Brereton and Company, Incorporated
Private Investment Banking

The Changing Landscape of the Food Industry: Harvesting Profit or Pain?

Food Industry Reporter - Volume No. I - October 9, 2002

Introduction to the Brereton Food Industry Reporter

The *Brereton Industry Reporter* is a quarterly journal designed to assist management and investors in the food industry. The journal attempts to address and explain current and anticipated market influences, investor sentiment and the valuation implications of the economic environment; including private company acquisition activity. By introducing quarterly data and highlighting critical market issues, we hope that the *Brereton Industry Reporter* can help management and investors gain effective insight into the valuation and organization of their business.

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Executive Summary

Among the many trends confronting the food industry, several issues and challenges have emerged as key determinants of success. One central concern is how to compete effectively following a decade focused on the "value chain." Lead by megacenters, value-chain management has resulted in massive gains in efficiency and lower prices for consumers. It has reshaped the competitive landscape, resulting in razor thin margins and competitors scrambling for a means of differentiating themselves on dimensions other than price.

Another, albeit closely related, emerging matter in the food industry is the increased concentration of ownership of retail and wholesale food companies. Does this shift the balance of power between retailers and manufacturers? How is pricing affected?

In this quarter's issue, we will address these two trends and also provide an update on how these and other topics are influencing the valuation and merger activity of the sector.

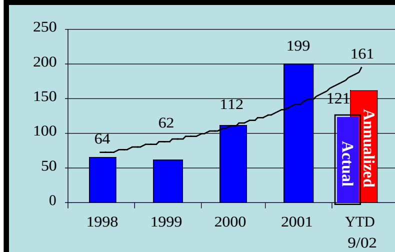
We would like to invite your insight on these or other industry related topics. Our contact information is on the back cover.

"Benefit Based Marketing"

During the 1990s the food industry focused on Value Chain Economics, with the largest competitors realizing major cost savings and efficiency gains. The remainder are finding it increasingly difficult to survive. Traditional supermarkets and their suppliers are losing market share, and the structure of the industry has profoundly changed. ***It is clear that future growth depends on participants finding ways to deliver unique value to consumers on dimensions other than price.*** To do this the industry must develop a better understanding of the consumer. Emerging needs involve our aging population, increasing ethnic diversity, changing house-hold makeup and impending social issues such as obesity and diabetes reaching epidemic proportions. These areas present opportunities to engage consumers on levels that may hold considerable growth and profit potential. The industry is reinventing itself again.

"Benefit Based Marketing," a term coined by the Food Industry Center, reflects the next evolution in competitive strategy. ***The basic principle involves a better understanding of the market place, the intricacies of consumer attitudes and needs, and the positioning of services and products to meet those needs.*** As a result, effectively positioned goods operate on a different plane than the price-based competition. Recognizing Americans pay less for food as a percentage of income than any other citizens in the world, it stands to reason that if the food products, retail stores, and restaurant menus are perceived to deliver greater benefits to consumers, sales and profit margin of firms could grow. Food can be packaged to deliver a multiplicity of life enhancing benefits. In addition to nourishment, food is a means of enjoyment, entertainment, medication and an expression of love and friendship. Food experiences that deliver these benefits result in significant value to consumers. The primary role of branding is to identify your product with these benefits or solutions. The

Food, Beverage and Tobacco M&A Deal Volume



It continues to be a very hot M&A market in the Food Industry

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Branding (Continued)

recognition of the unique value that a business can deliver will provide a means of creating equity with consumers. This equity enables businesses to price accordingly, resulting in higher profitability – so a better measure of success may be return on investment versus market share. With consolidation of the industry, competitors either need to increase their level of marketing sophistication or jeopardize survival. ***The trick is to anticipate consumer lifestyle needs and stand for something before competitors do it.***

Retail Consolidation and Manufacturer Economics

The fact that the retail food industry in the United States is in the midst of a period of rapid consolidation is well documented. An examination of food retailing during the last ten years reveals classic signs of industry maturity:

- <u>Nominal Sales Growth</u> – Averaging 3-4% per year
- <u>Overcapacity</u> – Measured by the number of stores and total square footage relative to the population
- <u>Increased Inter-industry Competition and Channel Blurring</u> – The growth of supercenters and food sales in other retail channels such as drug stores, discount stores and restaurants
- <u>Consolidation and Concentration</u> – Rampant M&A activity from small local stores to national chains

	1994	2000
Grocery Sales ($ Billions)	$402	$490
Market Share of Ten Largest Firms	27%	50%

Source: Progressive Grocer, Hoover's, The Food Institute.

