BOTTLED WATER

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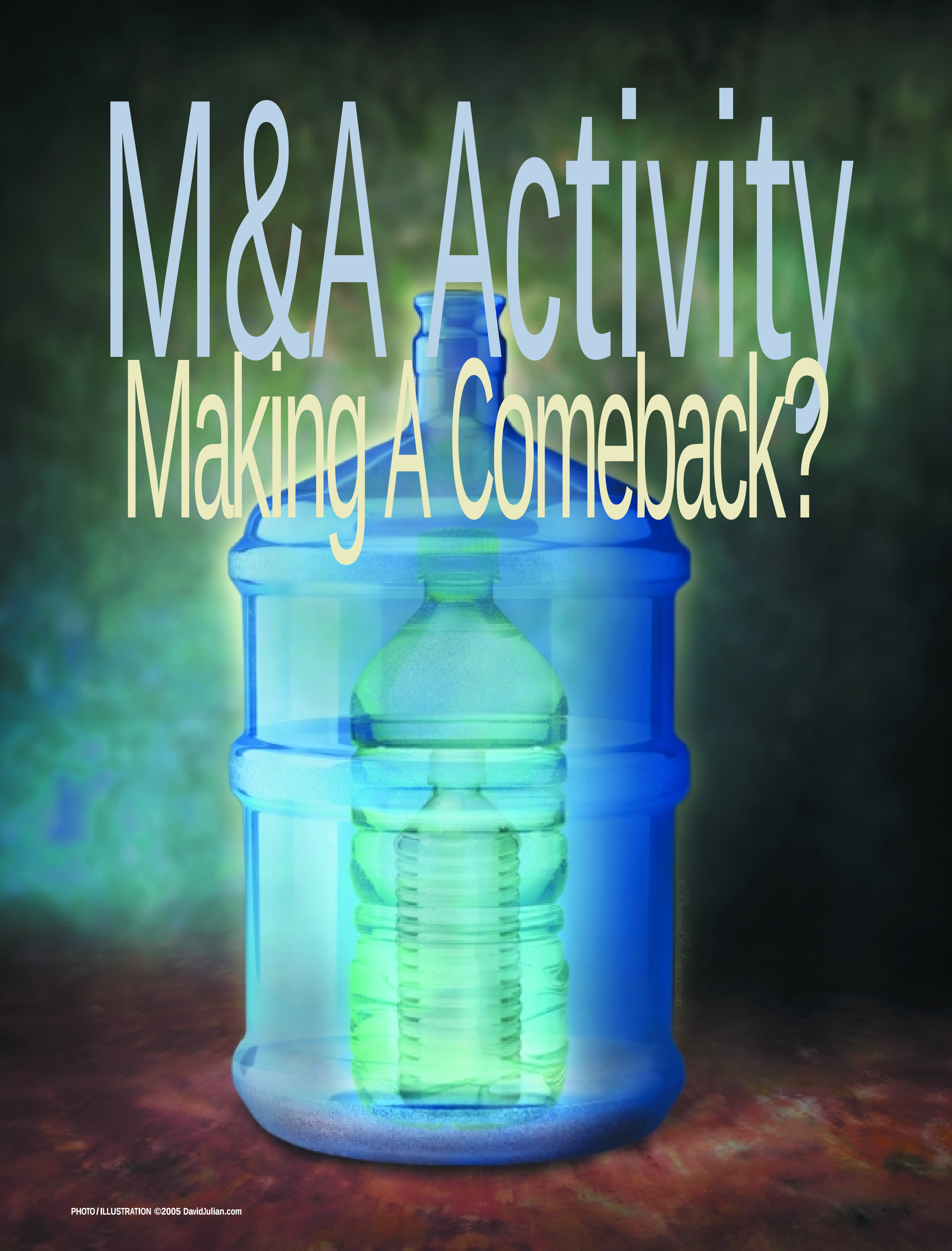
M&A Activity Making A Comeback?



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After the wild ride of the late '90s, merger and acquisition activity came to a virtual standstill in the bottled water market. But toward the end of 2003 and on into 2004 things began to change, with renewed prospects and a higher level of optimism.

By Lance R. Tullius, The Tullius Company, Inc.

What a wild ride the markets have seen dating back to the late 1990s. In January 2000, for instance, the Dow Jones Industrial Average (DJIA) hit an all time high, closing at 11,723. Mergers and acquisitions were being done at a frantic pace in virtually all industries, particularly within the high-tech sectors. Pricing multiples and company valuations were unbelievably high, supposedly justified by aggressive and bullish projections of market trends. There seemed to be no end in sight to the market's growth. Then in the spring of that same year, 2000, the market fell to below 9,800 in a span of less than two months. While concern began to settle in, mergers and acquisitions continued at still relatively high valuations. By May 2001 the market had recovered most of the decline it experienced from January through March of 2000, leading to even further false confidence that the market could sustain a significant dip and still not miss a beat.

Following 9/11, on September 17, 2001, the market witnessed its biggest one day dollar loss, placing it at 8,900, and it continued to fall from there to a low of 7,300 in October 2002. Merger and acquisition activity came to a standstill as a result of the circumstances this created. Companies and their executives began "running scared," bracing for the effects of this sustained market decline. Instead of huge appetites for growth, companies began laying off employees at never before seen levels. And that was those companies that stayed alive. Many businesses simply couldn't survive the fallout.

