

Penrose: Valuing the Maxwell Group

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This case was written by **Denis GROMB**, Antin I.P. Chair Professor of Finance at HEC Paris, as a basis for class discussion rather than to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.

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“Three *Black Sheeps* and two *Bishops Fingers*, luv’!” Dave Penrose, CEO of Penrose plc, had elbowed his way to the bar for a round of real ales. His firm was weighing a bid for Maxwell, a subsea cable protection provider for offshore wind (OW) farms, which would be its third acquisition of 2018. Maxwell’s board had agreed to listen to offers and Penrose now had to set a price. To cap a long day, Dave had taken colleagues to *The Grace Darling*, a country pub in the English North-East. While waiting for the ales and salt-and-vinegar crisps, he observed Hadrian’s Wall tourists in Burberry jackets and Wellington boots, drying out by the fireplace. It was already late July, after all.

Penrose plc

Robert and Tiffany Penrose founded the Penrose Company in 1966 to manufacture machines for the coal mines of Yorkshire. With the decline of mining and the pit closures that followed the failure of the Great Miners’ Strike of 1984-1985, Penrose’s days looked numbered... until salvation came from the sea. Discovered in the 1970s, North Sea oil and gas fields had become viable for exploitation as oil prices skyrocketed due to the OPEC-led oil shock of 1973 and the 1979 oil crisis triggered by the Iranian revolution. New discoveries in the 1980s persuaded Dave to transform his Uncle Bob and Aunt Fanny’s business into a manufacturer of equipment for offshore rigs.

By the 1990s, Penrose had grown into a leading supplier of engines and compressors for Oil & Gas (O&G) offshore platforms, which it designed and manufactured in plants in the North-East. It also had a smaller maintenance activity. In 1994, Penrose went public on the London Stock Exchange to finance its organic and external growth.

Offshore Wind (OW)

Yet, Dave was troubled by the wide fluctuations of the company’s profits, caused by the high cyclicity in sales of large-ticket heavy equipment and by the high fixed costs involved in manufacturing. Its pure O&G focus was another concern, in light of the company’s near-death experience with coal. A taskforce was set up.

In 1999, following a study trip to Denmark where the first large scale offshore wind (OW) farm was being built, the taskforce advised that Penrose develop a service business for the OW industry for several reasons: this would be both close to and a hedge for Penrose’s O&G activities; services, such as maintenance, were more stable than manufacturing; though more difficult and costly to build, OW farms enjoyed stronger, steadier winds than onshore wind parks and raised no “not-in-my-backyard” issues; and crucially, Penrose would stake a claim to a new market with high long-term potential. In 2000, Penrose acquired turbine installation firm B.A.T. to form its new OW Service unit.

The long-term came early as investments in renewable energy took off sooner than expected, driven by new regulation, demand for clean energy, improving reliability, and fast-falling costs. By 2018, global OW capacity was six times higher than in 2011, and poised to grow by 10-to-20% per year until 2030. Thanks to its early start, Penrose’s OW Service unit was thriving and now contributed 17% of profits. It had recently acquired AquaX, a project designer for OW, and BB Direct, a shore-to-rig crew-transfer fleet operator. The Maxwell Group was next on its to-buy list.

The Maxwell Group

For 97 years, the Maxwell family had owned and managed the namesake business based in Aberdeen, Europe’s oil capital. Reinvented many times, the group now focused on subsea cable protection and associated services for the OW industry. It drew revenues from manufacturing cable solutions (43%) and from services (57%), i.e., project design, engineering, geotechnical analyses, installation, operation and maintenance, etc.

Cable failures, the primary source of OW farm failures, caused weeks of downtime and millions in lost revenues and repair costs. Maxwell had patented technology that drastically reduced cable failure rates, costing £30,000 per turbine, a mere 0.2% of a project’s cost. Its order book was full as viability required OW firms to reduce costs and risk at existing and new sites. However, hindered by operational and financial problems, Maxwell’s sales growth was below expectations, and the stock price at a record low. Some family members advocated selling the firm.

