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Patriot Transportation Holding: For The Long Haul

- *Patriot Transportation is a leading regional tank-truck carrier in the Southeastern US.*
- *With multiple ways for investors to "win"—it provides an asymmetric risk/reward with shares priced at only ~3.5x EBITDA.*

Introduction

Patriot Transportation Holding (PATI:NGS) is a leading regional tank-truck carrier. The company was spun-off from *FRP Holdings* (FRPH:NGS) in early 2015. Its business predominately consists of hauling motor gasoline to filling stations within the Mid-Atlantic and South-East regions of the United States. It also selectively contracts within several other liquid bulk chemical & commodity markets.

Investment Case

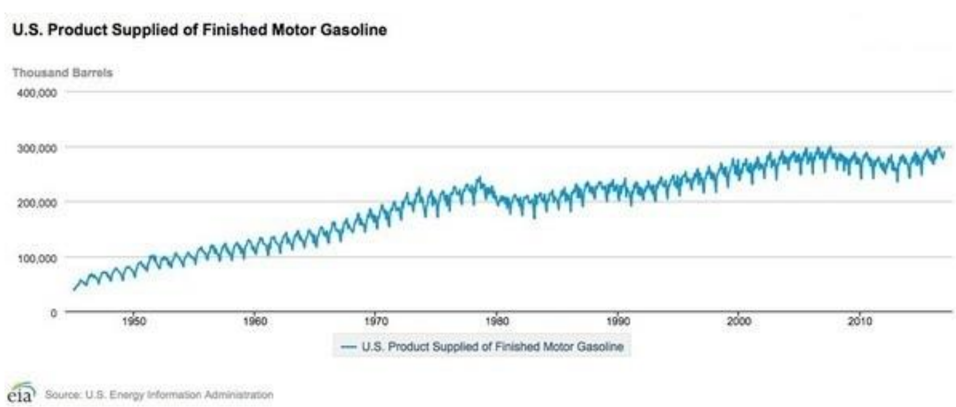
The investment case to support Patriot is relatively straightforward, predicated on a handful of key factors. First and foremost is that consumption of motor gasoline is likely to remain stable for the foreseeable future. Second is that the tank-trucking business is a more durable operating model than many investors give it credit; and therefore, Patriot's shares are priced at an unjustifiably low multiple of current operating performance at ~3.5x EBITDA. Third is the reasonable likelihood that the company will be able to materially grow its earnings over time through organic expansion and M&A. Fourth is that the investment benefits from a substantial margin of safety given the company's sizable unencumbered asset base and net cash balance sheet; and lastly, it would be a prime beneficiary from any potential U.S. corporate tax reform.

These factors provide the company with multiple ways for investors to "win," while also protecting against the downside—creating an asymmetrical risk/reward at the current share price.

Industry Overview

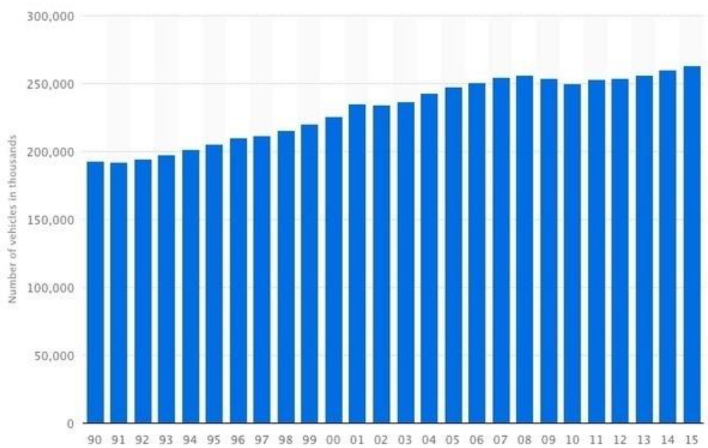
The tank trucking industry is primarily responsible for moving refined petroleum products to retail gas outlets such as highway service areas, convenience stores, etc. It is a vastly different market than the traditional and highly cyclical full-truckload (FTL) and flatbed carrier markets. Tank trucking is more akin to the midstream oil market, as demand for its service is incredibly stable driven by the overall consumption of motor gasoline. While reported revenue figures within the industry still tend to jump around a bit because of the cost structure on diesel fuel which acts as a partial pass-through to its customers, the tank hauler takes no ownership of the underlying commodity as a fee-based service business dependent on volume.

