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MDM Special Report:

2016 State of M&A in Distribution

Eric Smith

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M&A Mirrors Economy

Deals slowly picking up as end markets improve

Opposing forces hindered distribution M&A so far this year. While economic and commodity pressures have cut down on the volume and size of deals, lack of organic growth has companies seeking acquisitions to boost their top lines. This article looks at the current state of M&A and what's in store for the second half of 2016.

As end markets carried over their struggles from the fourth quarter of 2015 into the first quarter of 2016, merger and acquisition activity in distribution has mirrored that overall economic softness with smaller and fewer deals. But like the economy, M&A is poised for a strong finish to 2016 as private equity firms prepare to deploy capital and strategic buyers look to acquire growth and increase market share.

So far, however, three overriding themes – energy, price transparency and the strong U.S. dollar – have slowed the pace of M&A across distribution, especially in the industrial space, according to Jason Kliewer, co-head of Baird's distribution investment banking group.

"All of those key themes have meant that it's been a little harder to demonstrate the growth of a platform, and there's been a slowdown in upper middle market M&A this year," Kliewer says. "But at the same time, distributors are continually looking for ways to augment the top line so they have been active with bolt-on acquisitions."

Energy, in particular, stunted M&A activity as revenues, earnings and valuations tumbled, most notably among industrial distributors. Companies divesting divisions with exposure to oil & gas was the exception.

"For industrial supply distributors, there may be more of an energy exposure than people realized a few years ago, even if it's only 5 or 10 percent," Kliewer says. "The energy theme is one of the big ones. As that's unwound over the last year, it's dragged down organic growth for a number of distributors not typically viewed as energy focused."

Focus on core strengths

With headwinds creating overall softness – distributors averaged -0.1 percent revenue growth in the first quarter, marking the second consecutive quarter of negative growth, according to the most recent MDM-Baird Distribution Survey – potential strategic buyers have been primarily looking at strengthening their own businesses instead of targeting new assets.

"They've been saying, 'I need to focus within my four walls, execute my strategy and find efficiencies to maximize my earnings in what is a softer end market,'" says Reed Anderson, head of Houlihan Lokey's industrial distribution practice.

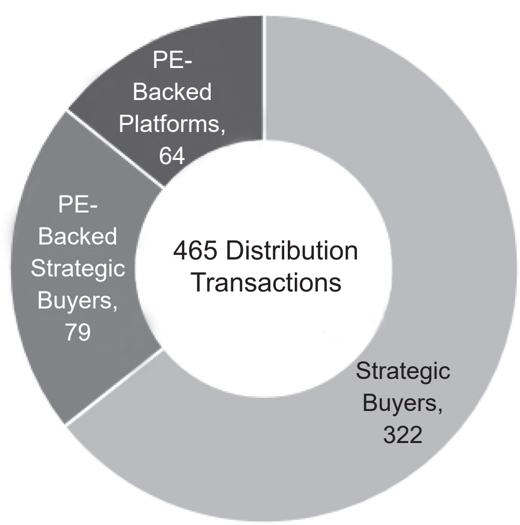
Distributors are even looking to shed underperforming divisions or adjacent businesses where they simply no longer want to spend time and energy, as HD Supply, Atlanta, GA, did recently when it agreed to sell its HD Supply Interior Solutions business unit.

The current economic climate – improving but not robust – is an ideal time to adapt to changing market conditions by strengthening your core and executing within it. If you don't want to invest in a part of the business, for whatever reason, it's time to get out.

"Boards are looking more closely at lower-priority items when things aren't going up and to the right," Anderson says. "It's not just dollars that they're interested in, but also management time."

Reinforcing and reinvigorating the core will play a factor in the deals that do – or don't

Figure 1: 2015 Distribution Transactions



Source: Supply Chain Equity Partners proprietary distribution database.

