

Customer & Market Due Diligence Of Flexible Packaging And Labeling Converter: Quickly Evaluating Customer Relationship Strength, Competitive Positioning And Commodity Price Risk

The Challenge: Our client was evaluating an opportunity to provide capital for an independent sponsor's acquisition of a regional family-owned flexible packaging and labeling business. The client had signed an LOI on the basis of the target's history of strong growth, positive market trends, and management's claims regarding customer relationships, and needed a focused customer & market due diligence to validate the investment thesis. Accordingly, the client engaged Gotham to: 1) establish the strength of the target's customer relationships; 2) assess growth opportunities with existing customers; 3) establish the target's competitive positioning; and 4) establish the target's sensitivity to commodity price variation.

Rapid Assessment of Family-Owned Company Positioning: The small size of the deal limited the due diligence budget, so Gotham designed a focused approach that leveraged our proprietary knowledge and databases in order to quickly address the client's most important concerns:

- **Market Dynamics:** Leveraging our proprietary flexible packaging knowledge base, Gotham established market size, segmentation, and trends by packaging type (e.g., basic protection, complex barrier, pouches), label type (e.g., pressure-sensitive labels, shrink sleeves), end-market (e.g., food & beverage, household goods, medical, chemical), and material type (e.g., polyethylene, polypropylene, PVC). Because the target focused on specific niches of the flexible packaging market, we analyzed growth trends/drivers and packaging type/material trends to establish market dynamics for the subsegments within these niches (e.g., basic protection bags for household goods, candy/confections, and baked goods).
- **Competitive Landscape:** Gotham established the competitive landscape by leveraging our interview-based proprietary database of flexible packaging and labeling companies, enabling us to quickly identify and profile the target's key competitive set (e.g., revenue from flexible packaging/labels, printing equipment/capabilities, number of employees/facilities, target end-markets, product categories, recent acquisitions). Given the niche and regional nature of the target's business, we also interviewed ~10 small direct, local competitors whose profiles were not already in our database.
- **Customer Relationships:** As is typical of family-owned businesses, the seller was sensitive about customer interviews, so we worked closely with management to address their sensitivities while developing the questionnaire. Due to those sensitivities, the seller only permitted customer calls once all deal-related issues were finalized, leaving a mere few days for customer interviews. Nevertheless, Gotham successfully interviewed all 12 authorized customers and gathered the necessary insight for the client to feel comfortable with the deal.

Commodity Price Risk Is Manageable As Prices Are Regularly Adjusted Based On Visible Underlying Commodity Price Index

To evaluate the target's exposure to plastic resin price volatility, Gotham reviewed the target's vendor/customer agreements and found that the target used informal price adjustment mechanisms for ~80% of film purchases and product sales. To validate management's claim that informal mechanisms effectively minimized exposure to commodity price volatility, Gotham analyzed purchasing/sales data to demonstrate that the target's film prices closely tracked the underlying commodity price index and then confirmed the effectiveness of informal price adjustments through customer interviews. Gotham quantified the potential impact of commodity price changes by developing best/worst case scenarios and calculating the impact of those scenarios on EBITDA margins, with the worst case exposure to resin price increases translating to a ~1% point decrease in EBITDA margins for each 5¢ increase in resin prices.

Target's Profitability Sensitivity To Resin Price Increases

Resin Prices Increase By 5¢

	Theoretical Worst Case Scenario		Target's Worst Case Scenario		Neutral Scenario		Target's Best Case Scenario		Theoretical Best Case Scenario	
	Base	Increase	Base	Increase	Base	Increase	Base	Increase	Base	Increase
Vendor Prices	Base	Flat	Customer 1: Increase Rest: Flat	Flat	Flat	Flat	Flat	Flat	Flat	Flat
Customer Prices	Base	Flat	Flat	Flat	Flat	Flat	Flat	Flat	Flat	Flat
Total Sales	\$100X	\$100X	\$100X	\$100X	\$100X	\$100X	\$100X	\$100X	\$100X	\$100X
Film Cost	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X
Other Material Costs	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X
Other Costs	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X	\$10X
Total Cost Of Sales	\$30X	\$30X	\$30X	\$30X	\$30X	\$30X	\$30X	\$30X	\$30X	\$30X
Gross Margin	\$70X	\$70X	\$70X	\$70X	\$70X	\$70X	\$70X	\$70X	\$70X	\$70X
Gross Margin %	70%	70%	70%	70%	70%	70%	70%	70%	70%	70%
EBITDA	\$50X	\$50X	\$50X	\$50X	\$50X	\$50X	\$50X	\$50X	\$50X	\$50X
EBITDA Margin	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%

Target's Operational Capabilities Position It Well Vis-à-Vis Both Large And Small Players

From our industry experience and competitor database, Gotham had an ongoing understanding of the basis of competition and go-to-market strategies for both large and small printers. Large players compete on cost, typically produce film internally, and work on long runs; small players compete on short lead times and superior service and focus on smaller volume, short-run business. We supplemented our ongoing knowledge with a brief conversation with management and competitor interviews to quickly establish that the target's top-tier flexographic press was on par with larger players' and better than many smaller players', allowing the company to take full advantage of market trends toward high quality graphics with multiple colors per job. Customer interviews showed that the target's lead times and ability to handle urgent orders was much better than any competitor's, which, along with the target's top-tier press, gave the target an advantage over both larger and smaller competitors for smaller volume, short-run business.

Target Has Opportunity To Gain Share Of Wallet As Customers Consolidate Vendors

While the client was initially concerned that a trend towards vendor consolidation might threaten the target's revenue, Gotham found that to the contrary, vendor consolidation regularly led customers to award the target business from competitors due to the company's excellent responsiveness. Customers particularly appreciated the target's reliable delivery, accessibility of top management, and ability to collaborate with customers on new, time-sensitive jobs. Vendor consolidation should continue to benefit the target moving forward, as customer loyalty is very strong. For example, one customer indicated that they might even bid the printed business separately from the unprinted business to give the target a better chance of winning the printed business.

The Outcome: Gotham's rapid assessment of market dynamics, customer relationships, the competitive landscape, and commodity price risk gave our client the confidence to provide the necessary capital to complete the acquisition.