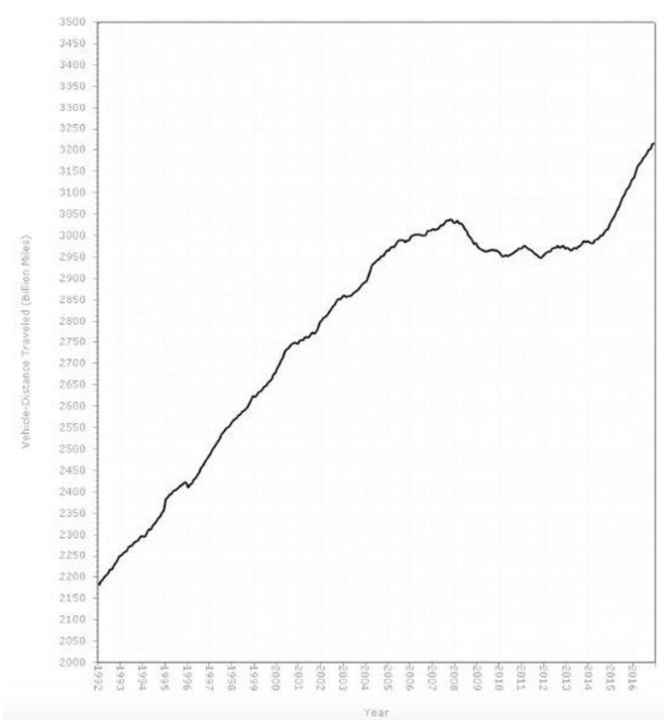
That has historically proved to be a very good business to be in, as trends in consumption for motor gasoline in the U.S. have remained on a solid growth trajectory since 1950. In total, gasoline consumption in 2015 was ~140b gallons according to the *Energy Information*



Administration (EIA). At an aggregate level, national consumption is almost entirely (~90%) from usage of light-duty vehicles such as cars and small trucks. This makes growth in consumption primarily reflective of the secular expansion in the installed base of registered vehicles, as well as any increases in total vehicle-miles traveled over time.

Both of these measures appear quite healthy. The total number of registered vehicles remains at a record level with more than 260m highway units, per the *Bureau of Transportation Statistics*; and the cumulative annual number of vehicle-miles traveled increased to a record 3.2 trillion miles in 2016, as measured by the *Federal Highway Administration*.





Demand for gasoline is relatively price inelastic—so the only major offset to consumption has been long-term improvements in vehicle efficiency. This has proved to have a relatively modest effect in dampening growth over time, although investor perception for how it will impact the business in the future is typically the subject of wildly differing opinions.

As of a couple of years ago, the EIA had been predicting that U.S. motor gasoline consumption would decline by about 1% per year through 2040 as improvements in fuel efficiency outpace any increases in miles driven. Unfortunately, this has not been borne out in results; and the projection appears increasingly unlikely to be achieved, at least for the next few years, as there has been a resurgence in SUV and truck sales. This has come in response to lower gasoline prices, which stemmed from the fall in crude oil prices starting in late 2014. Electric vehicles (EV), which will be discussed in detail within the *Risks* section, currently make up less than 1% of the total number of vehicles sold and are not expected to have a material effect on the market.

In any event, the likelihood of a sustained, meaningful decline in consumption happening anytime in the next 5-10 years appears unlikely. That should provide long-term stability during which the company can expand its business reach, grow market share, and complete accretive acquisitions.

Operations

Operationally, Patriot conducts all its business through a wholly-owned subsidiary, *Florida Rock & Tank Lines* (FRTL). That brand operates a network of over 20+ terminals and is well-known throughout the Florida, Georgia, Alabama, South Carolina, North Carolina and Tennessee markets. It typically receives product at regional storehouses along branches of the *Colonial* and *Plantation* pipelines and serves customers in a handful of important metropolitan areas such as Atlanta, Ft. Lauderdale, Tampa, Orlando, Jacksonville, and Nashville. These represent some of the most auto-dependent regions in the country having participated heavily in the "urban sprawl" of post-WWII America.

The tank trucking industry is a short-haul business and within its core markets, Patriot most often runs up against *Kenan Advantage Group* & *Eagle Transport*.

Kenan Advantage has long been the largest participant in the industry after having rolled-up a handful of smaller outfits over the period of about a decade. This included acquisitions such as *Reinhard Transport*, *Transport Service*, *Beneto Bulk*, *DistTech*, and *Klemm Tank*. At a revenue run-rate of approximately \$700m, the business was sold to *Goldman Sachs* (GS:NYSE) in 2010. It continued to make tuck-in acquisitions under

Goldman's ownership such as *Jack B. Kelley* and was eventually sold to *OMERS* private equity in 2015 for a reported price tag of $2bn.

