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2009 International Mergers & Acquisitions
executing deals in the economic downturn



■ The continued wave of consumer products mergers in the post recession world

BY J. NEELY

The consumer products industry is not immune to the effects of the global recession, and is currently in retrenchment mode, like most sectors. Even industry bellweathers like P&G have experienced rapidly changing dynamics leading to declining volume and prices for the strongest of their global brands. Consumers have demonstrated unprecedented willingness to shift to value brands and retailers are reinforcing this through increased emphasis on private or store brands and aggressive management of the shelf. While consumer pocketbook strings may loosen once again as the economy picks up, many recent surveys of consumers indicate they intend to maintain this newfound penchant for thrift. This may be easier to sustain if the short term cutbacks in the personal budget that are translating to trial of less premium products, buying on deal or simply going without, lead to long term conversion for those who discover they are perfectly happy with their newfound substitutes. While the dynamics will differ for fashion intensive categories such as beauty versus functional active based categories such as OTC versus food or beverage, the current environment is causing even the most secure players to rethink every aspect of their value propositions, and quickly.

The global economic crisis has also dampened consumer product M&A activity substantially in the past 12 months, as with many sectors. The volatile capital markets have scuttled numerous potential deals due to lack of financing, disagreement over valuation and a renewed sense of conservatism. However, the same underlying drivers of significant M&A before the crash remain intact and perhaps even more pressing as potential outlets for increasing efficiency and effectiveness and combating recession driven industry dynamics. Thus, the net effect of the meltdown has every

chance of accelerating the consumer packaged goods (CPG) M&A agenda in the coming years. The implication for every industry player is to use this window to get ready for the next big rounds of portfolio reshuffles. The winners that will emerge may not necessarily be the absolute biggest, but they will have high levels of portfolio coherence based on differentiating capabilities and will be able to extend these across multiple markets.

Organising around capabilities

The CPG industry has gone through multiple waves of M&A, driven by quests for efficiency from size, geographic expansion, and most recently alignment of portfolios against advantage sustaining capabilities. While elements of each wave are ever present in the industry M&A agendas, the game changing plays have been around adjusting CPG portfolios to have greater coherence so that investments into a few key areas can drive results across the entire portfolio. Players such as Con Agra and Sara Lee have aggressively trimmed their portfolios, divesting categories such as apparel or commodities so investments in capabilities such as trade promotion or consumer insights have more relevance to the remainder. P&G got out of food and bolstered beauty with Wella to ensure its portfolio contained high growth businesses that could make the most of its global branding and innovation power. Small regional players such as Chattem have found ways to buy tail brands or positions in niche categories and manage these portfolios in a different way than they were in large CPG companies.

While not as simple as size or scope as a measure, the anecdotal and empirical evidence is clear: organising CPG around capabilities

to drive focus works. Historical analyses of CPG performance over five and 10 year horizons shows a clear positive correlation between operating margin and metrics of portfolio coherence (alignment to a few core capabilities). Anecdotal observations of standouts such as Wrigley, which built a premier position in gum and mints before being acquired by Mars, reinforce the empirical analysis. Wrigley established a ruthless focus on the gum and mint categories and built two standout capabilities to support this business. These included excellence at retail execution – at the front of the store – to ensure high visibility, little out of stock and good shelf management, coupled with powerful and rapid innovation which led to high margin creations such as blister pack gum and rapid and overwhelming competitive responses to threats such as Listerine Pocket Packs (Wrigley launched five flavours before Listerine got its second SKU on the shelf). The result was a company that grew at greater than twice the category rate over a sustained period, generated commensurate operating income growth and ultimately became a must have for Mars to build out its confectionary portfolio.

The challenge of defining a capability agenda is that on the surface, most sound similar. There is a set of usual suspects including consumer insights, innovation, trade promotion and supply chain that are repeatedly listed in CPG statements of capabilities, competencies or similar declarations. These are increasingly augmented with emerging themes including green, digital, and demographics. As with many things, the truth lies beneath the surface, and the winners understand at a deeper level how broad concepts such as innovation translate to their chosen space in terms of process, know how and systems. For example, is the innovation process tuned for rapid development cycles or measured clinical trials, are they a leader or a fast follower, what common platforms are they driving across categories?

