L.E.K.

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Strategic Ingredients for Successful Food Industry Acquisitions

There have been nearly 3,200 food and beverage sector acquisitions in North America this past decade. L.E.K. Consulting analysis suggests that at least one-third of these destroyed value. Many more fell short of expectations. Flawed integration, culture clashes or weak due diligence are just some of the reasons that these deals underperformed. However, one of the most common and avoidable reasons that these deals failed is that they were based on false strategic premises.

They may have been doomed from the very start because managers relied on strategic concepts like "scale economies," "bundled offering" or "integrated solution" to justify deals without adequate testing that they truly support value creation. These and other strategic assumptions can sound very convincing in discussions around conference tables but can evaporate in the marketplace. The consequences are not just overpayment and value destruction but also the strain placed on management to turn around the investment, and the opportunity cost of not having the resources to pursue other investments with value creation potential.

Framework for Acquisition Strategy

L.E.K. has developed a management framework to support a more fact-based approach to acquisition strategy (see Figure 1). This framework can help senior executives more precisely answer the question, "How can I pay a 30% - 40% acquisition premium for this company and still create value?" A disciplined focus on three key sources of value creation can help managers develop more reliable answers to this question:

- Scale: When does scale deliver value? What barriers can exist to realizing scale economies?
- Scope: How do you determine when product, geographic or value chain breadth adds value?
- Skill: Acquired skills can be overstated or lost post deal. How do you validate and retain skill benefits?

It may seem very obvious how scale, scope and skill advantages create value. Some have even developed focused catch phrases like "razor-razorblade" and "one-stop shop" to define them. So the problem is not that we do not understand these sources of strategic fit. Instead, the problem is that we can imagine these concepts so readily that they are often accepted as fact and not subjected to adequate scrutiny or market testing. Managers may then be surprised that most customers shun the one-stop shop because they prefer "best-of-breed" specialist providers. Alternatively, customers may translate "bundled offering" into "volume discount." The remainder of this discussion examines each source of value creation to better assess the scenarios in which they will or will not create value.

Strategic Ingredients for Successful Food Industry Acquisitions was written by **Chris Kenney** and **Manny Picciola**, both Vice Presidents in L.E.K. Consulting's Chicago office. Please contact us at consumerproducts@lek.com for more information.

Figure 1

Strategic Fit Typically Arises From Three Potential Sources

Source of Strategic Fit	Selected Examples	Selected Issues/Considerations
Scale — "Get Bigger"	• Leveraging fixed or semi-variable costs • Distribution leverage • Supplier leverage	• Benefits can be "competed away" in an active bidding process • Scale economies may be overtaken by scale complexities • Does the target operate in the same strategic "segment"?
Scope — "Get Broader"	• Vertical integration • Product/service expansion • Geographic expansion • Channel expansion	• Does vertical integration reduce costs or increase effectiveness? • Do customers value a broad product line? • Will they pay a premium or favor you over narrower line competitors? • Are customers intent on purchasing nationally or globally? • Is demand shifting across channels?
Skill — "Get Better"	• R&D capabilities • Product developing skill • Manufacturing skill • Marketing skill	• Is acquisition the best approach to access/apply the skill? • Do you/they really have the skill in sufficient quantity? • What costs or barriers exist to applying the skill?

Weighing Scale Economies

Scale benefits are often considered to be the most quantifiable because the economic impact of leveraging fixed or semi-variable costs can be estimated with reasonable precision. In truth, enormous value has been created by scale economies within the food and beverage industry. Consider the case of Inbev's 2008 acquisition of Anheuser Busch for $52 billion in equity value. The combination created one of the world's top-five consumer products companies. Since completing this deal, the company has realized more than $2.5 billion in annual cost savings, and has grown earnings 37.4% relative to -6.2% for its next closest competitor, SAB Miller.

Despite this and other dramatic examples of scale economies, two subtle factors can erode the ability of organizations to translate acquisition-related scale economies into value creation.

Flawed Strategic Segmentation

One potential problem is that acquirers falsely assume that the target company is operationally similar to their own business and that the two companies will operate seamlessly together. Companies that look similar on the surface may actually be so different in critical aspects of their value chain that we consider them to be operating in entirely different strategic segments.

