

Customer & Market Due Diligence Of Electrical Products Manufacturer: Establishing Brand Importance And Recession Risk

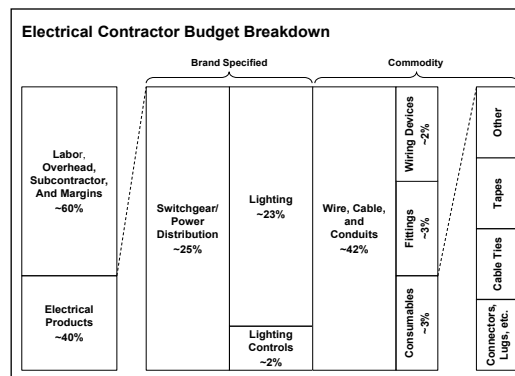
The Challenge: One of our longtime PE clients was looking to acquire a leading provider of electrical products, primarily serving commercial & industrial (C&I) markets. Our client was attracted by the target's portfolio of highly regarded brands across multiple product categories and its extensive presence in the electrical products distribution channel but was concerned about the importance of brand for electrical contractors and the target's recession risk. So our client retained Gotham for a customer & market due diligence to: (1) assess the target's cyclical exposure/recession risk; (2) establish the target's competitive positioning/reputation; (3) establish manufacturers' rep dynamics; (4) establish pricing dynamics/trends in the target's product categories; and (5) understand e-commerce trends in the electrical products market.

Data-driven Brand Importance And Recession Risk Assessment: Gotham conducted an early 2-week Phase I effort to answer our client's threshold questions: does brand matter; how do contactors purchase; and what is the target's competitive positioning and risks. We then conducted a deeper 3-week Phase II effort prior to the final bid. During these 2 phases, Gotham:

- Conducted 34 interviews and 168 surveys of electrical contractors to gain insights into: key product selection criteria and brand importance; role of distributors, manufacturers, and general contractors in the decision process; the target's reputation; and usage trends and growth outlook for the target's products, including usage by project type and the impact of recession
- Conducted 62 interviews and 171 surveys of electrical distributors and manufacturers' reps to gain insights into: role of manufacturers' reps in driving sales and influencing brand placement; perspectives and behaviors of suppliers and distributors during a recession; pricing trends for the target's product categories; and e-commerce trends
- Built an MSA-level market sizing model based on construction activity (new, retrofit, maintenance) and building inventory by end-market to establish market size and historic/projected growth rates for each of the target's 6 product categories
- Conducted an in-depth recession risk analysis based on the target's exposure to new construction, retrofit, and MRO, as well as the overall economic and construction outlook (e.g., projects under construction, permits) of the target's top 25 MSAs
- Leveraged industry data, interview insights, and research to build a detailed market map of all C&I electrical products, identify key competitors by category, and assess key market trends (e-commerce, LED lighting, and low voltage).

Contractors See Brand As Less Important Once The Brand In The "Club Of Trusted Brands"

In a typical electrical product category, a handful of brands have built a reputation of trust with contractors over their long history and contractors just purchase the brand carried by the distributor so long as the brand is a trusted brand. Distributors typically carry 1-3 brands, with their decision to carry a brand based on profitability factors (pricing, rebates, invoice terms, inventory policies, etc.) and brand reputation. If a contractor does not request a specific brand, distributors tend to offer their preferred brand, with relationships key to becoming a preferred brand. The majority of contractors' purchases are made up of high-volume items like wiring and conduit, with the target's product categories constituting a small part of contractors' total spend and are considered as a "part of the package" so contractors do not negotiate pricing for these products separately. When it comes to the distributor-supplier relationship, manufacturers' reps are preferred over direct sales force due to their: understanding of the local markets; training; and order/technical support. In fact, a major competitor's recent decision to eliminate reps in favor of a direct sales model opens an opportunity for the target to gain a larger foothold with distributors.



Target's Recession Risk Manageable Due To Its Product Focus And Geographic Distribution

The electrical distribution industry is growing at a rate of ~6%, with comparable growth expected in the near-term. Further, in most of the target's largest MSAs, the near-term construction outlook is robust. With ~ 50% of the market driven by maintenance activities, the target is well-positioned as it is over-indexed in MRO and retrofit relative to the overall market. With recession, the overall market shifts ~14% in favor of retrofit and MRO; in fact, during the 2009 recession, the target's categories only experienced an ~18% decrease while overall commercial construction had a 36% peak-to-trough decline. Finally, distributors and suppliers typically do not take drastic actions during a recession – some distributors might reduce inventory, consolidate suppliers, or ask for pricing/rebate concessions while suppliers may try to reduce inventory through special buy offers.

Target Has Opportunity To Consolidate Smaller Brands And Become A Tier 1 Player

The electrical products industry is segmented into: 4 Tier 1 suppliers with a broad range of product categories; 7 Tier 2 suppliers with some scale and participation in multiple categories; a handful of importers who provide a broad line of value-priced products; and dozens of specialized players with strength in a given product category. As a well-liked Tier 2 player, the target has an opportunity to become a Tier 1 player by consolidating smaller brands, typically lacking the scale to be carried by national distributors. This product line expansion would also make the target more attractive because contractors and distributors prefer to buy from suppliers with a wide range of products. Additionally, the target serves the lighting segment where LED conversion and new energy efficiency codes are driving demand. E-commerce is another avenue for expansion – while contractors are "old school" and like to do business in person with distributors, some do buy on Amazon for price and convenience.

The Outcome: Gotham's data-driven approach allowed our client to gain an understanding of the importance of brand to contractors, the distributor brand selection process, the role of manufacturers' reps, and the recession risk, providing the facts needed to successfully close the deal. Gotham's recession impact analysis allowed our client to develop a suitable capital structure to withstand a recession and the business performed within these quantified parameters during the COVID-driven demand shock.