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Targeting growth: Challenges and opportunities for the UK Food and Beverage sector

Sector Survey Report



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Introduction

About this report

Earlier this year, we published our Financing Your Strategy report, surveying UK business leaders across a range of industry sectors about the challenges and opportunities they are facing in the post-financial crisis environment. Tellingly, market sentiment among survey respondents from the FMCG space was relatively positive with 71% considering the sector to be in recovery from the worst effects of the economic downturn. In stark contrast, 56% of overall respondents still considered their industry sector to be in the midst of recession.

With senior executives from the Food and Beverage sector displaying such optimism, we commissioned Remark, the research and publications division of The Mergermarket Group, to gain further insight into the current state of the sector. To this end, we canvassed the opinions of 50 CEOs, and CFOs from UK-based Food and Beverage companies on a number of issues affecting the sector, as well as future growth expectations.

This report has taken into account the views of a wide cross-section of the Food and Beverage industry and as such some of the views will be more applicable to certain sub-sectors over others. However, the underlying sentiment is that, on the whole, the sector has emerged from the recession in advance of others, and while it is still faced with numerous challenges, it is well positioned and there are exciting times ahead.

Defining the UK Food and Beverage sector

The UK Food and Beverage sector is a broadly defined space that encompasses a range of sub-sectors. For the purposes of this survey, we focused on UK-based manufacturers and suppliers (both branded and private label) from the following sub-sectors:

- Frozen and chilled foods
- Soft beverages
- Dairy products
- Fish/meat/poultry
- Food (other)
- Agri processing/cereals
- Food ingredients
- Fresh produce
- Baked goods
- Sugar and confectionery

Key issues explored in the survey included the following:

- What strategies did Food and Beverage companies put in place to combat the effects of the financial crisis?
- Is the relationship dynamic between food suppliers and the 'Big Four' supermarkets changing?
- Which consumer trends offer the biggest opportunities going forward?
- Is M&A set to continue to be on the corporate agenda over the next 12 months?
- Do Food and Beverage companies feel they can fund their corporate strategy through traditional methods?

To add flavour to the report, we have included comments from a number of our clients and contacts as well as members of our own team who focus on the Food and Beverage sector.

Survival of the fittest

While UK Food and Beverage companies were by no means immune from the economic downturn, there are signs the sector avoided the worst effects of the crisis. Indeed, with a number of industries still struggling to come to terms with the changed marketplace, it is remarkable that 100% of survey respondents feel well placed to finance day-to-day operations going forward.

The UK Food and Beverage sector's ('Food sector') air of optimism surrounding the sector begs the question, how have UK Food companies avoided falling victim to the worst effects of the downturn? Certainly, one explanation is the relatively defensive nature of the sector, with a significant proportion of companies supplying staple goods to the market. However, it is arguably more pertinent to consider the spike in input prices that was seen in 2007 and into 2008. This hit an already lean sector extremely hard, forcing companies to adjust their business plans and having the unforeseen benefit of ensuring that the surviving businesses were well primed when the wider downturn hit in the second half of 2008.

The survey results also show that companies have quickly adapted to the new economic reality, reacting accordingly to the decline in conspicuous consumption and increase in home cooking as well as keeping in mind longer-term growth areas such as health and wellness, Fair Trade and free trade produce.

Nevertheless, despite positive fundamentals, the UK Food sector continues to face a number of challenges. The dynamic between manufacturers and the 'Big Four' supermarkets is still an issue for a significant minority of those surveyed, with one in four respondents describing the relationship as challenging. Elsewhere, businesses also face more generic problems stemming from the austere macroeconomic environment, with 48% noting that the weakness of sterling is adversely impacting upon corporate performance.

Such issues continue to squeeze margins and this will no doubt drive consolidation in the sector going forward. Cost pressures and a lack of scale are likely to be the principal sell-side drivers of M&A in the mid-market space, and there appears to be almost widespread recognition that there will be significant dealmaking in the sector. Notably, 69% of respondents expect M&A activity to increase over the next 12 months.

Twenty per cent of respondents are planning to broker a merger or acquisition over the same timeframe. This is a significant number and far in excess of historic levels. There are clearly opportunities and as the realisation dawns that the worst of the downturn is now over, it appears that M&A has returned to the corporate agenda. Much like the preferences of the consumers it serves, the Food sector is a dynamic and ever-evolving space, and those players that stand still now will undoubtedly suffer, either in their bottom-line performance or by becoming an acquisition target themselves.

An early recovery

As the UK economy slowly emerges from the impact of the worst financial crisis in decades, results from our survey suggest that the Food sector is relatively well placed to target growth in the coming months. A high proportion of companies operating in the space entered and exited the recession earlier than other industry sectors, largely due to heavy increases in input prices that occurred before the acute onset of the global financial crisis in the third quarter of 2008. This can be seen to good effect in the below graph with the wider FTSE AIM index significantly outperforming the Food and Beverage index throughout 2007 and into 2008.

Fig. 1 AIM Food and Beverage Index/AIM 100 Index



Source: Bloomberg; mergermarket research

Comment

It has been clear from the experience of a number of our clients that companies operating in the Food sector had to cut their cloth earlier than in some other sectors. Therefore it isn't surprising that they have recovered sooner.

Trefor Griffith,
Director, Corporate Finance,
Grant Thornton UK LLP

The rise in commodities prices over this timeframe was clearly painful for the wider UK Food sector, forcing many businesses to actively target efficiency gains well before the wider global economic downturn. "We were forced to absorb the increase in costs and had to try and become more efficient in terms of production," one frozen and chilled foods respondent remarks.

Elsewhere, pricing pressure from UK supermarket chains has also forced Food businesses to constantly target efficiency gains in recent years. Nevertheless, it is notable that following the spike in input prices, supermarkets did acknowledge the tough trading environment and accepted price rises from Food manufacturers.

Profitability was consequently boosted by the easing of input prices in the second half of 2008 and this was strengthened by the fact that supermarket prices remained robust. The presence of such sector specific factors meant that many firms were actually relatively well primed to enter the downturn as much of the pain had previously been felt over the course of 2007 and 2008.

As input prices continue to ease, there is now a degree of confidence in the sector, with 100% of survey respondents reporting that their company is able to meet its current funding requirements via traditional means.

Charles Lamplugh,
Senior Relationship Manager,
Lloyds Banking Group

It is most encouraging that businesses feel that they can meet their current funding needs through traditional means. Traditionally the Food sector is robust through a recession, although it does need to keep a close eye on costs. The consumer appears to be looking for value, which does not necessarily mean low prices. This is the crux of the challenge for those in the food business as they need to have a good quality product at a sensible and fair price.

