BUILDING EQUITY IN INVESTMENT

PRIVATE EQUITY HAS been making the news lately. Political surrogates from both presidential campaigns argue about the financial and societal benefits of Bain Capital. Those interested in transportation are following Canadian Pacific Railway as it deals with an activist hedge fund. In fact, the transportation and logistics industries have been inexorably transformed by private equity.

At its most basic level, private equity refers to investment transactions in companies that are already private — or those that become private as an outcome of the transaction. Structurally, these companies can be viewed as special mutual funds. They raise money from a pool of investors and invest the funds so the investments gain in value. Unlike the mutual funds most of us invest in, these funds have very high minimum requirements in the investment amount and the time required to hold.

Venture Capital

Innovation usually starts with a technical breakthrough. Launching a software or biotechnology firm is expensive. Venture capital firms take funds raised from institutional investors and make small investments in a large number of startups. These startups probably had some initial angel investors, who may have been early stage VC funds, or just “friends and family.” In most cases, the key attraction is the intellectual property the startup offers. Patent protection (often globally) is a key component.

Venture capital swings for the fences. Most of the investments strike out and disappear. VCs realize their gains when they have an exitable event. This may be selling some of the company to other private investors or it may be an initial public offering. A “sample” successful fund portfolio might include 25 small investments. Of those: 15 will fail; one will be a home run; four will produce some returns; and five will return the amount invested but no more.

Part of the confusion about Bain Capital is the result of its beginning as a VC before changing to a buyout firm. Staples and Sports Authority were some of its VC home runs.

With the exception of software, VC funding is largely absent from transportation. VCs funded many of the most effective software solutions used in our industry. Such software innovations have dramatically altered the way the transportation industry operates. Transportation and warehouse management software transformed planning and execution. Bid package software forever changed carrier-customer relations. GPS applications and terminal management software enabled carriers to increase productivity drastically.

There were many failures. During the dot.com boom, a number of startups acquired funding and disappeared because they lacked a market — or the product didn’t develop beyond a PowerPoint presentation.

In our industry, VCs have historically been obviated by the entrepreneur who raised money from family or friends (see Fred Smith of FedEx) or obtained mortgage funding from a bank (J.B. Hunt, for example) to acquire the necessary start-up funding.

Starting asset-light companies frequently made the startup a little easier, because there were no physical assets to acquire, although the mission outcome was no less daunting (Peter Rose of Expeditors International and Phil Yeager of Hub Group, for example).

Today, transportation innovation faces significant barriers to entry. There have been no new, innovative developments in years. Most new companies were started by individuals who worked elsewhere and tried to spin off, and take their customers with them. Of course, their previous employer might view this as stealing, not innovation. Does the general lack of creative industry development imply a future without promise, or a present wary of risk?

Private Equity

Private equity funds are the successors of the leveraged-buyout firms of the 1980s. PE investors take investments and borrow additional cash to buy private and public companies.

Unlike VCs, the number of investments is smaller and the investment size is much larger. Because most funds would fail if even one investment were an absolute loss, PE firms target mature companies. The transportation industry has seen a great deal of private equity. A PE firm purchased Pacer Stacktrain from APL. (Its successor remains a fixture of PE fascination today.) A PE firm formed Quality Transportation by buying two tank truck lines and combining them. Both companies later went public.

PE firms frequently search for economies of scope and scale. Companies such as TransPlace and FreightQuote — already owned by PE firms — have undertaken further (private) acquisitions to grow. Other PE portfolio companies believe the best way to grow is to become public first (XPO Logistics and Roadrunner Transportation, for example).

With the exception of airlines, it’s rare for asset-based transportation companies to be acquired by PE firms. The need to reinvest free
cash flow into assets is anathema to PE firms that seek to apply all free cash to paying off debt.

Some other exceptions exist. In the late 1980s, Kelso Partners acquired Arkansas Best, and Sea-Land turned to CSX as a white knight to repel a hostile takeover. The recent flurry of PE firms purchasing marine terminals hasn’t turned out well for many of the investors (as did most airline investments) and has perhaps reinforced the rule of avoiding asset-based enterprises.

CSX later sold most of Sea-Land to Maersk, but it retained the domestic business, which it sold in 2003 to The Carlyle Group for $315 million, including debt. In a little more than a year, Carlyle sold Horizon Lines (the new name) to another PE firm, Castle Harlan, for $663 million. While the price doubled, Carlyle’s return was estimated at 500 percent because of the amount of debt. Just 15 months later, Castle Harlan reportedly recovered twice its investment when it sold part of the company through an IPO. Six years later, Horizon Lines, still saddled with debt, was in severe financial straits.

That’s why the primary targets for PE firms in our industry are non-asset companies. Asset-based carriers — airlines, trucking companies, ocean carriers and railroads — usually acquire other asset-based carriers. These strategic buyers are often able to achieve significant synergies by keeping the new business and shedding a great deal of the previously associated expense.

For this reason, strategic buyers often are willing to pay more than purely financial investors. They are able to see beyond the deal and envision the new enterprise, whereas financial buyers refuse to fall in love — or to look beyond the immediate terms of the deal. There are exceptions, and they usually involve funds with very deep pockets and long timeframes (see Berkshire Hathaway’s purchase of BNSF Railway and Temasak’s acquisition of APL).

Starting with the leveraged buyout firms, private equity has transformed our business. In the 1980s, many U.S. companies that had enjoyed unchallenged economic prosperity for decades were complacent and inefficient. PE firms, in the form of corporate raiders (such as James Goldsmith and Al Dunlap), recognized the breakup opportunities.

CEOs quickly realized they needed to lead change in their companies, or somebody else might. Supply chain management became standard, and the deregulated trucking industry adapted to support it. Global sourcing became routine, air cargo, ocean carriers and, ultimately, railroads grew to handle the influx of volume.

In an effort to release cash from balance sheets and reduce operating expense, outsourcing became commonplace. 3PLs and contract logistics evolved to manage these processes and to assume the assets, headcount and management responsibility.

Hedge Funds
Hedge funds have historically avoided close regulatory scrutiny. Because their investors (by definition) are rich enough to lose everything, hedge funds have been allowed to invest in almost anything. Although the distinctions have blurred, there are two major differences between PE and hedge funds. Private equity firms buy entire companies with a view to sell them within three to six years. Hedge funds invest in individual securities — and they may buy and sell the same day. Hedge funds also can bet against companies by selling short.

Hedge funds frequently take company positions in the form of shareholder activism. By looking to replace board members — and senior management — they hope to introduce necessary changes and achieve rapid improvement and investment gain. Pershing Square just installed six new board members at CP, and is searching for a new CEO. CSX had a similar challenge in 2007 from The Children’s Investment Fund. Ultimately, new board members were seated, management remained in place, and TCIF sold out for a gain.

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Private equity will continue to impact our industry directly and indirectly. Financial engineering of industry participants will continue, reflecting the changing state of the world economy. As this happens, the transportation industry will encounter a range of new requirements, many of which will only be understood and met successfully by individuals and companies that nurture and support creative and innovative responses.

Transportation no longer can afford to be an insular industry. A panoply of private equity investors are sitting at the table now, and they often have many more chips. Joc

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THE FLURRY OF PRIVATE EQUITY FIRMS PURCHASING MARINE TERMINALS HASN’T TURNED OUT WELL AND MAY HAVE REINFORCED THE RULE OF AVOIDING ASSET-BASED ENTERPRISES.