



# M&A – A DEEP DIVE VIEW OF WHAT WORKS

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JON SKELLY

PRINCIPAL, PCE INVESTMENT BANKERS



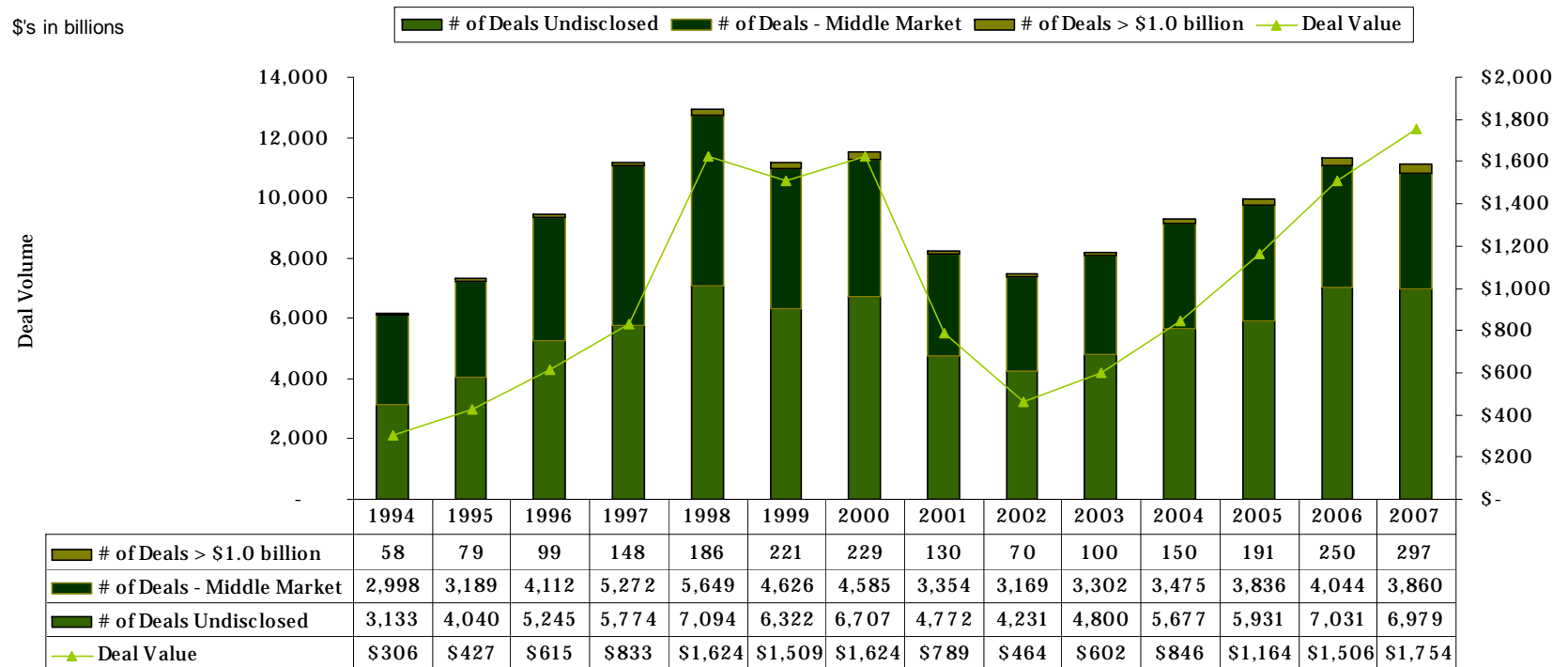
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# MIDDLE-MARKET M&A AND DISTRIBUTION INDUSTRY OVERVIEW



# US M&A MARKET

## 2007 was the strongest U.S. M&A market in history based on total deal value

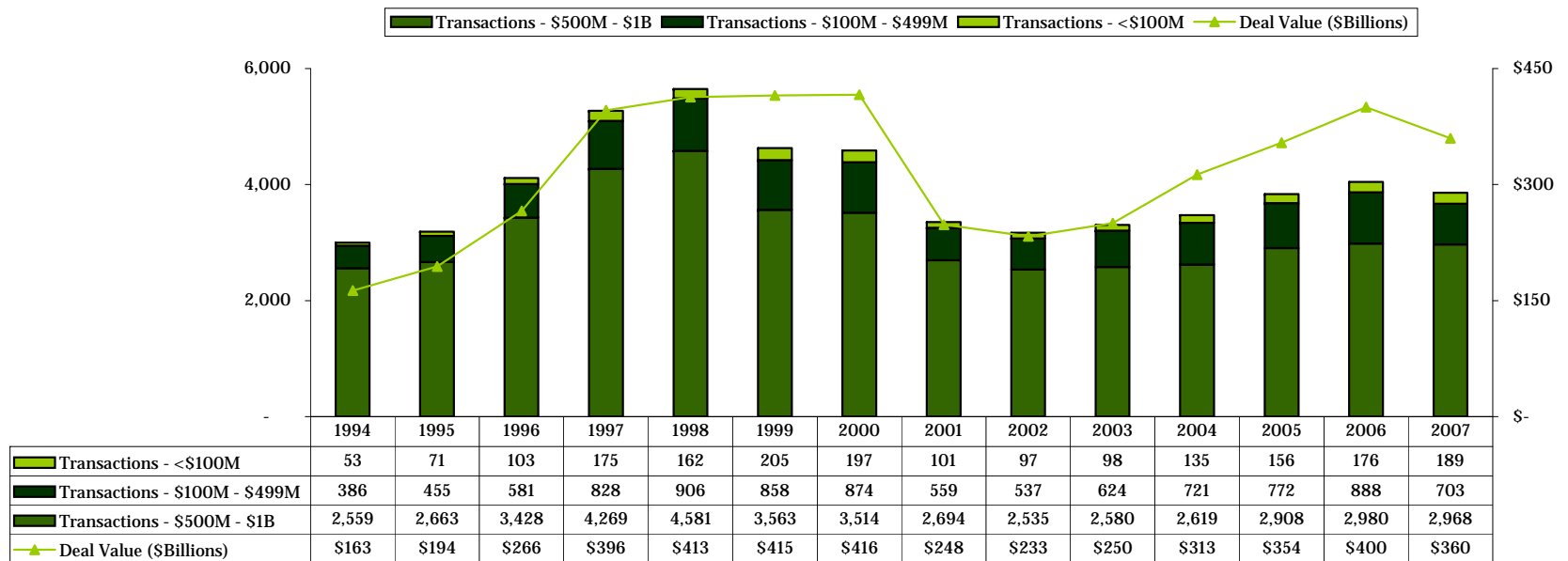


Source: CapitalIQ



# U.S. MIDDLE MARKET TRANSACTIONS

**While the “mega” private equity transactions received most of the headlines in 2007, the middle market was the main driver of strong M&A activity**



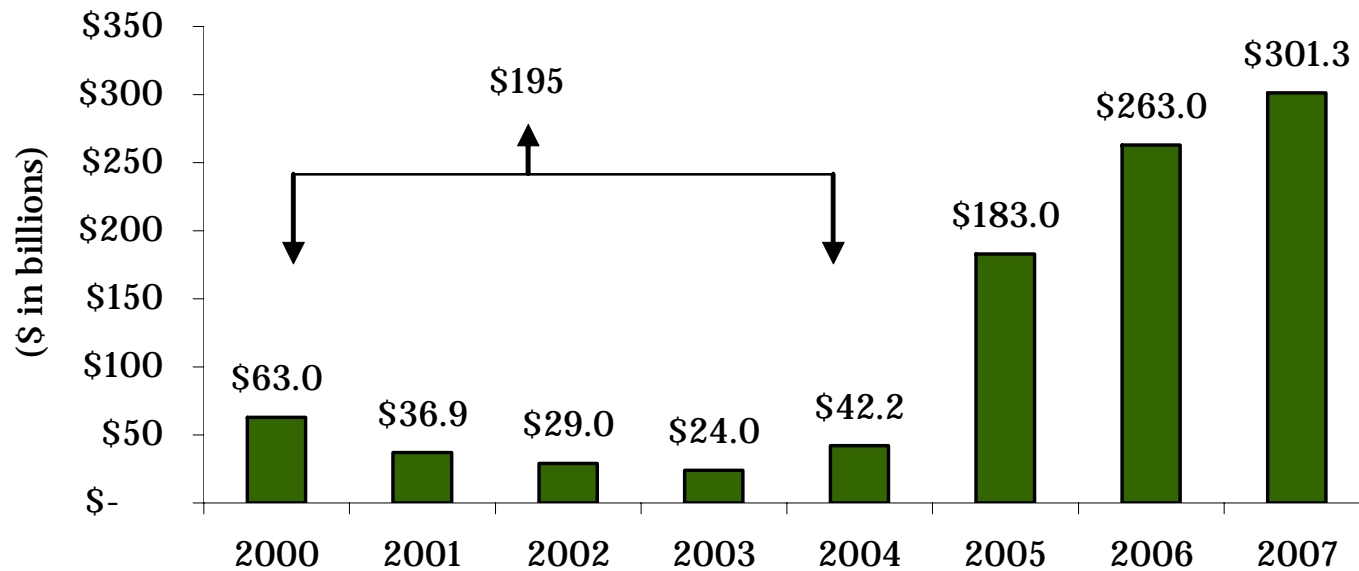
**Source: CapitalIQ**



# BUYOUT CAPITAL RAISED

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**Private equity funds were core drivers of this increased pace, having raised massive pools of capital**