Chris Ormrod,
Managing Director,
Ministry of Cake

When the economic depression first hit, all of the so-called market pundits began to predict the demise of the catering industry. Here we are two years later and it looks suspiciously healthy; consumers are still eating out, and smart new restaurants are still opening. What is closing would, I strongly suspect, have closed anyway.

The weak sterling has also helped some UK Food companies to expand into new export markets. Such opportunities are clearly as varied by product type as they are by foreign market. According to UK Trade & Investment, British Food companies are selling a wide range of products to a number of markets, including ready meals to France, Indian sauces to Spain, cheeses to Japan and breakfast cereals to China.

In addition to UK exports becoming relatively more competitive globally, companies have also been aided by the weakness of the pound eroding the competitiveness of imported goods. On the other hand, however, challenges persist for UK-based importers which are clearly struggling. Changing consumer preferences also represent a key challenge for the sector, although it would appear that companies are adapting to the changed marketplace and are cautiously optimistic regarding their growth prospects over the next 12 months.

Comment

In Northern Ireland, where I am based, Food and Beverage is a significant sector, contributing 17% of export sales; traditionally to Great Britain and the Republic of Ireland, but increasingly global. Tightening consumer spending, especially in the Republic of Ireland, has had an impact on business here, requiring a renewed and continuous focus on operating efficiencies. It is my view that most food businesses have proved resilient and have been quick to adapt to the changed environment.

Charlie Kerlin,
Director, Corporate Finance,
Grant Thornton UK LLP



Case Study

Turnaround success for McCambridge

McCambridge is a UK bakery business famous for its Soreen malt loaf and Irish Stoneground Wholewheat Bread. The current Group was created in 2007 by the acquisition of a former rival, Inter Link Foods PLC, out of administration, and has since seen a transformational turnaround plan shape it into a strong and sustainable business.

The Inter Link business acquired was in a far worse position than McCambridge had envisaged prior to acquisition, incurring estimated EBITDA losses of c.£14m in the year to May 2007. While McCambridge was able to substantially reduce the losses, in the year to June 2008, they were unable to eradicate them completely. In order to take stock and assess how the McCambridge business would turn the ex Inter Link business into a profitable operation, the McCambridge board commenced a full strategic review in October 2008.

Operational support for this project came from Grant Thornton, and by March 2009 a management restructure had been effected and a comprehensive three-year plan developed.

This working relationship led to the appointment of Neil Fraser, a former

Grant Thornton director, as group commercial director in June 2009. Neil ultimately went on to become the Group's chief executive in March 2010. Neil's job was to implement the turnaround plan consisting of three elements: to simplify the business by selling underperforming businesses with limited growth potential; to consolidate the northern bakeries, where appropriate; and to develop and invigorate the Soreen brand.

Since the turnaround plan came into force the Group has sold six businesses, closed its Oxford Head Office and consolidated four bakeries, while outperforming its three-year plan on all financial and operational metrics. The Group has continued to have the support of its lender Barclays Corporate throughout this process as demonstrated by the bank recently increasing facilities to support working capital. The overall operational plan will be completed by the end of 2010 with commercial initiatives running into 2011.

Like many other consumer businesses, McCambridge is taking heed of current consumer trends. For example, its Mrs Peek's brand appeals to those consumers looking for 'good old-fashioned home cooking' and larger packet sizes allows

McCambridge to provide its customers with better value. Overall, individual product developments depend on the different retailers that McCambridge serves and through which the products are sold to the end consumer.

The turnaround plan is very much a multilayered exercise, with operational investment into state-of-the-art manufacturing capability combined with brand revitalisation and the development of commercial and financial management excellence.

In the year to June 2010 the McCambridge Group had turnover of c.£122m and employed c.1,300 staff to generate an EBITDA in excess of £8m, which is a significant improvement over the previous year. It manufactures cakes, mince pies and Soreen malt loaf in England, bakery products in Poland and soda bread in Ireland. The Group's customers include all of the major supermarket groups in the UK, Ireland and some significant retail businesses across Europe and the rest of the world. Its principal manufacturing locations are in Blackburn, Bradford, Manchester, Salisbury, Rathcoole in County Dublin and Szczecin in Poland.

Findings

Challenges for the Food sector

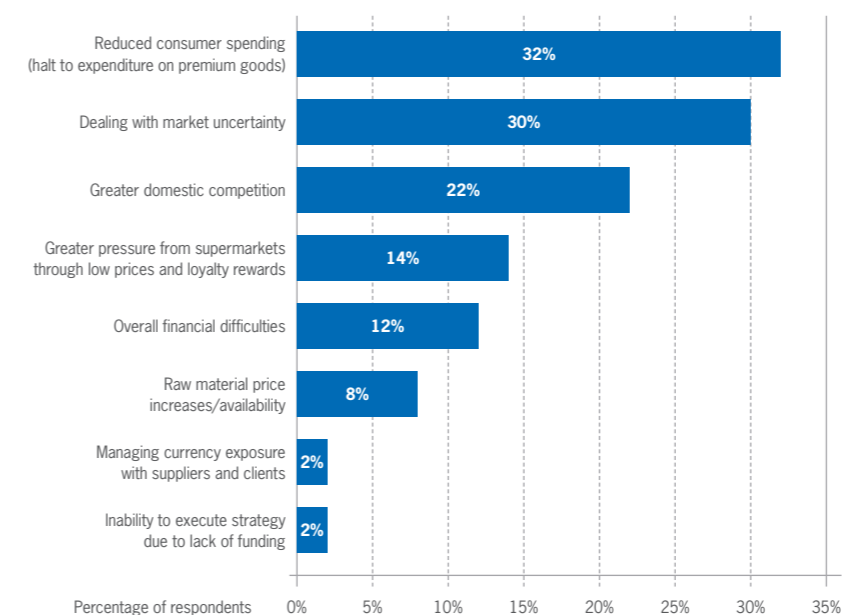
Comment

With the raw materials price spike tentatively on the ease, UK Food companies were facing seemingly better prospects on the supply-side when Lehman Brothers collapsed, spreading financial contagion across world markets. Whereas commodity price inflation ravaged Food companies before the financial crisis, the ensuing economic landscape over the past two years has presented a host of new challenges such as household belt-tightening and shifts in consumption patterns.

Companies which have been trading at the low end with customers going out of business, and those in the top tier, for example supplying top end product to M&S, will have been hardest hit by the financial crisis. For the latter, volumes have been reduced by customers trading down, both inter supermarket (M&S to Tesco) and between product ranges (finest to standard). However, this would only reduce volumes for those in the top tier, while it's swings and roundabouts for the rest of the market.

