Teneo

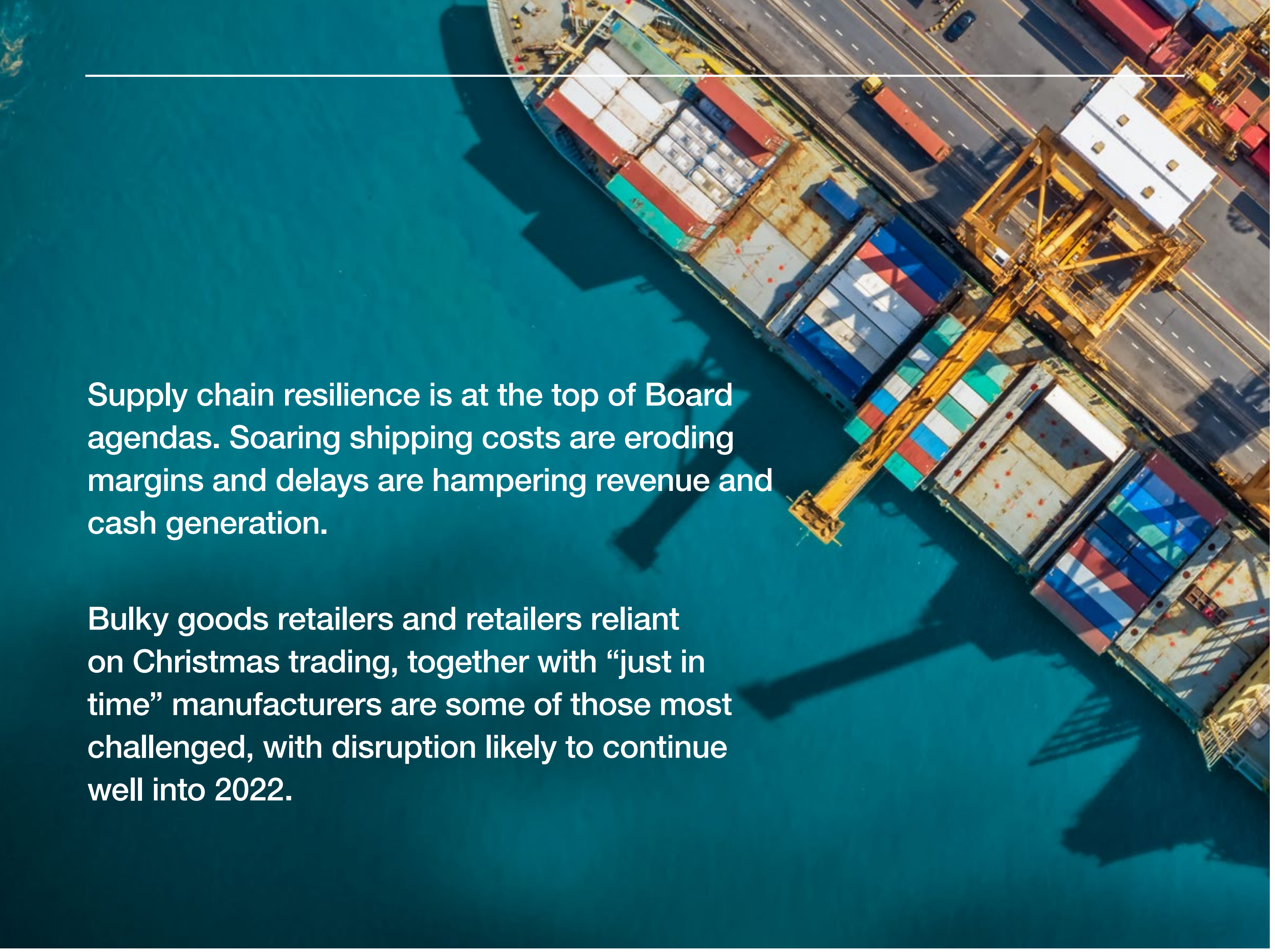
The Global CEO Advisory Firm

Supply Chain Crisis: Temporary Dislocation or the New Norm?

Part II: Global shipping disruption threatens the resilience of UK supply chains

Teneo Insights

October 2021



Supply chain resilience is at the top of Board agendas. Soaring shipping costs are eroding margins and delays are hampering revenue and cash generation.

