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Profitability in the Great Recession

An analysis of how some distributors stayed profitable despite decline

In this article, Profit Planning Group's Al Bates illustrates how top companies across sectors were able to deliver strong profit results relative to their peers during the recession. He explains the four profit drivers that often are the differences between typical and high-profit firms, and with that data, he shows what typical companies can do to recession-proof their firms.

By Al Bates

The so-called Great Recession created a unique set of financial challenges for distributors. In many lines of trade, sales didn't just decline, they fell precipitously. Overall, profits sank to the lowest point since distributor financial benchmarking was established in the 1970s.

Despite the challenges, a large number of firms continued to generate strong profits. A few even produced exceptional results. Understanding how they did that is essential for future financial planning for any distribution firm.

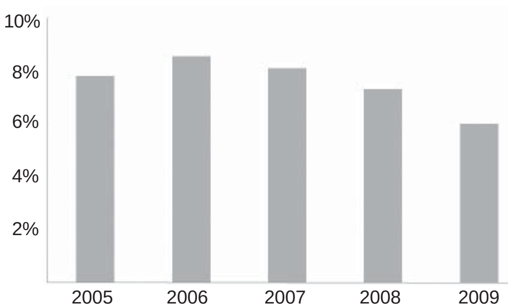
The Scope of the Problem

The Profit Planning Group maintains the largest data base on distributor financial performance in North America. For the 2008-2009 time period the firm collected information on distributors in 46 different lines of trade.

Not surprisingly, 40 of the 46 business categories experienced a sales decline in 2009 versus 2008. What is surprising is the six that did not. These were all in consumer-based product lines where continued purchasing is not discretionary.

For those industries not shielded by purchasing necessity, the results were closer to a depression than a recession. For firms serving the construction industries, sales were down more than 22 percent. Industrial supplies didn't fare much better, with declines slightly greater than 21 percent.

Exhibit 1:
Return on Assets: Aggregate



Profits, of course, fell as well. The aggregate results for all 46 lines of trade from 2005 to 2009 are presented in Exhibit 1. The exhibit uses return on assets (profit before taxes as a percent of total assets). Return on assets (ROA) is the best way to evaluate profit performance as it measures profit against the totality of the investment in the business. As can be seen, ROA performance peaked in 2006 and declined to 6 percent in 2009.

Experience suggests that 5 percent is something of a minimum point for acceptable financial performance. Below that level, the advisability of reinvesting in the business is called into question. The 6 percent level in 2009 provided limited breathing room.

A little more than a third of the industries fell below the 5 percent base line. Of that group, one industry operated right at breakeven, and two experienced aggregate losses for the year. At the other extreme, six industries exceeded a 10 percent ROA, which is considered outstanding industry-wide performance.

Holding the Line

As disquieting as the profit results were,

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INSIDE

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PERSPECTIVE ■ *Commentary by Thomas P. Gale*

Spurt of M&A Deals Indicate a Rebounding Industry

MDM reported on a dozen announced acquisitions in the past month, and October was active, as well. It's interesting how diverse the deals are across sectors and size. Some companies are shedding units to focus on the core; some are buying market share, and others are extending product and service capabilities. Many companies are trying to get deals done before year-end. Credit markets are indeed improving, people are adjusting to a long-term/low-growth scenario, and larger companies have a lot of cash to do some pre-holiday shopping.

In manufacturing, there were a few international deals, with Midwest-based U.S. companies acquired by European companies. SKF agreed to buy U.S. manufacturer Lincoln Industrial, and ABB will buy motor manufacturer Baldor Electric Company. In both cases it means an expansion of not only geography, but also into complementary product areas. Belden agreed to buy the communications products business from Thomas & Betts, a logical transfer. On the distributor side, WESCO is buying TVC Communications, a broadband products distributor.

MSC Industrial is buying Rutland Tool from Lawson Products for $11 million in cash. Rutland fell on hard times after it was acquired by Airgas in 1996, when Rutland reported $65 million in revenues. Airgas took about a $60-million hit on Rutland when it sold it in 2005 to Lawson. My take: Rutland finally found a nest with a bird of the same species.

Parker Hannifin acquired Gulf Coast Seal, a hybrid manufacturer-distributor into offshore oil and gas operations. MDM's proprietary Value Warning System blasts a red alert whenever a manufacturer buys distribution, as 99.9 percent of historical record indicates the same reaction occurs as when you combine matter and antimatter (you can assign which is which based on your industry affiliation). Often deals like this have been about taking a niche market segment direct, with customers often losing service value. But there is a product line extension opportunity here, as well. This is the New Normal so I am keeping an open mind. It will be interesting to see how Parker manages other franchised distribution transitions.

Some of these deals add strong service components, one of the clearest emerging trends in terms of how distributors, after getting smoked the past few years, are rising from the ashes and redefining how they differentiate and compete in 2011 and beyond. I expect we'll see some innovative add-ons. After spending the past few years fishing or golfing, the M&A guys may not have a lot of free time for the holidays this year. I think they'll get over it.

