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Bite Size

Recent activity in the food and beverage sector

Summer 2014

Welcome to the latest edition of 'Bite Size', our quarterly overview of activity in the food and beverage sector. This edition provides analysis of M&A activity in the second quarter (Q2) of 2014.

In this issue we also take a look at the factors companies should consider when managing their working capital. In addition we present a case study of Warburtons, the leader in the bread market, which provides an excellent example of successful innovation in a tough competitive industry.

We hope that you find this newsletter useful. If you have any further questions or queries, or would like to know how Grant Thornton can help you and your business please do not hesitate to contact me.

Trefor Griffith
Head of Food and Beverage, UK
T +44 (0)20 7728 2537
E trefor.a.griffith@uk.gt.com

In recent years, working capital pressures in the F&B sector have been driven by a number of factors including input cost inflation and retailer demands around increased discounts, extended payment terms and enhanced service level expectations. So how well are F&B companies responding to the challenge?

The answer is with mixed results. A company's size, position in the supply chain and geographical location of its customers and suppliers will all have a major bearing on what good looks like. Regardless of these factors, however, there is still plenty of 'self-help' available with those companies who treat working capital as an organisational responsibility, rather than simply a finance problem, being the ones at the forefront of best practice.

Some of the practices we are working with leading companies to implement are as follows:

- Increased collaboration across the supply chain with customers and suppliers sharing information to support accurate demand forecasting, supporting optimal manufacturing and procurement
- Effective operations planning driven by strong levels of internal coordination and information sharing between sales, manufacturing and procurement
- Utilising full end-to-end visibility and understanding of the economic impact of customer and supplier working capital performance to support discussions around payment terms and decision making - especially in relation to rebates, incentives and discounts
- Transparent and consistent payment policies that are adhered to, moving away from an approach of making tactical supplier payment holds around reporting period ends
- Clear organisational roles and accountability for credit control including appropriate customer segmentation driving business rules around collection strategies with timely and effective dispute identification and resolution
- Working to ensure the accuracy of master data files to improve the accuracy and timeliness of billing as well as supporting more effective account management

What is clear is that adopting a proactive approach to managing commercial agreements, driving consistent processes based around an understanding of best practice and tightening controls can have a transformational impact on cash flow. We have supported clients in delivering sustainable release of cash from working capital often exceeding 5% of annual turnover.

For more information please contact:

Mark O'Sullivan
Partner, Working Capital Advisory
T +44 (0)20 7728 3014
E mark.osullivan@uk.gt.com

Warburtons

Warburtons have been baking bread since 1876 and are one of Britain's favourite bakers. Please refer to the back page to read about their success.

M&A activity – Q2 2014

Quarterly deal value doubles

The overall picture of deal activity in the second quarter is a positive one. Total food and beverage deal value rose significantly in Q2 2014, rising by 109% compared with the first quarter and by 16% compared with Q2 2013[1].

In contrast, overall deal volume fell by 24% in Q2 compared with the first quarter of the year. However, taking the first and second quarters together, deal volumes in the first half of 2014 were 5% higher than in the first half of last year. Soft drinks and wholesale and distribution were the most active sub-sectors, each accounting for 17% of quarterly deal volume.

Indicative of the stronger UK economic climate, distressed M&A activity also declined, dropping by 38% between the first and second quarters of 2014[2].

From a thematic perspective the second quarter provides further evidence for a number of the underlying trends that have been driving M&A activity in recent quarters: portfolio optimisation by the large global players, geographic diversification and ongoing interest by private equity (PE).

Portfolio optimisation

The quarter's largest deal, the £1.3 billion acquisition of Unilever's Ragu and Bertoli pasta sauce brands by Japan's Mizkan Group, illustrates portfolio optimisation from the seller's perpsective.

For Unilever, divesting its pasta sauces business is part of its ongoing strategy to move away from food to focus more on FMCG categories. The deal follows Unilever's sale in the first quarter of its meat snacks business, which includes Peperami in the UK and Ireland, to US meat snacks group Jack Link's.

The other side of the portfolio optimisation theme is evident in the buy and build strategies of many companies lower down the market capitalisation scale. There is strong activity among middle market companies to build an optimal portfolio by expanding their presence through acquisitions of complementary businesses - such as Golden Acre Dairy Foods acquiring Elsinore Foods, Orchard Valley Foods acquiring Food Ingredients International and Bart Ingredients expanding into wet foods with the acquisition of OTP Foods.

