M&A State of Play

Activity has been on the rise for years, but it takes a thorough strategy to determine if acquiring – or being acquired – is right for your business

By Rich Keener

Mergers and acquisitions have long been a part of a business strategy that seeks to increase an organization's chances of financial success and minimize its financial risk.

While hard numbers are hard to come by, most players in the lubricant manufacturing arena recognize that there has been an increase in M&A in the industry. Statistics tracking a broad index of publicly traded chemicals and materials companies seem to support the notion that M&A has been on the rise over the past 10 years.

Industry experts say the lubricants and metalworking fluids market has been witnessing a high level of interest and deal activity for a number of years, and considerable consolidation in distribution has already occurred.

Benjamin Scharff, managing director at Grace Matthews, an industry M&A consultant that has assisted with multiple acquisitions, said industry participants frequently contact Grace Matthews expressing a strong interest to grow via acquisition. Large, publicly traded industry players have healthy balance sheets and face continued pressure to grow.

One cause of this increase in M&A activity is that valuations in the industry remain at historically high levels, Scharff said. This is somewhat buoyed by the trillions of dollars of governmental liquidity that has been added to the market through pandemic relief efforts. "Clearly, values remain high in the market," he said. "Margins have rebounded for most industry participants. I think many companies within lubricants and metalworking fluids, and a lot of the raw material providers, got beat up a bit in 2019 and 2020 from a pricing perspective.

"And now, although they're battling supply issues, margin and profitability issues have largely abated," he added. "So the market is receptive in terms of values being high and companies performing well, and significant amounts of capital are out there chasing deals."

Advanced Lubrication Specialties purchased the renowned American Oil & Supply International at the beginning of 2021. Greg Julian, president at Advanced Lubrication Specialties, said there is another reason for the tremendous consolidation.

"Generally speaking, you don't like your customers to get bigger than you, because then they end up dictating to you what needs to happen as opposed to you controlling your own destiny," Julian said. "In addition, as a company gets bigger, it looks for better economics to support its growing business. So, there's a natural inclination to look for growth through acquisitions."

Generational changes play into the M&A activity, as well. When major oil companies downsized in the late 1970s and 1980s, many of the skilled employees let go by those companies went on to start privately held, independent lubricant manufacturers.

Julian said that while many of these founders have second-generation family in the business, some do not, and those who do not are exiting the business without anyone to take over.

Matthew Lowe is vice president of sales at PLZ Aeroscience Corp., which purchased specialty lubricants manufacturer Champion Brands in July 2021.

Lowe echoed Julian's comments. "Private equity firms are looking for family-owned businesses that are interested in taking advantage of the current market dynamics as opposed to transitioning to the next generation," he said.

Lowe suggested that the increased number of M&A reveals that when it comes to independent lubricant manufacturers, the term "independent" may be a bit of a misnomer. "It seems as though the truly independent lubricant manufacturing companies are few and far between," he said. "Moreover, you just do not see people starting new lubricant packaging companies. It is certainly not unique to this industry, but it is notable nonetheless."

Why Consider M&A?

Some of the initial questions in any acquisition process are around supply chain management, sourcing and raw material availability. Companies throughout the industry are facing shortages and allocations, which make it challenging to service end customers. Acquisitions help develop multiple sources of supply for key raw material inputs, and there has been an increase in requests for maintaining contractual minimums with key suppliers.

Other factors contributing to uncertainty and leading companies to consider acquisitions include ongoing pandemic concerns, a tightening regulatory environment and potential changes in the tax environment. "The COVID-19 pandemic has put tremendous stress on the industry and on many companies," Julian said. "And I think it has made a lot of people ask, 'Why am I doing this? It's not worth it.'"

With so much M&A activity in the industry, one has to ask: What are the specific benefits of M&A for independent manufacturers?

According to Scharff, M&A advantages center around the benefits of scale, both tangible and intangible. Tangible benefits are numerous, and they include leveraging raw material purchasing, administrative savings, production synergies, supply chain efficiencies, ability to diversify operations, currency risk mitigation, extending geographies, increased technical capabilities and lower cost of capital.

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Intangible benefits include leveraging brand strength, managing uncertainty in an uncertain time and providing opportunities for employees to grow within a larger organization.

Geographic representation can be both a benefit and a drawback of consolidation. Increased representation across geographical regions is often a benefit. "If you're a strong regional player, and you're competing with someone who may be in multiple

regions and you're going after opportunities in multiple regions, you tend to be at a disadvantage," Julian said.

At the same time, he said, a potential drawback of M&A activity is that companies may lose much of their regional identity. "What I mean by 'regional identity' is that certain regions in the country may have certain products that are unique to them," Julian said. "Typically, when a company goes through a consolidation and looks at a reduction in portfolio, they may determine that certain types of products or customers are no longer of interest to them. So that specialty component gets lost."

