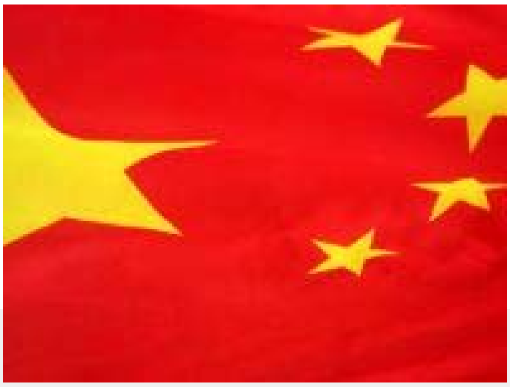
Special Briefing: What is the future for the Chinese logistics industry?

20/Mar/2008



Lee Perkins, Head of Ti's China Practice, will be speaking at the upcoming Global Distribution Strategies Conference, May 13-15, Marriott Hotel, Amsterdam. Here he talks to Logistics Briefing Editor Thomas Cullen about some of the key trends in the market.

Thomas Cullen (TC). Is the growth of the logistics market continuing at the same rate as in the past or has it slowed? If slowed, is this as a result of economic slowdown elsewhere in the world or for other reasons?

Lee Perkins (LP). This is a complex question and you tend to get conflicting opinions. In the long run, all of the indicators are still pointing in the right direction, and given the amount of investment in fixed assets in the sector, and general overall demand, growth is likely to continue for the next few years - all things being equal.

What is far harder to predict and monitor are the shorter term trends and anomalies. In this area we see a number of issues that either are affecting growth in the Chinese logistics market, or are possibly about to.

One example of this was the rather disappointing throughput growth figures announced by Shanghai International Port Group (SIPG) for the month of March. Sources at the port have essentially brushed off the results as nothing more than a late Chinese New Year. However, given that this slowdown in growth is mirroring a slowdown in US TEU throughput at most major ports, which in the past has been a very reliable indicator of economic climate in the US, for example foreshadowing an unexpectedly high rise in unemployment figures, it is likely that this slowdown is part of wider global trend.

Coupled with this, if we look at the effects of the appreciating RMB, and the way in which shipping lines are already shifting capacity from the US to Europe, it does begin to look like there could very well be falling handling rates at a number of ports in China over the next year to eighteen months: Europe doesn't maintain the kind of spending power necessary to drag the Chinese economy single-handed.

One of the interesting parts of this analysis is that supply chains across the globe tend to be so well managed and tightly run that port throughputs have become very reliable indicators of economic performance, and in many ways a good deal more accurate than traditional indicators such as employment which tends to carry a significant time lag element.

This situation could, theoretically, be compounded by the massive amount of capacity due to come on line in the near future. ACT's internal market estimate figures indicate that even without a US - or indeed global - recession operational utilisation in the Pearl River Delta as a whole in terms of TEU throughput is likely to fall in the short term to around 90%. Demand and supply should equalise at maximum utilisation by 2013.

TC. Won't any slowdown in export growth be counterbalanced by increasing domestic demand and capital investment?

LP. In the event of a global slowdown, China may be able offset its potential liability by upping infrastructure spending as it has done quite successfully in the past. As export driven growth slowed towards the end of last century, in line with greatly decreased spending power across SE Asia, China was able to compensate for this with increased infrastructure spending. As a result of this fixed asset investment growth actually exceeded export driven growth, depending on who you read, for the first time since the start of the open door policy.

In summary, any slowdown in the China transport market in the short term is likely to remain short term.

However I don't believe increased domestic spending, on its own, will compensate for a global recession. In my opinion China is likely to suffer from some elements of the domestic economic austerity that Japan did for so many years of its development. There have been numerous attempts to boost domestic expenditure over the past ten years in an effort to decrease China's economic dependency on the outside world – all of which have largely met with differing degrees of failure.

However the true extent of any potential slowdown is very difficult to gauge as any accurate forecast depends ultimately upon calculating the true nature and depth of the impending US recession and a lot of structural issues in China. However, recent forecasts have downgraded growth of the Chinese economy to around 9.7% to take account for this.

TC. What do you think is the future for the Chinese logistics industry? Will it follow trend towards consolidation as it has elsewhere?

LP. All aspects of the road haulage industry are ripe for a prolonged and sustained period of merger and acquisition activity. This is largely because many companies have seen profit margins eroded by rising costs and an inflexibility in pricing i.e. the customers unwillingness to accept rising prices and cut-throat competition between enterprises and the availability of low cost small scale 'family' enterprises.

A general decline in profit margins across the medium domestic provider sector has left many enterprises with an inability to finance expansion and cover operational costs, such as replacing or upgrading equipment and facilities.

Given the large levels of under agglomeration in the industry and the fact that the central government is likely to make low cost loans available to the express delivery sector in the near future, it is likely that some of the larger enterprises engaged in the industry will take advantage of this and aggressively expand their networks.

Also within the overall industry structure profit margins within domestic enterprises in the general road haulage and express delivery sectors tend to be low. For the majority of companies, profit margins tend to be around 10%. It is this level of profit that has led to many enterprises expanding their business networks through means that require minimal investment.

It is these methods, for example alliances, franchised branches and partnerships that in many ways contribute to the overall under-agglomeration of the industry, and the overall lack of standardisation across all levels of the industry. This is also one of the over-riding reasons why many of the companies in the industry have enormous difficulty building their brands and imposing standardised customer service provisions across their companies.

