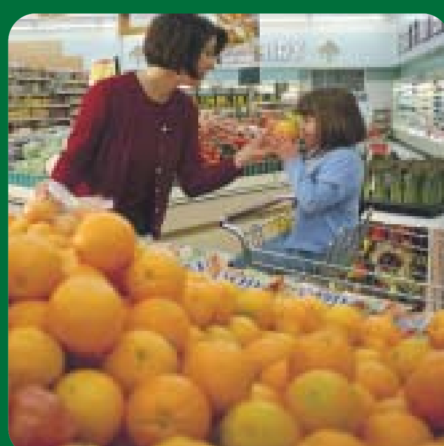
The world is yours

Feeding growth

The role of private equity in the food and drink industry



2003

A 3i sector report produced in co-operation with the Economist Intelligence Unit

About 3i

3i is a world leader in private equity and venture capital. We invest in a wide range of opportunities, from start-ups to buy-outs, focusing on companies with high growth potential and strong management. Our investments span more than 20 industry sectors and over 200 of our portfolio companies have achieved stock market listings in the last 10 years.

It's the effort we put into understanding people, as well as business, that has made us a leading force. 3i has a highly qualified and professional team, and through our network of experts operating in three continents we help companies identify and exploit opportunities on a global basis.

3i and the food and drink sector

3i is the leading provider of private equity and venture capital to food and drink companies in Europe with an investment portfolio of more than 100 companies spanning a range of categories including convenience foods, nutraceuticals, food ingredients, retailing and food service – including the following companies:

Braes Group Ltd	Manufacturer of natural food ingredients
Exoliva	Producer of olives
Halo Foods	Manufacturer of snack bars
MicVac	Developer of valve-based technology for ready meals
Prize Foods Group	Manufacturer of chilled and frozen foods
Refresco Holdings	Manufacturer of fruit juices and soft drinks
Sapori Mood Media SA	Producer of background music for retail premises
Winery Exchange	Producer of private-label custom wine brands
Witwood Foods	Global supplier of food coatings and marinades

Foreword

Welcome to this European food and drink sector report produced by 3i in co-operation with the Economist Intelligence Unit. This is the latest in a series of reports that examines the role of private equity and venture capital within key sectors of the global economy.

Brian Larcombe
Chief Executive, 3i Group plc

Food and drink is one of the powerhouses of the European economy, supporting some 29,000 companies and employing 2.7m people. It is also one of the most active sectors in terms of new investment. As this report highlights, the amount of private equity and venture capital invested in Europe's food and drink companies increased from €2.7bn in 2001 to €4.5bn in 2002.

The key reasons for that rise are changes in lifestyle, the pressures of consolidation and increasing levels of innovation. All are impacting on the dynamics of the food and drink sector to create opportunities for start-ups and established companies.

Navigating the new food economy requires a clear understanding of these dynamics. The winners will be the companies that build strong relationships with knowledgeable, networked partners from the business and financial community. The role of private equity and venture capital has never been more important.

We look forward to meeting many of you at our forthcoming conference to discuss the key themes of this report further.

3i European Food & Drink Conference

The 3i European Food & Drink Conference is taking place on 27–28 November 2003 at IESE Business School, Barcelona, Spain. The conference will provide a unique opportunity to network with other senior executives from leading European food and drink companies. It will also provide an ideal forum for further discussion around the key themes and topics raised within this report.

There are a limited number of places still available. To request an invitation please email Charleen_Cannone@3i.com at your earliest opportunity.

Feeding growth

The role of private equity and venture capital in Europe's food and drink industry

The food and drink industry is a powerhouse of the European economy, employing 2.7m people and producing goods worth over €600bn[1]. It has ridden the current economic downturn well, and stocks in the industry have outperformed other industries in the last two years.

But the industry looks safe rather than exciting. Markets are mature; growth is steady rather than spectacular. Projected population declines in some of Europe's key countries, and shrinking margins caused by consolidation among the big retailers, militate against buoyant growth.

