Welcome to Food Insights, an annual review of M&A activity and key trends within the European food manufacturing sector by PricewaterhouseCoopers Corporate Finance. This year’s edition includes a special focus on ethical supply chain management, an issue of growing importance for today’s food manufacturers.

After a relatively quiet year in 2004, M&A activity picked up in the food sector last year with deal volumes increasing by 11%. The combined value of these deals rose by 44%. Several of the largest transactions in the food industry last year were conducted by private equity houses, which show no signs yet of having sated their desire for food-related investments.

Levels of deal activity and a number of pending deals in the first quarter of 2006 indicate a positive outlook for deal flow in the food sector during 2006. Consolidation continues to be driven by the intense margin pressures placed on food manufacturers by retailers, and from the increasing energy costs that they face. In addition, manufacturers now have to contend with a wave of new requirements and expectations, particularly in terms of the nutritional value of food, its packaging, labelling and ethical sourcing.

To stay ahead of the game, companies often need to achieve economies of scale and to cut costs further, for example through manufacturing in cheaper economies. At the same time, companies need to gain access to consumers in these emerging markets – notably Central and Eastern Europe (CEE) and Asia-Pacific – to counteract stagnating consumer spending in western Europe.

With a team dedicated to the food sector, PricewaterhouseCoopers Corporate Finance is well-placed to identify industry trends such as these and to assist clients – particularly in the active middle market – in applying the most effective corporate strategies; whether these are growth through acquisition, restructuring or realising value in your business.

This edition of Food Insights presents just some of our thoughts on this exciting industry and, as always, your feedback and responses are extremely valuable. We would welcome the opportunity to hear your views and to discuss how the issues raised here might affect your business.

Neil Sutton
Food Sector Leader
Corporate Finance
PricewaterhouseCoopers LLP
neil.sutton@uk.pwc.com
The M&A arena heats up

M&A activity in the European food sector was back on full-power last year. Following a 13% drop in deal numbers in 2004, volumes rose by 11% in 2005 to 350 transactions from 315 the previous year.

Boosted by increased activity at the top end of the market, the total disclosed value of these deals was up 44% – following a 9% drop in 2004 – to €10.5bn from €7.3bn.

This vigorous appetite for significant corporate manoeuvres took the aggregate value of European food sector transactions ahead of the trend for European M&A in general, where total disclosed deal values rose by 30% in 2005. Volume-wise, however, dealflow in the food sector fell below the general industry-wide trend line with overall growth for European M&A up 19% last year.

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Big spenders

Last year, 21 deals valued at more than €100m were completed compared with 17 in 2004. The tally includes six €500m-plus deals, compared with three in 2004.

The two largest transactions were both Private Equity (PE) backed: the €975m IPO of Doughty Hanson’s bakery and grocery products company, RHM, on the London stock market and the acquisition of Panrico, the Spanish bread and pastry producer, in a €900m LBO led by Apax Partners.

Largest disclosed deals in the European food sector in 2005

<table>
<thead>
<tr>
<th>Completion Date</th>
<th>Deal Value (m)</th>
<th>% Acquired</th>
<th>Target</th>
<th>Target Nationality</th>
<th>Target Description</th>
<th>Bidder</th>
<th>Bidder Nationality</th>
</tr>
</thead>
<tbody>
<tr>
<td>27-Jul-05</td>
<td>975</td>
<td>70</td>
<td>RHM plc</td>
<td>UK</td>
<td>Branded bakery and grocery products company</td>
<td>Various investors</td>
<td>Not applicable</td>
</tr>
<tr>
<td>01-Nov-05</td>
<td>900</td>
<td>100</td>
<td>Panrico</td>
<td>Spain</td>
<td>Bread and pastry producer</td>
<td>Apax Partners &amp; Co</td>
<td>UK</td>
</tr>
<tr>
<td>20-Apr-05</td>
<td>706</td>
<td>80</td>
<td>Geest plc</td>
<td>UK</td>
<td>Chilled convenience food manufacturer</td>
<td>Blákkavor Group</td>
<td>Iceland</td>
</tr>
<tr>
<td>16-Aug-05</td>
<td>702</td>
<td>100</td>
<td>HP Foods</td>
<td>UK</td>
<td>HP, Lea &amp; Perrins and Aroy brands</td>
<td>HJ Heinz</td>
<td>US</td>
</tr>
<tr>
<td>25-Apr-05</td>
<td>639</td>
<td>100</td>
<td>Panzani</td>
<td>France</td>
<td>Branded pasta and pasta sauces company</td>
<td>Ebro Puleva</td>
<td>Spain</td>
</tr>
<tr>
<td>28-Feb-05</td>
<td>568</td>
<td>41</td>
<td>Snack Ventures Europe</td>
<td>Belgium</td>
<td>Snack food manufacturer</td>
<td>PepsiCo</td>
<td>US</td>
</tr>
</tbody>
</table>

Source: dealogic, M&A Global
Criteria: Deals with a disclosed value only, acquired stake greater than 20%
The mid-market (deals valued at €50m – €500m) was buoyant last year; 30 deals were completed in the European food sector with disclosed values totalling €4.7bn.

