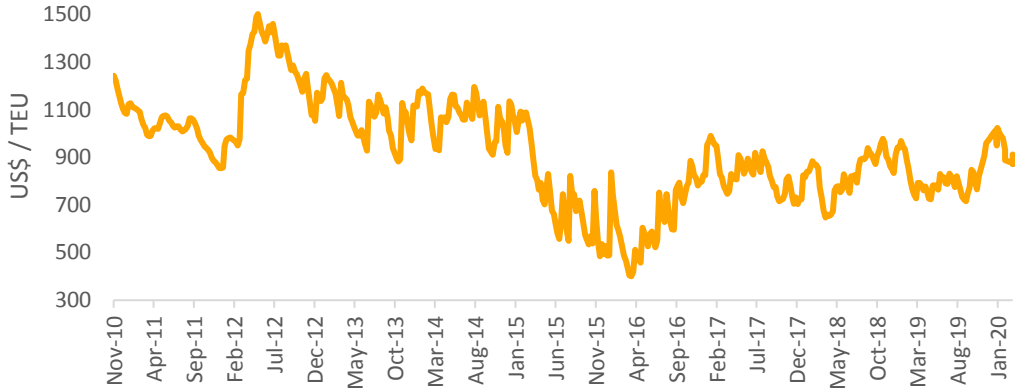
The global container traffic grew at a robust pace clocking two-digit growth rates almost each year during 2000-2007. In 2008, following the beginning of the financial global crisis, the growth rate for container traffic moderated to 3% (YoY) before sharply dropping by 9% in 2009. While there has been a recovery seen from 2010 onwards, the growth in container traffic has been at a moderate CAGR of ~4.4% for the 8-year period from 2010 to 2018, which is significantly lower than the growth of 12% registered during 2000-2007 period, prior to the global financial crisis.

With the early signs of recovery in the global economy in 2010 where global container traffic rebounded by ~19% (YoY), the major container shipping lines started ordering for large-size container ships. However, the traffic growth witnessed a slowdown subsequently and the growth moderated to ~1-2% during 2015 and 2016. There was some recovery in CY2017, when traffic increased by ~6.6% but again moderated to ~4.4% in CY2018. The growth in CY2019 declined significantly with a modest growth of 1.4% on the back of weak global trade environment during the year due to factors like cyclical slowdown in global economy as well as specific factors like the US-China trade issues.

Due to the subdued demand in recent years and the continued increase in fleet, the industry found itself to be in a state of oversupply, thereby impacting the freight rates as seen from Exhibit 2. The freight rates had witnessed significant moderation to $400/TEU in March 2016 but witnessed recovery subsequently to ~$1000/TEU by March 2017, but has remained volatile since then, being in the range of $700-1000/TEU. During CY2019, the rates remained subdued at ~$700-800 /TEU level between March to October, but witnessed some recovery and touched around $1000/TEU during the last quarter. However, the rates have again witnessed moderation in the first three months of CY2020 due to continued weakness in demand and the impact of the Covid-19 outbreak.

Recovery in rates will be dependent on revival in volumes, post stabilisation of Covid-19 impact on global economy

EXHIBIT 2: Trend in container freight rates (Shanghai Containerised Freight Index)



