2015

Funding for growth with Food and Beverage

In our recent global study 'Hunger for growth – Food and beverage looks to the future', 53% of Australian food and beverage executives indicate that their organisations required capital to fund their growth.

Raising capital to fund this growth is vital for many businesses, however in the current climate this can be extremely challenging. A financing growth strategy is therefore a vital part of a business's overall plan.

Agility requires investment

Food and Beverage (F&B) manufacturers and distributors, more than ever need to be agile in order to capitalise on opportunities and mitigate threats to succeed in their growth strategy. Not dissimilar to other parts in the world, Australian businesses are heavily exposed to retailers and are vulnerable to changes in the supermarkets' strategies as they tackle their on-going competitive challenges. Often it is the agility of the business to be able to adapt to these strategies quickly which dictates the success or failure of their product.

As competition increases in the Australian retail sector with accelerating growth of low cost retailers such as Aldi and Costco, those manufacturers and distributors currently supplying to Woolworths and Coles may expect further pressure on their own margins. Additional pressures such as the growth in private label and reduction of branded products on supermarket shelves add further concerns to Australian food and beverage manufacturers.

F&B companies are responding both by becoming better at what they already do and by focusing on new or differentiated products and businesses. Product innovation is occurring in new areas such as healthy eating and premium luxury products but Australian businesses can still do more.

The results of our global survey indicate that Australian F&B businesses spend just under 1% of sales on research and development (R&D) compared to their North America counterparts who spend double that amount. This situation is not aided by the federal government's recently legislated cap on expenditure of $100m, above which the tax offset rate is equal to the corporate tax rate.

Many Australian businesses expect to build or expand plants, to aid in both supply chain pressures and development of new product capabilities as mentioned above. Others are planning to implement new information technologies and to pursue mergers and acquisitions. According to the Hunger for growth study, more than three-quarters of executives from across the globe report that their organisations will increase spending on equipment, new product development and information technology in the next 12 months. Some businesses are catching up on investments postponed during the global financial crisis, while others focus on growth through innovation, acquisitions and more recently overseas markets.

Investment in overseas markets, however, requires capital. As outlined in our soon to be released global F&B report 'Expanding Horizons', only the largest companies with very deep pockets can fund these investments in overseas markets from cash flow.

Over half of Australian F&B respondents to the Hunger for growth study are likely to require additional funding in the next 12 months. In order to be successful, businesses require detailed growth plans that prioritise their investments by return on investment. They will then use this analysis to pursue cost-effective financing – whether through traditional banking relationships, alternative financing, or partnerships with suppliers and customers.

A changing funding landscape

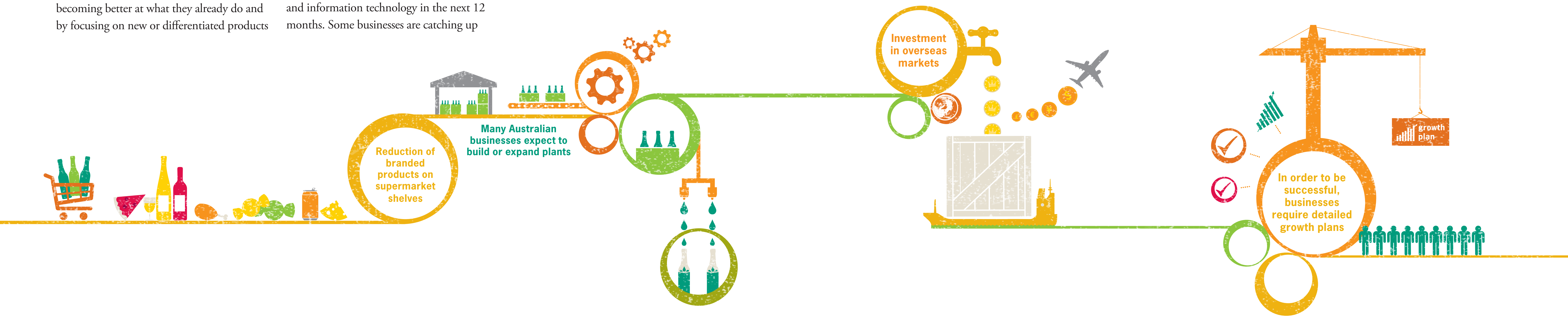
Historically, F&B companies raised short to medium-term amortising debt, with a tenor of three to five years. A three-year debt cycle, however, effectively means that the company needs to consider its refinancing requirement within about 12 to 18 months of facilities maturing. This can be particularly challenging, as capitalising on new market opportunities in overseas markets for example, may require funding well beyond the traditional debt cycle.

