Consolidation

Industry Consolidation & Your Exit Strategy: Opportunities & Threats

Presented by Michael Marks

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Industry Consolidation and Your Exit Strategy: Opportunities & Threats
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2016 Critical MHEDA Impact Factors

This list of eleven issues was put together by the MHEDA Executive Committee

4. Third party management companies continue to market to end users for equipment acquisition, service and fleet management. This can be a channel disrupter and members will either compete with them or cooperate with them. This will disrupt traditional valuation methods

5. Consolidation of dealerships and OEMs is accelerating. Members must have a strategy to deal with this in their market. This is simply a challenging change in the competitive environment

6. A sales, acquisition and/or succession plan is critical for organizational perpetuity and succession strategies of the principal, key managers and senior executives. This is the piece that most fail to consider until too late

AGENDA

Review of the forces driving consolidation
Consolidation means to make stronger
As owner-operators age out and large firms need growth, the number of transactions will steadily increase, but then stop

What is a dealer worth?
Issues when the purchaser is the key supplier
What is a shareholder alternative analysis?
Our Current State - The Search For Growth

Dealers only have to grow fast enough to keep their major suppliers
Manufacterers must grow or competitors steal their oxygen and they die

Joseph Schumpeter, the economist said that as economies became more efficient they also became more fragile

Consolidation means to make stronger and it is measured by concentration of the share of the market enjoyed by the ten largest competitors

- Each of the 129 industry verticals in NAW are at different stages
- Adam Fein said distributors need to get big, get focused, or get out

The Wal-Mart Disease and the race to the bottom*


Increased Competition for Deals

- Publicly-traded distributors, flush with cash, aggressively acquiring
  - Robust corporate earnings and excess cash to put to work
  - Premium for growth
  - Transatlantic acquisitions

PE Buyer Activity – By Sector of Distribution

*Industrial distribution represented over 30% of the transactions funded by private equity in 2015.
In The Beginning….(1945 to 1970)

Most wholesaler-distributors were started in the 50’s and 60’s and all had the same business model

*I sell service with excellent people*

(The generic customer intimacy strategy)

• They added value to customers by placing product closer to the point of consumption
• Their sales staff provided personal attention to overcome weaknesses in supply chain reliability (trust had economic value & still does)
• They provided pre and post sale service along with customer working capital and transaction support

Early Foundations Of Growth Up To 1970

Strong structural GDP and population growth in North America (baby boomers)

*The rising tide raised all of the ships*

Dealers grew by splitting territories, opening additional branches and getting stronger suppliers who were market leaders

• Scale advantages were primarily from supplier price concessions for volume and economies of scale with internal operations

The Transition From The Good Old Days (1970 to 2010)

In 1970 John Bough rolled up 12 regional distributors and went public as Sysco Food Service- now a Fortune 100 firm
In 1978 Cameron-Barkley did the first integrated supply contract with a DuPont plant
In 1996 WW Grainger converted their massive branch structure from P&L centers to cost centers

Large customers discovered that they could leverage their purchase volume with national contracts

*Markets began to align by size and dealers adapted, think manufacturers taking national accounts direct*
Transitional Sources Of Growth (1970 to 2010)

Acquisitions and mergers as aging entrepreneurs wanted out
Rise of master distributors to support smaller dealers as manufacturers consolidated
Emergence and growth of “carve-out” specialty competitors
New and aftermarkets diverge then realign
Distributor/dealer consolidation has come in waves (think about eating and digesting)

Some spectacular bankruptcies have occurred

Revenue Growth Sources
1. Market
2. Inflation
3. Share

The Current State Of The Industry 2010 and beyond

The traditional service/resource package is unbundling and we are now in the neutral zone

• The customer’s primary source of product information used to be the sales rep, but now it is the Internet
• E-Bay and Craig’s List has created a viable used equipment market (price transparency)

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“Men marry because they are tired; women, because they are curious. Both are disappointed.”
Oscar Wilde

Substitute acquiree and acquirer and both are often still disappointed
Factors Affecting Shareholder Value

A. The market of buyers, both financial and strategic and how you look

B. Amount of EBITDA less CapEx $$ & % ($25m is worth more per dollar than $5m, which is worth much more than $2m)

C. You are a platform company that is well managed and self growing

D. Additional capacity to grow with existing infrastructure and systems

Most capital goods dealers businesses are worth 4 to 5 times adjusted TTM (Trailing Twelve Months) EBITDA (Earning Before Interest Taxes, Depreciation and Amortization) less CapEx

- Adjustments are usually needed to create arms length management (market rents, employed low value relatives, high or low owner salaries, etc.)
- Uses of cash/depreciation are critical to the valuation

Are You A Platform Company* Or An Add-On?

Which came first, becoming a platform or getting higher growth than competitors?

Growth implication: investing to become a platform may have a better ROI than doubling revenue

- They all have significantly higher growth rates than their competitors without undue concentration risk
- Most are already professionally managed but some are still lifestyle owner-operators
- Scalable infrastructure (IT, service techs, sales reps)
- They are a critical link in their supply chain
- Possess attractive customers and leading suppliers

They are valued up to 2+ extra EBITDA multiples

Value Creation Plans (A Generic Platform Play)

1. Buy $40 M revenue firm for 6X adjusted EBITDA - CapEx ($2M X 6) = $12 M
2. Pay 50% to 80% to the owner for chips off the table, or not for Add-Ons
3. Execute 12 - 18 month growth initiatives and performance enhancements
4. The new shareholder value is ($5M X 7) = $35 M

You just created ~$17 M in shareholder value for a 94% ROI in less than 24 months

A 10% revenue growth for two years at a 5% EBITDA margin produces = 1/10th or $ 2.5M

Often adds 2 points to the bottom line. You already did this, right?
Key Concepts
The value of your business is primarily defined by your commercial success
• It has nothing to do with how much money you need to leave
• Setting your expectations based on industry gossip is foolish
• Getting “a buddy” to help market your business is even dumber
• Your acquirer will not pay you anything for their combination synergies
In addition to commercial success (EBITDA margin and growth rate) three things have major impact on the value of a dealer
1. Do you have very clean financial statements?
2. Is there management that remains after the transaction (think platform) that can preserve revenue and customer relationships
3. The quality of your earnings (volatility, customer switching costs, etc.)

