ICRA

Shipping charter rates witness turbulence across segments; uncertain demand recovery

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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 impact on demand for segments like containers and dry bulk. While the charter rates in these segments had witnessed pressure with the intensification of the Covid-19 pandemic, in recent months with easing of the containment measures and the pick-up in economic activity there has been some recovery in rates for the dry bulk segment. The container segment has also witnessed a sharp 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, 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 a 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 a 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 expected to remain subdued in the current fiscal, the rates are likely to witness pressure. Any recovery will depend on the pace of demand recovery and any supply corrections. There could be some improvement in rating if there is a revival of storage demand as a second wave of contango in oil prices has emerged in the recent period, however, the same remains to be seen.
- The scrapping levels were muted in H1 CY2020 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. However, the expected impact of IMO 2020 regulations, kicking in since January 2020, did not materialise as the premium between low and high sulphur fuel remained low and has witnessed further moderation in the last few months. This, coupled with low crude prices, should provide some support to shipping companies. However, companies which had installed scrubbers in their vessels will see a longer payback period due to the low premium.
- Among the domestic shippers, companies with higher share of tankers would have benefited during the spike in the tanker rates in Q1 FY2021, while companies with dry bulk and container segment would have benefited in Q2 FY2021, as tanker rates collapsed. ICRA believes that companies with diversified fleet and low leverage will be at an advantage to withstand the downturn in current fiscal, given the demand uncertainty and high volatility in charter rates.

Despite some recovery in recent months, outlook uncertain for dry bulk

The dry bulk segment witnessed pressure since early CY2020, post the Covid-19 pandemic and the 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 charter rates had witnessed high volatility even prior to the pandemic due to factors like the US-China trade wars and the disruption in global iron ore trade due to adverse climate in Brazil etc. After the Covid-19 pandemic the rates remained subdued till May 2020 but witnessed some recovery in June 2020 and have since increased sharply in July 2020. Subsequently, there has been some moderation in August 2020, but rates have remained at higher levels compared to those witnessed between November 2019 to June 2020, although it was lower on a YoY basis. The recovery in rates was driven by recovery in global trade from China, mainly for commodities like iron ore and agricultural products, even though trade for coal continued to witness a moderation. This was despite the fact that some of the other major regions like the US, Europe and India continued to witness contraction in trade volumes.

EXHIBIT 1: Trend in Baltic Dry Index

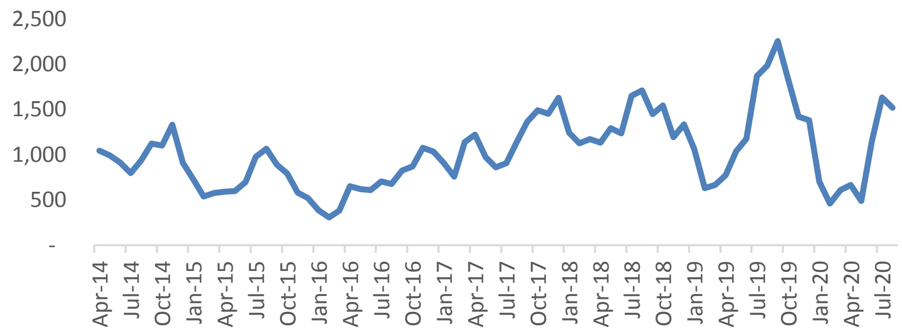
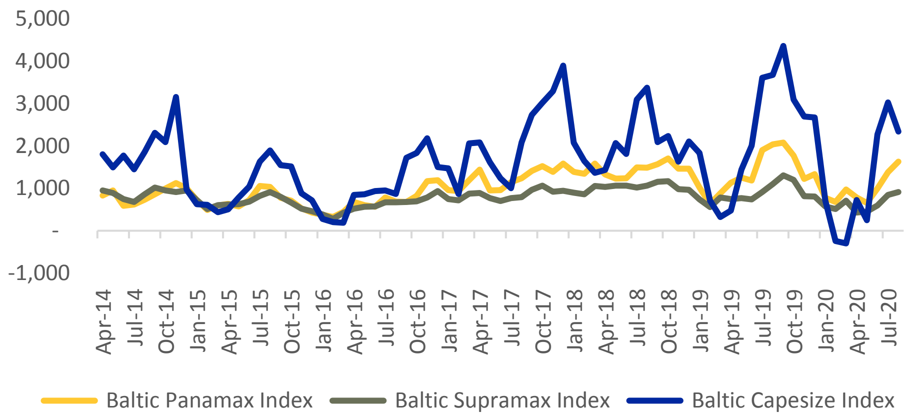


