PRIVATE EQUITY | DECEMBER 2022

Shifting Gears:

Private Equity Looks to Spark Industrial Growth

Cherry Bekaert
Your Guide Forward

Key Observations

- Deal activity is down from the record highs in 2021, but remains higher than pre-pandemic levels
- Macroeconomic headwinds, including supply chain disruptions, labor shortages, high inflation, and rising interest rates, pose a challenge to the industry
- Business transformation, particularly around supply chain and labor force constraints, serve as key counterpoint to economic pressures
- Ongoing global issues, including the war in Ukraine and a surging U.S. dollar, is affecting commodity pricing, and generating economic uncertainties
- Government stimulus programs in the sector is expected to attract more private equity engagement in the next three to five years

2022

$150B Expected PE Industrial Sector Investment

1,500+ Deals Expected to be Completed

Rate of Add-on Deals **Doubled Since 2016**

Private Equity Industrial Segment Leadership

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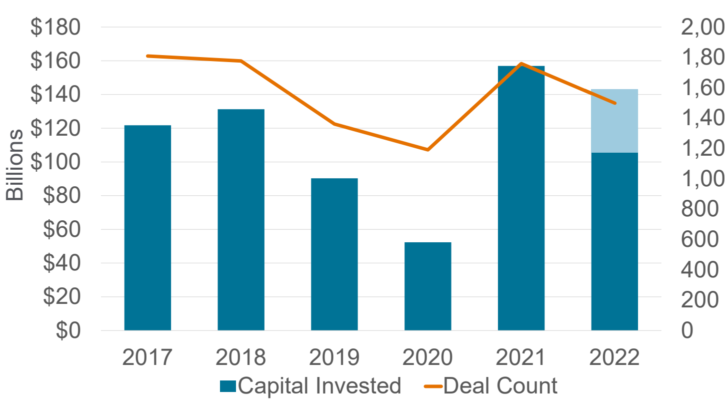
Background

Excluding a slump at the onset of COVID-19, deal volume in the industrial segment as a percentage of overall middle-market deal activity has remained flat, as compared to other segments such as technology and healthcare. More recently, supply chain interruptions and labor shortages have further dampened deal activity. However, the industrial segment has been the beneficiary of an array of positive sentiment arising from COVID-related fiscal and monetary stimulus programs, including the Infrastructure Jobs Act of 2021, and most recently the Inflation Reduction Act of 2022. These are some of the factors contributing to private equity investors showing a renewed interest in the sector. By the end of 2022 private equity investments in the industrial sector is expected to surpass $150 billion, eclipsing the pre-pandemic high-water mark of $131 billion established in 2018.

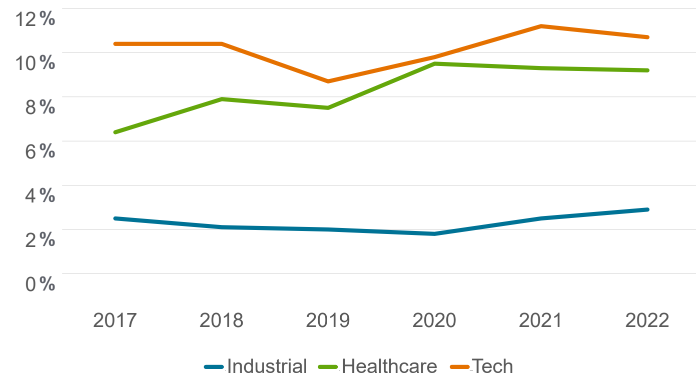
Industrial Capital Investments & Deal Count



Source: PitchBook | Geography: US
**As of September 30, 2022 – Q4 2022 data is projected*

> Many companies are passing on increased costs to consumers as they adjust to high inflation, but these adjustments may not be keeping pace with the level of rising input costs which inevitably creates margin pressures that can result in growth stagnation."
>
> *– Matt Brady, CPA*
> *Partner, Industrial Industry Leader*

U.S. Private Equity Deal Activity by Sector



Source: PitchBook | Geography: US
**As of September 30, 2022 – Q4 2022 data is projected*

