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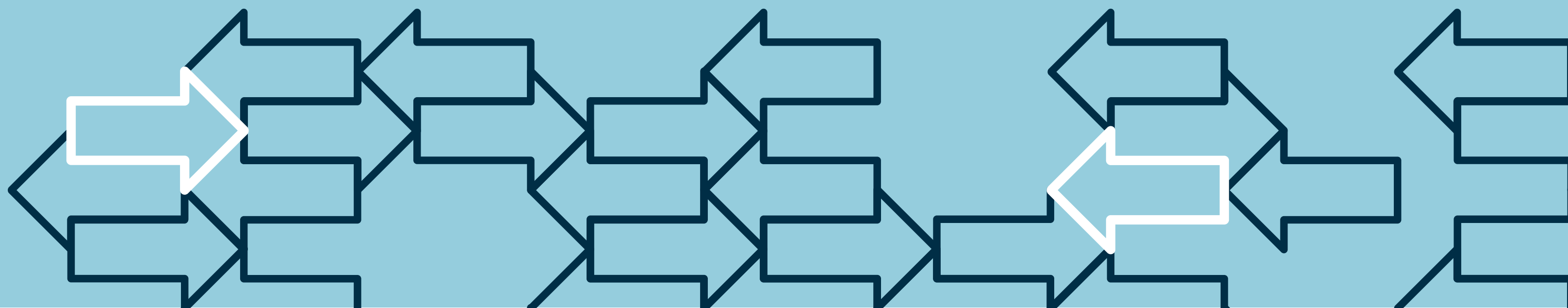
Braving container terminal headwinds: a playbook for investors



Today's North American container terminal business is a far cry from what many current investors thought they were buying into just a few years ago. Powerful trends—starting with a global recession of historic proportions—have upended the common assumption this is a steadily growing business with consistently healthy returns for investors and management.

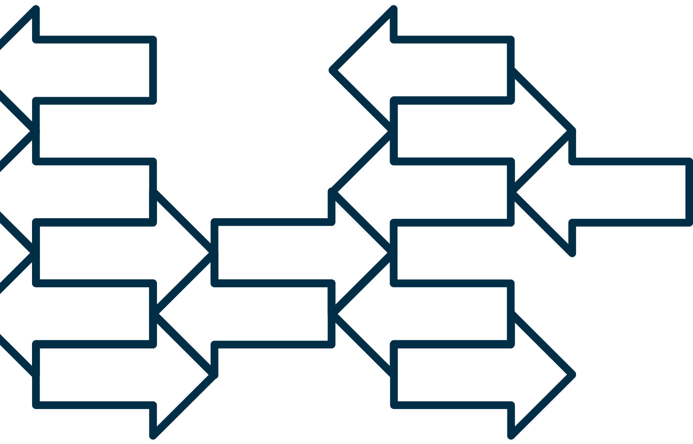
It hasn't worked out that way. Container shipping has been slow to snap back from the recession. From 2001 to 2006, container volumes for 14 major gateways in the United States and Canada rose 9.1% annually. Since 2010, the annual growth rate has slowed to 4.9%.[1] In other words, the days of the easy play are gone. Now, to create value, terminal owners must clearly understand both (1) the macrotrends of shipping and ports and (2) the dynamics of the particular port in which they operate; and they must devise plans for increasing a terminal's value within that sharply defined strategic context.

Amid the uncertainty around the global container shipping market, at least one conclusion is obvious: sitting tight and hoping for the best is not a serious option. This article outlines some of the major trends reshaping the industry—and how investors can confront them.

THE BATTLE FOR GATEWAY DOMINANCE

Winners and losers are emerging in the battle to become dominant gateway ports for container trade in North America. Although US West Coast ports continue handling nearly 54% of North America's total 20-foot-equivalent-unit (TEU) volume, that's down from almost 60% in 2007.[2] The combination of risk associated with periodic labor disruption problems at Southern California ports, as well as the opportunity to send larger vessels through the expanded Panama

[1] JLL Research, *Port, Airport & Global Infrastructure,* North America, 2017.
[2] JLL Research, *Port, Airport & Global Infrastructure,* North America, 2017.



