2015 Wholesale Distribution Industry Outlook

An MDM Webcast transcript, featuring:

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- David J. Manthey, Senior Research Analyst, Industrial Distribution Services, Robert W. Baird & Co.
- Jenel Stelton-Holtmeier, Editor, *Modern Distribution Management*
- Ranga Bodla, Wholesale Distribution Industry Lead, NetSuite

This is the full transcript of the MDM Webcast "2015 Industry Outlook" from January 2015.

The Webcast presentation slides are included at the end of this transcript.

Tom Gale: Welcome and thank you for joining us for today's MDM webcast the 2015 distribution industry outlook. Our 60-minute program today is sponsored by NetSuite, and this is, in fact, the fourth year that we have partnered with NetSuite to conduct this research and do this annual call with them. I appreciate that continued support.

My name is Tom Gale. I'm the publisher of Modern Distribution Management newsletter and our website mdm.com. I have the pleasure of moderating today's program.

We live in interesting times as we enter into 2015. We're several years into a recovery, one that's largely been carried on the shoulders of industrial markets. As we'll hear shortly, the macroeconomic indicators offer much reason to be optimistic about continued strength in North American markets over the next few years.

In the past few years we've held this call, a common theme was turbulence – economic, political, competitive. The good news is these headwinds have moderated in many ways. We're in a good place today. But there's some interesting shifts from a year ago that we're seeing from our surveys and the research of leading wholesale distribution companies that we conduct throughout the year.

In our program today we're going to dig a little bit deeper into some of the key subsector trends that we've seen emerging. And we'll also take a look at five predictions that our research team here at MDM has identified that will really shape the competitive landscape in the year ahead. We're going to use the most recent survey work we've conducted in partnership with NetSuite to map out some of these deeper underlying strategic issues and some of the best practices that we think are shifting the industry from six and 12 months ago. Some of them are subtle and some of them are more deafening depending on your specific markets.

We have a great agenda today, so let's get started. I'm delighted to introduce our speakers. David Manthey is Baird's senior analyst covering industrial distribution services. In 2014 David was ranked

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by StarMine as the No. 3 earnings estimator in trading companies and distributors. And in 2011 he was ranked No. 3 in the Wall Street Journal's Best on the Street Survey. David earned a B.S. from the University of Wisconsin-Madison and an MBA from Indiana University with a major in finance and a minor in management information systems. MDM has had a long partnership with Baird for research, and I am very much looking forward to David's comments today.

Ranga Bodla is the wholesale distribution industry lead at NetSuite with almost 20 years of combined product management and marketing experience and expertise in software technology. In his current role Bodla's charged with driving the strategy for NetSuite and wholesale distribution. He received a B.S. in engineering from Trinity University in San Antonio. And likewise, we have done much research with the support and partnership of NetSuite and are delighted to have Bodla's input today as well.

Jenel Stelton-Holtmeier is our editor here at *Modern Distribution Management*. She leads our research team and has a special interest in economics and government policy. Prior to joining MDM in 2008 she spent seven years in the banking industry and also wrote for a number of publications including *The Denver Post*. She has undergraduate degrees in both political science and journalism and a master's in journalism from the University of Colorado. Welcome, all.

Our agenda today brings together a number of resources to help sharpen the crystal ball here today. David Manthey will be taking the first 20 minutes or so to give a brief macroeconomic overview, but his focus will really be in his deep knowledge of the subsectors of distribution and the public companies that he covers closely. He'll be sharing the latest results of our joint quarterly survey that MDM partners with Baird on. Jenel will then take the lead on our discussion of the fearless five predictions that we selected for today.

As part of that, we'll share some of the insights from our latest survey in December, conducted in partnership with NetSuite. You will receive a copy of our 2015 Outlook for Wholesale Distribution that summarizes much of our content as a follow up to today's call as well. Finally, we have scheduled time at the end of hour here for Q&A and so we will have an opportunity if you do have questions to address those at the end of our program as well.

With that I'd like to hand it over to you Dave to begin our program.

David Manthey: Very good, Tom. Thank you very much. I appreciate it. Again, my name is David Manthey. I'm the senior industrial distribution research analyst for Robert W. Baird. I've been covering distribution for most of the 20 years that I've been with Baird. I would point out that even though I've had a number of No. 3 rankings the last couple of years, I also have several No. 1s. You're not dealing with the B or the C team here. Hopefully, we have some great information, and we can help you with what we can.

With that I'd like to thank MDM, first off, for this opportunity. It's a great opportunity to discuss the macroeconomy as well as some more granular industry details from our joint quarterly survey. I'll start here on slide five and the punchline here is that we have some good news.

The U.S. economy is broadly seen as the strongest in the world today, and although we've enjoyed moderate growth, low inflation has really kept the Federal Reserve on the sidelines and allowed that to continue. But on the horizon, a hike in interest rates is broadly expected. Twelve of the 15 FOMC participants believe that rates will rise in 2015 to an average of around 1 percent from the current rate – as you can see here of effectively 0. Expectations are about 2 percent in 2016, and longer term the Fed governors are looking for a target range of about 4 percent.

Based on a decent economy that we've seen, decent growth, you can see the job creation in the U.S. employment numbers drifting down over time and the low interest rates. The U.S. stock market has enjoyed the fourth longest bull market in history. We've only had two 10-percent corrections in the past six years. Those were in 2010 and 2011. To Tom's point about past turmoil turning into a much more stable environment, in 2014 there were never more than three down days in the stock market in a row, something that we have never seen and will likely not see again any time soon. So I think we've had remarkable stability in the equity markets and fairly good stability in the broader economy as well, which we can talk about.

Slide six, I wanted to start with this. You really can't pick up a newspaper today without reading about oil prices. And when you look at the price of oil in the top chart there, the gray line shows you that the price of oil has essentially been more than cut in half over the past six months, which you all know. The blueish line on the top chart shows you the U.S. land-based rig count and you can see that that's only

just started to inflect lower now. The energy analysts at Baird believe that we'll need a rather drastic rig count decline to actually curtail U.S. production and that's what we show in the bottom two charts here on slide six. When you look at these scenarios, scenario one is a flat rig count. So with no additional rigs, we still see gains in product over time due to higher productivity. Scenario two is a 10-percent decline, scenario three is a 20-percent decline in the number of rigs that are active. You can see it takes that much, at least, just to flatten out the production in the major U.S. onshore basins over the next couple of years. So our analysts believe we're probably talking down 30 percent or more in terms of rigs in the U.S., probably in North America including Canada.

Bottom line here, while lower oil and natural gas prices are clearly a negative impact for that 15 percent of industrial production that is in direct producing industries, lower prices at the pump for you and me represent effectively a tax cut, if you will. The estimates are well over $100 billion for the U.S. consumer which, of course, makes up about two-thirds of the U.S. economy.

Slide seven, translating this to the industrial economy that we all focus on, so far we've really seen little impact and the overall environment has been very good. ISM has been above 50 nearly all of the time since 2009. Industrial production has been stable.

The public distribution companies here we single out: Fastenal, Grainger, MSC. In their monthly data, they've seen steady to improving trends. Fastenal reported their fourth quarter results this morning, their December average daily sales were up 17.4 percent. So we're seeing continued good strength among the public distributors. The OEMs represent customers of a lot of you and a lot of these distributors. Sales growth has been more volatile and it's clearly a trend worth watching as you look into the end of 2014. Certainly not as strong as the trends that we've seen among the distributors, so something we want to keep our eye on.

Turning to slide eight, capacity utilization you can see here is approaching the 80 percent level, which historically has been good for capital goods purchases. New orders for durable goods for the year of 2014 are tracking about up 5 percent year over year. November rating, that's the most recent rating, a little bit softer, just below 2 percent, but it was 8 percent year to year in October and September. So good strength, a little more volatile but good strength there.

And the U.S. dollar, in the lower right, you see has been particularly strong as of late. That's partially why commodities have been falling as most of them are priced in U.S. dollars. You're able to buy more copper, wheat, oil with a stronger dollar. According to Baird economist Bruce Bittles the good news about the stronger dollar is that it will keep inflation low during 2015. The bad news is that it will hurt top-line growth for S&P multinationals, which could impede their growth, impede their profits and that's mainly due to the currency translations as they translate foreign currencies back to the U.S. dollar. Given that PE ratios are already high by historical measures this represents somewhat of a headwind for large cap stocks, some of the smaller stocks or those that are net importers along with consumer based companies might do a little bit better. But I think we're going to have crosscurrents here that will lead to a more volatile stock market than what we've seen in recent years and certainly more volatile than last year which is unprecedented lack of volatility.

Historically, as it relates to distributors, a strong U.S. dollar usually translates to deflation. That's been a net negative for the public industrial distributors. As all of you know, deflation, even when you assume constant gross margin percentages, leads to fewer gross profit dollars leading to lower net profitability and that's something that none of us really hope for.

Slide nine. We're looking here specifically at nonresidential construction trends. The bottom line is that nonresidential construction broadened through 2014 and I have a few of comments from some of our respondents to the survey in a little bit to substantiate that. You really see the architectural billings index is now above 55, with 50 being the demarcation of growth. Construction spending, as it's reported by the U.S. government, you can see that we are on a growth trend. FW Dodge contract's up and commercial real estate loan demand is also solid. So signs of continuation of these good trends into 2015 are evident today.

On slide 10 we look at some of the residential construction trends. And here the residential construction market is certainly recovering but still far below the historical average as you can see in the upper left hand chart. The sub-industry dynamics are mixed. You can those below. We'll have more details on that to follow, but I think what you see here is we're seeing a recovery, a slow recovery in residential construction and existing home sales but still well below the peaks that we've seen historically.

So on to slide 11 where we get into details about the survey. I hope that big picture of macroeconomic

discussion was helpful in setting the stage here. Now, I'd like to drill down into some of the results from the most recent MDM-Baird survey. And as many of you know, Baird in conjunction with *Modern Distribution Management* conducts a quarterly survey which encompasses over 500 respondents across 19 subindustries of industrial distribution. The aggregate annual revenues of that group is usually over $100 billion and reflective of the very fragmented industry that we all know and love. Although we have some participants that are billion-dollar, multibillion dollar companies, about half the respondents have revenues of $25 million or less which is very representative of the industry that we have here.

For those who participate we thank you and we trust that you're seeing a high return on your invested time. If you do not, please shoot me an email. I'd be happy to include you. The participants in the survey get a full slide deck with much of the information you'll see on the following slide. And we just think this is some market intelligence that we're sharing amongst ourselves that you just can't get anywhere else. I think it's really good data and we would encourage to participate in the future.

Slide 12, you can see the 19 subcategories and this is the overall results from our third-quarter survey. We are, right now actually, completing the fourth-quarter survey. We'll have those results within a week or so. That fourth-quarter survey is closed but as I said, if you send me an email I'll send you the fourth-quarter results as soon as they're out and then ask you to participate in the first quarter survey in about 90 days' time and participate in those results, as well.

The key themes, though, having seen the third quarter as well as the fourth quarter results, are that broad growth in industrial trends continues. The revenue forecast for the fourth quarter and into 2015 points to continuing industrial momentum. Non-resi construction is particularly strong. Some of the manufacturing industries also I would say, product groups like cutting tools, hoses, pipe valves and fittings, safety products and electrical and datacomm – also some of the strongest categories.

Across the board I would say one of the key themes is that pricing remains challenging. We've seen this low inflation environment continue and that's led this subdued pricing trends through 2014, which we think will continue going into 2015 as well. Notable exceptions to that would be industrial gas categories where they're seeing decent improvement, as well as HVAC, which has some industry specific factors leading to better pricing there.

Moving to slide 13, we will go specifically into a few of these categories quickly and I'll give you some representative comments from the participants of the survey. First of all, industrial supply and general industrial – here think MRO, safety products, cutting tools, fasteners, etc. Industrial momentum has been sustained here, as I mentioned. Gross margin has been under pressure slightly and that's mainly because of the low-inflation environment and the industry trends at the larger distributors that we cover specifically of dealing with larger customers, national account type customers that put the pressure on gross margin.

The 2015 forecast predicts a steady demand environment, as well. We're looking for growth of about 4 percent and a continuation of the trends we've seen. A few other the comments, just quickly looking to 2015, generally they're thinking it's going to be a pretty good year. Many people saw a very strong time period between Christmas and New Year's, which is unusual but the streak is expected to continue. AmazonSupply, which we'll talk a little bit about in a bit here, is pretty much a nonfactor from what we're hearing. I think it's out there. There's a certain group that's using it, much less of a factor than I think people thought initially. I would say that the respondents to the surveys are much more concerned about what's going on at Grainger and MSC and McMaster-Carr than they are about Amazon specifically.

Pricing gains are limited, as I mentioned. And then finally consolidation, one of the respondents said the single biggest competitive threat to their business was the national accounts process. The technological advances of the past decade have really helped the big guys squeeze out the small guys. I think that's a trend we're also going to talk about a second.

On to slide 14, industrial gases. These are really later-cycle industries when you think about this. It's gas and cylinder rental, as well as safety products and welding hard goods including consumables and welding equipment. Trends here are strong. Seeing some positive pricing with some sporadic supply shortages. As we look to 2015 the outlook is positive for construction, metal fabrication and even some of the downstream energy and chemical which should drive some additional activity specific projects that are ongoing that should help this space specifically.

Some of the comments that we've heard from respondents would be around the fact that metal fab is particularly strong. Gas supply issues – they're out there but they seem to be alleviating today, things like

helium and argon which are coming back now. M&A activity has hit something of a soft patch. I think it's still out there. It's available, but it has not been happening just recently. And then finally price increases. In this industry specifically seeing good mid-single digit type price increases as is typical particularly in the late cycle.

Next, on slide 15, this category deals with a lot of the building materials. A lot of these would be residential but facilities maintenance would also be for repair and renovation of existing structures. The themes vary pretty widely here and I think they correlate pretty closely with what we talked about with the residential trends versus the nonresidential. Some of the categories of residential are doing well, things like HVAC, pool & spa. Some things are not doing so well, like roofing where there are some challenges and then nonresidential broadly I would say is getting better and is broadening out slightly. Some of the responses that we got from the survey and I think probably the most important is as it relates to the nonresidential environment seeing a broadening out. So if you go back a survey or two, we were hearing that they were seeing strengths specifically in some of the major metros. More recently we're seeing a broadening of that into some of the smaller markets and we're seeing more activity, more projects being led, etc. I won't go into too much detail about these submarkets. HVAC is particularly interesting right now. We can talk about that in the Q&A, if you care.

Roofing is challenging clearly, and, I think, with oil prices going down and asphalt being a key input to shingles, it's going to be a challenge this year as well.

Slide 13: electrical and datacomm. Here, again, nonresidential construction, that's showing good strength. We're also seeing a benefit from the move to data centers. And as that trend continues the cloud and so forth it's driving data center growth. It's good and bad. The positive is that it's growing. The negative is that you're consolidating a lot of that buying power with one large buyer instead of being spread out across all of enterprises across the U.S. And here, again, we're talking electrical. We're talking building wire, lighting, switch gear and industrial automation. Datacomm is cables, racks, raceways and all of the inactive gear that you would use to make a network. I won't go into any more detail about non-res; we said that's strong.

The one key factor here besides the trends in non-res and data centers would be copper, which if you're watching copper, much like oil, we've seen a pretty significant retrenchment over the past six months or so from north of $3 to about $2.50 today. We're hearing a lot of comments about that. It hasn't had an impact yet but it's certainly something that participants are keeping a close eye on.

