

## Customer & Market And Operational Due Diligence Of Propane Distributor: Determining Branch-level Margin Expansion Opportunities And Market Position

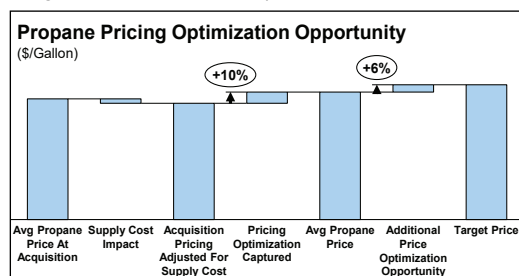
**The Challenge:** Our client, a large PE firm, was pursuing an investment in a leading propane distributor that was built through the acquisition of 25+ family-owned companies. Our client was attracted by the target's platform as an integrator of local propane distributors with a track record of margin expansion through implementation of differentiated pricing strategies and operational improvements. As such, our client wanted to validate the target's stated ability to capture margin expansion opportunities and its competitive positioning in its local markets. With the bid due date fast approaching, our client asked Gotham to conduct a 2-week customer & market and operational due diligence to: (1) determine pricing optimization opportunity; (2) identify opportunity to reduce operating expenses; and (3) assess local market competitive landscape, regulatory risks, and substitution threat from other fuels.

**Branch-level Market, Competitive, Pricing, and Margin Expansion Opportunity Assessment:** To conduct a rapid, fact-based market and operational assessment, Gotham undertook a multi-pronged effort:

- Analyzed zip-code-level propane supply, consumption, pricing, and heating degree day trends to determine addressable market, growth outlook, and substitution threat from alternative heating sources in target's service areas
- Surveyed ~750 propane consumers in target's service areas to understand: attitude toward pricing; likelihood to switch suppliers; and use of/attitudes toward propane and other heating sources
- Identified/profiled key competitors and conducted 32 competitor interviews in target's local markets to understand their pricing tactics, customer segmentation, and operational practices, as well as the target's opportunity to grow margin in its markets
- For each of target's 25+ acquisitions:
  - Analyzed pricing to pin down increases (adjusted for supply price changes) captured by the target since acquisition and benchmarked local competitor pricing to determine additional pricing optimization opportunities
  - Analyzed delivery and backoffice expenses to establish operations improvement opportunities captured since acquisition and developed a model to determine route optimization and backoffice opportunities across underperforming locations.

### Differentiated Pricing Strategy Provides Opportunity to Improve Profitability

Gotham established that propane pricing in the market was typically executed at the local level based on tank size and annual volume, with major national players pricing at premium, local discounters pricing low, and regional/quality local players pricing somewhere in between. Gotham identified 3 consumer segments based on consumer shopping behavior: Price Shoppers account for only 10-15% of consumers; and remaining segments (Set and Forget and Price Aware) are focused on service not price and tend to have long-term, loyal relationships with their propane suppliers. Gotham's consumer survey analyzed consumers' price elasticity behavior and concluded that a significant pricing increase opportunity remains, especially given prevalence of low propane prices. Gotham validated target's differentiated pricing strategy and its ability to capture price increases at acquired companies and identified an opportunity to increase pricing further via a more analytical approach based on operational considerations (e.g., route optimization, marginal cost, supply cost, cost-to-serve, seasonality/weather), local competitive dynamics, customer relationship (e.g., contact type, payment plan, tank ownership), and customer demand patterns.



### Margin Expansion Opportunity From Further Backoffice Cost Reduction and Route Optimization of Acquisitions

Gotham analysis indicated the older the acquisition the better it performed on delivery and backoffice cost benchmarks, indicating that the target has been able to increase margins at acquired companies. Internal and external benchmarking indicated opportunity to further reduce backoffice expenses by consolidating non-customer-facing functions/activities and improving operational efficiencies at more recent acquisitions especially. Gotham also identified a significant route optimization opportunity due to target's "Keep Full" customer base (can be refilled at its discretion). Also, predictability of usage enables creation of optimized delivery schedules and routes. Finally, we found opportunities to increase route density at newer acquisitions. We established that implementation of a world-class management information system is key to reducing operational expenses as it enables full transparency and continuous improvement in routing, pricing, marketing, service, and safety.

### Highly Fragmented Market Driven by Local Dynamics with Minimal Substitution Threats from Alternative Fuels

The propane distribution market is highly fragmented with ~500 branches from around 150 companies competing in the target's service areas. The overall propane distribution market comprises 3 majors that compete by marketing aggressively, 25-30 professionally managed mid-sized players, and many local companies that retain share based on local relationships. While regulatory dynamics pose minimal threat to propane use in target's service areas, the propane market varies greatly by region, with local infrastructure driving viability of alternative heating sources. While natural gas is >50% less expensive per BTU than propane for home heating it poses limited threat to propane – natural gas infrastructure is expensive for utilities to expand and for consumer to hook in to; and utilities are currently focused on replacing/upgrading their existing pipelines and not on expansion. Electricity is more expensive and less reliable in remote and rural areas making it a less attractive option. Heat pumps lose efficiency and provide less attractive heat output in colder climates.

**The Outcome:** Gotham's in-depth assessment of local market and competitive dynamics and analysis of pricing and operating expenses at acquired companies allowed the client to gain a clear picture of the target's branch-level margin expansion opportunities and market position. Comfortable with the target's opportunity to acquire family-owned local propane distributors and capture pricing/operations improvements, our client was able to move forward with an aggressive but well-informed bid.