Manufacturing Sector

March / April 2004

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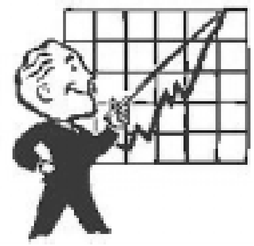
Upswing!



After a long cold winter, has spring finally arrived for U.S. manufacturers? In March, for the first time in 44 months, the U.S. manufacturing sector stopped losing jobs. Factory orders were up 4.3% from February, the biggest increase since July 2002.

The ISM index of manufacturing activity for April was 62.4, bringing its string of expansionist results to 11 consecutive months. "The second quarter is off to a very strong start," said ISM survey director Norbert Ore in a news release. "Many respondents indicate that order backlogs are growing for the first time in several years."

Capacity, Production, and Backlog

Manufacturing capacity utilization, according to the Federal Reserve's figures, has been steady and low the past few months, ranging from 74.4% in December to 75.2% in March. Year-over-year, utilization is up 190 basis points since March 2003, yet remains well below its 30-year average of 80%. In the past year, capacity has expanded 1.0%, meaning utilization on last year's base is up more like 270 basis points.

The recovery in durable goods production continued with gains of 3.9% in February and a surprising 5.0% in March. Industrial machinery production was up 15.2% in March. Durable goods manufacturing capacity utilization was 72.5% for Q1, up 240 basis points from Q2 2003.

Among the non-durable goods sectors, the Commerce Department reported a broad-based recovery with non-durable goods orders increasing 3.5% after dropping 1.8% in February. On the capacity utilization side, the Fed's report demonstrated at least a couple of bright spots: plastics and rubber products utilization reached 82.0% in March, continuing its steady climb up 290 basis points from Q2 2003; and electrical equipment, appliances and components utilization reached 77.3%, up 420 basis points from 73.1% in Q2 2003.

Of the ISM respondents who report their backlog of orders, 43% reported greater backlogs in April, 10% reported smaller backlogs, and 47% reported no change from March. Anecdotally, Newbury, Piret's clients have benefited from the improving environment, with both better visibility and profitability.

Pricing and Costs

While price pressures remain difficult for many manufacturers, the big picture indicates improving pricing power. Regional Fed reports indicate strong pricing gains in February and March.

The cost side of the equation has been a drag on margins as commodity costs escalated. Companies surveyed by ISM said that higher prices of certain commodities, such as aluminum and steel, were causing some difficulties. With the ongoing conflict in Iraq, oil prices are pushing $40 per barrel. Mr. Ore noted that the "list of metals up in price is quite extensive – almost every category of product has seen price movement." In April, the Wall Street Journal reported that steel prices were starting to level off after shooting up 77% since January. Three-quarters of supply executives surveyed reported paying higher prices in April than in March.

ISM's prices paid component rose to 88.0 in April, the highest level since November 1979, from 86.0 in March. It was the 26th consecutive month the index has increased.

Employment and Inventory

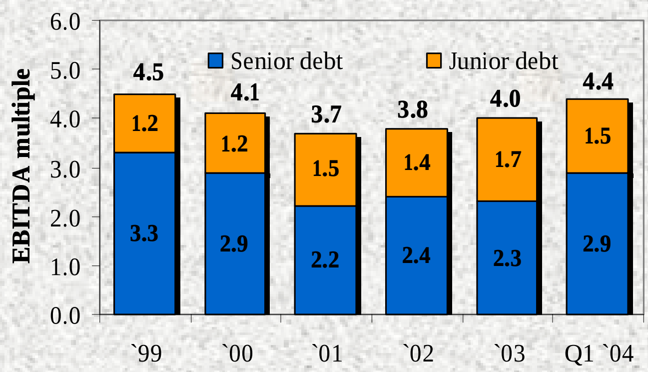
More factories added workers in March than at any time since 1987. Companies expect to increase hiring this year as an improving economy boosts sales. The need to rebuild depleted inventories should also drive demand. Relative to sales, stockpiles were held at the leanest ever in February, suggesting increased production, and consequently employment, to meet demand.

Financing Environment

With the improved confidence in the economy and upswing in manufacturing, financing has become more available for companies looking to expand through capital investment and acquisitions. Innovative structures such as "last-out" debt participations are filling the gap in many cases and allowing leverage multiples to rebound to over four times EBITDA. Newbury, Piret is bullish on middle market manufacturing and has supported manufacturing management teams recently in MBOs and acquisitions.

Total leverage multiples increased strongly in the first quarter of 2004. Middle market debt to EBITDA multiples reached levels not seen since 1999. According to Standard & Poor's, multiples reached 4.4x, up from 4.0x in 2003.

Debt multiples back over four times EBITDA



Product Innovation in a Growth Cycle

How much of your revenue comes from new products, e.g. those introduced in the last three years? A Deloitte Research study indicated that 21% of manufacturer's revenues came from new products in 1998, with the expectation of 31% coming from new products by 2006. A PwC survey on innovation in manufacturing companies found a mean percentage of turnover from products introduced in the past five years of about 60%, with four to six new products being introduced on average per year.

Companies with a relatively high percentage of revenue from new products tend to outperform their industry in shareholder value creation. Launching new products and services will be the primary driver of near-term growth for 89% of manufacturers, according to Deloitte & Touche, leading alternatives such as "economic turnaround" and "developing new channels."

The allocation of resources between innovation and expansion opportunities may be a key decision for managers over the next twelve months.

Newbury, Piret is a leading private investment bank to growth companies in business services, manufacturing, healthcare, and technology.