Negative outlook continues for the shipping sector - Dry bulk and container markets see recovery; tanker rates plunge

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Summary Opinion

- With the onset of the Covid-19 pandemic since March 2020, the shipping industry has been adversely impacted due to the adverse impact on demand for segments like containers and dry bulk. While the charter rates in these segments have witnessed pressure with the intensification of pandemic, in recent months with some easing of containment measures and pick-up in economic activity there has been some recovery in rates for the dry bulk segment.
- The container segment has also witnessed improvement in rates, despite the container volumes continuing to witness contraction. This has been on account of fleet management by liners by idling and blank sailing of vessels.
- However, the outlook for both dry bulk and container trade remains negative in the near term due to uncertainty pertaining to the economic recovery, the risks of re-intensification of the pandemic and the containment measures, changes in supply chain and trade patterns. The rates are expected to remain volatile and sustainability of recent rate improvement remains uncertain.
- Unlike the other segments, the tanker segment had witnessed spike in rates during April and May 2020, despite the steep fall in crude oil prices. This was mainly on account of the increased demand for storage as there was a strong contango witnessed in crude prices making it more favourable to store it. Further, with a lag, there was spike witnessed in product tanker rates also with the similar storage requirement playing out. However, once the contango in crude and petroleum products moderated, the tanker charter rates witnessed a steep decline. Going forward, with the demand for crude and petroleum products is expected to remain subdued in the current fiscal and the rates are likely to witness pressure. Any recovery will depend on the pace of demand recovery and any supply corrections.
- The scrapping levels were muted in Q1 CY2020 and is expected to remain so in Q2 CY2020 as well due to the lockdowns and the yard closures at several locations due to the containment measures adopted. However, with the easing of the containment measures, there may be an increase in the scrapping levels if the demand does not improve much.
- The steep fall in crude prices was, however, partly favourable for the shipping sector during the subdued market due to lower fuel prices. Especially, since the fuel cost was expected to increase with the IMO 2020 regulations kicking in since January 2020. However, despite the adoption of higher priced low sulphur fuel or marine gas oil, the fuel expenses moderated with the decline in crude prices. However, with the increase in crude prices in recent weeks, if the charter rates don’t increase correspondingly or are sustained, it is likely to put pressure on earnings of the shipping companies
- Among the domestic shippers, companies with higher share of tankers would have benefited during the spike in the tanker rates. However, going forward with the tanker rates moderating and rates in other segments expected to be volatile, the financial performance is expected to witness pressure in the near term.

Dry bulk volume outlook remains subdued; volatility in rates expected

The dry bulk segment witnessed pressure since early CY2020, post the Covid-19 pandemic and containment measures adopted by China, which is the main driver for global dry bulk trade. Subsequently as the impact of the pandemic spread across other regions and countries adopted containment measures of varying degrees, the demand remained subdued for the dry bulk segment. This resulted in a moderation in the charter rates from January 2020 onwards. The Baltic Capesize Index turned negative for the first time in Feb 2020, while the Baltic Dry Index witnessed a significant contraction. The charter rates had witnessed high volatility even prior to the Covid -19 outbreak due to factors like the US-China Trade wars and disruption in global iron ore trade due to adverse climate in Brazil etc. This had resulted in a moderation in the rates in early CY2019, but the rates recovered subsequently with improvement in demand. After the Covid-19 outbreak the rates remained subdued till May 2020 but witnessed some recovery in June 2020 and have increased sharply in early July 2020. The recovery in rates is because of some uptick in demand with the easing of the containment measures in several countries, including China. However, the sustainability of these rate improvements remains to be seen and ICRA expects the segment to continue to witness volatility in the near term. This is due to the demand uncertainty for underlying commodities like iron ore and coal, with contraction in global economic activity expected. The pace of recovery in demand will be susceptible to the risk of subsequent waves of the pandemic and containment measures, and changes in trade patterns and supply chain during the recovery phase.

