industrial products

outlook

The rise and rise of private equity

Global competitiveness is driving the fast pace of change among Australian industrial products companies in a market that is striving to remain relevant. The global impact is real and should not be treated lightly. Private equity funds have emerged as key players in this market. Their impact to date has been significant.

Australian industrial products companies have become attractive targets for private equity, which has a thirst for change and a focus on operational improvement. Once ownership has changed, private equity funds have forced companies to review their entire operations to gain maximum efficiencies. Costs are being stripped from businesses to improve margins and profitability. New processes are being designed along with innovative refinements to products and markets. New talent is sought and more relevant technologies are reviewed on a cost/benefit basis. Overall returns are set and pursued.

Important lessons are being learned in the process, by companies that private equity has acquired and those that have escaped it. It is our view that private equity is doing nothing more than what management should be doing, albeit at an accelerated rate. With no "baggage" or relevant company history, private equity players are able to move swiftly and their every move is fully supported by immediate access to major funding.

Australian industrial products companies need to sit up and take notice.

Graeme Billings
Industrial Products Leader
PricewaterhouseCoopers
December 2007


Private equity
is here to stay.

The rise and rise of private equity

In the year to 30 June 2007, Australian private equity funds raised a record of $8.9 billion to invest predominantly in the Australasian market. That figure was more than double the sum invested the prior year, which had itself been a record. With this level of investment comes significantly increased competition for assets, which translates to higher prices.

Private equity funds must therefore drive businesses they invest in harder to generate returns, and their focus on operational improvement is having a far-reaching impact on the industrial products sector. In private equity-backed companies, there are no sacred cows and anything that can be done to lift performance will be done.

The industrial products sector has attracted, on average, around 36 per cent of the private equity invested over the past eight years. Several sub-sectors have changed significantly due to the emergence of private equity-backed consolidators and aggressive leaders. Some companies must react urgently to the pressures private equity presents. All have an opportunity to learn from how private equity approaches its investments and proactively adopt strategies to mitigate future threats.

Private equity is here to stay. It is forcing companies to lift their performance or face a bleak future in a rapidly changing competitive landscape.

The Outlook

- The growth of private equity in Australia shows no signs of abating, and its share of Australian investment funds will continue to increase.
- Private equity-controlled industrial products companies will continue to drive industry consolidation and competition.
- Industrial products companies that ignore the threat of private equity risk becoming marginalised.
- Industrial products companies that learn lessons from how private equity approaches operational improvement and proactively adopt similar approaches stand the best chance of succeeding in the longer term.

A growing force in Australia

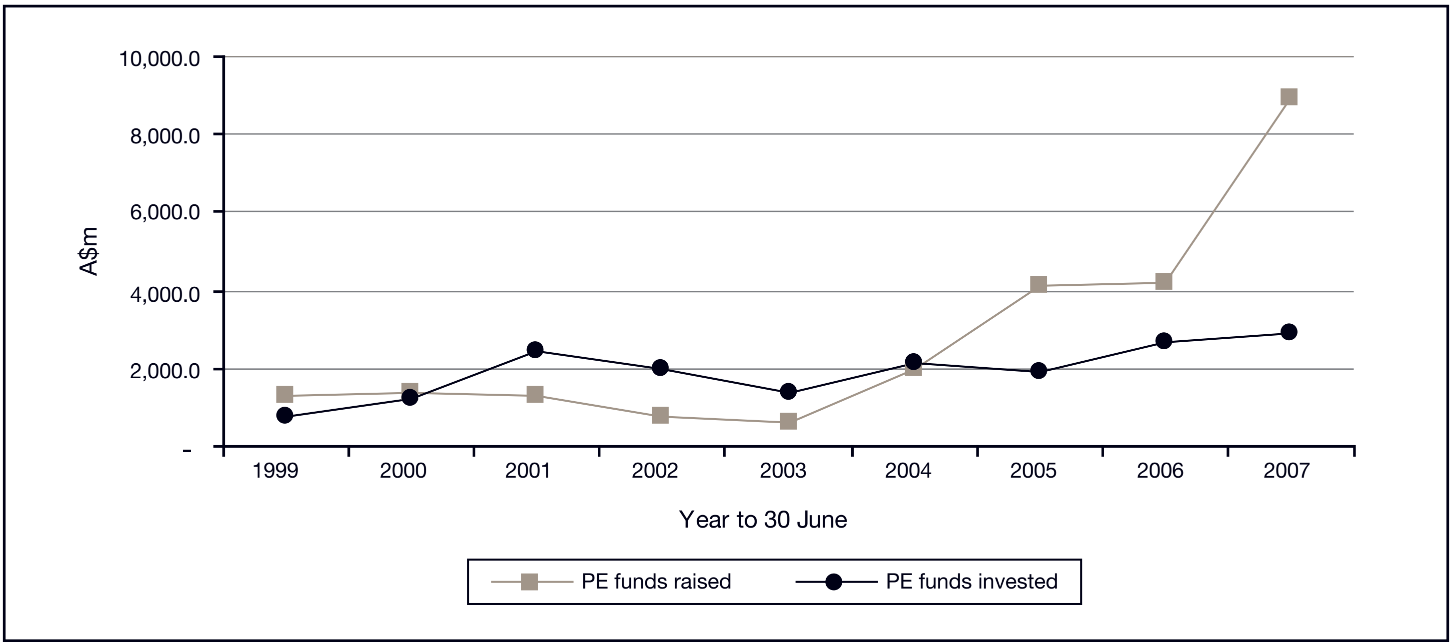
After a slow start relative to the US and Europe, private equity has grown to become a major driver of merger and acquisition (M&A) activity in Australia. It has instigated some of the largest transactions (and attempted deals) in Australian history, such as those involving Coles, Myer and Qantas. Many listed companies have begun wondering if they are next.

