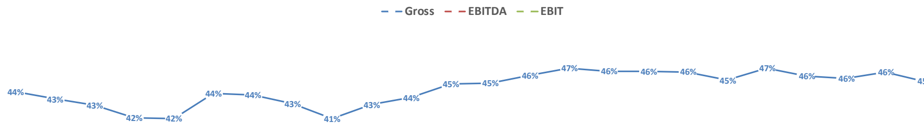
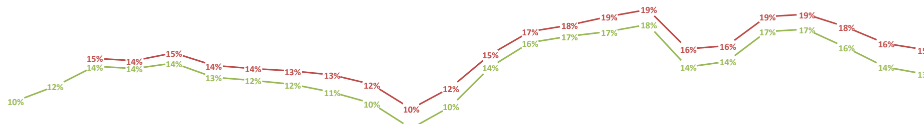
MSC Industrial Direct

NYSE: MSM

# MSC Industrial Direct (NYSE: MSM)

# Stock Price: $72.40




| | EV/Sales | EV/Gross Profit | EV/EBITDA | EV/EBIT | EV/ Owner Earnings |
|---|---|---|---|---|---|
| DXP Enterprises | 0.48 | 1.69 | 7.29 | 8.63 | 8.63 |
| Applied Industrial Technology | 0.69 | 2.48 | 8.39 | 10.32 | 10.32 |
| Grainger | 1.53 | 3.61 | 9.99 | 11.33 | 10.22 |
| Fastenal | 3.55 | 7.06 | 15.05 | 16.62 | 16.62 |
| MonotaRO | 6.32 | 21.01 | 47.85 | 51.36 | 51.36 |
| | | | | | |
| Minimum | 0.48 | 1.69 | 7.29 | 8.63 | 8.63 |
| Maximum | 6.32 | 21.01 | 47.85 | 51.36 | 51.36 |
| Median | 1.53 | 3.61 | 9.99 | 11.33 | 10.32 |
| Mean | 2.52 | 7.17 | 17.72 | 19.65 | 19.43 |
| STDEV | 2.45 | 8.00 | 17.11 | 17.97 | 18.11 |
| CV | 97% | 112% | 97% | 91% | 93% |
| | | | | | |
| MSC Industrial Direct | 1.65 | 3.66 | 10.72 | 12.69 | 9.46 |

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Minimum | Maximum | Median | Mean | Standard Deviation | Variation |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Sales | 125 | 142 | 175 | 248 | 305 | 462 | 615 | 683 | 831 | 869 | 794 | 845 | 955 | 1,100 | 1,318 | 1,688 | 1,780 | 1,490 | 1,692 | 2,022 | 2,356 | 2,458 | 2,787 | 2,910 | 125 | 2,910 | 912 | 1,194 | 853 | 71% |
| Gross Profit | 55 | 62 | 75 | 103 | 127 | 203 | 270 | 294 | 345 | 373 | 346 | 380 | 430 | 504 | 613 | 780 | 823 | 688 | 767 | 941 | 1,078 | 1,119 | 1,286 | 1,317 | 55 | 1,317 | 405 | 541 | 395 | 73% |
| EBITDA | | | 26 | 36 | 46 | 64 | 83 | 91 | 108 | 104 | 76 | 98 | 143 | 190 | 236 | 317 | 347 | 232 | 268 | 379 | 447 | 435 | 448 | 449 | 26 | 449 | 166 | 210 | 152 | 72% |
| EBIT | 13 | 17 | 24 | 34 | 43 | 59 | 76 | 82 | 93 | 87 | 60 | 83 | 131 | 178 | 221 | 291 | 320 | 205 | 242 | 350 | 412 | 386 | 383 | 380 | 13 | 412 | 112 | 174 | 138 | 80% |
| Receivables | | | | | 36 | 48 | 64 | 81 | 94 | 97 | 95 | 94 | 104 | 120 | 156 | 195 | 210 | 191 | 193 | 244 | 282 | 321 | 364 | 393 | 36 | 393 | 138 | 169 | 106 | 63% |
| Inventories | | | | | 118 | 158 | 161 | 192 | 245 | 249 | 219 | 204 | 214 | 228 | 265 | 318 | 329 | 284 | 266 | 315 | 369 | 406 | 434 | 478 | 118 | 478 | 257 | 273 | 96 | 35% |
| PP&E | | | | | 27 | 44 | 64 | 92 | 112 | 119 | 117 | 110 | 105 | 103 | 112 | 125 | 128 | 130 | 138 | 146 | 162 | 213 | 273 | 293 | 27 | 293 | 118 | 131 | 66 | 50% |
| Working Liabilities | | | | | 36 | 50 | 62 | 75 | 79 | 74 | 70 | 75 | 82 | 89 | 119 | 142 | 128 | 109 | 126 | 162 | 171 | 184 | 206 | 211 | 36 | 211 | 99 | 112 | 52 | 46% |
| Net Tangible Assets | | | | | 144 | 200 | 227 | 290 | 372 | 391 | 361 | 332 | 341 | 363 | 414 | 496 | 540 | 496 | 471 | 544 | 642 | 756 | 866 | 954 | 144 | 954 | 403 | 460 | 213 | 46% |
| MARGINS | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Gross | 44% | 43% | 43% | 42% | 42% | 44% | 44% | 43% | 41% | 43% | 44% | 45% | 45% | 46% | 47% | 46% | 46% | 46% | 45% | 47% | 46% | 46% | 46% | 45% | 41% | 47% | 45% | 44% | 2% | 0.04 |
| EBITDA | | | 15% | 14% | 15% | 14% | 14% | 13% | 13% | 12% | 10% | 12% | 15% | 17% | 18% | 19% | 19% | 16% | 16% | 19% | 19% | 18% | 16% | 15% | 10% | 19% | 15% | 15% | 3% | 0.17 |
| EBIT | 10% | 12% | 14% | 14% | 14% | 13% | 12% | 12% | 11% | 10% | 8% | 10% | 14% | 16% | 17% | 17% | 18% | 14% | 14% | 17% | 17% | 16% | 14% | 13% | 8% | 18% | 14% | 14% | 3% | 0.20 |
| TURNS | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Sales/Receivables | | | | | 8.47 | 9.59 | 9.58 | 8.39 | 8.80 | 8.96 | 8.38 | 8.99 | 9.20 | 9.14 | 8.44 | 8.66 | 8.46 | 7.80 | 8.76 | 8.29 | 8.36 | 7.65 | 7.66 | 7.40 | 7.40 | 9.59 | 8.46 | 8.55 | 0.61 | 7% |
| Sales/Inventories | | | | | 2.59 | 2.93 | 3.83 | 3.56 | 3.39 | 3.49 | 3.62 | 4.15 | 4.47 | 4.82 | 4.98 | 5.30 | 5.40 | 5.25 | 6.35 | 6.41 | 6.38 | 6.05 | 6.42 | 6.09 | 2.59 | 6.42 | 4.90 | 4.77 | 1.27 | 27% |
| Sales/PPE | | | | | 11.38 | 10.43 | 9.67 | 7.42 | 7.45 | 7.32 | 6.79 | 7.69 | 9.09 | 10.70 | 11.75 | 13.52 | 13.88 | 11.42 | 12.28 | 13.83 | 14.57 | 11.53 | 10.21 | 9.94 | 6.79 | 14.57 | 10.57 | 10.54 | 2.40 | 23% |
| Sales/NTA | | | | | 2.11 | 2.31 | 2.71 | 2.35 | 2.24 | 2.22 | 2.20 | 2.54 | 2.80 | 3.03 | 3.18 | 3.40 | 3.30 | 3.00 | 3.59 | 3.72 | 3.67 | 3.25 | 3.22 | 3.05 | 2.11 | 3.72 | 3.02 | 2.90 | 0.53 | 18% |
| RETURNS | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Gross Profit/NTA | | | | | 88% | 101% | 119% | 101% | 93% | 95% | 96% | 114% | 126% | 139% | 148% | 157% | 152% | 139% | 163% | 173% | 168% | 148% | 149% | 138% | 88% | 173% | 138% | 130% | 28% | 0.21 |
| EBITDA/NTA | | | | | 32% | 32% | 37% | 31% | 29% | 27% | 21% | 30% | 42% | 52% | 57% | 64% | 64% | 47% | 57% | 70% | 70% | 58% | 52% | 47% | 21% | 70% | 47% | 46% | 15% | 0.33 |
| EBIT/NTA | | | | | 30% | 29% | 34% | 28% | 25% | 22% | 17% | 25% | 38% | 49% | 53% | 59% | 59% | 41% | 51% | 64% | 64% | 51% | 44% | 40% | 17% | 64% | 41% | 41% | 15% | 0.36 |
| GROWTH | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Sales | | 13% | 23% | 42% | 23% | 51% | 33% | 11% | 22% | 5% | -9% | 6% | 13% | 15% | 20% | 28% | 5% | -16% | 14% | 19% | 17% | 4% | 13% | 4% | -16% | 51% | 14% | 16% | 15% | 0.95 |
| Gross Profit | | 12% | 21% | 38% | 23% | 60% | 33% | 9% | 17% | 8% | -7% | 10% | 13% | 17% | 22% | 27% | 5% | -16% | 11% | 23% | 15% | 4% | 15% | 2% | -16% | 60% | 15% | 16% | 15% | 0.98 |
| EBITDA | | | | 40% | 29% | 39% | 30% | 9% | 18% | -3% | -27% | 29% | 45% | 33% | 24% | 34% | 9% | -33% | 16% | 41% | 18% | -3% | 3% | 0% | -33% | 45% | 18% | 17% | 22% | 1.29 |
| EBIT | | 30% | 43% | 40% | 28% | 36% | 30% | 7% | 14% | -6% | -31% | 38% | 58% | 36% | 24% | 32% | 10% | -36% | 18% | 45% | 18% | -6% | -1% | -1% | -36% | 58% | 24% | 18% | 24% | 1.29 |
| Receivables | | | | | 32% | 35% | 32% | 23% | 10% | -4% | -1% | -1% | 22% | 11% | 47% | 10% | 6% | -24% | 34% | 21% | 12% | 16% | 11% | 5% | -24% | 47% | 11% | 15% | 16% | 1.10 |
| Inventories | | | | | 83% | 7% | -3% | 43% | 17% | -12% | -12% | -2% | 12% | 3% | 29% | 13% | -5% | -23% | 16% | 21% | 14% | 7% | 7% | 13% | -23% | 83% | 10% | 11% | 23% | 1.99 |
| PP&E | | | | | 166% | 27% | 56% | 38% | 9% | 4% | -7% | -5% | -3% | -1% | 19% | 5% | 1% | 2% | 9% | 4% | 17% | 44% | 17% | -1% | -7% | 166% | 7% | 20% | 38% | 1.92 |
| Working Liabilities | | | | | 74% | 15% | 31% | 15% | -3% | -11% | 3% | 10% | 8% | 9% | 56% | -3% | -17% | -12% | 48% | 14% | -2% | 18% | 6% | -2% | -17% | 74% | 9% | 13% | 23% | 1.82 |
| Net Tangible Assets | | | | | 82% | 15% | 11% | 43% | 17% | -5% | -10% | -5% | 11% | 3% | 26% | 15% | 4% | -20% | 13% | 18% | 18% | 17% | 12% | 9% | -20% | 82% | 13% | 14% | 21% | 1.54 |

# SINGULAR DILIGENCE

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## MSC (NYSE: MSM) is a Distributor Focused on Manufacturers Generally and Metalworkers Specifically

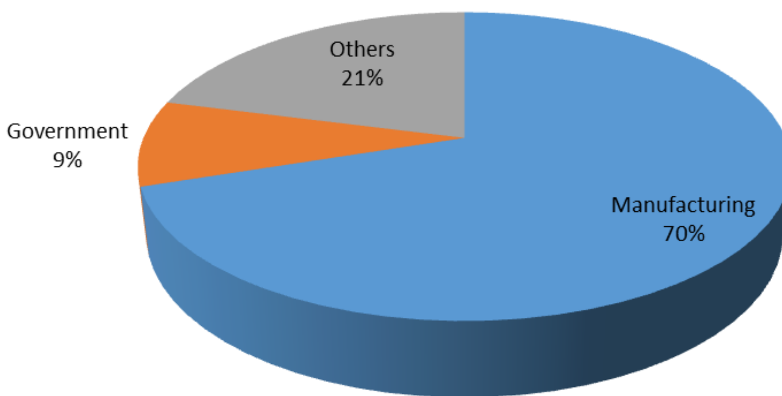
TABLE OF CONTENTS

DURABILITY 2
MOAT 4
QUALITY 6
CAPITAL ALLOCATION 8
VALUE 9
GROWTH 11
MISJUDGMENT 13
FUTURE 15
APPRAISAL 18
NOTES 20

## OVERVIEW

MSC Industrial Direct is an MRO (maintenance, repair, and overhaul) distributor focused on the metalworking industry. The company's initials originally stood for Manhattan Supply Company. This is a company MSC's predecessor acquired many years ago. MSC can trace its roots to Sidney Jacobson's Sid Tool Company. Sid Tool was founded in 1941 in Manhattan. Sid Tool's store sold cutting tools and accessories to New York City machine shops. The company moved to Long Island in the 50s. Business grew rapidly after World War Two. But Sid Tool soon became dependent on two key customers. Grumman Corporation and Republic Aircraft made up 90% of Sid Tool's sales. To diversify its sales, Sid Jacobson started a catalog business. The catalog offered discount prices on imported cutting tools. Since it was a catalog instead of a store, the book was able to offer a wider range of products. Sid Tool's catalog was launched in 1961. By 1964, it had over 150 pages. Today, MSC's catalog – known as the "Big Book" has over 4,000 pages.

Within a few years, Sid Tool's catalog sales were greater than the sales it had been making to those two key customers. Sid Tool was selling products it found at trade shows. Jacobson would visit trade shows and make up lists of the products he wanted to sell. Or manufacturers who saw Sid Tool's catalog would contact him and ask to be put in the catalog. This allowed the catalog to have a wide range of products. But, it created a problem in the late 1960s. An imported item was out of stock. Sid Tool didn't have the product on hand – though it was in the catalog – and was told it would take 6 months to fill the order. Jacobson wanted to make sure this would never happen again. So, in 1969, he installed a computerized inventory control system. MSC has been quick to adopt technology to manage inventory and fill orders quickly and accurately ever since.




*MSC gets 70% of all its sales from manufacturing customers.*

In 1970, Sid Tool acquired Manhattan Supply Company. This is where the MSC name comes from. MSC opened its first distribution center in 1978. In the 1970s, Sidney Jacobson's son, Mitchell Jacobson, joined the company and soon took over day-to-day management. Mitchell Jacobson was very young when he took over the company. So, he is actually still with MSC today. He serves as the company's Chairman. Members of the extended Jacobson family control much of the economic interest – and a majority of the voting power – of MSC to this day.

Under Mitchell Jacobson, MSC started a geographic expansion. It went from 3 branches in the mid-1980s to 26 branches in 1990. That same year, MSC opened a second distribution center in Atlanta. This gave the New York based company better geographic coverage. The company also made same day shipping a priority. By 1991, MSC was shipping 98% of orders the same day it received them. This was several years before e-commerce became a reality in the U.S. So, same day shipping under almost all circumstances was not yet common. MSC's management decided same day shipping helped differentiate the company from its competition. So, it pressed this advantage. For orders placed by 4:30 p.m., MSC said it would either ship the

order that day or it would send the customer a check for $50. In the first 3 years of the program, MSC had a 99.99% same day shipping rate.

MSC went public in 1996. Revenue was $305 million at that time. We know what MSC's sales were in the mid-1970s. So, we know that MSC had achieved a 20% annual sales growth rate from 1976 through 19996. It was a growth company. But, it was determined to invest in additional infrastructure. From 1996 through 2004, MSC opened 3 new distribution centers, added 60 branches, and increased its catalog by 400,000 stock keeping units. In the 20 years since its 1996 IPO, MSC has grown sales by 12.6% a year and earnings per share by 13.3%. The stock price has compounded at 11% a year while the company stuck to a 30% to 50% dividend payout rate throughout those two decades.

There are two ways to look at MSC today. The first is to see it as one of the big MROs like Grainger and Fastenal. By this measure, MSC has 2% of the North American MRO market. It has 1.1 million stock keeping units available online. And it actually stocks 880,000 of these items. Orders placed by 8 p.m. have a 99% chance of being shipped that same day. If you think of MSC as just another broad line MRO distributor like Grainger and Fastenal – it appears more centralized. MSC ships almost everything out of just 5 distribution centers. The company still has 100 branches. But, these branches should not be thought of as stores like the small ones Fastenal operates or the large ones Grainger runs. MSC's 100 branches are really just sales offices. They carry very little inventory.

So where is the inventory? It's in MSC's 5 distribution centers. And it's in vending machines. MSC is mostly an e-commerce company. MSC has sales of $3 billion. About 57% of those sales come from electronic sources. Metalworking revenue is 50% of all sales. So, actually, MSC is almost 30% a pure online metalworking supply company. It can be thought of as about half online and half offline and it can be thought of as about half metalworking and half non-metalworking. MSC's relative market share within metalworking supplies is big. The company has 10% market share in metalworking. This is several times the size of its nearest competitor.

The Jacobson family has 82% of MSC's voting power and 49% of its economic interest. We've included shares owned by the Chairman (Mitchell Jacobson), a Jacobson family trust, shares held by Mitchell's sister, and shares held by his niece and nephew. Calculated this way, the Jacobson family controls MSC. It is a family controlled company despite being public for 20 years now.

MSC has $3 billion in sales. It just completed a major expansion of its infrastructure which included a second headquarters and a fifth distribution center. The company will not be running "at capacity" till it hits $4 billion in sales. The EBIT margin is 13% now. But, Quan estimates the EBIT margin will peak in the 16% to 18% range when MSC once again operates at capacity. This is an important point to keep in mind throughout the issue. MSC might look like it is trading at a P/E of 19. But, over the next 5 years, MSC can increase sales, increase margin, and pay out free cash flow without additional investment in infrastructure. So, 2016 earnings are very low compared to what we expect 2021 earnings to be. When a buy and hold investor looks at a stock, it isn't this year's earnings they should price the stock off of. It's earnings five years down the road. MSC is not cheap compared to what it is earning if you buy it today. But, today's stock price is cheap compared to what MSC will be earning when you sell it in 2021.

## DURABILITY

### *MSC is Dependent on U.S. Manufacturing – Especially U.S. Metalworking for Most of Its Sales and Profits*

When they first hear about what MRO distributors do, a lot of investors worry about price competition from new online competitors like Amazon. This fear is misplaced. First of all, competition in MRO distribution is not based primarily on price. It is based on total cost.

Let's start by talking about what an MRO distributor does for its customers beyond being a source for a certain product at a certain price. MRO distributors have complex relationships with their customers. There is often one preferred supplier for a site. And that supplier tends to get more and more of that site's spending as the customer consolidates its purchases under one order. Here is how MSC's CEO explained the MRO business to analysts in 2011: "…buyers are dealing with millions of parts across thousands of suppliers. And these are small dollar items. So spend is fragmented. In addition, item use is inconsistent. And it's infrequent. So, you're talking about lots of inexpensive parts with random purchase patterns. On top of that, many MRO items are critical to the customer's production process. So, the stakes are high for choosing the wrong item…. MRO is the polar opposite of what's the historical sweet spot for procurement, which is set up to deal with large amounts of spend that are concentrated in a handful of high-usage, repeat items." Using a preferred MRO supplier and consolidating a lot of purchases with that one company is like outsourcing procurement. Some of the biggest benefits to using the right MRO distributor are better inventory management and lower expenses – not lower product costs.

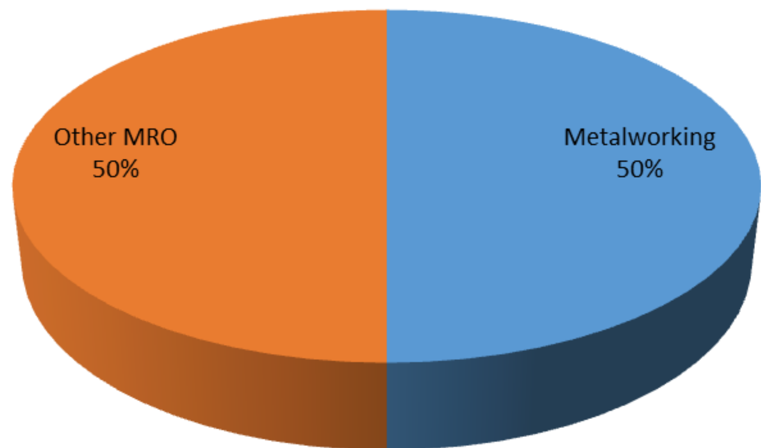
The truth is that many of the successful broad line MRO distributors – like MSC Industrial Direct, Fastenal, and Grainger – don't price below their local competitors. Yet, they have managed to take more and more market share from these local competitors. If the firms selling higher priced products are gaining share in an

industry – price competition is not the main competitive force in that industry. Here is MSC's CEO on a 2012 earnings call: "…for years and years, we've been competing against local distributors in this business and, if you look at most published reports, the average gross margin of a local distributor is around 22% (or) 23%. Clearly, for years and years, we've been competing against folks who were good competitors but price lower than we do. So if price were the game, we wouldn't be able to continue taking share from the locals the way we do."

So price is not the game. There is no evidence that MSC, Fastenal, and Grainger price below local competitors. In fact, we think they price above local competitors. Over the years, these companies' biggest customers have cut their spending with the lowest priced suppliers and concentrated it with these bigger distributors. Why have they done that?

Because they care about total cost not product price. MSC, Grainger, and Fastenal can all save money for their customers through reducing expenses on product selection, order entry, receiving, and invoicing. They can also save customers money on inventory. This may be especially true for some of the products metalworking customers buy from MSC. Customers may keep more inventory than they need on hand in cases where the parts failure would cause them to shut down a line till a replacement could be found.

MSC also tries to save customers money. Here is MSC's CEO at a 2013 investor conference: "In a manufacturing operation, to (save money), you have to be able to engineer productivity on the plant floor, technical expertise, recommendations on tooling, on what materials, what tooling to use for what materials. That comes with a lot of deep and rich experience that we've acquired over the years. And I think that's a big differentiator for us in the manufacturing world."




*MSC depends on U.S. metalworking customers for 50% of sales and U.S. manufacturers overall for 70%.*

His last point is true. There is information in comments by the management of both Grainger and Fastenal that suggests they have trouble competing with MSC when it comes to metalworking customers. MSC combines expertise in metalworking with a broad product selection. You need to have both. Kennametal – a maker of products used by metalworkers – actually sold its distribution business to MSC because customers wanted to consolidate their purchases with one distributor and so a combined manufacturer / distributor under one corporate owner was a bad combination. There's no way to consolidate enough of your purchases with a single manufacturer to get the kind of savings you can get by combining purchases with a single distributor. Only a distributor can aggregate enough within one order and one relationship.

In 2015, MSC's Vice President of Digital and Strategy compared what MSC does to what a bank does: "Anybody who does automated banking, if you've got – if you are paying your bills online or depositing checks online or automated investing… what would it take for you to have to change that relationship with your bank? And that's the way we think…if you're like me it's going to be a very high bar to say do I want to go set up a new bank and new processes, a new bill pays, and all of the new work and setup and workflow that would be required…. for us and the customers that we engage with electronically, it's not just a website. It's workflow, it's approval processes, it's a spend level…it's interactive quoting, it's interaction with your sales rep. You have now engaged us in a more efficient, more effective way to do business…it's a higher bar, stickier…in terms of being swapped out."

The reason why product cost doesn't matter as much as you'd think is that an MRO distributor can reduce ordering costs and can – at least in the metalworking field – increase productivity. Here is MSC's CEO: "…saving money on the product cost itself is only a very small part of the story when it comes to MRO. If the typical items costs, say $50, then even a 20% savings is only $10." Studies show that most companies have more overhead associated with MRO purchases than they actually spend on the cost of the product. So, using the $50 item example, a product that costs $50 to buy might have $50 worth of overhead associated with it. This sounds unbelievable at first. But, remember, someone in the company had to notice the product on the floor needed to be replaced, someone had to select the vendor to buy a replacement from, they had to enter an order online or by phone or in person, they had to receive the shipment, they had to pay the bill when it came due, and they had to keep a spare in inventory for next time. If you are repeatedly buying the same products from the same source – all of this is pretty cheap. You

find the vendor once. You establish a relationship. You re-order electronically as needed. But, here is what an MRO order often looks like. This example comes from MSC's former Vice President of Finance: "…if you have a standard order, let's say, you want to order today some safety goggles, some fuses, a drill set, and some cleaning supplies. That typical order may be $250. But you would go to a sanitary distributor, an electrical distributor, a safety distributor, and a broad line industrial distributor to find those different items…to buy that $250 worth of stuff may cost you as much as $600 in overhead." Cutting down on this overhead is why customers like to consolidate four distribution relationships into one whenever possible. It's also why they like to use online ordering.

MSC has one difference from Grainger. It's focused on metalworking. About 50% of MSC's business is metalworking. This real life example of a productivity improvement comes from something MSC's CEO said in 2011: "The customer is a machine fabricator, and the purpose of the call was to do a site assessment in order to put together a cost savings proposal. The specialist identified a drilling operation that was being done inefficiently. The drill used was too small. So, as a result, the machine operator had to make an extra cut with the drill and then use a reamer to come in and make the hole the right size. And because of all that manual effort, often times excess material was being wasted. So, the specialist called one of our suppliers, identified a larger drill that would do a better job and, the following week, he ran the test with the new drill alongside the machine operator. And, by the customer's own calculation, our specialist saved them $30,000 annually in labor and materials."

The durability of MSC's existing relationship with clients is based on the way an MRO distributor is integrated into the processes of its big customers. It is based on the fact that competitors with lower product prices have failed to take MSC's customers. So, price competition is an ineffective way to win business. And it's based on MSC's two key abilities to reduce overhead by consolidating purchases and improve productivity by being a metalworking specialist. For metalworking customers, the two key things their purchasing managers need to do is consolidate as much of their orders as possible with one MRO distributor and use a distributor with metalworking expertise. MSC is the only company with both the scale and the expertise to be the right choice for most North American metalworking businesses. That's why MSC has 10% market share in this business and no one else has even a small fraction of that.

Even an aggressive growth company like Fastenal hasn't had a lot of success competing with MSC in its metalworking niche. In 2014, Fastenal's CEO said: "We continue to work very hard in metalworking. It's continuing to outgrow the overall company revenue, not by the amount that we had expected…people, I think, had too high of an expectation going in, thinking we are going to be as big as MSC overnight, and that didn't happen." Grainger made an acquisition to gain expertise in metalworking. MSC is the market share leader in MRO sales for metalworking and it has only 10% of the market. There is a lot of room to grow. Most of the market is in the hand of local distributors. These distributors are severely disadvantaged versus MSC, Grainger, and Fastenal. Local distributors usually price at lower gross margins. This causes them to generate low returns on capital. They therefore have less retained earnings to invest in competing on anything other than price. Focusing on having the lowest product prices is not a good long-term strategy in this business. But, once your main method for competing is on the product price – it's hard to compete on other aspects of the customer relationship. It really does seem certain that the big customers of MSC, Grainger, and Fastenal will stay with those companies. They aren't going to leave for local distributors. And they aren't going to leave if Amazon offers lower product prices. In the MRO industry, the lowest price does not constitute the best offer.

## MOAT

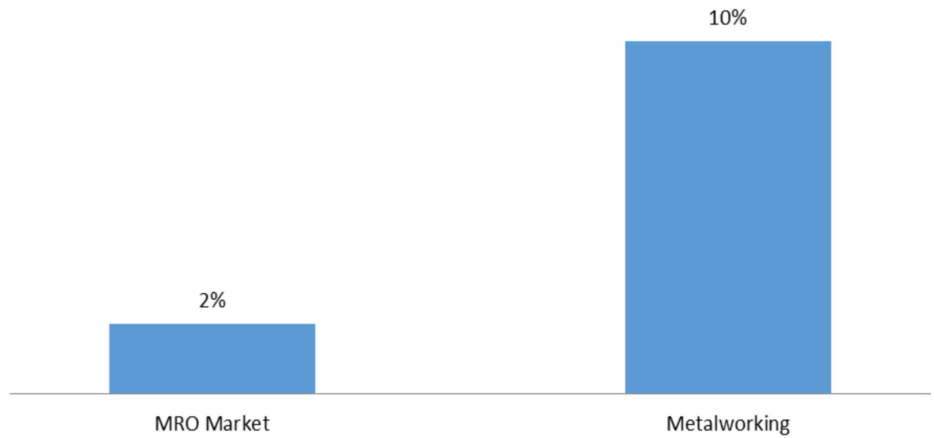
### *MSC's Moat is its Existing Relationships with U.S. Metalworking Customers Who Buy MSC's Cutting Tools and Make Use of MSC's Technical Expertise*

MSC's moat comes from its existing customer relationships. It is hard for one MRO distributor to take business away from another MRO. These relationships are often sticky. And the real test of a moat is how much damage one competitor could do to another. In the MRO industry, the answer is very little. Both Amazon Supply and local competitors probably have lower prices on average than Grainger, Fastenal, and MSC. However, Grainger and Fastenal and MSC are the ones who gain market share over time. This is because price competition is not an effective way to win new customers in the MRO industry. MSC gets about 50% of its revenue from metalworking products. An MSC customer's average order size is $400. About 45% of MSC's stock keeping units are cutting tools. And everyone agrees that MSC is the number one distributor of cutting tools in North America – by far. So, the metalworking revenue that Fastenal and Grainger get does not make them close competitors of MSC in the specific niche of cutting tools. MSC believes selling cutting tools to machine shops is a key way to establish a primary relationship with that machine shop that can then develop into a relationship where MSC is the source for all kinds of unplanned purchases at that shop. This means MSC hopes to start a relationship as a distributor of every kind of cutting tool imaginable and then also fill the needs Grainger fills for its customers.

MSC is a multi-channel distributor. It has 100 sales office around the country so it can have a sales force presence everywhere there are big machine shops. Most customers do not use the public website at MSCdirect.com that you would see if

you typed that address in your web browser. Instead they use a private website. The private website gives them discounted prices and integrates with the customer's enterprise resource planning system (for inventory management). MSC can also provide vending machines on site. However, the products in these machines are delivered via UPS or whatever carrier MSC sends its regular shipments to the customer in. The purpose of a vending machine is so a customer can set a minimum and maximum inventory level for a stock keeping unit and have those levels automatically maintained by MSC. Here is what MSC's CEO said about vending machines in 2012: "We're seeing where we install vending big deltas in the growth rates for customers that have a vending machine. We're seeing very strong retention rates, and I think more importantly, high levels of customer satisfaction. …Vending is a great tool, but it's just a tool. And it has to be applied to the right type of customer, and to the right type of products within that customer….our approach…really starts with the customer's needs and doing a profile of what their needs are."

In this way, MSC is similar to Grainger. Both companies get a lot of growth from big customers. And many customers have multiple sites. So, when you see a high growth rate at MSC – as it has had for most of the last 40 years – you may think that is due to signing up a lot of completely new firms as customers. This is unlikely. A lot of MSC's growth is probably due to gaining additional share of a single site's spending – for example, a site going from just buying cutting tools to buying all sorts of MRO supplies from MSC – and from getting orders from multiple sites owned by the same company. It isn't easy for an MRO to take over as the biggest supplier to a company it has never done business with before. All companies have some vendors they buy from already. And there is some level of integration of that supplier into the way their site




*MSC's market share is 5 times higher in the metalworking MRO market segment than in the U.S. MRO market generally.*

runs. Here is how MSC's Vice President of Digital and Strategy explained that integration and the stickiness it creates in 2015: "…for us and the customers that we engage with electronically, it's not just a website. It's workflow. It's approval processes. It's a spend level. It's (purchase order) management, it's interactive quoting, it's interaction with your sales rep. You have now engaged us in a more efficient, more effective way to do business. And it's a higher bar, more sticky rather than less, in terms of being swapped out."

The moat around Granger, Fastenal, and MSC is wider today than it was 10 to 15 years ago. It would be harder today to take a customer from one of these companies than it was in the past. And the reason for that is the increase in breadth of what these companies do for their biggest customers and the increase in how many different aspects of the supplier are integrated into the customer's own operations. We know that a typical big customer of Grainger does business with Grainger across several different channels. It places orders online, on site, by phone, in store, etc. When we say a company like MSC has multiple channels you might assume that means different channels are for different customers. But, often that's not the way it works. The same customer may want a vending machine on site while placing most orders via the private (discounted) website and occasionally dealing with a sales rep.

In 2011, MSC's CEO cited the reasons why one customer was loyal to MSC: "He asked, why would a metalworking shop need to do business with anyone other than MSC? He was describing that there were several things he appreciated about MSC. First, the combination of our enormous product offering and superior logistics which means he doesn't have to worry about keeping inventory on the shelf, nor does he have to worry about an out of stock that could affect the production run. Second, the technical strength of our local salesperson and our metalworking specialist means…we are providing advice on the plant floor to generate productivity and cost savings. Third, our technology solutions, including e-commerce and now vending, as he was getting ready to install his first vending machine, streamline his purchasing process, and help take inventory out of his system. The best part about this customer is the fact that despite high levels of satisfaction and despite the fact that this is a six figure account for MSC, we see runway to more than double our revenues based on additional opportunities within the plant."

