# Morningstar© Stock Strategist Industry Reports

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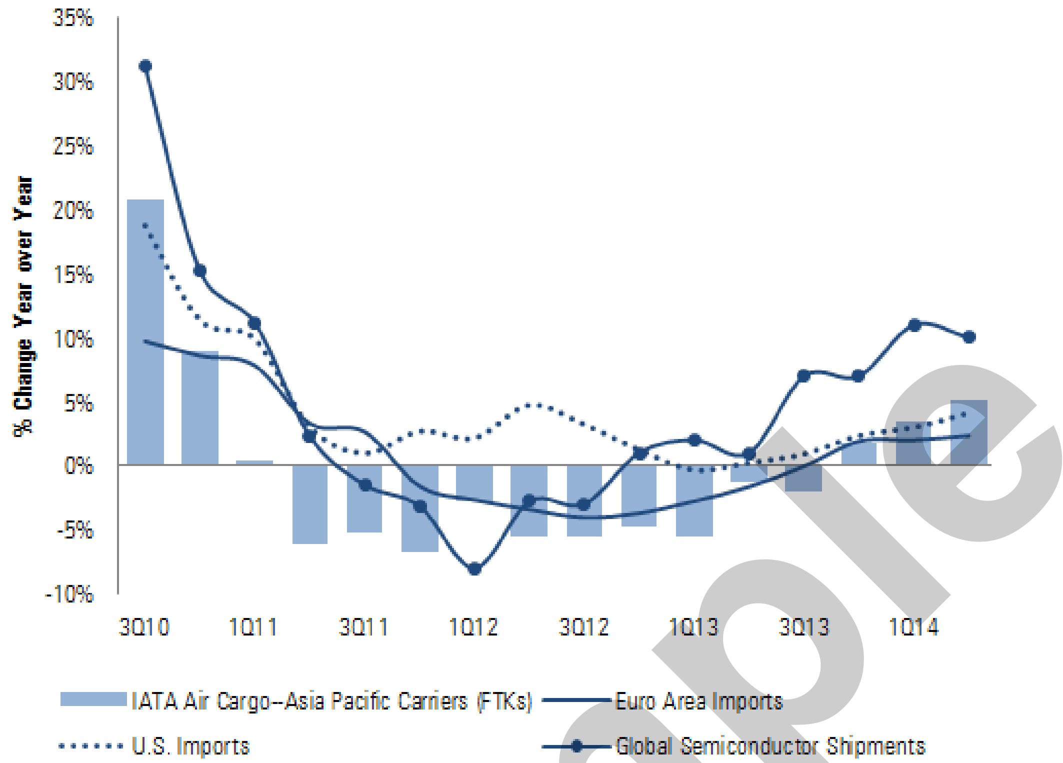
## Forwarders Finally See Airfreight Gain Altitude

Airfreight demand began improving in the second half of 2013, and trends have stayed positive since. Ocean freight has held up better over the past few years, with help from the trade-down from the skies and healthy demand thus far in 2014. We don't anticipate robust growth in either mode as global trade on core east-west routes will probably remain subdued and overcapacity will limit rate gains. That said, moat-worthy global freight forwarders should see benefits from industry consolidation. Within our coverage universe, Expeditors International EXPD is among the best positioned to take market share. While UTi Worldwide UTIW has potential, it needs to work through distractions associated with its long-running IT rollout.

The industry's demand decline ran from early 2011 to the middle of 2013 and weighed heavily on the results of most global forwarders, since airfreight is no small component of their operations--it makes up 43% and 30% of gross revenue for Expeditors and UTi Worldwide, respectively. We use IATA's Asia Pacific international air cargo statistics as a proxy for underlying industry demand. While not perfect, the index includes shipments on key East-West trade lanes (Asia-Europe and Asia-North America) where forwarders like Expeditors and UTi Worldwide conduct most of their business. Total industry tonnage fell 5% in both 2011 and 2012 and about 4% during the first half of 2013. On Asia-North America lanes alone, volume contracted 6% in 2012 and 2.5% in 2013, according to data from Boeing. Despite its best-in-class execution capabilities, even top-shelf provider Expeditors saw its air volume plummet 6% in 2012 before rising in early 2013. These headwinds also suppressed investor sentiment, pressuring stock prices throughout the global third-party logistics industry.