Figure 1 below demonstrates the growth in private equity activity in Australia since 1999. Of particular interest is the significant excess of funds raised over funds invested in the past three years – funds that need to be put to use.

This increase is the result of factors including:

- growth in superannuation funds, which have increased their exposure to private equity
- growth in the number of private equity funds in the market
- strong returns which have increased investors' appetite for private equity deals.

Figure 1: Private equity activity in Australia



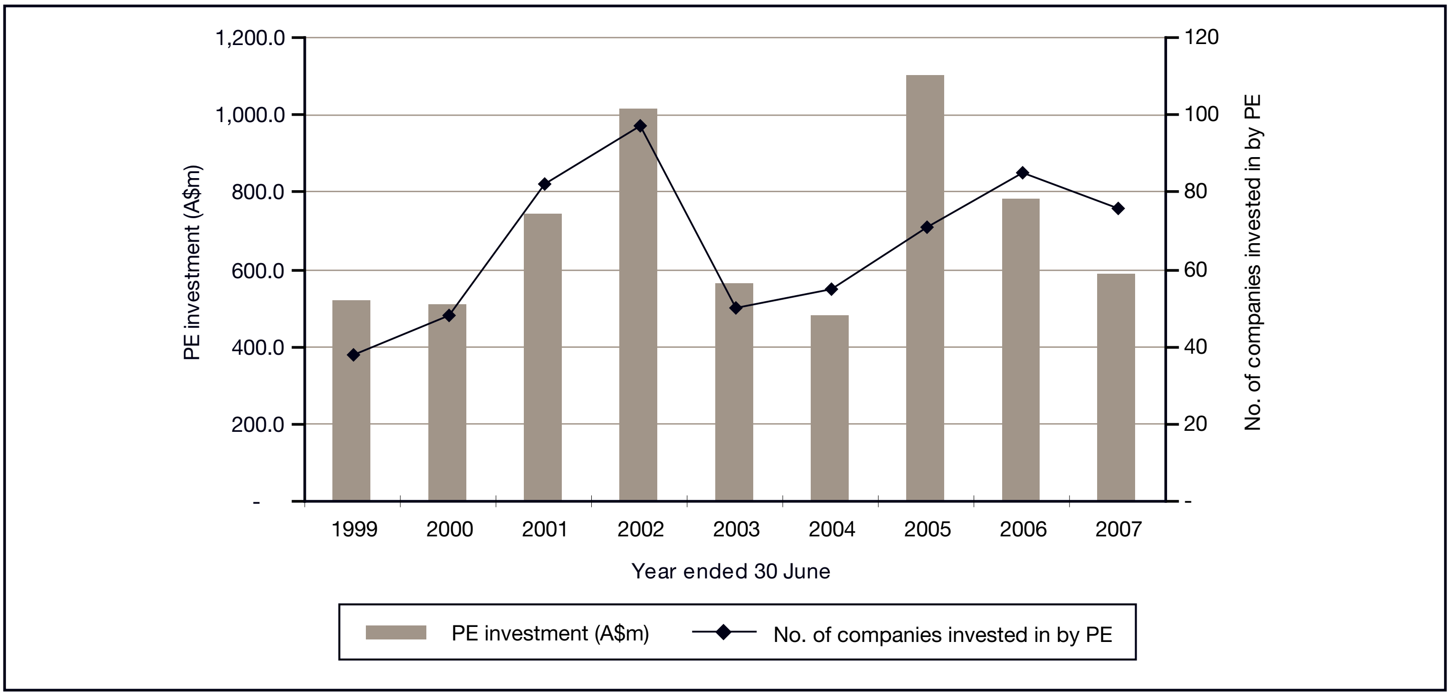
Source: Thomson Financial & Australian Venture Capital Association Limited Survey, year ended 30 June 2007.
Note: PE funds invested includes foreign-sourced funds in Australian investments; PE funds raised includes only those funds raised in Australia.

