Despite persistent volume growth, in recent years many lines have seen poor financial performance. Underlying adverse market conditions have been the imbalance between supply and demand, causing major fluctuations in freight rates. Increasing orders for ultra-large vessels, now in the region of 20,000 TEU, have generated overcapacity, driving rates down further. The combined effect of overcapacity, depressed rates and container flow imbalances has been to reduce profits significantly – down 15% in the last five years for the top 20 carriers. This figure would be worse were it not for the inclusion of those lines which have countered this trend and outperformed competitors.

**Liner Performance**

Strong financial performance has largely been limited to the world’s biggest lines, most notably Maersk Line and CMA CGM; MSC’s performance is difficult to judge accurately due to its private nature, although its plans to expand capacity substantially suggest that it too has strong underlying finances. By contrast, smaller operators in general have persistently struggled in recent years.

This divergence raises the question of why bigger lines are outperforming their smaller competitors. This in turn leads to the question of what the future holds for the industry, how market conditions will change and how all lines, regardless of size, will have to adapt.

Firstly, it is worth examining the market pressures which the industry has faced recently. These have been varied, and lines’ responses diverse.

**Post-Recession Blues**

Central to low profits has been the patchy recovery in international trade following the global financial crisis, allied with a concerted cost-cutting campaign by customers. Even as recovery set in, albeit erratically, many in the sector struggled to bounce back from the crisis and suffered record losses in 2009, and then again in 2011. Against this backdrop, the steady decline, harming profitability. Many predict that low rates will become an established fact of doing business in the container industry. In addition, there is evidence that some customers doubt whether significant savings will permit operators to maintain an adequate level of service.

Amongst the large carriers who have defied the adverse conditions, Maersk Line stands out. Since suffering huge losses in 2011 it has enacted a significant turnaround. Its annual profit in 2014 was US$2.3 billion, up from $1.5 billion in 2013.

In addition, the two other largest operators have continued to expand. CMA CGM recorded strong growth in 2014 – its third quarter net income of $200 million, more than tripling the equivalent figure for 2013. Following this strong performance, it has just confirmed that it has ordered three ships with a capacity of 20,600 TEU. Similarly, MSC is increasing capacity and once all of the vessels it has on order are delivered, it will operate 20 ships with a capacity of 20,000 TEU. It is in this respect that the larger lines have pulled away from the smaller operators, especially Maersk Line. Since 2011 it has undergone significant restructuring, with increased emphasis on cost and efficiency savings. Numerous costly projects have been dropped and the company’s focus has shifted to creating more integrated planning and operating systems.

Analysts Sealintel have said that Maersk Line’s efficiency programmes have helped it grow even in the face of falling rates, and that this has set it apart from its peers. Dropping unit costs demonstrate the programme’s success: they are down from $3,108 per TEU in 2011 to $2,731 in 2013, then dropping again to $2,630 in 2014.

Beyond Maersk Line, efficiency and cost-cutting has been seen across all of the largest operators. This has started to show results, such as the improved 2014 figures announced by Hanjin Shipping and APL. So far though, no efficiency drive can match Maersk Line’s – Sealintel predicts that if the other lines followed its lead more closely then they could save a combined $6.8 billion annually.

**Alliances**

The cost-saving ethos has also been central to the major line strategy of forming alliances. By optimising slot costs and extending operators’ geographical reach, the ‘mega-alliances’ – 2M, G6, CKYHE and Ocean Three – should further strengthen their members’ positions. Maersk Line hopes to save around $350 million annually through its 2M alliance with MSC.

**The Future**

Despite recent efficiency-driven growth, cost-savings alone will not sustain long-term profits. The easier cutbacks have already been made. Moreover, overcapacity is expected to worsen and freight rates could continue to decline, harming profitability. Many predict that low rates will become an established fact of doing business in the container industry. In addition, there is evidence that some customers doubt whether significant savings will permit operators to maintain an adequate level of service.

