European freight forwarders: Which way to turn?

So far, deregulation has destroyed profits in this essential sector

But markets are growing and three distinct customer needs are emerging

Here's a plan for turning around incumbents

Few industries are as essential to Europe's economy as trucking. Truckers – or more accurately land-based freight forwarders – move up to 80 percent of goods within the European Union, providing not just the transport but also the collection, consolidation, storage, reloading, and tracking services that expedite the movement of goods on the Continent. The industry is worth $150 billion in annual revenue: smaller than Europe's food, automotive, chemicals, electronics, and machinery sectors, but larger than textiles, pharmaceuticals, and paper. Lest anyone forget how powerful a role it plays, periodic strikes by Continental truck drivers serve as a reminder to businesses, public, and governments alike.

Today, the industry is at a crossroads. The stakes are high, particularly for traditional freight forwarders – large businesses with costly regional networks – whose customers are being siphoned off by small low-cost local operators, or by sophisticated newcomers that can deliver services anywhere

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Peter C. Burckhardt

Sharad Elhence

Marc C. W. van Rooijen

in Europe. The prospect of a fully deregulated EU market is forcing these old-style companies to reevaluate the way they do business. Pressure on profitability will increase, and some firms are likely to disappear. At the same time, however, new opportunities are emerging for those willing and able to change direction.

The stakes are also high for European business customers that depend on high service levels in their supply chains to keep their operations running smoothly. They are likely to benefit from more and better service at competitive prices, although to what extent depends on how nimbly traditional freight forwarders move to secure their survival and then pursue growth.

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Peter Burckhardt is a consultant in McKinsey's Zurich office, *Sharad Elhence* is a consultant in the Dallas office, and *Marc van Rooijen* is a principal in the Amsterdam office.

The threat

The freight forwarding industry has not been healthy for some time. According to estimates extrapolated from an analysis of industry leaders, it has destroyed almost $10 billion in value over the past decade. Many of the sector's larger companies are either unprofitable or earning less than their cost of capital. Some have lost money for years, but carry on because their parent companies subsidize land-based operations (sometimes without realizing it) with profits from logistics and air and sea freight businesses. In addition, inadequate management information systems and consolidated financial reports – typically compiled on a country-by-country basis and combining air, sea, and land freight – have prevented shareholders and management from understanding the performance of individual businesses.

These businesses are losing money for two main reasons. The first is deregulation, which has contributed to the industry's fragmentation and increased competition. The second is that traditional operators are caught in the middle of the competitor pack with high costs and undifferentiated services. These factors are likely to exert further pressure on profits in the future.

Deregulation

Before 1988, the freight forwarding industry was regulated nationally and internationally. All companies could count on guaranteed incomes within the boundaries of fixed prices, operating restrictions, and various taxes for national and international traffic.

In 1989, free price setting was introduced, first for international traffic crossing country borders, and then for national traffic. With the opening of international borders, entry barriers began to fall (Exhibit 1). New companies found it easier to start up, and competition for customers intensified.

Exhibit 1

Deregulation of land-based freight forwarding

Major impact on industry

	Regulated industry	Deregulation		
		Phase1	**Phase 2**	**Phase 3**
Timing	Pre-1988	1988–90	1990–93	1993–98
Market access	Domestic traffic confined to domestic haulers International traffic regulated by bilateral agreements	Cabotage allowed, but limited by quotas Bilateral quotas replaced by EU quotas	Passenger cabotage liberalized Quotas abolished	Freight cabotage fully liberalized Country permits replaced by EU permits*
Tariffs	Varied by country (eg, tariffs in France and Germany; free price setting in Benelux)	Freedom granted to set prices for international freight transport		Freedom granted to set prices for domestic transport
Taxes and restrictions	Varied by country	Partial harmonization of technical restrictions	Partial harmonization of VAT rates and excise duties	Full harmonization of road taxes, VAT and excise duties, and technical restrictions
Labor regulations	Varied by country	Mutual recognition of qualifications EU-wide legislation	EU-wide legislation on working hours	EU-wide social legislation

* Quotas still in place for non-EU–based entities

Today, the industry is fragmented across thousands of providers, with no company claiming more than 3 percent of the market. Even the top ten traditional freight forwarders combined have less than a 20 percent share. Their results are unspectacular: $16.9 billion in revenue for 1996, and an average return on sales of 1.4 percent. The prospect of total deregulation by the middle of 1998 is exacerbating the fragmentation and instability. EU companies will soon be able to transport goods anywhere outside their home countries, making it even easier for new companies to start up – and for poor performers to be driven out.