The final subcategory we'll talk about today is pipes, valves and fittings. This category is not only for municipal, water and sewer applications but also industrial, which would include oil and gas applications as well. When you look at this category broadly, water and sewer are expected to do better than industrial. Within industrial, process industries and manufacturing, chemicals, etc., are expected to better than oil and gas. But even in the fourth-quarter survey energy is not as negative as I would have thought.

Now, what I would attribute that to is I do think that there are some projects that are wrapping up and we're seeing the tail end of that. We'll see what happens into 2015. Overall, with U.S. rate counts expected to be down by a third or more, you have to believe that the pipe, valves and fittings related to energy industry applications will be under pressure in 2015, both in terms of price as well as unit volumes.

To wrap up here on slide 18, the end of my comments, I would say cautious optimism into 2015. More potential headwinds, however. In terms of the stock market, we're coming off a period of unprecedented stability. There are crosswinds ahead, mainly the Fed raising interest rates I think is seen as a key factor across a lot of the topics we'll take about today. Macroeconomically, moderate growth is expected to continue. We talked about the drop in oil prices and how that's good for all of us as consumers, two-thirds of U.S. GDP and some of the specific issues there as it relates to industries. And then, finally, within industrial distribution we have some highlights here of what we just talked about.

But I think the overall tone is we're seeing a continuation of moderate growth and a lack of pricing across most of the categories of industrial distribution. So it should be another good year, maybe not a great one but a good one. And we'll leave it there. I'll turn it over to Jenel and we'll move on to the next section of the presentation.

Jenel Stelton-Holtmeier: Thanks, Dave, for all of that information. As we mentioned before we're going to go into the five predictions that we've identified for impacting distribution in 2015. These are the five things that we think are going to really drive what's going on in your businesses this year.

To provide a little bit of context for our discussion about these five predictions that we think will shape the industry, our team of researchers here at MDM is constantly talking with executives and leaders in the wholesale distribution industry. We're talking with experts in the industry and in business. And we conduct ongoing reader surveys and partner with other organizations, such as the quarterly survey with Baird that Dave mentioned, to keep the pulse on what's really happening in the industry and how distributors are responding.

We also closely track the 19 sectors that make up the more than $5 trillion wholesale distribution industry in the U.S. And then we'll also present some of the results of our recent survey conducted in partnership with the sponsor of this webcast NetSuite. The 2015 Outlook for Wholesale Distribution whitepaper will be sent to you as a follow-up for this webcast.

The five trends that we've identified for this year are that M&A will accelerate, talent management will deepen, digital strategy will be imperative, there will be a bigger drive towards operational excellence and we'll continue to hear some regulatory noise. Whether that will result in anything we don't know yet but there will definitely be some things for you to keep your eye on.

But before I get into those trends, I just wanted to touch on a few things that came out of the survey itself and just to follow up on what Dave was talking about. In our 2015 Industry Outlook Survey, we asked respondents about their revenue outlook for the 12 months ahead, as well. The interesting thing to note is how few respondents expect sales to be flat or to decline in 2015 – something we haven't seen in a long time. And you'll notice on this slide that only three sectors had any respondents expecting declines, and in those sectors the respondents who expect really strong growth of more than 10 percent far outnumber those looking at those declines.

So now to move onto the actual predictions. Our first prediction is that M&A will accelerate. 2014 saw a pretty good number of headline-making deals, and forecasts from a number of sources and experts say that we're just at the beginning of renewed consolidation. Here's just a small sampling of some of the M&A activity we reported on in 2014.

One of the biggest deals this year was obviously Sonepar's acquisition of Industrial Distribution Group. The deal here is representative of one of the drivers of consolidation in the industry: the desire to expand both geographically and through product and service offerings. Another good example of this was Kaman's acquisition of BW Rogers at the beginning of last year. After the deal, Steve Smidler, Kaman Industrial Technologies' president, told me that part of the attraction was in gaining a company that could be used as a platform for building its fluid power business.

Another notable trend from M&A that we saw this past year was a lot of activity in the building material space as represented on the right hand side of that slide. This was led by acquisitions by ABC Supply Company and US LBM Holdings. And a lot of other consolidators, including Bunzl and Applied Industrial Technology, picked up steam in their expansions as well. So we've seen a lot of activity but like I said going into 2015 we may see even more than this. So, Dave, what are you hearing over at Baird?

Manthey: Well, specifically and I think you have a chart here which outlines the expectations of our banking group and the past several years within the M&A environment. I think what you see here is that coming off a lull that we had in '08 and '09, we saw a resurgence in 2010 through 2011, a little bit of a retrenchment in '13 but a reacceleration in '14.

My banking group, some of the best in the business, obviously, advised IDG on that transaction. They expect things to continue for further growth in 2015 and the environment is right. And quite frankly when I think about why that is, when you think about the environment we're in, the range of potential buyers and sellers, I think, first and foremost the reason we're seeing so much activity is quite simply it's cheap money. What I mean by that is from a private equity standpoint, first of all there's about $465 billion of dry powder in global private equity buyout funds right now. That's up from about $180 billion 10 years ago, so massive growth there. With the low rates they're able to really get much more attractive returns with higher degrees of leverage.

Second, the strategic buyers, particularly the public companies that I deal with on a day-to-day basis, it's easy for those companies to make acquisitions and have them be EPS accretive. And even though I always look at deals on an enterprise value-to-EBITDA basis to judge value creation, a lot of the Street will put a multiple on earnings per share.

If these deals are EPS accretive, which they almost all are at current borrowing rates, they're seen as

being accretive deals and viewed positively by Wall Street. The types of deals that we see getting done would be those not just run-of-the-mill companies, but typically it would be either a service or solution. We've seen integrated supply, vending, VMI, solution selling. Grainger's done a few of those. So I think the deals that are getting done tend to have something a little bit more, maybe a capability or a technology or something that the buyer is interested in.

From an industry standpoint, industrial gas always tends to be the area where there's the most attention and the most chatter. HVAC, safety, some of those areas, also fairly active in addition to sort of any industrial supply company with some sort of angle as I talked about with a service angle.

And then finally, looking forward, I think that we're probably in a seller's market right now given the low rates and given the environment and all of the dry powder that's out there. As we move forward and as I mentioned earlier, if the expectations beyond 2017 are for rates to rise from 0 to 4 percent, all else equal that's going to make M&A a bit more challenging and so that's a factor. There's also industry-specific challenges like oil and gas today. There's a couple of clear acquirers or consolidators out there and we haven't seen a whole lot of deals lately. I think that's primarily because not only are some deals challenged at sub $50 oil, there's a potential that some of them are simply not viable at that level, as well.

I would say the environment, at least in the near term, remains positive. It looks like 2015 will be a good year. But as we move further and further down the road and rates move higher, I would say the pendulum starts to swing back the other way.

Gale: And, Dave, just to add to your comments, from what I've been hearing recently is one of the unique things that's developed here is across the cycles that I've covered over the last 20 years, you typically will get into an economic condition where either financial buyers or strategic buyers have clear advantages depending on what's happening with interest rates and some of the factors that you describe. But from what I've been hearing, right now and the expectations at least through 2015 and from what you say is potentially into 2017 is that there really is unprecedented competition for companies. And there are more and more buyers out there, people who are entering into sectors they hadn't been into but also more financial buyers coming in.

And just for reference somebody asked about M&A and shame on us. But M&A is the acronym for mergers and acquisitions. We're really talking about the companies that are up for sale, the whole market and the cycle for buying and selling companies in the different distribution sectors.

Stelton-Holtmeier: So basically, we'll have a lot of headlines still going forward on acquisitions is what I'm hearing here.

Gale: Absolutely.

Stelton-Holtmeier: Moving on to the next trend and that's the talent management challenge deepens. In the Industry Outlook Survey, we asked our readers what their top three business priorities would be for the next 12 months.

Unsurprisingly the top two were growing revenue and increasing profitability. This is business after all. But employee training was a relatively close third place on this list with 42.6 percent of respondents choosing it as a top priority for their businesses in the next year. We also asked an open-ended question about the top three business specific concerns and by far the most oft repeated responses revolved around getting, keeping and developing top talent. Nearly half of the respondents picked at least one if not all three of these topics as part of their top three business-specific concerns. Some respondents were focused on one or the other but it really was hard to separate them out just because they crossed over so much.

The difference this year compared to prior years is that it appears that companies are prepared to invest more time and money into making sure that they have the right people in the right places at all times. The industry is still challenged to find new employees to bring into the industry. A few years ago many employers had enough applicants to try and pick the quote-unquote "plug-and-play employee" as someone had mentioned to me at that time. But that's not just the case anymore.

Now, as one respondent noted, they want someone who is trainable and someone who will fit within the company culture. There's a specific set of skills they need but they're willing to take the time and effort to make sure that people have that.

But that may also mean shifting how you pitch your company to potential employees. Younger workers want more than a paycheck. They want to feel like they're contributing to something more than themselves. A study in November from The Conference Board highlighted the importance millennials place on working for companies that give back to the community. It's not just about how much money they're going to make. So you might have to sell your company as being part of that community as well if you want to get that top talent that's really focused on doing more.

The second piece of the talent management challenge is training. Respondents noted that the need to develop the technical skills of their team needs to be improved. That the sales force is becoming more professionalized requiring more skills and a different set of skills for that. There's a focus on developing leadership skills as other people leave the work force and they need people to replace them going up through the ranks.

This also plays a role in retaining top talent. Millennials don't necessarily want to change jobs. They just want to feel like they're continuing to grow and develop within a company, so there has to be time and effort placed on investing in those employees to make sure that they have a long-term place within your company. And as such professional development is becoming an increasingly important part of a company's HR strategy.

Gale: Yeah, you know, Jenel, the interesting thing in this area that I've been seeing and hearing from many people is that with retirements, a lot of industry knowledge has been leaving companies and there's been this gap to replace. It's been a difficult challenge, I think, partly because of some of the factors and focus on just trying to recover from the recession.

Up until the last year or two, companies really couldn't focus on looking out a little bit farther. So I think some companies have been caught a little bit short in this area, and I think that's why we're starting to see this now. Particularly there are a couple of areas, the sales aspect that you mentioned in particular, in terms of skill development there.

The other added dimension here is and, of course the trends we talk about here aren't all siloed, the whole adoption of technology has really accelerated so much in the last 12 to 24 months that you're also seeing this skills gap in terms of the different aspects of technology, whether it be in digital aspects or analytics is another area that we've certainly seen in terms of people really looking for new skill sets to bring into the company to try to move forward.

Stelton-Holtmeier: And that's a perfect transition into our third trend which is that digital strategy is imperative. Technology investment, as Tom mentioned, has been a continued priority. We asked survey participants about their plans in this area for the next 12 months and fewer than 10 percent of respondents said that they had none. As in last year's survey, as you can see in this chart, customer relationship management was the top focus, with e-commerce right behind. There's a lot of different areas that companies are investing in.

Ranga Bodla: Yeah, it's really interesting, Jenel. This is the fourth year now, I think, that we've been doing this survey with MDM and we appreciate the partnership. But what's interesting is, I think, the CRM and e-commerce piece has continually come to the top of the things that people are looking for. I think it's just consistent with where things are going.

A few years back when we asked this question and we kind of got some of the color behind it, right, it was a question of "We're kind of exploring e-commerce, we're kind of thinking about it." The following year it's like "Okay we know we need to do it. We just need to figure out how we're going to get there." I think now we're at this point where everyone is like "We've got to go get it done and we're either already on our way in that journey or we're late to the game." And the people that are late to the game, especially, are trying to figure out "How do I catch up?"

The people that are – maybe have already started a strategy are trying to figure out how do I now implement strategy that I put in place? So I definitely think it's really interesting to watch how this has been consistently happening over the last four years that we've been doing this with you.

Stelton-Holtmeier: Definitely, and that change in thought process is also showing through in that more people were mentioning that they recognized that they're on outdated systems now, whereas four years

ago what we were hearing was that "Our systems work, why do we need something new?" This focus on investment in all of these platforms is becoming much more important.

But adding to the complication is this idea that there are so many options out there for software that that in itself is overwhelming to a lot of people. That's become one of the technology challenges: How do you choose the right software? So we're going to see distributors focusing much more on finding that right piece of software – but one that can integrate with their other systems. They recognize that these systems need to communicate and work with each other much more cohesively. And part of that is this drive towards big data. Most distributors aren't there yet but there's this shift in mind set towards getting there. They want to be able to get that usable data out of all their technology platforms that they can put together.

Bodla: I was just going to say this is very consistent with exactly what Tom said about people looking for folks with analytics expertise and how do they go and find information and data within their organizations. So very consistent with that talent management challenge as well.

Stelton-Holtmeier: Absolutely. And as Tom mentioned a lot of this is cross disciplinary. Everything kind of ties together.

One of the other interesting things from the survey though was the fact that mentions of AmazonSupply dropped off dramatically, probably, in part, because as Dave mentioned, it's no longer the unknown. We kind of know where it's at and it's really a nonfactor for a lot of people so far.

But in its place, more people are talking about Alibaba – the new unknown. Alibaba's blueprint in China was to create an online marketplace for manufacturers, particularly small manufacturers, to level the playing field for companies that really were not known and needed some sense of credibility. So instead of just doing what Amazon does and allow people to just sell on it, what Alibaba had done in China is it provided consultative services to help lend that credibility and get these unknown companies in front of new buyers, particularly in the rural areas of China where they may not have had access to these types of products before.

This was for manufacturers, this was for distributors, this really was B-to-B and B-to-C. I've heard it referred to in China as the dating site for buyers and sellers of all types. We don't know what kind of impact it's going to have in the U.S. and Europe right now. We do know, however, that it is targeting growth in these two areas. We have to just watch to see what it is in the future. But one thing I can tell you is that if you want it, it's pretty much guaranteed you can find it on Alibaba at this point. Whether it's the cheapest place or the best place to get it, that I can't tell you yet.

Bodla: I'd echo what we were seeing. We're seeing the exact same conversation. AmazonSupply, I think, it's like you said, the unknown factor when that first came out. And now we're seeing more and more questions about these unknown factors. I think it's more they understand where it is. They understand how it fits into their strategy.

I think probably the only other comment I'll make about just kind of AmazonSupply and Alibaba, in general, probably the biggest thing that it highlighted was the need for people to really be thinking about e-commerce and how that effected them. And be able to take lessons from what they built as far as a consumer grade experience for distribution.

Stelton-Holtmeier: Great. Our fourth area is operational excellence and Tom would you like to take the lead here?

Gale: I'd love to. Thanks, Jenel. Sort of continuing our connecting the dots theme here, operational excellence certainly isn't anything new, but I think a little bit of what our survey has indicated this year is some of the different ways that people are connecting the dots and what some of the priorities are.

The top aspect with nearly two-thirds of our survey respondents was that improving employee productivity was really one of the ways they really were looking to cut costs, operational costs over the next 12 months. That's shifted quite a bit. If you look down the list here, it used to be very much product focused, process focused. We're starting to see some different priorities come into place.

The whole aspect of reducing transportation costs is also continuing to rise. Dave mentioned a few

things related to the transportation and the shipping and logistics aspects. Again, there's a lot of cross-currents going on in there that definitely have an impact on 2015 in terms of some of the negative things, such as the current driver shortage. Certainly Mexico shows a lot of promise in terms of really starting to shift the equation here in North America, but with the security issues that's potentially still a few years away. But there's continued optimism that's really going to be the next growth arena here in North America.

Finally, the West Coast port dispute definitely continues to put a drag.