EXHIBIT 2: Trends in Baltic Capesize, Panamax and Supramax Index



Source: Industry Data, Bloomberg and ICRA research

China has been a major driver for global dry bulk trade in the last two decades. Some of the key trade routes are for iron ore trade from Brazil and Australia to China, coal from Australia and Indonesia and agricultural products like soybean from Brazil. As can be seen in the chart below, the iron ore import was subdued during Q1 CY2020, with ~1% YoY growth; although the coal and lignite volume was up 28% during the period. However, subsequently, for iron ore trade, while volumes picked up ~18% in April, it again moderated to ~4% in May. However, in the subsequent two months, there was a sharp recovery in iron ore imports with YoY growth of 35% in June and 24% in July 2020, before again moderating to around 6% in August 2020. The recovery in iron ore demand from China, resulted in the recovery in charter rates for dry bulk vessels, especially the capsize segment. The Baltic Capesize Index, which had turned negative in February and March 2020, witnessed an improvement in the subsequent months and has largely mirrored the trend in improvement in iron ore imports from China. Apart from the iron ore segment, other commodities which have also aided in the dry bulk segment are improved grain demand from South America and soybean demand from Brazil to China, which supported some recovery in the panamax and supramax vessel categories, although the subdued demand in the coal segment moderated the recovery in these vessel categories. Apart from the demand from China, the other factors that impacted the charter rates included demand for commodities from other major economies like India, Japan and other regions, which remained subdued during the period. However, the Chinese demand improvement had offset the demand.

Nonetheless, despite the recovery witnessed the segment remains susceptible to volatility in rates, given the subdued economic environment in major economies and the risk of subsequent waves of pandemic intensification, the sustainability of demand remains a concern. Further growing tension between China and other countries also remains a concern and could have an adverse impact on trade. While a part of the Chinese demand improvement is driven by domestic stimulus measures, which include the spend on infrastructure, the recovery in demand for exports from China to other regions for steel and other manufactured products will be crucial to sustain the demand for iron ore and recovery in coal demand. Further, the supply of dry bulk vessels also remains stable, with the deliveries largely matching demolitions during the period. However, the new order bookings in current year have witnessed moderation, which should be favourable for the segment going forward, if there is traction in scrapping as the same will lead to rationalisation in supply.

EXHIBIT 3: China iron ore imports and Capesize rate correlation

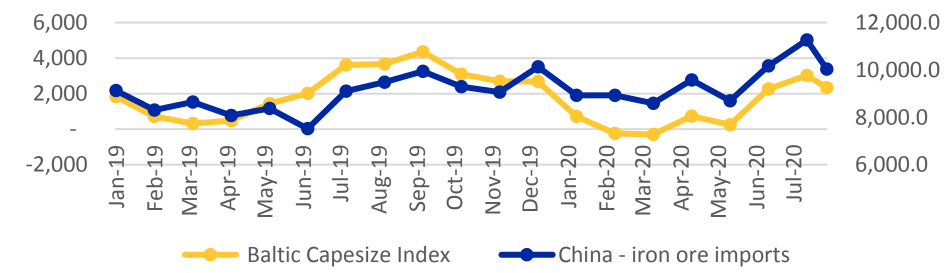
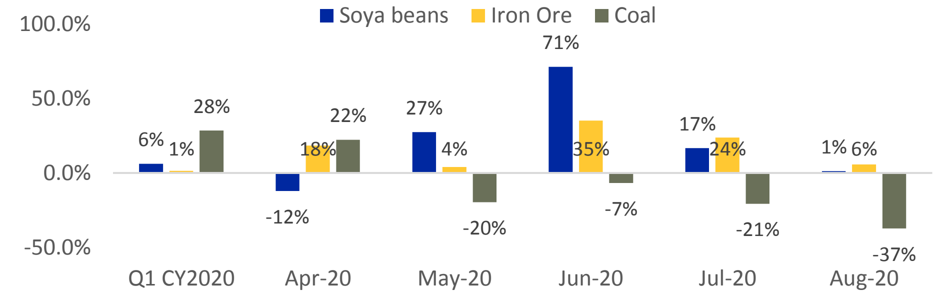


