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Buzzword for the Decade: VUCA! Volatility, Uncertainty, Complexity and Ambiguity

A View from FRG's Chairman, Kerry Dustin



Wow, is this a really big thought! I cannot claim this is original - I was listening to Kevin Roberts on Bloomberg radio talking about "VUCA" and "SuperVUCA" and its effect on marketing. Quite frankly, I tuned out his message as I grasped the words: Volatility, Uncertainty, Complexity and Ambiguity. I rolled them around in my mind and thought about our M&A world, the M&A "process."

As soon as I got to the office I asked one of our bright young analysts to find out more so I could learn and share these thoughts with our team, our clients, our friends and prospects. Wikipedia does a great job here. It turns out that the Army, a fan of acronyms, (SNAFU, ASAP, FUBAR, AWOL, etc.) introduced the concept to describe a more volatile, uncertain, complex, and ambiguous world at the end of the Cold War.

Well, as we all know, the pace of change since then has merely accelerated and our world is more "VUCA" than ever. For example, the uncertainty of "Brexit" has had many companies simply waiting. "We are reticent about investing in the UK. In fact, we are also concerned about the impact on the rest of Europe, too. Speaking frankly, we would not do anything in the UK until after June 23rd." - James Lockhart CEO at WL ROSS.

So, how do you, our clients and friends, deal with VUCA? By applying the flipside: Vision, Understanding, Clarity and Agility.

A **vision** for the particular transaction is vital.

Uncertainty is countered with deep **understanding** of why the transaction makes sense for the people and the business on both sides of the table. The leader's job is to stop, look and listen at all stages of the process. (Note Falls River Group leads the mergers and acquisition's sale process for this very reason.)

Complexity is countered with **clarity** in communications, particularly when the attorneys start the inevitable battle over the purchase agreement and reps and warranties, etc. This is where Falls River Group's ability to

simplify, explain and determine what the risks are and why there is "heartburn", can be helpful in navigating the rough waters of Due Diligence and Purchase Agreements.

Ambiguity is countered with **agility**, the ability to communicate to all of the parties and stakeholders and to move quickly to apply solutions. We are proactive not reactive.

So, VUCA is increasing. Why are leaders waiting? Perhaps they are not really leaders? Leaders make change happen!

My early view re Brexit is that more Global M&A will flow to US acquisitions due to US market size and stability. This should increase already high US multiples over the next 18-24 months. EU and UK M&A will suffer due to the uncertainties. Already low debt rates will continue in the US.

Below are the thoughts of two team leaders at FRG - Maegan on the Pet space and Rob on the Energy space.

The Humanization of Pets: From the Dog House to the Main House



I'm sure most of us remember the days when the family dog happily resided in a dog house out back, living off Alpo and table scraps if lucky. The family cat got food scooped out of a tin can that smelled similar to the beach during an epidemic of red tide. This is clearly no longer the standard of care for the past ten to fifteen years for dogs and cats. There is now a multi-billion dollar phenomenon known as the "humanization of pets" which includes innovations in nutrition as well as a focus on the physical and emotional well-being of dogs and cats.

There is little disagreement that pets are the family members everyone seems to like. We have become a country of pet fanatics. According to the American Veterinary Medical Association, there are more than 77 million pet dogs in the U.S. and nearly 85 million pet cats. Approximately 43 million households own dogs and nearly 37.5 million households own cats. Why are these numbers increasing over 4% annually? Because people like the warmth and companionship of a dog or cat, pets help them set a routine, pets lessen stress levels and pet ownership is considered an investment in one's quality of life.

