GRANT'S
INTEREST RATE OBSERVER®

Vol. 35, No. 09c Two Wall Street, New York, New York 10005 • www.grantspub.com MAY 5, 2017

# In the Bezos bullseye

In a perfectly competitive world, so the economics professor was patiently trying to tell you, prices are transparent, data ubiquitous and profits de minimis. Sitting in the back of the lecture hall, you perhaps thought that this analytical construct was preposterous. That was before Amazon.com, Inc. brought it to life.

Now begins a bearish analysis of a trio of industrial-products distributors, with a particular focus on W.W. Grainger, Inc. (GWW on the New York Stock Exchange). Writ large, it's the story of profit compression and stock-price levitation in this, the digital age. We commend it to investors, central bankers and to Jeff Bezos personally, as soon as the entrepreneur returns from Mars.

What would Adam Smith say about the internet? Resurrected for a demo, he could walk into a store, use an app to scan bar codes and compare the prices he saw on the shelves with the ones on offer in the cloud. It's not from the benevolence of Wal-Mart Stores, Inc. or Best Buy Co., Inc. that we feast today on low, low prices, the author of *The Wealth of Nations* might record of his visit to the 21st century. The source of this cornucopia is rather the self-regard of the surviving, quaking retailers.

Perfect competition is utopia for consumers, dystopia for producers. On the one hand, the advent of the 20-cent Dollar Shave Club cartridge was heaven-sent to the clean-shaven man who bridles at paying as much as $6 per Gillette refill. On the other hand, Procter & Gamble Co.'s 12% reduction in prices of its Gillette subsidiary's razors last month brought no joy to the stockholders of that consumer-products behemoth.

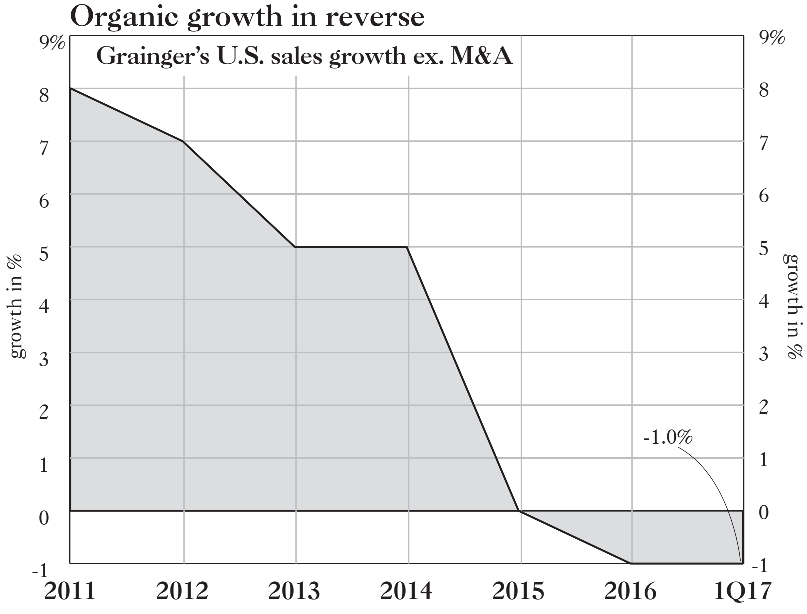
The price revolution rages in the office and on the factory floor as well as in the home. Office supplies and work-site staples are likewise cheaper online—Amazon Business can prove it. Only now are companies that sell to other companies beginning to feel the Amazonian heat. If it's any consolation to the stockholders of the disrupted B2B vendors, their pain is the consumers' gain.

William Wallace Grainger would hardly recognize the electric-motor wholesale business which he founded in Chicago 90 years ago. Today's W.W. Grainger—"for the ones who get things done"—is America's largest distributor of maintenance, repair and operations products, or MRO, as they say in the trade. You name it, Grainger sells it. The famous Grainger catalogue, fatter than the old Manhattan phone directory, offers 1.6 million products. Top product categories include safety and security goods (18% of sales), material handling and metalworking (12% each), cleaning and maintenance (9%) and hand tools (8%).

Grainger does a U.S.-centered, worldwide business. In the 12 months ended March 31, domestic sales generated $7.9 billion of the $10.2 billion total, with Canada ($1.1 billion) and "other businesses" ($1.6 billion) contributing the balance. Even these data understate the primacy of the 50 states. Over those 12 months, the United States and "other businesses" generated operating profit of $1.3 billion and $50.4 million, respectively; Canada chipped in an operating loss of $69.7 million.

In the beginning, there was Grainger's MotorBook catalogue. Nowadays, on-

**Organic growth in reverse**




source: company reports

line sales account for more than 60% of total revenue, up from 30% five years ago. There is, in addition, the Grainger branch network, of which the 284 American branches (not quite half of the total) produced 11% of U.S. sales in 2016.

