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MDM Special Report:

Distribution M&A Playbook

By J. Michael Marks

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About this Report

Many distribution verticals are experiencing consolidation, and those that haven't are ripe for it. In this three-part series, author Mike Marks examines factors that have transformed distribution M&A and how companies can succeed in the new market. He provides tips for evaluating deals and for successful integration after close.

About the Author

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Pt. 1: Unlocking Shareholder Value

Private equity firms shift the distribution M&A landscape

Many distribution verticals are experiencing consolidation; those that haven't are ripe for it. In Part 1 of this three-part series, author Mike Marks provides a look at what's driving consolidation, as well as the rise of private equity firms in distribution M&A, which has transformed the market.

More than 99 percent of the 30 million businesses in the U.S. are small businesses, according to the U.S. Small Business Administration. Less than 20 percent have more than 19 employees. Many of these small businesses will eventually fail or simply close when the owner ages out.

The successful ones acquire. A successful dry cleaner, for example, becomes a chain of dry cleaners, opening new locations and acquiring weaker competitors.

No matter the industry, as markets mature they will consolidate. The degree of consolidation is typically measured by concentration, i.e., how many firms it takes to represent 50 percent of total industry or market revenues. This natural economically driven process drives strong emotions among industry incumbents, but nothing will stop it. In fact, interest in M&A has risen dramatically over the past decade.

Consolidation, when done properly, unlocks significant value for the final shareholders from three primary drivers:

1. The selling owner-operator, running a lifestyle business, often lets loyalty trump competence. Over time, this lowers financial returns by raising expenses. Being small, most of these businesses have few economies of scale and little use of technology. In an acquisition, however, loyalty to an exiting owner has no value, so marginal employees are let go; at the same time, professional management is introduced and other changes are made that improve operating effectiveness.
2. The acquired business becomes competitively stronger, gaining share from others in its market. With additional capital from new owners, it grows through investments in capacity and bolt-on acquisitions.
3. The additional scale is used with upstream suppliers for purchase-price concessions, improving margins as the business leverages their "takeaway" power.

All of this combines to increase the free cash flow EBITDA measure of profits.

If not yet affected by this wave of consolidation, distributors need to prepare by understanding the landscape, their place in the consolidation cycle and the new measures of shareholder value.

The numbers

Business-firm valuations are typically expressed in terms of multiples of adjusted EBITDA so firms can be easily compared, independent of debt or capital structure. The adjustments include recasting the financials to create an arms-length set of values, without the overpaid son or the company condo in Vail.

The purchase price ranges based on the market, the transaction size, a company's value-creation plan and other secondary factors. Typically, service businesses are valued at 4x adjusted EBITDA, manufacturers at 10x and distributors at 5x to 7x. Well-run distributors with some competitive advantage go for around 12x. We have even seen distribution multiples of up to 20x EBITDA, albeit rarely.

Market multiples will typically rise as buyers start to outnumber sellers. Toward the end of the consolidation phase, market multiples will decline.

When a distribution vertical is in the early stages, for example, private equity firms acquire platform investments that can absorb additional bolt-on acquisitions. In general, platform purchases are worth approximately two more multiples than add-on acquisitions, reflecting the difference in value to the purchaser.

In all acquisitions, except those run by rookies and fools, a company's value-creation plan impacts how much the buyer is willing to pay. As an example, assume a lifestyle distributor with $2 million in adjusted EBITDA has a market-value range of 4x to 7x. The buyer may pay between $8 to $14 million to purchase the target firm, typically using roughly 50 percent debt and

50 percent equity.

