

This piece was published before the May 2007 rebranding of Mercer Management Consulting, Mercer Oliver Wyman, and Mercer Delta Consulting as **Oliver Wyman**.

Oliver Wyman

Oliver Wyman is building the leading global management consultancy, combining deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm works with clients across a range of industries to deliver sustained shareholder value growth. We help managers to anticipate changes in customer priorities and the competitive environment, and then design their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities.

www.oliverwyman.com



MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

Networks: the Key to European Logistics

By Mark Kadar and Alexander Neuhaus

The European logistics sector continues to see high growth, but its profit margins remain under pressure. A recent study by Mercer found that there is a strong correlation between the profitability of a logistics company and its business design: specialized contract logistics companies with sophisticated service offerings are proving to be far less successful than companies that add contract logistics as a sideline while focusing on enhancing their core network businesses.

Segmentation in the Logistics Market

This year the European logistics industry will generate roughly €600 billion (\$771 billion) in sales, with Germany accounting for about a quarter of the total. Over the last 5 years the industry has grown by about 8 percent per year, and globalization and EU expansion should ensure sustained growth in all segments of the logistics market. Profit margins, however, vary widely. The courier/express/package (CEP) market is dominated by four worldwide suppliers—UPS, FedEx, DHL/Deutsche Post and TNT—and the margins in this market are correspondingly large. In contrast, margins in the heavily fragmented freight logistics industry remain under heavy pressure.

During the stock market boom at the end of the 1990's, it was assumed that in the future the most successful logistics providers would sell only services (e.g., contract logistics) without investing in fixed assets. For the most part these assumptions have been proven wrong. Assets such as distribution centers, warehouses, and vehicle fleets still form the basis for a profitable logistics business. As a result, CEP companies are almost always more profitable than freight forwarders, which in turn trump straight contract logistics specialists.

The Continuing Success of Network Business Designs

In total, Mercer identified and evaluated six major business designs for logistics providers, as shown in Exhibit 1.

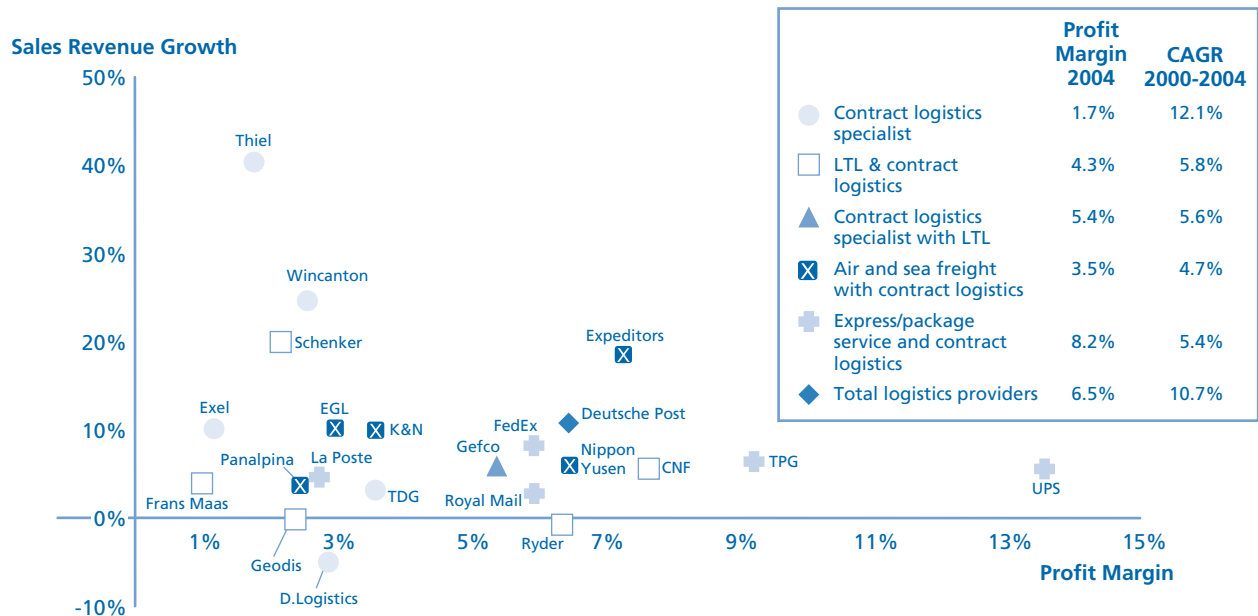
Exhibit 1 Six Major Business Designs in (Contract) Logistics

