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Hanjin Shipping struggles as shipping industry remains in the doldrums

by Siddharth Batra

In the wake of the global financial crisis, as world economic growth plummeted and international trade slumped, the South Korean shipping industry found itself saddled with massive overcapacity hurting freight rates at a time of tepid demand. Even as large global economies have since made tentative progress towards normalcy, the industry still suffers from emaciated pricing power and stretched balance sheets.

South Korea's largest shipping line Hanjin Shipping Holdings Co. (ninth largest in the world) has seen its market capitalization erode to about USD 117mn as of 24 Sep 2014 from a peak of about USD 730mn in 2007 as it struggles to generate operating cash flows and keep pace with its large debt service obligations. The 1-Year RMI Probability of Default (PD) of Hanjin Shipping Holdings rose from 220bps as of 31 Dec 2013 to 813.6bps as of 26 Sep 2014 (as illustrated in Chart 1) on account of mounting operating losses and deteriorating capital position.

Chart 1: 1-Year RMI PD of Hanjin Shipping Holdings Co. Source: *Risk Management Institute*

The demand and supply of maritime transport services largely govern the shipping rates on an ongoing basis. As such, the shipping industry has been challenged on both fronts since the financial crisis. The global demand for container shipping has trailed supply for 5 out of the last 7 years (Chart 2a) as the world economic growth slowed down considerably from a high of 5.35% in 2007 to 3.01% in 2013 and total world trade growth – comprising of total exports and imports, has slowed from 15.3% to 1.9% in the same period.

The South Korean shipping industry in particular has not just been hurt by this overall slowdown in global demand but more specifically by the softness in Chinese economy, which is Korea's largest trading partner both in terms of imports and exports. China has slowed down even faster with its economic expansion halving from 14.2% in 2007 to 7.7% in 2013 as shown in Chart 2b.

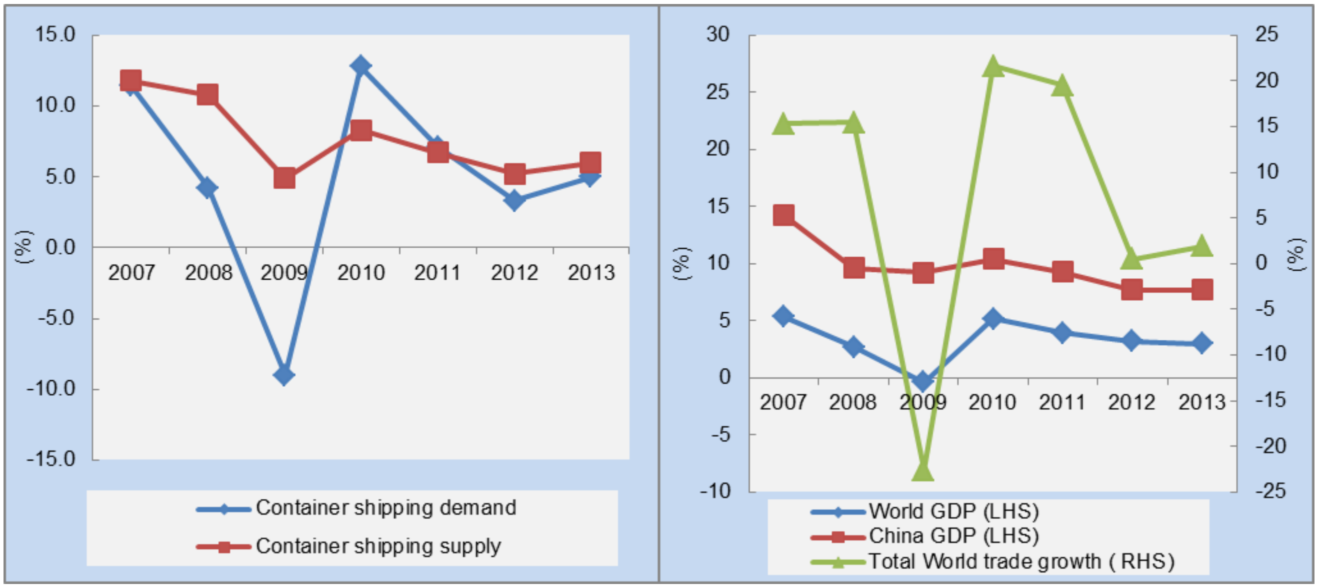
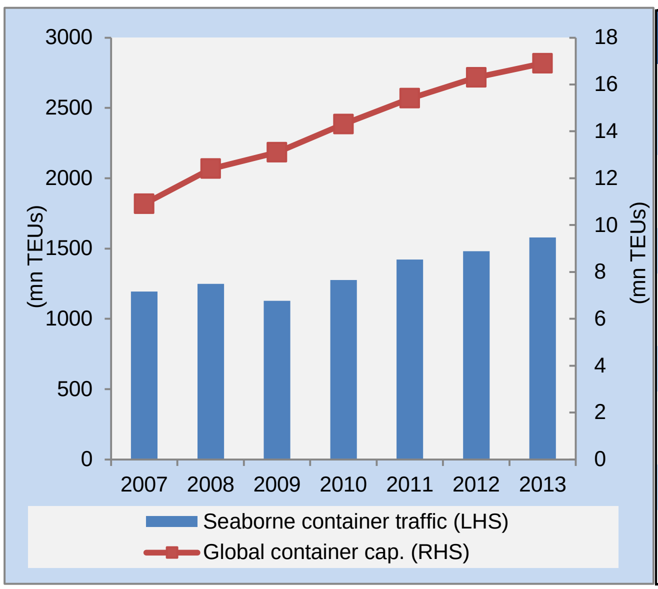


