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Profit Improvement – It’s Not Impossible

Introduction

The liner shipping industry experienced a dramatic turnaround in early 2001, when almost overnight, record profits became significant losses. Industry experts predict that the adverse conditions will continue through 2002 – and perhaps longer.

As liner shipping companies struggle for survival, profit improvement is paramount. Here, we will seek to analyze the ways in which liner shipping companies might improve their profitability. These initiatives are categorized into three broad approaches: cost reduction, revenue enhancement and structural change.

Cost Reduction

Many business executives feel that cost reduction is the key to profitability because a $1 expense reduction can reasonably be expected to become $1 profit, whereas a $1 revenue increase carries no such guarantee.

Know Your Costs

There is an old adage which says, “that you can’t manage what you can’t measure.” Today, many steamship lines still manage expense using traditional vessel and voyage accounting methods of cost “buckets” (i.e., how much money was spent on a specific function.) The solution to better management is not more cost codes. Companies need global access to cost information by individual customer transaction.

And not only must the costs be specific, they must also be accurate. Liner shipping is an asset intensive business characterized by vertical integration. Hence, calculation and allocation of its costs are often assigned somewhat arbitrarily. Part of this may be due to the fact that operating units do not carry a true cost of capital, which is managed at the parent level. In addition, liner operation may acquire vessel and/or terminal operating capacity from a related company.

Because most liner shipping companies are global multinationals, transfer costing is a common practice. Frequently, the transfer prices are established to minimize tax liability, or to make certain business segments appear more (or less) profitable. True costing must often overlook arbitrarily established transfer prices.
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Successful companies have by now implemented activity based costing (ABC), which identifies how activities generate costs, which then are transferred to products and customers. But ABC implementation is complex and most steamship lines lack the specific information required to manage profitability accurately.

Avoid Death by Average

Some of today’s steamship lines employ a system of averaging costs to determine shipment profitability. Twenty years ago, most manufacturing companies realized that traditional accounting systems were providing faulty cost information. By not identifying actual product cost, these systems failed business managers who were responsible for pricing a diverse product mix to various customers. The resulting accumulation of average costs perhaps hid real customer profitability – or lack thereof.

Some lines developed rudimentary NCTV (net contribution to vessel) programs, which can actually enhance problems. For instance, such programs use system average costs – rather than specific detailed ones. As a consequence, the line may retain more of the undesirable sectors of business, while better-informed competitors solicit the better pieces of business.

Average costs are also dangerous because their validity may vary by range or time. The result is that these average costs constantly lag real time. This can be disastrous in a time of cost validity. It is not unusual for specific vessel costs – the largest expense item for steamship lines – to experience seasonal [volume] cost fluctuations.

Optimize Combined Routing

Although liner shipping is an asset-based, network-operating business, most carriers do not optimize their use of the entire network for routing purposes. Optimization is usually limited to individual vessel strings. Lines seek to fill individual vessel strings. In reality, many shipping movements can involve more than one vessel string and/or inland movement.

The prejudice is usually towards direct vessel shipments over trans-shipments. This may -- or may not -- always be the best solution. Consider the following:

- If the customer requires extended free-time, it may be more efficient to store at an intermediate, trans-shipment point than at the final port of discharge.

- Inland transportation savings available by intermediate transshipment may be greater than the additional rework cost.

Operations research evaluates Kuhn-Tucker conditions. The fundamental issue is always whether a solution provides a local optimum or a global one. Combined routing should utilize these criteria.
Understand Equipment Cost of Ownership – and the Tradeoffs

Equipment often suffers sub-optimized decisions. Some of the more common reasons for this are included below.

- Equipment utilization is not thoroughly tracked. All loads are assumed to share the same turntime.
- Accessorial revenue is not associated with the customer transaction. It is not enough to say that long equipment turntime is bad. A customer that utilizes equipment for storage – but pays the demurrage or per diem – may be much more profitable than a customer that turns the equipment in a couple of days.
- Equipment repositioning expense often appears as a transportation linehaul expense, and is therefore not recognized as an equipment expense.
- Expenses associated with leasing equipment are often not specifically recognized. Conversely, cost reduction opportunities from leasing companies are not pursued because daily equipment rates for leasing may be higher – but cheaper than the actual, fully realized cost.
- Although shippers have routinely seen cost savings from transloading, carriers are still reluctant to pursue this arbitrage opportunity. The traditional excuse has been a fear of incurring freight claims, but as more lines begin managing cargo logistics, they will undoubtedly be less nervous about more complex moves.

