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2007 FOOD INDUSTRY M&A REVIEW:

Activity Driven by Healthy Products, Rising Commodity Costs, and Private Equity

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EXECUTIVE SUMMARY

Merger & acquisition activity in the US food & beverage industry continued at a strong pace in 2007, driven by three major trends: strong consumer demand for food & beverage products that promote health & wellness, sharply-rising raw material prices, and private equity investors' heightened focus on CPG companies. As all three factors continue to influence the sector, expect further consolidation in many sectors of the food & beverage industry in 2008.

HEALTH & WELLNESS

The health & wellness trend that has influenced product development and marketing efforts across the food & beverage industry also fostered merger & acquisition activity in 2007, both nationally and internationally.

Health & wellness is a broad term and a broad trend, encompassing topics such as obesity and diabetes, allergies and immunity, and more intangible feelings of wellbeing and energy. Overall, the term is shorthand for consumers' desire to eat foods and drink beverages specifically to prevent or minimize an illness or condition. Products positioned to promote health & wellness include organic, better-for-you, and fortified/functional foods. The benefits may come from the absence of detrimental ingredients or additives (gluten-free, pesticide-free) or the addition of beneficial ingredients (omega-3 fatty acids, antioxidants, probiotics). The most-purchased health & wellness foods are whole-grain breads and cereals, followed by cholesterol-reducing oils and margarines and fruit juices with added supplements/vitamins:[1]

Regularly Purchased Wellness Foods

Product Category	Regularly Purchased
Whole grain, high fiber products	55%
Cholesterol-reducing oils and margarines	41%
Fruit juices with added supplements/vitamins	32%
Bread with added supplements/vitamins	25%
Iodine-enhanced cooking salt	24%
Milk with added supplements/vitamins	23%
Yogurts with acidophilus cultures/probiotics	22%
Cereal with added folate	12%
Soya Milk	10%
Fermented drinks containing “good” bacteria	4%

Source: ACNielsen’s Consumer Interest in Functional Foods & Organics

More and more, consumers seek organic, natural and functional foods in an attempt to gain wellness benefits from eating. In a 2006 survey by Datamonitor, 29% of US and 38% of European respondents said that they had chosen more natural and organic food and drinks over standard variants during the previous year. There are 39 million “loyal” users of natural products in the US and another 58 million in Europe. Along with 123 million American and 177 million European “occasional” users, well over half the total population of the US and Europe uses natural foods, and the number of people who do not seek out natural products is forecast to decline by 3% per year.[2]

In their desire to pursue health & wellness through diet, consumers are willing to pay a premium for functional nutrition. Recent merger & acquisition activity reflects the value of that premium and the dealmaking appeal of the top health & wellness food categories as Post cereal, Smart Balance spreads and Glaceau fortified water all traded hands in 2007.

COMMODITY PRICES

Inflationary pressures on both food and energy inputs battered 2007 profit margins for companies in the food & beverage supply chain, and these pressures continue in 2008. Record-high oil prices have increased utility costs for manufacturers and have raised delivery costs as the price of diesel spirals upward.

Grain prices have also skyrocketed. High oil prices have created strong demand for biofuels as an alternative energy source, leading to competing demands on the US corn supply as ethanol plants spring up across the Midwest and corn previously available for food is diverted for fuel production. Demand for corn has been augmented by global industrial development (particularly in China), as growing worldwide consumption of meat has increased demand for cattle feed. Increased demand for corn has increased production costs and selling prices for meat and dairy products and for processed corn products such as corn oil, cornstarch, and high fructose corn syrup. Similar global demand, combined with increased acreage devoted to corn, has led to sharply-rising prices for other grains. Soybean prices were up 70% in 2007 and wheat prices doubled, trading recently at all-time highs. Prices for these grains and grain-based products continue to rise, along with prices for other food commodities including sugar, coffee and cocoa. Pepsico CEO Indra Nooyi predicts that “structural inflation for food is here to stay for another two to three years.”[3]

Faced with these higher input costs, food & beverage companies seek to recover lost profit margins through price increases, product reformulations, commodity hedging, and acquisitions. General Mills, Kraft and Unilever all increased food product prices in 2007, and Unilever and others recently announced increases for 2008 in response to commodity costs. For companies with strong balance sheets and/or private equity backing, the search for margin will lead to increased M&A activity in 2008. The increased demand for acquisitions will likely be matched by an increase in supply, as some business owners decide to sell in the face of these cost and margin pressures.

PRIVATE EQUITY INVESTMENT IN FOOD & BEVERAGE

Food & beverage companies appeal to private equity investors due to their steady cash flows, consolidation opportunities in the industry, and an active M&A market in which to exit investments. A surplus of uninvested private equity capital remains available for M&A deals, despite recessionary trends in the overall economy and despite the well-publicized "credit crunch" that side-tracked many mega-sized private equity deals in 2007. (In the restaurant sector, for example, the turmoil has delayed the ongoing sale of Wendy's International). These large deals often involve a half-dozen or more layers of complex debt financing. Middle market private equity deals, which typically involve no more than two or three levels of debt, have been less affected by the credit crunch.

