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Market Perspectives from the Industrials Sector

Geraldine Alias, a senior portfolio manager at Choate Investment Advisors, is joined by Chip Grace, a founding partner of private equity firm May River Capital, to discuss May River's investment philosophy, the types of industrial companies May River believes will outperform in our current environment, and how May River and its portfolio companies are navigating the effects of COVID-19.

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Transcript

Geraldine Alias: Hello this is Geraldine Alias, a senior portfolio manager at Choate Investment Advisors. Joining me today is Chip Grace a founding partner of May River Capital. May River Capital is a private equity investment firm based in Chicago that seeks to help lower middle market, high caliber industrial businesses grow and thrive. May River started in 2012 with a simple premise, leverage the friendship, complementary skills, and experience of the three founding partners with the singular focus on underserved but attractive market differentiated industrial growth businesses. Thank you very much for joining us Chip.

Chip Grace: Thank you for having me. It's really nice being with you today. Thank you.

GA: Chip if you don't mind, I wanted to start off by talking about the economy. People often say that the U.S. no longer has a strong industrial sector. Is that your experience?

CG: It's not. You know, our brand of industrial is really focused on high value industrial businesses. So these are typically companies that have their own intellectual property, it may be a traditional form of IP, like engineering drawings, patents, etc. It may be a unique manufacturing capability or some type of process know-how that's you know differentiated. But most of our businesses, if you think of, you know, traditional manufacturing, which is the bulk of what we do. We own a service business today, but most of what we do involves some form of manufacturing or assembly. If you think of manufacturing, our typical companies are producing low volume parts that have high mix characteristics. So these are again, kind of smaller volume sizes and a great variety of product. So, a lot of the typical products that are considered to be, either have been offshored or thought of as being, you know, produced in Asia or otherwise, you know, tend to be, you know very high volume type of products. Most of what we do has

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never gone offshore. We certainly have supply chains that exist in Asia and Europe and other places, but by and large you know manufacturing our brand of manufacturing in the United States is still alive and well. These are again typically very differentiated products and services. They tend to have a high cost of failure and they may be selling into some form of regulated industry or end market or they may also be serving a clientele that has very rigorous standards for product quality. For example, we own a business that produces valves and actuators primarily for the Navy supply chain. So those by definition have to be made domestically. There are a great number of specifications that are laid out by the Navy and by the prime contractors that really disallow those types of products to be produced offshore or even any type of supply chain within the production set of a given product to be offshore. So, those types of companies have never gone offshore. Will never go offshore. Again these are kind of high cost of failure. Low cost product. Mission-critical type product application. So, you know, while we do leverage global supply chains, I'd say the vast majority of our manufacturing really has never left the United States and certainly more recently you're hearing, I think a louder drum beat with respect to on shoring. And that narrative has certainly picked up over the last six to twelve months, with respect to critical parts of the economy, like the pharmaceutical category, PPE, etc. Things that have really risen up through the pandemic have shined a very bright light on this whole concept of reshoring and the need to produce those types of products entirely domestically and not be reliant upon global supply chains. So that would be an interesting trend to watch over the next decade. It can't be done overnight, obviously. But certainly we think it will benefit the industrial economy stateside.

GA: So Chip that's fascinating. So can you talk a little more about the evolution of the industrial sector and the U.S. economy maybe 20 years ago, 10 years ago, now, and obviously you already gave us little insight to potentially what the future will look like.

CG: Sure, I'm not much of an industrial historian. But, I'll take stab at it. You know I think offshoring to lower cost labor environments really began in earnest I'd say in the eighties and continued through the nineties and into the two thousands. Obviously beginning with China, but then, seeing more activity in Mexico, near shoring, seeing Southeast Asia have its comeuppance, particularly in light of the pandemic, where a lot of the production has been moved to places like Vietnam or at least secondary sources being created in Southeast Asia as an example. But you now have the advent of automation, which has become a huge category in and of itself within the industrial segment and I think we'll narrow that gap with respect to the cost of producing a given part whereby domestic sourcing very well could be roughly proximate from a cost standpoint when you factor in kind of fully landed costs with shipping, time on the water, things of that nature. So, I suspect that automation, IOT, these kinds of new economy, new industry 4.0 discussion points will all work collectively to create a more robust domestic manufacturing economy. Clearly the narrative that I discussed earlier with respect to reshoring. What you're hearing, certainly in the political environment now, in light of the pandemic, but also around concerns involving intellectual property theft, national security, as you hearing about with respect to Hauwei and other factors. These are all interesting points that I think point to a general movement within the domestic industrial economy to become more robust. But our brand of industrials have never really been susceptible to offshoring fully and again going back to the low mix high volume environment being susceptible to offshoring that's been overseas for a very long time, things like consumer electronics have been offshore forever, as long as I've been in this business in the mid-90s, when I got into investing banking originally. So, our brand is again kind of high mixed, low volume, which is the opposite of those product by and large have never really gone offshore albeit we do source globally across our portfolio.

