How Market Assessment Drives Successful Acquisitions

Let's agree right up front that a successful acquisition effort relies on in-depth assessment. Most acquisition teams are loaded with financial analysts, CPAs and operations experts. And the due diligence process is excruciating. But our contention is that all that analysis can do is DIS-qualify unhealthy candidates – it can't predict success. Predicting success is predicated on a thorough strategic market assessment. That market assessment must address two key questions:

1. What is the market potential / sustainability of the business acquired in the future?
2. Does the target company "fit" with both the acquirer's business model and with the intended strategy for the acquisition?

CPG companies have become dependent on acquisitions for growth. According to Price Waterhouse Cooper, CPG companies racked up $91B in acquisitions in 2013. Compare that to only $55B for internet/software companies and the impact of acquisitions on our industry is crystal clear.

The objective of an acquisition is almost always to be accretive – usually in top line sales, certainly in EBITDA and most often in both. The rare exceptions usually focus on some sort of defensive competitive objective.

Some acquisitions are successful in achieving this objective while other, seemingly similar, acquisitions are not. In the beer business, AB/Inbev is heralded as a success, harnessing multiple global and regional brands together. But the Australian backed attempt to use G. Heileman to do the same with venerable regional breweries such as Stroh's and Pabst has faded. The Kroger acquisition of Harris Teeter is lauded as the Haggen/Albertson's deal heads to bankruptcy. Even two longtime adversaries like General Mills and Pillsbury managed to survive the integration process – while a seeming slam dunk fit of the Ralcorp private label business into ConAgra has since been regurgitated.

How does that happen?

Buying organic growth, buying scale or buying EBITDA are all common strategies for acquisitions. Each of those strategies looks quite different and has its own requirements for success.

- Buy Organic Growth
  - The strategy is to purchase innovation. It requires investment in R&D, distribution and branding if the innovation acquired is to realize its market potential. The key question is "what is that market potential and how sustainable is it given a range of possible competitive scenarios?"
  - Recent CPG examples in this category include Coca Cola's purchase of Glaceau (vitamin waters) or their investment in Keurig (in-home soda dispensing) or Monster Beverages (energy drinks).

- Buy Scale
  - The strategy is to purchase new geography or market share. Successful implementation requires wringing synergies out of SG&A, sales and distribution to fund either EBITDA or growth. Key questions here include "how much of the acquired business will be incremental versus cannibalization?" and "how will the customer base react to this consolidation of power from its supplier(s)?"
  - Recent CPG examples in this category might include Snyder's/ Lance (followed by Kettle Chips); Kellogg/Pringles and, most recently, JAB Holdings / Keurig Green Mountain.

- Buy EBITDA
  - The strategy is to purchase sustainable brand equity coupled with bloated cost structure. Then strip out costs and leverage residual brand equity to rapidly grow EBITDA. The key marketplace question for this strategy is "how much of the business is sustainable under our planned scenario for efficiency? And for how long?"

- A recent CPG example of this strategy is the Kraft Grocery / Heinz roll-up and merger under 3G Capital and Berkshire Hathaway.

- Some combination of the above
  - In rare cases one acquisition target may provide multiple opportunities. The example of Pinnacle Brands purchase of Boulder Brands may be such a case. The stated strategy of the acquisition is to acquire innovation in the form of Boulder Brand's gluten free products. But Boulder also brings stable brands, such as Smart Balance, which can easily be leveraged by Pinnacle's existing systems. Thus, providing an EBITDA "safety net" to the acquisition should the gluten free trend prove shorter lived than expected.

What determines success?

Simply running the financials and determining that "the numbers work" is not enough to ensure success. No matter how good the multiples for the deal look in the investment banker's spreadsheets, management – and in particular Sales, Marketing and Operations management -- still has to make the deal work.

Of course, in addition to the need for meeting marketplace and operational goals, there are multiple financial and cultural factors that can sink a given acquisition. In particular, if the acquisition contemplates retention and integration of some or all of the acquisition target's team, remembering Jack Welch's admonition that mergers are 10% strategy and 90% culture is imperative. Often factors like these are hard to assess until the acquisition is made.

But DHC believes there are two steps companies can and should take prior to an acquisition that are entirely within management's control. The first is to specify the strategy the acquisition is intended to fulfill. The second is to carefully assess whether the candidate has the market potential to successfully fulfill that strategy. This will include assessing the competitive, retail and consumer strength (or potential) and liabilities of the brand(s) involved.

So, how do I go about such an assessment?

Step 1 Identify the intended strategy for the acquisition target.

"Ok, that sounds simple enough. We want all of the above."

