



Managing Amidst the Market Meltdown: What Can Logistics Owners Do?

By Benjamin Gordon

Warren Buffett recently said, “You should be fearful when others are greedy, and greedy when others are fearful.” Amidst the turbulence of 2008, what should you do?

In many respects, 2008 has been the most tumultuous year since World War II. The financial markets plunged over 50%. The five largest investment banks at the beginning of the year all either went bankrupt, got sold, or got restructured as commercial banks. The trucking sector experienced record levels of bankruptcies, including the failures of top-100 companies such as Gainey Transportation. DHL announced plans to terminate their U.S. domestic parcel service. Meanwhile, the logistics market is in turmoil too.

In this article, I will address three topics:

- *What caused the current crisis?*
- *What are the implications for the logistics and supply chain sector?*
- *What are the options for supply chain owners?*

What Happened?

Overall, the 2008 financial crisis was fueled by an enormous asset bubble, spanning across all asset classes.

First, the U.S. real estate market is a key culprit. Many of us grew used to double-digit returns over the past decade. But in fact, long-run real estate data tells a different story. As the below chart indicates, housing values have bounced up and down, including a thirty-six year period (1906-1942) where housing declined nearly 50%. From 1890 to 1997, housing generated a return of less than 3%, in line with GDP growth. See the below chart, “Real Estate: the Baseline, 1890 to 1997.” In short, housing tripled in value from 1997 to 2006, but that period was an aberration.

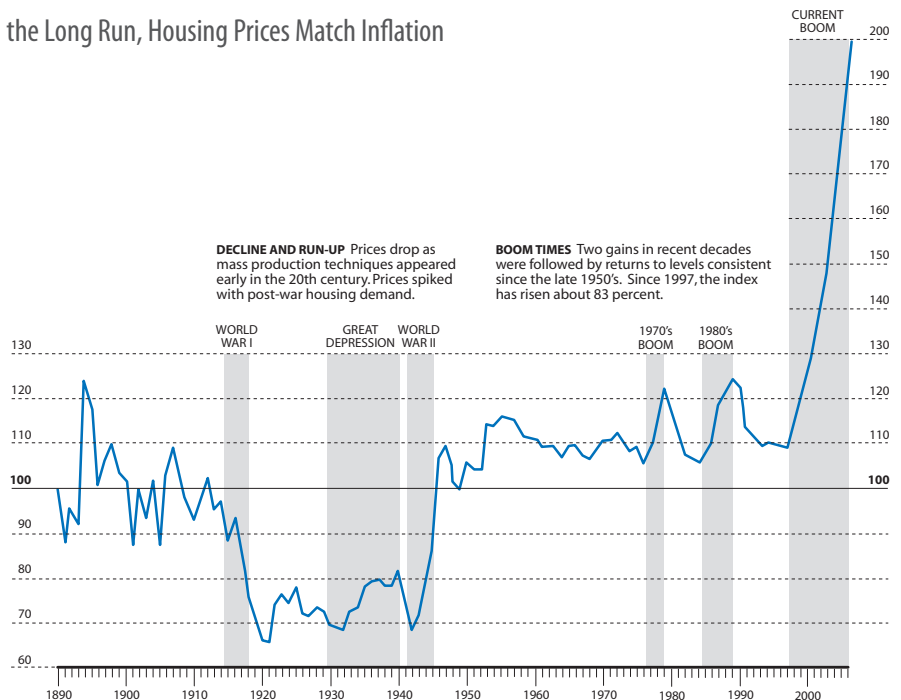
Second, the U.S. stock market also skyrocketed to levels in excess of their historical norms. Those who invested in the market enjoyed a 12% rate of return from 1982 through 2007. However, the long-run tells a different story. From 1900 through 1982, the

CHART 1 – Real Estate: The Baseline, 1890 to 1997 – In the Long Run, Housing Prices Match Inflation

