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INDIAN SHIP-BREAKING INDUSTRY

Sharp Rupee depreciation and softening in the steel scrap prices to hit margins and viability in the near term

JULY 2022

Key Highlights

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Higher procurement cost exacerbated by sharp rupee depreciation and softening in steel scrap prices to turn operations unviable at current levels

Dismantling volumes and margins are expected to come under pressure in the current fiscal

- Favourable demand for shipping trade and increase in freight rates resulted in sluggish number of vessels being offered for scrapping globally. India witnessed the lowest tonnage dismantled in a decade at 1.4 million light displacement tonnage (LDT) in FY2022 compared to 1.8 million LDT in FY2021.

- India's market share (in gross tonnage) also declined to ~20% in the calendar year 2021 from historical levels of ~30% owing to stiff international competition and high ship procurement prices.

- Sharp rupee depreciation further elevated the already high procurement cost of vessels. The problem was compounded by the softening in realisations. Domestic steel scrap prices corrected by ~10-15%, post imposition of the export duty in the recent past, affecting the viability of the ship-breaking operations.

- Indian ship-breaking players remain exposed to adverse forex movements more so as only a limited number of these engage in foreign exchange hedging. Sharp weakening in rupee is also likely to result in forex losses on maturing LCs in the coming months, thereby adversely impacting profitability.

- ICRA expects a significant decline in new ship purchases in the coming months. Correspondingly, dismantling volumes are expected to be lower by ~10-15% in H1 FY2023 on YoY. Margins are also expected to remain under pressure in the current fiscal.

Industry Background

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- Over the past decade, India, Bangladesh, and Pakistan have emerged as the ship-breaking hubs, accounting for over 90% of the global ship-breaking activity. Asian countries dominate the industry because of lower manpower cost and relatively less stringent environmental/health regulations compared to western countries. India, Bangladesh and Pakistan use the beaching technique for ship-breaking because of their favourable tidal conditions. Moreover, it is less capital intensive and hence, more cost effective in comparison to the advanced dry dock method. These factors have enabled these countries to become the preferred ship dismantling destinations. Also, there is a strong demand for steel in the South Asian countries due to the presence of a large recycling industry wherein everything in the vessel is recycled.

- In India, ship-breaking yards are present in Gujarat, Maharashtra and West Bengal. However, majority of the ship-breaking activity is concentrated in Alang, Gujarat accounting for more than 90% of the India's ship-breaking activity mainly on account of favourable site that falls in the high tide zone

- The Alang breaking yard is located along a 10-km strip of coast and has 170 yards with a total annual capacity of 4.5 million Light Displacement Tonnage (LDT).

- Ship-breakers derive a major share (~80-90%) of their revenue from sale of ferrous or mild steel (MS) scrap, which consists of re-rollable scrap and melting scrap. The domestic demand for a ship's steel scraps is mostly generated from the feedstock demand of re-rolling and rolling mills, which is essentially influenced by demand and prices for scrap steel plate, steel prices in a country and imported steel scrap prices. A part of the ship recycling revenue also comes from the sale of a variety of other recyclable materials and products (non-ferrous metals, machines and equipment, hardware, fittings and furniture, oils and other consumables) recovered from the ships.

- Majority of the ship breakers purchase ships by way of Letter of Credit (LC) with a tenure of 90-270 days depending on the size of the ship. The transaction is denominated in foreign currency at time of purchase of ship and there is time lag in actual sales after ship breaking leading to exposure of their profitability to forex risk and commodity price risk. Furthermore, due to high hedging cost compared to low profitability, ship breakers are often resistant to hedge its cash flow.

