AlixPartners

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# 2021 CONTAINER SHIPPING OUTLOOK

## Carriers have a chance to break the cycle. Will they take it?

For at least three decades, the container shipping industry has been locked in a recurring boom-and-bust loop. During times of strong macroeconomic growth, shipping rates would soar and container ship operators would reinvest their profits in new, ever-larger vessels. Then the economy would slide into a downturn, demand would plunge, rates would tumble, and operators would find themselves burdened with heavy debt and idle vessels. As overcapacity kept a tight lid on rates, leverage would expand, revenues would fall, and ship operators would tumble into bankruptcy—or stay out of court, thanks only to amend-and-extend agreements with their creditors.

## Today, however, the fundamentals that would support a breakaway from that cycle are in place.

The industry is enjoying a boom phase, with global container freight rate indexes topping $5,000 per 40-foot container in February 2021 after climbing steeply and steadily since May 2020.[1] And this time, with a few notable exceptions, carriers aren't flooding the world's shipyards with orders—yet. Instead, carriers have to date successfully managed capacity, keeping rates stable even as demand slipped by 5% during the first nine months of 2020 while overall capacity increased by just 2%. Meanwhile, idle capacity, which rose to 11% in May 2020, retreated to 3% by the third quarter of the year because the industry increased blank sailings and suspended service on some routes. Carriers also cut sailing speeds, which fell 1.8% in 2020.

Merger-and-acquisition activity continues apace, furthering the industry's consolidation: seven global carriers now each control at least a 5% share of the market, and three alliances have helped increase pricing leverage. Fuel costs remain low despite strict new regulations aimed at reducing sulfur emissions as a prelude to additional measures intended to decarbonize the industry. One effect of those new regulations has been to limit capacity growth.

A sustainable departure from boom-and-bust, however, requires carriers to exercise discipline over their pricing and order books, as rates make their eventual and inevitable regression toward the mean—discipline that carriers historically have been quick to abandon when profits were climbing. In a sign that such discipline may already be fraying, a number of carriers recently placed large orders for new vessels—but further additions to fleet capacity could severely dilute any pricing power that carriers have been able to establish.

1. Drewry World Container Index

# HISTORY REPEATING

The container shipping industry has long followed a distinct pattern. Consider the industry's actions during the recession years of 2001 to 2003 and the subsequent economic recovery. A recession brought on by the bursting of the first dot-com bubble led to a sudden drop-off in demand, followed by a lengthy spell of low shipping rates. Ships ordered when times were good—starting in 1999 and through the early months of 2001, before the bubble burst—were delivered just as demand and rates were starting to fall off the table. The new builds drove up vessel overcapacity, which got further aggravated because shippers kept their inventories low relative to sales. The industry had become highly fragmented, with no alliances of liner operators forming to boost supply-side pricing power. Fuel prices were low but offered only limited relief to carriers, whose greater problems were the familiar ones of too much capacity and too little demand.

**HISTORY REPEATED ITSELF IN SOME RESPECTS IN THE PERIOD FROM 2009 TO 2015.**

In 2009, after several years of rising rates, profits, and capacity, the Great Recession struck and demand cratered. Rates plunged by more than 50% in 2009 and then, following a brief rebound, dropped again by 50% when a recovery failed to take hold in 2010. Although operators idled 10% of their fleets and reduced sailing speeds, those moves came too late to counter the record-setting capacity buildup of 2004 to 2008. Several lines went under or got acquired in the aftermath—part of a consolidation wave launched in 2013 that left the top four carriers in control of 46% of global 20-foot-equivalent units (TEUs) and in the longer term, offered the promise of greater capacity control.

Despite signs that a different dynamic now prevails across the industry, carriers could cast aside pricing and capacity discipline at any time they believe doing so would serve their interests. It has happened before. In 2014, for example, the industry appeared on the verge of entering a period of sustained capacity control and consolidation, but after a few carriers opted to place orders for new vessels, the rest of the industry soon followed suit, perpetuating the boom-and-bust cycle.

