Corporates Outlook
Container Shipping: Trade tensions, fuel rules may rock the boat

The container shipping industry's credit outlook is stable for 2019, with slightly improved industry fundamentals contrasting with growing risks from trade tensions, slowing global growth and the looming uncertainty caused by new 2020 fuel regulations.

More balanced supply and demand ensured that freight rates stabilized after the volatility recorded between 2015 and 2017. While we expect freight rates to steady in the months ahead, the political, economic and regulatory challenges confronting container shipping companies within the next 12 to 18 months could impinge on their credit quality.

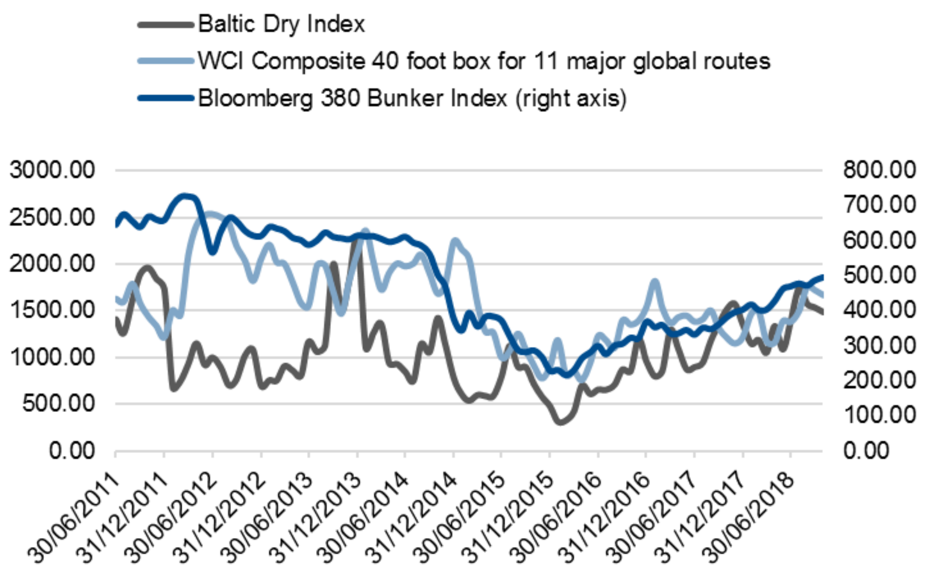
Freight rates bounce back from lows

Global container shipping rates (black and light blue lines in Figure 1) have continued to recover in 2018 from the lows seen in the first half of 2016. The WCI composite container price index for 11 major global routes has further gained throughout the year to around 1,700 as of early November 2018, which is more than twice the level of the lows seen in Q1 2016. This recovery in charter rates was mostly due to a robust world GDP growth and growing international trade volumes as well as an improved capacity utilisation that we anticipated in our 2018 Scope sector forecast.

However, those revenue increases were mostly compensated by higher fuel costs (dark blue line) that have been rising throughout 2018 as well.

Main Indicators

Figure 1: Shipping Rates vs. Bunker Costs



*Emission Control Areas: Coasts of U.S., Canada, the Caribbean Sea, the North Sea and the Baltic Sea
Source: IMO, Scope Ratings

For 2019, we expect a container shipping rates to move sideways in the light of mostly unchanged capacity supply/demand forecasts if no material external shocks appear.

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Regulatory, political, economic risks loom large next year

In Scope's view, the three most prominent risks to the sectors financial performance in 2019 are:

1. Industry turmoil caused by the numerous implications of the nearing IMO's 2020 low sulfur bunker rules (MARPOL)

Less than 13 months left to comply with fuel regulation

As of 1 January 2020, there will be stricter rules regarding the sulphur content in ship emissions globally. This bears potentially serious implications for the industry with not much more than a year for shippers to find permanent or stop-gap measures to ensure their vessels meet the new emissions requirements. Despite industry complaints about short lead-times and possible shortages in low-sulphur fuel among other issues, the IMO remains committed to implement the rules in full and on time. Moreover, there is also a noteworthy lobby of supporters *within* the industry calling for a timely implementation such as the so-called Clean Shipping Alliance 2020 (CSA 2020). Pro-implementation industry groups such as the aforementioned CSA 2020 consist of major shipowners and charterers that have already invested in filter-technology (so-called scrubbers) for their vessels and are therefore looking to protect their investments. Hence there are several political, legal and even industry driven reasons why it is likely that the IMO's new bunker rules will be put into force as of 1 January 2020.

Compliant fuel supply uncertainty remains

The race is on for owners and operators to find a technically and financially viable way to comply with it.

Please see our recent more detailed research report on the MARPOL 2020 topic. (*MARPOL 2020, IMO's new fuel rules promise choppy waters for the shipping industry)*

2. Weakening global trade volumes caused by spiraling trade tensions and/or a cooldown of global economic growth

Trade tensions between the United States and several of its leading trade partners, most importantly China and the E.U. sharpened in 2018 and look set to hang over global commerce next year too, hence Scope's expectation of slower global GDP growth. Maritime trade volume growth, which is closely tied to the global economic developments, may therefore suffer as well in 2019.

