FINANCIAL TIMES
THURSDAY 7 JULY 2016

Lex.

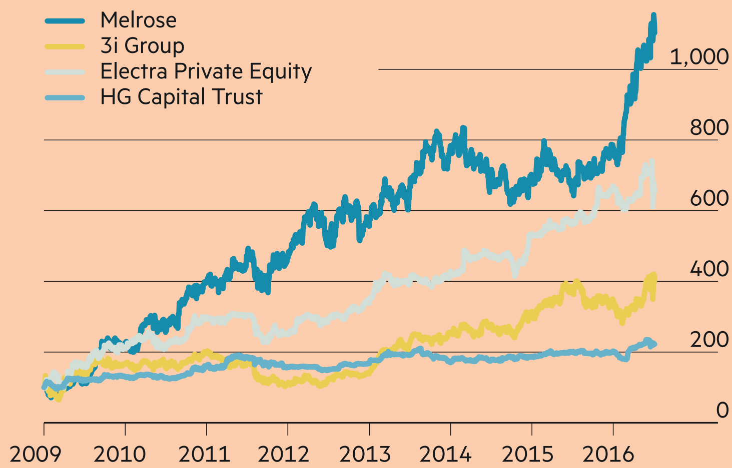
Twitter: @FTLex **Email:** lex@ft.com

Melrose: Improving returns

Melrose's strategy of acquiring individual companies is riskier than the portfolio approach of private equity firms. But returns have been strong, helped by a focus on raising margins

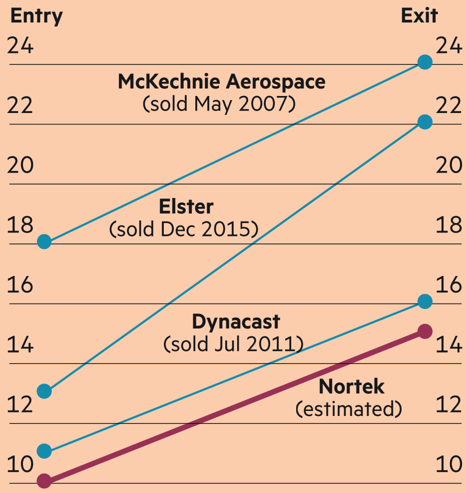
Melrose versus listed private equity firms

Total returns (rebased)



Margin improvement

Headline operating margin (%)



FT graphic Source: Thomson Reuters Datastream; company

Buy, improve, sell. The mission statement of Melrose is admirably clear. But while it sounds uncannily similar to private equity, the UK industrial group's modus operandi is notably different.

Yesterday, it announced the acquisition of Nortek, a quoted US company that manufactures heating and ventilation products. Three-quarters of the £2.2bn enterprise value of the transaction will be financed via a deeply discounted rights issue. Previous deals, such as Elster in 2012 and McKechnie in 2005, were similarly financed. A typical private equity transaction would use a far heavier debt load.

Nortek's returns are depressed by its overleveraged balance sheet — interest expenses eat up about two-thirds of operating profit — so a quick win will be to cut debt and refinance the remainder at a much lower rate. The cash flow this liberates will mostly be reinvested in the business to improve operating margins; cutting costs is important, but not the primary consideration.

There is no private-equity style "2- and-20" fee structure. Managers are paid a salary and an annual bonus, and there is an incentive plan that in 2017 will pay out (in shares) 7.5 per cent of any increase in the market value of the company, adjusted for inflation, since 2012. Shareholders are also rewarded differently. Listed private equity groups typically pay regular dividends, with the remainder of the return coming from rising net asset values that are reflected in the share price. Melrose pays regular dividends, but has a history of large, ad hoc payouts. Most recently it handed back £2.4bn following the sale of Elster to Honeywell.

And whereas private equity firms typically run a portfolio of investments via limited-liability funds, Melrose will absorb Nortek. Its progress in the next several years will largely depend on its latest acquisition. This is a riskier approach, but Melrose's record is reassuring. And it makes valuation easier. Applying a profit multiple to a Nortek with higher margins is one way to explain the 30 per cent jump in Melrose's share price after the deal.

© THE FINANCIAL TIMES LIMITED 2016