# FILTRATION INDUSTRY

**Research Coverage Report**

***"Market Intelligence for Industry Players"*** **Q1 2006**

Capstone Partners
Investment Banking Advisors

BOSTON

SAN FRANCISCO

**CAPSTONE PARTNERS LLC**
One Boston Place
39th Floor
Boston, MA 02108
617.619.3300 (o)
617.619.3301 (f)

845 Oak Grove Ave.
Suite 115
Menlo Park, CA 94025
650.323.1600 (o)
650.323.1611 (f)

**www.capstonellc.com**

**SPECIALTY PRODUCTS GROUP**

**John Ferrara**
**Managing Partner**
**617.619.3325**
jferrara@capstonellc.com

**Kevin Jolley**
**Director**
**617.619.3330**
kjolley@capstonellc.com

**Noah Brown**
**Vice President**
**617.619.3321**
nbrown@capstonellc.com

**Russell Chung**
**Associate**
**650.323.1600 ext 101**
rchung@capstonellc.com

**Craig Piccirillo**
**Head of Research**
**617.619.3333**
cpiccirillo@capstonellc.com

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# EXECUTIVE SUMMARY

Filtration products are employed across a diverse group of end-markets and segments of the economy including water processing, life sciences, truck and automotive engines, aerospace, defense, semiconductors and electronics. Despite the modest growth projected for the sector overall (i.e., typically 1% to 2% above inflation, depending on the market segment), Capstone Partners believes that the demand for filtration and separation products worldwide will continue to grow as global industrialization accelerates and population growth continues.

The market experienced significant consolidation activity in 2005 as both financial sponsors and strategic acquirers sought to capitalize on the steady, profitable growth opportunities in this large, fragmented industry. Based on Capstone's active coverage, we believe that M&A transactions will increase over the next 12 to 18 months at a pace 15% to 20% above historic levels. As the transaction pace will be driven by larger industry participants hunting for lucrative niche opportunities, established middle market companies should enjoy a highly competitive transaction market through Q2 of 2007.

## TRANSACTION TRENDS

*The filtration market is highly fragmented and is characterized by high switching costs, significant barriers to entry, and positive cash flow dynamics.*

**Consolidation Fundamentals –** The filtration industry exhibits all the classic indicators of a market set for consolidation. In general, the industry is highly fragmented, with the top 10 market participants accounting for just over 25% market share. In addition, the industry also exhibits relatively high barriers to entry due to technology and R&D requirements, the nature of OEM relationships, and the advantages of product breadth and scale production. These barriers to entry are also compounded by high customer switching costs, which help entrenched players defend market position.

**Mega Deals Give Way –** The large transactions garnered most of the attention in 2005: 3M acquired CUNO for $1.4 billion; and Parker-Hannifin acquired Dominick Hunter Group for $501.9 million. However, Capstone expects the lower middle market deals (i.e., $150 million and below) to dominate the next twelve months as niche acquisition targets will attract most of the attention. Due to the technological requirements and customer relationships necessary to enter these niche markets, many competitors will choose to "buy versus build." Likewise, the larger acquirers are also looking at slower growth markets where organic growth is more difficult for them to obtain.

**Stable Valuation Support –** Acquirers and investors have been attracted to the filtration industry's relatively stable and predictable profitability traits as well as the consistent secular demand for filtration products and replacement filters. The high level of consumable sales in filtration have helped enable public filtration companies to achieve average gross and operating margins of approximately 33% and 14%, respectively, with free cash flow margins typically ranging between 3% and 8%. Capstone expects that private company transactions will continue to receive valuations ranging from 1.0x to 1.5x revenue and 6.0x to 8.0x EBITDA (depending upon the characteristics of the individual business). Companies exhibiting above average growth and profitability, supported by a technology advantage and a loyal customer base will secure the largest valuation premiums.

**Pervasive Vertical Strategies –** The evolution of new, higher growth, end-market applications for filter products in segments such as biosciences and biotechnology, and the adoption of more advanced production techniques by industrial companies have spurred demand for new filtration technology and products. Major players in the filtration industry are targeting these end-markets by broadening their product scope through both innovation and acquisition and by leveraging existing customer relationships and sales channels. Capstone is seeing significant interest in companies with commanding positions in these emerging markets despite their lower scale production.

*Despite the maturity of the market, global industrialization and the improving global economy is contributing to significant trends in the market*

**Global Market Expansion –** The Asian market will remain an attractive growth avenue due to its rapidly expanding economy, large local market potential, and emerging environmental consciousness. Due to their rapid industrialization, China, India and other developing countries represent a growing market opportunity. These markets also provide manufactures with lower cost production capacity. Increasing raw material costs for steel, aluminum, and plastic resins have driven manufacturers' cost of goods sold higher and margins lower, encouraging companies to seek out lower cost production options abroad. Partnerships have been a primary vehicle for manufacturers to establish a presence in these markets; however, M&A is taking on a more significant role as companies become more familiar with local markets and with the role of foreign governments.

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