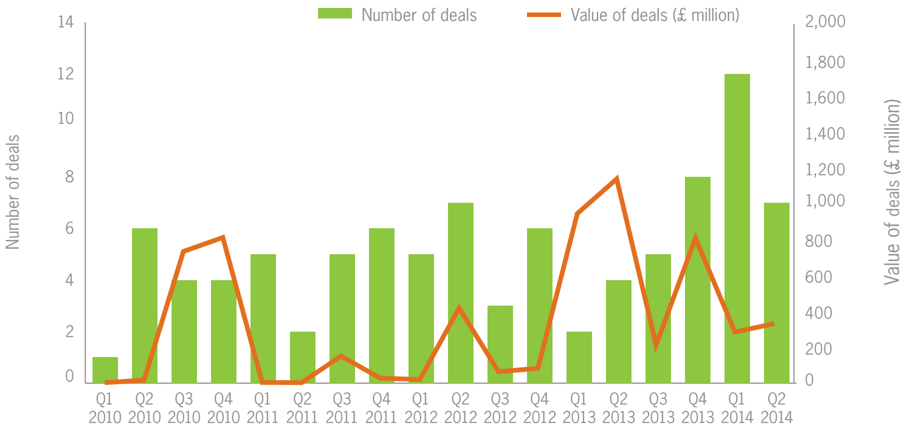
NPD and geographic diversification

For Mizkan, the Ragu deal represents a further geographic diversification away from the Japanese market in pursuit of a more global footprint in categories that it is already familiar with. The acquisition also offers an opportunity to focus on the new product development (NPD) opportunities provided by a well-established brand. The Ragu deal follows Mizkan's acquisition in 2012 of Branston from Premier Foods and in May Mizkan rolled out its first NPD since acquiring the brand, announcing the launch of five new relishes.

The themes of geographic diversification and the NPD potential of target companies were also evident in some of the smaller deals in the quarter. Cott Beverages, the UK subsidiary of Canadian soft drink manufacturer Cott Corporation, acquired UK food and beverage group Aimia Foods for $80 million (£47.7 million) to gain access to new categories and expand its customer base. Cott said that the acquisition brought a strong hot and cold beverage platform and multiple foodservice relationships into its portfolio. About 85% of Aimia's sales are in categories in which Cott is not currently represented.

Announced M&A activity in food and beverage - quarterly

Announced PE activity in food and beverage - quarterly



NB: the spike in 2010 deal values is attributable to the Q1 acquisition of Cadbury by Kraft for £11.9 billion

Optimism and appetite

Continuing appetite for M&A is apparent among both potential acquirors and vendors in the food and beverage sector. Against a more upbeat economic backdrop, valuation multiples are rising. A business that previously would have been valued at 6x EBITDA, might now be worth a 7x multiple. The increase is being driven in part by buoyant equity markets and by the availability of debt on borrower-friendly terms. In June, for example, frozen food maker Iglo, which is owned by private equity group Permira, announced a $2.2 billion covenant-lite loan and bond refinancing.

Permira is also reportedly considering listing the business. While IPO activity has been less in evidence among F&B manufacturers than in some other sectors, it is one of the options being considered by both PE and trade owners. Earlier this year, for example, Brazilian meat producer Marfrig announced a £170 million investment into its Moy Park business in Northern Ireland and CEO Sergio Rial said that the group was looking at an IPO of overseas businesses that could include Moy Park.

Whether or not these companies are brought to market, the fact that the IPO market remains open – in July, airport and train station food retailer SSP successfully listed – provides vendors with additional options and we remain optimistic about the M&A outlook.

Deals summary – Q2 2014

Also on the geographic diversification theme, Swedish confectionery company Cloetta acquired Aran Candy, the Dublin-based firm, which owns the Jelly Bean Factory brand, for €15.5 million (£12.6 million). Aran Candy, which manufactures gourmet jelly beans, exports more than 98% of its production to 55 countries.

Private equity still in the hunt for innovative niche brands

The number of PE deals fell by 42% in Q2 2014 compared with the previous quarter, but this was more a reflection of the strength of activity in Q1 than weakness in the last three months. Indeed, first half PE deal volume has already matched the total for the whole of 2013. PE total deal values in Q2 2014 also increased by 17% compared with the first quarter.

