American Shipper

Matson’s diversity helps lifts revenues

Chris Dupin

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Matson Inc. on Thursday reported higher revenue for the full year 2018 and the fourth quarter of last year, but profit was lower because of the one-time boost the company had gotten the prior year from the Tax Cuts and Jobs Act of 2017. However, when last year’s net income was adjusted downward to cancel out the effect of last year’s tax windfall, net income was up for both the full year and fourth quarter.

“Our operating performance in the fourth quarter was in line with expectations, with strong demand in our China service and strong execution across all service lines in logistics," said Matt Cox, Matson's chairman and CEO.

"For the year, we performed well with exceptional performance in our China service and significant contributions from logistics and SSAT (the company’s joint venture with Stevedoring Services of America that operates seven terminals), all of which helped propel the company’s annual cash flow from operations to a new high,” he added.

For the full year 2018, Matson had total operating revenue of $2.2 billion, an 8.6 percent jump over 2017. In the fourth quarter of 2018, total operating revenue amounted to $565 million, a 9.5 percent increase over the fourth quarter of 2017.

Net income for 2018 was $109 million, down from $232 million in 2017. However, that adjusted net income of $109 million actually was 41.6 percent higher than the adjusted net income of $77 million in 2017 ($232 million minus the $155 million tax adjustment).

The Tax Act was signed into law by President Trump on Dec. 22, 2017, so the entire effect was seen in the fourth-quarter results. In the fourth quarter of 2018, net income was $20.6 million, compared with $166.9 million in the fourth quarter of 2017. But the $20.6 million was 73.1 percent higher than the $11.9 million adjusted net income in the fourth quarter of 2017 (166.9 million minus the $155 million tax adjustment).

“The diverse nature of our transportation and logistics businesses rang true in 2018,” Cox said in a telephone call with securities analysts on Thursday. “The favorable contributions in our China service, SSAT and logistics outweighed the impact of the ongoing competitive situation in Guam and lower southbound volume in Alaska. For 2019, we expect the diversity of the business drivers to continue to bring consistency to the consolidated group.”

Matson's CEO. Cox, 57, has worked at Matson for 19 years and has been CEO since June 2012. He was president of the Matson Navigation subsidiary going back to 2008. At that time, Matson was a subsidiary of Alexander and Baldwin. It became a standalone company trading its own shares on the New York Stock Exchange in 2012.

“It’s a great culture here and it’s a pleasure to be part of this organization,” he said during a wide-ranging interview at Matson's office in Oakland, Calif. Cox is based in Hawaii, but splits his time between Matson's locations there, in Oakland and the company's far-flung network.

While the company does not break out financial results by market, the company long has been associated with Hawaii, beginning in 1882 when Capt. William Matson sailed a three-masted schooner from San Francisco to Hilo.

That's been good for Matson, Cox said. "The Hawaii economy is doing very well. It's been on a nice, long economic run."

Looking forward, Cox pointed to the annual forecast from the Economic Research Organization at the University of Hawaii, which said in December that "Hawaii's economy remains on a favorable path, with record-high visitor numbers, record-low unemployment, and ongoing — if unimpressive — income gains. As expected, the economy's rate of expansion has slowed as the business cycle has matured and risks to the external environment have increased. But at present there are no signs of an imminent downturn. Instead, further growth at a restrained pace is the most likely outcome for the next few years at least."

Cox said, "When I got here 19 years ago, Hawaii was such a large part of Matson's consolidated results. One of the thoughts that we had was that given our long presence in the Hawaii market it was unlikely that we were going to grow differently than that market itself."

So the company has worked to "diversify into other markets for which we felt we knew how to operate that we could add value that were consistent with how we ran the Hawaii trade," he said.

Today, Matson has several "earnings platforms," in addition to the Hawaii trade, which it can draw on, including:

• Matson Logistics, which accounted for 26 percent of Matson's overall revenue in 2018.

• Matson's container service to Alaska, which it acquired in 2015 from Horizon Lines.

• Matson's "China-Long Beach Express" or CLX service, the eastbound leg of which offers a fast transit time from Xiamen, Ningbo and Shanghai to Long Beach.

• Service to Guam, the Marshall Islands and Okinawa on the westbound leg of its CLX. After its Long Beach call, the CLX rotation calls Honolulu and Guam before returning via China.

• A growing presence in the South Pacific that was launched in 2013 after it acquired the Auckland, New Zealand-based Reef Shipping. Core trade lanes extend from New Zealand and Australia to the island nations of Fiji, Samoa, American Samoa, Cook Islands, Tonga, Niue, Nauru and the Solomon Islands. In addition, Matson offers service from the U.S. West Coast and Hawaii to American Samoa, Samoa and Tahiti.

