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**Research Update:**

## **A.P. Moller - Maersk A/S 'BBB' Rating Remains On CreditWatch Negative Pending Clarity On Future Capital Structure**

**Primary Credit Analyst:**

Izabela Listowska, Frankfurt (49) 69-33-999-127; [izabela.listowska@spglobal.com](mailto:izabela.listowska@spglobal.com)

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## Research Update:

# A.P. Moller - Maersk A/S 'BBB' Rating Remains On CreditWatch Negative Pending Clarity On Future Capital Structure

## Overview

- We do not have clarity on how A.P. Moller - Maersk will use the proceeds from the divestment of its energy businesses, including the allocation of funds between debt reduction and shareholder remuneration.
- We are keeping our 'BBB' rating on the company on CreditWatch with negative implications, where we placed it on Aug. 23, 2017.
- The CreditWatch reflects that we could lower the rating, likely by one notch, if the debt reduction resulting from asset sale proceeds does not fully offset the loss of business diversification.

## Rating Action

On Nov. 27, 2018, S&P Global Ratings said it was keeping its ratings, including the 'BBB' long-term issuer credit rating on Denmark-based A.P. Moller - Maersk A/S (Maersk), on CreditWatch with negative implications.

The ratings were originally placed on CreditWatch on Aug. 23, 2017 (see "Danish Conglomerate A.P. Moller - Maersk 'BBB' Rating Put On CreditWatch Negative On Sale Of Oil And Gas Unit To Total").

## Rationale

We have extended the CreditWatch because we do not have clarity how Maersk will use the proceeds from the divestment of its energy businesses, in particular shares in Total S.A., including the allocation of funds between debt reduction and shareholder remuneration. We understand that the company will clarify its future capital structure following the demerger of Maersk Drilling via a listing on the Copenhagen Stock Exchange, likely in the first half of 2019.

The demerger of the drilling segment (accounting for 90% of the remaining energy assets) will be a milestone in the transformation of Maersk into a focused, integrated transport and logistics company, which began in September 2016. Since then, Maersk has sold the tanker segment (Maersk Tankers) to its controlling shareholder through its subsidiary APMH Invest A/S and the oil and

gas subsidiary Maersk Olie og Gas A/S (Maersk Oil) to Total S.A., generating total net cash proceeds of about \$5 billion (including about \$1.2 billion pro forma for the demerger of Maersk Drilling). In addition, Maersk sold Total S.A. shares (as a part of sale of Maersk Oil, Maersk received shares in Total S.A.) for an aggregated amount of \$1.2 billion in July 2018 and \$0.5 billion during October-November 2018. Maersk used the proceeds to strengthen its balance sheet, while retaining 69.3 million shares in Total S.A., with a current aggregated value of \$3.9 billion.

We view the separation of energy businesses as transformational, resulting in the loss of diversification benefits that we previously factored into our rating on Maersk. That said, we still believe that if the company were to apply a significant part of the proceeds from the divestments toward net debt reduction and strengthened its financial profile to fully counterbalance the loss of business diversification, this could allow us to affirm the rating. Maersk has stated its commitment to maintaining an investment-grade rating. However, we understand the exact allocation between deleveraging and shareholder remuneration has not been determined. The outcome of our CreditWatch resolution will also depend upon our view of whether the container shipping industry prospects and the company's ability to restore earnings over 2019-2020 (after lower-than-previously-expected EBITDA generation this year) supported the 'BBB' rating. We believe that debt reduction alone, absent EBITDA improvement, might not be sufficient for Maersk to restore its credit measures to be consistent with a 'BBB' rating, which include S&P Global-adjusted funds from operation (FFO) to debt improving and remaining at 40% or above and sustained strong free operating cash flow (FOCF) generation.

The overall demand-and-supply conditions are shifting in favor of ocean carriers after a difficult 2018, in which container liners struggled to pass through the elevated bunker (fuel to run ships) prices via higher freight rates, in particular in the first half of this year. With no incentive to place new large orders, as demonstrated by the muted contracting activity since late 2015, the containership order book has reached close to its historical low, at currently 13% of the total global fleet. Combined with funding constraints and more stringent regulation to cut sulfur emissions to 0.5% as of January 2020, these factors will likely help to restore the demand-and-supply balance in the containership segment as we progress into 2019-2020.

