



Review of Industrial Economy & Industrial Distribution Trends

September 22, 2015

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CLEVELAND
RESEARCH COMPANY

Today's Agenda

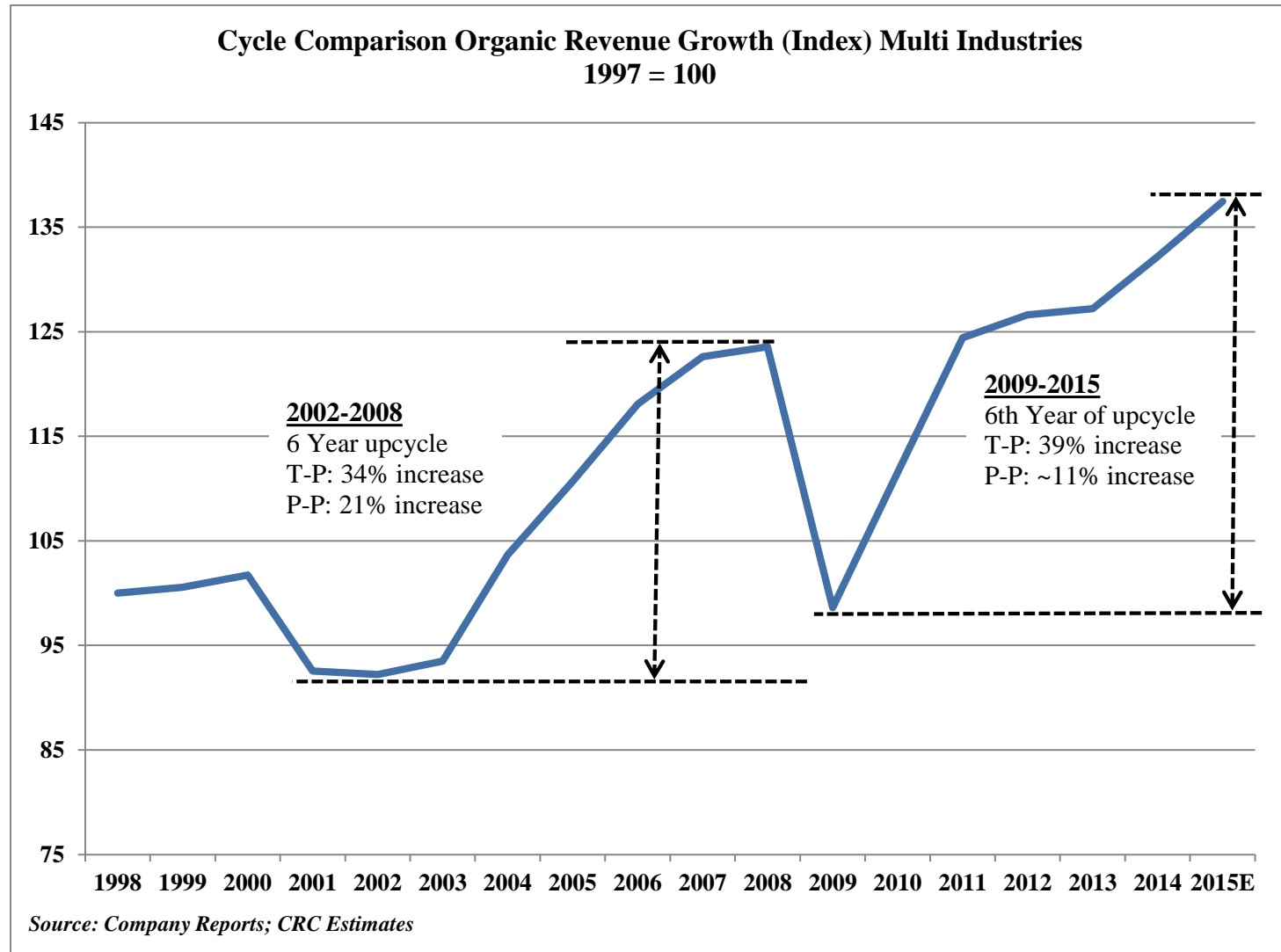
- Macro / Industrial Backdrop
- FPDA / ISD Market Trends
- Initial 2016 Outlook
- Question & Answer
- Appendix: Industrial Distribution Industry Trends