• The company also has a joint venture with Stevedoring Services of America that operates two terminals in Long Beach, two in Oakland and one in Tacoma and two in Seattle.

While Matson does not break out revenue and earnings figures for individual trade lanes, it does publish the number of containers (measured in 40-foot equivalent units or FEUs) it moves on each trade lane. In 2018, it moved 148,700 Hawaii containers, 69,100 Alaska containers, 61,600 China containers, 19,700 Guam containers and 16,300 containers on other trades to various islands in Micronesia and the South Pacific as well as Okinawa, Japan. It also moved 63,100 Hawaiian automobiles.

"We have grown significantly outside of our original Hawaii routes," said Cox, while heavily investing in improving service to the Aloha State.

Jones Act Mainstay. Matson is in the final stages of replacing five older, steam-powered containerships with four new diesel ships for service between the U.S. West Coast and Hawaii.

Because the ships are operating in trades between two points in the United States, they are subject to cabotage laws, commonly known as the Jones Act. As a result, they must be registered and built in the U.S., which is much more expensive than construction in a foreign shipyard, and crewed by U.S. mariners.

"We're going to be basically bringing in four new Jones Act vessels, just under $1 billion dollars' worth of investment in Jones Act ships," he said.

While the Jones Act is the subject of intense criticism — the late Sen. John McCain was a longtime opponent and the Cato Institute has a major campaign attacking it — Cox said, "We have terrific support, both Democrat and Republican."

He said the law supports American jobs for mariners and shipyard workers, supports border security because it prevents foreign-built vessels from going into inland waterways and is attractive to the military because it provides trained crews in times of national emergency and helps maintain shipyards that can be used to build and repair naval vessels.

Mike Hansen, president of the Hawaii Shippers Council, said that while he welcomes the new ships, he is concerned that their high cost will result in freight rates rising. His group was formed in 1998 to support the Jones Act Reform Coalition, which unsuccessfully sought to allow ships for the Hawaii, Alaska and Puerto Rico trade to be built overseas.

During a conference at the Cato Institute last year, he said, "Not only would allowing foreign-built U.S. flags into the trade lower the capital cost by approximately four-fifths, it would also bring new competition into those trades, new competitive pressures into those trades as soon as the barrier to entry is dropped so dramatically by allowing the lower-cost ships into the trade."

The first of two new 3,600-TEU ships built for Matson by Philly Shipyard, the *Daniel K. Inouye*, entered service in November, and the second, *Kaimana Hila* (a transliteration of Diamond Head), is getting delivered at the end of March and will be in service in the second quarter of the year.

Two combination container/roll-on, roll-off ships (conro) — the *Lurline* and *Matsonia* — are under construction at the General Dynamics NASSCO shipyard in San Diego and are scheduled to enter service at the end of this year and in the third quarter of 2020, respectively.

Cox said the two new containerships will call Honolulu, Seattle and Oakland rotation, while the combination conros will call Honolulu, Oakland, and Long Beach.

In combination with the existing five-ship CLX service, Matson will be able to replace its current 10-ship deployment in the Hawaii trade with nine ships. The company says that will result in annual savings of about $13 million a year.

The four new ships Matson is building at Philly Shipyard and NASSCO have engines that can be converted to LNG and space to install LNG tanks, if the company decides to move in that direction.

"We elected not to do it up front because there was no LNG commercial fuel source available on the West Coast at the time," he said. "We do believe that over time an LNG market for fuel will be available on the West Coast. … Over the 40-year life of these vessels, having the ability to convert to LNG could be a good outcome for us."

Hawaiian Trade. Matson is upgrading its Sand Island terminal in Honolulu, installing three new gantry cranes and upgrading three others, as well as the terminal's electrical infrastructure. It is planning to expand its terminal when Pasha, its main competitor in the Hawaiian trade, moves to the new Kapalama terminal in Honolulu.

When Horizon Lines went out of business, Pasha took over the company's Hawaii service. A well-established stevedoring and vehicle processing company, Pasha put its first ship, the roll-on/roll-off ship, *Jean Anne,* into the U.S. West Coast-Hawaii trade in 2005. It added a second combination conro ship, the *Marjorie C,* in 2015, while also acquiring Horizon's Hawaii business. Pasha currently has two 2,525-TEU containerships that will be fueled with LNG under construction at the Keppel AmFELS yard in Brownsville, Texas, that are scheduled for delivery in 2020.

In addition to Pasha, Matson faces competition in Hawaii from barge services, such as those operated by Lynden Transport's Aloha Marine Lines from Seattle and Hawaii and Sause Brothers from Rainier, Ore. While those services do carry some containerized goods, Cox noted they also carry a great deal of construction material that is not containerized.