The growth in private equity activity in Australia has been reflected in the proportion of private equity transactions as a percentage of total M&A deal value. In 2006 in Australia, this proportion was 18 per cent compared with 37 per cent in the United Kingdom.[1] This gap demonstrates that the private equity industry in Australia may have some way to go before truly reaching maturity.

As demonstrated in Figure 2, the scale of private equity investment in the industrial products sector has varied from 1999 to 2007, as has the number of industrial products companies attracting funds.

[1] Source: Dealogic 2006.

Figure 2: Industrial products-related private equity investment in Australia



Source: Thomson Financial & Australian Venture Capital Association Limited Survey, year ended 30 June 2007. Includes industrial, energy and other products (non-consumer related) sectors.

Figure 3: Recent private equity transactions in the industrial products sector

Building materials	Chemicals & Plastics
Acrow Group	Aperio
Australian Temporary Fencing	Australian Vinyls (AVC)
Clark Tanks	Dotmar
EW Cox	Envotec
Hirepool	Epic
Hudsons Building Supplies	Finewrap
Instant Access	GEON
Intercast & Forge	Plexicor (MCK)
Ironstone Group	RED Paper
New Zealand Crane Hire	RoyalPlast (Mulford)
Steelforce	Shorko
Steel Line	Sulo
United Equipment	Vanglobe
Waco	

The way I see it

Adam Cleeve
General Manager
Australian Vinyls Corporation

I've spent a large part of the past 10 years at Australian Vinyls (AV), over four years in corporate ownership and the past five years with two private equity owners. And I have to say, it's been a very positive experience and one I've learned a great deal from.

AV was established in 1997 through the merger of the ICI Australia (now Orica) and PolyOne Australian PVC businesses at the time each of the parties brought a PVC plant into the business. In February 2002, the shareholders sold to a consortium, AVC Holdings, which included Murray Winstanley and myself and the listed CPHI Group, which was backed by the Packer family. The financial performance of the business had been poor and the deal was seen as a turnaround. I became the commercial director, and Pam Freeman, a CPHI nominee, became the CFO.

Private equity players tend to buy with the express purpose of selling, and that's exactly what AVC Holdings did in 2005. The decision had a lot to do with where CPHI was at the time – they were restructuring their portfolio around the Challenger group and no longer wanted a holding in an industrial company. The shareholders' agreement allowed the major shareholder, CPHI, to "drag along" the other managers, which we were all happy to do.

The buyer was Colonial First State, a private equity business owned by the Commonwealth Bank. As is often the case with a private equity buy, the manager shareholders were expected to participate in the secondary buy-out, with equity priced at full value. Private equity buyers, of course, need to maintain continuity with key members of the management team, and the equity stakes helped ensure ongoing commitment. In 2007, the business was sold again, this time 100 per cent to the Wesfarmers Group-owned CSBP Limited. Murray and Pam moved on and I chose to remain as an employee.

Private equity ownership is tremendous at getting you to focus on the critical business issues. They are prepared to look closely at the tough issues and take a hard line. They also bring a lot of cashflow management experience. They're very rigorous on this, mainly because private equity almost necessarily means you're in a highly leveraged position. Shareholder managers are really on the hook, financially and also in terms of their reputation – there's no place to go hide. Some in the private equity market are really tough players who drive managers and deals pretty hard. Owner managers can often end up getting their equity or rewards ratcheted down substantially if things don't go to plan. For me, overall it was a good experience, thanks to a combination of a robust business plan and some favourable market circumstances.

