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What Does Industry Consolidation Mean for a Company's Value?

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Merger mania has clearly captured the American business scene. The total dollar value offered in net merger and acquisition announcements has increased from $226.7 million in 1994 to $1.2 billion in 1998, with an 81.4% increase from 1997 to 1998 alone.

What does industry consolidation mean to the owner of a privately owned business? How can one tell if an industry is consolidating or will consolidate in the near future? How does that affect the value of a company and its long-term plans? Furthermore, what does it mean for estate planning valuations (the IRS and its experts are also aware of these trends)?

Why Merger Mania?

Why have the number of transactions more than doubled since 1994, and why has dollar volume increased by more than five-fold over the same period? Like most trends, a combination of factors is responsible, including the following:

- Anticipated economies of scale from combining or eliminating operations
- Lofty stock prices provide "cheap" acquisition financing
- Management's attempts to fend off being acquired by someone else
- "Purchasing" market share and revenues
- Globalization of business
- Geographic expansion
- Product line expansion
- Deregulation

Synergy

Probably the most-often used word when talking about mergers and acquisitions is "synergy." The concept of synergy suggest that the sum of Company A's value and Company B's equals C, which is greater than the individual values of A and B. The term "synergy" is most often used when describing fragmented and inefficient industries, such as petroleum marketing, automobile dealerships or funeral homes. Consolidators seek to purchase competitors in fragmented industries for many reasons, including:

- Cost reduction by removing owner perquisites (e.g., owner compensation and benefits at levels higher than a professional management team), and eliminating duplicate distribution channels and sales forces
- Increasing profit margins by using increased volume to squeeze concessions out of suppliers
- Buying access to new markets and new products
- Bringing professional management skill to the table that is not possessed by the typical small, closely held business owner
- Creating a new business model for an industry that stands to transform and reshape the landscape of how business is done

One example is the rapid consolidation occurring in the ranks of automobile dealerships through acquisition by mostly large, publicly traded companies.[1] The historic business model in the industry has traditionally been one of small, closely held dealerships serving a local community. However, the consolidators want to apply mass-merchandising retailing techniques to the industry to control large market share to leverage clout over the car manufacturer for pricing concessions, and use sophisticated marketing techniques to generate sales to consumers. This potential threat, combined with the high priced purchase offers have induced hundreds of dealerships to be sold to these consolidators.

The list of industries where consolidation is occurring is potentially huge, so it is not possible to list every one. Table 1 shows a representative list of a few of the many diverse industries being reshaped by mergers and acquisitions.

Signs of an Industry Ripe for Consolidation

The closely held business owner or advisor may already know if his or her industry is currently consolidating because competition is increasing, or customers or trade publications are stating so. Some of the following are signs that an industry is heading toward consolidation:

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Deregulation. The elimination of regulatory protection of an industry brings down the barriers to competition, leading to new entrants into an industry. An excellent example is the local telephone industry, which previously benefited from monopoly protection.

Product Life Cycle Nearing Maturity. Product life cycle is an easy concept to understand. There are four stages in a product's life: development (low sales levels), expansion (large profits as demand grows), maturity (increased competition and reduced profit), and decline (consumer satiation, declining sales). For example, the personal computer industry runs through a complete product life cycle each time a new generation processor is introduced. The initial price for the fastest processor is high, then declines as more are produced. The computer becomes functionally obsolete after only a few years because faster generation processors are continually introduced.

Most products and services reach a stage in their life cycle where they are mature, with limited or slow-growing future opportunities. The days of rapid growth and fat profit margins are gone as existing industry participants fight to maintain market share as profit margins narrow and competition increases. Many participants either go out of business or leave the industry since profit margins become insufficient, and merger and acquisition activity increases. These factors lead to a sharp reduction in the number of industry participants. When the shakeout is over, a limited number of competitors remain that can meet the future demand for the industry's products, and profit margins recover to a level sufficient to provide a reasonable, but not excessive return. In short, equilibrium is reached.

Technological Change and Innovation. An increased reliance on technology in an industry can lead to greater competition. The heavy level of financial investment needed in technology in order to remain competitive often cannot be sustained by smaller, closely held companies, leading to consolidation. Additionally, technology can create the potential for new ways to transact business. A good example is the Internet, which brings the customer closer to the producer in many industries, eliminating or reducing the need for middlemen, such as wholesalers and distributors. Even if the need for middlemen is not eliminated entirely, a modest degree of penetration by Internet-related companies into the distribution channel has the potential to significantly reduce the profit margins of traditional wholesalers and distributors.

