Transformation through transaction

How innovative investment strategies are helping CEOs embrace disruption

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Introduction

CEOs need grit to face the toughest headwinds of today's business environment: disruption from new market entrants, new products and new customer expectations — all enabled by continually developing technologies. But they have a powerful tool at their disposal. Investment strategies such as acquisition, partnerships and divestitures give firms the benefit of agility without the upheaval of wholesale transformation.

When Jim Hackett was announced as the new CEO of Ford Motor Company in May, he was hailed as the right man to lead the company "during this transformative period for the auto industry".[1] Despite its strong brand and a history of strong results, the car maker had been struggling with a falling share price, and turned to the head of its driverless car division for strategic direction. "Extraordinary times call for extraordinary leadership," said executive chairman Bill Ford.

Ford is not alone. CEOs across all industries now recognize that disruptive influences have moved beyond the technology sector and are a fact of life for business. But most also accept that disruption is something to embrace rather than fear. In the KPMG Global CEO Outlook, more than six in 10 CEOs see disruption as an opportunity, not a threat, while three in four say their businesses are aiming to be the disruptors in their sectors.

Clearly, businesses are ambitious when it comes to innovation. At the same time, there is significant and mounting interest in assets that can help corporations respond to fast-paced change. Across all sectors, businesses that are embracing new areas of disruption are commanding high prices. So what are the options for supporting such change with transaction activity while overcoming the challenges of uncertainty?

[1] https://media.ford.com/content/fordmedia/fna/us/en/news/2017/05/22/ford-appoints-jim-hackett-as-ceo.html

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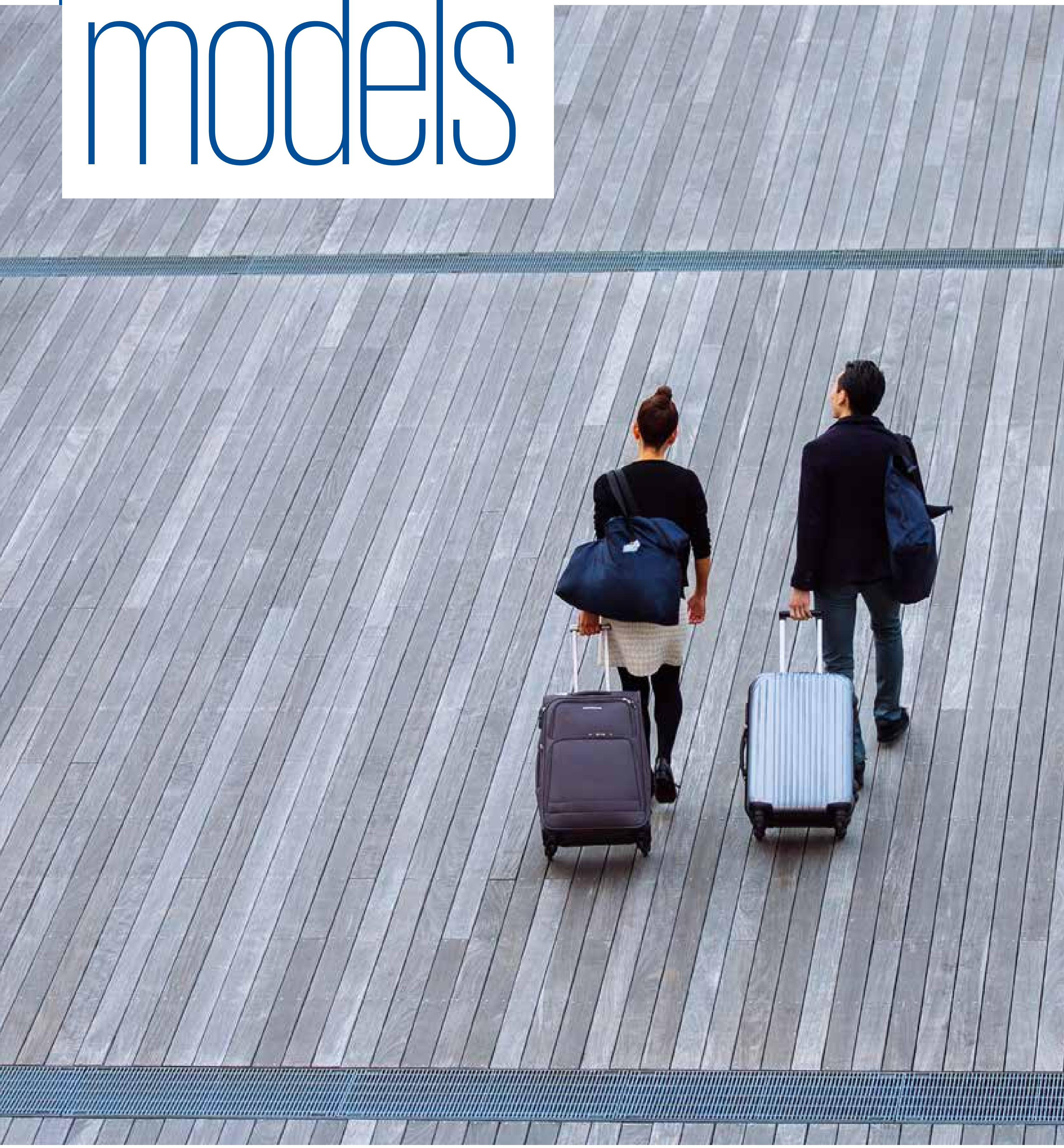
Different models



