



PARTHENON

Parthenon-EY Perspectives

Investing in distribution

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Investing in distribution

Summary



1

US distribution and maintenance, repair and operations (MRO) represent large, growing markets with multiple value-added niches/segments.

2

Most segments remain heavily fragmented, leading to several interesting acquisition targets and consolidation opportunities.

3

Distributors continue to be a critical part of the supply chain and increasingly encounter opportunities to provide value-added services and earn higher margins.

4

Acquirers have significant levers to increase business value.

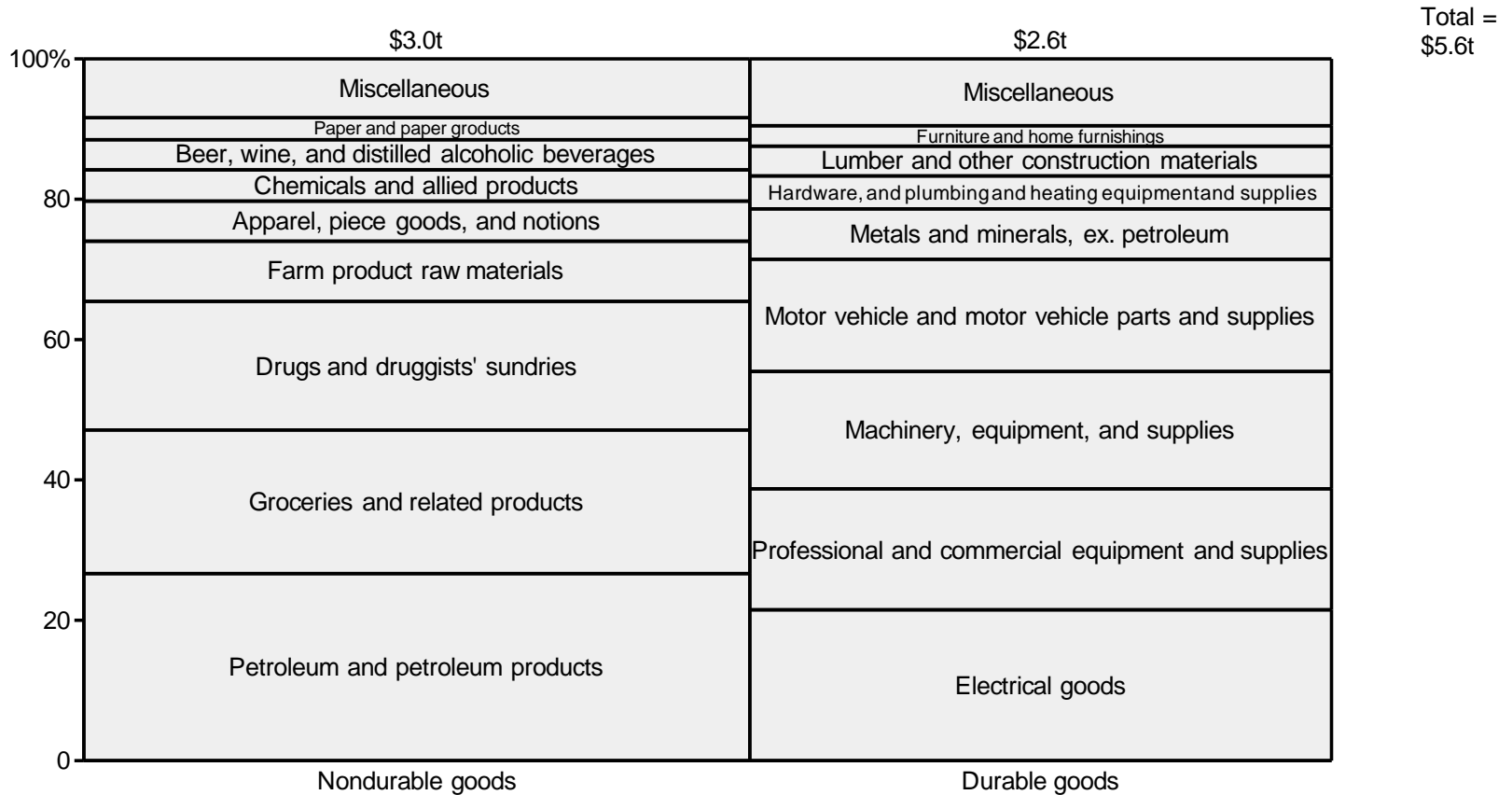
Agenda

- ▶ **Distribution industry dynamics**
- ▶ Drivers of profitability in distribution businesses
- ▶ Parthenon-EY overview and relevant experience

Distribution industry dynamics

Wholesale distribution is a massive market (\$5t+) in the US, with opportunities across many sectors

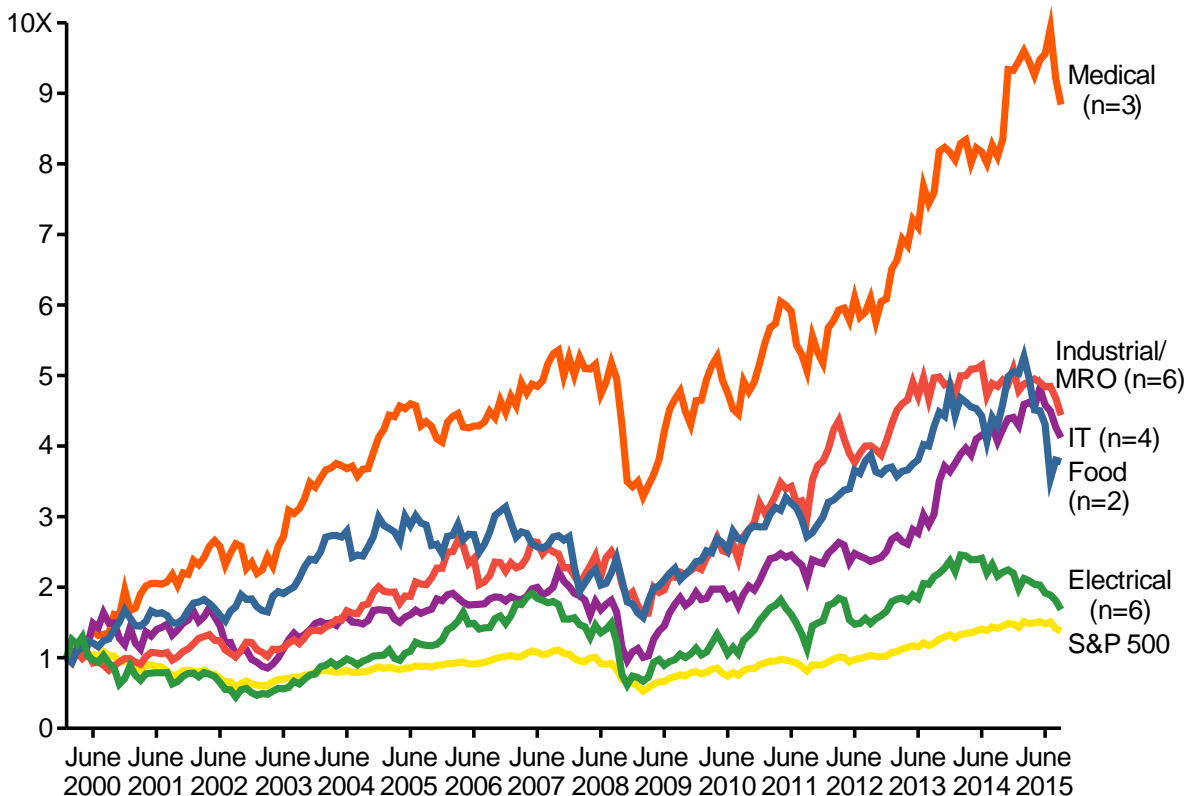
Total sales of US merchant wholesalers, by segment, 2014