If patterns observed in the United States are repeated in Europe, the full effects of deregulation may not be felt for years. But when they are, they could be severe. Deregulation of the US freight forwarding industry got under way in the early 1980s. Since then, the sector has experienced falling prices and consolidation among suppliers. Of the ten largest players before deregulation, only three still exist today. Of the remaining companies with annual revenue topping $10 million, 74 percent had disappeared.

High costs, undifferentiated services

As well as having to contend with the effects of deregulation, many traditional freight forwarders have cost and service disadvantages that make it increasingly difficult for them to compete against low-cost operators (in the case of price-sensitive customers) or sophisticated new entrants (in the case of premium customers).

Cost disadvantage. Traditional freight forwarders have higher costs than small operators, mainly because of their network investments and associated operating expenses. Low-cost operators typically own and operate just one or two trucks, haul for a few customers on selected routes within a small geographical radius, and dispatch a truck only when it is full. Traditional operators serve hundreds of companies within and across regions. They have to invest heavily in terminals for loading, unloading, and holding goods, and in sales offices, tracking and tracing systems, and other assets to enhance their network. They also have to dispatch trucks on schedule even when they are not full, and need more labor for the additional shipment handling involved in a network operation.

But in areas where the two compete, the customer sees little difference between the service provided by a traditional forwarder and that offered by a low-cost operator. As a result, old-style companies cannot charge high enough prices to justify their network investments or cover their costs.

Service disadvantage. Newer entrants to the industry that serve customers across Europe, such as United Parcels Services and DHL Worldwide Express, or specialist companies such as trans-o-flex, a small business catering for

German pharmaceutical manufacturers, can guarantee the delivery of small shipments (up to 70 kilograms) anywhere in Europe. Such companies target customers willing to pay premium prices for their services. They are also positioning themselves to provide the same high level of service for larger shipments – formerly the exclusive preserve of traditional operators.

Traditional operators cannot offer the same level of delivery, or the service guarantees. As a result, they are unable to win business in premium market segments. Neither can they provide a pan-European service. Some do have a presence in locations across Europe, but their strength is usually concentrated in a few core regions around their home countries. Schenker is strong in Germany, Austria, and also Scandinavia through its acquisition of BTL. Nedlloyd is strong in Benelux and Germany, ASG in Scandinavia, NFC in the United Kingdom, and Geodis in France.

The opportunities

The flip side of the coin for traditional operators is that intensifying competition and profit pressures are accompanied by opportunities. There is huge scope for companies that read the trends and ride them to their advantage. The market is large and growing, particularly in Eastern Europe, and customers' needs are changing.

Large and growing market

Total European land-based freight traffic amounted to an estimated 800 billion ton-kilometers in 1996.* This figure is expected to grow by 2 to 3 percent a year, although some market segments are expanding faster than others.

The market is divided into inter-regional and intra-regional segments (traffic among countries within a region). The four regions are central Europe, northern Europe (including the United Kingdom), southern Europe, and eastern Europe. The largest segment measured in tons moved is central Europe, where 102 million tons were transported in 1992.

The second and third largest segments are inter-regional. Some 33.8 million tons of land-based freight were moved between central and southern Europe in 1992, while 16.3 million tons moved between central and northern Europe. Eastern Europe is the smallest segment, but it is also expected to grow the fastest, by 7 percent a year.

Emerging customer needs

While overall market prospects are good, growth could be higher if traditional freight forwarders were able to meet one or more of the three rapidly

* The ton-kilometer combines the two most important measures of freight quantity: weight and distance. One ton-kilometer represents one ton of freight carried for a distance of one kilometer.

emerging customer needs: pan-European transportation; reliable, guaranteed service; and value-added services.

Pan-European transportation. Corporate customers increasingly want to adopt best practice in purchasing and supply management. One way to do so is to consolidate the number of suppliers they use. Many companies say they would like to use a single supplier for all their land-based transportation. Achieving that goal is currently impossible, because no provider offers a truly pan-European operation at the necessary level of service.

Reliable, guaranteed service. Freight forwarders could exploit the opportunity to develop clear service standards and offer guarantees such as fixed delivery times. A growing number of customers want rapid, reliable delivery of materials to accommodate their just-in-time manufacturing needs. Freight forwarders that can provide guaranteed delivery and tracking services will have a chance of becoming an integral part of customers' logistics chains.

