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OPPORTUNITIES

in

INDUSTRY CONSOLIDATION

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The Tullius Company, Inc.

As the saying goes, the only constant in our world is change itself. With consolidation so prevalent in today's business environment, many industries have been witness to remarkable change. The bottled water industry has been no exception. With rampant merger and acquisition activity, the industry has welcomed new entrants, seen others merge and even said good-bye to familiar players. But as the industry continues to consolidate, what is in store for those currently competing in the industry? Furthermore, how can those players make consolidation an opportunity that can be taken advantage of?

At last year's IBWA convention in New Orleans, my company had the pleasure of hosting a seminar regarding mergers and acquisitions and the consolidation of the bottled water industry. Among the topics discussed were how all industry companies, small, medium and large, can turn the industry's consolidation into an opportunity. It seems that so many of us equate the consolidation of an industry with larger companies gaining power at the expense of smaller ones. This does not have to be, and is certainly not always the case. Our seminar's purpose was to inform attendees of options that can be available to all types of companies in the midst of a consolidating environment.

To understand how consolidation provides opportunities for different types of industry competitors, it is important to know what factors lead to an industry's consolidation. Generally, consolidation is a function of where an industry is in its life cycle. Industries that are in their infancy are often characterized by high market fragmentation—many small to mid-size companies competing for market share, none of which controls a significant piece of the market. Whether understood or not, these companies, if successful, will validate the viability of the industry, and thus carry the industry into further stages of its life. By doing so successfully, these companies will trigger, among others, two particular effects. First, in many cases these companies will not be adequately capitalized to service the growth that results from their industry's success. Second, and somewhat as a result of the first, other larger and better capitalized companies will seek to enter the industry. This is where consolida-

tion can begin to take place. In an effort to compete more effectively, industry competitors may look to partner resources or merge with one another. Additionally, new entrants will often discover that it is more cost-effective to enter the industry through the acquisition of an existing company, rather than from scratch. These effects generally lead to the first phase of an industry's consolidation.

As an industry continues to mature, consolidation can take on added dimensions. Companies that are well capitalized will often seek to improve their market positions. One way to do this is to acquire companies that can help generate increased market share, and thus a better market position. Additionally, in an effort to strengthen earnings, companies may look to make acquisitions that will provide economies of scale and economic synergies that can yield higher earnings.

So, in addition to the above references, how can consolidation provide opportunities for all types and sizes of bottlers? One phenomenon that is often synonymous with consolidation is the large movement of capital into and within an industry. Whether this capital comes from institutional lenders, private equity funds or any other type of capital source, consolidation is typically the result of the deployment of major sums of capital into an industry. This in itself, provides flexibility and opportunity for the industry's competitors. This flexibility is in large part what creates the many options available to an industry's participants.

Opting for Internal Growth

One option that seems to be the most synonymous with consolidation is the sale of the company. But first, what about those who, for whatever reason, do not want to sell? How can consolidation play a positive role in their long-term strategic planning process? At our conference in New Orleans, we talked about opportunities for companies to access capital and grow. We referenced, in particular, two types of growth: internal or organic growth and growth through acquisition. As an industry becomes more viable and progresses through a consolidation movement, companies of all types and sizes become the beneficiaries of better access to capital. For those companies that either lack the infrastructure to service acquisitions or are not presented with any viable acquisition targets, an internal growth strategy can provide an attractive vehicle for growth. Like with any strategic decision however, the importance of appropriate planning is vital.

Prior to seeking growth capital, there are a number of questions that need to be addressed. How will the company grow? Will the company penetrate into new markets with the same product/service, or will the company expand its presence in existing markets with

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new products/services? On the other hand, will the company simply attempt to gain market share in its existing market with its existing products/services? How much capital will be needed to execute the plan, and when will the capital be needed? Is the management team and staff in place to service the anticipated growth? If not, where and how will this resource be secured? Together, the answers to each of these questions can make or break a

company's strategic growth plan. Furthermore, all of these questions should be carefully and thoughtfully answered prior to sourcing capital.