**Airfreight Demand Endured a Few Rough Years Before Improving in 2H13**




Note: $R^2$ (Semis, IATA FTKs)=0.91; FTKs represent freight ton kilometers; import volume includes all transport modes
Source: IATA, Semiconductor Industry Assoc., CPB World Trade Monitor



**What Was Behind the Weakness**

Anemic business sentiment in the West pressured air cargo activity, despite modest U.S. macroeconomic growth. Throughout 2011 and most of 2012, shippers (retailers and manufacturers alike) assumed a cautious stance and aggressively managed inventory levels to uncertain demand conditions in their own end markets. At the top of shippers' concerns were recessionary conditions in Europe and an ambiguous economic outlook in the United States, including the impact of political uncertainty related to the fiscal cliff and concerns about unemployment. Together, these factors tempered international trade flows (especially eurozone imports from Asia) and overall demand for high-value airfreighted cargo, particularly goods from the high-tech and telecom sectors. Global semiconductor shipments, which can serve as a proxy for the movement of various high-tech electronics goods, declined 3% on average in 2012. Semiconductor shipments and airfreight activity are highly correlated, as these products represent core cargo for global forwarders--high-tech verticals constitute nearly 30% of Expeditors' net revenue mix, for example.

Furthermore, heightened economic uncertainty and fragile business confidence offered an incremental incentive for European and North American shippers to shift to less expensive (albeit slower and less reliable) ocean shipments in an effort to reduce supply chain costs and mitigate the risk of replenishing inventory too quickly; containerized ocean freight can be more than 10 times cheaper per unit than airfreight. This trade-down is one reason containership cargo activity performed better than airfreight in recent years. Improvement in various U.S. economic sectors, including the housing market (which drives demand for imported home goods), helped ocean demand as well. As measured by container shipments at the ports of Los Angeles and Long Beach, U.S. ocean freight activity was up 1% on average during the time that airfreight was in the doldrums.

These factors raise the question: Why haven't forwarders seen a greater degree of lost airfreight volume related to mode-shifting show up in their ocean activity? First, shippers with significant annual volume requirements often have direct contractual relationships with ocean carriers because of sufficient buying scale with which to negotiate favorable rates--liners still originate about 65% of shipments on trans-Pacific lanes. Thus, when large shippers transition cargo from air to ocean, it is not uncommon for the account to end up working directly with a carrier, rather than through a freight forwarder. Second, even in cases where a forwarder retains the transaction, gross profit margins tend to be lower because of the pricing differential between air and ocean freight, a factor that places incremental pressure on net revenue growth. Putting it all together, periods of meaningful modal shifts to the ocean mode create headwinds for transportation intermediaries. The forwarders saw little in the way of top-line gains in recent years thanks to shippers' avoidance of airfreight.

**Airfreight Recovered in Second Half of 2013, and Momentum Continues**
Europe's emergence from recession and modest acceleration in U.S. economic activity have boosted global trade on key Asia-U.S. and Asia-Europe freight lanes, thus breathing new life into the forwarders' airfreight business. We also expect peak-season shipment demand (typically straddling the third and fourth quarters) to be better this year, with incremental help from various high-tech consumer product launches. Global semiconductor shipments, which we use as a proxy for the movement of high-value goods throughout shippers' supply chains (aiding airfreight), increased at a high-single-digit annual rate over the past year. Overall, the IATA Asia Pacific air cargo index expanded more than 5% year over year during the first nine months of 2014, and activity appears healthy thus far in the fourth quarter, based on commentary from several carriers and third-party logistics providers.



U.S. West Coast port volume expanded about 5% year over year in during the first nine months of this year. Forwarders' volume trends also reflected the solid growth. Underlying macroeconomic conditions in the U.S. (and Europe) have proved favorable for containerized imports. Additionally, ocean shipping is probably still benefiting somewhat from the gradual, secular trade-down from airfreight, driven by shippers' IT-related advancements in supply chain visibility and multimodal planning over the past five years. Still, we think some of the added volume strength seen thus far this year stems from U.S. shippers (especially those in retail end markets) moving goods ahead of the peak shipping season to hedge against potential West Coast port disruption linked to ongoing labor negotiations between the International Longshore and Warehouse Union and the Pacific Maritime Association. We expect year-over-year volume growth (as measured in TEUs, or 20-foot equivalent units) to moderate for the international forwarders in the fourth quarter, given the pull-forward of some cargo that otherwise would have shipped during the peak season. The recent slowdown in manufacturing activity in Europe, particularly Germany, could play a role as well. That said, at least through the third quarter, commentary from industry participants points to healthy underlying demand. Market-leading ocean carrier Maersk Line anticipates mid-single-digit growth for total global containerized shipping this year, and we continue to expect high-quality forwarders like Expeditors to exceed that rate with help from market share gains.

