Week in China

FOCUS

Summer 2017
www.weekinchina.com

Ruling the waves?

New fleets, new ports and new shipyards: how China is setting sail in the world of merchant shipping

CHINA'S BELT AND ROAD WILL RESHAPE THE 21ST CENTURY ECONOMY.
WE KNOW THE WAY.

Forecast to boost trade to $2.5tn per year in the next decade and reaching 63% of the world's population, China's Belt & Road Initiative will change the face of global trade. HSBC's vast experience of doing business with China, alongside our strong global footprint, can help your business navigate the opportunities.

Visit rmb.hsbc.com

HSBC

The shipping forecast

How Belt and Road is set to bolster China's maritime ambitions

Table of Contents

Shipping's contribution to the global economy is often overlooked, perhaps because so much of it is happening over the horizon, far from human habitation. In fact, the sector is crucial to our everyday lives with more than 90% of the world's trade carried by sea. Without seaborne transportation supply chains would seize up, power would run out and supermarket shelves would empty.

China's contribution to the maritime world has been mixed, however. Six hundred years ago its imperial fleet was unrivalled in size and sophistication, sailing vast distances in search of trade and commerce. Yet there were later periods in which China's emperors turned inwards, outlawing ocean-going travel. One of the consequences of this isolation was the so-called Hundred Years of Humiliation from the mid-19th century, when the Qing were forced to cede sovereignty in the Treaty Ports, cowed by the gunboats of the European powers.

Much more recently, the Chinese have been rediscovering their maritime instincts, although the media coverage has mostly carried headlines about Beijing's military aspirations, including the commissioning of its first homegrown aircraft carrier and the efforts to take control of disputed islands in the region's seas.

China's influence in the world of merchant shipping is less remarked upon, despite its emergence from a period in which its fleet was a rounding error to a position today in which it has become a key player.

This transformation – and its impact on the wider shipping world – is the topic of this Focus edition, the latest in WiC's series of special publications.

Boxed in: containers at the port of Qingdao in eastern China

China sets sail

On most of the maritime metrics, the Chinese are now a major force. China's shipping lines carry the most cargo, with the largest share of the world's agricultural and industrial commodities making its way to Chinese ports, and two-thirds of the world's container traffic handled by Chinese-owned or invested terminals. The proportion of the global fleet under Chinese ownership has grown substantially over the last 20 years and the Chinese have the largest order book for new vessels, many of them from the country's own shipbuilders.

None of this would have been imaginable 40 years ago when Deng Xiaoping's reforms launched the Chinese economy in the modern era. This process of opening up to the wider world only picked up rapidly in pace – as far as the shipping industry was concerned – after China's accession to the World Trade Organisation in 2001 (see section one for more on China's growing significance to the shipping cycle). But the boom was followed by a devastating bust, brought about by a cavalcade of construction at China's own shipyards (we look at some of the challenges facing China's shipbuilders in section four).

The Belt and Road boost

Compared to the golden era a decade ago, shipping has spent the last few years in the doldrums, trying to survive much tougher trading conditions. Nonetheless, Chinese firms have strengthened their position in terms of vessel ownership (see section two) and by controlling some of the largest lines and newest ports (see section three).

Over the last six months there have been signs that prospects might be improving in shipping once again. Over the longer term the great hope is that China's Belt and Road Initiative – a multi-year programme of billions of dollars of investment in trade and transport infrastructure along the ancient Silk Road to the Mediterranean and Africa – will serve as a catalyst for growth.

WiC reviewed Belt and Road in more detail last year (the full edition is available to download at http://www.weekinchina.com/focus-editions/) and we won't cover the same ground in this publication. But the maritime element of the plan


THE NEW SILK ROAD,
WHERE WILL IT TAKE YOU?
With the One Belt, One Road initiative bringing together Africa, China, Central Asia, Europe and Russia, significant opportunities will arise for ambitious businesses.
At HSBC we have always been committed to connecting customers to opportunities, by providing expert local knowledge through our global network.
Explore how far the new roads to China could take you.
Visit our RMB Resource Centre at www.rmb.hsbc.com
HSBC
Issued by HSBC Holdings plc.

Photo: Basil Pao

is going to have the greatest impact, simply because the massive majority of goods are shipped by sea. For all the talk of new roads, railways and pipelines, they will never sideline seaborne traffic. As a single example: the Silk Road freight trains that are connecting cities in China with Europe carry just 1% of the cargo of the largest containerships.

In the shorter term, building the Belt and Road's infrastructure will be more beneficial for the bulk shipping lines, with more cargoes of steel, cement and construction equipment. Steelmakers will want more iron ore, keeping the Capesize fleet busy transporting it from Australia and Brazil, and the new power stations in the plan will need greater supplies of coal, boosting bulk shipping again.

In the medium term, Belt and Road is promising to bolster the economies of the participating nations, which should prove a positive for the container lines, with more spending on cross-border goods. And the rollout of the plan will also have an impact on how some of that trade is transported. Container terminals in northern Europe have welcomed the lion's share of Asian exports for decades but Chinese investment in the Mediterranean is already encouraging new activity along Europe's southerly edge. Ports in Sri Lanka are offering new transshipment options in the Indian Ocean, while terminals along Africa's eastern coast will open up markets too.

90%

The share of global trade carried by sea

Are the Chinese taking charge?

One of the suspicions sometimes cited about Belt and Road is that it is designed to give the Chinese greater control over the world's trade routes, making it easier for their companies to dominate foreign markets.

Chinese spending on ports and fleets has triggered similar fears of a takeover in merchant shipping and it's certainly the case that parts of the industry have grown more dependent on the Chinese as customers and investors.

It's also true that the Chinese government would like the country's shipping firms to establish a more commanding position. This is a recurring theme in this Focus edition and we review the debate on maritime mastery in the final section.

What is undeniable is that China's economy has been a mainstay for the shipping sector, chewing up imports of raw materials and churning out exports of finished goods. The container trade grew at a faster rate than global GDP for years, while China's appetite for coal and iron ore has been fundamental to the fortunes of the bulk carriers. The Chinese are now trying to reduce some of their reliance on fixed investment and exports as engines of economic growth, turning more of their attention towards the services sector and a stronger role for domestic consumption. Both trends could dull some of the demand for shipping's services but as far as the world of merchant shipping is concerned, China's contribution is still going to be crucial.

Boom to bust, and back again?

Ruling the waves: China's rise has reshaped the world of shipping

China's economy has grown at such a bewildering pace in the last 20 years that some of its more recent records haven't raised much reaction, however staggering the statistics might be.

So it was easy to miss another mind-blowing milestone when the Chinese topped a billion tonnes of imports of iron ore last year, accounting for more than two-thirds of seaborne trade in the commodity. A delivery rate of 32 tonnes a second is barely believable in logistical terms and it would have been impossible to imagine in 1961 when China's government acquired the first ship for the newly created China Ocean Shipping Corporation (or Cosco as it came to be known).

A second-hand passenger steamer was purchased from a Greek merchant and it sailed to Jakarta on its maiden voyage, ferrying back to China some of the Chinese-Indonesian migrants unnerved by local unrest in the Southeast Asian country.

The longer-term goal was to carry a greater share of China's trade on ships of its own, however, and Cosco responded by building up its fleet, largely through purchases of vessels from overseas.

All the same, the merchant fleet wasn't much larger than a few hundred vessels at the beginning of the 1980s, when Japanese lines were carrying the large majority of Chinese exports and foreign brokers were arranging most of the ships that were importing commodities for its industrial base.

Previous contact with the shipping world had been limited to joint ventures with communist partners in countries such as Albania, Poland and Czechoslovakia. But by the time that Tim Huxley – now the chairman of Mandarin Shipping,

Photo: Reuters

Once the dominant gateway for Chinese exports: Hong Kong's container port

an owner and operator of feeder container ships – started his career in ship broking in the 1980s more of the business was shifting to Hong Kong. Contact with key customers across the border was heavily restricted, however. Sinochart, a government agency, had sole responsibility for chartering and its relationships with the shipbrokers were limited. "We never met any of them in person and they were identified only by number so we didn't even know their names," Huxley recalls. "We would send them the lists of ships that were available and then negotiate the rates entirely over the telex machine. It was all centrally controlled, so effectively we were haggling with the Chinese government."

Hong Kong's shipbrokers had little experience of Chinese vessels, most of which were operating in China's coastal waters, and contact with the country's shipbuilders was also minimal, because the shipyards didn't have an international outlook.

"That was apparent in things as basic as the design of the railings in the engine rooms, which were too small for Westerners to get their hands around without chafing their knuckles," Huxley remembers.

Trade starts to take off

As China's economy began to open to the wider world, contact with the world's merchant fleet started to broaden as well. "Sinochart's stranglehold on bulk chartering didn't last for long," Huxley says. "Ocean Tramping and Yick Fung – two state-backed firms that worked primarily with Chinese customers – began to contract for more vessels, and they were joined by industrial giants like Baosteel and Sinochem, who even purchased some of their own ships."

Something similar was happening in the container trades, where Richard Hext was working for the shipping division of John Swire & Sons.

When Hext first arrived to work as a "ship jumper" in Hong Kong in 1978 China's manufacturing miracle was only just beginning and the majority of exports were coming direct from the British colony, which was still a manufacturing hub in its own right.

"All the container boxes at the port were either identified as Hong Kong 'local' cargo or Hong Kong-China transshipments, and for the early years of my career the 'local' category was the bigger business," he says.

The growth of export processing zones in the Pearl River Delta and around Shanghai soon meant that more of the trade flows were starting to originate across the border in China. For a while Hong Kong kept a firm grip on the international container trade, because the ports in China were so inefficient. Heavy congestion was keeping vessels waiting at anchor for days. In the early 1990s in-

Tim Huxley: formerly of Clarksons and Wah Kwong Shipping; now managing director of Mandarin Shipping

Photo: Reuters

vestment in modern terminals and deepwater berths was reducing the delays. By then Hext was running P&O Swire Container's trade between Australasia and Asia (now a part of Maersk) and his business was one of the pioneers in making direct calls at China's export hubs. "Shanghai was first for the Australian trade but there were more direct services to other points as trade flows grew, including the new terminals in Guangdong province, which were undercutting Hong Kong on price," he recalls.

Inbound flows of commodities like coal, iron ore and oil were growing rapidly as well, fuelled by urbanisation and industrialisation in the Chinese economy, and the consequences for the shipping industry were profound.

Construction of larger cities with bigger populations – as well as the infrastructure that connects them – generates greater demand for steel. Steelmakers need raw materials, especially iron ore, which thus is imported in ever-growing quantities by the bulk shipping lines. Increases in industrial activity pushes up demand for electricity, requiring more shipments of fossil fuels such as coal or oil. And as China's provincial economies modernise their exports increase, stimulating demand for containerships to carry the finished goods.

China's GDP was expanding at a pace and scale unprecedented in history. Total imports surged from 200 million tonnes in 1998 to a billion tonnes in 2008, accounting for 60% of the growth in seaborne trade. Exports trebled from 150 million tonnes to 400 million tonnes, and containerised exports grew even faster, increasing at 25% a year on the key US and Europe routes.

"These trade flows are what changed the world of shipping. Demand for raw materials saw China's industrial economy come to life, boosting the bulk trade, and then exports took off, triggering the surge in the container business," Huxley says.

Richard Hext: formerly of John Swire & Sons and Pacific Basin Shipping; now chairman of Vanmar Shipping

The boom in dry bulk

The clearest evidence of how China was transforming the shipping world came in the five years after 2003, which was a golden period for the dry bulk carriers.

For much of this time Hext was in charge of Pacific Basin Shipping, one of the leading fleets of mid-sized dry bulk vessels. Demand from China for commodities like coal and ore was already buoying prices, he says, but a key factor in the subsequent surge in charter rates was a shortage of ships. Shipbuilders had suffered from years of low profits before the boom, so shipyard numbers had dwin-

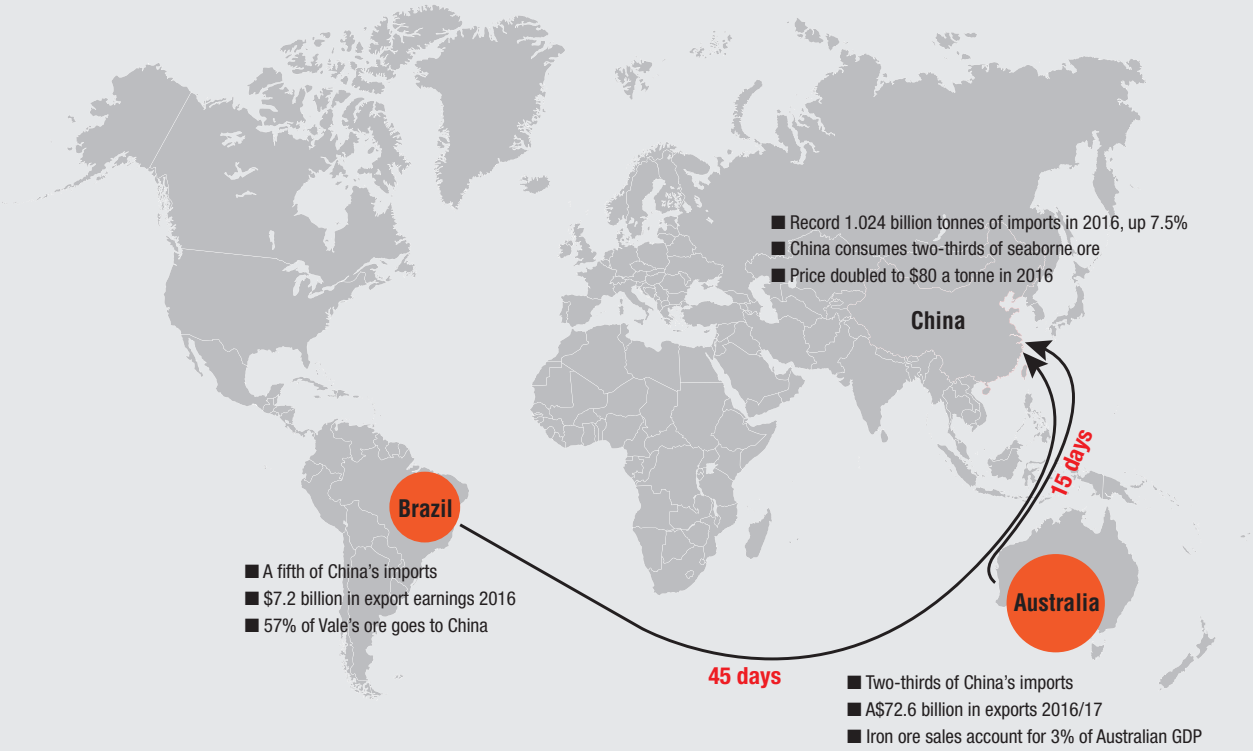
Photo: Reuters

Iron ore stockpiles at the port of Tianjin

75%

The new vessels on order at the height of the 2003-2008 boom, as a percentage of the existing fleet

