

NXL News

June 2009

What's Next for the Logistics Market, Once Things Settle Down?

Robert J. Bowman, Global Logistics & Supply Chain Strategies - May 2009

Even as logistics providers struggle to cope with rising costs and a drop in customer demand, they are thinking about how to prepare themselves for economic recovery.

The latest economic crisis has forced all businesses into survival mode. But logistics service providers can't just withdraw into a shell and wait until things get better. They still have to meet the strict service requirements of their customers.

In fact, shippers have a greater need than ever for the most reliable service that carriers and intermediaries can provide. At the same time, vendors must cope with a slump in demand, see-sawing fuel prices and greater unpredictability of major market trends.

For transportation providers, "the biggest problem right now is the lack of freight," says Gary Girotti, vice president of Chainalytics' transportation practice in Atlanta. Carriers have witnessed a double-digit decline in import volumes – the mainstay of the U.S. freight market – in recent months. On the trucking side in particular, he says, there is a "massive imbalance" between supply and demand.

The problem has carriers scrambling to reduce their equipment burdens. Even before the worst of the recession hit in late 2008, they were moving to cut capacity by selling trucks overseas. According to Girotti, around 21,000 used Class 8 (heavy-duty) tractors were exported from the U.S. in 2007, up from 10,000 in 2006. Activity in 2008 was roughly equal to that of the prior year.

The big jump was largely the result of increased demand for equipment by the oil industry in Nigeria and Russia, Girotti says. That source has since dropped off due to the global economic downturn, with the export market for used tractors returning to its traditional level of 10,000 to 15,000 units per year.

Additional trucks have simply been parked by their owners, awaiting the return of demand for consumer goods. Similar moves have taken place in other modes of transportation. There are an estimated 2,000 commercial aircraft sitting idle at several locations in the California, New Mexico and Arizona desert. And ocean carriers have reduced their containership fleets by more than 10 percent, according to Bill Villalon, vice president of land transport services and product development with Oakland-based APL Logistics.

Finally, there is the loss of equipment and capacity caused by the failure of many operators. There were more than 3,000 bankruptcies in the truckload industry last year, notes John Carr, president and chief operating officer of YRC Logistics in Overland Park, Kan. Most of those were smaller entities, unable to cope with sliding business volumes, the cost of insurance and other operating expenses.

The capacity shrinkage leaves open the question of how carriers will handle a surge of demand when recovery comes. It won't just be a matter of reacquiring equipment that was shed during the downturn. Many of those older units don't comply with the latest government emissions standards for commercial vehicles.

Girotti, however, downplays the problem. "There will be a lag for carriers to bring them back on line," he says, "but it won't be dramatic."

The Driver Dilemma

The more serious dilemma is one of human resources. For years, truckers have complained of a lack of qualified drivers, as companies coped with turnover rates of 100 percent. That crisis has abated with the downturn, but it's likely to flare up again when things get better.

Many drivers also work in the construction industry, and if a revival of that moribund sector leads general economic recovery, they will flock back to those jobs. Long-haul trucking requires lengthy spans of time away from home, and construction tends to pay more anyway. So the current rate of driver turnover in the trucking industry—at 65 percent, the lowest since the mid-1990s, according to Girotti—could shoot back up.

"I really believe that the driver shortage will be pretty dramatic, especially if there's recovery in the construction industry," says Rob Estes, president and chief executive officer of Estes Express Lines Inc. of Richmond, Va. "Wages will have to go up to attract drivers. And prices will have to go up, because cost goes up."

Use of 3PLs by Fortune 500 Companies Remains Strong, According to Armstrong & Associates

One thing the recession hasn't hurt, it seems, is the use of logistics service providers by major businesses. According to a new report by Armstrong & Associates, 77 percent of domestic Fortune 500 companies are using third-party logistics players for logistics and supply chain functions. Drawing on a database of more than 3,900 3PL customer relationships, Armstrong finds widespread reliance on outsourcing by some of the nation's largest companies. General Motors, Procter & Gamble, Wal-Mart, PepsiCo and Ford Motor Co. each use 30 or more 3PLs. Services provided to the average customer fall into three distinct categories: supply chain manager and lead logistics provider on the strategic end, accounting for 18.5 percent of the companies surveyed, and tactical relationships, which make up the remaining 81.5 percent.

