

SDL

UK Express Parcels Market and Trends Study

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March 2004

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1 Executive Summary

1.1 Market and competition

The UK Express Parcels market is around £4.1bn in size and in recent years it has grown slowly at around 1% per year. The fundamental driver is economic growth, but increased just-in-time manufacturing (JIT), subcontracting of manufacture and home shopping are also important. It remains a very competitive market, with around 20 established operators.

The major acquisition of the last year has been DHL buying the remaining proportion of Securicor that it did not already own, opening the road to a merger of the two operations. Nightfreight, Initial City Link, Business Post and Securicor have shown the strongest gains in market share. Parcelforce has lost significant share, mainly through a redefinition of its business. Others who have lost market share include ANC and Hays DX.

The most profitable operator is Hays DX, which has a slightly different business model, being more of a specialist mail service than a parcels carrier. Of the more conventional carriers, Initial City Link and Business Post have the highest margins, with Amtrak performing badly and UPS still not in profit.

1.2 Customer needs & buying behaviour

Customers perceive remarkably little differentiation between the majority of operators, believing that any of a large number of alternative suppliers could meet their needs. This results in price-driven supplier selection – customers who say *price* is their most important purchase criterion outnumber those who put *reliability* top by five to one.

45% of customers told us that they would switch suppliers if they could reduce costs by 10% or more. Suppliers are normally reviewed annually. While this does not usually lead to a change, it acts to keep prices in check. Price increases are hard to achieve, unless the customer feels that an enhanced service is being offered.

Improved reliability, value added services and European capability might also lead to a change of supplier.

1.3 Strategies for success

We identify several strategies which could be employed in this market. One that we do not recommend is pursuit of cost leadership through increased scale, as we believe that the scale economies in UK express are limited. It is interesting to note that there is very little relationship between market share and profitability. Cost advantages may be achievable through other sources. One that we are not aware has yet been explored is offshoring of some of the admin and customer service processes to lower cost locations such as India. We expect that those operators with more centralised customer service operations might explore the feasibility of this in the near future

Other strategies involve creation of a premium service that can achieve premium prices, or obtaining incremental volume to put through the (largely) fixed cost base of the network, through alliance or start-up. A premium service might involve doing the same things better, or it could be based on a more strategic relationship with the customer – becoming their trusted advisor for all logistics requirements. Examples of incremental volume opportunities include alliance with a global operator or creation of an associated logistics operation. We believe there is merit in these strategies and that opportunities in these areas should be pursued.

One goal which we believe parcels carriers should towards is to become more like the lead logistics provider for their major customers. This will involve taking on some responsibilities outside their traditional focus on the parcels network, but by doing it, customer lock-ins and margins may be improved.

We also expect the combined DHL and Securicor to be a powerful force in the industry and would not be surprised to see a weaker player forced out of business due to the intensity of competition in the marketplace.

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3 About SDL

SDL is a consulting and market analysis firm founded in 2002 to provide strategic business information and solve business problems. We have significant experience in the following industry sectors:

- Business services, including logistics, facilities management and support services.
- Wholesale and retail distribution, including supply chain and home shopping.
- Technology, including telecoms and IT.

In addition to publishing reports on key issues and trends in the sectors where we have expertise we provide consulting support to help clients to deal with strategic business issues, such as:

- Understanding market trends,
- Identifying and exploiting growth opportunities,
- Improving the effectiveness of organisation structures and processes,
- Improving customer retention,
- Finding, executing and integrating mergers and acquisitions.

We also help private equity and venture capital investors to find, evaluate (strategic due diligence) and add value to deals.

Our previous logistics industry report, on the European Technology Logistics sector was published in July 2003. It has been used by several leading organisations on which to base their strategies in this sector, and we were invited to present highlights from the study at the Interlog 2003 conference in Amsterdam.

3.1.1 About the authors

This report was written by Frank Proud and Sheila McGovern.

Frank Proud is SDL's Managing Director. He has advised many corporations in the logistics, business services and technology sectors on developing and implementing strategies. He has also advised leading private equity firms on the merits of acquisitions and investments in these sectors. Frank previously led the logistics and IT services practices at Bridgewater and has also had spells with KPMG and Ernst & Young.

Sheila McGovern has written a large number of published reports on technology and business services. She has regularly spoken on these subjects at events. Sheila previously worked at IDC, where she was a Research Manager in the European Services team, and at Admiral plc.

4 Report methodology

The following are the main sources which have been used in researching and compiling this report:

- Interviews with express parcels customers, senior managers at parcels companies and others with extensive knowledge of the logistics sector.
- Parcels company accounts and annual reports
- Published information including press searches, trade magazines, company literature, web sites and on-line databases.

The market size and growth numbers are drawn directly from our model which builds up a picture of the market from the revenues of the individual operators.

The report also draws on the experience of the authors in working with several leading express operators and with investors who have acquired or evaluated businesses in the sector.

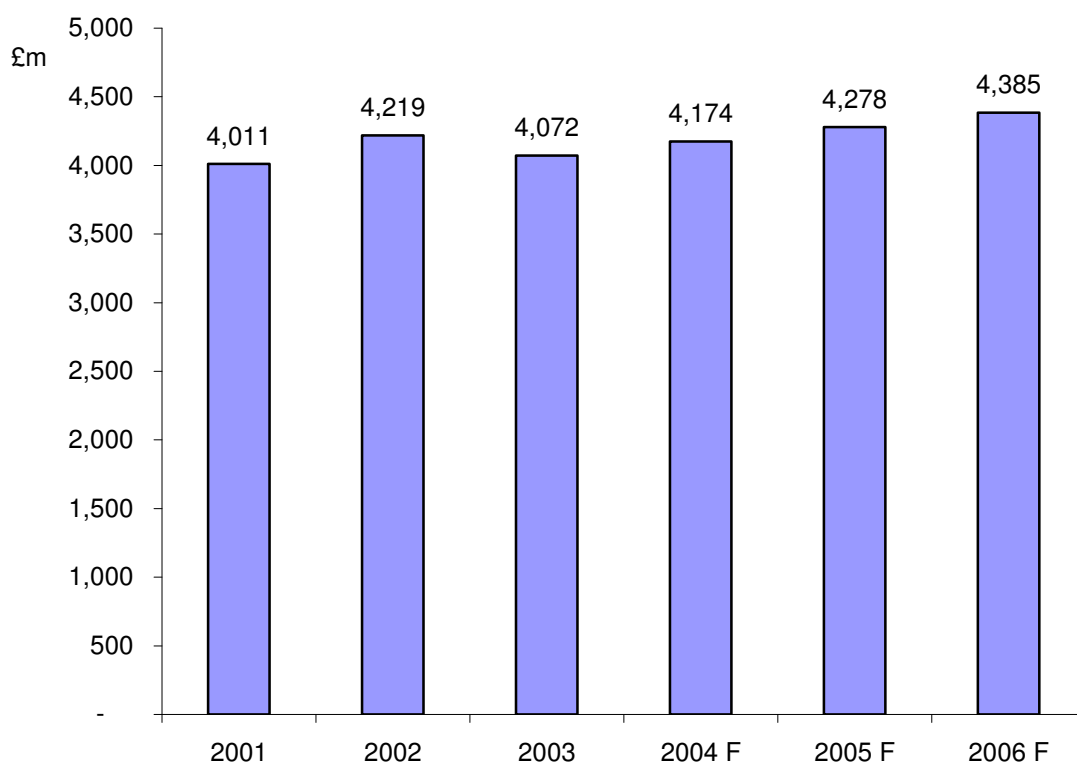
5 Market Overview

5.1 Size and Growth

Based on our supplier model we believe that the UK express parcels market is now around £4.1bn in size, as shown in Chart 1.

Growth is slow. There is evidence that the market actually declined slightly in value terms over the last year, with the Iraq war and consequent economic uncertainty, and the changes which took place at Parcelforce most commonly cited as reasons for this. Previously, 2002 had shown healthy growth of 5% over 2001. The compound average of those two figures gives a two-year growth rate of just 1%.

Chart 1 – Parcels market size



Source: Company accounts, SDL industry model

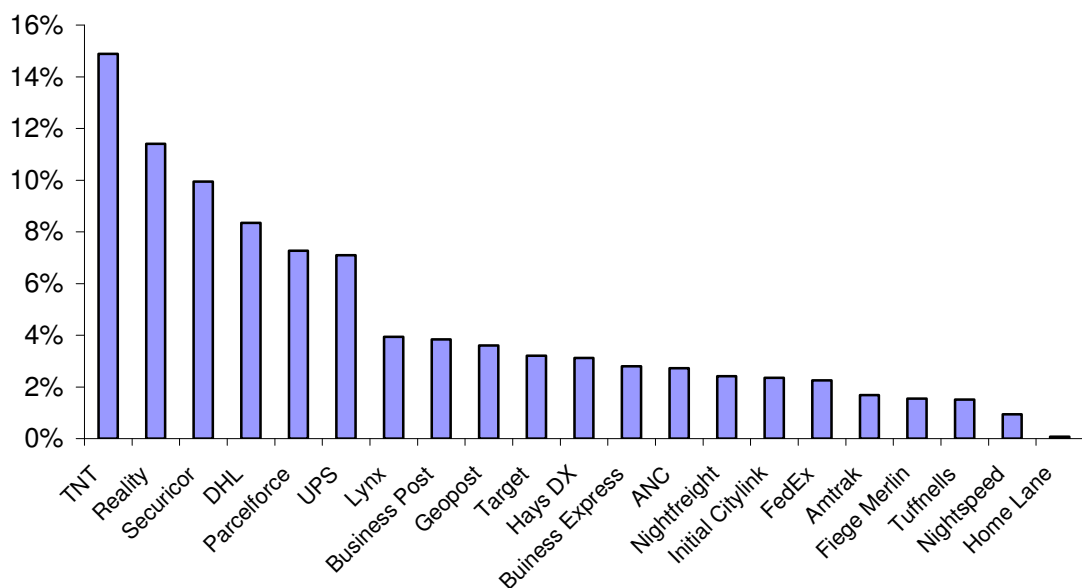
Based on customer expectations of their future requirements and other drivers such as the economy, we expect that the market for express parcels services will grow by 2-3% in value and 3-4% in volume terms. This would give a market size of £4.2bn for 2004, increasing to just under £4.4bn by 2006

It is fair to say that the relatively flat top level figures mask some significant changes occurring beneath the surface. For example the international deliveries are understood to be showing healthy growth while the domestic UK market is very mature. Similarly, there has been growth in the premium, guaranteed early delivery products with the 2-3 day domestic product having largely disappeared. Home delivery is believed to be on the increase. At the level of individual customers, some report that they are rapidly increasing their volumes as their own sales increase and Just-in-Time (JIT) delivery becomes more prevalent, while others are reducing volumes and even going out of business altogether.

5.2 Market shares

The clearest message, shown in Chart 2 (below) though is that express parcels service provision in the UK remains a fragmented industry with at least 20 significant national operators.

Chart 2 – Market shares



Source: Company accounts, SDL industry model

In recent years there has been some consolidation. The major acquisition in the last year has been DHL (which is now owned by Deutsche Post), buying the remaining 50% stake in Securicor that it did not already own. This brings together two leading operators in their respective market segments. Another recent acquisition has seen Amtrak and Target brought under common ownership.

While Federal Express has a partnership with Business Post we would not see that as necessarily leading to eventual merger or acquisition. Given FedEx's history – it launched domestic parcels operations in several European countries in the 1980's but baulked at the losses it sustained and pulled out in the early 90's recession – this is more likely to be an operational partnership designed to extend FedEx's network coverage and feed incremental volume into its European and global express networks.

The other driver of consolidation is of course operators going out of business and in recent years PanicLink and United Carriers have ceased trading. Given the losses which some operators have sustained, it is possible that others could follow.

