C.H. Robinson's Growth Trajectory Will Moderate in 2019, but We Expect Continued Strong Execution

Wide-moat third-party logistics leader C.H. Robinson's Board selected chief operating officer Bob Biesterfeld to take the reins on May 9, following longtime CEO John Wiehoff's retirement. We note Wiehoff has been CEO for roughly 17 years, overseeing C.H. Robinson's long stretch of industry-leading execution in the North American asset-light highway brokerage industry. Wiehoff will remain chairman of the board. The decision is the result of a leadership succession plan that we believe the board mulled over for quite some time. In short, our initial take is this is a good decision and we expect no material disruption from this change in the executive team. We see no reason to alter our $83 fair value estimate.

At first glance, we consider Biesterfeld a solid choice to lead the company. For one, having joined in 1999, his tenure at C.H. Robinson spans two-decades. He took on the COO role early last year and was previously president of the firm's core North American Surface Transportation (NAST) division—which houses the flagship truck brokerage operations—a position he held since early 2014. Thus, Biesterfeld is deeply familiar with the firm's unique entrepreneurial sales culture and best-in-class operational know-how. In our view, this is a vital qualification for someone looking to advance C.H. Robinson's long history of market-leading profitability (throughout the freight cycle) and successfully thwarting ubiquitous competitive threats. The firm has done an admirable job defending and expanding its market share over the years, despite gradually increasing competition.

Business Strategy and Outlook 02/04/2019

C.H. Robinson dominates the $79 billion U.S. highway brokerage market, and its immense network of shippers and asset-based carriers supports a wide economic moat. Although the company isn't immune to cyclical downturns, its variable-cost model helps shield profitability during periods of lackluster freight demand, as evidenced by a long history of above-average operating profitability. The firm does not own transportation equipment, and more than 70% of operating expenses are tied to performance-based variable compensation, which tends to move in line with net revenue growth over the long run. We think the firm remains well positioned to capitalize on domestic third-party logistics consolidation (including market share gains) despite intensifying competition.

Over and above underlying shipment demand trends, market share gains will remain the key growth driver for Robinson. For perspective, we estimate Robinson's stake of the domestic freight brokerage industry approached 20% in 2017, up from 13% in 2004, based on market data from Armstrong & Associates. The truck brokerage business is still vastly fragmented, and smaller, less sophisticated providers are finding it increasingly difficult to keep up with rising demand for efficient truckload capacity access and informational know-how. Robinson's industry-leading network of
asset-based truckload carriers (most small) will likely remain valuable to shippers in the years ahead. This is particularly because truckload capacity will see growth constraints over the medium term due to the limited driver pool.

Robinson has also positioned its international air and ocean forwarding operations to contribute to growth. In this segment, it competes with other top-shelf providers like Expeditors International. In late 2012, it purchased Phoenix International, which more than doubled Robinson’s scale in this business. More recently, the firm acquired Australian global forwarder APC Logistics (September 2016) and Canadian forwarder Milgram (late 2017). Buying scale is important in order to secure adequate capacity for shippers, particularly during the peak season.

**Economic Moat**

C.H. Robinson maintains a wide economic moat thanks to the network effect. Its industry-leading network of shippers and carriers reinforces a compelling value proposition, and duplication by small providers with fewer resources would be a formidable task.

In its core North American Surface Transportation segment (64% of net revenue), which largely reflects highway brokerage operations, C.H. Robinson’s substantial customer base of more than 40,000 shippers affords significant buying power. As a result, the company can procure capacity at lower rates than shippers could generally obtain directly with carriers, thereby providing customers with opportunities for material cost savings. Shippers also enjoy the added benefit of converting fixed transportation costs (such as a large traffic management department) into variable costs when outsourcing logistics management functions.

Furthermore, C.H. Robinson’s vast network of more than 60,000 asset-based carriers (most small) across most transportation modes acts as a valuable source of capacity for shippers. As in past tightening cycles, the company’s unmatched truckload capacity access has proved quite valuable over the past year given unusually tight capacity rooted in widespread ELD adoption (ELDs have tempered small truckers’ productivity). Further, the constrained driver pool has prevented most truckers from offsetting lost miles (from ELDs) with fleet growth. Additionally, C.H. Robinson’s relationships with air, ocean, and rail carriers support multimodal capabilities that optimize shippers’ use of truckload, less-than-truckload, and rail intermodal on the domestic front and air and ocean freight for overseas shipping. We believe demand for multimodal solutions is rising, driven in part by improving service levels from the rails and shippers’ focus on supply-chain efficiency. This dynamic should play well into the hands of 3PL providers such as Robinson because asset-based truckers must focus on maximizing tractor utilization.

From the perspective of carriers (including truckload and LTL), C.H. Robinson is a highly attractive source of freight opportunities, given its ability to aggregate fragmented demand across a broad customer base of shippers. In this way, truckers can minimize empty miles and supplement sales efforts.

While competitors with sufficient capital can replicate technology, C.H. Robinson’s robust proprietary IT platforms provide differentiation from smaller providers with fewer resources. We expect the company to garner additional market share from less capable 3PL competitors as supply chains continue to increase in complexity, requiring sophisticated informational expertise and broad, vetted capacity relationships. C.H. Robinson’s strong technology infrastructure, coupled with a vast reservoir of market data, also enhances internal pricing decisions and improves customer connectivity and reporting.