Distribution industry dynamics

Distributors have outperformed the equity markets, corresponding with a vibrant M&A environment

Distributor stock performance by segment vs. S&P500, indexed to January 2000



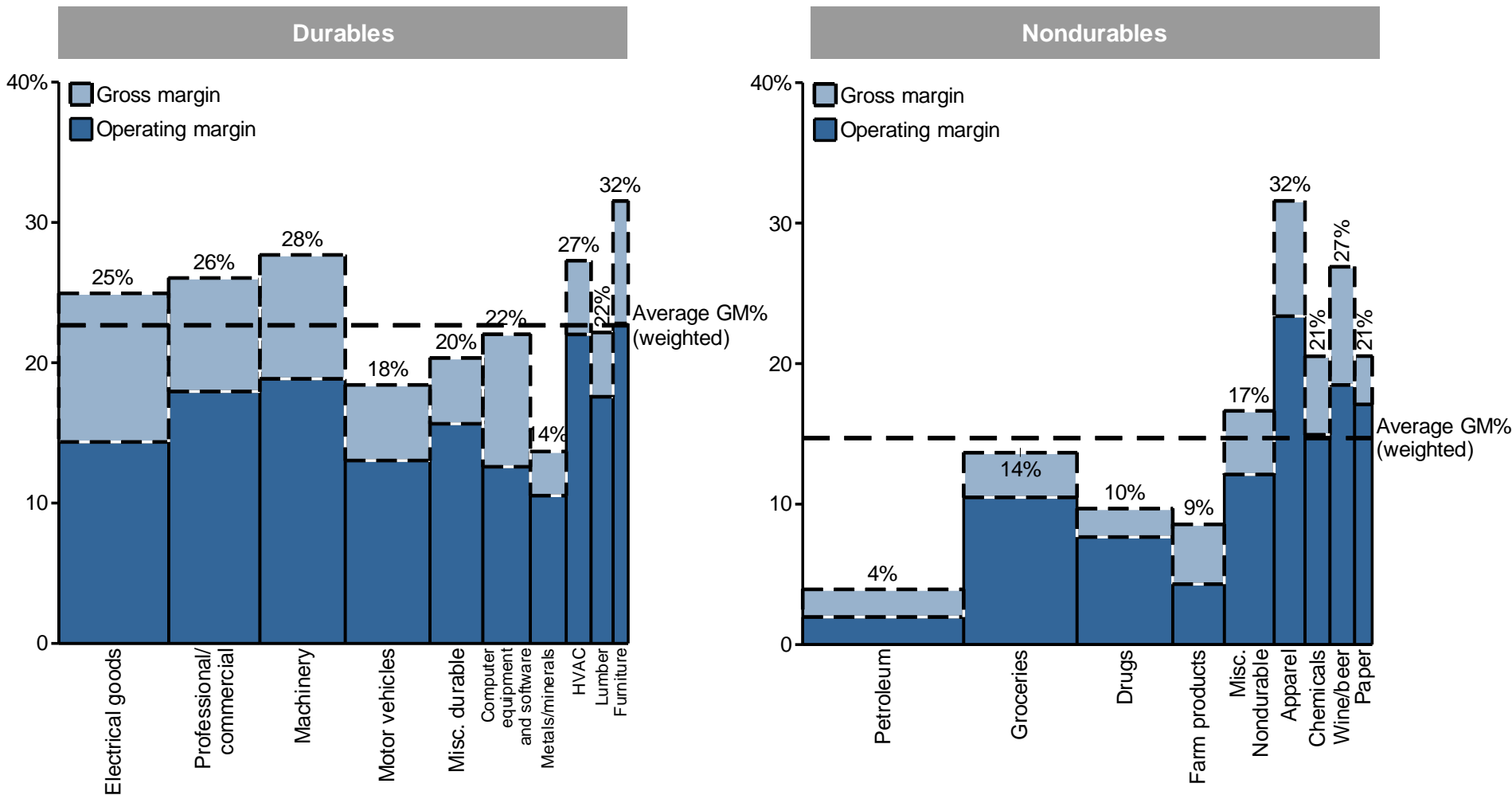
Number of acquisitions by public distributors since January 2000

| Company name by segment | Number of acquisitions |
|---------------------------------------|------------------------|
| Electrical | |
| ADDvantage Technologies Group Inc. | 8 |
| Anixter International Inc. | 14 |
| Arrow Electronics, Inc. | 63 |
| Avnet, Inc. | 75 |
| VOXX International Corporation | 25 |
| WESCO International Inc. | 24 |
| Food | |
| Sysco Corporation | 49 |
| United Natural Foods, Inc. | 13 |
| Industrial/MRO | |
| Applied Industrial Technologies, Inc. | 24 |
| Fastenal Company | 4 |
| MSC Industrial Direct Co. Inc. | 10 |
| Lawson Products Inc. | 2 |
| Watsco Inc. | 9 |
| W.W. Grainger, Inc. | 26 |
| IT | |
| Insight Enterprises Inc. | 6 |
| McKesson Corporation | 48 |
| ScanSource, Inc. | 13 |
| Tech Data Corp. | 18 |
| Medical | |
| Henry Schein, Inc. | 55 |
| Patterson Companies, Inc. | 35 |
| Owens & Minor Inc. | 11 |

Distribution industry dynamics

Profitability varies across verticals, with durables commanding higher gross margins than consumables

US merchant wholesalers gross and operating margin, by segment, 2013



Source: U.S. Census

Distribution industry dynamics

Profitability is generally driven by a combination of industry and company-specific factors

