

Forwarder Momentum

Opportunities for value creation in freight forwarding.

BY MERGEGLOBAL VALUE CREATION INITIATIVE

As a direct beneficiary of globalization, the global freight forwarding industry has enjoyed rapid growth while generating returns on capital that asset-based air and ocean carriers can only dream about.

Both financial and strategic investors have been attracted to the forwarding industry's positive fundamentals, leading to a growing number of mergers and acquisitions, at steadily rising multiples, predicated on the general notion that "bigger

is better." This maxim is not always true, as some investors have recently discovered.

Still, considerable opportunity remains for financial and strategic investors in the freight forwarding sector. While there may never be another Expeditors (stock price appreciating by 255 times its split adjusted initial public offering price in 1984), there are many little known, small and midsized, high quality, highly profitable forwarders who can be repositioned for rapid, long term, sustained growth.

For logistics players seeking a forwarding capability (or vice versa), a pragmatic and disciplined strategy can create enormous value by exploiting the narrow but lucrative overlapping activities of each entity's value chain. Likewise, as history has shown, such combinations can destroy enormous value when premised upon broad visionary statements of convergence and globalization without in-depth understanding of exactly where synergies exist and how to exploit them. To be successful, such combinations must be rooted in a highly disciplined financial approach (starting with valuation in the mergers and acquisitions process); systems enabling understanding of customer and service profitability; and a culture in which operating management can exercise judgment and be held accountable. Given the low margins (high return on capital employed notwithstanding) of most forwarding and contract logistics businesses, a one percentage point improvement or decline in operating margin can have an enormous impact on financial performance and, ultimately, value.

Globalization is driving sustained growth in long-haul trade. As a percentage of world gross domestic product, the value of intercontinental trade has almost tripled from 5.2 percent in 1962 to slightly more

than 15 percent in 2006, and we expect its share to continue to rise. This trend directly benefits freight forwarders on whom most manufacturers and retailers rely to organize and supervise the door-to-door movement of goods. This unique positioning has allowed forwarders to not only participate in the expansion of global freight flows but also to control the most complex and valuable activities of these flows.

As the forwarders' influence in the market has increased, customers, competitors, strategic buyers and financial investors seek to better understand how and why forwarders have been able to consistently generate superior profit and create value over a long period of time.

In this article, we will provide our perspective on how and why freight forwarders are able to generate attractive financial returns. Our insights are drawn from fact-based analysis and our cumulative experience in advising clients on several recent M&A transactions and value creation engagements in the freight forwarding industry.

The MergeGlobal Value Creation Initiative comprises **Brian Clancy, David Hoppin, John Moses and Jim Westphal**. Clancy, Hoppin, Moses and Westphal are managing directors of MergeGlobal, a specialist firm that provides clients in the global travel, transport and logistics industries with services ranging from financial advisory to strategic consulting. This is the first in a series of reports in which MergeGlobal will team with *American Shipper* for multi-issue coverage throughout 2008.

Specifically, we will address the following issues:

- Why are freight forwarders uniquely positioned to create value?
- Why are the dynamics in the intercontinental freight industry favorable to forwarders?
- What is driving M&A in the forwarding industry?
- What are the common mistakes in forwarder M&As?
- What are the most important variables that impact value creation in the freight forwarder business model?

Forwarders uniquely positioned

The global supply network has changed considerably with trade liberalization. Sourcing and manufacturing has been progressively shifting from high labor cost markets like the United States to low labor cost markets like China. The shift started 30 years ago with low-value consumer products and is moving up the product value spectrum. As sourcing patterns have shifted, manufacturers and retailers have increasingly relied on freight forwarders to be the network managers of their intercontinental supply chains. End customer reliance on forwarders has created a \$115 billion industry.

The customer base of a typical freight forwarder comprises large, medium and small manufacturers and retailers. Services provided include:

- Transportation (intercontinental and destination delivery).
- Customs brokerage.
- Origin consolidation.
- Destination deconsolidation.
- Warehouse contract logistics services.

Most service types are priced on a transactional basis per shipment or total volume.

Freight forwarders are both competitors and customers of asset-based air and container sea freight carriers. They compete with asset-based carriers for customer freight shipments, and purchase capacity from the same carriers to manufacture origin/destination itineraries for their customers. In 2007 freight forwarders controlled an estimated 46 percent of the combined air and containerized sea freight market (Figure 1).

Forwarders dominate the air freight sector with 85 percent revenue share of heavy

freight shipments. This estimate excludes the express small package market where the big four integrated carriers control 90 percent of this market segment. Over the last 10 years, forwarders have increased their share of the air freight market by 9 percentage points, as airlines have progressively reduced direct sales efforts to shippers.

Forwarder share of the sea freight sector is lower at 34 percent revenue share of full containerload shipments and 74 percent revenue share of less-than-containerload shipments. Forwarders' share of FCL has increased by 6 percentage points since 1997. Forwarders' high share of the LCL segment is due to expertise in handling smaller, complex transactions similar to air freight. (For the same reason, certain integrated carriers are targeting LCL flows as well).

Forwarders are able to generate attractive returns on capital employed by focusing on activities that require intellectual capital instead of physical assets. Figure 2 arrays the historical returns by industry segment with the worst performing on the far left and the best performing on the far right. Freight forwarders' return on capital employed (ROCE) is the highest among all segments of the freight and logistics industry, reaching a peak of 64 percent, a trough of 53 percent and average of 57 percent throughout the industry cycle.

