Teneo
The Global CEO Advisory Firm

Supply Chain Crisis: Temporary Dislocation or the New Norm?

Part III: Can logistics providers keep UK supply chains moving through the headwinds?

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UK Logistics providers: increased demand, unprecedented disruption

Delays in HGV tests, withdrawal of agency labour and the impact of Brexit have contributed to a steadily increasing shortfall in HGV drivers that has seen the industry make headlines in recent weeks. A closer look unveils an industry running on thin margins with rising cost pressures and, despite growth from online sales, not all sectors are upholding demand.

The UK haulage industry comprises a few large, national operators who will typically own warehousing space and offer a wide range of end to end logistics services, including storage solutions, warehouse management and supplier management alongside general haulage, and smaller mid-market operators who will fulfil their own contracts and may also be subcontracted by larger players.

These smaller operators may also be a member of one of a handful of national pallet networks that provide a distribution network across the UK. Networks will typically have hubs located across the country, supplemented by strategically positioned member depots (by postcode area) to ensure maximum geographical coverage and facilitate efficiencies through route optimisation and reduced mileage.

Whilst certain operators in the industry are experiencing significant growth and increased demand, some businesses are struggling to adapt to the rapidly changing competitive landscape. This is especially evident with smaller players which lack the ability to pass on increasing costs and we are starting to see companies succumbing to these issues.

We expect to see clear winners and losers emerging in the sector in the coming months, depending upon an operator's ability to attract and retain staff, pass on rising costs and/or absorb margin reduction.

Heavy Goods Vehicle ("HGV") Driver shortages

This driver shortage issue existed prior to both Covid-19 and Brexit and has been steadily increasing for several years, due to relatively low pay and tough working conditions making it difficult to attract new drivers to replace an ageing workforce.

Technology and ESG investment

A continued focus on sustainability and increasing environmental regulation will continue to impact the sector. Disruption, uncertainty and increased bureaucracy resulting from Brexit has also caused delays, increased costs and placed a greater focus on the systems and processes required to deliver an efficient service. Larger, cash rich operators are more likely to invest in certain technologies to increase efficiency, improve profitability and meet increasingly important Environmental, Social and Governance ("ESG") targets.

Shifting retail landscape

As noted in Part 2 of our Supply Chain Crisis series looking at Shipping, consumer demand in the West has shifted from services to goods, which has driven demand for UK hauliers to transport container goods to market once landed from overseas.

However, not all customers are maintaining demand levels and disruption and delays in goods coming into ports has led to reduced demand and empty trailers in certain sectors.

Increased demand for warehouse space

The shift to online retail and increased demand in the Business-to-Consumer sector has increased the focus on "the last mile" and ensuring maximum speed and efficiency in the final leg of any movement of goods from transportation hub to delivery destination.

This, alongside a move to increased stock holdings in the face of continued supply chain disruption, has continued to drive increased demand for warehousing space with vacancy rates currently at record low levels.

Haulier and labour shortages

As touched upon in Part 1 of our Supply Chain Crisis series looking at Consumer Products suppliers, the sector is experiencing an unprecedented shortage of HGV drivers. The shortfall is estimated to stand at 100,000 drivers in October 2021 by the Road Haulage Association ("RHA"), driven by various factors including:

- Foreign drivers who returned to their home countries due to Covid-19 or Brexit;
- The cancellation and subsequent backlog of HGV driver tests due to Covid-19 restrictions;
- A lack of younger drivers to replace retirees (average age of an HGV driver is 55);
- The withdrawal of agency labour due to IR35 tax changes earlier this year (businesses not classed as 'small' are now responsible for determining whether IR35 legislation applies and accounting for relevant taxes and NIC on payments made to workers engaged via personal service companies); and
- The introduction of HGV Driver Certificates of Professional Competence in 2009 has led to many drivers taking early retirement or leaving the industry upon expiry of their 'grandfather rights' rather than completing 35 hours of training every five years to maintain their qualifications.

Cost implications for operators

In response to the shortages, operators face increasing costs to attract and retain drivers in a highly competitive market by way of greater remuneration and the requirement to improve driver welfare and working conditions. Companies that are short of drivers are being forced to try to make up the shortfall with agency or temporary drivers, which, if available, are typically more expensive than permanent employees.

The lack of drivers is also beginning to manifest itself across hauliers' administration departments as operational and back office staff seek to retrain as HGV drivers, leading to increasing rates of pay to retain administrative employees or backfill these roles.

