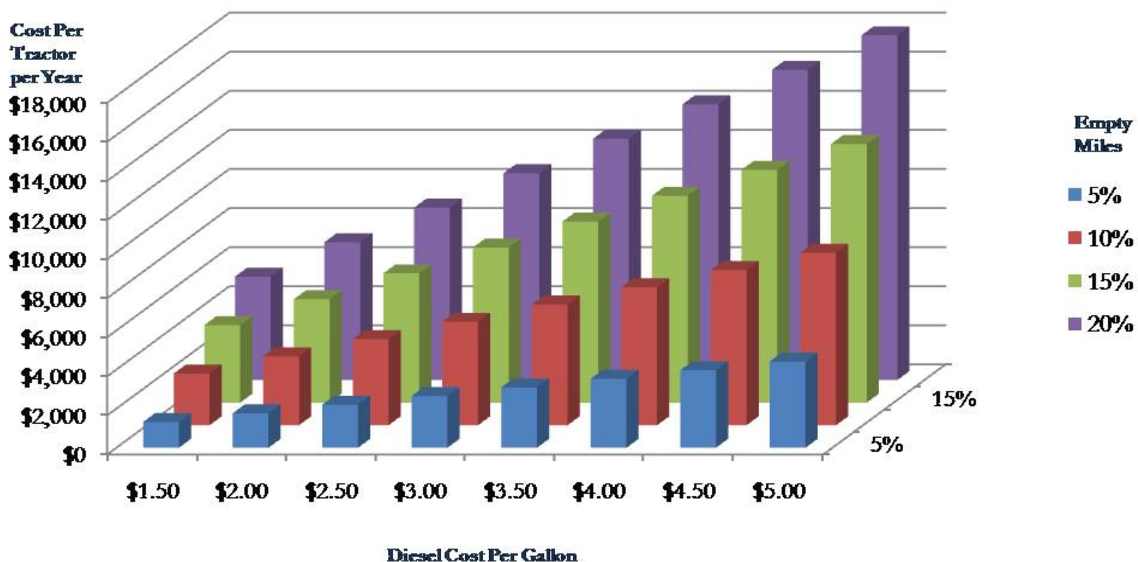
The Impact of High Fuel Costs on Mergers & Acquisitions in the Trucking Industry

The trucking industry has gone through, and continues to go through, some of the most difficult times since the Motor Carrier Regulatory Reform and Modernization Act of 1980. Deregulation effectively eliminated scores of major carriers over a ten year period as carriers fought for survival. The year 2008 is shaping up to be just as difficult as we are experiencing what can best be described as a "*Perfect Storm*". There are five key events that are occurring simultaneously:

- Skyrocketing fuel prices
- Major reductions in economic activity
- Massively changing supply chains
- Falling US dollar
- Significant pockets of debt secured by trucking assets

Skyrocketing fuel prices are creating significant costs for truckload carriers that cannot be fully recovered through existing fuel surcharge formulas. The inherent problem with these fuel surcharge formulas is that they are based on *loaded miles* only. All truckload carriers (other than dedicated contract carriers) have an inherent number of miles that they must run empty when dropping off one load and picking up the next load. Some carriers manage this very well by optimizing their customer shipping and delivering points. Large carriers have enough customer diversification that they have plenty of loads to choose from. All carriers, though, pay for the fuel they use for every mile that they run empty. The chart below illustrates what this costs for a tractor each year at ranges between $1.50 and $5.00 per gallon for diesel fuel. Each chart assumes 120,000 miles per year, per tractor, and an average of 6.8 miles per gallon:



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As you can see, the simple rise from $2.00 per gallon to $5.00 per gallon, using a moderate 10% empty miles factor, is a $5294.12 per tractor, per year, hit to the bottom line of a truckload carrier. Using average revenue per mile of $1.65 per mile, as an example, generates $198,000 per year, per tractor. This extra fuel cost represents 2.7% degradation in income margin. This could be the entire income of a marginal carrier.

