Navigating disruption

Food

ALANTRA

CONTEXT

Even before the Russian invasion of Ukraine, prices of staple food products were on an upward trajectory driven by pandemic-related strains on the global supply chain and climate change-related crop disruptions. The war between two of the world's major breadbaskets, which supply 12% of all traded calories, has further inflated prices and threatens to tip the food system into a global crisis.

Wheat prices have risen to all-time highs this year, surpassing prices seen in 2008, when the world was on the cusp of a financial crisis. The lack of wheat exports from Ukraine is driving hunger to famine levels in developing countries, according to more than 75 speakers taking part in a ministerial-level UN Security Council meeting in May.

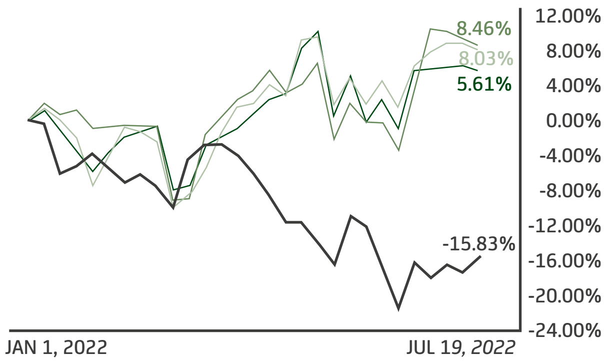
Food inflation in the Euro area reached a historical high in May as a European Central Bank report warned that higher costs for European farmers and food producers went beyond just those that rely directly on imports from Ukraine or Russia and is likely to drive broader increases in what consumers spend on their weekly groceries.

The ECB said food inflation was "expected to stay high in the coming months, despite some counterbalancing factors," such as increased domestic production and a switch to alternative sources.

These factors are trickling through to the food and beverage industry. Rising labor and freight costs last year, as well as spikes in raw materials costs in 2022 due to higher wheat and oil prices, have hit food producers and have led to price hikes for key retail and foodservice customers.

Despite the inflationary scenario, many consumer food companies have been able to maintain margins while passing on higher prices to retailers and end consumers. Shares of global food groups such as General Mills, Kellogg's and Campbell Soup Co. have risen 8.46%, 8.03%, and 5.61%, respectively, this year, even as the S&P 500 has fallen 15.83% as of July 20.

Evolution of shares of General Mills, Kelloggs and Campbell Soup Co. vs S&P 500



Source: S&P 500 and Bloomberg data

General Mills
Kellogg's
Campbell Soup Co.
S&P 500

Notwithstanding the ability of larger food groups to stay mostly ahead of inflation, smaller and mid-sized consumer food players have experienced a more mixed impact on their margins. Some have been in a nearconstant game of "catch-up" while others have managed to keep pricing ahead of cost pressures. This often relates either to the sophistication of their corporate systems and controls or to the quality of their relationships with suppliers and customers.

During the lockdown phase of the pandemic, savings rates spiked in most developed economies thanks to generous government handouts and the inability to spend on travel and other goods. With these restrictions on movement mostly over, consumers are now spending those savings on restaurants and higher-quality food items. The return to dining out has been dramatic. According to data from the USDA, expenditures on 'Food away from home' surged 111% between April 2020 and April 2022, compared to a corresponding decline of 47% during the lockdown period between April 2019 and April 2020, even excluding the effects of inflation. Retailers are also restocking after the shortages that became widespread during the pandemic, as supply chain bottlenecks are cleared.

