Global Manufacturing Market Experiences Upswing

Industry Today, September 2010

Industry Today published the byline article by Nick Merkel (IMAP Ohio), Wolfgang Wagner (IMAP Germany), and Eduardo Morcillo (IMAP China) about the global manufacturing industry in its September issue.

No electronic link available.

IMAP Inc., one of the oldest and most active M&A (mergers and acquisitions) organizations, recently scrutinized the world's three major production zones. Its fact-finding mission provides cause for optimism.

Within the United States, Germany and China—the leading global production zones—recovery of the international mergers-and-acquisition (M&A) market appears imminent, if not already in full swing, reports IMAP Inc., a leading international M&A advisory firm.

US in Recovery
In the U.S., the market for manufacturers with annual revenues below $250 million gradually improves, reports Nicholas B. Merkel, a senior M&A transaction advisor from IMAP's Cleveland, Ohio office.

During the past two years, he informs, inadequate profitability of prospective sellers and limited availability of acquisition financing presented the greatest impediments to completed transactions. On average, lower-middle market companies experienced a 30- to 40-percent business drop during the recent recession vs. 15 percent overall. Given the high fixed costs associated with most manufacturing operations, profits (in many cases) evaporated.

However, according to the Federal Reserve, U.S. manufacturing has recovered close to half the production volume it lost since the depths of the recession. "That being said, smaller manufacturers have had more to regain, percentage-wise, than larger competitors who tend to be more diversified, better financed and more active in emerging markets," says Merkel.

Still, even as business conditions improve for smaller manufacturers, it may take a couple of years for them, as a group, to achieve pre-recession levels of sales and profits, says Merkel.

While the recession's negative effects are widespread, the impact is uneven, and a number of manufacturing sectors have fared comparatively well, yielding more than their proportionate share of completed transactions at attractive selling prices, he points out. These include aerospace, medical products and technology-based manufacturers. Other sectors have experienced a significant amount of forced consolidation, notably suppliers to the automotive, residential construction and apparel industries, Merkel adds. Still, most U.S. manufacturers have struggled to recapture the profitability level that makes selling worthwhile.

The acquisition multiples (prices paid) for profitable, strategically desirable manufacturers in

attractive industry sectors have dropped very little since 2007. "It's simply a matter of supply and demand," says Merkel. "There are comparatively few such companies on the market at the same time that private equity groups are reportedly trying to deploy more than $400 billion in uncommitted investment capital. At the other end of the spectrum are contract manufacturers, effective job shops, and proprietary producers of commodity products. Those which might have sold for as much as six times EBITDA (earnings before interest, taxes, depreciation and amortization) two years ago would now be fortunate to receive five times EBITDA."

Since January, access to acquisition financing has improved significantly, and it's readily available for solid transactions involving sellers with $10 million or more in EBITDA, says Merkel. Smaller acquisitions, particularly by strategic buyers, are getting financed as well. However, lending multiples are lower with smaller transactions. As a result, buyers must contribute a higher equity percentage (often 50 percent or more of purchase price) and sellers will likely have to take back notes and/or possibly earn-outs.

"As lower middle-market manufacturers return to reasonable profitability levels, more will come on the market for all the traditional reasons, including owner/manager burn-out, retirement, health concerns and the desire to diversify personal assets," says Merkel. "Given the challenges they've been forced to endure over the last two years, there should be plenty of owner motivation to cash out and move on."

He adds: "These companies will be joined by others with depleted working capital and a need for added investment to fund continued growth."

Finally, expect to see private equity groups start selling off their older holdings as they seek liquidity for their investors. "Considering these combined circumstances, if the economy stays on track, pent-up demand should produce an outstanding market for buyers and sellers of U.S. manufacturing companies over the next few years," Merkel concludes.

Stabilization in Germany
Indications also point to recovery in the German market. Anyone quick enough to react by selling now can hope to get an appropriate purchase price, observes Wolfgang Wagner, a senior transaction advisor with IMAP's Mannheim office.

A recent study conducted by IMAP Germany ("Company Development During the Crisis") surveyed 100 German companies with annual revenues ranging from €50 billion to several billion Euros. More than 40 percent of respondents plan to expand through targeted acquisitions. They prefer German companies, as they believe their national market demonstrates the greatest growth potential.

Such companies are financially well equipped for their "shopping tour," says Wagner. Almost 90 percent of those willing to do an acquisition can—and even wish to—finance an acquisition at least partially from their own pocket. More than one-fourth of the companies with revenues of up to €100 million, as well a half of the companies with revenues between €100 million and €500 million, said they would finance a planned acquisition with their own financial resources. If they use additional external funding, it will most likely be sourced entirely via credit institutions.

