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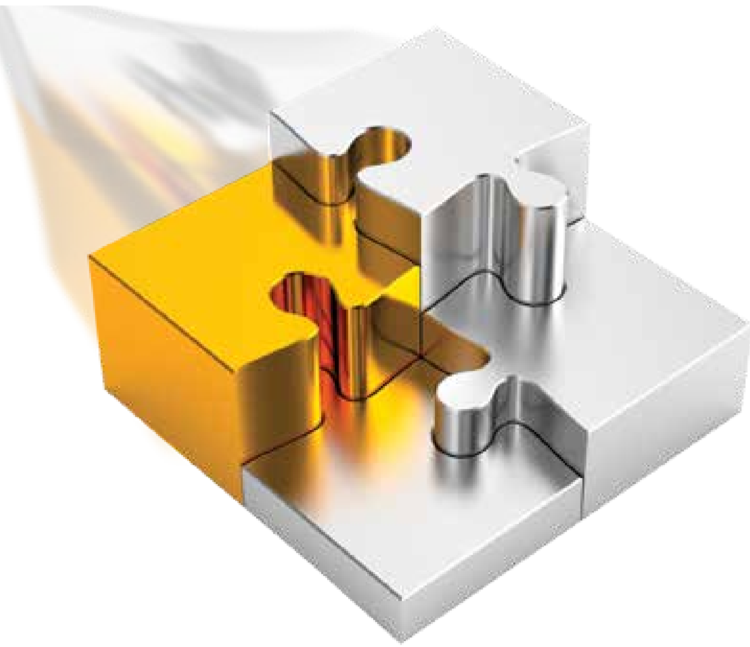

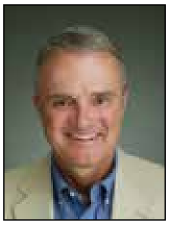

Maxwell

Merger Mania: A Look Back and a Look Forward

The North American water industry has been experiencing a frenzy of external investment, mergers, consolidation, and acquisition activity for almost two decades now. Continuous ownership changes and nonstop wheeling and dealing seem to be the norm in this industry, and sometimes it's downright hard to remember who owns whom. People in the industry have gotten used to having a new owner or a new boss every other year. Everybody wants to get into the water industry. Owners of anything remotely resembling a water company get so many purchase solicitations that they tend to throw them in the wastebasket without looking at them. Even though it almost always seems to be at a new historic high, investment interest in this industry seems to just keep growing. Why? What started this? How long is it likely to go on? And what effect is it having on the water business—specifically on the drinking water utility industry?

Starting in the early 1990s—with the roll-up of dozens and dozens of water companies into U.S. Filter Corp. and the widely touted "foreign invasion" by European water utilities in search of privatization opportunities—many key assets in the domestic water industry have changed hands, some multiple times. Hundreds of major industrial companies and private equity investors have sought to strategically position themselves for the vast perceived opportunities offered by the water business. A gradually building interest in investing in water has evolved into a virtual feeding frenzy.

As many of the midsized water players gradually disappeared into the ranks of the larger consolidators, available and reasonably sizable platforms for expansion and diversification became harder to find, but investment interest continued to intensify. We all know what happens when demand is high and supply is low—prices go up. Thus valuations in water merger and acquisition transactions were pushed to stratospheric levels. This trend seemed to reach its peak in the 2003–05 time frame, when General Electric (GE) was in the midst of its aggressive acquisition spree in the business. Those who have been around this industry for more than a few years will recall the 12 times, 15 times, or even higher EBITDA (earnings before interest, taxes, depreciation, and amortization) multiples that GE, Danaher, and others were then paying for key water

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assets—companies like Ionics, Cuno, Osmonics, Trojan, and Zenon.

But, as Isaac Newton explained, what goes up must come down. When it became clear that the United States was in fact not going to move toward widespread privatization of its drinking water systems, most of the European acquirers gradually exited and returned to their more traditional utility and infrastructural services businesses. As the number of bigger players gradually thinned out, and most significantly, as early signs of the "Great Recession" began to appear in late 2007, merger and acquisition (M&A) activity in the water industry—as across US industry in general—began to wane.

