Vendors Find the Urge to Merge Irresistible

Charles Brewer
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ACTIONABLE INTELLIGENCE

Biography and Contact

Charles Brewer is president of Actionable Intelligence, a US-based market research firm dedicated to the digital imaging industry. With over 20 years covering business and technology, Mr. Brewer was an editor for *Inc.* magazine and *ComputerWorld* during the 1990s and later the managing editor of Lyra Research's *The Hard Copy Supplies Journal*. Launched in 2009, Actionable Intelligence has established itself as a thought leader in the digital imaging space. Its website, www.Action-Intell.com, has attracted hundreds of thousands of visitors from across the industry, including executives from OEMs, remanufacturers, 3rd-party supplies vendors, and specialty chemical makers, along with legal experts, financial analysts, and many other industry watchers.

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Agenda

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1. Have we reached another inflection point?
2. Recent mergers that have changed the industry

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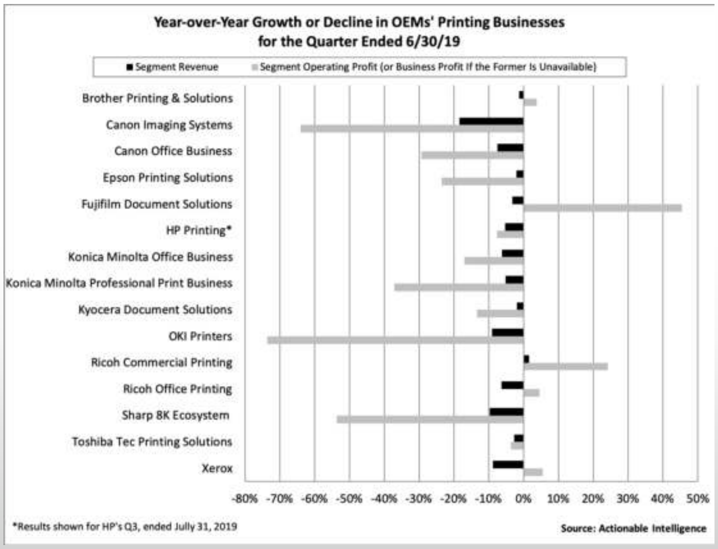
Another Inflection Point?

It Seems the Industry has Hit Another Dip

- Business for hardware manufacturers improved in 2017, but sales fell in 2018
  - While revenue was down for most last year, operating profits grew
- This year, OEMs' printer businesses reported declines in both revenue and profits
  - During the second quarter of this calendar year, only Ricoh's Commercial Printing revenue was up
  - We expect that vendors will adjust their guidance downward for the year
- Economic troubles are adversely impacting hardware and consumables sales
  - The U.S./China trade war is taking a toll on the industry
  - Some firms are reporting that their European business is worsening
    - HP's supplies business in Europe is causing big problems for the firm
- So far, U.S. markets are holding up thanks to the strong U.S. economy
  - But there seems to be a growing concern that the global economy may contract

April–June was Really Ugly!



As Bad as Things Are for OEMs, It's Worse for Third-Party Supplies Vendors

- 2019 has been a horrible year for the two largest remanufacturers in the United States
- In July, Moody's Investors Service downgraded the debt rating on 4L Technologies (4L), which operates Clover Imaging Group (CIG)
  - Moody's downgrade indicated that revenue from CIG's imaging business totaled $525M in FY 2018
    - We expect revenue to decline more than 10% this year
  - *Bloomberg* reported that CIG's total revenue fell to $820M in FY 2018
  - *The Wall Street Journal* reported that Bank of America resigned as the loan agent to a group of CIG lenders to avoid getting embroiled in an expected debt restructuring
- After rumors swirled all summer that LMI Solutions' investor, Turnspire Capital Partners, was pulling its investment, in August the Phoenix, AZ-based remanufacturer went into receivership
  - LMI representatives vow that the company will continue as a going concern
- CIG's current situation is unclear
  - Sources say the firm has a new investor and the company is looking to roll up North American remanufacturers
    - Rumor has it that Clover is currently looking to purchase LMI's assets

