Gardner Denver (Ticker: GDI) Porter Street Research Initial Idea Screen

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Summary:

- Gardner Denver is a manufacturer of pumps, valves and compressors for the energy, general industrial and medical industries. The company is over 100 years old and re-entered public markets in 2017 following a $3.9bn buyout by KKR in 2014. KKR continues to own 35.6% of the company. Shares are up slightly from where they re-entered public markets in May 2017. GDI's 2019-2020 forward EV/EBITDA multiples have declined from 11-12X down to 7-8X today despite the company beating and exceeding revenue and earnings estimates throughout most of 2018

- GDI is anticipating another strong year in 2019 with a rebound in energy activity and continued strength in the general industrial/medical segments which should allow it to generate $300-$400mn in FCF to further support the balance sheet in the event there is an economic downturn

- KKR is led by Vicente Reynal. Despite the fact he is just 43, Mr. Reynal is already an accomplished industrial executive. He was trained at Danaher and is implementing many of the lean techniques, philosophies and cultures that Danaher is known for at Gardener Denver. While the end markets are different, the three industries that GDI competes in: energy, industrial and medical are each large, highly fragmented and GDI is the number 1, 2 or 3 competitor in each. GDI is in a position of strength to consolidate these industries given the cash generating nature of the businesses, high free cash flow conversion and balance sheet capacity

- GDI and KKR gave employees up to 40% of their salaries in deferred equity at a cost of around $100mn. We see this as a rare acknowledgment of who drives the actual decision making and performance within the company. If Reynal truly has a long-term view and thinks GDI can become more Danaher like over time, we view this step to create an ownership culture as a positive

Key Stats, Consensus Estimates: What is Priced in?

Price	$		20.9
Shares			199
Market Cap	$		4,167
Debt	$		1,753
Cash	$		269
Enterprise Value	**$**		**5,651**
Key Stats			
52 Week High	$		38
52 Week Low	$		19
2018 Return			-44%
Credit			
Debt/EBITDA		2.4	
EBITDA/Interest		6.8	
EBIT/Interest		5.3	
Ownership			
KKR			35.6%
T Rowe Price			6.8%
Artisan			5.2%
Vanguard			4.8%
FMR			4.5%
UBS			3.1%

Consensus	**FY 2018**	**FY 2019**	**FY 2020**	**FY 2021**
Revenue	$ 2,715	$ 2,821	$ 2,964	$ 2,912
EBITDA	$ 689	$ 719	$ 769	$ 775
EBIT	$ 536	$ 580	$ 617	
EPS+	$ 1.86	$ 1.95	$ 2.14	$ 2.61
FCF	$ 365	$ 400	$ 458	$ 452
Cap-Ex	$ 43	$ 47	$ 48	$ 50
Growth				
Revenue		*3.9%*	*5.1%*	*-1.8%*
EBITDA		*4.4%*	*7.0%*	*0.8%*
Margin				
EBITDA	*25.4%*	*25.5%*	*25.9%*	*26.6%*
EBIT	*19.7%*	*20.6%*	*20.8%*	
Valuation				
EV/EBITDA	8.2	7.9	7.3	7.3
EV/Sales	2.1	2.0	1.9	1.9
FCF Yield	6.5%	7.1%	8.1%	8.0%
FCFE Yield	8.8%	9.6%	11.0%	10.8%
PE	11.3	10.8	9.8	8.0
Debt/EBITDA	2.5	2.4	2.3	2.3

Source: Bloomberg

- Shares today are discounting a decline in the rate of EBITDA and earnings growth in coming years. GDI's mix of businesses can trade at EBITDA multiples between 8-16X (energy the lowest, medical the highest) and we think in periods of accelerating revenue and margin expansion the business will trade in the 10-12X range vs. 7-8X today. If things are less bad than discounted, GDI's businesses could re-rate and fundamentals could surprise to upside in 2019/2020 supporting shares in near term

- Gross Debt/EBTIDA of 2.8X appears concerning but net debt is lower at 2.4X on a TTM basis and could fall under 2.0X in 2019. EBIT to interest at 4.3X is well covered and EBITDA would need to decline 44% for GDI to be close to breaching any covenants. GDI's debt is in the form of two term loans: one USD denominated, and another Euro denominated, both of which are due in 2024

What is Creating an Opportunity?

