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UK COMPANIES

Industrials. Buying to sell

Melrose sees light at end of tunnel in acquisition hunt

Engineering turnround specialist eyes potential big targets after three-year search

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Well fitted: Melrose says it is unlikely to sell its Brush electricity generator unit despite having owned it since 2008 - several years longer than usual

Melrose Industries, the British engineering group, is preparing to end the hunt for its first big acquisition in more than three years as it tries to clinch a deal for up to £4bn.

The London-listed company, which buys and turns round underperforming manufacturing businesses, says more potential takeovers are emerging from the industrial gloom.

High asset prices had proved an obstacle to its search for a target. But the commodities slump and China's economic slowdown have driven industrial stocks downwards.

"The likelihood of buying at the right price has definitely increased in the last few months," says Simon Peckham, chief executive. "Valuations are certainly looking a lot more attractive than they were, which is a reason why this year we're pretty optimistic that we'll be able to find a deal."

Melrose would "happily do a £1bn enterprise value and deal" and "could probably stretch up to £3bn or £4bn", he adds. "Finding the right thing in the right circumstances at the right time— that's much more important than the absolute size."

Three-and-a-half years have elapsed since Melrose's last sizeable acquisition —of Elster, the utility meter business, in August 2012.

In its biggest transaction to date, it completed the sale of Germany-based Elster for £3.3bn to Honeywell last year —generating a substantial return on the £1.8bn it paid.Melrose returned £2.4bn from the sale to investors in January, with most of the remaining proceeds used to pay off debt.

Before the sale Elster accounted for about 80 per cent of Melrose's market capitalisation and a similar level of its operating profits, after central costs and an incentive plan in 2014.

> Buying the Philips bulb unit would be the biggest deal yet for the former lighting group executives

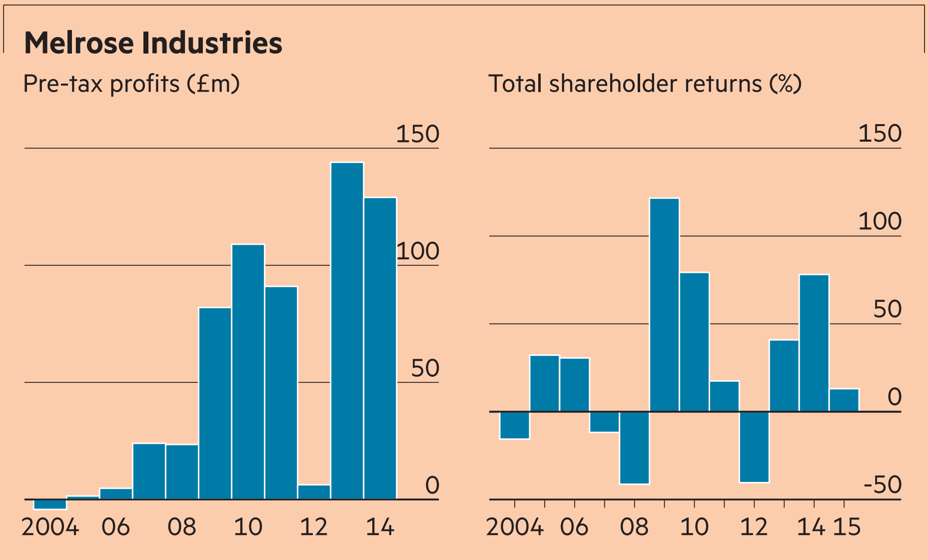
Speculation has mounted that the group has joined the second round of bidding for the lighting division of Philips—believed to be valued at about €5bn by its seller — alongside the buy-out firms Blackstone,Onex and Apollo. Mr Peckham has not confirmed the group's involvement in the process.

Buying the Philips lighting unit would be Melrose's largest takeover yet. It would mean managing a business that makes old-style incandescent bulbs, which are in decline, LEDs, which are replacing them, and fittings.

Such territory would not be uncharted for Melrose. Its three founders ran a lighting systems business when they were executives of Wassall—a similar buy-to-sell mini-conglomerate that was sold to private equity group KKR shortly before the dotcom crash, for a premium of more than 40 per cent.

Mr Peckham, David Roper and Christopher Miller set up Melrose in 2003 with £13m of funding and are still on its board.

Since its first deal 11 years ago, the team has built a reputation on a model that involves buying engineers cheaply,



Sources: Bloomberg; Thomson Reuters Datastream

raising margins by 5-7 percentage points and selling for a profit. A die-cast metal parts producer and a maker of window hinges are among businesses that have passed through its stable.

Melrose says it has delivered £4.3bn in cash to shareholders, from whom it has raised about £2bn since floating on Aim in 2003. Now listed on London's main board, Melrose typically raises equity capital after lining up a purchase.

With its "buy, improve, sell" motto, the company has drawn comparisons to private equity. However, its management plays down the suggestion, emphasising that as well as cutting costs Melrose makes investments.

"They fish at the different end of the pond from us," says Mr Miller, executive chairman. "We're looking for problems to fix; they're not."

Mr Peckham says there are similarities. "[But] we invest about a third of the acquisition price back into our businesses — that's how we generate returns".

Melrose's directors are heavy investors themselves, having put in £16m of their own money since 2007 — far higher than any other UK engineer, according to research by Stephen Swanton of Redburn, the broker.

Its four leading executives received the bulk of a £126m stock payout in 2012 from a five-year incentive scheme.

Melrose also says it borrows more conservatively than private equity companies — some of which have encountered difficulties raising bank finance amid turmoil in credit markets.

"If they have more restricted access to leverage then that's got to be in our interest," says Mr Peckham.

Until another acquisition is finalised, he says, Melrose is unlikely to offload the sole remaining business in its portfolio, Brush, even though it has owned the supplier of electricity generators to the offshore and power sectors since 2008.

The company's typical holding period is three to five years.

At financial results next month investors will be looking for signs of improvement. The energy price slump has contributed to a fall in orders at Brush, and operating margins slipped from about 20 per cent to 12.3 per cent in the most recent half-year.

"We got the selling point of a lot of our businesses right," says Mr Peckham. "In a sense, I guess we have to accept we slightly missed this cycle."