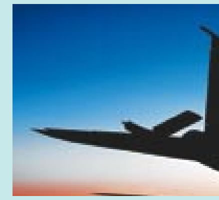
LOGISTICS 2005:
Assessing the Seven Mega-Trends



2005 has been a banner year for the third party logistics sector.

The logistics market continued to expand in nearly every respect. Warehousing, freight forwarding, truck brokerage, dedicated contract carriage, and a broad range of niche logistics segments all exhibited growth in excess of 10%. In the public marketplace, Eagle Global Logistics and Landstar forecasted earnings growth in excess of 20% for the next years, as did UTi, Expeditors, and C.H. Robinson.

Why, then, are stock market valuations retreating? After skyrocketing 58% in 2004, the basket of non-asset forwarders (UTi, Expeditors, and C.H. Robinson) was actually down 1% in 2005 year to date. Similarly, Eagle and Landstar were down 31% and 23%, respectively. What explains this anomaly?

On balance, market valuations remain at or near record highs. For instance, the basket of non-asset forwarders is trading at 29 times 2005 net earnings, and at 16 times 2005 earnings before interest, taxes, depreciation, and amortization (EBITDA). This high valuation level reflects the strong threshold of confidence that investors continue to place in these firms. At the same time, a number of clouds are appearing on the horizon, threatening to dampen the strong historical performance that top logistics firms have achieved.

As a result, the logistics market is in the midst of competing pressures, reflecting both opportunities and challenges. These top seven mega-trends are outlined next.

1. ASSET-LIGHT FORWARDING: WILL THE PARTY CONTINUE?

The asset-light forwarding sector continues to exhibit powerful growth, particularly in the all-important Asia-North America trade lane. For instance, Expeditors' first quarter revenues were up 19% over the equivalent period in 2004. This represents a slower growth rate than Expeditors has achieved historically, however.

Similarly, the ocean-forwarding category pulled ahead of the air-forwarding market, reflecting the continued cost sensitivity of shippers. This divergence in market demand is causing some firms to falter. Eagle's net profit is down 2%. Although Wall Street expects Eagle to recover and continue at a 20%-plus growth rate, the past quarter raises questions.

2. ASSETS: A RISING TIDE LIFTS ALL BOATS...

The conventional wisdom has long maintained that an asset is an albatross to be avoided whenever possible. However, the past year demonstrated the benefits of owning assets in capacity-constrained markets. Neptune Orient Lines, for example, achieved a 16% jump in year-over-year profits. As President John F. Kennedy once put it, "a rising tide lifts all boats."

Much of this growth is attributable to the explosion of demand for Asia-US supply chain services. It will be critical to observe whether steamships flood the market with capacity in the coming two to three years, pulling down prices, as has happened historically. For the moment, it's a great time to own assets in the shipping sector.

3. ... BUT IN COMMODITY BUSINESSES, ASSETS STILL SUFFER

Perhaps a better way to rephrase the conventional wisdom is that assets outperform when capacity is scarce, and under-perform when the reverse is true. In the trucking sector, a chronic oversupply of capacity is plaguing the less-than-truckload (LTL) category. Central Freight is losing money, for instance, and considering asset sales to shore up its balance sheet.

It's worth noting that the company's market capitalization is approximately $55 million. Meanwhile, its real estate has been appraised at $103 million. In other words, investors are valuing the operating company at negative $48 million! This, on the heels of the Consolidated Freightways bankruptcy and the consolidation of USF and Roadway into Yellow, reflects the dim view investors hold on the LTL sector.

In the truckload (TL) sector, the industry has not seen the same kinds of problems. But the combination of skyrocketing fuel costs, insurance, and driver shortages make for an unholy trinity. According to the American Trucking Association (ATA), we are experiencing a shortage of 20,000 truck drivers today. If nothing is done, this is forecasted to spike to 111,000 by 2013. While trucking companies have enjoyed a year of growth, inevitably these pressures will create inflation, which could squeeze future profits.

4. INTERMODAL: A LOW-COST SOLUTION

If the preceding is enough bad news to give you an ulcer, the good news is that lower-cost logistics models are gaining traction. A prime example is intermodal.

