

MODERN DISTRIBUTION MANAGEMENT

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Beyond the HD Supply Factor

An update on trends and drivers in distribution M&A

The volume of mergers and acquisitions activity in distribution has increased substantially over the past 12 months. Along with a continued increase in interest from private equity firms, strategic buyers have reentered the fray, both in the U.S. and overseas. The market will likely plateau or even soften in the next year or so, especially in sectors affected by the downturn in residential construction. Right now though, the market is hot – maybe even too hot, according to some industry experts. What's more, an HD Supply spin-off could have an impact on valuations and provide opportunity to competitors of its diverse units.

HD Supply

Home Depot's potential spin-off of its \$12-billion wholesale division – announced in February by the \$90-billion retailer – has already had a slight impact on valuations in the distribution M&A marketplace. That's the consensus of panelists at a recent MDM audio conference on M&A trends.

"It's amazing how many armchair Monday morning quarterbacks there are today that said 'I told you so,' once the Home Depot announcement came out (that it was considering options for HD Supply)," said Jim Miller, who heads the distribution practice at investment banking firm Vetus Partners, a middle-market investment bank headquartered in Cleveland, OH.

Miller, who provides advisory services to distributors and financial buyers on the buy- and sell-sides, as well as financial restructuring services, said the effect of talk of a divestment comes from two areas: "One, the position of Home Depot as a competitive buyer against another bidder, or at least the perceived threat of Home Depot as a competitive buyer.

"And two, Home Depot Supply as a potential exit opportunity. There were several private equity funds that were chasing

distribution investments with the intent of buying them, holding them for a period of time and potentially flipping them to HD Supply."

But with the recent announcement, more financial buyers are taking a step back, waiting to see what happens with HD, Miller said.

Tom Lange, leader of the distribution and supply chain technology team in Robert W. Baird & Co.'s investment banking group, agreed.

"I think the absence of HD Supply as a buyer for distribution businesses could have a valuation impact. ... They were aggressive, often paying a compelling price when they thought there was a strong fit," he said.

"... (If sold) the next owners may have a different philosophy or approach to M&A. I also believe that within HD Supply there are some very good businesses and that overall the financial performance of HD Supply has been strong."

Is the Market Too Hot?

HD Supply aside, the volume of activity in distribution has increased substantially over the past 12 months. More than 100 private equity firms are targeting distribution right now, Miller said. And valuations have held strong, with "no real significant tick down yet."

"I actually think there may be too much activity," Miller said. "There's a lot of companies out there on the market right now that I don't think were ready to go to market. There's more funds interested in distribution than truly understand the space, and there's more financial advisors jumping in the space who have not done a lot of deals and are pushing for transactions where they probably shouldn't."

Brent Grover, 25-year industry veteran
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and consultant with his firm, Evergreen Consulting, agreed: "Some companies have seen the market become very hot, and they have brought some bad merchandise to the marketplace. I think there are some pretty unattractive companies that have been dressed up and the market figures out pretty quickly that it's not the kind of firm they want to buy."

Lange said low-cost financing, high valuations and a healthy earnings environment have fueled strong buy-side interest and, in general, a "great selling opportunity for quality distribution businesses."

There's a greater percentage of uninvested equity dollars in the market as compared with last year, Miller said. "It's a good time to be seeking a liquidity event and targeting the private equity market right now if you're a best-in-class distributor."

Last year at this time, Miller said, "a lot of the strategic buyers were just starting to come off the sidelines." Many are now back in the market.

In some sectors, valuations will ease off in the next year thanks to a hurting residential market, volatile commodity pricing, and a dampening of other parts of the economy. "I think the likelihood is that we are at or near a plateau," Miller said.

Grover said he has started to see profits weaken, which he pointed to as evidence of issues that may affect valuations in the next year. "I'm delighted to see that the sun has been shining on distribution the past couple years, and

that people recognize the potential for return on investment even though return on sales is not that strong for distributors.