Increased Regulatory Costs. The costs to comply with various regulatory rules is becoming cost prohibitive for small- and mid-sized participants in many industries.

Powerful Suppliers and Customers, and Increased Competition. Increasing bargaining clout from large suppliers and/or customers makes it difficult for smaller companies to compete. For example, large wholesalers and distributors have the ability to demand substantial volume-related pricing concessions from suppliers that are not available to smaller local and regional competitors. Also, mid-sized and larger customers are reducing their number of suppliers by using "sole-sourcing" techniques, where all or a majority of a business's needs are purchased from one or several broad range suppliers. Many smaller wholesalers do not have a sufficiently broad line of products to be a sole source, and often cannot afford the large investment in information systems and additional working capital resources to meet these demands.

Just how powerful is this trend towards consolidation? Wholesaling and distribution-related industries, which make up a huge portion of the U.S. economy, provide a telling example. According to the *U.S. Industry and Trade Outlook 1999,*[2] and research published by the Distribution Research and Education Foundation, *Consolidation in Wholesale Distribution: Understanding Industry Change,* significant consolidation is occurring in 42 of 54 (78%) of wholesale segments, and in 14 of those 42 industries, the number of wholesalers has declined by more than 40%.

Impact of the Internet. Despite the hype, the Internet poses a significant threat to many industries, particularly wholesalers and distributors. Because Internet commerce can be transacted very cost effectively, it has the potential to radically reshape how business is done. In the future, the Internet will be a central force leading to consolidation and/or restructuring of whole industries.

Table 1 Examples of Consolidating Industries

Automobile dealerships	Food wholesalers	Printing supply wholesalers
Banks	Freight forwarders	Propane gas dealers
Beer distributors	Fuel oil distributors	Public accounting
Chemical wholesalers	Funeral homes	Scrap metal dealers
Commercial printers	General and specialty contractors	Seafood wholesalers
Communications wireless	Heating and air conditioning contractors	Soft drink bottling companies
Convenience store chains	Home insulation contractors	Temporary staffing firms
Electrical wholesalers	Industrial supply wholesalers	Textile yarn producers
Equipment rentals	Information technology consulting firms	Trucking
Floral supply distributors	Local telephone companies	Video retailing
Food manufacturing	Primary care medical practices	Water utilities

Table 2 Competitive Participant Types in the Distribution of Gasoline and Convenience Items

Operator Type	Comments
Traditional Full-Service Independent Service Stations	Buying their gasoline from independent oil jobbers, these operators are rapidly disappearing due to an inability to meet environmental compliance costs and a move by consumers to self-service gasoline.
Convenience Stores Owned by Major Oil Refineries	These have major gasoline cost advantages over independents and access to large amounts of capital for expansion and modernization.
Large Independent Regional (Often Multi-State) Convenience Stores	Often selling unbranded gasoline, these companies buy fuel and groceries in large volume at discounted prices, and pursue aggressive volume-oriented pricing policies.
Small One and Multi-unit Local Convenience Store Chains	These generally must buy fuel from local oil jobbers at higher prices, often on consignment due to the level of capital investment required. Many cannot afford the capital cost of real estate and must lease sites from third parties, often the oil jobber who also sells them their fuel.

Example of Industry Consolidation: The Petroleum Marketing Industry

The petroleum marketing industry can be used as an example of how forces are leading to consolidation. Petroleum marketing includes several categories. "Oil jobbers" are gasoline and diesel fuel distributors who purchase one or several brands of fuel from the refinery and then sell and deliver it to the retailer. Many also own and operate their own convenience ("c-store") stores, while others distribute to retailers but share in profits on gasoline sold. There are also numerous other variations of wholesale and retail sales. Traditionally, oil jobbers have been largely local or regional in nature. The sale of gasoline and convenience items is made through a variety of industry participants as shown in Table 2.

The entire petroleum industry in the U.S. consolidated in the late 1990s due in part to the cost of meeting stiffening standards for running an environmentally friendly station. Additionally, mergers at the refinery level have limited the supply options of independent marketers. This and the cost of regulatory compliance have resulted in a number of mergers and acquisitions at the marketer level. Smaller and marginal operators held off making the required investments to meet new environmental standards while deciding whether it was more prudent to make the investment or get out of the business. Larger marketers with stronger cash-flow positions have acquired smaller competitors who were unable to make the upgrades.

