# Rating Methodology for Shipping Companies

## Overview

The global shipping business is marked by high capital intensity, volatile freight rates, commoditised product offering and high level of fragmentation. The business is global in nature because of competition from foreign lines, which are free to operate across the continents. Besides, historically Indian tonnage has not grown in line with the trade requirements leading to Indian liners having low market share. It is estimated that Indian flagged vessels account for only around 13% of the India based Exim trade. The credit risk profile of shipping sector is also heightened by generally high level of leverage adopted by the ship owners to fund new/second hand ship acquisition. Offsetting the financial risk partially is the high quality of ships as security. Seizing and auctioning ships is relatively easy, as compared to manufacturing companies' assets, and hence offers a good exit route for the lenders. Notwithstanding the above concerns, there are some shipping companies who have adopted several mitigants to offset the risks which face the sector. ICRA's assessment of shipping companies involves a study of both business and financial risk profile, with emphasis on the risk mitigants.

## Business Risk Profile

**Fleet quality:** Tradability of a ship is mainly determined by her quality. Fleet quality is a function of a) age of the ship b) hull and other structural aspects and c) vessel pedigree. Age is important as new ships command a premium over older ships because of advantages such as lower fuel consumption, high speed , high automation, low staffing and maintenance expenditure. Although old ships do find employment, they suffer discount on the charter rates over a new ship, which can progressively increase over the years and a point is reached where it is no longer viable to operate the ship. Besides, in a scenario where supply exceeds demand, tradability itself can be question mark. Older ships are also subjected to rigorous classification norms, leading to higher expenditure. A younger fleet on the other hand can also provide additional funding flexibility for management as its collateral value tends to be both higher and more transparent. Hull and structural aspects are important for ships which transport environmentally sensitive commodities such as crude oil or heavy distillates. Certain countries have imposed restrictions on the plying of singled hulled tankers. Pedigree of the vessel can arise from its flag state, classification and oil major approvals (for tankers).

ICRA notes that, as per a Government of India policy for PSU charterers, Indian shipping companies enjoy the first right of refusal, so long as they can match the L1 rate offered by a competing foreign flagged vessel. This regulatory protection can partly offset some of the age related disadvantage suffered by the Indian shipping companies. However, their earnings will continue to be volatile, with the policy ensuring only deployability of the vessel.

**Size:** Given the fragmented and commoditised nature of most of the shipping segments, absolute size does not translate to market or pricing power. Size, however can provide economies of scale (e-g lower port charges/steve doring expenses/insurance costs/discounts on new builds or dry docking/funding costs) to drive higher levels of operating profit and cost efficiency. A certain size should also allow a company to offer more frequent and reliable services. A larger fleet should also increase flexibility to react to shifts in geographical trade and transportation patterns. Smaller companies are more susceptible to the rise in costs, changes to the regulations as well as to the other vagaries of the shipping industry.

**Diversification:** Diversification provides a company with an ability to offset changes to demand and supply in a given segment, region, industry or among its customer base. The diversification in the shipping business can be along three lines viz. (i) segment (ii) geography (iii) clients. Segmental diversification, such as across tankers, gas carriers, dry bulk, containers, offshore vessels, passenger services, can offset the volatility associated with certain segments such as crude oil tankers, mitigate structural shift in a particular sector and can provide a hedge against event risk. Geographical diversification a) mitigates revenue volatility from cyclical and structural changes in regional demand patterns b) balances revenues across trade lanes c) enables reallocation of vessels to maximize utilization d) mitigates region or country specific regulatory changes and e) mitigates geo political event risks. Customer diversification is assessed to see the dependence on specific customers. Some shipping companies are highly exposed to a few customers (e-g oil producing companies or global freight forwarders), while others have a more diversified spread of customers. As switching costs can be low for customers, it can impact the fleet utilization in the case of switch by large customers.

**Chartering philosophy:** ICRA assesses the philosophy of the company’s management with regard to the chartering of its fleet viz spot and long term charter, as this would determine variability in cash flows. In general, spot charter rates are more volatile than medium to long term charter. Volatility in shipping takes two forms – cyclical and random. The cyclical volatility is related to the broad demand-supply balance in the shipping market. It arises due to the tendency of capacity build-up overshoot in the industry. New ships take up to 2-4 years to build and orders placed during a freight boom translate into ships two-three years later when the demand conditions may have changed. The random element in shipping freight rates refers to the fluctuations associated with short-term events like strikes, accidents, weather-related/other congestion in key shipping lanes etc. Such events are a constant feature of shipping markets and affect freight rates by altering the demand for or availability of ships for relatively short periods of time (say a few days to few months). These short-term events are impossible to forecast, but the sensitivity of the market to such events gets heightened when the capacity utilisation is already high.