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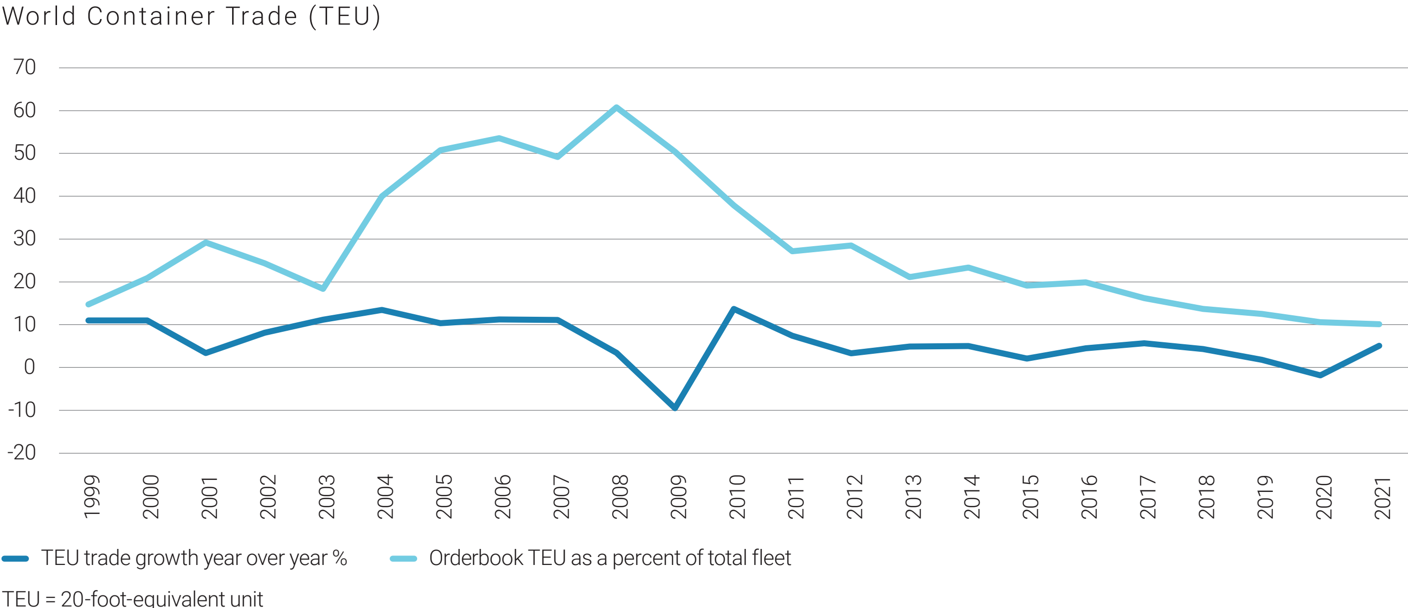
# WILL CARRIERS SEIZE THE OPPORTUNITY?

For the moment, most carriers are exercising restraint in the face of improving market fundamentals. Some of the most-compelling evidence of a change in the industry dynamic can be found in the latest data on shipping capacity: whereas in the past, demand shocks hit just as orders for new vessels were increasing or already at elevated levels, in the latest cycle a sudden drop in demand occurred while both capacity *and* orders for new vessels were relatively low (figure 1).

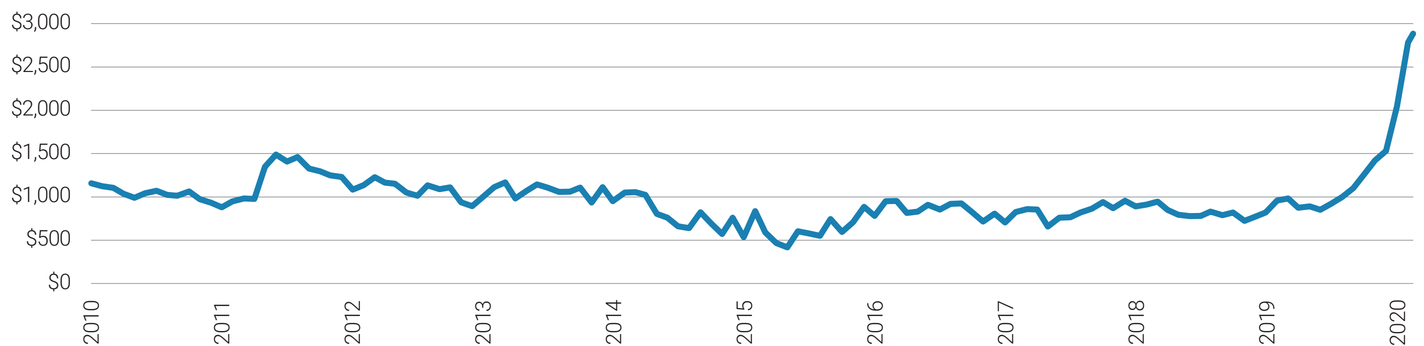
**FIGURE 1: CAPACITY IS UNDER CONTROL—FOR A CHANGE**