David Cockburn,
Partner, Corporate Finance,
Grant Thornton UK LLP

Fig. 2 As a consequence of the downturn, what are the biggest challenges your business is currently facing?



Flight to value

Our survey shows around one-in-three corporate respondents believe that reduced consumer spending and a halt to premium goods sales has been one of the biggest challenges facing their firm since the onset of the crisis.

"People are not going out as much as they did before. There is not enough confidence as they are worried about what may happen in the future," laments one food ingredients respondent.

Market uncertainty

“Dealing with this volatility in demand is a big challenge,” says another respondent from the soft beverages sector. Clearly, such market uncertainty is a genuine worry for many, with a significant 30% of those surveyed identifying it as one of the biggest challenges currently facing their business.

Competition

Against the backdrop of this challenging business environment, it is hardly surprising that competition among mid-market UK Food firms is adding ever greater pressure on players in the sector: around one-quarter of survey respondents (22%) identify greater domestic competition as one of the biggest challenges confronting their businesses. “We have not been able to make the price of our products competitive enough for our customers,” mentions a financial director from a frozen and chilled foods firm. Elsewhere, it is remarkable that not a single respondent highlights competition from foreign firms as a significant challenge.

Comment

Not a single respondent to the survey highlighted competition from foreign firms as a significant challenge currently facing their business. This is likely to remain the case until the pound strengthens.

Trefor Griffith,
Director, Corporate Finance,
Grant Thornton UK LLP

Weak sterling

Meanwhile, in addition to the aforementioned factors, wider macroeconomic problems in the UK have precipitated a slide in the value of sterling, presenting further challenges for domestic businesses reliant on imports of foreign supplies. Indeed, 48% of respondents say that sterling weakness adversely affects their business, with many complaining that higher input prices eat into profit margins. One financial director from a food ingredients company explains, “It pushes our costs up which means we have to go back to supermarkets and negotiate for increases in our selling prices. And we are forced to have short term contracts with suppliers and buyers.”

Mark Devine,
Group Finance Director,
McCambridge Group
Holdings Ltd.

The weak pound has resulted in UK manufacturers importing inflation; this impacts on both gross costs, for example in the form of fruit, nuts and sugar (euro linked) and overhead costs, such as fuel (dollar linked). However, it could also be that many businesses are short sighted and do not look outside their national borders from a consumer perspective. The weak pound should also reduce competition from imports to their products in UK markets by making imports more expensive (creating an opportunity to favourably adjust their marketing mix and grow sales as part of a wider successful competitive strategy), and should also allow them to compete in foreign markets, thus growing exports. The key is that businesses need more than ever to know both their costs (and what makes them up) and their markets.

Comment

In the fresh produce sector, typically growing, packing and selling to multiples, the rise in input prices has had a double effect in that it has squeezed margins but also demanded considerably more working capital. This sector, having relatively long production cycles, inevitably is cash hungry. Many of these businesses trade as non-corporates, and prior to the increase in input costs enjoyed high profits in the 2006 and 2007 harvests. This has resulted in high tax bills paid in 2008 and 2009, which has

coincided with the increased working capital requirement and lower margins. Some businesses have suffered severe working capital problems. Even though interest rates are low, banks have been demanding detailed information, higher margins and arrangement fees to provide additional funding. In the arable sector the current shortage of world grain has had a dramatic impact on prices and profitability. Grant Thornton’s annual Farm Business Survey covering 100,000

acres indicates a reduction in profitability of around 20% in 2009, over the previous year. The 2010 harvest based on current prices indicates an increase of 68% over 2009 with a small drop of around 8% in 2011. The volatility in this market makes it difficult to manage cash, profitability and tax planning.

Gary Markham,
Director, Agriculture Group,
Grant Thornton UK LLP



Responses to the downturn

As difficult as the downturn has been, the defensive nature of the sector as a supplier of staple consumer goods has offered some shelter from the worst of the crisis. Nonetheless, UK Food corporates have had to remain nimble throughout the downturn, deftly responding to the changing marketplace.

Cost cutting is the most common response undertaken by those surveyed, with 43% saying they have reduced costs to deal with the challenges. “We are basically controlling costs, increasing efficiency and trying to navigate the market in ways more favourable to us,” says one manufacturer of crisps and snacks, while a financial director from a frozen and chilled foods firm comments, “We are trying to directly procure raw materials from agricultural producers to reduce costs.”

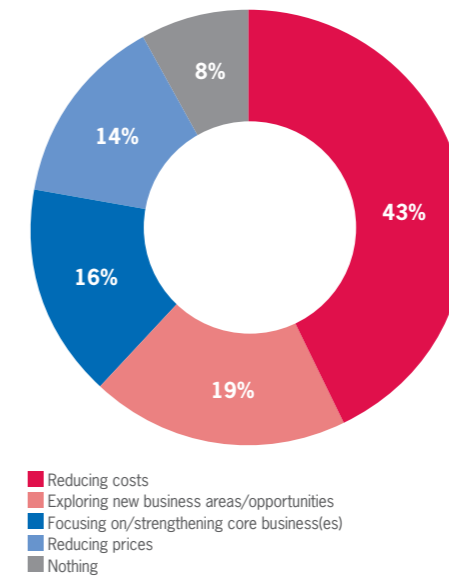
Comment

Most market players have benefited from favourable energy prices and low interest rates. However, the key is to fully analyse the cost base of the business and invest in resources which enhance business performance and drive growth, and reduce or eradicate those which have low added value. It sounds simple, but businesses which cut or under invest in resources to achieve budget may find themselves in financial difficulty even after the recession.

Adrian Richards,
Partner, Recovery & Reorganisation,
Grant Thornton UK LLP

Aside from this, other respondents say they are exploring new business areas (19%) such as pushing into new markets, introducing new products and aggressively seeking out new clients in order to expand their customer base. On the other hand, however, 16% say they are concentrating more on their core operations. “We’re focusing more on the quality of our food and service,” states one fresh produce respondent. Meanwhile, a slightly smaller proportion (14%) say they are reducing prices, with a managing director at a food ingredients company saying, “We’re making sure our prices are right. Low margins and competitive prices help to maintain volume.”

Fig. 3 How is your company dealing with these challenges?



Comment

It is clear that businesses have had to react to a move away from out-of-home consumption. One of our clients indicates that had they not switched their food distribution from hotels and restaurants to retail they would be out of business by now. In the future there is likely to be a continued focus on delivering value proposition to consumers while maintaining quality alongside consumer demand for healthier and convenient foods.

