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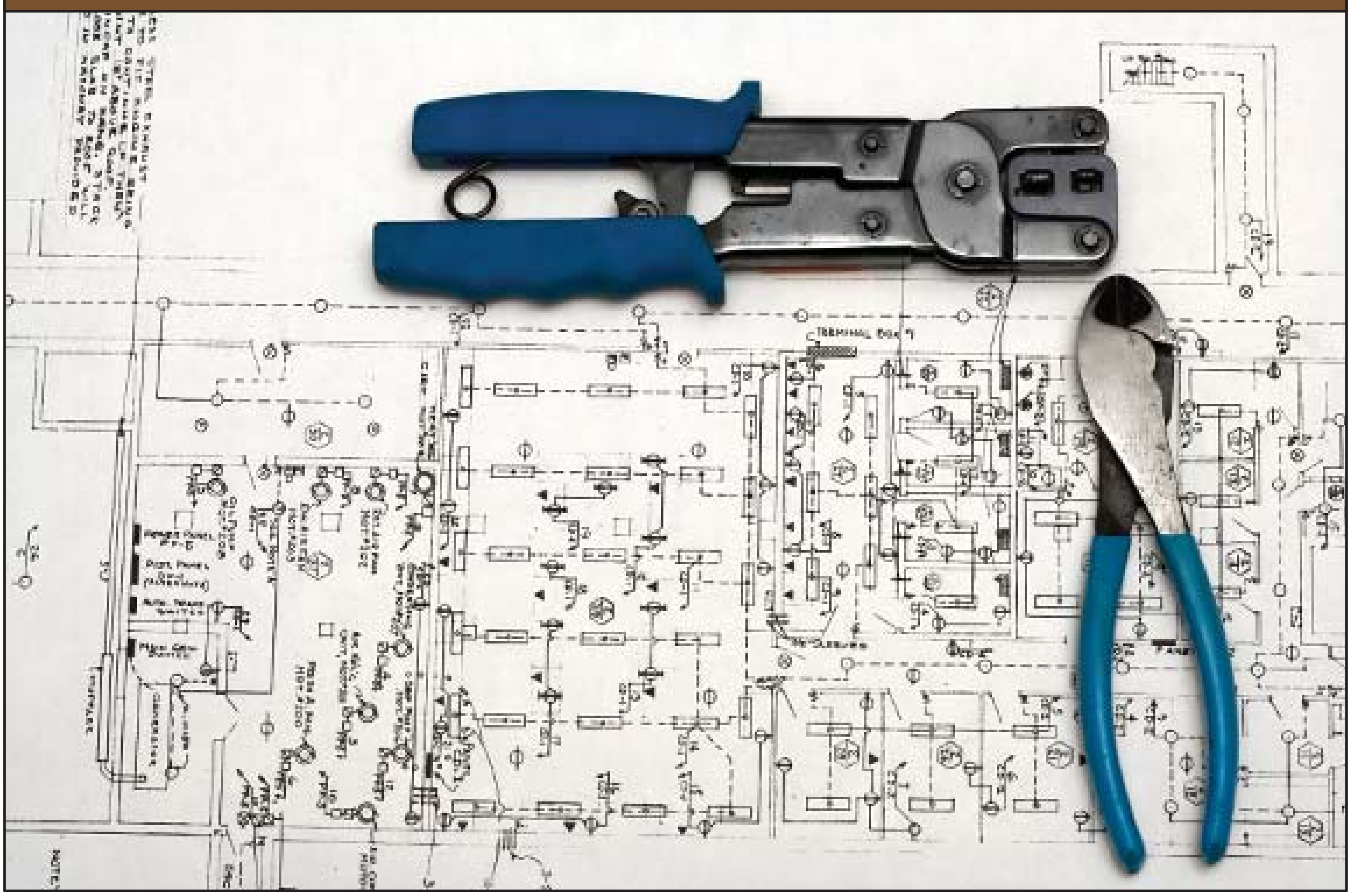
MERCER CAPITAL

Understand the Value of Your Electrical Distributorship



About Mercer Capital

Mercer Capital's business valuation services are provided for a wide variety of needs, including corporate valuation services, tax compliance, litigation support, financial statement reporting compliance, and employee stock ownership plans. Clients range from public to private, from smaller companies to large multi-nationals in a broad range of industries as well as numerous governmental agencies.

