FREIGHT BROKERS: VOLUMES UP, MARGINS DOWN

SEPTEMBER2019

FREIGHTWAVES FREIGHTINTEL RESEARCH

Key Highlights

- **Contract rates in the transportation world are often called "paper rates" and resemble rate agreements that can be modified by either party at any time rather than firm perpetual agreements.**

- **For this reason, we will identify contract rates as paper rates in this white paper.**

- Freight brokers are very optimistic about capacity for the remainder of 2019. Not so optimistic about margins.

- Thoughts are that there is plenty of capacity and enough spread between spot and paper rates to cover enough loads to keep current shippers happy. Getting their feet in new doors is more difficult, though, as shippers are culling carriers and brokers from their routing guides.

- Freight brokers are most pessimistic about paper rates and gross margins over the next few months.

- If the spot market continues to remain depressed, shippers will likely become more active with rebidding of paper rates.

- 54 percent of freight brokers are optimistic about negotiating rates with shippers, while only 44 percent are optimistic about negotiating rates with carriers.

- When it comes to paper rates versus spot rates, 36 percent of freight brokers handle more paper freight than spot.

- The Pareto Rule or 80/20 power rule isn't quite in effect in brokerage. Just over half of brokers collect at least 60 percent of their margins from "core" customers.

- Surprisingly, 25 percent of freight brokers say their core customers generate less than 40 percent of their gross margins. This indicates that a number of freight brokers are working with a high number of low volume customers, which makes their book of business difficult to scale.

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Contract Rates vs. Paper Rates

In this white paper, we refer to contract rates as "paper rates." This is due to the fact that contract rates in trucking and brokerage do not have guarantees for specified volumes or capacity at specified rates for the duration of the contract. Each lane can be accepted or rejected based on capacity or rates and can be rebid by either side at any time.

The main reason paper rates are rebid during the "contracted" period is that the spread between paper and spot rates widens to the point that it does not make economic sense for one of the parties to continue tendering or accepting loads based on the paper rates in place. Either the spread between rates has increased to the point where the shipper can cut costs by moving loads to the spot market, or the freight broker is underwater when buying transportation in the spot market above the paper rates in place. Carriers, too, can choose to allocate a portion of their capacity to the spot market if spot rates meaningfully exceed paper rates.

The tendency for the paper/spot spread to widen and then narrow explains why the spot market leads paper rates either up or down, depending on classic supply and demand fundamentals.

When the spread between paper and spot rates widens to the point it makes no economic sense to continue the agreement, either the shipper, carrier, or freight broker is incentivized to mark the paper rates to market. This means either side will rebid the paper rates closer to the spot market. A shipper actively rebids when the spot market declines below the existing paper rate, and a trucking carrier or freight broker actively rebids when the spot market moves above the existing paper rate.

The Freight Intel Group has recently conducted research on the magnitude and duration of the paper/spot spread necessary to trigger significant movements of volume and capacity from the contract market to the spot market. A survey of more than 500 shippers, carriers, and brokers found that, on average, the spread needs to widen to between 5 and 15 percent for more than one month to prompt a shift in volume and capacity.

Once these conditions are met on the downside, shippers start moving loads to the spot market to reduce costs. When met on the upside, shippers must move loads to the spot market to find capacity that has evaporated as freight brokers and carriers reject tenders at the paper rates and move their attention and trucks to capitalize on the spot market.

2019 Began with a Recession. How Will This Year Finish?

In our third quarter carrier outlook survey, *Carrier Outlook and the Freight Recession of 2019*[1] we found carrier sentiment in the tank. Only 31 percent of carriers were optimistic about load volumes for the remainder of the year, and only 20 percent thought line-haul rates would recover in 2019.

