Research Update:

German Container Liner Hapag-Lloyd Upgraded To 'BB'; Earnings Should Normalize But Remain Strong; Outlook Stable

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Rating Action Overview

- Hapag-Lloyd achieved stronger-than-expected EBITDA in 2020 and we expect it to outperform our October 2020 base-case in the current year.
- Strong free operating cash flow (FOCF) generation allowed Hapag-Lloyd to reduce its adjusted debt and increase its financial headroom, and we expect it to sustain these improvements. This should help to mitigate the likely lower EBITDA from 2022 as freight rates moderate, or unforeseen operational setbacks.
- We are therefore upgrading Hapag-Lloyd to 'BB' from 'BB-'. At the same time, we are raising our issue rating on the company's senior unsecured debt to 'BB' from 'B' and revising the recovery rating to '3' from '6'. We are also assigning our 'BB' issue and '3' recovery ratings to the proposed €300 million senior unsecured notes due 2028.
- The stable outlook reflects our expectation that freight rates will fall to historical averages (from the current abnormally high levels) in the second half of 2021, resulting in lower EBITDA generation for Hapag-Lloyd, and that Hapag-Lloyd will maintain S&P Global Ratings-adjusted funds from operations (FFO) to debt of at least 25%, our threshold for a 'BB' rating.

Rating Action Rationale

The COVID-19 pandemic and subsequent multiple national lockdowns across the globe prompted a remarkable shift in consumption, toward tangible goods from services. The combination of accelerated penetration of e-commerce, bottlenecks in air freight logistics from lower availability of belly capacity in passenger aircraft, congested marine ports, and a shortage of containers triggered a surge in container shipping freight rates toward the end of 2020.

Rates continued to strengthen into 2021. In particular, the freight rates on the main container liner trades--Transpacific and Asia-Europe--hit record highs at the end of February 2021. According to Clarksons Research, the Shanghai Containerized Freight Index (SCFI) increased by close to 35% in 2020, compared with 2019, to an average of 1,234 points. In the year to date, it has trended between 2,700-2,900 points, far above its 10-year historical average of 950 points.

Growth in global trade volumes also turned positive from the third quarter of 2020, and has gained momentum in subsequent months. According to estimates by Clarksons Research, the global seaborne container trade shrank by about 1% overall in 2020, but had seen a 7% decline in the first half of 2020. Global trade recovery remained solid into the first quarter of 2021, despite the usual seasonal slowdown. As a result, we now forecast a recovery in shipped volumes consistent with the global GDP growth of about 5% in 2021.

We expect container liners to pursue their disciplined capacity deployment, and that containership supply growth will remain muted over the next several quarters. There has been no incentive to place new large orders by industry players, given the subdued contracting activity since late 2015. Therefore, the containership order book is historically low--12% of the total global fleet. Persistent funding constraints, potential pandemic-related disruptions, more stringent regulation on sulfur emissions (permitting only 0.5% sulfur emission from January 2020), and broader considerations about greenhouse emissions in general--particularly in the context of decarbonization--will likely result in uncertainties over the costs and benefits of various technologies and fuel, and should limit ordering in 2021.

Low levels of new containership orders have translated into much tighter supply conditions. We expect this to continue in 2021, underpinning solid industry trading. Soon after the initial COVID-19 outbreak, there was a withdrawal of sailings from China and container liners continued to adjust capacities to demand trends in a timely manner throughout 2020. These measures demonstrate industry players' reactive supply management, which we consider normal in a sector that has been through several rounds of consolidation in recent years. The five largest container shipping companies now have a combined market share of about 65%, up from 30% around 15 years ago.

In 2020, Hapag-Lloyd achieved S&P Global Ratings-adjusted EBITDA of €2.7 billion, which is above €2.0 billion in 2019 and our October forecast. Stronger-than-expected operating performance was largely due to a significant increase in freight rates in the fourth quarter and was supported by low bunker fuel prices and successful cost containing measures over the year, despite a slight decline in trade volumes, whose recovery in the second half of the year did not fully offset the drop in the first half. Fueled by the extraordinarily strong first quarter of 2021 on account of the record-high rates, which we expect to moderate as favorable pandemic-related effects ease, and supported by the anticipated low-single-digit growth in trade volumes, our 2021 EBITDA forecast is now €3.0 billion-€3.5 billion, which is significantly above €2.0 billion in our October base-case.