The other aspect in this survey here and what's been interesting is actually inventory trends. Vending really didn't make as much noise in our survey this year as it did last year. That said, I think it's really just been more of a maturing and it's become much more embedded as a segment of the industry and one that is still highly competitive and being carved out particularly by the large players. Dave, I'd be really interested in your thoughts as you cover this arena so closely.

Manthey: Sure. To cross over a little bit here from e-commerce into vending on the e-commerce side, we saw a study that said 90 percent of organizations are supporting corporate applications on personal mobile devices. I think that just tells us where we're going and the comfort people have with that technology.

The e-commerce as these companies, the Fastenals and the Graingers and MSCs, define it continues to rise, growing 10 or 20 percent-plus within this categories. MSC defines it as anything that has electronic components, so they put vending in with that, but they've seen over 20 percent growth over the past four years compounded annual growth rates.

Finally on Fastenal, they're at a point where right around 40 percent of Fastenal's revenues are coming from customers that at least have a vending machine. They've got over 30,000 of these things out there in the wild, and they're probably going to put in another 5,000 this year. So it has some implications for their business. It's obviously a solution that resonates more with larger or national account type customers and that has implications for margins and so forth.

But even though it may have died down in terms of interest lately among the surveys and so forth, I would say the large public distributors, even including a company like Now Distribution, DNOW, which is in the energy space, they've got vending machines. I mean this is a big push by the companies that have a lot of working capital, a lot of capital to deploy on these machines and the ability to keep them filled and have high fill rates and high service levels for the customer. It's definitely not slowing down as an initiative among the large public distributors out there.

Gale: Thanks, Dave. The final piece of the inventory trends and some of the shift that we've seen is really an increase in supply chain services. Really some niches starting to develop there and a lot more interest by many distributors in terms of developing that as a revenue stream and a profit center and really looking at how they can develop those capabilities. Any thoughts on that?

Bodla: So Tom, I've been seeing this is a really interesting trend that you're seeing demand for management supply chain. I think it kind of comes back to the previous trend we talked about with analytics. In general people are looking at what's the best mix between doing third-party logistics, doing their own management, their own warehouse, where do they put inventory?

But making sure that as they distribute their inventory how do they understand where it all is, how do they make sure that they're tacking it, where it's in containers, things like that. I think it's just there's a lot more moving pieces and that's about reducing costs and inefficiencies. But at the same time there's some greater management challenges as part of that.

Gale: Great. Thank you, Ranga. Let's go to our final piece here and Jenel let me hand it back to you to talk about the regulatory noise.

Stelton-Holtmeier: Great. I won't spend a whole lot of time on this but it was raised as a concern or a pain point by a number for respondents and there are a number of issues that distributors and manufacturers need to take note of.

The first thing though is that we have a new Congress, but what does that mean particularly on the

regulatory front? We don't know yet. We don't know if it will have a big impact but one of the things they've already brought up is calling for a public input on regulatory matters. This bill passed the House. It hasn't progressed any further yet, but that could change the dynamic of what happens with regulations if somehow they manage to get this through the President.

On the regulatory front, there are, like I said, several actions that you need to keep your eye on. First, the implementation of chemical labeling changes goes into effect in 2015. For manufacturers, it goes into effect the summer. For distributors you have to sell through your old product with old labels on it by December.

Another thing is they're looking at expanding overtime eligibility which could have a huge impact on a lot of different businesses. Business crowd-funding is being reviewed, which could impact angel investors in your business. And streamlined union elections, which a coalition has filed a lawsuit against a rule that was passed; it finalized in December to do the quickie union elections. We'll see what happens and we'll keep an eye on what happens out of the courts with that.

These trends are all very important, obviously, and they're ones that we're going to continue covering over the next year and that we'll update in our annual Distribution Trends Report, which will be released in June.

If you're not a subscriber, I recommend going to www.mdm.com/subscribe to sign up today. And let me know if there's anything I can add to what we're doing to give you the best coverage possible. So now I'm going to hand it back over to Tom for some final thoughts.

Gale: Great. Thank you, Jenel and we do have a little bit of time here for Q&A. We'll get to as many questions as we can here as we come up to the top of the hour.

I have one here to start and going back to vending, Dave. Profitability was a factor not long ago and people were talking about that and I think it came up on the radar screens in terms of Fastenal because they were just expanding so fast with that. Can you give us a little bit of an update in terms of where does that stand in terms of vending and profitability?

Manthey: Well, the profitability of vending solutions, particularly of Fastenal, they are lower profit sales but maybe not for the reason you think. It's primarily because it impacts the mix of products they're selling.

If you've seen a FAST 5000 machine, it's got the helix, almost like a candy bar machine where it has a spiral and the product drops down into the receptacle. These really aren't suited for fasteners which is Fastenal's highest gross margin product. So they're selling a lot more in terms of safety and personal protection and Sharpie markers and fluorescent green safety vests and things like that, which are much lower margin for Fastenal and for everybody.

There is a lower cost to serve for that because they have much better visibility into the supply chain. They can set mid/maxes and they know when the customer is going to run out in a particular machine that can get it stocked more effectively. So there's a lower cost to serve but I think because of the mix it's just going to continue to put some pressure on gross margins, in particular.

Gale: And, Dave, I just have to say that in the 20 years that have I been hosting both audio conferences and webcasts, that probably ranks right up there with one of the most unfair questions to ask in a matter of a minute or two on a topic that probably we could easily take two or three hours to really adequately explore, so I just wanted to acknowledge that. And thank you for a very concise and good answer in a short amount of time.

We do have a number of other questions here and let's just dive into a few of them. Why do you believe AmazonSupply is a relative non-factor?

Manthey: Is that for me, Tom?

Gale: Well, take a whack at it. I certainly have an opinion. If you do, I'd be happy to have you take it.

Manthey: Yeah, I'll keep it fairly short here too. I think there is a customer for that type of solution. Clear-

ly, if a handful of us went out and started a machine shop and we were looking for a Rubbermaid garbage can, we could spend a half hour searching around finding the cheapest one.

But as it relates to procurement of product that's being ordered quite frequently, in some cases unknown product until you need it, it doesn't necessarily lend itself to that type of solution.

And I would just point to the survey that we've done, again, $100 billion worth of distributors told us, out of all of those folks, 1 percent said they're seeing a significant impact from Amazon. Ninety-three percent said they're seeing no impact to their business from Amazon. So I would say that's effectively what's going on out there according to all of you and the people that are responding to the survey.

Gale: Ranga, what are you seeing?

Bodla: I'd say it was coming back to that comment that Jenel made. It's less about the nonfactor being, I think, originally it's like this is going to turn the whole industry upside down, the unknown around it and what it was going to do, right, just like what they did in some of the other industries that they went into.

I think that you're not seeing that same impact that they were expecting. As people get to know what it actually is, I think Dave brought up some good examples here. Where I think the biggest impact, again, I'd come back to is the drive and the push that "Hey, we have to broaden our reach and we need to be able to be aligned and at least have that as an option." I think that's probably the biggest factor. But in terms of is it directly effecting actual revenue because people are going to Amazon instead, I think they're seeing less of that in a lot of these industrial sectors.

Gale: Yeah, great, thank you. I'd like to just take a pause here because we are coming up at the top of the hour. I'd like to be respectful of people's time. What I'd like to do is hand it over to Ranga to just talk for a few minutes here and then we'll come back to the top of the hour here.

What I'd like to do is we can continue with some Q&A here as we do move into the first five minutes or so of the top of the hour. But Ranga, let me hand it over to you here. I would like to give you an opportunity to allow you to give people a little bit better idea of what you're doing in NetSuite. And then we'll come back to a few final questions.

Bodla: Thanks, Tom. I appreciate it and I'll go fairly quickly. For those that aren't familiar or haven't or don't know who NetSuite is we've been working with MDM. We've been partners with them, partnering on a number of different publications with modern distribution management.

And the big part of it is, we view ourselves as helping companies transform themselves and a big part of that is working closely in the distribution industry. So if you aren't familiar with us you know we can obviously there's more time to at a later point to go and talk more about what we do. We are a publicly traded company. We've been around since 1998, over 3,500 employees, continuing to grow quite rapidly. But I think the big thing is the number of organizations and distributors around the world using NetSuite to really run their business.

And so we're really focused on how do we drill over that integrated suite that delivers the analytics, delivers commerce and delivers the entire foundation for a business to operate and run itself? And we're seeing that people making those choices as they're looking at technology as a new thing. And the reason we partner with modern distribution management is we see a lot of synergies with what we're doing and the needs of requirements that we see for modern distribution management.

So I'll just end quickly with the big thing that we see which is the transformative results we're seeing from companies adopting NetSuite which is huge improvements in inventory costs, gross margin, IT support, as well as the actionable insights they get from the information. So with that I'll turn it back over to you, Tom, just to go ahead and last minute questions and go ahead and wrap us up.

Gale: I appreciate it and thank you so much, Ranga. There are a few here that relate specifically to a little bit of the discussion that we had around Alibaba and AmazonSupply. Is Alibaba a site for excess inventory to be sold as well?

Stelton-Holtmeier: Well, I'll go ahead and take that. Absolutely, Alibaba can be used by manufacturers or distributors to sell excess inventory. Really it tries to be, it wants to be the marketplace for everything. So

that may be a great starting point for someone who wants to sell on Alibaba.

Gale: Thanks, Jenel. I have another question here, and, Dave, you might have a perspective on this in terms of what you're seeing. Given the dropping price of oil and low interest rates, how effective are distributors in pushing through manufacturer price increases?

Manthey: Well, what we've heard so far is not very. I think it's widely known out there that inflation is pretty subdued. There's not a lot of inflation so when manufacturers come with their typical annual price increases, they're getting quite a bit of pushback. And that was one of the comments we heard from the fourth-quarter surveys that there is expected to be much more pushback this year in terms of actually accepting and trying to push through price increases.

And then clearly, there are some areas that will be directly impacted, whether that's copper prices' impact on high gage wire and cable or any sort of derivative of that. Like I mentioned asphalt is related to shingles prices and so forth. So some will get impacted significantly to the negative. Others, I think, it will probably be very flat with the one exception being the FedEx, UPS price increases might lead to slight increases as people's logistics costs have gone up but other than that it's looking pretty flat right now.

Gale: There's a question here about are more distributors looking for cost rollbacks versus increases. Are you seeing any trending in rebates or those types of directions?

Manthey: I am not. I think they'll be the pushback. And, again, if what you're selling has a direct line to one of these commodities that's rolled over hard or cut in half in the case of oil, you're going to have issues. If not, of course, there's labor components, there's logistics, there's technology and so forth in some of these products where it's less of a factor in commodities, less of a factor. But I haven't heard anything specific. I would just anticipate in those commodities where you have a direct line to product there's going to be turmoil in 2015.

Gale: When you were talking about Fastenal you mentioned, I believe, it was, you got my attention with a more than a 17 percent increase in December, I think. Can you just give a little bit more color to that in terms of my recollection was that November and December were both short months in terms of selling days. Is that indicative of specific sectors, specific to Fastenal or is that more general in terms of specific end market activity?

Manthey: Well, I think that level of growth is specific to Fastenal and there have been some things they've done internally in terms of adding people in order to drive that level of growth. So I wouldn't just have a broad statement and say that's what everyone is seeing.

Having said that, the trends continuing through year-end we heard from a number of respondents to the survey and my associate Luke Junk who talks with a lot of the people that participate one on one, they saw unusual strength between Christmas and New Year's to an extent that it actually became a trend. I mean you hear from seven or eight people and it becomes a real thing.

And so I do think that the strength – and I'm speaking broadly here – but I do think the momentum that we've seen of good growth is continuing into 2015? We haven't seen a change in trend yet but that level of growth at Fastenal, I think a lot of it has to do with what's going on at the company and the people they're adding and so forth as opposed to the market is accelerating to the extent that they're seeing.

Gale: Well, and what a wonderful way in terms of your comments about continuing growth into this month and beyond to end our discussion today. Thank you very much for that, Dave.

Just a final thought from putting this together and our conversation here is that our five predictions here in some ways aren't new, but we're definitely seeing different ways that people are combining some of these and the focus that's taken place across some of these areas. And it's starting to define differently what's taken shape here this first quarter, and into the second quarter I think. So it will be very interesting to see how this year shapes up.

And with that, thank you so much, Jenel, Ranga and Dave. I very much appreciate your comments today. With that, thanks very much, Happy New Year to all, and this concludes our program.

mdm webcasts

THE 2015 DISTRIBUTION INDUSTRY OUTLOOK

Featuring: David Manthey, Tom Gale, Jenel Stelton-Holtmeier & Ranga Bodla

January 15, 2015

Produced by:

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Agenda:

- **Introduction** – Tom Gale
- **Economic & End-Market Outlook** – David Manthey
- **5 Predictions for Distribution in 2015**
- **Q&A**
- **Close** – Tom Gale

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Industrial Research
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The 2015 Industry Outlook

In partnership with Modern Distribution Management

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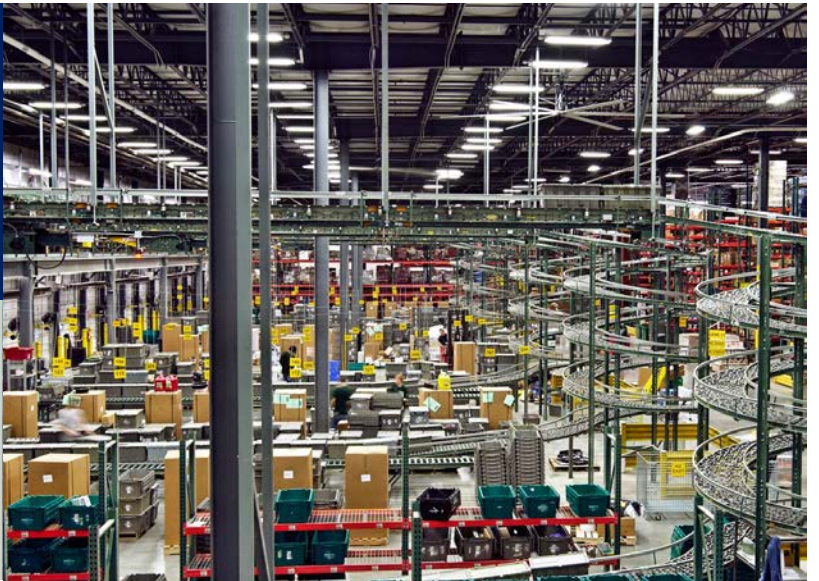
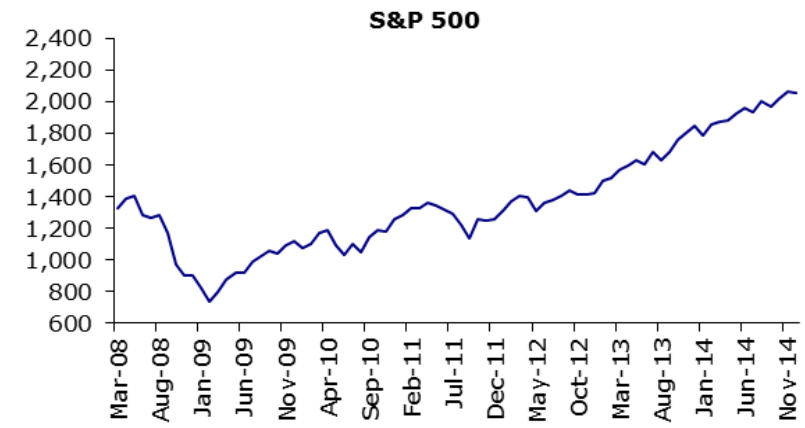