The same equipment cost information issue that plague container moves, exists – perhaps doubly so -- for chassis and gen sets.

Purchase More Effectively

In today’s dire economic environment, many lines seek to save money by persuading vendors to lower costs. Towards this goal, strategies vary from outright demanding to pleading. One common scenario casts the vendor is a “partner” who should share in the customer’s pain. Vendors, who see this as just the latest in a long line of rate decreases, rarely offer relief. Additionally, vendors have hardened attitudes about the negotiation process and they refuse concession requests on the grounds that in current market conditions, any savings are granted will immediately revert to the line’s customer – forcing the lines to initiate a new series of cost savings. Despite this vicious circle, opportunities still exist for reducing the cost of purchased goods and services.

- Negotiations approached on a “win-win” basis, often reveal opportunities for expense reduction. Allowing the vendor to eliminate an unnecessary service or services (or kickbacks) can yield shared savings.
- Large transaction costs which can be eliminated still exist. Paper, faxes and extensive documentation (now virtually pointless) are still common and significantly drive up costs all around.
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- Lines can help in other ways, such as improving (i.e., shortening) payment terms. Creative methods of guaranteeing payment, extending their credit rating or insurance, offer possible incentives to vendors.

- Because of fuel surcharges on ocean freight, most lines feel that they have little exposure to bunker price fluctuation. This may be true, but fuel hedging could greatly reduce fuel expense.

**Revenue Enhancement**

Increasing the top line is still a valid goal, and revenue enhancement is possible through several courses of action.

**Price Specifically**

Common practice is for price to be determined by origin, destination and equipment. Level of service is usually not a factor. Ocean shipping is perhaps the only transportation mode where premium transit times are charged the same rate as slower services. One pricing paradigm needs to change.

Transit time should not, on its own, drive specific pricing. Many customers enforce unusual operating requirements, which translate into questionable discharge ports and inland transportation routing. These choices can even sometimes imply extended free-time and terminal handling. Sometimes, but not often, a customer will agree to pay the extra expense incurred by these demands. In such instances, pricing should recognize these additional costs. Of course the ability to price specifically is predicated on the ability to know, with accuracy, specific costs.

**Negotiate a Better Contract**

The process by which lines negotiate service contracts with customers has room for improvement. Sales personnel may have been assigned an unrealistic goal in terms of an expected price and volume commitment from the customer. Regardless of general market conditions, the sales person always faces a challenge because the customer knows there is additional currency which may be used to negotiate with the carrier.

All kinds of factors affect these dealings. Savvy sales people familiarize themselves with the corporate cultures with whom they work, as well as with the countries from which they come. The more the customer is known and understood, the better the probability a favorable deal will be made.

**Unbundle Surcharges**

Some steamship lines yearn for the days when conferences could set rates with impunity and enforce carrier discipline. Confidential contracting has made that impossible and even discussion agreements have been unable to retain any semblance of market price establishment.
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One exception exists. Discussion agreements have been able to establish surcharges that seem to have been universally accepted and remained diluted. Currency adjustment and bunker surcharges are longstanding price items. Terminal handling and delivery charges at origin and destination are also common in many trades. In recent years we have seen surcharges for: war risk, peak season, equipment imbalance, Canal use (Panama and Suez), documentation preparation and chassis use.

The result is a combination price that has uniform surcharges and widely disparate pricing for the ocean freight. There are many reasons for the success of surcharges. Part of the reason is that discreet pieces of the cost structure are broken out for inspection and assessment. Yet a great deal of their success is that the surcharge amounts are easy to assess and verify. Often, the customer paying the freight is not the party levied the surcharge, so they are willing to accept a surcharge -- paid by someone else -- in exchange for another benefit.

Reconsider Logistics

Many steamship lines have embarked on a revenue enhancement strategy centered around logistics. The plan seems to be based on the premise that ocean shipping is now a commodity, and that “value-added” services offer an opportunity to generate greater returns from a global office infrastructure which is already in place.

Such a strategy is risky. The margins in logistics have not been universally demonstrated to be high. Like all businesses, there are stories of success and of failures. Unlike liner shipping, logistics does not require “hard-asset” investments. It does, however, require significant information technology capability which exceeds the abilities of many hopeful participants.