The value-creation plan helps the buyer determine what they can afford to pay and still have the acquisition be accretive. The plan starts with the $2 million in existing EBITDA and details the actions that will be taken over the next 12 to 24 months to arrive at a revised improved EBITDA. Each action is linked to an incremental improvement. The buyer will never pay the seller for synergies as these offset the core risk in any acquisition. These values do help the buyer decide where to be in the $8 million to $14 million purchase price range. These plans are often summarized in a waterfall chart like the one in **Figure 1.**

Rise of private equity

Private equity has risen rapidly, with more than 1,400 PE firms now that need to invest shareholder funds to create and extract value. Each search for their version of the Holy Grail: an industry segment with high customer switching costs, that is highly fragmented, run by small and aging owner-operators, that produces adequate returns even with high SG&A expenses so it can be consolidated, realizing huge efficiencies in back-office expenses that create significant shareholder value for both the short and long term.

Once the specific segment is uncovered, the play is simple: Buy one of the best firms in the space as a platform company and make a series of add-on acquisitions while transitioning to professional management and achieving significant economies of scale. Then sell it to another firm that plans to do the same thing and get a huge return for your shareholders.

Competitive intensity in M&A, which has increased dramatically in the past decade, is driven by three converging forces:

- the rise in the number of PE firms
- the huge amount of capital available for investment
- the shrinking number of firms available to purchase

This has driven up the price required to purchase a firm – usually expressed as a multiple of adjusted EBITDA – and in many cases has lowered the historical 20 percent returns to investors in PE firms to less than 15 percent today.

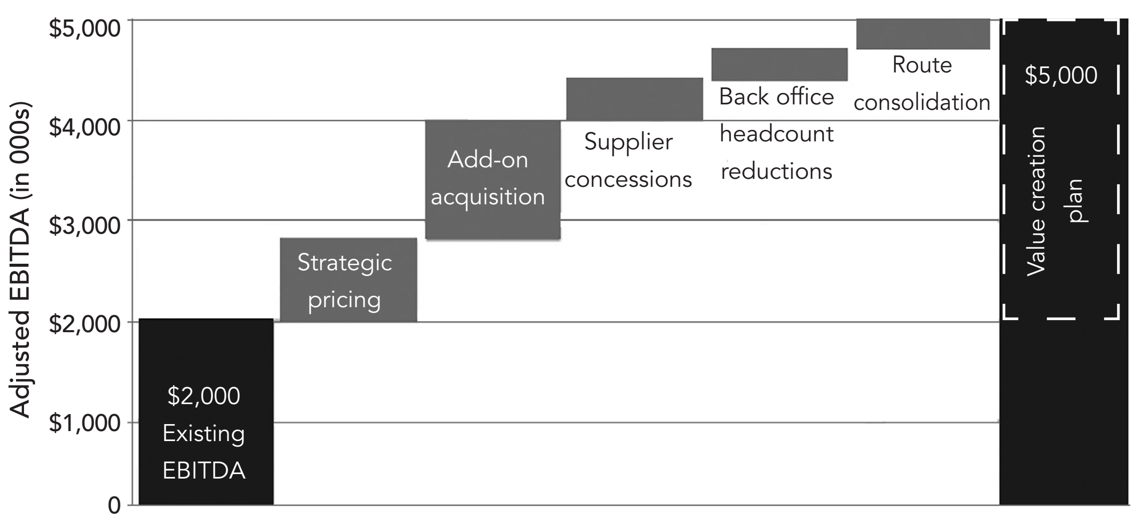
Competition among PE firms is complicated by a fourth factor. Existing firms in these attractive verticals need to demonstrate growth, especially if they are publicly held. This has created an ever-expanding interest in generating growth via their own acquisitions. Once a PE firm acquires a platform company, it essentially behaves as a strategic buyer, putting them at competitive odds with other PE firms.

Shareholder value for distributors

In 2016, there were more than 244,000 wholesaler-distributors in the U.S. with average revenues of just over $21 million, according to U.S. Census data. More than 200,000 of these firms have fewer than 20 employees and fewer than 200 have revenues exceeding $1 billion. The majority are owner-operator entrepreneurial businesses.