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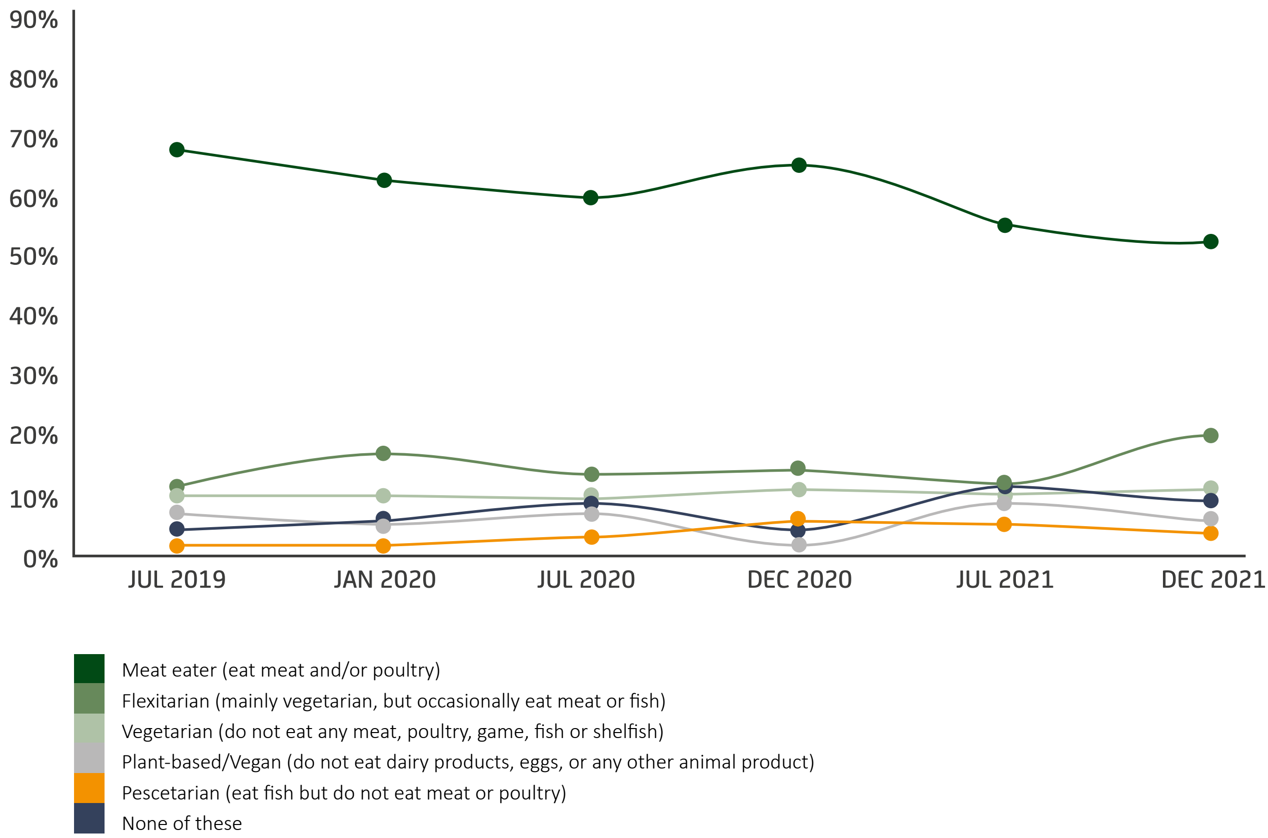
Longer-term trends

Notwithstanding the above, several longer-term trends will drive M&A activity for consumer brands regardless of the economic environment.

Diets are changing at a dramatic pace, especially among young people. A YouGov poll in the UK found that the Number of 18–24-year-olds who considered themselves meat eaters fell to 52% in Dec 2021 from 67% in July 2019. In the same period, the number of young people who identified as flexitarian (mainly vegetarian but occasionally eat meat or fish) nearly doubled to 20% from 11%.

It's not just consumers driving demand for healthier and more sustainable eating options. Regulations are poised to accelerate the shift away from junk food. In the UK, new legislation will oblige supermarkets to move unhealthy foods out of temptation's way by banning prominent locations on the shop floor for products high in fat, sugar, or salt,

Dietary choices of Britons



Source: YouGov Data

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affecting about £17.5 billion ($20.7 billion) of products such as ready meals, pizzas, ice cream, and confectionary. E-commerce is also subject to the new rules through bans on advertising and product placement on the homepage and checkout page of supermarket websites.

Consumers are increasingly squeezed for time, and this is creating an opportunity for growth in snacking and meal replacement products which provide all that a consumer needs - from vitamins to proteins - in one go. A handful of brands, such as Huel, have enjoyed growth in the UK. Its nutritionally complete foods, guided by a philosophy that we should 'eat to live", not "live to eat," has driven exceptional growth, recording more than £100 million ($118 million) in annual sales for the year ending July 2021. Additionally, time pressure on consumers has driven growth in high-quality 'grab-and-go' meal solutions – the "Deli prepared" food category in the USA saw dollar sales growth of 12% in April 2022 vs April 2021 and 66% vs April 2020, which is much higher growth than the overall 'Food at home' category (+7.5% and 15.4% in nominal growth, respectively).