Either some of these water assets were strikingly undervalued just a few years ago, or they are being dramatically overvalued today.

By mid-2008 the credit markets began to dry up, major financial organizations started to collapse, and the stock market tanked. As the overall economy teetered uncomfortably on the precipice of collapse, most industrial firms sat on their hands—opting to preserve cash for an increasingly likely "rainy day," rather than spending it on acquisitions—and even the private equity buyers got spooked. As deal interest declined, valuations also began to decline—back down into a realm of reasonability. In turn, potential sellers retreated to the sidelines to wait for better values, and transaction activity pretty much ground to a halt in 2009. In late 2008 and early 2009, many of the transactions that were already in process collapsed, and few new discussions between buyers and sellers were initiated. The value of publicly traded water stocks fell by anywhere from 35 to 50% during the last several months of 2008, and the valuations of those few M&A transactions that did occur probably fell at least by a similar amount.

As it turned out, however, the world didn't end—at least it hasn't so far. As we wound through 2009 and into 2010, the fear of total economic collapse began to fade, and things started to return to at least something resembling a sort of "new normal." Throughout this whole downtime, some of the more growth-oriented and acquisitive firms had developed a "pentup demand" for more transactional activity, and by late 2010, this demand could no longer be held back. M&A activity started to pick up again, and many of the standard suspects began to edge back into the market.

The major players on the buy side of the M&A marketplace by this time were names familiar and well-known to most people in the water industry—GE, Pentair, Xylem (the new name of the recently spun-out ITT Corp. water business) Watts, Danaher, and so on. But there were also many other emerging players with interests in water whose names might not be quite as familiar to some—Teledyne, Idex, Roper, and SPX. Foreign industrial companies began to more actively sniff around US businesses—firms like Halma, Axel Johnson, and Schlumberger. And new buyers continued to emerge—companies such as Ashland, Toro, and John Deere. Many other companies that have not yet revealed their strategy or that have yet to make their first move also began to hover around the edges of the industry searching for a good entry point. In addition, of course, literally hundreds of private equity investors had by this time started to evaluate the industry, with quite a few—such as Carlyle, CD&R, J.P. Morgan, and Blackstone—having already made significant investments in the water industry.

Early in 2010, ITT picked up Nova Analytics—the largest remaining independent player in the water instrumentation and monitoring sector—and Godwin, a $200 million pump manufacturer. Gorman-Rupp announced the acquisition of National Pumps, and Energy Recovery snapped up Pump Engineering Inc. Sembcorp picked up Cascal. On the engineering side, the British firm W.S. Atkins bought Post Buckley, whereas Arcadis nabbed the well-known water firm Malcolm Pirnie. Later in 2010, Thermo Fisher Scientific announced that it would buy Dionex Corp., one of the largest publicly held instrument companies active in the water sector. M&A activity in the water industry was definitely getting back in gear.

With that as a warmup, 2011 somewhat unexpectedly turned into another blockbuster year for M&A activities. Bank credit was more readily available, and with typical valuation expectations still fairly reasonable, deal activity started to spike up again. Private equity players—still sitting on huge piles of capital and eager to invest after the slow period—were also starting to have more of an impact. As opposed to their generally milder influence in the past, private equity firms were starting to be serious bidders in many deals.

Early in the year, ITT Corp. made the announcement that it would split itself into three separate companies, with its Fluid Technologies division becoming an independent publicly traded firm named Xylem—at once becoming one of the largest pure-play industrial water companies in the marketplace.

In April, Pentair agreed to purchase the Clean Process Technologies (CPT) division of Norit for approxi-

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mately $705 million plus debt. With a reported 2010 EBITDA of approximately $50 million, Pentair paid top dollar for the opportunity—an imputed multiple of approximately 14 times. This was the first significant indication that valuations were starting to creep back up—close to where they had been almost 10 years earlier—and to a level few people thought we would see again.

