

23rd ANNUAL STATE OF LOGISTICS REPORT

Slow and steady

The logistics industry has yet to climb back to the profitability it hit in 2007. According to the report's author and industry analysts, it may be a while until the overall industry hits full stride again.

BY PATRICK BURNSON, EXECUTIVE EDITOR

When the Council of Supply Chain Management Professionals (CSCMP) released its *23rd annual State of Logistics Report (SoL)* late last month, logistics and transportation management professionals were again advised to be patient: industry growth will slowly, but surely crawl back as the macroeconomic picture improves.

The report, authored for the past eight years by Rosalyn Wilson, president of Delcan, Inc., an engineering, planning, management, and technology firm, reveals that total U.S. business logistics costs in 2011 rose to \$1.28 trillion, a 6.6 percent increase from the previous year, accounting for 8.5 percent of the U.S. gross domestic product (GDP).

"The economy improved in more areas than it retreated over the course of my reporting," says Wilson, "making me hopeful that there would be some genuine good news to report for 2011."

But there really wasn't. In fact, Wilson calls 2011 "a rather unremarkable year" for logistics statistics.

Consumer confidence trended upward since the 2010 report was unveiled last June, leading consumers to spend on items beyond necessities. "The negative side of that is that many dipped into savings or extended their credit," she says.

During this time, Wilson says that businesses demonstrated their expectations of a stronger economy in 2011 by adding new workers and stepping up manufacturing, which continued into the first half of 2012. "The manufacturing sector of the economy has been in expansion mode for over 27 consecutive months, but just barely," she adds.

Key takeaways

The *Annual State of Logistics Report* represents a snapshot of the economy over the past year, the logistics industry's key trends, and the total U.S. logistics costs over that time. The report also examines which sectors of the industry are recovering, which are facing challenges, and then highlights areas that can be targeted for increased investment.

While somewhat "unremarkable," according to Wilson, here are some of the high-level takeaways from 2011:

- Trucking, which comprises 77 percent of the transportation component, posted a 6.2 percent rise, but the real leader was the railroad sector that saw a 15.3 percent increase.

- Declines in manufacturing, financial difficulties in the European Union, China's slowing economic growth, and shrinking import/exports all have the potential to stall momentum in the industry.

- Inventory carrying costs increased 7.6 percent. The increase in carrying costs was due to higher costs for taxes, obsolescence, depreciation, and insurance.

- The result of higher inventories and historically low interest rates was a 31.4 percent drop in the interest component of carrying costs.

- Air, water, and pipeline revenues declined in 2011, while railroad, truck, and forwarders experienced revenue growth.

- One of the leading manufacturing sectors was motor vehicles and parts, which grew 17.7 percent during the final three months of 2011. Americans spent more on vehicles, and companies restocked their supplies at a fairly robust pace.

Richard Thompson, executive vice president of the global supply chain practice for Jones Lang LaSalle, served as panel moderator at the *SoL* press conference at the National Press Club in Washington. For him, the *SoL* represents both a legacy and a "baseline that provides shippers with a year-to-year metric on the health of logistics."

For example, said Thompson, the report validates that with overall revenue 15.3 percent higher than 2010, railroads gained market share over the course of 2011.

"This was especially true in intermodal because it didn't experience capacity problems faced by the trucking sector," says Thompson. "In fact, trucking companies are also using intermodal rail to help offset the impacts of driver shortages and the costs of acquiring and maintaining new equipment." And in spite of tightening capacity and an overall decline in volume, he adds that trucking rates were still up 5 percent to 15 percent over the course of 2011.

Even with the air cargo sector's record year for exports, the report shows that the industry still experienced a decline, with domestic air cargo revenue down more than 3 percent compared with less than a 1 percent decline in international revenue.

The challenge facing the ocean container industry is even more disconcerting, says Thompson. "The carriers just keep building new vessels to keep up with competitors, when they really should be limiting capacity." Thompson attributes this



RANDY LYNUS

behavior to a holdover from the days when the mantra for ocean carriers was “grow or die.”

“But what they’re really doing,” adds Thompson, “is growing excess capacity, thereby contributing to rate erosion, service declines, and operational losses.”

