Deutsche Bank
Research

Rating
Hold

North America
United States

Industrials
Multi - Industry & Electrical Equipment

Company
Colfax Corp

Reuters	Bloomberg	Exchange	Ticker
CFX.N	CFX UN	NYS	CFX

Date
19 November 2018

Company Update

Price at 16 Nov 2018 (USD)	27.98
Price target	30.00
52-week range	41.76 - 27.16

Our Thoughts on the DJO Global Acquisition

Valuation & Risks

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CFX announced the long-awaited platform acquisition

For some time, CFX management has foreshadowed adding a new platform to its portfolio, noting that it was spending much time evaluating large deals that would take the business in a completely new direction. Today, we woke up to the long-awaited announcement - the company will acquire DJO Global for $3.15bn, increasing its revenue base by one-third ($1.2bn acquired revenue) and taking it into the less cyclical, higher margin (22% on Adj. EBITDA basis) world of Med Tech (DJO supplies orthopedic devices, software and services). We have mixed feelings about the acquisition - we understand the attractiveness of a less cyclical Med Tech business with low-20s Adj. EBITDA margins, but we are not sure levering up the balance sheet to ~4.6x net debt/EBITDA, forcing the sale of A&GH this early in its recovery path and issuing $500-700m of equity after a 40% YTD decline in the share price is the best use of capital. The stock price reaction (-15% today) was clearly negative, but the bulk of this can be explained by the anticipated $500-700m equity issuance to finance the deal.

The pros

From our perspective, we see three major positives in this acquisition. First, the deal multiple did not look as stretched as we would have expected for a Healthcare asset - 11.7x EV/EBITDA. Of course, this can partially be explained by high leverage (~9x on a net basis today) and a lower growth rate (LSD), but we will go into that in the next paragraph. Second, the movement into the lower volatility Med Tech space reduces the cyclicality of CFX's earnings; the standard deviation of proforma organic revenue would have been about 25% lower than CFX's reported results over the last five years. Third, the business carries higher than average Adj. EBITDA margins of 22%, a premium to CFX's current Adj. EBITDA margins of ~13%. And finally, we calculate $0.16 EPS accretion in year one (consistent with management guidance for $0.10-0.20), ramping to $0.51 in year five.

The cons

However, we are not convinced that DJO Global is a top-tier Med Tech asset; organic growth has recently stepped down to the 2-3% range as the company underinvested in new product innovation (and was hurt by negative reimbursement trends), and we are not sure that a movement back to 4-5% over the next 5Y (as projected by management) will be easy, particularly since this is predicated on 4-5% market growth in bracing. Moreover, FCF has been negative in each of the last five years - and while we understand that most of this can be attributed to the high level of debt on DJO Global's balance sheet ($170-190m annual interest expense) - it will take time for CFX to bring this down. And the most common pushback we've heard from shareholders has been around the company's decision to lever up the balance sheet (to the highest level it's ever been) at this point in the cycle, when growth concerns are mounting. This will also require the company to pursue strategic options for A&GH a bit earlier than we would have liked (when the business has only enjoyed one quarter of rebounding organic order growth and segment margins), as well as a $500-700m equity issuance after the stock is down 40% YTD.

Our Thoughts on the DJO Global Acquisition

This morning, Colfax announced the acquisition of DJO Global, a global leader in orthopedic solutions, from private equity funds managed by Blackstone for $3.15bn in cash; the acquisition is expected to be financed with ~$100m in cash from CFX's balance sheet, $2.4-2.7bn of new debt issuance (including a combination of term loans/senior bonds) and $500-700m issuance of equity/ equity-linked securities. The transaction is expected to close in 1Q19, and management forecasts $0.10-0.20 EPS accretion in year one, as well as 10% ROIC within five years of closing.

