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# Highlights of Major Shipping Companies' Financial Results for Fiscal Year Ended March 2019

The following are Japan Credit Rating Agency, Ltd. (JCR)'s perception of the current status and highlights for rating concerning the financial results for the fiscal year ended March 2019 (FY2018) and earnings forecasts for FY2019 of Japan's 3 major shipping companies: Nippon Yusen Kabushiki Kaisha ("NYK"), Mitsui O.S.K. Lines, Ltd. ("MOL") and Kawasaki Kisen Kaisha, Ltd. ("K Line").

## 1. Industry Trend

The shipping market is mixed. The containership market remains lackluster. This is probably due to the stagnant cargo movements in the situation where shift to ultra-large ships with capacity of 10,000 TEUs or more pursuing economies of scale has been continuing. Although it is less likely that the containership market will significantly worsen, because the U.S. economy remains strong and major containership companies reduced their services, JCR will closely watch trend of Chinese economy and U.S.-China trade friction.

The dry bulk market has been stagnant. In particular, capesize bulk carriers which transport steel materials have been in severe conditions due to break of dam for mine in Brazil and occurrence of a large cyclone in Australia. Going forward, imports of iron ore are expected to remain solid thanks to China's economic stimulus packages. JCR also sees that the lowering ship operating rate and the increasing ship scrapping in compliance with environmental regulation can work as a supporting factor for the freight market, but considers that it is necessary to closely watch whether the market slump can linger.

The tanker market seems to have bottomed out. Since the second half of 2018, the market has recovered by several developments including Iranian economic sanctions by the U.S., wider procurement area against the backdrop of increasing crude oil production in the U.S, and increasing ship scrapping. As newly built VLCC deliveries are expected to remain at a high level for the time being, it is less likely that the freight market will enter a rising phase. However, it is also less likely that the market will fall, because demand for crude oil is expected to increase in emerging countries and a decline of ship operating rate and an increase of ship scrapping are expected.

## 2. Financial Results

The total ordinary income of the 3 companies for FY2018 resulted in a loss of 12.4 billion yen (61.4 operating income for FY2017) (Chart 1). Deterioration of business performance of their integrated containership company, Ocean Network Express Pte. Ltd. ("ONE"), is a factor for placing a downward pressure on their profits. ONE faced difficulty in its operations at the time of the start-up, and its after-tax profit for FY2018 resulted in a loss of USD 586 million due to the lower cargo loading than planned and increased fuel price (forecasted income of USD 110 million at the beginning).

NYK and K Line incurred an ordinary loss. Worsened business performance of NYK's consolidated subsidiary, Nippon Cargo Airlines Co. Ltd., further decreased the NYK's profit, while allowance for loss on charter contracts for containerships further decreased K Line's profit. MOL showed its achievements in its efforts for expansion of stable earnings sources such as LNG carriers and reduction of market exposure for small- and medium-sized dry bulk carriers, etc. Stable profit from the real estate business has also helped increase the profit of MOL, which reduced the impact of ONE's loss and secured an ordinary income.

Their total net income attributable to owners of parent was a loss of 128.8 billion yen for FY2018 (loss of 16.8 billion yen for FY2017), resulting in the 4th consecutive recording of losses. While MOL returned to profitability, NYK and K Line recorded a net loss. While both NYK and K Line recorded an ordinary loss, NYK expanded the net loss due to its recording of allowance for loss on charter contracts for containerships and impairment loss on aircraft, while K Line expanded the net loss due to its recording of loss on cancellation of chartered vessels.

On the financial side, their combined D/E ratio as of March 31, 2019 (without taking into account equity content of subordinate loans of MOL and K Line) was 2.3 times (2.0 times as of March 31, 2018), and is further worsening (Chart 2). NYK and K Line impaired their equity capital, while MOL slightly increased it. K Line, facing severe conditions concerning the financial structure, raised funds of 45 billion yen through subordinated loan (equity content: 50%) in FY2019 and strengthened its financial base to a certain degree.