Please refer to Appendix:
Important Disclosures and Analyst Certification

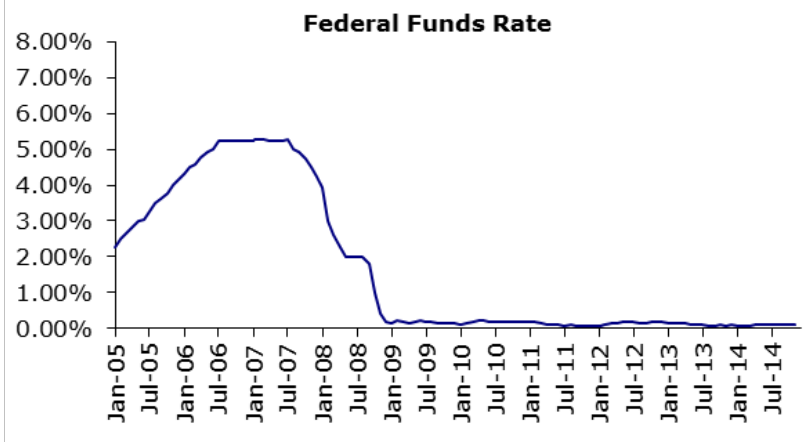
Overview

Macroeconomic Commentary

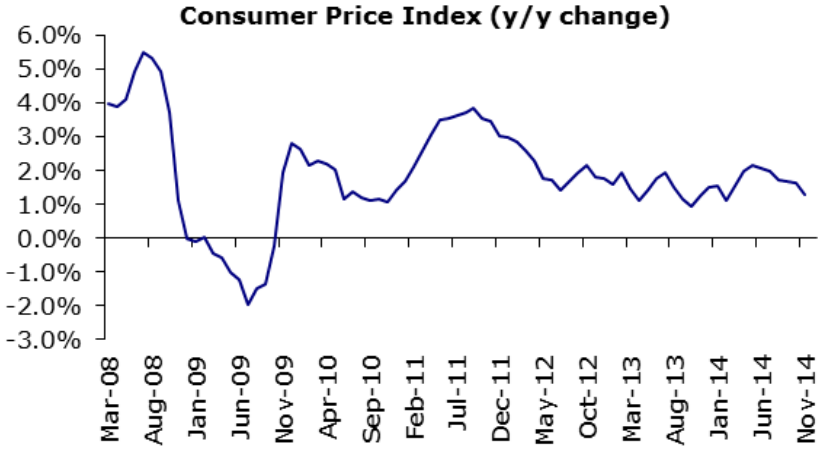
"4th Longest Bull Market In U.S. History"