- Since going public, GDI has had impressive organic growth and margin expansion driven largely by its energy segment. As the rate of organic growth slows, there are concerns over GDI's ability to grow incremental margins over the next few years. Also, the company had implemented a $30mn cost saving plan that was completed in 2017 and rate of change of incremental operating cost savings could decline in near term leaving the drivers of operating margin expansion flat

- GDI's end markets are difficult to forecast. While book to bill and backlogs are provided for segments, it is difficult for investors and Wall Street to try and asses the businesses with confidence over short periods of time: 6-12 months. GDI thinks each of its businesses can grow at GDP+ type rates. Each segment has different cycles and the businesses are a mix of short cycle, long cycle and aftermarket: all of which are difficult to forecast. This creates opportunity for long term investors

- How the mix of businesses will perform in a downturn is a concern. Given how the energy segment has changed over the last few years with a greater percent of the business coming from the aftermarket/consumables, the energy segment could be more insulated than during the last downturn where revenue in the business fell 45%. The combined company now generates 40% of its revenue from aftermarket sales and the market could be too concentrated on OE side while ignoring AM potential/benefit during a downturn. Higher gross dollar profits from AM exposure is valuable during a downturn

- The 40%+ decline in oil prices in the Q4 2018 has added to concerns over potential weakness in the energy segment. GDI has an almost 20% share of the pressure pumping market in the US where y/y growth has decelerated considerably

- During the 2014-205 oil downturn, GDI invested aggressively in energy related businesses. Despite revenue in the segment being flat GDI was able to deliver the same EBITDA margin in 2017 as 2014, which is indicative of a positive business mix change and better management. This could be undervalued/mis understood during the next downturn

- There is potential for a large replacement cycle in pumps/valves in energy that were installed in 2011/2012 that have a typical five-year life that may have been extended to 7-8 years given slowdown in activity in 2014. In a true replacement cycle, GDI could see demand increase in 2019-2020 helping to stabilize/support energy business vs consensus. If a slowdown comes, this could be further pushed out, so question becomes is the replacement cycle a WHEN not if?

- It is estimated that around 5% of GDI's business is exposed to the Permian basin. Given pipeline and capacity constraints in 2018, there is concern over the near term/next few quarters that the business will hit an "air pocket", earnings/margins could suffer, and the industrial/medical sectors won't be enough to offset the loss of revenue/earnings and consensus estimates for 2019/2020 are too high

- Any time a company comes public after an LBO it pays to be skeptical. KKR has sold about half of its position in GDI selling over 75 million shares. This selling and rotation of ownership into the hands of long term holders has likely added to pressure on shares and could be keeping investors away until the selling is complete

Initial List of Questions/Where Are There Additional Opportunities for Research

GDI has a long history as a public company and there are materials from years ago available online that help to understand the history of the business and how it has grown over time. These materials can also allow for due diligence to provide a better sense of segment exposure and break outs vs. today where company is less transparent i.e exposure to offshore oil and gas vs. upstream E&P/downstream. *Bottom line: there is a lot of data and context on this business that makes digging a worthwhile exercise.*

Q: What are the organic growth profiles within each segment? What is price/what is volume driven?

Q: What are the sales channels? How do you address the needs of customers for these one off/specific blowers/compressor markets etc?

Q: How do you get a handle on competition within each segment? What are you missing about the nature of the products and whether these segments are easy/difficult to enter? Who are top 3-5 comps in each segment? What does best in class margins/sales/working capital look like for each?

Q: What are the risks of growth through acquisition strategy? Roll up etc. What is base rate of success in companies being able to buy businesses within fragmented markets, run them better and deliver sustained operating and gross margin growth – not simply cutting costs

Q: What does it say about the nature of the businesses/mix that GDI has been able to expand and maintain margins even though sales declined significantly?