In 2004 there were 24 disclosed deals in this segment worth a combined €3.5bn.

Relatively few UK bidders made major commitments in the sub-€500m range last year, with only Premier Foods’ €255m purchase of Marlow Foods and Cranswick’s acquisition of Brookfields and Studleigh Royd, appearing in the top ten compared to three UK-originated acquisitions in 2004.

Middle-market picnic

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A taste for local cuisine

Scandinavia stepped up to the plate last year with BNS Industrier AB, a Swedish Newco formed by investment firms United International Enterprises Limited and Melker Schörling AB, merging the business of Aarhus United, the Danish edible oil company, with that of Karlshamns AB, the Swedish vegetable oil and fat manufacturer.

The merger took the form of two separate acquisitions valued at €324m and €315m, respectively.

While UK bidders kept their hands out of the cookie jar as far as sizeable mid-market deals were concerned, the number of UK deals in the European food sector as a whole increased slightly last year – to 59 from 56 in 2004. But it was Scandinavia that had the most conspicuous increase in consumption. It piled on 23 more food sector deals in 2005 than in 2004 with a run of deals in the fish and seafood sector, which is rapidly consolidating.

Source: dealogic, M&A Global
(CEE is defined as: Albania, Bosnia Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonian, Poland, Romania, Serbia and Montenegro, Slovakia, Slovenia)
CEE earns its place at the table

Food industry deals in CEE increased from 43 in 2004 to 59 last year.

This was due largely to 15 taking place in Serbia and Montenegro, where none was recorded in 2004.

This activity illustrates the growing stability of these less developed areas of the CEE region alongside the quest by western companies for cheaper sources of labour near the large EU market.
PE houses queue for second helpings

PE investors continued their appreciation of the European food sector last year, bagging 68 companies in deals worth a total of €2.0bn. This compares with 57, totalling €2.6bn, in 2004.

Food deals involving PE investment

At the other end of the production line, PE firms exited from 25 food companies last year (2004 – 27). Realisations of particular interest included the IPO of RHM, Montagu Private Equity’s sale of Marlow Foods and the divestment of the Noon Group by Bridgepoint Capital.
While the European food sector generally remains attractive to PE houses, the volume of unquoted equity investment in the UK by PE firms declined last year to seven deals from 11 in 2004. This was not due to a reduced appetite but rather to a resurgence in the importance of corporate buyers in the sector: the auction of HP Foods attracted a broad spread of well-qualified trade interest.

Food deals involving PE investment by location in 2005

Source: dealogic, M&A Global
Confidence in UK deal activity continues to be affected by pensions-related issues and there have been a number of high profile cases. Last year the PE-backed bid to take Uniq, the UK-based chilled food group, private proved unsuccessful when agreement could not be reached over the company’s £102m pension deficit. Meanwhile, some PE buyers are feeling the effects of fiercer competition and falling sales; PE-backed Golden Wonder Crisps was placed in administration in January this year.

Given its maturity and competitiveness, the UK food market is clearly no guaranteed gold-mine. Having said this, PE companies continue to be motivated by the chilled food sector as well as iconic brands and secure niches such as “functional”, “organic”, or “healthy eating”.

The organic food market in particular is continuing to experience high levels of market growth. Increasing numbers of consumers are willing to pay a premium for the perceived trade-up in taste and quality, and the confidence gained from greater transparency over where their food is sourced and how it is produced.

The Mediterranean diet is finding most favour among PE houses with Spain the hot target destination. No fewer than 15 Spanish food businesses were bought last year by PE houses (2004 – nine). Benelux also remained active with nine PE-related deals (2004 – 11), bolstered by the acquisition by NPM Capital in the Netherlands of Premier Foods’ Dutch canned vegetable business Jonker Fris and Premier Foods BV as well as Heinz’s Hak brand of preserved vegetables.

