WHITE PAPER

What's Next for Container Shipping in the Red Sea Crisis

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Houthi attacks on the Bab el-Mandeb strait, between the Red Sea and the Gulf of Aden, have continued long past the hoped-for quick resolution. Container lines have now brought online all the new capacity they're likely to gain soon, and beneficial cargo owners are no longer holding back shipments. With most Red Sea transit freight rerouted around the Cape of Good Hope, and shipping rates rising, the industry—with its impressive efficiencies—is at a turning point. We have revised our earlier article on the crisis accordingly.

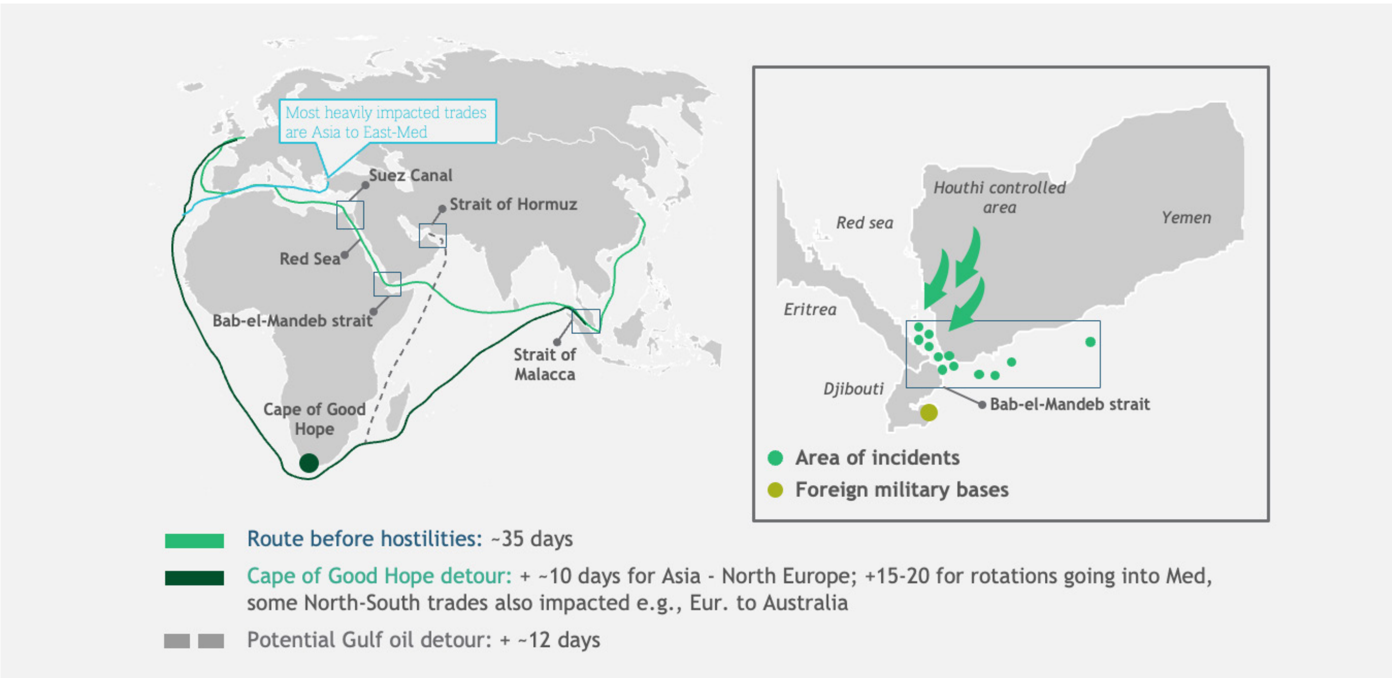
To help container lines and cargo owners respond, we present four scenarios for this dynamic and evolving crisis. Rather than a short-term aberration, we see the trouble as a signal for the industry to invest in preparedness for future disruption.

