2010 STATE OF LOGISTICS:

Make your move

The cost of the U.S. business logistics system declined 18.2 percent in 2009—the largest drop in the history of the *State of Logistics Report*. But as the economy slowly improves, shippers will need to be more cautious and tactical as they face increasing volumes, tight capacity, and higher rates.

BY PATRICK BURNSON, EXECUTIVE EDITOR

During World War II, the U.S. Navy enlisted world champion chess player Reuben Fine to calculate—on the basis of positional probability—where enemy submarines were most likely to surface. Years later, Fine was asked about the project's outcome, and modestly replied: "It worked out all right."

While logistics managers may not be consulting with chess masters these days, they are posing one big question to economic theorists willing to take it on: Is "The Great Freight Recession" finally coming to an end? Analysts and industry insiders are telling us that things are indeed getting better for shipper organizations, but that the tenuous business climate and tightened credit controls will make it difficult for carriers to rapidly expand capacity for the remainder of 2010.

The shipper imperative, then, will be to collaborate with carriers like never before. With capacity tightening, a new urgency should be placed on mitigating risk and controlling cost.

The 21st Annual State of Logistics Report (SoL), released by the Council of Supply Chain Management Professionals (CSCMP) and presented by Penske Logistics at the National Press Club last month, confirmed what many shippers had been suspecting. The worst may be over, but as the economy continues its slow recovery, shippers are going to be faced with an entirely new set of tactical challenges.

"We are definitely seeing a recovery," says Rosalyn Wilson, the report's author, "but not the kind that will generate a lot of new business this year. Granted, shippers have already made a great many sacrifices—that shouldn't change suddenly in the short term."

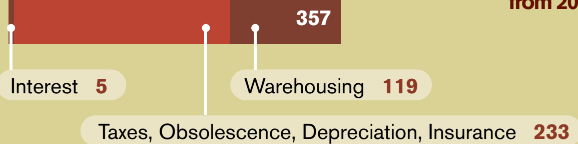
Indeed, according to Wilson's research, the cost of the U.S. business logistics system declined 18.2 percent in 2009—the biggest drop in the history of the report. Meanwhile, business logistics costs fell to $1.1 trillion, a decrease of $244 billion from 2008. Combined with the drop in 2008, total logistics costs have declined almost $300 billion during the recession. In fact, 2009 logistics costs as a percent of the nominal Gross Domestic Product (GDP) hit a historic low at 7.7 percent.

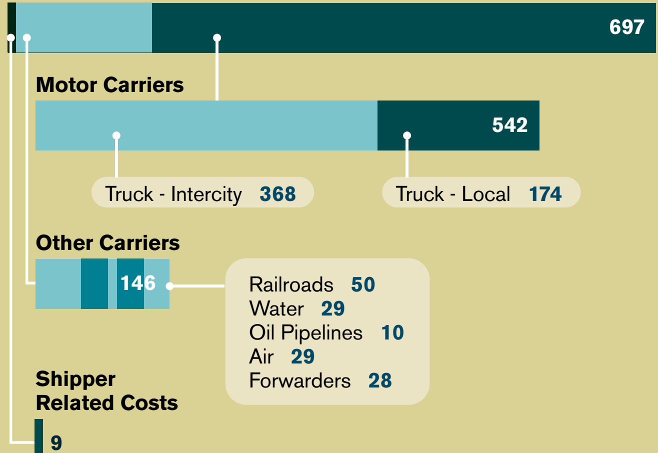
"Both major components of the cost models declined in 2009," explains Wilson. "Inventory carrying costs fell 14.1 percent in 2009, and this decrease in carrying costs was due to both a 4.6 percent drop in inventories and a 10 percent drop in the inventory carrying rate." Transportation costs, she adds, plummeted 20.2 percent from 2008 levels. Trucking, which comprises 78 percent of the transportation component, declined 20.3 percent while all other modes combined declined 20.5 percent.

RAPHEAL RICOY

Snapshot of the U.S. Logistics Market 2009

$ billions





Logistics Administration

42

Total logistics cost $1,095 billion

Down 18.2% from 2008

Source: CSCMP's 21st Annual *State of Logistics* Report

CAPACITY GAMBIT

The recession—which began in December of 2007 and continued through more than half of 2009—had a negative impact on all segments of the logistics system.