Hapag-Lloyd deployed its 2020 strong free operating cash flows for debt reduction. The company lowered its adjusted debt to €4.9 billion as of Dec. 31, 2020, compared to €6.7 billion a year ago. This, in combination with EBITDA expansion, led to a significant improvement in our adjusted FFO-to-debt ratio to 49% in 2020, compared to about 23% in 2019 and our October forecast of 26%-27%. We furthermore expect the company to maintain the reduced adjusted debt level in 2021. This is despite Hapag-Lloyd's order for six liquid natural gas (LNG) powered ultra large container vessels in December 2020 for a total of $1 billion, which are scheduled for delivery in 2023. With prepayments already starting in 2021, this should raise Hapag-Lloyd's capital investments beyond the relatively low level of about €430 million-€530 million in 2019-2020. We also expect the company's discretionary spending to increase with the proposed dividend of €3.50 per share for 2020, as compared to €1.10 per share for 2019, which translates to about €625 million cash outflows in 2021, as well as a recently announced acquisition of a Dutch shipping company with a strong foothold in Africa. That said, we expect the higher cash outflows for capital expenditures (capex) and discretionary spending to be fully absorbed by the anticipated strong operating performance in 2021, which also should be sufficient to cover the annual debt service requirements. This leads to a further improvement in credit measures, with an adjusted FFO to debt forecast of 60%-65% in 2021.

We do not view Hapag-Lloyd's EBITDA in 2020 and expected in 2021 as sustainable. We anticipate that once the pandemic-related effects ease, freight rates, currently extraordinarily high, will moderate later in 2021. We still believe the company will be able to turn its present EBITDA strength into sustainable EBITDA-value of about €2.0 billion from 2022, assuming the industry players' stringent capacity management and tariff-setting discipline, as well as Hapag-Lloyd's consistent grip on cost control and ability to recover bunker price inflation. We continue to believe that the container liner industry is tied to cyclical supply-and-demand conditions, which will likely translate to fluctuations in Hapag-Lloyd's EBITDA performance. That said, we still believe because of the industry consolidation and demonstrated more rationale behavior by container liners, the swings in freight rates will be flatter and their peak-to-through periods shorter than in the past.

We view Hapag-Lloyd's financial policy as essential in balancing off the anticipated decrease in free operating cash flow (after lease payments) in 2022. We expect Hapag-Lloyd's EBITDA to moderate to about €2.0 billion from 2022 while capital spending rises with an order for six new LNG vessels. This could be complemented by additional capex for new ships and/or containers seeing that the ratio of capex to depreciation remained below 1.0x during the last five years. That said, as demonstrated during the past few years, the company is unlikely to order new ships on a speculative basis or absent favorable demand prospects. We factor into our upgrade Hapag-Lloyd's flexibility and discipline in discretionary spending, which is key to prevent a material build-up in adjusted debt and keep the rating commensurate credit metrics. We also take into account Hapag-Lloyd's stated intention to maintain a ratio of net debt to EBITDA (leverage target) at maximum 3.0x, compared with 1.8x achieved in the 12 months ending Dec. 31, 2020. This compares with our base-case projection of adjusted debt (including pension adjustment) to EBITDA of 2.7x in 2022.

Outlook

The stable outlook reflects our expectations that freight rates will fall to historical averages in the second half of 2021, resulting in Hapag-Lloyds's EBITDA moderating to about €2.0 billion and weighted-average adjusted FFO to debt staying above 25%. We think this will be underpinned by the sustained capacity discipline of the industry players and Hapag-Lloyds's balanced financial policy.

Upside scenario

We could raise the rating if our adjusted FFO-to-debt ratio stays above 35% once freight rates moderate. In our view, this will largely depend on Hapag-Lloyd's ability and willingness to keep adjusted debt at around the current lowered level of below €5 billion. This would mean shareholder remuneration will remain prudent and Hapag-Lloyd will not unexpectedly embark on any significant debt-financed fleet expansion or mergers and acquisitions not accompanied with an offsetting increase in earnings.

Downside scenario

We could lower the rating if Hapag-Lloyd's EBITDA sustainably plunged below €2.0 billion; for example, if trade volumes were much lower than we anticipate and the industry's measures to adjust capacity to sluggish demand were ineffective, resulting in worsened freight rate conditions. Alternatively, we could lower the ratings if Hapag-Lloyd was unable to offset fuel-cost inflation because of unsuccessful pass-through efforts or a failure to realize cost efficiencies. This would mean adjusted FFO to debt deteriorating to less than 25%, with limited prospects of improvement.

A downgrade would also be likely if the company adopted a more-aggressive financial policy, resulting in credit measures falling short of our rating guidelines.

