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How Commodity Volatility Affects Diligence in Food Deals

Dealmakers need to note revenue growth, industry benchmarks and product-sales mix when valuing a business

By Jesse Evans and Marc Shaffer, Crowe Horwath

With U.S. agribusiness currently in a mature phase, industry participants often find it more efficient to acquire businesses than to launch them. Mergers and acquisitions involving food producers and suppliers typically are priced as a multiple of Ebitda. The biggest variable cost affecting earnings is food commodity prices.

To protect their interests, both sides of a potential transaction need to take into account the volatility of food commodity prices when constructing models to arrive at a valuation multiple that reflects the earnings potential of the company by segregating the component of Ebitda that is related to commodity price volatility. Failing to anticipate uncertainty in food commodity prices, the largest component of cost of goods sold (COGS), could result in buyers overpaying for an acquisition or sellers divesting their businesses for less than they are worth.

Buyer and Seller Concerns

Because standard due diligence typically does not include modeling future commodity price changes, buyers risk overpaying for an acquisition as a result of inadequately taking into account the effect of food commodity price changes on the bottom line. Buyers want to minimize their risk by arriving at an Ebitda base that proves to be a useful indicator of a company's earning potential, even amid the uncertainty of commodity price gyrations.

Since sellers are inclined to seek buyers and push for a sale when earnings and transaction multiples are relatively high, the sellers are at a disadvantage because uncertainty about food commodity price leads to lower Ebitda multiples. Sellers fear underpricing their divestment by accepting a valuation multiple that does not reflect the full future earnings potential of the company.

Long-Term Consequences of Volatility

U.S. domestic agribusiness is a $2 trillion industry that produces and processes food that eventually is sold in the retail market. Producers supply crops and livestock, and processors transform them into edible products. Approximately 2.6 million U.S. businesses – including wholesalers, farm equipment makers, and agricultural services – are engaged directly or indirectly in these activities.

The largest market for agribusiness products is found in the industry itself. Many commodities are processed into other products that will be used further along the food supply chain. By analyzing a company's long-term financial performance, buyers may arrive at an Ebitda multiple that incorporates the uncertainty of future commodity prices on the seller's business.

Regulatory decisions made years ago can affect commodity prices today, so it is important to analyze the impact of prices on sellers' operating margins over an economic cycle. The extended effect of corn prices on livestock contracts provides an example. Corn is the most planted crop by acre in the United States and can be used in multiple products. Due to federal mandates, ethanol production increased dramatically in the early 2000s, and corn became a source of energy. The demand for corn-based ethanol drove up the cost of cattle feed, causing many livestock owners to trim their herds – which in turn reduced the beef supply and pushed up feeder cattle prices. The recent record-high contracts for beef cattle primarily were a result of the diversion of corn crops from livestock feed to biofuel.

Impact of Commodity Price Changes

More than any other factors, supply and demand affect commodity prices. In some circumstances, farmers are able to set prices, but, due to the structure of the agribusiness industry, usually farmers are price takers. Their ability to pass along higher production costs to their customers via higher prices is limited. Food commodity suppliers and processors have little control over the macro forces that govern supply and demand. However, companies can increase profitability by entering into long-term contracts that give them an advantage over the spot market in certain situations. For instance, farmers with contractual agreements to sell their crops or livestock at favorable prices when the markets are falling, or who have entered into purchasing agreements when production costs are rising, are better positioned to maintain their margins than suppliers who lack such contracts. Farmers also might be able to hedge some of their price volatility by using derivatives.

Food processors also can take advantage of contracts to maintain selling prices and minimize production costs. They have more flexibility than producers do to negotiate prices and pass along some of their rising costs. Food processors sell products to food retailers that can rapidly pass price increases to consumers.

How quickly and to what degree companies can transmit rising commodity prices to their customers, how well they can hold the line on falling prices, and the agreements in place to lock in primary production costs have a sizable effect on a company's operating margin. Because M&A deals usually are priced based on a multiple of normalized Ebitda, changes in commodity prices over time need to be segregated from COGS to quantify their impact on earnings.

Quantifying the Impact

Normalized Ebitda represents the base of the future earnings capacity of a company. Arriving at a normalized Ebitda begins with analyzing the company's past revenues, COGS, and sales mix. The analysis typically looks back three to four years. At a minimum, the buyer and seller should evaluate the following:

• Revenues
What was the company's revenue growth in past years?
How does the company's revenue growth compare to that of its competitors and industry benchmarks?

• Sales Mix
What was the company's mix of product sales in past years?
What percentage of changes in earnings can be attributed to changes in the product mix?

• COGS
What are the significant components of the company's COGS, and how has the cost of the components of COGS changed over the past few years?
How does the company's COGS compare to that of its competitors and industry benchmarks?
What percentage of earnings increases or decreases can be attributed to changes in commodity prices?

Earnings are then normalized by removing nonrecurring revenue and expenses and making other adjustments. In particular, buyers want to be sure that a seller's earnings expectations remove extraordinary income and retain recurring costs. Once the impact of commodity price volatility on earnings is quantified and earnings are normalized, buyers are able to establish an Ebitda multiple for a deal. Companies with significant earnings uncertainty usually fetch lower acquisition multiples than businesses with more predictable profitability do.

Naturally, both sides of a potential M&A deal want to protect their interests. To do so, buyers and sellers should quantify the impact of price volatility for commodities to arrive at a normalized Ebitda valuation multiple that will serve as a realistic basis for negotiating a deal. M&A

Jesse Evans is a senior manager, and Marc Shaffer is a partner at Crowe Horwath Advisory Services.