cutting through complexity

KPMG Transport Tracker

Global Transport Market Trends and Views

November 2014

kpmg.com

Contents

We are delighted to present the third edition of the KPMG Transport Tracker, our regular publication looking at the latest market indicators and trends in the global transport market.

Introduction

In this third edition we focus on the continued uncertainty in the global aviation, shipping and logistics markets at the end of Q3 2014.

Our analysis shows that transport sub-sectors reveal mixed pictures of the global economy:

→ World trade growth, as well as business and consumer confidence has slowed down to a certain degree in Q3, negatively affecting share prices of transport companies which are very sensitive to economic development. At the same time, declining fuel and oil prices are a positive sign for most transport & logistics players as they result in easing cost pressures for the operators.

→ In aviation, the market continues to show strong growth in both the passenger and freight segment. However, freight growth in Europe has turned negative in September, with certain short term risk factors putting pressure on airlines globally.

→ In shipping, the picture remains unchanged with slow demand growth and existing overcapacities. Parcel and express logistics continues to grow on rising e-commerce and yet some worrisome signs are visible in Q3. As the peak season for home deliveries is about to start shortly, logistics companies are trying to find the right operating model required to be successful in this growing, but challenging market

As always, we would be pleased to discuss the results of our analysis with you.

Dr Steffen Wagner
Global Chair, Transport

Dr Steffen Wagner
Global Chair,Transport

“The peak season for home deliveries is about to start shortly and logistics companies are trying to find the right operating model required to be successful in this growing, but challenging market.”

Market Fundamentals

Transport: still a lead indicator of the economy?

We are currently experiencing geopolitical risks and turbulence in a number of different regions across the globe that could hamper growth opportunities for transport companies. Some global transport operators have also recently issued growth and profit warnings.

However, looking at the transport market fundamentals in the third quarter of 2014, it is hard to identify a clear indicator of an upcoming downturn. Global PMIs are still positive with values above 50 indicating growth in all regions and yet, a decline is visible over the last three months of the third quarter. The Eurozone PMI, in particular, is only slightly above 50 and on a downward trend for manufacturing activity, showing how fragile the economic recovery in the Eurozone still is. News on tumbling factory orders and declining industrial production and exports in Germany added to the economic worries. The PMI in China remains positive, yet at a low level, showing how the country is struggling to keep its economy and industrial production growing at past growth rates. However, China's exports rose more than expected in September while imports improved unexpectedly according to a Bloomberg survey(1).

World trade growth averaged 2.6 percent for the first eight months of 2014 according to the CPB World Trade Monitor which is below long run but still clearly positive. Interestingly, industrial production is growing at a stronger pace than trade which points to shorter supply chains as compared to pre-crisis levels, due to increasing re- and near-shoring of productions. In addition, the updated GDP forecast from the International Monetary Fund (IMF) has been revised downwards by 0.1 and 0.2 for 2014 and 2015 respectively to reach 3.3 percent and 3.8 percent.

Share prices of transport companies have also been trading downwards over the last few weeks of the third quarter with public transport operators being the only exception, benefitting from a business model that is less affected by economic downturns. Shipping companies are the clear underperformer on the capital markets over the last twelve months, ending up at -8 percent compared to the prior year. The freight forwarding and logistics peer group managed the best performance over the last twelve months which would rebut the presumption of a recession (listed companies in this subsector have historically been viewed as a good indicator of upcoming economic development). On a similar note, air and ocean freight are expected to see good trade volume growth through the third and fourth quarters of 2014 according to Stifel Logistics Confidence Index(2). Expectations in September rose in both air and ocean freight with the combined index for sea and air freight above the 50 percent mark for 20 straight months.

Fuel and oil prices are showing a clear decline since mid June 2014, ending up 10 percent below the prior year thus easing the cost pressure faced by carriers and forwarding companies.

Share prices:

