

# Sectoral impact of Red Sea trade disruptions

February 2024



## Background

Houthi rebels in Yemen are attacking cargo ships plying the waters connecting Asia with Europe and the United States (US) in a bid to stop Israel's offensive against Hamas in Gaza. As a result, traffic is being forced away from the Suez Canal and redirected around the tip of Africa.

The disruption is causing delays and driving up costs at a time when economies around the world are already grappling with concerns of resurgent inflationary trends.

The extent to which escalating shipping costs will reflect in consumer prices is still unclear. This is especially in Europe, where weak consumer demand means businesses will face pressure to absorb extra shipping costs.

### Trade flow diversions due to the ongoing Red Sea crisis



## Sectoral impact

The impact of the ongoing crisis around the Red Sea on the Indian industries is expected to be varied, depending on trade and sector-specific dynamics. The impact on specific sectors has been collated below.



### Capital goods

Impact: **HIGH**

A sustained disruption in trade routes, particularly one causing delays in the timely delivery of goods, holds the potential to significantly impact players within the capital goods sector. The ripple effect of such disruptions extends to various facets of the industry, potentially leading to an undesirable inventory build-up. This accumulation can, in turn, exert pressure on the operational efficiency of engineering, procurement and construction companies operating in this sector. The intricacies of supply chain management become more pronounced as delayed deliveries may contribute to a slowdown in the crucial process of order conversions along with shooting up of logistics costs. Consequently, the sector could grapple with the dual challenges of managing excess inventory and a deceleration in the conversion of prospective orders, impacting the overall business dynamics and performance of these enterprises.



### Crude oil

Impact: **MEDIUM**

India's overall import of crude depends on Russia (37%), Iraq (21%) and Saudi Arabia (14%). While the supply has largely remained unaffected, the current escalation has resulted in elevated freight and insurance costs. Furthermore, crude prices have started inching upwards consequent to the escalated geopolitical tensions. This is likely to impact incremental spreads observed by the oil marketing companies in the domestic market. Tighter shipping markets would further impact exports; Europe accounted for 21% of India's overall petroleum product exports in fiscal 2023. Incremental shipping costs are likely to reduce overall spreads of petroleum product exports, impacting the profitability of standalone refiners.



### Fertilisers

Impact: **HIGH**

The Red Sea conflict has impacted Middle East's fertiliser exports to India. As per reports, the crisis has extended shipment timelines by nearly 15 days and hiked freight costs. Import of the key fertiliser, muriate of potash (MOP), from Jordan and Israel has been majorly affected. Israel constitutes 10-15% of MOP exports to India, while Jordan constitutes 25-30%. Though the Indian government has assured a sufficient buffer for fertilisers, MOP supplies from these countries will be affected if the situation persists for long.



### Metals

Impact: **LOW**

In the steel sector, which accounts for the largest pie in the metals sector, 95% of the demand is met through domestic supply. Hence, the Red Sea crisis will not have a major impact. Neither will there be much of an impact on the trade front since most imports are from East Asia. Some minor impacts of the current crisis are as follows:

Logistics costs for metals exports to Europe, which account for ~2% of Indian production, have risen \$40-60 per tonne, which may impact export realisations for major flat steel producers. Raw material cost for scrap-based steel producers (melters and re-rollers) in western and northern India (~3-4% of India's steel production) has risen 5-8% due to the increased cost of steel scrap imports.

In case of base metals (aluminium, copper, lead and zinc), the logistics cost has increased 0.25-2% of raw materials/export goods cost. Hence, no material impact is anticipated.



## Pharma

Impact: **MEDIUM**

Some 50% of the Indian pharma industry's revenue comes from export markets, with the US and Europe contributing majorly. While the US and Europe contributed ~50% of the overall formulation exports, Europe alone contributed one-third of the overall bulk drug exports between April and November 2023. Out of the overall exports, almost two-third of pharma exports are by sea; with the Red Sea being the shortest route connecting Asia with Europe and North America, there could be some turbulence if the situation persists in the longer run. This may result in increased shipping surcharges and freight costs, which will eventually impact the margins of industry players. The delay in product deliveries may lead to an additional financial burden on them.

Having said that, so far, the impact of this event is not pronounced. Overall pharma exports grew by a healthy ~12.5% on-year (rupee terms) between April and November 2023. This growth was supported by the drug shortages in these two geographies and other factors such as exporters planning well in advance for the long year-end vacations in the US and Europe. Hence, exports to these two key markets happened well in advance to gear up for the peak season. However, from a broader perspective, considering India's dependence on the US and Europe for pharma exports, the current crisis, if prolonged, may lead to deterioration of margins, increased shipping/freight charges and an additional financial burden due to delay in product delivery over the longer term.



## Shipping

Impact: **MEDIUM**

Shipping freight rates have spiked of late because of geopolitical issues in the Middle East and attacks on vessels sailing through the Red Sea. While container shipping freight rates globally are now 2.5-3.0 times higher than in early December 2023, spot rates for vessels transiting through the Suez Canal — particularly from Asia to Europe — have surged nearly five-fold. Also, rates from China to the US have more than doubled.

