

Assessing Mergers and Acquisitions in the Food and Beverage Industry

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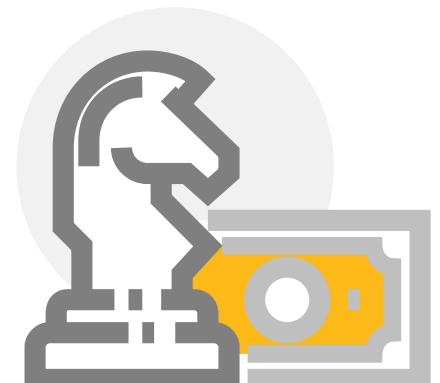
Agenda

- Identify attractive sectors in which companies are buying and identify the organizations that are expanding operations in today's food and beverage industry marketplace.
- Recognize the funding sources and institutions that are supporting M&A efforts in the food and beverage sector.
- Articulate unique characteristics of food industry transactions and identify which areas of the industry are "hot."
- Understand the role federal and local governments play and how to stay abreast of the latest information about compliance with these agencies.
- Understand the tax aspects of acquiring in the food and beverage industry.

M&A Market and Target Locations

Food Industry M&A Market

- With U.S. agribusiness currently in a mature phase, industry participants often find it more efficient to grow through acquisition as opposed to organic growth.
- Food and beverage industry M&A activity is strong overall.
- Strategic buyer activity in food and beverage increased year over year.
- Debt and equity financing remain in ample supply and at attractive rates.
- Overall valuations are at or near all-time highs.



Buyer Characteristics

The Buyers

- Many different types of organizations are participating in the food market – multinationals, national players, and private equity firms are all competing for food assets.
- Strategic buyers are the most prevalent buyers, acquiring approximately 80% of all food and beverage companies.
 - In the last quarter, large market CPG players such as Kellogg's, The Hershey Co., Hormel Foods, Campbell Soup Co., McCormick & Co., Tyson Foods, and even Amazon, who in the past was primarily a support vendor to CPG firms, have made acquisitions.
- In addition, private equity firms such as Wynnchurch Capital, Palladium Equity Partners, Pamplona Capital Management, Advent International, and Warburg Pincus have completed food deals in 2017.
- Private equity firms closed twice as many food and beverage deals in 2016 compared to 2015 and all prior years in the decade*.

* Source: Harris Williams & Co., *Food and Beverage Industry Update*, September 2017 publication



The Buyers

- Most buyers of U.S. food businesses are domestically headquartered, although some globally based companies such as Nestlé, Smithfield Foods, and Grupo Bimbo have been active in the U.S. market recently*.
- From the domestic strategic buyers active over the last quarter, we have seen a fairly even split between companies with global operations and those who are focused solely on the U.S. and North American market, such as US Foods and Anheuser-Busch*.
- While private equity is only reported as the buyer in about 20% of food and beverage transactions, several of the “strategic buyers” – such as Caribou Coffee, B&G Foods, and E. & J. Gallo Winery – have financial sponsor backing*.

* Source: The Chicago Corporation, *The Cupboard*, June, July, and August 2017 publications



Target Locations

- For the two month period from mid-July to mid-September, transactions in Europe and North America were split*:
 - Targets with cross-border operations represented 20% of the sector transactions.
 - Targets based in Europe represented 50% of the sector transactions.
 - Targets based in North America represented 30% of the sector transactions.

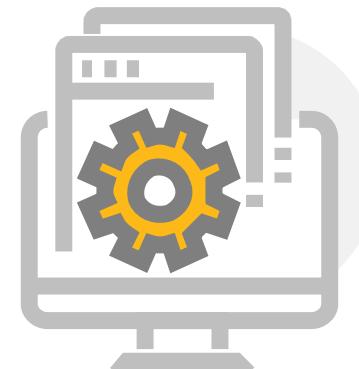


* Source: Harris Williams & Co., *Food and Beverage Industry Update*, August and September 2017 publications

