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Manufacturing and Industrials M&A Predictions
Rising Tide

Autumn 2014

Contents

Foreword

Welcome to the fourth edition of Deloitte's Manufacturing and Industrials M&A Predictions, which examines M&A sentiment in our sector as 2014 draws to a close.

Our latest survey takes place towards the end of a strong year for the UK economy, with the UK on track to be the fastest growing G7 economy this year. However, there are a number of significant challenges on the horizon with continued Eurozone weakness, political uncertainty due to the forthcoming UK elections and a weaker than forecast deficit reduction programme. Our results are broadly consistent with the Deloitte Q3 2014 CFO survey, which identified a softening level of optimism set against a perception of an improved, cheaper financing environment during 2014.

In this edition we have examined the trends over the last eighteen months by mapping responses against our previous editions, and drawing out some of the themes from this period. Key questions addressed in this edition include: How have expectations for M&A activity developed over time? Has there been significant change in M&A strategies during the period? How does private equity involvement impact upon a transaction process? This last question is one we have sought to examine through a number of specific questions based on the experience of our respondents in dealing with private equity.

We have also sought the views of the private equity community, specifically through our interview with Zeina Bain, a London based Investment Director at The Carlyle Group. We would like to express our thanks to Zeina for sharing her insights, and to all of you that took the time to share your own insights with us.

We hope you enjoy the read!

The M&A Manufacturing and Industrials team

Key highlights

An overwhelming 94 per cent of our respondents describe themselves as acquisitive, with 56 per cent describing themselves as very acquisitive. This is consistent with both the current levels of activity and a more stable market environment, which has developed in recent months. This confidence is further underpinned by our respondents' expectations of valuations, with 87 per cent expecting deal multiples to either stabilise or increase in the next 12 months.

The less buoyant outlook for emerging markets, together with the relative strength of the UK economy, has seen a shift away from the former being the most significant source of target businesses (down by 32 per cent to 31 per cent). These macro trends are also likely to have contributed to the increased importance of private equity for deal origination, with 56 per cent of our respondents now seeing this as a key source of target businesses.

At the same time, we continue to see a consistency around availability and cost of finance, which allows an increased level of M&A. Despite the strong levels already available, our respondents expect this to continue and to improve further, with 44 per cent expecting an increase in the availability of debt finance in the next twelve months.

Our respondents' experience of private equity has seen the majority (57 per cent) adapt their approach to M&A. In particular, the responses highlight the importance of strategic buyers identifying their competitive edge and recognising that private equity bidders offer different strengths and opportunities compared with corporates. Additionally, our respondents note the increased information flows that private equity bidders typically require and that PE involvement, unsurprisingly, can add competitive tension and drive prices higher.

So overall, what do we think?

The last six months has shown signs of returning to a more stable M&A environment, particularly in the UK; with strong debt markets, good activity levels across most Industrial sub-sectors and good levels of confidence among industry participants. As we move into 2015, we believe that this positive sentiment is likely to continue, with our pipeline of deals looking strong, albeit with some caution expressed arising from macro economic risks that could destabilise the environment quickly.

At a glance

94% describe themselves as acquisitive, of whom 56 per cent are very acquisitive

50% are optimistic for the sector's financial prospects in the next 12 months

56% of respondents are expecting increased M&A activity in the next 12 months

56% see private equity owned businesses as a key source of target businesses.

79% stated that identifying their competitive edge was the key to competing with private equity.

57% of respondents have changed their approach to transactions following their experience with private equity.

Key highlights

Ross James
Partner, Corporate Finance Transaction Services
Corporate Finance Manufacturing and Industrials Lead

"Continued positive economic news and strong availability of finance has led to a strong appetite for acquisitions from our respondents. Almost every company we spoke to is looking for deals. In addition, private equity exits are providing dealflow, as well as keen competition for assets which come to market. We expect the Manufacturing and Industrials sector to see continued growth in M&A volumes as we approach the end of 2014, and a pipeline of transactions into 2015."

Mark Adams
Partner, Corporate Finance Advisory
Industrials and UK Industry Leader for Chemicals

"UK and European chemicals sector M&A continues to be relatively strong, particularly at the smaller end of the market. We continue to believe that the fundamentals are in place to drive activity levels and would not be surprised to see average deal sizes rise as 2015 gets under way."

Nick Wood
Director, Corporate Finance Advisory
UK Industry Leader for Paper, Pulp and Packaging

"The uptick in M&A activity in the PPP sector experienced in 2013 has continued into 2014. Consolidation, geographical expansion and broadening of product portfolios are common M&A strategies being followed. From a deal volume and value perspective, whilst deal volumes in the first nine months of 2014 were 3% lower than the same period in the prior year, total deal value increased by a staggering 42%. Given the ongoing appetite in the sector from private equity (particularly at the top end of the market) and a number of active corporate acquirers, we expect to see valuation levels being maintained in the short term."

