Natural Selection in the Trucking Industry

By Benjamin Gordon

British economist Herb Spencer coined the phase "survival of the fittest," where he incorporated Darwin's idea of natural selection into his concept that a stronger business is more likely to survive during various stages of the business cycle. This concept is particularly pertinent when analyzing the trucking industry today. The current transportation market faces several major pressures: skyrocketing fuel and insurance costs, plummeting driver availability, the "China effect," and a "just-in-time economy". Under these conditions, some truckers will thrive, while others will fall behind. The following article provides an insight into the trends, challenges, and opportunities that leaders of the trucking industry must contemplate as they continue to evolve.

The China Effect and the New World of Trucking

In July 2006, Werner Enterprises established a freight forwarding operation in China. What is the nation's fourth largest truckload carrier, an Omaha-based heartland company, doing with freight forwarding services in China?

Werner is not the only large trucking operator currently expanding from US trucking into global logistics. In May 2006, Schneider National completed the acquisition of American Port Services (APS), establishing a foothold in the port services marketplace. The next month, it divested its glass-hauling division to Maverick USA. Why would a multi-billion dollar trucking company buy a small port logistics company and sell a trucking division?

In fact, these two counter-intuitive initiatives are part and parcel of the same trend: the "China Effect."

Werner recognized that the locus of decision-making was shifting to the Far East. As manufacturing moves to China, and as freight forwarders decide how to route freight back to the US, trucking companies may see their volumes fluctuate dramatically. By establishing a Chinese freight forwarding base, Werner wanted to ensure that it would be in a position to guide its customers' products from factories, through ocean ports in China into the US, and ultimately onto a truck – most likely, a Werner truck. As a result, Werner saw the need to enter freight forwarding in China, both as an offensive move (to capture the high growth Asian forwarding opportunity) and as a defensive move (to protect the US trucking foundation).

Schneider was responding to a similar pressure. As decisions shift upstream, trucking companies like Schneider and Werner are at risk to lose business. Schneider bought APS in order to establish a beachhead within the new king-makers in the port services marketplace.

As the Werner and Schneider examples highlight, the market is forcing would-be winners to make aggressive investments in their future. In a transportation industry already squeezed by skyrocketing fuel and insurance, severe driver shortages, and hours of service pressures, the China Effect will multiply the difference between winners and losers. Giants like Werner and Schneider are investing in new capabilities to respond to these forces. But many small and mid-sized companies lack either the resources or the willpower to take action.

Amidst this rapidly changing marketplace, what can your company do to ensure success?

The Driver Shortage

The driver shortage is probably the number one factor affecting capacity. According to the American Trucking Association, the driver shortage has reached 20,000 today and is expected to exceed 114,000 by 2014. Further, because of the high rate of turnover, over 300,000 new truck drivers are expected to be needed over the next 5 years. This problem is large and growing. Barring a sudden solution, many operators may soon see a combination of idle fleets and lower margins, as driver pay may have to double by 2014 in order to alleviate the driver crunch.

This is not a speculative risk – it is already occurring. In Werner's recent second quarter release, it conceded that 129 trucks in their fleet are sitting idle due to the current driver market.

How can trucking CEOs respond to the driver crisis?

At a tactical level, companies can take several steps to address driver retention. In the truckload industry, where turnover ranges from 75% to 100%, and driver training costs can range from $4,000 to $9,000 per driver, the cost of turnover is an enormous hidden expense. Tactical options include higher pay, driver perks, well-equipped sleeper trucks, and training programs. However, these responses require companies to make a significant investment of time and resources.

At a strategic level, some truckers are responding by taking a more dramatic step, and actually opting out of trucking. Companies like Schneider and Werner are seeking expansion into areas that do not require revolving-door driver recruitment, by targeting new sectors such as port services and freight forwarding for acquisitions.

Small to mid-sized truckers face a competitive disadvantage when it comes to the driver problem. Larger players have the competitive advantage of being able to provide more competitive driver pay and benefit packages, and so are more likely to lure the scarce pool of driver talent. For instance, JB Hunt has been very effective in retaining and acquiring truck driving talent, and actually increased their trucking fleet by as many as 400 more trucks in service. In contrast, many small to mid-sized trucking companies may lack the resources to achieve this goal.

Increasingly, smart trucking companies may choose to follow Schneider and Werner's lead, by diversifying into asset-light logistics services that provide strategic control while reducing dependence on drivers.

Hours-of-Service Regulations

Hours of Service Regulations have intensified the challenge of an already painful driver shortage by essentially decreasing the capacity of the national fleet. New regulations will increase the need for drivers by 25-30%, according to a 2006 Global Outlook report on the trucking industry.

