Transition mode

Key **issues**

With no discernible peak season apparent this summer, we forecast only 3.4% growth in container traffic in 2012 with a small recovery to 4.9% in 2013

Spot market rates in the core Asia to North Europe trade have dropped 40% since their May high point and carriers are now under pressure to take action

Carriers are enforcing a $500 per feu GRI on the Asia-Europe trade in November, but we doubt its success unless carriers can back this up with further significant capacity cuts

We are projecting a very small loss for the industry this year – possibly a decent result given the awful performance during the first quarter

Carriers have deployed 5% less capacity in the core East-West trades this year than in January-July 2011, but it has not been enough to stabilise the industry

The orderbook is showing more signs of activity with carriers again interested in big ships governed by the slot cost argument and the need for fuel efficiency

Capacity management is crucial for this winter and into 2013 – more slow steaming and idling

The industry continues to be in transition and we believe that this will continue until at least 2014 and even 2015, by which time some supply-side pressures will at least have dissipated. Unfortunately, there are a number of negative influences in the industry right now and it will take some time for the key players shrug these off. We may want to fool ourselves otherwise, but the reality is that global demand is weak, asset prices are low, charter rates remain poor, ship financing is restricted, freight rates are under pressure, fuel prices are high and carriers have serious problems with cascading and deployment.

This year has been a strange one for the industry and ocean freight rates have generally not been governed by the usual supply-demand fundamentals. Most of the success of the carriers' GRI initiatives this year has been attributed to their uncharacteristically steely resolve. In other words, pricing between January and July was driven largely by carriers being prepared to pull capacity from particular routes and whether they prioritised rate increases ahead of market share.

Throughout the summer months during a time normally enhanced by peak-season volumes, Asia-North Europe load factors remained well below 90% and were probably closer to 80%. There was no peak season. Carriers tried to raise rates every month, but the inherent weakness of the market actually came to the fore and a serious market correction is needed quickly if carriers are to stem the continued rate erosion.

Since the market highs in May, Asia-to-North Europe spot rates have fallen by 40%. By the end of September, carriers had given notice of two service suspensions in the Asia-Europe trade, but in our opinion this is not enough. The major lines know that they need to keep spot rates as strong as possible because these will dictate where contract rates will sit for the next year – and to a large extent their revenue streams for the next 12 months.

To this end, most lines have announced Asia-Europe westbound GRIs of about $500-$525 per feu, effective 1 November. It should be remembered that whatever happens in the Asia-Europe trade tends to have an influence on most other routes.

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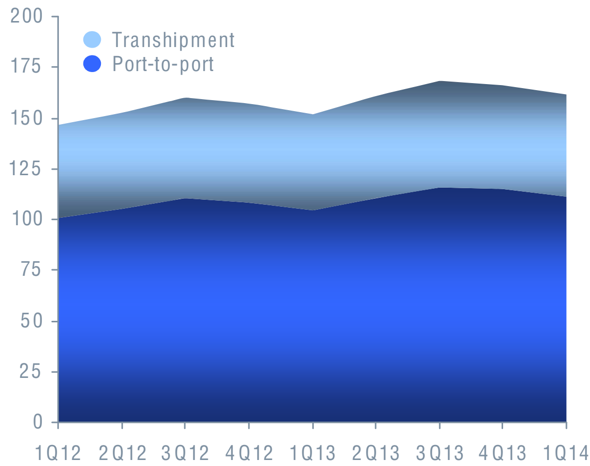
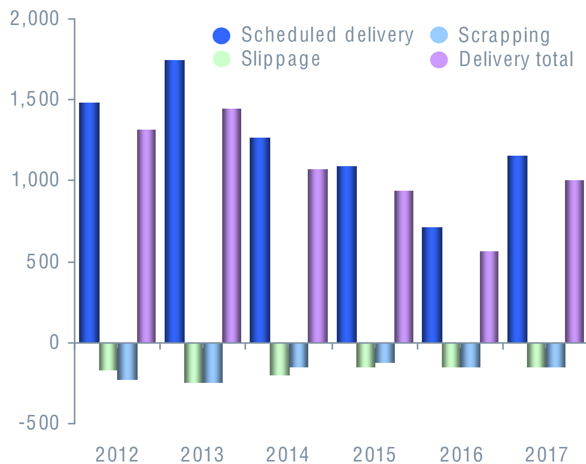
Figure 1.1 **Forecast development in world container traffic** (million teu)