Unlike during previous demand disruptions, rates have held up, although current levels are certainly unsustainable. Rates dropped significantly during the 2001 to 2003 recession before rebounding steadily during the recovery. The period following the Great Recession was marked by chronically low rates, interrupted only by two, relatively shallow, spikes. The current cycle is marked by a strong increase that began in the first quarter of 2020 and has continued into the first quarter after 2021 (figure 2).

**FIGURE 2: RATES INCREASED SHARPLY AS 2020 UNFOLDED**

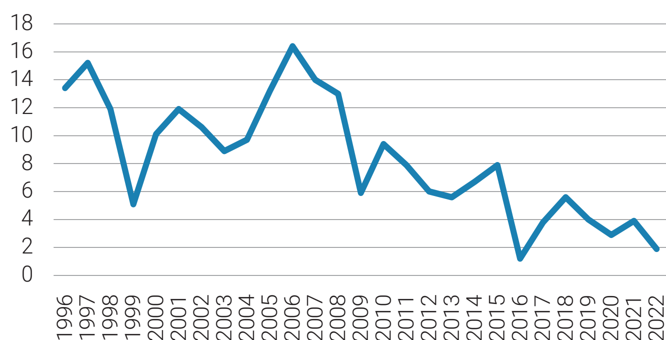
Shanghai Shipping Exchange: Shanghai (export) Containerized Freight Index (SCFI)



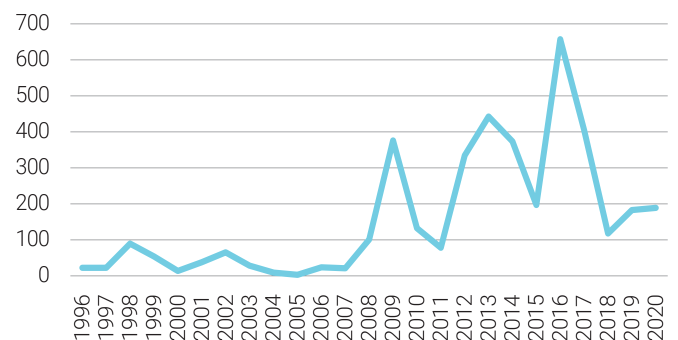

Restrained growth in vessel supply goes a long way toward explaining the favorable rate environment. In previous cycles, the industry was aggressively adding to capacity when demand dried up, thereby creating a supply glut that took years to work off. In the current cycle, by contrast, the industry was slashing capacity when the COVID-19 global pandemic slammed the brakes on the world economy, having initiated a period of intensive ship demolitions in 2009 that persisted through 2018 (figure 3).

**FIGURE 3: GROWTH IN TEU CAPACITY HAS TURNED NEGATIVE**

Fleet Growth: YoY change in TEU capacity (%)




Vessel scrapping: Demolitions in TEU capacity (000s)




TEU = 20-foot-equivalent unit, YoY = year over year

**SUPPLY**

- Growth in TEUs has dropped to record lows
- Both of the historical downturns in rates were proceeded by periods of high TEU growth, leading to a glut of supply just as demand dropped
- In 2009 to 2015, demolitions increased to try to take supply out of the market, and the effort was completed by 2018