This story is important for two reasons. One, it shows MSC's strengths with metalworking shops. But, two, it shows how hard it is to win all of a customer's

wallet. It shows how slow the process is. MSC has been doing business with this customer. He is pleased with them as a sort of one-stop shop for his needs. But, if MSC saw the opportunity to double its revenue at this site, we know that at least half of this very satisfied MSC customer's wallet was actually being spent with a variety of other suppliers who compete with MSC in various ways. This is the long-term growth opportunity at MSC as it is at Grainger. They can get a larger and larger piece of the overall MRO spending at sites where they are already the biggest single supplier. But, this also shows the moat around an MRO relationship. If MSC really is so much better than any other suppliers in this customer's eyes – why does he still get any of his MRO needs filled elsewhere? We can guess it is because he has probably been doing things a certain way for a long time. We can probably guess that he has not sat down and looked carefully at every activity he needs done that MSC could possibly do and consolidated it under one account. So, yes, we can expect that MRO will get a bigger and bigger piece of this satisfied customer's business. But, we can also see that shifts in market share are really slow in this industry. Most companies have a history of buying different supplies form different suppliers. Over time, the biggest suppliers should take share from the smallest. Sites should consolidate more and more of their MRO buys under one account. Broadly, a company like Grainger benefits from that. And narrowly, within the metalworking industry that is MSC's focus – MSC will be the biggest beneficiary of this winnowing of the supplier list.

## QUALITY

### *MSC Can Charge a High Mark-Up*

Like Grainger, MSC has a higher gross margin than a typical distributor. There are two reasons for this. One reason is that many purchases from MSC are unplanned. Unplanned purchases often have higher prices than planned purchases. However, meeting unplanned purchases requires keeping a lot of inventory. MSC keeps over 800,000 different stock keeping units on hand at all times. This is a much broader range of inventory than most distributors carry. The other reason that allows MSC to have a higher gross margin is the value added services it provides. Local competitors of Grainger and MSC charge less for their products. They have gross margins below 25%. The big MRO distributors like Grainger, Fastenal, and MSC have gross margins well above 25%. This is because they serve large customers who are focused on the total cost of meeting their MRO needs rather than the price of a specific product.

From 1997 to today, MSC's gross margin has averaged 45%. In those 18 years, it has ranged from a low of 41% to a high of 47%. The variation in MSC's gross margin has been extraordinarily stable. Few companies of any kind have as stable a gross margin as MSC. MSC's high and stable gross margin is due to customers' high willingness to pay. It is probably also due to a very diversified mix of products. Some companies experience fluctuations in their gross margin from year-to-year because the mix of products they sell changes and different products have different gross margins. MSC meets a lot of immediate and unplanned needs. While the overall volume of its sales may fluctuate with U.S. manufacturing activity generally and metalworking activity specifically – the kinds of things it sells does not vary much from year to year. Customers can't put off purchases. So, there is low cyclicality. The gross margin pattern looks a lot more like that of a company selling consumables rather than durable capital goods. This is because customers buy product from MSC as they need it. The reason customers have a high willingness to pay for a product is because MSC offers them one stop shopping, a broad product offering, next day service, technical expertise in the metalworking field, and helps them manage their inventory. These value added services make the relationship between MSC and the large metalworking shops it serves stickier. They act as switching costs. An MSC customer does not want to go out and price shop for a 4% lower price on some specific product. They may not even want to go price shopping for a 10% lower price on some specific product. What they care about is whether there is another distributor that can keep them all their MRO needs at less than MSC. This can include concerns like how much inventory they have to keep on site.

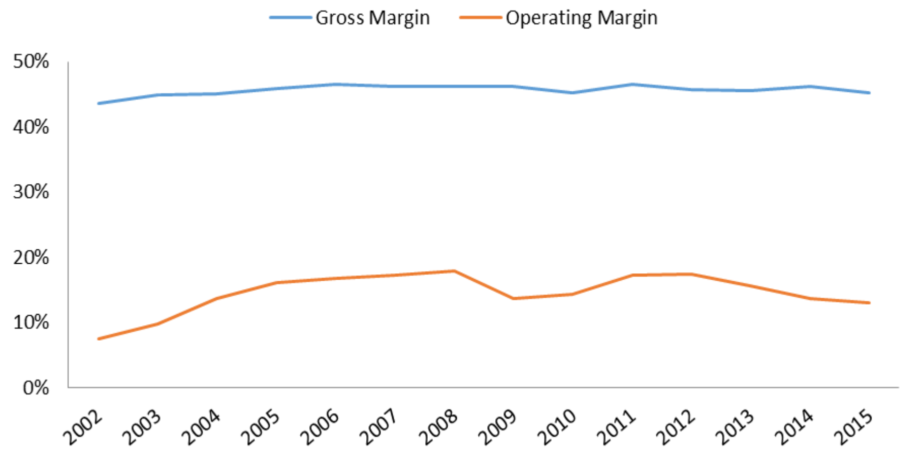
MSC is a big MRO distributor. There are a few other large MRO distributors in the U.S. Grainger, Fastenal, and McMaster-Carr are all big. However, each of these companies actually has a slightly different focus. Grainger is very good at being a broad supplier of all sorts of needs to large national accounts in the U.S. It is very strong in areas outside manufacturing. And even when serving manufacturing companies, Grainger is strongest away from the factory floor. Fastenal is strongest in fasteners specifically and construction and manufacturing generally. MSC gets probably 70% of its sales from manufacturing overall and 50% just from metalworking. MSC is by far the biggest distributor of cutting tools in the U.S. Different sources give slightly different figures on relative size. This is probably due to confusion over the classification of sales by category. Fastenal has a meaningful business selling to metalworking companies. So does Grainger. If we define market share as all sales of metalworking related supplies, then MSC would be the biggest player. But, Fastenal and Grainger would have reasonably large market share. However, if you look at cutting tools specifically – MSC is probably several times

bigger than Fastenal. It is much, much bigger than any local competitor. It is worth mentioning here that competition for a site's business is usually between a big MRO distributor like Grainger, Fastenal, or MSC and local competitors. Everyone you talk to at Grainger, Fastenal, and MSC will say the same thing. They compete less directly with each other than analysts think. In the field, their sales people are usually competing with local distributors. MSC gets about $1.3 billion in revenue from metalworking. This is estimated to be 10% of the U.S. market.

MSC and Grainger both say that some inflation is beneficial to their business. This is because they are able to increase prices to customers ahead of increases in their own product costs. They can raise the price on an output before being hit with the price increase as an input. This does not mean they can raise the real price of their products over time. It just means that if inflation in something like the producer price index is running at 2% a year instead of 0% a year – they can always have higher gross margins (by some amount between 0% and the annual rate of inflation) than they would in a stable price environment.

The likelihood of gross margin expansion at MSC is less than at Grainger. MSC gets less private label sales than Grainger. The brand of a cutting tool is more important than the brands on most of what Grainger sells. MSC will have a hard time increasing its gross margin over time. However, it will be really easy for MSC to increase its operating margin over the next 5 years. In fact, excluding recession years – Quan and I think MSC is certain to expand its EBIT margin between now and 2021.

MSC started to expand its infrastructure in 2013. It built a second headquarters. And it built a fifth distribution center. It also increased adoption of its vending program. The vending program has a long selling process but a high retention rate. There are start-up expenses associated with putting the machine in place. Growth at sites with vending machines tends to be higher than growth at sites without vending machines. So, installation of vending machines causes a temporary decline in the EBIT margin followed by a subsequent increase in the EBIT margin.




*Like Grainger and Fastenal, MSC's gross margin is much higher than its smaller competitors*

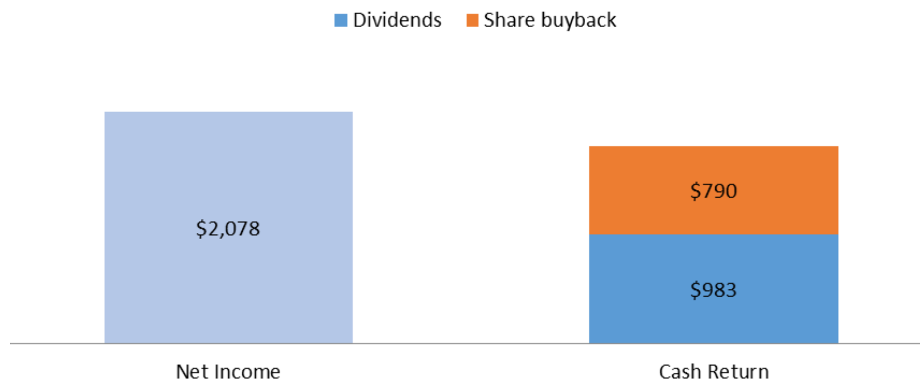
The period from 2002 to 2012 can act as an illustration of one possible future for MSC. At the end of 2002, MSC had just completed a national expansion program. It added fulfillment centers. It invested in its website. It doubled its sales force. The economy slowed around this time. MSC's EBIT margin declined to 8%. Ten years later, MSC had much the same physical infrastructure and sales force. Yet it was now doing $2.4 billion in sales versus $1 billion back in 2002. The company's EBIT margin expanded from 8% in 2002 to 18% in 2012. MSC is by far the most centralized MRO distributor. Fastenal is very decentralized. Grainger is somewhat centralized. MSC is completely centralized except for having its sales force positioned within driving distance of customers. The actual distribution is centralized. Inventory is kept in just 5 distribution centers. All orders ship from these sites via a carrier like UPS. MSC does not have any of its own trucking like Fastenal does. It has no stores to ship to like Fastenal and Grainger do. All orders go from a distribution center to a customer site via a package delivery company. The average order size of $400 is larger than at an MRO like Grainger.

From 2005 through 2013, MSC had an EBIT margin of between 16% and 18%. Fastenal tends to have a 21% EBIT margin. Grainger tends to have an 18% EBIT margin. It is reasonable to expect that MSC – because it can do $4 billion of revenue with its existing infrastructure and sales force – can have an EBIT margin of 17% within 5 years. The company tends to have a ratio of sales to net tangible assets of 3. So, 17% times 3 equals 51%. We expect MSC can – within the next 5 years – achieve a 50% pre-tax return on equity which is a more than 30% after-tax ROE. Any business that can earn a 20% to 30% return on equity without using leverage is a high quality business. MSC has a very high quality business model.

## CAPITAL ALLOCATION

*Even While Growing Quickly, MSC Can Return 60% of Earnings to Shareholders*

Since 2005, MSC has returned 85% of its earning to shareholders. MSC's free cash flow generation and return of capital to shareholders is very similar to what we saw at Grainger. Since 2005, MSC generated $2.37 billion in total cash flow from operations. Net income totaled $2.08 billion. And the cash return was $1.77 billion. So, this means MSC returned 85% of its earnings and 75% of its cash flow from operations. However, the number that really matters is only the amount of cash return above that needed to offset share dilution. Over the last 10 years, MSC has used almost $500 million just to buy back stock that offsets dilution. From a shareholder's perspective, this is equivalent to cash compensation to employees. Employees are given shares. But, the company uses cash it would otherwise pay out to shareholders to buy back stock and offset these stock grants. So, MSC's total cash return from 2005 through 2015 was actually $1.3 billion in excess of what was needed to keep the share count from increasing over that time. This means MSC returned about 62% of reported earnings and about 55% of its cash flow from operations. This is almost identical to what Grainger paid out in dividends and stock buybacks in excesses of dilution offsets. Grainger paid out 66% of reported earnings and 51% of cash flow from operations. In this sense, we can say that Grainger and MSC are effectively identical in terms of how much of their earnings they return to shareholders. They both pay out something like 60% to 65% of reported earnings in a combination of buybacks that actually reduce share count and dividends. If you prefer, you can look at cash flow from operations and see that both companies tend to pay out 50% to 55% of cash flow from operations in buybacks and dividends beyond what is required to keep the share count stable.




*Over the last 10 years, MSC reported $2.08 billion in earnings while spending $790 million on stock buybacks and paying out $983 million in dividends.*

What's important though is not how much a company pays out to shareholders. What's important is the return it gets on the money it retains. This is where MSC's record looks really good. From 2005 to 2015, MSC grew sales by more than 10% a year while retaining just 38% of reported earnings. This means the company generated a roughly 27% after-tax return on the earnings it retained. Some companies pay out more of their earnings than MSC does. And some companies grow faster than MSC does. But, very few companies grow as fast as MSC does while paying out as much in dividends and buybacks as MSC does. In fact, MSC has a high dividend payout ratio for such a fast growing business. Over the last 10 years, MSC has tended to pay out something between 30% and 50% of its EPS in dividends while also growing earnings per share by more than 10% a year. Many companies that grow EPS by 10% a year or higher choose to pay almost nothing out in dividends.

MSC is not opportunistic in how it returns capital. Management of MSC – like almost all public companies – claims to be "opportunistic" in how it times buybacks. However, the record clearly shows otherwise. MSC returns cash when it has cash. It balances buybacks and dividends. It likes to increase dividends each year. And it sometimes pays special dividends. The payment of special dividends is probably done to diversify how MSC returns capital. There isn't much logic to how MSC chooses whether to make a special dividend payment or a stock buyback. As an example, MSC spent about $191 million on share buybacks in 2014. The average price paid was just under $81 a share. As I write this, the stock is at $74 a share. So, it might seem MSC overpaid. That's not necessarily true. Even at a P/E of 22, we don't think MSC would underperform the S&P 500 over the next 5 years. This is because we think it can grow earnings per share a lot faster than other public companies. In large part, this is due to the fact MSC has already invested in the infrastructure needed to grow sales over the next 5 years. So, the company can grow sales without growing fixed expenses for several years. This isn't true at most companies. Most public companies will not be able to expand their profit margins over the next 5 years. MSC will expand its profit margin. Based on MSC's past growth rate and its return on retained earnings, it's actually not a bad stock at 22 times earnings. And buybacks are more tax efficient for long-term shareholders than dividend payments. So, the $190 million spent buying back stock at $81 a share did not destroy value. But, it can't be called "opportunistic" either.

Here is how Quan and I think MSC really makes its capital allocation decisions. MSC avoids having net cash. And it avoids having net debt much above one times

EBITDA. Debt is highest when MSC makes an acquisition. But, putting the moment of an acquisition aside, MSC is run as an unleveraged company. It doesn't use "anti-leverage". That is, it doesn't pile up cash either. So, MSC's decisions on when to buy back stock and when to pay special dividends really have nothing to do with the price of MSC's stock. Instead, they have to do with the level of MSC's debt. When net debt is above one times EBITDA, MSC may not return much (if any) cash in buybacks and special dividends. When net debt reaches zero – and MSC would risk having net cash – the company returns the most cash. So, MSC isn't managing its stock price. It isn't being "opportunistic" with the pricing or timing of buybacks and dividends. It is simply managing its cash and debt levels. When it has cash, it returns it. But, MSC doesn't build up debt just to do buybacks or pay special dividends. Separately, MSC likes to pay a regular dividend that rises somewhat over time. This is typical of many public companies. MSC is unlikely to cut its dividend. And it is likely to make some increase to the dividend whenever possible. But, the company shows no real preference for dividends over buybacks or buybacks over dividends. And it doesn't really make decisions based on the price of its own stock. It simply doesn't allow cash to build up on the balance sheet. The two theoretical rules we've posited – 1) That MSC doesn't want net cash and 2) That MSC doesn't want net debt to stay above 1 times EBITDA for long – force the company's hand when it comes to buybacks and dividends. MSC generates free cash flow. It has to do something with that free cash flow. So, once the stock of net debt is paid down and net cash is about to build up – the company has to do some combination of buybacks or dividends. And MSC doesn't seem to have a strong preference for one way of returning capital or the other. So, the company might pay out around two-thirds of reported earnings in buybacks and dividends. Maybe a third of earnings will be paid out in dividends. And maybe a third of earnings will be paid out in stock buybacks. The rest goes to buying back stock to offset dilution. Quan and I don't consider that actual stock buybacks. It's really just a roundabout way of compensating employees.

Remember, MSC is family controlled. So, it is perhaps less likely to be taken over than other public companies. There is, however, always the possibility the family takes the company private. We estimate the Jacobson family (some of whom have other last names – like the current CEO, Erik Gershwind) control 82% of all voting power and 49% of the economic interest in the stock. So, MSC is very much a family company. The family probably wants to keep control of the company, grow the company as fast as is reasonably possible, and then pay out all capital that can't be used for prudent growth, while never using much leverage at all. That is a good description of what management's past actions seem to suggest. Quan and I expect MSC to follow that basic pattern in its future capital allocation. So, MSC's capital allocation over the next 10 years should look a lot like its capital allocation over the last 10 years.

## VALUE

### *MSC is an Above Average MRO Distributor – Like Grainger and Fastenal – Trading at an Average MRO Distributor Type Price*

MSC Industrial is now trading for a little less than 10 times its normal EBIT. MSC's revenue is $2.9 billion. Between 2006 and 2012, EBIT margin was 17% to 18%. From 2013 on, MSC invested heavily in the business. This tends to reduce EBIT margin short term. But, it does not reduce EBIT margin long-term. If we assume MSC will achieve a 17% EBIT margin once again in the future, its $2.9 billion of revenue translates into $493 million in EBIT. It does not make sense to use anything other than a company's peak EBIT margin in an industry that has tended to have stable to rising EBIT margins over time. We often use the past peak EBIT margin to value non -cyclical companies. MSC's two closest peers are Fastenal and Grainger. Grainger's EBIT margin has been around 17% to 18%. Fastenal's has been around 21%. MSC's own EBIT margin last peaked around 17% to 18%. So, it makes sense to use current revenue and apply a 17% EBIT margin to that number. This captures future margin expansion. It does not capture future sales growth. So, if MSC grows earnings faster than sales, this will not matter for our valuation if we use the past peak EBIT margin. It only becomes an issue if we use today's lower EBIT margin. Therefore, Quan and I prefer to use a combination of MSC's past peak EBIT margin to value the company and its likely future sales growth – not earnings growth – when analyzing the company's growth prospects.

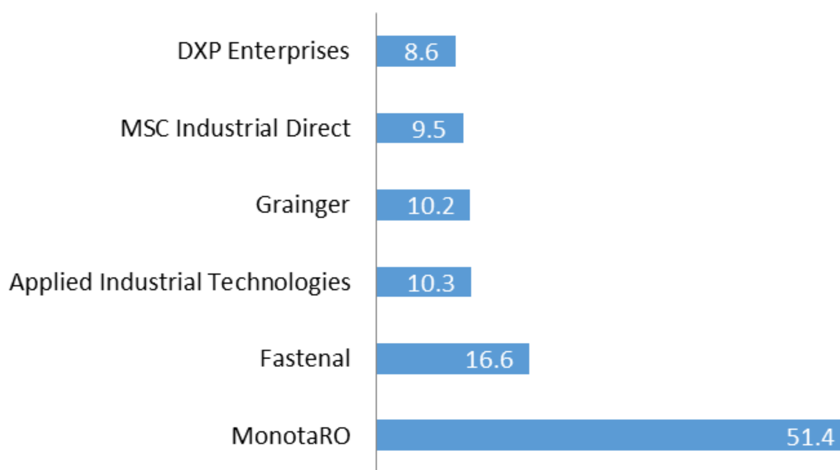
MSC has several public peers. DXP Enterprises is the cheapest. This company gets 66% of its revenue from oil and gas. A lot of it is from upstream and production. Oil and gas production is 23% of revenue, upstream is 19%, midstream is 18%, and downstream is 6%. This means that over 40% of DXP's revenue comes from oil and gas production and upstream activities. This is an extraordinarily high percentage of revenue coming from areas that can be very badly hurt by low oil prices. The most attractive energy companies right now are those that get lumped in with oil producers but actually get most of their profit from downstream activity that does not depend much on the price of oil. DXP trades at just under 9 times EBIT. However, the company had net debt equal to about 5 times adjusted EBIT. That's a huge debt load. So, this is a very, very risky stock. It is extremely cyclical. And it is extremely heavily indebted. DXP also has an inferior business model to MSC. DXP was a very fast growing business. But, this coincided with a series of acquisitions and a huge run-up in oil production activity in the U.S. So, it's not clear that DXP will actually grow much faster than Fastenal, Grainger, and MSC over the next 5 or 10 years the way it did over the past 5 to 10 years. Like I said, DXP trades at less than 9

times EBIT. But, it shouldn't be valued as highly as MSC. It's really a highly leveraged supplier to the U.S. oil and gas industry. So, its valuation at 9 times EBIT is not meaningful when looking at MSC.

Applied Industrial Technologies has a very different business model from Grainger, Fastenal, and MSC. It has low margins and high turns. Gross margin is 27%. EBIT margin is 7%. The company can achieve a 30% return on capital before tax and 20% return on equity without the use of debt. So, it's a high quality company despite its low margins. However, AIT's growth was incredibly slow. Over the last 15 years, Applied Industrial Technologies has grown at less than 4% a year. That's not good. But, the truth is much, much worse than that number makes it appear. AIT spent over half of its cash flow from operations on acquisitions during this 15 year period. That either means that the acquisitions destroyed a ton of value or that AIT's core business would have shrunk considerably without the acquisitions. In other words, organic growth at AIT might be near zero. And capital allocation is suspect. AIT's business model is fine. It's high quality. But, the company's growth and capital allocation is bad. The stock trades at just over 10 times pre-tax profits. MSC is far superior to AIT in both growth and capital allocation. MSC should definitely be valued above AIT.

Grainger is MSC's closest peer. We did an issue on this company. Quan and I think Grainger will be a good stock to own over the next 5 years. The company's EV/EBIT is about 11. We estimate price to owner earnings is a bit lower at around 10 times. Grainger is much better than both AIT and DXP. Is Grainger better or worse than MSC? This is a hard question to answer.

Let's look at the similarities between Grainger and MSC. Grainger and MSC both keep over 500,000 stock keeping units in inventory. A lot of their sales are for unplanned purchases. Both have a multi-channel approach to sales.




*On an enterprise value to adjusted EBIT basis, MSC is priced between DXP and AIT even though it is a higher quality growth company than both of those peers.*

In fact, Grainger and MSC are both far more multi-channel than Fastenal. These companies make a lot of sales online and via vending machines. Grainger and MSC have the best e-commerce capabilities of any MROs. They are both stronger than Fastenal in this area. And probably much, much stronger than local competitors. Grainger and MSC both ship a lot of product from their distribution centers (warehouses) instead of from stores. MSC has no real stores (only sales branches). Grainger has a limited number of stores that will probably become less important to the company over time. Grainger and MSC – as well as Fastenal – have all shown an excellent ability to gain market share over time. It's clear that all 3 companies have gotten a larger share of their customer's MRO spend over time. They all win business from smaller competitors. Grainger and MSC both make a pre-tax return on capital in the 40% to 60% range. This is equivalent to an unleveraged ROE of 25% to 40%. Any business that earns a 25% return on equity without using debt is a great business. If such a profitable business can grow – that growth is very, very valuable. The growth prospects at Grainger and MSC are both good. Quan thinks MSC's sales growth potential is better than MSC's. Both of us think that MSC's earnings growth potential – that's sales growth plus margin expansion – over the next 5 years is well ahead of Grainger. I think the two companies are pretty much perfect peers. MSC should trade at the same price as Grainger. Quan and I think both Grainger and MSC are undervalued.

We're not sure Fastenal is undervalued. Fastenal is a terrific business. However, it has a different model than MSC and Grainger. Fastenal has more than 2,700 stores and more than 54,000 vending machines. Stores are tiny. The average store has no more than 4 employees working there. While Grainger and MSC focus on non-recurring purchases, Fastenal focuses on items that are repurchased over and over again. The company's single biggest product category is still fasteners. MSC's biggest category is cutting tools. Fastenal ships from its stores to its customers. Grainger and MSC both focus on shipping through delivery services. They ship from their warehouse to the customer. Fastenal uses its own trucks to move product from warehouses to branches. Fastenal's inventory often sits for two months in a distribution center and then 3 to 4 months in a store. Stores are periodically re-stocked by distribution centers. So, Grainger and especially MSC are as different from Fastenal as Amazon is from Wal-Mart in terms of how they handle their inventory. Fastenal's growth record is better than MSC's. Over the last 26 years,

Fastenal grew at a rate of 19% a year. However, over the last 5-10 years, Fastenal has only grown at 10% to 11% a year. This is quite comparable to MSC. Fastenal trades at 15 times EBIT. It's possible that MSC and Fastenal should now trade at similar multiples. It's not clear that Fastenal has a better future in terms of growth. However, 15 times EBIT is a high price. So, it's not clear that Fastenal is undervalued. It's very clear to both Quan and I that Grainger and MSC are undervalued. Of the MROs we've discussed, we consider only Grainger and MSC to be clearly undervalued and worthy of your investment. AIT and DXP aren't great businesses with great futures. Fastenal is an above average company with above average growth prospects. But, its price is now also about 50% above average compared to where most U.S. stocks have often traded in the past.

MSC is really only comparable to Grainger and Fastenal. Grainger trades near 10 times EBIT. Fastenal trades near 15 times EBIT. MSC should be somewhere in this range.

In the past, MSC has always traded at a very high price. From 1998 through 2015, MSC's lowest P/E ratio for the year ranged from 9 to 35. The median lowest P/E for the year was 19. The only times MSC had a P/E below 16 occurred during the very volatile stock market declines of 1999 through 2001 and 2008 through 2009. MSC's highest P/E for each year was off the charts high. In an average year, MSC often hits a P/E of 30 at some point. So, this has historically been a high quality growth stock that was priced like a high quality growth stock.

MSC deserves a high multiple. It has historically been able to grow sales at 10% a year while returning more than half of its earnings. MSC's two closest peers are Grainger and Fastenal. All 3 of these companies have been very successful at growing earnings per share while earning a high return on capital. The future looks as good as the past for MSC. It's comparable to Grainger and Fastenal. Quan and I can't decide the exact order these 3 companies should trade at relative to each other. Grainger trades at 10 times EBIT and we're sure it's undervalued. Fastenal trades at 15 times EBIT and we're not sure if it is overvalued but we're also not sure if it's undervalued. Therefore, MSC should definitely trade for more than 10 times EBIT but perhaps should not trade for more than 15 times EBIT. Basically, we're sure MSC should trade for more than $75 a share. But, we're not sure MSC should trade for more than about $125 a share. It wouldn't be unreasonable to hold MSC stock at prices between $75 and $125 a year. And, in normal times, the stock's intrinsic value could grow as rapidly as 10% a year. MSC is not a cheap stock. It's not a value stock. But, it's an excellent "growth at a reasonable price" stock. Quan and I think that the long-term growth in EPS at the trio of big MRO distributors (Grainger, Fastenal, and MSC) is as certain as any growth stock can be. So, while a price of 10 to 15 times EBIT may sound expensive, these 3 companies – Grainger, Fastenal, and MSC – are 3 of the highest quality growth companies around. They will grow earnings per share while paying out dividends not just for the next 5 years but for the next 10 and 15 years too. These are predictable growth companies. Even the multiple of 15 times EBIT that Fastenal now has isn't unreasonable. It's not cheap. But, Fastenal could certainly be worth 15 times EBIT. MSC is definitely worth more than 10 times normal EBIT. Quan and I think normal EBIT is more than $500 million. So, a reasonable price range for the stock is $75 to $125 a share.

## GROWTH

### *MSC Industrial Can Continue to Gain Market Share in the Overall MRO Industry for Decades*

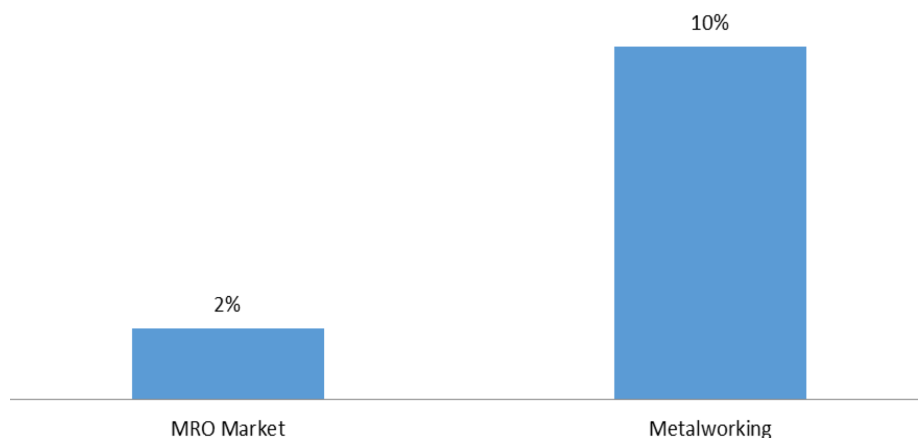
MSC can grow over time. However, a lot of this growth will come from gaining a bigger share of the MRO spending at companies it already serves. In 2005, MSC had $2,500 in revenue per customer. In 2015, it had $8,000 in revenue per customer. MSC may have lost some small customers and retained large customers. And this figure is not per site. It is per customer. So, it can be misleading to think that MSC has really increased sales at each existing customer by an average of nearly 12% a year over the last 10 years. But, it's not misleading to think that a lot of MSC's growth comes from doing more business with existing customers. Most of Grainger's growth in recent years has come from big customers. Since the financial crisis, Grainger's sales to its biggest customers grew at 8% to 9% a year. Sales to medium customers were relatively flat. And Grainger lost a lot of small customers. So, it's not surprising that MSC has increased sales per customer just as Grainger has.

MSC is focused on metalworking. Over the last 20 years, manufacturing in the U.S. grew at about 2% a year in real terms. If inflation is normally between 2% and 4% a year, then this would mean that manufacturing output in nominal terms would grow at no more than 4% to 6% a year. In other words, U.S. manufacturing does not grow faster than nominal GDP. It may grow slower. The MRO market actually grows at least as slow as manufacturing overall – and perhaps slower. In 2015, Grainger's CFO said: "…the (MRO) market will grow 2% to 3% as it's been growing for some time." This was a prediction for the next 5 years. It suggested that growth would be 0% to 1% a year in real terms with inflation of 1% to 2% a year. If manufacturing grows at no more than 2% in real terms and the MRO market grows no more than 1% in real terms – how can MSC grow much at all? Fastenal, MSC, and Grainger have all grown at rates equal to nominal GDP or even better than that at times when the MRO market as a whole was barely growing at all above the rate of inflation. In fact, these 3 companies always grow faster than the MRO market. They gain market share.

MSC now has about $3 billion in sales. At various points in the past, management has said it has "an ultimate vision" to grow the company to $10 billion. Here is MSC's CEO, Erik Gershwind, in 2011: "…MSC operates in a very large and highly-fragmented marketplace providing us with tremendous opportunity for growth…. (MSC is) uniquely positioned within that market to delight customers and to take share…our operating model gives us leverage and scale as we grow, providing room for further operating margin expansion…and…we have a repeatable growth formula that we intend to apply over and over again to achieve our ultimate vision of being a $10 billion plus business."

This sounds promotional. But, most of what Gershwind said is supported by a lot of historical data from MSC, Grainger, and Fastenal. A lot of companies say they are in "very large" and "highly fragmented" marketplaces. For the MROs, this is an understatement. MSC is the leader in metalworking. It has just a 10% share of the metalworking MRO industry. It's unusual for the clear number one in an industry to have just 10% market share. And it won't last. MSC will have a much bigger share of the metalworking MRO industry in the future. We know this because we can look at how the industry has consolidated year after year as Grainger, Fastenal, and MSC have all gained share.

Let's talk about just how fragmented the MRO industry is. Grainger divides the market into large, medium, and small customers. The large customer segment is a $40 billion market. The medium customer segment is a $50 billion segment. And the small customer segment is a $40 billion segment. Let's test the idea that Grainger, Fastenal, and MSC might be overstating how fragmented it is. We know all 3 companies – Grainger, Fastenal, and MSC – do especially well with big customers. This is compared to local competitors. So, maybe local competitors can always keep a lot of small and even medium sized customers. Fine. Let's pretend the entire U.S. MRO industry consists only of large customers. That would make it a $40 billion market. Grainger has $5.9 billion in revenue in that market. Let's imagine – and this is just for the sake of illustration – that Fastenal and MSC get every dime of their sales from only large customers. They don't. We're just pretending that's true to see the absolute maximum possible market share they could have today. Fastenal has $3.9 billion in revenue. That's a 9.8% market share ceiling. We just proved that Fastenal has to have less than 10% of the large customer MRO market. MSC has $2.9 billion in revenue. That's a 7.3% market share. We just proved that MSC has to have less than a 7% share of the large customer segment. Rounding off each of these numbers, we can definitively say that Grainger has less than 15% of the large customer MRO market, Fastenal has less than 10% of the market, and MSC has less than 7%. These are the 3 biggest MRO distributors to large customers. So, we can now say that the top 3 MRO distributors have less than 32% (15% + 10% + 7% = 32%) of the large customer MRO market.




