Container Shipping
Outlook 2016

Overcapacity Catches Industry in Undertow
At a Glance

The already beleaguered state of the containerized ocean freight industry will likely worsen in 2016. The gap continues to grow between expanding fleets that are adding ultralarge vessels and languishing demand, which is hitting the industry’s financial results hard. In the third quarter of 2015, revenue decreased 16% compared with the same period in 2014, and earnings before interest, taxes, depreciation, and amortization (EBITDA) declined 35%—more than twice the rate of decrease in revenue. This was disastrous. Margins continue to shrink, driving the imperative of lower costs by a shift to larger vessels. And the advent of that new capacity in major trade lanes continues to distort the supply-and-demand balance globally.

Recent multibillion-dollar mergers such as Hapag-Lloyd’s acquisition of CSAV, CMA CGM’s purchase of Neptune Orient Lines, and the government-engineered combination of China Shipping Container Lines and COSCO are signposts for an industry that’s reshaping itself. As the integration of major carriers grows more complex, the stakes of each transaction become higher. High debt levels may already limit initial opportunities and certainly add to the pressure to rapidly realize synergies through effective postmerger integration.

Further consolidations and financial overhauls will be necessary to achieve the stability that traditional cost-cutting initiatives have failed to provide individual companies. Factor in certain recent, steady declines in that peak preholiday shipping quarter, which is traditionally the make-or-break period for the calendar year, and the emergence of a new normal in container shipping is clear.
The containerized-ocean-freight industry suffered in 2015. Its continuing financial woes accelerated because nearly all key financial indicators declined from 2014. At the heart of the industry’s problems, a persistent global supply-and-demand imbalance is to blame. All signs point to a continuation of that theme into 2016 and beyond. The most-recent forecasts expect global container fleet capacity to grow by 4.6% in 2016, and another 4.7% in 2017, though spot prices for major routes have dropped 21 to 44% from a year ago because of plunging demand, now about half the current growth forecast.

Since the Great Recession of 2007–09, carriers have struggled to find feasible solutions to this systemic problem. Most chose to act independently, embracing such initiatives as slow steaming, vessel idling, organizational cost-cutting, and information technology (IT) modernization. Although those initiatives have provided some tangible benefits, the carrier community may finally be coming to grips with the need for significant industry consolidation. Such consolidation will likely happen operationally, through more-powerful alliances, and financially, through mergers and acquisitions (M&A).

At the close of 2014, Hapag-Lloyd announced the acquisition of Chilean-based CSAV, effectively setting the stage for an active year in ocean carrier M&A. Notable 2015 deals were French line CMA CGM’s agreeing to acquire Singapore-based Neptune Orient Lines and its APL brand, which provided a significant market share boost in the transpacific trade. Meanwhile, the Chinese government orchestrated the merger of China Shipping Container Lines and COSCO, thereby combining two meaningful players in the container trade lanes into and out of Asia.

The argument for industry consolidation is sound. Fewer competitors controlling more vessels should lead to more-effective management of existing capacity and future vessel orders that would be more in line with demand forecasts. Scale can also reduce the cost of moving containers from point to point, so those carriers not actively pursuing consolidation or operational collaboration risk being marginalized or getting acquired.

However, carriers—and their financial backers—have to be wary of the cost of consolidation fueled by debt. And even though money is still relatively cheap in the global financial markets, the carrier industry has produced dismal results in the past five years and lenders will be looking for a premium to cover those risks. If the market for container shipping services does not turn in favor of carriers in the near term, carriers with increasing costs for servicing their debt could be at risk.

**Carrier industry financial results remain poor**

Last year started off with promise, as carriers generally reported improved profits through the first half of 2015 on the backs of stronger freight rates and declining fuel costs. But the good times were short-lived. Supply-and-demand imbalances on major trade lanes such as Asia–Europe and the transpacific were thrown into sharp focus when traditional peak demand failed to materialize in the third quarter. Freight rates collapsed, and the carrier industry gave back its gains from the first and second quarters when the benefits of lower fuel prices eroded because fuel surcharge mechanisms had caught up with the market.

A deeper examination of the past 12 months’ results reveals that cash from operations fell 12%—almost twice as fast as the EBITDA decline of 7% (figure 1). Those figures suggest that carriers have to fund working capital at a greater rate than they have previously. Likely causes include tighter payment terms imposed by, for instance, fuel vendors and longer payment cycles from shippers. In fact, heading into 2016, the finances of those carriers are worse than the latest last-12-months (LTM) period results, indicating that the third quarter of 2015 was disastrous. Revenue was down 16% compared with the same period in 2014, and EBITDA declined at more than twice that rate: 35%. Many expect fourth-quarter 2015 results will not be any better as both freight rates and demand remain low.