Iron ore rivals: Australia and Brazil



Source: CRU, BHP Billiton Analysis. Location of the trade flow arrows in indicative

Iron ore prices are heavily determined by demand from the Chinese steel industry. When sectors like property construction and car making are running at full tilt, the steel mills favour higher-grade foreign ore so that they can maximize output. Most of it comes from mines in Australia and Brazil, which provide about 80% of China's ore imports between them. Australian exports – led by shipments from Port Hedland in West Australia – are the largest because the shorter distances and lower freight costs to China give the sellers a higher margin. However, Brazil clawed back a little market share last year, shipping most of its ore out of Tubarao, another jumbo-sized port. Rizhao, Tangshan and Caofeidian are among the key ports for unloading in China, although Qingdao in Shandong province is the biggest recipient of shipments.

dled. When China's appetite for iron ore suddenly started growing at 15% a year, there wasn't the seaborne capacity to carry it.

"We got to a point where there simply weren't enough ships to meet demand and by 2007 the freight rates were going through the roof," Hext confirms.

As the super cycle accelerated, charter rates for Capesize vessels – the largest in the dry bulk fleet, and the biggest carriers of iron ore – climbed the highest, surpassing $150,000 a day at their peak. The supercharged returns also drove up asset prices, with the price of a modern Capesize rising from $24 million to as much as $165 million five years later. Hext says that many of Pacific Basin's fleet quintupled in value between 2004 and 2008, while the company's share price rose more than sevenfold in what was one of the most profitable periods in the industry's history.

But the super cycle was sowing the seeds of its own destruction as the lure of quick profits saw investors pour unprecedented capital into shipbuilding.

A conversion programme of oil tankers into ore carriers brought more vessels into service in some of the most overheated parts of the market but capacity really surged as a result of hundreds of new shipyards in China, which were churning out new vessels in record numbers. The result: an order book that soon ballooned to more than 75% of the existing fleet.

All of this was happening as the impact of the credit crunch began to ripple through global finance. Slowdowns in the wider economy were starting to take

China's steel mills: key customers for iron ore

hold in the US and Europe, and the mood darkened in China too, where steel production crashed and economic growth fell to its lowest level since 2001.

Lehman Brothers collapsed in the autumn of 2008 and trade finance dried up completely, just as many of the new ships were setting sail for the first time. Freight rates dropped viciously and the market in dry bulk charters capitulated in a matter of months. Average daily rates for Capesize charters had been $175,000 in the second quarter but they had disintegrated to not much more than $2,300 in the first week of December. The super cycle had come to a shuddering halt.

China as the market maker

The shipping world has spent most of the last nine years trying to survive the effects of the market collapse, particularly in absorbing the oversupply of new vessels.

The adjustment has been more painful in a time when the world economy has been slowing. Average growth in global export volumes was 2.9% between 2008 and 2015, according to IMF data, or less than half the corresponding figure for the previous seven years.

Bigger picture, the landscape has been changing from a period in which China's impact was felt most as a customer – and as the key contributor to the fabulous profits that were made at the peak of the market.

Over the last decade the Chinese have been emerging as competitors for the international shipping lines, and companies like Cosco and China Shipping have built up their own franchises in the bulk and container trades (see section 4).

Equally significantly, the Chinese yards have been key players in the newbuilding spree that has laid the industry so low, contributing a major share of the surplus ships (see section 5).

Analysts now seem cautiously optimistic that the shipping sector could be set for a more sustainable recovery. Perhaps the worst is behind the container shippers, for instance, as demand has shown signs of improving, while new orders have been reduced by years of poor performance.

Container trade grew at about 5% year-on-year in the first quarter of this year and throughput at China's top eight ports increased by 7% in the first five months.

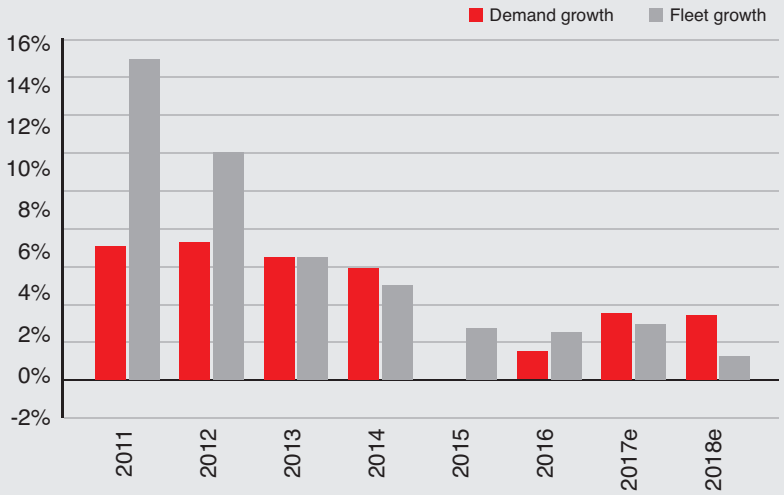
The bulk shipping market has also suffered horribly since the collapse in freight and charter rates in 2008. After averaging about 1,300 points in the 18

$2,300

Daily rate for a Capesize charter in early December 2008, down from $175,000 earlier in the year

Photo: Basil Pao

Dry bulk: back towards balance



Source: Clarksons Research Services, HSBC estimates

years before the super cycle, the Baltic Dry Index shot up almost ten times during theboom, reflecting the surge in Chinese commodity demand. Apart from brief rallies in 2009 and 2010, the index has been trading at deeply depressed levels since the boom turned to bust, and it fell to its lowest ever point in February last year.

In the second half of the year the index recovered some ground and it has been trading higher again in 2017. China's thirst for commodities was once more a key factor after steelmaking picked up, fuelled by spending on domestic infrastructure and real estate construction. Higher demand for electricity has lifted imports of coal at a time when local miners have been prevented from operating at full capacity, while lower oil prices have encouraged stockpiling of crude and more ordering from China's smaller 'teapot' refiners.

What's clear is that shipping executives will be watching China closely for evidence that more optimism is warranted.

Among the bearish signals this month were reports that iron ore inventories have reached record highs at Chinese ports, raising fears that orders of future shipments of the commodity might start to weaken. Output at Chinese iron ore producers will also be scrutinised for signs that the pick-up in prices is encouraging domestic firms to restart their operations.

In a similar way, the shipping community will be monitoring Chinese coal production, hoping that a fuller implementation of government restrictions on the most inefficient and high-polluting producers will prompt further spikes in imports from overseas.

On the supply side, any evidence that the authorities are paying out more in scrapping subsidies will be welcome, as well as news that more of China's shipyards are being denied credit by the local banks. Both trends would help in shrinking capacity across the world's fleets, a key factor as far as the two maritime veterans from Hong Kong are concerned.

Indeed, both men highlight how what happens in China is fundamental to the fortunes of their industry.

"You have to hope that demand for the raw materials that China needs to underpin its continued industrialisation and urbanisation will hold up, whilst its yards will not (again) turn out too many ships," says Hext.

Huxley agrees: "This prolonged downturn has very much been driven by oversupply of ships, so keeping an eye on Chinese shipbuilding capacity is key. But China is also going to remain the driver of the bulk trades, so cargo volumes – and where they are sourced from – are key indicators of shipping's future health".

290 points

The lowest ever level in the Baltic Dry Index, recorded in February 2016

Why is the Baltic Dry Index important?

Established in 1985 at the Baltic Exchange in London, the benchmark is compiled from prices quoted for the freight rates that shipping companies charge to move raw materials such as iron ore, cement and coal. Analysts watch it for insights on whether companies want more or less of these goods. A lower price for the benchmark is often regarded as a sign of weakness in key sectors like manufacturing or construction and as warning signal for a potential slowdown in the wider economy.

Commentators have praised the BDI in the past because it grants a real-time glimpse of economic behaviour. Indicators like the inflation figures or oil prices can be heavily influenced by governments and speculators, but the benchmark for dry bulk has been portrayed as a purer signal of market forces.

The BDI's reputation for giving a forewarning of the economic mood got its first boost when it plunged in August 1986 because of a slowdown in imports to the United States. A year later the Black Monday stock market crash brought on a global recession. In 2008 the BDI sounded the alarm again when it lost a quarter of its value between May and July. A key factor was that cash-starved banks were denying credit to commodity traders, forewarning the onset of the wider financial crisis a few months later.

How has the index been performing?

In the 18 years leading up to the beginning of the super-cycle in 2003, the Index averaged 1,289. At the height of the boom in May 2008 it peaked at 11,793 points before disintegrating almost 95% to 663 points by December – its lowest point in 22 years.

There were brief surges back above 4,000 points in 2009 and 2010 but the benchmark has ricocheted around at lower levels since then, descending into its deepest trough of 290 points in February last year.

This year the BDI has been trading around the 1,000 points mark. That's much lower than the levels that preceded the credit crunch almost a decade ago, stirring speculation that another crisis could be imminent. But the benchmark's detractors say that its predictive powers have dwindled after a decade of frenetic shipbuilding at China's yards. So many new vessels have been launched that charter rates have fallen. In this context the index is responding more to an increase in supply than a shortage of demand (or, put simply, trade in bulk commodities hasn't been growing as quickly as the number of ships that carry them). As a result, some commentators discount what the BDI is indicating about the health of the wider economy.

How about the indices for container shipping?

The Baltic Dry Index reports on the seaborne flow of bulk commodities like coal and iron ore, most of which are arriving in China from other parts of the world. Two other benchmarks serve a different purpose in measuring the movement of goods out of China, this time in containerised form.

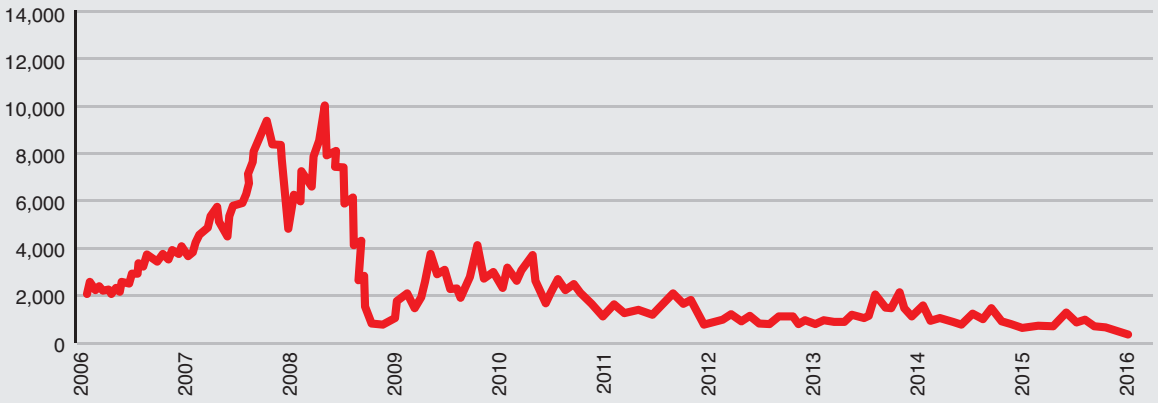
Compiled by the Shanghai Shipping Exchange, both indices are seen as proxies for tracking demand for Chinese exports. The Shanghai Containerised Freight Index (SCFI) is based on the spot rates for shipping containers from Shanghai on 15 different routes and tends to be more commonly cited in the industry. The second benchmark is the China Containerised Freight Index, or CCFI, which tracks spot and contractual rates for containers heading from 10 ports to 14 destinations around the world.

The SCFI serves as the more immediately accurate of the two indices because it reports spot rates. But it isn't as representative as the CCFI as about three-quarters of the world's container trade is contracted on longer-term chartered rates.

Additionally, the SCFI only gives shipping information out of Shanghai – China's largest port in throughput terms. The CCFI covers a wider range of the country's container terminals, which can weigh differently on the results. The broader benchmark dropped about a fifth last year on the previous year, for instance, or more than twice the rate of decline on the Shanghai-only figures.

Like the BDI, both indices plunged to historical lows in the middle of last year but they have recovered since then – doubling to more than 800 points. Another similarity to the dry bulk benchmark is that the container trade indices reflect changes in the supply of container vessels and not just the changes in shipment volumes. By way of example, the SCFI dropped by around half in 2015 in a year in which the volume of containerised trade departing Shanghai grew by a little under 4%.

Baltic Dry Index



Source: FactSet & WSJ.com

Photo: Reuters

Flying the flag

Basil Pao with permission of Wah Kwong Maritime Transport Holdings

Fifty years ago Aristotle Onassis was probably the world's best-known shipowner. Such was the success of the Greek-Argentine tycoon that his wealth helped to bring the term 'shipping magnate' into popular parlance and Onassis cemented his celebrity by marrying Jackie Kennedy, the widow of the American president.

