Food & Beverage Industry Snapshot

Grant Thornton Corporate Finance Summer 2012

Deals continue to perk

Grant Thornton Corporate Finance LLC (GTCF) is pleased to present its semiannual Food & Beverage Industry Snapshot for summer 2012. This snapshot contains timely commentary on key factors affecting the food and beverage industry, an overview of trends in M&A and a summary of industry stock market performance. This issue also features a section focused on the coffee sector, which includes trends, M&A activity and public market information.

Through offices in more than 100 countries worldwide, the partners and employees of Grant Thornton International Ltd member firms serve several hundred food and beverage clients ranging from global conglomerates to middle-market companies in all sectors of the industry. GTCF teams have advised on more than 50 food and beverage industry M&A transactions over the past three years.

Overview

The food and beverage industry has been a very active sector for M&A activity since the beginning of the year, and there are indications that this trend will continue. Reported deal value exceeded $6 billion during the first six months of 2012, a 30% increase over the same period last year. Driving this activity are factors that have been addressed in earlier issues of this publication, such as the move toward healthier lifestyles, budget-conscious consumers and food safety concerns (and their associated compliance costs). These factors continue to present industry participants with challenges and competitive pressures that often lead to M&A activity. Recently, another trend has had a generally positive effect on many food and beverage participants, particularly downstream.

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Falling commodity prices

As illustrated in the food and beverage commodity price index (CPI) chart shown above, commodity prices have subsided from the highs seen in early 2011. Wheat and corn prices declined 25% and 13%, respectively, over last year’s. Crude oil prices dropped 4% over the past 12 months, largely as a result of increased OPEC production, looming European economic concerns and slower growth in emerging markets (such as China and India), whose tremendous demand had previously pushed up commodity prices. While prices remain high on a historical basis, the recent softening in the commodity market is a positive sign for the food and beverage industry. Higher commodity prices have exerted considerable pressure on margins in recent years, but that pressure is now easing. Meanwhile, consumers worried about their budgets have been resistant to accepting price increases; indeed, many of them have been choosing lower-cost items instead. While most observers feel, at least for the moment, that the slowdown in the Chinese economy is temporary, the current commodity market is making it somewhat easier for food and beverage companies to operate profitably. The longevity of this trend will depend largely on whether China resumes its aggressive growth and whether and when the European economic crisis can be averted/addressed.

For the time being, the benefits associated with lower commodity prices are accruing primarily to producers, distributors and retailers. Consumer prices have not yet responded — the U.S. Bureau of Labor Statistics reported a 3% rise in the food and beverage CPI over the past 12 months — but if commodity prices continue to fall, consumers might still benefit.

Trends in the metrics

Total U.S.-target food and beverage M&A activity for the first half of 2012 was essentially flat compared with the same period last year, which was one of the strongest six-month periods since 2007. However, deal value increased by 30% (from $5 billion to $6.5 billion) because several large transactions, including the following, were announced in the first half of the year:

- Kellogg acquired The Wimble Company (which sells snack products under the Pringles brand) from Procter & Gamble for $2.7 billion. This acquisition helps Kellogg expand its global snack business by adding to its existing brands such as Keebler and Cheez-It.
- Italian dairy company Parmalat announced in May 12 its intent to acquire Lactalis American Group, a U.S.-based cheese manufacturer, for $904 million. This acquisition will facilitate Parmalat’s entry into the U.S. market and expand the company’s product line.
- In May 2012, refined sugar processor Imperial Sugar sold its stake in Wholesome Sweeteners to Arlon Capital Partners for $177 million. This transaction was completed in an effort to increase Imperial Sugar’s liquidity because the company had been facing financial problems due to rising input costs (mainly raw sugar prices). Imperial Sugar was sold to Louis Dreyfus Commodities for $150 million in June 2012.
- The world’s no. 1 brewer (by sales), Anheuser-Busch InBev, recently offered to purchase the 65% share in Mexico’s Grupo Modelo that it does not already own. Grupo Modelo produces the Corona brand, which is the best-selling imported beer in the United States. The deal, which contemplates a value of $29 billion for Grupo Modelo, has been approved by Modelo’s board of directors.