For the first time, the annual report includes spend estimates relating to specific industries, for the years 2005 through 2008. It also drills down into sub-segments of the various verticals. Looking beyond U.S. borders, Armstrong estimates the value of the global Fortune 500 3PL market in 2008 at \$199.7bn, up from \$187.4bn in the prior year. Global 500 customers in the technology sector alone spent more than \$45bn on 3PLs in 2007 and 2008. Among sub-segments of that industry, companies involved in electronics and electrical equipment led all others in 3PL spend, topping \$18bn

Like most major logistics providers, San Mateo, Calif.-based Con-way Inc. has reduced its headcount in recent months. But Randy Mullett, vice president of government relations and public affairs, says the company is also thinking about how to position itself for recovery. Options include putting some employees on a part-time basis, or retaining the benefits of laid-off workers. "We're exploring some ways that we normally wouldn't have looked at in the past," he says. "Companies that take these kind of actions early are better prepared to take advantage of the uptick when it does come."

The Fuel Factor

Fuel is another wild card. Oil prices have come down from last year's highs, but carriers remain nervous about the possibility of another spike. Still, claims Girotti, the unpredictability of fuel prices is nothing new. "They've been making predictions for the last 20 years and they never get it right," he says.

Truckers have acted to protect themselves through the inclusion of fuel surcharges in contracts with customers. Such deals are tied in some cases to weekly price reports by the Department of Transportation. Ocean carriers have long had similar provisions in their dealings with shippers, although the parties have disagreed about the extent to which the surcharges recover the carriers' true cost of fuel.

The real problem lies in the increased volatility of fuel trends. When prices soar, carriers have to lay out the higher expenditures up front. They might not get reimbursed through surcharges for 30 days or more. (Many carriers insist that they never fully recover their fuel expense—a claim that is hotly debated by shippers.) In the past, that wasn't a major concern, since most carriers had ready access to short-term credit. With the collapse of the credit markets, that option no longer exists for all but the strongest entities.

Some carriers, especially on the airline side, rode out the last wave of fuel-price increases through hedging strategies. They made forward buys at then-current rates, protecting themselves against future rises. But such a strategy only works if fuel prices do indeed go up. In the current economic climate, carriers could find themselves paying more for fuel as a result of their hedging efforts. "A carrier should be hedging its fuel to make sure it has certainty in its costs," says Girotti, "but eventually that catches up with you."

Carriers are also laboring to reduce fuel expense. Con-way has lowered the top speed of its truckload fleet from 70 miles per hour to 65 mph, and its less-than-truckload units to 62 mph. The slowdown only adds between 15 and 20 minutes to most transit times, says Mullett, while resulting in an annualized savings of some 6 million gallons of fuel.

Response to Uncertainty

With the downturn has come an overall level of uncertainty that has disrupted traditional order and shipping patterns. St. Louis-based Logistics Management Solutions, a third-party logistics provider specializing in chemical and industrial markets, saw customers' raw-material orders drop by as much as 60 percent at the end of last year. The remaining activity is erratic.

"It used to be very easy to predict," says LMS president and chief executive officer Dennis Schoemehl. "In most industries, your week started off slow. You started building inventories, and by Friday things would really break loose. Now you could have a slow Friday and Monday breaks loose."

Carriers have responded by disrupting some of their own patterns, especially with regard to service coverage. "Very large truckload carriers are doing things we've never seen before," says Schoemehl. "We're seeing them take loads in the East out of the Midwest, where traditionally they wouldn't go." In addition, long-haul carriers are accepting loads with shorter transits, while shippers enjoy their pick of capacity and ever-declining rates.