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Canal, has contributed to increasing levels of business for alternative ports—especially on the Gulf of Mexico and in the southeastern US (figure 1)—as well as to the shifting of some discretionary volume to alternative gateways in Canada and Mexico.

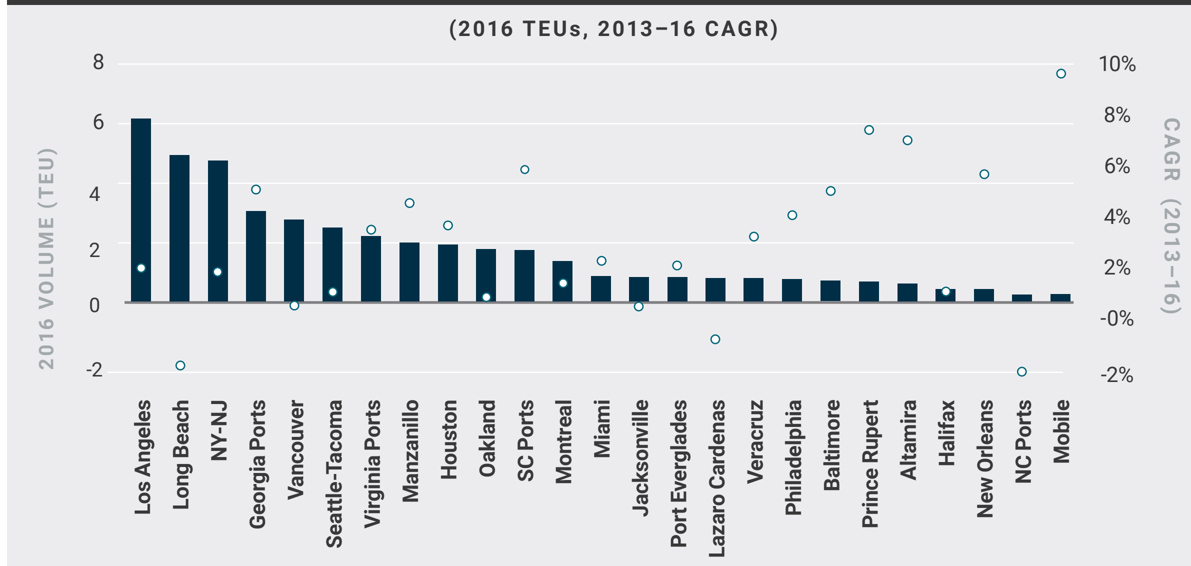
CARRIER CONSOLIDATION DRIVES TERMINAL INDUSTRY CHALLENGE

Many of the leading cargo gateways are fragmented collections of terminal operators and stevedores with their own affiliations and relationships with the top carriers. But consolidation—among and between shippers and terminals—is fundamentally changing the competitive map for multiple gateways.

In April 2017, the shipping industry experienced the latest round of consolidation by contracting from four leading alliances to three. Those mega-alliances, along with other M&A activity and bankruptcies, generally strengthen the industry; they enable carriers to reduce costs and raise competitiveness by sharing vessels, slashing overcapacity, and eliminating overlapping routes.[3] And that directly affects terminals in two immediate ways: (1) At the most basic level, fewer vessels means fewer calls, which reduces terminals' customer bases. And (2), at the same time, those fewer vessels discharge more containers with each call, which causes operational challenges in ports with constrained infrastructures.

Consolidation in the carrier market is reducing the number of potential customers that terminals can serve, which makes each deal critical as the volume in play increases (figure 2). At the same time, through a variety of investment structures, many of the leading carriers already have affiliations with terminals in leading ports, so the odds are tilting against independent terminals, thereby driving them to compete on price.

