

# STERLING CONSOLIDATED CORP.

## M&A Strategy to Turn STCC Into a Major Player

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### STERLING CONSOLIDATED CORP. (OTC:QB –STCC - \$0.225)

Price Target: \$1.00

Rating: Speculative Buy

### COMPANY SNAPSHOT

Sterling Consolidated Corp., through its wholly-owned subsidiary, Sterling Seal and Supply, has been a leading supplier of hydraulic and pneumatic seals to the automotive and industrial marketplace for more than 40 years. Through a combination of leveraging its logistical expertise and sophisticated, experienced management, the company intends to be an active and strategic consolidator by acquiring profitable firms in this highly fragmented market in order to gain market share and emerge as one of the most profitable firms in the industry.

### KEY STATISTICS

Price as of 9/20/13	\$0.225
52 Wk High – Low	\$0.29– 0.15
Est. Shares Outstanding	37.2M
Market Capitalization	\$8.4M
3 Mo Avg Vol	5,000
Exchange	OTC:QB

### COMPANY INFORMATION

Sterling Consolidated Corp.  
1105 Green Grove Road  
Neptune NJ 07753  
[www.sterlingconsolidated.com](http://www.sterlingconsolidated.com)  
IR: KCSA, Todd Fromer/Phil Carlson  
212.896.1215

### INVESTMENT HIGHLIGHTS

Through its wholly-owned subsidiary Sterling Seal and Supply, the Company has been a leading supplier of hydraulic and pneumatic seals to the automotive and industrial marketplace for more than 40 years. Operating in a multi-billion market, Sterling Seal and Supply is a top 10 independent supplier of O-rings in the industry.

**Sterling boasts 3,000 customers across the country along with its three regional distribution centers on the East Coast.** The Company's seal products, particularly the O-rings, are ubiquitous and renewed growth in key industries such as energy, are driving sales. End users of Sterling's products include some of the largest firms in the world.

**Sterling has implemented a roll-up acquisition strategy with \$1.2M in funding to acquire other firms in the highly fragmented, multi-billion dollar seal market, at favorable private market valuations.** Typical M&A targets generate up to \$5M in annual revenue with 8-10% net margins and may sell for 3-5x EBITDA.

**The Company is led by a very seasoned and yet entrepreneurial executive team that is engaged in on-going M&A discussions with multiple prospects.** If all of Sterling's M&A targets are acquired in the next 12-18 months, the annual revenue run-rate would quadruple its \$6M+ in annual sales and net income would exceed \$1 million.

**STCC is set to reap huge profits and enjoy a huge increase in valuation as it executes its roll-up objectives.** As a result, we believe that the stock could reach \$1.00 in 2014, or north of 20x forward 12-month EPS. We rate these shares Speculative Buy.

