

Rating Methodology - Shipping Companies

Industry Overview

The Shipping Industry is a global industry. 90% of the global trade (in terms of volume) is carried via sea route, making the industry the lifeline of the world economy. Due to the mobile nature of the asset class (ships), the freight rates ruling in any particular route is not significantly different from those of another. This makes the Indian Shipping Industry highly intertwined with Global Shipping Industry. Depending on the nature of cargo carried, Shipping Industry can broadly be classified into three segments: Dry Bulk, Wet Bulk (Tankers) and Containership segment. While Dry Bulk Carriers carry Iron Ore, Steel, Coal etc., tankers are used for transporting Crude Petroleum (Crude Carriers), downstream refined products (Product Tankers) and Chemicals (Specialized carriers e.g. LNG carriers). Containerships initially transported breakbulk (commodities which are shipped in bundles, pallets, bins etc.) but today are used to carry huge variety of other cargo too. The Multi-modal transport that the containers facilitate is leading to exponential growth in containership segment.

Characteristics of Shipping Industry

The Shipping Industry is characterized by its volatility. Due to choppy revenue streams, shipping companies usually have some years of super normal profits and some years of losses. The vessels constitute almost 90% of the fixed assets of shipping companies. As the vessel cost can range between USD 20-300 mn, the industry in addition to being cyclical is also capital intensive. The standardized nature of the shipping services makes it difficult for any single company to wield significant pricing power, thereby lowering switching costs for customers. The industry is regulated by the rules and regulations of IMO and other international bodies in addition to the fiscal, judicial and manning requirements of the flag state. The shipping companies attempt to stabilize earnings by deploying their vessels in a judicious mix of time charter, voyage charter, BBCD and other contract arrangements. The

fleet age too has an impact on the earnings. Higher age of fleet leads to higher operating expenses, lower charter rates, greater risk of accidents etc.

Demand -Supply Dynamics of Shipping Industry

The freight rates are determined by the demand-supply dynamics. The Demand for ships depends on:

- a) World economic position
- b) Regional Disparity in availability of natural resources and production of final products
- c) Political events greatly affect the oil tanker business because of the concentration of the oil supplies with few select countries
- d) Natural disasters like hurricanes etc. can also impact the demand for vessels due to closure of production or refining facilities.

The Supply of ships depends on (i) Fleet size (ii) Scrapping of vessels (iii) Delivery schedule of new vessels, and (iv) Capacity for Shipbuilding (New Ships can be built only if there are slots available with shipbuilding yards). As on April 1, 2009, the fleet size of the Indian Shipping industry aggregated 15.3 mn dwt. Of the same, the tankers accounted for the highest share at 58% of the total with the contribution of dry bulk vessels next at 32.9%. The share of containerships and general cargo vessels remained miniscule at 2.8% & 0.2% respectively. Further, the industry is largely dominated by only a few large players due to their size and scale of operation. The large Indian Shipping Companies mainly operate in Dry Bulk and Wet Bulk segment with a miniscule presence in the containership segment.

Rating Methodology

CARE's approach towards analyzing Indian shipping companies includes both qualitative as well as quantitative assessment. Quantitative assessment comprises analysis of size and scale of operations, business segments and operating efficiency. CARE also analyses the company's capital mix, operating cash flow and free cash reserves to carry on business during lean period (when freight rates are down). Whereas qualitative assessment involves management evaluation, corporate governance practices and concentration risk in client portfolio. CARE has identified following six factors to be considered while analyzing the credit risk of a shipping company –

1. Economies of scale and scope
2. Revenue Characteristics
3. Operating Efficiency

4. Cash Flow Volatility
5. Financial Strategy and Capital Mix
6. Management Evaluation

Economies of scale and scope

Scale and scope of operations bear crucial impact on the credit profile of the shipping company.

Scale, in terms of larger fleet size, is likely to provide benefits such as discounts from ship brokers, lower port operating costs (dry docking expenses and fees of stevedoring agents) to the company. Besides this, larger fleet size also improves its flexibility to cater to the global customer base. In contrast, small companies are highly susceptible to the external factors in the shipping industry such as increase in bunker cost, volatility in freight rates and changes in government regulations. The small companies also suffer from lower bargaining power vis-à-vis. other large players in the industry.

While undertaking credit assessment of a shipping company, CARE views larger fleet size as strength in revenue generation capability.

Scope is determined by the different segments the company is operating into, its geographical reach and customer base.

Operating segment – As discussed earlier, there are three segments viz. wet bulk, dry bulk and container ships. Since the dynamics of these segments are driven by different factors like government policies, trade scenarios etc., the company which is present in all of these segments gets the natural hedge against the vagaries arising out of any one of these segments.