However, we remain cautious on the freight rates' outlook, forecasting a flat average fixed-bunker freight rate for Maersk in 2019-2020 after a single-digit rate increase this year. We believe that persistent significant deliveries of greater than 12,000 twenty-foot-equivalent (TEU; a measure of container-carrying capacity) containerships scheduled in 2019 will constrain rates, in particular on the main Asia-Europe and Transpacific lanes (where these mega-containerships operate), despite the likely favorable demand-and-supply balance in the industry in general. Risks are also evident in the demand outlook, most importantly from the ongoing U.S.-China trade dispute. Bearing in mind the supply pressure coming from the deliveries of ultra-large containerships, freight rates will ultimately depend upon how

prudent the leading container liners are in their capacity management and rate-setting decisions, which are even more important given high bunker fuel prices. Maersk's stringently managed capacity and no plans to order new large ships in the next minimum 12 months should support lower volatility in rates, particularly because the company's closest peers will likely follow suit. We would normally expect this behavior from a now more concentrated industry, which has been through a few rounds of consolidation over the past several years such that the share of the top five players escalated to 65% this year from 30% around 15 years ago.

Under our base case, we assume Maersk's 2018 reported EBITDA of \$3.7 billion-\$3.8 billion will only moderately exceed its reported EBITDA of \$3.53 billion in 2017. We add about \$1.35 billion of operating lease component and about \$250 million of recurring dividends from equity investment to arrive at S&P Global Ratings-adjusted EBITDA of \$5.3 billion-\$5.4 billion in 2018. We estimate Maersk to reach reported EBITDA of about \$4.4 billion in 2019 and about \$4.8 billion in 2020.

In our base case, we assume:

- Worldwide economic growth to remain vital to the container shipping industry because shipping is very sensitive to global economic growth and trade flows. While historically, containership demand growth increased at 2.0x-3.0x the rate of global GDP growth, it has sustainably slowed to 1.0x-1.5x. Under our base-case scenario, we expect that continued growth in the developing economies, mainly in Asia, will stimulate increased commodities trading in 2019. For example, we forecast that China's annual GDP growth will only marginally soften to 6.5% in 2018 and to 6.3% in 2019 from 6.9% in 2017. However, there are evident risks in the demand outlook, most importantly from the ongoing U.S.-China trade dispute.
- Annual growth rates in Maersk Ocean's (container liner segment) transported volumes of 3%-4% in the period 2018-2020, based on global GDP growth trends.
- Deployed capacity in Ocean to remain flat at around 4 million TEU until 2020.
- Bunker fuel expense in Ocean of around \$5 billion in 2018, compared with \$3.3 billion paid in 2017, which we keep constant in 2019-2020 for the purpose of our base case. We assume that a future bunker cost increase or decrease (typically closely linked to movement in a crude oil price) will be either passed through or given back to customers via higher or lower freight rates, respectively. We believe industry-wide freight rate increases will be inevitable when low sulfur regulation (IMO 2020) becomes effective and fuel bill increases likely from January 2020, because the liners will seek to recover cost inflation. We assume that Maersk will fully pass through higher IMO 2020 compliance-related bunker costs with a time lag of a few months. Otherwise, we forecast flat fixed-bunker freight rates over 2019-2020, after a low single-digit freight rate increase this year supported by the consolidation of Hamburg Süd, which has a different trade mix compared with Maersk Line,

particularly on the intra-regional and North-South trades, and hence it generates higher average freight rates than Maersk Line.

- Flat cost per container (at fixed bunker price) over the forecast period 2019-2020. This is more conservative than management's guidance of annual unit cost reduction by 1.0%-2.0% and reflects Maersk's strict cost control, including the realization of further efficiency gains and synergies from Maersk's transformation and merger with Hamburg Süd, which will counterbalance the inflationary pressures.
- Annual growth in Maersk Terminals' containers handled/terminal moves (weighted with ownership share) of 3%-4% over the forecast period, largely in line with growth in transported volumes.
- Increase in utilization in terminals driven by collaboration with Maersk Line.
- Largely stable terminal revenue per move and unit cost per move, resulting in a consistent high-single digit EBITDA growth in terminal operations over the forecast period. This will be complemented by moderate and gradual EBITDA expansion in the towage segment (Svitzer).
- Decreasing capital expenditure (capex) to \$2.0 billion-\$2.5 billion in 2019 and 2020 (from \$3 billion expected in 2018 and \$3.6 billion spent in 2017), which will boost FOCF generation and create scope for further net debt reduction.

Based on these underlying operating assumptions and--even allowing for material distribution of the value from the sale of energy businesses to the shareholders--we believe that Maersk has the capacity to achieve adjusted FFO to debt of 40% or above, underpinned by its well-invested asset base and prudent capex plan.