Background on the Crisis

Houthi spokespeople claim the attacks are a way to show solidarity with Palestinians and opposition to Israel's assault on Hamas in the Gaza Strip. Yet, most of the targets have no obvious connection to Israel or its allies, and have even included ships bringing humanitarian aid to Yemen. The Houthis actually began attacking shipping in 2020, but escalated after October 2023, and have so far refused attempts to negotiate peace. Unlike pirates, they have not tried to board ships or steal cargo. While their goals are unclear, the attacks have been surprisingly effective. Combining guerilla tactics with drones and mobile launchers, the Houthis have carried out dozens of attacks and inflicted significant damage on many large cargo ships, even sinking one and killing civilians.

US and British forces have targeted both surface and underground infrastructure. Yet the Houthis have not backed down, and shipping remains perilous. Attacks have actually increased and broadened, with greater firepower at a longer range. In July, the Houthis sent a long-range drone to Israel, causing damage and killing one person; in response, the Israelis bombed the major Houthi port of Hodeida, killing a reported six people.

Exhibit 1 - Trade disruptions in the Red Sea have severe impact on global shipping



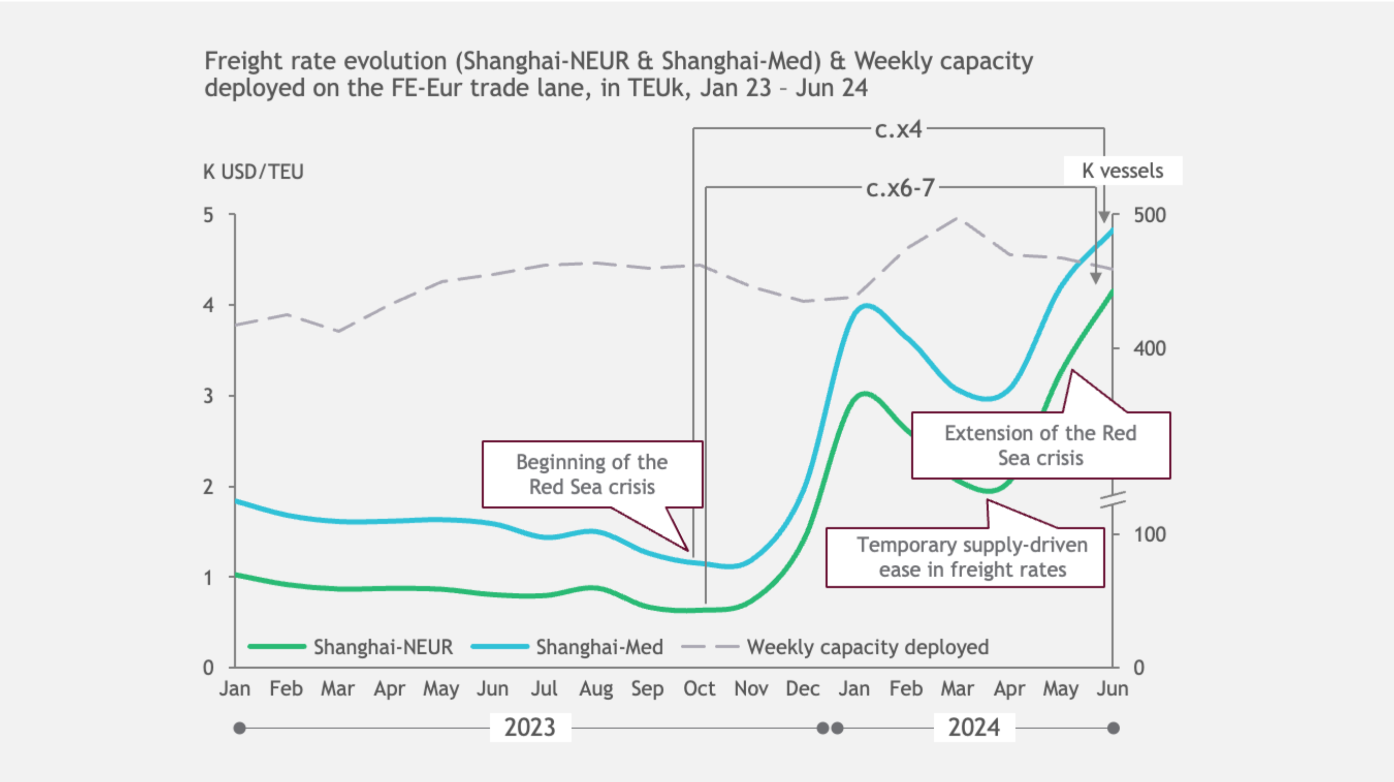
1. Rerouting shipments around the Cape adds ~10 days to trip duration, depending on vessel type and speed. Note: Other key North-South routes not depicted on this map, e.g., North-Europe – Med – East Africa/ANZ. Sources: Clarkson; WSJ; Goldman Sachs; S&P; Economist; Politico; EIA; BCG analysis.