**Market Share Will Carry Much of the Load for Top-Shelf Providers**
Organic share gains from small providers will be a critical source of growth for moat-worthy international transportation managers. This is because low-single-digit underlying air and ocean demand growth is likely to be the steady state over the next few years, below the high-single-digit expansion posted in prior decades. Macroeconomic growth in Europe and the U.S. will remain mediocre at best, and foreign production sourcing (offshoring) from high-cost to low-cost manufacturing geographies like China will not deliver the tailwind it once did. In fact, gradual near-sourcing for some North American manufacturers is probable over the long run--shorter lengths of haul carry lower profits for forwarders. We also don't expect forwarders to see much of a near-term boost from pricing gains, thanks to persistent overcapacity among air and ocean carriers.

We expect the global forwarders to see core demand and pricing growth (combined) of only 3%-4% on average in the years ahead. Behind this, we look for airfreight industry revenue to expand 2%-3% on core east-west trade lanes, with ocean industry revenue rising at a slightly higher pace (3%-4%), in part because of incremental modal shifts. Since the downturn, large shippers are becoming more proactive and adept at supply chain and inventory management, thus maximizing the less costly ocean mode.

Based on October 2014 International Monetary Fund forecasts, GDP growth among advanced economies will stay somewhat subdued at 1.8% this year and 2.3% next year. Historically, international trade has expanded at 2-3 times the rate of GDP growth in the developed world, but we believe that relationship will be closer to 1-2 times going forward (on average). This is partly due to the absence of a foreign production sourcing tailwind. In prior decades, companies in the U.S. and Western Europe sent large portions of their manufacturing operations to lower-cost geographies like China. Looking ahead, absolute levels of outsourcing will remain high, but we suspect growth will stagnate because of sluggish economic expansion and rising interest in nearshoring among U.S. manufacturers and retailers. Cost differentials between developed and developing nations are shrinking, and there is the rising potential of protectionist measures from regulators. That said, we do not anticipate a sudden wave of manufacturing to return to the U.S. or transition from China to Mexico. Instead, nearshoring will probably prove gradual and measured, since production capabilities and supply chains throughout Asia Pacific are well established. Sourcing shifts within traditional low-cost manufacturing regions are more likely in the short run. For example, some manufacturing activity in China has migrated inland, and many U.S. retailers have turned to Vietnam and Thailand to source apparel merchandise.

