Food & Beverage: Hungry for Growth

The private equity opportunity in the food and beverage industry

Plus:
Expert Q&A with William Spizman, Partner, Transaction Advisory Services

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Key Findings

1. New eating trends create market opportunities
2. The slow economy makes consumers more thrifty—and food more appealing
3. Talented management is plentiful
4. Technology and innovation drive value creation
5. Many sellers have been motivated by tax-rate changes

The Panelists

Dan O’Connell
Founder and CEO, Vestar Capital Partners

Joan McCabe
Managing Partner, Brynwood Partners

Cristin Singer
Partner, RSM

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1. New eating trends create market opportunities

You wouldn’t guess it from the obesity rate—one in three U.S. adults is obese—but Americans are eating less fast food these days. Sales of fresh fruits and vegetables are up. The organic food and beverage industry was valued at $31.5 billion in 2011 and is estimated to have grown by another nine percent in 2012.

Food and beverage is an ever-evolving sector, which means a steady supply of opportunities for private equity.

“It’s constantly innovating, a really dynamic space,” said Dan O’Connell of Vestar Capital Partners. “The biggest trend has been health and wellness. A big movement toward ethnic foods, new flavors, and, from a packaging standpoint, toward freshness.”

This dynamism has a downside, of course. Trends can turn sour. Today’s Flamin’ Hot Cheetos could be tomorrow’s Celery Jell-O (yes, they did—it was supposed to go in salads). But the fact that the food sector is always in flux also eases access.

“Two-thirds of all purchases are made at the store on impulse,” Joan McCabe of Brynwood Partners said. “So it’s not an industry where you’ve got to spend years of research and have patents. You can do something a little different and have great success if you have a pulse on the consumer.”

That pulse is ever quickening. The demographic trend toward two-income households means family members on the go, fewer sit-down meals, and more snacking. With snack food, in particular, the bar of entry is relatively low and the upside relatively high.

“You have a lot of people who are interested in snack-ing and small meals,” Cristin Singer of RSM said. “And they want to eat healthy—so fresh, healthy snacks that you can grab on the go.”

2. The slow economy makes consumers more thrifty—and food more appealing

It’s counterintuitive, but lower consumer spending actually means increased opportunity in the food-and-beverage market.

Frozen Vegetables, Hot Deal

Some deals start cold, then warm up considerably. That was the case with Vestar Capital’s acquisition of Birds Eye. Just two years after completing the deal, Vestar watched as EBITDA dropped from $125 million to about $80 million while the company languished in the frozen-foods aisle.

After engaging some of the best consultants in the food industry, the firm set about finding a new technology for steaming frozen vegetables in a microwavable bag.

The innovation, called Steamfresh, was an instant success. “Steamfresh became a disruptive technology in the food business and gave us a lead over the competition,” O’Connell said. Birds Eye’s new CEO, Neil Harrison, who joined the company from Heinz, then added starches to the bag and extended the Steamfresh technology to snacks and meals like Pasta & Broccoli with Cheese, and Mushroom & Green Bean Risotto.

In 2009, Vestar agreed to sell Birds Eye to Pinnacle Brands for $1.3 billion, earning itself a healthy profit. “It was a wonderful transaction, but the key thing for us was learning that, when you invest in a legacy brand, you need to have not just one innovation but a whole series of them,” O’Connell said. “Because they very quickly get copied by the competition.”
“With the recession, we’ve had a bifurcation of consumers who are more value-oriented than they might have been in the past,” McCabe said. “And large companies have historically focused on brand building. So there’s a niche in the market that has opened up for private equity to get in and work with companies that are focused on value brands or private labels.”

A corollary of consumer thrift is consumer splurge. When people do indulge, they do it with more discernment, because they want the best quality for their buck. This is where private labels come in—and the opportunity for private equity.

For example, McCabe’s firm had a “very successful” investment in a private-label frozen-pizza company called Richelieu Foods.

“When we got involved, it was your plain old pepperoni-and-cheese pizza for 99 cents,” she said. “And we just emulated restaurant quality. People want to have a California Pizza Kitchen experience, but they don’t want to spend the money on it. As a private equity investor, you can be a fast follower. You don’t have to spend a lot on research. You just go to California Pizza Kitchen and make that same pizza.”

3. Talented management is plentiful

Too many cooks—in the food sector that’s a good thing. And private equity investors enjoy an abundance of operating talent, because managers in the food space are a bit like chefs: When a dish is done, they like to move on to the next recipe.

“It’s a lot of fun for a former corporate executive at one of these big companies to dig in and get involved in a smaller company that’s been neglected, where they can get to understand the brand equity—what it really stands for, what can be done with that brand, and how it can be extended,” O’Connell said.