EXHIBIT 1: Trend in Baltic Dry Index

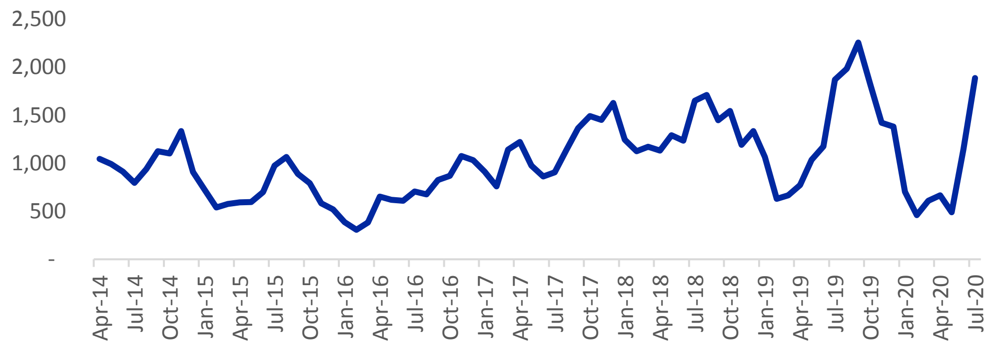
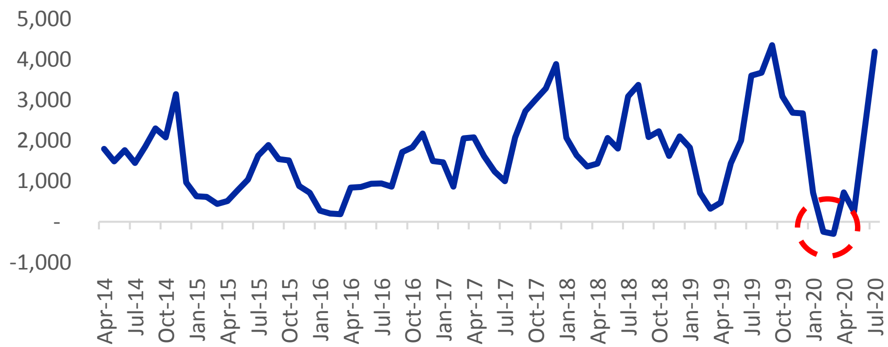