Interest Rates Remain Low



Inflation Subdued

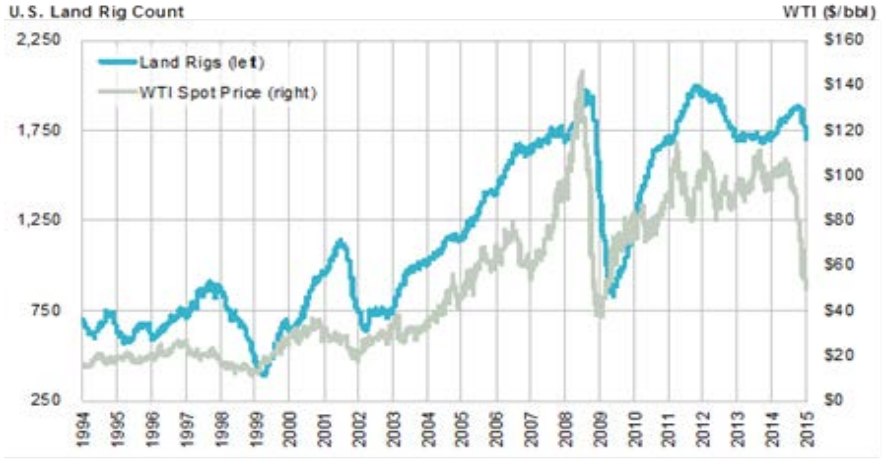


Unemployment Rate Down Significantly

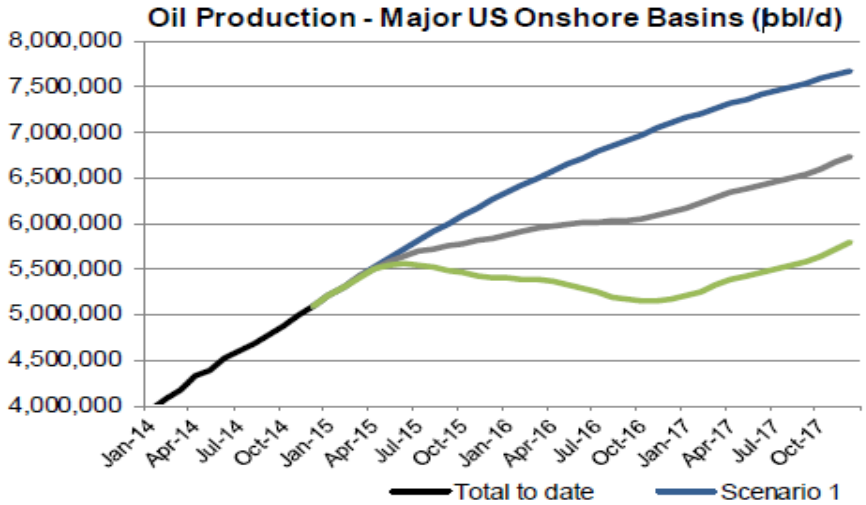
Source: Baird Analysis

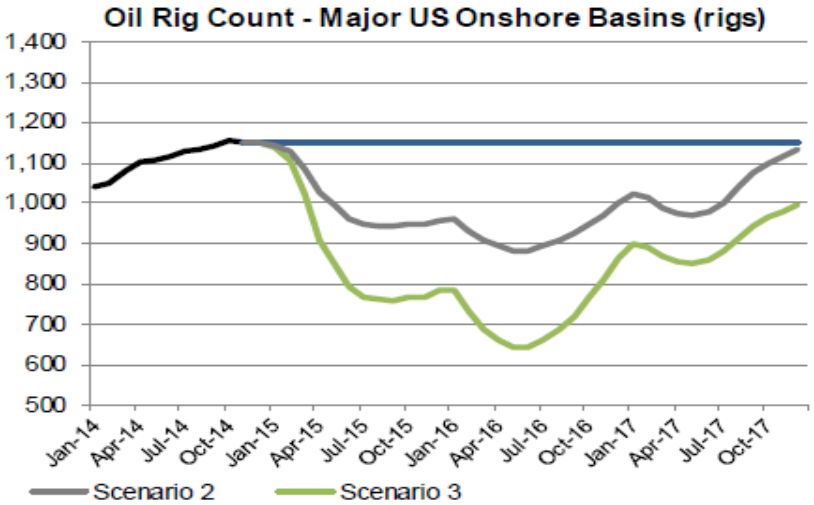
Overview

Oil & Gas



Source: BHI, Bloomberg, Robert W. Baird





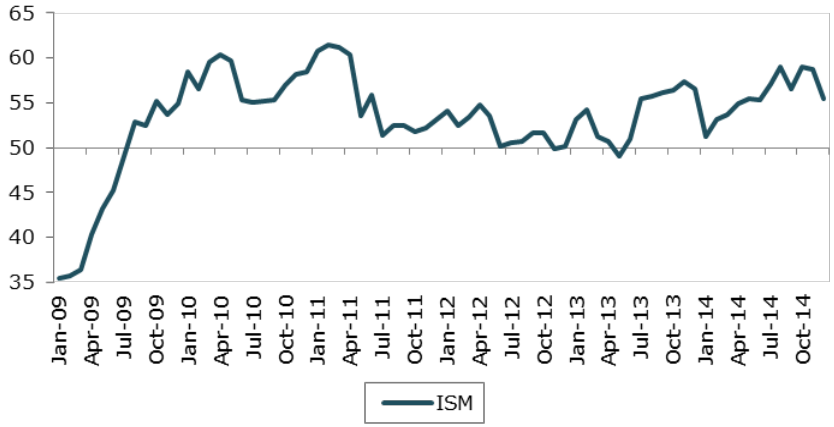
Source: Baird Energy Research Team

Source: Baird Analysis

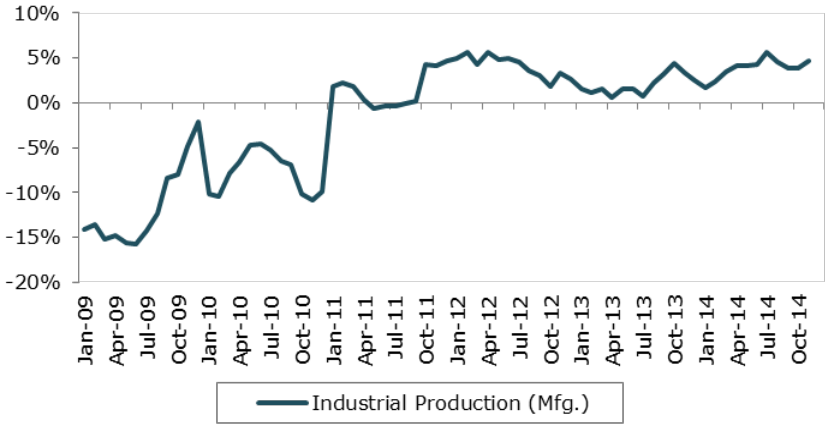
Overview

Industrial Economy

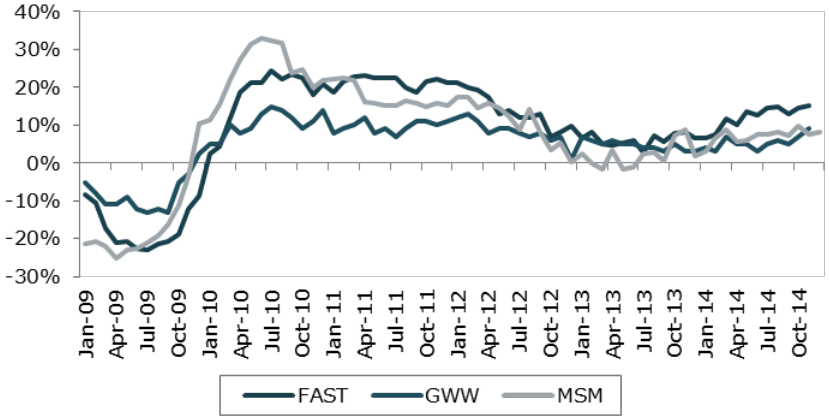
ISM Solidly Above 50



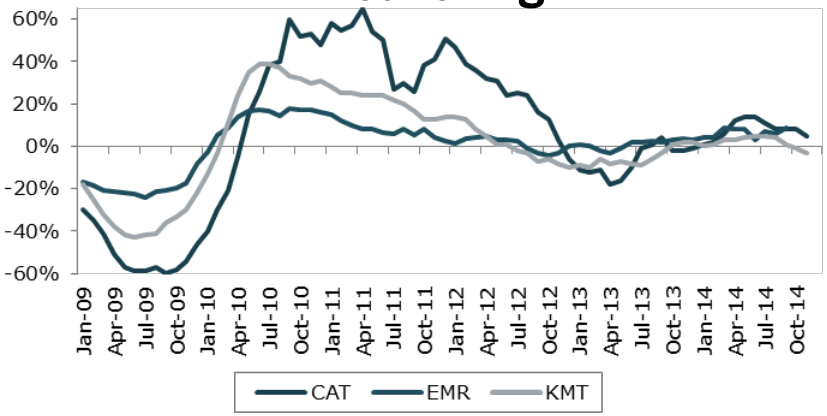
Manufacturing IP Stable



Distributors Strong…



…Although Manufacturers Weakening

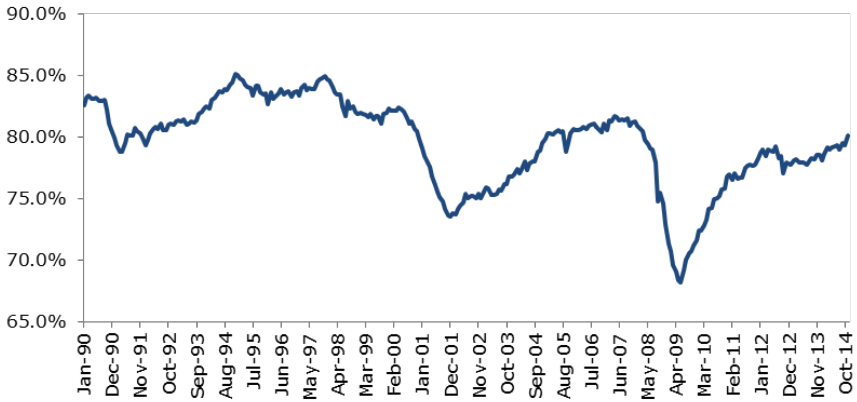


Source: Baird Analysis

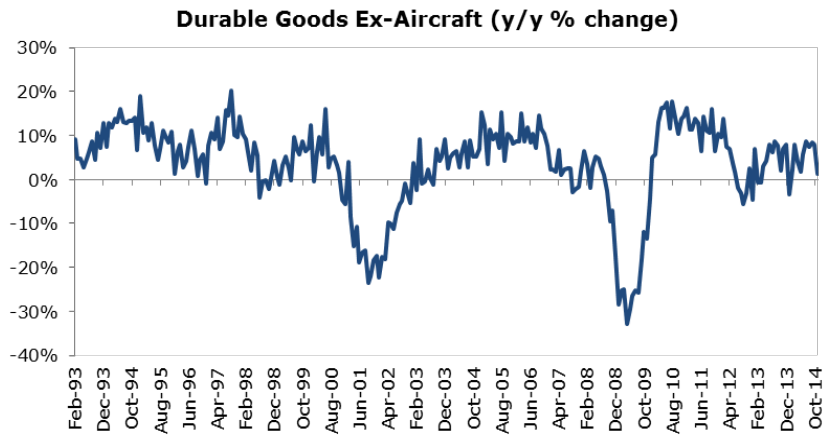
Overview

Manufacturing

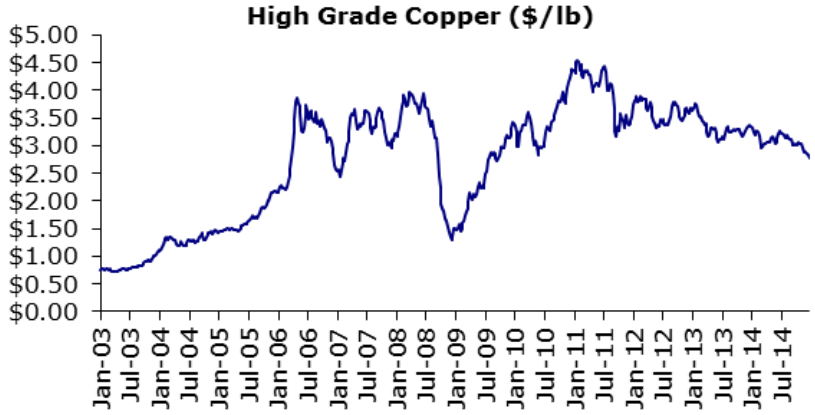
Capacity Utilization Rising



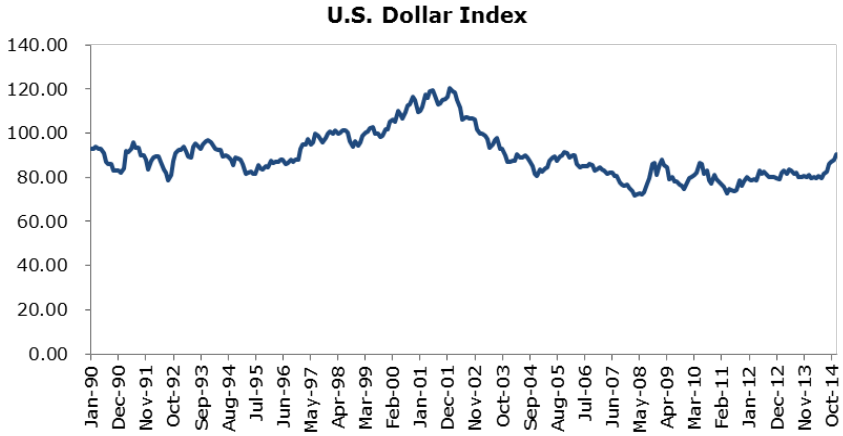
Durable Goods Orders Healthy



Copper Prices Falling



U.S. Dollar Strong

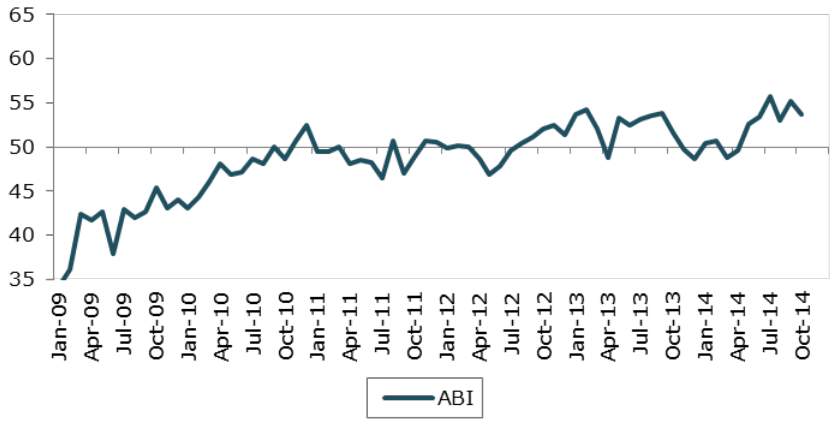


Source: Baird Analysis

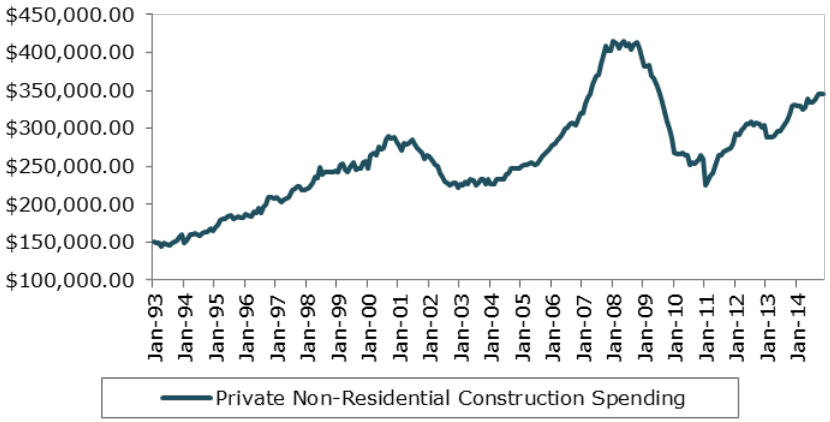
Overview

Non-Residential Construction

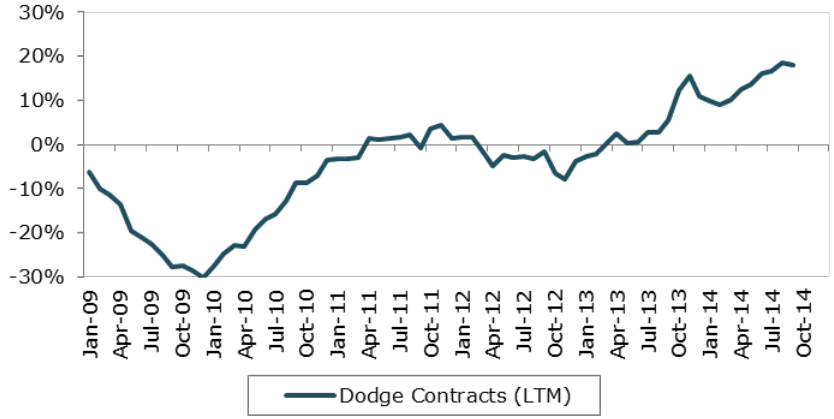
ABI Index Above 55



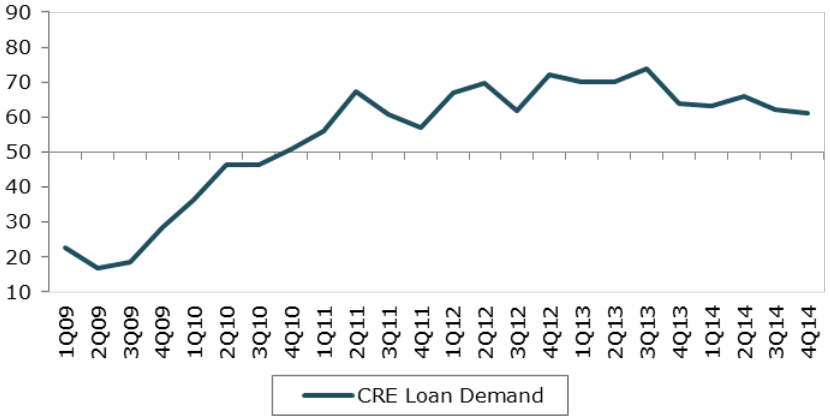
Construction Spending Trending Up



Dodge Gains Continue



CRE Loan Demand Also Solid

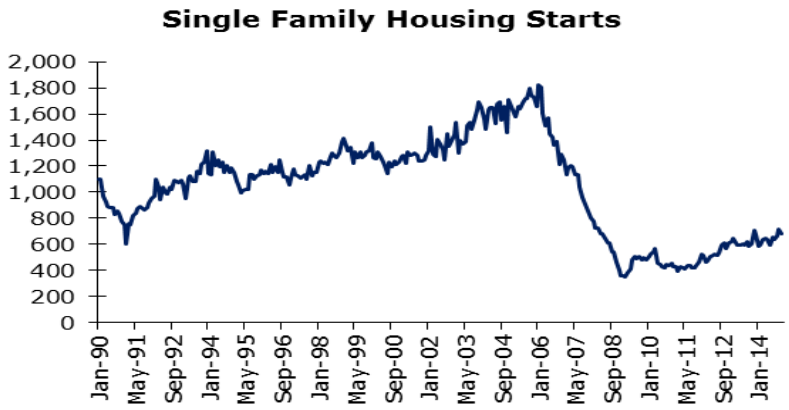


Source: Baird Analysis

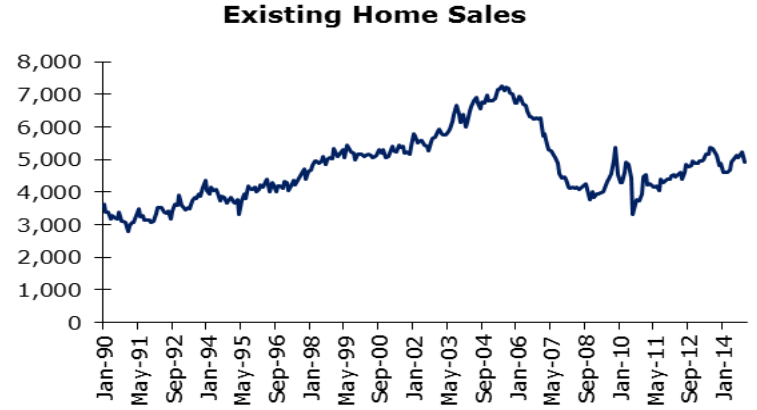
Overview

Residential Construction / Repair

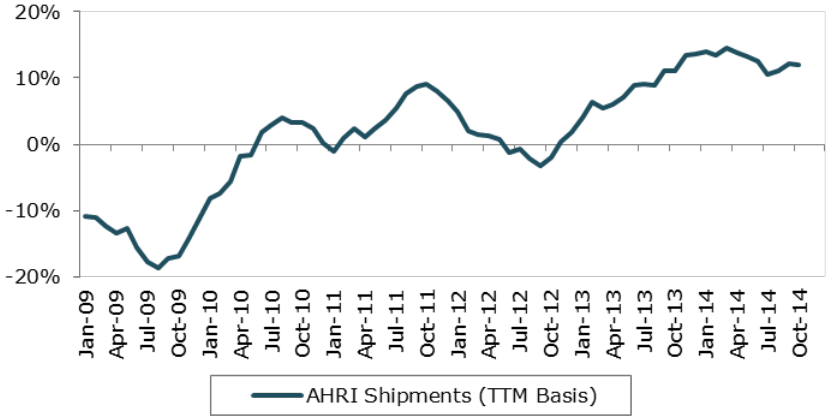
SF Housing Starts Slowly Recovering



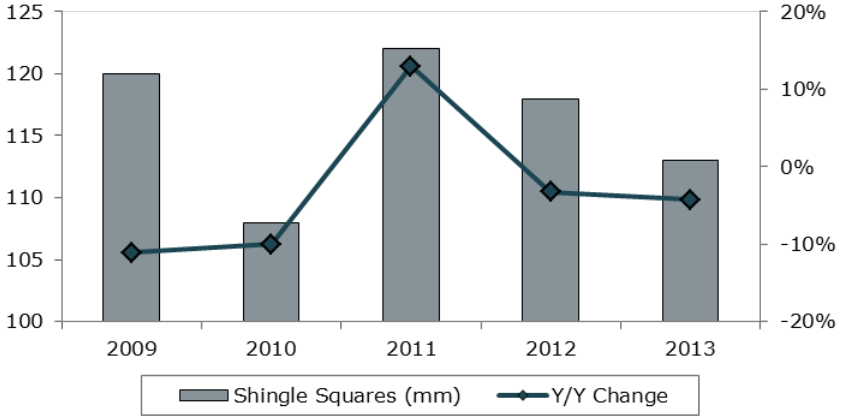
Existing Home Sales Take a



AHRI Shipments Remain Strong



Shingle Growth Lackluster

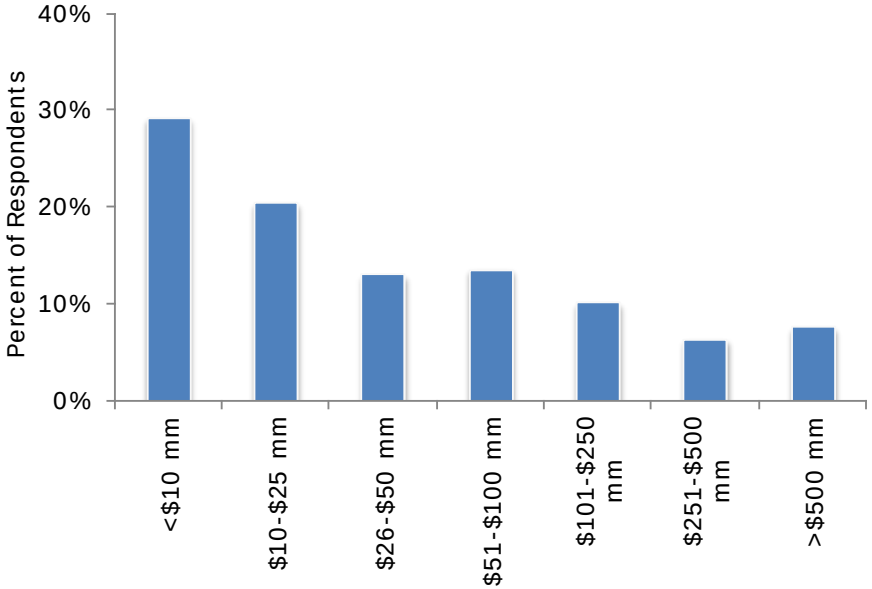


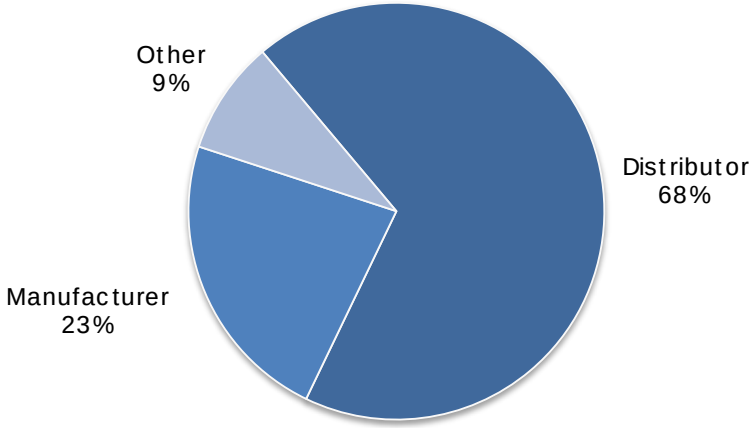
Source: Baird Analysis

Baird Industrial Distribution Survey

Overview

~500 Respondents / ~$100 Billion Aggregate Annual Revenue





Source: Baird Analysis

Baird Industrial Distribution Survey

Overall Results

	3Q14 Revenue Growth	3Q14 Pricing	4Q14 Forecast	2015 Forecast	Robert W. Baird & Co. Commentary
Hoses & Accessories	6.5%	1.0%	5.1%	6.9%	Highest 2015 revenue growth forecast in the survey
Cutting Tools	4.5%	1.6%	5.8%	6.5%	Trends at machine shop customers remain healthy
Datacomm	7.4%	1.3%	5.5%	6.1%	Continued shift to larger data centers a longer-term secular negative
Pool & Spa	3.2%	0.6%	3.5%	6.0%	Positive industry trends partially offset by cool summer in Snowbelt
Fasteners	2.7%	0.6%	2.9%	4.7%	Import prices out of Taiwan have risen slightly
Welding Hardgoods	3.4%	1.6%	3.8%	4.7%	Metal fab trends remain strong, driving improved consumables
PVF - Water & Sewer	5.3%	2.0%	3.0%	4.7%	Geo-political concerns could weigh on pricing
Plumbing	6.6%	1.2%	4.4%	4.5%	Competitive chatter remains high
HVAC	3.5%	0.6%	4.3%	4.2%	Cool summer weighs on industry growth, heavy 13-SEER pre-build
Electrical	4.8%	1.1%	4.9%	4.2%	Non-residential construction recovery expected to accelerate in 2015
General Industrial (MRO)	3.7%	1.3%	3.8%	4.1%	Improved industrial momentum sustained
Overall	4.4%	1.1%	3.8%	4.1%	
Roofing	1.8%	-0.3%	-0.6%	4.1%	Shingle pricing pressure increases (spotty demand/high inventory)
Gases & Cylinder Rental	3.0%	2.4%	3.4%	4.0%	Argon supply issues surface, as expected
Mechanical/Power Transmission	3.4%	1.1%	3.4%	3.6%	Second quarter of 3%+ growth following six flat-to-negative quarters
Safety	4.9%	1.6%	2.7%	3.6%	National distributors pushing the (purchasing) advantage
PVF - Industrial & Energy	5.8%	0.5%	2.0%	3.3%	Oil & gas resurgence continues, but margins coming under pressure
Building Materials	1.4%	0.3%	2.8%	2.8%	Pricing closer to flattish despite higher lumber prices
Facilities Maintenance (MRO)	3.1%	1.4%	2.6%	2.6%	Overall industry momentum remains positive
Rental Equipment	1.9%	2.0%	0.4%	0.8%	Higher capexmay be leading to lower rental welder demand