Charlie Kerlin,
Director, Corporate Finance,
Grant Thornton UK LLP



Findings

Spotlight on supermarket relationships

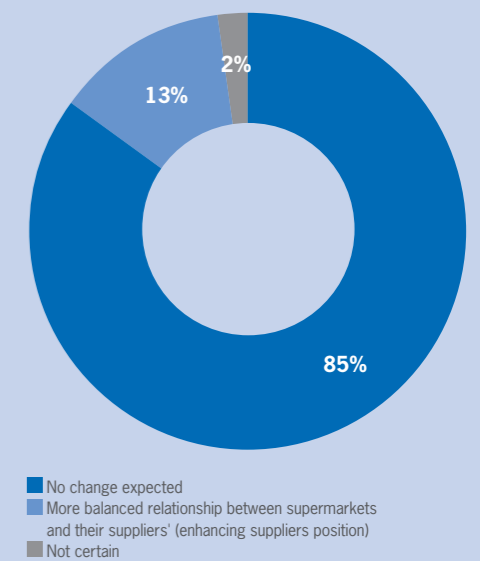
Despite 45% of respondents describing their relationship with the UK's major supermarket chains as excellent, around one-quarter say it is challenging. Tellingly, survey results vary widely depending on the size of the business in question, with the smallest firms appearing the most dissatisfied with their relationship with the big supermarket chains. For instance, 38% of respondents in the £25m-£100m range say they have a challenging relationship with the big UK supermarkets, a figure that falls to just 13% and 10% for firms in the £100m-£250m and £250m-£400m ranges, respectively.

One source of tension may be supermarket pricing and loyalty reward sales models. As one soft beverages respondent spells out, "Some supermarkets are even doing 'buy one, get two free'. This puts a lot of pressure

on margins. We are looking into selling to schools more. They are price-sensitive, but don't slash prices." Indeed, 14% of respondents similarly feel that supermarket pricing is adding strain to their business. In this regard, firms that lack scale are clearly feeling the pain more than others.

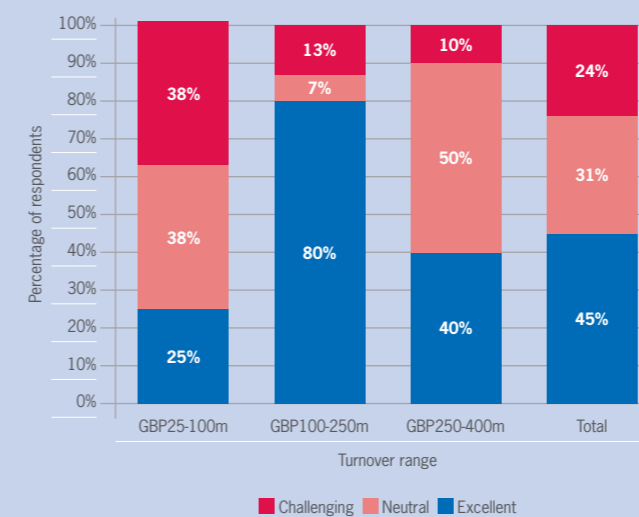
Interestingly, respondents from businesses of all sizes hold a dim view of the government-proposed 'ombudsman' to mediate between suppliers and supermarkets, with 85% saying that it will make no difference. One frozen and chilled foods respondent simply describes the proposal as a 'toothless tiger'. Another respondent from a soft beverages company elaborates, "It will have no effect. It all depends on how you get on with the buyer. We're small fry. You can get someone who is old-school and will squeeze you as much as possible

Fig. 5 What positive changes would you expect from the government-proposed 'ombudsman' to mediate between suppliers and supermarkets?



on prices, or someone who takes a more balanced approach. But, at the end of the day, a big company comes in to negotiate with you and you have to sit down and listen and take them seriously." And lastly, one respondent from a soft beverages firm pointedly explains, "It's a waste of time. If you blew the whistle on a supermarket, you'd never get a contract from anyone ever again."

Fig. 4 How would you describe your relationship with the UK's major supermarket chains?



Seizing the moment – opportunities in today’s market

While the UK Food space has undoubtedly been affected by the downturn, the impact has been heterogeneous, presenting both challenges and opportunities across different market sectors. Changing consumer behaviours have presented opportunities to launch new products and enter into new markets, joint ventures and acquisitions. In fact, 25% of respondents say that the decline of conspicuous consumption in itself offers a significant opportunity. This is because

households, in cutting back spending, have bolstered demand for home cooking products and sales of value foods. At the same time, in recent years, there has also been a shift in consumer attitudes towards home cooking by households with greater discretionary spending power. Indeed, inspired by the wave of home cooking shows, more and more people see cooking more elaborate meals with premium products and eating-in as preferable to a night out at a restaurant.

Neil Fraser,
Chief Executive Officer,
McCambridge Group Plc

Aligning your offering to the changed environment is key to being a success in this market.

Staying in

Not surprisingly then, a combined 31% of respondents identify the increase in home cooking as a significant or very significant opportunity going forward. In the same vein, on the trend for staying in, one respondent from a soft beverages company comments, “Our beverages can be used for cocktail mixes, and we hope that those who avoid going to the pubs, because of money worries, will do their own cocktail mixes at home.” The rise in home cooking and shift towards value products is also a boon for frozen foods producers, a trend that a total 30% of respondents say presents a significant or very significant opportunity.

Going out

On the flipside, in the restaurant sector even those consumers eating out have altered their consumption patterns in the down market. On the one hand, the fast food segment, offering an inexpensive menu, has done relatively well in the recession, which is not surprising. In addition to offering cheap meals, many quick-service restaurants also saw opportunity and have increasingly pushed into the breakfast space, which has been a key growth area for such firms. At the same time, full-service restaurants have had to be more reliant on promotional offers to attract customers, but they may start to see a rise in business as the economic recovery continues to progress. And in the pub niche there have been a lot of closures, particularly among the independents.