*In the U.S., MSC has a 10% share of the metalworking MRO industry and a 2% of the overall MRO industry.*

There are industries where the top 3 competitors have two-thirds of the overall market. So, it is easy to imagine a future where competitors other than Grainger, Fastenal, and MSC go from having more than 68% of the total market to having just 35%. Even in a period of very low inflation, Grainger expects the MRO market to grow 2% to 3% a year (including inflation). Assume the combination of Grainger, Fastenal, and MSC grow 5% a year faster than the market. It would take these 3 companies more than 15 years to have anywhere near two-thirds of the market. And we think that even after 15 years of growing 5% a year faster than the market – so 7% to 8% a year – these 3 companies combined wouldn't really have two-thirds of the market, because Fastenal and MSC actually get sales from medium and small customers. For the sake of illustration – and because the companies don't give good data on customer size segmenting – we assumed they only serve large customers. This is false. So, even if these 3 MROs were limited to just the big customer segment, they could grow at 5% a year faster than the industry for 15 years before the 3 companies would control somewhere between say half and two-thirds of the big customer market.

Let's do this illustration looking only at MSC. Say it has 10% market share in metalworking MRO today. Now, assume metalworking MRO grows at 2% a year over the next 25 years. If MSC grows at 7% a year for the next 25 years, it would have a 34% share of metalworking MRO in 2041.

These aren't predictions. They're illustrations of a general point. Yes, U.S.

manufacturing output grows pretty slowly. Yes, MRO spending grows very, very slowly. And, yes, inflation is low right now. None of that matters as much as you'd think. Grainger, Fastenal, and MSC all have very low market share and a history of growing that market share. They can grow for decades purely based on market share gains. Let's use one final illustration. Let's say each of these 3 companies has a focus. Grainger is focused on big customers. Fastenal is focused on fasteners. And MSC is focused on metalworking. As of today, Grainger only has a 15% share of the big customer MRO business. Fastenal only has 10% of the total fastener market. And MSC only has 10% of the metalworking MRO market. Imagine all of these companies will – in 30 years – have one-third of the total market in their area of focus. How fast could each company grow its specialty? Grainger could grow 3% a year faster than its market. Fastenal could grow 4% faster than its market. And MSC could grow 4% faster than its market. Over a full 30 -year period, inflation is often close to 3% in the U.S. So, let's imagine real growth in each of these markets is close to zero. They only grow 3% a year in nominal terms. That would still mean Grainger could have 30 years of 6% growth within its circle of competence (big MRO customers). Fastenal could have 30 years of 7% growth left in fatseners. MSC could have 30 more years of 7% growth in metalworking MRO. None of these estimates assumes that the overall market will grow in real terms. And none of these estimates assumes any of these 3 companies will have a better than 33% market share in 2046. In other words, even if you assume the MRO market will experience real growth of nearly nothing and stay "relatively fragmented" compared to many other industries for the next 30 years, there's really an unlimited runway of 7% annual growth for these companies. That's better than nominal GDP growth for companies in an industry that doesn't have to grow much at all for them to achieve it.

Finally, these companies benefit from economies of scale. Both gross margins and operating margins tend to be stable to expanding over time. That's not true for MRO distributors that don't grow. Since 2000, MSC grew sales by 9% a year. The company could grow at 9% a year for many, many years without so much consolidation in its industry that it was only competing directly with other big companies. MSC can be a growth stock for at least the next 15 years. And we expect earnings to grow faster than sales over the next 5 years. A long-term growth rate above 6% a year and below 10% a year seems likely for a long, long time. I know it seems like a paradox when we say that we're certain MSC will grow faster than the U.S. economy while also being certain that the market it competes in will grow slower than the U.S. economy. But all we're really saying is that we're certain MSC will gain market share.

## MISJUDGMENT

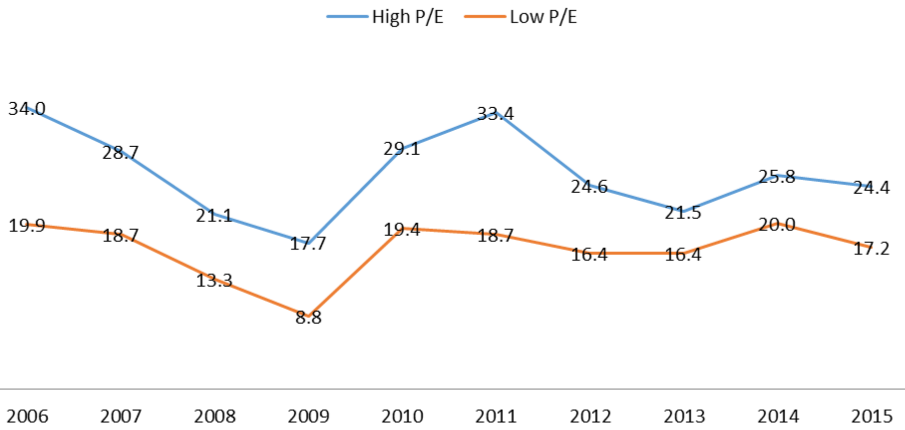
### *The Market Considers MSC's Current Earnings to Be 'Normal'; Quan and I Don't*

Like Grainger and Fastenal, MSC has a high short interest. About 12% of the company's freely tradeable shares are sold short. One explanation for the high short interest could be fear of a recession. However, MSC is a U.S. focused company. So, fears of a global recession generally shouldn't have much influence on MSC's share price. MSC is really an all U.S. business. It is 70% manufacturing. About 50% of sales are metalworking. So, the level of activity in U.S. manufacturing generally and U.S. metalworking specifically would be the only valid macroeconomic concerns. It has been a long time – about 7 years now – since the U.S. had a recession. And the Fed is planning to raise rates. Those are signs that would normally point to a recession in the future. However, there will always be recessions. MSC stock has sometimes been a bit cheaper than normal. This usually happens around the time of a recession. The stock was inexpensive relative to its own past around 1999-2001 and 2008-2009. Today's price is closer to where the stock traded at its lowest points in 2006-2007 and 2010 through the present. The stock is not at crisis type levels. But, it is somewhat inexpensive compared to the P/E ratio range of 18 to 25 at which MSC most often trades in a given year. Quan and I think MSC is cheap. We think of it as a "growth at a reasonable price" stock. However, this is not because the actual P/E ratio is low. Rather it is because MSC's profit as a percent of sales is low right now. We think it is very likely that MSC's profit margin will expand over the next 5 years. This means MSC's profits will grow faster than sales. So, the stock is not especially cheap compared to today's earnings. Nor do we expect sales growth to be unusually good. Rather, we think that today's stock price is low compared to the profits MSC will make by 2021. This is how we like to look at any stock. How cheap is the price today compared to what we think the earnings per share will be in 5 years? That might make MSC more of a growth stock than a value stock. It's possible Quan and I could have badly misjudged the next 5 years if the macroeconomic environment – by which we mean U.S. manufacturing generally and U.S. metalworking specifically – declines sometime in the future and stays at a low level for a longer time than we'd expect. A recession sometime between 2016 and 2021 would be our sort of "base case" for looking at and valuing MSC. We aren't saying there won't be a recession. But, if there is a recession like 2008 that lasts a long time in terms of reduced manufacturing activity – that would hurt MSC's customers and would hurt MSC's own sales. Less metalworking means less cutting tools. And cutting tools are an important part of MSC's business. MSC is probably much more susceptible to a recession than Grainger is. Grainger is much more diversified by product category and by industry. Fastenal and MSC might see their sales decline more in a recession than a competitor like Grainger. However, they have historically seen their sales

expand faster during an expansion. Maybe we are underestimating how bad and how long the next recession will be. Or maybe we just have a longer term view and short sellers have a shorter term view. They expect MSC to do worse over the next 1-2 years. We expect MSC to do better over the next 4-5 years. That's a possible explanation for why some people want to short a stock we thing is a good long-term investment.

Another area of possible misjudgment is MSC's business model. I don't think the risk of misjudgment is big here at all. But, it's something we need to talk about. Grainger, Fastenal, and MSC all have different business models. They have different infrastructure in place. They hold and move inventory differently. They sell to customers differently. In particular, Fastenal and MSC have what you might call "opposed" business models. In some ways, MSC zigs where Fastenal zags and vice versa. This has been true historically. And both Fastenal and MSC have been quite successful for quite a long time doing business in the opposite way. If you talk to people at Fastenal, they will tell you their way of moving inventory is most efficient. If you talk to people at Grainger, they will tell you their way of moving inventory is most efficient. Theoretically, this can't be true. In theory, using outside delivery services to ship all inventory from one of a few distribution centers directly to customer sites has to be either more or less efficient than periodically shipping inventory from distribution centers to stores and then from stores to customers using your own trucks and your own employees.

Here is what someone from MSC investor relations said to us in response to Fastenal's claim that its model has lower operating expenses: "I would not agree with Fastenal's point on (operating expenses). Having all of those stores and of course inventory out in the field cannot be a cost advantage. Our central warehouse model has tremendous leverage opportunity – though you haven't seen it in the last few years as we invested in a major warehouse just as sales growth turned down and has now gone negative – and we can grow sales to roughly $4 (billion) without having to make any further major infrastructure investments."




*Outside of stock market panics, MSC tends to trade at a P/E of 18 to 25 regardless of how 'normal' its current earnings really are.*

Metaphors are always lies in some sense. But you could say Fastenal is the Wal-Mart of MRO. Or even the convenience store chain of MRO. MSC is the Amazon of MRO. MSC invests in big distribution centers and e-commerce and doesn't have stores. Fastenal has thousands of tiny stores. MSC never ships within the company. Fastenal never uses outside delivery services. Once they've chosen a model and invested hundreds of millions or even billions of dollars in that approach to storing and moving stock keeping units – you can't really graft an Amazon on to a Wal-Mart or vice versa. You can have both approaches under the same corporate umbrella. But, there aren't synergies in shipping inventory directly from distribution centers as customers order them today and periodically moving inventory from a distribution center to a store in anticipation of customer needs say once a week. Those are two different modes that don't work well together. Fastenal is committed to stores. MSC is committed to distribution centers.

Here is MSC investor relations explaining why they don't believe in stores: "…we have never believed that a distributor can know exactly what (stock keeping units) a customer will need on short notice, once more resulting in our belief that the store model is not optimal…. We do not believe in the store concept as we cannot predict what to carry in the store for unplanned purchases. If the purchases are planned, what do you need a store for? The items go directly from the distribution center to the customer…for consumption."

I presented MSC's belief in its online model and its disbelief in the store model because this is an issue on MSC. Fastenal believes just as fervently in its store model. And Fastenal has said it will never get as much of its sales from e-commerce as MSC does because Fastenal is committed to stores and MSC isn't.

There is one key area in which Fastenal's approach makes a lot more sense: vending machines. Fastenal and MSC both have vending machines at customer sites. Fastenal puts the product away. MSC leaves that up to the customer. Normally, an MSC customer stocks the on-site vending machine. This is because Fastenal has a branch network. As Fastenal's CEO said in 2012: "…if your person providing the vending machines at your office said that they will just ship the product to the dock and you guys can put it away in the morning, probably you would find a new – or you may find a new supplier." That's true. Fastenal's vending machines work like a Coke machine. MSC's don't. MSC aggregates everything into

one order per site and that company receives the shipment – sent via UPS, or whatever – the same way regardless of how the order was generated by the customer or whether or not the inventory is now going to be put in a vending machine, a storeroom, or go right out onto the factory floor this instant. MSC really does work like an online version of its catalog. The company has a sales force and specialists that are different from a consumer facing business like Amazon. But, in terms of how it handles inventory – MSC really is like an Amazon for metalworkers. This is completely different from how Fastenal operates. Of course, the business overlap isn't that big. Fastenal is big in fasteners. MSC is big in cutting tools. Fastenal is big in construction. MSC is big in metalworking. We're really comparing business models in terms of their theoretical efficiency. How efficient these two ways of moving things are doesn't really get tested head to head in trying to serve the same customers as much as you might think. Fastenal and MSC represent two very different ways of structuring an MRO distributor. But, it's important to keep in mind, that we're talking more about two competing concepts than two head to head competitors. MSC and Fastenal are peers. They aren't competitors in the way Coke and Pepsi are competitors. Most of the direct competition Fastenal faces is local and run differently than how MSC is run. Most of the direct competition MSC faces is local and run differently from how Fastenal is run. Quan and I just wanted to talk about the completely different approaches Fastenal and MSC take, because the truth is we can't prove one is better than the other. They sell different products in different ways to different customers. There are so many differences between the two companies that although we've tried to test the relative efficiency of one versus the other – that's not a testable concept. I'm not even sure it's a useful concept. It's possible that Fastenal is better at serving certain kinds of needs for certain customers and MSC is better at serving certain kinds of needs for other kinds of customers. We've mentioned their biggest product categories – fasteners and cutting tools – are different. Their biggest industries served are also different. Maybe most importantly of all though – MSC probably gets a lot more unplanned purchases relative to its total sales than Fastenal. Meeting a customer's planned MRO needs and its unplanned MRO needs is totally different. The model that best serves unplanned needs would not best serve planned needs and vice versa. Quan and I aren't confident that MSC's model is more efficient than Fastenal's. We are confident that there is plenty of room for both MSC and Fastenal. Fastenal and MSC can both stick to what they do best and both grow for many years to come without getting in each other's way. We said that MSC is kind of like the Amazon of metalworking MRO. That does not mean that Fastenal is kind of like the Barnes & Noble in this analogy. The level of competition is nowhere near as direct. Both models can and will survive. And neither company is going to suddenly switch to their competitor's approach.

## FUTURE

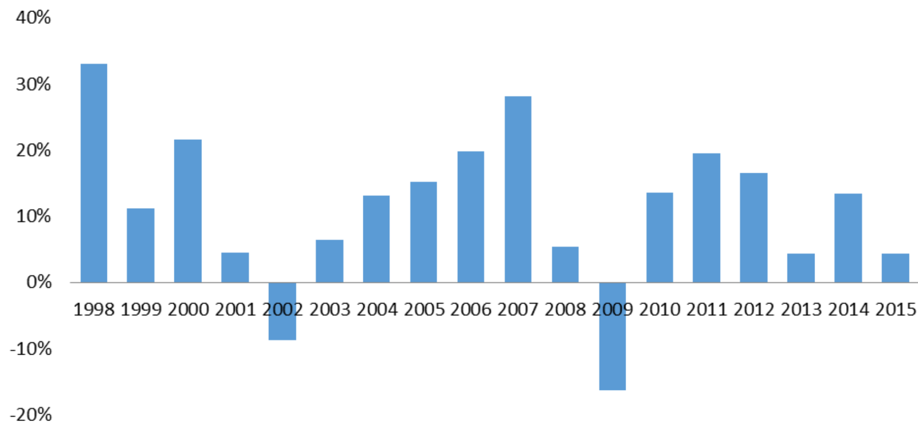
### *MSC's Sales and Profits Will Plunge During the Next Recession – But They Will Quickly Recover*

This is a buy and hold newsletter. So, let's take a look at what might happen if you buy MSC shares today and hold them for 5 years. Let's look at a possible 2021 at MSC. First of all, MSC's CEO – Erik Gershwind – should still be running things. He's only 45 years old now. And he's a member of the extended family that controls about 80% of the voting power at MSC. So, there's no reason to expect a change in the chief executive over the next 5 years. Nor is there a reason to expect a change in the board. MSC is a family controlled company. The Jacobson family and descendants of the founder – with different names, like Gershwind – who are related to that family controls the company. The Chairman of the Board at MSC is Mitchell Jacobson. So, really, you have a family member CEO and a family member Chairman of the Board and a family that controls a majority of the voting power at MSC. This is a controlled company. We shouldn't expect any changes in leadership. Nor should we expect the company to be sold to a competitor or a private equity buyer. That might happen. But MSC has been public for 20 years now and the family has no problem keeping control of the company. So, why sell out? Why go private? Let's assume that 5 years from now MSC has pretty much the same CEO, the same board, the same family as majority owner, and remains public. Those aren't sure bets. But, they're pretty safe bets.

MSC has already invested in the infrastructure needed to have $4 billion in sales. Growth at MSC is certainly cyclical. It was strongly positive from 1998-2000. In 2001, it slowed a lot. In 2002 it turned negative by almost 10%. In 2003, it was positive but low. And then MSC grew faster and faster each year as the economy expanded in 2004, 2005, 2006, and 2007. Growth peaked then and was already very slow by 2008. In 2009, MSC's sales dropped even more than in 2001. Growth again expanded strongly in the recovery of 2010, 2011, and 2012. Sales growth has been slow over the last few years. MSC didn't grow sales very quickly from 2013 through 2015. And it did invest a lot in the business. In MSC's history as a public company we can see only two examples of recessions. MSC shrank in both cases. Sales declined by close to 10% for one bad year in 2002. And sales declined by nearly 20% in one bad year in 2009. We could spend a lot of time discussing when the next recession will be and how bad it will be and how long it will last. But, that would be a waste of time. We aren't looking to trade MSC stock. We're looking to buy and hold it. So, all we need to do is look at MSC's history as a public company over these last 20 years. There have been two big down years for MSC during those 20 years. They roughly coincide with the two recessions that happened in the U.S.

over the last 20 years. And one of the two down years – 2009 – was about twice as bad as the other. This also lines up with the economic situation. The post financial crisis recession in the U.S. was much worse than the post dot com crash in the U.S. So, we can say that yes MSC's sales decline in a recession. MSC will shrink in a recession. We only have a public history for MSC going back about 20 years. But, if we include the early 1990s recession in our look at the last 25 years or so of U.S. economic history – we can say there were about 3 recessions in the last 25 years. One of these was much worse than the others. So, what if there is a recession about once every 8 years? What if there is one big recession – one 2008 financial crisis type event – every 25 years? What does this mean for MSC? MSC was able to grow at close to 10% a year over periods in which there was about one recession every 8 years and one "Great Recession" every 25 years. That's the period from the 1990s through today. So, let's say that in the short to medium-term there may be a recession. It may be more like the early 2000s recession than the 2008 financial crisis. MSC's sales might drop 10%. Is that what investors who avoid MSC and short sellers who bet against the stock are afraid of?

Let's look at what kind of damage an early 2000s style recession would have on MSC. Instead of talking like a true short-term trader and worrying about one year changes in sales – let's talk like someone who is at least focused on the medium-term rather than the short -term. We'll define medium-term as 3 years. MSC had a bad medium-term during the early 2000s. Sales were $831 million in 2000 and rose to just $845 million in 2003. That is a 3-year growth rate in sales of just 0.6%. Basically, that's stagnation. And that's what happens cumulatively to MSC in the year immediately before a recession, the year of the recession, and the year coming out of the recession. Basically, MSC treads water for 3 years. What about in an economic expansion?




*MSC's sales declined by 10% or more in each of the last two recessions. However, in both cases, sales growth over the following 3 expansionary years was very fast.*

MSC's sales went from $845 million in 2003 to $1.3 billion in 2008. That is a 5-year growth rate of more than 9%. Let's look at it another way. Let's say a "full economic cycle" happened between 2000 (a peak type year) and 2007 (the next peak like year). MSC's sales went from $831 million in 2000 to $1.69 billion in 2007. That's a 7-year growth rate of better than 10% a year. It was followed by the 2007-2010 period where growth was basically 0%. So, over a 10-year period MSC may see something like a 10% a year expansion for 7 good years and then a 0% growth rate for the 3 bad years. What if the next 3 years are the bad years? What if MSC doesn't grow at all over the years 2016, 2017, and 2018. That's frightening for an investor. But, MSC often came out into the first good years of the economy growing at rates of 13% to 17% a year. So, while it might be scary to buy into a stock that could – if a recession comes soon – grow at 0% a year for 3 years, think about how fast that stock would be growing when you plan to sell it in 2021? If history is any guide, growth of 0% in 2016, 2017, and 2018 could easily be followed by growth of 13% or better in 2019, 2020, and 2021. The P/E multiple on a stock growing 10% to 15% a year is often very, very high.

More importantly, Quan and I are convinced that MSC will have a much higher EBIT margin in its next peak earnings year than it does today. MSC had an 18% EBIT margin just before the financial crisis. It invested heavily during the last few years. Let's say MSC has $4 billion of revenue in 2021. That requires a sales growth rate of less than 7% a year over the next 5 years. MSC is capable of doing that even if there is a recession between now and 2021. MSC's EBIT margin can expand. So, the growth in its earnings will exceed the growth in its sales.

Now, here is where Quan and I don't sound like value investors. In this hypothetical future, we think MSC will have a high P/E multiple. In fact, we think the stock's P/E multiple in 2021 will be about 20. A P/E of 20 is not low. Should you buy a stock betting on a P/E of 20 at the end of your holding period? MSC is a very high quality business. More importantly, it will almost certainly be a very high quality growth stock in 2021. This is the key part to keep in mind. You shouldn't think about whether a stock has a high return on capital when you buy it. Nor should you think about whether a company has a high growth rate when you buy it. You are only buying the stock today. You aren't selling it. Today's return on capital doesn't matter to you. Today's growth rate doesn't matter to you. Only today's stock price matters to you. You aren't going to sell MSC in 2016. You're going to buy MSC in 2016 with the plan to sell it sometime in 2021 or later. Quan and I believe MSC deserves a P/E of 20 in the year 2021, because we believe that MSC – like Fastenal and Grainger – will almost certainly still have a high return on capital in 2021. It will

look like it can earn a good return on capital for years to come. It will also look like it can grow for years to come. And it will be paying out a good dividend.

For these reasons, it's possible that your capital gain in MSC could be as high as 13% a year from 2016 through 2021. Now, this is only possible if you agree with us that MSC deserves an EV/EBIT ratio of 12.5 in 2021. That's about 25% higher than the average stock. However, an EV/EBIT ratio of 12.5 is not high versus what MSC has historically traded at. Nor is that EV/EBIT ratio high compared to what MSC's two peers – Grainger and Fastenal – have tended to trade at in the past. A P/E of 20 might sound high for an average stock. But a P/E of 20 is not high compared to what investors have paid in the past for MSC, Grainger, or Fastenal. That's a normal price for those kinds of stocks. MSC has a dividend yield of 2% right now. The company should be able to return most of its earnings. In the past, it returned about two-thirds of its earnings in dividends and share reductions (net of dilution). MSC's dividend payout is much lower than the cash it will generate. We estimate MSC will already generate more than $100 million of cash in excess of dividends right now and this number could rise to over $150 million a year within the next 5 years. MSC tends to buy back stock or pay dividends. The company has 48 million shares outstanding. Over the next 5 years, it should generate over $1.50 per share in yearly after-tax cash in excess of dividends. The company can use all of this cash to buy back stock – which would reduce shares outstanding by about 2% a year. Or the company could pay a special dividend. Either way, the dividend yield you see of about 2% is only half the picture. MSC will either buy back stock or pay special dividends of another 2% a year on top of this. So, that adds up to 4% a year to your return through a combination of dividends and buy backs.

How gloomy can the future be and still work out okay for you in MSC? We know dividends and buybacks should add up to about 4% a year. That part of the picture is solid. It doesn't really require sales growth. We think MSC will trade at 12.5 times EBIT (basically, a P/E of 20) in "normal" times. Let's say it trades at only 10 times EBIT though. That would still be a return of 8% a year in terms of capital gains if Quan and I are right about MSC's future EBIT. Together, that would add up to a return of 12% a year between earnings growth, dividends paid, and stock buy backs. Since you should already be getting 4% a year in dividends and buybacks while you hold MSC – you really only need 6% a year in profit growth to get to a 10% annual return in the stock over the next 10 years. And since MSC has already invested in what it needs to go from $3 billion in sales to $4 billion in sales – Quan and I expect profit growth to exceed sales growth. Invert this to solve for the worst possible performance that still gives you, the buy and hold investor an adequate return in the stock – and you get the idea that sales growth can be slower than profit growth. If you only need a 6% annual rate of growth in profit to justify buying MSC today – then you don't need any more than a 6% growth in sales to justify the investment. So, the real question here is not how fast MSC will grow. Nor is it when will the next recession be. Nor is it even how bad will that recession be. The one question that your investment – as a buy and hold shareholder – hinges on is: will MSC grows sales by 6% a year from 2016 through 2021? If the answer is yes, you can get a 10% annual return in this stock over 5 years. If the answer is no, you can't. Or at least you shouldn't expect to. That's the way I look at the stock. What is the minimum total return hurdle MSC stock has to clear over the next 5 years for you to consider it a successful investment? It has to make you 10% a year. And what is the minimum sales growth hurdle MSC the company has to clear over the next 5 years to ensure you a successful investment? It has to grow sales 6% a year. MSC can grow sales by 6% a year or better from 2016 through 2021 even if there is a recession. And you can make 10% a year or better in MSC stock by buying it in 2016 and holding it through 2021 even if there is a recession. In fact, I think it's more likely than not that there will be a recession in the next 5 years and MSC stock will be a successful investment over the next 5 years. So, you don't need to fear a recession. You just need to fear selling out when a recession is priced into MSC stock. Selling MSC on the eve of a recession is the real danger. And you have complete control over that.

# MSC Industrial Direct (NYSE: MSM)

# Appraisal: $97.27

*Price-to-Appraisal Value: 76%*

| MSC Owner Earnings | (in $ millions) |
|---|---|
| | |
| Sales | $2,910 |
| * Normal EBIT Margin | 17.5% |
| = Pre-tax Owner Earnings | $509 |

**Business Value**

MSC's business value is $6,363 million.

- Pre-tax owner earnings are $509 million
- Fair multiple = 12.5x pre-tax owner earnings
- $509 million * 12.5 = $6,363 million

**Fair Multiple**

MSC's business is worth 12.5x pre-tax owner earnings

- MSC is worth 20x after-tax owner earnings
  - MSC can grow earnings in the high single digits
  - MSC needs to retain only one third of its earnings
- 12.5x pre-tax owner earnings is equivalent to 20x after-tax owner earnings
  - Effective tax rate is 37-38%

**Share Value**

MSC's stock is worth $97.27 a share

- Business value is $6,363 million
- Cash: $38 million
- Debt: $417 million
- Equity value is $5,984 million
- $6,363 million + $38 million - $417 million = $5,984 million
- Equity Value = $97.27/share
  - 61.52 million outstanding shares
  - $5,984 million / 61.52 million = $97.27

**Price/Appraisal**

MSC is trading at 76% of its value.

- Business Value = $6,363 million
- Enterprise Value = $4,833 million
- $4,833 million / $6,363 million = 76%

| | EV/Sales | EV/Gross Profit | EV/EBITDA | EV/EBIT | EV/Owner Earnings |
|---|---|---|---|---|---|
| DXP Enterprises | 0.48 | 1.69 | 7.29 | 8.63 | 8.63 |
| Applied Industrial Technology | 0.69 | 2.48 | 8.39 | 10.32 | 10.32 |
| Grainger | 1.53 | 3.61 | 9.99 | 11.33 | 10.22 |
| Fastenal | 3.55 | 7.06 | 15.05 | 16.62 | 16.62 |
| MonotaRO | 6.32 | 21.01 | 47.85 | 51.36 | 51.36 |
| | | | | | |
| Minimum | 0.48 | 1.69 | 7.29 | 8.63 | 8.63 |
| Maximum | 6.32 | 21.01 | 47.85 | 51.36 | 51.36 |
| Median | 1.53 | 3.61 | 9.99 | 11.33 | 10.32 |
| Mean | 2.52 | 7.17 | 17.72 | 19.65 | 19.43 |
| STDEV | 2.45 | 8.00 | 17.11 | 17.97 | 18.11 |
| CV | 97% | 112% | 97% | 91% | 93% |
| | | | | | |
| MSC Industrial Direct (Market Price) | 1.65 | 3.66 | 10.72 | 12.69 | 9.46 |
| MSC Industrial Direct (Appraisal Value) | 2.18 | 4.83 | 14.15 | 16.75 | 12.50 |

# ABOUT THE TEAM

### *Geoff Gannon, Writer*

Geoff is a writer, blogger, podcaster, and interviewer. He has written hundreds of articles for Seeking Alpha and GuruFocus. He hosted the Gannon On Investing Podcast, The Investor Questions Podcast, and The Investor Questions Podcast Interview Series. He wrote the Gannon On Investing newsletter in 2006 and two GuruFocus newsletters from 2010-2012. In 2013, he co-founded The Avid Hog (the predecessor to Singular Diligence) with Quan Hoang. Geoff has been blogging at Gannon On Investing since 2005.

### *Quan Hoang, Analyst*

Quan is a stock analyst. Quan won first prize in Vietnam's National Olympiad in Informatics in 2006. He graduated from Manhattanville College in 2012 with a B.A. in finance and a minor in math. In 2013, Quan co-founded The Avid Hog (the predecessor to Singular Diligence) with Geoff Gannon.

### *Tobias Carlisle, Publisher*

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: a Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business Management (1999).

