

July 2009

Delivering the goods: Keep your eyes on the road

A self-made man in his 50s, "Mick" walks the loading bay wondering where it all went wrong. Two years ago, with the economy humming and demand for steel driving the growth of his business, this place was a hive of activity. Now, with those lucrative steel deliveries down by 50%, there are 20 almost-new prime movers parked around the edges of the loading bay gathering dust.

For every minute they sit idle they are costing Mick money. But there is not enough work to keep the wheels rolling. He can't afford the cost of insurance and registration and the trucks are worth less than the debt. The company's financial situation is so dire Mick can't afford to lay off people – it is more cost effective to keep them idle than pay the redundancy entitlements that would allow him to implement the corporate restructure the business desperately needs.

For Mick and plenty of other self-made transport specialists like him, the downturn has taught a particularly tough lesson. Overgearing and rapid expansion has left operators particularly exposed to the impacts of economic decline. For some businesses it will literally be the end of the road.



In this issue of Ferriers Focus we examine the road transport industry, identifying the boom-time traps that have undone many medium-sized transport specialists. In particular, we highlight the lessons Ferrier Hodgson has learned through exposure to struggling transport businesses and identify the characteristics common to those businesses that are continuing to prosper in the current climate.

So, how bad is the current climate? Road transport is taking a battering. An Australian Trucking Association survey of 140 road transport operators earlier this year found 62 per cent had recorded negative or no growth in the previous six months and the same number anticipated negative or no growth in the coming six months.

At the Port of Melbourne alone there has been a 16% reduction in activity and IBISWorld holds expectations of a 6.6% decline in road freight

revenues in FY08/09. Industry averages suggest increasingly fragile revenues flowing from reduced activity and declining freight rates.

Over the past 12 months, the sector has seen the collapse of many well known and respected operators, such as GR George, McArthur Express, Frank Marchetti & Sons, Wakefield Transport Group and Pure Logistics. Key road transport equipment manufacturers Kenworth and MaxiTRANS have cut production and staff: Kenworth retrenched 80 of its 1,100 strong workforce last August and MaxiTRANS cut 54 of its 380 workers in March.

Yes, conditions are tough, but there are still transport businesses making money. Toll, Linfox and K&S, the largest operators, are obvious examples. Those companies continuing to thrive appear to have one common characteristic: throughout the boom times they continued to think and behave strategically, even conservatively.

In our experience, booming economic climates often have the dangerous effect of disguising poor business decisions. Businesses continue to thrive despite significant strategic errors and poor management because of the size of productivity or sales increases. But now that there has been a rapid severe economic downturn, those poor strategic decisions are being unmasked and businesses are paying for their mistakes.

Another differentiating characteristic between those that are struggling and those that are motoring along is the ability of a business to embrace change. When the chill winds of an economic downturn blow, it is those businesses that lack the ability to adapt to changing business conditions that will be the first to feel the pinch.

Staring down the road to success, there are three key rules we have identified that will help road transport operators remain flexible:

1 Don't be overexposed to any one industry

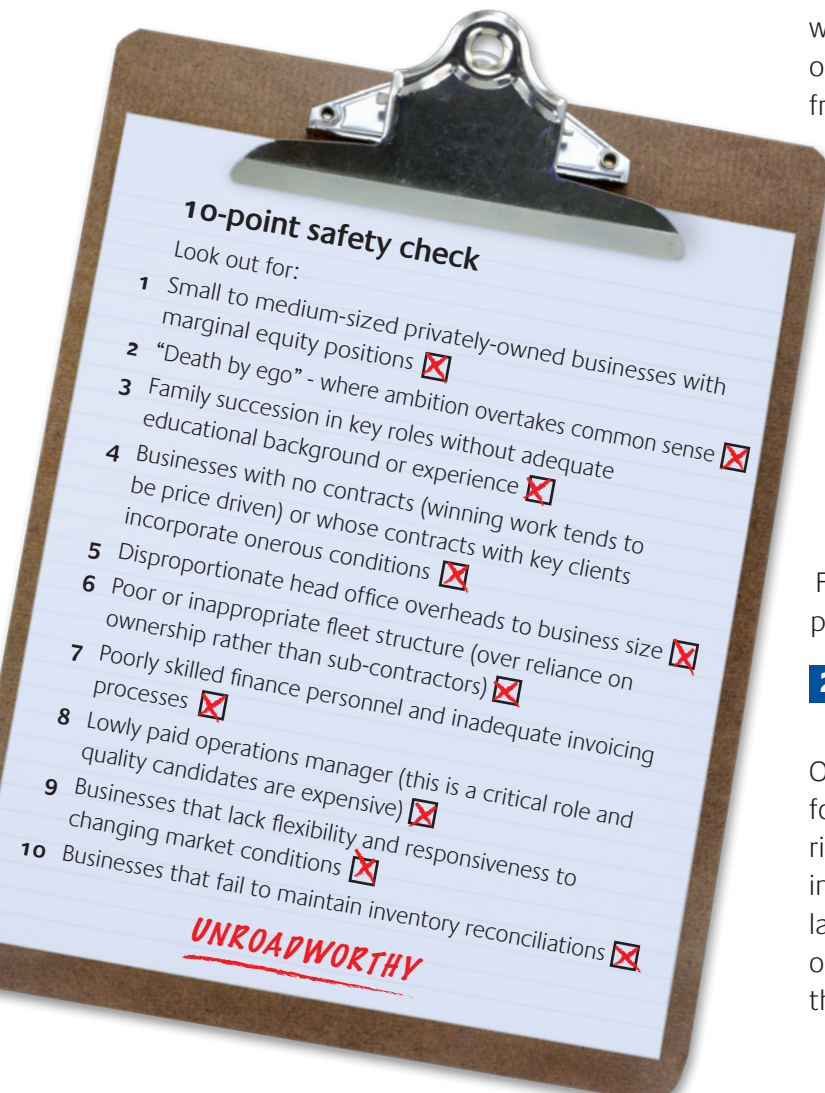
Any operator fixed to a specific industry base for the majority of its income is susceptible to a decline in that industry, particularly where specialised assets are involved. Take the case of specialist container transporters – particularly skel trailers, single-purpose shipping container trailers that cannot be utilised for any other tasks. An operator specialising exclusively in container transport lacks the flexibility to shift focus to other transport opportunities. The option of sub-contracting idle prime movers is unlikely to provide a big enough buffer to balance a significant downturn in revenue.

We have seen several examples of road freight operators with customer books heavily biased towards the resources sector which are now experiencing downturns in turnover of 40% to 50%. Regardless of managerial strength, any business subject to turnover decline of this scale will have difficulty coping with the management of ongoing debt commitments: even relatively debt-free businesses will struggle to meet daily wages, fuel and maintenance commitments. The industry average EBIT of 5–6% provides little protection against a 50% decline in revenue.

Don't misunderstand the message here: a niche or specialisation can be a good differentiator, but only when the business is not cyclical. A business locked into one tightly focused sector is in dire straits if that sector declines. Any management team seeking a niche position needs to ensure that the niche has relevance in good and bad economic climates. Failing that, management had better be good at putting money aside for a rainy day!

2 Resist the temptation to expand into third party logistics (3PL)

Over the past decade there has been a tendency for larger road transport operators to hedge their risk in pure road transport operations by diversifying into full warehousing and distribution facilities. The largest industry operators recognised the benefits of this strategy decades ago and have strengthened their businesses enormously as a consequence.



However, warehousing and distribution centres today actually operate on lower EBITs than most straight trucking operations. While large facilities with contracted revenues of greater than \$10 million per customer enjoy EBITs of 7 or 8% of revenue, normal EBIT for a small to medium-sized distribution facility is just 3 to 4%. As this has dawned on new entrants, overcapacity has emerged as a major problem. The newspapers are filled with evidence: advertisements for sub-let opportunities in warehouses and container storage yards. A warehouse with 3% EBIT when full is a disaster when empty. Finding a sub-tenant in the current economy is mission impossible. Now is not the time to be expanding into 3PL.