Source: Baird Analysis

Sub-Industry Themes

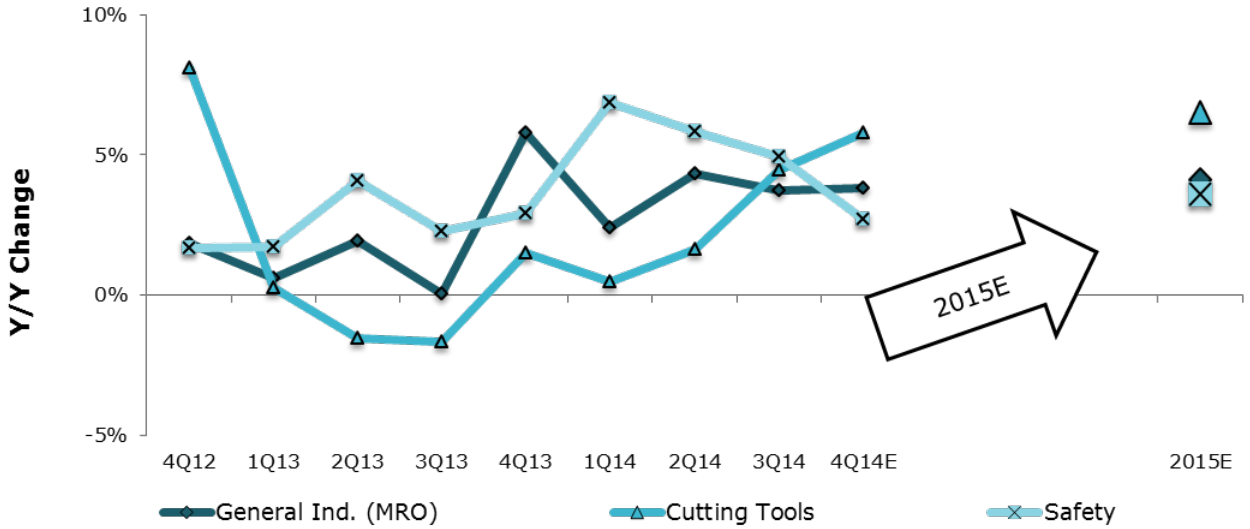
Industrial Supply / General Industrial

Current Conditions

- **Industrial momentum sustained.** The U.S. industrial economy appears to have maintained solid growth through the end of 2014, although gross margin continues to be pressured due to the low-inflation environment and industry trends such as the outsized growth of national account customers.

2015 Outlook

- **2015 forecasts predict a steady demand environment.** Survey participants overall see industry growth of ~4% in 2015, with only a modest improvement in selling prices. E-commerce and vending initiatives remain top-of-mind for industry players, while AmazonSupply continues to be a relative non-factor.



Source: Baird Analysis

Sub-Industry Themes

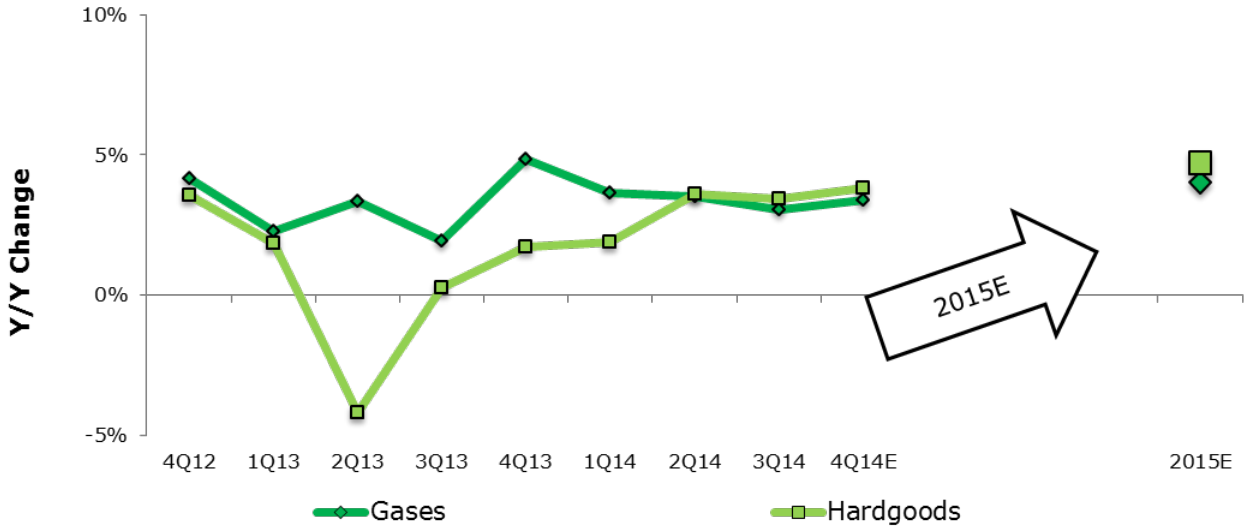
Industrial Gases

Current Conditions

- **Industrial gas companies benefitting from later-cycle dynamics.** Steady volume growth continues across all three major delivery modalities, augmented by pricing tailwinds driven by sporadic supply shortages. Additionally, customers remain positive on capital spending plans leading into the new year.

2015 Outlook

- **End market demand trends to remain strong.** Construction, metal fabrication, and downstream energy/chemical activity should continue to support industrial gas strength into 2015, particularly in the US, while international trends are generally less-favorable.



Source: Baird Analysis

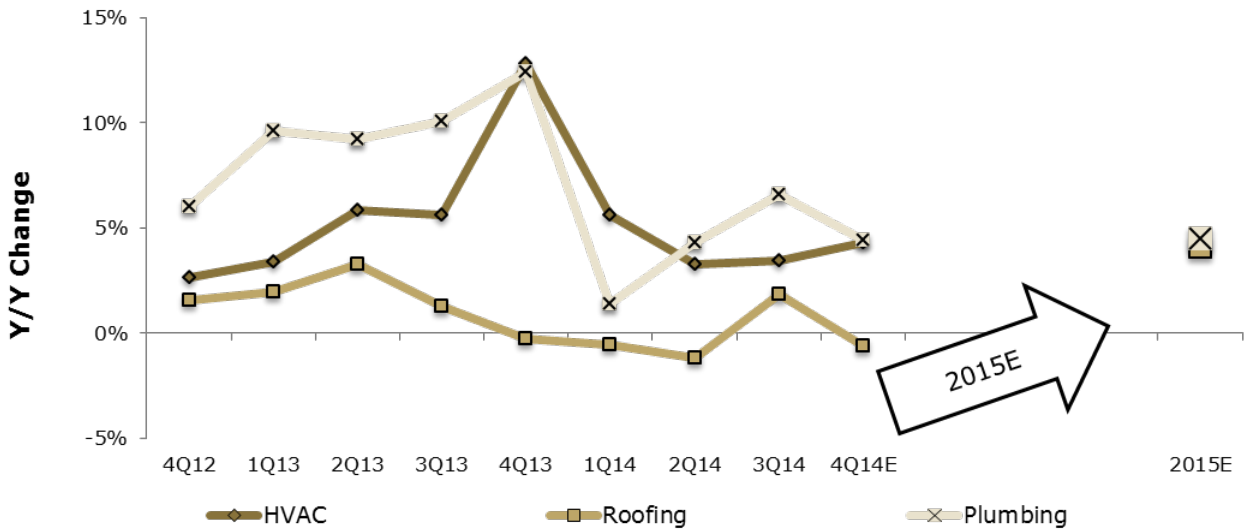
Sub-Industry Themes

Current Conditions

- **Themes vary widely within building products.** A slower-than-expected residential construction recovery likely weighed on many building product categories through year-end 2014, though non-residential markets fared relatively better. Industry trends in HVAC, Pool & Spa, and Facilities MRO appear healthier, while Roofing has remained sluggish.

2015 Outlook

- **Non-residential construction recovery broadens, residential slow and steady.** Industry participants expect a further broadening of non-residential construction activity, though many lackluster residential indicators may prove uninspiring.



Source: Baird Analysis

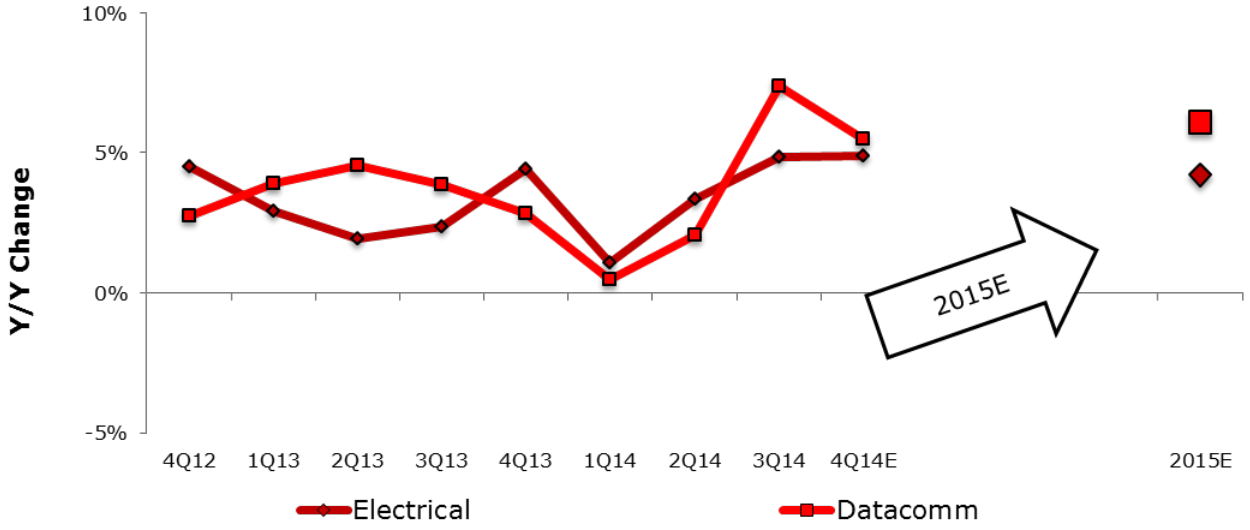
Conclusion

Current Conditions

- **Non-residential recovery shows broad-based strength.** Non-residential construction activity spread to additional markets throughout 2014, with private non-residential construction spending on a steady upward trajectory. Additionally, company backlogs remain strong as more industrial projects are being released.

2015 Outlook

- **Cyclical recovery seen in 2015.** Sustained non-residential momentum into 2015 should support electrical & datacomm players. Also, following several years of relative weakness, IT capital expenditures appear set to rebound, while the shift to large data centers continues.



Source: Baird Analysis

Sub-Industry Themes

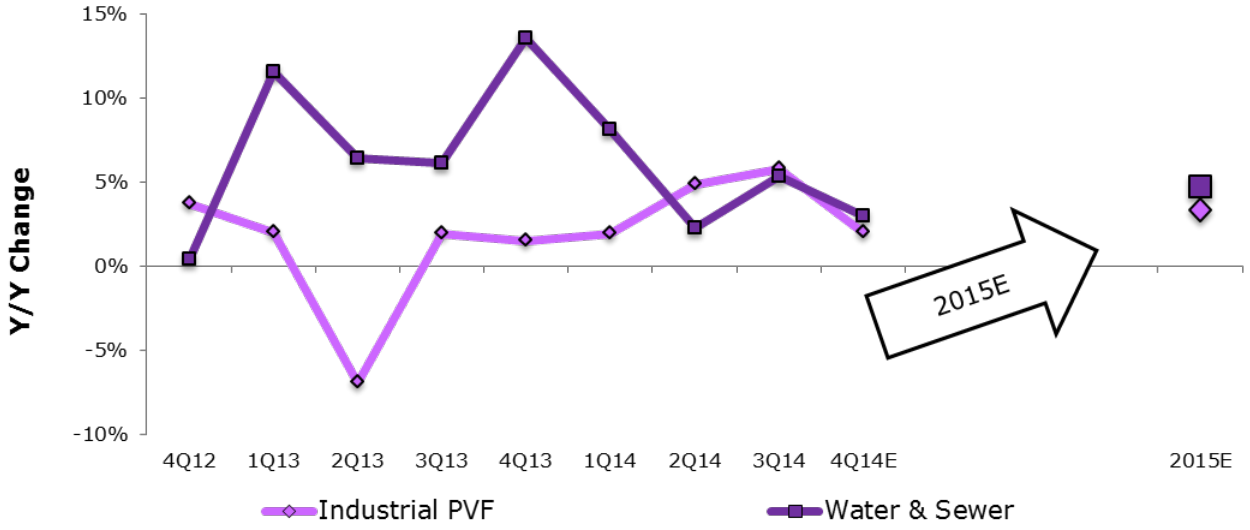
Pipes, Valves & Fittings

Current Conditions

- **Oil and gas activity continues to drive PVF industry, though prices under pressure.** Increased domestic shale drilling has led to strong demand for PVF products. However, pricing remains challenging in many pipe product categories, though recent trade case rulings may provide some support.

2015 Outlook

- **Industry overshadowed by crude oil concerns.** The well-documented collapse in crude oil will lead to an uncertain demand environment in 2015 as companies adjust to falling upstream capital budgets. However, activity in the midstream and downstream markets are expected to remain more resilient.



Source: Baird Analysis

Conclusion

Cautious Optimism into 2015, Although With More Potential Headwinds

Stock Market

- **Unprecedented Stability – Crosswinds Ahead.** After the 4th longest bull market in history and only two 10% corrections in the past six years, tighter Fed policy, high valuations and strong USD could lead to increased volatility.

Macroeconomics

- **Moderate Growth Continuing.** US economic indicators remain positive, with moderate ongoing strength in commercial / industrial markets. Drop in oil prices negative for Energy industry, but $100+ billion tax cut for consumers who represent 2/3 of US GDP.