Favourable freight rates to keep vessel supply for dismantling under check

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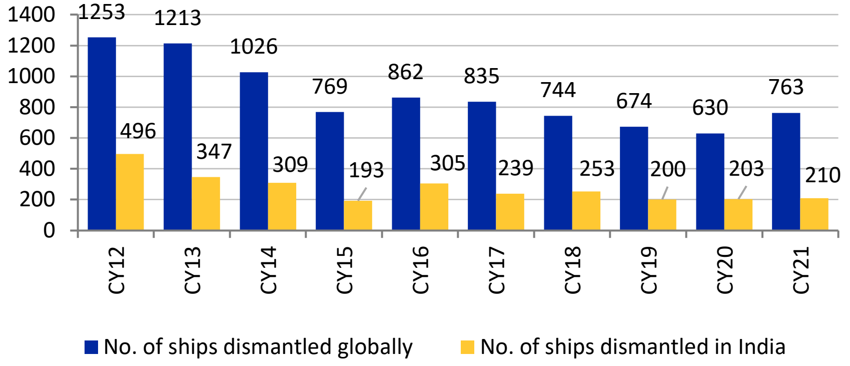
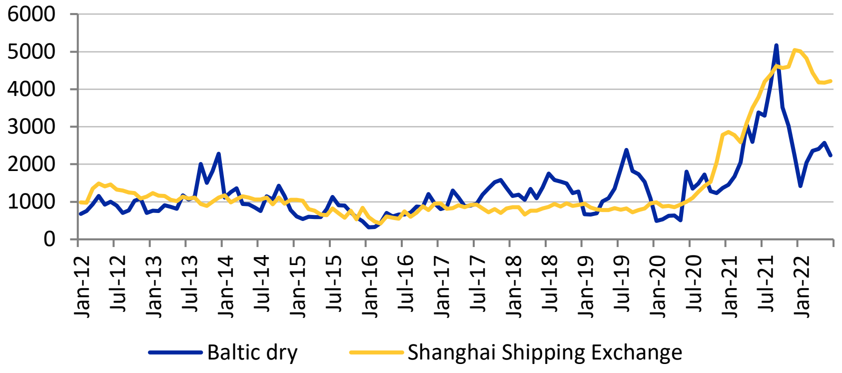
Exhibit: No. of ship dismantled



Source: ICRA Research, Shipbreakingplatform.org

Exhibit: Baltic dry index trend for last 10 years



Source: ICRA Research , Bloomberg

- The global supply of ships for dismantling has halved over the last one decade; with volumes falling to 763 ships in CY21 from 1253 ships in CY12. The improvement in earnings for the shipping companies following higher fright rates and the traction in the seaborne trade, the overall supply of vessel for dismantling was relatively lower in the recent past.
- The availability of ships for recycling is inversely correlated to the freight rate of shipping vessels, which in turn is a function of the global demand for seaborne transport and supply of new vessels.
- Freight rates has witnessed quite a volatility specially in the last two years. Global shipping constraints, port congestion and an overall rebound in commodities demand post pandemic led to significant uptrend in the freight rates. A strong recovery from the pandemic caused demand to significantly outstrip supply, with Baltic Dry Index touching its peak in September 2021. Though these have come down in the current calendar year, nonetheless, it remains favourable for the shipping industry.

Lowest volumes dismantled in a decade

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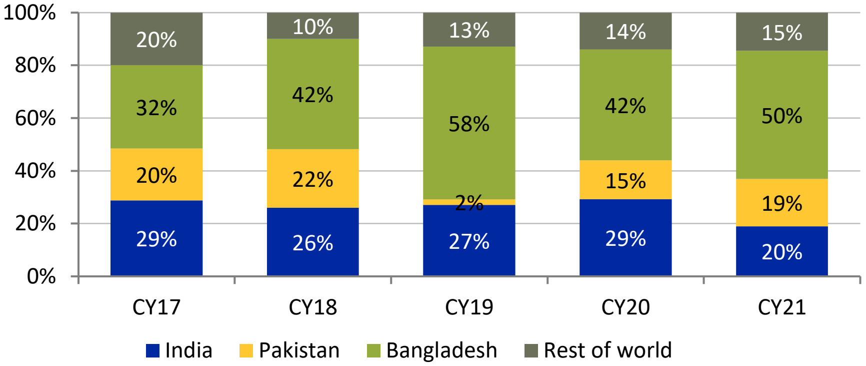
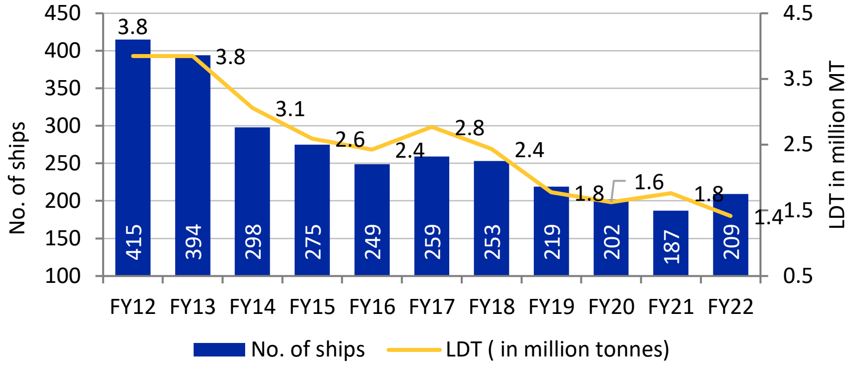
Exhibit: India’s market share (Gross Tonnage)