Today's candidates for the title of world's largest shipowner are a lot less glamorous, although China Cosco Shipping has a claim with the world's biggest fleet of tankers and bulk carriers.

Other contenders are the shipping finance subsidiaries of the Chinese banks, which have become major owners themselves over the last five years. ICBC Financial Leasing is the largest, leasing out more than 320 vessels in a portfolio worth at least $9 billion.

Indeed China's merchant fleet has more than tripled in tonnage terms over the last decade and the implications for the rest of the shipping world could be momentous as Beijing bids for further control over the maritime sector.

Who's at the helm?

Working out the world's shipowners by nationality is a challenge: ownership is generally defined by the location of the parent company but the realities of a secretive and fast-moving sector mean that the final figures are always open to interpretation.

The Japanese fleet – the second largest – is a little easier to quantify as its vessels need to be flagged and controlled in Japan to qualify for domestic tax breaks.

Owners from Greece, the largest national grouping, can be harder to pin down

– they might be living in Monaco or London, flagging their vessels in the Marshall Islands, and running their fleets from offices in Hong Kong or Singapore.

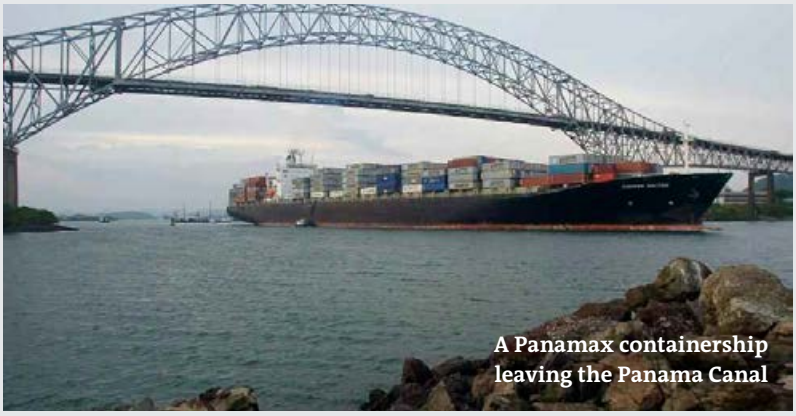
The ownership data for China is also complicated by whether to include Hong Kong-registered vessels. Nonetheless, the estimate from last year is that the Chinese have the world's third largest fleet at 9% of the world's tonnage, trailing the Japanese (13%) and the Greeks (16%).

At the head of the China-owned fleet is Cosco and China Merchants and the number of vessels under national control is growing rapidly, with a threefold expansion of Chinese ownership over the last decade to about 140 million gross tonnes (excluding Hong Kong-registered ships), according to Clarksons Research.

Taking control

Most of the Greek shipping firms are family-controlled, with a focus on vessels in the bulker and tanker sectors. Japan's ships are privately owned as well, although tax concessions from the government have been hugely influential in bolstering domestic ownership. In China the state plays a more direct role through the operational activities of majors like Cosco and the lending of the shipping finance subsidiaries at the state-owned banks. The Chinese owners are some of the biggest and best-capitalised, which makes them more active in the newbuild market, where they have been ordering a growing share of the largest vessels.

The Japanese have the world's second largest fleet by tonnage



A Panamax containership leaving the Panama Canal

Getting shipshape

Different types of vessel employ different criteria for their sizes. Bulk carriers and tankers are generally described in terms of deadweight tonnage (how much a ship can safely carry), container ships by the number of twenty-foot equivalent units (TEUs) they can transport, and gas carriers by their capacity in cubic metres. The broadest classifier is gross tonnage – a measurement of ship volume – because it can be applied across different types of vessel.

Vessel ownership is determined by where the controlling company is located and not where the ship is registered, because owners often employ so-called 'flags of convenience' from jurisdictions like Panama and Liberia to reduce their operating costs. About half of China's merchant fleet operates under foreign flags, according to Hellenic Shipping News.

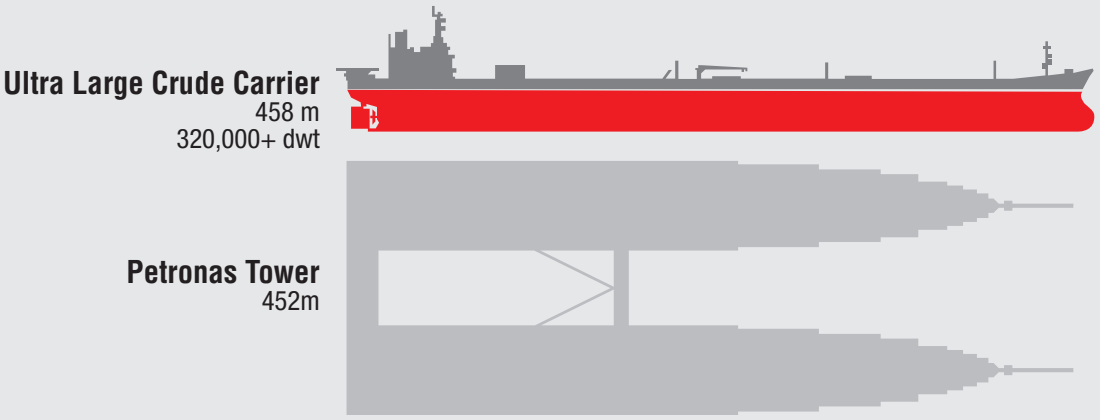
Another feature in shipping lexicon is categorisations that depend on the length, width and carrying capacity of the vessel. Handymax and Supramax are smaller cargo ships, capable of operating at smaller ports with length and draught restrictions, and they make up the majority of ocean-going cargo vessels. Mid-sized Panamax ships – named because they can pass through the Panama Canal – weigh in at about 50,000 deadweight tonnes. As containerships they are generally capable of carrying up to 5,000 TEUs, although the Canal has now been widened to accommodate larger vessels. Aframax and Suezmax are oil transporters, and both capable of navigating the Suez Canal fully laden. Capesize ships are 400,000 deadweight tonnes or more. They work in regions with deepwater terminals and are primarily used for transporting coal and iron ore. As the name suggests, they are too big for the Panama and Suez Canals, and they must navigate Cape Agulhas in southern Africa or Cape Horn at the tip of Latin America instead.

400,000

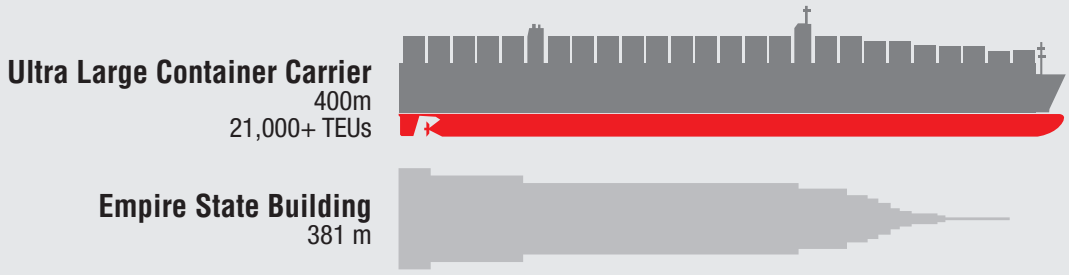
Weight in deadweight tonnes of the largest Capesize ships

Photo: Reuters

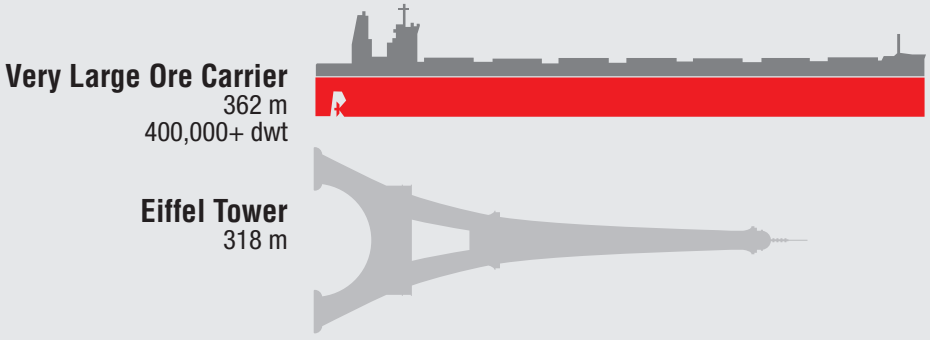
Monsters of the Deep: the world's largest vessels



Also known as supertankers, ULCCs are mostly used for transporting oil from the Persian Gulf. Knock Nevis, the longest supertanker ever built at just over 458m, was too large to navigate the English Channel. Bombed during the Iran-Iraq War, it was salvaged as an oil storage facility before being scrapped 10 years ago. The largest supertankers today are about 380m in length and carry 3 million barrels of oil.



A vessel built for Hong Kong's Orient Overseas Container Line (OOCL) has just been crowned as the world's largest container ship, with capacity for 21,413 containers. It's unlikely to hold the title for long: three ships have broken the record already this year and there are 51 ultra-large vessels due for delivery in the next two years, according to Alphaliner.



MS Vale Brasil was the first VLOC to set sail for Brazilian mining company Vale in 2011. With seven cargo holds, they can move cargos twice as heavy as Capesize ships and enough ore to forge the steel for three Golden Gate bridges. The VLOC fleet makes four trips a year to Asia and the Chinese shipping majors have 30 of the vessels on order. They are often called Valemaxes.

Photo: Reuters

Smaller, independent owners have more of a presence in the secondary market in China, says Basil Karatzas, who runs New York-based Karatzas Marine Advisory. He describes owners of this type as well-connected businesspeople who buy dry bulk carriers and persuade their local steel mills to charter them for the supply of raw materials. "We've seen a lot of second-hand ships sold to Chinese customers in this way," he says. "A typical target is a 10-year old vessel in the $3 million to $7 million range, which is about twice its scrap value so it's not a hugely significant amount of cash to put at risk. If they can lock up a year's charter with a steel mill, the shipowners can cover most of their capital".

Nonetheless it is the orders for larger vessels that get more of the headlines and the average size of the ships in the Chinese fleet has almost doubled over the last decade, highlighting the deliveries of larger tankers, bulk carriers and container ships.

Contributing to the trend are diktats from the central government that more of the country's trade should be transported on ships owned by companies from China.

The first signal of the policy came in the oil industry, where China depends on imports for more than half of its consumption. Most of it arrives by sea and Beijing has been pushing for a larger tanker fleet for years, encouraging its shipping firms to buy bigger ships under the banner of "national oil, nationally carried".

State-owned operators like Cosco and China Merchants have responded enthusiastically, ordering significant numbers of VLCCs (very large crude carriers). Leading the charge is China VLCC, a subsidiary of China Merchant Energy Shipping, which was established just three years ago but is now the largest operator of oil tankers worldwide, with 40 vessels in operation and orders for 13 more. Cosco's fleet of the same type of vessels is only a little smaller.

Fifteen years ago, the Chinese owned about 2% of the world's oil tankers but today they control closer to 15% of the fleet and they have a greater share of the order book.

The strategy of establishing more control of how the key industrial commodities are transported has been similar for shipments of iron ore, where China's shipping interests clashed with Brazilian miner Vale over how iron ore would be shipped from Latin America (see sidebar). Vale eventually capitulated, selling most of the ships to the Chinese and leasing them back on long-term contracts. Last year the Chinese majors splashed out $3.5 billion on orders for 30 more of the mega-ships in what looks like an attempt to control more of the freight rates on the Brazil-China route into the future.

15%

Share of Chinese control of the world's oil tankers

Financing the fleet

Another feature in how ownership of the world's merchant fleet is changing is ship finance, where the Chinese banks have become powerful players.

Until recently the European banks provided most of the loans, explains Jonathan Silver, head of Shipping at Norton Rose Fulbright in Hong Kong. But

Iron ore transporters being loaded at Port Hedland in Western Australia

How Vale was vanquished

More than two-thirds of the world's seaborne iron ore heads for China's steel mills. The large majority comes from Australia, although Brazilian iron ore giant Vale competes with Rio Tinto, BHP and Fortescue, the leading Australian miners.

Vale's problem is that voyages to Qingdao – China's main iron ore port – are much shorter and cheaper from western Australia than from its home terminals in northeastern Brazil.

Ten years ago, in a bid to reduce the differentials in freight costs, it opted to establish a fleet of its own, bringing down the delivered cost of ore and capturing more of the profits from the shipping firms.

The proposal was to build a fleet of very large ore carriers or VLOCs. Also known as Valemax, they are the world's largest dry bulk vessels with more than 400,000 deadweight tonnes of capacity. Vale put in an initial order for 14 ships and it signed long-term charter contracts with several independent shipowners who placed similar orders.

Company executives gave the majority of the business to Chinese yards, presumably hoping to win Beijing's favour for the broader plan. Initially it looked like that might work: China's banks offered finance for some of the VLOCs and there was talk in the press about how the fleet would bring down the cost of iron ore for the country's steel mills.

But after only a handful of port calls the first generation of these Valemax vessels were blocked from unloading in China. Officially they were banned on safety grounds, despite protests from Vale that the megaships had docked safely in other countries. The more likely reason was that China's bulk carriers saw the commercial dangers of allowing one of their largest customers to operate its own fleet at a time when the industry was already in dire straits.

Zhang Shouguo, vice chairman of the China Shipowners Association, was pretty explicit in saying so, claiming that Vale was "hoarding the cargo to itself and now intends to control shipping tonnage", and the Chinese shipowners led the campaign against allowing the Valemax vessels to unload, arguing that it was a moment of national importance.

"It is a matter of monopoly and unfair competition which not only harms the shipping interests of mainland China but also those of South Korea, Japan and Taiwan," Zhang warned.