In May, R&R Ice Cream, which is owned by French PE group PAI Partners, agreed to buy Australia's Peters Food Group from its private equity owner, Pacific Equity Partners, for A$450 million (£247 million). R&R is Europe's second-largest ice cream maker and its licensed portfolio includes Mondelez and Nestle brands such as Cadbury Dairy Milk, Milka, Kit-Kat and Oreo. The purchase of Peter's, Australia's leading ice-cream manufacturer, is R&R's first overseas expansion outside Europe.

In June, Purity Soft Drinks, which is backed by Langholm Capital, acquired Firefly Tonics for an undisclosed sum. Firefly makes botanicals and blended fruit juices free from artificial colours and flavourings, which it exports to more than 40 countries. Purity said that Firefly's innovative range of all-natural premium juice drinks would be complementary to its Juiceburst brand. Langholm has previously made successful investments in the F&B sector, including Tyrells and Dorset Cereals.

Langholm also provided backing for The Bart Ingredients Co.'s buyout of OTP Foods. Bart, a supplier of herbs and spices, last year moved into wet ingredients with the launch of sauces and marinades. The acquisition of OTP, a specialist in wet ingredients, furthers Bart's diversification strategy.

Mid-market PE firm LDC backed the MBO of Ministry of Cake from listed food producer Greencore in a deal valued at £11million. Ministry of Cake is the UK's market leader in chocolate fudge cake, with a strong presence in the foodservice market.

Large deals with disclosed values (>£250 million deal value) [3]

Sector	Date	Target	Acquirer	Deal value (£ million)
Dry grocery	May-14	Unilever United States Inc.'s Ragu and Bertolli pasta sauce business	Mizkan Group Corporation	1272.31

Mid market deals with disclosed values (£50 million - £250 million deal value)

Sector	Date	Target	Acquirer	Deal value (£ million)
Functional	Jun-14	Knighton Foods	Premier Foods plc Specialty Powders Holdings Ltd	63.2*
Dairy/Frozen Foods	May-14	Australasian Food Group Pty (Peters Food Group)	R&R Ice Cream	247.0
Soft Drinks	May-14	Aimia Foods	Cott Beverages	47.7
Wholesale and Distribution	Apr-14	NFT Distribution	Management and EmergeVest	60.0

a new JV created by Premier and Specialty Powders, £63.2 is the JV value ascribed

Small deals with disclosed values (<£50 million deal value)

Sector	Date	Target	Acquirer	Deal value (£ million)
Confectionery	May-14	Aran Candy - The Jelly Bean Factory brand	Cloetta AB	12.6
Bakery	May-14	Ministry of Cake	MBO team backed by LDC	11.0
Fruit and Veg	May-14	The Jersey Royal Company	Produce Investments	15.0
Catering	Apr-14	Alliance in Partnership	Management and Key Capital Partners	11.0

Key undisclosed deals

Sector	Date	Target	Acquirer	Deal value (£ million)
Fruit and Veg	Jun-14	Scotherbs	The Langmead Group	ND
Soft Drinks	Jun-14	Firefly Tonics	Purity Soft Drinks (backed by Langholm Capital)	ND
Dairy	May-14	Glanbia Ingredients Ireland's Fivemiletown soft cheese brands	Dale Farm	ND
Dry Grocery	Apr-14	Food Ingredients International	Orchard Valley Foods	ND
Wholesale and Distribution	Apr-14	Elsinore Foods	Golden Acre Dairy Foods	ND
Dry Grocery	Apr-14	OTP Foods	The Bart Ingredients Co. (backed by Langholm Capital)	ND
Bakery	Apr-14	The Fabulous Bakin' Boys	Daelmans NV	ND
Alcoholic Drinks	Apr-14	First Ireland Spirits Co.	Quintessential Brands	ND
Wholesale and Distribution	Apr-14	Sher Brothers (Glasgow)	Bestway (Holdings)	ND

Notes

[1] All deal activity is based on announced date of the deal and includes deals where there has been any UK or Ireland involvement (target or acquirer). Administrations, liquidations and receiverships are collated but not counted as M&A unless they have subsequently been acquired.

[2] Business failure data includes administrations, receiverships and liquidations. For the purposes of collating failure statistics, all 'failures' are counted irrespective of whether they were subsequently acquired. Only business failures announced in the press are included in the count for years 2007-2011. For 2012 onwards London Gazette data will also be included.