3. Highlights for Rating

Recovery of business performance is expected in FY2019. The total ordinary income and net income attributable to owners of parent of the 3 companies are expected to reach 92 billion yen and 77 billion yen for FY2019, respectively. The reasons for return to profitability include the following: (i) prospect for improvement of shipping market; (ii) ONE's return to profitability and finish of costs in the first year for the containership business; and (iii) improvement of car carriers and dry bulk carriers businesses. ONE expects its after-tax profit to be USD 85 million thanks to recovery of cargo loading and reduction of operating costs. JCR sees that the financial forecasts for FY2019 announced on April 26, 2019 are roughly the same as assumed at the time of rating review for the 3 companies in February 2019. On the financial side, JCR considers it will take time for them to strengthen their financial bases, because improvement of equity capital through income accumulation will remain gradual.

Going forward, JCR firstly will pay attention to ONE's profit improvement. ONE was established to reduce earnings volatility of their containership businesses. Although they realized synergistic effects which were initially planned, ONE started its business in a difficult condition and resulted in a disappointing performance in FY2018. The disorder at the time of start-up has been reduced, and ONE will be put to the test of whether it can show itself at its best in FY2019. JCR considers it is necessary to watch whether ONE can strengthen its earnings structure through replacement of cargoes with those having higher profitability, revisions to more efficient operating routes, etc.

Next, JCR will pay attention to their compliance with environmental regulation. Under regulations on sulphur oxide (SOx) emissions by International Maritime Organization, C-heavy oil, in principle, cannot be used as ship fuel, and low sulphur fuel oil (LSFO) which contains 0.5% or less sulphur shall be used, in principle, in and after January 2020. Measures for the compliance include the following: (i) use of fuel oils in compliance with the regulation (compliant fuel oil); installation of exhaust gas purifier (scrubber); and (iii) shift to vessels using fuels as alternative fuels such as LNG. The use of compliant fuel oil, which is a major countermeasure for the regulation, will expand differences with C heavy oil in price, which will cause a significant increase on costs for shipping companies. In containership industry, which is expected to be the most influenced by the change, major shipping companies are presenting new Bunker Adjustment Factor (BAF) to cargo owners. The cargo owners' understanding of the new BAF is widening, and their efforts for price revisions have been going well.

Improvement of car carriers business remains an issue facing the 3 shipping companies. This business' profitability has declined due to reduced shipping from Japan against the backdrop of automakers' shift to overseas production and stagnant transportation to the Middle and Near East which is highly profitable. Given that the 3 companies are world's leading car carriers operators, it is necessary to increase profit of this business in order to recover their consolidated business performance. JCR will closely watch whether they can improve their profitability through more efficient assignment of vessels and recovery of freight rate.

Finally, JCR will pay attention to the strengthening of financial base. As shown by the worsened D/E ratio and equity ratio as of March 31, 2019 from a year earlier, they have not stopped the decline of their financial strength. As a large amount of investments in vessels is required for a shipping company to maintain and improve its competitive strength. Given this trend, their interest-bearing debt can easily increase. In light of earnings volatility risk over a medium term, JCR considers that it is essential for them to enhance their equity capital, which can work as a risk buffer, in order to strengthen their financial bases. All 3 companies impaired their equity capital up to several hundred billion yen over the past few years. Some companies raised funds through subordinated loan with equity content, but their profit accumulation in general has been delayed, and there remains much room for improvement of financial base.

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## (Chart 1) Financial Results of 3 Major Shipping Companies