In addition, Mercer Capital provides investment banking and corporate advisory services including sell-side and buy-side merger & acquisition representation, fairness opinions, solvency opinions, business interest and securities valuation, and board presentations, among others.

Mercer Capital is an employee-owned independent financial advisory firm. We have experience in a broad range of industries, including, but not limited to, automotive, consumer products, distribution, energy, financial services, health care, industrial products, media and entertainment, pharmaceuticals, technology, telecommunications and utilities.

For over twenty-five years, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world. Rely upon the expertise, experience, reputation and critical thinking of Mercer Capital.

Understand the Value of Your Electrical Distributorship

After 25 years and over 6,500 engagements, Mercer Capital has provided valuation or advisory services for companies in a multitude of different industries. A substantial portion of our engagements have been with wholesale distribution businesses operating in a variety of industries. Our experience in this area is broad, having worked with wholesale distributors in industries such as lumber, electrical equipment, food supplies, aircraft components, beer, bricks, motor oil, aggregates, grain, and more.

Regardless of the industry in which the wholesaler competes, the role of the wholesaler, in its simplest form, is to connect those who make products with those who use them. The wholesale business is unique in that many distributors are finding it necessary to become "value-added wholesalers" in order to maintain their position in the value chain between the manufacturer and the end user. Also unique to the business model is that, unlike manufacturers which typically have relatively high fixed costs, most of a wholesaler's cost structure is variable or embedded in the cost of goods. This type of business model places an emphasis on the wholesaler's ability to leverage volume purchases, either through co-op buying groups or, if large enough, through its own financial means. These large volume purchases must be coupled with prudent inventory management, so that inventory keeps turning at an efficient rate. Wholesalers who can manage these issues, and others addressed later in this article, are found to create and sustain value for shareholders.

We have valued and/or advised a number of electrical distribution businesses at Mercer Capital. Electrical equipment wholesalers operate in a highly fragmented industry, consisting largely of family-owned business with a few locations within a relatively close proximity. The industry also has a handful of large multinational distributors and regional chains. As is typical to this type of mixed competitor environment, many of the larger wholesalers have been buying the "mom and pop" distributors to enter into new markets and increase their purchase volume leverage.

This article is intended to provide insight into the situational (when and why) and analytical (how) aspects of valuing electrical distributors. A lack of knowledge regarding the value of your business could be very costly. Missed opportunities to sell the business at full value or even the implementation of an estate plan with an inaccurate or incomplete understanding of value could be costly.

THE OWNERSHIP TRANSFER MATRIX

Like all private companies, ownership interests in an electrical distributor will eventually transfer. At Mercer Capital, we have developed the Ownership Transfer Matrix to illustrate the universe of ownership transition scenarios. As depicted on the following page, these scenarios range from voluntary transfers such as gifts to family members or an outright sale to a third party to involuntary transfers such as those precipitated by death or divorce. Our point is worth reiterating: An understanding of the value of a business or business interest is a critical element in preparing for any of these eventualities.

OWNERSHIP TRANSFER MATRIX	Partial Sale/Transfer	Total Sale/Transfer
Voluntary Transfers	ESOP Outside Investor(s) Sales to Insiders/Relatives Combination Merger/Cash Out Going Public Gifting Programs Buy-Sell Agreements	Sale of Business Stock-For-Stock Exchange w/Public Company Stock Cash Sale to Public Company Installment Sale to Relatives/Insiders ESOP Management/Buyout Buy-Sell Agreements
Involuntary Transfers	Divorce Forced Restructuring Shareholder Disputes Buy-Sell Agreements	Death Divorce Forced Restructuring Bankruptcy Shareholder Disputes Buy-Sell Agreements

BACKGROUND CONCEPTS OF "VALUE"

Before covering some specific details related to the electric distributor industry, it is important to understand some basic concepts related to valuation analysis.

It comes as a surprise to many business owners to learn that there is not a single value for their business. Numerous factors (legal, tax or otherwise) play important roles in defining value based upon the circumstances of the transfer of equity ownership. There are significant nuances to each of the following topics, so it is helpful to be able to combine the economics of valuation with the legal framework of a transfer (either voluntary or involuntary).