GA: That's fascinating Chip. I know you started May River for a specific reason with a specific focus and I'd love to get a little insight into the private equity side of the industrial landscape. In other words, why start May River, what was specifically something you thought was missing in the private equity landscape?

CG: Our origins in the industrial segment, in my case and in my partner, Steve's case, really go back to our upbringing. Our family business was started in the 1890s, believe it or not, and was in our family is an industrial business, now owned by a larger publicly-traded conglomerate, but was in our family for four generations and you know you grow up as a kid and discussions around the dinner table are about the family business and our parties were company parties that had at our house and so that's kind of how I grew up and Steve's family business is also very similar also an industrial company was started by his grandfather in the thirties. It's kind of in our blood and something that is really kind of second nature to us as far as a focus and an interest. But what we observed, my former firm and throughout our careers and Dan the same at his former firm, was that the industrial segment within private equity was really populated by firms that had had tremendous success and had really grown themselves out of the lower middle market and what I mean by that is that they had raised subsequent funds with increasing fund sizes and now today, probably managing billion to 4/5 billion dollar funds. Because they had success and generated great returns for their investors, they were given the latitude and the support to raise subsequently larger funds and what that did was really create a bit of an air

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pocket within the lower middle market which we defined as companies with EBITDA under $10 million that we felt was underserved and that's really where we play. You know 3 to 10 million of EBITDA is really our sweet spot to initiate a platform and what we find in that part of the market from a size segmentation perspective is that of market private equity has a hard time investing in those types of businesses from a return on time standpoint and from a capital allocation standpoint meaning, they have a hard time as a billion, 2 billion dollar fund, justifying a 5 million dollar EBITDA business because the equity check isn't large enough. In every deal, it takes a similar amount of time whether it's a five million dollar or a fifty million dollar EBITDA business. You still have to work the diligence process, the documentation process, you know work through the portfolio management phase, you know, etc. etc. So the larger funds have really tried to focus upmarket and has provided us with an opportunity within the private equity landscape to take advantage of that gap. The other thing we've noted is that strategic buyers, again these are largely publicly-traded industrials corporates, they really have a hard time buying those same businesses, the five million EBITDA example that I gave earlier for the same reasons, which is this return on time concept and you know these are businesses that just aren't needle moving as a couple, three, four or five billion dollar market cap company. You know they're not going to get a lot of bang for the buck by buying 5 million dollar EBITDA business. They'd rather see us buy those businesses, build them, introduce real processes and systems, introduce a real commercial front end, a sales and marketing function within the business, top grade leadership teams, scale them from a 5 million EBITDA business to a 15 or a 20 million dollar EBITDA business and really create what we call a move-in ready house. So, that this buyer, whether it's a strategic acquirer or an upmarket private equity firm, really doesn't have to do the heavy lifting that we did to really create that move-in ready house. So, a simple kind of strategy but it's very difficult to execute and we've thankfully been blessed with excellent relationships within the executive area of the industrial space. We have terrific executives within our bench, so to speak, that really help us transform these businesses, scale them, improve them, make them more valuable and then hopefully again kind of create that move-in ready house, graduate them to a strategic acquirer or a bigger private equity firm.

GA: And everyone says right now that there is a lot of dry powder of there. In other words, a lot of capital that is waiting to be invested in companies. Is that your experience?

CG: It is. I think it's kind of undeniable if you just look at the statistics, you know, I think now a trillion and a half of private equity, you know dry powder, I think the latest statistic I saw it's a staggering number, but again, I think most of that capital is really pointed toward bigger businesses and I think you know a lot of people talk about the private equity landscape as a barbell. You know you either want to be at the very small end of the barbell which is where we play with a very specific sector focus. Ours being high-value industrial growth companies or you want to be at the bigger end of the barbell, multibillion-dollar funds, mega funds. I think the tough areas in between where you get strategic buyers, you get upmarket mega funds, you get leverage packages, that are five, six, seven times EBITDA or greater, that's a hard place to play. That's why we want to stay focused exclusively on the lower middle market and not change really anything about our investment focus or strategy. Just get better at what we do.