A History of Home Values

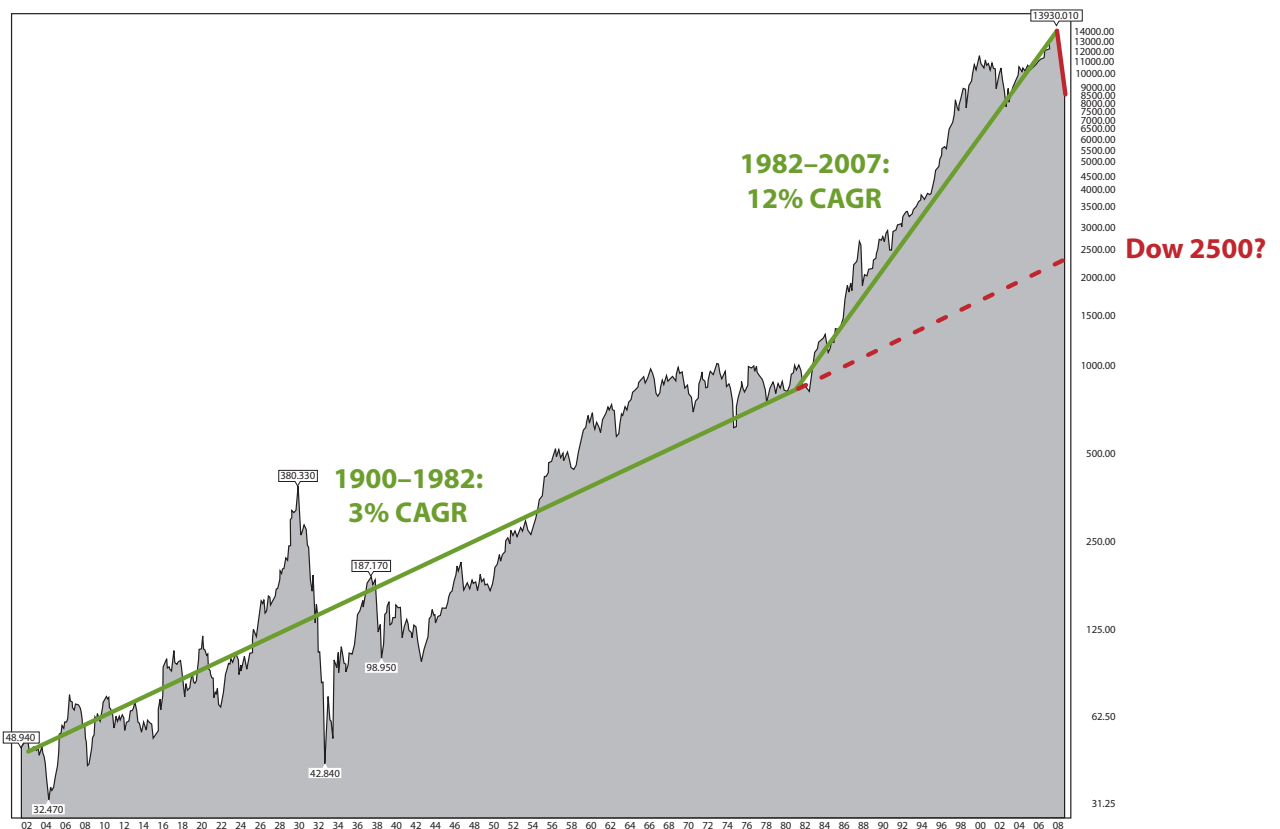
The Yale economist Robert J. Shiller created an index of American housing prices going back to 1890. It is based on sale prices of standard existing houses, not new construction, to track the value of housing as an investment over time. It presents housing values in consistent terms over 116 years, factoring out the effects of inflation.

The 1890 benchmark is 100 on the chart. If a standard house sold in 1890 for \$100,000 (inflation-adjusted to today’s dollars), an equivalent standard house would have sold for \$66,000 in 1920 (66 on the index scale) and \$199,000 in 2006 (199 on the index scale, or 99 percent higher than 1890).



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CHART 2 – The Stock Market: The Baseline, 1900 to the Present – Crash? Or Regression to the Mean?



Source: *StockChart.com*

Dow Jones Industrial Average generated a return of just 3%. See the above chart, “The Stock Market: the Baseline, 1900 to the present.” In truth, the historical returns of stocks, like real estate, are close to 3%, in line with the long-run growth in GDP.

What does this long-term analysis tell us? Since the real estate peak of 2006 and the stock market peak of 2007, we have experienced a drop of 25% and 50%, respectively. However, if we were to regress to the baseline rates of 3%, both markets could drop another 50% before reaching equilibrium!

Furthermore, these asset bubbles have been magnified by the ripple effects of derivatives (a \$60 trillion market), hedge funds (a \$2 trillion asset pool), and an increase in leverage ratios (from 10x to 30x debt-equity ratios for financial institutions). This accelerated the increase in asset values in the last decade. Conversely, like dominos, these forces are now accelerating the decrease in asset values today. As financial institutions cut their leverage ratios down from 30x back to 10x, “de-leveraging” will systematically remove capital from all sectors of the economy.

What are the Implications for Supply Chain Companies?