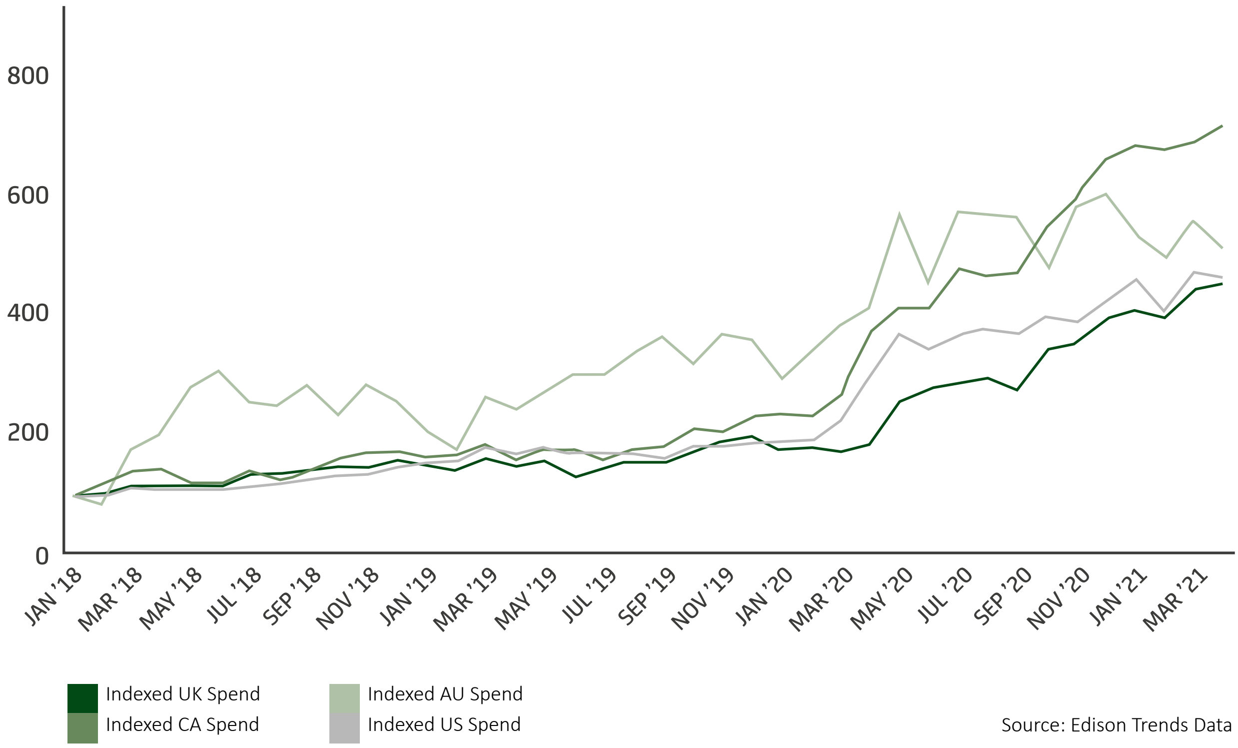
Despite the trend toward healthier food, there's still a robust market for "little indulgences". Premium-quality products that satisfy consumers' desire for tastes and experiences that are different or special, such as flavor enhancers, baked goods, and desserts, are expected to fare well in the coming months.

Investment implications

These changes in consumer behavior are driving a back-to-basics trend in the sector. With consumers flocking back to physical stores, acquiring the right shelf space has regained importance. Digital marketing is becoming less efficient and more costly, no longer yielding the same returns as in previous years as social media companies and other online marketing avenues have changed their algorithms in the face of privacy regulations. Delivery companies like Uber Eats, Delivery Hero, and Deliveroo are reconsidering their financials, pricing, and geographical presence.

A post-pandemic climate of uncertainty is driving financial and strategic buyers to question the sustainability of the high growth no profit model of the many upstart food sector brands that are benefiting from current tailwinds in certain sales channels and product categories. Furthermore, volatility in cost inputs and prices makes it difficult for acquirers to pin down the longer-term margin profile of potential targets, even in more traditional food sector categories.