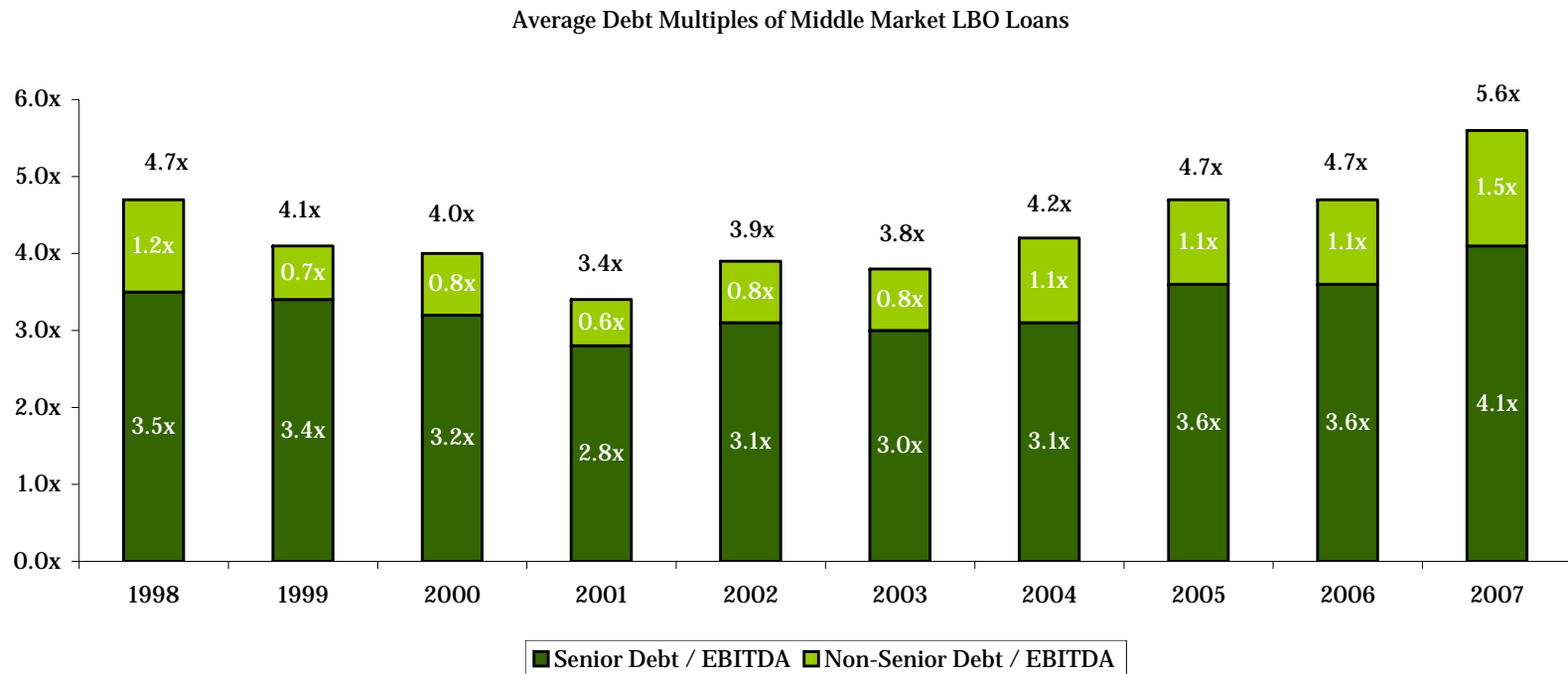


**Source: *Buyouts Magazine*. Includes mezzanine and fund of funds.**



# AVERAGE DEBT MULTIPLES OF MIDDLE MARKET LBO LOANS

**Private equity capital was then coupled with historically high levels of available credit**



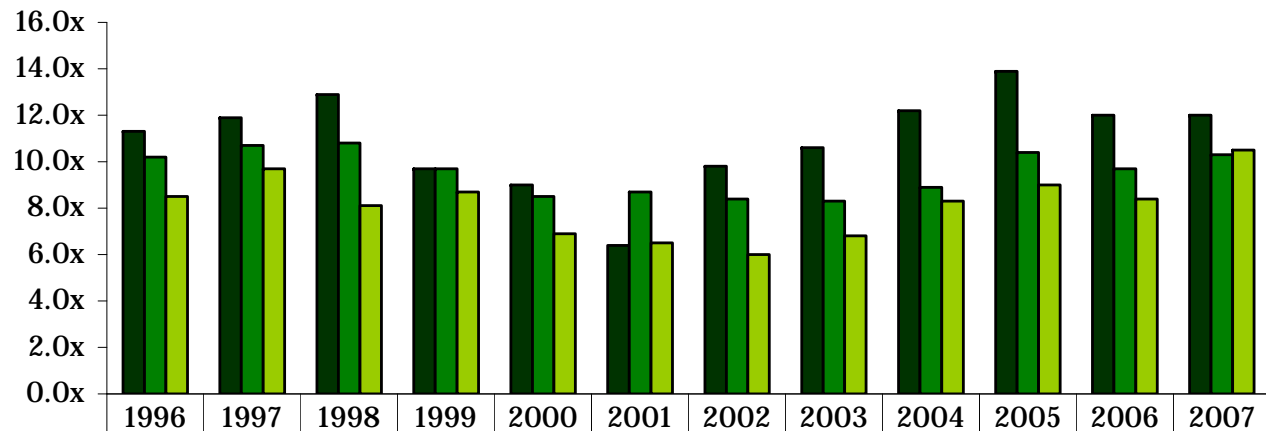
**Source: Standard & Poor's LCD**



# MIDDLE MARKET EBITDA MULTIPLES

**This capital availability led to increased competition for transactions and astonishing valuations**

■ Transactions - \$500M - \$1B ■ Transactions - \$100M - \$499M ■ Transactions - <\$100M



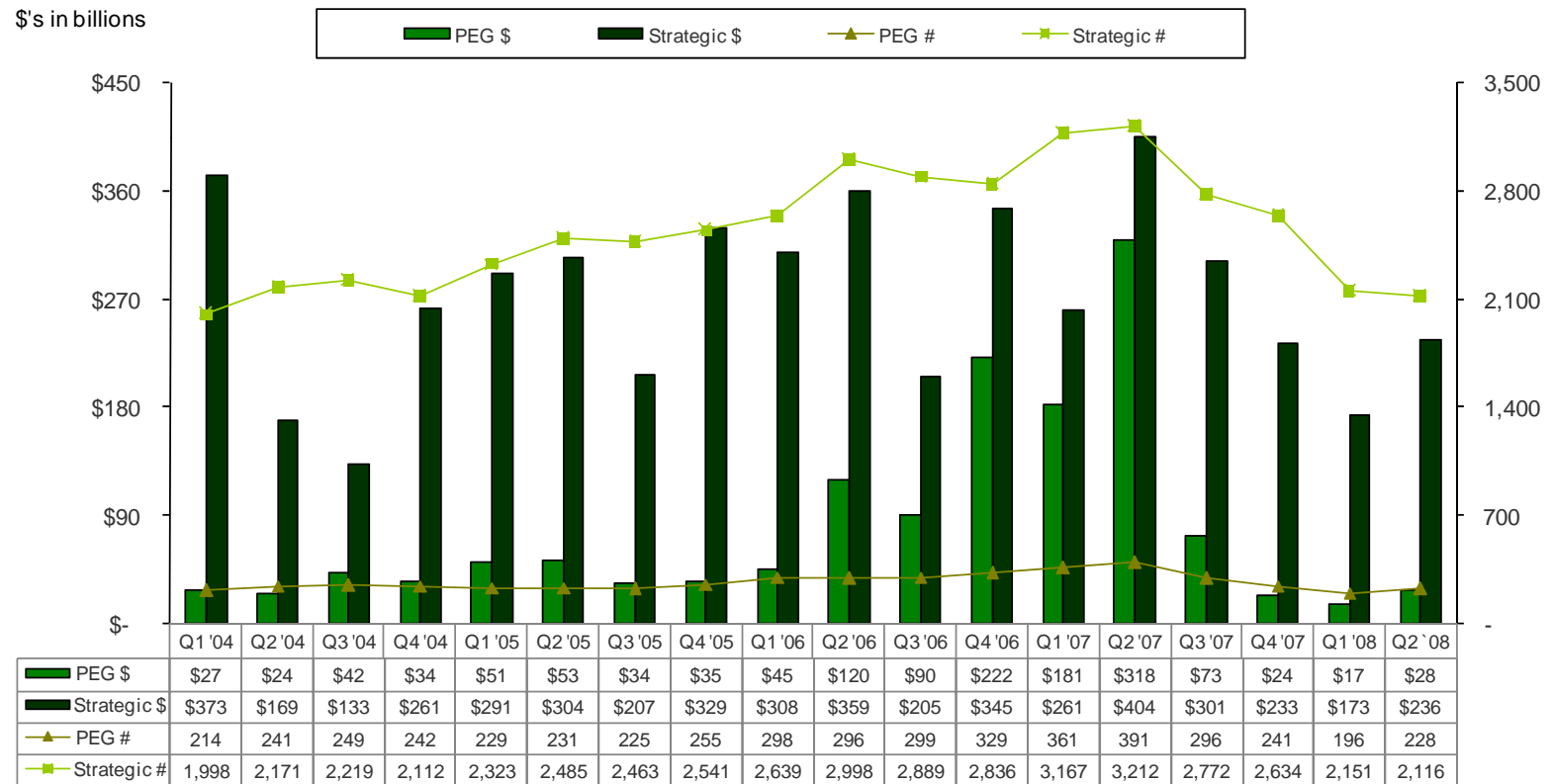
■ Transactions - \$500M - \$1B	11.3x	11.9x	12.9x	9.7x	9.0x	6.4x	9.8x	10.6x	12.2x	13.9x	12.0x	12.0x
■ Transactions - \$100M - \$499M	10.2x	10.7x	10.8x	9.7x	8.5x	8.7x	8.4x	8.3x	8.9x	10.4x	9.7x	10.3x
■ Transactions - <\$100M	8.5x	9.7x	8.1x	8.7x	6.9x	6.5x	6.0x	6.8x	8.3x	9.0x	8.4x	10.5x