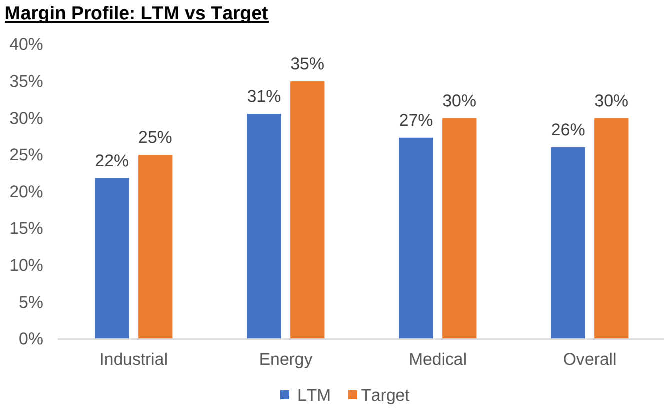
> Ex: Management has already shown an ability to run parts of the business more profitably. In energy for example, despite a substantial decline in revenue and a headcount reduction, EBITDA margins were the same in 2017 as 2014
>
> Q: What is the reason for this and is it repeatable/sustainable?

Q: What is typical replacement cycle for the energy/pump segments? How transparent is this data?

> - A lot of the products GDI makes are “in the dirt” they are used/torn up and thus the aftermarket/replacement market is large and consistent
> - Energy AM segment apparently makes 5x revenue over life of product relative to cost
>
> Q: How do you confirm/verify all of this?
> - Why cant someone else just make a better pump?
> - How much R&D/cap-ex needs to be spent to maintain/grow cometetive advantage?

Q: How does mix of aftermarket revenue effect the overall business given how episodic and difficult to forecast it is?

Q: What drives management’s target margins? Gross margin expansion? Operating? Costs improvements? Mix? Continuous improvement initiatives etc. greater AM as a % of total? Are the assumptions based on increased or flat revenue base?



Source: PSR and Gardner Denver

Q: How has and will GDI's culture change under new management? Can they adopt a true lean philosophy where employees are not only engaged, but solving problems proactively?

Q: Understand GDI's revenue and profit exposure by country and region. How important is FX? What risks/opportunities are there in their emerging markets exposure?

Q: How much money do they spend on R&D?

- Company is investing in new products, sales, marketing but where else other than cap-ex?

Q: What are main other uses of cash? What is nature of cap-ex? What are they investing in?

Q: How transparent is the business breakout between fixed and variable costs?

Q: What is the working capital intensity of the business? Where is there waste, how can inventory be reduced and turns improved? What % sales is good? How much is this the key driver of margins?

- Simple framework: Throughput, inventory, operating expense

Q: What is the return profile of the business? How will this be distorted by history of deals? How can you measure/adjust to get sense of ROIC and incremental returns? How to adjust for large amortization

Q: How is management compensated? What metrics are they running the business off? How many options/shares do key people own?

Risks: Potential Red Flags and Challenges of Due Diligence

➢ Company has debt of around 2.8x Gross DEBT/EBITDA for 2019, net debt closer to 2.0x. Company has already rapidly de-levered from 4.0x in Q2 2017 to now

  - What is debt structure, major covenants and risks to re-financing if any?
  - Are there any off-balance sheet or contractual obligations not clear on first read?

➢ KKR could want to be out/forced selling could cause technical issues with stock. If possible identify which KKR entities and funds own the shares and what their remaining life is and how willing they are to remain shareholders

➢ How bad could things be in a downturn? Energy business fell 45% in 2009. GDI could fall 20-40% in a downturn. Does company have opportunity/capacity to invest aggressively during a downturn?

- What are the dangers of assuming a company can/will be able to continue to grow by acquisition?

