Transportation is getting hot: US trucking companies Knight and Swift to merge in an all American new giant

Swift Transportation Co (SWFT:NYQ) – market cap as of 29/04/2017: $3.27bn
Knight Transportation Inc. (KNX:NYQ) – market cap as of 29/04/2017: $2.76bn

Introduction

On April 10, 2017, Swift and Knight have agreed to merge in an all-stock transaction that is expected to create the largest player in the Transportation and Truckload industry. The combined entity, with an implied EV of $6bn, will be named Knight-Swift Transportation Holdings Inc. and will trade in New York under the ticker "KNX". The merger is expected to be accretive for Knight, and the two companies' boards expect a significant amount of synergies coming from sharing best practices, geographic scale and enhanced cash flow profile.

About Swift Transportation

Swift Transportation is a Phoenix based company founded in 1966. The firm started as a family-owned business, but it grew rapidly and today is one of the leading companies in the Transportation industry in the US, with $4bn in revenues and approximately 20,000 trucks (as of FY2016, average operating trucks stood at 17,548). Its business is not only composed of trucks and transportation, as Swift also holds a terminal network of 40 full service facilities spread between the US and Mexico. In fact, the value proposal of the firm is to provide customers with a one-stop-shop for truckload transportation needs and this is reflected by the broad range of products offered: line-haul services, dedicated customer contracts, temperature-controlled units, intermodal freight solutions, flatbed hauling, freight brokerage and logistics and cross-border services towards Mexico and Canada. Swift's view is aligned with its business strategy, as the company is willing to attract and retain customers offering best in class transportation solutions while leading the industry through innovation.

Despite offering multiple services, in FY2016, Truckload, Dedicated, Swift Refrigerated and Intermodal accounted for $3.72bn operating revenues out of a total of $4bn. In terms of profitability, the first two segments are the fundamental profit-generating units as their operating income accounts for almost $290m against an overall profit of $242m, which is driven down by losses in other segments. Net income for FY2016 stood at $149m and the low margin is attributable to significant operating expenses: $3.79bn against $4bn operating revenues, most of which is composed of wages, employee benefits and purchased transportation.

About Knight Transportation

Knight Transportation is also based in Phoenix and was founded in 1990. Similarly to Swift, it has grown from a family-owned business to a $1bn revenue company in 2016. Its product portfolio is particularly wide, as the firm offers dry van, temperature-controlled units, port and rail services, intermodal, dedicated service brokerage and third party capacity; it also offers truck and trailer sales across the US and warehousing and cross-dock operations in the ports of Los Angeles and Long Beach. Knight operations are mainly organized in two major segments: Trucking and Logistics. Trucking relies on three operating units, namely: Dry Van Truckload, Temperature Controlled Truckload and Drayage services; Logistics is composed of Freight Brokerage services and Rail Intermodal. As a leading firm in the industry, Knight aims at sustaining its strategy through future growth, based on the strengthening of customer relations, improving asset productivity, expanding and diversifying services both through organic and external growth.

Financial statements for FY2016 show that the two operating segments have different relevance, as Trucking generated $900m revenues and Logistics the remaining $226m. This figure clearly shows which of the two areas is impacting more the profitability of the firm and the segmentation is confirmed by the fact that it remained stable throughout the whole 2014 – 2016 period. The asymmetry also remains at the operating income level: out of a total of $148m, $136m is attributable to the Trucking segment alone. Net income reported for 2016 amounts to $93.8m and confirms the low marginality showed also by Swift, given $1.1bn in revenues. Even for Knight operating expenses had a significant impact, standing at $969m, majorly including wages, benefits and purchased transportation.

Industry Overview

The commercial freight transportation and logistics industry has been historically considered a sector characterized by high volatility, especially due to the uncertainty associated with energy and fuel prices. However, during the last few years, the industry stabilized, as transportation services remained constant. Evidence of this trend is shown by the U.S. Department of Transportation Services Index, measuring industry output, as it only increased by a couple of points. Despite the stabilization of transportation services over the last few years, industry dynamics are rooted primarily in the changing needs of commercial transportation and logistics customers, as well as the increasing complexity of shippers' supply chains. The context is best explained by five major trends: fracturing of supply chains and development of shippers' distribution networks aimed at reducing delivery time to customers; rising recognition among shippers that transportation and logistics represent a source of competitive advantage for them; expanded presence of high-margin suppliers selling specialty products (i.e. pharmaceutical companies) which require exceptional reliability, handling and security; natural disasters, labour strikes, and geopolitical uncertainties which cause shippers to re-evaluate their logistics networks; e-commerce growth triggering new demand patterns.