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The nature of any acquisition strategy will vary depending on the appetite and proactivity of the company. Many sectors are content with the traditional M&A model: *acquisition* of a smaller asset. The greater a company's desire for control, the greater its need to own the asset, and this is particularly true if its work is close to its core activity. Acquisition tends to support expansion strategies, particularly cross-border.

> "The likes of BMW, Daimler and Volkswagen are buying into small tech companies in order to compete in a new data-driven ecosystem."
>
> **Leif Zierz**
> Global Head of Deal Advisory

Corporate venturing, meanwhile, is picking up. Companies in the US industrial sector, for example, are reacting to disruption by forming venture-style arms that allow them to invest in autonomous vehicle technologies. This activity harks back to the late 1990s, when many corporates first formed venture funds in order to dabble in the early wave of internet-based innovation (see Figure 1).

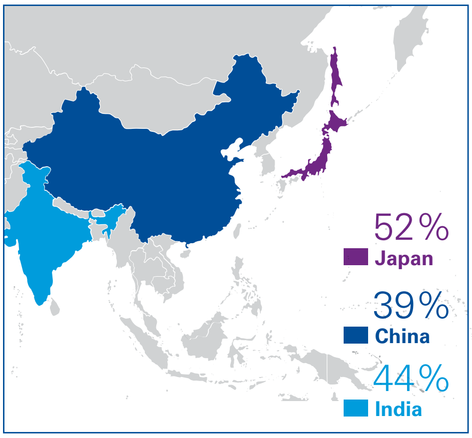
"The likes of BMW, Daimler and Volkswagen are buying into small tech companies in order to compete in a new data-driven ecosystem," says Leif Zierz, Global Head of Deal Advisory at KPMG. "But they are taking a much smarter portfolio method, not only considering affordable majority stakes, but also more collaborative approaches like partnerships or minority stakes."

The Chinese conglomerate Alibaba is an example of this: it's numerous, relatively small acquisitions are designed to increase its odds of having access to what is likely to form part of a future business model. If you have enough capital to put bets out there, you can wait until one of the winning models comes up — and then you make your move.

The recent KPMG Global CEO Outlook surveyed over 1,200 CEOs and found that collaborative partnerships have emerged as an appealing alternative to M&A for companies seeking growth and innovation in a shifting business landscape: Three out of 10 of CEOs surveyed say they are pursuing partnerships/joint ventures as a way to expand their businesses, and the appeal of this approach is obvious.

Say a company is looking to move into producing electric cars in Asia. Alongside the cars, it needs to secure the infrastructure, from batteries to recharging stations, and it may be unwilling or unable to invest the necessary capital. And perhaps it lacks the capability to manage parts of this value chain, given that it could include companies ranging from regional software startups to multinational battery producers. Partnering with other companies allows it to reap the benefits of innovation without any ownership and incentive entanglement.