Three years of deadlock followed in which hardly any of the Valemax were given permission to unload in China and only then in limited quantities. Vale fought back by refusing to charter vessels from the Chinese majors and trying to enlist the support of China's steelmakers by offering them a share of the savings.

In the meantime the Brazilian miner was forced to move its iron ore cargo onto smaller vessels at transshipment points in the Philippines and Malaysia before shipping it onwards to China, which undermined the economics of the original plan.

Falls in global freight rates further eroded the commercial justification for owning such a troublesome fleet and Vale showed the first signs of surrender at the end of 2013 when it sold four of the VLOCs to privately owned Shandong Shipping.

A few months later there was a fuller capitulation when 12 more of the ships were sold to China VLOC, China Ore Shipping and ICBC Leasing. All of the ships were chartered back to Vale on long-term contracts.

The press was full of predictions that the blockade would soon be lifted and sure enough, the Ministry of Transport issued notices approving the berthing of Valemax vessels at four of China's ports.

The embargo was over and the first full cargo of iron ore from Brazil was unloaded at Qingdao.

Photo: Reuters

The Chinese banks are financing more of the world's fleet

when the European lenders started backing away from the sector following the financial crisis a decade ago, the Chinese lenders began to offer more of the loans themselves.

Initially the support came from commercial banks like Bank of China and later from policy lenders, led by China Development Bank. But in 2013 the banks started taking a back seat to a new breed of leasing company that finances the construction of new ships and then leases the finished vessels back to their operators at a profit.

"Shipowners are using sale-and-leasebacks to refinance existing loans and to pay for contracts with yards for newbuilds," Silver explains. "The customer might put down 10% of the ship's price in equity but it then novates [substitutes] the contract, getting the capital from the lessor to meet the payments for building the vessel. The lessee pays off the principal and the interest over the duration of the lease and at the end of the period there is usually some kind of purchase option."

Silver says that lease finance has flourished because shipowners have been finding it harder to get bank loans. As state-owned enterprises, the lessors don't have the same difficulties finding finance and they enjoy much lower costs of capital than traditional owners, who are seen as more of a credit risk.

The lessees have welcomed the new arrangements because the leasing deals generally incorporate higher loan-to-value ratios than bank loans and they are structured over longer tenors that stretch out the repayment schedules.

The lessors are split into two main groups. Larger shipbuilders like CSSC have leasing divisions that provide funding for orders from their yards but most of the ship financiers are subsidiaries of the main banking groups, focusing purely on financial returns. Remarks in March from Mao Wanyuan, a director at the China Banking Regulatory Commission, suggested there were 23 financial institutions providing ship lease finance, with a portfolio of 989 vessels valued at Rmb114 billion ($16.5 billion). ICBC Leasing is the biggest, with Minsheng Financial Leasing and Bank of Communications Financial Leasing also significant players.

Almost all of the early leases had a national flavour involving Chinese yards or Chinese counterparties, and the lessors prioritised longer-term contracts with reliable customers, such as the biggest miners and steel firms. More recently they have started to do business with parties lacking the same national connection and they have been coming into contact with smaller, independent customers – potentially much riskier propositions. Another feature of the landscape is an increase in 'operating leases' in which the lessor retains ownership of the vessels at the end of the contracts. The industry is so new that few of these leases have

Jonathan Silver, head of shipping in North Asia, Norton Rose Fulbright

Photo: Reuters

reached their natural conclusions, so the industry is waiting to see whether the Chinese can manage their multi-billion dollar portfolios profitably.

The gathering storm

Karatzas argues that shipping is set for a period of transformative change as the Chinese start to assert more control. One trend is that more of the country's international trade will be carried on Chinese vessels in the same way that a greater share of its imports of oil and iron ore have shifted to Chinese operators. Another is that commercial capacity is going to concentrate around larger lines and shipyards, some of which will emerge as national champions.

"Previously China's shipping sector was relatively unstructured with a lot of duplication. There were five companies competing in tankering, another five battling in the container trade, and five shipyards chasing every new contract," he claims. "But that's starting to change as the government brings the bigger names together. We are seeing it in the way that Cosco is being built up and in the campaigns to close the weaker shipyards."

In the bigger picture this is part of the process in which the Chinese are moving from their position as the primary customer of the industry into a role in which they are a leading supplier. And the opportunity is growing for China's shipping firms to play the national card, especially when state-controlled customers are involved. "If a vessel owned by a company from another country is bidding with a Chinese competitor for a contract, who is going to win the business?" Karatzas asks. "I think it's logical to assume that the government is going to want the Chinese ship to be preferred, whether that is stated openly or not."

The broader argument is that Chinese firms are taking control of the largest vessels, buying stakes in more of the world's ports, and benefiting from more financial and political support from their government, much of it under the aegis of Beijing's backing for Belt and Road infrastructure investment.

Karatzas also says that too many of shipping's traditional participants don't seem to appreciate how much the fundamentals are changing. Many of the world's shipowners have made most of their returns by trading the asset values of their vessels rather than making a profit from operating them. Their strategy is to try to time the economic cycle, buying ships during downturns for cents on the dollar and managing them through a period of negative cash flows as they wait for better times. When the value of the vessels increases, they sell for a profit.

The warning from Karatzas is that shipowners are adopting a business-as-usual approach and basing their bets on picking up vessels at bargain prices and waiting for the recovery in values.

But that's a strategy that may not survive as the Chinese accumulate larger fleets of their own that seem set for dominant positions across many of the world's trade flows. "All of these new vessels will take a lot of the volatility out of the market for the independent shipowners and the strategy of buying low and selling high becomes a lot less viable," he predicts.

Basil Karatzas predicts that the Chinese will take greater control over transporting the world's trade flows

Photo: Reuters

Investment in Belt and Road offers opportunities for Chinese shipping firms

Commanders of the seas

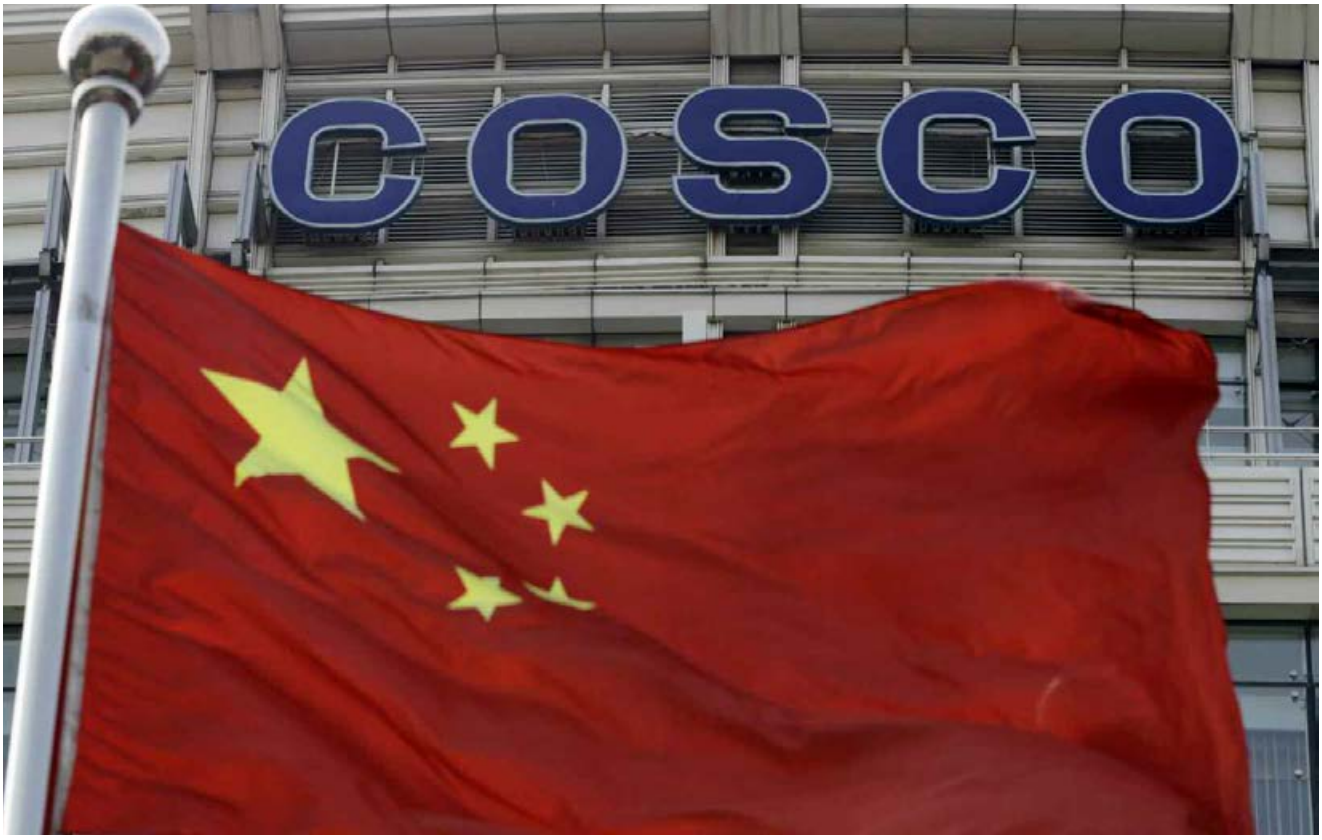


Photo: Reuters

Curious crowds gathered at quaysides in the United States this May to greet the largest ship ever to call at ports along the eastern seaboard.

The spectators were scanning the horizon for something familiar – the vessel was four times as long as the Statue of Liberty is tall, the local media had been marvelling – but the newcomer was actually Chinese.

Owned and operated by China Cosco Shipping, the 13,000-TEU vessel had just set a record as the largest to pass through the recently-widened Panama Canal and ports along the US east coast have been deepening their harbours in a bid to welcome more arrivals from China.

A quick survey of the shipping headlines for the same month shows that Cosco's reach has been expanding as well. One of its vessels carried the key parts for a Chinese-designed nuclear reactor to Pakistan and another of its containerships made the inaugural call at Asia's first fully automated terminal in Qingdao. There was another new high for container traffic at Cosco-controlled Piraeus in Greece, plus the launch of a multi-billion dollar fund promising to scoop up maritime assets around the globe. In another piece of news Cosco has even revealed that it is taking a stake in a trading zone in Kazakhstan, thousands of miles from the sea.

Headlines like these sound promising after a period in which Cosco's fortunes were torpedoed by the global financial crisis and the subsequent slump in freight rates. But one of the results of the stormy seas was a mega merger with China Shipping – another giant – that will reshape the sector at home and overseas.

Merger mania

In another of the state-sponsored marriages in Chinese shipping China Merchants is taking over Sinotrans, bringing together the latter's logistics kingdom with the former's ports and tanker assets. The combination of Cosco and China Shipping, however, is launching a leviathan with well over a thousand vessels and it creates a stronger candidate for national champion.

The newly merged entity operates across most of the maritime industry. Cosco Shipping Bulk and Cosco Shipping Energy Transportation own the world's largest bulk and tanker fleets, respectively. Cosco Shipping Holdings is the fourth-largest owner of containerships and Cosco Shipping Ports is the number two container terminal operator. Cosco Shipping Development, the group's leasing arm, is the second largest non-operating owner of container vessels, while Cosco Shipping Heavy Industry is China's third-largest shipbuilder.

Photo: Reuters

Beijing's buccaneer

Wei Jiafu – or Captain Wei as he is known in the industry – started as a radio officer at Cosco in the 1960s and climbed the ranks to take the helm as chairman in 1998.

Unlike the bosses of many state-owned firms, Wei is an outspoken figure. His personal story even includes an episode in which he claims to have been taken hostage by pirates in the Malacca Strait. Regularly ranked as one of the most influential people in world shipping, he was also a buccaneering leader in building up Cosco's fleet, although his career ended in relative disaster when a gamble on charter rates led to losses of more than $5.5 billion between 2009 and 2013.

Cosco was then forced to sell assets in its bulk shipping division to avoid a humiliating delisting from the Shanghai stock exchange. Wei stepped down as chairman and after years of adoration, the press coverage was suddenly less flattering. Cosco's management was later investigated for falsifying its earnings and some of its senior executives were detained for corruption.

