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2018 GLOBAL CONTAINER SHIPPING OUTLOOK

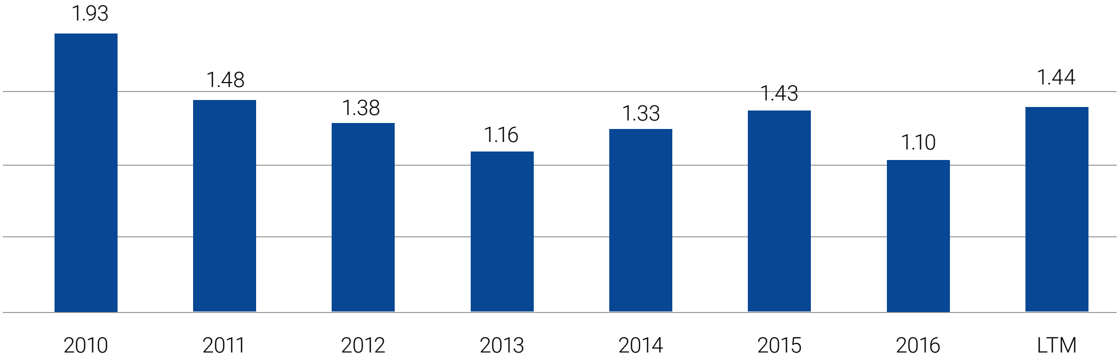
Though challenges remain, opportunities exist for carriers

The 2018 outlook for global container carriers is decidedly mixed. Although the industry enjoyed modest improvement in 2017, it still needs to address the dual challenges of rising costs and oversupply—driven mostly by fleet expansion—to keep the momentum going.

The industry's financials showed some improvement in 2017, though they remain at relatively low levels. Take, for example, the industry's average Altman Z-score,[1] which rose significantly in 2017 to 1.44 from a grim 2016 historical low of 1.10. That's a clear improvement, but the number still shows cause for concern because it still puts the industry squarely in the danger zone—and certainly nowhere near the safe zone of higher than 2.99, which we've not seen since 2007 (figure 1).

Freight rates were stronger in the first half of 2017, but they remained low in a wider historical context. Generally, they've settled back to where they were before the Hanjin Shipping Co. bankruptcy in late 2016. Demand is growing slowly but steadily, and after a brief lull, fleet capacity is once again on the rise. Estimates of growth in fleet capacity for 2018 range anywhere from 4% to more than 5% compared with 3.3% in 2017. Total new-container-ship capacity of around 1.3 million twenty-foot-equivalent units (TEUs) is due for delivery in 2018, and approximately 30% of that new capacity will be for megaships of 18,000 to 25,000 TEUs.[2]

FIGURE 1: INDUSTRY AVERAGE ALTMAN Z-SCORE



Source: AlixPartners analysis, CapIQ, company reports

[1] The Z-score—a formula for predicting the likelihood of bankruptcy based on a number of metrics from a company's public statements—of less than 1.81 suggests financial distress

[2] https://ihsmarkit.com/research-analysis/operators-are-the-greatest-danger-to-container-market.html

Rates will continue to be squeezed as long as supply continues to outpace demand for containerized services. Consequently, total demand—at the very least—will have to meet expectations of a 4 to 5% increase to provide any real opportunity for margin growth.[3]

Operating expenses, too, are once again ticking up, thanks in part to rising bunker prices. Bunker prices more than doubled from the end of January 2016 to the same point in 2018.[4] Larger customers have been rejecting surcharges such as the low-sulfur-fuel surcharge and frequently demanding contract rates with bunker adjustment factor included, thereby eliminating carriers' ability to pass on fuel price fluctuations. Consequently, carriers will have to step up other efforts to manage expenses and lower the cost base.

Furthermore, the industry remains susceptible to black-swan events ranging from the impacts of shifting geopolitics to cyberattacks. After a year of harsh rhetoric and rancorous negotiations, it remains unclear what impacts Brexit, America First policies, and volatile financial markets might have on specific demand and routes. Although the global economy started the New Year with broad strength, the potential remains for the development of political crises, for major corrections in the financial markets, and for ongoing dangerous cyberattacks such as the 2017 breach of Maersk Line, which the company said cost it an estimated $200 million to $300 million.[5]

OPPORTUNITIES FOR CARRIERS

At the same time, we see a number of opportunities for carriers to significantly improve performance through effective management in areas actually within their control. The first area is pricing discipline. Ongoing fleet consolidation has created a situation wherein the five top carriers will now control almost two-thirds of global capacity.[6] That realignment of ownership creates a unique opportunity for the industry to demonstrate a level of price discipline that has been lacking for years.

