Industrial Distribution Insights

From the Trenches: Inside Industrial Distribution M&A

In this Q&A, Baron Carlson, Partner in AEA Investors LP’s Small Business Fund, one of the most active private equity investors in the industrial distribution sector, and T.J. Monico and John Newman of the KeyBanc Capital Markets® (KBCM) industrial investment banking group, share perspectives on the market for mergers and acquisitions (M&A) in the distribution industry.

It has been an eventful year for middle market M&A, with valuations on the rise and private equity players fiercely competing for high-quality investments. For many middle market distribution business owners, partnering with a private equity firm to diversify personal wealth while positioning a company for higher growth is an increasingly attractive alternative. Furthermore, M&A offers a way to capitalize on today’s unprecedented transaction valuation multiples without disrupting a company’s culture, employees and management autonomy.

In an effort to guide business owners who seek to better understand their options, we recently sat down with representatives from AEA Investors and KeyBanc Capital Markets, both highly focused and experienced with investing in and advising industrial distribution companies. The discussion provides insights applicable to middle market distribution business owners from both a buy-side and sell-side perspective.

Is now a good time for industrial distribution (ID) companies to explore a private equity investment?

Baron (AEA): Absolutely. We have seen a significant pickup in M&A volume throughout the year. As the economy continues to recover, capital comes out of the woodwork. In 2014, we’ve seen significant interest in the ID sector from private equity players competing with one another for quality deals—even greater than in 2007, our benchmark for a peak year. The abundance of capital on the sidelines relative to the number of available opportunities has resulted in elevated valuations and a continuing strong market for business owners to explore a liquidity event. While many business owners remain hesitant to explore a transaction with private equity, it is important to understand the benefits of exploring a partnership transaction in today’s strong market. The reality is, here at AEA we are more interested in investing in business owners seeking to grow their companies versus those simply looking to sell.

T.J./John (KBCM): The availability of private equity sits at near record levels. Industry data shows the amount of money raised and not yet invested, referred to in investment circles as “dry powder,” was a record $1.073 trillion globally at the end of 2013, up almost $130 billion versus 2012. And the pace has continued well into the first half of 2014, as firms have close to $1.141 trillion in private equity capital waiting to be invested.

This year will continue to be a seller’s market, and less volatile than the last few years. In 2012, tax considerations drove an increased amount of M&A before the start of 2013, so 2013 numbers were artificially low. Now, interest from capital sources has become exceptionally strong, coupled with a robust debt financing environment resulting in a seller-friendly market. Also, business owners are realizing that they can benefit from diversifying personal wealth and aligning with a partner to accelerate growth while valuation multiples are at peak levels, and purchase agreement terms are favorable.

Deloitte LLP polled 525 middle market executives and found 57% of them expect to or would be willing to pursue a private equity partner in 2014. (Source: Deloitte “2013 Report on America’s Economic Engine.”)

How should a company prepare for private equity investment?

Baron (AEA): Before a company considers private equity options, they need to be prepared to very clearly answer the following three questions (in order to maximize value and interest):
1) How does the company plan to grow?
2) How does the company plan to compete and take market share?
3) How do customers view the company relative to the competition?

T.J./John (KBCM): Companies should be ready and able to clearly articulate their value proposition to potential investors. How are they executing on their business plan and what makes them better, or different, than their competitors? And they should be prepared with supportable financial
projections that show how they will grow and be successful, demonstrating a compelling forward-looking story. By illustrating unique competitive positioning and strong planning, business owners look more attractive to potential investors.

**What are the common mistakes companies make when seeking a private equity partner?**

**Baron (AEA):** Sometimes business owners become too focused on operations at the expense of strategy. The strongest executives find time to develop a strategic plan, execute it, and think more broadly about market opportunities. Admittedly, it’s hard to simultaneously operate and plan; that’s why having a strong management team is so critical to running a successful industrial distribution business long-term.

Another shortcoming we encounter is the business owner who knows everything about their own business, but lacks a true understanding of their competition. Companies that are successful over the long term pay close attention to the competitive landscape.

**T.J./John (KBCM):** When companies fall short, it is more often than not due to an inability to articulate what they are, what they are doing, and why they have and will continue to beat the competition. For example, if you’re not prepared to articulate a view on investing in talent, new products, and markets, you’re not going to successfully position the company for investment at a premium valuation.

**What do companies stand to gain with a private equity partner?**

**Baron (AEA):** Our philosophy is to give companies the freedom and autonomy they need to grow their business. We invest in strong management teams, and empower them to do what they do best. Where we get involved is at the board level, where we can help companies think strategically through the resources necessary for growth and the longer-term business planning. Many privately owned companies have been financing growth out of their own pocket. A private equity partner can provide a larger capital base and a much wider corporate network from which to successfully grow via acquisition, as well as valuable insights and contacts. For example, ERP implementation, sales force/geographic expansion, entering new end markets, acquisitions, HR/recruiting, among many others.

**T.J./John (KBCM):** There is a common misperception that companies give up more than they get when they partner with private equity. In my experience, however, companies gain much more than just capital. They gain access to business expertise and guidance, not to mention the ability to diversify their personal wealth. In the end, owners still enjoy freedom to run the business, but with a partner who provides them the additional capital and resources to do so.

The middle market grew at a rate that was five times faster than the S&P 500 in 2013.

For 2014, middle market revenue is projected to increase 4.3% (organically) and employment to grow by 2.2%. Combined with an understanding that the distribution model held up relatively well during the recession, this should be good news to private equity investors. (Source: National Center for the Middle Market Survey.)

What’s the most important thing for a business owner to understand about the market right now when considering a private equity partner?

Baron (AEA): There is a scarcity of high-quality distribution businesses right now, so it is a very favorable environment for ID companies to begin evaluating options. Investors like AEA are looking for those high-quality companies ready to take their business to the next level. And it all starts with a quality management team.

T.J./John (KBCM): For many companies, the rewards of aligning with a private equity partner outweigh the risks – but this seller’s market won’t last forever. As more companies take advantage of today’s compelling market dynamics, a more balanced market should return in the next several years where valuations will return to more normalized levels.

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