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THE STATE OF FREIGHT

IS THE FREIGHT MARKET STILL IN LIMBO?

FREIGHTWAVES SONAR

FreightWaves CEO and founder Craig Fuller and Zach Strickland, head of freight market intelligence, explored disconnects between rates and volumes in the freight market during the latest State of Freight webinar on Monday.

Fuller and Strickland broke down the evolution of the current trough in the freight market, one of the longest and deepest down cycles in recent memory: why it occurred, the unique characteristics that distinguish it from previous cycles, who it's affecting the most and how long it might last.

First, they sought to explain what FreightWaves has called "the freight brokerage winter." Fuller pointed out that in the past four months, at least four non-asset-based freight brokerages have failed, a rarity in trucking.

"It was a story that I had been following for a couple of months," Fuller said, "and I had a number of people who are much closer to the [profit and loss statements] of the brokers — folks in that whole ecosystem, bankers and others — who said, 'Look, there is a systemic issue in the freight brokerage industry, particularly in these high-growth brokers.'"

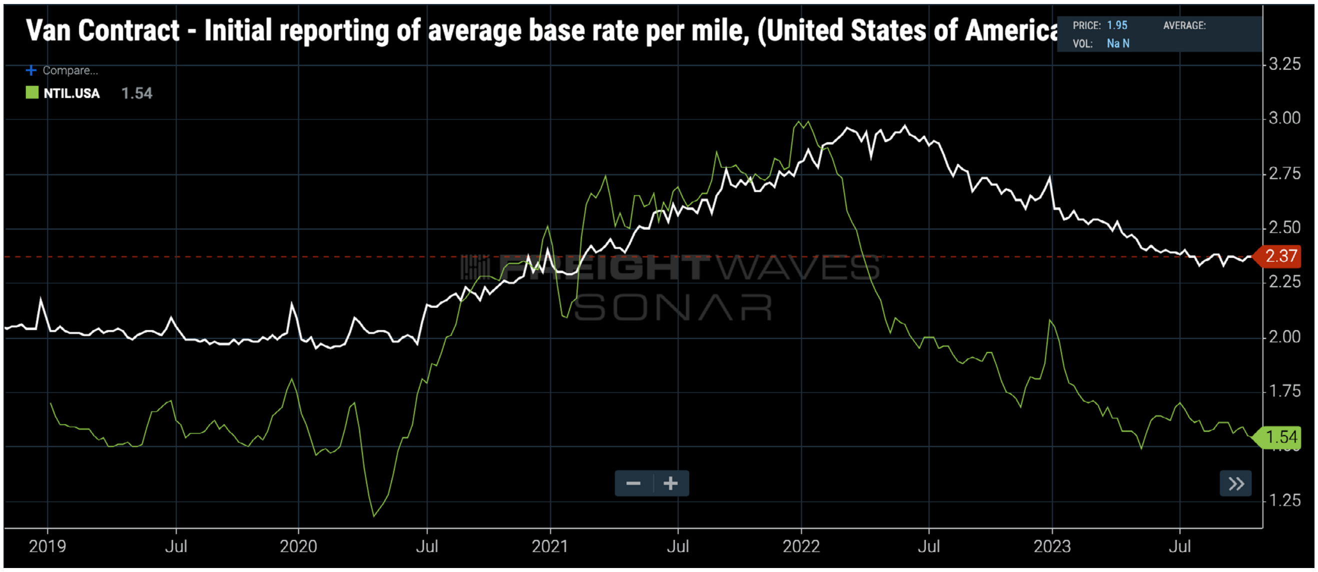
Fuller went on to recount how the freight brokerage industry grew rapidly over the last 20 years during a nearly continuous zero-interest-rate environment, enabled in part by the availability of cheap debt to finance their growth. Twenty years ago, freight brokers were a relatively small part of the trucking industry, but today they control approximately 25% of U.S. truckload volumes.

These intermediaries occupied a niche between the shipper and the trucking carrier, and in a world where truckers need to be paid quickly but shippers pay on net 60-day terms or even more slowly, fast-growing brokers continually strain their working capital and run short of cash. The answer was asset-backed lending, or ABLs. The brokers borrowed against their receivables from banks that were willing to advance them money based on the creditworthiness of their customers, typically large corporations.

But as interest rates rose, brokers went from paying 4.5-5% interest on their ABLs to 10-12%, at the same time that their margin dollars per load were compressing significantly.

"There were also decisions made in that cycle that we're now paying for," Fuller said. "Capital was super cheap. That 2010-2020 period was an unusual period where interest rates were low, and it was an expansion cycle for the broader economy, but cost of capital was basically cheap. What that enabled was a lot of freight brokers, less so asset-based carriers but certainly brokers, to grow their businesses and use debt to finance that growth. They raised money from private equity, which also piled on debt, and the interest rates they were paying, 4.5-5%, are now 10-12% and they can no longer grow through debt financing.

"At the same time in the freight market, volumes have dried up and margins have started to compress because the rate spread delta has started to move in, and that's why I think we're seeing a number of freight brokers starting to go under, because they can't withstand the fundamental changes in the freight market on top of the broader economy," Fuller said.



Van contract rate per mile in white and the spot rate National Truckload Index - Linehaul in green. Chart: FreightWaves SONAR. To learn more about FreightWaves SONAR, click here.

One of the more perplexing features of the current down cycle is how different market segments are experiencing significantly different rate environments. Because shippers allocate up to 80% of contract truckload freight to asset-based carriers, reserving only about 20% for freight brokers (although they dominate spot freight), contract rate indexes primarily reflect what trucking carriers, not brokers, are charging their customers.

