RAYMOND JAMES

Private equity opportunities in lubricant distribution

Assessing the case for "buy and build"

Recent private equity successes have proven the viability of a "buy and build" investment thesis in the lubricant distribution space. Leveraging the momentum of a wave of consolidation in the industry, capital has been effectively deployed by financial sponsors to aggregate a number of smaller operators on a common, professionalized platform. This trend has resulted in:

- The creation of formidable industry players
- Full realization of the benefits of a strong M&A strategy
- Very attractive investment exits

In this white paper, we examine the market, its current trajectory and the significant opportunities for private equity investment.

GETTING TO KNOW THE MARKET

The sale of lubricants in the United States is a $25 billion market, and products are used to serve large, steady end markets, providing a base of stability for investment. Margins for lubricants are attractive relative to other refined petroleum products and exhibit good resiliency in uneven commodity environments. As another general industry characteristic, revenues are typically recurring in nature, especially if value-added services (e.g., technical analysis, remote tank monitoring, custom blending, etc.) are provided in any meaningful way. Taken together, these attributes indicate that leverage is more easily attainable for lubricants than for other commodity-linked businesses.

KEY TAKEAWAYS

Industry dynamics and market structure offer significant opportunity for private equity investment in the lubricant distribution space.

The sale of lubricants in the United States is a $25 billion market, and products are used to serve large, steady end markets, providing a base of stability for investment.

The sector also offers relatively attractive and stable margins, high customer retention, and, despite more recent consolidation, a highly fragmented industry.

An organizational focus on growth through acquisition backed by a strong integration capability can achieve rapid growth and an attractive exit.

Over the past decade, the number of lubricant distributors in the United States has declined by more than 50%, yet the industry remains highly fragmented. Looking forward, several outcomes seem likely:

- Consolidation will continue as the major oil companies continue their push to rationalize the number of distributors with whom they maintain relationships.
- Customers will continue the already growing trend of seeking suppliers that can serve as value-added partners, providing critical services and solutions to address their lubricant needs.
- Scale will become increasingly important.
- Opportunity for private equity to participate in the continued consolidation of the lubricant distribution space will be significant.

LARGE, STABLE END MARKETS AND STEADY, IF UNSPECTACULAR, GROWTH

As a whole, approximately 2.4 billion gallons of lubricants were sold in the U.S. in 2015. Of that total volume, slightly more than half of lubricant gallons sold were engine oils for passenger cars and heavy-duty vehicles as well as industrial engines. The process oil category, a broad grouping that captures specialty oils used as components in manufacturing processes, comprises approximately 17% of industry volume. Transmission and hydraulic fluids comprise approximately 7%. Cutting oils or metalworking fluids, which help cool and lubricate metal workpieces as they are being milled or machined, are approximately 7% of the total. Other general industrial oils and greases represent the remainder, approximately 16%.

In aggregate, the U.S. finished lubricants market is expected to grow less than 1% on a volume basis over the next several years according to industry consultants. Notwithstanding that unspectacular growth trajectory, the market is large and demand is steady.

Lubricants are sold into stable, large end markets whose volume can generally be demarcated along the following lines: consumer automotive (25%), commercial (22%) and industrial (53%).

In the first segment, passenger car motor oil (PCMO), automatic transmission fluid (ATF), gear oil and grease for passenger vehicles are sold to auto service centers, auto dealerships, fuel retailing facilities and many other retail outlets offering individually packaged motor oils. Generally, demand for passenger vehicle automotive oils is a function of the size of the U.S. passenger car fleet and the frequency of oil changes. Overall U.S. adult population growth (approximately 1%) is a good estimate for the rate of growth in operating light vehicles.

