Oil tanker industry faces increased credit risk due to lasting pressure of low freight rates

by Sean Lau Koon Leong

- **Due to "floating storage" opportunities, tanker rates hit an all-time high in March causing the PD of the industry to temporarily decline**
- **However, rates are likely to remain low for the foreseeable future due to the lasting effects of the oil price war and pandemic–induced demand reduction**
- **Agg PD uptrend since start of 2020 looks likely to continue into future as seen in Forward PD**

China's shutdown due to the COVID-19 pandemic in Q1 2020 as well as the global fall in oil demand due to the end of the seasonal winter months saw the oil price and tanker rates plummet at the start of 2020 as seen in Figure 1a. Global lockdowns and the ongoing oil price war between Saudi Arabia and Russia in March further accelerated this trend. The poor tanker rates resulted in the industry's NUS-CRI Aggregate (Median) 1-year Probability of Default (Agg PD) rising to BB- in March when referenced to the PDiR2.0[1] in Figure 1b.

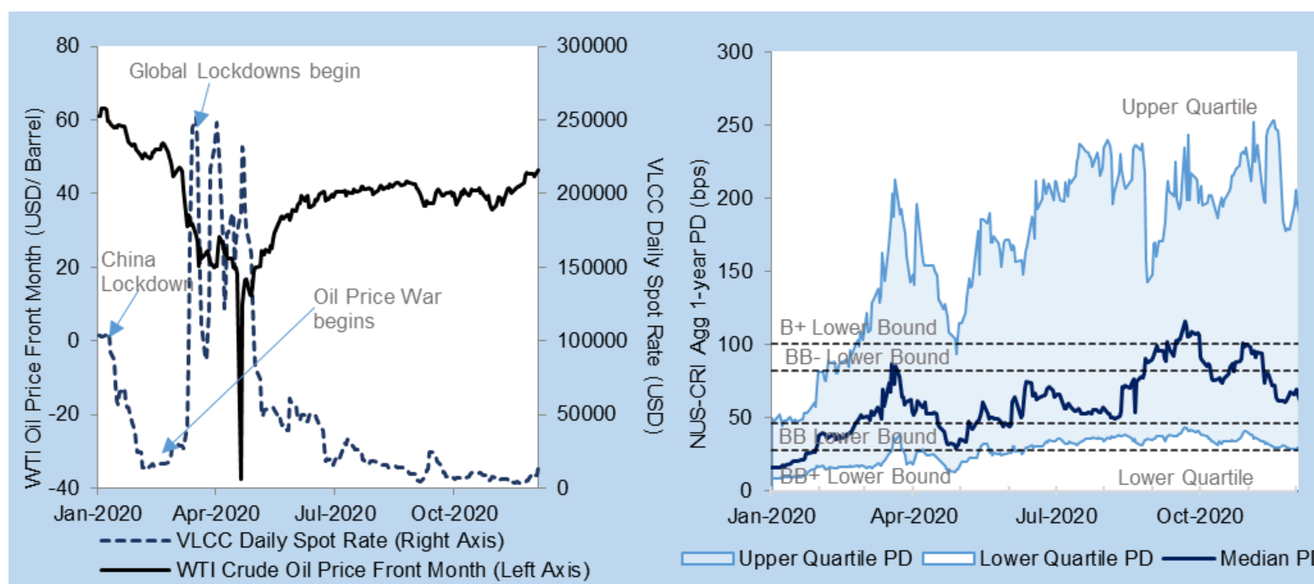

Figure 1a (LHS): WTI Oil Price Front Month and VLCC Daily Spot Rate graph. Figure 1b (RHS): NUS-CRI Agg 1-year PD of the oil tanker industry, split into median, upper quartile and lower quartile with reference to PDiR2.0 bounds. Source: *NUS-CRI & Bloomberg*.

At its lows, the oil market entered a steep contango[2]. With the wide spread between the spot and futures prices, many oil traders sought storage space to capitalise on the arbitrage opportunity of buying oil at its low spot rate while simultaneously selling the more expensive futures contract, profiting from the spread. With storage facilities on land filling up, traders started turning to oil tankers, creating a new "floating storage" business opportunity for the industry. This drove the spot freight rates of Very Large Crude Carriers (VLCCs) to a high of USD 250,000 per day, allowing the oil tanker companies to make record profits due to low daily operation cost of only USD 25,000.

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

[2] Contango is a rare phenomenon in the oil industry whereby the futures price of oil is higher than the spot price.