Freight forwarding and logistics **14%**

Transport infrastructure **8%**

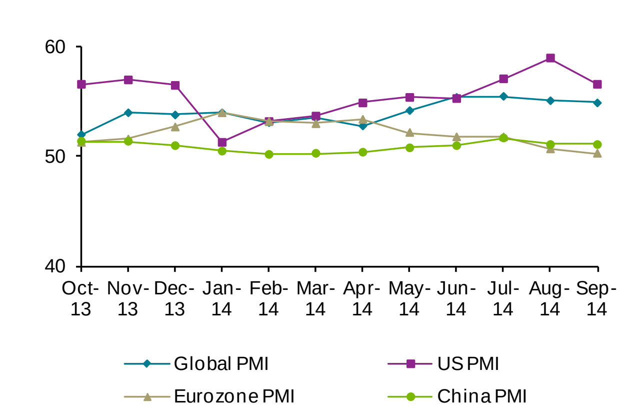
Airlines **12%**

Public transport **9%**

Shipping **-8%**

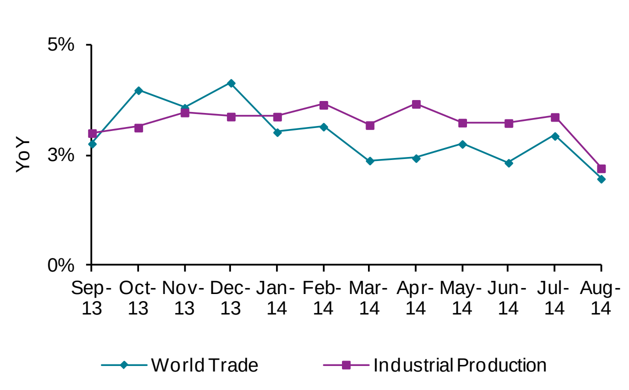
1. http://www.reuters.com/article/2014/10/13/china-economy-exports-idUSZZN07A90120141013
2. http://www.joc.com/international-logistics/stifel-growth-air-sea-shipments-expected-second-half_20140922.html

Global Purchasing Manager Indices (PMI)



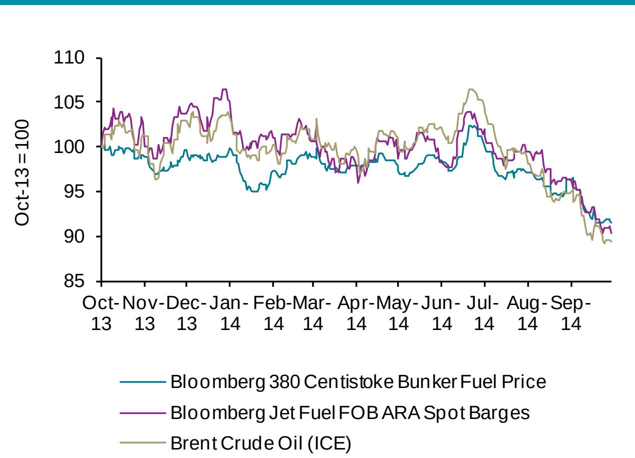
Note: Values above 50 indicate growth
Source: Institute for Supply Management (ISM), Markit, JP Morgan, China Federation of Logistics & Purchasing

World trade and industrial production



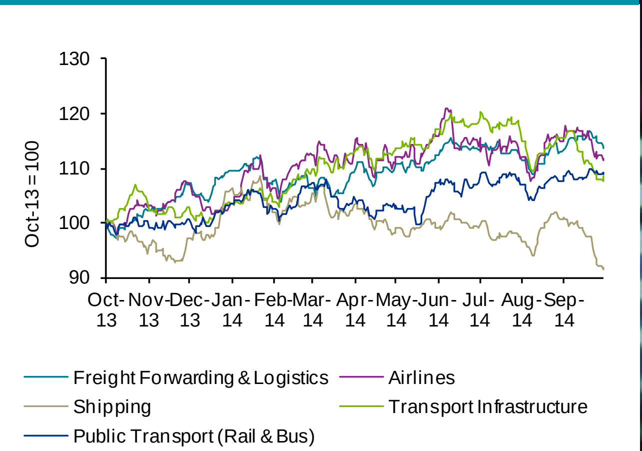
Source: CPB Netherlands Bureau for Economic Policy Analysis

Fuel and oil prices



Source: Bloomberg, ICE (Intercontinental Exchange)

Share prices of transport subsectors



Source: Bloomberg, KPMG Research

Shipping and Sea Freight

Recovery? What Recovery?

After some signals of hope earlier in the year, the greatly anticipated recovery has not really arrived. There are signs of hope: we have seen some rate volatility across some segments - notably tankers - which suggest demand and maybe at least short term supply factors can drive a decent return, but in the main the markets look to be in a state of torpor. We are still broadly in the bath tub shaped recession!

Demand has indeed picked up, but the global recovery is patchy, particularly in the Eurozone and some of Asia. Slow steaming and to some extent the impact of increasing tonne-miles (especially for crude oil) has helped a little. But the biggest depressant is now probably the fact that supply has continued to grow as rapidly as demand. On the bright side, the rate of deliveries has slowed, so generally one could say that things are not getting worse.

The bright spots are:

+ the North-South box trades - but how much 8,000-9,000 TEU tonnage will cascade as the heavily ordered mega carriers consolidate their grip on the sluggish mainline trades?

+ in dry bulk, which is generally moribund versus historic norms, the Capesize outlook is not so bad. Rates here are broadly up 50 percent on last year driven, as usual, by Chinese ore demand;

+ Tankers may be the best bet for improvements as even the strong fleet growth in the Product tanker segment has been matched by increased demand. Growth in Asian refinery capacity and the disruption from US shale means tonne miles are up for both crude and product. Tanker rates are up 6 percent for dirty and 4 percent for clean tankers with share prices of tanker shipping companies up 11 percent as the only shipping subsector with shares trading above the prior year at the end of the third quarter 2014.