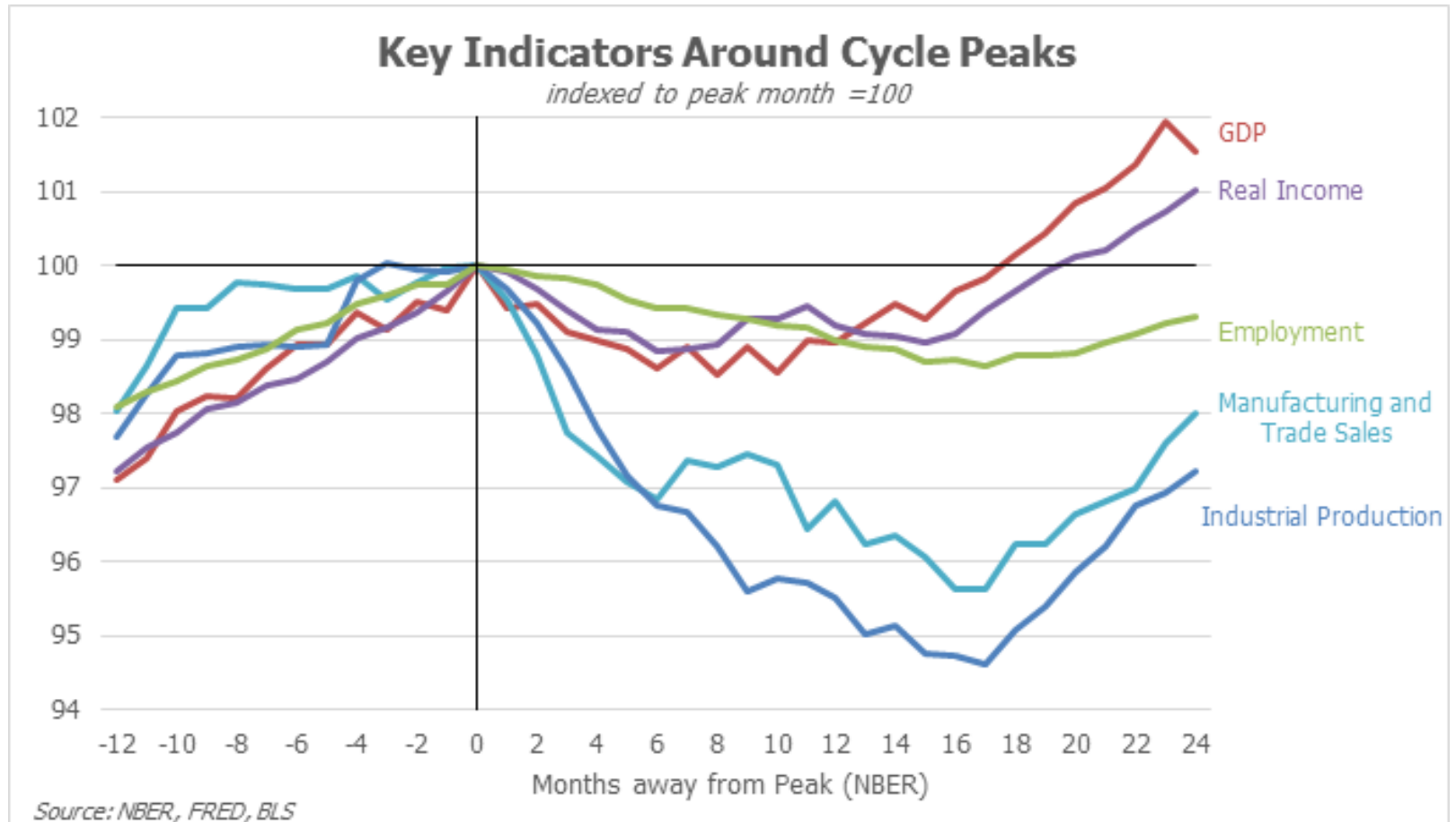
Industrial Backdrop



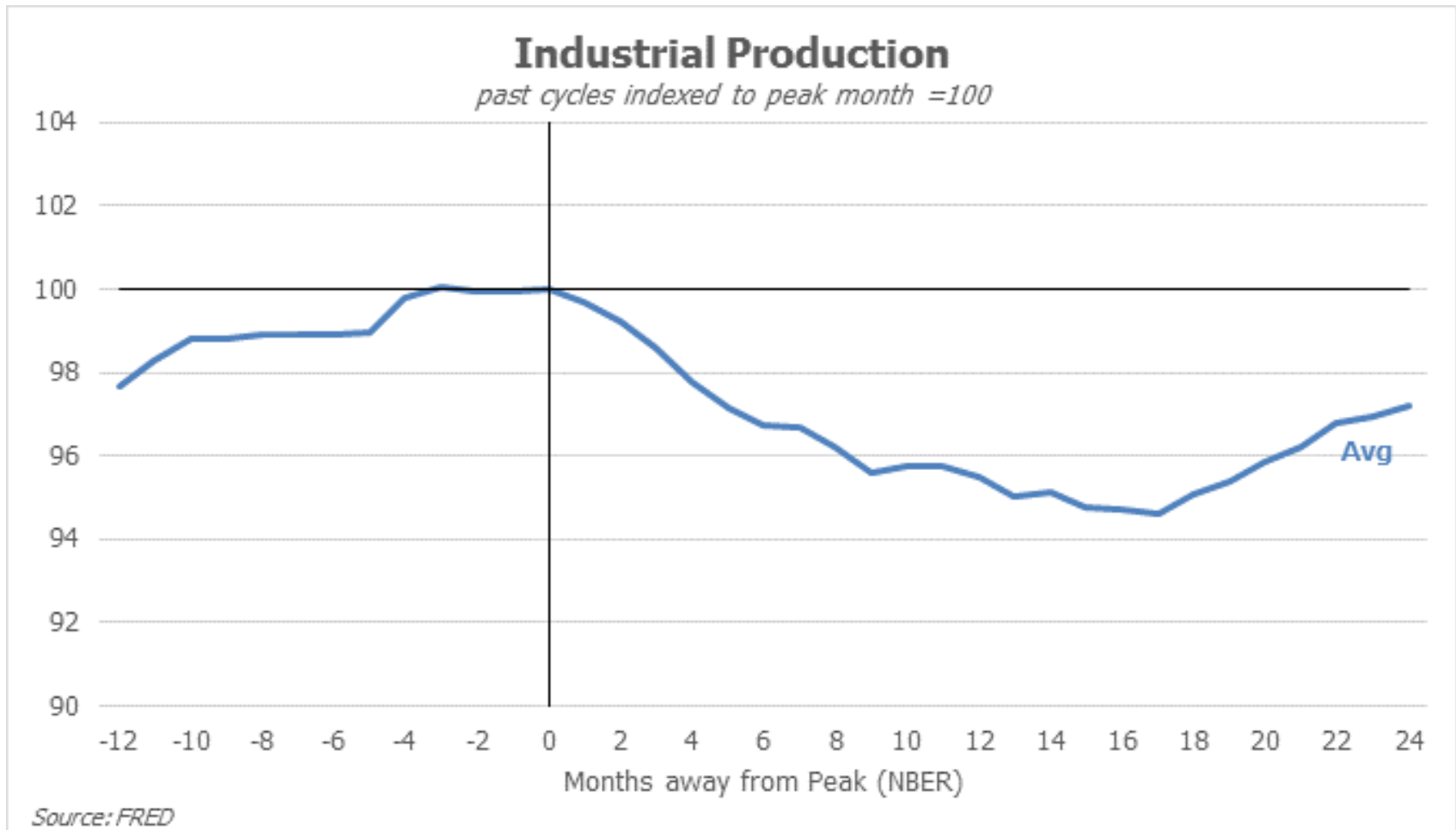
Where are we in the cycle



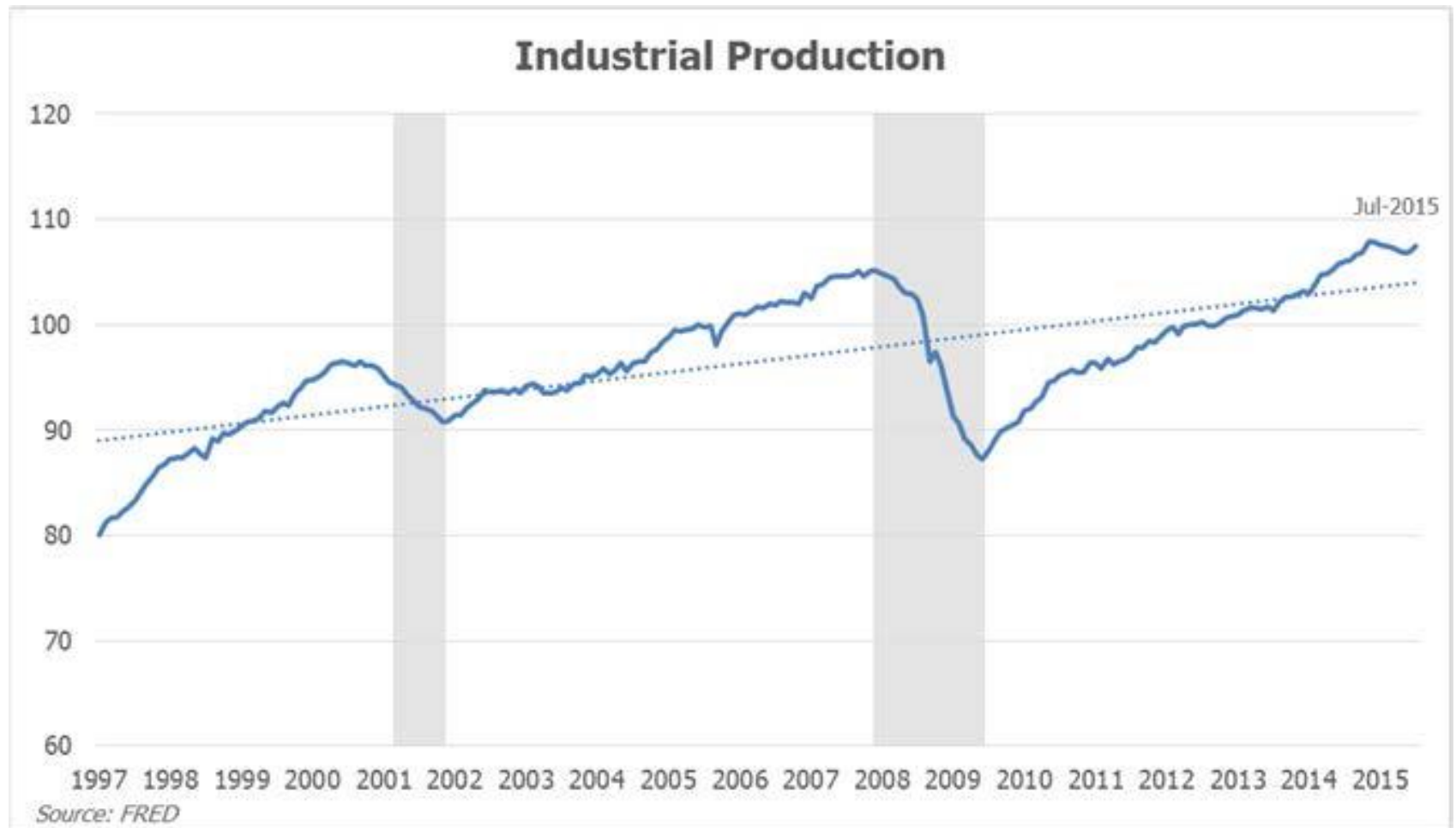
Where are we in the cycle



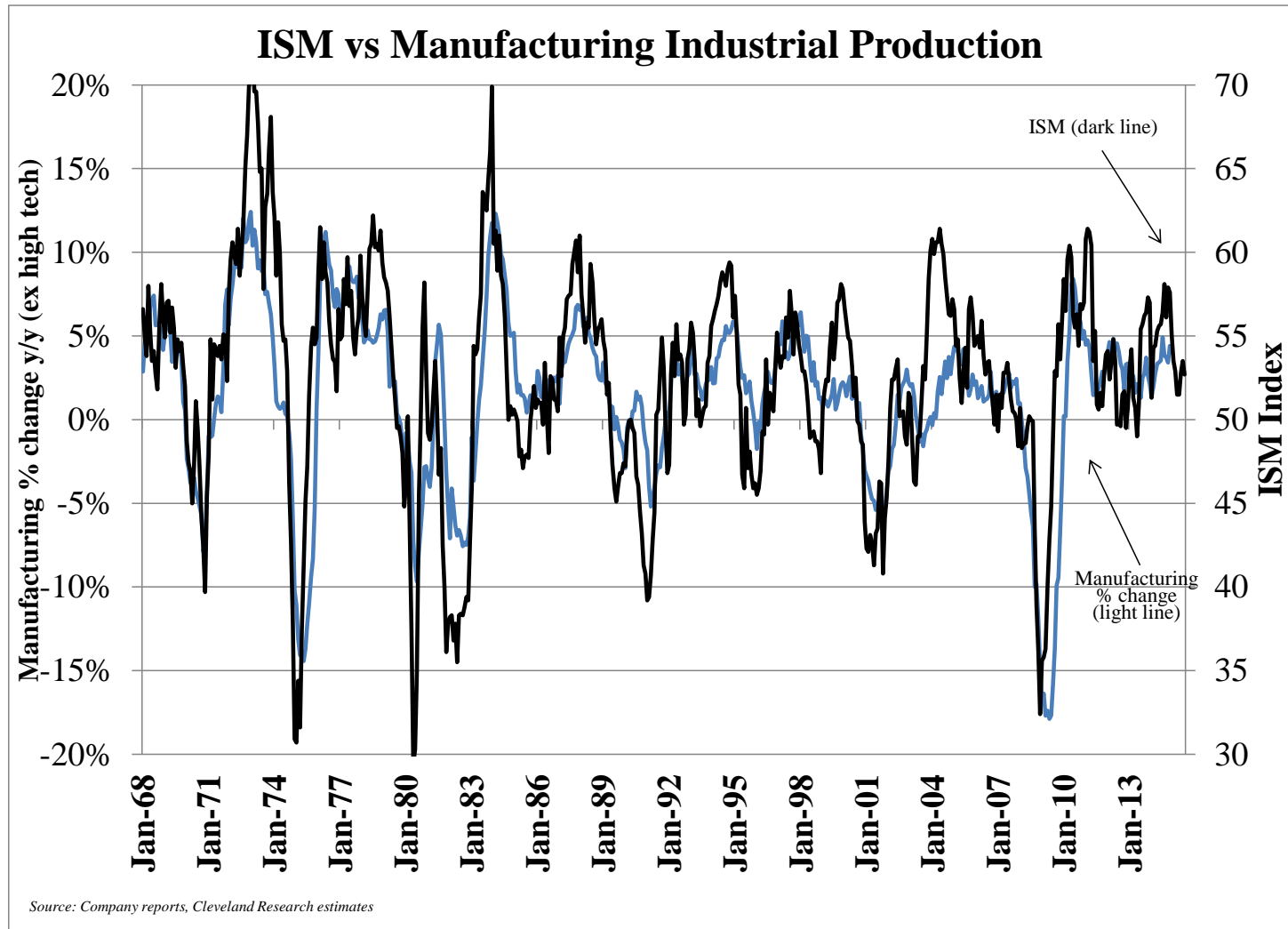
Where are we in the cycle



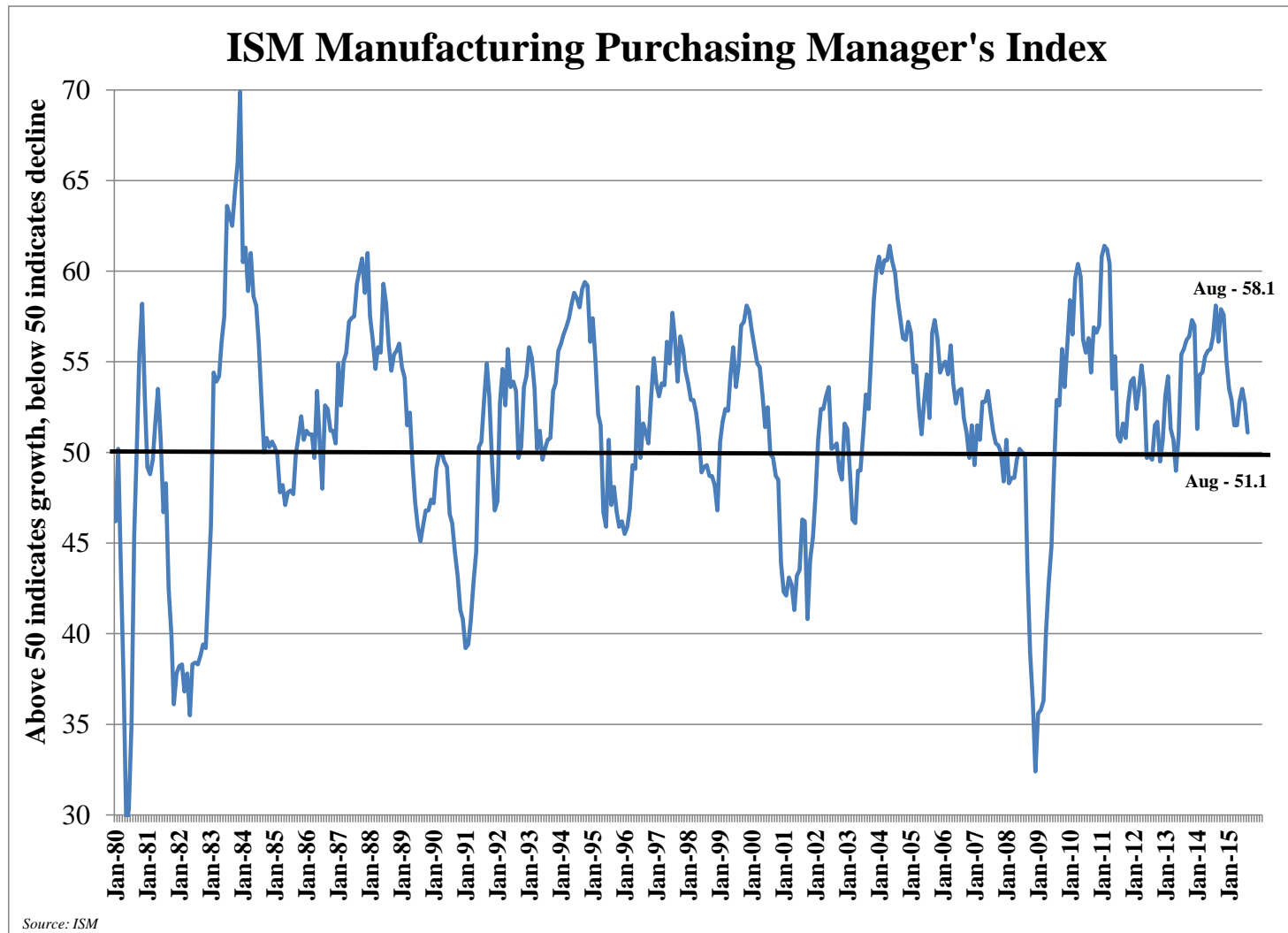
Where are we in the cycle



ISM correlates well with IP



ISM is softening



Our Industrial Surveys

HVAC

**Aggregates
Freight Forwarders
Intermodal
Paper & Packaging**

**Ag Equipment
Electrical
Flatbed Trucking
Gas & Welding
Rails**

Lighting

**Boxboard
Small Parcel Shipping
Waste Services
Wallboard**

**Mining Equipment
Monsanto
Fluid Power
Industrial Distribution
Containerboard**

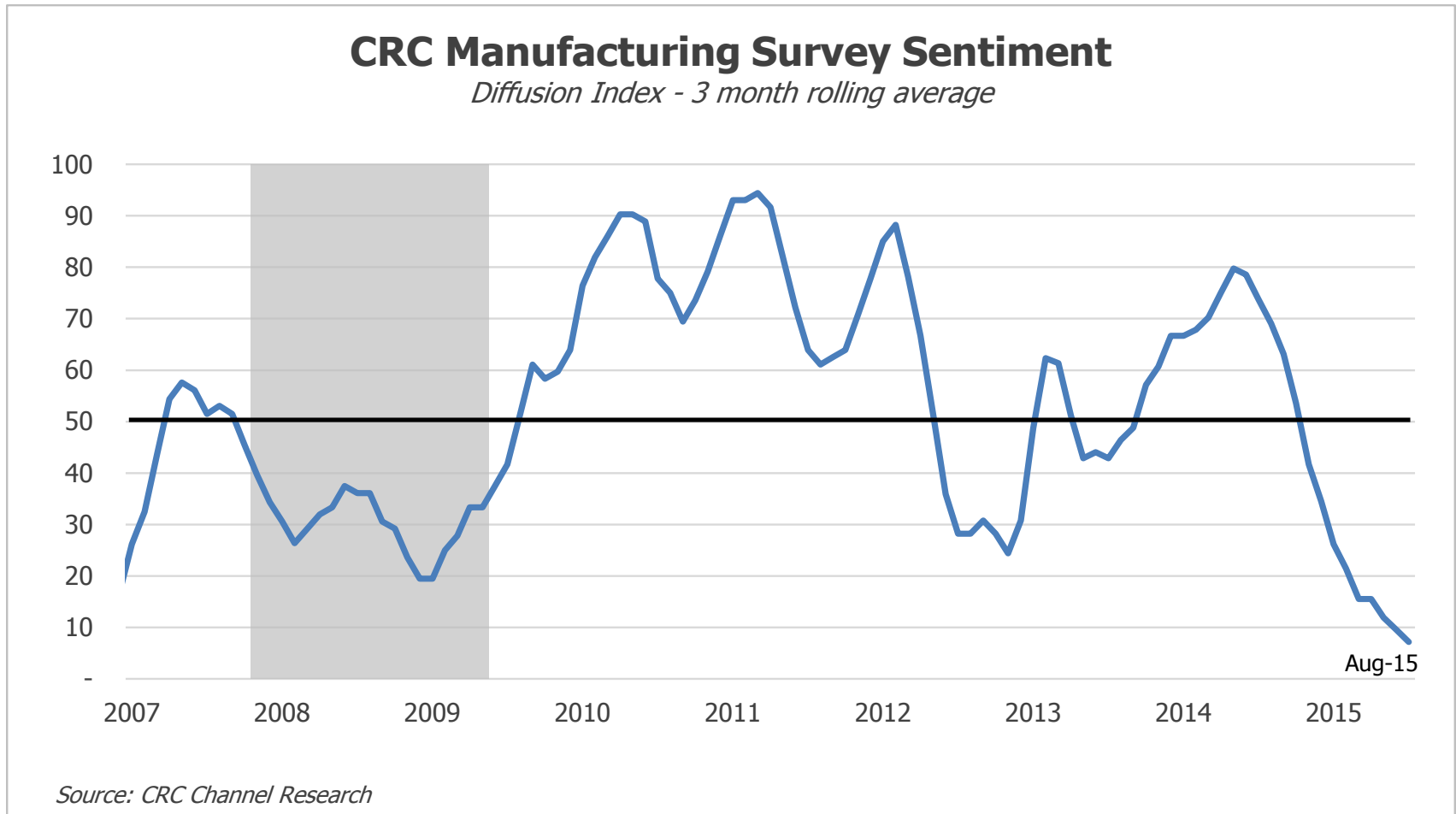
Truck Brokerage

**Cement
Ethanol & Oilseed
Fertilizer**

**Oilfield Services
Industrial Automation
Frac Sand
LTL Trucking**

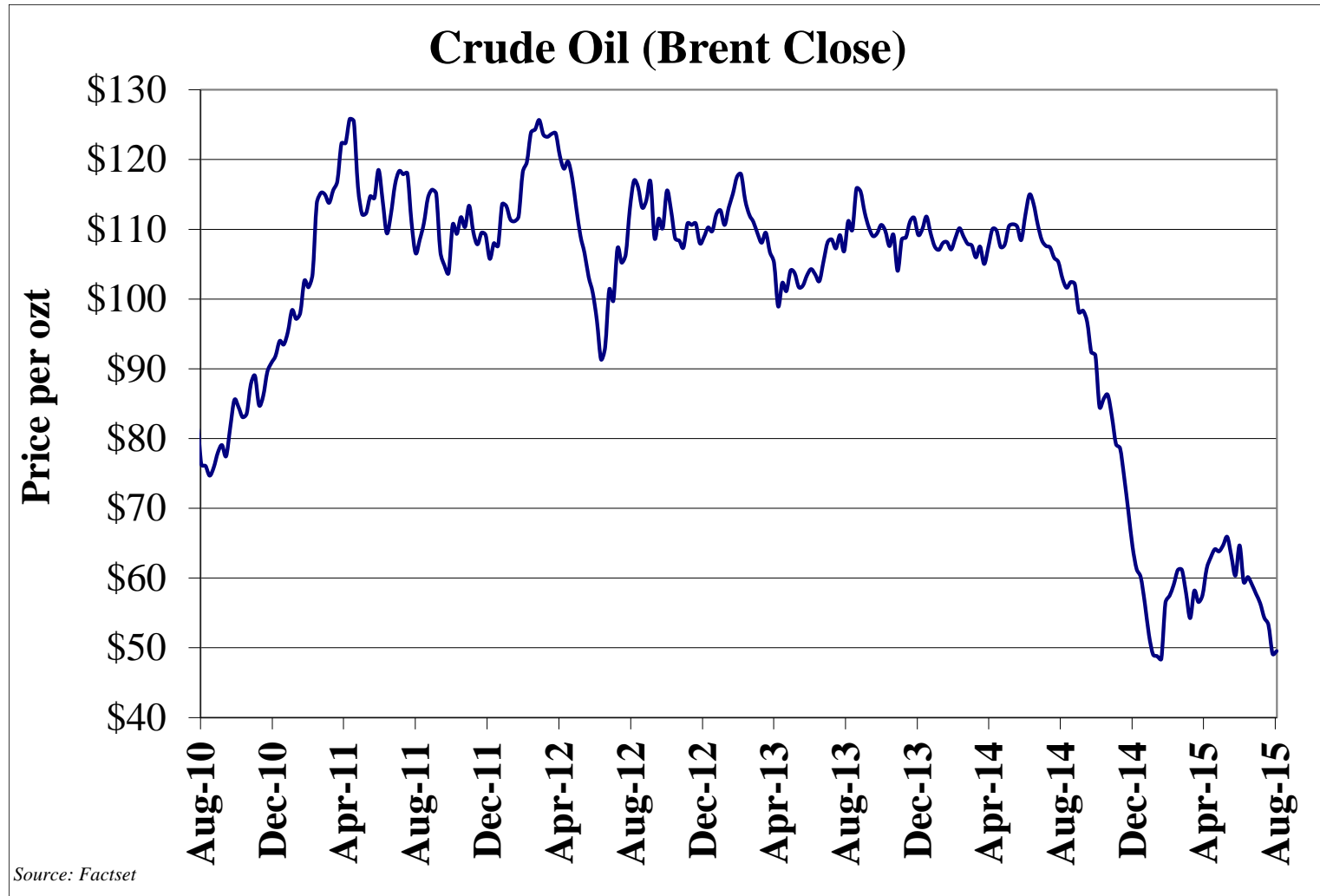


Manufacturing Sentiment Rolling Over

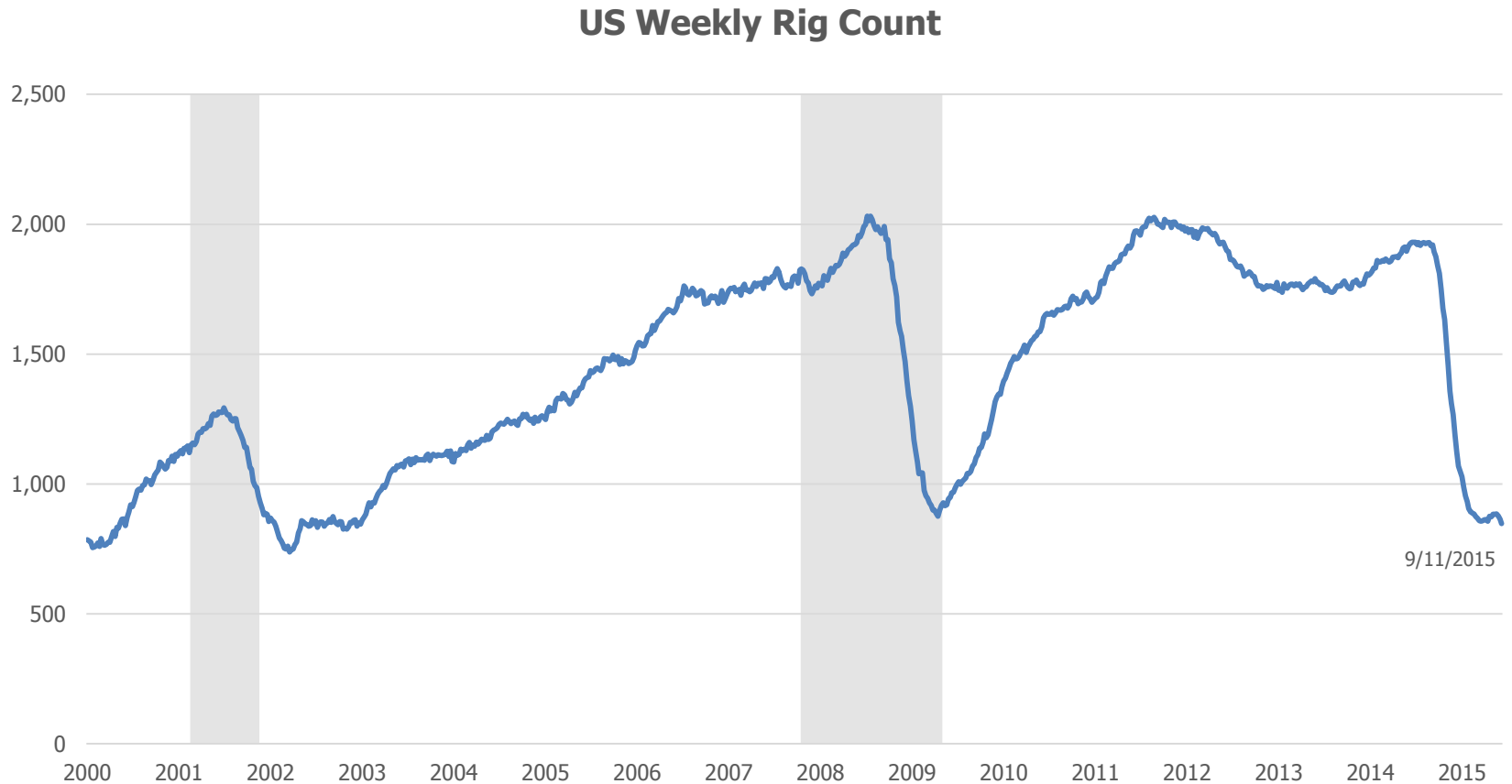


What Changed?

Oil prices collapsed



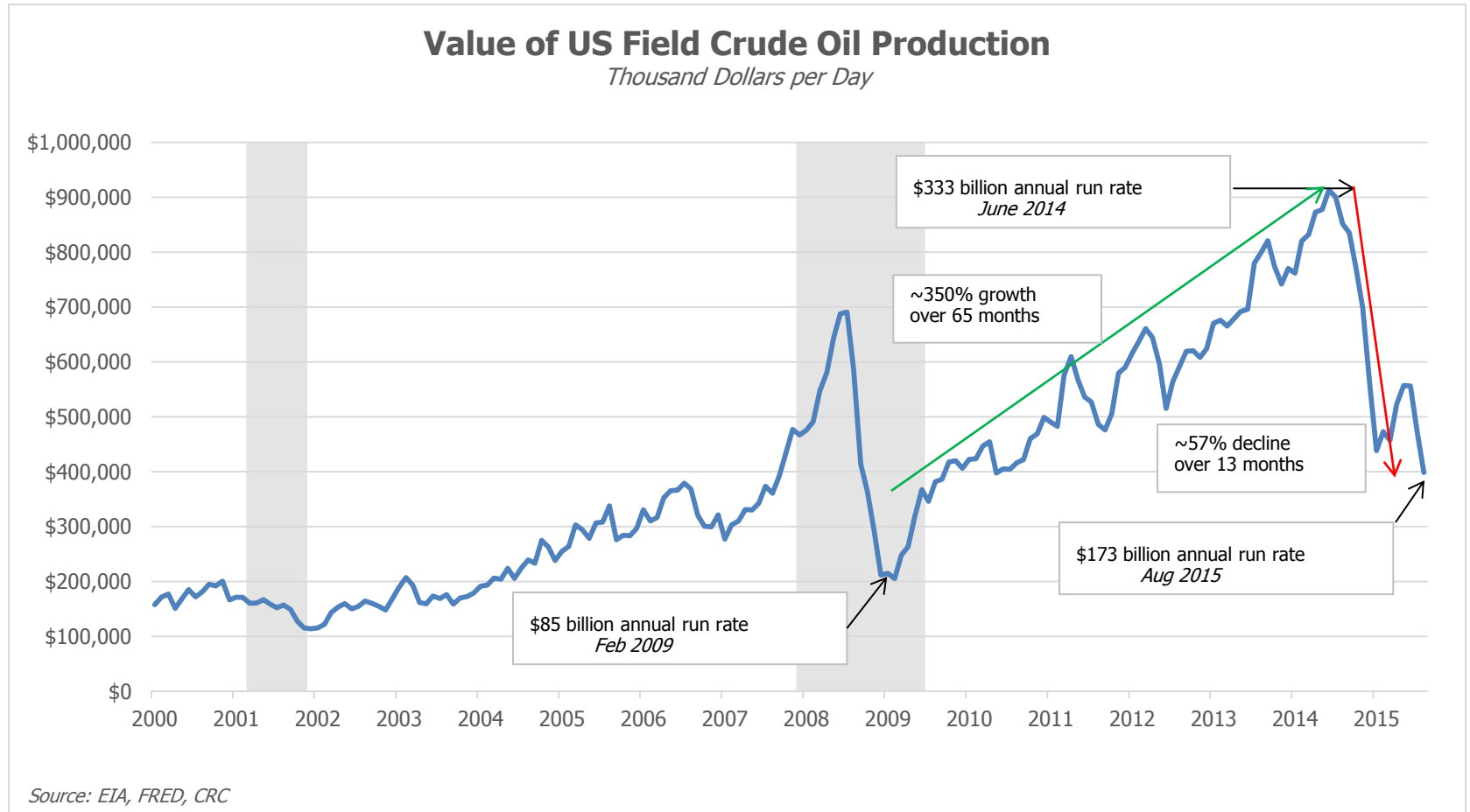
Collapse in rig count started last October



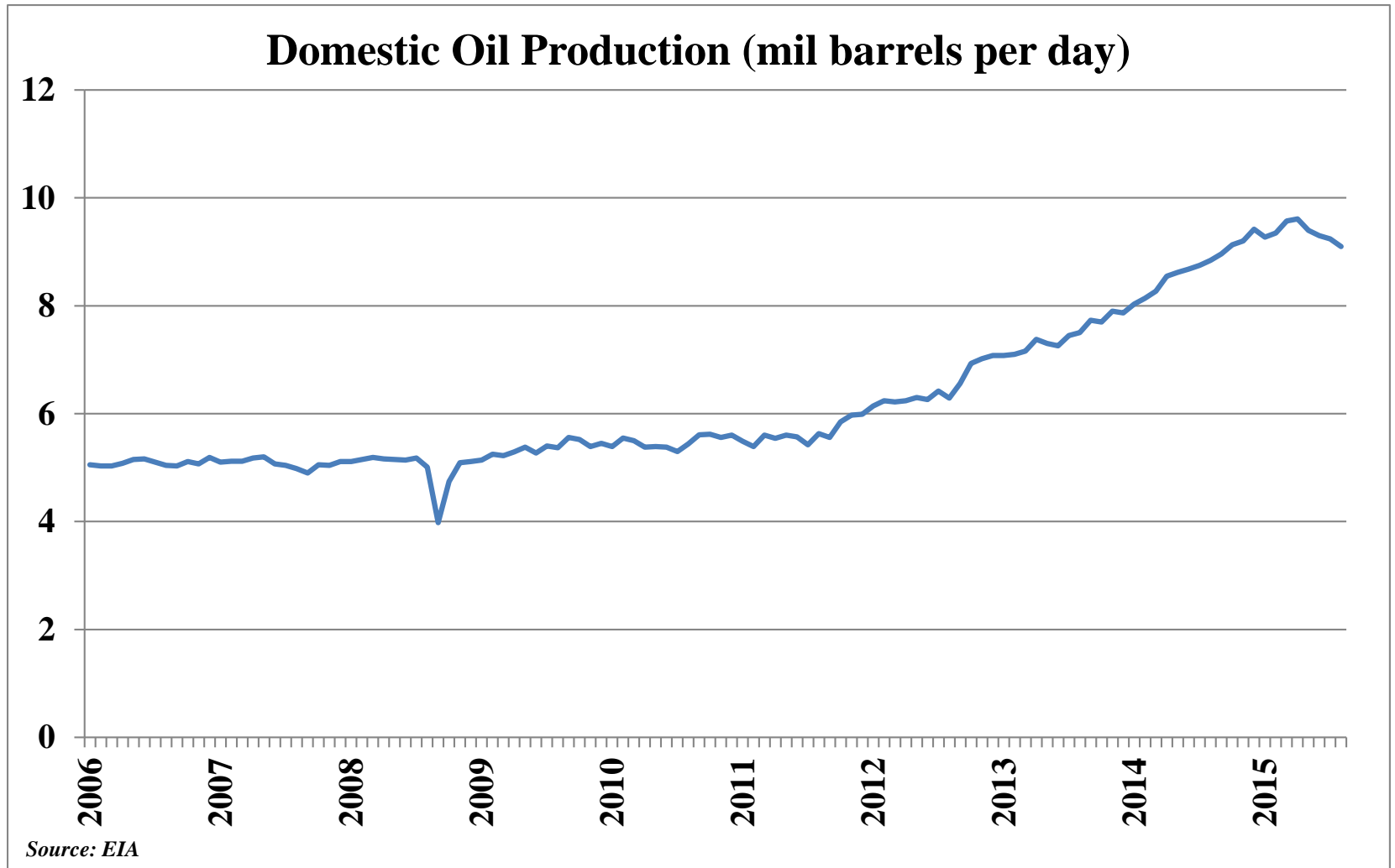
Source: Baker Hughes Rig Count



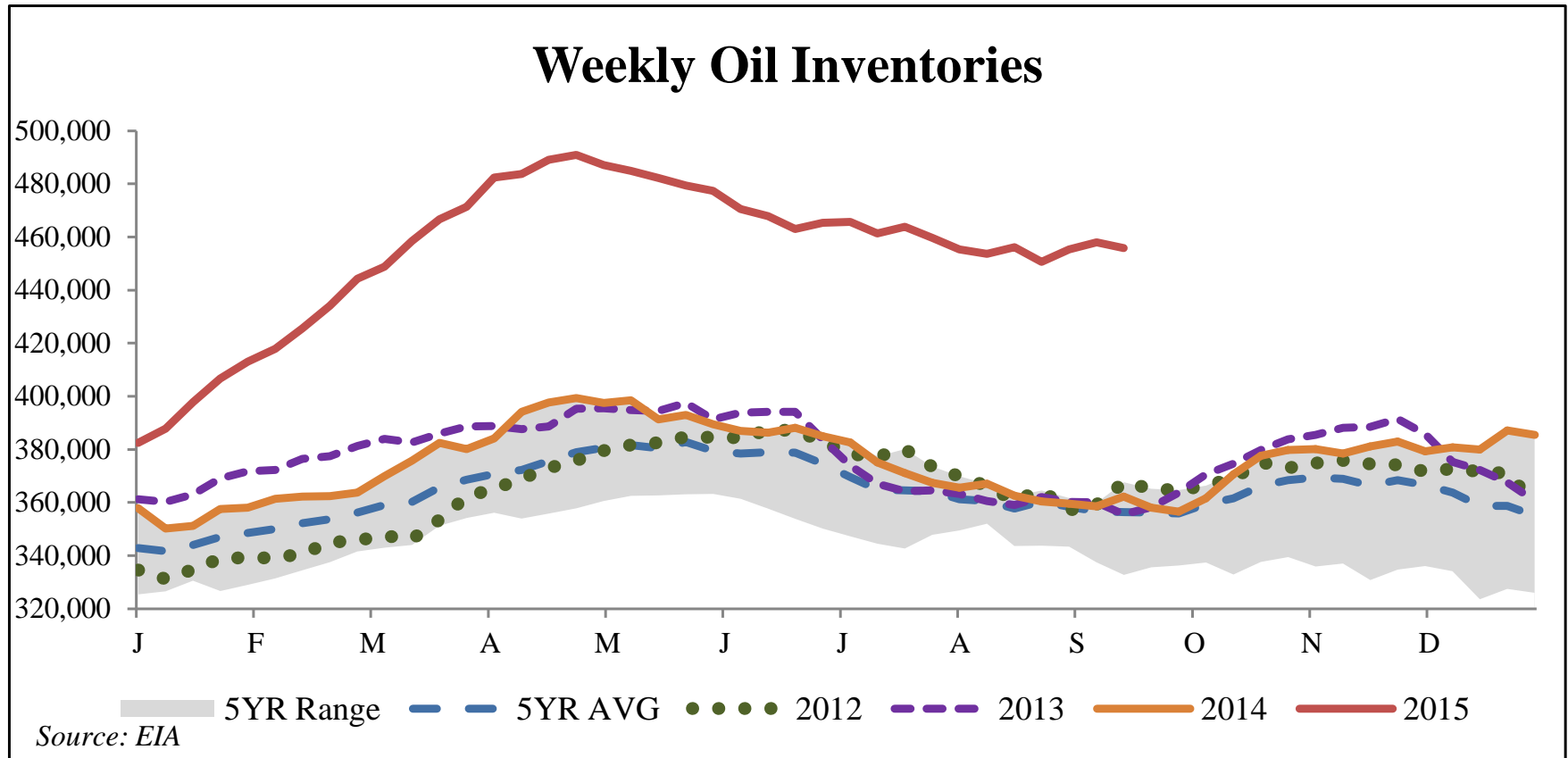
Production down ~60% over past year



Excluding price production is still up y/y

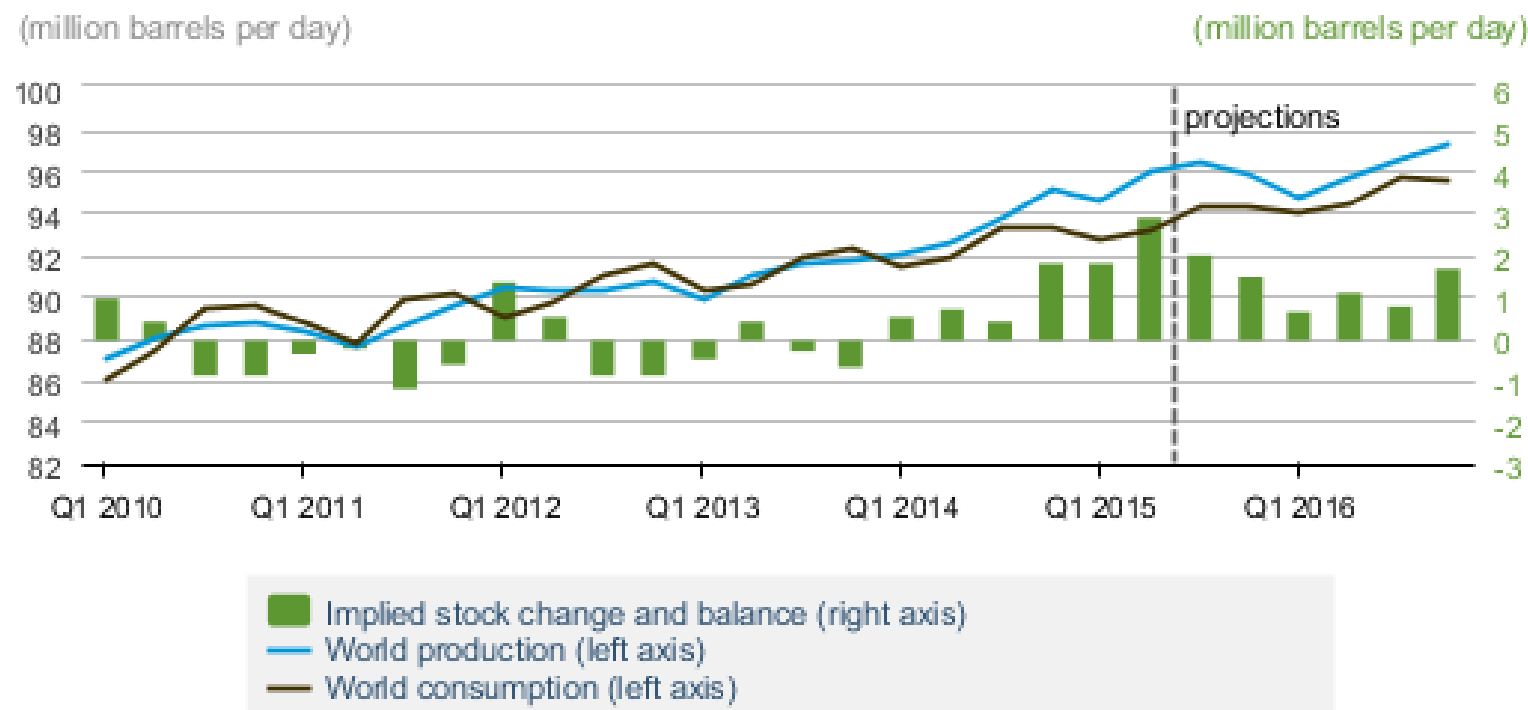


Inventories are at all-time highs



Not projected to improve

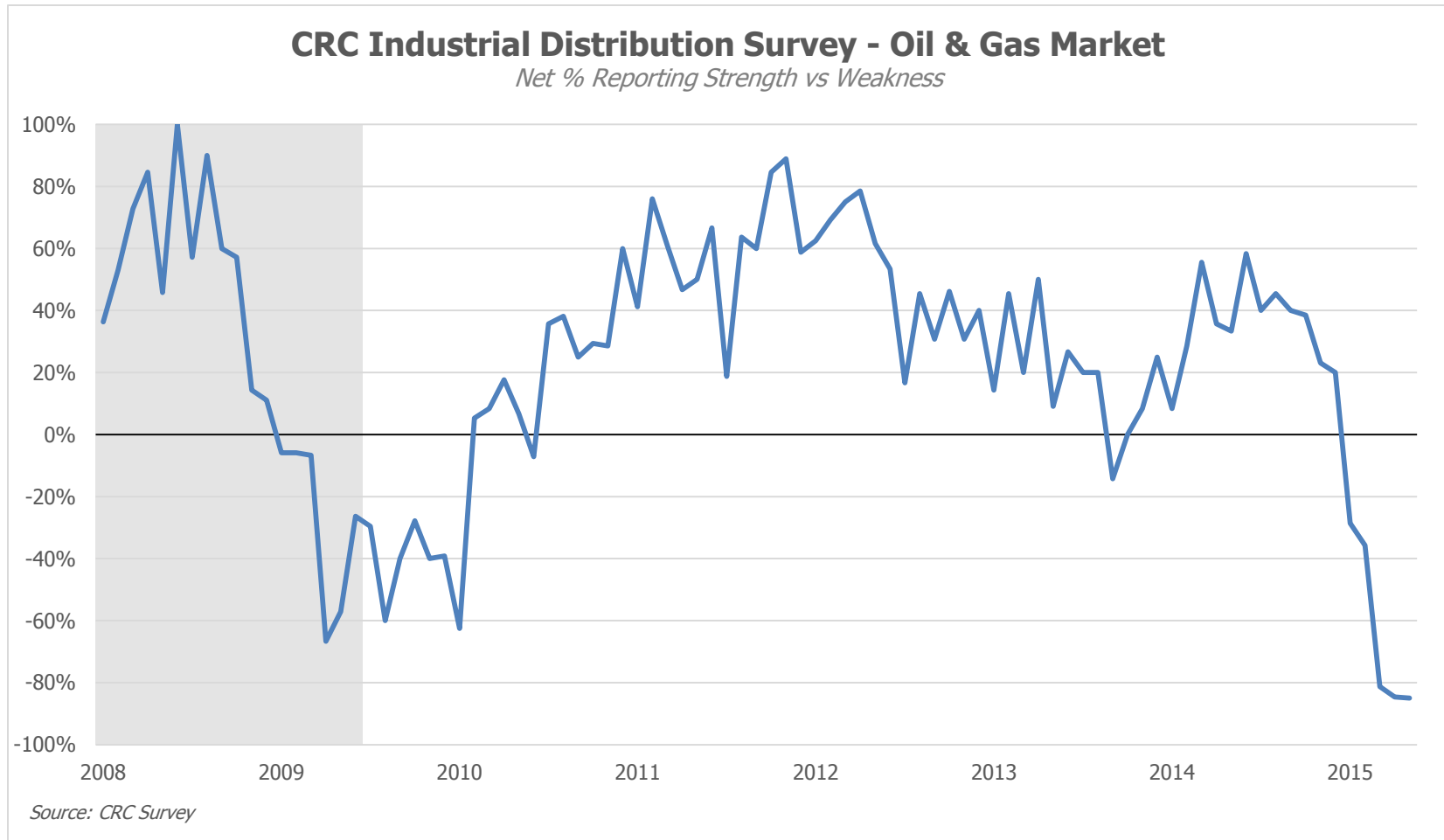
World Liquid Fuels Production and Consumption Balance