The entire industry felt the negative effects of the downturn more than most other industries since the slump in each individual sector translated into a loss in shipment volume. According to Wilson, inventories continued to climb for the first half of 2008 fill-

ing warehouses and retail shelves. In mid-2008, bloated inventories began to be drawn down until they reached pre-recession levels in late 2009.

"Throughout the period, orders for new goods dropped off substantially and carriers competed for a dwindling volume of shipments," Wilson says. "Spot rates for some modes fell below costs, further adding to financial decline. Excess capacity in the system was rationalized—or reduced—particularly in the trucking and air cargo industries. Some was the natural result of carriers that went out of business, but much of the reduction was the result of business decisions."

And with the economy showing stronger signs of new life as we move into the second half of 2010, Wilson and others maintain that it's likely that we'll have capacity problems in many areas by year's end.

> "Shippers were shell shocked last year due to low volumes and extreme rate pressures, and very soon became risk adverse."
>
> —Rosalyn Wilson, author of the State of Logistics Report

As in modern chess, the typical response to a moderately sound gambit is to accept the material (be it made by bishop, knight, or rook) and give the material back at an advantageous time. Vincent Hartnett, Jr., Penske's president, suggests that this board play can work for logistics managers as well, taking what carriers will offer now and negotiating for balanced rates later.

"Shippers are striking up strategic alliances with logistics services providers that can respond quickly to market changes and are capable of reducing costs rapidly," Harnett says. "At the same time, providers are looking out for best practices and shippers with the most agile supply chains."

KEEP PUSHING PAWNS

But it wasn't as if shippers hadn't been trying this all along. In an interview with LM, Wilson tells us that after rising more than 50 percent in

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PETCO
GREEN MOUNTAIN COFFEE ROASTERS
FASTENAL
Audi
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BMW
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TGW is one of the best kept secrets in automated material handling solutions. To make it easier to know some of the companies that have discovered the secret of using TGW to optimize their supply chain, we provided this handy list.
- Carton, tote and unit load conveyor & sortation systems
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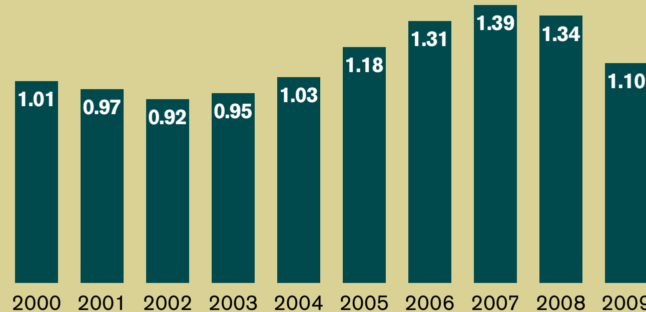
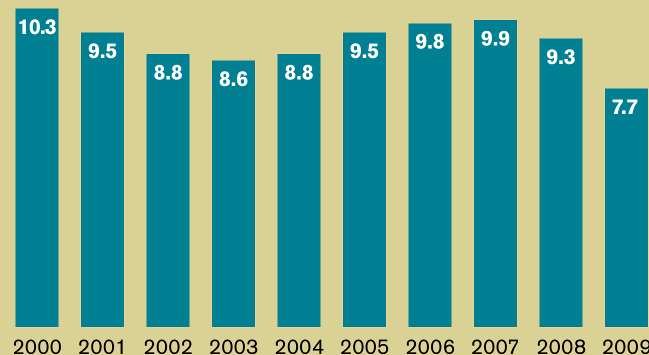
the five years leading up to the recession, total logistics costs fell in 2008 and 2009. Transportation costs were down more than 20 percent in 2009.

"Shippers were shell shocked last year due to low volumes and extreme rate pressures, and very soon became risk adverse," Wilson says. "At the same time, interest rates continued their downward spiral while inventory levels dropped off, leading to another double digit drop in inventory carrying costs. Logistics as a percent of our nominal GDP fell to 7.7 percent to the lowest level measured since the series started in 1981."