Sourcing Companies to Acquire

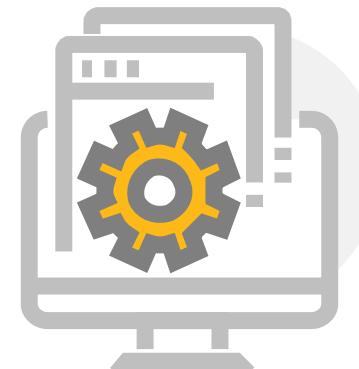
Deal Sourcing

- Deal Sourcing – the process through which companies wishing to grow through M&A such as private equity firms, family offices, business owners, and strategic buyers are able to discover, evaluate, and potentially select investment opportunities
- Deal sourcing is affected by market conditions. Acquirers sometimes have a surplus of capital to deploy but too few deals, which can make sourcing a deal more difficult and lead to participation in auction processes (widely marketed typically for best prices). Currently, there is more capital chasing deals, which pushes up valuations. Common deal sources include:
 - Investment bank or other advisers
 - Typically used for larger deals
 - Robust database of potential targets
 - Significant resources to research potential targets
 - Experience with multiple M&A transaction structures
 - Banks can provide financing for leveraged buyouts
 - Boutique investment banks may specialize in niche industries (for example, agribusiness investment bankers include William Blair and Auctus Group Investment Banking)
 - With investment banks typically comes a “finder’s fee”



Deal Sourcing (continued)

- In-house corporate development team
 - Continuous deal sourcing
 - Specialized knowledge of the acquirer's industry
 - Avoid a finder's fee, but have fixed costs associated with an in-house team
- Conferences and trade shows
 - Food & Beverage conferences, Association for Corporate Growth, CFO forums, and other M&A conferences
 - Link companies within the same industry
- Other intermediaries
 - Accountants, lawyers, consultants, asset managers, etc.
 - Deep knowledge of the company looking to sell
 - Buyer should have a strong reputation in the market and a history of closing deals
- Online platforms
 - Online deal sourcing platforms have increased in recent years
 - Both buyers and sellers can reach a wider audience with online tools to connect buyers and sellers
 - Examples include SourceScrub, Dealnexus, Dealflow, and PitchBook Data



Unique Industry Characteristics

Unique Industry Characteristics

- Commodity Volatility
 - The biggest variable cost impacting a Company's earnings
 - Top line revenue can be inflated or deflated based upon the volatility in commodity prices
 - Where is the Company in the food supply chain? Can they absorb that cost or can they pass on to customer?

Producers → Food Commodity Suppliers → Food Processors → Food Retailers → Consumers

- What is the Company doing to minimize price risk?
 - Position risk monitoring – key inputs, key outputs, and net position
 - Futures with broker
 - Over-the-counter (OTC) swap contracts
 - Forward contracts with customers and suppliers – long term contracts vs. spot market



Unique Industry Characteristics (continued)

- **Barriers to Entry**

- Capital intensive – typically, large capital investment (facilities, borrowing needs, etc.)

- **Long-Term Stability**

- Population growth
 - Demand for protein – as world economies continue to grow, their population demand for protein, calories, and diet will increase

- Continued shift to prepackaged and ready to eat products
 - Growth in snack bars, protein drinks, etc.

- **Cyclical nature of agribusiness industry – peaks and valleys**

- Long-term investment horizon (more than seven years)
 - Agribusiness was counter cyclical to the U.S. economy during the recession, which attracted investors

- **Foreign market expansion**

- As global demand continues to increase, strategic investments in foreign markets will also increase



Polling Question One

When competing to acquire a food and beverage company, which is your most likely largest competitor base?

- a. Family offices
- b. Foreign strategic buyers
- c. Local market participants
- d. National strategic buyers
- e. Private equity groups



How are F&B companies valued?

Valuation Measures

- Price-to-earnings ratio (P/E)
 - Level of analytics – low
 - Information requirements – publicly available for public companies
 - Benefits – ability to contrast with comparable public companies
 - Pitfalls – beware of one-time special charges affecting earnings – normalize using 10-K footnotes
- Enterprise Value to Earnings Before Interest, Taxes, Depreciation, and Amortization (EV/EBITDA)
 - Level of analytics – low
 - Information requirements – publicly available for public companies
 - Benefits – ability to contrast with comparable public companies
 - Pitfalls – beware of one-time special charges affecting EV and EBITDA – normalize using 10-K footnotes



Valuation Measures (continued)

