JEFF KRAMER *MANAGING DIRECTOR* / 303.619.0611 / jeff.kramer@nrc.com

The Impact of Market Shifts on Fuel and C-Store Mergers & Acquisitions *September 25, 2024*

Here is the entire three part presentation on Mergers and Acquisitions I gave at the NASM meeting of Shell distributors on September 12 in Houston. Many thanks for assistance and support to Faheem Jamal of Chestnut Markets; Natasha Pitcock, Executive Director of NASM; and Malachi Bennett of Shell Oil.

The presentation consisted of three sections; the first being on the Economy and Interest Rates, the second on Industry Trends, and finally Mergers & Acquisitions which is actually mixed in all sections.

Follow along with the accompanying reference slides.

Please feel free to stop by NRC's booth N-2462 at the upcoming NACS Show 2024 in Las Vegas, or call or email me to meet at the Show's Hunter Club or elsewhere for an appointment. I arrive on Sunday, October 5.

PART 1

Today's section on the economy and interest rates is shown on pages 5-13. When asked whether the audience felt like we were in a recession or not, every attendee thought we are not. With Q3 2024 almost completed, most forecasts are currently in the +2.5 to 3.0% real GDP range, which is a very good rate of growth for the U.S. in the 21st century.

The chart on page 7 simply shows the short term Federal Funds rate, 5.25% earlier this month and since reduced .5% to 4.75%, minus the standard Consumer Price Inflation rate, or CPI, which has been steadily decreasing for some time. The CPI is currently being helped by gasoline prices declining to under $3.00/gallon in many parts of the U.S. The gray vertices show recessionary periods, which are often preceded by declines of varying time frames by many months in the index, so called periods of 'pain' until inflation is more under control. The chart also shows how far behind the Fed was in raising rates during Covid, adding confusion whether we are headed for a 'soft landing' or not. Many countries of the world follow our lead in monetary policy. In fact, just this week, China announced a huge monetary easing to try to stop their deflation, which is often much more difficult to reverse. Our economy is five times the size of China's, and we'll see how long it takes to impact their economy and others. China uses large amounts of raw materials including hydrocarbons, metals and grains, so we'll watch those price trends next year.

We still have our own issues as shown on page 8 reflecting the dramatic increase in the size of our Federal debt, now over $34 Trillion and growing almost $2 Trillion per year. Our interest payments as a percentage of our economy is now one of the largest in the world (page 9), and actually are greater than our entire defense budget. Can capital spending for data centers to support Artificial Intelligence (AI), on shoring, infrastructure, new fuels, etc., allow us to grow our way out of these deficits while also helping inflation? We continue having the strongest economy by far.

- Near term, looking at the charts on pages 10 and 11 give us some clues of where we are in the U.S. business cycle.
- The chart on page 10 shows the so called Treasury Bond Yield Curve, which is simply the difference between the 10 Year Treasury Bond yield minus the 2 Year Treasury Bond yield. It is a key indicator that reflects tightening monetary policy when declining and easing policy when rising as determined mostly by open market transactions. Rising above the zero line reflects fast monetary easing when the Fed realizes they may be creating a recession, so it says it's time to ease quickly, although at times too late or not enough as shown by the vertical recession lines. It is currently at +.2% and rising.
- Unemployment is what the Fed says is their focus at the moment.
- Chairman Powell has noted that one inflation spurt frequently precedes a second one, but promises of AI benefits are keeping markets hopeful.
- Watch the U.S. Dollar for economic clues. The U.S. maintains an AAA rating in spite of having its very high ratio of debt to GDP. We need a strong Dollar to support foreign purchases of real estate, stocks and especially bills and bonds to help fund our deficits.
- Page 11 shows the trend of the 10 Year Treasury Bond Yields, still historically quite low. Many countries want an alternate currency to the Dollar, most obvious being the BRICS group of Brazil, Russia, India, China and South Africa.

