AQUIN

LIGHTING IN JEOPARDY?

TECHNOLOGY REVOLUTION WAS YESTERDAY. PRICE PRESSURE IS TODAY.

During our numerous conversations with lighting manufacturers and distributors, the dismal summer of 2018 came up time and time again. However, the discussion was not the lack of rain, but the lack of sales. It is said that one swallow does not make a summer, and a dismal "lighting summer" does not yet imply a crisis. There are, however, already some thought-provoking warning signs.

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The share price performance of lighting companies gives an indication of the way outsiders assess the prospects for the industry. Since mid-2017, share prices have been slipping at an alarming rate – some faster, some less dramatically. In comparison to the market as a whole, only very few lighting companies are listed on stock exchanges, which makes it necessary to more closely examine whether the falling share prices alone are an alarm signal for our industry.

An interesting indicator may also be the development of the number of active lighting companies. While their number increased significantly with the upswing of LED lighting, it is now noticeably decreasing, as some (by necessity) withdrew from the market and others have integrated into larger groups.

As seen in Figure 2, extraordinarily many transactions happened during the wave triggered by the transition to LED. Sellers were attracted by the good enterprise values that could be achieved, and buyers as well as sellers were convinced that company size and market access were of increasing importance. Currently, not only valuations but also M&A activity seem to stabilize, but still at a relatively high level compared to other industries.

There is no doubt, however, that price pressure in the lighting sector has continued to increase dramatically to the extent that it often could not have been offset by lower manufacturing and sourcing costs. Margins have therefore shrunk. As shown in Figure 3, listed lighting companies also suffered slight losses in profitability last year. Price pressure had an even greater impact on small and medium-sized players in the market. This is, at least, our impression from numerous discussions with entrepreneurs. There is reason to fear that this development will not change in the future; however, the downward steps are expected to be smaller.

Reasons for the problems

As is so often the case, causes for the signs of crisis are manifold and cannot be narrowed down to a single aspect. Looking at the economic headlines and forecasts, it is obvious that the overall economy in our main markets has peaked. We do not believe a crash will occur, but rather in a calmer to

Figure 1: Share price performance of selected European lighting companies in comparison to EURO STOXX Index

to stagnating growth trend. Particularly in the construction sector, order books are still full – which is having a stabilizing effect on the lighting industry. In individual market segments, on the other hand, difficulties are becoming more apparent. The retail sector, for example, is suffering from weak margins and especially from the influence of the e-commerce boom and floor space is therefore reduced.

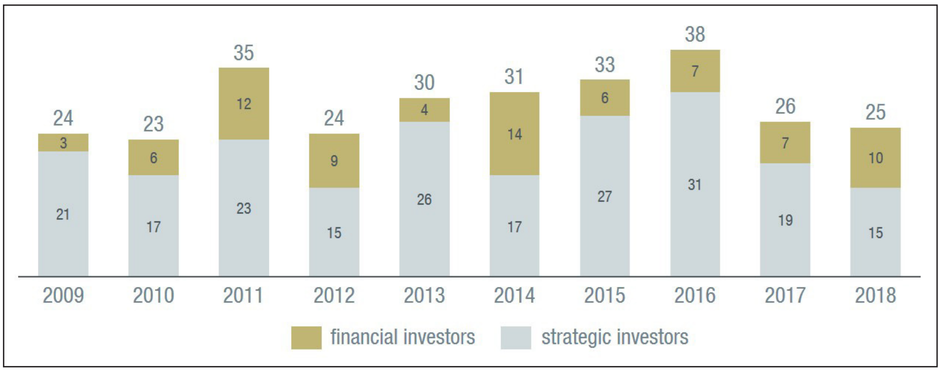
In addition to macroeconomic trends, market changes in the lighting industry itself also have lasting impacts on market opportunities. Meanwhile, LED luminaires have finally become a matter of course and no longer an innovation. Due to the fact that LED lighting has become a commodity, the additional margins have been eliminated for this technology that was considered innovative until recently. Especially smaller, innovative, and new lighting companies are encountering difficulties because their advantage over mostly larger incumbents is shrinking and costs cannot be adjusted accordingly.

Surprisingly, a few flagships in the lighting industry are currently struggling. On closer inspection, however, these difficulties seem to have mostly in-house origins and are therefore not suitable for generalizations.

It is becoming increasingly clear that with the introduction of LED as a light source, not only lighting technology has fundamentally changed, but "clock speed" too. The cycles at which changes take place have shortened dramatically, reaching a level that we know from the semiconductor industry. Consequently, this causes problems for many lighting companies that are used to much longer cycles.

