Grace Matthews

North American Architectural Coatings: The End Game?

Independent formulators may face their greatest challenges yet

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KEY TAKEAWAYS

- Consolidation in the North American architectural coatings market has been occurring for decades. However, the three large, strategic deals announced by Sherwin-Williams, PPG, and Valspar in the fourth quarter of 2012 are true game changers. After taking into account recent M&A activity, four companies account for an estimated 84% of architectural coatings sold in North America.

- Sherwin-Williams' acquisition of Comex provides additional geographical coverage in under-represented regions and enhances its market-leading position in North America. We believe that management's target of $70 million in cost synergies from the deal may prove conservative.

- PPG's acquisition of Akzo Nobel's North American Architectural Coatings business was a net positive for both PPG and Akzo Nobel. PPG will emerge as the largest coatings company in the world and a strong #2 player in North American architectural coatings. Akzo Nobel received a healthy value for a business that has struggled in recent years and can now refocus its resources on businesses with greater growth potential.

- Valspar's supply agreement with Ace Hardware and acquisition of Ace's paint manufacturing assets demonstrates a commitment to the architectural coatings market and provides an opportunity to significantly expand distribution and brand awareness.

- Structural benefits of consolidation in architectural coatings include improved raw material purchasing, manufacturing efficiencies, transportation cost savings, enhanced market coverage, and strategic brand management. These factors will continue to drive consolidation over the next several years.

- Balance sheets for the largest architectural coatings companies (including Sherwin-Williams, PPG, and Valspar) remain strong despite recent acquisitions. The quest for growth amid a low-growth environment should support a healthy pace of M&A.

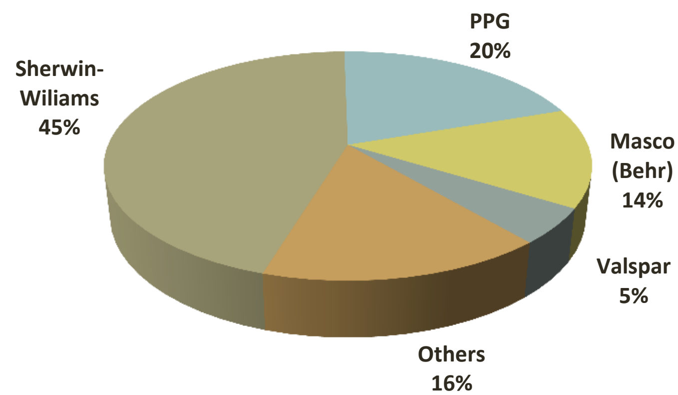
- We believe that in the short and medium term, large regional paint store chains can remain competitive due to a loyal customer base and strong local brands. The longer-term picture is more uncertain due to increasing competitive pressure from the market leaders. The smallest chains and those serving the independent dealer channel may be more challenged.

- Independent formulators supplying independent dealers, hardware stores, and other retailers may be faced with the greatest risk. With a lack of scale and limited distribution, these formulators are most susceptible to threats from market consolidation. Tight cost management and near-perfect execution will be required to stay competitive, and this is difficult to maintain over the long term. With all of their advantages, the Big Four can afford to make a few mistakes (but don't count on it). The current economic environment requires small and mid-sized formulators to execute flawlessly, as the headwinds are very strong.

PART I: CONSOLIDATION IN THE NORTH AMERICAN ARCHITECTURAL COATINGS MARKET

Consolidation in the North American architectural coatings market has been a key theme for several decades. According to estimates from The ChemQuest Group, 54 companies operating company-owned paint stores sold 55% of all U.S. architectural coatings in 1960. By 2006, 55% of architectural coatings were sold by 21 companies. And by 2010, just four companies – Sherwin-Williams, Akzo Nobel, Masco, and Benjamin Moore – held an astonishing 71% market share in the U.S. While these figures relate to the U.S. only, the level of consolidation in Canada and Mexico has been similar.

Figure 1: North American Architectural Coatings Market Share*



**Sales through all channels; adjusted for pending Sherwin-Williams and PPG acquisitions*
Source: Company reports, Grace Matthews estimates

Following a brief pause in activity due to the Great Recession, the wave of consolidation has resumed with vigor. Over a two-month span in late 2012, the industry saw three deals (Sherwin-Williams acquiring Comex, PPG acquiring Akzo Nobel's North American Architectural Coatings business, and Valspar acquiring Ace's paint manufacturing assets) collectively valued at more than $3 billion and representing more than $3 billion in revenue. This activity collectively impacts nearly 20,000 points of distribution (5,100 for Comex, 10,600 for Akzo/ICI, and 4,000 Ace Hardware locations).

In the wake of these transactions, the new "Big Four" – Sherwin-Williams, PPG, Masco, and Valspar – account for approximately 84% of the North American architectural coatings market. If the architectural coatings market were a poker tournament, we'd be down to the final table.

Figure 1 presents a view of the North American architectural coatings market after taking into account the recent acquisitions. Figure 2 lists the key benefits of scale in architectural coatings, which has been a fundamental driver of the recent M&A activity.

The story is the similar if we look more narrowly at company-owned paint stores in North America (Figure 3). Of the nearly 5,300 stores owned by the top ten operators at the end of 2011, almost 90% were held by the top four players. After taking the recent M&A activity into account, those same units would be owned by just two players, Sherwin-Williams and PPG.