Addressing the HGV driver shortage

The UK Government has announced that up to 50,000 more HGV driving tests will be made available each year due to streamlining of the testing process. The RHA, however, has raised safety concerns in respect of the new testing processes.

A number of operators are also implementing initiatives to tempt new and returning drivers into the workforce (e.g. some hauliers have been paying signing-on bonuses to attract new drivers).

However, training or retraining workers, particularly drivers, takes time (c.6-9 months on average) and the impact of any recent initiatives are unlikely to be fully felt in time for the peak Christmas trading period.

Temporary Workers

The UK Government has announced a scheme to allow 5,000 qualified overseas HGV drivers to come to work in the UK as Temporary Workers.

Of this allocation, 4,700 visas intended for overseas food haulage drivers will be extended beyond the initially announced three month period and will now run from the end of October 2021 to 28 February 2022. Following the announcement the Chancellor, Rishi Sunak, stated that "pragmatic controlled immigration" could also be part of the short-term solution and it remains to be seen if the number of temporary visas will be increased or their timeframes extended as we approach the Christmas period and early part of 2022. The Department for Transport confirmed that 100 visas had been granted to food hauliers as of 5 October 2021.

Separately, following the recent fuel supply shortages which saw motorists panic buying and lengthy queues at petrol stations, 300 bespoke temporary visas have been specifically allocated for foreign fuel tanker drivers. These fuel drivers will be able to commence work in the UK immediately until 31 March 2022. As of 13 October 2021, UK Government ministers admitted that only 20 visas had been issued to fuel hauliers from around 300 applications received with documents reportedly taking three weeks to process.

UK Government long-term solution

Despite sanctioning these emergency temporary measures to ease current supply chain pressures, the UK Government is seeking wider reform within the haulage industry by way of investment in the domestic workforce (i.e. improved pay and working conditions) as the longer-term solution. However, whilst welcoming the steps taken by the Government, many business leaders believe they do not go far enough and that more permanent and sustained action is required to plug the gaps in supply from the UK workforce.

In response, the Transport Secretary is preparing a £50m package aimed at addressing working conditions complaints and making the driver profession more attractive by increasing parking capacity and upgrading facilities (such as showers, toilets and cafes) at lorry parks across the UK.

Technology and ESG investments adding to cost pressure

A key challenge within the sector is an operator's ability to harness technology to ensure efficiency and flexibility.

System improvements and the sustainability agenda

Many larger operators are expected to invest in technology with the principal aim of increasing profitability and/or cutting costs. This investment may take the form of upgrades to existing management systems or sustainable measures such as the installation of solar panels or LED lighting in warehouses, which will also help customers achieve their increasingly important ESG agendas.

Alternative tech solutions

In light of recent disruption caused by Brexit and other regulatory changes and container shortages, it is essential that "empty miles" are avoided at all costs. This takes careful planning and efficient and well-operated systems are essential. Many large operators are turning to technology to achieve this. The global shipping and supply chain company Maersk, for example, uses sophisticated Internet of Things technologies to track and monitor each of the 380,000 containers in its fleet[1].

Other examples of the increasing importance of tech in the industry is the use of Blockchain to maintain VAT and other records and the use of Artificial Intelligence and warehouse automation in reaction to the social distancing regulations associated with Covid-19 and skilled labour shortage. However, the adoption of such technologies requires capital investment and costs can be prohibitive to smaller, less cash rich, operators. A continued focus on sustainability and increasing environmental regulation will continue to impact the sector.

Protecting the planet

The world's first Ultra Low Emission Zone was implemented in London in 2019 and Clean Air Zones were introduced in Bath and Birmingham in 2021, with more set to follow. These zones require charges to be paid for vehicles which do not meet minimum emissions standards. This leads to increased costs and is expected to result in a shift towards vehicles fitted with abatement technology or fully electric vehicles.

Businesses need to consider the requirement to incorporate more sustainable technologies into their future operations and how they will meet any associated costs.

1 "Logistics: 10 key trends to look for in 2021", Ashurst LLP

Ongoing supply chain disruption in sectors such as manufacturing will hit logistics suppliers hard

There has been a clear shift in the retail landscape to online in recent years, which has been accelerated by the Covid-19 pandemic and associated lockdowns. However, not all customers are maintaining demand levels.

End-user markets driving operator performance

The extent to which logistics operators have thrived during the pandemic has largely depended upon the sectors they are servicing with those focusing on e-commerce, last mile deliveries and healthcare generally faring well, whilst those exposed to, for example, manufacturing, leisure & hospitality and bricks and mortar retail have tended to struggle.

