**LOOKING AHEAD – 2013**
**THE "RACE" BACK TO THE FUTURE**

*Strategic issues in the apparatus service industry in 2013 and beyond.*

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**BUSINESS CONDITIONS**

Our elected officials at all levels of government have created unprecedented business uncertainties. These include major health care reform, tax increases, fiscal cliff, budget battles, government shutdowns, county and city bankruptcies, sequestration, IRS scandals, Benghazi, and increased onerous regulatory requirements. These uncertainties pile on to the ever-present business uncertainties of changing markets, cyclical economies, geopolitical instability, and more.

The 800 pound gorilla in the uncertainty room is the eventual ending of the Federal Reserve's QE (Quantitative Easing) program that has been artificially maintaining low interest rates in order to theoretically spur job growth and lower the unemployment rate. When, how, and how fast the program will end are hotly debated subjects.

And most important: what will be the impact on the business cycle? The Chairman of the Federal Reserve upset the stock markets this week with his indication that the QE program may begin slowing down as early as this fall depending on the economic conditions. (The slowing down is described by economists as "tapering.") Some economists are already predicting a significant business slowdown in 2014. Coal mining, coal transport, and coal fired utilities are particularly at risk with the ongoing conversion to natural gas.

As these uncertainties pulsate through the economy, they directly impact your business. Impact areas include increases in health care costs, higher taxes, and the added costs for conforming to new OSHA, EEOC, EPA and other regulations. Indirectly, they impact your business through your customers' uncertainties to make capital expenditures and discretionary maintenance and repair expenditures.

The latest Federal Reserve forecast has the United State Gross Domestic Product (GDP) growing between 2.3% and 2.6% in 2013. The electrical apparatus service industry appears to be ahead of this growth rate – at least year-to-date.

The re-emergence of domestic manufacturing and the further investment in energy independence particularly in wind power, fracking, and the switch from oil and coal to natural gas are some of the main drivers propelling growth in the electrical apparatus service industry today and next couple of years.

## HISTORICAL ACQUISITION RACE

As a result, we are seeing an acceleration of an old trend in the industry: the acquisition of multiple shops under one corporate umbrella. To understand this renewal, we need to look at the acquisition race from 1976-1983: yes, over three decades ago.

A short history will explain this look in the rear view mirror. The 1973-1975 oil embargo triggered a stock market decline and a marked slowdown in the economy. In the early 1970's, General Electric and Westinghouse were the dominant, national, multi-location players. The independent players with more than one location were regional and a very few exceeded $10 million in sales. As the economy slowly improved during 1976-1977, a race to acquire electrical apparatus service shops began.

The race was driven by:

- Economic uncertainties realized by the abrupt cut off of the oil supply, and the threat that it could happen again.
- Certain manufacturers realized the electrical apparatus service market continued to grow through the embargo and the subsequent impact period. They speculated that this market would be a hedge against economic slowdowns.
- The success of GE and Westinghouse in this industry.
- A host of owners who were WWII veterans reaching retirement age.
- A belief that investment by the government and industry would substantially be increased to reduce the nation's energy dependence on foreign oil that had kept us in line at the service station to buy gas – often for hours.
- Early investment and research into electric vehicles that were quickly minimized as the oil markets stabilized.

Reliance Electric, Siemens, Emerson/U.S. Motors, and National Electrical Coil all went "racing" after profitable, larger companies.

For five to seven years, buyers courted the larger companies in the industry, bid up the prices paid, and completed deals as they built out their network of shops. These buyers then drew national maps of the markets they served and the markets that were not served. Medium sized companies were approached and purchased to "fill in the gaps."

> *Author's note: I was the Controller for the Emerson/U.S. Motors service division during much of this race and was immersed in the acquisitions made in the industry.*

This race lasted through the early to mid-1980's. Over the following two decades, most of these networks of shops, including Westinghouse, were dismantled, with the notable exception of the Reliance shops. Today, remnants of these networks exist within some of the larger companies in the industry. Most of the shops were

sold off to independent owners. GE drastically reduced its number of shops, mostly through closures.

Since the waning of that race, other buy-sell transactions (some big, many small) have happened throughout the industry, but they do not have the same accelerated pace or pricing frenzy.

## TODAY'S ACQUISITION RACE

It's now 2013 and we are again slowly recovering from an economic downturn: the financial crisis created by the housing bubble. The acquisition race is back on.