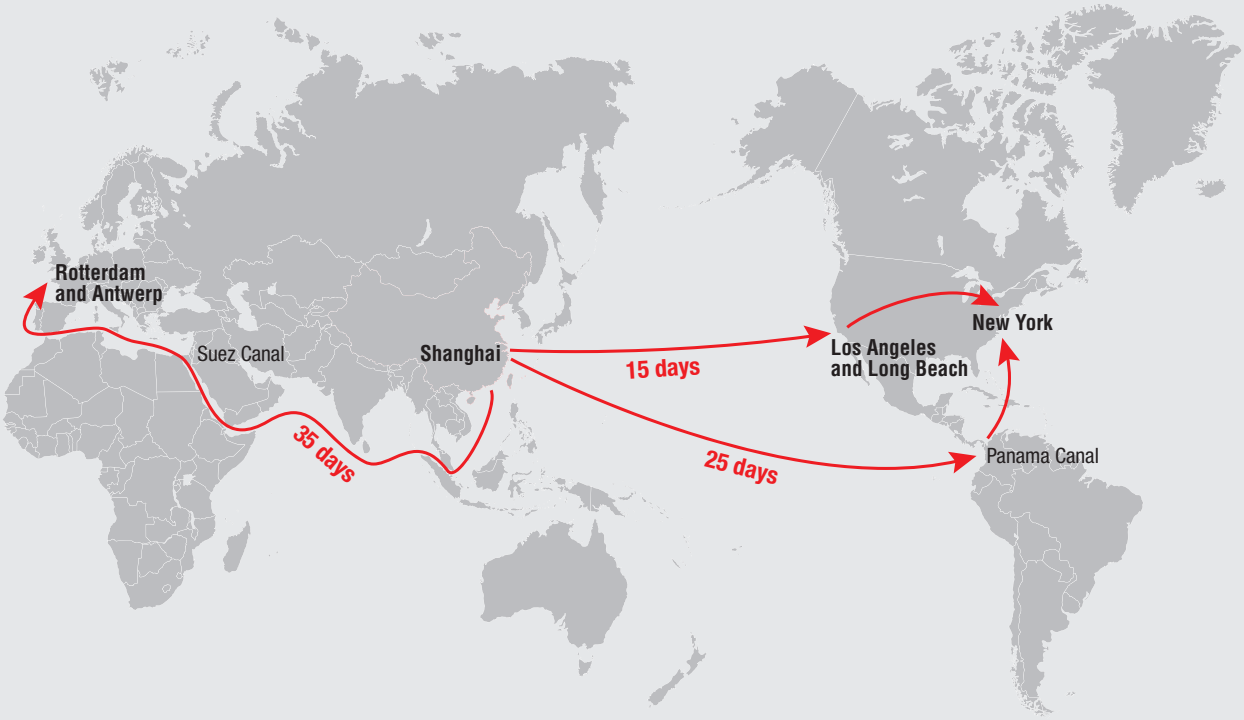
Wei hasn't been directly linked to the investigation and he has refuted criticism of Cosco's financial performance, claiming that his mission was as much about "social responsibility" and "making a contribution to humankind" as earning a profit. "As long as Cosco is fully understood by the Party leaders and the State Council, it's enough for me," he has insisted.

Perhaps he has a point. The case against Wei is that he made terrible bets in buying ships and committing to long-term charters at a time when the Baltic Dry Index was close to record levels, leaving the company in a perilous financial position when the market turned for the worse. Critics say that Cosco's risk management was rudimentary and the company was castigated for reneging on some of its charter contracts as the sector slumped. Yet there is also a sense that China's strategic planners wanted control of a bigger portion of the world's bulk carriers and that Cosco was encouraged to grow its fleet even as prices were peaking.

Captain Wei walked the plank when these decisions proved disastrous but he wasn't the only man on deck when the worst of them were taken.

$5.5 billion
Cosco's losses between 2009 and 2013

East to West for exports: the Asia-Europe and trans-Pacific trade lanes



The trans-Pacific and Asia-Europe routes (also known as East-West lanes) make up about 30% of the world's container trade. They are the key battlegrounds for the world's largest container ships and they carry the majority of China's exports to developed markets. Traditionally, the flows in the opposite direction has been much lighter, although 'back haul' trade has started to increase relative to China-originating traffic.

The world's container lines lost an estimated $13 billion between them in 2016 after a price war drove freight rates to record lows. It was a tumultuous year, with a series of mergers and acquisitions, plus the bankruptcy of the South Korean line Hanjin Shipping, the widening of the Panama Canal to allow larger vessels, and record scrapping of about 700,000 TEU of tonnage. Lower numbers of new orders meant that supply grew slower than demand for the first time since 2010, however, and spot freight rates improved in the final quarter, particularly on the trans-Pacific lane.

Rates have improved further so far this year and HSBC is predicting a modest profit for the industry in 2017.

The background to the bringing together of the two state-owned giants is a tale of weakness as much as strength. A disastrous run of losses had put Cosco in financial peril, forcing the sale of its dry bulk fleet to its parent to avoid its shares being delisted in Shanghai. Policymakers pushed hard for the combination with China Shipping as a way of reshaping the landscape and most of Cosco's old guard were compelled to stand down (Wei Jiafu, the man most associated with the booms and busts of the earlier era, had departed in 2013: see insert).

The new leadership is wrestling with the challenge of coalescing the two companies into a single entity. "Our two firms had similar operations, we did not have many advantages in the various sectors we operated in, and we could not count on economies of scale," explains Xu Lirong, the new boss.

Cosco now enjoys even greater scale as the owner of the world's largest fleet in tankers, bulk carriers and containerships combined. The supersizing is supposed to steer it into profit, although some commentators have been sceptical about the restructuring that its executives are promising, noting that state-owned firms are reluctant to make radical changes, especially if they lead to lay-offs.

True to form, Xu has made public commitments that no jobs will be lost as a result of Cosco's coupling with China Shipping, for instance.

Parash Jain, head of transport research for HSBC in Asia-Pacific, argues that there are still plenty of savings to be made, however. Taking the container divi-

Photo: Reuters

Cosco's first containership makes its transit through the new Panama Canal

sion as an example, he says that larger lines offer more extensive services and that they should be able to achieve higher levels of efficiency. Consolidation helps further in creating a more stable industry, with greater predictability in pricing.

Cosco is looking first for synergies across its "hard infrastructure", Jain reports. One of the more immediate benefits is more effective deployment of vessels across its network and another advantage is that it can return ships that were chartered too expensively in the past.

After a $1.4 billion loss last year, Cosco has reported a profit of $39 million in the first quarter, fuelled by improvements in its container division. Cargo volumes increased by more than half compared to the same period last year, reflecting the addition of China Shipping's fleet. The company said that cost efficiencies and improvements in freight rates had also boosted margins.

Cosco's performance since the merger has been better than most analysts anticipated, although it is too early to tell how effectively it will transform its business. "The merger happened during some of the worst conditions in living memory and everyone else has rebounded over the last two quarters as well. It will take longer to determine whether the restructuring is going to result in long-term gains," Jain reports.

China's container shipping – still punching below its weight

One of Cosco's advantages is that it is already aligned with some of the strategic priorities of the Chinese government. Its dry bulk division has locked in long-term contracts to ship iron ore from Brazil to Chinese steelmakers and its tanker group is spending $1 billion on new deliveries to carry more of China's shipments of seaborne oil. Another area where profit and policy overlap is the Belt and Road Initiative, and Cosco announced in January that it had secured Rmb180 billion ($26 billion) in financing from state-owned China Development Bank for maritime investment under the banner of Xi Jinping's signature plan.

Back in the world of container shipping, consolidation is a trend shaping the sector in general. Bleak trading conditions have spawned a survival of the fittest mentality and takeovers have reduced the number of leading lines from 20 to 12 over the last three years. The leading lines now control about 60% of the world's fleet, or double their share in 1996.

Cosco is a member of the elite with about 8% of the market in fleet strength, although it trails AP Moller Maersk (from Denmark), MSC (Switzerland) and CMA CGM (France) in total carrying capacity. The arrival of new vessels over the next year and a half was going to see Cosco move close to third place, however, and a proposed takeover of Orient Overseas Container Lines announced in July will seal the move into third position (see final section).

But wresting more business from its rivals in some of the other main trades

$26 billion

Cosco's credit line for Belt and Road investment projects

Parash Jain, Head of Transport Research for HSBC in Asia-Pacific

Photo: Reuters

Photo: Reuters

Mixed fortunes for China's port operators

The Belt and Road Initiative has prompted investments in ports around the world as the Chinese extend their maritime reach. One of the success stories is in the Mediterranean, while an investment in the Indian Ocean has been proving more problematic.

The project in Europe features Cosco Shipping Ports, which put money into the Greek port of Piraeus (pictured above) by buying the rights to operate two of the three piers at its container terminal. Spending on deepwater berths and cranes improved handling and introductions to new customers such as HP and Huawei brought in new business. The port's fortunes were transformed: throughput has increased from 880,000 containers in 2010 to 3.74 million last year.

But the spillover benefits for the terminal that stayed under the control of the Piraeus Port Authority, a state-owned entity, failed to materialise. Hamstrung by antiquated working rules, the Greek terminal lost business to the Chinese operations and it soon looked destined for takeover. Local workers resisted, fearing changes to their working conditions, but Cosco's response was withering, telling the union that its members needed to stop drinking beer and work harder.

Cosco took majority control of the port last year, overcoming last-gasp resistance in the Greek parliament.

"They turned the business around at the container terminal first," says Parash Jain from HSBC. "But the fuller takeover is taking them into new areas like cruise terminals and bulk cargo handling, so they are now running the port, not just the container operations."

Piraeus is now a flagship for the Belt and Road plan but it also puts Cosco into the spotlight for how it handles the relationship with the Greek government. Commitments for further investment at the port of at least €350 million ($408.5 million) should help to smooth relations and Chinese policymakers are holding out the wider prospect of turning Piraeus into the maritime gateway for a new network of roads and railways that reaches deep into southern Europe.

The maritime mood in Sri Lanka has been harder to navigate. There, the main operator is China Merchants Ports, one of Cosco's rivals. It operates the largest of the container terminals in Colombo, where throughput increased almost a third last year to record highs of more than 2 million TEUs. Chinese firms have also pushed ahead with construction at a new trade zone around the deep-sea port of Hambantota, the hometown of former president Mahinda Rajapaksa. But the venture went sour when Rajapaksa lost office and new leader Maithripala Sirisena attacked the arrangements for the new zone, demanding that the Chinese take a debt-for-equity swap on some of the $8 billion in loans made to the Sri Lankan government.

Beijing played hardball as the negotiations dragged on and the Sri Lankans failed to find alternative sources of finance. Late last year China Merchants announced that it would be taking majority ownership of the port at Hambantota on a long-term lease and that an additional 15,000 acres would be made available for a new industrial zone. Violent protests against the agreement then forced the Sri Lankan government to go back to the Chinese again, asking that China Merchants get a shorter lease for the zone and a smaller share of its profits.

The row over control of the Hambantota zone is yet to be resolved. But Colombo has little room for renegotiation because Sri Lanka is in the middle of a balance of payments crisis and desperate to delay some of its debt repayments to the Chinese.

isn't going to be easy. Jain gives the North-South route (Latin America related traffic) as a prime example, where Asian shipping lines have relatively small market share. Cosco's claims on Asia-Latin America traffic have been minor, making it harder to build a profitable business from scratch.

Even in the trans-Pacific lanes the Chinese lines have punched below their weights, carrying a lower proportion of traffic than China's share of international trade would seem to support. National loyalties seem a lot less pronounced than in Japan, for example, where local lines control about 8% of the world's fleet but transport more than 40% of the country's trade with the US.

Part of the reason is that Japanese brands such as Honda, Toyota and Sony have more sway in choosing their national carriers to transport their goods. More of the orders for Chinese exports are coming from American retailers and their logistics partners, who have less reason to be loyal to companies like Cosco. In bulk shipping and tankering the situation is different – more of the demand comes from 'national' customers, and China's oil and steel giants can specify how the commodity should arrive. The country's consumer goods firms need to secure a stronger foothold in overseas markets before they can set the same terms on how containerised freight should be transported. "If China's phone and television brands get more popular with consumers the companies that make them will get more say about how the goods are shipped," Jain says.

Container terminals: looking further afield

Chinese ports have been direct beneficiaries of the country's export boom, with the emergence of a number of gateways along the country's southern and eastern coasts.

Traffic through Chinese ports currently accounts for almost 30% of the world's containerised trade flows and its terminals, including Hong Kong, rank in seven of the top 10 positions as the world's busiest ports.

Somewhat paradoxically, the push from terminal operators such as Cosco Shipping Ports and China Merchants Ports to invest overseas is being prompted by slowing growth in container traffic, however. In the 1990s, container volume growth was 3.5 times global GDP growth; from 2000 to 2009 it was 2.7 times, and since 2010 it has been moving towards par. Flows through China's top eight ports are now growing by less than 3% a year, significantly less than the previous decade. This slowdown has stimulated the operators to look overseas, with billions of dollars of Chinese investment in about half of the world's top 50 container ports since 2010.

The outflow is backed by the Belt and Road blueprint, which prioritises spending on infrastructure that supports cross-border trade. With this kind of policy support, Chinese firms are in a stronger position to overcome their rivals when new projects come up for bidding. "Port operators from other countries might commit to building a new container terminal but they tell the host government

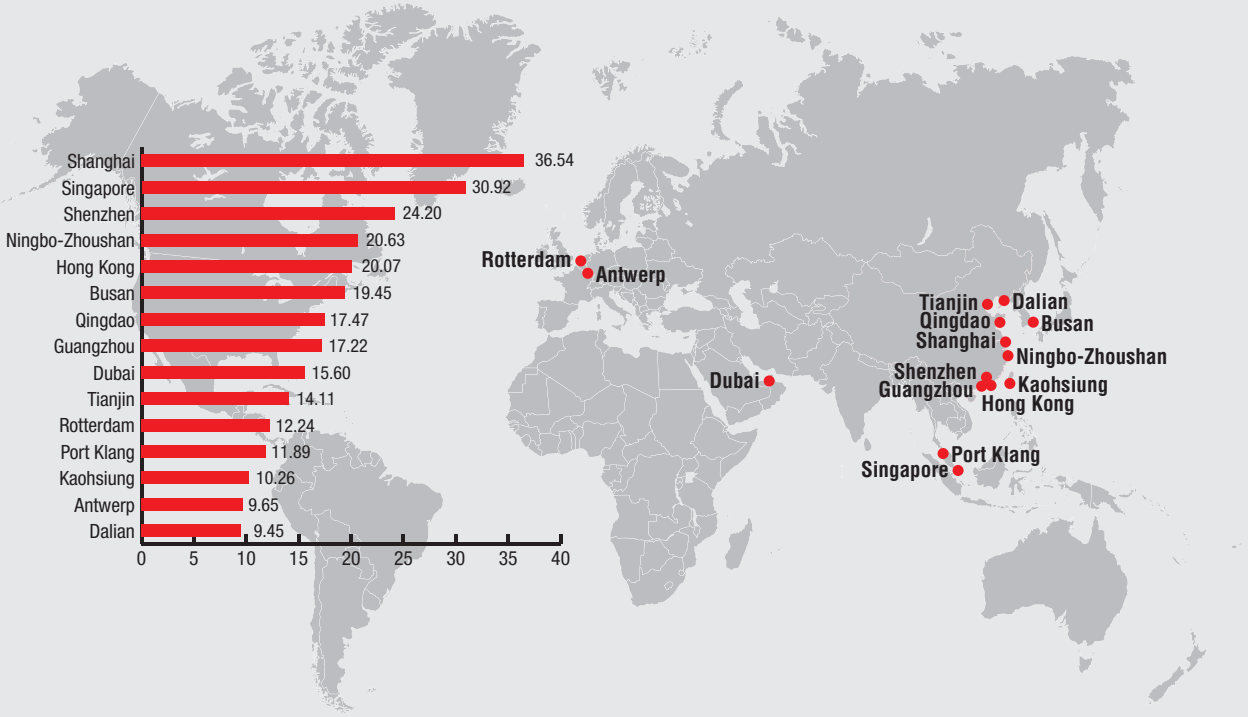
3.5 times

Container traffic growth as a multiple of GDP growth in the 1990s. Today it is closer to par

Photo: Reuters

More sales for brands like Huawei could boost the reach of Chinese ship firms

The world's leading container ports (in million TEUs, 2015)



that it has to provide the roads, the railways and the power supply around the port," Jain explains. "The Chinese make a fuller offer than building a port alone. They are committing to roads and railways, power stations and special economic zones, and they bring the financing to make it happen."