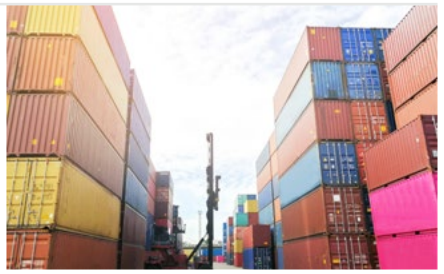
Bulky goods retailers and retailers reliant on Christmas trading, together with "just in time" manufacturers are some of those most challenged, with disruption likely to continue well into 2022.

Shipping: why is it in the headlines?

Resurging demand, a dislocation of containers, and delays at ports have sent prices across all routes out of China soaring, with no certainty of when the disruption will dissipate.

1. Container dislocation

As the initial stages of the pandemic eased and shipping resumed, thousands of empty containers were stacked up in Western ports, rather than in the Asian ones where needed. Even now, delays mean 20% more containers are bound up on ships than before the pandemic[1].



2. Consumer demand recovery

Demand for goods in the West rebounded robustly in the latter half of 2020, as people shifted consumption from services (e.g. hospitality) to goods (e.g. home improvements). With around 90% of global imports by volume transported by ocean freight[2], higher consumer spend translates into demand for container ships.

3. Delays at ports

Ports have been operating under heightened pressure due to Covid-19 safety measures and staff shortages. China's zero-Covid policy has led to weeks of Covid-19 lockdowns in some of the world's largest ports, including an unprecedented shut down of strategically vital ports such as Yantian and Ningbo last summer. Compounded by high levels of demand, ports are overwhelmed, reducing productivity and slowing turn-around times. In September 2021 a record 73 freight ships (vs. a norm of less than one) awaited entry into California's two largest ports, which account for a third of US imports[3]. This means ships are taking longer to return to Asia, with fewer containers, where they are desperately needed.

4. Suez Canal blockage

2021 has also seen the Suez Canal blockage in March. This stopped all freight for a week, and was estimated to be holding up $9.6bn of trade along the waterway each day[4]. In a freight network with capacity, rescheduling should have mitigated these shocks. However, with no spare capacity, blockages have a cascade effect. This has resulted in further congestion and delays, and therefore further capacity reductions as ships wait at port. This congestion is taking months to unwind.

5. Shipping companies' response

Shipping companies are earning record profits as they secure higher pricing in a market where demand exceeds supply. Hapag-Lloyd's profits for the last six months have outstripped the combined profits of the last decade, whilst Maersk has upgraded its full year profit forecast for the third time this year, from $4-6bn in February, to $14-15.5bn in August, to $18-19bn in September.

However, there has also been investment in supply. In 2021, orders for new container ships have already set an annual record after just eight months of the year, as well as orders to make millions more containers. Whilst supply will dramatically increase (there are currently 687 container ships on order, supporting 5.6m in TEU capacity), with a two-to-three year lead time on ships, this release valve will not start to operate until 2023.