Pauline Biddle
Partner, Corporate Finance Transaction Services
UK Aerospace & Defence ("A&D") M&A industry lead

"M&A volumes continue to improve, with commercial aviation continuing to be a major driver and a number of defence companies seeking to look at newer markets as government budgets remain constrained. Recently reported Cobham's $1.5bn acquisition of Aeroflex is an example of this trend, as is BAE Systems' acquisition of SilverSky. M&A volumes within the sector will continue to improve, most likely through increasing vertical integration within the commercial aviation supply chain and through defence businesses further focusing on newer markets."

Private equity: An interview with Zeina Bain from The Carlyle Group

Zeina Bain, The Carlyle Group

Our recent Industrials M&A surveys have highlighted 'the return of Private Equity' as a driver of M&A activity and potential source of deal flow. We have therefore included an interview in this edition with Zeina Bain, a member of the London private equity community focusing on the Industrials sector, to understand the PE point of view.

Zeina Bain is a London based investment director at The Carlyle Group. She focuses on the Industrials sector and is a member of the Board of Directors of Chesapeake and the RAC and observer on the Board of Axalta Coating Systems. She has previously served on the boards of Firth Rixson, AZ Electronic Materials, Britax Childcare and Stahl Holdings.

Why is Industrials an attractive sector for you?

I see a broad range of value creation opportunities, whether it is driving top line growth through geographical expansion, product innovation or capital investment or through improving production efficiency. Good manufacturing businesses typically have a strong asset base and IP, both of which can help protect margins and underpin growth prospects particularly as they often lead to a more attractive market structure in terms of competition.

What particular sub-segments of Industrials do you consider particularly suitable to PE investment?

I take an interest in a wide spectrum of industrial assets, but find it less easy to invest in businesses where there is a higher degree of price volatility and am more attracted to companies who innovate or have a strong engineering component, as these attributes give you more control over profitability.

More IP-based or specialist sub-sectors such as niche packaging, specialty chemicals, engineered products for the oil and gas or transportation markets lend themselves more readily to a leveraged environment as they are a little more predictable. A common feature among attractive industrial businesses is where the product is a low percentage of the overall bill of materials for the end customer but has a high impact on overall end product value (be it appearance or performance) – for example paint coatings for cars.

Do you think PE has the right focus/expertise around the Industrials sector?

Traditionally other sectors have had a greater following among the larger private equity houses – particularly given the greater level of cyclicality and some painful experiences during the recent recession. With manufacturing, being such an asset-heavy industry, there is a need for the investor to have a strong local presence in a large number of different countries to be able to address the operational challenges of such complex businesses. Many manufacturing businesses can display lower growth characteristics and so a private equity house's investment thesis needs to consider other levers for value creation such as product adjacencies/new markets and operational improvements. Certain sub-sectors require investors to have a strong existing knowledge base such as chemicals with its complex value chain and aerospace and defence with its numerous acronyms and platforms.

Do you see particular challenges as a PE buyer when speaking with vendors and management teams in the Industrials arena?

We find management teams can be wary of private equity houses offering in-house operational expertise although they can be appreciative of input from our network of former industry executives who can relate to the challenges faced by our management teams and help push the art of the possible. Management want a partner who has affinity with the business, appreciates its strategic needs and is sometimes prepared to look beyond the financial model. On the vendor side, the historical stigma of corporates selling to private equity seems to have largely abated – the industrial space has witnessed a number of very successful carve-out transactions with private equity sponsors investing for growth as well as efficiency and thus being a good home for non-core assets.

Where do you see that you have an advantage over corporates as a buyer?

Historically speed has been an advantage (both in deal execution and decision making) and in some cases anti-trust issues have played in favour of private equity. Sometimes we may give greater credence to the growth story presented by management as strategics apply their own lens to a target company's business plan. We have also found that target company management are concerned that, as part of a large corporate, they may get less focus and have to compete for capital with other parts of the business which may be larger or higher-margin whereas, within a PE context, each portfolio company is managed individually to maximise value. We tend to configure a specific board around the management team that has good personal chemistry with the senior executives, relevant industrial knowledge and experience that matches that of the strategic priorities of the investment – be it growth, diversification or improving competitiveness.

Any predictions for the future now that brighter horizons loom?

A lot of businesses were badly hit in the recession and as a result have focused heavily on margin improvement and cash management such that there is now less to do in that area. Public company valuations are currently high as economic recovery is already factored into share prices and balance sheets are strong. Competitive pressures are consistently increasing – often from emerging markets where players are looking to expand scale or market reach. Consequently many companies are running out of options outside of M&A. Perhaps it is wishful thinking but we are definitely seeing more M&A activity, which in turn usually fuels more primary deal activity for PE houses.

Our M&A predictions

We asked our panel of CEOs, CFOs and M&A professionals in Industrial and Manufacturing businesses questions covering the current economic environment, deal drivers, valuations and key themes of successful deals.

