Baseball and boats

As baseball's regular season comes to an end and post-season play commences, much discussion is focused on the prevalence of teams with large payrolls. Earlier this year, Major League Baseball received a report that had been under way for 18 months. Findings were grim — the widening payroll disparity between teams is making the sport uncompetitive and may ultimately lead baseball to financial ruin.

An impressive group prepared the report. Members included columnist George Will, former Senator George Mitchell, former Federal Reserve Chairman Paul Volcker and Yale University President Richard Levin. If only they were available to evaluate the liner shipping industry.

They would discover striking similarities. Like the pack mentality that led some owners to push player salaries into the stratosphere, liner executives have been known to order big new ships with little regard for their overall effect on the market. The pack mentality increases the risk of failure for everyone.

Yet baseball isn't doomed, and neither is container shipping. Last year provided welcome relief to most shipping-related businesses. One survey reported that average operating profit as a proportion of revenue increased to 5% from 4.5% the previous year.

The profit increase seemed to benefit lines with significant exposure in the Asian export trades. Other routes, such as the trans-Atlantic and South America, were not nearly so robust. These results were enhanced by the absorption of other companies of two industry laggards — Sea-Land and TMM.

The increased profitability of the Asian export trades has been driven by a number of factors. The increase in Asia-to-U.S. demand has allowed for higher freight rates — a trend that has remained strong because capacity has not increased more rapidly than trade volumes. Additionally, many lines realized that it's less costly to haul an empty container back to Asia than to go to the trouble of seeking and carrying an unprofitable return load. (It also makes terminal operations much simpler.) The result has been some minimal rate increases for U.S.-to-Asia loads.

Improved profitability is not a complete surprise, considering the generally favorable global economic climate, but the lack of major mergers has surprised many.

Maersk's acquisition of Sea-Land's international services not only put it in control of more than one-seventh of the industry's capacity but made it almost twice as large as its next-largest carrier. A slew of mergers was expected to follow, consolidating the industry into a handful of true mega-carriers. It may be early to consider merger prospects eliminated. Since most ship lines fiercely protect their independence, it is not surprising that few companies wish to be acquired.

With profitability restored — at least for now — there is less need for conglomerates to shed their liner shipping businesses. And the desired purchase price has increased with earnings.

The exception is Sea-Land, which became a financial drag on CSX, which had gone deeply into debt to acquire Conrail and then encountered severe operating and financial problems.

The economic environment also plays a role. The economic crisis threatening Asia in 1997-98 was effectively halted and Asian stock markets have greatly recovered. But some concern still exists about whether structural problems in that economy have been solved, or simply ignored with the recovery. If the latter is true, the recovery may be nothing more than a "dead-cat" bounce. While China seems poised to continue trade growth with the United States, a great deal of concern still exists about Japan's public-debt burden — 200% of GDP, highest of any OECD nation.

The most pressing issue for the liner shipping industry may be a planned expansion in capacity. According to London-based Clarkson Research, the liner shipping industry has ordered new vessels which will more than double existing capacity.

Furthermore, this capacity is mostly in post-Panamax vessels of 5,000 TEUs or larger.

As these vessels are introduced, lines will be asked to increase their market presence. Since existing market growth cannot keep up with expected projections, lines will have to increase market share at the expense of their competitors — effecting extreme price competition and rate erosion.

This has happened several times in the past 20 years. But the magnitude in today's industry is unprecedented. And financial pressure will increase due to the need to invest in terminals and equipment to support the new vessels.

As these new vessels come in, we should get a valuable lesson in economics. Short-lived profitability will likely disappear, forcing shareholders to consider alternatives such as merging. The phenomenon of mutually self-destructive behavior in shipping — like in baseball — may reappear.

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