



Shipping - Batten down the hatches

Bringing industry challenges to the surface
RS Sector Outlook Series

October 2016

Introduction

The international shipping industry, carrying around 90% of world trade¹, has been in decline since the economic crisis of September 2008². This period since has been characterised by increasing costs, overcapacity and a lack of liquidity. This trend is likely to continue, intensified by current market conditions including Britain's decision to leave the EU, the slow-down in China and recessions in natural resource economies such as Brazil and Russia.

The collapse of one of the world's largest shipping firms in August 2016, Hanjin Shipping of South Korea, has rocked an industry already fraught with chronic over-supply, and the outlook for the global shipping industry appears to be negative over the next 12-18 months.

Figure 1 - Forces leading to distress in the shipping industry



¹ International Chamber of Shipping
² More than Shipping

Distress levels in dry bulk, container and tanker markets

Moody's anticipates a 7-10% earnings decline across the Global Shipping Industry in 2016. This sentiment is echoed by a H1 earnings index for shipping vessels, compiled by research firm Clarksons, which reached a 25 year low in mid-August – 80% below its peak in December 2007. However, that level of decline masks the differing levels of distress in the three broad industry segments: Dry Bulk, Containers and Tankers.

Dry bulk shipping

Dry bulk ships transport the basic raw materials of global trade e.g. iron, coal and food. Over the past two years the Baltic Dry Index, measuring the rates for chartering dry bulk vessels, has consistently found record lows although it has recently stabilised (as outlined in Figure 2).

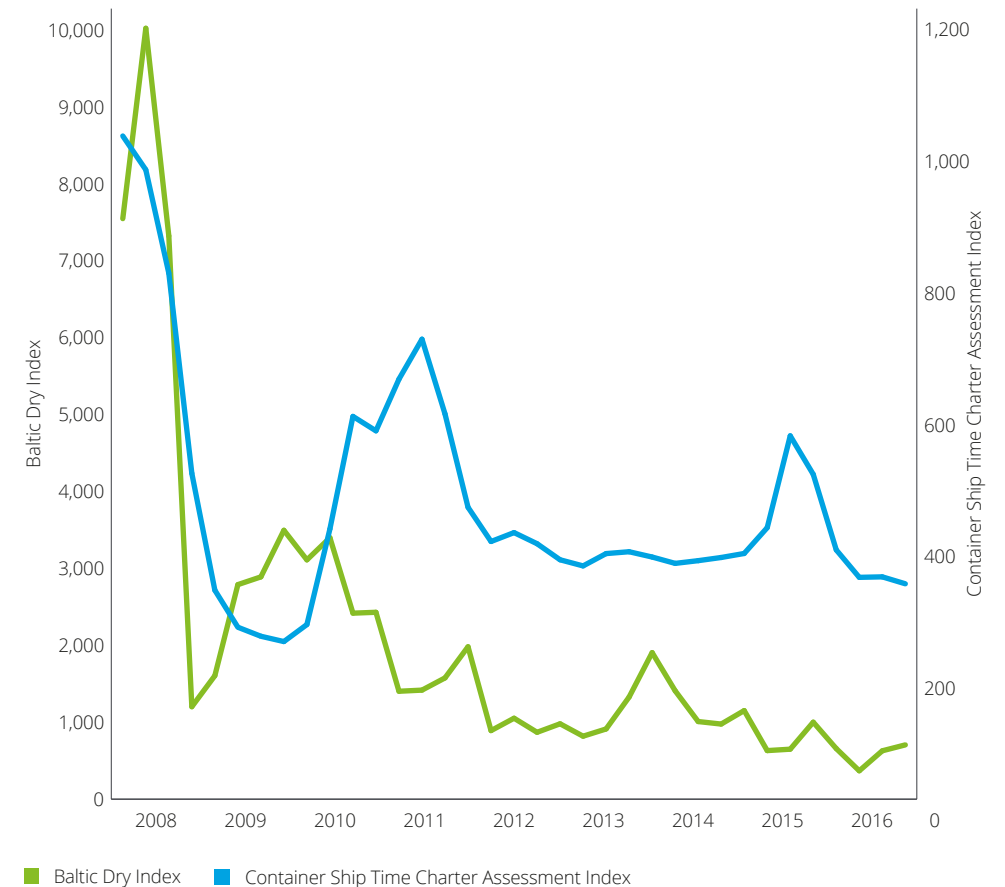
The primary reason for this dip is due to the economic slowdown in China, the destination for over half of the world's iron ore and a quarter of coal. The subsequent reduction in steel production has lowered the demand for key dry bulk commodities of iron and coal, causing the sub sector to plummet.