Energy question missing

Conspicuous by its absence this year was any detailed analysis of the volatile energy rates and expenses. Derik Andreoli, Ph.D.c., senior analyst at Mercator International, a logistics and infrastructure advisory, and *Logistics Management’s* popular Oil & Fuel columnist, notes that shippers should be asking a few questions about this aspect of the overall state of logistics.

“Oil and fuel markets are extremely complex, and forecasting price moves requires insight into both supply and demand for oil, diesel, gasoline, and dollars,” says Andreoli. “Since the beginning of May, crude oil prices have fallen by a staggering 22 percent. This decline was largely due to the rapidly evolving opinion among Wall Street oil traders that tight oil markets were set to soften.”

But he notes that this sentiment is certainly not out of line with the news flowing from Europe or the recent lackluster performances of emerging markets—especially China.

“As Greece continues to dance with default and expulsion from the Eurozone, Moody’s has downgraded France’s

The U.S. business logistics system cost is the equivalent of 8.5% of current GDP in 2011

\$ billions

Carrying costs - \$2.064 trillion all business inventory

Interest	3	Up 7.6%
Taxes, Obsolescence, Depreciation, Insurance	294	
Warehousing	120	
Subtotal	418	

Transportation costs

Motor carriers		Up 6.2%
Truck (Intercity)	431	
Truck (Local)	198	
Subtotal	629	

Other carriers		Up 6.2%
Railroads	68	
Water (International 28, Domestic 5)	32	
Oil pipelines	10	
Air (International 17, Domestic 16)	32	
Forwarders	35	
Subtotal	177	

Shipper related costs	10	Up 6.6%
Logistics administration	49	
TOTAL LOGISTICS COST	1,282	

Source: CSCMP’s Annual State of Logistics Report

credit rating, and bond yields across Portugal, Italy, Greece, and Spain have skyrocketed,” says Andreoli. “As borrowing becomes more expensive, the only choices that are available are to cut spending or leave the Euro. Neither of these options is attractive.”

Andreoli adds that the problem with austerity is that spending—be it by the government, consumers, or businesses—greases the wheels of growth. The problem with leaving the Euro is that the value of the drachma would plummet, causing Greece to muddle through a prolonged recession.

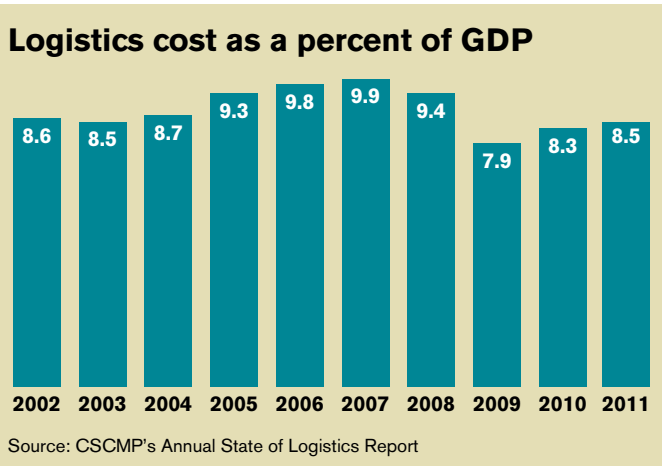
“The irony, of course, is that the underperformance of Eurozone economies has kept the value of the Euro suppressed against the level that it would be if every Eurozone economy performed similarly to Germany.” As a consequence, he says, Germany’s exports remain cheaper than they would otherwise be. “Germany is the only country that is strong enough to pull the Eurozone out of its slump, but seeing that the country has for years benefitted from a dysfunctional Euro, it won’t likely throw out a life preserver until the alternative to ‘muddling through’ looks relatively more attractive.”

Andreoli says that as the Eurozone skirts recession, European oil demand remains suppressed. So too are European imports from China and other emerging markets, which suppresses economic activity in these countries.

“Of course, MENA [Middle East and North Africa] oil consumption was also significantly reduced as the Arab Spring chopped away at economic activity leaving a wide swath of economic disruption across the region,” says Andreoli.