Drivers of profitability

Industry specific

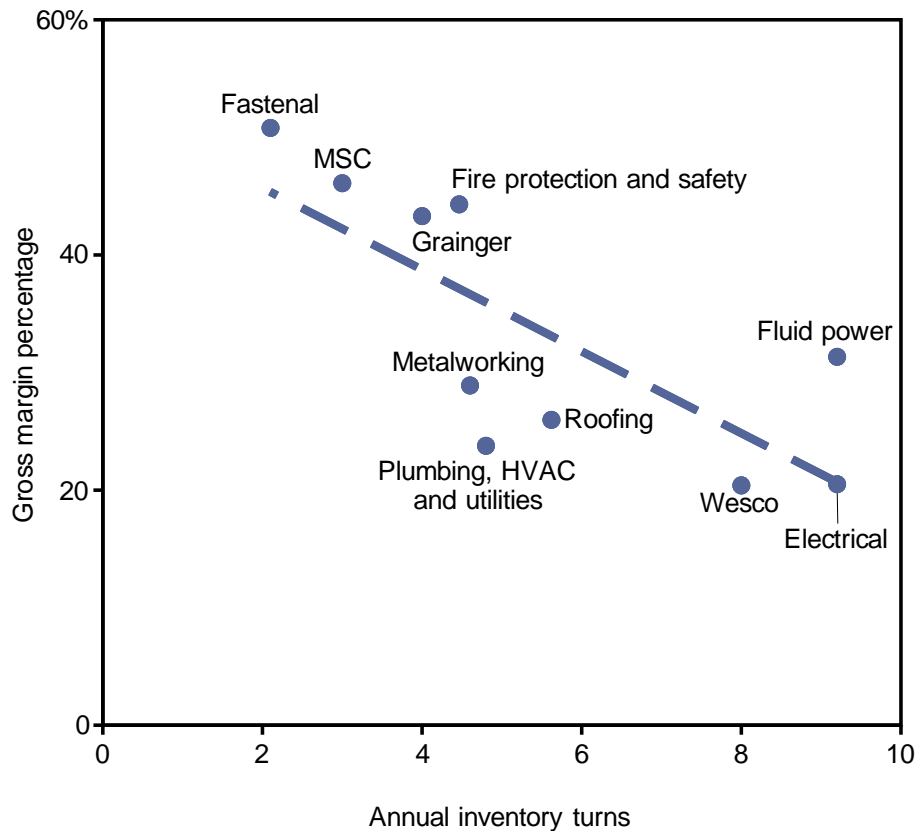
- ▶ **Inventory turns**
 - ▶ Distributors are paid to hold inventory; slower-turning inventory typically indicates higher margins
- ▶ **Product complexity and technical sales requirements**
 - ▶ Technical expertise and consultation increase distributor value to customers and create stickier customer relationships
- ▶ **Fragmentation of supplier and customer base**
 - ▶ High fragmentation typically indicates additional value-add from distributors
- ▶ **Regulatory environment**
 - ▶ Strict regulatory environments can control margins or require the use of certain products and impact growth
- ▶ **Pricing dynamics**
 - ▶ Pricing environment can play a major role in distributor profits

Company specific

Distribution industry dynamics

Inventory turns are inversely correlated with profitability, as distributors are paid for holding inventory longer

Industrial distribution, inventory turns vs. gross margin, public companies and representative private companies



Commentary

- ▶ *“The higher the inventory turns, the lower the margin. Distributors are paid for holding the inventory because it needs to be available on demand.”*
–Distribution industry analyst
- ▶ *“Retail distributors in apparel or groceries want to turn their inventory as fast as possible and sacrifice margins to do so. Something like complex, heavy machinery parts have longer sales cycles and shelf lives, so higher margins are earned.”*
–Distribution industry analyst

Distribution industry dynamics

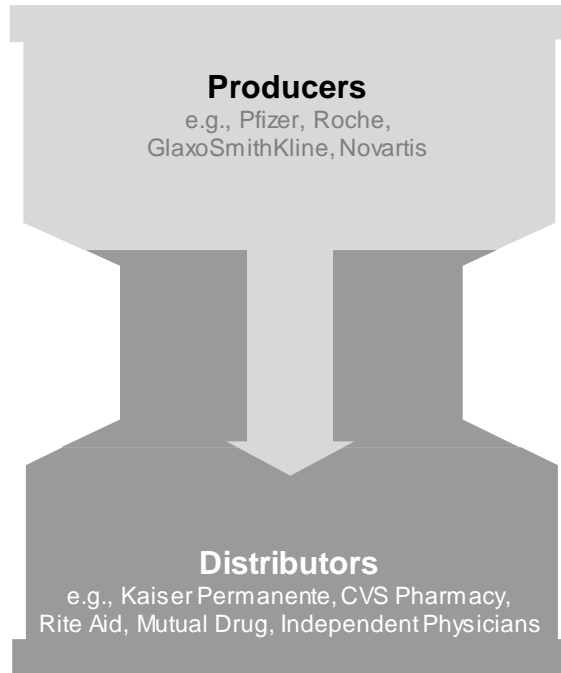
Distribution of more complex products with additional technical support is associated with higher margins



Distribution industry dynamics

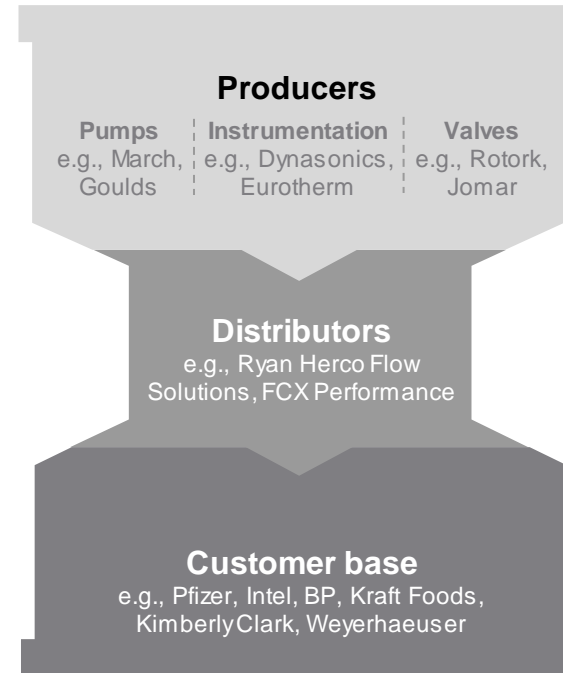
Distributors in traditional “hourglass” supply chains with fragmented supplier and customer bases create value by facilitating distribution, and typically earn higher margins

Pharmaceutical distribution dynamics



- ▶ More consolidated supplier base leaves less opportunities for distributors to add value in the supply chain

Industrial components



- ▶ Highly fragmented supplier and customer base creates opportunities for distributors to add value in supply chain

Distribution industry dynamics

Regulation can allow distributors in certain industries to command higher margins and provide technical expertise

Alcohol

- ▶ Value-chain position of the distributor is protected by law as the 21st Amendment ensures that wine, beer and spirits must move in legally sanctioned transactions from producer to wholesaler to retailer or restaurant
- ▶ Several states have laws that regulate distributors' markup on alcohol; markups can range between 20% and 50%