Source: ICRA Research, Shipbreakingplatform.org

Exhibit: No. of ships and tonnage dismantled in India



Source: ICRA Research , steelmint

- In line with global trends, the number of ships imported for dismantling in India also declined over the last one decade. Stiff competition from the global peers (mainly from Bangladesh and Pakistan) and sharp increase in procurement cost, ship owners preferred breaking smaller vessels in tonnage resulting in a lower market share.
- In terms of LDT volumes, the dismantling volumes declined to ~1.4 million LDT in FY2022 compared to 1.8 million LDT in the FY2021 and 3.8 million LDT in FY2012.
- Domestic industry aspires a ~50% stake after passing of the ‘Recycling of the Ships Act, 2019’. The Act ratifies the Hong Kong International Convention for the safe and environmentally-sound recycling of ships, the ships that are currently not coming for breaking to India from the treaty nations of the US, Europe, and Japan will begin arriving in India.
- The domestic players are still in a process of fully complying with the suggested regulatory norms and this may result in higher compliance and capex cost in the near term, however, the same is expected to be neutralised by higher volumes and competitive procurement costs in the long term.

Note: LDT or Light displacement tonnage is the weight of a ship excluding cargo, fuel, water, ballast, stores, passengers, crew.

Steep rupee depreciation to further elevate the procurement cost and hit margins

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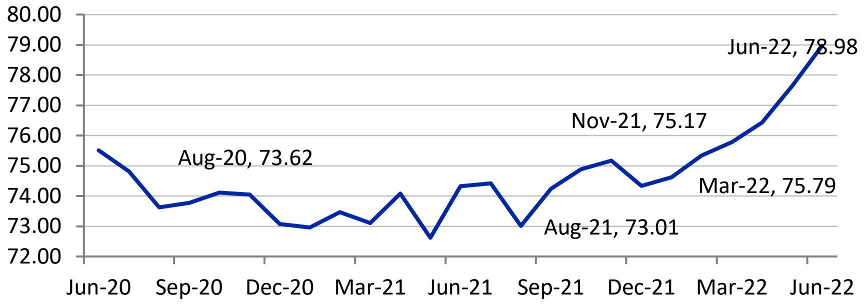
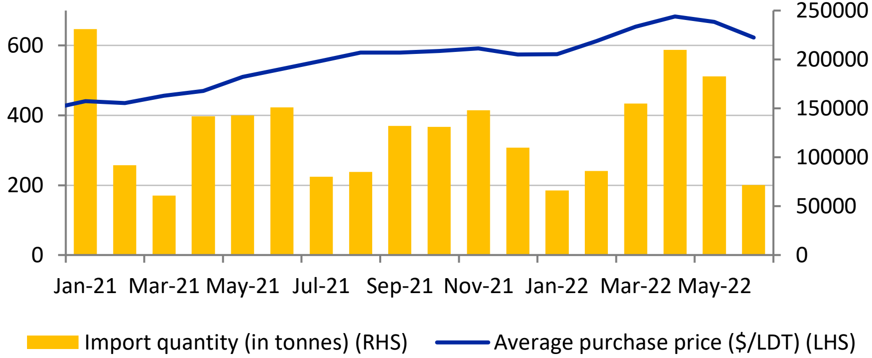
Exhibit: INR/USD trend for last 2 years



