AlixPartners
when it really matters

OCTOBER 2016

Ocean freight shippers need to think short term

Ocean freight rates on major trade lanes have declined to historical lows and are struggling to rebound from persistent overcapacity. After years of low revenue, carriers are now struggling, causing cost-cutting measures that have reduced their reliability. In that environment, savvy shippers (manufacturers and retailers) may not be able to operate as they have in the past, with long lead times and annual request-for-proposal (RFP) processes.

Instead, they will have to become far more flexible in procuring freight volume, relying on the spot market and in applying other, alternative strategies. Success in the new environment requires deep market intelligence and sophisticated forecasting, which in turn entail investing in the requisite people, processes, and tools needed to run supply chains with greater agility.

MARKET DYNAMICS UPEND THE STATUS QUO

Manufacturers and retailers (shippers) with meaningful ocean freight volumes tend to see their annual RFP processes as compulsory exercises. A recent study by *American Shipper* suggests that more than two-thirds of shippers still procure freight volume annually—as aligned to industry norms or their companies' fiscal calendars—whereas the remainder handle the process in a wide variety of ways with no specific preference. The RFP process has become so deeply rooted because it functioned well (or well enough) for many years. Shippers could obtain capacity, service-level guarantees, and favorable rate levels while protecting themselves from the volatility of spot markets. And carriers locked in volume commitments.[1]

[1] "Transportation Procurement Benchmark: Flat Market, Tactical Focus," *American Shipper*, August 2013, http://digital.americanshipper.com/i/145550-august-2013/7.

Today, however, things are changing. As overcapacity has led to steadily declining freight rates, carriers face unprecedented financial losses. One major carrier has already filed for bankruptcy, and the threat of a similar fate has pushed others into survival mode in a search to cut costs wherever possible, including using such tactics as blank sailings, skipped port calls, rotation changes, and even—in extreme cases—suspension of service due to solvency issues. BlueWater Reporting[2] estimates that nearly 600,000 20-foot-equivalent units (roughly 1.5%) of nominal capacity on major head-haul lanes originating in China were blanked in the first seven months of 2016. Those sudden changes, often with little or no advance notice, have created persistent disruptions for shippers, especially those that rely on a few high-volume lanes.

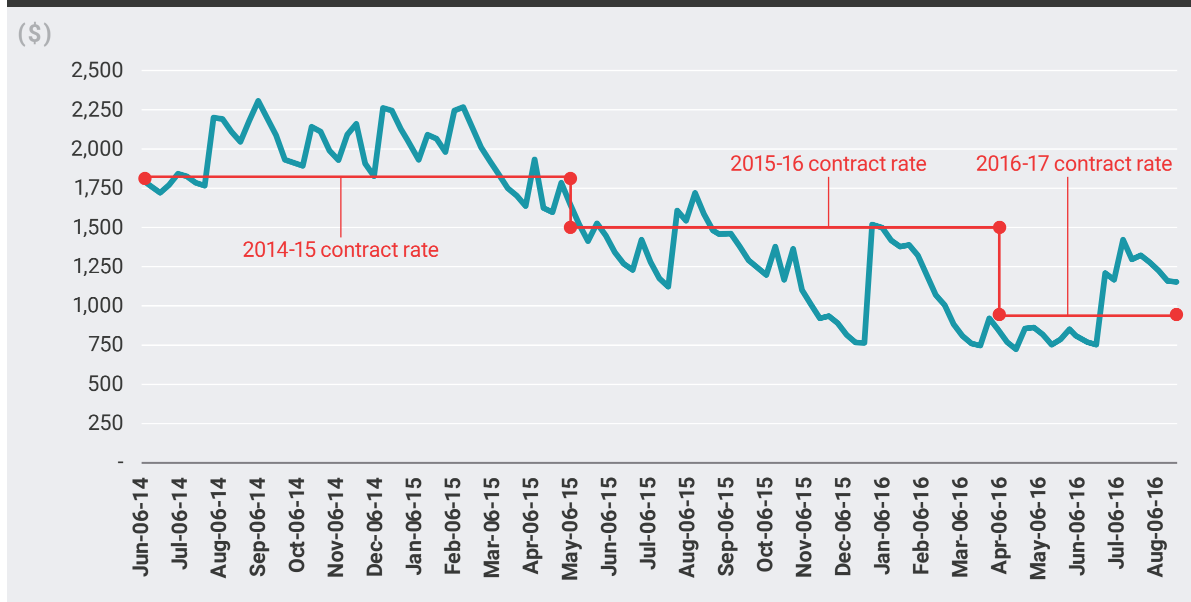
Recently, declining annual freight rates have been a boon for most shippers, enabling them to capture significant savings without active effort. Within a given year, shippers have left money on the table due to the nature of their contracts, but the savings have generally been significant enough to keep executive management content.