Although virtually every shipper and carrier involved in the supply chain slashed costs and increased productivity, this precipitous drop was caused more by the rapid decline in shipments and the cut-throat rate environment. Revenues for most carriers were depressed in 2009 and some—like Maersk Line—had losses for the first time in their firm's history. However, many ocean carriers are forecasting a better revenue picture for 2010. (See Ocean Cargo synopsis page 31.)

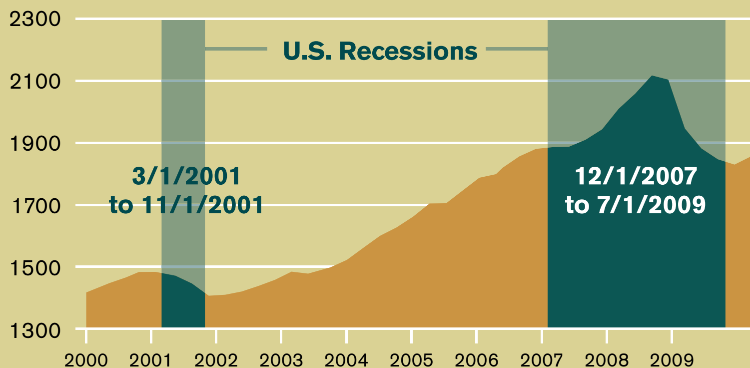




Having hit rock bottom, inventories are slowly "inching up," says Wilson. She also notes that orders are being placed and commodities are moving again. In addition, interest rates have been steadily rising. "With volumes picking up, capacity tightening, and higher rates on the way, much of the drop in transportation costs should reverse itself. Although it will probably be 2011 before we see pre-recession levels," she says.

For carriers who have survived these hard times, adds Wilson, the future looks relatively bright, but it's still not time for them to let their guard down. They will have emerged in a seriously weakened state and will depend on their ability to capitalize on growing market opportunities to bolster their position. This poses a fresh challenge for shippers: "They would be wise to be first at the table negotiating rates and capacity," says Wilson. "Guarantee a minimum level of business in return for guaranteed carriage and limited rate hikes two or three years out. Consider offering assistance, perhaps in the form of new terms, to weaker links in your supply chain to ensure carrier survival."

In other words, keep pushing pawns until a tactical goal is made and strategic models are developed. "We need to continue to mind the bottom line and keep costs in check," says Wilson.



Patrick Burnson is Executive Editor of Logistics Management

LTL:
Carriers upbeat on rates

No sector of the transportation industry was hammered harder over the last year than the $25.6 billion less-than-truckload (LTL) sector. When industry leaders such as FedEx Freight and Con-Way began posting quarterly losses and laying off workers for the first time in their companies' history, that proved times were tough.

Battered by the twin demons of having high fixed costs and demand levels that fell nearly 30 percent during the peak of the recession last year, most LTL carriers simply hunkered down and were in "survival mode," as one carrier executive put it.

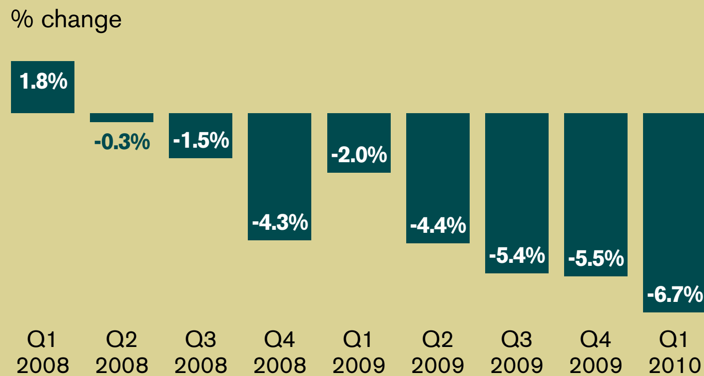
Some analysts estimated that there was as much as 25 percent overcapacity in the LTL sector last year. Making matters worse, analysts say, was the precarious financial position of YRC Worldwide that holds about a 20-percent LTL market share. Some rival carriers, sensing YRC was on its last leg, went on an all-out pricing war, dropping rates as much as 80 percent off the listed tariff price.

