AlixPartners

MAY 2019

FORK IN THE ROAD?

With health and wellness trends on the rise in the UK's food and beverage manufacturing sector, how are Companies, Private Equity and Venture Capital reacting to the ongoing disruption from consumers demanding healthier products?

THE CHOICE IS STARK: INNOVATE OR DECLINE

As attitudes towards health, wellness and sustainability continue to cause disruption within food and beverage markets, large companies are being forced to adapt their approach to innovation. Western markets are under pressure with low growth and input cost volatility, while many heritage products are losing their relevance to consumers. Innovative products are satisfying the desire for healthier, more sustainable eating and this is reflected in strong growth performance for these segments.

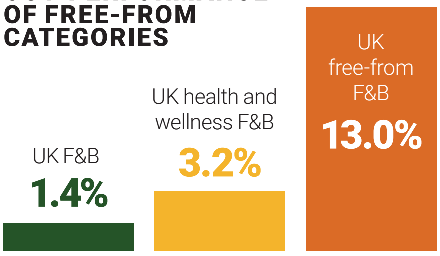
72% of UK shoppers are buying healthy food — with less salt, sugar, fat or calories

65% of UK shoppers prefer to buy products from companies who demonstrate fairness, transparency, and integrity

63% of UK shoppers are attracted by new/innovative products

Source: Information Resources Inc. (IRI)

SIGNIFICANT OUT-PERFORMANCE OF FREE-FROM CATEGORIES



Source: Euromonitor. Data based on 2013 to 2018 CAGR, in value terms

The food and beverage consumers' demand is changing. As demonstrated by the free-from movement, it is becoming healthier, more transparent and sustainable in its production and packaging.

This shift is also represented in the way new products are undergoing development. With consumers looking for a different experience, companies are responding by widening their product offering. These dynamics are taking place against the backdrop of lower consumer confidence, fluctuating input costs and uncertainty surrounding Brexit. Adding to this pressure is increasing own-label competition from traditional grocers and discounters.

Companies are responding by adapting existing product portfolios to meet key health and wellness trends, pushing new product development or acquiring existing brands to improve top-line growth. However, agile start-ups are well placed to deliver successful new product development within the UK's F&B sector. Large companies are far less nimble than smaller competitors, so it is difficult for large companies to adapt at pace. With the need to get new products to market quickly to exploit these new growth sectors, large companies have been increasingly looking to acquisitions as a means of fast-tracking innovation. As an alternative to investing in new product development, acquisitions offer the opportunity for large companies to acquire an emerging leader in a growth segment or channel rather than build from scratch.

THE SEARCH FOR GROWTH

Unilever stated in May 2018 that its most sustainable brands grew faster than the rest of its business by:

46%

Source: Unilever press release

PAYING THE PRICE FOR INNOVATION

The market is seeing more and more acquisitions of smaller founder-owned businesses by larger companies as they seek to buy their way into the health, wellness and sustainability sub-sectors. This method of acquisition as a shortcut for innovation is increasing as these emerging sub-sectors continue to show strong growth in a F&B industry that is under pressure to regularly announce improving revenue and profitability figures.

31.8%

of all food innovations in the UK in 2015 were related to health and physical fitness

Source: XTC World Innovation

Companies are seemingly willing to pay over the odds for acquisitions in the scramble to exploit these new opportunities. Recent deals, such as Unilever's purchase of graze and Lotus Bakeries' acquisition of Kiddylicious, have taken place for significant multiples.