Private equity investors seek to make money by purchasing companies using a combination of debt and equity, repaying that debt with company earnings over time, and then re-selling the company either to an industry competitor or to another private equity group. Food & beverage companies fit this investment model because they own physical assets that can be leveraged to obtain debt financing, and the annuity-like performance of a strong brand provides the ongoing cash flow needed to service that debt.

To increase return on investment beyond the effect of debt leverage, private equity groups often put additional money to work in their portfolio companies by investing funds to fuel growth and to add other brands and businesses to the portfolio company. In food & beverage – an industry known for slow volume growth and mature markets – private equity financing can fund the research and development necessary to create innovative products to capitalize on health & wellness and other current trends. Similarly, the ongoing consolidation in the sector creates opportunities for well-financed food & beverage companies to grow through add-on acquisitions.

Finally, food & beverage companies are attractive to private equity groups because there is a clear path to exit the investment by selling to larger CPG companies, or to other private equity funds similarly attracted to the sector by the industry's favorable characteristics. Larger consumer product companies are often risk-averse and slow to capitalize on emerging trends. As a result, they often prefer to buy smaller, successfully growing companies – as seen in the following examples of 2007 M&A activity.

2007 FOOD & BEVERAGE MERGERS & ACQUISITIONS

DIVERSIFIED FOOD COMPANIES

The health & wellness trend influenced acquisition activity among leading food & beverage companies in 2007, both nationally and internationally. Most prominently, Nestle announced its strategic intent to become a health, wellness and nutrition company. During 2007 Nestle closed on its Jenny Craig acquisition, bought Gerber from Novartis, acquired the medical nutrition division of Novartis to gain share in the healthcare nutrition segment, and announced a joint venture with Jamba Juice to introduce healthy ready-to-drink smoothies and fruit beverages into the grocery channel. Most recently, Nestle announced it is working with New Zealand dairy cooperative Fonterra to build and run a new dairy joint venture in Brazil.

Groupe Danone also bought into nutrition and baby food, purchasing European manufacturer Royal Numico and selling its European biscuit business to Kraft. Other noteworthy acquisitions driven by the health & wellness trend included Hain Celestial's purchase of the meat alternative business of Dean Foods' subsidiary White Wave Foods; Lance, Inc.'s purchase of a minority equity interest in organic snack food manufacturer Late July Snacks LLC; and Boulder Specialty Brands' acquisition of GFA Brands, the maker of Smart Balance heart-healthy spreads. In the broader CPG arena, Clorox paid up for Burt's Bees natural personal care products and announced a new line of Green Works eco-friendly household cleaning products.

Kellogg remained focused on the cereal aisle but was influenced by the health & wellness trend, as it bought two health food companies in 2007, Bear Naked Granola and Wholesome & Hearty Foods Co. In January 2008 Kellogg announced its acquisition of United Bakers Group, one of Russia's largest cracker, biscuit and breakfast cereal producers.

Affected by the adverse impact of rising ingredient costs, other large food manufacturers retrenched to focus attention on core product lines. In 2007 Kraft Inc. sold its VeryFine and Fruit2O beverage business to Sunny Delight, sold Post cereals to Ralcorp Holdings, and sold

Nabisco Cream of Wheat and Cream of Rice hot cereals to B&G Foods. Kraft became the world's largest biscuit company through its purchase of Groupe Danone's global biscuit business in 2007, and now is said to be in talks to acquire M. Dias Branco SA, a Brazilian pasta and cookie company.

Like Kraft, Unilever chose to divest some of its non-core brands in 2007, selling its Boursin cheese business to Le Groupe Bel and selling its Lawry's marinades and seasonings business to McCormick & Company. Conversely, for McCormick the Lawry's deal extended its dominance in the spice and seasoning segment.

Treehouse Foods, Inc. (the bottled foods and pickle business spun off from Dean Foods) went on an acquisition spree in 2007, buying Canadian condiment, sauce and dressings manufacturer E.D. Smith, pickle company DeGraffenreid LLC, Mexican sauce company San Antonio Farms, and Santa Fe Ingredients. Also in 2007, the J.M. Smucker Company added to its roster of center-of-the-store brands by purchasing Eagle Family Foods and by acquiring the Carnation Canadian business from Nestle. Private equity investor Blackstone Group bought Pinnacle Foods after acquiring United Biscuits in 2006.

BEVERAGE COMPANIES

Consumer demand for noncarbonated functional drinks and the allure of higher margins from those products continued to drive M&A activity in the beverage sector in 2007.

Pepsico followed its 2006 acquisitions of IZZE Beverages and Naked Juice by expanding through numerous international transactions in 2007 including Russia's largest juice company, Lebedyansky, and by launching fortified water products under its Aquafina brand. On the food side, Pepsico announced a joint venture between Frito-Lay and the Strauss Group to market Sabra hummus, and in January 2008 Pepsico bought Bulgarian nut and seed company Penelopa to target both the health & wellness trend and the Eastern European market.

Coca Cola also expanded its presence in the noncarbonated functional category with its acquisition of Fuze Beverage, its eye-popping purchase of Energy Brands (the maker of Glaceau fortified waters), and, in early 2008, its investment in iced tea maker Honest Tea.

