AlixPartners

FEBRUARY 2023

2023 CONTAINER SHIPPING OUTLOOK

This time is different

The period from mid-2020 to the fourth quarter of 2022 was a high-water mark for the container shipping industry, and with it came unprecedented turmoil, disruption, and prosperity. That period was, above all, a period of extremes: extreme rate rises, extreme container and labor shortages, extreme delays, extreme congestion, and extreme chaos for exporters and importers alike.

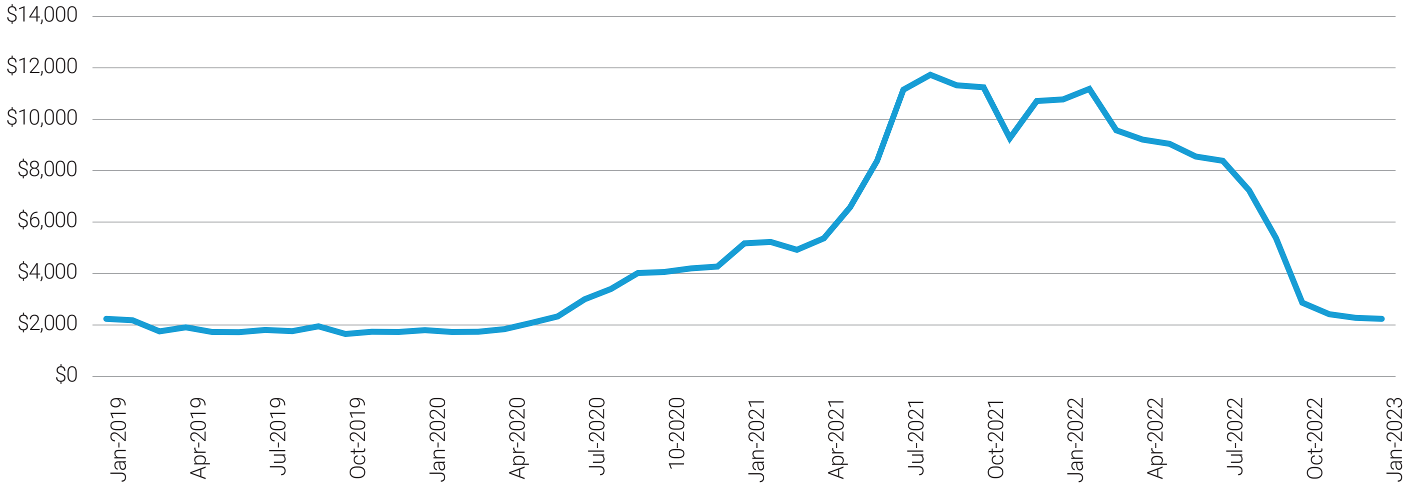
For container ship operators themselves, it was an era of extreme revenues and extreme earnings. Thanks to those earnings, the container shipping industry, long known for its cyclical swings and volatile and precarious returns, is enjoying unaccustomed financial stability and with it, the luxury of choosing among a broad range of strategic options.

Of course, every high tide eventually recedes. In this case, the tide turned in the fourth quarter of 2022, when both consumer demand and industrial demand plunged precipitously just as significant new shipping capacity was beginning to come online.

Rates plummeted, touching levels unseen since the early days of the pandemic, though still well above all-time lows (figure 1). Since then, container capacity and cargo volumes have regained a semblance of equilibrium, and service levels have climbed out of the depths, leaving industry stakeholders to reckon up their gains and losses, assess their competitive positions, and plot their future courses.

FIGURE 1: SHANGHAI TO LOS ANGELES OCEAN FREIGHT RATE EVOLUTION ($/40FT CONTAINER)

Although rates have come down from the historic peaks of 2021-2022, they are still far from the industry's lows