Source: Shanghai Shipping Exchange, ICRA research

The order-booking of container vessels witnessed a spike in 2015 (i.e. 2.3 million TEU[1]), the highest since 2008 crisis, but in subsequent years, the order booking witnessed some moderation to ~0.7 million TEU in 2016 and ~0.27 million TEU in 2017. There was some recovery in orders in CY2018 to 1.3 million TEUs, which was attributed to some recovery in global demand and the fact that new orders were lower in the preceding years. However, the order booking has been slower since Q4 CY2018 and has been moderate at ~0.7 million TEU during 9m CY2019. The global fleet has grown at a CAGR of 5% during CY2014-CY2018 and based on 9m CY2019 trends, the growth in CY2019 is expected to be similar. However, even though the capacity growth has exceeded the demand growth in recent years, the impact on freight rates has not been as severe as seen in CY2016, when the rates were severely impacted by other factors like steep moderation in bunker prices and the idling rates were high at ~6-7%. The idling of vessels has been in the range of 2-3% in 9m CY2019 compared to ~1-2% in CY2018, which have been lower compared to earlier levels, indicating better absorption of capacity. The uptick in idle capacity in CY2019 has been mainly on account of needs to retrofit vessels with scrubbers to meet the IMO requirement. Further, the order book-to-fleet ratio has moderated from ~20% as on March 2015 to ~11% in September 2019. While, this is a positive for the sector, the near-term outlook remains negative for container shipping due to the impact of the Covid-19 outbreak on the global economy and trade and the resultant impact on global container trade. While, there has been significant disruption in container transport during Q1 CY2020 due to the lockdown and contraction of economic activity in China, with the impact of Covid-19 currently evolving and several major economies going for a shutdown as preventive measures, the container trade over the next three to six months is expected to be subdued.

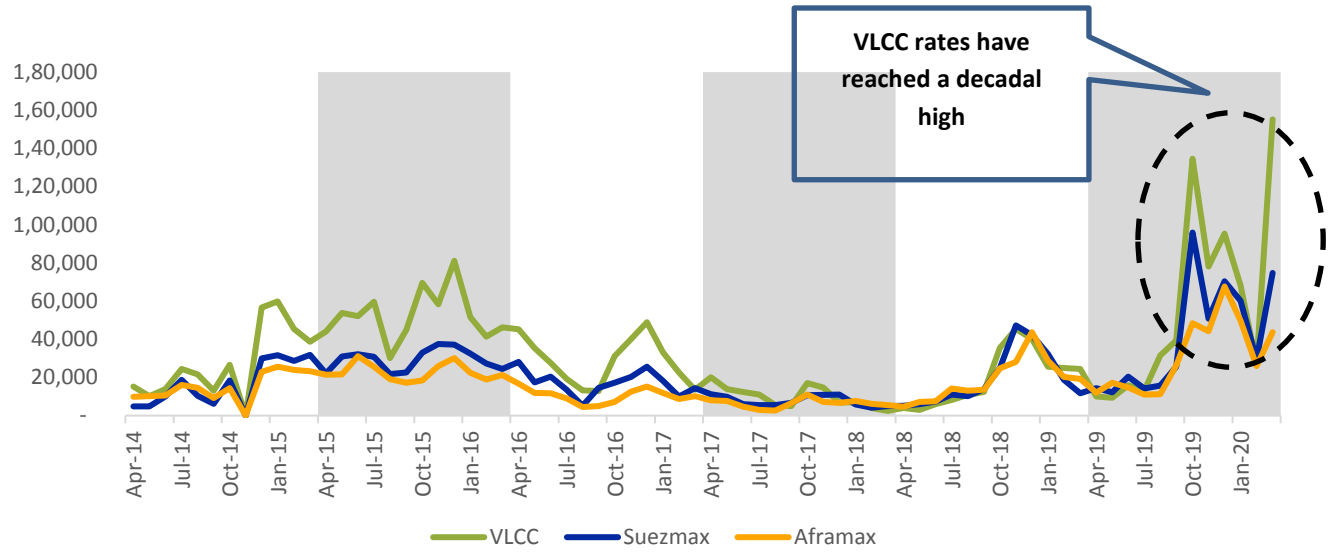
[1] TEU: twenty-foot equivalent unit is the unit used to describe the capacity of container ships and container terminals

Tanker rates have seen large volatility due to impact of IMO 2020 and oil price dynamics

Tanker charter rates have touched decadal high in March 2020

Crude tanker charter rates witnessed a sharp recovery during CY2019 after witnessing steep decline during 2017 and early 2018. The growth in CY2019 accelerated during Q4, reaching the highest level not seen in the last 10 years, driven by several factors, as shown in Exhibit 3.

