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A SUPPLY CHAIN OF TOOLS: MAKING THE RIGHT INVESTMENT MOVES WITH LOGISTIC SERVICE PROVIDERS

By Alan Lok, CFA, Eunice Chu and Guruprasad Jambunathan

Logistics is the backbone of today's supply-chain ecosystem, ensuring that people and goods are transported efficiently from one point to another, on time, in good condition, and at competitive prices. The sector is evolving rapidly, as advances in technology respond to distribution demands from e-commerce firms. Furthermore, disruptive forces are in play as new entrants create services that we suddenly cannot live without.

Logistics is also a labyrinthine industry that includes a multitude of stakeholders, ranging from governments to warehouse operators, freight specialists, port authorities, transport companies, and ultimately, the end-user.

In the logistics industry, finding two firms that are entirely alike is difficult. Thus, establishing a complete picture of a company's portfolio of services to gain insights into the logic of its business model is vital. For example, does the company cater to the retail or industrial markets? Armed with that information, you will have a roadmap to help drill into the demand factors in each division of the logistics company's business.

As in any other industry, demand is fundamental in logistics. Find out where in the world the company's demand originates, paying attention to the different services offered by the company and the types of cargo moving from one point to another. Volume is another crucial factor—how many packages are regularly in transit and at which times of the year?

The logistics industry is relatively sensitive to unpredictable external events, so don't lose sight of macroeconomic factors. Gauge the sensitivity of the business to changes in the economic conditions and levels of consumption in the regions in which it operates. Firms that specialise in home delivery could flourish in territories where there is a burgeoning middle class, but are also vulnerable to downturns in established markets. Indeed, the home delivery functions of logistics players, which have until now been buoyed by the growth of e-commerce, could be threatened by the so-called e-tailers—Alibaba and Amazon, among others—who are looking to forward integrate into distribution.

With a basic understanding of the various demand drivers that impact each arm of the company's portfolio of services, examine the company's pricing model by comparing it with that of its peers within the same industry. Logistics firms do not have much wriggle room when it comes to pricing. For example, if we take two broadly similar businesses transporting good from Kuala Lumpur (KL) to Singapore by road, we see they both face the same fuel prices and distance covered, yet will undoubtedly offer different freight rates, discounts, and pricing models. To find out how they do this, research (among other things) the firm's transport planning. Is it efficient? A good measure to examine is its load-to-truck ratio—a lower ratio translates into cheaper freight rates. What is its vehicle mix? Is it flexible enough to adapt to changes in demand? Does the company own its trucks or just lease them? Also, consider whether a bias exists toward contract drivers or full-time employees.

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From an environmental, social, and governance perspective, the logistics industry offers a certain amount of clarity to help you formulate your research. The global transport of goods consumes large amounts of fossil fuel, so take stock of the emissions intensity of the company's operations and the steps it takes to offset its carbon footprint. Packaging is another angle to contemplate—think of all those small online purchases that arrive in large boxes! Therefore, enquire whether the company is seeking to reduce packaging and use biodegradable or recycled material.

Another aspect to inspect is the operational performance of the company and how its key metrics, such as margins and costs, compare with its competitors. What impact do changes in freight rates, fuel costs, and exchange rates have on these metrics? As we know, past performance is no guide to the future, so look at how the long-term megatrends—macroeconomic conditions, exchange rate movements, technology, and demographics—affect the company's logistics business model. These will be the key differentiating factors that separate a top-performing logistic player from its peers.

If we return to our two trucking businesses plying the KL/Singapore route, you should get to know how they are utilising technology in their different functions. For example, have they automated their warehouse operations and eliminated the need for forklift truck drivers? As e-commerce continues to evolve and competition increases, automation is unavoidable. In a similar vein to what has happened in the financial industry, the logistics space is heavily influenced by the development of cutting-edge technology. If the phrase has not already been coined, we can call this evolution *logtech*.

About the Authors

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Sector Analysis: A Framework for Investors

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Infographic showing the step-by-step process of analyzing the Logistics industry

01 DEMAND FOR SERVICE

- Service Mix
- Seasonal effect on demand
- Sensitivity to macroeconomic factors

02 REVENUE MODEL

- Freight pricing model
- Comparison by market and to peers
- Seasonal variation of rates
- Pricing model for bulk and repeat customers
- Sensitivity of demand vs per unit changes in freight rates

03 PERFORMANCE

- Freight volume growth
- Capacity utilization rates
- FX sensitivity and hedging
- Costs as a percentage of revenue
- Fuel costs as percentage of total costs

04 STRUCTURAL INFLUENCES

- Economic growth in key markets
- Demographic trends in key markets
- Consumption vs. Investment contribution in key markets
- Impact and adoption of technology

05 LOGTECH

- E-commerce penetration in key markets
- Scalability of e-commerce infrastructure
- Strategy to compete with asset-light competitors
- Opportunities and threats from e-tailers

06 ESG

- Emissions per unit of ton-mile
- Carbon footprint offset
- Working conditions
- Marine pollution
- Use of biodegradable / recycled packaging material

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Common to the Sector

1. Please provide details of the company's portfolio of services.

a. What are the different services provided: surface transportation, air cargo, marine shipping, forwarding?
b. Which market segments are catered for: retail, commodities, industrial?
c. What type of cargo is handled: bulk, raw material, finished goods?
d. Which regions are currently being served?