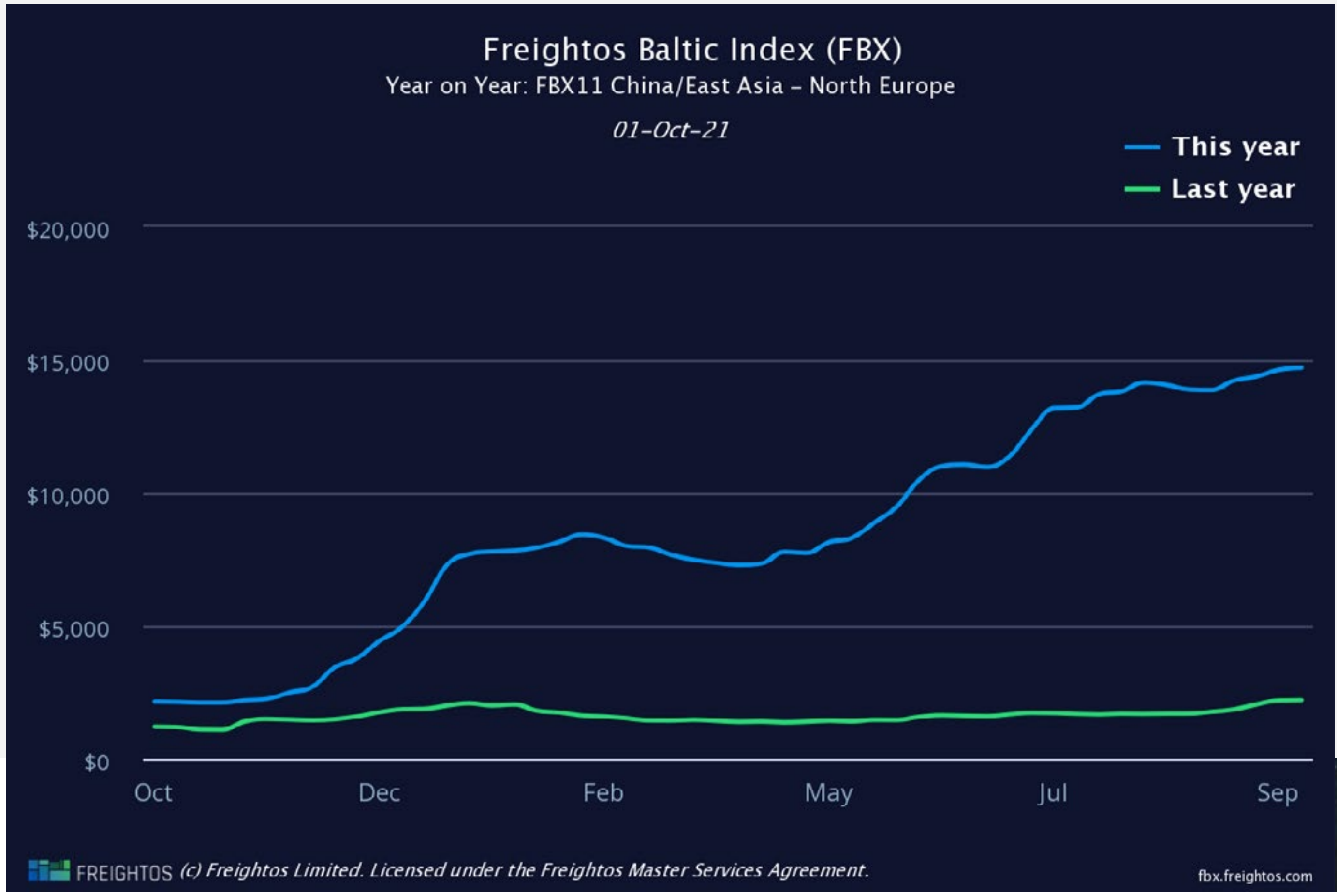
The repercussions for businesses on shore

Delays

The shipping cycle has been severely disrupted since 2020. The average door-to-door shipping time for container shipments has gone from 41 days pre-pandemic, to 70 days[5].