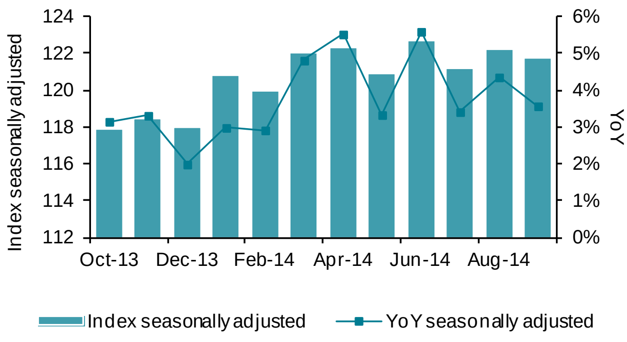
Container throughput is showing no clear tendency in 2014 so far with the Throughput Index decreasing from 122.2 to 121.8 points in September. Average growth in 2014 is 4 percent which is way below historical averages and also below the post-crisis revised long term forecasts of 5-6 percent by most industry analysts[3]. Growth was strongest on North-South trades in the Atlantic and intra-Asian trading lanes. So far, no initiative of the top liners operators to raise freight rates has been sustainable. However, the new container shipping alliances might have the potential to substantially increase the level of freight rates in the longer term. At the same time, the new ships being delivered over the coming years will cause the cascading of older and less efficient ships on the major trading lanes.

Share prices of dry bulk companies are down 37 percent at the end of Q3 reflective of the 47 percent year-on-year fall in the Baltic Dry Index. More broadly speaking, the current depressed state of most shipping stocks betrays a lack of confidence in a sustained recovery.

John Luke
Global Head of Shipping

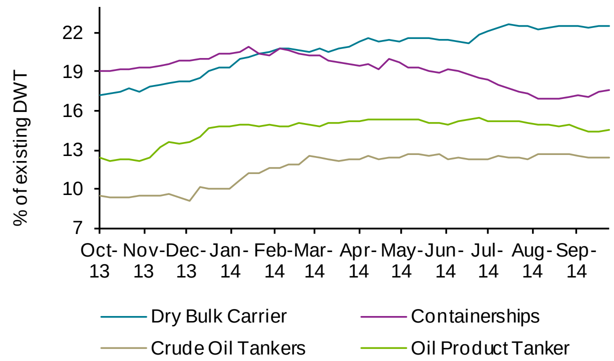
3. http://worldmaritimenews.com/archives/141794/major-trade-lanes-to-grow-by-5-5-pct-in-2015/

Container Throughput Index



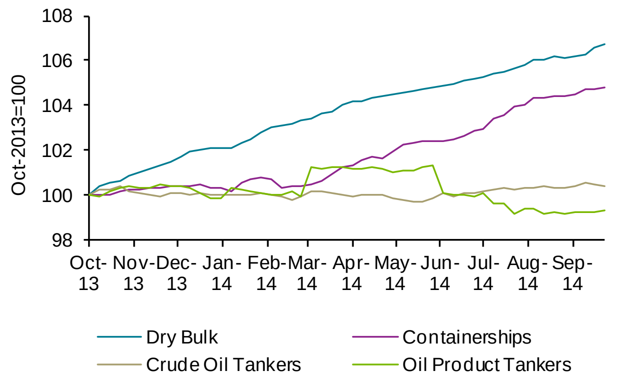
Note: Based on flash estimates of 73 ports, 2008 = 100
Source: Institute of Shipping Economics and Logistics (ISL)

Orderbook in % of capacity



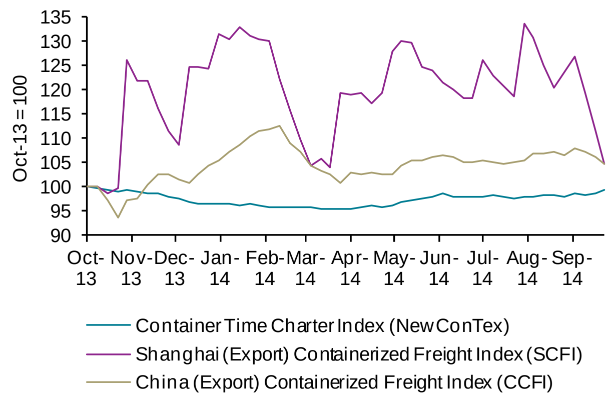
Source: Global Insight

Total fleet capacity (DWT)



