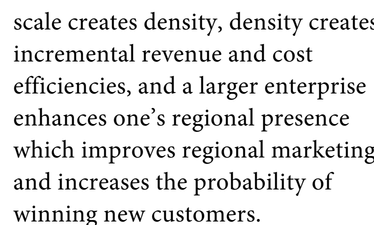
Seizing the moment

Independent distributors and the time for M&A

By Doug Horn, Partner at Clairvest Group Inc.



"We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful," said the Oracle of Omaha (Warren Buffett) in 1986, but it could be equally true today for independent packaged gas distributors.

The industrial gas industry is at a crossroads, battered by both the macroeconomic backdrop and factors specific to the industry. We are exiting the longest period of economic expansion on record, caused by the Covid-19 pandemic. This shock-tested companies' propensity to save for a rainy day, prioritize employee wellbeing, while continuing to deliver essential customer service to those industries requiring gases in a time of need.

While this crisis shall pass, gas distributors continue to contend with a shifting competitive landscape which has been underway for some time. Local distributors have witnessed two mega mergers over the last two years and the (re)entry of new large, integrated competitors in North America. Hardgoods distribution is fundamentally changing as non-traditional competitors (think Amazon, Grainger) offer speed, variety, and low prices.

Indeed, across industries, we are seeing big companies prosper at the expense of small and medium-sized businesses, as entire supply chains use size as a shortcut for quality. How independent players respond today could very well shape the structure and nature of the industry for years to come – not to mention the very survival of certain owner-operated firms.

Size matters

As an independent distributor, what can you do to scale up and position your business for success?

At Clairvest, we have spent the last three decades helping owner operators, across many industries, grow and strengthen their strategic positioning. We were founded by a group of successful entrepreneurs looking to create an organization that would provide equity capital and strategic advice that they wish they could have accessed as they were scaling their businesses.

Over our history we have entered 52 different equity partnerships and completed 315 acquisitions alongside our portfolio companies; many of which were regional consolidation strategies. We have found that implementing a thoughtful acquisition strategy has been one of the most successful ways to enhance the strategic position of smaller enterprises in industries such as waste management, equipment rental, oilfield services, HVAC services, office bottled water delivery and renewable energy maintenance. It may be the single largest lever to enhance the value of your business and create generational wealth for yourself and your family.

> "Too few independents have contemplated their own M&A-driven growth strategies…"

We have all witnessed roll-up strategies in industrial gas: Airgas of yesteryear under Peter McCausland; Big Three Industries; Valley National; Union; GT&S; American Welding & Gas; and Tech Air under private equity's stewardship.

Independent distributors have lately been content to either sell to one of the integrated industrial gas companies (and give up some value) or hold on to their ownership with aspirations for incremental growth.

Too few independents have contemplated their own M&A-driven growth strategies – only a handful of the large regional companies have pursued acquisitions selectively, some of the larger local companies have provided alternatives to selling to the large, international competitors, and one or two have consummated transformational merger of equals. It has been the exception rather than the norm. For sellers, buy-and-build strategies offer a compelling solution to succession issues and competitive disadvantages caused by insufficient geographic reach. Further, buy-and-build can create mechanisms for value appreciation if sellers are willing to roll some of their ownership into the merged entity.

Why does size matter? Not because bigger, in and of itself, is necessarily better but because for gas distributors, scale creates density, density creates incremental revenue and cost efficiencies, and a larger enterprise enhances one's regional presence which improves regional marketing and increases the probability of winning new customers.

On the cost side, density in a geographic region allows branches to share fixed assets like fill stations, achieve greater cylinder utilization/inventory turns, optimize route deliveries, purchase gas and hardgoods at better prices, and centralize head office functions like billing and customer service.

Likewise, scale incentivizes going after more and larger customers, increasing the share of wallet from existing ones, while reinvesting profits to expand your service offering and market reach.

Six stages of M&A

There are six key stages to a merger and acquisition (M&A) strategy. We find (and indeed recommend) that entrepreneurs seek counsel and expertise – both within their firms and from outside – to execute these stages successfully.

This M&A support can come from accountants, lawyers, co-investors/partners, consultants, and in-house talent found within your team.