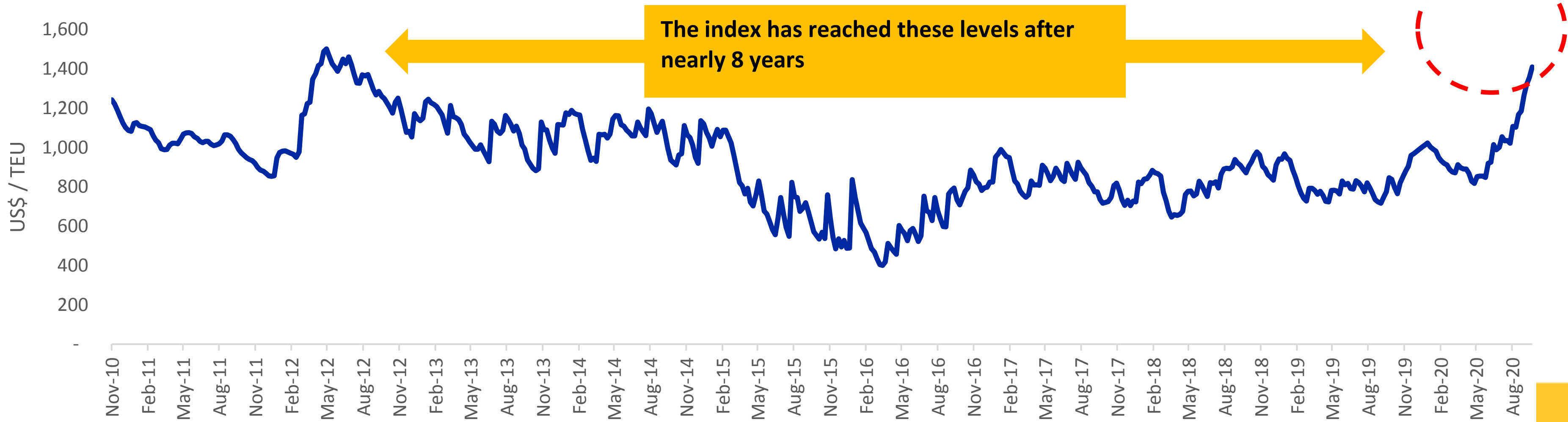
EXHIBIT 4: YoY trend in key commodity imports from China



Container rates witness strong recovery; but sustainability a concern

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 contraction in Q2 CY2020 worsened with ~10% decline due to the impact of the containment measures adopted by the various governments. While some recovery is expected in Q3 CY2020 with easing of the containment measures, given the weak global economic environment and subdued demand, the pace of recovery remains uncertain. Further, there is also the risk of re-intensification of the pandemic and the containment measures, which adds to the uncertainty. However, despite the weak volumes, the container charter rates have witnessed recovery since May 2020 and have reached the highest level in the last eight years in September 2020. This can be attributed to the tight supply arising from increased idling and blank sails by liners and better fleet management by players. This has been aided by the consolidation witnessed in the sector in the last few years. Nonetheless, in the absence of a sustained recovery in demand, the rate improvement will be difficult to sustain and may witness volatility. Further, due to the steep rate of increase witnessed in recent months, there could be increased scrutiny by the authorities about cartelisation by liner companies, which could also impact the rates going forward. 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 5: Trends in Container Freight Rates (Shanghai Containerised Freight Index)



Tanker rates remained subdued in recent months 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 the formation of a strong contango in crude markets, which resulted in high demand for tankers of crude storage and also for continued supply to refineries, which had not immediately cut down production to that extent. Subsequently, the demand for storage of 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 as well. The tanker rates for certain categories like VLCC for crude tankers touched decadal highs and the product tanker index surpassed the crude index. However, once the contango in the oil markets weakened, the rates witnessed a steep moderation as the storage requirement moderated. At these rates, it will be difficult for vessels to achieve a break even. Nonetheless, there has been early signs of a second wave contango in oil prices due to demand concerns in the last one month, which if it persists, may again provide some filip to the storage demand. However, considering the fact that the earlier vessel supply, which was used for storage, is not completely back for voyage availability, the uptick may not be the same. Going forward, any sustainable improvement in 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 6: Trends in crude tanker rates ($/day)