Amidst this market meltdown, logistics companies are not immune. For instance, for over two decades, the bellwether of the industry has been considered to be Expeditors. From 2000 to 2007, Expeditors maintained strong growth, and its stock market performance reflected its success with a 22% CAGR. However, in the last year, Expeditors’ stock has dropped more than 35%. Please see the following chart, “What does the Financial Crisis Mean for You?” In essence, the market anticipates deterioration in Expeditors’ future growth prospects. It is reasonable to assume that the market assumptions are similar for the entire logistics sector.

In sum, the last two decades represented a period of unprecedented value creation, but much of it was fueled by unsustainable assumptions. Growth, profitability, and valuations will all be tighter in the coming decade, as we wrestle with a return to sustainable value creation and accurate risk assessment. Operating performance will soften and valuations will continue to decline. As leverage becomes more expensive, the pool of domestic buyers and private equity buyers will become smaller, thus narrowing M&A exits. It is reasonable to temper expectations for the future logistics industry performance.

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What Can Supply Chain Owners Do?

Owners can prepare for several challenges. These include:

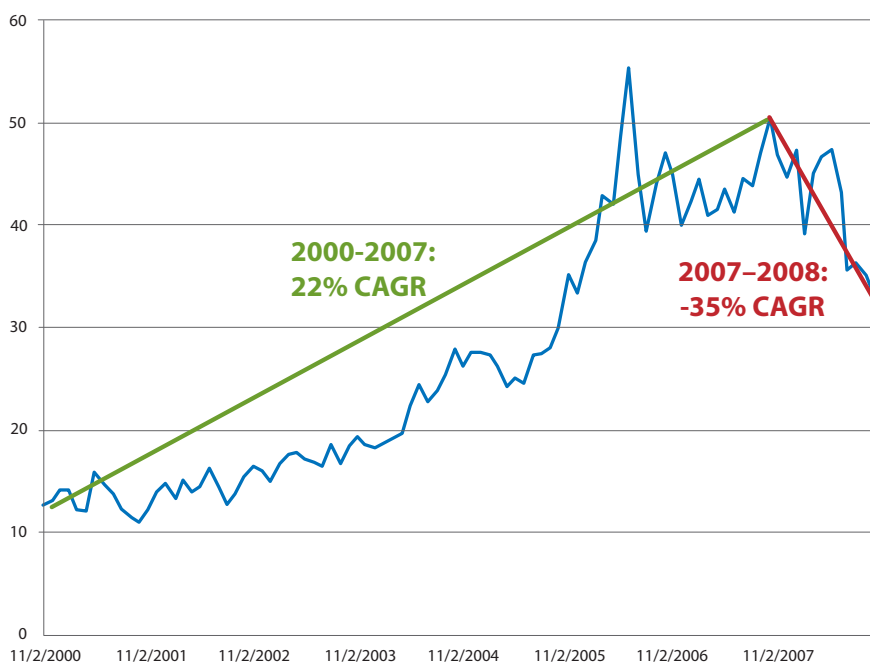
- *The emergence of global customers seeking to reduce the number of logistics suppliers they use (one-stop shops)*
- *The increase in market consolidation (market share controlled by the top 50 logistics players has increased from 20% in 1998 to 50% today)*
- *The emergence of sector specialists and formidable competitors in targeted niches of logistics (e.g. reverse logistics, high-tech solutions, and others)*
- *The disappearance of old profit pockets, such as real estate*

In addition, the political climate may only make matters more challenging. The advent of Card Check legislation facilitating union drives, pending tax hikes, a global consumer spending recession and resulting slowdown in all sectors, and the political trend towards re-regulation are all looming headwinds.

As a consequence, you have several options. You can choose to do nothing. You can cut costs and hunker down. You can pursue aggressive growth. Or you can take profits and/or cash out. On the one hand, now is a good time to think again of Warren Buffett's dictum. In a time of economic chaos, you can make aggressive bets on expansion and reap outstanding rewards. On the other hand, set against a long-term backdrop, now is still an attractive time to sell. Valuations have dropped below the peak levels of 2006-2007, but are still considerably higher than the historical baseline. At a time of increasing risk, more and more CEOs are choosing to explore all options.

In sum, now is a great time to study the financial markets, consider new threats, understand their linkage to your business, and take action.

CHART 3 – What Does the Financial Crisis Mean For You? – Logistics Companies are Not Immune: Expeditors Stock Performance



- *Valuations are plummeting*
- *Operating performance is softening – and not just with asset-based providers*
- *M&A exits are narrowing – no more private equity buyers, fewer domestic buyers, and no leverage*



Benjamin Gordon is founder and Managing Director of BG Strategic Advisors. BGSA is the leading strategy-led investment banking firm for the supply chain and logistics sector. For more information, please visit BGSA's website at www.BGSA.com, contact Managing Director Benjamin Gordon at Ben@BGSA.com, or call BGSA at (561) 932-1601.