More merger mania

China National Offshore Oil Corp.’s unsolicited $18.5 billion bid for Unocal is one of the more stunning recent merger and acquisition events to hit the news. Although the Chinese company ultimately abandoned the chase this month, the offer clearly demonstrates the extent of globalization in the economy.

Transportation and logistics industries have benefited from these kinds of transactions, which have enabled a handful of companies to become global leaders. Deutsche Post and Exel are the results of a complex series of transactions by their predecessor companies. FedEx and UPS have used their stock as currency to expand upon their already successful core operations.

Companies expand to take advantage of scope and scale economies. The two are closely related. Scale seeks increased volume to lower variable costs — making the business more profitable and pricing more competitive. Scope enables a provider to serve a wider range of customers and markets. Scope attracts additional volume that makes scale possible. Scale reduces cost and enables scope expansion.

Companies often seek expansion into related lines of business that complement their core competency. (We have not yet seen a return to the formation of conglomerates that seek to diversify business among unrelated industries.) For example, UPS purchased Overnite Transportation to add less-than-truckload service to its air and surface parcel portfolio. Interestingly, Overnite was spun off from Union Pacific less than two years ago because it was not seen as a strategic fit for a railroad.

Some providers seek to span domestic and international transportation. Outside the global behemoths, not many companies have been able to make this leap. Recently, however, Yellow Roadway invested in one of China’s largest air forwarders, while Schneider National purchased a major transloading operation. With trucking so embedded in customers’ supply chains, these acquisitions appear to be logical moves.

It is unclear whether smaller players must follow the leaders. Expansion is not always advisable. UPS purchased Fritz once Fritz imploded from a series of misbegotten acquisitions. EGL has yet to recover from its acquisition of a crippled Circle International. Meanwhile, iconoclastic Expeditors International grows and prospers without any M&A activity.

Some financial analysts believe that transportation carriers (with extensive assets and fixed costs) lend themselves better to merger activity than do logistics companies. The railroad and airline industries are constant sources of merger rumors. The liner shipping industry is agog over A.P. Moller-Maersk’s proposed acquisition of P&O Nedloyd. This transaction would boost the market share of the industry’s largest carrier to nearly 20 percent.

The deal is not truly surprising. From the seller’s side, P&O Nedloyd never developed into the industry powerhouse it was expected to be following its 1996 merger — and current stock market conditions seem exceptionally favorable. As a buyer, A.P. Moller-Maersk has learned much from its previous acquisitions of Sea-Land and Safmarine. Maersk should be able to absorb the capacity, retain most of the business and shed significant variable costs (i.e., redundant offices and personnel). The premium paid on the stock will likely be a good investment — and one that is recouped easily.

Frequently, an industry leader’s transaction will set off a round of activity among competitors lagging in scale. The result in the liner shipping industry, where most carriers are part of extensive, vertically integrated enterprises with substantial national interest, could be very interesting.

The current takeover target is CP Ships. A publicly traded company that is not part of an integrated industrial company, it can be acquired as only a liner operator. CP Ships’ strategy — to combine seven operations and allow them to function as independent entities — was inefficient in an increasingly global world. It also kept backroom costs high. (It was not unusual for CP Ships to have multiple steamship agencies in a single city representing its various “brands.”) A belated effort to merge backroom functions blew up in accounting problems.

Today, the evaluation of transportation M&A is a different proposition because of the presence of transportation equity funds and hedge funds. The former are a source of capital to conduct acquisitions on their own. (The buyer is not necessarily another carrier.) The latter are glorified day traders, yet their ability to cause dramatic stock price shifts in the short run could turn companies into unintended targets.

Our industry has always been in the forefront of global commerce. The difference today is that we might be the buyer and seller (of companies) rather than just the movers.

Ted Prince is senior vice president of Optimization Alternatives Ltd. He can be contacted at (804) 754-2291, or at ted@oax.com.