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Highlights of Major Shipping Companies' Financial Results for Fiscal Year Ended March 2017

The following is Japan Credit Rating Agency, Ltd. (JCR)'s perception of the current state and highlights for rating concerning the financial results for the fiscal year ended March 2017 (FY2016) and earnings forecasts for FY2017 of the three 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 bottomed out in the first half of 2016 and is picking up. However, oversupply has yet to be eliminated despite a steady increase in cargo volumes. With generally imbalance of tonnage supply-demand, the recovery is only at a moderate pace. The full recovery still has a long way to go and the severe business situation will persist.

Freight market for the container shipping segment did hit a low point in 2016 but is still lackluster. Spot rates on North American routes turned upward against the backdrop of the bankruptcy of Hanjin Shipping in 2016, but the freight rates for 2017 negotiated for annual contracts seem not to have reached the ones the major shipping companies had expected. In 2016, the industry has made progress in restructuring, including the consolidation of China Ocean Shipping Group and China Shipping Group, the world’s largest container carrier Maersk’s acquisition of Hamburg Sud, and the announcement of the agreement on integration of liner container shipping businesses of the Japanese big three companies. On the other hand, overcapacity of tonnage has not eased as the shipping companies keep increasing supply arise from the shift to ultra-large ships with the capacity of 10,000 TEUs or more to bring about higher efficiency.

In the dry bulk fleet segment, the Baltic Dry Index hit bottom in February 2016 and has since been on a recovery path. The market condition for capesize vessels, in particular, is improving, driven by the boost of China’s import of iron ore. Likewise, the market for Panamax and smaller vessels bottomed out in early 2016. Although newly built vessels have peaked out, the oversupply situation has not been eliminated, indicating that market recovery will remain weak for the time being.

The market for tankers is sluggish. Crude oil demand is expected to continue moderately increase in China and India. This positive factor, however, will be more than offset by the expected significant inflows of newly built vessels. Consequently, supply-demand gap is highly likely to be further widened. Hence, the market is likely to remain stagnant.

2. Financial Results

The major shipping companies suffered very poor results in FY2016. Their combined ordinary income had seen growth in the three consecutive years from FY2012 through FY2014, but it slashed by 45.9% year-on-year to 99.6 billion yen in FY2015 and ended up with an ordinary loss of 25.9 billion yen in FY2016. The shipping markets fell to the record lows, leaving the three companies with decline in ordinary income. NYK and K Line posted a net loss attributable to owners of their respective parent of more than 100 billion yen each, weighed by the restructuring expenses. K Line markedly slipped into an ordinary loss of 52.3 billion yen. The positive effects of the FY2015 structural reform and cost reduction did not fully offset the headwinds containerships and dry bulk carriers faced in the deteriorating markets and the stagnant performances of marine resource development and heavy lifter businesses. Meanwhile, NYK, notwithstanding the segmental losses from the core businesses such as liner trade and bulk shipping, managed to secure an ordinary income of 1 billion yen, primarily contributed by one-time gain from selling real estate trust beneficiary interests in the real estate segment. MOL also generated an ordinary income of 25.4 billion yen supported by the effect of restructuring of dry bulk shipping business as well as steady performance in the real estate business.

Their combined ordinary income is expected to be 66.0 billion yen in FY2017 (Chart 1) against the backdrop of market recovery for containership and dry bulk carrier sectors, as well as benefitted from the structural reform, amidst expected rise in fuel oil prices. That said, it is still lower compared to 145.8 billion yen of FY2013 and 184.3 billion of FY2014. The market for containerships is still in its historical low level, albeit having bottomed out. In the car carriers sector, overall transport volume is strong but the transport efficiency is lessened due to curtailed transportation for resource-supplying countries and emerging economies which are affected by the sluggish crude oil prices. The business recovery is slow, reflecting the deteriorating tanker market and weak car carriers segment. NYK is projected to increase income year-on-year and K Line to turn profitable, while MOL is projected to see decrease in income for four consecutive years mainly due to worsened energy transport business.

On the financial front, the three companies' combined D/E ratio (without taking into account of the equity capital attributes of subordinated loans of MOL and K Line) deteriorated to 1.9x at the end of March 2017, versus 1.5x a year earlier (Chart 2). While MOL's equity capital rebounded by securing positive net income and financing through subordinated loans, NYK and K Line posted net losses, which led to significant erosion of their equity capitals and increased interest-bearing debts due to negative free cash flow.

Their financial structures are unlikely to improve substantially in FY2017. With sluggish performance causing delay in improvement of cash flow generating abilities, combined with investment cash flow remaining at high levels stemmed from continuous investments in vessels, NYK and MOL are expected to have negative free cash flows. Besides, their net incomes are expected to increase only at modest rates, resulting in constrained growth in equity capitals.

