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PRIVATE EQUITY

PERSPECTIVES

PODCAST

EPISODE 12:

MANUFACTURING AND DISTRIBUTING PRIVATE EQUITY VALUE

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

INTRODUCTION

Todd: Hello and welcome to another episode of BDO's Private Equity PErspectives podcast. I'm Todd Kinney and I'm a National Relationship Director with our Private Equity practice based in New York City. I'm actually very excited to have two guests, two good friends, here with me today. First, we'll start with Ken Heuer joining us from Kidd & Company. Ken is a principle focused on strategy-led investments in the lower middle market. Ken, thanks for joining us.

Ken: Thanks, Todd. Appreciate being here.

Todd: Secondly, I'd like to welcome to the program Charlie Fox. Very good client, head of business development at GHK Capital Partners. As head of business development, Charlie assists his firm in pursuing investments primarily within the industrial sector. Charlie, it's great to have you here today.

Charlie: Thanks, Todd. Glad to be here.

BACKGROUND QUESTIONS

Todd: Appreciate it. Why don't we jump into it? Ken, would you like to kick things off by telling us a little bit about Kidd & Co and your role there?

Ken: Happy to, Todd. Thanks again for inviting us. So, just by way of background, Kidd & Company is a family office, private equity investment group based in Greenwich, Connecticut. We're looking for opportunities typically less than $10 million of EBITDA, family-owned and operated companies that have a history of success but have reached the end of their tether in terms of being able to continue growing at the same level that they may have experienced in the past. So, if we can come in and partner with those

TOPICS DISCUSSED INCLUDE:

management teams, offer them a liquidity event through a transaction, but look to keep them involved operationally in partnership with us as general business builders, that's usually a good recipe for success.

Todd: Good stuff. Charlie, as head of business development at GHK Capital Partners, I was hoping you could tell our listeners a bit about the company and your role there.

Charlie: Sure. Thanks, Todd. And thanks for having us here. GHK Capital was founded last year by Gil Klemann after 17 years at Goldman Sachs leading industrial investing in PIA within the merchant banking division. Our strategy is to bring large cap value creation methodologies down to the lower half of the middle market, which we're defining as sort of 10 to 30 of EBITDA with sort of flex up to 40. Our focus is primarily in what you might call traditional industrial businesses, manufacturing, building products, services, distribution, packaging. My activities within GHK: I focus primarily on business development interfacing with both intermediaries and also business owners throughout the country.

Todd: Awesome. Well, two great guests – we're happy to have you. I'm sure you've got a lot of interesting experiences to share with our listeners. Let's jump into the first topic. Ken – I'll start with you. At Kidd & Company, your work focuses on conducting technical, financial and market due diligence, as well as overseeing strategy execution for existing investments. Could you highlight a couple of trends around due diligence for manufacturing and distribution?

Ken: Sure. Well, being generalists in the lower middle market probably gives us a little bit of a disadvantage in terms of depth of industry insight. And so, when we're looking at a manufacturing or distribution business, one of the first things we have to get comfortable with is what are the macro trends that may be impacting that particular subsector of manufacturing. For example, we've got a couple of investments in aerospace manufacturing businesses that we invested in in 2011 and 2012, which, at the time, we were really comfortable with what the outlook was for build rates, particularly within aerospace, the balance of commercial and defense. And so, as I think about today's investment climate and manufacturing in particular, certainly, we focus on domestic-based businesses. So, you've got to look at what is the competitive playing field globally because most manufacturing sectors do have competition on a global stage. Figuring out the relative importance or competitiveness of US-based manufacturers. Then, as we'll get into a little bit more detail, what is the sourcing of raw materials and components and where do those come from? If they are offshore in today's increasingly complex tariff-led environment, that does lead to some other considerations that you have to weigh in. But that's just at a high level, some of the things that we look at.

Todd: Appreciate the insight. Charlie, from your perspective, what's driving or even hindering private equity deal making in M&D sector?

Charlie: Sure. I think in terms of what's driving deal flow right now—obviously, the economy is doing great domestically. And in the part of the world that we tend to spend our time, there's a lot of people making a lot of money. There's also capital in the space which is driving the flow. In terms of hindering, there's obviously concern about interest rates going forward, whether or not our cycle that we're on right now will continue to grow. Our view is that we will continue to see growth. Housing has been flat for two years. We believe that that will come back. Investment in business domestically, again, where we tend to operate has been strong. So long as we can continue this trend, we think there will continue to be great flow.

TARIFFS & TRADE TENSIONS

Todd: That makes a lot of sense. Now, there has been a lot of talk within the industry about shifting trade alliances, NAFTA renegotiation and significant tax overhaul, as we all know. Some fund managers with a stake in manufacturing and distribution are reporting changes in how they evaluate deals. I'll ask both of you, and Charlie, we'll go to you first and then Ken. How is PE evaluating supply chains, taking steps to de-risk, or evaluating due diligence differently, given all of these concerns?