Companies have been willing to pay a median of 14.8x EBITDA for UK health and wellness F&B businesses – 43.8% higher than what would be expected for a typical UK F&B acquisition.[1]

1. Based on a median of relevant transactions since January 2015

Source: AlixPartners research, Mergermarket

RECENT EXAMPLES OF COMPANY ACQUISITIONS OF UK HEALTH AND WELLNESS F&B BUSINESSES

- Unilever – graze (February 2019)
- Science in Sport – PhD Nutrition (November 2018)
- Finsbury Foods – Ultrapharm (September 2018)
- Lotus Bakeries – Kiddylicious (July 2018)
- Unilever – Pukka Herbs (September 2017)
- Lotus Bakeries – Urban Fresh Foods (December 2015)
- Monde Nissin – Quorn (September 2015)

While on the surface this may seem a panicked approach to the pursuit of growth, there are understandable motivations behind these eyewatering deals:

1 Companies need to adapt their existing portfolios to meet long-term shifts in consumer tastes towards health, wellness, and sustainability;

2 These acquisitions are typically strategic investments with less need to generate swift returns in the short run; and

3 Companies can gain significant revenue synergies by expanding the acquired businesses into existing channels or internationally. In addition, cost synergies can be achieved by realigning operations or through increased bargaining power with retailers.

Companies' willingness to pay high prices for quick access to innovation is influenced by the realities of a fast-changing market. Consumer preferences continue to evolve over time, and getting to market quickly is important to avoid missing the boat. Higher multiples mean more pressure to succeed, and making the right choice of company to purchase is paramount. Poor investment decisions are inevitable, however, as consumer preferences shift and trends become outdated. The priority is getting the valuation right, integrating carefully and ensuring a robust strategy.

ALIXPARTNERS' COST SAVINGS AND INTEGRATION CAPABILITY CASE STUDY: ITALIAN DESSERT SECTOR

AlixPartners recently advised a major Italian dessert company. The business was struggling following a combination of a difficult macroeconomic climate, increased competition and a foreign exchange impact due to the Brexit referendum result. AlixPartners was mandated to advise the company on identifying and implementing several profitability initiatives, and also on the integration of a recently acquired company.

AlixPartners identified and implemented a series of initiatives resulting in a €4.9 million improvement in EBITDA and identified permanent improvements to the financial control function.

SELF-SUSTAINABILITY

As large companies begin to accept that traditional models of innovation are no longer working, F&B multinational companies are developing their own innovation units such as SnackFutures, which is part of Mondelēz, the global snacking company and owner of the Cadbury brand. Launched in October 2018, SnackFutures is focused on three key areas:

- Invention of new brands and businesses in key strategic areas.
- Reinvention of small-scale Mondelēz brands with large-scale potential.
- Venturing with start-up entrepreneurs to seed new businesses.

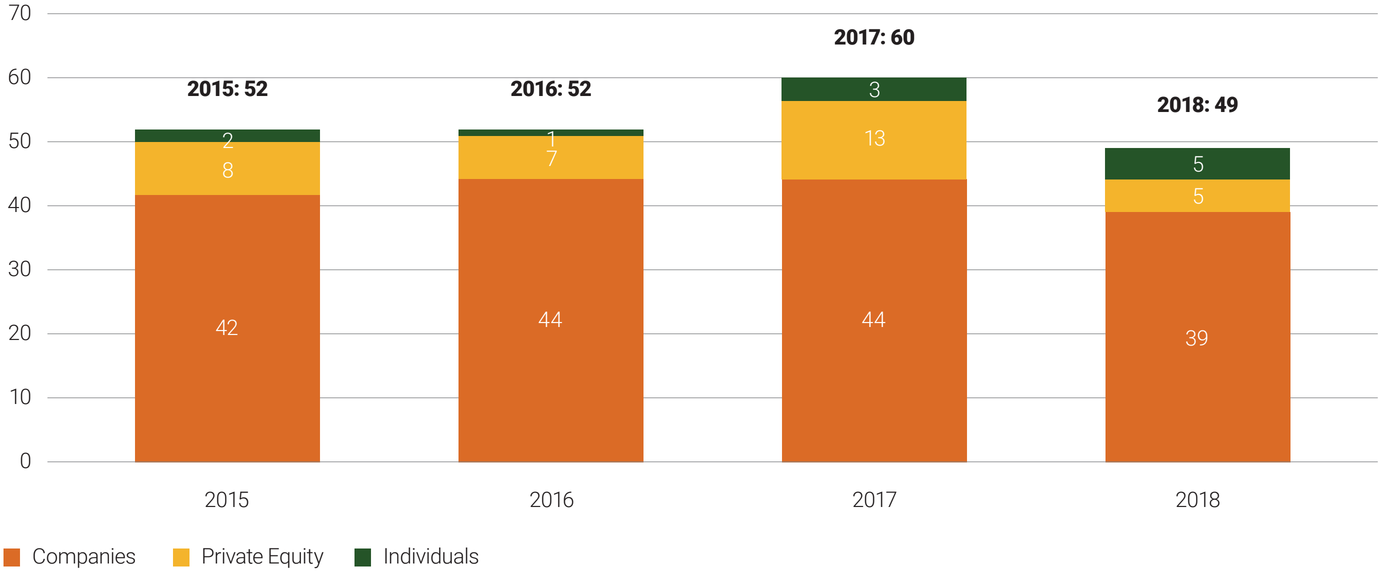
Bringing an innovation unit in-house aims to ensure a continuous pipeline of innovation, while embedding an innovation culture into the company's DNA.