Due diligence and ESG audit

Penrose conducted thorough due diligence on all its targets to identify problems and opportunities. In addition to financial data, strategic position, operational assets, or legal matters, Penrose analyzed Environmental, Social and Governance aspects, in response to new regulation but also to demand by its institutional shareholders.

Dave was aware that, on average, firms scoring high on some ESG items delivered higher stock returns and operating performance, but he was unsure about what such statistics implied. He also realized that ESG initiatives often covered mere “greenwashing” and policies companies would have implemented anyway, ESG or not. But Dave had seen how, as an additional grid of analysis, ESG due diligence could help elicit certain business issues that might have been overlooked otherwise, and how setting ESG objectives could increase employee motivation and retention, and indirectly spur long-term thinking by management, as with Penrose’s early venture into offshore wind.

Problems and opportunities

For the Maxwell Group, the primary conclusions of Penrose’s preliminary review were as follows.

Due to long payment collection periods and low inventory turnover, Maxwell’s net working capital (NWC) was 51% of sales, well above its peers’ average. Penrose thought a rebates system might accelerate payments, thus reducing receivables. As for Maxwell’s inventory problem, it originated from an excessively wide product range. Refocusing on its star products could rationalize purchases and inventory. In total, NWC might drop down to 46% of sales.

The ESG audit had flagged unusually high levels of absenteeism and turnover among employees. Further investigation, notably of social network posts by staff, had linked the issue to Maxwell’s weak response to a series of accidents, causing unrest and low morale for many employees. The cost to Maxwell was not only reputational but also economic, if only due to the loss of days worked and that of well-trained, experienced employees.

Penrose’s priority would thus be to put an end to accidents while rebuilding employee trust through visible reforms: a full Health & Safety (H&S) review involving employee representatives, mandatory H&S training for all staff, a new H&S management system with one H&S manager per site, clear targets, and full transparency on all incidents. Bringing absenteeism and turnover down to industry standards could reduce costs from 87% to 84% of sales. Less easily quantifiable gains might follow too, e.g., employee engagement could boost process innovation.

Cost synergies were expected: by avoiding overlaps with Penrose’s salesforce and support functions Maxwell could cut another 3% off its costs (i.e., from 84% of sales, if the H&S plan succeeded, to 81%). Putting a figure on revenue expansion synergies was much trickier, but Penrose might insert Maxwell products in the solutions it offered its OW clients and perhaps adjust them to suit the O&G market, which remained its core business.

To ensure the family retained control, Maxwell had avoided tapping equity markets. Meanwhile, its conservative AA rating target had limited borrowing, and sizeable cash dividends had been maintained to placate some family members. Believing that these financial constraints had stifled growth, Penrose hoped its BBB rating target and zero-dividend policy would free up sufficient financing for sales growth to rise from 6% to 12% per year, for some time at least. The additional debt would also reduce Maxwell’s tax bill, shaving some 0.5% off its cost of capital.

Valuation

Listed on AIM, Maxwell’s stock had seen its price rise from £5.01 four weeks prior to £5.52, due in part to takeover rumors. Its board of directors had indicated it might advise shareholders to accept a bid of £7.00 in cash. For the 2018 fiscal year (FY18), ended on June 30, Maxwell’s earnings and EBITDA were £3.9m and £11.9m, the analysts’ consensus forecasts being £4.1m and £12.2m for FY19, and £4.7m and £12.9m for FY20. Maxwell had 15 million shares, 55% owned by the family. Its equity beta was 1.05, its cost of debt 5.6% and its tax rate 28%.

Penrose had 18.4 million shares and its stock price was £27.21. It had £101.6m and £242.7m in short-term and long-term debt, and £114.5m in cash accumulated from retained profits and equity issuances. Its equity beta was 1.92, its cost of debt 6.3%, and its corporate tax rate 28%. Long-term government bonds had a yield of 2.9% and estimates of the market risk premium currently centered around 6.0%.