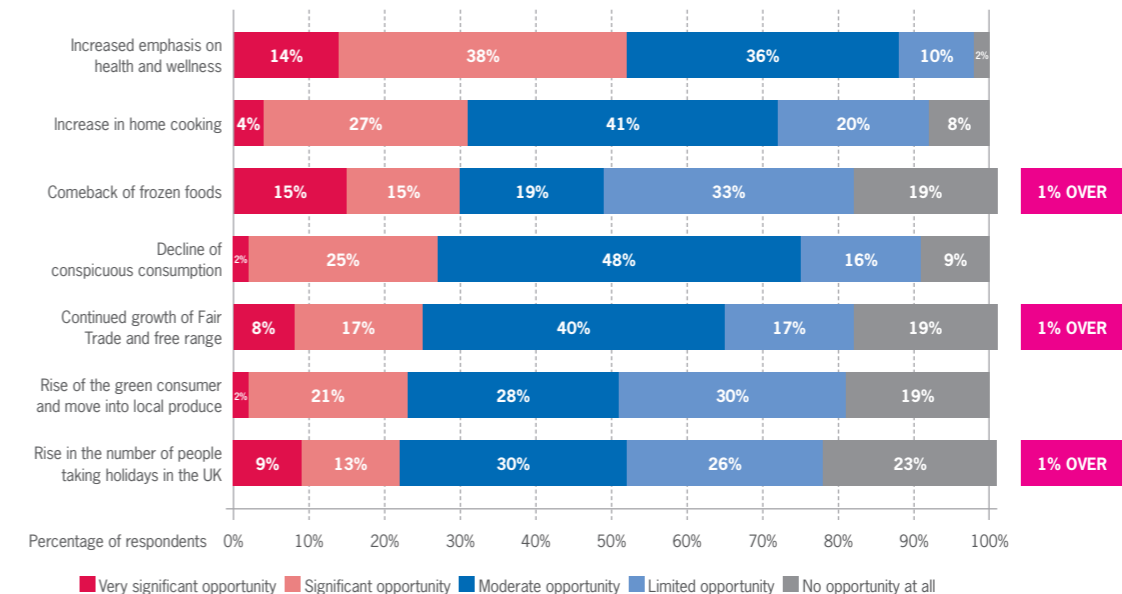
Comment

Looking ahead, it appears that fast-casual restaurants, offering a full service dining experience but with more competitive prices, will be a huge growth area in the restaurant sector.

Pete Dawson,
Partner, Transaction Advisory Services,
Grant Thornton UK LLP



Fig. 6 Looking at current consumer trends, which offer the biggest opportunities to your company? (Please rate 1-5 where 1 = no opportunity at all; 5 = very significant opportunity)



46% of respondents say they are considering expansion into new markets as part of their growth strategy.

Healthy eating

Whether going out or staying in, many consumers are also choosing healthier foods, presenting a lucrative area for growth in the UK Food sector. Indeed, over half of respondents (52%) say the increasing emphasis on health and wellness presents a significant or a very significant opportunity. These lifestyle and attitude changes towards eating, being as they are more resilient to the transitory shifts in consumption patterns, offer significant longer-term growth opportunities.

Local, green and ethical

Likewise, as attitudes change towards the way foods are produced, both in terms of the environmental impact and whether they are ethically sourced, new market opportunities are also opening up for these products. One-quarter of survey respondents say there is at least significant opportunity in the Fair Trade and free range spaces, while a combined 23% say the same about the rise of the green consumer and move towards local produce.

Innovation and NPD

These changing consumption trends are clearly playing a role in defining corporate growth plans for the future. It goes without saying that firms that do not innovate and adapt, face being left behind. Accordingly, 90% of those surveyed listed a number of ways changes in consumption trends impact upon their future plans, with the largest proportion (34%) saying these trends influence new product development and refinement of existing lines. In this regard, one food ingredients respondent says, “Home cooking is certainly increasing and we are trying to be more innovative to make home cooking easier with our products,” while another player in the ingredients niche states, “Our focus is on supplying healthier ingredients.”

Oliver Wyncoll,
Partner,
Langholm Capital

An inevitable by-product of the recent downturn and the squeeze by retailers on supplier margins is that innovation gets pushed off the agenda from the brand leaders' strategy. This has left an attractive space for the challenger brands to occupy as the retailers look for on-trend brands and innovation to restore margins and generate growth. Langholm has invested behind several such brands, for example Dorset Cereals, Tyrrells and Bart Spices. Such brands have competed successfully with the incumbent leaders' which are significantly larger in terms of market share, but also less innovative and flexible, and importantly offer the retailer a lower net margin for renting the shelf space.

Chris Ormrod,
Managing Director,
Ministry of Cake

For those of us who make a living supplying restaurants and pubs, life has subtly changed, but maybe not as drastically as people suspect. Yes we are working on reducing fats and salt, and yes NPD is more important – but then it always was. What interests me is turning trends into niche opportunities, before they go mainstream. To that end organic is old hat now, but using locally sourced fresh ingredients allows our company to claim ‘provenance’ and ‘authenticity’, and that – in turn – helps increase margins. So, I’ll work on a chocolate fudge cake, using named estate cocoa, with Fair Trade sugar and British cream. Then I’ll make it in a factory powered by sunlight and wind, and all waste will fuel my (green) company car – then I can command a good premium from happy customers. My biggest worry in all of this inward looking thinking is that – given the forecast growth in world population – we may not be able to source key raw ingredients in 30 years’ time.

Comment

Consumers are demanding healthy eating products, but are much more price aware and demanding these at lower prices, which is a tough balancing act for the sector.

Ian Marwood,
Partner, Corporate Finance,
Grant Thornton UK LLP

Comment

The ability for any food manufacturing company, or retailer, to maintain market share and grow sales lies in their ability to not only serve the customers with the usual product offering at the right price, but the ability to offer innovative products which offer new eating experiences to the customer, while also servicing their changing eating requirements. This is being done through the type of food on offer, the way it is prepared, the way it is stored and of course the way it is branded. With new technologies, new types of food production, increased marketing and changing consumer trends, the ability to have a well researched and well populated NPD pipeline is not only a requirement for the successful sector players, but a standard necessity for all food manufacturers and retail participants.

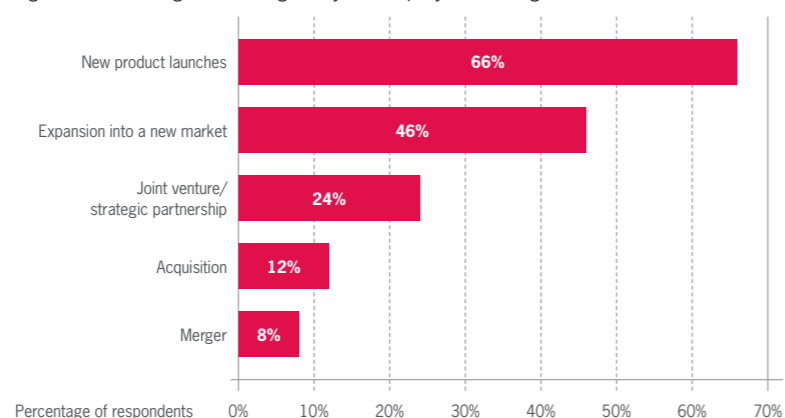
Lushani Kodituwakku,
Head of Strategy and Commercial Due Diligence,
Grant Thornton UK LLP

Future growth strategies

By and large, making products that are more appealing to consumers will be the key growth strategy for corporates going forward. Two-thirds of respondents to our survey say they are considering launching new products in the next 12 months. Around half of survey participants (46%) say they are considering expansion into new markets as part of their growth strategy. According to UK Trade & Investment, while the US and European markets are the mainstay markets for British Food and Beverage producers, countries further east in the Gulf and Asia are presenting tremendous opportunities. “We produce fresh products and moving into the frozen foods space will expand product shelf life and will give more opportunities to export,” one dairy products producer says.