Eagle Transport is based in North Carolina and it is moderately larger than Patriot, according to the *Bulk Transporter's Gross Revenue Report*. The company appears to have a strong presence in the mid-Atlantic region and is a solid, rational competitor.

Bulk Transporter's **Tank Truck Carrier 2015 Gross Revenue Report**

Fleet Name	2015 Rank	2015 Revenue In 000s	2014 Revenue In 000s	2015 Ratio
*[1]Kenan Advantage Group Canton OH	1	1,566,800	1,566,800	—
*[2]Quality Distribution Inc Tampa FL	2	991,758	991,758	—
[3]Trimac Transportation Inc Calgary AB and Houston TX	3	616,228	778,800	—
Foodliner/Quest Liner Inc Dubuque IA	4	245,152	249,244	—
[4]Superior Bulk Logistics Inc Oak Brook IL	5	244,777	260,194	—
Groendyke Transport Inc Enid OK	6	241,843	240,167	—
A&R Logistics Inc Louisville KY	7	235,000	243,000	—
*Schneider National Bulk Carriers Green Bay WI	8	215,900	215,900	—
[5]Ruan Des Moines IA	9	202,551	225,600	—
[6]Dupre Logistics LLC Lafayette LA	10	201,803	203,138	99.39
*TransWood Carriers, Inc. Omaha NE	11	189,300	189,300	—
Martin Transport, Inc. Kilgore TX	12	151,448	183,205	—
Eagle Transport Corp Rocky Mount NC	13	131,117	131,500	97
Tankstar USA Milwaukee WI	14	125,613	132,887	—
[7]Patriot Transportation Holding Inc Jacksonville FL	15	122,882	129,162	—

* 2014 revenues repeated for 2015.

— Revenues and/or ratios not available.

1 Figures include Advantage Tank Lines, KAG West, Bulk Express Inc, Kenan Transport, Klemm Tank Lines, North Canton Transfer, Petro-Chemical Transport, Transport Service Co, DistTech Jack B Kelley Inc, CTI, and KAG Logistics.

2 Figures include Quality Carriers Inc and Boasso America Corporation.

3 Figures include Harris Transportation and NRT.

4 Figures include Superior Carriers, Carry Transit, and Super Flo.

5 Figures include Ruan Transport Corporation and Ruan Logistics Corporation.

6 Figures include Site & Private Fleet Services, Strategic Capacity Services, and Energy Distribution Services.

7 Figures are for Florida Rock & Tank Lines.

Barriers to Entry

The industry has meaningful barriers to entry/scale in the form of *drivers*, *contracts*, and *capital investment*.

The largest barrier is local drivers. Truck drivers (and specifically tank drivers) are difficult to hire, train, and retain. This is important since in order to achieve scale an operator needs ~25 drivers per terminal to be able to compete economically in a local market. Retention of drivers is at a premium right now due to a national shortage of qualified drivers, as is being reported by the *American Trucking Associations* (ATA). It is worth noting that the shortage has less to do with the trucking industry specifically, as within trucking, tank driving is generally looked at favorably due to the short-haul nature of the routes—driver can be home to their family every night. The shortage likely has more to do with the significant recovery in construction jobs, as those labor pools tend to overlap somewhat. As a result, Patriot has been forced to absorb this dynamic through various measures to improve retention, including higher pay. Near-term, that has translated into a less favorable margin structure than it has historically achieved, which has been masking the company's results prior to any rate relief through a renegotiation of base rates across the industry.

Successful operators also obviously need to have contracts. This is largely a function of reputation, as a history of safety and quality service play an important role in the selection process, beyond the stated rate. There is a high-cost to delivery errors and significant potential liabilities can arise from any major accident. This makes it a "trust" business and it is relatively hard to steal market share. The regional aspect of the industry also plays into this dynamic, since while the business is highly fragmented at a national level, this is not so much the case at the local level. Given a limited number of local participants, it discourages attempts to win business via dropping price, especially since many of the same businesses will compete against each other in multiple markets.

Before an operator can hire drivers or win contracts, it first needs to make a relatively significant investment in tanks/tractors (about ~15 per terminal), insurance, maintenance access, etc. The business also needs to secure access to industrial-zoned, real-estate property that is relatively close to a tank farm, otherwise the "dead-head" portion of the route become significantly less economical to absorb. All told, this can easily run into the $5m-$10m+ range for a reasonably sized terminal. While this may be "pennies" if the likes of a *Google* or *Amazon* up and decided it wanted to contend in the tank-trucking industry, but in the context of the industry itself, it typically represents a sizable, lifetime capital commitment for a small, independent owneroperator or carrier; and one that requires continuous reinvestment.