While consolidation drives efficiencies, it also reduces options and competition. Both customers and suppliers are left at a potential disadvantage, negotiating with a smaller group with greater pricing influence. Eventually, certain segments of the industry can no longer be supported, or companies face difficulties finding people to manufacture those products.

Scharff said that another factor is the evolving environmental, social and governance (ESG) standards that continue to drive interest and focus in M&A processes. Companies continue to develop and define ESG goals and objectives and strive to achieve them internally and through inorganic growth, through acquisitions. "The regulatory environment has created systemic headwinds against smaller businesses, causing them to seek out the benefits of scale," he said.

In response, companies are developing investment theses around ESG, and those that can articulate a strong ESG strategy are commanding significant interest in the market.

What About Risk?

In all the acquisitions and mergers, there is risk for all the players involved. So, why do some transactions succeed while others fail?

According to Scharff, rarely does a transaction fail based on valuation. In many cases, it is dependent on the buying organization having a clear strategy and being mindful about integration — not acquiring to simply build scale, but to enhance manufacturing capabilities, geographical presence and technical resources, and to build out its management team. "Some buyers put significant time and effort in getting to the finish line of a transaction and very little thought or energy in assimilating culture and integrating operations," he said. "These companies tend to integrate too quickly and lose some of the value of what was acquired.

"Companies that are successful tend to be slow, thoughtful and methodical in the process of integration — leveraging the best practices, people and capabilities of both organizations once they've had the opportunity to fully assess what they own," he added.

Julian agrees that merging different cultures presents perhaps the greatest challenge to a successful acquisition. "What you'll find is the people that ran the business when you acquired them slowly go away because they don't like the new culture, and they don't like the new processes," he said.

Similarly, Lowe said the success or failure of acquisitions all depends on

the focus and attitude of the larger organization. "In our case, PLZ is very focused on maintaining the integrity and fidelity of our brand and our processes," he said. "At the same time, we have an incredible amount of experience to offer. There is no doubt in my mind about the benefits of the PLZ approach."

What's the Big Picture?

With the right methods and attitude, and with cooperation among the players, individual companies can find success in consolidations. But what about the larger picture? Might consolidation help the industry overall grow?

While the answer to this question is unclear, it often lies in leveraging technical, sales, and regulatory and compliance resources, according to Scharff. "M&A has proven to be a successful strategy for taking the technology developed by smaller organizations and leveraging it across the broader channels to the market of larger acquiring companies," he said.

While Julian is not so sure M&A is a vehicle for overall industry growth, he thinks it will help the industry remain viable.

If consolidation in the industry leads to viability, there should be optimism for everyone that the industry will remain viable for some time to come.

Scharff mentioned chatter in the second quarter of 2021 about meaningful tax changes for 2022 that could have pushed capital gains tax rates to ordinary income rates. For many sellers, that would mean federal and state ordinary income rates of approximately 50%, or double what many are paying on transactions today. Such talk clearly led to an increase in private owners going to market in 2021 to try to avoid the tax uncertainty going forward.

And as of late 2021, there was roughly $1.5 trillion of "dry powder" (money raised by private equity funds that is yet to be deployed) in the market. With this money accounting for roughly 50% of the purchase price in most deals (the other half funded through bank borrowing), this equates to about $3 trillion of available capital to fund new transactions.

"That is an incredible amount of money out there chasing deals, and companies are getting super aggressive trying to differentiate themselves and make those deals happen," Scharff said. "In addition, large players are more apt to take a portfolio approach in managing their business: purchasing to optimize their portfolio,

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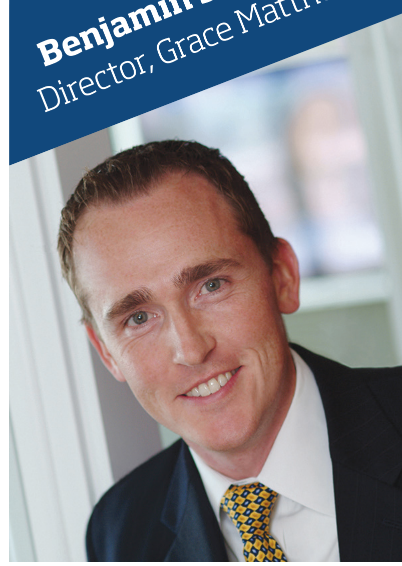

divesting noncore assets and redeploying those proceeds elsewhere in their operations.

With this kind of activity in the market, expect the amount of M&A activity to remain vigorous throughout 2022 and beyond.

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