Merger mayhem

According to a recent Lehman Brothers study, the global downturn of the last year has led to a sharp slowdown in merger and acquisition (M&A) activity. The value of total global M&A peaked at $1.1 trillion in 2000, but amounted to only $476 billion last year, a level last seen in 1997.

M&A results have been a favorite topic in the news — and most of the news has been bad. Bernard J. Ebbers abruptly departed as president and chief executive officer of WorldCom, a telecommunications giant formed from 75 acquisitions over two decades. Qwest Communications International, another telecommunications giant formed by mergers and acquisitions, recently reported a $698-million loss in its first quarter.

M&A failures were not limited to the United States. Vivendi Universal CEO Jean-Marie Messier survived a hostile annual meeting and obtained a board vote of confidence — only to see the company’s stock continue to plummet. In Japan, the world’s largest bank, Mizuho Holdings (which merged three major banks) disrupted business throughout Japan when the merged computer systems failed.

Even successfully completed mergers came under scrutiny. General Electric and Tyco International saw their share price savaged by suspicions about M&A accounting. And a report recently surfaced that Boeing misled investors in 1997 about the scope of their production problems to prevent the decline of their stock price prior to the closing of their intended merger with McDonnell Douglas.

The HP-Compaq combination (the computer industry’s largest merger ever) eventually was resolved when a Delaware court dismissed a lawsuit by Walter B. Hewlett. This transaction will provide an instructive case study, as most technology mergers have failed. In fact, a recent study conducted by A.T. Kearney estimates that 70 percent of deals — when measured by change in shareholder value and combined profitability — fail.

Industry consolidation is usually no substitute for innovation and speed to market. Successful technology transactions have been those in which large companies acquired easily absorbed businesses to fulfill specific niches. Cisco Systems is often cited as a leading example of this approach. In fact, for years Cisco refused to acquire any company
located more than 30 miles from its San Jose headquarters.

The largest transportation mergers of the past decade have involved railroads. In the past decade four major U.S. railroad systems endured a series of mergers — and the consequent trauma. The seemingly inevitable march to two transcontinental systems was halted — at least for now — by regulatory work arising from the intended merger of the Burlington Northern and Santa Fe and Canadian National.

One reaction has been an increase in marketing alliances between railroads. These arrangements offer single-source customer solutions without actual unified ownership. Some feel these offer a viable alternative to merger. Others consider it an attempt by the industry to overcome an obstacle imposed by the Surface Transportation Board — and that mergers will follow once railroads fail to demonstrate sufficient earnings.

The logistics industry also has seen its share of mergers and acquisitions. Companies such as FedEx, UPS, and Deutsche Post have grown by aggressively pursuing acquisitions, most of which have been focused on filling a specific product and/or geographical niche. These companies are all global transportation and logistics multinationals with a core business serving as a platform for growth — the Cisco model.

Companies smaller than the global titans have not fared well. Last year, UPS bought Fritz Cos. for $450 million. Over a five-year period starting in the late 1980s, Fritz grew from a customshouse broker to a global logistics provider. Wall Street encouraged this strategy and the market valued the company with a strong multiple. Using stock as currency, Fritz grew rapidly, making over 50 acquisitions. The strategy worked until its acquisition of Intertrans (and associated accounting problems) brought the growth to a standstill. Once burned, the market penalized the stock valuation and the only exit strategy was acquisition by a larger company.

Eagle Global Logistics (EGL) may be following a similar path. This company had a very successful domestic operation, but felt the need to expand internationally. That ultimately led to a $543-million acquisition of the troubled Circle International — whose problems seem contagious. (It is interesting to note that one of the most profitable global logistics companies has been Expeditors International, which has an iconoclastic culture of internal growth and eschewing mergers.)

The transportation industry has also seen roll-ups — a specific type of merger activity. Roll-ups buy up numerous small companies in a fragmented industry seeking economies of scale, but whose track record may not be stellar. Boom-and-bust results have often wiped out investors — including the “mom-and-pops,” who sold their companies in exchange for shares. It often seems that deal-making skill did not equate to operating expertise.

The intermodal industry awaits its first roll-up success. Late last year, one of the early intermodal roll-ups, RISS/USSI (of WorldPoint Logistics) declared bankruptcy. Final determination is still pending on two other roll-ups: RoadLink USA and Pacer Global Logistics.

RoadLink was formed from seven regional drayage companies after much turmoil and several fitful starts at financing. Opportunities abound for a national drayage company. The company seeks to create superior customer value by “blending the synergies of an integrated, national network with local market experience.” But two years after the company was announced, some operations are still being run as discrete units — perhaps because combining insurance coverage presents an insurmountable challenge.

Pacer International Inc. was a roll-up of numerous intermodal marketing companies, trucking operations and the former APL Stacktrain Services. With almost $400 million in debt, the company is seeking an initial public offering that will repay more than half the debt and allow some participants to cash out.

One common problem with M&A transactions is rampant overpayment. Some industry experts feel that Pacer might have done this in their rush to grow. Furthermore, Pacer’s
purchase of RailVan generates questions because RailVan’s business model (scrupulously fixed customer fee) differs sharply from that of other Pacer-owned intermodal marketing companies (arbitrage — and retain — increased customer margins).

If the Pacer IPO fails to raise sufficient funds, the outlook for Pacer may be dismal. Because it is so large, it may fall to their underlying railroad carriers to pick up the pieces. Ironically, the railroad(s) could merge it with some of their other business lines to achieve the synergies that eluded Pacer.

We may be entering a period of reduced M&A activity. Past results have been somewhat disappointing. Companies today seek to conserve cash and stock valuations have been reduced. Survival is the priority in today’s business environment. Acquisition most likely awaits those companies not strong enough to survive.

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