HEALTHY COMPETITION?

So, what does this increased M&A activity mean for private individual sellers of businesses and Private Equity? For Private Equity funds, it has meant being priced out of the market for the fastest-growing brands, such as graze. For private individuals, families and founders, who are the owners of most UK F&B businesses and also sell the most UK F&B businesses, this means seriously considering a sale to a larger company.

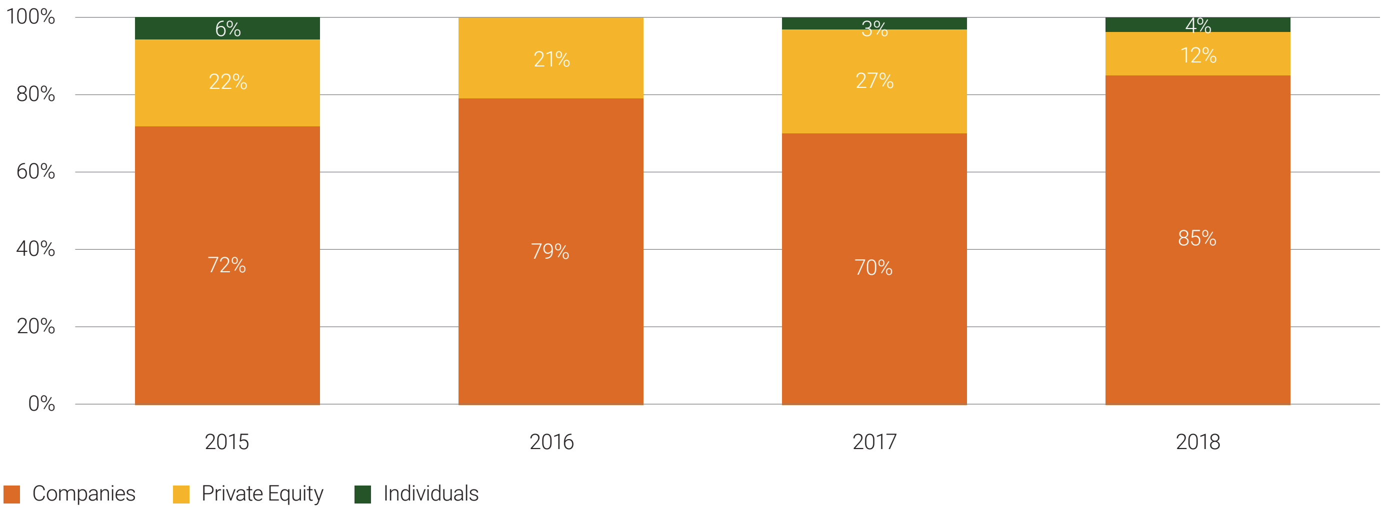
As the figures show, Private Equity funds saw a significant drop in the number of food and beverage deals completed, from 13 in 2017 to just 5 in 2018. In addition, Private Equity have also had a far smaller presence in acquisitions of individually-owned businesses, the main owner of food and beverage businesses, falling heavily from 27% in 2017 to 12% in 2018.