So why is the smart money still flowing into the industry? Private equity investment in Europe's food and drink sector jumped last year, while overall investment volumes fell. The industry has consistently pulled in more private equity funding than other industries, technology aside. This sector report, produced by 3i in co-operation with the Economist Intelligence Unit, identifies four industry drivers that explain the mutual attraction between the food and drink sector and private equity:

The innovation imperative. Beneath a staid exterior, the food industry is fizzing with new ideas. It has to be. Overall volume growth is not on the menu—nor are price rises. Demographic patterns are driving the expansion of the higher-margin ready-meal market. Greater health consciousness on the part of consumers is spilling through into the burgeoning market for functional foods. Safety scares and bioterrorism fears drive demand for better food testing and traceability technologies. Global venture capitalists are specialists at matching innovative businesses with networks of suppliers, partners and customers, and the food and drink industry is a good place to demonstrate those skills.

> "Navigating the new food economy takes knowledgeable, networked partners with a clear understanding of the industry's dynamics."
>
> **Keith Ellis**
> Global head of the food and drink sector, 3i

The consolidation movement. The industry remains extremely fragmented, particularly outside the UK, in the food service market. Concentration offers the possibility of reaping huge economies of scale, and private equity firms can use buy-and-build strategies to develop new markets among numerous smaller companies. Consolidation among the industry's large players is meanwhile accompanied by the disposal of non-strategic assets, many of which have brand equity just waiting to be unlocked and

1 Data from the Confederation of the food and drink industries of the EU (CIAA)

exploited. Other, less obvious opportunities are also there to be taken by private equity firms adopting a more proactive approach to creating and executing deals.

■ **The untapped potential of continental Europe.** The UK has traditionally taken the bulk of private equity funding in Europe, but a shift to other markets is well under way. There is far greater scope for consolidation in fragmented markets such as Italy and Spain, and far more room for growth in a category such as ready meals that has proven itself in the UK but has yet to take such a hold elsewhere in Europe. Private equity investors with international reach can be instrumental in transferring industry knowledge from market to market within Europe.

■ **The evolving nature of the food economy.** A new food economy is springing up, one where there is increasing cross-fertilisation between food disciplines and areas such as biotechnology and information technology, and where a global and highly flexible supply chain relentlessly seeks greater economies of scale and improved responsiveness to customer demand.

Far from being staid, therefore, the food and drink industry in Europe turns out to be a surprisingly dynamic environment, one in which private equity firms are natural players. That isn't just welcome news for entrepreneurs; it also brings tangible benefits to corporates. Private equity firms can give companies insight into emerging technologies and innovation that can help them realise their strategic plans. And they are a critical source of deal flow, enabling firms to spin off non-core assets and providing companies with valuable acquisition opportunities. "Navigating the new food economy takes knowledgeable, networked partners with a clear understanding of the industry's dynamics," says Keith Ellis, 3i's global head of the food and drink sector. That's as true for established companies as it is for youthful start-ups.

Contents

Industry trends

Investments in Europe's food and drink sector rose to €4.5bn in 2002.

Europe's big players
Food industry production, €bn, 2001 estimates

France	115
Germany	110
United Kingdom	98
Italy	93
Spain	67
EU-15	626

Source: CIAA

Figure 1

We consume its products all of the time, but even so it is a surprise to find out just how large the European food and drink industry is. Over 29,000 European companies operate in the space, and the industry employs 2.7m people. Europe's processed food exports are worth more than €45bn. In 2000, the EU was the world's largest producer of all foodstuffs, exceeding US production value by €80bn. The sector is bigger than Europe's automotive, chemical, machinery and equipment industries, according to figures from the Confederation of food and drink industries of the EU (CIAA).

With size comes stability. Despite the economic downturn, food and drink sector production grew by an estimated 2% in 2002 year-on-year, an increase over the 1996-2001 average growth rate of 1.3%. That has kept stock performance relatively buoyant: European food and drink stocks have outperformed the broader market over the last two and a half years. Consumers may change their habits when money is tight – by eating out less or buying cheaper products – but they do not consume less food.

But few would call the sector sexy. Industry growth of 2% isn't exactly heady. And structural trends in the western half of Europe, at least, are less than encouraging:

1. Food accounts for a declining proportion of disposable income in developed markets. Many of the world's biggest food and drink companies are ploughing their money into emerging markets in Asia, Eastern Europe and Latin America in search of growth.