Some companies took advantage of the short-term spike in tanker rates to book long term contracts above normal market rates, locking in higher revenue for the following quarters. For example, DHT Holdings managed to book 6 of its VLCC ships on one year contracts in April at an average daily rate of USD 67,300. The company currently also has a large part of its fleet already booked for 2021 such that spot cash break-even for the fleet is only USD 3,400 a day, insulating the company from the tanker rate volatility. Due to this, the industry is on track to comfortably register its highest recorded annual revenue this year, as seen in Table 1. These record profits have enabled oil tanker firms to reward their investors with generous payouts. They have also enabled the firms to improve their financials, as many companies took advantage of the opportunity to deleverage. The industry's average debt levels currently sit at a 4-year low while the median Debt / Equity ratio sits at a healthy 0.82. This has allowed companies such as Euronav, which has a Debt / Equity ratio of 0.44, to reduce its debt by USD 325mn while paying out 21% of profits as dividends and repurchasing USD 118.5mn of stock this year. Deleveraging greatly reduced the industry's credit risk, causing the industry's PD to fall at the end of March in Figure 1b. At a time when most of the economy was reeling from lockdowns due to the COVID-19 pandemic, the tanker industry enjoyed its best quarter.

	2017	2018	2019	2020 YTD as of Q3
Industry Average Debt (USD mn)	753.16	830.14	926.99	745.18
Industry Average Revenue (USD mn)	419.35	462.14	537.91	505.74
Industry Median Debt / Equity Ratio	1.03	1.07	1.06	0.82
Industry Average Debt / Equity Ratio	1.14	1.47	2.08	3.22

Table 1: Oil Tanker Industry average debt, revenue and median and average Debt/ Equity Ratios. *Source: Bloomberg*

However, this bonanza did not last long as the industry's core business of transporting oil had already been suffering since the start of the COVID-19 outbreak in China. As the long-term demand implications of the pandemic and the ensuing slow economic recovery became more apparent, the spot and futures spread of the oil price narrowed. The resulting reduction in the contango effect led to a massive fall in the demand for floating storage. These factors caused the daily VLCC rate to tumble to less than USD 10,000 in September, far below the average breakeven rate of USD 25,000. With the floating storage opportunity gone, the oil tanker freight rate will likely remain low until global oil demand recovers. Moreover, it is unlikely that the industry will experience the traditional rates boost in winter months this year due to the OPEC+ supply cuts and newly imposed lockdowns in many countries facing their 2nd or 3rd wave of the virus. Finally, the EIA has forecast that the low global levels of oil consumption will likely persist through 2021, only recovering to its 2019 highs in 2022.

To make matters worse, tankers are under increasing climate regulations over their emission of pollutants. The International Maritime Organisation has mandated that all tankers reduce their fuel sulphur content from 3.5% to 0.5% this year. Tanker operators can either install costly scrubbers on their vessels or purchase more expensive low-sulphur fuel oil (LSFO) putting further pressure on the profitability.

As the industry enters a cash burning cycle, Figure 2 illustrates that the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[3]) has worsened from April when the oil price was at its lowest. The PD outlook of low credit risk companies do not significantly change from April to December. However, the dispersion between the firms with the lowest and highest credit risks in the industry widens due to difference in sensitivities to the prolonged period of low rates. A large part of this is due to the operational planning and booking of a company's vessels. The dispersion highlights the success of firms at navigating the volatility of the tanker rates as firms with more exposure to spot rates have suffered in the latter part of 2020. The difference in the industry's average versus median Debt / Equity Ratio (3.22 versus 0.82) as shown in Table 1 further highlights this dispersion. This suggests the existence of a few companies that are already struggling in the low oil price environment and have taken on a lot of debt this year, skewing the average Debt / Equity levels higher.