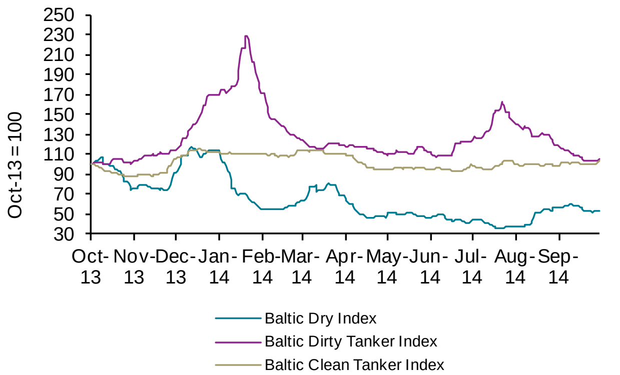
Source: Global Insight

Container freight and time charter rates



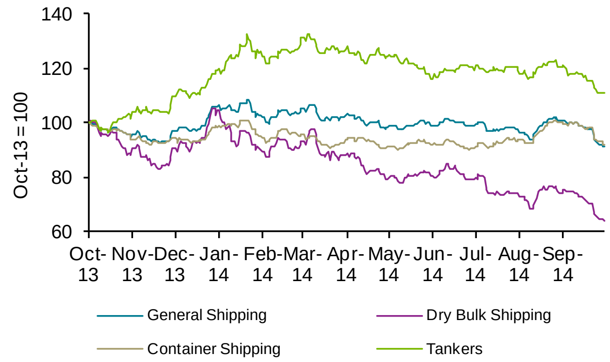
Source: Vereingung Hamburger Schiffsmakler und Schiffsagenten (VHSS), Shanghai Shipping Exchange

Baltic shipping indices



Source: Baltic Exchange

Share prices of shipping subsectors



Source: Bloomberg, KPMG Research

Aviation

Ready for take-off?

Overall

Optimism picks up in the airline industry as IATA reports growth of 5.9 percent for this year, the best since 2011 and above the 5.5 percent trend of the past 20 years[4]. This accelerated growth is attributed to the positive global economic performance in 2014 to date, but with some shorter term risk factors including the West African Ebola outbreak; the threat of Russia shutting off its airspace to European aircraft; and conflicts in the Middle East.

Middle East

Airlines in the Middle East experience the strongest growth of 13 percent in 2014, which is twice the global growth average[5]. Key events in the region impacting results in the short term include the impact of regional unrest, resulting in carriers having to re-route flight paths in order to avoid conflict areas. In addition:

- An 80-day runway closure at Dubai International Airport (for resurfacing) resulted in schedule changes and some disruption; and
- Middle East Respirator Syndrome (MERS) reduced travel to Saudi Arabia.

Middle East airlines continue to operate at amongst the lowest breakeven load factors (but with relatively low yields and unit costs). Unit costs are lowered partly because of structural reasons (fuel and regional staff costs low), but also capacity growth which helps spread – at least in the short term – the cost of fixed overhead more thinly across operations. Middle East carriers are, however, looking at capacity carefully, particularly in the LCC segment.

Etihad continues to pursue its global equity alliance strategy, with the latest major addition being Alitalia. This may impact on European airlines serving Italy as they try to reclaim some historic losses to LCCs.

Europe

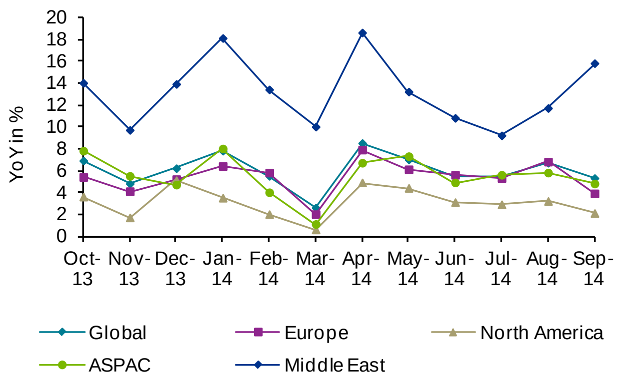
Volume growth and price pressure define air travel in Europe, with the majority of the large airline groups experiencing decline in RASK[6]. Capacity is a particular issue in the LCC and short-haul market driving lower yields.

Despite this two of the larger LCC's have issued improved profit guidance:

- Ryanair attributes this to higher traffic and load factors and lower cost per passenger than previously expected[7];
- easyJet continues to focus on unit costs and gives an increased forecast for upcoming full-year earnings in the latest indication of the success of its low-cost model[8].

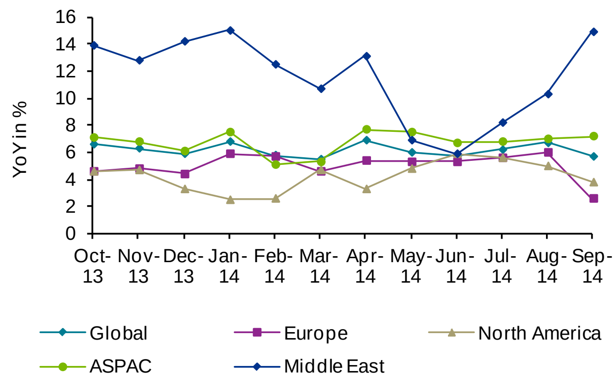
However, looking at the share price performance of LCCs vs. legacy carriers, no clear winner can be identified over the last twelve months. This reflects nervousness about the domestic market, with legacy carriers responding to intensive competition from LCCs, and capacity from the Middle East. Indeed Air France-KLM and the Lufthansa Group sent a letter to the European Commission accusing Gulf carriers of "excessive growth". The carriers' response to competition includes an increased focus on short-haul restructuring, with Air-France KLM announcing an expansion at its low-cost subsidiary Transavia, and Lufthansa focusing on Germanwings. This is not a frictionless process however, with industrial action being threatened by the unions.