GA: One of the many things I love about May River is your motto: "Always take the meeting." How do you go about doing this during these unprecedented times?

CG: Yeah, my former boss said, private equity is a shoe leather business which I've always taken that to heart and it stuck with me. But we really believe that as the phrase indicates "always take the meeting". You really never know where your next opportunity is going to come from. Whether that's a traditional means like an investment banker or a business broker or some other M&A intermediary or it can be an executive from industry. It could be a consultant. It could be an LP, it could be a lender. You know these are all folks that have touch points into relevant deal flow and so we go out of our way to take any and all meetings, calls, etc. Really trying to tell our story as to what is our investment focus, how are we differentiated, both in terms of that focus, but also our firm culture. What's important to us, how we really put the human element at the forefront of what we're doing each and every day. How we are terrific partners to management teams and business leaders. That's really where I think the rubber meets the road within the lower middle market. These are generally small businesses that are typically founder family entrepreneur owned. People matter in these businesses. They can be fragile enterprises and you have to really take good care of them and by the same time you want to make progress, make a change in a positive way. So there's a fine balance between that, but yes, always take the meeting, you never know really where your next deal opportunity is coming from. It's hard for guys loving getting on airplanes and really would rather be talking to a business owner or a management team than anyone and touring facilities. It's been hard not tapping into that lifeblood. We are making do. ZOOM is a great tool, but it's really no replacement for person-to-person interaction. To physically walk a plant floor, understand the flow of products, the nature of the manufacturing, talk to the people that are operating the machines, there's really no replacement for that, so, I think it's going to be a little awkward as we kind of work

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through the remainder of this year into next year. I think there is no real blueprint for how to conduct yourselves in this environment. Obviously, we'll be listening to the health experts and trying to invoke all the guidelines into our own businesses, but it does make for a challenging dynamic when you're wanting to get on a plane and go meet a management team if that's just not a safe proposition. So, we are making do, but it's tough for guys that really kind of thrive, like we do, on meeting with companies and management teams and business owners.

GA: So shifting gears a bit, I imagine all your portfolio companies were deeply impacted by COVID-19. Would you mind giving our listeners a sense of what life was like for them back in March?

CG: So we have six platform companies today, just to give some context. They range in size from the lowest from a revenue standpoint, to fifteen million, our largest business is roughly sixty million in revenue. So again, these are smaller businesses. We have sixteen facilities, globally. We have an operation in France, we have two locations in the UK, we have two locations in Canada. All 16 of our facilities globally were deemed essential businesses or whatever that country's equivalent of that is for example, in France or Canada they stayed open you know throughout the pandemic. We worked really hard with our management teams to work through that process to remain open and our leadership teams did an excellent job of making sure all of our employees were safe and healthy and felt comfortable coming into work every day. You know we implemented some unique processes during that time for example, we instituted staggered shifts and many of our operating environments, whereby say the red team worked on Monday, Wednesday and Friday and the blue team worked on Tuesday, Thursday and Saturday. The idea being that if there was an outbreak within either the red or the blue team, you could shut down that team and continue to operate the facility with the other team. So things of that nature that we did which were just you know not earth shattering in terms of their novelty but I think just smart business decisions. But all of our businesses were again deemed essential. If you look at our revenue year over year through June, our businesses were down in the aggregate seven percent. Which you know in today's GDP numbers, the Q2 contraction of I think just about 30-33%. We certainly fared better than the broader economy and feel very good about the performance of our portfolio having been down only 7%. We saw the trough really it looks like in April that was the low point. You might recall Geraldine that a lot of our businesses have a backlog. There's a time gap between when an order is received and when you actually recognize revenue. So there's a little bit of a lag effect. So March was an okay month for most of our businesses just given they had orders in house that they processed. April was not as great as they worked off the backlogs. The order activity really troughed in last week of March, first week of April for all of our businesses, but it's been increasing since. It hasn't been a perfect line for all of our companies up into the right, but a trend line nonetheless whereby we think the April and May months, from a revenue standpoint, in terms of recognized revenue was really the trough. June has improved and so far what we're seeing in terms of indicators for July are also positive. But, it was a trying time and no doubt about it. The uncertainty caused tremendous consternation for everyone and we felt that our companies felt it. One thing we did recently was to try to physically get to a few of our businesses that were either drivable or found other safe means to get there. Just to thank our employees for showing up every day, for keeping the businesses firmly on the rails. I think that small gesture meant a lot to them and so, again we did as a whole within the portfolio a great job of kind of managing through that. I think we had four COVID cases across the entire portfolio which all four of those people are back to work and healthy, thankfully. Very pleased with the performance overall. But no one's really slapping each other on the back, it's a very difficult time for our country and more globally given the high level of unemployment, the broader economic devastation that this is has ravaged, so we're trying to keep our eye on the ball, but so far so good from our standpoint.