Advantages of Larger Retailers

The retail sale of gasoline and convenience store foods and items is intensely competitive and is increasingly dominated by large regional and national distributors, including independent dealers and the marketing arms of large national and multinational oil companies such as Exxon-Mobil, BP and others. Because gasoline is a commodity item, it is priced with very thin profit margins, giving large retailers with access to cheaper supplies through volume purchasing a cost advantage.

Large national and regional petroleum marketers have several major competitive advantages over smaller independents as follows:

1. **Volume Purchase Savings.** They buy gasoline and groceries in large quantities, obtaining substantial volume discounts. Their large volume of fuel purchases enables them to buy direct from the refinery. Small companies must buy through oil jobbers at a higher price.

2. **Lower Costs for Unbranded Gasoline.** Most sell at least some or a majority of unbranded gasoline which is cheaper than name brands. Branded gas typically costs about $0.02 to $0.03 more per gallon for regular unleaded, about $0.05 more per gallon for mid-grade, and about $0.06 per gallon for premium. Since gasoline is increasingly being sold as a marginally profitable, break-even, or even loss-leader item to get the customer into the store, this places smaller branded independent dealers at a cost disadvantage.

   One view historically has been that this disadvantage may be offset by the draw that a branded name has to consumers. However, large nonbranded dealers are increasingly well-known to consumers and have achieved "branded" images of their own by virtue of their large network of stores, but without the cost of branded gas.

3. **Pricing Strategy Advantages.** Their large number of stores allows these larger independent companies to aggressively price gas in specific localities, while making up for this by charging more in other areas. By contrast, smaller c-store chains, whose stores are all concentrated in one small geographic area, can be forced into severe price competition without the opportunity to offset these impacts in other communities.

Growth in Self-Service and Convenience Stores

In recent years the number of new convenience stores has exploded, leading many in the industry to fear that the industry is nearing saturation. The historic rapid growth of convenience stores and self-service gasoline sales appears to have been due primarily to three factors:

1. **Shift to Self-Service Gasoline Purchases.** A shift away from the purchase of gasoline from the higher-priced full-service traditional independent retail service stations contributed, in part, to growth.

2. **Role of Convenience.** The move by consumers to convenience purchases played an important role in the expansion of convenience stores.

3. **Environmental and Related Regulatory Compliance Costs.** Environmental regulations enacted in the 1980s required that underground tanks and pumps be removed and checked for groundwater contamination and be replaced with new and/or relined tanks and underground contamination monitoring systems. Many independent service station operators could not afford the expense of complying with the regulations and simply went out of business.

Thus, much of the recent growth in the revenues and numbers of convenience stores may not have been driven by long-term sustainable forces, but rather by shifts in the nature of distribution from one historic model (the independent service station) to another (the c-store). Since this transition is now largely complete, the long-term demand and growth of convenience store sales will be limited primarily by the rate of population growth, the numbers of autos on the road (tied largely to population), the rate of per capita gasoline consumption (tied to gasoline fuel efficiency of autos and per capita miles traveled), and inflation.

Other Factors Leading to Consolidation

The petroleum marketing industry's ability to grow at a rate above inflation and achieve volume growth will become difficult since it will increasingly require the ability to take market share from others, something that is difficult to do in a commodity business without hurting profits. This suggests that industry profit margins will potentially decline and that consolidation will ensue. Declining industry growth rates go hand in hand with the product life cycle. If there is little growth in the industry, competitors either have to take customers from each other or buy them away via acquisitions.

Technology. Pay-at-the-pump fuel islands, point-of-sale computer systems, tank monitors and instant electronic communications with vendors are commonplace at modern c-stores. This technology costs a lot of money and requires specialized knowledge. Those c-stores that do not keep up with the current technology lose business.

Co-Branding. Other trends in the c-store industry include quick-serve restaurants, such as the "co-branding" of branded c-stores with McDonald's or Subway. If the local or regional marketer cannot or is unwilling to invest in franchise food operations, customers may go to a competitor that will.

Deregulation. Deregulation hit the petroleum marketing industry in several ways. The deregulation of the trucking industry allowed marketers to sell their product wherever they wished, and deregulation of the petroleum refiners stopped the assignment of territories by brand. Marketers can now sell their product wherever they wish. The assignment of territories fostered fragmentation, and deregulation now plays a limited role in the consolidation trend.

Powerful Suppliers. Powerful suppliers can force consolidation as competitors merge to increase buying power. For example, price per tanker at the terminal can vary based upon the monthly volume purchased. Competitors in a low margin industry like petroleum marketing often informally or formally band together to wrestle away some of this power from its suppliers. This has become more of a factor recently as refiners have merged. Customers have power if they perceive little difference between competitors or if substitutes are readily available. Price becomes the key determinant. Competitors must cut costs to compete on price and consolidators take advantage of synergies in these very cost sensitive industries.