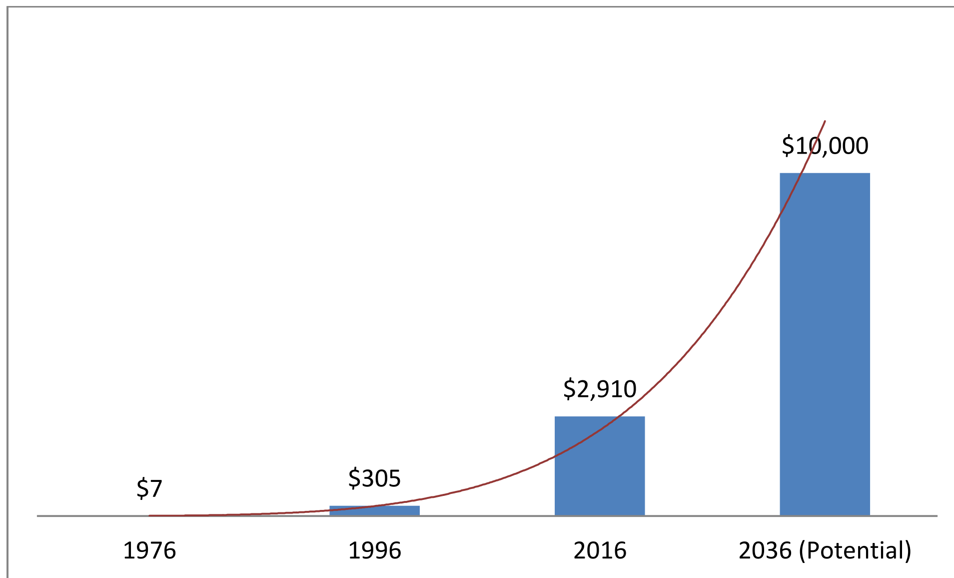
NOTES

MSC Industrial Direct

NYSE: MSM

Overview

**MSC Industrial Direct: a Great Company that Lasts**




*MSC may grows into a $10 billion company in the next 20 years*

- Sidney Jacobson started Sid Tool Company[1]
    - In 1941
    - In 177 Mulberry Street, NY
        - Now the heart of Manhattan's Little Italy
        - But at the time was close to the center of the borough's thriving machine tool industry
    - His store sold cutting tools and accessories to NYC machine shops
- Sidney Jacobson relocated the company to Plainview, Long Island
    - In 1955
    - He found a suitable 25,000-square-foot building
- Sid Tool prospered during the postwar years
    - But traditional manufacturing operations began leaving Manhattan
    - Sid Tool became over dependent on 2 customers
        - Grumman Corporation
        - Republic Aircraft
    - By 1960s, these 2 customers accounted for 90% of Sid Tool's sales
- Jacobson launched a catalog business
    - In 1964
    - He hoped to diversify his sales mix

        - And reach out to more customers
    - Jacobson was able to offer imported cutting tools at discount prices
        - No one else had attempted at the time
        - To assemble his range of imported products
            - He attended trade shows
                - And contacting manufacturers
    - The catalog was successful
        - => manufacturers interested in marketing via the catalog contacted him
    - The catalog is now known as the Big Book
        - In 1964, it had 150 pages
            - Jacobson printed 2,000 copies
        - Today, it has over 4,000 pages
- Catalog sales surpassed regular sales within a few years
    - In late 1960s, one particular import item was out of stock
        - It would take 6 months to replenish the supply
    - This event prompted Jacobson to install a computerized inventory control
        - And order processing system
        - In 1969
        - This was an unprecedented step in the industry
- Sid Tool acquired Manhattan Supply Company
    - (another cutting tool marketer)
    - In 1970
    - It was the initials of this company that would form the MSC name
- MSC opened its first distribution center (DC)
    - In 1978
    - In Plainview, NY
- MSC's revenue reach $7 million
    - By the mid-1970s
- Mitchell Jacobson joined the company
    - In 1976
    - Mitchell Jacobson as Jacobson's son
    - He was a recent graduate of New York University School of Law
        - He was 25 years old
        - He had previously worked part-time for MSC
            - In summers and holidays
- Mitchell Jacobson took over the company
    - By the late 1970s

- Sidney Jacobson's wife was experiencing some health problems
  - He decided to devote himself to his wife
  - He withdrew from the day-to-day running of the company
  - He told Mitchell Jacobson to either
    - Sell the business
    - Or run it
- Mitchell Jacobson chose to keep the company
  - He embarked on a research trip
    - Went to a number of industrial supply houses
    - Identified their best practices
    - Apply them to MSC

- Mitchell Jacobson started growing the company
  - He replaced his father as president of the company
    - In 1982
    - And became MSC's CEO
      - In 1985
  - MSC began to add branch offices
    - Grow from 3 in the mid 1980s
      - To 26 in 1990
  - MSC opened the second DC
    - In 1990
    - In Atlanta
  - A Total Quality Management initiative was introduced
    - Helped improved MSC's back-end operations
      - It was able to ship 98% of orders same day
        - By 1991
    - To stand out from competitors, MSC guaranteed to ship same day
      - For orders placed before 4:30 p.m.
        - (The cutoff time has been extended to 8:30 p.m.)
      - Otherwise, it would send customers a check for $50
        - The check had to be cut only 0.01% of all orders
          - In the first 3 years of the program
- MSC went public
  - In 1996
  - Sales was $305 million
    - 20% 20-year sales CAGR
      - Since 1976

        - When Mitchell Jacobson joined the company
  - Erik Gershwind joined the company
    - In the same year
    - Erik Gershwind is a nephew of Mitchell Jacobson
  - Erik Gershwind was 25 years old when he joined MSC
    - He became COO
      - In 2009
      - When he was 38 years old
    - He became CEO
      - In 2013
      - When he was 42 years old
  - Today, Mitchell Jacobson is MSC's Chairman
    - He's currently 65 years old
- MSC went public to fund an ambitious infrastructure build out[2]
  - From 1996 to 2004
    - Opened 3 DCs
    - Added over 60 branches
    - Recruited and trained hundreds of field sales reps
    - Added 400,000 SKUs
    - Re-wrote and purchased the entire operating and financial system
- Since the IPO
  - Share price increased 11% annually
    - 1996: $9.5
    - Today: $72.13
  - Sales grew 12.6% annually
  - EBIT grew 12.2% annually
  - EPS grew 13.3% annually
    - Maintain 30-50% dividend payout
- MSC today is one of the largest MRO distributors
  - It ships almost all orders out of 5 DCs[3]
    - Over 1.1 million SKUs are available online
    - MSC stocks over 880,000 SKUs
    - Offer 99% fill rate
      - Deliver next day
      - 8:00 pm cutoff time
  - It has 100 branch locations
    - These are sales offices

            - Carry little inventory remotely
    - Its ControlPoint inventory management solutions includes
        - Vending machines
            - Store high value item
        - Store room/tool crib management
            - Customers or MSC's reps refill items
                - By scanning bar code of each item
        - Customer site is connected to MSC via the Internet
            - Inventories are replenished about once a week
    - MSC's revenue is almost $3 billion
        - Shipped over 6.6 million orders last year
            - Averaged $439 revenue per order
        - E-commerce represents 57% of sales
            - Website
            - EDI
        - Metalworking accounts for 50% of revenue
        - MSC is the largest MRO distributor in metalworking
            - Has 10% market share
            - Several times bigger than the next biggest competitor
- MSC is still controlled by the founding family
    - The family hold **81.5%** voting power
        - **49%** of economic interests
        - Mitchell Jacobson holds
            - **43.4%** of voting power
            - **26%** of economic interests
        - Mitchell L. Jacobson 2005 GRAT #2 Trust holds
            - **10.6%** of voting power
            - **6.4%** of economic interests
        - Marjorie Gershwind Fiverson holds
            - **13.8%** of voting power
            - **8.2%** of economic interests
        - Erik Gershwind holds
            - **7.7%** of voting power
            - **5%** of economic interests
        - Stacy Bennett holds
            - **6.0%** of voting power

            - **3.6%** of economic interests
    - Marjorie Gershwind Fiverson is Mitchell Jacobson's sister
        - Erik Gershwind is her son
        - Stacy Bennett is her daughter
- MSC's vision: $10 billion revenue
- MSC's current earnings is depressed
    - MSC has just finished its latest phase of investment
        - In 2013-2014
            - Built a second headquarter
            - Built the fifth distribution center
    - Current infrastructure can support $4 billion revenue
    - Sales growth can leverage operating expenses
        - Current EBIT margin: 13%
        - Similarly
            - EBIT margin was 10% in 2000-2003
                - Its previous phase of investment
            - EBIT margin was 16-18% in 2006-2013
                - When it operated at capacity
- The market currently pays only for MSC's current earnings
    - $72.13 per share
    - 19.3x P/E
        - Consistent with MSC's historical valuation
    - MSC can gives investor more than 15% annual return over the next 5 years
        - Sales growth
        - Operating leverage
        - Strong cash generation

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[1] Source: MSC Industrial Direct History, http://www.fundinguniverse.com/company-histories/msc-industrial-direct-co-inc-history/

[2] "There has never been a more exciting time than today in the 63-year history of our company. We have a unique opportunity at a $1 billion run rate to be a part of a consolidation of a huge fragmented industry. **When we went public in 1995 we did so in order to fund an ambitious infrastructure build out. In the last nine years we opened three distribution centers, over 60 branches, recruited and trained hundreds of field sales associates, added 400,000 SKUs, re-wrote or purchased**

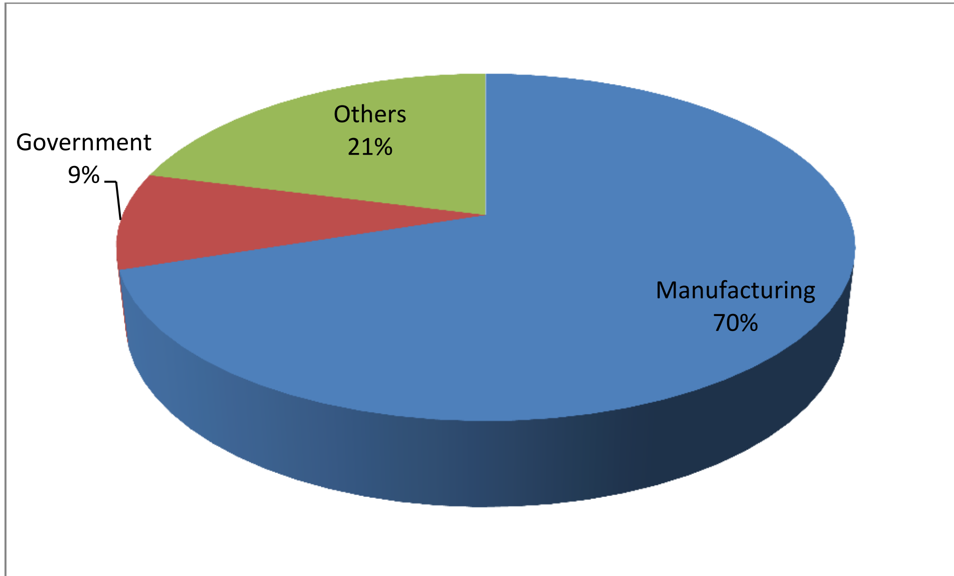
**virtually our entire operating and financial systems, and built a management team and group of associates with unmatched talent and depth**.

As we close out our first billion dollar run rate quarter, I remain as excited about the growth opportunities inherent in this business as I was in 1976 when I joined the $6 million industrial distributor with new ideas and huge vision." – Mitchell Jacobson, MSC's Chairman, MSC 2004 Q3 Earnings Transcript, 07 July 2004

[3] "I'll now turn to an overview of our capabilities. Our customers need to increase their productivity. They want to get more products to market faster and at a lower cost. **MSC's 4 distribution centers or, as we call them, our customer fulfillment centers, are strategically located to ensure that our customers always have the products that they need when they need them. Together, our network brings world-class service to our customers. We offer over 99% fill rates across our product offering and next day delivery with an 8.00 pm cutoff time**.
…
If there's an additional takeaway from this slide, it's scale. **Virtually all of our shipments come out of 1 of our 4 CFCs or come directly from a supplier. So, unlike many with a branch-based model, our inventory is centralized, which gives us great leverage on future growth. In addition to our 4 CFCs, we have roughly 100 branch locations around the country, but these are predominantly sales offices, as we carry very little inventory remotely. 91% of the output within our target end-markets is concentrated in the top 100 metropolitan statistical areas across the U.S**. What that means is that we won't need hundreds of additional branches in order to continue fueling this growth story." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 09 November 2011

Durability

**MSC's Technical Expertise and Breath of Services Helps Big Customers Reduce Total Costs**




*Manufacturing customers and the government accounts represent 79% of MSC's revenue*

- **Biggest Negative**: No negative
- No risk that manufacturers will sell directly to customers
    - MRO is complex[1]
        - Millions of parts
            - Abrasives
            - Cutting tools
            - Measuring instruments
            - Lubricants
            - Sanitary supplies
            - Cleaning supplies
            - Hand tools
            - Power tools
            - Electrical supplies
            - Plumbing supplies
            - HVAC
            - Etc.
        - Thousands of suppliers

        - MRO include inexpensive parts with random purchase patterns
            - Small dollar items
            - Item use is inconsistent and infrequent
        - MRO represents semi-planned and unplanned needs[2]
            - Unplanned: something breaks and you need to replace it
            - Semi-planned: things you know you're going to use up over time
                - Just don't know when you're going to need it
                - How much you're going to need
                - => stock in tool cribs or store rooms, or vending machines
                    - Very large inventories of these items
                        - Just in case
                    - Missing these things may shut down a machine
                        - Or a line
                        - Or an entire factory
        - MRO is polar opposite of what's the sweet spot for procurement
            - Large amounts of spend concentrated in a handful of high-usage, repeat items
    - Customer want to consolidate MRO suppliers
        - To save administrative cost
    - Manufacturers can't risk its relationship with distributors[3]
        - => don't want to have its own distribution
        - Example:
            - Owning distribution create a trust issue with Kennametal's independent distributors
                - Customers want to consolidate their buying
                - => no alternative way to buying from distributors
            - => Kennametal sold its distribution business to MSC
                - In 2006
- Online competitors pose no threat
- MSC sells to big customers
    - Manufacturing customers represents **70%** of revenue
        - As a rule of thumb, manufacturing customers are big MRO customers
    - Government accounts: **9%** of total revenue
    - Metalworking represents **50%** of revenue[4]
        - Customers choose their metalworking supplier very carefully[5]
            - This product segment is vital to their success
            - A broad, totally reliable supplier can

        - Lower overall procurement costs for metal-working supplies
        - Add productivity in the production process
      - Once you become the preferred supplier
        - There's tremendous opportunities to sell a much broader MRO products
          - That's how MSC grew its MRO business
  - Customer needs vary greatly by size of company[6]
    - Smaller buyers: transaction-oriented approach
    - Larger buyers: solutions-oriented approach
    - (Please refer to Grainger's notes for more discussion on big customers)
- MSC helps reduce total cost for customers
  - MSC helps customers save time and money[7]
    - Save time by doing 2 things
      - Provide one-stop shopping
        - MSC offers over 1 million SKUs
        - Customers can purchase through different channels
          - Sales representatives
          - Website
          - Onsite solutions
            - (for planned purchase)
            - Tool crib or storerooms
              - For low value items
                - Such as fasteners
            - Vending machines
              - For high value items
                - Such as power tools
        - Consolidate their orders into one supplier
      - Make the transaction very fast and very efficient
        - Customers can order by 8:00 p.m.
          - And get the product next day
    - Save money by 3 ways
      - Product cost
        - Good-better-best product offering
          - Customers can choose from several price points
        - Private label offerings have lower price points
      - Reducing inventory levels

        - Inventory Management Solutions streamline inventories
            - Free up cash
    - Increasing productivity on the plant floor
        - MSC's core is metalworking
            - Has years of deep-rooted experience
        - Applies that experience to engineer cost savings for customers
- Example of saving cost through consolidation[8]
    - The administrative cost of manually sourcing one order is $150
        - Looking for an item in catalogs
            - And get quotes from several suppliers
        - Get approval
        - Create a purchasing order
        - Receive the shipment
        - Process the invoice
    - A typical $250 order
        - Safety goggles
        - Some fuses
        - A drill set
        - Some cleaning supplies
    - => Goes to 4 distributors (with  lowest prices)
        - Cut 4 different purchase orders
        - Expedite 4 orders
        - Receive 4 shipments
        - Pay 4 distributors
    - => Cost as much as $600 overhead
        - Consolidate into one supplier => bring cost down to $150
            - Save $450
        - Through electronic means => bring cost down to $10[9]
            - (MSC is integrated into customer's purchasing system)
            - A requisitioner can log onto mscdirect.com
            - Find all of his MRO from one source
                - Can see real-time inventory status and pricing
            - Complete the requisition
            - The requisition is moved instantly to a supervisor to sign off
            - The materials come in the next day
                - All in one receiving

            - All under one invoice
                - If combines mscdirect.com with a procurement card
                - => only needs to see one invoice per month
                    - Give them detailed reporting on spend by individuals
- Amazon can't offer a total cost reduction solution like MSC
    - B2B is more complicated than what Amazon does in B2C[10]
        - Price and transaction are a relatively small % of the total equation
            - MSC is bringing
                - Supply chain savings
                - Productivity on the floor
        - The average margin of local distributors: 22-23%
            - Price lower than MSC
            - But MSC still gains market share
    - Amazon can't offer a multi-channel solution[11]
        - MSC's value-add dimensions
            - Sales force presence
            - A private website
                - Discounted prices
                - Integrations into customer's ERP system
            - VMI
        - Create stickiness as MSC engage with customers electronically[12]
            - Workflow
            - Approval processes
            - Spend level
            - Purchase order management
            - Interactive quoting
            - Interaction with sales rep
- Amazon can't help customer improve productivity as MSC does
    - Saving money is tricky[13]
        - Have to be able to engineer productivity on the plant floor
        - Make recommendations on what tooling to use for what materials
        - This is MSC's big differentiator
    - Grainger and Fastenal found it hard to get metalworking customers
        - Grainger had to acquire E&R to get expertise in metalworking[14]
            - It takes many years to build up customer credibility[15]

            - Fastenal entered the metalworking market[16] [17]
                - But didn't succeed as expected
    - Amazon is much less capable than Grainger and Fastenal
        - It's just an order taker
    - Examples of how MSC specialists help improve productivity
        - One customer use a drill that's too small
            - Led to inefficiencies
                - Had to the make extra cut with the drill
                - Used a reamer to make the hole the right size
                - => took extra manual costs
                    - And wasted materials
            - Changing to a larger drill => save $30,000 in
                - Time
                - Materials
        - Modern-Tec[18]
            - Challenge: cut a new stainless steel impeller component
                - Existing process was too long
                - The tooling was expensive
                - Tools were breaking
                    - => premature failure
            - Solution
                - MSC's specialist work with Kennametal's sales rep
                - Studied the situation on the shop floor
                - Discuss how to gain maximum metal removal
                    - (in cubic inches per minute)
                    - While increasing the overall tool life
                - They set a goal of shortening the projection of the cutting tool on the spindle
                    - Allow a heavier, deeper and wider cut of the stainless steel
                - => recommended a HARVI 1 4-flute carbide end mill
            - Result
                - Increase overall depth of cut more than 15 times
                - Slashing cycle time by 30%
                - Reduced the cost of the part more than 300%
                    - Or $25,000

- Interesting statistics

- Amazon appears 99 times in Grainger's earnings and analyst conference
  - Appears 20 times in MSC's earnings and analyst conference
  - Appears 2 times in Fastenal's earnings and analyst conference
    - These two times are mentioned arbitrarily by the management
      - Not asked by analysts
      - Not related to
- Differences:
  - Grainger
    - Has some small business
    - Sells more general MRO
    - Sell both planned and unplanned purchases
  - MSC
    - Deals mostly with big customers
    - Sells both planned and unplanned purchases
    - Is specialized in metalworking
  - Fastenal
    - Deals mostly with big customers
    - Focuses on planned, recurring purchases
    - Has a store-based model
    - Is specialized in fasteners

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[1] "So, as you can see, MRO is difficult, and it's complex to deal with for a bunch of reasons. **For starters, buyers are dealing with millions of parts across thousands of suppliers. And, these are small dollar items, so spend is fragmented. In addition, item use is inconsistent, and it's infrequent**. So, you're talking about lots of inexpensive parts with random purchase patterns. On top of that, **many MRO items are critical to the customer's production process. So, the stakes are high for choosing the wrong item**.

For example, take a cutting tool that's used to cut the metal that forms a finished product or a pair of safety glasses that keeps sparks from flying into a machine operator's eye. This is procurement's worst nightmare. **MRO is the polar opposite of what's the historical sweet spot for procurement, which is set up to deal with large amounts of spend that are concentrated in a handful of high-usage, repeat items**." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 09 November 2011

[2] "The total MRO marketplace in the United States alone is approximately $300 billion. If you exclude the demand from original equipment manufacturing, you probably have a $150 billion marketplace. **That $150 billion represents what we call semi-planned and unplanned needs. Unplanned needs are pretty much self- explanatory ' something breaks and you need to replace it**.

So you call a distributor and they have the part and you get it. **Semi-planned are those things you know you are going to use up over time; you just don't know when you are going to need it and how much you are going to need. Generally, these are things that people stock in tool cribs or in supply rooms and historically they keep large inventories of these items just in case they need them**. They are not things you want to be out of, because you can shut down a machine or a line or an entire factory. I mentioned the industry is very fragmented." – Shelly Boxer, MSC's former VP Finance, The Wall Street Transcript Interview, 27 September 2004

[3] "**We analyzed the market and found that our strategy needed** to change, Kennametal needed to **develop an independent distribution channel to successfully reach new customers**," says Taylor *[Ty Taylor – Director, global distribution development for Kennametal's Metalworking Solutions & Services Group]*. "**We realized owning distribution would create a trust issue with our independent distributors, and that to fully commit to this strategy, Kennametal would have to divest its owned distributors**."

…

In addition, Ramsey *[Mike Ramsey – Kennametal's distribution development manager for North America]* says, Kennametal was finding that its **customers wanted to consolidate their buying**. "That trend confirmed us going with an independent distributor model. **There's no more effective way a customer can consolidate his purchasing than to buy from distributors."**" – *Distributing Success*, Raymond Hertz, Tooling & Production magazine, January 2007

[4] "Hamzah Mazari, Analyst: Great. And then just on how much of your business is true MRO? How would you define that?

Erik Gershwind, MSC's CEO: Yes. I mean, when you say true MRO, I mean, by some measures, all of it is MRO. If where you are going is, what is not metalworking, what we have described as **metalworking is roughly 50% of our business, so the other 50% would be MRO**." – MSC 2013 Q3 Earnings Transcript, 10 July 2013

[5] "The first one is that we have a deep knowledge of J&L, its team, its most significant suppliers, and of course, the market in which it sells**. We know that the hundreds of thousands of customers in the durables sector choose their metalworking supplier very carefully because this product segment is vital to their success**. A broad, totally reliable supplier who performs flawlessly can lower the overall procurement costs for metalworking supplies and add productivity in the production process, making these companies more competitive in the global marketplace.

**We have learned that once you become that preferred supplier, there is a tremendous opportunity to sell a much broader selection of MRO products to those customers. In fact, that's the exact strategy we used in the past to grow our MRO business and that has been vital to our success**.

J&L brings 74,000 customers that currently buy metalworking supplies from them. We believe that there is minimal customer overlap between the two companies. As a result, we are excited about the opportunity to sell MRO supplies to these customers. The combined metalworking capabilities of J&L and MSC positions us with significant benefits to offer our customers in this segment. We feel that our product breadth and value add as a combined entity will be far superior to any company in the marketplace.

**We've been very successful at using our metalworking expertise to penetrate our customers' MRO spend. We'll be able to replicate this with the J&L customer base and use our enhanced skills to grow the metalworking segment for years to come**." – David Sandler, MSC's former CEO, MSC to Acquire J&L Industrial Supply Conference, 16 March 2006

[6] "Another takeaway you see is that customer needs vary greatly by size of company. **Requirements move from a more transaction-oriented approach for smaller buyers to a more solutions-oriented approach for larger buyers**. And, we've built the MSC business model to efficiently service both segments of the market. Our distribution network and broad product offering combined with our industry-leading website and our direct marketing program, allows us to effectively serve the smaller-sized, transaction-oriented segment. And, at the same time, our value-add solutions, our industry-leading technology, and our 1,000-person, technically-oriented sales force makes us a great fit for the higher end of the market." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 09 November 2011

[7] "So, let's talk about how MSC goes about helping our customers turn this nightmare called MRO into something that's manageable and actually efficient. The first thing that we do is to help our customers simplify. At the end of the day, our customers have two

goals**. They want to save time, and they want to save money**. So, we've designed the MSC value proposition around these very two simple and guiding principles.

We **save our customers time** by doing two things. First, we **provide one-stop shopping that allows our customers to consolidate their orders into one supplier**. **And, second, we then make the transaction very fast and very efficient**. The best example of that is mscdirect.com. We continually invest in and upgrade our website to improve the service experience.

Now, let's talk about how we **save our customers money**. And, there's three ways that we go about doing this. First**, our good-better-best product offering allows customers to choose from several price points**. **Our private branded offering is especially appealing to customers who are looking for high-quality product at a lower price**. And, while private brands are still a relatively low percentage of our sales today, that's another number that's growing rapidly as a percent of total. **Our private brand offering is just about 70,000 SKUs today and, again, that number is growing**.

**But, saving money on the product cost itself is only a very small part of the story when it comes to MRO. If the typical item costs, say, $50, then even a 20% savings is only $10**. So, let's talk about the other two ways that we go about helping our customers save money. **Reducing inventory levels is the second way. We offer a suite of solutions that streamline inventory and, therefore, free up cash**. And, you'll see a real-life customer example in just a minute.

**The third way we save our customers money is by increasing productivity on the plant floor**. While MSC is a broad-line MRO distributor, **the core of our business is metalworking. We have years of deep-rooted experience, and we apply that experience to engineer cost savings for our customers**. In addition to our national sales force, **we have a large network of metalworking specialists who come with extensive manufacturing backgrounds**.

And, let me share an example that will bring this to life. I recently joined one of our specialists on a visit to a new customer. **The customer is a machine fabricator**, and the purpose of the call was to do a site assessment in order to put together a cost savings proposal. **The specialist identified a drilling operation that was being done inefficiently. The drill used was too small. So, as a result, the machine operator had to make an extra cut with the drill and, then, use a reamer to come in and make the hole the right size. And, because of all that manual effort, oftentimes**

**excess material was being wasted**. So, the specialist called one of our suppliers, identified **a larger drill that would do a better job** and, the following week, he ran the test with the new drill, alongside the machine operator. And, **by the customer's own calculation, our specialist saved them $30,000 annually in labor and materials**." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 09 November 2011

[8] "MSC is a superior business model because we have 540,000 SKUs in stock compared to the 15,000 or so a small distributor stocks. This allows an individual or a business or an educational institution or a government agency to consolidate their buying to one very reliable vendor that has it in stock and can get it to them quickly. Quick illustration: **manual sourcing is probably one of the most expensive things that businesses can do, and according to the Institute of Supply Management, can cost as much as $150 an order for an average American business**. So **if you have a standard order, let's say, you want to order today some safety goggles, some fuses, a drill set and some cleaning supplies. That typical order may be $250**, but you would go to a sanitary distributor, an electrical distributor, a safety distributor and a broad line industrial distributor to find those different items. So **you would cut four different purchase orders, have to expedite four orders, receive four shipments, pay four distributors, etc. To buy that $250 worth of stuff may cost you as much as $600 in overhea**d. But what we do is say, 'Well, you can cut out three of those four streams of overhead by bringing that business to us,' so that **you will save $450 on a $250 order. And that's our message, it's one of cost savings. The next thing we do is attack that $150 per order. Through electronic means, we can bring that cost down to the $10 range and we have done that for large businesses across the United States**." – Shelly Boxer, MSC's former VP Finance, The Wall Street Transcript Interview, 27 September 2004

[9] "**"mscdirect.com is built for the purchasing manager**," says Gershwind, explaining that "**our customers' administrative costs range from $110 to $150 to get a $200 MRO average order out the door. Our goal is to help our customers drive those costs down to $10.**"

To do this, he explains, **the requisitioner would log onto mscdirect.com and find all of his or her MRO supplies from one source, all in stock**. He would see real-time inventory status and pricing in a matter of minutes, **complete the requisition**, which would move instantly to purchasing or **a supervisor to sign off on the order if required. The materials come in the next day, all in one receiving and under one invoice, or, if the company combines mscdirect.com with a procurement card, purchasing only needs to see one invoice per month that would give them detailed reporting on spend by individuals**. Combining a p-card with msdirect would

also allow purchasing to maintain controls by setting spending limits that requisitioners must abide by."" – *The Bricks Fight for Clicks*, Susan Avery, Purchasing Magazine, 03 May 2001

[10] "Yes, a couple of points on Amazon in specific. One is, from what we see, **it's much more complicated to take what they do in a B2C environment and apply it to B2B**. In the second thing is, even if they're successful doing so, again, go back to the point that I just made with you about pricing, that **the price and transaction are really a relatively small percentage of the total equation with our key accounts and where we are bringing value, so supply chain savings, productivity on the plant floor, that's really where we believe the game is won and lost**.

And just as a proof point here, for years and years, we've been competing against local distributors in this business and, if you look at most published reports, **the average gross margin of a local distributor is around 22%, 23%. Clearly, for years and years, we've been competing against folks who were good competitors but price lower than we do. So if price were the game, we wouldn't be able to continue taking share from the locals the way we have**." – Erik Gershwind, MSC's CEO, MSC 2012 Q3 Earnings Transcript, 28 June 2012

[11] "So the question was around Amazon and its Amazon Supply, and the impact in the distribution marketplace. So the answer is, it's certainly somebody we pay attention to. We'd be crazy not to. I would tell you that big picture we feel pretty good about our positioning. And if you look at Amazon -- **I think to date the answer is virtually no impact**. I think, but we're also smart enough to realize that at some point, Amazon probably gets it right. I think there's a question about whether they do. I mean it's a big move into industrial, but **let's assume for a second that they get it right**. **I think there will be an impact for those whose value proposition is strictly around -- you mentioned one competitor that would fall into this -- strictly around just spot-buy, transactional relationships**.

If you've looked at what -- part of the strategic plan and one of **our goals has been to move the mix of our portfolio to more value-add dimensions to our business. So that would include a sales force presence. That would include ecommerce and our ecommerce, most of it is not public website. It's private website, discounted prices, integrations into customer's ERP system**. So it's a much different profile of ecommerce. **The value-add would include inventory management services like VMI, which is our acquisition is BDNA, heavily into VMI, our vending program**. We've really moved the portfolio of our business to a much higher value-add, deeper integration with our customers. And I think as a result, **somebody like an Amazon is**

**less likely to have an impact on that profile of business.**" – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 06 November 2013

[12] "Let me give you a different analogy, because I think it's a great question. And I think the way to think about it or the way we think about it is -- and I would ask or challenge folks in the room. **Anybody who does automated banking, if you've got -- if you are paying your bills online or depositing checks online or automated investing, you name it.**

**What's the likelihood and what would it take for you to have to change that relationship with your bank**? And that's the way we think -- and if you're like me, it's going to be a very high bar to say do I want to go set up a new bank and new processes, a new bill pay, and all of the new work and setup and workflow that would be required?

**And for us and the customers that we engage with electronically, it's not just a website. It's workflow, it's approval processes, it's a spend level, it's PO management, it's interactive quoting, it's interaction with your sales rep. You have now engaged us in a more efficient, more effective way to do business. And it's a higher bar, more sticky rather than less, in terms of being swapped out.**" – Steve Baruch, MSC' VP Digital and Strategy, Deutsche Bank Conference, 04 June 2015

[13] "**Saving money is the trickier one. In a manufacturing operation, to do that you have to be able to engineer productivity on the plant floor, technical expertise, recommendations on tooling, on what materials, what tooling to use for what materials**. That comes with a lot of deep and rich experience that we've acquired over the years. And I think **that is a big differentiator for us in the manufacturing world.**" – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 06 November 2013

[14] "**So we talk about manufacturing being about a third of our business, between heavy and light. But it is really the facilities maintenance piece of it where we have been strongest.**

**Some of our competitors have been stronger on the manufacturing floor, and cutting tools and abrasives or fasteners or different areas**. And we cross over, certainly; we compete with each other.

But we are investing to become more significant in some of those places as well. So we have segmented part of our salesforce to call on manufacturing only, whereas they

used to call on multiple different segments, to help them sharpen their skills and train up on being really good in that space.

The E&R acquisition we made in August really helped us acquire a lot of talented salespeople with many years of experience selling on the manufacturing floor. So oftentimes it is different products but at the same customer, or different levels of expertise. Or it could be the same product but in a different instance." – Ron Jadin, Grainger's CFO, Barclays Capital Industrial Select Conference, 20 February 2014

[15] "Ryan Merkel, Analyst – William Blair: And then the follow up question I had is when I think of the large equipment manufacturer, I'm also thinking about production fasteners and production cutting tools. Are you securing this business as well?

Jim Ryan, Grainger's CEO: Sometimes, but that, **today isn't our strength**. Our strength in the fastener business is MRO fasteners. And if you've been following us lately, you'd see that **we're building a much more legitimate cutting tools offering. And the acquisition that Court talked about of E&R industrial is one of the ways that we're building expertise, specific technical expertise in key product categories like cutting tools and the braces**.

So overtime, as we build out, not only build out the product category which we've been doing the last couple years, but as we start adding services and technical expertise around those product categories. We've become a much more attractive supplier.

Unidentified Audience Member: Yes, two questions for you. First, why buy a company like Techni-Tools? Couldn't you go get their catalog? See what they're selling? Replicate it yourself? I mean is there something that they have that you need to buy that you couldn't replicate yourself at a lower cost?

Jim Ryan, Grainger's CEO: I'll ask Court to jump in here as well. We could. We could start -- we could develop those capabilities on our own. **We're large enough where we don't have much difficulty getting access to the product lines that we'd like**. So we can do that. **And we can develop the technical expertise ourselves, but partnering with somebody that's been in that business for a long time brings that expertise right now** and puts us in a position where we think we can scale it faster. Would you add anything?

Court Carruthers, Grainger's Group President Americas: (inaudible - microphone inaccessible) I think it's really like Techni-Tool, the issue that you have is that the technical expertise on the tech bench, we're not -- we haven't been anywhere near that.

So for that pretty far afield from what we've been doing, that one would be harder to build internally, quite frankly it's a very different set of skills and products.

**I think the best examples on E&R**. So we've been doing well in manufacturing, adding metal working product line, adding metal working specialist, doing really well organically, but **what this allowed us to do is just to leap frog that much farther ahead. And the credibility that we have with the customer to say, not just that yes, we've gotten better with this, but here's the guy who's been doing it for 50 years and are experts. That customer credibility takes a really long time to build up, and that allows us to leap frog that piece too**." – Grainger Analyst Meeting, 13 November 2013

[16] "**We're continuing to work very hard in the metal working. It's continuing to outgrow the overall company revenue, not by the amount that we had expected but we're growing well above what we see our public peers that are working in that area**. Our metal working sales are growing well above anyone else that we can get public data on." – Will Oberton, Fastenal's CEO, Fastenal 2014 Q2 Earnings Transcript, 11 July 2014

[17] "**People, I think, had too high of an expectation going in, thinking we are going to be as big as MSC overnight, and that doesn't happen**.

But our metalworking business has grown -- not double-digit, but almost double-digit above the Fastenal growth over the last -- in 2014. It even did better than that in 2013, and we've grown a very nice sized business. We're doing well with it and we think the upside is great.

It's just hard to grow a business that -- **right now it represents about just under 10% of our total revenue. So it's a meaningful sized business. It's hard to grow it more than 20%, 20%-plus year over year with a business that big**. So we're very committed and we think we're going to continue to do well in it for a long time." – Will Oberton, Fastenal's CEO, Fastenal 2014 Q4 Earnings Transcript, 15 January 2015

[18] "**Challenge:**
**Modern-Tec was having problems with the cycle time to cut a new stainless steel impeller component. The process was taking too long, the tooling was expensive and there was pre-mature failure because tools were breaking**. Christopher Matyas, Modern-Tec CEO, approached the MSC Metalworking Team's Specialist Tom Prisaznukfor a recommendation.

