The Indian consumer sector

What's the deal?

A significant portion of deals fail in the due diligence phase, largely due to misalignment around valuation expectations and businesses not being prepared for a transaction. In our experience between 50-60%[1] of deals that go into due diligence in emerging markets fail to complete. To ensure that more deals are converted, preparation is seen as a vital stage in the deal making process. Corporates (whether they are buyers or vendors) are recognising the need to invest time preparing for a deal, prior to approaching the market.

In this paper we focus on the some of the areas corporates in the consumer sector need to consider when preparing for a domestic or overseas acquisition. We also highlight the areas that shareholders and management teams must look at when preparing for an equity divestment or raising funds.

1. PwC, 'Leveling the playing field: avoiding the pitfalls of the past when doing deals in emerging markets' (2012)

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1. The M&A landscape

India's fast moving consumer goods (FMCG) sector witnessed considerable deal activity over the last few years, through a combination of private equity, domestic and cross-border mergers and acquisitions. Interest in the sector stems from several factors such as, rising incomes allowing for more discretionary products, growing consumer aspirations to experiment between products, product categories and brands, up-trading in some categories (e.g. skincare), entry of new brands etc. Also working in India's favour is the overall consumption forecast for the country and the FMCG segment being relatively unrestricted from an FDI perspective. Financial investors and corporates have been capitalising on these favourable market dynamics, year after year. Deals have occurred across a range of FMCG segments, particularly food and beverage, personal care and household products. Acquirers are looking to buy brands in under-penetrated categories that have a high growth potential and in markets that have not seen high levels of competition. Recent examples of international players entering the Indian market include multi-nationals such as General Mills and McCormick buying businesses in the food space.

Indian players are also venturing outside the country. Notable examples include Godrej in the personal care and household products segment. The company has made acquisitions in South East Asia, Africa and South America (part of its 3x3 strategy to be a leader in home care, personal care and insecticides in Asia, Africa and South America). Similarly, both Wipro and VLCC recently announced acquisitions in South-East Asia; LD Waxson and Wyann International respectively.

2. Key areas to consider when preparing for an acquisition

Corporate strategy: Corporates need to ensure that the key objectives for an acquisition are defined - geography, product, size, structure, etc. All these areas need to be well thought through before the companies commit to any specific process, let along engage with a potential target.

Target market: A thorough understanding of the local environment needs to be conducted, such as studying the size of the addressable market, consumer tastes and preferences, sales channels and environment. A notable number of deals perform below expectations due to buyers not understanding the local market and therefore not handling a business in the correct manner post acquisition.

Funding ability: Based on expected deal size, buyers need to have a strong understanding regarding how they propose financing any deal. Demonstrating a ready ability to fund an acquisition will add significant credibility in the minds of vendors, and it may also be factored into pricing. Funding may be available through several avenues (e.g. internal accruals, equity, debt) and should be considered much before approaching prospective acquisition targets.

Valuation discrepancies: Views on value need to be clear internally, but stakeholders must also mindful of the local operating environment that they are seeking to buy into. With a significant number of deals breaking down due to perceived value differences, acquirers need to have a well thought out strategy. While price may play a key factor in a vendor's final decision to sell, acquirers need to consider and 'push' other areas of value that they bring to the table as a buyer - e.g. R&D capabilities, procurement synergies etc.

Cultural differences: Indian acquirers need to be aware of differences in the cultural nuances of other firms (especially overseas), their shareholders and particularly their employees. Being able to appreciate the differences in culture, religion, language, taste will go a long way in achieving a successful result.

Identify the decision maker: While corporates in India are usually controlled by one single decision maker, namely a promoter or promoter family, businesses outside India may have a different management structure. Ensuring you are engaging with the correct individual or individuals will be critical to eventual deal success.

3. Geographical nuances[2]

It is essential that FMCG buyers understand the local market nuances associated with other territories. Following are the list of challenges presented by different emerging market geographies:

Asia: Strong competition from rival bidders and alternate sources of funds makes valuation one of the key issues for doing deals in Asia. Based on our data, about 50% deals begin diligence but are aborted because of valuations.