The Houthis are attacking at a choke point. Before 2023, Red Sea shipping carried 12% of global trade and 40% of Asia's trade with Europe, as it is by far the most convenient route from East Asia to Europe. The Bab el-Mandeb strait itself saw a third of global container traffic. (See exhibit 1.)

With the attacks having continued into the summer, container liners have now exhausted their short-term adjustments. They have rerouted nearly all their East Asia-Europe vessels south through the Cape of Good Hope. That adds 30% more time for shipping from Asia to Northern Europe, and even more to the Eastern Mediterranean. As for the Suez Canal, its deep-sea cargo transits have fallen by more than half. Feeder vessels and oil tankers that originate north of Yemen are still going through.

Global freight rates initially tripled in January 2024 over the previous January, then fell temporarily in March 2024 as cargo owners delaying shipments and liners added capacity to the trade lanes (either new ships or those drawn from elsewhere). The rates are now rising again, exceeding the earlier levels, and customers have fully resumed their shipments. (See exhibit 2.)

Exhibit 2 - Freight rates already increased by x4-7 since Oct. 23, despite a temporary ease in April 24 driven by supply by cascading of ships and speed increase

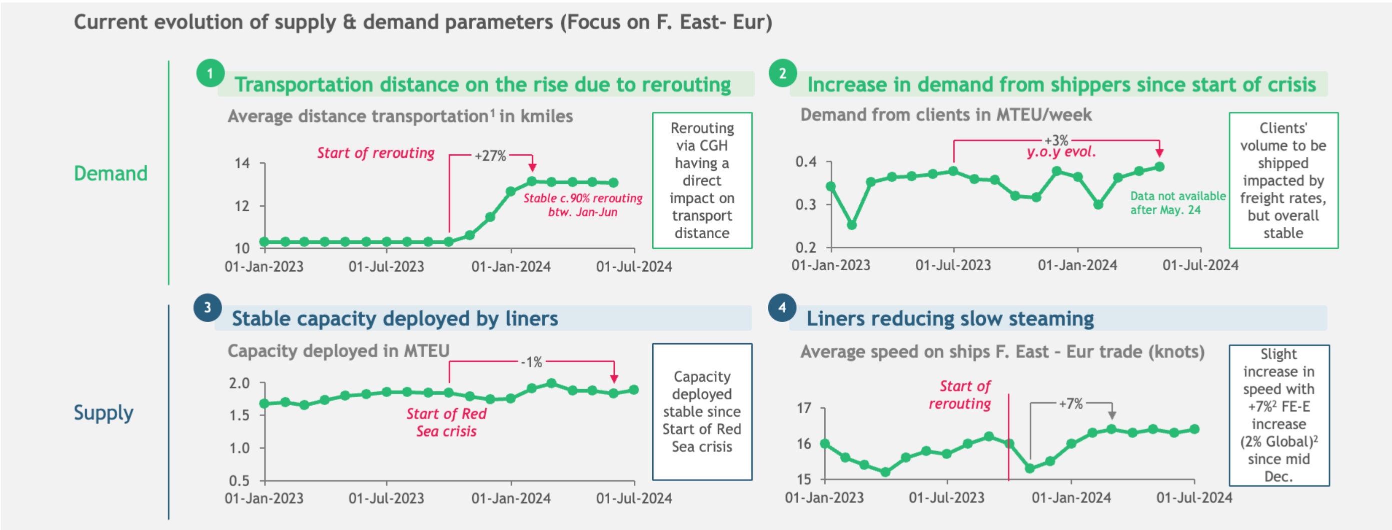


1. Cape of Good Hope

Source: Alphaliner; Clarkson; Expert interviews; BCG analysis.

While raising rates, the liners moved quickly to secure their customers' supply chains by rerouting vessels. They also absorbed part of the costs of operational adjustments, and have worked to re-optimize vessel usage, frequency, and fuel efficiency. Plus they have negotiated with suppliers and sought cost-sharing through alliances (See exhibit 3.)

Exhibit 3 - Which has been only partially compensated for by an increase in supply.



Using rerouting ratios reported by Clarkson for F. East- Europe (incl. F.East – Med) and hypothesis of +30% miles for FE-E

Source: Source: Clarkson, Alphaliner (Monthly monitor); BCG analysis.

With these short-term levers exhausted, all available capacity is now in service and operating at higher speeds, while overall demand has largely returned. The container lines can still fulfill orders, but at much higher rates. Some ships that used to run from Asia to the Indian subcontinent have shifted to Northern Europe.