And It's Not Much Better in Europe

- As the big remanufacturers in North America struggle, the word out of Europe isn't any better
- Turbon Group's preliminary report for H1 FY 2019 indicates that revenue is down 12.5% and it has lowered its guidance for the full year €60M-€65M to €58M-€60M
  - Turbon Printing H1 revenue was down about 18.2% from €28M last year to €22.9M ($26.0M)
  - Laser cartridge sales tumbled 29.2% year-over-year, falling from €16.8M in H1 2018 to €11.9M ($13.5M) in H1 2019
- Moody's reported in March that CIG's total European revenue was €90M last year
  - We estimate its cartridge sales were between €40M and €50M—about half of its 2015 revenue
- While it didn't mention revenue numbers, Print-Rite has reorganized its European management team
  - Steve Weedon is the new CEO of Print-Rite Europe Limited, Print-Rite Pelikan GmbH Germany, and Print-Rite Pelikan SAS France

Even China Is Showing Signs of Stress

- As large western companies struggle, many of the new-build compatible cartridge makers in China are feeling pressure
  - Our research indicates that unit shipments for most firms are up, but revenues are down
    - Razor-thin profits are being squeezed
- Since 2016, several of China's largest new-build manufacturers have gone out of business
  - Kolion Technology, National Resources & Jingie Imaging Products, and Rich Imaging are gone
    - The assets for the firms have been divided among some of China's largest players, including Dinglong Chemical, Ninestar, and Orink Infotech
- More recently, Dinglong, which markets cartridges, toners, chips, and other components, has reported declining revenue during H1 FY 2019
  - Revenue tumbled to CNY 558.7M ($81.4M) during H1, a 16.9% decrease compared to H1 2018
    - Cartridge demand has softened, while sales of chips and chemical toners are up
  - The firm is moving into the reman ink cartridge market by taking a majority stake in Speed Infotech

More Consolidation Is All but Certain

- As the markets for hardware and supplies continue to decline, expect the dizzying amount of merger and acquisition activity in our industry to continue
- Because of all the uncertainty in the market and the industry, we don't see any big OEM mergers this year
  - While down over the last year and a half, the price tag for possible acquisition targets remains high
    - Xerox, for example, had a market cap of $6.71B as of September 6, up from about $5B in January
- There will be more realignments and strategic alliances, however
- For the supplies industry, the situation is quite different
  - The competitive landscape will experience a seismic shift during the next 6 to 18 months
- OEMs are changing their business models, while many of the world's largest third-party supplies vendors face existential threats

Mergers That Are Changing the Industry

The Industry Has Already Changed…A Lot!

- The industries that currently manufacture digital printing devices for the home and office and the consumables used in these machines have been coalescing for decades
  - Initially, all the M&A activity was driven by the need to acquire either technology or scale—or both
  - For the past 10 years, the "urge to merge" has been primarily driven by overcapacity and margin compression
- 15 years ago, the paper industry dealt with a similar overcapacity problem, but the outcome was very different than what has happened to OEMs and third-party supplies vendors
  - Dozens of large mills rushed together, leaving only a few giants
- Aftermarket sales have prevented OEMs from going the way of the paper makers
  - Even a small installed base can support a business for a long time
  - Third-party supplies vendors can also survive supporting this installed base
    - And, with the right support, they don't have to be too big
- There is still too much capacity in the industry, however, and margins continue to be squeezed so more M&A activity is inevitable

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Recent M&A Activity That Is Changing the Industry

- Looking out over the ocean of mergers that have occurred in the industry over the past five years, two will prove over time to be the most disruptive
  - HP's acquisition of Samsung's printing business
  - Ninestar's acquisition of Lexmark
- While these two deals have meant big changes for the acquiring firms, they also have changed the industry and will continue to do so
- By acquiring its own electrophotographic assets, HP has fundamentally changed its longtime partnership with Canon
  - But, HP's opportunities in office printing previously had been limited because it lacked access to A3 technology and the channels that sell A3 machines
- With Lexmark, Ninestar emerges as China's strongest player in the hardcopy industry
  - The firm's close connections to other large Chinese high-tech firms like Alibaba and Lenovo and its ties with the PRC government suggest a bright future

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The Acquisitions Open New Doors for HP and Ninestar

- The Lexmark and Samsung acquisitions allow both HP and Ninestar to change the way they do business
- Both companies have entered new market segments and attracted new channel partners
- HP and Ninestar also have become key technology providers to some large industry players
  - HP announced it will supply print engines to Xerox
    - Builds on Samsung's legacy as an engine provider
  - Similarly, Ninestar is supplying Lexmark technology to Toshiba and Konica Minolta
    - The firm also has low-end engines from its Pantum line that it can supply to other OEMs
- Through their acquisitions, HP and Ninestar are now free to change in new ways that were simply not possible in the past

HP's Samsung Assets Are Truly a "Game Changer"

