Container Line Profitability Does Not Have to be So Disparate

How do we explain the growing trend in recent years of the vast and widening profit gap among the container lines?

The "why's" are perplexing if not mysterious; most of the carriers are in Alliances so there shouldn't be much difference there; some have bigger ships, some don't, that has to be part of it. We all read the latest reports from CEO's who say they are implementing cost cutting programs, so little difference there; slots costs are dropping for all, but apparently not at the same rate. All carrier revenue per container is dropping as the overcapacity conditions continue to impact the supply-demand equation. Volumes overall are almost at a standstill, up 1 to 2% globally.

Does any of this really explain why one company is in the Billions in profitability with an ROIC of 14% while others struggle to make a profit and the next closest line is making a 5% return?

They share the economies of big ships for lesser slot costs, slow steaming for lower fuel costs, are in Alliances to reduce fixed costs and have been in joint services for years. There must be more to it and there is - Far more- and it frankly gets down to the senior management of one company defining all of the pieces that affect and impact the bottom line and systematically attacking all of those issues over nearly a ten year period. While others have tried to mirror many of the moves, and others have done some, none have managed the consistency and long term discipline of purpose. Achieving a ten year head start on your competition in a very mature industry is a remarkable condition, but it is a fact.

Some History

Let's start by reviewing some of the huge changes in every aspect of the industry over the last 25 years.

- Global volumes have more than doubled during that time

- New markets have emerged
- Technology from vessel propulsion to terminal handling equipment to IT systems have all undergone significant changes.
- The numbers of rail trains that the ocean carriers control has tripled (yes they control rail trains).
- They've emerged from relatively simple shared vessel cross slot charters to very complex multiple carrier Alliances with upwards of twenty vessel strings plying the major trades of the world.
- That doesn't begin to address the changes in the vessels; sizes have doubled and quadrupled requiring deeper drafts at ports as well as requiring taller and longer reach gantry cranes.
- Larger terminals, but with space limitations requiring vastly changing operations (remember all-wheeled terminals??).
- Skyrocketing fuel prices, with a brief respite in recent months.
- Building new capacity every 4 to 5 years with the competitive useful life as short as 6 years.
- Rates of today are at or below levels of 25 years ago in spite of the high fuel costs and wage and price increases
- Labor costs are rising, capital asset costs increasing and increasingly tight capital access for most participants.
- A global economy that tanked in the middle of massive growth that had spurred the ordering of vessels that caused overcapacity, causing pressure on prices.
- And many management teams simply couldn't cope.

I know that this is not an all-inclusive, list, but it is a reflection of what these companies have gone through and how one of them has emerged in a far better place than the rest.

Why and how is what we will examine more closely in trying to explain the differences and then we'll discuss the implications?

The Whys and Hows:

Because of the changing complexities noted above, the cost structures have undergone significant changes and while all carriers have focused on them in one way or another, some have simply been better at it.

Some started 10 years ago ordering 15,500 teu vessels and later 18,000 teu vessels. This is where many have tried to mirror the cost cutting and the cost per slot reductions that larger vessels give you. Others are just now joining the party, ordering vessels in the past few months. And yet other major players have yet to order even while knowing that on the major Asia/Europe trade lanes they are totally non-competitive on a cost per slot basis. The cost differentials have been described as significant by some and not so much by others, yet those with the assets in service have a distinct advantage as evidenced in their financial reports. These bigger vessels have made a quantum difference, and one carrier has a ten year head start on 80 percent of the competition.

So is that it? Get a bunch of big vessels and you're done? Hardly. At about the same time that the big vessels were being deployed, our one carrier eliminated 20 US inland locations from its services. Analysis indicated that the costs associated with these inland points was far above the revenues derived and when the shippers were approached to increase rates to compensatory levels, they turned to other carriers who gladly took their cargo – happily or unknowingly accepting losses. This pattern of understanding costs and thoroughly analyzing the true value of major pieces of cargo and eliminating them from the cargo flows continues today, with major pieces of business being taken by others at a loss. This single activity, which we'll call revenue management, may be the single largest differential between those who make Billions per year and those who barely squeeze out a marginal profit or continue to lose money. If that activity is visible to anyone who pays attention, let alone those who are deeply involved day to day, why don't more do it? Or more logically, why don't they all do it? Because it runs counter to the age old industry mantra that volume can and does resolve all problems; Couple that with the complexity and scope of today's networks, dated systems and structures that do not provide accurate real time or complete origin to destination cost analysis by customer and teu or the ability to control those through flexible and smart cargo allocation/acceptance processes and the problem is not such a mystery.