**Source: CapitalIQ**



# STRATEGIC VS. FINANCIAL M&A

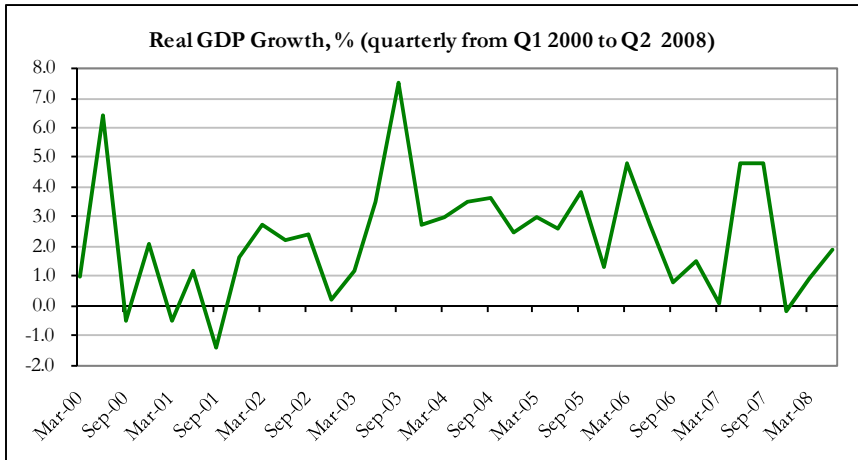
**Then the summer of 2007 credit crunch hit and the environment changed in 2H 07**



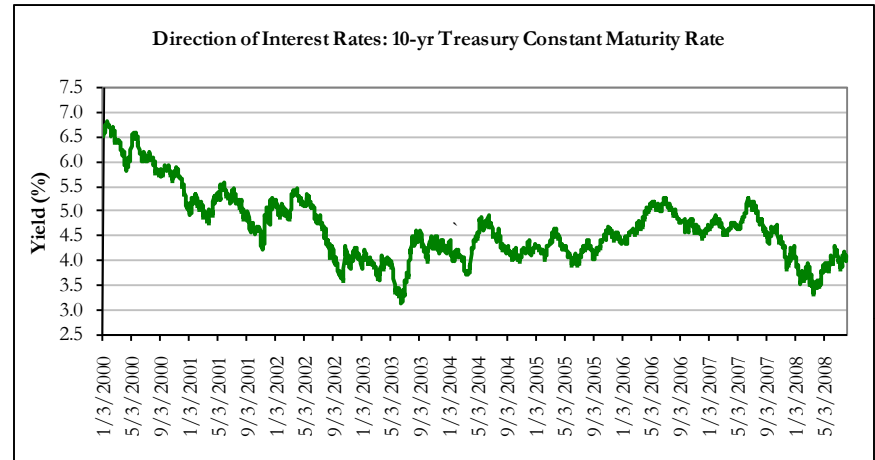
**Source: CapitalIQ**



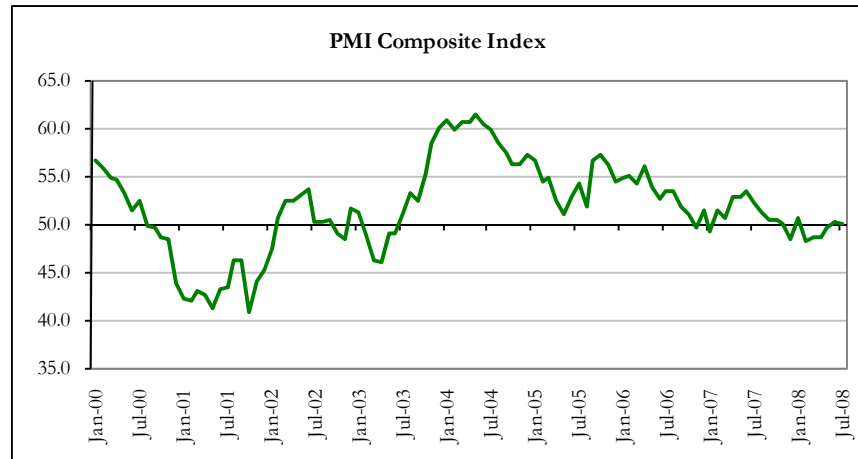
# DISTRIBUTION INDUSTRY DRIVERS



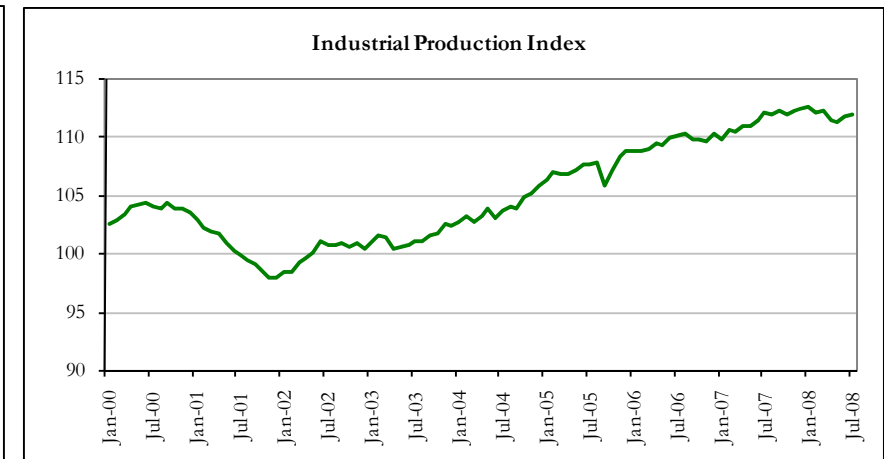
Source: Bureau of Economic Analysis



Source: Board of Governors of the Federal Reserve System



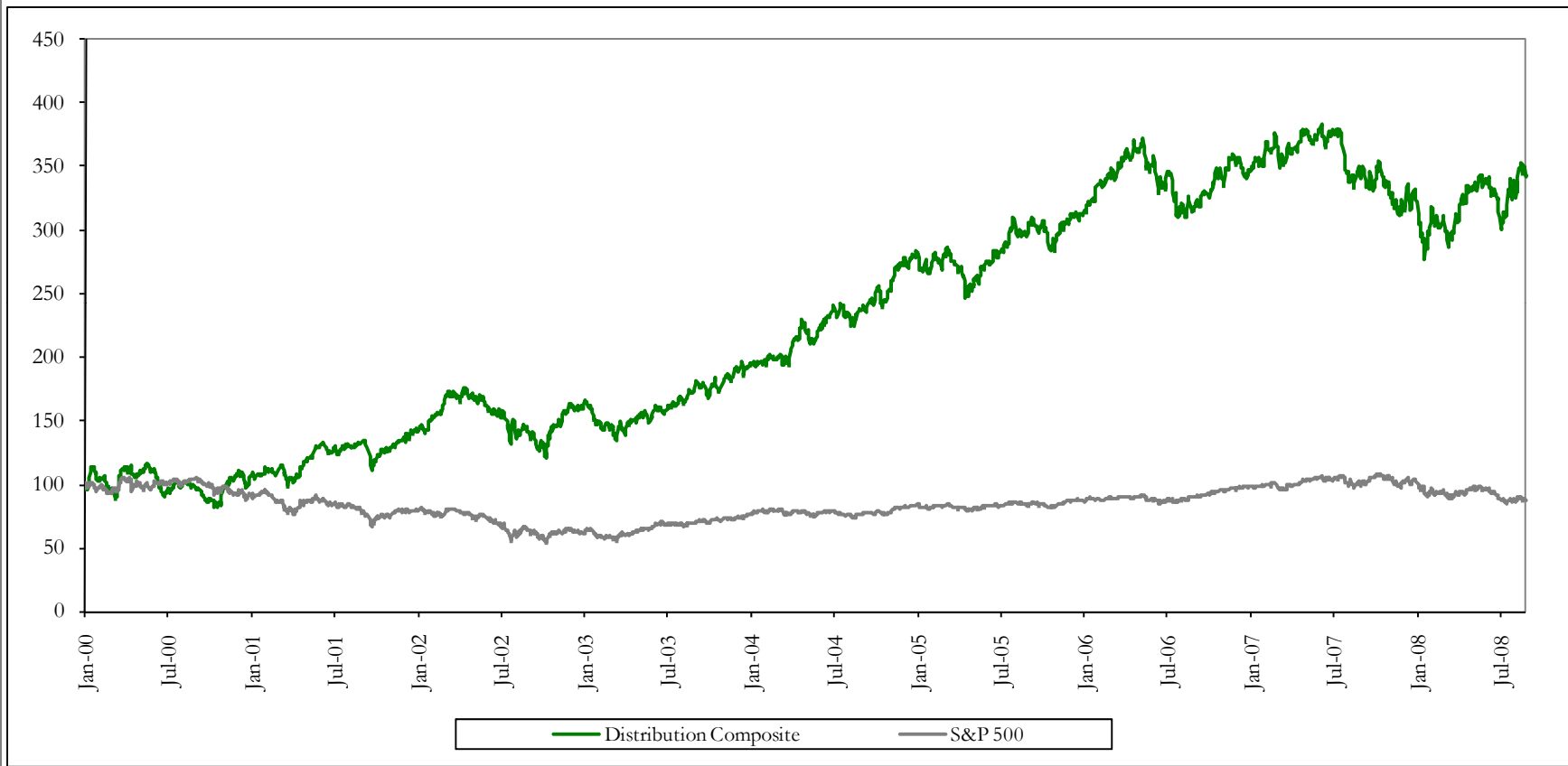
Source: Institute for Supply Management



Source: Board of Governors of the Federal Reserve System



# DISTRIBUTION SECTOR STOCK TRENDS: 1/1/2000-8/26/2008



Distribution Composite includes Airgas, Applied Industrial, Barnes, Beacon Roofing, Builders First Source, Building Materials Holding Corp, DXP Enterprises, Fastenal, Industrial Distribution Group, Interline Brands, Kaman Corp., Lawson Products, MSC Industrial, SCP Pool, Watsco, Wesco International and W.W. Grainger.