The increase in global spot rates is also because of a shortage of available vessels at ports owing to unscheduled rerouting around the Cape of Good Hope, which is causing delays of up to two weeks. While ~80% of the shipping contracts are long term, their renewals can be affected if the geopolitical tension in the Middle East persists. That said, the additional cost for the detour may not be significant for the vessel operator when compared to the increase in freight rates. In fact, the operator could benefit from not having to pay the Suez Canal toll.

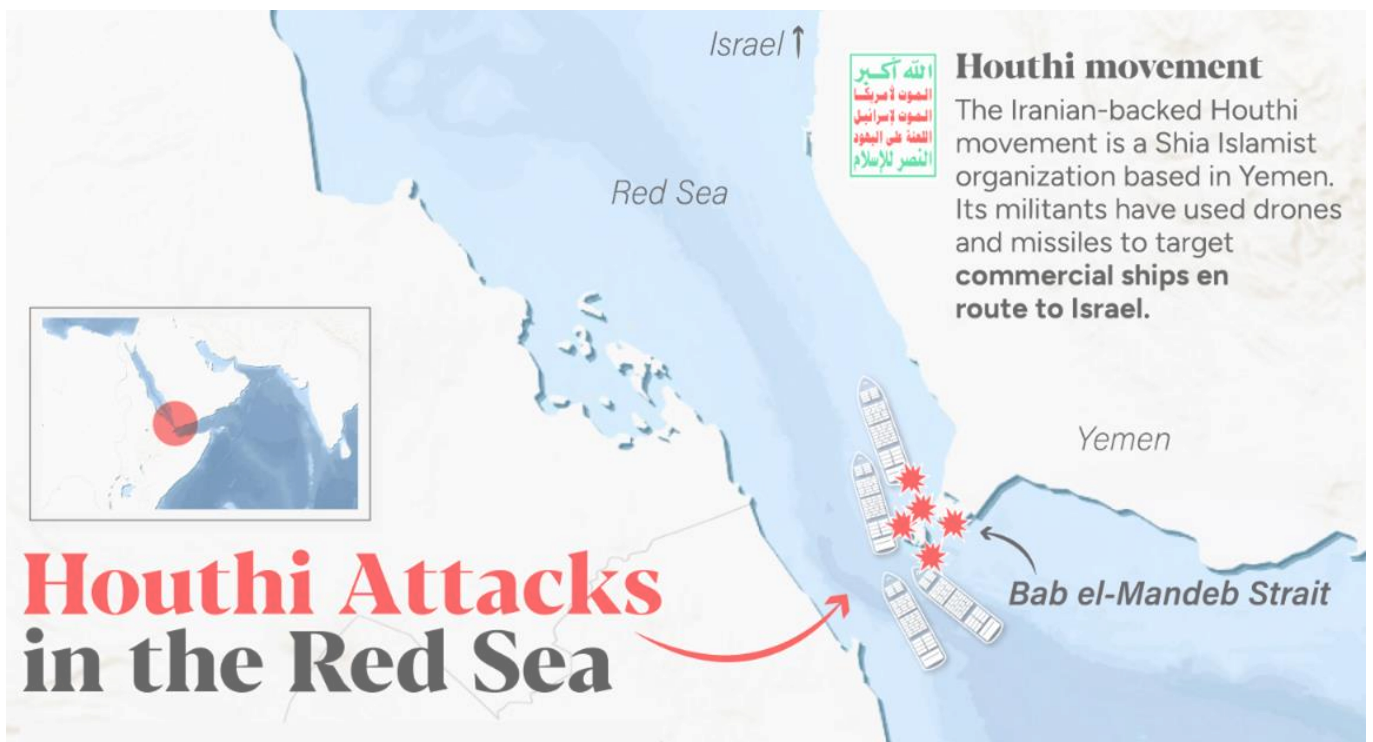
To summarise, the overall impact of the situation has been positive to neutral on the shipping industry given the fact that the elevated freight rates have more than compensated for the incremental operating costs and additional risk borne by the operators.



**Textiles**

Impact: **LOW**

The textiles industry is unlikely to be significantly impacted by the Red Sea crisis. Around three-fourth of the sector is oriented towards the domestic market. With the crucial festive season behind us, the ongoing quarter is unlikely to see higher export demand. In sum, the textiles industry is not expected to struggle in the near term, primarily because of a weak trade cycle. Buyers in overseas markets may also be able to absorb higher freight cost, thereby insulating the profitability of exporters. However, a prolonged crisis is likely to dent margins and stretch the working capital cycle.



## For further information,

### Analytical contacts

**Aniket Dani**

Director-Research

**CRISIL Market Intelligence and Analytics**

aniket.dani@crisil.com

**Pushan Sharma**

Director-Research

**CRISIL Market Intelligence and Analytics**

pushan.sharma@crisil.com

**Sehul Bhatt**

Associate Director-Research

**CRISIL Market Intelligence and Analytics**

sehul.bhatt@crisil.com

### Media contacts

**Aveek Datta**

Media Relations

CRISIL Ltd

M: +91 99204 93912

B: +91 22 3342 3000

aveek.datta@crisil.com

**Prakruti Jani**

Media Relations

CRISIL Ltd

M: +91 9867868976

B: +91 22 3342 3000

prakruti.jani@crisil.com

**Roma Gurnani**

Media Relations

CRISIL Ltd

M: +91 7066292142

B: +91 22 3342 3000

roma.gurnani@ext-crisil.com

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