Consider the example of two baked goods companies with direct store delivery operations. Both companies create value by being able to service the unique needs of their customers with a flexible supply chain and wide product range. On the surface, combining these two companies should provide a number of scale benefits – they could leverage distribution infrastructure, sales resources, and product catalogs to drive value. However, one business primarily sells frozen baked goods and maintains a frozen distribution chain. The other business sells ambient products distributed in mildly climate-controlled vehicles. Thus, achieving scale benefits in the distribution infrastructure of the business will be difficult to achieve without significant investment across the supply chain.

Other examples include high-volume grocery product companies that acquire lower volume artisan product companies. These and other differences may not mean that scale economies exist, but rather they may lead the acquirer to overestimate the magnitude of these scale benefits. (*Where Value Hides*, a book by Stuart Jackson, co-leader of L.E.K.'s Food and Beverage Practice, explores the role of strategic segmentation in more detail.)

Scale Economy Sharing

So let's assume that the buyer and target companies are truly similar and the prospect for significant scale benefits exists. How much of the value will the buyer keep in the transaction? It depends entirely on whether the process to buy the company is competitive with rival bidders who can derive the same or more scale benefits. In this case, the ultimate purchase price may transfer up to the full value of the scale benefit to the seller. In the food sector, where consolidating acquisitions is the norm, scale economies alone may not be sufficient to create value because rival bidders count on similar scale economies.

The winning bidder is likely the company that transferred most of these savings to the seller to win the deal. In addition, customers may also have their hand out post-deal to receive a share of scale-related savings. Very large retail customers like Walmart or large foodservice customers like Aramark will likely seek to receive some portion of the benefit associated with improved scale economies.

Given the common challenges in realizing scale benefits, L.E.K. recommends buyers consider the following actions:

1. Understand your strategic market position: The key to understanding your strategic market position is to accurately segment your key markets. A proper segmentation is often defined by variables beyond product or channel segmentation to include production/distribution technology and customer sub channels. With this understanding it will become easier to avoid a "flawed strategic segmentation."

2. Evaluate the bidding environment: When assessing the magnitude of scale economies, also evaluate how much of these benefits may have to be passed on to the target's owners and to customers. Ask yourself if this target is likely to be pursued by strategic buyers with a similar ability to derive scale benefits. Consider customer concentration and the ability of customers to press for some portion of these benefits.

Scope Benefits and Barriers

Companies often identify opportunities in potential transactions to broaden their capabilities either through an expanded product/service scope or entry into a new geographic market. One core risk associated with scope-based strategic benefits is that economic improvement is most often generated through revenue increases, not cost reductions. Many companies rightly attach lower risk to cost-based acquisition benefits than they do to revenue growth benefits. This is because many of the "levers" that need to be pulled to achieve cost synergies are under the buyer management's direct control. Revenue-based benefits, on the other hand, often require a complex change in behaviors by people that the buyer management does not directly control. Consider the following scope-related examples and the potential pitfalls associated with each:

- Cross-Selling: The concept is simple. Buyer and target company both sell related products to the same market but with incomplete customer overlap. To the extent that buyer or target can introduce each others' products to their customers, value can be created. For example, General Mills and Kellogg acquired Small Planet Foods (2000) and Worthington (2008), respectively, to take advantage of strong growth in organic foods. These deals were based in large part on the notion that organic offerings were growing within traditional retailers, and both General Mills and Kellogg could leverage their strength in these traditional channels to drive organic product sales.

- Product Range Expansion: A similar concept is where the buyer acquires a target to fill one or more product line gaps. So rather than "cross-sell" a sister company's products, the buyer is collapsing the target company's products into its own line to be sold entirely by its own sales force and/or distributed by its own distribution channel. To justify these deals, managers refer to filling product gaps to leverage sales force or distribution capacity. Nestle purchased Kraft's pizza operations early in 2010 to round out its large frozen meal and snack position in the U.S and leverage Kraft's frozen foods direct store delivery channel.