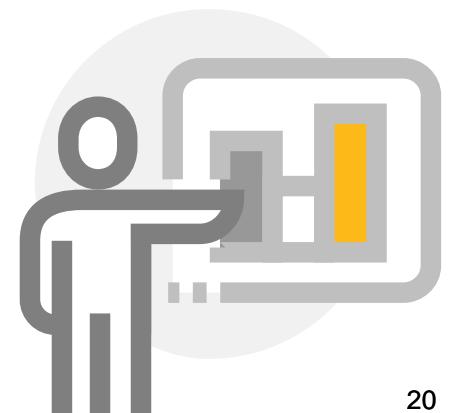
- Discounted Cash Flows (DCF)
 - Level of analytics – high
 - Information requirements – projected financial information
 - Benefits – detailed review of business
 - Pitfalls – overly optimistic (sometimes unrealistic) future performance forecasts; seasonality in the data



Industry Segments

Attractive Segments

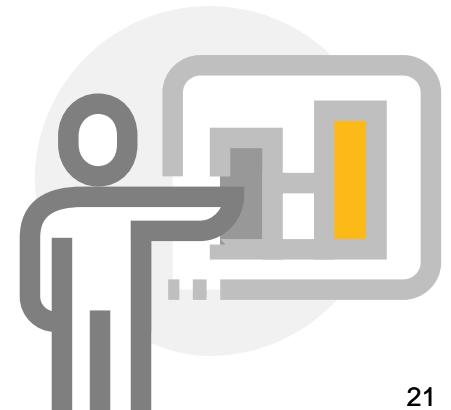
- Health and wellness (better-for-you) products have become one of the most consumed assets in the market.
 - Plant-based foods have seen the highest sales growth, making them attractive targets.
- As a category, beverages have consistently been the most sought after, followed by protein and baked & snack goods. Dairy products have been the least popular.
 - Alcoholic beverages remain the largest source of M&A activity in the industry.
- More recently, however, protein, ethnic foods, and sauces and condiments have drawn interest.
- Aquaculture is an expected area for future higher M&A activity.



Active Buyers by Segment *

- Healthy, Natural, and Organic Offerings
 - Kellogg's – RXBAR (\$600 million) – 2017
 - Danone SA – WhiteWave Foods Co. (\$12 billion) – 2017
 - Pinnacle Foods – Boulder Brands (\$1 billion) – 2016
 - General Mills – Annie's Homegrown (\$800 million) – 2014
- Craft Breweries
 - Sapporo USA – Anchor Brewing (\$85 million) – 2017
- Private Label Products
 - TreeHouse Foods – ConAgra private label operations (\$2.7 billion) – 2016
- E-commerce
 - Amazon – Whole Foods (\$13 billion) – 2017

* Source: S&P Capital IQ

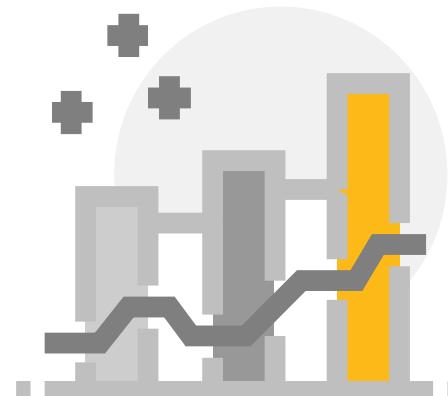


Industry Transaction Multiples

Industry Transaction Multiples

- P/E ratio*
 - 26.4x at the end of 2016
 - Industry is trading above the 10 year average by approximately 25%
- EV/EBITDA*
 - 14.1x at the end of 2016
 - Industry is trading above the 10 year average by more than 23% and has been above the 10 year average since the third quarter of 2012

* Source: "Industry Survey – Food Products", CFRA Equity Research, May 2017 – powered by S&P Capital IQ



Industry Sector Multiples

- As beverages have been the most sought-after assets, the multiples paid for these assets have been the highest at around 17x forward EBITDA.
- Ingredients on average garner a mid-teens multiple with baked goods/snacks, dairy, and packaged/manufactured foods running in the low double digits.
- Distribution, protein, and retail have seen only single digit multiples, on average.