Road ahead

U.S. consumers, meanwhile, are benefiting from the slow but steady decline in gasoline prices, and retail analysts expect that growth will resume



and should pick up through the fall.

“This economy thus far is working like an old machine with many fits, starts, and even some sputtering,” says Jack Kleinhenz, chief economist with the National Retail Federation (NRF).

The NRF reported that May retail sales, which exclude autos, gas stations, and restaurants, were down 0.3 percent on a seasonally-adjusted basis from April and up 4.8 percent on an unadjusted basis annually, marking the 23rd consecutive month of retail sales growth.

This observation resonated with Wilson, who says that this year’s *SoL* suggests a slow rebound. “Manufacturing has slowed, but not stalled, and new orders have been picking up,” she says. “Industrial output has been stuck at one level for a couple of months, but inched up in May.”

Wilson agrees that consumer confi-

dence was climbing, but that it has been in decline for the last three months. “Unemployment had dropped several times, but rose again in May. The transportation sector, however, added 36,000 jobs in the same month—almost half of the 69,000 jobs added last month,” she adds.

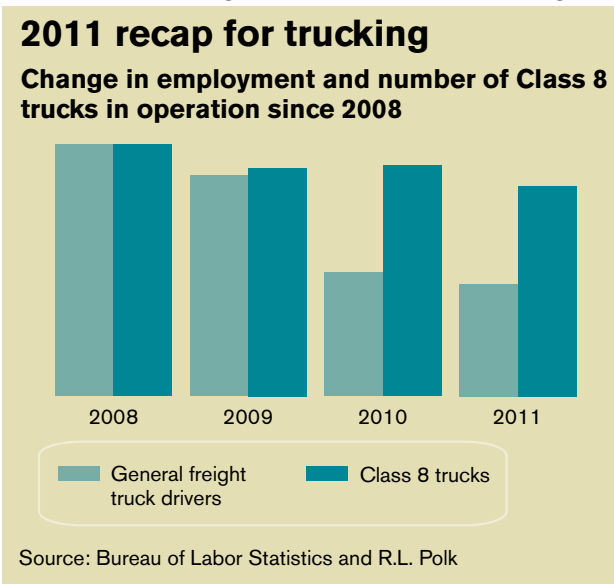
Meanwhile, another recent study indicates that logistics managers regard the reduction of overall supply chain costs as the “number one” priority in the coming year. IDC Manufacturing Insights’ 2012 *U.S. Supply Chain Survey* found that the vast majority of respondents are still aggressively attacking expenses.

“According to our findings, the key supply chain challenge facing all manufacturers today is the juxtaposing of complex and extended supply networks with increasingly fast and volatile demand networks,” says Simon Ellis, IDC’s supply chain practice director. “At the same time, shippers are dealing with the increasingly ineffective role for inventory as a way to buffer cadence mismatches.”

While manufacturers face increasing complexity as customer demand diversifies and supply globalizes, supply chain organizations are adapting to respond to requirements such as complex and extended global supply networks and growing regulation—particularly in the area of traceability.

To address these challenges, the IDC study found that manufacturers continue to increase the amount of low-cost country sourcing. Analysts recommend that shippers “revisit” the profitable proximity sourcing approach and how that concept, supported by IT, can ensure sourcing decisions to create a competitive edge.

“While there is anecdotal evidence to suggest that 2012 may indeed represent the most challenging time in the history of the manufacturing supply chain, significant opportunities also abound in terms of the supply chain this year,” says Ellis.



LTL: Privately held carriers lead the sector

The less-than-truckload (LTL) market is a dichotomy. Privately held LTL carriers are far and away hauling more freight at better rates, providing those carriers with far better margins than their publicly held counterparts.

The publicly held sector, dominated by operating companies Arkansas Best Corp. (parent of ABF Freight System) and YRC Worldwide (parent of YRC Freight national and regional units), is struggling to get in the black.

However, the LTL sector is more “in balance” than in past years with capacity aligning with demand. And for the first time in at least five years, the sector is showing positive operating margins, albeit scant.

