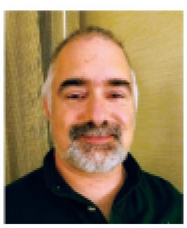
Merger Mania

The Pros and Cons of Consolidation in the Towing Industry

By Brian J. Riker with George Metos



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Consolidation is happening, ready or not. It is no big secret that business is tough, and the current economic, political, and social climates only make it tougher every day. Of course, change is inevitable. Time does not sit still and neither should any business. An organization can either adapt to the changing environment to stay viable, or be left behind and disappear. Success depends upon the ability to respond quickly and accurately to changing environments.

Looking back on the 30 years that I have been in this industry, my first wrecker was a Holmes 440 with a sling, and it was used well into the mid 1990s, on a daily basis as a primary response truck. Just a few short years later, a wheel lift and car carrier were the industry standards, and much more modern than the trusty old Holmes. Progress was necessary in order to adapt to newer, unibody cars, along with the tow market's demand for these types of trucks. So too, a changing industry requires this same ability to adapt.

WHY CONSOLIDATION?

Towing has historically been an industry full of bootstrapping entrepreneurs, and mom-and-pop outfits with little more than sheer willpower to survive. Most towers were either born into the industry, or became captivated by helping others in a time of need, and turned it into a career. Personally speaking, I still get a thrill when I get the chance to go on a live call and make someone's day just a little bit brighter.

Given the people-focused nature of towing, some towers may wonder why consolidation is happening now. The answer is simple—money.

As pointed out by George Metos of Business By George (specializing in brokering the sale of towing companies), the advantages of consolidation are many. These include brand recognition, economic efficiencies, negotiating power, and attracting employees, among other factors. In towing specifically, the ability to share equipment between locations allows managers to spread their assets more effectively within a region. With all these advantages, it is clear that consolidation of the towing industry will continue.

In recognition of the push towards a global economy, and the effects that has had on supply chain and labor, we are seeing unprecedented increases in the cost of doing business. From labor to trucks and everything in-between, costs are out of control.

Political pressure is mounting on the industry to rein in fees and provide consumer protections. States are attacking the minimum wage, raising it to unsustainable levels in some areas. Other forces are at work to remove certain exemptions from the Fair Labor Standards

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Act that have for decades helped motor carriers remain competitive with their wages without unnecessary regulations.

As a result, it's likely that smaller companies will struggle to survive. It's time to address the issues that are coming from external forces such as rate regulation, customer relations and many other operational considerations, and examine ways to move forward.

HISTORY REPEATS ITSELF—MAYBE

For many seasoned towers, consolidation is nothing new. Several companies tried it previously, with the most notable being Road One, backed by the Miller family of Miller Industries and United Road Towing. This independent consolidator grew from a family-owned towing company into a large player in the towing and auto transport industries, before splitting into separate operations and facing financial difficulties.

This consolidation effort wasn't completely successful, though. The timing wasn't right, and the management methods needed adjustment. They were just too innovative for the industry at the time, trying to "corporatize" the operations. In contrast, many towers enjoy working for smaller towing companies with more relaxed atmospheres where they are able to build personal relationships directly with the owners. That is the polar opposite of a large corporation, and towers were just not ready for that in the 1990s.

Valuable lessons were learned from these initial failed ventures, and new approaches are being applied today for a much more robust consolidation effort, one that has a very high chance of success.

WHY NOW?

The short answer is the generational shift. Today's workers do not tend to build a long career with any single employer. Depending on age group and occupation, the tenure at a single employer can be as short as a few months and up to just a few years. The U.S. Department of Labor average duration for laborers (which is what most towing company employees would be classified as) is only 2.8 years. Breaking this down further, older workers tend to stay with the same employer longer (9.8 years for age 55 to 64) than younger workers (2.8 years for age 24 to 35).

Gone are the days where an employee at a towing company would willingly work around the clock without days off, sacrificing time with family and friends in the name of retaining a job. The same holds true with owners.