The recent consolidation activity, while itself a symptom of maturity, is also a response strategy on the part of the industry. Wall Street stock valuations require sales growth in excess of what can be organically produced in a saturated marketplace – the response has been significant acquisition activity on the part of the large industry players. Also driving acquisition activity has been a desire to achieve scale economies in purchasing and technology. Finally, acquisition has been a means for large players to boost otherwise pressured profit margins via the elimination of supply chain redundancies.

Consolidation poses many challenges to the industry. The balance of power between retailers and manufacturers may be shifting – spawning a host of new trade relation issues and behaviors.

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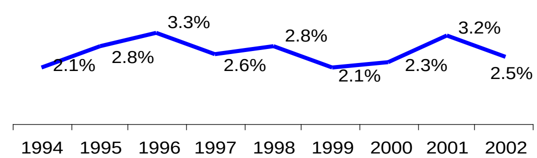
According to a recent study conducted by Cap Gemini Ernst & Young, 75% of manufacturers surveyed fear the consequences of the retail channel's increasing strength. The relationship between concentration, prices and profits has been studied and examined for several decades using various economic and business theories. Findings focus on two major questions: 1) Does the concentration of retail food firms increase food prices and firms' profits? 2) Has the retail sector become relatively more profitable and, thus, more powerful than the manufacturing sector?

Concentration and Pricing

While intuition and most economy theory would suggest that the increased consolidation would lead to higher prices, through oligopolistic negotiating power, this has not been the case. In fact, food expenditures as a percent of personal disposable income has been falling steadily. As evidenced below, food price expansion has been in line with overall inflation.

Normalized Food CPI Index



Source: Economic Research Service, USDA.

Explanations for this phenomenon have been that the retail sector still has significant competition or that it is simply increasing profit by exerting more pressure downward, onto food manufacturers.

Retail Versus Manufacturer Power and Profit

Over the past decade a popular observation has been that the "power" has shifted away from food manufacturers toward food retailers. Changes leading to this belief include continued consolidation among retailers, ever bigger stores, and improved inventory control. ***However, according to recent studies* the profit margins of retailers have not increased over the last twenty years, while the profit of manufacturers has increased slowly.*** This suggests that, at least to date, advances in production technology and parallel consolidations kept the balance of power in the hands of the manufacturers. So while it may still be difficult to determine the flux of power between retail and its suppliers, it certainly can be concluded that scale and technology have become of increased importance for every segment of the delivery chain.

*Messinger, P.R. and Chakravarthi N., "Has Power Shifted in the Grocery Channel?", *Marketing Science.* Farris, P.W. and K.L. Ailawadi. "Retail Power: Monster or Mouse?" *Journal of Retailing*

Valuation Review

Year to date, the equity markets have been challenging for investors. Muted economic indicators and concern over the health of consumer sentiment has led some to posit the probability of a sluggish recovery or even the possibility of a double dip recession.

In troubled markets, food companies tend to outperform due to their perceived defensive nature. On a year to date basis, as can be seen from the chart below, food stocks have held true to that theory. The more commodity oriented food companies have underperformed the packaged food group but almost universally outperformed the market.

It should be noted, however, that food stock's success is only on a relative basis. In terms of pricing multiples, we have seen no expansion in the last year.

	Enterprise Value*/	
	LTM Sales	LTM EBITDA
Avg. Large Cap Food Members[(a)]	**2.4x**	**10.7x**
Avg. Mid Cap Food Members[(b)]	**1.0x**	**10.2x**
Avg. Small Cap Food Members[(c)]	**0.9x**	**9.2x**

Sales figures based on last twelve months ended 6/30/02.
** Enterprise Value is equal to market cap minus cash plus preferred equity and debt.*
(a) Universe includes: UNA, CAG, HNZ, SLE, GIS, CPB, K, RAL, WWY, HSY.
(b) Unvierse inculdes: TSN, MKC, SZA, HRL, DF, DOL, IBC, TR, SXT, DRYR, SJM, LNCE.
(c) Universe includes: SFD, PLB, RAH, HAIN, IMC, JJSF.