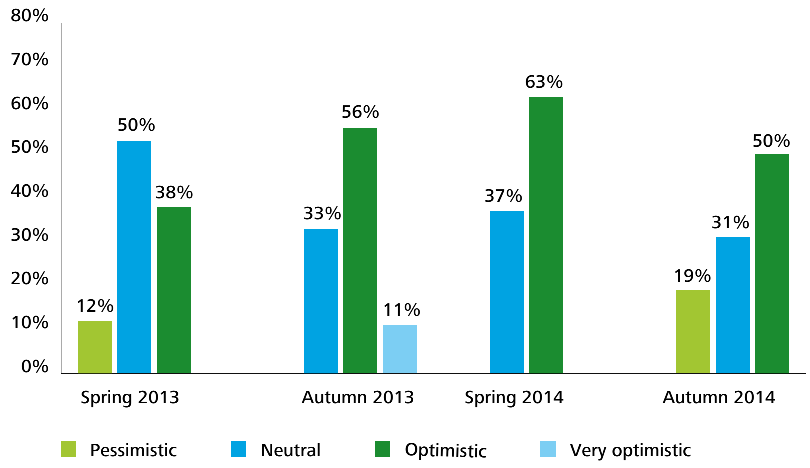
The M&A environment

The responses from our Autumn 2014 Manufacturing and Industrials survey show a decline in optimism since the Spring, although over half of respondents still expect higher levels of M&A activity.

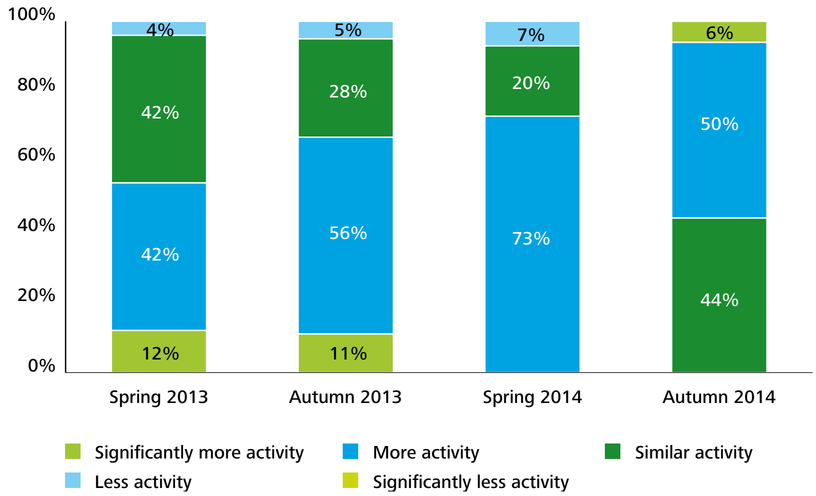
The optimism which characterised previous surveys has diminished, though 50% are still optimistic about the financial prospects for Manufacturing and Industrials.

For the first time in 18 months, some of our respondents now are now pessimistic.

How do you feel about the financial prospects for your sector in the next 12 months?



How do you feel about M&A activity for your sector in the next 12 months?

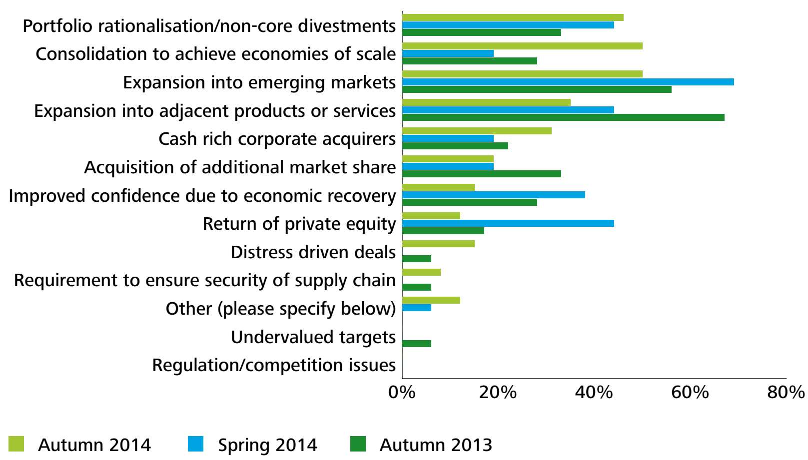


While there has been a shift in sentiment, a majority (56%) are still expecting M&A levels to increase.

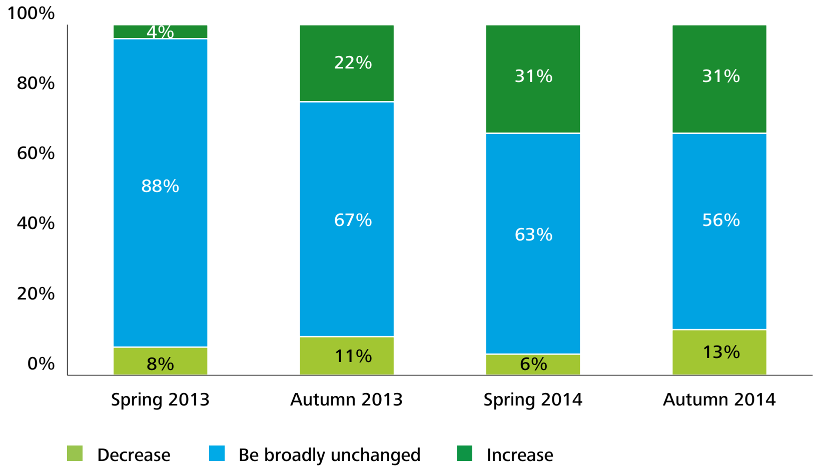
Portfolio rationalisation and the need to consolidate in order to achieve economies of scale are both seen as even more important than in the Spring.

