Pace Equity Forecast for Mid-Market M&A in 2015

PART 1

INTRODUCTION: Pace Equity is a long-standing and authoritative M&A Boutique advising on M&A and capital fund raising across a wide range of industry sectors in the UK and internationally. Our mid-market M&A forecasts are based largely on our own research and experience and we offer this forecast for information only. We regret we cannot accept responsibility for actions that may be taken based on these forecasts.

The UK economy is set for another year of healthy growth in 2015. Despite some early wobbles in the first week of January with stock markets heading south, some sectors reporting a drop in confidence and worries about the Eurozone, the majority of company directors, economists and market commentators continue to believe that there is every reason to be optimistic about the UK economy this year.

In Mergers and Acquisitions, 2014 was a year for a number of large, landmark deals such as WhatsApp, NestLabs and potentially BT/EE and this filtered through moderately into the mid and lower mid-market sectors. Globally, M&A surged to $3.3tn in value, up 47%. Thirst for deals is expected to continue throughout 2015, led by the USA and the UK. In the EU, growth minded CEOs will need to invest in opportunities outside their main markets, if they are to achieve profitable growth for their own companies in the near term. Energy was the busiest sector in the UK to mid December 2014. But, as ever, different sectors experienced very different levels of activity. Broadly, in 2015, we believe M&A activity will gain further momentum, but for a whole host of different reasons to those of 2014.

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Let's address internal UK deals first in the mid-market. Private sector deal flow has still not reached the levels of 2007/8 and there remains a significant level of pent-up demand on the part of both buyers and sellers in the mid-market and below. In 2014, a silent majority of private company shareholders remained unconvinced that market values had reached optimum levels and were still holding out for further rises in value. We believe this year we will see realisation hit and more shareholders will be confident of achieving good market values, resulting in solid M&A growth. The underlying factors are all there. Market values have risen, the economy is building well, and mid-market companies with strong balance sheets need to build market position or be left behind by their competitors. New

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technologies are impacting business models and CEOs know they need to acquire these technologies to keep ahead of the game. Private Equity is awash with funds and there is a pressure on PE Managers to invest. Some traditional banks are regrouping their investment teams, but Challenger Banks are actively out in the market seeking and creating opportunities. New forms of lending to small and growing businesses are gaining traction and encouraging entrepreneurs to experiment with new and innovative funding for growth. Towards the middle of 2014, general confidence levels reached new highs not seen since 2007. Most importantly, the housing market, which tends to have a disproportionate impact on confidence, experienced its best performance for over 5 years. All the above augers well for the M&A market in mid-market private companies during 2015.

On the negative side, there are real concerns in business about the pending general election and its outcome. Markets hate uncertainty and there is likely to be a lot of that about until May. The Eurozone is a worry for UK business as poor performance in Europe will have a negative spin off for UK growth. Continuing decline in the Russian economy will impact much of Europe and a Greek exit from Europe will be met with mixed, though potentially negative reactions. These concerns may well impact the enthusiasm for investment and could encourage an unadventurous approach to M&A activity amongst some CEOs.

Coming back to the positive outlook – oil and energy prices have dropped dramatically in recent months, giving many sectors a cost saving boost, potentially releasing additional funds for investment and acquisitions. European CEOs, faced with stagnant economic forecasts over the next few years will be looking to invest in familiar growth countries such as the USA and the UK and M&A volumes will be driven up as a result.

Now let's turn our attention to specific industrial sectors.

We will present this forecast for mid-market M&A activity in 2015 in 2 parts. Part 1 will cover:

- Health Care, Equipment & Services
- Food Producers
- Travel & Leisure
- Energy and Support Services
- Consumer Goods
- Construction & Materials

And over the course of the next 2 weeks we will publish Part 2 which will address the following:

- IT and Tech
- Media
- Financials
- Telecommunications
- General Industrials and Automotive
- Industrial Engineering
- Aerospace & Defence

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Health Care, Equipment & Services

In 2014 the Healthcare, equipment and services sector enjoyed very buoyant M&A conditions, with over $1.2tn of M&A deals globally and 96 deals worth more than $5bn. The USA led the way, but the EU and UK followed on strongly.

In the UK, as we see the economy emerging from 6 years of difficult times there will be an increasing realisation that the NHS is going to have to take a rapid and determined look at constructive and viable ways of cutting costs. Management buy-outs are ripe pickings for Private Equity who need to deploy their investors' funds into tried and tested businesses, so the NHS will increasingly attract more attention. Many existing businesses in the sector now have strong balance sheets and CEOs will be under pressure to invest those funds in growth, market share and wider services ranges. Expect European healthcare businesses to view the UK as a fertile field for growth for their businesses, caught in the mire of the European economy this year.