Logistics requires a multicultural workforce that looks local and works global. This is not the case with many lines who continue to maintain a “head office” mentality throughout the world. Turnover of local workforce is an even bigger problem for logistics providers because intellectual capital is constantly depleted.

Finally, there are already several well-established logistics subsidiaries of major lines (i.e., Maersk and NOL/APL) and others are following their lead (i.e., OOCL and NYK.) Budding companies will find that the only way to capture market share will be to cut price – setting off the vicious circle they sought originally to avoid.

Structural Change

The final category of profit improvement is that of structural change. Initiatives of this kind usually take the form of fairly significant changes in the method of conducting business, and they can impact both cost reduction and revenue enhancement. In many cases, the issue comes down to one of value – and whether or not it is being received. Rather than seeking profit optimization, a line usually is attempting either to minimize expense or to maximize revenue.
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**Leverage Information Technology**

Any number of technology solutions could benefit today’s steamship lines. Unfortunately, the ocean shipping industry has not experienced real technology success. Steamship lines tend to fall into one of two categories. There are first lines which utilize legacy systems. These are probably mainframe-based and over 20 years old at their core. For years, they probably defined the standard for EDP support. They are challenged by high maintenance expense and major migration efforts. Then there are lines with little in the way of technology. They may have undertaken major effort(s) to modernize, only to abandon the effort after spending a small fortune. In both cases, businesses are attempting to upgrade without “betting the company.” This is very difficult because funds available for investment are limited.

The problems start with management. Most senior management in the shipping business came of age before the introduction of widespread computer use. They remember obsolete equipment and procedures. They may be online with electronic mail, but they are unprepared for the radically changed business and technology realities. Methods of performing tasks – as well as the very tasks themselves – have all changed. Management may fail to recognize that the scope and scale of transaction volume alone makes using yesterday’s practices disastrous. An oversimplified business view will doubtless lead to unrealistic expectations. And when these goals are not met, the disappointment in understandably mixed with confusion and frustration.

The development of industry portals may be the catalyst that finally enables some steamship lines to harness technology. The portals provide critical mass for solutions, appropriate technology and the human resources necessary to support solutions.

**Understand Customer Service**

Many ocean carriers have a difficult time understanding the role of customer service in their overall profitability. Reasons for this are fairly complex.

- Many lines cannot measure service delivery on a global basis. (In most cases this is an information technology shortcoming.) Service measurements are limited to vessels – rather than individual shipments.

- The customer service support function is often viewed as a cost center. To reduce costs, some lines have cut salaries and benefits by moving to low cost areas – and thereby sacrificing accumulated, or institutional knowledge. Customer disruption and/or loss are factored as a cost of doing business.

- The value of a retained customer is many times that of acquiring a replacement account, still some lines behave as if customers will be easily replaced – or appeased by further rate cuts.

- In an industry where tradition sometimes impedes development, some lines may offer the best service to the least profitable customers for reasons of tradition or past personal relationships.
Solutions -- better technology such as yield management or customer relationship management software – exist, but they ultimately require management and leadership which may or may not be stymied by organizational obstacles.

Rethink the Organization
Steamship agency is as old as shipping. Traditionally, shipping companies maintained a series of relationships with general agents worldwide. General agents managed a range of matters for the line (the “principal”) including sales (customer solicitation, advertising and customer service) and traditional traffic functions (vessel husbanding, booking, documentation, inland movement, freight cashiering and line accounting). As lines grew, they increasingly discarded agents who represented multiple lines in favor of their own agency.

A paradigm shift may be imminent, whereby steamship lines become willing to outsource operational support while retaining commercial control. Steamship lines must concentrate on their commercial relationships. Sales, booking, customer service and documentation are all functions close to the customer that carriers could retain. A few offices can manage this. On the other hand, operational support has become commoditized and is often considered too expensive.

Consider Vertical Dis-Integration
The advent of container shipping was one of vertical integration. Carriers were forced to invest in vessels and containers to provide basic service. Steamship lines marketed their own vessels, terminals and containers. Asset ownership became crucial to the customer. Today’s customer is asset-blind. With the onset of alliances, asset ownership became completely muddled. (e.g., Steamship Line #1 is selling a service that will move on the vessel of Steamship Line #2 and through the terminal of Steamship Line #3.) This does not concern today’s customer, who cares much more about economics and time-definite delivery.

