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Smiths faces price conundrum over Medical sale as pensions liability poised to swallow proceeds

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A top 10 shareholder in **Smiths Group** [SMIN LN] said the company's management team would risk angering shareholders if it accepted a bid for Smiths Medical of less than GBP 2.45bn.

Smiths rejected a GBP 2.45bn approach from Apax Partners for the division in January 2011.

"The market may be different but I think they would have a hard time with shareholders if they sold it for less than they were offered before," said the institutional shareholder. He added that the interest appears to be serious but the Apax approach complicates matters. The shareholder said he had not had discussions with Smiths management on the matter so far.

A sector banker familiar with the group believed it was a mistake to turn down the Apax offer in 2011 and cautioned an offer at that level or higher will be difficult to achieve now. "I have never understood why Smiths felt they could turn down GBP 2.4bn," he said, describing it as "an almost miraculously good offer". "I can't see that offer being topped this time," he added.

A second sector banker agreed it would be difficult for Smiths to sell below the Apax approach. "They are going to have to put money into the pension liability and management is going to want some money to play with. It's a matter of practicality as well as reputation," he said.

But this banker and an analyst said Smiths CEO Philip Bowman rejected the Apax offer outright because he knew the private equity group would have talked the offer down. "Bowman realized that [GBP 2.45bn] wouldn't be the final offer," the analyst commented.

San-Diego-based CareFusion [CFN US], which is said to be the main suitor for the division, must have come to this deal with the Apax price point in mind, the second banker said. But he questioned whether the US group would try to talk it down in negotiations.

The banker, who has approached a number of potential buyers following confirmation of the approach, said there was currently very little appetite among strategic buyers to do the deal, adding it was unlikely to be a competitive process. He said that the division, which provides medical devices for hospitals, emergency services and specialist environments, would not be a technology enhancing deal, but rather a cost-cutting exercise. "The only motivation is costs," the banker said. He added that none of the strategic players with significant overlaps with Smiths Medical currently had the appetite for the cost-cutting exercise on the ground and redundancies required to extract synergies.

The market is facing challenges because of the new tax on medical devices in the US, coupled with anaemic growth, this banker said. But the banker believed that a synergistic deal would allow a bidder to reach or exceed the Apax approach.

Based on a projected FY13 EBIT of GBP 193m and an average peer multiple of 11.5x EBIT, the medical division has a valuation of around GBP 2.2bn, the analyst said. Adding a 30% takeover premium, the valuation could rise to GBP 2.9bn. Given low interest rates in the US and the synergies from the deal, a debt-financed deal from CareFusion could be accretive even at GBP 3bn, he estimated, though he said this would be a "pretty punchy" valuation.

Smiths' CEO has communicated to analysts that the company's approximate GBP 382m pension deficit as of 31 January 2013 has raised the bar in terms of the price the group is prepared to accept for its divisions, as any disposal would require a contribution to the pension fund. The net pension deficit fell from GBP 620m at 31 July 2012, reflecting asset returns and a slight increase in the discount rates upon which the liability is calculated.

The analyst believed Bowman would rather wait for discount rates to move higher to ease the pension issue before selling major

divisions so that the bulk of the proceeds don't have to be handed over to the pension fund.

The first banker also noted that the arrival of new Chairman George Buckley could have an impact on how the situation plays out. "He's the real deal in terms of managing businesses," he said. "I think he will come in with a view that previous management have underperformed and will want to put his stamp on the company, but will this sale be it? I'm not sure it will be," he added.

The banker also pointed to Buckley's background at 3M in healthcare, noting that he may view having a multi-industry approach as interesting and want to keep Smiths Medical in the group.

Smiths has not made any statement on the situation since 31 May when it confirmed an approach for its medical division had been made. A spokesperson declined to comment.

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