Source: Short-Term Energy Outlook, September 2015

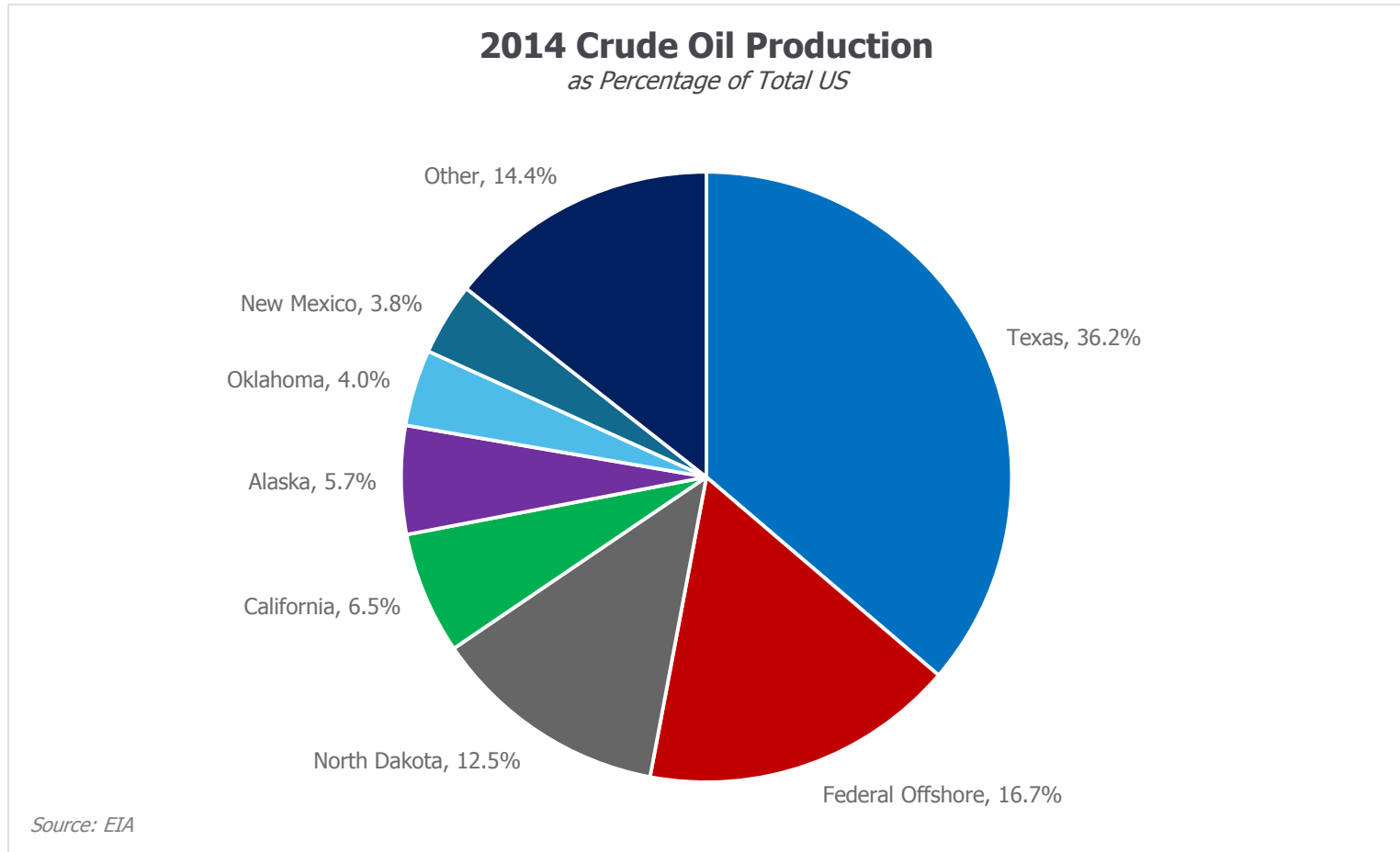


O/G weakness is spilling over to industrial



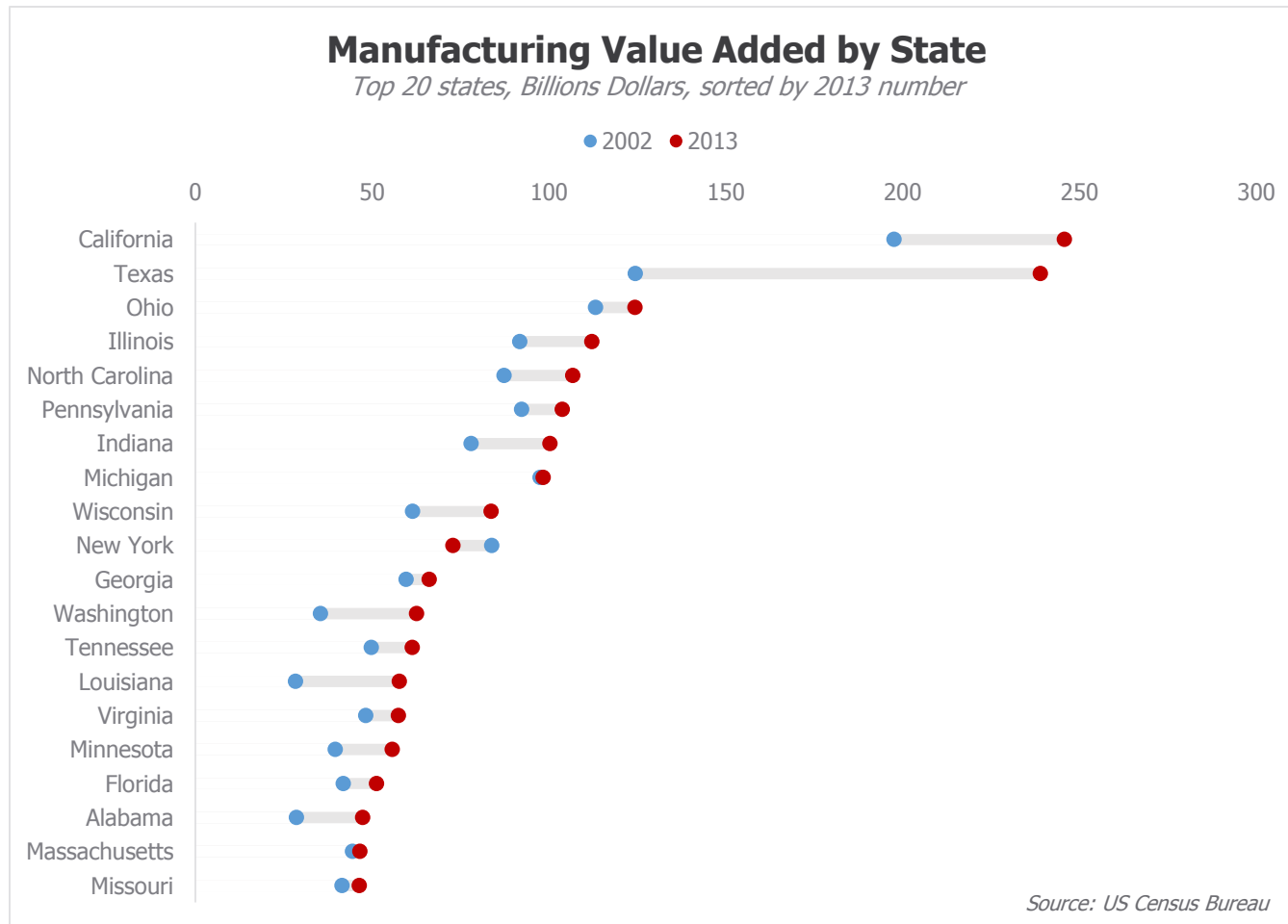
Manufacturing

Where the US Oil & Gas boom happened



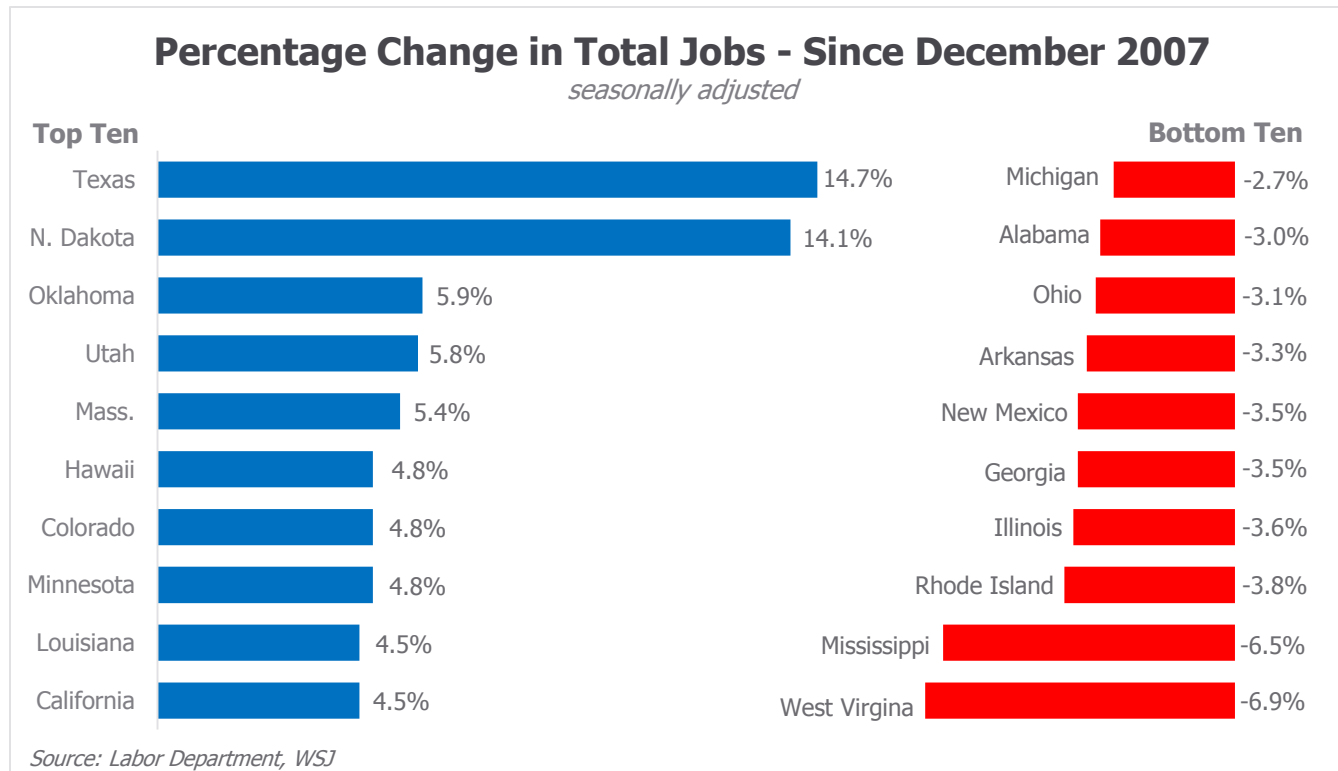
Manufacturing

Texas!



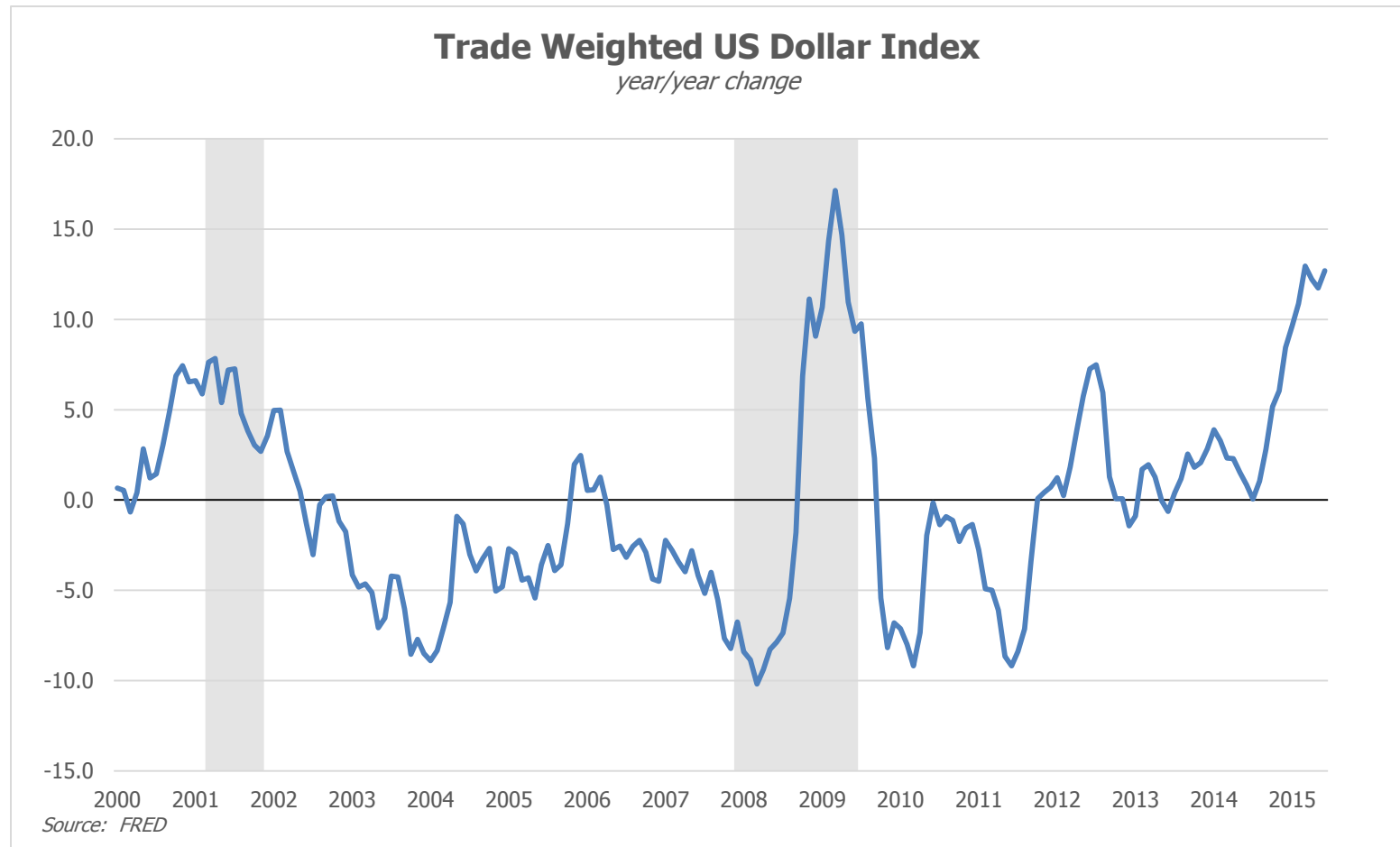
Employment

Job Growth by State, Since Start of Great Recession

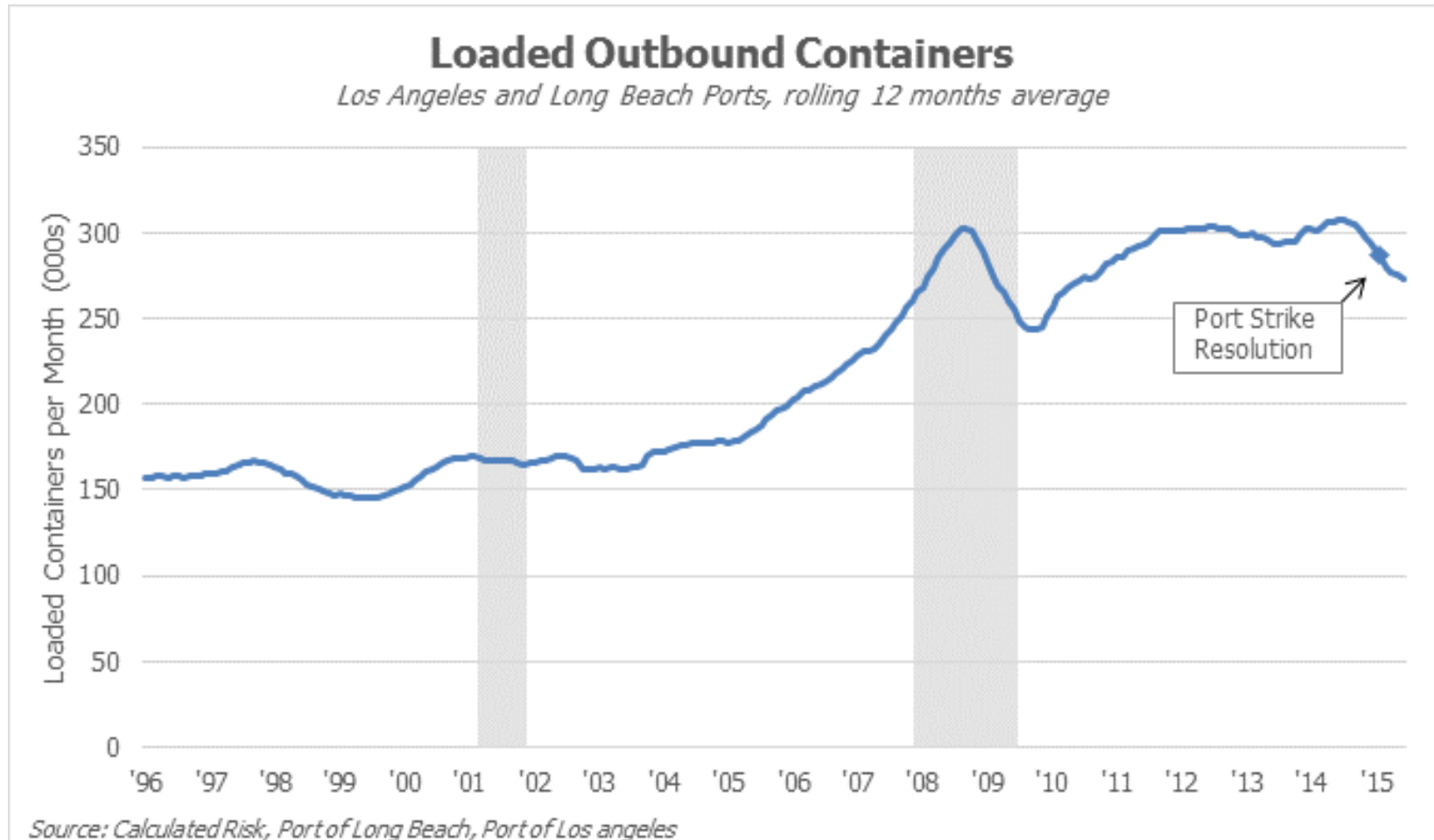


Currency headwinds

On top of Oil & Gas weakness...



US Dollar strength pressuring export demand



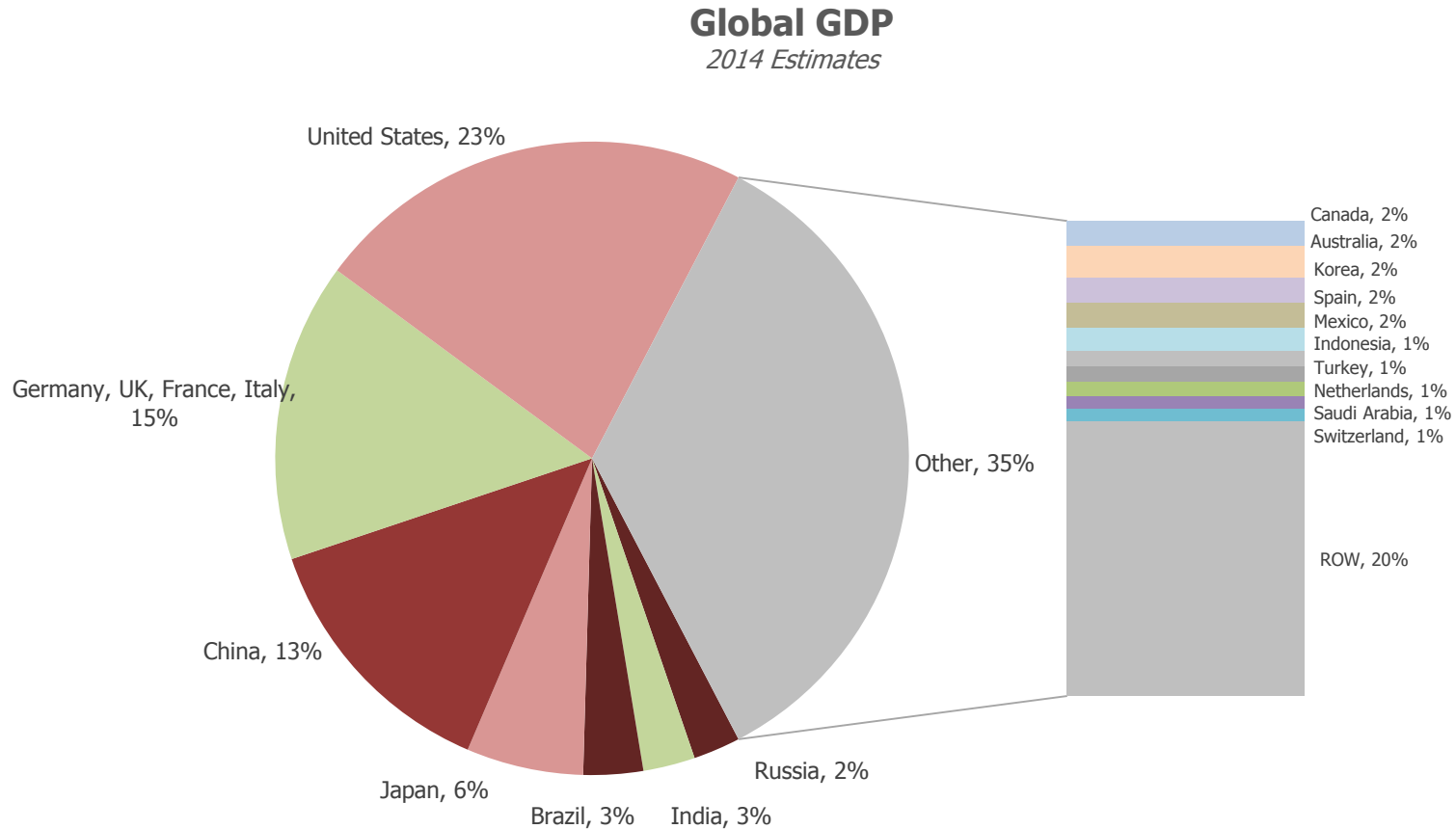
Export demand

Outsized impact to industrial & capital goods



Global Picture

Pronounced weakness in China, Russia & Brazil



Source: IMF World Economic Outlook



What matters most – employment



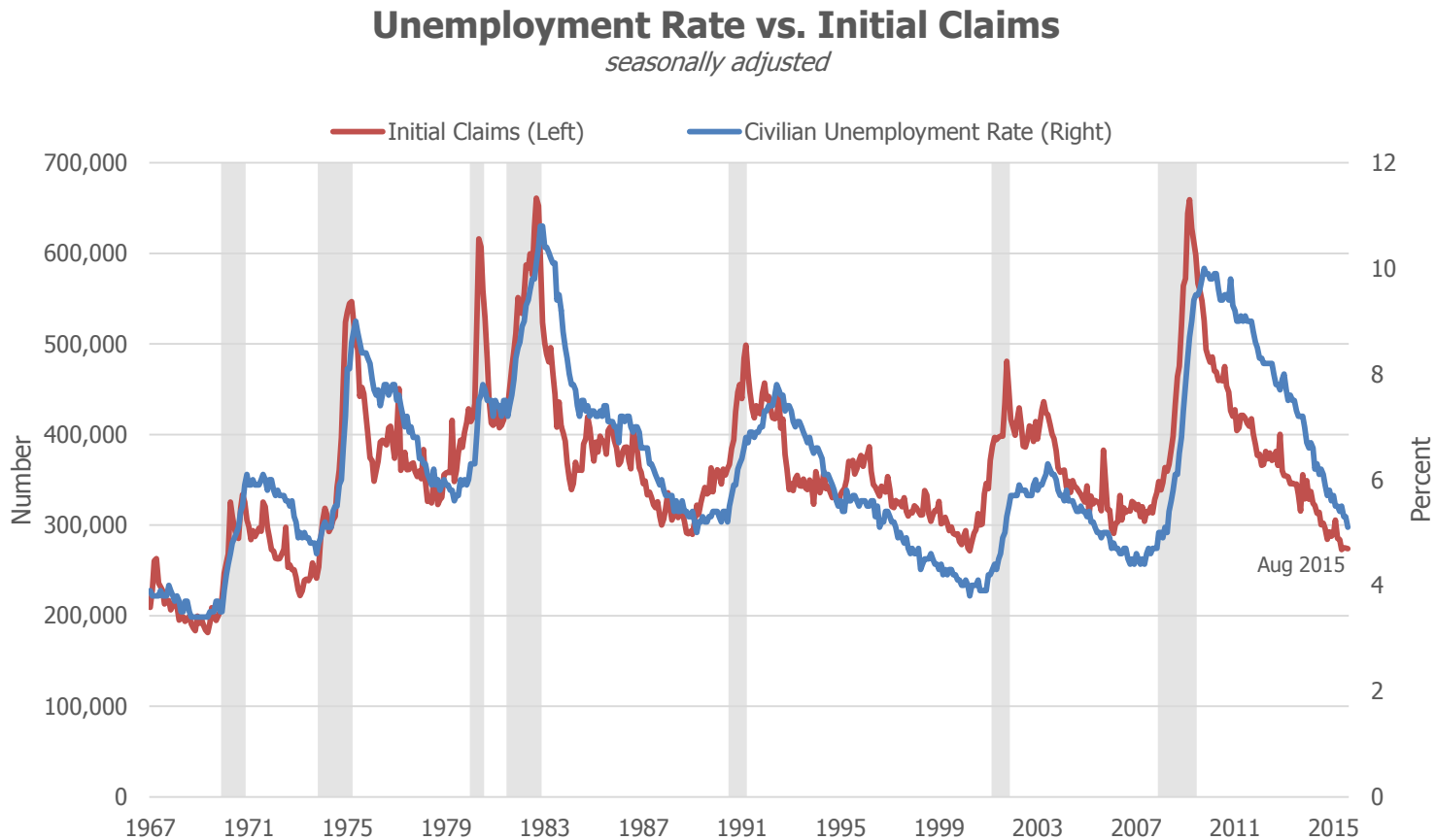
“Recession is when your neighbor loses his job. Depression is when you lose yours. And recovery is when Jimmy Carter loses his.”

— [Ronald Reagan](#)