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The prevalence of larger M&A transactions is a strong indication of a robust deal market. Accordingly, deal activity in the food and beverage sector is expected to remain healthy through 2012, continuing the trend we have observed over the past few years. Both financial and strategic buyers are flush with cash and are under pressure to deploy it. Further, barring any action by the federal government, the capital gains tax rate will increase from 15% to 20% at the end of the year. In 2010, the market expected capital gains rates to rise during 2011, so we saw heavier-than-normal deal activity, particularly in the fourth quarter of 2010. We expect that 2012 could exhibit a similar pattern. Companies considering a sale will likely try to complete the sale by the end of the year.

The GTCF Food and Beverage Index depicted at left reflects data from industry participants that are broadly categorized as either food processors, food distributors, food retailers or beverage companies. This data shows that food and beverage companies have outperformed the S&P 500 for the past several years, and the gap appears to be widening. We expect this gap to widen further, especially if commodity prices continue to ease. And while overall public market performance remains slightly below its 2007 peak, the food and beverage industry is performing well above 2007 levels. Although not all participants are performing uniformly well, the industry taken as a whole is a bright spot in today’s economy.

Another way to look at public market performance is by examining EV/EBITDA multiples, which provide insight into how valuable a company is when both debt and equity are taken into account. These multiples also allow observers to compare the values of companies that have different business models. As shown in the chart below, EBITDA multiples for all categories have risen since last year. These increases are attributable to growth expectations in the near term as well as the likelihood of profitability enhancements resulting from commodity price declines.

Notably, food and beverage companies in the United States appear to be performing very well compared with those in the European Union (EU) and those whose revenue is heavily EU-dependent. Considering the present state of the European economy, it should come as no surprise that EU companies are trading more than 2.5x lower than their U.S. counterparts. Additionally, their average valuation levels have fallen during the past 12 months, in stark contrast to improving valuations in the United States. Unless and until the economic issues in the EU are resolved, we expect these differences in valuation to persist.

### Food and beverage EBITDA multiples

<table>
<thead>
<tr>
<th>Category</th>
<th>% of 52-week high</th>
<th>Enterprise value (SM)</th>
<th>LTM EBITDA %</th>
<th>EV/EBIT</th>
<th>LTM EV/EBITDA</th>
<th>06/30/11 EV/EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food distributors</td>
<td>83.0%</td>
<td>$7,812</td>
<td>4.0%</td>
<td>12.0x</td>
<td>9.5x</td>
<td>9.4x</td>
</tr>
<tr>
<td>Food retailers</td>
<td>82.7%</td>
<td>28,541</td>
<td>13.5%</td>
<td>15.4x</td>
<td>10.4x</td>
<td>10.0x</td>
</tr>
<tr>
<td>Food processors</td>
<td>92.6%</td>
<td>26,525</td>
<td>16.1%</td>
<td>13.9x</td>
<td>11.2x</td>
<td>10.4x</td>
</tr>
<tr>
<td>Beverage companies</td>
<td>94.9%</td>
<td>42,566</td>
<td>22.7%</td>
<td>16.0x</td>
<td>12.5x</td>
<td>11.1x</td>
</tr>
<tr>
<td>U.S. average</td>
<td>88.3%</td>
<td>26,361</td>
<td>14.1%</td>
<td>14.3x</td>
<td>10.9x</td>
<td>10.2x</td>
</tr>
<tr>
<td>EU average</td>
<td>87.2%</td>
<td>54,522</td>
<td>11.3%</td>
<td>10.4x</td>
<td>8.3x</td>
<td>8.8x</td>
</tr>
</tbody>
</table>

As of 06/30/2012

Sources: Public company filings; certain financial information provided by S&P Capital IQ
As consumer preferences shift to higher-end roasts, companies such as McDonald’s, Dunkin’ Donuts and Tim Hortons, all of which are commonly known for selling lower-quality blends, are now beginning to offer freshly brewed premium roast coffee. McDonald’s has even started a coffeehouse-style chain called McCafé that features a line of specialty drinks.

