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Wave of Consolidation Continues Through Industry

Analysts Say Focus Will Shift Next to Smaller Carriers Surviving as Niche Providers

By Daniel P. Bearth
Senior Features Writer

Last year's purchase of Roadway Corp. by Yellow Corp. — a $1.05 billion deal that combined the two largest less-than-truckload carriers in the United States — was the most noteworthy industry event in 2003 and one that continued the churning process of mergers, acquisitions and bankruptcies among U.S. and Canadian fleets.

Industry analysts said it was a large-scale version of what is to come in trucking as smaller companies that have resisted expanding their geographic reach or portfolio of freight services may well have to consider the viability of that strategy, they said.

"Consolidation has already claimed many of the big names," said Theodore Scherck, president of the Colography Group, a logistics research firm in Atlanta. "Now the focus will turn to the smaller players that have heretofore survived as niche providers."

The LTL segment, Scherck said, "faces encroaching competition from the likes of [package carriers] FedEx, UPS and DHL, while the truckload segment, fragmented and burdened by [long-run] overcapacity, enters into a period of intense rationalization."

Consultant Satish Jindel said he believes that within five years 20% of the small, independent LTL carriers will either be "bought, sold or closed."

For the companies that can pull them off, mergers and acquisitions represent a "huge opportunity if [they are] done right," said Lee Clair, a partner in the consulting firm Norbridge Inc. who advises companies on strategic planning.

(*See* MERGERS, *p. 5*)

Tannen Maury—Bloomberg News

The merged Yellow Roadway Corp. now ranks No. 3 on the TT 100 and is the largest less-than-truckload carrier on the list.

Select Carriers Craft Low ORs With Painstaking Attention

By Mindy Long
Staff Reporter

Truckload carriers Heartland Express and Knight Transportation have remained among the most profitable companies in the industry by minimizing expenses, being selective of the freight they accept and focusing on the short- to medium-haul market, industry analysts said.

TRANSPORT TOPICS looked at their operating ratios. OR expresses a company's total expenses as a percentage of revenue, and like a golf score, lower is better.

In 2003, Heartland's OR was 79.0 and Knight's was 82.5. Heartland's annual report said last year's OR got a boost from a one-time favorable adjustment of $8.3 million on workers' compensation claims. Excluding that adjustment, Heartland's OR would have been 81.0.

Three large carriers — parcel giants FedEx Ground and UPS Inc. and air-freight specialist Forward Air Corp. — also had operating ratios below 90 for the year. CD&L Inc., a same-day and deferred-air package courier, broke 90 as did USF Reddaway, a less-than-truckload subsidiary of USF Corp. that operates in the western United States and Canada.

Refrigerated carriers Prime Inc. and Stevens Transport were under 90 as well. Prime, No. 32 on the TT 100 list, had an OR of 89.7. Stevens, No. 63, finished at 89.6 (see related story, p. 6).

However, Heartland, No. 43, and Knight, No. 58, were the two truckload carriers on the TT 100 list that generated the lowest ratios for the year.

Thomas Albrecht of BB&T Capital Markets said of Knight, "The single best thing they do is scrub their bad freight."

Kevin Knight, the chairman and chief executive of the business he founded with his brother Keith and cousins Gary and Randy, said, "I would say we just find the freight that works for our network.

"That is where our discipline comes in. We stick to that principle of finding the freight that fits our network." He said that meant his managers choose shippers with locations and types of freight Knight wanted.

Russell Gerdin, chairman, chief executive officer and founder of Heartland, said he attributed his company's success to its being debt-free. "We just don't have to make any short-term decisions to make analysts' numbers for a quarter," he said. "We're always thinking long-term."

One such analyst, Robert Dunn of Sidoti & Co., had more to offer: "It isn't one specific thing you can point to and say they do this better. They do a lot of things better," he said of Heartland.

Gerdin agreed that there is no silver bullet. "What we really do is we do 20 things one-tenth of a percent better," he said. "That adds up to that extra 7% or 8%."

Dunn said that Heartland was also very selective about freight. "If a load doesn't meet their profitability criteria, they'll turn it down," he said. "Heartland will say, 'We'll only take the best-profitable business.' They're able to do that because their service levels are very high."

Heartland also trimmed its OR by reducing empty miles, Dunn said. "If they can't match up loads, they won't take it," he said. "Another company would just take it and try to make a dollar off of it."

Heartland and Knight both travel in high-density traffic lanes between major cities to further minimize empty miles, analysts said.

In addition to seeking profitable freight, Heartland's and Knight's shorter lengths of haul added to their profitability, analysts said. Both companies reported an average length of haul of 532 miles in 2003.

"Shorter lanes enjoy higher rates per mile," said Daniel Moore, a transportation analyst with Stephens Inc. "The trick is maintaining high levels of utilization, which can be difficult to do in a shorter-haul lane."