Figure 1: Desire for collaborative partnership is strong in the largest countries of Asia



Source: KPMG Global CEO Outlook 2017

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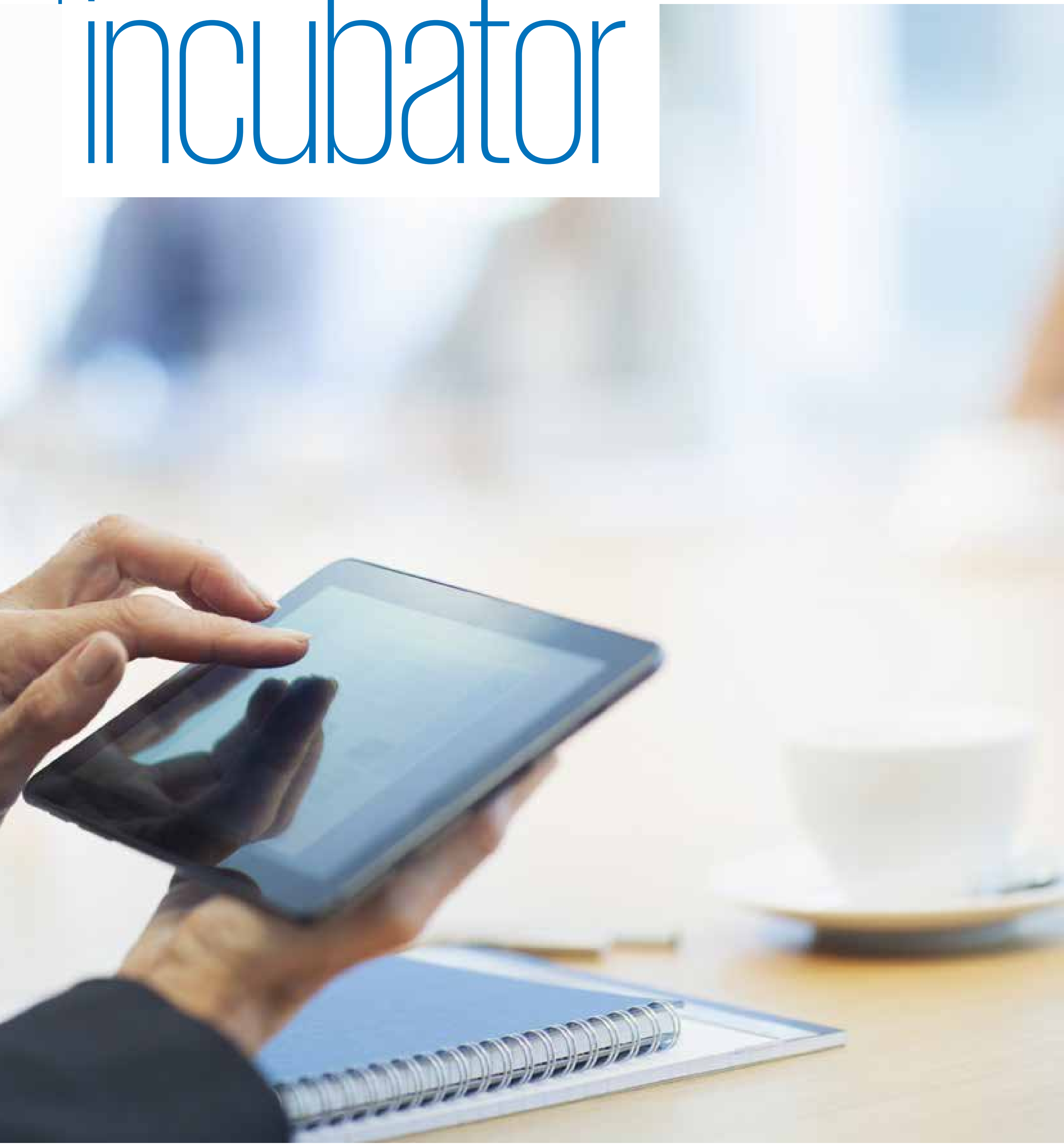
Be the incubator



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However, the reality remains that the larger and more successful the company, the harder it is to both adopt any strategy that conflicts with an existing business model, and link up with an entity that is not similar in structure.