By all measures, the first half of 2019 was brutal compared to the high-flying freight markets of 2018. This is highlighted by the first half market indexes below:

Figure 1 - Freight Market Recession in the First Half of 2019

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Metric	Q1 2019	Q2 2019
Tendered Load Volumes (OTVI.USA) y/y	-0.5%	-5.7%
Tender Rejections (OTRI.USA) y/y	-78.3%	-78.7%
DAT Spot Rates (DATVF.VNU) y/y	-22.4%	-27.5%
Carrier Sentiment for Load Volumes % Change	-22.0%	-5.0%
Carrier Sentiment for Line-Haul Rates % Change	-23.0%	-21.0%

*y/y is year-over-year
*Carrier Sentiment is % change from previous Quarter

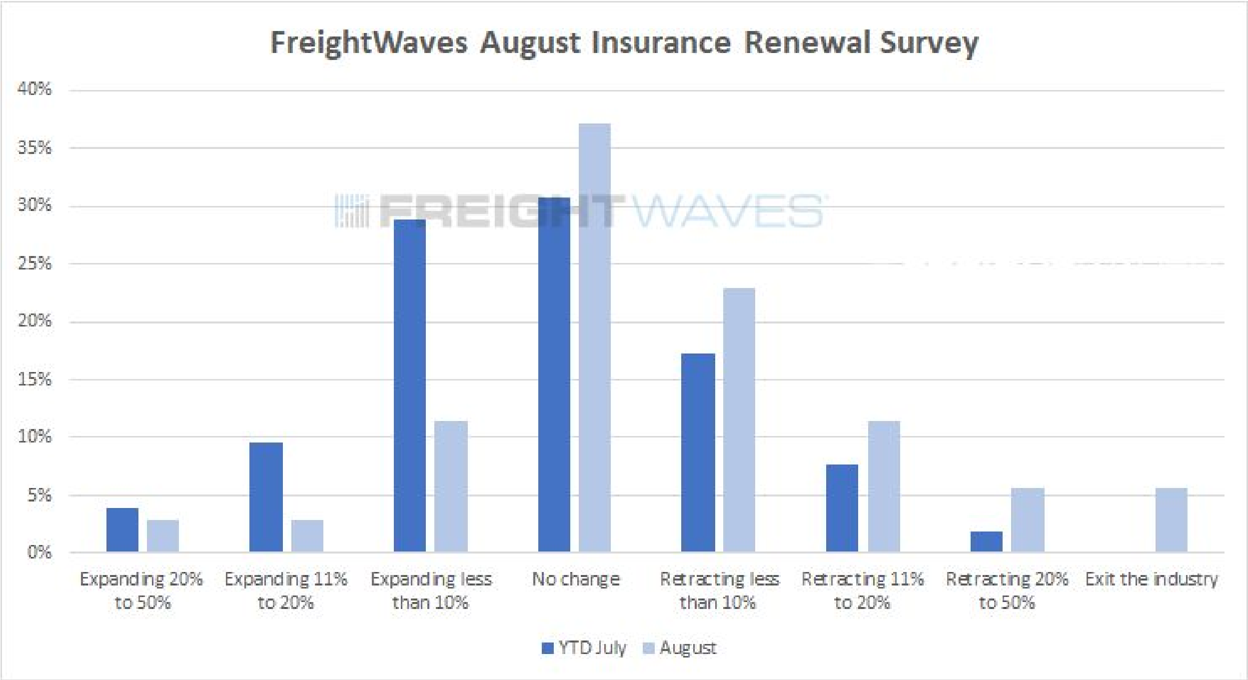
Source: SONAR, Q3 2019 Carrier Outlook Survey

The third quarter of 2019 is off to an improved start though. Tendered load volumes as measured by OTVI.USA moved above 2018 freight volumes on July 24, 2019. As of the beginning of September 2019, the index showed tendered load volumes are 3.87 percent higher than the same time last year.

Capacity continues to be loose though. In August 2019, FreightWaves surveyed insurance companies to find out what they were seeing with policy renewals for their trucking customers.