Source: Drewry

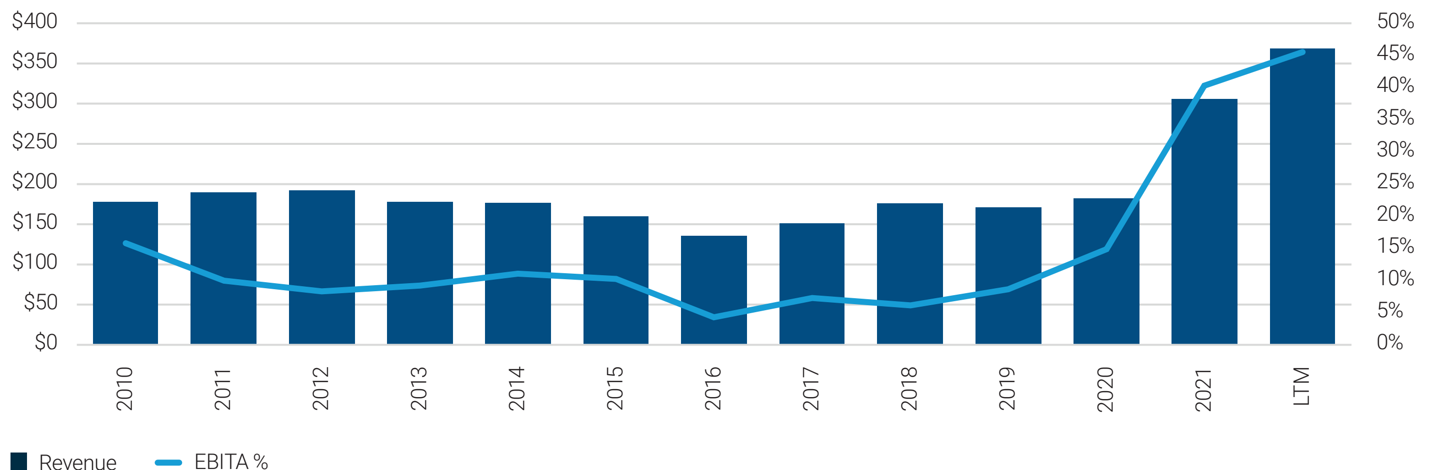
A RESHAPED COMPETITIVE LANDSCAPE

Undoubtedly, the greatest beneficiaries of the boom times have been liner operators. In the 12 months ended September 2022, the world's 15 largest carriers reported combined revenue of $369 billion, up 21% from 2021—which was itself a record year—and 116 times 2019's results. Aggregate profitability surged, with EBITDA rising 36% from 2021 to $168 billion. EBITDA margins reached 46%–4.7 times the historical average of about 10%–in the 12 months ended September 2022 (figure 2). And speaking of extremes, those 15 carriers reported cumulative cash from operations of $179 billion in the 12 months ended September 2022; in the 11 years from 2010 to 2020, the same carriers' cumulative cash from operations amounted to $169 billion.

The high-rate environment buffed the liners' balance sheets as well as their income statements. The industry's debt-to-EBITDA ratio stood at 0.6x as of September 2022, compared with 82x 10 years earlier, in 2013.

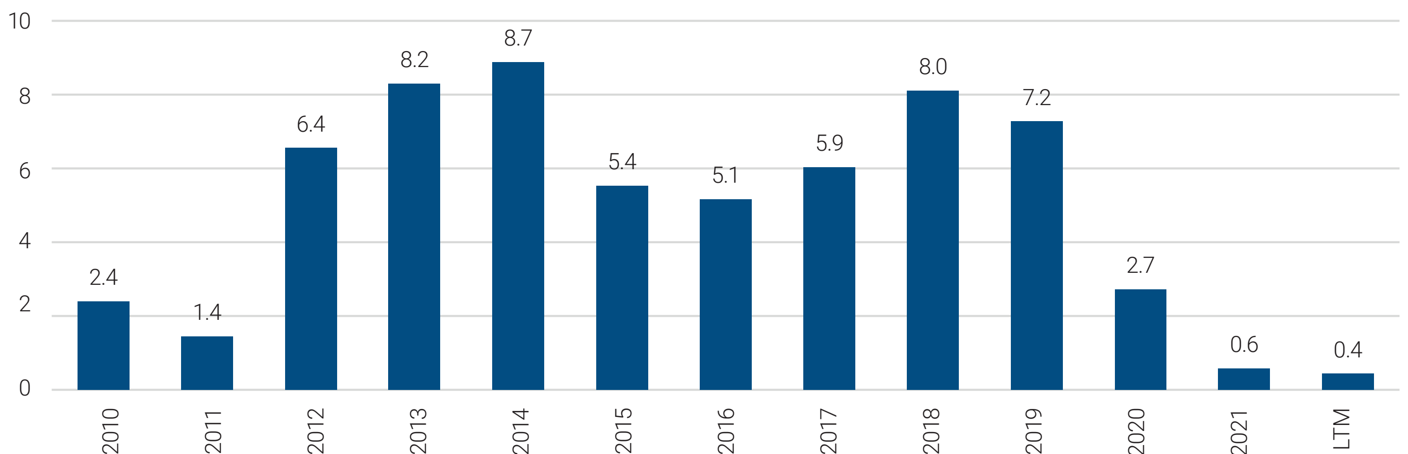
Interest coverage has soared to 40.8x—that's right, enough to cover more than four decades of debt service—while the industry's leverage ratio (calculated as EBITDA/total debt) plunged to 0.4x at the end of September 2022 from 8.5x in 2019 (figure 3).