As companies transition from generation-to-generation, many new leaders do not want to be married to their businesses, and instead are opting to invest in passive-income schemes or forgoing some of the profits to have more managers on the team to share the workload.

With this mindset shift, many companies already have in place excellent management teams capable of running a towing operation successfully with absentee ownership. This was a critical failure with early consolidations, as the previous ownership would often leave the business shortly after selling. Or, if they remained on as a manager, they couldn't effectively manage without being there 24/7, which led to burnout and failure.

ECONOMIC CONCERNS

Low-cost financing and trucks being readily available are no longer the norm. To survive today, a company needs readily available access to capital, and the ability to effectively execute long-range plans. Purchasing trucks to keep the wheels rolling now requires 12 to 18 months of advance planning, often tying up large amounts of capital or credit while waiting for the revenue-producing assets to arrive. Smaller operations simply do not have this type of financial reserve available.

With the increased costs of equipment, it makes sense to share resources regionally. While this approach may not be an option for independent businesses, it can easily be accomplished with joint ownership of consolidated companies. The return on investment associated with a million-dollar piece of equipment must be substantial to make financial sense. Yet, many tow company owners make these purchases based on emotion, simply because they don't want to let their competitors have any perceived advantage.

According to Metos, the favored target of consolidators thus far has been HD and Recovery towing. Why would investors focus on this type of towing? First, he points out that they can be very profitable, with higher average per-tow revenue, and recoveries generating tens of thousands of dollars. Sure, these companies have high CapEx (Capital

Expenditure) costs in wreckers, rotators, and class A drivers. But Metos notes that this same CapEx creates a barrier to entry to keep the competition to a minimum. We all know that wreckers are not getting any less expensive. Secondly, he adds that the network can attract a particular HD customer at many of the locations that they've built along the interstate. Consolidators want HD and Recovery companies that are placed strategically near the interstate, along with proven financial performance, a reasonably up-to-date fleet, and a good group of drivers. These attributes are unique to HD and Recovery towing and seem to make such towers more attractive to the consolidators.

INSURANCE ISSUES

Additionally, as the cost of business increases, so does the amount of business that is done at a loss. Towing is one of the few industries that is expected to respond and provide service without concern for the customer's ability to pay, and then have to fight with insurance companies and other third parties over what is deemed fair compensation. In some markets, more than 40% of all calls for service result in non-payment and disposal of abandoned vehicles, costs that are difficult for small family-owned businesses to absorb.

Regarding insurance, commercial auto premiums have recently skyrocketed, making it almost impossible for smaller outfits to maintain proper insurance coverage. The large companies, while still affected by this, have an advantage that allows them to pool their resources and self-insure against the average risk, or to join in the growing "captive" markets (explained below), again offering greater insurance coverage at substantial discounts from what is available to a smaller fleet.

Insurance captives are not new, although they are exploding in popularity among many service-based industries, including towing. The problem with captives, which can result in significantly lower overall cost for insurance, is having the excess capital to enter into one, and fund your first year of expenses. Unlike traditional premium-based products, with captives you are responsible for the overall losses of all members combined. In essence, the companies within the captive must be very well run and have safe operations with large cash reserves to cover the expenses.

Corporate companies with dedicated safety programs, in-house trainers, and other resources to manage these risks, can thrive in captive insurance programs. Independents, not so much. ▶

THIRD-PARTY SERVICES

Call aggregators, also known as dispatch companies, have completely changed the automobile transport and general freight segments of trucking in much the same way as motor clubs and other third-party services (that provide work to local towing companies) have changed the industry. Gone are the days of a handshake and a meal with the Service Manager at the local dealership, meaning you would then get their tow calls. Today, many towers get their work from third-party services, and while they have their place within the industry, it makes it difficult for a small company to develop their own contracts.

