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Megamergers Impact on Indian Agri Industry

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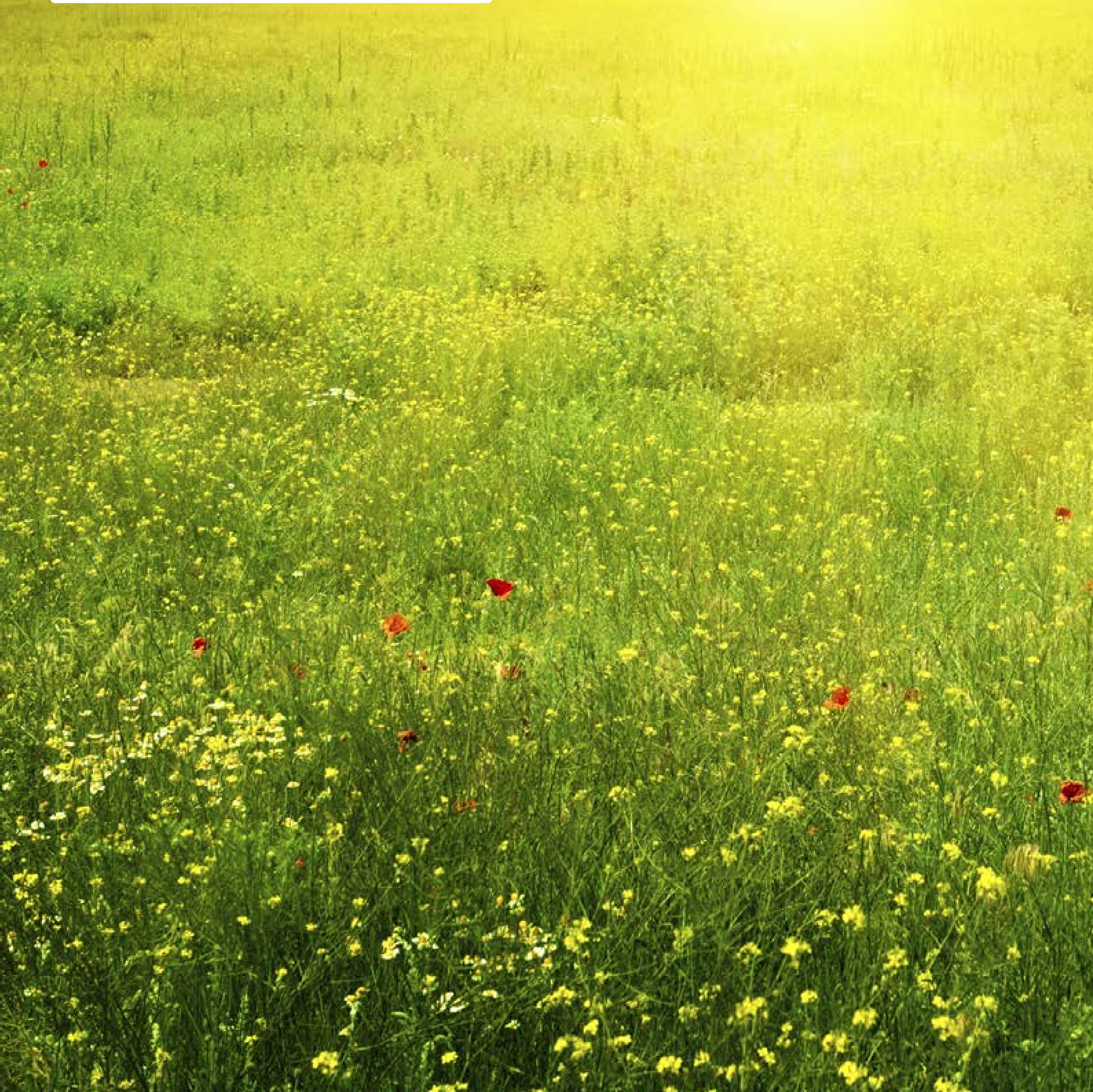