Early on, it seemed the crisis might prompt cargo owners to redirect parts of their cargoes toward the India-Middle East-Europe Economic Corridor (IMEC) or Iraq-Turkey corridor. But we've seen little shift, as significant operational constraints remain. Those routes won't be a practical alternative for another decade. Air freight has increased, especially Asia-UAE air cargo transportation to Europe, but not enough to make a meaningful difference

Because the crisis has continued, global logistics will remain unsettled for some time to come. Even if peace came tomorrow, shipments would face delays for months. That's because the ports have reshuffled their operations to avoid the congestion from the new timings of ship arrivals. The industry would need at least three months to overcome this congestion to return to its previous timeliness. Even with apparent peace, liners and cargo owners will wait to be sure before reverting services to their pre-crisis rotations.

To accommodate this eventual normalization, some affected ports, such as Jeddah Islamic Seaport and King Abdullah Port in Saudi Arabia, have actually expanded capacity. But the accustomed, efficient, just-in-time flow of containers and other big freighters worked only when the sea lanes were truly open. That situation looks far off, if it ever returns.

How the Crisis Could End

A resolution in the next few months is still possible, as political and military leaders try to manage the crisis. We focus on container shipping with four scenarios:

1 **Quiet End to Turbulent Year:** The attacks peter out this fall due to sporadic Western responses, combined with Houthis depleting their stores and the end of fighting in Gaza and elsewhere in the region. Containers largely return to the Red Sea, but normal shipping doesn't resume until 2025.

2 **Military Escalation:** Houthi attacks intensify until the Western allies assemble a major military response that finally ends the crisis in early 2025. Normal shipping resumes by the end of 2025, but liners diversify routes to avoid conflict, with a moderate shift to other trade corridors.