After the first deal in 2002, we were able to remove a large proportion of fixed costs from the business by not buying the second PVC plant at Altona. This was closed by Orica/PolyOne. This changed the whole dynamics of the business and moved AV to a more competitive position. The previous owners had not made this major change to the business. It was this structural change to operations that caused the improvement of financial performance, and demonstrating this over the ensuing three years provided the basis for the second sale.

In 2005, the secondary buy-out moved well beyond a turnaround deal. The value growth for the new buyer was more about improved market conditions for feed stocks, growth in demand and strong cost management. No major structural changes, good tight management and endeavouring to meet customer expectations. This was key in a business-to-business environment, where the support of key customers is a very important driver for success.

How private equity's approach has changed

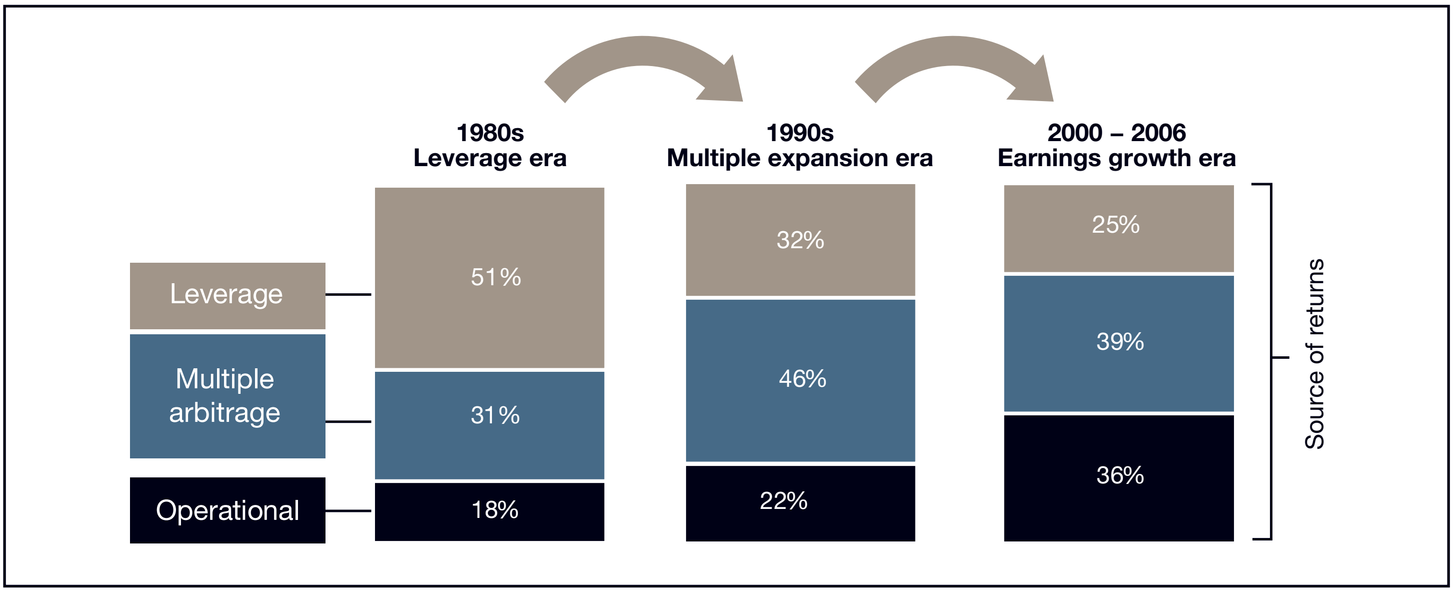
The growth of private equity in Australia has inevitably changed how private equity funds approach deals. In the early days, deals were typically in the private company space and often executed on a one-on-one basis with a willing vendor. Acquisitions were typically aggressively geared, with returns generated by a post-acquisition focus on cash flow, paying down of debt and a subsequent exit.

