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Time to get focused

2016 Manufacturing & Industrials
M&A Predictions

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Foreword

Crystal ball gazing

Twice a year Deloitte surveys M&A professionals in UK-based manufacturing, chemicals and packaging businesses. This survey was conducted at the end of the third quarter, giving us an excellent chance to hear what people were thinking about the future a full three months after the Brexit vote. We found that the shock had died down and business was returning to normal.

Our survey respondents were overall quite positive about the future and positive about M&A, especially outside the UK. This was a big shift from how they felt when we last questioned them in March, when sentiment seemed to be more hesitant.

Duncan Johnston
Partner – Transaction Services, Financial Advisory
Manufacturing and Industrials Lead

"[Actively doing deals] has always been our strategy, Brexit *brings no changes*."

Survey respondent, M&A executive at Fortune 200 company

UK Industrial Products M&A Survey and Outlook

'May you live in interesting times'

By most measures, 2016 is shaping up to be a strong year for M&A globally. Totals by value are less than in 2015, which saw $4.2 trillion of deals done, an all-time high that surpassed the previous record set in 2007 *(see Figure 1)*. Year-to-date levels are similar to 2014, another very respectable year, making it the third year in succession to pass $2 trillion by the end of the third quarter *(see Figure 2)*.

Figure 1: Worldwide Mergers & Acquisitions
($billions)

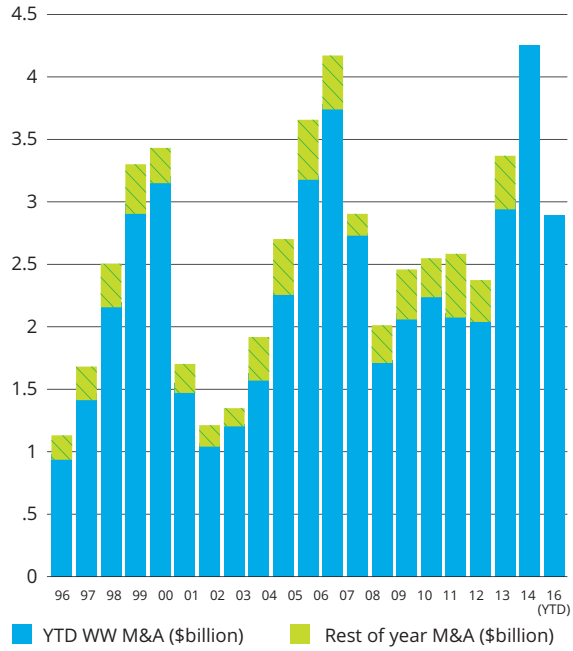
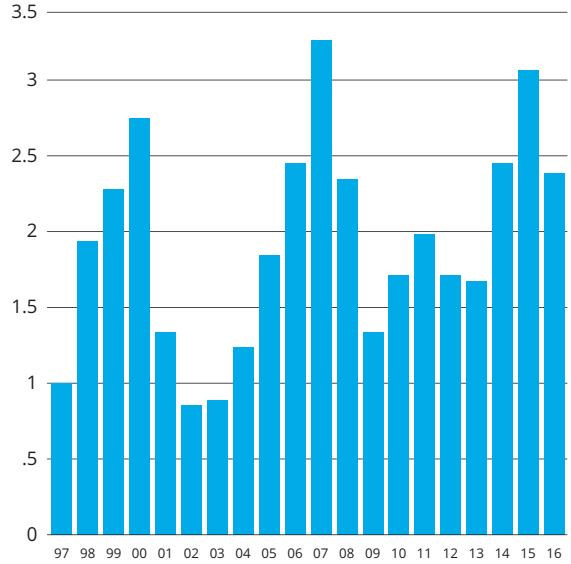


Figure 2: YTD (3Q) comparisons
($billions)



Source: Thomson

Figure 3: Withdrawn M&A

Source: Thomson

The lower total, down about 22 per cent from 2015, is due to a number of factors. One is an increase in uncertainty in two key M&A markets, the UK and the US, caused respectively by the Brexit vote in June and the US presidential election in November. Another is the increase in M&A deals announced and then subsequently called off, which have reached a new peak *(see Figure 3)*.