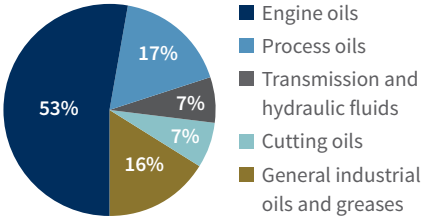
Offsetting that growth in vehicles, demand for lubricants on a volume basis is being eroded by customer preference for higher-quality products that deliver longer drain intervals. Additionally, government regulations requiring greater fuel efficiency have shifted demand up the quality scale – more efficient engines are formulated to require

BY THE NUMBERS

2.4 billion gallons sold

$25 billion in sales

TOTAL PRODUCT VOLUME



U.S. END MARKETS

INDUSTRIAL — **53%** of volume

CONSUMER AUTOMOTIVE — **25%** of volume

COMMERCIAL — **22%** of volume

Sources: 2016-2017 Lubes'n'Greases Lubricants Industry Factbook; Kline & Company; The Freedonia Group.

lower-viscosity, higher-quality lubricant products (synthetic products, in particular). As a result, distributors will benefit longer term on an absolute margin basis as projected declines in volume (slightly less than 1% per annum, according to industry consultants) will be more than offset by the shift to higher-margin products.

Lubricant products to service the nation's on-highway commercial fleet comprise the second major customer segment. Products sold into this portion of the market include heavy duty motor oil (HDMO), ATF, hydraulic oil, gear oil and grease. Similar to the consumer automotive market, the size of the U.S. commercial hauling fleet drives demand. Meanwhile, advances toward more efficient engines requiring higher-quality lubricant products will serve as a counteracting force on volume growth. At a macro level, the quantity and quality of the roads and highways across the country inherently serve as capacity constraints to the size of the total commercial fleet. Therefore, underlying growth over the long term will be linked to the political will for badly needed infrastructure investments.

Industrial lubricants include process oils, industrial/off-highway engine oil, metalworking fluids, grease and other general industrial oils. These products lubricate equipment for heavy industrial uses; consumption is likewise closely linked with general macroeconomic performance and the breadth of the nation's manufacturing capacity. Reshoring of that capacity will serve as a long-term tailwind for industrial lubricant growth in the U.S. This segment will produce the highest growth rate among the U.S. lubricant customer base.

Industrial lubricants will produce the highest growth rate among the U.S. lubricant customer base.

RELATIVELY ATTRACTIVE AND STABLE MARGINS

Lubricant margins compare very favorably across the refined petroleum products universe. Additionally, they are generally quite stable and insulated from commodity price volatility. Base oil price increases are gradual and are passed along to customers with very inelastic demand characteristics. Inelasticity is due to the prices of lubricants being a relatively low cost input, especially when compared to the cost of equipment failure.

Higher performing lubricant products have become more in-demand with greater fuel efficiency requirements. This tailwind for higher-margin products has provided considerable expansion of the overall margin pool. One industry expert recently estimated a nearly threefold expansion of the global pool over the past decade-and-a-half – this growth experienced at the same time volumes rose less than 1% per annum.

Also attractive, complementary suites of services provided to customers generate great margins (in addition to enhancing customer stickiness).

HIGH CUSTOMER RETENTION

Lubricant products help optimize the performance, longevity and reliability of equipment utilized across a panoply of end markets. Relative to the costs associated with equipment failure, consumable lubricants are low-cost, indispensable products for the applications and users that require them. As a result, lubricant distributors generally enjoy high customer retention and a regular order pattern.

Distributors have developed full suites of complementary services to cement their statuses as value-added partners to their customers. These services may include lab work, diagnostic technical analysis, equipment cleaning, fluid filtration, training and waste management. To illustrate messaging to the market, one key player has branded its comprehensive lubricant management solution as its "total fluids management" business. In addition, many operators are adept at designing complex lubrication systems as well as offering custom blending operations that produce specific formulations tailored to meet customers' particular lubrication needs.

In addition to building broad service offerings, distributors commonly loan and install lubricant tanks and equipment at customers' sites and periodically refill them as needed. Remote tank monitoring systems can be installed to trigger an auto-refill order at predetermined levels. This fairly effective razor/razorblade model increases switching costs and likewise, a customer's propensity to stick with their current distributor.

