High leverage exposes shipping companies to weak market conditions

by Liu Yuan

As the main engine of the global trade, the shipping industry is facing headwinds due to falling demand amid the COVID-19 crisis. Particularly, the steep decline of volumes that shipping companies are facing causes a potential of USD 23bn losses, which could result in a cash flow crunch for this sector's companies. Measured by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD), the credit risk for listed companies in the shipping industry reached at one point in March its highest since 2009, before slightly decreasing to around 45bps. Despite this, the industry's credit risk remains higher compared to its pre-pandemic level due to the unfavourable global macroeconomic conditions and its highly leveraged nature.

Figure 1: NUS-CRI Aggregate 1-year Probability of Default (Agg PD) for listed companies in the shipping industry bounded by PDiR 2.0[1]. *Source: NUS-CRI*

Due to its business nature, the shipping industry has a high operating leverage. While this might be advantageous during a period of economic expansion, it could also be detrimental during a period of economic slowdown. Therefore, many shipping companies have responded by cutting capacity to reduce costs. Captured by Net Debt/EBITDA in Figure 2a, the shipping industry's leverage remains elevated at a level of 3.6 in 2019. This high leverage increases the credit risk for shipping firms during a period of economic downturn as it can cause debt repayment and refinancing problems. Figure 2b shows around USD 6bn of debt maturing this year and more debts will mature in the upcoming 5 years. Considering the current level of high leverage and depressed revenues, the shipping industry might face a further increase in default risk if they fail to roll over the existing obligations.

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

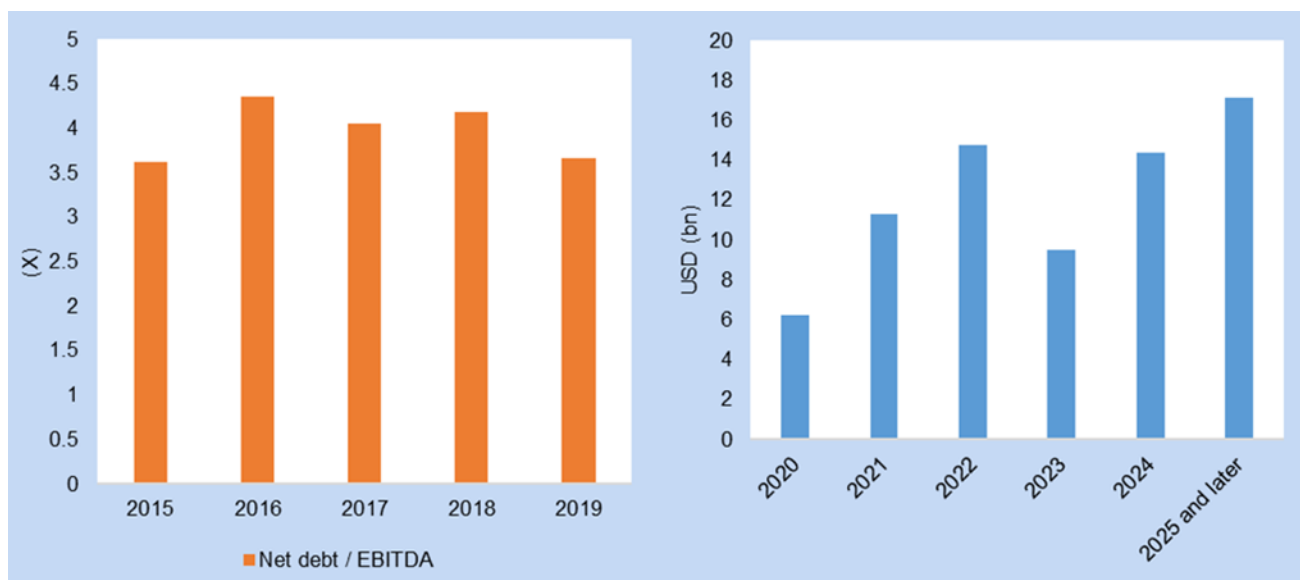

Figure 2a (LHS) & 2b (RHS): Industry median Net debt/EBITDA for companies in shipping industry (LHS) and the maturity of debts issued by companies in the shipping industry (RHS). *Source: Bloomberg*

COVID-19 hit the shipping industry in a time when it already had to face several other challenges. For the past years, the shipping industry has struggled with oversupply and unsustainably low freight rates, reaching its biggest one-day percentage decline of the Baltic Exchange Dry Index, an indicator for the general shipping market, in 6 years in Jun 2020 due to depressing demand for dry bulk vessel segments. Furthermore, since 2018, the trade war between the US and China caused disruptions of supply chains, which affected an estimated 2% of the world maritime trade volume. Since the beginning of this year, a new regulation of the International Maritime Organization on sulphur fuel limits also came into force, increasing shipping costs. All these circumstances already negatively affected the condition of shipping companies at the start of 2020 before COVID-19 impacted the whole economy.