The second opportunity is operating expense management. Although carriers have improved their capacity management skills, they have yet to produce the anticipated cost savings from fleet consolidation. Therefore, major opportunities remain for fleet operators to make dramatic cuts in redundant expenses and to modernize operations.

Finally, it is imperative that carriers curb their voracious appetites for new ships. New orders slowed, and deliveries were deferred during much of 2017, but in September, the buying spree resumed in earnest, thereby ensuring the continuation of the current margin-crushing balance of supply and demand unless scrappage activity accelerates dramatically.

In 2018, we will begin to see the impacts that might result from the industry's reconfiguration into two tiers: the five large global players and about two dozen much smaller players, many of which compete either as specialists or exclusively in niche markets. The traditional second tier of midsize carriers has been absorbed by the giants. As controlling power within the industry stabilizes, it becomes more important than ever for carriers to step up their efforts to improve their performance, discipline their investments, and sharpen their strategies for succeeding through scale or specialization.

[3] https://www.bimco.org/news/market_analysis/2018/20180102_2017-was-year-of-change-in-shipping
[4] http://www.bunkerindex.com/prices/bixfree_1801.php?priceindex_id=2
[5] http://www.forbes.com/sites/leemathews/2017/08/16/notpetya-ransomware-attack-cost-shipping-giant-maersk-over-200-million/#6df8e1a4f9ae
[6] https://alphaliner.axsmarine.com/PublicTop100/

FIGURE 2: CARRIER INDUSTRY FINANCIAL RESULTS SHOWS APPROXIMATELY 50% YOY IMPROVEMENT IN EBITDA FROM END OF 2016 AND 2017

KEY METRICS ($ MILLION)	2010	2011	2012	2013	2014	2015	2016	LTM
Revenue	183,772	196,126	192,315	178,027	176,928	159,646	139,273	156,228
Total debt	76,325	87,446	99,868	104,561	92,581	83,053	74,435	84,040
EBITDA	28,128	18,943	15,971	16,416	19,588	16,389	10,024	14,712
EBIT	17,429	8,391	4,795	5,417	9,382	6,158	623	5,007
CAPEX	(17,044)	(23,362)	(24,049)	(19,847)	(17,666)	(14,985)	(9,775)	(12,793)
Cash from ops	18,928	11,035	8,621	13,588	18,902	15,692	8,278	11,259
OPEX	150,897	181,274	187,520	172,610	167,546	153,489	138,650	151,220
Interest expense	2,680	1,727	2,401	2,227	2,795	2,293	1,689	N/A
RATIOS	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**LTM**
Cash from ops/CAPEX	1.1	0.5	0.4	0.7	1.1	1.0	0.8	0.9
Debt/EBITDA	2.7	4.6	6.3	6.4	4.7	5.1	7.4	5.7
OPEX as percentage of revenue	82%	92%	98%	97%	95%	96%	100%	97%
Cash from ops as percentage of revenue	10.3%	5.6%	4.5%	7.6%	10.7%	9.8%	5.9%	7.2%
EBITDA minus CAPEX/interest exp.	4.1	(2.6)	(3.4)	(1.5)	0.7	0.6	0.1	N/A
Average Altman Z	1.93	1.48	1.38	1.16	1.33	1.43	1.10	1.44
Negative EBITDA	1	6	3	4	1	3	5	2
EBIT percentage	9.5%	4.3%	2.5%	3.0%	5.3%	3.9%	0.4%	3.2%
EBIITDA percentage	15.3%	9.7%	8.3%	9.2%	11.1%	10.3%	7.2%	9.4%
Q3 ($ MILLION)	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Revenue	44,918	42,864	47,821	36,197	36,564	37,098	31,588	33,590
EBITDA	5,791	1,714	2,564	2,014	3,016	1,122	(948)	1,431