“I think the actual numbers of companies has hardly reduced at all. This obviously has an effect on prices, and I think it is fair to say margins have been squeezed by this across the board.”

- Express Parcels operator

5.3 Share Trends

There have been some significant winners and losers of market share over the last couple of years (see Chart 3). We believe the major winners have been Nightfreight, Initial City Link, Business Post and Securicor Omega Express (now being integrated with DHL), who have all shown annualised growth in double figures over the last two years.

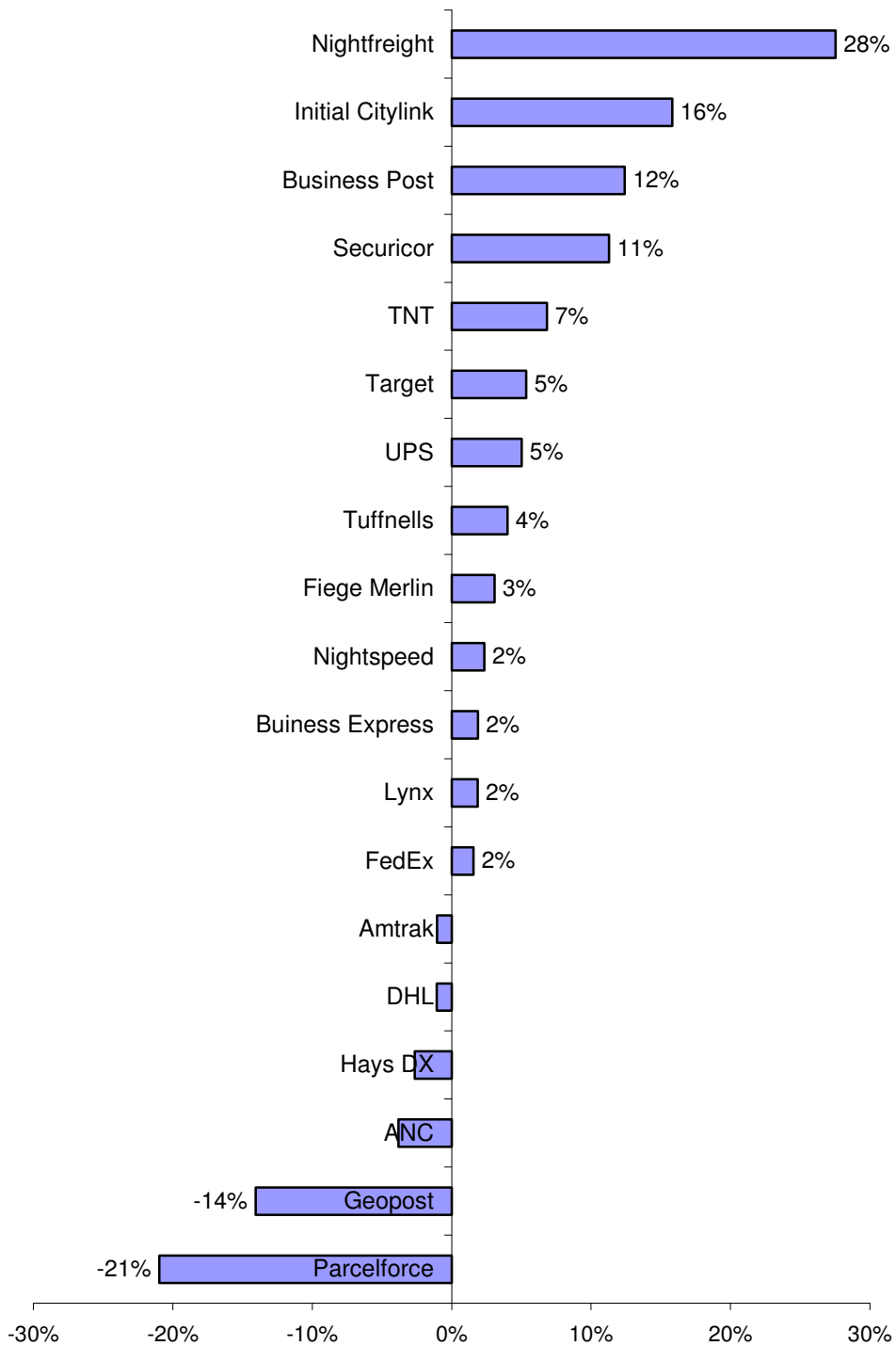
Nightfreight, which has grown at over 15%, undoubtedly benefited from the collapse of United Carriers, an ugly freight competitor, which allowed it to pick up new customers.

Business Post has continued to follow a bold expansion strategy, acquiring BXT, a technical courier business, in 2003 and forming a delivery agreement with the Royal Mail that will allow it to compete for Business Mail services.

ANC and Hays DX, DHL and Amtrak have all lost share but by far the biggest change has been at Parcelforce. In 2002 it withdrew from its basic service, reducing its capacity by 40 million parcels, to focus on higher value-added time-sensitive deliveries. In the long run this should enhance profitability but there was a dramatic short-term revenue reduction, of over £170m. In addition it had to deal with significant negative publicity because some customers, who had had their contracts terminated at a few weeks notice, had based their logistics strategy around the availability of these services.

Elsewhere, the problems at the parent and the fact that it is up for sale have bound to have had an unsettling effect at Hays.

Chart 3 – Growth Rates of Express Parcels operators



Source: Company accounts, SDL industry model

6 Operator comparisons and trends

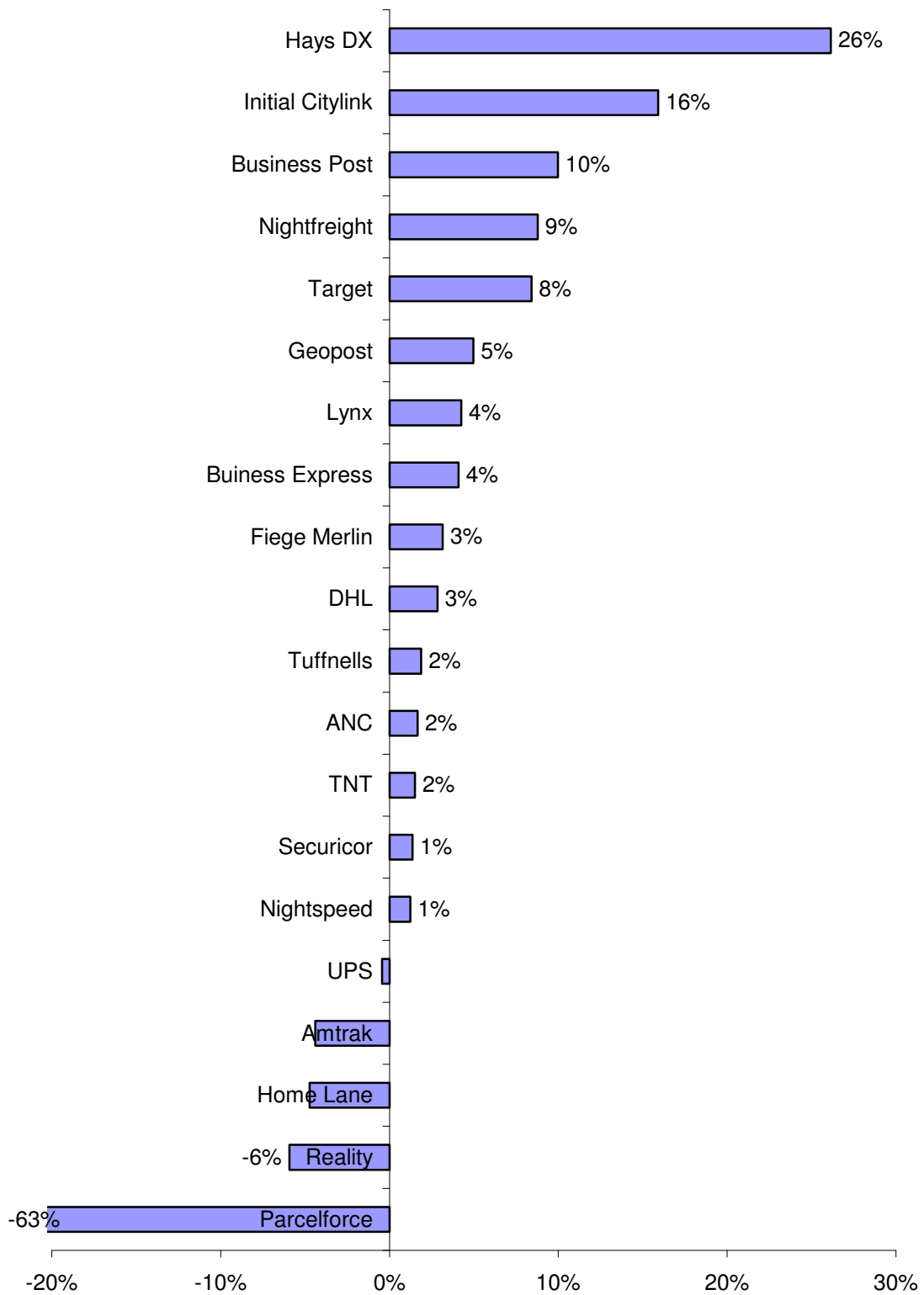
6.1 Profitability

There are large variations in the margins that the operators report, with three groups emerging. At the top end, Hays DX, Initial City Link, Business Post, Nightfreight and Target all make healthy return on sales (pre-interest and tax). Returns above or close to 10% represent an impressive performance for any logistics business, particularly in a market with this level of competition.

In the middle, there is a group of operators getting 0-5% returns, in which we would include the global giant, UPS, which is only slightly loss-making. Finally there are a group of significant loss-makers, with Parcelforce, where a whole product area has been recently terminated along with the associated revenue (see above), being the worst. Reality, the former GUS White Arrow business makes big losses, as does a much smaller home delivery specialist, Home Lane. As Chart 4 (below) illustrates this.

Level of profitability is always a critical metric, however we would concede that, for the major global integrators (UPS, DHL, TNT and FedEx) looking at the standalone profitability of their UK operations does not quite give the full picture. These companies earn their profits largely from providing a global service and ability to deliver into the UK is important in underpinning their proposition elsewhere. We believe that the level of UK profits that these companies display is likely to be influenced by other factors such as their transfer pricing policies for international business and corporate taxation issues.

Chart 4 – Return on Sales



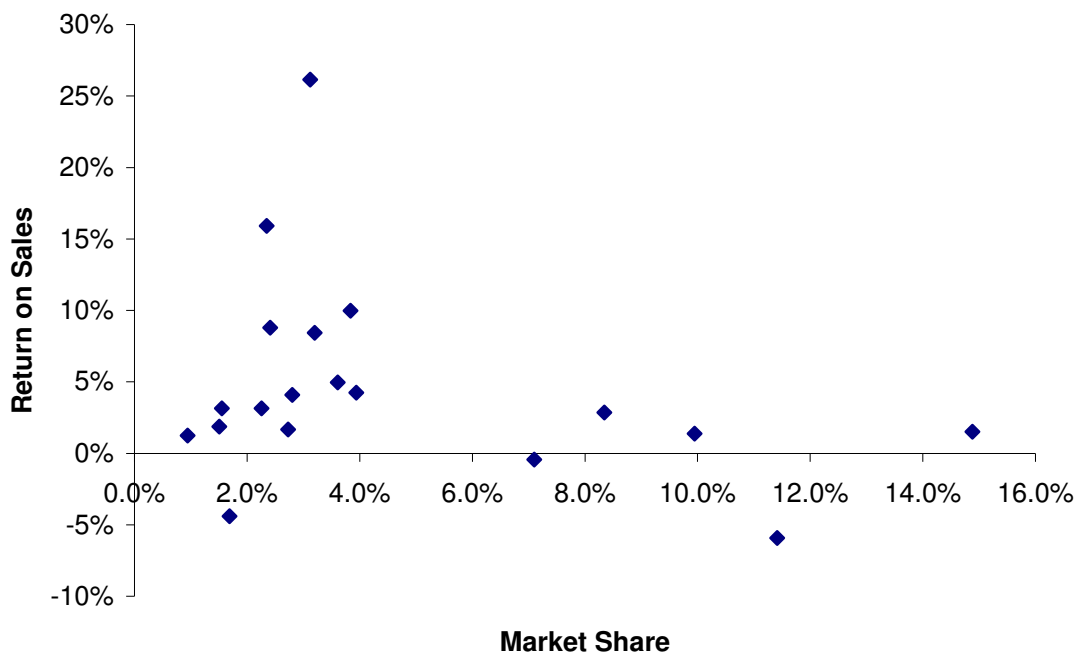
Source: Company accounts, SDL industry model

It is interesting to explore the relationship between profitability and scale, or market share. A strong correlation between the two would suggest that there are appreciable scale economies in this market and support the case for further consolidation.