Pricing within the banking sector has remained relatively stable with the spread on business lending only decreasing on average, 7 basis points above the decline in the cash rate for the 12 months to September 2014 (Reserve Bank of Australia). However, stability presents opportunities for F&B businesses to firm up assumptions underpinning future cash flow projections and growth opportunities by sourcing financing from the non-traditional sector at lower cost. The spread in the yields within the money market over the same period decreased on average 34 basis points (Reserve Bank of Australia).

Despite stronger M&A activity, illustrated by recent large deals such as the acquisition of Joe White Maltings Pty Ltd by US owned Cargill Australia Limited for $339m in October 2013 and the $537m sale of Warrnambool Cheese and Butter Factory Holdings Ltd to Saputo Inc. in February 2014, the F&B market is not without its funding hurdles.

More recently, the funding landscape has started to change and we believe it will continue to do so. More non-bank lenders are entering the market, with hedge funds, credit funds, specialist Agri funds and private equity looking to put capital to work. Money is available for companies to re-start capital expenditure and to consider M&A opportunities and more of this funding is now finding its way into the mid-market. We are seeing more and more of these types of lenders particularly interested in Australian Agricultural assets and F&B manufacturers and distributors.

Non-bank lenders tend to offer longer-term non-amortising fixed rate debt with tenors as long as 6 to 10 years. This type of debt can be attractive for F&B businesses as it eases pressure on working capital, allows free cash flow to be reinvested rather than going towards amortisation payments and allows the company to focus on growth, as well as providing headroom in the event of a poor harvest affecting input costs. There is a degree of trade-off required to gain these advantages, as an additional premium is payable for the increased flexibility.



These alternative capital providers have in recent times significantly increased their focus on the F&B sector where they see valuable opportunities in partnering with businesses across a wide range of F&B sub-sectors. The "covenant lite" approach from these types of funders provides organisations with runway to invest and grow their businesses without the need to constantly look in the rear view mirror.

Recently, Grant Thornton assisted a client in securing debt funding from an alternative capital source to execute its M&A strategy which will result in a significant uplift in this company's competitive market position and earnings profile. Unlike a traditional lender who would require a demonstrated track record of earnings delivery before contemplating new lending, the alternative capital provider was willing to buy into the future strategy and lend the funds to allow the business to execute its strategy. Whilst these funds come at a premium to traditional debt, from the borrower's perspective, it was still significantly cheaper than the cost of missing this opportunity to create a steep change in their business.

Asset based lenders (ABL) are continuing to enter the food and beverage industry, providing flexible and complementary solutions to traditional lending. ABL solutions highlight not only a strategic option for businesses that are still finding traditional cash-flow based facilities challenging, but also a flexible way to raise capital.

They are typically revolving facilities based on outstanding accounts receivable and inventory, alongside the term-loan structured against freehold property and overdraft offerings. F&B lends itself to ABL due to the general working capital requirements and investment needs of these businesses as well as the demands of their customers.

The gap in funding sources that has occurred post global financial crisis has yet to be plugged and as potential buyers, both private equity (PE) and corporate investors have identified the main challenge as low availability of debt funding.

To an extent ABL have started to fill some of the gap in the F&B industry and this trend is likely to continue as:

- The mainstream banks are keen to focus on ABL due to their capital requirements and F&B sector businesses tend to have a more asset rich structure than, for example, service based industries.
- ABL is generally suitable to the F&B sector given the financial strength of the large customers and the security that provides.
- There are a number of 'independent' ABL providers who are building up strong portfolios in the sector, which is is increasing their comfort around some of the specific issues faced, for example the funding of perishable goods.
- ABL is usually not obtrusive for the customer going forward, for example with stock finance facilities requiring detailed bi-annual valuations or even desktop valuations dependent on the relationship built with the funder.
- The funding can be more innovative and bespoke which is therefore advantageous. An example in the wine industry has seen advances on inventory from the grape on the vine rather than waiting to for it to be a finished bottled product, ultimately creating flexibility for the customer.
- Many of the larger international F&B companies also run supply chain financing programmes which can help suppliers avoid the pressure on working capital and ultimately this benefits the industry as a whole.