EXHIBIT 3: Trend in crude tanker charter rates ($/day)



Source: Industry, ICRA research

Charter rates have been very volatile in the last few years due to oil industry trends and supply situation in the segment

The charter rates for tankers, especially for VLCC had been on a declining trend since CY2016 and touched about US$3,000 / day by March 2018, far below the break-even levels estimated for most vessels. The receding rates were driven by the high order-booking by the shipping companies in the prior years when VLCC rates were above US$50,000 / day in 2015. The deliveries increased during CY2016 and CY2017, while scrapping remained moderate during this period. The fleet growth in CY2018 was, however, modest at 0.7% due to lower deliveries and increased scrapping. The deliveries during 9m CY2019 was higher, while scrapping remained moderate. However, the order book-to-fleet ratio has moderated from ~13% in the last few years to ~9%, during this period, which led to some recovery in rates and VLCC rates touched around $45000/ day in November 2018, driven by a gradual absorption of capacity, but again witnessed moderation in the subsequent months and declined to ~$9000/day by May 2019, mainly on the back of weak demand, lower refinery margins, economic slowdown and maintenance undertaken by refineries prior to the IMO 2020 regulations kicking in. However. on a YoY basis, the rates were still better as they were supported by trade dynamics of increased export of oil from the US, which resulted in higher tonnes miles for crude tankers.

High rates are expected to support tanker segment profitability in the near term, but they remain susceptible to oil industry dynamics and sustainability remains to be seen

The rates again witnessed recovery between June to Sep 2019 and increased to ~$39000/day despite the global oil trade remaining subdued and the attack on the Saudi Aramco field. However, the rates spiked to ~$134000/day in the month of October 2019 and has remained in the range of $78-85000/day for the next two months. The steep spike in rates during Q4 CY2019, despite an increase in deliveries and low scrapping was driven by several factors, including sanctions on companies like Cosco Shipping and other Iranian tankers, which resulted in a moderation in available supply, which, coupled with expectation of increase in demand due to IMO 2020 regulations, drove up the prices. Subsequently, there was some moderation in rates as the demand spike for low sulphur fuel was not as high as expected and there was relaxation of sanctions on Chinese vessels. However, in March 2020, the rates once again increased steeply to ~$1,55,205/day, especially for VLCC, which is at a decadal high. This has happened in the wake of the decline in crude oil prices, following the lack of OPEC plus agreement around production cuts, and buyers trying to take advantage of the same, which resulted in suppliers trying to secure more vessels to supply crude from the Middle East. Further, with oil futures markets in a contango structure, wherein the spot prices are much lower compared to far away months, there is also an increasing demand for use of tankers as floating storage, whereas the supply of tankers for storage purpose is low, which will also aid in higher prices in the near term. Moreover, sustainability of the current high rates in the wake of the sustained slowdown in global demand for oil and further reduction in prices, remains to be seen. The situation is expected to remain volatile in the near term for the tanker segment.

Dry bulk segment witnesses volatility due to US-China trade disputes in CY2019; outlook negative due to impact of Covid-19

Charter rates in the dry bulk segment have been volatile in CY2019 due to US-China trade issues and disruptions in iron ore trade from Brazil

The dry bulk segment had witnessed significant impact, post the financial crisis in 2008 and the Baltic Dry Index declined steeply by more than 90%, in few months during 2008 due to impact of global financial crisis. Subsequently, there was some recovery but from mid-2010, the rates again witnessed a moderation due to over supply and demand slowdown, resulting in a moderation till March 2012, witnessing a decline of ~80% during the period. After remaining subdued following some volatility till H1 2013, the rates again witnessed a traction and increased by ~129% till the end of the year on the back of some improvement in demand. The trend was nevertheless, short-lived and rates contracted and reached an all-time low just below 300 points in February 2016. However, driven by the recovery in commodity prices and the pick-up in iron ore demand from China, the rates witnessed some recovery till August 2018. But there was again a trend reversion and the index witnessed a steep decline to ~665 in March 2019, on the back of a subdued trade. This was followed by a steep recovery during the next six months, with the index touching 2255 by Sep 2019 due to improved demand from the Chinese steel industry but witnessed a decline again during Q4 CY2019 due to the general economic slowdown, trade issues between the US and China and the disruption in iron ore trade from Brazil. The rates have further moderated in Q1 CY2020 due to the impact of Covid-19 on China and the general global trade and Baltic Capesize Index turned negative for the first time