Fruit juice and bottled water dominated other beverage deals in 2007. Sunny Delight added to its noncarbonated and functional beverage offerings by purchasing VeryFine and Fruit2O from Kraft. Private equity groups were active buyers as HM Capital bought Advanced H2O from Lasalle Capital, Clearlight Partners bought Apple & Eve LLC from Weston Presidio, and Allied Capital bought Old Orchard Brands.

CONFECTIONARY

M&A transactions in the confectionary segment were driven mainly by strategic considerations during 2007. Campbell Soup Company sold Godiva Chocolatier to the Ulker Group, Turkey's largest food company. Barry Callebaut AG purchased a number of cocoa processors (including Food Processing International in Pennsylvania and Morinaga in Japan) to expand its worldwide production capacity, and signed outsourcing agreements with Hershey, Nestle and Cadbury.

Confectionary brands were of particular interest to private equity, as American Capital Strategies bought NECCO, Madison Dearborn Partners bought Topps Company, Brynwood Partners bought the Turtles brand from Nestle, and Catterton Partners' subsidiary Farley & Sathers Candy Co. bought Brach's from Barry Callebaut.

The biggest news in confectionary M&A was a deal that did not happen, as Cadbury Schweppes separated into separate entities for confectionary and beverage after flirtations with private equity buyers and with potential merger partners.

INGREDIENTS

As food & beverage manufacturers move into health & wellness products, natural ingredient suppliers are consolidating to increase size and relative bargaining power. For example, natural food company SunOpta bought Tradin Organic in the Netherlands, a provider of globally sourced organic food ingredients; bought natural ingredient supplier Neo-Nutritionals, Inc., bought soymilk manufacturing facilities from ProSoya, and bought two Mexican fruit processors.

SUPERMARKETS

M&A activity in the supermarket sector was relatively quiet compared to 2006's mega-deal in which SuperValu acquired Albertson's. The two most prominent supermarket deals in 2007 were A&P's acquisition of Pathmark and Whole Foods' acquisition of Wild Oats. The A&P/Pathmark deal resulted in a merged entity with approximately 450 stores and with leading market share in metro NY and increased shares of the Philadelphia and Baltimore markets. The Wild Oats purchase helped Whole Foods to consolidate its position as the largest US natural foods retailer and to defend against the expanding offerings of organic foods in mainstream supermarkets. The rocky regulatory path of both transactions showed that supermarket deals continue to attract lengthy and detailed antitrust scrutiny from the US Federal Trade Commission.

Private equity firms were active in the supermarket space in 2007, attracted by retailers' strong regional brands and cash flows. Morgan Stanley Private Equity bought Tops Markets from Royal Ahold, Sun Capital bought Marsh Supermarkets, and Apollo Management bought Smart & Final.

RESTAURANTS

The most prominent chain restaurant deal of 2007 was IHOP's acquisition of Applebee's International. The transaction created the largest full service restaurant company in the world – at least temporarily, as IHOP has recently begun selling certain Applebee's locations to franchisees. Private equity buyers were active in this sector as well, as Mainsail Partners bought Togo's from Dunkin Brands and LNK Partners bought Au Bon Pain in January 2008. Sun Capital led the way, picking up Friendly's, Smokey Bones Barbeque & Grill, Boston Market, and Restaurants Unlimited. Sun also bought specialty food cataloger Hickory Farms.

FOODSERVICE

In broadline foodservice distribution the biggest news was Ahold's sale of US Foodservice (the nation's second-largest distributor as ranked by ID magazine[4]) to private equity groups Clayton Dubilier & Rice and Kohlberg Kravis Roberts. Reinhart Foodservice moved up to number five in the ID rankings by acquiring Catanzaro and NATCO, and by purchasing various branches and territories from King Provisions, Food Services of America, and Harker's Distribution. Foodservice distributor consolidation continues in 2008 as Performance Food Group, number three on the ID list, announced in mid-January that it will be acquired by Blackstone Group and Wellspring Capital Management, who will merge PFG with Vistar.

The pace of consolidation among produce distributors lessened in 2007, as Sysco Corp. subsidiary Freshpoint closed on its acquisition of Incredible Fresh Produce (first announced in late 2006) and digested the two other deals it made in 2006 and the four deals it made in 2005. In the MidAtlantic region, Coastal Sunbelt Produce and its parent MCG Capital bought L&M Produce to form the area's leading produce distributor.

CONCLUSION

Strategic buyers' ongoing appetite for acquisitions to capitalize on the health & wellness trend and to replace margin lost to escalating raw material costs, plus private equity investors' interest in food & beverage, indicate that M&A activity will continue in many sectors of the food & beverage industry in 2008 despite ongoing turmoil in financial markets and a looming recession. The investment bankers at Tully & Holland offer a unique combination of operating experience at leading food & beverage companies and strong dealmaking skills, and would welcome the opportunity to advise you on future transactions.

REFERENCES

[1] The Food Institute Report, March 27, 2006.
[2] Datamonitor, Food Business Review.
[3] London Times online, January 21, 2008.
[4] 2007 ID Top 50 Report.

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