For nearly 18 months, companies that had been aggressive acquirers remained relatively quiet. But, as it turned out, we eventually would discover that the markets had bottomed out, and the climb upward began slowly but steadily to where we are today. And while it's taken time to regain the confidence of investors, both individuals and businesses, we can now say that during the past 12 months, we've seen a resurgence in the markets and corresponding activity.

Past Bottled Water Deals

This general scenario has played out its own life within the bottled water industry. In the late '90s and early 2000s, consolidation was the buzzword in the bottled water business. The busiest acquirers during this time were Perrier (now Nestlé), and the companies that are now known as DS Waters and Danone.

Some of the notable acquisitions these entities made included Sparkling Springs' acquisition of Canada Springs in British Columbia, McKesson's purchases of both Ephrata Diamond and Keystone in Pennsylvania, and Perrier's deals to acquire Black Mountain in California and Aqua Cool in the Northeastern U.S. and Europe. Since these deals, McKesson and Suntory have, through a series of moves, effectively come together as DS Waters, while Sparkling Springs was acquired by Group Danone. So considering that DS Waters and Nestlé are presently not acquisitive, none of the four most active industry acquirers of five years ago is even pursuing acquisitions today. As a result, for most of 2002 and 2003 the bottled water industry saw virtually no M&A action. But towards the end of 2003 and on into 2004 things began to change, with renewed prospects and a higher level of optimism.

Less Money for Acquisitions

As the DJIA began to rise out of its trough in 2003, several interesting and favorable developments occurred, some as a result of the market's

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rise and some that likely had an impact in spurring that rise. First, even amidst the market drop, interest rates remained relatively low. However, one of the first things to occur in the business lending environment as a result of the market's fall was a reduction in advance rates for acquisition financing. Whereas lenders once were advancing the equivalent of 4 to 5 times a company's cash flow or EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization), almost overnight these rates dropped to generally between 2 and 3.

Without the ability to apply as much leverage on transactions, and thus the need to capitalize deals with more equity, company valuations and pricing multiples that had been commonplace for several years simply could not be justified in this new environment. Correspondingly, one of the first things to pick up as the market began to rise again was these advance rates. Compounding this has been an increased focus by a number of lending institutions on the bottled water space. The result has been a lending environment that is quite favorable at present and has led to rising company valuations versus the low point of a few years ago.

Private Equity Groups Emerge

Also coinciding with these lending developments has been the increased appeal and exposure of the bottled water industry to other investor types, most notably private equity groups. Even considering the fluctuations in company valuations over recent years, the fundamentals of the bottled water category remain attractive. The category has demonstrated good growth, remains quite profitable in certain sectors and still holds opportunity for further consolidation. These "new" investors have taken notice and in many cases have acted on their position that the bottled water industry represents an attractive investment opportunity.

Two of the more significant examples of this were the recent acquisitions of Culligan International and Deep Rock Water Company. Culligan was acquired by Clayton, Dubilier & Rice, a private equity firm presently managing an active fund of roughly $3.5 billion. Deep Rock was acquired by private equity groups Norwest Equity Partners, headquartered in Minneapolis, and M2P Capital, based in Denver. In each of these cases, the acquiring private equity firms will use these industry businesses as platforms for what they hope will be substantial growth, much of which is anticipated to come via acquisition. While these groups represent three of the several that have actually invested in the industry, many more have put the space on their radar and it is likely that we will see more new entrants in 2005.

A More Consolidated Industry

So in the midst of these trends and the activity they've helped create, the speculation is that we'll see more of the same in 2005, which means a good opportunity for independent bottled water companies to capitalize on. But how long might we expect this opportunity to last? What can we anticipate to take place in the industry in the longer term, perhaps the next five years or more?

While it's true that the bottled water industry is still quite fragmented, it has a much different look than it did 10 years ago. Mostly because of the significant merger and acquisition activity that has taken place in the business, the industry is much more consolidated today than it was a decade ago. And with this new phase of activity, it's sure to be further consolidated over the course of the next decade. This means fewer companies and fewer opportunities for new entrants to come in and attempt to execute a consolidation strategy. For most companies, the valuations applied to industry businesses in the late '90s and early '00s will not be seen again. The factors that drove those valuations simply won't be present as the industry matures.

And how about the industry's major players, those that either directly or indirectly led and sustained the rampant consolidation of just a few years ago? While these groups, most notably Nestlé and DS Waters, have not made a significant U.S. acquisition in some time, it's likely they'll make selective acquisitions in the future. However, you can be sure that at least in the U.S. market, we won't again see them as active as they once were. Given the business they've already amalgamated, the motivation won't be there for them to pursue that level of acquisition activity. This will have the greatest impact on the smaller independent companies, many of which were able to field valuations of 2 to 2 1/2 times annual revenues during that last consolidation. With the existing landscape, we're already seeing these businesses trade for one times revenues, and sometimes lower. In those instances where the majors do acquire, it will be the larger and in many cases multiple market independents that benefit most by being strategically positioned and of good scale to motivate a major to pay an aggressive premium. Yes, there will be exceptions, but this will be the rule.

Conclusion

So the moral of the story, I suppose, is that like any other sector, the bottled water industry will continue to evolve, and with that evolution some will fare better than others. The ones that come out ahead will be those that confront reality and subsequently position themselves so that they can take advantage of that reality. For different companies that will mean different things. Some will say they need to accelerate their growth and attempt to get in on making acquisitions, while others might come to the conclusion that the time is right to take advantage of an opportunity to sell their business. Whatever your conclusion might be, don't sit still and wait for something to happen to you. For despite the size, history and current position of your business, you *can* effect your destiny!

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