Employment

Tough to go much lower for jobless claims and unemployment



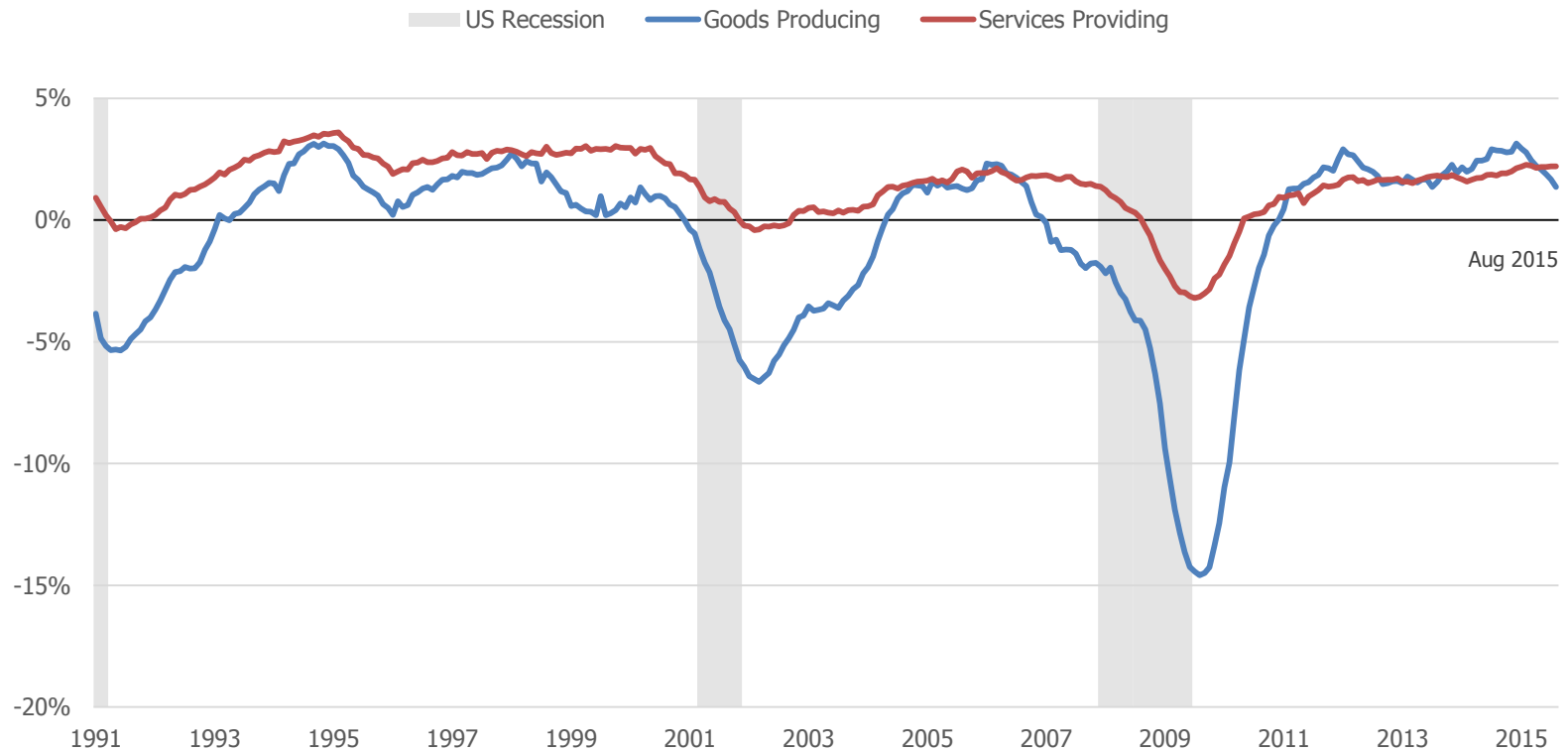
Source: FRED

Employment

Goods producing employment leads service employment

US Goods and Services Producing Employment

y/y change, correlation=0.91

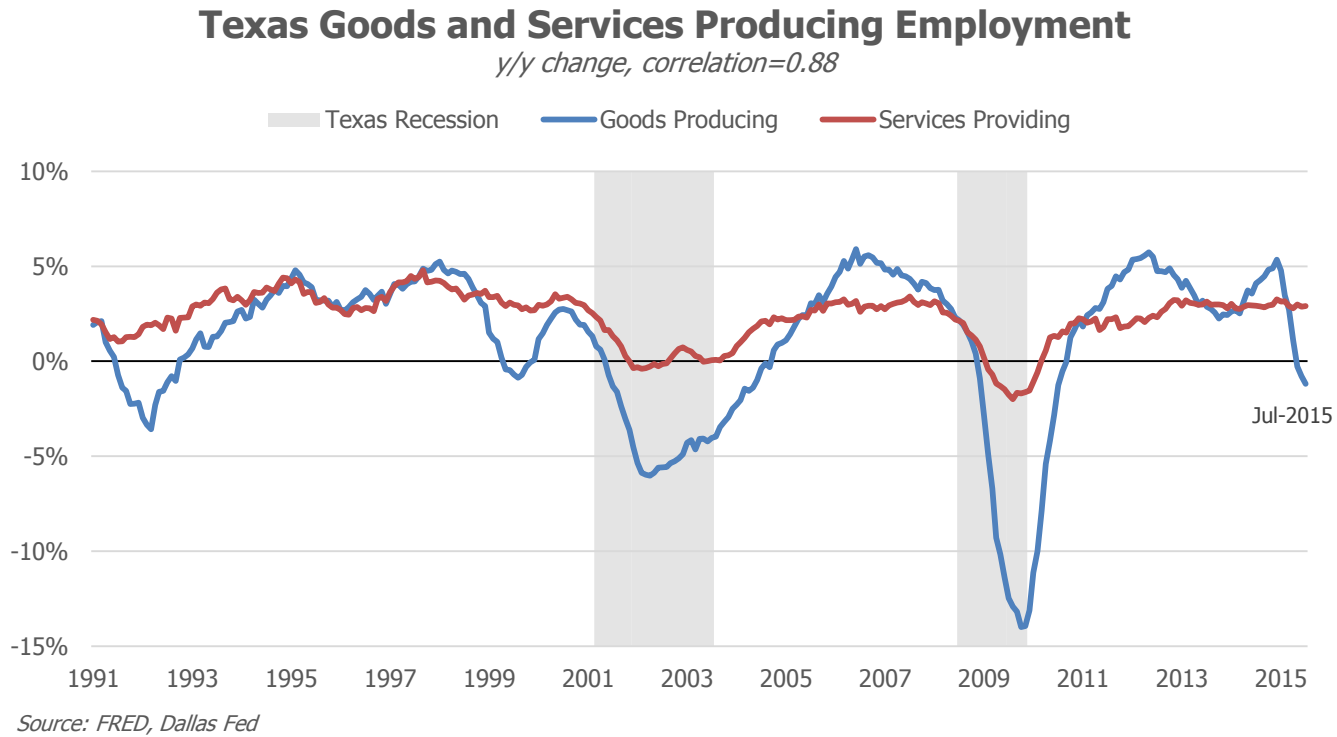


Source: FRED



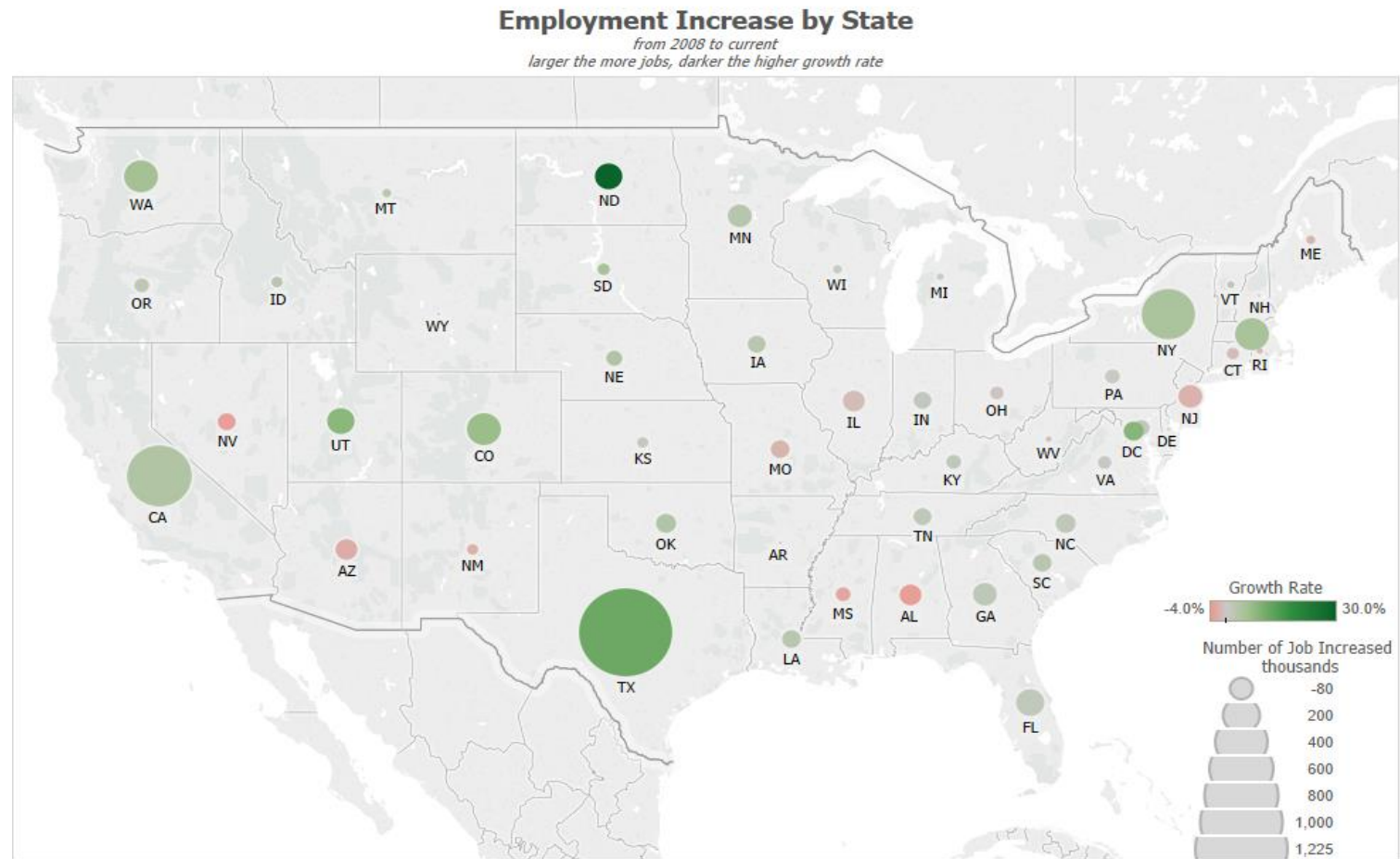
Employment

Keep an eye on Texas...



Employment

Keep an eye on Texas...



Data source: BLS

Summary Thoughts

Risk of an industrial recession is growing by the day

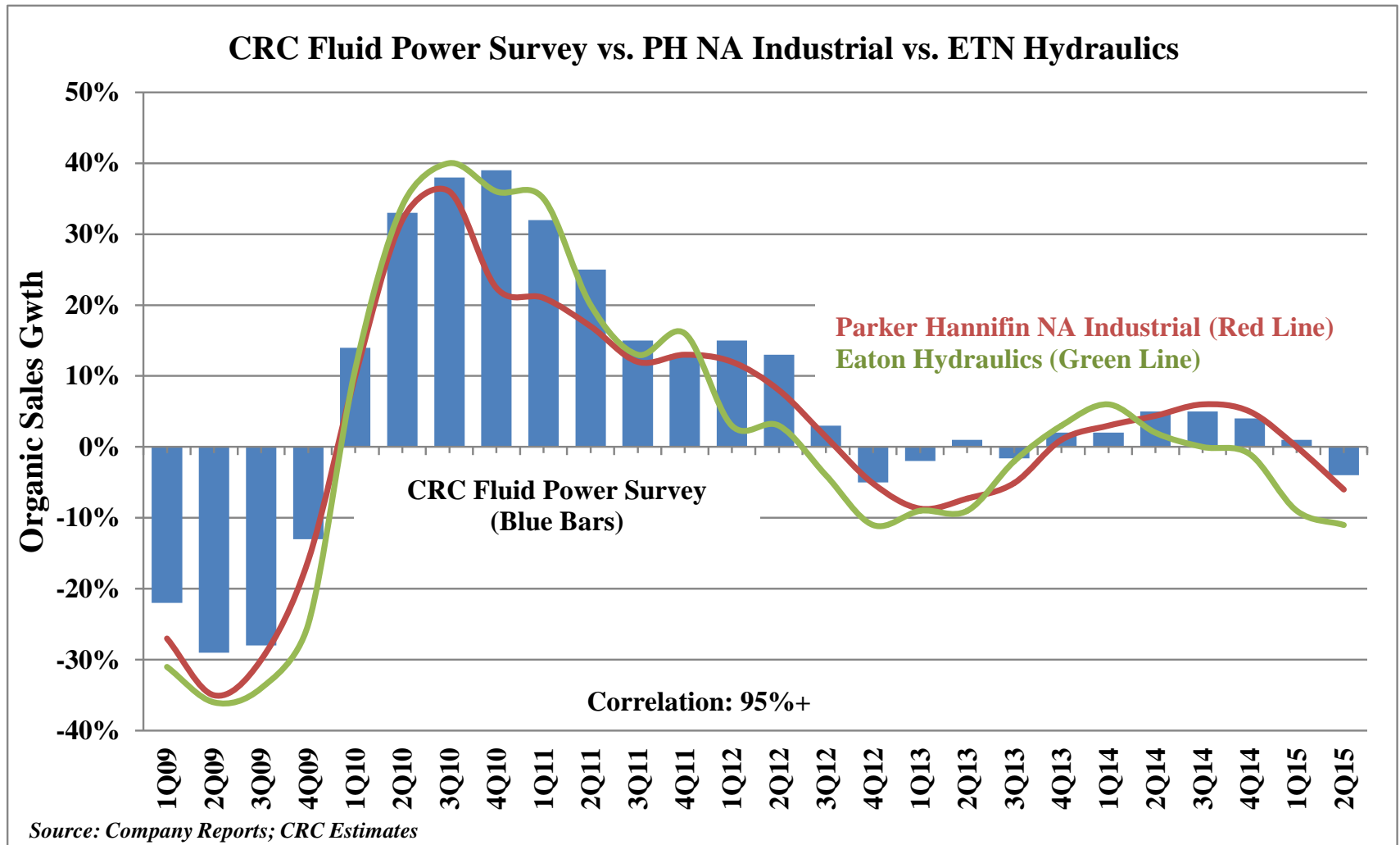
- Tough to overstate the importance of oil & gas to industrial growth over the past 5 years
- Strong dollar and sluggish international markets not helping
- Thankfully the Fed postponed a rate hike last week



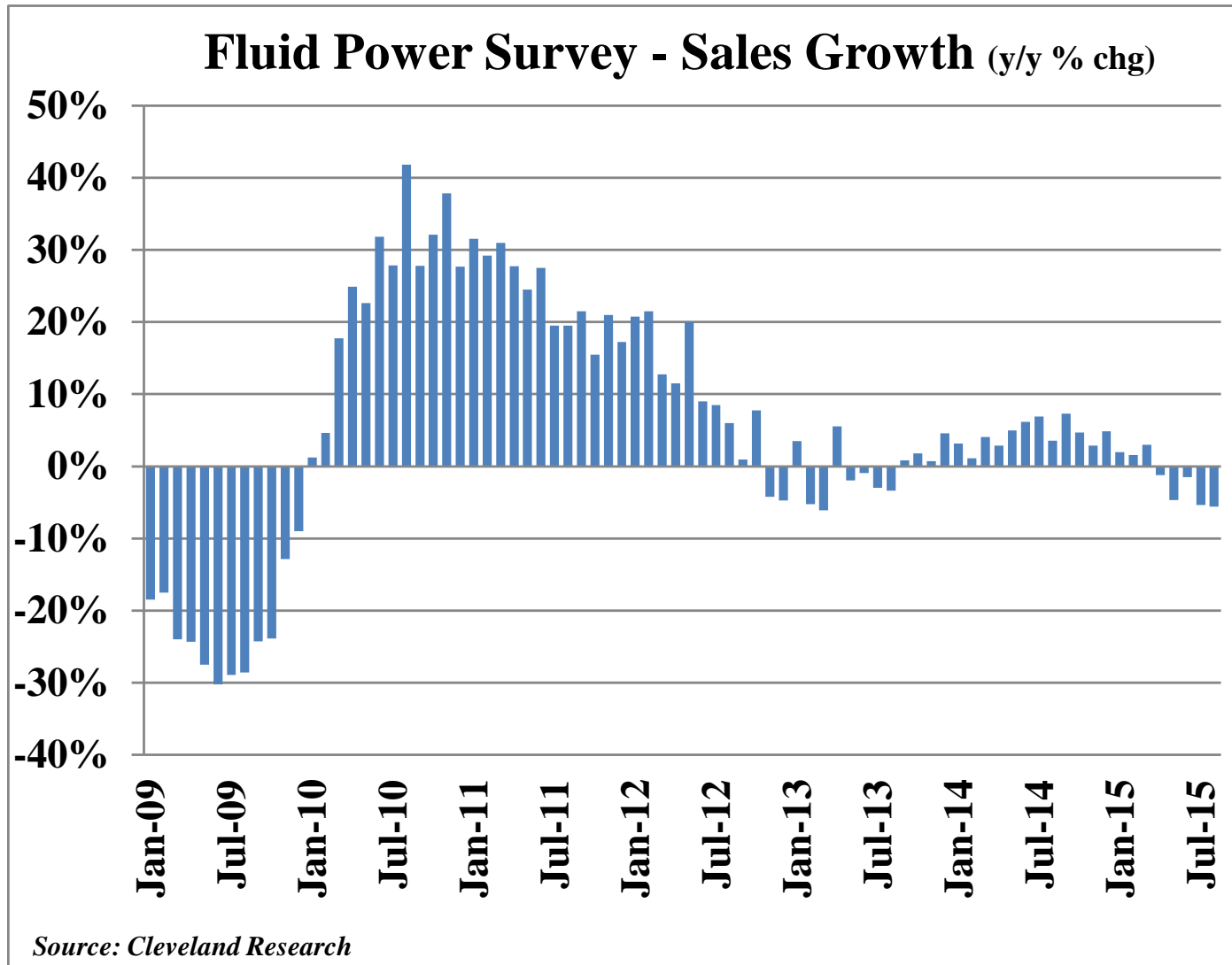
FPDA / ISD Market Trends



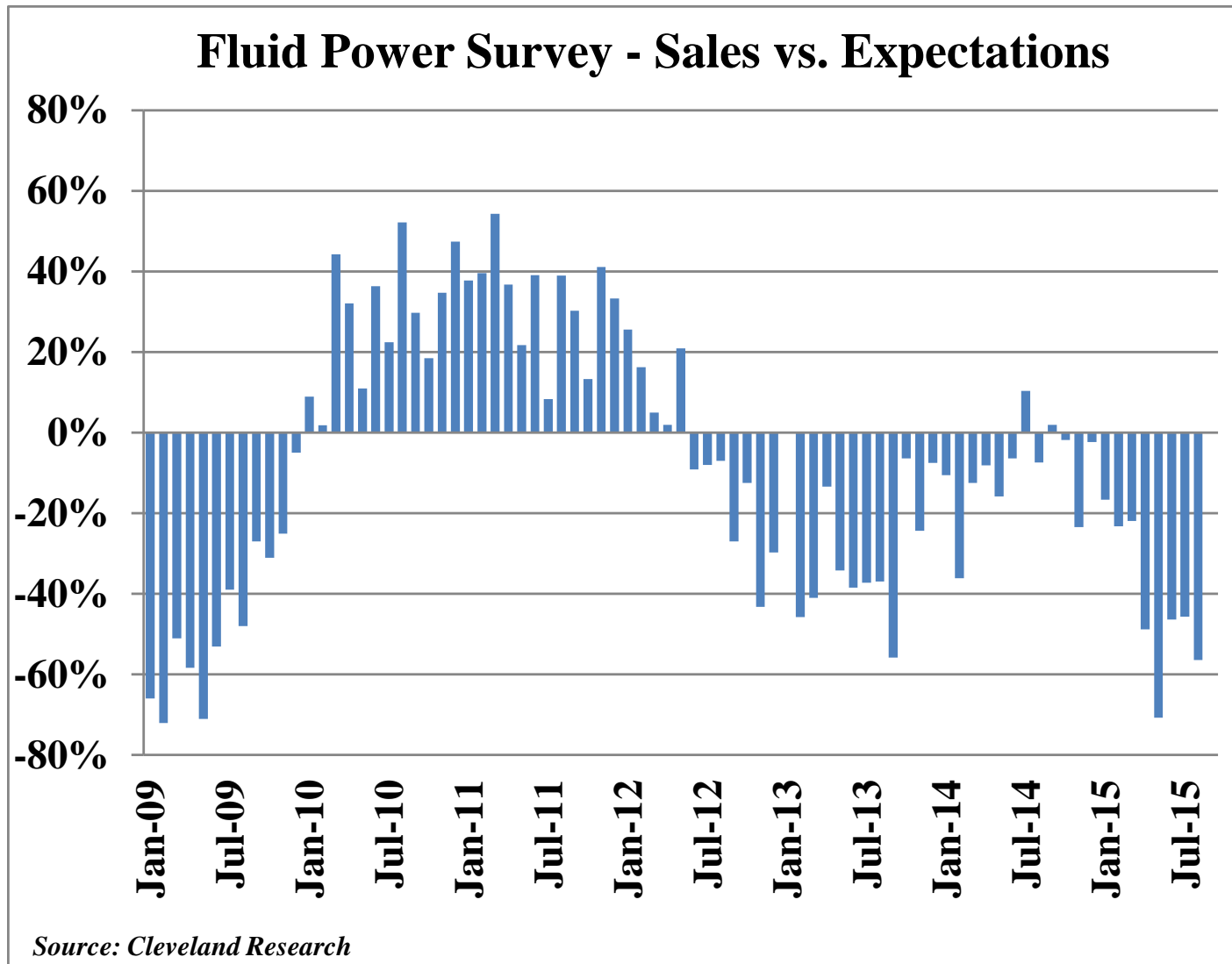
Fluid Power Industry Survey



Negative Sales Growth Past Five Months

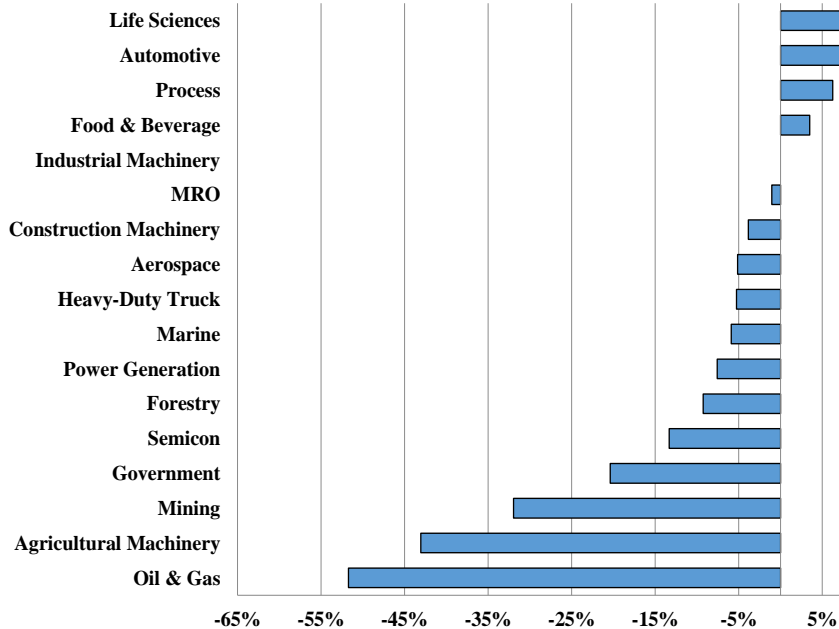


Results Have Been Disappointing



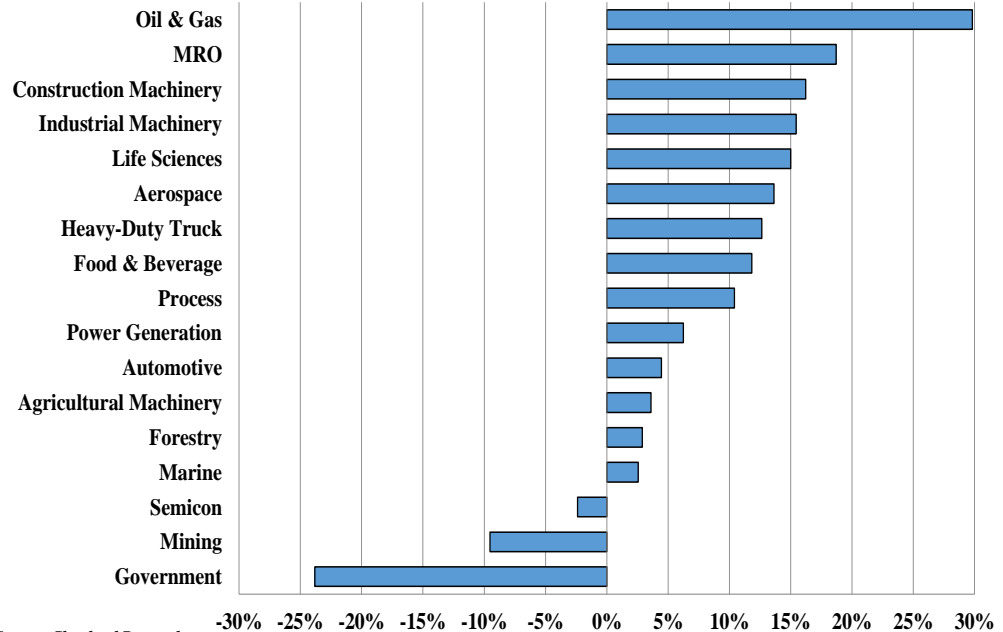
End Markets: Quite a Contrast

End Market Ranking (Net % Strong - Weak)
August 2015



Source: Cleveland Research

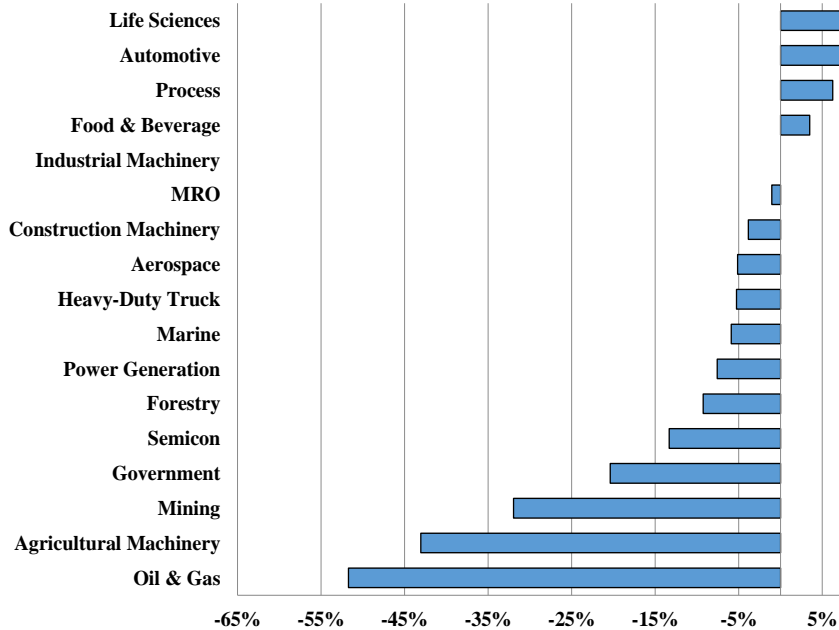
End Market Ranking (Net % Strong - Weak)
August 2014