Source: ICRA Research, Bloomberg

Exhibit: Monthly import price and import volume trends

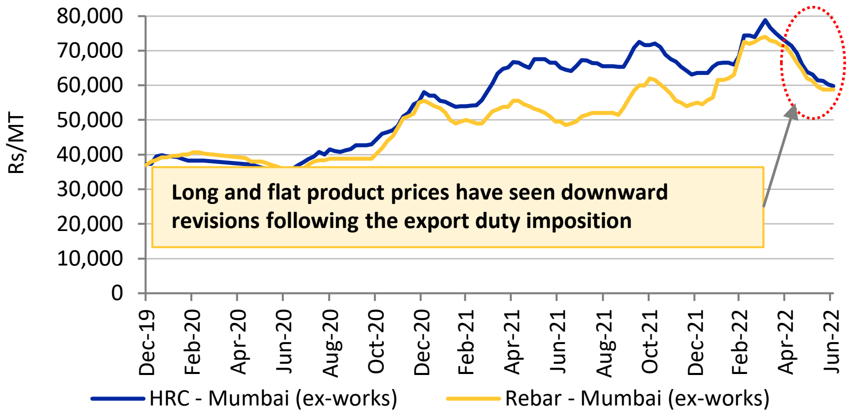


Source: ICRA Research , Steelmint

- Procurement prices remained higher in line with stiff competition and higher steel prices globally. The prices remained above 600 USD/LDT in the last 6 months. Sharp decline in INR (visa-vis USD) in the recent months led to further increase in the procurement prices.
- Players with existing unbroken inventories and unhedged exposures are likely to be adversely impacted, since purchases transactions are denominated in USD and are backed by 90-180 days letter of credit.
- Industry witnessed a drastic dip in the import volumes for ships in June 2022 that plummeted to 0.7 lakh LDT, down by 61% on a monthly basis. This was mainly led by the skepticism of ship-breakers amidst a highly volatile conditions led by the increased the vessel procurement cost. The volumes are expected to further decline in the coming months with given uncertainty in the forex rate.

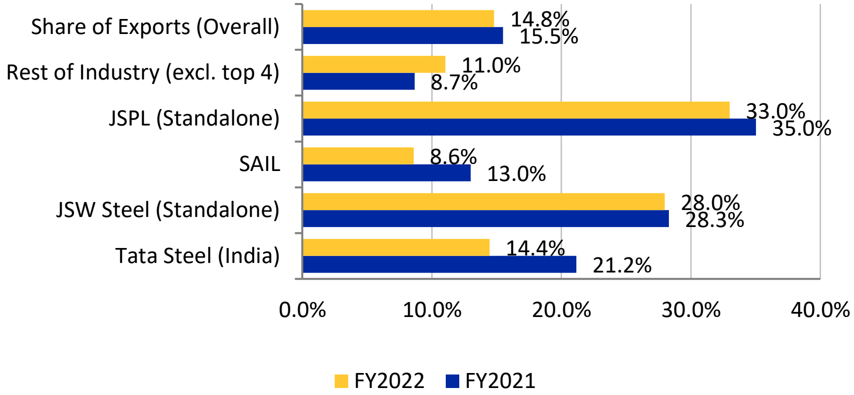
Domestic steel prices correct by 10-15% since the imposition of export duty

Trend in HRC and Rebar prices in Mumbai (ex-works)