Developing an Exit Strategy

Additionally, at our merger and acquisition advisory services company we attempt to emphasize to companies the importance of developing an exit strategy, so that strategic decisions made in the interim can be compatible, thus adding value to the exit strategy. Therefore, when considering the answers to some of the questions above, it makes sense to think about how those answers and plans might affect the ultimate exit plan. For example, in the direct delivery (home and office) bottled water business, profitability is largely a function of route density. Because companies making acquisitions often lean heavily on the target company's earnings when valuing the business, companies with strong route density often generate better pricing, terms and conditions. As a result, when developing an exit strategy consisting of cooler placement growth, management would be well served to penetrate markets that can either increase its route density or provide the demographics needed to eventually achieve a stronger density.

Matching the Cultures

Another strategic option that can produce quicker and more rapid growth is one designed around making acquisitions. With an acquisition plan, many of the same questions listed above need to be addressed prior to pursuing acquisition targets. A major difference, however, is that depending on the size and motive for making the acquisition, two entire companies will be blended together. With these companies come their respective cultures, essentially dictating the way they do business. What this really means is that regardless of how perfect an acquisition might appear to be on paper, if the personalities of the two companies are not compatible, the results of the acquisition will likely be unfavorable. Therefore, it is imperative that during the due diligence phase, prior to completing the transaction, the respective management teams determine what philosophy is going to drive the business forward.

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As with internal growth strategies, it is important to develop acquisition parameters that provide the company with the greatest opportunity to add value to an exit strategy. For example, many companies in the direct delivery business rent coolers rather than sell them to the bulk of their customer base. There are certain market regions, however, that for a variety of reasons have among their characteristics a large percentage of customers who own their coolers. When pursuing acquisitions, a company that considers renting coolers to be an important component of its business should be very cautious prior to making an acquisition of a company that sells coolers to most of its customers. Unless management has identified a very compelling reason to make the acquisition, it would appear on the surface to be a transaction that may not provide appropriate benefits to long-term value. While nobody can accurately predict the future, by using good business sense, acquisition growth can handsomely enhance a company's exit.

Selling and Staying On

One of the most talked about phenomena relating to consolidation is the opportunity that it provides for companies of all sizes to take advantage of attractive exit or sale conditions. While these conditions are often measured in economic terms, there are certainly other benefits. For example, through our experiences working in consolidating industries, we have worked with a number of clients who were simply not ready to leave their business. At the same time, however, they understood that partially as a result of consolidation, the value of their business arguably was as high as it had ever been. Because of the relatively high demand for good acquisitions and the premium placed on strong, seasoned management, opportunities are often available that can accomplish multiple goals. In the case of someone who believes it might be, economically speaking, a good time to entertain an exit but is interested in continuing to actively manage the business, there is very possibly an opportunity available that can satisfy both of these objectives.

Additionally, for those companies that are undercapitalized, and thus are unable themselves to take advantage of attractive market demographics, a sale may represent a viable alternative to stagnant growth. And again, a sale, particularly in a consolidating environment, does not have to mean the departure of management. In fact, most acquirers, large and small, will tell you that amongst their acquisition parameters is the need for strong management and staff. On that note, a sale in this type of environment often times provides a company's personnel, especially key employees, the opportunity of a lifetime.

Things to Ponder when Planning to Sell

But just as with planning for growth, be it internal or by acquisition, it is imperative to plan for a sale. I harken

back to the development of an exit strategy. Whether you think you might be considering a sale this year, a few years from now or further into the future, a detailed exit plan will make for a more attractive transition. Among the questions to consider when preparing this plan are: What factors will trigger the execution of a potential exit? Depending on when the plan is executed, will ownership want to remain with the acquiring company? If not, how can an appropriate management team be groomed to steer the company in the right direction? As with the questions that should be answered prior to implementing growth strategies, the answers to these questions will most likely have an impact on value.

In conclusion, there is no one universal option that provides the answer for every company. Rather, taking into consideration a specific company's circumstances, one or several of these alternatives can provide positive results over time. Just remember, before embarking down a strategic path, know why it is that you have chosen that path. Be sure that it provides you the best opportunity to satisfy your long-term goals. In other words, manage your business with a method to your madness!

The Tullius Company, based in Portland, OR, specializes in providing merger and acquisition/financing services to companies in the bottled water industry. The company can be reached at 503-236-9955.



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