MANUFACTURING & DISTRIBUTION M&A QUARTERLY

Q3 2022

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MANUFACTURING & DISTRIBUTION M&A QUARTERLY: Q3 2022

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Rising interest rates, ongoing supply chain disruption, higher costs of doing business, and a possible recession all continue to impact M&A deal flow for Manufacturing and Distribution businesses in Q3 2022. While overall deal volume was low, the average deal size remains consistent among other recent quarters over the past two years. In addition, although we may see a shift to smaller deals closing over the next couple of quarters as more entrepreneurs and family businesses are sold, deal pricing in the Manufacturing and Distribution sector remained high during Q3.

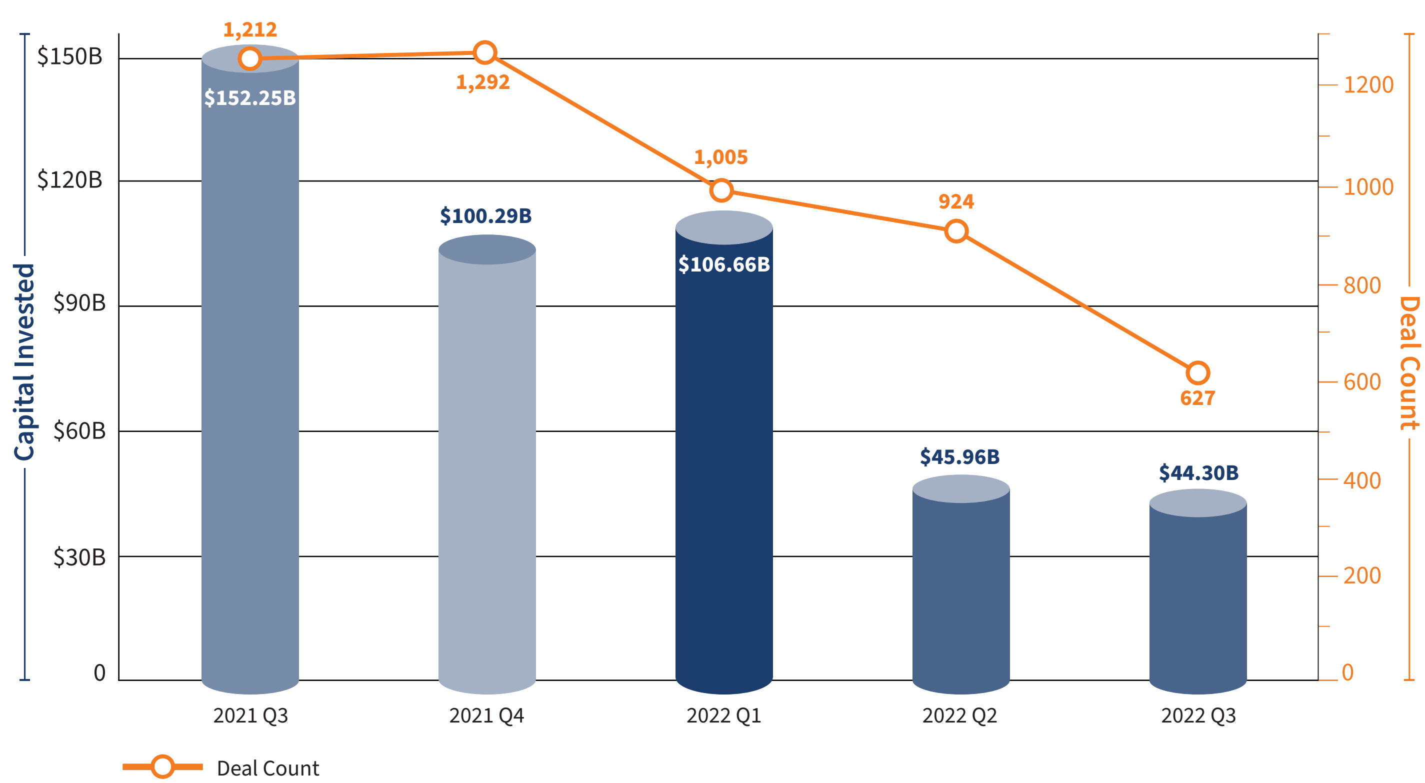
The total capital invested in the Manufacturing and Distribution sector during the quarter was $44.30 billion across 627 deals. This compares to $45.96 billion across 924 deals during Q2 2022. The top deals for this quarter included II-VI's $7.01 billion acquisition of Coherent, a developer of photonics-based technologies, and the $5.8 billion sale of building material manufacturer Cornerstone Building Brands to Clayton, Dubilier & Rice.