**Fair Value and Profit Drivers**

Our fair value estimate is $83 per share. C.H. Robinson’s consolidated net revenue grew a robust 14% in 2018 thanks to historically tight truckload-market capacity rooted in solid freight demand, limited driver availability, and widespread electronic logging device (ELD) adoption among small truckload carriers. Recall that asset-light highway brokers perform best during periods of supply disruption. Tight
supply/demand kept Robinson’s value proposition strong throughout 2018 as shippers sought additional help finding trucks; supporting the firm’s sell rates to shippers (especially on committed business), which previously proved sluggish in 2016 and 2017. Truckload capacity constraints showed signs of easing in fourth-quarter 2018, partly because carriers are adjusting to ELD-related disruption. As a result, historically high spot rates retreated from record levels posted in first-half 2018. We expect overall truckload market pricing to prove roughly flatter than a year-over-year basis in 2019 as spot rates normalize. Overall, Robinson’s net revenue growth will moderate meaningfully in 2019 as sell rates (to shippers) normalize and spot activity abates. We look for 6% total organic net revenue growth in 2019, versus midteens growth in 2018. Behind this, we look for high-single-digit net revenue gains in the core North American surface transportation division (namely truck brokerage) and mid-single-digit increases in the global air and ocean forwarding segment. We anticipate EBIT margin (calculated off net revenue) to come in relatively flat, near 33.6%, in 2019 as net revenue growth moderates and the firm continues to invest heavily in IT infrastructure to support greater transaction automation. That said, C.H. Robinson remains among the most profitable providers in the industry, and we expect that to persist. Looking further out (2020-23), we think the company can expand organic net revenue in the ballpark of 5%-6% on average, driven by the combination low-single digit underlying freight-demand, market share gains from small brokers, and modest increases in average sell rates. The asset-light truck brokerage industry remains vastly fragmented, and the network effect bestows powerful advantages for providers with scale, particularly during periods of supply disruption. We think the firm can generate a consolidated midcycle operating margin (calculated off net revenue) of approximately 34.0% (our forecast for 2023).

Risk and Uncertainty 02/04/2019

Although C.H. Robinson’s variable-cost model provides a partial buffer for profitability (relative to asset-intensive providers), the company is not immune to cyclical downturns in freight demand—when economic conditions deteriorate, gross revenue trends will reflect declining shipment volume and challenging pricing on both transactional and contractual accounts.

During periods of accelerating freight demand, truckload capacity typically firms and carrier rates rise. Historically, this dynamic has driven gross profit margin (net revenue over gross revenue) compression because the firm passes through higher carrier rates to customers on a time lag. Along these lines, Robinson’s migration to large, price-committed customers over the past five years is a double-edge sword—these shippers provide a greater degree of sticky, scheduled freight, but they also boost gross margin risk.

Broader trucking industry issues such as driver availability and 2018 electronic logging device rules for truckers will probably drive intermittent capacity constraints on key lanes in the years ahead, assuming modest freight demand growth. While C.H. Robinson’s value proposition tends to strengthen in such an environment because of its deep capacity access, gross margins usually get squeezed in the short run as carrier rates spike. This is because it takes time to pass through rising capacity rates to shippers, especially on contractual business.

In Robinson’s core truck brokerage operations, fuel costs (paid to asset-based carriers) are largely a pass-through to shippers. That said, declining fuel prices artificially boost the firm’s gross profit margin percentage because lower fuel surcharges will reduce gross revenue with little impact on net revenue. The opposite occurs when fuel prices spike.

Stewardship 02/04/2019

Our stewardship rating for C.H. Robinson is Exemplary. The company’s senior leadership has done an admirable job managing the firm’s asset-light freight brokerage model, which includes truckload and less-than-truckload brokerage, rail intermodal, and global air and ocean forwarding. A history of positive cash flow from operations, industry-leading profitability (including gross and operating margins), and impressive returns on invested capital (25% over the past five years) is evidence of
above-average execution in a shifting and highly competitive marketplace. CEO John Wiehoff has been at the helm since 2002 and with the company since 1992. In June 2015, Andrew Clarke succeeded Chad Lindbloom as CFO. Clarke has significant leadership experience in the transportation industry, having served as CEO of Panther Expedited, which was acquired by asset-based LTL carrier ArcBest in 2013. Before that, he spent five years as CFO of top-shelf airport-to-airport LTL shipping specialist Forward Air.

Management believes its entrepreneurial culture and decentralized structure stand behind its success over the years. Employees are compensated based on the profitability of their local office, and the company sustains its culture by promoting from within its ranks. Robinson pays a quarterly dividend, which has increased annually over the past decade, and has a long history of share repurchases. Robinson has not historically been acquisitive, but its strategy has been shifting. In 2012, it acquired top-shelf global air and ocean forwarder Phoenix International, which materially lifted Robinson's scale in that market. In early 2015, it acquired less-than-truckload brokerage specialist Freightquote, which expanded Robinson's base of small and midsize shippers. Additionally, Freightquote broadened Robinson's LTL carrier network and boosted its LTL business by 30%—brokered LTL freight is on the rise, in part because carriers are looking to supplement revenue sources.

Overview

Profile:

C.H. Robinson is a top-tier non-asset-based third-party logistics provider with a significant focus on domestic freight brokerage (66% of net revenue), which reflects mostly truck brokerage but also rail intermodal. It also operates a growing air and ocean forwarding unit (20%) and a legacy produce-sourcing operation (9%). The remainder of net revenue reflects transportation management services and the firm's European truck brokerage operations.