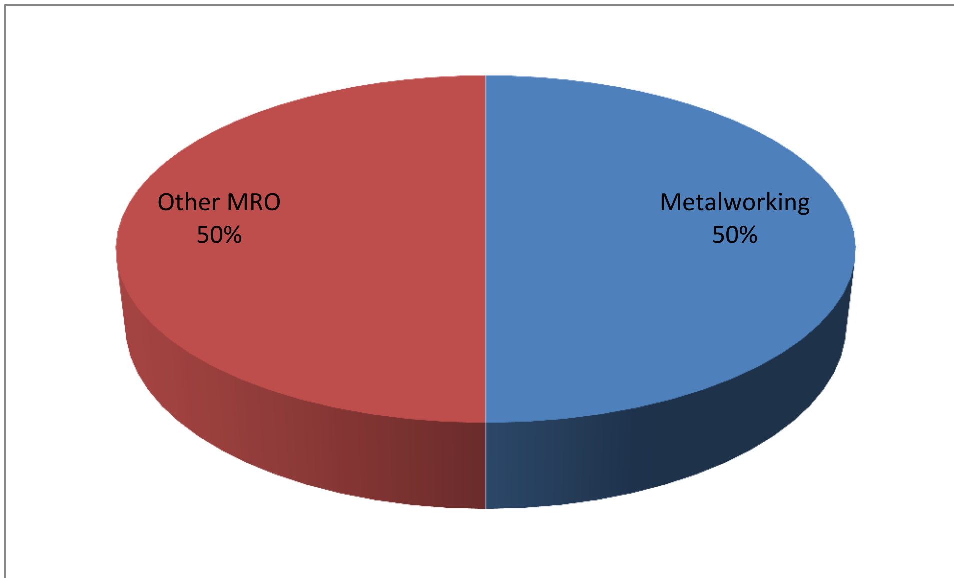
**Solution:**

Working with the Kennametal representative, Ken Szeluga, Prisaznuk studied the situation on the shop floor and drew upon industry experience to discuss how they could **gain maximum metal removal in cubic inches per minute while increasing the overall tool life**. The MSC/Kennametal team set a goal of **shortening the projection of the cutting tool on the spindle, which would allow a heavier, deeper and wider cut of the stainless steel. They recommended a HARVI1 4-flute carbide end mill** that goes into a holder, which provided advantages in **flushing out the chips from the cutting zone. This allowed them to increase the overall depth of cut more than 15 times**.

**Results:**
Understandably, Matyas was skeptical the tool would work and worried the spindle could not handle such a dramatic depth of cut. The solution worked. In fact, **it exceeded expectations by slashing the cycle time more than 30% and reduced the cost of the part more than 300% --or $25,000**." – MSC's Case Study of Modern-Tec

Moat

**MSC is the Undisputed #1 Distributor of Cutting Tools in North America**




Metalworking accounts for 50% of MSC's revenue

- **Biggest Negative**:
    - MSC doesn't stock inventories at branches
        - Can't serve immediate needs
- **Michael Porter Questions**
    - (-) means low
    - (=) means medium
    - (+) means high
    - **For the industry**
        - Is the threat of new entrants high or low?
            - **(=)** Amazon may disrupt the small-customer business
        - Is the bargaining power of buyers high or low?
            - **(=)** MRO distributors don't have pricing power
                - Customers can pay a premium for service
                - But distributors must keep price competitive
        - Is the threat of substitutes high or low?
            - **(-)** suppliers and buyers are fragmented
        - Is the bargaining power of suppliers high or low?
            - **(=)** it depends
                - Some products are commodity

        - Some products are branded
    - Is the rivalry within the industry high or low?
        - **(+)** Price competition is high
            - Distributors must price to the market
                - Some enjoy price premium
                - But still don't have pricing power
- **For the company**
    - Is the threat of new entrant different for this company specifically?
        - **(-)** It's hard to enter the large-customer segment
            - MSC does a lot of business with large customers
    - Is the bargaining power of buyers different for this company specifically?
        - **(=)** Large-customers sales have lower gross margin
            - But also lower operating expense
    - Is the threat of substitutes different for this company specifically?
        - **(-)** similar to the industry
    - Is the bargaining power of suppliers different for this company specifically?
        - **(-)** MSC has greater bargaining power than local competitors
    - Is the rivalry within the industry different for this company specifically?
        - **(-)** Large customers are sticky to large distributors
            - Large distributors don't compete directly

- Customer retention: great
    - MSC mostly does business with large customers
        - Strong customer engagement
            - Multichannel
                - MSC's value-add dimensions[1]
                    - Sales force presence
                    - A private website
                        - Discounted prices
                        - Integrations into customer's ERP system
                    - VMI
                - Customers with vending machines have strong retention[2]
                    - High level of satisfaction, and
                    - Strong growth rate
            - Create stickiness by engaging with customers electronically[3]
                - Workflow

            - Approval processes
            - Spend level
            - PO management
            - Interactive quoting
            - Interaction with sales rep
        - One customers said about things he appreciated about MSC[4]
            - Enormous product offering
            - Superior logistics
                - He doesn't have to worry about keeping inventory on the shelf
                    - Or about an out of stock that could affect the production run
            - Technical strength of MSC's salesperson
                - And MSC's metalworking specialist
                - => providing advice on the plant floor
                    - Generate productivity and cost savings
            - Technology solutions
                - E-commerce
                - Vending
- Customer acquisition: strong
    - Local competitors control about 70% market share
        - They developed great relationships locally with a plant[5]
    - MSC has huge advantages over local competitors
        - Can get national contracts thanks to
            - Breadth of products and services
                - Over 1 million SKUs
                    - Stock over 880,000 SKUs
                    - Industry average: 15,000 SKUs
                - Multi-channel services
            - Superior logistics
                - Deliver next day for orders placed before 8:30 P.M.
                - Fulfillment rate: 99%
                    - Industry average: 58%
            - E-commerce capabilities
        - Strong balance sheet
            - Especially in bad times
                - Local competitors are minimally restocked

            - They often go into a drop-ship route
                - Takes several days to deliver
            - => service failures
        - MSC can hire a lot of sales people from local competitors[6] [7]
            - These talents have deep customer relationships[8]
- Local competitors are under great pressure
    - Large customers are trying to reduce overall cost of procurement[9]
        - Need a distributor with
            - A broad footprint
            - Scale
            - Plug to the electronic platform
    - Some trends are putting pressure on local competitors[10]
        - More and more customers want to do business electronically
            - Over 30% of MSC's business comes through its website
            - Small competitors can't make the needed investment
        - Customers are demanding more value-added solutions
            - Vendor-managed inventory
        - Large companies with multiple sites want to consolidate their spend
            - Want national contracts
                - Leverages their buying power
    - Context for accelerating trend towards consolidation in the industry[11]
        - 2008 recession: a catalyst for change
        - Technology:
            - Ecommerce favors larger, well-capitalized distributor
            - Technology in manufacturing
                - Improving customer supply chain
                - Vending initiative
        - National account phenomenon
            - A decade ago: local distributors could service local plant effectively
    - Even when a local competitor is successful in a plant[12]
        - It's going to get displaced
        - The headquarters want to consolidate
            - Go on an e-Procurement platform
        - Small competitors can't offer a whole package[13]
            - Enhanced web design

- Connect to modern electronic buying systems
- VMI
- Smart vending machines

- Story:
  - One facility used a competitor for the majority of is MRO spend[14]
    - MSC signed a national account agreement with its headquarter
    - The facility was encouraged by the headquarter to use MSC
    - MSC assigned one sales rep
      - Able to get a sense for MSC's unsurpassed delivery and service
    - Now consider MSC's rep as one of their own associates
      - Does $400,000 per year in sales with MSC
    - (We see similar stories at Grainger's large accounts)
- MSC's advantage over national competitors: technical expertise
  - Some stronger local distributors are able to engineer cost savings on the plant floor[15]
    - But they don't have
      - Broad product offering
      - Superior logistic
      - Web capabilities
    - => can't save time for customers
  - Some big competitors are good at saving time
    - But don't have the level of technical capability
    - => MSC is uniquely positioned to do both
  - Grainger and Fastenal found it hard to get metalworking customers
    - Grainger had to acquire E&R to get expertise in metalworking[16]
      - It takes many years to build up customer credibility[17]
    - Fastenal entered the metalworking market[18] [19]
      - But didn't succeed as expected
  - Examples of how MSC specialists help improve productivity
    - One customer use a drill that's too small
      - Led to inefficiencies
        - Had to the make extra cut with the drill
        - Used a reamer to make the hole the right size
        - => took extra manual costs
          - And wasted materials
      - Changing to a larger drill => save $30,000 in

        - Time
        - Materials
    - Modern-Tec[20]
        - Challenge: cut a new stainless steel impeller component
            - Existing process was too long
            - The tooling was expensive
            - Tools were breaking
                - => premature failure
        - Solution
            - MSC's specialist work with Kennametal's sales rep
            - Studied the situation on the shop floor
            - Discuss how to gain maximum metal removal
                - (in cubic inches per minute)
                - While increasing the overall tool life
            - They set a goal of shortening the projection of the cutting tool on the spindle
                - Allow a heavier, deeper and wider cut of the stainless steel
            - => recommended a HARVI 1 4-flute carbide end mill
        - Result
            - Increase overall depth of cut more than 15 times
            - Slashing cycle time by 30%
            - Reduced the cost of the part more than 300%
                - Or $25,000

- Margin protection
    - The industry average margin: 23%
    - MSC's margin: 46%
    - Customer willingness to pay is high[21]
        - Item cost is a small part of the story
        - Supply chain efficiency is more important
        - Productivity gain is important
            - Saving money is tricky[22]
                - Have to be able to engineer productivity on the plant floor
                - Recommends what tooling to use for what materials
                - This is MSC's big differentiator
    - The secondary factor is buying advantages
        - MSC is the biggest distributor in metalworking

            - 10% market share
            - About $1.3 billion revenue
                - Several times bigger than the next competitor
                - Much bigger than local competitors
    - => MSC had stable gross margin
        - Averaged about 45% over the last 24 years
            - Min: 39%
            - Max: 47%
            - Median: 45%
            - Mean: 44%
            - Standard deviation: 2%
            - Variation: 0.05
- Moat evaluation
    - Barrier to entry: high
        - Successful entrant must be able to help customer reduce total costs
            - Must stock a lot of products to be a one-stop shop
                - Over 500,000 SKUs
                - Ship quickly
            - Must have a full suite of solutions
                - E-commerce
                - Sales people
                - VMI
        - Need millions of customers to have buying power for each item
        - Need technical specialists and credibility to get metalworking customers
            - Takes many years to build
            - Grainger must acquire E&R to get expertise in metalworking
        - The supplier consolidation trend hurt small distributors
            - Favor existing big distributors
        - Only Amazon can enter the market with large scale
    - Impact of new entrant: small
        - Amazon has few impact on
            - Large-customer business, or
            - Business that requires technical expertise
        - MSC has only **2%** of the MRO market
            - **10%** of the metalworking market
            - => market share gained by others has small impact on MSC
        - Customers are sticky

- Customers choose their metalworking supplier very carefully[23]
  - This product segment is vital to their success
  - A broad, totally reliable supplier can
    - Lower overall procurement costs for metal-working supplies
    - Add productivity in the production process
  - Once you become the preferred supplier
    - There's tremendous opportunities to sell a much broader MRO products
      - That's how MSC grew its MRO business

- Rivalry among existing firms: weak
  - Local customers still hold 70% of the market
  - It takes a long time to consolidate the industry[24]
  - MSC's primary competition is the local distributors[25]
    - Not large, national distributors
    - Not running up against Grainger or Fastenal
      - The market is just so fragmented
  - Most of business that MSC takes from local distributors[26] [27]
    - Not from Grainger or Fastenal
  - MSC faces Grainger or Fastenal much less frequently in the market than at conferences[28]
    - Top 3 competitors are often local competitors
  - Each of the large national distributors came from different roots[29]
    - Has different strengths

- Conclusion: MSC has a wide moat

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[1] "If you've looked at what -- part of the strategic plan and one of **our goals has been to move the mix of our portfolio to more value-add dimensions to our business. So that would include a sales force presence. That would include ecommerce and our ecommerce, most of it is not public website. It's private website, discounted prices, integrations into customer's ERP system**. So it's a much different profile of ecommerce. **The value-add would include inventory management services like VMI, which is our acquisition is BDNA, heavily into VMI, our vending program**. We've really moved the portfolio of our business to a much higher value-add, deeper integration with our customers. And I think as a result, **somebody like an Amazon is less likely to have an impact on that profile of business.**" – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 06 November 2013

[2] "You're hitting on, certainly in mentioning **vending, one the fastest growing growth initiatives we have right now**. So I'll start out by saying vending has been a big part of our growth and we foresee it continuing as a big part of our growth. **We're seeing where we install vending big deltas in the growth rates for the customers that have a vending machine. We're seeing very strong retention rates, and I think more importantly, high levels of customer satisfaction**. I think to get to your question, one of the reasons, one of the ingredients here as part of our secret sauce with how we bring vending to market really tracks back to the culture of the Company. **We're very much a customer-centric culture, which means that when we go out with any solution, and certainly in this case, vending. Vending is a great tool, but it's just a tool. And it has to be applied to the right type of customer, and to the right type of products within that customer**. So our approach is to really target the right fit for vending, and that really starts with the customer's needs and doing a profile of what their needs are. When we do that, that's really what's driving the great performance, is beginning with the customer, and selecting the right fit." – Erik Gershwind, MSC's CEO, MSC 2012 Q1 Earnings Transcript, 05 January 2012

[3] "Let me give you a different analogy, because I think it's a great question. And I think the way to think about it or the way we think about it is -- and I would ask or challenge folks in the room. **Anybody who does automated banking, if you've got -- if you are paying your bills online or depositing checks online or automated investing, you name it.**

**What's the likelihood and what would it take for you to have to change that relationship with your bank**? And that's the way we think -- and if you're like me, it's going to be a very high bar to say do I want to go set up a new bank and new processes, a new bill pay, and all of the new work and setup and workflow that would be required?

**And for us and the customers that we engage with electronically, it's not just a website. It's workflow, it's approval processes, it's a spend level, it's PO management, it's interactive quoting, it's interaction with your sales rep. You have now engaged us in a more efficient, more effective way to do business. And it's a higher bar, more sticky rather than less, in terms of being swapped out.**" – Steve Baruch, MSC' VP Digital and Strategy, Deutsche Bank Conference, 04 June 2015

[4] "A recent visit to a large machine fabricator in the Northeast was another validation point for me. I had a chance to meet with the plant manager who described to me the history of the relationship between MSC and his Company. As he was doing so, he

asked a question of me that I have to admit made me smile. He asked, why would a metalworking shop need to do business with anyone other than MSC? He was describing that there were several things he appreciated about MSC. First**, the combination of our enormous product offering and superior logistics which means he doesn't have to worry about keeping inventory on the shelf, nor does he have to worry about an out of stock that could affect the production run**. **Second, the technical strength of our local salesperson and our metalworking specialist means in that we are providing advice on the plant floor to generate productivity and cost savings. Third, our technology solutions, including e-commerce and now vending, as he was getting ready to install his first vending machine, streamline his purchasing process, and help take inventory out of the system**. The best part about this customer is the fact that despite high levels of satisfaction and despite the fact that this is a six-figure account for MSC, we see runway to more than double our revenues based on additional opportunities within the plant." – Erik Gershwind, MSC's CEO, MSC 2011 Q4 Earnings Transcript, 26 October 2011

[5] "While it was an extremely tough year by so many measures, it was also a time during which our team stepped up, learned some new things, and positioned our Company to be ahead of an economic recovery. **We believe that FY '10 and '11 will see what I call the greatest land grab in modern history in the industrial distribution business**. There have been unprecedented dislocations in the customer-distributor relationship across the country due to bankruptcies, branch closings, inventory reductions, accounts receivable tightening, layoffs, and movement among customers, buyers, and distributor salespeople. **Those tight connections between traditional local distributors and their customers have been severely stressed in ways that they have never before been put to the test. Top line growth will further exacerbate this stress. Weak balance sheets will crumble and service levels will further deteriorate as the weaker competitors struggle to do even more with less.**" – David Sandler, MSC's CEO, MSC 2010 Q1 Earnings Transcript, 07 January 2010

[6] "One of the things that we've talked about since, really since the start of the downturn is that we've seen the -- and **David described this as part of the land grab of the smaller regional distributors who employ some of the really strong salespeople in our industry historically had a tight attachment to those businesses. And we saw that the downturn really broke a lot of the bonds that were there, and as a result, we've been, since the downturn, and this continues, hiring really top notch industry talent that in years past we would not have been able to recruit**. And we see that runway as long, and it's continuing." – Erik Gershwind, MSC's CEO, MSC 2012 Q1 Earnings Transcript, 05 January 2012

[7] "Quite frankly, **one of the most exciting things, if you can call exciting about a downturn, is the opportunity to acquire some great talent, to make some great investments that really juice the returns coming out of the recession. And we said this time will be no different.**" – Erik Gershwind, MSC's CEO, MSC 2015 Q4 Earnings Transcript, 27 October 2015

[8] "**Since the beginning of the downturn, the smaller, less well-capitalized competitors that make up the bulk of the market have continued to suffer from service failures, lack of inventory, and the loss of key personnel.** The competitive advantage that MSC enjoys over the regional and small distributors has grown substantially over the past few years and we continue to widen the gap and gain market share.

**Throughout the downturn and now in the recovery, we have hired many new and experienced salespeople from our competitors, people who would have been difficult to attract in the past. These are associates with deep customer relationships and often bring strong technical capabilities to our sales team**." – David Sandler, MSC's former CEO, MSC 2011 Q2 Earnings Transcript, 06 April 2011

[9] "You know, remember that we compete -- that this marketplace has a few of us large national distributors. But the bulk of it is still controlled by that small to mid-sized traditional distributor. In fact, about 75% of the market is still held by that distributor, and that is really time and time again where we see that we are taking share. That distributor is under a lot of pressure, especially to serve those **large customers that are trying to focus on reducing their overall cost of procurement and acquisition. In particular, large multinationals, multifacility national customers that need a distributor with a broad footprint, scale, to plug the system, the electronic platform, the broad product offering; all to be able to consolidate their supplier base into a much more streamlined, cost-effective distributor**. That is really where we have enjoyed market share gains.

And, in fact, **as things are tough and get tougher, historically what we have seen and, frankly, where anecdotally we're seeing that today, the distributor service models, they begin to break down. They struggle with cash flow. They are not able to maintain their inventory levels**. So oftentimes what happens is that a customer that has traditionally been able to get a particular item reliably from a distributor, if all of a sudden they have a break in service, it catches their attention, and **that gives MSC an opportunity to gain a foothold in that customer**. And typically what we find is, as we are able to gain that foothold and be able to show the kind of

service levels that we're able to provide, that is where we gain a customer often for life." – David Sandler, MSC's former CEO, MSC 2008 Q3 Earnings Transcript, 01 July 2008

[10] "So, speaking of those local and regional distributors, let's take a look at how their value proposition stacks up against MSC and, once again, you'll see why our growth opportunity is so compelling. Without sufficient scale or capital on their side, it's very difficult for local distributors to compete with us over the long run. And, beyond the numbers, **there are several industry trends that are putting even more pressure on locals.**

**First, more and more, our customers want to do business electronically**. Over 30% of our business comes through our web site today, and that's a number that continues to grow year over year. **Smaller, less well-capitalized companies simply can't make the needed investments to provide a satisfactory e-commerce experience**.

**Second, our customers are demanding more value-added solutions beyond just selling product**. Vendor-managed inventory and vending programs are two examples where, once again, the **smaller players have a tough time keeping up with the rate of innovation and investment that are required to be a leader**.

And, **third, larger companies with multiple sites want to consolidate their spend across locations. They want national contracts that leverage their buying power**. And, by definition, local distributors simply can't give that large segment of the market national coverage.

One last point I'll highlight on this slide is **our gross margin of 46%. It looks like an outlier compared to the industry average of 23%.** So, let me explain why we command that large gap and why we're confident that it's sustainable going forward. **For one thing, our strong value proposition allows us to charge premium pricing**. **Also, our relative size advantage, particularly within our core business of metalworking, allows us to achieve preferential purchasing arrangements with our suppliers**. And, finally, our company has a long history of **global sourcing**, dating all the way back to the 1970s, and this is **another means of achieving a cost advantage over local distributors who don't have the scale to globally source**." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 09 November 2011

[11] "Before I get to the Company specifically, let me talk a little about the market. Because one of the questions I get asked often is -- why now, **why is consolidation starting now, and is what you see any different from what's been happening in**

**this industry for a while**? And we do see a change. And I wanted to touch on that for a second because I think it's very important to understand the context of the goals of the Company and some of the things going on now.

The first thing I'd point out is that we'd see -- if I divide my career in two sections, life pre-recession 2008-2009, and post-recession, the amount of change that's occurred in the marketplace post-recession is enormous. So we think that **the recession was absolutely a catalyst for change for customers, for manufacturing, for suppliers**.

The other thing I'd point out is technology. There's a few inflection points that we can point to specifically that are accelerating the consolidation story. **So one of those being technology as it relates to commerce, ecommerce, and the fact that customers are demanding ecommerce transactions that's favoring larger, well-capitalized distributors. The second one I'd point out is technology in manufacturing, in improving customer supply chain.** And the example there would be our vending initiative, our VMI initiatives that come -- they're capital intensive. They require innovation. That is weeding out the playing field for local distributors.

**And the third thing I'd point out that I think is influencing this consolidation trend is what we refer to as the national accounts phenomenon**, and I think it ties directly to the recession. **Our customers, manufacturing customers, are much more aware** than they were a decade ago **of supply chain costs, of the need to lean out inventory and supply chains, speed to market, and looking at indirect spend, not just direct spend**. And what that's led to is for where most of the money is in the market is with larger companies who have multiple plants. **Going back a decade, a local distributor could service that local plant effectively and it would be tough to dislodge them. We think that's changed quite a bit and continues to change quite a bit as procurement, supply chain, and some of these centralized functions are taking a much stronger role in the buying decision**. All of those tipping points are moving us towards consolidation.

Now, I haven't answered your question on MSC specifically, but I do think it's important context because there's been a lot of change in a hurry. So I think that's actually one of the answers to your question of why all at once. I think the market has moved quite a bit over the past five years." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 06 November 2013

[12] "What's interesting about what's been happening in the landscape, which is why it is so difficult for the locals and why, frankly, those with a national platform have such an advantage, is that **even when a local is doing a great job servicing a facility, when**

**the mothership comes in, headquarters, and says, you know what, we want to consolidate our spend, we want to go on an ePro platform or whatever, the locals, even when they are successful in a plant, are often going to get displaced because they are not able to provide that national scale, they are not able to provide what a national account these days is looking for**. That's been a trend that, if anything, has been gaining steam now for a period of years. Especially in this environment it is that much more pervasive. And many of these national account customers have more and more control over their spend, which means that **when we get awarded, or any of our nationals get awarded, frankly, we displace many of the locals that are in that local plant**. And that has been one of the prevalent landscape shifts that has really boded well for our model and one of the reasons that we're so excited about what we see moving forward." – David Sandler, MSC's former CEO, MSC 2010 Q2  Earnings Transcript

[13] "While some of the stronger regional and local players have stabilized, **the bulk of the traditional competitors in this highly fragmented market continue to be capital constrained and experience delivery failures on a regular basis with their customers. In essence, the land grab continues**.

You might ask, why does it continue even though the market has rebounded? **The smaller competitor's inventories have generally been minimally restocked and as a result they are often forced to go in the direct or dropship route from suppliers to fulfill the order**. **That method generally takes several days for products to reach the customers and does not deliver the timely service experience that customers require in today's just-in-time world**.

It's further exacerbated by the pressures that the manufacturers are under given the increased demand. These breaks in service are the windows of opportunity that open for the MSC model to capture share.

In addition, traditional distribution falls further behind as we continue to execute on our plan to deliver a continually expanding value basket. **They are not able to compete with a package that includes enhanced Web design, the ability to connect to modern electronic buying systems, BMI, CMI, smart vending machines, all coupled with our model.** We enable customers to order well into the evening from MSC's 600,000-plus product supermarket giving them confidence that their order will be delivered accurately and ready to be put to use in the machine spindle to run tomorrow's job." – David Sandler, MSC's CEO, MSC 2011 Q2 Earnings Transcript, 06 April 2011

[14] "Before reviewing our financials, I would like to share in MSC's success story which I personally experienced on a recent customer visit. I visited a large national account of ours in the mid-Atlantic region to better understand our customer's thinking on what MSC does well and what improvement opportunities we may have. **Before becoming a national account, this customer used a competitor of ours for the majority of their MRO spend. They were encouraged by corporate headquarters to change to MSC after the signing of our national account agreement**.

All of the customer's associates that I spoke with told me that **they had been reluctant to change to MSC from their prior supplier. They said that after MSC assigned a sales rep to penetrate this account**, things began to change. Our sales were slow at first, the **customer was able to get a sense for MSC's unsurpassed delivery and service. Shortly thereafter, our rep had developed a relationship and earned the trust of both users and requisitioners in the facility. Our rep was invited to participate in customer teams to recommend solutions to our customer's maintenance needs.**

**The customer told me that they now consider our rep as one of their own associates. Now do approximately $400,000 per year in sales with this one facility**. As we continue to build out our sales force and enhance our local field with customers, we will have the same penetration opportunity with many accounts." – Chuck Boehlke, MSC's former CFO, MSC 2004 Q3 Earnings Transcript, 07 July 2014

[15] "So, here you can see how MSC's value proposition stacks up against the broader distribution marketplace. MSC is uniquely positioned to save our customers time and to save them money. There are some in the distribution landscape who are also able to save customers money, and I point to **stronger local distributors who are often able to engineer cost savings on the plant floor. But, without the broad product offering, superior logistics, and web capabilities, they're not able to save their customers time** which, as we know, is an equally-as-valuable asset.

On the other hand, **there are those who are pretty good on the saving time dimension, but those players typically don't have the level of technical capability that's needed to take cost out on the plant floor**. Once again, MSC is uniquely positioned to do both." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 09 November 2011

[16] "**So we talk about manufacturing being about a third of our business, between heavy and light. But it is really the facilities maintenance piece of it where we have been strongest.**

**Some of our competitors have been stronger on the manufacturing floor, and cutting tools and abrasives or fasteners or different areas**. And we cross over, certainly; we compete with each other.

But we are investing to become more significant in some of those places as well. So we have segmented part of our salesforce to call on manufacturing only, whereas they used to call on multiple different segments, to help them sharpen their skills and train up on being really good in that space.

The E&R acquisition we made in August really helped us acquire a lot of talented salespeople with many years of experience selling on the manufacturing floor. So oftentimes it is different products but at the same customer, or different levels of expertise. Or it could be the same product but in a different instance." – Ron Jadin, Grainger's CFO, Barclays Capital Industrial Select Conference, 20 February 2014

[17] "Ryan Merkel, Analyst – William Blair: And then the follow up question I had is when I think of the large equipment manufacturer, I'm also thinking about production fasteners and production cutting tools. Are you securing this business as well?

Jim Ryan, Grainger's CEO: Sometimes, but that, **today isn't our strength**. Our strength in the fastener business is MRO fasteners. And if you've been following us lately, you'd see that **we're building a much more legitimate cutting tools offering. And the acquisition that Court talked about of E&R industrial is one of the ways that we're building expertise, specific technical expertise in key product categories like cutting tools and the braces**.

So overtime, as we build out, not only build out the product category which we've been doing the last couple years, but as we start adding services and technical expertise around those product categories. We've become a much more attractive supplier.

Unidentified Audience Member: Yes, two questions for you. First, why buy a company like Techni-Tools? Couldn't you go get their catalog? See what they're selling? Replicate it yourself? I mean is there something that they have that you need to buy that you couldn't replicate yourself at a lower cost?

Jim Ryan, Grainger's CEO: I'll ask Court to jump in here as well. We could. We could start -- we could develop those capabilities on our own. **We're large enough where we don't have much difficulty getting access to the product lines that we'd like**. So we can do that. **And we can develop the technical expertise ourselves, but partnering with somebody that's been in that business for a long time brings that**

**expertise right now** and puts us in a position where we think we can scale it faster. Would you add anything?

Court Carruthers, Grainger's Group President Americas: (inaudible - microphone inaccessible) I think it's really like Techni-Tool, the issue that you have is that the technical expertise on the tech bench, we're not -- we haven't been anywhere near that. So for that pretty far afield from what we've been doing, that one would be harder to build internally, quite frankly it's a very different set of skills and products.

**I think the best examples on E&R**. So we've been doing well in manufacturing, adding metal working product line, adding metal working specialist, doing really well organically, but **what this allowed us to do is just to leap frog that much farther ahead. And the credibility that we have with the customer to say, not just that yes, we've gotten better with this, but here's the guy who's been doing it for 50 years and are experts. That customer credibility takes a really long time to build up, and that allows us to leap frog that piece too**." – Grainger Analyst Meeting, 13 November 2013

[18] "**We're continuing to work very hard in the metal working. It's continuing to outgrow the overall company revenue, not by the amount that we had expected but we're growing well above what we see our public peers that are working in that area**. Our metal working sales are growing well above anyone else that we can get public data on." – Will Oberton, Fastenal's CEO, Fastenal 2014 Q2 Earnings Transcript, 11 July 2014

[19] "**People, I think, had too high of an expectation going in, thinking we are going to be as big as MSC overnight, and that doesn't happen**.

But our metalworking business has grown -- not double-digit, but almost double-digit above the Fastenal growth over the last -- in 2014. It even did better than that in 2013, and we've grown a very nice sized business. We're doing well with it and we think the upside is great.

It's just hard to grow a business that -- **right now it represents about just under 10% of our total revenue. So it's a meaningful sized business. It's hard to grow it more than 20%, 20%-plus year over year with a business that big**. So we're very committed and we think we're going to continue to do well in it for a long time." – Will Oberton, Fastenal's CEO, Fastenal 2014 Q4 Earnings Transcript, 15 January 2015

[20] "**Challenge:**

**Modern-Tec was having problems with the cycle time to cut a new stainless steel impeller component. The process was taking too long, the tooling was expensive and there was pre-mature failure because tools were breaking**. Christopher Matyas, Modern-Tec CEO, approached the MSC Metalworking Team's Specialist Tom Prisaznukfor a recommendation.

**Solution:**
Working with the Kennametal representative, Ken Szeluga, Prisaznuk studied the situation on the shop floor and drew upon industry experience to discuss how they could **gain maximum metal removal in cubic inches per minute while increasing the overall tool life**. The MSC/Kennametal team set a goal of **shortening the projection of the cutting tool on the spindle, which would allow a heavier, deeper and wider cut of the stainless steel. They recommended a HARVI1 4-flute carbide end mill** that goes into a holder, which provided advantages in **flushing out the chips from the cutting zone. This allowed them to increase the overall depth of cut more than 15 times.**

**Results:**
Understandably, Matyas was skeptical the tool would work and worried the spindle could not handle such a dramatic depth of cut. The solution worked. In fact, **it exceeded expectations by slashing the cycle time more than 30% and reduced the cost of the part more than 300% --or $25,000**." – MSC's Case Study of Modern-Tec

[21] "**So the question is around the gross margins at MSC, which are roughly in the mid-40s**. And really, if you look at John's chart extending for a decade, [within] a pretty tight band in the mid-40s. **And the question was around comparing that and contrasting that to the average in the industry of 23%**, so what accounts for that gap. And I think that **the simple answer there is the value proposition, the value that we're bringing to a customer**.

So **the ability, all the things that we do in terms of the one-stop shopping, the broad product offering, the next-day service, combined with technical expertise, inventory management, that combination of things really isn't matched in the industry**.

And certainly, if you're referencing the gross margin of a local distributor who makes up the majority of the market, they just can't bring that kind of value to the customer. And hence, **the customer is willing to pay a premium to get that level of service. That's the biggest thing. Certainly, I would point to a secondary factor of buying advantages, being a larger company, but I think the biggest thing is the value to**

**the customer**." – Erik Gershwind, MSC's CEO, Raymond James Conference, 03 March 2015

[22] "**Saving money is the trickier one. In a manufacturing operation, to do that you have to be able to engineer productivity on the plant floor, technical expertise, recommendations on tooling, on what materials, what tooling to use for what materials**. That comes with a lot of deep and rich experience that we've acquired over the years. And I think **that is a big differentiator for us in the manufacturing world.**" – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 06 November 2013

[23] "The first one is that we have a deep knowledge of J&L, its team, its most significant suppliers, and of course, the market in which it sells**. We know that the hundreds of thousands of customers in the durables sector choose their metalworking supplier very carefully because this product segment is vital to their success**. A broad, totally reliable supplier who performs flawlessly can lower the overall procurement costs for metalworking supplies and add productivity in the production process, making these companies more competitive in the global marketplace.

**We have learned that once you become that preferred supplier, there is a tremendous opportunity to sell a much broader selection of MRO products to those customers. In fact, that's the exact strategy we used in the past to grow our MRO business and that has been vital to our success**.

J&L brings 74,000 customers that currently buy metalworking supplies from them. We believe that there is minimal customer overlap between the two companies. As a result, we are excited about the opportunity to sell MRO supplies to these customers. The combined metalworking capabilities of J&L and MSC positions us with significant benefits to offer our customers in this segment. We feel that our product breadth and value add as a combined entity will be far superior to any company in the marketplace.

**We've been very successful at using our metalworking expertise to penetrate our customers' MRO spend. We'll be able to replicate this with the J&L customer base and use our enhanced skills to grow the metalworking segment for years to come**." – David Sandler, MSC's former CEO, MSC to Acquire J&L Industrial Supply Conference, 16 March 2006

[24] "Ryan Merkel, Analyst: Okay, great. And then if I can slip one more in, kind of a big-picture question. There's a view by some that the MRO industry is more competitive, more consolidated today, and therefore, the growth going forward will be slower, potentially less profitable.

So what is your view, and has anything changed in your view over the past 10 years?

Will Oberton, Fastenal's CEO: Well, things have changed, but **if you look at the big players and whoever you throw into that group, we've all grown nicely. So maybe we've gone from 25% market share to 28% or 30%.**

**So it has consolidated, but pretty slow rate** when you look at the combined -- if you look at us, MSC and Grainger combined, and there's others, I know. But our growth is probably 10% if you add us all up.

