



## Cameron Partners Insight Series

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### The Food & Beverage Industry – How has it fared in the credit crisis? Where to now?

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#### Introduction

It has been a tumultuous time, both locally and offshore, since Cameron Partners' last Insight Series article on the food and beverage industry was published a little over 12 months ago (*"Food Industry Acquisitions Set to Continue"*, Nov 2007).

The previous article focused on the key drivers behind the high number of food and beverage (F&B) transactions and contended that activity in the sector was likely to continue.

Were we right? What's happening now and where are we headed?

This article looks at recent developments including, most significantly, the impact of the credit crisis which was emerging around the time the last article was published but has fully bloomed in the past six months. We examine what this means for NZ F&B companies in the near future.

#### What's been happening?

In our last article we discussed two key trends:

1. The move towards healthier and higher quality foods and drinks.
2. The push for increasing consolidation of the sector to match retailer power.

Our conclusion was that the strong interest in the New Zealand F&B sector was likely to continue in the medium term. This conclusion was driven by a view that these trends were powerful and by their nature, not dependent on a continuation of a strong economic environment. Essentially, whatever the environment, M&A activity in the sector would continue.

The last 12 months has provided a strong test for M&A activity:

1. The credit crisis has seen the availability of credit plunge with banks here and abroad seeking to reduce their exposures to companies and shareholders.
2. "Accepted" levels of leverage for any given cash flow/asset base have reduced significantly.
3. A large and broad based rise in input prices via commodity price increases. More recently these have reversed just as quickly (together with the exchange rate), but the benefit of these falls is only likely to be felt once existing stocks run through – probably from Q2 2009. There is also the question of how quickly FMCG manufacturers will need to pass on the benefits of falling import prices to consumers.
4. A change in consumer behaviour – from June 2008, there was a noticeable change in consumer buying habits reigning in

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discretionary expenditure and changing purchasing habits (focus on house brands, cooking at home, staples, value focused etc).

The first two factors have affected balance sheets, impacting the ability of acquirers to fund deals or take advantage of market opportunities. The latter two have directly impacted on company profitability (higher costs, lower revenue growth) and thus the attractiveness of deals and/or willingness of vendors to consider an exit.

### M&A activity

Despite the difficult local and global environment since our November 2007 article, Cameron Partners has led a number of deals in the F&B industry sector involving local companies - including advising Old Fashioned Foods on the sale of Baker Hall fruit syrups to Coca-Cola Amatil, advising Brandlines on a sale of the business to Crescent Capital Partners and advising Prolife Foods on the acquisition of the Mother Earth brand from Cadbury. We also advised the under-bidder on the Frucor sale.

Cameron Partners' database of New Zealand M&A transactions over the last five years highlights some interesting statistics.

The last 12 months (i.e. calendar year 2008) has actually seen more successfully completed F&B transactions than for calendar year 2007 – 12 in 2007 versus 16 in 2008. In 2008, F&B has also accounted for a higher proportion of all deals at 13% versus only 7% in 2007. This rise was assisted by a drop in total transactions completed with 180 transactions closed in 2007 compared with 125 in 2008.

Also interesting is the purchaser mix in deals completed. In 2007 there were 7 private equity deals and 5 trade deals but in 2008, of the 16 transactions, only one was led by private equity. The other 15 deals were all completed by trade players.

What about the type of deals being done? In 2007 roughly half of all deals were stand alone deals with the other half being consolidation based deals. 2008

saw a dramatic change – 94% of all deals were consolidation based with only 6% being stand alone investments.

In terms of deal size, while both years saw some large deals such as Independent Liquor (2007) and Frucor (2008). The average and median deal size in 2008 was greater than in 2007 - the median deal size was \$88m in 2008 and \$55m in 2007.

The country of origin of the buyers has also changed over the last 12 months. In 2007 42% of acquirers were NZ domiciled but this has increased to 56% of all deals in 2008.

### Valuations – its not all bad news

At the time of writing the previous article in November 2007, there was much market discussion about whether the high prices being realised could be sustained.

The New Zealand stock market was down by 33% in 2008 and the Australian market even more at 39%.

So what has happened to sale prices of food businesses – are they lower by a similar amount?

The answer is no – but it is not straight forward. For a start the NZX contains only one food company (GFW) and thus is not a reliable indicator of relative performance of the F&B sector. In Australia the F&B sector performed significantly better than the wider market in 2008 and was down by only 16% (versus 39% for the total market).

However, the vast majority of F&B transactions in NZ are private and this market is a better indicator of pricing than looking at other listed markets such as Australia.

In this respect the good news is that the prices achieved over the last 14 months have been surprisingly strong and have held up well against prices achieved in 2007. Analysis of our database shows the median forecast earnings multiple (measured by EBITDA) was only 5% lower than in

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2007. The median forecast EBITDA multiple achieved in 2008 was 7.0x versus 7.40x in 2007<sup>1</sup>.

This may appear odd given the weak general market conditions, however we note:

1. The food and beverage industry has well acknowledged “defensive” qualities (e.g. many foods and beverages are staples; people tend to eat at home more; impulse buying tends to hold up) and as such tends to perform better in a downturn.
2. The majority of transactions have been strategic – where the buyer has access to synergies (lower costs, higher revenues or better market position) which have the effect of lowering the overall cost of an acquisition.
3. Parts of the food industry continue to be perceived as a high growth sector and as such multiples have held up better than for other sectors – especially for branded products.