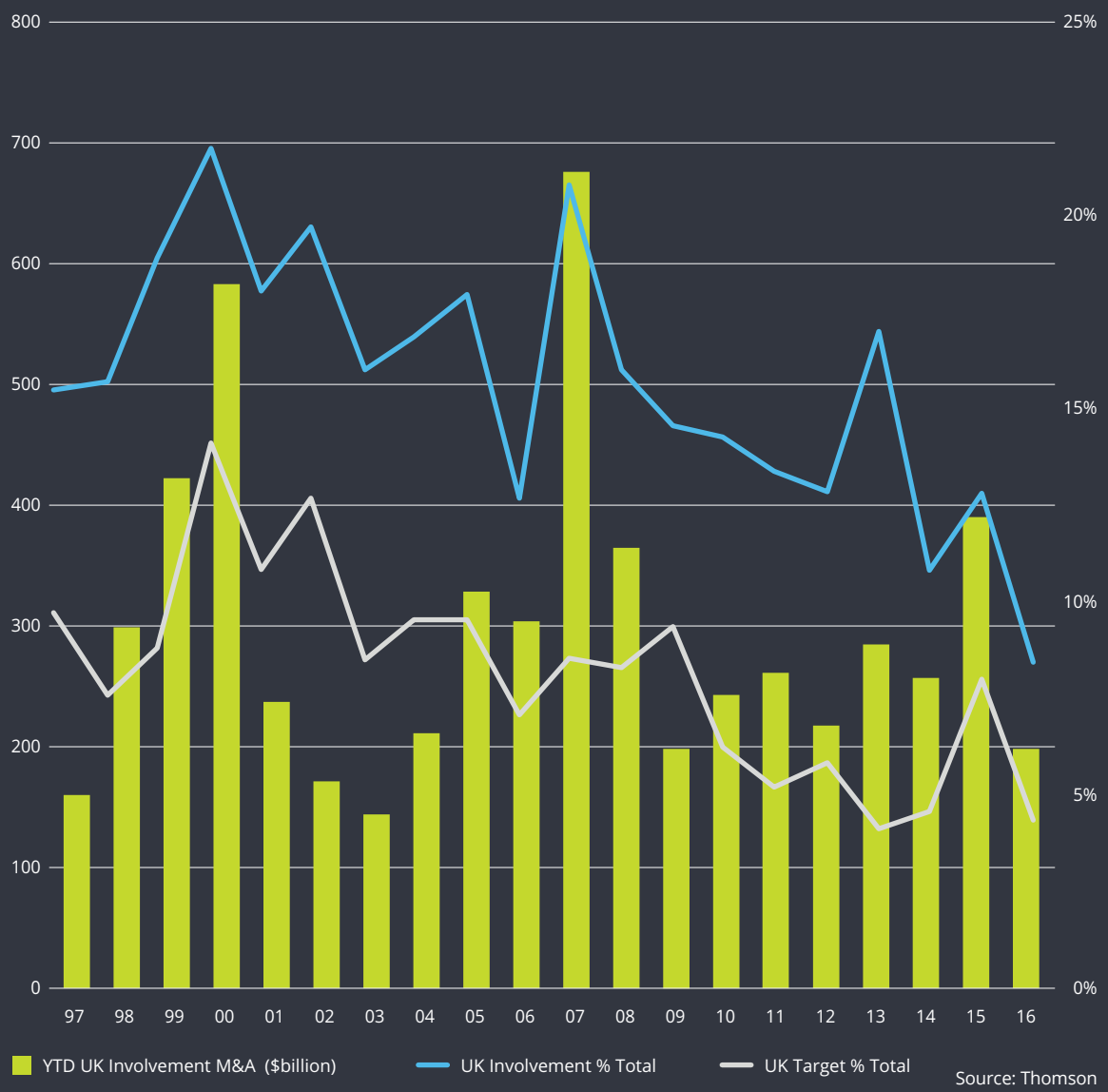
Financing remains cheap and availability remains good, but high valuation multiples and an absence of large businesses coming up for sale have restricted the volume of private equity deals. Top sectors in this year's deals include technology, energy and power, materials and industrials.