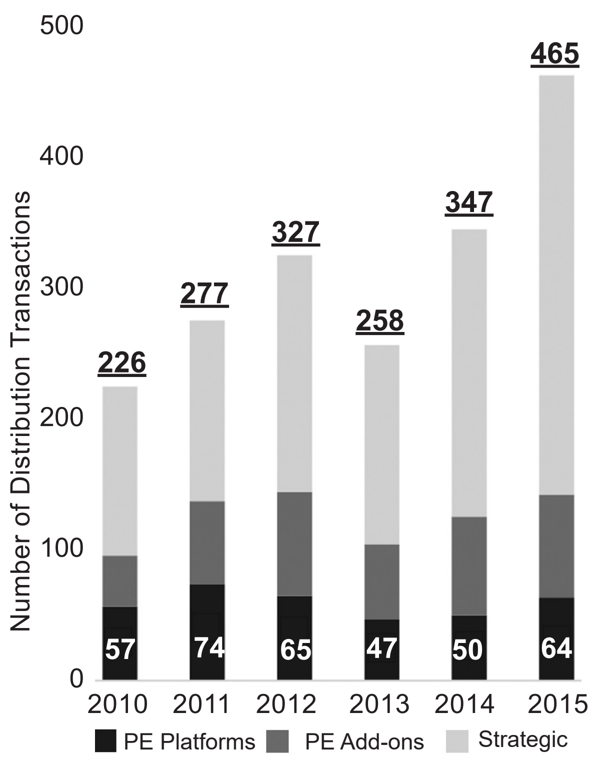
– happen. A company has to know itself first before getting to know anyone else and making an acquisition, according to Dave Gabriel, president, Sonepar North America, Charleston, SC, who spoke on a panel at the National Association of Electrical Distributors national meeting this month in Washington, DC.

"Look at your core business today and say, 'What am I really good at? What do I do well and do better than someone else? What is close to that? I think I can create some traction and some scale,'" Gabriel says. "If you have an alignment … then maybe it makes sense. Know yourself first. Chasing volume for the sake of volume, or chasing geography for the sake of geography, I wouldn't advise that for anyone."

"Slight pullback" in volume, quality

Yet some distributors have an opposite mindset of "We're going to do all that, but we know we're not going to grow at the top-line rate we'd like to grow. And we need M&A to augment that growth, particularly in the industrial sectors that might be a little bit softer," Anderson says.

Figure 2: Number of Wholesale Distribution Transactions



Source: Supply Chain Equity Partners proprietary distribution database.

The result of these conflicting forces has been a tepid M&A market that hasn't matched the volume and size of deals from a year ago, when M&A was flush with high-dollar and high-profile acquisitions.

"You factor all that in and we are seeing a slight pullback in volume as well as the quality of companies in the market selling their businesses, both private equity-owned and family- or founder-owned businesses," says T.J. Monico, head of distribution, investment banking, KeyBanc Capital Markets.

According to data from Supply Chain Equity Partners' proprietary distribution database, there were 465 wholesale distribution transactions completed in 2015. Of those, 322 were strategic buyer transactions, 79 were private equity-backed strategic buyers and 64 were private equity-backed platforms. (See **Figure 1**).

The 2015 total was up 34 percent from 2014 (see **Figure 2**) and continues the S-curve of M&A in distribution – a period of numerous acquisitions, followed by a period of entrepreneurs breaking off and starting their own businesses, followed by another period of acquisitions. The drop-off in M&A activity this year, even slight, furthers this cycle.

"That is going to continue in this industry," says Jim Miller, a principal and founder at Supply Chain Equity Partners, speaking on the same NAED panel that featured Gabriel. "You're going to have waves of consolidation and waves of new businesses expanding. And you're always going to have dozens and dozens of companies that don't have succession planning, so when it comes time, they're going to need to sell."

Slow or immediate growth?

The modest pace of economic recovery bodes well for increased M&A activity as companies look for other ways to boost their top lines, Monico says.

"Organic growth is going to be a challenge, given that we're not firing at all cylinders right now," he says. "Companies will look to supplement organic growth with acquisition growth. It's cheaper to buy growth than to wait for organic growth to return."

Purchasing competitors in new markets or even expanding their product focus is also the fastest way for distributors to prosper as they look to balance organic and acquisition growth, according to Sonepar's Gabriel.