Industrial Distribution

- **General Industrial.** Momentum maintained, lackluster pricing
- **Industrial Gas / Welding.** Later-cycle beneficiary, moderate pricing
- **Building Products.** Mixed residential; Broadening non-residential trends
- **Electrical / Datacomm.** Good growth / outlook on non-res trends
- **Industrial PVF.** Water & Sewer > Industrial > Oil & Gas (rigs, pricing)

Source: Baird Analysis

Question & Answer

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Source: Baird Analysis

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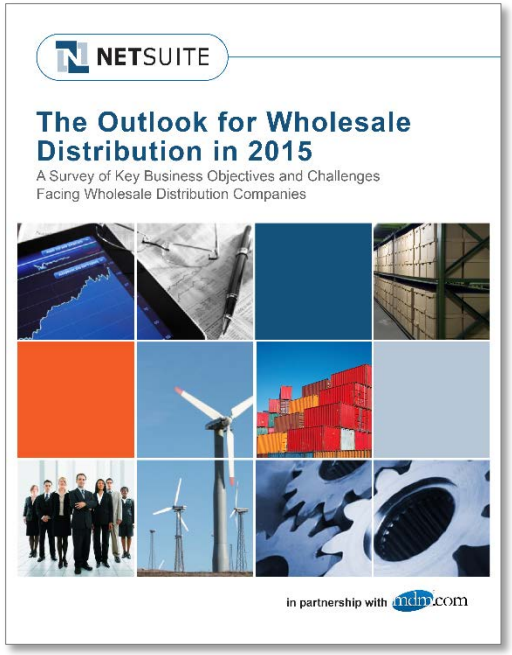
5 Predictions for Distribution in 2015

mdm webcasts

Sources

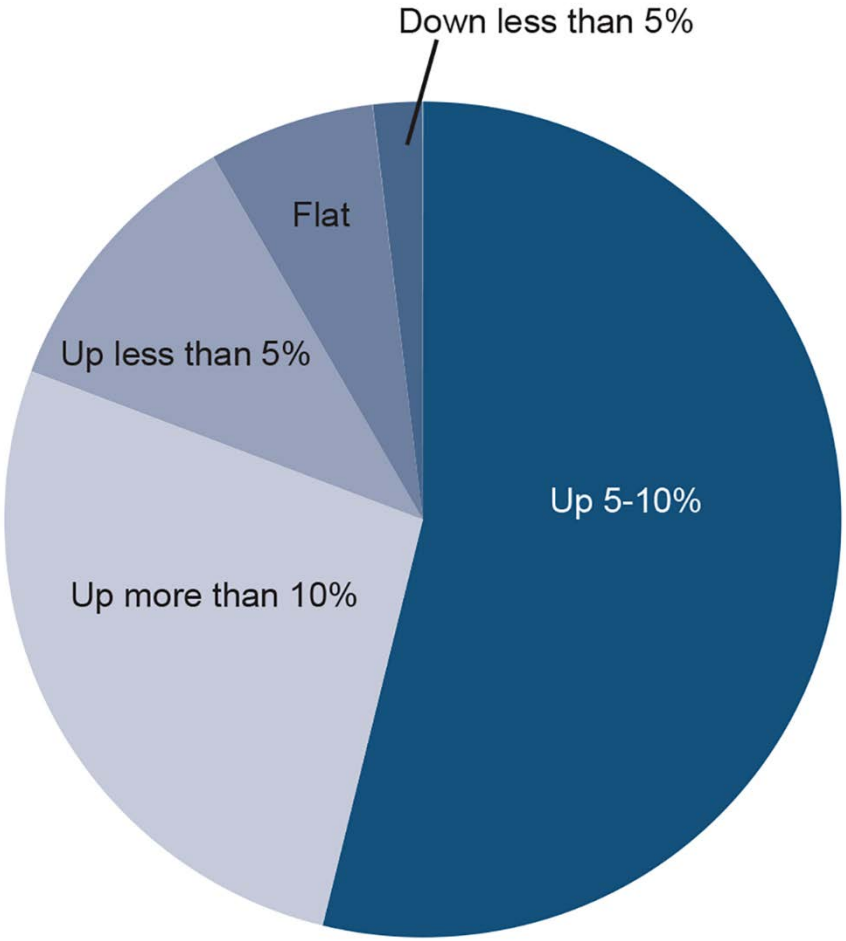
- MDM Research Team
  - Interviews with distributors & industry consultants
  - Ongoing MDM reader surveys
  - Public distributor reports
- 2015 Wholesale Distribution Industry Outlook Report from MDM and NetSuite



Predictions

- M&A accelerates
- Talent management deepens
- Digital strategy imperative
- Operational excellence
- Regulatory noise

2015 Revenue Outlook



Source: MDM-NetSuite 2015 Industry Outlook Survey
www.mdm.com/2015outlook

mdm webcasts

2015 Revenue Outlook

	Up more than 10%	Up 5%-10%	Up less than 5%	Flat	Down less than 5%	Down 5%-10%
Building Materials	29.8%	46.8%	19.2%	4.3%	0%	0%
Chemicals & Plastics	23.8	71.4	4.8	0	0	0
Consumer Products	33.3	61.2	0	4.8	0	0
Electrical/Electronics	30.8	56.4	10.3	2.3	0	0
Grocery/Foodservice*	55.6	44.4	0	0	0	0
HVACR/Plumbing	33.3	54.6	12.1	0	0	0
Industrial	26	58.3	6.3	7.3	2.1	0
Janitorial Supplies	25	58.3	12.5	0	4.2	0
Oil & Gas Products	29.6	63	3.8	3.8	0	0
Pharmaceutical*	0	100	0	0	0	0
Pulp & Paper	26.1	73.9	0	0	0	0
Safety Products	33.3	47.1	9.8	7.8	1.2	0

* Small sample: fewer than 20 respondents

Source: MDM-NetSuite 2015 Industry Outlook Survey
www.mdm.com/2015outlook

mdm webcasts

#1

M&A Accelerates

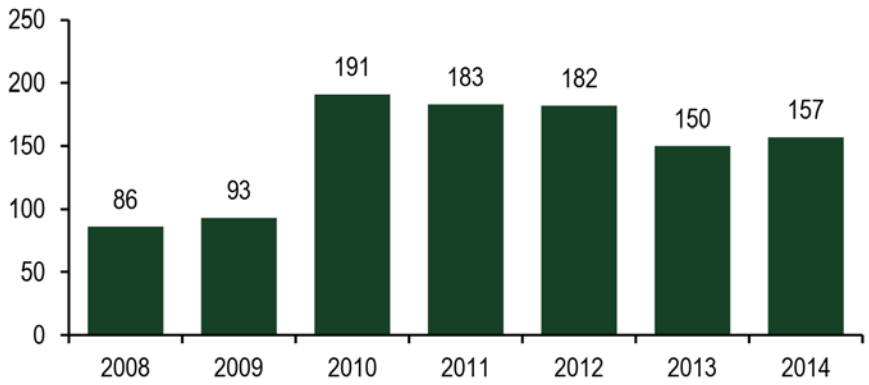
#1

- Strategic acquisitions in 2014

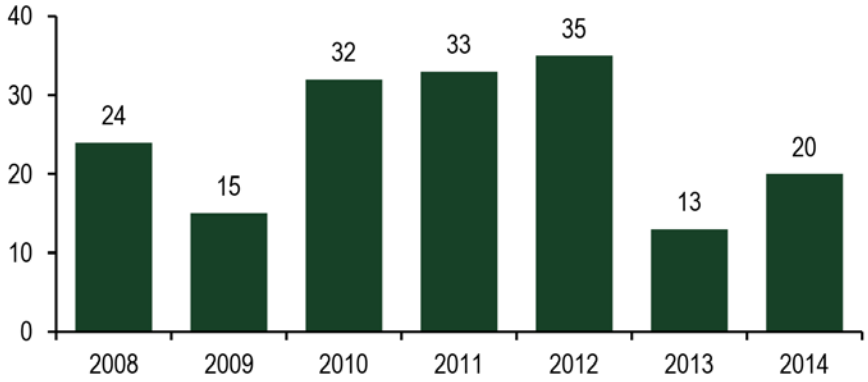
Commentary

- Distribution M&A activity rebounded strongly in 2010 and remained strong in 2011 and 2012
- Activity was down modestly in 2013
- Activity has rebounded slightly in 2014 and is poised for further growth in 2015

Total Announced Distribution Transactions



Announced Distribution M&A with Disclosed Values of $10 million+



Note: Annual counts are for industrial distribution transactions with disclosed values of at least $10 million.

Distribution M&A Activity by Deal Size

($ in millions)	2012	2013	2014
Deal Count			
<$100M	12	3	8
$100M-$500M	16	5	9
>$500M	7	5	3
Undisclosed	147	137	137
Total	**182**	**150**	**157**
Transaction Value			
<$100M	$689	$76	$364
$100M-$500M	4,293	1,463	3,344
>$500M	7,045	4,235	5,105
Undisclosed	**	**	**
Total	**$12,027**	**$5,774**	**$8,813**

Note: Transaction value represents the aggregate enterprise value of corresponding deal count by grouping above.

Industrial Distribution M&A Activity

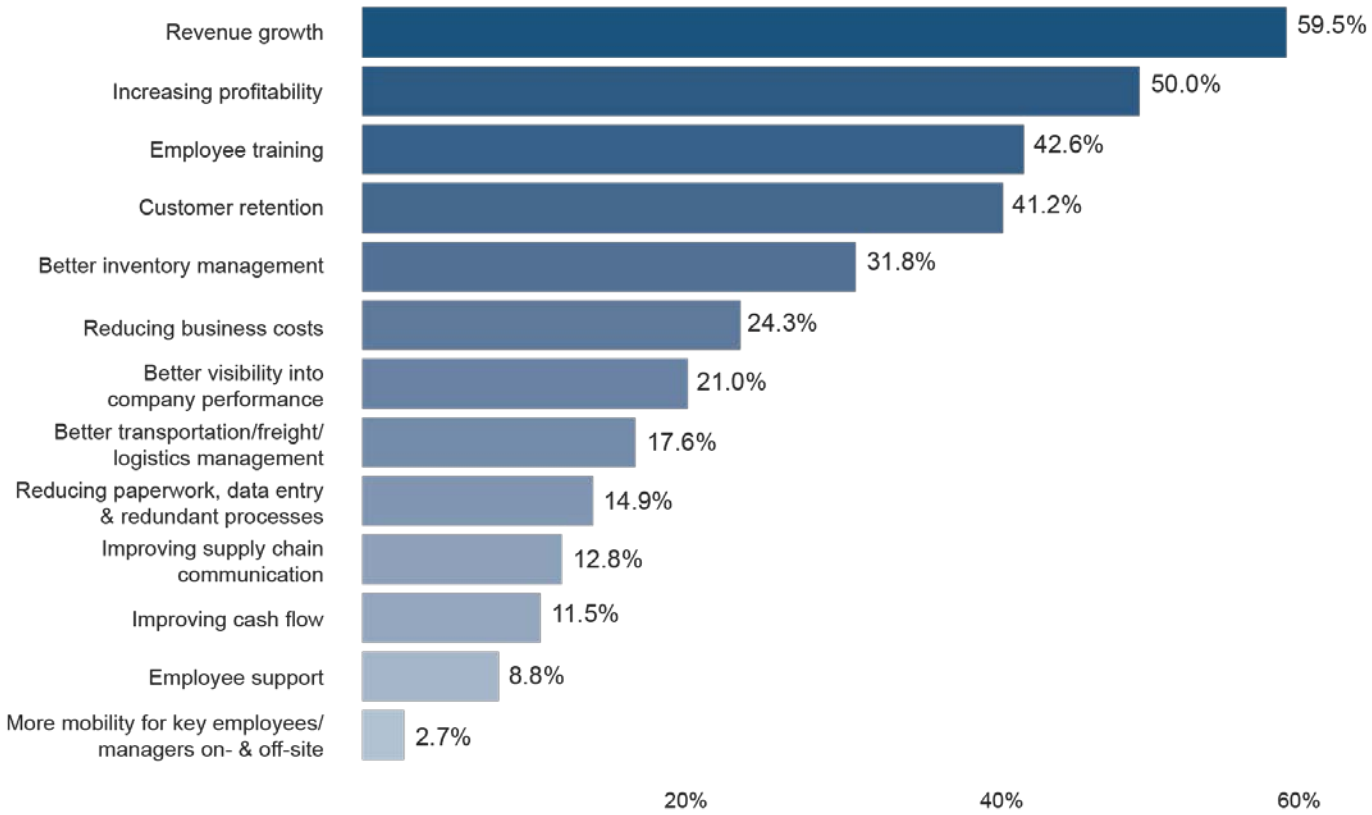
M&A analysis based on Baird's proprietary Industrial Distribution database

#2

Talent management deepens

#2

What are your top business priorities for the next 12 months?



Respondents were asked to choose three.

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#2

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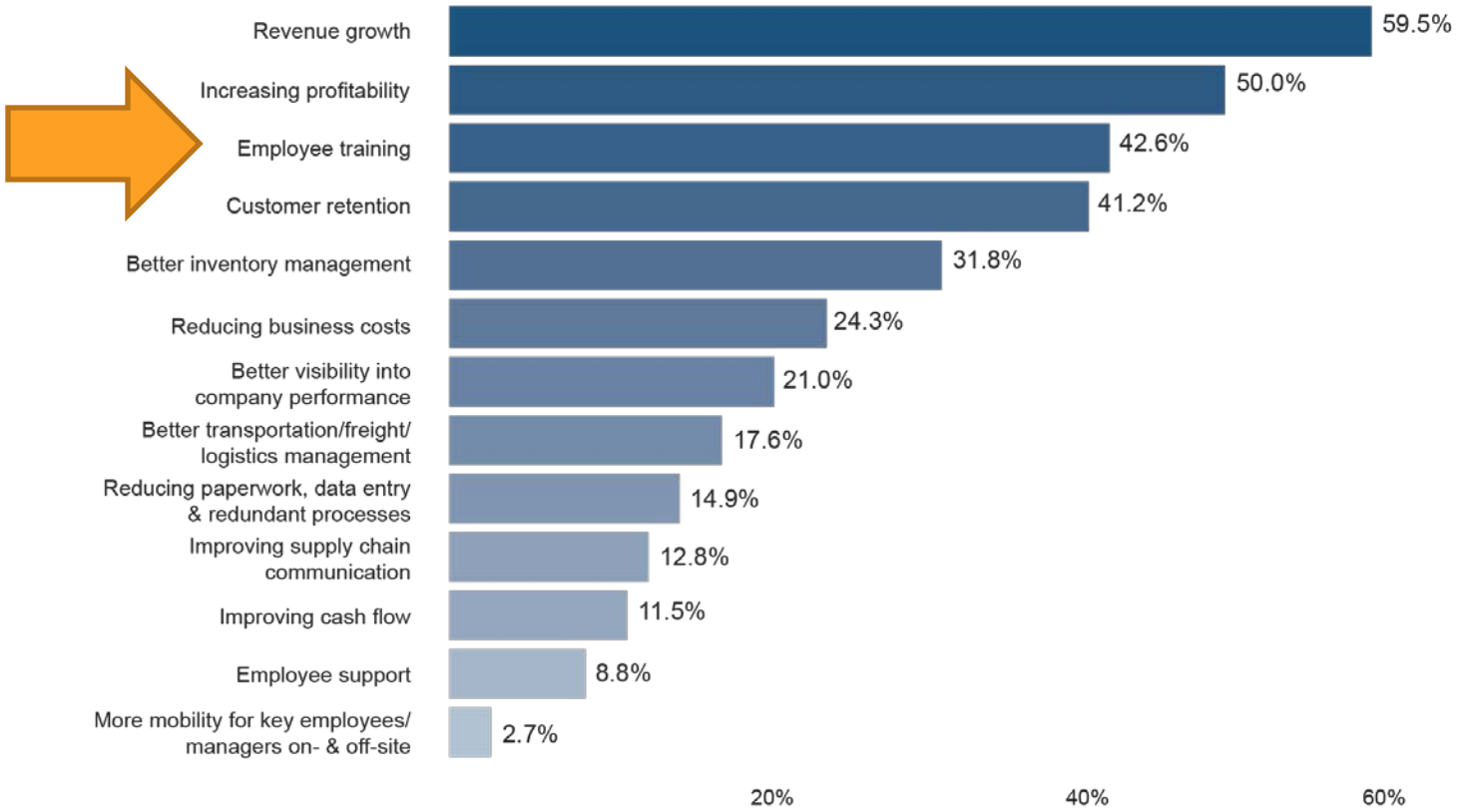


Respondents were asked to choose three.