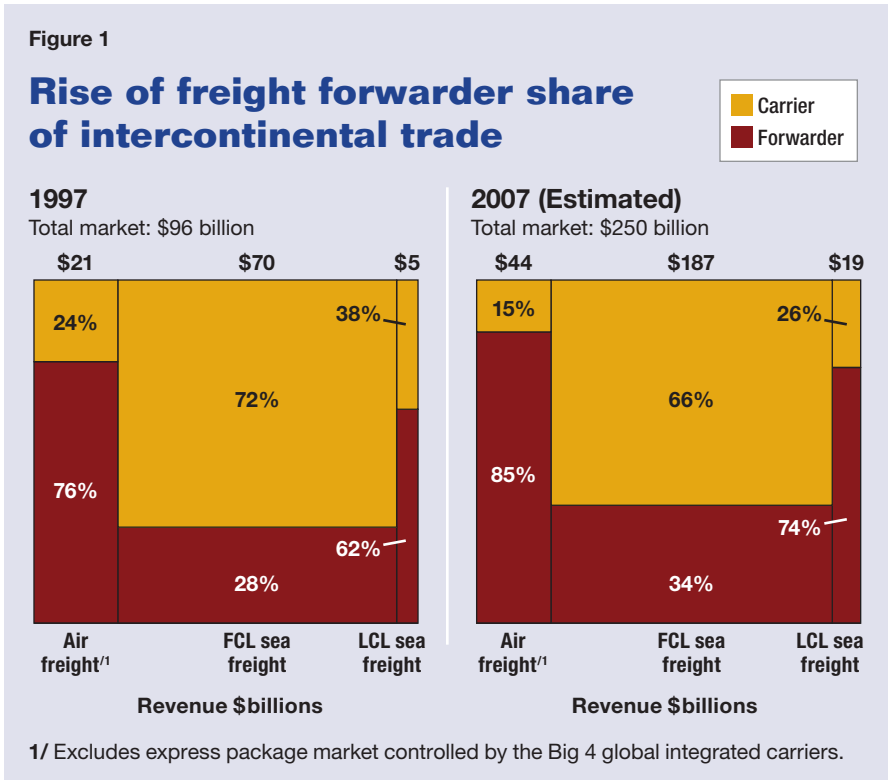
Scheduled air freight and container carriers have significantly lower average ROCE and a high variability between peak and trough returns. Their lower returns can be explained by the need for significant investments in transportation assets and daily exposure to capacity utilization risk. While entry barriers exist, availability of low cost capital — often government subsidized — allows new entrants to more easily add physical capacity even in poor industry conditions.

Structural factors favor forwarders

There are several structural factors in the forwarding industry and its business model design that allow forwarders to generate superior financial returns compared to air and container carriers. These include:

- Control of the end-user customer.
- Ability to provide better supply chain information to customers.
- Flexibility of services across modes and different carriers within each mode.
- Ability to attract and retain high quality people.
- Better understanding of costs due to less complexity.

However, contrary to conventional wisdom, there is also a level of fixed costs and



Source: MergeGlobal Inc. estimates from industry data.

commitments which forwarders maintain including:

- Information systems.
- Facilities.
- Minimum volume commitments with air and container carriers in front haul markets with tight supply.

Forwarders are able to take control of the end-customer relationship as asset operating air and container carriers increasingly rely on forwarders' wholesaling capacity instead of direct marketing to end customers, especially medium and small sized accounts. These carriers are adding capacity to fulfill long term market share objectives and are not constrained by the quarterly earnings expectations of shareholders.

Capital for asset-intensive transport activities is shifting to emerging markets, particularly in the form of local companies investing in capacity for market share growth. Such entities are not equipped and cannot easily build the intellectual capital and customer relationships that asset-based companies located in developed markets have established. As a result, as market share shifts to these entities, forwarders will take greater share of retail control of end customers.

Two examples of this trend are Emirates in the air freight sector and China Shipping in the container sea freight sector.

Emirates is building substantial capacity in the Asia/Europe trade as part of the United Arab Emirates' long term economic diversification strategy and desire to be-

come a global air logistics hub. Emirates has 10 747-8 and eight 777 freighters on order. Among non-integrated air freight carriers, this is the one of the largest freighter orders on the books.

China Shipping is a young government controlled container carrier founded in 1997. The company has embarked on an aggressive expansion strategy to build up its position in its home market. To support the growth, China Shipping continues to add containership capacity, especially eight 13,296-TEU vessels to be delivered over the next five years, and will aggressively use freight forwarders to fill its new ships.

In both cases, wholesaling of capacity to freight forwarders is their key sales channel strategy to fill their new capacity.

Forwarders are better suited to provide end customers with granular transaction data that allow customers to calculate landed product costs, which is necessary to optimize supply chains. Their ability to provide better data is enabled because they capture all transactions of a customer's trade flows for a specific route corridor. The carrier view of customer trade flows is fragmented because it sees only the transactions that use its services and not the transactions that use other carriers — and further it sees only a portion of each shipment's door-to-door journey.