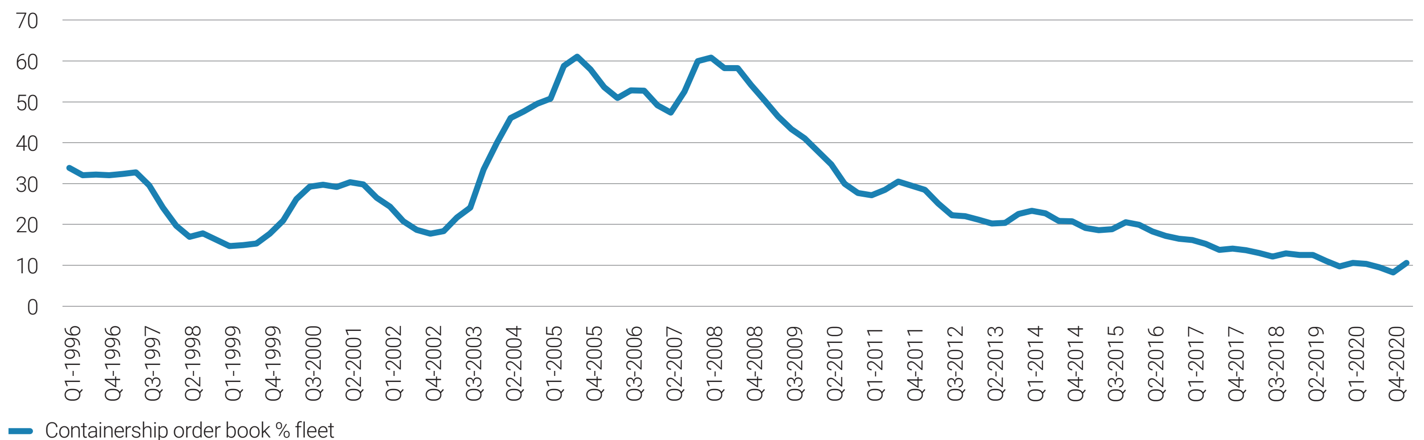
### AT PRESENT, ORDERS FOR NEW VESSELS STAND AT HISTORICAL LOWS (FIGURE 4).

Although, as noted, several carriers placed large orders for new vessels recently, it will take several years to replace the tonnage that was demolished. Capacity management has improved because carriers have increased blank sailings, reduced sailing speeds, and suspended service on some routes.

**SUPPLY**

- The order book as a percentage of the global fleet is currently at historical lows
- Even with the recent uptick, it will take time to build in the medium term
- Leading up to the over supply period of 2009 to 2015 there were record-setting orders
- Leading up to 2001 to 2003, orders were up significantly compared with previous years

**FIGURE 4: CARRIERS ARE SHUNNING THE SHIPYARDS**




Inventory-to-sales ratios, meanwhile, have fallen to below-average levels after ballooning when economic activity plunged at the outset of the pandemic. Typically, sharp drops in the inventory-to-sales ratio signal that a restocking phase is imminent, lifting demand for shipping services. In the current case, recent container ship activity at US ports suggests the restocking is already under way. US imports from Asia in December 2020 were up 30% from their year-earlier level, to a record 1.6 million TEU, according to IHS Markit. The volume of imports was headed for continued growth in the early months of 2021, as retailers ship more goods ahead of the Chinese Lunar New Year. Favorable conditions for global carriers could persist over the longer term as well if, as many forecasters predict, a strong, demand-driven recovery materializes as more and more of the population gets vaccinated and the pandemic fades.

**TWO CAUTIONARY THOUGHTS, HOWEVER:**

US consumers with disposable incomes shifted much of their spending to goods from services in 2020. Typically, US consumers spend about 33% of their disposable incomes on services and 67% on goods, according to *FreightWaves*[2]; in 2020, the split was closer to 40% goods and 60% services. As more and more people get vaccinated and more and more service establishments reopen, consumer spending could swing back to services, eventually depressing container demand.

Moreover, carriers will have to address their recent, abysmal reliability record. Global container vessel reliability slid to a record-low 35% in January 2021—a staggering 34% below the year-earlier reading, accordinto IHS Markit. Although late deliveries are attributable in part to port delays brought on by pandemic-related labor shortages, carriers bear ultimate responsibility for container shortages and overdue deliveries.

Carriers that charge record rates fall down on customer service risk, thereby doing themselves long-term damage after the market returns to something like equilibrium.

# IN THE SWEET SPOT

Before the outbreak of the COVID-19 pandemic in the first quarter of 2020, fuel costs and new International Maritime Organization (IMO) regulations that mandate drastically lower sulfur emissions made by far the biggest story in the container shipping industry. But those costs and regulations have become more of an afterthought. Contrary to predictions that fuel prices would soar in the wake of the implementation of IMO 2020, as the new regulations are known, fuel prices have remained low after bouncing off the bottom they hit shortly after the pandemic struck. During the recession of 2001 to 2003, for comparison, low fuel prices prevailed throughout the downturn, whereas the recessionary and postrecessionary period from 2010 through 2015 was notable for high fuel costs that carriers were unable to recover entirely. Taken together, the data across the three recessionary periods since 2001 suggest strongly that although carriers are able—within limits—to pass along higher fuel costs to shippers, fuel prices have little correlation with rates, which react more immediately to other drivers—in particular, demand and capacity.