Nevertheless, the industry's credit profile was able to improve within the last two months. As global markets appear to be recovering, driven by rally in the equity markets[2], liquidity injections by central banks and improving bond markets, the credit risk of the shipping industry decreased as well. To face the COVID-19 crisis, several governments provided financial support for some shipping companies. For example, South Korea's HMM got USD 600mn from state entities, Taiwan announced a USD 1bn credit facility to support big container operators and CMA CGM, the world's fourth largest liner, secured a EUR 1.05bn loan, with the French state guaranteeing 70% of it. Moreover, Singapore, one of the world's most important maritime centres, implemented a COVID-19 package to relieve the financial pressure of the maritime industry. To ensure smooth operations of the maritime transport, UK exempted seafarers, offshore and maritime workers from the 14-day quarantine rule during the lock-down period. Lastly, port authorities in several countries signed an agreement to keep ports open for trade amid COVID-19 to secure an unimpeded maritime trade where possible.

Looking into the future, even under strong supports from governments, credit risk for the shipping industry could still deteriorate. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[3]) below indicates that credit risk for shipping companies will continue to deteriorate at least for the next two years. As early as 2016, the collapse of South Korea's Hanjin Shipping Co Ltd, the seventh largest container shipping company in the world, has already implicated how vulnerable large shipping companies could be despite prolonged state supports. The highly leveraged nature of the shipping industry and complex global macroeconomic conditions will remain to be the sector's two biggest challenges in the future.

[2] The stock index return is one of the inputs of the NUS-CRI PD model and the market capitalization of the corporates affects their Distance to-Default, which is another input of the NUS-CRI PD model.
[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

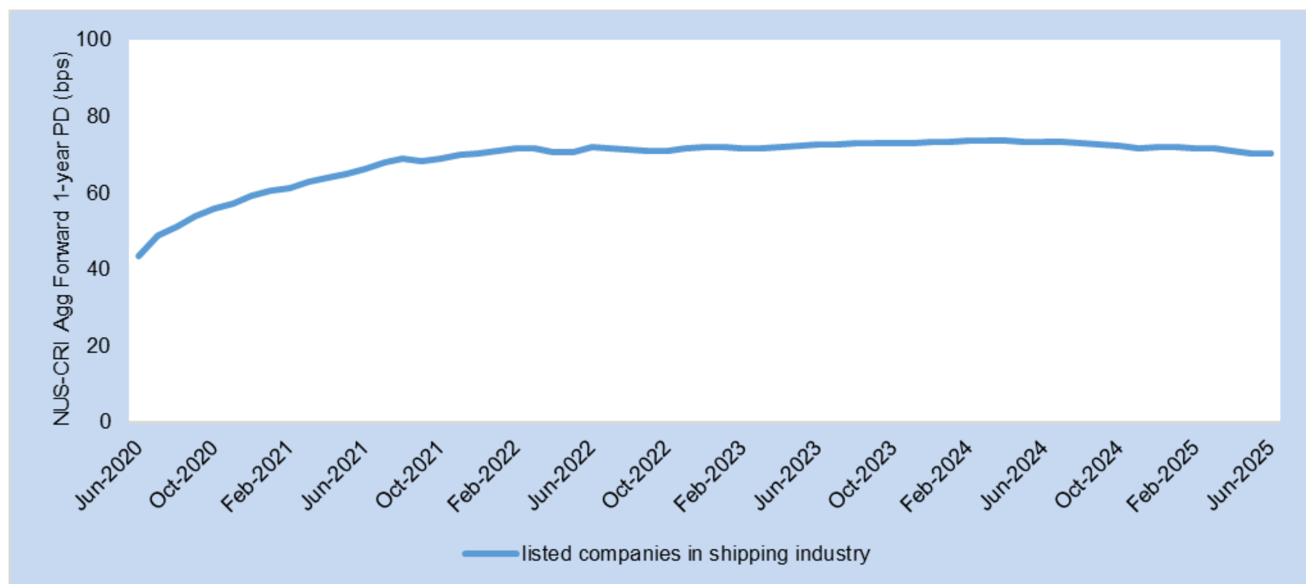

Figure 3: NUS-CRI Agg Forward 1-year PD for listed companies in shipping industry. *Source: NUS-CRI*

Credit News

Record debt bill pushes Philippine firms back to bond market

Jun 15. In 2021, the biggest companies in the Philippines will need to repay the most debt ever. Some of the firms start to return to the debt market after the lockdown which caused debt issuance to plunge to a four-year low. At the moment, companies are keen to borrow as interest rates are still low to prepare for massive debt repayments. About USD 8.3bn in corporate bonds and loans are due in the second half of this year and another USD 16.4bn in 2021. Meanwhile, falling interest rates may increase demand for Philippine corporate securities as peso-denominated five-year government bond yields dropped to a seven-year low in this month. However, this can change in the future as the central bank plans to gradually resume offering term deposits to financial firms and increase reverse repurchase facility volumes. (Bloomberg)