"The bull case for Grainger," relates colleague Evan Lorenz, "begins with two facts: Whereas the industrial supply markets are fragmented, customers want to do business with fewer vendors. Grainger, though the largest distributor of industrial goods in America, owns no more than a 6% share of the estimated $125 billion-plus American MRO market and a 3% share of the $366 billion-plus worldwide market."

A bear will find nothing to like in Grainger's sturdy, single-A-plus quality finances. As of March 31, net debt of $2.1 billion equated to 1.5 times trailing earnings before interest, taxes, depreciation and amortization (EBITDA). Then, too, in the first quarter, operating income covered interest expense by 17.6 times. And as for analytical sentiment, the Street is cool to lukewarm—a bear would of course prefer heedless universal bullishness. The bearish story in a nutshell is that the Grainger stock price is out of line with the company's visibly deteriorating fundamentals. Janet Yellen and William Dudley, please copy.

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The shares spurted after the presidential election on hopes of a Trumpian boom. At peak hope, they fetched 22.9 times trailing adjusted net income, compared with 18.6 times on election eve and a 10-year average of 19.1 times. In the cold light of the post-reflation trade, Grainger is being appraised more for the Amazon disruptee it is than for the reflation beneficiary that the market had hoped it would become.

Not that Grainger is unaffected by macro tides. On the contrary, the sheer breadth of its product offerings makes it a kind of derivative of the GDP. A little less exposed to the national economy—and more to industrial production, specifically—are Grainger's two nearest comps: Fastenal Co. (FAST on the Nasdaq), which derives 36% of sales from screws, studs, bolts, rivets, concrete anchors, etc., and MSC Industrial Direct Co., Inc. (MSM on the Big Board), which has a specialty in metalworking tools.

The results that MSC and Fastenal reported in the first half of April did nothing to reignite the hopes of the reflation faithful. Each company delivered a modicum of revenue growth. Neither could tell the much longed-for pricing story.

"Let me start by saying," MSC chief Erik Gershwind told listeners-in, "even if things pick up, competition remains fierce and the pricing environment remains challenging."

On April 18, it was Grainger's turn to disappoint. Adjusted earnings per share came in at $2.88, down by 9% year over year and lower than estimates of $2.99. Sales weighed in at $2.54 billion, up by 1% year over year but lower than estimates of $2.57 billion. Management cut full-year guidance for EPS to $10.00–$11.30 from $11.30–$12.40 and lowered its projection for sales growth to 1%–4% from 2%–6%. Since Feb. 21, Grainger's stock has tumbled by 26%.

"No mystery as to why," writes Lorenz. "Grainger has been slashing prices by up to 25%. What's important to know is that while Grainger sells 1.6 million products, it offers far more than 1.6 million prices. Small customers who walk into a Grainger branch or browse the company's website see one price. Larger customers who have more negotiating heft see another. As of March 31, Grainger estimates that 57% of its sales were at 'competitive' prices while 43% were at 'less competitive' prices."

Deane Dray, who rates Grainger "underperform" at RBC Capital Markets, elaborates: "That is because they had these branches that customers had to go to, to get what they needed to get that afternoon. Grainger would show you the studies about their customer base and the hierarchies of needs. Number one was: Do you have it in stock? Way down the list was price. In effect, these people would go to Grainger and be price-insensitive, and the reality is that Grainger was able to command a massive pricing premium for people who came to the branches. This existed for years and years and years. It wasn't until e-commerce started and people would go online to buy the exact same thing because they could get next-day delivery and they said, 'Oh, my gosh! Look at the difference in price.' They started to leave in droves. So, the last three to four years, Grainger has had a relentless loss of their customer base, and they started to shut the branches down selectively, but painfully."

Dray does not exaggerate—at least, the Grainger CEO, Donald G. Macpherson, seems to agree with him. On the April earnings call, the head man said this: "[W]e have not been able to acquire a customer under the Grainger brand for years, and we are now going to start acquiring customers for the Grainger brand starting in the third quarter [of 2017]."

The numbers have been there to see for some time—that is, for any who cared to look. Sales have flat-lined for years, management's claims to the contrary (e.g., the supposed lucrative opportunity to roll up an atomized industry) notwithstanding.

"Excluding the effects of acquisitions," Lorenz observes, "U.S. sales were flat in 2015 and fell by 1% in 2016. They fell by 1% again in the first quarter, despite the introduction of price cuts (all comparisons are year over year). Investors may have turned a blind eye to the lack of growth on account of the 'industrial recession' that dinged Fastenal (see issues of *Grant's* dated Feb. 7, 2014 and July 25, 2014). As noted above, however, Grainger is driven less by industrial production than by GDP, which, in nominal terms, rose by 3.7% in 2015 and by 3% in 2016."