SKIP TO A SECTION:

Q3 2022 TRENDING NUMBERS

All data gathered from PitchBook Data, Inc., as of Oct. 3, 2022

Capital invested by deal count



As the business world works to right itself from the impacts of the pandemic, while also preparing for economic uncertainty, the amount of capital invested in Manufacturing and Distribution leveled off during Q3. Furthermore, although deal count was low at just 627 total transactions (versus 924 for the previous quarter), the average deal size remained consistent at approximately $70.65 million. This is interesting because we assumed multiples would retreat as debt levels increased, but the market clearly hasn't moved in that direction yet.

The top investors during Q3 included Advent International, Arcline Investment Management, Audax Group, Bain Capital, Kohlberg Kravis Roberts, One Equity Partners, SK Capital Partners, and AEA Investors. Most of the top investors in the Manufacturing and Distribution sector have remained active during previous quarters, although Advent International was a newer entrant to the Top 10 list for the third quarter.

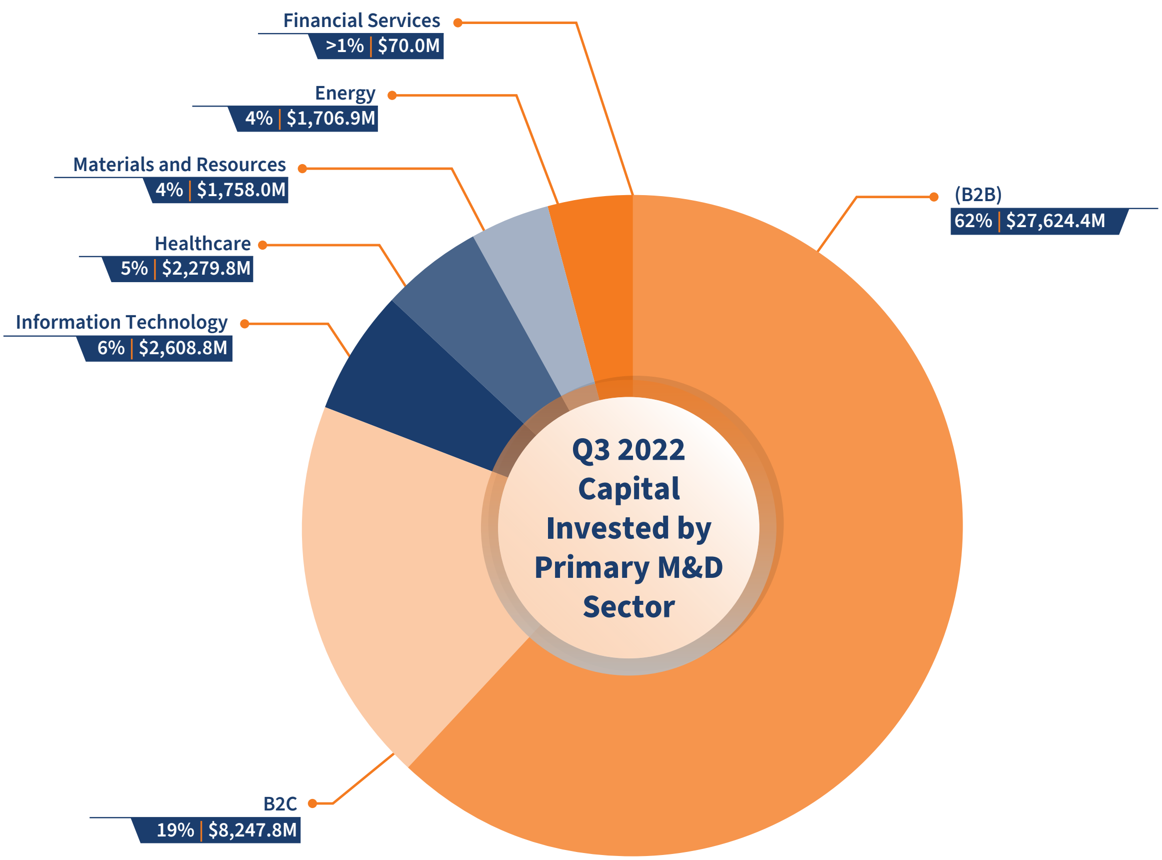
Q3 2022 top investors: Most active private equity firms based on number of deals

