Q4 2020

Privcap/ Report

Q4 2020 | Dealmaker Roundup

Gear Change for U.S. Manufacturing

- COVID impact on portfolio companies
- Technology haves and have-nots
- Just-in-time vs. just-in-case
- Disrupted supply chains
- Appetite for acquisitions

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Gear Change for U.S. Manufacturing

This report is based on an edited transcript of a recent Privcap podcast.
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Privcap: Christen, as an investor in manufacturing companies, please give an overview of how the COVID crisis has affected your portfolio and deal flow.

Christen Paras, MiddleGround Capital: A lot of people don't realize that we were in the midst of a mini industrial and manufacturing recession back in 2019. For example, looking at the Purchasing Manager's Index—which is largely based on new orders, inventory levels, production, supplier deliveries and employment—you saw that index plummet below 50 percent. Below 50 percent implies a contraction and some suffering in the manufacturing sector. You saw that index plummet in April as COVID really hit, but leading into COVID, there was pressure from tariffs and trade wars. Then, you had some rebound, depending on the end markets you were in.

MiddleGround had a great Q4 2020 across the board. We have real diversity in terms of end markets. Even though we own a portfolio today of six manufacturing businesses, they all have exposure to various parts of the economy. April and May, when the brunt of the pandemic hit, really did affect them in a lot of different ways.

To your question about deal flow, it really fell off back in March, April and May. But, over the past 60 to 90 days, we've seen a real pickup in smaller opportunities below what we would see to be a threshold for a platform. The larger deals may be somewhat delayed.

Privcap: Eric and Jason, as advisors to the M&A market and private equity market, what have you seen happen to the manufacturing industry in these interesting times?

Eric Michael, RSM: After the initial impact—and to the point Christen made—the last 30, 60, 90 days have seen significant pickups in certain sub-sectors. A lot of businesses saw closures, but only for a couple of weeks. You still have some people who are very conservative and they're stepping back and saying, "All right, we're not going to do anything until more of this rebounds." You have other people who are on the attack, going after smaller, opportunistic plays.

Jason Alexander, RSM: For a lot of the bigger deals, you're just not seeing a lot of those right now. A lot of companies are looking at deals that will help boost productivity or cut costs. On the private equity side, I've seen firms pushing their portfolio companies to really become more productive and more efficient. This has led to a significant increase in looking at two things from a technology perspective: robotic process automation and the implementation of much more robust data analytics programs. This would help increase visibility and create that additional sense of agility and transparency, especially as it relates to the supply chain.

CONTINUES ON NEXT PAGE

Privcap: Please talk further about how the three of you are focused on the small and middle market, and how different those markets are today from the very large industrial and manufacturing companies.

Paras: One of the cornerstones of our strategy is paying down debt right away, and using modest leverage to begin with. We create a lot of our returns at MiddleGround from our operational expertise that we can help the management team leverage, whether it's shop-floor improvements, focusing on cash-generation initiatives or EBITDA-enhancement activities.

We're very high-touch with our companies. One of the things we were able to do early on during COVID was to work hand-in-hand with management to develop action plans before a lot of this pandemic was taken very seriously at the state and federal level. Being able to manage through some of those challenges with our help has been great for our businesses. Our companies are relatively scaled relative to some of the smaller mom-and-pop competitors that are really suffering out there.

This is also a good time for us to add on to our existing platforms. We were able to do two add-ons and we have two more under LOI right now. In this market, you have a lot of groups out there that are smaller, that are suffering. They are aware of a possible change in tax code with an administration change. So, there are a lot of motivating factors. Getting through COVID was challenging—maybe they got some PPP money, maybe they didn't. We were able to be a good partner in this situation and to help our management teams think about the long-term, so they didn't have to scramble with forced layoffs, which would have put them in a hole when it came time for the ultimate rebound, which has been much quicker for a lot of our companies than originally forecasted.

Alexander: That's a great point, in terms of the pace of recovery. Manufacturing activity has come in well above the analysts' estimates. The pace of recovery has accelerated for a lot of the end markets that our clients are playing in right now. We have seen a divergence between the organizations that did invest in information technology before the pandemic versus the ones that didn't. Industry 4.0 technologies are going to enhance productivity on the shop floor and create greater transparency and resiliency in the supply chain. Historically, a lot of middle-market manufacturers have under-invested in technology infrastructure. So, to be able to take advantage of some of these advanced technologies nowadays, they're going to have to spend a significant amount of money bringing their infrastructure up to standards. This is going to be another case of diverging paths between the companies that see this as a strategic priority and those that don't.