Passenger traffic growth (RPK)



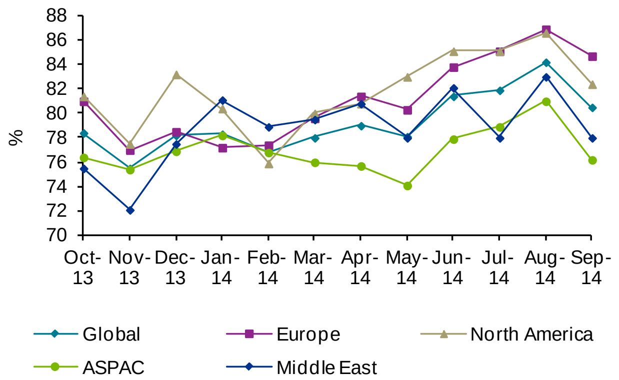
Source: International Air Transport Association (IATA)

Passenger capacity growth (ASK)



Source: International Air Transport Association (IATA)

Passenger load factor



Source: International Air Transport Association (IATA)

Source:

James Stamp
Global Head of Aviation

> "Middle East airlines continue to operate at amongst the lowest breakeven load factors"

Aviation (cont.)

North America

The North American domestic market is buoyant with legacy US carriers American, Delta, and United all recording strong revenue performance. In Canada, robust demand has also been observed, with WestJet driven to increase its capacity mainly by higher aircraft utilisation.

However, the maturity of the US in particular means that airlines that have typically sourced almost all of their traffic from the home market, are looking outwards: Southwest announced that it is looking to "near-international" locations, and is seeking bilateral agreements with Mexico, for example. The Caribbean and Latin American markets remain central to JetBlue's network, even though significant capacity growth in the region over the last two quarters has put pressure on yields. In the short term, limited international exposure may prove an advantage as legacy carriers continue to focus on refining capacity.

Asia-Pacific

Because of the combination of geography (long sector lengths) and the emerging middle market in developing Asia, this region has seen the continued development of the long-haul low-cost model, that has so far proved challenging. By way of example:

→ AirAsiaX announced large losses in Q2 driven by weak performance on its Australian routes, and over-capacity in its core Malaysian market, compounded by its own expansion plans[9]; and

→ Jetstar reported a large EBIT loss, which had widened from the same period in prior year, attributable to higher fuel costs and yield declines across the competitive South East Asian market. Start up losses in Jetstar Japan were also incurred due to rapid expansion into a previously underserved Japanese domestic market[10].

Both carriers anticipate a correction in capacity over the second half of the year, which they believe will translate high load factors into higher RASK by driving up yield.

In the legacy space, Malaysian Airlines has announced a significant restructuring triggered by the tragic events in Ukraine and the loss of MH370.

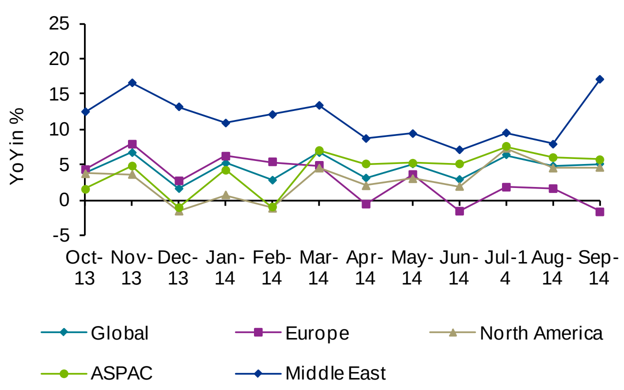
Aircraft capacity

Boeing and Airbus announced that they are considering increasing production of their most popular single-aisle aircraft. Boeing said it is considering lifting the rate of its 737 jetliner to 52 a month in 2018 compared to 42 a month currently. Airbus is considering increasing production of the A320 plane to 50 per month up from 42 currently[11]. Any such increase in production may cause strain on suppliers, who are already operating at or near capacity, but would eat into the order backlog, and potentially create over capacity if demand falls away.