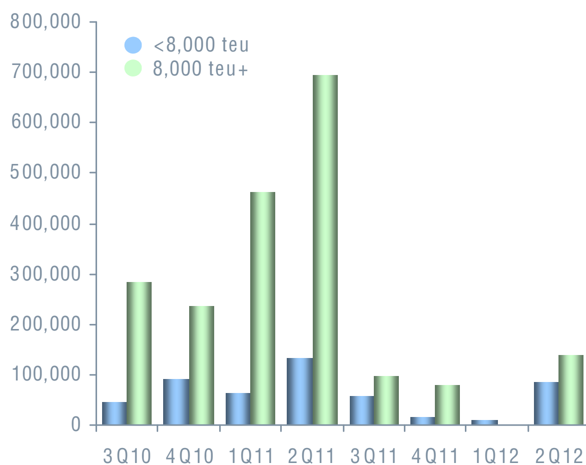
Source: Drewry Maritime Research

Figure 1.2 **Adjusted containership orderbook** ('000 teu)



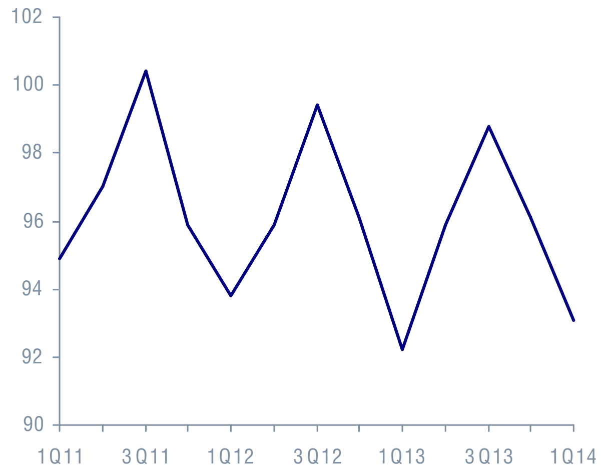
Source: Drewry Maritime Research

Figure 1.3 **Recent orders, split per vessel size** (teu)



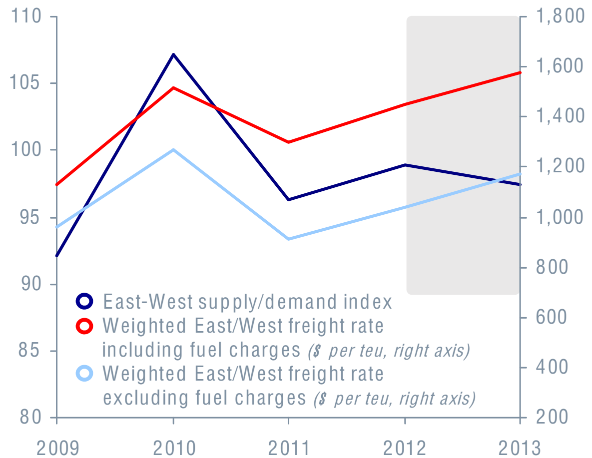
Source: Drewry Maritime Research

Figure 1.4 **Global supply/demand index**



Source: Drewry Maritime Research

Figure 1.5 **Weighted freight rates and supply/demand index comparison on East-West trade**



Source: Drewry Maritime Research

Carriers seem to be trying to push rates up significantly during the slack season without the support of favourable market supply-demand fundamentals – i.e. they believe they can do it merely by hard-lining. In our view, carriers will struggle to achieve this without the help of considerable adjustments on the supply side.

To be fair to the market leader Maersk, noises have already been made by senior executives that something will be done, although nothing concrete has been announced yet. Maersk North Asia chief executive Tim Smith promised, "It will be a significant adjustment we'll make in the fourth quarter."

Two factors have shaped the financial health of the industry in 2012 – the foolhardiness of carriers' strategic actions in 2011 and the obvious weak demand in the core

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Figure 1.6 **East-West trade spot rates, 2011-12 ($ per feu)**

Source: Drewry Maritime Research

Table 1.1 **Drewry – key supply and demand changes**

	Jun-12	Sep-12	Market direction
Global container traffic growth 2012	4.3%	3.4%	Downgraded
Global effective supply growth 2012	6.4%	5.3%	Downgraded
Global supply/demand Index 2012	95.7	96.3	Upgraded
Asia-N Europe w/b demand growth 2012	0.1%	-1.0%	Downgraded
Asia-US e/b demand growth 2012	3.1%	3.0%	Downgraded
Ave. E/W freight rates incl fuel - 2012	11.8%	11.6%	Downgraded
Ave. E/W freight rates excl fuel - 2012	13.3%	14.0%	Upgraded

Source: Drewry Maritime Research

trades experienced this year. We have downgraded our growth forecasts for this year to -1% on the Asia-North Europe trade and -10.5% on the Asia-Med: two routes that are also seriously affected by the delivery of new capacity.

With our forecasts for global container traffic growth of 3.4% for 2012 and 4.9% for 2013, carriers will continue to be seriously challenged on the vessel deployment front.

Our latest forecast is that the industry will be very close to break even for this year - recording a small loss of about $100 million on the back of their GRI work in March and April. This only serves to emphasise how much damage they had already done in 2011, which spilled over disastrously into the first quarter of 12, although a pat on the back to carriers could be considered for turning this around. But, the industry has now had three poor profit years in four and we are not projecting strong returns for carriers, even for 2013.