As simple as it sounds, the sequence of interactions required to create value in product/service scope expansion can often be quite complex. Several key issues that often emerge include:

- Sales Force Barriers: Improperly aligned sales force organization, priorities and incentives can be a key driver in under-delivering value in a scope-related transaction. As an example, the existing sales team may be laser focused and incented to drive volume of the buyer's existing product lines. How do you modify these priorities and incentives to ensure that sufficient time and effort is spent on the acquired company's products? If the two sales forces are to be integrated, how do you ensure that customer relationships remain supported and key sales people do not exit during the integration?

- Misplaced Customer Value: As market channels steadily consolidate, retail and food service customers are gradually reducing the number of suppliers in order to create supply chain efficiencies and other benefits. Expanding product ranges can allow a company to create a single source or "one-stop shop" for customers. While this may be a general trend, buyers would do well to prove that, in each specific deal, customers place a value on having access to a broader product line. As an example, a large diversified food manufacturer recently acquired a private label baked goods offering to complement its branded commercial aisle products. The thinking was large grocery buyers would value having a consolidated supplier for several product lines. However, this value was never realized because of the specialized buyers and unique requirements of the two departments in the grocery store. The in-store bakery buyer and commercial aisle buyer have little incentive to work together to drive value as they are managed as separate departments with distinct P&L's. In addition, the stocking requirements, promotional requirements, and expertise required for each category was distinctly different.

- Geographic Breadth: Despite the fact that a significant number of food companies can claim to be global, there are surprisingly few food and beverage segments that are competitive internationally. Mega consumer products brands like Coke, Nestle, and Kellogg exist, as do large Quick Service Restaurant (QSR) chains like Subway and YUM! Brands (operator of KFC, Pizza Hut and Taco Bell). While aspiring to become a global supplier may seem like a sensible strategy, the reality is that there are very few channels which value geographic breadth. In fact, the vast majority of food segments compete largely on a national or regional level. However, there are several examples of companies that have been able to use M&A to establish a large geographic footprint. With the ongoing consolidation of North American food retailers, food manufacturers need to expand to serve all North American outlets of warehouses like Costco and major supermarket chains like Safeway. This can create an imperative to expand a company's geographic footprint to strengthen this key customer relationship. In addition, companies like East Balt and Fresh Start Bakeries have grown to become leading suppliers to McDonald's across the globe by expanding geographically and providing a consistent product across their locations.

There are also two potential drawbacks to a geographic expansion strategy that companies need to consider:

- Local/Regional Tastes: Widely varying local tastes, very different retailer or distributor structures, and the need for local production cause many food segments to compete on a regional or even local basis, and therefore limit the synergy from geographic expansion.

- Distribution Economics: Often, the economics of supply dictate a fixed distance from manufacturing facilities. So the localized producer will likely derive very few benefits by acquiring companies outside of its relevant geographic scope. It would make sense only if they have a truly unique and transferable brand or product attribute that could benefit the acquired company.

Given the common challenges in realizing scope benefits, L.E.K. recommends buyers consider the following actions:

1. Perform in-depth customer needs analysis: Customers often hold the ultimate answer as to whether a broader product range adds value, and they should be rigorously consulted to test the value creation premise before a scope-expanding deal is closed.

2. Frame the geographic boundaries: Again, perspectives on the optimal geographic scope can be derived from a fuller understanding of customer needs. For example, mass retailers like Costco may choose regional supply strategies for some categories and national strategies for others. You can gather valuable insight on how much customers are willing to trade off cost for consistency. With this information, it is easier to place value on a path towards geographic expansion.

3. Align sales force structure and incentives: Realizing scope-related benefits hinges on the ability of the sales force to translate these benefits to customers. Detailed planning and support is required to ensure that the sales strategy and structures are robust enough to achieve the synergy targets and maximize the revenue opportunity.

Skill – Translating Competencies into Value

A common source of value creation in food acquisitions is the ability of the acquirer, target or both to benefit from specific skills brought to the deal. For example, Schwan's Food Company acquired Edwards Frozen Desserts as a way to leverage Edwards' brand in the freezer case. In addition, Schwan's was able to leverage Edwards' expertise in baked goods to augment its school and home channel offerings. A wide range of capabilities exist in every stage of the food industry value chain; therefore, a powerful source of value creation is the ability of less skilled players to "raise their game" by tapping into the lessons or assets of higher skilled players.

