Corporate Finance

Insights

Food Sector 2003/2004
Analysis & Opinions on European M&A Activity

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Despite the continuing economic uncertainty, food industry consolidation continued unabated in Europe last year. While this produced stable year-on-year deal volumes - 349 deals compared with 374 in 2002 - mega-deals were off the menu, resulting in a steep drop in total deal values for the sector during 2003.

New challenges facing the industry include the introduction of radio frequency identification (RFID) as the successor to bar-coding, and, in particular, rising concerns about health and obesity levels with a greater burden of responsibility falling on the food industry. There has been significant M&A activity in the retail convenience sector in 2003 and early 2004 and we consider the impact on food manufacturers.

With a team dedicated to the food sector, PricewaterhouseCoopers Corporate Finance is well-placed to identify industry trends and to assist clients - particularly in the highly-active middle market - in applying the most effective corporate strategies.

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.
M&A in the European food manufacturing industry held up well last year with deal volumes declining by just seven per cent to 349 deals in 2003 (2002 - 374 transactions). This compares favourably with a 16 per cent drop in deal volumes for the European M&A market as a whole.

With a scarcity of large transactions, the total value of disclosed M&A deals in the European food sector was down 40 per cent to €7.7 billion in 2003 compared with €12.8 billion in 2002.
Last November also saw the announcement of Hicks, Muse, Tate & Furst’s acquisition of Unilever’s Ambrosia for in excess of €150 million, as well as the €925 million LBO of the UK-based breakfast cereal maker Weetabix, but with these deals still pending at the year end, they will be included in the deal numbers for 2004.

The spotlight has been on smaller deals in 2003, with the average disclosed size for European food sector deals at the sub-€500 million level falling to €27 million in 2003 from €44 million in 2002.

In 2003 only eight food sector deals weighed in at between €100 million and €500 million, compared to 19 deals the previous year.
Central and Eastern Europe

A magnet for acquirers

The UK has been the most active M&A market for food transactions in Europe over the last three years. However, in 2003 the UK equalled Central and Eastern Europe (CEE) in deal number terms. Interestingly, the UK had only one deal in the top ten European food deals completed in 2003, being Montagu’s acquisition of Marlow Foods for £96 million. The larger transactions in 2003 occurred elsewhere in Europe. Five of last year’s €100 million-plus deals took place in France. Two involved the Italian energy company Edison in non-core divestments with the €397 million sale of its 42 per cent stake in the French sugar group Beghin-Say to a French farming consortium and the €363 million disposal of its 44 per cent stake in the French cooking oil company Cereal to the USA’s Bunge.

Activity in CEE centred particularly on the eight countries from this region which joined the European Union (EU) on 1 May 2004. Poland recorded 16 food sector deals in 2003 with eight deals reported in Hungary. The largest deal in Poland was the completion of the French company Saint Louis Sucre’s long running battle with the Polish Government to acquire a 95% stake in the state owned sugar company Slaska Spolka Cukrowa for €71 million. Other countries to watch include Bulgaria and Romania - with eight and four deals respectively last year - both are due to accede to the EU in 2007.

The Nordic region saw a significant increase in deal activity in 2003 - up to 40 deals from 31 in 2002. Norway surged from averaging just two deals per year in the last five years to chalk-up nine deals in 2003. Sweden doubled its food M&A activity last year to 16 transactions.

Perhaps due to negative sentiment caused by the difficulties at Parmalat and Cino del Monte, M&A activity in the Italian food sector decreased sharply last year to nine deals from 19 in both 2002 and 2001. As the futures of both companies unwind, we expect to see deal activity in Italy resume more normal levels in 2004.

Looking ahead, European countries outside the UK are likely to be the most fertile hunting grounds for food sector deals as consolidation gains pace. In particular, the low cost, rapidly expanding yet highly-fragmented markets of CEE are likely to be magnets for acquirers.