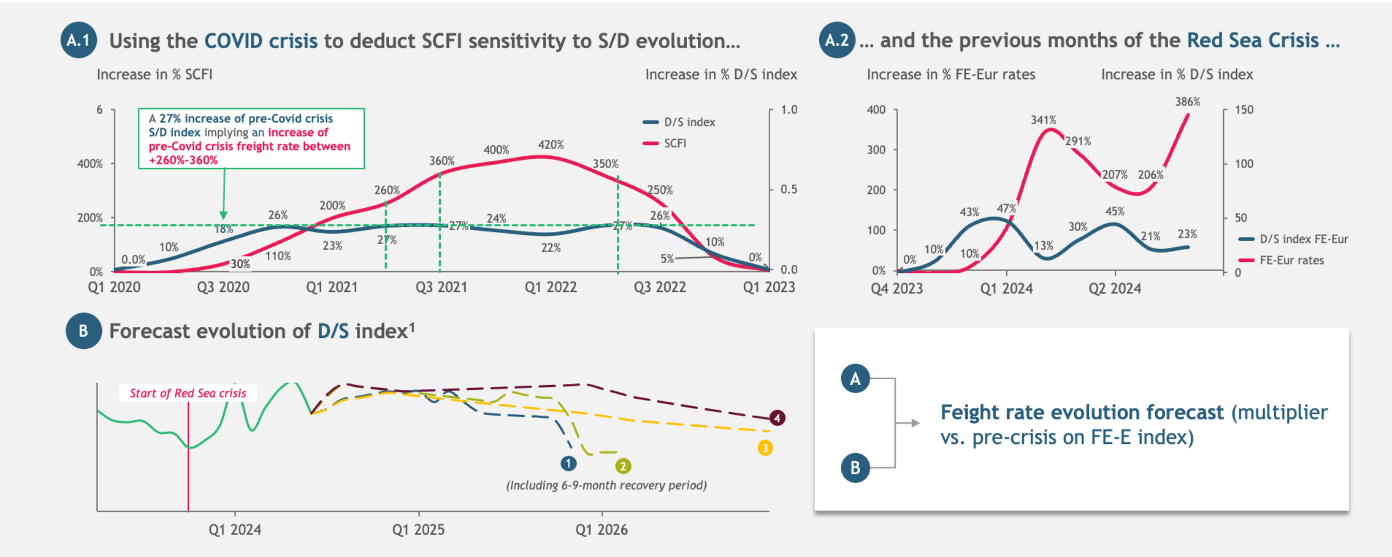
3 **Muddling Through:** The attacks ebb, but persist into 2026, as the allies cannot find a common solution. The crisis is contained at the Red Sea, but the continued lack of security prompts a medium aggregate loss for the region, with trade shifting to other corridors.

4 **Regional Crisis:** The attacks escalate on all sides, and warfare engulfs the Arabian Peninsula. A broad economic impact continues to 2026 and beyond, depending on cease-fire negotiations. The Bab el-Mandeb strait is effectively closed, with all traffic rerouted to the Cape of Good Hope, and shipping rates rise further. The region suffers a high aggregate trade loss, with a medium-mix shift to other corridors as the new normal. Maritime trade begins to adapt on a long-lasting basis. Demand for shipping from the Far East to Europe falls 2+%, as global GDP itself falls by 1%.

Shipping Dynamics

With attention to key variables, we built a model to show the impact of these scenarios. (For the variables in the model.see exhibit 3, for methodology see exhibit 4.)

Exhibit 4 - Methodology of calculation of freight rate evolution is based on Covid crisis & current crisis data and forecast S/D index



Demand/Supply ratio evolution versus pre-crisis level (i.e., proxy for demand/supply disequilibrium triggering price increases) – computed with Demand index and Supply index evolutions described in previous slides.

Source: Clarkson, Alphaliner, Expert interviews, BCG Analysis.

Under scenario 1, liners concentrate on the logistical problem of returning to quasi-normal. Ports need several months to clear out congestion, due mostly to the equipment imbalances.

Under scenarios 2–4, liners see no immediate hit to profitability, but cargo owners may start reorganizing production flows and alter their manufacturing and supply chain networks. They might also increase their prices wherever possible to preserve margins, which might also reduce cargo volume (See exhibit 4.)

Indeed, an extended crisis would significantly hurt customers' profitability, especially those with low-value/high-volume cargo. On the carrier side, similar to what happened during COVID-19, the liners' revenue from higher freight rates would likely exceed the additional operational costs from longer transit times.

Liners, directly or through logistical arms, would probably also develop a wider product offering to give options to their clients. Examples might be routes to Europe via the IMEC, or Um Qasr in Iraq. But these alternatives would need several years of investment, as they are already suffering from operational bottlenecks and other constraints. Under scenario 4, the entire region, including India, would in any case lose its central positioning as a re-export hub.