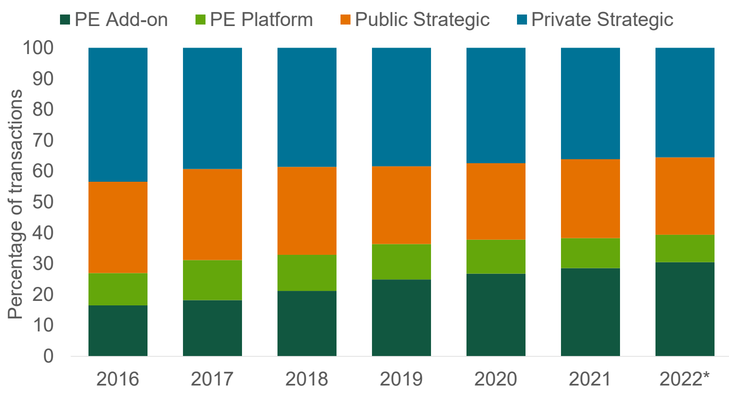
Inflationary Pressures

Over the past 24 months, the U.S. industrial segment has experienced a number of COVID-19 induced challenges, particularly caused by the global shutdowns. However, record high inflation and a rising interest rate environment are presenting a new set of issues, the likes of which the industry has not experienced in more than 40 years.

While many believe the U.S. economy is teetering on the brink of a recession, it is currently faring much better than other advanced economies such as the United Kingdom, other European nations and Japan. The Federal Reserve's hawkish monetary policy to combat rising inflation has caused the U.S. dollar to surge in value relative to other currencies. While this may benefit American consumers who buy foreign goods, it also means U.S. exports have become more expensive for global consumers—many of whom are in countries already experiencing more severe economic pressures than the U.S.

If history is any indication of the future, periods of economic downturn will move private equity firms to pursue add-on acquisitions which are easier to finance as compared to platforms. Add-on deals also create opportunities to take advantage of reductions to private market valuations while increasing market share for a platform business. Heading into 2023, private equity add-on acquisitions are expected to continue to outpace strategic buyers as a percentage of completed transactions.

Strategic vs. Private Equity Buyers



Source: Capital IQ (YTD ending October 27, 2022)

Commodity Pricing and Inventory

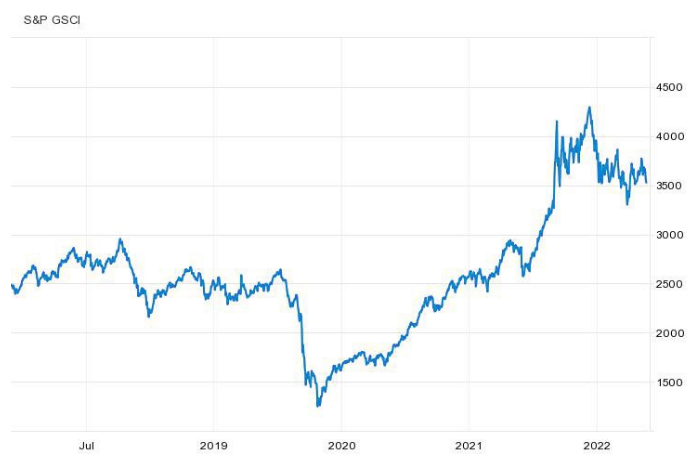
Few industries are impacted by movements in commodity prices more than the industrial segment. As inputs such as energy, materials and labor become more expensive there is often a delayed reaction in the ability to pass these higher costs on to customers. Since the Summer of 2021 commodity prices have experienced a rapid and unpredictable increase. Russia's invasion of Ukraine in February caused a further spike in commodity prices that has adversely impacted many European economies.

Surging commodity prices combined with supply chain and logistical challenges caused many industrial businesses to begin stockpiling inventory levels as early as the Spring of 2021. These companies are now faced with the challenge of addressing bloated balance sheet inventory levels in the face of potential recession-related declines in consumer demand.