FIGURE 1: TOP 25 PORTS: CONTAINER TRADE GROWTH (2016 TEUS, 2013–16 CAGR)

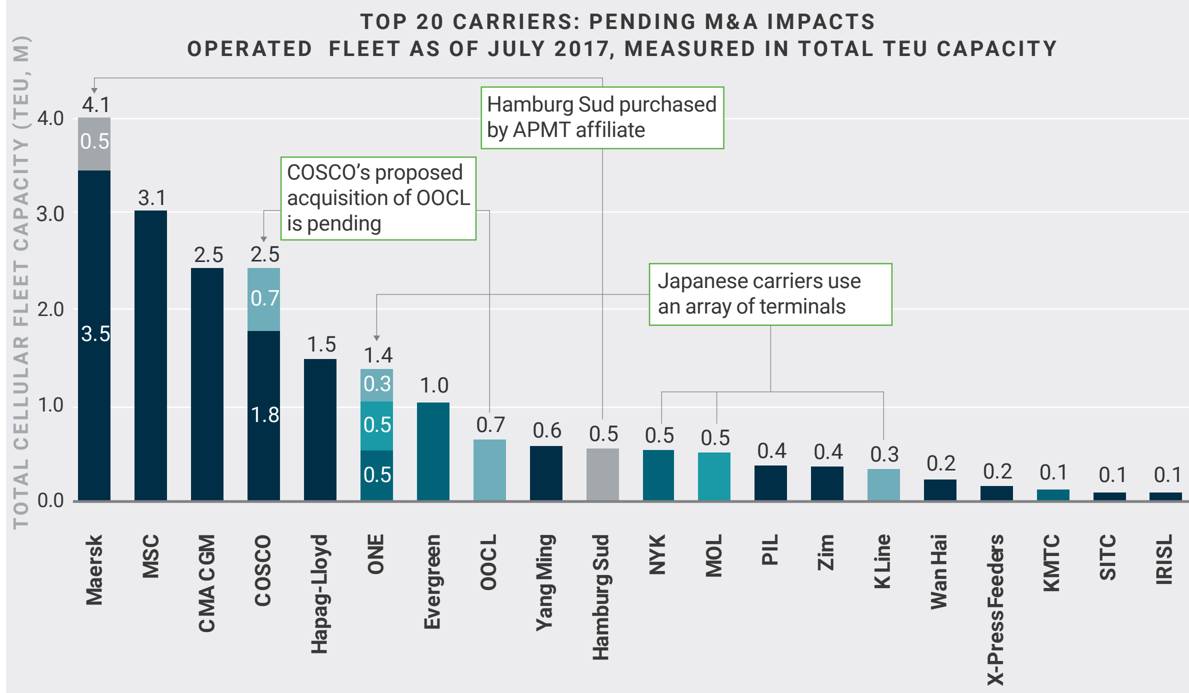


■ Volume ○ CAGR

Source: Journal of Commerce

[3] JLL Research, *Port, Airport & Global Infrastructure, Seaport Outlook,* 2017.

FIGURE 2: CARRIER CONSOLIDATION IS SHRINKING THE POTENTIAL CUSTOMER BASE FOR INDEPENDENT TERMINALS OPERATORS



Source: Alphaliner.com

As carriers continue cleaning up their portfolios, we anticipate further consolidation of the patchwork of partnerships between carriers and terminals—especially in the Southern California, New York, and SeaTac gateways.