New regulations have punished some segments of the market harder than others. For example, chemical tank carriers like Jevic Transportation, once a leader in chemical and hazardous waste transport, have lost efficiency, since the rules stipulate that loading and unloading times must be included in the calculation of hours of operation. The segment has responded by entering a massive consolidation cycle, creating tighter capacity, which in turn has led to higher pricing. In fact, SCS Transportation (now Saia) has recently sold the struggling Jevic Transport to Sun Capital Partners for a price of just $40 million.

Fuel Prices

Fuel prices are the second highest operational cost for truckers. With fuel costs in the $2.75 to $3.25 a gallon range, many trucking operators are only maintaining profitability by imposing surcharges. Unfortunately smaller trucking operators have had more difficulty than large companies in passing on surcharges to their customers. Going forward, it appears likely that smaller truckers will not be able to mitigate the increase in diesel fuel. Additionally, larger trucking operators can count on economies of scale, which enables them to buy fuel in bulk and control their own filling stations. In contrast, smaller operators are forced to pay retail prices.

Skyrocketing fuel prices not only exacerbate the pressure small truckers feel in comparison with larger competitors, but also encourage shippers to reconsider lower-cost rail options. The recent expansion in intermodal transportation, which has increased from a growth rate of 5% in the 1990s to 9% today, is a direct result of these trucking cost shocks. The $14 billion intermodal market is dwarfed by the $312 billion truckload market, but is growing into an increasingly competitive alternative for shippers.

As fuel prices continue to increase, smaller trucking companies will increasingly face margin pressures. In response, we expect bankruptcies to skyrocket. In 2005, the trucking sector saw 2,250 bankruptcies. By 2010, we expect this number to more than double.

Opportunities

Smart trucking companies face several opportunities to emerge victorious amidst these turbulent times. Three options appear particularly compelling: go niche, combine with asset-light logistics providers, or seek scale.

1. ***Go Niche.*** Trucking companies that develop differentiated services in specialty services enjoy stronger profitability and growth. For instance, expedited ground transportation provider Panther II has prospered by focusing on same-day freight needs, which it provides on an asset-light basis. In June 2005, Panther sold its business to a private equity firm, Fenway Partners, for $142 million. In a marketplace where trucking companies typically get valued at four to six times

operating profit, Panther received a valuation of nearly double that rate. Similarly, in an environment where truckers may get valued at 0.5-0.7 times sales, Panther received more than 1 times sales (with $138 million of revenues). This reflects the strong underlying performance niche carriers can achieve. It also highlights the superior valuations that asset-light trucking companies can receive.

2. ***Combine with Asset-Light Logistics Providers.*** Truckers that merge with other logistics service providers can generate more valuable combinations. Schneider's acquisition of APS highlights one model. For smaller companies, it may be more practical to consider selling rather than buying. For example, one of the leading drayage and intermodal trucking providers in the country, Comtrak, recently agreed to be acquired by the Hub Group, the intermodal marketing company. The combination provides a tighter suite of intermodal services for Hub customers.

3. ***Seek Scale.*** Small and mid-sized trucking companies can also seek to generate scale by merging with one another. In the intermodal trucking arena, RoadLink USA was formed by the simultaneous merger of six regional companies. On a more conventional one-to-one basis, Estes Express and GI Trucking joined forces. The companies decided that they would be more likely to cut costs, complete a national network, and provide superior marketing as a combined entity. As a result, they merged to add scale.

Conclusion

As the China effect magnifies the importance of fuel, insurance, driver capacity, and regulatory pressures, the middle market will be the front lines in the coming consolidation of the trucking industry. Giants like Schneider and Werner can make investments to re-invent their business and integrate into the Asia-to-US supply chain. Owner-operators may be squeezed out of business by the growing costs of fuel, insurance and security compliance. In between, the mid-sized transportation companies sit in the balance.

The economy has already started to slow down. In Q1 2006, the U.S. GDP grew at a healthy clip of 5.6%. In Q2 2006, growth fell by more than 50%, and dropped down to just 2.5%. As the economy continues to cool down in the coming year, mid-sized trucking companies will face increased pressure. How will they respond?

Smart trucking executives will choose to take decisive action. They can take advantage of strong demand and sell, they can seek targeted mergers to gain scale, or they can raise capital to fund a niche specialty strategy.

In the 19th century, Herb Spencer wrote about "survival of the fittest." In the trucking industry today, the survivors – and indeed the winners – will be those companies that make clear choices about how to compete. Will your trucking company be one of them?

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