Chart 2a – 2b: Massive oversupply has hurt the container shipping industry as demand dwindled with a slump in world trade and lower growth rates in China and the world. *Sources: UNCTAD, World Bank, IMF, WTO*

On the supply side (chart 3a), the total global container fleet capacity has continued to increase relentlessly from 10.9mn TEUs (or Twenty-Foot Equivalent Unit, a measure of container ship capacity) in 2007 to 16.9mn TEUs in 2013 while the total seaborne container traffic has only grown modestly – severely damaging the pricing power of the marine shippers. As a result, on major East-West (Europe) and North-South shipping routes, freight rates have been either stagnant or declined since 2009 (chart 3b).



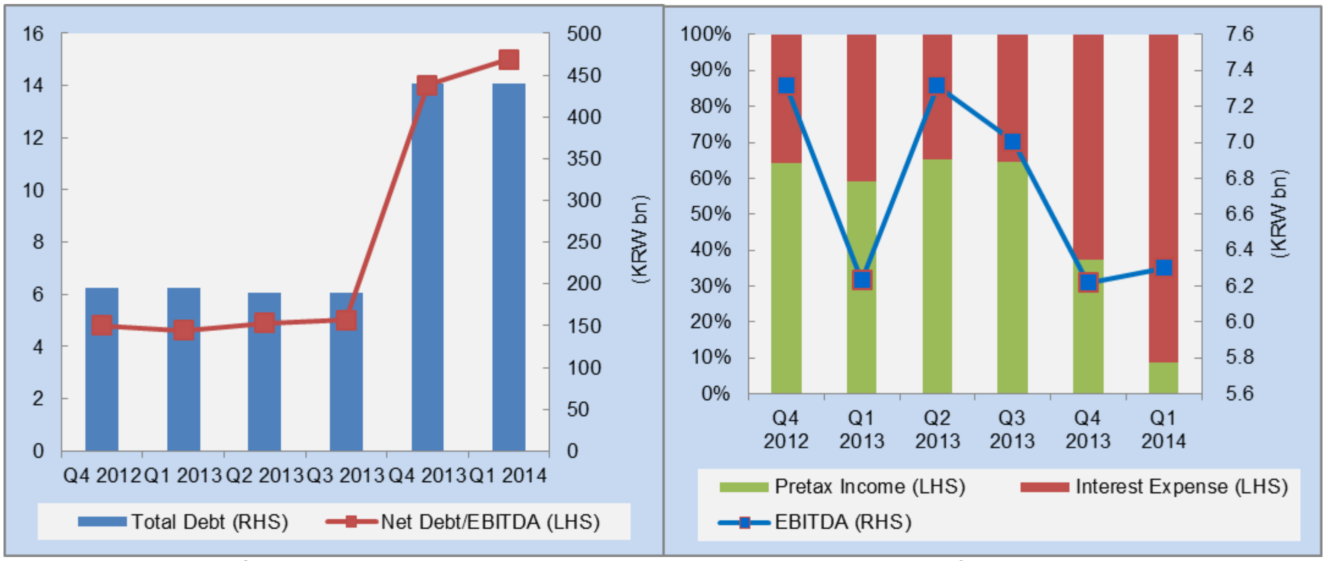
Freight Rates (USD / TEU)				
Freight markets	2009	2010	2011	2012
Trans-Pacific				
Trans-Pacific: Shanghai-US West	1,372	2,308	1,667	2,287
Trans-Pacific: Shanghai-US East	2,367	3,499	3,008	3,416
Far East - Europe				
E-W: Shanghai-N.Europe	1,395	1,789	881	1,353
E-W: Shanghai-Mediterranean	1,397	1,739	973	1,336
North-South				
N-S: Shanghai-Aust/NZ	1,500	1,189	772	925
N-S: Shanghai-S.Africa	1,495	1,481	991	1,047
Intra-Asia				
Intra-Asia: Shanghai-SGP		318	210	256
Shanghai-Dubai	639	922	838	981