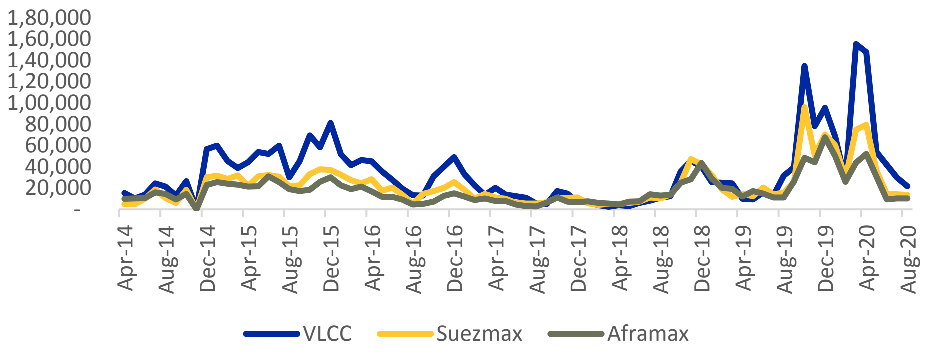
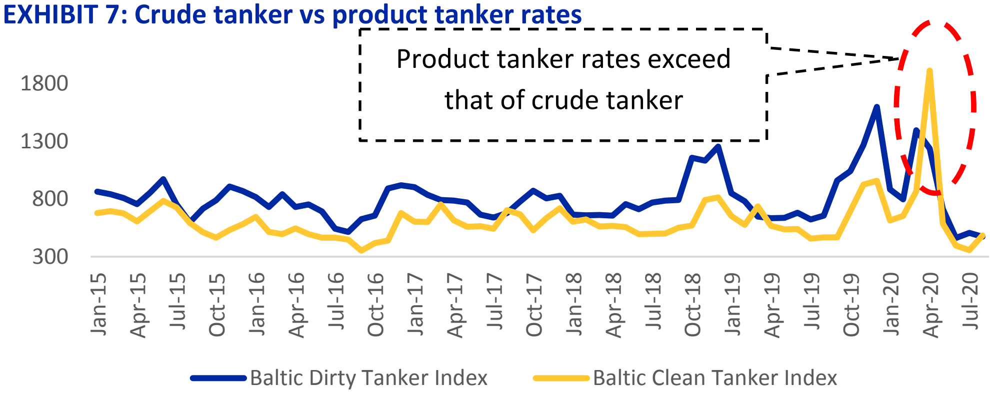


EXHIBIT 7: Crude tanker vs product tanker rates



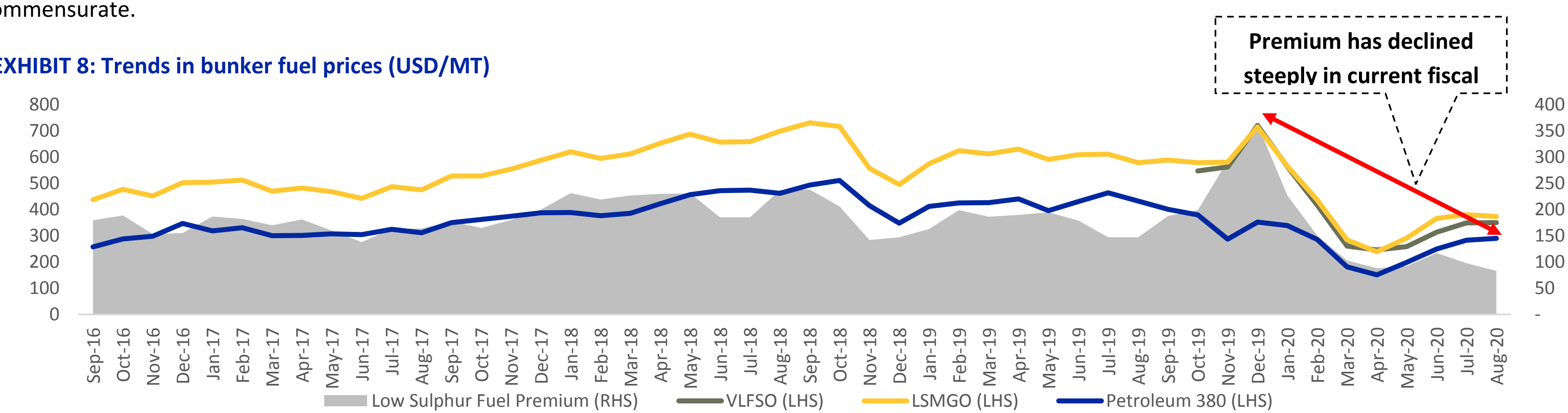
Source: Industry Sources and ICRA research

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 the OPEC+.

Low sulphur fuel premium remains low in last few months

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 is also down. The premium further moderated since April and has remained at less that $100/MT, except in the month of June. Many companies had 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 any major 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 8: 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 of different segments have witnessed steep volatility in the last six months in the backdrop of the Covid-19 pandemic, oil market fluctuations and supply management by shipping companies in specific sectors. However, despite the charter rates witnessing recoveries or record highs for a brief period of time in specific cargo segments, the sustainability of the rates is uncertain due to subdued economic activity and muted demand trends at major economies. Further, the geo-political and trade disputes of China, the major driver of ocean transport in several commodities; with other major economies have also added to the uncertainties. The sustainable improvement in charter rates will happen only if there is sustained recovery in global economic activity and the supply of vessels remains rationalised. If there is an increase in the scrapping of vessels and thereby leading to tightening of supply, it should be favourable for the sector and conversely, an increase in new build orders or higher deliveries may lead to an over-supply situation. The demand and rate outlook also remain vulnerable to a second wave of the pandemic and re-intensification of containment measures at major economies.

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 the performance would have been adversely impacted, while the recovery in the dry bulk and the liner segment would have mitigated the impact. ICRA reiterates that 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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