



Article Appearing in:
Electrical Wholesaling
February 2006



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Consolidation ... Changing the Landscape

The times are a changing. While the industry has benefited from commodity price inflation, a rebound in industrial MRO expenditures, significant residential growth and continued improvement in the commercial marketplace, this "perfect storm" is creating different opportunities for some.

Before the past is forgotten, many industry observers will recall the hard times that fell upon the industry. Distributor net profits were about 1%, the industrial flight to China was in full swing and "dot coms" became "dot bombs". Many electrical distributor businesses suffered, and a number of owners lamented that they "did not sell their business during the 'good times', like some of their brethren."

Recognizing that the acquisition market was dry, companies either crafted growth strategies to gain share, improved operational processes to reduce costs, implemented both of these strategies or continued to persevere and maintained their income (a lifestyle company).

Fast forward to today. Distributor revenues, and profitability, have improved. Leading companies made investments in technology. Industry stalwarts are aging. Larger distributors seek new areas of growth and capital is available from banks and other investors.

Last year there were 30+ electrical distribution acquisitions. Are the conditions ripe for more? And how could this change the competitive landscape of the electrical industry?

Watershed Event

In the words of one industry veteran, Home Depot's acquisition of Hughes Supply could be a "watershed event" for the industry. Not because of Home Depot entering into electrical distribution but because of the cache of the Home Depot name to generate interest in the industry,

and discussion amongst distributors and manufacturers. Will the heightened visibility change industry practices?

Many say yes. Manufacturers expect that the combined organization will seek "low" prices and "high" rebates, as they uncover the negotiations of the combined organizations. It is also expected that Home Depot will bring its operational best practices to Hughes. Alternatively, new services could be developed such as national accounts for large homebuilders to "kit and stage" houses, small projects and multi-unit facilities that require multiple trade-groups.

Alternatively, only 10% of Hughes was electrical. Potentially more important to Home Depot was Hughes' MRO, waterworks and plumbing businesses. The MRO business helps Home Depot's Maintenance Warehouse business and service government contracts; plumbing/HVAC is a natural fit for a company that excels in servicing homebuilders, remodelers and contractors; and the water and sewer businesses complement Home Depot's waterworks group.

Many of these trades are transactional-driven industries. Electrical is more complex, especially the commercial and project aspects of serving customer needs.

But the visibility may accelerate change.

Recent Research

Channel Marketing Group and Allen Ray Associates recently surveyed, and interviewed, over 100 industry thought-leaders to understand why people sell, whom they believe acquirers will be and how consolidation may affect the industry in the next 3-5 years.

Distributors and manufacturers of all revenue sizes responded to the survey.

Key Observations

Top 100 Becomes Dominant

As of 2004, the Top 200 distributors, as ranked by Electrical Wholesaling, were responsible for



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47.7% of industry revenues, with the Top 100 generating 43% of industry sales. Survey respondents believe that the Top 100 distributors will account for 60-65% of industry revenues in 3 years. A 17% increase, or \$18-20 billion more than today. Most of this revenue aggregation will be due to distributor consolidation.

Who will Acquire?

Survey respondents focused on many of the expected acquirers. Companies frequently mentioned were:

Sonepar	34.0%
Home Depot	15.7%
National / Regional Chains	11.1%
Rexel	8.5%
Private Equity	7.2%
WESCO	7.2%
Lowe's	4.6%
Global Players	4.6%
CED	3.3%
Other	3.9%

Additionally, non-traditional potential acquirers could include:

- Asian or Indian manufacturers seeking distribution (or could they be buying manufacturers?)
- Ferguson, a division of Wolseley PLC, a \$13.4 billion company that made over 25 acquisitions in 2005. Ferguson has purchased plumbing companies that have significant electrical revenues.
- Interline Brands, an \$800 million multi-industry public company with a number of electrical groups, and extensive private labeling experience.
- WinWholesale, the purchaser of Noland, with over \$2 billion in revenues, 500 locations, and an estimated \$250M+ in electrical revenue.
- CES, from the U.K., focuses on start-ups and plans to expand to 5-7 more states in the coming year.
- Private equity companies either on their own or supporting industry veterans.

According to Thomson Venture Economics, private equity firms raised \$106 billion in 2005, which could be leveraged into \$400 billion in buying power. A percentage of this is targeted at distribution and industrial manufacturing.

And don't forget that regional distributors expect to grow through acquisition, expanding into new markets with contiguous acquisitions and continuing to make smaller acquisitions to "fill-in". This is especially important for Rockwell Automation distributors who believe the company wants to reduce its distributors from 50-60 to about 20. Large contractor houses will also make acquisitions to develop greater efficiencies and increase their market share. In fact, survey respondents expect 8.5% of their future revenue growth to come from acquisitions.