Expeditors International is the best example of a forwarder that has built information technology systems that capture rich transaction data and allow it to manage

(continued on page 42)

both physical flows of products and mission critical information flows such as customs clearance and trade quota compliance. This capability is especially attractive to small and medium sized customers that do not have large internal staffs to manage complex trade logistics. In contrast, carriers have a tendency to direct most of their IT spending on internally focused systems that are required to run and optimize their transportation networks instead of systems designed to manage their customers' trade flows.

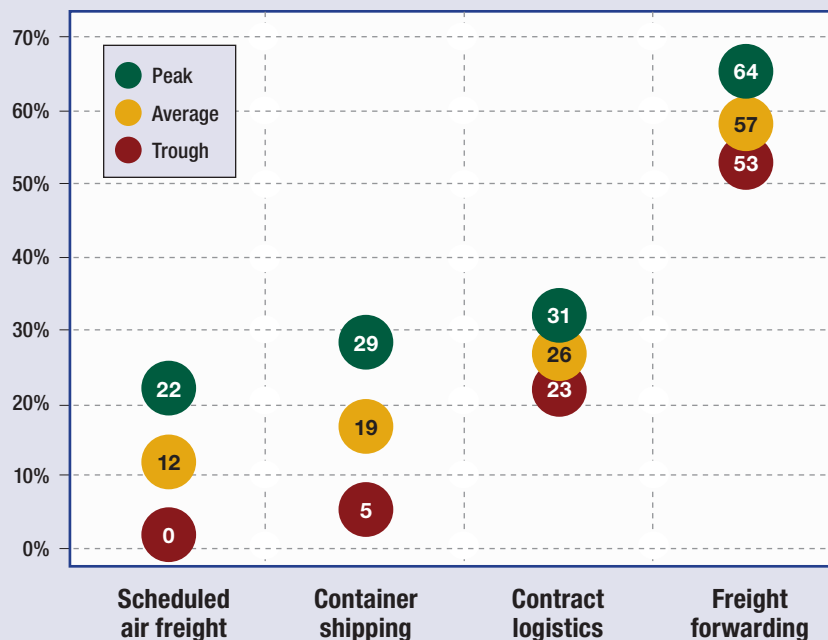
Forwarders can be more flexible with customers and are able to customize their services to specific requirements because they have no planes or ships to fill each day and are indifferent about which routings and carriers to use for customer shipments. Carriers are focused on maximizing the load factor and yield of each flight or vessel departure and they have an incentive to encourage customers to choose routings that best optimize the use of the carrier's assets instead of a customer's distribution network.

Forwarders have competitive advantage in human resources. They are able to attract and retain high quality people because of their ability to promote faster and pay well due to higher growth and profitability. Many forwarders reward employees based on station level profitability. Expeditors is known for setting aside up to 20 percent of its pre-tax profits for staff bonuses at the station level. It also regularly uses stock options as an additional source of compensation for its best employees. Opportunities for career advancement have been limited at most air and container carriers due to financial restructurings and merger integrations. While carriers can pay bonuses and award stock options, the bonus ranges are smaller and the value of the underlying stock is more volatile.

Forwarders know their costs better because their business models are less complicated. Forwarders choose to buy key inputs instead of making them internally, and this fundamental decision eliminates a significant layer of complexity inherent in operating transportation assets. Forwarders are far less complex because they focus on the basics: sales, terminal operations, transportation services procurement and customer facing IT.

Operating transportation assets requires expertise in a wide range of areas, including asset acquisition, aircraft and vessel operations, terminal operations, maintenance and overhaul, labor management, fuel purchasing and regulatory affairs. This wide range of disciplines requires lots of experts in multiple

Figure 2

ROCE¹ by industry segment: 2000–2006

Return on capital employed (ROCE) is defined as earnings before interest, tax and amortization (EBITA) divided by net working capital plus net property, plant & equipment.

Source: MergeGlobal Inc. analysis; Capital IQ; company reports.

functional silos, most of which are internally focused and not facing the customer.

Another complication for carriers is that asset-based network businesses involve significant shared costs that can confuse asset-based carriers due to arbitrary cost allocations resulting in bad pricing decisions and a poor understanding of customer profitability. Good forwarders are able to trace the majority of a specific transaction's costs to specific purchased inputs thereby limiting the number of transactions that are priced below direct costs.

Freight forwarder M&A continues

Mergers and acquisition are a tool that companies can use to grow an existing business or enter a new industry segment. It is often used when a company determines that it would take too long to grow organically or it lacks the expertise to establish a de-novo operation in a new industry segment.

As manufacturers and retailers continue to shift their sourcing offshore, domestic-oriented competitors are entering the intercontinental freight market by acquiring freight forwarders. Figure 3 depicts the major competitor segments in the global freight and logistics industry and their participation in each step of the intercontinental

