Roll-ups roll downhill

The transportation industry is awash in some accurate and some flawed speculation regarding consolidation activity. Merger and takeover candidates continue to be popular topics of industry gossip. Interestingly, all this takes place amid increased regulatory oversight of transportation companies by the United States and the European Union.

To many observers, the railroad guessing game is the most entertaining one. Thanks in part to the lobbying efforts of former Union Pacific CEO Drew Lewis, railroads continued to benefit from different antitrust regulations. Lewis, in an effort to guarantee success of the UP-SP merger, lobbied for the Interstate Commerce Commission's successor, the Surface Transportation Board, to evaluate proposed mergers under a different standard than that employed by the Justice Department for other mergers.

The STB merger story earlier this year bears similarities to plots to the airline industry. United Airlines' plan to acquire US Airways for $11.6 billion faces strong opposition from industry competitors, who are planning their own mergers. Their concern is the new United would be so large that American and Delta acquire additional acquisitions to protect their interests.

The Justice Department is already voicing concern about airline consolidation. They have sued to undo Northwest Airlines' 1998 purchase of a controlling stake in rival Continental Airlines. They're also pursuing American Airlines for alleged use of predatory pricing.

These merger activities are the result of global economic forces. Carriers seek increased economies of scale and scope — the former allowing for lower unit costs and the latter enabling fulfillment of all customer requirements. But the two are closely linked. The appeal of mergers is their ability to achieve economies without adding extra capacity, which would undercut rates.

Carrier consolidation could lead to a handful of global companies with sufficient market clout to control prices. But would the new Internet economy change some of the assumptions driving consolidation?

The transportation and logistics industry is still a large and highly fragmented one. Over the past five years the trend has been toward acquisitions and roll-ups (where financial investors purchase multiple small companies and combine them, with the intent of creating one publicly traded concern.) This "Main Street to Wall Street" strategy has proven successful for many industries, ranging from motor coach services to funeral homes.

The spectrum of transportation roll-ups is confounding. One investment company rolled up tank trucking firms. This is an industry with barriers to entry due to necessary asset investment, terminal network and safety requirements. However, we have also seen consolidation in industries with no assets beyond a Rolodex of accounts (for example, intermodal marketing companies) as well as industries fragmented beyond belief (such as intermodal drayage.) The roll-up benefits here are practically impossible to detect.

Not surprisingly, many of these roll-ups have failed on Wall Street. They couldn't grow as fast as their stock prices demanded, and there was an inability to achieve sufficient economies of scope and/or scale. The fault here lies with two problems. Commercial relationships that existed on a small scale were not successfully transferred to the combined company. Additionally, sufficient information technology was not installed to accommodate the new, larger company. While justifications for roll-ups remain, a better alternative may exist.

Changes in the business landscape have many business owners feeling overwhelmed and looking for an exit strategy. Some of these companies have decreased in value, but are still valuable properties. Estate planning and succession have many owners looking to sell an asset which is not necessarily liquid.

The time for consolidation by roll-up may be over. While e-commerce may have created threats to smaller companies, it also offers opportunities. Small, undervalued companies may prove to be attractive investments if new management can leverage e-commerce to transform them.

Such transformation through e-commerce might be affected in two ways. Business support services can now be purchased online to provide economies of scale (i.e., pooled purchasing, financing, insurance and employee benefits.) And operations support for small companies are available through application service providers, which offer access to a whole range of tools — such as optimization, yield management, advanced planning, accounting and other back-office tools — that were once too pricey and complex for any but the largest corporations.

As the "new economy" changes the established rules of success prerequisites, it is worth evaluating the application of e-commerce with under-valued small companies combined with large-company best practices. Such a strategy could help grow the size and value of the acquired companies. Acquisition targets would become much more strategic and be pursued to fulfill specific needs — rather than to merely enable a company to bulk up.

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