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### COMPANY OVERVIEW

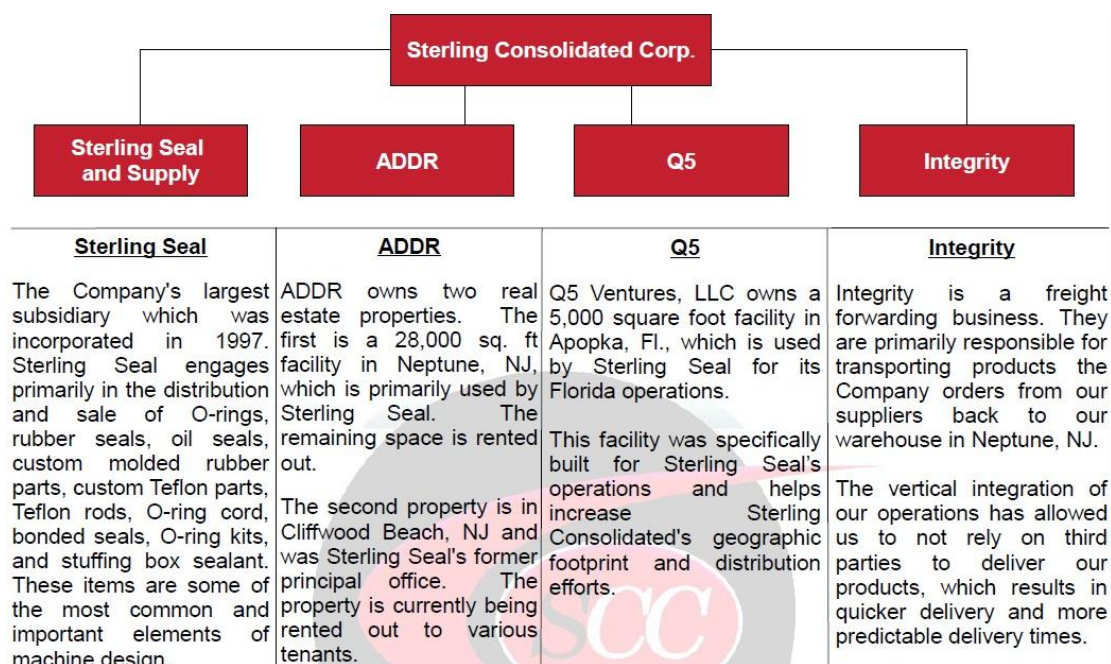
Sterling Consolidated Corporation (OTCBB: STCC) was founded in 1970 by the current Chairman of the Board, Angelo DeRosa, as Sterling Plaster & Rubber Products. The Company has been a stable and consistently profitable supplier of hydraulic and pneumatic seals to the automotive and industrial marketplace over the past 40 years. In 1997, the firm became Oceanview Acquisition Corporation, and then went public in May of 2012 with the current company name. The Company is headquartered in Neptune, New Jersey.

Sterling Consolidated Corporation provides O-rings, rubber seals, oil seals, custom molded rubber parts, custom Teflon parts, Teflon rods, O-ring cords, bonded seals, O-ring kits, and stuffing box sealant products for use in automotive, pump, transmissions, oil and energy, machinery, and packaging industries and has over 3,000 customers. Currently management is in negotiations with over 10 acquisition targets as the Company's strategy is to grow by consolidation, leveraging logistical expertise, experienced management and public company status to consolidate the fragmented multi-billion dollar seal industry. Sterling is particularly focused on the automotive and industrial sectors for growth. By implementing this strategy, Sterling can generate meaningful economies of scale, efficient distribution and freight forwarding, greater margins, and a premium to market valuation relative to its peers.

Figure 1 illustrates shows a breakdown of Sterling Consolidated Corporation and its subsidiaries by function and location. The flowchart illustrates the diversity of the business and the growth potential associated with differentiation in logistics and delivery.

**Figure 1: Sterling Consolidated Corporation and Subsidiaries**

Source: Sterling Consolidated Corp.



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The Company's roughly \$6M in annual revenue breakdown is represented largely by distributors (70%) rather than end users (30%). However, the Company's ubiquitous products are used by some of the largest companies in the world, including BMW, Chrysler, Ford (NYSE – F), Emerson, Amazon (NASDAQ – AMZN) and Eaton Hydraulics, a subsidiary of industrial giant Eaton Corp. (NYSE – ETN).

*Image 1* illustrates the current distribution centers which are strategically located. Sterling has set up these locations to minimize the costs associated with expediting UPS Next Day Air and satisfy quick turnaround times in customer emergencies. This is a critical factor in differentiation and can mean the difference between keeping a customer and losing a sale.

### Image 1: Sterling Consolidated Regional Distribution Centers

Source: Sterling Consolidated Corp.



Keeping inventories at the optimal levels at all facilities strikes a balance between customer service and inventory costs and is an area of expertise for Sterling that is also a true industry differentiator. The implementation of principles like Just-In-Time and Kanban signals from the Toyota Production System have been adopted and perfected by the Company to keep efficiency at its highest levels.



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**Image 2: Sterling Consolidated Sample O-Ring Products**

Source: Sterling Consolidated Corp.



Importantly, the Company has and will continue to remain focused on manufacturing and supplying products that can be used across varied applications. Moreover, administering a parts library that maximizes applications with fewer part numbers and revisions has set the Company apart in the past and will be a crucial factor in operations moving forward. For example, Sterling can offer the same products for varied applications in different environments. For example, water seals used in various pool applications can also be used in sealing the water used in the waste applications for fracking. Minimizing engineering and manufacturing changes in new products/applications will continue to be smooth given management's track record.

