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Creating value in transportation and logistics

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The "new normal" for the sector is tougher than for many other industries. Here's how transportation and logistics businesses can increase their economic profit.

To unlock growth and profitability in a challenging sector, transportation and logistics companies need to make bolder and more astute strategic choices than ever before. The sector's checkered history of value creation is counterbalanced by compelling lessons from successful players in a range of transportation and logistics industries, both pre- and post-crisis. For all of the upheaval facing the sector, a number of powerful megatrends will create unprecedented opportunities to enter new markets and redefine existing business models. The asset intensity and geographic breadth of transportation and logistics companies will reward granular fact-based decisions about the markets in which to play, city by city, route by route. This is an opportune moment for executives in the sector to challenge whether their strategy will meet and outperform market expectations.

We looked at the capital-market performance of 264 listed transportation and logistics companies from around the world over a period of ten years, examining the drivers of value creation, both before and after the economic crisis, across eight industries that comprise the sector: airline, bus, freight forwarding, postal/CEP (courier, express, and parcel), rail, shipping, trucking, and contract logistics. Our key findings were:

- *The through-cycle capital market performance of the transportation and logistics sector is below investors' requirements.* Over the last ten years, the companies in our sample have generated an average total return to shareholders (TRS) of 7.2 percent, a figure well below the sector's cost of capital (10.5 percent). Although the sample did produce average to above-average revenue growth at a compound annual growth rate of 3.6 percent, the sector's return on invested capital (ROIC) of 7.5 percent was lower than in most other sectors.

- *Even in the worst-performing industries, successful players provide valuable lessons for those seeking a pathway to economic profitability.* Overall, companies in the bottom 60 percent of the sample destroyed 3.5 times the economic profit created by the top 40 percent. All is not lost, however. Individual "winners" in each industry have been able to create value, typically by making bold strategic moves to boost margins and capital efficiency. An example here is the large new aircraft orders placed by easyJet and Ryanair in a saturated intra-European air transport market—a bet that has paid off. Both companies have delivered continuous value-creating growth through rigorous "clean sheet" cost control and an unmatched asset productivity, benefiting from large-order discounts and highest-in-class flight hours per day.

- *Improving ROIC is the key to overcoming investor skepticism about the sector and increasing valuations.* Market expectations for transportation and logistics are lower than for the S&P 500 Index on average. Although growth expectations are weak, a poor ROIC in particular drives valuation multiples of about 11 (versus 13.5 for the S&P 500). Transportation and logistics players cannot simply grow their way out of the situation—addressing comparatively low ROIC must be at the core of any value-creating strategy.

- *Winning strategies will make the most of seven megatrends that are shaping the transportation and logistics sector.* The emergence of more and more megacities and new regional pockets of growth will change the places where transportation and logistics companies can fuel their organic growth. Shared transportation and disruptive technology-related solutions will generate new competition, but also new markets. Companies will face the challenges of understanding how the digital revolution will affect their business and of mastering their own digital transformation. Technological progress will require companies to make conscious choices about their asset intensity and investment program to avoid the "asset trap." Rapidly changing regulatory and geopolitical environments will call for smart approaches to managing external relations in complex stakeholder landscapes. Finally, an increase in the volatility of demand and input factors will require greater strategic agility and flexibility than in the past.

Ingredients for value creation

To design and implement strategies to beat the market, senior executives of transportation and logistics businesses should ensure their strategies incorporate five imperatives:

Be agile in resource allocation. Companies that are better prepared to flexibly reallocate resources are more successful in generating a higher TRS. Nowhere is this more true than in the geographically diverse network industries of the transportation and logistics sector. In this largely asset-intensive business environment, huge strategic bets have to be made—and run the risk of even greater misallocations. Yet 90 percent of companies' allocation decisions are anchored on "last year, we . . ." approaches. Few transportation and logistics companies have been more agile in reallocation recently than Singapore Post—cutting capital expenditures for the traditional mail business and even divesting several printing and mailing businesses to allow for bold investments into the growing e-commerce logistics business, expanding coverage across Southeast Asia. Executives can unlock the benefits of agility by overcoming common barriers that hinder flexible resource reallocation—typically, a lack of intent, an inadequate process, and a lack of the right skills and mind-sets.

Resolve the asset dilemma. Our analysis suggests that the flexibility provided by financial leases rarely justifies the premium that asset-intensive companies pay for them, implying that many transport companies could outperform competitors by owning a larger part of their core fleet. A through-cycle procurement strategy is also required to overcome pro-cyclical asset purchases that create vicious cycles of capacity influx in times of lower demand. An understanding of the enormous efficiency gains in the newest equipment models helps avoid the "asset trap" (that is, sinking money into transport equipment or infrastructure that rapidly loses value and/or becomes obsolete). A shipping line has saved five percentage points on the costs of adding new asset capacity relative to competitors by consistently better timing its vessel purchases through the cycle for the last 15 years, thereby avoiding having to pay the substantial price premium that is charged during "order booms." Also, the first movers into innovative asset-pooling concepts, starting with aircraft-engine pools, have been rewarded with higher capital efficiency.

Make your digital transformation a success story. Almost every company is facing the pressure of digitally enabled change from customers, new competitors, and shareholders. Turning a potential threat into an opportunity will require each company to define a digital strategy tailored to its own value drivers, and to make its transformation a success on its own terms. Instead of just "adding" digital outside of existing structures, corporations can create much more value from digitization if they build on their existing assets and strengths (product portfolio and product-development team, existing customer relationships, company assets, and business-building approaches). For most companies, this will mean defining and executing objectives that digitize their core processes, reinforce the IT foundations of their business model, and stake a claim along new frontiers. The latter could reach from digital auxiliary products to partnering with digital giants to develop completely new solutions.

Develop programmatic M&A and cooperation capabilities. Transportation and logistics players have been active consolidators with a bias for using M&A as the predominant source of growth. The sector's current "firepower" (excess cash and debt-raising capacity) means that many companies stand to benefit from considering additional M&A opportunities. Instead of chasing "the one big deal," companies will need to develop a programmatic capability to identify, execute, and integrate attractive acquisition targets—just as many of the leading freight forwarding and contract logistics players have being doing since the year 2000. In addition, companies will need to continue to use alliances to access new markets and capabilities in a cost-effective way.

Manage for an uncertain world. Now more than ever, a market-beating strategy will often mean departing from a company's traditional markets and experience. Doing so prudently will require executives and boards to be explicit about building the assessment and management of risk and uncertainty into the strategy process. Among sources of uncertainty, changes in regulation can put substantial value at risk. Mitigating the negative impact of regulatory change, and capturing the opportunities it creates, requires a company to rigorously map its stakeholder landscape, engage stakeholders with the right mind-set and fact base, and build crack external affairs capabilities and resources. This will be particularly important for incumbents and entrants in the most regulated industries within T&L—postal services (under the universal service obligation) and passenger rail—but this is no less critical for carriers reliant on access to public transport infrastructure such as ports and airports.

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Blending these five strategic ingredients into a compelling strategy will require ambition to outperform the market, tailored analytics, granular understanding of individual markets, and flawless judgment. Executives who are able to combine these inputs will have mixed a potent cocktail that has every chance of beating the market. □

Download the full report on which this article is based, *Pathway to value creation*, on mckinsey.com.

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