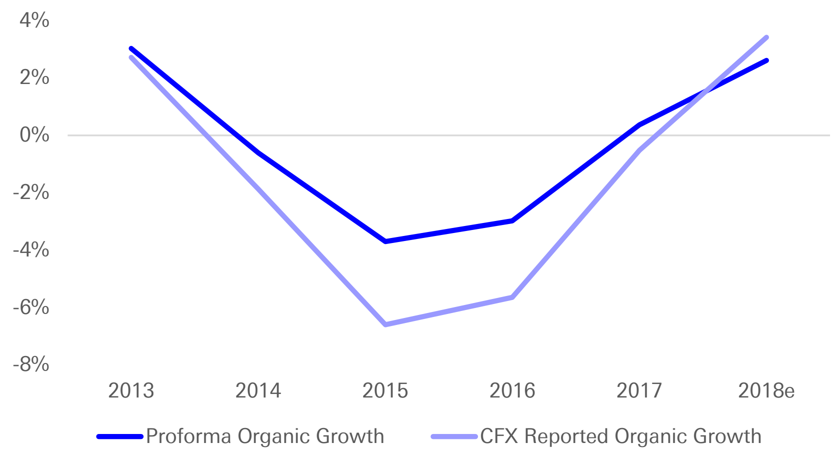
We have mixed feelings about the acquisition. Overall, the deal is a lot bigger than we had expected (we highlighted $1.5bn of M&A firepower in our initiation report, based on 4.0x net debt/EBITDA), and management is choosing a curious time to take balance sheet leverage to a historical peak, as an increasing number of investors are expressing concern over the cycle trajectory. Moreover, we would argue that it is a bit early to be putting the A&GH business up for sale, as it has only shown one quarter of traction in orders/margins after several years of decline/ disappointing results. As for the quality of the DJO Global business, we are not totally convinced that organic revenue growth can accelerate to the 4-5% range, and DJO has not generated positive FCF over the past five years - although we do agree with the EPS accretion calculation (we come to $0.16 in year one, ramping to $0.51 by year five).

Adding a Med Tech segment reduces the cyclicality of CFX's portfolio

We have a number of concerns about this acquisition, but we do see one major positive: adding a Med Tech asset to the portfolio should reduce the cyclicality of Colfax's organic growth profile. This is depicted in Figure 1 below; we have plotted proforma organic revenue growth against CFX reported organic revenue growth, and find that the standard deviation moves from 4% to 3% - we see a clearly less volatile historical organic revenue curve for CFX including DJO rather than in its current form. This is not particularly surprising since healthcare companies tend to grow in the low-single digits across a cycle, with less variance.

This aspect of the acquisition should be viewed in a positive light, since investors tend to pay a premium for greater predictability of revenue/earnings.

Figure 1: On a proforma basis, CFX's historical organic revenue growth would have been less volatile



Source: Deutsche Bank, company information

We agree with management's accretion calculation

Colfax guided for $0.10-0.20 year one EPS accretion from the deal (ex-one-time costs and deal-related amortization), and our math gets us to $0.16, in line with this range; we come to $0.51 EPS accretion by year five. Note that this is predicated on the following major assumptions: 1) organic growth steps up to 4% by the end of the forecast period, towards the low end of management's 4-5% range, 2) Adj. EBITDA margins expand by 50bps p.a., 3) A 6% interest rate on $2.55bn of new debt issuance, 4) A mid-20s tax rate, and 5) Issuance of $500m of equity, or 21m shares.

Figure 2: DB's DJO Global accretion analysis

$'millions	2017	2018e	2019e	2020e	2021e	2022e	2023e
Revenue	1,186	1,210	1,234	1,265	1,303	1,349	1,402
% Y/Y	3%	2%	2%	3%	3%	4%	4%
% Organic Y/Y	2%	2%	2%	3%	3%	4%	4%
Adj. EBITDA Pre-Synergies	257	270	267	285	300	318	338
% Margin	21.7%	22.3%	21.6%	22.5%	23.0%	23.6%	24.1%
% Incremental	116%	55%	-14%	60%	40%	39%	37%
Cost Savings	-	-	15	10	10	10	10
Adj. EBITDA Post-Synergies	257	270	282	295	310	328	348
% Margin	21.7%	22.3%	22.8%	23.3%	23.8%	24.3%	24.8%
% Incremental	116%	55%	48%	43%	40%	39%	37%
D&A	111	111	111	111	111	111	111
Incremental Interest Expense	-	-	140	140	140	140	140
Pre-Tax Income	146	159	30	43	59	76	97
Taxes			8	11	15	19	24
% Rate			25%	25%	25%	25%	25%
Post-Tax Income			23	33	44	57	72
Share Count	124	121	142	142	142	142	142
EPS Accretion			0.16	0.23	0.31	0.40	0.51