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Profitability

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the fact that things weren't worse is nothing short of astounding. Sales declines in the 20 percent range should not just impact profit, they should decimate it. In 2009 it seems that when the going got tough the tough really did get going.

Exhibit 2 presents a representative response to the economic challenges. It is extremely important to note that distribution firms come in all sales sizes with various levels of gross margin, expenses and profit. The exhibit is not meant to be an amalgam of the 46 industries. Such an amalgam is only possible at the return on investment level, not at the detailed income statement level.

Instead, Exhibit 2 represents a mid-size, mid-margin firm that serves as a proxy for what happened across many industries. The sorts of changes shown in Exhibit 2 were seen in many distribution sectors. The numbers were different by line of trade, but the pattern was similar.

The firm in Exhibit 2 experienced a 20 percent sales decline so it is illustrative of distributors serving both construction and industrial customers. Absent any actions by management, a 20 percent sales decline would have pushed the firm well below its breakeven point.

It is worth mentioning that in a more "typical" recession sales would have fallen somewhere around 5 percent. With that modest decline management probably would have made only minor changes to keep the business structure intact. In essence the firm would have ridden out the storm.

With such a sizeable sales decline, however, fine-tuning and waiting for better days was simply not an option. In general, distributors took three specific actions:

Gross Margin – Despite strong pricing pressures, a very modest improvement in the gross margin percentage was achieved. In a down market this is exemplary performance.

Payroll Expenses – Overall payroll expenses (including bonuses) were cut by about 10 percent while sales fell by 20 percent. This reflects the inability of firms to match wage reductions

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Exhibit 2:

How the Sales Decline Was Offset - Example Firm

Dollars	**2008**	**2009**	**% Change**
Net Sales	$50,000,000	$40,000,000	-20.0
Cost of Goods Sold	37,500,000	29,875,000	-20.3
Gross Margin	12,500,000	10,125,000	-19.0
Expenses			
Payroll and Fringes	7,000,000	6,275,000	-10.4
All Other Expenses	4,250,000	3,450,000	-18.8
Total Expenses	11,250,000	9,725,000	-13.6
Profit Before Taxes	$1,250,000	$400,000	-68.0

Percent of Sales		
Net Sales	100.0	100.0
Cost of Goods Sold	75.0	74.7
Gross Margin	25.0	25.3
Expenses		
Payroll and Fringes	14.0	15.7
All Other Expenses	8.5	8.6
Total Expenses	22.5	24.3
Profit Before Taxes	2.5	1.0

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Profitability

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to sales reductions. However, it still represented something much closer to sharp pruning of the staff than to making selective reductions.

Other Expenses – If it wasn't people, it was cut almost to the point of matching the sales decline. Nothing was sacred.

All expense cuts were painful. The representative firm did not emerge lean and mean. It emerged anemic and chastened. A lot of infrastructure was jettisoned to save the ship. Rebuilding that infrastructure will undoubtedly prove to be arduous and time consuming.

What Recession?

As noted earlier, profit results vary widely by industry. At the same time, within every industry profit results also vary widely. The most important segment to follow in any industry is the high-profit group. This group represents the top 25 percent of the firms in terms of ROA performance.

It is unfair to suggest this group did not feel the impact of the recession. It is fair to suggest that they managed to maintain outstanding profit results relative to their peers across every industry. In 2008 the high-profit firms generated an ROA that was 2.9 times as high as the typical firm. In 2009, the ratio only fell to 2.8 times. For them, profitability fell from great to very good.

With their stronger financial results, the high-profit firms were able to gain market share by keeping "feet on the street" and not sacrificing training or customer support. They were also positioned to absorb failing competitors.

There are four profit drivers that often explain the differences between typical and high-profit results. In the Great Recession, two were at work and two were not:

Sales Size – The size of the firm had no calculable impact on results. Large firms enjoyed both economies and diseconomies of scale.

Sales Growth – This is almost always a major factor in profit performance. But this time the results were different because everybody experienced large sales declines (excluding those few industries discussed at the beginning). Sales growth did not play a role.

Gross Margin – The high-profit firms enjoyed a higher gross margin in almost every industry.

Expense – Across virtually every industry expenses were lower. Much of the advantage was in payroll and interest.

The last two items on the list were almost exact mirror images. The high-profit firms simultaneously had 4 percent higher margins and 4 percent lower total expenses.

This means for example, that in an industry where the typical gross margin percentage was 25 percent, the high-profit firms were at 26 percent (25 percent multiplied by 1.04). By the same token if total expenses were 20 percent in a specific industry, then the high-profit firms would be at 19.2 percent (20 percent multiplied by 0.96).

Amazingly, something close to the 4 percent variation held true across the vast majority of industries. The high-profit firms were able to parlay small, but meaningful, advantages in margin and expenses into large advantages in ROA.