CEOs find themselves caught between two conflicting pressures. On one side, shareholders and boards of directors expect them to generate exposure to the more disruptive and interesting areas of the economy. Yet most multinational corporations have risen to prominence by generating hyper-efficient business models that are optimized for the requirements of their sector or value chain. So on the other side is the knowledge that they will be fundamentally changed by exposure to new transformational businesses that come with different talent, compensation models, ways of working, and processes.

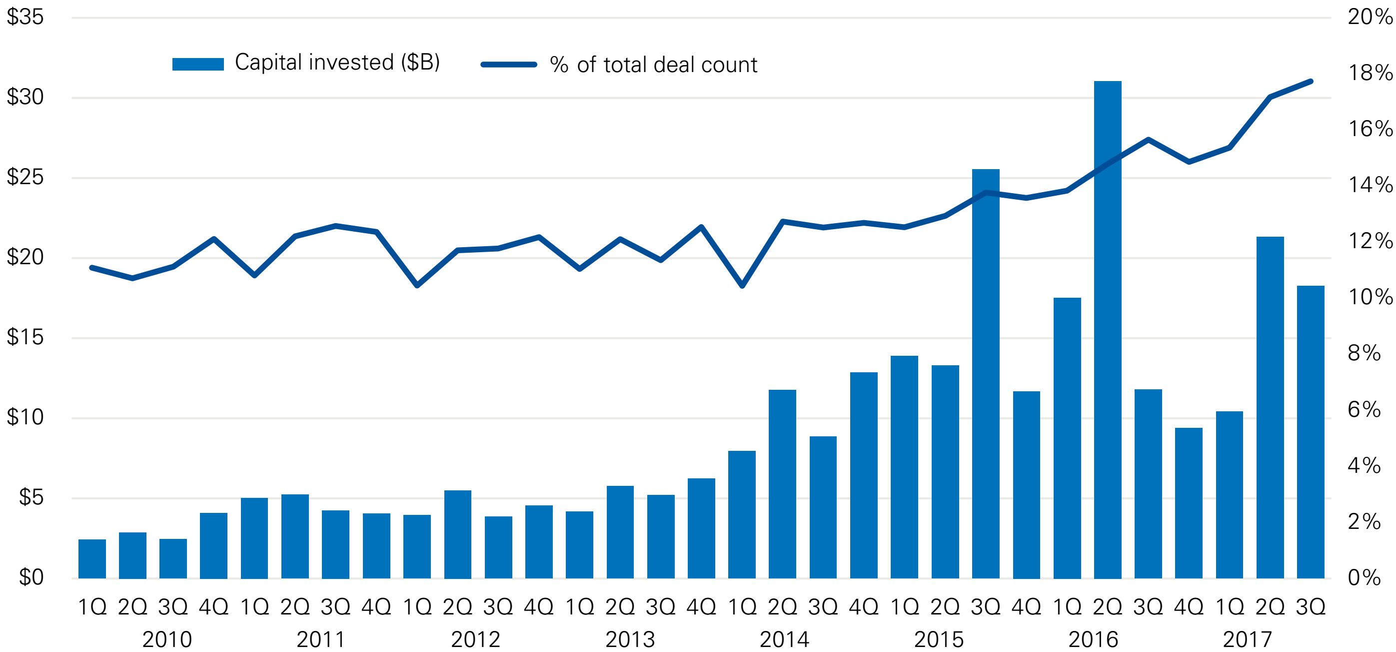
The idea of creating a transformative model in scale that becomes part of a corporation is not something that sits comfortably with most CEOs; instead, they generally prefer to acquire it fully formed. Some bolder senior executives are making larger bets and buying into technology that differs with parts of their existing business. We see this in the ever increasing corporate participation in venture capital (see Figure 2).