Tens of billions of dollars are spent annually on dogs and cats and this phenomenon is attracting unprecedented attention from private equity, venture capital, institutional investors and private family offices. The pet industry received heightened attention when it grew more than 5% year-over-year on average from 2007 to 2011 according to the American Pet Products Association while the rest of the economy was in a serious recession. The pet industry has not shown a decline in the last ten years and is expected to continue the upward movement because of the increasing appetite for dog and cat owners to keep up with the newest trends in pet food, treats and products. Pet consumers have proven to be steady, stable and open to spending more for basics as well as luxury items. According to the Wall Street Journal, 81% of respondents in a recent marketing survey said they would spend the same or more on their pets even if there was another recession and would be willing to cut their budgets elsewhere. This includes items such as pet outfits, personalized pet food and bowls, pet massages and acupuncture, electric tooth brushes for pets, vacations with pets, pet insurance, pet allergy experts, health insurance and pet sitters that cater to the pets at home.

Aware of increasing per capita disposable income and favorable consumer behavior trends, traditional retailers are offering additional high-end goods and services to differentiate themselves from new entrants. Pet Business reported that in 2010, 22.0% of retailers added pet-related services, such as grooming and pet boarding, to improve sales and profit margins and benefit from increasing spending on pet services, which increased from \$48.4 billion in 2010 to an estimated \$62.7 billion in 2016. IBISWorld expects that in 2016, the continued emphasis on pet services will be a primary sales driver. Specialty stores further differentiate themselves with exclusive access to ultra-premium pet products from manufacturers, shielding their business from big box and on-line competition. Differentiating efforts have been successful in maintaining year-to-year industry growth despite competition. Favorable economic and consumer behavior trends should further accelerate growth. Rising price-premium product and service sales has driven increased revenue for pet specialty retailers, resulting in a drop in wages as a share of revenue. These trends are expected to boost average industry profit margins to 8.1% of total revenue in 2016, up from 5.8% in 2010.

Here's a quick overview of the most prominent product and services segments of the pet industry focused on dogs and cats:

Day Care	From dog walking to pet adventure camps and play groups, opportunities exist to make sure consumers' pets are cared for during work hours.
Training	Obedience, agility and show training along with animal behavioral psychologists.
Boarding Services	When you are out of town, these services look after your pets, with accommodations available for every price and comfort level including home stays. No longer bare cages but upscale dog and cat "camps" are available.
Pet Supplies	From general product stores to designer name brands, there are thousands of options to fit every dog and cat's needs. Vending machines for pet supplies are coming soon for people and pets on the road.
Dog Food / Pet Food	This is the fastest growing sector with hundreds of new offerings in the past few years. Delivery services are available with gourmet menus and organic pet food offerings based on the dog and cat's specific dietary likes and need.
Grooming	Do-it-yourself pet grooming locations in many retail pet stores, all-inclusive spas, and pet massage services.
Waste and Odor Removal	Home visits are scheduled to sanitize homes, runs, yards and kennels. New innovative products are on the market such as Odor Klenz that uses natural minerals, not harmful chemicals.

One last pet service item that deserves recognition are the millions of pet owners that are writing wills to include the care of their pets for their lifetime in the style to which they were accustomed. So the next time you shoo a cat away or tell the neighborhood dog to behave, be careful, they just might be represented by legal counsel.

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Technology and the Oil Price: It's Different This Time



The high oil prices from 2008 through 2014, driven by emerging markets demand led by China, pushed the oil industry to explore and pursue new, unconventional, higher-cost sources of oil. Projects in oil sands, deeper water, the Arctic, LNG, and shale suddenly became economical and fundamental to the long-term strategies of many oil companies.

During that period, U.S. production grew from 5 million barrels per day to 9 million barrels per day, a growth increment representing approximately 20% of U.S. demand. The growth in production was a result of the shale oil boom in the U.S. which benefited from increased expertise and advancement in technologies as investment poured into unconventional resource opportunities. As illustrated below, from 2010 to 2015 technology developments caused a 35-50% reduction in the average costs for producing a barrel of shale oil, thereby economically unlocking vast oil reserves for production even as the oil price moved lower and growing supply outpaced demand.