Never Again

Nobody is eagerly looking forward to the next recession. However, assuming the current recession does not prove to be a double dip, the countdown clock has already started on the beginning of the next recession. As painful as it might seem, now is a great time to recession-proof the firm in anticipation of next time.

Two sets of actions are required. The first of these involves changing the profit structure of the firm. The second requires rethinking the risk structure of that firm.

The profit structure issues are simple. Everybody needs to copy what the high-profit firms are doing, namely getting control of gross margin and payroll. The laundry list of things to do in these two areas is well beyond the scope of this article. However, the end result is not.

Every firm needs to drive profit to a point where its breakeven sales volume is a full 20 percent below its current sales level. This is almost exactly where the high-profit firms were going into the recession. At the same time, the typical firm had only a 10 percent cushion between its current sales and its breakeven point. For garden-variety recessions that was probably good enough. When the big one hit, that safety factor was completely overcome.

Thinking that there will never be another big one does not seem prudent. Any firm that does not strive to get to a 20 percent cushion is derelict in its planning. The changes in gross margin and payroll required to get there are not large, but they require systematic effort.

Risk is always in the eye of the beholder. Some management teams abhor debt. Such firms would rather grow with internal funds or not grow at all. Historically, their growth rates have been slower than their peers. At the other extreme, some firms appear to relish debt. With heavy debt, these firms almost always grow faster than their peers.

While attitudes toward risk are a personal, philosophical issue, one truism persists in every recession. That truism is that firms die in inverse risk order. The highly-aggressive firms that are leveraged to the hilt are wiped out first. When banks decide to stop lending this reality is magnified.

The prudent firm should make sure its debt-to-equity ratio is under 1.0, its cash-to-current liabilities ratio exceeds 20 percent and that it can operate for 15 days without a single penny of revenue coming in (the defensive interval ratio).

In short, every firm needs to join the high-profit club. It would also be nice to join the low-risk club. Only then will success be guaranteed in any set of economic conditions.

MDM's 2011 Economic Forecast Webcast feat. Al Bates
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Uncertain economic times call for hard data you can use to plan for 2011. This webcast features a panel of experts providing a forecast for key end-markets and practical advice on how to use that data: **Al Bates** of Profit Planning Group, and economists **Ken Simonson** of Associated General Contractors of America and **Don Norman** of Manufacturers Alliance/MAPI. **Order the DVD** for just $49 at mdm.com/2011economicforecast or call 1-888-742-5060.

Top Business Concerns in Reader Survey

And how readers have adapted their businesses over the past two years

MDM recently conducted its annual Reader Survey. On that survey, MDM asked questions about top business concerns for 2011 and what distributors, manufacturers and others have done to adapt to changing business conditions over the past two years. This article is a synopsis of those responses and provides insight into the mindset of the distribution industry as we move into the new year.

By Lindsay Konzak

In the 2010 MDM Reader Survey, not surprisingly, the economic recovery and uncertainty that has accompanied it was one of the top three business concerns for many respondents.

Some readers are concerned the economy will decline again, while others are just not sure what's coming next for their markets – despite mostly positive economic indicators.

Outside of the economy, the following issues or concerns floated to the top:

- Pricing and margin pressure
- Inventory and A/R management
- Retaining and attracting good employees
- Uncertainty over government policies, including health care
- Competition from national distributors and due to consolidation
- Currency swings

Asset Management & Profitability

A key focus for many survey respondents for 2011 was asset management. Building inventory back up after a couple of years of lean inventory management has been a focus to ensure they can meet growing demand.

One reader wrote: "We had to adjust our inventory, but we didn't 'panic' and have been ready to handle all the growth we have experienced in 2010."

More recently, vendor lead times have been a concern for about half of the respondents to the survey.

MDM posed the question about top business concerns on its LinkedIn Group forum. A group member wrote that suppliers in some sectors are keeping inventory at "very low levels" and that back orders have been common.

Cash flow continues to be top of mind, in part due to slower-paying customers; profitable sales are also a concern. Many are focused on maintaining current business levels, which has been difficult over the past couple of years.

As a result, price wars have erupted in many markets, putting downward pressure on

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margins and moving pricing front of mind for many distributors looking to be more strategic about their approach to getting paid for the value they provide.

Pricing was noted by many respondents as a very important issue over the next 12 months. Many distributors continue to face margin pressure, and competition for new business continues to be steep.

MDM's question on its LinkedIn Group forum sparked a conversation about margin pressures. One participant wrote that many distributors in the market are lowering margin to increase volume, in an effort to survive.

And while "smart distributors" are staying focused on customer service and improving their businesses, lowering margins hurts the entire market, he said. One respondent said that even customers with whom they have strong relationships are looking around for better prices.

Commodity price fluctuations in some sectors are making this issue more pressing for some, forcing them to fight rising COGS and falling prices. This has made defining and documenting customer value even more important for many readers.

Another critical issue for many readers was the retention and recruitment of good employees. If and when to hire again was one question.

