BTG Advisory

INDUSTRY UPDATE

Transport Sector: Shipping

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Will consolidation be enough?

BTG Advisory examines the container shipping industry. Too many ships chasing too little cargo. Bottom lines have hit rock bottom and corporate survival is a real danger. Is the solution to build more ships and form bigger alliances?

Sea Sick

The container shipping industry is in deep trouble. This is not exactly a newsflash. Rather it is a regularly occurring phenomenon of containership companies rising from economic depths, then cresting, only to plunge into yet deeper troughs… and then gallantly trying to remerge to profitability. It's been this way for decades with no apparent end to this stomach-churning cycle. What is the solution? The industry response to the challenge was building more and progressively larger mega-containerships. While this sounds less like a cure than a cause, there is a well-established, albeit debatable, logic.

Less than two decades ago, a line-haul container ship was 6,500 TEUs (20-foot equivalent units). These ships were roughly 800ft in length and drew around 35ft of water. The new ultra-large container ships (ULCS) are over 1,100ft in length and when fully laden draw 50ft of water. How ordering larger ships solves the problem of too many ships chasing too little cargo may seem a mystery, but the business of shipping from the very beginning has been based on economies of scale. In essence, the concept is that a larger ship can presumably operate more efficiently than a smaller vessel. The second important element in liner shipping strategy is the notion of market share – the ability to dominate an industry sector or market by creating favourable conditions of pricing and services to establish competitive advantage.

Ideally, with these two concepts working in tandem, a steamship line can leverage its capital assets (i.e. ships) to maximise revenues when global demand rises. In short, command better freight rates, as well as exploiting size for more liftings (freight) than its competitors.

Additionally, maximising revenues in the 'good times' enables a containership operator to not only survive the periodic drops but to pressurise competitors during the down cycles.

However, a problem for all containership operators is the unpredictable nature of the global economy. While global trade and seaborne commerce are increasing at a modest clip (container trades grew by 1.1% in 2015 and the 2016 forecast is only 1.6%) other destabilising political and economic influences have raised unpredictable havoc with seaborne commerce.

For example, consider the impact of the Greek bailouts, which far exceeds their real economic value – a GDP smaller than a borough in New York City. The Russian ban, oil price decline, commodity slump, China slowdown (GDP 2016 forecast of around 6%), US elections, Brazilian presidential crisis, Venezuela's descent to 'failed state' status, the spread of Middle East turmoil and the Brexit are but a few of an unsavoury menu of ongoing issues dampening trade.

Consolidation Strategy

The containership operators have over the past decade dabbled with a number of strategies to stay competitive. Like many industries, cost control measures such as automation ('big data' is now fashionable in industry IT circles), outsourcing and staff reductions have become commonplace. Other cost-saving measures (aside from building more ships) include slow steaming and vessel lay-ups (lay-ups hit one million TEUs end of 2015, the highest since the 2009 financial crash). These measures are deployed as a means to use less fuel (and more time) to pull 'supply' out of the equation to increase demand and ultimately increase freight rates.

While these may be short-term strategies, they have failed to alter the fundamentals of supply and demand. The new generation of mega-containerships is being built to be 'slow steaming' energy-efficient ships and already many less efficient classes of containerships have been pulled out of service or found their way to the ship-breakers.

The only other survival strategy for containership operators is potentially restoring supply and demand through industry-wide consolidation and disciplined capacity management, which will no doubt bump into regulatory scrutiny.

Consolidation through merger and acquisition (M&A) or alliances is a complex affair with no guarantees that the participants will be any better off at the end of the day. But for well or ill the gambit of consolidation of the containership operating industry is now well underway.

Back in December 2014, Chile's Compañía Sud Americana de Vapores (CSAV) merged its entire container business with Germany's Hapag-Lloyd, kicking off the present round of consolidations. Motivation? Possibly because Hamburg's Hapag-Lloyd and Bremen's Hamburg Sud are better suited as rivals than partners, or perhaps because establishing market share in South America was critical to the corporate strategy, or even that the company needed 'weight' to compete with other ultra-carriers like Maersk, MSC or CMA CGM, was behind the decision. Finally, bringing a company public as a big operator is always preferable to the alternative.

Almost exactly a year later, Paris-based containership operator CMA CGM announced it would acquire the Singapore-government owned APL for $2.4bn. Barely two months later, China's two biggest shipping lines – COSCO and China Shipping – combined to form one of the world's biggest fleets, China COSCO Shipping Corp.

Not surprisingly, the underlying theme for the first round of liner shipping M&A is underperformance. Debt for the containership operators in 2015 is estimated to be in the region of $100bn (down some from the estimated peak of nearly $114bn in 2013). Simply put, the main motivation for M&A is financial survival while the secondary feature is 'scale' or 'market share' on specific trade routes.