Source: AlixPartners analysis, CapIQ, company reports

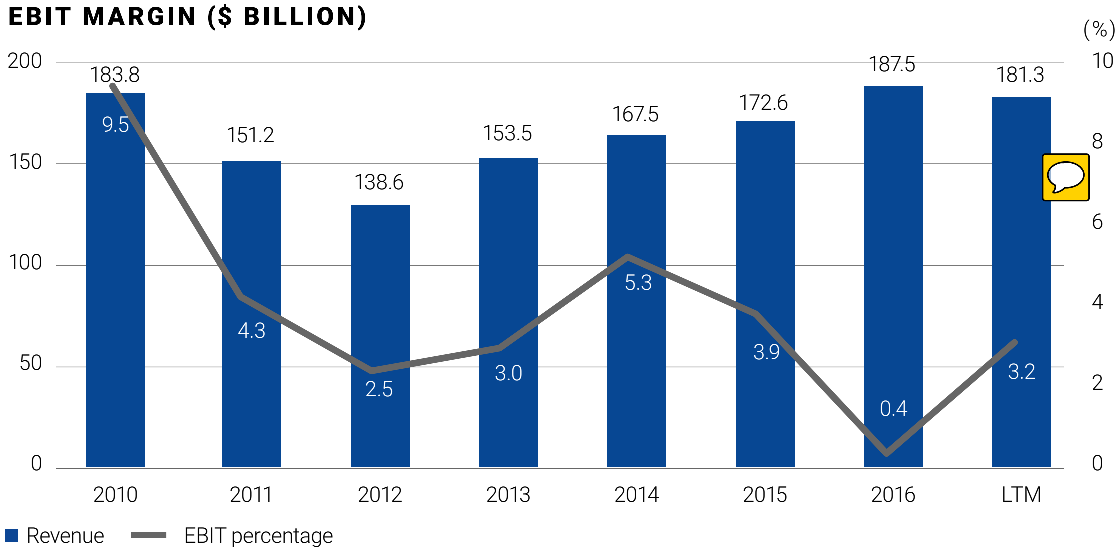
FINANCIAL RESULTS

The overall financial picture remains challenging, although 2017 showed some year-over-year improvement. Cash from operations increased by 36%, a significant turnaround after a two-year decline (figure 2). The all-important third quarter was good for many carriers—and truly great for a few—with industrywide revenue up 6% from 2016's anemic Q3, although still the second-weakest Q3 performance since recovery from the Great Recession. Similarly, Q3 earnings before interest and taxes (EBIT) rebounded into positive territory after a two-year slide but remained at historically low levels.

Cash from operations increased by

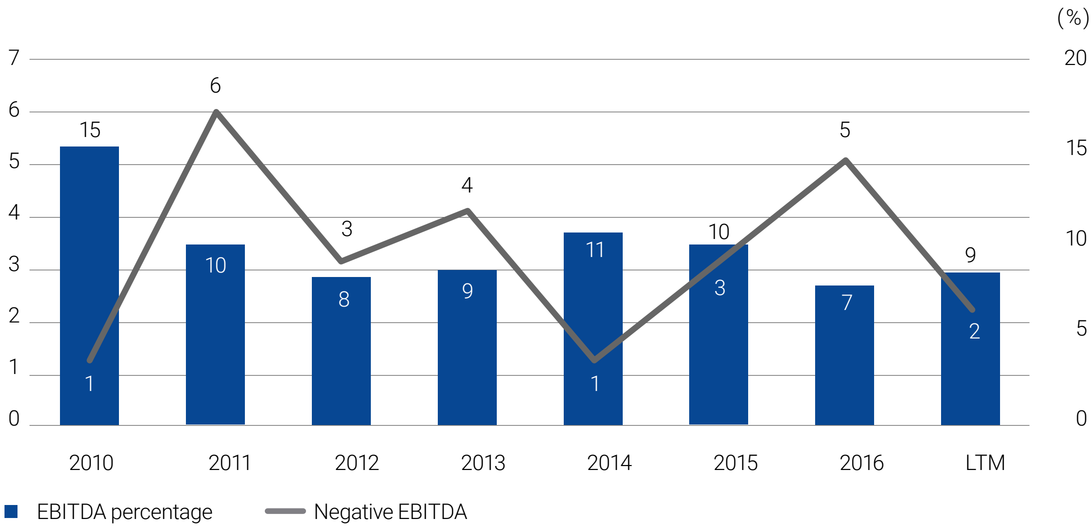
36%

FIGURE 3: EBIT AS PERCENTAGE OF REVENUE – REVENUE VERSUS EBIT MARGIN ($ BILLION)