A second: redesigning compensation and incentive plans to keep valuable employees in place.

Also, distributors and suppliers are facing a growing number of employees who are near retiring, and they recognize the need to recruit younger and "eager" employees, making effective training another concern for the new year.

How Have Readers Adapted?

In the second business conditions question asked on the survey – What changes have you had to make in your firm to be successful in the economic environment of the past two years? –many named aggressive pricing and better cost management, as well as, "tightening the budget until it cannot breathe." Reduction of bank debt was also noted.

But outside of cost cuts, approaches included becoming more aggressive on the sales and marketing front by using market information to identify growth market opportunities and staying closer to key customers.

"We have had to be more focused than ever before at driving our brand at the end-user," wrote one reader.

Another wrote: "We've had to become more entrepreneurial, and we've had to look beyond our traditional markets and methods."

One reader established an inside sales team. Others increased their focus on application-based selling and broadened their service offerings.

New product offerings have also been in the mix. One reader said he has focused on products that "immediately save customers money," and has expanded rental offerings.

Readers are increasing their focus on margins in the selling process, as well as revising their compensation programs to "place more emphasis on growth and goal attainment."

Technology investments have been important to many readers in the past two years, not only in new systems, but in making sure they use all of their current systems. Many have also increased their investment in online capabilities.

One reader is "using technology to improve customer profitability using data analytics and instituting a strategic pricing model."

In contrast to the above more forward-looking actions, last year's MDM Reader Survey seemed to highlight more defensive action. Some of the more common comments last year included cutting wages, reducing budgets, furloughs, inventory reductions and hiring freezes.

But this year readers seemed more proactive.

While we are certainly not out of the woods yet, this shift in mindset bodes well for smart distributors looking to gain an edge in a highly competitive environment.

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MSC Industrial's Investment in Growth

Distributor keeps focus on taking market share, expanding gross margins

Manufacturing production and new orders continued to expand in November, according to the latest Purchasing Managers Index, signs that the recovery is underway. But not every distributor has been able to take advantage of increased demand, says Erik Gershwind, COO of industrial distributor MSC Industrial Direct, Melville, NY. Gershwind recently presented at the Robert W. Baird Industrial Conference.

The cuts many "mom-and-pop" local and regional distributors have had to make put them in a precarious situation now that demand in increasing, Gershwind says. "They face severe pressure on working capital in the form of inventory and receivables," he says. "So many of these businesses can't afford to put the cash back into their businesses."

And that has given MSC opportunity to grab market share, according to Gershwind. He says that MSC was able to maintain and grow its sales staff to focus on the opportunities even during the downturn. As of Aug. 28, 2010 – the end of the company's fiscal year, MSC employed 973 direct sales representatives, a 3.6 percent increase over the prior year.

And the company is expanding its geographic presence – particularly in the western U.S. "Our market share in the state of Connecticut is 3 percent, which is a tiny number but it's still a growing number," Gershwind says. "But if you take our Connecticut market share and extend it across the rest of the country, you have a business doing in excess of $4 billion in revenues (each year). Without doing anything much different than what we're already doing today, we have a huge growth opportunity in this company."

MSC's growth strategy also includes building upon its position in metalworking, looking at new customer segments, making "selected acquisitions" such as the recently announced acquisition of Rutland Tool & Supply Co., and expanding product offerings. (MSC currently has more than 600,000 SKUs on its website.)

The investments seem to be paying off for the distributor. Fiscal 2010 sales were up 13.4 percent over 2009, and even up 2.4 percent when compared to fiscal year 2007 – before the recession formally began.

Beating the Industry

At 46 percent, MSC's gross profit margin is double the company's estimate of an industry average of 23 percent. A higher-than-average gross profit margin is a result of three key strategies, according to CEO David Sandler, also speaking at the Baird Industrial Conference.

The first reason is the type of demand MSC targets: unplanned and semi-planned demand. "The semi-planned demand is the stuff that fills the storeroom," Gershwind explains. "They know they're going to need it, but they don't know when and they don't know how much."

MSC offers options for its customers to manage the unknown, through automated replenishment systems and vendor- or customer-managed inventory. It also works to reduce the cost of orders that are often low-dollar.

The size of MSC – the distributor reported sales of $1.69 billion for fiscal year 2010 – also provides an advantage for maintaining a high profit margin. "While we're not a huge company, we are quite large in our space," Sandler says. "Which means we enjoy a lot of leverage with our suppliers, and we use that leverage to command better pricing."

The third reason identified by Sandler for MSC's success in maintaining higher gross margins is its focus on branding and private label. While the company does not publicly disclose what percentage of its revenues are from private label, he said it is "significant." "It's really impossible for a small distributor to be able to import directly, and that gives us an enormous advantage on the gross-margin line," he says.