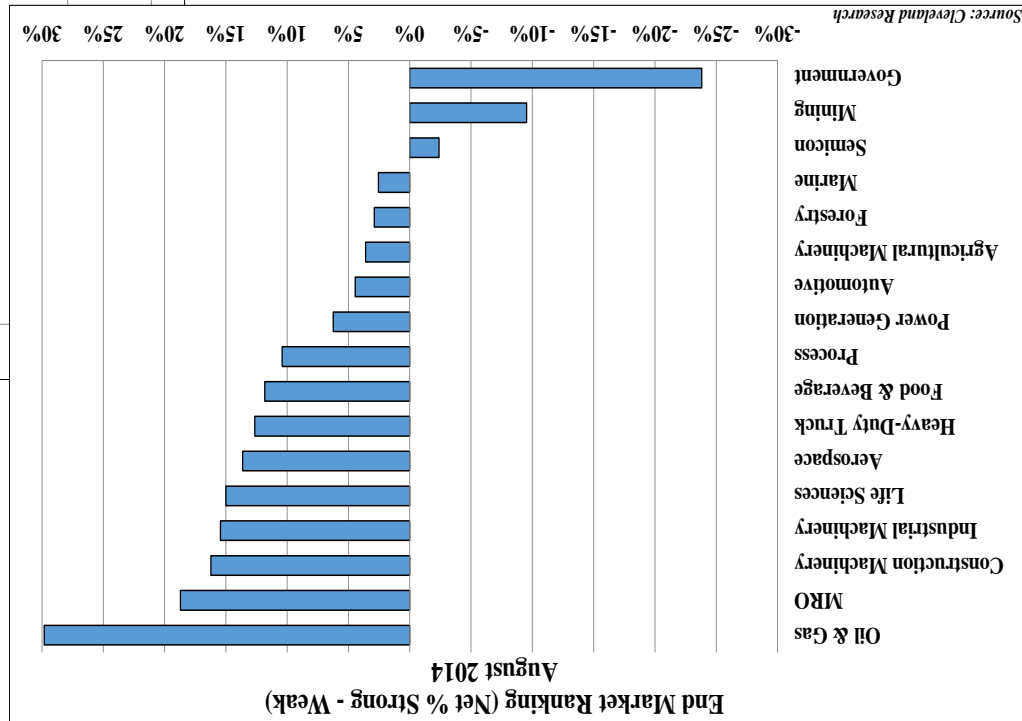
Source: Cleveland Research

End Markets: Literally turned on its head

End Market Ranking (Net % Strong - Weak)
August 2015



Source: Cleveland Research

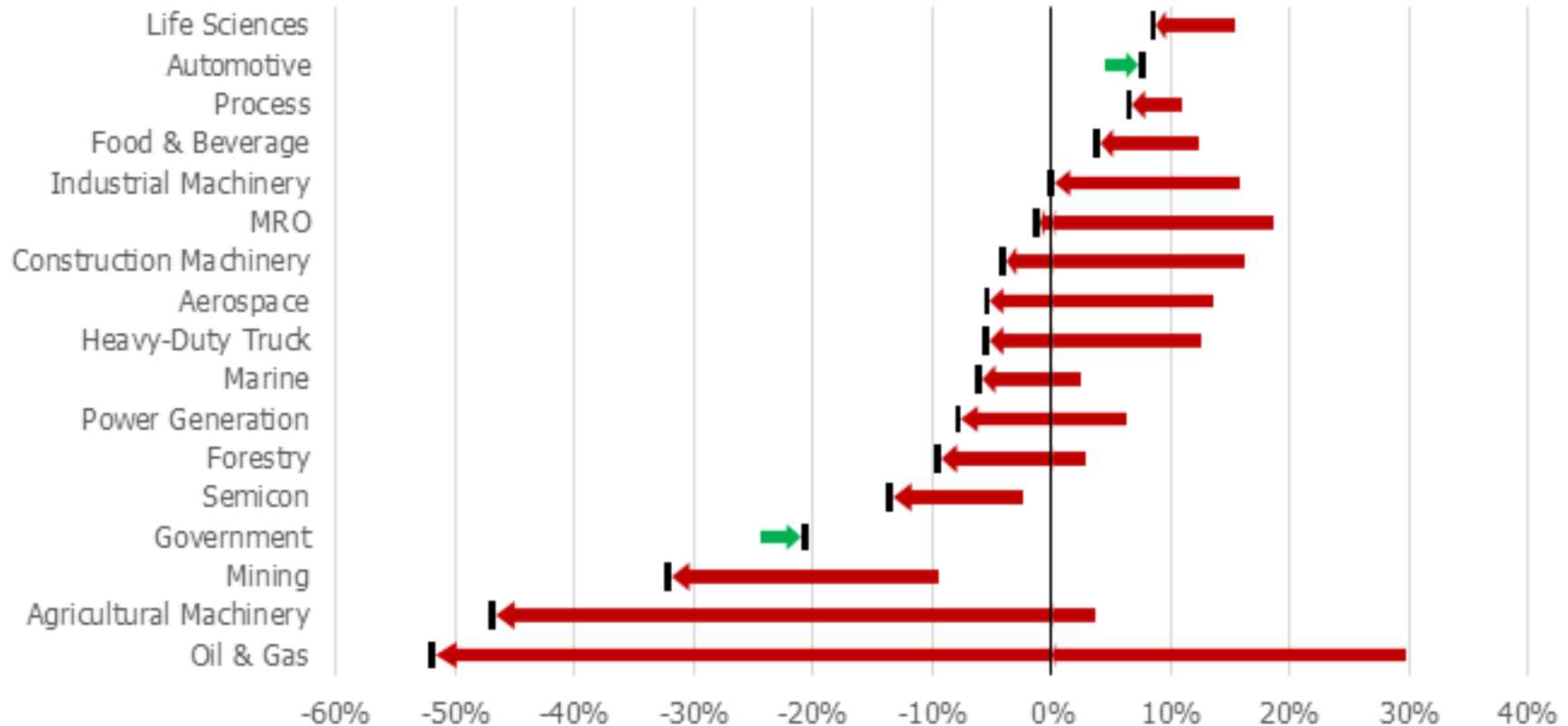


Source: Cleveland Research

End Markets: A Different View

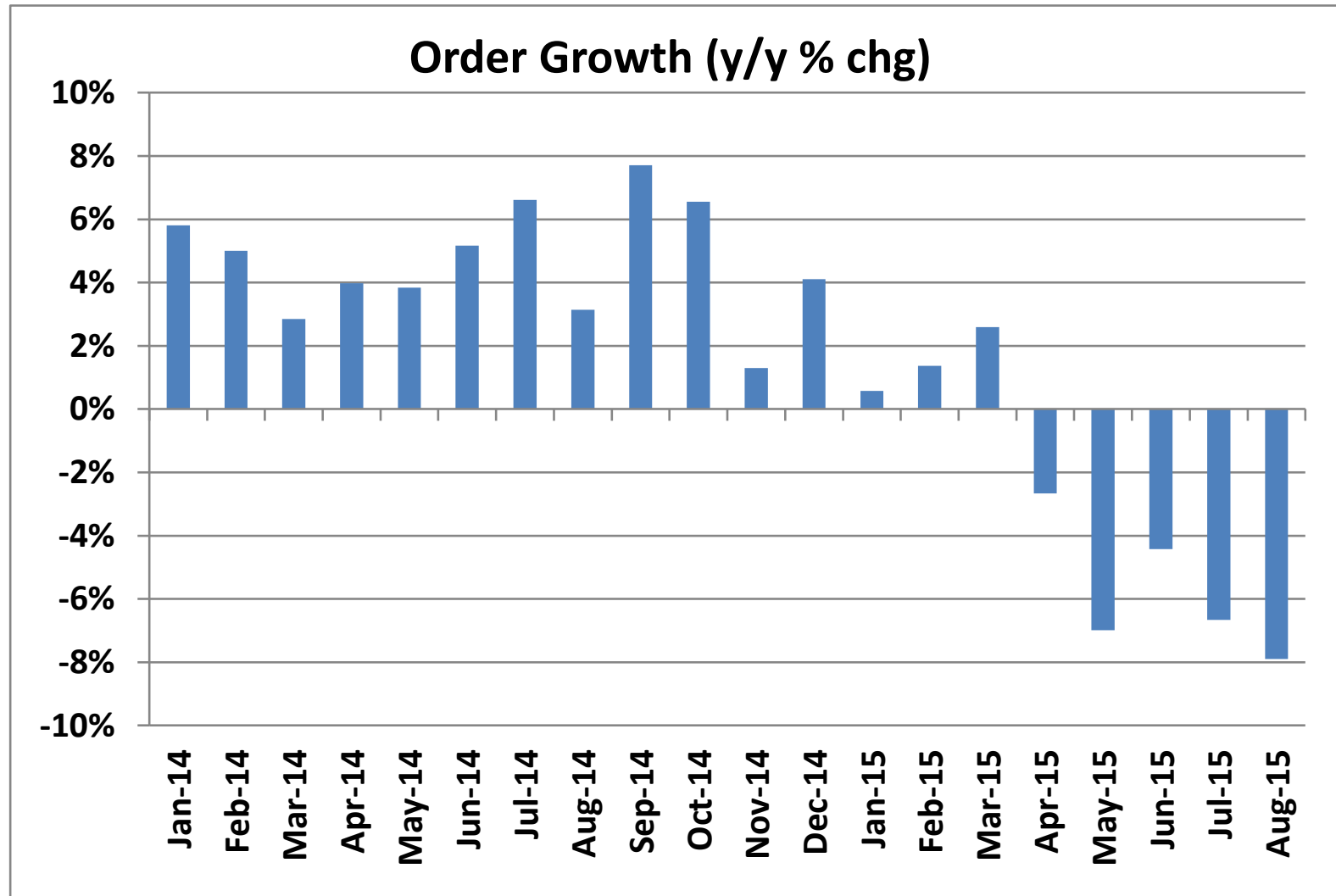
CRC Fluid Power Survey - End Market Strength

Net % of Reporting Strength/Weakness in Aug 2015; Arrows show change vs Aug 2014

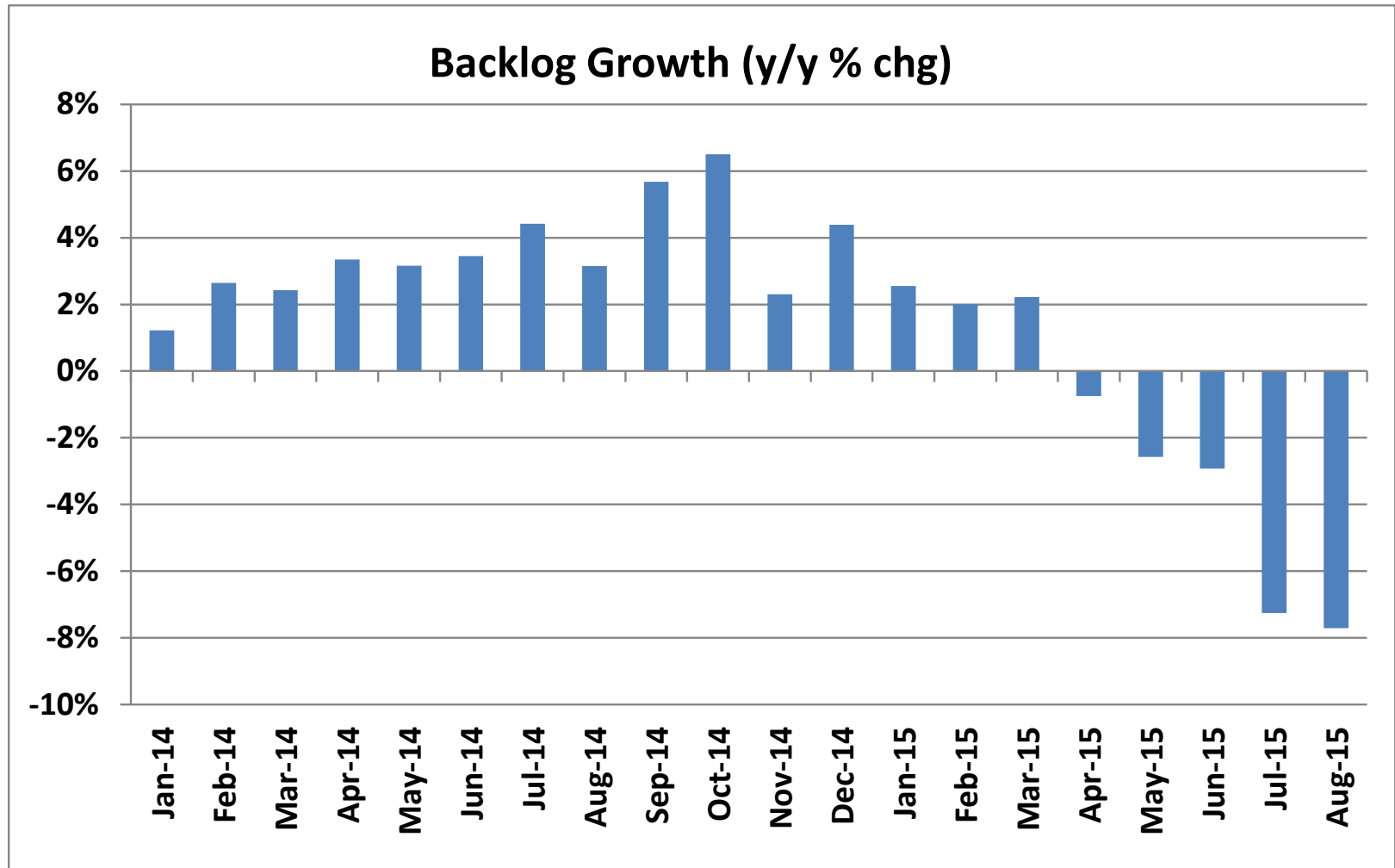


Source: CRC Fluid Power Survey

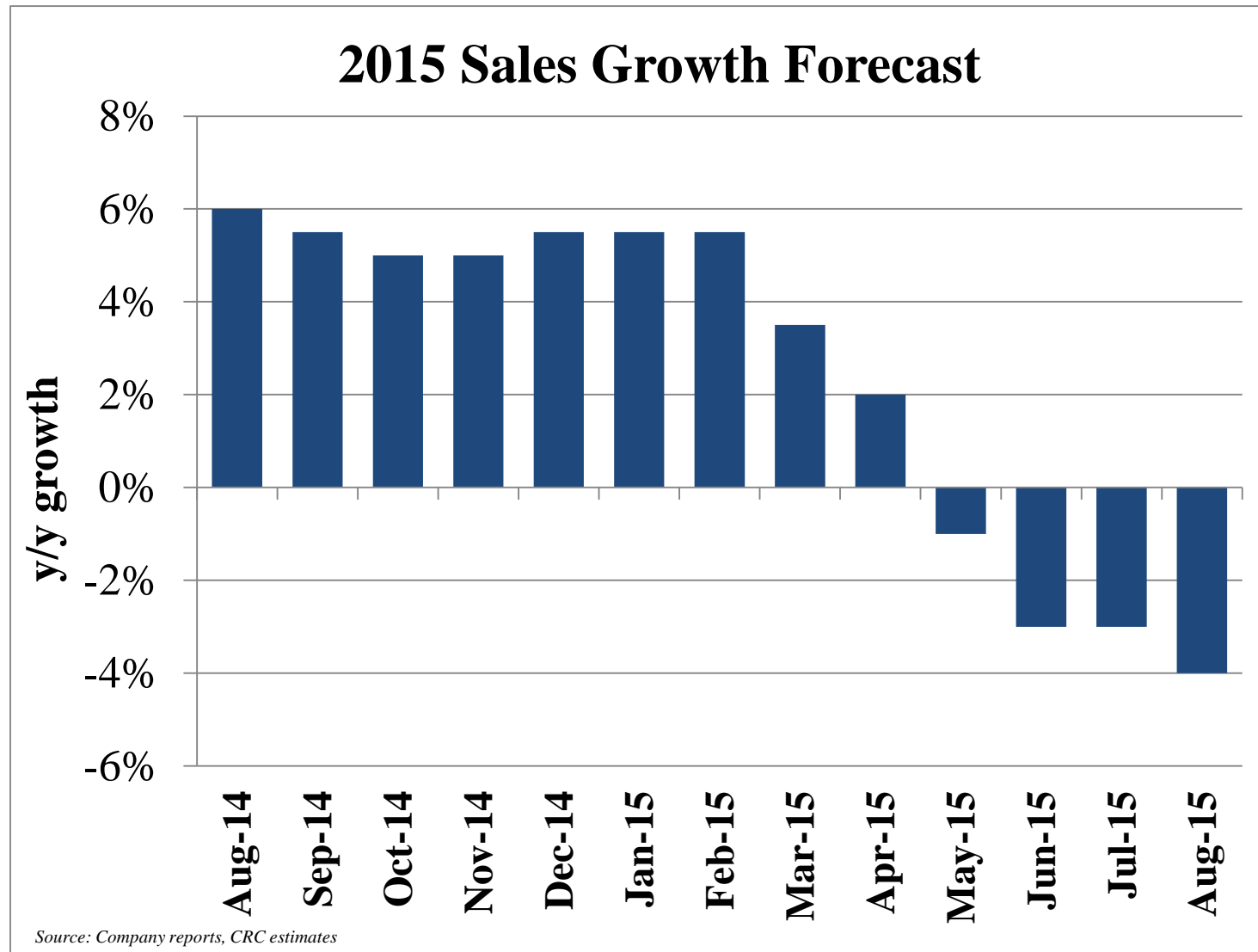
Weak Orders



Declining Backlogs



Outlook Down 1000bps



End Market Review / 2016 Outlook

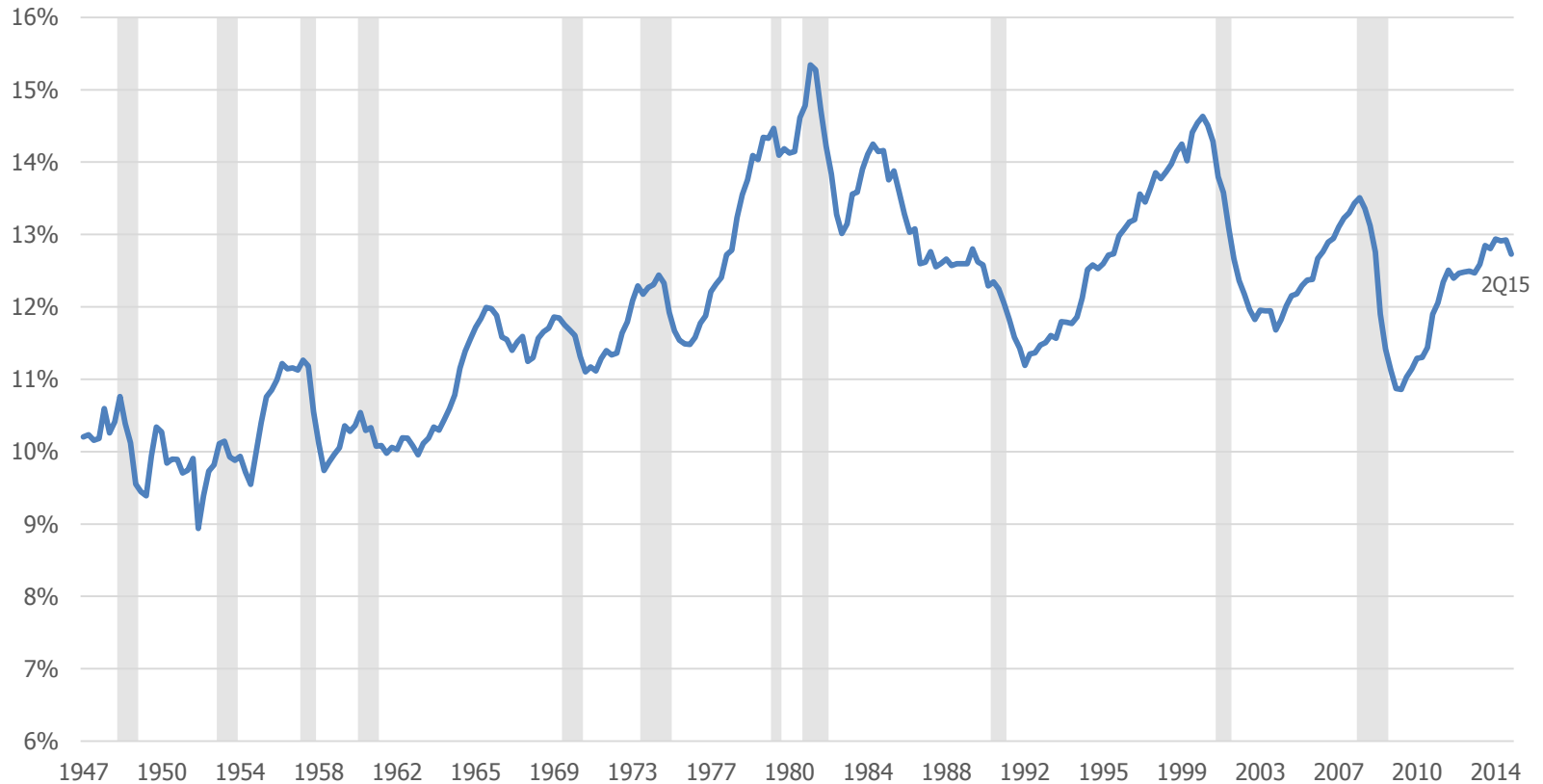


Capital spending cycle

Showing signs of a top

Capital Spending As % of US GDP

Nominal



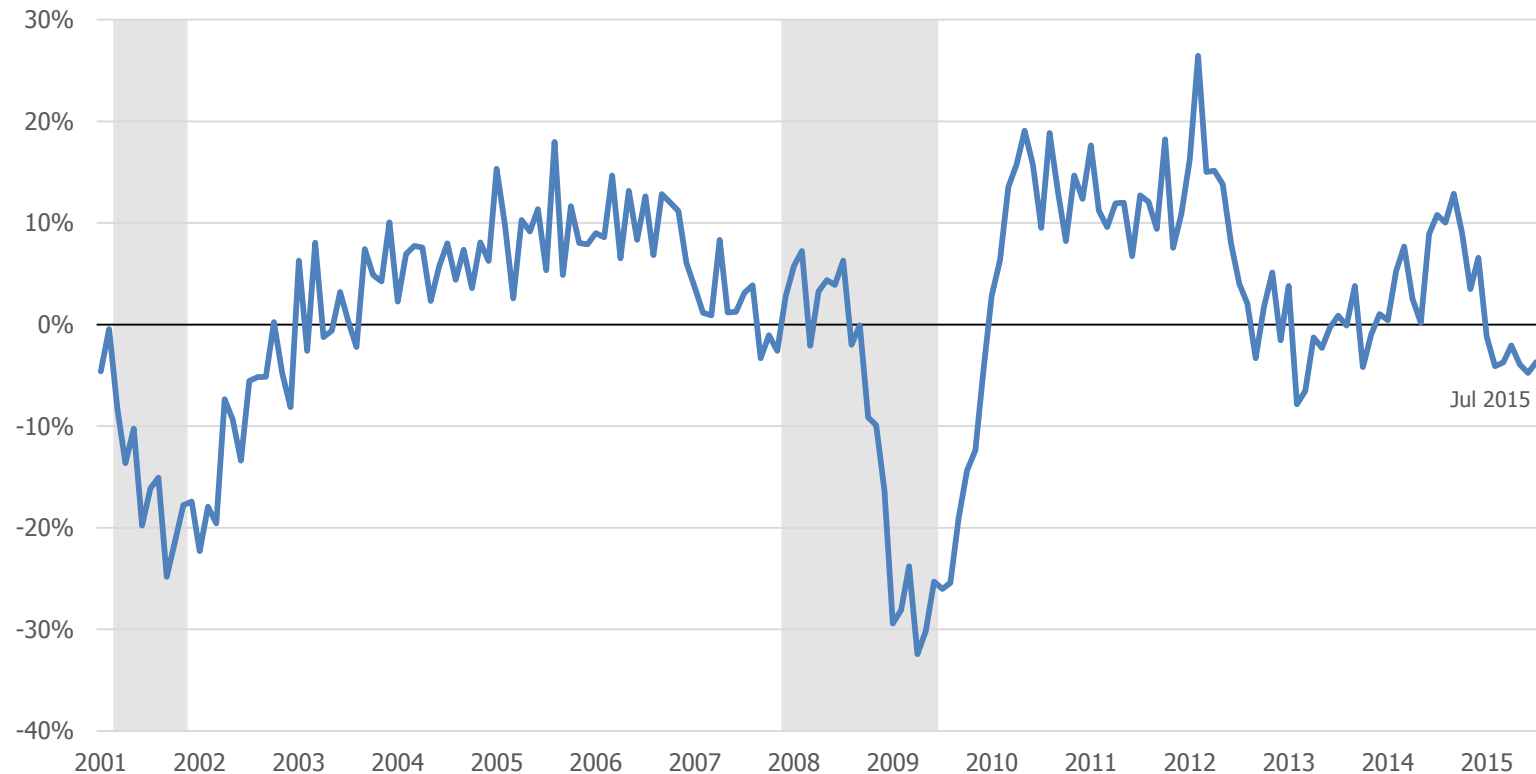
Source: FRED



Capital spending cycle

Capital goods orders rolling over

Manufacturers' New Orders: Nondefense Capital Goods ex Aircraft
Non seasonally adjusted, y/y change