In general the sector is ripe for a sustained period of integration and standardisation. However, the nature of this process depends greatly on forthcoming legislation and the desire of the Chinese government to protect small and medium scale enterprises in the sector. However, whatever happens, it seems likely that market developments in the near future will either eventually be forced to lead to increased profit margins in one way or another. Whether this is achieved through increased pricing or consolidation of the industry remains to be seen.

In addition many companies intend in the near future to attempt to diversify their operations from package delivery provision into areas such as supply chain management, and warehousing, which many see as a more stable and profitable sector than road transport, given the recent fluctuations in the market and the relatively underdeveloped nature of supply chain management in China.

TC. How effective has the Chinese government's 'Go-West' strategy been?

LP. The Go-West strategy is bearing some fruit. Not least with high value, high profile investments from major multinationals such as Intel (vis their new Chengdu plant). However, critical issues remain. Not least of which is whether China can conceivable make the strategy work before lower cost labour coming on line in countries like Vietnam makes it a moot point. In this respect China should worry. If not only because Vietnam labour is cheap, but also because there is a limited amount of bureaucracy a country the size of Vietnam can sustain, a noteworthy difference to China.

If done correctly, the Go-West strategy could work in theory. I personally believe that the people that could really benefit from the Go West strategy are not necessarily manufacturers hoping to save costs and cut margins on export goods, but instead companies that are focused both on local and export markets. By locating factories further inland, large scale manufacturers may be able offset increased transport costs in the interior, against domestic consumption profits in largely untapped inland markets. Being further inland also allows access to markets which have not been already inundated with media marketing, which could grant some with a keen eye for opportunity whole untapped consumer markets.

One of the linchpins of the Go West strategy is the new nationwide fully-intermodal containerised rail network, which is due for completion soon. This is an extremely important step for China in realising the potential of the Go West strategy. Another major factor for China is the Inland Waterway (IWW) transport network. In this respect China is spending a lot of money on upgrading facilities all along what some have referred to as China's third coast, the Yangtze. China's drive to open up the river is not in small part motivated by a desire to attract foreign investment further inland, thereby stimulating growth in China's vast hinterland. In recent years western development has lagged woefully behind the more developed eastern seaboard cities and in many ways the government sees the drive to open up the river as pivotal to its 'Go-West' strategy.

China's policy to generate an economic corridor stretching westward has already led to huge investment in supporting infrastructure winding its way out of the river basin, bringing millions of low cost workers online, opening markets and lower rent property to both foreign and domestic investors. To date, the government has invested more than RMB 850bn Yuan ($105bn) on 60 key projects from airports, rail lines, terminals, and pipelines to power stations, and broadband installation in the western region.

TC. Where are the key growth areas? Are they still around cities such as Shanghai and Shenzhen?

LP. Shanghai in my own opinion is already overdone. There is way too much investment, prices in most sectors are over inflated, wages are too high, staff retention is almost impossible, and speculative capital is already starting to see decreasing marginal returns. There are certainly opportunities in the Beijing-Tianjin and North-eastern area although we are starting to see very high rates of growth in terms of pricing in most of the eastern seaboard regions. In my opinion it's just a question of time before pricing becomes an issue in that region too. Ultimately the best advice is Go-West, if you're brave enough. Start looking at airport development, infrastructure projects, and road haulage consolidation for the big opportunities.

In terms of the maritime industry, major growth areas are likely to be Fujian and surrounding areas. Under a deal already agreed between Taiwan's KMT and Beijing, direct shipping routes are likely to open in the near future. It is expected that the bulk of these routes will depart from China's largely underdeveloped and generally neglected coastal province of Fujian. Should this happen, the province which has until recently been pretty much starved of investment, should become a conduit for cross straits logistics and manufacturing investment. Until now most have overlooked the region due to its massive military deployments and its political and strategic sensitivity given the cross straights' tensions.

TC. How widely is logistics out-sourcing being adopted?

LP. Five years ago, the chemical, high tech and pharmaceutical, sectors were more likely to outsource logistics services, whilst industrials preferred in-house services. Although this trend continues to a degree, a majority of companies across the board have begun outsourcing much of their logistics needs. Furthermore, many heavy machinery manufacturing companies have begun marketing their specialised logistics services to other clients.

TC. Where would you say the greatest opportunity for logistics companies lies?

LP. Cold chain is massively under developed - there is a huge opportunity for a consortium of major players to come in and wrap up the entire industry. A shocking proportion of agricultural produce is lost en route, creating a gaping hole in the market for anyone with the capital to fill.

TC. What impact will the Olympics have in short and long term?

LP. In the short term, the Olympics will mean an overall increase in passenger traffic with bottle necks occurring in and around Beijing. Disruption of rail traffic may impede the flow of coal, although after the trouble this winter, the government will likely be stockpiling fuel at plants so that everything runs smoothly.

Over the long term, the Olympics as an event will have little effect. The hosting of the games, however, has meant a number of large scale infrastructure projects with deadlines in early 2008.

For further information on the services which Ti offers in China including consultancy, and its online knowledge portal, China Supply Chain intelligence (CSCi) follow the link. To meet Lee and find out more information about the China logistics market, as well as many of the other developing markets, register for the Global Distribution Strategies Conference 2008.

Source: Transport Intelligence, April 9, 2008