Of course, as on the mainland, much of what is on store shelves in Hawaii are goods imported from overseas. Ocean Network Express operates a weekly service from Shanghai, Busan and Yokohama to Honolulu using ships with capacities ranging from about 700 to 1,000 TEUs.

While it might seem logical to import goods directly from Asia to Hawaii rather than bringing them all the way to the U.S. West Coast and then shipping them back to Hawaii, Cox said there are a number of reasons why companies do this.

For one thing, he said, Hawaii is well off the "great circle routes" from Asia, so it's unlikely to attract many additional carriers.

He also explained that many of Matson's customers, such as big box stores or grocery chains, like to load multiple products into containers at warehouses on the West Coast and then send them to stores in Hawaii.

"Much of that cargo is trucked from our terminal in Sand Island directly to the store," he said, adding that there is limited warehouse space in Hawaii and what space there is is expensive.

The eastbound transpacific trade from Asia to the U.S. West Coast is dominated by foreign-flag carriers with large ships benefiting from economies of scale. Matson has been able to compete with those carriers by offering fast transit times and a service in Long Beach that moves the containers on chassis to an off-dock location that makes it fast and easy for shippers to retrieve cargo.

The service is also a double "headhaul trade." Instead of carrying low-paying freight and empty containers back to Asia, Matson's ships are filled with domestic cargo bound for Hawaii and Guam.

The CLX service is in high demand by shippers. In the call with analysts last week, Cox said the ships out of China are full every week, with the exception of a few weeks after the Lunar New Year when factories in China shut down.

In 2010, Matson had started a CLX 2 service using foreign-flag vessels, but folded it the following year. At the time, Cox said, "Sustained high fuel prices, rate volatility and overcapacity in the Asia market have made this growth initiative unprofitable."

He noted many international ocean carriers over long periods of time "can't even earn their cost of capital given the boom and bust cycles of that trade."

Serving Guam. Cox said the U.S.-Guam trade had been served by two carriers for nearly 70 years, but seven years ago Horizon exited the trade because of its financial difficulties.

While Matson had the trade to itself for a few years, APL entered the trade to Guam and

Saipan at the end of 2015 with its Guam Saipan Express service. Unlike Matson, which offers direct sailings from Long Beach and Oakland to Guam, APL's Guam Saipan Express (GSX) service operates two ships, the *APL Guam* and *APL Saipan*, that feed cargo between Yokohama, Japan and Busan, Korea and the two islands. In Yokohama and Busan, they connect with APL's global network, including APL's U.S.-flag Eagle Express service, a transpacific service with a Los Angeles, Oakland, Yokohama, Naha, Busan, Qingdao, Shanghai Busan, Los Angeles rotation.

Matson is challenging the U.S. Maritime Administration's approval of stipend payments for the two APL ships in the Maritime Security Program (MSP) in U.S. District Court for the District of Columbia.

Matson contends the APL ships are ineligible for MSP subsidies, because "they do not operate exclusively either in foreign trade or in mixed foreign trade and domestic trade permitted under a registry endorsement issued pursuant to 46 U.S.C. § 12111. Specifically, trade with Saipan is neither foreign trade nor domestic trade permitted under a registry endorsement. Accordingly, the APL vessels do not meet the statutory and/or regulatory eligibility requirements."

Because Matson's CLX ships operate in the protected West Coast-Hawaii Jones Act trade, they are not eligible for MSP stipends.

"Our view is, we're happy to compete with anyone, but we're competing with somebody who's receiving a subsidy against Matson, who received no subsidy for the same trade," Cox said. "Our whole goal in raising the complaint is not that we're afraid of competition, but we just wanted a level playing field."

Matson recently was unsuccessful in appealing a U.S. Transportation Command (TRANSCOM) contract for the transportation and storage of privately owned vehicles belonging to members of the military service and civilian employees. Matson would have transported some vehicles itself and contracted with other companies for others.

Even though Matson's $879.5 million bid was considerably lower than the $973.4 million bid of the incumbent contractor, International Auto Logistics (IAL) of Sea Island, Ga., was awarded the contract.

Matson protested the award, but in a decision handed down last month, the Government Accounting Office denied the protest, noting that TRANSCOM said IAL's customer service ratings have been 99 percent or better as indicated on comment cards, that IAL's "pricing did not pose an unacceptable risk to the government," and that "the selection official reasonably justified the finding that IAL's higher-rated past performance warranted the additional price premium and offered the best value to the government."

"Were we disappointed? Sure. But we knew it was an uphill battle," Cox said. He added that there is a possible appeal process, but did not want to discuss what Matson's next steps might be.

North To Alaska. Matson entered the Alaska trade in 2014 with the demise of Horizon Line.