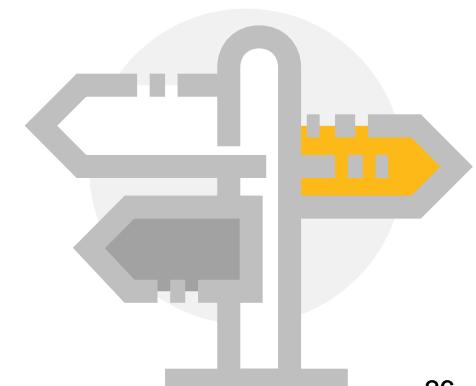
Source: Stout Risius Ross, LLC research and S&P Capital IQ, STOUT Food and Beverage Industry Update Q2 2017



Unique Risks of Industry Participants

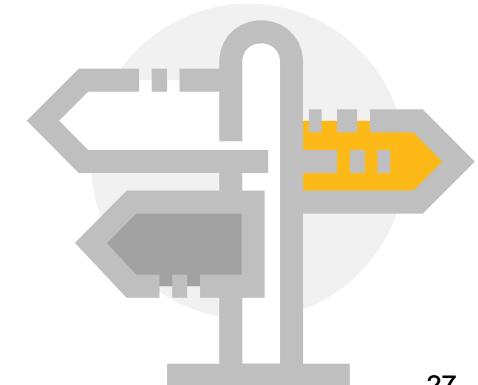
Unique Risks of Industry Participants

- Environmental
 - Environmental concerns
 - Weather-related issues – drought, hurricanes, hail impact on yield logistics and markets
 - Water usage and discharge
 - Pests and disease
- Evolving regulations
 - *Food Safety Modernization Act (FSMA)*
 - Shifting federal focus from responding to contamination to preventive controls
 - Impacts throughout the food supply chain (food processors, dairy farms, distributors, etc.)
 - Mapping the food supply chain
 - Labeling (non-GMO, organic certification)
 - Traceability



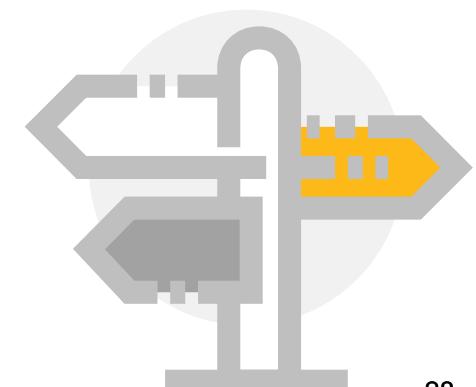
Unique Risks of Industry Participants (continued)

- Sustainability
- Agricultural technologies (GMO, antibiotics, etc.)
- Global supply and demand
- Governmental influence on markets
 - World trade
 - Farm Bill
 - Mandates (ethanol)
 - Tax incentives
- Transportation
 - Cost
 - Availability



Unique Risks of Industry Participants (continued)

- Other unique risk
 - Shortage of production labor
 - Changing environment for migrant workforce
 - Long growing cycle
 - Lack of sophistication in financial reporting (production agriculture)
 - Special-purpose property, plant, and equipment



Polling Question Two

The Food Safety Modernization Act (FSMA)

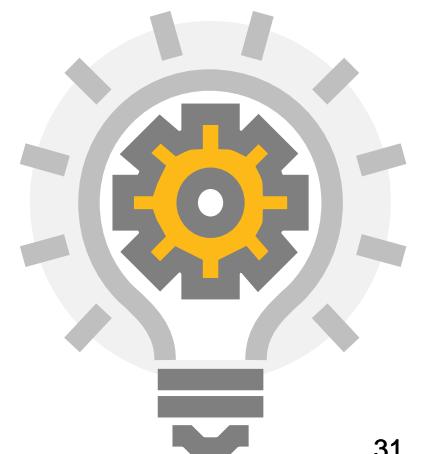
- a.** Is focused on responding to food contaminations
- b.** Is focused on preventing food contamination
- c.** Effects only growers
- d.** Effect only restaurants
- e.** Is an antiquated regulation soon to be replaced



Innovation and Technology

Innovation and Technology

- The pressure on water, land, energy, and labor resources will necessitate innovation to enhance agricultural productivity.
 - Robotic dairy production
 - Selective embryos to enhance milk production
 - Logistics – improvements to reduce waste and spoilage
 - Enhanced feed performance improvements (feed conversion rates, digestive studies, etc.)
 - Big data
 - Variable rate technology
 - Crop yield enhancements
 - Drones
- Recently, MIT began offering a course called “Innovation and Technology in Agriculture and the Environment.”



Financing Sources

Financing Sources

M&A deals can be financed through buyer capital, seller financing, and third-party financing (bank debt), or a combination of the three.