The summer of 2011 was a particularly busy time. National Oilwell Varco, one of the oil industry's dominant equipment makers, agreed to acquire Ameron International—a major water transmission pipe manufacturer—for $772 million, commencing a major strategic thrust into the water market. That deal represented a value of almost 1.3 times revenues, and—primarily because of poor short-term earnings—about a 19-times multiple on recent EBITDA. A few days later, the Swiss Lonza Group said it would buy Arch Chemicals. British player AMEC picked up major engineering firm MACTEC. Xylem entered into a definitive agreement to acquire instrument company YSI at a price of more than three times revenues. In the biggest deal of all, Ecolab acquired major water treatment firm Nalco for $8.1 billion, creating a truly global cleaning, sanitation, and water treatment firm. Even for a mature and relatively slower-growing chemicals manufacturer, this deal came in at a multiple of about two times revenue, and some 11 times trailing 12-month EBITDA. General M&A activity and valuations were suddenly right back up at their earlier 2003–04 levels.

The next year saw more of the same. Early in 2012, an unexpected buyer in the form of Cabot Corp. turned up in the sale of Norit's activated carbon business. With 2011 sales of $360 million and adjusted EBITDA of $92 million, the valuation of about $1.1 billion on this deal worked out to an EBITDA multiple of almost 12 times—yet another strong valuation for essentially a chemicals company.

In the year's true blockbuster deal—and perhaps one of the last that the industry is likely to see—Pentair announced that it would undertake a merger with the Flow Control division of Tyco International, valued at about $5 billion. This deal was part of a bigger and more complicated breakup of Tyco. The deal valued Tyco at around 11 times 2011 EBITDA, and 9.5 times projected 2012 EBITDA. The combined company will have about $8 billion in annual revenue, roughly doubling Pentair in size—and essentially making it the larg-

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est player in the industrial water sector. The deal also enhances Pentair's ability to penetrate higher-growth markets, reduces its exposure to the residential segment, and enables it to significantly deleverage its balance sheet. The combined business was expected to generate 2012 revenues of around $7.7 billion, rising to $9.7 billion in 2015.

Dominating more recent water industry M&A activity this past year has been a rush to get into the rapidly growing oil-field environmental and water management services field—with all the current attention on the water–energy "nexus," this is certainly the fad of the moment. National Oilwell Varco continued its expansion into the area by acquiring the publicly held Robbins and Myers at a total valuation of about $2.5 billion, representing an EBITDA multiple of about 9.0. Heckmann Corp. has conducted numerous acquisitions in this sector, most recently merging itself with the North Dakota–based Power Fuels, significantly accelerating its goal of providing a one-stop national shop for comprehensive energy-related environmental solutions. Demonstrating the breadth of interest in this energy–water space, even the solid waste management company Waste Connections announced a deal to get into the sector.

So, merger mania is definitely back in the water industry—and there is little indication that it will slow down any time in the near future. This consistent trend has various implications for the future of the business—changing ownership often implies changing strategic focus, changing levels of service, changing personnel, and so on. In turn, there are almost always implications—sometimes good and sometimes not so good—for customers, employees, and other stakeholders.

What lessons are there to be learned from the recent resurgence of merger activity, and what does the future hold for the overall industry if this trend continues unabated? There are a few examples of transactions that have occurred, or that are occurring, that may be instructive in terms of future trends.

The experience of the private equity owners of Norit (Doughty Hanson and Euroland Investments) serves as one illustrative case study for the current investment frenzy and perhaps the longer-term trend in terms of private equity expectations for this industry. The combined valuation received by these two PE firms as a result of the two deals mentioned earlier was about $1.8 billion. This compares with the $900 million that they paid previous owner Gilde in 2007, effectively doubling their investment value in five years. Even more striking, today's valuation compares to the $176 million that the financial investment firm Gilde paid the Dutch utility Nuon for the business in 2003, and finally, the $134 million that Nuon originally spent in 2000. This is a picture-perfect illustration of the standard and widely touted "private equity model"—buy a firm at a reasonable price, grow its size, make it more efficient, perhaps add some complementary pieces to it, and then sell it at a handsome gain a few years later. The Norit business has obviously demonstrated good growth during this timeframe, but this is nevertheless a dramatic example of skyrocketing valuation trends prevalent in this industry—the firm was apparently worth 13 times more today than it was 12 years ago. Examples like this seem likely to entice many more financial parties into an already flooded market.