2. Populations in Europe are declining. The United Nations has predicted that the population of the EU will be down by around 40m people in 2050, compared with today's population. Other demographers take a more cautious view, but significant population declines in three of Europe's big markets – Germany, Italy and Spain – are widely expected.

3. Retailers wield increasing clout. As retailers consolidate, the big players have been able to leverage their buying power more effectively, driving down manufacturers' margins. The large manufacturers in turn pressure their suppliers to cut costs. Squeezed margins are not the only problem. So reliant are the manufacturers on the large retailers that they often also find themselves being asked to finance in-store promotions, or to offer retrospective discounts based on volumes sold.

Branded suppliers must also fight against many supermarkets' 'own-brand' goods. Although these have not swept all before them, as predicted in the 1990s, some supermarkets now only give shelf space to the two market leaders, plus their own-brand equivalent.

Investor appeal

A mature industry, facing growing pricing pressures and battling adverse long-term demand drivers, doesn't sound like the natural home for private equity firms. But here's some food for thought. According to data from Initiative Europe, a research organisation providing information on European private equity and venture capital markets, total venture capital and private equity investments fell in 2002. Yet investment in Europe's food and drink sector rose from €2.7bn in 2001 to €4.5bn in 2002.

Much of the growth centred on continental Europe. The UK hoovered up 57% of all venture capital and private equity placements in the years 1995 to 2001, but only 25% of investments in 2002. Investment in French firms grew from about 20% of the total European pie in the years 1995-2001 to 32% in 2002. In Italy, investments grew from 1% to an astonishing 26% last year.

Private equity firms are making money as well as investing it, most notably through trade sales and secondary buy-outs. According to PricewaterhouseCoopers, the total value of private equity exits in the European food sector in 2002 reached €1.2bn.

The amount of private equity funding invested in the food and drink sector continues to be high relative to other industry sectors. At €24.1bn from 1995 to 2002, food and drink was second only to the careering telecoms and technology sector, surpassing pharmaceuticals and chemicals, publishing, retailers and all other sectors for investors' funds.

What is it that private equity firms see that others might not? Two answers, says Keith Ellis, 3i's global head of the food and drink sector: "Since the European food and drink sector is not going to experience much volume growth unless population trends reverse or society starts eating significantly more, the food and drink sector must either innovate or consolidate." In both areas, innovation and consolidation, private equity's strengths come strongly into play.

Eating less...

Food, beverages and tobacco as % of consumer expenditure in Western Europe

1990	1995	2000	2005[a]
20.1	18.5	17.5	16.6

... slimming down

Mid-year population estimates

	2003	2050a
Germany	82,398,326	73,607,121
France	60,180,529	61,017,122
United Kingdom	60,094,648	63,977,435
Italy	57,998,353	50,389,841
Spain	40,217,413	35,564,293

a Forecasts.

Source: Economist Intelligence Unit; US Bureau of Census

Figure 2

I. The role of private equity and venture capital: Nurturing innovation

> "The top ten chilled food suppliers still command just over 50% of the market."
>
> **Neil Sutton**
> Partner and food sector leader for PricewaterhouseCoopers in London

The goal of private equity houses has always been to realise value from their investments. In the 1980s, they focused attention on selling off assets to drive value. Now they zero in on areas with high non-cyclical growth, steep margins, high repeat usage and multiple markets – areas where innovation, operational improvements, increased productivity and expansion strategies, such as buy-and-build, can drive higher returns. No easy task, but look hard enough and such areas of dynamic growth do exist. In this section, we pick out four.