The fact that one of the largest operators, Parcelforce, has reported heavy losses would appear to contradict this view. However we think Parcelforce has to be considered an exception, because it has incurred losses at a level that would be hard for a private sector business to sustain, partly as a result of a significant restructuring (see above). Therefore we have ignored it for this comparison.

However, the pattern that emerges in Chart 5 shows no obvious relationship between market share and profitability, even without Parcelforce. The scatter chart illustrates this well, but if the relationship is explored mathematically we get a correlation coefficient of -0.32 . This indicates that there is actually a weak negative relationship between size and profitability.

Chart 5 – Return on sales vs market share



Source: Company accounts, SDL industry model

In short, the larger operators do not make greater profits. This is consistent with absence of significant scale economies, and makes it difficult to justify further

consolidation of the market on scale grounds alone. This finding and its implications are discussed in more detail in Section 8

6.2 Employee and depot ratios

There are several factors which influence these ratios:

Value added

How value added does the customer perceive the service to be, and therefore what price are they willing to pay for it?

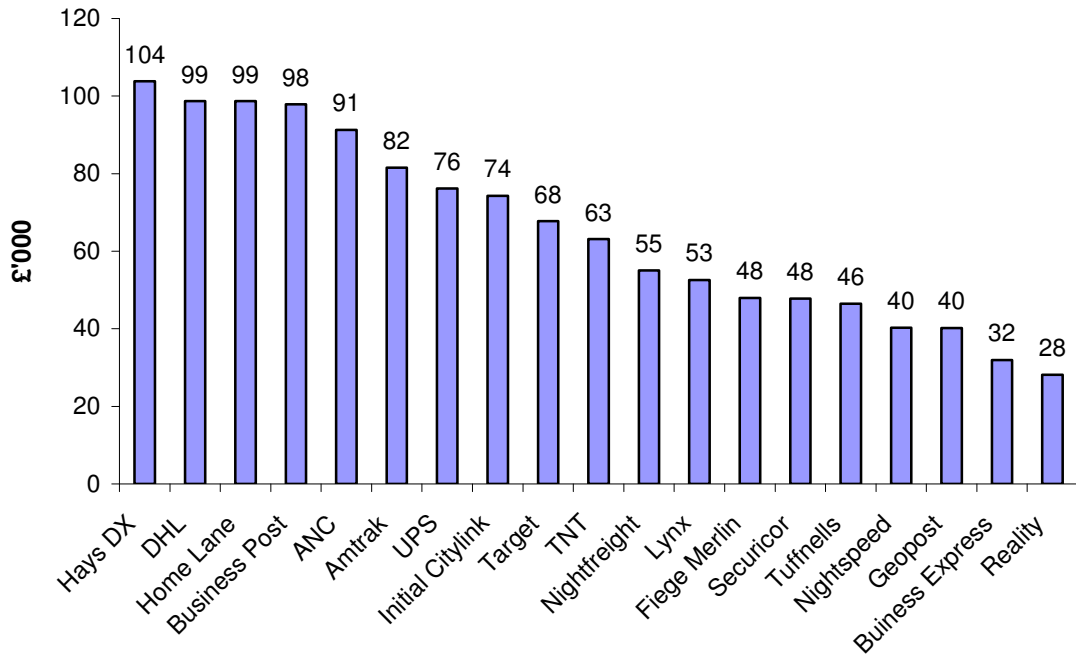
Mix of business

Parcels businesses typically have a variety of customers, some of whom are highly profitable and some only make a contribution to fixed costs. A key goal for management is to get a 'richer' mix of business, with proportionately more customers who take the higher margin services

Operating model

Some carriers do everything themselves in-house, while others outsource not only non-core areas but also stages of their service process. Common examples of this are franchising of local depots (eg Interlink or ANC), extensive use of self-employed couriers (eg Hays DX) and outsourcing of areas of business which the carrier chooses not to operate in (eg international traffic, 'ugly' freight or deliveries to Highlands and Islands)

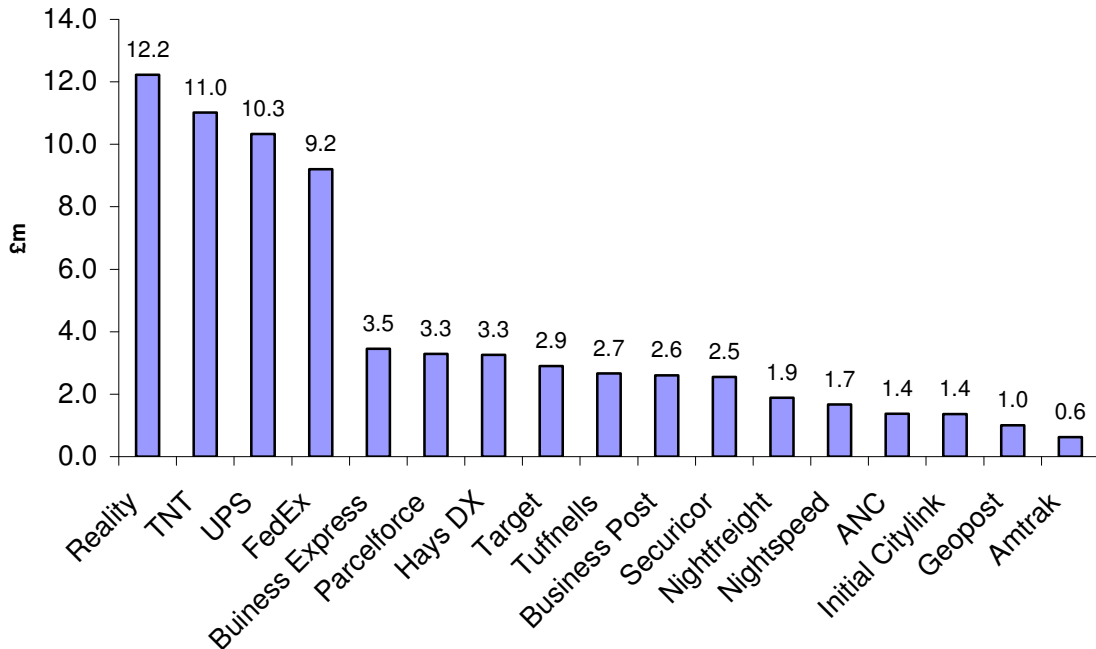
Chart 6 – Revenue per employee



Source: Company accounts, SDL industry model

There are significant variations in revenue per employee, displayed in Chart 6, although the figures are remarkably evenly distributed, from home delivery specialists, Reality and Business Express, at around £30,000 up to Hays DX at just over £100,000 per head.

Chart 7 – Revenue per depot



Source: Company accounts, SDL industry model

Another interesting insight on the differences between carriers and their operations comes from looking at their revenue per depot. This is shown in Chart 7 above.

Reality stands out with over £12m in revenue per depot. This indicates it operates a very different business model from Business Express and Parcelforce, its most direct competitors.

TNT, UPS and FedEx come next, also with high figures of around £10m per depot. These companies compete for high-end international corporate business and might be expected to have a similar model (although FedEx has a much less extensive network in the UK).

The majority of operators have much smaller depots, with some of the more heavily franchised companies, such as Amtrak, Geopost, ANC and Nightfreight in particular standing out at this end of the graph.

6.3 Private equity and Express Parcels

The last decade has seen a series of investments and acquisitions in UK parcels operators by private equity firms such as Barclays Private Equity, Legal and General Ventures, HSBC, Bridgepoint and 3i (see Table 1 below).

Table 1 – Private Equity investments in UK Parcels Carriers

Company	Investor	Date	Amount invested/£m
ANC	HSBC	1995	61
ANC	PPM Ventures	1999	75
Tuffnells	3i	1995	31
Lynx	Bridgepoint	1997	42
Amtrak	3i	1998	143
Target	L&G Ventures	1998	160
Target	3i	2000	200
Nightspeed	3i	1999	31
Nightfreight	Barclays Private Equity	2001	32

While some of these investments were attractive on their own merits, it is a little surprising that so many were made. We feel that parcels became a fashionable sector with private equity firms, based on the belief that a profitable exit could be achieved because consolidation of the market was likely, driven by one or more of the following factors.

Acquisition by a major overseas operator looking to add a UK leg to its network

This is the strategy carried out most notably by UPS which acquired a string of parcels carriers in major European markets, including Carryfast in the UK. Since then other international operators have obtained their UK arm without acquiring one of the private equity backed operators. La Poste acquired Interlink and Parceline from Mayne Nickless. More recently DHL has bought Securicor from its plc parent. Federal Express has a partner relationship with Business Post which involves that company acting as a pick-up and delivery partner for FedEx’s global network in the areas of the UK that it does not cover. USPS has similar relationship with Lynx. As a result of this activity, it is hard to foresee international operators as likely buyers of further UK parcels operators.

Acquisition by logistics players looking to diversify into express parcels

In recent years there has been convergence between different logistics functions. In particular many of the leading freight forwarders have now been acquired or merged with contract logistics groups to support the creation of integrated logistics operators who can fulfil the Lead Logistics Provider (LLP) role. Also the global parcels networks, UPS, DHL, TNT and to a lesser extent, FedEx, have added logistics capabilities to their parcels networks. Many observers expected the leading logistics groups to move in the opposite direction and add a parcels network to their capabilities. However the logic was never compelling enough and, whilst we are aware that some groups did consider it, no significant moves of this nature came about, and now do not look likely.

Consolidation of the market by one player buying up the others.

There are two reasons why we believe this has not happened and is not likely to do so. Firstly the fact that so many UK operators are run on a franchise model makes this problematic. The franchise business model has considerable strengths, such as getting entrepreneurial and highly motivated depot managers, but there is a critical drawback when it comes to merging networks. It is that the relationship with the customer is inevitably owned by the local franchisee, not the parent network, and the franchisee can potentially switch allegiance to another network, taking his customers with him. The normal depot rationalisation that would be required to deliver cost savings from a merger is not therefore feasible.

Perhaps more importantly, as we discuss elsewhere, we believe that the scale economies in UK parcels are not great enough to justify consolidation (see Section 6.1). So even if it were possible, we doubt that there would be major benefits from a 'buy-and-build' strategy

These hoped for scenarios have, for the most part, not come about. In the light of this it is widely believed that many of the private equity investors regret having bought up such a large proportion of the parcels industry, now that a profitable exit looks less likely than ever.