# MARKET VALUATIONS — WHOLESALE DISTRIBUTORS

## Wholesale Distributors

	Ticker	Market Data				Performance Data, LTM (\$MM)				Valuation Multiples		
		Stock Price 8/26/2008	% of 52- wk high	Equity Value	TEV	Net Sales	3-yr Sales CAGR	Gross Margin	EBITDA Margin	TEV/ LTM Sales	TEV/LTM EBITDA	TEV/ LTM EBIT
as of 8/26/2008												
Anixter International Inc.	AXE	\$ 67.20	77.3%	\$ 2,361	\$ 3,367	\$ 6,101	20.2%	24.0%	8.1%	0.55	6.78	7.26
Airgas Inc.	ARG	57.86	88.4%	4,772	6,344	4,219	19.0%	52.0%	16.8%	1.50	8.95	12.44
Applied Industrial Technologies, Inc.	AIT	28.79	80.7%	1,218	1,142	2,089	6.8%	27.2%	8.0%	0.55	6.83	7.47
Barnes Group Inc.	B	23.60	64.0%	1,284	1,728	1,491	12.4%	37.9%	15.5%	1.16	7.47	9.71
Beacon Roofing Supply Inc.	BECN	15.55	92.0%	689	1,061	1,711	28.8%	22.7%	6.3%	0.62	9.88	14.72
Builders FirstSource, Inc.	BLDR	5.12	38.7%	185	389	1,294	-16.3%	22.9%	-1.5%	0.30	NM	NM
Building Materials Holding Corp.	BLG	1.30	8.6%	38	363	1,830	-8.7%	18.5%	-0.4%	0.20	NM	NM
DXP Enterprises Inc.	DXPE	51.87	95.6%	332	436	632	55.6%	27.5%	7.8%	0.69	8.87	10.59
Fastenal Co.	FAST	50.75	95.4%	7,538	7,461	2,223	17.2%	51.8%	20.8%	3.36	16.15	17.60
Genuine Parts Co.	GPC	42.01	81.3%	6,797	7,229	11,038	5.4%	29.7%	8.4%	0.65	7.75	8.59
Interline Brands Inc.	IBI	15.87	62.8%	514	867	1,231	16.1%	38.1%	10.0%	0.70	7.04	8.06
Kaman Corp.	KAMN	29.03	73.8%	737	821	1,149	3.5%	27.3%	6.7%	0.71	10.63	12.29
Lawson Products Inc.	LAWS	33.31	86.0%	284	292	502	6.0%	58.6%	8.7%	0.58	6.66	8.12
MSC Industrial Direct Co. Inc.	MSM	49.80	91.2%	3,132	3,313	1,782	18.5%	46.2%	19.7%	1.86	9.43	10.22
Pool Corp	POOL	24.19	72.8%	1,158	1,574	1,859	9.9%	27.8%	7.1%	0.85	11.81	13.19
Watsco Inc.	WSO	48.64	91.4%	1,378	1,396	1,806	7.5%	25.5%	6.4%	0.77	12.05	12.84
WESCO International Inc.	WCC	37.20	72.9%	1,574	2,743	6,088	14.9%	20.1%	6.7%	0.45	6.64	7.21
W.W. Grainger, Inc.	GWV	88.50	92.2%	6,747	7,011	6,688	8.2%	42.5%	12.7%	1.05	8.22	9.79
<b>Average:</b>			<b>75.8%</b>	<b>\$ 2,263</b>	<b>\$ 2,641</b>	<b>\$ 2,985</b>	<b>12.5%</b>	<b>33.3%</b>	<b>9.3%</b>	<b>0.9x</b>	<b>9.1x</b>	<b>10.6x</b>
<b>Median:</b>			<b>81.0%</b>	<b>\$ 1,251</b>	<b>\$ 1,485</b>	<b>\$ 1,818</b>	<b>11.1%</b>	<b>27.7%</b>	<b>8.1%</b>	<b>0.7x</b>	<b>8.5x</b>	<b>10.0x</b>

Source: CapitalIQ



## GROWTH RATES - REVENUE

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- Revenue growth rates have slowed substantially from the 2004 – 2006 growth cycle

	2004	2005	2006	2007	Projected	
					2008E	2009E
Builders FirstSource, Inc.	22.9%	13.6%	(4.2%)	(28.9%)	(25.1%)	15.0%
Fastenal Co.	24.5%	23.0%	18.8%	14.0%	14.8%	14.2%
W.W. Grainger, Inc.	8.2%	9.4%	6.5%	9.1%	6.3%	7.9%
Interline Brands Inc.	16.2%	14.5%	25.3%	16.1%	3.4%	5.7%
MSC Industrial Direct Co. Inc.	13.1%	15.1%	19.8%	28.1%	5.5%	4.2%
WESCO International Inc.	13.8%	18.2%	20.3%	12.8%	0.1%	4.5%
Watsco Inc.	7.3%	28.1%	6.8%	(0.7%)	0.0%	2.0%
<b>Average:</b>	15.1%	17.4%	13.3%	7.2%	0.7%	7.6%

*Source: Analyst Research Reports*

# DISTRIBUTION TRADING STATISTICS — BY SECTOR

## ➤ The valuations of core distribution industry sectors now vary considerably

<b>Industrial</b>		Market Data				Performance Data, LTM (\$MM)				Valuation Multiples		
as of 8/26/2008		Stock Price	% of 52-	Equity		3-yr Sales	Gross	EBITDA	TEV/	TEV/LTM	TEV/	
Ticker	8/26/2008	wk high	Value	TEV	Net Sales	CAGR	Margin	Margin	LTM Sales	EBITDA	LTM EBIT	
Airgas Inc.	ARG	57.86	88.4%	\$ 4,772	\$ 6,344	\$ 4,219	19.0%	52.0%	16.8%	1.50	8.95	12.44
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Lawson Products Inc.	LAWS	33.31	86.0%	284	292	502	6.0%	58.6%	8.7%	0.58	6.66	8.12
MSC Industrial Direct Co. Inc.	MSM	49.80	91.2%	3,132	3,313	1,782	18.5%	46.2%	19.7%	1.86	9.43	10.22
<b>Average:</b>			<b>82.6%</b>	<b>\$ 2,320</b>	<b>\$ 2,663</b>	<b>\$ 2,863</b>	<b>15.9%</b>	<b>38.3%</b>	<b>11.5%</b>	<b>1.0x</b>	<b>8.3x</b>	<b>9.9x</b>
<b>Median:</b>			<b>83.6%</b>	<b>\$ 1,251</b>	<b>\$ 1,435</b>	<b>\$ 1,636</b>	<b>9.6%</b>	<b>33.8%</b>	<b>8.6%</b>	<b>0.7x</b>	<b>8.3x</b>	<b>10.0x</b>

<b>Construction Related</b>		Market Data				Performance Data, LTM (\$MM)				Valuation Multiples		
as of 8/26/2008		Stock Price	% of 52-	Equity		3-yr Sales	Gross	EBITDA	TEV/	TEV/LTM	TEV/	
Ticker	8/26/2008	wk high	Value	TEV	Net Sales	CAGR	Margin	Margin	LTM Sales	EBITDA	LTM EBIT	
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<b>Average:</b>			<b>62.7%</b>	<b>\$ 837</b>	<b>\$ 1,254</b>	<b>\$ 2,431</b>	<b>6.0%</b>	<b>22.9%</b>	<b>4.1%</b>	<b>0.5x</b>	<b>10.1x</b>	<b>12.0x</b>
<b>Median:</b>			<b>72.8%</b>	<b>\$ 924</b>	<b>\$ 1,229</b>	<b>\$ 1,818</b>	<b>8.7%</b>	<b>22.8%</b>	<b>6.3%</b>	<b>0.5x</b>	<b>10.8x</b>	<b>13.0x</b>

Source: CapitalIQ



# DISTRIBUTION TRADING STATISTICS — BY SECTOR

## Other

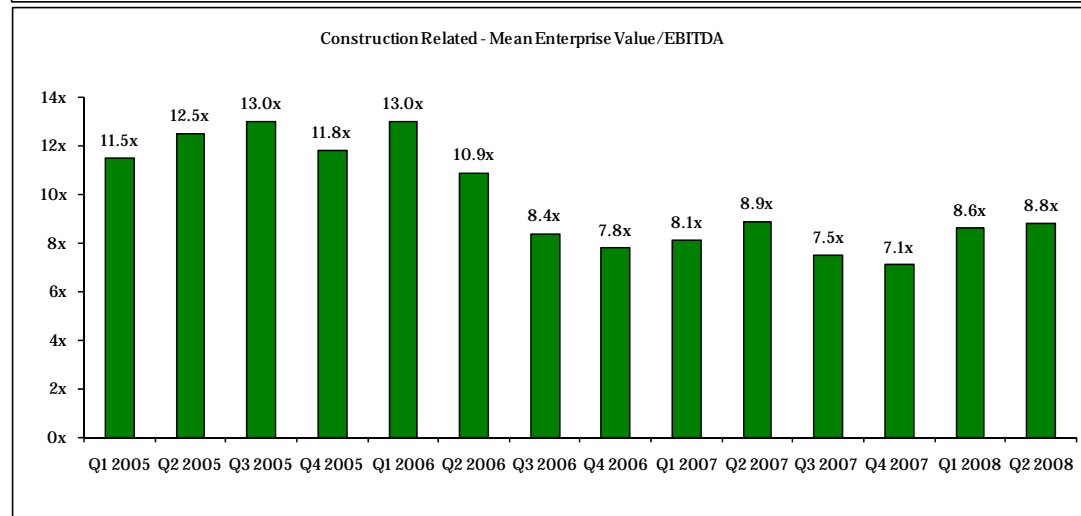
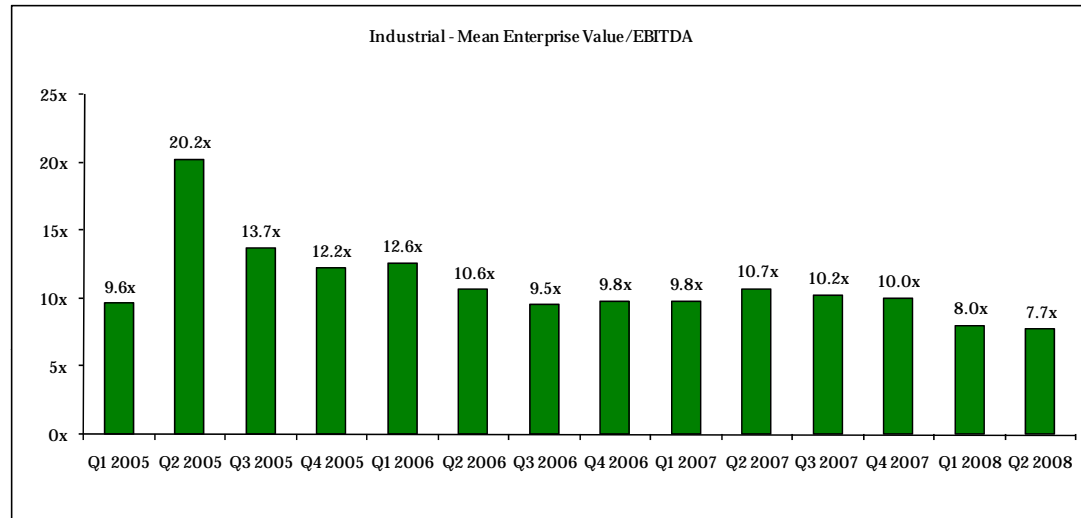
as of 8/26/2008

