Record low Baltic dry rates and bankruptcies cast shadow over dry bulk cargo market

by Dexter Tan

Last week, the Baltic Dry Index (BDI), which measures the cost of shipping dry bulk commodities such as iron ore, grain, coal and finished steel, dropped to a record low. The dry bulk shipping industry is witnessing its worst downturn in 30 years on the back of a slowing Chinese economy and an oversupply of ships. Extremely low freight rates are making it difficult for companies to operate at a profit. Dry bulk carriers are more willing to idle their ships than take on cargoes with negative time charter earnings. At least three dry shippers have filed for bankruptcy protection this month. On Feb 11, South Korea's Daebo International applied for court receivership and on Feb 12 China's Winland Ocean Shipping Corp filed for bankruptcy. A privately owned Danish company Copenship also filed for insolvency in Copenhagen in early February. Copenship operated over 50 bulk vessels and was one of the world's leading dry bulk shipping firms. RMI previously noted the downward trends in the broader shipping industry and it appears that the dry bulk sub-sector is struggling in a tough business environment overwhelmed by overcapacity and very low charter rates.

The RMI aggregate 1-year probability of default (RMI aggregate 1-year PD) for twenty global listed dry bulk carriers has been increasing in recent months, as a reflection of the abovementioned problems (see Figure 1). RMI aggregate 1-year PD was below 10bps at the start of last year, but the companies' credit quality gradually worsened through the second half of 2014, rising to as high as 29bps in December. During the same period, the BDI declined from 2277 to 782, and dropped further to 509 on Feb 18. The index is reported by the Baltic Exchange and is a compilation of daily charter rates from its ship broker members. The Baltic Exchange calculates the BDI according to the spot time charter weighted average of four vessel classes – Capesize, Panamax, Supramax and Handysize.

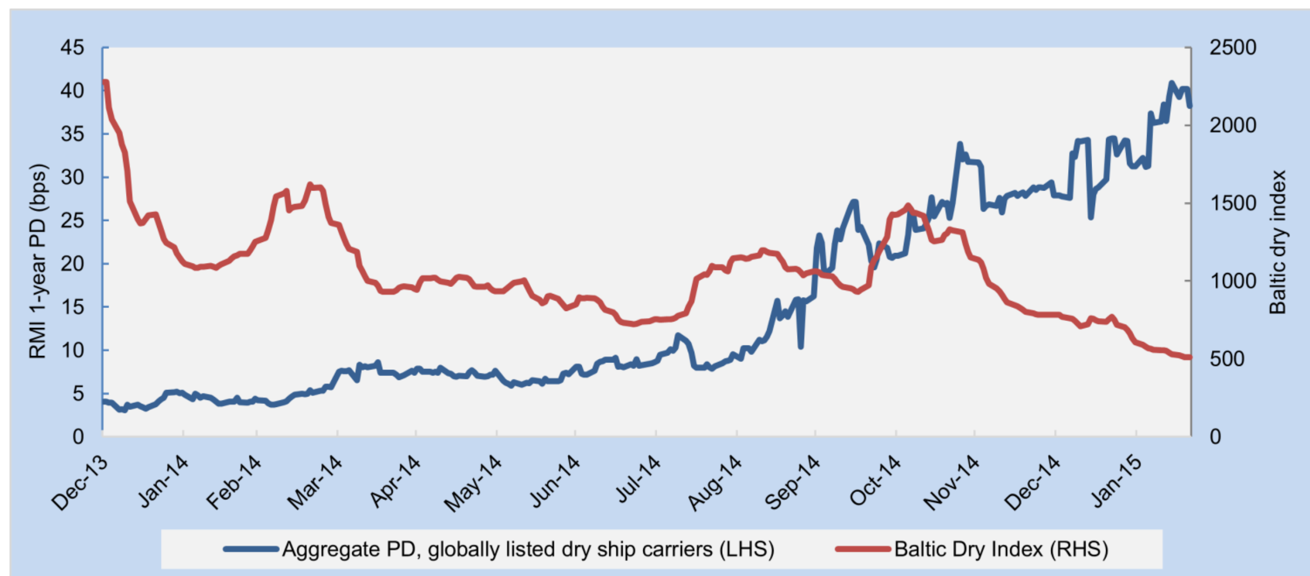

Figure 1. RMI aggregate 1-year PDs of listed dry bulk carriers vs. the Baltic Dry Index. *Source: Risk Management Institute, Bloomberg*