"... I think if people get disillusioned with earnings they're going to look elsewhere."

Cross-Border

Cross-border M&A grew from 19 percent of all M&A activity in 1986 to a third of all activity last year, Lange said. "The geopolitical and other barriers to cross-border M&A have largely gone away in many countries with the opening of trade across Europe and the globalization of business activity," he said.

Distributors like UK-based Wolseley plc and France-based Rexel have been active in the U.S. Lange said 5 percent of all global cross-border M&A is trans-Atlantic – involving a U.S. company buying a European company or vice versa. However, in real dollars, there have been a substantial amount of U.S.-European transactions (across all industries) in the last five years: \$425 billion in U.S.-led deals and another \$300 billion in European acquisitions of U.S. businesses.

Cross-border M&A holds its own challenges, not the least of which is different laws in different countries, Lange said. "There is what I would describe as a markedly different due diligence process ... I do think there are key differences that one needs to think about in terms of timing and approach when you're doing a transaction like that," he said.

Lange said cross-border transactions can be attractive simply because customers want

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a closer relationship with a distributor, which has an opportunity to become a vendor's global partner. "Many times there are barriers to this for well-run U.S. companies, for example, because they just don't see the benefit of reaching over the pond, of the risks associated with a deal. They may feel there's still a lot of runway left in the U.S."

Consolidation at the vendor level has reduced the number of vendors serving distribution sectors, Lange said, and vendors are working with the same distributor in multiple countries – especially in Europe.

"I think the concept of global customers looking to work with fewer distribution partners across multiple locations and often in several countries can pull distributors into international markets," Lange said.

Wire and cable distributor Anixter, Chicago, IL, is one example of a U.S. distributor who has worked to build out and leverage its multi-country distribution network.

In addition, U.S. distributors are continuing to build out a broader North American presence. "We probably get a call a week from a distributor that is trying to establish a greater presence, specifically in western Canada," Miller said

Too Small?

Grover addressed issues for smaller distributors in M&A markets. He reported that private equity firms generally focus on companies that have \$5 million of EBIT and above, though there are specialty firms that will work with smaller distributors.

"Some distribution companies have recognized that they may be too small to play in the game of being sold to a big company or to a private equity firm and they have looked at mergers of similar-sized distributors as a transitional step," he said. This makes them a bigger and better acquisition target.

Multiples for smaller companies are, of course, on another level than historically high large and middle-market distributor valuations. Multiples for smaller companies are generally in proportion to company size, Grover said. "These median multiples in the lower and higher quartile are not going to be welcome news to any distributors who are listening and thinking of selling their companies. They are interesting for those who are thinking of buying smaller companies.

"... It's pretty hard to value a small company because you don't have good comparables. The owner's expectations are often way out of step with reality because until they actually deal

with real buyers and real money, they just often have an inflated idea about what their company is worth. Small company valuations also are often very much tied into the lifestyle needs of the seller."

Grover advised that smaller companies looking to sell need to first consider "curb appeal." "Curb appeal is necessary to get the buyer to look at your business," he said. "Nobody wants to buy a house with a flooded basement no matter how great the house is. So you've got to fix up the facilities and the management team, and also your information systems."

Topics addressed during audio conference:

- Current M&A market conditions and activity
- Key M&A drivers
- Valuation multiples and forecast trends
- Cross-border consolidation
- Strategic acquisition activity
- Smaller distribution company M&A trends
- Selling to a private equity firm: What it means for your company
- Post-acquisition integration

This is a summary of key points made in MDM's recent audio conference, "Distribution M&A 2007 Update." Three industry experts spoke on the current key drivers of M&A in distribution, in North America and internationally, as well as discussed some of the key players in the market.

To order a CD of this two-hour event, complete with handouts and written transcript, please go to www.mdm.com/conferences/ma2.html

Next MDM audio conference:

Succession Planning for Distributors

Join Evergreen Consulting's Brent Grover and two distributors who will share their stories at a June 21 audio conference on the topic.