U.S. Distribution M&A Continues in an Evolving Market

Macroeconomic uncertainty, particularly the combination of widespread price inflation (and the Federal Reserve's response to it) and expectations for a downturn in 2023, have eroded investor confidence since mid-2022, driving volatility in the credit markets and suppressing mergers and acquisitions (M&A) activity. While these challenges are expected to continue for the next few quarters, there are areas where investors remain active and deals are closing, particularly in recession-resilient sectors.

Below, Lincoln International explores these factors and their indications for the near-term outlook for M&A in the distribution sector.

KEY FACTORS AFFECTING M&A ACTIVITY

The overall M&A environment has been impacted by numerous dynamics, causing investors to be more selective in where they spend their efforts and more disciplined in valuation. Nevertheless, there are "green shoots" that portend a market rebound in the near term.

Inflation: Price has risen across the board since mid-2021, for both goods and services, hampering economic productivity and leading to flat-to-down GDP prints in Q2 and Q3 2022. This further translated to reduced consumer spending at the end of the year, with the U.S. Department of Commerce reporting declines in November and December despite the holiday shopping season. However, with inflation beginning to ease and the labor market remaining strong, analysts now foresee a "soft landing" for the economy and an increased likelihood of the U.S. Federal Reserve stabilizing interest rates in 2023.

Labor Market: Despite layoffs in the technology and sectors, the labor market remains strong with high overall employment and labor demand. Wages have been rising and despite minor downticks late last year, consumer demand remains robust.

Lending Market: The Fed raised interest rates to fight inflation, increasing the cost of debt and interest payments and reducing borrowers' ability to cover fixed charges at elevated debt multiples. Some lenders raised their required equity cushion to 50%+, while the spread on first-lien debt increased by 75-100 basis points and original issuer discounts became prominent. Additionally, with fewer refinancings, lenders were under less pressure to deploy capital into new transactions and became increasingly selective and less "borrower-friendly" on the credits they pursued. Combined with a pull-back in public equity valuations, these dynamics are bringing purchase multiples in private market M&A down from the lofty valuations seen in 2021 and early 2022.

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Despite these M&A market headwinds, the distribution sector has stood out as a bright spot in the broader landscape. With many investors cycling away from industry verticals that are directly levered to consumer spending and technology, distribution has stood out as an attractive area of the economy with more defensive and diversified investment opportunities. More specifically, distribution platforms serving markets with identifiable tailwinds and naturally resilient demand drivers have demonstrated strong investor interest and M&A activity. Several sectors that are performing well include:

Industrial Maintenance, Repair and Overhaul (MRO)

Distributors providing consumable products, and particularly those serving MRO applications with "need it now" demand dynamics, have thrived. Overall industrial activity remains strong and supply chain issues have abated, enabling producers to meet demand that had remained underserved since the onset of the COVID-19 pandemic. Strong revenue and earnings reported by key industrial distributors demonstrate the continued strength in this sector, enabling these corporates to pursue aggressive acquisition programs:

WW Grainger (earnings up 51.5% in 2022)
Fastenal (up 17.5% in 2022)
Applied Industry Technologies (up 77.8% in 2022)
MSC Direct (up 56.7% in 2022)
Genuine Parts / Motion Industries (earnings up 38.4% in Q3 2022)

Tools, Parts and Consumables for Other Non-discretionary

Distributors of hardware that serve non-discretionary consumer needs and commercial applications – such as the heating, ventilation and air conditioning (HVAC), plumbing and the automotive aftermarket industries – continue to see robust demand with M&A activity remaining strong.

Government / Civic

Distributors serving civic institutions, such as governments, schools and hospitals, continue to perform well both commercially and in the financial markets. Buoyed by hundreds of billions of dollars of infrastructure funding from legislation passed in response to COVID-19 – including the CARES Act, CRRSA Act, ARP Act, the CHIPS Act and the Inflation Reduction Act – these sectors will continue to be strong performers for years to come.

Distribution platforms enable investors to gain exposure to desired industries and end markets in a manner that is naturally diversified – across original equipment manufacturers, brands, geographic regions and customers. The "asset-lite" nature of the distribution business model and favorable cash flow dynamics that can counter-balance temporary demand retraction further make these platforms highly desirable as leveraged buyout candidates.

As the market evolves, it presents opportunities for strong businesses with several key characteristics to capitalize on changes in key economic fundamentals and dynamics, as well as accompanying shifts in investor appetites. These traits include:

- Leaders in sectors with **recurring customer demand**, such as ones that provide recession-resilient repair and maintenance services
- **Best of breed organizations** with strong brand awareness and loyalty
- Companies with **strong balance sheets**
- Businesses situated in **attractive geographic markets**, particularly with respect to the construction and infrastructure sectors

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