7 Customer needs and buying behaviour

This section explores:

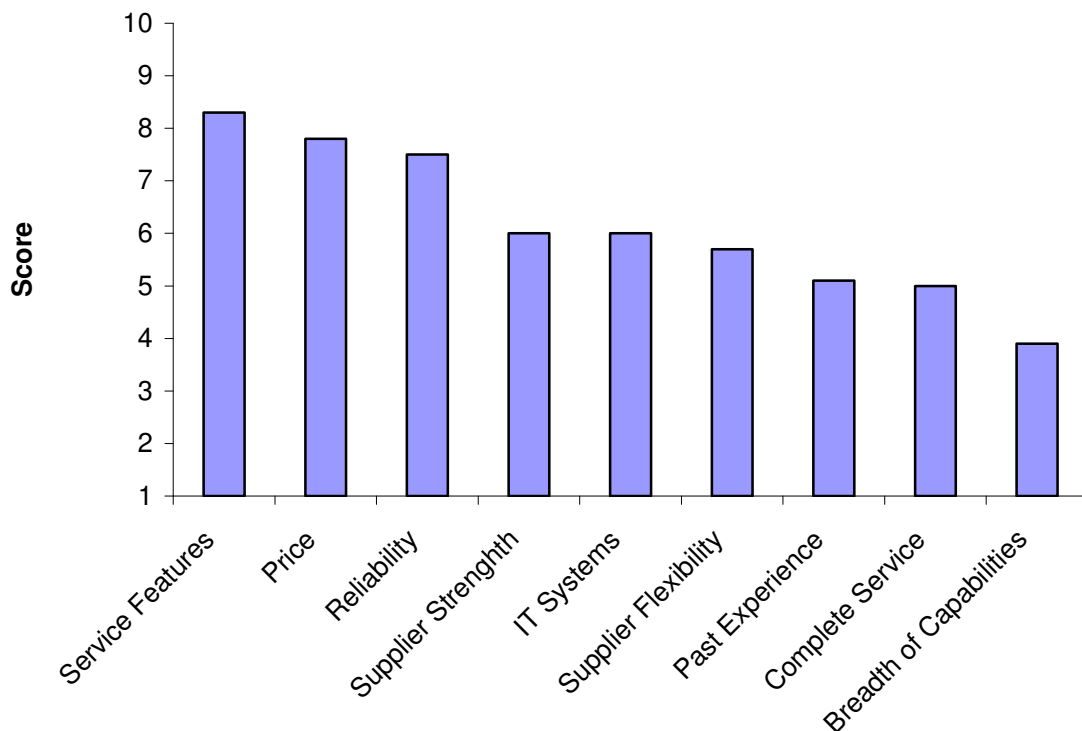
- What factors are important to customers in their choice of express parcels carrier
- How they actually go about making their decisions

It is based on discussions with decision-makers from customer organisations. They are drawn from a variety of industries and management disciplines, including logistics and procurement professionals.

7.1 Purchase criteria

Chart 8 shows the average score given to purchase criteria, with 1 being ‘completely unimportant’ and 10 being ‘extremely important’. The chart shows that *service features, price and reliability* are rated most highly.

Chart 8 – Customer purchase criteria



Note: Scores from 1-10. 1 = ‘completely unimportant’; 10 = ‘extremely important’

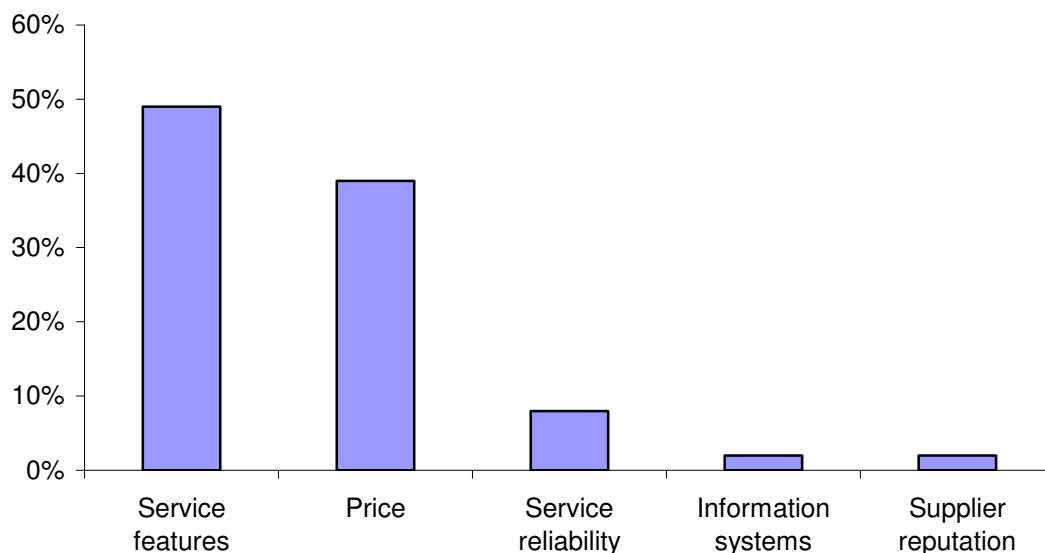
Source: Customer interviews

Our survey clearly shows that *service features* is the most important factor in supplier choice. This primarily refers to the destinations, time-slots and categories of freight which a carrier serves. We believe it is likely that this is more of a qualifier than a factor used to choose between alternatives – a company who make no claim to offer the required service is unlikely to be selected.

Not regarded as being so critical are *breadth of capabilities* and *offering a complete service for all of your requirements*. This illustrates that customers are not looking for a one-stop shop but prefer to select the best carrier or combination of carriers for their specific need.

When customers are asked to single out their most important purchase criterion, a slightly different picture emerges. Once again, *service features* is top, regarded as most important by almost half of customers, but as discussed above, we believe this is a qualifier. The most interesting thing is that almost 40% regard *price* as the most important single factor, almost five times more than the number of customers who put *reliability* first. Compared to other markets, this is an unusually high ratio. We believe this confirms the price-sensitive nature of the express parcels market. As Chart 9 illustrates, no other criteria are regarded as most important by a significant proportion of customers.

Chart 9 – Most important purchase criterion



Source: Customer interviews

7.2 Satisfaction levels

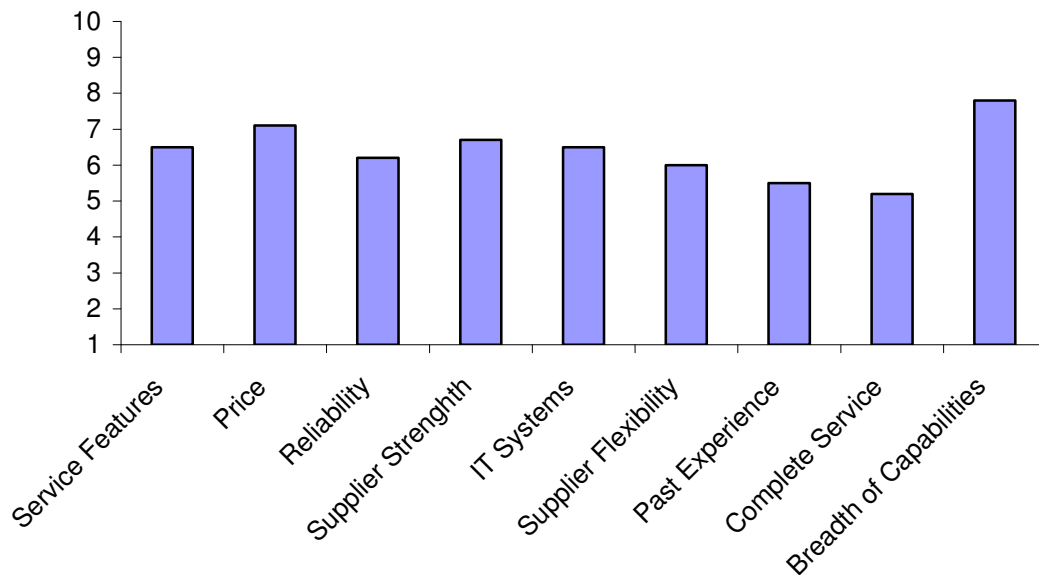
Customers are most satisfied with the *breadth of capabilities* which their parcels suppliers present, confirming that they are not looking for each supplier to offer them everything.

Price is also regarded highly. At first glance it might seem surprising that customers are satisfied with the prices they are paying given we have seen above that it is so important to them. However it is consistent with a market where the level of

competition enables customers to get the service they need at an attractive price. It suggests that, were it not for the presence of competitors offering such attractive prices, customers would regard it as reasonable to pay more for the service they receive.

As Chart 10 shows, the areas where customers are least satisfied are *ability to provide a complete service* and *past record of the supplier*. The first finding is consistent with the view that customers are keen to reduce the number of suppliers they deal with, as a way of reducing their own complexity level and hence costs. The second sounds like a response to service failures they may have experienced in the past.

Chart 10 – Purchase Criteria: Satisfaction

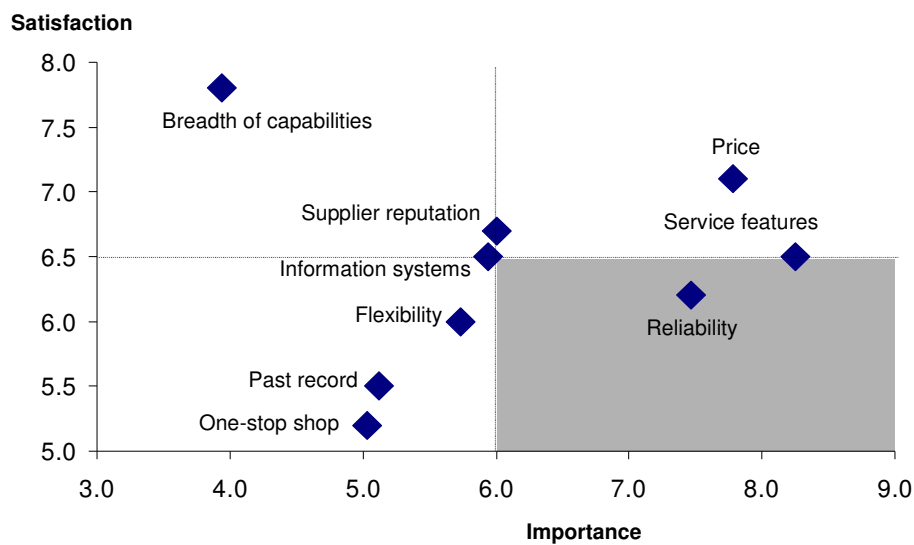


Note: Scores from 1-10. 1 = 'completely dissatisfied'; 10 = 'delighted'

Source: Customer interviews

When satisfaction is evaluated relative to the importance of purchase criteria, the critical area is the shaded box (bottom right) in chart 11. This contains the criteria which customers feel to be important but where they are relatively dissatisfied with the service they receive. Criteria in this box are normally considered those most likely to actually lead to a supplier change. *Reliability of service* is clearly in this quadrant.

Chart 11 – Purchase Criteria: Satisfaction vs Importance



Note: Scores from 1-10. For Satisfaction, 1 = 'completely dissatisfied'; 10 = 'delighted'. For Importance, 1 = 'completely unimportant'; 10 = 'extremely important'.
Source: Customer interviews

7.3 Supplier differentiation

A major issue for the express parcels industry is that many people do not perceive there to be much, if any, difference between suppliers. This inevitably results in more intense price competition because customers feel there are a large number of operators who could meet their needs. From our work in the sector it is clear that it is not only customers who perceive this lack of differentiation. As Table 2 shows, suppliers themselves, when speaking anonymously, have acknowledged it too.

Table 2 – Lack of differentiation – Customer comments

“All carriers are much-of-a-much-ness.”

- Customer

“There is no real differentiation among the operators.”

- Express Parcels operator

“I think that delivery companies we work with are all pretty much the same. We stopped working with the inefficient companies...the only difference I see is that the biggest international delivery companies such as UPS, FedEx or DHL are slightly more expensive.”

- Customer

“For a while a certain carrier will be great and another less good and then it changes ... they are pretty much the same and it is just a question of negotiating price and capacity.”

- Customer

“Prices are decreasing as there is strong competition in the market.”

- Customer

“There are a lot of perceived competitors because companies get reps knocking on their door every day. Therefore, suppliers can not get away with a big price differential.”