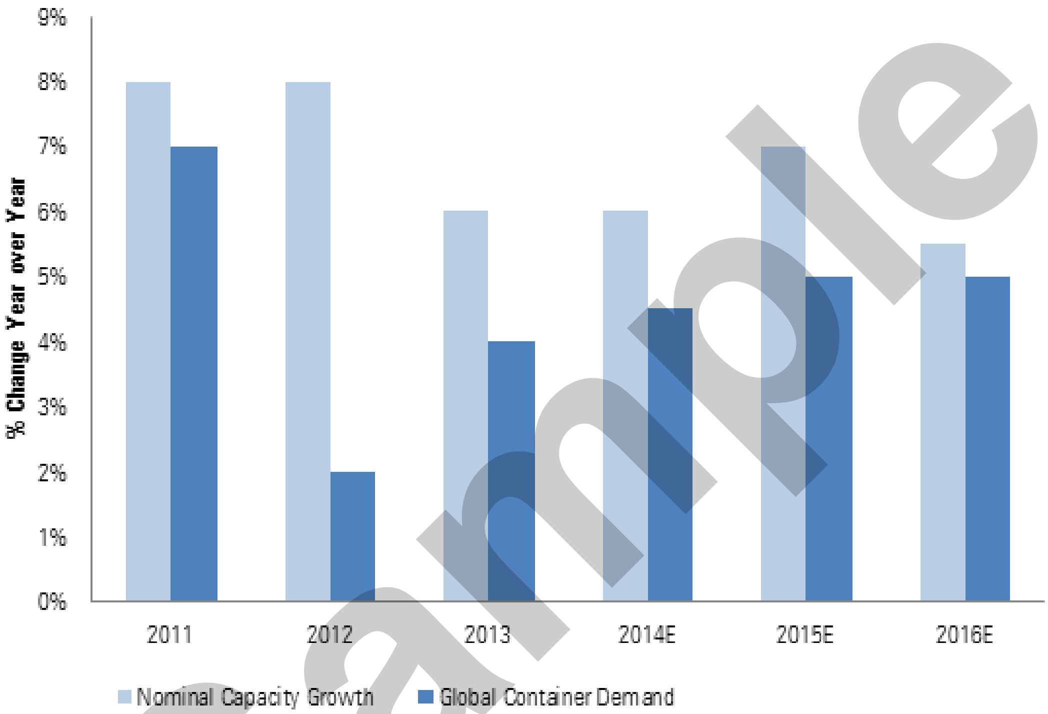
It's worth noting that despite its high cost, inherently volatile nature, and lackluster growth prospects, airfreight as a mode will not disappear. The airfreight market is small compared with containerized ocean shipping--in 2013, global airfreight traffic approximated 208 billion revenue ton-kilometers versus 11.2 trillion RTKs for ocean activity, according to Boeing's World Air Cargo Forecast. Still, it remains an indispensable component of shippers' supply chains and a critical means of secure, rapid overseas transport, especially given the high levels of foreign sourcing and distribution among Western manufacturers and retailers. Ocean deliveries can take up to a month to arrive, compared with a day or two for airfreight, which is also more reliable. Airfreight also provides a vital transportation safety valve for inventory replenishment or during periods of unexpected demand spikes--historically about half of airfreight movements relate to ad hoc, emergency shipments. Moreover, demand stemming from decent economic growth within Asia Pacific will keep airfreight a relevant transport mode. East-west trade lanes constitute the largest chunk of business for the top U.S. and European forwarders, but most providers naturally have built a meaningful presence in key emerging markets, where we expect gradual benefits from expanding intra-Asia trade.

**Unfavorable Supply/Demand Relationship Constrains Pricing**

Save for seasonal upticks in demand, the air and ocean shipping markets are flush with an abundance of cargo space. Naturally, oversupply is a challenge for asset-based carriers, but it also weakens the intermediaries' pricing power and increases variability in capacity buy rates, adding noise to gross profit margins. For example, Expeditors has seen yields fall more than 100 basis points year over year (on average), through the third quarter , despite decent tonnage growth. There is little evidence of a near-term pullback in capacity levels in the air or ocean markets. Thus, unlike the domestic freight brokerage industry, which is benefiting from a secular tightening of truckload supply, global third-party logistics providers focused on international shipping won't find much incremental growth via rate gains.

Ocean capacity. Overcapacity is most pronounced in ocean shipping markets, where liners are grappling with a chronic supply/demand imbalance. While vessel orders are not as elevated as they were before the 2009 freight downturn, carriers have nonetheless continued to order larger, more fuel-efficient containerships in an effort to reduce bunker fuel consumption and maximize scale economies. Doubling vessel size can lower unit costs by as much as 25%, assuming the carrier can fill the ship with containers, and this is an attractive proposition to liners struggling to break even in a challenging market. The problem is that the industry order book has hovered near 20% of capacity over the past three-plus years, despite the prospect of soft pricing and low- to mid-single-digit global containerized trade growth (at the low end on traditional east-west trade lanes). Accordingly, nominal capacity additions (deliveries net of scrapping) have long exceeded increases in freight demand, and that will persist as massive vessels capable of carrying up to 18,000 TEUs are still being added to major Asia-Europe trade lanes. Many of the existing 10,000-14,000 TEU ships (which are already much larger than previous-generation 6,000-8,000 TEU vessels) are transitioning to U.S.-related trade routes.

**Overcapacity Is Plaguing the Ocean Shipping Industry**




Note: Nominal capacity is defined as vessel deliveries less scrapping.

Source: Maersk Line, Alphaliner.



For perspective on liners' seemingly inexorable inclination to overbuild, consider that total global container demand was up 7% between 2003 and 2013, while nominal capacity expanded 10%. More recently, in 2012 and 2013, global demand rose 3% on average while new vessels boosted the fleet 6%, net of scrapping activity. Carriers' efforts to manage the influx of vessel space via slow steaming have helped reduce the supply/demand gap, but only in part, and although current order data suggest that gap will not widen in the years ahead, it won't disappear. According to market leader Maersk Line, new tonnage deliveries will add 6% (net) to the industry containership fleet in 2014. This compares with our 3%-4% industry growth assumption for the core Asia-U.S. and Asia-Europe trade routes.