Hence, we maintain our stance that the industry has no choice but to continue to adapt in order to weather this difficult period. We do not necessarily expect liner companies to go out of business, but they need to manage themselves differently. For the short- to mid-term future, we foresee the following trends becoming more apparent:

- More vessel sharing agreements and operational alliances across all trade routes
- Proactive reaction to supply-demand imbalances and the emergence of more market leaders
- Consolidation in the shipowning sector
- Scrapping could increase, governed by asset prices and fuel-efficient designs
- Slow steaming incidence to increase, particularly in the North-South trade lanes
- Increased idling of vessels and a move to idling larger ships

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Surprisingly, carriers have managed capacity deployment pretty well this year, at least until the summer months. If we take the East-West core trades combined, 5% less capacity was deployed at the mid-year point in 2012 than in 2011. However, the debilitating effect of weak demand and the non-appearance of the peak season have worked against carriers and, with the newbuild delivery schedule for 2013, we expect there to be problems for a while yet.

In simple terms – the Asia-N Europe capacity adjustment is still only half way through completion, and if peak-season vessels are only 80-85% full this year, it can only be expected that carriers will have an even more difficult task to fill available slots in 2013. This will surely put more pressure on commercial pricing strategy.

Industry feedback suggested that the launch of Evergreen's Asia-N Europe CEM service in August, even at the 8,500 teu level, gave the rate erosion an increased momentum and the carriers concerned reverted to "capacity share" mode in order to fill slots.

Despite the pressing capacity concerns, recent reports suggest that there could be another mini-wave of vessel ordering after a rather quiet 9-12-month period. All carriers (including Evergreen) are convinced by the 'bigger is better' strategy for ships, and that this will drive down unit costs and give them a competitive advantage.

Our analysis in Section 5 shows how the cascade has worked its way through the system and average vessel size across the North-South trade routes is now 3,900 teu – up 18% year-on-year.

At the moment, the orderbook for 2014 and 2015 (but not 2013) is very small and there are several big orders that are under negotiation or have recently been concluded. They include:

- CSAV – up to 10 x 10,500 teu units with options for a further 10 vessels
- UASC – an order for as many as 10 x 18,000 teu or 20,000 teu vessels
- Yang Ming – 5 x 14,000 teu vessels
- CMA CGM – arranged long-term charter of 10 x 9,200 teu vessels ordered by Chinese container operator CIMC

The companies concerned will obviously disagree, but the industry simply does not need another injection of capacity. CSAV has once already put itself in a virtually untenable position by ordering too much capacity and we doubt the wisdom of comments made by its ceo that the company could go down the same road again. The threatened decision by UASC to join the big league must be considered as risky given its minnow status in the Asia-Europe trade lane.

The other factor driving ordering is the desire to deploy more fuel-efficient tonnage. New regulations concerning the use of low-sulphur fuel and the need to reduce CO2 emissions will become much more important by 2015 and this may lead to an increase in new orders placed and indeed in the level of scrapping. The relative worth of a vessel in both the charter market and the secondhand market is now very much driven by its fuel efficiency.

Given the number of factors currently shaping the industry, carriers seem to want the best of both worlds. They firmly believe that deploying ever bigger ships across all the major trade lanes is the way forward, and yet by doing this they cannot forget the likely negative influences on freight rates. The industry faces the fundamental challenge of aligning supply with demand in order to keep freight rates at healthy levels and yet at the same time relatively few carriers are prepared to take the lead and adjust capacity – or if they do, it is always on a reactive basis.

Rates on the Asia-Europe trade have been weakening rapidly since July and yet carriers have thus far stubbornly resisted any attempts to remove significant tonnage, as they did last year. Were they simply waiting for a peak season that would never come? Slow steaming has for some time been used primarily as a tool to help control capacity, rather than simply to save on fuel costs, but it cannot be considered as a panacea for the industry. Now is the time for carriers to implement capacity programmes seriously aimed at stabilising freight rates, or else the industry will caught in a current of falling rates while using GRIs to paddle upstream against market fundamentals. This may well have worked for the carriers in March/April of this year, but can they seriously rely on this strategy to control their revenue streams for the next few years, given the considerable worries about global demand? And will European regulators allow carriers to adopt overtly anti-cyclical pricing indefinitely?

A more realistic approach needs to be found. If the industry finds more responsible ways of adjusting trade lane capacity, there should at least be an opportunity for carriers to secure reasonable returns. Where are the new market leaders and why does this industry only react when Maersk decides to venture down a certain path?

For shippers, slow steaming will increase and we believe freight rates will remain volatile as carriers continue to react to supply pressures on a short-term basis. Additional costs such as low-sulphur fuel adjustments will also be continue to be passed on.

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