MARKETPULSE BY CURT TATHAM

id fact

82% of distributors say they are taking steps to prepare for an economic recovery, according to ID's *63rd Annual Survey of Distributor Operations*.

More positive signals on the horizon

Economic news continues to improve, but distributors' valuation multiples remain static

THE SEVERITY AND length of the current "great recession" may at times make you feel as though we will never emerge from this period of severe economic challenges. However, like all economic downturns that have come before, this one will eventually appear in our collective rearview mirror. Indeed, increasingly we are seeing economic indicators display encouraging signs that the rate of economic contraction is slowing and that stabilization is approaching—or perhaps is upon us already in certain sectors. Recent encouraging data include:

- Housing starts rose at an annual rate of 17 percent in May
- Housing purchases have begun to pick up in certain areas of the country
- Durable-goods orders in May posted a better-than-expected 1.8 percent increase (the third increase in the past four months for durable-goods orders)
- A narrower gauge of business investment marked its largest improvement in more than four years

The Institute for Supply Management's Purchasing Managers Index rose to 42.8 percent in May from 40.1 percent in April, above the 42 percent expected by economists—the highest reading since September and well above the 28-year low of 32.9 percent in December.

A key ISM sub-index, new orders, moved above 50 percent in May for the first time since November 2007, a sign that some parts of the manufacturing sector are beginning to recover.

Credit markets have stabilized, as reflected in the decline of the LIBOR (London Interbank Offer Rate) to .60 percent from a high of 4.82 percent in October while the Ted spread (an indicator of perceived credit risk in the general economy) fell to an 11-month low of .48 percent in May.

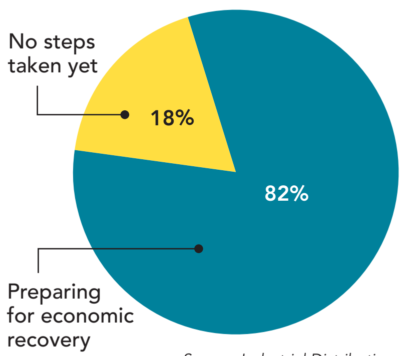
Following a two-day meeting in June, the Fed's Federal Open Market Committee said on June 24, "Information received since the FOMC met in April suggests that the pace of economic contraction is slowing, financial market conditions are improving and businesses are getting a better grasp on how much inventory is needed for the sales rate."

Distributors have been hoping for signs that customer destocking had reached bottom relative to the level required to meet shipment demand. However, while the Fed seems to feel that the structural adjustment to inventory levels resulting from the recession has progressed meaningfully, a closer look at the

INDUSTRIAL DISTRIBUTION INDEX: VALUATION UPDATE

			Enterprise Value / LTM EBITDA as of					
Company Name	Market Cap	Enterprise Value	12/29/2008	2/27/2009	4/30/2009	6/30/2009	Stock Price	% of 52 Week High
Airgas Inc.	$3,310	$5,067	6.6x	5.7x	7.0x	6.8x	$40.53	66.8%
Anixter International Inc.	1,326	2,282	4.2x	5.0x	6.2x	6.0x	37.59	50.1%
Applied Industrial Technologies Inc.	832	909	5.0x	4.8x	7.0x	6.2x	19.70	63.0%
Barnes Group Inc.	631	1,091	4.9x	4.4x	5.6x	5.8x	11.89	45.4%
DXP Enterprises Inc.	148	290	6.3x	5.7x	5.6x	5.2x	11.47	33.6%
Fastenal Co.	4,927	4,816	9.9x	9.0x	12.2x	10.5x	33.17	58.7%
Houston Wire & Cable Co.	210	234	4.5x	3.2x	5.0x	7.1x	11.91	54.1%
Interline Brands Inc.	444	725	5.8x	5.5x	7.0x	7.3x	13.68	73.6%
Kaman Corp.	427	523	6.5x	4.5x	6.0x	6.3x	16.65	49.1%
Lawson Products Inc.	121	126	4.5x	3.8x	6.2x	7.6x	14.21	36.9%
MSC Industrial Direct Co. Inc.	2,211	2,289	6.6x	5.9x	8.5x	7.4x	35.48	66.1%
Rexel SA	2,176	6,254	6.2x	6.1x	7.3x	7.2x	8.47	57.4%
United Stationers Inc.	827	1,366	4.8x	4.8x	5.8x	6.0x	34.88	65.1%
W.W. Grainger Inc.	5,995	6,267	6.4x	5.6x	7.3x	7.1x	81.88	87.1%
Watsco Inc.	1,404	1,379	9.9x	9.1x	11.4x	15.1x	48.93	80.1%
WESCO International Inc.	1,058	1,978	4.5x	4.7x	5.8x	5.8x	25.04	61.7%
Adjusted Mean(1)			**5.9x**	**5.4x**	**6.9x**	**6.9x**		**59.2%**
Median			**6.0x**	**5.3x**	**6.6x**	**6.9x**		**60.2%**

Although times may be bleak for many distributors, most anticipate a recovery and are beginning to take steps to prepare for better economic times.



Source: Industrial Distribution

data is not as comforting. The May inventory-to-shipment ratio rose to 1.90 from 1.89, indicating that manufacturers' inventories are actually getting further out of line despite massive efforts to reduce production and rationalize inventories. Meanwhile, in a recent Boston Consulting Group Study titled "Collateral Damage," the inventory-to-sales ratio actually remains higher today at 1.45 than the long-term average of approximately 1.25.

The valuation scenario

This mixed picture of macroeconomic data combined with continued soft results reported by public industrial distribution companies has resulted in relatively static valuation multiples for the Lincoln International Industrial Distribution Index since our last issue. The adjusted mean EBITDA multiple on June 30 remained at 6.9x the last 12 months ("LTM") EBITDA. This is the same multiple as of April 30, 2009, but up meaningfully from year-end 2008 when the adjusted mean for the Lincoln IDI stood at 5.9x. Like the overall market, the IDI's components have reflected a mixed bag since the last edition, with seven of the companies realizing multiple expansion, eight realizing multiple contraction and one multiple remaining static.

However, strictly reading backward-looking valuation multiples during a period of economic contraction can be misleading. While the adjusted mean LTM EBITDA multiple remained at 6.9x, the total market capitalization of the IDI actually shrank by $1.5 billion, or 5.4 percent, to $26 billion from $27.5 billion. Actual value creation, as opposed to multiple maintenance or expansion, will ultimately require improved quarterly results—or at a minimum, results that are simply "less bad." Evidence of improved results have yet to appear at most companies, as shown by the most recently announced quarterly results at MSC Industrial, Fastenal and W.W. Grainger, which reported year-over-year sales declines of 23 percent, 21 percent and 13 percent respectively.

Meanwhile, on a relative stock price performance basis, since year-end 2008, the IDI had increased 1.4 percent as of June 30, which compared favorably to the S&P 500, which was down 1.3 percent. However, the IDI pulled back meaningfully (as did the broader market) during June after peaking at a level up 12.9 percent compared to year-end 2008.

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