Value-added services. These encompass any service beyond traditional transportation. Specific opportunities should be defined industry by industry or customer by customer, but typically fall into the category of third-party logistics services. For a customer that assembles computers, for example, such services could include managing the production warehouse, managing the supply chain from component manufacturer to computer assembler, and fulfilling orders from the end customer who uses the finished computer. All these services transcend what a typical forwarder might offer today: straightforward transportation of components to the manufacturer, and of assembled computers from the manufacturer.

The third-party logistics market is tiny compared with the freight forwarding market, but is expected to grow five to ten times faster over the next decade. This explosive growth is being driven by several trends in manufacturing, retailing, and information services.

First, companies in many industries are embracing the notion of mass customization. They want to deliver customer-specific products at prices that compare with those of mass-produced goods. Examples include built-to-order desktop computers and "tailor-made" women's jeans. Mass customization demands a reliable logistics chain, particularly the timely supply of parts and materials and the timely delivery of finished products.

Second, more companies are adopting just-in-time manufacturing and virtual inventory practices. Their goal is to free working capital rather than tying it up in raw material stocks. To keep their operations running, they depend on suppliers to deliver parts or materials exactly when they are needed.

Third, companies are moving toward virtual company structures in which they outsource almost all of their business processes and reduce their fixed assets. This trend creates opportunities for third-party logistics providers (Exhibit 2).

Exhibit 2

Opportunities created by the virtual company

		Integrated information management		
	Design value	**Create value**	**Deliver value**	**Extract value**
Company	Monorail Inc*	SCI	Federal Express	SunTrust
Role	Design high-quality home PCs	Just-in-time manufacturing	Total supply chain provider	Bank: receivables management
Activities	Design, engineer, and market product Design and control value chain	Source low-cost components just in time Manufacture PCs just in time	Manage customer order entry Deliver order to manufacturer (SCI) Deliver shipment to customer (CompUSA) Deliver invoice to customer (CompUSA) and send copy to bank (SunTrust)	Manage customer payments

* Founded in November 1996 by former Compaq executives

Future direction

The industry may be at a crossroads, but the direction it needs to take is clear.

Find out where money is being made and lost

Freight forwarders can find out where they are making and losing money by setting up simple information systems and measuring performance at the route and network level.

Set up simple, practical information systems. Companies need information systems that show how much revenue and profit is generated by each line of business and by each truck departure, route, customer, and order. At present, important data is either not recorded, or stored in a way that makes it difficult to retrieve. In effect, many forwarders start each day with a blank sheet of paper and end it by throwing away all the information they have collected.

Since comprehensive information systems may take years to bring on line, what can managers do in the meantime to gain insights into business performance? Three actions can help:

- Develop a simple manual process for recording information such as loading rates, revenue, and profit per truck.

- Periodically use the data to analyze the profitability of each leading customer and route, decide the future growth of the business, and support pricing policy.

- In parallel, identify the requirements for a simple computer-based management information system. Don't add bells and whistles until the basic system is up and running and it is clear which bells and whistles you need.

Measure performance at route and network level, not at each location. Part of the difficulty in getting accurate information stems from the way freight forwarders account for revenue and profit. Companies typically run each location as a profit center, which motivates locations to enhance their own profitability without regard to the profitability of the corporation as a whole.

Transfer-payment accounting practices also set up unproductive conflicts between locations. Consider a shipment that is picked up in Frankfurt and delivered in Paris. Frankfurt "owns" and collects revenue from the customer, and pays Paris for handling and delivering the shipment. Frankfurt will try to maximize its profitability by taking credit for the customer revenue and paying the smallest possible amount to Paris. Paris will try to do the same for shipments going the other way. Rather than cooperating, the two locations compete for customer revenue and fight over transfer payments.