Fast forward one year later: YRC is still in business, and also still losing money. But shipment volumes are rising, overcapacity is easing, and some LTL carrier executives are reporting brisk demand for their services.

"It's fairly strong and has been since the beginning of February," says Charles Hammel, president of Pitt Ohio Express, a leading LTL carrier. "Revenue, shipments, and tonnage are up with tonnage being up the most."

But is it sustainable? "The jury is still out on that question," Hammel says. "Business in the marketplace today would suggest that it is, since we continue to be busy with no slowdown in sight."

But Hammel and other industry executives and analysts say there are still unanswered questions about the economy. For instance, what happens to the U.S. economy after the government stimulus money ends? Another unanswered question revolves around how tight the credit markets will be going forward.



However, a major carrier bankruptcy or cessation of business is not out of the question. Many analysts believe banks were reluctant to shutter YRC because of the low demand for used trucks during the recession. How will lenders react if the used truck market bounces back, as it appears to be doing?

No shipper or carrier knows the precise answer to all those questions. But carrier executives and analysts seem to agree that LTL rates are rising. They almost have to. As the accompanying chart illustrates, LTL revenue per hundredweight has declined for eight straight quarters. Those declines hit 6.7 percent in the first quarter of this year.

But analysts say a combination of increasing freight volumes, better carrier discipline, expiring contracts, and concerns over capacity are all creating a better overall pricing environment in LTL.

"The LTL industry has shown a little more pricing discipline," says Satish Jindel, principal of SJ Consulting. "They've taken some drivers out of the network which has helped balance. Demand is up in the low-single digits and excessive overcapacity is coming out. There is still overcapacity but not so such that it will limit them seeking some marginal rate increases between 2 percent to 4 percent."

That jibes with Hammel's advice for shippers. Noting that most shippers have rates locked in through contracts, Hammel says he's expecting LTL rates to rise between 3 percent and 5 percent in the coming year.

"I would advise shippers to lock in the capacity they think they will need moving forward in their contract," Hammel says. "What good are great rates if your carrier can't or won't give you the capacity that you need?"

By John D. Schulz,
Contributing Editor

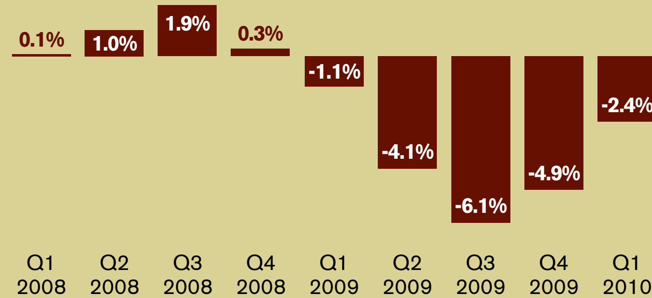
Truckload:
Bargain rates disappearing

The truckload (TL) sector, which accounts for more than 90 percent of the $542 billion trucking industry, is rebounding from its three-year freight recession. In fact, it all boils down to this: Shippers should be prepared to pay more as the TL capacity tightens.

In its recent Business Expectation Survey, Transport Capital Partners (TCP) found that 88 percent of TL carriers surveyed expect volumes to increase over the next year and 84 percent expect rate increases over the same period.

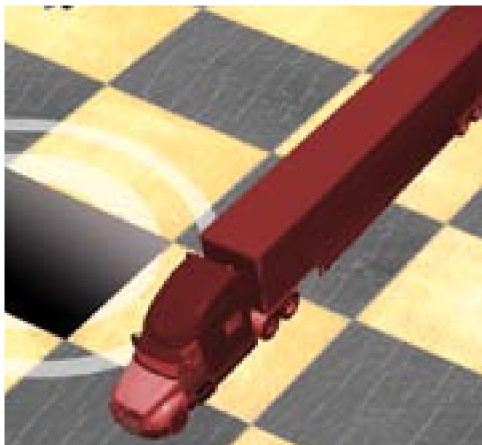
"The clear message from all the respondents was that their outlook for our industry has improved tremendously," says Richard Mikes, a partner at TCP, a leading transportation mergers and acquisitions advisory firm.