"Managing that short haul is harder to do, but if you can get that last half load on, it makes a difference," Gerdin said.

A Bear, Stearns & Co. report said Knight Transportation focused on being a low-cost provider and would figure out a way to make freight

(*See* LOW OR's, *p. 4*)

Heartland Express

Heartland Express, of Coralville, Iowa, leads this year's TT 100 with the lowest operating ratio — 79.0. The company prefers to run short hauls through high-density traffic lanes.

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Acknowledgements and Sources

The 2004 Transport Topics 100 is a special project of the TT Publishing Group that features financial and operating information on the largest for-hire freight carriers in the United States and Canada. Information was compiled from annual reports of publicly owned companies, telephone interviews with executives of privately owned companies and other sources.

Senior Features Writer Daniel P. Bearth was the project coordinator, assisted by Shivram Vaideeswaran and the Economics and Statistics Group of American Trucking Associations. The design is by Patrick Donlon, assistant director of art and production.

Heartland, Knight Sculpt Low ORs in 'Glorified Warehouses'

(Continued from p. 3)

profitable rather than turn down a load.

Knight concurred. "If we're hauling something that doesn't work, we'd like to work with our customer to eliminate the inefficiencies and keep hauling it," Knight said. "It is easier to fix what you've got rather than go find something new."

Albrecht said Knight and Heartland both focus on existing customers. "A lot of companies will be focused on winning new business, which is fine, but you always have to be looking at the business you already have," he said. "They are committed to servicing existing business as much as they are as winning new business."

Both companies run a decentralized profit-and-loss terminal schedule, which encourages each terminal to improve its profitability, Albrecht said. "Each terminal has its own OR and bonuses data — that should not be underestimated," he said. "A terminal won't get new trucks until it improves."

"It makes each one of those guys his own boss and there is an extreme amount of competition among our outside terminals to have the best OR," Gerdin said. "It is like playing sports. They're out there to win."

Keeping expenses down was another key in Heartland and Knight's ability to maintain a low OR, Moore said.

"You can typically judge a company's management team just by looking at its headquarters," Moore said. Knight in Phoenix and Heartland in Coralville, Iowa, "operate in glorified warehouses," he said. "Many of their peers operate in elaborate headquarters that do absolutely nothing for shareholders."

Gerdin said, "We don't believe in bells and whistles. [Our headquarters] are functional and clean and warm in the winter and cool in the summer," he said.

Knight said, "We try to invest the money in what makes us the money. Certainly that is our people, our trucks, our trailers and so forth. The buildings don't make us the money."

Heartland's annual report said the company's tractors have an average age of 21 months. Dunn said the newness of Heartland's fleet added to the low OR. "Their maintenance costs are a lot lower because they only run their fleet under warranty."

Analysts said Knight and Heartland both had low insurance and claims costs, according to their annual reports. Insurance and claims made up 4.9% of Knight's revenue and 0.5% of Heartland's. Analysts said the companies keep insurance costs down by hiring experienced drivers.

"Both are fanatics about training. Both of their companies are skewed to experienced drivers — it also ties to safety," Albrecht said.

"Heartland pays more for their drivers on per-mile basis," Moore said. "Heartland pays top notch for its drivers for a reason."

Gerdin said, "We're the only public carrier that does not use any driver trainees. We pay for the experience and we feel we get our increased pay back by lower insurance costs and more dependable, on-time service that certain shippers will pay more for."

Higher pay helped to lower driver turnover and also decreased expenses, analysts said. "Heartland's pay scale ranks at the top of the industry," Albrecht said. "Knight is above average but isn't at the top."

Albrecht also attributed Knight's and Heartland's success to their conservative accounting practices. He said both companies take a conservative approach to recognizing bad debt and setting aside money for insurance claims.

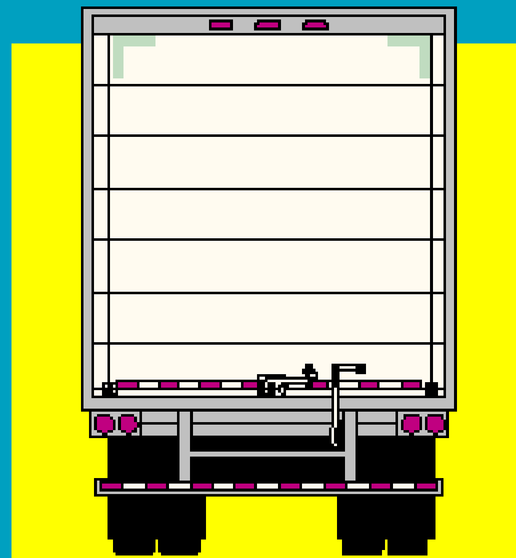
"It forces discipline when an organization has conservative accounting practices," Albrecht said. "People know if they're going to hit their numbers they have to do it through hard work and smart business practices and not cooking the books."