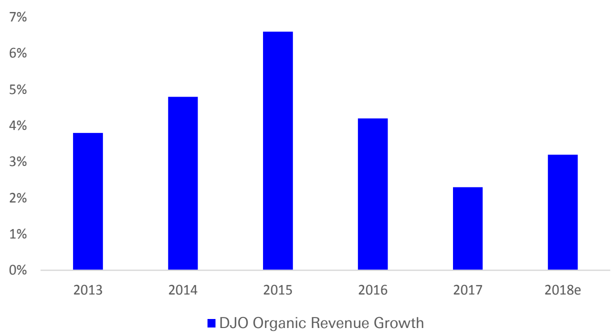
Source: Deutsche Bank, company information

Management assumptions for organic revenue growth looks aggressive vs. history, and it will take time to FCF conversion to normalize towards unlevered FCF conversion

We dug through several years of 10-K and 10-Q filings for DJO Global, and find several areas of concern (which could be responsible for the fact that the 11.7x EV/EBITDA transaction multiple looks pretty cheap for a Healthcare asset).

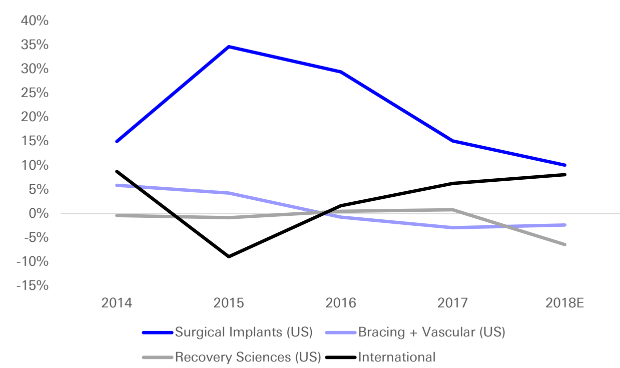
First, organic growth has been on a decelerating path since 2015, most recently in the 2-3% range (for 2017 and 2018 YTD). As per Figure 3 below, we show revenue growth by segment, and we find that this has been driven by most of the businesses within DJO's portfolio - but surgical implants in particular. Management attributed this to issues with reimbursements, and a step-down in innovation activity (presumably due to less capital available for investment given that DJO has 9x net leverage on its balance sheet and is not generating positive cash flow), and expects that reinvigorating the new product pipeline will drive an upward shift back to the 4-5% organic growth range (near the end of the next five year period). However, we see very low single digit growth organic growth over the next several years as the most realistic outcome.

Figure 3: Recently, DJO's organic revenue growth has decelerated to the 2-3% range



Source: Deutsche Bank, company information

Figure 4: This has been driven by a step down in nearly all business segments

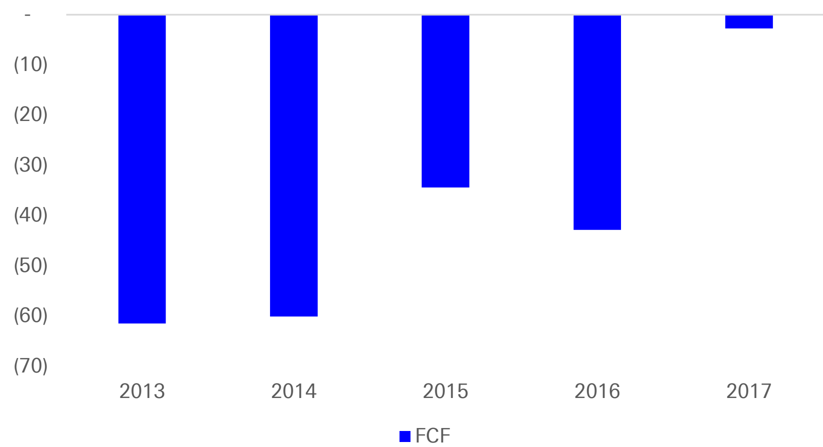


Source: Deutsche Bank, company information

Second, while Adj. EBITDA margins look attractive, forecasted at ~22% for 2018e, and management sees scope for 50bps of improvement p.a. over the next five years, the business has not generated positive FCF for the past five years. While management did note that unlevered FCF conversion is in the 100% range, it will take time for the company to pay down debt, and so we aren't sure this is the best metric to consider when looking at the 5Y trajectory.