Winds of change in the agro-chem industry

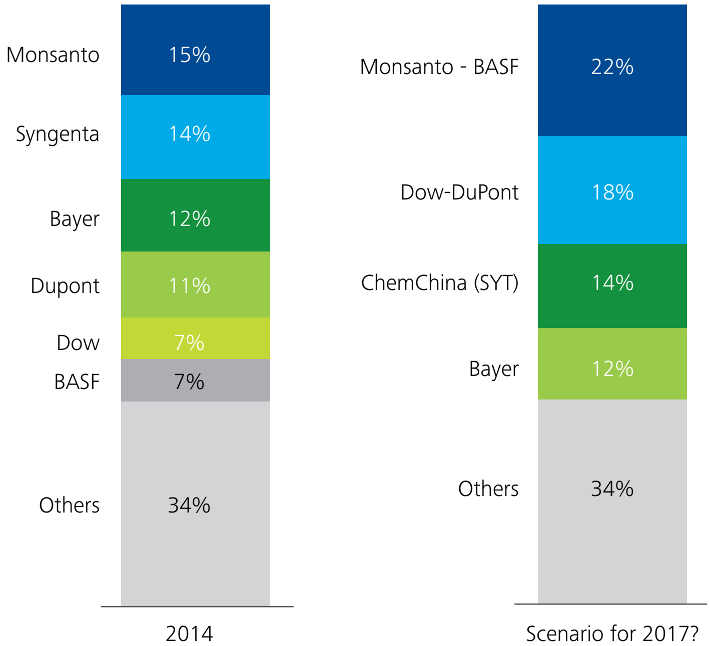
The world is becoming truly globalized with flutters of any major business shifts in one part of the market being felt immediately across the globe. Consider this: farmer incomes in the US have dropped by nearly 43% since 2013. This in turn will have a profound impact on how farmers in India buy agri-inputs from seeds, to nutrients, to crop protection. What is driving this change?

Sustained de-growth in commodity prices globally is leading to a shake-up in the agri-industry. The recent announcements of a ~$130bn merger between Dow Chemical and Du Pont and the ~$43bn ChemChina – Syngenta deal have pushed the remaining global as well regional and local players back to the drawing board to evaluate the impact of these tectonic shifts and decide their next course of action.

Further, the big M&A frenzy is not over yet - Monsanto is expected to look for an acquisition, BASF and Bayer are the only likely targets with the required scale and size. The end-state would thus be a polarized industry with four giants (4Gs) controlling ~55-60% of the global market (as against the 'Big Six' currently). Assuming the 4Gs take 12-18 months to integrate, there will be a relatively small opportunity window for regional and local players to reposition themselves so as to stay relevant and competitive in the post-consolidation era.

These changes assume greater significance for India, given that it's affecting one of the largest sectors (agriculture accounts for ~16% of GDP) of the 3rd largest economy in the world. What will be the impact on Indian companies and how will they react to these market shifts?

From 'The Big Six' to 'Four Giants (4G)' – Global Crop Protection and Seeds Market (share in %)



Imperative for Indian Agri-Companies

While the primary trigger for the global transactions has been cost-efficiency and access to technology, there will be significant implications on the market-side in all major agri-markets across the world.