EU membership is expected to promote greater regional stability and harmonisation of fiscal, legal and regulatory systems. This should remove some of the ‘fear factor’ associated with deal-doing in these areas, and encourage more buyers to consider opportunities in the new EU member countries.
Private Equity

Appetite for deals continues unabated

Private equity (PE) houses from the US and Europe continue to demonstrate an active interest in the European food manufacturing sector. PE-backed deals increased to 55 in 2003 from 41 in 2002.
However, despite the high volume of PE deals last year, their combined value decreased to €877 million from €2.9 billion in 2002.

Just two PE-supported deals worth €100 million-plus were completed last year, the largest being Rohm & Haas’s disposal of its salt business Salins-Europe to a consortium lead by Union d’Etudes et d’Investissement SA (the private equity arm of Credit Agricole) for €592 million and Arca Impresa Gestioni SGR’s and Barclays Private Equity’s acquisition of a 33 per cent stake in Marr, the food distribution business owned by the Italian food group Cremone, for €100 million.

This contrasts with 11 €100 million-plus PE deals in 2002 led by the €1 billion buyout from Danone of the Italian cheese and salami business Galbani, backed by BC Partners; the €220 million secondary buyout of Young’s Bluecrest from Legal & General Ventures by CapVest; and Industri Kapital’s €128 million acquisition of a majority stake in the French specialist food company Labeyrie.

The mid-market provided the PE mainstay in 2003 with Montagu Private Equity acquiring Marlow Foods, the UK-based manufacturer of the Quorn-branded range of vegetarian products, from AstraZeneca for €96 million; and Orlando Management GmbH and FAB GmbH of Germany, acquiring the German distributor of fish, Pickenpack, from Dutch investment fund Glide for €60 million.

At the other end of the deal life-cycle, there were 22 realisations of PE food sector investments totalling €240 million in 2003. This compares with 18 exits worth a combined €1.2 billion in 2002.

With the exception of Bridgepoint’s successful split-sale of Golden Wonder to The Snack Factory and Pepsico in 2002, secondary buyouts have been the most popular realisation route over the last few years.

PE firms look set to continue investing in the sector with several having stated publicly that food manufacturing is a core area of focus.

We would expect a further increase in deal volume and value over the next year, with secondary buyouts playing a key role in this activity.

Going forward, continental Europe - which is extremely fragmented - will afford PE players better opportunities to add and extract value. Additionally, large multinationals continue to restructure and divest non core assets, providing opportunities for PE houses. In particular, significant focus is being applied to high growth market niches - witness Montagu’s investment in the meat alternative sector with Marlow Foods and Bridgepoint’s focus on the ethnic food sector through its investment in WT Foods, which in 2003 acquired the ethnic specialist Marston Valley Foods.
Therefore, due to the likely cost of both supplying tags and upgrading IT software and systems, and the current lack of consistent coding standards in the industry, many suppliers view this development with trepidation. In addition, privacy issues need to be understood by the retailer to reduce the risk of a consumer backlash.

RFID technologies will be phased in over two stages, case/pallet tracking in the near term with item level tracking introduced over the longer term. For example, Tesco has announced a four year roadmap for RFID adoption, with item level tagging already being trialled on selected lines such as razor blades and DVDs. Tesco has also stated that it expects its suppliers to be RFID compliant by 2005.

For most suppliers, item level tagging is an issue of expense; at current levels of approximately €0.07 per chip, it is not cost effective for most food manufacturers.
UK convenience sector storms ahead

The UK retail convenience sector has witnessed significant activity over the last 18 months and that trend looks set to continue.

Tesco added to its Tesco Express format by acquiring T&S in November 2002 and a further 45 Adminstore sites in January 2004; Sainsbury’s has recently bought up Bells; the Co-op has acquired Alldays and Balfour; Somerfield bought Scottish convenience store chain Aberness; and Londis has attracted wide interest. Both Tesco and Sainsbury’s are also partnering with Esso and Shell respectively in developing joint fuel and convenience store forecourt operations.

