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Manufacturing Sector M&A Prospects

As InterOcean predicted earlier this year, M&A activity in the manufacturing sector increased in the second quarter of 2010. The increased activity was driven by factors impacting both the supply of and demand for acquisition opportunities.

Supply. As business conditions improved, many of our manufacturing clients saw their order books grow in the first and second quarters of the year. With more robust sales activity, cash flow improved for many firms. However, in many cases increased sales required a commensurate increase in working capital. For some firms with excess inventory, improved sales created an opportunity to manage inventory lower and pay down debt. This improving cash flow is setting the stage for increased value expectations and the potential for higher net proceeds for potential sellers. In addition, many private company owners are motivated to complete sale transactions before the end of 2010, because they anticipate that the capital gains rate will be raised.

Demand. Many prospective strategic buyers have an abundance of cash, because they maintained level earnings over the past 18 months and accumulated cash to enhance liquidity in an environment with uncertain access to capital. These companies are under pressure now to grow their businesses. With a slow-growing economy, organic growth is challenging and acquisitions are an attractive alternative. Strategic buyers are being aggressive in assessing value and creative in deal structuring. Deals are often being priced off forward earnings and include earnout structures that might not have been considered in the past. While more aggressive in other sectors, private equity firms have not demonstrated a willingness yet to bid up manufacturing company purchase prices to compete with corporate buyers – unless they already have a related company in their portfolio.

InterOcean anticipates the pace of M&A activity in the manufacturing sector in Q3'10 to stay roughly the same as in Q2'10, but we may well see upward pressure on valuations. This will be particularly true for firms that demonstrated success navigating the economic turmoil of 2008 and 2009 and that delivered a strong rebound in performance in the first half of 2010. If the slowing pace of economic expansion tempers the supply of opportunities, buyers might be forced to bid up for more scarce quality targets.

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