December 13, 2017

INVESTMENT THESIS

Lawson Products (LAWS; $24.42) is an overlooked small cap industrial distributor. Caught up in the poor sentiment that has plagued the industrial distribution space, investors are showing little interest in a company that looks fairly valued on most trailing metrics. A closer look reveals a company with a differentiated service offering that is on the cusp of an earnings inflection, as organic and acquisition-related growth are set to drive earnings meaningfully higher over the next two years.

REASON FOR OPPORTUNITY

Investor sentiment in the industrial distribution space has been abysmal for years. This group of once-revered companies has faced eroding gross margins for the last four years as secular pressures associated with online price transparency have impaired the margin structure of most industrial distributors. The threat of competitive encroachment by Amazon's Amazon Business offering has left many wondering what role these companies will have left to play in the future. And cyclical goods deflation has further hampered gross margins while also making the task of discerning the true causes of gross margin contraction – cyclical or secular – quite difficult. With $288M in LTM sales, LAWS is a small company seemingly directly in the cross hairs of these unfavorable and persistent trends and one that does not screen as overly cheap on today's trailing numbers.

VARIANT PERCEPTION

How then could a company of this size survive, let alone thrive, in this type of operating environment? Because it's a service business. As we will highlight further below, their heavy private label mix and service-oriented Vendor-Managed Inventory (VMI) offering is differentiated from many of their larger peers who have a greater mix of business directed to simple parts delivery. This high service component has helped to insulate their gross margins against many of the forces negatively impacting the group for the last four years. In addition to an economic backdrop that has been largely uninspiring over this period, we identify four factors as being most critical in contributing to the group's gross margin compression. They include growth in mix of national account customers who are less profitable on average, growth in mix of lower gross margin vending programs, growth in mix of lower margin SKUs like safety products and also a general lack of inflation as well.

While LAWS is not immune to all of these factors, we note that gross margin compression has been most acute at companies growing their mix of sales through the online channel where the impacts of price transparency are most consequential. Distributors with a lower and slower growing mix of eCommerce business have seen more favorable gross margin trends – a point of differentiation that seems to be underappreciated amongst many investors. The below table highlights this trend:

		CY14	CY15	CY16	CY17E	CY18E
GWW	GM	43.3%	42.4%	40.7%	39.2%	38.6%
	eCom mix	36.0%	41.0%	47.0%	48.0%	50.0%
MSM	GM	45.8%	45.2%	44.9%	44.3%	43.7%
	eCom mix	44.0%	48.0%	55.6%	58.2%	60.0%
FAST	GM	50.8%	50.4%	49.6%	49.4%	49.0%
	eCom mix	M-HSD	HSD	HSD	HSD	HSD
LAWS	GM	60.4%	61.3%	60.8%	60.4%	60.3%
	eCom mix	L-MSD	L-MSD	L-MSD	~5%	~5%

MSM eCom is presented on FY basis. eCom estimates for CY18 are CECM estimates.

THE BUSINESS

What it is - LAWS is a small player in the large highly fragmented, industrial distribution market providing Vendor Managed Inventory (VMI) solutions for consumable Class C parts like fasteners, cutting tools and chemicals. The company serves customers with a high-touch, customer-focused VMI model in which company reps visit customer warehouses and plants to stock bins on a weekly or more frequent basis. Reps seek to maintain an optimal amount of small parts inventory to keep the shop running, cut down on unnecessary working capital for customers and reduce the overall cost of procurement. This VMI offering is at the forefront of the trends in the industrial distribution marketplace as distributors seek to get closer to their customers by offering higher service levels to develop stickier relationships.

Market dynamics – LAWS serves a highly-fragmented market (~$20 - 25B as LAWS management defines it versus the broader MRO market of $125 – 150B) that fits the preferred many-to-many distribution industry structure. The company offers a broad SKU assortment and distributes 200,000 SKUs to 70,000 customers. The largest customer comes in at ~2% of sales while the company has an impressive private label offering (60% of mix at a higher gross margin than third-party sourced products), which helps the company generate gross margins at the 60%+ range. Most of the SKUs are low cost but high value items, particularly relative to their customers business operations. Management highlights the nature of their service offering on the recent 2Q 2017 call.

