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Overcapacity and weak freight rates worsen the credit outlook of the global container shipping industry

by Amrita Parab

- **NUS-CRI Agg PD of the container shipping industry improves as benefits from peak rates seen in 2022 continued to support the industry's credit health**
- **NUS-CRI Forward PD of the container shipping industry indicates a potential worsening in credit quality over the coming 12 months as the industry faces falling demand, weak freight rates, and overcapacity issues**

The resilience of the shipping industry to lockdowns paved the way for the industry's credit profile to improve in the current macroeconomic climate. The container shipping industry experienced an unprecedented surge in demand following the initial wave of the Covid-19 pandemic in 2020 as online orders surged and global shipping lanes became vital to the supply chain. This intensified demand resulted in a shortage of ships, with vessel scarcity propelling freight rates to unprecedented levels and resulting in the accrual of record profits for the industry in 2021 and 2022. As seen in Figure 1a, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for the container shipping industry has been decreasing since Jan-2023 and has stabilized below the BBB- upper bound when referenced to PDiR2.0 bounds[1]. Looking ahead, however, a reversal is underway as global demand slows down drastically in the face of soaring cost inflation and higher borrowing costs. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) in Figure 1b suggests that the fall in demand in conjunction with the increased capacity impacting firms' free cash flows is bound to negatively impact financial performance and is likely to burden the industry's aggregate credit profile over the next 12 months, potentially pushing the Agg PD into non-investment grade territory.

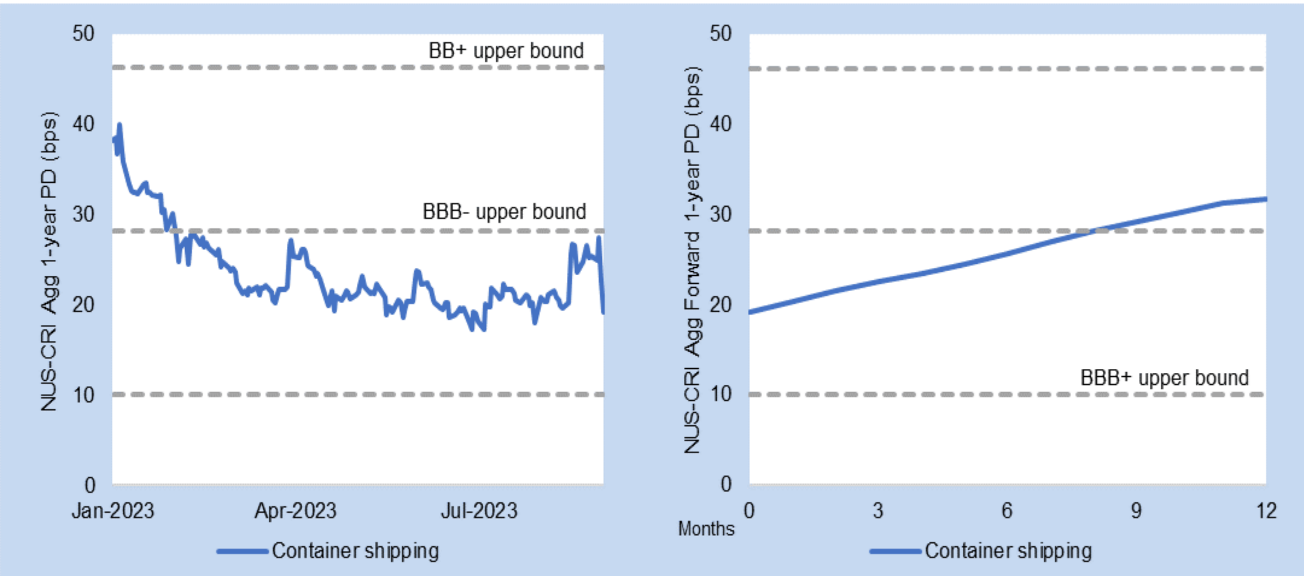

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Container shipping, with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Container shipping as of Aug-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Presently, companies are grappling with bloated inventories, which were accumulated during periods of increased consumer demand over the past couple of years, resulting in a sharp decline in demand for container

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by 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.