"In a slow-growth environment, which I think we're in, execution on organic (growth) is

Figure 3: Private Equity Buyer Activity – By Sector of Distribution

	2015		2014	
Sector of Distribution	Number of Distributors Acquired by PE in 2015	% in 2015	#	% in 2014
Industrial	45	31%	50	40%
Building Materials	32	22%	20	16%
Foodservice & Beverage	17	12%	7	6%
Auto / Truck Parts Aftermarket	11	8%	18	14%
Consumer Products	9	6%	10	8%
Electrical / Electrconics	8	6%	6	5%
Specialty Chemicals / Lubricants	7	5%	6	5%
Health Care	5	3%	5	4%
Other Sectors of Distribution	9	6%	4	3%
Total # of Distributors	143	100%	126	100%

*Building Materials category includes HVACR/Plumbing distribution M&A, as well as other transactions involving distributors of product categories such as roofing, lumber, landscaping, kitchen cabinets and construction-related supplies.

Source: Supply Chain Equity Partners proprietary distribution database. PE transactions include PE platforms and add-ons.

extraordinarily important to all of us, and then selective targets on the acquisition side is even more important," Gabriel says.

Acquisitions are equally important for regional distributors, yet many of those companies remain hesitant to acquire too much too quickly, which has cut down on the number of deals across distribution.

For example, HVAC, refrigeration and plumbing distributor F.W. Webb Co., Bedford, MA, has made three acquisitions in the past year – Grant Supply, Water Works Supply Corp. and State Line Supply – but while buying adds market share, the company often has to say no or "wait and see" if the deal might make sense later, COO Bob Mucciarone says.

"You want to improve the top line, but you don't want to do it at the expense of the bottom line," Mucciarone says. "You want the top line to grow at the same slope as the bottom line. If you do too many, too quickly, your top line will grow but your bottom line will go the other way."

New themes emerging

A few themes emerged in distribution M&A last year, most notably financial and strategic buyers increasingly competing for the same targets. While that is still true to a degree, most strategic buyers are "staying within their lane" this year, Anderson says.

"In periods of economic boom, it's easier for strategics to move outside their lanes and get into adjacencies that may be complementary business," he says. "In the market we're in today, we're seeing strategics be much more focused."

Another difference in 2016 is a lack of blockbuster announcements. This year has seen large distributors adding small companies that meet a geographic or product need, while last year saw several high-profile deals that included Air Liquide acquiring Airgas, Builders FirstSource acquiring ProBuild, Anixter acquiring the Power Solutions Division of HD Supply, The Home Depot acquiring Interline Brands, Beacon Roofing acquiring Roofing Supply Group, and Stock Building Supply merging with Building Materials Holding Corp.

Also unlike last year, when building materials & construction consolidation was rampant and big deals in that space were routinely announced, no single sector has emerged as an M&A leader so far in 2016.

"There's so much diversity across a lot of the distribution landscape here that even when you look within industrial you can find certain categories that are way up and certain categories that are way down from an end-market perspective," Anderson says. "Both of those can drive M&A – some wanted M&A and some unwanted M&A if you're struggling and have no other option."

Other sectors have shown flurries of consolidation, from gases & welding equipment to HVAC & plumbing, yet industrial supply and building materials & construction should see the most activity, especially from private equity buyers, as they did last year (see **Figure 3**).

While most analysts agree that it's difficult to predict what will happen with M&A in distribution for the second half of 2016, most forecast a bump from the first half as the economy improves. Strategic buyers will look to buy growth and financial buyers will deploy capital in distribution.

"What's going to happen the remainder of the year is a tough question to answer," Miller says. "There's still tons of cash on the sidelines. The strategic buyers are dominating the market right now, but that comes in waves, as well. There's a trillion dollars of buying power in private equity right now, and they have a period of time that they need to invest that money. With every day that passes, that money needs to be invested, and there's increasing pressure to invest that money."

Navigating the M&A Landscape

Best practices for distributors looking to buy or sell

With M&A poised for a strong finish this year, distributors on either side of a deal should strategically prepare now for the opportunities that will arise. Buyers must carefully examine how a targeted asset fits, and sellers must ensure maximum value before entertaining offers.

Midway through 2016, a trio of headwinds – energy, price transparency and the strong U.S. dollar – stunted revenues across distribution and, in turn, slowed the pace of merger and acquisition activity.

Yet a lack of organic growth in many industry verticals has companies seeking acquisitions to boost their top lines. With the economy forecasted to recover in the second half of 2016, M&A is expected to accelerate as strategic buyers scour acquisition pipelines to buy growth while financial buyers look to deploy capital and pad their portfolios.