EXHIBIT 2: Trend in Baltic Capesize Index

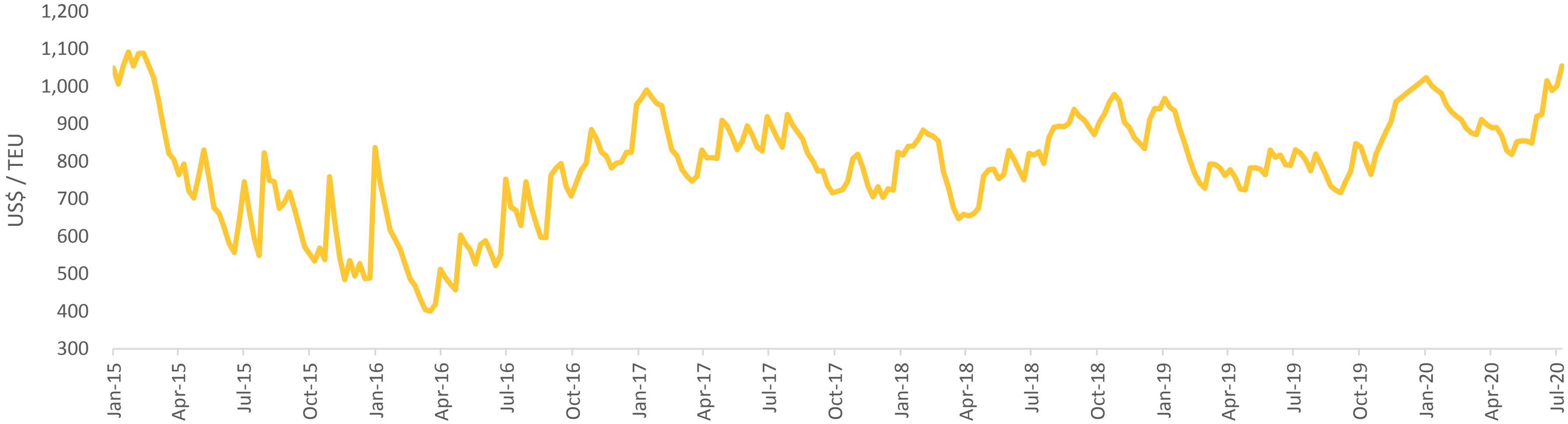


Source: Industry Data, Bloomberg and ICRA research

Supply correction sees container rates improve despite weak demand

The container shipping segment was also adversely impacted due to the pandemic and the global container trade declined by ~4.7% (Source: A.P.Moller Maersk) in Q1 CY2020, due to its impact on the supply chain and demand. This had resulted in a moderation in the charter rates. The trade volumes are expected to witness a major contraction in Q2 CY2020 and the outlook for recovery remains negative on account of uncertainty. However, despite the weak volumes, the container charter rates have witnessed recovery since May 2020. This can be attributed to tight supply arising from increased idling and blank sails by liners and some improvement in demand in the recent months in certain areas. The consolidation witnessed in the sector in the last few years also allowed better fleet management by the players. Nonetheless, in the absence of sustained recovery in demand, the rate improvement will be difficult to sustain and both volumes and rates are expected to remain under pressure in the near term. Prior to the Covid-19 pandemic the rates had witnessed pressure during H1 CY2019 due to weakness in global trade arising from factors like the US-China trade wars.

EXHIBIT 3: Trends in Container Freight Rates (Shanghai Containerized Freight Index)



Tanker rates cool down after record highs

The tanker segment had witnessed a steep spike in rates in March 2020, post the steep fall in crude prices due to formation of a strong contango in crude markets, which resulted in high demand for tankers for crude storage and also for continued supply to refineries which had not immediately cut down production to that extent. Subsequently, the demand for storage for products also increased as the end-user demand was severely impacted due to the containment measures, which led to a steep rise in product tanker demand also. The tanker rates for certain categories like VLCC for crude tankers touched decadal highs and the product tanker index surpassed the crude index. However, with the contango in the oil markets weakening, the rates have witnessed a steep moderation as the storage requirement moderates. At these rates, it will be difficult for vessels to achieve a break even. Going forward, the rates will depend on the demand recovery in the segment from end users, the outlook for which remains negative as oil product demand is expected to remain subdued in the current fiscal.

EXHIBIT 4: Trends in crude tanker rates ($/day)

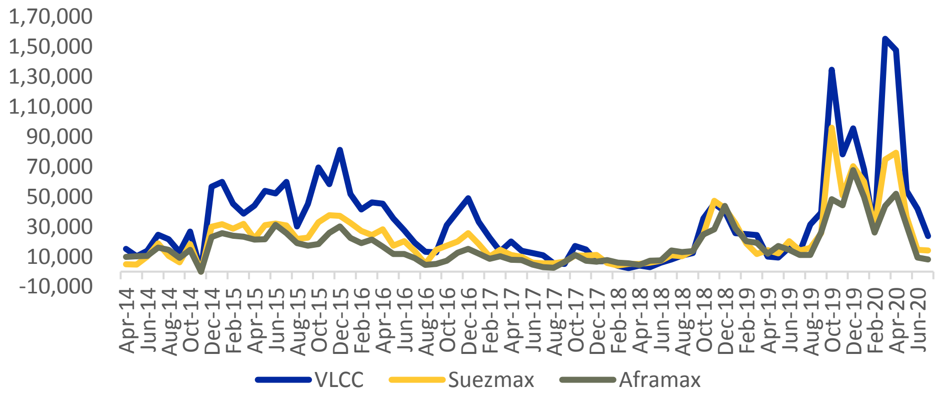
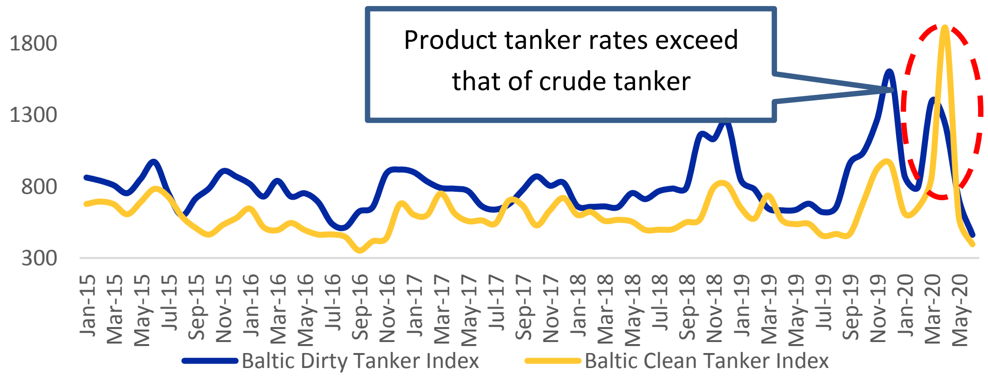