When it comes to rates, it's important to remember that about 75 percent of TL freight moves under contract or under dedicated service arrangements. Many of those contracts, usually a year long, have not expired yet. So those shippers will likely retain the bargain rates they negotiated when volumes were low.



But when those contracts expire, shippers can expect carriers to look for 1 percent to 3 percent rate increases, depending on geographic lane, volume, and other factors. At press time, spot market rates were already rising from what analysts say were unsustainably low levels last year.

Freight demand for TL services has continually grown since it hit bottom in the second quarter of 2009. Both large and small TL carriers are reporting brisk demand for services, and concerns about tight capacity have already started. More importantly, U.S. business is starting to destock inventories, which hit record high levels last year as both manufacturers and retailers were unsure how deep the recession would be.



In her 2010 Annual State of Logistics Report, analyst Rosalyn Wilson notes that the inventory-to-sales ratio began "skyrocketing" from 1.26 in late 2007 to 1.48 early last year. By the end of last year, the ratio had return to 1.26. The most recent inventory-to-sales figures available showed that it had dropped to 1.23—a low number that signals greater demand for trucking services.

Truckload carriers are showing a "high level of optimism that is reflected in the general upward swing of the economy," says Lana Batts, managing partner for TCP and a longtime analyst and TL industry official. Revenue, tons, and miles are all increasing, according to various industry sources.

The TCP survey in the most recent quarter showed that 45 percent of TL carriers had raised rates, compared with only 9 percent in the previous quarter. Finally, analysts say, supply and demand dynamics are lining up in favor of the carriers once again.

"It's easier in the TL sector than the LTL sector which has higher fixed costs so that when the LTL industry eliminates revenue, they don't reduce their costs," says Satish Jindel, a principal of SJ Consulting. "In TL, you move point to point. Rates are going to vary by region, but if shipment volumes continue as they have for the next few months, I would expect yields to be 1 to 2 percent higher in TL than LTL."

The reasons for this are numerous, analysts say. The overall economy is improving. Government stimulus money is flowing. The housing market, while not robust, is off the floor. Auto sales are rising. Plus, there are seasonal issues helping TL, as volumes usually grow sequentially through the third and early fourth quarters.

As the construction market improves, that could exacerbate the driver shortage, which could limit TL capacity, analysts say. Already one leading transport economist, Noel Perry of FTR Associates, is predicting driver shortages beginning this year and continuing into 2010—reaching 400,000 next year.

By John D. Schulz,
Contributing Editor

Rail:
Volumes on track

Compared to a year ago, volumes for all modes of freight transportation currently look healthy and encouraging. But when you think about just how bad the economy was last year it puts things into a different perspective—that's particularly true when it comes to the freight railroad industry.

In 2008, when most freight transportation business was witnessing earnings and volume freefall, the railroads moved down the line with strong pricing power and financial returns intact, even though volumes dipped compared to the record-breaking years of 2006 and 2007. But in 2009, it was clear that market conditions had changed and the recession had indeed caught up to the railroads.

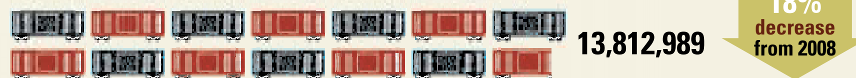
However, in the first half of 2010, it appears to be a different story, with strong first quarter earnings serving as an indication that the railroad industry is kicking back into higher gears. But even though 2010 volumes are ahead of 2009, they are still lagging 2008 levels by roughly 10 percent to 12 percent on the carload side and 7 percent to 10 percent on the intermodal side.

"A year ago, the biggest issue was not just the volume drop but the lack of visibility in terms of how far it was going to drop," says Anthony Hatch, principal of New York-based ABH Consulting. "And it appears that now, with volumes returning, railroads can plan over the intermediate term because customers are indicating that there is going to be at least decent improving volumes trending toward previous levels. They are still well off of the peak, but they are heading in the right direction."