Because of such a volatility, it calls for great deal of expertise to play in the spot market. While returns can be higher in such a strategy, risk associated is also equally high. From rating perspective, ICRA takes comfort if a shipping company derives a large share of revenues from a predictable medium to long term charters. In the Indian context, long term charter duration varies from 1-3 years, while globally duration as high as 25-30 years is prevalent especially in LNG ships, which are highly capital intensive and the ship financiers are comfortable mainly with a long term contract.

**Fleet utilization:** Managing logistics is key to raising the capacity utilization and optimizing revenues. Examples are optimum ballasting (when the ship travels empty to pick up cargo) and timing of dry docking schedules to coincide with a ballast leg or a cyclical trough in the market to minimize the revenue loss. A key measure analysed by ICRA to understand the fleet utilization is the trends in tonne-mile achieved by the fleet vis a vis tonne-mile capable of achieving during the year, based on number of days of deployment of ships.

Fleet acquisition and disposal philosophy: Ship owners resort to both purchase of new ships ( by placing orders with ship building yards) and second hand vessels (from the market). While purchasing new ships can be time consuming, varying from 2-4 years from the placement of order, second hand acquisition can be consummated within a matter of weeks, if the funding and other clearances are in place. While both the strategies have merits and demerits, buying a second hand vessel calls for deep market insights and ability to time the market to profit from the strategy. Second hand vessel prices are volatile and are often influenced by the prevailing freight rates. Successful companies, who resort to asset play strategy, aim to buy during cyclical downturn, deploy the ships for few years and dispose off the same during cyclical peaks. On the other hand, there are companies who prefer to buy new ships and operate through its life cycle, which is considered positive from the rating perspective.

**Manning pattern:** Indian shipping companies adopt various strategies for manning the ships, ranging from complete outsourcing to entire inhouse manpower. These strategies have implications on the manpower costs. The industry of late has been experiencing skilled manpower shortage especially in the officer category. Ability of the companies to ensure optimum manning of the ships, including training initiatives to develop the skill sets, is thus a critical parameter from the rating perspective.

Moreover, as the competition is global, the industry is forced to gross up the salary for income tax, as the crew in foreign flagged vessels are exempted from Income Tax. Thus because of taxation issues, overstaffing and small fleet, operating costs of Indian ships in general tend to be high vis a vis some of the foreign flagged ships. In this context, companies with competitive staffing pattern will stand to gain over others.

## Management Quality

All debt ratings necessarily incorporate an assessment of the quality of the issuer’s management, as well as the strengths/weaknesses arising from the issuer’s being a part of a “group”. Also of importance are the issuer’s likely cash outflows arising from the possible need to support other group entities, in case the issuer is among the stronger entities within the group. Usually, a detailed discussion is held with the management of the issuer to

understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the issuer's industry. Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Attitude of the promoter/management to risk taking and containment
- The issuer's policies on leveraging , interest risks and currency risks
- The issuer's plans on new projects, acquisitions, expansion, etc.
- Strength of the other companies belonging to the same group as the issuer
- The ability and willingness of the group to support the issuer through measures such as capital infusion, if required.

## Financial Risk Profile

The objective here is to determine the issuer's current financial position and its financial risk profile. Some of the aspects analysed in detail in this context are:

**Cost structure:** Standing charges and capital servicing charges would largely constitute the cost structure of a ship on a time charter equivalent (TCE) basis, which are analysed per day ($/day) basis taking into account the number of days of deployment of the ship. Standing charges mainly comprise crew expenses, repair & maintenance expenditure, insurance for hull & machinery and admin expenses. Capital costs comprise interest, depreciation and in-charter expenses. In addition, dry docking expenditure is also incurred at periodical intervals (once in every 2.5 years). For ships operating on voyage charter, voyage related expenses such as bunker costs, port charges, canal charges and broker commission are incurred in addition to standing charges.

Standing charges, including dry docking expenses, is largely a function of the age of the ship and regulations. Capital servicing charges are influenced by the acquisition cost, the funding strategy adopted for fleet acquisitions and residual life of the fleet, with new ships funded with high debt, having higher charges. With regard to voyage related expenses, while they are generally pass through items to the charterer by way of freight charges, any abnormal rise in expenditure such as bunker fuel during the voyage period can impact the effective TCE.