- Buyer capital

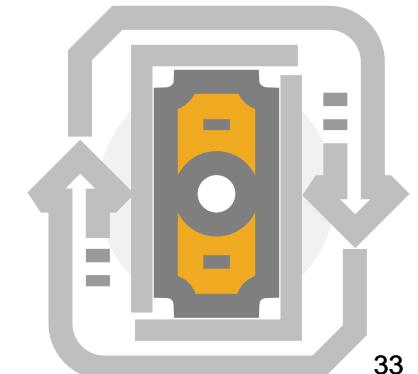
- The acquiring company uses its own capital to fund all or a portion of the transaction. Commonly, strategic buyers have the capital to fund the entire deal.
- Buyers can also issue their equity to the seller.

- Seller financing

- Seller note, in which the seller is paid the cost of equity over time

- Third-party financing

- Typically cheaper than equity
- No dilution of ownership
- Tax benefits
- May reduce a company's ability to borrow in the future
- Burden of cost of debt and lender covenants
- Third-party financing is not a guarantee. The Five C's of Credit (character, capacity, conditions, capital, and collateral) will help determine the possibility of third-party financing.



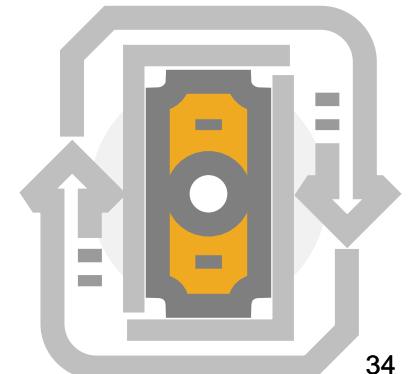
Financing Sources (continued)

- Types of third-party financing

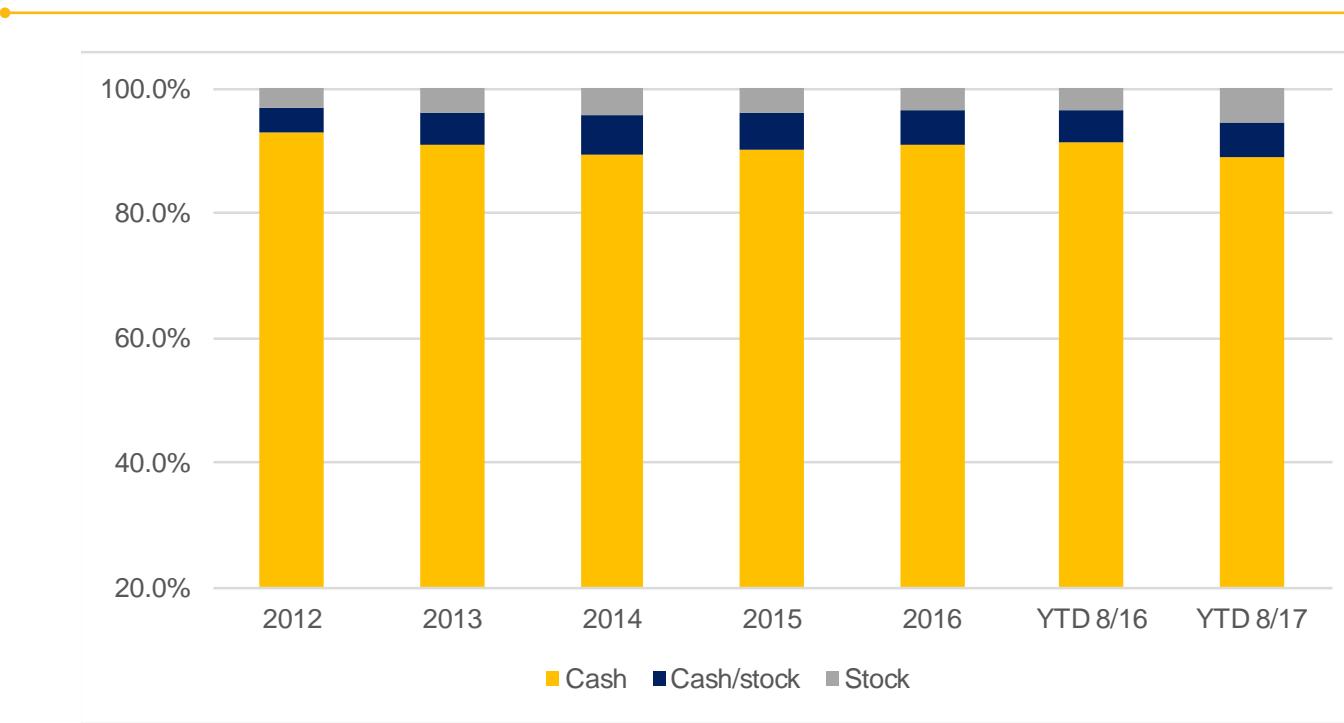
- Asset-based lenders that lend against hard assets
- Term loans and asset-based loans from community and commercial banks
- Term loans from financing companies
- Investment banks that underwrite an offering as resellers of both debt and equity in a deal
- Other investor groups that provide financing on both debt and equity deals

