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Melrose seeks out next purchase as it eyes Elster sale

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Melrose Industries is lining up the sale of its 21st business next year, as the UK engineering turnround specialist considers plans to put Elster Water, a maker of water meters, on the auction block.

The potential sale of the first part of its Elster group of businesses, a German manufacturer of utility meters which Melrose purchased in 2012 for £1.8bn, comes as the group prepares to make its next big acquisition.

"We think 2015 may well be a very good year for us," says Simon Peckham, chief executive, adding that the 11-year old company does its "best deals when the markets are tough".

Mr Peckham is one of three founding executives at Melrose, alongside David Roper and Chris Miller, who set up the company in 2003 with £13m of funding. Today, it has a market capitalisation of £2.7bn.

Established by the former executives of mini-conglomerate Wassall - which was sold to KKR shortly before the dotcom crash for a 40 per cent premium - Melrose has become adept at buying engineers cheaply, raising margins 5-6 per cent, and selling for a profit.

The company, whose motto is "buy, improve, sell", has been on the lookout for its next big deal for the past year but high prices have seen the management team err on the side of caution.

"We've found some cracking opportunities we'd like to own where we think we can improve the margins but at the moment pricing isn't right," says Geoff Martin, finance director at Melrose.

Mr Miller says they have learnt not to feel the pressure. "You absolutely have to wait for the right moment. I know the tagline is 'buy, improve and sell' but the first bit is probably the most important. If you buy the right company at the right price, that's where the whole thing starts. You get that wrong, and you've got it all wrong," he explains.

Melrose's strategy, alongside its typical three to five year time horizon for turning groups around, has drawn comparisons with private equity. The management team is at pains to stress that its model diverges sharply from that adopted by private equity groups, however.

The Melrose approach lies not just in cutting costs, but in investing where necessary. With the exception of 2009 and 2010, capital expenditure in its stable of companies has exceeded depreciation in each of the past eight years. Analysts are expecting a ratio of 1.8 this year.

Mr Roper says they have a rule of thumb that they will sign off capital expenditure requests within 48 hours of receiving them in the head office. "We're really happy to invest capital. We generally say yes because the businesses know what we're looking for," he adds.

The management team are heavy investors themselves. According to research by Stephen Swanton, an analyst at Redburn, Melrose directors have invested £16m of their own money into the group since 2007, accounting for nearly half of the £34m purchases by boards in the capital goods sector.

Executives and founders of Melrose.
L-R **Simon Peckham, David Roper, Chris Miller and Geoff Martin.** Credit: David Parry/ FT

In the absence of a big deal since the purchase of Elster in 2012, Melrose has focused on selling businesses and returning money to shareholders. Its latest sale was Bridon, a maker of industrial cables, for £365m to Canada's Ontario Teachers' Pension Plan last month.

This takes its disposal tally to six businesses over the past two years for roughly £1.3bn, which saw the return of about £600m to shareholders in February and a further £200m to follow early next year.

A sale of Elster Water next year could generate about £250m, according to analyst estimates. Since its acquisition, Elster Water has improved the most, with Melrose lifting its margins from 4 per cent to 15 per cent.

Mr Peckham says it is considering putting Elster Water up for auction, rather than a private sale, because it could be sold to either a trade buyer or a private equity group.

Of its remaining businesses, Brush, a turbogenerator manufacturer, is likely to be next on the disposal list. The management team say this is unlikely to happen until 2016, however, once its new £30m Chinese factory is opened at the end of next year.

Mr Peckham says there are no immediate plans to sell either Elster Gas, which makes up roughly 80 per cent of Elster's profit, or its smaller division Elster Electricity.

Despite both Mr Miller and Mr Roper being in their sixties, they insist they have no plan to retire any time soon. Even if Melrose finds itself being bought, the management team say they would happily do it all over again.

This may in part be due to their own financial remuneration as part of Melrose. The three former Wassall executives and Mr Martin received £126m payout two years ago after the crystallisation of its five-year incentive scheme. The next one - due in three years' time - is likely to be another bumper payout.