**It takes a long time to consolidate the industry. It's always been competitive, and I think it will remain competitive**. But there's a tremendous amount of opportunity out there, and we think the opportunity is as good as it's ever been.

And that's why we're so focused, as Lee talked earlier, about staying close to our customers, using our same-day store model to grow our business and take market share." – Fastenal 2014 Q4 Earnings Transcript, 15 January 2015

[25] "I think the battle is -- what we've talked about -- **the battle ground is really between us and the local distributors, so we don't necessarily see it as a battle between the large guys when it comes to recruiting, when it comes to share gains, due to the fragmented nature of our market. Our primary competition is the local distributor and the same would go for recruiting**." – Erik Gershwind, MSC's CEO, MSC 2012 Q1 Earnings Transcript, 05 January 2012

[26] "I know **there's a desire to line up Grainger, MSC, and Fastenal**, but as we look big picture, and you said it was a big-picture question, and look out over the number of years, we see just an amazing growth opportunity that we're marching right along towards our goals, and **most of the business that we take doesn't come from those two guys. It's really from the 70% of the market that's made up of local distributors. That's where our eyes are set, and that's where we see the biggest opportunity**." – Erik Gershwind, MSC's CEO, MSC 2012 Q4 Earnings Transcript, 31 October 2012

[27] "Yes, **so our share gain is going to come from the small competitors for sure. They just don't have the capacity to invest in the scale that we have already built and the scale we continue to build**. In fact, I would argue many of our larger competitors have not yet built that kind of scale. So when we talk about building eCommerce platform on SAP -- and **we've been on SAP in the U.S. for over six years now, fully integrated**. The seamless nature of how we can do business through eCommerce, where **you can place an order on eCommerce channel, then call our customer service people and ask them about the orders, in the next minute they**

**can see the same thing and everybody can see availability real-time with the new platform we're building**. That's something I don't think many people have to offer.

And when we think about eCommerce capability like that, we're thinking about the best in the industry around eCommerce, not our direct competitors. **So the challenge for the small competitors will be more and more significant with the investments we are making. So we don't see how they can continue to keep pace**. We don't have facts on who is closing and who is not, but we know that's who we come across the most who we seem to take share most from." – Ron Jadin, Grainger's CFO, Bank of America Merrill Lynch Conference, 06 December 2011

[28] "So the question was -- repeat the question, right, David? Given the fragmentation, how often does MSC run into Fastenal and Granger? When we win, why do we win relative to them, relative to locals in general? So the first thing I'd say is not nearly as often **-- when we come to conferences like this, because of the public nature of the companies, we get lined up next to each other all the time. I would tell you in the marketplace that's a lot less frequent than it is at a conference like this**. So just by virtue of the fact that 70% of the market is local. When I go out and ride with our sales people, and I do that religiously, **I always ask them, tell me who your top three competitors are. Maybe one of those names makes it into the top three. It's rarely one or two though. I mean it's typically local distributors**.

Where we do run into them -- I think one of the opportunities, and Jeff was talking about the large accounts programs. One of the things we find appealing about the large accounts is that the dynamic I described of more centralization in the purchasing decision over the last several years weeds out a lot of competition, a lot of the locals. So that would be the arena where we do more often." – Erik Gershwind, MSC Industrial Direct's CEO, Robert Baird Industrial Conference, 06 November 2013

[29] "It's a very good question. **So the question was really around industry consolidation. When do the big guys start competing more regularly and more directly**? Let me start by saying we don't think anybody is as good as us. What I would say there, in all seriousness, what you're seeing happen **in distribution is each of us -- I think and I say it tongue-in-cheek, but also seriously -- in what we do in our core business, we don't think there's anybody as good as us.**

**I would also tell you that some of the other large nationals in their bread and butter, each of us came from different roots, and also performing companies and have different strengths**. The beauty is at this point, certainly, I would say we are

seeing signs, certainly, inflection points, that I see. I've been in this business 20 years. Since 2008, 2009, I've seen a clear change in the world.

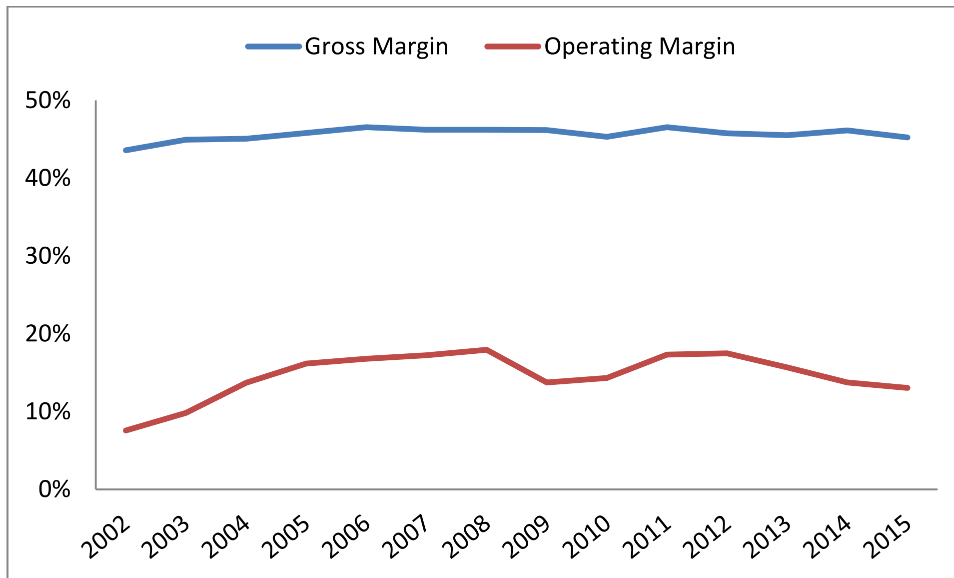
**And there's a few inflection points that I would point to, technology being one; the national accounts phenomenon that we see**, which is being fueled by technology being another, that are tipping points and that are increasing the pace of consolidation.

So **I think what you're seeing play out is if you look at our published national accounts growth rates and those of our strong performing peers, you're starting to see a widening in the gap relative to what's happening to the rest of the market.** The beauty is though that because we're coming from a place that is so fragmented, it's still -- we see this story playing out well over a decade.

**So if you take the concentration ratio of the top 50 at 30% today, if we looked back 10 years ago -- and don't quote me on the exact number -- order of magnitude, something like 20%, 20%, 25%.** So certainly, there's been some consolidation over a decade. **If you asked me is it going to be faster or slower over the next decade, I would say faster, but we have a long way to go before any handful of competitors are slogging it out.**" – Erik Gershwind, Raymond James Conferene, 03 March 2015

Quality

**Margin Expansion will Result from Operating Leverage**




*Operating margin expanded from 8% in 2002 to 18% in 2008*

- **Biggest Negative**:
  - MSC doesn't have pricing power
- **Michael Porter Questions**
  - (-) means low
  - (=) means medium
  - (+) means high
  - **For the industry**
    - Can the industry charge a high price?
      - **(+)** Gross margin is higher than a typical distribution business
        - Because of low-volume purchases
    - Does the industry have low costs?
      - **(=)** Doesn't have low costs
    - Does the industry have low need for assets?
      - **(+)** High need
  - **For the company**
    - Can the company charge a higher or lower price than the industry?
      - **(+)** MSC enjoys a premium
        - Large customers is care about total cost
          - Instead of product cost

        - Does the company have higher or lower cost than the industry?
            - **(-)** MSC has lower cost
        - Does the company have more or less need for NTA than the industry?
            - **(=)** No way to compare
                - Turnovers depend on product categories
                - But MSC's centralized model might be more efficient
- MSC has stable gross margin
    - Gross margin was about 45% since 1997
        - (gross margin in the 1992-1996 period wasn't comparable)
            - Min: 41%
            - Max: 47%
            - Median: 45%
            - Mean: 45%
            - Standard deviation: 1%
            - Variation: 0.03 (extremely stable)
    - MSC has high, stable gross margin because
        - Customer willingness to pay is high[1]
            - Item cost is a small part of the story
            - MSC's value proposition
                - One-stop shopping
                - Broad product offering
                - Next-day service
                - Technical expertise
                - Inventory management
            - => customers are willing to pay a premium
        - Product cost advantage
            - Huge relative size to competitors[2]
                - Particularly in metalworking
                    - MSC has 10% market share
                    - About $1.3 billion revenue
                        - Several times bigger than the next competitor
                        - Much bigger than local competitors
                - => get preferential purchasing arrangements with suppliers
            - Global sourcing
    - Gross margin can be cyclical in the short run
        - The ability to raise price depends on manufacturers raising their list prices[3]

- => Depends on inflation in
  - Raw material cost
  - Manufacturing cost
- MSC can take price increases ahead of cost increase[4]
  - (the same is true for Grainger)
- => inflation is beneficial to MSC's gross margin

- There's chance to expand gross margin overtime
  - MSC gain buying power
  - MSC adds more private label
    - Does more global sourcing
    - But this opportunity is less significant than at Grainger
      - Brand is more important in MSC's main product categories
        - Working items are critical to production
      - Must build up enough of a track record of credibility to introduce private brands[5]
    - Private label items account for 13-14% of MSC sales[6]
      - (25% of Grainger's sales)
      - The number can climb up to 20%
- MSC's current EBIT margin is lower than normal
  - 2015 EBIT margin: 13%
  - Current gross margin is negatively impacted by
    - Low inflation
    - Vending
      - MSC's vending solution is exceeding its internal targets
      - It creates a modest gross margin headwind[7]
        - Brings MSC deeper into customers' operations
        - Capturing more technically oriented, production business
          - Comes in larger volumes
          - But lower gross margins
          - Locks MSC into key accounts
            - Taking customers' most important issues on the plant floor
        - Give MSC opportunities to capture spot-buy, unplanned business
          - At higher gross margin
      - Example: in 2013 Q3
        - Gross margin was 45%

        - Down 0.7% from 2012 Q3
        - 0.5% was due to dilution from the vending program
  - Operating expenses are now "under-levered"
    - Vending program temporarily depress margin
      - Upfront cost[8]
        - Long selling process[9]
          - Yet high retention rate
        - Significant start-up expense
          - Installation expenses in putting the machine in place
      - Vending account of 3 years old is right around the Company's EBIT margin[10]
    - MSC started to expand its infrastructure in 2013
      - Built a second headquarter
      - Built the fifth distribution center
      - These investment coincided with a slowdown in manufacturing[11]
      - MSC's current infrastructure can support over $4 billion revenue[12]
        - MSC believe it'll make high-teen margin when revenue reaches $3.5 billion
  - MSC experienced a similar situation before[13]
    - In 2001-2002, it had just completed a program of national expansion[14]
      - Filled 3 fulfillment centers
      - Completely new IS system
        - Formidable internet site
        - Opened many branches
        - Doubled sales force
    - EBIT margin declined to 8%
      - In 2012
    - Then MSC enjoyed nice operating leverage
      - Had the same number of distribution associates when MSC did $2.4 billion as when it did $1 billion revenue[15]
      - EBIT margin expanded to 18%
        - In 2008
- This business can have EBIT margin expansion[16]
  - MSC has a centralized model
    - MSC's inventory is centralized at 5 DCs[17]
      - Offer 99% fill rate
        - Deliver next day

                - 8:00  pm cutoff time
            - Have 100 branch locations
                - Sales offices
                - Carry little inventory remotely
            - Won't need hundreds of additional branches
                - 91% of the output within MSC's target end-markets is concentrated in the top 100 MSAs in the U.S.
        - Inventory management services
            - Vending machines
                - Store high value item
            - Store room/tool crib management
                - Customers or MSC's reps refill items
                    - By scanning bar code of each item
            - Customer site is connected to MSC via the Internet
                - Inventories are replenished about once a week
    - Virtually all of MSC's shipments are coming out of its DCs
    - => can leverage its operating expenses overtime[18]
- MSC can make 17-18% EBIT margin again
    - MSC made 16-18% EBIT margin in the 2005-2013 period
    - Fastenal makes 21% EBIT margin
    - Grainger makes 18% EBIT margin in the U.S.
- MSC has high ROIC
    - Sales/NTA is about 3x
    - EBIT margin was about 13-18%
    - => 39-54% pre-tax ROIC
- 8 dimensions of quality
    - Relative size
        - Great
            - No single supplier accounts for more than 6% of purchases
            - MSC compete mostly with tiny local competitors
    - Focus
        - MSC is focused on selling to the same customer
            - In the manufacturing floor environment
    - Customer engagement
        - Very high level of integration into customer's operations
    - Cross-selling
        - High

- Retention
  - High large customer retention
- Words of mouth
  - No information;
  - Perhaps not important
- Reinvestment rate
  - Less than Grainger and Fastenal
    - Over the last 15 years, total CapEx was
      - Grainger: $2.5 billion
      - Fastenal: $1.4 billion
      - MSC: $463 million
      - AIT: $139 million
      - DXPE: $67 million
  - Fastenal's investment was big because it opened a lot stores
  - MSC and Grainger invests the most into its DCs
- Stock's popularity
  - Short interest: 12%
  - Share turnover: 390%
  - MSC is less popular than Fastenal
  - Gurus own MSC:
    - Allan Mecham
      - 8.44% of his portfolio
    - William Von Mueffling
      - 2.4% of his portfolio
    - Robert Olstein
      - 0.58% of his portfolio

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[1] "**So the question is around the gross margins at MSC, which are roughly in the mid-40s**. And really, if you look at John's chart extending for a decade, [within] a pretty tight band in the mid-40s. **And the question was around comparing that and contrasting that to the average in the industry of 23%**, so what accounts for that gap. And I think that **the simple answer there is the value proposition, the value that we're bringing to a customer**.

So **the ability, all the things that we do in terms of the one-stop shopping, the broad product offering, the next-day service, combined with technical expertise,**

**inventory management, that combination of things really isn't matched in the industry**.

And certainly, if you're referencing the gross margin of a local distributor who makes up the majority of the market, they just can't bring that kind of value to the customer. And hence, **the customer is willing to pay a premium to get that level of service. That's the biggest thing. Certainly, I would point to a secondary factor of buying advantages, being a larger company, but I think the biggest thing is the value to the customer**." – Erik Gershwind, MSC's CEO, Raymond James Conference, 03 March 2015

[2] "One last point I'll highlight on this slide is our gross margin of 46%. It looks like an outlier compared to the industry average of 23%. So, let me explain why we command that large gap and why we're confident that it's sustainable going forward. **For one thing, our strong value proposition allows us to charge premium pricing. Also, our relative size advantage, particularly within our core business of metalworking, allows us to achieve preferential purchasing arrangements with our suppliers. And, finally, our company has a long history of global sourcing, dating all the way back to the 1970s, and this is another means of achieving a cost advantage over local distributors who don't have the scale to globally source.**" – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 09 November 2011

[3] "**In the distribution business, the ability to raise prices is really triggered off of primarily one thing, and that's manufacturers raising their list prices**. That's what gives you the impetus for distributor to pass along increases on those manufacturers and then more broadly.

And seeing -- what we've seen over the past couple of years and what that slide on the intermediate goods PPI showed is that typically manufacturers -- **the rate and pace of manufacturing increases is going to be a function of what's happening with their raw materials and their manufacturing costs**. So for sustained -- an unusually long period of time, there has not been commodities deflation, and that's what led to a much less fertile pricing environment, and the rate and pace of manufacturing increases has been, therefore, much lower." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 11 November 2014

[4] "Essentially, what you have going on is as I talked about, **inflation means margin expansion for the Company because we are able to take sale prices ahead of cost increases. And while we certainly pushback on suppliers and I think do a very good job on the buy side**, given the sustained commodities pressure that has been at least a year now over a prolonged period of time on an absolute level, **we do**

**see elevated levels of purchase costs, and that takes time to bleed through the P&L. Whereas with sale price we are getting it earlier on**. So in general, the formula has played out to produce sizable gross margin expansion, but there is a bit of mismatch in timing and that's when we talk about purchase costs catch-up. That's what we were referring to." – Erik Gershwind, MSC's CEO, MSC 2011 Q4 Earnings Transcript, 26 October 2011

[5] "Karen, just a little more on vending. I think generally the program is still growing, as we see signings continue to escalate. I think what you've seen from us is the program's growing. The gross margin dilution is still moved though in a relatively tight band, so I don't think you have to extrapolate huge changes in the gross margin dilution as the program continues growing. **I think what you described, things like private brand, introductions of private brand, selling additional pull-through product is part of the promise for us in why we see the potential to grow the margins**.

We're really focused on out of the gate, and I had a couple of recent customer visits that really cemented the point for me, where talking to presidents of companies where we've embedded ourselves with vending and they are saying other than raw materials, you are my most critical supplier. We're entrenching ourselves in our key accounts. We have to be careful. **Because obviously we want to grow gross margin, but to introduce private brands, particularly in metal working items that are critical to production, you want to be very careful and have built up enough of a track record of credibility before doing that**. That's all upside for us as part of this vending story." – Erik Gershwind, MSC's CEO, MSC 2013 Q2 Earnings Transcript, 10 April 2013

[6] "So what we have given you is the percentage of products that the private brand products represent of our total offering and we said that is roughly comparable to revenues**. And figure that is in the 13% to 14% range as a percentage of total. That number is continuing to climb year-over-year by pretty nice clip. And obviously, as you would imagine of course, higher-margin great customer value. It is going up year-over-year by a pretty nice clip**.

If you asked, without giving a specific target, if you asked me over time, **could that number get to 20%? Would I think that is possible? I think that is possible, but I'm hesitant to give you a specific time. But that gives you a sense of runway**." – Erik Gershwind, MSC's CEO, MSC 2013 Q4 Earnings Transcript, 30 October 2013

[7] "We've mentioned our vending program a few times, so I'd like to highlight this initiative, as it's contributing significantly to our high growth rates. Our vending program is unique in the marketplace. We combine a customized supply chain technology with

deep technical expertise on the production floor and our industry leading product and service offering. As a result, we're able to improve our customers' cash flow by better managing inventory, reducing waste and shrinkage, and by taking out hard costs on the plant floor. **The program is exploding, as our rate of implementations is growing rapidly. Our vending program is currently adding roughly 4 points to our growth rate based on current customer volumes**, and we see it as a continued growth tailwind well into the future.

As David mentioned, and you'll hear more from Jeff in just a minute**, it's also serving as a modest gross margin headwind. The reason is that the vending program brings us deeper into our customers' operations. We're capturing more technically oriented, production business that comes in larger volumes, but lower gross margins. Doing so locks us into our key accounts by tackling our customers' most important issues on the plant floor. This affords us the opportunity to capture even more spot-buy, or unplanned business at higher gross margins, as we further penetrate with our broad Big Book and web offerings**. Over time, we would expect the gross margin headwind to abate, as pull-through business in conjunction with private brand, and other gross margin improvement programs gain traction." – Erik Gershwind, MSC's CEO, MSC 2012 Q2 Earnings Transcript, 04 April 2012

[8] "So let me put a little color on it. **Year one, there is a lot of work up front that goes into installing a vending machine and developing the program. That's selling costs, that's implementation costs**. What happens year one is you've got a high amount of fixed costs, number one. Number two is **the gross margins tend to be a little lower up front because of the products that are running through the machine tend to be the production-related items.**

**What we see is you have a high burst of fixed costs that brings profitability levels down significantly for year one**, and then as we look to years two and three, two gets considerably better than year one, and year three gets considerably better than year two. **The story you have going on is tremendous growth in the account, very high retention rates, a leveraging of the fixed costs that were needed upfront to sell and install the system, not to mention the gross margin upside that we have, by pulling through lots of products on the plant floor around the plant floor, but not through the machine at higher gross margins.**" – Erik Gershwind, MSC's CEO, MSC 2012 Q4 Earnings Transcript, 31 October 2012

[9] "Vending is a great example where, just to put some color on that, in the near term with vending, the issue is you have -- **it's a long selling process, so longer than typically going in and just selling on a transactional basis. Start-up, you have**

**significant start-up expenses, implementation expenses in putting the machine in place**.

**But over the long run, what happens is we see a large growth delta, so all of a sudden we start leveraging all the fixed upfront investments across a larger sales base and we see incredibly high retention rates**. So all of that produces this great long-term picture." – Erik Gershwind, MSC's CEO, MSC 2012 Q3 Earnings Transcript, 28 June 2012

[10] "**So the headlines on vending continues to be a key growth contributor**, continues to appeal to customers in this environment who, really what we are hearing is a heavy emphasis on productivity and lean from our customers. This is a great match and that's why I think you're seeing the growth, the high customer retentions. As we've called out the area that we wanted to improve as productivity and profitability.

So to answer you directly, yes, we do have machines in their third year. We've reached the point where the third year -- **so the profile of the third year vending account is now right around the Company op margin. Total program margin when you combine all the classes is still below as we've described, but we expect that to reach Company average within the next couple of years.**" – Erik Gershwind, MSC's CEO, MSC 2013 Q4 Earnings Transcript, 30 October 2013

[11] "So I just want to give you a quick financial framework for the Company a little bit. So **historically, we've been a high single-digit organic grower with stable gross margins and basically high teens operating margins**.

Obviously the last few years, **you've seen a lower level of operating margin, in the 13% to 14% area, which has reflected the heavy investment spending, both on infrastructure and growth that Steve mentioned as well as the CCSG acquisition, which was roughly a $300 million business doing an 8% to 9% EBIT margin**. So that's also weighing on the operating margin.

**Not to mention, of course, the very challenging macro environment in terms of demand and price, which has exaggerated the effect of our investments**. Most recently, it was the oil and gas collapse, which led to the strong US dollar as well. And that hurts the exports, obviously, of our customers. **And then the last three years, the lack of commodities inflation has had a tremendous impact on pricing**." – John Chironna, MSC's IR and Treasurer, Deutsche Bank Conference, 04 June 2015

[12] "The third thing we're doing to set the stage for the future is **we're laying the next groundwork on our infrastructure, and that infrastructure is going to enable the**

**Company to achieve the kind of scale that we need that I just described, over the next decade**. And the infrastructure is coming in a few forms. **Number one, we've recently collocated our headquarters.** So the Company has grown up on Long Island, New York. We've collocated our headquarters in Davidson, North Carolina, which is in the Charlotte area. **The second thing we're doing is we're adding a fifth distribution center in Columbus, Ohio**. **We've had four for quite a while. This fifth one sets us up through at least $4 billion in revenue to support our growth**. We're making other moves. We're outsourcing a datacenter. All of these moves are aimed around securing the infrastructure that's going to support the next decade worth of growth.

…

We also talked about the fact that we saw FY14 as the bottoming point and we expect operating margins to accelerate thereafter, modestly in 2015 and then more robustly in 2016 and beyond, and talked about the fact that **we do see the business as a high-teens operating margin business pretty comfortably over the next few years**. And the guidance we provided was that the point at which we'll achieve that objective would be roughly with MSC plus the BDNA business, so what we call our base, **reaching around $3.5 billion in revenue**." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 06 November 2013

[13] "The second thing I'd say is I think companies go through life cycles. And it's not unusual and it's certainly one that has been part of the history of MSC as we've been through periods like this where we've hit inflection points and have seen the need to invest in infrastructure. **So most recently, during my career, we hit one in the late 1990s where were doing a bunch of things at the same time. We saw this incredible growth path and we had the need to sort of step up the next level of infrastructure. And at the time, it was building out our Reno distribution center. It was building a new website. It was rapid product expansion. It was a new sales order entry system**. I sort of see a mirror image and I look back, and it was this intense period of investment.

**And at the time, there were folks who weren't so thrilled with it, saying, why aren't you reading more through to earnings in the near term. And the story was about setting the stage for tremendous growth**, and sure enough, you know how the story played out for the next decade. **We leveraged those investments**." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 06 November 2013

[14] "We are a very different company than **in the last recessionary period of 2001 and 2002 when we had just completed a program of national expansion, filled three fulfillment centers and a completely new IS system, including a formidable internet site, opened many branches, doubled our sales force, had significant excess capacity and were burdened with an enormous fixed cost.**" – David Sandler, MSC's former CEO, 2008 Q1 Earnings Transcript, 10 January 2008

[15] "Our network together provides world-class service to our customers. We offer over 99% fill rates across our very broad product offering and next-day delivery if a customer calls in by 8 PM.

Our CFCs combine into over 2 million square feet of warehouse space, and they are all easily expandable. We invest heavily in upgrading our systems, our technology, and our business process in order to improve service levels and to bring down our cost to serve. So just to talk -- as an example, we've brought our fulfillment costs as a percentage of sales down by over 40% in recent years.

**And to put a little more color on that, we have roughly the same number of distribution associates today servicing our nearly $2.4 billion in volume as we did when we were just a bit over $1 billion in size**." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 07 November 2012

[16] "So you've seen us marching along the path here executing this strategy while expanding operating margins. I think if we look to the future on the margin profile, **we don't see a natural ceiling on margins and we don't see a reason why over long periods of time those couldn't be expanded**. And again, I'd say the proof is in the pudding there. So even as we penetrate a product line, we're doing it today in metalworking, and you're seeing we're doing that while expanding operating margins. So we feel very good about the strategic plan, and about our ability to expand margins.

Your other question was around infrastructure. And I'd start out by saying, one of the exciting things about being part of this ride and part of this vision is that with the kind of growth rates we've experienced, every couple of years we need to continually, and have been taking a look and a pressure test at all sorts of things from infrastructure to our operating process because every few years the Company is growing by leaps and bounds. So with respect to infrastructure, certainly it's going to be an area that we're going to have to look at. I'll give you one as a for instance, and you had mentioned it. **Our logistics network our four CFCs have been -- we view our logistics network as a real source of competitive advantage for the Company. That's both in terms**

**of the customer service** that we're able to bring to bear with the next day delivery in APM and the accuracy. **It's also been a source of competitive advantage in terms of productivity. We really like our centralized model. We think it gives us a lot of leverage and scale and going back to that margin discussion, it's one of the reason why we feel so good about our ability to expand margins over time**.

**The four centers we have remain expandable and scalable as we've always described. That said, the kind of continued high growth that we're seeing now** and we anticipate that's going to come will put a strain on our network that's large enough that will lead to the **need for a fifth CFC**. We are, right now, in the early stages of planning that's really -- we join this up and marry it with our strategic planning cycle. So as we build out a more robust plan and timelines and so forth, we would return to you with more color." – Erik Gershwind, MSC's CEO, MSC 2012 Q1 Earnings Transcript, 05 January 2012

[17] "I'll now turn to an overview of our capabilities. Our customers need to increase their productivity. They want to get more products to market faster and at a lower cost. **MSC's 4 distribution centers or, as we call them, our customer fulfillment centers, are strategically located to ensure that our customers always have the products that they need when they need them. Together, our network brings world-class service to our customers. We offer over 99% fill rates across our product offering and next day delivery with an 8.00 pm cutoff time**.

…

If there's an additional takeaway from this slide, it's scale. **Virtually all of our shipments come out of 1 of our 4 CFCs or come directly from a supplier. So, unlike many with a branch-based model, our inventory is centralized, which gives us great leverage on future growth. In addition to our 4 CFCs, we have roughly 100 branch locations around the country, but these are predominantly sales offices, as we carry very little inventory remotely. 91% of the output within our target end-markets is concentrated in the top 100 metropolitan statistical areas across the U.S**. What that means is that we won't need hundreds of additional branches in order to continue fueling this growth story." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 09 November 2011

[18] "Ryan Merkel, Analyst – William Blair: **Can you get back to 18%?** And then, maybe use the framework and talk about under what circumstances you would get there faster versus you would get there slower.

Erik Gershwind, MSC's CEO: Sure, Ryan. So I think just back to -- I think the first thing I would say is we certainly see, given that **we are coming off of what has been an unusually soft pricing environment in particular for three years** -- and if you want to get a reference point, the best thing I would point you to is the commodities has been

the real issue. One of the indices that we will track is the intermediate goods PPI, which would give you a sense of how commodities pricing has fared over multiple decades. What's happened in the last few years has been an outlier, to say the least.

So I think what we do when we look over periods of time is we try to normalize for some of near-term noise, and that would mean what we would consider to be over extended periods of time an average pricing environment and extended periods of time an average demand environment. You pick the indice, whether it's the ISM or metalworking index, whatever. But under a normalized environment, what we would see is, as I said, high single-digit topline.

**I think the story on gross margins is a relatively stable one, and then the earnings leverage that comes in is a function of leveraging the topline**, which I certainly see opportunity to do. There is always opportunity, now more so perhaps **because of the stepped-up infrastructure investments that we made that are just waiting to be leverage**. So I think the punchline is in a normalized environment, I see expansion.

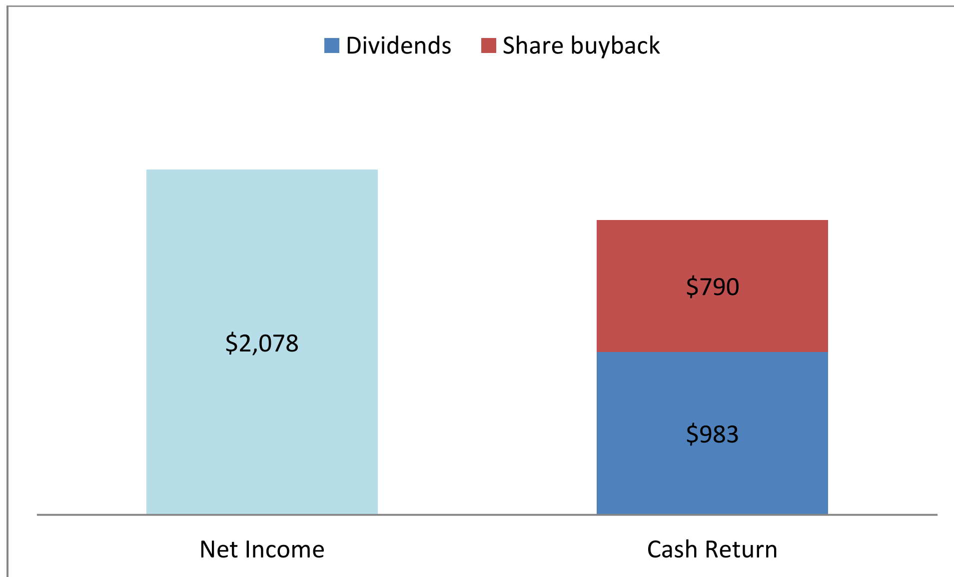
In terms of how quickly that happens, really that's a function of two external factors, I would say, beyond the internal factors that are within our control around taking share and driving productivity. And the two external factors would be the price environment and the demand environment.

So, certainly, in what we track and what's most controllable to us on the topline is our share-gain delta, the growth rate above market. To the extent the tide lifts and demand environment firms up, our share-gain delta should be at least as strong, and the topline gets into double digits, you start to really see leverage there. That would be one.