Rates have witnessed a steep decline in Q1 CY20 due to the Covid-19 impact. The Baltic Capesize index turned negative for the first time

EXHIBIT 5: Trend in Baltic Dry Index

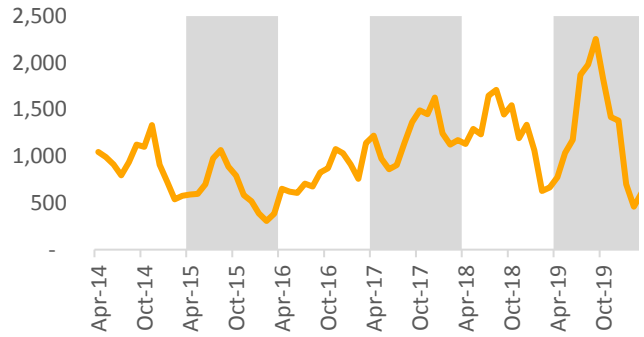
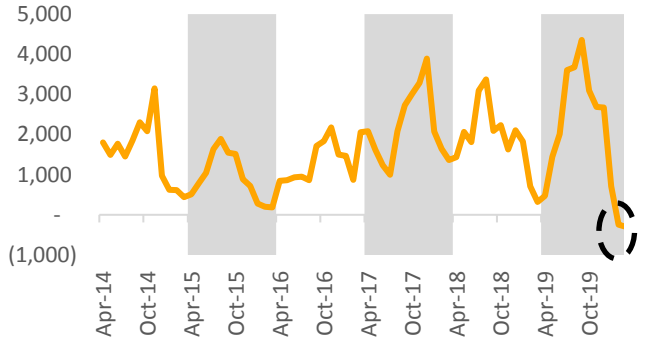


EXHIBIT 6: Trend in Baltic Capesize Index



Source: Industry, ICRA research

While the Indian shipping companies involved in international trade largely follow the global trend, the coastal segment (including containers and product tankers) witnessed healthy growth in the last few years, due to the Government's focus on increasing coastal shipping's share among India's transport. To support this, the Government of India (GoI) had offered several incentives like lower GST on bunker fuel, discount on vessel-related charges, introduction of green channel clearance at major ports, and investment for improved port infrastructure at ports for coastal cargo. The major cargo handled by coastal shipping are coal, iron ore, containers, cement, iron & steel and POL. The Government had also relaxed the cabotage rule in May 2018 to allow foreign flagged vessels to carry coastal cargo. In FY2019, the total cargo on the coastal route was 120 MTPA, accounting for ~6% of the cargo traffic at ports, which grew at a CAGR of 11% in the last two years.

Outlook for dry bulk segment remains negative in the near term, recovery will be dependent on revival of global trade and economic activity in China