Two other aspects of Revenue Management are:

1. Wholesale versus Retail: What percentage of each carrier's cargo liftings are "wholesaled" to NVO's versus retailed to Beneficial Cargo Owners? We see a range from 30 percent to 70 percent. It is "easier" and certainly less expensive to "sell" to NVO's but the long term impact on profitability when the percentage of this sales channel is too high is devastating.
2. Contract versus Spot market shares: Longer term Contracts are good for enabling planning for vessels base load factors and providing cargo interests consistency of rates, but the practice has been for cargo interests to have low minimums and comfortable maximums rather than significant fixed commitments over the life of their contract. Lowering the percentage of contractual space allocations commitments (not the contracts themselves) enables carriers to take advantage of constantly changing spot market rates which can raise average rates per box and provide significant boosts to bottom line profits. Cargo interests who must have space commitments to protect supply chain interests are willing to entertain higher minimums or mix contract and spot rates to insure space on vessels in high demand times.

Both of these areas require data driven analysis and management that understands that less can actually be more; A challenge for most companies.

As a consequence, to mask the lack of revenue management it is here that the issue of market conditions and market share gets trumpeted.

For sure market conditions are not supply side favorable. The quadrupling of global trade between 1986 and 2006 had carriers build more and more capacity, and one or two getting out there with the 15,000teu + vessels while others chose the more conservative approach of nothing bigger than 10,000 teu. But order ships they all did, they literally had to or watch others in the markets streak well ahead of them in capacity, volume, revenue and market share, and any other measure of rank.

Plus the market experts in mid-2006 said that global trade would double again by 2016, so they ordered more ships – 8,000 teu ships. By mid-year 2006, order books at major shipyards around the world were so full that ships being ordered then would take three years to deliver – almost double the time to deliver large container vessels.

But a strange thing happened on the way to the forum; 2006 was the beginning of a major downturn in the global economy and by 2009 the markets had retreated 30%, not raced ahead. And those ships were on order and being built. This brought a quick halt to further ordering, it brought delays in deliveries; and it brought about a significant negative impact to the bottom line of all carriers. Many were on the verge of bankruptcy with massive debt accumulating from building ships and revenues/bottom line results falling like rocks below the surface.

By late 2009 the conditions were so bad that the industry did something never done before – or since. With 2009 financial results showing a $21 Billion loss for the industry, the carriers individually took out a significant amount of tonnage and capacity from services, at one time over 650 container vessels were anchored in various venues including Singapore and the northern European fjords. The result of this action was a $30 Billion turn around in results: From a $21 Billion loss in 2009 to nearly $10. Billion in profits in 2010. Logic would say that the industry leaders seeing the extremely positive result, would simply mirror what they had done in 2010 again in 2011. Think again; they pulled up the anchors flush with the knowledge that they had made a profit in 2010 and that was enough to encourage them unleash the dogs and they have done so since 2010. Not so surprising, 2010 was the last year that the industry as a whole made money.

Overcapacity has plagued the industry since 2010; the new builds, delayed in delivery from 2009 and 2010, started to be put into service and it continues today as the markets continue to be over supplied with capacity and forecast to be that way for another couple of years. So the industry suffers, some do at least, and as this White Paper addresses, some have thrived in the chaos.

So the rationale, or excuse, of many is that market conditions, including overcapacity, cause them to struggle to make money or continue in a loss mode. They haven't given any thought to turning away loss giving cargoes or embarking on a more nuanced management of cargo selection. They are frightened that they will lose market share, choosing to lose money and place their hope that some turnaround in supply demand ratio will come in the near term future to rescue them from their loss making: All while one carrier makes considerable profit and only two others do relatively well.

Another significant "why" is the utilization of assets. It is one thing to look at the strings going back and forth between Asia and the US and see there is basically a round trip revenue stream. But when the vessels are going between Asia and Europe, there are multiple streams available and again some do it far better than others. While many will take a load from Shanghai to Rotterdam for $1800 to fill their allocation on an Alliance vessel, others chose to do a thorough analysis of the markets and take say 30% of their capacity to the Middle east at that same $1800 or higher, and then take a $1000 load to Northern Europe from the Middle East Receiving $2800in revenue for what amounts to an extra lift on and lift off cost vs the $1800.. This is oversimplified, but the theory and process is exactly right, and again one company does it extremely well while others do it at their convenience. Another example of revenue management where the company is thinking on an enterprise level and not simply from the success of one origin meeting its lift allocations

Far less visible because of the lack of publicity is that of managing the business as an enterprise and not as a traditional ocean carrier. Ocean carriers have a long history of being family run businesses; generations of owners who in many ways are patriarchal to the entire industry as well as their own firms. Indeed, the three most apparent successful container carriers today have that trait – almost. And before we get far into this debate, recall how many ocean carriers are owned by, are subsidized by or largely supported by governments. Put those into this category of family run ocean carriers. Having had the privilege of working for one of these companies, including being the first American Director in the home office of one of these companies, I observed business practices that were actually inefficient, in that they pursued cultural practices that actually reduced or inhibited profitability and did not promote efficiency. Employment was virtually guaranteed even in down times regardless of merit. Not all of these practices are bad in and of themselves, but it is a matter of degree. Contributing to this is finding the elusive balance between centralized and distributed management responsibility.