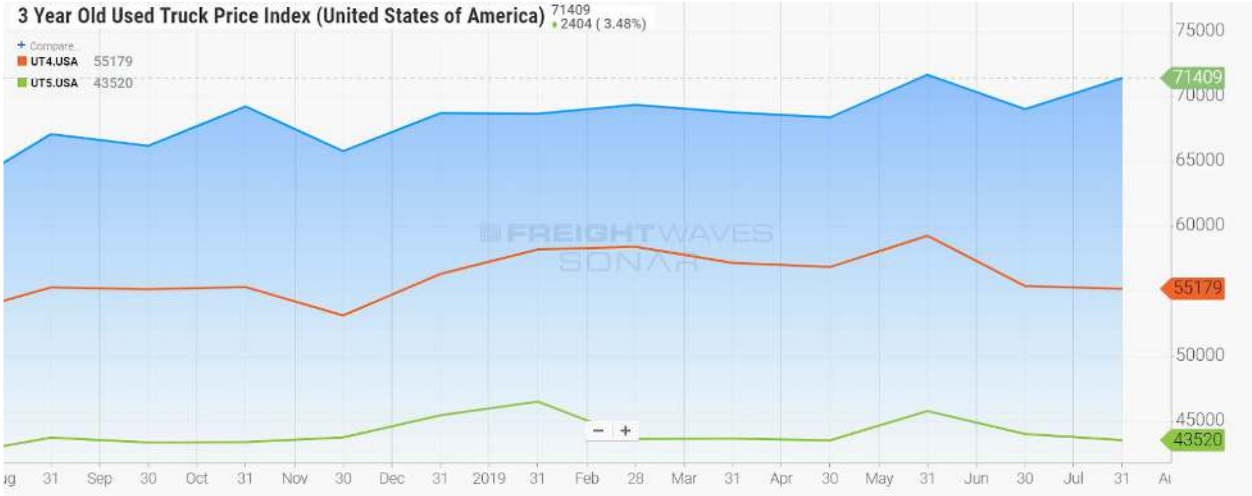
[1] Carrier Outlook and the Freight Recession of 2019 can be found live in SONAR by clicking the lightbulb icon in the menu on the upper right-hand corner of your screen.

Figure 2 - Fleet Insurance Renewals in 2019



Source: FreightWaves July 2019 Insurance Survey, and FreightWaves Insurance Survey August 2019

Figure 3 - Values for 3, 4, and 5 Year Old Used Truck Values

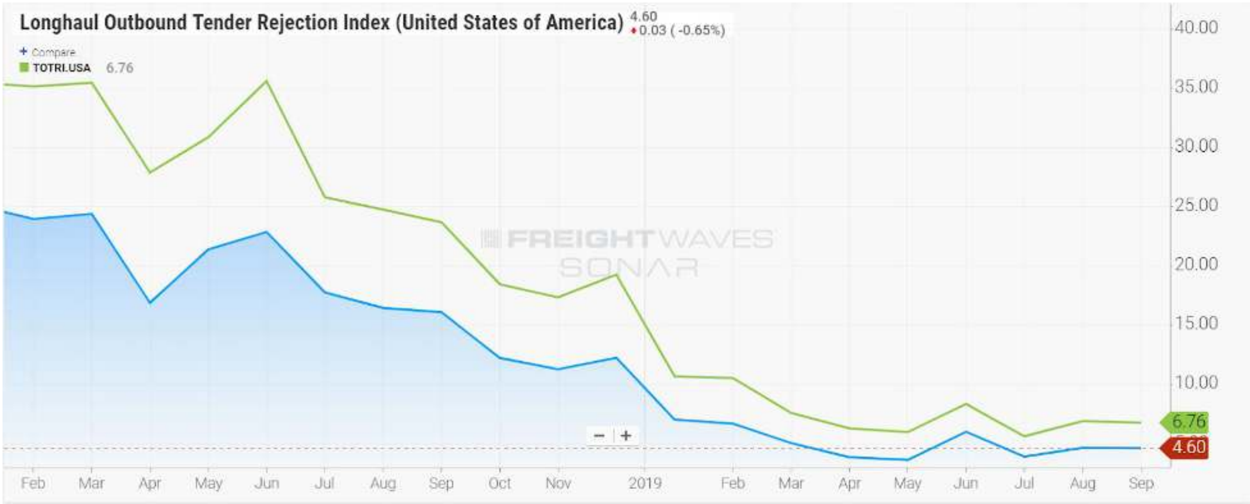


SONAR: UT3.USA, UT4.USA, UT5.USA

We found that insurance companies were seeing a net expansion in fleet size in the first half of 2019. Though in our latest survey of August insurance renewals it has now turned to a net contraction. This is consistent with other data points in the market. Used trucks continue to hold their values, especially in 3-year used trucks, but 4-year and 5-year used trucks may be on the verge of rolling over in value (see Figure 3).