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Our major research project for NAW was published in 2007 as, “Working at Cross Purposes; How Manufacturers & Distributors Can Manage Conflict Successfully”

“A Cautionary Consolidation Note To Manufacturers
From 50,000 feet up it seems obvious that your lifestyle owner-operator dealer network needs consolidation to be more professional

Consider this first:
• Life style businesses have lower required financial returns that larger professionally run businesses
• As scale increases in dealers, the value of supplier relationships decline
• Larger firms become very sensitive to concentration risks
• Larger firms will be more interested in make-ready services for ANY equipment manufacturer when serving a local national account
• A consolidated dealer network has much more market power leverage over their suppliers than a fragmented one

Learn from Parker-Hannifin and John Deere
OEMs Getting Into The Dealer Business

OEMs that acquire dealers to make growth or profit numbers have ALWAYS failed in the long run, just study what happened to those initiatives by General Electric, International Paper, Trane, Westinghouse, Ingersoll Rand, or Anderson Windows—go read HBR’s “Strategy And Your Stronger Hand”

The fact it takes years to figure out doesn’t help today’s dealer
If they are your major line and they decide to buy you, there isn’t much you can do about it or they pull the line

Supplier concentration risk is the largest and most dangerous risk faced by MHEDA dealers
If your key supplier threatens termination, get them to amend the contract with a defined purchase price formula that is acceptable, if exercised
If they refuse, recognize that you are hostage to a partner that does not have your best interests as heart, so find an exit or harvest the business

Your Acquirer Might Be Someone New

MHEDA Critical Issue #4: Third party management companies continue to market to end users for equipment acquisition, service and fleet management. This can be a channel disrupter and members will either compete with them or cooperate with them.

Decide in advance if you are predator or prey
Linkbelt & Mercruiser Marine could not get access to traditional distributors and dealers, so they broke the rules and innovated in their channel designs
Construction equipment dealers didn’t like the equipment rental business (it was too different and they were very old and comfortable) so they gave it up to others who are now growing much faster, think asset utilization and Uber.
As the specialty solution providers become more attractive to your end users you can either acquire some or abandon that segment of your market

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“Old men always stay too long”
“Denial is more than a river in Egypt”
“A king has his reign and then he dies…it’s inevitable”
Prometheus
Our Starting Point- Lifestyle Businesses

A lifestyle business is a business that is set up and run by its founders primarily with the aim of sustaining a particular level of income and independence.

In conventional business terms, lifestyle businesses typically have limited scalability beyond the leadership of the entrepreneur. Often their founders create them to exercise personal talent or skills, achieve a flexible schedule, work with other family members, remain in a desired geographic area, or simply to express themselves. But without the founder’s deep personal involvement, such businesses are likely to flounder. Professional investors are therefore rarely involved with lifestyle businesses.

The Owner-Operator Dilemma

You can’t have acquirers if there are not acquirees

An owner-operator is both the owner of the capital (majority shareholder) and the senior operating executive (CEO/President)

• All entrepreneurs are owner-operators
In almost all cases, the owner-operator thinks and acts differently than a non-operating Chairman of the Board or an employed CEO/President who is accountable to a board of shareholders.

• This difference usually appears as a strong bias towards reacting quickly to perceived opportunities and threats versus acting with deliberation and intent

Any successful succession requires ending the owner-operator view.

Foundation Concepts

1. Effective succession involves two very different processes
   • Transition of management
   • Transition of ownership

2. Different skills from your existing skill set will be needed in the future, so the successor needs to be selected for the future, not to replicate you
   • Even if the successor is a relative, there must be a plan B that is shared
   • The next generation needs to have input on being developed as an operator or a successor owner (This is very different)

4. Decision making will shift from exploiting opportunities and avoiding risk to optimizing shareholder value for a defined future point in time.

You do not need to make this transition if you choose not to do it.
The First Choice: Your Exit

You will not be young, risk tolerant, and good looking forever, so strategy requires thinking about your exit position before you get there.

If you don’t do this then you define yourself as a lifestyle business run by an owner-operator (Nothing is wrong with this, just don’t BS yourself)

1. You need an envelope: If you get hit by a truck someone opens the envelope and has instructions to follow
   • So who is the person and what are their instructions?

2. Determine your preferences, not firm decisions yet, around what you want when you are old
   • Remember that old men always stay too long

There are fundamentally four exit positions and having ten years to optimize one of them creates significant wealth for the owner

The Four Succession Alternatives

1. The owner-operator can turn the business over to a blood relative, keeping ownership in the family
2. The owner-operator can bring in non-family executive management, keeping ownership in the family
3. The owner-operator can arrange the sale of the business to an outsider creating a “liquidity event”
4. The owner-operator can talk about it, taking no decisive action, until they have a personal crisis forcing others to decide

The evaluation of these fundamental choices is called a strategic alternatives analysis
   • When performed pre-crisis, decisions are taken while the owner-operator continues running the company

Discussion