James Stamp
Global Head of Aviation

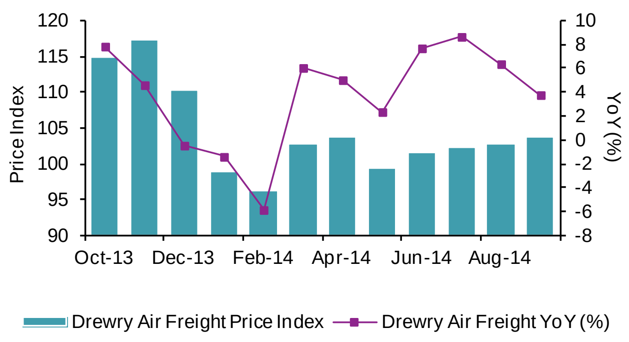
4. IATA, Economic Performance of the Airline Industry
5. http://www.iata.org/whatwedo/Documents/economics/passenger-analysis-sep-2014.pdf
6. http://centreforaviation.com/analysis/europes-airlines-1h2014-results-season-shows-improving-trend-but-cost-reduction-is-the-key-driver-185674
7. http://centreforaviation.com/analysis/ryanair-raises-fy2015-profit-guidance-after-strong-1q-warm-and-fuzzy-oleary-may-be-working-179902
8. http://www.reuters.com/article/2014/10/03/easyjet-results-idUSL6N0RY0E620141003
9. http://centreforaviation.com/analysis/airasia-x-records-2q2014-loss-as-australia-underperforms-but-long-term-prospects-are-still-bright-183044
10. Qantas Group Financial Result, http://www.qantasnewsroom.com.au/media-releases/qantas-group-financial-result?print=1
11. http://www.reuters.com/article/2014/09/22/boeing-airbus-production-idUSL6N0RN4AK20140922

Freight traffic growth (FTK)



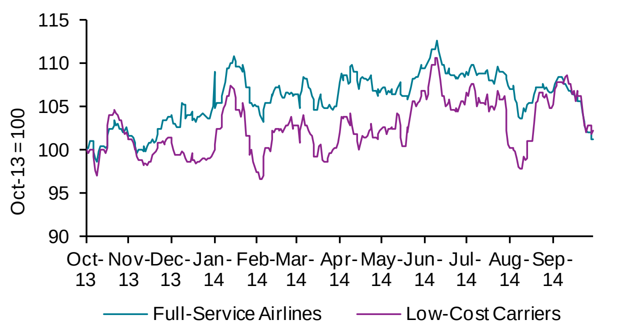
Source: International Air Transport Association (IATA)

Air freight price index



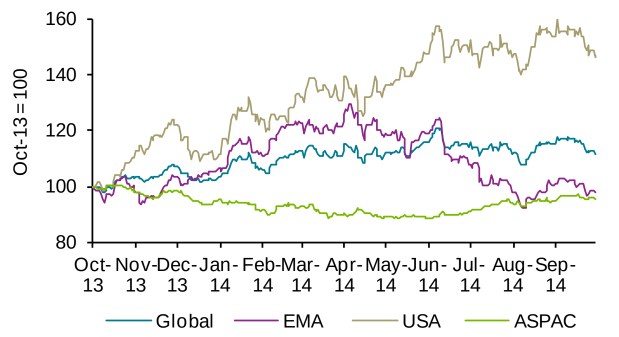
Source: Drewry

Share prices by business model



Source: Bloomberg, KPMG Research

Share prices by region



Source: Bloomberg, KPMG Research

Aviation (cont.)

Air Freight – dark clouds disappearing

Air freight has always been a leading indicator of slowdown. However, the industry has been in the doldrums for so long, that a downturn might be hard to spot. Also, this "rule" held true while China was very much export focused, but as its economy has internalised (and US has re-shored some production), the correlation between Chinese production and air cargo is weakening. In fact, IATA's latest data for global air freight markets showed continued robust growth in air cargo volumes with traffic in the first three quarters of 2014 up 4.4 percent. Middle East and Asia reported the strongest growth while European carrier's volumes growth turned negative in September but still remains positive for the year 2014 so far. Boeing now expects the global air-freight market to double in the next two decades (4.7 percent annually) [12].

With freight capacities growing at a slower pace than traffic, air freight rates increased substantially over the prior year. Rates growth remained positive for the past six month which is another sign of a midterm recovery. Although IATA is pointing to the limiting factors of this upswing, air freight numbers outside of Europe do not show clear signs of an upcoming slowdown. However, it is very much worth watching the market in Q4 and keeping an eye on the long-term downside risks of this recovery.