Source: US Census Bureau

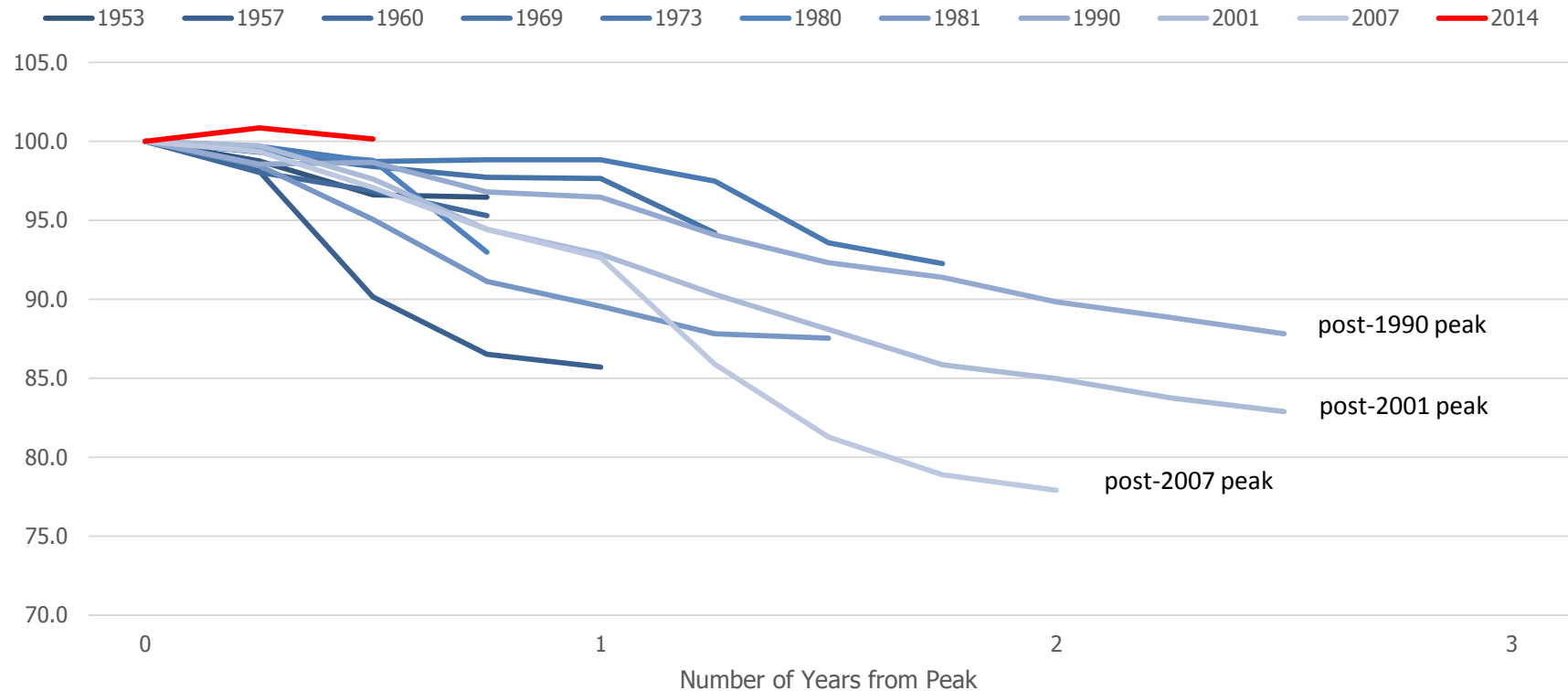


Capital spending cycle

When it turns it doesn't come back for awhile

Capital Spending Cycle - Peak to Trough

Index Fixed Investment Peak=100, Inflation Adjusted

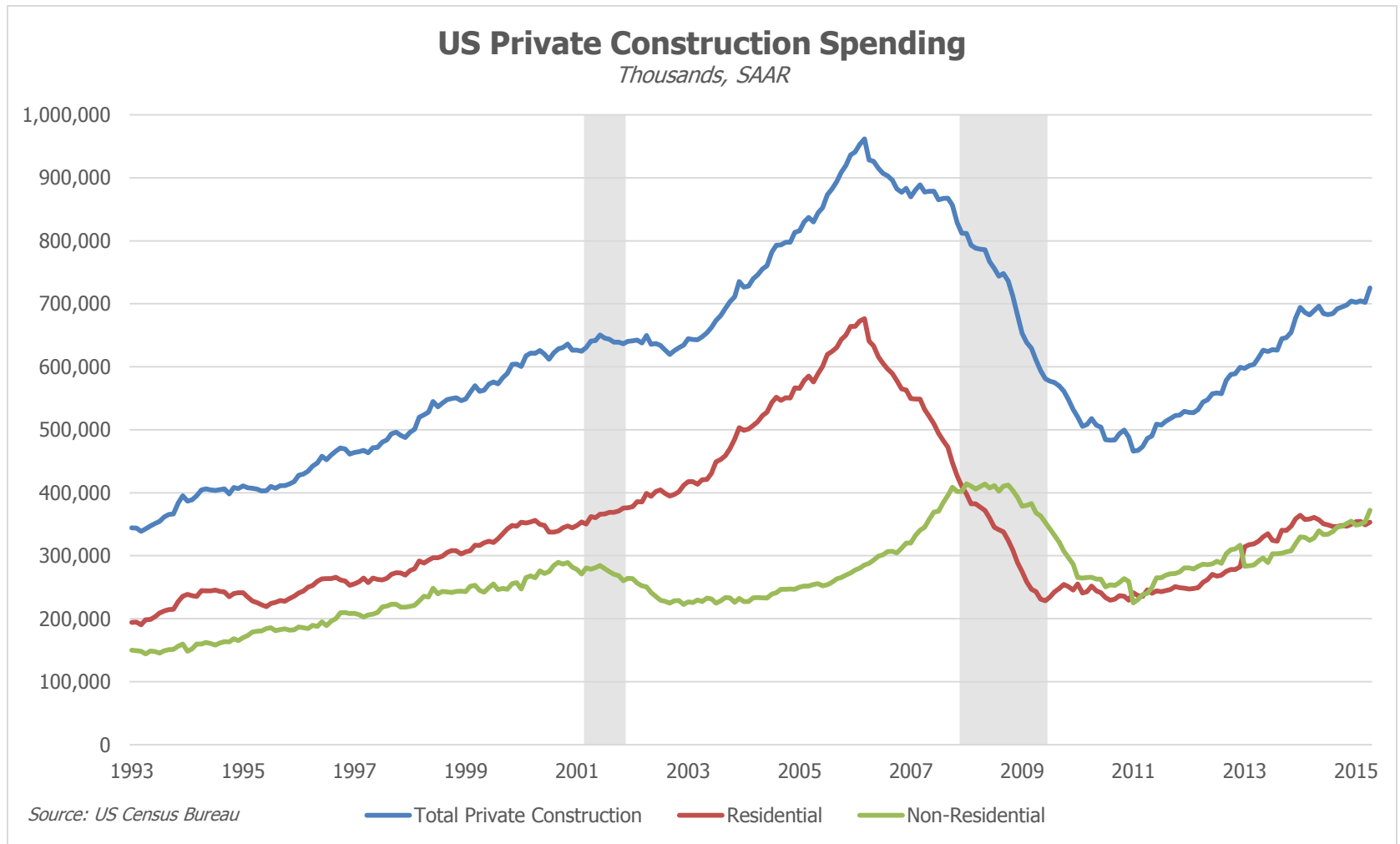


Source: FRED



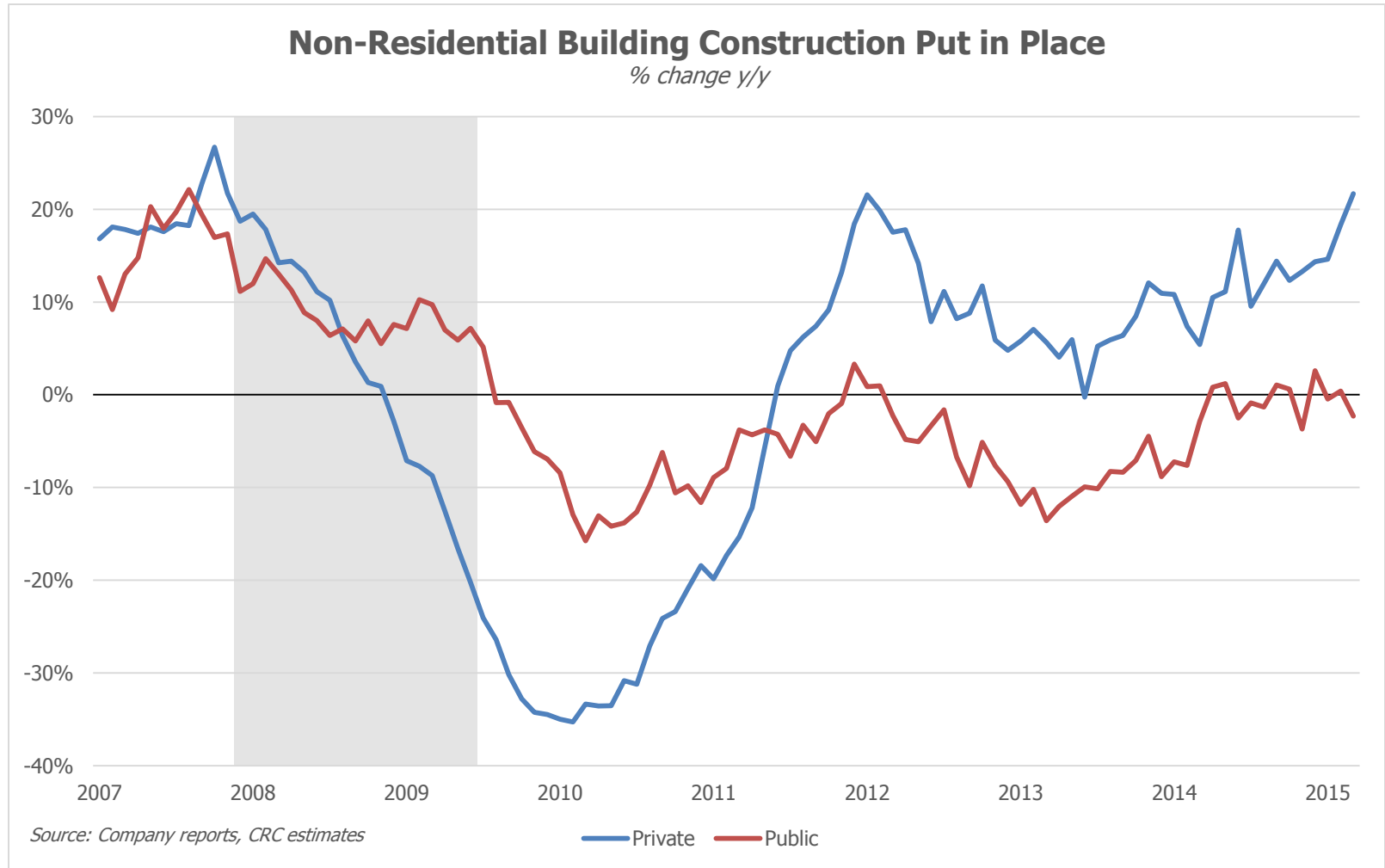
Construction / Construction Equipment

Residential & Non-Residential – long cycles



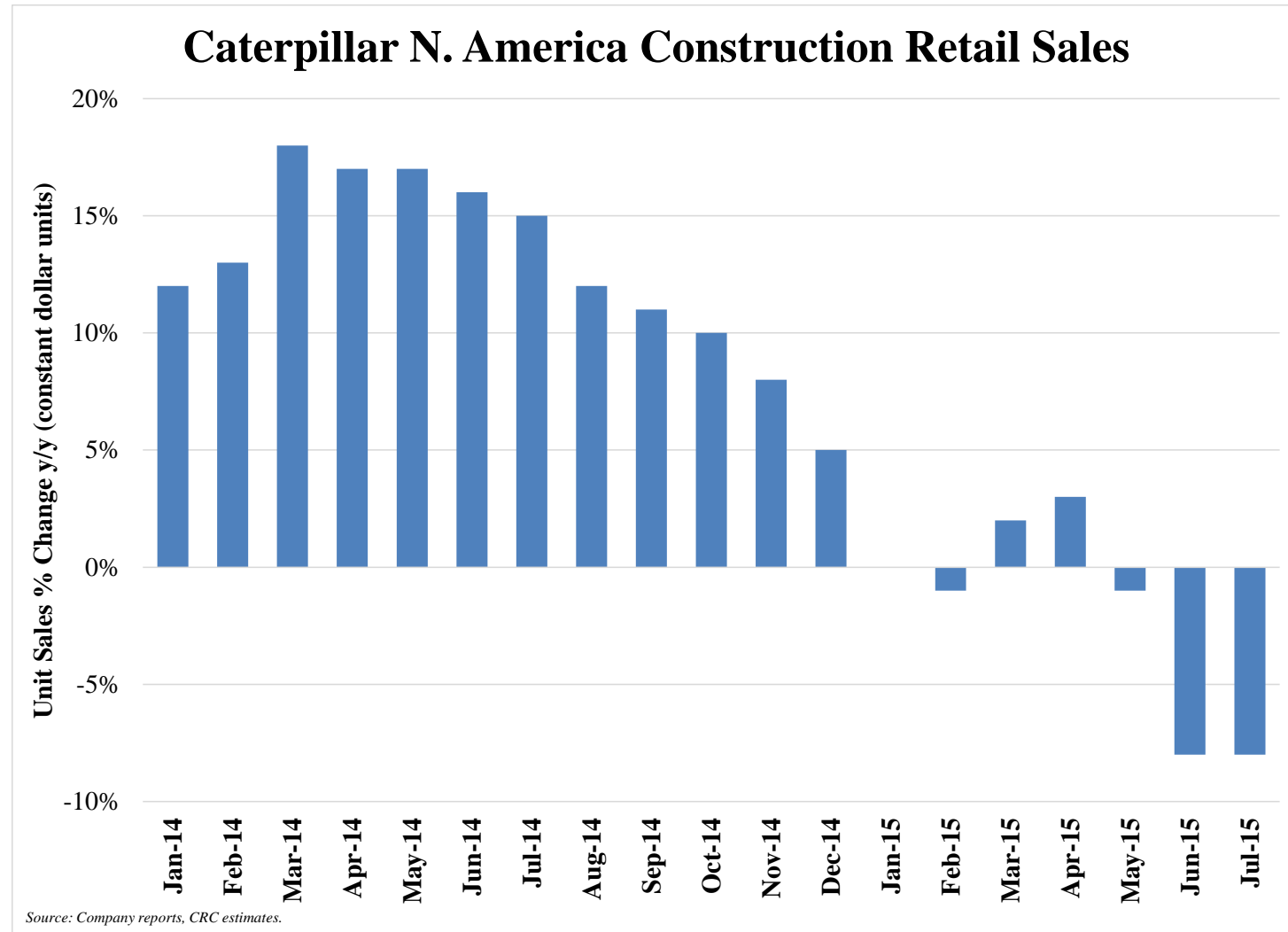
Construction / Construction Equipment

Non-Residential - acceleration in 2015 driven by private investment



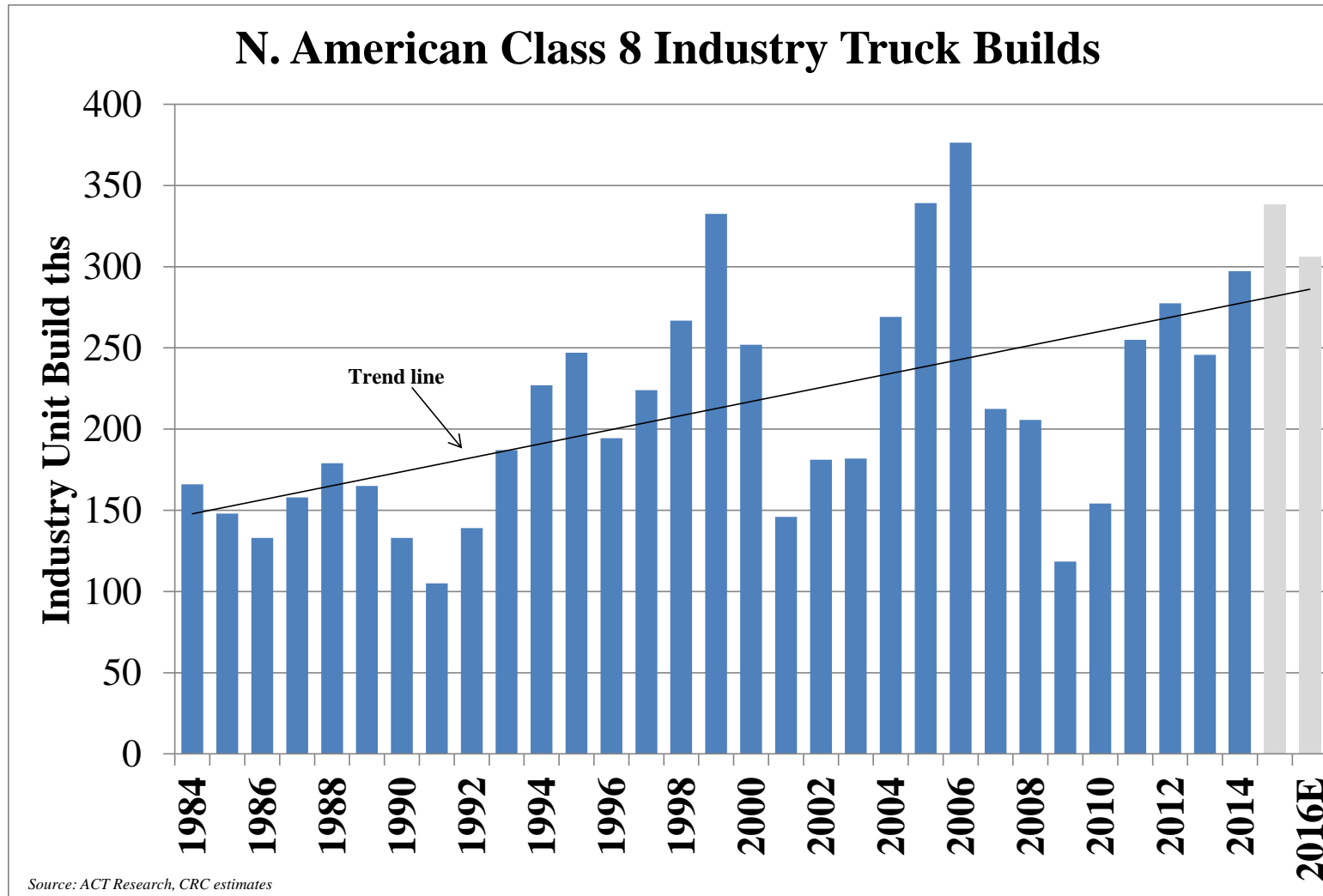
Construction Equipment

Oil & gas weighing on otherwise healthy market



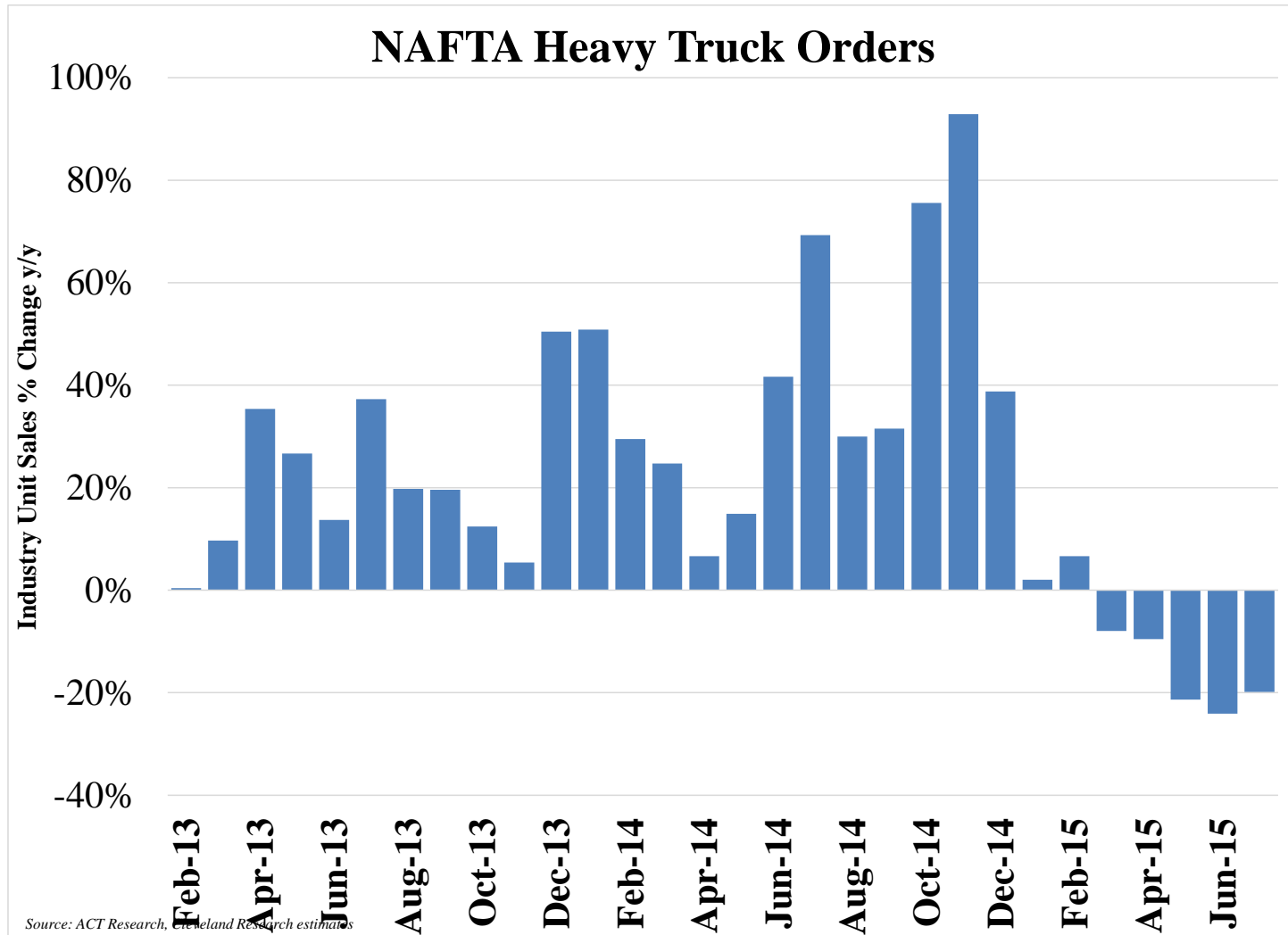
Heavy-Duty Truck

Builds to grow 10% this year...



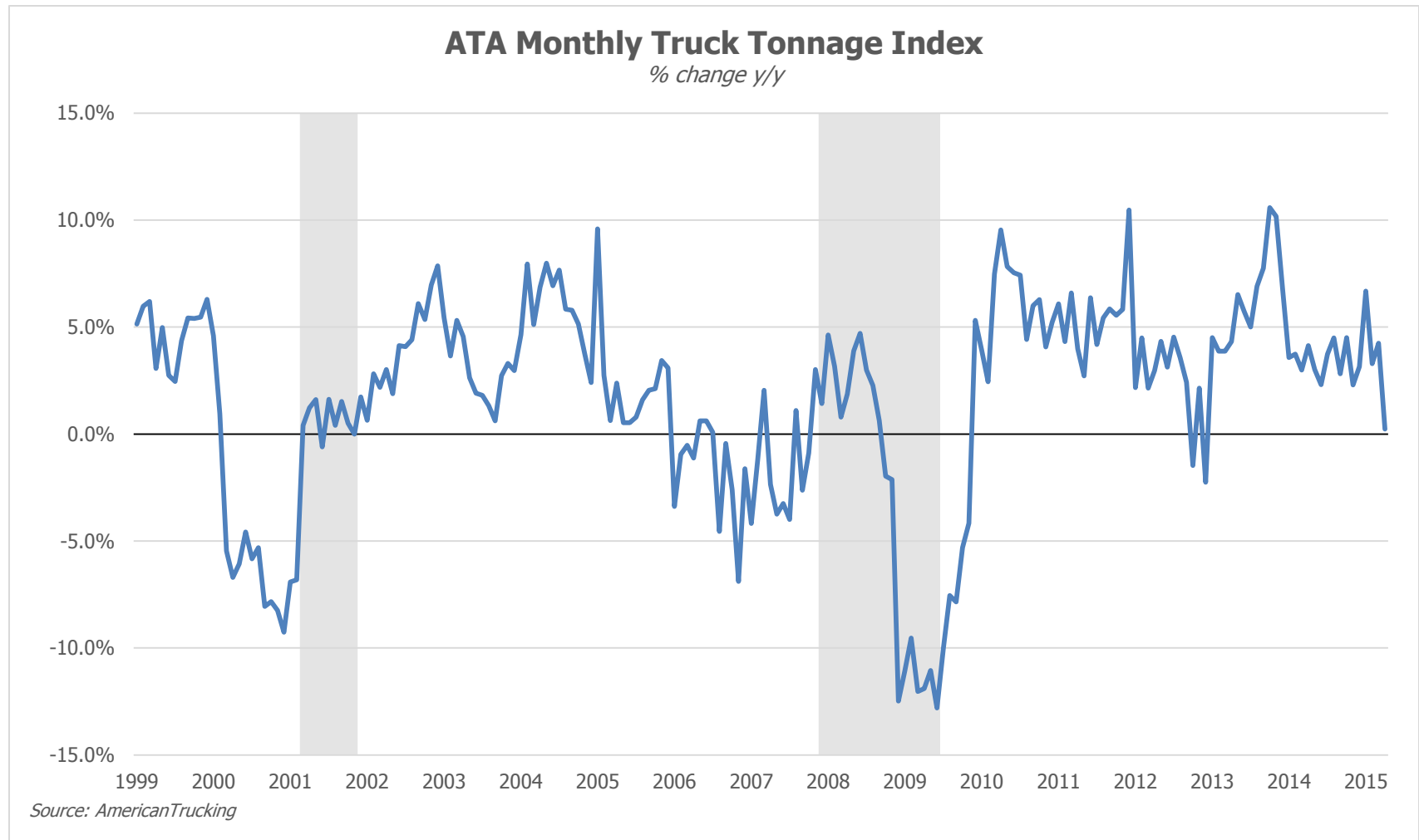
Heavy-Duty Truck

...but +20% order declines mean 2016 will be a down year.



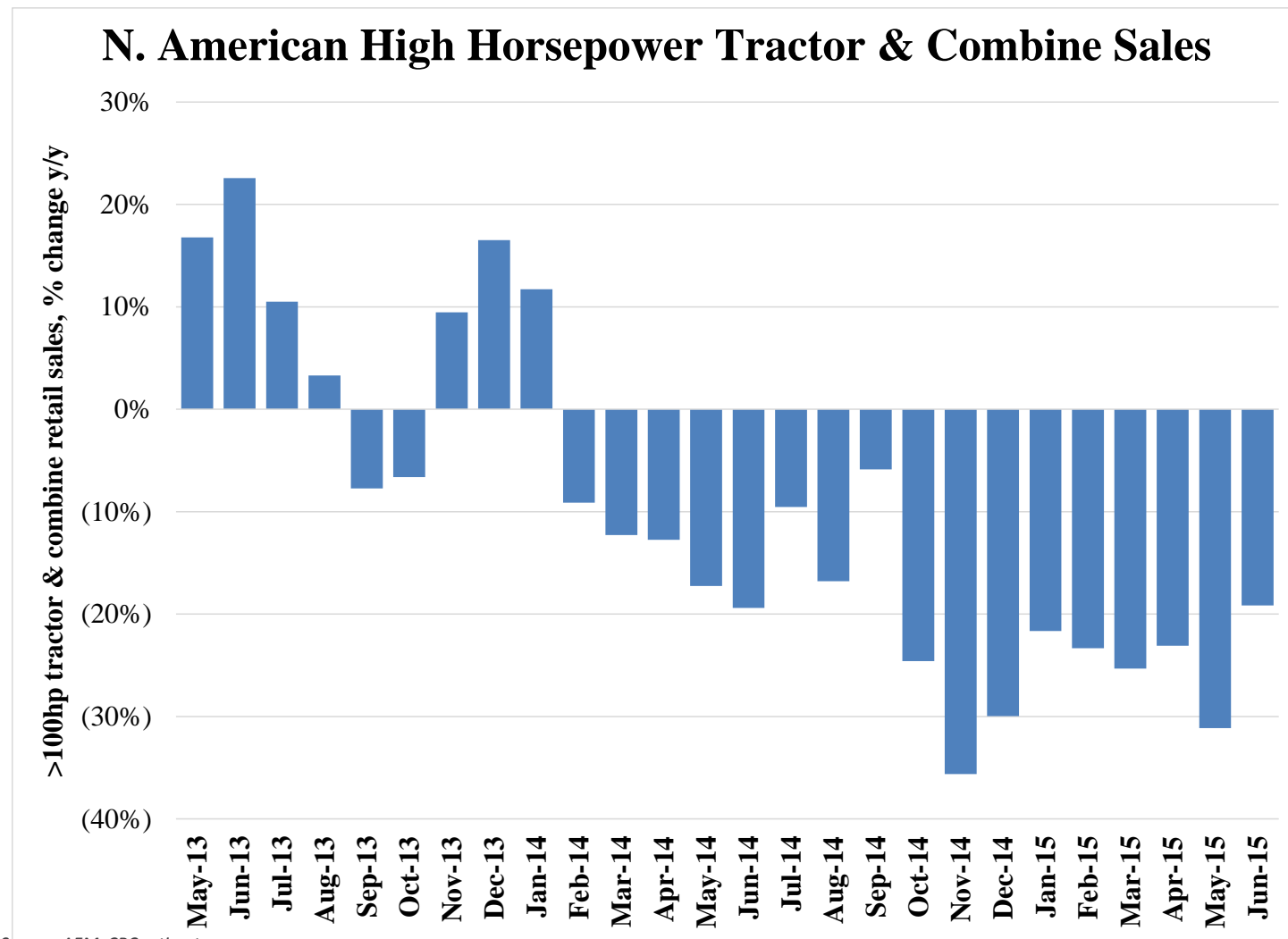
Transportation

ATA data confirming weakness



Ag Equipment

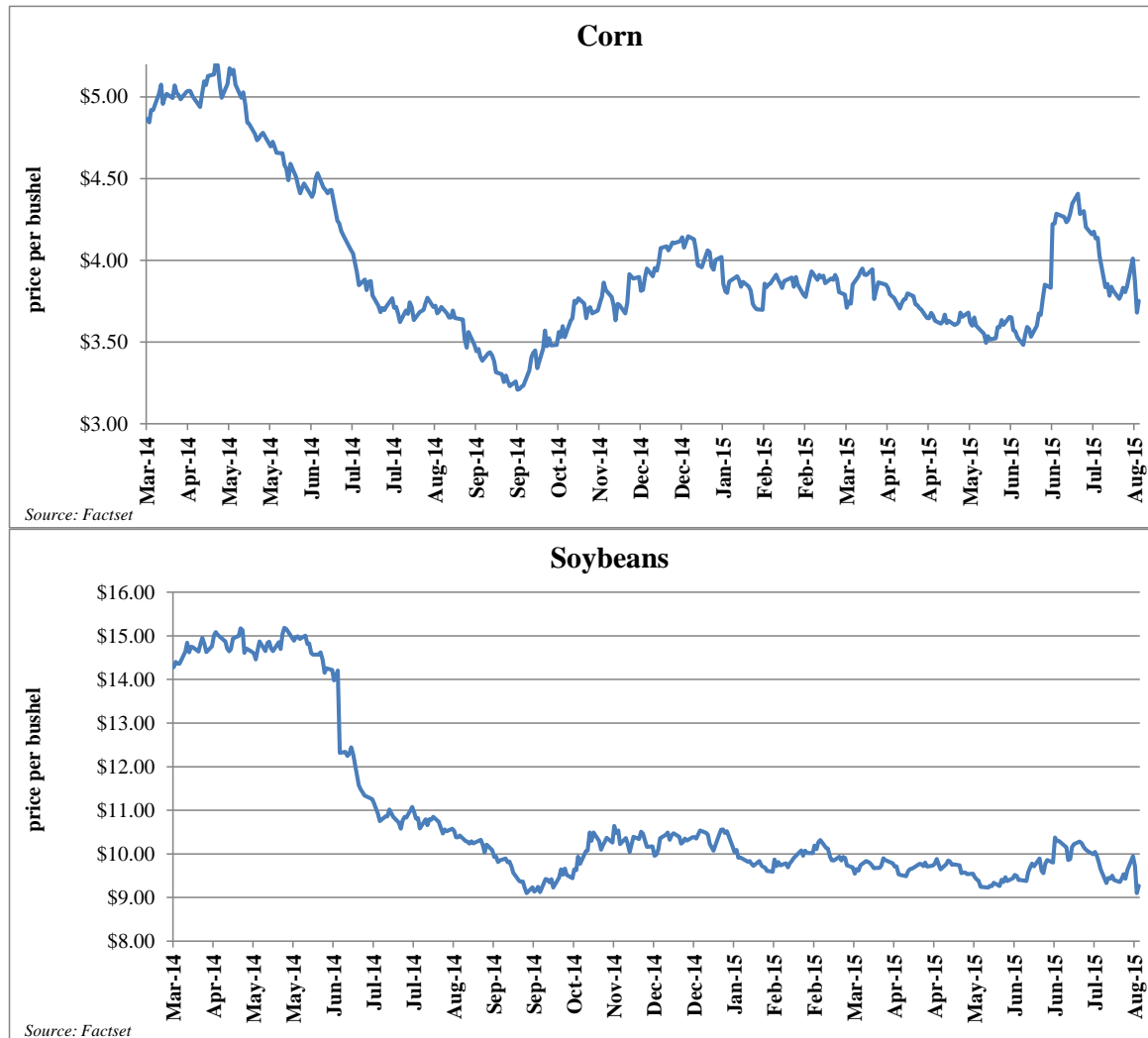
2015 sales to decline 25-30%...



Source: AEM, CRC estimates

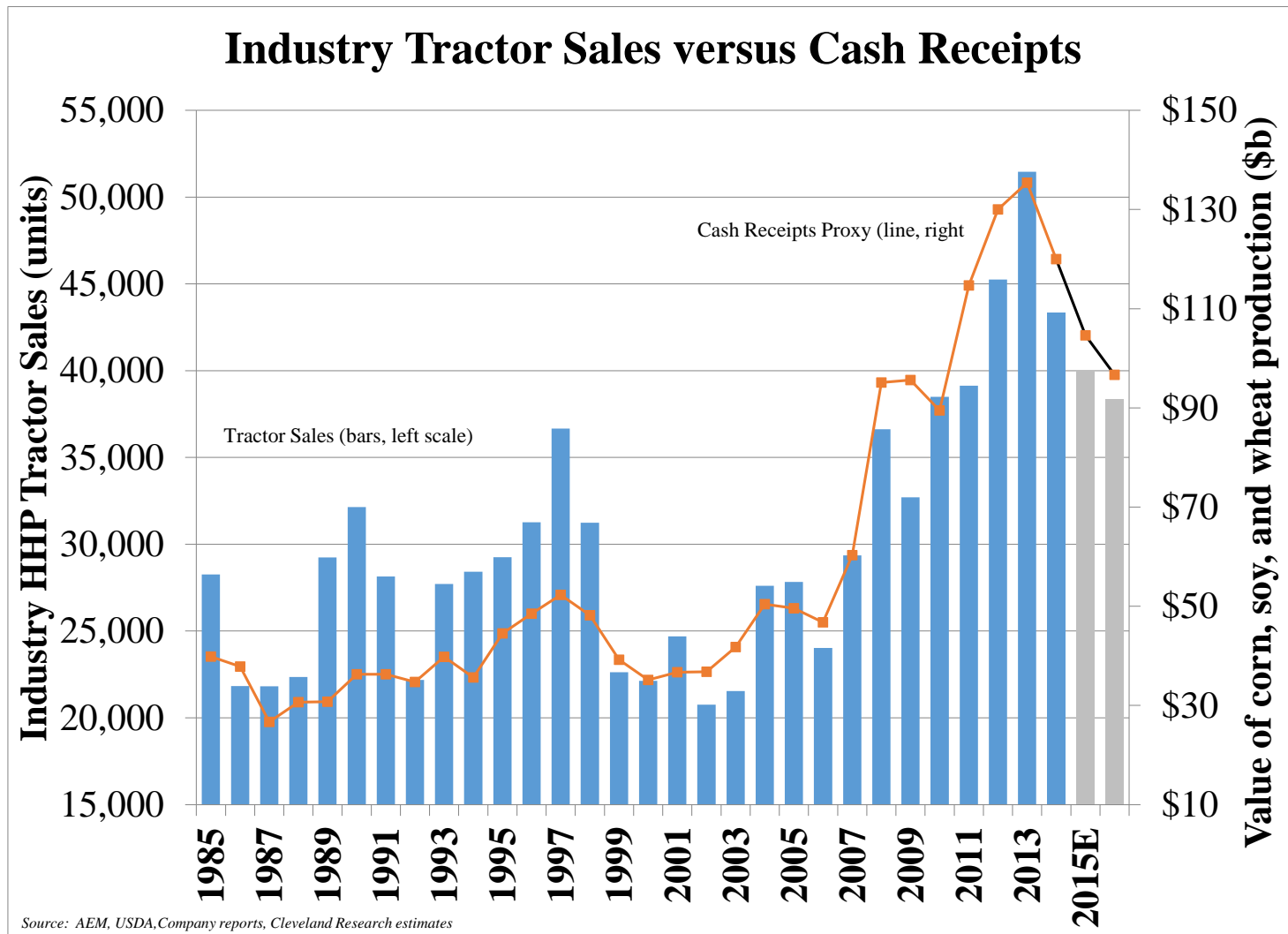
Ag Equipment

...as corn & soybean prices drift lower...