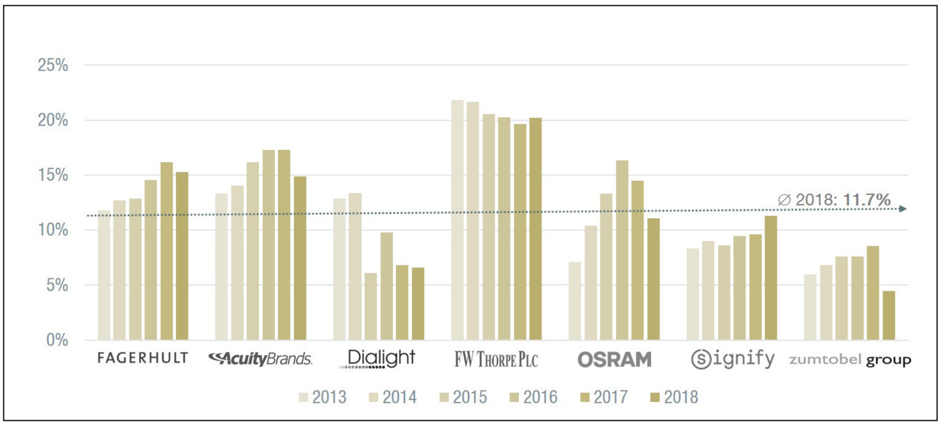
We see another significant reason for rougher times ahead by observing that professional luminaires have begun to follow a similar path as consumer luminaires did many years ago. A critical look at building ceilings shows that in many – if not most – cases, standard luminaires, which can be produced in large quantities and at low cost, are or could be hanging there. Companies that do not have a "legacy", such as LEDVANCE, have shown how such a path could look, and other manufacturers have (partly) already embarked on this path. The added value of local manufacturers concentrates primarily on design, special aspects of development, quality assurance and marketing. In this way, sourcing costs are lower than manufacturing costs, so the number of employees in the luminaire plants in Western Europe is declining and price pressure is increasing.

► **Figure 2:**
Number of transactions in the lighting industry with European target companies



Source: Capital IQ, Mergermarket, Aquin research

► **Figure 3:**
EBITDA margins of selected listed lighting companies from 2013 until 2018



Source: Capital IQ; some margins for 2018 were forecasted

Ways out of the crisis

Just as there usually isn't only one reason for problems, there is also not one, correct strategy as a cure-all. We see the following starting points as a way out of the crisis:

Of course, it is advantageous to be able to explore new market opportunities with further innovations after the LED innovation wave and thereby also achieve additional revenues and above-average margins. There are several trends visible for the future. They mostly have to do with the controllability of LED systems, such as Human Centric Lighting, Smart Home, Smart City or Smart Lighting in offices and retail stores. Unfortunately, however, considerable investments and patience are required before a market breakthrough can be achieved, whereby success can never be guaranteed.

In any case, we see importance in the ability to communicate online. Lighting manufacturers should be able to communicate in uncomplicated, intuitive and fast ways with their respective customers on all levels.

Another strategy to escape the price-cost-trap could be to occupy niches, which can only be served by special products and are not suitable for mass products. These niches should be large enough to be profitable in the long term, but not too large to be perceived as attractive by mass producers. Unfortunately, these attractive niches are usually already occupied by incumbents that cannot be pushed out easily.

We believe that a good strategic approach can also be found by thinking profoundly about which products should be or rather need to be produced in-house and close to the customer in high-wage locations, and which products are better sourced from low-wage countries. In our opinion,

a combination strategy can be a solution here: basic luminaires or basic parts are imported, whereas premium luminaires and special modifications come from workshops close to the customer.
Undoubtedly, the size of the company has increased in importance. It will become more and more difficult for smaller companies, especially if they are not anchored in niches, to coexist comfortably in the more competitive environment of the lighting industry.
Size is crucial for innovation, secure and cost-effective purchasing, defending market positions and maintaining competitiveness on the cost side. The "optimal company size" in the lighting industry is, of course, very dependent on various situations and cannot be generalized.

Numerous takeovers and mergers can also be expected in the coming years. Price pressure, the still-short innovation cycles and the extremely high fragmentation of the market speak for themselves. So far, every financial investor has still been astonished by the enormous quantity of exhibitors at the Light & Building fair when visiting for the first time.
Cooperations, joint ventures, acquisitions and the sale of one‘s own company have long ceased to be far-fetched measures. In the lighting market, they have become a natural part of strategic considerations. Finding the best solution for each company in its specific situation, with its owners, employees, equipment, distribution channels and markets requires a very individual and professional approach. ◄

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Dr. Kurt Gerl became Senior Advisor at Aquin in 2009. As a former member of the management board at OSRAM GmbH, Dr. Gerl has wide experience and deep insight into the global lighting and electrical appliances industries. Before his accession to the management board, the General Lighting division among others was under his direction. Dr. Gerl also passes on his expertise as a lecturer for the MBA-course General Management at the long-distance college Hamburg.

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Martin Kanatschnig specializes in the purchase and sale of technology-oriented companies, corporate spin-offs, management buy-outs and growth financing. As an internationally experienced M&A-expert, he successfully completed numerous transactions, including 12 in the lighting industry. Prior to joining the M&A-business in 2005, he worked at Siemens Corporate Technology. He studied Business Administration and Technical Physics at the Universities of Graz and Manchester.

ABOUT AQUIN

Aquin is a corporate finance advisory specialized in medium-sized, privately held companies. We stand for independent corporate finance solutions in the context of company successions, growth-related capital increases, spin-offs, acquisitions and corporate financing.

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