Higher costs

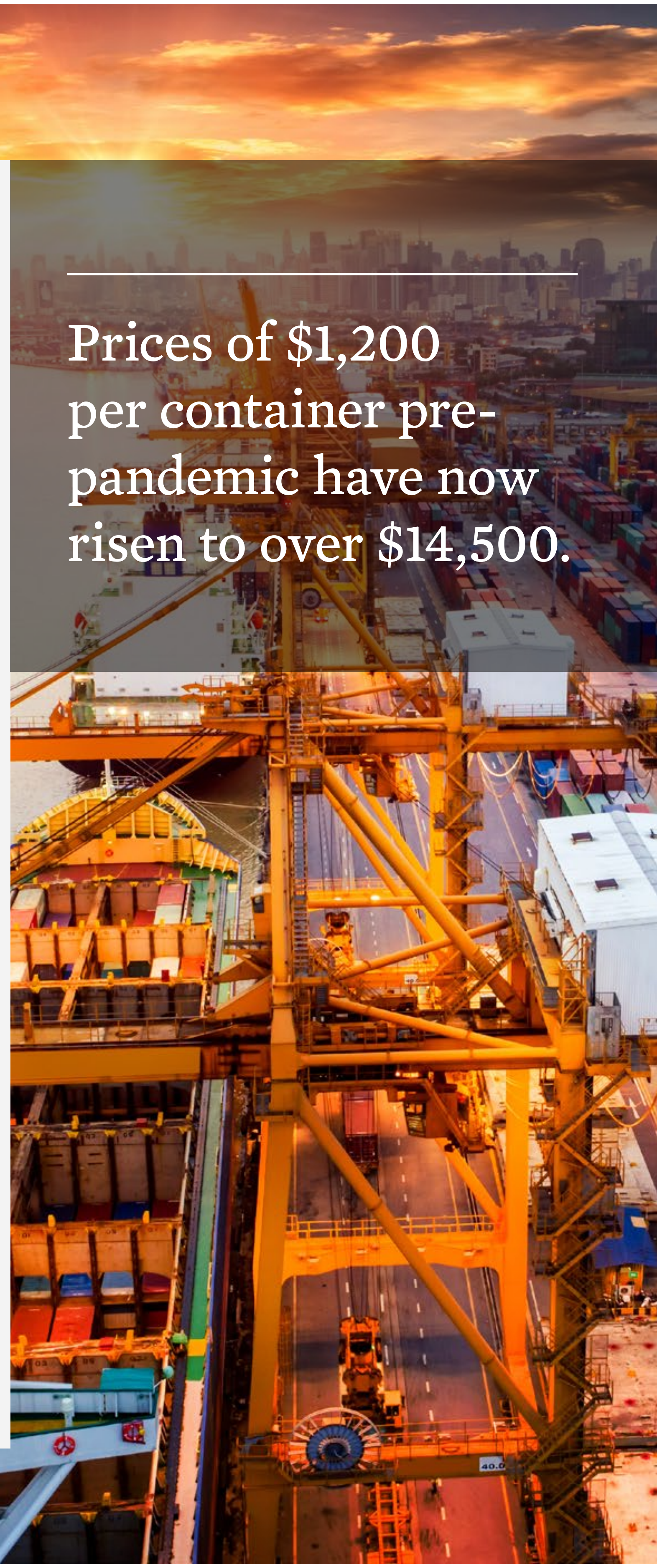
Having been relatively stable for a number of years container shipping rates doubled in the year to October 2020. However, the key China – North Europe shipping route has seen a startling 600% rate increase since October 2020[6].



Size counts in the race to secure containers

Moreover, some businesses are struggling to secure container space at all:

- The likes of Walmart, Ikea and John Lewis have chartered ships and additional freight capacity to secure certainty[7]. Coca-Cola has chartered three bulk carriers (usually used for products like coal or grain), instead of conventional containers to keep production lines running. Other large companies have trucked goods from China to Europe and then shipped across the Atlantic to avoid Chinese ports.
- These solutions are beyond many businesses. SMEs have experienced delays of weeks in securing container space, resulting in lost revenues, and are less likely to have dedicated procurement teams to navigate these resourcing challenges.
- Air freight is costly and in short supply given reduced air traffic (a significant proportion of air freight has been transported in the belly of passenger planes historically), making it only relevant for those with high value, low weight, and time critical goods.



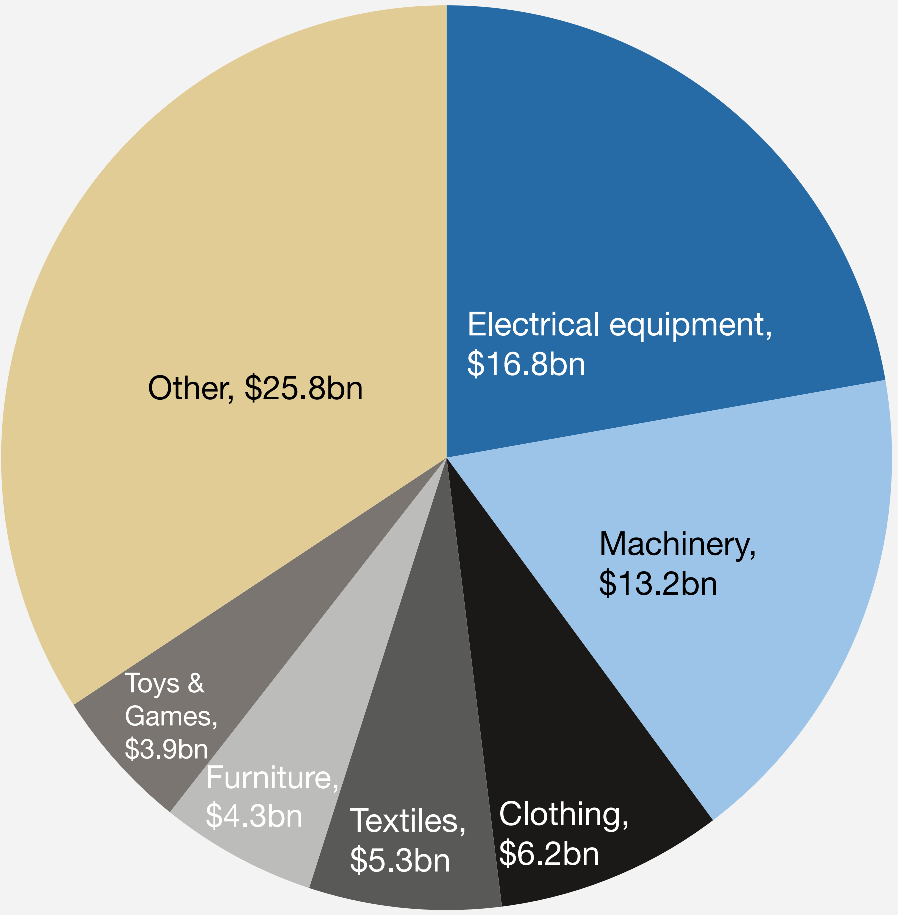
Prices of $1,200 per container pre-pandemic have now risen to over $14,500.

