TM CAPITAL

EQUIPMENT RENTAL & DEALER REPORT

Q & A WITH DAVID FELTS

We recently sat down with David Felts, a Managing Director at TM Capital Corporation to gain insight into the merger and acquisitions activity in the equipment dealer market.

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Q: David, in Part 1 of this three-part discussion, and based on TM Capital's expertise in investment and M&A activity in the equipment dealer market, you shared thoughts on your 2023 dealer sector report, dealer industry evolution, and tailwinds supporting investor interest, and you gave an assessment of current M&A activity in the dealer sector. In part 2 of this discussion, let's turn our attention to valuation. How have the rental and dealer sectors compared over time?

A: Publicly traded equipment rental and dealer companies have traded over the last 10 years in relatively narrow ranges, respectively, on an Enterprise Value / EBITDA (earnings before interest, taxes, depreciation and amortization) valuation basis. As noted below, throughout the 2010s, dealers traded at premiums ranging from 2.0x to 4.0x EV / EBITDA vs. rental businesses, driven by a higher proportion of sales generated from recurring revenue streams (i.e., parts and services) and protected territories, each of which often help support superior gross margins, strong free cash flow and stable, long-run performance.

However, the historical dealer valuation premium has evaporated of-late, as rental and dealer median valuation multiples evidence convergence. That said, as of the end of July 2023, a representative index of equipment dealers traded at a slightly higher premium to a representative index of equipment rental companies versus at year-end. This valuation convergence/reversal is occurring on both sides of the equation. First, equipment rental multiples grew through the end of 2021, before retrenching along with broad public equity market weakness and then recovering since the beginning of 2023.

Equipment dealer valuation multiples have been on the descent since the end of 2020 but evidence a similar recovery. For rental companies, strengthening multiples reflects the impact of increasing rental penetration rates and the growth impact of add-on acquisitions. These positive impacts are somewhat muted by investor concerns regarding economic cyclicality and the capital expenditures required to fund the rental model. Conversely, dealers' historically premium multiples have suffered recently, we believe, due to continuing concerns regarding supply chain issues and sensitivity to economic cycles. When the supply chain normalizes, we would not be surprised to see multiples return to historical levels.

Equipment Rental

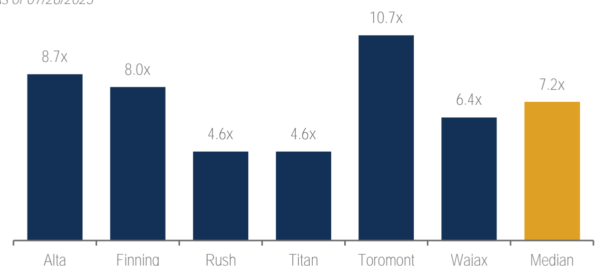
TEV / EBITDA Trading Multiples

As of 07/28/2023

Equipment Dealer

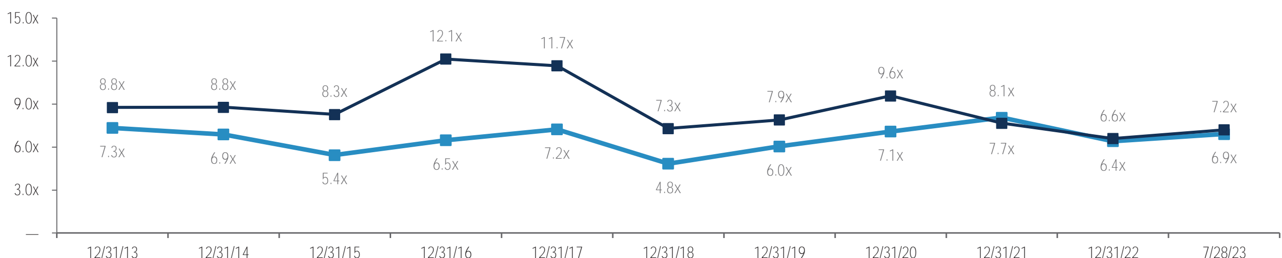
TEV / EBITDA Trading Multiples (1)

As of 07/28/2023



Historical Equipment Rental & Dealer TEV / EBITDA Trading Multiples (1)

As of 07/28/2023



(1) Equipment Dealer "Net Debt" calculation does not consider Floorplan Financing as debt in instances where company specifically reports Floorplan Financing on Balance Sheet

Equipment Rental   Equipment Dealer

Q: More specifically to dealers, what do you think are the key business model elements that influence a dealer's valuation?

A: While every dealer is fundamentally unique, we've identified the following variables as key drivers of value for equipment dealers:

BRAND PORTFOLIO: Investor perceptions of brand strength, reputation and market share are important, especially regarding a flagship brand. In addition, a portfolio representing additional lines addressing diverse end markets is also a positive. The portfolio mix of compact, heavy and specialty equipment is a key influence as well.

OEM "ATTITUDE": Arguably one of the most important valuation elements is to what extent any flagship OEM is open to external investment in its dealer network and supportive of further greenfield and consolidation growth. Dealers with supportive OEM relationships generate outsized acquisition interest and premium valuations relative to those whose OEM relationships discourage or limit outside investment or are highly sensitive to dealer size/growth.

