



The Short Tale

Near-sourcing trends create new winners and losers in the supply chain. BY BENJAMIN GORDON AND KAREN RUTT

In the 1970s, deregulation spawned a new era of growth in transportation. Nimble trucking companies like Schneider and J.B. Hunt capitalized on this opening to become multi-billion-dollar giants. In the 1990s, the demand for outsourcing produced a new category of winners, known as 3PLs. Logistics firms like CH Robinson and Expeditors became major beneficiaries. Today, we are on the precipice of the third major change to sweep through the supply chain. Like its predecessors, it has the potential to create new classes of winners and losers. The name of this powerful new trend? Near-sourcing.

The move toward near-sourcing is underway. Car manufacturer Tesla Motors just canceled plans to manufacture its 1,000-pound batteries in Thailand as previously planned. By manufacturing them closer to Tesla's home base in California, it will decrease the shipping distance of each battery approximately 5,000 miles. Other major manufacturers are following suit.

Also called "reverse globalization" or "shortening

the supply chain," near-sourcing describes the return of American manufacturing in order to decrease shipping expenses. As freight costs remain high, globalization has become less competitive and is expected to remain so for the foreseeable future. We will share why near-sourcing is happening, discuss implications for the supply chain industry, and conclude by offering ideas to supply chain business owners to ensure their success amidst change.

Near-Sourcing: Requiem for Globalization?

Historically, cheap gas fueled globalization. It enabled companies from all over the world to shop globally for cost-saving business solutions. However, fuel costs have nearly doubled since January of 2006, and have shot up by nearly six times in the past six years (see Chart One). In a recent CIBC World Markets Report, analyst Jeff Rubin estimates that the cost of transporting imported goods into the United States is now equivalent to a 9% tariff on imports. Companies will recalculate the costs and benefits of global outsourcing as the cost of energy



Pacer Stacktrain

is expected to remain high indefinitely.

Supply chain businesses are feeling the pinch. Industry bellwether Expeditors International, a Fortune 500 outsourced logistics company offering freight forwarding and customs brokerage services, confirms in its recent 8-K, "The cost of fuel is a serious issue. Historically, fuel has been 15% of carrier operating costs. Today, it is estimated to be substantially over 40%."

The devaluation of the dollar has further added to the blight of global business. Between September 2006 and September 2008, the dollar has lost an average of 11% of its conversion value against the yuan, yen, and euro (see Chart Two). As the U.S. dollar has decreased in value, the cost of purchasing goods and services in countries with stronger currencies (such as China and Japan) has increased, causing outsourcing to be even less competitive.

WINNERS

As skyrocketing fuel and plummeting dollars shake the foundations of global trade, who will be the winners and losers?

U.S.-Mexico Trade Lane 3PLs

One winner will be the U.S.-Mexico trade lane, and the supply chain companies that serve it. U.S. imports from Mexico are increasing as fuel costs climb (see Chart Three). The U.S. Department of Commerce reports an 8.7% increase from year-to-date imports through Mexico compared to the year before. Mexico is able to offer an alternative to expensive overseas outsourcing destinations. As a result, we expect increased demand for transportation, customs brokerage, import/export

services, and regional warehousing companies in the U.S.- Mexico trade lane.

U.S. Exporters

A second winner will be those supply chain firms that target U.S. exports. The Port of Long Beach, California, a major West Coast trade port, reports a 13.5% increase in loaded outbound containers for 2008 year-to-date versus the same time period in the prior year. Container movement trends confirm a shift in U.S. outbound volume. Increasing export activity suggests growing demand for all U.S. export-based service providers, including freight forwarding, customs brokerage, and other export services.

Rail Service Providers

A third winner will be low-cost providers in the rail, intermodal, and drayage arena. As trucking costs have increased due to fuel, driver shortages, insurance, and other variables, rail is becoming more cost-competitive with trucking. Pacer Stacktrain, an intermodal service provider and a division of Pacer International, recently expanded intermodal services with the BNSF Railway. Pacer CEO Michael Uremovich credited much of their recent success and financial improvements on the expansion and success of the intermodal segment. Their intermodal operating income increased \$7.5 million compared to the second quarter 2007, representing a year-over-year increase of 30%. Other 3PL companies are also experiencing increases in their rail-related services. J.B. Hunt Transport Services reported a 17% year-over-year increase in load counts with their JBI segment, which offers intermodal and drayage services. Due to

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the increasingly competitive rail business, supply chain companies offering rail transport, intermodal, drayage, and short haul trucking are well positioned.