The continued over-capacity in the first half of 2019 has kept tender rejection rates near all-time lows. Long-haul (LOTRI.USA) and tweener-haul (TOTRI.USA) rejection rates are a fraction of their levels year-over-year[2]. Though with key FreightWaves indicators suggesting capacity may have finally began leaving the market the final few months of the year might see an environment of tightening capacity.

Figure 4 - Longhaul and Tweener Tender Rejection Rates

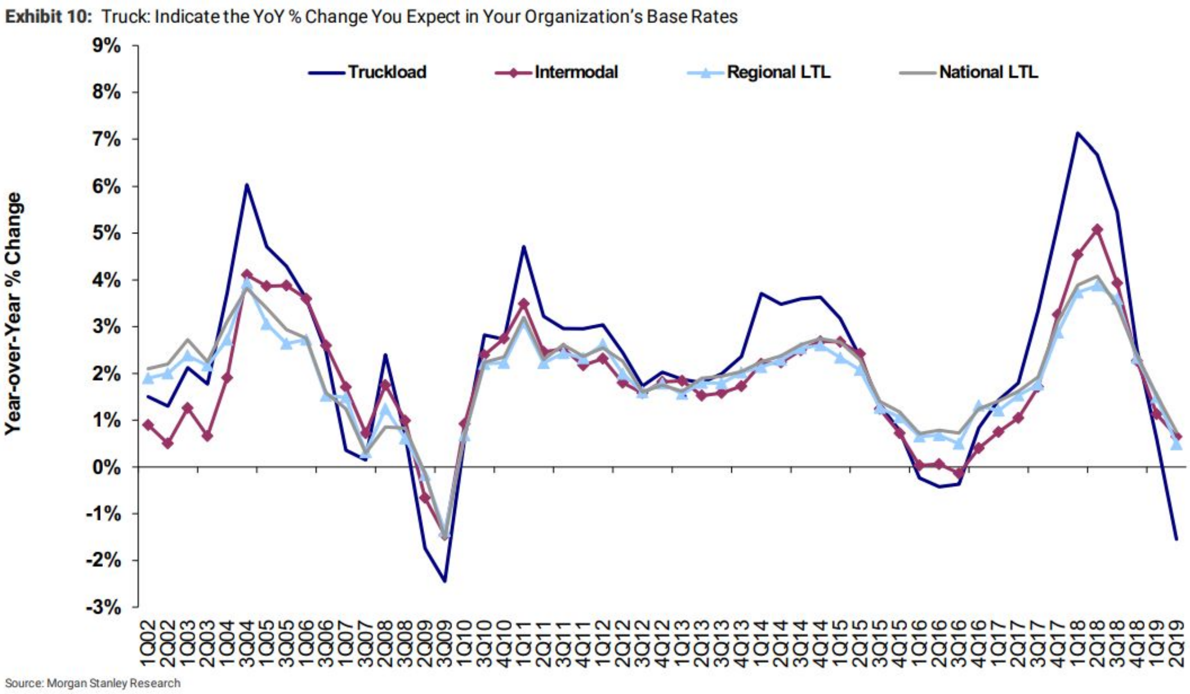


SONAR: LOTRI.USA (Longhaul) and TOTRI.USA (Tweener Haul)

Shippers are hyperaware of the loose capacity so far in 2019 and are actively clawing back paper rates. In Morgan Stanley's latest shipper survey, contract renewals are expected to turn negative in the second half of 2019. This isn't surprising considering how loose capacity is now compared to the second half of 2018 when shippers were routinely agreeing to 8 to 10 percent increases in paper rates to find capacity.

[2] Tweener Haul is defined as length of hauls between 450 and 850 miles. Long-Haul is defined as length of hauls over 850 miles.