With ***major reductions in economic activity*** there is less freight being shipped. Smaller carriers in particular are doing more chasing to find backhaul freight. This increases the number of empty miles driven by a carrier. With LTL carriers there is a secondary effect from rapidly rising diesel fuel prices. Fuel surcharges are passed on based on the previous week's fuel prices. When diesel prices rise very rapidly there is a lag between the fuel surcharge rate and the price of diesel fuel purchased that week. This has an immediate impact on earnings. Conversely, this is a benefit when diesel prices fall rapidly as well. As an additional contributing factor to a drag on earnings, lower economic activity results in smaller average shipment sizes for LTL carriers. It costs generally the same amount to pick up an 800 pound shipment as it does an 840 pound shipment but there is less revenue. The same is true for delivery costs. This has a direct impact on the bottom line of LTL carriers.

As the cost of a gallon of diesel fuel rises rapidly, this creates a major impact on the costs of certain products which will result in significant changes in those supply chains. Case in point – lettuce and other produce. With recent diesel fuel prices approaching $5.00 per gallon, this results in a $1.00 fuel surcharge for refrigerated goods. These types of commodities cannot simply wear the cost of transportation across great distances anymore. This will result in more locally grown produce and other lower value products being warehoused locally. This also increases the cost of imported goods as steamship companies pass on their fuel surcharges coupled with an already weakened dollar. Near-sourcing for supply chains then becomes more popular versus production in Asia.

A weakened US Dollar is actually creating a double phenomenon with imports slowing and exports rising. This changes the freight flows both domestically and internationally. Is it dramatic? No, but it all has an impact on changing supply chains.

In the first six months of 2008, 1,908 trucking companies have closed their doors and liquidated or gone bankrupt. This has resulted in approximately 120,000 tractors leaving the roads. A 6% drop in trucking capacity. While an estimated 30,000 of these used tractors and trucks have been shipped overseas, this represents a significant flooding of used equipment into the marketplace. Prices for used tractors and trailers have fallen like a rock. The trucking industry has historically been an asset intensive business. This has generated a significant amount of debt to be continually reinvested in new equipment. The first sources of collateralization are the tractors, trailers and trucks. ***There is no clear estimation of how much debt actually exists in the trucking industry where the debt exceeds the value of the assets.*** This potentially looming crisis is not something that is written about in the press but certainly exists. This is a situation not likely to change anytime soon unless economic activity increases.

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What does all of this mean to merger and acquisition activity in the trucking business today?
There are numerous owners of trucking businesses that would like to sell their business before the bank forecloses or they are forced to close their doors due to losses. These distressed businesses are selling at very attractive prices. In some instances they are going for just the market value of the assets. In other cases there is a slight premium of 3% - 6% of the revenue for the customer base. It is a buyer's market for these marginal carriers and many successful trucking business owners are taking advantage of this market condition. If your balance sheet is strong and your management team capable, this is a terrific period to add geographic coverage, new service offerings, or just more volume and density at a very low cost. Not unlike the aftermath of the Motor Carrier Act of 1980, this is a time where the strong carriers get stronger and the weak carriers get weaker.

Private Equity Funds and Hedge Funds are now circling the marketplace. Their investment thesis is that with reduced capacity; pricing will rise (which it is now doing in the truckload market segment). Additionally, some of these larger carriers that have significant amount of debt are also looking attractive as that debt begins to trade down in value. They will insert stronger management (which is supposed to be strong suit of Private Equity), put a stronger focus on growing non-asset services and bet on an economic recovery. A private equity firm can exit this investment in three to five years with an attractive return from their original bargain priced investment.

What does this mean to profitable carriers? The M&A market is still alive but slower. Valuations are trending closer to 2X – 3X EBITDA based on an efficient mix of assets. Obviously, significant investments in land or specialized rolling stock change these numbers.

Non-asset or asset light logistics companies are mostly unaffected by high fuel costs. This segment continues to grow and thrive in difficult economic times. Client volumes do fall and this is usually reflected in lower variable revenue. The merger and acquisition activity for this segment is extremely strong. There are just not enough logistics companies that are willing to sell to meet buyer demand.

I was prepared, until the banking meltdown, to predict the beginning of a financial recovery for truckload carriers. Real GDP was up 3.3% in the second quarter of 2008, capacity is down and pricing is on the rise. Unfortunately, these are extremely volatile times that suggest that meaningful economic recovery that drives freight volumes is probably sometime well into 2009.

In summary, what does this mean for Merger & Acquisition activity for the logistics industry in a high fuel cost economy?

- Buyers market for distressed trucking companies
- Trucking business valuation fundamentals are improving
- Credit risk on trucking equipment debt is rising
- Decent market for profitable trucking companies
- Still as a seller's market for non-asset logistics companies.

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