Net/net, we would argue that CFX's assumptions for both organic revenue growth and FCF conversion seem aggressive relative to historical results.

Figure 5: FCF has been negative for DJO Global in each of the last five years



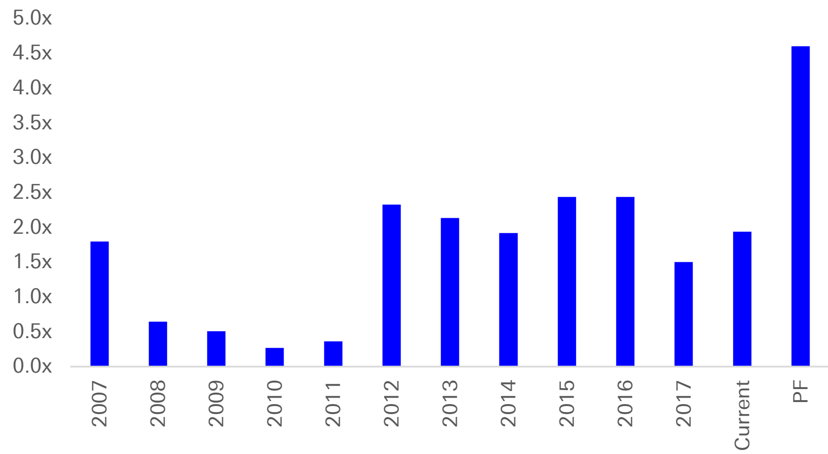
Source: Deutsche Bank, company information

Levering up the balance sheet late in the cycle, and selling A&GH near trough

Perhaps what is most concerning to the investors we've spoken with today (we agree) is the fact that Colfax is levering up its balance sheet to it's highest historical level when we are arguably closer to the end of the cycle than the beginning. We have been hearing increasing concern about where we are in the broader economic cycle since 3Q earnings season, given that organic growth is now on a generally decelerating path (particularly for short-cycle end markets) and companies sound a bit more cautious about the potential for the ongoing US/China trade war to weigh on global growth. As such, we are not surprised that a number of investors are worried that Colfax is levering up its balance sheet too much for where we are in the cycle.

To this point, leverage will sit at ~4.6x net debt/EBITDA once the acquisition closes, the highest the company has ever gone - even after the Howden acquisition, net leverage only stepped up to ~2.5x. While we do not think the cycle is teetering on the edge of recession, we were surprised at the size of the DJO Global transaction - especially since the company plans to issue $500-700m of equity after the stock is down 40% YTD.

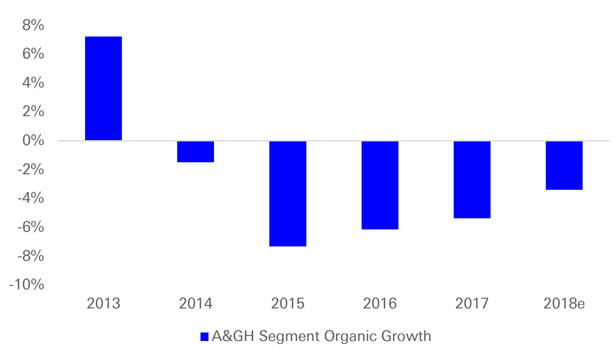
Figure 6: Proforma net leverage will be the highest it's ever been for CFX post-deal



Source: Deutsche Bank, company information

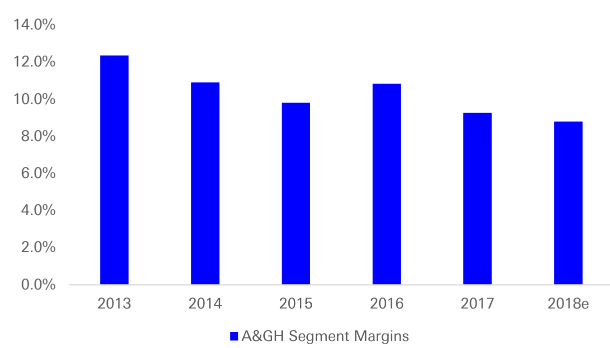
Moreover, management noted at as part of the de-levering process (the company is targeting mid-3x net leverage by year-end 2019e), it will explore strategic options for the Air & Gas Handling business. In our view, this is not the best time to pursue a sale (or other strategic options) - we have only just seen the first signs of positive inflection in segment profitability after several quarters of Y/Y decline, and organic revenue continues to fall (albeit orders did turn positive in 3Q). We would have preferred to see management continue to show traction with respect to restructuring payback - and a few more quarters of solid Y/Y order growth - before the company puts the business up for sale. We are not sure this will maximize shareholder value, particularly since the A&GH business is likely to be sold at a somewhat depressed valuation (perhaps 8-9x EV/EBITDA, consistent with E&C companies.