  - How do you asses the underlying organic growth/health of the business lines?
  - Are certain business lines declining at an accelerated rate but that is masked by buying new companies? *(This needs to be an area of focus)*

- Where could the business be vulnerable to potential write downs or impairments? What segments, what sense of estimates/assumptions could be useful in assessing any potential future write down? Would you have to quantify by looking back at all major deals done historically?

- What is the case for shorting the stock? What are you blind to on first view? Is this a "trust me" roll up story? Should it concern you at all how many conferences management goes to where they say the exact same thing over and over and nobody asks good questions?

- What is the quality/true nature and sustainability of FCF and Adj EBITDA? At first glance, the use of Adj. EBITDA from 2014-2016 is a disaster/misleading. Use of CFO – Cap-ex seems more appropriate
  - How to adjust/consider the true FCF conversion with CFO and NI?

<u>Back of Envelope Upside: Does GDI Have 15-20% IRR Return Potential over 3-5 years? What is downside?</u>

2021 Simple Upside		**3YR Growth**
Revenue	$ 2,906	7.0%
EBITDA	$ 763	10.8%
Debt	$ 1,753	
Cash	$ 269	
FCF 2018-2021	$ 1,000	
Net Debt 2021	$ 484	

Multiple	12	10	8	6
EV	$ 9,159	$ 7,632	$ 6,106	$ 4,579
Equity Value	$ 8,675	$ 7,148	$ 5,622	$ 4,095
Price/Share	**$ 44**	**$ 36**	**$ 29**	**$ 21**
Upside	*111%*	*74%*	*37%*	*0%*
IRR	*28%*	*20%*	*11%*	*0%*

2021 Simple Downside		**3 Year Growth**
Revenue	$ 2,116	-22.1%
EBITDA	$ 423	-38.6%
Debt	$ 1,753	
Cash	$ 269	
FCF 2018-2021	$ 500	
8X Mutiple	$ 3,385	
Equity Value	$ 2,616	
Share Price	$ 13	
Downside	-36%	

- Assumes minimal revenue growth + *flat margins* and FCF growth in upside scenarios. In true upside where revenue growth accelerates and margins expand towards medium term goals, $40-$60/share is achievable

- Downside scenario haircuts the FCF generation and assumes 20% consolidated margin vs. 26% current. No real way to know how bad it could be

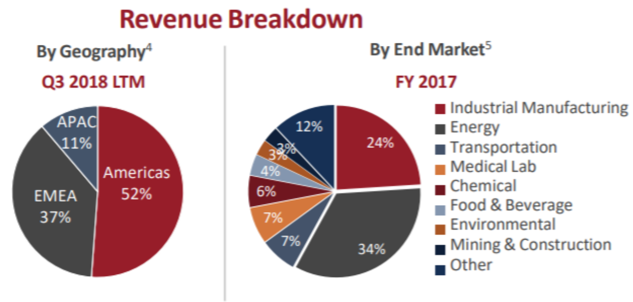
- *Back of envelope return projection seems OK/worth considering. This has compounding potential*

Background and Reference Slides

Q3 2018 LTM Financial Overview

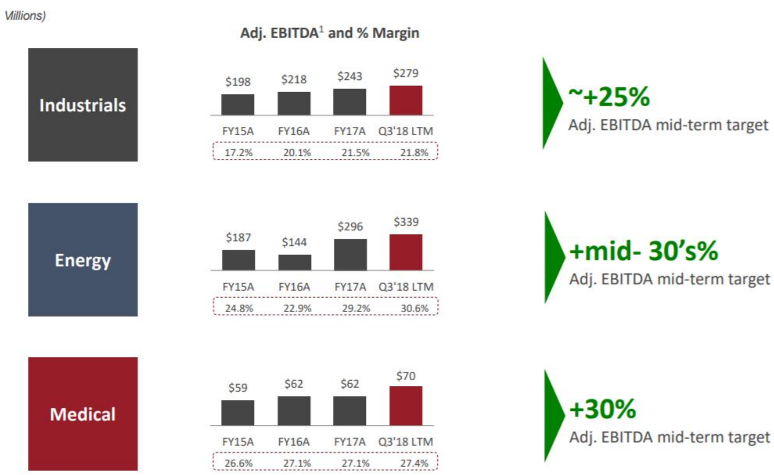
($M)	Industrials	Energy	Medical
Revenue	$1,277	$1,109	$256
Adj. EBITDA	$279	$339	$70
Adj. EBITDA Margin	**21.8%**	**30.6%**	**27.4%**
% of Total Revenue	*48%*	*42%*	*10%*