[3] Deal values are primarily sourced from corporate websites, however if no press release is available they are sourced from deal database BvD Zephyr or from press commentary released at the time of the deal. Deal values may subsequently be amended pending earn outs or other finance arrangements or/and as further detail is released by the acquirer.

Sources: All deal data is gathered as it takes place from numerous sources including trade press, BvD Zephyr and ThomsonReuters.

Warburtons

Case study: Warburtons

The UK wrapped, sliced bakery market is a tough competitive landscape, but over the last four years market leader Warburtons has grown share even as overall market volumes have declined. This outperformance is testimony to the success of the company's growth strategy, which is rooted in its long history of Warburton family ownership.

"Warburtons has been in stable family ownership for all of its 139 year history," says Damien Ghee, Warburtons' New Business Development and Strategy Director. "This provides a continuity of decision making not shared by our rivals, which have either undergone changes of ownership or are driven by the requirements of quarterly reporting."

Private ownership allows Warburtons to take a long-term view of the market and to form long-term business relationships. "The company makes good decisions with regard to use of capital and our current outperformance reflects previous successful investment decisions," explains Mr Ghee. Per capita consumption of bread in the UK has been in decline since the 1950's, firstly, as increased food choices, such as the growth of breakfast cereals, secondly, increased competition for share of mouth at different meal occasions and then from 2000 onwards as the trend towards healthier eating has driven some consumers to reduce their carbohydrate intake.

"At the top level the bakery market is shrinking, but there are one or two segments that are growing strongly," says Mr Ghee. "Warburtons has led market growth in a new category – sandwich alternatives - investing in new production facilities to produce our sandwich thin product, which is a 100 calorie, sliced, soft flat bread." Warburtons has continued to invest in the new technology required to deliver new products and now has three production lines, each built at a cost of about £15 million. The company has also not shied away from taking tough decisions, having sold one and shut two further older bakeries manufacturing traditional wrapped sliced bakery products. "We continually review demand relative to supply and take a pro-active stance towards our level of production," says Mr Ghee.

Warburtons has one of the most well invested asset bases in the industry, which is supported by a unique and dedicated supply chain. The company contracts with farmers, both in the UK and Canada, to grow wheat to its own specifications, has bakeries across the UK in key locations and owns a fleet of vehicles large enough to put it on a similar scale to a major distribution company. "Our supply chain allows us to produce a fresher, better quality product that justifies the premium position we enjoy," says Ghee.

Recently, the company made its first acquisition in 30 years, buying Giles Foods to gain access to a number of new categories and a foothold in the food service industry. "We've learned that we're not always experts and it's sometimes better to acquire than build organically if you can find the right target," explains Ghee. Looking ahead Warburtons now plans to leverage this acquired expertise to maintain its successful growth strategy.

Looking forward

Intense competition among the UK's supermarkets has driven food price inflation to record low levels. In July, the British Retail Consortium reported that food prices rose by just 0.6% year-on-year in June, the smallest increase on record since the survey began in December 2006. With the grocers continuing to announce price cuts, a cessation in the price war appears unlikely. In June, Morrison's chief executive Dalton Philips described the company's latest price reductions as "permanent price cuts, not promotions" and said, "they won't be the last".

This continuing intensification in competition in the UK grocery market is structural rather than cyclical. We have previously highlighted BHS's decision – now being rolled out in trial stores – to enter the discount food market as traditional consumer resistance to hard discounters is diminishing. In the online market competition is just as fierce. Amazon is set to offer a new fresh food home delivery service in the UK and Tesco plans to combine its food and non-food online offerings to leverage its supply chain, cut costs and offer a faster service to customers.

While consumers are set to benefit, the cost of the significant changes underway in the food retail market will be partly borne by the grocers' suppliers. A few years ago, many manufacturers were not servicing the discounters, which often stock different lines and pack sizes, but their continuing growth means a strategy is needed. The changing grocery market also emphasises the importance of focusing on additional channels. Expanding geographically into export markets and into the food service industry are two possible alternatives, both of which are likely to entail further M&A activity.

Trefor Griffith
Head of Food and Beverage
T +44 (0)20 7728 2537
E trefor.a.griffith@uk.gt.com

Tracey Jarvis
Research Manager
Food and Beverage
T +44 (0)20 7728 3275
E tracey.jarvis@uk.gt.com