The relative importance of 'improved confidence in the economy' and 'the return of private equity' has diminished, whilst the importance of more strategic drivers has increased.

What are the three main drivers of M&A activity for your sector in the next 12 months?



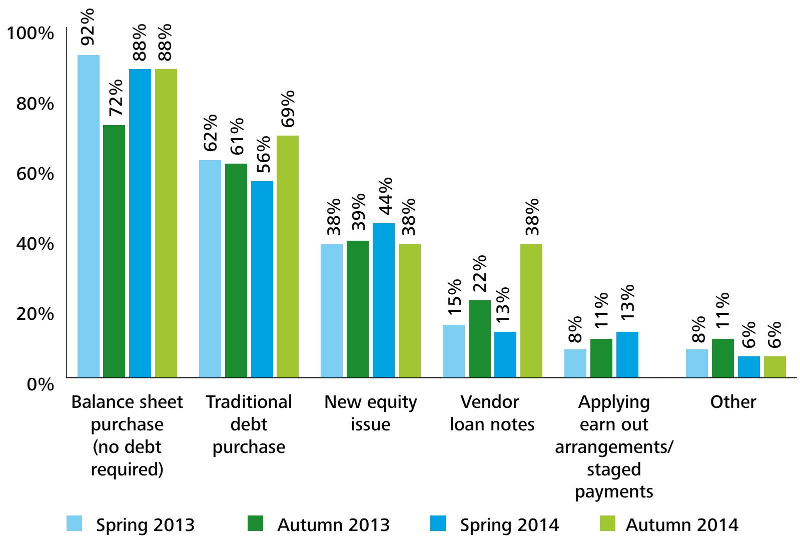
Deal multiples for companies in your sector in the next 12 months will:



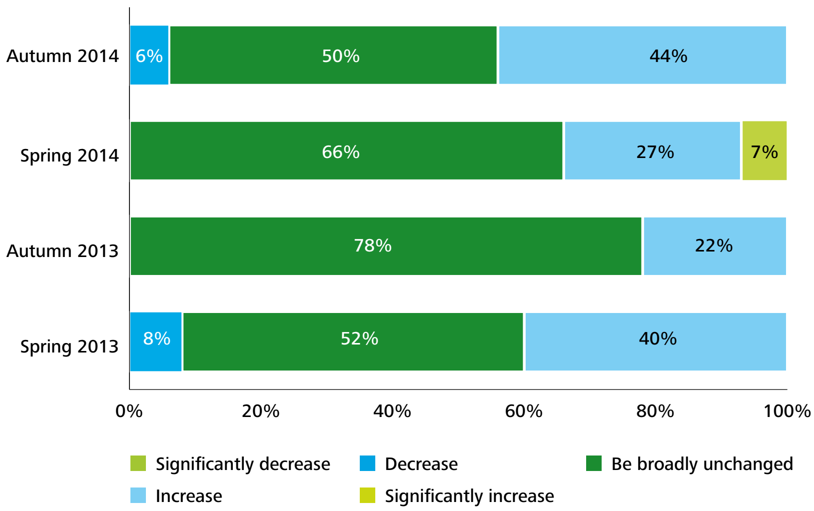
87% of respondents expect multiples to increase or stay flat, with the majority anticipating they will be 'broadly unchanged' in the next 12 months.

Although the relative importance of sources of finance has not moved since Spring 2013, the 13% increase in respondents favouring traditional debt purchase reflects the low cost and high availability of financing currently in the market. This was also identified in our latest CFO survey.

What sources of deal finance will be most popular in your sector in the next 12 months?



Availability of debt finance for deals in your sector in the next 12 months will:

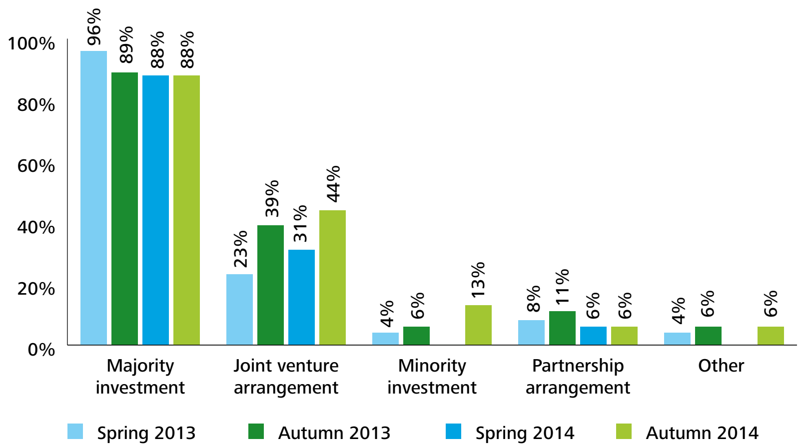


The responses on the availability of debt mirror those to our question on M&A activity shown overleaf, with 94% of respondents expecting both to remain either broadly unchanged or increase.