We expect to see a steady increase in the volume of deals, particularly in the lower mid-market arena, where volumes have not yet picked up to their 2007 levels.

Food Producers

Share prices of 10 major listed companies in the sector rose 14% in 2014 and P/E ratios climbed from 11 at the start of the year to 27 by mid-December. On the surface, the share price growth is positive, but the rapid increase in P/E ratios may reflect a reduction in net margins due to price pressures and increasing competition in the retail sector from lower priced competitors such as Lidl and Aldi.

The CEO of Diageo observes that 1.7bn people will enter the middle classes in China and India and brands will be very important.

Price is the No1 driver of shopping habits for the masses, but shopping habits are changing and this will have a knock-on effect right back to farmers and food manufacturers. Price pressures will force more M&A activity in the lower mid-market where smaller producers will need to consolidate to reduce overheads and find economies of scale to match what will be increasing pressure from the massive buying power of Tesco's and Sainsbury's.

While consumers are expected to return only slowly to higher levels of spend on food, that spend will be highly selective and carefully considered. Treat products will benefit initially. Food and drink is essential and will continue to benefit from the growing economy, but the industry is exceedingly mature and slow moving, so do not expect a flurry of M&A activity.

On the international scene, the CEO of Diageo observes that 1.7bn people will enter the middle classes in China and India and brands will be very important. M&A in recognised brands is expected to benefit from this trend.

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Travel & Leisure

An industry in interesting times! There are three dominant and potentially divergent forces impacting this global industry. The rapid fall in oil prices will have a positive impact on the industry and will provide airlines, railways and shipping the opportunity to reduce prices to increase demand. At the same time, consumers feeling more positive about their economic prospects could potentially be spending more on travel. Potentially overriding all this will be concerns with events such as those in Paris and Belgium over the last couple of weeks. The apparent rise in Jihadism is likely to have a profound impact on those keen to travel and will direct tourists away from perceived high risk areas.

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The UK enjoyed record tourism in 2014 which passed the £20bn spend threshold for the first time and forecasts are that this will rise a further 10% to £22bn in 2015. London accounted for the dominant share of the tourist spend, approaching 65% of the entire spend in the UK. For the 3 months to September 2014 the USA accounted for 17% of tourist spend, the EU 44% and the rest of the world 38%.

The industry as a whole needs to embrace more technology to improve information, online booking and the use of mobile technology. Cybersecurity is also a major concern as most companies hold significant databases of personal and financial information which could all be facing increased risk. Smartcard technology will penetrate the industry further this year

On the FTSE, 35 listed companies showed average share prices growth of 11% while P/E ratios for the industry reached an average of 22 indicating high expectations for 2015. This will all have a positive impact on M&A and we anticipated M&A activity to grow strongly in 2015.

On the global scene, TUI Travel was acquired by its German shareholder TUI in 2014. The merger has led to the creation of the world's largest integrated travel business worth £5.2bn. Expect this to spawn other large M&A deals during 2015.

Energy and Support Services

The future of the energy industries has come sharply into focus in the early weeks of 2015. The dramatic decline in the oil price has led to high expectations for energy price reductions. The boom years for the Oil and Gas industries are over for the foreseeable future. This will have an immediate impact on M&A in the energy sector, both good and bad.

Some oil suppliers in Saudi Arabia think a low oil price can squeeze out competing suppliers such as Shale Gas or Fracking Suppliers in the USA and Russian competitors facing sanctions from the West. In an estimate from one source, there are 250m new customers for commercial energy each year and Saudi Arabia is clearly keen to rebuild market share for the future. OPEC is unable to control members or the market and it is now back to basic supply and demand.

Technology will play a major role in finding lower cost solution to get fuels out of the ground at prices below $50/barrel. The cost of fossil fuels will come down and this will have an immediate impact on renewables. Some commentators believe that we will soon be living in an “age of plenty” as far as energy is concerned! The winners in this new game will be those who seize the initiative and turn the new reality to their advantage.

2015 is the year for Energy Utility companies to chart the course for future growth and returns. The defensive strategies of the last few years, focusing on strengthening company balance sheets and cost reduction from M&A activities must now be refocused to build real strategies for innovation, growth and improved services with new and emerging technologies and business models. This will mean buying those technologies to secure positions for the future and will encourage M&A in new sectors.