Some companies still find it challenging to manage their business as an enterprise and not a sum of many parts, especially those where the government is directly involved with ownership. But one company pursued a rather significant change to those poor management practices several years ago. Instead of protecting the home country citizenry workers as they had done for decades, they outsourced some work to low cost locations. Instead of allowing the staff to bloat in good times and then protect all in bad times, they vigorously embraced the “lean and mean” sizing of the company, took advantage of outsourcing where it made sense, and also took advantage of the economies of scale that they have. This occurred far more rapidly after the patriarch had passed on the torch of leadership to an industry outsider, but competent leader and visionary.

The new management had to make several changes to their management processes that again to the outside world was not all that visible, but they got buy-in at all important levels of the chain of command to bring about a more disciplined and consistent approach to running the business. They also shed many non-related businesses to the core revenue and profitability of the group allowing them to take greater advantage of the well trained cadre of management that they had trained and groomed for decades, focusing on the critical few rather than on a much broader spectrum of non-related businesses. There will be those who point to the relative success of the still remaining “family business” approach – but none of them made multi Billions of dollars the last few years.

Summation of Why’s

It’s a relatively simple list:

1. Cost containment and reductions in all aspects of the operation led by the right sized organization and assets in the major, long distance trade

lanes – yes, the big ships in Asia/Europe markets make a significant difference. And to a relative degree, in other major trades as well.

2. Revenue management, with a full understanding of forecasting, utilization and costs, turning away freight that loses money where revenues can't be increased to make them profitable
3. Evaluate the optimal contract, spot and wholesale/Retail mix of each trade lane. Maximize margins, not market share.
4. Asset utilization, taking full advantage of the vessels capacity along the routes to generate more than one stream of revenue. And when conditions dictate, take capacity out to reduce costs and reduce pressure on price.
5. Manage the enterprise in an efficient and effective manner, with data driven decisions constantly challenging the models of yesterday and changing when those models don't fit today's factual business world.
6. An enterprise level management system that provides for a top down vision with strict accountability for execution at each area of responsibility

Implications

So what are the implications of all of this? Well to start with, the above is not a fully comprehensive list of issues but a broad view of the differences between those who are making Billions vs those who are making Millions vs those who continue to lose money. The recent drop in fuel will not save those in the latter category; it has only given them a temporary reprieve from bigger losses.

So who will be impacted and what might or will the impacts be?

First the carriers themselves. Many in the industry today trying to continue to be a global player are losing their positions within the top 25 carriers in the world. They are losing money or struggling to make a small profit and they are facing competitive conditions that are so unfavorable so as to have to consider their long term viability. Those who haven't invested in the big ships yet, and there are fewer than half of those in the Top 25 who have, they are the most vulnerable (absent those who are owned or are heavily subsidized by governments whose motivation to be in business may not be profit but solely prestige). Why continue to try and be a global player if you can't or won't invest in assets that keep you competitive? Become a niche or regional player where you can be successful or try and merge with another entity which, when combined makes a more viable enterprise.

To those who have invested, or are going to invest in the assets required to be a global player, go back to the latter part of 2009 and through 2010 and repeat or closely replicate what you did then – manage capacity to be more in line with the global market. A high percentage of your assets today are chartered not owned, start turning back those assets to the non-operating owners as the timing is right. Right-size the global fleets to reflect the global market. It will allow the stabilizing of prices and get you into the realm of reality on how much of a return it takes to prolong the effective financial life of the enterprise.

Manage the business as a business and not as a family enterprise; be in the business of making money by efficiently and effectively moving cargo, not in the cargo moving business trying to make money.

At the present levels of profitability and losses, within 5 to 7 years there will be far fewer companies in the business than there are today. How many? I've said for years that by 2021 or 2022 the Top 10 container carriers in the world will control 90% of the containerized capacity and market share. Nothing that I see today makes me think any differently.

Who else is impacted? Lots of people and entities, including shippers. If my forecast is correct on their being 10 carries who move 90% of the cargo, well let me remind you of the fact that in the 1970's there were over 25 major railroads in the US, now there are 4. How is it dealing with them today? They too were struggling back then to make money and had little incentive to invest in the future. Now they make record earnings and re-invest regularly, all good results for them and those who use them. They may not have the lowest rates in the world, but they are moving record volumes and are slowly regaining lost ground to truckers – who have a whole set of problems of their own.

Could it be that when there are 10 ocean carriers, the relationships will be very much like they are today with the railroads? Only time will tell.