Private Equity Fund	Deal Count
Advent International	7
Arcline Investment Management	4
Audax Group	4
Bain Capital	4
Kohlberg Kravis Roberts	4
One Equity Partners	4
SK Capital Partners	4

In addition to the Coherent and Cornerstone Building Brands deals, Q3 also saw Neogen acquiring 3M's Food Safety Business for $5.3 billion, Hewlett-Packard buying lightweight communications device maker Poly for $3.3 billion, and manufacturer Oldcastle APG acquiring Barrette Outdoor Living for $1.9 billion. Rounding out the list of Top 10 deals were SpaceX, LiveWire EV, Manitowoc Ice, Elkay, and Natus Medical.

Most of the deals that closed during Q3 involved B2B-focused companies (62% of deals), followed by B2C, IT, healthcare, materials and resources, and energy. Within those larger categories, companies in the healthcare, materials and resources, and food space were among the most popular acquisition targets during the three-month period.

Q3 2022 capital invested by primary M&D sector



MARKET FACTORS IMPACTING THE DEAL SPACE

There are several trends and market factors that are impacting the Manufacturing and Distribution deal space, although performance during Q3 for the most part aligned with what we're seeing in the broader market. Some of the top factors include:

Top market factors impacting the deal space

- **Rising interest rates make money more expensive to borrow**
- **Labor issues and business disruptions persist**
- **Russia-Ukraine war impacts**
- **Rising prices**
- **Recession talk**
- **Inflation continues**

- **Rising interest rates make money more expensive to borrow.** The Fed continues to bump up the interest rates in an effort to curb inflation, but that's also making debt more expensive. As a result, investment in the manufacturing industry is estimated to grow at a tempered 1.2% in 2022, according to IBISWorld.
- **Labor issues and business disruptions persist.** The lag between employee wages and the inflation rate affects productivity and increases personnel turnover. This leads to decreased output, delayed deliveries, and lower invoicing in the short term, all of which may have impacted deal flow during Q3.
- **Russia-Ukraine war impacts.** Many companies have seen their business costs increase this year as a result of the war, with the rising numbers partly due to the reliance on oil, gas, wheat, corn, sunflower seed, semi-finished iron products, and other staples of American life that are exported from Russia and Ukraine. It continues to drive up food costs for basics like oatmeal, bread, and cereal.
- **Rising prices.** We have seen companies increase customer pricing to offset the higher pricing they have received from their own vendors. It is not clear yet how sustainable it is for companies to continue to pass price increases onto customers and retain the demand.
- **Recession talk.** One economist pointed out that during recessions, outputs come down and employment rates go up. We're not seeing either of those trends play out yet, so the uncertainty around whether we are actually in – or, heading into – a recession is high at this point.
- **Inflation continues.** Inflation may create negative real returns on investment in the short to medium term. It may also trigger further strategic portfolio review and divestment of non-core assets to focus investments on growth areas of their business portfolios. If the inflation trend continues down its current path, it may also drive a distressed M&A market.

Q3 2022 Top 10 deals

Company Name	Deal Size (millions)	Investors	Deal Type
Coherent	7,010M	II-VI	Merger/Acquisition
Cornerstone Building Brands	5,800M	Clayton, Dubilier & Rice	Buyout/LBO
3M (3M's Food Safety Business)	5,300M	Neogen	Merger/Acquisition
Poly	3,300M	Hewlett-Packard	Merger/Acquisition
Barrette Outdoor Living	1,900M	Oldcastle APG	Merger/Acquisition
SpaceX	1,900M	Alpha Dhabi	Later Stage VC
LiveWire EV	1,770M	AEA-Bridges Impact	Reverse Merger
Manitowoc Ice	1,600M	Pentair	Merger/Acquisition
Elkay	1,560M	Zurn Water Solutions	Merger/Acquisition
Natus Medical	1,197M	ArchiMed	Buyout/LBO

WHAT'S NEXT?

For Q4, we may see deal pricing recede somewhat, the sustainability of companies' earnings will likely be challenged, and investors may remain concerned about the current market conditions. For now, sellers still appear to expect high valuations – a reality that may be impacting the total number of Manufacturing and Distribution deals that are closing. There is an obvious continuance of longer negotiations between the seller and the buyer to agree upon a company's final valuation. As a result, it is taking the average deal longer to close than ever before, which is reflected in the total volume of deals closing.