One of the most widely cited strategies has been innovation in management practices, going beyond simple efficiency and consolidation drives. For consultants McKinsey, a major challenge is altering the “deeply conservative” business attitudes in the sector. This means tackling poorly managed systems based on “outmoded” principles such as pricing strategies, network and route design, fleet management and revenue management. McKinsey estimates that this could improve earnings by 10-20%.

Whilst operators of large vessels benefit from economies of scale, cutting voyage costs by up to 30%, they encounter particular challenges. For a start, ports have to possess the capacity to handle ultra-large
vessels, otherwise congestion and delays will wipe out the advantages of size. Doubts have also been raised by Martin Stopford, former director of Clarksons. He has questioned the commercial wisdom of strategies based on ultra-large vessels, arguing that they do not offer flexibility for operators. They reduce the ability to offer differentiated services, locking lines into operating fleets at rock-bottom costs, with rigid port rotations and a reduced ability to react swiftly to sudden market changes.

CONCLUSION
The argument that large vessels and efficiency savings reduce customer choice has been reinforced by Kuehne + Nagel. At the TPM conference in March 2015, Chairman Karl Gernandt said that this approach reduces the quality of the services offered and that many customers are willing to pay a premium for a better service. At the same conference, however, Maersk Line confirmed that it had dropped its premium service, Daily Maersk, due to weak demand. Although some customers are willing to pay higher prices for better services, it appears that this sentiment is not shared widely in the market.

Additionally, and again despite warnings that efficiency savings alone cannot deliver robust growth, cost-reduction will remain a key part of most lines’ strategies. The question is whether operators will follow the advice to integrate cost-cutting into wider-ranging corporate restructuring initiatives. In another indication of how the sector might develop, the consultancy BCG has made similar proposals respecting the ‘mega-alliances’, which it says could run along more sophisticated lines. Significant savings could be made through consolidation — including joint procurement, operations, and IT — which would not detrimentally impact the quality of service provided.

In the short-term, many large operators are bullish about their prospects despite falling rates. Maersk Line has said that it can build on its 2014 results and increase profits through the 2M alliance. But how operators perform in the long-term when faced with turbulent conditions remains to be seen and will depend largely on how they address the challenges of an evolving sector.

ABOUT THE AUTHOR
Matthew is a Partner who focuses on transactional corporate and commercial law with a particular emphasis on ports, transport and the logistics sector. He has experience of a wide range of high value international corporate and commercial transactions. His high profile international port and terminal project experience includes port development, privatisation, restructuring, concessions, as well as management and operation. He works with global and international terminal operators, UK ports and stevedores, and international government bodies. His previous industry experience with Maersk Line and Nedlloyd Lines in a variety of commercial and operational roles in the UK and Denmark gives him a firsthand understanding of the ports, liner shipping and logistics industries.

ABOUT THE ORGANISATION
Holman Fenwick Willan (HFW) is a global law firm advising on all aspects of international commerce. With over 475 lawyers operating in 16 offices across 14 countries spanning Asia, Australia, Europe, the Middle East, and South America, we provide a global and seamless service 24 hours a day. HFW has worked on over 100 port projects internationally and our experience has been gained not only from our involvement with the world’s leading port operators and users, but also through the employment of lawyers and industry experts from terminal operating companies and shipping lines. We have one of the largest groups of transactional and dispute resolution lawyers specialising in legal matters relating to the development and operation of national and international ports and terminals.

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STATE OF THE CONTAINER MARKET 2016

It comes as no surprise that there remains significant oversupply in the container shipping sector. This, combined with a weak global economy and consequential lack of demand, inevitably means that freight rates remain at very low levels. Even the collapse of Hanjin, the world’s seventh largest carrier, failed to make a significant sustainable impact on rates, which initially increased before stabilising at lower than hoped-for levels due to the sheer level of overcapacity. It is not all gloom however, a glimmer of hope for the industry as a whole is on the horizon in the form of higher levels of scrapping and increased market consolidation.