- Industry Expert

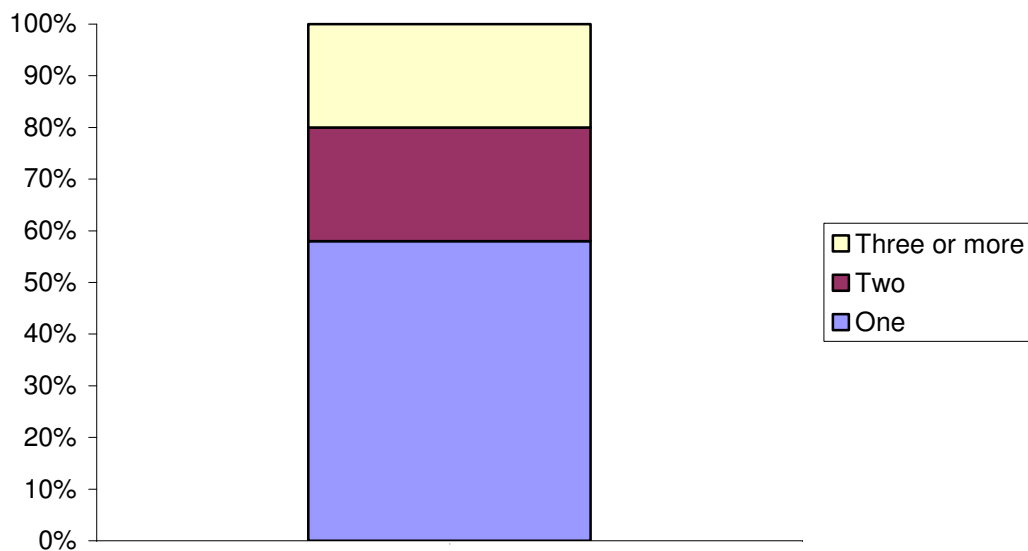
7.4 Multi-sourcing

As Chart 12 shows, the majority of customers use a single supplier. In our experience, companies which single source their parcel requirements tend to come from the following categories.

1. Smaller shippers, who do not have the volumes to justify the extra complexity from shopping around
2. Those with basic or uniform needs, where a single carrier can comfortably do all they require. For example they may not require international service, ugly freight or demanding delivery times.
3. Companies based in rural or remote locations, where there are fewer alternative carriers providing a full service

We believe multi-sourcing is more appropriate for customers with a significant volume of traffic who have some diversity of requirements.

Chart 12 – Number of suppliers



Source: Customer interviews

The advantages of using a single supplier include time saved in managing relationships and maximising buying power. However there are two basic reasons for using more than one supplier. Firstly customers often have diverse requirements and perceive particular suppliers as being better at certain types of work, or find certain

suppliers offer them better prices for a particular type of work. For example they may choose a different supplier for:

- Different time segments (eg early am guaranteed vs next-day or two day),
- Destinations (local vs national vs European vs global)
- Types of consignment (ugly freight vs small parcels vs letters and documents)

Secondly, customers often feel they are in more control if they maintain an alternative supplier. It allows them to avoid dependency, to keep in touch with the market, to have greater leverage when rates are discussed, to give back-up in case of major service failure due to industrial action or similar.

Multi-supplier customers tend to have a lead supplier who receives a dominant share, perhaps 80%, of their business. Table 3 gives some customers' views on this.

Table 3 – Multi-sourcing – Customer comments

Desire for single supplier

“I want a one-stop shop ... unfortunately, it’s impossible because some companies don't deliver to remote areas, or don’t do it quickly enough, some don't ship ugly freight and others can’t do express. A single sourcing policy is still a dream in the UK.”

- Customer

“We definitely want a one stop shop. We have so many shipments going out that it would be a nightmare if every time we would have to chase up a supplier.”

- Customer

Reasons for different requirements

“I find two different segments in the market. The small companies [...] will usually have a single source policy. They tend to be less sophisticated and therefore can't manage multiple supplier relationships. Using one delivery company means they develop a relationship with someone they know, and it's less hassle. They are willing to pay a touch more for that. The larger clients are more sophisticated and can manage a multiple sourcing model, getting the best rate on a route or even job basis.”

- Express Parcels Operator

“If a customer is rural or reasonably small in terms of volume, they will go for a one-stop shop; if they are a large company with a lot of volume, they’ll go for a “multi-source” strategy and price pick.”

- Industry Expert

“Basically customers dual source - one carrier for conventional, one for ugly freight. It’s only if they have a very good relationship with a particular company that they might use just one supplier.”

- Express Parcels Operator

7.5 Pricing trends

There is a widespread belief in the industry that prices are either static or being forced down. The critical drivers appear to be related to supply rather than demand. As we have seen above, a high level of competition and supplier overcapacity are felt to exist. This is compounded by lack of differentiation, making it very hard for most operators to charge a premium price for the bulk of their work. This is brought out strongly by the comments in Table 4, below.

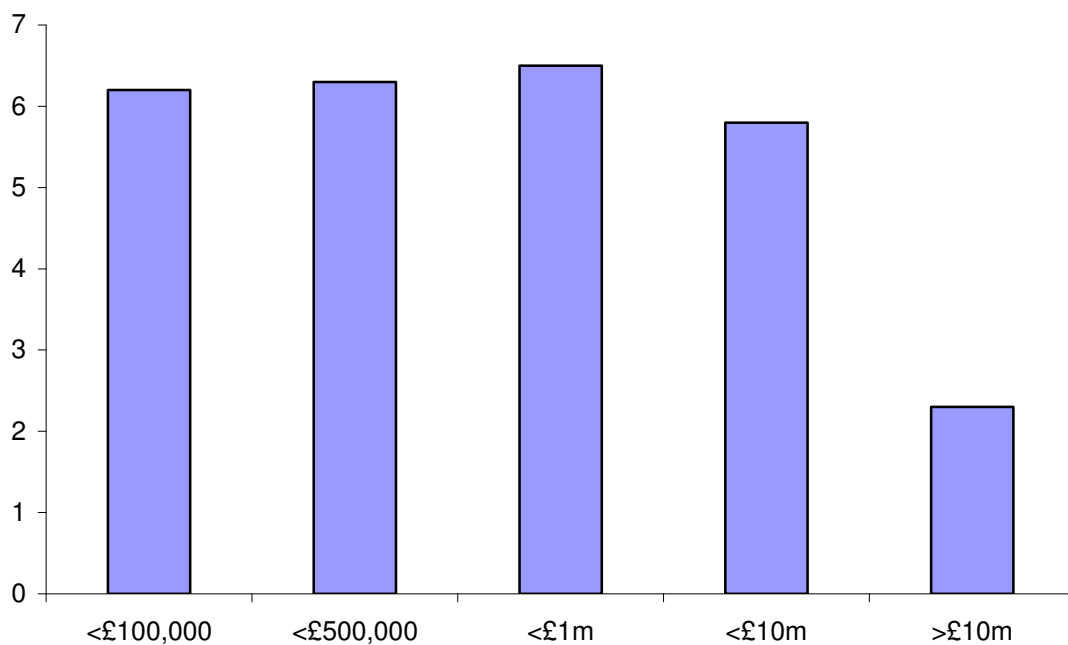
Table 4 – Pricing – Customer comments

<p>Downward pressure on prices</p> <p><i>“It only takes a 15% price cut to get express customers to change carriers”</i></p> <p style="text-align: right;"><i>- Industry expert</i></p> <p><i>“In general delivery service prices are decreasing as there is strong competition in the market.”</i></p> <p style="text-align: right;"><i>- Customer</i></p> <p><i>“Of course the fragmentation in the market and the fact everyone can do almost the same thing means it has an effect on price. We probably charge less today to transport a package than we did 10 years ago [...] There's no-one who can really command a price premium in the long run.”</i></p> <p style="text-align: right;"><i>- Express Parcels Operator</i></p> <p>Price is not paramount</p> <p><i>“The most important criterion in choosing a supplier is delivery performance. Then comes range of services and the IT system. Price only comes afterwards.”</i></p> <p style="text-align: right;"><i>- Customer</i></p> <p><i>“Price is always important when you look at a supplier but it is secondary to delivery performance.”</i></p> <p style="text-align: right;"><i>- Customer</i></p>

7.6 Buying and review process

There is much evidence from customers that they perceive the presence of alternative suppliers to be a strong factor in enabling them to negotiate favourable rates. In talking to customers we discovered that, on average, customers believe that there are around six suppliers who could meet their needs. As chart 13 shows, only for the largest customers, with annual budgets in excess of £10m, does this level of perceived competition come down to around 2 potential suppliers.

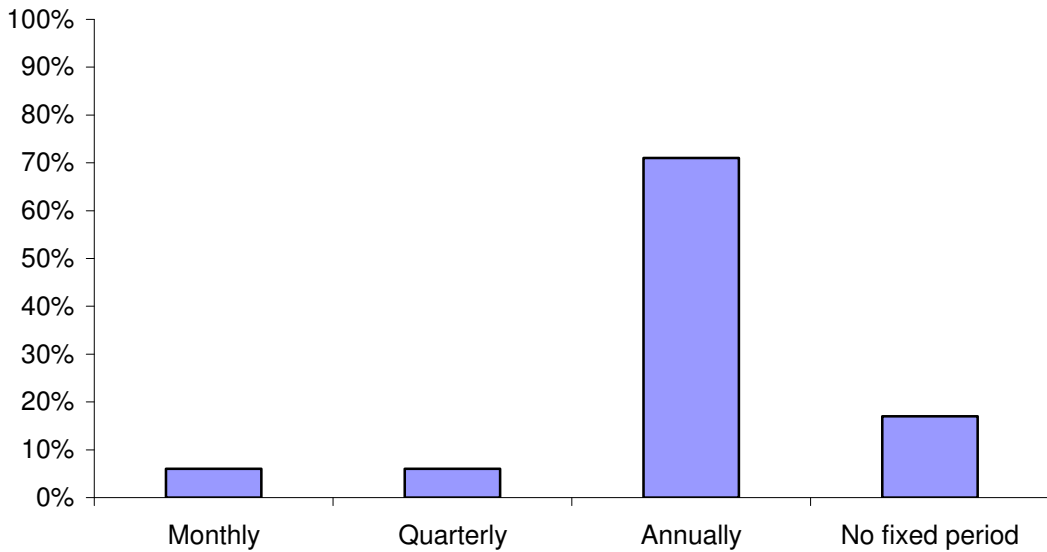
Chart 13 – Parcels Spend and perceived number of suppliers



Source: Customer interviews

As chart 14 shows, the majority of customers review their contracts on an annual basis with only 17% having no fixed period but reviewing when problems occur

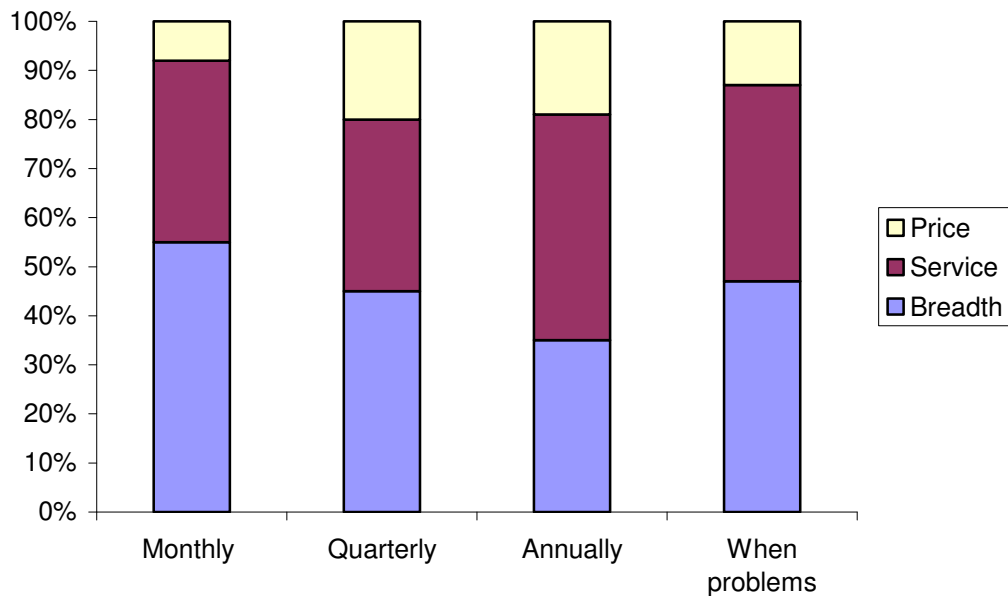
Chart 14 – Frequency of supplier review



Source: Customer interviews

As might be expected, those customers who review most frequently, or as a reaction to service problems, tend to be more price sensitive (see chart 15)