As the accompanying chart from trucking analyst firm SJ Consulting indicates, operating margins for the top publicly held LTL carriers averaged 0.7 percent for the first quarter of 2012, compared with a -11.7 percent margin just three years ago.

This vital \$32 billion market amounts to only about 5 percent of the total trucking market, but because of its reach into both the retail and industrial sector, LTL remains an important cog in the U.S. trucking engine.

Right now, LTL executives say the market place favors neither carriers nor shippers. Rather, demand is roughly aligning with capacity and LTL rates reflect that equilibrium.

“It’s not a buyers’ or a sellers’ market,” says Rob Estes, president and CEO of Estes Express Lines. He recently said that the LTL market is “still in the recovery mode” from the depth of the recession in 2008-2009.

But some carriers are faring much better than others. The profitability of the LTL sector is skewed in favor of large, non-union companies such as Old Dominion

Freight Line (ODFL) and Con-way. Consistently profitable, ODFL posted first-quarter net income of \$31 million on \$497 million revenue, while Con-way’s LTL unit earned \$34 million on \$831 million revenue.

Yet similarly large companies such as financially ailing YRC Worldwide lost money. YRC’s national LTL unit lost \$56 million on \$789 million revenue in the first quarter, but its regional unit earned \$11 million on \$402 million revenue in that period. Similarly, FedEx Freight and UPS Freight reported basically break-even figures in the first quarter, typically the slowest period for LTL truckers.

“The larger companies had very marginal performances,” said Satish Jindel, principal of SJ Consulting. “They’re struggling to create value in LTL with the (expensive) technology and marketing that they have. Pricing and yields are better than last year, but you have to manage it. Capacity is there.”

LTL carriers’ fortunes are largely tied to that of the overall U.S. economy. Eric Starks, president of FTR Associ-

ates, a leading freight forecasting firm, is forecasting 2.5 percent growth in Gross Domestic Product (GDP) for the rest of the year. Overall, he is “less pessimistic” than he was a year ago on overall economic conditions, which ought to eventually translate into more profits for the LTL carriers. “Truckers are relatively healthy,” Starks said. “It’s not a bad time to be in trucking as rates continue to edge higher.”

Overall, Jindel says, privately held LTL carriers such as ODFL, Saia, Pitt Ohio, Dayton, AAA Cooper, Southeastern, and New England Motor Freight outperformed their publicly held counterparts.



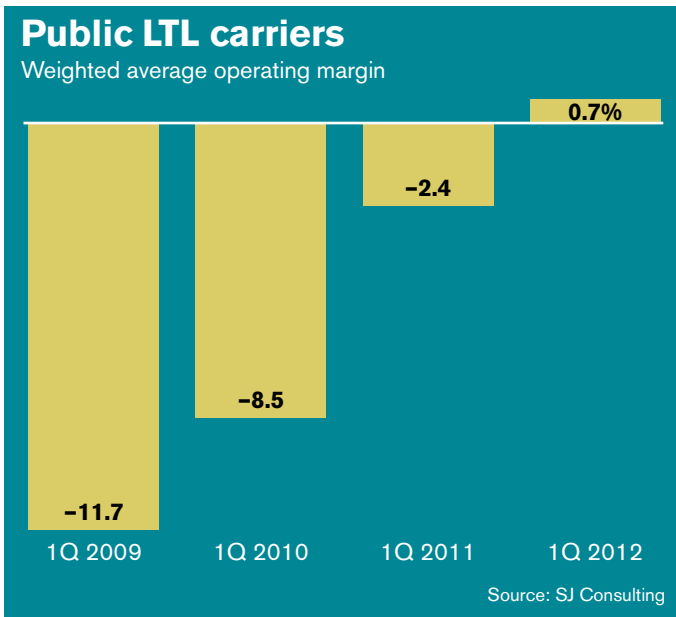
“The top eight privately held LTLs had much better operating ratios than the large publicly held carriers,” Jindel said. “It comes down to managing the business with fewer levels of bureaucracy and more timely and efficient responses to business trends.”

