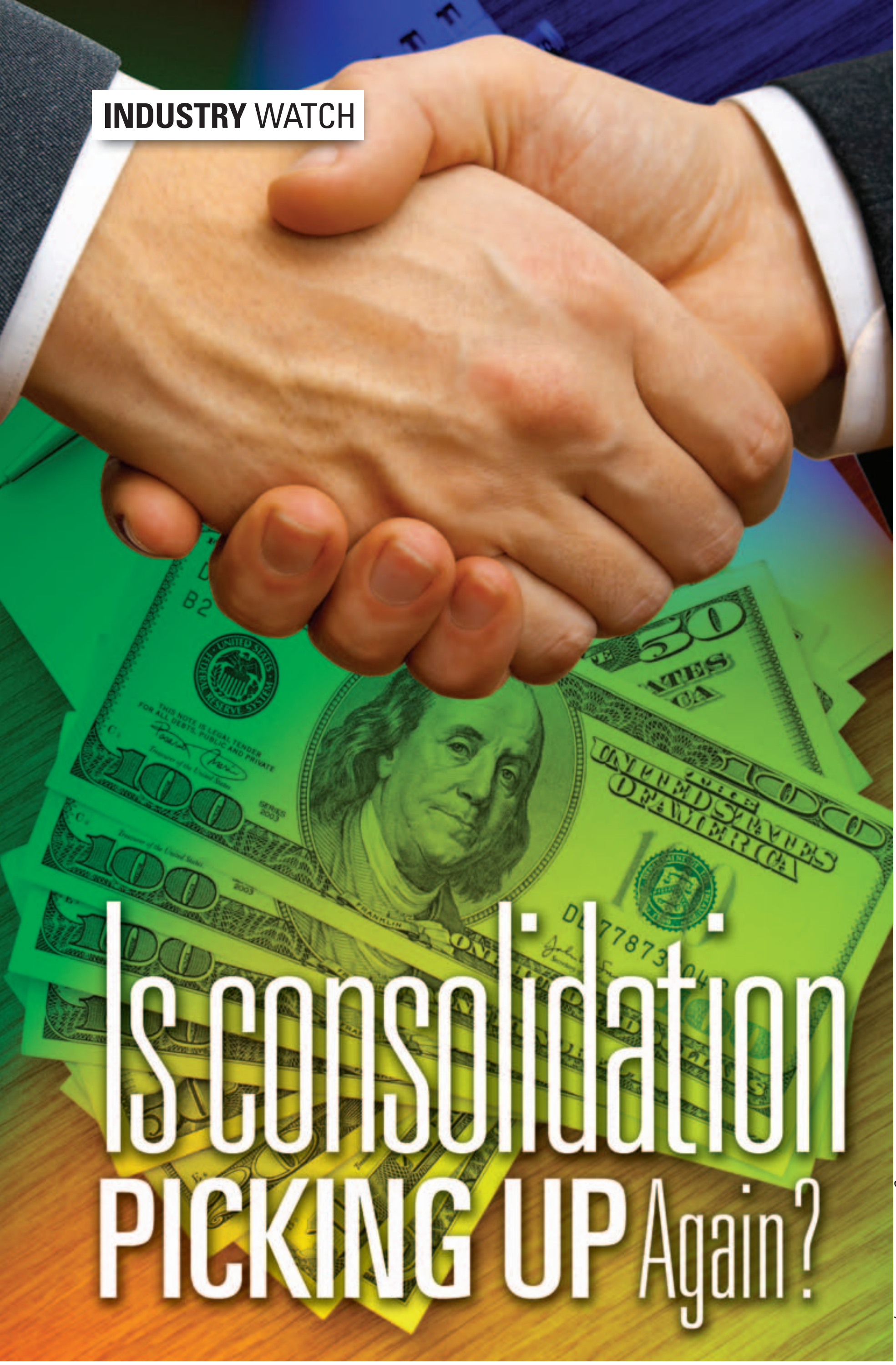
INDUSTRY WATCH



Is consolidation PICKING UP Again?

Oleg Prikhodko/istockphoto

Merger and buyout activity is heating up across the United States—the M&A newsletters are full of it. Brokers and investment bankers are looking for a very good 2005. In fact, they are praying for one, because after the past three or four years, their cupboards are pretty bare. But, those reports are broad-based, and not specific to electrical distribution. Frankly, in our industry, the reports are mixed. Nevertheless, there are indications of a pickup, and plenty of evidence that there is growing pressure for more consolidation.

BY JOSEPH SULLIVAN

Before delving into what's happening now, take a look at the charts to the right. A reasonable conclusion might be that the boom-time period of what Federal Reserve Chairman Allen Greenspan called "irrational exuberance" affected the market for electrical distribution companies just as it affected the stock market.

Consider the thrilling days of yesteryear: The "new economy" was booming. Money was flowing. Prices for businesses were driven ever higher largely because buyers felt they were in a race, didn't want to miss a good chance, and feared they would somehow get left out. It was an all-time record boom. Prices for electrical distributorships routinely went as high as 6 to 8 times adjusted EBIT ("earnings before interest and taxes"—see sidebar on page 64). Rumors circulated throughout the industry of prices as high as 12 times in at least one case.