Source: Steelmint, ICRA Research

Share of finished steel and semis exports by leading steelmakers

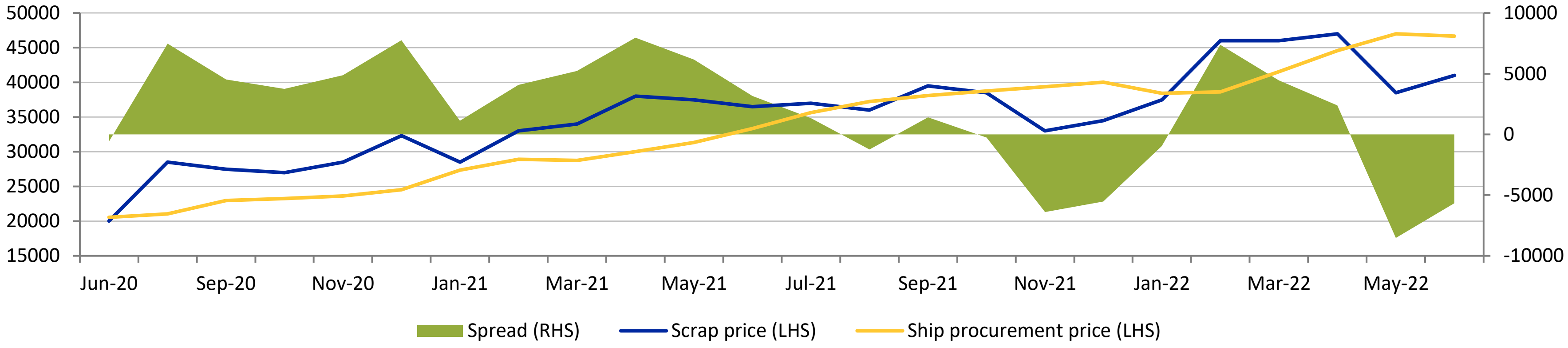


Source: JPC, Company Publications, ICRA Research

- Share of exports by the leading steelmakers significantly higher than the rest of the industry; competition in the domestic market to intensify going forward as larger players could look to divert part of the export volumes to domestic users.
- Following the imposition of duty, domestic mills have announced 10-15% price cuts; further cuts in the coming months cannot be ruled out as demand remains soft in the seasonally weak Q2 FY2023, which is also likely to put pressure on the scrap prices and realisations of ship-breakers.
- Input cost pressures, along with steel price correction, to drag steel industry earnings to Stable territory now after being in Positive range for two years. Accordingly, ICRA has revised the domestic steel sector outlook from Positive to Stable.

Softening in steel scrap prices coupled with higher procurement cost leads to negative spread

Exhibit: Steel scrap, procurement price, spread trends (Rs. Per MT)

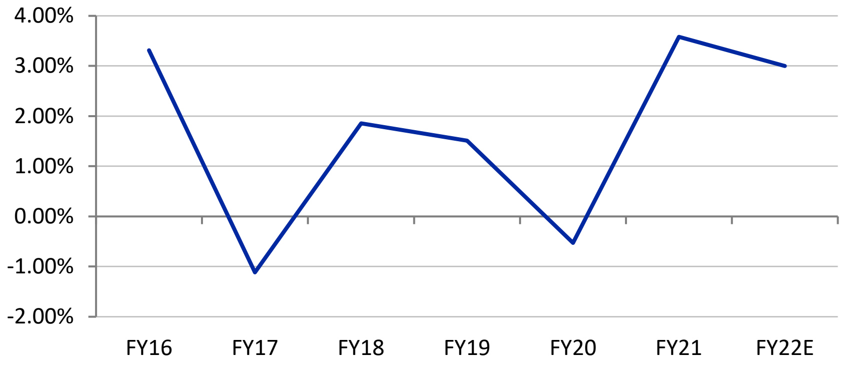


Source: ICRA research, Bloomberg, Note: ship procurement prices are adjusted for other components like non-ferrous material

- About 80-90% of the overall volumes of a ship comprises re-rollable scrap and melting scrap while about 10% is formed by furniture, machineries, non-ferrous scrap and used diesel oil.
- The steel scrap prices have been at an increasing trend, primarily from September 2020 and touched an all-time high of Rs. 47000 in April 2022. The prices corrected by ~15% in the last two months from its peak to Rs. 41000/MT in June 2022. The decline was attributed to imposition of export duty on pellets and steel products.
- The prices of steel in the Indian market have not moved in synchronisation with INR depreciation resulting in an inability of the ship-breakers to pass on their increased procurement costs to their customers thereby resulting in a squeeze on profitability.
- Moreover, the negative spread in recent times has also resulted in unviability for shipbreakers to procure ships.