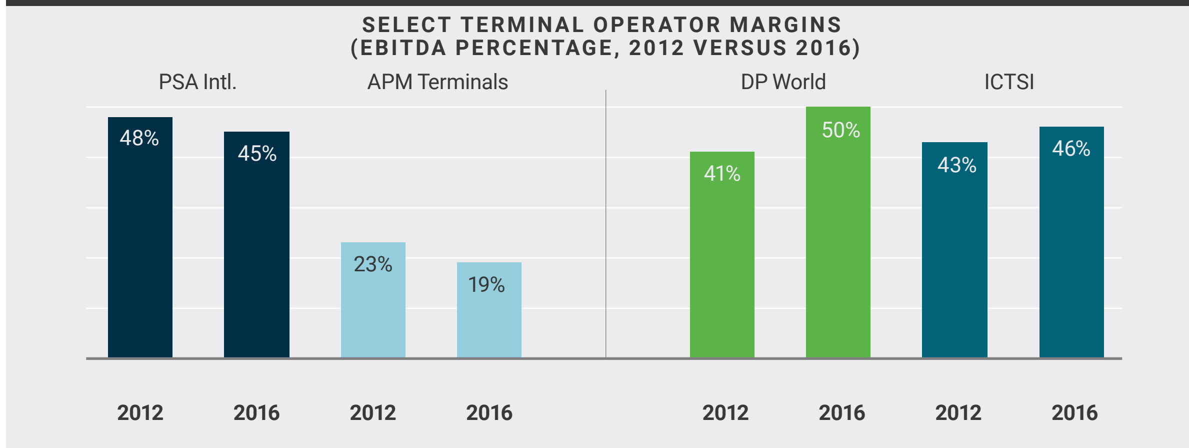
Overall, terminal operators with exposure to major hubs and gateways are experiencing falling margins, and their peers with operations in secondary and developing markets are seeing their margins improve (figure 3). We believe this trend will take root in the US market as competition in major gateways becomes fierce and as savvy operators in secondary ports seek opportunities to provide niche services.

LARGER VESSELS COMPLICATE MATTERS

Another major trend being felt in multiple ways is the rise of larger vessels, which the shipping alliances have been ordering as they gradually modernize their fleets. When its new shipping lane opened in June 2016, the Panama Canal became able to accommodate supersize, Neopanamax vessels with maximum capacities of nearly 13,000 TEUs compared with the standard 5,000-TEU capacity of vessels using the existing lanes.[4]

The larger vessels make fewer calls—and only at select gateways; they can only call at ports that have the channel depths and air drafts to handle them (figure 4). When they

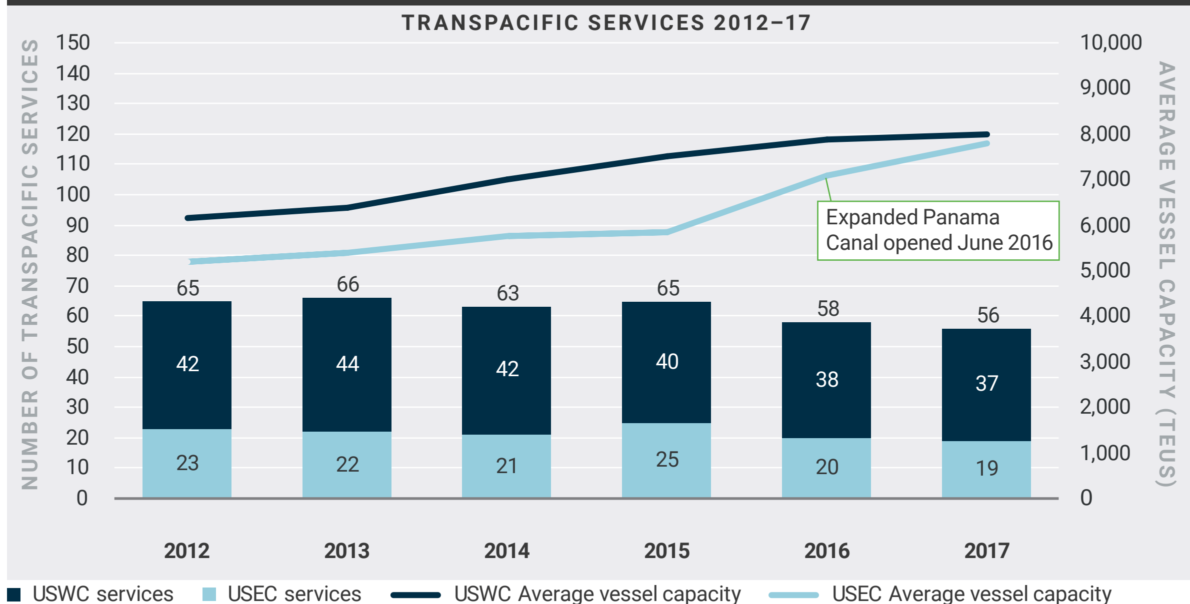
FIGURE 3: OPERATORS WITH SIGNIFICANT EXPOSURE TO MAJOR HUBS AND GATEWAYS ARE SEEING MARGINS SQUEEZED



Source: S&P Capital IQ, company reports

[4] JLL Research, *Port, Airport & Global Infrastructure, North America*, 2017.