U.S. rail cargo volumes

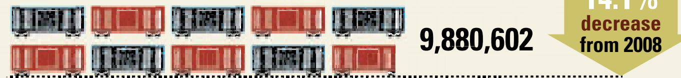
2009

Total carloads



13,812,989 — 18% decrease from 2008

Total intermodal loadings



9,880,602 — 14.1% decrease from 2008

January-May 2010

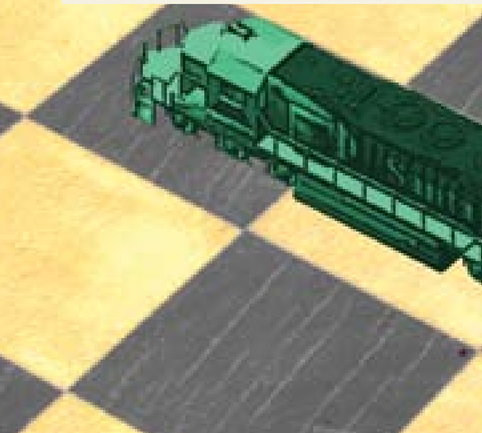
Total carloads

5,923,332 — 23.5% increase from the first five months of 2009

Total intermodal loadings

4,333,559 — 10.3% increase from the first five months of 2009

Source: Association of American Railroads (AAR)



While volumes are not reaching the same levels from recent years, it appears that the railroad industry is on solid footing, with Class I railroads taking the required steps to invest in their operations and infrastructure, as evidenced by a $9.95 billion cumulative investment by Class I railroads in 2009, according to the Association of American Railroads.

These investment tallies are impressive, considering that 2008 was a record year for Class I investment at $10.2 billion while 2006 and 2007 hit $8 billion and $9.4 billion, respectively. While impressive, these investments are also vital as rail carriers are financially responsible for track upgrades and improvements while barely earning above their cost of capital.

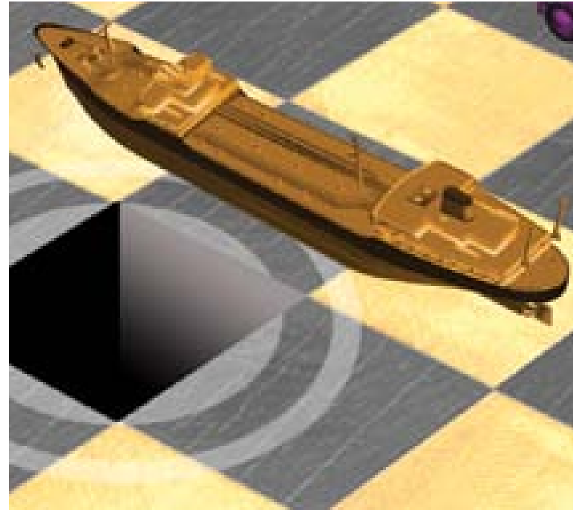
Despite this situation, the railroads are not getting any sympathy from shippers, many of whom have maintained over the years that rail rates are too high, coupled with low service levels. "We hear continued complaints for escalating railroad pricing and poor service," says Bob Szabo, executive counsel for Consumers United for Rail Equity (CURE). "People are continuing to have trouble with the railroads and complaining about robust pricing."

But as has been the case in the past, rail carriers have made it clear that prior to the last six years, rail rates were largely flat or down year-over-year since the industry was effectively deregulated in 1980.

While many of the differences between railroads and shippers largely remain the same, legislation focusing on STB re-authorization, known in the industry as "railroad re-regulation," may end up paving the way for shippers to gain rate relief and more transparency regarding rate disputes as well. But with several more well-known pieces of legislation ahead of it in line, it remains to be seen how that will play out.

By Jeff Berman,
Group News Editor

Ocean:
Capacity comeback



Shippers are scrambling for space and may be squeezed for higher rates when they find it. According to the Paris-based container-shipping consultancy Alphaliner, the shortage of containers has reached critical levels, with lines blaming the shortage on the "exceptional" high demand that developed since the Chinese New Year in February.

A recent Alphaliner newsletter states that prices for new containers have soared to their highest levels in almost 20 years as both carriers and container leasing companies rush to place fresh orders to meet the new demand. The report adds that the current price for 20-foot dry containers has reached $2,750/unit compared to less than $2,000/unit at the end of last year.