This is especially true in the heavy-duty towing segment where trucking companies are also facing great consolidation pressures, reducing the number of large fleets available for a heavy-duty tower to contract with. Add to this their own efforts to build service-provider networks and it will not be long before most heavy-duty work—including even emergency work like crashes—is controlled by in-house networks, and direct contracts between the major trucking companies, and many of the largest towing industry consolidators.

Metos observes that regional networks are being built by well-funded, bright people who want to create a large geographical footprint. They value a good operation and the know-how of a seasoned staff. He feels that there's no reason why these networks won't succeed with their business plan. They have the capital to buy the private towing companies, acquire more trucks, compensate employees competitively, bring long-term financial security, provide flexibility in employee movement within the network, and increase the control of their territories. The consolidators are good at building management infrastructure, which becomes necessary as a towing operation grows in size.

On the other hand, Metos notes that there are also many localized networks around the US and Canada where an operator has a handful of locations within a 100-mile radius. That's not quite the same as regional consolidation driven by an investment group, which provides a more complete picture of consolidation. These localized networks may be attractive to the regional networks if they've built it wisely. Or they may remain private and thrive.

WHAT ABOUT THE AVERAGE TOWER?

Given that the average towing company in the United States has five to seven employees, it is still an industry of small family businesses.

Consolidation will affect niche segments first, such as private-property impound and heavy-duty towing and repair services. These segments are appealing because they have large revenue potential and usually have commercial contracts that are transferable, unlike the light-duty segment of the industry where revenue sources are much smaller and less reliable.

The same can be said about collision centers. The key takeaway from consolidation in the repair industry is twofold. First, economy of scale makes an enormous impact on costs of goods sold and the bottom line.

Second, retain the real estate when the company is sold. This will create residual income regardless of how the new ownership manages the towing operations, and land can always be repurposed or leased to someone new. The best part about retaining land, it is in short supply, and we are not making any more of it.

TAKE ADVANTAGE OF CONSOLIDATION

Selling to a consolidator can be a viable exit strategy, especially when you don't have anyone waiting in line that wants to assume the risks and responsibilities of owning and operating the family business.

Even so, Metos outlined some potential troubles faced when it's time to sell for whatever reason. Businesses are valued in a few different ways, usually some combination of the value of the physical assets like property and trucks, plus proven income and profit, along with a bit of "blue sky" added to account for the name recognition and goodwill between a current business owner and their customers.

If a company's books do not accurately reflect all the income and business expenses, a potential buyer will have to presume your company is worth less than you think.

"You don't want to be in an undervalued position when it is time to sell, especially if the buyer is an absentee owner like a consolidation company or investment firm," Metos points out. "They will need to make sure the company makes enough profit to pay a professional manager and still return a profit for their shareholders."

He adds that owners commingle their personal and business funds, using company money to pay for personal expenses, instead of taking it out of the company as payroll or a dividend, which results in an inaccurate balance sheet when appraising their company."

"These skewed financials can be very difficult to explain or correct if a quick sale is of essence," Metos noted, "resulting in a greatly reduced sale price."

To maximize the return on investment, consider some of these proven strategies, which are best applied three to five years prior to selling. The longer these measures are in place the better the return will be.

Begin with an accurate accounting of all business income and keep those funds separate from personal funds. Commingling business and personal funds is the equivalent of embezzling from yourself. Even sole proprietors should have, at a minimum, two separate checking accounts for business and personal funds.

SHARING RESOURCES WITH FELLOW TOWERS

Consolidation will have a greater impact on the shape of the towing industry more than ever before. Today's big players, like Guardians of the Highway, and other lesser-known entities, have one thing in common. They are well funded, professional-management organizations that understand how to operate in the current global economy.

Insurance reform, ever expanding consumer protection, and even major disruptions to how law enforcement selects service providers, are not major obstacles to these organizations because they have the manpower, expertise, and resources to either retaliate or adapt to the changing landscape.

The days of going it alone have been replaced by networking and association memberships. Power in numbers is critical to thrive in the current marketplace. Find positive ways to share resources among friendly competitors, or risk being forced out of existence when the larger, more resourceful companies enter into your market.