No material impact yet, but 2019 may show a different picture

Although there has been tariff increases and further threats of increasing those tariffs within 2018, no significant negative volume effects have been observed so far. This is also due to the effect of clients moving goods now in anticipation of further tariff increases or restrictions.

3. Fierce cost competition among the leading carriers and alliances

As we stated in our last sector research publications, the players within the industry are heavily reliant on having best-in-class cost structures that can only be achieved by having critical scale and a smart approach on asset optimization. The most recent third big industry consolidation wave is again increasing the gap between the leading players and alliances and the rest of the industry. Please see the table of leading industry alliances below.

Figure 2: Major alliances amidst industry consolidation

2M	OCEAN Alliance	THE Alliance
• **Maersk Line** • **MSC** • **HMM**	• OOCL • CMA CGM • COSCO • Evergreen	• Hapag-Lloyd • Yang Ming • ONE (K-Line, NYK, MOL)

Further worsening of the competitiveness of smaller players and thus increasing cost pressure

Today we already see a significant split in credit quality within the industry with a vast majority of companies in the lower end of the high yield space while industry leader AP Moeller Maersk continues to show investment grade credit quality and ample access to the capital markets.

High/low sulphur fuel price spread will also determine steaming speeds

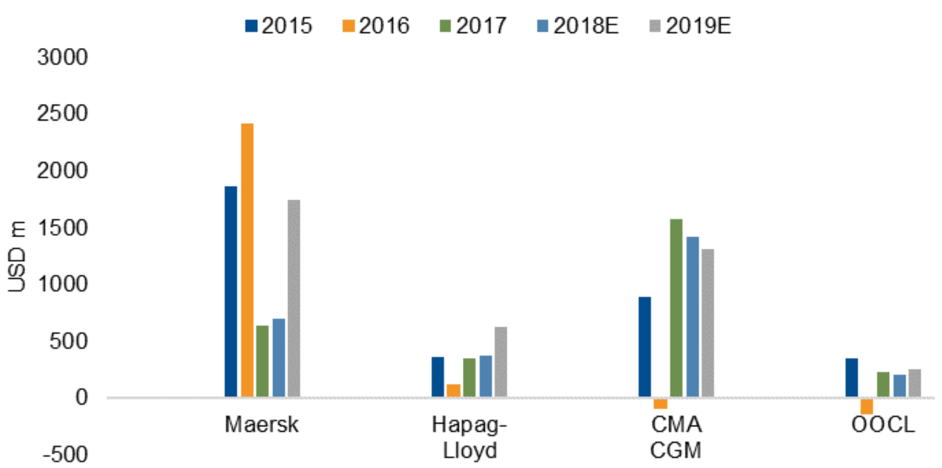
As bunker prices have been increasing for more than three years now, improving fuel-efficiency remains key for container shipping companies in order to improve their operating profitability. ‘Slow-steaming’ should continue to play a role in reducing bunker cost, but the most crucial measure to improve on fuel/cost efficiency is to use newer and larger vessels that are more fuel efficient and improve the total cost per container transported. It remains to be seen how steaming speeds will be adjusted by market players following the 2020 fuel regulation, as the speed also determines effective transport capacity available. It is likely that ship operators that have fitted scrubbers to their vessels will run on higher speeds as they might profit from a significant drop in fuel prices for dirty high sulphur fuel that may still be used if a scrubber system is fitted.

Vessel scrapping volumes are in our view set to stay at the improved levels that we saw throughout 2018, helping to keep global shipping capacities at reasonable levels.

Profitability Outlook

Operating profits on EBIT-basis have improved on average throughout 2017 and 2018 on the back of improving shipping rates.

Figure 3: EBIT trends of major players

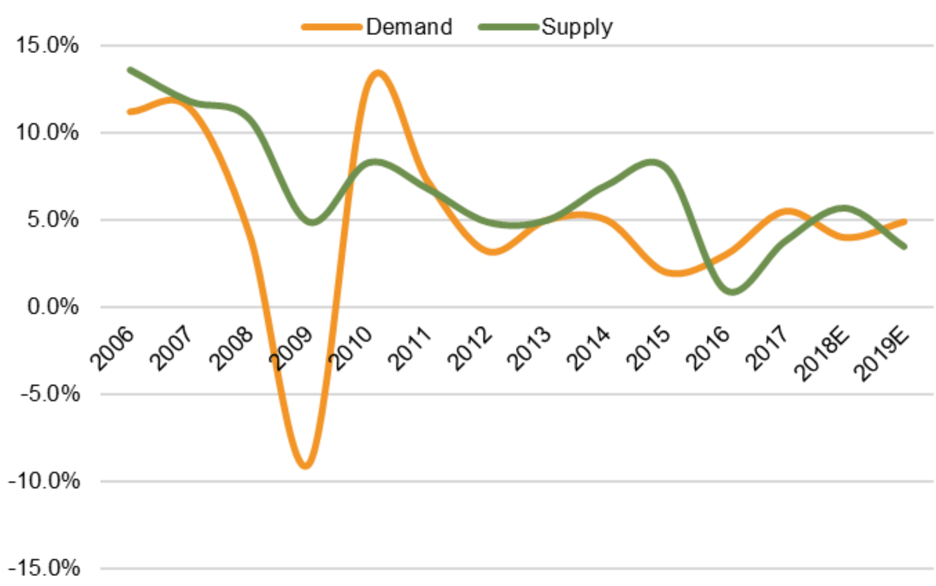


*Source: financial reports of issuers, Scope Ratings forecasts

Moderate new vessel deliveries likely to limit capacity growth

The other main input factor for global capacity growth are new vessel deliveries. After the glut of new deliveries in container vessels in 2014 and 2015 that put severe pressure on rates, we expect to see a lower delivery number in 2019.