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<b>Average:</b>		83.5%	\$ 4,933	\$ 5,113	\$ 3,381	13.9%	44.1%	14.5%	1.7x	10.5x	11.8x	
<b>Median:</b>		92.2%	\$ 6,747	\$ 7,011	\$ 2,223	16.1%	42.5%	12.7%	1.0x	8.2x	9.8x	

Source: CapitalIQ



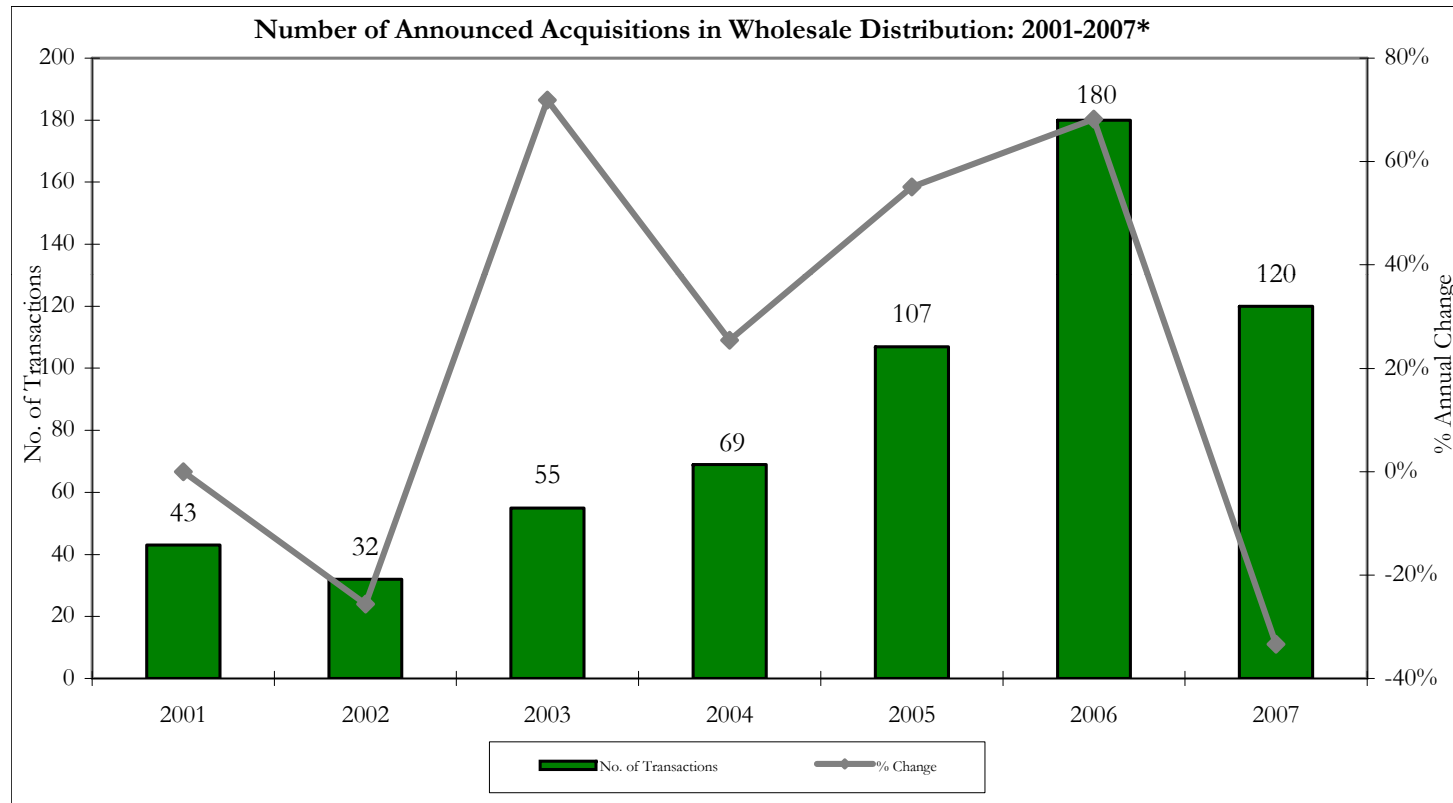
# DISTRIBUTION VALUATION STATISTICS — BY SECTOR



Source: CapitalIQ



# RECENT M&A ACTIVITY IN WHOLESALE DISTRIBUTION



\* Excludes transactions in the retail consumer markets

Source: CapitalIQ

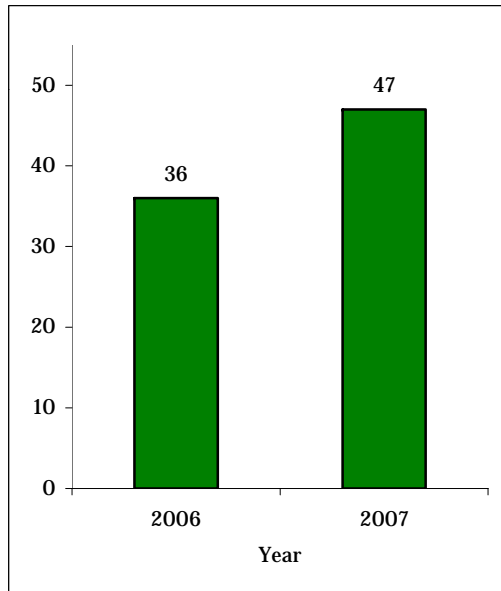


# M&A ACTIVITY BY KEY END MARKET

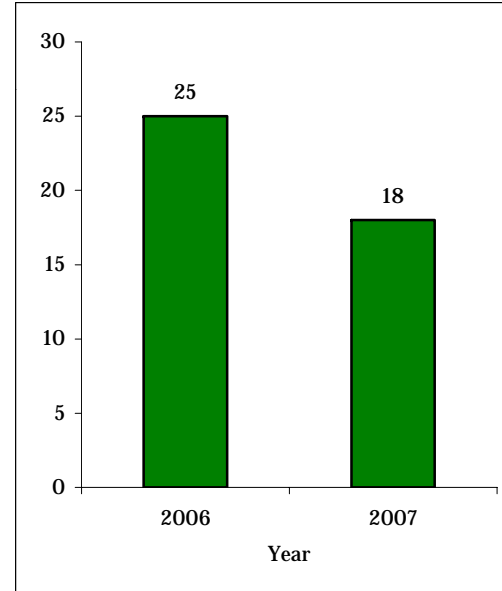
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- Sector valuation trends have transferred over to deal activity

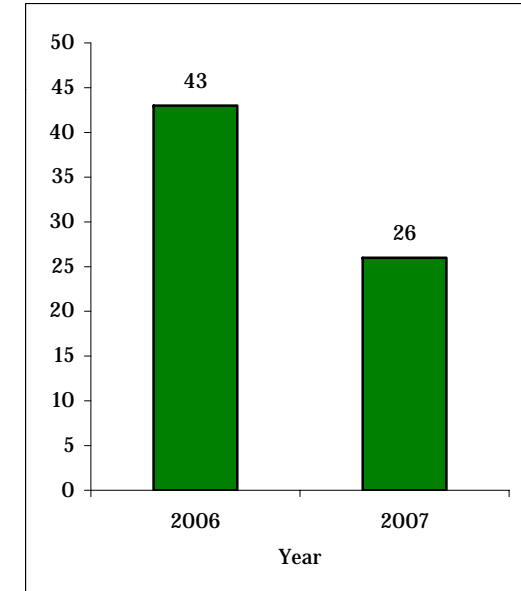
**Industrial - # of Deals**



**Electrical - # of Deals**



**BP - # of Deals**



*Source: CapitalIQ and PCE analysis.*



# CREDIT MARKET UPDATE

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- Liquidity for non-middle market transactions continues to be scarce; this has trickled down to the middle market
- Mortgage malaise continues
- Leveraged loan write downs by the major investment banks should be persistent throughout 2009
- The Fed and Treasury continue to seek creative ways to stabilize the credit markets and inject liquidity
- These factors will limit M&A activity in all ends of the marketplace (both large-cap and middle-market)
- **This has created an opportunity for well-funded, strategic buyers**