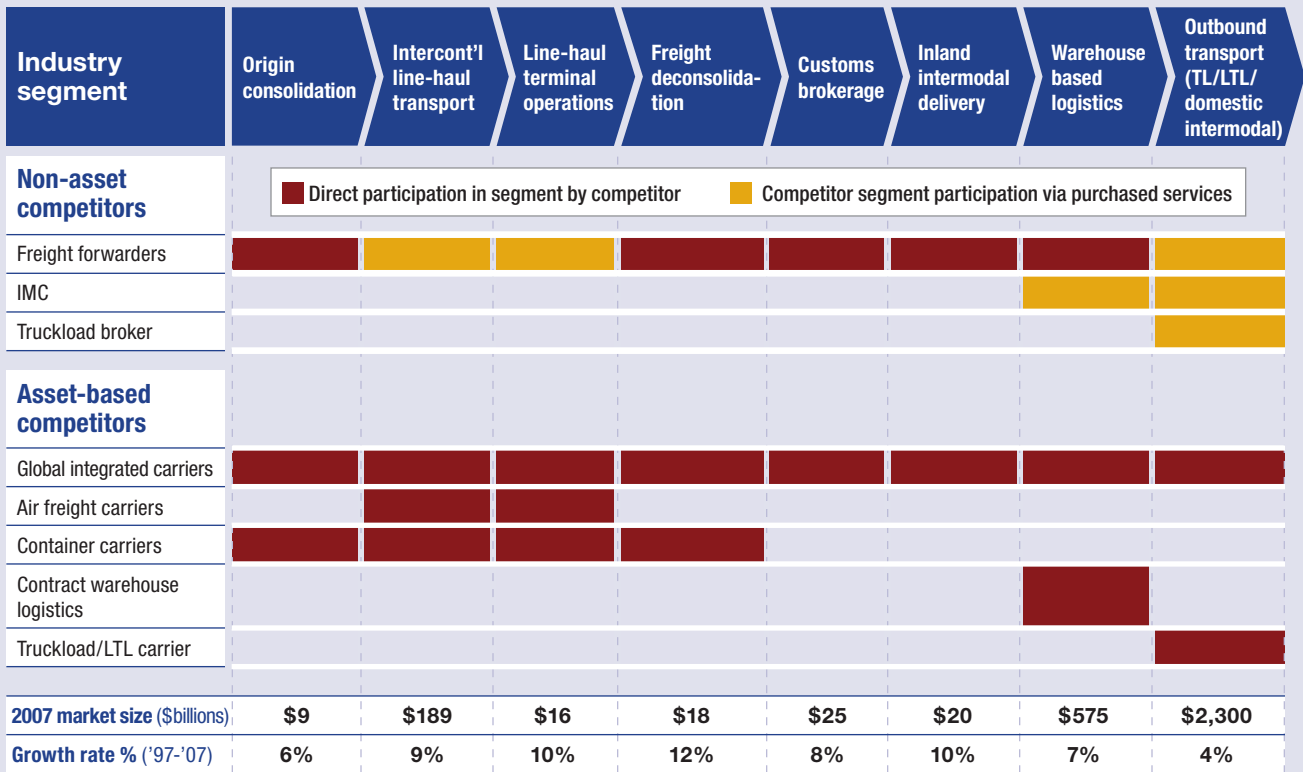
freight network. Freight forwarders and integrated small package carriers span the entire chain. However, forwarders focus on heavier freight shipments while integrators specialize in small packages. Air freight and container carriers tend to focus on line-haul and terminal operations serving a mixture of wholesale (forwarders) and retail (end-users) accounts. Domestic competitors, such as intermodal marketing companies (IMCs), truckload carriers, LTL carriers and warehouse-based logistics companies, lack an intercontinental freight transport capability and are moving from their large destination markets in North America and Europe upstream into Asia by acquiring freight forwarders. They seek to follow their customers offshore and increase their exposure to faster growing markets because the domestic market is mature and will grow roughly at local GDP.

As a result of the need to go offshore and build scale, M&A in freight forwarding has been relatively steady over the last several years. Figure 4 is a list of the major freight forwarding and related transactions since 2000. The buyer universe comprises strategic acquirers and financial sponsors. The stated rationale among strategic acquirers for buying forwarders includes:

- Large multi-segment transport conglomerates pursuing the idea of the one-stop

Figure 3

Illustrative competitor segment participation



Source: MergeGlobal Inc. primary research and estimates from industry data.

shop for global 1000 shippers created a global forwarding platform through numerous acquisitions over the last decade (Deutsche Post buying AEI and Exel, and Deutsche Bahn-Schenker buying BAX Global).

- Larger forwarders buy smaller forwarders to add geographic scope and build lane density in markets already served (Schenker's acquisition of BAX Global in 2006).

- Warehouse-based logistics and trucking companies needing a forwarding capability to meet their customer's intercontinental forwarding needs or forwarders deciding they need to lock in their customers by moving up the supply chain into logistics management (Toll's recent acquisition of BALtrans, Geodis' purchase of TNT Freight Management, PWC Logistics' entry into forwarding with its acquisition of Geologistics, and various warehousing acquisitions by UTI and Kuehne + Nagel).

Financial buyers are drawn to the attractive returns of forwarding due to its high growth and capital efficiency. Financial buyers believe they can exit from their forwarder investments either by selling to a strategic or via IPO. Private equity firms with an investment in freight forwarding include:

- Apollo Management bought EGL in 2007 and merged it into its 3PL portfolio company CEVA to create the world's fourth-largest logistics company.

- Welsh Carson through its 3PL portfolio company, Ozburn Hesse, purchased Barthco and Dart and hired Mick Fountain, former chief executive officer of Exel Freight Management, to build up the forwarding platform.

- 3i bought ABX Logistics in 2006 as a divestiture from the Belgian Railroad.

- Solis Capital acquired Kamino Transport in 2006.