Why Sell

For the past 10 years, the lack of succession planning and the dearth of incoming talent to the industry have been frequent topics at industry meetings. This, coupled with continued distributor investments in technology and the perception that some distributors "missed" prior selling opportunities, are converging to accelerate the consolidation trend.

Survey respondents indicated,

- 59% felt companies sold due to lack of a family succession plan
- 57% expressed concerned about the future of the economy & their ability to cash out later
- 53% viewed themselves as stewards of the family business and had a fiduciary responsibility to the family
- 48% had reluctance to further invest in their business
- 24% perceived that distributors were not making enough money
- 10% had concern about doing an ESOP.

The recent high-profile acquisitions of Rexel, Hughes and Irby have further heightened interest in selling due to the multiples that were paid.



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Home Depot paid 12-13x earnings. According to sources, the other deals were high single to low double digit multiples. The reality is that these acquisitions were strategic platforms for the acquirers, and hence they may have "overpaid".

The wisdom of strategic acquisitions can usually be determined within 12-18 months. Consolidation is ongoing, however, historically, if an acquiring company does not receive synergistic benefits within a year, it does not achieve those advantages long-term.

According to acquirers and financial buyers, future deals will be closer to 6-8x EBITDA. The key to receiving more is for the acquiree to be positioned as a growth-oriented, strategic acquisition.

Does it Matter Who Acquires?

Industry insiders say "yes". Private equity firms have access to capital and will fund acquisitions that accelerate consolidation. It is felt that these "professional money people" will bring improved financial discipline to the industry and increased focus on achieving supply chain efficiencies. Professional money will bring an enhanced passion for profits, as well as a desire for growth to accelerate the value of their investments.

Conversely, it is felt that "industry outsiders" will focus on profits to the detriment of the business, resulting in a loss of customer focus at acquired locations; customer and supplier relationships will wither; employees will seek security; and a short-term mentality will prevail.

Similarly is felt about companies on the "outskirts" of the industry entering into the market. Few believe that companies that do not focus on this market can succeed. Is this fact or perhaps because it either hasn't been done before or the "right" structure needs to be implemented?

Changing Industry Landscape

The accelerated pace of acquisitions bodes of future challenges and opportunities for

distributors and manufacturers. It would not surprise us to see 200 less independent distributors in 3 years (a 6% reduction). Combine this with a 17% increase in revenues for the Top 100 distributors, and it will be important for channel participants to reevaluate their strategies.

Manufacturer / Distributor Relationships

With size comes "power", defined as the potential to leverage the business. If 60% of revenues are sold through 3% of the industry, many expect larger distributors to receive preferential pricing, larger rebates, increased marketing support and more personal attention. Size will matter and relationships, while important, will not be decision-drivers.

The volume that these companies bring may come with a sharp edge...the perception that the distributor controls the business and that manufacturer products are commodities. This could lead to switching suppliers based upon line profitability and/or a heightened interest in private labeling.

For manufacturers, marketing and training could become differentiators and reasons why smaller distributors stock their lines. Branding will become more important as the need to gain greater access, and influence, at the end-user becomes essential for a manufacturer to support their business.

Manufacturer profitability may further shrink with the need to "serve" the larger distributor, enhance branding efforts, market to smaller distributors and focus more on end-users. In an effort to maintain acceptable profits, manufacturers will seek to work with distributors who offer supply chain efficiencies (something Home Depot knows something about) and help the manufacturer differentiate themselves in local markets.

We asked survey respondents how manufacturers may refine their distribution strategies. The top 10 expected strategies include:



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1. Seek to strengthen relationships with independents.
2. Electronically integrate with large distributors.
3. Increase usage of national account managers.
4. Change the role of manufacturer reps.
5. Maintain level of rebate to marketing groups.
6. Seek distribution alternatives on fear that the consolidating distributor's service levels may decline.
7. Provide special customer pricing to servicing distributors.
8. Provide more marketing support to large distributors.
9. Provide special pricing allowances to large distributors.
10. Provide greater volume rebates to large distributors.

Notice the focus on large distributors. Small to mid-sized distributors need to consider how to capture share of mind from the manufacturer, and manufacturers will need to consider how to balance their efforts to take advantage of market opportunities and capture their share of the remaining 40% of the business.

The Role of the Rep Evolves

A potential major "casualty" of consolidation is the role of independent manufacturer sales reps. Rather than retain their sales role, many believe that reps will need to become better custodians of their markets. They will need to focus more time at the end-user, gain specs from influencers, and generate demand. And with increased expectations expect increased rep consolidation due to the need to offer more services.

Large distributor relationships will be managed by national account managers with reps supporting initiatives in executional roles. Small distributors will be the domain of reps who will maintain their traditional roles of distributor development, account management, local marketer and demand creator with these customers.