Charlie: Sure. From a supply chain perspective, we've looked at opportunities that certainly have exposure, particularly to metals coming out of China. While it's a diverse market, we believe it's a relatively mature market, and we were able to identify ways to sort of navigate through direct exposure to those sources of metals. In terms of end users and exporting, we spent a fair amount of time and diligence in trying to find ways to work around it. However, in a peer environment, we believe that we can work around those concerns.

Todd: Ken, care to share any thoughts?

Ken: Sure. To build on what Charlie said, one anecdotal example is we own a medical device contract manufacturing business. When we made that investment back in 2015, the consideration at that point in time was for companies that manufacture outside the US, such as China and the Far East, how do they have a competitive advantage versus what we're doing here in the United States because of the labor arbitrage, because of other attributes that may give them an advantage. That was really a major point of due diligence as we thought about the competitive advantage of manufacturing domestically. If you fast forward to today, the consideration is really more about, as Charlie mentioned, to what extent are you sourcing raw materials or components from overseas and what's going to be the cost impact of having to pay more through the effect of the tariffs that are going on? I would say, obviously, it's a consideration, particularly if you had sourced historically cheap labor or components from overseas. What is going to be the financial impact on margins and to what extent can you pass that through to customers or otherwise? Or just have to deal with a business that's going to be lower margin going forward. And then the question is, are these going to be permanent shifts in tariffs or are they temporary? I don't think anybody can really handicap that yet. In terms of our businesses, to a large extent, when we manufacture domestically, we're not really sourcing a lot of the components or raw materials from overseas. So, we haven't seen a tremendous impact on the tariffs. But the other thing I'm aware of is, I mentioned the aerospace investments we have earlier, we do have price protection on any fluctuations in raw materials. To the extent, in certain places where prices have gone up due to tariffs or otherwise, it's a direct pass-through based on the contracts that we have with our customers. So, it's a consideration, certainly, to look into due diligence. What are the contractual relationship for the type of parts that you're supplying? And ultimately, to what extent you're exposed or on the hook for some of the price increases that may be coming. Another example, we do own an RV dealership and have been put on notice from many of the OEMs that we buy RVs from that there are going to be price increases attributable to some of the tariffs that they're experiencing in some of their components. So those are effective kind of right now. I don't think we have a full appreciation for how much of our margins will be impacted and to what extent we can pass those cost increases on to consumers that purchase RVs from our dealerships. But I think everybody's kind of struggling with the same sort of timing, and it's early days to try to figure out what the real impact on business is going to be.

Todd: Well, pretty interesting perspectives from both of you, and I know who to go to when I'm ready to get my first RV, Ken.

Ken: Absolutely. I'll give you a good deal, Todd.

Todd: Awesome. I guess, on top of those, many organizations that rely on imported goods are seeing their production costs increase. Again, to both of you. And Ken, why don't you start? Is this a consideration that you're seeing play out in PE really in terms of which companies are becoming attractive targets or which firms are distressed?

Ken: Yeah, I mean, again, as we discussed briefly, it's a consideration. I don't necessarily see a slowing deal environment because of some of the tariff implications or otherwise. It's really just another factor in due diligence. At the end of the day, you're not going to be able to necessarily rationalize paying a lower multiple because if you do, you're going to be at a competitive disadvantage for the guys that are going to be out there used to paying higher multiples. And again, in the current environment, it's just one more factor of due diligence that needs to be considered. And if there is a longer-term impact, obviously, you're paying a multiple based upon the future earnings of the business, so you have to take that into consideration.

Todd: Sure. Charlie, thoughts?

Charlie: I agree. To piggyback on Ken's comments, I think that the idea that the supply chain costs in a certain segment is going to affect all players in that space. If you're operating in the United States in the domestic market or if you have international exposure, so long as that supply chain cost is comparable across your competitive landscape, you could certainly get comfortable with that and the idea that we could pass that cost then onto the end user.

COFFEE BREAK WITH STEVE MCCULLOUGH OF BDO'S CENTRAL REGION

Todd: All right. Well, thanks to both of you for the thoughts. They are really important things to keep in mind. Now I'd like to switch gears momentarily for our coffee break with BDO's Steve McCullough in Chicago. Steve leads our Transaction Advisory Services Tax practice for BDO's Central Region and focuses largely on the industrial products industry. Let's hear his insights.

Steve: From a tax perspective, with respect to the manufacturing and distribution industry, one of the hot topics emerging from tax reform pertains to bonus depreciation. Now, buyers of both new and used property can take advantage of bonus depreciation, which enables a buyer to expense 100 percent of the cost of qualifying property, for example, certain machinery and equipment, through December 31, 2022. The expensing of 100 percent of the cost of qualifying property gradually phases down during 2023 through 2026. There is no bonus depreciation available for property placed in service after December 31, 2026. Now, in the world of M&A, there's a lot more focus on bonus depreciation than ever before because, as I mentioned, it can now apply to used property. As such, in deals that are structured as asset deals—for example, an actual asset deal or a deal that is treated as an asset deal for income tax purposes, for example, a stock deal with a Section 338(h)(10) election—any purchase price that is allocated to qualifying property may be immediately expensed by a buyer, as opposed to being depreciated over a much longer life.