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

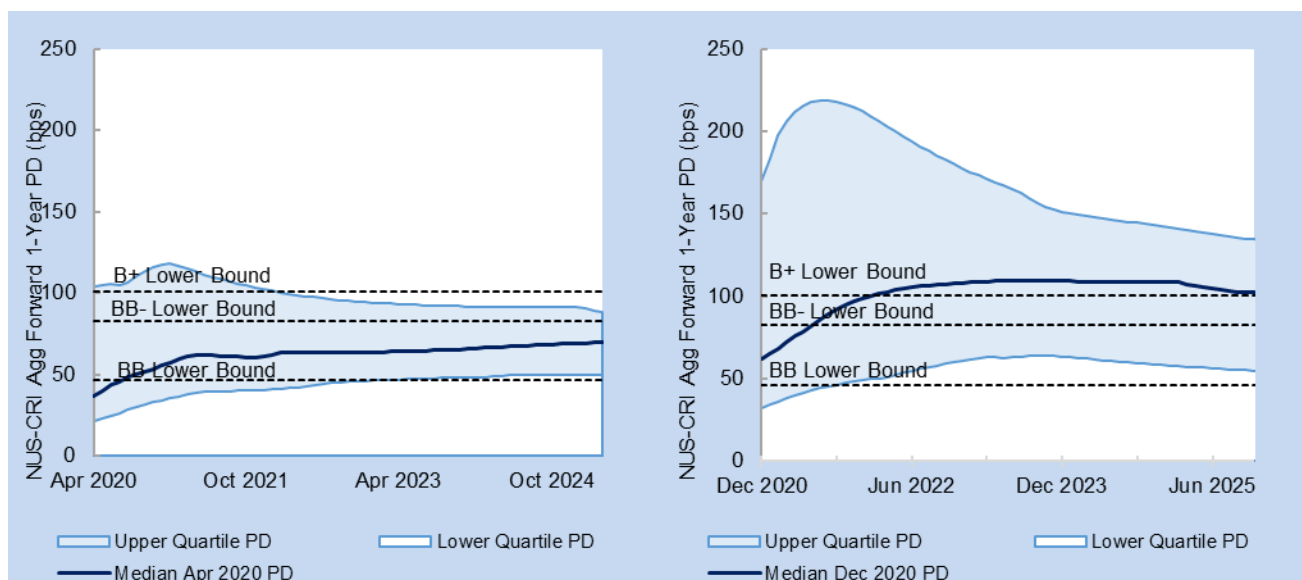

Figure 2a (LHS): NUS-CRI Agg Forward 1-year PD of oil tanker at lowest point of oil price in April with reference to PDiR2.0 bounds. Figure 2b (RHS): NUS-CRI Agg Forward 1-year PD of oil tanker in December with reference to PDiR2.0 bounds. Source: *NUS-CRI*

The total global fleet size for tankers reached a 2-year high. With the market being oversaturated, companies were forced to book their ships at a loss. However, the oil tanker order book is at a 23-year low and the newly imposed climate regulations could accelerate scrapping as it becomes less cost effective to fit scrubbers or purchase more expensive oil for older ships. This will reduce supply of tankers in the future allowing companies to streamline their operations. If oil prices remain supressed for the next 2-3 years, the global oil tanker fleet size could significantly downsize, thus leading to better rates in the future. As oil demand is also expected to increase by then, these favourable demand and supply factors could lead to better tanker rates and a decrease in the PD in long term, especially for riskier firms.

There are also several developments that will likely lend a boost to the industry in the short term. China has regained its economic footing and the country's oil consumption has returned to pre-COVID-19 levels. Pfizer's, Moderna's and AstraZeneca's vaccine progress will likely accelerate a global economic recovery and the recovery of oil demand. These factors have already resulted in the PD for the oil tanker industry to fall in recent months as seen in Figure 1b. Notwithstanding these positive developments, it took 2 years to run down the supply glut after the last oil price crash in 2015. With the oil glut being even worse this time, OPEC+ will have to continue to maintain low oil production levels to destock storages. As OPEC+'s economies have suffered greatly from both the diminished demand due to the COVID-19 pandemic and the loss of a large portion of their GDP due to the oil price crash, it is unlikely that the production cuts will be long term. In last week's meeting, it was decided that OPEC+ will gradually increase its production starting in January. This could ensure that the oil price remains depressed for the foreseeable future as the demand recovery is met with an increase supply, prolonging the destocking of the large amount of oil in storage.