Acceleration of e-commerce

Whilst some trends will be specific to the pandemic, the continued shift towards increased online retail is expected to be permanent and has merely been accelerated in the past 18 months.

According to the Office for National Statistics, internet sales accounted for 25.9% of total retail sales in September 2021 compared to 18.1% in September 2019 (this is down from a peak of 37.1% in the run up to Christmas 2020).

Overall, the chances of an operator weathering the storm will depend upon its ability to be flexible, replace lost customers and pivot quickly towards other sectors where demand remains high.

Warehousing space in short supply

The race for space

The continued shift to online has driven the importance of "last mile" efficiencies and the speed at which goods can be delivered. This continues to drive a need for more space and the British Property Federation estimates an additional 21 million sq ft of warehouse floorspace will be required nationally each year based on population growth if current trends continue[2].

Recent disruption has highlighted the fragility of global supply chains which may lead to more businesses moving from "just in time" to "just in case" stock models. These factors will add to growing demand for warehouse space against the backdrop of record low vacancy rates (3.6%)[3] whilst the ongoing lack of availability of building materials is also constraining the supply of new warehouse units and inevitably pushing up costs to the end customer.

Location of this space is also key with demand for space in the South East, within easy reach of the London population, being particularly high. We are also starting to see retail and high street locations being repurposed to meet the demand for warehouse space to service online retail.

Working capital requirements can be onerous

Working capital and cash flow

The working capital cycle of haulage businesses can quickly become cash negative. Payment terms for key input costs are often short, with companies needing to pay for fuel (seven days), labour (seven/14/28 days) and asset rental (30 days) in advance of customers settling invoices, with contract terms often stretching to 30-60 days. Protracted and bespoke billing arrangements for certain end-user sectors can further extend the cycle and result in a drain on cash flow.

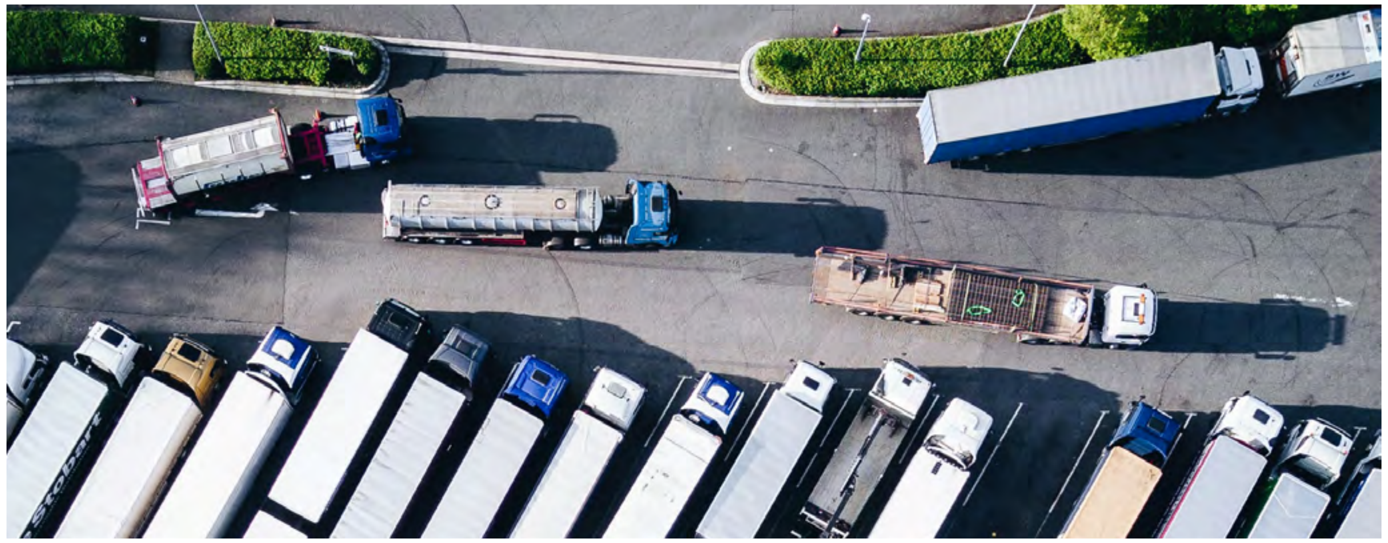
Fleet financing

ABL funding is prevalent within the sector, with many operators using invoice financing facilities and leasing, rather than owning vehicles. The ability to scale up fleet size to meet seasonal peak demand and renew/replace ageing assets is critically dependent upon access to asset finance credit lines. Stressed companies can find credit limits reduced or removed which in turn impacts on their ability to meet customer requirements and contractual commitments.