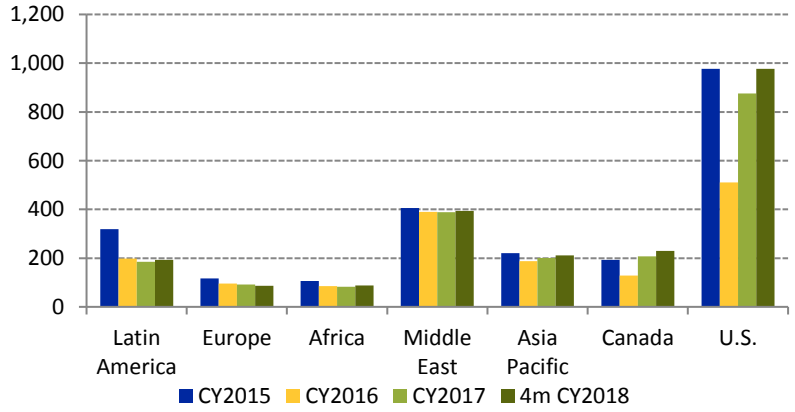
The outlook for the dry -bulk segment remains negative in the near term due to the adverse impact of Covid-19 on global industrial production and trade, due to the lockdown and quarantine adopted as mitigation measures by major global economies and the situation is still evolving. Further, on the supply front, the dry bulk segment has continued to witness order booking in the last few years, with the order book-to-fleet ratio of ~9-10%, whereas the scrapping rate has moderated in the last two years. Further, fleet additions during the subdued demand environment will be negative for the sector, however, any traction in scrapping during the lean period may be beneficial, once the demand recovery commences. Any recovery in demand and rates for dry bulk segment will be contingent on the recovery of global economic activity and trade, post stabilisation of the Covid-19 impact, especially in China, which has been the major driver of global dry bulk trade. The pace of recovery for the segment will also be influenced by any changes in global supply chains and trade pattern during the economic recovery phase, if countries decide to diversify the high concentration in China. The impact on the coastal shipping segment may be mitigated to an extent due to the nature of the cargo involved like coal, POL etc, which are essential in nature; however, given the contraction in industrial production expected in India due to the shutdown being undertaken - the coastal segment will also be impacted in the near term. Further, the increased competition from international players, post cabotage relaxation, may also add to the pressure on the domestic coastal shipping entities.

Some recovery witnessed in offshore segment during CY2019; however, the steep drop in crude prices is negative for the sector

E&P activity is expected to remain subdued in the next six months and one year, which will have an adverse impact on demand for offshore vessels

The offshore segment was badly hit with the fall in the crude prices back in 2015 that led to a decline in exploration & production (E&P) activities globally. The segment has continued to underperform since then as low oil prices for large periods have discouraged any meaningful uptick in the E&P activities. The global E&P activity had continued to moderate between 2014 to 2018, from ~$295 billion to $113 billion, however, the E&P spend has been flattish in 2019. Nonetheless, there has been some improvement in the utilization of assets in the offshore segment. While, there has been pick-up in jack up rigs market in the last few years (as can be seen in Exhibit 6), the OSV utilization has also witnessed an improvement in the last one year, although at a low base. This has also resulted in some improvement in the pricing of these segments. However, there is still a lot of idling in the PSV and the AHTSV segment, which continue to operate mainly on the spot market. The improvement witnessed in the recent period was on the back of improved demand in the Middle East and also in some Asian countries, including India. The improvement in utilization and pricing was also supported by increased scrapping, which had improved the supply position. Further a high percentage of rigs which are more than 25 years old. Additionally, slippages in deliveries for offshore vessels are expected to continue and hence the supply situation is expected to witness a gradual improvement in the rigs and the OSV segment. Despite the positive trend witnessed in the last one year, the near-term outlook has turned negative for the sector in the wake of the coronavirus-induced disruption and steep correction in crude prices, following the lack of agreement in the OPEC+ around the production cuts. Due to these factors, the E&P activity is expected to remain subdued in the next six months and one year, which will have an adverse impact on the demand for offshore vessels. In the medium to long term, sustained correction in supply and increase in E&P activity will be the drivers for improvement in this segment.