2. What are the various factors affecting demand for the company's services?

a. What is the mix of demand from different services, market segments, cargo types and regions?
b. How is the demand mix in terms of number of packages, volume of cargo and freight tariff charged?
c. What are the seasonal variations in this demand mix?
d. How have the demand mix and seasonality been historically and how are these trends evolving?

3. What is the impact of macroeconomic factors on demand?

a. How sensitive is demand to economic conditions and consumption in regions in which the company operates?

4. What are the company's freight rates, discounts and pricing model?

a. What freight rates are charged for different services and cargo types?
b. How do these rates vary by market segment and by region?
c. How do the company's rates compare with those charged by peers?
d. On what basis are rates determined?
e. What pricing model is adopted for bulk and repeat users?
f. Are there any seasonal variations in the rates charged?
g. How sensitive is demand to per unit changes in freight rates?

5. What are the long-term factors expected to drive growth? How does the company expect these to evolve?

a. What are the demographic and macroeconomic growth trends in key markets?
b. What is the mix of consumption share versus investment share of the economy in markets where the company operates? How is this evolving? Is the firm's operating model geared to align with these trends?
c. What is the likely impact of an expected shift from ownership based (buy and use) to access-based (rent/share and use) consumption models?
d. To what extent is the impact of technologies such as autonomous driving, robotics and drones impacting the company's operations?

6. What is the level of market concentration and entry barriers?

a. What is the market share of the top-three and top-five players? What is the company's current market share?
b. What are the significant barriers for new players to enter the industry?
c. To what extent does technology facilitate the entry of new entrants?

7. To what extent is technology utilized in different functions?

a. Does the company have an integrated platform for cargo handling and tracking?
b. Does the firm use technology-driven solutions to prevent loss of packages?
c. Are automated updates provided to customers about the movement of their packages?
d. How much technology is utilized in forecasting demand and optimizing resources?
e. Are software solutions utilized to optimize deliveries?

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8. How has the company performed operationally? How do key metrics compare with peers and how are trends expected to evolve?

a. What freight volume growth trends exist in terms of number of packages, tonnage and ton-miles carried?

b. How have the company's capacity utilization rates evolved? Is there any seasonality in utilization rates?

c. How much have freight rates changed in the past five years?

d. What are the company's costs as a percentage of revenue?

d. What is the company's fuel cost as a percentage of total costs?

9. How has the company performed financially? How do key metrics compare to peers and how are trends expected to evolve?

a. What is the currency mix of the company's revenue and cost base?

b. What are the company's gross, operating and net margins?

c. How sensitive are revenues and margins to per unit changes in freight rates?

d. How sensitive are margins to per unit changes in fuel costs?

e. What is the sensitivity of revenues and margins to changes in exchange rates?

e. What is the firm's hedging strategy to manage volatility in fuel costs and exchange rates?

Logistics Providers

10. How will the evolution of e-commerce likely affect the company's operations?

a. What is the share of e-commerce in key markets and across product categories?

b. How mature is the payments infrastructure required to support the growth of e-commerce?

c. How does the company view the trend of large e-commerce retailers, such as Amazon setting up their own logistics operations?

d. What is the company's strategy to leverage opportunities arising from the rise of e-commerce?

11. How much competition is expected due to new business models?

a. What is the company's view on the evolution of asset-light models, such as Postmates and Amazon Flex?

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Marine Shipping

12. What factors affect demand for shipping services?

a. How sensitive is shipping demand to changes in global trade growth and mix?

b. To what extent has new capacity been added to the industry? How has this impacted demand and price realization?

c. How does the company foresee capacity addition evolving in future?

13. What is the impact of macroeconomic factors on demand?

a. How does the company view the impact of manufacturing moving back to developed countries from developing countries, driven by industrial automation and 3D printing?

14. What factors facilitate/impede the entry of new players?

a. What different licenses and approvals need to be obtained for a company to operate shipping services?

b. How difficult is it to obtain these and what are the typical costs involved?

c. How vulnerable to piracy are the routes the company operates in? How much additional cost is incurred in minimizing the risk of piracy?

15. How has the company performed operationally? How do key metrics compare with peers and how are trends expected to evolve?

a. What proportion of the company's freight ships are owned and leased?

b. How does the company decide whether to own or lease vessels? What are the implications for the balance sheet and margins?

Environmental, Social and Governance

16. The company's ESG principles, practices and track record.

a. What is the emissions intensity of the company's operations? What emissions are generated per unit of ton-mile handled?

b. Are customers offered the option of offsetting the carbon footprint of their consignments?

c. Does the firm encourage customers to reduce packaging and use biodegradable or recycled material, and facilitate such choices? Do plant-based packaging materials sourced from suppliers adhere to recognized forest certification schemes?

d. What proportion of the company's facilities are certified for / practice measures to save energy, water and reduce emissions?

e. What is the company's track record relating to working conditions for employees and contractors?

f. What measures are implemented in the company's facilities, fleet and other operations to ensure the health and safety of personnel? What is the company's track record in terms of fatalities, injury rates and lost time incident rates?

g. What is the company's track record with respect to marine pollution (discharge of black and grey water)? What measures have been implemented to minimize environmental impacts?