Market Report

What's Driving Mergers and Acquisitions in Lubricants?

By Ben Scharff

Like many specialty chemicals industries, lubricants manufacturing and distribution is characterized by a handful of large, global companies that account for the lion's share of the market, followed by a substantial number of smaller niche players that serve specialized markets or geographies. Our experience as investment bankers working almost exclusively in the chemical markets is that such industry structures represent fertile ground for mergers and acquisitions (M&A). It's not just larger companies buying up smaller ones — smaller companies are joining together in order to remain competitive in today's market.

In the past few years, we have seen a fair number of acquisitions in lubricants, and the pace of M&A in the industry seems to have picked up over the last two years. By our informal count, for 2017, 13 deals have been announced year-to-date through May, which is on pace to equal or exceed the 28 transactions in 2016. By contrast, we counted 16 deals in 2015. The reasons for the increased activity, we believe, have to do with economies of scale and pressures to maintain growing sales and profits. Increased scale gives lubricant formulators more leverage throughout the value chain — dealing with base oil suppliers, additive manufacturers and their channels to market. Simply put, in an increasingly challenging market environment, larger companies are able to achieve sourcing, operating and sales efficiencies that give them significant advantages over smaller rivals.

Lubricant manufacturers and distributors face pressures from both the supply and the demand sides. From the supply side, it's hardly a secret that volatility in the prices of crude oil and feedstocks is a reality that might be here to stay. On the demand side, continuing weakness in manufacturing and capital spending, not just in the U.S. but also globally, means that suppliers of lubricants and process fluids face an uphill struggle if they want to grow their business.

Having the advantages of large scale can help mitigate the uncertainties on both sides of the supply/demand equation. Larger firms can more easily absorb the shocks of changes in the price of crude oil. When prices rise, a large company has a greater ability to pass the increased cost of production to customers, and if it is a leader in the market, it often is the first to raise prices, in effect setting a price level that smaller competitors follow. Scale also has the advantage of spreading fixed costs over a larger base. For example, an argument can be made that the cost of complying with increasingly burdensome safety and environmental regulations falls disproportionately on smaller companies. Larger firms can more easily absorb these costs and might even have dedicated compliance departments to handle regulatory matters. Rarely will a small or midsize manufacturer have these resources, and the costs of compliance might make an outsized dent in its bottom line.

Even though the technology for lubricants keeps evolving, manufacturers and distributors operate in mature markets, most of which are growing slowly and face uncertain futures. But this doesn't mean they escape the same pressure to grow that affects all companies in a market economy. Because of this, producers and distributors are increasing acquisitions as an instant way to achieve growth and realize economies of scale.

Quaker Chemical, a market leader in supplying specialty lubricants and process fluids to the steel, metalworking and coatings industries, is a notable example. Quaker has a history of successful acquisitions, and management and the board consider acquisitions to be an integral part of the company's growth strategy. Most recently, Quaker announced that it will acquire Houghton International for about $1.4 billion, with the deal expected to close in the fourth quarter of 2017. The acquisition will double Quaker's sales and earnings, with the combined companies generating about $1.5 billion in revenue and $227 million in adjusted earnings before interest, taxes, depreciation and amortization (EBITDA), based on 2016 data.

The companies are similar in many respects, with complementary products and services, overlapping geographies and compatible corporate cultures. Because of this strong strategic fit and Quaker's strong balance sheet, Quaker

expects the transaction to be immediately accretive to earnings in the first year. Moreover, Quaker's management believes that within three years, the combined companies will realize an additional $45 million in incremental EBITDA, achieved mainly through economies of scale that include cross-selling opportunities, optimization of manufacturing and freight/warehouse operations, raw material purchasing benefits and workforce integration, among other measures.

Another approach to gaining scale through acquisitions is occurring in the distribution sector. "Bolt-on" transactions, in which a larger parent buys a smaller company with a strong strategic fit, are becoming common, with a number of active acquirers in the lubricants industry, including Fuchs Petrolube, Quaker, PetroChoice, Brenntag and RelaDyne. Bolt-on deals work because the target company gains access to the parent's management and financial resources, and the parent gains the target's loyal customers and the operating leverage that allows it to spread fixed costs across a larger customer base.

A prominent example of a company actively engaged in bolt-on acquisitions that are rolled up into a larger enterprise is RelaDyne. A value-added distributor of specialty lubricants, fuels, diesel exhaust fluids and industrial reliability services, RelaDyne is a relatively new company. It was formed in 2010 from the merger of four well-established lubricants companies. Initially backed by the private equity fund AEA Investors, RelaDyne is now majority owned by Audax Private Equity, which has continued to back an aggressive acquisition program with the goal of building a national distribution business focused on excellent customer service and ensuring the reliability of customers' equipment. RelaDyne has made 14 acquisitions in the lubricants and fuels market since 2011, and in June announced No. 15 — the acquisition of Western Marketing. Although most of these transactions have been relatively small, each transaction has strategically expanded the company's geographic reach, with an emphasis on a central corridor running from the Gulf Coast to the Upper Midwest, a heavily industrialized area that constitutes about 50 percent of the U.S. lubricants market. The company is also expanding into Western states and has established a particularly strong presence in Utah.

Looking ahead, we expect a continued, robust environment for M&A in lubricants. The roll-back of industry regulations and the implementation of large-scale infrastructure and re-industrialization plans by the Trump administration could enhance the prospects for lubricants companies, and by extension, the value of companies that are brought to market. Interest rates are relatively low and corporate balance sheets are relatively flush with cash. An index of the values of publicly traded chemicals companies tracked by Grace Matthews recently hit a record high. All this is good news if you're an owner of a private lubricant company and are considering selling your business, particularly if you have attracted the attention of one of the large strategic buyers.

Scharff *is managing director at Grace Matthews and has over 20 years of chemical investment banking experience. He is recognized as a leader in the industry and has been quoted in various publications, including* CoatingsTech, Middle Market Growth *and* IHS Chemical Week. *Scharff received a bachelor's degree in economics from the University of Wisconsin-Madison. He is a member of the Wisconsin Chapter of the Association for Corporate Growth and previously served in the U.S. Marine Corps.*