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PORTS

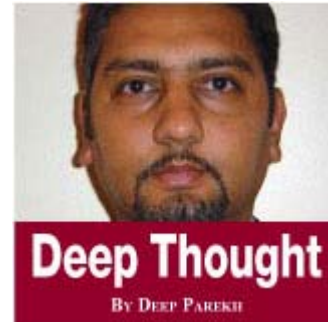
Hawkish on ports and terminals

Private equity offers a source of capital, but required return can put squeeze on operators.

“The new economic order has its own distinct opportunities and pitfalls. If past economic transformations are any guide, those who play by the new rules will prosper, while those who ignore them will not.”

Kevin Kelly

author, *New Rules*
for the New Economy



Globalization, rapid industry consolidation, growing disparity between leaders and laggards, increasing profusion of technology enablement, and other factors together are spinning out a new economic order in the ports and terminals business.

It is inevitable that investors will follow the food chain to see where their profits and growth is being stymied. The buck stops at the ports and terminals - for now.

Investors have essentially opened up all the faucets on global companies, who are doing the best they can to maximize output. Sony may have all the capacity in the world to make new PlayStations, but it does neither Sony nor its investors any good if U.S. West Coast ports are too congested to allow the bulk of its shipments to reach the retailers by the launch date, destroying an abundance of value for the shareholders and jeopardizing their competitive advantage in the marketplace. Sony just points the finger at the ports and can rightfully say, “we did all we could, but the port messed up.”

Think about ports and terminals as the “pipe” through which your trade flows, much like electronic bandwidth for the Internet. In the early days of the consumer-driven Internet, Web pages were all the rage, until people figured out that they couldn’t do much to reach the consumer unless they actually had sufficient bandwidth to download all those beautiful well-conceived Web sites and rich graphics-laden Web pages. Companies like Akamai, Cisco and Avaya grew exponentially because they provided smart ways to get a bigger “pipe” through which you could push content.

With ports and terminals being the “low bandwidth” of global trade today, not the supplying companies, the investors and participants in global trade have begun to focus on their bottleneck - ports and terminal operators. Frankly, ports and terminals are doing little to help themselves in this matter. Historically mismanaged, these entities are bringing about either boom or bust upon themselves. As Kevin Kelly said in his book, *New Rules for the New Economy*, those who play by the new rules will flourish, those who don’t won’t survive. Whereas it is dated in terms of the “new economy” of the dot-com days, it is more than relevant in today’s economic environment of the ports and terminals.

Need For Capital Injection. With the high price tag for expansion and modernization, ports today are thirsting for capital. With infrastructure as much as 20 to 30 years old, and capacity utilization nearing maximum, ports are being forced to perform at or near record levels.

Whereas this is good news for those who welcome it and can deal with it, it spells disaster for those who cannot. Governments are hesitant to put in more money, after having rescued several ports during the past few decades during economic downturns and before the globalization boom.

This is where we see more players from private equity trying to work deals in this industry. Private equity today is somewhat backed up - there is too much capital flowing in considering the deal-flow at record lows. Not wanting to invest in flamboyant and unsustainable Internet startups, the private equity market is cash-laden with relatively few investment alternatives with which to grow value for their shareholders.

Given the current state of the ports and terminals business, it is no wonder private equity firms are interested in investing there. Historically, when companies are mismanaged, or the sum of their parts is greater than their consolidated value, private equity steps in to either forge a deal to put in a new leadership team and/or to sell the business or components off to different investors or interested parties.

Depending on which side you look at, private equity can be a savior or bane to port businesses. From the investor perspective, ports and terminals have the potential to be efficiently run, have decent infrastructure and sustainably high traffic levels, but just lack good leadership and decision-making. The investors would be demanding of their ports and would ensure they return to high profitability levels and have healthy balance sheets. The private investors, unlike governments or public outfits, would be keen to maximize their shareholders' value through either increase in return on investment capital or in growth. From the perspective of the port or terminal operators, the demands would quickly add up, the sense of urgency of action, the mounting pressures for growth, return on capital, clear accountability, efficiency pressures, and cost-cutting measures on an already lean base. Private equity firms typically look for short positions during which they can closely manage the outcome. Imagine the analogy of the private equity firm as the author of a book that has written the last chapter of the manuscript, and will work backwards to make sure the port or terminal it acquires writes the story for the rest of the book that can make the ending happen as written.