A further cause of the decline is the industry's rapid oversupply as the global dry bulk shipping fleet continues to grow despite slowing trade flows. China's record growth out of the 2008 financial crisis prompted ship owners to place orders for a huge number of new vessels. Many of these vessels are only coming onstream now, with new build delivery showing no signs of slowing until 2019/2020 when the reduction in orders over the last 12 months will take effect.

The only solution in the short term appears to be removing vessels from the operating fleet, as the market correction from the inevitable insolvencies (as seen by Hanjin) do not appear to be sufficient to correct the market.



Figure 2: Dry Bulk and Container Indexes



Source: Bloomberg

Container shipping

Container ships transport consumer goods around the world in 20ft or 40ft containers. The rise in global trade, coupled with the economies of scale generated by size and efficiency, have seen container ships increase in size by 90% over the past two decades.



However this increase in size has led to the same oversupply problem as with the Dry Bulk sector. This is illustrated by the average age of the global Container fleet, which is decreasing with older, less energy efficient vessels being uneconomical (until the recent uplift in oil prices).

Global container shipping is experiencing the worst financial distress since the 2008 financial crisis. Maersk, the largest container carrier in the world and seen as a bell-weather for the Container industry, saw profits fall by 82% in 2015 despite forming an alliance with Geneva-based Mediterranean Shipping Company (MSC) in 2014. More recently the Chinese market leader, Cosco Shipping, reported a record loss of Rmb7.2 bn for H1 2016, a quadrupling of their losses compared to the same period last year.