James Stamp
Global Head of Aviation

“

Air freight has always been a leading indicator of slowdown. However, a downturn is hard to spot

”

12. http://www.bloomberg.com/news/2014-10-07/boeing-forecasts-20-year-air-cargo-traffic-to-grow-4-7-annually.html

Parcel and Express Logistics

Mixed signs in the e-commerce growth story

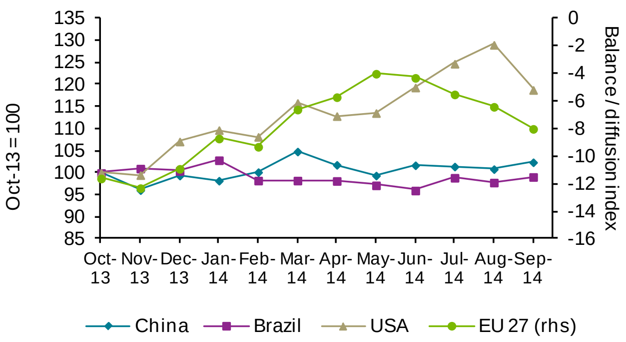
Express remains the growth story for the logistics sector in 2014. Express & parcel revenues of major integrators increased by an average of 4.5 percent in 2014. However, a number of parcel and post companies have recently issued profit warnings or negative trading updates (TNT Express, Royal Mail and UK Mail). Adding to those worries, in Morgan Stanley's latest Freight Pulse 35 Shipper Survey (September 2014), parcel volume growth expectations over the next six months versus prior year fell and are now between 1 and 3 percent for Air, Ground and International. In the UK, online retail orders in August were down 13.6 percent month-on-month[12] but still up 20 percent for the whole year 2014 on a year-to-year basis.

At the same time, FedEx published record profit numbers in September and UPS reported robust third-quarter growth with rising package shipments both in the U.S. and abroad. Both companies are now preparing for the massive Christmas package delivery peak with peak days at both companies roughly doubling their average daily volumes[13]. Looking at the numbers, some early warning indicators can be seen in declining consumer confidence in Europe and the US which will ultimately dampen B2C deliveries. Share prices of express logistics companies are also trading downwards over the end of the third quarter. Overall, the global express logistics group underperformed the S&P 500 as well as the STOXX 600 in the first nine month of the year according to Bloomberg.

Furthermore, major challenges need to be addressed by express delivery companies. In the future, we expect that the mix of international and domestic deliveries will be shifting as e-commerce moves cross-border. This combined with the multi channel delivery solutions required by e-commerce will change the operating model required to be successful. The lowest cost home delivery option may come only second best as customers increasingly demand a flexible delivery time and location model (e.g. in the evening or at work), later cut off and delivery conveniences such as notifications or tracking, especially in cross-border logistics.

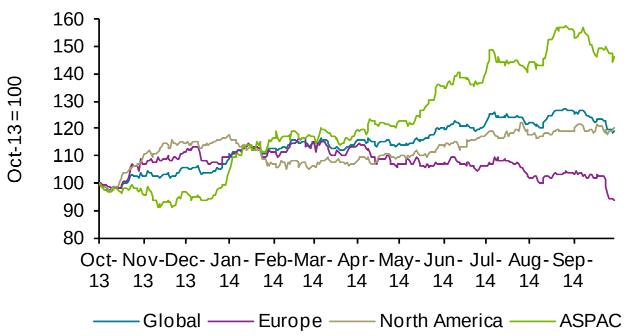
The opportunities in cross-border e-commerce for logistics companies are highlighted by the possible disruptive effects of IT start-ups and software platforms entering the express delivery market. Take the example of tax, customs and payment related problems of cross-border e-commerce. A recently published blog by eft demonstrates how IT start-ups are getting rid of those obstacles that once prevented consumers from cross-border online shopping[14]. Logistics companies will need to make sure that they adapt their business model to this new competition in order to benefit from additional opportunities. Providing seamless end-to-end cross-border e-commerce solutions including handling of customs and VAT, fulfilments and returns, cross-currency payment flows and IT-integration will thus be the new business models for global integrators and logistics companies.

Consumer confidence indices



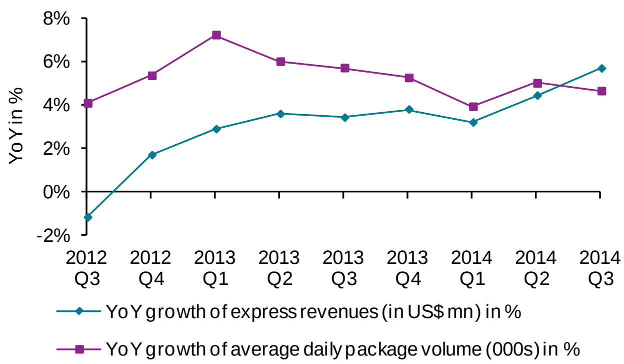
Source: National Bureau of Statistics of China, CNI (Confederacao Nacional das Industrias, Conference Board, European Commission)

Express logistics share prices



Source: Bloomberg, KPMG Research

Quarterly express delivery revenues and volumes

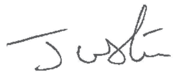


Note: Based on quarterly company filing of UPS, FedEx and TNT Express
Source: KPMG Research, Bloomberg

> “The lowest cost home delivery option may come only second best as customers increasingly demand a flexible delivery time model.”