#1 - #3 Position in Our Markets[3]



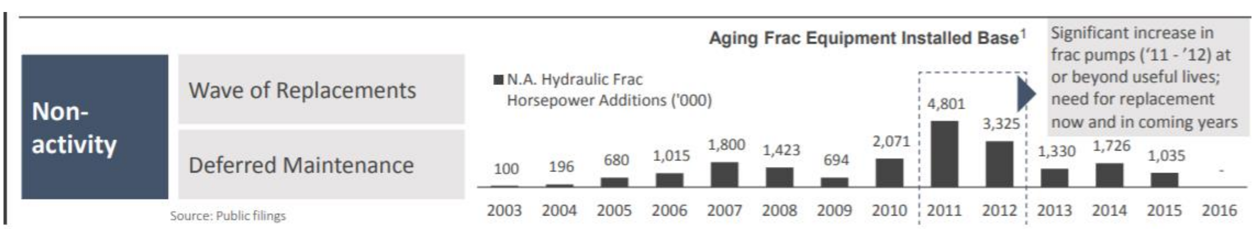
Source: Gardner Denver

Companies Goals/Plans for Future of Business Lines



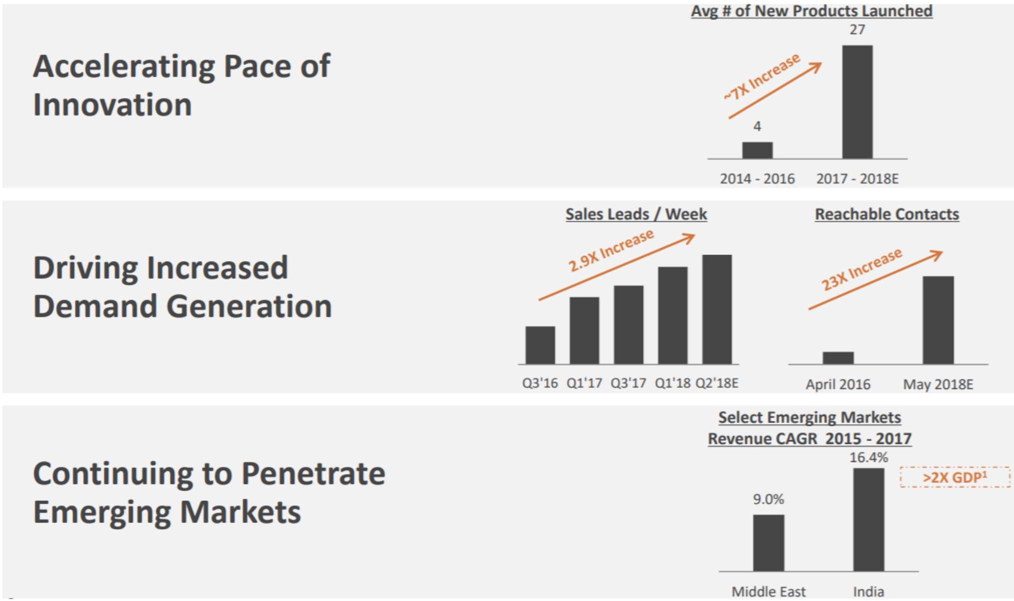
Source: Gardner Denver

Large Potential for Replacment in Frac Pumps Could Drive Energy Upside



Source: Gardner Denver

Danaher/Lean Like Approach to Investment and Sales/Demand Generation Planning



Source: Gardner Denver