Valuation Date

Every valuation has an "as of date" which simply means that it is the date around which the analysis is focused. The date may be set by legal requirements related to a death or divorce, or be implicit, such as the closing date of a transaction.

Purpose

The purpose of the valuation is important because it is linked to the transfer event (such as a sale, estate planning, etc.). A valuation prepared for one purpose is not necessarily useful for another.

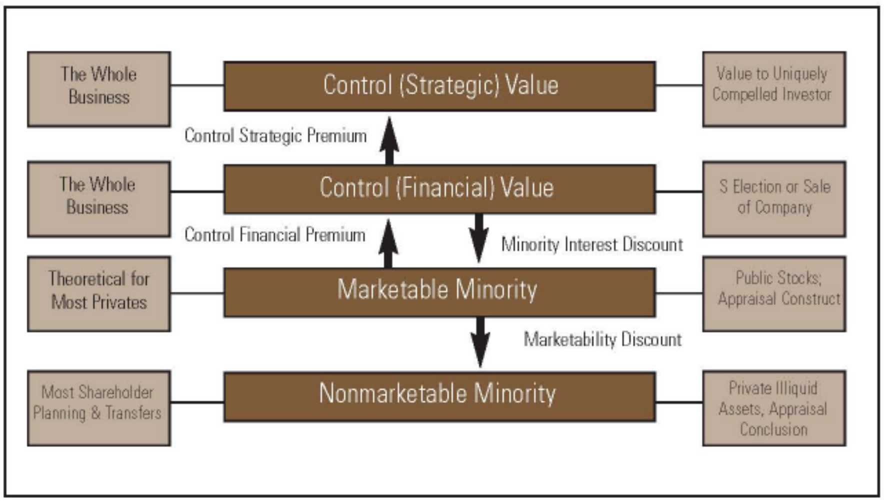
Standard of Value

The standard of value is an important legal concept, which must be addressed in every valuation assignment. Fair market value, which is most commonly used in tax matters, is the most familiar. Other important standards are investment value (purchase and sale transactions), statutory fair value (corporate reorganizations), and intrinsic value (public securities analysis). Using the proper standard of value is crucial in obtaining an accurate determination of value. There are many standards of value just as there are many types of ownership transfers. The standard of value will influence the selection of valuation methods and the level of value.

Levels (Premise) of Value

When business owners think about the value of their business, they are almost always implicitly thinking about the value of the business in its entirety. The value of a single share, for example, is the value of the whole divided by the number of shares. In the world of valuation, this may not be true if the block of stock under consideration does not have control of the enterprise. The determination of whether the valuation should be on a controlling interest or minority interest basis can be a complex question, yet it is of great importance. A minority interest value can include discounts for the lack of control and marketability, therefore it is quite possible for a share of stock valued as a minority interest to be worth far less than a share valued as part of a control block.

The following chart represents the concept graphically.



INDUSTRY OBSERVATIONS

As mentioned previously, wholesalers which fail to provide services that go beyond merely buying, storing and selling electrical equipment may find themselves becoming less relevant in the value chain. Since the day the supply chain was invented, forces have been at work to eliminate the added cost of a "middle-man" by employing strategies to sell direct. Wholesale distributors that provide true value-added services have fortified their position in the supply chain. This type of value-added service may take the form of creating customer demand for new product offerings for the manufacturer or having the technical expertise and product knowledge that enables them to provide custom solutions for the end user. By fortifying their position in the supply chain, profit margins can be stabilized or even enhanced.

Attracting, training and retaining qualified sales staff is one of the most important factors in delivering value-added distribution. Both the outside and inside sales staff must have the product knowledge and relevant technical knowledge to recommend solutions to the customers, which are primarily electrical contractors. In addition, managers and salespeople that are viewed by customers as dependable and knowledgeable are often times the key to consistent recurring business from a company's client base. We have found that companies that have attracted and/or groomed high quality management and sales staff typically report higher gross margins, even if their sales commission rates are more aggressive.

The loss of seasoned outside sales professionals can have more of a detrimental effect on smaller electrical wholesalers who are contained to a specific geographic market with a smaller customer base. The most successful professionals within this industry establish themselves as a valuable resource to their customers because of their understanding of a particular customer's discreet and unique needs. This situation is a double-edged sword for management because as the "superstar" sales professionals generate and grow revenue through customer loyalty, the revenue may become disproportionate to that generated by other sales staff, creating a level of dependency on the superstars. Such dependency can have a detrimental effect on value because of the inherent risk of losing these superstars to competitors.

