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Rivalry at the Top? Growing Concentration in the Coatings Industry

An industry expert explains recent merger and acquisition activity in the paint and coatings industry.

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The coatings industry in North America has been consolidating for decades, to the point that in certain end market segments, fewer than ten players – and in some cases, five or less – control over 90% of the market, and in most other markets, the level of concentration is at least 75%. For the industry in total, the American Coatings Association and ChemQuest Group have estimated that the top ten manufacturers represent nearly 75% of total industry revenues and that the next ten represent about another 10% of the market.

Some sectors of the coatings industry are beginning to resemble the structure of the automobile, tobacco, or defense industries, where a handful of global or super national behemoths have achieved large economies of scale, such that they control the vast majority of the market and are beginning to squeeze out, or more likely acquire, the remaining players.

In coatings, this trend toward concentration at the very top became especially evident about a decade ago, when Sherwin-Williams participated in an auction in an attempt to buy SigmaKalon, then the second largest coatings manufacturer in Europe. Sherwin-Williams has a storied history as a successful buyer of coatings businesses, with a record extending back as far as the late 19th century. SigmaKalon would have been the largest acquisition in its history, providing it with much needed diversification away from its dependence on architectural coatings in North America. It therefore must have come as a disappointment when Sherwin Williams lost that auction to PPG, which paid over $3 billion for SigmaKalon.

Sherwin-Williams tried again in 2012, when it reached an agreement to buy Comex S.A., ("Comex"), Mexico's largest paint company, for $2.34 billion. Without a doubt, Comex was a nearly perfect strategic fit: with a heavy emphasis on selling Comex branded products through a network of 3,300 independent owner-operated franchise stores throughout in Mexico, Comex was in essence a Latin American version of Sherwin-Williams. In fact, the deal may have been too much of a perfect fit, at least for Mexican regulators who blocked the deal on the grounds that the combination would have given Sherwin-Williams over 50% of Mexico's architectural coatings market. Sherwin-Williams did receive a (much smaller) consolation prize of sorts, managing to acquire Comex's U.S. and Canadian operations for $165 million, which included 314 company-operated stores and five manufacturing plants. That left Comex's remaining Latin American operations in play, and sensing an opening, PPG reached an agreement to acquire the business within three months after the Sherwin-Williams/Comex deal fell apart. PPG paid $2.3 billion, essentially the same price that Sherwin-Williams originally had agreed to pay for the whole of Comex.

At the time, PPG was in the process of realigning its business units to focus on paint and coatings, with acquisitions and divestitures of non-core businesses as the primary means of implementing this strategy.

Over the years, it had built up its coatings business through the acquisition of many smaller firms, but the most significant step in this direction after Comex was its purchase of AkzoNobel's North American architectural coatings business in early 2013. The transaction, valued at $1.05 billion, included all of Akzo's architectural coatings manufacturing and distribution facilities, paint stores, and product lines in the United States, Canada, and the Caribbean. The acquisition gave PPG 600 company-owned paint stores (the former ICI Glidden stores) as well as access to 10,000 additional points of distribution, including big-box home centers, mass merchants, and independent dealers.

The transaction meant that PPG had passed both Sherwin-Williams and Akzo to claim the number one spot as the world's largest coatings company, even though it remained the number two player in architectural coatings in North America, second to Sherwin-Williams. But in less than two years, PPG had used acquisitions to become the greatest competitive threat to Sherwin-Williams on its home turf.