Companies can lessen the impact of unforeseen developments by converting fixed cost to variable cost wherever possible, says Tom Jones, senior vice president and general manager of supply chain solutions with Ryder System of Miami. In Ryder's case, that means reducing the use of its own trucks and contracting out for a larger portion of capacity. Such a strategy gives the company more flexibility in adjusting to sudden changes in demand. Ryder is also working with its leasing division to locate equipment where it is most needed, Jones says.

Another way to battle uncertainty is through greater visibility of goods in transit. LMS takes pains to track each order, either through satellite communications or cell-phone hookups with drivers. That level of detail isn't always easy to acquire, however. Many carriers have antiquated information systems which make it difficult to relay information to shippers and intermediaries in a timely fashion. And a lot of transportation management systems, especially those offered by large "enterprise" vendors, aren't as advanced as they should be, says Schoemehl.

Nevertheless, today's information technology offers a range of visibility solutions that won't necessarily break an organization's limited budget. Companies needn't spring for a fully functional enterprise application costing millions of dollars and taking months to deploy. Some smaller, Web-based applications can accomplish at least part of the job at a much lower price point, according to John Coates, president and chief executive officer of The Fennimore Group in Arlington Heights, Ill. The bells and whistles of a complete suite can come later. "Those are the directions that companies are pursuing," he says.

Infrastructure Woes

The steep falloff in business hasn't alleviated one problem that has plagued carriers for decades: that of inadequate transportation infrastructure. Major roads and bridges are in a state of serious disrepair, victims of deferred maintenance and competing congressional priorities for public spending. In addition, carriers complain that lawmakers and regulators aren't viewing the system holistically, failing to account for ports, airports, railroads and the links between modes.

The economic stimulus package passed by Congress earlier this year was intended in part to address the infrastructure crisis. But transportation industry executives wonder how much the bill will really help them. "There's going to be a very small portion for the freight business," says Mullett. "Shovel-ready" projects promoting urban transit and reducing congestion, along with improvements in water and sewage systems, will be on the front burner.

What money does go to transportation will mostly be targeted for highway projects, giving short shrift to rail, Villalon says. Roads and bridges are important, he adds, "but they're not the whole thing. The interconnectivity of our infrastructure is critical."

Schoemehl agrees that carriers should be moving more freight on the intermodal network, both from the standpoint of cost and environmental impact.

Planners continue to talk about building a truck-only lane on the stretch of Interstate 70 between Kansas City, Mo., and Indianapolis. “But right next to it is a railroad,” says Schoemehl. “That track is used maybe an hour a day.” More attention needs to be paid to boosting the efficiency of rail so that it can better compete with long-haul truck, he says.

Railroads, which continue to rely heavily on traditional commodities such as coal, wouldn’t mind the extra business. Operating at or near capacity five years ago, they are coping with a 15-percent decline in railcar loadings today, says Toby Kolstad, president of Portland, Ore.-based Rail Theory Forecasts. “There’s more than enough capacity for the next three years,” he says.

Longer term, he sees some dark clouds on the horizon. Concerns over the environmental impact of the mining and burning of coal could lead to a severe drop in use of that key commodity. Currently coal shipments account for a third of all railcar shipments, according to Kolstad. “The rail transportation system in this country handles almost every commodity imaginable,” he says, “but without coal [it] wouldn’t exist.”

In any case, he says, there’s a limit to the amount of additional container and trailer business that railroads can support. Rail is only competitive with truck for long hauls of 1,000 miles or more. Still, that hasn’t stopped carriers such as CSX and Norfolk Southern from investing heavily in certain corridors, to make them more suitable for double-stack container trains.