FIGURE 2: REVENUE AND EBITDA % MARGIN EVOLUTION ($M)



Source: Companies financial statements, CapIQ data, AlixPartners analysis

FIGURE 3: 15 LARGEST[1] OCEAN CARRIERS LEVERAGE RATIO EVOLUTION (INDEX)

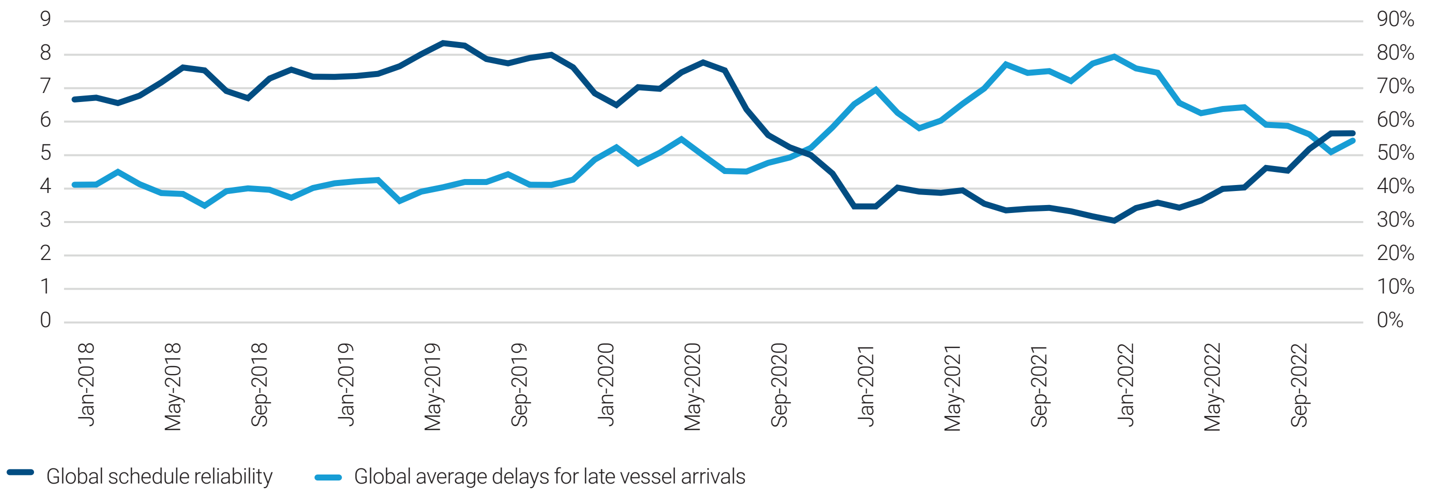


1. Based on revenue

Source: Companies financial statements, CapIQ data, AlixPartners analysis

FIGURE 4: GLOBAL SCHEDULE RELIABILITY AND GLOBAL AVERAGE DELAYS FOR LATE VESSEL ARRIVALS (%, INDEX)