The other thing **what you have seen from us historically is with a bit of inflation, so certainly if the environment returns to anything like a normal pricing environment. Today we're getting something like zero price contribution. That is really an outlier for what the Company has done historically**." – William Blair Growth Stock Conference, 10 June 2015

Capital Allocation

**MSC can Return Two Thirds of Earnings to Shareholders while Growing 8% Annually**




Since 2005, MSC returned 85% of earnings to shareholders

- **Biggest Negative**:
  - No negative
- MSC is family-controlled
  - The family hold **81.5%** voting power
    - **49%** of economic interests
    - Mitchell Jacobson holds
      - **43.4%** of voting power
      - **26%** of economic interests
    - Mitchell L. Jacobson 2005 GRAT #2 Trust holds
      - **10.6%** of voting power
      - **6.4%** of economic interests
    - Marjorie Gershwind Fiverson holds
      - **13.8%** of voting power
      - **8.2%** of economic interests
    - Erik Gershwind holds
      - **7.7%** of voting power
      - **5%** of economic interests
    - Stacy Bennett holds

        - **6.0%** of voting power
        - **3.6%** of economic interests
- Mitchell Jacobson: MSC's chairman
    - He's the son of MSC's founder Sid Jacobson
    - He began working for MSC in 1976
        - 25 years old
    - Became president in 1982
        - 31 years old
    - Became CEO in 1995
        - 44 years old
    - He left the CEO position in 2005
        - 54 years old
        - 5 months after his parents died of carbon monoxide poisoning
            - In their Long Island home
- Erik Gershwin: MSC's CEO
    - He's Mitchell Jacobson's nephew
    - He's son of Marjorie Gershwind Fiverson
        - Marjorie Gershwind Fiverson is Mitchell Jacobson's sister
        - She has never served as a director at MSC
    - He joined MSC in 1996
        - As manager of acquisition integration initiative
        - He was **25 years old** when he joined MSC
    - He served as
        - VP of MRO and Inventory Management
            - From August 2004 to April 2005
        - VP of Produce Management
            - From April 2005
        - Senior VP, Product Management and Marketing
            - From December 2004
        - COO
            - From October 2009 to January 2013
            - He was **38 years old** when he became COO
        - CEO
            - Since January 01, 2013
            - He was **42 years old** when he became CEO
- Stacey Bennett is Erik Gershwin's sister
    - Marjorie Gershwind Fiverson's daughter

- Share-based compensation results in 0.5% annual dilution
    - Gross dilution: 1.3%
    - Net dilution: **0.5%**
        - Takes into accounts share purchased by using
            - Proceeds from exercise of stock options
            - Non-cash share-based compensation
- Compensation includes
    - Base salary
        - Targeted at or below the median of MSC's competitive market data
    - Annual incentive bonus
        - Based on achievement of rigorous diluted EPS growth targets
        - Maximum payout of 150% of target realized only if MSC exceeds targets significantly
    - Long-term Incentive Compensation
        - Mostly stock options
        - Annual grants are based on performance for the prior fiscal year
            - Stock options vest 25% on each of the 1st through 4th anniversaries of grant
- MSC's vision: grows into a $10 billion-plus business[1]
    - 2 steps[2]
        - First step: deeper product line penetration
            - Closely related category (521)
                - Safety
                - Fasteners
                - Hand and power tools
                - Material handling
                - Etc.
            - They're related because (521)
                - Consumed on the plant floor in metalworking environments
                - Often purchased by the same buyers
        - Second step: new end markets (521)
            - Inching out into durable and non-durable manufacturing environments
                - MSC's sales force will call on familiar environments
                    - Within 4 walls of the manufacturing plant
            - Then move to non-manufacturing environments
    - Organic growth is the priority[3]

- Focus on share gain
- MSC invest for the long run
  - MSC tends to be aggressive in down turns[4]
    - Maintain service level
    - Hire a lot of sales people from local competitors[5] [6]
      - These talents have deep customer relationships[7]
- MSC is interested in 2 types of acquisitions
  - Interested in 2 types of acquisitions[8]
    - One is a platform
      - Help move into an adjacency
        - Product line
        - New end market
      - Hard to estimate potential operating margins
        - Vary greatly based on product lines and end market
    - Fold-in
      - Fuel MSC's geographic build out
        - And penetration of the metalworking market
      - Most industrial distributor has lower margin than MSC
        - MSC can significantly increase
        - => end up similar to MSC's business
- MSC made only 2 big acquisitions
  - J&L Industrial Supply
    - MSC paid $349.5 million
      - In 2006
    - This is a fold-in acquisition
      - J&L was the distribution arm of Kennametal
        - One of the largest metal-cutting and finishing specialty distributors
    - J&L had
      - $265 million sales (111)
      - $31 million EBITDA
    - MSC's price was
      - 1.32x sales
      - 11.3x EBITDA
      - 7x EBITDA after cost synergy
        - $20 million synergy
    - MSC's gross margin was higher than J&J[9]

        - J&J’s margin would move closer to MSC’s current gross margin
            - Take advantage of MSC’s preferential buying positions
        - With hindsight, the acquisition was great
            - In 2008, EBIT margin of the whole company was 18%
    - Banes Distribution North America (BDNA)
        - MSC paid $550 million
            - In 2013
        - This is a platform acquisition
        - Extending its inventory management offering into **Class C items**[10]
            - Low dollar, high turn consumable items
                - Fasteners
                - Fittings
                - Fuses
                - Etc.
            - 95% of the business coming through the VMI channel
                - Broaden MSC’s inventory management solutions
                    - From vending in manufacturing floor
                    - To storerooms
        - BDNA represents[11]
            - A product line adjacency
            - End market extensions
                - 31,000 active customers
                    - Transportation
                    - Natural resources
                - Little customer overlap
                    - => cross sell opportunity
        - BDNA made
            - Revenue: $290 million
            - EBIT margin: 9%
        - MSC expected
            - Enormous value given
                - $100 million present value of cash tax benefits
                - $15-20 million cost synergies
        - MSC paid $550 million for BDNA[12]
            - $450 million after cash tax benefits
                - 17x EBIT

            - 10-11x EBIT after synergies
        - MSC achieved the cost synergies
            - Although on the low end of the targets
            - Decided not to close 2 of BDNA's distribution operations
        - Revenue synergies have been elusive
            - Salesforce retooling and transformation remains a work in progress
            - BDNA's business faces challenging environment
                - Just like Fastenal's fasteners business
    - Other small acquisitions are all fold-in acquisitions
        - Total $120 million since 1994
            - Average size was less than $15 million
    - Total money spend on acquisitions were **38%** of total CFFO since 1994
        - Total CFFO: $2.8 billion
        - Total acquisitions: $1.06 billion
    - This number may decline in the future
        - MSC grows => generate more cash flow
        - There aren't many big MRO distributors to acquire
- MSC is hesitant to move too much away from manufacturing[13]
    - Got very strong position in metalworking
    - Very strong position on the plant floor
- MSC will likely have fewer shares in the future
    - Only issued shares in 1996-1997
        - Went public to fund an ambitious infrastructure build out[14]
            - From 1996 to 2004
                - Opened 3 DCs
                - Added over 60 branches
                - Recruited and trained hundreds of field sales reps
                - Added 400,000 SKUs
                - Re-wrote and purchased the entire operating and financial system
        - The second big expansion was funded by cash flow
            - In 2013-2014
                - Built a second headquarter
                - Built the fifth distribution center
- MSC return all excess cash to shareholder
    - Don't have a payout policy[15]

            - But dividend has tended to be in the 30-50% range of net income
            - Would like to increase dividends each year
                - Don't want to reduce dividends
    - MSC tend to have zero net cash
        - But comfortable with 1x net debt to EBITDA
            - When making an acquisition
    - MSC complement regular dividends with
        - Share buyback[16]
            - Usually to eliminate any dilution
            - But MSC is also "opportunistic" when repurchasing more shares
                - "Random" is the more correct word
                - MSC spent $191 million in share buyback in 2014
                    - Paid about $80.7 per share
                        - About 22x P/E
                - MSC tend to balance share buyback with special dividends
        - Pay special dividends every 3 to 5 years[17]
- Since 2005
    - Total CFFO: $2,370 million
    - Total net income: $2,078 million
    - Total cash return: $1,772 million
        - 85% of total net income
        - 75% of total CFFO
    - Excluding share buyback to negate dilution:
        - Total cash return: $1,294 million
            - 62% of total income
            - 55% of total CFFO
            - => similar to Grainger's number
                - 66% of total income
                - 51% of total CFFO
    - Over this period, sales grew 10.22% annually
        - 2005: $1,100 million
        - 2015: $2,910 million
    - => after-tax return on investment is about 27%
        - 10.22% / (1-62%) = 27%

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[1] "There are four messages that I hope you take away from today's presentation. **Number one, MSC operates in a very large and highly-fragmented marketplace,**

**providing us with tremendous opportunity for growth**. Number two, MSC's value proposition is uniquely positioned within that market to delight customers and to take share. Three, our operating model gives us leverage and scale as we grow, providing room for further operating margin expansion. And, four, **we have a repeatable growth formula that we intend to apply over and over again to achieve our ultimate vision of being a $10 billion-plus business**." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 09 November 2011

[2] "**So what's next? How do we now go from $2 billion to $10 billion over the years to come? We will follow the same measured approach that we followed in the past**. We see ourselves as teammates in a relay race. The baton has now been handed to us to take MSC to the next level.

**The first step for the current team has been to move into deeper product line penetration. This means selling not only the unplanned spot buys that have been the Company's bread and butter, but the broader set of needs that our customers have**. And we decided to start in **the lowest risk place there was, metalworking**. It was the easy choice to get started. As the clear market leader, **we have share approaching 10%, which is multiples bigger than the next biggest guys in our space**. At the same time, it provides us with a large runway of profitable growth right in our sweet spot.

**With the experience in hand for metalworking on how to penetrate a product category, we've begun to move across other lines like safety, fasteners, hand and power tools, material handling and more**. You've heard us refer on **recent calls to these product lines as closely related adjacencies. That's because they're consumed on the plant floor in metalworking environments and oftentimes they're purchased by the same buyers who are buying metalworking supplies**. In addition, we already have experience in these product lines. They were some of the early MRO editions back in the 1990s. We have brought product offerings in our book, long standing relationships with key suppliers, and years of experience in learning what products sell and what additional value added services will be required to become a leader. **Executing upon our product penetration strategy, will give us experience in lines consumed outside of metalworking environments. Making it easier to now sell those products into new customers**.

**Our next step will therefore be to move into new end markets. Since our current penetration levels even within durable manufacturing are low, we'll begin this journey by inching out into those durable and non-durable manufacturing**

**environments where we're under penetrated. This allows our sales force to call on environments that are familiar to them, as they're all within the four walls of the manufacturing plant**. We've begun to lay the foundation in these newer segments through our national accounts program, but we'll get the true penetration in the years to come. **From there, we'll move to non-manufacturing environments where our products are consumed, opening up a whole new set of verticals to us**. We've also laid a foundation here in the form of our government business. And once again, deeper penetration will happen in the years to come. Finally, we'll move to geographies outside of the US, most likely starting with North America.

So that's the road map for our journey well into the future. **To move from $2 billion to $10 billion in sales. From the past, our regional spot buy supplier of metalworking supplies, to the present, a national distributor of metalworking and MRO supplies selling value added solutions through a large sales force, to the future, a $10 billion global distributor, deeply penetrated across many product lines, and many vertical end markets**. The tactics have and will continue to change. From direct mail to web, from product transactions to technology solutions and so on, but the vision remains the same." – Erik Gershwind, MSC's CEO, MSC 2012 Q1 Earnings Transcript, 05 January 2012

[3] "I would say with respect **to M&A, very consistent with our overall perspective. Which is, we see it as an important part of the growth story over time. You've seen us do it strategically**.

I think you could expect in the future us to do it strategically again as part of the growth story. **But I will say that we've always said at our hearts, in our core, we are organic growers. And what I would say is I think for right now, our primary focus is on organic growth and share gain**.– Erik Gershwind, MSC's CEO, MSC 2015 Q3 Earnings Transcript, 07 July 2015

[4] "Looking beyond 2016, I remain confident about our business and its future. Economic slowdowns are the times when MSC makes its greatest strides. These are the times when the local and regional distributors that make up 70% of our market suffer disproportionately.

**History tells us what will happen to local distributors if this downturn prolongs. Reducing their inventory leaves customer service vulnerable. Clamping down on receivables disrupts longstanding customer relationships**.

**Laying off people creates hiring opportunities to acquire industry talent not typically available**. We are just starting to see the very early signs of these things occur in the marketplace. The pace will accelerate the longer these conditions hold.

**We are pleased with our share gain performance to date and would anticipate it to continue or even accelerate the longer these conditions last, and that will lead to disproportionate top-line growth when the environment does improve**. We are also using this time to improve our cost structure through productivity initiatives and tight expense management, and that should create significant earnings leverage when revenue growth returns." – Erik Gershwind, MSC's CEO, MSC 2016 Q1 Earnings Transcript, 06 January 2016

[5] "One of the things that we've talked about since, really since the start of the downturn is that we've seen the -- and **David described this as part of the land grab of the smaller regional distributors who employ some of the really strong salespeople in our industry historically had a tight attachment to those businesses. And we saw that the downturn really broke a lot of the bonds that were there, and as a result, we've been, since the downturn, and this continues, hiring really top notch industry talent that in years past we would not have been able to recruit**. And we see that runway as long, and it's continuing." – Erik Gershwind, MSC's CEO, MSC 2012 Q1 Earnings Transcript, 05 January 2012

[6] "Quite frankly, **one of the most exciting things, if you can call exciting about a downturn, is the opportunity to acquire some great talent, to make some great investments that really juice the returns coming out of the recession. And we said this time will be no different.**" – Erik Gershwind, MSC's CEO, MSC 2015 Q4 Earnings Transcript, 27 October 2015

[7] "**Since the beginning of the downturn, the smaller, less well-capitalized competitors that make up the bulk of the market have continued to suffer from service failures, lack of inventory, and the loss of key personnel.** The competitive advantage that MSC enjoys over the regional and small distributors has grown substantially over the past few years and we continue to widen the gap and gain market share.

**Throughout the downturn and now in the recovery, we have hired many new and experienced salespeople from our competitors, people who would have been difficult to attract in the past. These are associates with deep customer relationships and often bring strong technical capabilities to our sales team**." – David Sandler, MSC's former CEO, MSC 2011 Q2 Earnings Transcript, 06 April 2011

[8] "I will take a moment to refresh you on how we think about M&A. **There are two types of acquisitions contemplated in our strategy. One is a platform which would**

**represent a move into an adjacency such as a product line or a new end market. The other is a fold-in, which is a way to fuel our geographic build out and penetration of the US metalworking market. It is tough to paint the potential platform moves with one brush in terms of operating margins** as they will vary greatly based on the product line, end market, where the individual target being considered. Those will need to be described on a case-by-case basis. Conversely, based on our significant experience, **we are able to broadly describe the characteristics of fold-ins**. As you know, virtually all of traditional industrial distribution operates at significantly lower gross and operating margins than MSC. This means that **when we buy a local distributor, it will almost certainly be dilutive to gross margin and to operating margin**.

However, **because these businesses are in our core, synergies are large, like the ones we described for American Tool. Those synergies help make fold-in acquisitions accretive quickly and also served to significantly increase the target companies gross and operating margins over time.** Our acquisition program from the 1990s, 10 or more years later, now gives us a solid understanding of what we can expect for the future. We have seen that **over extended periods of time the traditional branch space acquisitions we made end up looking pretty similar to an organic MSC branch**. We are confident that our formula for acquiring and integrating these businesses will significantly expand their operating margins and is repeatable for the future. The MSC value proposition continues to excel in delighting customers." – Erik Gershwind, MSC's CEO, MSC 2011 Q4 Earnings Transcript, 26 October 2011

[9] "Number one, volume opportunities. **We anticipate further incentives from suppliers such as discounts and rebates given the increased overall dollar volume of our purchases. Number two, improved private label opportunit**y. The combination of both companies' private brands should allow for an improved gross margin from a shift and sales mix. **And number three, MSC's gross margin is currently higher than that of J&L. It is anticipated over time that the J&L margins will move closer to MSC's current gross margin as we take advantage of our preferential buying positions**.

Operating expense savings are primarily derived from the following areas. **Number one, systems consolidation. We anticipate savings by migrating J&L off of the Kennametal systems and running J&L on MSC's systems**. These savings would accrue once the integration is complete. **Number two, elimination of back office redundancies**. As with all acquisitions, there will be opportunities to reduce redundant costs allowing for higher levels or profitability than would be achieved in the standalone

environment. **Number three, contract expense reductions. We would anticipate savings from the purchasing power of negotiating expense contracts at significantly higher volumes than exist today. And number four, co-op advertising**. We intend to extend our current programs to J&L where they currently do not exist." – Chuck Boehlke, MSC's former CFO, MSC to Acquire J&L Industrial Supply Conference, 16 March 2006

[10] "The acquisition of BDNA significantly strengthens MSC's value proposition by **extending our inventory management offering into Class C items. Its sticky value proposition of solution selling is right in the MSC wheelhouse, with roughly 95% of their business coming through the VMI channel. We'll broaden MSC's inventory management solutions from the production floor to the tool crib**, and we have already seen from our vending initiative that embedding ourselves in our customers as an inventory management partner translates into high retention rates, deep account penetration, and higher growth.

Our history shows that once you become a customer's preferred supplier, there is a tremendous opportunity to sell a much broader selection of MRO products. **BDNA also serves as a high margin product line extension for us. The Class C market consists of low dollar value, high turn consumable items that are used extensively in the maintenance environment. Products span many categories, but are typically associated with fasteners, fittings, fuses, and others. As they're low value, they're typically dispensed without transaction level tracking, and are maintained in a common area, which is replenished by third-party Class C providers**." – Erik Gershwind, MSC's CEO, MSC to Acquire Barnes Distribution North America Conference, 22 February 2013

[11] "BDNA not only represents a product line adjacency, but it also provides end market extensions. **The business brings roughly 31,000 active customers that currently buy Class C supplies from them. Its sales team has deep relationships with a broad and diverse customer base, and we believe that the customer overlap between the two companies is relatively small**.

**As a result, we're excited about the opportunity to sell MSC's broader portfolio of MRO supplies to customers in industries that are new to us, such as transportation and natural resources.** We're drawing from proven experience, as we know from the J&L acquisition and from our own buildout of MRO, that there is significant growth potential. **We also look forward to introducing MSC's other value-added services, such as e-commerce**. Finally, BDNA is a great geographic match for MSC. Their expansive sales force that cover the entire US, coupled with their presence in Canada, will expand MSC's addressable market access. This gives us opportunity for

future market penetration and reach." – Erik Gershwind, MSC's CEO, MSC to Acquire Barnes Distribution North America Conference, 22 February 2013

[12] "Let me now talk a bit more about how we view the economics of the deal. When we evaluate acquisitions, we look at cash on cash returns. **In this case, by virtue of realizing more than $100 million in net present value cash tax benefits, and by executing on the cost synergies that are right in front of us, we rather quickly earn above our weighted average cost of capital.** In other words, the deal makes economic sense even without growth. But this is ultimately a growth play for us. The returns start getting incredibly attractive as the business grows. We ultimately see the potential for this business to be at or even above MSC's operating margin levels.

**At today's revenue rate of around $290 million annually, the business is doing around 9% in EBIT margins. If we execute on our cost synergy range, between $15 million and $20 million, we will add between 500 and 600 basis points to EBIT margins**, already bringing the business in the neighborhood of MSC levels. And then **because of the high gross margins, the incremental margins in the business are quite high**, even when factoring reinvestment back into the business. And finally, we see the **opportunity to improve the current levels of BDNA sales force productivity by bringing the MSC offering to their customers**, and by bringing MSC's sales management practices to the table. Ray Rutledge and his team have gotten to know the BDNA organization quite well, and are excited by the excellent talent who make great additions to our team." – Erik Gershwind, MSC's CEO, MSC 2013 Q3 Earnings Transcript, 10 July 2013

[13] "**We will look for opportunities outside of manufacturing, but our thesis is that manufacturing is a good long-term bet. And therefore, we are hesitant to move too much away from it and make too many adjustments because we feel like we've got very strong position in metalworking, very strong position on the plant floor**. And when things rebound -- and to me, that's a when, not an if -- we think by keeping focus, we're going to disproportionately benefit." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 10 November 2015

[14] "There has never been a more exciting time than today in the 63-year history of our company. We have a unique opportunity at a $1 billion run rate to be a part of a consolidation of a huge fragmented industry. **When we went public in 1995 we did so in order to fund an ambitious infrastructure build out. In the last nine years we opened three distribution centers, over 60 branches, recruited and trained hundreds of field sales associates, added 400,000 SKUs, re-wrote or purchased virtually our entire operating and financial systems, and built a management team and group of associates with unmatched talent and depth**.

As we close out our first billion dollar run rate quarter, I remain as excited about the growth opportunities inherent in this business as I was in 1976 when I joined the $6 million industrial distributor with new ideas and huge vision." – Mitchell Jacobson, MSC's Chairman, MSC 2004 Q3 Earnings Transcript, 07 July 2004

[15] "**So we have raised the dividend significantly over the last few years**. The latest one being 21% for this year that we're in now. And **we typically raise it once annually and then pay it out over the following four quarters. We don't formally have a payout policy, for instance. Although it has tended to be in the 30% to 50% range of net income**.

So that's really what I can tell you. The way we look at it is that **we want to keep it at least at a minimum. We never want to back off of it, so we'd like to increase it each year probably. And given our cash position and the dynamics of the Company, I think we are comfortable in saying that we will build to continually increase it.**" – John Chironna, MSC's VP, IR and Treasurer, Deutsche Bank Conference, 04 June 2015

[16] "**Over the past decade, you can see that we have maintained a stable and continually increasing ordinary dividend. And at the same time, we typically repurchase shares to eliminate any dilution each year, but are also opportunistic when it comes to further share repurchase or M&A opportunities. You can see we also employ a use of special dividends from time to time**.

Currently, **we operate at a leverage ratio or net debt to EBITDA of about 1 times. This is slightly more progressive than in the past and this is a level with which we are comfortable**, as it affords us the flexibility to go higher should additional repurchase or M&A opportunities arise. Going forward, we will continue to take a balanced approach to capital allocation." – John Chironna, MSC's VP, IR and Treasurer, Raymond James Conference, 03 March 2015

[17] "I guess I would use two words to describe our capital allocation and that would be one of balance and opportunistic. **So you can expect that we will still be quite conservative, but at the same time, we've gotten a little bit more progressive where we have leveraged up to 1 times.**

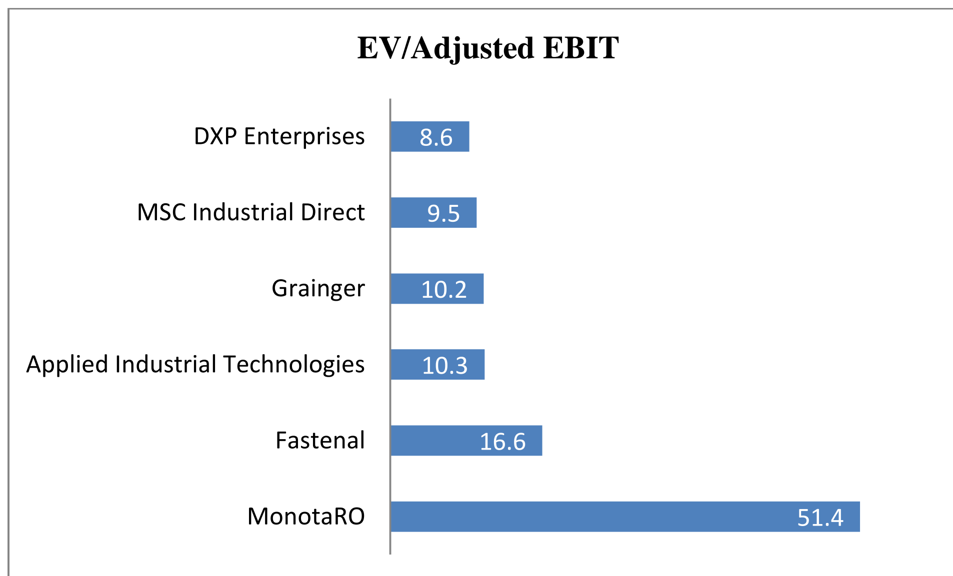
**Historically, we've been at zero or even net cash, so we are -- the 1 times is what I would call a comfortable range. It's not intended to be any kind of formal target, but it allows us to flex up if need be for the right opportunities, whether that be share repurchase or M&A**. Although I would say that probably over the next few

quarters, I wouldn't necessarily expect to see us to a deal on M&A, just because valuations are still high and we've got a lot we're chewing on inside the Company.

Other than that, **you will continue to see a balanced approach in terms of continually increasing ordinary dividends; share repo from time to time. We just did a special last fall and we tend to do those every three to five years**. And of course, we will always continue reinvesting for organic growth." – John Chironna, MSC's VP, IR and Treasurer, Deutsche Bank Conference, 04 June 2015

Value

## MSC Deserves a High Multiple




*MSC is trading like an average MRO distributor*

- **Biggest Negative**:
    - MSC usually trades at 18-25x P/E
- Key inputs
    - Number of shares: 61.52 million
    - Share price: $72.13
    - Cash: $38 million
    - Debt: $417 million
    - EV: $4,816 million
    - Normal EBIT: $509 million
    - EV/Normal EBIT: **9.46x**
    - Effective tax rate: 37-38%
- MSC can make **$509 million** normal EBIT
    - MSC's current revenue: $2,910 million
    - EBIT margin was between 17-18% for most of 2006-2012 period
    - Current margin is depressed by
        - MSC's last phase of investment
            - Started in 2013
        - Weak market condition
        - Lack of inflation

        - There's natural margin expansion in this business
            - It makes sense to use peak EBIT margin to estimate earning power
        - Grainger and Fastenal makes higher margin than MSC
            - Fastenal: 21% EBIT margin
            - Grainger: 17-18% EBIT margin
- Peers include
    - DXP Enterprises (DXPE)
        - DXPE is the 20th biggest MRO supplier
            - $1,247 million revenue
        - DXPE focuses on
            - Rotating Equipment: **53%** of revenue
            - Safety Product & Services: **15%** of revenue
            - Bearing & Power Transmission: **14%** of revenue
            - Metalworking: **13%** of revenue
            - Industrial supplies: **5%** of revenue
        - DXPE has
            - 8 regional DCs
                - Stocks 60,000 SKUs
            - 185 locations
        - DXPE grew very fast
            - Sales CAGR was
                - 1992-2015: **11.79%**
                    - 1992: $96 million
                    - 2015: $1,247 million
                - 2000-2015: **13.68%**
                    - 2000: $183 million
                    - 2015: $1,247 million
                - 2005-2015: **21.02%**
                    - 2005: $185 million
                    - 2015: $1,247 million
            - DXPE grows by making small bolt-on acquisitions
                - At 4-6x EBITDA
        - DXPE has an inferior supply chain to MSC's and Grainger's
            - DXPE grows through acquisitions
                - Invests little in the supply chain
                    - Total CapEx since 1994: $79 million

        - DXPE focuses more on high-volume, recurring items
            - Stock only 60,000 SKUs
    - DXPE's current valuation
        - Share price: $17.04
        - Market cap: $246 million
        - EV: $593 million
        - EV/S: 0.48
        - EV/Gross profit: 1.69x
        - EV/Adjusted EBIT: **8.63**
    - There's good reason for DXPE's low valuation
        - $348 million net debt
            - 5x adjusted EBIT
        - Huge exposure to oil & gas
            - 66% of DXPE revenue is related to oil & gas
                - Upstream: 19%
                - Production: 23%
                - Midstream: 18%
                - Downstream: 6%
- Applied Industrial Technologies (AIT)
    - AIT focuses on categories such as
        - Bearings
        - Power transmission
        - Fluid power
    - AIT's catalog has about 30,000 products
    - AIT serves customers from 565 facilities
    - AIT's product categories seems to have
        - Low margin
        - High turnover
    - AIT has
        - Gross margin: 26-27%
        - EBIT margin: 7%
        - Cost of Goods Sold/Average Inventories: 6-7x
        - EBIT/NTA: 30%
    - AIT's growth record was mediocre
        - Grew only **3.7%** annually over the past 15 years
            - 2000: $1,601 million

                - 2015: $2,752 million
            - While spending $705 million in acquisitions
                - **52%** of total CFFO
                    - Total CFFO: 1,355 million
        - => AIT is an inferior peer
        - AIT's current valuation
            - Share price: $40.11
            - Market cap: $1,575 million
            - EV: $1,906 million
            - EV/S: 0.69
            - EV/EBIT: 10.32
    - Grainger
        - Grainger is the biggest peer
        - Grainger focuses more on facility maintenance
        - Grainger is the most similar peer to MSC
            - Both stock over 500,000 products
                - Sell a lot of unplanned purchase
            - Both have multi-channel model
            - Both invest heavily in the e-commerce capabilities
                - Ship from warehouses
            - Both (and Fastenal) consistently gain market share
            - Both make about 40-60% pre-tax ROIC
        - Grainger's current valuation
            - Share price: $217
            - Market cap: $13,395 million
            - EV: $15,269 million
            - EV/S: 1.53
            - EV/Adjusted EBIT: 11.33
            - EV/Owner Earnings: 10.22
    - Fastenal
        - Fastenal has a store-based model
            - 2,737 stores
                - Stores are small
                - Average less than 4 employees per store
            - 54,291 vending machines
            - Focuses on reoccurring purchases

        - About 10,000 items
      - Keeps a lot of inventories at branches[1]
        - Stock 160-165 days of inventories
        - Inventories sit in a DC for 60 days
          - Sit in a store 100-110 days
        - => DC restocks stores on a periodic basis
      - Fastenal ships from store to customers
    - Fasteners represent **40%** of Fastenal's sales
    - Manufacturing accounts for 50% of Fastenal's sales
      - Manufacturing + construction = 70% of Fastenal's sales
    - Fastenal's EBIT/NTA is about 40-60%
      - Sales/NTA: 2-3x
      - EBIT margin: 20%
    - Fastenal had great growth record
      - Revenue was
        - 1990: $52 million
        - 1995: $223 million
        - 2000: $746 million
        - 2005: $1,523 million
        - 2010: $2,269 million
        - 2015: $3,869 million
      - Sales CAGR was
        - Since 1990: 19%
        - Since 1995: 15%
        - Since 2000: 12%
        - Since 2005: 10%
        - Since 2010: 11%
    - Fastenal's current valuation
      - Share price: $42.10
      - Market cap: $12,142 million
      - EV: $12,378 million
      - EV/S: 3.20
      - EV/EBIT: 14.96
  - MonotaRO
    - MonotaRO is Grainger's single-model online business in Japan
      - Grainger owns 53%
    - MonotaRO's revenue grew 26% annually since 2009:

            - 2009: 14.2 billion Yen ($123 million)
            - 2010: 17.7 billion Yen ($154 million)
            - 2011: 22.2 billion Yen ($193 million)
            - 2012: 28.7 billion Yen ($249 million)
            - 2013: 34.6 billion Yen ($300 million)
            - 2014: 44.9 billion Yen ($390 million)
            - 2015: 57.6 billion Yen ($500 million)
        - Current EBIT: $60 million
        - MonotaRO's EBIT/NTA: 50-80%
        - MonotaRO's current valuation
            - Share price: ¥2,953 ($25.94)
            - Market cap: ¥368 billion ($3.2 billion)
            - EV: ¥364 billion ($3.2 billion)
            - EV/S: 6.32
            - EV/EBIT: 51.36
- We can divide peers into 3 groups
    - Inferior peers: **DXPE** and **AIT**
        - AIT has
            - Weaker growth
            - Weaker margin
            - Weaker ROIC
        - DXPE has
            - High leverage
            - High exposure to oil & gas
            - Lower quality of growth
                - DXPE grows through acquisitions
                - Valuation increases as DXPE makes bigger acquisitions
        - These peers trade at around 9-10x EBIT
    - Comparable peers: **Grainger** and **Fastenal**
        - Grainger and MSC trade at similar multiple
        - Fastenal is significantly more expensive
            - Trading at 16.6x EV/EBIT
    - High-growth peer: **MonotaRO**
        - MonotaRO's valuation is off the roof
- MSC's historically trade at high multiple

- High-year price to earnings:
  - (from 1998 to 2015)
  - Min: 17.7
  - Max: 62.5
  - Median: **30.6**
  - Mean: 32.16
  - Standard deviation: 10.8
  - Variation: 34% (volatile)
- Low-year price to earnings
  - (from 1998 to 2015)
  - Min: 8.8
  - Max: 34.9
  - Median: **18.6**
  - Mean: 18.43
  - Standard deviation: 5.9
  - Variation: 32% (volatile)
  - Excluding 1999-2001 and 2008-2009, min P/E was **16.4**
- Min P/E over the last 5 years: **16.4**
- At $72.13, current P/E is **19.3**

- MSC deserves a high multiple
  - Historically, it was able to grow sales 10% annually
    - While returning over 60% of earnings
  - It can continue to have high single digit growth for many years

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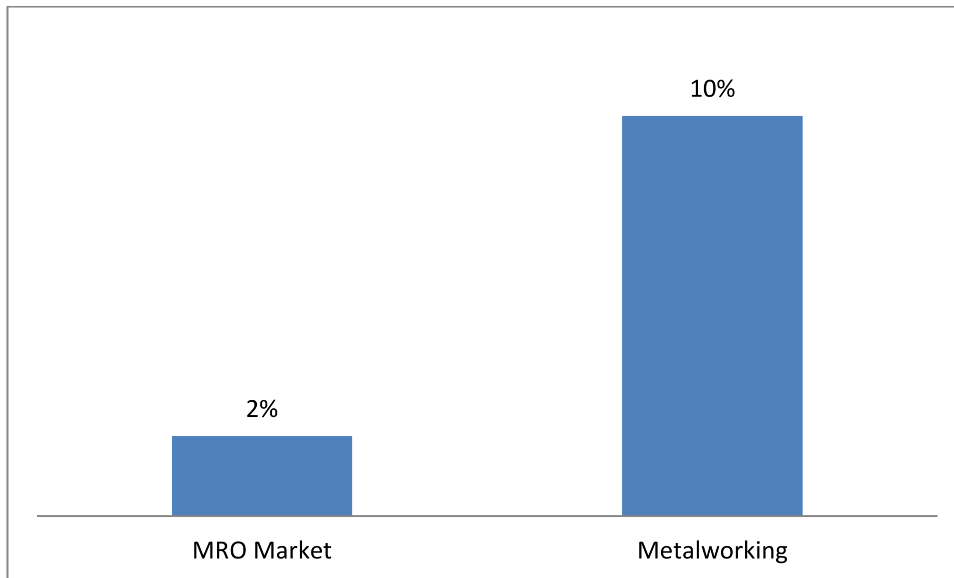
[1] "Right behind you and you've heard us talk over the last few years about THUB, this new distribution center we were building to support our vending initiative. One thing to think about when you're touring THUB and then when you are touring IHUB, is they are fundamentally two different facilities. **If you think of our business for many years, so our public numbers, we stock about 160, 165 days worth of inventory. And if I think about our supply chain, about 60 days of that timeframe is inventory sitting in a distribution center and about 100 to 110 days of that supply chain is inventory physically sitting in a store. So our distribution centers are fundamentally about restocking on a periodic basis, inventory going to the store and the inventory is sold from there**. What fundamentally changed with vending is the breadth of SKUs that you're talking about isn't this wide anymore. It becomes this wide, but the frequency is off the chart. So requires a fundamentally different type of distribution center to handle that and that's what you will see when you're looking through a THUB facility versus what you're looking in an industrial **-- a typical**