Gross margin: 25-30%
Operating margin: 8-10%

HVAC/safety equipment

- ▶ Building codes require that certain HVAC safety and energy-efficiency standards are met
- ▶ Increased regulation and financial grants/incentives to make buildings more energy efficient have allowed HVAC distributors to offer higher-quality, higher-margin solutions

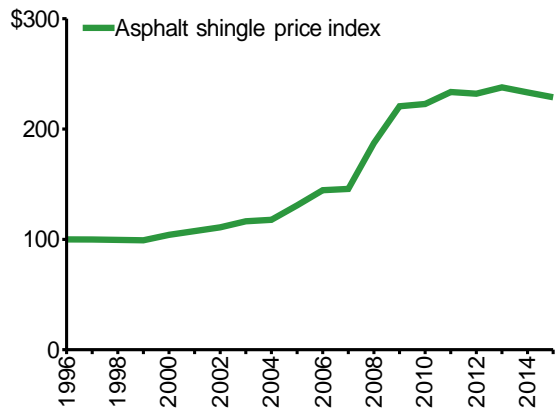
Gross margin: 25-30%
Operating margin: 5-7%

Distribution industry dynamics

Distributors can benefit from (or succumb to) the underlying pricing environment of distributed products

Sustained increase in product prices

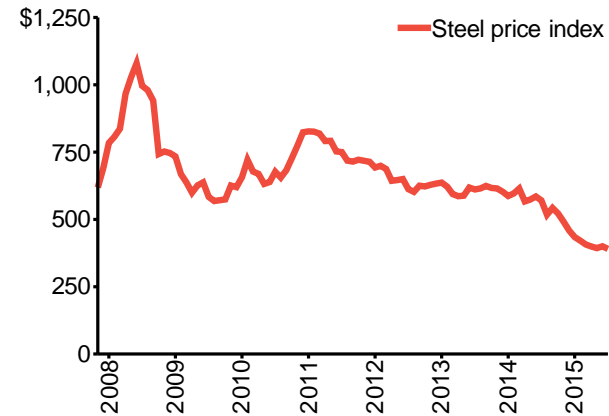
- ▶ Distributors can stand to benefit (and earn great profit dollars) from increasing prices of their end products
- ▶ Example: The roofing shingle industry consolidation led to sustained price increases and distributor profit growth



“Higher prices are a win-win for manufacturers and distributors across the value chain as long as distributors can pass along price increases.”
– Roofing industry CFO

Significant decrease or high volatility in product prices

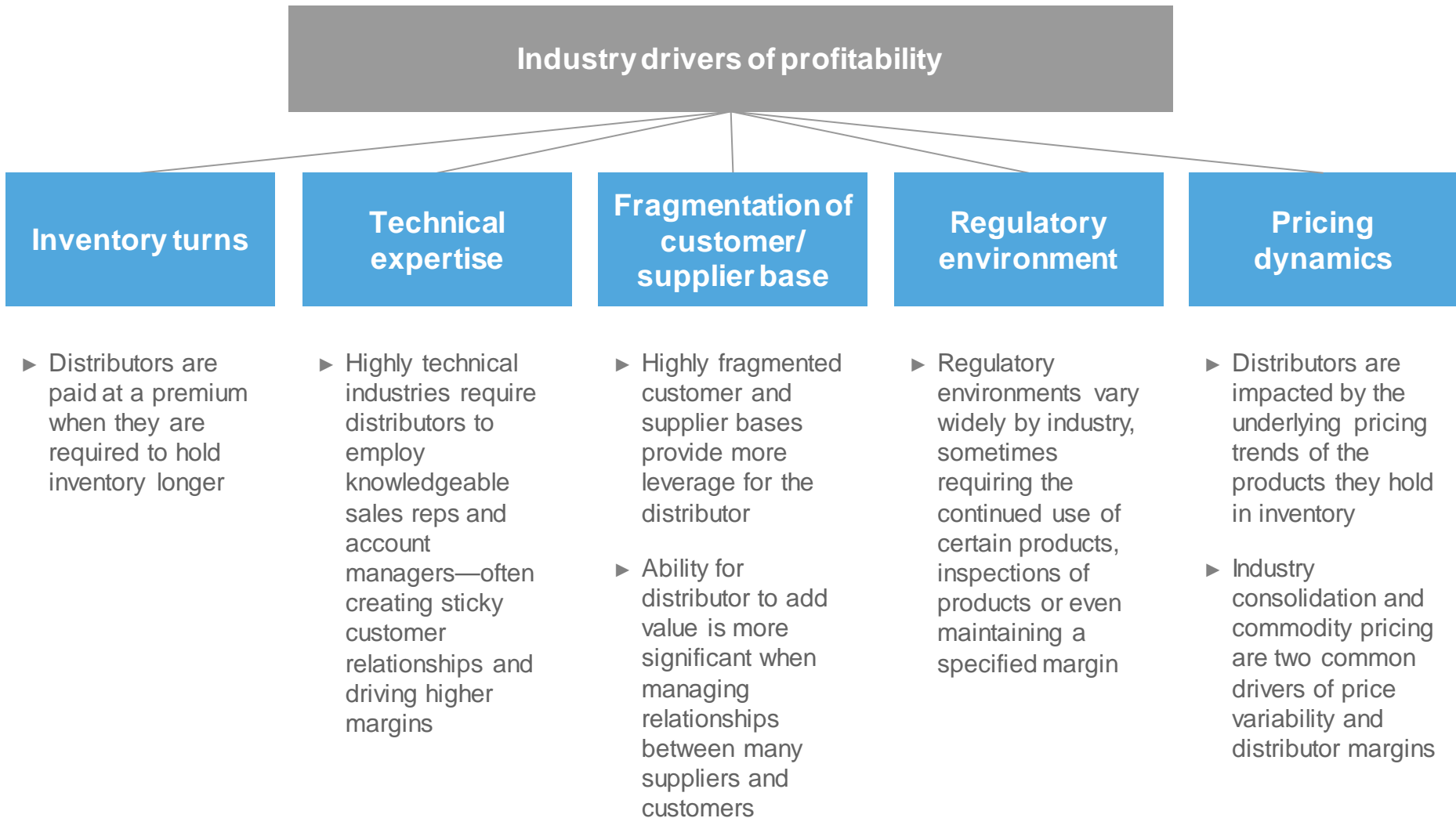
- ▶ Conversely, distributors carrying inventory come under significant or even catastrophic pressure when prices fall
- ▶ Example: Distributors were severely impacted by precipitous declines in steel



“One of the issues with imported steel is that you have to be able to plan much farther in advance, and once you commit your money it is tied up.”
– Plumbing supply purchasing manager

Distribution industry dynamics

Industry drivers of profitability



Agenda

- ▶ Distribution industry dynamics
- ▶ **Drivers of profitability in distribution businesses**
- ▶ Parthenon-EY overview and relevant experience