Figure 5 – Morgan Stanley's Shipper Rate Expectations Survey Results



Data Source: *Morgan Stanley:54th Shipper Survey July 22, 2019*

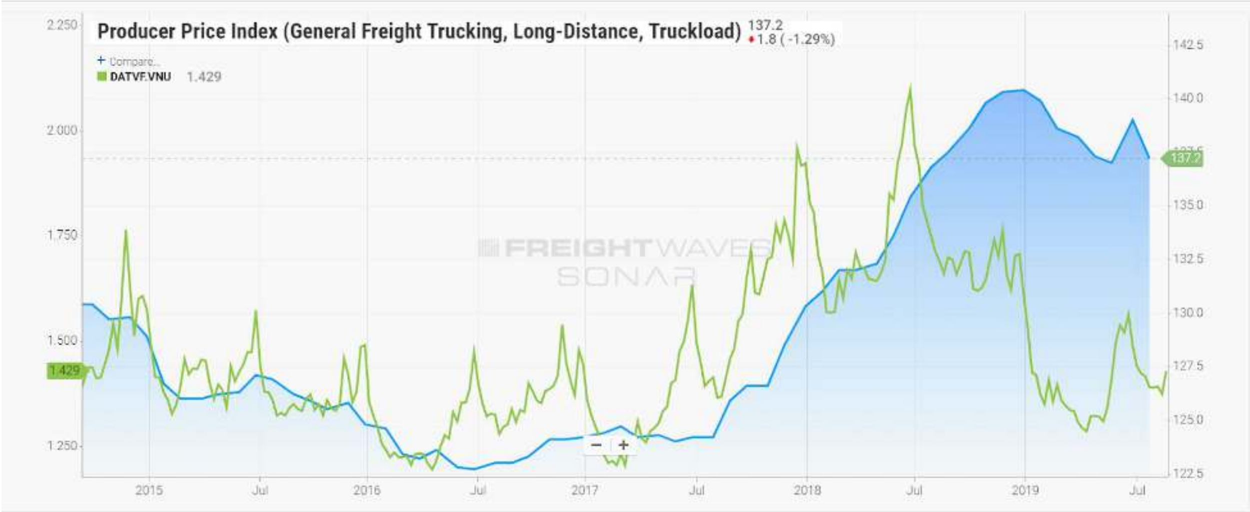
This is also the trend with the Producer Price Index for Long-Haul trucking data that is published on a monthly basis. This is the most used proxy for full-truckload long-distance trucking paper rates.

The sharp spike in spot rates in the fourth quarter of 2017 can be seen with the green line in Figure 5 on page nine (paper rates are in orange). The first spike occurred after hurricanes hit Houston, Texas and Miami, Florida. This combined with the electronic logging device (ELD) mandate constrained capacity at unprecedented levels. On the demand side, volumes increased with the economic boost of lower corporate tax rates.

The spikes in spot rates pulled paper rates up as tender rejections spiked to 20 to 30 percent nationally. This forced shippers to begin moving loads to the spot market and rebid paper rates to find capacity. This activity peaked early in the first quarter of 2019 as capacity loosened and demand leveled off. In the second and third quarters of 2019, the reverse happened as spot rates sank well below paper rates. This has put shippers back in the driver's seat and they are moving more loads into the spot market and rebidding lanes

If the current trend continues throughout 2019, paper rates will likely post negative year-over-year numbers for the first time since late 2016.

Figure 6 – Producers Price Index for Long Distance Trucking Compared to DAT Spot Rates



Source: SONAR: PPI.LDTL (Paper rates in Blue) and DATVF.VNU (Spot Rates in Orange)

What does this mean for freight brokers? The market is shaping up to be one with rising freight volumes compared with 2018, but with much looser capacity as well.

