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Floating assets? How investors should think about container ships

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New investors are testing the waters. While container ships are an attractive bet at present, investors need to understand the risks.

The past 12 months have seen several investments in new container ships. The deals are notable both for the new investors coming into the sector, especially private equity, and for a geographical shift. Much of the new money is coming from Asia-based banks and investors. This follows the shift in shipping over the past 50 years, in which first shipyards, then shipping lines, and now funding shifted to Asia; the industry's center of gravity is moving east. For example, CIMC, a Chinese shipping group best known as a manufacturer of containers, has agreed to help finance ten new ships for CMA CGM, the world's third-largest container line.

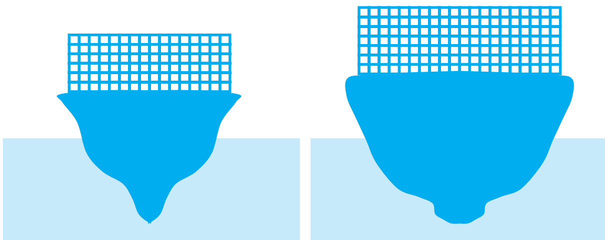
These moves, and others like them, have left some puzzled. Container-shipping companies continue to make losses. Shipping was one of the sectors worst hit by the crisis and continues to suffer from slowing trade growth and continued glut of supply. In this context, why are ships attractive assets? Why do container lines want them, despite the oversupply? And what is the opportunity for investors?

Lines need new ships...

The answer lies with the stubbornly high price of fuel, which accounts for about 30 percent of a container line's operating costs. Larger vessels burn less fuel per container—a main reason why ships have gotten progressively bigger in recent years. Now, even more important, there has been a major shift in ship design. Most ships today are narrow, streamlined vessels designed to travel at 25 knots and compete with air cargo (though few or none currently travel at this top speed, because fuel economy is greater at lower speeds). The newest designs have wider and flatter hulls; critically, they are designed for fuel-economizing speeds of 15 to 18 knots (Exhibit 1).

These new vessels are 20 to 30 percent more efficient in fuel cost per container. The net present value of the savings in operating cost is, in most cases, more than enough to justify the purchase price of the new vessel. Coupled with this, shipyards are struggling as they too face overcapacity. Prices for new vessels have fallen 25 percent from the peak in 2008 or so. A new large container vessel may now cost $100 million, whereas five years ago the same ship would have cost $130 million.

Exhibit 1 A new generation of vessels has arrived.



From	To
▪ Designed for speed to compete with air freight (25 knots)	▪ Designed for efficiency (15–18 knots)
▪ Narrow beam, V-shape hull	▪ Wider beam, U-shape hull
▪ Small, allowing liners to focus on frequency	▪ As large as possible, to capture scale economies

Fuel savings of 20–30% per container

...but don't have the money to pay for them

Some of these ships are already in operation. As more leave the yard, they will alter the industry's economics. Every container line will need the latest low-cost vessels to remain competitive. But most container lines do not have the cash to purchase new vessels themselves, due to several years of losses, and they are already highly leveraged.

This is a not unfamiliar situation—in past cycles, when container lines have lacked financing, shipping banks (mainly European) and German private shipping funds (called KGs) have stepped up to fund new vessels and lease them to the lines. But these traditional funding sources have dried up: banks and KGs are lumbered with losses from the large fleets of conventional vessels already on their books, for which they cannot find demand. The fleet consolidations that are currently being proposed for the banks and KGs will help, but they will not slow the coming obsolescence of the older design.

An unmet need could signal an opportunity—but beware the risks

The drying up of traditional funding sources, coupled with renewed demand for leasing from container lines, has led to today's opportunity for new investors. Returns well above cost of capital are possible, and latent demand for the efficient ships appears to be sufficiently large that the risk of underutilization in the medium term is small.

Investors are right to be cautious, however. The potential for high returns always implies high risks, and the container-shipping opportunity in particular exposes new investors to some complex and perhaps unfamiliar risks.