Company profitability drivers

Profitability is generally driven by a combination of industry and company-specific factors

Drivers of profitability

Industry specific

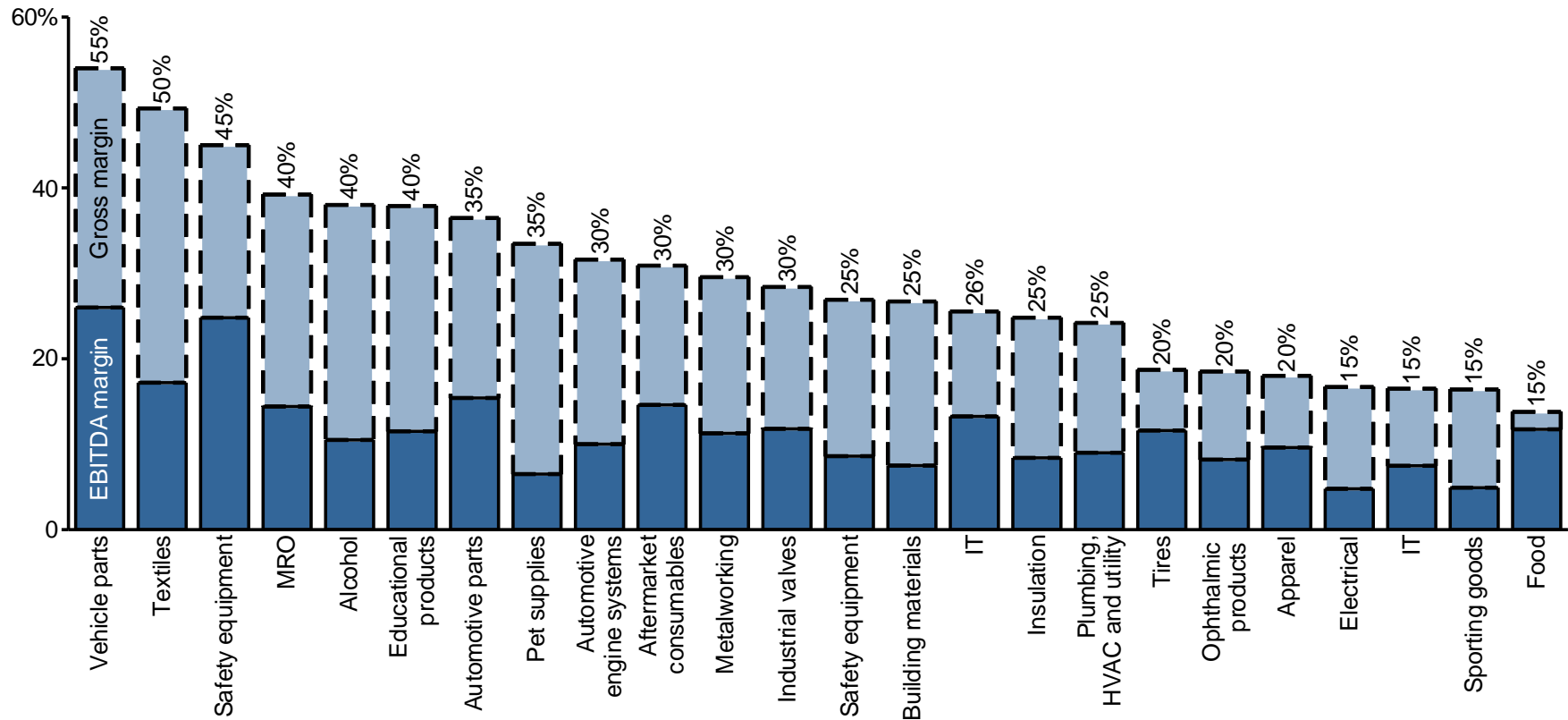
Company specific

- ▶ **Relative market share (RMS)**
 - ▶ High RMS increases purchasing leverage, brand awareness and pricing power
- ▶ **Private label products**
 - ▶ Private label products are generally more profitable, removing a step in the supply chain
- ▶ **Sales strategy and account management**
 - ▶ Many distribution businesses are simply order-takers, while others aggressively pursue new accounts and increasing share of wallet
- ▶ **E-commerce**
 - ▶ Online sales require less customer service and account management, and can also serve as a customer acquisition tool
- ▶ **Value-added services**
(i.e., fabrication, remanufacturing, repair)
 - ▶ Additional services allow for additional revenue streams and up-selling opportunities

Company profitability drivers

Distribution businesses can have very different margin profiles

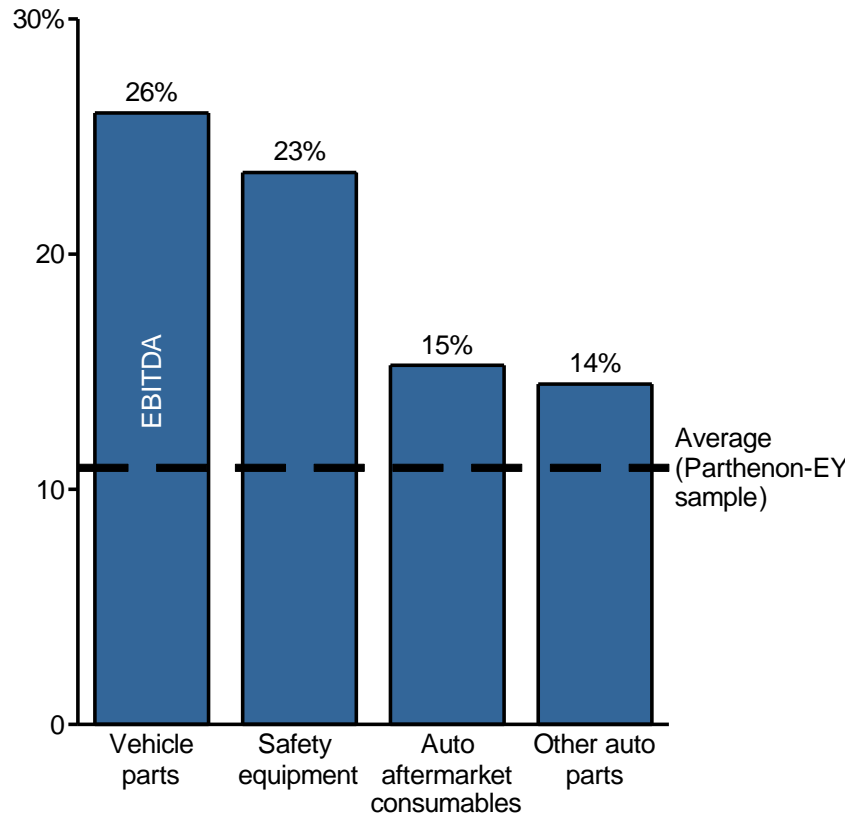
Sample distribution company gross and EBITDA margins