Increasingly, companies are seeking to combine inexpensive rail service with short-haul trucking. Railroads Burlington Northern Santa Fe (BNSF) and Canadian Pacific (CP) have been prime beneficiaries, relying on intermodal for 34% and 28% of their total revenues, respectively. From 2002 to 2004, the number of domestic intermodal load-

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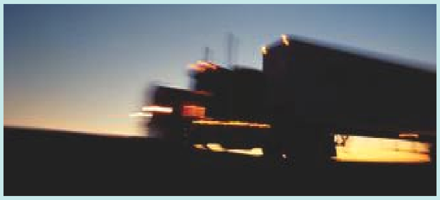
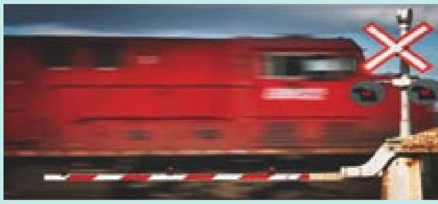
Changing the Industry

by Benjamin Gordon



ings has grown from 10.5 million to 13 million, reflecting an 11% annual growth rate. Meanwhile, BNSF's intermodal revenue is up slightly higher, at 12% year over year, reflecting the fact that they are gaining share at a faster clip.

5. TECHNOLOGY: ADOPTION CONTINUES

Technology analysts tend to view the technology market from extreme perspectives. Adoption is characterized as either dramatic or nonexistent. In reality, new technologies are being adopted, but at a slower rate.

In radio frequency identification (RFID), new capabilities are being rolled out, vertical by vertical. In the pharmaceutical sector, where the underlying products' high value justifies more aggressive spending, Project JumpStart appears to have been a success.

During an eight-week trial period, 13,500 pharmaceutical packages were shipped, tracked, and traced. Participants included Abbott, Barr, Cardinal Health, CVS, J&J, McKesson, Pfizer, P&G, and Rite Aid. Proof of concept was accomplished, as the project team read 98.6% of case tags and 96.8% of unit tags inside a case.

Meanwhile, the real technology adoption is taking place on the web. Online models continue to exhibit lower-cost, higher-service characteristics. At Seko, a global freight forwarder, online shipping volume surged five times, to 25% of its total revenues in just one year. Similarly, at DHL, the company estimates that each electronic invoice saves $1.80. Online pick-up requests save $2 versus phone calls. And online payment cuts time to collect from 40 days to one day. Web-based technologies are continuing to deliver powerful savings and benefits to customers and operators.

6. MERGERS MARCH ON: BOUNDARIES BLUR BETWEEN GEOGRAPHIES AND SERVICES

The level of merger and acquisition (M&A) activity in the logistics sector continues to expand to all-time record highs. In the past year, we witnessed such high-profile deals as the acquisition of Tibbett & Britten by Exel, the acquisition of Unigistix by UTi, the acquisition of NewBreed by Warburg Pincus, and the acquisition of Ozburn-Hessey Logistics by Welsh Carson. Customers are increasingly pressing for such transactions, as they simplify the number of logistics providers required to serve them.

We can disaggregate the M&A trend into two core components:

- ***Geographic convergence:*** PBB Global Logistics recently acquired Unicity Integrated Logistics and Unicity Customs Services. A primary reason for this move was to strengthen PBB's position as a leading, cross-border specialist, and to concentrate on the 10% US-Canada cross-border transportation growth.

  Similarly, Yellow's acquisition of GPS reflects its view of the importance of the Asia-US trade lane. Meanwhile, European firms continue to look for US opportunities, attracted by the relatively high-growth potential in North America: 15% annual growth versus 2% in Europe.

- ***Service convergence:*** The most common trend in M&As over the past five years has been the convergence of warehousing and global freight forwarding. Transactions such as Kuehne & Nagel-USCO, UTi-Standard, UTi-Unigistix, and APL-GATX reflect this pattern. This year, PWC Logistics' acquisition of Trans-Link and TransOceanic showcased the desire of a regional warehousing firm to transform itself into a global multi-service solutions provider.

7. CLO FOR HIRE: THE LOGISTICS FUNCTION IS GROWING IN IMPORTANCE

Historically, logistics executives were treated as a secondary function within organizations. This is all changing. In a world where the world's largest company (in revenues), Wal-Mart, selects a CEO who rose through the ranks of the organization's logistics division, the market is increasingly valuing the importance of supply chain executives.

In a recent poll, over 70% of CEOs surveyed by UPS-Harris Interactive called supply chain management "very" or "extremely" important. Of particular note is the recruiting world. Motorola lured Stuart Reed from his position as IBM vice president of manufacturing to become senior vice president of global supply chain, reporting directly to CEO Ed Zander. This is a sign of the increased importance firms are attaching to logistics.

In sum, it has been another growth year for the logistics sector. However, as these competing trends continue to play out, the gap between the winners and the losers will continue to widen.

For logistics providers, it will be increasingly important to assess the market and invest in new capabilities. For logistics users, it will be crucial to evaluate your logistics providers and ensure they will be among the winners. And for logistics investors and acquirers, there will be continued opportunity to seek attractive niche businesses. ▮

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