But as more private equity funds enter the marketplace, attractive assets have become more difficult to identify and acquire on a one-on-one basis. Combined with the growing awareness of private equity in the marketplace, vendors have realised they need to play off several potential acquirers in a competitive auction process to extract maximum value for their business. Such sales often involve a mix of strategic/trade buyers and private equity.

The inevitable result of this increased competition in M&A transactions has been multiple expansion, whereby businesses sell for ever-higher multiples of earnings. In such a market, private equity funds largely derive returns by selling businesses at higher multiples than they originally paid for them – so-called multiple arbitrage. Financial leverage is still relevant but becoming commoditised and therefore less of an advantage for a private equity fund.

However, this multiple arbitrage phase is coming to an end and private equity funds are having to become more imaginative about how they approach acquisitions to generate sufficient returns for their larger number of investors. As a result, the focus of private equity funds has now shifted to post-acquisition operational improvement to improve earnings and, consequently, returns. This progression is shown in Figure 4 below.

Figure 4: The changing source of private equity returns



Source: Australian Venture Capital Association Limited / GSAM

The focus on operational improvement

With private equity funds now facing efficient markets for both asset acquisitions and debt financing, performance depends on the extent to which they can improve a business's financial and operational performance.

The operational improvement phase normally begins early in the due diligence process. Where once due diligence focused on identifying risks in the target business, today it focuses more on determining what drives value and designing solutions to monitor and improve these factors.

When paying high prices for businesses, as many private equity firms are doing, due diligence and the execution of operational improvement plans are crucial.

Due diligence typically lasts between four and eight weeks. It is an intensive period of analysis of macroeconomic factors, industry trends and the business's people, systems and processes. The goal is to identify opportunities to improve financial performance and the result is a post-acquisition operational improvement plan, usually created in close collaboration with management. Importantly, in the private equity environment, if a tough or sensitive decision is needed to improve performance, it will be taken. The move to private equity ownership is often the catalyst for major change.

Implications for non-private equity companies

In late 2006 and early 2007, PricewaterhouseCoopers commissioned Woolcott Research to canvass company attitudes towards private equity as part of its Business Insights Survey. The survey found that of the industrial products companies surveyed:

- more than 50 per cent of respondents had little or no knowledge of private equity funds or venture capital investment in Australia
- 72 per cent would not consider private equity or venture capital funding for their business
- loss of control (49 per cent) and private equity's short-term investment horizon (43 per cent) were key concerns.

That 72 per cent of respondents would not consider private equity or venture capital funding is not surprising. The finding that more than half the respondents had little or no knowledge of private equity funds was more concerning. Even though a company may not want or need private equity – it's not for every business – the way private equity firms approach investments can have a profound impact on the sectors as a whole.

Private equity is now firmly focused on operational improvement, which can take many forms including cost reduction, geographic or product line expansion and industry consolidation. This can change the competitive environment significantly and quickly.

Consider the printing industry, which has long been fragmented and characterised by over-capacity, price competition and corporate failures. Over the past few years, two private equity funds (Gresham Private Equity and CHAMP Private Equity) have acquired a number of small to mid-sized participants in an industry consolidation play.

Consolidation started with Gresham's November 2005 purchase of Pacific Print Group (PPG). PPG had acquired printing businesses in New Zealand and Australia before Gresham bought it and has since acquired a further seven companies, including the ASX-listed Promentum (formerly Penfold Buscombe). PPG has also been renamed GEON Group, which now turns over close to A$450 million and employs nearly 2,000 people.

CHAMP's strategy began in December 2006 with the acquisition of Blue Star Print Group. It has since acquired a further three print-related businesses, taking the number of businesses under the Blue Star Print Group banner to 15.

Through a range of performance improvement measures, including capacity rationalisation, cost consolidation and service offering synergies, both GEON and Blue Star will soon get to a position which will make it very difficult for smaller, commodity-based print providers to compete on price. Anecdotal evidence shows this is already occurring.

Lessons from private equity

Private equity is on the rise in the industrial products sector. The rapid emergence of powerful new private equity-backed industry players with disciplined performance improvement plans could surprise and quickly marginalise the unprepared.

Companies need to understand the implications for their business and proactively consider how to mitigate any risks or threats that private equity might present. In many cases, the best way to reduce these risks and threats is to employ the same strategies private equity funds use to improve the performance of their investee businesses.