Looking ahead, investors and companies in the Manufacturing and Distribution space should also be paying attention to:

- **A broader focus on environmental, sustainability, and governance (ESG) initiatives.** Business partners, investors, and customers are demanding it, and more than one-third (702 total) of the world's largest publicly-traded companies have already established their own net-zero targets. Companies in the Manufacturing and Distribution sector could follow suit and have a competitive advantage over other companies that are not moving in this direction.

- **Reshoring, onshoring, and near-shoring** increases as manufacturers work to get better control over their supply chains. According to the Reshoring Initiative, reshoring exceeded foreign direct investment (FDI) by 100% in both 2020 and 2021 – a recent trend not seen since 2013. The group said FDI exceeded reshoring every year between 2014 and 2019. "Additionally," the group added, "the number of companies reporting new reshoring and FDI set a new record of over 1,800 companies."

- **The government is working on tariff rollbacks.** The Section 301 (for imports from China) and 232 (on steel and aluminum products from most countries) tariffs put in place are also making headlines again as the Biden administration looks to roll them back. The U.S. placed tariffs on nearly $400 billion of imported goods in 2018-2019. Aside from several exclusions or "waivers" that were put in place, both the Section 301 and Section 232 tariffs have remained intact for the last four years. In May, the United States International Trade Commission (USTIC) launched a fact-finding mission to determine the economic impact of the tariffs on U.S. industries. As part of its investigation, the USITC held a public hearing about the Section 301 and 232 tariffs in July. The tariffs may stay in place in at least some form for the immediate future.

- **Value creation becomes a focal point.** In the current M&A market, investors are placing a bigger emphasis on value creation. They are looking for targets that understand their own value, know how much of that value has been created over the prior 12 months, and understand both where their business value is increasing and where there are gaps. According to BlueWave, a consulting and solutions provider to private equity (PE) funds, value creation accounted for 68% of PE activity during Q2, up from 59% during the same period in 2021.

DATA DUE DILIGENCE: RETAINING MARGINS AND INCREASING VALUE

All companies begin feeling their margins tighten as passing along price increases to their customers is no longer an option. This means they have to find other ways to retain margins and increase their value. With so much data available, organizations can get a more accurate picture of their own customers' price elasticity, know where the barriers are, and make better current and future demand predictions.

Particularly in manufacturing – and to some extent, distribution – there is so much throughput that data is the fuel that powers the organizational engine. For example, data supports inventory controls, the ability to do accurate forecasting and planning, and in-depth visibility into customer and supplier relationships. It also helps companies pinpoint and address any externalities and constraints that are in the environment.

CohnReznick recently worked with a distributor that wanted a better assessment of its "true demand." It was experiencing a high volume of lost sales due to inventory stock-outs and was doing demand planning based on the prior year's sales. Using a comprehensive approach to available data (i.e., ecommerce, external web data, social, and existing sales) we built out a more reflective demand profile picture. This allowed the distributor to make better inventory management decisions, particularly for fast-moving items that were either being passed over by customers or bought from a competitor.

This is just one example of the critical nature of data availability and visibility at every level. Without it, we can't make decisions about the target, the market, or the investment thesis. This makes data a critical part of value creation for integration and separation. Data also helps position the target company to operate more effectively, make decisions quickly, report accurately, and maintain internal integrity.

Here are some additional points that middle market companies and investors should keep in mind during the upcoming quarter:

- Data is the foundation for how all transactions come together and decisions get made; whether that be the availability of data to conduct quality of earnings, the propensity to have integrity in the numbers, or confirmation of the fitness level of finances that are being evaluated.
- When evaluating a company's technology and operating footprints in terms of diligence, investors are looking more closely at the fitness, availability, quality, and security of data. Investors understand that the data not only helps support better decision making, but that it also leverages potential value creation plans.
- Any family-owned and/or entrepreneurial companies coming into the market right now may have historically focused on growth over financials and data. As a result, companies cannot really get a good understanding of where their business stands, and lack the detailed financials and metrics to substantiate their value.
- Manufacturers and distributors that are reliant on legacy technology systems are struggling to find coherence in their disjointed technology. This can impede access to accurate, relevant, and current data, which often must be manually extracted from systems and then shared on spreadsheets. As part of their digital transformation efforts, companies are increasingly turning to enterprise resource planning (ERP) platforms that help them bring their data and operations into a single platform.