- Brynwood Partners, the original financial sponsor of AEI, bought InterJet Systems and renamed it IJS Global. The company hired former AEI executive Georgio Lacona as CEO to lead its growth strategy.

Prices paid for forwarders have risen in recent years. Multiples of earnings before depreciation and amortization (EBITDA) have been as low as 7.7 times last 12 months (LTM) EBITDA for UPS's purchase of Fritz during the 2001 tech bubble to nearly 15 times for Toll's announced acquisition of BALtrans in December 2007. While multiples vary considerably based on business and earnings quality, the general trend is upward as there is a perception of

growing scarcity of high quality forwarder companies with gross revenues above \$500 million that are available for purchase. We expect a lot of the M&A activity will be at the lower end of the market with companies that have between \$200-500 million in gross revenue. We also believe that there are a large number of mid-size high quality forwarders who can be strategically repositioned for growth.

Freight forwarder value drivers

Wall Street has emphasized several broad success measures for freight transport and logistics companies, including forwarders. These include a focus on global market share and breadth of service capability (the one-stop shop and end-to-end solutions).

Being the biggest does not guarantee being the most profitable. Maersk several years ago embarked upon a route leadership strategy that was based on the hypothesis that the carrier with the highest relative capacity share on a trade route would end up with an equally high relative market share and this would translate into above average operating margins. The company built its capacity share with a combination of organic growth and acquisitions. The complication was that the integration of the acquisitions proved to be difficult and costly

Figure 4

Historical freight forwarder mergers and acquisitions: 2000-2007

Buyer type	Acquisition rationale	Date	Acquiror	Target	Value (MM)	Revenue	EBITDA	EBITA
Strategic	AU-based 3PL needs Asia forwarding platform	Dec-07	Toll Holdings	Baltrans	HKD2,385	0.5x	15.0x	17.4x
Strategic	NZ-based 3PL needs North American forwarding	Sep-07	Mainfreight Ltd.	Target Logistics	\$52	0.3x	13.9x	17.8x
Financial	3PL needs forwarding platform for cross-sell synergy	May-07	Ceva Logistics (Apollo)	Eagle	\$1,993	0.6x	14.4x	18.7x
Strategic	3PL seeks to build EU forwarding scale	Nov-06	Geodis	TNT Freight Management	€460	0.6x	11.6x	NA
Financial	Financial group building end-to-end China-U.S. capability by combining ocean forwarding and deconsolidation	Nov-06	Summit Global	FMI	\$130	1.1x	9.5x	11.3x
Strategic	China apparel sourcing company acquires U.S. import infrastructure to create end-to-end China-U.S. capability	Aug-06	Li & Fung	Impac (IDS Group)	\$43	0.9x	7.7x	NA
Strategic	AU-based 3PL buys Asia geographic footprint	Jul-06	Toll	Sembcorp	SGD 1,207	1.2x	11.4x	15.3x
Financial	3PL needs customs brokerage and forwarding platform	Jul-06	Ozburn Hessey (Welsh Carson)	Barthco	NA	NA	NA	NA
Financial	Sponsor bets on furniture industry shift to China	Jun-06	GTCR	Global Link	\$129	1.0x	10.2x	NA
Strategic	Forwarder buys truckload broker for inland network	Mar-06	UTi Worldwide	Market Industries	\$197	1.8x	NA	NA
Strategic	EU-based forwarder needs transpacific footprint	Jan-06	Deutsche Bahn	BAX Global	\$1,100	0.3x	9.3x	14.1x
Strategic	Global integrator adds forwarding scale and logistics	Dec-05	Deutsche Post	Exel	£3,959	0.5x	11.3x	18.6x
Strategic	3PL seeks global expansion with forwarding platform	Sep-05	PWC Logistics	Geologistics	\$454	1.2x	15.0x	21.5x
Strategic	Global integrator buys cheaply and gets IT platform	Dec-04	UPS	Menlo Worldwide Forwarding	\$260	0.1x	7.9x	NM
Strategic	Transborder customs broker buys transborder truck broker	Jul-04	PBB	Clarke	CAD 50	2.0x	6.9x	NA
Strategic	Global integrator buys forwarder for one-stop shop	Jun-04	TNT Post	Wilson Logistics	SEK 2,350	0.4x	9.8x	11.8x
Financial	Sponsor invests in China-U.S. import platform	Jun-03	KRG Investors	FMI	\$103	1.4x	7.1x	NA
Strategic	Global integrator buys into forwarding to build one-stop shop	May-01	UPS	Fritz	\$512	0.8x	7.7x	13.3x
Strategic	Global forwarder adds automotive forwarding/logistics platform	Apr-01	Exel	Coughlin	\$210	0.6x	NA	17.2x
Strategic	U.S.-based forwarder buys international platform	Oct-00	EGL	Circle International	\$556	1.6x	10.2x	15.5x
Strategic	Global integrator buys transpacific forwarding footprint	Feb-00	Deutsche Post	AEI	\$1,122	2.2x	13.2x	17.5x

NA – Not available NM – Not meaningful CAD – Canadian dollars HKD – Hong Kong dollars SEK – Swedish kronor SGD – Singapore dollars

Source: MergeGlobal Inc. primary research.

and that the increases in relative market share did not translate into better pricing power and higher yielding cargo mix.

APL, on the other hand, made the right decision to stay small globally, but to seek high market shares in very specific customer and trade routes where it could leverage the uniqueness of its integrated terminal and intermodal operations. Today, APL is a more profitable company than Maersk.