As shown in Table 1, RMI distance-to-default (RMI DTD) values for dry bulk shippers have declined through 2014, in tandem with a falling market cap. RMI DTD is a volatility adjusted measure of leverage, with a lower DTD indicating higher potential insolvency. The aggregate market value of dry bulk carriers decreased 37% as earnings continued to fall. Profitability, measured by median net profits / total assets, fell sharply in Q3 and Q4 to -1.29% and -2.11% respectively. Given the capital intensive nature of the dry cargo shipping industry, this ratio is a good indicator of the firm's ability to generate a meaningful return on its assets. The profitability of the firms would depend on factors including the efficiency of its vessel management and quality of maintenance. Asset turnover ratio, a measure of the companies' utilization of assets, declined from 11.7% to 10.8% during 1H 2014. More ships were left idle as demand for dry bulk cargo shipping fell.

As of	Total market cap (USD mn)	Median DTD	Median NI/TA (RMI adjusted)	Median Cash/TA (RMI adjusted)	Asset turnover	Fleet size	Net debt / EBITDA	Retained cash flow / Net debt
12/30/2013	13080	4.09	-0.17%	13.5%	11.7%	737	5.62	0.70
3/30/2014	12237	3.55	0.10%	10.4%				
6/30/2014	11751	3.19	-0.01%	11.3%	10.8%	676	9.13	0.21
9/30/2014	10993	2.70	-1.29%	11.1%				
12/30/2014	8184	2.52	-2.11%	10.0%	N.A.	N.A.	N.A.	N.A.

Table 1. Pro-forma financials and RMI credit risk metrics of 20 listed dry bulk carriers. Fleet size is computed based on 12 companies. The firms were selected based on their major revenue source, which should primarily (>50%) be in dry bulk shipping. It would not include liner operators, liquid bulk carriers, diversified shipping firms and inland river barge service providers. Companies that did not disclose their revenue streams would not be included in the rated universe. *Source: Risk Management Institute, Bloomberg, company reports.*

The fleet size of dry bulk carriers could be an indirect determinant of the industry's earnings and credit profile. Firms with more vessels are able to negotiate insurance costs and discounts on dry docking expenses. Generally, a larger fleet delivers economies of scale, higher cost efficiency and greater optimization of resources to maximize profit growth. As a result, bigger dry bulk carriers would be able to offer customers a more frequent and reliable delivery service. Smaller dry bulk carriers do not have the flexibility to adapt to shifts in trade and transportation patterns and are more vulnerable to volatile freight rates. Smaller vessel companies therefore could have higher credit risk. According to company reports, 12 listed shipping firms had a combined fleet size of 676 in June 2014, which is lower than the 737 vessel strength reported at the end of December 2013. The drop in fleet size coincides with an increase in the RMI aggregate 1-year PD during H2 2014.

The firm's vessel strength can also be a proxy of the firm's financial ability to obtain new capital. Secured funding is crucial to dry bulk carriers due to the asset heavy nature of the business. Since the 2008 financial crisis, firms have not been able to access unsecured funding easily without paying a high interest rate. In order to raise funds at reasonable costs, many shippers have used their fleets as collateral for new funding arrangements. Financial leverage for the industry has increased last year. The overall industry's ratio of net debt to EBITDA increased from 5.6x to 9.1x during 1H 2014, but its ability to repay principal on its outstanding debt has dropped. The ratio of retained cash flow to net debt decreased from 0.7x to 0.21x. In addition, liquidity for the sector has declined. The median cash to total assets ratio, an input to the PD model, has dropped from 13.5% to 11.3% between December 2013 and June 2014.

The overall credit deterioration in the dry bulk market can be attributed to a number of factors, some of which are linked to the shipments to China. Iron ore shipments, for instance, account for the largest share of overall dry bulk trade and are mainly shipped from Australia and Brazil. The largest Brazilian miner Vale has been expanding its own shipping fleet and cannibalizing demand for freight vessels by conducting freight transactions on its own instead of engaging dry bulk companies for transport. Additionally, China's seaborne imports of coal have contracted 10% in 2014, reversing the growth of 16% in 2013. China is attempting to solve its air pollution problems and it has reduced industrial coal consumption, curbed the construction of coal powered power plants and enforced the switch to natural gas powered plants which emit less carbon particles into the air.