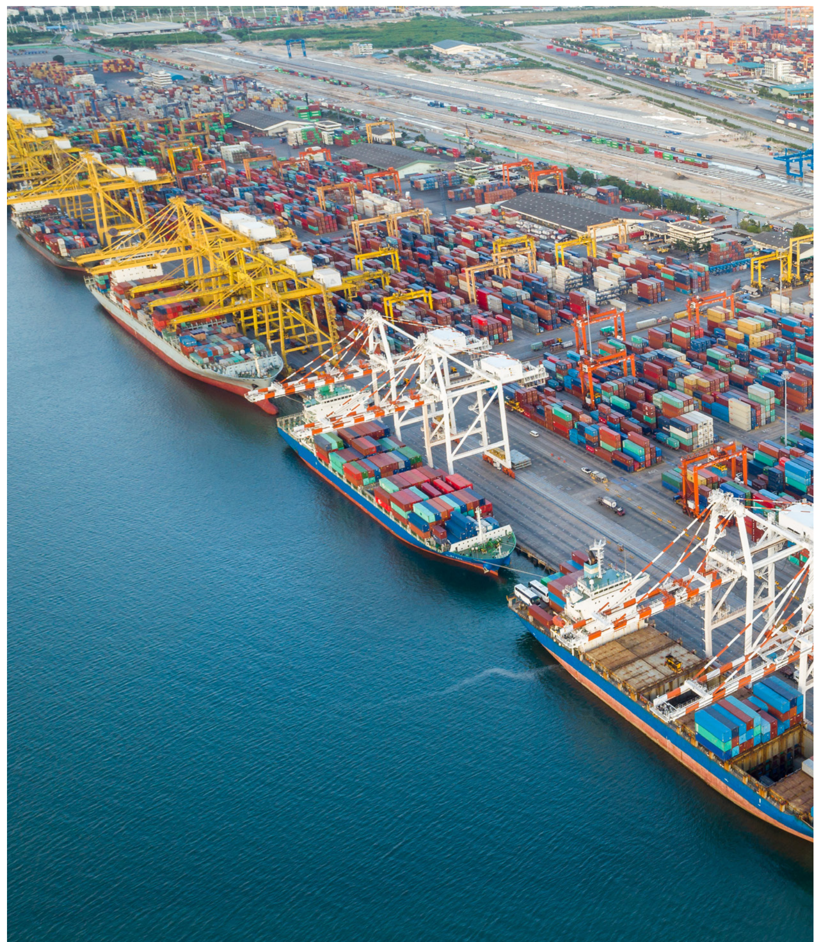
While service levels have improved significantly from what we saw in 2020 to 2022, they still have room for improvement.



Source: Sea-Intelligence

Even the slowdown in demand since the third quarter of 2022 has its upside. The letup in shipping activity has enabled liners to build on the steady improvement in service levels that has been under way since early 2022. On-time arrivals rose to 57% of sailings in December 2022, well above the all-time low of 30% touched in January 2022 (figure 4).

Some carriers will continue to invest in service improvements as they put their bulging cash hoards to work. Although carriers directed large outlays toward deleveraging their balance sheets, expanding operating fleets and vertically integrating through mergers and acquisitions in 2020 and 2021, they retained 55%, or $43 billion, of the cash windfall generated in those years on their balance sheets. They appear to be taking a different course with the cash generated since then. Some 23%, or $42 billion, of the cash generated in the 12 months ended September 2022 remains on balance sheets, with the remainder going toward debt paydown, dividends and investments in securities, M&A, and CapEx.



HOW OTHER STAKEHOLDERS FARED

Carriers weren't the only stakeholders to gain a competitive advantage in the wake of the rate boom. Port operators that invested in expanded terminal capacity, dredging, and adjacent infrastructure have laid the foundation for sustainable service improvement. Despite near-term drop-offs in cargo volumes, they are well-positioned to benefit from increased trade over the medium term.

Smaller, regional port operators have also emerged into the post-boom environment at a disadvantage to their larger rivals. When port congestion and on-time service were at their worst, many carriers bypassed the smaller ports, leaving them with little financial wherewithal to invest in improved infrastructure. Port operators will be hard-pressed to win back the large-vessel traffic they lost to larger ports and will likely need to increase their reliance on transshipments as a source of volume.

Large shippers have also weathered the high-rate storm without sustaining significant damage. Their financial strength enabled them to absorb higher shipping costs while they retooled their operations to insulate them against future cost surges. Many have repatriated their supply chains and assembly facilities to the U.S. or shifted them to Mexico to be closer to their home markets, while redirecting shipping away from the heavily trafficked eastbound transpacific (EBTP) lanes toward the U.S. Gulf Coast and East Coast.

Small shippers have not fared as well. Higher rates threw their cost bases out of balance and crushed their margins, while their comparatively smaller shipping volumes left them at the back of the line when seeking concessions or relief from service shortcomings. Many have learned from that experience to take a more proactive approach to freight strategy, with many signing on with non-vessel operating common carriers (NVOCCs) or leveraged buying consortiums. Such moves should act as a hedge against future supply constraints, service disruptions and rate squeezes.