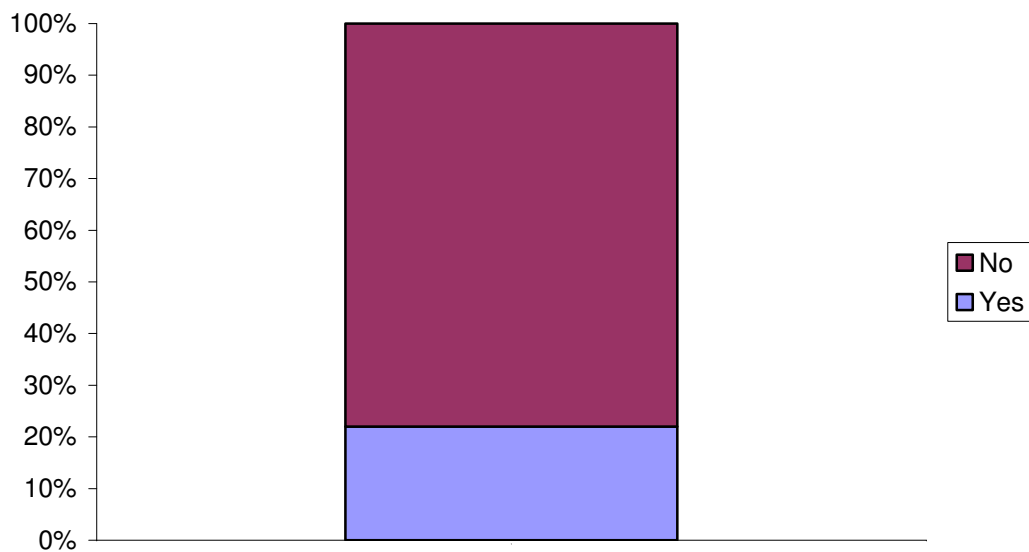
Chart 15 – Purchase criteria by frequency of supplier review



Source: Customer interviews

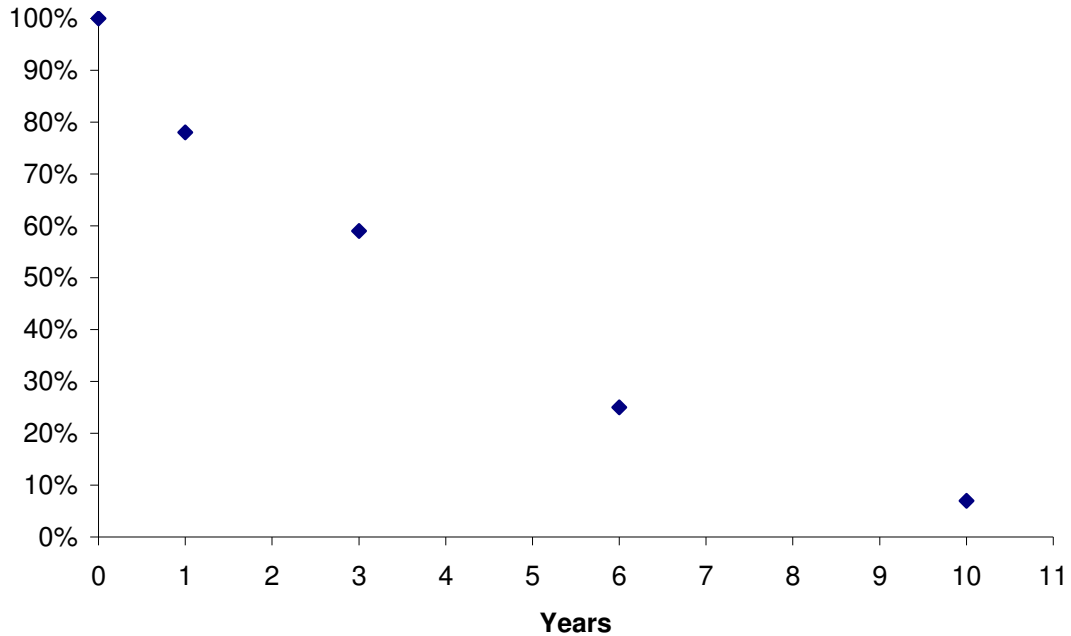
Although suppliers are reviewed regularly, the reviews do not necessarily lead to changes of supplier. As chart 16 shows, only a quarter of organisations have actually switched one of their main suppliers in the last year.

Chart 16 – Have you changed a supplier in the last year?



Source: Customer interviews

Chart 17 – Length of relationship

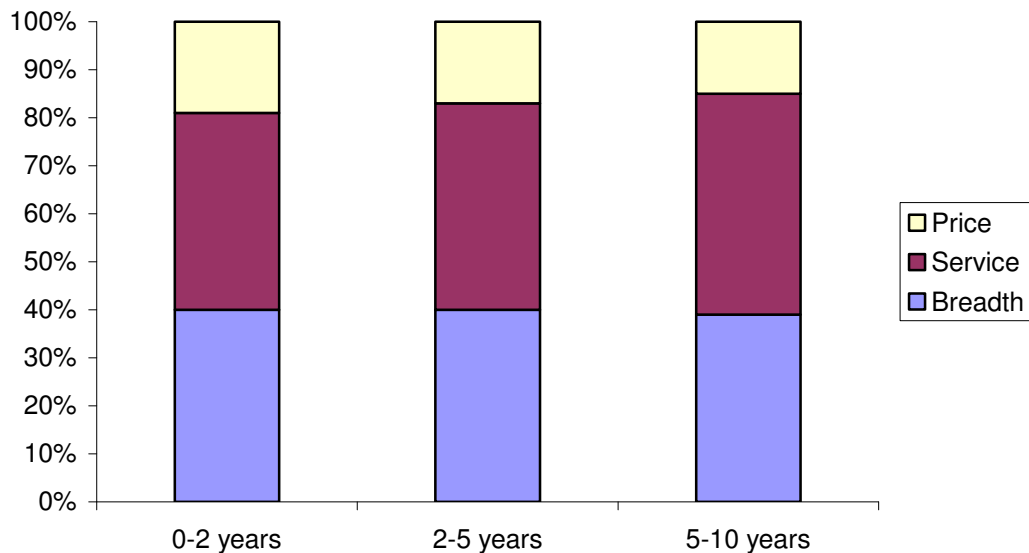


Note: Points indicate % of customers who have used their main supplier for at least the indicated length of time
Source: Customer interviews

Chart 17 shows that 60% of customers have a relationship with their main parcel carrier in excess of two years. From the carrier’s point of view, by this time the exceptional costs involved in winning a new customer and bringing their business on-line should have been covered and the customer should be making a healthy financial contribution. But compared to other business services sectors, 60% of customer relationships having endured for two years or more is not high. If a parcels supplier can increase its retention rate to have a higher proportion of these ‘mature’ customers, profitability should improve.

With this in mind, we would expect price to become less important in longer-term relationships as suppliers tailor their service more and more closely to meet specific customer needs.

Chart 18 – Purchase criteria by length of relationship



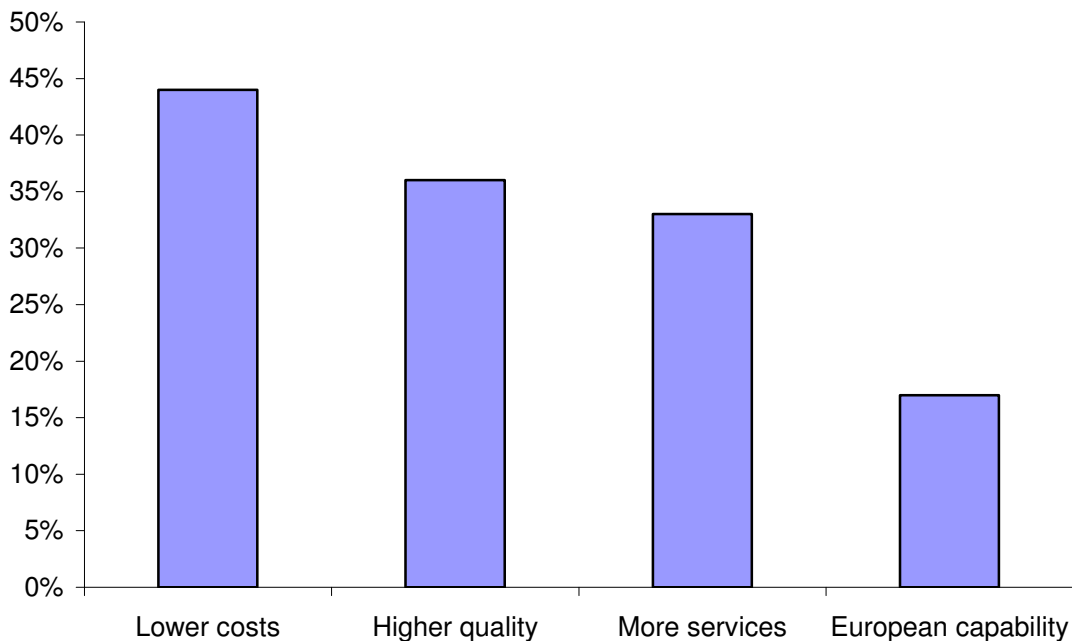
Source: Customer interviews

While this trend is just about discernable in Chart 18 in that a lower proportion of customers with 5-10 year relationships put price at the top, it is not nearly as marked as we usually see in other industries. This does not actually say prices are only slightly better with long-term customers, but it clearly tells carriers that they cannot afford to get complacent, even with a customer who has used them for many years.

7.7 Switching behaviour

We asked customers what would actually make them change suppliers. Four main drivers were mentioned, as chart 19 shows. 45% of customers would switch if they could lower their costs by a meaningful level, defined as 10% or more. Around a third would look to switch if they felt they could get a higher quality of service, defined as improved delivery reliability. A similar number would switch for value added services and around 15% would be attracted by European capability.

Chart 19 – Reasons to change supplier



Source: Customer interviews

Although there is much evidence that the market is very price sensitive, we believe this is rather encouraging. The fact that 55% of customers would *not* switch suppliers for a 10% price cut indicates that they do value the relationships and the service they receive. It is consistent with the picture described above of frequent supplier reviews leading to an actual switch of supplier only in the minority of cases.

This is illustrated by the following comments from customers (Table 5). They are examples of actual customers who did explore switching, but in both cases they stuck with the original supplier, in one case because of service failures, and in another case because the price differential was more than they could justify.

Table 5 – Supplier change – Customer comments

Service failures

“A while ago we changed our delivery company. The new ones were cheaper but there were unacceptable delays, damaged products, they lost several of our parcels. Even worse, they didn't accept their responsibility for this. They don't have a decent claims policy. . The last time we used them, they lost 2 parcels. They credited us back £40 whereas each one was worth £60 - we showed them the receipts. It was the last straw. The relationship lasted 6 months.