These distributors operate within more than 100 discrete verticals, including food, pharmaceuticals, building materials and car parts. Each vertical is consolidating at different rates. Some

Figure 1: Value Creation Plan Example



verticals, such as laboratory products and semiconductors, are already fully consolidated. Some have yet to see any meaningful consolidation.

Notice how closely this profile fits the private equity Holy Grail?

Most distribution executives came up through sales, and the original driver of shareholder value was to grow revenue and get larger. This is no longer true. The distributors with the highest shareholder value, as measured by the EBITDA multiples that multiple buyers would be willing to pay, is a firm that has the following five characteristics:

1. They have organic growth that is 2 to 3 times that of the competitors in their vertical.
2. They have an EBITDA margin of 10 percent of revenue or higher.
3. Most of their growth (up to 60 percent) comes from being able to successfully acquire and integrate accretive add-on acquisitions.
4. They have a clear value proposition in the supply chain that goes beyond "We sell service with excellent staff."
5. They are professionally managed.

How customer value is being measured has changed, as well. Distributors started out in the 1950s as local businesses to put products close to the point of consumption, adding value that compensated for poor and unreliable supply chains. With today's reliable supply chains and the internet – think Amazon Prime Now – do we still need 244,000 distributors in the U.S.?

The entire industry is in a shakeout as each distributor grapples with the transition to digital and multichannel. It is too early to determine the ultimate winners and losers, but current size has historically been a poor predictor.

M&A is going to be a critical strategic driver in this shakeout. If you are the owner or an executive, M&A will be one of the powerful tools you will use to create growth going forward.

Enjoy the ride, it is going to be bumpy and exciting.

Pt. 2: The 8 Fatal Flaws in M&A

These common pitfalls can derail transactions of any size

Many M&A transactions fall prey to the same mistakes. This article, the second in a three-part series, will help buyers avoid common pitfalls that can derail M&A transactions.

In many of our merger and acquisition engagements over the past 30 years, Indian River Consulting Group has been retained to fix situations that came off the rails. Here are eight M&A flaws that we've encountered that will likely lead to transaction failure.

1. Failing to pay a multiple appropriate for where the transaction is in the consolidation cycle.

Consolidation cycles take years to occur. There are typically two rounds, with the initial consolidators acquiring each other in the second round. Industry disruptions can greatly compress these cycles. For example, a recession or another concurrent surprise acquisition may mean a deal never gets above water. Getting this wrong can cost as much as overpaying by two multiples.

The best way to avoid this mistake is to study the history of past transactions going back multiple years and pay attention to the external forces operating on the vertical. Management guru Peter Drucker said when looking to the future, anchor your study by looking back as far as you need to look forward. In today's terms that means that looking at a deal requires understanding deal history and structure starting in 2010, based on the typical private equity firm investment horizon of five to seven years from initial-platform acquisition to divesture.

2. Failing to know when to walk away (or suffering from "Crazy to Win").

When evaluating a potential purchase, a responsible seller will invest tens of thousands of dollars in due diligence. Imagine that you make a fair bid based on the market and what you have in your value-creation plan. Then the seller's investment banker comes back and tells you, "My client really likes you as a buyer, but your number is too low and needs to increase by

16 percent."

You know that 16 percent more puts you a bit higher than the higher market range but it is still in the market window. And, after all, they are only estimates anyway. So you adjust some of your assumptions in your value-creation plan. You have already invested close to $100,000 in the deal, so you want to move forward.

But what happens when there is a third round of bidding?

We have seen really large firms fall for this, especially PE firms struggling to find good companies to acquire. Over the next several years they will sell off strategic parts of the business to try and get back above water. In our experience, this is the No. 1 driver of zombie investment funds – those so underwater that the shareholders can never get an acceptable return.