The rate boom also took a heavy toll on logistics managers. Burnout led to high turnover in the ranks, leaving a persistent shortage of talent in its wake. Those that remain on the job can expect closer C-suite scrutiny of their activities, while negotiations with carriers will likely grow more contentious and protracted.

Finally, Asian suppliers may see a reshuffling in their ranks. Bangladesh, Malaysia, and Vietnam have already eaten into China's share of consumer goods exports, and China's position could erode further as nearby countries increase their shares of supply chains and as government policies and business strategies outbound momentum. Mexico and Eastern Europe stand to gain over the medium term as more and more volumes shift out of China and to neighboring countries.

WHAT'S AHEAD FOR THE CONTAINER SHIPPING MARKET

The days of maximum turmoil in the container shipping industry appear to have passed, but that doesn't mean the market will return to the pre-pandemic status quo. The market's fundamentals have shifted dramatically, with some formerly active trade lanes starting to fall from favor and others gaining volume and maintaining relatively high rates. Labor-market dynamics will reinforce some of the shifts in trade activity, while sharp expansion in carrier capacity will counteract any increases in demand.

Several trends will likely exert a strong pull on the future course of rates. They include the following:

DYNAMIC TRADE FLOWS

The sharp decline in EBTP rates has not been matched by rate moves on other lanes. What has emerged since late 2022's price break has been a decidedly localized market, with rates holding relatively steady on the North Atlantic–East Coast and Gulf Coast ports in the U.S. and Europe–South America trade lanes. The long-term shift toward the reshoring of assets and assets and operations will likely reinforce this rotation away from Asia, as North American manufacturers **invest in operations in Mexico** and their European counterparts increase their presence in North Africa and Eastern Europe.

Labor market concerns will likely drive additional traffic to East Coast and Gulf Coast ports in the U.S. as shippers seek to sidestep potential disruption of West Coast port operations. The outcome of negotiations to replace the contract that expired in July 2022 between the International Longshore and Warehouse Union (ILWU) and the Pacific Maritime Association (PMA) was unknown when this report went to press, but the possibility of a prolonged strike has already contributed to both **a decline** of as much as 25% in Port of Los Angeles container volumes in recent months and a shift in container volumes to the U.S. East Coast, leading to a surge in demand for East Coast sailings and port infrastructure.

The Port of Los Angeles isn't the only West Coast port affected by labor market jitters. The continuing threat of labor disruption by the ILWU, which represents 22,000 workers at 29 West Coast ports, has driven volume declines in other Pacific ports and increased the rate differential between East Coast and West Coast destinations. Elsewhere, labor actions disrupted port operations in the **U.K., Germany,** and **Australia** in 2022 and, as Europe wrestles with double-digit inflation, further labor action could be on the horizon. Any strikes would almost certainly exert upward pressure on rates and degrade service.

ALLIANCE SHAKE-UPS?

Carrier investment in capacity growth has redrawn the alliance landscape. Now that MSC has achieved sufficient scale to operate efficiently on its own and Maersk has focused on its strategic repositioning as an integrated supply chain provider, the two carriers have elected to dissolve the 2M alliance. While the change won't take effect until 2025, it raises the possibility that other alliances, in particular the Ocean Alliance and THE Alliance, will reconfigure themselves or dissolve when their alliance agreements end in 2027 and 2030, respectively. Any churn among alliances, which have been a key contributor to maintaining capacity and pricing discipline, would likely heighten competition among carriers, to the ultimate benefit of shippers, especially while carrier capacity remains high and shipping demand relatively low. Disruption in alliances could lead to more rate volatility as carriers look to capture volume to maintain or rebuild utilization.