Higher the costs, lower will be the ability of the ship to weather cyclical downturn in the charter rates, which can often occur suddenly and severely. A key metric to capture this risk is to compute the break even TCE rate (to cover the standing charges and debt service commitments) for each class of ship, and compare that with current charter rates, long term charter rates and anticipated charter rates in the next couple of years based on forecasted demand-supply in the industry. Lower the break-even, better it would be from the rating perspective.

**Operating profitability:** The analysis here focuses on determining the trend in the issuer's operating profitability and how the same appears by peer comparison.

**Financial policies:** In general, ships are funded with a high leverage because of the comfort of the lenders with such a funding strategy arising from the liquid nature of the collateral. However, from the rating point of view, which aims to capture the timeliness of debt service rather than the ultimate recovery by the lenders, it may not really be a source of primary comfort as there can be marginal time delays (largely procedural in nature) in taking possession and disposing the same. Hence, higher leverage does translate to higher financial risk profile, albeit may not be of the order of manufacturing companies. ICRA thus assesses the financial policies of the management with regard to its overall capital structure, keeping adequate cash balances to act as a cushion during downturn and maintaining certain level of coverage indicators (Total Debt/OPBDITA, OPBDITA/Interest etc).

Long maturity profile of the loans can partially offset the risk associated with high financial leverage, as the pay back period for ship acquisitions can be long. In this context, ability of the issuer to access long term loans from foreign lenders is assessed, as the appetite of the Indian lenders for long term foreign currency loans is limited. Besides, funding of the loan in a currency where most of the revenues are generated could translate to competitive interest costs, thereby lowering the cost of capital. As shipping business is global in nature, access to long maturity loans at competitive rates, will be considered a key competitive advantage.

ICRA also assess the financial flexibility enjoyed by the issuers such as refinancing ability, access to unencumbered vessels, liquid investments etc, which can also partly offset a high financial risk profile.

**Retained cash flows through the business cycle:** A shipping company's cash generation is significantly impacted by the inherent volatility of charter rates, resulting in a volatile operating cash flows. Given the capital intensity of the industry, most shipping companies have significant cash needs to re-invest into the existing fleet. A stable and strong retained cash flow helps liquidity and provides flexibility to invest in new ships. Besides, positive retained cash flow is an indicator of an issuer's ability to service the debt in a timely manner. Debt protection indicators such as RCF/Total Debt and RCF/Interest are also analysed to see how long it would take for the issuer to repay its debt and cushion available for servicing interest.

**Other areas which are analysed include the following:**

- **Foreign currency related risks***:* Such risks arise if an issuer's major costs and revenues are denominated in different currencies. Examples in this regard would include companies selling in the domestic market but making large imports, and export oriented units operating largely on the domestic cost structure. The foreign currency risk can also arise from unhedged liabilities, especially for companies earning most of their revenues in local currency. The focus here is on assessing the hedging policy of the issuer concerned in the context of the tenure and nature of its contracts with clients (short term/long term, fixed price/variable price).

- **Tenure mismatches, and risks relating to interest rates and refinancing*:*** Large dependence on short-term borrowings to fund-long term investments can expose an issuer to significant re-financing risks, especially during periods of tight liquidity. The existence of adequate buffers of liquid assets/bank lines to meet short-term obligations is viewed positively. Similarly, the extent to which an issuer would be impacted by movements in interest rates is also evaluated.

- **Working Capital Intensity**: The analysis here evaluates the trends in the issuer's key working capital indicators like Receivables, Inventory and Creditors, again with respect to industry peers.

- **Accounting quality**: Here, the Accounting Policies, Notes to Accounts, and Auditor's Comments are reviewed. Any deviation from the Generally Accepted Accounting Practices is noted and the financial statements of the issuer are adjusted to reflect the impact of such deviations.

- **Contingent liabilities/Off-balance sheet exposures**: In this case, the likelihood of devolvement of contingent liabilities/off-balance sheet exposures and the financial implications of the same are evaluated.

## Summing up…'

As in other manufacturing sector ratings, rating of shipping companies involves an assessment of business risk, management risk and financial risk profile. While the cyclicality in the shipping sector exposes it to a high business risk profile, that can be partly or almost fully offset by adoption of prudent business and financial risk mitigants discussed above. The final rating judgment is based on both quantitative and qualitative factors, with more emphasis on future cash flow generation and debt servicing ability.

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