This projected rise in M&A over the next six months should prompt company executives – no matter what side of a deal they're on – to consider strategically preparing for this surge of opportunities.

"I think the slowdown in M&A at the beginning of the year is going to be temporary and that M&A will pick up meaningfully for the back half of 2016," says Reed Anderson, head of Houlihan Lokey's industrial distribution practice. "Momentum tends to pick up for deals because there's that time lag on M&A."

Advice for sellers

For the best results, companies looking to sell to a strategic or private equity buyer must be prepared when a suitor emerges. Just as someone selling a house can't expect top dollar if they haven't made some enhancements and upgrades such as a remodeled kitchen, a distributor hoping to get market value or better has to get their business in order, as well.

"M&A is not a flip-the-switch activity," Anderson says. "It does take a little while to successfully sell a business. So if you're going to move down that path if you've made a strategic decision to sell, it takes a little bit of time to execute that strategy to get a deal done."

While no company is perfect when it's put on the market, it is critical to think about removing as many blemishes as possible, or "de-risking your business before taking it to market," Anderson says.

The first item on any seller's checklist is deciding how quickly you want out. The timeline will dictate the type of maintenance you need to perform on the business, according to Jim Miller, a principal and founder at Supply Chain Equity Partners.

If you're looking to exit the business quickly – for example, in one year – the approach should be centered on "cleaning your financials, getting your inventory cleaned up, getting your receivables cleaned up," Miller says.

But for many businesses, delaying the sale might make more financial sense because it allows time to drive value into the company. Strategically investing in the company now, even if the exit plan is a few years down the road, will yield a larger payday when an offer emerges.

"On a five-year plan, the advice we give distributors is to build your business as if you're never going to sell it," Miller says. "Invest in the people, invest in training, invest in IT systems, invest in infrastructure, invest in the product lines."

A recent example is Airgas. The company in 2011 rejected a $5.8 billion takeover attempt by Air Products, an offer that the company's founder Peter McCausland said "grossly undervalued" the company and its growth potential. Last year Airgas agreed to a $10.3 billion offer from Air Liquide. In between, Airgas invested heavily in its e-commerce capabilities, among other areas.

But with so many distributors operating as lifestyle businesses, in which the owner is also the chief executive, they tend to make reactive decisions to threats and opportunities and aren't as good at making intentional, proactive moves when there is no apparent business need to do so, according to Mike Marks, Indian River Consulting Group.

"They add staff or they add IT when the system's just about to break and everybody's complaining," Marks says. "Then they'll step up to the plate, and they'll go do it."

Smart company executives don't wait for something to force a move that adds shareholder value. They start planning now for the next generation – or next owner – to take over.

"Real shareholder analysis is where you sit down with somebody and say, 'How do I get out of here? Do I bring somebody in to run it? Do I have offspring to pass it off to? Do I want to sell it? Do I want to keep it in the family?'" Marks says. "Having those discussions before the fact, so people can start to think about what it is they want to do, creates a lot more shareholder value."

Where to invest?

In today's M&A landscape, it is critical to invest in your business – especially technology – even when the economy is soft and profit margins are slim. This will help distinguish your company from other targets that buyers might be pursuing, says Jason Kliewer, co-head of Baird's distribution investment banking group.

"A strong ERP system enabling quick turnaround on diligence questions inspires confidence in a sale process, as does a clearly articulated growth strategy with metrics used to track progress," Kliewer says. "Each of these factors can have a meaningful impact on valuation."

Technology isn't the only area where a company can create a competitive advantage within the acquisition pipeline. Hiring the right talent, especially a superlative sales force, makes a distributor more attractive to suitors.

Forming an industry-leading customer experience also helps you rise above peer companies. While buyers will look at specific metrics when contemplating a deal, those that dig deeper in their due diligence might see how an abstract concept like the "customer experience" manifests itself in top- and bottom-line growth for distributors, says T.J. Monico, head of distribution, investment banking, KeyBanc Capital Markets.

"You see the better metrics with companies that know how to create a better, more progressive customer experience," Monico says. "You also see it evidenced in their growth rates, as well, so that companies growing above the industry growth rate – implying that they're taking some share from other companies – they either have a disruptive technology to help them deliver a better customer experience or just a better approach to making their customers happier. Otherwise it's harder to differentiate themselves."