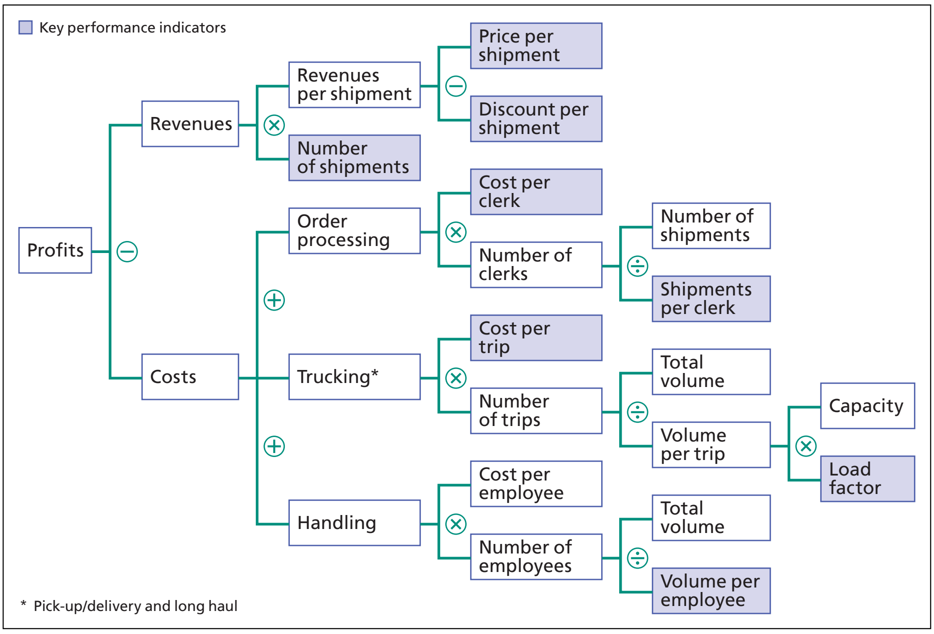
A company can take several steps to focus functions and locations on its overall performance targets:

- Measure performance at network and route level to promote cooperation and joint ownership of performance metrics among local offices. In other words, measure the profitability of the Frankfurt–Paris route, not the two separate locations.

- Define the key indicators that link operating performance to financial performance (Exhibit 3). Communicate the indicators throughout the organization and regularly review performance against them.

Exhibit 3

Key performance indicators



◆ Benchmark performance against the indicators internally and, where possible, externally. By comparing the performance of different geographic locations, companies can identify high-performing locations and best practices. Competitive benchmarking can be even more help in identifying areas in need of urgent improvement.

Improve the performance of the business

Once sources of profit and loss are clear, companies can act to restore profitability. The potential is significant, but realizing it will call for operational changes across the board, new pricing schemes, and greater organizational accountability.

Operational changes. Scope to save money exists at every stage of the operation:

◆ Order processing costs can be halved if companies move from manual entry and reentry of each order to single-entry computerized solutions.

◆ Handling costs can be cut by 20 percent or more through optimal shift planning and the deployment of part-time staff to ensure labor is used to the full and present only when there are shipments to be loaded or unloaded.

◆ The cost of transportation between terminals and of shipment pick-up and delivery can be lowered if companies adopt more efficient network configurations (by deciding the right number of hubs for consolidating shipments, which terminals to use as hubs, and which routes to use for direct service); use standardized and flexible assets (such as swap bodies that enable loads to be interchanged with other truck tractors or with rail wagons or ferries with minimal handling); and ensure that each truck's capacity is used profitably as it leaves the terminal.

◆ Incentive schemes can make performance expectations clear and help motivate workers to improve their efficiency.

Companies can maximize the value they obtain from these improvements by refining the way they exchange information with customers. They can accept orders over the Internet, say, attach bar codes to shipments, and provide tracking information electronically.

New pricing schemes. Customers are often given different price quotations for the same shipment by the same freight company, depending on which salesperson they talk to. This is because sales staff routinely offer heavy discounts from their list prices in the effort to match current market rates. By changing to a systematic value-based pricing scheme, freight forwarders could enhance their revenue. Such a scheme would involve two main steps:

◆ Setting product prices that reflect the value the company adds and the customer's price elasticity. A top-of-the-range electronics manufacturer may value speedy, reliable pan-European delivery service and be willing to pay a premium to forwarders that can guarantee it. A manufacturer of cheap washing machines, on the other hand, will probably have less need for speed and be more price sensitive.

◆ Designing a pricing package for a chunk of a customer's traffic. The customer gains efficiency by having one supplier provide all or most of the services it needs in a package deal instead of arranging each transaction separately. The freight forwarder avoids having to negotiate prices for individual services and destinations and achieves more stable volumes.