I then asked Faheem if he thought whether the higher cost of debt and always present industry headwinds were affecting industry construction spending and M&A. It is certainly some, partly as well because our industry is facing more price competition making it more difficult to pass through cost increases. These uncertainties have certainly been a factor increasing the M&A earnings multiple spreads between sellers waiting for higher multiples and buyers more cautiously bidding. Normally, the extent of expected Federal Reserve easing narrows these spreads and increasing M&A transactions are expected in our space.

In addition, we discussed the non-bank private debt and equity markets now said to be as much as $20 Trillion worldwide, which of course also includes cryptocurrencies. Fortunately, our industry has been looked at quite favorably by Wall Street and the standard banking system because of often prime real estate ownership and the flexibility to add profit centers like foodservice, financial services, gaming, etc., such that it appears the non-bank alternative financing market has not been used much, so far.

PART 2

Today's section is titled Gas/C-Store/Foodservice (?) Industry. Page 14 mentions several key points, perhaps the main one being that convenience remains a key consumer priority in any economic environment as we rarely have enough time to accomplish everything in today's busy world. So many c-store sales are for immediate consumption, and we often purchase with our eyes and/or smell. Being deemed an essential industry during Covid introduced new customers to our stores, and increased average sales per transaction. Post Covid is seeing more competition often at the pump depending on location, plus the geographic spread of more c-store 'disruptor' brands whose main focus is Foodservice as a draw. And now rapid delivery and competitive prices from giants like Amazon and Wal Mart are formidable for stretched consumers, especially on the lower end of the income scale, often our main customer base.

FUEL

Fuel remains a key profit center, and often an important draw for inside store sales. And the nature of petroleum fuel keeps evolving, as reflected from increasing ethanol blending, biodiesel, renewable diesel fuel, electric chargers, etc. Most of these new fuels use less petroleum to manufacture, so combined with better fuel economy standards and changing work styles like work from home, crude oil demand is down considerably. At the same time, crude oil supply keeps decreasing due to technology improvements like fracking and the extension of crude oil reservoir lives. The crude oil chart on page 16 reflects the overall decline in crude prices, the main component of gasoline costs. The U.S. has been the clear leader in adding to supply, as we now produce 13.3 million barrels per day, far exceeding former leaders Russia and Saudi Arabia, likely both producing less than 10 million barrels per day.

Credit to NACS' State of the Industry (SOI) data starting on page 17. First, gasoline usage in the U.S. shown on page 18 remains well below 2019 pre Covid levels. So far in 2024, gasoline actual fuel usage tracker OPIS indicates that demand is down another 4-5% below 2023 levels. Fortunately, page 19 shows retail motor fuel pool margins continue at record breaking levels, and holding fairly well this year. The net result on page 20 is total fuel gross profit remains at or near record levels despite less volume.

An interesting comparison of retail regular gasoline margin in random cities on page 22, courtesy of OPIS, reflects some incredible differences. There are many variables, but it is interesting that many of the areas with low margins have M&A activity often as strong as high margin areas, and just as frequently have selling price cash flow multiples just as strong as well. Real estate values are critical too, but the comparisons show that M&A markets work for both buyers and sellers.

INSIDE STORE

Page 23 clearly shows the growing importance of inside store sales this past decade, even without including foodservice. Granted, unit growth has slowed recently, but the relative stability of the category and the ability to add new products and profit centers is a huge advantage compared to many other box store retailers. Will the trend towards healthier eating affect sales? It will certainly to some extent, but if healthier products can continue to improve with public preferences, convenience may pick up the slack.

Foodservice is clearly the most recent game changer, much as was the transition from fuels sales to c-stores. Old mainstays such as fountain and coffee have evolved into sandwiches, fresh salads, etc., often rivaling QSR quick serve restaurants and even other fast serve sit down restaurants. The other complimentary items a c-store offers, frequently with brand freedom of choice or even less expensive private label, gives the industry a huge competitive advantage for sales. It is very difficult to achieve scale with foodservice due to waste and labor costs (hence my ?), but fortunately many companies have successfully paired up with national or local QSR or quick serve restaurants to enhance their return on investment. Clearly, the biggest 'disruptors' in the business today are those with great sites and great foodservice as a draw. Studies show that companies like Buc-ees are a destination purchase as far as 50 miles away.