As organizations grapple with high inflation, there has been a renewed interest in LIFO (Last-in, First-out) inventory tax planning strategies. During periods of inflation, organizations with increasing (or consistent) inventory costs may benefit from higher tax deductions from LIFO elections where the most recently purchased or produced goods are the first items expensed through cost of sales thereby reducing taxable income and preserving cash for other uses.

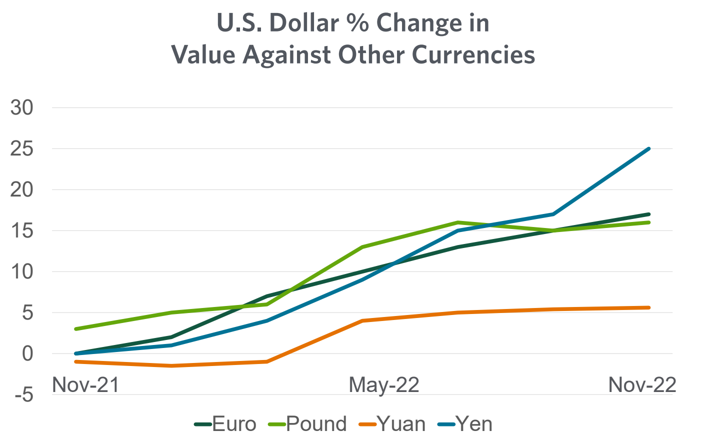
While overall input costs remain high, there are developing signs which indicate the worst impacts of rising interest rates and inflation may be in the rearview mirror. In October, PMI data compiled by S&P Global showed input costs were rising at the slowest rate in six months, signaling a potential cooling of global consumer price inflation heading into the fourth quarter. Although input costs have moderated on previous occasions since 2020, this time looks different due to a faltering of demand that is not related to COVID-19 containment, a greater-than-previously-seen easing of supply constraints, and evidence of less inventory buildup (and even destocking).

Commodity Pricing Exposure



Source: https://tradingeconomics.com/ (data as of October 30, 2022)

> During periods of inflation, organizations with increasing inventory costs may benefit from higher tax deductions by electing LIFO which can reduce taxable income and preserve cash for other uses."
>
> *- Al Sanifar*
> *Partner, Private Equity Tax Services Leader*



Source: X-Rates (www. X-rates.com/table)

Supply Chain Revolution

For decades the focal point around manufacturing was globalization. However, there has been a reversal of this trend in recent years—one that predates the pandemic but was certainly expedited because of it—as industrial companies seek supplier diversification with a greater emphasis on domestic sources to fill orders. While shorter lead times and higher product accessibility are some of the obvious benefits of supplier diversity, other benefits are being realized in the form of more competitive pricing, less expensive freight costs, faster fulfillment times, and innovative suppliers who are differentiating themselves from competitors through the use of disruptive technologies and solutions.

It is anticipated the trend to reduce reliance on foreign suppliers will continue to make domestic options a more critical component of vendor management. However, the investment needed to produce this change has become more expensive given the rising interest rate environment and the need to better manage working capital requirements.

With years of experience in supply chain management and driving business transformation, supply chain and logistics is an area where private equity can accelerate positive change, which may partly explain private equity's willingness to stay engaged in the sector.

Industry 4.0 - Movement to Smart Manufacturing

Over the past 18 months, nearly every business has felt the impact of labor shortages and higher labor costs. With less people entering the workforce in recent years, it is predicted as many as 2.1 million manufacturing jobs will go unfilled nationwide by 2030, according to The Manufacturing Institute.[1] This may pose a problem for sustainable growth in the sector. However, one solution being adopted across the manufacturing spectrum is the movement to "Smart Manufacturing" which focuses on automation and digital transformation.

Structural changes within the industry, including automation and digitalization has the potential to offer significant investment opportunities for private equity funds, particularly by sustaining valuations and increasing multiples even in the face of an economic downturn. Industry 4.0, which refers to the fourth industrial revolution in manufacturing, is revolutionizing the way companies manufacture, improve and distribute their products. Manufacturers are integrating new technologies, including Internet of Things (IoT), cloud computing and analytics, and AI and machine learning into their production facilities and throughout their operations.

