

Distributors cite the economy, customer closings and price competition as their main concerns this year, according to ID's 63rd Annual Survey of Distributor Operations, to be published this summer.



Signs of improvement emerge

M&A: Bridging buyer and seller valuation expectations remains a challenge

THE U.S. GROSS domestic product shrank 6.1 percent during the first quarter, barely better than the 6.3 percent contraction in the fourth quarter. The two quarters combined marked the economy's worst six-month performance in more than 50 years. However, some economists pointed to the first quarter's large decline in inventories and an uptick in consumer spending as encouraging signs that the economy is getting closer to the beginning of a recovery. Meanwhile, the Institute for Supply Management's Purchasing Manager's Index rose to 40.1 percent in April, up from 36.3 percent in March. This marked the PMI's highest reading since September and suggests the pace of economic contraction is slowing (while remaining below 50, typically viewed as the benchmark reading of a growing economy).

Broad stock market indices' recent performance suggests growing investor optimism. Since late February, the S&P 500 has increased 18.7 percent. Meanwhile, the Lincoln International Industrial Distribution Index (Lincoln IDI) enjoyed a mean increase of 32.2 percent during that 60-day period. Investor perception that industrial distributors often find themselves at the economy's leading edge is one possible driver of the strong performance. Distributors are usually among the first to incur the economic pain at the onset of a recession and are often the first to realize the upside in an economic recovery as manufacturers increase inventories depleted during the downturn.

Following the stock price advances, the Lincoln IDI recorded an adjusted mean last-12-months (LTM) EBITDA

multiple of 6.7x as of April 30, up markedly from the 5.4x noted in the last Market Pulse column.

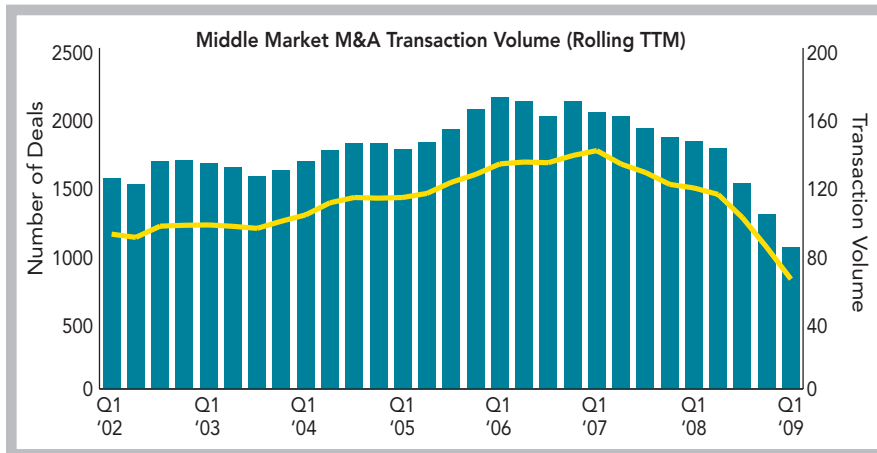
The M&A landscape

Broad recovery in the M&A market will take time, and successful completion of M&A transactions in the near term will favor well-capitalized strategic acquirers. Sellers now find themselves affected by several factors that handicap valuations. EBITDA market multiples have contracted; in most cases, LTM EBITDA performance has declined, financing is not readily available and the growth outlook for the near term is uncertain. As a result, sellers today feel they are selling their business at a large discount. "Earnout" provisions can bridge buyer and seller valuation expectations to ease this situation.

Earnouts involve the buyer and

INDUSTRIAL DISTRIBUTION INDEX: VALUATION UPDATE

Company Name	Market Cap	Enterprise Value	Enterprise Value / LTM EBITDA as of				Stock Price	% of 52 Week High
			10/30/2008	12/29/2008	2/27/2009	4/30/2009		
Airgas Inc.	\$3,507	\$5,338	6.5x	6.6x	5.7x	7.0x	\$43.12	65.9%
Anixter International Inc.	1403	2,359	4.7x	4.2x	5.0x	5.5x	39.78	53.0%
Applied Industrial Technologies, Inc.	950	1,027	5.3x	5.0x	4.8x	6.4x	22.50	71.9%
Barnes Group Inc.	741	1,213	5.2x	4.9x	4.4x	5.6x	14.16	43.8%
DXP Enterprises Inc.	171	334	5.0x	6.3x	5.7x	5.6x	13.28	38.9%
Fastenal Co.	5698	5,587	12.2x	9.9x	9.0x	12.2x	38.36	67.9%
Houston Wire & Cable Company	170	205	5.0x	4.4x	3.2x	5.0x	9.64	42.4%
Interline Brands Inc.	420	761	5.6x	5.8x	5.5x	7.0x	12.96	64.3%
Kaman Corp.	431	517	8.0x	6.5x	4.5x	6.0x	16.91	49.9%
Lawson Products Inc.	98	101	5.3x	4.5x	3.8x	3.5x	11.48	29.8%
MSC Industrial Direct Co. Inc.	2545	2,624	6.9x	6.6x	5.9x	8.5x	40.85	74.8%
Rexel SA	2162	6,071	7.0x	6.2x	6.1x	6.9x	8.37	52.7%
United Stationers Inc.	776	1,315	4.8x	4.8x	4.8x	5.4x	32.73	61.1%
W.W. Grainger, Inc.	6141	6,414	6.6x	6.4x	5.6x	7.3x	83.88	89.2%
Watsco Inc.	1226	1,206	10.4x	9.9x	9.1x	11.4x	42.95	70.3%
WESCO International Inc.	1098	1,999	4.7x	4.5x	4.7x	5.3x	26.00	55.9%
Adjusted Mean(1)			6.2x	5.9x	5.4x	6.6x		58.1%
Median			5.4x	6.0x	5.3x	6.2x		58.5%



seller agreeing to an amount of additional cash consideration to be paid at a future date if the acquired company meets certain performance goals after closing. Often, the earnout is tied to achieving EBITDA targets in the first one or two years after closing. In some cases, the payouts are absolute, meaning that if the target is missed by even a small amount, no earnout is paid to the seller. In other cases, the earnout formula can be graduated so that, for instance, if 90 percent of the earnout target is achieved, then 90 percent of the earnout is paid.

Earnouts offer a way for sellers to ultimately achieve what is, in their minds, fair value for their business. For buyers, the earnout offers a way to pay a fair price at closing while taking little risk on the additional funding, as it is most likely contingent on achievement of an EBITDA level that exceeds what they've forecasted in their valuation model. In essence, the buyer's return on any additional capital paid out via an earnout is by definition attractive because it means the target's performance exceeded the buyer's expectations reflected in the base pur-

chase price paid at closing. A seller's willingness to agree to an earnout can also assist in negotiations, as it sends the signal to the buyer that the seller has enough confidence in the business going forward that they are willing to "put their money where their mouth is."

However, earnouts can pose challenges. Most notably, they are based on the company's post-closing performance, which is controlled by the buyer. Many sellers struggle with the concept of relinquishing control of the company when decisions made after closing can have a meaningful impact on the company's performance. Nonetheless, earnouts are a topic we will hear more about in coming months as buyers and sellers attempt to bridge valuation gaps in a challenging market.



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