Gerdin said, "We don't ever want to be in a position where we're showing numbers we don't already have."

Knight said the use of accessorial charges has been important for his company. "It isn't that we're trying to collect the money; we're trying to bring accountability to the inefficiencies in the supply chain," he said. "Charges to offset those inefficiencies help bring light to those."

Moore told TT that Knight and Heartland both planned to expand their businesses, which he said could be the biggest threat to each company's OR.

"The larger you get, the less disciplined you become," Moore said.



Look-alikes? Sure.

"They have to make sure they balance the interests of growth and profitability."

Knight said he recognized that challenge. "I think we've got to continue to manage the complexities of growth and continue to manage the complexities of change," he said.

Dunn said Heartland had been able to keep its OR low after making acquisitions in the past. He said a drop in the OR from an acquisition has usually been only "a temporary phenomenon" that soon recovers.

Gerdin told TT that accidents posed the biggest threat to Heartland's OR. "It is a bad accident that gets you, and that is the one that moves you," he said. "If you get a bad accident or two in a quarter, that'll hurt you." Heartland recently increased its insurance deductibles to $2 million from $500,000 a year ago.

Analysts said another threat to staying below 90 would be changes in management. One analyst, who asked to remain anonymous, said he thought Knight Transportation was perhaps better suited to handle management changes. The analyst told TT he wondered if there was someone in the line of succession at Heartland who would be as qualified as Gerdin to run the business.

Gerdin replied, "They all think it's Russ — well, it's not Russ. We have a super group of young guys in their 30s who have been with us for 10 years and I think our strength really hasn't shown."

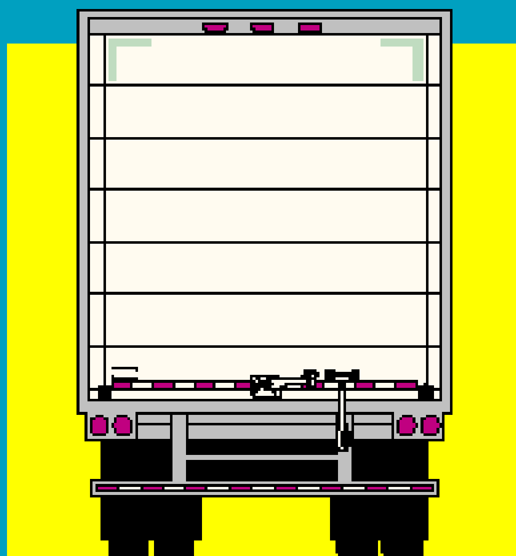
Albrecht told TT that both companies were "working with people between the ages of 25 and 40, ingraining them on the proper way to run the company."

Analysts said they expected Knight and Heartland to be able to maintain their low ORs.

"We weathered a tremendous storm between 2000 and 2003 — high insurance rates, falling equipment values, rising new equipment prices, lack of freight — and each lowered their OR since 1999," Albrecht said.

"To be able to improve their ORs with those obstacles and high fuel is truly astonishing. Now that freight is plentiful, it will make it easier to maintain or improve the OR."

Moore told TT, "I think their operating ratios will only continue to improve, which is surprising because they're the best in the business."



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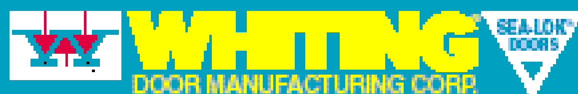

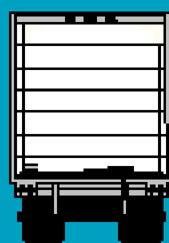

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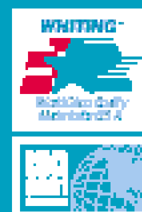

Mergers

(Continued from p. 3)

Although M&A activity can help build companies, the process also carries risk for carriers. Executives who have bought other companies said that successfully integrating such a purchase can be difficult and sometimes even ruinous.

Consolidation in trucking is not new. Nearly every company on the 2004 TT 100 list of the largest for-hire carriers in the United States and Canada has been party to a merger or acquisition (see related story, p. 30).

Scherck said he thinks the time is ripe for a major increase in merger and acquisition activity as shippers demand an ever-expanding array of transportation services at lower costs.

At the same time, a resurgent economy means that many carriers are in a position to take advantage of their improving bottom lines and low interest rates, which would enable them to take over weaker rivals and provide customers with additional freight-hauling capacity or services.

Jindel cited FedEx Corp. as an example of this strategy. In its June earnings report for fiscal 2004, the Memphis, Tenn., company showed strong growth in its express, ground and LTL operations, providing evidence, Jindel said, that shippers are giving more business to companies that can offer "bundled" freight services.