Who is impacted in the UK?

Ultimately, each business' ability to minimise operational and financial impacts will be unique to its own operating environment. However, to consider how sensitive different importers will be, we explore three key factors:

(i) the type of product and its criticality to the wider supply chain;
(ii) timing sensitivity and;
(iii) balance sheet strength to secure continuity of service.

In 2020, the UK imported $75.4bn of goods from China across a range of products as illustrated below:



Source: Trading Economics, UN ComTrade data

	More vulnerable	More resilient
Product and margin	• Low-cost and bulky goods • Goods which are easily substituted by customers, or with limited price elasticity • Products which are integral to a complex production line Examples: furniture (particularly low-cost or garden), bulky electrical goods and machinery. Companies face a choice between raising prices (and risk not selling stock) or absorbing eroded margins. The price of not accepting high shipping costs is lost revenue and cash conversion, and ultimately market share. *A national furniture retailer client has projected a fall from c.40% gross margin to sub 20% unless it is able to increase selling prices.*	• Small products • High margin products • Goods with a differentiated market position or not easily substituted Examples: high-end retail and re-sellers of small electrical components e.g. computer chips, semi-conductors. *Small is beautiful: for a 40ft container of 8,000 pairs of shoes, the current extreme costs should be "bearable" according to the head of a large European manufacturer. The shipping cost per pair was 25 cents a year ago, now it stands at $1.75[3].*
Time sensitivity	• Highly seasonal businesses or products • Complex production lines • "Just in time" operating models Examples: retailers reliant on key shopping windows (e.g. Christmas and Black Friday) and manufacturers dependent on imported components that are critical to keep production lines running. *A national clothing and homeware retailer is resorting to air freight to ensure product supply ahead of Christmas trading period.* *This business was concerned about stock shortages due to delays, followed by stock write-offs if stock arrived outside of the critical window. It concluded the margin impact of expensive air freight was worth pursuing to deliver certainty.*	• Non-seasonal businesses • High inventory reserves • On-shore or near-shore supply chains Examples: manufacturers who can easily substitute components from closer sources, or who source and make their products in the UK, supermarket chains to an extent, as their time critical products are likely to use air freight already. *A fixings and fastenings wholesaler normally holds 4-5 months' worth of stock in the UK. These buffer stocks have helped minimise disruption, and enabled them to keep selling goods to customers, potentially taking market share from competitors awaiting deliveries.*
Balance sheet strength	• SMEs • Weak balance sheet or limited cash reserves • Weak relationships with shipping companies, historically 'shopped around' for the best freight rates Examples: SMEs with limited financial strength to secure container space or higher cost alternatives and those with smaller margins are more vulnerable to lost sales.	• Financial firepower to absorb the working capital impact or secure container space • Advance contract on shipping rates or other means of hedging their freight cost • Businesses with experienced procurement teams Examples: larger, more sophisticated businesses are likely to have more mitigation strategies in place and alternatives to deal with disruption.