Impact on the Arabian Peninsula

While the continuing crisis affects all global shipping, ports on the Arabian peninsula have seen the greatest impact. Most affected are those along the Red Sea, especially Saudi Arabia's west coast ports of Jeddah and King Abdullah. Their long-distance container volume has collapsed, and their transshipment activity has also fallen, though their reliance on small feeder lines has actually increased, mostly for domestic supply.

The main hit, especially with scenarios 2–4, would be in further losses in transshipment. Liners have already shifted cargo to Mundra, India, and Columbo, Sri Lanka. Ports along the eastern Arabian Peninsula have also benefitted, partly with feeder services. The United Arab Emirates, especially Dubai, has been well positioned as an entry point for intermodal options in the region as these have emerged.

In scenario 4, where the entire region becomes dangerous for shipping, even those options would be off the table. Already, the momentum to develop IMEC has stalled. The entire Arabian peninsula could lose its relevance as a re-export hub with transshipment. Even under scenarios 2 and 3, customers might move their re-export business elsewhere. The local economies, from Egypt to Central Asia, are already suffering from increased pressure on certain resources and infrastructure, coupled with declines elsewhere, and these trends would worsen.

The Need for Preparation

Besides these largely tactical issues, we see a substantial change in the container industry. We urge the following for liners:

- **Embrace the new normal of geopolitical flux:** Liners are understandably hoping for the continuation of the previous few decades of relative geopolitical stability. In those decades, container shipping expanded dramatically with economies of scale, and shipping rates and insurance fell substantially. But with rising geopolitical tension generally, that stability is unlikely to return for a while even with peace in the Middle East. Seamless access to key nodes of containerized trade, such as the Red Sea, cannot be taken for granted.

- **Forge resilience against the tide of crises:** Liners should prepare for a new era of recurring disruption. Even where navigation faces no attacks, governments may impose restrictions in response to tension. Hot spots can flare up on short notice.

- **Cultivate agility.** In the shadow of global unrest, liners need to boost their responsiveness and flexibility, while cargo owners need supply chain security. Liners that address these challenges will preserve or expand their revenues. Strengthening geopolitical muscle can help here.

- **Learn from the legacy of crisis navigation.** Liners can follow the example of commodity shippers working in volatile regions, which have long invested in the capability to address crises while maintaining long-term profitability.

- **Initiate a strategic reawakening.** The ongoing Red Sea crisis, however resolved, can prompt a new agenda of preparation—an opportunity to rethink, retool, and rejuvenate strategies for a world in which stability is the exception, not the rule.

For cargo owners, the impact depends on their inventory level, need to ship goods, sensitivity to transport prices, and sensitivity to transport time. With their short-term remedies exhausted, and limited alternative routes available, the longer conflict scenarios will reduce their profitability, especially those with low-value/high-volume cargo.

They likely will not wait for structural changes; they can work now on rethinking their value chains to limit risk, including intermediate stops and transshipment. Should they doubt the long-term stability of the Middle East, they may want fewer hubs there, and more in India or Sri Lanka. Even in peace, things could go wrong, so they need to think strategically. The following are options to reduce risk and boost resilience:

- **Review their manufacturing network.** Cargo owners can reorganize production flows within the current network, and/or broaden the network, potentially through relocalization. Re-shoring or near-shoring may make more sense, as they cannot expect a magical return to normal shipping.

- **Adjust distribution.** They can perform regular inventory level checks and rebalance their storage vs. shipment ratios, assess potential internal rerouting options through other storage centers, and in the long run alter the distribution away from impacted routes

- **Adjust pricing.** They can reassess and renegotiate procurement with logistic suppliers, and preserve margins through careful price increases to customers.

We hope this continuing crisis leads not just to short-term responses, but also to an awareness of greater risk generally in a less-stable world.

