TEST TIME FOR LTL

MORE THAN SEVEN years ago, the bottom fell out of the freight industry, and numerous less-than-truckload carriers scrambled to protect their market share. The result was a segment-wide price war from which some carriers are still recovering. Since then, freight volumes have grown consistently, albeit slowly at times, and pricing has followed as carriers have focused strategies on bottom-line expansion.

During the last five years, LTL carriers have sought meaningful rate increases across their customer base, while investing in new technologies such as freight dimensioners and in-cab driver coaching tools to drive operating performance. But with LTL carriers facing the first industrywide volume decline in more than half a decade, will they remember what happened in 2009 and 2010, or will they decide to increase pallet counts at the expense of profits?

LTL market conditions are many times better than they were at the start of the Great Recession. Tonnage dropped by about 4 percent year-over-year at the end of 2015, far from the more than 10 percent decline at the end of 2008. Likewise, no large LTL carrier is teetering on the edge of financial collapse, so there's no motivation for strongly positioned LTL carriers to try to price a weaker competitor out of business.

But two major aspects that weren't present during the Great Recession could impact LTL carriers' future execution. One is the role third-party logistics providers and brokers play in LTL carrier dynamics. In 2008, 3PLs and brokers controlled about 12 percent of LTL carrier revenue, a figure they doubled to more than 25 percent in 2015. Carriers and shippers began flocking to third parties during the economic downturn, and 3PLs' and brokers' share of the LTL pie has expanded consistently since. Some LTL carriers now procure nearly half of their total revenue from this sales channel.

The prowess and success of these companies in securing LTL shipments was on full display in some brokers' recent quarterly results. C.H. Robinson expanded its LTL shipments organically by 17 percent in the fourth quarter of 2015, and Echo Global Logistics' volume grew 6 percent year-over-year. That stands in start contrast to the collective decline among LTL carriers.

A further reduction in demand this year will create an opportunity for 3PLs and brokers to leverage their control over freight volumes to play LTL carriers against each other in an attempt to extract rate concessions, resulting in a margin decline for less sophisticated carriers.

Another major factor at play is that XPO Logistics, a major 3PL, has added an asset-based LTL carrier to its portfolio. With the market watching to see if a non-asset-based company can operate an asset-based LTL operation profitably and avoid losing LTL revenue from its 3PL competitors, XPO is likely to focus on increasing profit over grabbing market share by lowering rates.

The company's recent decision to eliminate some unprofitable terminals, we hope, is driven by a mindset to focus on operating income over revenue. The market also is watching XPO's ability to cross-sell its broader portfolio of services and divert the more profitable LTL shipments of existing brokerage and warehousing customers toward its LTL carrier.

Despite the uncertainties shadowing the LTL market, some carriers have expanded their door count. The fixed capacity for the 25 largest LTL carriers, which account for more than 90 percent of market revenue, increased by a collective 2 percent last year, the fastest rate of growth since before 2008. If an increase in trucks and drivers accompanies the growth in fixed capacity, the industry will be challenged to maintain its single-digit operating margins.

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Fortunately for the industry, large LTL carriers that experienced extreme margin dilution during the previous downturn, including FedEx Freight, YRC Freight and XPO, have kept a lid on their capacity additions. Still, the majority of LTL carriers are experiencing a diminished return on assets because of less freight through their networks, leading to a decline in operating margins in the last quarter.

Surprisingly, even with loose capacity and the growing power of 3PLs and brokers over LTL carrier revenue, pricing has remained rational. Contractual rate increases are averaging 3 to 4 percent, in line with levels in 2013 and early 2014. With the decline in global GDP and a slowing U.S. economy, an overly optimistic outlook for the rest of 2016 will lead to excess capacity and destroy pricing discipline.

2016 is a test year for LTL carriers in how they react to reduced demand and the new aspects at play. Carriers should recall the difficulties in 2009-10, and that it took more than four years to regain lost profit. They must avoid price discounting to fill trucks with freight.

Failure to manage capacity during the down market will demolish the recent gains carriers have made toward improving their collective margin to 10 percent, a mark already achieved by other industry segments. JOC

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