Figure 2: Key Benefits of Scale

- Raw Material Purchasing
- Production Synergies
- Administrative Cost Synergies
- Brand Strength
- Supply Chain/Logistics Efficiencies
- Enhanced Geographical Coverage
- Expanded Distribution
- Opportunity for Diversification

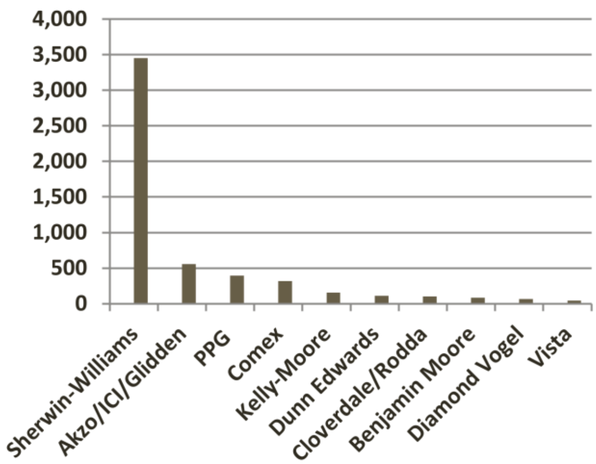
Source: Company reports, Grace Matthews estimates

What has driven this level of consolidation in the paint industry? Will it continue? What does it mean for the remaining players? In this paper, we begin by taking a closer look at the recent transaction announcements in the architectural coatings industry. Next, we analyze the key factors that have driven industry consolidation. Finally, we provide our outlook for M&A in the North American architectural coatings market and the implications for companies that remain.

Sherwin-Williams' Acquisition of Comex

In November 2012, Sherwin-Williams announced its intent to acquire Consorcio Comex, S.A. de C.V. (Comex), a leading manufacturer of architectural coatings in Mexico (66% of sales), the U.S., and Canada. The transaction was valued at $2.34 billion, which is 1.7X Comex's 2011 sales ($1.4 billion). Assuming a 12% EBITDA margin and 5-10% sales growth for Comex in 2012 (comparable to Sherwin-Williams' metrics), the acquisition would be valued at approximately 13X Comex's 2012 EBITDA. If we incorporate the synergies that Sherwin-Williams expects to achieve from the deal (discussed below), the pro-forma EBITDA multiple would be approximately 9-10X. Note that as of early 2013, Sherwin-Williams' stock was trading at more than 15X its trailing twelve months' EBITDA.

Figure 3: Top 10 Paint Store Chains (North America) – 2011



Company	Number of Stores	% of Top Ten
Sherwin-Williams	3,450	65%
Akzo/ICI/Glidden	558	11%
PPG	393	7%
Comex	318	6%
Kelly-Moore	154	3%
Dunn Edwards	109	2%
Cloverdale/Rodda	104	2%
Benjamin Moore	84	2%
Diamond Vogel	67	1%
Vista	45	1%
Total Top 10	5,282	100%

Source: Company reports and Grace Matthews estimates

In our view, this transaction has the potential to be the best strategic acquisition of significant size in architectural coatings in recent memory. The strategic rationale is solid, and in many ways, Sherwin-Williams is buying a smaller Mexican version of its dominant Sherwin-Williams brand. Comex has over 3,300 points of sale in Mexico, which are operated by 750 independent concessionaires exclusive to Comex. Comex also operates 240 stores in the U.S. and has 78 company-operated stores and 1,500 independent dealers in Canada. Collectively, the deal will add more than 5,000 points of sale to Sherwin-Williams' North American distribution network. At the time of the announcement, only Sherwin-Williams, Akzo Nobel, and PPG operated larger store bases than Comex in North America.

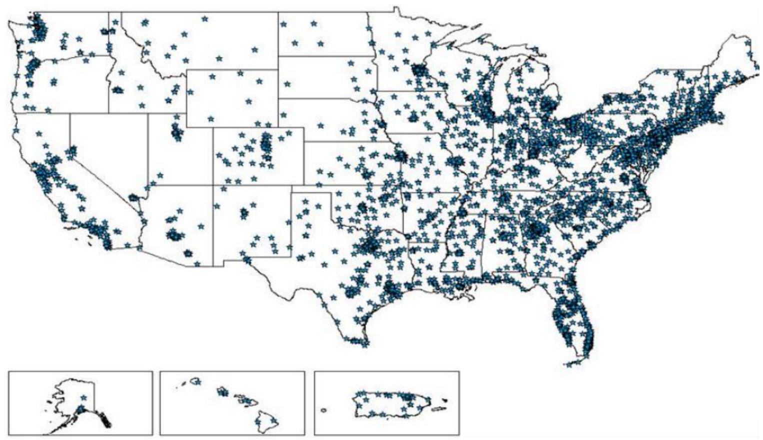
Like Sherwin-Williams, Comex's business is heavily skewed toward architectural paint (75% of sales) and primarily serves the professional painter market. From a geographical coverage standpoint, the benefits are immediate and obvious. The addition of Comex essentially doubles the size of Sherwin-Williams' business in Mexico/Latin America. The acquisition also significantly enhances Sherwin-Williams' business in the western U.S. and Canada, where its current store penetration is low on a relative basis. Figure 4 presents Sherwin-Williams' store base before the Comex acquisition.

The Comex store base in the U.S. and Canada operates under several brands, including Frazee Paint (western U.S.), Kwal Paint (mountain and southwest states), Color Wheel Paint (primarily Florida), Parker Paint (northwest U.S), and General Paint (Canada). In the near-to-medium term, we believe Sherwin-Williams will continue to operate the acquired stores in the U.S. and Canada using their existing branding. While these stores have struggled financially and strategically in the past, Sherwin-Williams' ability to operate stores is unparalleled, and the overlap in key markets suggests that cost savings via consolidation are likely. Over time, Sherwin-Williams is likely to transition the acquired U.S. and Canadian stores to its namesake brand. In Mexico, we see potential for Comex stores retain their current branding over the long term.

On an investor call to discuss the acquisition, Sherwin-Williams' management cited technology sharing as an additional benefit of the transaction. Comex has historically maintained a strong R&D function, which should help accelerate technology development and provide technology transfer opportunities within the combined organization.