Even at these higher prices, demand will still outstrip supply for the current peak season. In the meantime, container manufacturers are facing difficulties in restoring full capacity following the halt in production of dry containers since October 2008, the report states. Total capacity at the main container producers have been cut back significantly since late 2008, as production lines were shut and twin-shift operations reduced to single shifts.

Although annual production capacity at the two largest container manufacturers, CIMC and Singamas, is over 3.5 million twenty-foot equivalent units (TEUs), these two suppliers are expected to produce only 1.35 million TEUs this year. The global output of new containers is estimated at 1.5 million to 2.0 million TEUS for the full year, well down from the peak of 4.2 million TEUs produced in 2007 and a global capacity of 5 million boxes.

Meanwhile, demand has picked up significantly since the beginning of the year. CIMC is reporting sales of 102,900 TEU of dry van containers in the first quarter alone, compared to 60,400 TEU in the whole of 2009.

In terms of rates, spot prices for transpacific shipping services have grown by more than 180 percent during the past 12 months to reach a five-year high. Experts describe the increase as a "mini container-shipping boom."

Shipping consultant Drewry's Hong Kong-Los Angeles container rate benchmark hit $2,607 per 40 foot (FEU) container in June—19 percent higher than the previous month and 182 percent higher than year-to-date 2009. But Drewry pointed out that the trade had been suffering with "serious overcapacity and price discounting" in 2009.

Analysts also note that the jump in transpacific container rates reflected new peak season surcharges, very tight eastbound transpacific ship capacity, and a shortage of boxes that is becoming an issue in China as well as in the U.S.

Drewry says that eastbound transpacific freight rates, under annual contracts signed in May and June for the 2010/2011 season, were also more than twice the previous low levels of the 2009/2010 season.

"The rebound in spot container freight rates has been phenomenal, as rates now substantially exceed pre-crisis levels of about $2,000 per 40-foot box," says Philip Damas, editor of the Drewry Container Freight Rate Insight Report. "Whether you look at Hong Kong-to-Los Angeles, Shanghai-to-Los Angeles, Shanghai-to-New York or Shanghai-to-Chicago, all our weekly container rate benchmarks from port to port or from port to inland point show year-on-year increases of more than 60 percent."

By Patrick Burnson, Executive Editor of Logistics Management

AXS-Alphaliner Top 20 operated fleets-2010

Operated fleets as per June 16, 2010

Rank	Operator	TEU	Share
1	APM-Maersk	2,067,734	14.6%
2	Mediterranean Shg Co	1,675,777	11.8%
3	CMA CGM Group	1,117,302	7.9%
4	APL	595,269	4.2%
5	Evergreen Line	571,201	4.0%
6	Hapag-Lloyd	544,361	3.8%
7	COSCO Container L.	506,268	3.6%
8	CSAV Group	494,744	3.5%
9	CSCL	451,790	3.2%
10	Hanjin Shipping	448,051	3.2%
11	MOL	383,042	2.7%
12	NYK	365,927	2.6%
13	OOCL	359,764	2.5%
14	K Line	336,753	2.4%
15	Hamburg Süd Group	335,464	2.4%
16	Zim	320,461	2.3%
17	Yang Ming Marine Transport Corp.	317,197	2.2%
18	Hyundai M.M.	282,109	2.0%
19	PIL (Pacific Int. Line)	227,841	1.6%
20	UASC	204,100	1.4%

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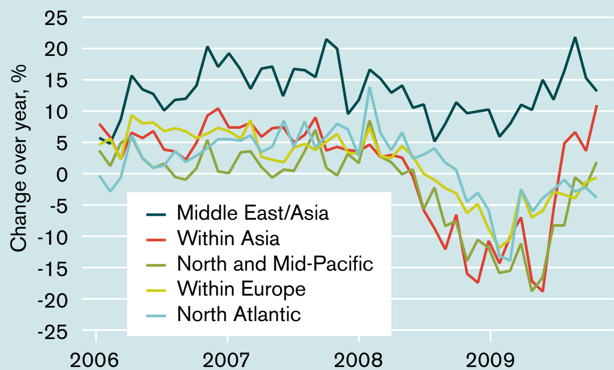
Air Freight:
Back up in the air

All of a sudden the airways seem to be calming for the airlines. Back in March, the International Air Transport Association (IATA) projected a $2.8 billion loss in 2010 for the industry. The IATA now forecasts a $2.5 billion profit, with cargo volume growth now projected to hit 18.5 percent from the previously forecast 12 percent. To top it off, IATA expects airline revenues to reach $545 billion, up from $483 billion in 2009.