Over the long haul, efficiencies realized through automation and digital transformation produce competitive advantages in the marketplace. However, while automation and digital transformation may help address specific pain points, the broader reality is that the industry as a whole must find new and innovative solutions to attract, retain and upskill its workforce if it is to fully realize the growth opportunity the market currently presents.

> When you can't find people, machines can help fill the gap. Automation can help manufacturers augment human workers and free them up to focus on more valuable tasks, enabling a new level of productivity."
>
> *– Bob Misch, PMP*
> *Partner, Business Strategy & Digital Transformation*

[1]https://www.themanufacturinginstitute.org/2-1-million-manufacturing-jobs-could-go-unfilled-by-2030-11330/?stream=a-fame-graduate-finds-a-fresh-start

Outlook

Although dealmaking and lending activity in the industrial sector is pulling back from the pace we saw earlier this year, there is strong optimism that the COVID-induced stagnation in the industry may well be behind us. The private equity market still has plenty of uncalled capital to work with and management has a number of tools in the toolkit to promote growth and attractiveness. As of September 30, more than $800 billion was committed to buyouts, and private equity funds have an unrivaled $2.5 trillion in unspent capital. Consequently, private equity investors are well-positioned to not only withstand the effects on an uncertain marketplace but to take advantage of it and grow beyond what we have seen in over the past decade.

Jeffrey Bengtson
Partner, Deal Advisory Leader

Cherry Bekaert's Private Equity Practice

Ranked among the largest accounting and consulting firms in the country, Cherry Bekaert provides guidance and support that helps our clients achieve their business objectives. Our integrated approach to serving private equity funds and their portfolio companies enables us to provide assurance, tax planning/compliance, transaction advisory, and digital services tailored to the unique needs of our private equity clients.

Our Transaction Advisory Services professionals work closely with our industry teams, as well as our tax, assurance, and accounting services teams, to provide first-in-class M&A advice across a wide range of industry sectors, specializing in Deal Advisory, Transaction Tax, Valuation and Digital Transformation. We ignite growth with forward-looking industry solutions that add value at every phase of the investment lifecycle.

Q&A

Can you tell us about the overall state of the industrial and manufacturing industry? What impacts are you seeing from the larger macroeconomic pressures on deal making, as well as value drivers?

Matthew Brady, CPA
Partner, Industrial Industry Leader

The strength of the U.S. industrial and manufacturing industry is a critical indicator of the country's overall economic health. In times of economic turbulence, we have seen the industry innovate and transform to meet those challenges. While we saw a surge in the industry in 2021, there are still larger macroeconomic headwinds the industry must overcome. The U.S. manufacturing industry will (again) need to reinvent itself to remain competitive and they appear to be up to the task. We are already seeing companies and their investment partners reimagining their manufacturing processes and paradigms, aiming to make them more sustainable, digital, skilled, and resilient.

There are several key themes expected to drive activity in the industry which are generally centered around capital availability, commodity prices, intensifying focus on Environment, Social, and Governance (ESG) investing (the application of non-financial factors as part of their analysis process to identify risks and opportunities), as well as U.S. governmental commitments to infrastructure.

The industrial industry has been recovering rapidly after the pandemic, but it is not immune to the challenges associated with an elevated risk environment and supply chain inefficiencies. Rising raw materials, rising labor costs, and transportation and logistics costs are among the challenges manufacturers face. Manufacturers continue to invest in new technology and labor productivity, even though these investments may not yield the expected benefits for some time into the future.

Accelerated by COVID-19, digitalization is now essential to maximize operational efficiency and leverage opportunities for new business models and revenue streams. Commodity prices remain in a state of flux, leading corporate leaders to rethink their sourcing and pricing strategies, while closely monitoring the impact of inflation. With a significant dry powder war chest and record high capital raising, private equity continues to look for opportunities to invest in the sector. In addition, GPs and LPs have continued to formalize ESG commitments as ESG becomes a focus of investors and consumers alike. Over half of total fundraising—the highest percentage ever—flowed to firms with formal policies and this trend is expected to continue and potentially drive additional growth.