3. Highlights for Rating

JCR is paying attention to whether the liner container shipping business generates profits in FY2017. In the segment, mixed results are expected, with K Line returning to profitability, NYK recording break-even income, and MOL slipping into negative territory. The effect of the integration of the three companies' line container shipping businesses, which was made public in October 2016, is expected to contribute to income growth in full from FY2018 onwards. The start-up expenses will be incorporated in FY2017. JCR will closely watch the development of the container shipping market as well as whether the joint venture company, which is planned to be formed in July 2017, gets off to a good start.

Secondly, JCR also monitors the progress of car carrier business, the strong arm for the three companies. The automobile production is expected to grow moderately. Nevertheless, the earnings environment is changing where exports from Japan, which has high transportation efficiency, decreased as automobile manufacturers have shifted production overseas following the Financial Crisis and the demand for automobiles is changing depending on regions, as exemplified by stagnant shipping to the Middle East of late. To address this situation, they need to take measures to boost efficiency in operating vessels.

Financial foundations need to be strengthened, in our view, by increasing equity capital, etc. The three companies posted substantial extraordinary losses in FY2016 for NYK, in FY2015 for MOL and in FY2015 and FY2016 for K Line, which greatly deteriorated their equity capitals. With shipping market having bottomed out, earnings situation is unlikely to further deteriorate. Yet, given the risk of earnings fluctuations in the medium run, increasing equity capital is essential. JCR will keep watching the development of their earnings metrics over the medium term and whether the financial structures will be strengthened, to reflect these factors in the ratings for the three companies.

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(Chart 1) Financial Results of 3 Major Shipping Companies

(Y100 mn, %)

FY		Net Sales	YOY Change	Operating Income	YOY Change	Ordinary Income	YOY Change	Ordinary Income/Net Sales (ROS)	Net Income Attributable to Owners of Parent	YOY Change
NYK (9101)	2015	22,723	-5.4	489	-26.0	600	-28.5	2.6	182	-61.7
	2016	19,238	-15.3	(180)	-	10	-98.3	0.1	-2,657	-
	2017 (forecasts)	20,080	4.4	245	-	230	App. 22x	1.1	50	-
MOL (9104)	2015	17,122	-5.8	23	-86.5	362	-29.3	2.1	-1,704	-
	2016	15,043	-12.1	25	10.1	254	-29.9	1.7	52	-
	2017(forecasts)	16,100	7.0	90	251.8	220	-13.5	1.4	100	90.2
K Line (9107)	2015	12,439	-8.0	94	-80.4	33	-93.2	0.3	-514	-
	2016	10,301	-17.2	(460)	-	(523)	-	-	-1,394	-
	2017 (forecasts)	11,300	9.7	240	-	210	-	1.9	210	-
Total	2015	52,284	-6.2	607	-53.8	996	-45.9	1.9	-2,037	-
	2016	44,584	-14.7	(615)	-	(259)	-	-	-3,999	-
	2017 (forecasts)	47,480	6.5	575	-	660	-	1.4	360	-

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

(Chart 2) Financial Structure of 3 Major Shipping Companies

(Y100 mn, times)

FY		Equity Capital	Interest-bearing Debt	D/E Ratio	EBITDA	Interest-bearing debt / EBITDA	Operating Cash Flow	Investing Cash Flow
NYK (9101)	2014	8,103	10,838	1.3	1,755	6.2	1,364	267
	2015	7,736	9,278	1.2	1,613	5.8	1,428	-468
	2016	5,224	9,344	1.8	839	11.1	279	-1,446
MOL (9104)	2014	7,825	11,584	1.5	1,146	10.1	924	-1,591
	2015	5,409	10,219	1.9	1,053	9.7	2,091	-266
	2016	5,719	11,019	1.9	1,016	10.8	176	-739
K Line (9107)	2014	4,415	4,919	1.1	1,052	4.7	1,018	-111
	2015	3,553	4,808	1.4	622	7.7	396	-295
	2016	2,194	5,138	2.3	41	122.8	-439	-248
Total	2014	20,343	27,341	1.3	3,954	6.9	3,307	-1,435
	2015	16,700	24,305	1.5	3,289	7.4	3,916	-1,031
	2016	13,139	25,501	1.9	1,897	13.4	16	-2,434

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

<Reference>

Issuer: Nippon Yusen Kabushiki Kaisha

Long-term Issuer Rating: A Outlook: Negative

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

Long-term Issuer Rating: A- Outlook: Negative

Issuer: Kawasaki Kisen Kaisha, Ltd.

Long-term Issuer Rating: BBB Outlook: Negative

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