Company profitability drivers

RMS matters—distribution companies with high relative market shares are associated with better performance

EBITDA of distribution market leaders



| RMS | ~3x | ~8x | ~3x | ~1.5x |
|-----|-----|-----|-----|-------|
|-----|-----|-----|-----|-------|

Distributor case studies

| Vehicle parts | Safety equipment |
|---|--|
| <ul style="list-style-type: none"> ▶ Distributes aftermarket parts and accessories to businesses and consumer markets ▶ ~40% market share | <ul style="list-style-type: none"> ▶ Distributes protection and safety equipment to those who inspect, maintain and repair fire equipment ▶ ~8-10% market share in very fragmented market |
| Auto aftermarket consumables | Other auto parts |
| <ul style="list-style-type: none"> ▶ Distributes consumable maintenance parts and accessories to oil change shops ▶ 15-20% market share | <ul style="list-style-type: none"> ▶ Distributor of automotive aftermarket driveline solutions to driveline repair outlets, general repair shops, fleets and auto retailers ▶ 7-10% market share |

Company profitability drivers

Technical expertise and value-added services—such as maintenance, product repair, or in-house design and engineering—enable some distributors to drive higher margins

Representative industrial distributor profiles

| | Fluid power and motion control technologies | Electrical |
|-----------------------------|---|---|
| Description | Fluid power and motion control technologies and solutions to OEMs and MRO customers | Electrical parts primarily used in construction and for industrial applications |
| Inventory turns | 9.2x | 9.2x |
| Technical expertise | High Provides value-added system design and engineering services | Low |
| Maintenance/repair services | High Owns service and repair centers | Low |
| EBITDA | ~9% | ~4% |

Distributor case studies

Fabrics and textiles

- ▶ Distributor of fabrics, working with 5,000+ architectural/design firms and 600 furniture manufacturers
- ▶ 3,500+ SKUs developed by in-house design team and sourced from various manufacturers
- ▶ Between 2005 and 2010, won 15 industry awards for design and innovation
- ▶ 15% EBITDA

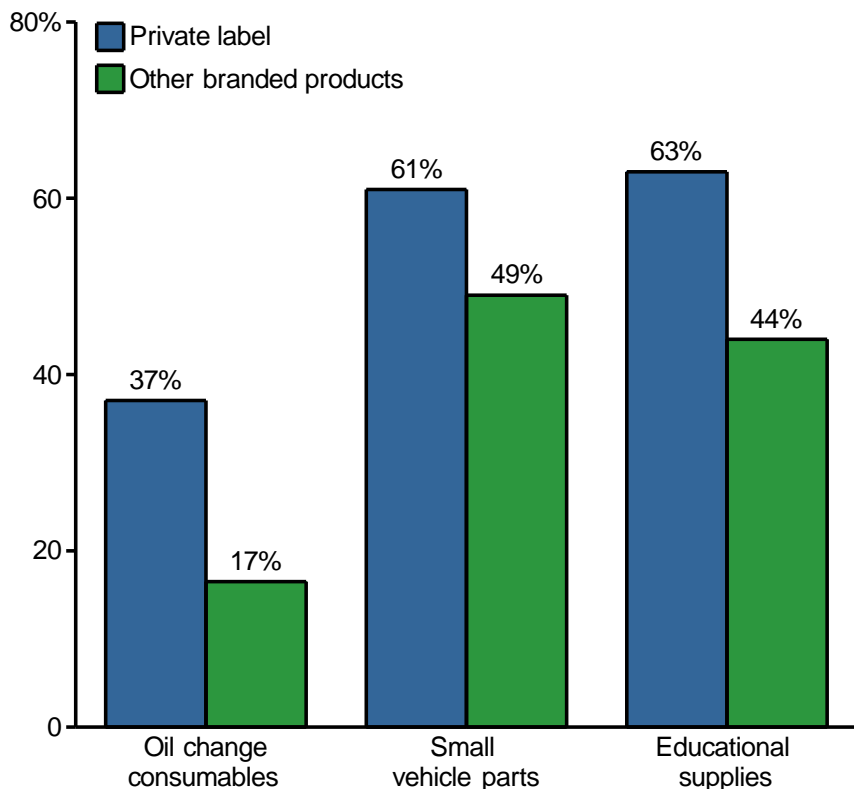
Apparel

- ▶ Distributor of undecorated branded apparel and athletic accessories
- ▶ Sells 38,000 SKUs from 55 brands to over 24,000 advertising companies, promotional products distributors, and screen printers and embroiderers
- ▶ Little value-add in addition to management of many SKUs, vendors and customers
- ▶ 9% EBITDA

Company profitability drivers

Emphasis on private label products, which typically generate 20% higher gross margins, can be a tool to expand margins

**Gross margins,
private label and branded products**



Distributor case studies

Educational supplies

- ▶ Distributes early childhood educational products to schools, districts, early learning centers and more
- ▶ Private-branded products have increased from ~29% of sales in 2008 to 34% in 2010; EBITDA margin grew 200 basis points in that time

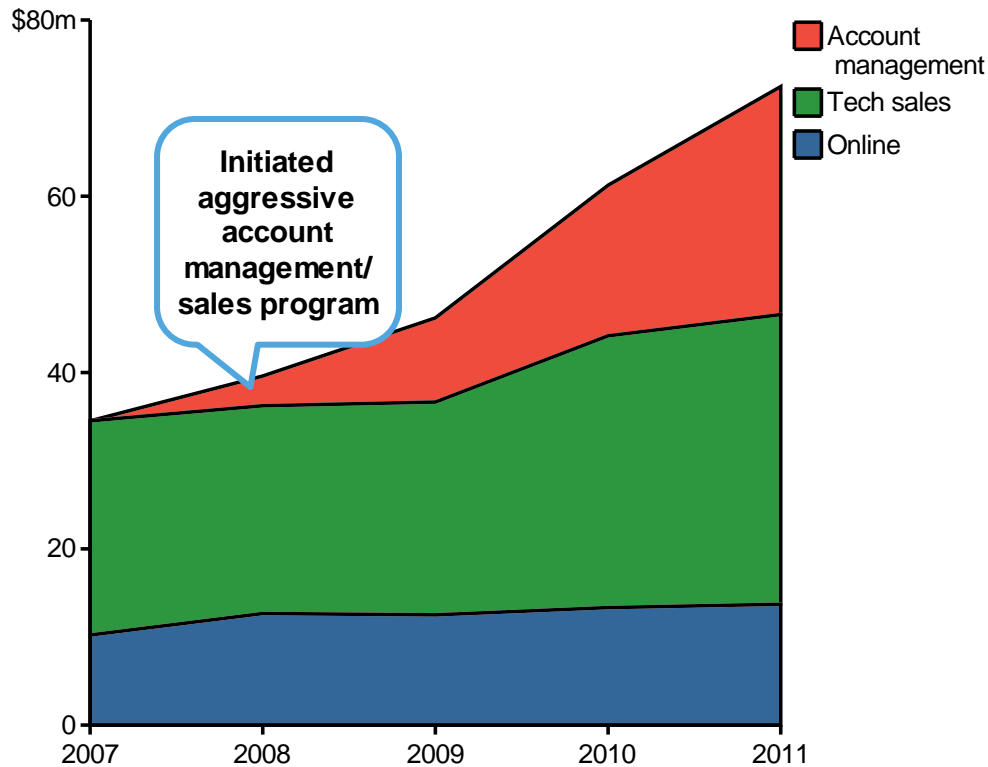
Small vehicle parts

- ▶ Distributes aftermarket parts to businesses and consumer markets
- ▶ Internationally sourced, proprietary products have increased from ~35% of revenues to 50% from 2006-10; gross margins have increased from 40% to 55%