However, as food companies consider this path to creating value with particular acquisitions, they should also consider the following risk areas:

- Sellers are paid to overstate competencies: The process of selling a company is well designed to extract every possible dollar from potential buyers. This institutes a strong bias on the part of target management to place their company, skills and capabilities in the most positive light.

- Skill transfer barriers: Even if clearly differential skills exist, buyers and targets often find it difficult to apply them in new areas. This is because the people involved cannot be freed from their current jobs. Alternatively, cultural gaps can limit the ability of buyer and target management to work together effectively to realize skill benefits.

- Loss of key talent: Even though key target managers can pledge that they are committed to staying with the business long term, they often are not. A significant cash windfall that often accompanies the deal close can loosen key manager's ties to the business. An acquisition and subsequent integration can be traumatic events, and subsequent cultural differences can arise that increase talent flight.

To reduce the risk of not achieving skill benefits in a transaction, companies should consider the following activities:

1. Buy, Hire or Ally?: Management should examine options to access key skills. Alliances can enable an organization to target very specific areas of collaboration. The food industry has historically innovated internally or acquired innovative companies. However, opportunities do exist to structure alliances that involve less capital and a potentially higher return.

2. 360-Degree Due Diligence: It is critical that buyers have the opportunity to talk directly with the target's key customers, distributors, suppliers and management to gather as much independent input on the target's capabilities relative to competitors. With this understanding an acquirer can have more confidence that target core competencies exist.

3. Talent Integration and Retention Plan: A critical part of any transaction is to develop a comprehensive plan for the integration and retention of key talent. This involves determining who is responsible for ensuring that the organization can capitalize on differential strengths and determine how to realize these benefits. Answers to these and related questions can help ensure that skills are transferred to help create value.

Conclusion

Acquisitions succeed or fail for a wide range of reasons. However, strategic risk can be dramatically reduced if managers follow certain key steps:

1. Understand the Sources of Value Creation: Identify if value will be created primarily through scale, scope or skill benefits. Most deals will involve a combination of these benefits. Clarity regarding how much of total value creation is likely to come from each area can help focus strategic due diligence efforts.

2. Pressure Test Sources of Value Creation: Apply the following types of tests to ensure that the sources of value creation are valid and achievable:

   a. Scale Benefits

      i. Buyer and target are serving strategically identical market segments such that activities can be combined.

      ii. Buyer will avoid transferring potential scale benefits to the seller in a highly competitive selling process or to customers in the form of discounts.

   b. Scope Benefits

      i. Customers value the increased product or geographic scope and you will benefit through increased revenue, margin or customer retention.

      ii. Sales structures and organization support the ability to transfer increased scope into value.

   c. Skill Benefits

      i. Seek evidence that the selling company has the targeted competency. Is it driving higher growth or margins? Do customers attest to the skill?

      ii. Determine if there are sufficient resources and mechanisms to support skill transfer. Who is responsible? Can the right managers be freed up to apply targeted skills?

Food and beverage industry executives live in a world where low, single-digit market growth can be called "attractive." Meanwhile, equity analysts or private owners apply ever-increasing pressures to achieve growth. In this environment, acquisitions represent a tempting path to achieve this growth. The problem is not that companies embark on this path – it is that some companies do so without a sufficiently clear and tested strategy to not only recover a substantial acquisition premium but to also deliver added value. Following a fact-based management framework to assessing acquisitions can help maximize value creation.

For further information contact:

Boston
28 State Street
16th Floor
Boston, MA 02109
Telephone: 617.951.9500
Facsimile: 617.951.9392

Chicago
One North Wacker Drive
39th Floor
Chicago, IL 60606
Telephone: 312.913.6400
Facsimile: 312.782.4583

Los Angeles
1100 Glendon Avenue
21st Floor
Los Angeles, CA 90024
Telephone: 310.209.9800
Facsimile: 310.209.9125

New York
650 Fifth Avenue
25th Floor
New York, NY 10019
Telephone: 212.582.2499
Facsimile: 212.582.8505

San Francisco
100 Pine Street
Suite 2000
San Francisco, CA 94111
Telephone: 415.676.5500
Facsimile: 415.627.9071

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