"Matson had had a long interest in the Alaska market," Cox said. "To us, it looked a lot like Hawaii. It is not easy to get to; it is a 'lifeline' service" that involves the movement of foodstuffs and supplies need to support the Alaskan economy."

He also said that 80 percent of the volume that Horizon moved to Alaska was already customers with whom Matson was doing business.

Cox said Matson retained every Horizon employee in Alaska and most of those at Horizon's Tacoma operation. It eventually consolidated Horizon's Dallas back office with Matson's Phoenix office, again offering employees the ability to make the move.

"We were buying a business and the team that was running the business," he said. "I think the integration has gone well."

Unfortunately, he said Alaska was heading into a recession when Matson made the acquisition and Horizon has seen modest declines in freight. This year the service had disappointing southbound volumes because the seafood harvest was much smaller than in 2017.

"At this point we're hearing for the first time that 2018 looks like the bottom," he said. "2019 may be the first year where we see a small increase in jobs in construction activities."

He also said there is more activity in the oil and gas industry, and "people are cautiously optimistic about where the economy is going from here."

Matson operates three ships in its Alaska service that it acquired from Horizon. Because of Horizon's financial difficulties, Matson had some concern when it acquired the ships that they might need a "lot of TLC and catch-up maintenance. But we found them to be in excellent condition when we acquired them," Cox said. "We have since put a significant amount of life-extension work into them, including installing emissions scrubbers" so that they can continue to use high-sulfur fuel even though the ships operate much of the time in an Emission Control Area where the use of 0.1 percent fuel is required for ships without scrubbers.

Matson expects those ships will not have to be replaced until sometime after 2025.

After entering the Alaska market, Matson acquired Span Alaska, which is run by Matson Logistics. Span takes pallets and small shipments of cargo, consolidates them into containers and after they have arrived in Alaska, deconsolidates the cargo and takes it to its offices throughout Alaska and delivers the shipments to their final destinations.

"They are the largest freight forwarder in the state of Alaska," Cox said, and "a very complementary business." He noted other ocean carriers to the state also have affiliated forwarders: Saltchuk, the parent company of TOTE Alaska owns Carlile Logistics and Alaska Marine Lines is affiliated with Lynden Logistics.

Matson Logistics had strong growth in 2018. Revenue grew 22.4 percent to $581.5 million and operating income was up 56.5 percent to $32.7 million, with higher contributions from both transportation brokerage and freight forwarding.

It was also a good year for SSAT, Matson's joint venture with Steverdoring Services of America. Matson owns a 35 percent equity stake in SSAT and uses its terminals in Long Beach, Oakland, Seattle and Tacoma.

SSAT "does two things for us," said Cox. "It gives us control over our product on the West Coast because we operate through the joint venture, but we obviously have a big say about the way the terminals in which we operate are conducted. And then we get an economic benefit attached to the earnings that come out of the third-party business. So for us it's been a terrific investment."

In 2018, Matson said, SSAT contributed $36.8 million, compared to $28.2 million in 2017.

SSAT is currently in discussions with the Port of Seattle and the container terminal arm of Mediterranean Shipping Company (TIL) about taking over and renovating Terminal 5 in Seattle. If that happens, Matson would move its operations for the Hawaii trade in Seattle from Terminal 18 to Terminal 5. Matson's Alaska service operates out of a terminal in nearby Tacoma.

South Pacific Presence. Matson also has been growing in the South Pacific.

"We had this insight that if we're going to grow, we're going to grow outside Hawaii. We want to grow in things we know and think we are good at," Cox said. "We know how to deliver on time. … We're also good at serving island economies and economies that are remote and depend on these lifeline services.

"These are natural extensions potentially of our hub in Guam and in Honolulu. So our idea was let's look at markets that are adjacent to ours that are in need of reliable, fast service. And so we a few years ago acquired a company that was based in Auckland, New Zealand, called Reef Shipping," he said.

Reef operates between Auckland and various islands, including the Cook Islands, Niue, the Samoas and Tonga, and two years ago, Matson started up what it calls its South Pacific Express (SPX) service, which moves cargo from the U.S. West Coast to Hawaii, where it is relayed to destinations such as Tahiti, Somoa and Tonga so that the two services are linked.

"We are still in startup mode with SPX and we continue to believe that it's going to provide an important growth engine for Matson," said Cox. "These are smaller markets, so I don't think we're going to be able to retire early from the results of this trade, but from an incremental standpoint, it provides incremental freight and revenue into a largely fixed network. So the economics are compelling even though the overall numbers are relatively small."

Because of Matson's 137-year history, he said, "there are still people in those communities who remember the Matson passenger ships.

"Connecting these island economies and cultures and … improving the ties of these Pacific communities is pretty neat," Cox said.