Given that this was the second time in seven years that PPG had come out ahead of Sherwin-Williams in competition for a significant "transformative" acquisition, it may have been inevitable that Sherwin-Williams' management and Board of Directors would have been tempted to pursue something big. Nevertheless, it came as a surprise to many industry professionals when Sherwin-Williams announced that it would acquire Valspar in March 2016 for an enterprise value of $11.3 billion or 15 times Valspar's estimated 2016 EBITDA.1 It was surprising because many thought that a merger between the second largest coatings company in the world (Sherwin-Williams), and the fifth largest (Valspar) would be out of the question due to anti-trust considerations. Anticipating this, Sherwin Williams built some safeguards into the merger agreement allowing for a purchase price adjustment in the event one company or the other had to divest assets over a certain dollar limit in order to get the deal approved. But it appeared that Valspar and Sherwin-Williams had remarkably little overlap that would concern regulators, and in fact, it may be that Valspar is the only major coatings company Sherwin-Williams could acquire that the U.S. Federal Trade Commission would allow. Still, to obtain the necessary approvals, Valspar had to divest its North American industrial wood coatings business, which it sold to Axalta in April for $420 million. The Sherwin-Williams/Valspar merger is now scheduled to close in Q2 2017, and it may have already closed by the time you read this.

When the deal was announced, it was priced at a 41% premium over Valspar's average daily closing stock price for the preceding 30 day period. Such a large premium over the stock price and an EBITDA multiple of 15 may seem like a rich valuation for a coatings company, but Sherwin-Williams' management expects that the acquisition will be immediately accretive to earnings and will generate approximately $280 million in synergies by 2018. Factoring in these expected synergies reduces the Enterprise Value/EBITDA multiple to about 11 times.

From a strategic perspective, the transaction will strengthen Sherwin-Williams' grip on architectural coatings in North America, adding about $1.0 billion to the approximate $9.4 billion in revenues generated by Sherwin-Williams' Paint Stores and Consumer Groups. But the real value of the transaction for Sherwin-Williams lies in its diversification benefits. The combined companies will have a more balanced portfolio, less dependent on architectural coatings and more international in scope.

Once the deal closes, Sherwin-Williams will displace PPG and once again be the largest coatings company globally. But recent developments indicate that it's possible it won't retain that position for long. In March, PPG extended an unsolicited offer to acquire Akzo (3rd largest global coatings company) for about $22 billion. Akzo's board rejected that offer as too low, leading PPG to increase its offer twice more. The last offer, made at the end of April, valued the company at $27.1 billion. Akzo appears determined to remain independent, rejecting each offer in turn and proposing instead to increase value for its shareholders by spinning off or selling its specialty chemicals business. PPG has some support from Akzo shareholders,

[1] "Enterprise value" refers to the market capitalization, or the total value of outstanding stock, plus the value of assumed debt. Sherwin-Williams cash offer was for about $9.3 billion; it would also assume another $2 billion in Valspar's debt, resulting in a total enterprise value of $11.3 billion. EBITDA stands for Earnings Before Interest, Taxes, Depreciation and Amortization.

including the activist investor Elliott Management Corp., which is calling for a shareholder meeting to oust Akzo's chairman and pressure the board to begin negotiations with PPG. As of this writing, the situation is unresolved. It has been reported that PPG is considering a public tender offer for Akzo's shares, which in effect would amount to a hostile takeover, something of a novelty in the coatings world. That would be a risky undertaking with no assurance of success, because under Dutch law, Akzo's board would retain the right to nominate replacement directors, so the winning shareholders in a takeover attempt may have less leverage than they would if Akzo was based in the U.S.

There also would be intense regulatory scrutiny on a PPG/Akzo deal. The combined companies would have over $25 billion in revenues, dwarfing the roughly $16 billion that Sherwin-Williams/Valspar would have. Its position at the top of the industry would be secure for the foreseeable future; there is no single company that Sherwin-Williams/Valspar conceivably could acquire that would enable it to rival PPG/Akzo in size.

Despite all the drama, none of this should be interpreted as simply the jockeying of two giant companies vying for bragging rights of being number one. It's really all about economies of scale, and strategies to achieve scale are normal in consolidating industries. The bigger the company can become, the more purchasing and pricing power it will have, along with manufacturing and distribution efficiencies, the ability to fund new market initiatives, and the wherewithal to weather economic downturns. Quite simply, scale makes it easier to keep growing -- something that is very important when the global economy itself may be growing at only 2% to 3% a year.

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