EXHIBIT 7: Trend in rig count across different geographies



Source: Industry, ICRA research

Stricter regulations imposed on shipping companies and subdued rates may lead to higher scrapping

High capex requirements for retrofitting of vessels and subdued rates may lead to higher scrapping of old vessels

While, the scrapping rate had been moderate and volatile in the last few years, as can be seen in the Exhibit, stricter norms on shipping in the form of requirement for ballast water treatment system and installation for scrubbers as per the IMO 2020 norms are expected to result in increased cost for shipping companies for retrofitting. Due to these regulations, shippers may decide to scrap older vessels, instead of retrofitting them and this may lead to a much-needed supply correction. Further, with further stringent regulations by IMO expected to be put in place by 2030, there might also be some slowdown in the new orders, unless there is substantial improvement in economic activity and demand. While the scrapping rates remained modest in CY2019, the same may accelerate in the dry bulk segment during CY2020, given the impact of Covid-19 and the subdued outlook, which may result in a longer payback period for any retrofitting capex.

EXHIBIT 7: Scrapping trends

% of fleet	CY2014	CY2015	CY2016	CY2017	CY2018	CY2019
Crude Tanker	1.60%	0.23%	0.35%	2.35%	4.62%	0.61%
Product Tanker	1.19%	0.61%	0.62%	1.42%	1.64%	0.43%
Dry Bulk	2.25%	4.03%	3.67%	1.77%	0.54%	0.92%

Source: Industry, ICRA research

Ballast Water Management Convention - Invasive aquatic species present a major threat to the marine ecosystems, and shipping has been identified as a major pathway for introducing the species to the new environments. The Ballast Water Management Convention (BWM), adopted in 2004 and implemented by the International Maritime Organisation (IMO), aims to prevent the spread of harmful aquatic organisms from one region to another, by establishing standards and procedures for the management and control of ships' ballast water and sediments. The convention has been made effective from September 8, 2017. The ballast water management standards have been phased in over a period of 1-2 years and have been laid out categorically for both old and new ships and had to be adopted by September 2019. However, the actual adoption has been around 25-30% by this time as many shippers had renewed their IOPP[2] certificate, prior to adoption of the standard in 2017, which has provided them time till 2022 and retrofitting is expected to be staggered during this period.

Limit on sulphur content in fuel oil - In 2008, IMO set a global limit for sulphur content in the fuel oil used on board ships at 0.5% m/m (mass by mass) to be effective from January 1, 2020. The new limit is significantly lower than the erstwhile limit of 3.5% m/m, which has been in effect since January 1, 2012. This regulation is expected to significantly reduce the amount of sulphur oxide emanating from ships. To meet the requirement, ships can use low sulphur-compliant fuel oil or gas as a fuel. Ships may also meet the SOx emission requirements by using approved equivalent methods, such as exhaust gas cleaning systems or “scrubbers,” which clean the emissions before they are released into the atmosphere. In this case, the equivalent arrangement must be approved by the ship’s administration (the flag state).

2

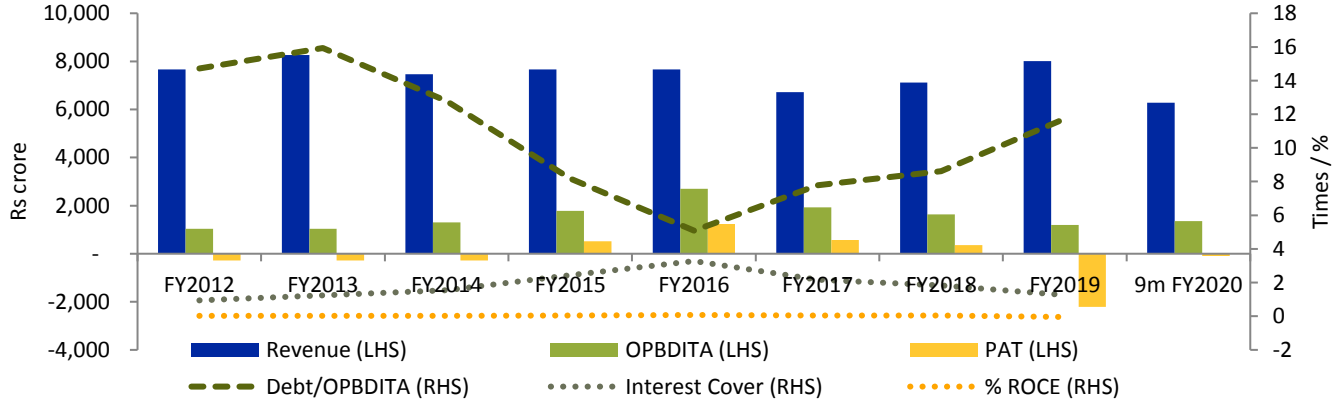
Financial performance of Indian shipping entities under pressure; mitigation likely for impact on companies with high exposure to tanker segment