Figure 7: A&GH segment organic revenue continues to decline...



Source: Deutsche Bank, company information

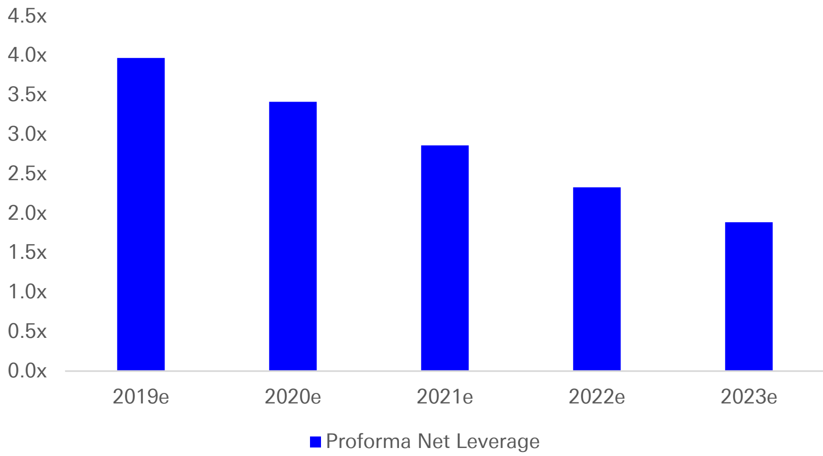
Figure 8: ...and margins only recently inflected positively for the first time in several years



Source: Deutsche Bank, company information

And who will be a willing buyer for Howden given its recent challenges? We are not sure - and if the business fails to be sold (and DJO is unable to generate 100% FCF conversion), we calculate that it will take CFX until 2022 to get net leverage back down to <2.5x.

Figure 9: If we assume CFX only uses projected FCF to pay down debt, it will take until 2022 to get <2.5x net debt/EBITDA



Source: Deutsche Bank, company information

Appendix 1

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Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Colfax Corp	CFX.N	27.98 (USD) 16 Nov 2018	1, 2, 7, 8, 14, 15

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Historical recommendations and target price. Colfax Corp (CFX.N)

(as of 11/16/2018)

Current Recommendations
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Hold
Sell
Not Rated
Suspended Rating

** Analyst is no longer at Deutsche Bank

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2.	12/19/2017	Hold, Target Price Change USD 41.00 John G. Inch**
3.	07/11/2018	Hold, Target Price Change USD 33.00 Nicole DeBlase
4.	07/30/2018	Hold, Target Price Change USD 34.00 Nicole DeBlase
5.	08/06/2018	Hold, Target Price Change USD 36.00 Nicole DeBlase
6.	09/28/2018	Hold, Target Price Change USD 38.00 Nicole DeBlase
7.	10/25/2018	Hold, Target Price Change USD 30.00 Nicole DeBlase

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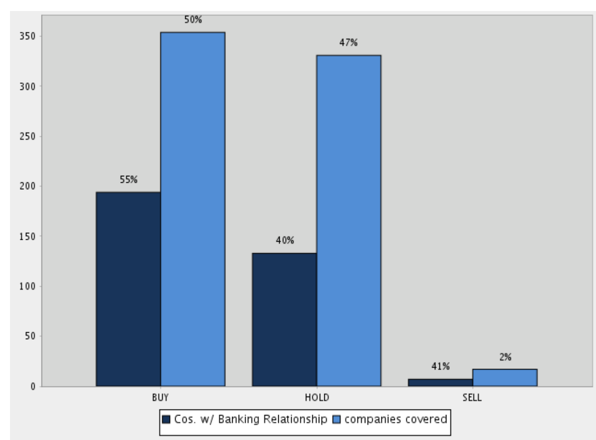

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