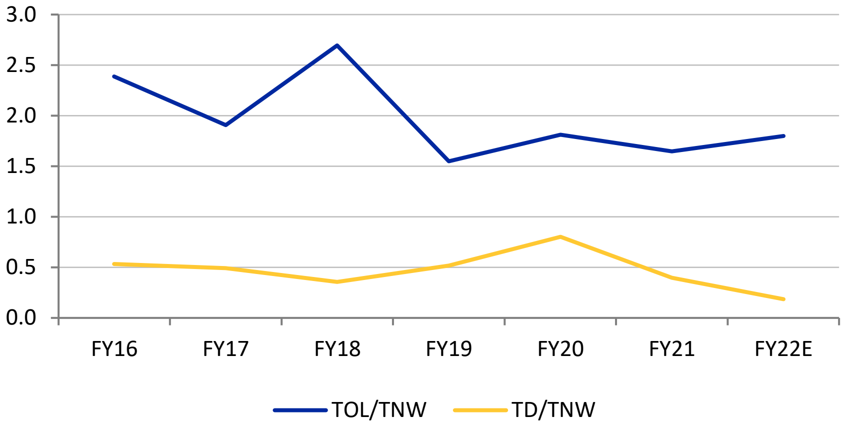
Trend in margin and leverage metrics

Exhibit: Operating margin trend^



Source: ICRA Research. Ace equity

Exhibit: Leverage - TOL/TNW trend



Source: ICRA Research, Ace equity

- The operating profit margin in this business is low (1.5-~3% of OPM) as the value addition is less and there is stiff competition from various players in the domestic industry as well as from competing countries.
- For ship-breaking companies, the debt requirement is mostly restricted to short-term working capital loans. The reliance on long-term fund-based facilities is low as the capex requirements are mostly met through unsecured loans, thus leading to a comfortable capital structure. However, TOL/ TNW remains high due to increased reliance on LC-backed purchases

Note: Aggregate of ICRA rated entities and listed entities – Rushil Industries Limited, Baijnath Melaram, Mariya Ship breaking Pvt Ltd, Dalkan Ship Breaking Limited, Paras steel Corporation, Shiv Ship Breaking, Vijay Kumar & Co. VMS industries Limited and Hariyana Ship breakers Limited

Conclusion

The industry players are facing turbulent times currently with volatile scrap/steel plates prices and unfavourable foreign exchange rates. Higher procurement rates of vessels due to growth in seaborne trade post lockdown also hurting viability for ship-breakers.

ICRA expects the domestic ship-breaking volumes to remain significantly lower in the near term amid these uncertainties. Ship import volumes are expected to be lower by ~10-15% in H1 FY2023 on a YoY basis and subsequently the revenues are likely to take a hit in the current fiscal.

Industry level margins remains subdued (OPM of ~3%-4%) due to limited value addition. The margins are likely to get squeezed further due to the softening in steel scrap prices and the weak rupee, given the limited number of industry players engaged in hedging.

Going forward, any meaningful recovery of scrap prices in the domestic market and stable foreign exchange rates or correction in the vessel procurement cost following a sustained downturn in the shipping freight rates, will be a silver lining for the industry.

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Analytical Contact Details

	Sabyasachi Majumdar	Girishkumar Kadam	Sanket Thakkar	Preet Ludhwani
	Senior Vice-President and Group Head	*Senior Vice-President and Co-Group Head*	*Assistant Vice-President and Sector Head*	*Senior Analyst*
Email	sabyasachi@icraindia.com	girishkumar@icraindia.com	sanket.thakkar@icraindia.com	preet.ludhwani@icraindia.com
Phone	0124- 4545 304	022 – 61143441	079– 4027 1528	079– 4027 1542

Business Development/Media Contact Details

L. Shivakumar	**Jayanta Chatterjee**	**Naznin Prodhani**
Executive Vice-President	*Executive Vice-President*	*Head Media & Communications*
shivakumar@icraindia.com	jayantac@icraindia.com	communications@icraindia.com
022- 6114 3406	080 – 4332 6401	0124 – 4545 860

Thank You!