As this portfolio alignment wave plays out, more generalised models, or ways to play, also appear to be emerging. Think of these as intersections of capabilities and categories that are highly synergistic. For example, clinically proven innovation, regulatory influence, claim development and Rx switch all play substantial roles in many key OTC categories. A robust DSD capability is essential for a number of fast moving, merchandising intensive food categories, and goes well with a rapid innovation for flavour news R&D model. As these natural capability/category clusters evolve, the driving force for M&A driven portfolio shuffles will increase. Internally, capabilities are shaping the definition of BU structures and the role of corporate. Externally they will play an increasingly important role in defining what is in and what is out for CPG portfolios.

Going global still critical – but where to go?

The drive to go global for growth is as pressing for CPG as it is for so many sectors. Reliance on North America or Europe alone is broadly a recipe for low single digit, GDP level growth. Given the

time it takes to organically enter and grow in an emerging market, M&A remains a critical lever for international expansion.

The BRIC countries are in the crosshairs for most major CPG companies. But just because growth is high doesn't mean success is easy in any of these countries. The market dynamics differ widely within each, as do local customs and tastes. For example, club store size packages do not work well in markets where consumers have to carry their goods home and may only have enough pocket change to purchase a single use versus a year's supply.

In addition, formidable local competition is growing rapidly in many markets. Consider China, where *Shan Zhai* companies (translates to businesses based on pirated or fake products) are rapidly evolving into more above board enterprises with true innovation capabilities, deep understanding of local consumer needs and leading market share. *Shan Zhai* product range is not just limited to knock-off cell phones or bootleg movie copies. Future Cola is now the third largest producer of carbonated beverages in China. It started by mimicking Coca-Cola's packaging and crafting a cola beverage that was more suited to local tastes. It grew its base in rural markets, began to add innovations such as nutritionals to its line up, and is now getting ready to go head to head with Coke and Pepsi in top tier markets. Multinationals have their sights set on finding local partners in emerging markets, but potential local partners are increasingly setting their sights on becoming market leaders themselves.

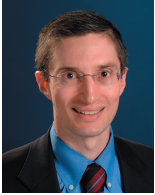
From an M&A perspective, these trends likely increase the urgency for developing and executing an emerging markets strategy. Finding the right partner and making the deal work remain as complex as ever.

Start your engines

So, while there has been a brief pause on big CPG M&A, do not expect it to last. Residual pressures from the recession, the drive to find scale by leveraging capabilities and the quest for global growth are going to continue to drive substantial portfolio rebalances. A few themes tied to these drivers are likely to continue playing out. These include: (i) continued separation of non-food and food businesses, and closer alignment of food sub-segments (e.g., DSD, chilled, frozen, fresh, etc.); (ii) sorting out of fashion intensive (e.g., beauty) from functional (e.g., household, OTC) categories; (iii) cutting the tail from large portfolios, or putting tail brands into a BU that is geared to managing them differently; and (iv) continued reach for geographic expansion, with significant emphasis on breaking the BRIC code.

The exact timing for the rebound in CPG M&A activity is not clear, but now is the time to get ready. The coming wave will really be just an amplified version of the changes that were underway before the recession started.

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J. Neely is a Partner with Booz & Company who specialized in planning and executing mergers and restructurings in consumer products and industrial sectors. He works with publicly traded and privately held corporations. Examples of his work include:

- Leading a merger planning program for two North American consumer products businesses, resulting in \$600 million in annual savings and a capability-building agenda that captured best practices from both companies
- Planning two mergers, three divestitures and a spin-out for a consumer healthcare business, resulting in \$200 million in synergies and \$70 million in stranded cost reductions
- Leading a global merger of two agricultural businesses, resulting in \$130 million in synergies, avoidance of bankruptcy, refinancing of the new company, and a strategy to take on more value added work and provide solution based services
- Developing a turnaround strategy for a polymers business facing a down cycle and demand shifts to international markets
- Leading a three-way, private equity based merger of bath and kitchen products companies

Dr. Neely has published numerous articles on merger and industry-related topics, including "Nine Steps to Prevent Merger Failure" (Harvard Business School Working Knowledge), "The Core's Competence: The Case for Recentralization in Consumer Products Companies" (strategy+business), "Seven Reasons Divestitures are Harder than You Think" (Chief Executive Magazine), and "Consumer Products Companies are Consolidating Again – Aren't They?" (GMA Forum).

Dr. Neely was previously at IBIS Associates, where he consulted on advanced materials technology commercialization. He also helped start a contract R&D firm, and was a researcher in M.I.T.'s International Motor Vehicle Program.

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This article first appeared in FinancierWorldwide's *International Mergers & Acquisitions 2009 Ebook*.
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