What are the benefits of digitalization and business transformation broadly speaking? And why is it particularly important for industrial companies?

Jim Holman
Director, Strategy & Operations Leader

As the world continues to embrace digital innovation, U.S. manufacturers stand to benefit from further investment in next-generation technologies. Investments in artificial intelligence, cloud computing, and the Internet of Things (IoT) now total around $300 billion a year. By 2030, industry-specific technology will be used in nearly every aspect of manufacturing, and it is expected to account for 50 percent of all 5G-connected devices.

Digital transformation and automation in manufacturing can greatly benefit organizations that want to increase their productivity and add value. The increased efficiency and speed in manufacturing can help organizations respond faster to changes in consumer demand and improve production quality, while reducing the amount of nonproductive time. Digital transformation in manufacturing can significantly reduce machine downtime as well as improve throughput and labor productivity. These advantages are often difficult to replicate when applied across large manufacturing works, but companies at the leading edge of the industry are capturing the benefits across the entire value chain.

However, it is important to note that digital transformation projects are complex and risky. To achieve optimum benefits, companies must follow strict project management principles. In addition, these initiatives need to be treated as a continuous cycle of optimization, digitization, and automation. Another advantage of digital transformation and automation in manufacturing is the ability to customize products. This increases efficiency and helps manufacturers keep prices competitive. Manufacturers can also use robots to handle hazardous environments and sensors to alert employees of potential hazards. These advances in automation can also help manufacturers recruit skilled workers. If done right, digital transformation and automation can help a company increase its overall production capacity.

Finally, digital transformation can make businesses more efficient at collecting and analyzing data. Before, data was spread across disconnected platforms. Today, businesses can leverage this data by creating a central data repository and creating tools to analyze it. This can make data analysis more accurate and effective and can improve corporate decision-making.

Q What are the deal dynamics taking place in the industry today and looking into the future?

Liz Slobasky
Director, Deal Advisory

Industrial manufacturing dealmaking was strong in the first half of 2022 but down from the record highs seen in 2021, where deal activity was mostly driven by pent-up demand. As noted in our **2021 Middle-Market Private Equity Report,** there was widespread expectation that the industry would experience relative contraction in light of a rising interest rate environment and inflation. This negative forecast was compounded by stubborn labor shortages, persistent supply chain disruptions, and a geopolitical conflict between Russian and Ukraine. That said, taking a wider view of dealmaking in the industry, there is an unmistakable growth trend and private equity is leading the way with over $150 billion in capital commitments expected in the industry.

Activity in the first half of 2022 was focused less on transformational megadeals (transactions exceeding $1 billion in deal value) and more on smaller, targeted acquisitions and divestitures. This was driven by buyers building out platforms and filling in market gaps with strategic add-on acquisitions, sellers divesting non-core divisions or assets and broad concerns of U.S. regulatory scrutiny. Deal activity in the first half of the year outpaced pre-pandemic numbers, particularly in Q1 as Q4 '21 deals progressed toward completion—notwithstanding growing uncertainty in the global economic market. The onset and persistence of the larger economic headwinds (commodity pricing, inflation, inventory costs, etc.) will likely challenge M&A through the rest of 2022 and into 2023. Given the potential shift to onshoring for manufacturing, localization rather than cross-border transactions will likely be a primary focus area for M&A in the near-term.

While most agree the economic slowdown we are currently experiencing will persist into 2023, the underlying economic fundamentals are somewhat reassuring for the long-term. Private equity firms have a record amount of dry powder on hand, and when combined with the promise of technology optimization to improve labor productivity, as well as strategic carve-out divestitures, many expect continued private equity dealmaking activity in the industry. In addition, the U.S. government is poised to inject significant public capital into the sector, which may mean a massive boon for manufactures, and will likely attract further private equity investments. According to one industry insider, "broad swaths of the manufacturing industry are going to see significant opportunity."

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