These strategies can include:

- Thoroughly reviewing the cost base of the business to identify areas for improvement (eg supply chain, manufacturing processes, corporate and overhead, working capital management).
- Analysing potential areas for revenue growth (eg geographic expansion, product enhancement, service provision).
- Participating in industry consolidation to gain synergies (revenue and cost) and improve the competitive positioning of the business.
- Implementing management incentive schemes which clearly align rewards with business objectives.

When considering how to improve operations, companies should look at using industry or service specialists that can help identify and implement appropriate and effective solutions. These specialists can provide insights into how private equity operates because private equity firms consult them to drive improvements in their investee businesses.

Companies that act to improve their own performance stand the best chance of succeeding in a more competitive and efficient marketplace.

The way I see it

Roy McKelvie
Chief Executive Officer
Gresham Private Equity Limited

I've enjoyed being part of the private equity industry for the past 18 years, initially in Europe as a director of 3i plc, then as managing director and Asian head of DB Capital. I joined Gresham Private Equity in Sydney at the beginning of 2004 and led the team that completed our acquisition of the Pacific Print Group (now GEON Group). My colleague Mark Rimmer and I are on the board of GEON and heavily involved in driving the strategy to create one of the largest printing and visual communication groups in Australasia.

Our activity in the printing industry illustrates the strengths of private equity and the impact it can have on an industrial sector. We acquired 50 per cent of PPG in 2005, largely to fund subsequent expansion and acquisitions. The remainder of the company was owned by a mix of print industry investors and the vendor management teams giving them a direct incentive to continue contributing to the group's success.

Since then we have corporatised the business by bringing in a group management team to drive growth and to realise the obvious benefits of being part of a larger organisation.

The business has acquired a further seven companies, which has enabled us to provide integrated solutions to clients across Australia and New Zealand. By expanding up the value chain into mail management, fulfilment and logistics, we are progressively offering our clients a more comprehensive yet simpler and more cost-effective solution to their communication needs.

We are also finding efficiencies and developing new capabilities by investing heavily in the latest printing technology and merging group companies together in locations such as the new Highbrook facility in New Zealand. When complete, this will be the largest single print site in the Southern Hemisphere.

Our focus is on high-margin businesses with strong cash flows that produce high-quality printed material, typically on a fast-turnaround basis. PPG had 700 staff and sales of about A$150 million when we bought into the business in 2005. Today, GEON Group has sales of nearly A$450 million and close to 2,000 staff.

This approach is a change for the commercial printing industry which, despite turning over around A$11.5 billion in Australia and New Zealand, remains massively fragmented. There are more than 2,000 printing business in Australia alone.

One of the top drivers for consolidation in the print industry is that large customers are demanding integrated national or international suppliers that can deliver cost savings and enable them to improve their operations. The industry is also capital intensive and the requirement to continually invest in new technology is increasingly making it harder for small companies to keep up.

A more subtle factor is that printing is not sexy, making it hard to attract top managers and even the next generation within family-owned businesses. By creating larger companies with sophisticated strategies, private equity has been able to offer more appealing careers for managers, has attracted higher-calibre management talent into the industry and can provide an exit path for founders.

I would agree that as private equity has matured in Australasia and competition for assets has increased, there is more focus on operational improvement. Private equity managers have always focused on building value and you will find they have a good understanding of the key drivers for companies within their portfolios. But given that the price paid for a dollar of earnings has approximately doubled since

continued...

The way I see it

...continued

I joined the industry, it is true to say you have to run harder to make the same return and therefore you have to be very focused on where you can add value.

One way we're adding value within GEON is in procurement. This is being centralised to increase buying power and ensure we are working with the best and most cost-effective suppliers across the group. This change has meant a significant cultural shift for many of our group companies, which have had long relationships with favoured suppliers, but is absolutely the most rational way to buy common equipment, raw materials and consumables.

Our procurement approach is a small example of how private equity, with its lack of vested interests, and smart, experienced people, can make industries more efficient and ultimately drive international competitiveness. Fundamentally, I believe that people who own a stake in a business, as all my team do in each of our deals, and as all our management teams do, are motivated to make better, more logical and focused decisions than they might if they were purely an employee. It is a great example of the reality of what academics call the agency/principal conundrum and is why private equity is shaping the Australian corporate landscape for the better.