Parcel and Express Logistics (cont.)

Another question that needs to be addressed: When will same day delivery drive changes in retail? As demonstrated by Amazon in the US and the UK, online retailers are keen to offer the possibility of same day deliveries, even if they need to build up carrying capacities of their own. Amazon is now working on a logistics upgrade that takes the company one step closer to taking over the entire delivery process for itself[15]. Google is also expanding its delivery service and will start charging membership fees, intensifying its battle with Amazon for e-commerce spendings[16]. Start-ups and software platform are also entering the market on a fast pace. Do market place solutions from uber, shutl or Deliv presage the disintermediation of the large parcel companies as retailers go direct to the delivery driver[17] for last mile solutions? It is exactly this disruptive effect of start-ups and crowdsourcing solutions on logistics companies and integrators that has the potential of changing the traditional B2C logistics chains.



Justin Zatouroff
Global Head of Post and Express

12. http://www.imrg.org/index.php?catalog=1343
13. http://www.businessinsider.com/r-ups-fedex-seek-ways-to-manage-massive-peak-season-package-bulge-2014-10?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+clusterstock+%28ClusterStock%29
14. http://www.eft.com/column/borderless-shopping-borderfree
15. http://www.wired.com/2014/09/amazon-takes-big-step-toward-competing-directly-ups/?mbid=social_twitter
16. http://blogs.wsj.com/digits/2014/10/14/googles-commerce-chief-on-deliveries-amazon-and-the-mobile-challenge/?mod=WSJBlog
17. http://www.transportintelligence.com/newsletter/31245/241868

KPMG Case Studies in Transport & Logistics

KPMG member firms advise transport companies worldwide on a wide range of commercial and financial projects. KPMG member firms also work with Government policymakers and regulators and infrastructure companies. Our Global Transport Network provides access to a pool of industry specialists and technical skills and brings sector-specific advice to clients wherever they may be.

This section of the Transport Tracker presents a selection of KPMG member firms' recent work in helping clients from across the transport sector.

Developing a business model for the use of mobile applications in air freight logistics

Client Challenge

Jettainer GmbH is the leading international service partner for outsourced ULD (Unit Load Device) management. Jettainer guarantees its customers the short-term availability of ULD at 350 airports worldwide on 3.500 daily flights. In order to increase the ground handling processes' efficiency and to improve the data quality by minimizing errors, Jettainer aimed to introduce a mobile application (JettApp) to replace manual data input by developing a digital solution.

KPMG Response

Mobile solutions in a business environment require high standards in terms of connectivity, synchronization, data security and device management. In addition, business processes in air freight logistics are highly complex and fragmentized, involving a vast number of different business partners. KPMG developed a business model for the implementation of the mobile application. This included a detailed analysis of economic framework, operating model and the evaluation of risks and benefits of this business case. An on-road test with Lufthansa Cargo was launched to examine the functions.

Benefit to Client

The mobile application enables the fast and precise recording of ULDs via barcode in order the monitor the inventory. The provided business model optimized the ground handling processes of the parties involved and improved the offered services. The digitalization of business processes reduced ULD overcapacities and increased the transparency for customers. Overall the application contributed to error reduction and fostered overall process efficiency.

KPMG Case Studies in Transport & Logistics (cont.)

Improving customer experience and operational efficiency in logistics

Client Challenge

A major transport & logistics company had decided to transform their order to cash process with the ambition of realising a significant improvement in customer experience and operational efficiency. The challenge the client faced was to identify the most appropriate technical solution and whether there was a viable business case for the implementation.

KPMG Response

KPMG's approach to address this challenge was:

- Developing a set of requirements which would deliver their desired business processes;
- Evaluating the ability of commercially available systems to deliver these requirements. This included evaluation of CRM, Transport Management Systems and Finance solutions;
- Developing a range of solution scenarios, which were then evaluated against an agreed framework; and
- Developing a business case, including estimated costs and financial benefits, for the preferred option.

Benefits achieved

With KPMG's help the client successfully identified the most appropriate solution in order to achieve their ambition. KPMG provided assurance that such solution was achievable and recommended a short list of vendors who would support the implementation. As a result, KPMG established a business case with significant Net Present Value and supported the client with an overall delivery plan for the solution.

We would be pleased to discuss the results of our analysis with you.

Contact us

Dr Steffen Wagner
Global Chair, Transport
T. + 49 69 9587 1507
E. steffenwagner@kpmg.com

John Luke
Global Head of Shipping
T. + 44 20 7311 6461
E. john.luke@kpmg.co.uk

James Stamp
Global Head of Aviation
T. + 44 20 7311 4418
E. james.stamp@kpmg.co.uk

Justin Zatouroff
Global Head of Post and Express
T. +44 20 7311 8415
E. justin.zatouroff@kpmg.co.uk

www.kpmg.com

Produced by CREATE Graphics | CRT29434B | November 2014