Companies who have pursued a 'one-stop' strategy have had highly mixed results in terms of building shareholder

value. Deutsche Post and UPS are examples of global transportation conglomerates that have attempted the one-stop shop strategy. Both companies made a series of acquisitions in small package, forwarding, contract logistics and LTL trucking over the last decade to build out their respective "department stores."

Integrating the acquisitions into their portfolios has been costly and time consuming. The fundamental problem with the strategy is that customers know that no one entity can possibly have the best cost structure

in every industry segment and geography. Thus, they do not want to rely on a single service provider for all of their transportation and logistics requirements.

Instead, the largest shippers like to act as general contractor and hire the best-in-class specialist for specific segments of their supply chain. This approach gives them the best balance of price and quality. FedEx took the opposite approach and focused on running only asset-based small package and freight networks instead of the one-stop shop. A focused strategy pays

because since November 2000 (Deutsche Post's IPO date), FedEx's share price has grown at 10.2 percent per year versus UPS's at 2.5 percent and Deutsche Post an even slower 0.6 percent per year.

We believe there is no substitute for disciplined strategic analysis if you wish to avoid the mistakes of chasing global market share or opening a one-stop shop. Understanding the value drivers of a forwarder helps a potential buyer focus on the key variables that matter most in creating value. Based on our experience in forwarding M&A transactions, we first like to start with a detailed understanding of a forwarder's value chain and the underlying cost structure.

A typical door-to-door value chain for a forwarder identifies the key activities associated with each step in the value chain and the expected behavior of the cost structure in terms of fixed versus variable and location of the costs. The vast majority of a forwarder's cost structure is variable because so many of the services can be purchased from third parties, including freight consolidation labor, air and container line-haul capacity and local pickup/delivery (P&D) services. If volumes decline so does the spending on these activities. However, many of these variable costs have minimum purchase commitments in order to obtain the best pricing from suppliers. A sharp falloff in volume could result in unfavorable actions by capacity providers (e.g., an airline or container line denying a forwarder access to peak-season capacity or repricing the services based on a lower annual volume commitment).

The geographic location of costs is another important variable to consider. Service industries, like forwarding, tend to have very local cost structures, where the cost structure and productivity of a facility in one market has very little to do with the costs of another facility at another location. Generally, labor that handles freight is location specific. Costs that can be shared across multiple locations generally involve information technology, customer service call center operations and sales.

Our next step is to identify the key factors that help or hurt the basic value creation equation. Value is created by revenue growth, operating margin expansion and efficient use of capital. How a forwarder structures its business, picks its customers and organizes its activities has a huge influence on its ability to create value. Ultimately, these decisions require management teams to make tradeoffs, and the managers that are best at deciding what not to do are often the best at creating value.

Figure 5

Six common mistakes in evaluating freight forwarders

1. Underestimating the cost of complexity in managing large, diverse logistics 'mini-conglomerates.' Forwarders have extremely high returns on capital but low margins. While there are potentially significant benefits of scale and scope in combining logistics entities with different activities, we have found that executives in such combined entities often fail to understand the real P&L of their various units due to organizational complexity. As a result, they cannot properly evaluate growth opportunities, understand customer/segment profitability, or eliminate unnecessary costs.

2. Aspiring to market share leadership in a geographic market that is defined too broadly. While the Jack Welch mantra of achieving global market share leadership is important in industries like jet engines, most of the costs in freight are local or regional. Having global capabilities is certainly important in serving multinational customers. However, route density is the single most important driver of cost structure, and many companies have destroyed value by building overly diffuse networks in pursuit of global market share. A balanced approach is needed and many focused geographic competitors are surprisingly more profitable than companies with broad geographic scope.

3. Correlating effective information technology with spending levels. Some of the most effective IT systems are homegrown and are simply a reflection of the business rules developed by forwarders with sound operations. We have seen little correlation between level of technology spending and the quality of systems.

4. Assuming customers will pay a premium for 'integrated solutions' or 'bundled products.' Big customers are very effective at disaggregating their supply chain and bidding it out to numerous logistics competitors. Forwarders who emphasize "cross-selling" of other logistics services while maintaining relative independence of other business units have generally been more successful than those who try to subordinate one activity to another or create a hybrid entity. (There tends to be more scope to provide premium priced bundled services to smaller customers.)

5. Equating customer lists with prominent multinationals (household names) as marketing or strategic success. Big customers, again, are often very effective at extracting price concessions from forwarders. While such customers can provide a forwarder with a volume base for lower costs, we have found that forwarders with a sales force capable of reaching less price-sensitive small and mid-sized customers tend to have superior profitability.

6. Failing to be specific and disciplined in defining specific activities in which synergy will occur. Intercontinental forwarding models and segments differ significantly. Many large acquisitions have been premised on vague notions of convergence between forwarding and contract logistics or other broad strategic visions. It is crucial to evaluate specific needs and behavior of customer bases and potential cost sharing in serving such customers.

Figure 6 outlines the key value drivers that we have identified during our strategic due diligence of forwarders. We have identified five revenue growth drivers that are consistently seen in high quality forwarders with strong growth and consistent profitability.