Tellingly, other respondents are considering a host of options that will see them join forces with other players in the market through either M&A, strategic alliances, joint ventures or some type of commercial partnerships in order to grow their businesses.

Fig. 7 What kind of growth strategies is your company considering in the next 12 months?



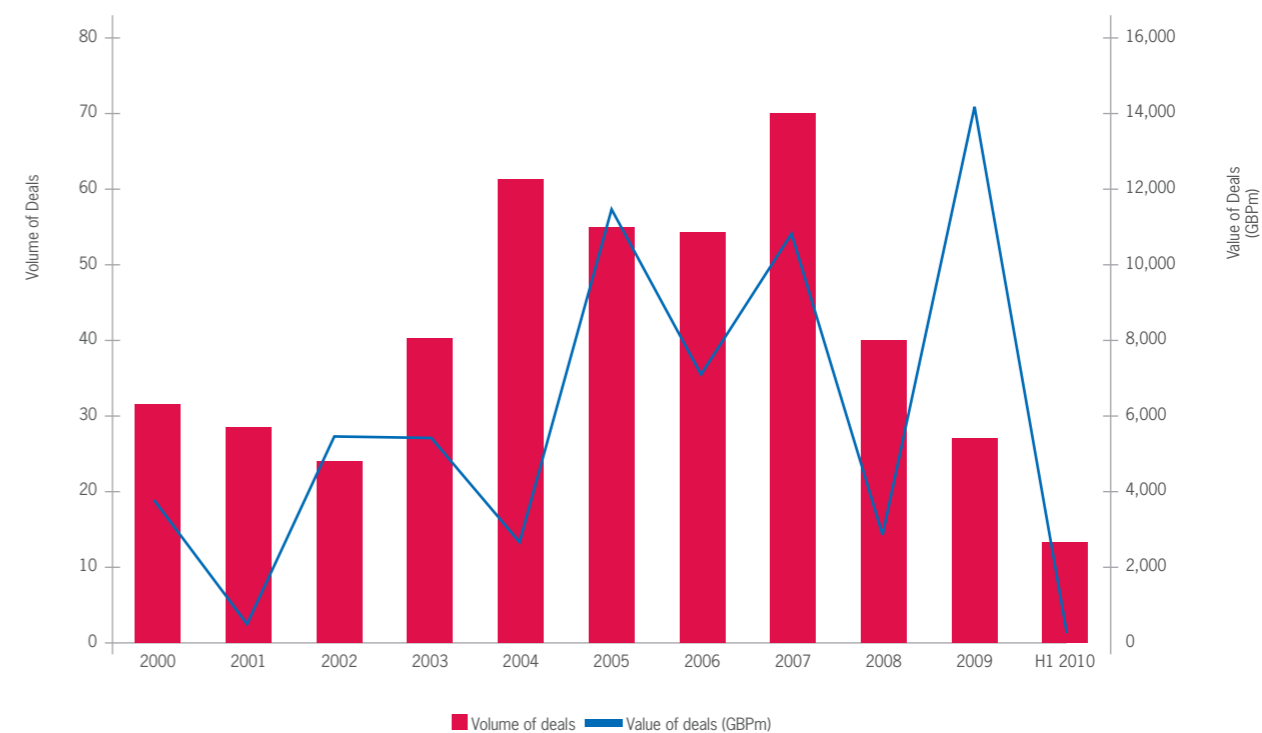
Findings

Eat or be eaten? The Food sector's appetite for M&A

The UK Food space has traditionally witnessed significant levels of consolidation with 259 deals announced since 2005, carrying an aggregate disclosed value of £46.6bn. Somewhat unsurprisingly, deal churn has fallen markedly in recent times, with the uncertain economic outlook and austere debt financing environment combining to stifle activity. Indeed, just 45 transactions have come to the market since the fourth quarter of 2008 with dealmaking centring

firmly in the mid to low end of the market, notwithstanding the anomaly that was Kraft Food's £13.7bn acquisition of Cadbury in the fourth quarter of 2009. Transactions that have been announced have generally been distressed-driven or very strategic in nature, although there are several encouraging signs that the landscape is changing with M&A making a prominent return to the corporate agenda.