Strategists claim that port operators could be in a position to play the national card by moving Chinese cargo first or exploiting control of the terminals to influence how the shipping lines do business. And it's certainly true that port ownership can benefit companies with a presence across the industry chain – shipping conglomerates can instruct their container ships to call at points where they control the terminals, effectively guaranteeing customers.

Yet Jain says that this strategy isn't much different to European majors like Maersk and MSC, who own port terminal businesses alongside their container lines. More likely it's the state backing for these deals that has been alarming China's rivals, especially India, which is concerned by what it sees as encroachment into its traditional sphere of influence in the Indian Ocean. On the other hand, many of the newest projects are in parts of the world that are fraught with political risk, as China Merchants has discovered in Sri Lanka, where it has interests in ports in Colombo and Hambantota (see sidebar). There is no guarantee of commercial success. Jain is cautious about some of the investments by China Merchants Ports in particular, fearing that it has overpaid for some of its new holdings, and that many of them don't seem to be tapping into the fastest growing markets.

Cosco Shipping Ports has done better by taking stakes in terminals that complement its container lines and bulk shipping businesses. The flagship is Piraeus in Greece and Cosco has strengthened its position in the Mediterranean with investments in the port of Vado in Italy, as well a majority stake in a Spanish company with port interests in Valencia and Bilbao, and two rail terminals in Madrid and Zaragoza.

Even so, few of these stakes are likely to deliver the same returns as the best of its port businesses in China. "The opportunities that you get as an incumbent in your home country can be difficult to replicate because you don't know your customers as well and you don't have the same relationships with the local regulators," Jain explains. "China's port operators have always enjoyed home advantages but they aren't going to get the same assistance overseas, where they've got to beat the likes of DP World, Hutchison Port Holdings and Maersk in a profit-driven environment."

Credit: Alphaliner

Another way to market? 'The Ice Silk Road'

The Arctic is said to be heating up twice as fast as the rest of the world, bringing a "massive decline in sea ice and snow," according to American scientists at the National Oceanic and Atmospheric Administration last year.

The coverage in the media this summer has looked for a silver lining to the changing weather – including an agreement between China and Russia to build an 'Ice Silk Road' through the Arctic into Europe.

Also known as the Northern Sea Route, the shipping lane runs between the Pacific Ocean and the Atlantic Ocean along Russia's northern coast and its promoters say it could shorten shipping times from Shanghai to Rotterdam by at least a week compared to sailing through the Suez Canal.

The Russians have the greatest presence in Arctic shipping and most of the region's traffic is exports of northerly deposits of oil, gas and minerals. A huge liquefied gas project on the Yamal Peninsula has been boosting cargo traffic to record levels, with nearly 300 vessels conducting more than 1,700 voyages last year. The limitations of the route as a trade lane for transit traffic are significant, however, with long periods in which the winter weather makes passage impossible. Critics say that containerised trade will be especially difficult, due to unreliable scheduling, lack of ports of call and higher insurance costs for ships that make the journey.

Transforming the route into a commercial proposition for bulk shipping is going to require a lot more climate change and huge amounts of capital. Much of the investment seems likely to come from Chinese sources: port operators like China Merchants have been looking at new projects in Norway, Lithuania and Iceland, while Beijing's state banks have already provided billions of dollars of loans to the Yamal gas field in Siberia. Oil giant PetroChina and the Silk Road Fund – a state-backed investor with a Belt and Road focus – both hold significant stakes in the same project.

More funding will be needed for ice-breakers, ice-strengthened cargo ships and a network of Arctic ports if the route is going to be opened up to transit traffic. In fact, no Chinese territory touches the Arctic directly, although officials like to talk about China as a "near-Arctic" state, and Beijing has observer status in the Arctic Council, where Canada, Denmark, Finland, Iceland, Norway, Russia, Sweden and the United States debate development opportunities for the region.

Yard sale on the Yangtze

Photo: Basil Pao

China's shipbuilding skills shone through in the size of the vessels in Zheng He's fifteenth century treasure fleets, which were four times as big as the Santa Maria, the ship that carried Christopher Columbus to the New World at a similar time.

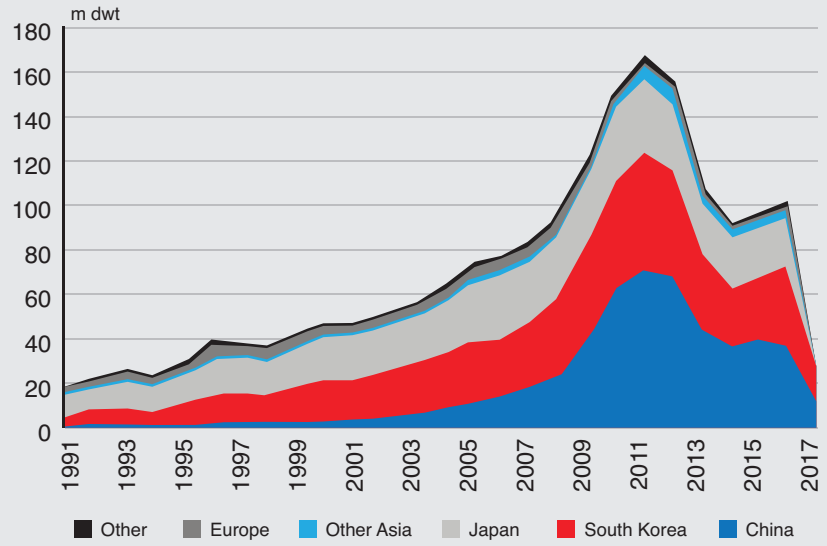
But the Ming Dynasty emperors eroded much of China's maritime heritage by banning seaborne trade. Ships, docks and shipyards were regularly destroyed and there were few signs of the industry reestablishing its international reputation until the 1920s, when Jiangnan Shipyard in Shanghai built a fleet of gunships for the United States Navy.

Since the 1990s the rise of the Chinese shipyards has been a lot more dramatic. Early efforts focused on boosting the number of vessels in the country's merchant fleet. Now there are too many yards and the challenge is more about how China's shipbuilders can sink their rivals in Japan and South Korea.

Filling out the fleet

In the 1980s less than a fifth of China's merchant fleet was domestically built and the vast majority of its international trade was carried in chartered or foreign-flagged ships. China's leaders wanted their shipbuilders to be more competitive and one of the first steps was converting the Shipbuilding Ministry into China State Shipbuilding Corporation (CSSC), which took control of the country's yards. Its shipyards were too limited in capacity and capability to deliver many of the larger tankers and containerships needed for the national fleet, but domestic demand for small-to-mid-sized vessels provided a vital source of orders and the best of the yards started to emerge into the international market.

Riding the wave: shipbuilding deliveries by builder country



Source: Clarksons Research

From very few newbuilding deliveries in the 1990s, the Chinese yards (in dark blue in the chart) have become significant players in the last decade, joining the South Koreans and the Japanese as the dominant producers.

The chart also highlights how the 2003-8 super-boom in dry bulk shipping prompted an unprecedented shipbuilding spree in all three countries.

The construction cycle for larger ships is typically two years from order through to delivery, which is why the spike in new builds was highest in 2010 and 2011.

By then the boom had subsided and the shipping industry suddenly had to absorb hundreds of new vessels – all at a time when charter rates had already plunged from their peaks.

In 1999 CSSC was split into two as a way of generating more competition. It kept control of the yards in the south and west, and China Shipbuilding Industry Corporation (CSIC) took control at shipbuilding operations in northern cities such as Dalian, Qingdao and Tianjin.

These state-owned champions led the efforts to boost the sector, helped by tax rebates, soft loans from the banks and cash bonuses for ships sold overseas. Today they sit atop the industry, controlling most of the leading yards, the marine component manufacturers, and the research and design institutes. In 2005 there was another round of policy sweeteners designed to position the Chinese as the top shipbuilding nation within a decade. But shipyard numbers had already started to surge in response to higher freight rates in the world market, which was fuelling billions of dollars of orders for new vessels. New entrants flooded the sector and many were privately owned. Some are sophisticated yards like Jiangsu Yangtzejiang, one of the largest shipbuilders in China. But the majority of the newcomers were speculative 'beach yards' chasing single contracts for newbuild. By 2010 there were said to be as many as 3,000 yards in operation and all the additional capacity was starting to churn out thousands of new vessels.

3,000

Number of Chinese shipyards at the market peak

The order book

One outcome of all the new capacity is that the Chinese have grabbed a greater share of the world's ship construction. Estimates of just how much depends on the definitions of output but in terms of completed tonnage, new orders received and order backlog the Chinese yards accounted for 36%, 65% and 44% of the global market last year, according to Cansi, the shipbuilding industry association.

Thomas Bracewell, director of newbuilding at Hartland Shipping Services in London, says that China's share has grown fastest in dry bulk vessels, where its yards now control about 60% of the order book.

Their main competitor in dry bulk is Japan, where the yards build ships more efficiently and fit them out to a higher standard (the steel in the hulls is lighter so the vessels tend to be more fuel-efficient, for instance). Chinese construction is less standardised and the yards rejig the production processes to the specifications that customers want. In this regard the Chinese are more flexible, Bracewell says, even though the final vessels are typically less reliable, less efficient and therefore less liquid assets than their Japanese competition.

Ultimately the Chinese yards are competing on price, however, especially for

Manual labour: China's shipbuilders can't match the best of the South Korean yards in technology and R&D

bulk vessels, where construction is less complex. Vessels purchased from Chinese yards are about 15% cheaper than their Japanese equivalents – a new Ultramax of about 60,000 deadweight tonnes costs about $26 million from Japan but only $23 million from China, Bracewell says.

The Chinese yards haven't won as much business for more sophisticated vessels. "They aren't getting as many of the higher-value added contracts for vessels for the very large oil tankers and gas carriers, where the Koreans are ahead. Only a few of the Chinese yards are winning these more complex vessel contracts, such as Hudong-Zhonghua Shipyard, which has started earning a name for itself building LNG carriers," Bracewell reports.

In the large tanker segments (VLCC, Suez, Afra & LR2) the South Korean builders hold around 50% of the order book and the Chinese 30% in tonnage terms. However Chinese market share would be much lower if one were to remove the Chinese domestic contracts. For example, in the VLCC sector, at the end of May Chinese builders had 29 vessels on order, of which 27 were for Chinese buyers and two for Japanese, at a builder which is a joint venture with Japanese firm Kawasaki.

In the international market, the South Koreans are dominant. The story is the same for the largest container ships and gas carriers, where the Korean yards' engineering capacity keeps them several steps ahead in technology and R&D.

Another difference is that the South Koreans and Japanese are known as market leaders in marine equipment manufacturing. Chinese shipbuilders rely more on international equipment makers, importing from Europe, Japan or Korea, or producing equipment under licence from the foreign manufacturers. Bracewell says that ship owners have to accept equipment made in China if they want to build ships in China but they usually demand that major items are manufactured under licence from European and Japanese brands.

The broader point is that customers see Chinese ships as acceptable rather than outstanding in quality terms. They sell at a further discount in the second-hand market and it can be much harder to find buyers when market conditions are weak. "At the bottom of the dry bulk market last year Chinese ships were selling at huge discounts to Japanese ones – or not selling at all. But as the mood improved, the price gap started to narrow," Bracewell says.

15%

The price discount on a ship made in China, versus one made in Japan

Source: Reuters

Cruise control: China's yards want liner orders

Forget deck quoits and tugs-of-war – some of the entertainment on cruise liners is now so sophisticated that passengers will be speeding around the decks in Ferrari-sponsored go-karts on one of the newest ships. The racing track is one of the attractions on Norwegian Cruise Line's specially-built liner for the Chinese market, which is being constructed at a yard in Germany.

The number of Chinese holidaymakers going on cruises has risen tenfold over the past five years to about two million tourists last year and there are forecasts of 4.5 million passengers by the end of the decade. All of the world's cruise companies want to welcome more aboard and the designs of the newest vessels have concentrated on how the next generation of liners will meet the needs of their Chinese patrons. Kitchens and restaurants are being redesigned to reflect different culinary tastes and entertainment areas are being fitted out with mahjong tables. There is more emphasis on shopping facilities too, because the Chinese spend three times as much as anyone else in onboard retail.

Customers for cruises in China are typically much younger than their international counterparts and they often travel with their entire immediate families, including their parents and their children, but they prefer shorter trips of five or six nights, making it harder to take them too far from home.