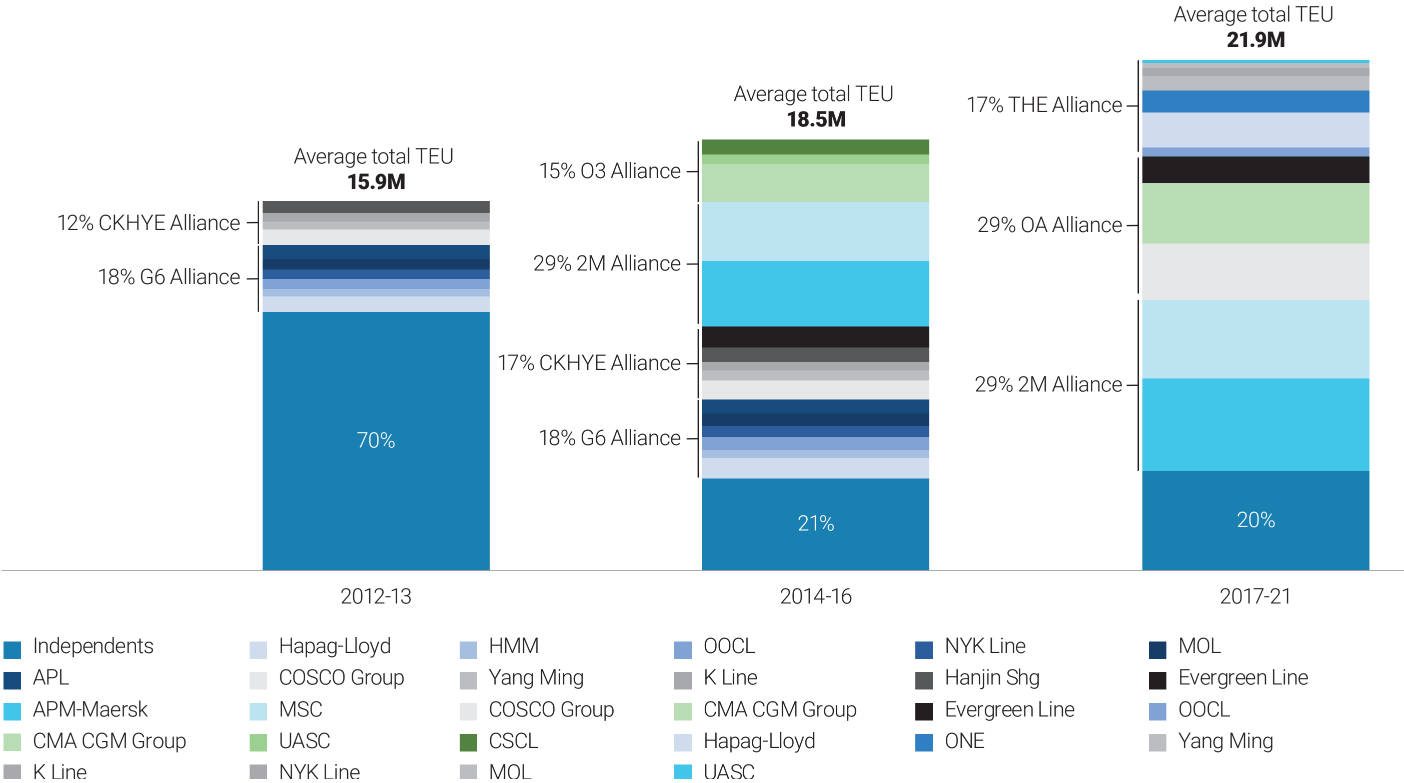
Nonetheless, IMO 2020—together with the broader drive to slash the global container shipping fleet's carbon dioxide emissions—has reinforced the industry's efforts to control capacity. With more-stringent fuel and emissions regulations possibly in the offing, shipowners are hesitant to commit to acquiring additional assets. They don't want to risk buying either obsolescent vessels unsuited to burning low-sulfur fuel or, on the other hand, vessels that are cleaner—and thus more costly—than regulations require. Until the regulatory picture clarifies, many carriers will likely slow their ships to reduce emissions, which effectively further limits capacity.

