Plenty of pitfalls in potential Hertz deal
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The road to the merger between Hertz and Dollar Thrifty has had many twists and turns. There are likely many more up ahead.

The markets fervently applauded the $2.3 billion merger announcement between car rental giants Hertz and Dollar Thrifty on Monday, giving both companies a healthy bump in shareholder value. But while the merger looks promising on many levels, it is hardly a done deal. Hertz still needs the approval of government regulators as well as Dollar shareholders to make it happen, two things the market shouldn't take for granted. And even if the deal goes through, it is still unclear how Hertz plans to achieve the revenue synergies needed to justify the hefty premium it will have paid.

In order to understand this deal we need to take a look back in time. The car rental business in the US has changed dramatically in the last decade. What used to be a diverse set of small companies fighting it out for market share and counter space at the local airport has become very concentrated. In the last few years National bought Alamo, Avis merged with Budget, Thrifty hooked up with Dollar (DTG) and Hertz acquired Advantage. Then in 2007, Enterprise Rent-A-Car acquired the combined National/Alamo fleet, making it the largest car rental company in the US.

By the end of the last decade the number of major car rental companies in the US had gone from about nine to just four: Hertz, Avis/Budget, Enterprise and Dollar/Thrifty. Together, the four car companies controlled 87% of the US car rental market. But the public remained mostly oblivious of the car rental oligopoly as the companies retained their old brand names, giving the illusion of choice when in fact there was very little. But despite their strong market power, rental car pricing still came under pressure during the 2008 recession. While none of the companies faced bankruptcy, profits were severely curtailed across the board as both the business and leisure traveler stayed off the road.

Seeing an opportunity to expand during the dip, Hertz decided to move in on its smaller rival, Dollar Thrifty. The rationale behind the deal was to ostensibly diversify Hertz's client base beyond its core customer: the business traveler. The story was that a combination with Dollar, whose customers were mainly leisure travelers, would allow the company to utilize its extensive fleet in a more efficient way as it could rent cars on the weekends when business travelers go home and leisure travelers take to the roads.

After a few months of negotiations, Dollar agreed to be acquired by Hertz (for the first time) in April 2010 for $41 a share or $1.2 billion. Fearing a lost opportunity, rival Avis Budget decided to make a higher, unsolicited offer for Dollar for around $1.3 billion. A bidding war between Hertz and Avis commenced, but Dollar's board seemed set on doing a deal with Hertz, even though Avis consistently outbid its rival. Dollar justified its position saying that while Avis's bid may be higher, it feared that any deal with Avis would be blocked on anti-trust grounds.

Dollar Thrifty shareholders felt they were being short-changed and that anti-trust concerns was just as much, if not more, of an issue with Hertz as it was with Avis. Shareholders ended up voting down Hertz's first offer, sending the whole process back to the drawing board. The move showed that Dollar's shareholders were a force to be reckoned with and that their support shouldn't be taken for granted. There is talk that major Dollar shareholders were consulted on the price before the latest offer was announced, but it is unclear if they were happy with the numbers. If not, they could end up derailing the merger yet again.

But even if the price is right, the deal still has to get past government regulators. Given that anti-trust was a major issue to shareholders the first time around, it was widely believed that a new deal wouldn't be announced until after the government issued its opinion. But the tedious government review process, which began all the way back in 2010, is still ongoing, raising questions as to Hertz's motives.

It is hard to see how all could be fine on the regulatory front given how big the company's footprint would be after the deal is consummated. Hertz has tried to downplay the market share argument, saying that the combined company would make up just 23% of the US car rental market, while its next biggest competitor, Enterprise, would have 36%. While that is true, it distorts the picture somewhat as it counts car rentals both on- and off-airport. It is at the airport where the big firms make most of their money as they can charge customers double the going rate off-airport. So if one strips out off-airport locations, the Hertz and Dollar deal would command around 38% of the of the rental market, which is sure to raise alarm bells in Washington.

Regulators will usually approve mergers if it leaves three or four competitors in a local market, but they start to show grave concern when it gets down to two. Given the limited competition already in the car rental market, there are several local markets where a Hertz and Dollar/Thrifty merger would lead to just such a scenario.

Nevertheless, Hertz tried to instill confidence in the deal yesterday by announcing the sale of its leisure-focused Advantage subsidiary. At the same time, the company said it is prepared to make other concessions to get the deal past regulators, but stopped short of saying what those concessions could be and how much revenue it could cost the combined company. But it should be noted that while jettisoning Advantage seems like a big concession, it really isn't.

Advantage on its own makes up less that 1% of the domestic car rental market, so its loss doesn't move the needle much. Hertz apparently sold the business for a piddling $16 million, according to Bloomberg News, which means that the business wasn't worth that much anyway.

But even if the government approves the merger, Hertz may be asked to divest some of its operations or make accommodations to level the playing field for regional car rental companies. This could get very expensive on many levels. If the government plays hardball, Hertz could be asked to make concessions that in the long run could far outweigh the $160 million in annual cost synergies that the company claims it can squeeze out of a tie-up. It would also decrease any revenue synergies that both Hertz and the market believe could be in the cards.

The question still remains as to whether or not the company could achieve meaningful revenue synergies to account for the premium Hertz just paid to absorb Dollar Thrifty. Part of that rests on the future of the car rental business. The last few years have been great, with double-digit percentage increases in revenue, but that could be coming to a swift end as the economy stalls. Dollar Thrifty reported flat revenue growth for the second quarter of this year compared with the same time last year after posting several strong quarters of growth. It actually made its numbers by slashing costs to the bone.

Also impacting future revenues is the recent dip in used car prices. Last month was the first month in three years that used car prices reported a decrease in value from the same time last year. That's important because rental car companies are a slave to the used car market as they constantly turnover cars. In fact a 1% move in used prices impacts the pretax profit of

rental car companies by 10%, according to Morgan Stanley. The decline in used car values is expected to continue through the year, which will make it that much harder for Hertz to justify this deal – that's, of course, if it ever actually gets done.

With so many unknowns it is no wonder that the deal has an extremely liberal merger agreement. Dollar reportedly has 30 days to freely entertain other bids and could walk away from the deal at any time without paying a breakup fee. This means that Hertz and Dollar Thrifty are either super confident that the deal will get done or are so unsure that they built an escape hatch. Either way, Hertz will have a lot of explaining to do in the next few months if it intends on keeping the recent pop in its stock.

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