Of the 43,000 new SKUs added to the 2011 catalog distributed in September 2010, about 30 percent of them were MSC proprietary brands, according to MSC's 10-K SEC filing for fiscal 2010. But focusing on a private label can create its own challenges in dealing with other suppliers. "It's definitely about creating a balance," Gershwind says. MSC has to make sure that other suppliers do not feel that the company is trying to compete with them. For MSC, that meant positioning its private label offerings on a different value proposition and not just on the lower price.

"We're in the early innings of a really powerful growth story, a story that we continue to invest heavily in," Gershwind says. "The way we're going to grow going forward is very much the way we've grown for the past 15 years." - *Jenel Stelton-Holtmeier*

Mergers & Acquisitions Set to Pick Up in 2011

Mergers & acquisitions activity has picked up in the fourth quarter of 2010 in wholesale distribution and manufacturing. And if a series of surveys out recently are any indication, pent-up demand for acquisitions will push consolidation on a global level to take off in 2011.

In the U.S., according to Robert W. Baird & Company's November global M&A report, there was a 22.7 percent increase in the number of transactions in October, and announced dollar volume of deals jumped 62 percent. Middle-market deals remained strong, as well, with deal count up 48.8 percent and dollar volume up 47.6 percent.

As MDM reported in early November, M&A deal value in global industrial manufacturing in the third quarter of 2010 was up year-over year, according to a PwC report. According to the report, "recent updates and projections for the worldwide economy point to a supportive backdrop for M&A."

What's contributing to an increase in deal-making? Factors include better economic conditions, healthy balance sheets among strategic acquirers, access to credit at attractive terms, and capital allocation requirements for private equity firms, according to the Baird report.

While experts focused on the wholesale distribution sector have said that buyers are still looking at distressed companies as an opportunity for purchase, it seems that buyers may be expanding their views in 2011.

In the Thomson Reuters and Freeman Consulting Group's 2011 Outlook for Investment Banking Services, the report outlines objectives reported by survey respondents on why they are pursuing deals in 2011. Gaining market share in existing markets was most often cited, followed by expanding geographical presence. Acquiring undervalued assets was the fifth most-cited reason. (See graphic below.)

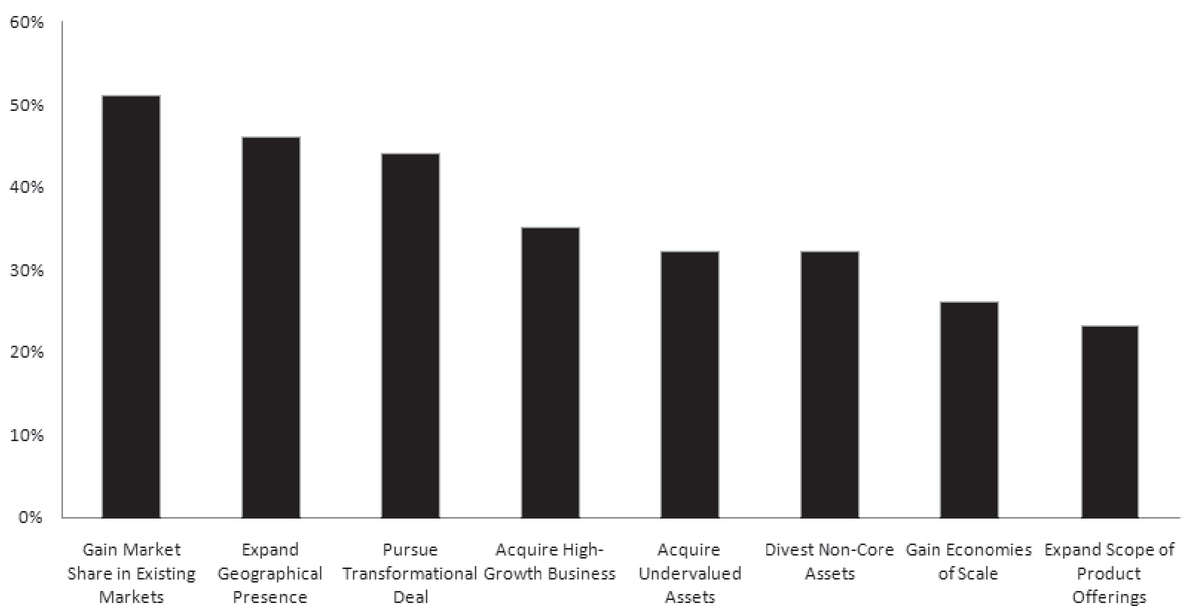
A recent survey from UBS Investment Bank and The Boston Consulting Group (BCG) looked at European companies' M&A plans for 2011. The survey results shed some light on plans by larger public companies globally. One in six of the companies surveyed are expecting to make a large-scale acquisition in 2011; large companies are twice as likely to do so.

One-third of respondents believe the next 12 months is the best time to go ahead with a major deal. Of those with M&A plans last year, half canceled those plans, according to the survey.