We anticipate the food industry to continue to grow at an inflation adjusted 2% per year, with slightly more aggressive growth in the ethnic, health and international markets.

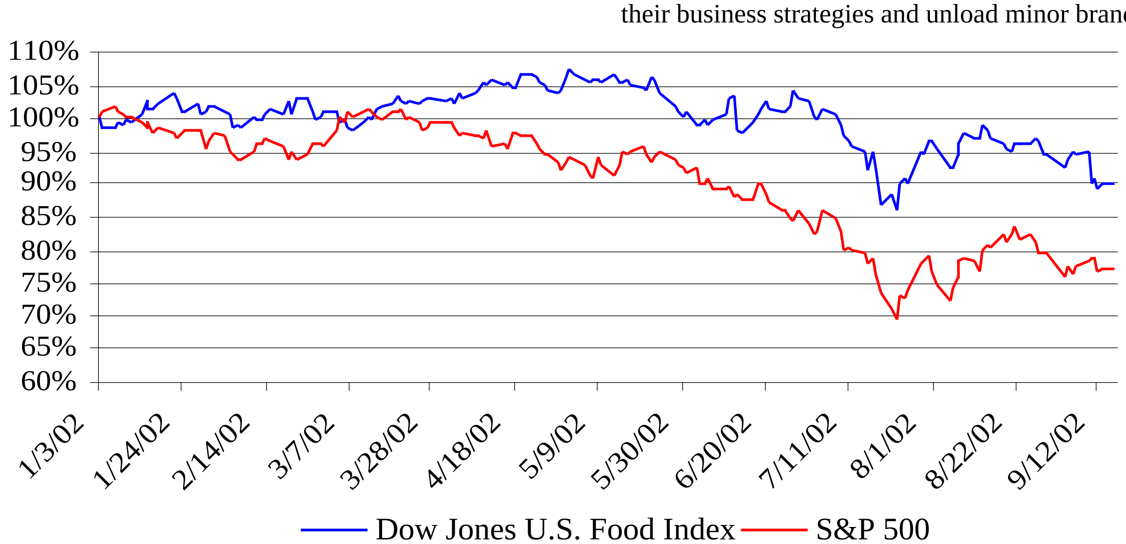
Merger and Acquisitions Review

The food industry has resurged as a result of rampant merger activity among several large food processors. In our view, industry consolidation among major packaged food companies was inevitable. The consolidation trend originated at the retail level. The pressure then mounted for manufacturers to get bigger and more technology savvy in order to become more important suppliers to their expanding retail customers.

According to MergerStat, as of September 2002 Food M&A is valued at $9.6 billion. For many food companies, mergers and acquisitions continue to be a means to achieve higher levels of sales and earnings growth that their business fundamentals wouldn't otherwise support. In addition, long-term growth can be enhanced by cost savings — and operating synergies — in manufacturing, product development, marketing, and distribution. Acquisitions can also enable a company to add new product lines with more favorable growth prospects.

Mergers and Acquisition Outlook

The pace of activity is bound to slow among the major players. For one thing, the number of attractive large candidates and deep pocket buyers has dwindled. However, many opportunities for small, niche acquisitions still exist. Since the food business is growing at an anemic 2 percent per year, many companies will find it hard to enhance sales and profits. We expect to see lots of consolidation among the smaller players, product portfolio adjustments and brand swapping as companies implement their business strategies and unload minor brands.



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ÿ Hands-on attention from experienced senior dealmakers who stay with your deal to closing

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ÿ Strategic planning framework for evaluation of financial alternatives
ÿ Structured timelines and processes for multiple bidder-based value maximization

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If you are:

ÿ*Undercapitalized and experiencing explosive demand for your product*

ÿ*Facing a difficult transition after many years at the helm*

ÿ*Unsure about how to best maximize the value of your business for your heirs*

ÿ*Ready to harvest your business investment to diversify your net worth*

Please give us a call. Our initial discussions and analysis are strictly confidential and complimentary.

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