Driving this new race are:

- Growing market demand for electrical apparatus repair and service in the manufacturing and utility industries.
- Renewed national focus on energy savings and independence including electric vehicles.
- Frustrated business owners disheartened from the unprecedented uncertainties created by our government.
- A generation of "Baby Boomer" owners facing retirement and needing to "cash out".
- Billions of available dollars of corporate and private equity money looking for decent investment returns.

Compare these drivers to the earlier ones; history does repeat itself.

The list below reflects the current status of this race. Many other transactions are under consideration. We may see other operating industrial companies and Private Equity Firms enter the race, and it will continue over the next three to five years.

**Large Electrical Apparatus Service Company**

**Transactions Completed in Recent Years.**

Note: this list does not include all of the other industrial service companies or divisions owned by the buyers, and the list may be incomplete.

Buyer: Boulder Capital, Chicago, IL (Private Equity firm) through Industrial Service Solutions, Chicago IL

Sellers:

- RAM Industrial Services, Inc., Leesport, PA
- Pennsylvania Electric Motor Service, Erie, PA

Buyer: Timken, Canton, OH

Sellers:

- Wazee Companies, Denver, CO (including H&N Electric)
- Smith Services, Princeton, WV

Buyer: Oak Tree Capital Management, Los Angeles, CA (Private Equity firm)

Seller:

- Shermco Industries, Irving, TX

Buyer: Integrated Electrical Services, Inc., Houston, TX

Seller:

- MISCOR, Massillon, OH (announced, not completed)

Buyer: Odyssey Investment Partners, New York, NY (Private Equity Firm), through Integrated Power Services, Greenville, SC

Sellers:

- The "old" Reliance chain of motor shops – multiple locations (Bought from The Riverside Company, New York, NY, (Private Equity Firm), who originally acquired these shops from Baldor/Reliance.
- Monarch Electric, Cleveland, OH
- Electro-Mec, Punxsutawney, PA
- TRICO TCWIND, Litchfield, MN
- Industrial Apparatus Service, Houston, TX

Buyer: High Street Capital. Chicago, IL (Private Equity Firm)

Seller:

- Koontz-Wagner, South Bend, IN

There are two types of buyers:

- Operating companies such as  Timken (NYSE: TKR) and Integrated Electrical Services, Inc. (NASDAQ: IESC)
- Private Equity Firms such as  Odyssey, Boulder, High Street and Oak Tree (NYSE: OAK)

The general criteria that the buyers are using for larger acquisitions in the industry are:

- Annual sales of $10 million and above,
- Restated Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) of $1 million or more,
- Growth Potential
- Management, Management, Management!!!

Buyers typically use an EBITDA multiple of 5x to 7x to calculate the purchase price of the total capital of a company, i.e. the stockholders' equity plus any interest bearing debt. A 6x multiple is not uncommon today. In the 1970-1980 race, the EBITDA multiple was nearer 5x due to higher interest costs. This purchase price excludes real estate which is typically leased or sold at an appraised fair market value.  Before applying any pricing multiplier, buyers will restate the reported EBITDA for certain discretionary expenses found in many privately held companies, for the market value of owner's salaries, and for the fair market lease value of stockholder owned real estate.

**HOW THIS RACE AFFECTS YOU**

If history is any indication, the following will affect the industry as this race continues.

1. Prices will be bid up to acquire the better industry players. While sales, profitability, and growth are important, the most important criteria evaluated by the buyers will be management, management, management.

Studies have shown that 60% to 70% of all business owners are gone from their companies within one year of a sale, regardless of contracts, employment commitments, etc. While I am sure the following is not 100% accurate, I can't think offhand of any owners from the earlier race that remained with the buyers more than a year.

The culture clash between operating as an independent owner versus working for someone else is often too great for the seller and/or the buyer. And, the seller now has a couple of million dollars for fishing, golfing or other bucket-list ambitions that have been deferred for years while growing the business.

The larger selling companies have a depth of competent management which buyers rely on to step up to the number one position within the structure of the newly gained parent company.

2. As these buyers draw their national maps to define their geographic gaps, the buying will trickle down to medium-sized companies with $5 million to $10 million in annual sales. There will be less "bidding up" of the prices as companies in this range of sales are more dependent on the management and technical skills of the owner. There remains the risk of the owner leaving while there is less other competent management to run the business.