Shale Oil Technology Developments Driving Down Cost



Illustration from National Oilwell Varco's November Q4 2015 Investor Presentation

As a result of the technology-driven cost reductions, the unconventional, higher cost sources of oil now have a break-even threshold in the range of \$50 to \$60 per barrel on average as opposed to the previous threshold in the \$100 range. Therefore, going forward as the oil prices go beyond \$50 to \$60, drilling activities will pick up and increasing supply will restrain the medium term oil prices from excessive increases. Unlike in previous oil price cycles, the world market has a new large source of accessible oil reserves, U.S. shale oil, that can be economically produced in meaningful volumes with the oil price in the range of \$50-60 per barrel. There has been a fundamental change on the supply side. While short-term spikes may cause higher or lower oil prices, prices in the range of \$60 to \$70 per barrel over the next decade would seem reasonable. Over the longer term, demand will continue to grow and a supply/demand balance should be reached that could support a stronger basis for oil price growth.

Downside and upside risks for the oil price include technological advances in alternative energy, supply disruptions due to wars or natural disasters, global GDP growth, emerging market growth, and government regulation. Could weakened OPEC economies lead to civil unrest and the threat of supply disruptions? Attacks on oil assets, geopolitical incidents, stepped up military activities or negative developments in OPEC countries could cause sharp spikes in oil prices which could remain in higher ranges for extended periods of time.

For struggling oil producers, while technology has played a role in causing their current financial challenges, technology is also a source of solutions to these challenges. The message from upstream producers and services companies is that they have accepted the new reality with regard to the here-to-stay oil price dynamics. Cutting costs and risks with technology is a fundamental part of their strategies throughout the chain including finding, producing, transporting, and processing oil while improving environmental safety and complying with increasing government regulations. For example, in Exxon Mobil's latest strategy presentation a key message is that they will apply technology to create value including: next generation seismic imaging, advanced reservoir modeling, digital surveillance technology, lower drilling and completion costs and increasing recovery. In early May 2016, in discussing the strategy, Baker Hughes CEO Martin Craighead stated, "Innovation is what we do best and what our customers need the most...More than ever, our customers need to lower their costs and maximize production...our employees are energized to turn our technology expertise into the latest game-changing product innovations."

Moore's Law suggests that technology can advance and improve at an exponential rate. If the oil & gas sector is indeed in a technological boom we may see even more improvements in costs and environmental safety over the next several years that could have significant financial and strategic impacts in the industry as well as in economies and geopolitics around the world.

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Recently you may have read in the press about a proposal by the US Department of Labor to impose a "fiduciary standard" on anyone advising an individual investor around a retirement account. The proposal has received tremendous opposition from many in Washington and the investment management and broker-dealer industry. It has also received significant support from many consumer advocates such as AARP, the Consumer Federation of America, and the Consumer Financial Protection Bureau. I have spent a great deal of my professional career as a senior international product development consultant (primarily Dick's Sporting Goods) with significant success in retailing, direct to consumer, supply-chain, product development, sourcing and product quality. Having spent many years either living Hong Kong or sourcing products in China, the following are my observations on doing business with the Chinese, their cultural norms and how the business paradigm may be shifting in China.



Chinese Labor Force

There are approximately 6-7 million students graduating from university each year in China and this number is increasing annually. Because of this high rate of graduates and the revised economic forecast, there are not enough skilled jobs resulting in high unemployment among new graduates estimated to be around 30%. High levels of educated Chinese are a new phenomenon and the resolution will require much stronger growth in China in the next five years. What differentiates these students from American students is that Chinese students struggle with analytical thinking, critical thinking and communication because they are taught to memorize instead of learning practical applications. Students lucky enough to plan on attending a university in the USA will take the SAT practice test repeatedly for years. This is part of the reason most Chinese students score so high on our admissions tests.