[2] 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 18 months, conditional on the firm's survival in the next 6 months.

freight services. As consumers begin to cut back on their purchases of goods, amidst pressures arising from an inflationary environment and rapid interest rate hikes, the decline in demand has become notably pronounced. Consequently, the spot rates on significant trade routes have swiftly decreased (See Figure 2a). Moreover, there's added pressure from terminal tariff increases and the escalating prices of depot space, pressuring storage and delivery costs for shipping firms and possibly impacting the industry's profitability in the short term. Combined with surging operating expenses, linked to elevated energy and labor costs, the industry has seen a significant erosion of profit margin and debt serviceability over the past two quarters (See Table 1). However, the industry's relatively low indebtedness provides support to its credit profile. Over half of the container volume that is currently being transported is under term contracts. A significant proportion of these contracts which were priced at peak rates are set to expire in H1 2023. Repricing these contracts at the current lower rates may contribute to a substantial loss of revenue considering the massive drop in freight rates over the past year, potentially contributing to the deterioration of the industry's credit profile over the next twelve months. Giants in the industry such as Maersk, CMA-CGM, and Hapag-Lloyd have all seen their profits slump in H1 2023 driven by weaker trade volumes and falling freight rates. As seen in Figure 2b, the NUS-CRI 1-year Probability of Default for Maersk has crossed into the non-investment grade territory over the course of this year as its revenue plunged by 40% YoY in Q2 2023. The NUS-CRI 1-year Probability of Default for Hapag-Lloyd on the other hand jumped higher than Maersk following a steeper revenue decline of 50%[3] in Q2 2023 as compared to the same period last year.[4] Both companies expect that the excess inventory which is responsible for depressed demand and freight rates, may persist till the end of 2023, with Maersk forecasting that the global shipping volumes will contract by 4% by the end of the year.

	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023	Q2 2023
Profit margin (%)	35.1	33.9	35.0	27.3	15.1	14.1
EBIT to interest expense	29.1x	18.3x	15.2x	11.8x	6x	6.5x
Total debt to total capital (%)	29.1	27.4	26.3	24.7	23.0	24.5

Table 1: Aggregate (median) key financial ratios of container shipping companies in the sample. *Source: Bloomberg*