To understand the mentality of the private equity investor, one has to understand some fundamental economic concepts, such as WACC, ROIC, and Growth.

WACC is the weighted average cost of capital, or the cost at which a company borrows money in the market, to invest in its business.

ROIC is the return on invested capital, or the return on the capital invested in the business.

Growth is the manner in which the company increases its top-line by acquiring more customers, expanding the base of business, or by consolidating or merging with another company.

Understanding WACC. According to Investopedia (www.investopedia.com), a firm's

WACC is the overall required return on the firm as a whole and, as such, it is often used internally by company directors to determine the economic feasibility of expansionary opportunities and mergers.

The capital funding of a company is made up of two components: *debt* and *equity*. Lenders and *equity* holders each expect a certain *return* on the funds or capital they have provided. The *cost of capital* is the expected return to equity owners (or shareholders) and to *debt* holders, so WACC tells us the return that both stakeholders - equity owners and lenders - can expect. WACC, in other words, represents the investors' *opportunity cost* of taking on the risk of putting money into a company.

To understand WACC, think of a company as a bag of money. The money in the bag comes from two sources: debt and equity. Money from business operations is not a third source because, after paying for debt, any cash left over that is not returned to shareholders in the form of dividends is kept in the bag on behalf of shareholders. If debt holders require a 10 percent return on their investment and shareholders require a 20 percent return, then, on average, projects funded by the bag of money will have to return 15 percent to satisfy debt and equity holders. The 15 percent is the WACC.

[Table 1](#) shows that for the transportation sector, the ROIC hovers cyclically between 6 percent and 8 percent. Contrasting this with the industry WACC of about 7 percent, we can surmise that the industry has neither created nor destroyed value. It's a zero-sum game. You put in \$1 into the industry and you get back the \$1 without any further gain or loss. This doesn't seem like too attractive a deal, does it?

[Table 2](#) shows there are two different paths to creating shareholder value, which the private equity firms would be looking to pursue. One is creating value through faster growth (left). The other is generating higher ROIC. Although the given charts assume a base ROIC of 9 percent, it is possible to directionally use these for our purposes. Clearly, for an industry whose WACC is less than 9 percent, it can achieve much higher value for shareholders through higher ROIC than through growth. Hence, a strategy of growth-oriented consolidations and acquisitions are somewhat mindless instead of squeezing returns from existing capital.

Bottom Line. When private equity investors begin acquiring ports and terminals, they will focus much more heavily on increasing ROIC through any means possible. Owing to the fact that the industry WACC is so low, the size of the prize is high. Looking at [Table 2](#), it shows that if the baseline ROIC is 9 percent, you could generate an incremental 26 percent of shareholder value by increasing ROIC by just 1 percent. It would not be unimaginable that a private equity firm could acquire a port or terminal company, squeeze incrementally more return out of it over the course of a couple of years, and sell it, leaving the port with unsustainable short-term gains at the cost of longer-term and harder-to-recover-from loss, yet coming out as heroes for the shareholder.

Looking at it from a private equity perspective, the prize is worth it, at minimal risk: acquire any port or terminal where ROIC is low. Put in a crack cost-cutting team or bring in the consultants. Cut costs or marginally improve return on investment. The gains are huge. Sell it off and walk away with millions of dollars for your happy investors.

Port and terminal operators will feel the squeeze as they are acquired, manhandled and let go.

These operators would be advised to pull up their operational performance, increase their own ROIC and be less of a target for private equity. Initiatives can be designed to increase ROIC internally and executed using existing resources and projects. From an external perspective, we see immense opportunities to tweak and adjust current operations in order to rapidly increase ROIC without too much incremental investment. Much depends, however, on labor participating in these activities and collaborating with management to ward off private equity investors. Work together and internally develop a roadmap for the future.

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