Contract freight rates continue to test historical lows, but shippers may struggle to deliver the same year-over-year savings that management has come to expect. Equally important, rates will eventually rebound as carriers consolidate, rationalize capacity, and, eventually, gain the market clout to increase rates. And service disruptions are becoming clear problems.

In this environment of unenforceable contracts and deteriorating service levels, shippers should consider new ocean- freight-handling approaches that will let them continue increasing their cost competitiveness—regardless of the rate environment—while maintaining adequate capacity and service levels. In fact, given the relationship between contract and spot rates, a smarter and more flexible procurement strategy could have led to even greater savings (figure 1). For example, if an importer had moved 15% of its volume through the spot market, it could have saved 1 to 4% of total ocean freight expense per year.

Already, new models are emerging that help shippers mitigate the uncertainty of ocean freight through the spot market. For example, new market exchange-type providers will soon let shippers book volume at an all-in rate—through contracts that are fully enforceable—with a bank as intermediary. These markets also let shippers resell their contracts—or portions of their contracts—to others. The result is a more dynamic and more reliable market that gives shippers greater flexibility to buy and sell volume without worrying about the enforceability of the underlying contract.

FIGURE 1: Contract rates compared to spot rates over the same period (2014 to 2016)



Source: Shanghai Containerized Freight Index, AlixPartners' benchmarks and analysis

Note: Data shows contract rates comparable to the US West Coast Shanghai Containerized Freight Index (SCFI) freight index pairing that are representative of a top 50 importer on the eastbound trans-Pacific lane.

[2] Analysis provided to AlixPartners by BlueWater Reporting.

WELL-INFORMED AND FLEXIBLE

To take advantage of the new procurement models, shippers have to become well-informed and flexible, as follows.

- **Well-informed:** Shippers should closely monitor spot markets and contract markets on their current and future trade lanes. This includes both (1) taking quantitative measures of market health obtained through data analysis and (2) holding qualitative discussions with key partners such as forwarders and carriers.
- **Flexible:** Shippers must reduce their levels of contract volume coverage to less than 100%. They also should consider alternative markets such as spot or forward markets to cover that freight when the timing is right.

Companies that take the necessary steps to become more informed and more flexible regarding ocean freight procurement will see clear benefits. Specifically: They may become more cost competitive regardless of the rate environment. They might get better access to reliable carrier capacity while becoming more agile by dealing with a wider range of carriers and services. And they may be able to maintain required service levels and avoid unexpected costs or last-minute disruptions caused by unexpected service reductions by cash-strapped carriers.

THREE SCENARIOS

Consider these brief illustrations of circumstances when a more-informed and more-flexible approach to ocean freight procurement could provide benefits. Ocean freight is of course a complex market, and this is an admittedly nonexhaustive list.

Scenario 1: Decreasing rate environment

In this situation, a shipper determines that spot market rates will likely decline below the shipper's contract rate levels in the coming weeks. In the old environment, the shipper could not capitalize because it all of its volume would be locked up through existing contract commitments with carriers. However, by contracting less than 100% of its volume—and maintaining connections to nonvessel operating common carriers—the shipper could capitalize on spot rate opportunities for the remainder. In addition, working with multiple carriers enables the shipper to mitigate the risk of declined capacity in case spot rates increase.

Scenario 2: Increasing rate environment

In this second situation, the shipper determines that contract rates will begin to rebound in the coming year. Minimum quantity commitments stipulated in existing service contracts might lock in low rates only until that threshold has been met. After that, carriers could impose market rates, leading to higher costs. However, our shipper can opportunistically tap alternative markets for capacity to cover specific segments of volumes or lanes at favorable rates. New models also enable the shipper to buy another shipper's excess—at a guaranteed rate and through an enforceable contract—and combine that with its own volume to capitalize on current spot rates before the rates rise.