### **INDUSTRY OVERVIEW**

The O-ring and seal industry is a multi-billion dollar market that touches about every aspect of life in a plethora of applications. Hydraulic and pneumatic seals are prevalent in homes, stores, factories, industrial products and just about everywhere fluid or high pressure gas is used in industry. If there is fluid or gas prevalent, then there are bound to be seals. Sterling and its subsidiaries and its competitors serve the following markets:

- After Market Automotive
- Pump and valve manufacturers
- Transmissions
- Energy-Oil and Alternative
- Pool and Spa
- Mining
- Machinery, packaging, food,
- Aerospace & Defense

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Due to the sheer variety of applications and industries, the hydraulic and pneumatic O-ring and seal industry is a steady solid one, but highly competitive and fragmented. In addition, the sub-\$10M market is dominated by Mom and Pop companies. All of the applications listed above represent meaningful growth opportunities for Sterling and the other players. However, growth in the energy (especially oil) and alternative energy sector combined with the comeback of the automotive industry represent the two largest areas of increased revenue potential over the next several years.

Figure 2 is a graph produced by the U.S. Energy Information Administration (EIA) for its 2013 *Annual Energy Outlook*. This illustrates identifies a significant spike in the demand for crude and natural gas through about 2020, with a 5-6% compound annual growth rate (CAGR) for both commodities. Given the sheer size of the industry segment, these markets offer a huge growth opportunity for all applications related to drilling, natural gas fracking, and alternative methods of oil and gas acquisition.

**Figure 2: U.S. Production of Petroleum and Other Liquids Forecast by Source  
(Millions of Barrels Per Day)**

Source: EIA: 2013 Annual Energy Outlook

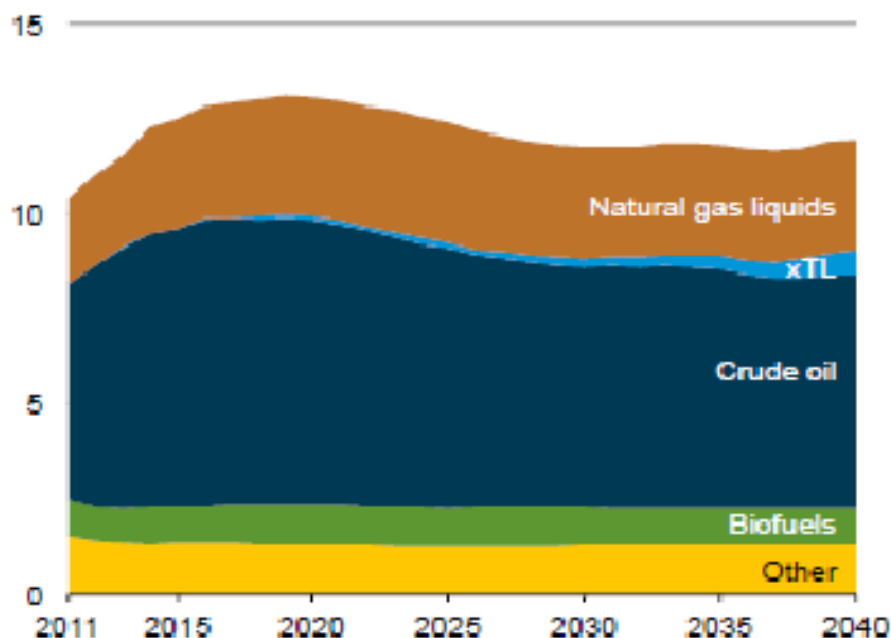
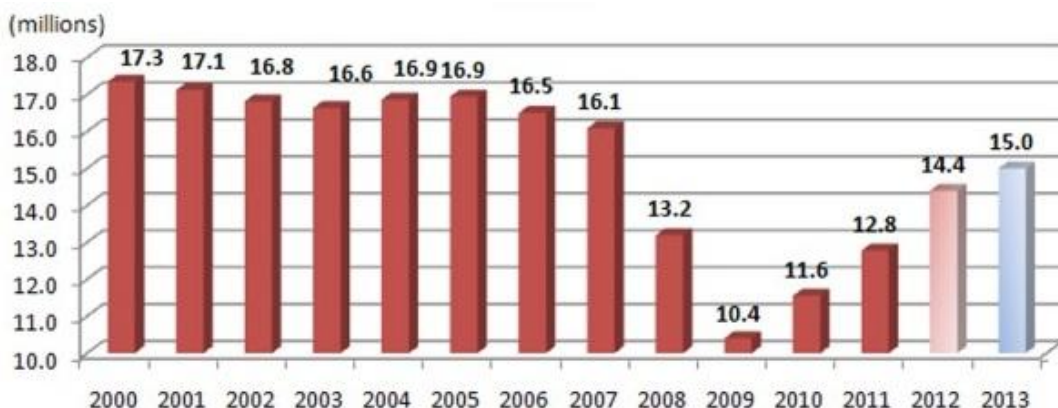