The rising level of respondents anticipating an increase in availability matches the trend for deal finance shown above.

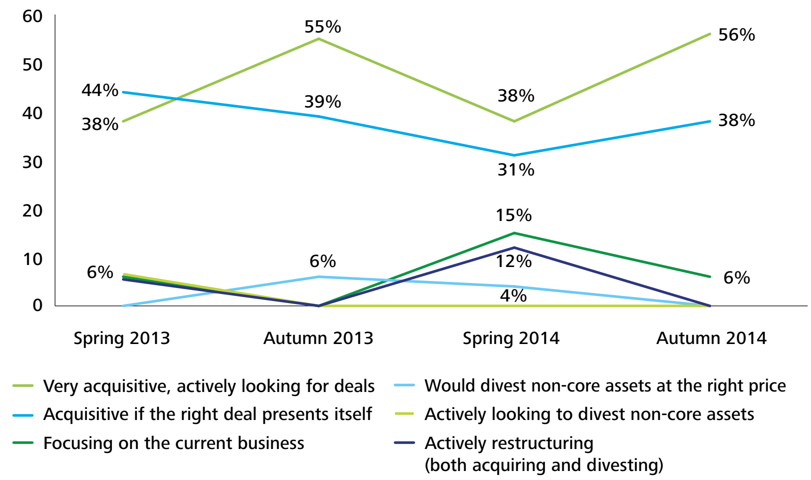
Strategy and origination

In your view, what will be the most popular investment strategy in your sector in the next 12 months?



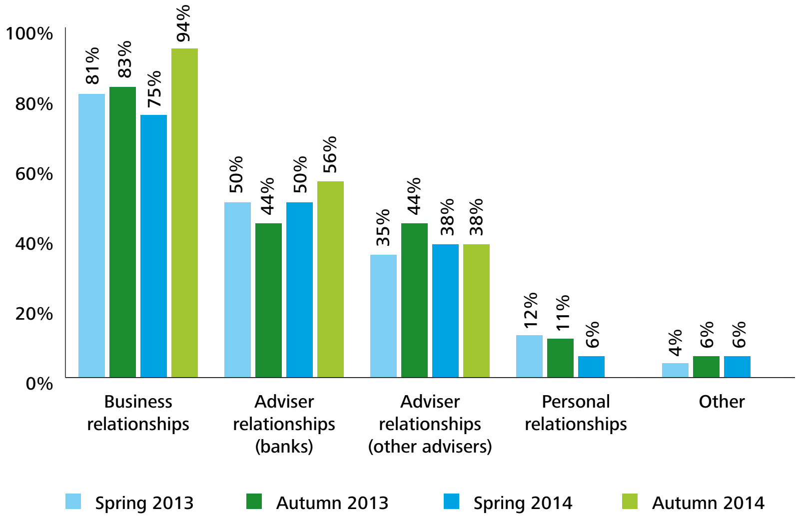
Our survey respondents continue to prefer majority investments far above any other investment strategy, though joint ventures continue to represent an increasingly significant minority.

What is your current M&A strategy?



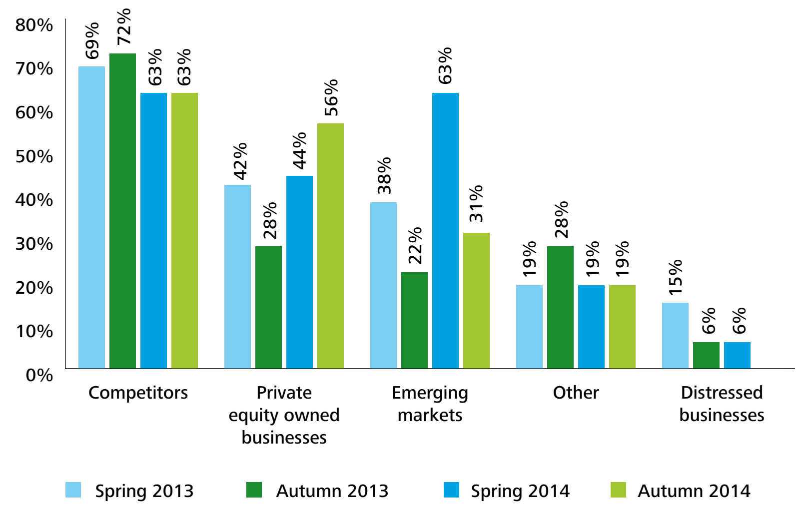
The vast majority (94%) of respondents are looking to make acquisitions, but with a significant shift from waiting for the right opportunity to actively seeking out acquisitions, in what are now widely seen as favourable market conditions for M&A.