Alexander Roos, head of BCG's global M&A practice says: "But companies remain cautiously optimistic about deal activity. The lingering uncertainty offers opportunities for those CEOs who are prepared. ... Next year's acquisitions – undertaken with the necessary rigor and with a clear strategy in mind – can hence become a powerful source of competitive advantage."

Objectives Underlying 2011 M&A Plans

Source: Thomson Reuters/Freeman Consulting Services 2011 Outlook for Investment Banking Services



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Industrial & Construction Markets Update

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Third Quarter Trends in the Canadian Economy

Canadian real gross domestic product rose 0.3 percent in the third quarter, following a 0.6 percent gain in the previous quarter, according to the latest release from Statistics Canada. Final domestic demand grew 0.9 percent, as business investment in plant and equipment advanced. On a monthly basis, real GDP by industry declined 0.1 percent in September.

Expressed at an annualized rate, real GDP grew 1.0 percent in the third quarter, after expanding 2.3 percent in the second quarter. In comparison, real GDP in the U.S. grew 2.5 percent in the third quarter.

Business investment in plant and equipment recorded its strongest quarterly increase so far this year, as investment in machinery and equipment expanded 6.5 percent in the third quarter. An increase in consumer spending also contributed to the growth in final domestic demand.

Exports of goods and services declined 1.3 percent after four consecutive quarters of growth. The main contributors to the decline in goods exports were automotive products (-2.1 percent) and energy products (-8.5 percent), while commercial services (-1.7 percent) contributed the most to the decline in services exports.

Housing investment declined 1.3 percent in the third quarter, the first decline since the first quarter of 2009. Expenditure on ownership transfer costs related to housing resale activity was down 10 percent, on the heels of a 13 percent drop in the second quarter.

The increase in the goods-producing industries (+0.8 percent) significantly outpaced that of the services industries (+0.1 percent) for a fourth consecutive quarter.

Business inventories rose $18 billion in the third quarter, an accumulation

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DXP Enterprises, Inc., Houston, TX, has agreed to acquire **D&F Distributors**, Inc., Evansville, IN, for $13.4 million. D&F operates out of six locations in Indiana, Kentucky, Tennessee and Ohio. D&F distributes and services industrial, commercial and municipal pumps and fabricates pump packages. The 2010 annualized sales for D&F are $22 million.

ABB, Zurich, Switzerland, has agreed to acquire **Baldor Electric Company**, Fort Smith, AR, for $4.2 billion, including $1.1 billion of net debt. The acquisition enables ABB to penetrate the North American industrial market and closes a gap in ABB's automation portfolio in North America. It also builds the company's global market presence for industrial motors, including high-efficiency motors, as demand for energy efficient motors and drives continues to grow.

ProBuild Holdings Inc., Denver, CO, will close 20 locations nationwide, according to an announcement that appeared in ProSales Magazine. ProBuild operates about 470 locations. The closures include a facility in Jackson, WI, and one in Jacksonville, FL; the other 18 locations have not been disclosed.

The Supreme Court of Delaware invalidated a bylaw amendment introduced by **Air Products**, Allentown, PA, at Radnor, PA-based **Airgas'** annual stockholder meeting in September. The amendment would have required Airgas to hold its next annual meeting on Jan. 18, 2011.

Arrow Electronics, Inc., Melville, NY, has agreed to acquire Jackson, MS-based **Intechra**, an information technology asset disposition company. Intechra had sales for the most recent fiscal year of $75 million.

The **Power Transmission Distributors Association** (PTDA) Board of Directors unanimously selected Ann Arnott, currently PTDA's vice president of programs and services, to succeed Mary Sue Lyon as the executive vice president of PTDA, effective Jan. 1, 2011.

PTDA members are projecting 10 percent growth on top of the 14 percent average growth expectation for 2010, according to the third quarter results of the **Quarterly Business Index released by the Power Transmission Distributors Association** (PTDA). In the third quarter, respondents experienced expansion, albeit at a slightly reduced rate than the second quarter. The overall reading for the third quarter was 74.6, compared to 77.0 in the second quarter. A reading above 50 indicates expansion.

Beacon Roofing Supply, Inc., Peabody, MA, reported sales for the fourth quarter ended Sept. 30, 2010, were $482.6 million, a decrease of 1.1 percent from the same period a year ago. Organic sales declined 3.8 percent. Profit for the distributor of roofing materials and complementary building products fell 11.4 percent to $16.9 million. For the full fiscal year, sales were $1.61 billion, down 7.2 percent from fiscal year 2009. Organic sales decreased 8.7 percent. Profit fell 34.1 percent to $34.5 million.

The U.S. economy continued to improve, on balance, during the report-

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MARKETS UPDATE SUPPLEMENT P. 2

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MDM News Digest

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ing period from early/mid-October to mid-November, according to the latest **Federal Reserve Beige Book**. Manufacturing activity continued to expand in almost all Districts, with relatively strong growth seen in metal fabrication and the automotive industries.