<table>
<thead>
<tr>
<th>Completion Date</th>
<th>Deal Value (€m)</th>
<th>Target</th>
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<td>Panrico</td>
<td>Spain</td>
<td>Bread and pastry producer</td>
<td>Apax Partners</td>
<td>UK</td>
<td>Caja de Ahorros y Pensiones de Barcelona - La Caixa/Banco Sabadell (35%)</td>
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<td>01-Apr-05</td>
<td>360</td>
<td>Cesare Fionucci</td>
<td>Italy</td>
<td>Sausage company</td>
<td>Vestar Capital Partners</td>
<td>US</td>
<td>Not applicable</td>
</tr>
<tr>
<td>01-Jul-05</td>
<td>198</td>
<td>DSM Bakery Ingredients</td>
<td>Netherlands</td>
<td>Manufacturer of bread and pastry ingredients</td>
<td>Gilde Investment Management</td>
<td>Netherlands</td>
<td>DSM</td>
</tr>
<tr>
<td>14-Oct-05</td>
<td>160</td>
<td>Icelandic Group (56%)</td>
<td>Iceland</td>
<td>Processor and distributor of seafood products</td>
<td>Investor Group</td>
<td>Iceland</td>
<td>Straumur-Burdaras Investment Bank &amp; Landsbanki Islands hf and other divestors</td>
</tr>
</tbody>
</table>

Source: dealogic, M&A Global
Market simmers gently

With seven deals valued at more than €100m awaiting completion at the close of 2005 – notably Nestlé’s €240m takeover of Delta Ice Cream in Greece and the €220m MBO of Nutrition & Santé, the French manufacturer of dietary and functional foods, backed by ABN Amro Capital France – corporate activity in the European food arena looks set to increase its momentum in 2006.

Several major divestments were announced at the turn of this year with Unilever and Heinz intending to sell their European frozen and chilled operations, and Cadbury Schweppes plc exiting from the European beverages market. Heinz is also divesting other non-core businesses such as its European seafood business, to a PE unit of Lehman Brothers.

On the PE exit front, 2006 has already seen the sale by BC Partners of Egidio Galbani, Italy’s largest cheese maker, to the French dairy group Lactalis and EQT’s divestment of Findus to CapVest. Meanwhile the market awaits the outcome of United Biscuits’ strategic review process.

The restructuring and refocusing recipe

Consolidation is expected within the following fragmented food sub-sectors: freshly prepared fruit, salads and vegetables; poultry; particularly as a result of price reductions caused by the threat of Avian influenza; cakes and desserts; sugar and chocolate confectionary; frozen food; bottled water; fruit juices; and tea and coffee as a result of:

- Continuing retailer pressure;
- Rising energy and raw material costs;
- Onerous regulatory and consumer demands; and
- Cheaper imported goods.

Companies are continuing to look further afield in a bid to achieve economies of scale and to ensure that they are well-positioned to optimise access to rapidly emerging consumer markets – notably Asia-Pacific and CEE.
Ethical supply chain management – the responsible way forward

As food companies increasingly choose to outsource and/or relocate manufacturing and services overseas, they commonly find themselves operating as part of complex international supply chains.

These chains tend to be controlled by the demands of key ‘downstream’ multiples and major producers who, helped by consolidation within the food industry, now have immense bargaining power. ‘Upstream’ suppliers must offer rapid delivery times, order flexibility and low prices.

Consumers, meanwhile, continue to nurture tastes for exotic goods to which the food sector must respond by expanding its product ranges. The parallel trend for luxury brands (often tied in with an “ethical” component to the brand, such as organic or Fairtrade ingredients) and healthy options makes quality, freshness, safety and nutritional content a top priority. Fairtrade Labelling Organisations International (FLO) records that between 2003 and 2004, Fairtrade labelled sales across the world grew by 56% to over 125,000 tonnes and sales have consistently grown year on year since 1997.

Emerging markets in China and India are growing in terms of population and disposable income and embracing the convenience, choice and hygiene of supermarkets. This represents a huge business opportunity for manufacturers able to adapt their products to suit local tastes and sensitivities, and their business models to operate in new and sometimes challenging environments.

Modern supply chains are increasingly extending to developing countries where production costs are cheaper, levels of compliance with local labour and environmental law may be low and standards of performance not in accordance with international good practice.

This can leave buyers with unprecedented levels of corporate, social, ethical and environmental risk in their supply chains which they must take steps to manage. How many large companies can say that they fully understand the environmental and human resourcing practices of their upstream suppliers, tier one and beyond? Companies and their brands can be damaged easily through high profile ‘exposés’ relating to Corporate Responsibility issues such as environmental damage, animal welfare or human rights.
Labour conditions
Cost pressures placed on producers can lead to increased working hours and lower health and safety standards. The 2004 incident in Morecambe Bay, UK, where 23 Chinese immigrant workers drowned whilst harvesting cockles led to the creation in 2005 of the “Gangmasters Licensing Authority” to operate a licensing scheme, set licensing conditions and maintain a register of licensed gangmasters.

