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A2Z MANUFACTURING

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Is This The Competitor You Should Really Be Worrying About?

FOCUS

Investment Banking # LEADING THE WAY FOR FUTURE GROWTH

Merger and acquisition activity has accelerated in the precision machining industry due to the confluence of three fundamental technological and market forces.

- Large capital inflows from **private equity funds**
- Automated, **digital manufacturing** processes
- **Digital integration** of the supply chain

The capital required to simply stay competitive is likely to soon leave a substantial portion of the industry field behind. The average firm owner may not yet have felt a serious impact, but complacency about the changes underway will threaten the competitive position of many industry participants and can have a serious impact on the equity they have taken years to build. Owners must recognize and confront pro-actively the building pressures for exploring a non-organic growth model.

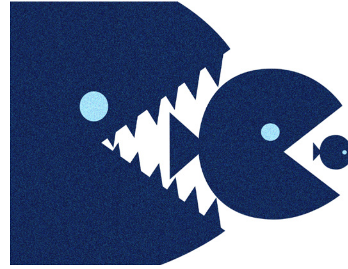
According to IBIS World, there were 18,000 machine shops in the United States at the end of 2016, with the majority employing fewer than 20 people. This results from a historically low monetary barrier to entry. One or more highly experienced machinists have been able to lease space and equipment, bring along a friendly customer and grow a new business from there. Often, this roadmap has allowed for a reasonable living and even the building of decent retirement equity. However, times are changing, and changing quickly.

Large private equity funds have zeroed in on precision machining and they know a business opportunity when they see one: a highly fragmented and undercapitalized competitive field, pressure from the OEM's and Tier 1's propagating down through the supply chain, and an entirely new plateau of technology and associated skill sets that will require a major revision in how future business is won and done. This money flow really matters.

The market forces reshaping the industry so profoundly are joined at the hip with the most critical resource of all – capital. If you don't make it your business partner, it may quickly become your worst adversary. For shops focused on the major high precision supply chain verticals such as aerospace, defense, automotive, medical, and soon, autonomous systems and robotics, this is especially true.

Private equity-backed firms are assembling aggressive fully integrated, highly automated, regional to national businesses. These are digitally connected from the shop floor to corner office, with advanced analytics and management software and design tools and weaponized sales forces. As they attain revenue bases well into the hundreds of millions annually, they'll set a high bar for production efficiency, cost, quality and networked supply chain relationships that will pressure industry margins top to bottom.

You may have read about IIOT (Industrial Internet of Things) and



Capital flows are creating an aggressive new competitor

Industry 4.0 (cyber – physical manufacturing). These terms reflect a real technological transformation on the shop floor, in early stages perhaps, but with a profound impact on the balance sheet. With a single high-end automated machining cell easily running to seven figures, many shops struggle with the reality that one system is out of reach, let alone a dozen. Getting efficiencies and useable data from advanced machine centers isn't feasible without additional investment in analytics, sophisticated business process management systems, network security, and digitally savvy salesforces (with a marketing budget).

Wes Colony, Territory Manager for Single Source Solutions, covers over 1,000 machining shops in Southern California and has a keen eye on the industry's dilemma. He sees shop after shop, even those north of the $10 million revenue range, really struggling with the capital investment required to acquire leading edge technology and automation. "In the past 12 months, I've seen more small to medium sized owners really struggling with the best decision path," Wes says, "even though the end game is fairly obvious."

Additive manufacturing is also a rising threat to traditional milling, but while its current share of the revenue pie is trivial right now, the technical capability is advancing very rapidly as is customer acceptance and familiarity. (GE recently spent $1.4 billion on metal additive capability in its purchases of SLM and Arcam, having seen firsthand the benefits of the technology as applied to its engine design parameters, performance and cost). The design, engineering and material knowledge skillsets are substantially different and the necessary investment is expensive. At FOCUS, we see the fusion of both capabilities in an integrated precision shop in near future, where the design, finishing and metrology requirements can be combined into a "best solution/lowest cost" offering.

Finally, industry consolidation is being driven top down by the OEM's and Tier 1 customers. Once, Boeing drove down costs by bidding work across its 10,000 suppliers, but there is little left to squeeze. The new multi-tier supply chain is becoming fully digitally linked, with order and design change management, production status, Cp metrics, and inventory status available in real time in an orchestrated fashion. Outside aerospace and medical, the same capabilities will soon facilitate supply chain hubs and online marketplaces across more industries, further pressuring the margins of the smaller player.