Regional 3PLs

A fourth winner will be regional contract logistics and supply chain providers, such as warehousing and value-added service providers and contract packagers. Each year, the International Warehouse Logistics Association (IWLA) surveys its members, comprised of over 500 3PL and warehousing companies, and shares data in its Annual Business Outlook. In its 2008 survey, over one-third of the respondents said they expect to experience growth of over 10% in 2008, and approximately 13% expect to see sales increases of 20% or more. 28% expected solid growth for value-added services, including packaging, pick and pack, and labeling. The IWLA report affirms that the outlook is bright for warehousing 3PLs despite a slowdown in other sectors.

BGSA anticipates that the contract packaging industry will also expand from increasing domestic supply chain activities. Our analysis indicates that contract packaging is an approximately \$20 billion market exhibiting 10+% annual growth. Increasing fuel prices could potentially stoke the need to couple packaging capabilities with

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warehousing and distribution. In a weak economy, companies often prefer to focus on core competencies, such as marketing and branding, as opposed to non-core competencies, including manufacturing and outsourcing. This is more good news for regional providers of contract logistics and contract packagers.

Other Geographies

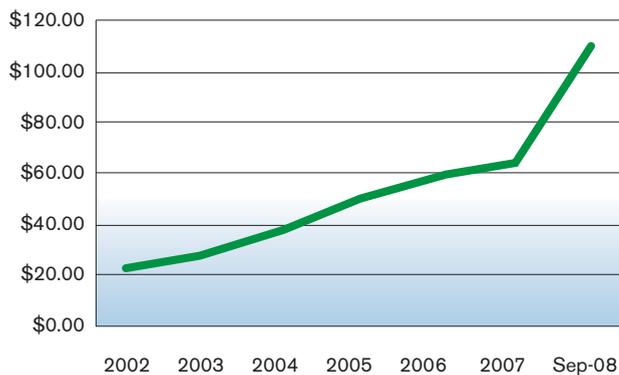
In addition to Mexico and the U.S., other countries are expected to better compete

with China's increasing manufacturing costs. As China develops, other markets are becoming lower-cost competitors, such as Mexico, Thailand, and Vietnam. The performance of industry bellwether Expeditors is again reflective of this trend. The company reported that revenue increased 28% in Mexico, 11% in Canada, and 51% in Latin America, which was attributed to "strengthening export volume growth." Domestic freight forwarding and customs brokerage companies that expand in these low-cost and/or North American markets will reap rewards.

LOSERS

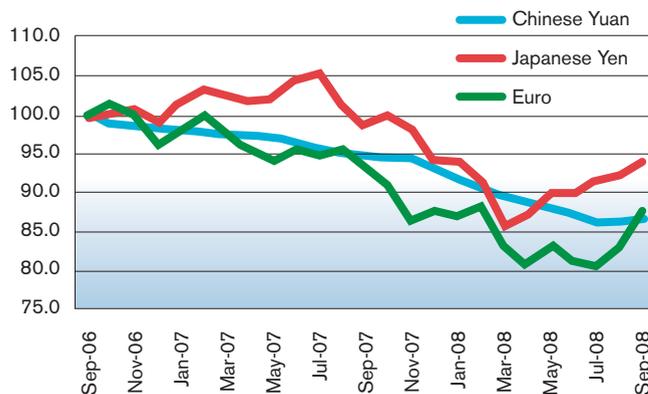
Some supply chain businesses will experience weakened demand as a result of traffic changes due to near-sourcing.

Crude Oil Prices Skyrocket (\$ Per Barrel)

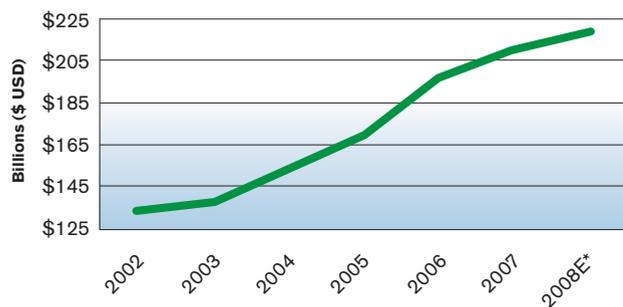


U.S. Currency Decline

(% Change from 2 Years Ago)



Imports from Mexico



Companies Dependent on One-Way Asia-U.S. Imports

West Coast import-based supply chain service providers are reporting a softening of the Asia-U.S. trade lane. As Mexican imports are strengthening, conversely Asian imports are softening. For instance, the Port of Long Beach is receiving fewer loaded containers. In its July 2008 monthly tonnage report, Long Beach reports an 18.1% decrease in loaded inbound containers to approx-

imately 272,000, down from approximately 332,000 over the prior year. For the three month period ending June 30, 2008, Expeditors reports that airfreight (tonnage) out of Asia decreased 4%. This was the first time that a negative industry airfreight tonnage was reported for the ex-Asia trade lane.