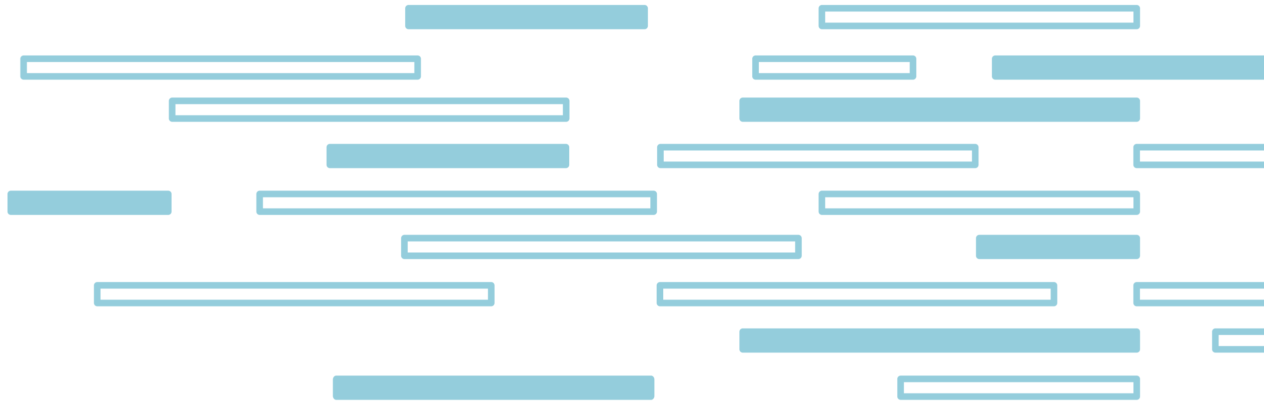
Scenario 3: Seasonal shipments

The third situation involves seasonal shipments. For example, the eastbound trans-Pacific procurement cycle is a one-size-fits-all process that caters to importers that are building inventory in advance of higher-volume shopping seasons. Because of the invariable volume, importers of seasonal products (such as outdoor furniture) purchase carrier services at a time that rates could be volatile because of uncertainty in market direction. However, by separating their seasonal volumes from their annual contract commitments, shippers could go to market during periods when rates are lower.

INVESTMENT REQUIRED

Shifting a portion of ocean freight to a more-flexible model is easier said than done, because for resource-strapped shippers, the traditional procurement cycle tends to take the path of least resistance. By contrast, the management of a variety of contract types, the spot market, and other evolving procurement methods require capabilities that most shippers do not have in-house. To break free of traditional procurement cycles, shippers must focus on enhancing their capabilities in three major areas: people, processes, and tools.

Regarding human capital, shippers should invest in their teams if they're going to capitalize on these opportunities. The ability to mix and match procurement methods so as to achieve the optimal result requires that shippers bolster this portion of their organizations with resources that are deeply knowledgeable about ocean freight markets and accountable for tracking the issues.



Second, shippers need a full understanding—and well in advance—of the freight they are taking to market. The areas include product and customer segmentation based on anticipated routes, shipment consistency, and service requirements. The degree of difficulty will vary widely from shipper to shipper in this category because some businesses are hard to forecast for a variety of reasons. Nonetheless and generally, shippers will have to invest to improve their forecasting capabilities.

Last, shippers need advanced tools to streamline the processes of soliciting and then executing on carrier bids. In particular, shippers should consider emerging platforms intended to reduce the uncertainty and risk inherent in spot markets. Tools that enable shippers and carriers to execute secured transactions and to open a secondary market for capacity commitments that cannot be met may offer shippers unique methods to act opportunistically without the myriad risks that have historically limited those strategies.

In sum, the uncertainty of global trade is an age-old problem, yet new models are emerging to help shippers mitigate that uncertainty. By investing in the right people, processes, and tools, shippers can capitalize on the new models. Specifically, tapping the spot markets opportunistically—through enforceable contracts and all-in rates—will give them better access to ocean freight volume at lower costs regardless of what the market holds. **A**

ABOUT THE AUTHORS

If you wish to contact the authors, please email Brian Nemeth, Henry Pringle, and Jim Blaeser.

ABOUT US

In today's fast paced global market timing is everything. You want to protect, grow or transform your business. To meet these challenges we offer clients small teams of highly qualified experts with profound sector and operational insight. Our clients include corporate boards and management, law firms, investment banks, investors and others who appreciate the candor, dedication, and transformative expertise of our teams. We will ensure insight drives action at that exact moment that is critical for success. When it really matters. alixpartners.com

The opinions expressed are those of the author and do not necessarily reflect the views of AlixPartners, LLP, its affiliates, or any of its or their respective professionals or clients. This article regarding Ocean freight shippers need to think short term ("Article") was prepared by AlixPartners, LLP ("AlixPartners") for general information and distribution on a strictly confidential and non-reliance basis. No one in possession of this Article may rely on any portion of this Article. This Article may be based, in whole or in part, on projections or forecasts of future events. A forecast, by its nature, is speculative and includes estimates and assumptions which may prove to be wrong. Actual results may, and frequently do, differ from those projected or forecast. The information in this Article reflects conditions and our views as of this date, all of which are subject to change. We undertake no obligation to update or provide any revisions to the Article. This article is the property of AlixPartners, and neither the article nor any of its contents may be copied, used, or distributed to any third party without the prior written consent of AlixPartners.