EDISON

Melrose Industries

Aerospace rising

Capital markets, disposal and cash return

Industrials

Following the disposal of Ergotron, Melrose has now completed four transactions since 2005 with an average IRR of 28%. Focus now turns to the fifth deal, GKN Aerospace. Recovery in the aerospace market and management confidence to lift margin expectations from 12% to 14%+, along with greater disclosure on the engine contracts, suggest GKN is recovering strongly, albeit value realisation is likely a few years out. In the shorter term, the fully restructured GKN Powder Metallurgy and GKN Automotive operations are likely to be exited, which should provide further support to our 246p/share valuation. Investor attention may also start turning towards the next acquisition and sixth deal.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/20	7,723	(41)	(0.6)	0.75	N/A	0.5
12/21	7,496	252	4.1	1.75	40.0	1.1
12/22e	7,718	307	5.6	2.25	29.3	1.4
12/23e	8,334	484	9.2	3.00	17.8	1.8

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Aerospace upgrade and capital markets day

The key takeaways from the capital markets event were: greater management confidence that the business will return to pre downturn levels by 2025 at the latest (2019 levels adjusted for disposals/exits); increase in the margin guidance on a fully recovered market from 12% to 14%+; and detailed information on the risk and revenue sharing partnerships (RRSPs) in the aero engine business including anticipated cash flows. Management provided additional detail on the recent restructuring activities and growth investment and a general drill down into the sub-divisional activities.

Ergotron disposal completes the Nortek transaction

The disposal of Ergotron for c £520m completes the exit of the Nortek portfolio acquired in 2016. Melrose has now completed four transactions under its 'buy, improve, sell' model generating an average internal rate of return (IRR) of 28% and return on equity of 2.7x. The funds from the Ergotron sales are being returned through a £500m buyback rather than the usual capital return.

Forecasts and valuation

We have revised our forecasts for the disposal of Ergotron, the share buyback and the upgrade in Aerospace. Our underlying EPS estimates for 2022 are down 12.8%, for 2023 are down 4.1% and for 2024 increase by 4.9%. Our valuation uses a sum-of-the-parts to reflect the different activities and stages of improvement. We have included a standalone valuation for the Aerospace RRSPs for the first time, but have reduced the valuation of the automotive business from our last model in October 2021. It is also worth noting that we have used quoted peer valuations providing potential upside if a competitive sale process for assets is achieved. Our valuation is at 246p, up from 226p in October 2021.

10 June 2022

Price	**164p**
Market cap	**£7,184m**

Net debt (£m) at 31 December 2021	950
Shares in issue	4,372m
Free float	98.7%
Code	MRO
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	38.9	44.2	(5.0)
Rel (local)	35.3	33.0	(8.1)
52-week high/low		190.8p	107.6p

Business description

Melrose Industries acquires underperforming industrial companies. It undertakes operational improvements through restructuring and investment before disposing of the assets. Deals are individually financed through new equity (and debt) with proceeds returned in cash post value realisation.

Next events

Interim results	8 September 2022

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Aerospace: Capital markets day

Melrose held in-depth presentations on the Aerospace division on 8 June. The key takeaways are described below.

Margin targets increased to 14%+

Management had historically set an operating margin target of 12%, which had been flexed to 12% post the pandemic on full market recovery and 10% without. Management has increased guidance to 14%+ on a fully recovered basis (ie 2019 excluding businesses sold or closed). From 2021 reported operating margins of 4.4%, 6% of the upside is expected to come from operational benefits generated by end market recovery and 4% from internal actions to achieve the 14%+ target. These actions are detailed in Exhibit 1 along with the benefits outlined in 2018 from the original restructuring.