Sherwin-Williams expects cost synergies to reach approximately $70 million (5% of Comex's sales) within three years of closing, primarily by eliminating redundant administrative, transportation, and manufacturing costs, as well as through raw material purchasing benefits from greater scale. We believe this estimate may prove to be conservative. Comex currently operates eight manufacturing sites in Mexico, five in the U.S., and three in Canada. Several of these facilities are likely to be shuttered by Sherwin-Williams, which continues to have excess production capacity in its network as a byproduct of the housing market downturn. Notably, Sherwin-Williams has both a manufacturing plant and a distribution center in Nevada, which appear well-positioned to serve the acquired Comex stores on the west coast.

Figure 4: Sherwin-Williams Store Base (Pre-Comex)



Source: Sherwin-Williams Financial Community Presentation, May 23, 2012

A key risk of the deal is that Sherwin-Williams will not directly control distribution in Mexico to the extent it does in the U.S. through its company-operated store base. Through its concessionary model in Mexico, Comex acts as an exclusive supplier of paint to its stores; however, it does not maintain complete control over store operations. Because the concessionary model is common and well-established in Mexico, Sherwin-Williams has no near-term plans to convert to a company-operated store model. We believe that the Comex brand strength will serve to mitigate this risk substantially. The size and breadth of the transaction presents another potential risk, although we believe that Sherwin-Williams' internal resources and existing presence in each of Comex's primary geographies will reduce the challenges associated with integrating the acquired business.

Although the transaction is the largest deal ever for Sherwin-Williams, we view Comex as an obvious fit that is consistent with Sherwin-Williams' M&A strategy: acquiring established, high-quality coatings businesses that enhance geographical coverage or provide well-known brands that can benefit from an extensive distribution network. While the deal's estimated valuation appears healthy, Sherwin-Williams' track record of acquiring and successfully integrating regional architectural store operators (five companies in the past decade alone) should provide confidence that the Comex deal will be beneficial to shareholders over the long term. In addition, with a net debt to EBITDA ratio below 1.0X before the deal announcement, Sherwin-Williams had significant financial flexibility to execute a transaction of this magnitude without over-leveraging its balance sheet.

PPG's Acquisition of Akzo Nobel's North American Architectural Coatings business

Consolidation in the paint industry continued in December 2012 when PPG announced the acquisition of Akzo Nobel's North American Architectural Coatings business. The transaction, valued at $1.05 billion (0.7X 2011 sales of $1.5 billion), included all of Akzo Nobel's architectural coatings manufacturing and distribution facilities, paint stores, and product lines in the United States, Canada, and the Caribbean. In addition to acquiring 600 company-owned paint stores, PPG gained access to 10,000 additional points of distribution, including 6,000 national home centers (e.g., Home Depot) and mass merchants (e.g., Wal-Mart) as well as 4,000 independent dealers. Importantly, the transaction included key Akzo brands such as Glidden, Flood, and Sico.

Akzo's decision to divest its North American Architectural Coatings business was not surprising to many, as the business has struggled in recent years. The business reported negative EBITDA of approximately $60 million in 2011, contributing to Akzo's decision to record a $500+ million impairment charge. Management characterized 2012 EBITDA as "slightly positive". Incorporating the $60 million of cost savings that PPG expects to generate at closing, we estimate that PPG paid approximately 12-13X EBITDA for the business. Assuming the full $160 million in cost savings expected by year three (discussed below), the pro-forma EBITDA multiple is less than 7X.

While performance in Canada (~35% of the business's sales) and the Caribbean (~5%) has historically been strong and the big-box customers attractive, Akzo's U.S. business (60%) was significantly affected by the downturn in the U.S. housing market and the resulting contraction in architectural coatings sales. On a conference call with investors to discuss the divestiture, Akzo Nobel's CEO Ton Buchner cited a lack of critical mass as one of the key contributors to the business's poor performance in North America. The divestiture will free internal resources and provide Akzo with additional capital that can be invested in businesses in which it has stronger position, such as industrial coatings.

Figure 5: PPG N.A. Architectural Coatings Distribution Network

Distribution Channel	Current PPG Outlets	Current Akzo Outlets	Combined Outlets	North American Ranking
Company Owned Stores	400	600	1,000	#2
National Home Centers	2,000	6,000	8,000	#2
Independent Dealers	2,000	4,000	6,000	#2
Total Customer Touch Points	**4,400**	**10,600**	**15,000**	**#2**

Source: PPG

Upon closing the transaction, PPG will be the largest coatings company globally and a solid #2 player in the North American architectural coatings market (and a much more formidable competitor to Sherwin-Williams). Figure 5 illustrates the impact the transaction will have on PPG's architectural coatings distribution in North America.

The transaction will significantly enhance PPG's geographic reach in the U.S., Canada, and Puerto Rico. In the U.S., the deal adds new regional coverage for PPG in the West and Northeast (Figure 6).

We view PPG's increased coverage in the West as particularly important in light of the recent Sherwin-Williams–Comex combination, which significantly boosted Sherwin-Williams' position in this region. The acquisition also extends PPG's reach into Canada (particularly eastern Canada), where Akzo had built a leading position in paint stores under the CIL, Glidden, and Dulux brand names. We expect PPG to operate its acquired Dulux stores under their current branding.

PPG projects $160 million in cost savings related to the deal, including $60 million at closing from certain pension and amortization expenses retained by Akzo Nobel, another $30 million by the end of the first year, and an additional $70 million by the end of year three. Not surprisingly, management expects to generate a large portion of the projected cost savings by eliminating duplicative administration, distribution, and manufacturing expenses. PPG also may be able to obtain better pricing on key raw materials (e.g., TiO_2), as the acquisition will increase PPG's scale within architectural coatings. By offering a broader range of paint and sundries for both professional and DIY painters through multiple channels of distribution, PPG also should have opportunities to strategically modify its brand positioning and pricing in order to improve margins, particularly within the acquired business.