We believe that the business risk profile weakened within the satisfactory category after the separation of the energy assets. The disposals left Maersk with a more narrow business scope, less diversification, and smaller absolute cash flow streams. Maersk's operating performance and profitability have become more volatile because of the group's heavy exposure to the shipping industry's high risk. This, in our opinion, stems from the industry's capital intensity, high fragmentation, frequent imbalances between demand and supply, track record lacking a meaningful supply discipline, and volatility in freight rates. Positively, and in contrast to peers within the container liner segment, Maersk's business profile benefits from large and strategic position in the infrastructure-like terminal business (built around a portfolio of 74 ports across 58 countries and five new terminals under construction), complemented by predictable towage operations, which we expect to jointly contribute close to \$1 billion in annual EBITDA and add to earnings' stability at the Maersk group. This is an essential and differentiating rating factor compared with the business risk profiles of rated container liner peers, such as CMA CGM S.A., as well as Hapag-Lloyd AG and Wan Hai Lines Ltd., which we assess as fair and weak, respectively.

Furthermore, we believe Maersk continues to benefit from its top-tier market positions and global footprint through a broad and strategically located container liner route and port terminal network; attractive fleet profile, supported by a large, young, and diverse fleet; and strong customer and end-market diversification. We also believe that the group's established track record of achieving consistent cost savings and proactive efforts to continuously improve cost efficiencies--combined with unlocked synergies from transformation and merger with Hamburg Süd--will continue to support above-container liner industry-average EBIT margins.

## **Liquidity**

We assess Maersk's liquidity as exceptional. We forecast that Maersk's liquidity sources will cover its uses by around 3.5x over the 12 months started Sept. 30, 2018 and remain above 3.0x in the following 12 months. Maersk's liquidity sources on-hand, such as cash balance and liquid shares in Total S.A., supplemented with several committed credit lines maturing beyond 12 months, provide an ample liquidity cushion. We expect Maersk to continue having uninterrupted access to capital markets. In our view, management has a proactive approach toward financing planned capital investments and Maersk's debt maturities are well distributed. Furthermore, Maersk benefits from flexibility through its large unencumbered asset pool and well-established sound banking relationships. We understand that there are no financial covenants in any corporate loan documentations.

We calculate the following cash sources for the 12 months commenced Sept. 30, 2018:

- Cash and bank balances of \$3.3 billion, excluding \$1 billion of restricted cash.
- About \$8.5 billion of undrawn credit facilities with maturity beyond 12 months.
- About \$5 billion in liquid shares in Total S.A.
- Unadjusted FFO (less working capital outflow) of about \$3.5 billion-\$3.6 billion.

For the same period, we calculate the following cash needs:

- Upcoming debt maturities of about \$3 billion.
- Capex of about \$2.2 billion.
- Cash dividends of \$0.5 billion.

## **CreditWatch**

We intend to resolve the CreditWatch once the listing of Maersk Drilling is complete and we have more clarity on how Maersk will use the proceeds from the sale of energy assets, in particular shares in Total S.A., including the allocation of funds between debt reduction and shareholder remuneration.

We will lower the rating, likely by one notch, if we do not see sufficient deleveraging at Maersk.

We could affirm the rating if the company's credit metrics improve, offsetting the loss of diversification. To remain commensurate with the current rating, we would expect a sustained ratio of adjusted FFO to debt of at least 40% and that Maersk generates strong free operating cash flows sufficient to fund likely higher shareholder returns.

## **Ratings Snapshot**

Issuer Credit Rating: BBB/Watch Neg/--

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Moderately high
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Exceptional (no impact)
- Management and governance: Strong (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb

## **Related Criteria**

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Railroad

And Package Express Industry, Aug. 12, 2014

- Criteria - Corporates - Industrials: Key Credit Factors For The Transportation Cyclical Industry, Feb. 12, 2014
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Transportation Infrastructure Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

CreditWatch Maintained

A.P. Moller - Maersk A/S

Issuer Credit Rating	BBB/Watch Neg/--
Senior Unsecured	BBB/Watch Neg

### Additional Contacts:

Aliaksandra Vashkevich, Frankfurt + 49 693 399 9178; [Aliaksandra.Vashkevich@spglobal.com](mailto:Aliaksandra.Vashkevich@spglobal.com)  
Industrial Ratings Europe; [Corporate\\_Admin\\_London@spglobal.com](mailto:Corporate_Admin_London@spglobal.com)  
Stuart M Clements, London (44) 20-7176-7012; [stuart.clements@spglobal.com](mailto:stuart.clements@spglobal.com)

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