Many struggling food businesses can be turned around with resources and TLC, and that’s appealing to managers in the food business. “You can really attract fantastic people,” O’Connell added, “people who have risen up to be CEOs of major companies but all of a sud-

Sweet Investment

McCabe says Brynwood Partners likes to adopt orphan brands abandoned by their corporate parents. Brynwood’s portfolio currently includes a business called DeMet’s Candy, which is made up of several confectionary brands discarded by Nestlé, including Turtles, Flipz, and Treasures.

“When we bought the Turtles brand, it was just really boxed chocolates, a very small business,” said McCabe. “But we invested heavily in the business to innovate and took it from what was essentially a boxed seasonal chocolate business to an everyday 99-cent bar.”

In the case of Turtles, Brynwood’s innovation was simply a matter of giving customers what they want. The firm made it easier for Turtles lovers to purchase the product by selling it as a candy bar. Brynwood also introduced a convenient stand-up box with six turtles per package. This small change had a large impact on the business when Costco put in a $20 million order.

Since Brynwood made the investment in those orphan brands, EBITDA has climbed from about $8 million to $35 million. “It’s not rocket science,” McCabe said. “It’s working with retailers and innovating for the consumer.”
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Going Greek

There’s still room in the food business for innovative start-ups to topple giants. Yogurt start-up Chobani needed just a few short years to muscle in on industry leaders like Yoplait and Dannon and disrupt the market.

Today, Chobani is the bestselling yogurt brand in the U.S., with sales reaching $1 billion in 2012. Chobani’s meteoric rise is fueled by America’s insatiable appetite for Greek-style yogurt, which contains less sugar and more protein than traditional brands.

“If I think about one of the great food innovations in the last couple of years, it’s Greek yogurt,” said Singer. “It’s just unbelievable.”

And Chobani continues to innovate, recently introducing 14 new health-conscious flavors like Blueberry Power, with chia seeds and walnuts, and Tropical Escape, with roasted coconut and granola. The surging popularity of Greek yogurt has transformed an entire product category, noted Singer. “Greek yogurt has been riding the wave of the health-and-wellness movement to the point where it has taken over and is now driving a huge part of the market share.”

4. Technology and innovation drive value creation

Most people don't normally associate food with high technology (Apple notwithstanding). But innovation plays a vital role in creating opportunity and value for investors.

Innovation can be applied to an existing company to bring fresh life—and significant returns. Or it can be the foundation of a new company. Take Muscle Milk, which is now owned by private equity firm TSG Consumer Partners. The company’s innovation was to take the nutrition bar and turn into a tasty, healthy drink.

“Conventionally, the nutrition bar was just that—a bar,” McCabe said. “And then TSG got involved with Muscle Milk, taking the idea of a bar but then drinking it. That’s a huge industry now.”

Sometimes an innovation can be as simple as introducing a new package. Kind, for instance, did something that no company in the nutrition bar industry had done before: It put its product in a see-through wrapper. “The growth in clean labels has been very high,” McCabe said.

Food companies and their private equity backers are now turning to social media to spot new innovations and emerging themes. “Just looking out there, you can see what people are blogging about, what they’re talking about, what the latest trends are,” Singer said. “It’s really become quite a phenomenon.”
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5. Many sellers have been motivated by tax-rate changes

Deal flow depends on seller motivation—and sellers in the food sector were highly motivated to make deals in 2012, mainly by coming changes in tax law.

“The increase in capital gains rates effective January 1, 2013, brought a lot of companies to market in the 2012 period,” William Spizman of RSM said. “That was a motivating factor, so sellers could reduce their income tax liabilities.”

That factor primarily impacted family-owned companies. Corporations have different tax concerns.

“One of the interesting things you see with a corporate carve-out or a product line being sold is that there are so many costs being allocated from corporate to the product,” Spizman added. “It could be showing a loss on the books because of the allocations. So oftentimes that’s a great opportunity for private equity.”

But investors must take care in such cases, McCabe pointed out. “Corporations have gotten smart. They don’t show you any of those allocations. So we’ll buy a business on brand contribution; it really is just sales, cost of goods sold, and direct marketing. It may look profitable to us, and on their books it may not be.”

Hungry to Sell

Seasoned entrepreneurs are hungry for a sale, and private equity is happy to satisfy their craving.

Spizman noted that successful entrepreneurs who have built their food companies from scratch are looking to cash in while still remaining involved in the business. “They don’t want to necessarily risk additional capital to grow the business,” he said. “Private equity is a great alternative to bring in additional equity and continue to run and operate their business into the future.”

Private equity is also a popular option for large corporations looking to unload an underperforming or slow-growing brand. “The only real way for corporations to maximize their return is to sell to private equity,” Spizman said. “They can get a much better return, because if there isn’t a lot of growth and there isn’t a lot of attention on the brand, private equity can nurture that product. A large corporation often cannot.”
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