Affordability
According to the World Business Council for Sustainable Development, over 740m people in developing nations are deficient in iodine. The serious health problems it causes include goitres, mental retardation, brain damage, congenital defects and stillbirths. UN research suggests that 30% of children under five in Africa suffer from iodine deficiency disorders. Unilever worked with local businesses in Ghana to outsource the production of iodised salt to make it cost-competitive with raw non iodised salt. Unilever also worked with schools to drive an education programme about the need for iodine in the diet.

Responsible marketing
In 2002 Sainsbury’s committed to source all its wild fish sold from sustainable sources (Marine Stewardship Council (MSC) certified fisheries) by 2010. 14 MSC lines are now available in Sainsbury’s stores in the UK. Sainsbury’s is running a proactive awareness raising campaign to inform customers about sustainable fishing issues. Marketing of food with poor nutritional content to children remains a tough issue as evidenced by the recent withdrawal of certain soft drink brands from school canteens in the UK.

Fair price to producers
Taking coffee as an example, since 1960, retail prices for coffee have remained stable despite producer prices dropping by more than two thirds. Roughly half the world’s coffee supply comes from small farms with fewer than five hectares under production. Low coffee prices are driving poverty amongst producers, with a growing number increasing diversification into prohibited crops such as coca or illegal logging. Fairtrade brands guarantee producers a market premium price for their goods. In 2002 Co-op announced a switch of all its own brand chocolate bars to Fairtrade in its 2,400 UK stores. In October 2005, Nescafé launched Partners Blend Fairtrade coffee.

Nutrition and obesity
WHO estimates that there are over 1bn overweight and obese people in the world. This is greater than the number that are underweight. Obesity leads to increased risk of diabetes, heart disease and cancer. As public concern grows, consumers are moving towards healthier and fresher foods, demanding choice and information in relation to salt, fat and sugar. Companies unable to innovate new product ranges that are convenient, cost effective and healthy risk losing out. Marks & Spencer has responded with its current “behind the label” campaign; Walkers crisps (Lays) has introduced a new line crisp low in saturated fat.
What should companies do?

Key steps in an effective supply chain risk management corporate response include:

- Establish internal leadership and commitment
- Map supply chain and assess product and country risk
- Develop a strong supplier code aligned to internal policies
- Develop a risk-based implementation strategy
- Commence supplier compliance and monitoring
- Develop mechanisms to support ongoing supplier rectification and long-term capacity building
- Performance measurements
- Continuous improvement mechanisms
- Strong internal and supplier reporting and communications

Integration of ethical sourcing considerations within the context of broader supply chain issues such as brand impact, quality and product safety.

Integration of ethical supply chain management objectives within wider business objectives and planning. In particular, integration with buyers’ performance metrics and targets.

Training of global procurement teams and local buying agents to be conversant in ethical sourcing issues.

Ethical standards should be translated into local information and reinforced through planned communication, as part of the company’s supplier development programme.
Increasingly companies are successfully coordinating their efforts to tackle ethical sourcing issues at an industry level in order to protect and enhance the reputation of a product in which they have collective interests. Examples in the food sector include the Ethical Tea Partnership (ETP), the MSC, the Roundtable on Sustainable Palm Oil and the Common Code for the Coffee Community to name but a few. This approach has the key benefits of an inclusive approach, a wide pool of available resources to draw on and, critically, avoidance of duplication of effort.

**Industry initiatives**

**Ethical Tea Partnership**

This industry partnership sources tea from over 1,200 tea estates globally, accounting for over 70% of the UK’s annual tea import. Its members have undertaken a shared responsibility to work with overseas tea growers and manufacturers to develop a clear factual understanding of the current situation and to improve social conditions on tea estates. PricewaterhouseCoopers was engaged to provide credible, independent monitoring of current standards against local labour law and collective bargaining agreements for approximately 300 tea producers annually. This service forms the long-term basis for encouraging continuous improvements in social conditions.

**Benefits**

- Companies develop a clear understanding of their supply chain – and the risks it represents. This helps them to take steps to manage risk and protect their reputation.
- The integration of responsible supply chain management within a wider operational framework helps to improve supply chain management processes, streamlining the agenda and reducing inefficiencies and silo effects.
- Companies develop a robust and credible action plan. If challenged, or if problems do occur, they can demonstrate that they are collaborating with suppliers and taking proactive steps to improve social, ethical and environmental performance in their supply chain.

Ethical supply chain management is becoming the focus for responsible food manufacturers and retailers. As consumer demand for ethically sourced products continues to rise, PricewaterhouseCoopers expects M&A interest in this area to increase significantly, evidenced by the acquisition of the Green & Black’s chocolate brand by Cadbury Schweppes plc.