- Customer

Good service but not cheap enough

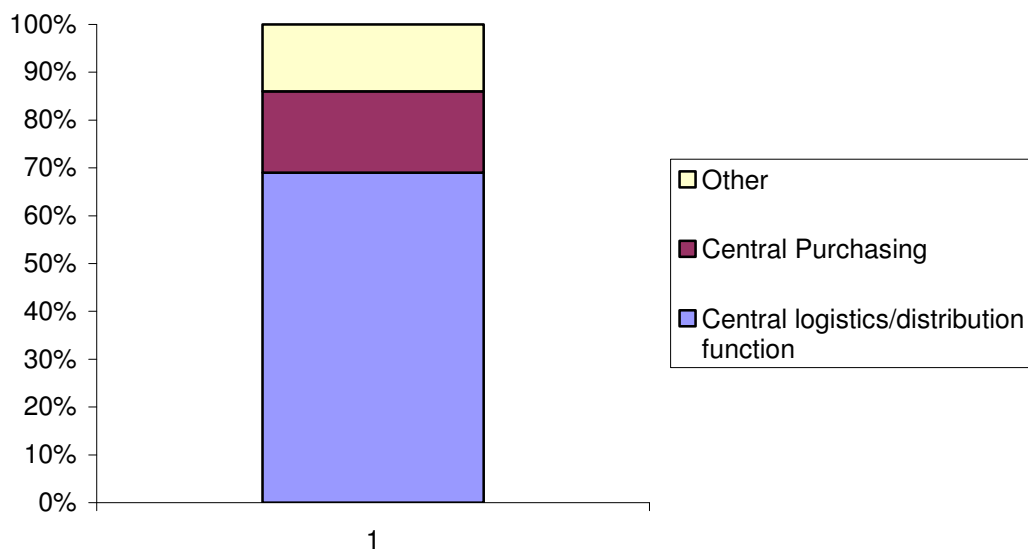
“We tried a new supplier a year or so ago. [They] were flexible, friendly and professional, with great ability. Very efficient and they take good care... However, all this has a cost, they were too expensive and that's too bad, so we stuck with our original company. We are a small company and a 10% price difference is enough to make us change supplier.”

- Customer

7.8 Who is the decision-maker?

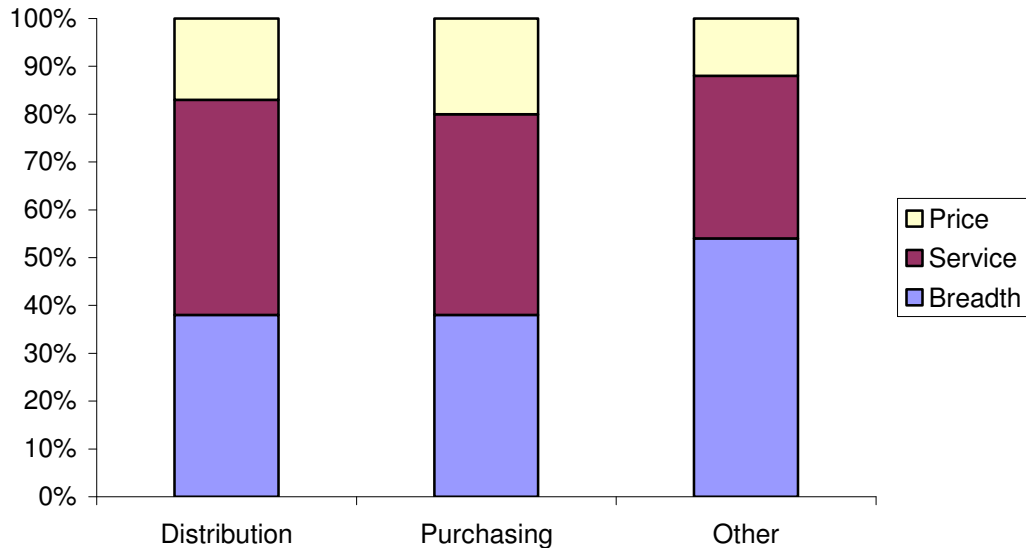
The parcels carrier is more frequently selected by a logistics department than a purchasing function or other department. Chart 20 shows that the Logistics function makes the decision in two thirds of cases.

Chart 20 – Decision making



Source: Customer interviews

Chart 21 – Buying criteria by Decision maker



Source: Customer interviews

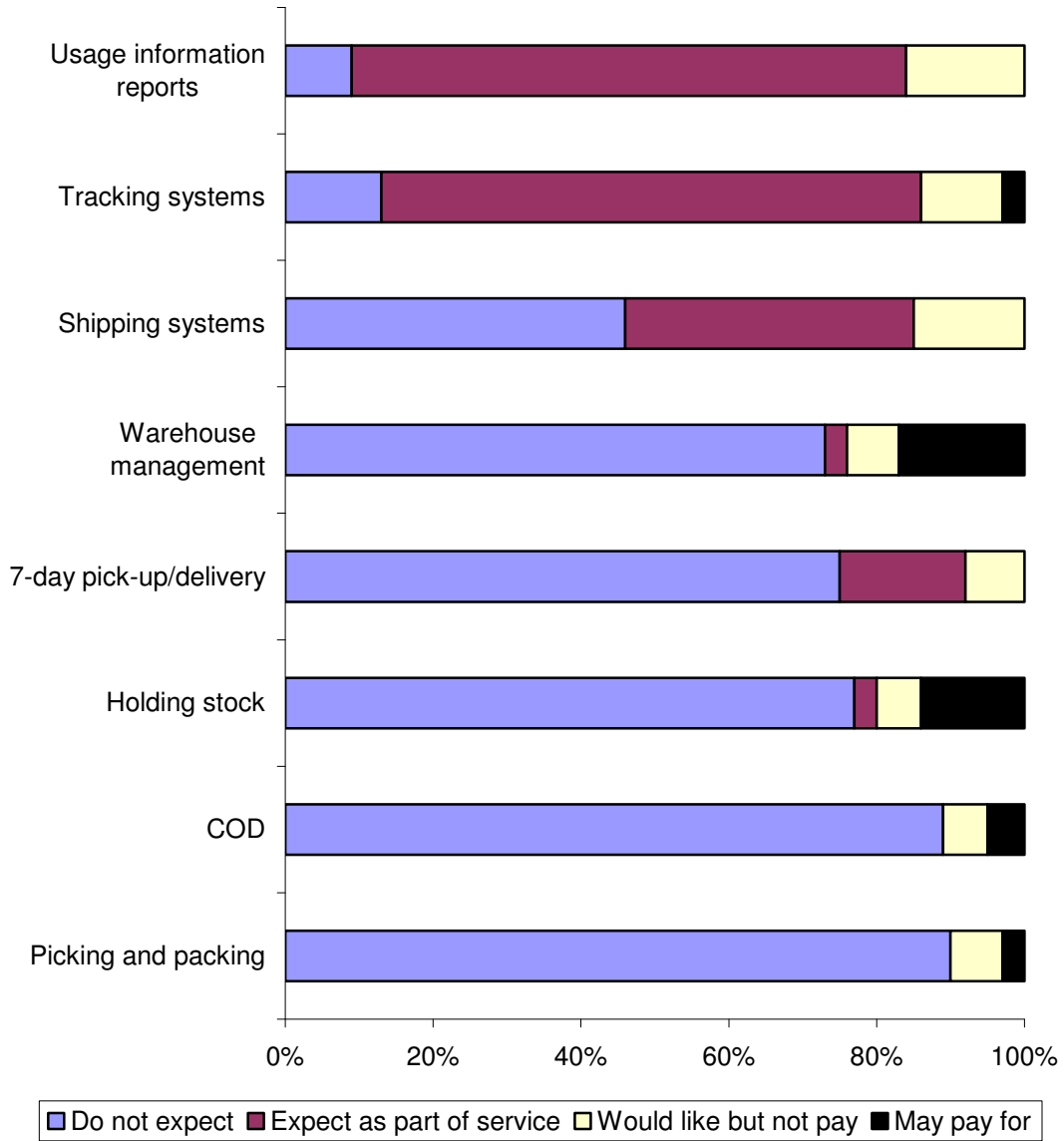
Where the decision is made can be important, as the different functions tend to attach different relative importance to the main purchase criteria. This has implications for parcel carriers in the strategy they should adopt when faced with a particular type of buyer. Contrary to what is often suggested, there is no evidence that purchasing professionals place a greater emphasis on price than logisticians. However, decision makers in areas outside central distribution or purchasing functions are notably more price sensitive, as Chart 21 shows.

7.9 Future requirements

It is clear that service innovations and added value services offer suppliers the chance to improve margins by building differentiation and hence customer lock-ins.

We asked customers about several specific areas to understand what they are expecting and what they might be willing to pay for (see Chart 21). Some opportunities are evident. While most respondents expect management reporting and access to tracking information as part of the service, a significant minority would consider paying for holding stock and warehouse management.

Chart 21 – Value added Service expectations



Source: Customer interviews

8 Strategies for success

8.1 The challenge

The fact that several operators, such as United Carriers and Panic Link, have been forced out of business in recent years illustrates the challenges of the express market only too clearly. Given declining price levels, stiff competition and fickle customers, many of whom see little differentiation between operators, the express parcels market can be tough.

However we believe that there are strategies that can be adopted to help carriers to create their own customer franchise – people who see them as the best provider for their needs, and different from the competition. This is the best way to ensure not only survival but also success in this marketplace.

Table 6 – Supplier Focus

Area of difference	Example carrier	Specific focus	Operational features
Geographical	DHL	International	Integrated air express network
Sector focus	Securicor	Retail/high street	Strong presence on the high street drives high customer density and stops per day
Time segment	Hays DX	Pre-9am	In-night network, able to hit early delivery slots as easily as later slots
Type of freight	Nightfreight, Tuffnells	Ugly freight	Manual sorting process, able to cope with huge variety Larger delivery vehicles, some with tail lift
	Hays DX, Business Post, DHL	Letters and documents	Highly automated sortation Delivery vehicles optimised for small packages only Actively discourage ‘ugly’ freight, or sub-contract to another carrier.

We believe that operators are, to varying extents, aware of this and, in many cases, are doing things to differentiate themselves and protect margins. Table 6 illustrates some examples of the strategic focus of particular carriers.

These strategies are not just a question of marketing spin or tactics but, in many cases, they depend as much as on core differences between physical operations.

Which is the best strategy? There is not a simple answer to this, but there are several basic strategic options open to carriers. Some may be applied in conjunction with each other and some conflict. However we believe that to be successful in this market it is necessary to embrace at least one of the models described in this section.

8.2 Cost leadership

This involves achieving the lowest cost position in the industry, enabling the company to set its prices at a level that competitors find painful, and unprofitable, to match. The classic way to achieve cost leadership is through having the greatest scale economies.

8.2.1 Scale driven

To understand the impact of scale on the UK express market it is necessary to look at which costs are fixed and which are variable. For most operators the biggest fixed costs are the hub, the network of trucks which move parcels between the hub and local depots. For some operators the depot network is also a fixed cost, however many companies operate on a franchise model, making the depot a variable cost, or make extensive use of sub-contractors, with a similar impact. One thing that is clearly not a fixed cost for a domestic UK carrier is an air network, owing to the relatively compact size of the UK and proximity of major business destinations to each other.

Using economists' language, the minimum efficient scale of UK domestic express is actually relatively small. The market is sometimes compared to the US, where a small number of domestic competitors operate in a market many times larger. In the US market there are much bigger fixed costs, because, to be competitive, an air network is required – effectively an in-house airline. This means the minimum efficient scale is much greater, explaining why there are far fewer operators (see Table 7 for comparison). In other markets, such as Belgium or Hong Kong, where distances are even smaller than the UK and population densities even greater, the

minimum efficient scale is lower. It might be possible to operate in these territories with only a single depot, making the entry costs very low.

