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Research Update:

German Container Liner Hapag-Lloyd Upgraded To 'BB+' On Strengthened Credit Risk Profile; Outlook Stable

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Rating Action Overview

- Hapag-Lloyd's €10.9 billion preliminary 2021 EBITDA exceeded 2020's level by 4x and our March 2021 forecast by more than 2x, fueled by steady and unexpected growth in average container shipping freight rates.
- We expect elevated freight rates to persist at least until late 2022, supporting Hapag-Lloyd's strongly improved credit measures.
- Furthermore, the company's strong cash flow generation will allow it to preserve a net cash position this year and bolster financial headroom under the rating for the expected moderation in freight rates, rising fleet investment needs, and possibly other discretionary spending.
- We have therefore raised our issuer credit rating on Hapag-Lloyd to 'BB+' from 'BB'.
- We also raised our issue rating on the company's senior unsecured debt and maintained the '3' recovery rating unchanged at 65% expected recovery.
- The stable outlook reflects our expectation that Hapag-Lloyd will maintain S&P Global Ratings-adjusted funds from operations (FFO) to debt above 35%, our threshold for a 'BB+' rating, which will be underpinned by the company's adjusted EBITDA ultimately stabilizing at well above the 2019 pre-pandemic level, and adherence to prudent financial policy.

Rating Action Rationale

Container freight rates are edging up across most trade lanes, with no signs of sustained moderation, contrary to our previous expectations. Freight rates will be kept high by robust container shipping demand, paired with persistent supply chain bottlenecks, equipment shortages, and marine port congestions--all exacerbated by the pandemic. Each quarter of 2021 saw a new, record-high freight rate level, with rates on the major trade lanes--the transpacific and Asia-Europe--rising disproportionately high. For example, on Jan. 2, 2022, the Shanghai

Containerized Freight Index (SCFI) hit the highest mark of 5,100 points, which is above the 4x elevated average in 2020 and 6x the pre-pandemic 2019-year average of 810 points.

Freight rates will remain extraordinarily high at least in the near term. The spread of the omicron variant continues to challenge global logistics and infrastructure and the supply of new vessels still lags the global demand for tangible goods. This will delay normalization in freight rates until late 2022 at the earliest, provided the pandemic's impact on container shipping eases. Thereafter, as overall industry capacity increases and vessels on order are delivered from 2023, ocean tariffs might face a further correction and ultimately stabilize at profitable levels that are above the pre-pandemic 2019 base, according to our base-case scenario. Still, our forecast is subject to mounting uncertainties. Omicron's high transmissibility has resulted in rapidly escalating cases and absenteeism from work (as employees are out sick or in quarantine) in many countries in Europe and in the U.S. We also believe that omicron presents a serious challenge to mainland China's and Hong Kong's local authorities given their zero-COVID stance. Mobility restrictions, port closures, and lockdowns of cities in the region might protract or even aggravate the already severely strained situation along global supply chains. We also understand that supply chain bottlenecks led many container liners' customers to increasingly opt for longer-term contracted freight rates, which should mitigate the impact on liners' earnings from declining spot rates, at least temporarily.

We expect global trade volumes in 2022 will largely trail the global GDP growth rate. The movement of essential goods, strong pickup in e-commerce, and shift in consumer spending to tangible goods from services have supported global container volume recovery since June 2020, with volumes recording a strong nearly 7% growth in 2021 (likely outpacing global GDP growth). This has been particularly fueled by flourishing transpacific trade, following a 1%-2% year-on-year contraction in 2020. In the current year, we expect the global seaborne container trade will decelerate somewhat, as the pandemic's effects on consumers' spending eases.

We expect average freight rates will plunge during 2023, and subsequently stabilize at profitable levels above the 2019 base. The expected easing of supply chain challenges and accelerated new containership deliveries from 2023 will exert heavy downward pressure on the current record-high freight rates. According to Clarkson Research, in January-November 2021, a record 4.1 million twenty foot equivalent units (TEUs) of containership capacity was ordered (a 300% increase as compared with the full-year 2020), corresponding to the orderbook of 23% of the total global fleet, with 2.3 million of TEU capacity currently scheduled to be delivered in 2023. That said, we believe that the industry will adhere to a similarly tight capacity discipline, as it demonstrated closely after the pandemic's outbreak in 2020, when the significant and abrupt decline in trade volumes was timely counterbalanced by blank sailings (skipping certain ports in the route or cancelling the route altogether) and other capacity containing measures. We consider such a reactive supply management as 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.