Investment funds partnered with top, seasoned management teams are generating aggressive competition. Firms with a large capital base will be able to make these investments in technology and a new data savvy talent pool, and amortize these costs across a sufficiently sized organization to radically reset the cost base and customer service standards for the industry. Undercapitalized firms left behind will become progressively uncompetitive, and could eventually be tagged "going concern" risks and excluded from bidding. The minimum viable size for a shop to compete profitably at this level is rising, and may well reach an annual revenue base of $30-40 million once this settles out. Many private-equity investors, and their platform companies, think it will be considerably larger than that… and are investing accordingly.

Bob Qualick, General Manager of Universal Aerospace Co., Inc. of Arlington, WA, agrees that scale is more important than ever to US precision manufacturing. Universal, a precision supplier to the commercial aerospace industry, recently partnered with Strength Capital, a Michigan-based private equity fund after an introduction through FOCUS. "Companies which embrace lean manufacturing systems, successfully deploy automation and technology, and can measure and analyze data, will ultimately succeed and prosper. Today's manufacturers need to be bigger, smarter and more vertically integrated to compete," Bob predicts. "With a Strength / Universal combination, we can invest in our mission to continously to raise the bar and exceed our customers' expectations."

Is this the view from your office?

The implications for future margin pressure should be cause for concern. There may not be many obvious ways for the small to medium sized owner to address it. However, the value of the shop owner's equity might be of even greater concern. As M&A advisors, we see literally billions of dollars of hard earned owner equity at significant risk of vaporizing if owners don't consider all their options and strike up a plan.

Owners should ask this question: is there any realistic organic growth roadmap that will carry me to that revenue ballpark over that time frame? If not, then it is time for some deep and honest reflection. Even if you are successful growing the top line 7-8% per year, but your margins drop 60% to keep things spinning, you are losing substantial equity over time -- perhaps millions -- and with it the financial wherewithal to manage or sell your way out of an increasingly perilous situation.

If full independence remains an overriding goal, taking in minority equity investment may be an option, but it is likely to have to come from friends and family, as venture capital and angel investor options are slim for this industry.

The second option is to partner with a much larger participant with an established balance sheet or private equity backing. Many shops will have undoubtedly received a call or two to explore this. Partnering up is not tantamount to retirement, though it can be. Just as often, deals ensure continuation of owner/managers in the new company. These deals should be explored to see how well the managements fit, and how attractive are the future compensation and growth strategy possibilities. A sale may also reduce or eliminate many unpopular administrative burdens, enabling the former owner/entrepreneur to focus on those activities at which he is best, typically production or sales. Frequently, acquisition offers a better overall equity outcome than the "grow and sell later" strategy, and may offer a second bite at the apple as the consolidation phase continues with the largest players.

A good example is the sale of our client Smiths Machine to ARCH Global Precision. Smiths was a family business with great customers, advanced equipment and a strong workforce. Continued growth and funding a generational transition demanded additional capital, which could only come from outside existing ownership. FOCUS assisted the firm in exploring a variety of options including private equity, but the best solution was a sale to ARCH, a large national leader in the precision machining sector.

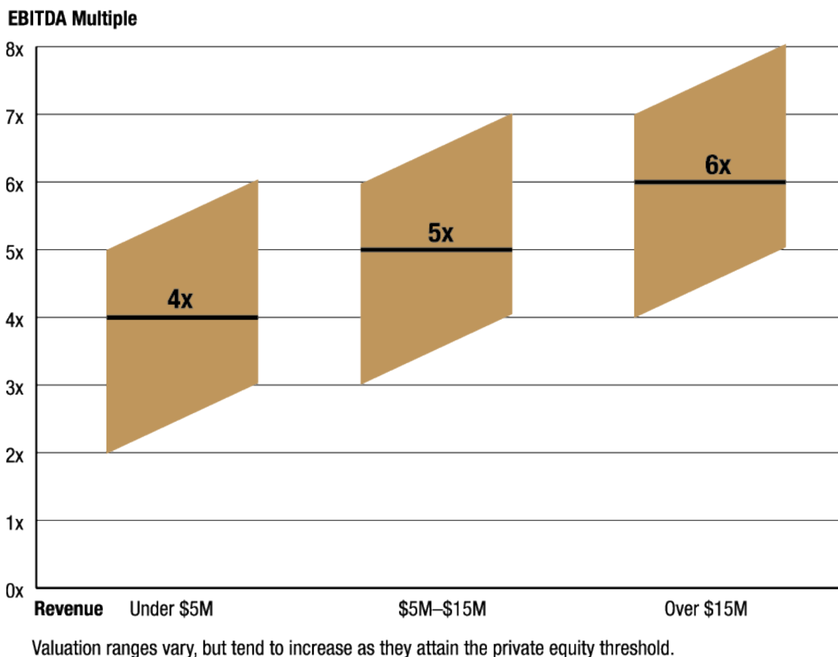
Two years on the sale has been an unalloyed success. Smiths is growing rapidly and is a standout performer for ARCH. Even more important, the Smith family has continued to play an important role in the company. Tim Smith, company CEO, has now graduated within the ARCH organization to head its national sales and marketing efforts in the key aerospace and defense sector. According to Tim Smith, "When we entered into this process, we assumed, like many entrepreneurs, that we wanted to remain independent. The sale to ARCH turned out to be the best thing that could have happened, both for the business and for our family."