Source: AlixPartners analysis, CapIQ, company reports

FIGURE 4: NUMBER OF CARRIERS WITH NEGATIVE EARNINGS – EBITDA MARGIN VERSUS CARRIERS WITH NEGATIVE MARGIN



Source: AlixPartners analysis, CapIQ, company reports

For the year, EBIT rose to 3.2 as a percentage of revenue from 2016's dismal 0.4% (figure 3). In addition, the number of carriers with negative earnings before interest, taxes, depreciation, and amortization (EBITDA) dropped to two in 2017 from five in 2016 (figure 4).

Despite the last year's modest upturn, there's no guarantee of a similar increase in cash from operations in the year ahead. In January 2017, thanks to the combined impact of the Hanjin bankruptcy and an early Lunar New Year, rates spiked to around $1,850 per 40-foot container, an indicator of where carriers might sustain rates with some discipline. But such discipline has been lacking because carriers have been challenged to maintain target rate levels on key trades like the European Biofuels Technology Platform and Asia–Europe lanes. By early February 2018, rates were back down to $1,500—almost exactly where they had been prior to the bankruptcy.[7]

[7] http://www.hellenicshippingnews.com/drewry-world-container-index-down-by-0-3/

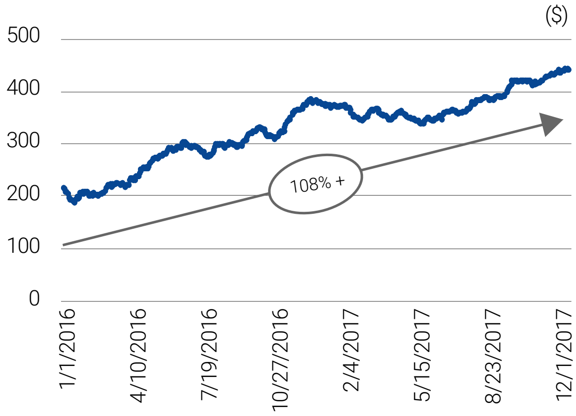
Indeed, rates remain mired at relatively low levels because of the constant threat of overcapacity. The total fleet, now estimated at 20,356,000 TEUs, is conservatively expected to grow this year by 4 to 5%. To be sure, orders for new ships evaporated during the first nine months of 2017, and some deliveries got delayed; Cosco deferred delivery of 10 megaships to 2019, and Yang Ming delayed 3, according to industry analyst Alphaliner.[8] But together, those account for only about 220,000 TEUs, a fraction of the 1.3 million TEUs scheduled for addition to the fleet this year.

The result is that the new capacity—much of it in the form of megavessels—is significantly outpacing scrappage and therefore resulting in industry growth that is "dulling the effects of alliances and industry consolidation," according to Stifel Financial Corp. What's more, since September 2017, carriers have ordered 20 new ships with a combined capacity of 440,000 TEUs.[9]

That activity is reflected in capital expenditures, which jumped by 31% in 2017 after declining for four consecutive years.

Another cause for concern is the 9% rise in the industry's operating expenses in 2017, which ended a four-year decline despite continuing fleet consolidation. A major factor has been a continuing increase in fuel costs, along with environmental regulations requiring ships to burn more-expensive low-sulfur fuel when in range of European and western US coastlines, which combine to offset the savings from more-fuel-efficient ships. Bunker prices at the end of January 2018 averaged $428 per metric ton—more than double the $206 price two years earlier, according to the Bunker Index 380 CST (figure 5).