A final and perhaps decisive factor in the capacity-control equation is the industry's continued consolidation (figure 5).

2. Andrew Cox, "Consumer Economy to Be 'A Tale of Two Halves.'" *FreightWaves*, January 8, 2021; https://www.freightwaves.com/news/consumer-economy-to-be-a-tale-of-two-halves.

Since 2016, Hanjin Shipping has filed for bankruptcy and undergone liquidation, and some of the stronger carriers have made opportunistic acquisitions that today leave the top four lines in control of 58% of TEU capacity. Leading carriers have joined forces in three alliances in the forms of the 2M Alliance, the Ocean Alliance, and THE Alliance, further concentrating the market and facilitating continued pricing and order-book discipline. The biggest risk the alliances now face involves becoming victims of their own success: should their leverage over the issue of pricing become too strong, regulators might take notice and investigate whether they are stifling competition.

**FIGURE 5: MARKET SHARE BY ALLIANCE**



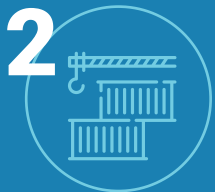

Long the sick man of the transportation ecosystem, the container shipping industry stands on the brink of a new era of sustainable profitability. But just as a lot of things had to break exactly right for container shipping to arrive at its current advantageous situation, so a lot of things have to break right for container ship operators before they can step off the boom-and-bust treadmill. Much of what has to break right is within carriers' control. For instance, it is within their power to balance capacity against demand, hold the line on pricing, and opportunistically pursue industry consolidation through mergers, acquisitions, and liquidations. If they can manage to execute along those dimensions—and that's a very big if—they'll have an opportunity to reshape container shipping into an industry built to withstand all manner of demand shocks—whatever their origin and duration.

## NEXT STEPS

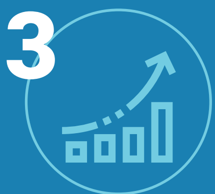
The reshaping of the container shipping market that began in 2020 and continues in 2021 bears implications for every industry stakeholder, as follows.

**CARRIERS** will be challenged to maintain their newfound discipline and hold the line on rates, to refrain from ordering new vessels, and to firm up their balance sheets so as to move quickly when and if acquisition opportunities arise. But they should be alert to any preemptive moves by rivals to acquire new vessels.

In addition, in recent months, on-time reliability has emerged as a key topic for shippers, which points to an opportunity for carriers to differentiate themselves. As noted, the industry has struggled to fulfill shipping schedules during the pandemic—in part because of container shortages and congestions at major port facilities. But shippers have long memories, and carriers that can offer shippers greater reliability and better overall service can create valuable, enduring relationships with shippers and forwarders.



**FORWARDERS,** enjoying a run of strong profitability, have a chance to form new long-term relationships with shippers by strengthening their value propositions—for example, by committing their own capital in the form of warehouse space to help shippers ride out market dislocations caused by limited port operations.



**SHIPPERS** have to adapt to a new normal of shipping rates that are higher than those that have prevailed through most of this century—though not as high as they stand today. Successful adaptation requires shippers to actively deal with the key drivers of transportation costs: urgency, dimensions, lead time, and distance, as detailed in the linked article. By improving container use, by extending delivery times to some customers, by stretching lead times for carrier bookings, and by reducing shipping distances, shippers can mitigate the effects of stratospheric freight costs.