Figure 6: Combined PPG/Akzo U.S. Store Base

Source: PPG

In general, we view this transaction as highly strategic for both PPG and Akzo Nobel. The acquisition significantly enhances PPG's position in the North American architectural coatings market and will allow PPG to compete much more effectively with Sherwin-Williams. The acquisition also appears timely, with recent data pointing to a steady recovery building in the North American housing market. For Akzo Nobel, the divestiture unloads an unprofitable business and provides capital that can be allocated more efficiently within its core businesses. After struggling for many years in the U.S. architectural coatings market, Akzo decided to cut its losses and move on. A now-stronger PPG represents a greater competitive threat to Sherwin-Williams and to the smaller regional operators that fight for customer traffic and shelf space within the market.

While the benefits and opportunities of the combination seem relatively clear, the transaction is not without risks. Some argue that the Glidden brand (historically a brand for both consumers and professional painting contractors) has been compromised by Akzo's multi-channel distribution strategy, and particularly through its placement in mass merchandisers like Wal-Mart. We disagree, and believe that Akzo faced a greater risk by doing nothing with the brand. In addition, the acquisition will result in PPG supplying both Lowe's (through its Olympic Paint brand) and Home Depot (through Akzo's Glidden and Sikkens brands), which will need to be carefully managed. PPG also will need to sort out the multiple brands currently offered in the independent dealer segment by both PPG and the newly acquired Akzo/Glidden business. Finally, PPG likely will need to selectively close some of Akzo's most unprofitable stores in the U.S., which must be conducted without alienating core customers. We believe the acquisition price appropriately reflected these risks and may prove to be very attractive if management can achieve its synergy targets. Based on our experience advising sell-side clients that were acquired by PPG, we believe that PPG's management will be highly diligent in evaluating and integrating the acquired business and will carefully consider the impact that any strategy changes will have on both the acquired business and PPG's existing business.

Valspar – Ace Hardware

In early January 2013, Valspar announced it had entered into a long-term strategic supply relationship with Ace Hardware. Under the agreement, Valspar will manufacture Ace-branded paint products and make a comprehensive line of Valspar-branded paints available to more than 4,000 Ace retail locations in the United States. In addition, Valspar acquired Ace Hardware's paint-manufacturing assets, including two manufacturing facilities located near Chicago. While the size of the deal was not publicly announced, the cost of acquiring Ace's plants was reported to be less than $50 million. Incremental revenue to Valspar under the arrangement is expected to reach $150 million annually by 2015.

The announcement provided a signal to the market that Valspar remains committed to selling architectural coatings (which today represents less than 40% of Valspar's business), and was well timed in light of Sherwin-Williams' and PPG's recent strategic acquisitions. Over the next year, Ace and Valspar will collaborate with Ace store owners to enhance their paint departments, which will include the introduction of Valspar-branded products in the fall of 2013. Under terms of the arrangement, Ace will retain ownership of its existing paint trademarks, including Clark+Kensington and Ace Paint, with Valspar acting as the exclusive manufacturer of Ace's products. Valspar believes that over the next several years, approximately 70% of the paint sold through the partnership will be under Ace's private label brands, with the balance consisting of Valspar and other brands.

Similar to the Sherwin-Williams and PPG acquisitions described above, this deal will provide Valspar with increased raw material (e.g., TiO_2) purchasing power and a significant increase in distribution for Valspar-branded products. Prior to the Ace alliance, Valspar's paints were sold primarily through Lowe's home centers and independent dealers.

The deal represents a blow for Benjamin Moore, which began supplying Ace Hardware stores in 2005 and currently supplies 1,400 to 1,500 Ace dealers. Benjamin Moore's management noted that the company wanted to retain a "selective distribution" business model, while Ace desired a national brand that could be sold in all of its stores. Ace has not commented on the future of the Benjamin Moore product line, although we believe it is unlikely that many Ace stores will carry a broad selection of both Benjamin Moore and Valspar-branded products.

The alliance with Ace is consistent with Valspar's commitment to growing its national brand of paints, spearheaded by CEO Gary Hendrickson. In 2007, Hendrickson led Valspar's successful initiative to re-brand the paint sold through its largest customer, Lowe's, from American Tradition to Valspar. With the Ace agreement, Valspar is positioned to significantly extend its brand geographically. This builds upon another recent geographic win for Valspar, as it secured a contract in November 2012 to supply the B&Q home improvement chain in the U.K. This was a significant victory for a U.S. brand.

Interestingly, the alliance is not the first relationship that Valspar has had with Ace. Beginning in the 1930s, Valspar manufactured private-label paints for Ace that were sold in its hardware stores. That manufacturing relationship ended in 1984 when Ace began producing its own paint.

We believe the deal makes sense for Valspar, as overlap between the core Ace and Lowe's customer base is likely to be low and increased distribution should lead to greater recognition of the Valspar brand over time. The deal also allows Valspar to increase its manufacturing capacity, which should support the company's growth efforts in upcoming years.

