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A.P. Moller-Maersk A/S

Balance sheet improvements may not offset ratings pressure from weak performance and industry-wide risks

Following the report of second quarter earnings by A.P. Moller-Maersk A/S (Baa2 under review for downgrade) on 17 August, we are continuing our review of the rating in light of expected announcements with regard to Total S.A. (Aa3 positive) shares and also increasingly focussing on the company's performance and industry conditions. We reiterate that for the rating outlook to be revised to stable Maersk would need to achieve debt/EBITDA below 3.0x at all points in the cycle pro-forma for the sale of the energy businesses. Also, we would expect greater stability in container shipping freight rates and, consequently, profitability, as measured by consistently positive EBIT margin. Conversely, the rating would likely be downgraded if Maersk's Debt/EBITDA ranges between 3.0x and 3.5x pro forma for the separation of the energy businesses whilst not exceeding 3.5x at all points in the cycle and the company's free cash flow (after capex and after dividends) is consistently negative. Absent marked improvement in the performance and industry conditions, we believe it would be challenging to sustain the rating at Baa2 notwithstanding the company's potential to strengthen its balance sheet. We would expect to obtain greater clarity before the end of the calendar year with respect to trade tensions' impact on demand and freight rate development in the seasonally strong Q3.

On 17 August 2018, Maersk reported total revenues of $9.5 billion and total EBITDA of $883 million for the second quarter of 2018. While the revenues grew by 24% as compared to the second quarter of 2017 (including the addition of Hamburg Sud), the EBITDA declined by 18% relative to the same period in 2017.

Revenue growth was driven by volume growth of 26% slightly offset by a 1.2% reduction in freight rate. This is reflective of the addition of Hamburg Sud, as well as broad weakness in freight rates that have been recovering slowly in the spring and summer following a decline in the first quarter.

At the same time, Maersk, along with other liners, experienced a surge in bunker costs in tandem with rising oil prices. Maersk reported a 28% rise in the average bunker price in the second quarter of 2018 compared to the prior year period. Although the company, along with a number of its peers, introduced emergency bunker surcharges, they only became effective in June and July; therefore, their effects will not be seen until the third quarter.

On a positive note, Maersk reported a 5.9% decline in unit costs at fixed bunker in the second quarter of 2018 as compared to the first. This is a key plus in the competitive and commoditised container shipping industry where margins are low (9% EBITDA margin in the second quarter of 2018) and cost control is vital to profitability. Importantly, Maersk mentioned that high unit costs seen in the first quarter of 2018 reflected initial integration with Hamburg Sud which suggests that poor cost performance was likely an outlier and not expected to be repeated.

Also positively, Maersk reported progress as expected on its two synergistic initiatives: the integration of Hamburg Sud and the integration of Maersk's existing businesses. Regarding Hamburg Sud, the company reported that $140 million of synergies were realised in the first half of 2018 placing it on track to achieve minimum $350 million - $400 million in synergies in total in 2019.

The business integration is also proceeding apace particularly between Maersk Line and APM Terminals, as well as Maersk Line and Maersk Container Industry (MCI). The cooperation between Maersk Line and APM Terminals resulted in volume growth at gateway terminals and increased hub terminal productivity while the closer ties between Maersk Line and MCI helped increase utilisation of container factories. To date, Maersk reported $200 million in realised synergies from the business integration activities with the overall goal of up to $600 million in 2019.

In addition to making progress on the integration of its business lines, Maersk announced further separation activities, specifically a demerger of Maersk Drilling and a sale of $1.2 billion of Total S.A. shares to support the company's financial flexibility. Maersk further announced a $1.5 billion debt financing for Maersk Drilling which will result in $1.2 billion in cash proceeds to Maersk for deleveraging from debt push down to Maersk Drilling. The company also reiterated its intention to distribute a material part of remaining Total S.A. shares to shareholders subject to maintaining its investment grade rating. Maersk noted that this distribution will occur following the demerger of Maersk Drilling, in 2019.