The Frucor deal in November 2008 highlights the points made above. The transaction price was impressive - in excess of 12x forecast (March 2009) EBITDA. The business is growing strongly, primarily courtesy of V, which has been a star performer here and in Australia - the brand has global potential. Other parts of its brand portfolio are defensive e.g. Just Juice.

However, less talked about and more obscure is the strategic value of Frucor to the successful acquirer, Suntory. Suntory has a close relationship with Pepsi Co, including owning Pepsi’s bottling business in the US since the 1980’s and markets and distributes Pepsi products in Japan. Frucor owns the Pepsi bottling licence in New Zealand but under Danone ownership has never really pushed Pepsi’s products given the superior margin it earns by pushing its own products via its extensive fridge network throughout the country (and in Australia). Essentially, this has meant Coke has been able to dominate the carbonated drinks market.

No longer. Expect the well known “Cola Wars” between Pepsi and Coke to re-emerge and to lead to further consolidation of the beverage industry. Indeed, the

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<sup>1</sup> Note, we favour using analysis of medians to eliminate outliers, although we note if we used averages the results would be similar

acquisition by Coca Cola Amatil (CCA) of the Baker Hall brand of fruit syrups (owned by Old Fashioned Foods) is evidence of this. It will extend CCA’s brand footprint into cordials and provides them with a potential growth opportunity to extend Baker Hall into the route trade.

Another interesting aspect of the Frucor deal was the participation of a number of Japanese brewers and distillers who are looking to diversify away from alcohol and outside of their home markets. These buyers have enormous fire power, no funding issues and a willingness to pay high multiples for strategic brands. There has been further evidence of this in Australia with the likely purchase of Cadbury-Schweppes Australian drinks operations by Asahi and Kirin’s purchase of National Foods. Such interest is likely to expedite industry consolidation.

So while Frucor achieved an additional premium recognising the unique strategic territory up for grabs, - other completed transactions over the last year have also recorded strong prices – including deals involving La Bonne Cuisine, Open Country Cheese, Mr Chips, Mother Earth and Baker Hall.

The key common ingredient to all these transactions? Trade buyers with synergies or other unique market opportunities for the acquirer.

Direct Capital’s minority stake investment in NZ King Salmon is interesting in that it is the only stand-alone investment in the F&B space in the last 12 months. It was completed at close to 7x forecast EBITDA – a good price - but one which recognises the strong historic financial performance of the business and the fact the business is extremely well placed to excel in the shift towards healthier foods with salmon’s well known high nutritional protein providing a strong selling point to consumers.

### Where to from here?

From our extensive transactional involvement (across all transaction types) there is little doubt that transactions are more difficult to complete.

Common themes making completion tougher are:

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1. Fewer "real" buyers.
2. More in-depth (and longer) due diligence by buyers.
3. More emphasis on actual rather than forecast earnings driving valuation (this is not to say forecasts are not considered, but there has to be strong evidence to support forecasts).
4. Shifting demand patterns impacting current results (uncertainty).
5. Fewer funding options – both debt and equity.
6. Lower funding capacity – banks appetite to lend has diminished.
7. Significantly longer time required to get banks comfortable with a deal (for buyers).

While getting a deal done may be tougher than before the credit crisis, transactions are still being completed and the volume of F&B transactions is higher than before the credit crisis (and a significantly higher proportion of all deals being completed).

We continue to be positive about the prospects for ongoing activity in the F&B sector in New Zealand. The reasons for our optimism remain the same as stated in November 2007:

1. Industry consolidation will continue as firms look for scale economies to lower unit costs or to improve their channel power in response to dominant retailer (supermarket) power.
2. The perception of the food industry as a high growth sector combined with the global focus on health continues to drive the "mainstreaming" of healthy / high quality food and beverages.

Having said this, the fact that buyers are no longer queuing up at the door means, more so than ever, if considering a sale of some/all of a business - significant pre-evaluation work is essential to achieving a successful outcome.

A first step is to ensure the "right" buyers are in a position to seriously look at the business/assets for sale. If not then it makes sense to hold off until they are. Information needs to be accessible, easily understood and well presented.

Often, some of the key messages buyers are looking to see do not come through clearly enough. For example:

1. Lack of a history of sustainable profitability. Where there have been "hiccups" these need to be explained and backed up by market evidence.
2. Poor (or no) detailed record of financial forecasts. These should be backed by analysis of market data which can be validated.
3. Analysis and explanation of current run rate and expected performance against budget.
4. Lack of well developed business plans for the each of the operating units.
5. Lack of core capability in key areas - strategy, planning, sales and marketing.
6. A simple and easily understood structure.

## Concluding insights

We believe market conditions are unlikely to improve quickly and the recessionary environment is likely to remain for some time.

In this environment, the biggest risk for companies is to do nothing. Most companies will already be focusing on balance sheet rebuilding by reducing capital expenditure, retaining cash (lower shareholder distributions) and improving working capital management. However the real winners will be the ones who can also:

- Respond early and decisively – e.g. strengthening the balance sheet (cash) will increase flexibility and provide opportunities.
- Review and revise business strategy.
- Accurately identify opportunities and threats.
- Be proactive.
- Grow and acquire – there will be attractive acquisitions with limited competition.
- Invest in proactive marketing strategies and launch new products focused on the new demand environment.

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