> "One such account is a multisite customer. In 2016, we sold $4 million across a broad array of products to this customer. The average piece price was $0.94. The average piece price of the 100 largest volume items that we provide to them is $0.11 and the average piece price of the 100 most expensive items that we provide to that customer is $3.54. These numbers have not changed over several years and are broadly representative of our overall customer base. As a plant manager, a branch manager or a shop manager, our customers focus their limited human resources on high value-added activities rather than putting away $0.11 fasteners or checking hundreds of bin locations to determine weekly usage patterns of expense items and placing purchase orders for dozens of unique items every week." – CEO Mike DeCata

Corporate history – Founded in 1952 by Sidney Port, Lawson has been publicly traded since 1970. Dr. Ronald Port, founder Sydney Port's son, is the lead shareholder, has been on the board since 1984, Chairman since 2007 and owns 1M shares, or ~11%. The company ran into trouble in 2012 when prior management simultaneously embarked on a headquarter relocation, SAP installation and consolidated its back-end operations from three distribution centers into one new, larger and more advanced distribution center in McCook, IL. Sales plummeted, and goodwill and inventory were written down amid an inability to meet customer service obligations. Mike DeCata, the current CEO, was hired in October 2012 and began leading a turnaround effort that has successfully hit a number of critical milestones. He is a veteran of the distribution business having once run the eastern portion of GWW's US business and having previously been President at Chef's Warehouse.

INVESTMENT CONSIDERATIONS

Large and growing market – LAWS defines the market as $20 - $25B and as highlighted below, after several weak years, the industrial economy is again improving. Both volume and pricing are again trending positively.

Unfilled distribution network – The McCook distribution center is a highly automated, large scale distribution center with significant excess capacity, so management does not expect any capex for growth needs until the company nears a $400M annual run rate. Maintenance capex needs are modest in the range of $2-4M per year.

Improving margin structure – Management talks to steady 60% GMs with 25 - 30% incremental margins positioning them to reach their 10% EBITDA margin target in two to three years.

High ROICs – Distribution businesses are often capable of high returns on invested capital due to limited capex needs and high recurring free cash flows and LAWS is no exception. As the company grows into its distribution footprint and generates higher EBITDA margins, we forecast it arriving at normalized ROIC levels consistent with other industrial distribution peers.

Clean balance sheet – Prior to the Bolt Supply deal the company was in a net cash position, with $19M of cash on hand against a $7M finance lease position. After the deal, the company has less than one turn of leverage on a proforma basis.

NOLs – At 2016 yearend, LAWS had $46.7 million of U.S. Federal NOLs subject to expiration beginning in 2030 meaning the company is unlikely to be a meaningful tax payer at any point in the near future.

Ownership – The Port family as a group remain large shareholders. Chairman Port still owns ~1M shares and altogether family ownership comes in at ~23%. Due to the nature of the family holdings and the length of investment period for several who are third-generation family members, it stands to reason additional liquidity may be available at higher prices. Additionally, Luther King now holds 25% and recently acquired a board seat. We note this large shareholder has a history of purchasing middle market distribution companies, having purchased IDG in 2008.

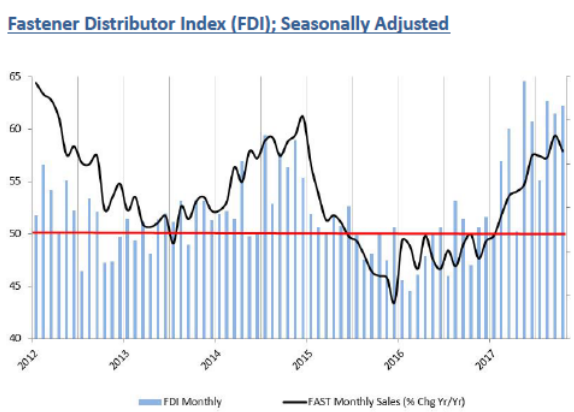
Tax reform – Should congress pass tax reform into law, most if not all industrials should benefit from strong industrial production growth. The immediate full expensing of capex warrants particularly close attention as it would likely have a materially positive impact on demand for LAWS customers and is not contemplated in our potential return scenarios.

GROWTH PROSPECTS

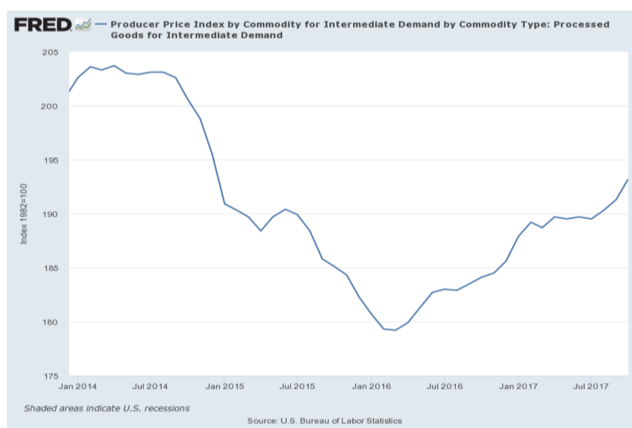
The company talks to three principal growth drivers: adding sales reps, increasing sales rep productivity and M&A.

Sales reps – At 2016 yearend, the company had 1,009 reps which compares to a prior peak of 1600. Reps are said to typically approach breakeven levels in the 12 – 18 month time horizon and approach the company average of ~$370k at around three years of experience. Recently, the company has been adding reps at a pace of around 50 per year.