## PRIVATE EQUITY TRENDS

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- **2006:** The abundant level of cheap debt created an environment for record EBITDA multiples, enabling high deal pricing with buyers still able to realize targeted returns
- **2007:** Liquidity sources had to contribute more equity to close deals at committed pricing
- **Near Term:** EBITDA multiples have come down and debt/equity ratios will revert to historical levels

	<b><u>2006</u></b>	<b><u>2007</u></b>	<b><u>Near Term</u></b>
EBITDA	\$20MM	\$20MM	\$20MM
Multiple	<u>7.00x</u>	<u>7.00x</u>	<u>5.75x</u>
Transaction Value	<u>\$140MM</u>	<u>\$140MM</u>	<u>\$115MM</u>
Equity	\$35MM	\$50MM	\$35MM
<i>% of Capital</i>	<i>25%</i>	<i>43%</i>	<i>30%</i>
Debt	\$105MM	\$90MM	\$80MM
Debt/EBITDA	5.25x	4.50x	4.00x



# HD SUPPLY : CASE STUDY

- The HD Supply transaction is a relevant example of the current credit crunch's impact on pricing

	<u>Original Deal Terms</u>	<u>Revised Terms</u>
Proposed Price	\$10.3B	\$8.5B
<b><u>Deal Financing</u></b>		
Private Equity	\$2.0B	\$2.5B
HD Equity <sup>1</sup>	n/a	\$0.3B
Debt <sup>1</sup>	\$8.3B	\$5.7B
<i>Debt/Equity</i>	<i>4.2x</i>	<i>2.0x</i>
<i>EBITDA Multiple</i>	<i>10.3x</i>	<i>8.5x</i>
<i>Equity %</i>	<i>19.4%</i>	<i>32.9%</i>

<sup>1</sup>Home Depot retained \$335M equity stake and guaranteed nearly \$1B in debt

**Source: The Wall Street Journal**



# NOTABLE RECENT STRATEGIC M&A ACTIVITY

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- Despite the slower pace, strategic buyers have taken advantage of a less competitive environment to execute deals that fit with their strategic growth plans

## Recent Strategic Transactions

Date Announced	Buyer / Target	Target Revenue
3/11/2008	Kaman Corp. / Industrial Supply Corp	\$55M
11/15/2007	United Stationers / ORS Nasco	\$220M
10/25/2007	Rexel / Hagemeyer	\$9,400M
8/20/2007	DXP Enterprises / Precision Industries	\$250M
7/11/2007	McJunkin Corporation / Red Man Pipe & Supply	N/A
10/10/2007	CED / US Electrical Services	N/A
7/13/2007	Kendall Electric / Roden Electrical Supply	\$120M
7/5/2007	Watsco, Inc. / ACR Group	\$240M





## : CASE STUDY

- The Industrial Distribution Group transaction is a relevant example of the divide between construction related vs. industrial focused M&A in today's market
- It is also an example of competition among strategic buyers for an asset that fits with their strategic growth plans (Platinum and WESCO integrated supply)
- Unknown: LKCM's value creation opportunities given rich valuation and lack of synergies



Source: IDG Proxy

# FUTURE M&A DRIVERS

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- **In addition to strategic buyers driven by strong balance sheets and “value” opportunities, other factors that will drive the future of Distribution M&A include:**
  - **Foreign Buyers**
    - Weak dollar has put U.S. “on sale”
    - Emerging economies actively investing in U.S. (Sovereign funds)
  - **Private Equity**
    - Massive pools of capital on the sidelines waiting to be invested (if not, returned to investors)
    - More realistic pricing, leverage and return outlook
  - **Demographic Trends**
    - Large number of private businesses owned/operated baby boomer generation (ample supply)
    - Baby boomer businesses need to implement succession plans or harvest



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# OVERVIEW OF M&A BEST PRACTICES

# ACQUISITION CONSIDERATIONS

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- **Accelerate growth rate**
  - **Ability to supplement organic growth**
  - **Speed and certainty versus Greenfield branches**
- **Diversification**
  - **Ability to broaden geographic reach**
  - **Ability to expand current product offering**
- **Improve operational performance**
  - **Opportunity to acquire strong operators and implement their core competencies within the base business**
  - **Access to management, sales and branch talent**
- **Potential Risks**
  - **Asset availability – are the quality companies for sale?**
  - **Integration / culture**
  - **“Eye off the ball” on the core business**
  - **May have to dilute existing shareholders to fund acquisitions**



# M&A STRATEGY

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- A vital first step to becoming a successful acquirer
- Research:
  - **Target market characteristics and trends**
  - **Product and service focus areas**
  - **Customer focus areas**
  - **Vendor focus areas**
  - **Competitors**
- Target List Creation
- Align with specific business unit and its goals and objectives
- Senior level involvement / attention is imperative
- Suggest the use of outside advisors (core competency)

# M&A STRATEGY TOOLS

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## Strategy Frameworks

- Five Forces Analysis
- SWOT Analysis
- Value Curves
- Others

## Market Intelligence

- Sales Force Surveys
- Vendor Surveys
- Customer Councils
- Competitor Public Information

## Strategy Development

- Based on strategy exercises and market intelligence:
  - What are we best at/worst at?
  - How can we change?
  - Can we build it or buy it?
  - What are the \$ involved?

## M&A Plan Creation (Playbook)

- Develop list of priorities
- Create a target list that matches these priorities
- Allocate capital for M&A effort
- Form an M&A team
- Develop a plan of execution



# OVERVIEW OF THE TRANSACTION AND DUE DILIGENCE PROCESS

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*PHASE I > PHASE II > PHASE III > PHASE IV > PHASE V*

- **Five phases of the process**
  - I. Exploratory due diligence / Valuation / IOI**
  - II. Transactional tasks / Formal due diligence process / Purchase agreement negotiation**
  - III. Approval / Sign purchase agreement / Announcement**
  - IV. Organizational / Integration planning / Closing**
  - V. Integration**
  
- **Timing**
  - **Phase I: 30 days**
  - **Phase II – IV: 45 to 90 days**
  - **Phase V: 90 days to completion**



# KEY TRANSACTION TASKS — PRE IOI

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## ➤ Preliminary Due Diligence

- Market/industry analysis
- Competitive analysis
- Product line compatibility/extension
- Customer attractiveness
- Operations and facilities
- Systems and processes
- Preliminary legal

## ➤ Valuation

- Historical financial performance – growth and margins
- Recurring earnings and cleanliness of company
- Projected financial performance
- Capital expenditures
- Commodity exposure
- Comparable valuation parameters – companies and transactions



# PRELIMINARY DUE DILIGENCE



## **DUE DILIGENCE QUESTIONNAIRE**

### ***Business Overview***

1. Briefly describe the Company's recent operating history and results
2. Discuss the Company's existing product and service offering
3. Discuss the Company's existing and long-term strategy and goals
4. Who are your top 10 vendors?
5. Discuss the Company's growth strategy
  - a. Organic growth (new product/service offerings)
  - b. Acquisitions
  - c. New geographic areas targeted for the future
6. What would be the three most strategic acquisitions for your Company?

### ***Customers***

1. Who are your top 10 customers?
2. Any customer contracts in place?
3. What % of your business is new business vs. repeat business?
4. Describe your customer sales and marketing efforts
5. What new customer base could use your current product offering?

### ***Market/Competitor Overview***

1. Discuss your current and potential new target markets
2. Discuss major industry trends affecting your business and how you identify trends
3. Discuss any governmental regulation that may affect your business
4. Provide an overview of the competitive landscape
  - a. Who are the participants?
  - b. Based on price or service level?
  - c. Company market share?
  - d. How do you measure performance vs. competitors?
5. Who are your best competitors and why?
6. How do you differentiate your Company from these competitors?

### ***Distribution/Facilities***

1. Describe the Company's distribution structure
  - a. Number, location and description of facilities
  - b. Owned vs. leased

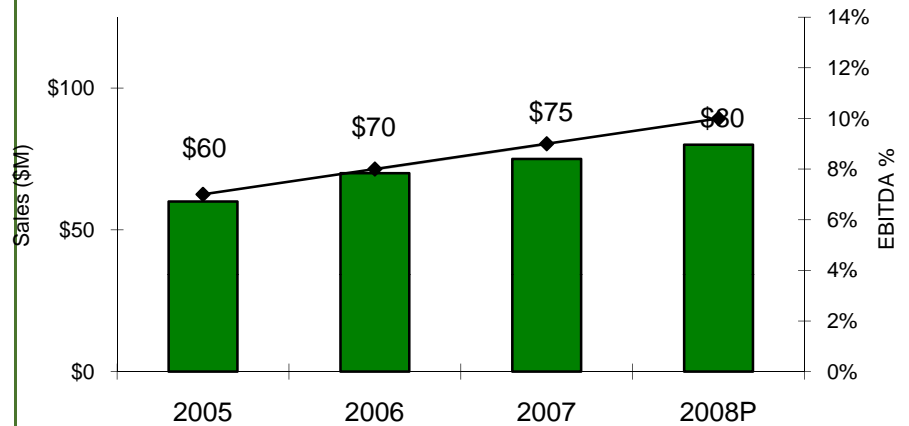


# SUMMARY DILIGENCE REPORTS

## Business Overview

- **Background:** [ ]
- **Branches:** [ ]
- **Employees:** [ ]
- **Ownership/Mgmt:** [ ]
- **Competition:** [ ]
- **Products:** [ ]
- **Vendors:** [ ]
- **Customers Mix:** [ ]

## Financial Overview



## Rationale

- [ ]
- [ ]
- [ ]

## Potential Risks/Concerns

- Limited IT capabilities / support

## Coverage Area



# VALUATION METHODOLOGY

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Comparable Company Analysis	Comparable Transactions	Discounted Cash Flow Analysis	LBO Analysis
<ul style="list-style-type: none"><li>• “Public Market” valuation</li><li>• Value based on public market trading multiples of comparable companies</li></ul>	<ul style="list-style-type: none"><li>• “Transaction specific” valuation</li><li>• Value based on multiples paid for comparable companies in sale transactions</li><li>• Can be distorted by deal specific issues</li></ul>	<ul style="list-style-type: none"><li>• Present value of projected cash flows</li><li>• Inherent value of the business</li><li>• Incorporates reinvestment requirements</li></ul>	<ul style="list-style-type: none"><li>• Value based on potential price in an LBO</li><li>• Value considered by debt capacity and interest return criteria</li></ul>

# INDICATION OF INTEREST

**Confidential**

[DATE]

Via **[E-Mail/Facsimile]**

[TARGET COMPANY NAME]  
[ADDRESS 1]  
[ADDRESS 2]

Attention: [NAME]

Re: [TARGET COMPANY NAME]  
Non-Binding Indication of Interest

Dear [NAME]:

[ ], a [ ] corporation ("[ ]") is pleased to confirm its interest in the potential acquisition (the "Transaction") of 100% of the [issued and outstanding capital stock/assets] of [TARGET COMPANY NAME], a [STATE] corporation (the "Company"), and further to your request we hereby submit this Non-Binding Indication of Interest ("Proposal") for your consideration. This Proposal sets forth certain non-binding understandings and certain binding agreements between [ ] and the Company.