Chart 3a – 3b: Global seaborne container traffic has recovered moderately after the financial crisis, but fleet capacity growth has far outpaced it, leading to a defensive pricing environment across major routes. *Sources: UNCTAD, Alix Partners*

Moreover, the South Korean shipping industry is hurt by fierce competition. Despite a challenging demand environment, Hanjin Shipping and others including Hyundai Merchant Marine and STX Pan Ocean have kept up with fleet additions in an effort to gain market share. Hanjin Shipping inducted 7x 10,000 TEU ships earlier in 2014 and another 4x 9,200 TEU are expected to be inducted in late-2015 on long-term charters at a time when the freight rates are not remunerative.

Hanjin Shipping has come under pressure with its total debt shooting up in the last few quarters from KRW 195bn in 4Q2012 to KRW 440bn in 1Q2014. Hanjin issued convertible bonds worth KRW 9.6bn (USD 9.2mn) on Sep 25 2014 to shore up the balance sheet and is also looking to potentially raise another USD 150mn through 2014 via overseas bond sales. As pricing environment remain tough, the debt service ability (Net Debt/EBITDA) has deteriorated from 4.8x to 15x in the same period. The financial leverage (Net Debt/Equity) stands at 0.98.

Operationally, EBITDA has declined from KRW 7.3bn in 4Q2012 to KRW 6.3bn in 1Q2014 as illustrated in Chart 4a, while Pretax Income has continued to decline from KRW 4.7bn to KRW 0.5bn (Chart 4b) during the same period as interest expense accounted for as much as 91% of operating profits in 1Q2014.



Charts 4a – 4b: Hanjin Shipping Holdings' balance sheet has been weighed down by increased financial leverage. Debt servicing has become burdensome on the cash flows. Source: *Bloomberg*

Going forward, Hanjin Shipping Holdings is expected to close down unprofitable trade routes this year - Far East and the Black Sea lines, as well as the trans-Atlantic service, to cut down on routes that do not even support operational costs. Additionally, affiliate firm Korean Air, is going to infuse close to KRW 420mn (USD 400mn) during 2014 to recapitalize the balance sheet of Hanjin Shipping. Other drivers that may support a turnaround are increased pricing discipline, lower fuel costs, increased ship-scrapping levels and a slowdown in new ship deliveries.

Credit News

European Commission tax probe could cost Apple billions

Sep 29. European Union regulators believe Apple Inc. has violated EU law. The tax deals granted by Ireland to Apple may have amounted to illegal state for the companies. The EU's central antitrust authority will explain later why the tax deals signed between Apple and Ireland violated the EU law. Apple will have a month to respond to the decisions once they are published in the EU's Official Journal. According to the news report, the EU probe may result in record fines of billions of euros for Apple and going forward, Apple's effective tax rate could also rise. (Seeking Alpha)

Banks shut branches over Hong Kong protests

Sep 29. Banks operating in Hong Kong have shut their branches following mass pro-democracy protests. Staffs in Standard Chartered and Bank of China have advised staffs to work from home after protesters clashed with police. The central bank said that the banks have activated their business continuity plans to maintain normal operations and will inject liquidity into the banking system if necessary. The creditworthiness of Hong Kong's sovereign bonds are not likely to be affected in the short term, according to rating agency Fitch unless the protests grow into a large enough scale to have a material impact on the economy. (BBC)

Credit rating upgrades buoy Japan Inc.

Sep 28. According to credit rating agency (CRA) rating and Investment Information, the creditworthiness of Japanese companies has improved on higher earnings, a weaker JPY and higher equity values. For example, Tire manufacturer Bridgestone was upgraded by one notch to AA, making it the first rating upgrade in a decade. The CRA said that the capital adequacy ratio of listed companies increased to a record 39% in March. Corporate issuances meanwhile reached the highest level in four years as companies were able to raise capital in a low interest rate environment. (Nikkei Asian Review)

Chinese borrowers break new ground

Sep 25. Chinese borrowers have become increasingly active in overseas markets as regulations allowing firms to sell debt offshore have eased. Companies have issued USD 66.5bn of G3 currency denominated bonds, up from USD 59bn in 2013. The Bank of Communications became the first lender to issue a foreign currency bond from its head office in Shanghai after selling USD 1.2bn of 10 year notes at a coupon rate of 4.62%. Hangzhou based automaker Geely also sold its debut international bond, borrowing USD 300mn in 5 year bonds paying a coupon rate of 5.25%. (FT) (Subscription required)