Scenarios are based on trends as of August 30, 2024. This analysis represents only scenarios and is not intended as a prediction or forecast.

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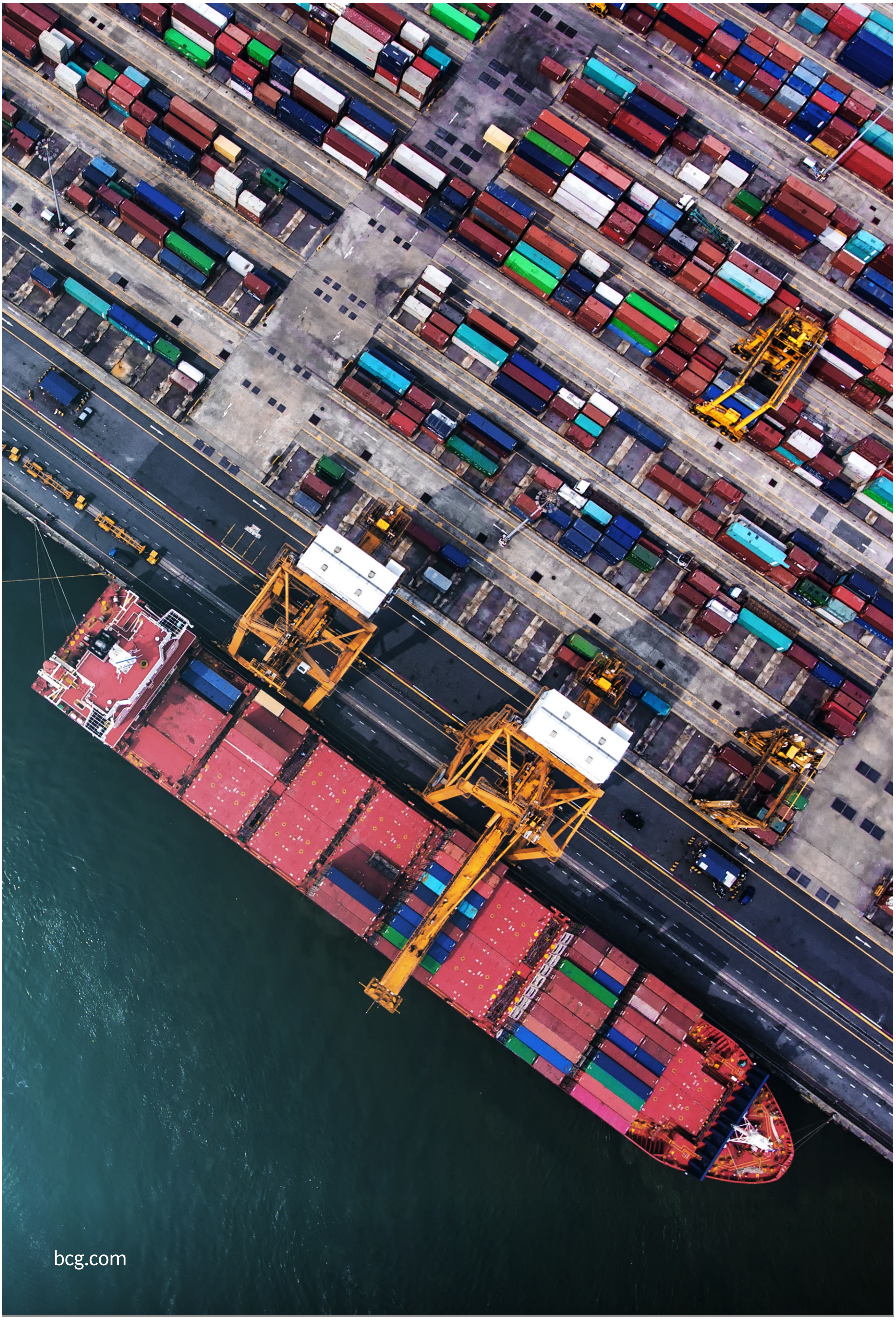
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