Source of origination



There has been no significant change in sources of origination across the surveys we have conducted, with business relationships continuing to be identified as the best source of origination.

Source of target business



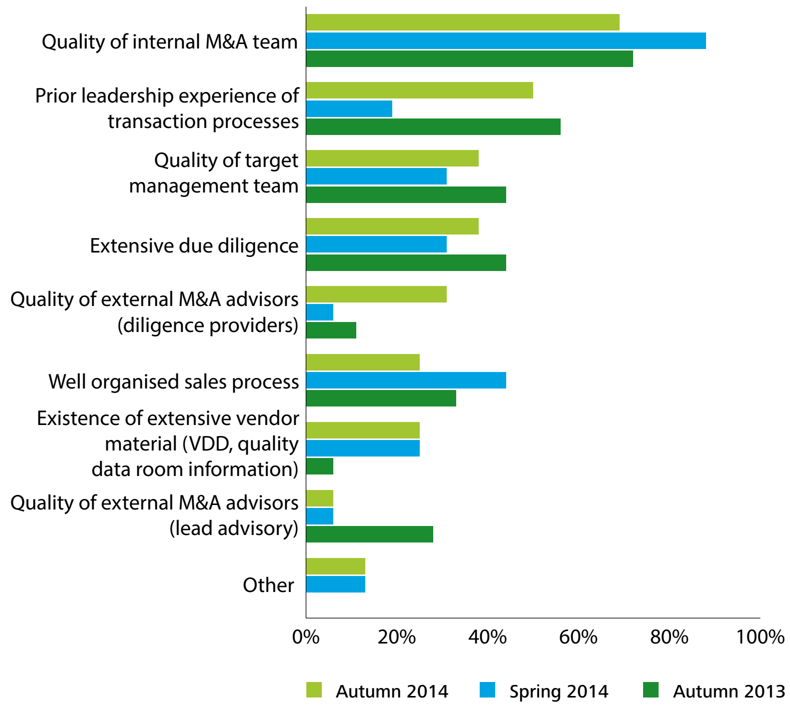
Private equity owned businesses appear to be an increasing area of focus for our respondents.

Notably, our respondents appear to be focussing less on emerging markets.

M&A execution

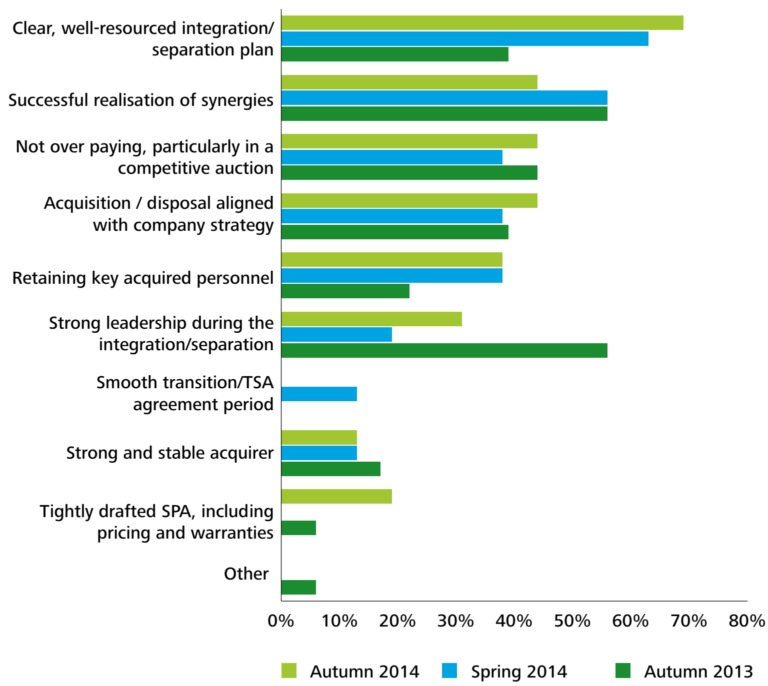
There has been limited movement in the relative importance of success factors across our surveys, however our respondents in this edition have placed significantly more emphasis on prior leadership experience of a transaction process.

Drawing on your experience, please name the most important success factors in executing a transaction



There has been similarly limited movement in the factors identified as determining whether or not a transaction is a success, with a continued focus on the long term implementation of integration / separation plans and realising the anticipated synergies.