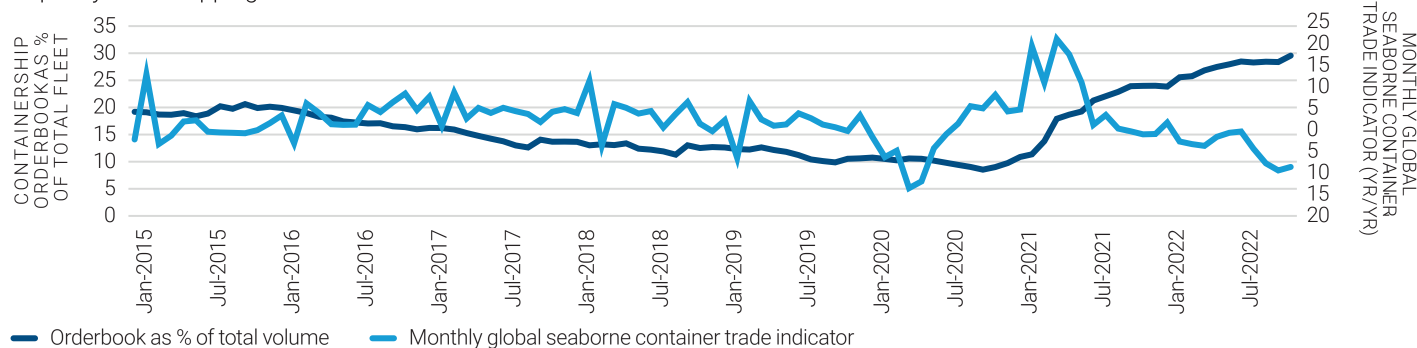
CONTRACT SEASON DYNAMICS

Carriers and shippers are already engaged in negotiating new contracts for 2023. In past years, negotiations tended to unfold along predictable lines, with shippers signing one-year contracts beginning on May 1 that were honored for the length of their terms. That tendency broke down in 2021, when capacity became sharply constrained by port congestion, leaving carriers unable to honor commitments to shippers. Shippers were forced to pay almost any price to secure capacity, and many went so far as to sign multi-year contracts at premium rates to ensure adequate container space.

Since the late-2022 rate collapse, shippers have sought to renegotiate those deals or shift volume to the spot market. And the new contract season may see even further deviations from the typical negotiating pattern, with some shippers seeking shorter terms, and carriers looking to offset rate declines via revenue increases in accessorial services. But shippers have little leverage as long as cargo volumes remain low. Their best defense may be to improve operating efficiency and **focus CapEx spending** on investments that will generate the highest returns in the shortest time frames. Carriers may also offer concessions such as offering extended payment terms to cash-strapped shippers and may lean into intermodal services to offset rate declines.

FIGURE 5: GLOBAL ORDERBOOK VOLUME RELATIVE TO GLOBAL CONTAINER INDICATOR (YR/YR) – (%, INDEX)

Capacity is outstripping demand



Source: Shipping Intelligence Network Timeseries

AN UPCOMING CAPACITY GLUT?

Complicating the ongoing contract negotiations is a looming oversupply of container vessels (figure 5). After a spate of new orders beginning in the last quarter of 2022 and extending until January 2023, the stage is set for significant new capacity to come online in the next two to three years. A sharp decline in ocean trade—by no means a certainty—could saddle carriers with excess capacity that might take years to work off.

The new ships are among the largest ever built, which will likely reduce shipping costs per container but will also limit the flexibility of both carriers and shippers. The trend toward supersized vessels may spur an increase in the supply of smaller, more flexible feeder vessels, which will move smaller cargoes to ports specializing in consolidating smaller loads.

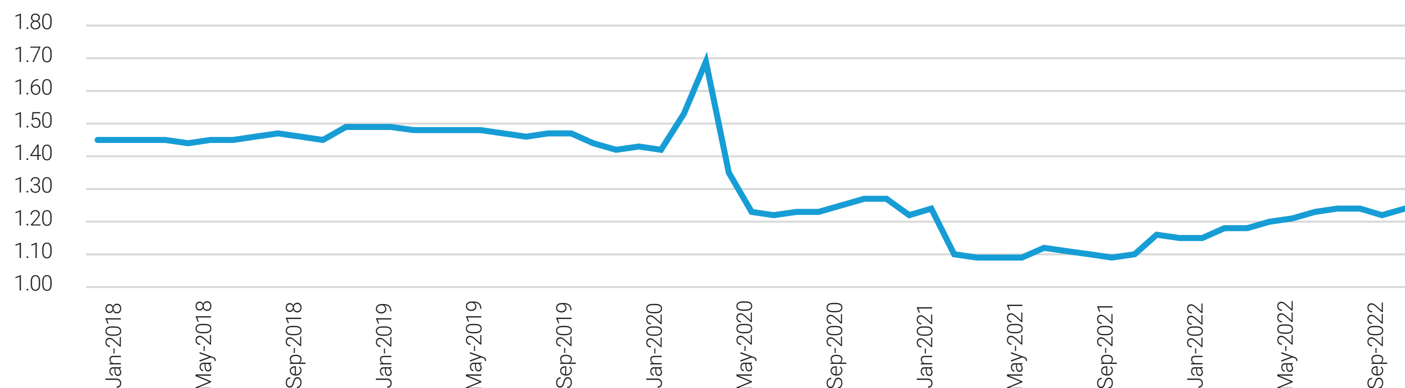
Tighter sulfur-emission limits imposed by the United Nations' International Maritime Organization could alter the supply-demand equation by slowing sailing times, removing non-compliant vessels from service, or imposing new costs in the form of fines and penalties. Of greater importance, however–and representing a far greater risk–is the drive toward decarbonization of the entire transport sector. The more slowly that carriers and their customers adapt to the energy transition, the greater the stranded asset risk to their banks and other funders.

