# Throwback to the 80s: the Melrose £8.1bn hostile takeover of GKN

**Melrose Industries plc [LON:MRO] - market cap as of 13/04/2018: £4.36bn**
**GKN plc [LON:GKN] - market cap as of 13/04/2018 £7.76bn**

## *Introduction*

On March 29, 2018, "Project Golf" (as the bid was called internally) got pushed to the last hole, when the turnaround specialist Melrose received acceptance from the British engineering company GKN's shareholders regarding the £8.1 billion hostile takeover bid it had been subject to. The deal, which saw Melrose raising the offer price to contrast growing disagreement on the proposed acquisition, is expected to close by the end of April – unless regulators make a move against it.

The main concerns for the historically-prominent automotive and aerospace manufacturer are concentrated on the management structure, employees and the reaction of customers such as Airbus and Boeing. The former two problems are addressed by Melrose by committing to no reorganization and improving the pension scheme for GKN employees, while the latter is still an open dispute.

## *About GNK plc*

GKN plc is a British engineering company headquartered in Redditch, Worcestershire. Listed on the London Stock Exchange and part of the FTSE100, the company - formerly known as Guest, Keen and Nettlefolds - traces its origins back to 1759 as an iron producer. It was recognized as one of the largest armaments manufacturers during WWI and WWII, producing steel helmets and Spitfire aircrafts. From the end of WWII, the firm suffered strong pressures for nationalization, which led in 1967 to an ownership transfer to the British government. After few years, due to significant increases in global competition, it was slowly made private through several consequent stake disposals by the government. Throughout its life, GKN then grew consistently both organically and through M&A and is currently a major manufacturer of automotive and aerospace components such as screws, nuts, bolts and other fasteners.

Today, the company is partnering with many strong players in the engineering industry, such as Leonardo (former Finmeccanica) in Italy, Volvo in Sweden or Airbus in France. Employing 59,000 people across 30 countries (6,000 of which in the UK), it operates through three main divisions: GKN Aerospace, GKN Powder Metallurgy and GKN Driveline. Prior to the final acceptance of the Melrose deal, GKN shareholders had agreed to the merger of the Driveline division with Dana (one of GKN's American suppliers in the automotive subsector) to benefit from rising car "electrification" and global emerging markets growth. However, the transaction was opposed by the takeover battle engaged with Melrose, where the latter emerged as the undisputed winner. Additionally, GKN has also confirmed its intention to divest GKN Powder Metallurgy in February.

The company's financial performance in 2017 was market by an 11% improvement in revenues, which reached £9.7bn and an EBT of £658m.

## *About Melrose Industries plc*

Melrose Industries plc is a London-based investment company which focuses on purchasing underperforming businesses, improving their efficiency and re-selling them after an average 5-year holding period. Listed on the London Stock Exchange and part of the FTSE250, it was founded in 2003 by two former accountants and a lawyer: Jock Miller (current Chairman), David Roper and Simon Peckham (former CEO).

The firm employs 12,000 workers and has so far benefited the most from four large acquisitions: Elster, FKI, Dynacast and McKechnie. Started as a £13m company, the business is now valued at around £4.3bn and over the last 15 years, it has achieved an average annual return on investment of 25%.

The GKN one is the largest deal Melrose has ever embarked in, also given the fact that its valuation is four times higher than Melrose's revenues in 2017 (£2.1bn vs £8.1bn). The company's motto is: "Buy, Improve, Sell", which is exactly the aim of the current deal, as the disclosed strategy is: "to improve all of the businesses in GKN, only realizing their value once they have reached full potential".

## *Industry Overview*

With operations ranging from aerospace and automotive manufacturing, to metallurgy and additives manufacturing, GKN's success strongly relies on customer acquisition and retention across different sectors, namely governments, aircraft manufacturers and car makers.

The turning point for global defense spending is expected soon, as many governments may seek to increase purchases in response to stronger geopolitical tensions. For example, the US Federal Government is expected to expand its defense spending by 5% in 2018 according to Moody's, while Britain is said to be about to launch an industrial plan aimed to maintain long-term air force capabilities. At present, GKN - contributing to the production of several transport and military aircrafts - is categorized as non-sensitive and falls outside the list of top 50 UK's military suppliers. Therefore, the government currently has little legitimacy to block the deal for possible spillovers of critical skills or military capabilities, but things may change.

Despite a stagnation across the US, UK, and Eurozone market in the recent past, the output measured by net production value in the aerospace industry is projected to experience an expansion of 3% this year according to the research firm Oxford Economics. Drivers of such expansion are to be recognized in increased order backlogs, low fuel costs, passenger growth and strong momentum in world trade. As a matter of fact, Boeing and Airbus have already experienced an increase in deliveries and net orders numbers this year.

As with many other industries, technological progress is the basis for competitiveness and advancement for aerospace and car manufacturers alike. In particular, such industries are characterized by a relatively small number of large firms who subcontract with numerous international smaller firms, acting as suppliers of specific components of their vehicles at every level of the production chain.