Other investor groups include:

- Mezzanine funds
- Hedge funds
- Small Business Investment Companies (SBICs)
- Private equity funds
- Venture capital funds

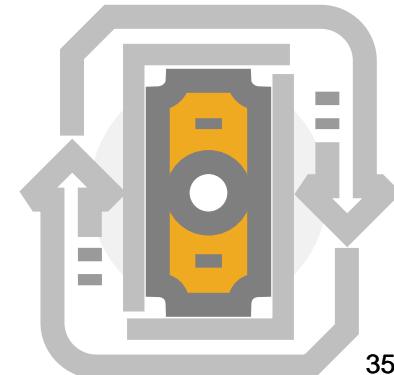


U.S. Middle-Market M&A Payment Method by Number of Deals



	2012	2013	2014	2015	2016	YTD 8/16	YTD 8/17
Cash	92.9%	90.9%	89.5%	90.3%	91.1%	91.2%	88.9%
Cash/stock	3.9%	5.4%	6.3%	5.9%	5.3%	5.3%	5.5%
Stock	3.1%	3.7%	4.2%	3.8%	3.6%	3.6%	5.5%

- Source: Dealogic and Robert W. Baird & Co. Inc. M&A Market Analysis, *Global Monthly M&A Analysis*, September 2017 publication
- Note: Figures exclude transactions involving minority stakes, stock repurchases, and spinoffs. Due to rounding, some percentages do not total 100.00%.



Polling Question Three

Third Party financing:

- a.** Is easy to obtain
- b.** Causes ownership dilution
- c.** Is more costly than using equity
- d.** All of the above
- e.** None of the above



Role of Government Entities in the M&A Process

Role of Government Entities in the M&A Process

Government and local agencies play a role in various subsectors of agribusiness. Some examples include:

- For Grain Traders, Elevators, and Processors

- OSHA and state-level safety organizations
- USDA warehousing licensing, state-level warehouse licensing, and state-level grain buyers licensing
- USDA certified organic

- For Agricultural Inputs and Production

- EPA – significant for fertilizer, chemicals (pesticides, herbicides, and fungicides), and petroleum distributors
- USDA certified organic
- OSHA and state-level safety organizations

- *Food Safety Modernization Act* – applies to any business in human or animal food industry

While these agencies do not create barriers to doing business, they do require additional paperwork and time to ensure compliance.

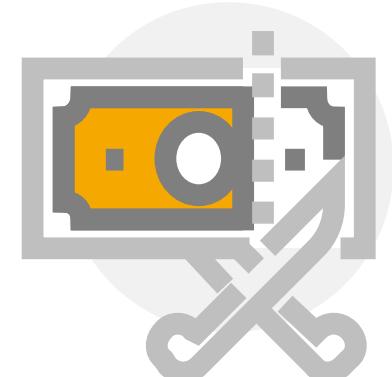
This is commonly an area of focus during buy-side due diligence.



Special Tax Issues

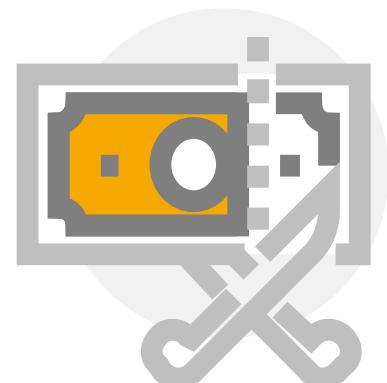
U.S. Income Tax Considerations – Deal Structure for Asset Purchases