Exhibit 1: Route to margin improvement

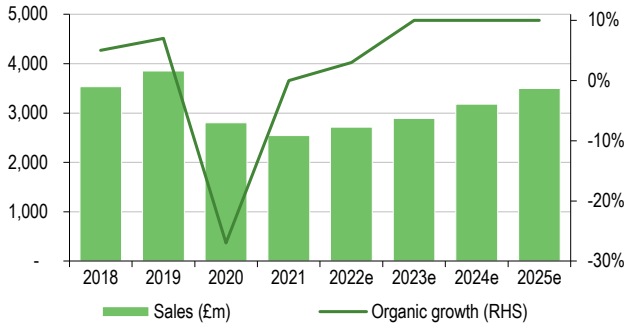
2022 actions	Savings (£m)	2018 actions	Savings (£m)
Operational excellence	50	Operational excellence	70+
Commercial actions	45	Procurement	40
Restructuring	50	SG&A	40
Total	145	Total	150+
Margin improvement	4%	Margin improvement	4%

Source: Melrose, Edison Investment Research

Recovery expected back to pre-pandemic levels by c 2025

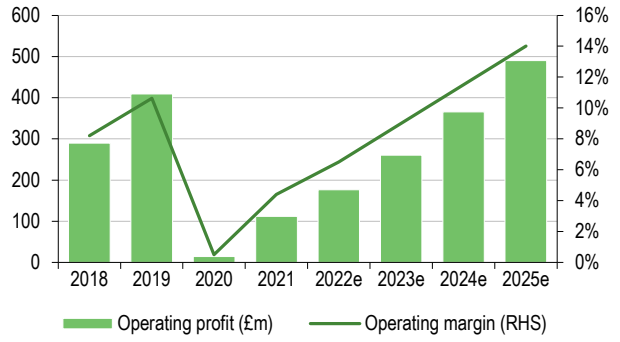
GKN Aerospace was badly affected by the downturn in aerospace, with revenues in 2020 declining 27% and operating margin falling to 0.5%. Management is now expecting annual underlying growth (ie excluding activities exited) of over 10% a year to 2025 (7% post 2025). This reflects GKN's bias toward civil over defence (59% to 41%) and a positive mix within civil highlighted by airframe and components exposure to narrow bodied and regional aircraft (39% and 37%) against the slower-to-recover wide bodied segment (24%). This recovery, along with the margin progression expectations, is reflected in updated Edison forecasts shown in Exhibits 2 and 3. Note that revenue is not expected to return to absolute 2019 levels due to disposals/exits.

Exhibit 2: Revenue and organic growth



Source: Melrose Industries, Edison Investment Research

Exhibit 3: Operating profit and margin



Source: Melrose Industries, Edison Investment Research

Growth potential

Given the recent difficulties in the aerospace sector and to highlight that the 'improve' element of Melrose's strategy is not solely focused on margin, it is worth noting some of the continued investment being undertaken to promote organic growth as highlighted in the presentation:

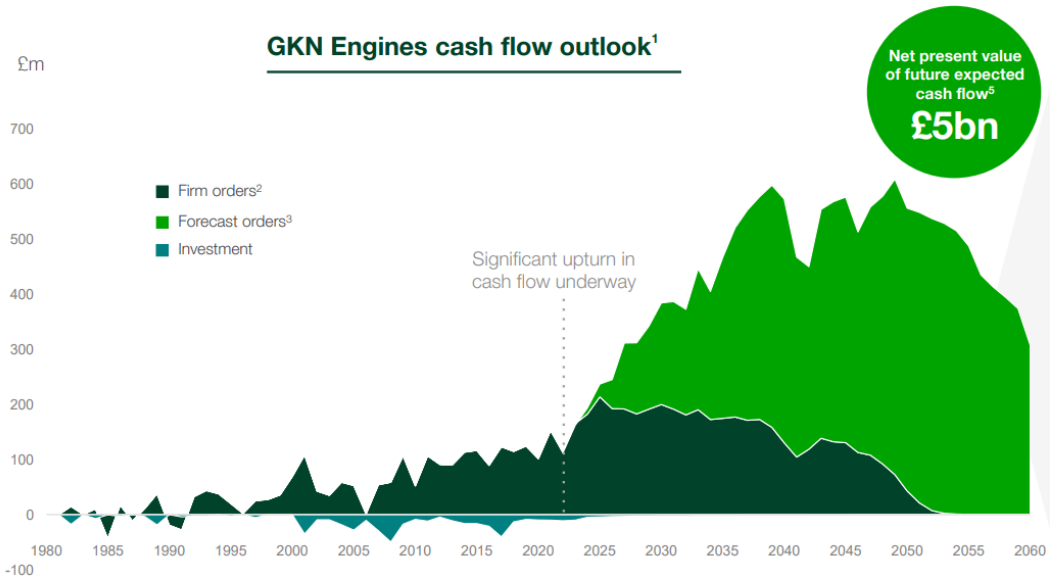
- Expanding the engine repair business, with shop visits expected to grow at a compound rate of 11% to 2030 and sales expected to increase by over £100m by 2025.
- Engine manufacturing technology adoption, such as additive manufacturing where GKN has been an early user, is expected to generate over £150m of additional sales between 2021 and 2025.
- Expansion in China through a joint venture with COMAC and AVIC, including supplying the narrow bodied C919. Management plans to expand manufacturing footprint by over 10x and sales to increase from c £60m in 2021 to over £250m by 2030.
- Investment in next-generation technology. This includes current areas of expertise such as the Wing of the Future programme in collaboration with Airbus looking at composites, wing profile and manufacturing techniques. In addition, GKN is involved in a range of future technology projects including electric, hydrogen fuel cell and alternative fuel powered aircraft with over £100m invested (including grants). Commercialisation for most of these programmes is unlikely until 2030 onwards, although the business does have components on smaller commuter electric aircraft, such as Vertical Aerospace's VX4, expected to be certified and to start production before 2025.

RRSPs

The RRSPs relate to participation in engine programmes and came with GKN's acquisition of Volvo Aerospace. In RRSPs, the supplier and engine manufacturer cooperate in the design, production and life cycle support of an engine and, for additional financing/risk taken on board (eg there are no volume guarantees), the supplier is considered as a partner and therefore entitled to a share of the future revenues. GKN's components are life-of-product rather than wear items. As a consequence, GKN is effectively investing at lower margin or a loss on supply of its components to the new build engine and is compensated as the aftermarket spares revenue comes through over the life of the engine, despite not supplying any aftermarket product.

Currently RRSPs account for 17% of aerospace revenues. However, this is expected to increase significantly, as highlighted in Exhibit 4. Note that, given the limited cost associated as GKN produces no aftermarket product, the cash generation and profit are expected to be of a similar magnitude.

Exhibit 4: RRSP cash flows



Source: Melrose 2022 Aerospace capital markets presentation

Corporate activity and share buyback programme

Melrose's latest disposal completes the 2016 Nortek transaction and, along with the cash retained from the 2021 disposals, provides further cash to return to shareholders.

Disposal of Ergotron

Melrose has agreed to sell Ergotron, a high-margin ergonomic furniture business and the final element of the Nortek acquisition, to The Sterling Group, a private equity group, for c $650m (c £520m). The deal is expected to close in early Q322. The price translates to EV/EBIT of 9.0x and EV/EBITDA of 8.4x based on 2021 reported numbers.

Validation of the model

The disposal of Ergotron completes the Nortek transaction and the fourth cycle of the group's 'buy, improve, sell' model. Exhibit 5 highlights the returns with an average IRR of 28% and return on equity of c 2.7x.

Exhibit 5: Deal summary since listing

Acquired	Company	Activity	Sold	ROE (x)	IRR (%)
2005	McKechnie/Dynacast	Aerospace components/zinc die casting	2007–11	3.0	30
2008	FKI	Turbogenerators, lifting products, wire, door hardware	2013–21	3.4	33
2012	Elster	Water and gas meters	2015	2.3	33
2016	Nortek	Ventilation	2021–22	>2	17

Source: Edison Investment Research

Proposed share buyback

Melrose has historically returned cash to shareholders through a capital return and associated share consolidation, the last being 15p/share in 2021. However, management has announced its first buyback programme following the proposed disposal of Ergotron. A £500m programme is expected to be completed by the end of October 2022. The impact will inevitably depend on the price paid, but at 150p a share would reduce shares in issue by c 7.6%. Post the return, leverage (net debt/EBITDA) would increase to c 1.5x.