Questions C-level executives and their procurement teams should ask themselves

	Margin protection	Supply chain resilience
Short term	*"What is the margin impact of sustained shipping costs or indeed further rises?"* *"Have you assessed the price elasticity of your product and your ability to pass this cost on to customers?"*	*"Does the business have alternative supply options it can access in short order?"* *"What assessment have you made of the supply chains of your tier one suppliers (or wholesale network), particularly for reliance on critical parts or products?"*
Medium – long term	*"What is the impact of sustained high shipping rates and disruption potentially continuing to Chinese New Year and beyond?"*	*"What is the margin and resilience trade-off under your current sourcing strategy? Does the shipping disruption show the current strategy to be fit for purpose or does it expose the business to too much risk?"* *"What near-shore alternatives could you consider to embed greater resilience, and what impact would this have on your working capital and ordering cycle, and margin?"* *"Integrated supply chains: Where you rely on Tier 2 and 3 suppliers, do you understand their reliance on sourcing from the Far East? Can you demand more transparency or control over critical items?"*

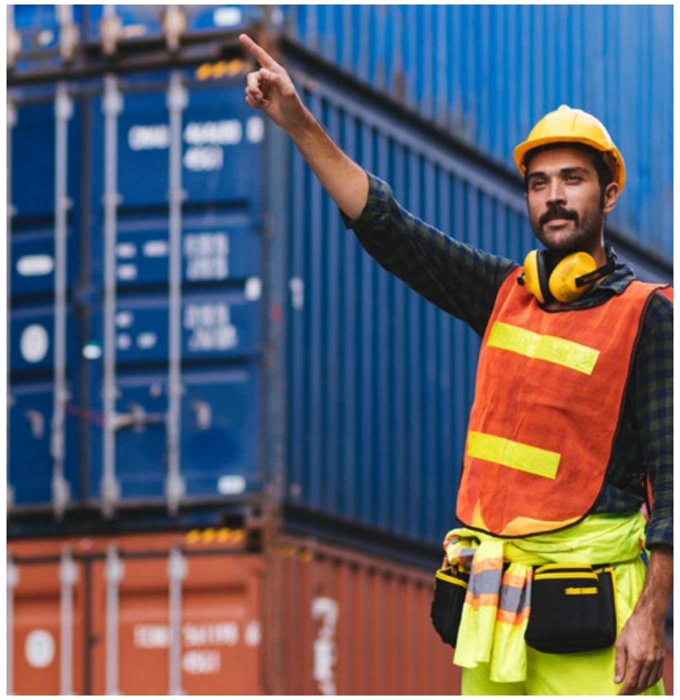
	Minimising logistics disruption	Financial planning
Short term	*"How are you securing and then allocating scarce container space?"* *"Have you factored into your forecast the impact of lost sales (and cash generation) if stock does not arrive for key trading periods?"* *"What is your stock clearance strategy if you miss the Christmas trading window?"* *"Have you considered air freight for non-bulky goods to ensure adequacy of stock, factoring in margin impact?"*	*"Are you buying at spot rates? If not, what level of hedging do you have in place and for how long?"* *"How are you forecasting and managing working capital through this challenging period?"* *"How are you communicating with your key stakeholders (e.g. lenders) as to the potential impact on trading, working capital and covenants?"*
Medium – long term	*"What level of buffer stock do you need to hold to mitigate against future dislocation events (e.g. further port shutdowns)?"*	*"What hedging strategy can be put in place to mitigate further shipping cost increases?"* *"Can you change your operating model to drive out cost to offset increased shipping rates?"* *"ESG planning and long term impact of maintaining distant supply chains"* *"Have you considered the consequences of sustained higher shipping prices / delays on your margin outlook and how this may flow through to longer term EBITDA generation and financial stakeholder implications (e.g. meeting investment case for PE sponsors or refinancing discussions on debt)?"*

Charting ahead

Immediate focus

In the weeks and months ahead, affected businesses will be navigating through the challenges of:

1. Stock levels (shortages and holding out of season stock);
2. Margin pressure (defined by ability to pass on price rises); and
3. Impact of ongoing lockdowns (e.g. Vietnam), to minimise trading disruption.



Duration

The rebalancing of freight supply and demand looks unlikely to emerge in the short term, with many commentators expecting no meaningful improvement until after Chinese New Year in February 2022.