Outlook for Improvement

Transportation providers aren’t looking for relief from current conditions any time soon. Even with the slump in demand, inventories were unacceptably high as of mid-March, according to Carr. He expects further business declines in the second quarter of this year, with a leveling off in the third. Activity should begin to pick up by the fourth quarter of 2009 and the first part of 2010, he says. At that point, carriers will face the task of shifting into a higher gear in order to handle renewed demand. “It’s going to be a challenge,” says Carr.

In the meantime, carriers will struggle to keep rates from falling further. Such an initiative was recently announced on the ocean side, with all members of the Transpacific Stabilization Agreement (TSA) vowing to avoid “non-compensatory, unsustainable rate levels” in service contracts for 2009 and 2010. By June 30 of this year, the 14 shipping lines that make up TSA plan to cancel any short-term rate reductions that were enacted in late 2008 and the first quarter of 2009. Earlier attempts to achieve that goal were stymied by additional rate concessions in the spot market, TSA chairman Ronald D. Widdows said in a statement.

Carriers taking too hard a line on rates stand to lose customers. Yet they must convince shippers that price isn’t everything. “There are a lot of hungry transportation providers out there right now,” says Jim Butts, senior vice president of C.H. Robinson Worldwide of Eden Prairie, Minn. “A shipper who is most effective recognizes the need to balance taking advantage of short-term opportunities with the more strategic approach of choosing the right partners and making long-term [decisions] to drive supply chain improvements.” Service quality is another key concern, he says, adding that non-compensatory rates could drive some of the best carriers out of critical lanes.

Shippers like low rates, Butts says, but they also want stable providers. “Most of the customers that we’re doing significant business with now are putting increasing [emphasis] on our financial viability and strength,” he says. “We think that’s a great thing.”

For its part, YRC Logistics is trying to convince shippers to look beyond basic freight rates and consider the total landed cost of moving goods, including inventory carrying expense. The goal, says Carr, is to speed up shipments from source points in China to markets in the U.S., Europe and Latin America. In some cases that might mean shifting freight from ocean to air, especially for higher-value items. In others, it involves the bundling of service and a reliance on smaller pools of carriers. The hoped-for result is greater service reliability, allowing shippers to place demand against goods in transit, instead of drawing on standing inventory.

Jones doesn’t believe that shippers choose carriers entirely on the basis of freight rates. Ryder is closely integrated with its customers in terms of technology and business processes. It works hard to tailor services to meet the needs of individual accounts. “Those aren’t relationships that are torn apart easily,” he says.

Carriers are also addressing their internal costs. YRC Worldwide Inc., the holding company for less-than-truckload giants Yellow and Roadway, recently completed an administrative integration of the two operating units, who will now do business under the name YRC Inc. The overhaul will also lead to better service to customers, the company claimed.

Creative Solutions

In the end, carriers that emerge from recession with a competitive advantage won’t be the ones that just hunkered down in bad times. Adversity gives creative executives the excuse to make bold moves that probably should have been carried out at the peak of the cycle. “The whole idea of what is value and what is service is being redefined,” says Coates.

Carriers and shippers alike have talked for years about lean techniques for eliminating waste from their operations. Now they have the impetus to move forward. APL Logistics is examining a wide range of internal processes that might no longer offer value to the company or its customers. “A lot of legacy administrative activities take on a life of their own,” says Villalon. “Every time you look, you can find waste.”

It’s more than a question of making the balance sheet look more attractive. Says Coates: “Everybody’s got the fiduciary responsibility to minimize costs in order to save dollars, because of the reality of what’s going on in the credit market. You can’t keep manufacturing goods when they are just going to go to inventory.”

The ultimate answer, he says, lies in creation of a true “pull-oriented” supply chain, tied to actual customer orders. Information technology can be deployed to automate key processes and streamline the flow of critical demand data.

Companies have made such efforts in the past, but a new sense of urgency brought about by economic crisis could finally provide them with the ammunition to get the job done. Innovations that once encountered opposition from entrenched interests are now being viewed as the key to survival, according to Coates. “The whole idea of what is value and what is service is being redefined,” he says.

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