Sinking or sailing?

My transportation career started at Conrail. While explaining the commercial strategy which had led to the largest bankruptcy in U.S. history, former Penn Central employees would quip “lose a little bit on each load — but make it up on volume.”

Future industry observers may use similar language to describe today’s liner shipping industry. The financial threat to liner shipping is unique, not only for its breadth, but for the speed with which it appeared. Less than a year ago, volume was strong and rates — if not escalating — were at least stable. 2000 was a year when ocean carriers uniformly reported their strongest results in years. For some, the first half of 2001 was even better.

The second half of 2001 has seen a dramatic turnaround. The expected peak season failed to materialize, and new capacity — ordered by most carriers during their brief prosperity — flooded markets. Any load is sought. Even intermodal wastepaper for export is considered cargo worth fighting for. Dan Clague, of investment banker SG Hambros, recently observed, “The outlook for the liner shipping industry in the remainder of this year is appalling. Although people are starting to say that the market is terrible, there is still worse news to come.”

Much discussion swirls around overcapacity. In the next two years, the top 20 carriers will add more than one million TEUs in capacity — a 25-percent increase. Most of these orders are vessels in excess of 5,000 TEUs. In 2001 alone, 30 such vessels will be introduced. Even the opportunity to scrap older vessels will not bring supply and demand into equilibrium. With an economic “soft landing” unlikely, and regulatory scrutiny posing an obstacle, lines are struggling to find methods of reducing capacity through their discussion agreements. Some lines are combining services. In some trades, carriers are “reducing” capacity piecemeal with individual sailing cancellations.

The capacity onslaught is the result of several factors. Recent shipbuilding improvements and general economic conditions made possible the purchase of 6,000 TEU vessels for roughly the same price as 4,000 TEU vessels only a few years earlier. The relatively strong results between 1998 and 2000 emboldened carriers, who sought increased profitability. Ironically, just as the vessel cost is reduced by economies of scale, the relative importance of the remaining variable costs increases — as does commercial expertise on revenue growth and protection.

Ocean carriers will seek to reduce costs to stay ahead of declining rates. Some will consider further use of vessel sharing agreements and alliances. Four large Asian lines — COSCO, Yang Ming, “K” Line and Hanjin — have agreed to closer cooperation, in hopes of improving vessel utilization. Transit times may improve, but significant global capacity reduction is uncertain.

“K” Line is an interesting case. For years, it avoided buying large ships, opting instead to obtain (by alliance or slot charter) inexpensive space from lines which had overinvested. Several years ago it abandoned that strategy and ordered 12 5,600-TEU vessels. Now, even before the vessels are delivered, “K” Line is looking to offload some of these vessels — perhaps to alliance partner Yang Ming.

Alliances may become more fragile. China Shipping, Zim and CMA-CGM have been engaged in a public on-again, off-again coalition. Alliances form to improve utilization, but continued mergers and acquisitions should continue to increase industry concentration. Maersk and Sea-Land merged once they had maximized alliance benefits — and still sought additional savings.

Middle-tier carriers will continue to be vulnerable, and bankruptcy will continue to pose a threat. The bankruptcy and liquidation of Cho Yang was not a complete surprise. The Hub Group, which finally wrote off $4.7 million, struggled for several years with the dilemma of whether or not to finance Cho Yang’s operations.

Ocean shipping vendors will constantly face the financial problems of their customers — along with increased requests for cost reductions and other concessions in the name of “partnership.” Railroads and drayage companies seem unlikely to give back further — after years of cost reductions and foregone rate increases. Organized labor will be seen as a possible source of savings, but it is unlikely the industry will see much movement on that front.

Ports and terminal operators, who have had to invest in order to accommodate larger vessels, will also face requests for price reductions from their liner customers. Price competition among ports could become more common. Hong Kong, one of the most expensive operations in the world, has seen increased competition from South China ports and has introduced flexible pricing to compete.

Where’s liner shipping heading? Perhaps observing a parallel drama could provide clues. Airlines are very similar to ocean carriers. They, too, are asset-based, network-operating companies. They also rely on innovative financing for their capacity and both utilize terminal infrastructure provided by other entities under long-term contractual guarantees. Many airlines are viewed by their governments as instruments of trade and economic policy.

Airlines are frantically seeking ways to reduce costs, including significant layoffs, cutting routes and reducing capacities by up to 25 percent. Vendors, such as Boeing, have initiated similar cutbacks.

Still, it seems that any lasting solution must eventually involve turning to the government. Perhaps one of the strangest outcomes of the events of Sept. 11 is resurgence in active government intervention. Many aviation experts feel that the U.S. government’s cash grants and loan guarantees will not be enough to guarantee the survival of carriers such as America West and U.S. Airways. We have already seen European carriers Swissair and Sabena start the slow march towards bankruptcy.

Robert Ayling, former chief executive officer of British Airways, recently observed, “The solution here is to face the fact that there have been too many airlines — particularly in Europe — for too long and to consolidate or liquidate.” Many ocean shipping observers believe that the same problems plague their industry.

While it is often much harder to evaluate the true financial condition of Asian companies (the intended spin-off of Hyundai Merchant Marine from its parent may yield an interesting first look,) the industry’s financial problems seem severe. It may be time for a handful of industry giants to emerge, with the period of alliances serving as an intermission for transacting partners to align.

There are many possible catalysts to this restructuring. Bankruptcy is the most dramatic. We could see a series of failures — each larger than the previous — with significant asset capacity being recycled at lower and lower prices. Government rationalization would be a more orderly process with the industry being consolidated in a series of deals. Either case leads to an industry that is very different from today.

While there is no clear agreement as to the path the industry will take, it seems inevitable that the industry will be transformed in the next several years — sooner if business doesn’t improve.

Theodore Prince is senior vice president of marketing and sales for Optimization Alternatives Ltd, Inc.