3. Failing to understand variation and mass customization.

The generic MBA playbook teaches that variation is bad and processes must be standardized to gain economies of scale and efficiencies. But this approach destroys shareholder value in a distributor. Six Sigma and lean processes are valuable to a manufacturer to get into flow (think plant utilization and no exceptions). Consistency is valuable for a retailer to create a predictable customer experience (think Nordstrom and McDonald's). But distributors operate with a generic customer intimacy strategy, and their margins are directly linked to customer-switching costs.

The value-creation play for any distribution business is to develop processes to manage variation with accountability, not eliminate it. For example, a PE firm interviewed us to help fix a large industrial distributor where the value-creation plan had failed on an epic scale. They were 18 months into the transaction, and it had become a poster child for how not to acquire a distributor. The operating managers were seriously at odds with the PE firm, revenues and margins had declined as the managers were forced to standardize practices, and EBITDA was basically gone. We told them that the managers were correct, and they were wrong. They needed to get back to the beginning and have the managers own the value-creation plan.

We didn't get hired. They chose a good Six Sigma consulting firm. The firm is still there, but they have changed out all of the senior executives, and the firm has never regained the performance it achieved before the acquisition.

4. Failing to recognize and capture the strong talent being acquired.

The typical playbook answer in an acquisition is to lock up the senior executives in the acquired firm with contractual agreements, options and money while treating everyone else as fungible. There is also an effort to ask managers to determine other key contributors further down in the organization.

The critical flaw in this process is that the manager answering the question might be marginally competent and mostly concerned for their own job when they are answering. Good distribution organizations are flat, and much of the real talent is closer to the customers than to the executive offices.

We had a PE firm that acquired a large distributor that successfully sold to blue-collar workers using sales representatives that looked and acted like blue-collar employees. After the acquisition, they put in new executives that were polished and sophisticated. The new team immediately decided to turn the "losers" into professionals or replace them. They put in lots of rules and a CRM system. All the best sales reps left. The process took six months. It has taken five years to get EBITDA back to the levels they had at the beginning.

The key to avoiding this is to never base talent judgments on a single source and invest significant time to get wide and deep into the organization immediately after the acquisition is announced. The most important staff to retain are those that want to do good, rather than those who want to look good.

5. Failing to have a strong and deep communication plan.

After a deal goes down, the acquirer feels like they just won the tournament and they want to celebrate while building relationships with their new senior executive team. In a show of trust, the acquirer lets the existing management team handle the bulk of the employee, customer and supplier communications.

This is a mistake. Those stakeholders already know the existing executive team; what they want to know now is the new ownership team and their values, intentions and planned actions.

Good communication plans involve both the new owners and the existing management team. Give key stakeholders the opportunity to share concerns about the transaction and even around existing managers. One-on-one access must be provided, even if it is never used.

The communication program needs a feedback loop so the acquirer can get unbiased information on how changes are experienced in the field. Care must be taken to not undercut the existing management, but frequent informal visits to field locations should be built into the plan. Leverage the existing HR department.

We once worked with an acquirer who was a genuine 1 percenter with considerable personal wealth. But no one in the acquired firm had any idea as he spent time in the warehouse learning how to pick and pack orders. He spent the first week after the announcement working with first-level staff in purchasing, sales and finance. With what he learned, the value-creation plan was fine-tuned and the CFO was replaced.

Target-company competitors will aggressively go after top talent on the first day after the announcement. Uncertainty is not the friend of the acquirer.

Arrow Electronics has been the poster child of effective acquisition integration plans; they've successfully integrated more than 60 firms in less than 10 years. They changed their CFO three times over the period as they found stronger ones in acquisitions. They got so good that it only took 60 days to go from announcement to being fully integrated. Their communication plan was widely shared so everyone knew the timeline and what would happen. These practices were documented in a research project we conducted on behalf of the National Association of Wholesaler-Distributors.

6. Failure to recognize that culture always trumps strategy.

If the value-creation plan is shared fully and early in the integration process, like with Arrow's best practices, the team will improve on it and support its execution. This requires that hard decisions like staff reductions and organizational changes be made early and quickly. It's a rookie mistake to say, "Nothing is going to change." Starting with a lie does not build trust. At some point, something will change and the response will be, "I told you so. They were lying. What's next?"

