Diminishing returns?
Ports and terminals
February 2016

Are we entering a new period where the money to be made from ports and terminals is markedly less than it was?
Are we entering a new period where the money to be made from ports and terminals is markedly less than it was in the past?

Investing in and operating container terminals has long been a highly profitable and resilient business sector. Underpinned by strong historic growth in demand, the nature of the industry, with its high barriers to entry and limited local competition in each port market has consistently translated into healthy profit margins and returns on investment. Typical EBITDA margins for global container terminal operators have remained in the range of 20-45% year after year, for example.

Ports are not immune to the volatility of the market and the world economy, but have proven their ability to weather storms – even in 2009, a year where global port volumes fell by nearly 9% and the worst year the industry had ever seen, all of the main global container terminal operators maintained their EBITDA margins, at least in percentage terms.

However, the global container port industry may be entering a new phase of its development, where several of the key variables are looking increasingly challenging.

### Table 1: Then and now: Changing environment for port and terminal operators

<table>
<thead>
<tr>
<th></th>
<th>Container port demand</th>
<th>Containership sizes</th>
<th>Shipping lines</th>
<th>Competition</th>
<th>Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>10-15 years ago</strong></td>
<td>Strong demand growth</td>
<td>Limited growth in ship size</td>
<td>Smaller shipping lines and alliances</td>
<td>Competition for acquiring port assets</td>
<td>Generally high returns</td>
</tr>
<tr>
<td><strong>Today</strong></td>
<td>Weaker demand growth</td>
<td>Huge growth in ship size (raising terminal opex and capex)</td>
<td>Much bigger shipping lines and alliances</td>
<td>Greater international competition for acquiring port assets</td>
<td>Lower returns</td>
</tr>
</tbody>
</table>

Source: Drewry Maritime Research (www.drewry.co.uk)
Demand growth

In the period running up to the global financial crash in 2008/09, container port throughputs raced ahead averaging double digit growth each year (~11%). Since then, the new normal has been much lower growth (~5% p.a.). This in itself is not surprising (the double digit growth could not last forever), but more worrying is the recent hard slowdown in growth triggered mainly by economic and political changes in China. In 2015, global container port growth was only around 1% and in 2016 it is not likely to exceed 2.5%. These are the lowest growth rates ever seen by the industry (apart from in 2009). The industry has adjusted to a new normal of ~5% growth p.a. but what if the new “new normal” is less than half of this?

Figure 1: Demand growth slowing to a lower “new normal”? 

Source: Drewry Maritime Research (www.drewry.co.uk)
Ship sizes

The industry is seeing average and largest ship sizes increase in leaps and bounds – something that was largely absent in the period up to 2009. Cascading of vessels from one trade lane to another means that all ports are seeing substantial increases in vessel sizes. In a low growth demand environment, the deployment of bigger ships results in lower frequency services and greater volume peaks. For terminal operators, capex and opex costs are increasing while demand is relatively static.

Figure 2: Ship size growth on steep upward slope, TEU
Musical chairs – alliances

The formation (and re-formation) of larger carrier alliances means that for ports and terminals, the size and complexity of each customer (alliance) is increasing, along with their bargaining power. This is a double edged sword though, because as ships and alliances get bigger, the choice of ports and terminals that can accommodate them reduces. The creation of alliances has resulted in market share volatility for many ports – and the makeup of the alliances is going to change again soon due to M&A activity in the liner sector.

The new nature of demand is for less fragmented terminal capacity (fewer, bigger terminals needed in each port) which requires consolidation of terminals, both physically and in terms of ownership. However, such consolidation is complex and expensive, and may not be possible, or may take a long time to achieve.

Table 2: Musical chairs: Major shipping lines and their respective alliances

<table>
<thead>
<tr>
<th>Shipping line</th>
<th>Alliance</th>
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<tbody>
<tr>
<td>Maersk</td>
<td>2M</td>
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<tr>
<td>MSC</td>
<td></td>
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<tr>
<td>CMA CGM</td>
<td>Ocean Three</td>
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<tr>
<td>China Shipping</td>
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<tr>
<td>UASC</td>
<td>G6 Alliance</td>
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<tr>
<td>NYK</td>
<td></td>
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<tr>
<td>OOCL</td>
<td>CKYHE Alliance</td>
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<tr>
<td>Hapag-Lloyd</td>
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<tr>
<td>APL</td>
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<td>MOL</td>
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<tr>
<td>Hyundai</td>
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<td>Cosco</td>
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<td>K Line</td>
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<td>Yang Ming</td>
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<tr>
<td>Hanjin</td>
<td></td>
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<tr>
<td>Evergreen</td>
<td></td>
</tr>
</tbody>
</table>

Source: Drewry Maritime Research (www.drewry.co.uk)
Competition for port assets

The attractive nature of the industry has long meant that there is typically a high level of interest in privatisations and acquisition opportunities. However, this has intensified in recent years due to the emergence of aggressive new players keen to expand internationally. Companies such as China Merchants, Gulftainer and Yilport have been highly active. Purchase price multiples, which had come down to moderate levels after the excesses of the credit boom period in the mid-2000s, have begun to edge up again.

Figure 3: M&A multiples creeping up again

Source: Drewry Maritime Equity Research (http://dmer.drewry.co.uk)
Lower returns?

Figure 4: Drewry Port Index*: Return On Equity

Source: Bloomberg, Drewry Maritime Equity Research (http://dmer.drewry.co.uk)

Note: *The Drewry Port Index is a market-weighted index, comprising 11 listed terminal operators Drewry Maritime Equity Research covers globally. The ROE estimates of respective companies are weighted accordingly.

Figure 5: EBITDA growth estimates of Drewry Port Index

Source: Bloomberg, Drewry Maritime Equity Research (http://dmer.drewry.co.uk)
The combination of the above factors indicate that it is becoming increasingly challenging for terminal operators to maintain their typical historical levels of financial returns.

For reasons beyond terminal operators’ control, costs are rising markedly while revenue is increasing much more slowly.

There are several possible scenarios:

1. Terminal operators and shipping lines cooperate much more closely together to mitigate the negative impact of larger ships and alliances. This will undoubtedly help, but is unlikely to solve the problem entirely.

2. Significant price hikes are be obtained from shipping lines in order to balance higher costs and maintain margins. Shipping lines, already feeling severe financial pain from overcapacity and weak demand, will resist strongly.

3. Terminal operators accept a new era of lower margins and returns. Some operators and investors may choose to leave the market.

4. Terminal operators choose not to invest in new capacity because the returns are insufficient for their shareholders. This is an extreme option that will in effect leave shipping lines with nowhere to berth their large ships.

Our View

The global container port and terminal industry is on the cusp of a critical turning point. To safeguard the provision of suitable capacity and productivity for the long term, changes will have to take place to ensure sufficient returns on investment for port operators. Something has to give.

Author

Neil Davidson
Senior Analyst
Ports and Terminals
E davidson@drewry.co.uk
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- Operational assessments
- Commercial due diligence
- Financial modelling and analysis
- Investment and divestment appraisals
- Market studies and forecasting
- Vessel acquisition strategies
- Vessel valuations.

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