Manufacturing & Distribution: Sector Valuation

August 2023

Overview & Valuation

As the current period of economic downturn continues, recent data is showing that the Bank of England's aggressive interest rate rises are placing a heavy burden on the manufacturing industry. The industry's output index hit a seven-month low of 46.5 showing all the signs of a contraction in the market while S&P Global's chief business economist commented that the industry had "come close to stalling" as consumers and businesses alike reign in discretionary spending.

While the long shadow of inflation may be shrinking somewhat, having fallen further than recently forecast, inflation is for many still the primary concern in the modern business landscape. Profit margins continue to be suppressed by rising raw material, labour, supply chain and energy costs forcing the meticulous revaluation of business models.

It remains to be seen where the new equilibrium will settle as optimisation and efficiency enters the spotlight and UK business leaders seeking to manage costs are forced to embrace digital and technological change. Recent announcements like Tata Group's plans to build a £4bn gigafactory in the UK also demonstrate that the decades-long march towards digital change is finally reaching critical mass.

Amidst the many challenges the UK manufacturing sector is facing, commentators can be quick to forget the inherent strengths that have seen it through the pressures already experienced since the beginning of 2020.

Make UK is of the opinion that "manufacturers are experiencing their calmest operating conditions since the inception of the pandemic" and that looking ahead, in the short term, the sector's relative stability may even permit it to show a modest level of growth.

Valuations

Given the high proportion of cost associated with material, labour and distribution charges in the manufacturing space, businesses are typically focused more on an EBITDA/cash-generation valuation methodology. Public multiples demonstrate the marked premiums for sub-sectors with specialist knowledge or strong brands, compared to the average levels for more commoditised sub-sectors such as construction and print and packaging.

Public Multiples

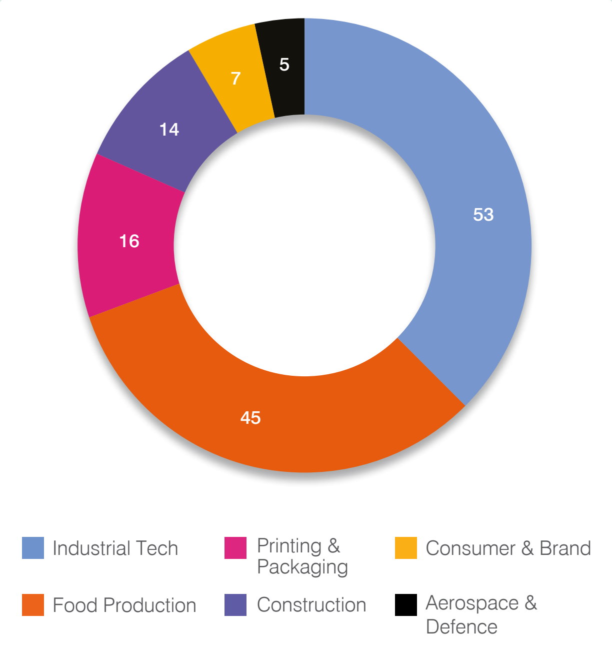
	EV/Rev	Forward EV/Rev	EV/ EBITDA	Forward EV/EBITDA
Aerospace & Defence	3.65x	3.20x	17.08x	14.72x
Construction	0.99x	1.02x	6.14x	6.33x
Consumer & Brand	2.04x	1.89x	10.10x	10.47x
Food Production	2.60x	2.29x	12.59x	12.19x
Industrial Technology	3.65x	3.41x	17.64x	15.98x
Print & Packaging	1.03x	1.04x	6.26x	6.62x
Specialist Manufacturing	3.22x	3.31x	9.77x	10.80x

In relation to direction of travel, M&D is expected to be pretty stable, with small differences between current and forward EBITDA multiples. The standout exception to this is in aerospace and defence, with profitability expected to recover further supported by the return of the travel market and defence spending, driven by the ongoing uncertainty in Ukraine.

Recent updates from Rolls Royce have already raised the outlook, following the announcement of a material profit expectations upgrade from between £0.8-1bn to £1.2-1.4bn for H1FY24 that was facilitated by operational improvements, increased military spending and the recovery of long-haul flying. Across the pond, US rival, General Electric also raised its full-year profit outlook on the robust demand for its jet engine spare parts and services.

