

MODERN DISTRIBUTION MANAGEMENT

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The Newsletter for the
Wholesale Distribution Channel

Navigating the Distribution M&A Landscape

Two experts discuss buy-side, sell-side considerations

MDM, in partnership with the National Association of Wholesaler-Distributors, sponsored a two-hour audio conference, "Wholesale Distribution Mergers & Acquisitions Landscape: Enhance Your Value & Position in 2006," April 20, 2006. In this synopsis of the event, learn the most common mistakes distributors looking to grow by acquisition make as well as what financial buyers are looking for when they invest.

Mergers and acquisitions in wholesale distribution have ramped back up in recent years. Whether distributors are looking for an exit strategy, looking to grow by acquisition or just wanting to get a better grasp of coming competitive pressures, it is important to understand this increasingly complex landscape.

Financial Buyers

As detailed before in the pages of MDM, private equity firms are pouring money into wholesale distribution companies like never before. The rush is unlikely to abate anytime soon. The competition between financial and strategic buyers has resulted in higher valuations, which is making now a good time for many distributors who have been considering their exit strategies.

Private equity firms are financial buyers looking for a high rate of return on their investments. They usually buy companies, build them up, and then sell them after several years, either to a strategic buyer, another financial buyer, or through an IPO.

Right now there is a backlog of available companies to invest in, says Jim Miller, managing director and principal of Brown, Gibbons, Lang & Co., an investment banking firm with offices in

Cleveland, OH, and Chicago. "There were several wholesale distribution companies that just through their natural timelines, doing estate planning or whatever, would've come to market 2000 through 2003. Those companies held off and they're now starting to go out and feel and touch the market."

Miller says that is being combined with large valuation multiples, which have drawn other distributors who were going to wait another five to 10 years to sell. "A higher percentage of those folks are now saying, 'Well, if the market's this hot right now, maybe I should see what I'm worth,'" Miller says.

Some owners had planned to work another five to 10 years, but valuation multiples are attractive so they decided to sell but continue working for the company.

Miller says he has seen a total transformation of investors' interest in wholesale distribution companies. "In the early 2000s, we had the negative perfect storm, where a lot of wholesaler distributors got pummeled. Right now we're in a positive perfect storm because there's a ton of capital available from private financial buyers, the gap markets are highly liquid, and more importantly a greater percentage of this capital is interested in the wholesale distribution sector than ever before.

"I think it's important to both buyers and sellers: Buyers understand your competition, or your potential competition, and sellers understand your liquidity options, because they're dramatically different than they were four years ago when the strategic buyers were clearly dominating the market."

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INSIDE

Strategic Pricing: Next Big Thing?

Better software and process tools will help distributors price smarter in an emerging area of distribution management.

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Navigating the Distribution M&A Landscape

Some great observations, analysis and tips on the current state of M&A by Brent Grover and Jim Miller – excerpts from a recent MDM audio conference.

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Home Depot Acquires Cox Lumber

Cox, a \$396-million Florida-based building materials and lumber distributor, almost doubles the size of HD's William Bros. Lumber unit in the Southeast.

Page 3 of the Industrial
& Construction Markets
Update (yellow section)

Targets

There's more than \$120 billion of private equity dry powder – or capital financial buyers have raised but have yet to invest. When you apply leverage rates to that figure, it grows to about \$400 billion in buying power.

But is there private money out there aimed at buying up smaller distributors? Or is most of this money – mostly controlled by large firms – directed at bigger players in the market?

"As these funds raise new funds, they're always going out looking for larger pools of capital: A \$150 million fund from 2003 may be out there looking to raise a \$500 million fund today, and when they get that capital they're going to need to look at bigger deals. So that's a good point," Miller explains.

"... What they're realizing is that as they move upstream it's not necessarily that attractive to compete with 800 other private equity funds of similar size and investment criteria. ... An example where they've already done it is Riverside Capital, where they have carved off a chunk of their funds to invest in smaller deals. And you're going to be seeing that out of other private equity funds here in the near future."

Platforms

Many private equity funds are adding onto existing platforms; but others are just starting their work in the sector.

"There's probably three dozen private equity funds to four dozen private equity funds that already have platform investments that will look

for add-ons," Miller says. "But even those private equity funds ... they may have a platform investment in industrial or electrical distribution, but they understand the value of wholesale distribution and if an attractive platform comes across in medical supplies or safety supplies, or something like that, they'll bid aggressively for those companies as well."

Just about every sector in wholesale distribution is ripe for investment right now, with the exception of automotive, Miller says. And even then, if a distributor is in the right geography, an automotive supplier may still attract attention.

"We've been out in the last year with janitorial/sanitary supplies and industrial, a couple of electricals, safety, education, automotive aftermarket – all of those sectors were widely loved by the private equity universe," he says. "In terms of the MRO versus the OEM, I have personally seen ... more interest in MRO." Investors still have concerns about disintermediation on the OEM side, Miller says.

Attractive Qualities

A select few characteristics financial buyers are looking for in new investments:

- Capable management – "The majority of the private equity universe, they are financial geniuses. They typically do not have strong operating backgrounds. They need management there to drive the business," Miller says. Non-shareholder management is important as well, as they won't benefit from the sale, and will have more incen-

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tive to stick with the company should there be a downturn in the economy.