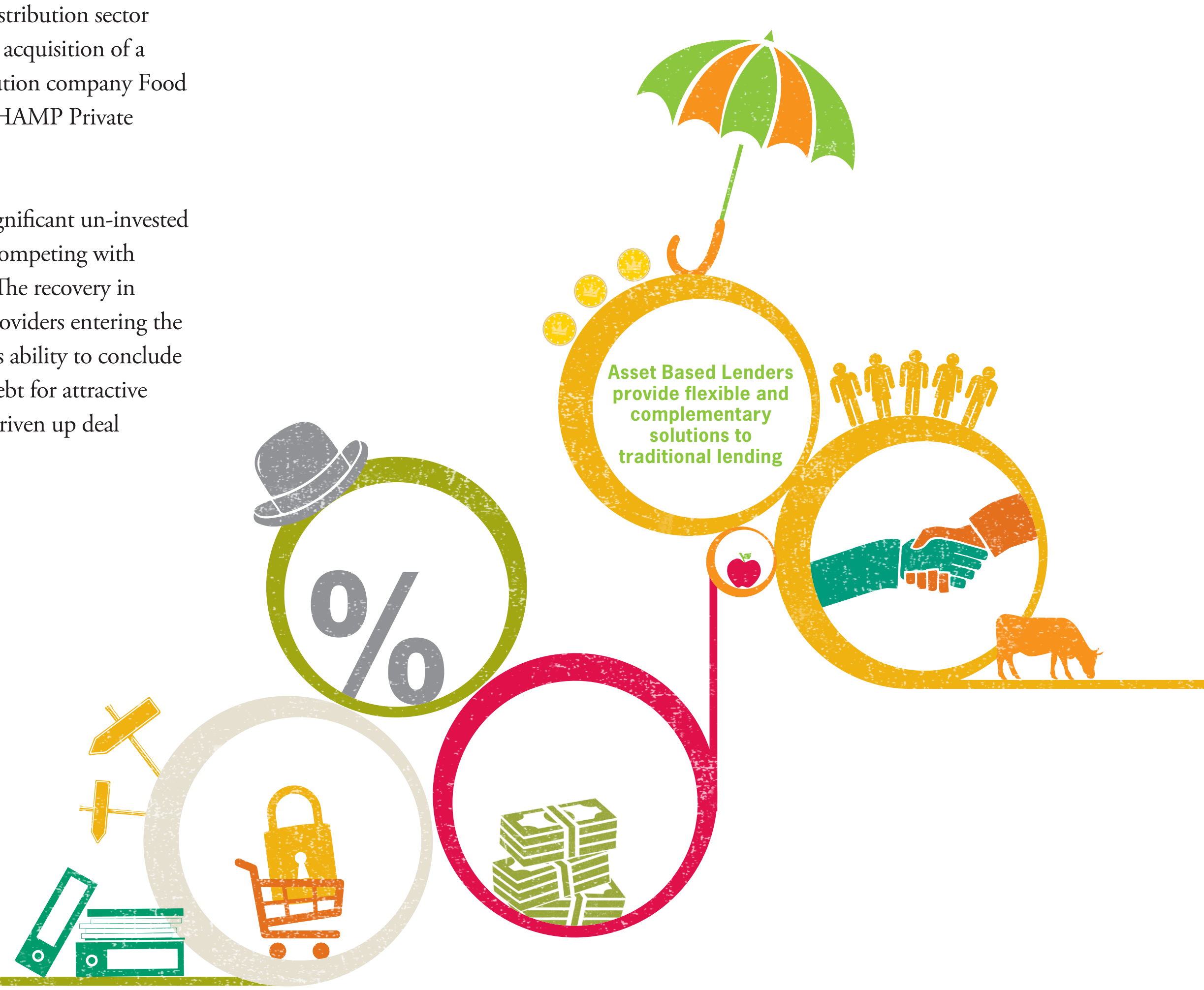
A joint venture is another alternative growth strategy that may appeal to local players in the market. Joint ventures can allow for growth without having to borrow additional funds. Australian F&B businesses can benefit from entering into joint venture partnerships both domestically and globally to grow their distribution and customer networks, whilst simultaneously sharing the risks with other joint venture partners.