As far as the car manufacturing industry specifically is concerned, electric vehicles are expected to drive industry dynamics in the medium term: according to McKinsey, the electric vehicle market is indeed estimated to grow in volume at a CAGR of 28.3% starting from 2017, with China as the new market leader. New registrations for electric vehicles in China grew by 69% to 352,000 in 2016 while Europe saw a mere 7% increase to 202,000 in the same year.

## Deal Structure

Melrose will acquire control of GKN via a hostile takeover, after having gained approval from 52.43% of GKN shareholders (where the threshold that needed to be achieved for the takeover to be approved was 50%+1 share). The final cash-and-stock offer Melrose extended to GKN values the latter's overall share capital at £8.1 billion. GKN shareholders will retain a 60% stake in the combined entity (they will indeed receive 1.69 new Melrose shares for each GKN share they own) and will receive £1.4bn in cash (81 pence/share). Finally, they will also receive a 6.2 pence dividend for each GKN share.

Altogether, based on Melrose's closing price of 224.7 on March 9, 2018 (the last business day before the announcement of the offer), Melrose values each GKN share at 467 pence, which constitutes a 43% premium to the above mentioned closing price of 326.3 pence of GKN shares on January 5th 2018 (the last business day before Melrose approached GKN).

## Deal Rationale

GKN was inevitably going to be broken up into its two main components: the automotive business, GKN Driveline, and aerospace business, GKN Aerospace. What was left to be decided was who was going to be in charge of the process between the incumbent management - who wanted to sell the automotive business to GKN's supplier Dana - or to the turnaround specialist Melrose. All in all, we believe it is for the best that Melrose will be the one to call the shots in the process.

The value of 467 pence per share which current GKN shareholders are expected to receive following the transaction is well above the GKN's 10-year high share price of 414.9 pence per share in February 2014. Considering the severe history of underperformance of the company (since 2003, total shareholder return of GKN has been 171%, against a value twice higher of the MSCI World Auto Components - 315% - and three times higher of the MSCI World Aerospace & Defence - 593%), the immediate value shareholders will lock in is indeed impressive. Furthermore, because GKN shareholders will get 60% of Melrose shares, they will gain an additional benefit. They will share the upside of the deal and Melrose, unlike GKN, has been very successful in its business: since October 2003, the date of its IPO, Melrose has produced total shareholder return of 3,019%, making it the third best performer of the FTSE350.

We believe that the alternative scenario of a $6.1bn merger of GKN's Driveline business with Dana, which would have left GKN focusing exclusively on the aerospace business, would have been less advantageous for GKN shareholders. Driveline includes the valuable eDrive electric vehicle technology and selling the majority of it without first making any improvement would have resulted in a lost opportunity. Such proposed transaction implies a valuation of 7.5x EV/EBITDA, far below the valuation of 8.9x EV/EBITDA that GKN itself had made of the division, according to a precedent transaction analysis: in absolute terms, this is c. £900m less. Nevertheless, merging with Dana is not without merits: GKN trades at a discount compared to companies that only operate in one of its two core sectors, and becoming a pure-play aerospace components manufacturer would offer an immediate fix to the conglomerate discount. Furthermore Airbus, GKN's largest customer in the aerospace division, has tacitly endorsed Dana over Melrose when it stated that it would be "practically impossible" to keep working with a Melrose-led GKN due to the excessive focus on the short-term that Melrose has shown in its past, and that it would "certainly prefer" an industrial buyer. It is however unclear why Melrose would choose to damage the longstanding relationship with Airbus in pursuit of a quick buck, as this would no doubt weigh on the profit it would make when it eventually disposes of GKN. Second, forsaking the merger with Dana means giving up on $235m of annual cost synergies over three years.

For Melrose, GKN represents the ideal candidate for its time-tested turnaround strategy: it is a high-quality manufacturing businesses, with strong fundamentals and with potential for significant development and improvement under better management. Furthermore, the aforementioned conglomerate discount at which GKN trades means that Melrose will be able to extract more significant value when splitting up the company than they would if GKN did not operate in both businesses.

### *Market Reaction*

The market reacted negatively on the announcement day, probably perceiving it as the necessary step towards a restructuring of GKN: cutting costs, breaking up the business and hopefully generating higher efficiency. Both share prices closed down on March 29: Melrose lost c. 1.5% and GKN lost c. 3.6%. In the following days, a downward trend continued and intensified as soon as the market perceived and priced the criticism coming from trade unions.

### *Financial advisors*

Melrose was advised in its takeover bid for GKN by RBC Capital Markets, Rothschild and Investec. On the other hand, GKN was advised by Gleacher Shacklock, JPMorgan Cazenove and UBS on both the defense against Melrose and on the proposed transaction with Dana.

**Tags:** GKN, Melrose, hostile, takeover, battle, PE, defense, Dana, JPMorgan, UBS, Rothschild, RBC, electronics, cars, aerospace, Airbus, Boeing, engineering, UK, Driveline, Powder, Metallurgy, Leonardo, Volvo, cash, stock,