PART II: STRUCTURAL BENEFITS OF CONSOLIDATION

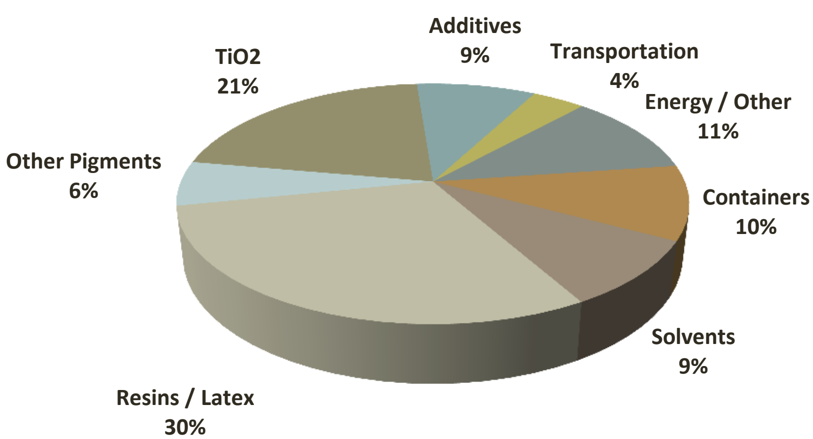
Acquisitions in the architectural coatings industry are driven by a variety of reasons, although specific M&A drivers will vary according to the size, core competencies, and strategy of both the acquirer and target company. While the benefits of consolidation often appear relatively clear and straightforward, they can be difficult to define with precision. In this section, we describe the primary drivers of M&A in the architectural coatings industry.

Raw Material Purchasing

According to the American Coatings Association's *U.S. Paint & Coatings Market Analysis (2010-2015)*, the average price per gallon of architectural coatings sold from 2001-2010 increased at a compounded annual growth rate of 2.8%, boosted by raw material cost increases that were passed through to customers. However, selling prices after adjusting for inflation using the Producer Price Index for Architectural Paints have actually *decreased* by 1.9% annually. What does this tell us? In essence, price increases have only served to partly offset the impact from increasing raw material costs, which have eaten into underlying profit margins for coatings companies. TiO_2 has been particularly burdensome, with global prices rising by 8% in 2010 and 40% in 2011, although prices did moderate somewhat in 2012.

With raw materials representing the largest component of direct costs for architectural coatings production, rising costs for any of the key inputs can have a dramatic effect on a formulator's profitability. Figure 7 illustrates the breakdown of raw materials costs within a typical can of paint.

Figure 7: Raw Material Cost Breakdown for Architectural Coatings



Source: Sherwin-Williams

Tune into most analyst calls held by the publicly-traded coatings manufacturers in recent years and you will hear endless discussion about raw material costs: how much they've gone up, how much they are expected to go up, and what impact they are having on profits. In an attempt to mitigate the impact from rising raw material costs, many companies have been proactively investing in R&D to develop formulations that utilize less expensive grades of raw materials, and some are even looking at vertically integrating by buying raw material suppliers in an attempt to secure their source of supply.

One way to reduce the financial pressure from rising raw material costs is to purchase in larger quantities. This is no secret, as most suppliers will offer a discount to customers willing to purchasing product in truckload or railcar quantities instead of in drums or totes. Through an acquisition, a company can immediately increase its purchasing scale and reduce the average price it pays for many of its key raw materials. The savings can be particularly dramatic in the case of a large coatings company (>$1 billion in revenue) acquiring a significantly smaller player (<$100 million in revenue). In those situations, raw material cost savings for the acquired company can often exceed 10%, and in some cases run dramatically higher.

When discussing its acquisition of Akzo's North American Architectural Coatings business, PPG's management projected $160 million of cost savings over a three-year period, a portion of which was attributed to raw material cost savings. While PPG already is one of the largest global purchasers of coatings raw materials, doubling its North American architectural business may generate some raw material cost savings through increased purchasing scale. These are hard synergies that can be quantified and that acquirers will value in an acquisition.

In addition to paying higher prices for key raw materials, many smaller coatings formulators found themselves more exposed to the supply shortages that occurred following the Great Recession. As the economy improved in 2010, many coatings companies were placed on allocation for certain raw materials by suppliers that had cut back dramatically on their production capacity during the recession. During times of supply constraints, larger organizations generally are better positioned to secure raw materials from alternative sources or to rely on their clout to obtain adequate quantities from key suppliers. In addition, larger formulators with significant in-house R&D capabilities are better equipped to reformulate their products using alternative materials if necessary. Either of these factors can be viewed by company owners as additional justification for pursuing acquisitions. Formulators also may view acquisitions as a means of securing the supply of a particularly scarce raw material if the acquisition target has secure access to those raw materials.

Manufacturing Efficiencies and Overhead Savings

While raw material cost savings typically represent a major source of synergies in an acquisition, manufacturing efficiencies also provide impetus for M&A. For example, a formulator with excess production capacity can acquire a capacity-constrained manufacturer without needing to invest significantly in incremental equipment. Architectural coatings do not generally require sophisticated equipment to manufacture, so production for acquired product lines often can be transferred to an acquirer's production facilities with relative ease. If the acquirer has sufficient excess capacity, an acquired facility may be able to be shut down entirely, resulting in a dramatic reduction in overhead costs. Cost savings of this nature can be particularly attainable during periods of lackluster demand when excess capacity is common.

Another key source of synergies available to strategic buyers is redundant administrative costs and other non-manufacturing overhead costs that may not be critical to the combined organization. For example, an acquirer may not require the full resources of the acquired company's marketing and finance department. These and other non-essential costs can subsequently be eliminated. Large companies with broad functional resources stand to benefit most from this type of cost savings, as acquisitions can often be integrated with a minimal level of incremental overhead.

Transportation Costs

In addition to lowering production costs, increased scale stemming from acquisitions can reduce the average costs of transporting finished product from production facilities to company-owned stores or to other points of distribution. For a small, independent chain of paint stores (say, 25 to

50 stores) the costs of transporting finished product to stores can be meaningful. As a store base grows and the manufacturer expands its network of production facilities and delivery vehicles, the marginal transportation cost per store begins to decline. As a store base climbs into the hundreds of units, the marginal transportation cost of adding a store in an existing geography becomes very small. Thus, transportation costs for a small to medium-sized paint store chain acquired by a company the size of Sherwin-Williams presents an added opportunity for savings that a buyer can define and will assign value to in an acquisition. In addition, acquired stores may be able to be supplied by a buyer's manufacturing facility that is in closer proximity than the target company's paint facility. This can reduce costs even further.