Manufacturing expanded in November, according to the latest **Manufacturing ISM Report on Business**. The report was issued by the Institute for Supply Management Manufacturing Business Survey Committee. According to the report, the manufacturing sector grew in the month, with both new orders and production continuing to expand. With the PMI at 56.6 percent, November's rate of growth is the second fastest in the past six months. Exports and imports continue to support expansion in the sector.

Construction spending during October 2010 was estimated at a seasonally adjusted annual rate of $802.3 billion, 0.7 percent above the revised September estimate of $797.1 billion. The October figure is 9.3 percent below the October 2009 estimate of $884.7 billion, according to the U.S. Census Bureau of the Department of Commerce.

The **Chicago Fed Midwest Manufacturing Index** (CFMMI) increased 0.7 percent in October, to a seasonally adjusted level of 80.9 (2007=100). Revised data show the index edged up 0.2 percent in September to 80.3. The Federal Reserve Board's **industrial production index for manufacturing** (IPMFG) increased 0.6 percent in October. Regional output in October rose 8.6 percent from a year earlier, and national output increased 6.7 percent.

In October, the **Canadian Industrial Product Price Index** (IPPI) and the **Raw Materials Price Index** (RMPI) were up 0.5 percent and 1.7 percent respectively from September, according to Statistics Canada. Both indexes advanced mainly because of petroleum and metal products.

New orders for manufactured durable goods in October decreased 3.3 percent to $196.0 billion, according to the U.S. Census Bureau. This decrease, down two of the last three months, followed a 5 percent September increase. Excluding transportation, new orders decreased 2.7 percent. Excluding defense, new orders decreased 2.1 percent.

Led by improvements in production- and employment-related indicators, the **Chicago Fed National Activity Index** increased to -0.28 in October from -0.52 in September. Three of the four broad categories of indicators that make up the index made small positive contributions in October, while the consumption and housing category continued to make a large negative contribution.

North American **HVACR average distributor sales** for October 2010 declined 2 percent from October 2009, according to the Monthly Targeted and Regional Economic News for Distribution Strategies (TRENDS) Report released by Heating, Airconditioning and Refrigeration Distributors International (HARDI). Running 12-month sales improved for the third consecutive month, falling in line with HARDI projections for 2010 growth to be between 5 percent and 10 percent.

The **unemployment rate** edged up to 9.8 percent in November, and nonfarm payroll employment was little changed (up 39,000), according to the latest report from the U.S. Bureau of Labor Statistics. Employment in manufacturing was little changed over the month (-13,000). Construction employment was down by 5,000 for the month.

U.S. business leaders are once again optimistic, according to Grant Thornton LLP's most recent **Business Optimism Index,** based on a quarterly survey of U.S. business leaders. Nearly half (47 percent) believe the U.S. economy will improve in the next six months, compared with just 34 percent in August. The job outlook is also improved, with 43 percent saying that their company plans to increase staff in the next six months (up from 38 percent). The Index itself is up 4.6 points to 63.0.

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Canada

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similar to that recorded in the second quarter. Manufacturers' inventories, especially inventories of durable goods, increased again in the third quarter. Wholesale trade inventories of both durable and non-durable goods, as well as the inventories of retail motor vehicle dealers, were up.

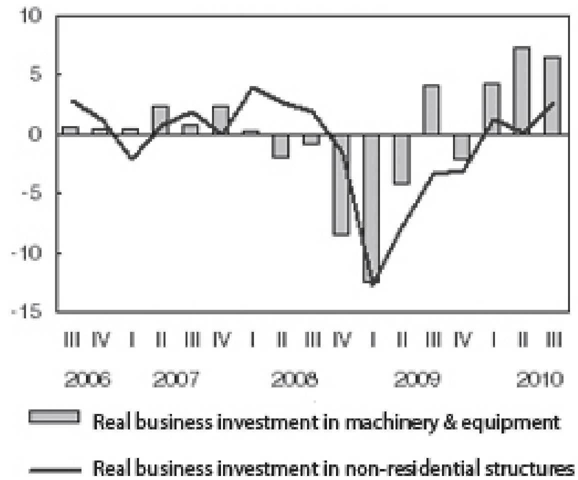
Manufacturing, mining and the public sector were the main sources of growth in the third quarter. The increase in manufacturing was concentrated in the production of durable goods, while the strength in mining was attributable largely to higher activity at copper, nickel, lead, and zinc mines. Construction and retail trade also contributed to the overall increase in GDP. Conversely, decreases were recorded in the output of real estate agents and brokers, as well as in wholesale trade and in the finance and insurance sector.

Manufacturing output declined 0.6 percent in September, with 10 of the 21 major groups contracting. Both durable goods (-0.8 percent) and non-durable goods (-0.4 percent) manufacturing were down. In particular, manufacturing of machinery, food products, transportation equipment, wood products and chemicals decreased. The output of primary metal products and printing increased.