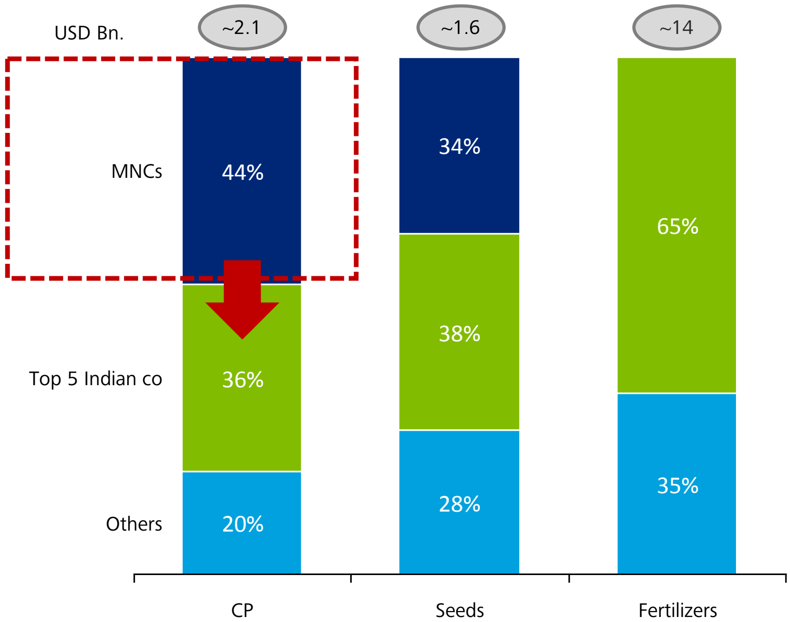
The Indian market is evolving as farmers become increasingly aware of and open to the use of better / newer technology. The channel landscape is also becoming more organized as distributors and retailers become larger, thereby improving access to the farmer. The pace of change will only accelerate as sophisticated competitors consolidate and increase scale. In addition, the sector is set to benefit from increased government focus. In the FY16 budget, the government has telegraphed its intent of doubling the farmer income through initiatives such as the introduction of Krishi Kalyan Cess, expanded coverage of irrigated land, etc. The industry's outlook appears even better with the government planning to bring the fertilizer industry under direct benefit transfer — a step that will improve overall profitability for the sector.

On the flip side, threat of price controls, arising out of potential dominance of one company in a specific niche (e.g., Monsanto controls ~85%+ of the BT cotton market in India), may lead to cautious investments & product introductions by global MNCs while impacting the extent of R&D and innovation-focused investments by Indian companies, similar to the behavior of the pharmaceuticals sector.

Sustaining growth in this post-consolidation and highly dynamic era will thus require Indian companies to re-evaluate their portfolio strategy. As Indian companies seek to create defensible positions, scale players will find themselves advantageously placed. Consider the example of fertilizers: in a segment characterized by limited new capacity build-up, an old asset base and low profitability, companies with scale advantage and having the most efficient operations will be the winners.

However, long product development cycles and even longer product registration cycles make it challenging to rapidly grow scale organically in the Indian market. Indian companies will have to resort to inorganic growth when looking to develop scale. Given the strong growth story of India and precedence of successful companies having taken this path, it is imperative for Indian companies to go to market with a consolidated base, thereby creating a differentiated and sustainable play.

MNCs are consolidating and expected to grow faster – Indian Agro-chemicals Market Landscape (share in %)



Buy: Potential inorganic plays

Indian companies have to think about the available M&A options available and grab the right opportunities to be well-positioned for the future. ‘Ambition Matrix’ (see below) is a simple and effective tool that lays down three potential inorganic plays for Indian companies.

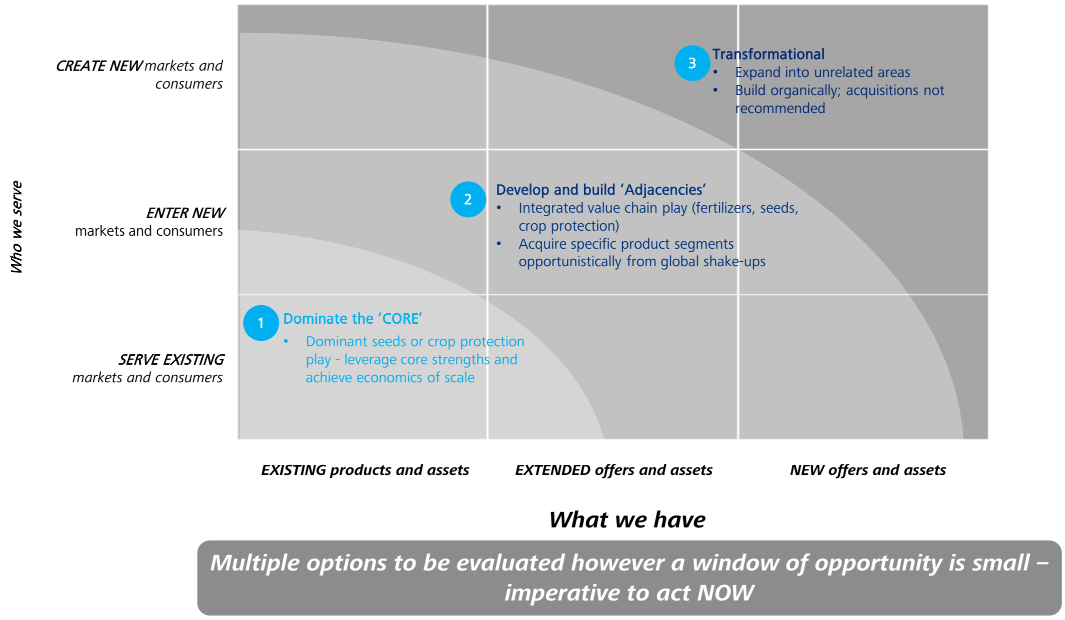
1. Dominate the ‘CORE’:

Pursuing ‘Core’ growth requires companies to strengthen presence in existing product segments in existing markets. However, the rationale for following this strategy may differ depending on the industry segment. The fertilizers segment has little brand or product differentiation and hence consolidation will largely be a capacity play. Zuari’s acquisition of MCFL is a recent example of such expansion. With the exception of Urea assets, which companies are reluctant to acquire due to challenges with feedstock (natural gas) availability, M&A within the fertilizers business can be a significant opportunity. On the other hand, in Seeds, acquiring a differentiated portfolio will drive consolidation as brand and product R&D gain significance. Similarly, portfolio (patented molecules) and distribution channel strength will be the key drivers for consolidation in Crop Protection.

2. Develop and build adjacencies:

Adjacencies will help companies expand and diversify their footprint and enhance their share of wallet in the channel and with farmers. Coromandel, a fertilizer company, developed a diversified play through its acquisition of Sabero which provided access and entry into the crop protection business through its insecticides play.

Ambition Matrix



3. Transformational play.

In this strategy, companies move from pure agro-inputs to become an agri-science company as they start addressing end to end needs of the farmer beyond agro-inputs. Companies start pulling multiple levers to have a deeper engagement with the farmer, influencing both elements of his economics – produce volume or farm yield and price realization for the same. Direct agro-inputs are only one way of improving farm yield. Firms can consider addressing other aspects, e.g., leveraging mobile technology to improve timely flow of crop-related information to the farmer, investing in innovative systems like drones which can be used by farmers to conduct aerial farm surveys and make informed decisions on application of seeds and pesticides. Similarly, price realizations can be improved by companies setting up forward end-market linkages. Organizations can develop a portfolio of products and services with this view and such opportunities will truly be transformational in nature. Through such a journey, significant long-term value can be unlocked for both the farmer and the company.

Currently, companies in the Indian agribusiness sector have not fully undertaken this approach. This strategy requires deep agri-science capabilities, higher investments, and risk appetite – typical issues Indian companies are circumspect about. However a few close examples in the Indian space do exist where fertilizer companies (e.g., Deepak Fertilizers and Nagarjuna Fertilizers) have diversified into forward market linkages, post-harvest solutions, drip irrigation, etc.

‘Acquirer’ and the ‘Acquiree’

On the basis of financial strength of Indian agri-companies, fertilizer companies appear to have the required scale of operations and financial strength to initiate an acquisition. In addition, the fertilizer industry is also struggling with low profitability (~2-5%) and has been evaluating options to improve its P&L. Higher average profitability in crop protection (~5-10%) and seeds (~10-15%) segments offer an attractive related diversification opportunity.