In a recent presentation to investors, Sherwin-Williams' management noted that improving the average fuel efficiency by one-tenth of a mile across its fleet of delivery vehicles results in over $200,000 in annual cost savings. With such a large opportunity available, Sherwin-Williams has enormous incentive to invest in its delivery vehicles and transportation network to maximize efficiencies. Recent improvements have included more aerodynamic trailers, aluminum wheel covers to reduce drag, and automated systems to ensure proper tire inflation. These, and other investments, have allowed Sherwin-Williams to tightly manage its transportation costs and maximize profit margins. While the highly-efficient transportation networks built by larger companies can put smaller formulators at a competitive disadvantage, they serve as an added source of operational synergy when acquisitions are considered.

Environmental Compliance

Tightening environmental regulations have been a major contributor to the wave of industry consolidation over the last two decades. The increasing direct and indirect costs of regulatory compliance are high and have proven to be difficult for smaller formulators to absorb. This added cost burden further compresses the already thin margins of many formulators, reducing their ability to compete in the marketplace.

For example, the amendments passed as part of the Clean Air Act included stricter requirements for VOC emissions in architectural coatings, forcing coatings producers to develop low- and zero-VOC coatings. While regulatory agencies argue that new requirements are being implemented in the name of health and safety, formulators are left with few other options but to invest in R&D in order to develop compliant products. Not only is it expensive to develop new formulations, but many "next generation" products require alternative raw material technologies that can be expensive or difficult to secure. Other costly compliance measures include the Toxic Substances Control Act (TSCA) in the U.S. and REACH in Europe. Non-compliance penalties for these and other regulations can include fines, business restrictions, and even criminal charges. Once again, the challenges related to these issues typically are inversely related to a company's size, with smaller formulators disproportionately impacted by new requirements enacted by environmental and other regulatory agencies.

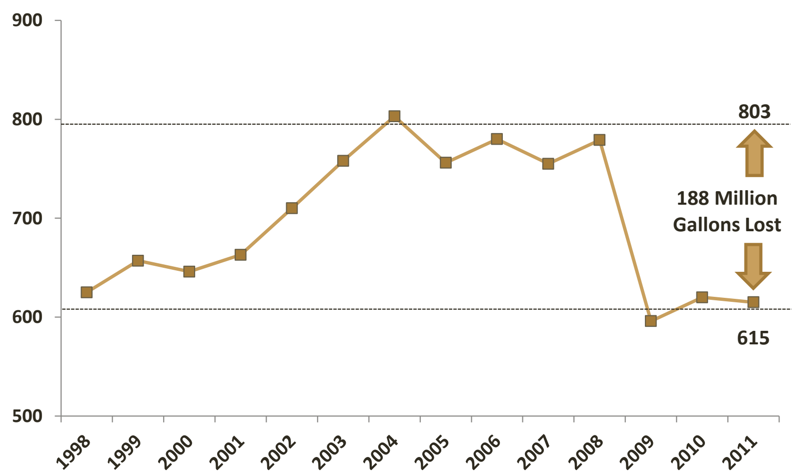
In recent years, the paint and coatings industry's governing bodies have encouraged their members to adopt improved environmental stewardship practices. These initiatives have focused on the transportation and storage of chemicals, export and import guidelines for raw materials, energy usage, waste reclamation, air releases, water discharges, and other business practices that impact the environment. While the potential benefits of such moves are generally understood, their implementation requires an added layer of costs that reduces margins and leaves smaller producers struggling to compete.

Paint manufacturers must accept the fact that environmental regulations and exposure concerns will only become more restrictive over time. Larger organizations, with greater R&D, compliance, and raw material sourcing resources, will find themselves with less of a financial burden to bear as the regulatory environment continues to tighten. Smaller companies with fewer internal resources will continue to be faced with key decisions about regulatory compliance that will affect their long-term viability.

Enhanced Market Coverage

A tangible benefit of consolidation is expanded market coverage, including access to a previously untapped or underpenetrated market (e.g., Comex providing additional coverage on the west coast for Sherwin-Williams and Akzo/ICI substantially strengthening PPG's position in Canada). Importantly, acquisitions can enhance a paint store operator's geographic coverage <u>without</u> introducing additional capacity into the market. This point is particularly relevant in light of the Great Recession, which severely impacted demand for architectural coatings in the United States. Between 2004 and 2011, demand for architectural coatings in the U.S. declined from approximately 803 million gallons to 615 million gallons, a decrease of 188 million gallons, or 23% (Figure 8).

Figure 8: U.S. Architectural Coatings Volume (Gallons Sold in Millions, 1998-2011)



Source: U.S. Department of Commerce MA325F Report

With current demand still well below the prior peak, an organic growth strategy (i.e., opening new stores) can prove risky and dramatically impact an operator's ROI. However, growth through acquisition represents an ideal way to expand market share regardless of the industry's current supply-demand balance.

Acquisitions can also expand market coverage by providing access to new distribution channels. Establishing a consumer brand (particularly with big-box retailers) is extremely difficult. By acquiring a target with established retailer relationships, a company may have opportunities to broaden the distribution of its own brands. Conversely, companies with established relationships in multiple distribution channels can use acquisitions to gain access to new brands that can be sold through their own distribution network.