Green energy is going to experience a mixed period. Scottish optimism for wave energy projects is drying up as the sector has been unable to produce sustainable faultless equipment. The US and Australia, along with Denmark and other Scandinavian countries are the main challengers. Wind power has lost a lot of its glamour and may have been over subsidised. In general, the reliance on VCs has meant too much focus on short-term returns. Developers must pool efforts to improve components and systems but this is going to take time. We anticipate a decline in the rate of growth in the sector and this will impact M&A activity.

Our forecast for M&A, particularly in the mid-market is that lower oil prices will force some companies to seek mergers or go to the wall. This will increase deal flow, but at considerably lower prices. On the other hand, astute companies who have made provision for lower oil prices will need to buy innovative technology to help lower the overall cost of production or services. This will encourage M&A in the technology sector and accelerate deals in this arena. Overall, we believe there will be a dip in M&A activity for at least the next 6-12 months and this will pick up again as new business strategies begin to emerge.

Consumer Goods

2014 saw share prices in the larger FTSE Consumer Goods companies rise by 8%. P/E ratios rose 1 to 17 at the year end. Dividend yields were relatively strong at 3.1%. A few high profile M&A deals caught the headlines, namely United Biscuits sale to Turkish Food Group Yildiz Holidings for a reported $2bn, the IPO of the Fever Tree beverage company raising £93m and the high profile merger of Dixons Retail with Carphone Warehouse to form Dixons Carphone.

In the mid-market, M&A deal activity was strong in the first half of 2014 with deal value reaching €27bn a 42% increase on the same period in 2013. The trend continued into the second half of 2014.

Private Equity firms are experiencing strong competition in auction processes from well capitalised trade buyers. Asian buyers are increasingly active in the sector and actively chasing recognisable brands which are achieving good value.

In the UK, as consumer confidence gained strength on the back of a growing economy, Black Friday sales and the run up to Christmas was the strongest experienced for 6 years. As wages start to rise again and the UK population gains further confidence from the return of growth in the housing market, we expect this trend to continue.

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Mergers and acquisitions will gain traction and we anticipate a good year for M&A in 2015, particularly in the mid and lower-mid market, where many private company owners have been awaiting a solid return to growth and value, before putting their companies on the market. We believe there is now a realisation that if private company owners do not react now to the favourable current market conditions, they will miss this important phase of growth in expectations and could miss good opportunities for a sale while values are still rising. Expect a particular rise in M&A activity where manufacturers and distributors can buy businesses that sidestep retailers and streamline the progress to the market.

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Construction & Materials

The Telegraph recently reported Tim Moore, senior economist at Markit, as saying: "Over the course of 2014, UK construction firms recorded the strongest calendar year of residential building since the survey began in 1997." The good news is expected to continue into 2015, with industry insiders anticipating that the UK's property market will be a key area of growth over the next 12 months. Mr Moore said: "Four times as many construction companies anticipate an upturn in output over the year ahead as those that expect a reduction."

These statements sum up the general consensus on both Construction Industry and Housebuilding for 2015. The Construction Products Association published their view that Construction output would grow 4.8% in 2014, followed by 5.3% in 2015.

Share prices of the top 14 FT listed construction companies showed a solid 3.2% upturn in 2014 and this may well accelerate in 2015, due to the a range of positive factors around the industry, including increasing optimism amongst sector CEOs, the fall in the oil price, the ongoing and increasing demand for housing, seriously outpacing the build output and the start of several major infrastructure projects such as the Electrification of the Great Western railway, the new HVDC subsea cable connecting Scotland to N England/N Wales, Network Rail's renewal programme and investment in Air Traffic Control infrastructure, to name just a few.

Recent high-profile M&A activity includes the sale by Heidelberg Cement of its brick making business for $1.4bn to Private Equity house Lone Star and CRH Plc's recent sale of brickmaking businesses Ibstock, to Bain Capital for £414m. These high profile deals will help spawn more deals further down the market as Construction Industry CEOs realise that this is the time to gain market share and secure future growth and profits.

Expect M&A activity to grow solidly in 2015 with a small number of high profile deals and a significant number of mid-market and lower mid-market deals encouraged by both renewed confidence in the sector and growing private equity interest growth opportunities over the next 5-year growth period.

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If you would like to contact Pace Equity to explore opportunities for your own company please e-mail callumboyce@paceequity.com or call one of the team (see www.paceequity.com/team) on 01491 577889

Pace Equity is one of the UK's longest standing and most authoratitive M&A Boutiques having been in business for 26 years. We offer a full-advisory service specialising in mid-market private companies. We advise companies and Boards of directors on Mergers, Acquisitions, Company and Share Sales, Capital Fund Raising, Valuations, Market Intelligence and Growth Strategies.

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