Corporate participation continues rise to record proportions in venture capital

Corporates are becoming increasingly involved in early stage investment, making bets on smaller players. Motivators can be pure-play financial or strategic or a blend of both. These investments are becoming increasingly important sources of capital and talent. In a world of fast-paced innovation, greater exposure to relevant technological advances is a strategy imperative. (VenturePulse, Q3'17, KPMG Enterprise)

Figure 2: Corporate VC participation in global venture deals

2010 – Q3'17



Source: Venture Pulse, Q3'17, Global Analysis of Venture Funding, KPMG Enterprise. Data provided by PitchBook, October 11, 2017.

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Get ahead of the game

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Despite these challenges, it would be a mistake to hesitate and implement change later through investment strategy.

In fact, early transformation presents fewer risks: moving ahead of the curve allows companies to place smaller bets, and more effectively balance risk and costs. It provides greater insight, at a lower cost, without the pressure to act wholesale. The challenge for most executives is that their decision to change comes too late. When you change late you have to make a bold move and your options become limited.

A drive in recent years toward efficiency has also meant that, for many companies, innovation has suffered. Organizations tend to increase or decrease innovation based on performance, but innovation is a long and unpredictable process that demands sustained investment. Any trade-off of innovation for efficiency can be extraordinarily damaging for companies, limiting their ability to move early and keep their options open.

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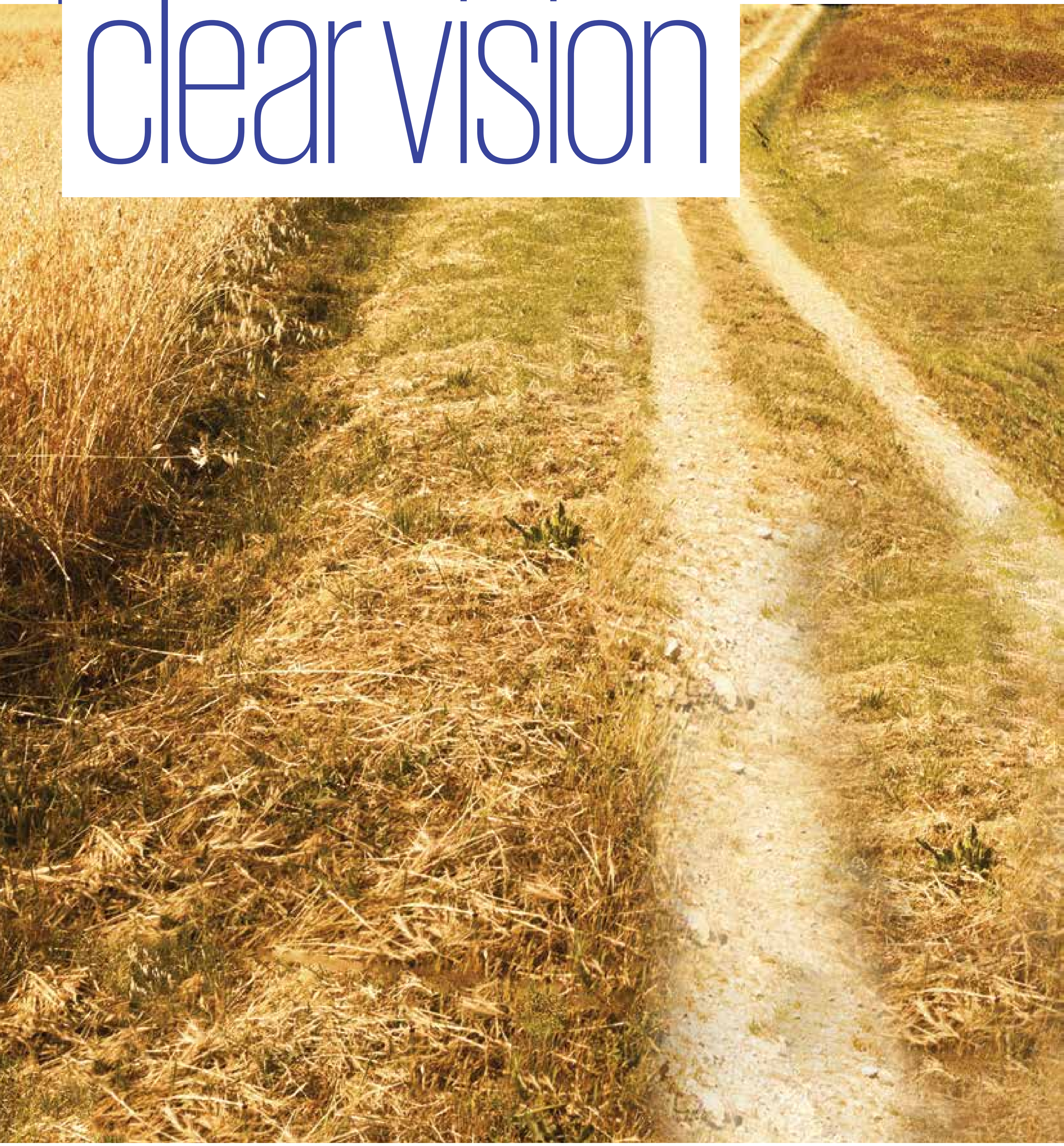
Establish a clear vision