Strategic Pricing and Brand Management

In the architectural coatings market, pricing is typically cited as one of the most important buying considerations for both professional paint contractors and DIY consumers. As noted previously, larger organizations are often able to more effectively manage their production costs and leverage fixed expenses over a larger sales base. Firms with a lower base cost per gallon tend to feel less pressure to raise prices during periods of raw material cost inflation and can better afford to adjust their pricing (if necessary) during periods of heightened competition. In addition, larger organizations with an extensive portfolio of products and brands may have opportunities to execute a tiered pricing strategy (e.g., good, better, best), as well as use private label brands, in order to maximize overall sales and profits. Brands with strong consumer recognition and broad distribution are particularly sought after by strategic acquirers in the architectural coatings industry.

One of the most difficult decisions facing the management of PPG, Sherwin-Williams, and Valspar in light of their recent deal announcements relates to brand management: *in which channel and geography should each brand be offered and at what price?* After the near-term cost synergies are harvested by an acquirer, true long-term value can be generated through brand management and strategic pricing. By no means is this an easy task, however. PPG, for example, must figure out a way to manage its newly-acquired Glidden brand, which is sold in various forms through big boxes like Wal-Mart and Home Depot, as well as in Glidden Professional Paint Centers under the Glidden Professional brand. Concurrently, PPG also is selling Olympic-branded paints through Lowe's, Pittsburgh Paints through Menards, and PPG-branded paints through its company-operated stores.

Brand segmentation has historically been found on a regional basis, likely due to local consumer preferences (and price points) as well as consolidation in the industry, with large national players acquiring local and regional formulators with established brands. As industry consolidation continues, particularly among the large national and global formulators that sell through multiple distribution channels, we are likely to see more consistent use of brands across geographies. We believe that companies with large brand portfolios will strive to develop more cohesive and consistent messaging to consumers. Simply put, branding is cheaper on a per-gallon basis when you sell more gallons.

Liquidity / Financial Stability

The Great Recession, along with the corresponding decline in the U.S. housing market, left many coatings formulators teetering on the edge of financial ruin. Some companies were left with no other alternatives but to file for bankruptcy or sell their business at a depressed valuation, while others found liquidity injections or cut costs. Those who survived are generally better run than they were prior to the recession and carry a lower cost structure. However, their ability to cut costs further is unlikely. While all coatings companies are subject to the whims of the end markets in which they operate, larger companies with a more diversified stable of businesses typically find themselves on more solid financial footing, even amid market declines.

With the housing market now turning a corner, many formulators are reinvesting in their businesses and executing a growth strategy. Some, well-aware of the benefits that scale can provide, are looking to acquire a competitor or an adjacent line of business. Others, particularly those that experienced near-calamities during the recent downturn, may use the market rebound to opportunistically sell their business while valuations are back to more palatable levels. With the memory of the recent downturn still fresh in the minds of many, we believe the pursuit of financial stability, or lack thereof, represents another factor that will drive continued consolidation in the coatings industry.

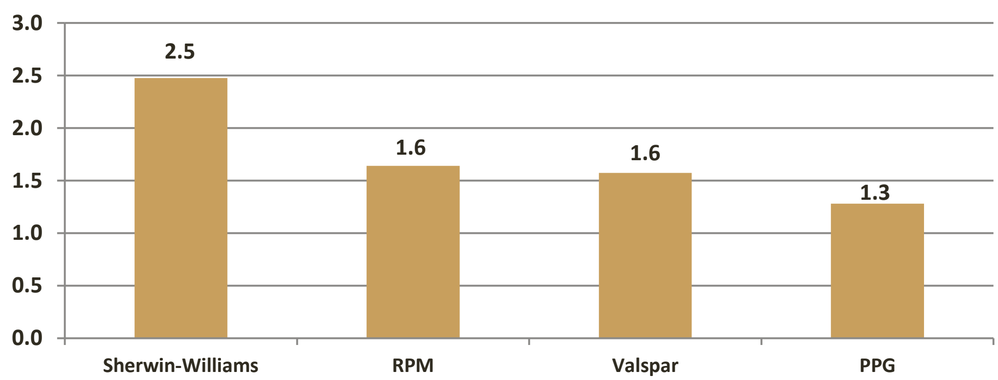
Putting it all together

While four large players already control a large percentage of the architectural coatings market in North America, the balance of the market (~16% of sales) remains extremely fragmented. As such, we see considerable runway remaining for further consolidation.

Acquisitions can offer an attractive way for formulators to enter new markets, expand their product portfolios, improve their profit margins, and compete more effectively. In the U.S., where GDP growth over the next few years is expected to remain tepid at best, acquisitions are one of the only ways to generate meaningful growth, which is crucial for public companies. Growth objectives forced upon the large public coatings companies by their boards of directors and shareholders often rely on some level of M&A to achieve, as organic growth opportunities remain scarce despite signs of recovery in many markets.

Not surprisingly, we believe the largest architectural players (e.g., Sherwin-Williams, PPG, Valspar, Masco) remain best positioned in the market, particularly following the recent spate of acquisitions and strategic partnerships. Broad geographic reach, a portfolio of strong brands, and access to multiple distribution channels provide formidable competition to small, regional players with more limited resources. Balance sheets for the market leaders remain generally strong and are capable of funding further M&A. Although Sherwin-Williams is taking on a moderate amount of leverage for its acquisition of Comex, the company is likely to continue evaluating small to medium-sized acquisition opportunities in 2013. Debt/EBITDA ratios (Figure 9) remain below 2X for RPM, Valspar, and PPG, providing significant financial flexibility to pursue acquisitions.