Cruise liners are currently built in Europe, with the top-of-the-range vessels costing as much as $800 million. Naturally, the Chinese yards want a piece of the action and Shanghai Waigaoqiao – an offshoot of CSSC – signed a $1.5 billion deal with the Italian shipbuilder Fincantieri to build the first two cruise ships of their kind in China earlier this year. The ships will serve a custom-designed brand for Chinese travellers operated by Carnival, a leading line from the United States. Fincantieri and CSSC also signed a letter of intent aimed at "creating a cruise ship industrial park" in Shanghai.

Insiders wonder whether the Chinese will be able to achieve the same kind of high-end finishes as the leading yards in Europe. "The hulls and the propulsion systems are similar but then you have to put in the hotel facilities and all the luxury amenities, and that kind of supply chain only exists in countries like Italy, France and Germany," says Thomas Bracewell from Hartland Shipping. "The Japanese have tried to get into the same market but they gave up after losing billions. Now the Chinese are saying they will be focusing on ships designed for Chinese passengers, but will they deliver the kind of vessels that the international cruise lines really want?"

The world's largest cruise ship: Harmony of the Seas

Photo: Reuters

The living dead

Confronted with the challenges of reducing capacity and improving quality, the State Council changed tack five years ago and announced that it wanted fewer yards. State support would be limited to a 'white list' of preferred producers.

Unsurprisingly the policymakers have been backing the largest, state-owned shipbuilders. These white-listed yards are seen as safer bets by their customers but the primary advantage is that they keep their access to credit from the major banks. The private yards don't get the same privileges and many have closed. More of the poorer performers have been culled this year as the authorities drop firms that haven't delivered ships or taken orders over the previous 12 months.

Getting rid of the yards completely can be a challenge. Hartland Shipping estimates that there are about 700 yards registered in China, a significant drop versus the peak of the cycle. But only about 150 of them are actually building ships and less than 100 have the capability to do so for the international deepsea market, highlighting the huge number of 'zombie' operators still to shutdown completely, despite little prospect of securing much business.

These zombie yards have been described by an executive from one of the larger shipbuilders as the "cancer cells" of the industry. "If the market starts to recover and you have the influx of speculative yards, they will throw the supply-demand equation off balance again," he warned.

The campaign to slim down the sector faces the same challenges as other oversupplied industries in China, such as local governments that refuse to close down local champions and banks that are reluctant to call in debts and crystallise losses on their balance sheets.

Yet there are also indications that the industry is starting to consolidate, with the top 50 yards capturing nearly all of the Chinese order book in tonnage terms. And as smaller yards close, their workforces are leaving the industry for good. "There is a lot of talk about the surplus of shipbuilding in China being massive but we need to differentiate between the infrastructural or hard capacity of the yards, and the human capital in the supply chain. And in this second area, there is a strong argument that the sector has been shrinking quite dramatically," Bracewell suggests.

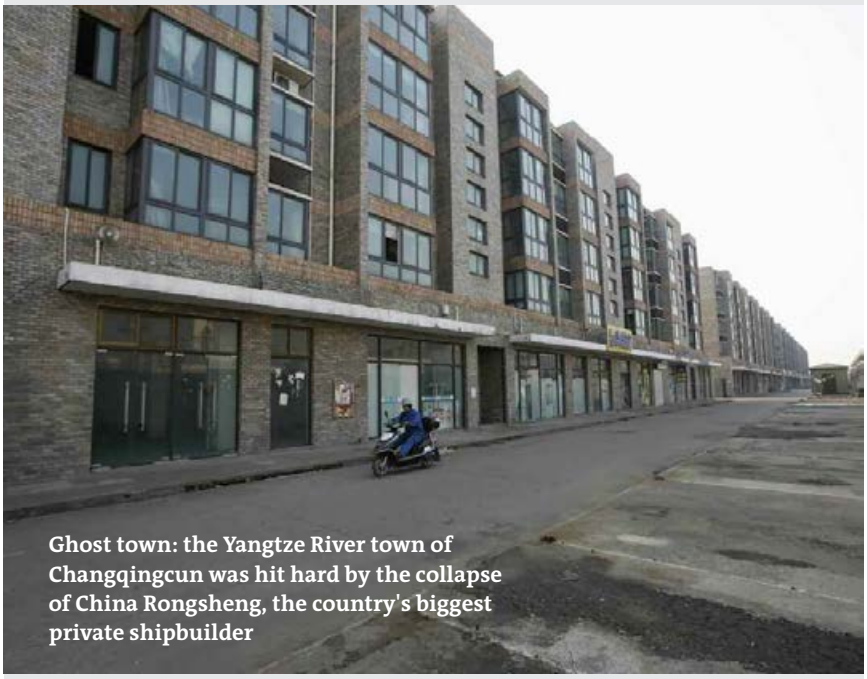
Thomas Bracewell says that China's shipbuilding sector is shrinking dramatically

Beijing at the helm?

Initiatives like the white-listing of the favoured shipyards show that the government's influence is still significant. But the state isn't an all-powerful force. There's a lot less sign of Beijing's guiding hand when state-owned yards compete between themselves for business, for instance. Bracewell says he has worked on

Photo: Reuters

Dockyards that won't die



Ghost town: the Yangtze River town of Changqingcun was hit hard by the collapse of China Rongsheng, the country's biggest private shipbuilder

China has too many shipyards but what do you do when the worst performers refuse to die, stumbling around in the shadows like zombies?

Sainty Marine is a typical case. It started out by buying and selling vessels, but then decided that it should be building them as well. Sainty secured finance from the banks, helped by its status as a subsidiary of a state-owned investment group, and grew quickly into the biggest shipyard in Jiangsu, listing on Shenzhen's stock exchange in 2011.

Once the cycle had peaked Sainty ran aground in a storm of cancelled orders and unpaid debt. Desperate for cash, it tried its hand at entrusted lending to property developers, advising its shareholders that the move into shadow banking was all about "making more efficient use of idle capital". In reality it didn't have the resources to survive. With no bidders for any of its assets, it filed for bankruptcy last year, the first publicly listed company from China to suffer such a fate.

Sainty hasn't disappeared completely, however. In January there was news that it is changing its name to Jiangsu Guoxin and raising another $3.2 billion to buy power assets from its state-owned parent.

China Rongsheng is another of the shipbuilding spectres that refuses to be snuffed out. Once known as China's largest privately owned yard, Rongsheng was a cause célèbre in the period of overexpansion and indebtedness in the sector. Despite its reputation as an independent yard, Rongsheng had actually fostered close ties with the local government. Its annual reports explain that it received billions of yuan in loans and subsidies in Jiangsu, its home province, because of the "essential role we play in the local economy". When it ran into financial difficulties Rongsheng turned back to the government for help in finding a saviour. The case became a test of whether Beijing was serious about slimming down a bloated industry. The answer was mixed: there was no rescue from the state shipbuilding giants but Rongsheng has managed to survive in life-support mode, championed by a local government terrified by the prospect of tens of thousands of job losses.

Since then, Rongsheng has looked even further afield for an escape route, purchasing stakes in four oilfields in Kyrgyzstan. Like Sainty Marine, it has also stumbled around in the shadows, fighting to stay alive. Creditor banks were persuaded to accept a pioneering $2.7 billion debt-for-equity swap last year and shares in the shipbuilder-turned-oil-explorer – now rebranded as Huarong Energy – trade at a punishing discount to their peak in Hong Kong.

Photo: Reuters

deals where two or three yards from the same ownership group are battling for the same contract.

Nor is the Chinese government unique in helping its shipbuilders out. The Japanese grant major tax advantages to ship owners that contract with local yards and the South Koreans have supported their own shipbuilders for years as well – Daewoo Shipbuilding & Marine Engineering, one of the largest yards, is effectively dependent on the Korea Development Bank, a state-owned lender.

In the United States the support has more of a legislative design: shipbuilders there are buoyed by the Jones Act, which mandates transport between American ports must be carried on American-built vessels.

Perhaps a key difference is that the Chinese are more direct about how they support their shipbuilders, with controlling shareholdings in the leading operators and unapologetic loans and subsidies for the favourites. And while the Korean and Japanese producers have a more market-driven approach, it's clear that China's yards are governed as much by political imperatives as profit. The most obvious of these priorities is job creation. Despite the closure of so many shipbuilders, there are still more than 300,000 workers at yards owned by the state, 100,000 in privately run facilities, and another 200,000 at companies that make marine equipment, according to Hartland Shipping's estimates.

"Lots of these yards aren't driven purely by profit, which is why we sometimes see prices for newbuild that seem so far below breakeven costs," Bracewell says. "And when the order books are thin, the instinct of these yards is rarely to fire people but to slow down construction. In effect, they deal with fewer orders by becoming less productive."

That kind of trend runs counter to efforts to improve the bottom-line in Chinese shipbuilding and it undermines some of the country's aspirations to challenge the South Korean and the Japanese.

If all the private yards go bankrupt, the state-owned survivors may feel less pressure to reinvent their own businesses, for instance, and Bracewell thinks that a broader overhaul of the sector would see more of the state operators going to the wall, improving the prospects for the yards that remain.

"Were it not for the sanctity of public sector jobs, China might remove the excess capacity in the sector more effectively, yards could increase their spending on R&D, raise productivity and improve quality, and eventually close the price gap with Japan and Korea," he says.

300,000

Shipworkers employed by state-owned yards

Photo: Reuters

On the horizon

Photo: Basil Pao

The story of the shipping container dates back to the 1930s and a truck driver who had a brainwave as he waited to make a dockyard delivery: instead of unloading his truck, why not just hoist the contents directly onto the ship?

Today virtually all of the 20-foot boxes that carry the world's goods are manufactured in China. And in another sign of how the Chinese are making waves in the shipping world, a shortage of new boxes has seen prices spike significantly.

A tax on toxic emissions comes into effect next year and manufacturers must coat their containers with environmentally friendly paint. The immediate impact is that more than two-thirds of the production line has slowed down as the factories are retooled. Prices for new containers were up more than two-thirds from last year to $2,200 a box by the end of June, stinging the shipping firms at a time when they seemed set to emerge from their worst slump in decades.

The container crunch is another sign of why shipping veterans such as Tim Huxley and Richard Hext watch events in China so closely. The reach of China's economy has made it a beacon for the sector. But what about the accompanying question: are the Chinese going to take control of the shipping world?

Photo: Reuters

Big is beautiful

After a long downturn, the shipping industry is betting that scale will bring back profits: smaller shipyards are closing down; bulk carriers are ordering larger vessels to carry commodities; gigantic containerships are being put to work on the main trade routes; and container lines are grouping together into global alliances.

Size matters more than ever and on this principle alone the Chinese should have a competitive edge. Their economy consumes the bulk of the world's raw materials and generates the largest proportion of its exports. Their shipping lines own and operate the fastest-growing fleets of containerships, tankers and dry bulk carriers. Their terminal operators have been adding to their portfolios of ports and their banks are offering the most readily available finance.

In this regard it's no surprise that the Chinese are being cast as pivotal players. Shipping firms from China have more momentum than their peers and their country is still underrepresented in the industry relative to its share of international trade. China is playing catch-up and the rest of the shipping world has little choice but to adjust.

Playing the national card

Trends like these have prompted fears that the Chinese are trying to take over the industry or at least that they want to bend it to their will.

Some of these efforts have been sponsored directly by the government, such as the campaign to build up an oil tanker fleet under Chinese ownership on energy security grounds. Others have enjoyed more implicit support, including Beijing's backing for its shipowners in their confrontation with Vale on control of shipments of iron ore from Brazil.

The mega-mergers of China's giants – most notably the combination of Cosco and China Shipping – have led to warnings from industry insiders like Basil Karatzas that the Chinese will divert more of their trade to their national lines.

Indeed, Karatzas thinks that they have a plan to move from a role as customers of the shipping sector to one in which they call the shots.

Talk of national strategies in shipping needs some context, however. Europe's shipping conglomerates have been defined as much by the families that control them as their countries of origin, and shipping titans that describe themselves in narrowly national terms look outdated in a world where supply chains extend across borders and time zones.

The raison d'être of the world's maritime leaders is that they have a presence around the globe – and that makes them international by design.

Shanghai: the world's next shipping capital?

Twenty years ago Shanghai announced ambitious goals to transform itself into a world-class financial centre on a par with Hong Kong. With a name that can be translated as 'Upon-the-Sea', Shanghai vowed to establish itself at the centre of the maritime world too.

How is it doing? Menon Economics, a consultancy from Norway that compiles a ranking of the world's shipping capitals, scored Shanghai fourth overall in its latest assessment in April, behind Singapore, Hamburg and Oslo.

The survey focuses on five main parameters: shipping, maritime finance and law, ports and logistics, maritime technology, and overall competitiveness.

Shanghai was outside the top five as a **shipping centre** (defined by ownership, operations and vessel management) and trailing Singapore, as well as Athens, which is home to the largest fleet in tonnage and value terms. Shanghai looks likely to narrow the gap as the Chinese increase their share of vessel ownership, however.

In the **technology** ranking on attributes like shipbuilding and R&D, Shanghai features strongly in terms of the stock market value of its shipyards and the value of the vessels manufactured in its yards.

But it still trails more technologically advanced locations like Busan in South Korea and first-placed Oslo in Norway. Menon points out that Chinese yards still import around half of the equipment installed in the ships that they make.

In **finance and law** London ranks first, buoyed by institutions such as the Lloyd's insurance market and the reliance on English law for most of the world's shipping disputes. Shanghai gets a helping hand from the second-largest market capitalisation for shipping companies on its stock exchange. Not mentioned is the increasing influence of China's banks in ship financing, which should bolster Shanghai's case in future.