Buoyed by improvements in the domestic auto market and a slower recovery in the U.S. housing market, LTL truckers are reporting more customers concerned about sufficient capacity. “When I talk to customers, they’re talking about capacity more than anything else,” said Scott Dobak, president of Roadrunner Transportation Services, which operates a large LTL operation.

He said shippers want to better understand what specifically is driving their cost pressures in trucking rates. “The days of just trying to browbeat the carrier to just get the lower rate are just about over,” Dobak said.

Jindel says shippers ought to be prepared to pay “mid-single digit” percentage rate increases during LTL contract renewals this year since carriers need the money to offset their cost increases. As Jindel says, “You can’t perform with a mid-90s operating ratio and recapitalize your business.”

—John D. Schulz, Contributing Editor



Truckload: Capacity in equilibrium with demand...for now

The \$300 billion for-hire truckload (TL) sector is by far the largest slice of the overall motor carriage market and the engine that drives the U.S. trucking industry. And according to leading analysts, this mostly long-haul, non-union sector is rebuilding its capacity to about where it was when the 2008-2009 recession occurred.

The recovery carriers expected is not exactly the one that they're getting, however. Truckload volumes have been building gradually through the year, but it's not the robust recovery some economists had been predicting. But carrier executives say that they prefer this slow, steady recovery to a sharp uptick, which could result in equipment and driver shortages.

While freight volumes are nothing to brag about, carrier profitability is. According to Eric Starks, president of FTR Associates, a leading freight forecasting firm, TL margins are way up in the past year. As the accompanying chart from trucking analyst firm SJ Consulting shows, TL operating margins for the public TL carriers are up 6.6 percent for the 2012 first quarter—more than double what they were just two years ago.

Starks is predicting that freight will grow slightly faster than his forecast of a 2.5 percent rise in Gross Domestic Product (GDP) and will remain “above its historical average” over the next several years. While the last peak year for trucking was 2006, Starks is predicting truckload demand won't return to its peak until 2015.

“The current environment isn't bad,” Starks said. “But we're not getting back to the peak for a few years.”

Carrier executives say that the TL recovery is progressing relatively well, with TL supply and demand pretty much in “equilibrium.” In turn, this is allowing some rate increases

that industry analysts say is necessary just to offset the sharp price increases for their equipment, fuel, and drivers.

Truckload rates are “pretty good,” said Dan England, chairman of Salt Lake City-based C.R. England, the nation's eighth-largest TL carrier. “However, they're never as good as you want them to be.”

Most analysts are forecasting 4 percent to 6 percent rate increases in the TL sector this year, depending on geographic lane, a shipper's individual freight characteristics, and the shipper's relationship with their carriers. But that forecast rise in rates might only be allowing TL carriers to keep pace with their costs, which are soaring.

Besides the sharp spike in diesel costs, TL carriers have endured at least a 25 percent rise in the cost of Class 8 trucks, rising labor costs associated with tighter driver supplies, and skyrocketing insurance.

“There is an economic schizophrenia,” said Bill Graves, president and CEO of the American Trucking Associations. “Some days there are signs that things are encouraging, then the next day there're numbers that are not.”

Manufacturing is continuing to



expand steadily, aiding in TL demand—and truckers prefer that gradual increase because it is so difficult to find qualified drivers now. “Trucking is a very tough business and driving a truck over the road is a very hard life,” Graves said.

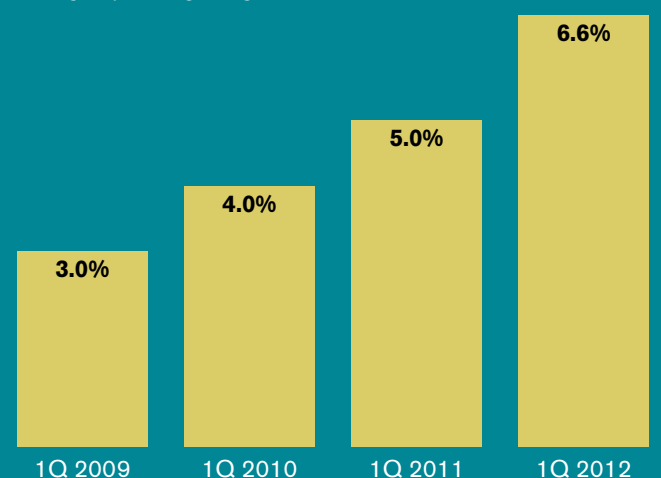
Then there's the issue of what fuels those trucks. Trucking consumes about 155 billion gallons of gasoline and diesel a year, meaning that the 2012 fuel tab for trucking will exceed \$600 billion—a new record.