In February FedEx added the Kinko's photocopying and office services retail chain to its stable of companies. The stores can also serve as drop sites for small-scale parcel shippers.

To keep up with larger or diversified companies, Jindel said, freight carriers would have to invest more money in technology and freight-handling terminals. Companies without the financial wherewithal will be forced to merge or go out of business, said Jindel, whose SJ Consulting advises companies on marketing strategies.

A well-executed transaction can bring in new customers, add freight density to certain lanes and increase profitability by combining back office functions and eliminating duplicative facilities. Companies making acquisitions can also benefit by gaining access to people with critical skills and new business processes and technology, said Joe Denny.

The owner of Chapman & Associates, a firm that serves as a matchmaker for people seeking to buy or sell trucking companies, Denny said the number of people interested in buying trucking companies is increasing.

(See MERGERS, p. 23)

Pair of Reefer Carriers Achieved ORs of Less Than 90 for 2003

By Mindy Long
Staff Reporter

Refrigerated truckload carriers Prime Inc. and Stevens Transport both had operating ratios under 90 last year even though they compete in a particularly tough segment of the industry. Prime, No. 32 on the 2004 Transport Topics list of the 100 largest U.S. and Canadian trucking companies, had an operating ratio of 89.7. Stevens, No. 63 on the list, had a ratio of 89.6.

Executives at both companies named their colleagues as the most important factors in achieving low ORs.

"The biggest single issue would be management — our whole management team," said Steven Aaron, the founder and chief executive officer of Stevens. "We work with a sense of urgency at all times. There is no time for much small talk," he said.

Dean Hoedl, director of finance for Prime, said the company had "good alignment between performance and compensation among in-house associates and drivers." The majority of Prime's owner-operators and in-house sales people and managers are paid a percentage of the revenue they produce, he said.

Aaron told TT that his company's strict pricing standards also contributed to its OR. "In return, we offer near-flawless service. We have 99% on-time delivery," he said. "We have a few hiccups, but they're few and far between."

Dallas-based Stevens and Prime, of Springfield, Mo., both run long-haul loads, as is common in the reefer sector. The average length of haul for both companies was about 1,300 miles, Aaron and Hoedl said. Both operate in the 48 continuous states and Canada. Stevens also operates in Mexico.

Both Aaron and Hoedl said the increased cost of diesel fuel had not hurt their ORs.

Stevens recouped a major part of diesel costs on tractors through fuel surcharges, but was not recouping any diesel costs on the reefer units that cool the trailers, Aaron said. "Those we're having to absorb in our operating costs. We're able to compensate for it through increased rates."

Hoedl said the longer-length hauls gave Prime more fuel efficiency relative to revenue. Prime also used a fuel surcharge "to insulate ourselves on fuel costs," Hoedl said.

One of Prime's strategies to minimize the company's OR was to minimize empty miles. Hoedl said the company would turn down a load if it did not meet its needs. "The best way to determine your revenue is to turn loads down," he said.

"We are a contract carrier and we have obligations to customers, so we have to meet their needs," Hoedl said. However, "we turn down loads if we can't get the revenue needed to justify it."

While a central tenet of truckload industry wisdom calls for keeping empty miles, or deadheading, at a minimum, Aaron said he takes another tack at Stevens.

"We're contrary to everybody. We run empty 13% of the time," he said. "We go after the highest revenue per mile. We may deadhead farther after a load of high-paying freight, but all we pay attention to is the net revenue per mile." In contrast, Aaron said, most long-haul carriers run empty about 7% or 8%.

Stevens has a lot of special circumstances with customers in remote places, "but the rates are high, so we run empty miles to get there," Aaron said.

Stevens also supplemented its revenue with accessorial charges, Aaron said.

He said the biggest threat to Stevens' OR would be a major accident: "We're carrying a fairly high deductible," he said. The company's deductible for the first accident is $1.5 million, then $1 million for any accident after that.

"Our cost of claims and insurance is running 2.7% of sales, that's low," Aaron said. "Our safety experience and claims experience is way above average."

Hoedl said the biggest threat to Prime's OR would be the inability to maintain high levels of asset utilization as measured by revenue generated per truck. "Primarily the threat is with the new [federal] hours-of-service regulations [for drivers]," he said. "They diminish our asset utilization more than we can compensate for with rate increases," Hoedl said.

Aaron said the hours rule has not had an impact on Stevens' OR. "We thought it might, but it hasn't," he said. "We run a lot of [driver] teams, so that has assisted in that area."

"I can only tell you that we have developed a very well-thought-out game plan, and we attempt to execute as close to perfection as is humanly possible," he said.

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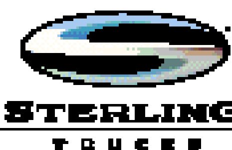

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