

Customer & Market Due Diligence Of Global Precision Parts Manufacturer: Validating Revenue Sustainability In Markets Under Transformational Changes

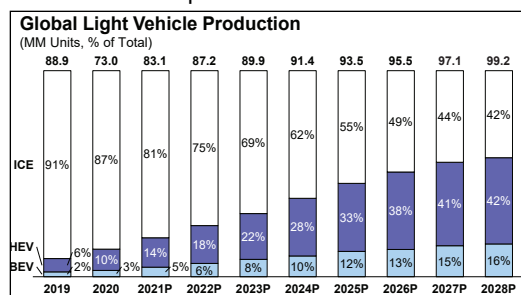
The Challenge: Our client, the tactical investment arm of a leading PE firm, was looking into a PIPE investment in a global precision parts manufacturer serving automotive, industrial, electrical, and aerospace & defense end-markets. The target was looking for a capital infusion due to balance sheet impact of COVID-driven slowdown in automotive demand. Our client was attracted to the target due to its global footprint, long-standing relationships with top OEM and Tier 1 suppliers, its high precision, high-volume manufacturing capabilities, and its diversification in multiple product applications. However, our client wanted to confirm the sustainability of the target's current business, especially the risk of electrification on its automotive business. As such, Gotham conducted a 2-week customer & market due diligence to: (1) establish the growth outlook of target's key product applications; and (2) establish the program lifecycle, target's competitive positioning, and margin outlook in each of target's top programs.

Rapid, Fact-based Assessment Of Multiple End-markets/Product Applications: Given the tight timeline, Gotham focused the due diligence effort on the 15 key applications accounting for the bulk of the target's revenue by:

- Building an automotive electrification impact model based on the: projected mix of Internal Combustion Engine (ICE), Hybrid (HEV), and Battery (BEV) vehicles by geographic region; and content per vehicle requirement for each of the product applications (e.g., engine components, valve train, transmissions, steering, braking, airbag, electric motors) by type of propulsion system
- Establishing the outlook for top programs within each key product application based on:
 - Analyzing target's program-level revenue projections and reviewing program forecast with target's management
 - Researching OEM/Tier 1 supplier strategies/outlook, technology landscape, and application growth outlook
 - Conducting interviews with customers to understand their outlook for the product application/program, target's positioning with them, their sourcing approach, and pricing trends
- Reconciling target's financial projections with program-level outlooks to determine how much of target's growth was coming from market growth net of electrification impact and what was due to market share gains
- Establishing competitive landscape for both mechanical and electric parts – identified key precision parts suppliers for each product application and profiled their size, geographic presence, and manufacturing capabilities.

Net Impact Of Automotive Electrification Expected To Be Minimal For Target

Although general press focus is on BEVs, industry projections indicate that automotive electrification will primarily be driven by HEVs. While global ICE vehicle share is expected to drop from 87% in 2020 to 39% in 2030, BEVs are expected to account for only 18% with HEVs accounting for the largest share at 43%. In North America, electrification adoption is slower with HEV and BEV 2030 market share projected to be only 26% and 14%, respectively. Considering that engines will remain in the bulk of vehicles for the foreseeable future and average cylinder count will decline only ~10%, the target's engine components business is expected to see some but not significant decline. While BEVs will eliminate target's engine components business and reduce target's content in transmissions (BEVs use less complex single speed transmissions), much of the target's product applications will either benefit (e.g., electric motors) or are not impacted (e.g., steering, air bags). Moreover, the target is one of the few suppliers equipped to serve the high-volume needs of Tier 1 automotive suppliers, further cementing its overall resilience to automotive electrification.



Electrical End-market Growth Outlook Strong Due To Investment In Aging/Evolving Technology

The target's business of supplying high-precision components for low-to-medium-voltage electrical equipment (e.g., switchgear, circuit breakers, transformers) is benefitting from several macro trends, including an investment in smart electric meters, the growing use of microgrids, growth in data centers, and increasing utility capital investment. Smart electric meter demand is driven by conversion projects (69% current penetration) and older generation smart meters reaching replacement cycle status. The growing use of microgrids is driven by the reduction in cost of distributed generation and improvement in storage technology. In turn, microgrid usage is driving the demand for commercial switchgear equipment. Data center buildout is driving demand for commercial and utility electrical equipment. Utility capital investment is driven by: aging infrastructure (60% of circuit breakers are 30+ years old and 70% of transformers are 25+ years vs. useful life of 20-25 years); and grid modernization (smart grid projects; wind and solar energy; and distributed power generation driven by tax credits, solar panel and storage cost reduction, and net metering policies). In addition, the target is well-positioned as one of 3-4 suppliers capable of manufacturing highly-reliable precision parts in high volume, and with its metallurgical expertise in both precious metals and bimetal.

Other Industrial End-markets Have Stable To High Growth Outlook

The target's diesel engine business is expected to remain stable for the foreseeable future due to slow adoption of alternative fuel source in trucks and its long-standing, strong relationship with Cummins. Furthermore, the target manufactures parts for diesel emission control technology, which has seen good growth due to EPA regulations. Target's industrial lasers business offers a promising growth opportunity as the adoption of lasers for cutting, welding, and micromachining is still early stage (~6% penetration) and growing; target has strong relationships with top industrial laser equipment manufacturers. Target's HVAC business is expected to show steady growth driven by strong housing market post-COVID lows.

The Outcome: Gotham's comprehensive assessment of target's key product applications/programs and modeled impact of automotive electrification provided our client a fact-based view of the sustainability of target's business and generated confidence to proceed with its investment.