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The clearer a management team is on its strategic direction, the better its acquisition strategies: rather than considering pure volume or scale, they need an understanding of how the business will look in three to five years' time. If there are essential parts of the puzzle missing that are needed for that vision to become a reality, acquisition could be the answer, and if the goal is to manage parts of the value chain, the management team will have to consider how to configure its relationships with partners or targets within the portfolio.

At KPMG, we have been exploring these differing relationships, particularly in more dynamic markets such as Asia. We ask management teams to draw a chart of their value chain mapping the product journey from the supplier to the warehouse, and the client journey from the warehouse to the customer.

With a grocery retailers, for example, this could include services from cool chain management to brand management, to buying and procurement. The team considers what is core to the business, what they will run themselves irrespective of the operating country, and what else is required in order to be successful at each step of the chain in five years' time. The more detailed the discussion, the clearer the acquisition and partnering targets become, and some of these — digital agencies, for example — may not have previously been considered to be in the value chain.

Armed with this deep insight into their business beyond its traditional framework and market, CEOs are better able to grasp change. If they stick within traditional parameters, they are late — sometimes fatally — to see what is happening on the fringes.

When Amazon first emerged, consumer goods companies used them to sell goods direct to the consumer, while downplaying this activity to traditional bricks-and-mortar retailers as simply an alternative channel. Over a decade later, the consumer goods companies are trying to adopt direct-to-consumer strategies of their own. Amazon, meanwhile, has purchased Whole Foods Market in a giant step into traditional retailing and a potential game-changer for traditional supermarket chains. If the traditional retailers and supermarkets had tried to understand the changing mindset of consumers earlier and had come up with the right investment strategy to immerse themselves in direct-to-consumer models, they would not be playing catch-up today.

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Alert your senses

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Spotting this fringe activity and being able to react early requires management teams to use their systems effectively to grasp the nature of future sources of disruption.

For example, every company has its own ecosystem defined by its customers and its products; by interacting with key members of this ecosystem — customers, academics, scientists, the media — it will gain invaluable insight into current and future sources of disruption.

"Now, we can analyze vast amounts of data that provide answers to these questions," says Alex Miller, Head of the Global Strategy Group, KPMG in the US. "Analytics platforms can interlink client, market and customer data, which companies can use to identify pockets of untapped value.

"The systems for storing data and the processing analysis are now so robust that there is no longer the risk of trying to do too much," he adds. "We can 'boil the ocean'."

This depth of data and understanding of market trends can also help firms to value their targets. Pricing acquisition targets proves difficult when much of the price is based on know-how rather than cashflow, and some businesses are being priced at extraordinarily high levels. This, combined with uncertainty over the current market environment, is causing many transactions to fail. The more sophisticated the use of data analytics, the greater the likelihood of accurately assessing value and the greater the deal certainty.

Increasing use of data analytics will lead to a requirement for different skillsets for transactions. In future, it will not be sufficient to have a strategy partner and a valuation partner at the table. Instead, acquisitions are incorporating real-time scenario analysis and multifunctional teams — even including the target team. Better acquisition scenario analysis and intelligent use of data analytics will increase all parties' confidence in the deal.

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Use divestitures wisely

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This scenario testing and analysis will also come into play in divestitures, which are currently a hugely undervalued part of the deal business.