Consolidation in the electrical equipment wholesale industry is a reality. Many electrical equipment wholesalers are owned and operated by second and third generation family members. Many of these generational businesses are seeing their competition sell out to large consolidators such as Sonepar, HD Supply, CED, Graybar, or Rexel. These larger wholesalers recognize the importance of having a staff with knowledge of the local or regional market. Because wholesaling is primarily a relationship, sales-oriented business, larger wholesalers know that acquiring a reputable wholesaler in an established market usually yields a superior return on investment than moving into town and setting up shop. As a result, many second and third generations are taking advantage of their market positioning and cashing in by selling their businesses to larger wholesale operations.

Expansion of the electrical wholesale business into new markets may be necessary to achieve a growth rate beyond the level of the local or regional economy. As stated above, it is difficult to enter a new market without understanding the market or having pre-existing relationships with contractors. Acquiring a local wholesaler would seem like the most logical approach, but acquisitions can be risky. Does the target business carry the same product mix or serve a similar customer base? Are they mostly focused on residential construction or commercial/industrial? Will the sales staff stay on board after the merger? Is the new market far enough away from the other markets that it will not cannibalize sales from other stores, or is it too far away to effectively manage? Electrical wholesalers that effectively execute their expansion strategy and not only diversify their customer base, but their geographic market, are typically valued at a premium to smaller, more localized wholesalers.

Pricing expertise within a wholesale business is crucial. According to Scott Benfield and Steve Griffith, in their article "I Can't Believe I Ate the Wholesale Thing!", pricing has the potential, in sales-driven distribution companies, to increase operating profits 30% or more without negatively impacting sales volume.[1] Many electrical distributors apply a cost plus approach to pricing products, as product pricing is primarily driven by the manufacturer. However, some wholesalers have become more savvy at pricing their products by employing specialized pricing modules embedded in software systems to determine optimal pricing for a particular customer segment, volume, geography or type of transaction. Creating pricing expertise across the enterprise, rather than depending on a few individuals within the management group to set pricing, can stabilize or enhance profit margins, as well as decrease dependency on key management. On the other hand, critics of enterprise pricing systems argue that pricing should be managed at a local level so that a wholesaler can change and quickly adapt to the local market. This is an advantage for smaller wholesalers when competing with national distributors.

1 *Accessed at www.benfieldconsulting.com*

FINANCIAL CONSIDERATIONS

When valuing a business, it is critical to understand the subject company's financial condition. A financial analyst has certain diagnostic markers that tell much about the condition of a business. Similar to the way a physician reads an EKG, appraisers look at the company's ratios to assess how the business has operated historically and how it operates relative to other businesses in the same industry. While most electrical equipment wholesale managers track the historical trends of their company's financial ratios, many do not know how they compare to others of similar size. The following ratios include performance measurements for electrical merchant wholesalers with over $25 million in annual revenue:[2]

- Median Current Assets as a Percent of Total Assets: 84.9%
- Median Gross Profit Margin: 22.6%
- Median Operating Expenses as a Percent of Net Sales: 17.1%
- Median Operating Profit as a Percent of Net Sales: 5.5%
- Median Accounts Receivable Days Outstanding: 50
- Median Inventory Turnover: 7.8x

These ratios are quick and easy ways to examine a wholesaler's operation. From an appraiser's viewpoint, while these ratios do not provide an absolute determination of a subject company's strengths or weaknesses, a company's deviation from the median figures typically deserves further investigation as to the operational aspect of the business.

APPROACHES TO VALUES (WITH RELEVANCE TO ELECTRONIC EQUIPMENT DISTRIBUTORS)

There are three general approaches to determining the value of a business – the cost, market and income approach. Each approach has a variety of methods used to produce an indication of value. Not all approaches necessarily produce a meaningful value for all businesses, but the final conclusion of value will ultimately reflect consideration of at least one approach, perhaps through a combination of methods.

The Cost Approach

The cost approach determines what it would cost to build the business from scratch, omitting the value of the company's intangible assets, such as its geographic market or brand loyalty. This approach is probably the simplest method, rooted in determining the value of the company's assets and liabilities. Once these two variables are determined, the value of the equity can be extrapolated: Assets – Liabilities = Equity (book value).