- Seller may have increased chance of ordinary income – depreciation recapture, inventory, and any other ordinary income-type property
- Buyer has a stepped-up basis in assets
- More focus on structuring and tax planning
 - Flexibility to implement optimal transaction structure
 - Evaluate impact of tax basis step-up on cash flows
- Consider cash requirements of potential transaction taxes
- Attention to contingent-type liabilities and “phantom” income



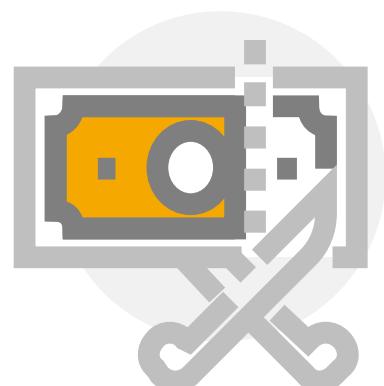
U.S. Income Tax Considerations – Deal Structure for Stock Purchases

- Seller generally has a capital gain
- Buyer does not get a stepped-up basis in assets
- Buyer inherits (i.e., the target comes with) all tax attributes and liabilities, including potential exposure for prior periods
- Stock purchase can be “embedded” in an asset purchase – such as when an asset held by the seller is stock of a foreign subsidiary
- Target has joint and several liability for all pre-closing periods during which it was a member of a consolidated group



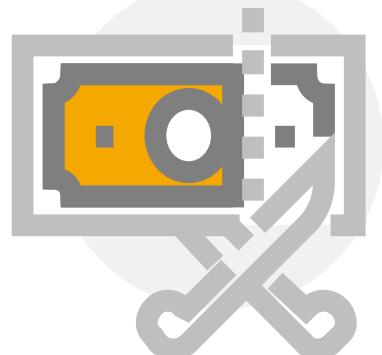
U.S. Income Tax Considerations – Deal Structure for Other Types of Structures

- Corporations: Internal Revenue Code (IRC) §338 Election
 - If certain requirements are met, an election can be made – for tax purposes – to treat the sale of stock as a sale of assets
- Partnership or Disregarded Entities
 - Purchase of interests in a partnership or disregarded entity can produce similar income tax results to a purchase of assets
 - Step up (or down) in basis
 - New tax accounting methods
- Tax Deferred Structures
 - Principal purpose is to avoid current tax on the disposition of target by target's shareholders in exchange for purchaser's stock
 - May not be available with foreign corporations



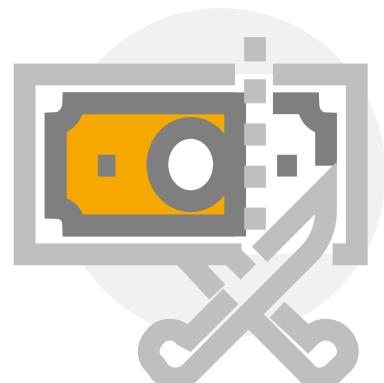
U.S. Income Tax Considerations – Common Considerations With Growers and Processors

- If the acquisition target is using the cash method of accounting where buyer is not eligible – consider the IRC §481 adjustment
- Inventory issues
 - For cash method taxpayers – general inapplicability of IRC §263A
 - For accrual basis taxpayers – applicability and application of IRC §263A
 - Inventory reserves
 - Hedging – permitted methods and proper identification
- Depreciation method for assets used in farming operations
- Taxation of rebates



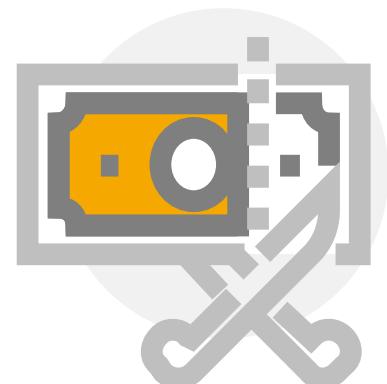
U.S. Income Tax Considerations – Common Considerations with Commodity Dealers

- Inventory valuation method
 - Mark-to-market
 - Revenue Ruling 74-223 and Revenue Ruling 74-227 exclude forward contracts
 - IRC §475 includes forward contracts
- Hedging
 - Documentation of hedging policies and proper identification of hedges
 - Matching of inventory valuation and hedging activity
- Sourcing of sales revenue (i.e., sale of financial products vs. physical inventory)