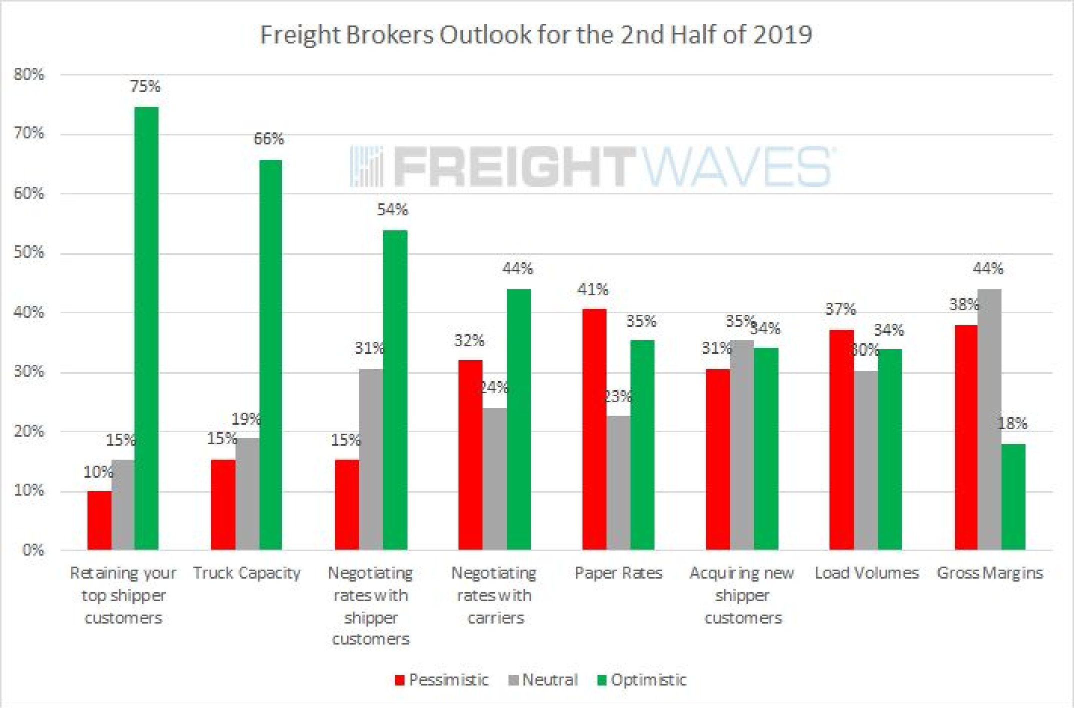
Upside: This is an environment where volumes will likely improve without a meaningful tightening in truck capacity. Higher volumes and depressed rates will make it easier for freight brokers to source capacity at current paper rates for the remainder of 2019.

Downside: Shippers are well aware of this imbalance in capacity and depressed spot rates well below the double digit rates many agreed to over the past year. Shippers are more aggressive this year clawing back paper rates and culling carriers and brokers from their routing guides. Because of this, all freight brokers are aggressively bidding and 2019 could become a raise to the bottom for line-haul rates.

Freight Brokers Expectations for the Second Half of 2019

In August of 2019, FreightWaves surveyed 160 brokers via email to measure their sentiment for the second half of 2019.

Figure 7 - Freight Brokers Optimism for the 2nd Half of 2019



Source: FreightWaves Freight Broker Outlook Survey, July 2019

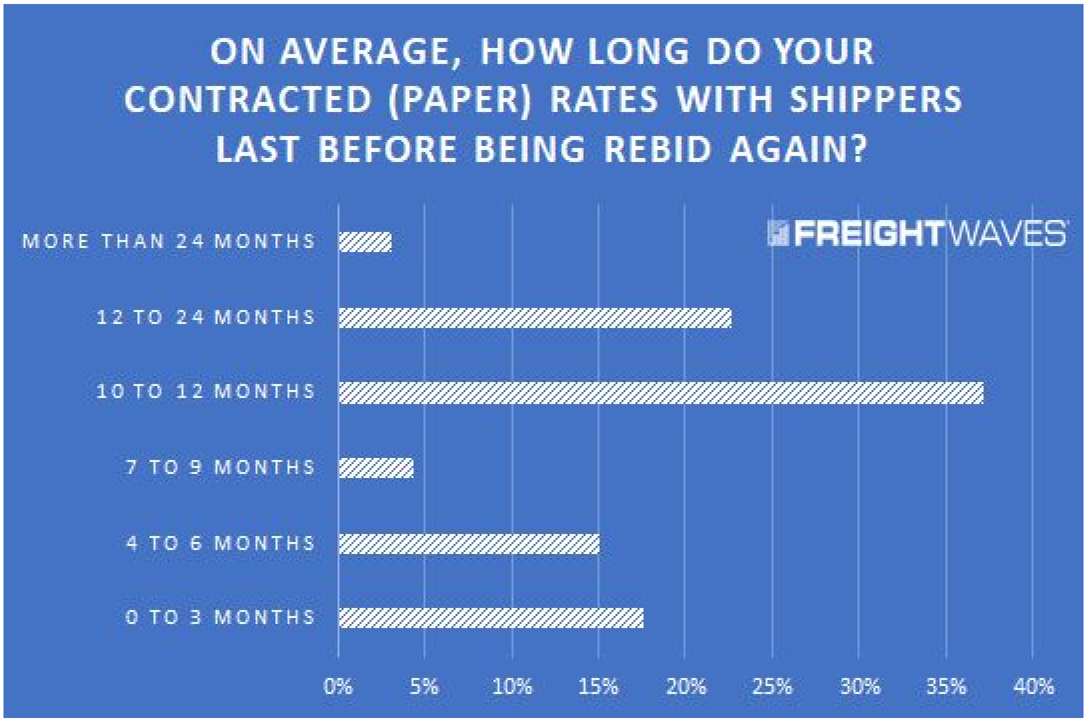
- While freight brokers are most optimistic about retaining current customers. Most believe this retention will come with lower gross margins.
- In fact, fewer than 20% of freight brokers are optimistic about gross margins for the rest of 2019.
- Only one-third of freight brokers are optimistic about acquiring new customers. With capacity this loose, shippers have been trimming down freight brokers and carriers in their routing guides.
- One of the more surprising results is that freight brokers are less optimistic about negotiating rates with carriers than with shippers. With capacity this loose, one would think it would be the other way around.