A newer product that has become widely successful over the past 10 years is single-cup coffee. Keurig — owned by Green Mountain Coffee Roasters (GMCR) — currently leads the single-serve coffee market but faces increased competition because its main patents related to the K-Cup are set to expire in September 2012. Kroger and Safeway are already planning to launch private-label coffee pods that work with the Keurig machine. In an attempt to hedge projected losses, GMCR has partnered with Caribou Coffee, Starbucks and Dunkin’ Donuts for production of these brands of coffee in its K-Cups.
Coffee beans trade as a commodity whose price is dependent on supply from the once-per-year harvest along with demand trends. The companies discussed earlier in this article have performed well on average, despite the recent volatility in the coffee bean market. The price of coffee beans has fluctuated much like the prices of wheat, corn and crude oil, increasing through April 2011 and then trending downward. As shown in the chart below, coffee bean prices rose 33% from November 2010 to April 2011 as adverse weather conditions in Brazil and Colombia limited the supply of coffee beans. Additionally, stronger demand from emerging markets put upward pressure on prices. This, plus increased fuel and packaging costs, translated to higher retail coffee prices for consumers as roasters and retailers cautiously passed on rising expenditures. For example, J.M. Smucker (the manufacturer of Folgers, Millstone and packaged Dunkin’ Donuts coffee) raised prices for its coffee brands sold in the United States by 10% in February 2011 and 11% in May 2011. This followed two price increases in 2010. And Starbucks marked up the price of packaged coffee by 17% in July 2011.

As coffee bean prices have dropped 32% over the past 12 months in response to expectations of a robust harvest from Brazil, companies have reduced retail prices, although not to the same degree as input costs have fallen. For example, both Kraft and J.M. Smucker have lowered their coffee prices by 6% twice — once in August 2011 and again in May 2012.

Consumer prices tend to be somewhat insulated by short-term swings in coffee bean prices due to extensive use of hedging. However, if changes in input pricing persist, retail costs will eventually rise or fall because hedging is short-term by nature.

### Notable transactions

Almost 40 transactions have been announced within the coffee market since the start of 2011. Some of these transactions are described below:

- In February 2011, J.M. Smucker acquired Rowland Coffee Roasters, maker of the leading Hispanic coffee brands Café Bustelo and Café Pilon, for more than $350 million. This acquisition improves J.M. Smucker’s place among Hispanic coffee drinkers in the United States.

- In October 2011, J.M. Smucker acquired a majority of Sara Lee’s North American foodservice coffee and tea business for $430 million. This acquisition will bolster J.M. Smucker’s position in the coffee market. Sara Lee sold the majority stake because the unbranded business faced challenges to growth.

- Sara Lee recently split up into two pure-play public companies: a meat-focused Hillshire Brands Company and an international coffee and tea company called D.E. Masters Blend. (The Sara Lee brand has not completely ceased to exist; it is being used for certain bakery and deli products distributed by Hillshire Brands.) Before debuting D.E. Masters Blend as a stand-alone business, Sara Lee chose to strengthen its offerings through acquisitions, which included The Coffee Company (Netherlands), Tea Forté (United States) and Expresso.Coffee (Brazil).

- Diversification through M&A has become a key strategy for Starbucks. Most recently, the coffee giant announced its intent to buy Bay Bread and its La Boulange bakery brand for $100 million in order to improve its food offerings. Moreover, Starbucks acquired juicer Evolution Fresh for $30 million during November 2011 in an effort to expand into the health and wellness sector. In addition to pursuing acquisitions, Starbucks plans to open a new Tazo tea shop this year and has decided to offer its own single-cup brew called Verismo. The company also expects to begin selling beer and wine in various locations in Atlanta and southern California by the end of 2012. Starbucks is in the early stages of its diversified growth strategy, and while some experts claim the company might face growth challenges, others are intrigued and believe that Starbucks will continue to succeed.