Figure 3 below is from *Edmunds.com*, which demonstrates the comeback of global automotive sales since the conclusion of the Great Recession which started in 2008. Most automotive analysts predict the growth will continue over the next 3-5 years at the current rate of about 6–7% CAGR.

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**Figure 3: Historical Trend for Automotive Sales – Total Number Worldwide**



Source: Edmunds.com

Finally another key metric that shows a positive trend for Sterling and the industry is the Institute for Supply Management (ISM) Index which monitors employment, production inventories, new orders and supplier deliveries. This is a key metric used to understand the broader economic conditions related to manufacturing production, which is directly correlated to supplier component (like seals and O-rings) health and growth. According to an article on [www.Marketwatch.com](http://www.Marketwatch.com) in early September:

“U.S. manufacturers expanded at the fastest pace in August in more than two years, according to the closely followed ISM index. The Institute for Supply Management index rose to 55.7% from 55.4% in July. That's the highest reading since June 2011. Economists surveyed by MarketWatch had expected the index to dip slightly to 54.1%. A reading over 50 indicates more manufacturers are expanding instead of contracting. The ISM's new-orders gauge surged to 63.2% from 58.3%....”

### **THE STERLING ROLL-UP ACQUISITION STRATEGY**

Sterling has implemented a roll-up acquisition strategy with \$1.2M in funding in place to acquire other firms in the highly fragmented, multi-billion dollar seal market. Management has elected to engage this initiative to take advantage of a number of opportunities in which the market has presented. By executing this strategy, Sterling can generate meaningful economies of scale, efficient distribution and freight forwarding, and greater operating margins. The Company is currently in advanced negotiations with over 10 acquisition targets. All of these prospects have a history of consistent results, including up to \$5M in annual revenue with 40% gross margins and 8-10% net margins.

Clearly, Sterling is using its public company status to successfully complete its M&A objectives as it can leverage the arbitrage between private market valuations of 3-5x EBITDA and enjoy substantially higher public

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market valuations. Since most of the targeted firms are Mom and Pop organizations with limited ability to materially grow in size and no succession plan, it is likely that most prospects would jump at the chance to sell to Sterling, a well-regarded 40-year player in the space.

This strategy has already proven to be successful on a larger scale by Hercules Fluid Power Group (a subsidiary of a public firm in the U.K.). Hercules has been acquiring firms in the \$10-25M in revenue range yet paying firms 10x EBITDA, which would appear to be a premium to the market. Given that the sub-\$5M in revenue company owners would have fewer exit strategy options, Sterling can emulate the Hercules strategy and substantially increase its public valuation at lower acquisition costs.

For example, if all of Sterling's M&A targets are acquired in the next 12-18 months, the annual revenue run-rate would quadruple its current \$6M+ revenue run-rate in annual sales and net income would exceed \$1 million. While major players in the industry segment such as Parker Hannifin Corp. (NYSE – PH) trade around 14x FY14 EPS, given the high growth nature of the STCC business, a P/E multiple of 20x or more would be considered reasonable.

We should note that Fastenal Corporation (NASDAQ – FAST), the leader in fasteners, and a company that could be considered in Sterling's broader peer group, trades 28x FY14E EPS, which confirms our higher valuation thesis for Sterling. By the way, although Sterling does not participate in a sexy industry, this should not hinder its likely substantial share price performance one iota. After all, according to a story in Bloomberg BusinessWeek last year, Fastenal is the best performing stock of the Russell 1000 over the past 25 years.