But with a significant percentage of the business being managed at a corporate level, and reps being relegated to implementers of strategy, many believe that the rep compensation model will change. It is doubtful that it will be based 100% on volume. More likely a combination of marketplace volume, account profitability and demand generation activities.

Key for manufacturers will be to determine the profile of the "right" rep, how to communicate with them; identifying the tools that they will need to achieve manufacturer defined goals; and what is the "right" compensation model. Perhaps piloting initiatives now would be appropriate?

If you're a rep, evaluate your market. Where do you expect consolidation? How do you need to change your organization to deliver value-added to your manufacturers and distributors? What is the "right" compensation model for you? How could you become a marketing engine for manufacturers? For selected distributors?

An Opportunity for Independents

Change creates opportunity. And while some will view the next few years as an opportunity to cash-out, others will recognize that this is a time for focus and growing their business.

In the words of many, independent distributors who

- Service their customers.
- Have strong customer relationships.
- Commit to a market segment and/or identify niches.
- Are nimble.
- Respond to customers.
- Have low employee turnover.
- Are operationally efficient, and
- Have strong balance sheets to financially take advantage of opportunities

will prosper.

To enhance their competitiveness, these distributors should



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- Stock appropriately, recognizing that national chains have a tendency to focus on financial measurements vs. customer needs.
- Belong to a marketing group to take advantage of enhanced rebates, networking opportunities, education and marketing support.
- Identify ways to generate operational efficiencies through technology and/or alliances.
- Become more proactive in marketing their differences and supporting supplier initiatives.

While consolidation may accelerate, there will always be many more independents who will be willing to work with a manufacturer for a mutually beneficial relationship.

Marketing Groups ... More than Rebates

While some believe that the groups will decline in importance with the loss of larger members, they still will represent a significant number of distributors, about 1000, with revenues of over \$15 billion, or about 25% of industry sales.

Historically the principal benefits of the groups have been financial, networking and market planning tools. As the industry consolidates, independent distributors will look to the groups to provide a broader array of services. Areas that respondents desire include:

- Increased education and training support. Areas include product, developmental skills and marketplace trends.
- Access to products at "better" prices through group buying.
- Marketing resources that small distributors can utilize for themselves.
- Opportunities to reduce operational expenses through either group buying or technological services.

From a manufacturer viewpoint, the marketing groups could become more important as a channel strategy. While the rebate expense is significant, many distributors would earn a significant portion of the rebates which are

currently paid regardless of belonging to a group. Perhaps the benefit of participating in a group for a manufacturer is enhanced interaction with distributors (given that all members attend A-D and IMARK meetings) and access to more effective communications systems?

Manufacturers should consider how to gain greater benefits from their memberships and perhaps the groups should more effectively market these value-added services as core competencies?

Declining Membership

In the words of one respondent, "Trade associations serve the industry regardless of make up. NAED will still exist if there are only 50 players."

While the survey asked for input regarding "associations", most of the input related to NAED.

Respondents were unanimous that the association will lose members and should continue to:

- focus on standards and education
- identify ways to reduce channel costs and enhance distributor profitability
- and promote a method for distributors to "quantify" the value of the association.

Some expressed that they like recent NAED improvements to highlight industry issues, even though the association is challenged with implementing taskforce recommendations. The input is beneficial to those who read/hear it.

Many felt that meetings will become less important with attendance dropping and marketing group meetings having more value (coupled with more small distributors joining the marketing groups). This requires the association to consider alternative revenue streams, streamline resources and maximize its usage of technology.

To serve the industry in the future, it will be important for distributors to expand the involvement of their people in the association and

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possibly for the association to niche itself, offering services that are more appropriate for larger companies while having other services for small distributors.

Associations can be important to industries. Other industries have experienced association consolidation, typically vertically, in an endeavor to aggregate resources, minimize expenses and eliminate duplicity. Is this a direction for the electrical industry? If so, "who leads the charge" and has a plan for how all industry participants can benefit?

Develop Your Plan

For some distributors consolidation may be an "early Christmas present" enabling them to secure their future. One national distributor suggests that "every \$25M+ distributor should develop a three year plan, forecast revenues and profits, show how they can grow and see what they are worth." While there may not be a buyer for everyone, the process of planning, by definition, determines company direction. Those who focus and execute can win.

Manufacturers have broader challenges. Some will be consolidated themselves, but channel challenges will require manufacturers, and their sales agents, to reevaluate distribution policies and strategies. Much power today is at the end-user level. If distributors gain influence with the end-user, how do manufacturers need to react?

The full effects of consolidation won't be felt for a couple of years but now is the time to "white board" ideas, develop concepts, test pilots and launch initiatives.

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