Trucking officials say the wild card is the 2012 presidential election, and whether Democrats continue to control the White House and House of Representatives. “We're very fearful of what that regulatory agenda might look like in a second term,” Graves said.

—John D. Schulz,
Contributing Editor

Public TL carriers

Average operating margin



Source: SJ Consulting

Rail: Pricing and service strength chug along

As the freight transportation sector ebbs and flows, one constant before, during, and after the Great Recession has been the railroad industry. Even with volumes stalled by coal declines, rail and intermodal remain ahead of the curve.

There are several factors that have left the rails in excellent shape amid the chaos that was—and to some extent still is—prevalent in freight transportation. Chief among those factors are strong service and reliability, which the rails have successfully leveraged as current volumes remain below pre-recession levels.

And the railroads will be the first to tell you that improved service and reliability are not incidental or happening by accident. Railroads are leveraging their strong service reliability into excellent returns for Class I carriers—even with the dramatic decline in coal loadings which represents 40 percent or more of total rail volumes.

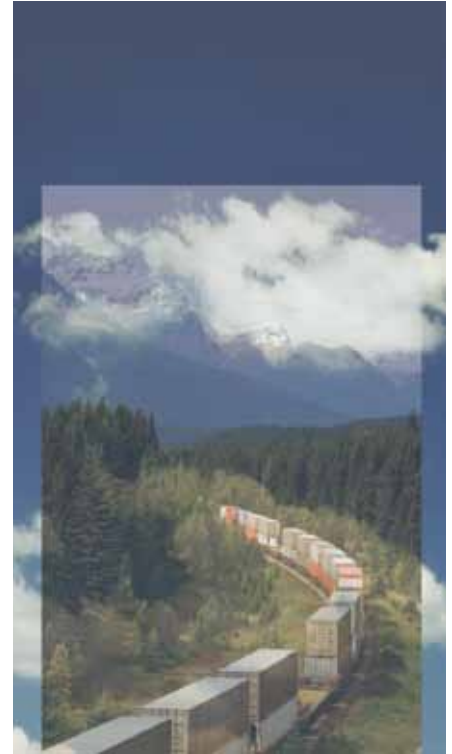
This is also evident in the many ways in which railroads are preparing for future growth on the tracks, whether it be for straight carload or intermodal movements, which continue to gain traction at a time when

truckload carriers are feeling the brunt of tight capacity.

Proof of this planning is evident and can be found in projected 2012 capital expenditure plans by Class I railroads, which represent a cumulative investment of a record \$13 billion by the seven North America-based Class I freight railroads. Capital is being allocated for things like expanding, upgrading, and enhancing the U.S. freight rail network in the form of new equipment, safety, rolling stock, terminal expansion, and asset utilization.

Some of the specific capex plans include a \$2.25 billion investment by CSX; \$2.4 billion by Norfolk Southern; and \$3.6 billion by Union Pacific. The Association of American Railroads has often highlighted that these capital expenditure investments are funded by private capital and not taxpayer funding, adding that the railroad industry owns, maintains, improves, and pays taxes on their rights-of-way.