Investors enjoy equity-like returns from a roaring bond market

Jun 12. Bonds sold since March by blue-chip US companies have surged in value as their attractive coupons had drawn investors. For instance, Intel's USD 1bn bonds maturing in 2060 soared to more than 144 cents from 98cents presale price while Morgan Stanley's USD 2bn 30-year bond increased to 148 cents from a dollar. Such returns are comparable to the equity market where S&P 500 index rose 34% from its March nadir. The Fed's bond buying program also boosted investor's confidence as they pour around USD 40bn into investment-grade bond funds and USD 965bn of bonds is now sold at an aggregate of USD 70bn above par value. The future of the bond market remains optimistic as interest rate environment will continue to remain low and companies emerging from the downturn is expected to be cautious, therefore, benefitting investors in the market. (FT)

'Resilient' subprime borrowers spread cheer in US debt markets

Jun 11. In this Covid-19 crisis, subprime borrowers show a surprisingly strong credit performance compared to previous downturns. The gap between yields on subprime-backed securities and US Treasuries has dropped sharply, which is due to flat delinquency levels across card, auto and other loans, while fiscal policy is keeping the subprime borrowers afloat. Meanwhile, USD 3bn in securities have been issued in auto loans and investors have more than covered these issues with orders. Since 2010, consumers are more responsible regarding their credit limits and in the last two months, more people are paying off loans rather than re-borrowing. However, caution remains as US government support programs are also responsible for

this development and higher loan extensions of loans in subprime ABS, which are usually followed by higher delinquencies, is about double the normal level. (FT)

China's companies find ways to avoid bond blow-ups

Jun 10. Chinese companies are avoiding or minimizing bond defaults, even as the economy shrinks for the first time in decades. Some Chinese companies are asking bondholders to wait longer for repayment, to forgo the right to redeem bonds early, or to switch into new longer-dated securities. There are parallels with China's banking industry, where defaults have been muted by a coordinated effort to let companies and individuals defer loan payments. As one of the largest corporate-bond markets, China has seen default recently, but the shock of the coronavirus pandemic hasn't produced anything to rival high-profile US collapses. (WSJ)

Rally in Europe's riskiest corporate bonds masks lagging sales

Jun 9. Europe's riskiest corporate debt has rallied to pre-crisis level, mirroring gains in US speculative-grade bonds, as investors looking for higher yields find few new bonds to buy. In Europe, the spread has tightened to 4.69 percentage points in the junk-bond market, while in the US, the spread has narrowed to 5.51 points. However, that masks key differences in the dynamics for the two markets. US companies have rushed to raise cash from the junk-bond market, while in Europe, activity levels have remained low, and there is a shortage of high-yield assets for funds to buy. One reason is that Europe has done little so far in terms of commitment, in terms of supporting fallen angles and the lower-rated part of the credit spectrum. (WSJ)

As pandemic roils Canada, companies tap bond market by most in a decade (Reuters)

Quicken Loans IPO may open up sector, say executives (FT)

US foundations issue first social bonds to fund USD 1.7bn coronavirus fightback (FT)

Regulatory Updates

Jakarta to use QE for as long as needed to tackle pandemic

Jun 15. Indonesia's finance minister announced that Indonesia will use quantitative easing (QE) and other emergencies monetary and fiscal policies to shore up the economy from the pandemic. Indonesia suffered IDR 125tn (USD 8.83bn) of capital outflows in the first quarter of 2020. Its yield on the 10-year rupiah denominated government bonds jumped from 6.5% to 8.3% and the currency depreciated from IDR 13,500 to IDR 16,300 against the US from February to March. The QE allows the Bank of Indonesia not only to buy government bonds in the primary and secondary market but also to stem outflows of foreign capital. So far the QE has been successful with increased foreign capital inflow, falling yields on 10-year government bonds and currency appreciation against the US. However, foreign holdings of government bonds have yet to fully recover. Some challenges that Indonesia is facing include ensuring good governance, low corruption and containment of the virus. These are essential to ensure money injected into the system can boost their economy in the long term. (FT)

Bank of England set to launce more quantitative easing after record economic plunge in April

Jun 14. The Bank of England will make use of more quantitative easing, which is estimated to amount to about GBP 100bn to further tackle the impacts of Covid-19 on the British economy, after a total of GBP 645bn was already unleashed until now. This year, Britain's economy will be the hardest hit with a slump in

GDP by 11.5% in 2020 and a possible further contraction by 14% in total if there is a second wave of Covid-19 this year. Meanwhile, interest rates are held at an all-time low of 0.1% with the Bank of England shying away from the idea of setting negative interest rates for the first time in Britain's history. (ITV)

China central bank injects CNY 200bn via MLF, keeping rate unchanged for 2nd month (Reuters)

Fed expands Main Street program to allow for both smaller and bigger loans (CNBC)

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