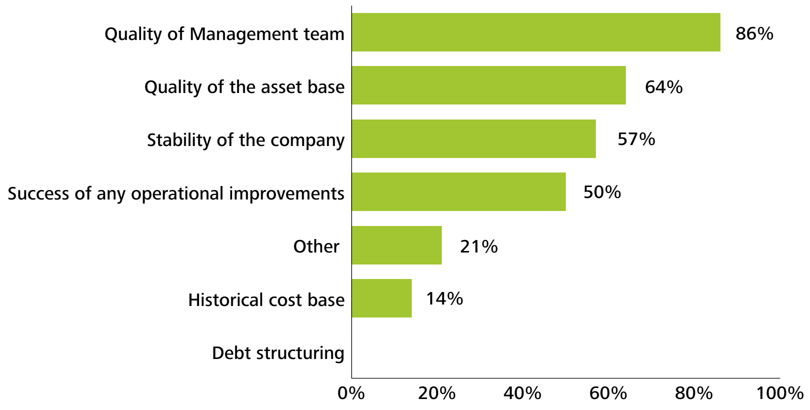
Drawing on your experience, please name the factors which most underpin a successful transaction



Private equity

Following the results of our previous survey, which identified the return of private equity to the market as a significant driver of M&A activity particularly when looking to make divestments, we have included within this edition questions on the experience of our respondents from interacting with private equity during transaction processes.

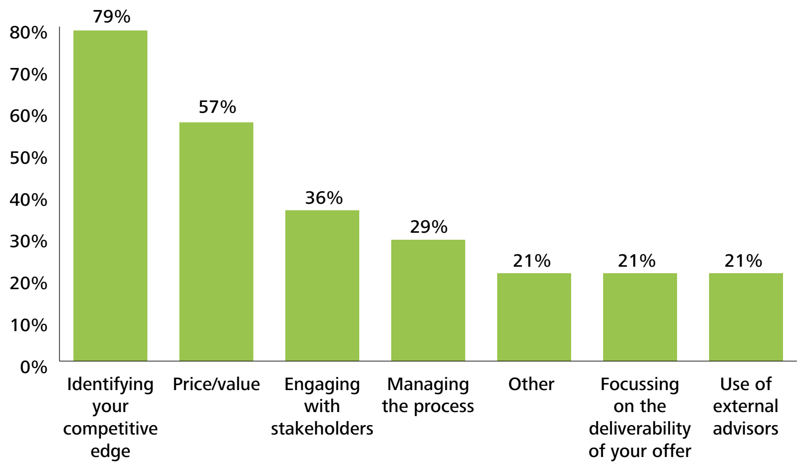
Please select what you would consider to be the three primary reasons for entering a joint venture arrangement



As you would expect, the quality of the Management team is by far the most important factor.

Significant importance is also attached to the quality of the asset base, stability of the business and the success of operational improvements made under private equity ownership.

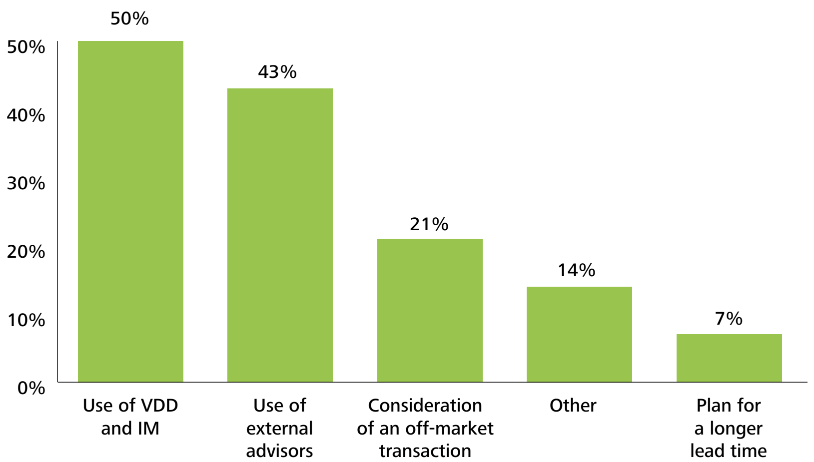
What are your key considerations when competing with private equity for an asset?



Our respondents were very clear that when competing with private equity for assets, it is vital to identify their competitive edge.

Other issues highlighted by our respondents include Management's preference, and the speed of completing a transaction.

Does the potential involvement of private equity in a process change the way you would structure a disposal?



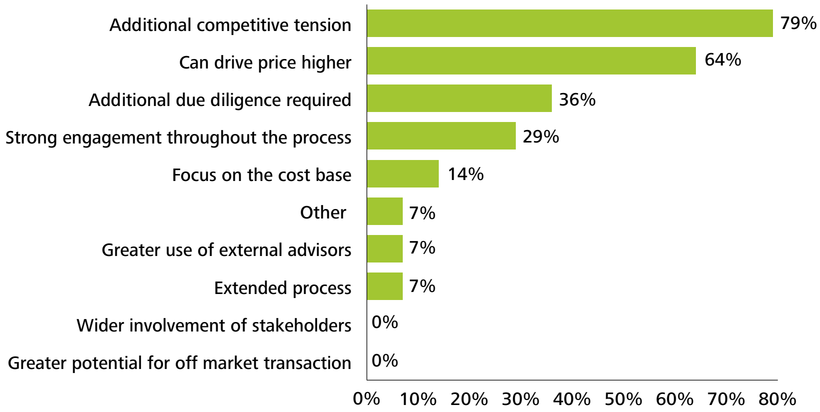
When entering a process, private equity bidders expect a certain level of information to be provided, and it is therefore to be expected that the use of VDD, IM and external advisors will be higher than when selling assets to another corporate.

