OWNERS: KEEP YOUR EYE ON YOUR EQUITY!

If you're a precision machine shop owner, things are looking good right now. The economy is re-opening, and orders are piling up; in fact, your biggest problem may be keeping up with demand.

But does that mean your business is destined to continue to get more valuable as revenue grows? Not necessarily. It's complicated.

Many shop owners have been contemplating selling because valuations are now at record levels, fed by the post-pandemic rebound and private equity's desire to put their low-cost capital to work. But with business so good, many owners are thinking they should continue to grow the business and cash in down the road.

However, the dynamics of the business are changing, the basis of competition is evolving, and owners are strongly encouraged to develop a strategy that is equity-focused, not sales-focused. An equity strategy is one that focuses on maximizing your invested wealth, after taxes, come your retirement date. Smaller independent businesses have a high-risk profile due to business concentration and lack of liquidity, and that's particularly true in an industry that's consolidating. An equity strategy explores all your options to grow the value of your business interests and your overall wealth over time. It keeps the eye better trained on the strategic risks of the business and the risks to the family balance sheet over the long term.

Where many owners err is in thinking that their equity in the business is growing just because their sales are growing. But they lose sight of the fact that company valuations—what prospective buyers are willing to pay—are based on a complex combination of company-specific, industry-specific and macro-economic factors; some you can influence, and some you can't. Your equity strategy, whose purpose is to secure your personal and family's needs and goals, needs to be founded on a realistic assessment of both risks and opportunities and a forecast of how these factors may affect future value.

An equity strategy for a consolidating industry

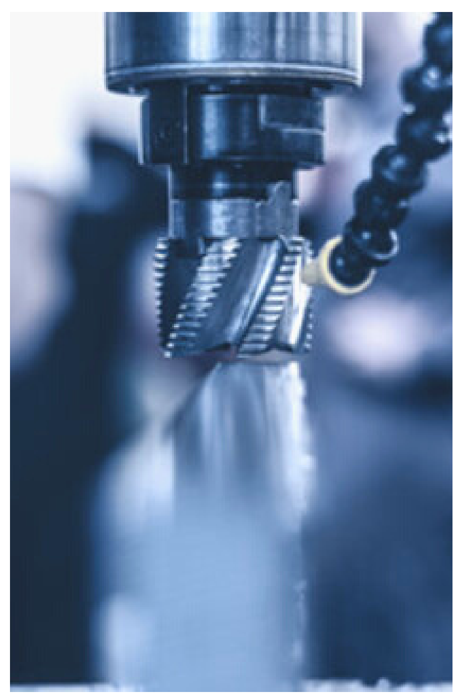
FOCUS has been in business for almost 40 years and we are well versed in the dynamics of industry consolidation. The precision machining business has all the classic drivers of a consolidating industry, and there is no way around it. Driven by money, technology and the supply chain itself, the industry is “in play” and we have a very good idea of where it will end up. If it follows the classic pattern, the strong will get stronger and the weak will get weaker.

Scale and **capital** are the trump cards that will drive the business to max efficiency that the supply chain will demand, and most importantly, sustainable margins. That requires you as an owner to cast an eye forward, assess your competitive and financial strengths, the stage of the financial cycle we’re in, and plan a navigable route to the equity goal and timing that works for you. You will find there are multiple ways to get there—and just as many ways you won’t.

The profit squeeze

In a highly fragmented industry entering into major consolidation, the bottom third of participants are typically most at risk and many won’t survive. Partnering may be a necessity, not a choice. Advanced technologies and automation are significantly upping the financial ante. New competitive technologies, like additive and new materials, can create additional headwinds. These advances demand new skill sets, inclusive of management, not developed on the shop floor as they once were. All roads lead to the need to scale up, and that takes capital. It’s hard to compete at the poker table with the shortest chip stack in the room.

The usual pattern is as follows: The larger, better capitalized (PE-backed) regional players invest for cost efficiency, attract the best talent, expand their capabilities, and generally make life easier for their customers. Infotech and connectivity increase transparency, putting pressure on old relationships. Margins will come under pressure to the point where owners will have to make costly investments to remain competitive—and profitable—or get left behind and possibly be put out of business. But if you can’t afford to make that investment to stay in the game, it’s a path to eventual trouble. Indeed, just because you want to remain in business doesn’t mean you should.



We’ve seen this scenario play out in plenty of other industries—from local print shops to tire shops to semiconductors—where small firms were pushed out by more efficient players or overtaken by new technology, or both, to the point that only a small number of large players remain.

The same thing is happening in the precision machining business, although it's still at an early stage. But make no mistake that it’s going to happen. Bigger companies around you are getting more efficient and are able to work on tighter and tighter margins. Eventually those shops that don’t make the investment won't be able to compete on margins. Jabil, a goliath serving the electronics industry, has an EBITDA margin of less than 7%, and Apple loves it. Precision machining operates at 18-22% EBITDA margins, so there is a lot of fat to cut out, and we bet Boeing will like that, too.

We estimate that there are 8,000 to 10,000 machine shops across the U.S., the vast majority of which are one facility, family-owned businesses. That's simply too many for large manufacturers to deal with. They want to deal with a smaller supply chain that can produce parts the fastest, at the lowest cost, and with real-time transparency. That means those with the best machines, the lowest cost of capital, strong buying power, and the best information systems.

If you're a smaller- to medium-sized machine shop, you probably can't afford all the technology you will need to compete. Simply put, technology is making the precision machining business a more expensive place to play. And if you can't afford the investment, you may find yourself between the proverbial rock and a hard place.

Private equity's role

Right now, the private equity industry sees the precision machining business as fertile ground for investment: a highly-fragmented industry ripe for consolidation into larger companies with the efficiencies, quality, and buying power necessary to compete. That's what driving the recent runup in valuations to the highest they have been in the last 10 to 15 years. We've also recently seen as many as 20 offers on smaller machining companies. This combination screams "peak cycle" to us.

The question is, how long will this last?

We don't pretend to have a crystal ball. But one thing we do know as investment bankers is that the M&A market, like the stock or housing markets, is cyclical. Company valuations can change significantly even if the overall business grows.

Here's a scenario to avoid: Let's say you have 20% profit margins today and your plan is to sell in four or five years. But then your margins drop to 15% or less because of competitive pressures. That's a 25% hit to your equity. If interest rates rise (likely), which raises the cost of capital to PE buyers, and they drop the multiple they can pay from 7X to 6X or 5.5X, you may have lost 40% of your equity over that time, even while growing your business. In other words, the M&A cycle matters to the equity strategy.

One way this could be avoided is not by exiting the industry, but by partnering with strength, and potentially getting a "second bite at the apple." This is because PE-backed firms will also eventually sell, usually on a five- to seven-year horizon, allowing owners and managers in the system to sell up again at a higher multiple still. Putting some of your chips into more diversified investments reduces risk. This might play better to the owner's long-term equity strategy than staying the course as an independent.

Still, owners who love the game and want to continue independently in a consolidating industry need a different strategy—perhaps by raising mezzanine capital and being the acquiror … and building sustainable scale and value for an exit 15 years down the road. That can work too.

Every owner should sit down with their advisors (and family) and formulate an equity strategy and business action plan. If you're at the lower end of the revenue spectrum, we think that's especially critical, because the organic growth model that worked before is going to get increasingly risky going forward.

About the Author

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