



Profitability

brace yourself

The mid-year report on transportation shows that while there is reason for optimism, it's still a rough road ahead

BY DAN GOODWILL

How did we get into this economic mess, what have been the impacts on freight transportation and where do we go from here are three important questions I want to address in this mid-year report. In preparing my analysis, I have relied on the input of a number of economists and industry analysts including a paper entitled, *Solving the Overcapacity Problem: Trucking Industry Trends and Forecast*, delivered by David G. Ross, principal of the transportation and logistics group for Stifel Nicolaus and Company, at the SMC3 Summer Conference in Las Vegas at the end of June.

The first half of 2009 was the culmination of a number of events that took place over the past three years. The bursting of the US housing bubble coupled with the decline in auto sales in 2006 produced a freight recession that preceded the current economic recession. This began the contraction in trucking fleets to bring supply in line with demand. The worldwide credit crisis in September 2008 led to a full-fledged recession. During the first six months of 2009, inbound shipments via ocean and air dropped dramatically. US housing starts hit a 50-year low and auto sales were the weakest since the '81-'82 recession.

With no more credit or home equity to use, consumer spending began to decline. Rising unemployment and decreasing consumer confidence further reduced demand. This encouraged companies to draw down existing inventories to limit manufacturing. This has resulted in major impacts on all sectors of transportation.



Less than Truckload

Revenue for the eight largest LTL carriers in the US fell by an astonishing 25.6% during the first quarter of this year. This group includes YRC (National and Regional), Con-Way, ABF, FedEx Freight, UPS Freight, Vitran Freight, Old Dominion, Saia and UPS Freight. This sector has been losing market share for a decade. More recently, companies in this segment have been under attack from truckload carriers that have been targeting heavier-weighted LTL shipments. It has also been hit by the transportation management companies and 3PL's that have been combining LTL shipments into full and partial loads and moving this freight at reduced rates. A number of companies have reported heavy losses in this sector. Con-Way has recently

announced a new heavy LTL pricing strategy in an effort to retain and secure heavy LTL shipments.

An estimated 8% of the LTL capacity has come out of the market. One expert has predicted another 6% reduction is required in order to bring supply in line with demand.

YRC remains one of the most discussed topics in transportation. This \$7 to \$8 billion giant controls an estimated 20% of the LTL market but has lost over \$1.8 billion during the past nine quarters. A report from David Ross at Stifel Nicolaus indicated that second quarter volumes at YRC National were down 40% year-over-year. YRCW is struggling under a mountain of debt stemming from its 2003 purchase of long-haul rival Roadway Express and its 2005 purchase



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of regional LTL carrier USF Corp. Ross has estimated YRC has approximately \$1.427 billion in total debt, including about \$728.5 million owed to its consortium of banks. The question is whether its customers will remain on board and whether it can shrink its way to profitability through a combination of asset sales, terminal integration, teamster wage concessions and ongoing support from its banks. The departure of YRC would bring supply into line with demand and change the entire nature of the LTL industry.

Truckload

The truckload sector is better able to reduce capacity than its asset-heavy LTL cousins and has shed an estimated 18% over the past two years. As a result, it has fared better. However, there is still excess capacity in this sector and shippers have been able to negotiate mid-single-digit rate decreases.

National truckload carriers have been targeting regional freight markets to retain revenues and improve profitability. As mentioned above, they have also been soliciting heavy LTL shipments to keep their trucks moving.

Cost-conscious shippers have been migrating some of their truckload freight to intermodal transport. J.B. Hunt, historically one of the largest US-based truckload carriers, now gets less than 25% of its revenues from dry van transportation. Their growth has come from intermodal and dedicated contract carriage. The spike in fuel costs facilitated this trend and the expected increase in fuel costs as the recovery gains momentum is likely to move more freight in this direction. Intermodal volumes are expected to almost double between now and 2020.

Truckload capacity is one variable to watch. In 2006, 256,000 Class 8 trucks were purchased. This year, the number is projected to be as low as 75,000. This will keep capacity constrained. More than 35% of carriers responding to a recent survey indicated that they had parked trucks and almost 33% said they had sold trucks.

To retain and build market share, 10 of the 11 publicly traded US-based dry van truckload carriers also do brokerage busi-

ness. Carriers are learning that they cannot meet all of the shippers' needs in a profitable way. As a result, some carriers are focusing on lanes where there is density and using third-party carriers on routes where they have less traffic.

Industry analysts expect the truckload sector to recover first. As inventories are depleted, manufacturing will begin again. This will move more truckload freight through the system. In addition, the stimulus programs will likely increase the amount of infrastructure freight being handled by truckload carriers.

Rail

The recession has caught up with the railroads as evidenced by declining volumes and layoff announcements. Weekly carload numbers for the Class 1 railroads are in the range of 250,000 to 270,000, well below average. However, the railroad's oligopoly pricing power allows them to perform better financially than their trucking colleagues. Citing a requirement to satisfy growth in future years, railroads are claiming that they are making the necessary investments in infrastructure. The rails argue that they need to keep their rates high so they can continue to recapitalize their fleets.

CSX was the first railroad to report on its second quarter financial results. Business volumes declined by 21% and revenues dropped by 24.8%. Intermodal volumes dipped by 12% while revenues declined by 24%. CSX was able to cut operating expenses, partly through right-sizing its workforce.

Where do we go from here?

It is unlikely to expect any support from consumers over the balance of the year. Unemployment is likely to continue to rise. Those who are working are required to build their nest eggs since home sales remain difficult.

Shippers will continue to tighten inventory, cut freight tonnes and miles from their distribution networks, put their business out for bid and continue to obtain 5-10% rate reductions as supply and demand continue to remain out of balance.

Truckers are showing some optimism. Among the truckload carriers surveyed by Transport Capital Partners in March and April, 36.9% expect their freight volume to increase year-over-year in the next twelve months and 54.1% expect rates to rise. The ATA index increased 3.2% in May, its first year-over-year since February.

Bob Costello, ATA chief economist, recently made these comments: "I am hopeful that the worst is behind us, but I just don't see anything on the economic horizon that suggests freight transportation is ready to explode...The consumer is still facing too many headwinds, including employment losses, tight credit, rising fuel prices and falling home values, to name a few, that will make it very difficult for household spending to jump in the near term." There are other headwinds including packaging consolidation, modal shifts and shrinking supply chains.

Costello also stated that "don't be surprised if (trucking company) failures start rising again with fuel prices." One can also expect less reluctance on the part of "creditors to liquidate debtors that are keeping struggling carriers alive."

What will it take to succeed? According to Jim Allworth, vice-chair of the Investment Strategy Committee, we will be living in a world where "global GDP is growing at a measurably slower pace...We expect a much sharper distinction between 'winners' and 'losers' will continue to be drawn over this interval. At a minimum, winning is likely to require the following corporate characteristics:

- A strong product or service offering that fits the environment and a well-conceived business plan to deliver the offering to the market;
- The ability to execute that plan on a sustained basis;
- The balance sheet strength to make the investments necessary to maintain a competitive advantage in a world where access to needed capital can't be taken for granted;
- The margin to be able to engage in what may be fierce competition over a sustained period."

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