Private equity looking to deploy capital

As noted in our publication, Bite Size – Dealtracker for the Food & Beverage Industry, PE buyers only participated in a relatively small proportion (14%) of total F&B deals in the period 1 January 2011 to 30 June 2014, however they were much more prevalent in larger deals.

Proportionately more of the PE deals occurred in the US and Canada whereas PE showed less interest in Asia Pacific. One of the largest transactions in the food distribution sector was Bright Foods Group's acquisition of a 75% stake in food distribution company Food Holdings Pty Ltd from CHAMP Private Equity for A$516m.

PE firms currently have significant un-invested capital to deploy and are competing with trade for attractive assets. The recovery in debt markets, with new providers entering the market, has improved PE's ability to conclude deals. The availability of debt for attractive assets has, in some cases, driven up deal multiples.



The return of the IPO

Over the 18 months to 30 June 2014, a total of 90 new companies listed on the ASX, compared with 100 in the preceding 18 month period. Whilst the total number of new listings was lower, there was more than a five times increase in the total value of funds raised. Not only was there a substantial improvement in the value of new listings over the period, but the total amount raised from new listings on the ASX in the financial year ended 30 June 2014 was higher than in the boom years immediately preceding the GFC. This is a very encouraging sign of improving market conditions.

The Australian Initial Public Offering (IPO) market in 2014 calendar year was a record for public floats raising $14.7bn according to Thomson Reuters. This is compared to $6.2bn in 2013. For F&B businesses, the IPO route is a feasible alternative growth strategy to finance growth both organically and through bolt-on acquisitions.

Australia had only one significant F&B listing throughout the observed period being that of Bega Cheese Limited (ASX:BGA) with a total offer size of $35m.

The company has since been trading at a premium to its offer price. There were 3 other significant IPOs for F&B businesses in 2014 with the most significant raising being Huon Aquaculture (Salmon) raising $133m. Bellamy's Australia (infant formulas) raised $25m and Australian Dairy Farms Group (fresh milk) raised a further $9m. All of these companies have good exposure to the Australian majors and perhaps more interestingly have strong growth prospects through export into the Asian markets, giving further evidence that the IPO route is a feasible alternative funding strategy for those F&B businesses with a similar profile.

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What is the tax impact?

Whatever the form of funding obtained there will be tax considerations to take into account. For example, Australia has recently tightened its thin capitalisation provisions restricting the level of debt that foreign controlled or Australian outbound entities are able to have in Australia. The safe harbour ratio has been reduced from 75% to 60% of relevant assets, with interest deductions denied in respect of excess debt.

There are a multitude of other tax issues to consider in the context of debt funding, such as whether the relevant financial arrangements are considered "debt" for tax purposes as opposed to "equity". Interest deductions will only be available on debt interests. Similarly, withholding taxes and gross up clauses will become highly relevant in the context of a non-resident lender. Foreign currency denominated loans will also give rise to potential assessable/deductible FX gains or losses.

It will also be necessary to consider the application of a tax accrual regime that may operate where applicable to spread deductions over the life of a financial arrangement rather than on a realisations basis.

In the context of IPO's or other share placements, the deductibility or otherwise of capital raising costs can cause issues, as with the recovery of input tax credits on such costs. It is also necessary to consider the impact of share issues on the availability of any tax losses purportedly carried forward in any corporate entity.

Globally F&B companies often utilise employee share scheme ("ESS") arrangements to remunerate and incentivise employees. Such arrangements go to preserve valuable cash reserves within the business. Current legislation (enacted July 2009) for ESS arrangements continues to provide unfavourable tax outcomes. In particular there is essentially a mismatch between point of taxation and realisation of the benefit. However, after considerable criticism the government has proposed amendments that would go some way to remedy these issues effective 1 July 2015.

It is wise in the context of raising capital to consider carefully these and other tax issues in order to avoid any unintended tax consequences.

If you want to know more, please contact us...