Divestitures have traditionally been unwanted and unloved divisions. After three years of underperformance, boards would grow tired of supporting a particular section of the business and call for its disposal. In future, however, it will become more commonplace to divest only certain parts of a business, which will be taken as a sign of a board that is managing a successful portfolio.

"Companies will have to be willing and able to divest some business units that might have served them well over, say, the previous ten years, but are unlikely to do so over the next five years. Thus, it's most important to understand who should be best owner for an asset and have the boldness to divest. Carve-outs can be a strategic option but are often overlooked," says Christoph Zinke, Head of the Global Strategy Group, KPMG in Asia Pacific. "They will also have to be more strategic — a divestment that is standalone-ready will sell faster, more easily, and for a better price."

As with acquisitions, divestments demand a deep assessment of the value chain. In the past, companies looked to vertically integrate across the value chain, and acquisition or divestment strategies have remained within manufacturing, retailing or distribution value chains. That is starting to change.

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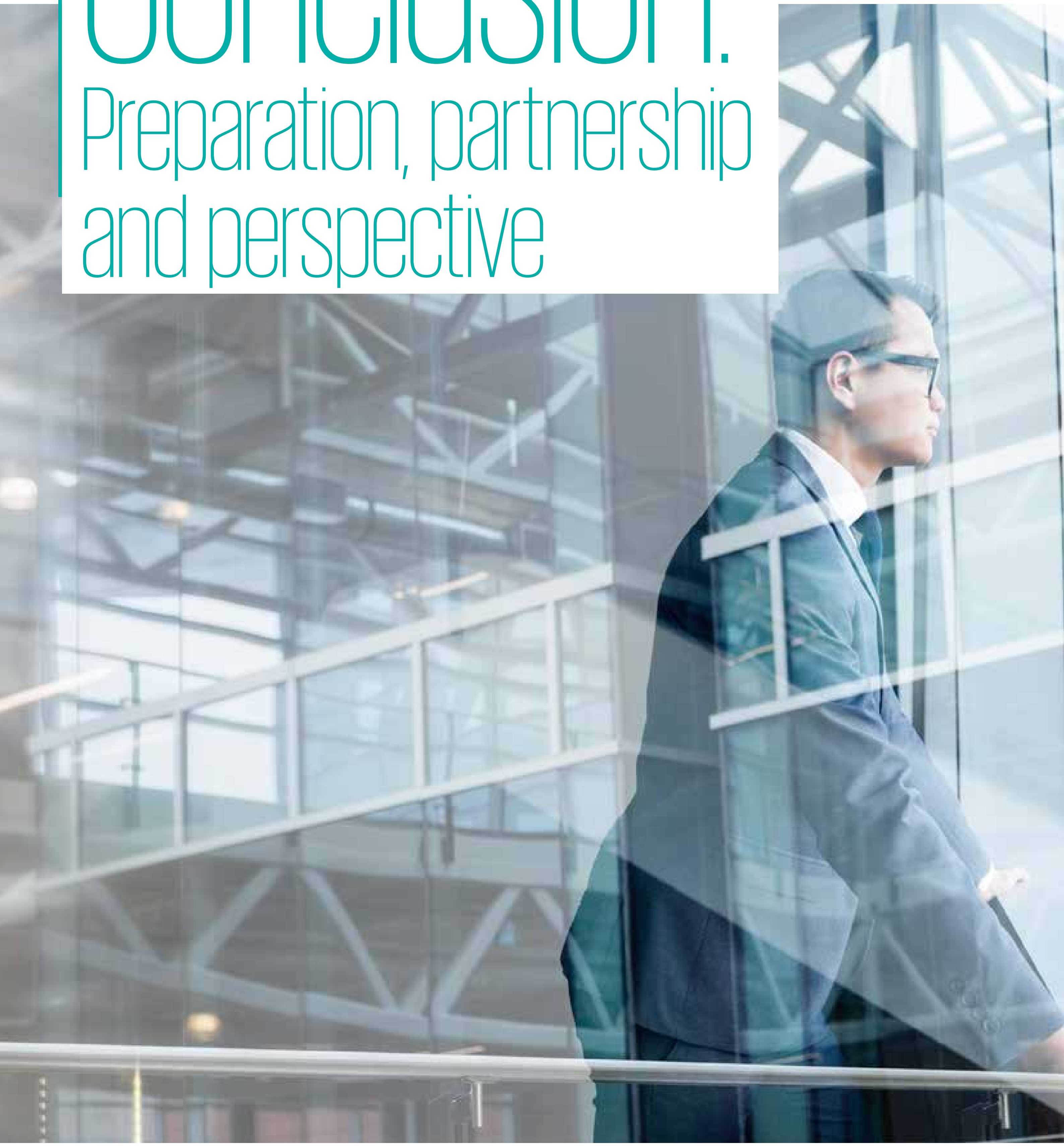
Conclusion:
Preparation, partnership and perspective



