The international merger muddle

International mergers in industry, finance, transportation and logistics have recently dominated the news. The proposed acquisition of Honeywell International by General Electric roller-coasted from a sure thing to a “no-go.” High stakes negotiations between GE Chairman Jack Welch and European Competition Commissioner Mario Monti were all the more dramatic by political involvement and lobbying from all sides of the Atlantic.

GE may still be hoping their deal will follow a similar path to the proposed acquisition of IBP by Tyson Foods. There, an agreement was reached on New Year’s Day, but Tyson walked away in late March after accounting irregularities — and lower earnings — were discovered at IBP. Less than two months later, the deal was resuscitated due to the Delaware Court of Chancery’s ruling that a cyclical business drop at IBP was not sufficient grounds to void the deal.

The transportation world has seen its share of merger fireworks, too. The airline industry is watching with interest as United Airlines attempts to acquire US Air. Some believe that if this transaction fails, US Air will be in a difficult position to continue in business (It is not a low-cost airline, nor does it possess a truly national route structure). TWA was in such a position earlier this year when American Airlines acquired them.

The U.S. Surface Transportation Board recently adopted new rules for major railroad mergers. This move was initiated after the proposed merger between Burlington Northern Santa Fe and Canadian National.

The railroad industry has traditionally served as a leading financial history indicator. The history of American finance, and the growth of corporate structure and strategy is a study of the railroad industry. The first regulatory agency, the Interstate Commerce Commission (predecessor to the STB) was established to regulate railroads. Before there existed Social Security, National Labor Relations Board or workmen’s compensation, legislation was established to address these functions within the railroad industry. Some historians believe the trajectory of Internet development resembles that of railroad industry growth — and shakeout.

Perhaps the STB ruling actually foreshadows future merger issues for the rest of the economy. At the core of the STB decision is recognition that the fundamental nature of the industry has changed. The railroad industry has transformed itself in a generation. Traffic growth and asset rationalization have effectively removed from the system any obvious overcapacity — one traditional rationalization for merging.

Merging itself faces a formidable operational challenge to both parties. Some recent railroad mergers have so crippled the affected companies as to call into question the benefit of the transaction. Future merger applicants will be forced to demonstrate their necessity with much more detail. They will need to provide evidence that improvement cannot come in the form of increased industry cooperation (short of merger). Formal service assurance plans and enhanced customer complaint resolution will also constitute part of the new STB rules.

Railroad companies are asset-based and network-operating. They invite an interesting comparison to other capital-intensive industries. Oil and telecommunications for example, have also seen extensive merger and acquisition activity. Yet, the results differ dramatically.

Oil industry history is full of mergers, but the recent round of transnational “super-majors” (e.g., Exxon and Mobil, and BP, Arco and Amoco) was likely to have been made more urgent by the collapse of oil prices several years ago. (Not long ago, oil was $10 a barrel). Justification for these mergers was often based on overcapacity. The argument was essentially that mismanaged assets — along with redundant infrastructure and personnel — could be “sweated” out. But the real benefits lay elsewhere.

Merged companies often result in stronger balance sheets, which help access cheaper sources of capital. Here, size may truly matter. Developing new sources of oil is a high-risk high-reward business. China, West Africa and former Soviet republics are no places for companies which cannot commit to the time, money and risk tolerance necessary for developing such sources.

Interestingly, the relative success of oil mergers has not been mirrored in the telecommunications industry. Telecommunications represents another asset-intensive business which acted as if bigger was better. Economies of scale and extensive vertical integration were meant to allow companies to manage the influx of technological change. Yet two leading acquirers, WorldCom and AT&T, have watched their market values tumble as planned mergers failed. An overseas investor may now acquire WorldCom, while AT&T is dismantling itself (again) into four companies.

With the development of a global economy, mergers are increasingly internationally. The addition of cultural challenges makes big mergers even more daunting. DaimlerChrysler may provide the case study for our generation. This merger began with the false premise that it represented a “merger of equals” (credit here goes to Daimler-Benz’s Jurgen Schrempe.) This myth, however, constituted the cornerstone of the entire deal. While Chrysler’s subsequent problems were manifold, including the mass exodus of its management talent, only a few years earlier, it had been the world’s most profitable automobile company.

There is an additional international aspect to the problems affecting DaimlerChrysler. Part of Schrempe’s international expansion vision included Japan, but his board would not support his decision to invest in Nissan immediately after purchasing Chrysler (Renault took the controlling stake and has already started seeing results). DaimlerChrysler later invested in Mitsubishi, a heavily indebted and fatigued company beset by scandal. Mitsubishi now resembles Chrysler — an overseas subsidiary losing money with the local managers resisting German control.

The transportation industry also struggles to reconcile cultural differences. Most industry veterans can point to mergers which failed due to culture clashes. But globalization is a fact of life and it affects financial transactions as it does everything else. The difference between hard-asset transportation providers and soft-asset logistics suppliers is increasingly difficult to distinguish. Companies continue to extend their scope by vertical integration (providing your own factors of production) and horizontal expansion into new business and geographical segments.

The successful companies will be those that can at once think globally and act locally. With growth as an imperative, some will argue for organic growth, while others will opt to buy it. In either case, the well-managed companies will be those poised for success. Barring a major policy change, mergers will continue to be part of the international business scene significantly into future.