Michael: Prior to acquisition, we're seeing a lot of buyers focus on these types of synergies and investments. They say, "We're buying a smaller company, usually not as sophisticated, don't always have that technology in place." They're bringing in guys like us to determine what it's going to cost. It's not just automating the workforce as much as being able to monitor and manage the workforce to be more efficient, because it always goes back to trying to cut costs as much as you can. More utilization equals more dollars.

Privcap: Christen mentioned trade wars. To what extent have assumptions about the global supply chain been upended by what's been going on over the past four years?

Alexander: The geopolitical tensions, especially those related to the United States and China, had a pretty significant impact on organizations' thought processes in terms of what their supply chains are going to look like on a going-forward basis.
If you look at what happened over the past 30 years, the focus of multinationals was, "Let's get our costs down to the cheapest possible just-in-time inventory." With the pandemic and then with the trade wars, we've seen disruptions to the supply chain, so organizations have taken a step back. They've gone from a just-in-time mindset to more of a just-in-case mindset. Ultimately, that's going to lead to further shifts. Organizations are going to be very focused on having that manufacturing and distribution closer to their end markets.

Paras: We invest in North American manufacturing businesses. Most of their supply chains are overwhelmingly domestic. So, we didn't really experience any negative issues directly in terms of having to reshuffle the deck and moving supply chains. That being said, we do serve a lot of large OEM industrial customers, and this is obviously something they've had to manage through. The potential is there for some re-shoring activity. We haven't really baked that into our forecast in our portfolio in terms of bringing a lot more domestically.

I agree with the point earlier about being closer to your end markets. Diversifying your supply chain, not being overly concentrated in any one region such as China, seems to be the immediate trend. But we're certainly optimistic about what it could mean for U.S. manufacturing and we look to capitalize on those opportunities.

Privcap: About 10 years ago, many American companies and private equity firms that invest in industrial companies were busy establishing China operations. What is the future of that?

Alexander: We don't think it's done. Our thesis is that supply chains are going to become much more regionalized. There is not enough capacity around the world right now to say, "We're not going to do it in China." Companies are going to take a step back and look at where ultimately those products are going to be destined. If you're going to have products that are going to ultimately be sold into the Chinese market, there's a strong possibility you're still going to have Chinese manufacturing operations and Chinese supply chains.

As you look at where production from an input perspective is going in the rest of the world, we're seeing a lot of companies look at shifting their production to Mexico or other locations in Southeast Asia. But, again, they are really focused on where ultimately the end market is going to be.

Privcap: How did the recession affect companies' abilities to manage their workforces?

Paras: The workforce is actually the biggest challenge. As COVID hit, we thought the rebound would be faster than what was suggested. We also knew that we really needed to manage a healthy workforce. One of the early things we did was put in place a continuous pay policy way before any of the federal stimulus went through, which basically said to our employees, "If you feel like you have COVID or flu-like symptoms, please stay home."

A lot of shop-floor workers who are making $15 an hour are often living pretty close to the edge. So, if they get sick, guess what they're doing? They're coming to work. In order to maintain the health and safety of our workforce, we wanted to give people the confidence that we were going to remove that worry. And, for the people who were coming into work, we wanted them to know that they have a safe environment.

"We were able to do two add-ons and we have two more under LOI right now."

–Christen Paras, MiddleGround Capital

We have about 30 facilities across our portfolio. We were pretty much open and operational across the board, with the exception of one or two that were forced to shut down. So, keeping that workforce intact was paramount. We didn't have any forced layoffs during that period. Now, while that was a little bit more expensive, it was the right long-term decision. It can be really challenging to ramp back up and meet increased demand if you don't have that workforce in place.

Privcap: Before a private equity deal or an M&A deal is done, what are buyers looking at by way of the workforce?

Michael: One of the biggest things that people are trying to understand is what did the company do to react to this crisis? And is it permanent? A lot of companies that had a knee-jerk reaction furloughed people. Other companies kept people on through the PPP loan. Then, when they brought them back, they figured out there was still uncertainty and they let people go.