National

Tony Pititto

National Head of Food
and Beverage

T 03 8663 6204
F 03 8663 6333
E tony.pititto@au.gt.com

Melbourne

Cameron Bacon

T 03 8663 6366
F 03 8663 6333
E cameron.bacon@au.gt.com

Adelaide

Adam Fisher

T 08 8372 6578
F 08 8372 6677
E adam.fisher@au.gt.com

Perth

David Hodgson

T 08 9480 2184
F 08 9322 7787
E david.hodgson@au.gt.com

Brisbane

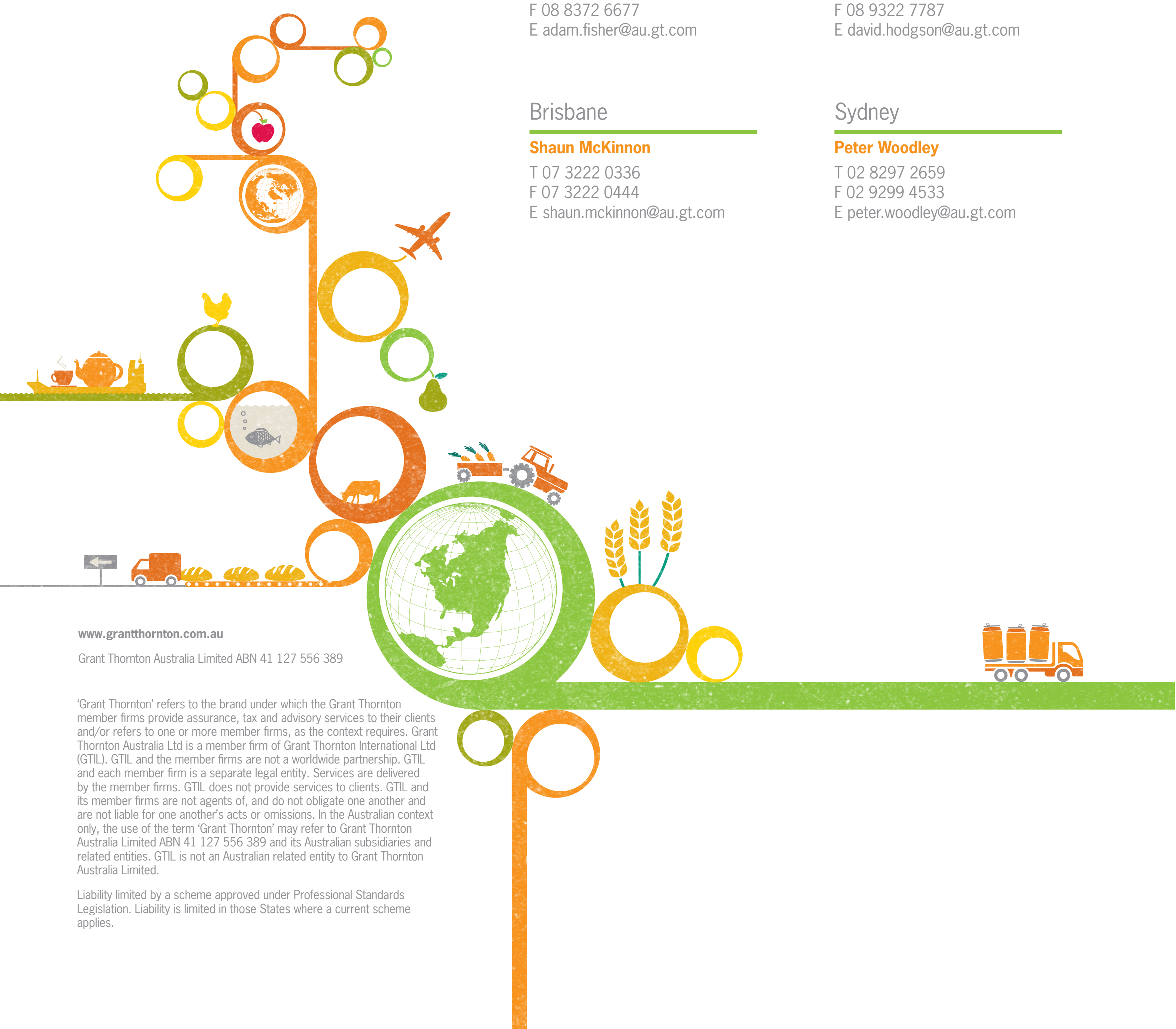
Shaun McKinnon

T 07 3222 0336
F 07 3222 0444
E shaun.mckinnon@au.gt.com

Sydney

Peter Woodley

T 02 8297 2659
F 02 9299 4533
E peter.woodley@au.gt.com



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