Right now, organizations are using data due diligence when undertaking any kind of transformation effort; before they restructure, make an investment in technology, or roll out any operational process improvements. Companies are also taking a hard look at their data, the quality of that data, and how it can be used for better, more informed decision making.

In the Manufacturing and Distribution transaction environment, data is being leveraged both for embedded due diligence and to support overall digital transformation efforts. However, in the coming years, an increased emphasis will be put on privacy and security maturity as a business differentiator – not just a cost center. Organizations must keep in mind that once data is collected and resides on an enterprise system, a connection between data privacy and cybersecurity is formed.

FOOD MANUFACTURING DEALS

Deal activity remained active in the food industry and we noted some interesting trends that are having a more pronounced impact on the food manufacturing, preparation, and delivery fronts.

Two deals that closed during the quarter were Gladstone Capital and Burlington Capital Partners' leverage buyout of food ingredient manufacturer Sokol & Co., and the $54 million in debt financing that brand-name food manufacturer and co-packing company, Chairmans Foods, received from three different banks.

Expect to see more debt refinancing deals – versus recapitalization – taking place in Q4 as food manufacturers seek out additional funding for internal investments and to manage operations in an inflationary market.

With 537 deals closed so far in 2022 for a total of $10.74 billion capital invested, food technology has been a popular target for investors. In June of 2021, for example, Motif FoodWorks raised $226 million in Series B funding and in May of this year they raised another undisclosed amount, highlighting the growing interest in the sector. Motif FoodWorks is using the capital to develop technology for the engineering and fermentation of better tasting plant-based food products. Also in Q2, MyForest Foods received a $15 million venture loan that it is using to scale up production of mycelium bacon (a bacon substitute made from mushroom roots).

Deal activity during this latest quarter is also revealing stronger interest in both ghost and cloud kitchens, and food delivery providers to close the final-mile gap between those kitchens (or restaurants in general) and customers.

Cloud and ghost kitchens utilize a commercial kitchen for the purpose of preparing food for delivery or takeout only, with no dine-in customers, often times with multiple brands operating from the same kitchen. Both cloud and ghost kitchens enable restauranteurs to expand an existing restaurant, start a virtual brand at minimal cost, or test several brands at once. They thrive on online ordering through different food delivery websites and do not have a physical dine-in facility. Unlike traditional brick-and-mortar locations, these kitchens allow food businesses to create and deliver food products with nominal overhead.

Q3 2022 FoodTech deals

Company Name	Deal Size (millions)
Gopuff	1,500M
Glovo	905M
Kitopi	715M
Wenger Manufacturing	540M
Rappi	500M
Weee!	425M
Plenty	400M
UPSIDE Foods	387M
Wonder	350M
Viridi Energy	320M

Meal delivery orders increased by more than 150% from 2019 to 2020 – and UBS anticipates the food delivery market to increase more than 10 times over the next 10 years, from $35 billion to $365 billion annually. More restaurant owners and food entrepreneurs are turning to cloud kitchens as an ideal business solution to capture this increase in food delivery demand.

During Q3, cloud kitchen platform developers Kitopi and Wonder raised billions in funding with Kitopi raising $715 million in Series C funding and Wonder raising $350 million in Series B funding. Also on the Top 20 food technology deal list, restaurant technology platform developer, Kitchen United Mix, raised $100 million through the combination of Series C and Series C-1 venture funding. We checked in with Kitchen United's Chief Business Officer, Atul Sood, regarding the company's intention for the recent capital raise and he reported that the new funds will be used to "further explore opportunities in the retail space with a particular focus on our partnership with Kroger where we've deployed ghost kitchens within a grocery environment and our proprietary technology stack, MIX OS, which powers food halls".

Of course, cloud kitchens need someone to deliver their meals and that is driving investor interest in companies like Gopuff, BeyondMenu, and Flipdish, all of which are working on their own food delivery applications and platforms, and all of which were acquired, received funding, or announced their intentions to go public in Q3. With more people working remotely and no longer "going to lunch" in urban hubs, we expect demand for these technologies to continue.

As we move into Q4, certain macro-factors will continue to impact the deal space. Investor interest in Manufacturing and Distribution companies that are innovative, and able to create value and their own growth paths will also continue to reap the benefits. We expect to see a strong Q4 transaction environment with companies looking to close prior to the New Year, and believe private equity funds will also continue to focus on businesses that give priority to technology improvements, automation, and the use of data to make more informed business decisions while also creating efficiencies in areas such as labor constraints, supply chain and inventory management, and access to raw materials.

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