The convenience society

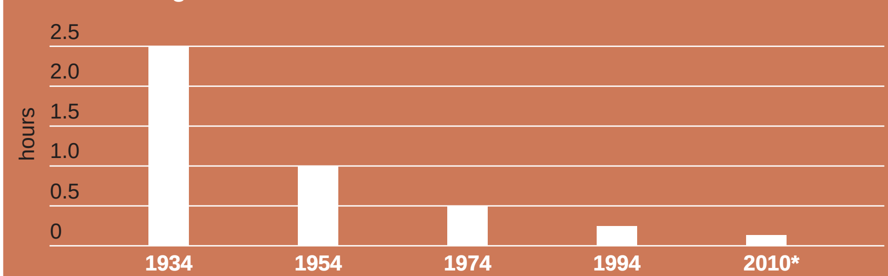
Convenience food is already one of Europe's most dynamic categories, and consumer appetite for minimal-skill, minimal-effort cuisine is growing keener.

There are more single-person and dual-breadwinner households in society: one-person households outnumbered family households in the US for the first time in the 2000 census, and Europe's profile is headed in the same direction. People are also cooking less. Professor David Hughes of Imperial College, London has charted a fall in the length of food preparation time in UK homes from 2.5 hours per day in 1934 to 15 minutes in 1994 (and this trend has continued). Even at France's famed cooking school Le Cordon Bleu, very few of the students who attend the school to become professional cooks arrive with an understanding of basic technique. Patrick Terrien, Le Cordon Bleu's Chef de Chefs de Cuisine in Paris, says that 85% of his professional students arrive without basic skills.

Not surprisingly, and no doubt much to Chef Terrien's chagrin, companies that have identified the need for fast, convenience food have generally won market share from those that are slower on the uptake. Pre-prepared chicken dishes, as well as health pressures, have helped poultry steal beef's market share.

One of the strongest examples of growth within the convenience sector is the category of chilled, ready-to-eat meals. These are meals that are sold fresh and cooked – and consumers merely reheat them at home. In recent research on convenience food consumption across Europe between 1998 and 2002, Mintel International Group, a research firm, revealed that sales of ready meals in the five major European markets rose by 29%,

Home cooking time in the UK



* Projected

Source: Imperial College, Professor David Hughes

Figure 3

"Many food manufacturers are less familiar with the time and costs associated with functional food development."

Keith Ellis
Global head of the food and drink sector, 3i

from €5.4bn to €7bn. The fact that these are higher margin products and usually not branded has been a significant source of bottom-line growth for retailers.

There's potential for more, especially in continental Europe. Frozen and ambient foods still fare better in continental Europe where the distribution and retailing infrastructure for fresh foods is not yet as developed as that in the UK. Mintel's research shows that the UK accounted for some 42% of total value sales in Europe's five major markets in 2002, leaving plenty of room for growth in France (21%) Germany (20%), Italy (9%) and Spain (7%).

Ethnic foods are piggybacking on the ready-meal trend. Mintel's consumer research reveals that 57% of ready-meal users in the UK claim to enjoy eating foreign foods, a similar level to France. Other European consumers appear to be a lot more conservative – for now. German consumers need to be encouraged to try new food products, with only four in ten enjoying foreign foods. This is even truer of Italy and Spain, where only 23% and 19% of consumers respectively have developed a taste for foreign foods.

Many predict that the higher margin ready-meal sector is likely to be one of the most active categories for consolidation and product development. It is still highly fragmented and retail products, particularly in the UK, are dominated by retailers' own label production. There is, therefore, plenty of scope for the kind of 'buy-and-build' consolidation strategies practiced by many private equity firms. "The top ten chilled food suppliers still command just over 50% of the market," says Neil Sutton, partner and food sector leader for PricewaterhouseCoopers in London. "As a high-growth and capital-intensive industry, the benefits of scale are more pronounced here than elsewhere in the food sector. Large suppliers who have the resources should be able to drive innovation and lead the market by influencing retailers' new product development."

Functional foods

Functional foods are foods that have components or ingredients incorporated into them to give them a specific medical or physiological benefit (nutraceuticals is the term often used to describe the component parts). Functional foods are designed for specific objectives, such as protection against cardiovascular disease, some cancers, diabetes, and obesity. "It begins to resemble more the world of pharmaceuticals than the food and drink sector," says Peel Holroyd, chairman of the agriculture and food consultancy Peel Holroyd and Associates and a former senior agriculturist for Marks and Spencer, a UK retailer.