(JPY 100 mn, %)

| | | Net Sales | YOY Change | Operating Income | YOY Change | Ordinary Income | YOY Change | Ordinary Income / Net Sales | Net Income Attributable to Owners of Parent | YOY Change |
|---|---|---|---|---|---|---|---|---|---|---|
| NYK (9101) | FY2017 | 21,832 | *13.5* | 278 | - | 280 | - | 1.3 | 201 | - |
| | FY2018 | 18,293 | ▲ *16.2* | 110 | ▲ *60.2* | ▲ 20 | - | ▲ 0.1 | ▲ 445 | - |
| | FY2019F | 17,300 | ▲ *5.4* | 380 | *242.8* | 370 | - | 2.1 | 260 | - |
| MOL (9104) | FY2017 | 16,523 | *9.8* | 226 | *786.7* | 314 | *23.8* | 1.9 | ▲ 473 | - |
| | FY2018 | 12,340 | ▲ *25.3* | 377 | *66.3* | 385 | *22.6* | 3.1 | 268 | - |
| | FY2019F | 11,940 | ▲ *3.2* | 260 | ▲ *31.1* | 500 | *29.6* | 4.2 | 400 | *48.8* |
| K Line (9107) | FY2017 | 11,620 | *12.8* | 72 | - | 19 | - | 0.2 | 103 | - |
| | FY2018 | 8,367 | ▲ *28.0* | ▲ 247 | - | ▲ 489 | - | ▲ 5.8 | ▲ 1,111 | - |
| | FY2019F | 7,600 | ▲ *9.2* | 60 | - | 50 | - | 0.7 | 110 | - |
| Total | FY2017 | 49,976 | *12.1* | 577 | - | 614 | - | 1.2 | ▲ 168 | - |
| | FY2018 | 39,001 | ▲ *22.0* | 240 | ▲ *58.3* | ▲ 124 | - | ▲ 0.3 | ▲ 1,288 | - |
| | FY2019F | 36,840 | ▲ *5.5* | 700 | *190.9* | 920 | - | 2.5 | 770 | - |

(Source: Prepared by JCR based on financial materials of above companies)

## (Chart 2) Financial Structure of 3 Major Shipping Companies

(JPY 100 mn, times)

| | | Equity Capital | Interest-bearing Debt | D/E Ratio | EBITDA | Interest-bearing Debt / EBITDA | Operating Cash Flow | Investing Cash Flow |
|---|---|---|---|---|---|---|---|---|
| NYK (9101) | FY2016 | 5,224 | 9,344 | 1.8 | 839 | 11.1 | 279 | ▲ 1,446 |
| | FY2017 | 5,518 | 9,713 | 1.8 | 1,261 | 7.7 | 890 | ▲ 1,379 |
| | FY2018 | 4,874 | 10,261 | 2.1 | 1,127 | 9.1 | 452 | ▲ 1,322 |
| MOL (9104) | FY2016 | 5,719 | 11,019 | 1.9 | 1,016 | 10.8 | 176 | ▲ 739 |
| | FY2017 | 5,112 | 11,001 | 2.2 | 1,239 | 8.9 | 983 | ▲ 1,008 |
| | FY2018 | 5,250 | 10,901 | 2.1 | 1,416 | 7.7 | 552 | ▲ 1,983 |
| K Line (9107) | FY2016 | 2,194 | 5,138 | 2.3 | 41 | 122.8 | ▲ 439 | ▲ 248 |
| | FY2017 | 2,170 | 4,735 | 2.2 | 544 | 8.7 | 11 | ▲ 228 |
| | FY2018 | 1,035 | 5,021 | 4.8 | 195 | 25.7 | ▲ 68 | ▲ 354 |
| Total | FY2016 | 13,139 | 25,501 | 1.9 | 1,897 | 13.4 | 16 | ▲ 2,434 |
| | FY2017 | 12,801 | 25,450 | 2.0 | 3,045 | 8.4 | 1,886 | ▲ 2,616 |
| | FY2018 | 11,160 | 26,183 | 2.3 | 2,739 | 9.6 | 937 | ▲ 3,661 |

(Source: Prepared by JCR based on financial materials of above companies)

<Reference>

Issuer: Nippon Yusen Kabushiki Kaisha

Long-term Issuer Rating: A- Outlook: Stable

Issuer: Mitsui O.S.K. Lines, Ltd.

Long-term Issuer Rating: A- Outlook: Stable

Issuer: Kawasaki Kisen Kaisha, Ltd.

Long-term Issuer Rating: BBB- Outlook: Stable

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