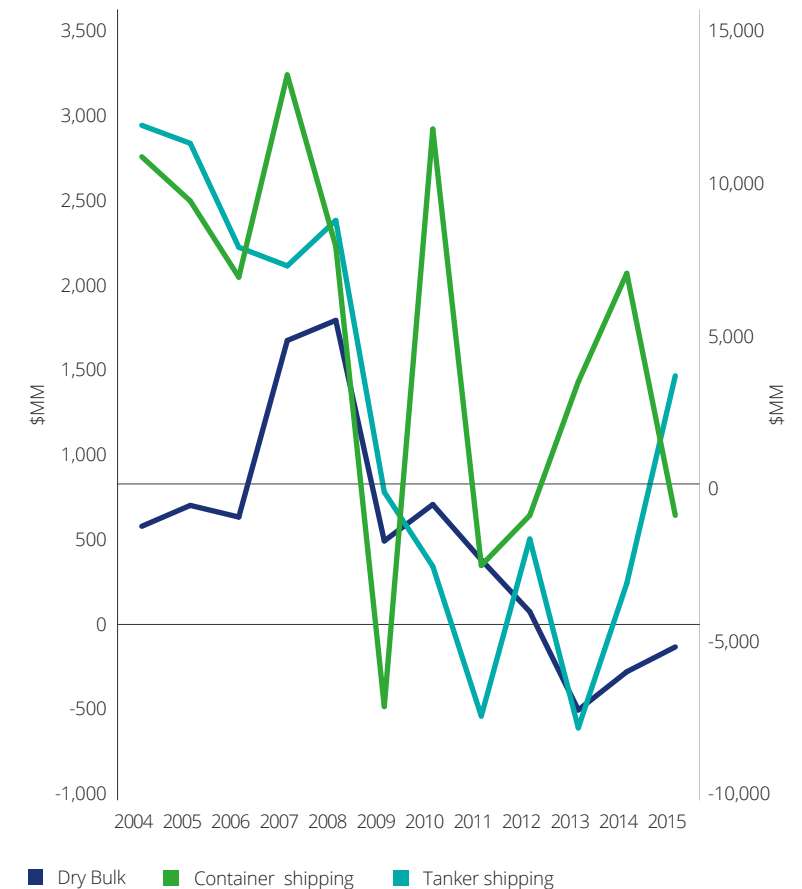
Tankers

Tanker ships transport liquids or gases in bulk. The Tankers sub-sector has benefitted from a prudent multi-year slowdown in fleet growth and the growth in longer haul trade routes as oil production shifts to lower cost economies that are further afield. Furthermore, in the Middle East, India and China, super-refineries are being built which will maintain tanker demand and limit many of the demand-side problems experienced by the other sectors.



Oversupply is also an issue in the Tanker sector, 2016 has experienced a greater number of new deliveries than in recent years, however it is less pronounced than in both Container and Dry Bulk industries and the forecast is more manageable.

Figure 3 – Bloomberg Shipping Group, Net Income



Source: Bloomberg

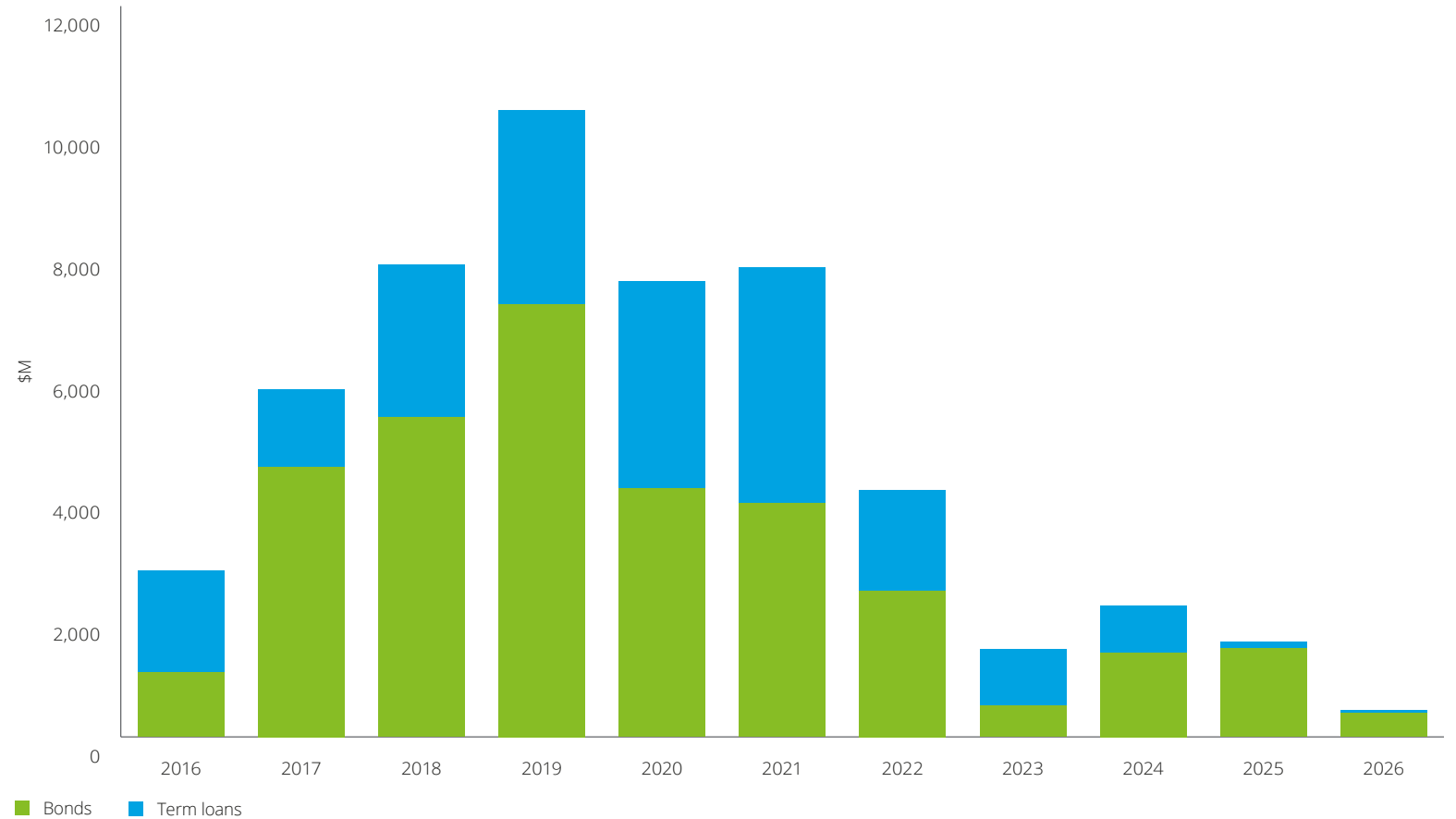
When examining upcoming debt maturities in Figure 4, it is apparent that both operators and lenders have a lot of work to do. Moody's downgraded outlook on rated shipping companies will only add further pressure to the wider market.