LINER PERFORMANCE
While in recent years, strong financial performance has been largely limited to the world’s biggest carriers, this year it is hard to even say that. Maersk Line, often considered the benchmark for the industry, produced a second quarter loss of $151m through low freight rates compared with a $507m profit a year earlier. The other major carriers have had similar misfortune and some analysts have even predicted further potential casualties in the year ahead.

IDLE FLEET
The problem of oversupply is reflected by the size of the current idle fleet. In July 2015, this stood at 127 vessels (345,916 TEU). It now stands at 371 vessels (1.33 million TEU) as of October 2016. With the state of the market in such dire condition it is hardly unsurprising that a new record was set with the scrapping of the youngest ever containership, the 4,923 teu YM Los Angeles, that was delivered less than ten years ago.

OIL PRICES
In addition to low freight rates, rising oil prices have affected revenue. In 2015, struggling carriers were helped by falling oil prices, which together with the typical time lag in the bunker adjustment factor or "BAF", resulted in delays in passing on lower bunker prices to customers and improved revenues for carriers. Now the reverse is true. Rising oil prices (by over 75% since February 2016) and BAF time lags means that carriers are currently paying more for fuel than they are receiving from their customers. According to Sealntel, the rising cost of bunkers is set to lead to a $1.5bn negative cash effect for carriers in the second and third quarters of this year.

SCRAPPING
In August 2016, the global containership fleet shrank by a mere one TEU. While by no means a monumental figure, it draws attention to how increasing levels of ship scrappage is helping ease supply growth. Indeed, the average age of scrapped vessels fell from 20.2 years at the beginning of 2016 to 16 years at the beginning of July. This year, 507,000 TEU has been scrapped up to October, compared to 185,000 TEU in the whole of 2015. Whether this continues at a high enough rate to counteract deliveries (1,404,724 TEU is on order for delivery in 2017 alone) remains to be seen.

MARKET CONSOLIDATION
Recent market consolidation may be another step towards easing the issue of oversupply. With the acquisition of APL by CMA CGM, the acquisition of UASC by Hapag-Lloyd and the merger of China Shipping Container Lines and COSCO, the top six carriers now control approximately 55% of the container shipping fleet. The latest announcement of a joint venture between the container shipping interest of the Japanese carriers, NYK, MOL and K-Line is bound to add further pressure on the remaining mid-sized global carriers such as Hamburg Sud, Hyundai Merchant Marine (HMM), Yang Ming and OOCL. In the long run, increased industry concentration should lead to fewer choices for customers and higher rates. Moves towards this direction have already begun as some of the larger carriers have announced gaps in some of their schedules and by the end of the year overall supply is expected to be down approximately 4.4% against last year.

Further co-operation can be expected in the coming months, with a move from 4 to 3 main shipping alliances coming into effect from the first quarter of 2017 onwards, as the CKYHE alliance becomes sidelined. K Line and Yang Ming strengthen what was the G6, now called “The Alliance”; HMM will join the 2M Alliance; and OOCL and Evergreen join the Ocean Three Alliance (now called the “Ocean Alliance”), amongst other moves. This consolidation means that carriers who want to serve the major East / West routes will likely need to join an alliance or else become marginalised and rely on regional specialisms to survive.

CONCLUSION
It will take time to see whether recent market consolidation has done enough to ease the issue of oversupply although the latest development between Japanese carriers has thrown up suggestions of whether similar moves could take place in Taiwan between Evergreen and Yang Ming. News of South Korean government support for financing newbuildings, up to US$5.67 billion, for its shipbuilding industry, isn’t likely to help the oversupply situation. Shipping consultancy Drewry indicates that 2016 has been the "trough of the container shipping market" and things will slowly start to improve, predicting a potentially optimistic collective operating profit of $2.5bn for 2017.