Increased Competition. The increase of competition may be a separate factor or may be simply the result of the above factors. Responding to competition can be accomplished by striving to be the low-cost provider (a difficult feat for small independent operators), or by developing a niche product (differentiation).

Differentiation is difficult with a commodity like gasoline, which is why many petroleum operators have diversified into c-store ownership, fast food co-branding, car washes and oil change operations. Differentiation often requires significant capital investment that is not available to the smallest independents. Becoming the low-cost producer requires being large enough to generate some economies of scale.

Getting a Good Price

If business owners are looking to sell their businesses and get the price they want, than their company has to have the

attributes for which the consolidators in a particular industry are looking. One can usually determine what those attributes are by reading relevant articles in industry trade magazines, or by looking at annual reports (form 10-K) or special reports (form 8-K) of public company consolidators. These reports generally discuss the consolidator's acquisition plans and often identify those specific factors sought in acquisition candidates.

Valuations for Estate Planning

If a business's operating characteristics would make it an attractive candidate to the industry's consolidators, then that would likely have an effect on value. There may be circumstances where industry consolidation may have little or no impact on company value, where the company is not a viable acquisition candidate, i.e., it is too small, operates in another region of the country than the consolidators, or does not offer the breath of services or products the consolidator demands. It is good business planning to identify the consolidators in the industry and learn what characteristics they seek in acquisition candidates.

Also, if the gifting of company shares is of a minority interest, its value for estate planning purposes may or may not be impacted by industry consolidation. Most minority interests have no ability to force a company's sale. If there is no plan or likelihood that the majority will pursue a possible sale, the impact on the minority shares of high consolidation-related prices being paid in the industry may be muted.

On the other hand, if consolidation is rapidly occurring and the prospect for a sale of the company is a real possibility, the impact may be very real indeed. Some have argued that the prices being paid in industry consolidations are not fair market value, but rather, investment value, i.e., the value to a specific buyer. Since fair market value is the standard of value for gift and estate planning, divorce, and other purposes, these voices would say that consolidation would have no impact on fair market value. However, if consolidation is driving the values in an industry and the prices being paid, fair market value will often converge towards or equal investment value.

Estate planners and business owners should not assume that the IRS is unaware of industry consolidation trends and their potential impacts on value. If consolidation is evident in an industry, the estate planner should ensure that the valuation addresses the trend and, if such consolidation does not objectively impact value, to clearly explain why it does not in an independent and unbiased manner.

Selling When a Business Is an Acquisition Candidate

Using an experienced valuation firm to determine the appropriate asking price based upon market forces is a necessity. Prospective sellers must think through what they will receive in cash and marketable securities. Public consolidators often pay for their acquisitions with their own publicly traded shares. These shares are restricted, meaning they cannot be sold to third parties for some period of time, often one to two years or more. Prospective sellers should have a high degree of confidence that the acquiring company will be as strong as they are now in one to two years, or their stock may be worth a great deal less. An experienced valuation firm can estimate the market value of restricted stock, which usually should be significantly discounted from its stated market value. Acquiring companies also use covenants not to compete as a way to extend payment terms over a long period of time. If the company goes bankrupt because it cannot handle the debt load resulting from its acquisition binge, the seller's expected monthly annuity can vanish.

Conclusion

Industry consolidation is occurring in many industries and has significant implications for company values, including purchase or sale, estate planning, buy-sell agreements, divorce, and dissenting shareholder actions (to name but a few). Also, family successio n planning, which may be aimed at passing the business on to the next generation, may require the need to consider whether or not these plans are realistic if consolidation is beginning to occur and in light of the resulting increase in risks such consolidation may bring. Prices in some cases might be at historic highs for an industry, prices that may not be seen again. This may force the family to give serious consideration to the need to shift gears and possibly pursue an outright company sale. Finally, if the decision is made to keep the company in family hands, how will these forces impact value for gift and estate taxation purposes? A well-prepared business valuation considers all of these factors and can help answer these questions in an unbiased and objective manner. ◆

END NOTES

[1] For a full discussion of the trends in this industry, see "Analyzing a Consolidating Industry: Auto Dealerships," *CCH Business Valuation Alert* (October 1999) 10-14.

[2] *U.S. Industry and Trade Outlook 1999* (McGraw-Hill Companies and the International Trade Administration of the U.S. Department of Commerce, 1999).