Rep productivity – Rep productivity, which is naturally correlated to rep tenure and also influenced by the pace of industrial production growth, stood at $1.212 sales per rep per day at the end of Q3 2017. This compares to $1.379 from 2013 which seems a reasonable near-term target, depending in some degree on the rate of addition of new reps. We note end market dynamics and inflation are important inputs in driving improving rep productivity and of late have been supportive to further growth in this metric.



Source: Robert W. Baird & Co., FCH Sourcing Network, company reports



M&A – Acquisitions are the final growth driver and until recently have been the least impactful. Management has taken a conservative and prudent approach to deals, seeking to first prove out their ability to execute and successfully integrate acquisitions on small deals before turning to larger ones that move the needle to a greater degree. In 2016, LAWS completed three small but successively larger deals in March, May and November, the largest of which being a $4M transaction. Since then, the company has been focused on larger deals and has stated a desire to do one to three per year. In October of this year the company purchased The Bolt Supply House, a MRO distributor in Western Canada, which looks set to add at least $.20 to earnings in year one. Future acquisitions should prove to be similarly accretive, as cost synergies are realizable from migrating the acquired company's operations into LAWS's supply chain while new reps can also benefit by offering the deeper and heavy private label LAWS product offering.

VALUATION

Analyst coverage is light with only two banks covering the name. The stock is currently trading roughly in line with larger peers, though we believe current multiples reflect little of the anticipated earnings inflection.

	Price	Mkt Cap	EV / FY17 EBITDA	PE FY1	PE FY2
GWW	$223.54	$12,750	10.9x	20.8x	20.1x
MSM	$90.23	$5,103	11.5x	20.2x	18.4x
FAST	$53.82	$15,467	15.7x	27.9x	25.1x
LAWS	$24.35	$224	12.2x	47.8x	22.8x

PROSPECTIVE RETURNS

LAWS closed the Bolt Supply deal on 10/3/17. Adding ~12% growth to the topline, it is a sizeable deal that will have some impact on the margin structure of the company. Management has indicated it will be dilutive at the gross margin line, but its double-digit EBITDA margins will be accretive at the EBITDA margin line. In our projections we have made the simplifying assumption that the deal will be completed at the start of 2018 for easier comparability across years. We have also included a base case that omits all deals which will exclude the already completed Bolt Supply deal in order to better gauge the potential financial performance of the business. We are using a cash tax rate of 10% due to the company's NOL position and a static fully diluted share count of 8.9M CSO.

Case	Description	FY18 Assumptions	FY19 Assumptions
Bull	Market growth continues at year-to-date pace - Bolt deal only included in M&A in FY18 - FY19 includes similar sized deal	20% sales growth on - 8% ADS growth - Bolt $34M USD contribution 60.0% gross margin	20% sales growth on - 8% ADS growth - $40M M&A contribution 60.0% gross margin

	FY 2017 E	FY 2018 E	FY 2019 E
Sales	$298.7	$358.4	$430.1
growth	*8.0%*	*20.0%*	*20.0%*
EBITDA	$16.4	$27.5	$38.6
margin	*5.5%*	*7.7%*	*9.0%*
growth	*42.6%*	*67.7%*	*40.4%*
Incr margir	*22.2%*	*18.6%*	*15.5%*
EPS	$0.89	$1.78	$2.56
growth	*nm*	*100.0%*	*43.8%*

EBITDA X	TEV	Target Price	Return
8.0x	$308.8	$33.3	36%
10.0x	$386.0	$42.0	72%
12.0x	$463.2	$50.8	107%

PE	EPS	Target Price	Return
17.0x	$2.56	$43.52	78%
19.0x	$2.56	$48.64	99%
21.0x	$2.56	$53.76	119%
23.0x	$2.56	$58.88	140%
25.0x	$2.56	$64.00	161%

Case	Description	FY18 Assumptions	FY19 Assumptions
Base	Market growth continues at year-to-date pace - Bolt deal only included in M&A	20% sales growth on - 8% ADS growth - Bolt $34M USD contribution 60.0% gross margin	8% sales growth on - 8% ADS growth 60.0% gross margin

	FY 2017 A	FY 2018 E	FY 2019 E
Sales	$298.7	$358.4	$387.1
growth	*8.0%*	*20.0%*	*8.0%*
EBITDA	$16.4	$27.5	$34.6
margin	*5.5%*	*7.7%*	*8.9%*
growth	*42.6%*	*67.7%*	*25.8%*
Incr margir	*22.2%*	*18.6%*	*24.8%*
EPS	$0.89	$1.78	$2.26
growth	*nm*	*100.0%*	*27.0%*

EBITDA X	TEV	Target Price	Return
8.0x	$276.8	$29.6	21%
10.0x	$346.0	$37.5	53%
12.0x	$415.2	$45.4	85%