“We have seen a reasonably steady and slow growth pattern this year,” said Anthony Hatch, principal of New York-based ABH Consulting, a leading railroad analyst firm. “This has helped the rails with planning for the future,



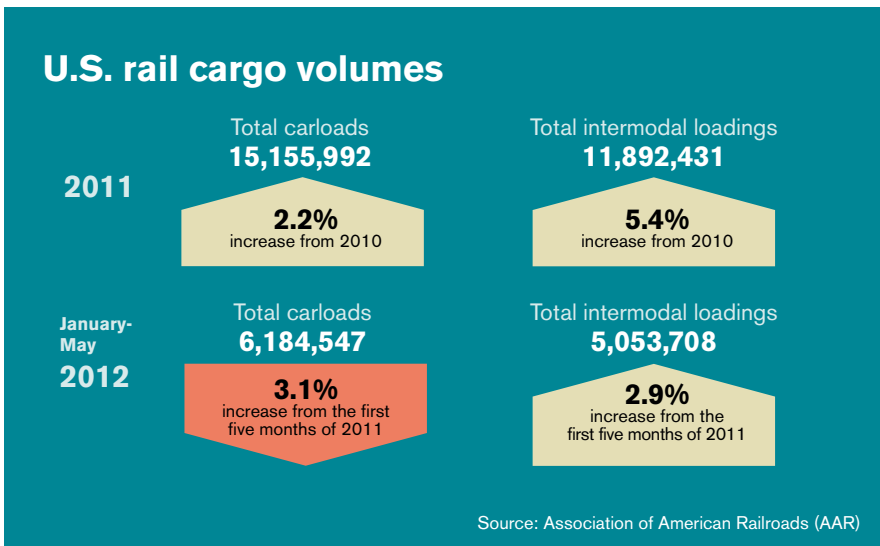
which is reflected in this year’s capex spending numbers, which are at record-high levels.”

Hatch added that shippers are generally satisfied with current service levels, although there is some concern about future capacity, with current capacity levels solid. But even with service levels intact, the age-old argument of rail rate disharmony between carriers and shippers remains. This is due to the rails having pricing power on their side going back to 2003.

At the heart of the matter during this time is how rail shippers, especially those that are captive to one railroad, maintain that they are not getting their money’s worth as rates increase, on average, by about 5 percent annually.

And over the last several years, this has led to conflicts between the parties over whether to re-regulate the railroad industry and re-authorize the Surface Transportation Board. Progress on both fronts has been slow, and with 2012 being an election year, not much is expected in the way of legislative action.

—Jeff Berman, Group News Editor



Ocean: Focus shifts to value

In a collective effort to stem the flow of eroding freight pricing, ocean carriers are now competing on the two major global trade lanes—EU-Asia and the transpacific—by focusing on value rather than rates. Indeed, all the major

players are telling shippers that the general rate increases (GRIs) will not be jeopardized by competition offering deep discounts this year.

While no major multinational corporation wants to hear that supply



chain expenses may soon escalate, there is actually an attractive aspect of this forecast. Ocean carriers—and the lead logistics providers who work with them—may rely on a sustainable level of capacity and service through 2012 and beyond.

According to Drewry, a London-based maritime advisory, nearly 60 new vessels of at least 10,000 twenty-foot equivalent units (TEUs) are being staged for deployment. And while the active global ocean cargo container fleet has grown by less than 2 percent to date, analysts feel that it will expand more than 7 percent by the end of this year.

The major question, however, is whether the buying spree of last year will pay off. Overspending and rate cutting to win market share proved to be profoundly damaging strategies for all but a few ocean carriers.

Just how bad was it? Maersk, the world's largest container line, reported a significant loss last year, along with France's CMA CGM SA and Hamburg-based Hapag-Lloyd AG. Industry analysts blame frenzied bidding on the world's two largest container-shipping trade routes. According to Sealntel Maritime Analysis in Copenhagen, the cost to the industry overall was a staggering \$11.4 billion over the previous 14 months.

Nor were things much better for COSCO, the largest integrated shipping company in China and the second largest in the world. Container shipping and related business moved volumes totaling 6.91 million TEUs in 2011, up 11.2 percent from the previous year. However, revenues from this segment were down 11 percent year-on-year.

What did the carriers learn through all of this? Several things have become clear:

- To save on ever-increasing bunker fuel costs, carriers will use “slow steaming”

on major trade lanes whenever possible. At the same time, they will impose the Bunker Adjustment Factor (BAF) as a surcharge to mitigate sudden fluctuations in fuel rates.

- Many carriers have now grouped together on the core Asia-Europe trade to pool their largest ships into fewer services and to share costs. This was

unlikely to have happened several years ago, but has been forced out of necessity.