An additional response to overcapacity and related profit pressure has been the formation of vessel-sharing arrangements, in which ocean liners pool resources with peers but keep vessel ownership, rate setting, and operational execution separate. The intent is to boost utilization and scale economies without the regulatory roadblocks associated with true mergers and acquisitions. There are numerous VSAs among the large ocean carriers, the most recent of which includes industry leaders Maersk Line and Mediterranean Shipping Company. Overall, we do not expect VSAs to do much for industry pricing in the short run, but such arrangements could reduce the propensity to overbuild in the future, since a liner can take advantage of a peer's service on certain lanes without adding its own vessels. Further, if liners can successfully employ VSAs to incrementally shore up profitability, service and rate volatility throughout the industry would probably decline.

Airfreight capacity. Despite cutbacks in dedicated freighter capacity in recent years, healthy growth in passenger demand into and out of Asia, along with U.S. and European airlines' strategic efforts to penetrate that market, has enticed airlines to expand their wide-body (twin-aisle) passenger fleets, leading to a proliferation of available belly-hold space on key freight lanes. The rise in belly space has generally exceeded airfreight demand growth, weighing on pricing trends for cargo carriers and forwarders alike. During the first half of this year, Expeditors' net revenue per kilo fell 3%, illustrating the pricing pressure, as sell rates to customers fell more than buy rates for capacity on certain business. While intermittent demand spikes may tighten capacity at times, the overall imbalance will probably persist, given the healthy backlog of airlines' passenger aircraft orders and high level of deliveries this year. The existing wide-body jetliner fleet is slated to rise 7% this year--ahead of demand, which was up 4% in the first half of 2014, according to IATA data.

**The Upside Beyond Modest Demand Growth**

We believe a long runway of opportunity still exists for moat-worthy forwarders to grab market share from less sophisticated 3PLs. The global air and ocean forwarding industry is highly competitive, but the marketplace is fragmented, with the top 10 providers composing only about 45% of the industry. There are thousands of small and midsize operations, many of which lack the resources to keep up with the local market knowledge, sophisticated IT, and reliable capacity access that global shippers require of their 3PL partners. There has been evidence of consolidation over time, as the top forwarders have lifted their share of the market from about 40% in 2006, according to data from Transport Intelligence.

This is where the network effect comes into play, supporting sustainable competitive advantages for several global 3PL providers. We award a wide Morningstar Economic Moat Rating to Expeditors International and a narrow moat to UTi Worldwide. We also think Deutsche Post DHL's DPW global forwarding business (the largest airfreight forwarder) enjoys moaty characteristics, which contribute to the firm's overall narrow moat. Each of these providers has built a vast global office network with a wide range of geographic locations through which to efficiently arrange trade, and each enjoys an immense base of customers that provides the buying scale necessary to secure cargo space and negotiate attractive rates with carriers. Deep carrier relationships are a key differentiator during the peak season, when air and ocean capacity tends to be limited and shippers scramble to restock inventories. Furthermore, shippers' intercontinental supply chains are an important target for cost savings. For example, since the 2009 downturn, many U.S. and European retailers have invested heavily in internal IT initiatives linking better demand forecasting with supply chain efficiency. For shippers that move goods internationally, this translates into strong demand for 3PLs' efficient mode optimization capabilities.

In our view, large shippers working directly with ocean carriers represent another opportunity. Over the past few years, most ocean liners have posted losses because of the capacity glut and related pressure on pricing, coupled with the asset-intensive nature of the business. Despite recurring attempts at general rate increases and efforts to limit capacity via slow steaming, many liners are still struggling to stay out of the red. Given carriers' limited resources and increased focus on large, contractual accounts, intermediaries have been taking a bigger slice of the market with small and midsize shippers. We think share gains have also been helped by forwarders' fee-based freight management services, in which the shipper still chooses the carrier but uses a forwarder to book the shipment. The ability to provide redundancy and flexibility by contracting with multiple carriers is also a valuable capability to shippers, considering shifting supply chains and constantly fluctuating service levels from carriers participating in VSAs. According to market researcher PIERS, forwarders processed roughly 36% of container volume on trans-Pacific lanes in 2013, up from 25% in 2006.