Company Description

Hapag-Lloyd is a leading global container liner, with 237 modern ships, 12 million twenty-foot equivalent units (TEUs) of cargo transported per year, and about 13,100 employees in 395 offices spanning 129 countries. The company has a fleet with a total capacity of approximately 1.7 million TEUs, as well as a container stock of more than 2.7 million TEUs, including one of the world's largest and most modern refrigerated container fleets. Its global network provides connections between more than 600 ports on every continent.

Hapag-Lloyd is owned by CSAV Germany Container Holding GmbH (30.0%), Klaus Michael Kühne (including Kühne Holding AG and Kühne Maritime GmbH) (30.0%), HGV Hamburger Gesellschaft für Vermögens- und Beteiligungsmanagement mbH (13.9%), Qatar Investment Authority (12.3%), and Saudi Arabia's Public Investment Fund (10.2%), with a 3.6% free float.

Our Base-Case Scenario

S&P Global Ratings believes there remains high, albeit moderating, uncertainty about the evolution of the coronavirus pandemic and its economic effects. Vaccine production is ramping up and rollouts are gathering pace around the world. Widespread immunization, which will help pave the way for a return to more normal levels of social and economic activity, looks to be achievable by most developed economies by the end of the third quarter. However, some emerging markets may only be able to achieve widespread immunization by year-end or later. We use these assumptions about vaccine timing in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

At the moment, our base-case scenario for Hapag-Lloyd factors in the following assumptions:

- Annual growth rates in Hapag-Lloyd's transported volumes of 2%-3% in 2021, constrained by ongoing port congestions, and normalizing to the global GDP growth rate of about 4% in 2022, compared with a decrease of 2% in 2020.
- Average fixed-bunker freight rate per TEU increasing by 10%-13% in 2021, compared to a 4% increase in 2020. We expect this to be supported by the extraordinary strong year-to-date performance in spot freight rates and strong freight rates, which Hapag-Lloyd fixed in about half of its contract portfolio for the next 12 months. That said, we expect the spot rates to

gradually moderate later in 2021, when the pandemic effect on the container liner industry eases. From 2022, we expect revenue per TEU to reach the 2020 level, with contracted freight rates somewhat lagging the moderation in spot rates.

- Crude oil price of $60 per barrel (/bbl) in the reminder of 2021 and 2022, compared to $43/bbl in 2020. We maintain our view that future bunker cost increases or decreases (typically closely linked to crude oil price movements) will either be passed through or returned to customers via higher or lower freight rates with a few-month time lag. Furthermore, we expect increasing fuel efficiency to offset the effect of trade volume growth, leading to lower fuel consumption per TEU.
- Operating costs (bunker excluded) per TEU in 2021 increasing at a low-single-digit rate, largely due to congestions in the key marine ports, which we consider as temporary. In 2022, we expect operating costs per TEU to decrease by 0%-2%. At the same time, we forecast the efficiency improvements to be largely counterbalanced by normal cost inflation.
- Annual capex averaging €1.1 billion in 2021-2022, up from €530 million in 2020 and €430 million in 2019. About two-thirds of it are prepayments for construction of six new ultra-large container vessels of 23,500 TEU each, with delivery between April and December 2023, investments into new containers, ship retrofits and modifications, and dry docks.
- A dividend payment equal to about 66% of previous-year net income in 2021 and subject to the Annual General Meeting approval and about 50% assumed in 2022, which is in line with the stated dividend policy of at least 30% payout ratio. That said, we understand that depending on the cash flow performance, Hapag-Lloyd has flexibility to adjust its shareholder remuneration.

Based on our base-case assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures:

- FFO to debt of 60%-65% in 2021, decreasing to about 30% in 2022, compared with 45%-50% in 2020 and 23% in 2019.
- Debt to EBITDA of 1.4x-1.5x in 2021, increasing to 2.5x-3.0x in 2022, compared with 1.8x in 2020 and 3.4x in 2019.

Liquidity

Hapag-Lloyd's liquidity remains adequate, with sources to uses of 1.7x-1.8x in the 12 months to Dec. 31, 2021, and about 1.2x in the following 12 months (we include only the container revolving credit line (RCF) due in 2023 under the available credit lines). We note, however, that liquidity coverage remains susceptible to Hapag-Lloyd performing in line with our base case given that our forecast FFO (after lease amortization) accounts for 50%-60% of total liquidity sources in the upcoming 12 months. Our liquidity assessment also reflects Hapag-Lloyd's proactive and timely treasury management and uninterrupted access to secured and asset-backed financing, which should support the smooth renewal of the existing RCF and asset-backed securities (ABS) program, which all expire in 2022.