Monthly Food Delivery Online Spend, by Country
January 1, 2018- April 30, 2021



Source: Edison Trends Data

Jeff Robards, Managing Director at Alantra: "Companies that can clearly demonstrate sustainable growth and margins may see even stronger interest and valuations from strategic and financial buyers."

Will consumer demand start to exhibit greater price elasticity as inflationary pressures persist, leading to a shift towards lower-cost food products? Will grocery retail and food service players challenge food producers to reverse price increases if raw material costs settle down? What will be the impact of an economic recession on consumers, retailers and food suppliers?

These kinds of questions are leading some buyers to be more selective in their evaluation of prospective targets, generating a more cautious approach to M&A in the food sector compared to the red-hot market in 2021. However, companies that can clearly demonstrate sustainable growth and margins in the face of these questions may see even stronger interest and valuations from both strategic and financial buyers in the coming year, according to Jeff Robards, Managing Director at Alantra specializing in M&A in the Food and Beverage sectors.

Supply chain disruptions will force innovation and consequently boost resilience. This could redefine our understanding of innovation in the sector, which has tended to focus on consumer trends. The im-portance of addressing the needs of disrupted com-panies will lead to new, unforeseen opportunities in the effort to get food products to consumers, aided by new software and the use of AI to identify and re-solve disruptions more swiftly. There will likely be an increase in reshoring and vertical integration, with more firms buying up assets one step up or down in the supply chain.

For example, Oatly, enjoyed super-sized growth over the last decade, reaching sales of around $400 million. The Company listed on Nasdaq in May 2021 with a market cap of $11.96 billion and an EV/Sales of 25.6x at its opening. It has since sunk to a market cap of $2.12 billion and a 2.8x EV/Sales as leaner competitors entered the market. A clear example of overvaluation as a product of excessive hype.

Oatly Group AB Market Cap evolution

	Market Cap*	EV/Sales
Opening	11.96	25.6x
Peak	17.00	36x
Now	2.12	2.8x

*Unit: billions of dollars.
Source: Bloomberg data.

Charles Lanceley, Head of UK Food & Beverage: "The highest quality businesses that demonstrate sustainable resilience will always sell at high multiples, irrespective of the broader economic environment."

Opportunities

The pandemic and post-pandemic era have driven corporations to rethink their corporate finance strategies. In many cases, they have been buying upstart brands, effectively outsourcing innovation. Mondelez, best known for its chocolate and cookie brands such as Cadbury and Chips Ahoy, announced in June it would buy US energy bar firm Clif Bar for $2.9 billion in a bet on the functional snack segment. Kellogg's announced in June plans to divide the company into three parts focused on snacks, plant-based foods, and cereals, in order to take advantage of the differing dynamics for (and resulting valuation approaches) to each of these categories.

In other cases, a sustained consumer preference for healthier options has generated interest from investors in the health and wellness food segments. In April, Farmaceutici Procemsa reached an agreement to buy Aakamp, a leading German producer of vitamins, minerals, and supplements, forming what will become the largest VMS CDMO's in Europe. The €2.5 billion German market is the third largest one in Europe behind Italy and the UK and has the fastest growing direct-to-consumer segment. And Bee Health, a leading innovator in the UK nutritional supplements sector, partnered with US-based INW and Cornell Capital last year to further expand its product capabilities and range of services.

Compared to the tech sector, where companies can leap from generating revenues close to zero to tens of billions of dollars seemingly overnight, the food and beverage sector is more stable in nature. Very few startups will get to scale, and those that do will rarely generate revenues over $100 million.

Nevertheless, the highest quality businesses that demonstrate sustainable resilience will always sell at high multiples irrespective of the broader economic environment. The current level of market uncertainty, however, will lead buyers to more closely diligence longer-term trends that underpin performance rather than accepting short-term run rate data in isolation, which had been common in 2021, highlights Charles Lanceley, Director at Alantra and Head of Food & Beverage M&A in the UK. Buyers are much more cautious about valuing businesses this year, and so far sellers don't seem inclined to agree with them, choosing to sit on the side line and wait for the cautiousness to dissipate.

Additionally, there is still significant private equity capital poised for deployment. The best assets still command strong valuations, especially those that deliver continued high growth and margin expansion. These trends indicate that mergers and acquisitions in the food industry could remain robust in spite of the economic headwinds.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