Table 7 – Minimum Efficient Scale Comparison

	US	UK
Number of domestic operators	3	9
Distance between leading and second most important business locations	3000 miles	100 miles
Operations required to provide next day service	Integrated air/road network. Multiple hubs	Road network One central hub
Level of investment required	Very high	Moderate
Minimum efficient scale	High	Low/Moderate

In practice, if the UK market has a low minimum efficient scale, it means that most scale benefits are achieved at a relatively low market share and that there are limited unit cost gains to be had from getting bigger.

The true picture is more complicated than this because the express market consists of sub-segments which overlap, such as UK domestic, intra-EU and international. Each of these has different characteristics, and a different minimum efficient scale. International services do require a higher fixed cost, and it is no surprise that this market has fewer true competitors.

Another important factor impacting the feasibility of price leadership through scale as a strategy in the UK is the existence of Royal Mail Parcelforce. Parcelforce has historically been the UK market leader by volume, but has operated at a loss. As part of the Royal Mail it has not had the same constraints as other commercial competitors, and the prospect of taking on such a competitor in the sort of price war that might be necessary to determine who has greatest scale and hence cost leadership is very unappealing.

For these reasons we do not think that the pursuit of scale as an end in itself is an attractive strategy in the UK domestic market. Indeed the empirical evidence (see section 6.1) bears this out, showing that there is not a clear link between market share and profitability

8.2.2 Offshoring

Cost advantages may be achievable through other sources. One that we are not aware has yet been explored is offshoring of some of the admin and customer service processes to lower cost locations such as India. In a parcels business these activities typically represent a significant proportion of the non-operational cost, so there should be potential to make savings, provided service levels are at least maintained.

There are different schools of thought on where the customer service and admin processes are best located. Some carriers, notably the big global operators such as UPS, but also some domestic UK carriers, have centralised their customer service operations in call centres not located at the depot. This gives them economies in the management of these processes and ensures consistent service across their network. Others, such as Tuffnells, have resisted this trend, believing that customers appreciate being able to speak to people in the depot, who they may get to know through repeated contact, and who, if push came to shove, could physically go out and have a look for their parcel.

In our view, both approaches have arguments in their favour. However, if the decision has been taken to move the customer service function out of the depot, it should be feasible for it to be located overseas, as long as service standards are not adversely impacted. Therefore we expect that those operators with more centralised customer service operations might explore the feasibility of this in the near future. Equally, those operators who have ruled out centralising of customer service might find that the economic argument becomes more compelling when the cost savings from offshoring are taken into account.

8.3 Differentiation

By creating a ‘value-added’ service that better meets the needs of customers, a company can justify a higher price. If the price premium outweighs the additional costs of providing the service it is a viable strategy.

In the express industry a premium service might involve doing the same things better – higher reliability levels, greater speed to a particular destination or a combination of earlier deliveries and later cut-off times. Alternatively it could involve a more strategic relationship with the customer, where the carrier is their trusted advisor for all logistics requirements, or, to use a currently fashionable term, Lead Logistics Provider.

8.3.1 Premium prices for premium services

The global integrators (ie UPS, DHL, TNT and FedEx) are generally regarded to have a high service level. Amongst domestic operators, Business Post (now FedEx’s UK partner) and Initial City Link are examples of those who enjoy a strong reputation. While their service levels mean that they are unlikely to be low cost operators, it is no surprise that Business Post and Initial City Link have just about the highest margins in the sector. Their customers are willing to pay a premium because they perceive they are getting a better quality of service.

There is a recognition that premium prices are possible for more demanding segments, such as pre-8am and in-night delivery, or ugly freight. One important factor driving this greater time sensitivity is the increase of Just-in-Time production methods, which is expected to continue.

Table 8 – Trends towards Just-in-Time

“There is a bigger trend towards Just in Time delivery because a lot of guys don't want whole stocks, even Argos have a low stock holding. The delivery can be made straight to the end-user. However the Just In Time deliveries make up a small proportion of our business. The real difference here will come within 5 to 10 years as this delivery method enters the IT and Communications arena more regularly. There is a lot of education required in these sectors.”

- [Parcels Carrier]

A variation on early delivery times is the operation of an in-night network. Examples of companies operating this in the UK include Hays DX and Lynx. Such a network is normally able to achieve earlier delivery times than a traditional operation but requires a dedicated night workforce to carry it out.

8.3.2 Lead Logistics Provider

Can a parcels carrier be the lead logistics provider responsible for coordinating the whole range of transport and logistics requirements for the customer? Traditionally this has not been how parcels carriers have been thought of, but in theory it should be possible. Significant cultural changes and upgraded account management skills may be necessary to achieve it. However we feel that the parcels carrier would be missing an opportunity if they do not aim for this type of relationship. Moreover, leaving it to contract logistics operators or virtual '4PL' operators creates the threat of being pushed down to a second tier of suppliers, with erosion of margins and weaker relationships with the end customer.

8.4 Focus

If a particular segment of the market can be identified which has different needs from the mass market, an offer can be created that meets those needs more closely. Examples of this include ugly freight, home delivery and industry-specific solutions.

While best practice in express parcels typically involves automation and smooth processes, which are most suited to uniform package volume, the ugly freight segment is an exception to this. Ugly freight is defined as parcels that are difficult to handle in a modern, automated process, either because they are too heavy, bulky, awkward shaped. These present the greatest problems for the most highly automated operators. UPS, with its industrial-engineered processes, conveyor belts and bespoke package cars, finds it inconvenient and costly to handle a palletised consignment. However, some operators focus on this niche. Tuffnells, which does not have a hub, and Nightfreight, which has a highly manual hub and larger delivery vehicles, are much more suited to ugly freight. Therefore they are able to offer better prices for this freight giving them a defensible core of business which is relatively protected.

These companies do not solely carry ugly freight. The majority of their volume is probably normal packages but the presence of the ugly freight in their network improves the economics of their business as a whole.

Home delivery can also be viewed as a niche which certain operators find easier to cope with than others. Typically the major networks focusing on corporate customers do not like home deliveries, with their high proportion of delivery failures and obscure addresses. Some operators, such as Reality, have it as their main focus, with a network and operational process designed around its demands. In the middle there are some operators who, while mainly focusing on business to business, are better able to cope with a certain proportion of home delivery in their package volume. An example of this is Interlink Express, a franchise operator with a large number of depots and hence a small geographical radius to its local depot franchises. This gives it greater flexibility to accommodate home delivery.

Specific industries often have specialised requirements which might relate to the handling of types of goods or the location of customer sites. The strength of Target in pharmaceuticals and Securicor in retail are examples of focus based on industry.

8.5 Enter adjacent markets

One strategy is to explore opportunities to use the assets of the parcels business to serve the needs of customers in related markets.

8.5.1 Alliance to get into international business

An example of this strategy is alliance with an international operator to generate incremental volume. There are several instances of this, such as Business Post's alliance with FedEx, Lynx's relationship with USPS and Parceline being part of the DPD network. Sometimes, in the case of DHL's acquisition of Securicor, it can be a pre-cursor to a closer relationship, but it is not necessarily the result of such cooperation.

8.5.2 Logistics

Another example is the creation, or acquisition, of other logistics businesses. Many in the industry have doubted that the synergies to be obtained from combining parcels operations with logistics contracts are extensive, pointing out that there are fundamental differences between logistics and express parcels.

Table 9 – Can parcels and logistics operations be combined?

“They really are different businesses. Parcels is a low value-added business, where the key is maximising utilisation of your hub. This core competence, and the mindset required to do it, is very different to that required for a logistics group, where you’re selling a customer your bespoke solution to manage his entire supply chain. A logistics company is trying to improve a customer’s supply chain management by reducing inventory and cutting delivery times from say 40 days to 10. A parcels company can only have an impact of hours on a supply chain - this is nothing as far as a logistics company is concerned”

- [Contract Logistics Operator]

“It is not possible to combine logistics and parcels businesses because of the difference in business. For parcels you need standard operations: a central site with sorting facilities, and a hub and spoke through which to process everything. For logistics, requirements vary for each customer and you have to set the whole system up for them and it is very expensive to do this”

- [Contract Logistics Operator]

“We would never see logistics and parcels as parts of the same business. Parcels is a tiny function at the very end of the supply chain which we would expect to sub-contract”

- [Contract Logistics Operator]

The demerger of Hays, which is currently taking place, is based on the recognition that no significant synergies had been obtained between its Logistics and Mail & Express divisions.

However, in spite of this there are arguments in its favour. In theory there should be value to be created by locating a warehousing operation next to a parcels hub. This could give benefits such as reducing the overall distribution cost by virtually eliminating the ‘pick-up’ stage or improving service by allowing orders to be taken much later in the day for next day delivery.

Several parcels operators have followed this general route, including Nightfreight, Lynx and ANC. Nightfreight has a portfolio of logistics contracts, some of which use the ugly freight capabilities of its parcels network to provide distribution resources.

Lynx and ANC both have significant logistics operations, both focusing largely on the technology sector. They include capabilities such as technical couriers and in-boot delivery. As such they appear to be more independent of the parent networks. These markets may be attractive in their own right whilst also potentially generating incremental volume to put through the parcels network, which will improve its economics. Even without operational synergies of any sort, another possible benefit is sharing of customers or cross-selling of services from one side to the other.

Adding support to this view, TNT recently announced that it intended to go further down this route, looking for greater synergies between its successful express and logistics operations, not just in the UK but also on a global basis.

8.6 The Future

We do not expect to see dramatic changes in the structure of the UK express market in the near future. Gradual evolution is more likely, with operators making incremental improvements to build differentiation and strengthen customer relationships.

For the reasons mentioned above, the grand consolidation which many have looked for is, in our view, unlikely to come about. Similarly we do not expect to see a series of acquisitions of parcels operators by foreign players or contract logistics operators. Also we do not expect rapid change in the UK mail sector. Although Business Post's UK Mail subsidiary has recently reached an agreement with the Royal Mail to enable it to compete for business mail customers, the economics of this market are not sufficiently attractive to make it a gold rush. Therefore the majority of this business will remain with the Royal Mail.

We think the following trends are more likely to occur.

- **Blurring of the distinction between express parcels and other logistics disciplines.** Operators will increasingly look to create solutions for their customers' logistics problems, rather than sell network capacity. This will lead to greater specialisation and hence differentiation between operators. This is similar to the trends which occurred in the contract logistics industry about five years ago, and which led to the creation of the Lead Logistics Provider (LLP) role (and also 4PL, which we do not believe is a sustainable model). By focusing on the customer's needs before their own assets, parcels operators will increasingly give greater consideration to using assets from other operators as well as their own to create the best solution. By doing this they can qualify for LLP-type relationships with their customers, with better customer lock-ins and a degree of margin protection.
- **Smaller add-on acquisitions** will be carried out by the parcels operators to bring on board new logistics skills to enrich their offer and help to build differentiation. Business Post's acquisition of BXT, a technical courier business, has been the best example of this in the last year. Alongside technology we see pharmaceuticals as being an important market with potential for this to occur.

- **The new DHL incorporating Securicor emerging as a powerful market leader.** In combination these two operators will have a market share of over 18%, making them the clear leader. We expect that this share will increase further, driven by cross selling of the services of each to the customers of the other. Service levels should improve and some costs should be cut from some rationalisation of operations and sharing of best practice. Also the combined entity is likely to have significantly greater marketing muscle than competitors, tilting the playing field slightly more in its favour.
- **Hays Mail and Express to recover** from the uncertainty surrounding its demerger from the plc to become a more powerful force in the industry under new, settled ownership.
- **Offshoring of customer service processes** (eg) to India to improve cost-effectiveness. While we have not yet seen an example of this, we feel the industry is well suited to it.
- **A smaller player to exit from the market.** We do not have a particular company in mind and it would be wrong for us to make suggestions. However we are aware that some operators are under financial pressure and factors such as increased interest rates could turn their bankers against them. Operators who are slower to innovate, who provide an undifferentiated service that makes them vulnerable to substitution and limits their margins are most at risk.