FIGURE 1: NUMBER OF UK F&B ACQUISITIONS BY TYPES OF ACQUIRER



Note: Private Equity acquisitions exclude bolt-on deals by existing Private Equity owned companies
Source: AlixPartners research, Mergermarket

FIGURE 2: ACQUIRERS OF F&B BUSINESSES OWNED BY INDIVIDUALS



Note: Private Equity acquisitions exclude bolt-on deals by existing Private Equity owned companies
Source: AlixPartners research, Mergermarket

Private Equity are clearly nervous of the market's shift towards high multiples and increasing investment in the UK from multinationals, as well as overall market concerns due to the uncertainty over Brexit. This has led to a tendency to be more selective when choosing companies. Naturally being more financially disciplined than companies, Private Equity are typically reluctant to pay over the odds for acquisitions due to their financial requirements, which stipulate an internal rate of return of at least 20% within three to five years. Any high-entry multiple will also require a high multiple on exit, which is not a surety.

WHAT ARE THE PRIVATE EQUITY STRATEGIES IN UK F&B?

There are three primary strategies for Private Equity to follow:

1. Build relationships with companies who wish to remain independent

This approach will increasingly require extensive searching, building relationships with owners and management teams, particularly when owners have a strong conviction to remain independent. This will come with deeper and more complex planning, as Private Equity tend to require defined entry and exit plans before taking the plunge. This approach allows smaller funds to get involved, and can feature deals that would be too small to appear on larger companies' radar. In addition, this can be very attractive for entrepreneur-led companies who do not wish to be swallowed up by a large corporate but simply wish to retain their own culture and values while gaining financial support for the next step of the journey.

In November 2018, Inverleith, a Scottish Private Equity fund who typically acquire businesses with revenues of £5 to £30 million, acquired a controlling stake in Montezuma, a founder-owned UK luxury chocolate brand that had seen success with a range of vegan, free-from and ethical products. Helen and Simon Pattinson, the founders, were keen to find a suitable investment partner who shared their values and could take the business to the next stage of growth. Following the deal, the Pattinsons stepped away from management roles and took ambassadorial roles and director positions in the business.

2. Acquire existing unloved brands and pivot their offerings to match new trends

This strategy can take the form of acquiring an existing brand in an unhealthy segment that could be developed into a healthier offering. This would typically require development capital expenditure, as well as a management team with a clear, executable vision for turning the brand around. An example is KKR's acquisition of Unilever's spreads division in July 2018 in a mega £6 billion deal, with potential plans to improve profitability and pivot the Flora brand into healthier and natural segments.

3. Buy and build a business

This strategy is typically pursued by larger Private Equity funds that have the capacity to acquire a number of businesses over a period of time. CapVest, who established Valeo Foods in 2010, have undertaken a complex strategy of acquiring eight businesses and increased the EBITDA to well in excess of €100 million from approximately €20 million in 2010. This approach requires extremely careful orchestration both in convincing owners to sell to them and also the ability to successfully integrate a wide range of organisations.

ALIXPARTNERS' CARVE-OUT CASE STUDY: GLOBAL BAKERY PRODUCTS SECTOR

AlixPartners recently advised a large Private Equity fund in a highly contested carve-out of a North American bakery products business from a major global bakery product firm.

AlixPartners advised the Private Equity fund on complex carve-out aspects including separation plans, supporting negotiations on the Transitional Service Agreement. AlixPartners also undertook operational due diligence with a view to identifying and quantifying significant risks and opportunities. In addition, AlixPartners was engaged to implement a Project Management Office. The transaction was completed ahead of schedule under an accelerated timetable.