After 2009, a disappointing years for most of the companies, land is now in sight, in terms of new

orders and growth perspectives, says Wagner. But he adds that these can only be realized if the companies first invest in infrastructure, purchase raw materials and recruit qualified employees. Many companies with revenues of less than €50 million currently can't do this, as last year forced them to spend their reserve money. "These days a visit at the house bank to obtain further (investment) credits is very disappointing," observes Wagner.

Based on the Basel II guidelines, as well as bad results in 2009, many medium-sized companies have a negative ranking. Consequently, the companies must look to alternative financial sources. Strategic partnership with suitable investor could be an effective solution, suggests Wagner. "Experience shows other positive aspects on company development and stabilization apart from the pure provision of funds: For example, the cross-selling effects in distribution or synergies, like manufacturing, marketing or administration."

In 2009, companies necessarily focused on securing the financing; thus, useful sales of companies and succession planning were often postponed, he said. This often happened because, from the point of view of the seller, both buyer and capital were missing and the corporate values suffered from the negative results. On the other hand, buyers complained about the lack of attractive targets and excessive purchase price expectations of some vendors.

The MidMaX-Deal-Index (developed from the German "Bundesverband M&A" in cooperation with the German magazine *Finance*) indicates that purchasing prices are rising again. The financial deal database, which underlies the MidMaX index, shows a reduction in closed transactions on a quarterly basis in 2009 (though, even after a severe drop in Quarter 2, the decrease proved only moderate). Purchase prices, however, remained relatively stable over the last two quarters, suggesting that purchasing prices slightly increased on average.

According to the IMAP study, many companies pursue growth via acquisitions and have the necessary capital. "In turn, entrepreneurs willing to sell quickly prepare the sell to benefit from these fast movers," says Wagner. "They understand that if more attractive companies return to the market, the buyers will have a wider range of choices and prices could remain static or decline."

China – the Modern "Boom Town"

China's quick growth pace in 2009 (9.3 percent GDP) and in FQ 2010 (11.9 percent GDP) fuels booming growth rates in various industries. The Chinese growth model is moving from an investment and trade balance-driven structure into a consumption market. The Politburo drives an industrial restructuring plan oriented to increase the average salaries (gross industrial cost is increasing by eight percent every year) and enhance the consumer confidence index (by investing in healthcare, environment, education and social infrastructures).

Such macroeconomic reform is reflected in China's shift from a "global factory" into the "largest global market." Multinational and medium-sized international players are quickly adapting to this new scenario. Nearly 90 percent of respondents to the 2009 US China Business Council survey place China at the top (or at least among its top five priorities) of their global strategic investment planning.

"Inbound M&A is becoming a key investment vehicle to achieve market quota at the right speed, in such a hectic environment," said Eduardo Morcillo, corporate practice director for IMAP China. Average transaction size and transaction number in 2009 remain active. Indeed, the year witnessed

880 consummated deals (average size: $70 million USD).

Recent months witnessed differential M&A activity in the medical equipment, pharmaceutical, clean tech, F&B, aerospace and automotive sectors, reports Morcillo. "Some of these industries are growing faster than 30 percent year on year. Most transactions are equity deals with a 50-50 percent or controlling stake, where the Chinese management and shareholders compromise to stay in the business."

Lack of sound targets—coupled with the increase of alternative investors—drive up transaction prices up, Morcillo found. Private Equity is booming in China, as local companies are starting to acquire. Also, general frenzy about IPOs in the Shanghai and Shenzhen stock markets are raising a 33 and 55 average PER, respectively. Price multiples (reaching average 18.14 times EBIT and 11.91 times EBITDA) reflect the market's fast growth and good prospects.

Meanwhile, the 2009 Chinese outbound deals reached record numbers, with the highest value (average $300 million USD) and volume (298 deals) ever reported. Most outbound transactions are state-enterprise driven and natural resource-focused. Monetary authorities encourage state-owned enterprises to buy these assets to satisfy China's growing manufacturing outputs and diversify away from low-yielding U.S. securities. Southeast Asia, Latin America and Africa are the clear destinies of more than 80 percent of Chinese investment abroad.

"This year, we've witnessed growing private-sector acquisition activity towards the US and EU, mainly in technology driven sectors, where Chinese seek to acquire cheap know-how and advanced technologies," observes Morcillo.

Still, it will take several years for the trend to consolidate, as few private-owned enterprises can afford to divest resources from the quick-growth Chinese market, and almost no Chinese corporation has internal resources and capacities to integrate a foreign target, he says.

An exclusive global organization of leading M&A advisory firms, IMAP Inc. has offices in all three countries. Established in 1973, and the world's sixth-largest player for player for M&A transactions valued up to $100 million, IMAP has 45 offices in nearly 30 countries throughout North and South America, Europe, Asia and Australia. IMAP advisers provide strategic merger, acquisition, divestiture and related corporate finance services for sellers and buyers. More company information is available at www.imap.com.