This growing interest from supermarkets in the £21.5 billion UK convenience market is being driven by a number of factors, including the struggle that chains are facing in gaining planning permission for larger outlets and the fact that it is among the fastest growing segments in the food retail sector. This growth is being fuelled by a range of socio-economic factors such as longer working hours, increased commuting times, higher numbers of women going out to work and the loss of basic cooking skills among younger generations.

These factors also open up a raft of new growth opportunities amongst suppliers as demand for fresh food and produce increases in local outlets.

Manufacturers that develop innovative new products and capitalise on the ‘healthy eating’ trend will certainly benefit from these changes. This includes the positioning of snack foods as having ‘functional benefits’ and recreating ‘traditional’ meals in a chilled, ready-to-eat format. Examples from both Heinz and Campbell include ‘hot soup on the go’ (microwavable soup cups) and in the chilled sector, Horizon Organic Yogurt Tubes, which allow consumers to eat on the move without the need for a spoon.

However, it is looking increasingly likely that retailers will embrace RFID.

Wal-Mart has told its top 100 suppliers that they must apply RFID to each pallet and case by January 2005, although recent technical issues may push out that timescale; Tesco is trialling a scheme with six FMCG suppliers and other retailers have similar testing plans.

There is little doubt that food manufacturers will be expected to shoulder the majority of the costs related to RFID - placing further pressure on profits, particularly for smaller manufacturers who may find it difficult to fund the investment required.

RFID may hasten M&A activity among those suppliers under the most pressure.
While manufacturers that already have strong relationships with the multiple retailers will be able to extend their reach into small stores, those not performing well could come under pressure. Secondary brands may also lose convenience store shelf space to retailers’ own brands. For smaller suppliers consolidation could deliver the solution, enabling them to increase operating efficiencies and fund increased product development.

**Weighty considerations**

It will be interesting to see how food manufacturers respond to the increasing debate on health and obesity issues.

The food industry came under significant scrutiny in 2003 as new figures from the World Health Organisation revealed that obesity rates have risen three-fold or more since 1980 in some areas of North America, the UK, CEE, the Middle East, the Pacific Islands, Australasia and China, with more than 1 billion adults overweight globally, of which at least 300 million are clinically obese. Food manufacturers are under growing pressure to implement stricter labelling and responsible advertising, produce healthy alternative products and back campaigns which encourage healthier eating.

Various governments in Europe are discussing proposals such as an extra tax on ‘junk’ foods, butter and whole milk, clearer food product labelling and packaging as well as advertising restrictions.
In response to these issues, food manufacturers have begun to make changes, such as Kraft, which has modified its product range and content to reflect public guidance on ingredients like sugar and salt.

Pressure is also being exerted by consumers as they become increasingly focused on healthy foods and shift their eating habits accordingly. The popularity of the Atkins diet in certain territories, such as the UK and North America, has also led to the creation of new product ranges including Nestle’s plans to launch a range of low carbohydrate products as part of its Stouffer’s Lean Cuisine range and Unilever’s Carb Options range.

Retailers have also indicated that consumers are buying healthier foods, with Tesco’s Healthy Living range growing by 12% in 2003, twice the growth of overall sales within the company.

Food manufacturers are expected to respond in one of two ways. First, for some manufacturers the current focus on obesity and health will drive a change in strategy - leading to diversification into more wholesome food ranges and/or the introduction of low fat and/or low carbohydrate products. We expect this to be driven both organically through the use of ‘healthy’ brands as an umbrella for new products and through acquisitions, leading to opportunities for those companies that are already focused on health.

Not every manufacturer will respond with such a strategic response to new product development. The second alternative will be to maintain a focus on an existing product range but as a minimum, to review the ingredients list and potentially evolve the product range to reduce the level of ‘non-healthy’ ingredients.

Finally, as an increasing number of companies include health and well-being in arriving at their ‘core’ activities, more brand disposals will be under consideration. The key issue here will be working out the population of purchasers for such brands.
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