Company profitability drivers

A focused and aggressive sales strategy, such as expanding the account management program, can significantly improve top and bottom line performance

Total revenue by sales channel, information technology distributor



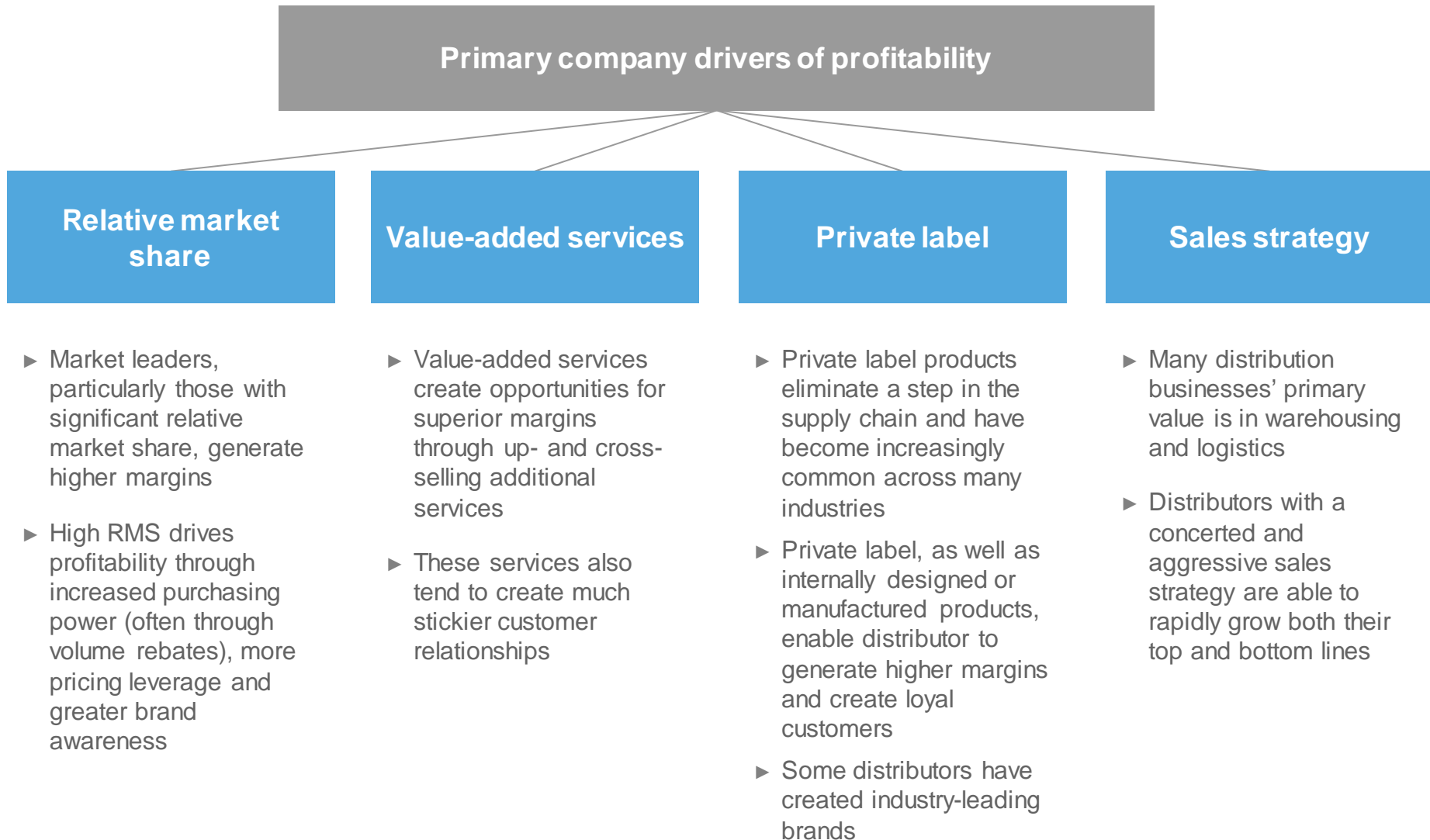
Distributor case studies

Information technology

- ▶ Distributor of digital data systems, such as product tracking systems (i.e., barcodes, scanners) through a multi-pronged sales approach
- ▶ **Online:** 20% of sales through e-commerce platform
- ▶ **Account management:** 40% of sales driven by outbound calling efforts by 40 account managers to existing customers to sell additional products
- ▶ **Tech sales:** 40% of sales are handled by 25 technically trained phone operators fielding incoming calls from potential customers seeking consultative advice
- ▶ Historical investments in customer relationship management (CRM) and enterprise resource planning (ERP) systems facilitate "metrics-driven culture"

Company profitability drivers

Primary company drivers of profitability



Company profitability drivers

Successful acquirers have been able to leverage the market structure to generate superior returns through multiple levers

| | Levers | Commentary | Value driver | Potential impact |
|-------------|-----------------------------------|---|--|------------------|
| Strategic | Roll-up/consolidation | <ul style="list-style-type: none"> ▶ Smaller players have struggled over the last few years and have limited ability to grow ▶ Larger players are driving consolidation in this market; ~80% of independent MRO distributors (facility sub-segment) have been approached in the last three years to sell their business | <ul style="list-style-type: none"> ▶ Roll-up accelerates share gain in a market where relationships are sticky ▶ Consolidation helps in volume rebates and getting dedicated regions from key manufacturers ▶ Limited savings on SG&A given the fragmented nature of the business | |
| | Value-added services/partnerships | <ul style="list-style-type: none"> ▶ Increasingly becoming an important part of the distributor's portfolio | <ul style="list-style-type: none"> ▶ Wrap-around services such as fabrication and engineering services are high margin and drive sticky relationships with end-users and manufacturers | |
| Operational | Pricing | <ul style="list-style-type: none"> ▶ Broad price changes will cause unsustainable share, however, selective pricing has the ability to drive revenue growth | <ul style="list-style-type: none"> ▶ Pricing, if used selectively, can add a few points of margin (customer segmentation, bundling, etc.) | |
| | Route optimization | <ul style="list-style-type: none"> ▶ Regional consolidation allows optimization of distributions routes, warehousing and sales resources | <ul style="list-style-type: none"> ▶ Optimized sales and distribution routes ▶ Consolidated warehousing ▶ Optimized sales resources | |
| | Cash management | <ul style="list-style-type: none"> ▶ Most independent distributors are not sophisticated managers of inventory and cash cycles | <ul style="list-style-type: none"> ▶ Optimizing inventory management/turns ▶ Improving the bill-to-cash cycle | |
| | Back-office consolidation | <ul style="list-style-type: none"> ▶ Fragmented nature of the business provides limited potential on the G&A, save back-office (finance, HR, procurement functions) | <ul style="list-style-type: none"> ▶ Consolidation of G&A functions | |