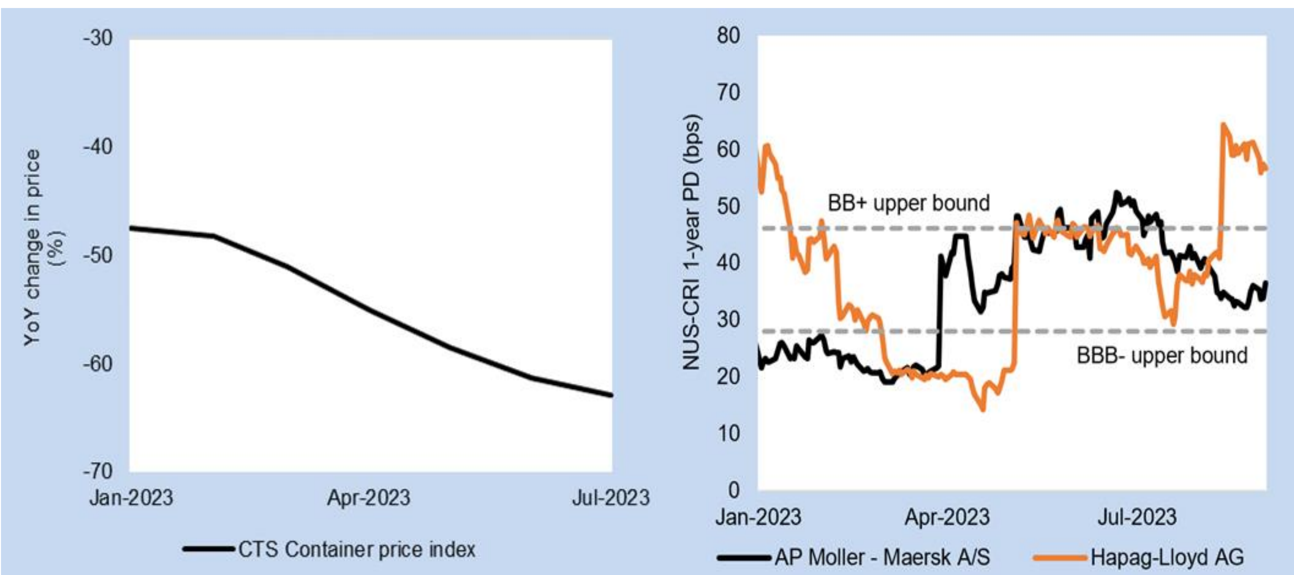

Figure 2a (LHS): YoY change (%) in the Container Trade Statistics (CTS) container price index. Figure 2b (RHS): NUS-CRI 1-year PD for AP Moller - Maersk A/S and Hapag-Lloyd AG, with reference to PDiR2.0 bounds. *Source: Bloomberg, NUS-CRI*

Another aspect negatively impacting the financial health of companies involved in container shipping is the problem of overcapacity. Driven by the need to close the shortage gap during the pandemic, new orders for container vessels from companies in the industry also jumped over the last two years. Due to the long lead time associated with the fulfillment of these orders, it is expected that 700 ships will be delivered during 2023-24, exactly at a time when the industry is experiencing a demand slowdown. With an industry leader like Maersk forecasting a persistent drop in global trade, it is highly unlikely that the new capacity added will be completely utilized, thus, exposing the industry to the problem of overcapacity and potentially leading to further pressures on profitability as freight rates depress further, and service and maintenance costs on new vessels add to the industry's operating expenses.

[3] Data from Bloomberg
[4] Both companies saw a more than 50% decline in free cash flows which further deteriorated their liquidity position.

Looking ahead, the container shipping industry faces diminished demand, weak freight rates, and overcapacity. The planned addition of capacity is expected to keep freight rates weak over the near to medium term. However, shipping companies have already begun to proactively undertake capacity management and cost management steps such as canceling port calls on routes where demand remains low and slowing ship speeds to reduce fuel consumption. Financial costs associated with new environmental regulations also promise to add a cost burden on the companies in the industry. Maersk recently raised USD 750mn via a green bond issuance with an aim to use the proceeds to buy methanol-powered vessels. Should headwinds persist, the perceived risks of following a continued demand slowdown may drive up the borrowing costs for the industry, potentially adding to refinancing pressures as well as any capital raises required to finance green transition projects. Consequently, a persistent downturn in global demand may push freight rates down and increase operating costs further contributing to the deterioration in the industry's credit health, as indicated by the Agg Forward PD in Figure 1b.

Credit News

Companies bet against high for long in bond blitz

Sep 10. Companies have flooded the bond market with over USD 110bn in global bond sales this week, marking the busiest start to September on record. However, the majority of issuances have shorter maturities of under 10 years, with a preference for shorter-term borrowing. Experts believe this trend reflects companies' reluctance to lock in higher yields for longer durations amid expectations that interest rates will eventually decrease. The current issuance rush is not expected to continue at the same pace and is viewed as a typical September occurrence after a summer slowdown. Demand is still anticipated to surpass supply, despite some signs of market indigestion. (Bloomberg)

Country Garden nears key deadline on bid to extend yuan bonds

Sep 11. Distressed Chinese developer, Country Garden Holdings Co., is in the final stages of a creditor vote regarding the extension of local bonds, with the outcome determining its repayment ability. The company, once China's largest builder, seeks a three-year extension for its eight yuan notes, totaling CNY 10.8bn (USD 1.5bn). Of particular concern is a CNY 1.435bn note due on September 14, which must be approved for an extension to avoid early repayment. Country Garden's financial troubles have rattled China's markets, as it symbolizes the broader property debt crisis, despite avoiding default so far unlike other high-profile developers such as Evergrande and Sunac China. The company faces nearly USD 2bn in bond payments across various currencies for the remainder of the year. Any payment defaults could significantly impact China's housing market and have wider implications for the country’s growth prospects. (Bloomberg)