MACROECONOMIC FORCES

A slowing global economy and reduced trade flows may have a greater impact on carrier rates than any changes in capacity or labor-market dynamics. U.S. consumer spending and retail sales are down since the first of the year, which could presage a recession despite record-low unemployment. And even as consumer spending slows, the inventory-to-retail-sales ratio has risen steadily in recent months. The ratio is generally a leading indicator of import demand, and a ratio usually signals softening demand while retailers work off their stocks (figure 6). Continued muted demand, reflected in the **sharp decrease** in manufacturing orders from China in recent months, will eventually manifest itself in lower rates.

FIGURE 6: RETAIL INVENTORY TO SALES RATIO EVOLUTION (INDEX)

Retailers have been rebuilding inventories relative to sales - slowly



Source: Federal Reserve Economic Data (FRED)

IMPLICATIONS FOR STAKEHOLDERS

Even as rates retreat and revenues moderate, stakeholders across the shipping value chain have opportunities to improve their competitive postures, optimize their operations and position themselves to outperform when the economic tide turns again.

OCEAN CARRIERS

The outsized financial gains may be gone for now, but the massive cash reserves remain, offering carriers a wide range of strategic options. Do shareholder rewards represent the best use of carriers' cash, or will carriers choose to invest in future stability and sustainability through vertical integration, expansion into adjacent markets, or offers of services? With the industry entering a down cycle, acquirers may have an opportunity to pick up valuable assets at reasonable multiples. Whatever course carriers decide to steer, their ultimate success will likely depend on optimal execution of their chosen strategies.

SHIPPERS AND IMPORTERS

The slowdown in shipping activity gives shippers time and space to define and optimize their supply chain cost structures and take steps to insulate themselves from the worst consequences of rate volatility. By rationalizing supply chain strategies today, shippers can set themselves up to outperform for years to come.

3PL AND FREIGHT FORWARDERS

Rate and volume volatility may be headaches for some stakeholders, but they represent profit opportunities for 3PLs and forwarders. In what is shaping up to be a choppy rate environment, middle-market players can prosper by assuming risks that other stakeholders would prefer to avoid.

INVESTORS

They may be in the best position of all. Short-term rewards, long-term value plays, distressed debt opportunities—they're all there for the taking. Merger activity is picking up as multiples decline, and as we've noted, there's no shortage of cash to work with. Financial investors and strategic acquirers alike are on the hunt, contributing to what's likely to be a lively deal flow in 2023 to 2024.

The era of sky-high container shipping rates and supply chain turmoil has passed, but that doesn't mean the seaborne cargo market has returned to the relatively placid conditions that preceded the pandemic. Instead, the market is undergoing something of a reset. Having built up large cash reserves and dramatically reduced leverage, carriers now enjoy the financial flexibility to make bold strategic moves. Shippers, meanwhile, are insulating themselves from disruption by reconfiguring supply chains and moving key facilities closer to their home markets. Middle-market players are refining their value propositions to help their customers mitigate supply chain risk. Port operators have invested in efficiency and scale and are ready to reap the returns.

In this transformed marketplace, nearly every player in the container shipping ecosystem is better prepared to prosper in the long term more than before rates went ballistic. Now it's up to those players to devise competitive strategies and execute rigorously against them. They have a rare opportunity to advance from a position of strength and to make moves to ensure their long-term resilience and sustainability.

ARE THEY READY TO SEIZE THE MOMENT?

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