Historically banks have provided support by way of extending maturities or defaulted loans, however, as the equity value has eroded in recent years, their own security and its value is increasingly at risk. The European banks have taken steps to deleverage over the last two to three years but substantial bank debt remains with problems unsolved. As nobody can call the bottom of the most prolonged downturn in history, refinancing will also be challenging notwithstanding the availability of the new money in Europe.

The continued expected market decline is likely to leave all stakeholders in the doldrums for the foreseeable future.

Across the industry asset values continue to fall whilst banks seek to reduce exposure (or exit entirely) following Basel III, IFRS 9 regulations and the next round of Asset Quality Reviews. Hedge funds also show concerns as cash reserves sits on the side-lines waiting to call the bottom of the market, with some funds having been badly burned over the last 24 months.

Figure 4 – Bloomberg Shipping Group, Net Income



Source: Bloomberg

What has been done to date?

Financing

Prior to 2008 and in the years immediately following, shipping companies borrowed significantly to finance fleet growth.

Traditional shipping lenders have negotiated stand-still agreements or facility extensions, but are now facing increasing pressure to reduce exposure and avoid becoming de facto ship owners in their own right following European Central Bank pressure to strengthen its balance sheet against bad shipping loans.

Banks across the globe are suffering, particularly in Northern Europe, Greece and South East Asia where owners, operators and ship builders form large swathes of the economy.



Formation of alliances

Echoing the announcement from Norwegian shipping bank DNB, there has been a recent wave of alliances as operators seek to counter the weakening market. By sharing the use of vessels, operators hope to avoid financial losses accrued by operating under capacity.

The survival of companies may depend upon finding immediate cost savings, such as those offered through well integrated alliances, but the “post-merger” integration will be critical in order for the alliances to be effective.

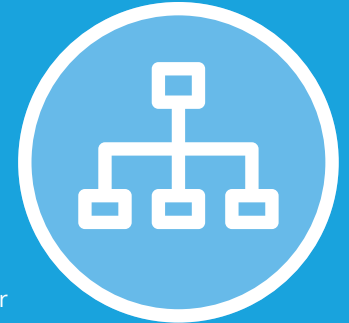
Alliances have not been limited to operators however. There have also been some highly publicised joint ventures between private equity and operators – notably the recent link between Elliott Advisors and Siem Offshore who together are seeking opportunities to purchase vessels at deeply distressed prices.