A third, less explored, model is to merge several smaller, well matched shops, achieving sufficient scale to attract both private equity investment and industry partners, generally $2 million in EBITDA or higher. Company valuations in this space are a nuanced function of EBITDA, margin ratios and size, seasoned with the uniqueness of each company's management, customers, equipment and so forth, but size and profitability are key.

Valuations are typically referenced as a multiple of EBITDA (4 – 6.5 times is the center range), and increase rapidly from 3-4 times for firms with EBITDA under $1 million, to 6 times or more for firms with profits north of $5 million but with a large amount of scatter. They also assume a "debt free" basis, to account for different levels of debt or equipment leases.

There can be substantial variation, however, in valuations even for companies of equal revenues and/or profitability. In many cases valuations are influenced by the process a firm follows in pursuit of a transaction, and by the effectiveness of its advisors and its management in presenting its strengths and capabilities.

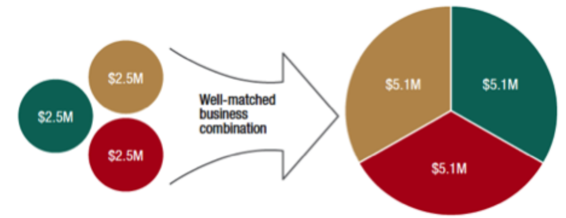
Valuation Trends



Valuation ranges vary, but tend to increase as they attain the private equity threshold.

Mergers amongst smaller players may lead to substantial gains in owner equity. Take a hypothetical healthy smaller company with $5mm in revenues, perhaps $1mm in EBITDA (20% margins), and $1.5mm in debt or equipment leases. It would not be surprising for a company of this size and profitability to sell for $4,000,000, (4X EBITDA) leaving the owner with about $2,500,000 in owner equity after accounting for debt. However, were the company three times the size with the same ratios of debt and profitability, the multiple may well expand to 5X or 6X EBITDA or even greater.

Consider what could happen if three similar owners with complementary businesses and the same metrics as above agree to merge and shine up the profit ratios just 10% with combined administration and sales teams. Assuming the combined business can coalesce well and demonstrate brighter growth prospects and broadened capabilities, the multiple should expand materially. If now valued at a premium 6X multiple ($19,800,000 valuation on $3.3M EBITDA) the three owners would now equally share net equity of $15,300,000, or $5,100,000 each. This is a nice 100+% improvement over each owner's stand-alone valuation before the combination.



A smart merger of smaller firms can yield attractive results.

If this partnership now chooses to explore a sale, it is likely to attract a better choice of potential partners. If not, it now likely has a better choice of financing options, a better foundation for effective technology investment and a lower risk profile in the supply chain. Either way, it illustrates there are very compelling financial and strategic reasons for investigating this strategy.

Corporate marriage is stressful, and mergers amongst equals may well be harder to negotiate in practice than conventional acquisitions, as more ownership interests are involved, but the result can truly be beneficial for all. To keep pace with industry trendsetters, owners should always explore options for non-organic growth, and retain licensed M&A advisors to assess appropriate strategy and partnering transactions.

The authors, Craig Ladkin and John Slater, Managing Director and Partner respectively of FOCUS Investment Banking, are members of the FOCUS Advanced Manufacturing and Automation Team. They have managed multiple M&A transactions in the machining and aerospace sectors, including the recent sales of Universal Aerospace Co., Inc., Smiths Machine and RID-LOM Precision Manufacturing Co.

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