Being in the right markets is extremely important. Forwarders make this decision by determining the geographic scope of their network. Ideally, a forwarder wants to have disproportionate participation in origins and destinations (O&Ds) in the largest and fastest growing trade lanes. In

today's world, this means an origin capability in China, India and Vietnam that connects the major consumption markets in North America and Europe. Markets with massive spending on infrastructure, like the Middle East, are also important if a forwarder wants to grow faster than the average. Markets with tight supply can be helpful to a freight forwarder even if the margins are lower because the purchased transportation rates tend to be three to four times higher in front haul markets than back haul markets. A lower margin on a much higher absolute

Figure 6

Value drivers in freight forwarding

	Operational driver	Mechanism	Impact
Revenue growth	Geographic scope of network	Network coverage in largest export markets	Enables faster growth due to high growth market exposure
	Service types offered	Balanced mix of air, sea and ground services	Enhances customer life cycle management
	Sales force vertical specialization	Intimate knowledge of customer industries leads to customer wins in complex segments	Enables capture of high-margin accounts and reduces attrition
	Medium and small customer account penetration	Smaller customers have less buying power and need for comprehensive services	Higher prices and sale of value-added services
	Customer facing IT functionality	Enables high-value-added services like origin consolidation	Reduces price elasticity and creates switching costs
Operating margin expansion	Relative market share on specific front haul O&D lanes	High shares on specific routes improves buying power	Reduces line-haul transportation unit costs
	Air freight customer freight density mix	Need a balanced mix of high and low density freight on specific O&Ds	Expands margin by reducing volumetric surcharges paid to carriers
	Core carrier program	Concentrates transport spend with smaller carrier base	Leads to preferential access to peak capacity
	Regional customer local origin and destination density	Creates regional P&D delivery density and reduced one-way trips	Generates lower P&D unit costs
	Balanced mix of high and low demand volatility customers	Minimizing demand volatility improves freight handling productivity	Lowers freight handling unit cost and increases peak capacity
	Forced consolidation gateway structure in NA & EU	Economies of consolidation facility scale and RFS lane density	Reduces freight handling and P&D unit costs
	Integrated operations IT platform	Single platform reduces key strokes and data entry errors while providing high value data	Reduces administrative staffing and associated costs
Capital efficiency	Higher share of medium and small size customers	Customer payment terms	Lowers net working capital required
	Use purchased transportation for P&D operations	Outsourced line-haul transportation	Lowers net PP&E employed
	Large customer of transportation provider	Supplier payment terms	Lowers net working capital required

Source: MergeGlobal Inc. primary research.

rate generally produces larger net revenue per unit transported. The higher net revenue per unit is where good forwarders make a majority of their profits.

Once its network has been defined, a good forwarder will offer a broad range of service types that are price and transit time options built around multiple modes of transportation. Attracting new customers is always the hardest thing for any business to do and it is no different in freight forwarding. A forwarder wants to be able to handle all or a large portion of a customer's trade flow in a specific region or country pair. In each trade lane, a major customer will have a portfolio of SKUs — each with different

unit values, growth rates and profit margins — moving at the same time. Forwarders that can offer multiple routing options at different price points, transit times and levels of reliability can help such customers lower their total distribution costs. This usually means offering sea freight, both FCL and LCL, air freight for high value or emergency shipments and sea/air services that provide the right balance of time and cost in markets that have really expensive air freight and extremely slow sea freight like Asia to deep South America.

A forwarder with a well-trained sales force that specializes in target end-customer industries can build a strong position in

specific vertical markets and defend those positions with knowledge. The barriers to entry in automotive, electronics and pharmaceuticals can be high as manufacturers must trust mission critical elements of their supply chain to an outside party, and the cost of choosing the wrong service provider can be career ending. In electronics and pharmaceuticals, the unit value of the products can get extremely high, and cargo security becomes a key issue, which requires specialized knowledge about the operations of these types of supply chains.

We have seen on numerous occasions that forwarders will often have more data about the customer and its specific transactions

than the customer has itself. This is a result of forwarders that have invested in strong customer-facing IT functionality. Capturing transaction level detail and making it available to customers electronically is a key revenue driver for forwarders. Customers will often award their account to forwarders that have the best functionality in this area. However, not all forwarders understand their costs of providing this IT capability and so they give it away for free. Other forwarders understand very clearly what it costs to provide these services and seek to get paid specifically or in the form of a higher price per freight transaction. Successful penetration of the retailing industry requires strong customer-facing IT in the form of vendor purchase order management systems that allow a forwarder to gather multiple vendor POs in China on behalf of a retailer and consolidate orders into a single box for transport to North America or Europe. This type of shipment is among the most profitable freight in the intercontinental freight market. It is one of the ingredients of the secret sauce that makes Expeditors International so successful every year.

A forwarder's mix by type and size of customer has a significant influence on revenue growth. Ideally, a forwarder should have a higher ratio of medium and small customers because these segments have a propensity to purchase high margin complementary services and are typically less price elastic. Oftentimes, a forwarder can position itself as the only service provider at small or medium accounts, which can significantly increase switching costs to the customer and lower sales costs for incremental business.

There are several decisions that management teams can make that can significantly influence margin expansion. These decisions often involve a combination of variables that interact together to produce the impact.

The single-largest expense category for a forwarder is purchased air and container line-haul capacity. There are several decisions a manager can make to lower his line-haul transportation unit cost.