Now, on certain transactions, we are seeing buyers push for as much purchase price being allocated to qualifying property as possible in order to take advantage of bonus depreciation. However, sometimes what's good for the buyer may not be good for the seller. So, like many things in life, this becomes a negotiation point. Now, please note that tax reform disallowed net operating loss carrybacks. As such, there's not an ability for taxpayers to report significant deductions attributable to bonus depreciation in order to create a net operating loss that taxpayers could carry back to prior years and claim a cash tax refund. Rather, now net operating losses can only be carried forward, and they can only be used to offset 80 percent of future taxable income. In addition to bonus depreciation, it is worth mentioning that some changes were made to Section 179, which allow certain businesses to elect to expense the cost of qualifying property. Following tax reform, the annual expensing limitation was increased to $1 million. Tax reform also increased the phase-out amount to $2.5 million.

And both bonus depreciation and Section 179 are taxpayer-friendly provisions to taxpayers in the manufacturing and distribution industry. And bonus depreciation should definitely be given some consideration when modeling a purchase price allocation and forecasting taxable income in the context of a transaction. So, with that, Todd, back to you.

Todd: Thanks for sharing, Steve. I really appreciate it. And now we'll jump back to the conversation with Charlie and Ken.

TAX REFORM'S IMPACT

Todd: Since Steve just shared some of his insights on tax reform, I'd like to hear your perspectives on the topic. The Tax Cuts and Jobs Act in 2017 marked the largest change to U.S. tax policy in decades for sure. Charlie, we'll kick this one to you first and then Ken. Do you think implications for manufacturers overall has been positive or negative and why?

Charlie: Sure. I think that absolutely the tax changes have been positive for businesses. Speaking solely about manufacturing businesses in the US, if you look at the growth in the economy since 2017 going forward and the continued sustained business investment, it's quite apparent to us, our view is that this has been nothing but good for business. The trickle-down effects going forward will have to be sort of discovered as they emerge. But quite frankly, we think it's great for US business so far.

Ken: Yeah. I agree with Charlie. To the extent you're not paying money to the government in taxes, it gives you that much more capital to put back into the business for capital expenditures and growth, which we're certainly big proponents of in the lower middle market where we play. I would say the double-edged sword or the flip side of some of the tax reform that's going on is the limitation on interest deductions that come, and since we do play in a leveraged environment, we certainly aren't getting the same benefit of interest deduction that comes with the debt component that we use to finance our businesses. So, on balance, I still think paying less taxes is a good thing.

So, we're all for it and look forward to what it holds in store for the future for our businesses.

VALUATIONS

Todd: Fair enough, both interesting points and perspectives. To conclude, let's move on to our last topic, as I'd like to talk about valuations in the M&D space. Clearly, valuations remain high for manufacturing companies due to a number of factors. With a record amount of dry powder, strategic buyers' appetite for deals really remains strong given an unending pressure to grow and the willingness in the lending community to fund deals. So, I will ask both of you, and Ken, I'll throw it to you first: Is this making it more challenging for PE investors to find bargains, and do you think it's creating a drag on investment activity?

Ken: Well, certainly, the environment, as Charlie mentioned earlier, is flush with cash, and a lot of newer funds being raised all the time making it more competitive to find attractive assets at reasonable valuations. I would say that, despite the current relatively high valuation environment, we're spending more of our time looking for manufacturing businesses in particular that may have a little bit more issues with them. In certain instances, we've bought companies that have high customer concentration. I know that in many ways, that's a dirty word in this environment. But if we can get comfortable that, say, for example, the medical device manufacturing business that we own, highly regulated environment for the suppliers that they provide products to, would require the recertification with the FDA in a heavily regulated environment. The customers tend not to want to take that risk and shop, switching manufacturers just to save a few bucks on the product. So if we can identify issues like customer concentration or the need to invest pretty heavily in CapEx or relocate to larger facilities to unlock value, those are things that we find that we can still find reasonable valuations in the lower end of the middle market, and then look to have the value inure to our benefit and our partners that we're getting into business with.

Todd: That makes sense. Charlie, what are you thinking?

Charlie: Yeah, I think that Ken and I are on the same page here in terms of you know sort of what our jobs are as investment managers. It's to find good value in a market that, frankly, is getting quite efficient in terms of capital flows. The velocity of transactions that are taking place at the lower half of the middle market where we sort of choose to operate, we believe there is inefficiency. There are great opportunities to find businesses that are sort of off-spec, that are not sort of squarely in the fairway for a traditional private equity investor. And I think that's where the greatest gains are made, and that's what we're paid to do by our investors is to find those opportunities. To Ken's point, customer concentration, industries that are not typically attractive to traditional private equity investors are where we're seeing a lot of great opportunity and good valuations. And again, that's our job to get out into the woods and find the good opportunities and create value with them.

Todd: Awesome, guys. Well, had a lot of fun chatting with you. We're unfortunately, to the end of another podcast. But Ken Heuer with Kidd & Co and Charlie Fox with GHK Capital, you both are very good friends and great clients of the firm, so we really appreciate your joining us today and our relationship with both of you as individuals and your firms. Thanks so much for joining us.

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