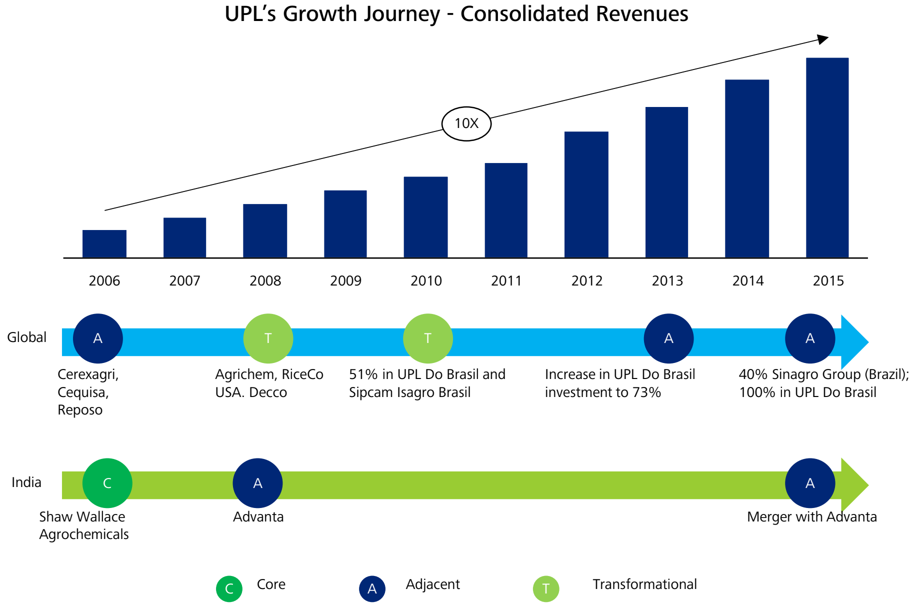
While seed companies have a better profitability profile, fertilizer companies appear to have better operational synergies with crop protection companies. Seeds is a fundamentally different business and requires different capabilities for a successful play. Whether it is the required organizational capabilities in product R&D and sales or the engagement with channel and farmer, seed companies operate very differently. Crop protection, on the other hand, is a relatively similar business and has natural synergies with the fertilizer business. In fact, many fertilizer companies are already entering the crop protection space (e.g., Zuari Agro), although it currently accounts for only a small share of their portfolio.

‘Big Bang’ or ‘String of Pearls’

Although companies can follow the footsteps of the 4Gs and go for a ‘Big Bang’ acquisition (similar to Dow-DuPont or Syngenta-Chemchina), there is a greater inclination towards a ‘String of Pearls’ strategy. Small is, in fact, big when it comes to shareholders' returns for acquirers. A study of 723 deals - domestic as well as outbound - since 2005 shows that small deals have been more beneficial to shareholders than big-ticket buys. The average deal size for companies that delivered positive returns to shareholders is $160Mn. This is against an average size of $283Mn for deals that delivered negative returns. A ‘Big Bang’ approach can be expensive in a growth market such as India. Indian companies are better at creating value from small transactions. In contrast, there have been multiple successful precedents of Indian companies in the agri-space creating value from multiple small acquisitions over a period of time.

For instance, UPL has grown 10x in 10 years through more than 20 acquisitions globally. Coromandel has also seen healthy growth on the back of multiple acquisitions such as Liberty Phosphates, Godavari and Sabero. Multiple opportunities for relatively smaller acquisitions exist in the Indian market (small or niche seed companies as an example). Depending on the maturity of their product pipeline, these can be attractive opportunities which larger fertilizer companies can evaluate.

UPL’s Growth Journey - Consolidated Revenues



Conclusion

Indian companies should use the Ambition Matrix to ask the pertinent questions of where to place bets and how they should configure their future portfolio. When evaluating their portfolio options and desired positioning in the agri-market, companies can choose from a mix of three strategies viz. Core, Adjacent and Transformation play. Companies like UPL have placed bets across the three strategic planks pushing for all-round growth across all segments in the value chain. The last area to address for an inorganic growth play will be to choose between 'Big Bang' vs 'String of Pearls'. Indian companies have a small time window to move swiftly and place themselves in a position of strength before the dust settles down and MNCs get through the transition period of post-merger integration challenges. While agri-business has generally lagged in the field of M&A, we see that changing going forward as companies try to create opportunities to sustain and grow in the ever-changing market environment.

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Major Agri-business Company Websites

Prowess Database for latest company financials in India

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