Hapag-Lloyd's preliminary 2021 EBITDA of €10.9 billion exceeded our March 2021 forecast by more than 2x. Hapag-Lloyd's all time-high earnings were fueled by the steady climb to ever-higher rates during 2021. This strength more than compensated for the rising bunker fuel prices and non-bunker-related transport cost inflation, as well as flat cargo volumes hindered by supply chain disruptions and maritime port congestions. In 2022, we forecast that supportive industry conditions will allow Hapag-Lloyd to largely replicate the strong EBITDA achieved last year, assuming that freight rates start normalizing from late 2022 at the earliest.

We do not view Hapag-Lloyd's extraordinarily high EBITDA in 2021 and expected in 2022 as sustainable. We still believe the company will be able to turn its present EBITDA strength into sustainable EBITDA value well above €2 billion, assuming the industry's players in general maintain their stringent capacity management and tariff-setting discipline, and Hapag-Lloyd also adheres to consistent cost controls. We continue to see the container liner industry tied to cyclical supply-and-demand conditions, which will likely translate into fluctuations in Hapag-Lloyd's EBITDA performance under normalized industry conditions. That said, we still believe because of the industry consolidation and container liners' more rationale behavior, the swings in freight rates will be flatter and their peak-to-trough periods shorter than in before the pandemic.

The extraordinarily strong 2021 operating cash flow has translated into a net adjusted cash position for Hapag-Lloyd. This compares with adjusted debt of €4.8 billion at year-end 2020 and €6.7 billion at year-end 2019. Supported by the anticipated strong cash flows in the current year, we expect Hapag-Lloyd to remain net cash positive, even accounting for the rising fleet investment needs and possible other discretionary spending. According to our base case, Hapag-Lloyd's credit metrics will be commensurate with our minimal financial risk profile category, providing an ample headroom under the rating for the expected moderation in freight rates.

Hapag-Lloyd lacks a track record of operating with the lower financial leverage we forecast in our base case. We apply a negative financial policy modifier to our 'bbb-' anchor for Hapag-Lloyd, resulting in an overall rating of 'BB+', because we note that the strongly improved credit ratios are a new achievement for the company. This means that there is no track record of Hapag-Lloyd operating at such a minimal leverage level; nor is there currently a commitment to maintain this degree of financial risk, which weighs on the rating. We also capture a relatively low degree of credit ratio predictability, beyond what can be reasonably built into our forecasts, and the risk that adjusted leverage could be higher than our base case. Our assessment also reflects the company's consistent leverage target of maximum 3x net debt to EBITDA, which is well above our expected leverage level in 2022-2023.

Outlook

The stable outlook reflects our expectation that Hapag-Lloyd will maintain adjusted FFO to debt above 35%, our threshold for a 'BB+' rating, while freight rates start normalizing from the current all-time highs, at the earliest from late 2022, if the pandemic's impact on container shipping eases. We think this will be underpinned by the company's adjusted EBITDA ultimately stabilizing at well above the 2019 pre-pandemic level and adherence to prudent financial policy.

Upside scenario

We could raise the rating if adjusted FFO to debt stays above 50% once freight rates appear to normalize, and the company commits to a financial policy to ensure this ratio level is sustainable.

Downside scenario

Although unlikely in the near term, we could lower the rating if Hapag-Lloyd's EBITDA sustainably plunged below €2 billion. This would stem from a sharp unexpected deterioration in demand for tangible goods, coupled with severe cost inflation and insufficiently counterbalanced by the industry's capacity containment measures or the Hapag Lloyd's cost savings measures.

We could also lower the rating if the company adopted a more aggressive financial policy, resulting in credit metrics falling short of our rating guidelines.

Company Description

Hapag-Lloyd is a leading global container liner, with 257 modern ships, about 12 million TEUs of cargo transported per year, and about 13,900 employees in 418 offices in 137 countries. The company has a fleet with a total capacity of approximately 1.8 million TEUs, as well as a container stock of about 3 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%);
- Saudi Arabia's Public Investment Fund (10.2%); and
- Free float of 3.6%.