Agenda

- ▶ Distribution industry dynamics
- ▶ Drivers of profitability in distribution businesses
- ▶ **Parthenon-EY overview and relevant experience**

Introduction to Parthenon-EY's Industrials practice

Parthenon-EY has deep experience in helping investors evaluate potential distribution investments

Key questions

- ▶ What is the underlying market growth? How stable is the market and how does it perform across business cycles?
- ▶ What is the role of the distributor? Is the distributor going to be disintermediated?
- ▶ How sticky are the relationships (vendor and end customers)? What are the platforms for growth?
- ▶ What are the potential business levers that an acquirer can use to increase value?

Parthenon-EY capabilities

- ▶ Proprietary and customized econometric demand and market forecasting
- ▶ Primary research, including market participant and sales force surveys, and industry expert interviews
- ▶ Market sizing and competitive analysis
- ▶ Revenue forecasting and full potential analysis

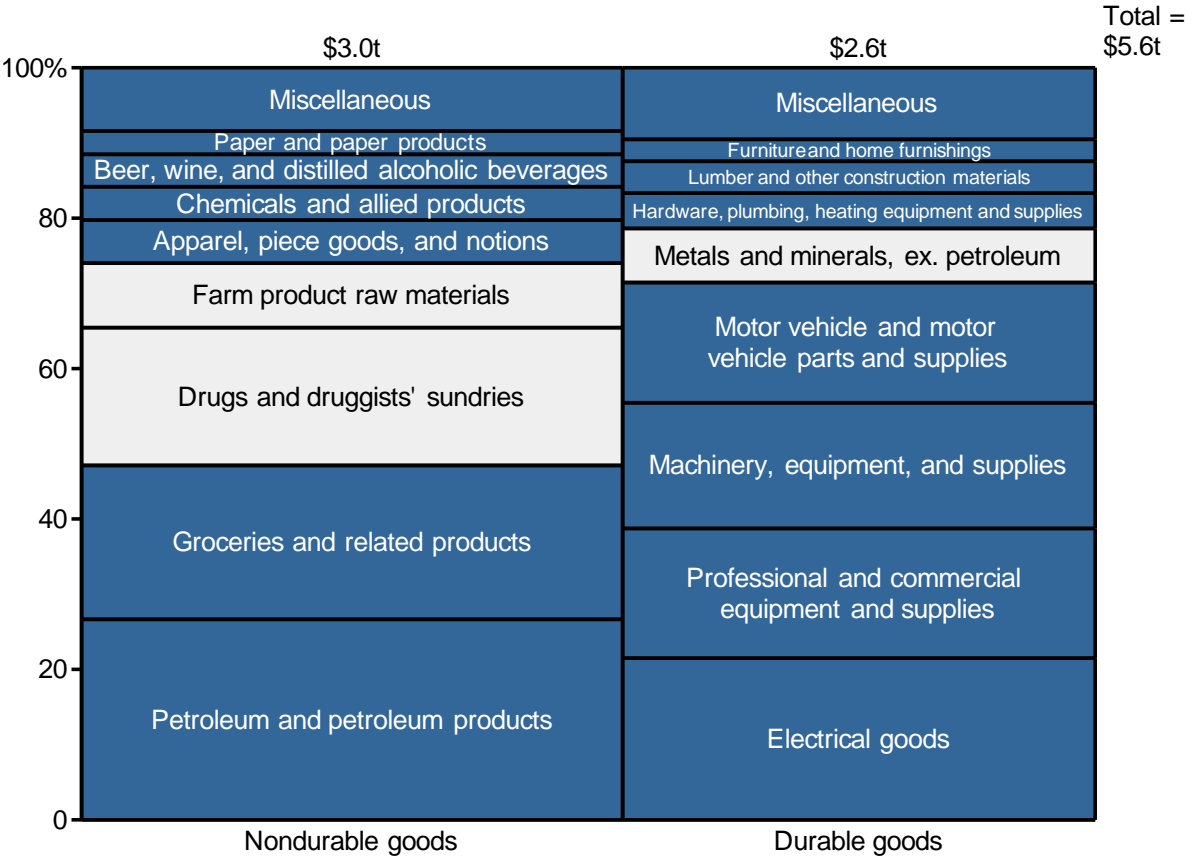
Representative engagements

- ▶ Over 100 industry evaluation and due diligence projects covering many segments within the distribution and industrial MRO market (e.g., HVAC, flow control, janitorial-sanitation, fluid power, electrical, automotive)
- ▶ Adjacent market and international market prioritization analysis
- ▶ Investment thesis generation and potential target company identification
- ▶ Sector scans for investment trends
- ▶ Identification of acquisition targets for potential industry roll-up

Introduction to Parthenon-EY's Industrials practice

We have broad experience across verticals

Total sales of US merchant wholesalers, by segment, 2014



Relevant Parthenon-EY distribution experience

- ▶ 100+ commercial due diligence efforts
- ▶ Experience across nearly all relevant verticals
- ▶ Proven process for integrating Parthenon-EY “toolkit” specifically for distribution businesses
 - ▶ Market size and segmentation
 - ▶ Macro economic forecasting
 - ▶ Customer and supplier research

Introduction to Parthenon-EY's Industrials practice

Parthenon-EY background and author contact information

About Parthenon-EY

Parthenon joined Ernst & Young LLP on August 29, 2014. Parthenon-EY is a strategy consultancy, committed to bringing unconventional yet pragmatic thinking, together with our clients' smarts, to deliver actionable strategies for real impact in today's complex business landscape. Innovation has become a necessary ingredient for sustained success. Critical to unlocking opportunities is Parthenon-EY's ideal balance of strengths – specialized experience with broad executional capabilities – to help you optimize your portfolio of businesses, uncover industry insights to make investment decisions, find effective paths for strategic growth opportunities and make acquisitions more rewarding. Our proven methodologies, along with a progressive spirit, can deliver intelligent services for our clients, amplify the impact of our strategies and make us the global advisor of choice for business leaders.

Learn more about us at parthenon.ey.com.

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