All told these barriers make the business significantly more durable than most investors seem to want to give it credit. It also provides the backdrop for growth opportunities as scale and consolidation begin to play a critical advantage.

Financial Model

Looking at the financial model, performance in FY'17 (Sep) appears set to show a moderate improvement over the prior year. Revenue-miles should see a modest increase to around ~44 million miles driven, as the company benefits from improved driver retention and a solid market environment. Revenue-per-mile should also continue to edge higher to ~$2.75+/- based on improvements in base rates. This would imply revenue before fuel surcharges of ~$120m.

With the exception of a few variables, the cost structure for the company has remained remarkably consistent over the years. Compensation expense has remained fairly tight in the $50m range for the past few years. It could increase moderately in the next year due to an increase in driver pay and various retention initiatives, offset by a modestly lower number of total drivers. Maintenance costs for repairs and tires typically run ~$8m annually; and accrued charges for depreciation of equipment is an incremental $9m/year. Rents, tags, and other regulatory expenses are slightly less than $10m/year. SG&A expense are also around $10m/year, plus an additional $3m/year which is recognized for unallocated corporate expense. Insurance costs are generally in the $10m range for the full-year, but are somewhat dependent on the company's safety record. The company's preventable accident frequency ratio (PAFR) jumped relatively significantly in FY'16 (Sep), but should hopefully revert back to more normal levels. From a P/L standpoint though, this net benefit would only start to show up in reported results during fiscal H2 as the company does not adjust its actuarial "loss-pick" in the first-half of the year. Finally, the non-surcharge portion of fuel expense should revert back closer towards a net cost of ~$8.5m per year. This had been a substantial drag to OP last year, due to the rate of decline in fuel surcharges prior to renegotiation of base rates.

Overall, this implies OP of in the $10m-$12m range, equivalent to an OP margin of ~9%. Adding back D&A, it equates to EBITDA of ~$20m at the midpoint. Patriot is debt-free and has minimal movement below the operating line from interest, commitment fees, etc. The company has occasionally registered gains/losses in the past related to items such as the BP recovery fund, divestiture of assets, etc; and it does have one sizable non-operating gain on the horizon from its S. Tampa facility which is under contract to be sold for $10m. That transaction is not expected to close within the next 12-months though, and will be discussed in more detail in the *Margin of Safety* section. Aside from that, there does not appear to be any recurring non-operating items that should need to be modeled from a normalized earnings perspective. From a tax stance, the company is a "full" corporate filer with a statutory rate close to 40%. This funnels to normalized EPS of ~$1.85 based on 3.3m shares fully-diluted (FD).

Two additional points worth noting from a regulatory standpoint:

First, the industry is expected to deal with a federally mandated electronic logging (*e-log*) requirement for drivers that will come into effect in 2017. Fortunately, this should have minimal impact on Patriot's reported results, since the company has already been compliant with the regulation for a number of years. It could spur on some potential M&A opportunities though, as some smaller targets that had previously not been compliant are likely to be challenged by the additional costs associated with the regulation.

Second is the opportunity for U.S. corporate tax reform under new Administration. While clearly not a shoe-in to occur, a reduction in the corporate tax rate to ~20% would bump Patriot's normalized earnings to ~$2.40 per share, exclusive of any additional potential growth from market expansion or M&A. While investors would be unlikely to award the increase with a full multiple, it would still represent a relatively dramatic increase in overall earnings power by ~30%-35%.

M&A Potential

The tank trucking industry is highly fragmented; and Patriot's management has clearly indicated that it would like to play the role of consolidator if the right opportunity presents itself. The company maintains the balance sheet flexibility that would allow it participate in relatively sizable industry deal flow and any acquisition(s) would likely be materially accretive to earnings at its current size/scale. Judging by the list of operators included in the *Bulk Transporter* report, there appear to be plenty of bolt-on targets out there.

Alternatively, Patriot could ultimately find itself as an acquisition target by a larger operator, particularly now that it has completed its 2-year anniversary since the spin-off from FRP Holdings. This should cement the company's tax-free status under *Section 355* of the IRS code, which might open it up to potential negotiations.