---

1. 2016 AlixPartners’ Container Shipping Outlook. The Outlook is an annual update on the state of the industry and the latest thinking on trends that may shape the coming year. All references, facts, and opinions contained in this article can be found in the 2016 Outlook.
Notably, the results of the third quarter—historically a strong period for carriers—have declined steadily in recent years as preholiday shipping peak volumes diminished (figure 2). Carriers traditionally depended on strong profits in the third quarter to shore up their finances for the rest of the year.

Ironically, that same drive to lower operating costs by way of larger, more-efficient vessels is what created the industry’s financially crippling supply-and-demand imbalances.

The LTM period through September 30, 2015, shows that margins remained tight, but few carriers reported negative EBITDA (figure 3), which illustrates a new normal, wherein rates are depressed and low-cost operations are paramount.

Carriers clearly recognize the financial threat from overcapacity, and in response, many have reined in capital expenditures (CAPEX) since the 2011–12 peak (figure 4). But is it too little, too late? The slate of vessel deliveries scheduled for 2016 and 2017 remains robust, and vessel scrapping activities remain muted.
Falling revenue, declining profit margins, and heavy debt loads have left the container carrier industry in distress, clearly indicated by the average Altman Z-score of 1.39 (figure 5). The Z-score—a formula for predicting the likelihood of bankruptcy based on a number of metrics readily available on a company’s public statements—of less than 1.81 suggests financial distress. The container shipping industry has not registered an average score above that level, which is considered a gray area, since 2010. The industry has not had an average score of about 2.99—considered the safe zone—since 2007.

The listing got delayed twice and eventually scaled back because the market for container shipping had deteriorated throughout the year, dampening investor interest. Israel-based ZIM Integrated Shipping Services postponed plans to hold an IPO in the first half of 2016 due to poor market conditions with no signs of recovery, prompting the resignation of chief executive officer Rafi Danieli.

Over the course of 2015, container freight rates dropped precipitously. Spot rates declined by more than 50% from Shanghai to Rotterdam and more than 70% between Hong Kong and Los Angeles—key indicators of the health of Asia–Europe and transpacific trade lanes, respectively.

The global fleet is forecast to continue growing 4.6% in 2016, and another 4.7% in 2017 as larger vessels continue to come online. Meanwhile, many demand forecasts are half that figure or less—generally, 1 to 3% globally.

Ultralarge container vessels capable of carrying more than 18,000 twenty-foot-equivalent units represent the fastest-growing segment of the global container shipping fleet. The arrival of such vessels exacerbates supply-and-demand imbalances on the major trade lanes. Only the largest and most sophisticated ports, located mainly in Asia and Europe, can serve these mammoth vessels with any frequency. At the same time, Europe’s economic decline has reduced demand on the Asia–Europe trade lane. And ports on both coasts of the United States are racing to develop capabilities for handling larger ships, but it appears unlikely that ports in other regions will develop the necessary infrastructure anytime soon, thereby confining the ultralarge container vessels to major east-west trades for the foreseeable future.

Active operational alliances have helped carriers compete globally and achieve scale economies while retaining some autonomy. New alliances such as 2M and Ocean Three (O3), as well as the existing alliances that merged to create the G6, may become disrupted. The recent spate of M&A activity in the carrier industry will make for interesting discussions because these deals cross the lines of traditional and newly formed allegiances.

On the heels of the CSAV acquisition and integration, Hapag-Lloyd held an initial public offering (IPO) in November 2015.

Looking forward, APL will almost certainly leave the G6 in favor of CMA CGM’s O3 alliance with United Arab Shipping Company, or another new alliance.\(^\text{[10]}\) But questions remain about which alliance will be chosen by the new Chinese entity formed from the consolidation of COSCO (a member of the CKYH alliance) and China Shipping (the third O3 member). If M&A activity continues in this market, the makeup of these global alliances will likely change considerably. Their prominence may potentially diminish, as mega-alliances give way to a handful of autonomous megacarriers.

**Consolidation: Do or die—or do, and die anyway?**

Consolidation in the container shipping industry is happening for the first time in a decade and will likely continue in 2016. Carriers in commoditized trades must reach scale to attain the operational efficiencies necessary to be profitable despite lower revenues. Carriers slow to achieve such efficiencies face the prospect of either becoming acquisition targets themselves or becoming marginalized or becoming bankrupted. However, the means of achieving that scale can itself present a longer-term burden, merely postponing rather than preventing bankruptcy.