GA: Well that's impressive Chip, knowing as you mentioned the numbers that have been showing recently with regards to unemployment, and the economy shrinking, only 7% decline is absolutely amazing especially in the sectors, the industrial sector, despite it obviously it being stilled. Very strategic it probably felt more than maybe the technology sectors that we've seen. So, very impressive.

CG: Thank you, thank you. Just to add to that, you know I think the last three years as a firm, we've certainly anticipated some form of economic downturn within the coming years and really conscientiously tried to shift our investment focus into those businesses that were, whether it's the attributes of the company perhaps they had a high aftermarket or MRO type of revenue mix, or the end markets that the business sells into from a demand driver standpoint, we really tried to point towards those businesses that we thought would demonstrate a fair amount of resiliency in the ultimate recession, you know that lied ahead, obviously having no concept of what did lie ahead and certainly the magnitude and the severity and just the quickness of all of this. But we did anticipate something as I mentioned before, we navigated it quite well and thankfully invested in some really good resilient

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businesses and backed some excellent managers of those businesses. So we're very pleased. But thank you.

GA: I know in many cases your portfolio companies do small tuck-in acquisitions. Have those conversations started back up again or are they still on hold?

CG: They have started back up again and those are typically long cultivation cycles with add-ons. You generally tend to plant seeds with those folks and try to cultivate those relationships. It could be over a matter of years and what we're seeing is that the business owners, particularly those that are of a certain age, a baby boomer demographic, I think they are far more willing today, in light of the pandemic, to consider a sale than they might have been last year at this time. Where things were blowing and going and the economy was going nicely and their businesses were thriving. I think it shocked a lot of folks and so I think it has opened certain of those doors back again and brought some folks to the table. So I suspect we'll be pretty active with add-ons over the coming 12 to 18 months.

GA: Great. One last question before we wrap up which I know could be a podcast topic on its own. The CARES Act established the paycheck protection program ("PPP"). A program that received a lot of press. Would a company's involvement with the PPP change how you view their business?

CG: Yeah, it's an interesting topic. So, let me make a comment and then I'll answer your question, but in the last couple of weeks of March, when all this was unfolding, there was a high degree of uncertainty. We frankly, I don't think anyone really understood what this all meant and what the impacts of their businesses were going to be. So we ended up applying for PPP loans in three of businesses that qualified and we actually received funds in each of those three businesses. As things started to come into greater focus in terms of how our businesses were impacted ultimately and as an additional color came out from the Treasury Department, the SBA, from the administration, with respect to the forgiveness provisions, with respect to eligibility, I think the SBA as an example released 13 different FAQs during the month of April alone. So, the sands were shifting on the program. It was really hard to understand exactly what lied ahead as far as that program and the forgiveness of the loans and all the nuanced points, criminal liability for folks that took loans that weren't ultimately eligible was tabled. Things of that nature which ultimately led us to return all of the funds from the three businesses that did qualify for loans, I think originally by the May 7th deadline. So, as things started to unfold and as our businesses performed well, and we became more certain that we would weather the storm in good shape, without the loans or without really other impacts in a positive way from these various programs, we decided to return all that capital back and we did so by the first kind of safe harbor deadline which was May 7th and I think they moved that deadline back a couple of weeks following our return of funds. But, back to your question, it does raise an interesting liability question, with respect to that debt that is on a given business and I think the deals that are done in the next 18 – 24 months, for companies that did take those loans, will have kind of a PPP section within the documentation, because it raises a lot of issues around that liability and so it will be an interesting point within deal making for those companies that did receive those loans and will be an interesting discussion with business owners about how to treat those loans. You know today is debt, but it might be forgiven later, so can how do you treat that. I think the cleanest way just has the owners pay that off. We'll see. It will be an interesting discussion, nonetheless.

GA: So Chip. Thank you so much for your time today. It's been a really fascinating conversation and I really appreciate you taking the time to talk with us.

CG: Well thank you. As an industrial guy we don't get a lot of opportunities to have a podcast, so it's very exciting for me and I appreciate the opportunity very much.

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