Figure 8 - Shippers Activity Level in Rebidding Paper Rates

Source: FreightWaves Freight Broker Outlook Survey, July 2019

- Freight brokers have indicated shippers have been more active than normal in rebidding rates over the past few months.
- On a scale of 1 to 10, freight brokers say shippers are at seven with rebidding rates so far in 2019.
- This lines up with the Morgan Stanley survey in Figure 4 on page eight, where shippers are expecting paper renewals to turn negative in the second half of 2019.

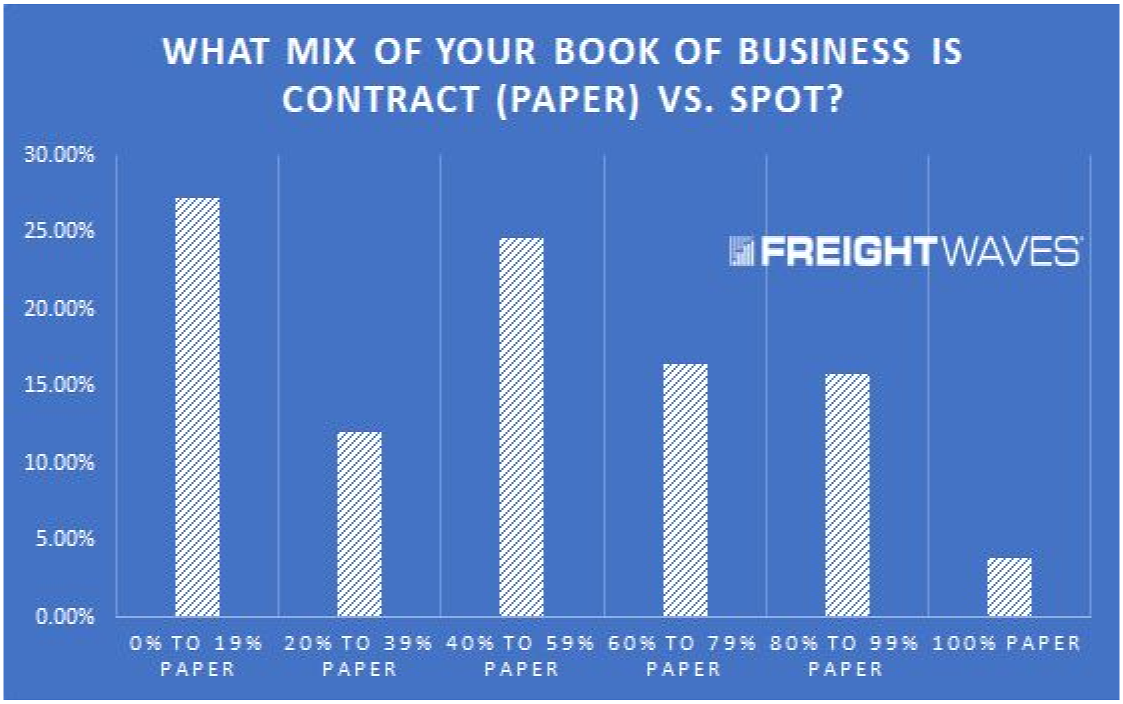
Figure 9 - Average Duration of Paper Rate Agreements