Fig. 8 Overall M&A activity in the UK Food Sector

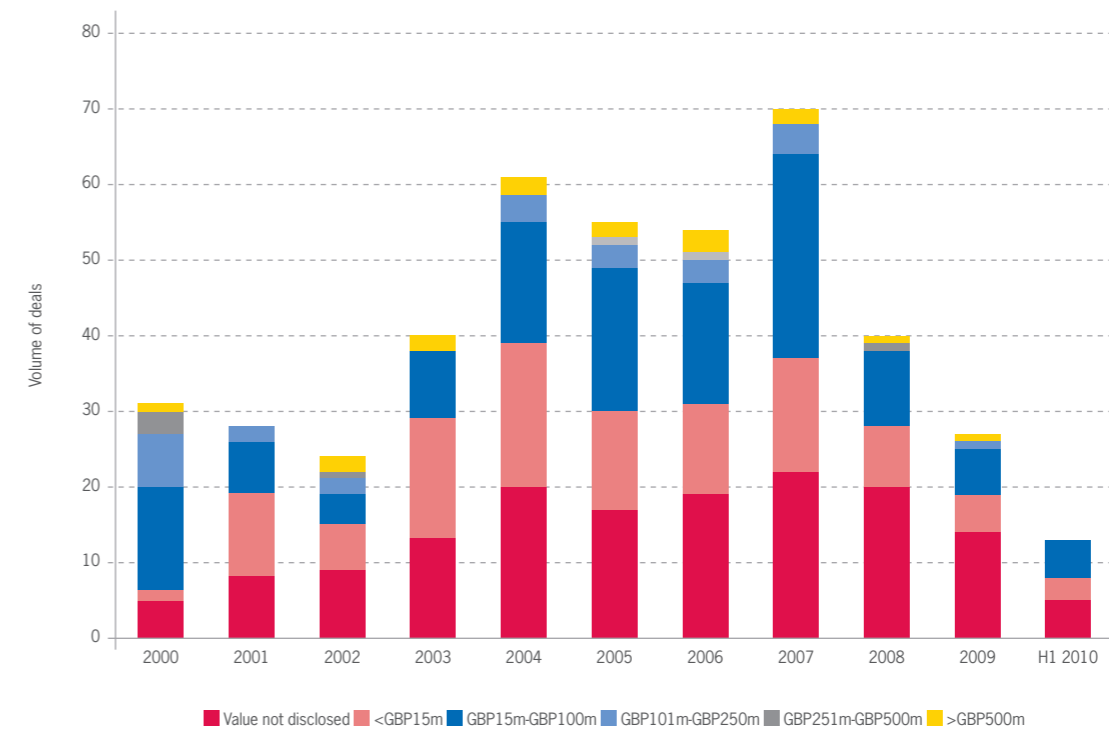


Source: Bloomberg; mergermarket research

Fig. 9 Top M&A deals in the UK Food sector, 2010 YTD

Announced Date	Status	Target Company	Target Description	Bidder Company	Bidder Dominant Country	Seller Company	Seller Dominant Country	Deal Value GBP (m)
7/8/10	Pending	Autobar Group Ltd	"UK-based distributor of beverage machines, snack, confectionery and food vending machines and provider of catering services	CVC Capital Partners Ltd	United Kingdom	Charterhouse Capital Partners LLP	United Kingdom	1000
1/7/10	Pending	Tate & Lyle (certain European sugar refineries)	Tate & Lyle's UK and Portugal-based cane sugar refineries, Golden Syrup factory in London and associated sugar and syrup brands, and the Tate & Lyle Process Technology consulting business	American Sugar Refining Inc	USA	Tate & Lyle plc	United Kingdom	211
9/4/10	Pending	Innocent Ltd (40% Stake)	UK-based manufacturer of soft beverages	The Coca-Cola Company	USA	Adam Balon (private investor); Richard Reed (private investor); Jon Wright (private investor); Maurice Pinto (private investor)	United Kingdom	65
5/3/10	Completed	Argent Group Europe Ltd	UK-based company specialising in procurement of fruit and meat on behalf of its retail and wholesale customers	Fletcher Bay Investment Company Ltd	United Kingdom	Cinven Ltd; Andy Hunter (private investor)	United Kingdom	32
10/2/10	Completed	Glisten plc	UK-based listed manufacturer and supplier of confectionery, ingredient, and snacking products	Bidco (acquisition vehicle formed by Raisio Group plc)	Finland			45
21/1/10	Completed	Gu Rensow Ltd (majority stake)	UK-based manufacturer of chocolate desserts	Noble Foods Limited	United Kingdom	James Averdieck (private investor); Mordechai Wosner (private investor)	United Kingdom	30

Fig. 10 Deal size split of M&A activity in the UK Food Sector



Source: Bloomberg; mergermarket research

Comment

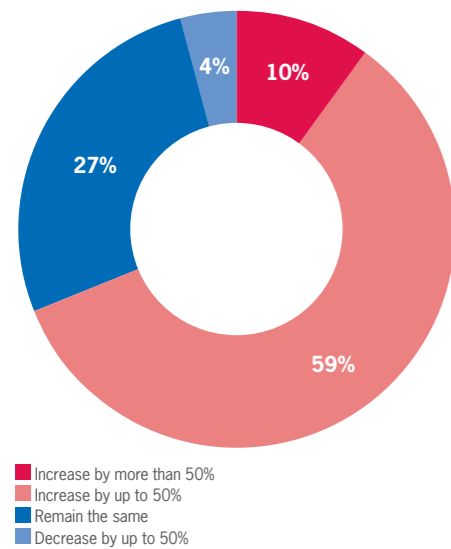
Most business owners we speak to still consider values to be low. However, some very high prices have been paid for branded food businesses recently and there is a decent level of M&A activity in the sector. This will increase now that things are on more of an even keel and businesses are spending more time looking out, rather than in.

Trefor Griffith,
Director, Corporate Finance,
Grant Thornton UK LLP

Looking ahead, UK Food companies clearly feel that the dealmaking environment is improving once again, with a significant 69% of survey respondents expecting M&A activity in the sector to increase over the next 12 months. Many companies have spent the last couple of years reducing costs and improving operational efficiency and, with little fat left to cut, M&A is clearly one of the few growth avenues available to companies. Certainly, conditions are improving with price dislocation between buy and sell-side parties narrowing and banks cautiously starting to lend once again.

36% of respondents feel that they would encounter difficulties securing financing for M&A.

Fig. 11 What do you expect to happen to the level of M&A activity in the UK Food sector over the next 12 months?



Against this backdrop, 20% are planning to undertake a merger or acquisition in the next 12 months. However, while all survey respondents feel well placed to finance their day-to-day operations, 36% feel that they would encounter difficulties securing financing for M&A in the coming months. Elsewhere, it is telling that businesses appear to be more receptive to undertaking a joint venture or strategic partnership with a competitor, with 24% of respondents considering employing such a strategy going forward. Nevertheless, rightly or wrongly, most mid-market acquirers clearly do not feel as if they are in a position to do an M&A deal.

Charles Lamplugh,
Senior Relationship Manager,
Lloyds Banking Group

As businesses have looked at their costs and supply chains, they have improved their efficiency. There will be some M&A activity as we pull out of recession as some businesses will have potential but be unable to fulfil the opportunities. Stronger companies will relish the challenge and their banks should be looking to support them. Banks will back sound management with a clear and sensible plan. The assessment process is taking longer, but the debt structures are more robust for all concerned and are more likely to stand the test of time.

Drivers of future M&A

So what will drive the increase in M&A in the UK Food sector predicted by 69% of survey respondents? Well, improving performance and recovering profitability seem to be encouraging a number of would-be acquirers, especially at the top of the market. Recent announced activity has been dominated by cash-rich trade players and, to a lesser extent, private equity houses, and this looks set to continue over the short term with corporates continuing to look at opportunities that enable them to access more products and improve control of the distribution process. On this subject, one respondent from a soft beverages firm notes, "The Coca-Cola/Innocent deal is interesting in that a big company acquired a majority stake in a small, ethical company. This could be indicative of a future trend."

