Keep On Truckin' with Arkansas Best

by Henry W. Schacht, CFA
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Conventional wisdom says the only way to invest in transportation these days is via the railroads. With Berkshire Hathaway buying **Burlington Northern (BNI)** shares by the trainload, who am I to argue? Warren Buffett obviously sees railroads as a "toll bridge". There are only a handful of competitors and a host of nearly captive customers. If you want to ship coal, you'll need a railroad and the choices are limited.

By contrast, the trucking industry is an extremely fragmented industry. Customers have almost unlimited choices from large integrated carriers to a guy in a pickup. The industry has often been characterized by excess capacity and irrational pricing. Let's not forget that rising fuel costs disproportionately penalize truckers. Combine that with worries about the global economy and you have an industry that investors avoid.

But opportunities exist.

To get over the hurdle of industry dynamics, think about insurance. Warren Buffett has often said that anyone can write an insurance policy. Pricing is cyclical and sometimes irrational, yet Berkshire has survived and thrived. This is thanks to a low cost structure and discipline. Berkshire simply does not participate in irrational pricing behavior. They are content to sacrifice short-term volume for long-term viability. This recipe for success is used by companies in the trucking industry as well.

There are even signs that the industry is becoming more stable as there are real structural changes taking place. One major contributor to this is the influence of **FedEx (FDX)**, **United Parcel Service (UPS)**, and other integrated transportation companies. In short, trucking companies can be very rewarding investments as Schacht Value discovered almost by accident.

Schacht Value Investors owned **Overnite Transportation**, a less-than-truckload (LTL) carrier in 2005. A one-time subsidiary of **Union Pacific (UNP)**, Overnite was spun-off to form an independent company. At Schacht Value, we review many spin-offs and we liked what we saw. Overnite was cheap at just 9 times earnings and the business had been neglected under Union Pacific's ownership. Simply put, there was plenty of potential upside in the operation and in the valuation. Not long after our purchase, UPS acquired Overnite. The deal valued Overnite at 14 times earnings and we made roughly 40 percent on our money in a matter of months.

Schacht Value has followed the industry and its participants ever since this experience. The timing of our Overnite purchase was pure luck, but the forces at work in its buyout are powerful and ongoing.

FedEx and UPS are locked in an arms race. Neither can allow the other to gain an advantage. After UPS bought Mail Boxes Etc. in 2001, FedEx followed with the purchase of Kinkos in 2004. Both firms are systematically expanding their capabilities, expanding their customer base, and building out huge networks. To that end, both have been regular and significant acquirers of other firms. Most recently FedEx bought LTL carrier Watkins to expand its offerings and bulk up its Freight division. The result: greater scale and immediate synergies.

Consolidation of this type will continue. The rationale is simply too great for it to stop. FedEx and UPS are working hard to build integrated networks, which must stay full to be efficient. There is plenty of work left to do in order to expand the breadth and depth of these transportation webs. At the end of the day, only a handful of players will succeed in this global quest. While FedEx and UPS are the largest and most visible firms on the worldwide logistics stage, they are not alone. DHL purchased Airborne Express' ground assets in 2003. They want a seat at the table too. As these companies and others compete for assets, there will be a lot of action for investors.

The valuation gap between the big boys and their potential acquisitions only accentuates the possibilities. FedEx and UPS have multiples in the mid to high teens compared to single digit multiples for many smaller transport companies.

The pattern that emerges is one of a rapidly consolidating industry benefiting from a virtuous cycle. As industry leaders get bigger, they will be less willing to participate in destructive pricing. Their massive investments and huge volume dictate a certain amount of sanity. In turn, smaller players will benefit from a pricing umbrella and should gradually be absorbed by the more integrated industry giants.

The net result has been and will continue to be a reduction in competition. The oligopoly created by the likes of FedEx and UPS continues to expand. This makes life better for big and small alike. This backdrop along with the negative sentiment that currently exists has led to ridiculous valuations on some high quality companies.

Our favorite is **Arkansas Best (ABFS)**, a North American LTL carrier. The company is solidly profitable and conservatively managed. For proof, look no further than the balance sheet. As of June 30th, ABFS had $136 million in cash and no debt. Indeed, cash represents 16% of the company’s $850 million market value. Adjusting for the cash, Arkansas Best trades for less than 10 times forward earnings.

To say ABFS is a prime buyout target is an understatement.

The largest inside owner of stock is the Chairman of the Board, Robert A. Young III, who owns about 9% of the company. We're pretty sure he has a vested interest in maximizing shareholder value. ABF isn't just hording cash. The company is committed to growing organically and correspondingly invests heavily in its own network to the tune of about $100 million a year.

Arkansas Best is not just another "me too" LTL carrier. The company has some unique services. Most intriguing is the firm's do-it-yourself moving service called UPack. ABF provides a trailer, you pack your belongings inside, and they drive it to your new home. The profit margins are well above average. Could we see FedEx or UPS buy ABF in order to add Moving & Relocation Services to their portfolios?

ABF would be an easy decision for any buyer. Well run, awash in cash, and cheap! On a standalone basis or as a potential buyout, Arkansas Best makes a lot of sense. And Schacht Value is not alone in this belief.

Gurus **Michael Price** and **Arnold Van Den Berg** have purchased Arkansas Best shares in recent months. We'll hitch a ride with these guys any day.

Disclosure: The author owned shares of Arkansas Best personally and on behalf of clients at the time of publication.

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