### **THE STERLING EXECUTIVE TEAM**

There are three key players at the C-Level and on the Company's Board of Directors that bring over 80 years of experience combined in the hydraulic and pneumatic seal industry and finance. Additionally, all three offer their own expertise to the acquisition committee which is actively acquisition candidates.

#### **Angelo DeRosa – Chairman of the Board**

Mr. DeRosa founded the Company's predecessor entity, Sterling Plastic & Rubber Products, Inc. in 1970. He is responsible for the financing and overall management of the entire organization. He also maintains key relationships with customers, banking institutions and industrial affiliations. Mr. DeRosa studied Business Administration while attending Fairleigh Dickinson University. He will facilitate company transactions and will maintain oversight of valuation information for his specific role on the acquisition committee.

#### **Darren DeRosa – Chief Executive Officer**

Mr. DeRosa has served as the Chief Executive Officer of the Company since 2000. He runs the day-to-day operations of the Firm, including managing business development projects in information technology, logistics and human resources, and seeking out potential acquisition targets. He earned a B.A. in Economics from Dickinson College and an M.B.A. from Monmouth University. He will also develop detailed implementation strategy and assign management personnel for the implementation process in his role on the acquisition committee.



**STERLING CONSOLIDATED (OTC:QB STCC)****Scott Chichester – Chief Financial Officer – CPA**

Mr. Chichester has over 20 years of experience in accounting and finance and has broad experience in both the private and public markets. He will oversee accounting integration protocol in addition to valuation for his part on the acquisition committee. Mr. Chichester worked as an auditor in the Financial Services division of Ernst and Young before moving to the Equity Controllers division at Goldman Sachs. Currently he serves as an independent trustee and audit committee chairman of an NYSE traded ETF fund complex which manages over \$1.8 billion in capital. Mr. Chichester earned his accounting degree, cum laude, from the Villanova University School of Business.

**RISK FACTORS**

In our view, Sterling's biggest risk factors are the typical issues facing industrial companies---the economy. Still, this is not management's first rodeo. With 40 years under its belt management has seen every type of economic and market environment, still persevered and largely remained profitable. The Company has just been a model of consistency. Risks related to the roll-up strategy are more tangible in our view. These would include integration issues, a failure to acquire its top targets, slower road to profitability objectives, greater cash requirements, etc. Competition from larger firms or even from newer entrants engaging in similar strategies is another typical concern and is also consistent with firms of Sterling's size and standing.

**CONCLUSION**

With a 40-year history of consistency and profitability, and a top ten ranking as an distributor of O-rings along with hydraulic and pneumatic seals to the automotive and industrial seal market, Sterling is primed to reach new heights as it implements its roll-up acquisition strategy. The Company is led by a very seasoned and yet entrepreneurial executive team that is engaged in on-going M&A discussions with multiple prospects that should result in the closing of a number of deals over the next 18 months. If all of Sterling's M&A targets are acquired, the annual revenue run-rate would quadruple its \$6M+ in annual sales, and net income would exceed \$1 million.

Clearly, STCC is set to reap huge profits and enjoy a huge increase in valuation. As a result, we believe that this low-float stock of roughly 2.8 million shares could reach \$1.00 in 2014, or north of 20x forward 12-month earnings which is the current forward valuation afforded PH and FAST, its two largest peers. Therefore, we rate these shares Speculative Buy.





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### Senior Analyst: Robert Goldman

Rob Goldman founded Goldman Small Cap Research in 2009 and has over 20 years of investment and company research experience as a senior research analyst and as a portfolio and mutual fund manager. During his tenure as a sell side analyst, Rob was a senior member of Piper Jaffray's Technology and Communications teams. Prior to joining Piper, Rob led Josephthal & Co.'s Washington-based Emerging Growth Research Group. In addition to his sell-side experience Rob served as Chief Investment Officer of a boutique investment management firm and Blue and White Investment Management, where he managed Small Cap Growth portfolios and *The Blue and White Fund*.

### Analyst Certification

I, Robert Goldman, hereby certify that the view expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the recommendations or views expressed in this research report.

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