It is also worth mentioning that freight and logistics companies' network configuration, assets, skills and service offerings are based on a precedent set of market conditions and customers' expectations. Therefore, inertia constitutes a big friction in adapting to market changes, which creates a big opportunity for new entrants to gain market share by offering more valuable targeted services that established incumbents are not able to provide. Consequently, existing incumbents are striving to establish a better balance between customer needs and operational efficiency. To this aim, a strategy of pursuing M&A activity to overcome operating model inertia, which renders changes to the operating model more difficult and less likely, has been put in place within the industry. Examples of previous deals are UPS's $1.8bn acquisition of Coyote Logistics and C.H. Robinson cumulative $1bn acquisitions since 2010. A parallel strategy enacted by logistics companies has been focusing on data analytics and digital management, with the purpose of capturing and storing data more efficiently and, as a result, considerably lowering costs.

According to industry forecasts for 2017, demand is expected to rise in the US thanks to a surge in e-commerce, combined with Trump's high growth oriented policies directed towards de-regulation, high infrastructure spending, and lower taxes, all showing a positive correlation with the commercial freight and logistics industry. The implementation of electronic logging devices (ELDs) in December 2017 and higher truck capacity to reduce the excessively high levels of inventories, together with increased demand, will likely result in an increase in rates for freight companies leading to an increase in revenues. However, higher fuel prices due to the OPEC agreement may offset this increase in revenues as fuel prices represent the second biggest expense (behind personnel costs) for all carriers.

Deal Structure

The boards of directors of both Knight and Swift have approved the merger, which is structured as an all-stock transaction and is expected to close in Q3 2017. The combined entity will still be headquartered in Phoenix, and will have approximately 176.1m shares outstanding and 178.9m shares on a fully diluted basis. Knight is expected to be the accounting acquirer – with Swift holding 54% of the combined company, and Knight the remaining 46%.

Under the terms of the agreement, one share of Swift will be converted into 0.72 shares of the Knight-Swift combined entity in a reverse stock split, while each share of Knight will be exchanged for one share of the new entity. With a $30.65 closing price per share of Knight on the last trading day prior to the announcement (as of April 7, 2017), the implied share price of Swift was $22.07. The implied price projects at a 10% premium over the closing price of Swift on April 7, 2017, which was $20.02.

The transaction is expected to be accretive to adjusted EPS due to predicted pre-tax synergies (evenly split between cost and revenue synergies) of c. $15m already in the second half of 2017, $100m in 2018, and $150m in 2019.

Deal Rationale

The transaction combines two long standing industry leaders creating North America's premier truckload transportation company with $5bn in annual revenues and a "Top 5" truckload presence in dry van, refrigerated, dedicated, cross-border Mexico and Canada, and a significant presence in brokerage and intermodal.

From Knight's point of view, the deal meets four primary goals: creating a company with the best strategic position in the industry, identifying significant realizable synergies, creating a business that over the long term would operate according to Knight's historical margins and financial, and obtaining a corporate governance framework suitable for such aims.

From Swift's point of view, the deal represents an opportunity for its shareholders, as they will be able to benefit from the upside of the business given the all-stock transaction, and to capitalize on economies of scale to achieve substantial cost synergies (Swift is almost four times bigger than Knight in terms of revenues).

Swift Transportation has a significant presence in Mexico and strength in its dsegment (which includes long-term contracts), in addition to a robust fleet size. On the other hand, Knight relies on its operating margins and superior returns in the dry van and refrigerated sector. The company also has brokerage expertise, which will be leveraged by the new entity. Thus, the two companies anticipate substantial revenue and cost synergies from the adoption of cross-functional teams. The combined company is expected to operate 23,000 tractors, 77,000 trailers, and over 70 service locations in 30 states. Furthermore, both companies have forward roles in the logistics market and their positioning is coherent with their shortening supply chains. Besides, driver domiciles play an important role in the deal as Knight-Swift will have nearly all major driver domiciles and the position of service locations with respect to major populated areas will result in more efficient service offerings.

The combined entity will generate approximately $5.1bn in total revenues, $416m in adjusted operating income and $806m in adjusted EBITDA - all metrics excluding the impact of synergies, transaction related expenses, and transaction accounting. Another important aspect of the acquisition regards the entity's leverage ratio, which will be approximately 1.3x giving it enough flexibility to pursue growth plans and benefit from a cheaper cost of debt.

Market Reaction

The market reaction on the day of the announcement (April 10, 2017) was positive, with a 23.73% increase in Swift's share price from $20.02 to $24.77 and a 13.38% rise in Knight's from $30.65 to $34.75. Post announcement both companies' share prices have followed the same trend, with a decline from the peak reached upon the announcement followed by a recovery as of April 28, 2017, signaling investors' confidence in the merger.

Advisors

Evercore Group L.L.C. served as financial advisor to Knight, while Morgan Stanley served as financial advisor to Swift.