	1. Contract Logistics Specialist	2. LTL & Contract Logistics	3. Contract Logistics Specialist with LTL Services	4. Air/Sea Freight with Contract Logistics	5. Courier/Express/Package/Contract Logistics	6. Total Logistics Provider
Contract Logistics						
LTL Transport						
Air and Sea Transport						
Express Services						
Examples	<ul style="list-style-type: none"> • D. Logistics • Thiel Logistic • Exel 	<ul style="list-style-type: none"> • Con-way Incorporated • Geodis • Ryder System • Schenker Logistics 	<ul style="list-style-type: none"> • Dachser • GEFCO 	<ul style="list-style-type: none"> • EGL • Kuehne Nagel • NYK Logistics • Panalpina 	<ul style="list-style-type: none"> • FedEx • TNT • UPS 	<ul style="list-style-type: none"> • Deutsche Post World Net

■ = Core business ■ = Sideline in contract logistics

The most successful of these business designs in terms of profit margins have been the big CEP providers, which focus on optimal usage of assets and networks, and Deutsche Post, which alone in the European logistics space has control of the total logistics value chain (Exhibit 2). Contract logistics specialists with their own trucking networks, such as Dachser and Gefco, show good margins largely due to their specialized equipment and expertise in particular industries. Similarly, air and sea freight forwarders and road carriers, while under pressure due to intense competition, generate profits based largely on their own asset/network utilization.

Exhibit 2 Positioning of Logistics Companies
(profit margin 2004 and sales revenue growth 2000-2004 in %)



Source: Mercer analysis. Latest year data available.

Companies specializing in contract logistics are less successful than those that add contract logistics jobs to their existing core businesses primarily because these companies often focus on determining logistics needs on a project by project basis, rather than on optimizing the use of their own production systems. Contract logistics companies are thus unable to realize the economies of scale and density that are available to operators of large existing networks. In most cases, possible higher margins from providing contract logistic services cannot compensate for inefficiencies or gaps within the underlying network. A logistics network should exist wherever the customer needs it, but it must have the right scale, i.e., the volume it handles must cover the costs involved in organizing and maintaining it.

This does not necessarily imply that logistics companies with the biggest and densest networks will also have the best market opportunities. But leading network suppliers offer their customers only those contract logistics services that can be easily handled with their existing production networks.

Why Contract Logistics Fail to Deliver

The reason why utilization is so important is that most logistics customers are unwilling to pay higher prices for higher-quality services, such as customized

contract logistics “solutions.” Thus, the bedrock of every logistics calculation remains basic services such as forwarding and warehousing, which also make up a greater percentage of the overall business.

There are two major reasons why customers prefer to outsource only basic services: First, they keep their logistics expertise in-house, making risks easier to control and creating no new dependencies on contract logistics companies. Second, through the use of deliberately interchangeable tenders for individual services such as warehousing and transportation, they can take maximum advantage of competition to obtain lower prices.

Only one in ten companies requests more complex services such as customer management or order processing that require tighter dovetailing of business processes. These requests are often custom tailored and therefore it is difficult for a contract logistics provider to develop standardized solutions that would lower costs. Likewise, a focus on pricing and a lack of loyalty to any one supplier inhibits contract logistics companies from developing long-term relationships that could enhance profitability.

Generating Value in European Logistics

Customers do appear to expect more and more from their logistics suppliers in terms of value added services, but at the same time, Mercer has found that they are unwilling to pay significantly more for them. This is forcing all logistics companies to further enhance the utilization and cost efficiency of their production networks. The most successful companies likely will be those that standardize and optimize large networks over their customer base, whether by focusing on individual industries or a specific geography.

Large logistics companies with a broad customer base and the ability to make integrated offers can both lower their operating costs and increase their chances of being made “preferred suppliers” for key accounts. Schenker, for example, has discovered that every euro of sales revenue earned in “transport-related logistics”—i.e., acquisition, warehousing, or commissioning—is matched by a euro in freight forwarding.

As a rule, contract logistics will only pay off in combination with other logistics and transport business. Companies that specialize in contract logistics, such as Exel, continue to maintain sizeable activities in traditional freight management. The margin performance in Exel’s various business segments reveals that profit margins for contract logistics jobs have dropped continuously over the last few years and now approach those for LTL services. Much the same can be seen at TNT and UPS.

In summary, in the competitive and price-driven European market, contract logistics as a business design does not appear to be sufficient. To maintain profitability, logistics companies will need to focus on effective utilization of core production networks, expanding access to customers, and streamlining cost structures. Contract logistics can then be a profitable “add on” that takes advantage of a strong company’s inherent efficiencies.