- IT systems – “We see several wholesaler-distributors that have great markets, a great company, great end customers, but that business can only grow so fast, so much before their current IT platform can’t handle it anymore. ... Obviously you’ve got to have ... a system that has the capacity to support that growth.”
- Value-added services/Defensible market position – “If you can hold your market share through your existing value-added services portfolio and you don’t have to develop that portfolio, these are dollars you can spend taking additional market share.”

Growth by Acquisition

Distributors can augment the natural, or organic growth, of their business by making a series of small lower risk acquisitions, says Brent Grover, president of Evergreen Consulting. Lower risk acquisitions are defined as a risk of not more than 5 or 10 percent of the company’s net worth on a company and a target of maybe one company every year or so.

“That is not going to add dramatically to the company’s size, but is going to augment its natural growth, being cautious not to outpace the company’s financial capacity or its management capacity to grow,” Grover says.

“So each individual company has its own micro economy based on its own set of customers and prospects; however growing by simply grabbing market share from competitors can depress margins and inflate costs. Growing by acquisition has the advantage of not adding distribution capacity to an already crowded marketplace.”

The National Association of Wholesaler-Distributors distributed an Internet-based survey to distributor CEOs across a wide range of industries. Three-quarters of the 403 companies in the survey reported sales of \$50 million or less. However, ten of these companies’ sales level is \$1 billion or more; 96 percent of the companies in the study are privately owned.

Due Diligence

Grover’s firm interviewed several of these distributors about their acquisitions and the marks they gave themselves for the job their management team did. “By and large, the CEOs felt they did a pretty good job with strategy and negotiation, but they were pretty hard on themselves in due diligence and integration,” Grover says.

“... There was a very significant gap in the due diligence between the deals that worked well and the deals that didn’t work. The poor due diligence was a very strong indicator of the deal not working out to their satisfaction, and nearly as strong was the integration practice. The lower the score they gave themselves on integration was a very strong predictor of the failure of the transaction.”

Oftentimes distributors in a rush to close a deal may overlook simple due diligence regarding issues such as supplier agreements, sales force commission plans, and customer profitability analysis.

“We use a 16-page distributor checklist and more than half of that checklist is not financial and legal in nature,” Grover says. For example, “some sellers are extraordinarily reluctant to let the buyer interview the salespeople and other customer contact employees. Personally I think that’s a very important step; you need to be able to look those folks in the eye and tell them what you plan to do with the company and see if they’re on board or not.”

Strategic Planning

Grover presented the steps of an acquisition in terms of a baseball diamond. First base is strategy. “It’s the underpinning of the whole acquisition process in choosing targets,” he says.

Distributors need a clear-cut business strategy to guide their acquisitions, Grover says. “It takes a lot of working capital to finance distributor growth. ... It requires about 25 cents of working capital for every dollar of sales growth, or \$250,000 for every \$1 million of growth,” Grover says.

“So growth consumes a lot of cash, whether it’s through acquisition or it’s generated internally. The fact is that many distributors have customers that are not profitable and it doesn’t pay a lot of dividends or rewards to the distributor to go out and buy more customers that aren’t profitable.”

Green-fielding vs. Acquisitions

Grover sees distributors with the best sales force as those who also have the best customers. Distributors with the best sales force can dominate in a fragmented market by simply having the best customers. “So the problem with growing organically is there is a real scarcity of truly talented salespeople, who are capable of going out there and building business from scratch. And a lot of distributor acquisitions ... are designed to gain excellent salespeople with a following

continued on next page

of good customers. The problem with organic growth is you hire salespeople," Grover says.

"They're expensive, and you hope they work out 50 percent of the time. It takes two to three years for a good salesperson to become effective. So to jumpstart that growth I'm suggesting the series of small acquisitions."

Miller offered his perspective. "If you're considering serving the same end markets within relatively similar geographies, I've seen green-fielding work out better than acquisitions.

"If you're looking to expand your geography or expand your end markets, I've seen folks really struggle to do that via green-fielding and really I'm having trouble thinking of very many successful ones. The successful ones have been via acquisition, buying into that new customer base, and buying into that new geography with those relationships with those customers in those geographies."

Other topics covered in the audio conference:

- How valuations are determined
- The mechanics of a leveraged buyout
- Impact of interest rates on valuation multiples
- Results from Grover's NAW survey
- Developing a strategy for growth by acquisition

- Implementing due diligence
- Customer Profitability Analysis
- Integrating IT systems

Jim Miller is managing director and principal of Brown Gibbons Lang & Company, an investment banking firm with offices in Cleveland and Chicago; www.bglco.com. He heads BGL's distribution practice.

Brent Grover is a 25-year distribution industry veteran, consultant, writer, CPA and educator. His firm, Evergreen Consulting, is a specialized consulting firm serving a select client base that includes owner-managed distributors, corporations that sell through distributors, and distribution industry trade associations; www.evergreenconsultingllc.com.

This article was adapted from a two-hour audio conference moderated by MDM Publisher Tom Gale. The audio CD package (includes audio CD and complete conference manual with presentation handouts, additional articles and written transcript of the entire event) is available for \$199. More information at www.mdm.com/conferences/ma1.html or by calling 888-742-5060.

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