While comparable transactions are difficult to assess given the small size and mostly private nature of the industry, it is worth noting that the two largest participants in the industry were both acquired within the past two years.

As mentioned earlier, *Kenan Advantage* was sold by Goldman Sachs to OMERS private equity in 2015 for a reported $2bn.

And *Quality Distribution* (former ticker QLTY) agreed to be acquired by the private-equity (PE) firm *Apax* in May-2015. That transaction was an all-cash deal which valued the company at approximately $800m. Quality is not a pure-play comp with Patriot since the Tampa-based company is mostly in the bulk chemical sector, operating the largest logistics network for chemical deliveries in NA. That is in addition to its intermodal tank container services and transport services business for the oil industry. The transaction was completed at a reported multiple of 11x EBITDA though and external growth is expected to remain a key part of the strategy.

Capital Structure

Looking at the company's balance sheet, Patriot is debt-free with net cash of ~$5m as of Dec-2016.

In connection with the separation from FRP Holdings in 2015, Patriot entered multiple credit lines to provide additional liquidity. This includes a $25m, unsecured revolver with *Wells Fargo* for a term of 5-years. It also includes a 2-year, partially secured $25m asset-backed loan (ABL) with *BBT* that will convert any draws on the facility into a 5-year term loan. Both facilities remain undrawn still, providing significant financial flexibility relative to its current market cap.

Margin of Safety

While it is always important to have upside, it is equally, if not more important to protect against the downside—since after all, not losing money is rules #1 and #2 of money management per Warren Buffett.

From a downside protection look, it is appropriate to start with book-value which stood at $13.60 per share as of the latest FQ1'17 earnings release. The company is debt-free; and so, that value primarily relates to the company's tangible, unencumbered ownership stake in ~500 tractors and 550+ trailers. It also holds a small, company-owned portfolio of real-estate relating to its existing terminals.

Most of this equipment is in good use as part of ongoing operations; and therefore while it is not additive to valuation, which would in essence be double-counting the working capital of the business, it does provide a margin of safety to the underlying "replacement value" for the company.

There is one specific asset though that does appear to have significant "hidden" value in excess of its current use as a terminal. That asset is the company's facility in Tampa which should have a higher-value case due to the property being located directly adjacent to the heavily trafficked *MacDill Air Force Base* (AFB).

The terminal had been marketed in 2016 by *Colliers International*; and as disclosed in a subsequent event within the 10-Q filed after the most recent quarterly release, Patriot went into contract to sell the property for $10m. Although still with significant contingencies and the deal not expected to be completed within the next 12-months, a sale at that price would be equivalent to approximately 15% of the company's total EV.

State	City	Terminal or Satellite Location	Owned/Leased
Alabama	Anniston	Satellite	Leased
Alabama	Birmingham	Terminal	Leased
Alabama	Mobile	Satellite	Leased
Alabama	Montgomery	Terminal	Leased
Florida	Cape Canaveral	Satellite	Leased
Florida	Ft. Lauderdale	Terminal	Leased
Florida	Freeport	Satellite	Leased
Florida	Jacksonville	Terminal	Owned
Florida	Newberry	Satellite	Leased
Florida	Orlando	Terminal	Leased
Florida	Panama City	Terminal	Owned
Florida	Pensacola	Terminal	Owned
Florida	Tampa	Terminal	Owned
Florida	White Springs	Terminal	Owned
Georgia	Albany	Terminal	Owned
Georgia	Athens	Satellite	Leased
Georgia	Augusta	Terminal	Owned
Georgia	Bainbridge	Terminal	Owned
Georgia	Columbus	Terminal	Owned
Georgia	Doraville	Terminal	Owned
Georgia	Macon	Terminal	Owned
Georgia	Rome	Satellite	Leased
Georgia	Savannah	Terminal	Leased
North Carolina	Charlotte	Satellite	Leased
North Carolina	Wilmington	Terminal	Leased
South Carolina	Belton	Satellite	Leased
South Carolina	Spartanburg	Terminal	Leased
Tennessee	Chattanooga	Terminal	Owned
Tennessee	Nashville	Terminal	Leased
Tennessee	Knoxville	Terminal	Owned

Equity Ownership

From an equity perspective, Patriot's stock is closely held. Much of this relates to the founding family's continued involvement and significant ownership.

According the latest proxy statement, the Baker family's ownership is held in three primary lineages—John Baker/Ted Baker, Edward Baker/Tom Baker, and Sarah Porter/Cynthia Ogden. In total the groupings control more than 25%+ of the outstanding shares.