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There is a strong desire among CEOs to disrupt their businesses. Yet the reality of introducing disruptive elements to a profitable and efficient operation is causing many, mistakenly, to hesitate.

At one end of the spectrum, there are those that can generate earnings growth by being extraordinarily efficient; at the other are those willing to expose themselves to the most interesting areas and ideas for long-term advantage.

Companies must avoid being stuck in the middle. As they explore their options and seek to innovate, they can minimize disruption and hedge their bets on what future business models will look like by investing in strategic partnerships and corporate venturing. Those parts of the business that are no longer a good fit will be discarded, and complementary businesses will be brought in. Divestments will become a more significant part of the transformation agenda, and these will require the same strategic insight as the acquisition process. For example, companies must decide who is the best owner for an asset.

Better planning will make the business unit a more attractive target. And the best way to prepare is through smart analysis of the widest variety of data. As in virtually every other part of the business world, data is becoming more and more critical to understanding market and future trends, and to firms' ability to set future investment strategy.

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Deeper deal insight leads to better foresight

The right deal can accelerate transformations and growth by harnessing new ways of managing capital. Well-executed transactions enable faster realization of growth through access to new markets, sales and distribution channels, new capabilities, or by simplifying and optimizing infrastructure, operations and costs.

As advisers, KPMG's teams of specialists combine a global mindset and local experience with deep sector knowledge and analytic tools to help you navigate a complex and fast changing environment.

Our professionals challenge conventional thinking with 'investor-grade' rigour, and work to provide on-the-ground end-to-end deal support.

When you are considering transformational change through transactions, KPMG's teams can help you establish what is core to your future business by asking the right questions, like:

- How will the transaction really enable new, sustainable growth?
- What are the steps to ensure value is extracted from every phase of a transaction?
- How do I ensure the value thesis become reality?

From helping to plan and implement strategic change to measurably increasing portfolio value, our professionals focus on delivering tangible results. The kind of results that let you clearly see what you gained from the deal at hand, and what you want to bring to the next deal down the road.

Flavor of the month?

US flavorings producer McCormick & Company recently announced its acquisition of Reckitt Benckiser's food business, including the French's Mustard and Frank's Hot Sauce brands. McCormick CEO Lawrence Kurzius has stated that these brands form part of a plan to draw in millennials who are drawn to bold flavors and place flavor at the core of the company's strategy. As part of the deal, McCormick also acquired nutrition bar brand Tiger's Milk. Given that it is part of the food processing business, its inclusion makes sense, and it is by no means a struggling brand. It does not, however, fit in with the company's new focus on strong flavors. How long before Tiger's Milk is seen as a divestment opportunity?[1]

The CEO dilemma: turning the ship around

One client in the consumer goods space is faced with the reality that its customers want to change the way in which they buy its product. The company is a fully formed, at-scale business that is extremely profitable. But now, because the consumers are changing their buying habits, the CEO must plan to change their own business and migrate to the new model while at the same time maintaining profitability and fighting off disruptive competition. How to disrupt themselves while at the same time maintaining their financial performance?

[1] Source: www.cnbc.com/2017/07/25/mccormick-ceo-defends-acquisition-of-reckitt-benckiser-brands.html

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Alex has more than 20 years of M&A and strategic advisory experience as a strategy consultant, private equity principal and business operator. Alex has helped clients build enterprise value, optimize free cash flow and accelerate growth via acquisitions, geographic and product line expansion, and corporate restructuring.

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