Regarding M&A, it is interesting that many of the disruptor companies use build-to-suit financing and often sale-leasebacks to enhance their rates of return and use remaining cash flows to build more sites, very similar to the most common financings for QSR's and other restaurant chains. This is quite different from value creation in the gasoline/c-store industry, as historically much of the capital appreciation when the business has been sold has come from real estate appreciation, pretty much forgone through leasing.

OVERALL PROFITABILTY

Despite constant headwinds like all businesses today, the chart on page 25 which depicts the total of all profit centers after direct store expenses, clearly shows that our industry has shown tremendous profitability over the last decade. We're back to the basics of marketing post Covid, and with the opportunities provided through Artificial Intelligence (AI); perhaps most noticeably for product selection and profitability, and also perhaps for labor saving automation on site and in the so called back room.

We all know petroleum fueling will not be ending soon. I have always said 'ya gotta fuel and ya gotta eat'. Finally, arguably there are important reasons why petroleum has lasted so long. It is arguably one of our most 'convenient' products of all, since there remain a number of dinosaurs left as petroleum to find, it is easy to transport, refined at a reasonable cost into chemicals, transportation fuels, etc., and it's easy to store for retailers and other users to supply on fast notice. And a very inexpensive price compared to houses, cars, travel, entertainment, and more.

PART 3

All things being equal, the current situation overall is supportive for a strong year ahead of M&A activity. In particular, the Fed is forecasting continuing monetary easing supported primarily by easing of inflation pressures for now. Labor remains tight in the U.S., but fortunately for our industry, employee retention rates have improved as fewer new job openings are available in the overall marketplace. No doubt this upcoming election is helping markets and our still strong economy for now. Most all countries are easing at least monetary policies, and the strong U.S. economy has led this trend and is needed to support sizable deficit spending that will have to be dealt with next year, likely at least partially through higher taxes somehow.

Our industry is feeling its own pressure now from increased competition at the consumer level, both for fuel and inside store sales, so there will be regional tests of pricing power. A new pressure could be the current trend towards healthy eating and weight loss, recently gaining momentum helped by pharmaceutical industry technology. Thus, more scrutiny of sales trends by buyers is likely since M&A selling prices are based on cash flows times a market multiple. Market multiples are set by interest rates and the partly by the psychological effect of expected growth rates in sales and earnings.

Yet, consumer demand for convenience is strong, which should continue to support good ROI's for rebuild activity at good sites, NTI activity, and M&A in general. NRC has generally looked at purchase multiples this year between 6.5-9.5X for owned retail stores and chains, a very wide range. Monetary easing and generally stable economic conditions have firmed and tightened multiples to a range of 7.5-10.0X for owned retail stores and chains. For a combination of reasons, larger size packages of good stores with adequate parking are selling at premium multiples sometimes exceeding a 10X multiple, especially for companies wanting to grow quickly, as it takes a very long time to permit and construct a large number of NTI sites.

This post Covid transition is expected to bring more M&A sellers to the market based on changes in these trends and management transitions. Even in strong markets, there is no guarantee they will remain as strong. For example, improved fuel mileage and eventually more hybrids and electric vehicles are coming. The leverage up or down from both earnings and the selling multiple is significant.

It is also important to remember that because of the great diversity of business segments in our industry, our overheads are typically sizable, which leads to important synergies for acquiring companies. Most notable synergies are related to store support, maintenance, cybersecurity, human resources, and technology in general. Some firms are constantly selling off weaker units to concentrate their business efforts and redeploy the proceeds. Some have dealer networks available to support as well. The promise of Artificial Intelligence (AI) is substantial in our industry for sales and profit optimization, and also for automation. Yet, AI is complicated and both labor and capital intensive on the front end.

Whether buying or selling, please stop by NRC's NACS Show 2024 booth at N-2462 to visit our team, or call or text me at 303-619-0611 or email at jeff.kramer@nrc.com to set an appointment at the booth, Hunter Club, or a convenient location.