Besides the Baker family, other executive management own approximately 4% of shares; and overall, between the founding family and executives, as well as reporting institutions such as *T. Rowe Price*, *Royce*, *Perlus*, *Dimensional Fund*, *Wellington*, *Willis Investment Council*, *Rutabega*, *Estabrook*, *Vanguard* & *Blackrock* approximately ~75% of the stock appears to be locked up in solid institutional hands. This provides a solid ownership base from which the stock can begin to move higher.

Valuation

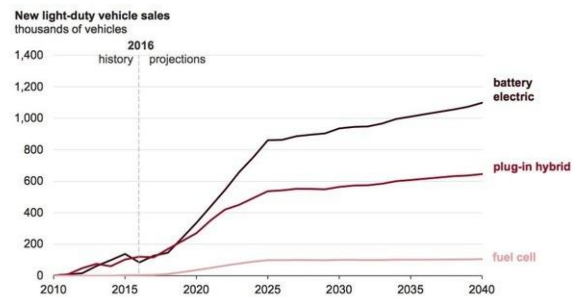
With regard to valuation, Patriot appear to be substantially undervalued. Based on its recent closing price of $21.50/share, the company has a market cap of just over $70m and an enterprise value of nearer to $65m. Given financial expectations for earnings and EBITDA to approach $1.85 and $20m in the current year, it implies shares trading at ~12x forward earnings on a P/E basis. On an EV/EBITDA basis, this equates to a multiple of less than ~3.5x EBITDA. This presents a sizable disconnect relative to other transportation & logistics sector industrial businesses, especially given the durability of the operating model and that cash-conversion of EBITDA could be set to improve in the case of any corporate tax reform materializing.

Bumbershoot Holding's internal target of $35/share per share represents a market cap of closer to ~$115m. This implies an earnings multiple of ~16x on the base business, exclusive of tax reform—representing a FCF yield of ~6.25%. It also accounts for the completed sale of the Tampa facility, plus retained earnings for FY'17.

Risks

In the longer-term, risks to the investment are likely to center around potential disintermediation to demand for motor gasoline. This would primarily relate to significant technological change from innovations such as electric vehicles (EV) and autonomous driving.

For EVs, battery electric cars currently make up less than 1% of total light-duty vehicles sold; and while forecasts do call for a steep ramp in adoption, even under that scenario, EV unit volume is not expected to cross the 1 million vehicle threshold until around 2035. That would probably be on a SAAR base of at least 20m vehicles; and could easily prove to be far too optimistic. This should mean that electric-vehicles will be far from dominating internal combustion engines and even in a worst-case scenario would certainly not eliminate the need for gas stations anytime soon.



Regarding autonomous driving, it feels weird to even have to include this as a risk, but it is top-of-mind for many tech/macro investors—and therefore is prudent to address. There is a lot more to the haul than just the driving. The routes are predominantly short-haul work which demands a lot of physical labor outside of the truck in terms of hooking up hoses, etc. Realistically, even from a technological standpoint, this would likely be decades away from being feasible to replace with robotics. Beyond that though, perhaps more obvious is that the company is hauling flammable, hazardous materials. Regardless of an investor's view of whether it could even be possible to replace the work with some combination of autonomous driving and robotics, it is highly unlikely that tank trucking would be one of the first business to make the transition. In my worries about the investment, this ranks exceedingly low on the list, but it still needs to be addressed, especially given the strides the technology industry continues to take in that direction including the recent "milestone" beer delivery by Uber's *Otto* in partnership with Budweiser.

Summary

Overall, Patriot Transportation has a number of factors that should make it a "winning" investment over time. The company has a highly durable business model that has been a solid, long-term cash generator. From an operational perspective, despite being priced cheaply relative to financial results at ~12x forward earnings, the company appears to have significant opportunities to grow the business through organic expansion and M&A. The company itself could turn into a desirable acquisition candidate as the industry consolidates, particularly now that it would satisfy the spin-off requirements of Section 355; and it would be a prime beneficiary of U.S. corporate tax reform which could dramatically improve its cash-conversion on EBITDA.

From an asset perspective, Patriot also demonstrates a significant margin of safety in terms of replacement value which should serve to protect the downside. It is debt-free with significant available liquidity. Insider ownership remains high with the founding-family still holding ~25% of shares; and the company is well-managed with a proven executive team.

With a fair-value target of ~$35/share, Patriot appears to represent a compelling value with ~60% upside to target. Accordingly, it represents one of Bumbershoot's largest investments within the *Micro* category.

Disclosure: long PATI