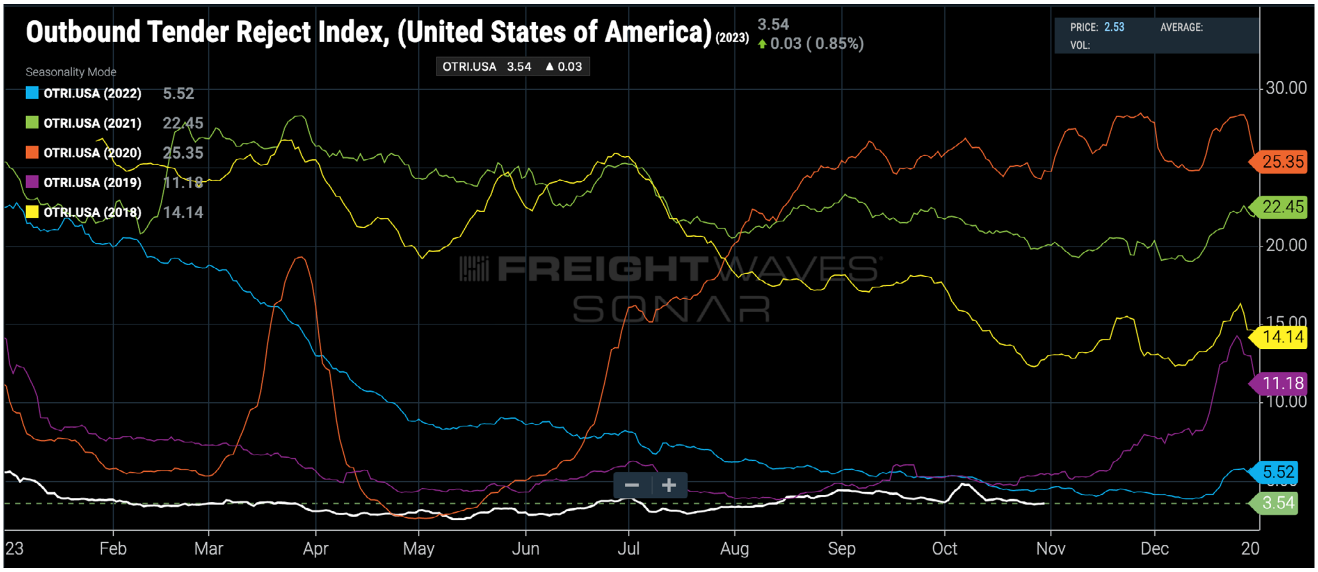
Those trucking carriers, which have seen their labor, insurance, maintenance and asset costs increase significantly over the past few years, are unwilling to bid down rates as aggressively as brokers — so brokers' effective contract rates are lower than national averages. In particular, drop trailer contract pricing may be propping up contract rates in the asset-based carrier segment of the market. Thus, for brokers, the spread between contract and spot isn't nearly as wide as it appears.

"What we're seeing right now is more rational pricing among carriers because in those RFPs, if we're only talking about 20% of the freight being bid out to brokers, those rates are pretty static until we have another bid," Fuller said. "Now bid season has kicked off and the carriers are looking at some pretty difficult operating conditions, knowing they have to be more aggressive, and I think we'll see that contract rates continue to come down next year. Those new RFPs come into effect in the second quarter and that's when we'll see the pricing reflect those really challenging conditions."

But that doesn't mean that asset-based carriers are having an easy go of it — Fuller and Strickland also discussed Heartland Express' surprisingly poor performance in the third quarter of 2023.

For many years, Heartland has been known as a disciplined operator that ran tight regional networks and got high asset utilization out of its tractors, keeping its operating ratio in the mid-80s, but last quarter its OR jumped to 102%, well into unprofitability. Part of that may have been due to its acquisition of CFI and Transport America, two longer-haul carriers with heavy exposure to automotive, but management also cited challenging conditions on the company's earning call.

The takeaway from Fuller and Strickland's discussion was that if Heartland is struggling to make money, then the environment must be really bad for carriers.



The Outbound Tender Reject Index measures the percentage of truckload tenders rejected by carriers and is an indication of the relative balance—tightness or looseness—of trucking capacity. Chart: FreightWaves SONAR. To learn more about FreightWaves SONAR, click here.

Fuller noted that extremely low tender rejection rates — approximately 3.5% — indicate that trucking carriers are taking all of the freight they can get, indicating downward pressure on rates in the current bid cycle. Strickland asked Fuller if he thought that the tender rejection rate would turn positive year over year in the fourth quarter, and Fuller said no.

“There’s no rule about how fast freight comes back,” Fuller said. “Everyone talks about the ‘three-year freight cycle,’ and that’s a rule based on decades of data, but the freight markets were different in those periods of time. So much has changed in the economy that it’s impossible for us to understand everything. We went from a zero-interest-rate environment to one of the largest increases off the low that we’ve ever had, we have inflation that’s hitting and a massive expansion cycle unlike anything we’ve ever seen.”

The massive buildup of trucking capacity during the pandemic years is what’s currently exacerbating the market trough, Fuller said, which makes this “freight recession” different from the Great Recession. The trucking market had a downturn in 2006 prior to the crash, which in retrospect was a warning about excesses in the economy, and by the time volume dropped off following the financial crisis in 2008, the industry was already pretty lean.

This time around, it’s different. During the pandemic, thousands of new trucking carriers were entering the market every week and that unprecedented glut of capacity is what’s dragging out the pain this time around.

To learn more about FreightWaves SONAR and the state of freight markets, click here.