"Matchmaker, matchmaker, make me a match"

As the second wave of liner shipping consolidation gets underway, the intricacies of matchmaking come to the fore. One of the long rumoured hook-ups is reportedly close to fruition. Hapag-Lloyd, whose quest for scale is well known – to enable it to be a player with weight similar to the big three of Maersk, MSC and CMA CGM – is said to be close to an agreement with UASC (United Arab Shipping Corporation), the 18th largest containership operator. The deal is rumoured to give the UASC owners a 28% stake in Hapag-Lloyd. The combination of Hapag-Lloyd's 920,000 TEUs and UASC 550,000 would make the new entity the fifth largest containership operator behind the newly minted merger of China's two carriers COSCO and China Ship (see opposite).

Top 5 Containership Operators

Rank	Operator	Ships	Total: TEU
1	APM-Maersk	601	3,027,556
2	Mediterranean Shg Co	487	2,670,877
3	CMA CGM Group	452	1,816,141
4	COSCO (includes China Ship)	282	1,522,461
5	Evergreen Line	187	930,514

Source: Alphaliner

It makes sense for Hapag-Lloyd, whose largest linehaul ships are 13,000 TEU, whereas UASC has six 18,800 TEU mega-boxships and another seven 15,000 TEU vessels. The bottom line is the addition of the UASC ships that automatically vaults Hapag-Lloyd into the mega-ship ranks.

There is plenty of distress still out there to encourage more M&A activity should the pairings be compatible with not only the commercial but the political interests (as witnessed by Beijing's orchestration of the COSCO-China Ship) as well.

Both the Korean ship operators Hanjin and Hyundai are in deep difficulties. Recently both were able to negotiate with the charterers owning a significant portion of their respective box fleets (the ships are leased from owners). Hyundai has been trying for nearly two years to escape spiralling costs and lower revenue. Like Hyundai before it, Hanjin plans to sell its bulk-shipping interests and other units as well as some property.

The recent sale of bulk shipping assets would in another time period be attractive to outside buyers but with bulk shipping in the same boat (the commodity collapse) as container operations, the return isn't that respectable to creditors.

Would Seoul like to see the ship owning interests merged similar to those in neighbouring China? Perhaps, but two underperforming lines doesn't necessarily add up to one that will be any better a performer.

Realigning Alliances

The other aspect of consolidation is the impact that merged operations have on container carrier alliances. These alliances between ocean carriers define the types of schedules and services on important trade routes, especially Asia-Europe and Asia-North America. In essence, they set up the competition between carriers for a shippers' freight. The largest alliance, by virtue of the carriers being number 1 and number 1A, is the Maersk-MSC alliance (2M). All the other alliances are trying to assemble enough ships (particularly mega-ships of over 15,000 TEUs) to keep up.

The Alliance

On May 13th 2016, six of the top fifteen containership operators, Mitsui OSK Lines (MOL), Nippon Yusen Kaisha (NYK), K Line, Hanjin, Hapag-Lloyd and Yang Ming announced they were forming a new partnership, simply called 'The Alliance'.

The Alliance, scheduled to start in April 2017 pending approvals and according to the announcement made by the individual parties, under the agreement will cover all East-West trade lanes – namely Asia-Europe / Mediterranean, Asia-North American West Coast, Asia-North American East Coast, Transatlantic and Asia-Middle East / Persian Gulf / Red Sea.

The initial term of the cooperation under the agreement's umbrella will be five years.

Overall the new agreement will bring competitive heft combining with a fleet of over 620 vessels totalling approximately 3.5m TEU or 18% share of the global container fleet capacity.

The group could get larger in the near future, as discussions between Hapag-Lloyd and UASC are ongoing, although no formal agreement on a merger has been reached and will be subject to regulatory approvals. When (and if) the merger is consummated it is anticipated that UASC will become part of The Alliance, which will increase the overall alliance capacity to more than 4m TEU.

What happens when alliance partners merge from separate alliance camps? The potential route changes because of alliance shifts can be devastating to individual ports and terminals, not to mention the carriers themselves.

In the case of UASC, the Arab carrier could have been pushed into the waiting arms of Hapag-Lloyd, when it was left out of the new larger Ocean Alliance composed of CMA CGM, COSCO, Evergreen and OOCL, from the predecessor Ocean Three agreement made up of UASC, CMA CGM and ex-China Ship. The Ocean Alliance is scheduled to become effective by April 2017 for an initial five-year period.

The original G6 alliance – Hapag-Lloyd, OOCL, MOL, NYK, Hyundai, APL (now merged with CMA-CGM) – has been decimated by the changes and could effectively be defunct in a short time.

Other alliances are finding their way – for now. The CKYHE Alliance, (COSCO, K Line, Yang Ming, Hanjin and Evergreen Line) is reorganising their service network for Asia-US East Coast trade in 2016 and are for now committed to the present arrangements on the related East and West Trade routes until the end of March 2017.

But all could change so rapidly. Hapag-Lloyd and UASC are close (and UASC has a working relationship with Hamburg Sud), Hanjin and Hyundai are possible; the Japanese carriers K Line, Mitsui OSK Lines and NYK could with Tokyo's help work as one (it has happened before) as could Yang Ming and Evergreen and maybe OOCL – where could it all end in a year or two? Consolidation. But what of the nagging question, of too many ships and too few cargos?

For Further Information

If you would like to discuss any of the issues raised in this update or would like to know further details about the services we provide to the sector, please contact me.

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