Profitability and credit metrics of domestic shipping industry weakened in FY2019

Performance of the Indian shipping companies has not been shielded from the volatility seen in the international markets. The financial numbers of the shipping entities started deteriorating post the 2008 financial crisis, before significantly weakening during the 2012-2014 period. In the meantime, the leading shipping entities enhanced their fleet through acquisition of vessels, expecting a healthy uptick in shipping volumes. This in turn led to an increase in their debt levels and thus weakening of the coverage indicators and return indicators. The improvement in the tanker rates in the subsequent years, i.e. FY2015 and FY2016, saw a healthy recovery in profitability levels for Indian shipping entities, given that the leading shipping companies in India have a high proportion of tankers in their fleet. The increase in operating profits coupled with the reducing debt levels, as the companies had slowed down on further vessel acquisitions, improved the overall debt coverage metrics. However, the improvement in the financial profiles of most of the domestic shipping entities was short-lived following the decline in tanker rates that led to significant erosion in net margins in FY2018. The performance in FY2019 also remained subdued with the industry reporting losses, on the back of subdued tanker rates and a steep decline in BDI during H2 FY2019. The return on capital employed (RoCE) continues to remain low, partly tempered by low cost of dollar-denominated debt. The trend during 9m FY2020 has been volatile with the industry reporting losses during H1 FY2020 due to sustained weakness in tanker rates, although there was some recovery in dry bulk rates, however, the performance during Q3 FY2020 witnessed improvement on the back of a steep recovery in tanker rates, partly offset by moderation in the dry bulk segment.

Performance in 9m FY2020 also remained subdued, but witnessed some recovery in Q3 due to spike in tanker rates

EXHIBIT 8: Annual trend in aggregate[3] financial performance of domestic shipping entities



Source: ICRA Research, Annual Reports

[3] Aggregate financials include the financials of six listed entities, viz. Shipping Corporation of India Limited, Great Eastern Shipping Company Limited, Mercator Limited, Chowgule Steamships Limited, Shreyas Shipping Limited and Essar Shipping Limited