Take action

- **Learn** what private equity is doing in your sector.
- **Proactively consider how to improve performance** to mitigate the threat of private equity-controlled competitors.
- **Review management incentive schemes** to ensure they are appropriately aligned with the company's objectives.
- **Consider the use of industry and subject matter experts** to help drive improved performance and ensure viability in the longer term.
- **Approach the above with an open mind** as to the potential range of options available.

Figure 5: Private equity-controlled industrial products companies in Australia

Company	Sector	Private Equity Fund
Air International	Machinery & equipment wholesaling	CCMP Asia
Amatek Group	Building products manufacturing	CVC
Aperio Group	Plastic bag & film manufacturing	Catalyst Investment Managers
Australian Portable Buildings	Pre-fabricated building manufacturing	CHAMP Ventures
Australian Water Systems	Plastic product manufacturing	NBC Capital
AutoBake	Food processing machinery manufacturing	ANZ Capital
Bayard Group	Electrical equipment manufacturing	DB Capital
Blue Star Print Group	Printing	CHAMP Private Equity
Bremca Industries	Electrical equipment manufacturing	ANZ Capital
Brickworks	Clay brick manufacturing	Pitt Capital Partners
Channell Bushmans	Plastic product manufacturing	ANZ Capital
Digga Australia	Mining / construction machinery manufacturing	ANZ Capital
Envotec	Paper stationery manufacturing	Catalyst Investment Managers
Form-it Services	Plastic product manufacturing	ANZ Capital
GEON (Pacific Print Group)	Printing	Gresham Private Equity
Global Food Equipment	Food processing machinery manufacturing	Advent
Hunter Valley Building Supplies	Wooden structural component manufacturing	Hawkesbridge
Integrated Packaging Group	Plastic bag & film manufacturing	Hastings Private Equity
Intercast & Forge	Iron & steel casting and forging	CHAMP Ventures
International Energy Services	Material handling equipment manufacturing	CHAMP Private Equity
Jeminex	Machinery and equipment wholesaling	AMP Capital
Lazer Safe	Machine tool & part manufacturing	ANZ Capital
Locker Group	Fabricated metal products manufacturing	Advent
MCK Group	Automotive component manufacturing	Archer Capital
Metro Glass Tech	Glass product manufacturing	Catalyst Investment Managers
Minelab	Electronic equipment manufacturing	CHAMP Ventures
Moen Glass	Glass product manufacturing	ANZ Capital
Nortruss Builders Supplies	Wooden structural component manufacturing	ANZ Capital
Parkside Towbars	Automotive component manufacturing	ANZ Capital
Price Plastics	Synthetic resin manufacturing	Equity Partners
Recovcorp	Scrap metal processing	Hastings Private Equity
SCF Containers	Metal container manufacturing	Archer Growth
Shorko Australia	Plastic bag & film manufacturing	Hastings Private Equity
Steel Storage	Fabricated metal products manufacturing	Carnegie Wylie
Steelforce	Steel pipe & tube manufacturing	Next Capital
Sulo	Plastic product manufacturing	Archer Capital
Vanglobe	Synthetic resin manufacturing	RMB Capital

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Graeme Billings leads the Industrial Products practice for PricewaterhouseCoopers in Australia. He has over 25 years experience providing assurance, transaction and consulting services with multinational and national clients in the automotive, construction and general manufacturing industries.

Graeme draws on his extensive experience with acquisitions and mergers and other business investigation areas such as due diligence, investigating accountants' reports, fraud investigations and internal control reports.

As a regular media commentator on the Ai Group/PwC Performance of Manufacturing Index, Graeme provides insight into the direction and challenges of the manufacturing sector.

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Nick has over 8 years experience in advising clients undertaking transactions, specialising in the industrial products and industrial services sectors. Working with a range of clients in Australia, Nick has advised on a number of private equity transactions, divestments, acquisitions, IPOs and capital raisings, assisting shareholders and boards in achieving their transaction objectives.

Dan Cotton
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Dan joined PwC in January 2006 as Director, heading up the Private Equity Originations Team. Dan was admitted to the Partnership on 1 July 2007.

Dan has been involved in a variety of transactions including mergers and acquisitions, expert reports, valuations and capital raisings.

Previously Dan spent 5 years with Goldman Sachs JB were in Sydney and also spent 3 years with Grant Samuel. Dan worked in London from 1991 – 1998, latterly with Granville & Co., the investment bank with a focus on mid-sized growth companies and private equity exits

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