Industrials M&A (including chemicals) in 2016 has been strong, including some of the biggest deals of the year: Johnson Controls' acquisition of Tyco International in January and CNCC's announced takeover of Syngenta in February. We note that the total value of M&A deals in any given year can be impacted significantly by a handful of 'mega-deals', which are also the ones most likely to run into legal or regulatory roadblocks.

The UK environment

Normally one of the top five markets globally, and the most active among EU countries by value, M&A with UK involvement has fallen to eight per cent of total global deals, the lowest percentage on record *(see Figure 4)*. Q2 deal-making in the run-up to the Brexit vote was particularly quiet.

Figure 4: UK-involvement M&A



Source: Thomson

Britain means Brexit

The immediate effect of the referendum result was a drop in the value of sterling, initially considered as a trigger for opportunistic deals. UK inbound M&A did see four big deals totalling $55.2 billion announced in the weeks after Brexit. The FTSE, however, rose to adjust share prices for companies with substantial overseas earnings. This offset the drop in the value of the pound, and deal-making dried up.

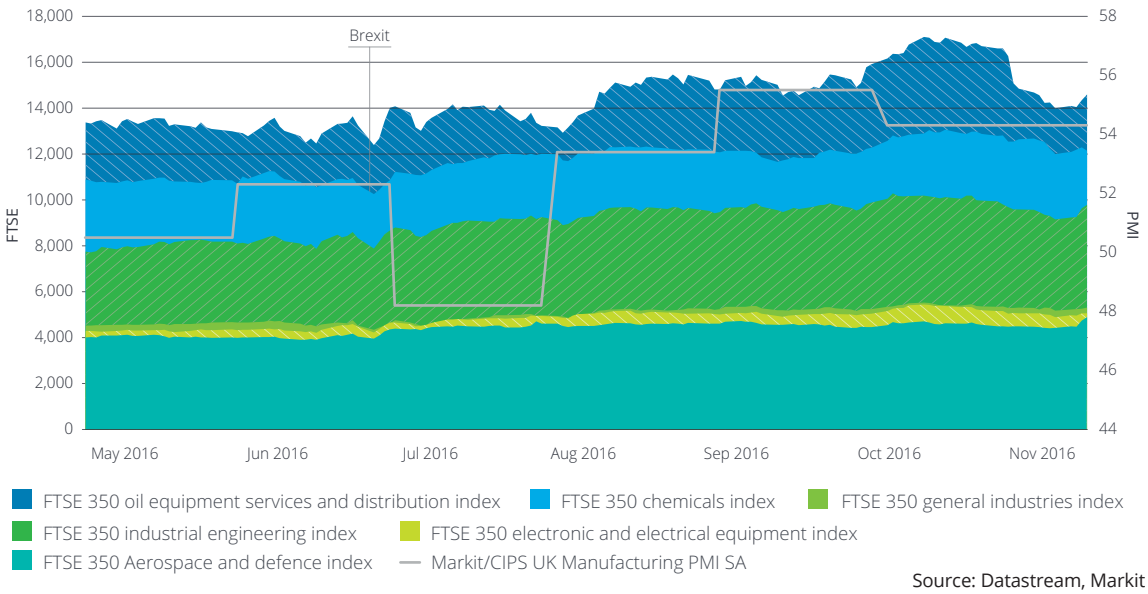
UK domestic transactions are down 62 per cent from the same period in 2015 and are at the lowest level for the same period since 1986. UK outbound M&A was up 59 per cent over the same period last year, attributable to a British tobacco firm's bid for an American competitor.

Industrial companies featured in some of the post-Brexit M&A, but these were mostly smaller deals. The largest to date has been Melrose Industries' £2.2 billion acquisition of Nortek, a US manufacturer of air management and security systems. So far, UK industrial companies have not been a target of opportunistic buying.

Defying expectations, most UK industrial indicators have remained robust, suggesting a more resilient sector than anticipated. The FTSE indices for industrial sectors have been up over the past six months, and UK manufacturing PMI, despite dipping in the month after the Brexit vote, has remained buoyant, hitting a 27-month high in September *(see Figure 5)*.