Finally, the "one stop shop" product and service provider model can establish a distributor as an indispensable partner to its customers. This is accomplished by complementing a comprehensive suite of services with an equally robust product offering spanning other consumable ancillary products. These could include: fuel, chemicals, solvents, cleaners, anti-freeze, filters, coolant, diesel exhaust fluid (DEF) and wiper blades, among other products.

A HIGHLY FRAGMENTED INDUSTRY

The lubricant industry in the U.S. is a **$25 billion** marketplace with more than 2,500 distributors generally confined to limited geographic areas. Although considerable consolidation has taken place over the past decade, the industry remains highly fragmented: the largest distributor comprises only 3% of industry volume, and the top six distributors control just approximately 10% of the market.

Four major players sit atop the industry; after which there is a significant drop-off in size. After the late 2015 acquisitions of J.A.M. Distributing Company (backed by Ridgemont Equity) and G.H. Berlin-Windward for a combined $440 million (8.8x announced forward EBITDA), Brenntag AG is the largest distributor of lubricants in the U.S. These acquisitions complemented Brenntag's existing U.S. platform Coastal Chemical, which is based in Abbeville, Louisiana, and was acquired by Brenntag in 1997. Its footprint now effectively consists of two disconnected geographic concentrations in the Texas/Gulf Coast region and New England.

PetroChoice was the largest distributor of lubricants in the U.S. prior to Brenntag's two acquisitions. It is currently held by Golden Gate Capital, which purchased the company from Greenbriar Equity Group in mid-2015. Greenbriar had purchased the company from KRG Capital Partners in early 2012. Under the ownership of its various financial sponsors, PetroChoice has completed 16 acquisitions since 2008 and has established itself as an acquirer of choice in the industry. The company's geographic coverage spans much of the Mid-Atlantic and Midwest regions as well as Florida and Texas.

Behind Brenntag and PetroChoice in size, RelaDyne is another acquisitive, private-equity backed distributor with aggressive growth aspirations leading the industry's consolidation wave. RelaDyne was acquired by Audax Private Equity in July of 2016 from AEA Investors, another private equity group that found success through a "buy and build" strategy. The company was originally formed by combining four distributors in Ohio, Illinois, Texas and Louisiana and immediately focused on realizing the benefits of scale and cross-selling opportunities across that combined footprint. It covers a geographic area spanning from Texas north and east through several Southeastern and Midwestern states.

Pilot Thomas Logistics was formed through a merger of Pilot Flying J and Thomas Petroleum in 2014 and includes the combined 10-million-gallon operation of Western Petroleum and Maxum Petroleum (both acquired by Pilot Flying J in 2012). Prior to the acquisition of Maxum, Waud Capital facilitated the acquisition and integration of

THE U.S. LUBRICANT INDUSTRY: AN OPPORTUNITY

$25 billion in sales

2,500 distributors*

3% of industry volume comprised by largest distributor

10% of the market controlled by top six distributors

Sources: 2016-2017 Lubes'n'Greases Lubricants Industry Factbook; Kline & Company; The Freedonia Group.

*The figure for number of U.S. distributors is a ballpark estimate from industry sources.

19 commercial fuel and lubricant distributors over a nine-year period. Pilot Thomas' geographic reach spans the western half of the U.S. and includes a non-contiguous Mid-Atlantic regional focus. It provides fuel, lubricants and chemicals to the energy, marine, mining and industrial markets.

Outside of the top four, no other distributor meaningfully approaches the same scale and U.S. market share. In this context however, another noteworthy private equity "buy and build" investment was Western Marketing, based in Abilene, Texas, which was held by Wingate Partners until its recent acquisition by RelaDyne in April 2017.

Notably, the vast majority of the industry is represented by "mom and pop" operators, which are increasingly losing their ability to effectively compete with distributors offering comprehensive suites of products and services. Compounding the challenge as discussed below, the major oil companies are seeking to rationalize the number of distributors with whom they maintain relationships, conferring supply advantages disproportionately upon larger players. In turn, the scale disadvantage leaves smaller operations under intense pressure to keep up with customer demands.