Figure 9: Net Debt/EBITDA for Leading Coatings Companies



**Adjusted for Sherwin-Williams/Comex and PPG/Akzo transactions*
Source: Company reports, Grace Matthews estimates

With broad market coverage throughout the U.S. and in much of Canada, Sherwin-Williams and PPG clearly are best positioned to continue taking share within the architectural coatings market. However, we believe that larger regional paint store chains (e.g., Cloverdale, Kelly-Moore, Dunn Edwards) will remain competitive due to their highly-loyal customer base (primarily contractors) and strong local brands. The longer-term picture is somewhat murkier, however, as the relative size of the regionals leaves them more exposed to unexpected turbulence in the economy and competitive pressures from the market leaders. The smallest chains (<50 stores) and those serving the independent dealer channel may face even greater challenges, as their territory may be viewed as an easy market share opportunity by the market leaders amid the rapidly-consolidating landscape.

In the home center channel, the acquired Akzo business will provide PPG with a stronger position at Lowe's and new entry into Home Depot (as well as Wal-Mart). With a fresh set of arrows in its quiver, PPG will need to make key decisions about brand positioning, product placement, and pricing. Channel conflict remains a key hurdle that PPG will face as it integrates the acquired business. If managed properly, PPG has opportunity to solidify its position as the #2 player in the North American market and compete strongly with Sherwin-Williams.

While Benjamin Moore continues to hold a strong position within the independent dealer channel, it clearly is in the crosshairs of its key competitors. The PPG-Akzo combination and Valspar-Ace alliance will only serve to heighten competition for shelf space among independent dealers. With its paint sold through both company-operated stores and independent dealers, Benjamin Moore also faces a potential channel conflict that will need to be thoroughly analyzed by management. Pardon the pun, but Benjamin Moore is somewhat painted into a corner despite holding a world-class brand. We wonder if Benjamin Moore itself will look to M&A in an attempt to strengthen its position in one of its distribution channels, particularly in the company-operated stores segment.

We believe the companies that will face the most daunting challenges amid the latest wave of consolidation are the small, independent formulators supplying independent dealers, hardware stores, and other retailers. When you boil down the drivers of M&A discussed above, they key really lies in scale (supporting price leadership), branding, and distribution. Formulators without strength in each of these key areas may have difficulty competing over the long term. With industry leaders like Sherwin-Williams and PPG continuing to expand their portfolio of brands, independent dealers and other retailers may find it difficult to continue carrying more expensive brands from lesser-known formulators. Since retailers can improve their own margins by purchasing from fewer vendors, smaller suppliers may ultimately be the ones that get squeezed.

Smaller formulators with strong brands may be able to remain competitive by tightly managing their costs. However, this strategy requires perfect execution, and will be difficult to maintain over the long term. As the competitive environment becomes more difficult for many players, we believe the pace of acquisitions will continue to increase until consolidation in the market is exhausted.

SELECT GRACE MATTHEWS TRANSACTIONS

GABRIEL PERFORMANCE PRODUCTS
has acquired select assets of the Capcure® business from
BASF
The Chemical Company
Grace Matthews, Inc. advised
Gabriel Performance Products

Audax Group
has sold its portfolio company
ColorMatrix
to
PolyOne
Grace Matthews, Inc. advised
The ColorMatrix Corporation

SYRGIS
PERFORMANCE INITIATORS
has been acquired by
UNITED INITIATORS
driving your success
Grace Matthews, Inc. advised
Syrgis Performance Products

columbia paint & coatings
merged with
SHERWIN-WILLIAMS.
Grace Matthews, Inc. advised
Columbia Paint & Coatings

Brockway Moran & Partners
has sold its portfolio company
celeste
Helping you create a great impression
to
ITW
Grace Matthews, Inc. advised
Brockway Moran

SPRAYLAT CORPORATION
has sold certain assets to
PPG
Grace Matthews, Inc. advised
Spraylat Corporation

LORD
has sold its Resilient Floor Coatings Business to
AkzoNobel
Grace Matthews, Inc. advised
LORD Corporation

AKZO NOBEL
has acquired
Chemcraft International, Inc.
Grace Matthews, Inc. advised
Akzo Nobel nv

PRAIRIE CAPITAL
has sold its portfolio company
Nicoat
to
Caltius Equity Partners
Grace Matthews, Inc. advised
Prairie Capital Management

ASHLAND
has acquired
Northwest Coatings
Grace Matthews, Inc. advised
Northwest Coatings, LLC

LANDEC INTELLIGENT MATERIALS
has sold its specialty chemical subsidiary
DOCKRESINSCORPORATION
to
LUBRIZOL
Fluid technologies for a better world™
Grace Matthews, Inc. advised
Landec Corporation

HEXION™
Specialty Chemicals
has acquired the assets of
pacific
Epoxy Polymers, Inc.
Grace Matthews, Inc. advised
Pacific Epoxy Polymers, Inc.

RAABE Corporation
has been acquired by
QUEST SPECIALTY CHEMICALS
HURON CAPITAL PARTNERS
Grace Matthews, Inc. advised
Raabe Corporation

PPG
has acquired the Longview, WA operations of
EQUA-CHLOR
Grace Matthews, Inc. advised
Equa-Chlor, Inc.

GSI GENERAL MATERIALS, LLC
has been acquired by
HD SUPPLY White Cap CONSTRUCTION SUPPLY
a subsidiary of
THE HOME DEPOT
Grace Matthews, Inc. advised
GSI General Materials, LLC

GRACE MATTHEWS

Grace Matthews' chemical investment banking group provides merger, acquisition, and corporate finance advisory services for basic and specialty chemical manufacturers worldwide. Our practice is global in scope and well known for its strong track record of success dating back to the early 1990s. Our three main practice areas are sell-side transactions (private companies, divestitures for large multi-national corporations and private equity-owned businesses); buy-side projects (typically for major multi-nationals); and financing, where we raise debt and/or equity capital to support private equity-sponsored management buy-outs or recapitalizations. For more information on Grace Matthews' chemical practice, visit gracematthews.com/chemicals.

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