3. There will be minimal direct effect on companies under $5 million in sales. The initial cost for buyers to acquire any business is many tens of thousands of dollars for management, legal, and accounting costs. These costs generally make the acquisition of smaller companies uneconomical.

However, there are indirect effects on the smaller shops that can produce very positive results.

- With any acquisition, there will be some shuffling of hourly and salaried employees.  The acquiring companies often reduce redundant personnel to save costs. While smaller companies often cannot match the pay or fringe benefit packages of the larger players, they can offer a more personal human relations environment and sometimes better working conditions.

- Some customers may not want to deal with new owners for a host of reasons. These customers become candidates for switching to smaller companies.

- Certain product lines may not be compatible with new owner’s current product lines. This offers an opportunity for a smaller company to fill that need for the product manufacturer.

Two well-worn, but true sayings summarize what is happening in the industry: “The only constant is change” and “History repeats itself.” We are experiencing constant change in the ownership of companies in the industry. This accelerated acquisition activity mirrors the late 1970’s and early 1980’s. For now, the race is on. It will be interesting to see who the winners are. Whether these combinations of shops will be dismantled after five to ten years, similar to the dismantling in the 1980’s, remains to be seen.

The majority of Private Equity Firms will exit from the companies they acquire within four to seven years. Anyone considering a sale to a Private Equity Firm should take that firm’s exit strategy into consideration with their initial sale decision, especially if the sale has any long-term seller financing or earn-out provisions.

Operating companies generally do not have an exit strategy. Their goals may include integrating the newly acquired companies into their current operations through such things as:

- Sharing customers
- Joint sales and marketing
- Consolidated purchasing
- Facility sharing

**SIDEBAR 1**

If you are still a "C" corporation and are considering a sale at some point in a five to ten year time frame, I strongly recommend converting to an "S" corporation this year. The waiting period to take advantage of the reduced single tax burden from the asset sale of an "S" corporation instead of the double taxation from the sale of a "C" corporation is temporarily reduced to 5 years from 10 years. However, as of now, that provision will revert back to 10 years at the end of 2013. I encourage you to check with your accountant for the details.

**SIDEBAR 2**

Please email me for a free copy of the ebook: "Buy-Sell Agreements for Baby Boomer Business Owners." (Offer good through August 1, 2013.)

This informative ebook is an easy read for business owners. It will save you money and aggravation if you have (or should have) a Buy-Sell agreement for any part of your company with partners, family members, managers, employees, ex-employees, about to be ex-spouses, or anyone else. Thoroughly planned and well documented Buy-Sell agreements are critical documents for succession planning, for keeping harmony within your company, for maintaining good family relationships, and for avoiding costly legal fees.

Buy-Sell agreements should address all of the potential issues in the actions covered by the acronym: QFRDDD or Quit, Fire, Retire, Disable, Die, Divorce. There are actually at least 20 “D” conditions that may arise where a good Buy-Sell agreement proves invaluable.

**MY CONTRIBUTION**

If you are approached by any potential buyer and you have questions, please call me. All inquiries are kept confidential: never an obligation for a brief phone call.

Regardless of size, business valuations and succession plans play an important role to any business owner considering the sale or succession of his or her company. For over thirty years I have assisted business owners in this industry in valuation and succession.

I will be staying at the Luxor Hotel next door to Mandalay Bay during the EASA Convention in Las Vegas. Please call me to arrange a confidential meeting. Of course, if you are not attending the convention, please call me at your convenience. (Cell: 205-837-4845)

The questionnaires I have prepared for helping to initiate a good discussion may be found at:

- http://www.emailmeform.com/builder/form/mr5TcsC2RffdG for valuation, and
- http://www.emailmeform.com/builder/form/Opu487J20rbh6A for succession planning.

They can be printed out for your use, or completed and submitted to me. The information will be kept confidential.

Hopefully you have found the information in this newsletter valuable. If you wish to be removed from this mailing list, please send me a reply email from the email address that received this newsletter. Put the word **REMOVE** in the subject line. I only send one issue of "Looking Ahead" each year. If a major economic or geopolitical event were to occur, I might send an addendum, but never more than two mailings a year.

Please send any questions or comments regarding this newsletter to the email address below.

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