Figure 4: Supply / demand balance



*Source: Drewry, IHS, Scope Ratings forecasts

On the demand side of the picture, we have seen most recently seen a slight softening of growth expectations by several institutions to a current range of c. 3.5% to 3.7% for 2019.

Global GDP growth outlooks are slightly softer than a year ago

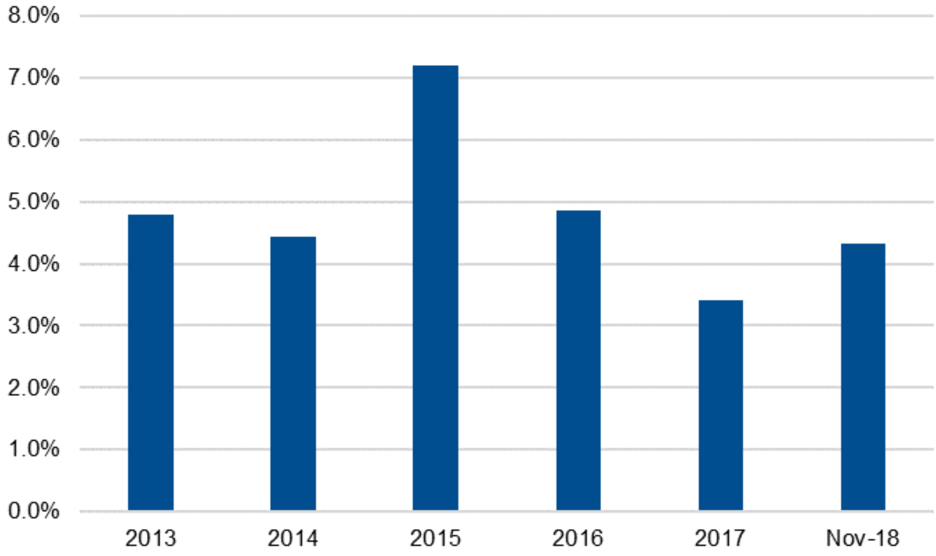
Considering that global trade volume growth has been usually higher than GDP growth historically, we would expect to see global trade volumes to grow again at about 4.5% to 5% next year.

Financing Conditions for Shippers

Interest spreads low so far – Scope expects pick-up in 2019

While the yield compression on outstanding bonds of large container shipping companies until 2018 has been significant, we see a first pick-up in yields within the second half of 2018. Hence, the bottom of the interest rate environment is likely to be behind us now, also for container shippers. Risk premiums nevertheless continue to stay rather low, whereas the overall interest environment is picking up, driven primarily by the U.S. Fed. On the back of robust economic and labour market data. However, credit investors should bear in mind that the yields on outstanding debt of container shipping companies has proven to be quite volatile in the past, reflecting high earnings volatility.

Figure 3: Yields on outstanding container shipping bonds



*Source: Bloomberg, average yield on a volume weighted basket of outstanding container shipping bonds, including bonds of Maersk, CMA CGM, Hapag-Lloyd, GSL and NOL.

The wave of consolidation slows after recent big M&A transactions

Furthermore, we expect industry pressure for further consolidation and alliances to remain in 2019 as profitability is still primarily determined by cost efficiency in the shipping industry. Uncertainty regarding the fuel supply and pricing situation as of 2020 adds to the problems for smaller companies with limited economies of scale and access to funding. We nevertheless think that the lion's share of sector consolidation has already taken place within the past three years.

Room for further consolidation among top 10 players narrows

Notable M&A activity in 2018 included merger of Japanese container shipping operators K Line, Mitsui Osaka Shosen Kaisha Lines and NYK Lines to form Ocean Network Express (ONE) and the merger of OOCL and COSCO that was cleared in late June. French container liner CMA CGM acquired 33% in logistics specialist CEVA, but said it would not target a full takeover.

Summary

Scope expects the industry to stabilize its operating profits on or slightly above the 2018 level on the back of a balanced capacity demand and supply situation.

Trade tensions and fuel cost uncertainty are major profitability threats for 2019

However, trade tensions, additional costs caused by the nearing 2020 fuel regulations and ongoing price pressure are likely to limit the earnings upside for container shippers in 2019 in our view. As we stated in our research paper as of July, (Container shipping firms focus on asset optimisation), asset optimization as well as scale remain key in order to successfully navigate the shipping market in 2019 and to keep credit quality at current levels.

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