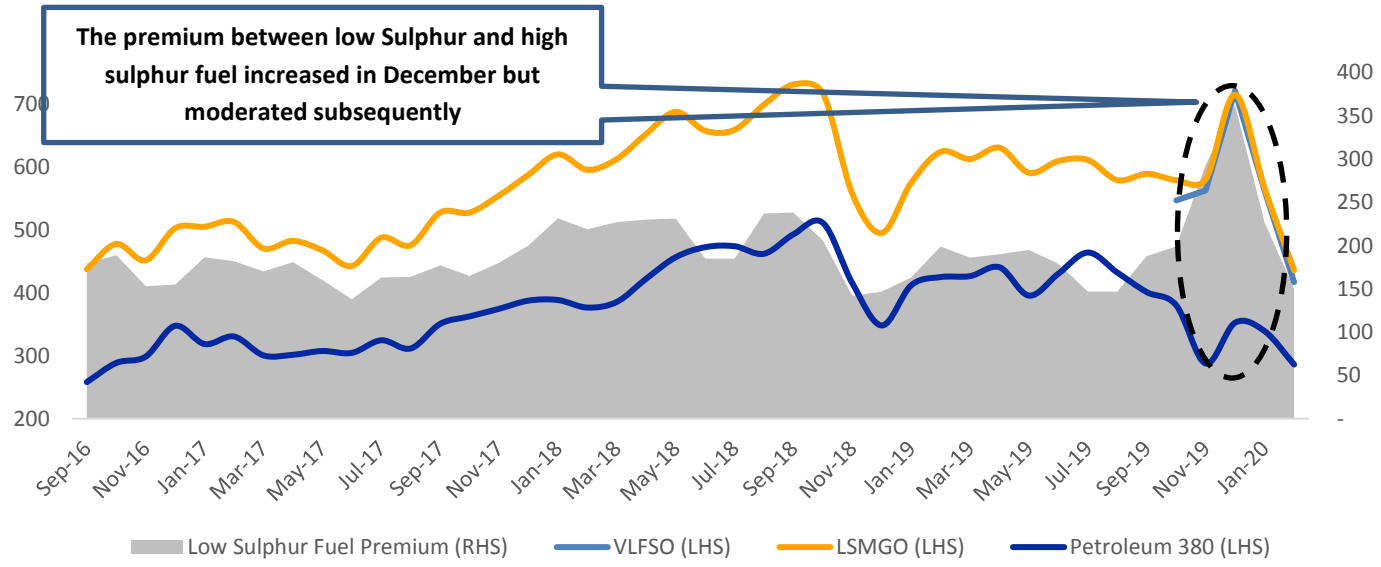
Outlook for the sector remains negative in the near term due to the impact of Covid-19, however, the impact may be mitigated for companies with large tanker fleet

The credit profile of most domestic shipping companies would continue to be stretched over the near term until there is sustainable recovery in rates. Further, the funding requirements may also increase for the leading shipping entities to meet the capex requirements so as to comply with the new regulations, apart from planned regular new additions to their fleet. However, many companies have deferred the upfront capex, opting for the use of low sulphur fuel. However, this will have an adverse impact on the operating cost due to higher prices of low sulphur fuel. But, the recent decline in oil prices should mitigate the impact on operating cost to some extent. Given the current subdued economic environment, the impact of higher fuel prices will be borne by the dry bulk and liner segment as they will not be able to pass on the cost in a low rate environment, however, for the tanker segment at the current rates, they will continue to be profitable despite the higher fuel costs.

The outlook for the shipping sector remains negative for the near term, due to the impact of the Covid-19 outbreak on the global economy and the current uncertainty with regard to the length of the outbreak and impact of the measures taken by Governments to contain the same. The companies with high exposure to dry bulk, container vessels and off-shore vessels will be adversely impacted, while companies with higher exposure to the tanker segment may do relatively better at current rates. However, the sustainability of tanker rates also remains a concern, given the dynamic nature of the oil and gas sector.

The premium between low sulphur and high sulphur fuel increased in December 2019 but subsequently moderated

EXHIBIT 8: Bunker price trend and premium between low and high sulphur fuel ($/Ton)



Source: Bloomberg, ICRA research

CONCLUSION

ICRA expects the challenging environment in the shipping sector to persist over the near term, following the adverse impact of the Covid-19 outbreak, which continues to evolve. The outbreak has led to a slowdown in the global economy and trade, with major economies like China, a major driver for the shipping industry, facing extended shutdown and other countries also adopting shutdowns as a measure to combat the impact, which is expected to result in major contraction/slowdown in the global economy, at least in the next three to eight months. This apart, the dynamics of the global oil and gas industry has also added to volatility in the tanker segment. Subsequently, during the recovery phase, the improvement in shipping sectors will be dependent on the pace of recovery in the major economies and changes in trade patterns and the supply chain implemented during the recovery phase. Recovery in the shipping sector, will also be dependent on the supply of vessels, which may witness additional scrapping in some segments, which might bring in some rationalisation in the demand-supply mismatch. The operational performance also remains vulnerable to fuel price fluctuations and any steep increase in prices, during subdued charter rates, will add to the adverse financial performance of the shipping sector. Companies which are highly leveraged, will be under pressure during the period, although the impact may be mitigated for companies with a higher share of tankers in their fleet

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