SCALE: Scale can result from market share and/or the presence of "platform" attributes to support a robust growth strategy. Scale typically drives a valuation premium and is often a key facet necessary to attract large financial investor interest.

AFTERMARKET REVENUE: Dealers that generate a meaningful portion of gross profit from aftermarket revenue sources including sales of replacement parts, preventative maintenance and emergency equipment service, and rental revenue – or have a meaningful opportunity to improve those categories – can generate stronger acquisition interest and achieve premium valuations.

PROXIMITY: In the context of dealers, we see a strong preference in acquisitions for geographic proximity. Dealer management teams are often lean, so the ability or desire to manage dealer operations at a distance seems more limited.

CUSTOMER MIX: A solid mix of small to midsize customers generates stronger investor interest. These customers offer advantages including (i) appreciation of dealers' service capabilities / product knowledge, (ii) better profit metrics relative to large-scale national accounts, and (iii) overall sales diversification.

END-MARKET RESILIENCY: Acquirers increasingly ascribe outsized value to a customer base that serves resilient, cycle-resistant end markets, such as commercial/industrial renovation and retrofit; infrastructure/utility maintenance; HVAC/plumbing/mechanical contracting; multifamily construction; municipal and education facilities; and data centers.

GEOGRAPHIC TAILWINDS: The "hottest" dealer markets closely correlate with population migration trends, which drive increased residential, commercial and industrial construction, as well as public infrastructure investment necessary to support such population growth – attractive geographic markets in the U.S. are predominantly in the Southeast, Southwest and West (i.e., the Sunbelt). On the other hand, the Midwest and the Northeast benefit from large existing populations and a more pronounced aging infrastructure. Candidly, infrastructure investment needs and related supportive legislation are expected to provide broad nationwide tailwinds for years to come.

RENTAL FLEET SIZE AND AGE: With the industry "rental penetration rate" consistently increasing, many dealers are offering a rental solution as well. Where we see the rental percentage of revenue in the 10%-25% range or higher – or where there is an opportunity to achieve that range – we find increasing investor interest. A fleet age of 3 to 5 years is perceived as more attractive.

MANAGEMENT CONTINUITY: The importance of management continuity is dependent on the type of acquirer. International strategic buyers and almost all financial acquirers act more aggressively when the target has motivated, tenured management teams actively seeking to continue to grow the business, while domestic

strategic consolidators may offer successful families, entrepreneurs and management teams the opportunity to exit their day-to-day duties.

Q: You include in TM's 2023 Equipment Rental & Dealer Report a section titled "Missing the Math." Can you describe the motivation behind this section?

A: The public market has come to understand the intrinsic value of the dealer model, evidenced by publicly held dealers historically trading at a 2.0x–4.0x multiple premium over publicly held rental companies (current supply chain-related convergence aside). Despite this, we often see financial investors ascribing modest dealer valuation multiple premiums over comparably sized rental companies, rendering themselves noncompetitive. Given the protected territories and the recurring demand for aftermarket service within the installed equipment base, we feel these businesses should be valued on their long-term future cash flows (a discounted cash flow model approach), not on a "net book value plus blue sky" or a traditional multiple of trailing EBITDA basis.

Further, while the appropriate treatment of floor plan financing is as a component of working capital (like accounts payable) and not as a debt-item reducing net proceeds to a seller, we still see some financial investors taking the position that it should be treated as debt, again rendering themselves noncompetitive.

There are several elements of the dealer model where we believe investors often "miss the math":

FLOOR PLAN FINANCING: Equipment dealers typically access attractive floor plan financing lines (whether directly through the OEM or from a related third-party financing source) supporting new equipment inventory with no or low carrying costs within normal time frames.

JUST-IN-TIME INVENTORY: (Again, current supply chain dynamics aside), OEM production processes support "just-in-time" delivery to a customer, shifting the dealer model to one more akin to an OEM "agent" versus a purely stocked dealer – significantly diminishing the inventory risk profile.

AFTERMARKET EBITDA GENERATION: Financial investors habitually compare EBITDA margins across business sectors, but with dealers this can be misleading, as new equipment sales typically comprise the majority of revenue but generate substantially lower gross margins versus other revenue streams. Conversely, aftermarket, recurring parts and services often comprise a smaller portion of revenue but 60%-75% of total gross margin and an outsized portion of EBITDA. Thus, investors need to look beyond "headline EBITDA margins" to develop a more appropriate, nuanced valuation.

EMBEDDED RENTAL FLEET: Dealers are increasingly "embedding" rental fleets within their product offering, with rental revenue representing 10%-25% or more of total revenue. Financial investors are typically less wary of the associated capital expenditures in this paradigm.

MODEST CAPEX: Apart from any rental component, dealer business models often require minimal levels of ongoing capital expenditures, relative to rental companies or businesses in other sectors.

TERRITORY PROTECTION: Dealers have significant, unique competitive moats. Investors need to view this territorial exclusivity, particularly in attractive geographies, as providing enhanced future revenue visibility versus businesses in other sectors.

Look for Part 3 of this interview next month, when we will delve into dealer sector transaction activity. •

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