Our respondents identified two themes as being of most importance:

- PE is seen to add additional competitive tension in a sales process; and (consequently)
- The potential for prices to be driven higher.

Our survey has also identified that private equity often engage in more due diligence than corporates, notably where the business operates in a different market to their existing portfolio assets.

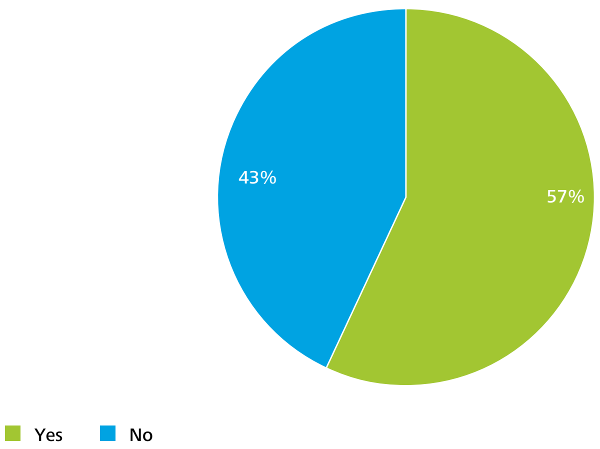
What are the key themes of private equity involvement in a process?



Over half of our respondents have altered their approach to transaction processes as a result of prior interaction with private equity, notably by:

- Being more aggressive, particularly in negotiations;
- "Front loading" a process by ensuring a strong information flow, particularly where potential PE buyers are new to the sector; and
- Being wary of differences in Management style and priorities which may impact post transaction.

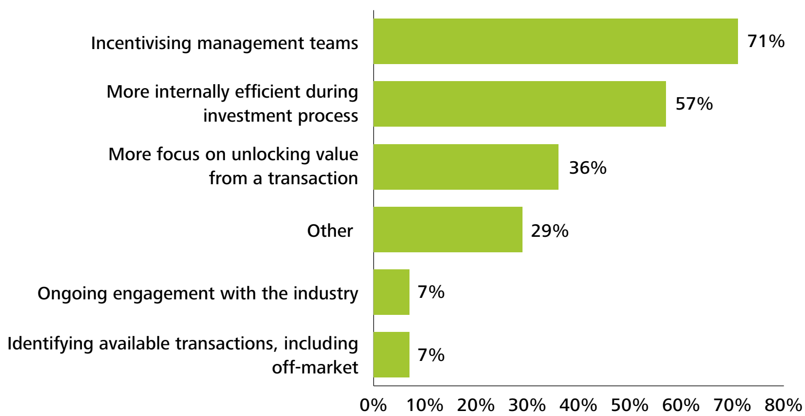
Has your involvement with private equity changed your approach to conducting a transaction in any way?



In your experience, in what areas does private equity typically differ in its investment approach compared with corporates?

The three key differences identified by our respondents were:

- Incentivising the management team.
- Speed of decision making.
- Focus on extracting maximum value from each transaction.



Our Manufacturing and Industrials M&A Specialists

Our team of M&A experts across the firm have extensive experience in providing innovative industry specific solutions to the Manufacturing and Industrials Industry. If you would like to discuss any of the findings in this publication or find out more about our services to the Manufacturing and Industrials industry, please contact one of the specialists listed below:

Transaction Services

Ross James
Partner, Corporate Finance Transaction Services
CF Manufacturing and Industrials Lead
020 7007 8192
rossjames@deloitte.co.uk

Pauline Biddle
Partner, Corporate Finance Transaction Services
UK Aerospace & Defence M&A Industry Lead
0118 322 2452
pbiddle@deloitte.co.uk

Duncan Johnston
Partner, Corporate Finance Transaction Services
020 7303 3849
dujohnston@deloitte.co.uk

Catherine Watts
Director, Corporate Finance Transaction Services
020 7007 2570
catherinewatts@deloitte.co.uk

Corporate Finance Advisory

Mark Adams
Partner, Corporate Finance Advisory
Industrials and UK Industry Leader for Chemicals
020 7007 3624
mjadams@deloitte.co.uk

Nick Wood
Director, Corporate Finance Advisory
UK Industry Leader for PPP
020 7007 2249
nwood@deloitte.co.uk

Tom Frankum
Director, Corporate Finance Advisory
020 7303 6636
tfrankum@deloitte.co.uk

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About the Deloitte UK Manufacturing and Industrials M&A Predictions

The Deloitte UK Manufacturing and Industrials M&A Predictions is a biannual summary of the views of CEOs, CFOs and M&A Directors of UK and European Manufacturing and Industrial companies (publicly listed, or private UK businesses).

The Deloitte UK Manufacturing and Industrial M&A Predictions gauges forward-looking expectations for M&A and the capital markets. The survey took place between 10 October and 10 November 2014.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000
Fax: +44 (0) 20 7583 1198.

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