- Samsung's laser assets allow HP to become the master of its own domain
  - With Instant Ink, HP tweaked the "razor-and-blade" business model for its inkjet business, but there were restrictions on what the firm could do with its LaserJet offerings
  - The June launch of the Neverstop Laser line in China indicates that HP is ready to start updating its consumables strategy for desktop laser devices
    - Neverstop machines feature the first A4 engines based on HP's own laser technologies
- Canon already has responded by expanding its A4 catalog
  - imageRUNNER and imageCLASS devices are no longer channel-specific
- Although the legendary Canon-HP relationship has been forever altered, the LaserJet installed base will keep them joined at the hip for years to come

Lexmark Gives Ninestar Newfound Powers

- Ninestar's acquisition of Lexmark has transformed the Chinese firm
  - In FY 2018, over three-quarters of Ninestar's total CNY 21.9B ($3.1B) revenue came from Lexmark
- China has wanted its own printer company for many years
  - Support from various levels of the Chinese government has been lavished on Ninestar along with investments from private groups
    - CNY 9B ($1.3B) has been dedicated to a new printer manufacturing center in Zhuhai
      - This does not include investments already made in a new cartridge plant
- Although the deal was expected to open the Chinese market to Lexmark, instead it appears to have allowed Ninestar to bifurcate its hardware businesses
  - Lexmark's business is focused primarily on markets in the United States, while Pantum machines are being targeted at China and other Asian markets, including India and Russia
- Ninestar's newfound strength may open even more doors for the firm
  - Last month, Konica Minolta formed a strategic alliance to go beyond hardware

HP's Xerox Deal Immediately Impacted the Supplies Industry—Will Ninestar's Alliance with Konica Minolta Do the Same?

- Within days of HP and Xerox jointly announcing their alliance, we began to hear rumors that third-party supplies vendors would be adversely affected
  - Xerox previously purchased remanufactured and new-build cartridges from several North American vendors, including CIG, Katun, and LMI, but swiftly it cut its orders after inking the deal with HP
  - The difficulties at CIG and LMI noted earlier are a result of the deal
- We are wondering if the Ninestar-Konica Minolta deal will be similarly disruptive
  - Prior to the alliance, we had heard that Konica Minolta was pressuring Ninestar to stop marketing third-party cartridges and cartridge components for its consumables
    - We checked on the Ninestar site this week and no G&G-branded Konica Minolta compatibles were available
    - We are not sure about chip availability
  - So, as an act of reciprocity, will Konica Minolta shift from CIG to Ninestar for remanufactured cartridges?
- Lots of interesting questions remained to be answered
  - Going forward, will Ninestar woo other OEMs with the promise of not marketing compatible cartridges for their machines?
  - Perhaps more importantly, will the firm similarly leverage its chip assets to negotiate deals?

Who Will Be Next to Wed?

- As noted earlier, we don't expect any big OEM mergers in the near future
  - But who could have predicted that HP would buy Samsung's printer business?
    - And we discredited persistent rumors about Ninestar buying Lexmark!
- We do expect that the third-party supplies industry will continue to consolidate
  - Rumors have swirled that CIG has a new investor and the firm is looking to roll up the US industry
  - Likewise, other groups, such as Blackford Capital, have said they are looking for acquisitions
  - Right now it's a buyer's market, and we doubt any North American third-party supplies vendor looking to sell would strike a hard bargain
- Chinese companies will make more investments
  - Domestically, there are several large firms that would make good acquisition targets, including Aster Graphics, Orink, and Print-Rite, as well as others
    - Many companies have invested in the latest technologies and have strong international networks
  - Several firms have expressed interest in expanding into new regions through acquisitions
    - Dinglong was in a bidding war with Katun and lost—is it still looking?
    - CET acquired Q2—will it invest in something bigger?
    - Will a Chinese group be the one to roll up the western industry?

Key Takeaways

- This year has been tough for OEMs and third-party supplies vendors alike
- Conditions for remanufacturers in Europe and North America are dire
- The industry appears to have reached another inflection point
- Over the past five years, the pace of M&A activity has been frenetic
- The two most important mergers have been HP's acquisition of Samsung's printing business and Ninestar's Lexmark acquisition
- These two mergers already have shaken up the industry, and more change is coming
- HP will fundamentally change its business model and enter new markets
- Ninestar is emerging as China's hardcopy giant and its full potential has yet to be realized
- Although another OEM merger seems unlikely at the moment, further consolidation is a given on the supplies side of the industry

Questions?

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