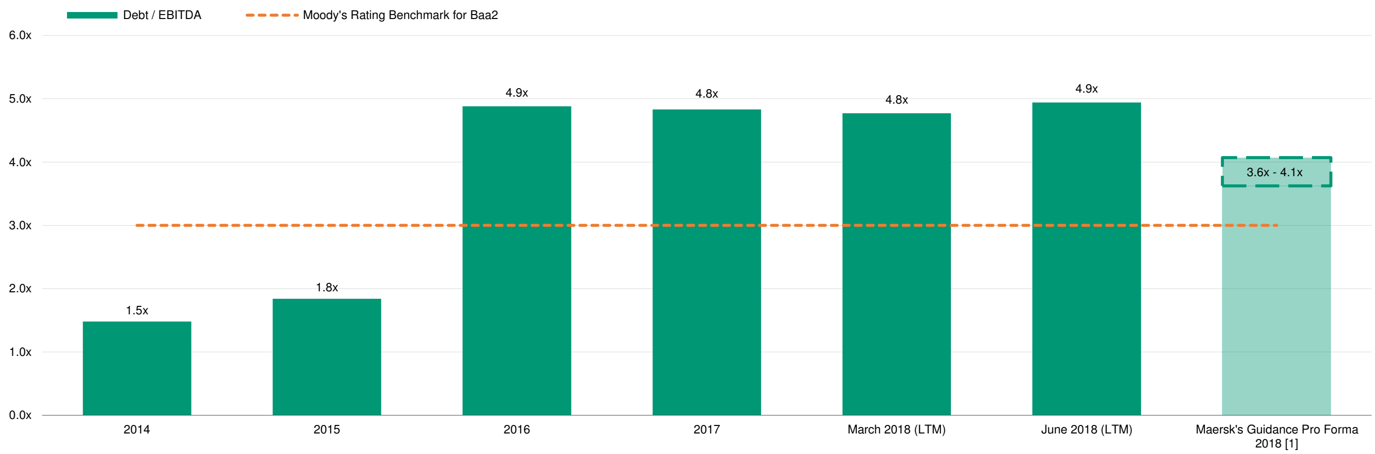
Despite these positive transactional announcements, we are increasingly concerned with the downside risks for the container shipping industry, namely, growing risks of a trade war between the United States and China and the delays in passing through the increased bunker cost to customers.

On 6 July 2018 the US implemented a 25% tariff on $34 billion of Chinese imports including electrical machinery, mechanical appliances, auto, aviation and rubber, with further tariffs likely. China responded by placing a 25% tariff on $30 billion of US imports such as agriculture, autos, rubber, chemicals, plastics and mineral fuels. Subsequent announcements pointed to $200-$500 billion of imports being affected. Moody's Global Trade Monitor published in July 2018 states, “We expect a prolonged US-China trade dispute and further trade measures throughout the rest of 2018.” In this environment, we are increasingly concerned about the robustness of demand for container liner services and, consequently, the likelihood of a stronger freight rate environment for the rest of 2018 and into 2019.

Separately, we are mindful of the sharp rise in bunker cost experienced by container liners in the end of 2017 and the first half of 2018 in line with the increase in the oil price. To date, it has proven difficult for container liners to pass these increases to customers and significant time lag has occurred. We are concerned that continuing inability to recover increased fuel costs will further pressure Maersk's already weak profitability. These sentiments – concerns about potential trade war and high bunker cost -- were also partially reflected in Maersk's recent guidance revision to an EBITDA range of $3.5 billion - $4.2 billion in 2018 from $4.0 billion to $5.0 billion previously.

As a result of the weakened earnings trends and ongoing separation of the energy businesses, Maersk's leverage has been above our expectations for the company's Baa2 rating as shown on Exhibit 1.

Exhibit 1



[1] Pro forma includes $1.2 billion Total SA share sale and $1.2 billion Maersk Drilling financing.
Source: Moody's Financial Metrics™

The negative free cash flow (after capex) in the first half of 2018 also contributed to slower than expected deleveraging; positively, capex is expected to decrease in the second half of the year. In 2018, we expect Maersk to reduce its debt from $17.5 billion at the end of 2017 taking into account $2.3 billion of proceeds from Maersk Oil, $1.2 billion of sold Total S.A. shares and $1.2 billion of Maersk Drilling financing.

Pro forma for the separation of Maersk Drilling, we expect Maersk's leverage to range from 3.6x to 4.1x based on the company's most recent guidance for 2018 and including Moody's standard adjustments. This leverage level is outside our rating guidance for the rating and absent credible turnaround trends in the third quarter of 2018, it would be difficult to sustain the rating at Baa2 despite Maersk's efforts to strengthen the balance sheet with proceeds from Maersk Drilling financing and the partial sale of Total S.A. shares.

Headquartered in Copenhagen, Denmark, A.P. Møller-Mærsk A/S is an integrated transport and logistics company and a global market leader in container shipping and port terminals. The company employs roughly 76,000 employees across operations in 130 countries. The group reported revenues of $30.9 billion and EBITDA of $3.5 billion in 2017.

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