1. **Source** – M&A begins with finding actionable opportunities that fit your criteria. More is better at the top of the funnel. Start with businesses operating in the same market and adjacent geographies. This requires building trust and relationships with your peers. Most high-quality companies care who they sell to, which is where independent distributors can differentiate themselves from large public companies as an exit option. Select business brokers might also be a source of deal flow once they know your strategy, capital availability and desire to make acquisitions. You will need to look at many prospects before you can be comfortable that you found a target that is a good fit for your business and can be purchased at a fair price.
2. **Negotiate** – Once there is a desire by both the seller and buyer to transact, you will usually communicate your offer in a term sheet, which will set out the key terms of the acquisition and provide for exclusivity for a defined time period (2-3 months, for example). There are important structuring elements to consider in order to create win-win situations, including will the seller provide vendor financing in the form of debt? Do you want to contemplate an earn-out based on customer/revenue retention? How will real estate, if any, be dealt with? Do you want to offer the seller a retained ownership interest in your business and under what terms?
3. **Diligence** – Now you are ready to verify the facts about the target company, confirm the risk-return profile of the acquisition and begin planning for value creation initiatives post-close. The investigation includes a multi-disciplinary approach encompassing financial systems and controls, insurance, environmental issues, customer analytics (price,

volume, composition, retention), key supplier agreements, operating cost profile, inventory levels and the state of the asset base (rolling stock, cylinders, facilities). This stage is more complex than we can do justice in an article but involves significant time to properly plan and execute.

4. **Document** – After you have finished diligence and are ready to move forward, the counterparties begin drafting the necessary legal agreements which include the purchase agreement, operating agreement or shareholder's agreement, leases, employment agreements and other critical documents. This is where the lawyers are most involved but the best deal maker CEOs also use this time to manage the emotions of the seller.
5. **Fund** – Ideally, before embarking on an M&A strategy, the buyer will need to secure equity and/or debt financing for the transaction and represent to the seller that he/she has the required capital to close the transaction. To increase the probability of success, we always counsel entrepreneurs to get their financing lined up in advance, whether that is discussing with your relationship banks, respective shareholders or new equity financing partners. There are different types of equity and debt capital out there and it is important to consider your individual preferences carefully before selecting one. The cost of debt includes the interest rate, repayment schedule and most importantly the terms and conditions, where great care must be taken to fully understand the implications if results do not go as planned. Likewise, the cost of equity is not only shared upside/downside but also the level of alignment and input you are seeking from your co-investors. Cash on your balance sheet is always a viable starting point.
6. **Integrate** – Perhaps the most important stage of M&A is integration. Acquisition success depends on execution. Do not underestimate the time and effort involved. Over time, M&A integration can become a core competency and a point of competitive advantage of your enterprise. Integration often starts with Day 1 readiness planning and a 100-day plan which spans domains such as HR/Insurance/Benefits/IT/Finance/PR/Marketing/Operations/Purchasing/Security/Compliance/Legal.

Now is the time to capture value

Successful, growth-oriented businesses use M&A to create sustainable advantages. One example is technology investments to enhance the customer experience (like online ordering interfaces, e-commerce platforms and employee training) and operational excellence (like cylinder tracking, delivery routing, telemetry, inventory efficiency). Growth minded companies tend to attract and retain talent better than slower growth competitors – the best talent wants to work for a 'winner' and see a path for career advancement (which growth helps demonstrate).

All of these benefits can accrue faster and with less risk than building it slowly yourself. The top performing branch-based businesses have typically combined greenfield organic expansion with acquisitions to build greater competitive advantages around the company. Larger enterprises have more resilience, stability, and sustainable growth prospects, which manifests itself in higher market values – revenue or EBITDA multiples.

"Now is the time to consider capturing value through M&A and going on the offensive. We are in a unique window..."

Now is the time to consider capturing value through M&A and going on the offensive. We are in a unique window to fortify the independent distributor base. Independents have always been known for their exceptional customer service, but a buy and build strategy can enable increased capital flexibility, asset intensity, human resource attraction, technology implementation, and service delivery innovation, all of which drive higher enterprise value.

Even after all these decades of consolidation, there remains a healthy number of small and medium packaged gas distributors in the US. Happy hunting! gw

ABOUT THE AUTHOR

Doug Horn leads the industrial distribution domain at Clairvest Group. Clairvest's mission is to partner with entrepreneurs to help them build strategically significant businesses. Clairvest is a top performing private equity management firm with over C$2.4bn of capital under management. Clairvest invests its own capital, and that of third parties, in owner-led businesses. Under the current management team, Clairvest has initiated investments in 52 different platform companies and helped monetise the value of 37 enterprises that, in aggregate, resulted in more than $2bn in proceeds for its entrepreneur partners.