Long Haul Trucking

Long haul trucking has also suffered due to increasing energy costs. Pacer reported in its recent quarterly report that increasing fuel costs caused a \$3.4 million decline in income from its logistics segment, partly due to the effect of fuel costs on the Company's trucking units. Similarly, J.B. Hunt's DCI (trucking) Segment reported a 17% reduction in its second quarter of 2008. Both Pacer and J.B. Hunt's intermodal operations helped to offset declines in their trucking business. Overall, long haul trucking will continue to face pressure, due to expensive fuel and inexpensive rail among other factors.

Others

The dislocation brought about by near-sourcing may create other losers. For instance, smaller companies that are tied to the fates of less attractive markets may be unable to adapt as quickly. As near-sourcing causes international manufacturers to change locations, companies that lack a full global footprint may find their network value shrink precipitously. Freight forwarders that lack a complete set of locations in the U.S., Asia and Europe may be particularly vulnerable.

Options for Supply Chain Business Owners

Amidst the challenging market demands of near-sourcing, how should you respond?

Supply chain business owners have several options for growth amidst these major pressures.

First, smart leaders should consider adding services that respond to near-sourcing. Now is a great time for trucking and shipping companies to pursue opportunities in logistics. This move can enable asset-based firms to enjoy growth in asset-light segments. In addition, logistics services can provide some insulation from the fuel shocks and cyclical capacity problems that plague much of the asset-based markets. Lastly, logistics services can enable asset-based firms to increase touch points and cross-selling opportunities with both current and future customers. For example, the refrigerated trucking leader C.R. England pursued an acquisition strategy to gain access to non-asset transportation management and freight forwarding. By acquiring Trans-Man Logistics and Dynalink, C.R. England was able to capitalize on increasing U.S. exports and increasing domestic 3PL service demand.

Second, companies in the segments of warehousing and packaging can consider combining. This convergence play can allow firms to cross-sell their capabilities, and can also reduce transportation costs. In a high-fuel era, customers are increasingly interested in finding ways to cut transportation expenses. The mergers of firms like Wilpak-Jacobson and Power-Exel create opportunities to pursue network cost savings.

Third, supply chain firms can target customer segments that are poised to benefit from near-sourcing. Domestic raw materials and manufacturing, for instance, are likely to benefit. Logistics providers to these domestic industrial segments could be winners.

The bottom line is that near-sourcing will create major dislocations in the supply chain market. Some companies will make aggressive investments in growth. For instance, C.R. England's acquisitions have the potential to reshape their business. Conversely, many other

companies face the risk of rapid decline. After a growth period from 2002-2006, we are seeing a sudden reversal of fortune for many. Two thousand eight has brought the fastest rate of trucking bankruptcies in seven years. Will others succumb to the cataclysmic change brought about by near-sourcing?

In sum, we may be at the precipice of a new era. The cheap fuel and long supply chains of the past 20 years may be over. In its place, the winners and losers of near-sourcing are yet to emerge. In the 1970s, deregulation enabled a few companies to thrive (e.g. Schneider and J.B. Hunt), while putting thousands of truckers out of business. In the 1990s, the shift to outsourcing enabled a few more companies to enjoy success (e.g. CH Rob-

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inson and Expeditors), while squeezing many of the small Mom-and-Pop operators. In this new age of near-sourcing, who will become the defining leaders of this generation?

As fuel prices soar, supply chains shorten, and the landscape changes, what will you do? Are you the category leader in your field? More importantly, is what you do likely to be vital amidst the age of near-sourcing? What resources will you commit to ensure success? Are you a buyer or seller? Whatever your decisions, now is an ideal time to rethink your strategy. WT

Benjamin Gordon is founder and Managing Director of BG Strategic Advisors, www.BGSA.com, and can be reached at Ben@BGSA.com. Karen Rutt is an Associate for BG Strategic Advisors.

For reprints of this article, please contact Cindy Williams at williams@bnpmmedia.com or 610-436-4220 ext. 8516.