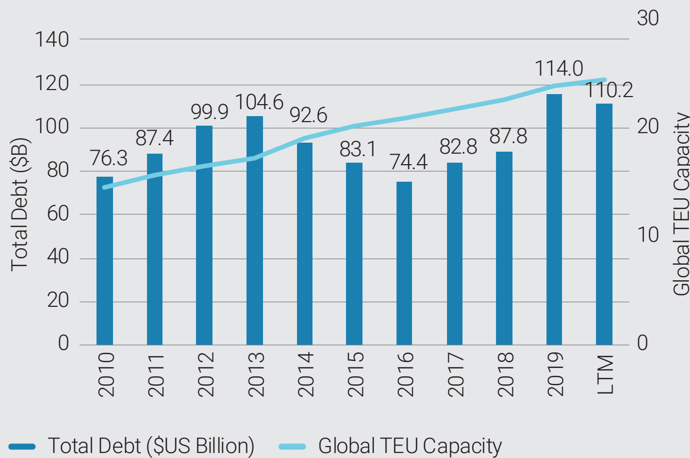
**INVESTORS,** including private-equity sponsors, have an opportunity to ride the container shipping industry's rising tide, which is lifting virtually every player in the container shipping ecosystem—except shippers. Investors should be mindful, though, that competition for the industry's profit pool will likely strengthen, and they should avoid overpaying for what are, ultimately, highly contingent earnings streams.

# APPENDIX: FINANCIAL STATS

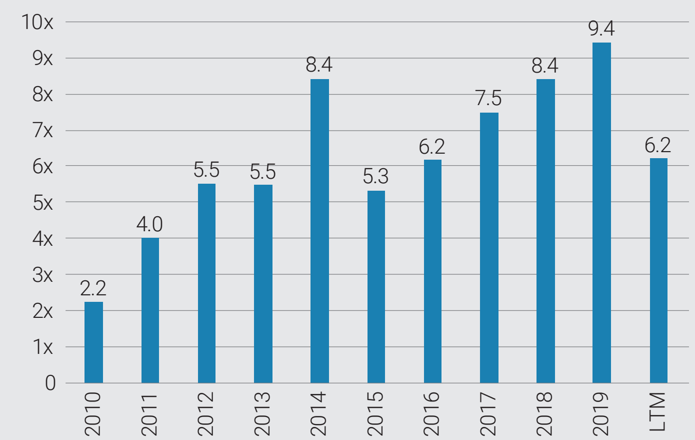
Because of the lack of information on Q4, when rates increased, the Last Twelve Months (LTM) information may have diminished predictive value.

Shipping lines have used their earnings from Q4 to buy back debt. While some new orders have been placed as well, the orderbook remains historically low.

## TOTAL DEBT VS. GLOBAL CELLULAR FLEET CAPACITY

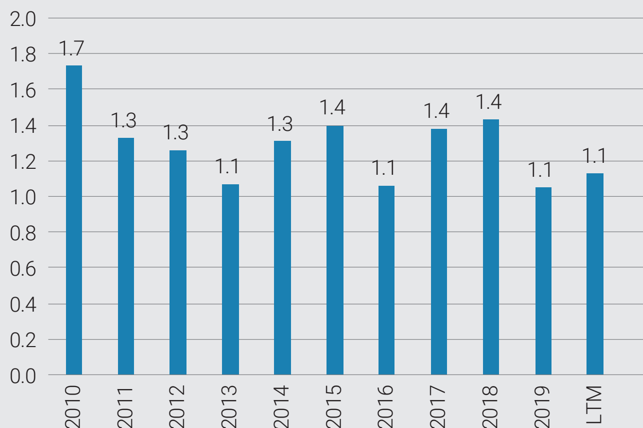



## LEVERAGE

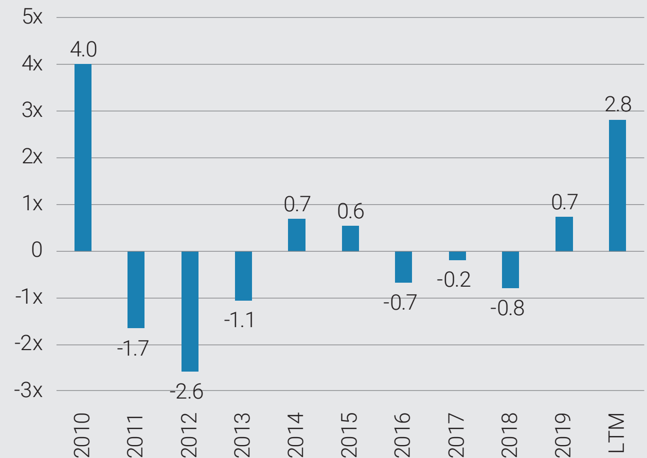



Altman Z-scores remain unchanged from last year, though 4 results are missing

## AVERAGE ALTMAN Z-SCORE




## INTEREST COVERAGE



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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.


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