Valuation

Our valuation is based on a sum-of-the-parts to reflect the different activities within the group. Within this model, valuations used primarily reflect quoted company valuations and are based on recovered earnings to reflect the 'improve' element of the strategy and the more likely value on disposal.

Aerospace

Exhibit 6 highlights the valuation of the aerospace peer group used based on 2025 expectations, when the sector is expected to have returned to more normal (pre-pandemic) levels of activity and we expect GKN Aerospace margins to be in the target range.

Exhibit 6: Aerospace peer group valuations based on 2025 consensus forecasts

	EV/EBIT (x)	EV/EBITDA (x)	Operating margin
Senior	9.0	5.5	8.2%
MTU	11.6	8.4	13.4%
FACC	9.3	5.4	7.2%
Spirit	5.8	4.4	11.6%
Triumph	7.0	5.5	13.5%
Average	7.9	5.6	10.8%
Median	8.0	5.4	11.6%

Source: Refinitiv 8 June 2022

Aerospace RRSPs

RRSPs have long held a potential value and are now starting to come to fruition, offering meaningful cash flows in the near future, as shown in Exhibit 4. Exhibit 7 highlights the net present value (NPV) of these cash flows as provided by Melrose. Our model, using the limited information provided, supports these numbers and adds a further conservative valuation using a discount factor of 12.5%. Melrose points to the mid-point valuation of £5bn. Our view is that it is unlikely that this cash stream can easily be divested as a standalone operation, and if it were, it would arguably reduce the likely interest and value in the core aerospace business. We use Melrose's cost of capital valuation of £3.7bn and reduce this by £900m or 20% of the underlying value of the aerospace division to avoid double counting, as RRSPs account for 17% of Aerospace sales, giving a valuation of £2.8bn. It is also worth noting that the cash flows extend beyond the International Air Transport Association's target for 'net zero' by 2050, including the use of alternative fuels and power sources (ie different engines).

Exhibit 7: RRSPs valuation

	Debt interest rate	Midpoint	Melrose cost of capital	Conservative
Discount rate (%)	5.0	7.5	10.0	12.5
NPV (£bn)	7.0	5.0	3.7	2.8

Source: Melrose, Edison Investment Research

Automotive

Exhibit 8 highlights the valuation of the automotive peer group used based on 2024, when IHS Markit and other industry forecasters anticipate a more steady state, after current supply chain issues affect 2022 and an anticipated bounce back in 2023. In our view, this is also the likely time frame for any transaction.

Exhibit 8: Automotive peer group valuations based on 2024 forecasts

	EV/EBIT (x)	EV/EBITDA (x)	Operating margin
American Axle	7.9	4.3	7.9%
Dana	7.0	4.5	6.2%
Magna	6.5	4.4	7.6%
Nexteer	4.0	2.1	7.0%
NTN	12.4	7.5	4.7%
Borg Warner	5.8	4.4	11.1%
TI Fluid Systems	5.6	3.8	8.1%
Average	7.0	4.4	7.5%
Median	6.5	4.4	7.6%

Source: Refinitiv 9 June 2022

Powder Metallurgy

Melrose was widely reported to be looking at a sale of Powder Metallurgy in 2018, with a price tag of £1.5–1.6bn, but a declining automotive market precluded the possibility of a deal. This would have suggested a valuation of 11x 2018 EBIT (Powder Metallurgy's 2018 operating margin was 11.8%). The only previous deal of scale in the sector was the 2013 acquisition of Höganäs, GKN's

key competitor in powders, at a valuation of c 13.8x 2012 EBIT (operating margin 13.5%). The Powder Metallurgy business is automotive orientated (c 80%), and there are concerns over key end markets such as transmission gears in the future electric vehicle environment, which might suggest a slight reduction in potential valuation, albeit there is also potential upside from Powder Metallurgy magnet production, which the business is investing in. However, we are expecting the business to be sold in 2023, when we are forecasting margins of 11.5%, which is still some way below Melrose management's target of 14%, suggesting upside potential. Hence, we see our valuation multiple of 10x on 2023 forecasts as balanced.