Ambani abandons USD 1.6bn hydropower deal

Sep 25. Shares of Jaypee Group plunged 19% after Reliance Power – owned by Indian billionaire Anil Ambani decided not to purchase assets from Jaypee Group. The acquiring firm said that regulatory uncertainties and tariff issues halted the deal to purchase three hydroelectric power assets in what could be the largest acquisition in India's power sector. This was the second failed attempt by Japypee Group to sell their troubled assets after Taqa, Abu Dhabi's state backed energy group did not successfully acquire two of the facilities. (FT) (Subscription required)

China funding costs rise, Beige Book shows

Sep 23. China Beige Book survey showed that the credit turned more expensive in the third quarter. Capital expenditure fell as the share of companies borrowing remained at 19% this quarter- the smallest proportion in 11 quarters of polling. Even though the central bank had injected RMB 500bn into the country's big five state-owned banks to ease the funding bottleneck, banks are not lending to small-and-medium-sized firms. Regulatory limits have hindered property firms and local governments' financing platforms from borrowing from banks. Thus many borrowers have turned to the shadow banks despite the higher rates. (SCMP) (Subscription required)

Alibaba gains approval to establish commercial bank in Hangzhou (SCMP) (Subscription required)

China's credit rating agencies could have cultural edge on big three (FT) (Subscription required)

Regulatory Updates

Big data drives US regulator, says senior official

Sep 29. Big data analysis will play a major role in the risk assessment of financial institutions. The sophisticated data tools designed by the SEC's Division of Economic and Risk Analysis (DERA) are increasingly used within the SEC to flag institutions for inspection, and are now as important as traditional tipoffs and referrals in the SEC's risk assessments. DERA uses data to help the SEC's other divisions in identifying non-compliant institutions and prioritize which should be visited first during regular inspections. Up to now, the big data analysis has proved successful to help SEC bring enforcement actions against rule-breakers; nevertheless, it remains to be seen how much big data analysis contributes to the inspection. (Risk.net) (Subscription required)

China regulator revises internal control guidelines for banks

Sep 29. China's Banking Regulatory Commission said that harsher penalties were required for violations against risk management and internal control rules. Banks have to adhere to a new set of guidelines which were first published in 2002. Laws governing the banking industry have to change with the developments in the banking landscape. The rules cover areas from corporate governance to internal audits. (SCMP) (Subscription required)

Investors positive as PSU banks to benefit with dilution of Basel III norms

Sep 24. Investors' concerns on capital requirement of major public sector banks may ease after RBI recently relaxed the norms for issuing Tier 1 instruments. As a result, large-sized public sector banks such as SBI, Bank of Baroda, Punjab National Bank and Canara Bank may be the major beneficiaries with the dilution of a few guidelines of the Basel III norms. Some of the noteworthy amendments made by the central bank include allowing retail investors to participate in Tier 1 instruments and a revision of loss absorption mechanism for non-equity instruments as temporary or permanent compared to permanent earlier. These measures will lower banks' cost of raising Tier 1 capital. Also, the equity requirement will be lower as Tier 1 debt capital may be raised at a cheaper rate. (The Economic Times)

Chinese banks poised to relax mortgage rates

Sep 23. China's biggest banks plan to lower interest rates on home mortgages, highlighting Beijing's concerns about the flagging property market and its impact on the broader economy. China's big four state-owned banks will allow people to enjoy the discounted rate available to first-time homebuyers, even if the buyer already owns a flat. The banks will also increase that discount to as much as 30 percent off the central bank's benchmark, up from 15 percent previously. It is also unclear how aggressively banks will implement the new policy. It is reported that the central bank informally urged lenders to increase the flow of mortgages and keep rates low. (FT) (Subscription required)

Banks face fresh curbs on leveraged loans

Sep 23. US banks that flout new regulatory guidance on leveraged lending risk higher capital penalties, as the Fed has begun to warn banks defying its guidelines that making risky leveraged loans could affect its assessment of their loan loss rates in the next stress test and in turn, would affect the Fed's capital ratio projections. Banks worry that failing the test would constrain a bank's ability to pay dividends to shareholders or to its parent company. The Fed move is not an enforcement action and is not considered to be an additional capital surcharge, but it is likely to influence bank actions and came as a surprise to the industry. The stress reviews are already a critical way for the central bank to rein in risky behavior and banks see passing the tests as a top priority. (FT) (Subscription required)

Fed officials take aim at regulations for small banks

Sep 23. Federal Reserve officials offered their support to the nation's community banks, saying that the Fed is too reliant on rules that were meant for large investment banks, while the complex rules saddle small lenders with a heavy supervision load and are not dependent enough on the discretion of local examiners. According to St. Louis Fed President James Bullard, individual regulators need to be on the ground in the banking districts that they oversee. (Reuters)

ISDA seeks green light on margin model (FT) (Subscription required)

South Korea's financial regulator to ease requirements on asset managers (Yonhap)

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