Credit News

Istanbul mayor looks to global markets to fund investment

Dec 4. Istanbul issued its first five-year Eurobond over the past week, garnering over USD 2.5bn in demand for the USD 580mn issuance. The bond, which holds a yield of 6.6%, was issued to finance the construction of metro lines in the city. Strained relationships between the opposition party mayor and the current sitting president Erdogan has led to tightened credit flows from state banks into the city, forcing them to look for alternative funding strategies. Uncertainty amongst investors remains concerning Istanbul's income, which could be negatively affected by governmental constraints. However, this is unlikely to deter the city, as they plan to enter the capital markets once more next year in hopes to fund future projects in the pipeline. (FT)

US regulatory panel warns pandemic driving 'elevated' financial risks

Dec 4. The Financial Stability Oversight Council warned regulators about the risk on smaller banks pertaining to a potential wave of bankruptcies and a collapse in the US real estate market. Come January, the treasury-led Financial Stability council will most likely take a more cautious and tougher stance on the "safety and soundness" of the financial system under the Biden Administration. Issues raised by the council included the USD 2tn of corporate debt downgrades since March; and the rising number of bankruptcies that are stressing the court systems and delaying restructuring prospects. The report also warned of "significant structural vulnerabilities" in the short-term wholesale funding markets, while emphasizing the need for significant capital build-up and liquidity in the banking system to further reduce the stress originating from this year. (Reuters)

Canadian banks face revenue growth challenges as focus shifts from managing loan losses

Dec 4. Despite ending 2020 on a high note with a surprise quarterly profit beat due to the lower than expected bad debt provision, Canada's top banks are warned of a challenging year ahead as economic growth remains uneven and the housing market slowing down. Thanks to payment delays and a large number of government aid programs, the current loan impairment of Canada's six major banks is still close to pre-pandemic levels. However, investors are worried that a slow economic recovery would not be able to stimulate enough credit demand. The banks said that a worse than expected economic deterioration could necessitate a further increase in provisions. (Reuters)

Chinese rating agencies stand by SOEs despite default spree

Dec 2. AA ratings are important for Chinese corporates. Enterprises with lower ratings are not allowed to seek funding publically. Today, more than 98% of Chinese bond issuances are issued by double-A corporates. There is a known reluctance for credit rating agencies to give lower ratings. More often than not, dominant State-Owned Enterprises (SOEs) are given higher ratings due to expectations in a government bailout. The credit evaluation gives less weight to business fundamentals. With pressures from politics and competition amongst Chinese agencies, there is a strong deterrence towards the downgrading of SOEs. (FT)

European bank bonds rally on stronger economic prospects

Dec 1. With rising prospects for economic recovery, bank share prices within Europe outperformed in Nov 2020. With lower perceived risk, the risk premium on debts has dived to its lowest since Feb 2020. Rising confidence has availed lower cost of funding to European lenders. The spread on government issues on ICE's EUR banking composite has fallen by 25 bps. Post Q3 2020, bad debt has fallen and trading revenue

continues to soar. With generally high Common Equity Tier 1 levels, senior bank executives have started lobbying for payouts and dividends, both of which have been banned during the spring. (FT)

Yongcheng Coal creditors approve more repayment plans after defaults (Reuters)

Energy trader Gunvor launches new USD 540mn biodiesel loan (Reuters)

US bankruptcies drop to 14-year low as coronavirus cases surge (Reuters)

Regulatory Updates

China issues first variable "DR"-based bonds in rate reform push

Dec 4. Last Friday, China issued its first bond with a floating interest rate linked to a key benchmark called "DR" to improve the pricing mechanism for financial markets. The People's Bank of China (PBOC) has already said back in August that it will make Depository Institutions Repo Rate (DR) a key reference for monetary policy adjustment and market price setting. Besides facilitating monetary policy transmission, floating-rate bonds could also help investors and issuers avert risks from volatility in interest rates. The PBOC is also encouraging financial institutions in China to use DR as a reference to price other products such as interest swaps and negotiable certificate of deposits (NCDs). (Reuters)

Libor's final retirement date may get delayed until mid-2023

Dec 1. The ICE Benchmark Administration Ltd is exploring plans to extend the retirement date for multiple London interbank offered rates (Libor) on dollars until June 2023, although regulators are still pushing banks to move away from the discredited benchmarks. The move away from Libor comes after major manipulation scandals and the drying up of trading data used to inform the rates. However, the COVID-19 pandemic raised fears that the markets are not ready for a seismic shift away from the benchmark so soon. Waiting until June 2023 should allow for the majority of contracts tied to the dollar Libor to expire naturally. This should allow regulators to facilitate an orderly transition by global authorities into a new benchmark. (Bloomberg)

MAS awards four digital bank licenses (Straits Times)

Fed readies more guidance on bond-buying plans (WSJ)

Published weekly by Credit Research Initiative – NUS | Disclaimer
Contributing Editors: Emir Hrnjic, Anthony Prayugo