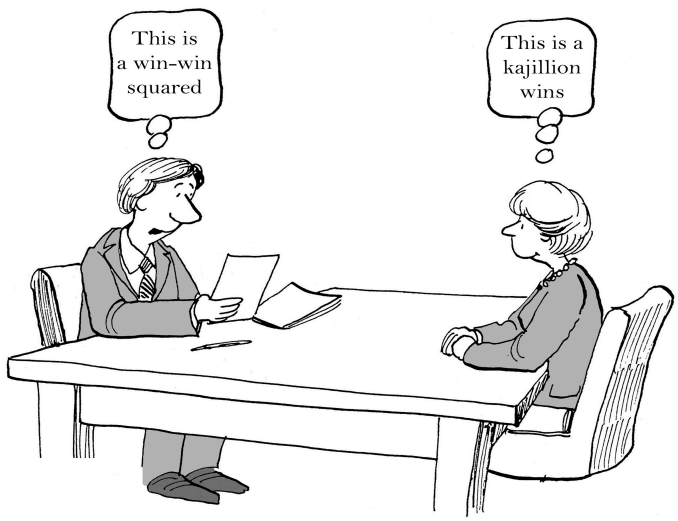
How Strategic is Your Deal?

Moving beyond cost synergies to create real value



"The agreement documents all look in order."

The equity markets place a high value on steady, above average, growth. Slowing demand in China, the collapse of oil prices and reverberations of these new realities around the global economy have made organic growth hard to come by in developed economies. As a result, companies are looking for ways to return to historically normal growth rates, and more and more of them are turning to M&A to provide the difference. At the same time, current valuations for many target companies are at historic highs, increasing the risks that acquirers will not earn an economic return on their M&A investments.

In the past few months, we have seen a number of strategic acquisitions with eye-popping purchase premiums or EBITDA multiples, or both. A recent, fairly typical, example is the report of the Valspar acquisition by Sherwin-Williams in March. SHW is paying $11.3 billion in cash for

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Assess Your Deal's Strategic Fit

It's not difficult to distinguish an apparently good "fit" between two companies and a truly strategic combination. The "Good Fit" examples rely on intuition about their potential and skip over essential details of how they will actually create a better business. The strategic fit examples, by contrast, provide detailed links between customer behavior and the economic benefit that is possible. Because behaviors and benefits are tightly linked, these examples point more precisely to "what must be true" for them to be operative, and ultimately to the steps required to achieve them.

Here's a guide:

"Good Fit" Examples	Strategic Fit Examples
Adjacencies: • Extends our core product line to cover more use cases • Opens up new geographies • Adds an upmarket (or mass market) capability Vertical integration: • Moves us downstream into… • Moves us upstream into… • Scale benefits Leveraging scale: • Greater purchase discounts from common suppliers • Reducing supplier count and concentrating sourcing in remaining suppliers • Target company suppliers create sourcing flexibility Cultural affinity • Similar values	Volume growth: • Customers needing both companies' products buy more of each when they can get them from the same source • Customers currently buying one company's product range from a competitor prefer the convenience of one-stop shopping • Higher retailer inventory turns with combined product line generates higher GMROII and greater retailer loyalty • Smaller competitors squeezed out of some channels Margin growth: • Combined warehousing, orders, shipments, billing and collection reduce cost of sales • Reduced number of combined total outlets concentrates revenue in the best while reducing some direct selling costs

Valspar, a 16x EBITDA multiple on announcement date. The $9.3 billion equity portion represented a 41% premium over the prior 30-day average stock price.

The strategic objectives were reported in the New York Times:

> "Combining with Valspar would bolster Sherwin-Williams's presence outside the United States and Canada. And it would add new product lines for Sherwin-Williams, such as coatings for food and industrial coils. 'We believe it expands and extends our capabilities into new geographies,' John G. Morikis, Sherwin-Williams's chief executive, said of the deal in an interview on Sunday. 'This is something we've looked for and believed would make a good fit for many years.'" Sherwin-Williams said it also expected the deal to yield $280- $320 million in annual cost savings within about four years."

Sherwin-Williams has an opportunity to make this a great combination. If the targeted cost synergies could be realized without damaging the ongoing business, the $2.4 billion acquisition premium would be covered by the cost savings, assuming they are captured and capitalized at 10x. About half of these savings - those related to supply chain costs and logistics - are actually strategic, but to the degree that they are required to compensate for a high purchase premium, they do not add true value to the acquirer. The company will need to generate even more value from the transaction to justify the leadership distraction, $200+ million of integration expense, financial leveraging, and cultural assimilation risks it is taking on.

Improved strategic positioning makes the deal pay off

In acquisitions such as this, the key to creating this additional value lies in improving the combined company's strategic positioning. Several of the keys to this opportunity, alluded to in Sherwin-Williams' statements, include:

- Ensuring that contractors and consumer channel partners in North America see the deal as providing benefits they want and value, generating an increase in market share (beyond pro-forma) for the combined company.
- Cross-selling Valspar's unique products to existing Sherwin-Williams industrial customers who had been buying these lines from a competitor.
- Building on Sherwin-Williams and Valspar combined sales in Asia-Pacific and EMEA based on the availability, product mix or convenience of the combined company's enhanced presence.

Each of these requires more than sales team hustle. The new team will need to take tangible steps to improve the value proposition for customers and capitalize on these and other growth opportunities in the months and years ahead. They will have to create aggressive operational goals linked to these potential improvements in their strategic positioning. And they will have to execute against these goals with at least as much urgency and discipline as they do with the cost synergy goals.

Deals that generate strategic benefits transform the acquiring company. This potential often cannot be achieved without disrupting the acquirer's own business model, organization structure, management systems and, occasionally, their culture. Disrupting one's own successful business model isn't easy, and many leaders resist it, missing out on the strategic opportunity.

So, what is strategic about your next deal?

Will your next deal really be strategic? Will you seek to change the basis of competition in ways that matter to customers and drive significant incremental growth? Or will it be a combination designed primarily to stay ahead

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of competitors in size, at a price that offers some accretion to earnings?

While it is easy to appreciate product line and market extensions and the potential "fit," like pieces of a puzzle, meaningful shifts are needed to achieve an improved strategic position through M&A. Answers to questions such as these can point the way to strategic repositioning:

- Can we create a tangible advantage that isn't available to either of us as independent companies? What must be true to make this possible?
- Are we planning to materially change some aspects of our business model with this acquisition? What changes are we targeting?
- What do we know about customer behavior that allows us to forecast incremental sales growth by making these changes?
- What investments in people and resources must we make to seize these advantages? What is the balance in year one between resources devoted to cost synergy capture and resources devoted to growth opportunities?
- Challenging and productive operational improvements usually require cross functional collaboration. Do we have agreement by leaders from across the business to specific objectives that represent their part of the transition?

Both Sherman-Williams and Valspar have a history of growing by acquisition, so the levers of successful integration ought to be known by them. What improvement in their strategic positioning will the new Sherwin-Williams team achieve? We'll have to stay tuned to find out!

John Pancoast

Who We Are

Acquisition Solutions is a partnership of professionals who are skilled at the art and science of post-merger integration. Building on many years of corporate transformation consulting, we focus on establishing acquisition integration excellence for strategic buyers of middle market companies. Please visit our web site for more information.

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