PE	EPS	Target Price	Return
17.0x	$2.26	$38.42	57%
19.0x	$2.26	$42.94	75%
21.0x	$2.26	$47.46	94%
23.0x	$2.26	$51.98	112%
25.0x	$2.26	$56.50	131%

Case	Description	FY18 Assumptions	FY19 Assumptions
Base no M&A	Market growth continues at year-to-date pace - No M&A contemplated in any year which also exludes the already completed Bolt deal	8% sales growth 60.3% gross margin	8% sales growth 60.3% gross margin

	FY 2017 A	FY 2018 E	FY 2019 E
Sales	$298.7	$322.6	$348.4
growth	*8.0%*	*8.0%*	*8.0%*
EBITDA	$16.4	$24.0	$30.2
margin	*5.5%*	*7.4%*	*8.7%*
growth	*42.6%*	*46.3%*	*25.8%*
Incr margir	*22.2%*	*31.8%*	*24.0%*
EPS	$0.89	$1.51	$1.90
growth	*nm*	*69.7%*	*25.8%*

EBITDA X	TEV	Target Price	Return
8.0x	$241.6	$28.8	18%
10.0x	$302.0	$35.7	46%
12.0x	$362.4	$42.5	74%

PE	EPS	Target Price	Return
17.0x	$1.90	$32.30	32%
19.0x	$1.90	$36.10	47%
21.0x	$1.90	$39.90	63%
23.0x	$1.90	$43.70	78%
25.0x	$1.90	$47.50	94%

Case	Description	FY18 Assumptions	FY19 Assumptions
Bear	Market growth slows to 3% ADS pace - Bolt deal only included in M&A	15% sales growth on - 3% ADS growth - Bolt $34M USD contribution 60.0% gross margin	3% sales growth on - 3% ADS growth 59.5% gross margin

	FY 2017 A	FY 2018 E	FY 2019 E
Sales	$298.7	$343.5	$353.8
growth	*8.0%*	*15.0%*	*3.0%*
EBITDA	$16.4	$24.6	$27.9
margin	*5.5%*	*7.2%*	*7.9%*
growth	*42.6%*	*50.0%*	*13.4%*
Incr margir	*22.2%*	*18.3%*	*32.0%*
EPS	$0.89	$1.52	$1.68
growth	*nm*	*70.8%*	*10.5%*

EBITDA X	TEV	Target Price	Return
8.0x	$223.2	$23.5	-4%
10.0x	$279.0	$29.9	22%
12.0x	$334.8	$36.2	48%

PE	EPS	Target Price	Return
17.0x	$1.68	$28.56	17%
19.0x	$1.68	$31.92	30%
21.0x	$1.68	$35.28	44%
23.0x	$1.68	$38.64	58%
25.0x	$1.68	$42.00	71%

Our Base case uses a 50/50 blend of 10x 2019 EBITDA of $35M and 21x $2.26 EPS to arrive at a two-year forward price target of $42/share. This assumes ADS growth consistent with year-to-date levels at 8% and no additional acquisitions beyond the Bolt Supply deal already completed. On a NTM basis, we note 21x 2018's $1.78 EPS implies a $37 price target and a near term return in excess of 50%.

Our Bull case uses a 50/50 blend of 12x 2019 EBITDA of $39M and 23x $2.56 EPS to arrive at a two-year forward price target of $53/share. This assumes ADS growth consistent with year-to-date levels at 8% and one additional acquisition in 2019 at a similar size and accretion level of the already completed Bolt Supply deal.

Finally, our Bear case uses a 50/50 blend of 8x 2019 EBITDA of $28M and 17x $1.68 EPS to arrive at a two-year forward price target of $26/share. This assumes ADS growth immediately moderates to 3% for both 2018 and 2019 and includes the already completed Bolt Supply deal. We note a true bear case would involve a downturn in the economy, negative market growth rates and a materially worse return outlook, though we currently do not see material risk of such economic circumstances barring any immediate and unforecastable events.

RISKS

- Cyclicality. End markets are pro cyclical and subject to industrial market health.
- Deflation. Declining prices are a negative to all distributors.
- Operational execution. Management must continue to drive both rep and productivity growth.
- M&A execution. The company must find, execute and successfully integrate deals.

CATALYSTS

- Earnings reports. Continued steady company execution should drive impressive earnings growth and attract new investors.
- M&A. The opportunity to drive above market growth via accretive acquisitions is significant and can expedite the company's progression to its 10% EBITDA margin target. The company itself may be a takeout candidate in the future, given the prior history of its largest shareholder.
- Greater investor discovery and enhanced trading liquidity. Currently only two sellside analysts cover the name. Hand in hand with greater attention comes potentially greater liquidity, often an issue for small caps.