Deal Activity

Over the past six months within the manufacturing and distribution sector there have been 140 reported deals, down from 466 in the same period in 2022, split as follows:



	No. of Deals	International Acquiror	Previous Year
Aerospace & Defence	5	4	23
Construction	14	1	47
Consumer & Branded	7	2	25
Food Production	45	12	155
Industrial Technology	53	22	155
Print & Packaging	16	3	61
Total	**140**	**44**	**466**

The sector has remained resilient despite considerable mounting headwinds. As inflation shows signs of coming under control, with the June forecasts beating estimates by 0.8%, eyes will remain on the Bank of England to see whether it will proceed with further hikes in the base rate. Deal activity for the second half will likely strengthen if actions signals the end of the current interest rate hiking cycle.

The switch in buyers' attention to strategic rather than speculative growth will favour the sector which has significant opportunity for efficiencies to be added through digital transformation initiatives. Furthermore, companies may seek to pursue acquisitions which can be funded through their existing balance sheet, fuelling consolidation of smaller players in the mid-market in order to avoid heavy debt and regulatory burdens associated with large-scale deals.

The switch to strategic has also led to an increase in the focus being placed on pre-sale preparation. The historic abundance of cheap capital powering the highly competitive M&A market previously allowed sellers to limit information and still secure premium valuations. Given the greater level of scrutiny and demands for "real evidence" to support value metrics, it is now hugely important to be "deal ready" when considering a sale to avoid price reduction pressure or buyer withdrawal.

Deal Spotlights

Defence

BARNES

Acquired

MB AEROSPACE

£577m

11.4x 2023 EBITDA

Print & Packaging

CCL

Acquired

oompln MADE

£4.8m

1.05x 2022 Rev

Industrial Technology

Halma

Acquired

FirePro.

£129m

14x 2023 EBIT

CALEDONIA INVESTMENTS

Acquired

AIR SERV

£143m

11.4x 2022 EBITDA

Food Production

THG

Acquired

Brighter foods

£43m

6.6x 2022 EBITDA

Finsbury Food Group

Acquired

Lees

£5.7m

6.3x 2023

Outlook

Polestar has observed three key themes we believe will continue over the coming year irrespective of any digital transformation initiatives.

Supply Chain Risk Management

Shocks in air and surface transport coupled with rising raw material costs and labour supply shortages are placing heavier burdens on producers. As a result of recent exposure to supply chain disruption, operators have been forced to create initiatives to manage demand volatility and supply risk. Stress testing has become essential in assessing the viability of operations focusing on mitigation and contingency planning for further inflation and allowing for navigation through the economic ripples stemming from China's manufacturing hubs.

Decarbonisation

Manufacturing is, in its nature, an energy intensive industry, accounting for 12% of total UK Greenhouse Gas emissions with over half of these coming from steel, cement and chemicals manufacturing. New investment in more efficient and greener capital stock to drive the industry towards the net zero economy will continue.

A recent UCL study, supported by HSBC, flagged that whilst deep emissions reductions are possible they will likely need strong, sustained and sophisticated government support:

Current government issues have shifted the burden of investment towards the private sector. However, with Ernst & Young commenting that industry leaders still believe focusing on ESG results in lower profits, it appears that other metrics may be prioritised over the chase for Net Zero.

Despite this, we see strong longer term benefits from building a greener business, with regulation spreading across industries and fund providers increasingly demanding evidence in the area. Valuation metrics at present feature weighted premiums from US buyers. Whilst the US is currently perhaps five years behind Europe Canada and Singapore, the huge scale of funding through the US and the inter-relationship with funds in Europe and elsewhere mean that Polestar expects the US to catch up over a relatively short time-frame. As it does, the premium for those businesses that can help differentiate the buyer from a sustainability point of view is likely to become more marked.

Workforce diversity, retention and upskilling

As operators try to find the right balance between efficiency and sustainably in a higher cost ecosystem, labour retention and upskilling, while remaining profitable, will be another core issue throughout the next 12 months.

Companies will find themselves challenged to ensure workforces are diverse and skilled enough to meet the demands of being smarter and more efficient in an ever-competitive market. This includes leveraging their workforce more effectively to drive business growth.

At Polestar, we have seen considerable interest in those companies that have built inhouse development processes and training academies to develop staff and augment specialist expertise to differentiate themselves from the market. We would expect this theme to continue.