FIGURE 5: BUNKER PRICES – PRICE $/MT

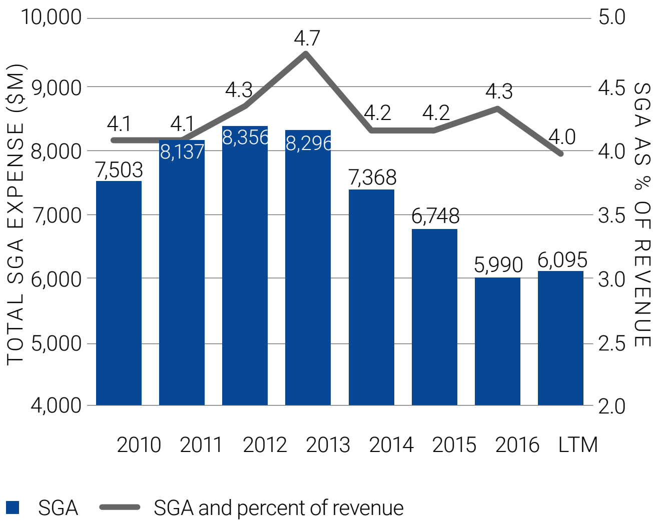


Source: www.bunkerindex.com/prices/bixfree_1801.php?priceindex_id=2

Accordingly, carriers must focus more sharply than ever before on finding every possible means for reducing operating costs. Carriers have sought to continue their capacity management skills through alliances, manipulation of service times, vessel deployment, and the like. They should also focus on maximizing the benefits of scale that should result from consolidation as a path to reduced operating costs. In particular, carriers should leverage their greater buying power with terminals, which now have fewer potential customers. Lower costs and cost-saving concessions (e.g. free time, guaranteed berthing windows, crane guarantees) might now be on the table, whereas they weren't before.

Consolidation has also provided carriers with an opportunity to realize synergies by eliminating duplication in back-office expenses. However, the fact that SG&A expenses have remained stubbornly flat indicates that the anticipated synergies have not yet happened (figure 6). Carriers must become even more aggressive in eradicating redundancies and excess overhead while investing in new technology.

FIGURE 6: SGA EXPENSES AND SGA AS PERCENT OF REVENUE[10]



Source: AlixPartners analysis, CapIQ, company reports

[8] https://theloadstar.co.uk/carriers-start-defer-ulcv-deliveries-face-overcapacity-softer-demand/
[9] https://www.bimco.org/news/market_analysis/2018/20180102_2017-was-year-of-change-in-shipping
[10] Carriers treat SG&A differently so the specific costs by carrier vary widely

IMPLICATIONS FOR THE REST OF 2018

FREIGHT FORWARDERS

Freight forwarders should benefit in 2018 from the volatility that will result from the convergence of two critical trends: continued overcapacity driven by new-vessel deliveries versus the consolidation of capacity control in few hands, which could lead to greater price discipline. The likely volatility should create opportunities for forwards to capture profits.

With industry consolidation, stable alliances, and learnings from the recent Hanjin bankruptcy, forwarders would be well served to have a strong relationship with a least one carrier in each alliance—and with independent carriers—so they can become able to provide their customers with consistent service and business continuity.

SHIPPERS

With carriers enjoying improved revenue and profits in 2017—especially in light of a strong Q3—shippers should expect tougher contract negotiations going into the transpacific contracting season (April to June 2018).

Shippers will have to be knowledgeable about their regional trades so they can know how each market is doing; rate volatility won't happen on a global level but, rather, on a trade-by-trade basis. Just because a shipper's rates for Asia to Europe decreased does not necessarily mean its transpacific rates will drop as well. Given the expected rate volatility in 2018, shippers should give strong consideration to allocating a portion of their business to the spot market rather than committing all business to long-term contracts.

PORTS AND TERMINALS

Carriers' determination to buy more and more large vessels—which will result in even more such ships coming on line in 2018 and 2019—is resulting in a continued trickle-down of larger tonnage calling at all ports. Even secondary ports are feeling pressure to keep pace with infrastructure demand: to provide the necessary water depth, air draft, and LOA capacity. Larger vessels have increased the number of moves per call. Terminals—more than ever before—must demonstrate their ability to turn ever-larger port calls efficiently, or lose customers. Berth productivity and hinterland connectivity are central to that efficiency.

Multiterminal gateways and transshipment ports are making renewed efforts to understand the impact of consolidation and bankruptcy on the terminal footprint resulting from alliances between carriers and terminals. Independent terminals must clearly communicate their value propositions to carriers, or risk losing out in the competition for volumes from a reduced number of potential customers.

Terminals with captive-market or preferred positions can generate healthy returns in the current environment. Total port throughput is increasing, and ensured support from a major alliance in turn ensures a strong revenue outlook.

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

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Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.