DHL Restructures Delivery; Express carrier turns to UPS for lift, scales back troubled U.S. operations

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A Deutsche Post World Net "radical and decisive" plan to keep its beleaguered DHL Express network running in the United States with the help of a competitor promises to reshape the domestic delivery landscape even as DHL tries to rebuild its strategy in the world's largest express market.

In a dramatic twist, DPWN announced a working agreement to outsource its air transportation in the United States to UPS in a yet-to-be-completed 10-year contract worth up to $1 billion annually, essentially unraveling a costly effort to go it alone in the United States with a tightly controlled, dedicated air and ground network.

Instead, facing billions of dollars already lost and the prospect of more in coming years, DHL will scale back its U.S. infrastructure by about a third and phase out the outsourced air transport it managed through two carriers and seek to turn around a push into the U.S. express market it launched amid huge fanfare five years ago.

Whether the DHL-UPS relationship eventually will embrace other regions around the world seems to be an open question. "For the time being, there's no discussion or negotiation going on for Europe or elsewhere," Frank Appel, DWPN CEO, said last week in announcing the long-awaited new DHL strategy in the United States.

That strategy also includes sharp cutbacks in the DHL stations in the United States through closing and consolidating stations, reducing pickup and delivery routes by about 17 percent and slicing ground linehaul sectors by about 18 percent.

Yet, DPWN and DHL officials say, less than 4 percent of the pickup and delivery volume will be affected. And only about 4 percent of the DHL Express work force will be shaved.

DHL will close stations in low-density areas or multiple-station locations while consolidating sites near one another. The company also plans to take advantage of more flexible work rules in a new agreement with the Teamsters union to rationalize its routing system and focus more on premium international and express products.

DHL also wants to eliminate linehaul routes in remote locations and get better equipment to improve route density. But the company said the cutbacks will have only a minimal impact on service, affecting only 3.3 percent of deliveries and less than 1 percent of its pickups.

"We can take a lot of cost out without having any material impact on our customer base," said John Mullen, DPWN management board member and CEO of DHL Express. "We can take drastic action our costs."

Others said although the changes may not diminish service, they don't really help, either.
"I don't see any change in the value proposition for the U.S. domestic parcel shipper to feel any different than they have," said Satish Jindel, principal of parcel delivery consultancy SJ Consulting. "It helps DHL with its cost structure and that is good news for investors. But from a shipper's point of view, how is DHL any better today than it was yesterday?

"DHL has realized that at this point, despite all their best efforts, the domestic business in the U.S. will be largely there to support the international business," Jindel said.

Even DHL insiders say the strategy the company has embarked on so far seemed primarily aimed at satisfying investors. At the very least, the DHL survivor plan will likely cut back on some of the deep discounting that shippers have enjoyed, firming up pricing as the DPWN's problem child tries to wrangle as much yield as possible as it cuts back on services and refocuses on prime customers and products.

The moves represent an about-face for a company that tried to be all things to all customers, the anchor of a "one-stop-shop" strategy built by ex-McKinsey consultant Klaus Zumwinkel on a foundation of the once-troubled German post office. Since the 1990s, Deutsche Post has used a series of often-blockbuster acquisitions to create the world's largest logistics company and bring it together with DHL, the international express giant.

But DHL's financial performance in the United States through this decade prompted analysts to question whether DWPN had overextended itself. DHL Express saw $1 billion in losses in 2007 and expects about another loss of about $1.3 billion this year - even including the planned operational triage.

"It's the group's biggest problem by far," said DPWN Chief Financial Officer John Allan. With the airlift outsourcing agreement and the planned service reductions, the company expects to reduce the losses to $900 million in 2009, $500 million in 2010 and $300 million in 2011.

Appel deflected questions about when the North American business might get entirely out of the red, however, saying, the company's goal is to have losses lower than the unit's "value contribution." He said DHL could withstand some losses in the region because of its importance to the overall network. "We are in the network business."

But the company can no longer withstand the current magnitude of the regional losses. "We can't proceed like today," Appel said.

The cornerstone of the change is the proposed agreement with UPS.

The pact, which the two sides hope to consummate later this year, essentially mirrors a landmark deal FedEx signed in 2001 with the U.S. Postal Service. That deal, also said by industry observers to be worth nearly $1 billion a year, marked a dramatic shift in competitive dynamics in the parcel industry, opening new possibilities for competitors to share space and lower costs.

That also opened new possibilities for DHL to seek a once-unlikely partner to solve its problems in the United States. DHL's announcement ended months of speculation that DHL would be partnering with FedEx or significantly increasing the ground shipping relationship with the U.S. Postal Service.

"Just about all speculation of the recent months was wrong," said Albert Saphir of ABS Consulting. "This removes a lot of inefficiencies, similar in a way to what the USPS did with their FedEx deal a few years ago."

Mullen said, "This is a significant milestone for our industry."

Instead of using ABX Air and ASTAR Air for airlift, DHL will now turn to UPS.

"We are exchanging two existing airline partners for one airline partner," Mullen said. "When we reach a final contract with UPS, we will be phasing out the majority of those operations. This will have an impact on the Wilmington (Ohio) hub."