Source: FreightWaves Freight Broker Outlook Survey, July 2019

- 37 percent of freight brokers say the average agreement length for paper rates with shippers are for 10 to 12 months.
- Almost a quarter indicated they have longer-term paper rates in place ranging from 12 to 24 months.
- Channel checks with freight brokers indicate the average length of rate agreements or paper rates has recently shortened as shippers are calling for rebids more frequently than normal.

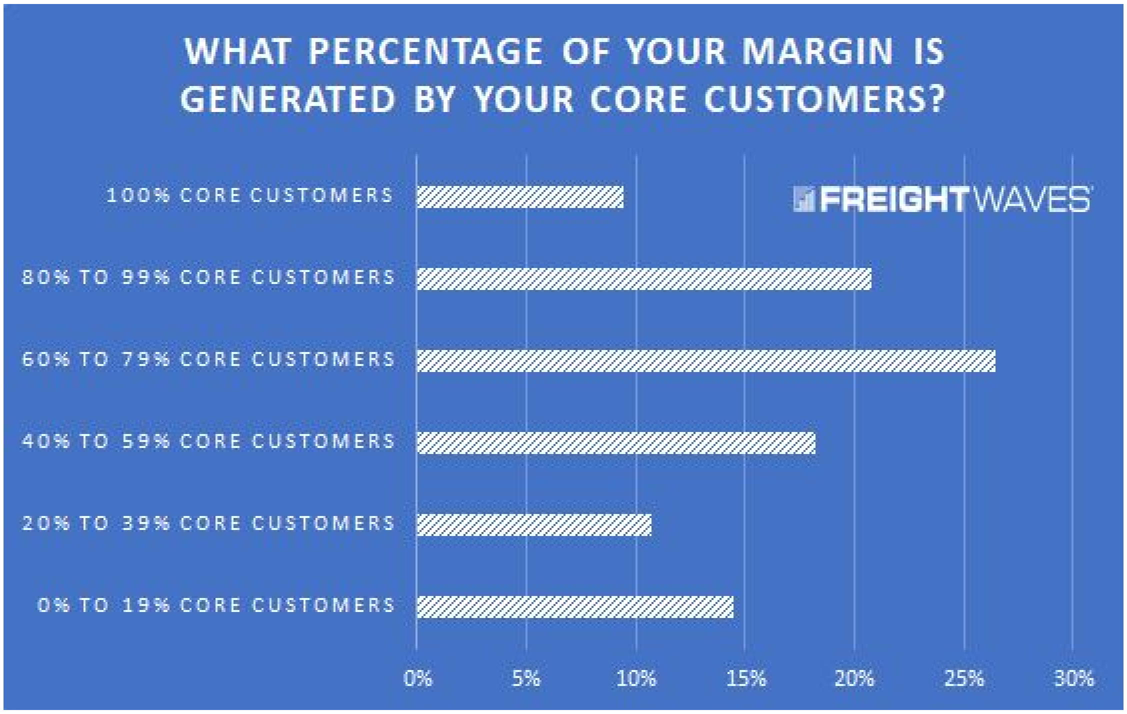
Figure 10 - Mix Between Paper and Spot Freight



Source: FreightWaves Freight Broker Outlook Survey, July 2019

- One-third of freight brokers have a mix of business that has paper rates in place for at least 60 percent on the paper side.
- Only one in four freight brokers work mostly spot market loads, where 20 percent or less of their business have paper rates established with shippers.

Figure 11 - Gross Margins from Core Customers



Source: FreightWaves Freight Broker Outlook Survey, July 2019

- The survey shows that the Pareto rule, where 20 percent of customers generate 80 percent of gross margins, isn't quite in place...but almost.
- 57 percent of respondents say their "core" customers generate at least 60% of their gross margins.
- Surprisingly, one in four freight brokers say their core customers generate fewer than 40 percent of their gross margins.
- This indicates that a number of freight brokers are working with a high number of low-volume customers, which makes their book of business difficult to scale.

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