In the past, owned-terminals were a source of “profit” for steamship lines. Not only would the line who owned the terminal use it, but so would lines without their own terminals – and for exorbitant rates. Today, so much terminal capacity exists that it is common for an outsider to pay less than the line who owns it. Often, the outsider will also receive preferential berthing over the owning line. Why would a line pay more -- and receive less value -- to use an asset they own? Most likely the line may not know. Terminals may go to great lengths to prevent the line from being fully apprised of cost details. Pricing is even used by some terminals as a subterfuge.

Vertical disintegration is common when asset-based, network-operating industries enter deregulation and other tumultuous times. The rise of global terminal operating companies also reflects an industry change. Many lines may find that they can reduce operating costs, eliminate balance sheet debt and realize significant cash by selling their terminal subsidiaries. The same may be true of other subsidiaries which perform related functions.
Leverage Alliances

In the past 10-15 years, liner carriers have migrated from space charters to vessel sharing agreements -- to strategic alliances. These alliances have enabled lines to enjoy economies of scale, scope and density. They have also supported the introduction of unprecedented vessel capacity.

Yet most of the alliances seem focused on maximizing vessel utilization. (Alliances have also proven useful in withdrawing some excess capacity.) Improvement in other asset categories has been minimal, as most alliance partners share the same traffic flows and peak volumes.

Steamship alliances are an example of “coopetition” – cooperation among competitors. For these alliances to succeed social issues (such as trust and shared values) sometimes matter more than the mere physical assets. Some liner shipping companies strive to achieve a real harmony while others just rely on each other to fill space on their own ships.

Steamship lines are now considering other brands of alliances. The development of Internet portals is one example of an alliance formed to solve information technology shortcomings. Liner shipping industry currently offers three portal initiatives: Inttra, GT Nexus and Cargosmart. These three portals experience overlapping participation and different business models, but they do share certain features.

- Common eCommerce requirements are funded collectively, rather than by individual participants.
- While each is developing revenue sources, they all began as expense reduction vehicles.
- They all seek to provide a single visibility point to customers using multiple carriers.
- Their business requirements complement the demands of the marketplace.
- All recognize the boundaries of their individual modes of transportation are unclear – and they seek inclusiveness of necessary related players.

The portal founders believe that their best option was to bring the laggards up to speed. Carriers could achieve cost savings and customer electronic integration with a portal (or two) that was easier than EDI with multiple carriers -- and the carriers could own and control the portals.

Perhaps the greatest challenge is figuring out how to develop commercial alliances. We may also see yet a new type of provider. Today we have vessel operating carriers (VOCs) and non-vessel operating common carriers (NVOCCs.) VOCs serve a market with their own vessels and those of their alliance partners. NVOCCs buy space from
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VOCs and resell to their own customers. Technically, a company can be a VOC with a single vessel, and (in some cases) that vessel may even be in another trade.

We may start to see NVOCCs or associations acquiring single vessels in order to be considered VOCs. Such a move will allow them to charter space directly from the line or alliance, and would complete the transition from customer to partner.

Consider Merger

Ultimately, carriers may find that the only remedy left for profit improvement is to merge. Merger activities are the result of global economic forces. Carriers seek increased economies of scale and scope -- the former allowing for lower unit costs and the latter enabling fulfillment of all customer requirements. The appeal of mergers is their ability to achieve favorable economies without adding extra capacity to the market (which would cause severe rate deterioration.)

Carrier consolidation could lead to a handful of global companies with sufficient market clout to control prices. Shippers fear this while carriers hope for it. It is unclear whether a given line would retain all of the business of the predecessors -- customers may wish to allocate business between a group of carriers. But with the demise of the conference system, it is easier for merged lines to retain business. The customer can always protect himself with suitable contract guarantees of service.

Mergers reduce expense. Headcount and administration costs can be lowered. Structural expenses that defied resolution with alliances -- such as multiple marine terminals -- can also be addressed. The Maersk acquisition of Sea-Land provides a textbook case for this. The two companies had a model alliance. There were only two parties, who were closely integrated for over ten years, yet they could only address and resolve structural issues after their merger.

Mergers will undoubtedly accompany other financial restructuring as our industry goes through the current cycle of financial trauma. But a great many opportunities for profit improvement still exist short of that.