Increased organizational accountability. Responsibility should be pushed to the front line: in other words, the people who dispatch trucks and manage customer relationships should be held directly accountable for the profitability of routes and customers. If this is to happen, roles and responsibilities will have to be redefined. Individual performance metrics, coupled with new measures for assessing organizational performance at route and network levels, can encourage different locations to cooperate to improve overall profitability.

Define new strategies for profitable growth

Having turned round profits, companies should ask themselves two critical questions: "Where to grow?" and "How?"

Where? Freight forwarders could expand in one or more of the following ways: by further penetrating existing markets; by expanding geographically through adding new customers or new destinations to their networks; or by entering new service markets. Each route has a different set of benefits, risks, and requirements:

◆ Further penetrate existing markets. This strategy could generate cost and service advantages by increasing pick-up and distribution density, and offer scale advantages in long hauls, terminals, and IT systems. The risk is that a company could set off a price war without actually winning market share. To succeed, it must have a clear service or cost advantage over local competitors.

◆ Expand geographically. As well as enabling a company to offer broader coverage of destinations, this approach might also afford scale advantages in long hauls, since the new territory would raise volume at the nearest hub terminal and help fill the trucks going in and out of it. These benefits would have to be traded off against increased pick-up and delivery costs in the enlarged region.

◆ Enter new service markets. A freight forwarder can enter new markets in various ways. It can pursue a small piece of a big pie by offering a new service to multiple industries: guaranteed 48-hour delivery across Europe, say. Or it can seek a big piece of a small pie by offering complete solutions to a particular industry: by moving auto parts from suppliers to car makers' plants, for instance, and guaranteeing to meet production schedules.

A few prerequisites apply regardless of the strategy a company chooses. First, achieving high density in pick-up and delivery – measured in number of shipments per pick-up/delivery stop and number of stops per route – is fundamental in freight forwarding economics. Second, providing guarantees or setting higher standards for service calls for disciplined and controlled operations. Third, streamlined administration is essential to reducing unnecessary costs. Finally, marketing and selling must be improved so that attractive customer segments can be targeted and services priced appropriately.

"How?" There are at least three ways of growing: through mergers and acquisitions, through webs of partnerships and alliances, or by becoming a systems integrator. Again, each has its own set of requirements, rewards, and risks:

◆ Mergers and acquisitions can help a freight company expand in desirable locations and offer a broader set of value-added services. This approach also enables the parent company to construct its own network and maintain full control over operations and customer relationships. However, it is probably the most difficult and costly of the three routes to growth. As some European freight forwarders have already discovered, huge capital outlays and much management time and attention are needed if acquisitions are to be properly integrated and operate in the desired way.

◆ Webs of partnerships and alliances have worked well in the airline industry, enabling carriers to offer standardized, transparent products and share flight codes through linked information systems. In the freight forwarding industry, an alliance has already been formed between Kühne & Nagel and Sernam, while the Deutscher Paket Dienst group, comprising Dachser, Hellman, Birkart, and more than two dozen smaller forwarders, operates a franchise system distributing parcels in Germany and offering related transportation and logistics services as well. The networks give companies competitive advantage by expanding their geographic coverage and enabling them to offer services they could not provide on their own.

Alliances require less time and investment than mergers and acquisitions, but also pose challenges because of the equal status of alliance members. It may prove difficult to align the various partners around common goals, resolve conflicts over which ally owns customer relationships, and ensure quality control across the network.

To make the model work, allies need to offer common (not patchwork) services, and to avoid rivalry over products and customers. For profit-sharing purposes, they also need transparency in costs and revenues, and linked computer systems. Clarity of information is also important in deciding which partners to bring into an alliance and which to avoid because they have a low or unprofitable business base.

◆ Becoming a systems integrator. A company that becomes a systems integrator or prime contractor maintains control over customer relationships, but outsources some or all of its operations. The concept has not yet been fully applied in freight forwarding, though it has been used successfully elsewhere. EDS acts as a systems integrator in the computer industry, for instance, and various prime contractors exist in the engineering and construction businesses. For the time being, outsourcing in the freight forwarding sector is likely to be largely confined to trucking.

Systems integration enables companies to achieve efficient production and offer a broad range of customized solutions with little investment. Issues that need to be resolved include who controls operations and customer relationships, and who gets what share of the profits.

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Traditional freight forwarders have an opportunity to restore profitability to their operations and grow in a deregulated Europe. But they must take fast and drastic action. Such recent industry developments as the repositioning of competitors and the forming of alliances suggest this is an opportunity that will not be around for long. Q