Logistics Acquisitions: Who Says Elephants Can't Dance?

By Benjamin Gordon

Smart transportation and logistics companies have always stood at the crossroads of commerce and innovation.

In 1883, three workers at the Canadian Pacific Railways (CP), William McCardell, Thomas McCardell and Frank McCabe, discovered a series of hot springs in the Canadian Rockies. The railway recognized the tourism potential amidst the soothing waters and dramatic sights of the Rockies. Shortly thereafter, the CP established the Banff Springs Hotel, at its time one of the finest hotel destinations in the world. The CP continued to build a series of hotels along its main line, and quickly established Banff and the Canadian Rockies as a premier tourist destination. Meanwhile, demand for Canada's first transcontinental railroad continued to grow. Now, partly as the result of creative initiatives such as the development of Banff and the Rockies, the CP stands at 236 billion ton-miles, covers 41 million miles of track, and generates over $4 billion of revenue and $413 million of net profit.

The same spirit of innovation drives other transportation and logistics firms to seek new opportunities. Today, the frontier lies at the intersection of new services. Mega-mergers like the proposed Deutsche Post-Exel transaction, which would create the largest logistics firm worldwide, have captured the media's attention, but are in fact only the tip of the iceberg. Throughout the market, we are witnessing a consolidation of logistics services, as firms seek to respond to three core trends: (1) customer demand for integrated services, (2) new technologies that enable firms to enter new markets, and (3) outside capital pouring into the logistics arena.

First, customer demand continues to expand for integrated services. Much has been made of GM's four-year-old decision to outsource all $6 billion of its logistics needs to Menlo, in the largest one-stop-shop contract in logistics history. While such large deals have captured the attention of the media, the real action is occurring under the radar screen. Firms like Kimberly-Clark, which at one point handled over 60 3PL relationships, are looking to reduce their logistics suppliers to no more than ten. While this trend lacks the drama of the "4PL" movement, it is having a much more significant impact in the mid-market, where the majority of logistics firms operate.

Second, new technologies are enabling firms to penetrate new customer and market segments. Companies that invest aggressively in such technologies are gaining corresponding benefits. For instance, Schneider Logistics invested over $70 million, cumulatively, over the past ten years. The result, a web-based transportation management system called mySumit, has enabled Schneider to win business within customers spending less than $50 million on transportation, which was not previously a core market for the company. New technology investments are changing the competitive landscape.

Third, outside capital is pouring into the market, in search of the best companies in the logistics sector. In the past year, we have witnessed such landmark deals as the Welsh Carson acquisition of Ozburn-Hessey, the Warburg Pincus acquisition of NewBreed, and the PWC Logistics acquisition of GeoLogistics.* All represent nine-figure transactions that were consummated at strong valuations – generally ranging from seven to twelve times operating profit, or EBITDA. In addition, we have seen a number of "tuck-in acquisitions," such as PBB's acquisition of Unicity, PWC's acquisition of Trans-Link, PWC's acquisition of TransOceanic, and various others. This flurry of acquisitions reflects strong strategic demand for high-quality logistics firms. They also showcase the new role private equity firms are playing in the logistics sector.

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We can disaggregate the resulting mergers and acquisitions (M&A) trend into three core components:

- **Geographic converge:** PBB Global Logistics recently acquired Unicity Integrated Logistics and Unicity Customs Services. A primary reason for this move was to strengthen PBB's position as a leading cross-border specialist, and to concentrate on the 10% US-Canada cross-border transportation growth. Similarly, Yellow's acquisition of GPS reflects their view of the importance of the Asia-US trade lane. Meanwhile, European firms continue to look for US opportunities, attracted by the relatively high growth potential in North America: 15% annual growth, versus 2% in Europe.

- **Service convergence:** The most common trend in M&A over the past five years has been the convergence of warehousing and global freight forwarding. Transactions such as Kuehne & Nagel-USCO, UTi-Standard, UTi-Unigistix, and APL-GATX reflect this pattern. This year, PWC Logistics' acquisition of Trans-Link and TransOceanic showcase the desire of a regional warehousing firm to transform into a global multi-service solutions provider.

- **Increased financial interest:** Private equity firms are pouring capital into the logistics sector because they see a compelling opportunity to generate an above-market financial return. For instance, many firms have taken note of the outstanding returns that Eos achieved with Pacer, or Oak Hill with GATX, or Great Hill with SmartMail. Similarly, because the debt markets have been particularly eager to lend to private equity firms in large logistics deals, these companies are able to reduce their effective cost of capital in a transaction.

In light of the recent surge in private equity logistics interest, an example showcasing the financial mechanics may be in order.

Let's suppose that "ABC Logistics," a well-run, $100 million revenue, $10 million EBITDA company, agrees to consider a sale. Historically, such a firm might have been valued at 5-7 times EBITDA, or $50-70 million. However, in light of the high levels of demand for such high-quality companies, ABC Logistics may be able to fetch the premium price of 8x EBITDA, or $80 million. In the event that the purchaser is a private equity firm, he or she will rely upon the debt markets to finance a portion of the deal. In such a case, the firm may be able to support a debt level equal to 5x EBITDA, or $50 million. What this means is that the private equity firm will borrow $50 million and finance the remaining $30 million with equity. Then, if the company uses its operating cash flow to pay down the debt by $10 million per year, in five years it should be virtually debt-free. Thus, even if the company "only" grows at the relatively slow rate of 10%, which is slower than the 14% rate which BG Strategic Advisors forecasts for the outsourced logistics market in the coming five years, then in five years the private equity firm could grow its equity value by a much higher rate.

The below table illustrates this point. Let's assume that, post-acquisition, ABC Logistics grows its revenues and EBITDA at 10% annually. In addition, ABC Logistics pays down its debt at $10 million per year, resulting in a virtually debt-free company in five years. Finally, because the market pays a premium for larger category leaders in logistics, ABC can expect to achieve a slightly higher valuation multiple of ten times EBITDA upon its exit in five years. As a result, ABC's equity value grows from $30 million in year zero to $161 million in year five, for a whopping 40% annual return!

ABC Logistics Buyout Example

	Year Zero	Year One	Year Two	Year Three	Year Four	Year Five	Growth Rate
Revenues	100	110	121	133	146	161	10%
EBITDA	10.0	11.0	12.1	13.3	14.6	16.1	
Valuation at 8x EBITDA	80.0	88.0	96.8				
Valuation at 9x EBITDA				119.8	131.8		
Valuation at 10x EBITDA						161.1	
Debt	50	40	30	20	10	0	
Equity Value	30	48.0	66.8	99.8	121.8	161.1	40%

What does all of this mean for your logistics business?

If you are a large, innovative leader in transportation and logistics, you may already be looking at acquisitions to expand into new services, in order to meet this market need. If you are a mid-sized, successful logistics firm, the chances are that you have already received a number of unsolicited bids for your business. In either event, now is a good time to develop a strategy for how to succeed amidst this rapidly-evolving marketplace.

In closing, to paraphrase Lou Gerstner, who says elephants can't dance? Just as the Canadian Pacific Railroad demonstrated in 1883, large firms with a focus on growth will continue to innovate. In the 19th century, innovation in transportation may have consisted of entering new markets to generate demand for core asset-based services. Today, in the 21st century, the cutting edge of innovation lies in blending services to produce integrated solutions.

In the sequel to this column, we will outline specific strategies for success that both large and mid-sized logistics firms may consider.

* Note: BG Strategic Advisors has worked with all of these firms, either on the transactions mentioned above or on other projects, and may continue to work with these firms from time to time.