- Carriers will make charter deals on a more short-term basis, too, as they do not want to run the risk of being in a locked-in contract when cargo demand suddenly ramps up. At the same time, cash-strapped carriers may alter this tactic somewhat by offering parts of their fleets on longer terms to generate sufficient revenue to remain operational.

- Indexed contracts will become more widespread, as both shippers and non-vessel-owning common carriers (NVOCCs) have a growing appreciation for them. That's because indexed contracts enable carriers to differentiate themselves based on service rather than price.

—Patrick Burnson,
Executive Editor

U.S. Ports improve slightly

Port	2011 TEUs	2010 TEUs	Percent change
Los Angeles	7,940,511	7,831,902	1.40%
Long Beach	6,061,091	6,263,499	-3.20%
New York	5,503,485	5,292,025	4.00%
Savannah	2,944,678	2,825,179	4.20%
Oakland	2,342,504	2,330,214	0.50%
Seattle	2,033,535	2,133,548	-4.70%
Norfolk	1,918,029	1,895,017	1.20%
Houston	1,866,450	1,817,169	2.70%
Tacoma	1,485,617	1,455,466	2.10%
Charleston	1,381,352	1,364,504	1.20%

Source: American Association of Port Authorities

Air Freight: Keep seat belts fastened

So far this year, it has been tough to find a silver lining in the clouds around the air cargo sector. Air freight revenue dipped by 2 percent in 2011, while over capacity led to bad load factors dropping domestic revenue ton-miles more than 3 percent. International air freight cargo, meanwhile, was bolstered by a record \$400 billion dollars in export goods transported by air.

“This was not enough to prevent a decline in international ton-miles, which fell just under one percent in 2011,” says transportation consultant Rosalyn Wilson of Delcan, Inc., the author of the 23rd *Annual State of Logistics Report*.

Meanwhile, some of the world's most successful cargo airlines are reporting that the EU's crisis has been pulling them down. Tim Clark, president of Emirates airline, says international airlines face a “perfect storm” from high fuel costs, a slowing global economy, and volatile exchange rates that could see many carriers forced to downsize.

“The euro is going south, the pound is going south, fuel costs are still too high,” says Clark. Indeed, the International Air Transport Association (IATA) has its revised industry outlook for 2012, noting that the outlook for European, Asia-Pacific, and Middle Eastern carriers has been downgraded, with European losses now expected to be \$1.1 billion—nearly double the previously forecast.

Not all of the news was bad, however. Tony Tyler, IATA's director general and CEO, says that although airlines face the common challenges of high fuel prices and economic uncertainty, the regional picture is diverse.

“Carriers in the Americas are seeing improved prospects for 2012,” says Tyler. “The rest of the world is seeing reduced profitability. For European carriers, the business environment is deteriorating rapidly resulting in sizable losses.”



North American carriers are expected to post a profit of \$1.4 billion in 2012, that's up from the March projection of \$0.9 billion and a slight improvement on the \$1.3 billion that the region's carriers made in 2011. The main driver of this performance

is a significant improvement in yields on the back of tight capacity management. Capacity growth for North American carriers is basically flat (0.1 percent) against demand growth of 0.5 percent, which, notably, is the slowest among all regions. Tyler says that one of the notable

features of this business cycle has been the limited expansion of capacity by airlines, and the resulting success in sustaining high levels of asset utilization. In any capital-intensive business this is a key factor behind profitability.

Over the rest of the year the forecast anticipates that, although demand is slowing, airlines will add capacity at an even slower pace. Growth in available tons kilometers (a combined measure for the passenger and cargo capacity) is forecast to be limited to 3.3 percent this year, compared with growth in both passenger and cargo traffic of 3.5 percent. Load factors and aircraft utilization are expected to be close to current high levels, limiting the reduction in airline profitability.

"The main upside risk would be a calming of the Eurozone crisis," says Tyler. "There is no scenario for an immediate solution to the crisis, but actions to provide further liquidity on a large scale and steps towards closer integration for Europe would give a modest boost to industry profitability."

—Patrick Burnson, Executive Editor