We estimate Hapag-Lloyd's principal liquidity sources during the 12 months from Dec. 31, 2020, comprise:

- On-balance-sheet available cash of about €380 million, after deducting $350 million of minimum cash requirements under a bank covenant.
- Availability of about €870 million under undrawn credit lines maturing beyond 12 months.

- Operating cash flows (after interest paid and lease amortization) of €2.5 billion-€2.6 billion, as in our base-case forecast.

We estimate that Hapag-Lloyd's principal liquidity uses during the same period comprise:

- Short-term maturities and scheduled amortizations of about €530 million.
- Capex of €1.1 billion, out of which about 60% is financed externally.
- Working capital outflow of about €200 million.
- Cash outflow for dividends of 66% of previous year net income, subject to approval at the Annual General Meeting in June.

Covenants

Hapag-Lloyd passed its financial covenant tests as of Dec. 31, 2020. Maintenance financial covenants on bank debt stipulate limits such as a minimum ratio of fair-market vessel or container value to debt, and the higher value of 30% of total assets and equity of €2.75 billion. The company had about €6.7 billion in equity as of Dec. 31, 2020. Other covenants stipulate minimum liquid funds of $350 million, with the company holding about €1.5 billion in liquidity reserves (consisting of cash, cash equivalents, and unused credit facilities) on the test date. We expect the company will pass the next covenant test in 2021. There are no leverage-ratio and interest-coverage covenants.

Issue Ratings--Recovery Analysis

Key analytical factors

- Hapag-Lloyd plans to issue €300 million senior unsecured notes with a maturity in 2028 to repay the existing notes maturing in 2024.
- Our issue rating on the proposed senior unsecured notes is 'BB', in line with the rating on the outstanding senior unsecured notes. The recovery rating of '3' indicates our expectation that lenders would receive meaningful recovery (50%-70%; rounded estimate: 65%) of the principal in the event of a payment default.
- At the same time, we note that the issue and the recovery ratings on the instruments are sensitive to even small changes in the enterprise value and secured debt. That said, we expect Hapag-Lloyd to maintain its secured debt at the lowered level going forward.
- As per our criteria, we cap the recovery rating at '3' given the unsecured nature of debt. The recovery rating benefit from the estimated residual at-default value of the company's assets after satisfying the prior ranking and secured creditors ahead of the unsecured claims.
- Our hypothetical default scenario envisions a prolonged downturn in the container shipping industry amid weak general economic conditions due to sustained lower demand from exporting countries and falling utilization and freight rates. We believe that this, combined with a chronic oversupply situation and depressed vessel values, would weaken Hapag-Lloyd's ability to downsize its fleet to generate liquidity and would trigger a payment default in 2026.
- We value the company on a going-concern basis, since we believe the business would retain more value as an operating entity than otherwise, and would rather reorganize in a bankruptcy

scenario than not. This view is underpinned by the company's scale and size, leading market positions, and broad diversity. Individual ships, however, could be readily sold to other operators to generate liquidity, and consequently we use a discrete asset valuation to evaluate the recovery prospects associated with the underlying assets.

Simulated default assumptions

- Year of default: 2026
- Jurisdiction: Germany

Simplified waterfall

- Gross enterprise value at default: €4.8 billion
- Administrative expenses: 10%
- Net value available to creditors: €4.3 billion
- Priority claims and secured debt: €3.9 billion*
- Unsecured debt claims: €385 million*
- --Recovery expectation: 50%-70% (rounded estimate: 65%)

*Priority claims and secured debt include our assumption of 85% drawing under the existing RCFs in a distressed scenario. All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating: BB/Stable/--

Business risk: Fair

- Country risk: Intermediate
- Industry risk: High
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/leverage: Intermediate

Anchor: bb+

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)

- Comparable rating analysis: Negative (-1 notch)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- German Container Liner Hapag-Lloyd Upgraded To 'BB-' On Resilient EBITDA And Lower Debt; Outlook Positive, Oct. 5, 2020.

Ratings List

Upgraded; Outlook Action		
	To	**From**
Hapag-Lloyd AG		
Issuer Credit Rating	BB/Stable/--	BB-/Positive/--
New Rating		
Hapag-Lloyd AG		
Senior Unsecured		
EUR300 mil sustainability-linked notes nts due 2028	BB	
Recovery Rating	3(65%)	
Ratings Raised; Recovery Rating Revised		
	To	**From**
Hapag-Lloyd AG		
Senior Unsecured		
Local Currency	BB	B

Recovery Rating	3(65%)	6(0%)