**Non-Binding Terms:**

1. Proposed Purchase Price.

(a) Based on our review of the information provided by the Company to [ ], and subject to the conditions stated in this Proposal, we would be prepared to acquire [all of the issued and outstanding capital stock and equity of/all of the assets of] the Company for \$[ ] million on a cash-free, debt-free basis (subject to adjustment as provided in Exhibit A, the "Purchase Price"). All outstanding unexercised options, warrants and convertible securities would be terminated prior to Closing. The Purchase Price is based only upon the information that has been provided to us as of the date hereof as being an accurate depiction of the operations and the current and prospective financial condition of the Company, and remains subject to the completion of our due diligence review as described in Paragraph 3 below. [ ] would deliver [90%] of the Purchase Price at Closing (as defined below). The remaining [10%] will be placed in escrow as described in Paragraph 1(c) below.

(b) The proceeds to the shareholders will be adjusted downwards, on a dollar-for-dollar basis, to the extent of the Net Debt of the Company. As used herein, "Net Debt" means the Company's total debt (other than any debt included in the calculation of Working Capital) less cash and cash equivalents. We expect that the Company's indebtedness will be paid by [ ] on behalf of the Company and shareholders at Closing from cash on hand of the Company at the Closing Date and from the Purchase Price. We would expect the Company would have Net Debt no greater than approximately \$[ ] million at the Closing Date.

(c) At the Closing, [10%] of the Purchase Price would be placed in an interest bearing escrow account with a mutually acceptable escrow agent as security for any adjustment to the Purchase Price as provided in Exhibit A, and for any breach of representations, warranties and covenants of the Company and its shareholders and other mutually acceptable matters. The escrow



# KEY TRANSACTION TASKS — POST IOI

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- **Management Meetings**
- **Financing/Capital Structure Discussions**
  - **Identify financing sources**
  - **Evaluation of financing proposals**
  - **Management of diligence process**
  - **Structuring and negotiation of terms**
- **Continued Valuation Analysis**
  - **TTM results**
  - **Synergies**
  - **Integration costs**
- **Transaction Structuring**
  - **Stock**
  - **Assets**
  - **338(h)(10)**



# KEY TRANSACTION TASKS — POST IOI

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- Facility Tours
- Operational Reviews
- Human Resources Reviews
- Environmental Assessments
- Transaction Documentation
  - Purchase agreement
  - Escrow agreement
  - Employment arrangements
- Agreement Negotiation
- Approval / Sign Purchase Agreement / Announcement – phase III
- Organizational / Integration Planning – phase IV
- Closing– conclusion of phase IV



# FORMAL DUE DILIGENCE

FUNCTIONAL AREA	SUMMARY OF KEY TASKS
<b>Legal</b>	Review and assess all corporate documents, company contracts, legal proceedings, compliance, environmental information
<b>Financial</b>	Review and assess all financial statements and reports, forecasts, accounting work papers, AR records, inventory records, PP&E, rebate information
<b>Human Resources</b>	Review and assess all organizational charts, personnel files, employee handbook, turnover statistics, compensation plans, benefit plans, employment agreements, policies/procedures
<b>Operations</b>	Review and assess management reports and operating metrics, order flows, purchasing, inventory management, logistics
<b>Sales</b>	Review and assess sales methodology (inside, outside), territories, commissions, pricing, growth
<b>Information Technology</b>	Review and assess all company hardware and software, IT service agreements, IT personnel
<b>Taxes</b>	Review and assess tax work papers, federal, state, local and foreign tax returns, sales tax, property tax, payroll taxes
<b>Safety / Environmental</b>	Review and assess OSHA logs, workers' comp claims, incident rates, safety & training materials, loss prevention
<b>Insurance</b>	Review and assess all insurance policies (general, environmental, casualty, automotive, workers comp, crime), insurance contracts, claims history, reserves



# FORMAL DUE DILIGENCE

PROJECT [NAME]  
Due Diligence Checklist

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## **I. DEAL KICK-OFF TASKS**

1. Negotiate CA with Target Company.
2. Send Target Company preliminary information request.
3. Prepare valuation of Target Company.
4. Arrange and conduct management presentation with Target Company.
5. Prepare 4-pager and receive executive approval.
6. Submit Initial Indication of Value / Execute LOI with Target Company.

## **II. INTERNAL DUE DILIGENCE PLANNING**

1. Form deal team and create working group list.
2. Send target complete Due Diligence Request List.
3. Distribute internal CAs for proposed transaction.
4. Prepare internal Due Diligence timeline.
5. Scan/upload all documents received from target into eRoom.
6. Schedule and hold due diligence kick-off meeting with deal team. Provide target overview, timing and key points.

## **III. EXTERNAL DUE DILIGENCE PLANNING**

1. Retain outside legal counsel.
2. Retain environmental firm and schedule Phase I environmental studies.
3. Schedule physical inventories of all target locations.
4. Retain outside tax or other advisors, if necessary.

## **IV. LEGAL REQUIREMENTS**

1. Prepare first draft of Purchase Agreement.
2. Prepare attachments to purchase agreement:
  - 1) Escrow agreement



# FORMAL DUE DILIGENCE

[Target Name]  
Due Diligence Document Request List

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# PURCHASE AGREEMENT NEGOTIATION



## **Purchase Agreement Market Terms**

### **Reps & Warranties**

- Financial statement rep
  - Fairly presents not qualified by GAAP (84%)
  - Fairly presents qualified by GAAP (14%)
- Undisclosed Liabilities
  - Included 92% of time (66% all liabilities, 34% GAAP liabilities)
- Full Disclosure Rep
  - Included 59% of time (83% without knowledge, 17% with knowledge)
- Accuracy of Reps
  - 53% at sign and close / 47% at close only
  - 59% all material respects / 37% MAE / 4% all respects
  - 59% disregard double materiality / 41% silent
- MACs
  - Stand alone (no MAE since agreement) 75% / Back door (no MAE since balance sheet) 20%
  - Quantified MACs – 8% of agreements
  - MAC includes prospects – 23% of agreements
  - Carveouts included 80% / No carveouts 20%
  - Types of carveouts:
    - i. General economic conditions – 65%
    - ii. Industry conditions – 59%
    - iii. Deal announcement – 44%
- Target counsel opinion
  - Appears 73% of the time
- Knowledge
  - Actual 48% / Investigation 52%
  - Defined group 84%

### **Indemnification**

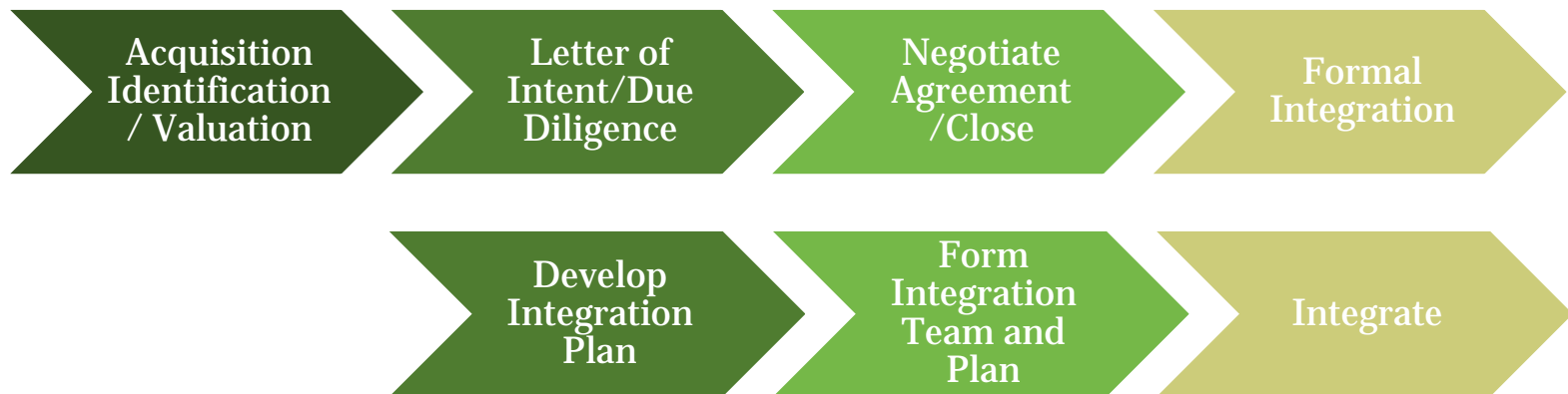
- Sandbagging
  - Pro-sandbag 56% / Anti-sandbag 5% / Silent 39%
- Survival
  - < 12 months: 5%
  - 12 months: 32%
  - 13 – 18 months: 32%
  - 2 years: 15%
  - > 2 years: 13%
  - Carveouts: Title (22%), Taxes (53%), Fraud (20%), Env (30%), Benefits (31%), Cap (38%)
- Baskets
  - Dollar 1 40% / Deductible 56%
  - Basket size
    - i. ½% - 1%: 49%
    - ii. <1/2%: 40%
  - Carveouts: Taxes (26%), Intentional Misrep (18%), Fraud (41%)
- Caps
  - < 10% of PP: 28%
  - 10% of PP: 15%
  - 10% - 15%: 27%
  - 15% - 25%: 14%
  - 25% - 50%: 12%
  - Carveouts: Fraud (77%), Taxes (27%), Intentional Misrep (28%), Capitalization (26%)
- Indemnity exclusive remedy – 76%