Sounds great – and your acquisition assessment team can probably gin up at least one or two scenarios where at least two of the three strategies defined above can be realized – say, buying scale and buying EBITDA. All you have to do is buy that competitive cereal brand, add it to your existing sales team's bag and roll the production into your current facilities. Voila! You have new volume and at a higher operating margin to boot.

But it doesn't often work out that way. Packing another brand into your sales team's time with the cereal buyer means less attention to something else. Even though retailers happily carried both Cranberry Bran and Raspberry Bran when they were from competing suppliers, will they continue to do so when they lose the incremental leverage of having one supplier to play against the other? How many duplicative skus are likely to lose distribution? Will your account executive be able to get twice as many promotion slots as before now that he/she has both brands? What will that do to volume of the combined brands?

When the new line is introduced into your plant, will unique equipment have to come with it? At a bare minimum there will be increased changeover costs as the line switches from one brand to the other. And if the formulas are even slightly different (which presumably they are) costly downtime for cleanout at each changeover can wreck operating efficiency. Add in additional inventory carrying costs as safety stocks are increased to reduce those changeovers. Perhaps outside warehousing expense. It doesn't take long to see those margin increases eaten away by unforeseen costs.

Specifying one strategy and then evaluating the target under that scenario is the first key to avoiding acquisition disaster.

Step 2 Perform the strategic market assessment.

Let's state the obvious first; each of the three major strategies – and, indeed each acquisition target evaluated under any of the strategies – will require an assessment approach tailored to that situation. That stipulated, there are some general areas of assessment and some accompanying methodologies that we can discuss.

Let's use acquisitions targeting organic growth as an example.

The key focus here has to be consumer interest in the concept and their satisfaction with the delivery of that concept by the target's product or service. Start with the generic size of the market for an idea – how many people are interested in collapsible footballs? How important is the benefit of being able to deflate the ball for storage? How big a trade-off is that with having to buy and store the device that re-inflates it every time you want to play catch with the kids? What would people pay for that?

Answering these questions falls to some form of appropriate consumer research. Picking the right methodology(s) to deliver management decision quality findings at the most efficient cost requires experience and judgement that the typical research firm may not have. DHC has been through this process multiple times in a variety of industries. We know what questions to ask and how to ask them.

The competitive environment comes next. How many other companies have a similar product that meets the same need? How wide is the development moat around the product you are considering buying? Can someone duplicate it easily? If you are considering acquiring Bear Bryant's Collapsible Football Company, how much value is there in the Bear Bryant name with likely buyers? How would they react if the Rawlings Football Company introduced a similar product at the same or lower pricing?

Some elements of competitive assessment are readily attainable. Sales and distribution of existing competitive products can be as close as your syndicated data supplier. But other situations are not so easy. Helping a client determine the likely competitive set requires appropriately defining the "need" being met. For example, convenient access to DVDs at a low out of pocket cost was the physical benefit for one client DHC helped. But we determined that convenient access to entertainment programming was the real market. And suddenly the competitive environment to be assessed went from "Blockbuster" to Video on Demand (streaming) and Pay per View – quite a different analysis.

The customer environment is also critical. How are retailers reacting to the idea? Is this an incremental purchase for them, or is the collapsible football more likely to replace the purchase of a regular football? Is this a trade-up in retail sales dollars or margin for them if it is a replacement item? Which channels are most likely to carry the item and what is their current strategy for the category?

Relying on your existing sales team (if the acquisition target is in the same industry) or on the current distribution team for the target product(s) is generally a poor source of this information. Aside from the different biases that can be involved (and there are many) customers may simply not want to answer questions posed by an existing supplier about another product or company. If a third party distributor is involved, they may not have the time or inclination to carry out this kind of customer research, even if they are told who and what to ask.

This problem quickly escalates in severity when non-standard businesses are involved. In one assessment DHC helped a potential acquirer evaluate the market potential of skill games in the restaurant, bar, convenience, food and mass merchandiser outlets. Simply identifying the outlets and finding credible contacts was a large and labor-intensive undertaking.

But the key value DHC was able to deliver was to uncover a potentially fatal flaw in the acquisition planning assumptions of our client. The target company was trying to achieve a valuation based on the revenue stream of current locations plus expansion potential. What we found in our work with customers was that the key issue our client would face was current placement retention. Many retail customers were considering removing equipment due to the perception that having skill games present in their lobbies hurt their image. Others felt the space could be put to better use in related vending such as snacks and beverages. Rather than valuing the business on growth, we identified the likelihood of decay. By conservatively estimating a range of potential decay rates, we helped our client complete the acquisition at a valuation that allowed them to meet internal hurdle rates for capital allocation and that continues to provide a positive return.

Acquisitions always carry risk. Adding an insightful market assessment to your due diligence will greatly reduce that risk. If you would like to discuss how DHC might enhance your own acquisition process, please contact us at: (949) 429-1999.