Everybody's trying to figure out whether these are permanent terminations. Is this the ongoing workforce? The biggest challenge that we've been going through is all the uncertainty surrounding the environment and wondering what the new reality is? Can you do more with less? Do you need to revamp it back up to where it was prior to COVID, or is this the new normal?

Privcap: Let's touch again on the question of technology. You've mentioned that some U.S. manufacturing companies have not made an adequate investment in new technologies, and they risk getting left behind. What kinds of technologies are you watching most closely to see an adoption rate?

Paras: We often have to implement at least a more robust ERP system when we come into our ownership of these companies. A lot of the businesses that we look at are family owned. The level of sophistication around managing supply chain or other aspects of their organizations are definitely different from what you would expect from a sponsor-backed business. It's been that way for many years. So, that's usually a lot of the heavy lifting that we have to do.

Michael: You're seeing more buyers doing that work up front. Historically, it was always a wait-and-see game. People would sit back and say, "We'll deal with some of those technology issues—infrastructure, ERP—on the backend in six to 12 months." Sponsors are now saying, "In order for me to run this business, I need information. I need data. I need management reporting tools. I need proper accounting. I need ways to monitor and manage my inventory." Now, it's an accelerated time frame.

A lot of organizations are focused on investments in the cloud and predictive analytics, cybersecurity. They are looking at automation and robotics and looking at tools to help them better with predictive maintenance and predictive analysis.

Privcap: Obviously, distress in manufacturing can happen at any time, not just during a recession. What predictions do you have for distressed investment opportunities going forward?

Paras: There are definitely going to be opportunities across various verticals within the industrials landscape. One place we've chosen to focus is in the automotive industry. We have a lot of expertise there. A lot of our operators actually come from Toyota. We've spent time in auto trying to understand where the most disruptive trends are going to be as the automotive industry changes from purely transportation to more of a robust mobility industry. We've done a lot of work to identify trends around electrification of the power-train vehicle, lightweighting, autonomous driving, connected cars. Obviously, you saw a very unprecedented impact

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of COVID on the auto industry, where it completely shut down the entire supply base for several months. We have never seen that before. Many large suppliers are tier ones who are surviving on their working capital cycle. They are completely stretched. There are businesses that are good businesses but have bad balance sheets, that are extremely over-levered. They've had to invest in these new trends I mentioned to be relevant to the OEMs.

> "Historically, a lot of middle-market manufacturers have under-invested in technology infrastructure."
>
> –Eric Michael, RSM

Michael: You're seeing more and more carve-outs. Large organizations have non-core assets they're trying to shed for cash purposes to pay off debt and for a variety of other reasons. They're very unique opportunities. The problem is, not everyone is comfortable with carve-out situations in standing up those businesses. Sometimes, you're looking at businesses that don't make a lot of money. But, under the right management team, those businesses can actually thrive in this kind of environment.

Paras: We certainly do carve-outs that we think line well with our having a deep bench of operators across the portfolio. We're starting to see more activity there as well. I would agree. A lot of public companies at first were looking to stabilize, especially when the stock markets were going a little nuts back in March. Now, they're finally starting to take more stock of what's core and to divest of anything that doesn't fit in that strategic thought process moving forward. They may have an M&A agenda that would allow them to pick up some assets.

Privcap: For the industrial leaders that you're all speaking to, what is the level of enthusiasm for doing deals right now?

Michael: It depends on how risk-averse my clients are. Some people are very excited about all these opportunities and they're jumping on them left and right. One of the problems is that there are so many deals out there right now, there are so many things coming across their desks, they sometimes don't know how to decipher what's good and bad. So, it's a weird environment right now. It also depends on the personality of some of my clients.

Paras: A lot of our CEOs are cautiously optimistic. They've started to see a rebound happen across the board, but it's difficult to know how another surge of COVID might affect things. We are finding great opportunities to add on to those platforms. As I mentioned, some of the smaller mom-and-pop competitors are struggling right now. It's a good opportunity for some of our scaled companies to take advantage of that and to add on capabilities, geographies or customers to further diversify the business, or to add more scale or explore a new end market.

Michael: It always depends on if the CEO is comfortable with these types of transactions. Some people feel it's outside their wheelhouse. I'm seeing some of my clients invest in automation equipment. They started with only the backend and now, all of a sudden, they're going to the front end and everything in between. That's because the people who are running the business are comfortable with all facets of the assembly line. It's about how comfortable you are in those situations. ■

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