Hydrogen

The group's hydrogen storage business is a nascent technology company currently entering field trials, suggesting full commercialisation is still a number of years away, making any valuation somewhat subjective. The closest peer, in our view, is Hexagon Purus (HEXAB.SS), which supplies high-pressure cylinders for hydrogen storage along with battery packs for electric vehicles and has a market capitalisation of c £750m. Hexagon is arguably more advanced than GKN Hydrogen, with sales for the current year expected to be £75m (GKN Hydrogen: less than £10m) and has two business streams, suggesting GKN Hydrogen at present should be valued at a discount, at least until there is greater acceptance of the technology. To reflect the level of investment at over £10m a year and progress to trial units, we have pencilled in an arbitrary £200m. We appreciate this is an unstructured estimate reflecting the lack of information available and uncertainties, but at c 1.5% of the total group valuation, the overall impact of any error is small.

Overall valuation

Exhibit 9 combines the operational activity valuations discusses along with the pension contribution at zero following the improved funding position, net debt forecast at the end of 2022 and management long term incentive plan (LTIP). Note that our sum-of-the-parts valuation per share is adjusted for the full share buyback (assumed at 150p).

Exhibit 9: Sum-of-the-parts valuation

	Sales (£m)	Operating margin (%)	EBIT (£m)	EBIT multiple (x)	Valuation (£m)	Expected realisation and valuation year
Aerospace	3466	14.0%	485.3	8.0	3,882	2025
Aerospace RRSPs					2,900	2025
Automotive	4492	10.0%	449.2	7.0	3,144	2024
Powder Metallurgy	1103	11.5%	126.9	10.0	1,269	2023
Hydrogen					200	2025
Pension top-up requirements					0	
Cash/(debt) (forecast December 2022)					(1,185)	
Management LTIP					(289)	
Net valuation					9,964	
Number of shares (m)					4,039	
Valuation per share (p)					246	

Source: Edison Investment Research

Forecasts

There have been no changes to current trading; see our update note published on 12 April. However, we have updated our forecasts to reflect:

- the disposal of Ergotron;
- completion of the £500m buyback (assumed at 150p/share); and
- the increased margin and growth expectations in Aerospace.

Overall, the Ergotron disposal dilution is not fully reversed by the buyback, and the Aerospace upgrade, while suggesting some benefit in the short term, has a greater impact in 2024 and onwards.

Exhibit 10: Forecast changes

£m	2022e			2023e			2024e
	Old	New	Change	Old	New	Change	New
Revenues	7699	7718	0.2%	8,348	8,334	-0.2%	8,848
EBITDA	894	831	-7.0%	1,081	1,016	-6.1%	1,273
EBITDA margin	11.6%	10.8%	-7.3%	13.0%	12.2%	-5.9%	14.4%
Normalised operating profit	484	431	-10.9%	681	626	-8.2%	873
Normalised operating profit margin	6.3%	5.6%	-0.7%	8.2%	7.5%	-0.7%	9.9%
Normalised basic EPS (p)	6.38	5.56	-12.8%	9.56	9.17	-4.0%	13.42
Dividend per share (p)	2.25	2.25	0.0%	3.00	3.00	0.0%	4.00
Net cash/(debt)	(1,134)	(1,185)	4.5%	(1,174)	(1,271)	8.2%	(1,030)