A new owner that works exclusively through the senior team in a command-and-control style runs the risk of creating passive – perhaps even active – resistance to change. In decentralized customer-intimacy businesses, it is fairly easy for the field to ignore corporate, for both strategic and PE buyers. Participation creates commitment. As early as possible, bring lower staff into the value-creation plan and clearly explain why specific actions were chosen. Once they understand the "whys," the staff will improve on the plan and execute. Every employee wants to work for a winner that is going places.

In the U.S., a common cultural trait is to respect performance more than hierarchy or position. Many non-U.S. acquirers have had issues with this. There are just as many cultural mistakes when U.S. firms acquire distributors overseas – the major sin is American arrogance. There are many global distributor consolidators, and some do it better than others. Wolseley and Sonepar stand out as global firms that have learned to respect these differences.

7. Failure to understand the market during due diligence.

There are no good surprises in an acquisition. Industry practices are often so ingrained that they are assumptive. It is not that the target fails to inform the acquirer; it is just "how things are done and everyone already knows."

There is so much variation within distribution that the smartest thing an acquirer new to a vertical can do is involve an industry insider as part of the due-diligence team. There are many one-man band consulting firms in each vertical where the principal was a long-tenured senior executive who knew everyone. They will often not be polished or capable of generating a report or readout acceptable to a PE firm, but they are cheap insurance.

Listed below are some idiosyncratic industry practices that have cost acquirers millions of dollars over the years.

- Many suppliers to distributors have agreements that allow them to terminate the relationship if the ownership changes. Some even have a permanent lien on the distributor's inventory that may have been documented back in the 1980s that can destroy the acquirer's ability to access debt.
- Some markets are changing very rapidly with nontraditional competitors. United Stationers (now Essendant) and Staples destroyed the office-product wholesaler vertical; Amazon Business is taking aim at facility supplies and other industrial products. Most of the existing industry incumbents typically stay in and ride it down, often unaware of the new threats until it is too late.
- Market power is always taken – never

given – in channels. In some cases, the primary power is held by the suppliers or customers. How well is a value-creation plan that leverages scale to get supplier price concessions going to work with the largest distributor in the industry making up a fraction of 1 percent of the supplier's revenue? On the other side, how much margin improvement can be generated when a vertical typically has two or three customers that represent 50 percent of a distributor's volume?

8. Not taking an acquisition seriously enough. An owner-operator distributor decides to make an acquisition and fails to get professional advice to save money. They don't know what they don't know, especially about market value, deal structure, warrants, escrow accounts and contingencies. They frequently say that nothing will change and really mean it. The net result is that they commit all the fatal flaws listed above and pay too much for a business, which then rapidly falls off the rails. The acquired CEO finds it hard to become a prince when he was once a king. (We have stopped two of these deals this year that didn't even have a documented value-creation plan.)

There are many more things that can go wrong in a distributor acquisition. What we shared are those you can specifically avoid. If you can do this, your chances of achieving your value-creation plan are much higher. When the focus is on increasing shareholder value instead of old-school revenue growth, it is almost always cheaper to buy than to build.

Pt. 3: Integration Best Practices

Shareholder value can be built or destroyed during integration

Every company struggles when merging. This article, the final in a three-part series, will help buyers plan an effective integration of a newly acquired business.

As I write this, Indian River Consulting Group is working on an acquisition with a distributor in India, an acquisition for a distributor in Korea (for whom we also developed an integration plan for their first acquisition) and a merger of distributors in Latin America.

Other than travel and time-zone challenges, it is interesting how little is different among them. Every company, no matter where they are, struggles with merging two businesses. Those that are experienced all know one thing: Poor integration is probably the largest destroyer of shareholder value.