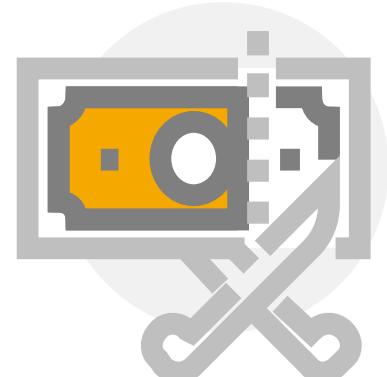
U.S. Income Tax Considerations – Other Taxes

- Sales and use taxes
 - Transfer tax on transactions – occasional sale exemption
- Payroll taxes
 - Successor employer rules
- Property taxes
 - Potential increases in tax assessments
- Unclaimed property
- Excise tax reporting
- Customs duties



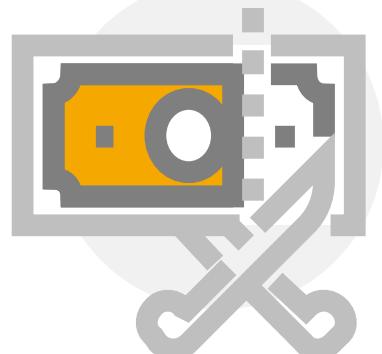
Foreign Investors – Tax Considerations

- Investing through U.S. corporation or LLC taxed as a corporation
- Income streams from U.S. corporation (e.g., interest and dividends) subject to 30% withholding – reduced by treaty when applicable
- Gains or losses on sale of shares not generally subject to U.S. tax
- Special rules if more than 50% of FMV of corporate assets attributable U.S. real property
 - Tax-free reorganizations generally not available
 - Gains on any disposition of shares are subject to U.S. tax
 - Buyer must withhold 15% of any sales proceeds
 - Foreign investor must generally file a U.S. income tax return to report disposition of U.S. real property interest



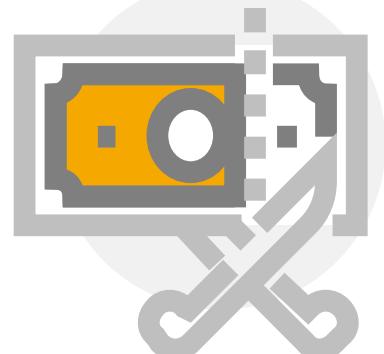
Foreign Investors – Tax Considerations

- Investing through a U.S. partnership or LLC not electing to be taxed as a corporation
 - Operating earnings of the investment vehicle and any lower-tier partnerships or LLCs are subject to U.S. tax at graduated rates to the extent of operating earnings from a U.S. trade or business.
 - Earnings not related to the U.S. trade or business but from U.S. sources (except gains on sale of tangible property) are subject to 30% withholding – reduced by treaty when applicable.
 - Earnings not related to a U.S. trade or business and not otherwise from U.S. sources are not subject to tax in U.S.
 - Foreign investor must file U.S. tax return Form 1040NR or Form 1120F to report effectively connected income (ECI).
 - U.S. investment vehicle must make estimated tax payments on behalf of foreign investors for their allocable portion of ECI.
 - U.S. investment vehicle must withhold on distributions of non-ECI U.S. source income (e.g., U.S. dividends, interest, rents, or royalties) at 30% or as reduced by treaty.
 - Special rules exist for the disposition of any asset defined as U.S. real property (e.g., land, buildings, mineral deposits, or timber stands).



Foreign Investors – Tax Incentives

- No real incentives specifically designed for foreign investors
- Some tax breaks for foreign investors designed to prevent disincentive
 - Portfolio interest – interest on loans from unrelated foreign parties that meet certain “registered form” requirements are not subject to U.S. tax or 30% withholding
 - Interest from foreign person bank deposits are not subject to U.S. tax or 30% withholding
- U.S. treaty networks reduce tax rates on (or exempt from U.S. taxation) certain payments from foreign investors unrelated to ECI
 - In order to incorporate any treaty exemption or rate reduction into withholding process, foreign investor must provide certain documentation
 - If appropriate documentation is not provided, foreign investor must claim a refund for amounts over withheld by filing a U.S. income tax return



Polling Question Four

Which transaction structures allow a step-up in the bases of assets for tax deductibility purposes

- a. Asset purchase
- b. Stock/Share purchase
- c. IRC §338 election
- d. a. and b.
- e. a. and c.



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