Source: Edison Investment Research

Exhibit 11: Financial summary

£m	2020	2021	2022e	2023e	2024e
Year to 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT					
Revenue (ex-associates)	7,723	7,496	7,718	8,334	8,848
Cost of Sales	(6,858)	(6,394)	(6,483)	(6,917)	(8,848)
Gross Profit	865	1,102	1,235	1,417	0
EBITDA	521	734	831	1,016	1,273
Operating profit (before amort/excepts)	141	375	431	626	873
Amortisation of acquired intangibles	(472)	(452)	(452)	(452)	(452)
Exceptionals	(156)	(374)	(250)	(200)	(100)
Share-based payments					
Reported operating profit	(487)	(451)	(271)	(26)	321
Net Interest	(182)	(123)	(124)	(142)	(143)
Joint ventures & associates (post tax)	0	0	0	0	0
Profit Before Tax (norm)	(41)	252	307	484	730
Profit Before Tax (reported)	(669)	(574)	(395)	(168)	178
Reported tax	114	172	0	0	0
Profit After Tax (norm)	(27)	197	240	373	547
Profit After Tax (reported)	(555)	(402)	(395)	(168)	178
Minority interests	(3)	(4)	(2)	(2)	(5)
Discontinued operations	32	1,283	0	0	0
Net income (normalised)	(30)	193	238	371	542
Net income (reported)	(526)	877	(397)	(170)	173
Average Shares Outstanding (m)	4,858	4,695	4,272	4,039	4,039
EPS - normalised (p)	(0.6)	4.1	5.6	9.2	13.4
EPS - normalised fully diluted (p)	(0.6)	4.1	5.6	9.2	13.4
EPS - basic reported (p)	(11.0)	18.7	(9.3)	(4.2)	4.3
Dividend (p)	0.75	1.75	2.25	3.00	4.00
Revenue growth (%)	(-20.0)	2.0	2.3	8.6	7.0
Gross Margin (%)	11.2	14.7	16.0	17.0	0.0
EBITDA Margin (%)	6.7	9.8	10.8	12.2	14.4
Normalised Operating Margin	1.8	5.0	5.6	7.5	9.9
BALANCE SHEET					
Fixed Assets	13,515	11,438	11,136	10,844	10,442
Intangible Assets	9,299	7,437	6,985	6,533	6,081
Tangible Assets	3,133	2,528	2,678	2,838	2,888
Investments & other	1,083	1,473	1,473	1,473	1,473
Current Assets	3,165	2,584	2,608	2,698	2,774
Stocks	1,126	893	903	942	975
Debtors	1,658	1,184	1,197	1,249	1,293
Cash & cash equivalents	311	473	473	473	473
Other	70	34	34	34	34
Current Liabilities	3,363	3,124	3,051	3,120	3,176
Creditors	2,456	2,051	2,074	2,163	2,239
Tax and social security	188	142	142	142	142
Short term borrowings	165	462	462	462	462
Other	554	469	373	353	333
Long Term Liabilities	6,207	3,358	3,631	3,631	3,212
Long term borrowings	2,926	903	1,196	1,282	1,041
Other long-term liabilities	3,281	2,455	2,435	2,349	2,171
Net Assets	7,110	7,540	7,061	6,790	6,828
Minority interests	29	33	33	33	33
Shareholders' equity	7,081	7,507	7,028	6,757	6,795
CASH FLOW					
Operating Cash Flow	521	734	831	1,016	1,273
Working capital	371	62	(22)	(62)	(51)
Exceptional & other	(9)	(321)	(335)	(250)	(130)
Tax	(14)	(65)	(68)	(111)	(182)
Net operating cash flow	869	410	407	593	909
Capex	(265)	(225)	(500)	(500)	(400)
Acquisitions/disposals	(11)	2,693	500	0	0
Net interest	(127)	(137)	(60)	(78)	(133)
Equity financing	0	(730)	(500)	0	0
Dividends	0	(69)	(82)	(101)	(134)
Other					
Net Cash Flow	466	1,942	(235)	(86)	241
Opening net debt/(cash)	3,283	2,847	950	1,185	1,271
FX	7	40	0	0	0
Other non-cash movements	(37)	(85)	0	0	0
Closing net debt/(cash)	2,847	950	1,185	1,271	1,030

Source: Melrose Industries, Edison Investment Research

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