**industrial distribution facility of Fastenal that is more about replenishing a store versus replenishing a machine, because in the machine you're talking about days and weeks of inventory not weeks and months.**" – Dan Florness, Fastenal's CFO, Fastenal Investor Presentation, 05 November 2015

Growth

**MSC can Continues Gaining Market Share for Many Years**




*MSC holds only 10% of the metalworking market and 2% of the whole MRO market*

- **Biggest Negative**:
  - Growth depends on strength of the manufacturing sector
- Manufacturing in the U.S. has low growth
  - Manufacturing real output index CAGR was
    - (Source: Federal Reserve Bank of St. Louis)
    - Since 1995: **1.98%**
      - 1995: 88.594
      - 2015: 131.087
    - Since 2000: **1.08%**
      - 2000: 111.500
      - 2015: 131.087
    - Since 2005: **1.42%**
      - 2005: 113.792
      - 2015: 131.087
  - Value-added manufacturing output CAGR was
    - (source: World Bank)
    - 1997 – 2013: **2.31%**
      - 1997: $1,349 billion
      - 2013: $1,944 billion

        - 2005-2013: **2.09%**
            - 2005: $1,648 billion
            - 2013: $1,944 billion
- The MRO market's normal growth is about 2-3%[1]
    - 1-2% inflation
- MSC's vision: grows into a $10 billion-plus business[2]
    - 2 steps[3]
        - First step: deeper product line penetration
            - Closely related category (521)
                - Safety
                - Fasteners
                - Hand and power tools
                - Material handling
                - Etc.
            - They're related because (521)
                - Consumed on the plant floor in metalworking environments
                - Often purchased by the same buyers
        - Second step: new end markets (521)
            - Inching out into durable and non-durable manufacturing environments
                - MSC's sales force will call on familiar environments
                    - Within 4 walls of the manufacturing plant
            - Then move to non-manufacturing environments
- It's possible
    - The market is highly fragmented
    - Local competitors still hold 70% market share
    - Big-customer business might be more concentrated
        - But it's still fragmented
        - According to Grainger's estimate
            - Large-customer segment: $40 billion
            - Medium-customer segment: $50 billion
            - Small-customer segment: $40 billion
        - If Fastenal and MSC are limited to large-customer segment
            - Top 3 distributors have **32%** market share
                - Grainger: **14.8%** market share
                    - $5.9 billion revenue
                - Fastenal: **9.8%** market share

            - $3.9 billion revenue
        - MSC: **7.3%** market share
            - $2.9 billion revenue
    - If Fastenal and MSC are limited to large and medium customers
        - Top 3 distributors have **16%** market share
            - Grainger: **8.1%** market share
                - $7.3 billion revenue
            - Fastenal: **4.3%** market share
                - $3.9 billion revenue
            - MSC: **3.2%** market share
                - $2.9 billion revenue
- MSC can further gain market share in metalworking[4]
    - MSC has only 10% market share in metalworking
        - Several times bigger than the next competitors
- MSC can grow outside of metalworking
    - Metalworking currently account for 50% of MSC's revenue
    - MSC can sell other product categories to customers
        - Other product categories are still fragmented
        - Example: A lot of opportunities to gain share from small competitors in Class C space[5]
            - Class C items are typically kept in a bin in a storeroom
                - Low dollar value items
                - Consumable items
                    - Fasteners
                    - Fuses
                    - Fittings
                    - Adhesives
                    - Etc.
                - The market is about the size of metalworking
                    - $12 billion
            - Fastenal has only **10-12%** market share in fasteners
                - Fastenal's fastener revenue: $1.3 billion

- How fast can MSC grow?
    - MSC grow revenue 9-10% over the last 10-15 years
        - Since 2000: 9.05%
            - 2000: $793 million
            - 2015: $2,910 million

        - Since 2005: 10.22%
            - 2005: $1,100 million
            - 2014: $2,910 million
    - Future growth might not be as fast
    - 5% growth is very easy
        - Assuming MSC's addressable market is $60 billion
            - Including
                - Large customers: $40 billion, and
                - Medium customers: $20 billion
                    - Or 40% of the medium-customer segment
        - => MSC has only **5%** market share today
            - If over the next 20 years
                - MSC grows revenue at 5% annually
                - The market grows at 2% annually
            - => MSC has only **8.9%** market share after 20 years
                - A very modest share gain assumption
            - If MSC grows at 7% annually instead
                - => MSC has only 13% market share after 20 years
- Conclusion: MSC can have high single digit growth for many years
    - MSC can have better near-term growth
        - Growth tend to ramp up after downturns
            - MSC gain more market share during downturns
        - Example:
            - 3-year revenue CAGR was
                - In 2003: 0.56%
                    - 2000: $831 million
                    - 2003: $845 million
                - In 2006: 16.62%
                    - 2003: $845 million
                    - 2008: $1,318 million
                - In 2010: 0.08%
                    - 2007: $1,688 million
                    - 2010: $1,692 million
                - In 2013: 13.26%
                    - 2010: $1,692 million
                    - 2013: $2,458 million
        - Organic growth over the last 3 years were weak

        - About only 4%
        - (Excluding acquisition of Barnes Distribution North America)
    - The market condition continue to be tough in 2016
        - Create opportunities for MSC to gain market share[6]
            - Local competitors tend to
                - Reduce inventories => hurt customer service
                - Clamp down on receivables => disrupt relationship
                - Lay off people => give MSC chance to hire
        - The longer the tough condition lasts, the better it is for MSC
    - => sales growth in the 2016-2021 can be very good

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[1] "And as we look forward five years -- over the next five and say well, what should our growth be and **what do you have to believe to think that it can grow organically high single digits, so 6% to 10%?**

**You need to believe that the share gains with our larger customers will ramp back up like we've been seeing the last five years** -- that that will continue in the next five. **That the market will grow 2% to 3% as it's been growing for some time except this year**.

**And that price -- well, we are kind of weighting it down probably heavily by our current experience, but -- because historically it has been 1% to 2%, we are saying zero to 1% growth each year over the next five years. And that is how we get to the 6% to 10%.**" – Ron Jadin, Grainger's CFO, Electrical Products Group Conference, 20 May 2015

[2] "There are four messages that I hope you take away from today's presentation. **Number one, MSC operates in a very large and highly-fragmented marketplace, providing us with tremendous opportunity for growth**. Number two, MSC's value proposition is uniquely positioned within that market to delight customers and to take share. Three, our operating model gives us leverage and scale as we grow, providing room for further operating margin expansion. And, four, **we have a repeatable growth formula that we intend to apply over and over again to achieve our ultimate vision of being a $10 billion-plus business**." – Erik Gershwind, MSC's CEO, Robert Baird Industrial Conference, 09 November 2011

[3] "**So what's next? How do we now go from $2 billion to $10 billion over the years to come? We will follow the same measured approach that we followed in the past**. We see ourselves as teammates in a relay race. The baton has now been handed to us to take MSC to the next level.

**The first step for the current team has been to move into deeper product line penetration. This means selling not only the unplanned spot buys that have been the Company's bread and butter, but the broader set of needs that our customers have**. And we decided to start in **the lowest risk place there was, metalworking**. It was the easy choice to get started. As the clear market leader, **we have share approaching 10%, which is multiples bigger than the next biggest guys in our space**. At the same time, it provides us with a large runway of profitable growth right in our sweet spot.

**With the experience in hand for metalworking on how to penetrate a product category, we've begun to move across other lines like safety, fasteners, hand and power tools, material handling and more**. You've heard us refer on **recent calls to these product lines as closely related adjacencies. That's because they're consumed on the plant floor in metalworking environments and oftentimes they're purchased by the same buyers who are buying metalworking supplies**. In addition, we already have experience in these product lines. They were some of the early MRO editions back in the 1990s. We have brought product offerings in our book, long standing relationships with key suppliers, and years of experience in learning what products sell and what additional value added services will be required to become a leader. **Executing upon our product penetration strategy, will give us experience in lines consumed outside of metalworking environments. Making it easier to now sell those products into new customers**.

**Our next step will therefore be to move into new end markets. Since our current penetration levels even within durable manufacturing are low, we'll begin this journey by inching out into those durable and non-durable manufacturing environments where we're under penetrated. This allows our sales force to call on environments that are familiar to them, as they're all within the four walls of the manufacturing plant**. We've begun to lay the foundation in these newer segments through our national accounts program, but we'll get the true penetration in the years to come. **From there, we'll move to non-manufacturing environments where our products are consumed, opening up a whole new set of verticals to us**. We've also laid a foundation here in the form of our government business. And once again, deeper penetration will happen in the years to come. Finally, we'll move to geographies outside of the US, most likely starting with North America.

So that's the road map for our journey well into the future. **To move from $2 billion to $10 billion in sales. From the past, our regional spot buy supplier of**

**metalworking supplies, to the present, a national distributor of metalworking and MRO supplies selling value added solutions through a large sales force, to the future, a $10 billion global distributor, deeply penetrated across many product lines, and many vertical end markets**. The tactics have and will continue to change. From direct mail to web, from product transactions to technology solutions and so on, but the vision remains the same." – Erik Gershwind, MSC's CEO, MSC 2012 Q1 Earnings Transcript, 05 January 2012

[4] "One of the beautiful things about the business is there's so much -- if you think about the priorities and the revenue road map we've laid out, **we see a ton of opportunities still in the core of our core business of metalworking, given the still relatively low share position, combined with leadership in metalworking. We then see opportunity outside of metalworking, but still on the plant floor in manufacturing. Third would be outside of manufacturing altogether**.

Certainly there's things that we're doing now to prime the pump and begin to get growth out of the non-manufacturing segment. The one I'd point to as an example would be the one we mentioned on the call in government, where we're really pleased with our performance. Certainly outside of manufacturing, but one that we continue to invest in and see as a growth engine for the future." – Erik Gershwind, MSC's CEO, MSC 2012 Q4 Earnings Transcript, 31 October 2012

[5] "I think the key point is virtually all the business being this **Class C**, and the reason we think it's relevant is, whether it's **fasteners, fuses, fittings, adhesives,** there is a whole bunk of stuff that all have very similar characteristics to them in the way they're consumed and the way they're purchased. What we like about this segment and this product set is obviously yes, **it's a nice extension from metal-working. We're in the plants already. But we really like the dynamics of this business, which are that they're low dollar value items with a high service component. It's tough, or really not worthwhile to price shop in this segment of the market, and we think we can really entrench ourselves with value-add, with the inventory management**, and really embed ourselves in the customer. We think that the more relevant thing here is this entire Class C universe has characteristics that we really like.
…
We really like this Class C space. Certainly, **we would take a look at the competitive landscape, and what we like about Class C, much like metal-working, much like the broader MRO market, is fragmented. I mentioned in the prepared remarks, highly fragmented. We see lots of opportunity to take share from smaller companies**, much the way we do in our core market." – Erik Gershwind, MSC's CEO, MSC to Acquire Barnes Distribution Conference, 22 February 2013

[6] "Looking beyond 2016, I remain confident about our business and its future. Economic slowdowns are the times when MSC makes its greatest strides. These are the times when the local and regional distributors that make up 70% of our market suffer disproportionately.

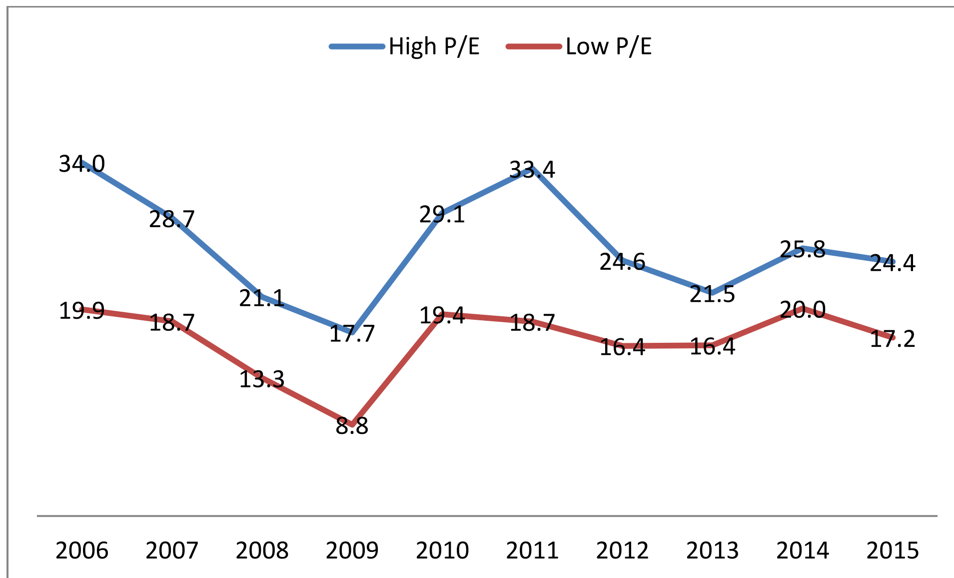
**History tells us what will happen to local distributors if this downturn prolongs. Reducing their inventory leaves customer service vulnerable. Clamping down on receivables disrupts longstanding customer relationships**.

**Laying off people creates hiring opportunities to acquire industry talent not typically available**. We are just starting to see the very early signs of these things occur in the marketplace. The pace will accelerate the longer these conditions hold.

**We are pleased with our share gain performance to date and would anticipate it to continue or even accelerate the longer these conditions last, and that will lead to disproportionate top-line growth when the environment does improve**. We are also using this time to improve our cost structure through productivity initiatives and tight expense management, and that should create significant earnings leverage when revenue growth returns." – Erik Gershwind, MSC's CEO, MSC 2016 Q1 Earnings Transcript, 06 January 2016

Misjudgment

### The Market Seems to Consider MSC's Current Earnings Normal




*Over the last 10 years, MSC usually trades between 18 and 25 P/E*

- **Biggest Negative**:
  - MSC has high short interest
    - 12%
- MSC can't offer pick up in-store
  - MSC doesn't keep inventories at its stores
  - Grainger has about 330 stores
    - Average 22,000 square feet in size
  - Fastenal has 2,575 stores in North America
    - Between 3,000 to 10,000 square feet in size
  - Grainger has reduced number of stores over the year
    - 2009: 423
    - 2012: 369
    - 2015: 330
  - But pick up at branch still represents 16% of Grainger's fulfillment
    - People go to stores to pick up if they need immediately[1]
      - Instead of making an order and wait for delivery in 2 hours
  - MSC thinks keeping inventories in stores isn't optimal[2]
    - It's impossible to know what SKUs a customer need on short notice
    - For high volume, planned items

            - Keeping inventories at vending machines or storerooms makes more sense than at stores
    - MSC says that next-day delivery is good enough for its customers[3]
        - The last thing a customer want is one of their employees run out
            - To buy something
            - That means vending or VMI solutions don't plan properly
        - MSC doesn't have exposure to customers who want immediate supplies
            - Such as non-residential contractors/subcontractors
                - These customers represent 20-25% of Fastenal's business
    - Fact: This disadvantage will be less significant than it was in the past
        - Branches have become less important for Grainger
            - And even for Fastenal
                - Fastenal closed some stores
                - Fastenal now focuses more vending machines
        - Vending machines allow MSC serve customers better for planned items
- Can MSC offer as good inventory management services as Fastenal?
    - Fastenal says local stores give it a big advantage to provide vending services[4]
        - It can put products into vending machines for customers
        - Some competitors just ship to the factory
            - Then the factory worker put the product away
    - MSC says it doesn't matter who restocks the machines[5]
        - Since customers own the stocks when they arrive
        - For vending machine
            - Either MSC or the customer can restock
        - For VMI solutions, MSC would restock the bins
    - Grainger says it doesn't need branches for inventory management services[6]
        - It has about 1,200 team members involved in KeepStock
            - (KeepStock is Grainger's inventory management service)
        - For some customers, it can have a dedicated team member
            - Being their day-in, day-out
                - 8 hours a day
        - For other customers, it may visit 1 hour a week
    - Quan's view: Fastenal offers better service
        - But Fastenal isn't as good as MSC and Grainger at serving unplanned needs
- It's unclear whether Fastenal has a more efficient model

- Fastenal claims to have cost advantage[7]
  - It ships from stores
  - Competitors ship from central warehouses
  - => high operating expenses
- MSC says the store-based model isn't optimal
  - Centralizing fulfillment helps it gain efficiencies in handling costs
    - And avoid 2-step distribution

- Will Fastenal hurt MSC in metal working?
  - Fastenal started focusing metal working since around 2011
    - Hired metalworking specialists[8]
    - Tries to sell to existing customers
    - Wants to grow the business 10% more than the company average[9]
  - Fastenal achieved better growth in metal working than the company average[10]
    - (off a small base)
    - Better than MSC's growth
    - But not at the level they expected[11]
  - Fastenal is now doing about $400 million in metalworking
    - Sales growth has slowed down
      - 2011: 30%
      - 2012: 25%
      - 2013: 12%
      - 2014: 16%
      - 2015: 5%
    - It'll be difficult to grow 20% annually
  - Fastenal's impact on MSC growth was limited
    - Over the last 3 years, Fastenal added $100 million revenue in total
      - => just 3% of MSC's annual sales
  - Fastenal's impact will be small in the future
    - Both have small market share
      - MSC: about 10%
      - Fastenal: about 3%
    - Fastenal won't be able to grow more than 20%
- Why investors hate MSC?
  - Short interest: 12%
  - Possible reasons
    - Manufacturing downturn
    - Slow growth

        - Declining margin
- Why MSC is cheap?
    - MSC isn't cheap based on conventional metrics
        - At $72.13 per share, current P/E is **19.3**
        - The price looks high given MSC's poor growth in the last 3 years
        - The price is consistent with MSC's historical valuation
            - MSC historically trades between 18-25 P/E
            - It only has low P/E in
                - 1999-2001
                    - 10.8 P/E sometime in 1999-2000
                - 2008-2009
                    - 8.8 P/E sometime in 2009
    - Perhaps the market neglects that MSC's earnings is currently depressed
        - Margin is depressed
            - Huge infrastructure expansion coincides with
                - Manufacturing downturns
                - Lack of inflation
        - Growth was depressed
            - Although the tough market helps MSC gain market share
    - Now is a good time to buy MSC
        - Medium-term growth can be very strong
            - Similar to the 2003-2008 period

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[1] "Unidentified Audience Member: Just a question on this differentiation of your ability to deliver within hours not just days. How does that relate to the branch infrastructure? Because I mean I would think in some sense to be able to deliver something in hours you have to have a branch, a lot of guys could have DCs and ship within days.

So you're shrinking the branch network but part of your value differentiation is the ability to deliver within hours. How does that all fit together?

Jim Ryan, Grainger's CEO: So we're not getting out of the branch business. **We're going to continue to have a branch network. It's very important for service but it's also very important to be able to deliver in minutes or hours.**

You can't do that without having inventory in the local market. And branches will continue to serve that purpose. In fact, particularly in the larger metro areas you'll see the average size of our branch network -- **we'll have fewer branches but likely larger**

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**and the larger branches are also can also serve as a hub in the major metro areas for same-day delivery within hours or less**.

DG Macpherson, Grainger's COO: I would just say that **we can deliver same day today. The customer pull has been modest.**

It is interesting, **a lot of customers that want to pick up from our branches happen to be mobile and sometimes they don't even pick it up same day, they will pick it up next day but they just want to pick it up somewhere close to where they are working**. And typically I think the space where somebody wants it delivered to them but doesn't need it immediately in our space **if something breaks I need it now, I'm going to go somewhere I am going to get it versus I'm going to wait an hour or two**.

**So we're still trying to understand what that space is where that same day two-hour delivery we do it but we don't get a lot of pull for that right now to be honest**. People are either used to getting it next day or something breaks I need it now or I'm mobile and I need it delivered somewhere specific. But that sort of two-hour delivery trying to figure out what the value proposition is there." –Grainger's Analyst Meeting, 12 November 2015

[2] MSC's investor relations told us: "I would not agree with Fastenal's point on OpEx. **Having all of those stores and of course inventory out in the field cannot be a cost advantage. Our central warehouse model has tremendous leverage opportunity** (though you haven't seen it in the last few years as we invested in a major warehouse just as sales growth turned down and has now gone negative) and we can grow sales to roughly $4b without having to make any further major infrastructure investments.

Also, for the record, **we have never believed that a distributor can know exactly what sku's a customer will need on short notice, once more resulting in our belief that the store model is not optimal**. FYI, Grainger is closing stores. All of this means that we get different exposures than the store model**. For example, we don't have exposure to the residential or non-residential construction markets (contractors/sub-contractors) as they need tools & supplies right away**.

…

**We do not believe in the store concept as we cannot predict what to carry in the store for unplanned purchases. If the purchases are planned, what do you need a store for? The items go directly from the distribution center to the customer [vending machines or storerooms] for consumption**."

[3] MSC's investor relations told us: "We truly put our customer first and I know of situations where a customer needed equipment immediately over the weekend. Our sales rep made calls and borrowed the equipment from another customer to get the original customer back up and running. That's of course a special circumstance and generally, **I would say our service level of "order today by 8 p.m. and you will receive it by tomorrow morning" is good enough for our customers. In fact, we are all about creating the most efficient order processing as possible, using our vending solutions, Vendor Managed Inventory (VMI) and other solutions. The last thing a customer wants is for one of their employees to run out the door down the street to buy some product...that means we didn't plan properly**. At the end of day, if they need to get something from a competitor, that would be fine with us."

[4] "**I think one of our biggest advantages compared to the big public companies that we all know of is our local branch network because this is a physical business. If you think about the person who is supplying your soda machines or pop machines in the office, those people aren't driving from three or four hours away in many cases**. Our local branch adds a service element that is going to be very hard to duplicate for some of our competitors. **I know some of our competitors, their strategy is to ship it in to the factory and then have the factory workers put the product away.**

But I would guess **if your person providing the vending machines at your office said that they will just ship the product to the dock and you guys can put it away in the morning, probably you would find a new -- or you may find a new supplier**.

**So we have that local advantage that really gives us some leverage and we have this distribution network to move the product more efficiently**. But machine to machine, product to product, it is not that dissimilar." – Will Oberton, Fastenal's CEO, Fastenal 2012 Q3 Earnings Transcript, 11 October 2012

[5] MSC's investor relations told us: "**As for logistics, things don't work much differently whether a customer uses our vending solutions, call center or website/eprocurement.** The order ships and arrives at the customer location (next day if needed)**. Then if for a vending machine, either we can stock it or the customer can. Since the customer owns the goods when they arrive, it doesn't matter who restocks the machine. With a VMI solution, we would restock the bins**. With other orders, their receiving department would forward it to the right department in the building."

[6] "**So Jim mentioned across North America about 1,200 teams members that are involved in KeepStock**. And what's been interesting is we've had a smaller number of

branches. **We've actually populated a number of those 1,200 team members and just moved from the branch-based customer service job to actually being onsite with a customer**.

We have a mix, if you think about the Berry Plastics example, **we have a number of dedicated full-time team members that just report day-in, day-out , eight hours a day, at a Berry Plastics facility**. **The 70,000 customer installed, we have a large number of those. We might be there for an hour a week**. And so you have everything kind of in between that. **It's not necessarily a requirement that there needs to be a local branch facility for KeepStock -- for KeepStock to work**." – Court Carruthers, Grainger's Group President Americas, Grainger's Analyst Meeting, 12 November 2014

[7] "The other type of competitor, we've large competitors, most of you know them, many of them are public. And there are a lot of good companies out there. We respect all of them. **Most of them have large -- broad product selections, competitive pricing, they ship the product well, good distribution, similar to what we would do; they have good e-commerce platforms**.

The thing that we believe, I believe and I believe our team thinks, is that **we have an advantage over the large competitors. One is that we are much closer to the customer**. We are working very hard to get close to the customer and you're going to hear about that today. **We believe we have better distribution and I am going to talk a little bit more about that in a minute. We have a lower cost distribution model**. And understand, **the product we sell is generally inexpensive**, it's processed steel, It's not like we're shipping electronics, it's inexpensive products, **so distribution and the cost to do it is very important**.

And the third one I would say about most of our large competitors is relative to their business model, they have high operating expenses. **The fact that we have lower operating expenses than companies that are basically just shipping from central warehouses gives us a structural advantage, because we're in the market, but we're not spending any more to be in the market.**" – Will Oberton, Fastenal's CEO, Fastenal Investor Presentation, 05 November 2015

[8] "On the metalworking initiative that we talked about, we feel very good about where we are. We have added a lot of product into our distribution system; that is part of our inventory growth. We've continued to work at signing up strategic partners, the partners we need to fill out our product line and that's gone very well.

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**And we had said we were going to put in 42 trained specialists. We have 37 in place, and 34 of them have gotten through our level 2 training, which is a training designed by an outside firm, again working with our suppliers**. And it is a very intense training. Our people are coming back with great feedback. So we really hope to see the results of this effort probably in the late of the first quarter, into the second quarter of next year. And these people are out selling now, start gaining some traction and start seeing the results into 2012. But we are very optimistic. We met with our product development lead yesterday, and he gave us an update and things seem to be moving in the direction that we had planned for them to move." – Will Oberton, Fastenal's CEO, Fastenal 2011 Q3 Earnings Transcript, 13 October 2011

[9] "We continue to work hard on metal working**. Our goal going into the year was to grow that business. The productline, metalworking productline at at least 10 points faster than the overall Fastenal growth. We have been able to maintain that -- actually exceed that goal and we continue to make nice wins still not a huge business for us but it is a nice sized business and it is growing meaningfully faster than the overall business**. So we are optimistic." – Will Oberton, Fastenal's CEO, Fastenal 2012 Q3 Earnings Transcript, 11 October 2012

[10] "Eli Lustgarten, Analyst: One other question. You've had an initiative in metal working that was started several years ago, which really hasn't done very much. Your relationship with Kennametal really just seems to be plodding along.

Is that still a focus of the Company or our future growth, whoever? Or has that just been put on the back burner?

Will Oberton, Fastenal's CEO: I'll jump in on that. Metal working continues to do well. Our relationship with Kennametal is good. **People, I think, had too high of an expectation going in, thinking we are going to be as big as MSC overnight, and that doesn't happen.**

**But our metalworking business has grown -- not double-digit, but almost double-digit above the Fastenal growth over the last -- in 2014. It even did better than that in 2013, and we've grown a very nice sized business**. We're doing well with it and we think the upside is great.

It's just hard to grow a business that -- **right now it represents about just under 10% of our total revenue. So it's a meaningful sized business. It's hard to grow it more than 20%, 20%-plus year over year with a business that big**. So we're very committed and we think we're going to continue to do well in it for a long time.

And part of what we learned is that, although Kennametal is a very good supplier, they don't have the full spectrum of what the customers need, and neither does any of the other suppliers.

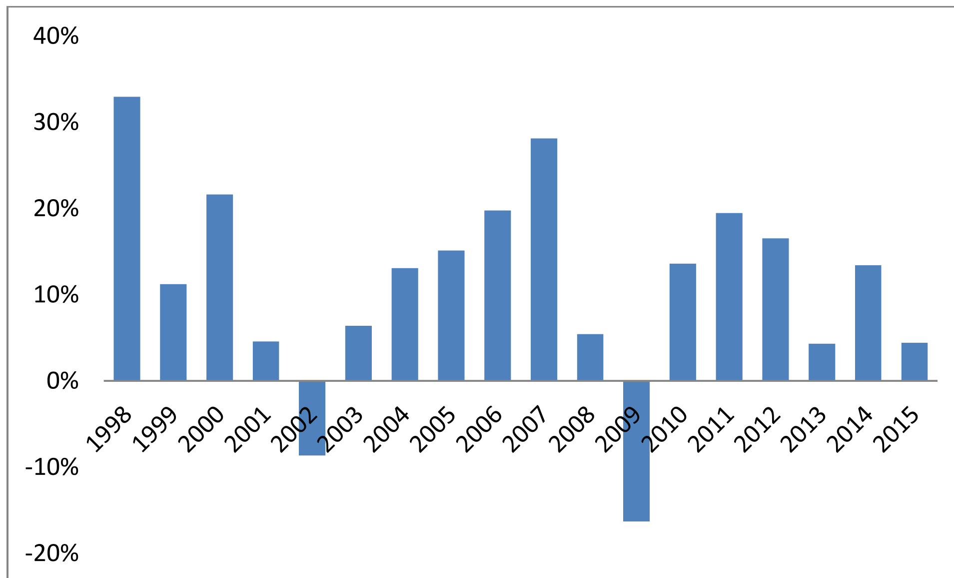
So we've developed relationships with a wide range of suppliers, and most of them are enjoying very good growth through Fastenal. So we're still very committed, and believe it's a great opportunity for the future of Fastenal.

**The main thing that makes sense is our fastener and MRO customers, most of those are using metalworking products. We already have developed relationships; now we have to develop the product relationship in this specific area**." – Fastenal 2014 Q4 Earnings Transcript, 15 January 2015

[11] "We're continuing to work very hard in the metal working. **It's continuing to outgrow the overall company revenue, not by the amount that we had expected but we're growing well above what we see our public peers that are working in that area**. Our metal working sales are growing well above anyone else that we can get public data on." – Will Oberton, Fastenal's CEO, Fastenal 2014 Q2 Earnings Transcript, 11 July 2014

Future

**Strong Recover and Margin Expansion Make MSC a Great Stock to Buy Today**




*MSC enjoyed double-digit growth after the downturns in 2000-2003 and 2008-2009*

- **Biggest Negative**:
  - Current manufacturing may last longer than we expect
- MSC's CEO will still be there
  - He's now just 45 years old
  - He's doing a great job
    - He understand MSC's strength
    - He has a measured growth plan
      - Penetrate the metalworking space
      - Penetrate the manufacturing space
      - Inching out of the manufacturing space
- MSC will make at least $4 billion revenue in 2021
  - That implies only 6.6% CAGR over the next 5 years
  - MSC is likely much bigger
    - Growth tends to ramp up after downturns
      - MSC gain more market share during downturns
    - Example:
      - 3-year revenue CAGR was
        - In 2003: 0.56%
          - 2000: $831 million

- 2003: $845 million
- In 2006: 16.62%
  - 2003: $845 million
  - 2008: $1,318 million
- In 2010: 0.08%
  - 2007: $1,688 million
  - 2010: $1,692 million
- In 2013: 13.26%
  - 2010: $1,692 million
  - 2013: $2,458 million

- Organic growth over the last 3 years were weak
  - About only 4%
  - (Excluding acquisition of Barnes Distribution North America)
- It's not a surprise if MSC double the business over the next 5 years
  - About $6 billion revenue
- At $4 billion revenue
  - MSC can have 18% EBIT margin
    - Similar to what it did in 2008
    - => $720 million EBIT
  - MSC will still have many years of high growth ahead
    - If MSC grows at 7% annually while the market grows 2% annually
      - After 20 years, MSC still have only 13% market share
  - => MSC will still trade at a high multiple
    - As always
  - => MSC would be worth at least $9 billion in 2021
    - 12.5x EBIT
    - $720 million * 12.5 = $9 billion
    - Implies 13.3% 5-year CAGR from today's EV
      - $4,816 million
- Cash distribution will add 3-4% to total return
  - Current dividend yield is 2.38%
    - MSC is paying 43 cent per quarter
    - This implies 45% payout ratio
      - (based on current margin)
      - About the same as D&A
  - In theory, MSC can return all of its earnings
    - MSC won't have to make much investment

                - Current infrastructure can support $4 billion revenue
                - Maintenance CapEx is about $70-80 million[1]
    - Current dividends cost MSC about $106 million a year
    - Last year MSC's net income was $231 million
        - EBIT margin was just 13%
    - => MSC can build up more than $120 million cash a year
        - Or $160 million a year if EBIT margin return to 15%
    - Two scenarios
        - MSC just builds up cash
            - In 5 years it'll add more than $600 million to its cash pile
                - Results in $221 million net cash
            - => equity value in 5 years is $9,221 million
                - => 15.75% 5-year CAGR from today's market cap
                    - ($4,437 million)
            - Adding 2.38% dividend yield
                - And Subtracting 0.5% annual share dilution
                    - => 17.5% 5-year investment return
        - More realistic scenario
            - MSC will repurchase shares
                - And has fewer shares in the future
            - MSC will pay some special dividends
            - MSC will have lower leverage
                - Or borrow some debt if it makes acquisitions
            - Capital allocation is more aggressively in this scenario
                - => total return is likely more than the first scenario
- Conclusion: MSC can return more than 15% annually over the next 5 years
    - (Current share price: $72.13)

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[1] "Just like in OpEx, we tightened our belt in terms of CapEx spending. **And CapEx is really comprised primarily of IT, infrastructure, supply chain spending, and some vending**. And I would say there were small cuts across all of these.

We're not prepared to provide guidance yet for FY16. But **I think it's fair to say that we're in a normalized range of that $70 million to $80 million**. And then depending on what projects we decide to take on next year, it may vary above or below that." – Jeff Kaczka, MSC's CFO, MSC 2015 Q3 Earnings Transcript, 07 July 2015