INDUSTRY RUNDOWN

Market Report

M&A Markets Cut Through the Noise

Mergers and acquisitions markets are showing continued strength

By Ben Scharff

As we navigate into the back half of 2018, a question we often hear is "Where are the mergers and acquisitions (M&A) markets going?" Despite the profit and loss noise created by the seemingly endless barrage of price increases being placed on formulators, 2018 is proving to be another strong year for sellers in the lubricants market. The equity markets have started to stabilize after six to eight weeks of volatility, debt remains readily available, the benefits of recent tax reforms are being felt and demand indicators for most chemical end markets tend to remain positive.

Looking at numbers alone, we expect to see an increase in completed lubricants transactions in 2018. Both 2016 and 2017 saw roughly the same number of announced lubricants deals — in the high 20s — based on middle-market investment bank Grace Matthews' estimates. At the time of this writing, 2018 is moving at a similar pace, but there is an overhang as a significant number of companies are currently out-to-market. This is creating a ripple effect of attention being placed on the lubricants sector from industry and financial buyers — both with a lot of capital to put to work. We believe that this will push annual transaction totals up into the low to mid-30s, likely a 10 percent to 15 percent increase in deal activity over prior years.

ILMA members have certainly been busy and are part of the storyline here, most notably in the recent acquisition of the majority of the operating assets of Royal Manufacturing Co. by AXEL Christiernsson. This transaction not only extends product offerings for AXEL, but also allows it to leverage the strong reputation and heritage of Royal while developing a much more substantive footprint in North America.

Another interesting transaction included Italmatch Chemicals' acquisition of Afton Chemical Co.'s metalworking fluids business. This came on the heels of the announcement from France-based private equity firm Ardian that it would be pursuing a process to divest the Italy-based portfolio company. The metalworking fluids acquisition expands the technology base for Italmatch in industrial lubricants, and it allows the firm to model in projected synergies as it looks to sell the collective businesses. This creates a value arbitrage for Italmatch by showing increased profitability from the acquired business and then selling it (along with all of Italmatch) at a higher multiple — leveraging the size and scale of the overall organization.

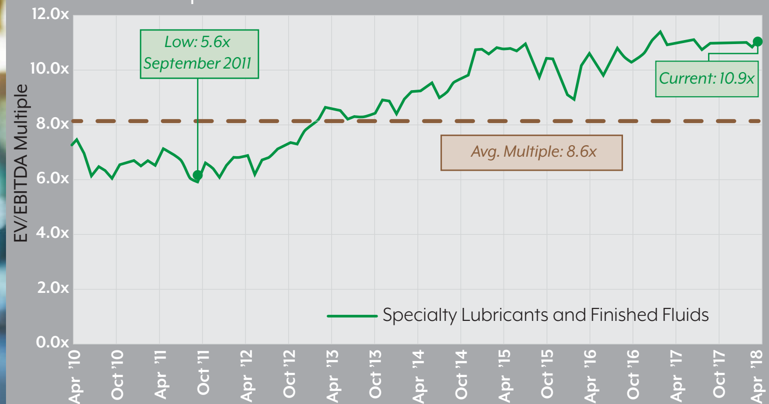
ACCRETION, ACCRETION, ACCRETION

Similar to Italmatch's arbitrage rationale for the Afton metalworking fluids acquisition, we see that publicly traded lubricants companies are benefiting from the significant spread over historical trading norms in making accretive acquisitions. Based on Grace Matthews' lubricants and finished fluids index, we see that select public companies in the lubricants space are trading at 10.9 times EBITDA (earnings before interest, tax, depreciation and amortization) as of the end of April — over two times higher than the average of 8.6 times EBITDA since the start of 2010. This allows publicly traded companies to pay more for an acquisition and still have that acquisition be accretive to its earnings. This is an important litmus test for any acquiring entity.

DEALING WITH MARGIN COMPRESSION

With across-the-board round two price increases (generally between 4 percent and 10 percent) being implemented by base oil suppliers and additive manufacturers, many formulators are coming up with strategies revolving around when and how they can push their own price increases through to their end customers. Companies with a strong market presence and high-service, value-add offerings tend to be able to push price increases through faster and more fully than competitors providing more commodity-like, me-too products. Reciprocally, should we see a reversal in the pricing trends of feedstock costs and a resultant drop in raw material costs, we will see companies with this pricing power being able to maintain pricing at current levels for a longer duration of time and thereby grab additional margin going forward.

POTENTIAL STRATEGIC BUYERS



In the M&A process, this becomes apparent and part of the "story" around the normalized current and future earnings of the selling entity. Companies that can show a clear path to regaining contribution margin (selling price minus raw material cost) after such raw material cost increases are often deemed to have a specialty niche and/or be critical partners to their end customers. These businesses tend to trade at higher multiples, and they are often viewed as more focused on selling solutions versus products.

This is not meant to be critical of suppliers of commodity products, as they serve a key function in the lubricants value chain. This is simply a reflection of how buyers generally place a higher valuation multiple on "specialty" companies versus "commodity" companies.

INCREASING COMPETITION FROM FINANCIAL BUYERS

It will take no one by surprise to hear that financial buyers (namely private equity) have become an increasingly dominant player in lubricants M&A over the past few years. Having already mentioned Ardian and its investment in Italmatch, there are three other major private equity players currently engaged in aggressive roll-ups in this space: Audax Group, Golden Gate Capital and The Jordan Co. Audax acquired RelaDyne in mid-2016, Golden Gate Capital acquired PetroChoice in late 2015 and The Jordan Co. acquired DuBois in early 2017. Collectively, these three firms have made approximately 16 add-on acquisitions since their original platform acquisitions were made.

Of the three above, the first part of 2018 has been largely dominated by Audax and RelaDyne, completing three acquisitions in the first four months of the year, including Conservancy Oil Group, T.A. Roberts Oil Co. and A&W Oil Co. This is a continuation of RelaDyne's stated strategy of aggressively pursuing geographic expansion through a roll-up of targeted and complementary businesses.

Creating further potential competition going forward, many other firms have expressed a very strong interest in developing new platforms in the lubricants space. Given private equity's appetite in the lubricants market, strategic buyers are going to have to show a willingness to move fast, be flexible and pay a full value to be successful in growing by acquisition.

In conclusion, while market volatility has served as a wake-up call for many private business owners, there really isn't a compelling reason for immediate concern. The pieces remain in place for a robust M&A market, with cash-rich buyers chasing too few deals — keeping values at a significant premium relative to historical norms. How long this will last is always uncertain; however, we anticipate this to continue through the balance of 2018. The next relevant data point might come from the shakeout of the United States' midterm elections later this year and the reading of the tea leaves on how it could impact the industry and markets going forward. Status quo would likely be a good thing for deal activity in the lubricants market. Regardless, the lubricants industry will remain highly fragmented, and opportunities will continue to exist for consolidators to play a dominant role in shaping this market going forward.

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