Grainger says that it's on a mission to make every price "competitive." Compared with the aforementioned 57% that satisfied that definition on March 31, management's new goal is 71% by the end of this year and 100% by the close of 2018. "[W]e all know that our prices have been a significant source of dissatisfaction for our customers," said Macpherson on the April call. "And we really haven't been able to leverage digital capabilities like digital marketing to acquire new customers and to grow with existing customers." Not that Grainger has designs on being the price leader, Macpherson added: "While we won't have the lowest price in the market, we will be competitive, which will be very attractive for our customers given our industry-leading supply-chain and service model."

What does Grainger bring to the table besides price? It does not bring service. Last year, the company shipped 66% of its sales; customers carried off another 14% from Grainger's branches. And what will become of those branches as online sales continue to grow? Having closed 49 locations in 2015 and 55 in 2016, management is mum on plans to shutter more this year.

In declining to seek the mantle of low-price vendor, Grainger may be ceding that distinction to Amazon. The Seattle e-tailer has identified industrial distribution as a "top priority" and a "must-win." Prentis Wilson, vice president of Amazon Business, spoke those words to the Staples, Inc. defense team as they deposed him in connection with the Staples-Office Depot, Inc. antitrust review in March 2016.

Amazon says it views its business portal as a fourth "growth pillar" next to its Prime business, Marketplace and Amazon Web Services. It says, further, that it regards Grainger as a "primary competitor," in fact, the only distributor that Wilson named in deposition. Pure and simple, Grainger is wearing a Bezos bullseye.

Jeff Bezos started his first foray in selling tools, mops, fasteners and the like in April 2012 (*Grant's*, Feb. 7, 2014). In April 2016, Amazon Business sales in the preceding 12 months topped $1 billion, or one-tenth of the size of Grainger's top line.

"People are used to shopping on Amazon in their own homes," Wilson told *Forbes* in a May 2016 interview. "The thing we hear most often from business customers is, 'Can we have an Amazon shopping experience at work?'" Wilson said that Amazon Business was growing at a rate of 20% month on month (*not* year over year), a rate which, if continued over 13 months, would imply that the Bezos subsidiary had virtually overtaken Grainger. No word on whether it has. Just like Grainger, Amazon Business offers customers credit, software that plugs into customers' purchasing software and other such digital-age amenities.

In recent months, Amazon Business has expanded into the United Kingdom and Germany, two important foreign markets for Grainger. On Feb. 8, the Bezos subsidiary won a multiyear contract with the public-sector purchasing organization U.S. Communities. From small beginnings, the Amazon unit will have the opportunity to bid on local and state government contracts worth $5.5 billion over the next 11 years.

"To be clear," Lorenz notes, "this is also a threat to Fastenal, MSC and other industrial distributors. But it is a bigger threat to Grainger. As noted, 36% of Fastenal's sales are fasteners, and fasteners are hard to move online on account of their low volume, low weight and low value. MSC enjoys some protection from Amazon by the nature of its metalworking products. More complex than generic industrial and maintenance products, they achieve higher margins than those simple SKUs."

In the 12 months ended March 31, Grainger's businesses yielded operating margins of 10.8% on overall sales, 16% on the American ones. Looming price cuts will shrink those figures this year and next, management acknowledges. Macpherson, however, projects an expansion in the range of 12% to 13%, from 10.8%, by 2019. Just how, he didn't say.

"Other distributors and retailers garner less than half of Grainger's 2019 target margin," Lorenz notes. "WESCO International, Inc. and Applied Industrial Technologies, Inc., industrial distributors focused on electrical and fluid power components, respectively, managed to post operating margins of 4.5% and 3.6% in the past year. Amazon's North American operations, which excludes the highly profitable Amazon Web Services, Bezos's cloud-based computer-service offerings, achieved 3% operating margins in 2016. Kroger Co. and Wal-Mart toiled to produce operating margins of 3% and 4.7% over the past 12 months.

"Management tells the street that Grainger will be able to cut prices and return to both revenue growth and historical margins. Yet, Macpherson also says Grainger is only aiming to be in the same 'ballpark' in terms of price. It is unclear how the company can achieve its goals."

With 13% of its float sold short and three buys, 14 holds, and five sells, it can't be said that the investment community is infatuated with Grainger's outlook. Then, again, Grainger executives aren't infatuated, either. In the past 12 months, insiders sold 115,364 shares for net proceeds of $27.5 million. Maybe the Federal Reserve might comment on the source of the seeming anomaly that Grainger's shares change hands at 16.9 times trailing adjusted earnings and 19.4 times trailing GAAP earnings. Earnings would be sawed in half, or more, if Grainger's margins reverted to the levels just quoted in other lines of competitive business.

Grainger's comment on the foregoing analysis? No comment, a spokesman told Lorenz.

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