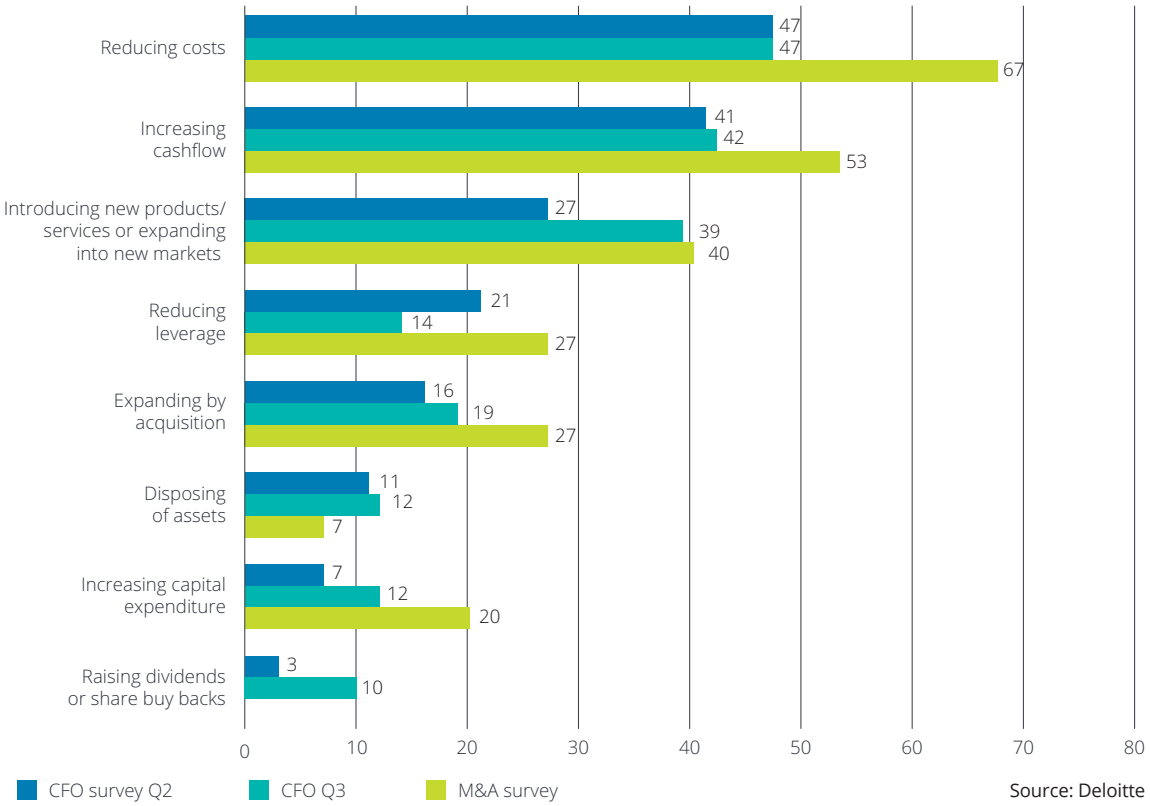
The fall in the currency was part of the reason for this, as industrial exports became more competitively priced. The September industrial PMI capped the best quarter of the year for economic indicators. And so far, the weaker pound has been the only big change affecting industrial companies since the Brexit vote. Yet the longer-term effects of the currency depreciation might offset some of these advantages: input prices jumped markedly in the October PMI report, the fourth highest on record.