Moreover, it is unlikely that prices will “tumble” to historical levels in short order beyond this point, due to the long lead times to bring new capacity to the market.

During this extended period, price rises will be pushed on to the end customer who may start to purchase less, and only as this limit to price elasticity is reached will consumption drop and ultimately flow through in to reduced shipping prices.

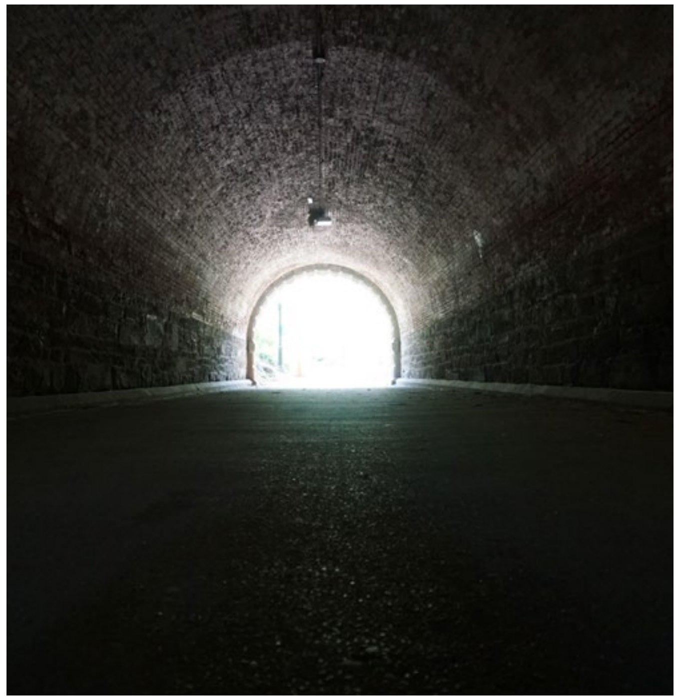
Building resilience

Given the fragility of the position and the impact of any further shocks, (e.g. another port closure) businesses are already setting aside investment for buffer stocks far in excess of pre-pandemic levels.

However, with reliability and resilience a much higher priority in the medium to long term, businesses are also starting to assess near shoring options to ensure breadth of sourcing strategy. Whilst for some, this shift in strategy will result in loss of margin, in other cases it is being offset by the resulting working capital gains.

More widely, geopolitical pressures and trade wars may lead Europe and the US to re-focus on domestic production capacity. This would radically reshape global trade patterns, employment opportunities and capital flows, and create significant change for container shipping.

However, with $75bn of imports from China alone, the ability of factories with capacity and skills in Europe and the US to ‘shift the dial’ would require extraordinary investment in the medium term.



Light at the end of the tunnel?

However, there is hope in an unexpected form; CMA CGM, the world’s third-largest container-shipping firm, stunned the industry by announcing it would cap its freight spot rates until February 2022.

Furthermore, a slow-down in growth in China is anticipated, as it experiences a “power crisis”, driven by coal shortages and high prices. This affects steel, aluminium and cement industries in the first instance, but it has also led to electricity rationing. We expect the effects will ripple out across a wide range of industries, and may reduce the volume of exports.

Ultimately, container shipping has historically been a heavily commoditised service. As new shipping capacity comes into service and the current supply and demand dislocations are overcome there will be a long term return to lower levels but potentially far higher than pre-pandemic.

How Teneo can help

If any of these issues resonate with you, please contact Teneo's team of situational and sector experts below.

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Appendices

1 Financial Times: Record freight container production fails to ease supply-chain crisis

2 Ocean shipping and shipbuilding - OCED: https://www.oecd.org/ocean/topics/ocean-shipping/

3 Maritime Exchange of Southern California

4 The cost of the Suez Canal blockage: https://www.bbc.co.uk/news/business-56559073

5 Freightos, a digital freight marketplace

6 Freightos Baltic Index

7 Maritime Executive: Ikea is Buying Containers and Chartering Vessels

8 Freightos Baltic Index, Teneo analysis

Sources:

Freightos Baltic Index, The Financial Times, The Economist, Business Insider, New Statesman, BIMCO (an international shipping association), Freightos (a digital freight marketplace), Drewry (a maritime research and consulting business).

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