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Rating Methods by Sector

Land Transportation

1. Business base

With progress in deregulation, competition is increasingly intense in the land transportation industry (which in this report excludes railway transportation). As a result, attracting and retaining business with superior customers have become prerequisites for survival. Meanwhile, the demands of customers for more efficient distribution have also been increasing, and the ability to make high-quality proposals and reduce costs are essential for ensuring profit. JCR focuses on the customer bases of land transportation companies and their ability to meet the needs of customers.

(1) Characteristics of the industry

(i) Market overview

Land transportation is basically a domestic demand-oriented industry, and is often linked to domestic business conditions. The maturity of the domestic Japanese economy and a shift in distribution to overseas markets have both limited growth in the overall volume of transportation. At the level of individual companies, meanwhile, some companies have the attributes of customers themselves, and some are dependent on major customers. As the first step in rating, therefore, JCR learns the characteristics of the industry to which major customers belong and follows the trends of that industry together with macroeconomic developments.

The industry was once heavily regulated for the purpose of adjusting supply and demand. Since the enactment of the two distribution laws of 1990 (the Trucking Business Law and Freight Forwarding Business Law), however, the industry has been increasingly deregulated in operational terms. In contrast, environmental regulations such as emissions controls and the Revised Energy Saving Law are being tightened. Regulatory trends may affect the management strategy and competitiveness of each company, which, together with their responses, must be monitored.

Changes have also been evident in the needs of customers. Beyond transportation, the volume of other operations in the factories and distribution centers of customers has been increasing. Further, demand for comprehensive logistics services that include inventory management (third-party logistics, or 3PL) has been increasing, and each company needs to have the ability to respond to this demand.

(ii) Competitive situation

The number of new entrants has been increasing as the industry is more deregulated, as already noted. The number of operators exceeds 60,000, many of which are small and medium enterprises with 10 trucks or less. While the crowded nature of the market is apparently a factor in the downward pressure on transportation fees, direct competition with the operators subject to the rating is limited.

A fact worth mentioning concerning deregulation is the abolition of business district regulations and a system of prior notification of fares and fees in 2003. This has encouraged large operators that had been separated to some extent in the market to expand their business areas, which tends to stimulate more direct competition among the large companies. JCR constantly checks the competitive situation, including future forecasts.

The 3PL mentioned above is joined by companies from other industries, such as trading companies, forcing players to compete against a variety of participants in addition to those within the industry. JCR focuses on the acquisition of new customers and the entry of other companies.

(iii) Cost structure

Major costs and expenses include personnel expenses, the cost of hiring trucks, and fuel expenses, of which the latter two are variable costs.

For personnel expenses, the challenge is balancing them with the acquisition of drivers. Large companies are faced with the difficulty of aging drivers and the task of recruiting young replacements. Ensuring an appropriate number of quality drivers naturally entails some cost, yet as described below, cost cutting is a key issue, and the responses and results of each company are important aspects in the rating. The cost of hiring trucks increasingly has the nature of a fixed cost as peak transportation capacity must be maintained even during the off-season with excess capacity. The companies are asking their subcontractors to lower their rental charges or are switching to their own vehicles. The latter means that the cost will actually be fixed cost, and the operation will have to be cost effective. Fuel expenses squeeze profits when fuel prices rise. A pass-through to transportation charges through, for instance, a surcharge system, would be ideal. But this can be difficult depending on customer relations and competition. JCR constantly updates actual responses and effectiveness.

Some companies invest in facilities such as a distribution center in order to develop distribution networks or serve specific customer needs. JCR continuously and over the medium term observes whether the investment generates the results initially expected and whether the investment is likely to be recovered without problem.

(2) Important factors in market position and competitiveness

(i) Market position

Large land transportation companies, excluding door-to-door delivery, have begun to compete nationwide as a result of the abolition of controls over business area, which has removed the geographical boundaries. Yet business models may still vary among large and smaller companies, and the subjects of individual comparisons are limited in general to large companies. Direct competitors are somewhat limited, and JCR focuses on net sales as an indicator of the customer base.