Our Base-Case Scenario

- Global trade to remain strongly correlated with economic growth, namely that of major contributors to trade volumes.
- A rebound in GDP growth in China to 8.0% in 2021 followed by slower-than-pre-pandemic growth of 4.9% in 2022 and 2023. This compares with 2.3% in 2020 and 6.0% in 2019. Asia-Pacific's GDP expanded 6.3% in 2021 and will grow 4.9% in 2022 and 2023, after a 1.4% drop in 2020. Eurozone GDP has returned to growth of 5.1% in 2021, to be followed by 4.4% in 2022 and 2.4% in 2023, after contracting 6.5% in 2020. North American GDP expanded 5.5% in 2021, and will carry on at 3.9% growth in 2022 and 2.7% in 2023 after contracting 3.6% in 2020. Latin America's GDP growth of 2.2% in 2022 and 2.5% in 2023, after it increased 6.3% in 2021. Global GDP rebounded 5.6% in 2021, after contracting 3.2% in 2020, and will further expand 4.3% in 2022 and 3.7% in 2023.
- Annual growth rates in Hapag-Lloyd's transported volumes mirroring global GDP growth rates.
- Average fixed-bunker freight rate per TEU in 2022 close to the record-high level of 2021, which jumped by 80% from $1,115/TEU in 2020. We expect this to be supported by the spot freight rates that reached new highs in January 2022 and strong freight rates, which Hapag-Lloyd fixed in about half of its contract portfolio for the next 12-36 months. We expect the spot rates to remain at elevated levels at least until late 2022. In 2023, average freight rates will decline significantly, but remain well above the pre-pandemic levels. Among others, we expect the realization of the longer-term quality freight product program (contracts with the duration of more than 12 months) should contribute to less volatile freight rates in general.

- Crude oil price of $75 per barrel (/bbl) in 2022 and $65/bbl in 2023, compared with $71/bbl in 2021 and $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 time lag of a few months. 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 2022 still close to the highly inflated level of 2021 caused by continuous marine ports congestions and other pandemic-related supply chain disruptions. In 2023, we expect operating costs per TEU to normalize. At the same time, we forecast any efficiency improvements to be largely counterbalanced by normal cost inflation.
- Our forecast of average annual capital expenditure (capex) in 2021-2023 of up to €2 billion, which is significantly above €530 million in 2020 and €430 million in 2019.
- A dividend payment of 50%-70% of the previous year's net income assumed in 2022 and 2023, which is at the higher end of 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.

Liquidity

We assess Hapag-Lloyd's liquidity as adequate, with sources exceeding uses by more than 2x in the 12 months started Dec. 31, 2021, and more than 1.5x in the following 24 months. Our assessment is underpinned by the forecast available cash of about €7.0 billion at the end of 2021, which significantly exceeds Hapag-Lloyd's $1.1 billion minimum liquidity reserve target. 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 common terms agreement revolving credit facility (RCF) and securitization program, which both expire in 2022, and the container RCF maturing in June 2023.

We estimate Hapag-Lloyd's principal liquidity sources during the 12 months from Dec. 31, 2021, comprise:

- Our cash forecast of about €7 billion, after deducting $350 million of minimum cash requirements under a bank covenant.
- Availability of about €200 million under undrawn credit lines maturing beyond 12 months.
- Operating cash flows (after interest paid and lease amortization) of €8 billion-€9 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 €500 million.
- Our cash-funded capex forecast of €800 million-€850 million.
- Cash outflow for dividends under the stated dividend policy of at least 30% of the previous year's net income.

Covenants

We expect Hapag-Lloyd passed its financial covenant tests as of Dec. 31, 2021, with ample headroom. 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 €12.2 billion in equity as of the latest reporting date, Sept. 30, 2021. Other covenants stipulate minimum liquid funds of $350 million, while we forecast Hapag-Lloyd's liquidity reserves (consisting of cash, cash equivalents, and unused credit facilities) of about €7.5 billion on the test date. We expect the company will pass the next covenant test in 2022. There are no leverage-ratio and interest-coverage covenants.

Issue Ratings - Recovery Analysis

Key analytical factors

- The issue rating on the company's senior unsecured notes is 'BB+'. 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 headroom for changes in the enterprise value and secured debt under the current issue and the recovery ratings on the instruments has somewhat increased since our March 2021 review.
- As per our criteria, we cap the recovery rating at '3' given the unsecured nature of debt. The recovery rating benefits 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 2027.
- We value the company as a going concern, since we believe the business would retain more value as an operating entity than otherwise, and would be reorganized in a bankruptcy scenario. 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: 2027
- Jurisdiction: Germany

Simplified waterfall

- Gross enterprise value at default: €5.2 billion

- Administrative expenses: 10%
- Net value available to creditors: €4.6 billion
- Priority claims and secured debt: €3.5 billion*
- Unsecured debt claims: €368 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: Minimal

- Cash flow/leverage: Minimal

Anchor: bbb-

Modifiers:

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Negative (-1 notch)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

ESG credit indicators: E-3, S-2, G-2

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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'; Earnings Should Normalize But Remain Strong; Outlook Stable, March 23, 2021.

Ratings List

Upgraded

	To	From
Hapag-Lloyd AG		
Issuer Credit Rating	BB+/Stable/--	BB/Stable/--
Senior Unsecured	BB+	BB
Recovery Rating	3(65%)	3(65%)