DEBT MARKET VIEWPOINT

Unlike other sectors, where credit funds account for approximately 50% of term-lending, the UK food and beverage lending activity is dominated by banks. Midmarket debt activity remained broadly stable in 2018, with notable UK bank deals in the midmarket included NIBC and Lloyds supporting Exponent's acquisition of Meadow Foods and the amend to extend of ComplEAT Food Group's banking facilities by HSBC and SMBC, owned by Equistone.

In 2019, we expect lender support for the sector to continue. Banks and credit funds are likely to be interested in resilient and emerging growth companies, particularly where there is an opportunity to provide expansion funding for buy and build deals.

NOTHING VENTURED

Venture Capital, whose traditional focus has been the technology sectors, have also woken up to the possibilities of the free-from F&B sector in a big way. Major Venture Capital firms such as Balderton and relative newcomers such as PowerPlant Ventures, New Crop Capital and Stray Dog Capital have focused on pumping money into innovative plant-based meat start-ups such as Beyond Meat in a bid to find a winner in this emerging growth market. The size of the prize is potentially huge as illustrated by Beyond Meat's $1.5 billion IPO and Burger King's partnership with Impossible Foods, another plant-based substitute business, to produce the meat-free Whopper burger.

A TASTE OF SUCCESS – THE CASE OF INNOCENT SMOOTHIES

Coca-Cola's investment in Innocent in 2008 was an early sign of a big player moving into the health and wellness beverage sector. Coca-Cola supported Innocent to follow its sustainable business approach and made further investments, culminating in a controlling stake after acquisition. Annual revenue was approximately £105 million in 2008, which has grown to almost £370 million by 2017.

BREXIT PERSPECTIVE

These disruptive health, wellness and sustainability forces are expected to continue for the long-term. However, depending on what kind of Brexit is reached, there will likely be manufacturing realignments in the short run, with companies seeking to bolster their presence in the UK, in mainland Europe or outside the EU, dependent on their end customers.

Regardless, UK brands will continue to provide significant new product development. British brands translate well across the globe due to significant innovation, use of quirky branding, high degree of product trust and the vast reach of the English language.

CONCLUSION

The mega-trends of health, wellness and sustainability are disrupting the F&B industry. Combined with a difficult macroeconomic backdrop, established companies are being forced to adjust their strategies to survive. With squeezed margins and higher price points on acquisitions increasing the pressure to succeed, companies must pursue robust planning on target identification, valuation and integration. This aggressive buying of innovation requires a clear-minded operational, organisational and strategic approach, but can offer inroads into growth markets for players who are adequately prepared.

Private Equity must also shift its acquisition strategy, moving off-market and connecting with owners who wish to retain independence while gaining investment. The need for careful targeting and screening here is paramount and Private Equity need to be very smart in selecting the correct winners, turning around an unloved brand or following a sophisticated buy-and-build strategy, which comes with its own execution risks.

The proliferation of food tech start-ups will also see greater activity from Venture Capital, or Company-backed Venture Capital funds who are willing to take greater risks in order to unearth the hidden gems of the future.

Realising the opportunities of F&B's growing health, wellness and sustainability sectors will require a mix of boldness, care and planning. If traditional players and new market entrants want to thrive in this rapidly evolving environment, they must update their approaches and think differently to win in the F&B market over the long-term.

AlixPartners is well placed to help Individuals, Families, Founders, Multinational Companies, Private Equity and Venture Capital in the food and beverage manufacturing sector:

- Access an international network of investors, entrepreneurs, companies and finance providers
- Generate deal flow through target identification and screening
- M&A lead advisory / debt advisory / valuations
- Complex integration / carve-out support
- Operational and IT due diligence
- Sale process preparation and exit readiness
- Support business through its development, including operational, organisational and strategy support
- Quick start following acquisition

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.