Forwarders with a high share of total demand on specific freight corridors (lane density) are able to command lower prices because air and container freight typically are priced by directional O&D market. Purposely targeting accounts that build O&D lane volume allows a forwarder to get bigger discounts per unit of capacity from carriers. Global size does not matter because a forwarder can be among the largest globally but have fragmented flows that cause it to fall within the second or third quartile in any given O&D market and therefore not get the best prices. Alternatively, a medium-sized forwarder with a high market share of a select group of routes can obtain the best line-haul prices and use it to win new business, often at the expense of larger forwarders.

Customer freight density mix is an extremely powerful value driver. Forwarders with a broad mix of voluminous and dense freight in same freight corridors are able to maximize profits by charging low density freight shippers' volumetric surcharges and then combining these shipments with high density freight into a tendered consolidated shipment that meets an airline's minimum weight per pallet. On certain routes, the difference between profit or loss is the ability to optimize consolidation density. Achieving such density mixes requires a well-coordinated approach between locations in origin countries and sales forces in destination markets, where most customers manage their freight forwarding relations.

A forwarder can improve its operating margin by aggressively managing its ground transportation procurement. By definition, all air and sea freight shipments are from shipper door to consignee door. The portion of the total door-to-door journey is a function of the competitiveness of a forwarder to quote a price/service combination that is better than what a customer can independently purchase. Use of dedicated truckload capacity on high density lanes can drive delivery costs down.

However, it requires significant coordination and planning to execute. Combining air freight and LCL sea freight can drive lane density to the point where a forwarder can shift from LTL to truckload service with the attendant reductions in unit cost. Investment in practical decision support tools also helps forwarders make better tactical decisions about ground routings and carrier selection.

Forwarders should seek out a balanced mix of customers with predictable demand and unpredictable demand in same freight corridors to reduce the risk of capacity spoilage on high demand routes where carriers require block spaced agreements. This combined with customers with peak season and contra seasonal demand reduces capacity procurement risk and makes the forwarder more valuable to the carrier in terms of shipment tender reliability. Carriers reward this type of customer loyalty with preferential access to overflow capacity during the peak season as well as boarding priority when freight must be rolled to the next departure. It is like an industrial frequent user card, where carriers take care of the best customers during periods of tight capacity.

Another way to build local and regional economies of scale is to construct a forced gateway consolidation network in North America and Europe. A forced gateway strategy involves selecting a few carefully chosen air or seaports with adequate frequency and capacity to a wide range of destinations, and then requiring all interior offices to route freight through these gateways to build O&D volume in ground feeder operations to/from the gateway and line-haul consolidation volumes to improve buying power and freight density mix on specific intercontinental lanes. A forced gateway also leads to a faster learning curve by accelerating cumulative experience by aggregating volumes. Freight handlers become more efficient faster with higher volumes flowing through their larger facility and back office workers are able to

obtain transaction processing experience at a faster rate at a large gateway than at a small sub-scale gateway. The volume aggregation benefits of a forced gateway also extend to economies of freight terminal size where larger facilities have lower real estate costs per unit handled and are more capable for handling peak season demand due to flexibility in facility layout. Outsourcing the labor for freight consolidation operations is an effective way for a forwarder to reduce its exposure to having a large semi-skilled workforce and keeping long term handling costs low while maintaining management control of key operational decisions that impact consolidation economics and customer service levels.

Investment in information technology has revenue benefits, as described above, but it also has a big impact on a forwarder's cost structure. A typical forwarding company requires an operations and financial IT. Forwarders with a single integrated operations system have lower administrative cost per transaction, higher data quality, greater visibility on shipment status and better cost driver information that can be fed into a financial system to analyze customer profitability to validate the company's pricing strategy. Many

forwarders do not have a single operations system, and several of the largest forwarders operate different systems for air versus sea freight and different systems in geographic regions and country markets. Forwarders with multiple systems generally grew through acquisition and failed to fully integrate acquired companies' IT. Botched IT integration projects have caused numerous earnings misses due to unexpected IT consulting fees, lost customers due to poor service and increased labor expense due to re-keying of data to port data across multiple systems. Forwarders that built and maintained a single integrated system consistently outperform those that have not. Another word of caution with IT is that the level of IT spending should not be considered a proxy for effective IT. Often the best IT systems are home grown and developed around the specific business rules of the company.

Management decisions also impact capital efficiency. Purposely targeting customers that pay their invoices quickly can help reduce capital employed by lowering the networking capital requirements. Outsourcing local delivery instead of operating an organic fleet keeps assets off the balance sheet and helps lower capital

employed. Finally, concentrating spending with key suppliers can make you important enough to that supplier to extract special payment terms that also help lower net working capital required.

Conclusions

The freight forwarding industry will continue to benefit from growth in trade and certain structural advantages over carriers. But it is important for a buyer of a forwarder to understand where the value drivers are and the relative importance of each one.

A buyer must also recognize the hidden costs of complexity when integrating a forwarding capability with freight network and contract warehousing type businesses.

Buyers must also recognize that synergies are limited to specific activities and that paying a high premium for activities in which there is not overlap is not wise.

Ultimately, value is driven by financial performance, and financial performance is driven strategic position. Strategic position must be assessed in a disciplined manner, which examines the discrete and inter-related activities within a forwarder value chain to understand sources of synergy and options to increase value. ■