On the flip side, the amount of shareholder value created in a transaction is driven by the effectiveness of the integration. A transaction always looks good on a spreadsheet, but when it comes time to evaluate the acquisition, the people involved in the original deal are usually long gone. A distribution best practice is to wait two to three years on every acquisition and then compare the original final executive presentation to the actual results. The presentations always miss. These gaps create institutional wisdom so you only make new mistakes.

The starting point defines the path forward

In any successful acquisition, you will have a value-creation plan that defines the benefits of integration. They are always built pre-transaction; this means there is always uncertainty and assumptions in the original plan. But remember, effective integration is driven by operating-line management.

Is this a merger or an acquisition? Is it a platform or an add-on? Are business models different? The path forward is different for each one.

Mergers: Often the word "merger" is used to make an acquisition more acceptable to employees. If there are backroom negotiations with both owners that determine which executive team drives the integration, it becomes a thinly disguised acquisition. One set of managers takes over the combined enterprise, and the other set of managers departs quickly.

These typically produce value for those exiting, but the ongoing business always loses shareholder value for those that remain. The question is how much? In each case, the companies say that they are different, and it won't happen to them. But they're usually wrong.

A real merger is when both sides are equally committed to growth in long-term shareholder value. The deal-makers generally plan to be involved in the business over the long-term. Board structures with outside directors will be a key component to resolve issues and keep the deal moving forward. We facilitated one of these where the two owners were stuck on who would own what percent of the combined business. When they figured out that ownership in the combined debt would also go with the same split if they went 65 percent and 35 percent, both decided that 50/50 was the best answer.

Platform acquisition: In the case of an investor acquiring a platform company (see part one of this series for a definition), there is a value-creation plan but it is mostly about transitioning from lifestyle to professional management and preparing the acquired business to acquire add-on firms. There is also a set of actions designed to improve the business. The content of this plan looks very similar to the add-on acquisition.

Add-on acquisition: In an add-on acquisition, the platform firm is seeking to gain talent, new customers, new capabilities or key supplier relationships. Beyond this, rapid consolidation of the add-on's existing organizational structure and redundant resources into the platform is typically the largest value-creation play. For example, Owens & Minor created significant value in the mail-order homecare market. It built a robust order-fulfillment model with strong and cost-effective logistics. It then rolled-up the highly fragmented market, eliminating major redundant costs in the process. This was tough for those who lost their jobs but created significant value for its shareholders, customers and suppliers.

Different business models: Integration is a bad idea in certain situations. There are three generic business strategies: customer intimacy, cost leadership and product innovation. If the acquired business has a different strategy than the acquirer, the businesses need to be kept and operated separately. Attempting to integrate in these situations can destroy shareholder value, as discussed in Geoffrey Moore's article for Harvard Business Review, "Strategy and Your Stronger Hand." The classic example is a manufacturer acquiring a distributor to gain control of its channel to market. In 30 years of consulting, we have yet to see manufacturer-owned distributors generating profits at the same levels as independently owned distributors of the same product.

Why distributors are different

When he was CEO of Arrow Electronics, Steve Kaufman acquired and integrated dozens of firms in fewer than 10 years. He summarized what made a distributor different from other businesses: "Manufacturers have property, plants, processes and patents as assets. Distributor assets go home at 5 or 6 o'clock, and we hope they come back in the morning."

The growth in shareholder value over his tenure at Arrow set the standard for A-player performance. Arrow's success has been documented in multiple Harvard case studies and a National Association of Wholesaler-Distributors Institute project conducted by our firm, "Distribution Leaders: The Power of People." They used 12 rules, which defined their success in integrating new businesses:

1. Integration is completed in 60 days (insurance, comp plans, territory mergers and facilities). Even if it took a year to get out of a lease, all employees knew what was going to happen.
2. Choose the best manager for each position. (Arrow changed CFOs three times over the decade.)
3. Set clear performance expectations, real performance appraisals and mandatory training and development. They embraced diversity before it was fashionable.
4. Be compassionate toward those who are released.
5. High-intensity integration planning with key "keeper" executives on both sides is critical before the acquisition is announced.
6. Losing control means that the good people leave and the bad ones stay.
7. Move quickly on synergies in human resources, accounting, IT, facility combinations and warehousing or production rationalization.
8. Be cautious but deliberate in supplier-facing and customer-facing roles.
9. Recognize that input from weak managers is distorted around who is good and who is not.
10. Make hard decisions fast (especially if more information won't make it easier).
11. Over-communicate consistently, with face-to-face conversations, to all employees for 60 days.
12. Make several high-visibility moves of acquired execs moving into the acquirer's firm.

As Arrow continued to acquire companies, this set of practices made them more attractive to acquisition candidates. Your ability to consolidate is much easier when the targets are calling you for a conversation.

Best practices in action

Before announcing the acquisition: At a minimum, a time-phased integration plan must be developed. This will be updated and clarified post-announcement by a team of key staff from the acquirer and the acquired. The individuals from the acquired business should be identified before acquisition and brought into the circle of silence right before the announcement.

In this pre-announcement meeting, all the phone calls, press releases and emails to suppliers and customers will be defined and scheduled. Communication to existing employees must be well-planned and provide opportunities for discussions. It is important to maintain active control over announcement messaging.

Announcement day to 30+ days after: Execute the detailed roll-out plan, including site visits, phone calls and team meetings. Because there is a team working in parallel, schedule conference calls to keep the team coordinated and highlight any issues that arise. Based on this input, relationship-building activities between the two companies are scheduled.

This 30-day window is the quick side of the range to ensure all stakeholder relationships are properly connected and potential issues that will require action have been identified. The focus is on risk management. The probability of uncovering a previously unknown major issue is low if you did your due diligence. But the financial consequences in losing a major customer, supplier, key manager or sales rep are all quite large.

There is a strong urge to take immediate action to improve performance, but wait. Remember that changes would be made on a foundation of significant assumptions. The primary goal at this time should be to achieve the value-creation plan.

How do you know it is complete? As the integration progresses, senior executives from both businesses should have an ongoing dialogue. They are mutually refining the value-creation plan based on new information uncovered.

A larger group should be brought together to develop a strategy going forward. This happens when the senior team has settled on their value-creation plan and the transaction is complete. At the strategy meeting, which typically occurs over two days, senior executives present the value-creation plan indicating that it only contains where we want to go, how fast we want to get there and some key initiatives that will create value. It does not contain the detailed steps to accomplish the key initiatives, the timeline or the sequence of what is most important – and who will do it.

The senior executives need to take the time to fully explain and discuss the key initiatives (e.g., strategic pricing, central logistics management or specialized sales roles). The full leadership team should then detail how the plan will actually be accomplished.

Having priorities aligned and agreed to is critical to effective integration.

Integration is complete when the management team understands and owns the value-creation plan.

Revisiting the basics

Keep the following in mind as you integrate acquisitions, as they can derail an otherwise smooth process:

People: The customer's value proposition for the distributor is often the individual sales rep that calls on them. Figure out who your A-players are and manage them so they won't leave. Most organizations have one or more individuals who will be negative upon hearing about the acquisition and will engage in subtle sabotage. Find those few quickly and terminate them.

Competition: Your competitors will aggressively attack your weak spot when you are going through an acquisition. If you are one of the very large competitors, other distributors will come after your smaller customers as they assume you will focus on the large customers. Don't wait for it to happen. Anticipate and develop your response to minimize the impact. Sometimes the best defense is a good offense.

Market shifts: In addition to the internal changes for both the acquired and the acquirer during the integration, keep an eye on external shifts. The strong distributor trade associations are all developing programs and tools to help their members manage large-scale changes like the rise of e-commerce, millennials and digitizing the selling function. Develop a strong capability in sensing the external environment and use your association to help.