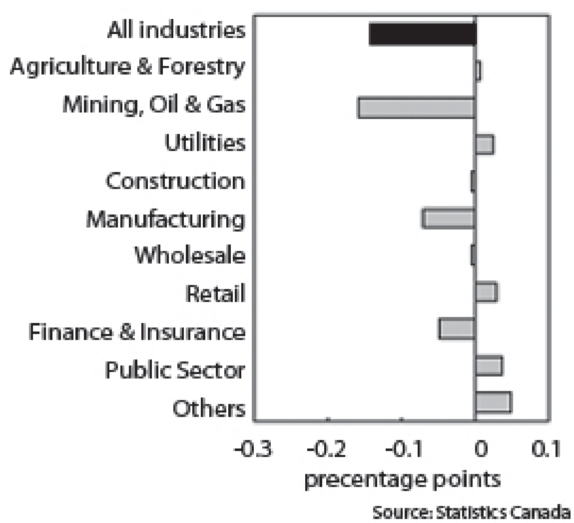
The public sector (health, education and public administration combined) rose 0.2 percent in September. Retail trade increased by 0.5 percent, with higher activity recorded at general merchandise stores and at new car dealers. Retailers of building materials and garden equipment and supplies reported a decline, partly mirroring the weakness in residential construction in September.

Business Investment in Plant & Equipment

Quarterly % Change



Industrial Sector Contribution to Change in GDP: Sept. 2010



Global Manufacturing Index Indicates Output Should Gain Speed in New Year

At 53.9 in November, up further from September's 14-month low, JPMorgan Global Manufacturing PMI rose to its highest level since July. The headline PMI has now remained above the no-change mark of 50.0 for 17 consecutive months.

Among the larger nations covered by the survey, PMIs rose in China (eight-month high), Germany (three-month peak), the UK (highest since September 1994), France (ten-year high) and India (six-month peak). The Japan and Brazil PMIs also increased, but, in contrast to the other nations mentioned, remained below the 50.0 no-change mark.

The U.S. PMI signalled a robust improvement in manufacturing operating conditions, with the rate of increase only slightly below October's five-month high.

Following a further expansion in November, manufacturing production has now increased throughout the past 1.5 years. However, the rate of growth was slower than in October and below the average for the recovery thus far.

David Hensley, director of Global Economics Coordination at JPMorgan, said: "Output growth should gain speed heading into the new year as the drag from the inventory adjustment fades."

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MARKETS UPDATE SUPPLEMENT P. 4

NABE Forecast for U.S.: Moderate GDP Growth in 2011

In the latest forecast from the National Association for Business Economists, projections for real GDP growth were sub-par through the first quarter of 2011, but accelerated gradually through the forecast period. For next year as a whole, the panel of economists expect GDP growth to be moderate.

"Factors restraining growth going forward include ongoing balance-sheet restructuring by consumers and businesses, and a diminished contribution to GDP growth from inventory restocking and government stimulus," said NABE President Richard Wobbekind, associate dean of the Leeds School of Business at the University of Colorado, Boulder, CO.

"Confidence in the expansion's durability is intact, but panelists remain concerned about high levels of federal debt, a continuing high level of unemployment, increased business regulation, and rising commodity prices."

Real gross domestic product (GDP) is expected to advance 2.7 percent (year-over-year) in 2010. Next year's projected GDP growth rate, as is typical in a recovery after a severe financial crisis, shows the lack of a more pronounced cyclical rebound.

The projected growth rate for 2011 is slightly below the panel's current estimate of the economy's long-term growth trend of 2.7 percent. The survey respondents' estimate of trend growth has declined by one-quarter-percentage point since 2007.

To a large extent, the latest NABE forecast reflects the view that the economy will struggle against financial headwinds.

Forty percent of survey respondents - compared with 37 percent in October - characterize the expansion as "sub-par with severe wealth losses and onerous debt burdens inhibiting spending and lending."

In contrast, 28 percent of respondents feel that "the economy will overcome its headwinds, and behave more in line with a traditional business cycle expansion: Real output will grow at a rate above potential, and households and businesses will boost discretionary spending."

The likelihood of either stagflation or the economy slipping back into recession is viewed as relatively low.

Consumer spending is expected to remain modest throughout the forecast horizon due to weak job gains, persistently high unemployment, and negligible growth in household net worth.

This year's holiday retail sales are still expected to be weak, rising only 2.5 percent from those of last year. Roughly half of the panelists expect the personal saving rate to fall over the forecast period, while the other half of the panel is divided as to whether it will rise further or stay at roughly the same rate.

Labor market conditions will improve slowly. Monthly payroll gains are forecast to average less than 150,000 until the latter half of 2011, at which time gains will improve at a range of roughly 150,000-170,000.

Joblessness will remain high, with the unemployment rate persisting at over 9.5 percent or higher through the first quarter of 2011 before easing- but only slightly - to 9.2 percent by year-end 2011.

This will mark the weakest post-recession job recovery on record. Panelists estimate the current long-run or natural rate of unemployment at 5.8 percent, up by one-half-percentage point since 2007.

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