Book value (or adjusted book value to which "net asset value" is sometimes referred) is a primary benchmark for value in many capital intensive companies, such as a manufacturer or a real estate-oriented business. As mentioned previously, a wholesalers' asset base consists mostly of accounts receivable and inventory, which are highly liquid assets. It is seldom that an appraiser would put much emphasis on this approach relative to an income or market-based approach, unless of course, the wholesaler is generating operating losses and the highest possible value of the Company's stock is the value of the assets minus the liabilities.

2 *2007 – 2008 Annual Statement Studies, Risk Management Association; North American Industry Classification System (NAICS) Code 423610, Electrical Apparatus and Equipment Wiring Supplies, and Related Equipment Merchant Wholesalers. There were 199 observations in the group.*

Market Approach

The market based approach is essentially no different than using comparable price per square foot data to determine the value of a residence. Real estate professionals will agree that this is merely a starting point in estimating a home's value, because few homes are just alike, and it is usually impossible to determine the factors compelling the seller or buyer in the transaction. When valuing a business, appraisers use market data from comparable public companies and transactions of similar companies to develop an indication of value. Finding truly comparable public companies is likely much more difficult than a residential real estate appraiser's task of finding a group of houses that can be reasonably compared. When searching business transaction databases, the same comparability problem exists, along with the problems of data accuracy, unknown seller or buyer compulsion, or the pricing differences dictated by different geographic markets.

While this method is not perfect, it is still a recognized and often effective method of arriving at an indication of value. Often an appraiser will begin with a group of comparable companies and then apply fundamental adjustments based on judgment. This is one place where art meets science in the appraisal profession. With the high level of acquisition activity among electrical distributors over the past several years, the use of comparable transactions as a means of developing a valuation indication is especially important. While data on private transactions is usually limited (as noted above), a valuation within this industry that does not at least attempt to place the derived value in the context of recent activity in the acquisition market likely incomplete.

Income Approach

The value of a business is directly related to the present value of all future benefits (cash flow) that the business is expected to produce through its operations and through an eventual liquidity event. The income approach incorporates this principle primarily by utilizing two variables: the company's cash flow and a capitalization factor (or multiple). It sounds simple; however, much process and thought goes into the development of both variables.

The two primary methods used under this approach are the single period cash flow method and the discounted future benefit method. The single period cash flow method utilizes an ongoing level of company earnings which is multiplied by a factor that incorporates the company's level of risk and a growth rate into perpetuity. This method is usually best for companies that have a stabilized level of growth and are not reinvesting all of their earnings. The discounted cash flow method incorporates the company's expected cash flow over the next several years, as determined by an estimated growth rate, and then discounts the cash flow relative to the risk of generating the cash flow. This method is generally best when valuing a company with a rate of growth that is expected to be higher (or lower) in the near-term, but then will normalize to a sustainable long-term growth rate.

Given the apparent shortcoming of the asset approach in valuing an electrical distributor and the difficulty in finding and applying meaningful market data from comparable companies and transactions, the income approach is often a primary focus in analyzing the value of a company in this industry. As noted previously, the value of any company is equal to the present value of all future benefits. The most direct consideration of these specific benefits (as well as the risk) of a subject company is through the application of an income approach.

FINAL THOUGHTS

Despite all that has been addressed in this article, ultimately a business' true value is what another party would pay to buy the business, assuming that there is a corresponding seller willing to transact at the same value. But how does a business owner develop an understanding of value before ownership is actually transferred? This is where business valuation professionals earn their money – providing an unbiased third party opinion of the value of a business or a business interest, taking into account all relevant factors within the business and considering the impact that industry and macroeconomic factors have on the business. For more information regarding Mercer Capital's business valuation or transaction advisory services, contact one of the professionals at Mercer Capital or visit our website at www.mercercapital.com.

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Mercer Capital At A Glance

Mercer Capital is a leading, employee-owned independent financial advisory firm, offering a broad range of consulting and investment banking services, including financial reporting and tax valuation, M&A advisory, fairness and solvency opinions, ESOP and ERISA valuation services, and litigation support.

For over 25 years Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world. Rely upon the expertise, experience, reputation and critical thinking of Mercer Capital.

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  - Limited partnership valuation
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