# INTEGRATION

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- Determines whether or not the deal will be successful
- If you wait until the transaction has closed you are too late
- Need to utilize senior level resources



# INTEGRATION PLAN

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## INTEGRATION PLAN

	Integration Task	Responsibility	Target Contact	Acquirer Contact	Start Date	End Date	Date Complete	Status	% Complete
<b>1.0</b>	<b>Pre-Closing</b>								
1.1									
1.2									
1.3									
1.4									
1.5									
<b>2.0</b>	<b>Day 1 Plan</b>								
2.1									
2.2									
2.3									
2.4									
2.5									
<b>3.0</b>	<b>Day 2 - 30</b>								
3.1									
3.2									
3.3									
3.4									
3.5									
<b>4.0</b>	<b>Day 31 - 60</b>								
4.1									
4.2									
4.3									
4.4									
4.5									
<b>5.0</b>	<b>Day 61 - 90</b>								
5.1									
5.2									
5.3									
5.4									
5.5									
<b>6.0</b>	<b>Long Term</b>								
6.1									
6.2									
6.3									
6.4									
6.5									



# INTEGRATION — CULTURE AND TALENT

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- Distribution is a people business so merging cultures and retaining talent should be the #1 priority
- Most failed acquisitions are due to incompatible cultures
- Important to screen for culture – be careful not “interview”
- Compensation methodologies should be out of bounds – if incompatible walk away
- Employment agreements / non-competes
- Communication!

# INTEGRATION BEST PRACTICES

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- Senior executive assigned to lead integration
- Full-time integration manager attached to the integration
- Cross-functional integration team created with resources from both the target and acquiring company
- Integration plan vetted and approved by both parties
- Weekly/Bi-weekly integration update meetings
- Tollgate meetings for key integration steps (plan approval, system conversion, etc.)
- For all decisions, think about how each one will affect the **customer**



# INTEGRATION COMMON PITFALLS

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- Cultural misfires
- Hastily completing tasks to “check the box”
- Not including the target company in the planning process
- Not communicating clearly and often
- Too worried about the numbers
- Diligence information not properly evaluated and handed off
- Over delegation

# BUYSIDE M&A KEY SUCCESS FACTORS

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- Proprietary deal flow / acquisition strategy
- Build an internal M&A team or utilize an experienced outside advisor
- Focus on core acquisitions and investigate vertical movements stringently
- Avoid fixer uppers – pay a little more for the winners
- Integrate relentlessly
- Do not succumb to deal heat – there are many great targets out there
- Culture – it is all about the people

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# SALE OF BUSINESS - CONSIDERATIONS

# SALE PROCESS CONSIDERATIONS

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- Before entering the marketplace, it is important to consider a variety of factors that will lead to a successful sale:
  - Is my company attractive to potential buyers?
  - What is the strength of the M&A and financing markets?
  - Who are the potential buyers of my business and what is the difference between them?
  - How will my company be valued and what are valuations like in today's marketplace?
  - How will a sale affect my leadership team and my employees?

# PREPARING FOR A SALE

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- **Develop a Reasonable Rationale for Selling** – Buyers want to understand your intentions and believe that you are committed to selling
- **Examine Overall Operating Performance** – If recent financial performance has consistently improved, the attractiveness of the business increases. If performance is inconsistent and declining, improve it before entering the marketplace and be able to explain the declines
- **Are the Financials “Clean?”** – If there are extensive personal expenses throughout the financial statements (i.e. club memberships, excessive T&E, salaries to non-employees), remove those to improve bottom-line performance and valuation. If the company does not have audited financials, consider an audit
- **Prepare a Strategic Growth Plan** – More than putting together next year’s budget, management must articulate how to successfully grow the company of the next few years
- **Tie Up Loose Ends and Prepare for Inspection** – This can involve everything from solidifying key customer and vendor accounts to cleaning up the physical appearance of branches



# BUYER AREAS OF FOCUS

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- **Financial Performance** – Acquirers focus on several financial benchmarks to determine an acquisition's attractiveness, including gross margin, operating margin and growth performance
- **Return on Invested Capital** – Acquirers, especially in distribution, typically only consider companies with a return on invested capital (ROIC) that exceeds the buyer's cost of capital
- **Market Factors** – Is the acquisition serving large, growing markets and are these trends within these markets favorable? Slower growth and smaller markets are less appealing
- **Company-Specific Risks** – Are there issues related to environmental, asbestos, or customer concentration?
- **Growth Potential** – Can the acquisition continue to grow organically or through acquisitions/consolidation?
- **Synergies & Integration** – Buyers seek acquisitions where  $1+1 = 3$ . This is accomplished through both growth and cost savings synergies



# KEY VALUE DRIVERS

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- **Geographic Footprint** – Does this acquisition expand existing geographic reach and provide access to new customers?
- **Product & Service Expansion** – Does it allow buyer access to new products & services, open new customer categories and provide for cross selling opportunities to existing customers?
- **Systems & Processes** – Does the acquisition operate on a current version of a distribution IT system and have standard business processes in place (this speaks to ease of integration)?
- **Vendor Alignment** – Do the target company's main vendors line up well with the acquiring company's preferred vendors? Buyers also look favorably upon targets that consolidate purchases with a core group of vendors
- **Management & Talent** – Distribution is a people business and quality management and sale talent are crucial. People are what the acquires are really buying. Cultural fit with the acquiring company is also important

# GOING TO MARKET — MARKETING STRATEGY

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## **Hard Auction**

Public announcement

Maximum bidders

Hard deadlines

Disruptive

Confidentiality is at risk

## **Modified Auction**

Limited announcement

Fewer bidders

Softer deadlines

Generally not disruptive

Confidentiality is generally protected

## **Negotiation**

No formal announcement

Select discussions

Limited leverage for seller

Confidentiality is generally protected

## **Pre-emptive Strike**

Select bid(s) in advance of marketing process

Accelerated closing

Premiums are common

Maximum price may be sacrificed

Maximum confidentiality



# STRATEGIC VERSUS FINANCIAL BUYERS

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## Strategic Buyers

- Create shareholder value through growth
- Leverage existing infrastructure to achieve synergies and reduce overhead
- Create cross-selling opportunities in same or related lines of business
- Add capabilities and services to strengthen relationship with customer
- Perform due diligence more quickly and effectively
- Payment in cash and stock
- Valuation based upon strategic synergies

## Financial Buyers

- Generate high IRR on invested capital
- Leverage investment to increase IRR
- Provide existing ownership with liquidity as well as continued equity participation and management role
- Execute transaction more quickly and effectively
- Acquire platform for further acquisitions
- Achieve synergies and growth for existing platform
- Determine valuation based upon capacity for leverage
- Payment in cash and deferred consideration

# KEYS TO A SUCCESSFUL SALE

Basic Elements	Investment Banker's Role
Business Understanding	<ul style="list-style-type: none"> <li>• Due Diligence</li> <li>• Business Evaluation</li> <li>• Financial Evaluation</li> </ul>
Clear Objectives/Commitment to Sale	<ul style="list-style-type: none"> <li>• Assist in establishing sale objectives/expectations</li> </ul>
Realistic Price Expectations	<ul style="list-style-type: none"> <li>• Provide realistic valuation assessment</li> </ul>
"Right" Marketing Strategy	<ul style="list-style-type: none"> <li>• Assist in determining form of marketing process</li> <li>• Assist in selecting appropriate potential buyers</li> <li>• Contact/assist potential buyers</li> </ul>
Quality Marketing Materials	<ul style="list-style-type: none"> <li>• Assist in business positioning</li> <li>• Coordinate preparation of business profile</li> <li>• Coordinate preparation of mgmt presentation</li> </ul>
Organization, Coordination, Efficiency	<ul style="list-style-type: none"> <li>• Manage/coordinate key aspects of sale process</li> <li>• Coordinate mgmt team and information flow</li> </ul>
Minimize Business Disruption	<ul style="list-style-type: none"> <li>• Manage/coordinate the process</li> <li>• Keep sale process moving efficiently</li> </ul>
Maintain Competition Between Buyers	<ul style="list-style-type: none"> <li>• Promote company to potential buyers</li> <li>• Create the "illusion of scarcity"</li> <li>• Maintain level playing field</li> <li>• Maintain back-up options</li> </ul>
Maximize Price	<ul style="list-style-type: none"> <li>• Generate competition / promote company</li> </ul>
Optimize Contract Terms	<ul style="list-style-type: none"> <li>• Assist in definitive agreement negotiation</li> </ul>



# PCE INVESTMENT BANKERS

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## **Jonathan Skelly**

Jon brings extensive investment banking and corporate development experience to PCE and its clients with specialized expertise in the wholesale distribution industry. Previously Jon was Director of Strategic Business Development/Mergers & Acquisitions for the HD Supply subsidiary of The Home Depot and its predecessor Hughes Supply, Inc. While at HD/Hughes, Jon completed acquisitions and divestitures in the distribution industry with over \$4 billion in transaction value. Prior to that Jon was an investment banker with Robert W. Baird & Co. where he worked on multiple engagements focused on the wholesale distribution sector. Jon received his Bachelor's degree in Finance with honors from the University of Florida and his Master's of Business Administration from the Fuqua School of Business at Duke University.

## **Contact Information:**

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