Geographical Reach – The geographical reach mitigates the volatility in revenue arising out of country - specific regulatory changes, regional demand-supply disparities, and political event risks. This is likely to stabilise revenue streams across trade lanes. There are seven trade lanes operating in the shipping industry such as (i) Intra-Americas, (ii) Intra-Asia, (iii) Intra-Europe (iv) Transpacific, (v) Transatlantic (vi) Asia-Europe and (vii) the rest of the world. Companies serving on most of these routes reduce the risk of being dependent to one particular region.

Customer base –The long -term relationship with clients provides stability to revenue streams of the company. However, it exposes the company to few customers. Wide customer base across the region mitigates the concentration risk of the company.

CARE emphasizes on well-diversified customer base, ability to operate across segments and geographical routes and views them as strengths while evaluating the company.

Revenue Characteristics

Movements in freight rates are determined on the basis of demand and supply of any commodity in any part of the globe and availability of vessels to transport the same. This makes the freight rates in the spot market volatile, leading to variable cash flow for shipping companies. Judicious mix of spot and long-term contracts provides flexibility to tap opportunities in rising market besides providing stability to the cash flows of the company. Cash accruals from stable earnings improve the company's capability in debt servicing as well as in making new investments in vessel acquisition. Long-term contracts protect company from unfavorable variations in the freight rates.

Although a trade off is essential, CARE emphasizes on the judicious mix of spot and contracted earnings so as to cover the fixed costs of the company.

Operating efficiency

Given the cyclical nature of the industry and low pricing power, high degree of operating efficiency would lessen the impact of volatile revenues. Operating efficiency primarily includes factors such as fleet age, combination of owned and leased vessels and fleet type.

Fleet Age - Operating expenses such as bunker cost, dry docking expense, insurance etc. will be higher for the older vessels which will adversely impact the profitability. The higher fleet age will also lead to frequent scraping of old vessels and their replacement. In other words, high provisioning will be required for asset acquisition.

Owned v/s Leased vessels – Outright purchase of vessels require higher capital outlay unlike vessels which are taken on lease. By exercising the latter option of leased vessels, the company can increase

its capacity (DWT) without incurring upfront capital expenditure. However, considering the volatile nature of freight rates and asset prices in the industry, track records of creating tonnage using heavy mix of owned and leased vessels and their effective deployment is an important parameter.

Fleet type – In line with the IMO regulations, there are restriction on operating single-hull tanker vessels to minimize risk to the marine environment. Besides, in the dry bulk segment, the geared vessels provide flexibility to operate in a port where there are no adequate material handling systems. As such, the fleet profile including double hull as well as geared vessels provide additional comfort towards continuity of the operations.

Based on the above arguments, CARE views higher fleet age as a concern while determining the operating efficiency of the company.

Cash Flow Volatility

Operating cash flow of a shipping company is influenced by freight and charter rates. Hence, cash flow is subjected to volatility. The capital-intensive nature of the industry requires stable cash flows to meet the debt servicing obligations and strategise their expansion plans.

While assessing the debt servicing capability, CARE positively views the company's stable cash flows as well as its prudent working capital management.

Financial Strategy and Capital Mix

Shipping being a capital-intensive industry, major portion of the asset funding is financed through long-term debt. Ship building is a time-consuming activity (18-24 months). This, makes the vessels highly marketable. The aforesaid mentioned liquidity helps companies to raise long-term debt to acquire new vessels and add capacity. However, high volatility in freight rates (cyclical nature of the industry) may impact the company's ability to service high debt level. To honor the debt obligations, the company should have adequate cash flows by way of a proper mix of contracted earnings and income from deploying vessels on spot basis.

CARE believes that the long -term contracts and stable relationship with large client base can provide financial flexibility to the company.

Management Evaluation

The success of a company lies in management’s ability to effectively implement strategies. Hence, management evaluation plays a pivotal role in the process of credit assessment of a company. Management’s ability to a gauge business prospects and industry trends is a key determinant for assessing management’s capability and vision.

CARE evaluates the management from different perspectives, like financial management capabilities, experience in the industry, track record in planning & implementing, managing manpower resources and their capabilities to deliver under stress.

Conclusion

The rating process is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CARE analyses each of the above factors and their linkages to arrive at the overall assessment of credit quality, by taking into account the industry’s cyclicity. While the methodology encompasses comprehensive technical, financial, commercial, economic and management analysis, credit rating is an overall assessment of all aspects of the issuer.

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