Comment

Many fresh produce businesses in the UK are suffering from low margins as a result of oversupply in the season, weak sterling while having to import out of season, water shortages, removal of pesticide chemicals, and retail competition. Margins in the UK are not sustainable and in some cases not sufficient to recover losses over the past few years. The sensible option for these businesses is to sell while they still have some value and are able to negotiate. Others are already forming strategic alliances with lower cost base areas in Eastern Europe and elsewhere in the world. The industry has moved on from the myth of food miles and is now focusing on water footprint and carbon footprint, making the pan European and also pan global supply logistics more socially acceptable to consumers. Therefore, in addition to mergers and acquisitions we shall see more collaboration and joint ventures as part of the restructuring process in the Food industry. The challenge to some of these structures is to retain the traceability and transparency required by the multiples.

Gary Markham,
Director, Agriculture Group,
Grant Thornton UK LLP

Comment

An impact of the current funding environment is that businesses are more cautious of how they will fund acquisitions, and this will have a knock-on effect on who will be doing deals and what structures will be employed. Cash-rich acquirors will have an edge in the short term, and strategic and joint arrangements between SME food businesses may become more evident.

Charlie Kerlin,
Director, Corporate Finance,
Grant Thornton UK LLP

Comment

Over the last 18 months, we have advised on a number of structured transactions where potential buyers and sellers have not had the confidence to enter into a full blown merger or acquisition. This enables the businesses to take advantage of synergies and economies of scale, while at the same time maintaining management structures sufficient to de-risk the transaction.

Trefor Griffith,
Director, Corporate Finance,
Grant Thornton UK LLP

Comment

Compared to the longer-term average, non-UK based acquirers have accounted for a larger share of dealmaking in the UK Food sector over the last couple of years*. Cash-rich companies from North America still seek to acquire established companies and brands in a stable UK market over the comparatively high growth but high risk emerging economies such as India, in an attempt to prevent stagnation in their mature home markets. The continued weakness of the British pound will make UK M&A targets more attractive for foreign suitors.

Jim Menzies,
Global Food Sector Leader,
Grant Thornton Canada

*Source: Mergermarket

Changing consumer trends will also shape activity as corporates look to either enter or strengthen their presence in several high growth niches. Indeed, as mentioned earlier, the economic downturn has precipitated an increase in home cooking, having a positive impact on the attractiveness of related sub-sectors such as frozen and chilled foods. Other established growth niches such as healthy and ethically sourced foods also present key opportunities for UK-based firms, although investment in these spaces is generally driven by longer-term attitude and lifestyle changes among consumers, as opposed to shorter-term macroeconomic trends.

Comment

There are a number of sub-sectors in the market that are ripe for consolidation, and a number of private equity houses which are interested in funding that consolidation through a buy and build.

Pete Dawson,
Partner, Transaction Advisory Services,
Grant Thornton UK LLP

Richard Babington,
Director,
NBGI Private Equity

There are still many deals to be done; after all, vendors still have a need for an exit and private equity still wants to invest. Increasingly though, the principle challenge coming to the fore in the Food sector is simply unlocking the opportunity – it is this barrier that is principally responsible for the huge fall in completed deals in the mid- to low-end of the market in the previous 18 months.

To bring deal activity back up to historical levels, private equity needs

to be more flexible in its approach in embracing buy-ins, turnarounds and lower levels of leverage to put a deal in play. Similarly, vendors need to play their part in being amenable to more creative purchase structures and risk sharing post transaction. For example, our recent MBI of Pasta King in the food service sector succeeded in part because NBGI Private Equity was the only potential buyer willing to consider the incumbent Managing Director's desire for a full exit on completion.

Comment

We are seeing some very strong acquisition values in the Food sector where there is a brand value to be acquired.

David Cockburn,
Partner, Corporate Finance,
Grant Thornton UK LLP

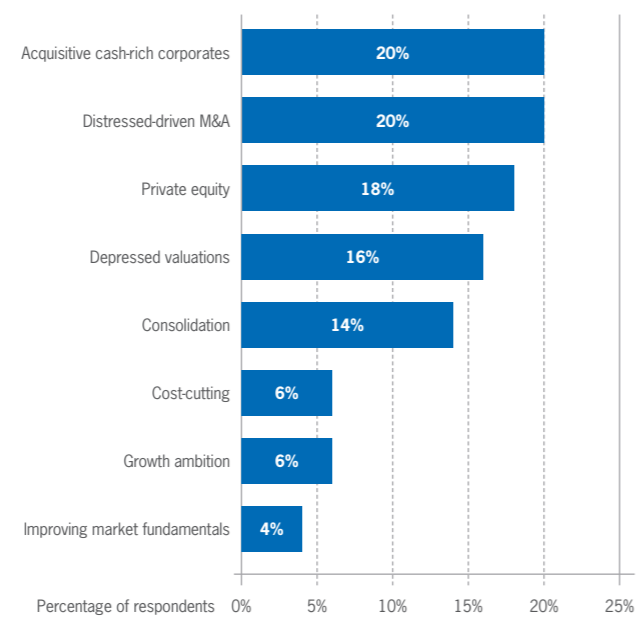
Neil Fraser,
Chief Executive Officer,
McCambridge Group Plc

As the industry overall recovers, M&A too will make a comeback. Overcapacity will be a key deal driver going forward.



Future consolidation will also continue to be driven by sell-side forces, particularly for small cap firms. Scale remains as important as ever and a number of smaller companies are struggling, with 33% of respondents remarking that a reduction in sales has been the biggest challenge of the economic downturn. Moreover, 32% say that a reduction in customer spending is the most significant obstacle currently faced, and integration into a larger group as a result of an M&A deal is certainly one way of easing the strain.

Fig. 12 What do you expect to drive M&A activity over this timeframe?



This is reinforced to good effect by the survey findings, with 20% of respondents expecting that both cash-rich corporates and distressed sales will emerge as the principal drivers of M&A in the coming months. One such respondent operating in the soft beverages niche comments that “There are a lot of companies looking for bolt-ons and big, opportunistic companies looking to acquire distressed small companies,” while a finance director at a frozen and chilled foods company notes, “...there will be distressed-driven M&A as margin pressures continue to increase.”

Standing still in a consolidating market is undoubtedly a risky tactic and many mid-market firms may turn into acquisition targets themselves if such reticence persists. One frozen and chilled foods respondent aptly summed this up in commenting that “The lack of availability of debt is still an issue and this will drive activity with weaker players being forced to come to the market.” Indeed, as the UK economy emerges from one of the most severe downturns, Food companies would be well served by exiting ‘survival mode’. It would certainly appear that growth through M&A is back on the menu for UK corporates. Eat or be eaten.

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