Figure 5: UK Industrial indicators and share prices



Source: Datastream, Markit

Figure 6: Top priorities for the next 12 months



Source: Deloitte

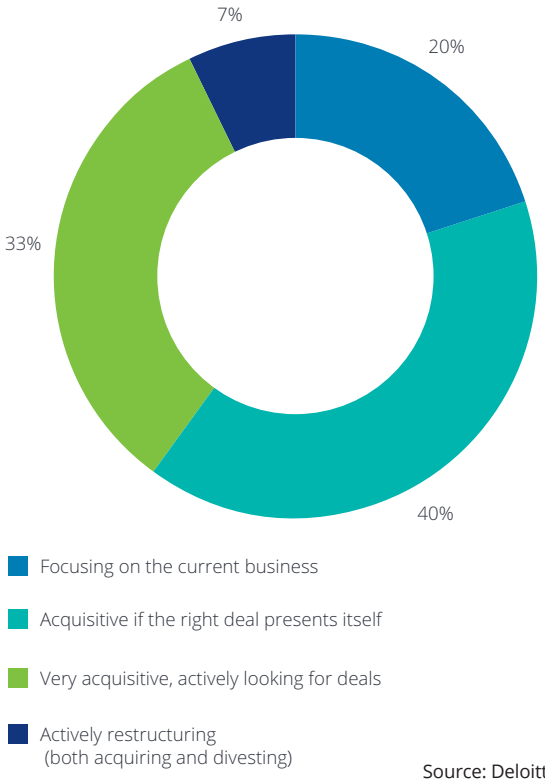
Our respondents echoed these relatively optimistic sentiments. We asked those surveyed to rate their top priorities in the coming 12 months and compared their answers to those of the Deloitte CFO Survey. UK industrials companies have similarly prioritised defensive strategies, such as increasing cash reserves and reducing leverage, but they also indicate a more bullish streak and are actively pursuing M&A *(see Figure 6)*.

Over 80 per cent of those surveyed expressed interest in doing deals *(see Figure 7)*. One decision-maker who reported that he was actively looking to do deals wrote, "This has always been our strategy, Brexit *brings no changes*" (emphasis his).

Key motivations are to expand into other sectors or to gain market share. One executive from an industrial conglomerate commented, "[We are] searching for higher growth markets and are looking more at software companies than straight product manufacturing."

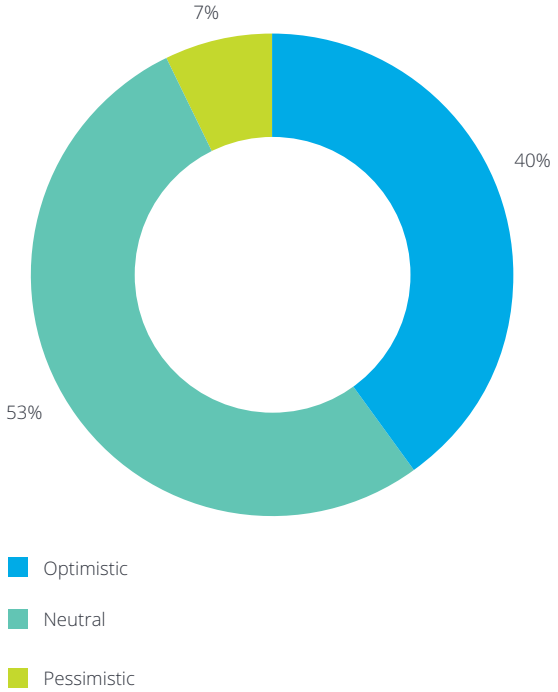
To a greater extent this year than in previous surveys, they expect earnings multiples to decrease – meaning it could be a very good time to buy. One reply stated, "Profits will recover, reducing multiples in some cases."

Figure 7: Current M&A strategy



Source: Deloitte

Figure 8: Sector financial prospects



Source: Deloitte

They are more neutral about the sector's financial prospects than they were in March: less pessimistic but also less optimistic. The majority seem to have adopted a 'wait and see' approach until there is more clarity on what sort of Brexit deal will be reached *(see Figure 8)*. To a greater extent this year than in previous surveys, they expect earnings multiples to decrease – meaning it could be a very good time to buy. One reply stated, "Profits will recover, reducing multiples in some cases."

Respondents report that the biggest obstacles to acquisitions are a lack of available targets, and agreement on price. One big turnaround from previous surveys is that buyers are looking at businesses in the same or adjacent sectors for acquisition opportunities, and private equity and distressed assets have decreased markedly as a preferred source of deals.

So perhaps Brexit has imposed some discipline? Unlike in previous surveys and consistent with their stated priority to increase cash flow and reduce leverage, companies would now prefer to finance their deals from cash reserves, rather than through debt.

