KEYNOTE INTERVIEW

Deal activity booms despite challenges

Last year saw record levels of manufacturing and industrial sector dealmaking and 2022 has started in the same vein despite recessionary fears, says John Stewart, founding partner at MiddleGround Capital

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Q What has the past year been like for manufacturing and industrials, and where did you see the most activity?

Last year was an interesting time to be in manufacturing, with the covid overhang and navigating issues like mandatory covid vaccination. We were forced to take a stance as employers at a time when governments around the world could not agree. There was also supply chain disruption and an economic boom. All our companies had huge backlogs, record revenues and record profitability but were also having trouble with their supply chains and managing labor.

We approached the covid vaccination issue from both a workplace safety and social responsibility perspective but also from the perspective of our workers, something I related to because I started my career as an hourly line worker with Toyota. We focused on providing a safe working environment while also not politicizing the issue. At the start of 2021, only 15 percent of workers in our portfolio companies were vaccinated. We wanted to encourage vaccination, but we didn't want to make it mandatory. We offered a $250 gift card to employees who got the vaccine and were able to increase the vaccination rate to just over 50 percent. Today, we continue encouraging people and have healthcare professionals who come onsite to deliver vaccines, but we don't believe we should push harder than that.

From a deal perspective, activity was up significantly for us last year. We saw a lot of deals in the second half and had a record year for capital deployment. There were so many deals in the market at the end of 2021 that investment banks were saying certain sponsors didn't have the resources to look at all the opportunities. That led banks to pull deals back into the start of this year, which has gotten off to a robust start.

The increase in interest rates has not really impacted leverage availability on transactions yet, but we expect that to happen. A lot of sponsors are bringing deals to market because valuations are high, and it is a good time to sell. There is so much pent-up demand from 2020, as many financial sponsors continue to have significant capital to deploy.

Q What are the major challenges facing manufacturers today?

Supply chain disruption is the biggest challenge, along with the labor market. There is just not enough labor available.

On supply chains, we see a lot of companies localizing their supplier base and that is really helping our portfolio because we invest in North American headquartered businesses. Because we buy a lot of the same raw materials, like steel and aluminum, shielding us from some of the worst disruption, we have been able to leverage our purchasing power across the portfolio to stabilize the supply chain and prices.

Raw material prices have increased dramatically over the last few years. At the end of 2019, steel was at a record low price and now it is at a record high. The same is true with oil. Commodity prices have a huge impact on the supply chain – it is difficult to get what we need, and we have to pay a premium.

Regarding labor, we see a great opportunity for the American worker because companies should be increasing manufacturing wages as well. Our main competition for resources is fast food, which is a completely different skillset. We have an initiative called "25 for 25," where we are trying to use technology across our portfolio to increase our lowest wage to $25 per hour by 2025. A manufacturing job should command a wage at a $10 premium to fast food.

Last year, we took the first step and got all our lowest paid workers to $15 per hour, which was a significant accomplishment. That's still only $600 a week and not enough to live on in 2022. Of course, the majority of the jobs at our portfolio companies pay much more than $15 per hour, and we think using technology to make processes more efficient will reduce non-skilled low wage positions and create higher skilled positions which allows companies to raise wages. We want to take advantage of the current backlog and strong future demand to make a shift in how our portfolio companies operate.

"Events like the situation in Europe with Ukraine and Russia could prove to be a tipping point, showing how fragile the economy is"

The infrastructure for manufacturing in North America has been heavily under-invested in for decades; the average company is using technology from before 1970. That creates a big opportunity for businesses to take advantage of advances in technology to become much more efficient and produce more products with their current employees. It is not about using technology to reduce costs, which has historically been the focus, but to produce more products with the current labor available.

Q How do you prepare your companies for a situation like a pandemic?

We do a few things differently to build resilience. We got through the pandemic without making any mandatory layoffs at any of our companies. There are not many financial sponsors with an industrials portfolio that can say that, but we knew that demand would snap back and wanted to have a strong workforce in place.

MiddleGround's heavy operational focus enables our companies to pay down significant debt early on and maintain strong access to liquidity. Additionally, even though we are a leveraged buyout group, we don't rely heavily on leverage, and we put more equity into our deals. That meant we had better balance sheets going into the pandemic and enabled us to make sound business decisions with a longer-term view. As we do add-on acquisitions, it is not unheard of for us to put in 100 percent equity. We can still create solid returns with moderate leverage. We buy good businesses with good free cash flow conversion, so we are happy putting in more capital in the initial transaction to reduce risk.

Not everyone has taken that approach, so we expect to see a big restructuring opportunity coming in the next 12 to 24 months. A lot of industrials companies used inflated valuations to take on more debt on fluctuating interest rates, and that is going to put stress on cashflows as rates rise.

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Q What trends do you think are going to most impact manufacturing in 2022?

It is supply chain disruption, the inflationary climate that we have right now, and the challenges around rising wages and access to labor.

On inflation, for now our companies are being successful in passing on pricing to consumers. The types of companies that we acquire do not make commoditized products, where things are more difficult. Our products are highly engineered so there is still high demand. We have people wanting those products regardless of the price, but that can't last forever.

The consumer has a lot of new money because of inflation in the stock market over the last few years, supported by the availability of credit. But as the interest rate starts to rise, that's going to hit people's pocketbooks and could lead to a squeeze on spending and demand.

Events like the situation in Europe with Ukraine and Russia could prove to be a tipping point, showing how fragile the economy is. Cutting off that supply of oil and gas to Europe will have major repercussions across the globe. Prices will rise and that could be enough to put us into a recession. That is something everybody should be preparing their businesses for in the next 18 to 24 months.

Q How does an industrial PE firm tackle something like ESG?

We were the first sub-$1 billion industrials private equity firm to sign the UN Principles for Responsible Investment back in 2020. We have been proactive – a lot of industrials firms have an ESG policy but no real metrics. We use ESG to evaluate new transactions and track certain key performance indicators for each business.

As mentioned, wages are important to us, and we have a commitment to keep the minimum wage over $15 per hour across our portfolio. That's significant – we recently bought a company paying $11, so we increased wages by $4 an hour.

We now have a dedicated ESG team and are dedicating resources to ESG across the portfolio. In manufacturing, there are a lot of industries that have been excluded from current laws on environmental or safety standards, so we see a big opportunity to make a difference where the government can't or won't. We are investing millions of dollars in our portfolio to address working conditions, wages, environmental impact and governance.

ESG is important not just to our investors but also to our workforce. There is a new generation of workers that care more about the impact that they can have than just how much money they make. Our motto is to leave everything better than we found it – it takes extra time and a little bit more work, but we are showing we can do that and still achieve strong returns for our investors.

Q What is the outlook for 2022?

We expect deal volumes to stay high for the near future. Valuations will stay high, certainly through the first half of 2022, and we will wait to see the impact of the situation in Europe on the economy.

The covid impact on businesses has been factored in and demand for manufacturing is going to remain robust. Raw material and commodity prices are going to continue to rise, and towards the end of this year we could be entering a recessionary environment due to inflation. To prepare for that, we need to increase the efficiency of our companies to take on this heightened demand and remain flexible.

Buying good businesses is the best way to build resilience going into a recession. Most of the companies that we buy have been around for decades and have survived the global financial crisis, covid and more. Customers are always going to need good products, even if volumes decline. As people continue to consume and new houses continue to be built, investing in core products that are still necessary is the best way to position your manufacturing portfolio for a recession. ■