No matter where the investment occurs, companies are "typically better off doing what makes the most sense for the business," Anderson says. "If you're looking at strategies, if you're looking at investments, and you think those are the right things to do for the business, those are likely the right things to do for an M&A sale, as well."

First and foremost, Miller says, companies should ask themselves, "Do I have a bad culture – a 'scraping dollars out of the business' culture – or do I have an 'investing in people' culture? Do I have a quality management team, quality recruiting and training and retention rates on quality people?"

If a distributor hasn't been keeping pace on ERP and inventory management, if it hasn't been hiring top-notch talent or creating a unique user experience, those problems will fall to the new ownership team and stunt future cash flow.

Best practices for buyers

All of those seller considerations are what buyers should be looking for in their new assets. SRS Distribution Inc., McKinney, TX, which has made 45 acquisitions since its founding in 2008, doesn't buy companies for "proprietary technology or proprietary products or access to anything new to the model," says President and COO Dan Tinker.

But "we certainly are always looking at the talent," Tinker says. "The financials are what they are; the key to us is are we acquiring a talented team of people that can grow the business with more resources and a different risk tolerance. Some people can do that, some can't, regardless of the company."

SRS looks for "people that can operate under our model, which is an EBITDA growth model rather than a privately owned family company model," Tinker says. "Can they thrive in that environment? You want them to come in and be excited about their new environment and really take the business to a new level with unlimited resources because they are now part of a national network and family of companies instead of being a mom and pop."

Other buyers, such as F.W. Webb Co., Bedford, MA, which has made three acquisitions in the past year, look to either extend the company's footprint or add a division in hopes of becoming a "complete solution for customers," says COO Bob Mucciarone.

The HVACR and plumbing distributor is strategic in making sure that the acquisition target will benefit the company in places it is looking to expand. Acquiring geography is often easier than launching a greenfield and trying to build a brand there.

"For example, down in New Jersey, acquisition is the way to go because you're buying relationships, you're buying people – and the biggest asset a company has is its people – and when we do an acquisition we keep most, if not all, employees," Mucciarone says. "And you're buying a customer list. They already have relationships with customers. That's significant because you have instant business. It's like turning on a switch."

Other considerations

Distributors looking to acquire in hopes of adding product lines, geographies or customer lists must be careful about who they target and why. They must first examine their core business and ask themselves, "What am I really good at? What do I do well and do better than someone else?" said Dave Gabriel, president, Sonepar North America, Charleston, SC, during a panel discussion at the National Association of Electrical Distributors conference this year.

"If you have an alignment … then maybe it makes sense," he says. "Know yourself first. Chasing volume for the sake of volume, or chasing geography for the sake of geography, I wouldn't advise that for anyone."

Gabriel says that during the due diligence process, Sonepar asks specific questions to determine a good fit. These include: How technical are they? What are the systems they have in place? What is the culture of the organization? Is it a good fit?

But as buyers look for a variety of factors that align with their business model, from talent to technology to geography to product line to growth rate, they must not act rashly, according to Marks.

"When you talk about acquisition, the first part is where do you add value? What's your value proposition?" Marks says. It doesn't make sense to just buy a company that gets you into a different market where there are no synergies. "There's a lot of really stupid acquisitions where people buy things and they destroy shareholder value."

A company also should focus on what it brings to the asset, not solely what the asset brings to the company. When Stellar Industrial Supply, Tacoma, WA, began looking at buying Impact Industrial Supplies, Tampa Bay, FL, last year, Stellar President and CEO John Wiborg said the company saw an opportunity to "bring some resources to Impact – and by that I mean not only financial resources but capabilities such as our vending solutions and also our metalworking capabilities."

But perhaps the biggest criterion a distributor should consider is culture. As Miller says, a buyer will inherit all the profit-draining traits of a bad culture, which is why Stellar and other savvy companies look to align not only product lines and geographies, but the basic principles of how each company's leaders run their respective businesses.

"When we're looking at acquisition possibilities, the first gate that's got to be overcome is, 'Is this organization we're looking at a great organization and are their values and business philosophy compatible with ours?'" Wiborg says. "They're never going to be exactly the same but they have to be compatible."