"Six months ago there was hope for a strong recovery," exclaims Michael Goentgens, Lufthansa Cargo spokesman. "Now it's a reality."



Source: IATA

Still, IATA warns that revenue projections are below the $564 billion achieved in 2008.

"The recovery remains fragile," says Giovanni Bisignani, IATA's director general and CEO. "Net margins hover around 0.5 percent while a major part of the global industry is still posting big losses."

In Europe, the stagnating economy, strikes, natural disasters, and the Euro crisis have left carriers struggling with an anticipated $2.8 billion loss. For its fiscal year 2010 (April 2009 – March 2010), British Airways World Cargo (BAWA) reports commercial revenue decreased 18.2 percent, and, excluding the impact of favorable exchange rate movements, commercial revenues were down 26.1 percent.

"This shows the fragility and criticality of air freight," comments Brian Clancy, managing director of global transportation analyst firm MergeGlobal.

A number of issues such as market and currency volatility and security issues (TSA rules for domestic air freight and exports on passenger aircraft goes into effect August 1) continue to be critical concerns for carriers and shippers alike. There's also traffic directionality, the industry's resistance to adapt e-freight, and continued volatility for oil prices. "Due to these factors I don't think we will get back to normal or peak-year levels until 2012," says Clancy.

Ram Menen, divisional senior vice president of cargo for Emirates Airlines, sees the air cargo market getting stronger in the second half of 2010. "We've seen particular strength on volumes out of China and India," says Menen. "Traffic is strong on transatlantic and African routes as well."

According to Goentgens, it's the same for Lufthansa Cargo, which added service to Tianjing effective June 2010. "Demand from Europe to China is also increasing," says Goentgens, who adds that just about all routes are performing very well for the carrier this year.

Boosting the Lufthansa group's capacity and service flexibility is AeroLogic, a start up company that's jointly owned by Deutsche Lufthansa AG and Deutsche Post DHL through subsidiaries Lufthansa Cargo and DHL Express. This year, AeroLogic will employ a new Boeing 777F that will join the fleet of Lufthansa Cargo's MD11 aircraft and Jade's 747. Goentgens emphasizes that the group will be the only carrier offering customers three different modern freight aircraft.

Many carriers are also strengthening intra-Asia business where markets are intensifying. Korean Air is making China its second base outside of Korea and established Navoi, Uzbekistan, as a hub for central Asian.

"Navoi has great potential," says Ilkwon (Justin) Jung of Korean Air's Cargo Strategy and Alliance Team. "Novoi is within six hours flying time to Europe and Southeast Asia and offers multimodal transportation links to neighboring countries."

Still, U.S. and European economic conditions and the possibility of over capacity—the result of reactivation of grounded aircraft and the introduction of new fleets—remains a concern for carriers.

But Neel Shah, vice president of cargo for Delta Air Lines, asserts that today air carriers are more rational about capacity, as was made evident by the Delta-Northwest merger. Delta, for one, now offers a broader range of mission capabilities. It discontinued the B747-200 freighter operations, continues to expand its global footprint, and recently launched a number of new high profile flights.

"Carriers will continue to take measured actions, like mergers, to maintain that approach," Shah says.

However, MergeGlobal's Clancy contends that the industry faces structural issues that will limit long-term freight growth. In particular is the cost of air freight relative to other modes, complicated by diminished price points on traditional air freight commodities such as electronics.

Add to this the trend toward nearshore production. All manufacturers are taking a hard look at logistics costs, he says. Consequently, Clancy sees express carriers like UPS and FedEx being the net winners overall.

By Karen Thuermer,
Air Freight Correspondent