ABX Air parent Air Transport Services Group has sought to spin away from the DHL orbit with new leasing customers, an effort that has caused a rift in ABX-DHL relations. That effort presumably will take on new urgency.
"We are disappointed that DHL has chosen not to pursue alternative means to improve its competitive position in the U.S. overnight delivery market," Joe Hete, CEO of ATSG, said in a statement.

DHL now accounts for about 75 percent of the group's consolidated revenues.

"While we look forward to further discussions with DHL about its plans, at the same time, we reserve the right to pursue all means at our disposal to assure that, at minimum, DHL fully honors its obligations under our existing commercial agreements with them."

Forwarders are also wondering about how their obligations will be honored. Many have space on DHL and UPS aircraft and a deal between the two could constrain space.

Appel likened the competitor-vendor scenario to some of the bank-to-bank deals DPWN does through Deutsche Postbank.

"This is a win-win situation," he said. "Both parties have a significant interest."

DPWN's main interest now is to turn around its DHL U.S. operations. "There's total management commitment to execute," CFO John Allan said.

"Today we're focusing on long-term problem part of express business," he said. "The rest of the express business continues to perform very well. We have a game of two halves here."

DPWN intertwined itself with DHL, getting a 22.5 percent stake in the company in 1998. At the time, DHL had 35 percent of the global market in courier dispatch.

By the beginning of this decade, Deutsche Post had added Danzas and Air Express International to its stable and the German company bought a majority stake in DHL International, with revenue of about $23 billion.

The big move in the United States came in March 2003 with the $1.05 billion purchase of Airborne Express. In 2005, the company bought British logistics rival Exel for about $6.7 billion in a deal that would control 10 percent of the world's logistics business.

The company's goal, Zumwinkel would say, would be to become the No. 1 logistics group in the world.

The expansion included putting shares of Deutsche Post, which still runs the German postal operations, on public markets in Germany. It was a bold move that went along with a growing liberalization of postal services in Europe but it also brought Zumwinkel and Deutsche Post new scrutiny from the investment community.

When Zumwinkel abruptly resigned in February amid tax evasion allegations, he was already fighting a push to dismantle some operations - including DHL's U.S. express network.

Appel, a Zumwinkel protege and Deutsche Post's management board member in charge of logistics, took over and quickly stated his intention to maintain a commitment to the United States but also conceded big changes were needed to right a troubled operation.

With about 6.6 percent of the U.S. domestic parcel shipping market in 2006, DHL ranks a distant fourth behind the U.S. Postal Service with 12 percent, FedEx with 29 percent and UPS with 52 percent, according to SJ Consulting Group.

Other industry observers said it appeared the company never successfully merged the DHL U.S. express business that had been largely around international import and export packages with Airborne's predominantly domestic express business. The company also faced a lengthy and costly legal challenge from UPS and FedEx to establish its expanded domestic operations. DHL successfully argued it was not violating U.S. prohibitions against foreign ownership or control of American-flag airlines, but the carrier also set up an often awkward outsourced air services structure with Airborne's former airline, ABX Air, and the remnants of the former DHL Airways, now called ASTAR Air Cargo.
The combination led to what the company itself conceded was a botched consolidation of two hubs into one in 2005, an abrupt switch that sent service plunging and shippers looking for alternatives.

"It's no secret our aviation structure is complicated, and is high cost relative to the competition," Mullen said last week.

While other parts of the company appear to be thriving, industry analysts estimate DHL lost some $2.8 billion in North America over the past four years. For the first quarter of this year, the operating profit at the DHL express division fell almost a third to $36 million, dragging down overall DPWN net profit, which fell 18 percent to $629 million.

DPWN dropped the first shoe in the restructuring earlier this year when it took an $874 million write-down for its troubled North American operations. Some industry observers say DHL may not only have underestimated the competitive resolve of UPS and FedEx but also the complexity of coping with the geographic and regulatory landscape in the United States.

But the bigger issue may have been service, which DHL has sought since its expansion to make a linchpin of sales efforts to shippers. That was a departure from the approach of Airborne Express, said Edwin Laird, head of the Seattle-based Air Cargo Management Group, which had a well-defined but limited place in the U.S. market as a low-price competitor.

Since then, customers have complained about scattered and inaccurate DHL back-office technology, including poor invoicing systems.

Given that, analysts such as Morgan Stanley say DPWN should treat DHL U.S. operations just as automobile manufacturer Daimler did to Chrysler and cut its losses. But DPWN says it needs to serve the United States to maintain its international customer base.

"Any options which include a withdrawal can be completely ruled out," Allan said in a memo to DHL managers shortly after media reports surfaced about possible negotiations with FedEx.

John Cameron, chief operating officer for DHL Express in the United States, said the firm counted $4.6 billion in revenue in the United States, about 20 percent of the company's overall express revenue and the largest share behind the $13.3 billion generated in Europe.

The carrier has 44,000 employees in the United States and has 19,300 delivery vehicles on roads.

"I'm telling all our clients to hang in there," said Bill Knasinski, a vice president at parcel distribution firm GENCO. "DHL is a world player and it's going to take more time for them to get a grasp on the United States."