Restructurings

There is a long list of shipping companies who have been through, in, or contemplating a restructuring. Chapter 11 is the restructuring tool of choice as it allows companies to remain in control and avoid the difficult question of how to deal with contingent liabilities for a UK office holder.

For smaller companies, the norm has been persistent bank negotiations or, where those negotiations have been unsuccessful, consensual sales or vessel arrests where the lenders have no other option.



Key considerations for stakeholders

Key considerations for owners and operators:

For existing vessel owners and operators, the critical factor will be continued access to capital to finance operations, as has been the case for a number of years. This will be challenging in an industry which, outside the major operators, there is a fragmented and often family led ownership structure.

- Increasing operational efficiency, particularly around bunker management, procurement and asset utilisations;
- Fixing balance sheets, reducing debt where possible and divesting non-core assets;
- Cash and working capital management; and
- Changing governance processes and transparency to make the business more attractive for financing.

Key considerations for lenders

- Vessel values have fallen to the point where security and therefore recovery may be below par. Refinancing through traditional bank channels will likely become more difficult as we see traditional lenders forced to divest their shipping interests.
- Government desire to support national industries is wavering, as see with Hanjin, particularly where there are other national operators to take up some of the operations and assets.
- Significant volumes of Bond debt matures in the near term; bondholders are likely to play an active role in any standstill or restructurings.
- Traditional bank lenders divestment could lead to opportunities for some hedge funds.
- As exemplified with Atlantic Offshore's restructuring earlier this year, an 'amend and extend' approach only lasts so long.
- This recognition of the need for fundamental underlying structural issues to be addressed through a proper focused restructuring process may be the turning point in fixing the current problems and a full restructuring can be completed using an insolvency process, even though historically it has not been the method of choice.

"We can see another round of significant restructuring negotiations between operators, their lenders and the broad range of stakeholders, as liquidity once again becomes a major issue, but an increasing number of insolvencies (whether at an operating company level or through vessel arrests) appear likely.

For lenders, keeping a close eye on operations is critical and portfolio sales or loss-sharing arrangements may again be order of the day. For the borrowers, in an industry with a growing demand/supply imbalance, operational efficiency and active stakeholder management will be critical."

David Soden, Partner

Case Study – Hanjin Shipping

Hanjin Shipping, South Korea's largest container shipping company, filed for receivership on 31 August 2016 making it the highest profile casualty of the current state of the global shipping industry and the first major operator to seek protection for over 30 years.

Although the company was widely considered “too big to fail” and expected to be rescued by a combination of group, creditor and counterparty support, negotiations were unsuccessful. What followed has demonstrated the impact of an unplanned insolvency filing: recognition being sought in over 40 countries to try to maintain some form of control, ships idling in open water with an estimated 500,000 TEU – or \$14bn worth - of cargo on board, charter parties in limbo, ports refusing entry to Hanjin vessels and so on. Some of this could have been avoided with a properly planned and co-ordinated insolvency and orderly wind-down, as unpalatable as that may have seemed to the company or lenders at the time, but many commentators now believe that liquidation is unavoidable. Although all parties will likely be seeking a way out of the receivership process, given the container shipping industry is as much about reliability as it is about price with the adoption of just-in-time production globally, it is questionable whether Hanjin will be able to recover from the reputational damage alone. At the time of going to print, that outcome remains uncertain.

What is also unclear is the longer term impact on the shipping industry – although the too big to fail mantra is clearly a thing of the past, there is continued dislocation between Admiralty law and insolvency law globally which inhibits the ability to properly restructure. This is evidenced by the fact that a significant number of shipping companies of all sizes are in financial distress, whilst there have been limited failures or “proper” restructures outside of debt repayment moratoriums. Continued intervention by both lenders and governments has not allowed market forces to operate – perhaps the lesson to take from Hanjin is that contingency planning is needed in any uncertain, distressed market.



Shipping credentials and contacts

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