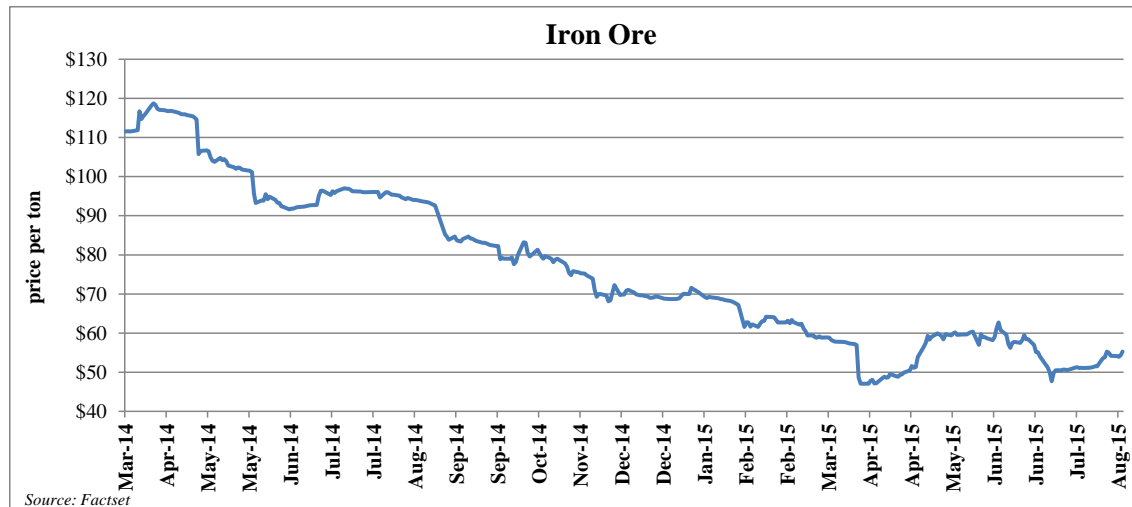
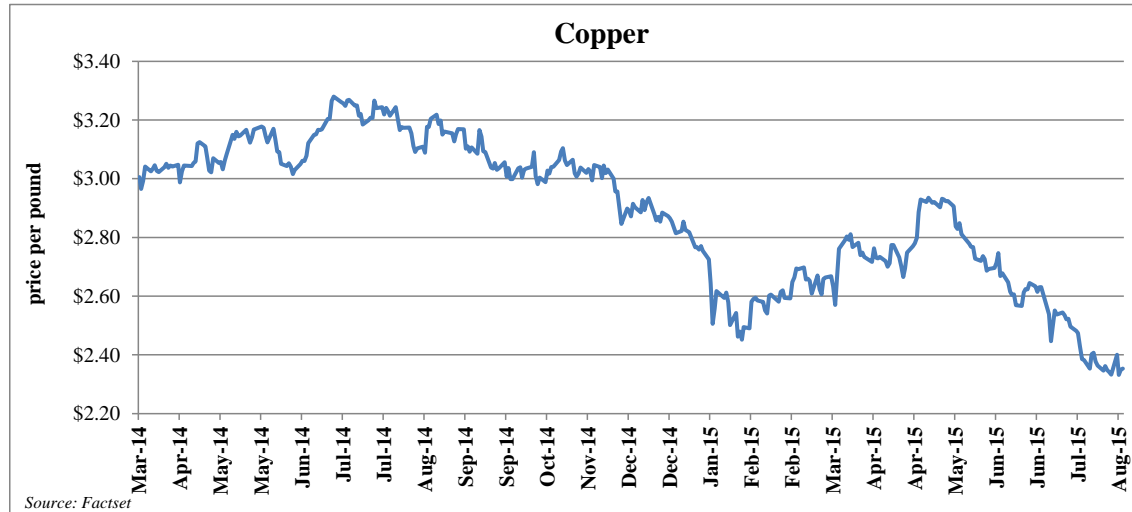
Ag Equipment

... and 2016 will be a down year as well



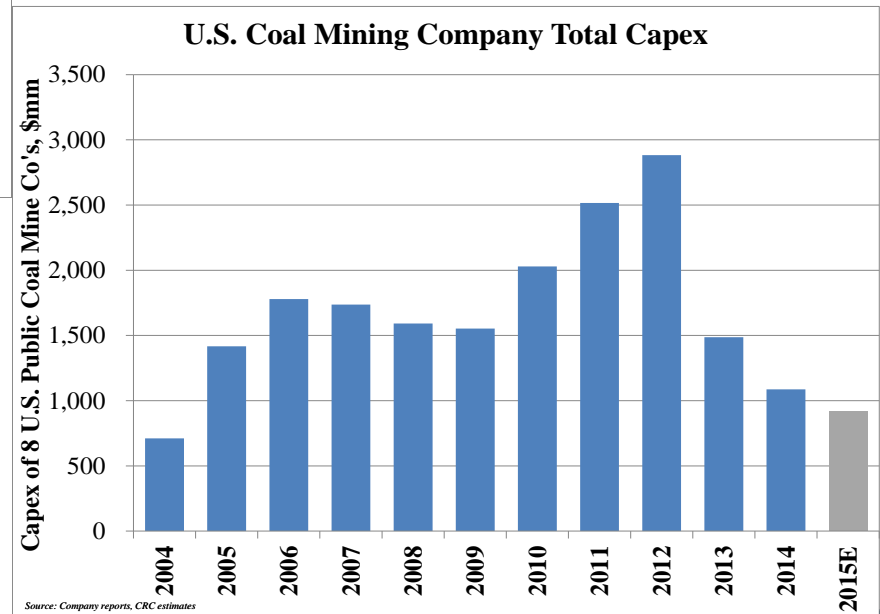
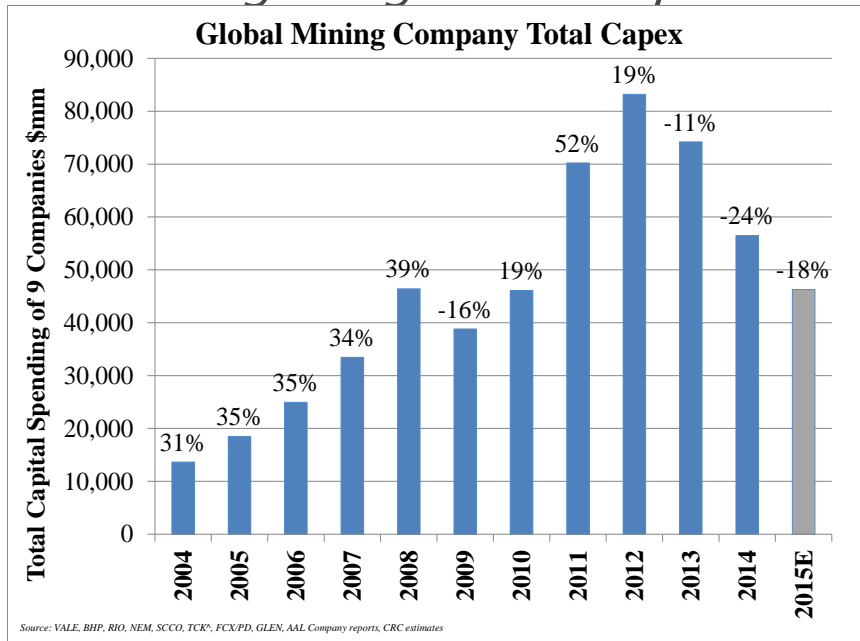
Mining Equipment

Mining - weak China demand impacting mined mineral prices...



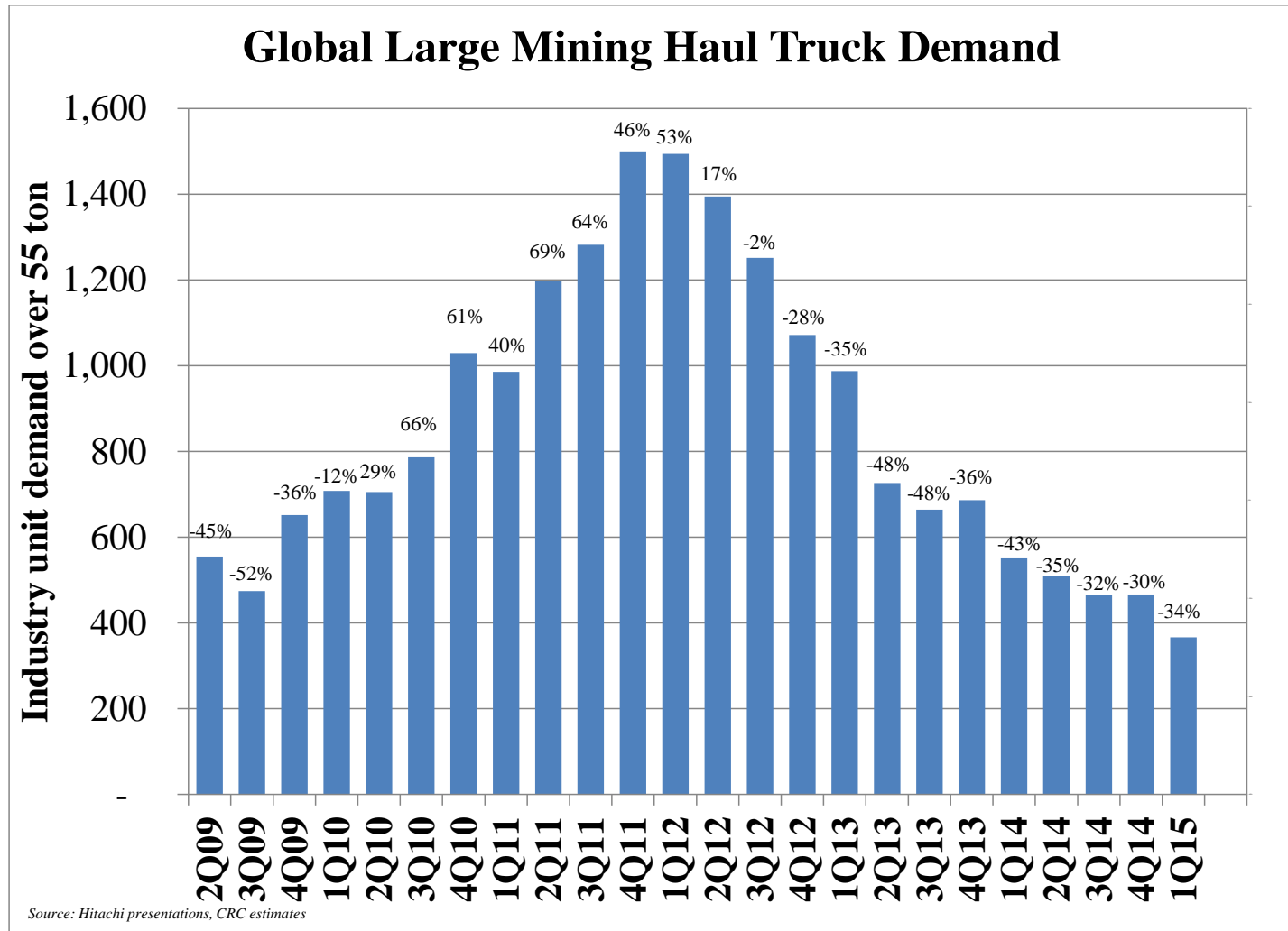
Mining Equipment

...resulting in significant capex cuts...



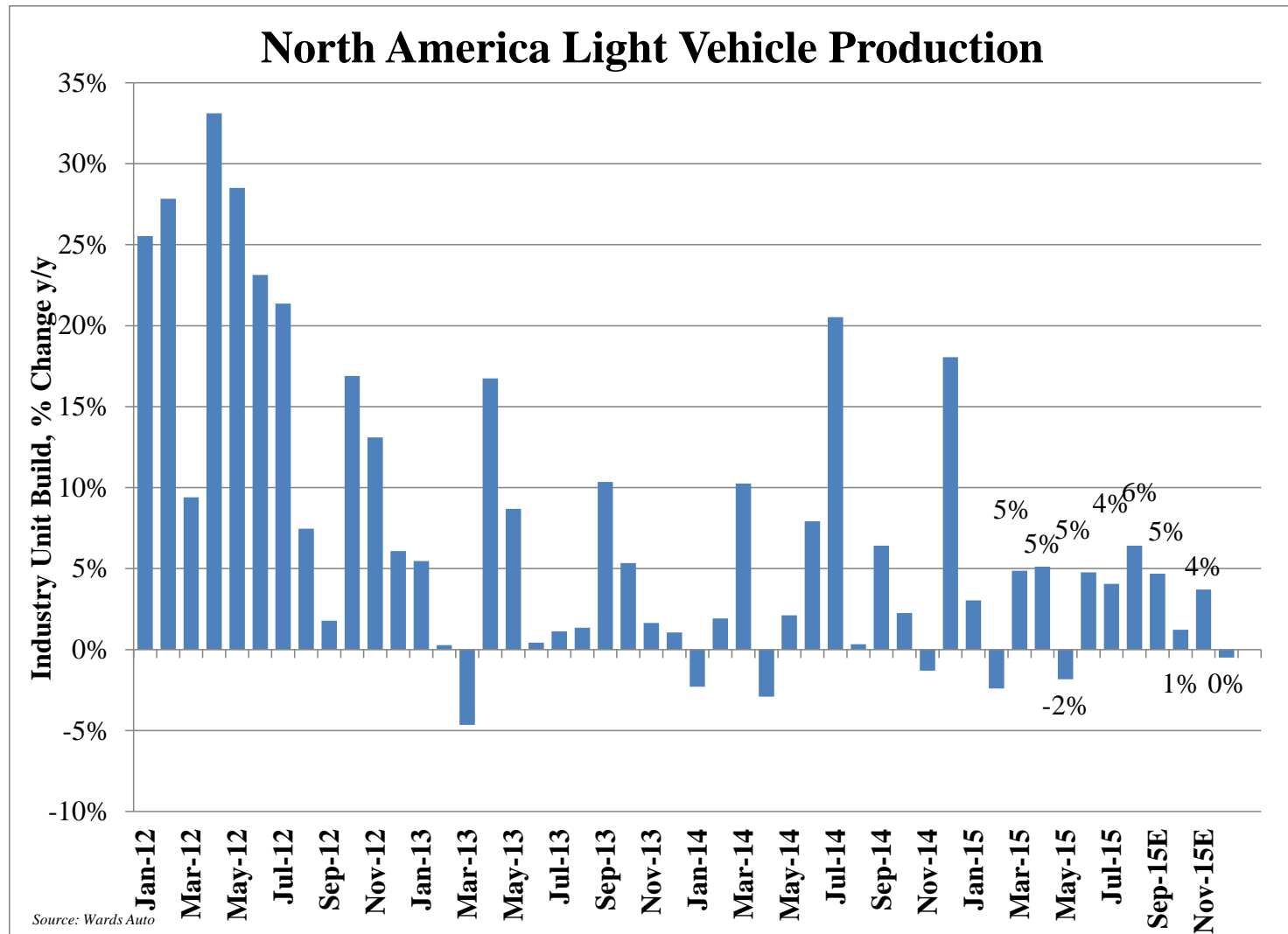
Mining Equipment

and significant equipment demand deterioration.



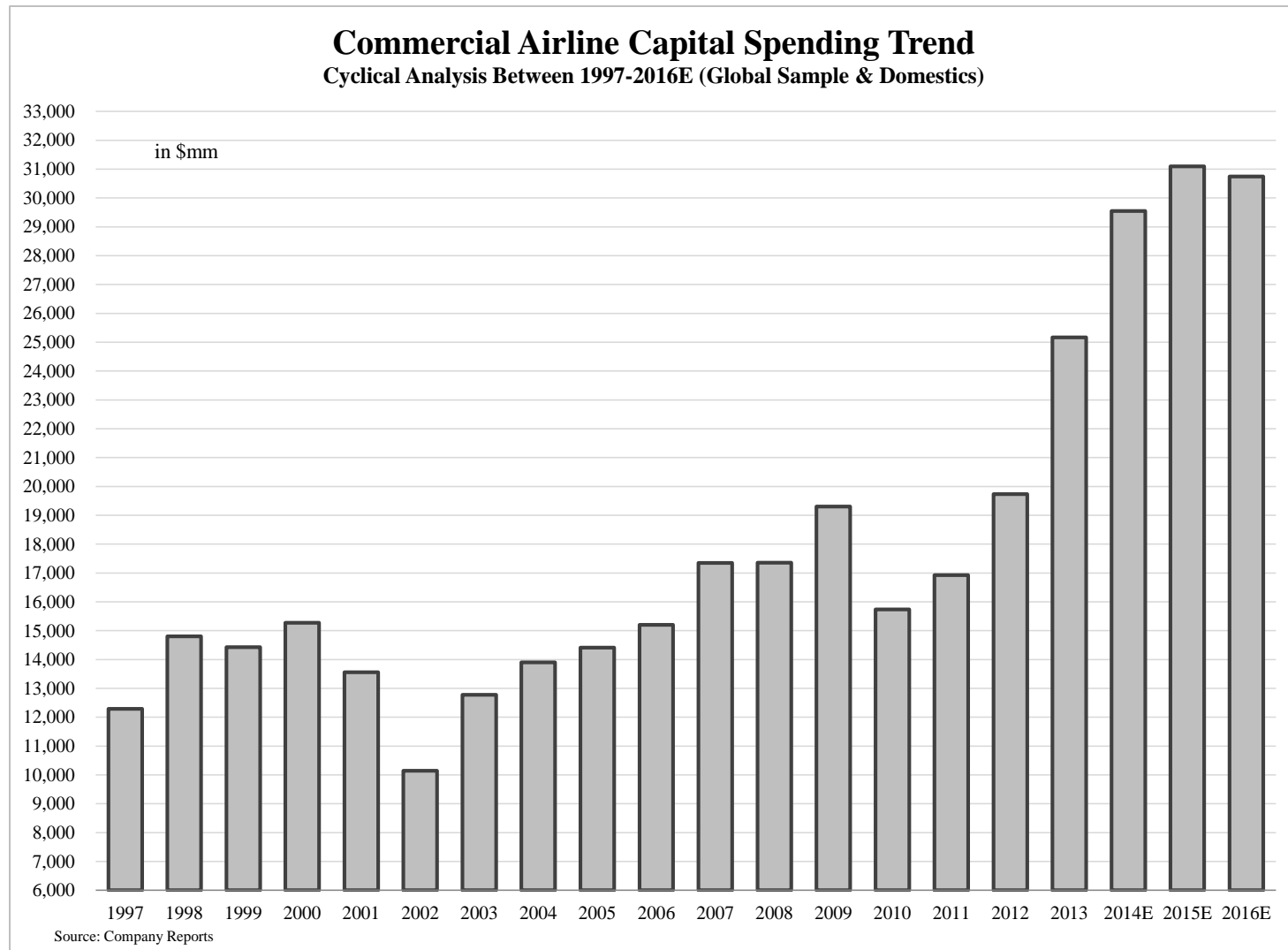
Few bright spots

Still strong auto production



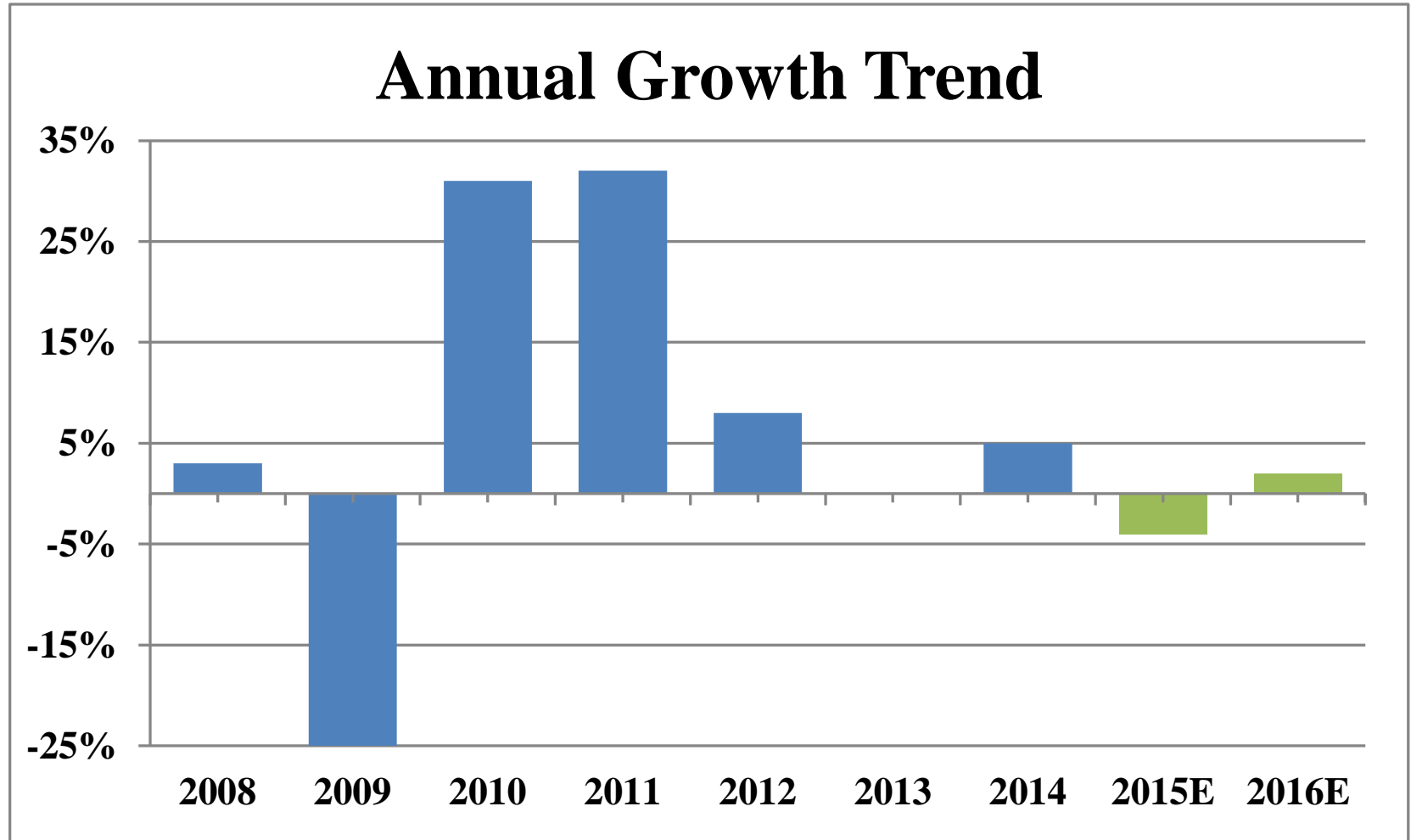
Few bright spots

Aerospace outlook still favorable



Initial 2016 Outlook

See sluggish growth with downside risk



Q&A

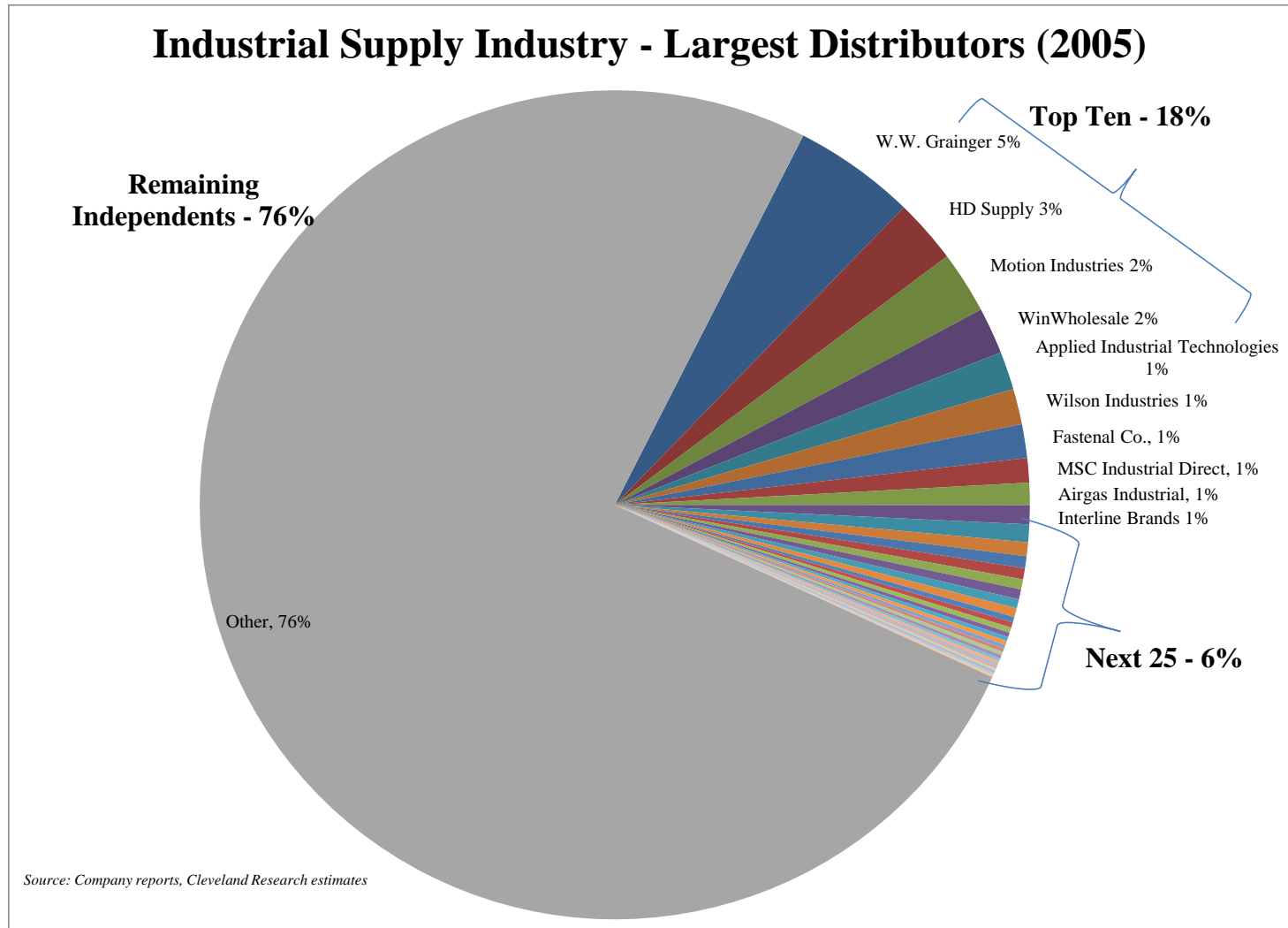


Industrial Distribution Trends



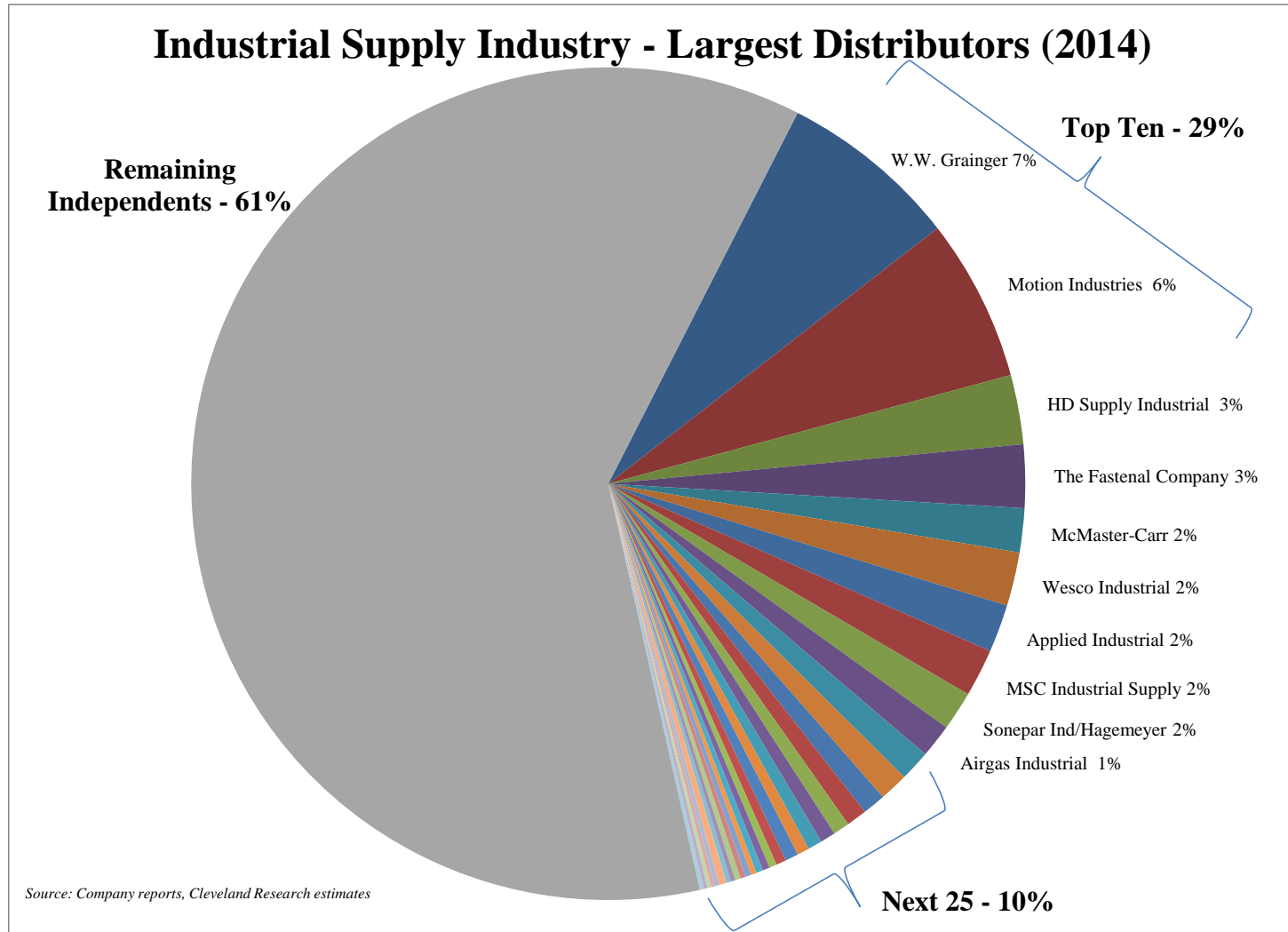
Key Trends In Industrial Distribution

Top Distributors in 2005...