Door-to-door delivery is an oligopolistic market in which two large companies comprise more than half of the shares. Taking into account also brand loyalty, market shares can be considered to mostly represent the companies' competitiveness. The trend in market shares is thus one of the most important indicators to monitor.

(ii) Customer base

Many land transportation companies maintain stable ties with major customers, which in turn provide the core of their earnings. JCR checks the leading customers and the status of business with them, their contribution to earnings, and other factors. JCR focuses on their customer portfolios, including, more specifically, industry structure, geographical composition, diversification, and other factors. Based on these, JCR identifies trends in earnings and the pattern of fluctuations of the companies being rated.

The acquisition of new customers and the status of dealings with existing owners are also important. JCR also takes the profitability of these activities into consideration. For existing customers, in particular, JCR focuses on measures for unprofitable customers (including negotiations to increase prices) and the results.

Meeting the needs of customers is essential to expanding and maintaining the customer base of land transportation companies, and this becomes a key factor in competitiveness.

(iii) Transportation quality

Transportation quality primarily serves the needs of customers, including punctuality, cargo security, flexible responses to the nature and amount of goods, and other factors. JCR also looks for a zero-accident record in transportation quality. Customers would not accept low transportation quality, and this would be critically disadvantageous. Large companies should boast reasonable abilities through their experience and through the development of systems. Whether they can maintain their abilities amid a trend towards more diversified and complex needs among customers such as overseas expansion becomes a challenge for the medium term.

(iv) Infrastructure

The infrastructure of each company is directly linked to its competitiveness. Infrastructure broadly consists of a distribution network (a distribution base and transportation and delivery routes) and an information system. The acquisition of drivers noted above is also included in infrastructure in the broad sense.

The distribution network requires comprehensiveness and efficiency, namely the optimization of the number of bases. Not all infrastructure needs to be funded by the company itself; cooperation with other companies in the same industry operating in different districts is effective in some cases.

The information system enables and develops transportation expertise to balance transportation quality, as noted, and provides efficiency and knowledge of the efficient operation of distribution facilities. This is essential also in 3PL, in which competition involving players from other industries is intensifying.

Since the Great East Japan Earthquake in 2011, customers are seeking to disperse distribution centers as a way to dilute risk. The importance of infrastructure is clearly growing, and JCR observes how each company effectively uses infrastructure to deal with the seemingly contradictory needs of customers for more efficient distribution cost and the dispersion of distribution centers.

(v) Cost competitiveness

The earnings of each company are under increasing pressure from, in terms of revenue, demands from customers for lower distribution costs and the dispersion of distribution centers and, in terms of costs, rising fuel price. Cost cutting is consequently an urgent and ongoing issue. JCR always checks the specific initiatives being taken by each company to reduce costs, the effectiveness of the cost cutting, and scope for further savings.

2. Financial base

(1) Earnings strength

As noted, JCR emphasizes net sales is as an indicator of the strength of customer bases.

Profit, also as noted earlier, tends to be under pressure from both revenue and costs. JCR focuses on future durability and cost cutting. If earnings power is lower, JCR checks the cause, revenue level, and the likelihood of a future recovery. Conversely, companies enjoying stable or increasing profit under such business environment are analyzed in detail to determine the causes.

Key financial indicators:

- Net sales
- Operating income
- Operating margin

(2) Cash flow

Responding to the needs of customers, in some cases, requires the construction of an exclusive distribution center. M&A also takes place for the expansion of business areas and the development of surrounding businesses. These strategic activities are supported by cash flow, and JCR monitors the level and trends of these activities in each company.

Key financial indicators:

- Cash flow from operating activities
- Free cash flow
- EBITDA
- Ratio of interest-bearing debt to EBITDA

(3) Safety

Meeting the needs of customers sometimes creates a financial burden, resulting in a considerable impact on a company's financial structure. Although business volatility is not necessarily high, there is increasingly severe competition for a limited market with new entrants from other industries, which suggests a need of substantial financial durability. JCR observes the financial policies and the strength and trends of the financial structure.

Key financial indicators:

- ■ Interest-bearing debt
- ■ Shareholders' equity
- ■ Debt equity ratio
- ■ Equity ratio

Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza,
Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026