#2

What are your top business-specific concerns?

#2

What are your top business-specific concerns?

Recruiting, Retaining, Training

47.7%

#2

- Talent Management Challenges
  - Finding qualified people
    - Or “trainable people”
    - Cultural fit

#2

- Talent Management Challenges
  - Training
    - Developing technical skills
    - Professionalization of sales force
    - Focus on leadership skills

#2

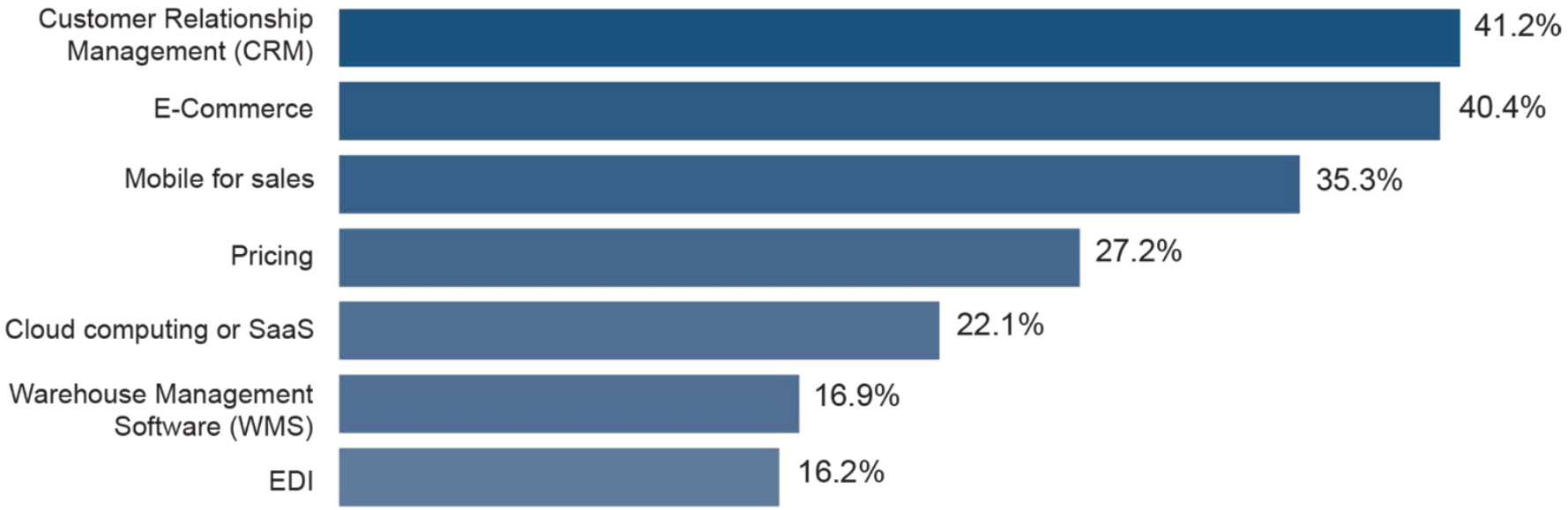
- Talent Management Challenges
  - Retaining top employees

#3

Digital strategy imperative

#3

Which new technologies do you anticipate exploring in the next 12 months?



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#3

- Technology challenges
  - Choosing the right software

#3

- Technology challenges
  - Choosing the right software
  - Need for integrated systems

#3

- Technology challenges
  - Choosing the right software
  - Need for integrated systems
  - Analyzing available data for better decisions

#3

- AmazonSupply

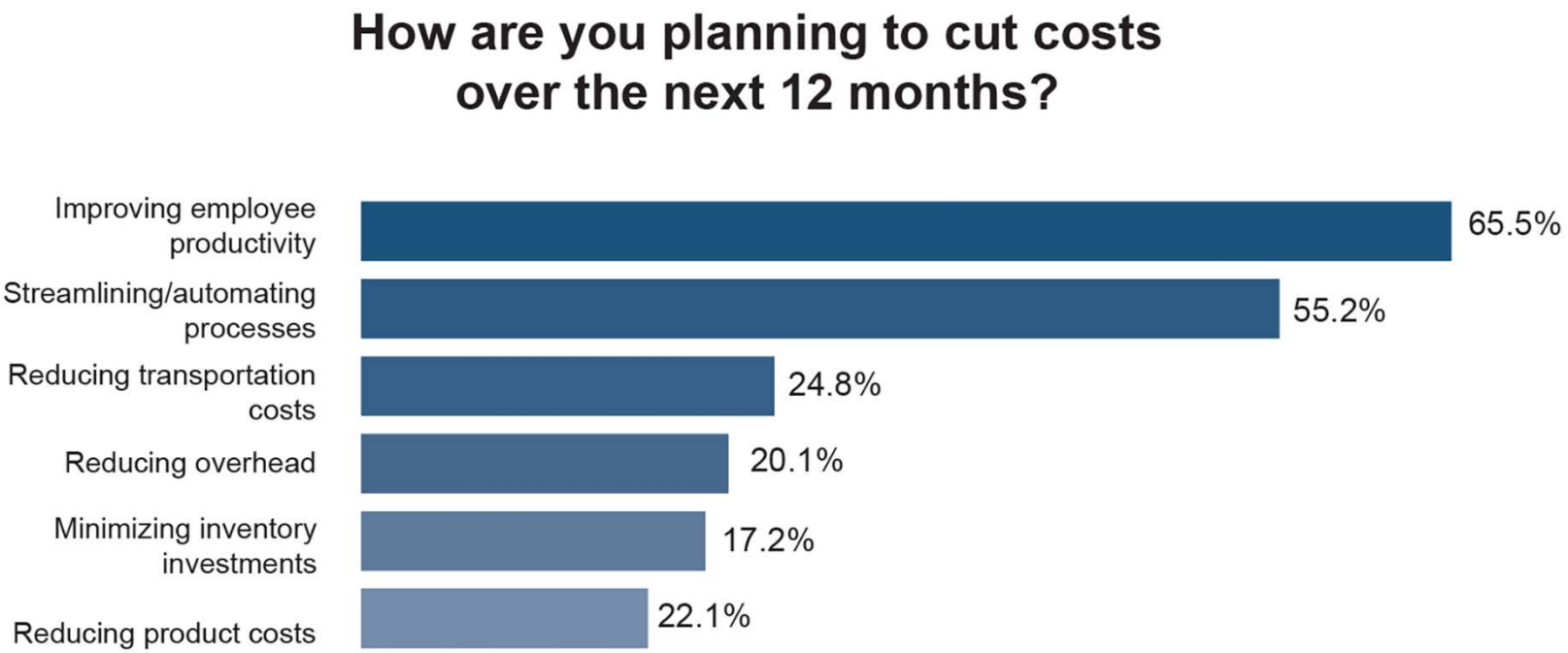
#3

- AmazonSupply
- Alibaba

#4

Operational excellence

#4



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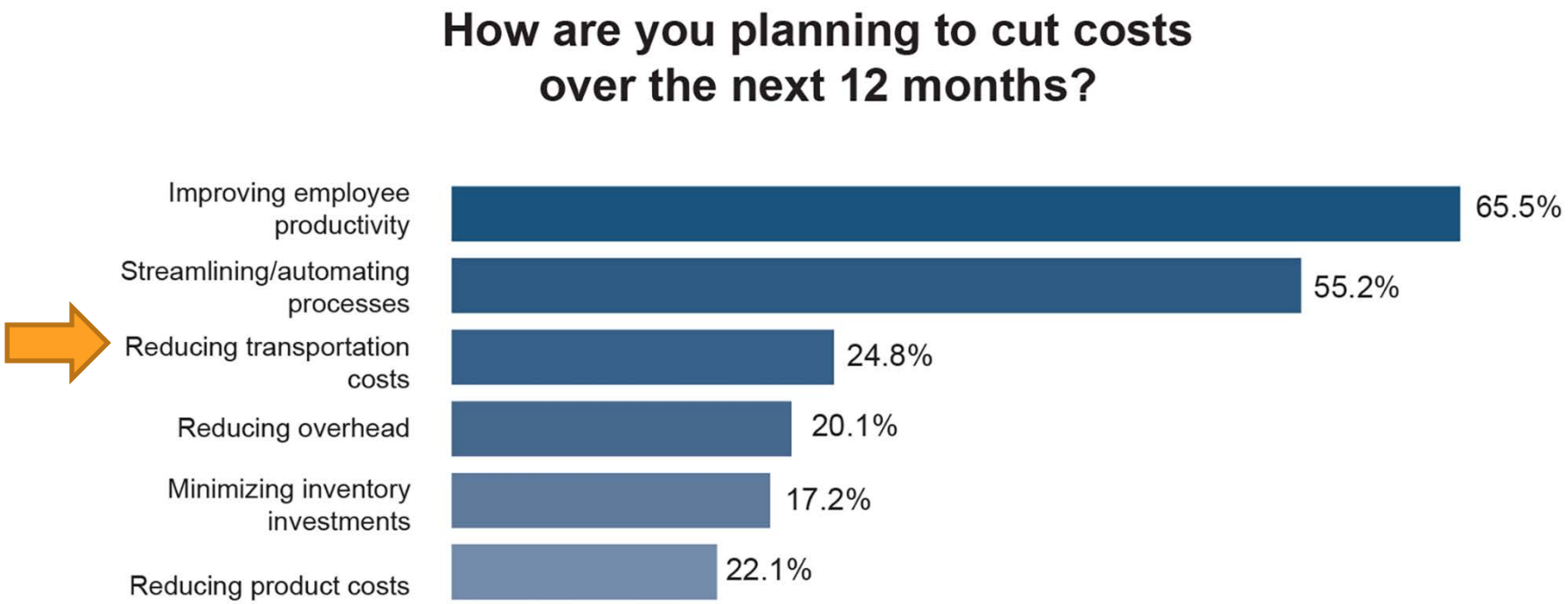
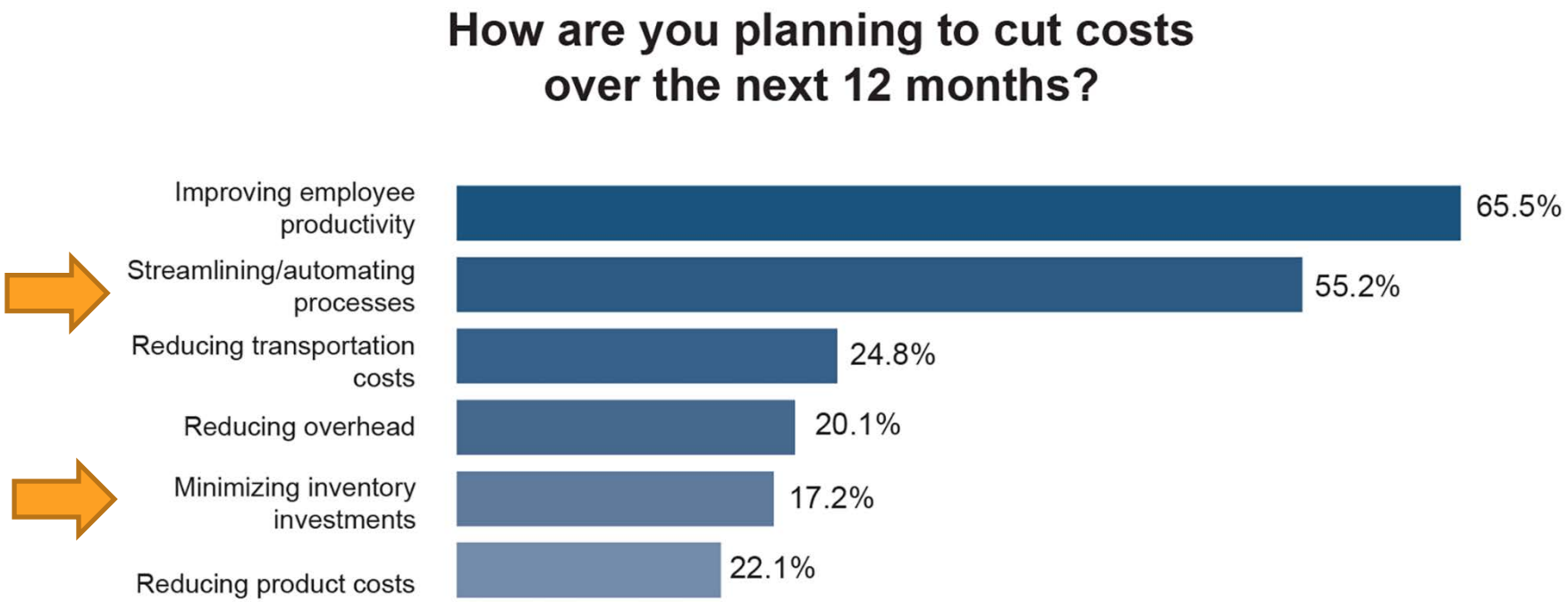
#4



#4

- Shipping/Logistics
  - Volatile price of oil
  - Driver shortage
  - Reshoring?
  - West Coast port dispute

#4



#4

- Inventory trends
  - Vending still a player, though not as big a noisemaker

#4

- Inventory trends
  - Vending still a player, though not as big a noisemaker
  - More demand for management of supply chain, not just physical inventory

#5

Regulatory noise

#5

- New Congress – but what does that mean?

#5

- New Congress – but what does that mean?
  - Call for public input on regulatory matters?

#5

- Some regulatory actions to watch:
  - Implementation of chemical labeling changes
  - Expansion of overtime eligibility
  - Business crowdfunding
  - Streamlined union elections

Get more

- Ongoing trend analysis in MDM Premium
  - If you're not a subscriber, join us at www.mdm.com/subscribe
  - Look for the 2015 Distribution Trends Report, released with the 2015 MDM Market Leaders lists in June.

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NetSuite: World's #1 Cloud ERP

Background

- Publicly traded on NYSE: "N"
- 3000+ employees
- $414.5M revenue in FY13
- $143.7M revenue in Q3 FY14

Performance

- Used by 20,000+ organizations
- Fastest growing top 10 FMS WW
- Used across 150+ countries

#1 Cloud ERP Suite

- **VISION:** NetSuite transforms how businesses operate so they can achieve their business vision.
- **MISSION:** NetSuite provides companies around the globe, cloud-based, unified systems that deliver unprecedented capabilities to drive their business.

Why Today's Distribution Businesses Choose NetSuite

Designed for Modern Business

Flexibility Built In

Business Insights For All

Commerce-Ready System

It Just Works

NETSUITE

Commitment to the Wholesale Distribution Industry

Vertical Focus

- Thousands of Distribution Customers
- Dedicated Software Experts In:
  - Implementation
  - Account Management
  - Support
  - Product Management
  - Executive Team

Specific Functionality

- Inventory Management
- Cycle Counting
- Procurement
- Warehousing
- Demand Planning
- Shipping
- Fulfillment
- Lead-to-Cash
- Ecommerce
- Reporting/Analytics

21st Century Choice

Shaw FLOORS

J.A. KING

GoPro Be a HERO.

MP MUSCLEPHARM

GREG SMITH Equipment SALES, INC.

NETSUITE

Transformative Results from Distributors

Actionable Insights

+56%

Gross Margin

+1-5%

Inventory Costs

-30%

IT Support Costs

-75%

Results as Measured in Comprehensive Study of NetSuite Customers Conducted By:

SL Associates

NETSUITE

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THE 2015 DISTRIBUTION INDUSTRY OUTLOOK

Questions?

Contact info@mdm.com

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