DECLINING NUMBER OF U.S. LUBRICANT DISTRIBUTORS

Industry consolidation has been driven primarily by two notable factors: customers' increasing demand for value-added lubrication services and the drive from top national suppliers to concentrate distribution among a set of fewer, more mature partners. Scale players in the market provide robust arrays of services to manage the day-to-day lubrication requirements of customers' onsite installed equipment. These services include inspections, audits, training, maintenance, and technical analysis of lubrication performance and requirements.

Smaller distributors are finding it increasingly difficult to compete with "one stop shop" service providers. In addition, product quality specifications from the major base oil suppliers outline stringent storage and handling procedures for lubricants. These requirements are increasingly more difficult to meet by smaller operations.

National lubricant suppliers are seeking relationships with fewer, larger and more professionalized distribution platforms. In many cases, major oil companies are arranging tie-ups and even withdrawing supply relationships to facilitate consolidation. As a result, the number of U.S. distributors has shrunk from approximately 7,000 operators in 2007 to 2,500 currently and will continue to diminish for the foreseeable future. Larger, regional players have taken advantage of current dynamics to aggregate a significant number of closely held family businesses; those with established platforms of scale with well-developed integration capabilities are well-positioned to lead consolidation efforts going forward.

CONSIDERABLE BENEFITS OF M&A

Developing an organizational focus on growth through acquisition and supporting it with a strong integration capability can produce the benefits of rapid growth as well as significant cost savings and operational synergies. Generally, minimal incremental

A SHRINKING PLAYING FIELD

7,000 operators in 2007

2,500 operators in 2017*

*The figure for number of U.S. distributors is a ballpark estimate from industry sources.

overhead is required to support the operations of an acquired distributor. As the platform expands, economies of scale through purchasing, route density, operational leverage and the elimination of working capital provide upside to the acquired cash flow stream. Pro forma acquisition multiples after the full effect of savings and synergies can be quite attractive.

Beyond the near-term benefits of combining with another distributor, cross-selling additional products into the acquired customer base and new, acquired products and services to legacy customers can drive additional upside. Retaining selling shareholders in critical roles and ultimately cross-pollinating the rest of the business with their experience and knowledge has proven to be another fruitful tactic.

PRIVATE EQUITY PLAYBOOK

The U.S. lubricant distribution industry exhibits structural elements conducive to the continued success of private equity in the space. Recent examples have proven the viability of "buy and build" strategies. More specifically, success appears to be driven by the ability of a sponsor to professionalize the business, create a scalable acquisition integration platform, and ultimately drive the consolidation of smaller distributors. As a concrete example, below is a summary of the private equity-led progression of a portfolio company during the course of a recent, notable investment.

INSIDE THE INVESTMENT

A step-by-step look at a recent private equity-led success

STEP 1 ▸ Installed executive leadership team

STEP 2 ▸ Professionalized organization, including a complete standardization of the sales and marketing function

STEP 3 ▸ Implemented fully integrated ERP system early into holding period

STEP 4 ▸ Built complementary service offerings and capabilities through acquisition

STEP 5 ▸ Established a disciplined, but aggressive business development team to proactively identify tuck-in acquisition opportunities

STEP 6 ▸ Completed nearly 20 add-on acquisitions during holding period, extending geographic reach and product offerings; in each case, cross-selling opportunities were identified and newly acquired expertise and/or capabilities were disseminated across footprint

STEP 7 ▸ Offered continued roles within organization for principals of acquired businesses to retain relationships, experience and institutional knowledge

STEP 8 ▸ Developed pioneering technology initiatives, including robust online ordering and inventory management system

The end result of the initiatives outlined above was a nearly sixfold expansion of EBITDA and ascension to position as one of the most significant lubricant distributors in the country. The company's growth trajectory and the steps taken to build a professionalized, integration platform drove considerable interest in the business during the sale process. The sponsor was able to achieve a very successful outcome for the investment.

To learn more about this investment opportunity, contact:

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