One executive from an industrial conglomerate commented, "[We are] searching for higher growth markets and are looking more at software companies than straight product manufacturing."

Looking ahead

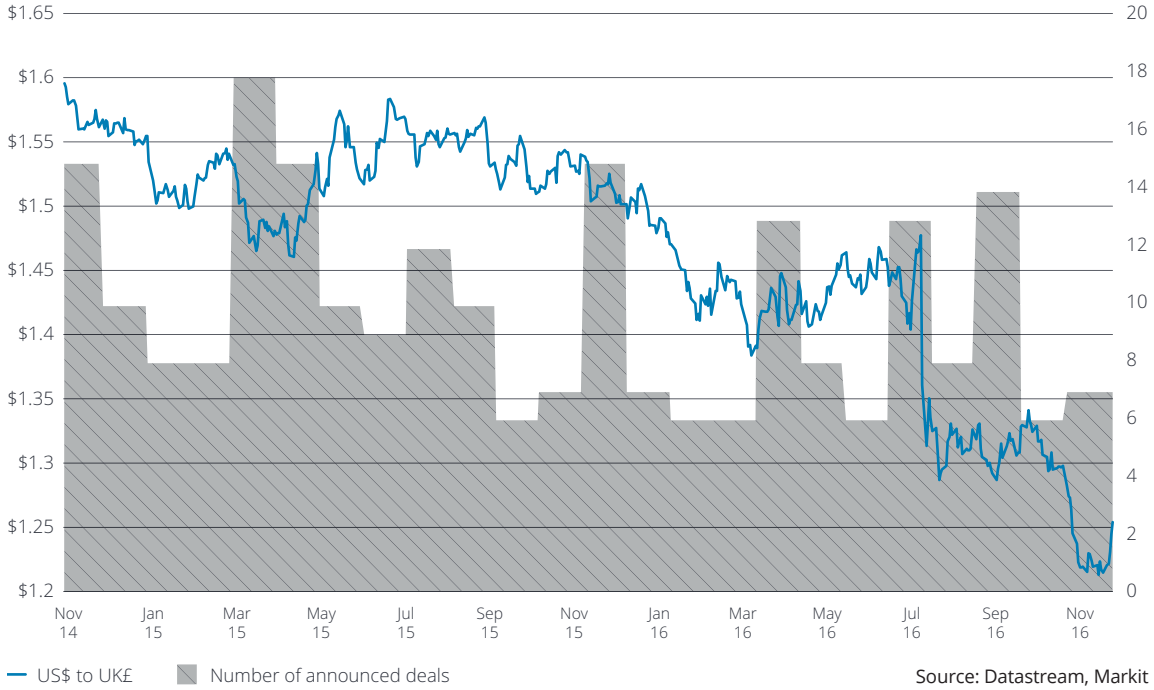
UK industrials companies, especially those in the FTSE 350, could be among those looking to acquire. Industrials is the sector most likely to see the highest M&A activity over the next 12 months, according to a Mergermarket survey.[1]

The profitability of capital goods companies increased considerably between 2010 and 2015, according to one analysis, then fell back on low organic growth and decline in key end markets.[2] As some of these end markets remain at the low end of the cycle, improvement is not expected in the sector in the next two to three years. We think this has the potential to drive cash-rich UK industrial companies to seek overseas deals, expanding their market share and geographical coverage. Our survey results support this view.

On the other hand, the continued weakness of the pound could encourage overseas companies to buy UK targets. In the past two years, there has been a noticeable uptick in deals done when the currency drops *(see Figure 9).*

Offsetting that, however, would be a Brexit deal that results in UK companies facing restrictions to tariff-free access to the European Single Market. With the election of Donald Trump in the US in November, some analysts, including Deloitte economists, have suggested that this could usher in a more protectionist era, impacting trade globally.

Figure 9: Currency movements and deals announced



Source: Datastream, Markit

[1] CMS-Mergermarket, "Into the unknown: European M&A Outlook 2016," November, p.16.
[2] UK Capital Goods: Rising above the Uncertainty, Deutsche Bank, 31 October 2016, p. 4.

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:

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Designed and produced by The Creative Studio at Deloitte, London. J9867