Although most transactions do not offer the clear series of historical data points that the Norit story does, many of the other transactions mentioned earlier have traded at similarly higher levels relative to their historical record. Obviously, the real value of water companies has jumped over the past several years in the eyes of investors—both strategic and financial. But the question of "how much is too much?"—in terms of valuation growth—remains generally

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unanswered in the court of public opinion. On the one hand, some argue that this quantum leap in valuation is a simple result of broader recognition of the scale of challenge and opportunity in the world water industry—and a greater sense that the business offers great long-term growth opportunities. On the other hand, a question that remains is whether the level of frenzy and "frothiness" in the current market is actually justified. Stated another way, either some of these water assets were strikingly undervalued just a few years ago, or they are being dramatically overvalued today. It's probably still a little early to say which of these assumptions is closer to the truth, but certainly some of these more recent deals seem overvalued relative to potential growth and return.

Let's consider another example—one that perhaps represents the other side of the coin. During the second half of 2012, the industry watched as the giant German company Siemens made the gradual decision to exit its large water business. This pending divestiture—and the roller-coaster experience of this old U.S. Filter unit over the past dozen years—represents another good lesson or parable for those who would seek to join the general stampede into the water industry. At the time Siemens acquired the business in 2004, it was widely charged with a "General Electric copycat" move of continuing the two firms' history of tracking each other into various new markets and businesses. (GE was, at that time, in the midst of its well-chronicled acquisition spree mentioned previously.) After buying the business, however, it seems as if Siemens never quite figured out what to do with it. Now, eight years, three CEOs, and a few reorganizations later, Siemens is throwing in the towel, with its Industrial Group CEO actually saying: "This business shows only minor synergies with our industrial portfolio." The market value of this set of assets has consistently declined since U.S. Filter was originally sold to Vivendi in 1999. There is much current speculation as to who will step up next and what they will pay; there are many observers who believe that the business would be worth more if it was broken up into several different pieces.

The Siemens saga is somewhat reminiscent of the experiences of another German firm—RWE, the big German power utility. RWE jumped into the business with much fanfare in 2001, shelling out some $6 billion in the acquisition of Thames Water to become the "third largest water company" in the world. But the company fled the business fewer than five years later, at a considerable loss, with its CEO saying that "the concept of a global water player has not really worked."

These kinds of examples led many people to ask how some of these big companies can change strategic direction so abruptly and how they can apparently get things so wrong. And these are not just isolated

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instances. There are many other similar stories—Thames Water itself got into and then back out of the U.S. treatment equipment business. Home Depot made a widely heralded but short-term move into the business.

So, what is the answer? Do some of these companies get overly caught up in the excitement and frenzy of a broader investment trend or fall victim to a fad? Do they actually overestimate the opportunity for growth or general profitability characteristics of the business? Do their leaders simply enjoy the "thrill of the chase" and conducting acquisitions more than they enjoy the mundane day-to-day management of the company's operations? Has the business itself actually changed during their tenure within it?

In my view, there is probably a good dose of several of these factors in many instances of transactional failure, but I think perhaps the primary lesson here is just how much the overall strategy of a large corporation is driven by its top executive—and just how much that strategy or direction can change when the person—or persons—in the seat of power changes. The passage of time will yield a more thorough and convincing answer to these questions, but for new firms looking to get into the industry, these types of case studies are certainly worth pondering. It can be pretty tempting to stretch and overpay to get into an exciting new business, but many firms live to regret that kind of move.

Although activity levels and valuations have waxed and waned somewhat—in concert with the economy over the past 15 years—the overall water M&A story hasn't really changed that much. As the magnitude of future water challenges and the accompanying investment opportunities continue to become better and more broadly recognized, more firms will express an interest in getting a foothold in the business. There doesn't seem to be any indication that this will change in the near future—financial and strategic investor interest in the water industry remains at a fever pitch.

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