First, and most apparent, an investment in new-design shipping is a bet on high fuel prices. If crude oil fell to $50 per barrel, say, demand for the newer ships would evaporate, and lines would happily redeploy their older, less efficient tonnage.

Second, ship owners are exposed to the risk of a step change in technology—just like the one that is happening today. A new and as yet untested technological innovation (say, an engine design that can use now-abundant liquid natural gas for fuel) could render the newest megacontainer ships obsolete before they reach the end of their 20-year payback lifetime.

A third risk is the shifting dynamics of demand. As mentioned, latent demand appears strong. But at some point, appetite for the new efficient ships will fade. That point appears to be far off, but if the rate of new builds continues, in a year's time investors should worry.

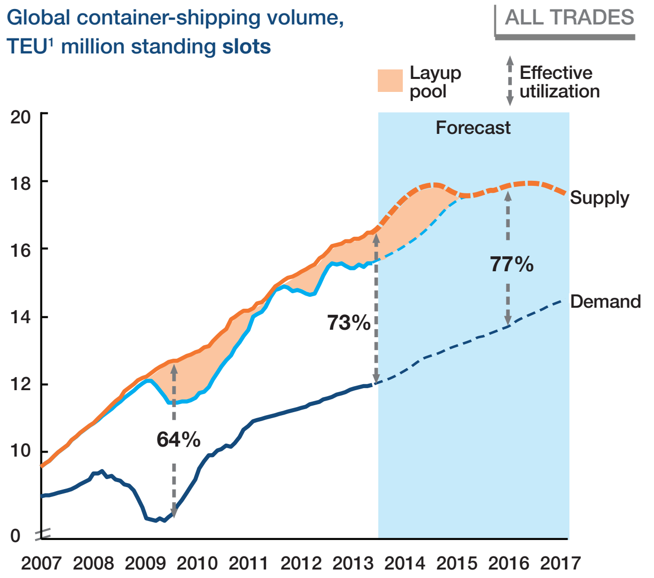
Finally, and most important, investors face the risk of credit exposure to the shipping lines. While lessors have an opportunity at the moment, the financial situation is likely to get worse for their shipping-line lessees. Oversupply is already chronic and increases with each new vessel. McKinsey projects that the supply-and-demand imbalance will only widen through at least 2016 (Exhibit 2).

Container lines will continue to feel massive pressure on yields as the new large ships are deployed—there is not yet sufficient demand to fill these new ships. Worse, vessels will cascade from Asia–Europe to other trade routes, forcing some routes that are today economically sound into loss. Absent massive consolidation and the write-down of billions of dollars of assets, it's hard to see how the container-shipping industry can be profitable in the next five years. Without those profits, shipping lines may not be able to pay for the leases they commit to for new fuel-efficient ships.

How can investors respond?

First, investors should get smart about the industry. This is not an easy asset class, and it pays to understand in detail the dynamics of market supply and demand, and their implications for vessel pricing and mid- to long-term utilization. For example, will the larger vessels lead to the emergence of a hub-and-spoke network model, thereby helping demand for smaller transshipment vessels as well? One private-equity firm used a sophisticated supply-and-demand model to identify a particular class of ships that looked to have more robust demand than others. Many new investors are partnering with ship-management companies or shipping experts to gain similar knowledge.

Exhibit 2 Oversupply is increasing.



1 Twenty-foot equivalent unit.
Source: McKinsey container forecasting model

Second, investors must be prepared to be resilient. History suggests they should expect some bankruptcies among shipping lines. If that happens, the leased vessels will return to the owners; investors will need to lay the groundwork so that they can quickly relet them to the remaining players.

Finally, investors should consider sharing some of the risks. For example, they might explore charter rates that are linked to fuel price, or to utilization. Shipping lines should be open to such innovations, especially those that help reduce short-term cash needs.

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The combination of a drying up of traditional funding and surging demand for innovative new vessels means a market opportunity. New investors can expect strong returns—but they need to get smart about the risks.

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