The Baltic Dry index's sharp decline shows that there is a drop in demand and an oversupply of ships in the market. Even though the decline may coincide with lower energy prices, many dry bulk shippers are shutting their operations and the industry is consolidating. Even the world's five largest dry bulk cargo shippers are working together to fight the downturn. On Feb 10, shipping firms Golden Ocean, Bocimar International, CTM, Golden Union Shipping and Star Bulk Carriers announced a joint venture to help reduce costs and streamline operations. The joint venture is expected to reduce the number of intermediaries between the dry bulk cargo customers and the ship owners.

Credit News

Greek government unveils reform summary

Feb 24. The Greek government submitted a summary of its reforms to secure a bailout extension with its creditors. Based on a provisional agreement between Greece and its lenders, the approval of the reform measures is a condition for extending the availability of bailout funds for another four months. The current program, is scheduled to expire on Feb 28. The main points of the reforms include creating a fair tax system, combating tax evasion, tackling corruption, targeting fuel and tobacco smugglers, implementing labor reforms on collective contracts and bargaining agreements and guaranteeing housing and free medical care for the uninsured and unemployed. (BBC)

Malaysia's 1MDB says to rely on finance ministry for debt refinancing if needed

Feb 23. Malaysian state fund 1MDB said that the refinancing of its debt will involve the finance ministry "as relevant and as required" after media reported that the government may inject up to USD 823mn into the fund. 1MDB last week said it would explore asset sales and the sale of development rights in prime property projects as it seeks to cut its debt - an USD 11.6bn burden that has weighed on the ringgit and the country's sovereign credit rating. (Reuters)

Dark days turn darker for HSBC

Feb 23. With its public reputation already battered by a tax-evasion scandal at its Swiss private bank, HSBC reported a sharp drop in pre-tax profits that sent its shares tumbling. Stuart Gulliver has in the past few months been forced to abandon both the return on equity and cost-efficiency targets he set as part of his strategic plan for boosting the bank's performance after taking over as chief executive in 2011. (FT)

Fannie, Freddie weak earnings raise possibility of future bailouts

Feb 20. The delay in reforming the nation's housing-finance system, including Fannie Mae and Freddie Mac, is presenting policy makers with an uncomfortable reality: The terms of the bailout out of the mortgage-finance companies could eventually lead to the need for a new bailout. The concerns took on increased urgency late this week, as Fannie and Freddie reported sharply lower Q4 earnings. (WSJ)

Quicksilver Resources won't pay interest due on bonds (Bloomberg)

European blue chip bond yields slip into negative territory (Reuters)

JP Morgan tops list of risky banks (ChannelNewsAsia)

Regulatory Updates

Big banks face scrutiny over pricing of metals

Feb 23. At least 10 major banks are undergoing investigations by US officials because of possible rigging of precious-metals markets. Prosecutors in the Justice Department's antitrust division are scrutinizing the price-setting process for gold, silver, platinum and palladium in London, while the Commodity Futures Trading Commission has opened a civil investigation. The agencies have made initial requests for information, including a subpoena from the CFTC to HSBC Holdings PLC related to precious-metals trading. (WSJ)

Looming bank rules haunt insurers

Feb 22. Big US insurance firms may face rules similar to total-loss absorption capacity requirements proposed for banks last year. The basic idea is to make the failure of financial firms less costly for taxpayers. The banks are suggested to have loss-absorbing capacity of 16% to 20% of risk-weighted assets, comprised of regulatory capital plus long-term unsecured debt. However, applying a bank like rule would trigger a big shift in insurers' balance sheets. Investors should be reminded that regulation still poses unpredictable risks. (Bloomberg)

FCA to investigate competition in investment and corporate banking services following review of wholesale

Feb 19. The Financial Conduct Authority (FCA) announced plans to launch its first wholesale market study into investment and corporate banking to assess whether competition in the sector is working properly. FCA has published a review into competition in the wholesale sector before. The review found that limited clarity over price and quality of services may make it difficult for clients to assess whether they are getting value for money, and that the bundling and cross selling of services could make it difficult for new entrants or smaller established firms to challenge established large players in the market. (FCA)

China's big banks sidestep 'too big to fail' capital buffers (FT)

UBS and Credit Suisse face tougher capital demands (FT)

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