

Unique Market Conditions Drive Acquisition Activity in the Fastener Industry

Acquisition activity in the market increased and is rapidly on the rise. Fastener distributors in the United States are looking to sell to diversify risk by selling a company to a financial buyer taking advantage of today's



fastener distribution significantly in 2005 and 2006. Owners of companies across the United States looking to sell a portion of their company or partner are taking advantage of today's

unique market conditions. Cash rich strategic and financial buyers are utilizing relaxed credit standards and inexpensive debt to compete aggressively to acquire quality fastener distributors resulting in justifiably high valuations. Prospective buyers and sellers of fastener distributors considering acquisition activity this year would benefit considerably from understanding the factors influencing such activity and the valuation drivers.

General M&A Market Conditions

Mergers and acquisition activity in the United States as a whole increased significantly in 2005 and recently announced deals put 2006 on target to surpass the boom years of 1999 and 2000.

A favorable bank debt environment has improved acquirers' expected return on their acquisitions. Credit standards have relaxed and banks are willing to lend acquirers on average over 4 times a target company's EBITDA (earnings before interest, taxes, depreciation and amortization), up from less than 3 times EBITDA in 2001. The combination of bank debt and readily available equity capital acquirers put into a deal have pushed purchase price EBITDA multiples up substantially.

Interest rates also make bank debt an inexpensive means to fund growth. Though interest rates are rising, they are still low relative to the strong economic growth projections. We are in a unique environment today with potential acquirers having access to inexpensive bank debt and outstanding economic growth prospects. Strategic and financial buyers are seizing this opportunity to grow by acquisition. However, if interest rates continue to rise, M&A activity will steadily decline, taking buyers out of the market and pushing down valuations.

In addition, corporations have recently experienced outstanding earnings growth and are generating significant amounts of cash flow from operations. This is a direct result of these companies cutting excess costs out of their businesses during the lean economic years of 2001 through 2004. But, now, with the excess costs out of their businesses, these companies are finding it difficult to grow organically. As a result, they are looking for acquisitions to fuel growth. This is especially true for companies in the fastener distribution industry.

Fastener Industry Specific M&A Market Conditions

Demand for fasteners in the United States is expected to grow approximately 4% in 2006 and 2007. Most companies within the fastener distribution industry have target

growth rates substantially higher than 4%. In the absence of industry consolidation, revenue growth is a zero-sum game—some distributors will hit significantly higher growth targets, but, it will be at the expense of other distributors. Any revenue growth for distributors in excess of the 4% growth in fastener demand will be a direct result of taking market share from other distributors. However, achieving growth by taking market share from competitors is expensive and often not very profitable. Distributors competing for market share often do so based on price, resulting in a general downward and unsustainable spiral of profit margins overall.

Market share growth targets can, however, also be achieved by acquiring other quality companies in the industry. Most of the largest and most successful fastener distributors in the United States have used acquisitions to fuel growth and gain economies of scale while maintaining, or even improving, gross profit and operating margins.

The \$20 billion fastener distribution industry is still very fragmented. There are over 3,500 fastener distributors in the United States, the overwhelming majority of which are small or middle market - having under \$100 million in revenue. This fragmentation makes it difficult for smaller distributors to get volume pricing from domestic and import vendors and continue to grow their customer base.

Technology and quality control systems embraced by the fastener distribution industry have created large barriers to entry for new start-up companies. However, the cost of advancements in technology and quality systems has also made it difficult for small and middle market distributors to keep up.

As a result, much of the value proposition that smaller fastener distributors historically offered their customers (volume pricing, inventory control and quality assurance) is being challenged. In addition, the internet has made domestic and import sourcing of fasteners appear easier. All of which has prompted an increase of distributor customers to at least consider going direct to fastener manufacturers to purchase product.

Conclusion

We are in a unique environment for M&A activity in the fastener distribution industry. Because of the increasing costs of technology and operations necessary to provide value to customers, many fastener distributors are facing difficult growth challenges. At the same time, the value of their company may be at its highest. There are a substantial number of strategic and financial buyers in the market ready to acquire quality fastener distributors. The competition for quality fastener distributors, along with the availability and low cost of capital has driven valuations up substantially; but, such higher valuations are justifiable for acquirers given current economic conditions and the necessity to grow beyond the 4% increase in fastener demand. As a result, many owners of fastener distributor companies will take advantage of these unique industry conditions and exit their companies with premium valuations this year. As such, acquisition activity in the fastener distribution industry will likely remain very strong throughout 2006.

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