2 "Delivering the Goods in 2020", British Property Federation
3 "UK Logistics market update, October 2021", Savills

Who is impacted in the UK and what their C-suite executives should be considering

Haulage operators



Some operators have seen a growth in demand during the pandemic and been able to increase pricing due to greater competition for limited supply. However, other hauliers have struggled and we have started to see a number of business failures, particularly in the mid-market space, with loss of customers, shortages of HGV drivers, rising supply chain costs and Brexit disruption cited as the main factors behind the collapses.

There is also potential for the trend of consolidation in the sector to continue with smaller operators (which may or may not be distressed) being bought and bolted-on to existing operations, particularly where opportunities for cost savings, service offering expansion or technological enhancement exist. We are also aware of retailers and wholesalers seeking to integrate their supply chains by securing their own haulage operations.

Supply chain disruption during the pandemic and change resulting from other wider, macroeconomic factors is now leading to reduced demand for haulage in certain sectors which, coupled with the lack of drivers, has meant that some operators are left with empty trailers due to issues at other points in the supply chain.

Such haulage businesses will see turnover reduce as demand slows, coupled with increasing costs in areas including wages, insurance and fuel. This is traditionally a low margin sector, where profitability can quickly be eroded if cost increases are not passed on.

An operator's ability to navigate the continuing supply chain crisis will depend upon the sectors they are servicing, their relative size and position in the supply chain and resulting ability to pass on increased costs to customers. Investment in the workforce and the ability to attract and retain talent will also be critical as well as the operating effectiveness of systems and processes used to ensure maximum efficiency (e.g. avoiding empty miles and/or unnecessary delays and cost).

Key C-suite questions:

- Which sectors am I supplying into and how are they expected to fare over the coming months?
- How diverse is my customer network?
- How am I monitoring the financial strength of my key customers?
- How strong are my contractual relationships and am I able to pass on rising costs?
- Do I have a robust financial forecast which reflects the unwind of any Covid debts and the end of support such as furlough? Have they been stress tested?
- What is the ageing profile of my asset base? Do I have a robust capex strategy to maintain my fleet?
- How can I optimise my working capital cycle?
- How am I harnessing technology to improve performance?

Haulage networks

Large haulier networks will be keenly focused on the performance of their members, which may even see networks providing short-term funding to avoid distress and the potential failure of members leading to gaps in network coverage.

Key C-suite questions:

- Have I reviewed the financial strength of my members?
- What would be the impact of an operator failure within my haulage network?
- What is my contingency plan if a member were to fail?
- Can my network cope with increased demand?

Customers

Almost all businesses, particularly those in the retail, wholesale and manufacturing sectors will incur some form of freight cost and each business will need to consider how anticipated cost increases and supply chain disruption will impact their operations and how they may be mitigated.

Key C-suite questions:

- Have I mapped my supply chain to understand areas of weakness or sole supply?
- Have I reviewed supplier contracts, including with hauliers, to understand whether costs are expected to increase?
- Could on-shoring or near-shoring reduce the potential risk of supply chain disruption? What financial impact would this have on my business?
- Do I have access to additional warehouse space if building up buffer stocks?
- Is my current haulage provider able to meet the changing needs of my business?
- What is my contingency plan if my haulage provider were to fail?
- Is my warehouse footprint optimal for my business needs?

How Teneo can help

If any of these issues resonates with you, please contact Teneo's team of situational and sector experts below:

Daniel Butters
CEO, Restructuring
07717 451389
Daniel.Butters@teneo.com

Stephanie McMahon
Clients and Industries
07748 333009
Stephanie.McMahon@teneo.com

Daniel Smith
Senior Managing Director
07884 234932
Daniel.Smith@teneo.com

Paul Evans
Director
07880 775689
Paul.Evans@teneo.com

Peter Callas
Performance Improvement
07920 593931
Peter.Callas@teneo.com

Fiona Kaufman
Supply Chain Resilience
07824 343462
Fiona.Kaufman@teneo.com

Anna Scott
Co-author
07795 640601
Anna.Scott@teneo.com

David McIntosh
Co-author
07825 974760
David.McIntosh@teneo.com

Teneo

The Global CEO Advisory Firm

London
5th Floor,
6 More London Place
SE1 2DA