EXHIBIT 5: Crude tanker vs product tanker rates



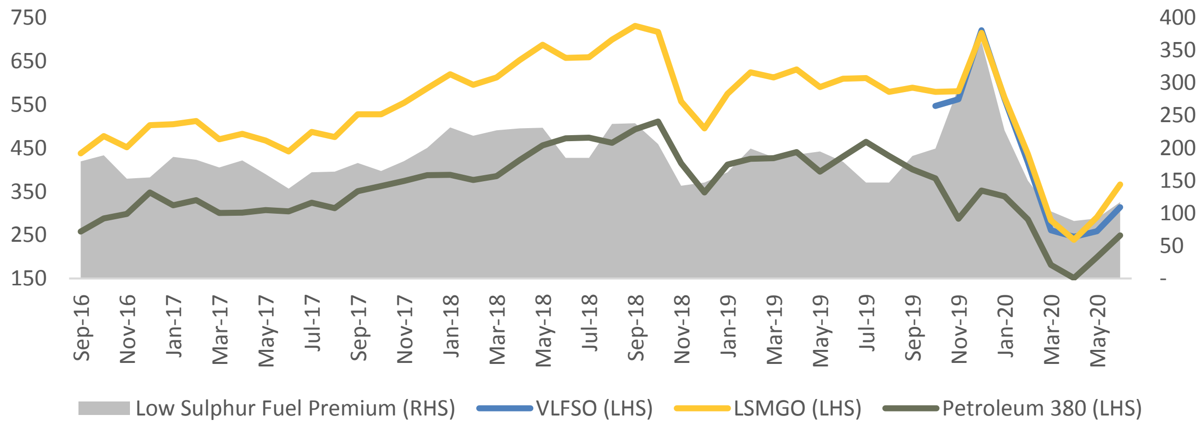
Source: Industry Sources and ICRA research

The offshore supply vessel segment is also expected to witness subdued demand in the near term due to the negative outlook on the E&P sector. While there has been some recovery in oil prices in the recent month, the uptick in E&P activity is not expected, given the uncertainty in oil demand due to the Covid-19 pandemic and sustainability of any production agreement by OPEC+.

Lower fuel prices to provide support to the shipping sector

Despite the headwinds witnessed by the shipping sector in the backdrop of the Covid-19 pandemic, the lower crude prices have resulted in lower fuel prices, which provided some support to the shipping companies plagued by lower demand and rate volatility. With the implementation of the IMO 2020 regulations, it was expected that there will be a steep increase in the fuel cost for the shippers due to high delta between low sulphur and high sulphur fuel. The delta was also expected to increase with the regulation kicking in as the supply was not expected to match the increase in demand. However, while the delta did increase prior to January 2020, it moderated subsequently due to the adequate availability of low sulphur fuel and the use of marine gas oil. Further, with the decline in crude prices, the overall fuel cost has also come down. Many companies had also opted for retrofitting of scrubbers, which will allow the use of cheaper high sulphur fuel, however, with moderation in delta between high and low sulphur fuel the payback period for such investments has increased and conversely companies which had postponed the retrofit will benefit in the current environment. However, with the increase in crude prices and if the delta expands significantly, the shippers may witness margin pressure if the increase in the charter rates are not commensurate.

EXHIBIT 6: Trends in bunker fuel prices (USD/MT)



Source: Bloomberg Data and ICRA research

Conclusion

ICRA expects the challenging environment to continue for the shipping sector in the near term due to the ongoing impact of the Covid-19 pandemic on the underlying demand. The charter rates are expected to witness volatility, however, sustained subdued demand is expected to put pressure on the rates going forward. While during Q1 CY2020, there was moderation in scrapings across all major segments, the scrapping levels are expected to be moderate in Q2 CY2020 also mainly on account of many yards being locked down or operating at lower utilisation levels due to the containment measures adopted. Nonetheless, the scrapping may increase if the demand remains subdued, which might be favourable for the sector once the pace of recovery improves.

As with the global shipping industry, the financial performance of the Indian shipping sector is also expected to witness stress in the near term. Companies with high exposure to tankers would have benefited from high rates in Q1 CY2020 and to some extent in Q2 CY2020, however with the moderation in the tanker segment and volatility in other segments, the performance is expected to be muted. Companies with a more diversified fleet and strong liquidity profile with moderate leverage will be in a better position to withstand the downturn.

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