No reasonable person expects a return to the boom. A growing consensus, however, expects growth and a reasonably good economy. The difference is very important to the consolidation. It all has to do with price and expectations. Boom-time expectations helped justify abnormally high prices, because buyers could rationalize that growth would add value rapidly enough to give them a good ROI. The recession put a cold, wet blanket on that kind of thinking. Today's economy is strong enough that buyers are shopping again. The difference is, this time they are not exuberant—they want good ROIs based on today's performance, not tomorrow's hopes.

Sellers are out there, too, driven largely by the need for liquidity—and a lack of successors and good transition plans. The graying of the baby-boom generation is pushing hard on both these issues. Owners need to do something with their businesses, and the need grows with each passing year.

So, we have buyers, we have sellers—but do we have deals? The answer is yes, but not like the good old days. Interviews conducted with knowledgeable buyers, along with other available information, suggests that by and large, buyers and sellers are still a ways apart in terms of price expectations. Buyers are interested in a range of 3 to 6 times adjusted EBIT, depending on the profitability and growth prospects of the company and its "strategic fit."

The 2005 Business Reference Guide, 15th Edition, evaluates current transaction data on a variety of industries and develops rules of thumb for pricing businesses. The average rule of thumb price for all kinds of distribution is 5 times EBITDA (EBIT, plus depreciation and amortization), but electrical distributors are placed on the lower end of the price range. Meanwhile, sellers on the whole are still hoping for something approaching a boom-time multiple of EBIT; asking prices as high as 8 times adjusted EBIT are being reported.

CHART A NAED Member Acquisitions

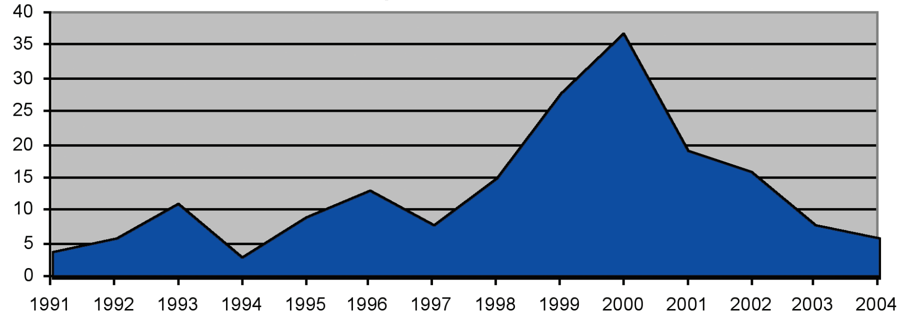


CHART B NASDAQ Closing Level

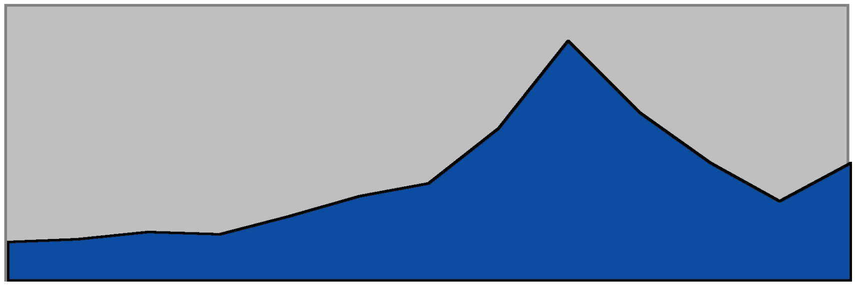


Chart A traces activity from 1991-2004; chart B shows the stock market bubble that happened at exactly the same time as the consolidation bubble. Note how remarkably similar the shapes look.

Despite this fairly wide spread in the bid and asked prices, deals are happening, and the pace appears to be picking up a bit. In January and February, four transactions were reported to NAED. That compares with a total of six for all 12 months of ▶

The ABCs of adjusted EBIT

Most pricing is driven off a multiple of adjusted EBIT, and a lot of negotiation and due diligence is focused on it. Here is how to figure it for yourself:

1. Start with reported earnings.
2. Add the value of any owner perks that would not be paid to a hired hand (e.g., expensive automobiles, generous travel and entertainment budget, special life and/or health insurance, vacation homes/condos, boats/airplanes, club memberships, family education expenses).
3. Add the value of the owner's income that is greater than what would be paid to a top-notch hired replacement manager.
4. Add back the cost of other special or one-time expenses, or anything not related to the business.

The result is roughly adjusted EBIT. But be careful, and be thorough. Don't get too aggressive or too cute—and don't try to tell the buyer how he or she will operate or what the overhead will be. Remember, lose credibility and negotiating strength will fade away.

2004, and eight in 2003. Of course, two months' results do not confirm a trend. That is especially true of January and February, because many deals struck in the second half of the year are scheduled to close after Dec. 31. Nevertheless, this burst of activity cannot be ignored.

The word on the street is that quite a few owners who missed selling during the boom pulled their companies off the market when they got hit with the double whammy of falling earnings and a falling pricing multiple. Some of those folks are now doing well again. Business is good. Profits are respectable if not outstanding. Deal pricing is better. The owners are now three years older. This is a recipe for an up-tick in transactions, if the buyers and sellers can get together on price. It looks like they are doing just that more and more often.

It truth, the consolidation is not back, because it never went away. It just got tired and took a nap. The underlying factors that have driven it for more than a decade are still there—in fact, they have grown stronger. In the improved economic environment, one can almost certainly look forward to reading a growing number of transaction notices in trade publications. ■■■

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