FIGURE 4: CARRIERS WILL FAVOR FEWER IMPORT GATEWAYS AS THEY USE LARGER VESSELS THAT RUN IN FEWER SERVICE STRINGS TO SERVE NORTH AMERICA



■ USWC services ■ USEC services — USWC Average vessel capacity — USEC Average vessel capacity

Source: BlueWater Reporting

do call, their enormous loads impose huge demands on dockside operations and logistics, sometimes causing major congestion and backups.

INFRASTRUCTURE CHALLENGES

The unique problems involved in unloading new and larger vessels merely underscore a more fundamental shortcoming: chronic underinvestment in US infrastructure, which critically limits the ability of ports and terminals to efficiently unload, store, and distribute containers.

Compared with other countries—particularly China, Japan, and India—the United States has been spending shockingly little during the past several decades. The American Society of Civil Engineers estimates a $1.1-trillion shortfall in estimated spending in the next 10 years on both surface transportation (roads and bridges) and rail,[5] which are the essential arteries for moving containers off docks, around surrounding metropolitan areas, and into the heartland. Today it's not uncommon at terminals in major population centers such as New York and Seattle to see trucks backed up into local neighborhoods—and even onto interstate highways—because congestion and inadequate infrastructure strangle the unloading process during peak periods. That congestion will grow only worse as the volume of larger vessels increases to require the unloading of even more containers in a short period of time.

STRATEGIC IMPLICATIONS FOR INVESTORS

Some combination of these macro- and microtrends could affect every US terminal—if it hasn't already. Consolidation among carriers, leading to the elimination of duplicate routes and a shift to larger vessels, will reduce the number of calls; alliances between shippers and terminals could further squeeze operators; the competition will be intense; and margins will be pressured. Meanwhile, the shift to larger vessels will favor certain gateways and marginalize others while ratcheting up the operational stress on facilities already suffering from inadequate infrastructures.

For investors who got into the terminal business during a different time and who assumed—based on the best information available at the time—that their investments would have paid off handsomely long before now, the situation calls for some hard choices. It requires an understanding of what investors can change, and what they can't (figure 5).

Traffic gravitates to gateways, not to specific terminals. So, the first challenges are (1) to understand the dynamics affecting a particular gateway and (2) to objectively evaluate that port's growth potential. Only then can an investor rationally assess the range of strategic options for increasing the value of a given terminal within that gateway. In the most extreme cases, the best option might simply be to exit, but even in the best of cases, the paths to value creation are limited, and investors must choose carefully.

[5] American Society of Civil Engineers 2017 Infrastructure Report Card.

FIGURE 5: INVESTORS NEED TO CONSIDER STRATEGIC OPPORTUNITIES BY LOCATION IN CONTEXT OF BOTH PORT-LEVEL GROWTH AND TERMINAL-LEVEL COMPETITIVENESS

Source: AlixPartners analysis

THE BASIC STRATEGIES ARE FAIRLY CLEAR

- **Build volume** by (1) consolidating with other terminals, (2) locking up long-term commitments, or (3) serving specialized niche markets.
- **Grow margins** by reducing the cost base and improving operational efficiency.

Of course, the two strategies are not mutually exclusive. It's crucial for terminal investors and owners to know precisely where they now sit on the matrix of gateway potential and terminal competitive strength and to determine whether their challenge is to begin making initial investments or to double down on previous moves so they can fully exploit the opportunity for market leadership.

For most investors, the bottom line is that there's still opportunity to create value in this market despite the changes that have reshaped the industry. But it won't be easy. It will require sharp analysis, difficult choices, and a commitment to rigorous, disciplined execution. **A**

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