Exhibit 1

Maxwell Group: Financial Statements FY16 – FY18

(all amounts in millions of GBP – fiscal year ending June 30)

INCOME STATEMENT	FY16	FY17	FY18
Sales	78.8	83.5	88.1
<i>Sales growth</i>	5.8%	6.0%	5.5%
Costs	68.5	72.8	76.2
<i>Costs/Sales</i>	86.9%	87.2%	86.5%
EBITDA	10.3	10.7	11.9
<i>EBITDA/Sales</i>	13.1%	12.8%	13.5%
Depreciation	5.2	5.2	5.8
<i>Depreciation/Sales</i>	6.6%	6.2%	6.6%
EBIT	5.1	5.5	6.1
<i>EBIT/Sales</i>	6.5%	6.6%	6.9%
Interest	0.5	0.8	0.9
EBT	4.6	4.7	5.2
<i>EBT/Sales</i>	5.8%	5.6%	5.9%
Taxes	1.2	1.2	1.3
<i>Average tax rate</i>	26.1%	25.5%	25.0%
Net income	3.4	3.5	3.9
<i>Net income/Sales</i>	4.3%	4.2%	4.4%
BALANCE SHEET	FY16	FY17	FY18
Assets			
Cash	5.1	5.2	4.5
<i>Cash/Sales</i>	6.5%	6.2%	5.1%
Accounts receivable (A/R)	41.1	42.5	46.3
<i>(A/R)/Sales</i>	52.2%	50.9%	52.6%
Inventories	13.4	15.8	16.0
<i>Inventories/Sales</i>	17.0%	18.9%	18.2%
Property, plant & equipment (PPE)	58.4	58.9	59.4
<i>PPE/Sales</i>	74.1%	70.5%	67.4%
<i>ΔPPE/ΔSales</i>	9.8%	10.6%	10.9%
Total assets	118.0	122.4	126.2
Liabilities and Equity			
Accounts payable (A/P)	14.7	15.0	16.7
<i>(A/P)/Sales</i>	18.7%	18.0%	19.0%
Short-term debt (STD)	1.3	2.2	2.4
Long-term debt (LTD)	3.0	4.7	4.7
Equity	99.0	100.5	102.4
Total liabilities and equity	118.0	122.4	126.2

Exhibit 2

Comparable Companies

(all amounts in millions of corresponding currency, except stock price and number of shares)

Industry Peers	Stock price & currency	Nb shares (millions)	Debt (millions)	Cash & equivalents	EBITDA		Earnings			
					FY18 (A)	FY19 (F)	FY18 (A)	FY19 (F)		
Hoesch	77.23 EUR	12.3	380.9	57.1	146.1	163.3	182.6	39.4	43.8	55.3
CGE Groupe	4.75 EUR	152.5	349.5	26.6	130.6	122.8	137.5	27.0	30.1	30.7
Harrington	8.29 GBP	43.9	166.2	19.5	71.7	57.4	63.1	12.6	14.9	15.2
Skandiwind	7.64 DKK	99.4	184.9	43.7	100.1	123.4	130.3	38.1	28.6	35.2
OceanTek	12.61 USD	44.8	584.7	61.4	(79.2)	(13.7)	132.7	(39.6)	(10.5)	34.9
HD-Caspian	72.36 USD	11.7	486.6	71.0	194.0	191.9	205.4	44.6	45.9	48.9

Exhibit 3

Comparable Transactions

(all amounts in millions of corresponding currency, except stock prices and number of shares)

Acquirer	Target	Transaction Year	Bid Currency	Undisturbed stock price		Shares (millions)	Target at deal year		
				1 day	4 weeks		Debt	EBITDA	
Holthausen	Remus	2018	6.03 SEK	4.55	4.37	22.8	70.1	17.5	20.1
Eoline	Générale Atlantique	2018	80.15 EUR	61.66	57.62	3.3	123.4	30.9	41.7
WindTech	A.T.D.	2018	11.20 USD	8.60	8.17	11.1	60.9	15.2	19.4
HD-Caspian	Forma Solutions	2017	47.30 USD	35.98	34.52	7.2	152.7	39.3	41.8
Artema	Starr & Monahan	2017	2.95 NOK	2.25	2.23	54.6	20.5	12.1	18.2
Skandiwind	Arping International	2017	23.27 DKK	18.60	16.85	12.0	101.4	59.1	44.9