In spite of educational advancements in China and more relaxed Communist Party rules, the strict one child rule in China for decades has resulted in many rural Chinese families suffering from this policy. For example, if the child decides to go to college, he or she will move to the city leaving the parents behind. It is a tradition that the child take care of the parents in old age and if they child is absent or dies, then the parents have no one to care for them. This one child policy has also resulted in a shortage of young women because of the desire for most families to have a male heir.

In the 80's, 90's and 2000's, many workers were willing to travel hundreds of miles to find work in coastal factories. There was a backlash as millions of families wanted to stay near their family's original hometowns. To accommodate this China built up regional cities offering tax breaks, land, laws requiring new businesses to move there. This has led to the demise of the former coastal special economic zone. Factories in the former special economic zones have lost millions of worker forcing many of these factories to move or close. On a personal note, a factory I used went from 23,000 workers in 2000 to 3000 workers in 2015, due the lack of migrant workers. Many areas within the former economic zones are environment nightmares because no one was accountable for what happened to the land or factories.

China is no longer a low cost garment producer. Wage rates in China are not competitive for many products requiring intensive manual labor because of competition from other countries in Asia. Vietnam, Cambodia, Bangladesh and Myanmar offer much lower wage cost. The garment and footwear industry are good examples of businesses that have left China. The challenge to move to another country is again labor. China has more than 1 billion people, Vietnam 90 million, Cambodia 15 million, Myanmar 53 million, and Bangladesh 156 million. There is so much competition worldwide the key is holding garment and footwear manufacturing prices stable. The key is to get your factory in first and retain the workers. Competition for skilled works is ruthless. Often a competitor will find out what you're paying your skilled labor and then he will increase the wages in his factory slightly more in an effort to steal your employees. I've seen a bus parked outside a factory with a poster on the side offering higher wages. People literally quit that day and got on the bus.

Doing Business in China: Manners

In China, good relationships (guanxi) are the key to doing business. Dinner, social events, drinking, golf, and meeting family members helps solidify a good business relationship. "Face" in China is extremely important. If you can give sincere compliments or an acknowledgement then you are off to a good start. Because it is important to show respect at every visit, I made a point to introduce myself to any new people at business

meetings. Generally the exchange of business cards is the first step in establishing rapport. When a person hands you a card you are to study it for a minute, then place it in front of you for the meeting. I never knew who could actually read English so I always had two-sided business cards, one side in English, one in Chinese.

You may not see traditional Western table manners in China. Quite often one can forget them all together. For example, I have been at business dinners where the guests spit fish and beef bones on the table. Adding to the drama of the spitting ritual, it is customary to toast each person at the table. The only way to survive is to take small sips or better yet "save face" and a hangover and tell them you prefer beer not liquor.

Assuming you are still upright following dinner, you may get invited to a Karaoke room where everyone is expected to sing. Regardless of how bad you think you are, trust me, no one will notice. Volume counts much more than range.

And why go to all this trouble of spitting, drinking, and singing? Because in most Chinese businesses, regardless of size, the owner makes the pricing decision on goods. If a Chinese businessman wants to stop selling you their products, he simply raises the price so much that his business is not competitive and you have to go elsewhere. This is not always so easy when sourcing for large USA companies as I was doing. So if I wanted to use another supplier I always had the option of "saving face" by being priced out. Chinese logic? No, American.

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FRG News Corner



Adria D. Starkey has been a close personal and professional friend for many years. She is one of the shining stars in Naples because of her work in financial services and her involvement in the community.

We have provided a link to an article Adria has written on a very important topic for estate planning purposes. Adria is currently Executive Vice President & Collier County President of Finemark National Bank and Trust.

Estate Planning: Your Summer Mission!

Falls River Group advises on the sale of Feeders Supply Company LLC to PNC Riverarch Capital, a private equity firm.

The sale of Feeders Supply represents Falls River Group's second transaction in the pet food sector in the last 15 months, a growing industry vertical for the firm.

Learn about our most recent transaction below!

Pet Supply: Best in Class

Quote of the Quarter

**"The most unprofitable item ever manufactured is an excuse." -
John Mason**



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