Latin America: The regulatory environment in Latin America (e.g. Brazil), particularly for tax and labour, is a complex one. There are high taxes and social charges on payroll, sales and income. Taxes are diverse and legislation changes fast. Also compliance with corruption laws is an issue in many companies, and there may be undisclosed balance sheet transactions and commitments.

Eastern Europe: Eastern Europe is in some ways becoming closer to a developed rather than a growth market. Corruption in businesses related to government contracts is still an issue in many Eastern European countries, although governments are taking steps to be more transparent in their purchasing, for example, using on-line auctions.

Africa: Government policy is more central to deals in Africa. Some countries can change the rules on tax or legal parameters quickly. There is a massive deviation of culture and economies within regions. Companies that have failed often have not had thorough understanding of the local people, business conditions and environment.

4. Preparing your business for sale or divestment of equity or a fundraising process

Shareholders or management teams need to invest significant time preparing a business for a sell-side process, not only to increase the chances of completing it, but also to maximize value. Three specific areas need to be focussed on:

Demonstrate the strong inherent value of your business:

- Ensure clear objectives (e.g. value range, funding requirement, equity to be divested) are set out for the process and all necessary stakeholders are aligned together
- Demonstrate a track record of historic growth through robust financials and a narrative outlining the key drivers (e.g. new product development, distribution growth etc.)
- Understand the business strengths, in particular those that will appeal to an investor / buyer, and be able to articulate them clearly to interested parties

... and, Maximise the long term value of the business

- Prove visibility and achievability of future earnings, thereby giving comfort to investors about how realistic the forecasts are
- Plan a well thought through process (e.g. readiness of information, timing of sale, what you want from an investor etc.) that leverages investor / buyer interest, thereby maximising the competitive tension and ultimately value
- Allude to new product potential / pipeline / future value drivers and opportunities for the business

.... While minimising the impact of any potential risks

- Maintain strict confidentiality regarding the process, at the same time as being prepared for any leaks. Concerns of key stakeholders (e.g. employees, customers) will need to be efficiently managed in the event of a leak
- Mitigate any tax and regulatory risks that may detract from value during a due diligence stage of a deal
- Consider your business' points of difference and how these will be maintained in future. What makes your business, product, brand stand out from its peers? How will these strengths be maintained in future?

2. PwC's Getting on the right side of delta, PwC analysis

5. M&A outlook for the consumer sector

Recent deals show that acquirers can gain significantly from choosing to follow an inorganic growth route. Some of the particular advantages are as follows:

- Opportunity to gain market share and a footprint in other fast growing countries / regions. E.g. Wipro's acquisition of LD Waxson will allow them to begin building a presence in the Chinese consumer market.
- Access to an established and well invested distribution infrastructure capable of leveraging existing products that will be adaptable to the new geography. Kraft's acquisition of Cadbury allowed access to Cadbury's pan-India distribution network, the benefits of which are already being seen through the roll-out of legacy Kraft brands such as Oreo.
- Technology that can be leveraged to develop new products in home territories. E.g. Godrej recently launched the Aer air freshener brand developed with the help of technology acquired through its acquisition of Megasari in Indonesia. We anticipate that as outbound M&A continues, we'll see an increase in the cross-pollination of brands across relevant markets where there is greater congruency in consumers' needs and aspirations.

Despite the current concerns around the global economy, it's likely that India will to continue to see M&A and private equity activity within the FMCG sector, both on a domestic and cross-border basis. The fast growing and differentiated Indian FMCG sector will continue to receive interest from financial investors, who will remain focussed on the demand being created by Indian consumers, and western corporates who need to look at emerging markets to meet wider growth aspirations.

Further, it's likely that established Indian corporates will continue to seek out acquisitions in overseas markets. While the slow growth and mature profile of western markets is unlikely to be appealing, Indian companies are likely to continue to focus on high growth markets such as South-East Asia, Africa, Latin America etc.

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