3 Critically examine the fleet structure

Just two years ago, Australia was experiencing a strong economic boom, fuelled by low interest rates and easy finance. This was a big temptation to some operators, like Mick, who took the opportunity

to upgrade their fleets. They now find their fleet is chronically under utilised and lacking equity.

Amongst Mick's idle fleet are 20 near-new trucks he is simply unable to sell. Auctioneers have told him about the sharp increase in trucks and trailers for sale – many from receivers or administrators acting on behalf of the financiers of failed businesses. Their values have plummeted – down 30% over 12 months on a like-for-like basis. The auctioneers tell Mick real values are likely to be considerably worse if all the idle assets find their way onto the market.

Across the industry it is generally accepted that the values of road transport assets are down 30-40% over the past nine months. Values are projected to deteriorate further as more trucking operators go to the wall and used assets flood the market. New assets are being substantially discounted as manufacturers and retailers try to clear excess stock.

Many of the operators thriving in the current climate have made a conscious decision not to acquire new trucking assets. Indeed, some have started expanding their use of tow operators. Tow operators are sub contractors who provide their own prime movers and tow the trucking company's trailer on its behalf. This allows companies to respond quickly to changing workloads by simply cutting the number of tow operators without penalty.

This tactic protects businesses from redundancy costs and the dangers of low or negative equity. It is an excellent strategy for ensuring flexibility in a rapidly changing business environment.

Credit handbrake

In the aftermath of the global financial crisis, one of the key issues facing road transport operators is the shortage of credit. MaxiTRANS Managing Director Michael Brockhoff said the lack of access to credit had limited the ability of trucking companies to benefit from the Federal Government's stimulus package.



"The 30 per cent investment allowance has created an upsurge of interest in buying new equipment, but many trucking companies are having trouble getting credit to turn their interest into sales," Mr Brockhoff said.

Roland Hollingsworth is the Managing Director of Paccar Financial, the finance arm of Paccar Australia, which has been designing and building Kenworth trucks in Melbourne for 40 years. He told the Australian Trucking Association: "We have applauded the Government's investment allowance stimulus, but are mindful that it can only advantage companies that can access funding to purchase new equipment."

The ATA's survey of transport industry operators in April found that 38 per cent of operators had found it harder to secure finance in the previous six months and 67 per cent expected it to get harder to obtain finance in the coming six months.

What we expect to see

Closer lender scrutiny

Most lenders are acutely aware of the risks facing the transport industry – after all, they are frequently the biggest stakeholders. Many lenders will place the microscope over transport operators who are not performing by seeking out independent investigative accountant reviews to find out what is really going on – and whether the business can be restructured to protect its future viability.

Some operators will be incapable of restructure and increased numbers of corporate failures in the road transport industry are inevitable. Those most at risk are heavily exposed to the resources and construction sectors and have large company-owned fleets of relatively new vehicles subject to finance and with rapidly eroding equity.

Increasing ATO debts

We expect to see struggling operators utilising “passive” creditors to manage their cashflow. In particular, and consistent with common practice, there is likely to be a substantial rise in tax-related debts. We have seen businesses avoid their tax obligations for more than 12 months, and with recent suggestions in the media that the ATO may adopt a softer approach to outstanding business-related tax debts, this is likely to increase.

Consolidation

Industry consolidation has been commonplace for many years. With the exit of some private equity players, we expect a number of business acquisitions and a further concentration into the hands of the dominant industry players. Watch operators such as Toll, Linfox, Scotts and K&S scouting the market to identify opportunities to pick up strategic assets at attractive prices. Players of this scale are not hamstrung by an inability to raise debt or equity and can quickly take advantage of emerging opportunities.

Conclusion

While there is no doubt the road transport industry is finding it tough at the moment, there are simple steps that can be taken to minimise the risks. The most important one is to review your exposure to the transport industry and ensure you are seeing regular and accurate business data from a well-maintained MIS (ensure no serious tax arrears, inventory reconciliations are current and that security documentation is tight). Awareness is the most important and differentiating characteristic in this business. Reading this article was a good first step. Acting on it should be the second.



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