Key Trends In Industrial Distribution

Top Distributors in 2014 - ~\$150 billion market



New Entrants



amazon



New Entrants

The Home Depot Announces Agreement to Acquire Interline Brands

Bill Lennie Named EVP of Outside Sales and Service

ATLANTA, July 22, 2015 /PRNewswire/ — The Home Depot®, the world's largest home improvement retailer, today announced its entry into a definitive agreement to acquire Jacksonville, Fla.-based Interline Brands, Inc., a leading national distributor and direct marketer of broad-line maintenance, repair and operations (MRO) products.

Under the terms of the agreement, The Home Depot will acquire Interline for \$1.625 billion in cash, subject to customary adjustments. The acquisition, which has been approved by the shareholders of Interline, is expected to be completed during The Home Depot's fiscal third quarter, which ends on November 1, 2015. The deal is subject to applicable regulatory approval and other customary closing conditions.



New Entrants

It doesn't always go right...



AmazonSupply is now closed.

AmazonSupply has been upgraded to Amazon Business, a new marketplace for businesses on Amazon.com. Customers who visit AmazonSupply are now redirected to Amazon.com

Source: Amazon.com



Key Trends in Industrial Distribution

Expanded Product Offering

Purchasing Magazine Survey - What is Most Important to MRO Buyers

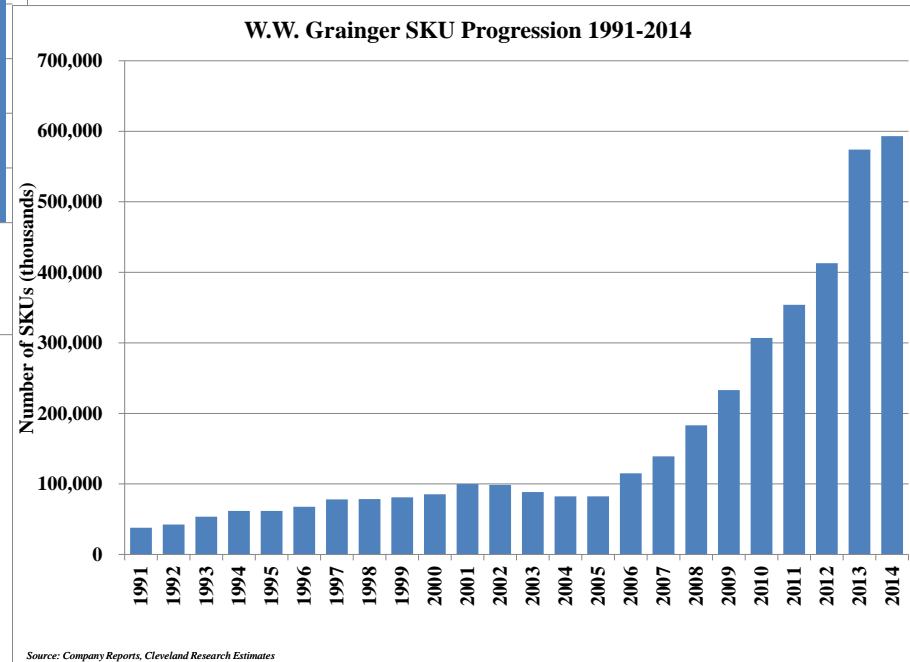
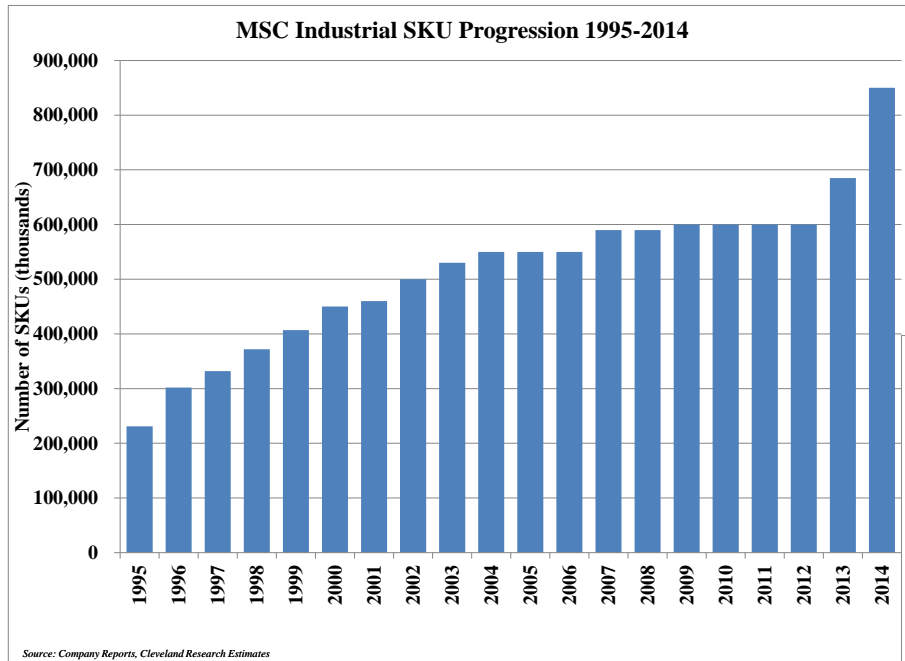
Ranked On Scale of 1 to 10 (Highest)	2008
Availability	7
Total cost	6
Quality	6
Price	5
Service	5
Technical assistance	4
Ease of doing business	4
Emergency assistance	3
Inventory assistance	2
Brands carried	2

Source: Purchasing Magazine



Key Trends In Industrial Distribution

Expanded Product Offering



Key Trends In Industrial Distribution

Inventory Management Services - \$20-25b Market



Applied Industrial Technologies Expands Maintenance Supplies & Solutions Capabilities with Acquisition of Parts Associates, Inc.

CLEVELAND, Dec. 21, 2012 /PRNewswire-FirstCall/ -- Applied Industrial Technologies (NYSE: AIT) today announced it has acquired Parts Associates, Inc. (PAI) of Cleveland, Ohio. PAI is a distributor of maintenance supplies and solutions, including fasteners, fluid flow, paints, chemicals, electrical, shop supplies, and related assortments. Terms of the sale were not disclosed.

Applied Industrial Technologies Acquires Atlantic Fasteners

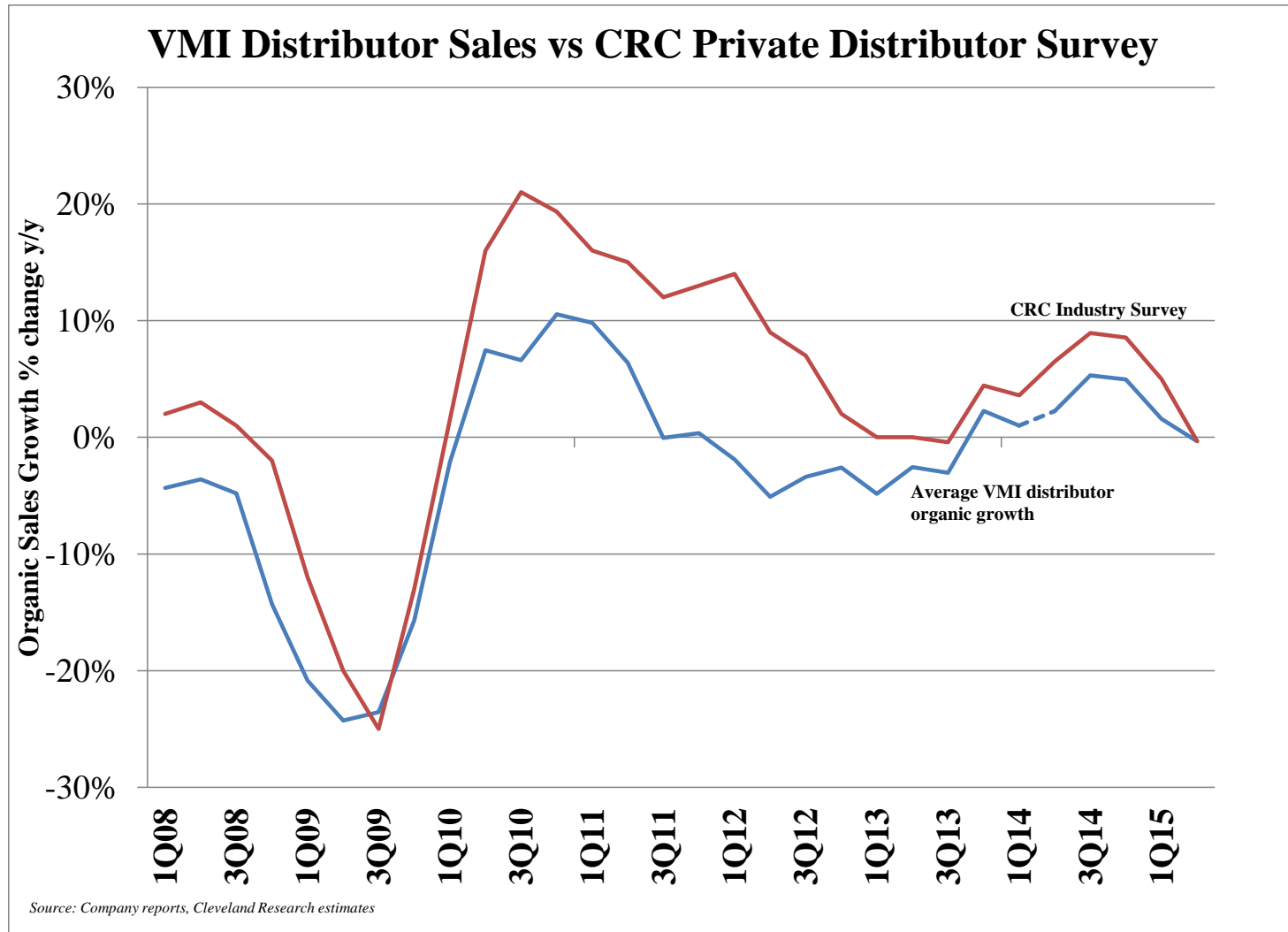
Further Strengthens Maintenance Supplies & Solutions(SM) Offering

CLEVELAND, Aug. 4, 2015 (GLOBE NEWSWIRE) -- Applied Industrial Technologies (NYSE:AIT) today announced it has acquired Atlantic Fasteners, a distributor of C-Class consumables located in Agawam, MA. Terms of the sale were not disclosed.



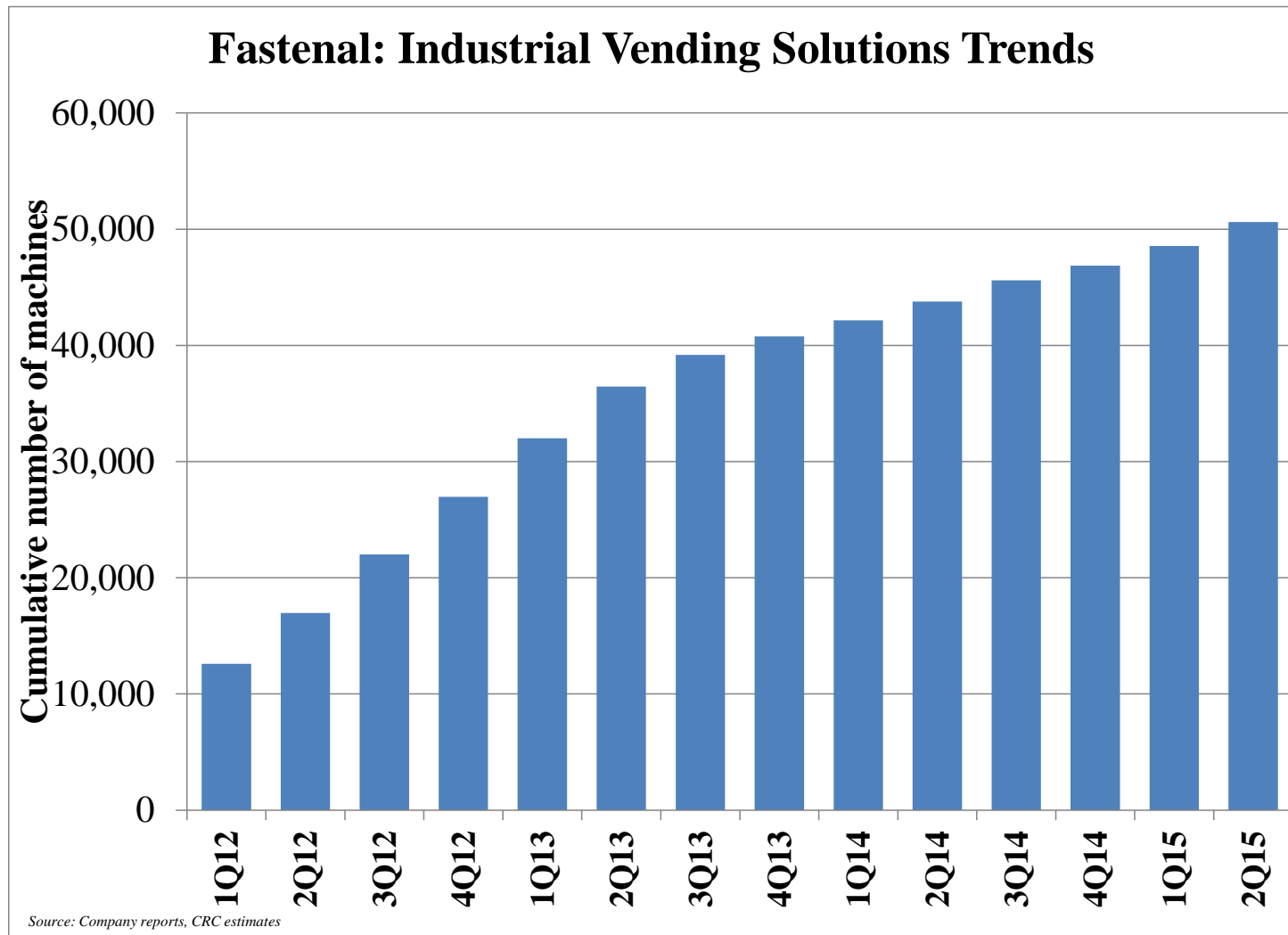
Key Trends In Industrial Distribution

Inventory Management Services – Flat for a While



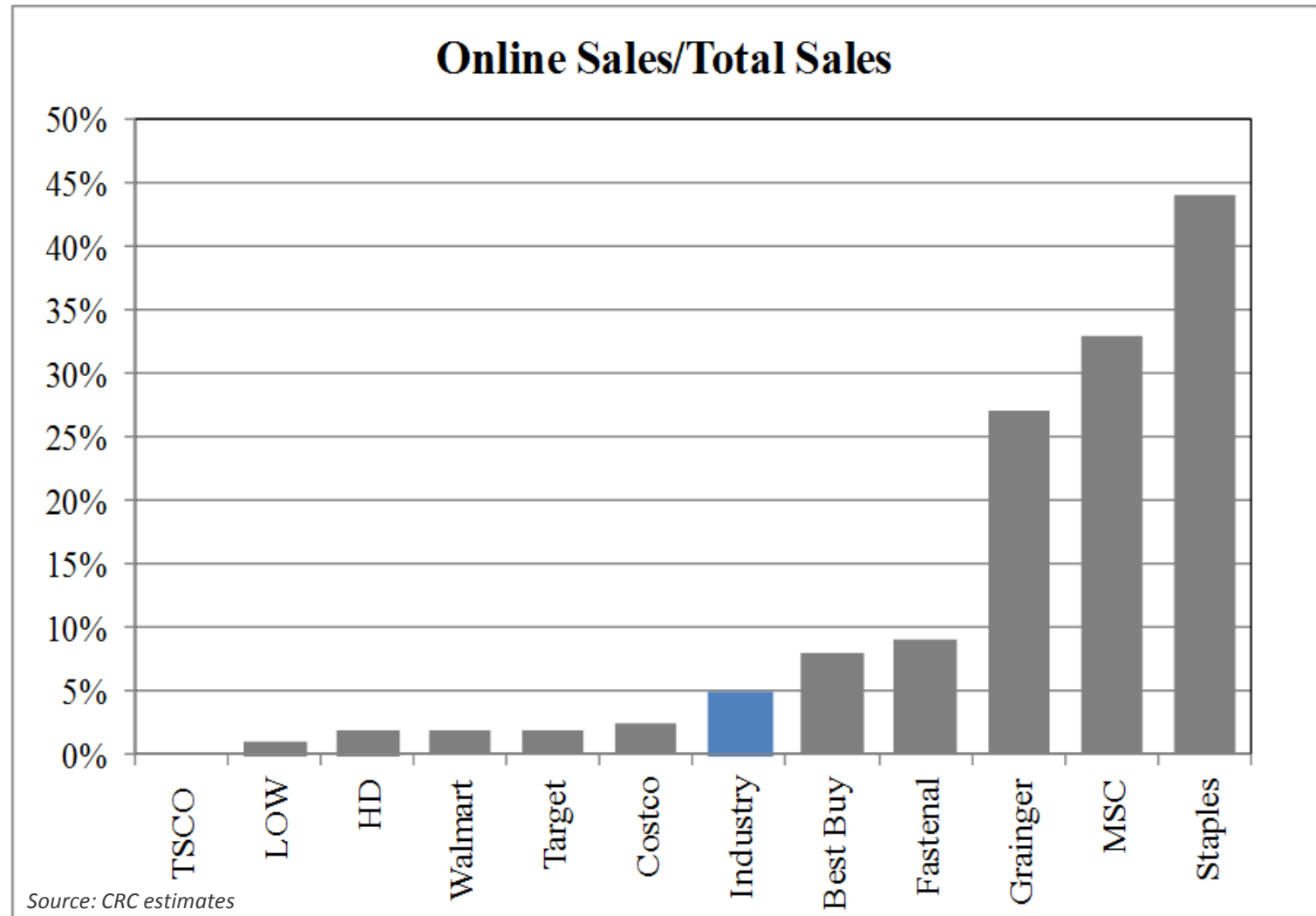
Key Trends In Industrial Distribution

Inventory Management Services



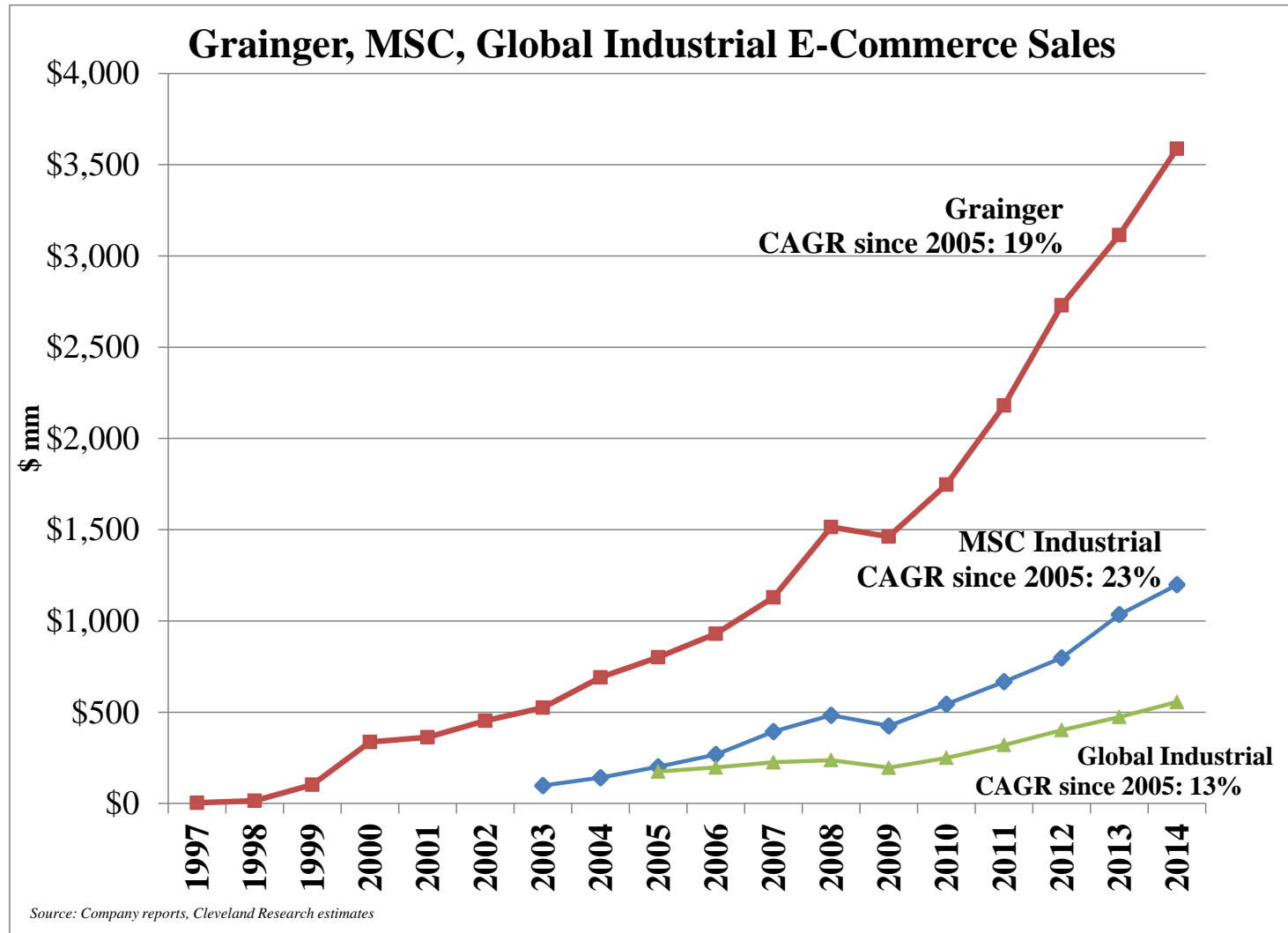
Key Trends In Industrial Distribution

eCommerce



Key Trends In Industrial Distribution

eCommerce



Key Trends In Industrial Distribution

What We Are Seeing at



- Zoro.com
 - Primary channel to reach small customers (5% of sales, 1/3 of market)
 - \$300 million in revenue, ~9% EBIT margin vs ~18-19% for GIS
- Salesforce Hiring Slowed
 - TSR plan halted, account managers hired instead
 - Slowing hiring plan from 400 to several hundred (from 8% to less than 5% y/y growth)
- Medium Sized Customer Pricing Strategy Changing
 - Trial greater discounts to stem sales declines with these customers
 - Pricing overall remains our key concern for the company
- Cromwell Acquisition
 - \$440mm UK based distributor acquired for 11x EBITDA. Provides Europe infrastructure.
- Restructuring Fabory Acquisition; Brazil Ops Closed; Investing in Clean Coal
- Court Carruthers Out, DG Macpherson now COO



Key Trends In Industrial Distribution

What We Are Seeing at



- Vending
 - Hit 50,000 unit mark, providing 3-5% growth tailwind to sales YTD
 - Over \$500mm business, running below prior lofty expectations, but goal is \$1.5 billion in vending sales.
- Salesforce Hiring Slowed
 - Headcount growth cut from 3,000 to 1,600 (15% growth to 7%)
- National Accounts
 - Key focus is winning new customers; 43% of sales today
- Lee Hein returns to COO role from CEO; Will Oberton now CEO
 - Board to name new CEO soon (internal promotion)



Key Trends In Industrial Distribution

What We Are Seeing at



- **Salesforce Growth**
 - Headcount plan cut from 8-10% growth to 2% for the year
 - Managed to demand growth going forward
- **Barnes Distribution Integration (CCSG)**
 - Integration moving forward post significant salesforce turnover (+30%)
 - Cross selling efforts under way (added 3-4% to CCSG sales)
- **National Accounts/Government**
 - 4-5% growth contribution over the last year, all of its growth in May quarter
 - 30-35% of sales, goal to expand further
 - Mix headwind to gross margins (GM peaked at 46.5% in 2011 vs 45% this year).
- **New CFO in Place, Still Recruiting Chief Customer Office (VP sales)**



Key Trends In Industrial Distribution

What We Are Seeing in the industry:

- Home Depot - *\$1.6b acquisition of Interline Brands, getting back into industrial supply*
- Sonepar – *acquisition of IDG, diversifying outside electrical*
- Blackhawk – *founded in 2009, already a significant player*
- Stellar – *multiple acquisitions building regional player*
- HD Supply – *divest Power Solutions to Anixter*
- Anixter – *divest Fastener distribution segment to private equity*



Disclosures

Disclosures: *I, Joe Calvello, certify that the views expressed in the research report(s) accurately reflect our personal views about the subject security(s). Further, we certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report(s). The analysts responsible for the preparation of this report have no ownership stake in this company. Cleveland Research Company provides no investment banking services of any type on this or any company. Proprietary research and Information contained herein which forms the basis for findings or opinions expressed by Cleveland Research Company may be used by Cleveland Research for other purposes in the course of compensated consulting and other services rendered to third parties.*

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