In **ports and logistics** Shanghai scores strongly as the world's largest container port, more than doubling its throughput in the last 10 years. It stands out further as a gateway to the vast manufacturing zone in its hinterland, although Singapore and Hong Kong are seen as more important transshipment ports. Menon predicts that Shanghai could soon overtake Singapore because of rising costs in the Southeast Asian hub, plus the momentum of the Chinese market for maritime freight demand.

Scoring is more subjective in a fifth criterion called **attractiveness and competitiveness** but here Shanghai doesn't do as well. Industry insiders cite challenges in doing business, a policy framework that needs overhaul, and problems with the city's 'cluster dynamics' (one criticism is that Chinese firms are too reluctant to share information).

Shanghai has overtaken Hong Kong in the overall rankings since Menon's last assessment two years ago. But the lower scores on competitiveness show that both the private sector and the policymakers have more work to do if Shanghai is going to grab the top spot.

Photo: Reuters

In fact, there's even an argument that cities are more important than countries on the maritime map, as globalising and urbanising trends shift the focus to a smaller number of mega-hubs. China has its own share of contenders in this category, not least Shanghai, which is pressing its claim as the world's maritime capital. But there are plenty of other candidates in other countries for the same title (see sidebar). China certainly isn't dominant yet.

Policy or profit?

Competitors of China's shipping interests complain that they are benefiting from too much government support. In many cases, they're right: Chinese firms have an easier time getting loans from the state banks and they have been piggybacking on policy priorities like the Belt and Road plan to make new investments in ports and fleets.

But identifying who might be pulling the strings on a coherent national strategy for shipping is a challenge. Government ministries trumpet plans and targets on a regular basis but implementation is often unfocused and outcomes are unclear. Interests that might look 'national' at first glance can also turn out to be fragmented and contradictory. Some of the battles being fought inside Chinese shipping are hardly unique to the sector – central government versus local, province versus province, and state-controlled versus private sector, to name just three. But the shipping industry is also home to a range of competing concerns that makes national consensus harder to achieve. Boom times for the shipbuilders aren't always a positive for the shipping lines as a flood of new vessels crimps freight and charter rates. A surge in new ship supply puts pressure on asset prices, alarming owners and investors. Ship financiers have different concerns to their clients in structuring loans and leases, while port operators make their money from maximising the fees from the ships that visit. Helping all of these parties to win at once is an impossibility.

Another suggestion is that China's policymakers want their shipping firms to shoulder the financial burden of an unprofitable sector for the greater good. In this respect the fleets and yards are loss leaders for the nation. The ultimate goal is control of the world's trade lanes and the benefits that it brings to 'China Inc'.

Cosco would serve as the flag bearer for this kind of strategy, underpinned by its wide-ranging resources: it already owns and operates a vast array of bulk and container vessels; it has stakes in many of the world's ports; and it has the capacity to build and finance more of its own fleet.

Yet the complexities in stitching these assets together are daunting. Companies like Maersk combine ownership of container lines and container terminals,

GLOBAL SCALE. INNOVATION. LONG TERM COMMITMENT.

HELPING OUR CLIENTS SUCCEED BY COMBINING STRATEGIC ADVICE WITH LEADING FINANCING SOLUTIONS.

May 2017

CHEMCHINA

USD 46.3 billion

Acquisition of Syngenta by China National Chemical Corporation (ChemChina).

HSBC acted as Lead Financial Advisor and Sole Initial Underwriter of $20bn of "BidCo" debt.

February 2017 (Announced)

rb

HEALTH · HYGIENE · HOME

USD 17.9 billion

Acquisition of Mead Johnson Nutrition Company by Reckitt Benckiser.

HSBC acted as Financial Adviser and Financier.

September 2016 (Announced)

BAYER

USD 57 billion

Acquisition financing in respect of Bayer's announced acquisition of US-based, publicly listed Monsanto.

HSBC acted as Underwriter, Bookrunner and Mandated Lead Arranger.

October 2016 (Announced)

TASNEE التصنيع

USD 2.2 billion

The National Titanium Dioxide Company (Cristal) will transfer its titanium dioxide businesses to Tronox Ltd, in return for USD 1.67 billion cash and a 24% stake in the combined entity.

HSBC acted as Financial Adviser.

October 2016

西王集团 XIWANG GROUP

USD 730 million

Xiwang Group, through its listed company Xiwang Foodstuffs, in partnership with Primavera Capital, USD 730 million acquisition of 100% of Iovate Health Sciences International.

HSBC acted as Financial Adviser.

April 2016

PING AN

Insurance · Banking · Investment

Acquisition by Shanghai Jahwa (Group) Co. Ltd (a subsidiary of Ping An Insurance), of Mayborn Group Ltd from 3i Group plc.

HSBC acted as Financial Adviser to Jahwa (Group).

HSBC

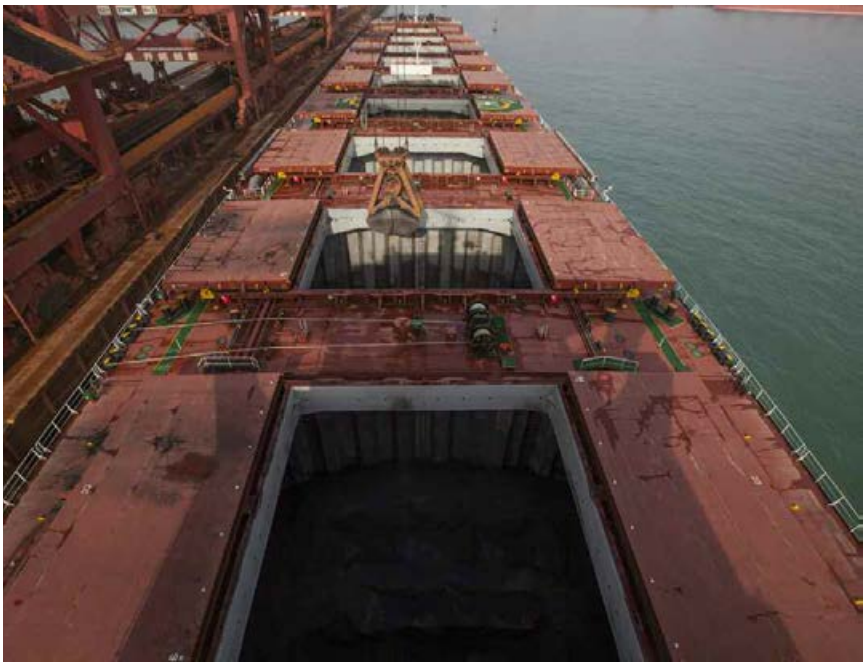


Photo: Basil Pao

but none of the majors have come close to mastering the seas in an all-encompassing way.

Such a task is demanded of a national champion laid so low by the meltdown in freight and charter rates a decade ago that it needed rescue by the state. And Cosco will have to achieve its Herculean endeavour as the industry transforms. The supply chain is already reshaping as manufacturing capacity shifts to countries like Bangladesh and Vietnam, while near-shoring of production closer to the largest markets in Europe and North America could also see more redrawing of the world's shipping lanes. The rise of digital services like Netflix and Kindle threatens more of the physical shipments of consumer goods in general and the advent of 3D printing and the 'sharing economy' could have a similar impact on flows of industrial materials. Even if it can establish an international empire, Cosco arguably might find itself as master of a diminishing domain.

Tracking China's champions

Some of the talk of maritime mastery might be a little overblown, but where will China's shipping firms make the most progress in the next few years?

Over the medium term its container lines are going to grab more business in many of the main trade lanes, increasing their share to something closer to China's proportion of global trade.

More immediately, its bulk carriers and tankers will carry more of the country's imports, buoyed by the delivery of a new fleet of megavessels to operators like China Merchants and Cosco.

Both companies will expand their presence across the world's ports and container terminals, often under the Belt and Road banner. Ports like Piraeus in Greece are crucial test cases: if the pioneer projects go well, they will serve as beachheads for another wave of investment in cross-border trade and transport.

Back at home in the Chinese shipyards, the focus will be quality rather than quantity. The weaker shipbuilders will close down, much to the relief of the industry at large. However, Beijing will push the survivors to challenge the Korean shipbuilders in higher-end vessels like gas tankers and the giant containerships, and to catch up with the Europeans on the next generation of cruise liners.

And of course, the Chinese banks will be providing a larger share of the financing for all this activity – indeed, another key feature of the years ahead is how astutely they manage their loans and lease books.

That's the short summary of how China is shaping the shipping world. Not yet dominant but still a determining force – and a much more integral part of the shipping world than a generation ago.

Cosco buys Orient Overseas

Bigger is better in the world of container shipping where supersized ships and high-profile takeovers have been key themes as the leading lines jostle for position. In Cosco's case that has meant a longstanding interest in Orient Overseas Container Line, the eighth biggest carrier worldwide in capacity terms.

After months of speculation that it was going to make a bid for the Hong Kong-headquartered line, Cosco finally made its move early in July, just as this publication was going to press. The $6.3 billion offer will catapult the Chinese carrier into third place in the world's container fleet.

Cosco executives are waiting for the green light from investors and regulators but in the meantime, how well does the bid stack up against the claim that China is intent on greater control of the seas?

'China Inc' in action

Evidence of the involvement of the Chinese state in the Orient Overseas bid is fairly compelling. The offer is being financed with $6.5 billion in capital from Bank of China, a state-owned lender, and Cosco has been joined by state-owned Shanghai International Port Group as a junior partner. Cosco is rumoured to be interested in taking a stake in SIPG, which controls the world's busiest container port and Cosco's ports division partnered with SIPG earlier this year to channel more traffic between Shanghai and Piraeus. A fuller collaboration between the two companies would put them in position to provide a fully integrated trade lane into Europe – container boxes loaded by SIPG in Shanghai, shipped on Cosco vessels, and unloaded at Cosco-controlled Piraeus.

"SIPG's involvement in the Orient Overseas deal is therefore not a left-field move but very much further evidence of the consolidation and intertwining of Chinese-owned port sector activity," reports Drewry Maritime Financial Research.

Of course, Orient Overseas is already reputed to have close ties with Beijing, despite being run from Hong Kong by the Tung family for almost half a century.

A consortium featuring mainland banks helped to bail the family out when it got into financial difficulties in the 1980s and Tung Chee-hwa – who was running the shipping line at the time – was later appointed as Hong Kong's first leader under Chinese rule.

That led to sniping in some of the city's media that Cosco's bid for Orient Overseas is a reward for the family's loyalty. "Tung Chee-hwa's story is an inspiring one," scoffed one local columnist. "Even when your company is on the verge of going under, the motherland will throw you a lifeline and give you another chance if you love your country enough."

The struggle for scale

Orient Overseas is widely regarded as an excellent candidate for a takeover, with a well-managed operation and a young, fuel-efficient fleet. Helpfully it is already a partner in the same shipping alliance as Cosco, alongside CMA CGM, the line that will give up third spot in the global rankings.

But the backdrop to the bid is the frenetic round of consolidation across the industry. All of the leading carriers have been active in acquiring smaller rivals and Drewry expects that the top seven lines will control at least three-quarters of the container fleet by 2021, compared with 37% in 2005.

China's container shipping world took its own merger medicine last year with the combination of Cosco and China Shipping, and shortly

Photo: Reuters

before it made its offer for Orient Overseas, Cosco gave notice that it was anticipating a net profit of about Rmb1.85 billion ($272 million) in the first half of 2017, compared to a net loss of about Rmb7.21 billion in the corresponding period last year.

Better conditions in the market had helped, it admitted, but there were encouraging signs that the merger with China Shipping was paying dividends in higher freight rates and surging cargo volumes.

Company strategists will be hoping for the same again with the Orient Overseas deal. If the takeover goes through, the combined entity will control the biggest share of trans-Pacific trade and the third-largest share in Europe-Asia trade, the two key routes. The larger entity will strive for lower unit costs and improved pricing power, steering more of its business towards terminals in which it has ownership stakes and driving a harder bargain at third-party ports.

Any more acquisitions ahead?

Cosco is running out of options for where it might look next for takeover targets as the group of medium-sized global carriers has largely been taken out.

The remaining Taiwanese lines like Evergreen and Yang Ming seem problematic in political terms and seem more likely to be pressured into domestic marriage by Taipei officials.

A bolder possibility is an investment in CMA CGM, one of Europe's heavyweight lines. Conveniently Turkey's Yildirim Holding wants to offload its 24% stake in the Marseille-based giant, although the French authorities aren't likely to be as laissez-faire as Hong Kong's in welcoming Cosco's attentions. A fuller merger between two of the world's leading container lines might find it harder to get regulatory approval too.

Cosco might still explore the possibilities of taking a stake in the French shipper and a bid would be a clear signal that the Chinese want more control over the shipping world.

"Over the coming months the Chinese will no doubt test the resolve of the French to block sales of CMA CGM shares to China," predicts Olaf Merk, a respected commentator, on his industry blog. He also thinks that France could play the national card in nixing Cosco's interest. "The French state might even consider buying shares in CMA to pre-empt the Chinese doing so, which might be a logical consequence of the discussion this year on what constitutes a strategic merchant fleet," Merk says.

Subscribe to Week in China

Week in China is an easy-to-read digital magazine that covers Chinese business, society and culture. Over the past seven and a half years we've covered all the major stories and trends that are shaping China's growth and development, and profiled many of the country's business leaders. Subscribers have full access to our website, which contains an archive of over 5,000 articles.

To sign-up for a complimentary subscription, use this URL:

www.weekinchina.com/beltandroad

Week in China


"THIS IS STILL THE ASIAN CENTURY AND CHINA IS STILL THE KEY PLAYER."
Peter Wong – Deputy Chairman and Chief Executive, Asia-Pacific, HSBC
Does your bank really understand China Growth?
With over 150 years of on-the-ground experience, HSBC has the depth of knowledge and expertise to help your business realise the opportunity.
Tap into China's potential at www.hsbc.com/rmb
HSBC
Issued by HSBC Holdings plc.