Carriers have managed to reduce their cumulative debt at a slightly faster pace than their declining EBITDA, leading to a reduction in leverage relative to earnings (figure 7). Thanks to the lower debt load and the current low-interest environment, EBITDA coverage of interest expenses remains at a healthy level (figure 8).

**FIGURE 7: Industry-debt-to-EBITDA ratio, 2010–15**

![Graph showing industry-debt-to-EBITDA ratio from 2010 to 2015](source)

**FIGURE 8: EBITDA (minus CAPEX)-to-interest-expense ratio, 2010–15**

![Graph showing EBITDA (minus CAPEX)-to-interest-expense ratio from 2010 to 2015](source)

Many carriers have faced debt issues for several years. Industry debt peaked at close to $114 billion in 2013 (figure 6), fueled by tonnage investment; and due to meager free cash flows, some carriers were soon struggling to cover interest payments. Industry debt level has retreated to less than $90 billion as carriers pared back capital commitments to larger tonnage and other capital projects, trimmed costs, redelivered excess charter tonnage, and, in some cases, divested of noncore assets.

Carriers pursuing debt-financed acquisitions potentially increase strains on balance sheets still recovering from a period of high capital investment. Industry EBITDA levels remain low, making it imperative that merging companies retain the combined customer base and realize sizable cost synergies to successfully service increased debt burdens. That challenge would heighten further if the cost of capital changed significantly over the medium term.

Thorough and effective postmerger integration is required to ensure that the newly combined carriers achieve reduced costs and increased revenue. Such successful postmerger integration is no small task, because carriers tend to have customer strategies, IT systems, operational alliance partnerships, vessel fleets, back-office investments, and corporate cultures that vastly differ from one another. The carrier integration challenges are similar to the challenges airlines faced as their industry consolidated during the past two decades (see sidebar: “Ready for takeoff?”).

Maersk’s 2005 purchase of P&O Nedlloyd (PONL) offers the most recent cautionary tale. Maersk had struggled with the PONL integration for years because of differences in corporate cultures, IT systems, and many other areas. Maersk lost market share in the process and was forced to attack the inefficiencies of the combined company again in 2008 through a major reorganization and cost-cutting initiative.\(^{11}\)

Ten years later, carrier integration projects have become even larger and even more complicated: Fleets have grown. Carriers have continued down disparate paths. There are complications within their critical IT systems. And corporate cultural integration remains a primary concern because many carriers have retained strong national identities despite their global operational footprints.

Credit analysts rate many global carriers below investment grade, and high debt ratios are closing off certain opportunities to some carriers. An increase in debt coupled with a difficult postmerger integration could spell disaster for those carriers, because combined entities may be unable to generate the returns necessary to service their debt.

**Conclusion**

The container shipping industry faces extreme market pressures and appears on the cusp of transformative consolidation. To survive the transition, carriers should take vital measures and:

- scrutinize balance sheets, reduce liabilities, and continue to divest of noncore assets so as to reduce debt burdens;
- exploit the ability to continually lower slot costs in order to grow margins in core liner businesses; and
- uncover opportunities: internally through cost-cutting initiatives and externally through collaborative partnerships.

Carriers that successfully shore up both their balance sheets and their income statements will likely be in prime positions to lead consolidation as the industry reshapes itself. Carriers that are not part of industrywide consolidation must find niche markets—in terms of trade lanes and specialized cargoes—to survive independently. Effective postmerger integration management could be critical for carriers who choose to combine through M&A, but historically, that has not been easy to achieve in this industry.

---

FOR MORE INFORMATION, CONTACT:

Esben Christensen  
Managing Director  
echristensen@alixpartners.com  
+1 (248) 225-7064

Foster Finley  
Managing Director  
ffinley@alixpartners.com  
+1 (404) 931-1349

Lian Hoon Lim  
Managing Director  
llim@alixpartners.com  
+852 2236 3525

Albert Stein  
Managing Director  
astein@alixpartners.com  
+44 (0) 20 7098 7588

ABOUT ALIXPARTNERS

AlixPartners is a leading global business advisory firm of results-oriented professionals who specialize in creating value and restoring performance. We thrive on our ability to make a difference in high-impact situations and deliver sustainable, bottom-line results.

The firm’s expertise covers a wide range of businesses and industries whether they are healthy, challenged, or distressed. Since 1981, we have taken a unique, small-team, action-oriented approach to helping corporate boards and management, law firms, investment banks, and investors respond to critical business issues. For more information, visit www.alixpartners.com.

AlixPartners. When it really matters.