Japan life insurers set to buy more ultralong bonds on BOJ policy shift

Sep 11. Japan's major life insurance companies are preparing to acquire more ultra-long-term Japanese government bonds (JGBs) in response to the Bank of Japan's recent relaxation of its yield curve control measures. This policy change allows 10-year JGB yields to exceed 0.5%, making ultra-long bonds a more attractive investment for insurers looking to align their portfolios with future obligations. Some insurers have already increased their holdings of these ultralong JGBs following the BOJ's policy shift in late July. The exact timing of increased purchases remains uncertain, but it is expected, as insurers have sold over JPY 13tn in currency-hedged foreign bonds in fiscal 2022. This move comes as insurers work to narrow the gap between their assets and liabilities in anticipation of new capital standards set to be introduced in 2025. (Nikkei Asia)

September flurry of corporate debt sweeps global markets

Sep 06. In September, global debt markets witnessed a surge in new deals as investment-grade companies rushed to secure borrowing at current rates before potential central bank rate hikes in the following days. On a single day, at least 40 businesses worldwide tapped into investment-grade debt markets, with over USD 36bn of new bonds issued in the US, marking the busiest session in deal count and daily supply for the year. Companies like BHP Billiton and Philip Morris International Inc. have taken advantage of this trend in the US, while banks were active in the Asian primary market. European businesses also joined the fray, with at least EUR 18.7bn (USD 20.1bn) in bonds issued on a single day. This flurry of activity is seen as an effort to lock in favorable rates ahead of potential changes in economic data and central bank policies. (Bloomberg)

European private loan market falters as corporate credit stress mounts

Sep 07. Direct lending, a costly but vital credit source for riskier European firms often shunned by banks, is showing signs of stagnation, indicating that aggressive interest rate hikes may be causing funding difficulties and worsening economic challenges. European private debt funds are witnessing a sharp decline in fundraising and deal-making activities. According to data from Preqin, the European private credit industry, which thrived after the 2008 financial crisis when banks reduced lending, has raised only EUR 26.1bn (USD 28.02bn) in new investments in 2023, marking a 34% drop compared to the same period last year. The reduction in private lending coincides with eurozone banks scaling back loan issuance amid slowing business activity. (Reuters)

Japan banks surge with yields on Ueda comments on negative rates (Bloomberg)

Asian banks tap US dollar bond markets for USD 4.75bn (Bloomberg)

WeWork Looks to Renegotiate Most of Its Leases as It Fights to Survive (WSJ)

Regulatory Updates

U.K. regulator to increase oversight of bank risk controls

Sep 08. The U.K.'s Financial Conduct Authority (FCA) has issued a warning to the country's largest banks, cautioning them against compromising their risk controls amid challenging economic conditions. The FCA emphasized that short-term revenue concerns should not override their regulatory obligations, expressing particular worries about financial crime, market abuses, and conflicts of interest in the banking sector. The regulator plans to intensify its oversight of banks and conduct more in-person visits, citing a decline in standards during the COVID-19 pandemic when some banks prioritized securing additional business over maintaining strict controls. Additionally, the FCA raised concerns about the lack of clarity in responsibility for activities related to environmental, social, and corporate governance within some banks, with roles unclear between front-line managers and supervisors. This warning comes as the U.K.'s banking sector faces challenges like inflation, weak growth, rising interest rates, and geopolitical tensions, emphasizing the need for improved risk management practices. (WSJ)

ECB to pause hiking rates on Sept 14; economists split on one more: Reuters poll

Sep 08. The majority of economists polled by Reuters expect the European Central Bank (ECB) to maintain its interest rates on Sept 14. However, just under half anticipate one more rate hike this year to combat high inflation. As the Eurozone's economic activity slows due to the cumulative 425bps of rate increases since July 2022, some investors believe it's time for the ECB to end its streak of nine consecutive hikes. While the ECB President hinted at this possibility in July, persistently high inflation and only a slight reduction in underlying price pressures suggest another hike is still on the table. The ECB's actions will depend on incoming economic data, but the potential for a recession looms, particularly in major Eurozone economies like Germany and the Netherlands. (Reuters)

FDIC says it should have supervised First Republic more closely (Reuters)

Poland’s central bank cuts interest rates heavily ahead of election (FT)

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