Although M&A transactions involving retail operations command the headlines, a considerable amount of deal activity occurs within the roasting market; some retail operators purchase roasters in an effort to secure vertical integration. Since 2011, there have been 13 reported transactions involving roasters (a sizable number of deals are not announced publicly).
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Public company comparables

The at-home coffee industry is largely composed of diversified food companies; coffee accounts for a minority of sales for three of the four participants listed in this category. For example, only 10% of Kraft’s total revenue for the year ended December 2011 came from coffee sales, and less than half (42%) of J.M. Smucker’s total revenue for the year ended April 2012 was derived from the retail sale of U.S. coffee. However, we have included these companies in our analysis because they own iconic coffee brands such as Maxwell House, Nescafé, Folgers and Millstone. These well-known brands dominate shelf space at major retailers and are very popular among consumers.

Despite its relative youth, GMCR — also listed in the at-home segment — has single-handedly commercialized the one-cup brew. The K-Cup has quickly established itself among iconic brands and, while GMCR serves a different target consumer, we have classified it in the at-home category because of its self-brewing characteristics. GMCR’s trading multiples have experienced considerable volatility over the past several years. As the K-Cup gained a sizable following, the company’s stock price soared; more recently, however, the impending expiration of its key patents has placed GMCR’s market dominance at risk, and its valuation multiples have come down dramatically (the company traded at more than 15x EBITDA at the end of 2011).

The away-from-home segment includes four well-known coffee shop chains whose EBITDA trading multiples average 13.4x — far higher than multiples for the at-home sector. The market is clearly dominated by Starbucks, whose revenue is more than four times greater than that of Tim Hortons, its closest competitor. However, the segment has been under increasing pressure because chains such as McDonald’s and Dunkin’ Donuts have introduced premium blend coffee. Valuation multiples, however, remain very strong in the away-from-home sector at more than 13x EBITDA. These multiples largely reflect the premium prices Starbucks and other high-end coffeehouses are able to command (as opposed to the economy pricing of McDonald’s and Dunkin’ Donuts).

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In terms of stock performance, the GTCF Coffee Index (consisting of the 10 publicly traded companies listed on the previous page) has outperformed both the GTCF Food and Beverage Index, and the S&P 500 for the past several years. The fluctuations in the GTCF Coffee Index during 2011 and 2012 are largely due to the volatility of GMCR’s stock. As we have seen, GMCR’s stock enjoyed a tremendous upswing in the first half of 2011 as one-cup brews became immensely popular, but the company has watched its stock price fall since then because of expected losses from its pending patent expiration. In contrast, stock prices for Starbucks, Caribou Coffee, Peet’s Coffee & Tea, and Tim Hortons — all of which have stand-alone retail locations — have seen slight fluctuations but have typically increased since 2009.

Conclusion

Coffee is a staple beverage for millions around the world. Competition in the United States is fierce, with a handful of brands controlling more than 85% of total retail market share. The U.S. coffee market has been reshaped in the past two decades — first by Starbucks, which introduced many Americans to a traditional European taste, and more recently with the advent of one-shot brewing, which allows a consumer to prepare a high-quality cup without making a whole pot. Further up the supply chain, recent trends have included vertical integration (through retailers’ purchase of roasters), consolidation within the roasting space, and a focus on fair trade coffee.

M&A activity has played a key role in reshaping the coffee industry. Consolidation among roasters and vertical integration by retailers buying roasters are being complemented by notable purchases of local and regional independent coffee shops. This activity augments existing organic growth strategies both in the United States and internationally. We expect M&A to continue playing a pivotal role in the coffee industry as participants face new challenges in the coming years.

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