Consequently, it's an area where private equity can bring particular skills for transferring technology and developing research and development activities into commercial products to bear. "Many food manufacturers are less familiar with the time and costs associated with functional food development," says 3i's Mr Ellis. "There is a need for a leader to help co-ordinate the process."

Growth expectations are again high. When *Prepared Foods Magazine* in the US surveyed 249 food and drink executives earlier this year, 59% of those with marketing and/or sales responsibilities said they were currently developing or marketing functional foods.

Recent research from Mintel puts the European market for functional foods third in value behind Japan and the US, but growing fast. In the UK, the functional food and drink sector grew by 159% between 1999 and 2001, to be valued at £667m.

For the moment, the dairy and yellow fats (embracing products such as Flora ProViva, Becel and Benecol) sector is leading the functional foods charge. Probiotic drinks such as Yakult, LC1 and Actimel have integrated convenience of product with health benefits. A number of European processors have also

Case study:

Matrix Microscience

Speedy sampling

Matrix Microscience was established three years ago with a focus on the development of patented products for the rapid detection of food-borne pathogens. According to Dr Adrian Parton, managing director of the UK company, "For many types of food, such as pre-prepared sandwiches, the product's life cycles are so short that pathogen testing itself has been of little use."

Matrix has created PATHATRIX, a new detection system that can purify and detect pathogens directly from complex food matrices within 16 hours – and with total hands-on time of two minutes. For priority cases, the PATHATRIX can be coupled to Matrix's FLURATRIX system to produce results in as little as 4.5 hours from point of sample. "Our products have significant benefits not only in terms of test speed, but ease of operation, reduction in laboratory costs and high test specificity," says Dr Parton.

"For many types of food, such as pre-prepared sandwiches, the product's life cycles are so short that pathogen testing itself has been of little use."

Dr Adrian Parton
Managing director, Matrix Microscience

The technology is also unique in the way that it samples food. Instead of taking a tiny sample from a standard 25g food mass and allowing it to develop cultures over multiple days, Matrix's system physically searches the entire 25g of food for pathogens, thus increasing the likelihood of finding them if they exist.

In a recent successful test to gain Association of Official Agricultural Chemists (AOAC) R1 Validation, Matrix's PATHATRIX system successfully detected low numbers of E. coli O157 in 88% of the raw ground beef samples tested, whereas only 24% of the samples tested by the United States Department of Agriculture method were confirmed as positive.

Since the majority of other companies working on food testing have focused on improving the detection part of pathogen testing and not the sampling method itself, it took an investor with specialist industry knowledge to see the value that could be derived from Matrix's work. Finding a venture capital (VC) company that understood the process of clinical trials and scientific validation tests also helped. "Being able to leverage the credible global network of a venture capital firm accelerated our progress and became a competitive advantage for us," says Dr Parton.

identified niche markets for milk products. In Portugal, one brand of milk is being marketed solely at expectant mothers, while night milk in Finland is produced from the second milking of the day and contains a high level of a natural relaxant.

But functional foods are also increasingly prevalent in other categories such as breakfast cereals and soft drinks. And 3i's expectation for the sector is so strong that Mr Ellis predicts that: "Given well-managed businesses, with good functional food products and an educated consumer base, the concept will cross into all food categories, far beyond the current focus."

Food safety

The US Center for Disease Control estimates that food- and drink-related illnesses kill 5,000 Americans each year and that 76m Americans a year get some form of food poisoning, 325,000 of them seriously enough to need treatment in hospital. In Europe, no one knows the extent of the problem because the figures are not collected centrally. But it has been serious enough for Romano Prodi, the president of the European Commission, to make it one of his highest priorities.

Food crises – from diseases such as BSE and foot-and-mouth to pathogens such as E. coli 0157 or Salmonella enteriditis – are teaching consumers throughout the world not to trust blindly the food they eat. They are also an extraordinarily expensive failure for industry. After a safety scare in Japan, Snow Brands, a local food and drink company, reported a 38% dive in revenue from US$9.8bn in the previous year to US$6.1bn for the fiscal year ending March 2003.

The scale of the food safety issue represents opportunity for some companies. Take food testing. The biggest problem in food pathogen testing is the time needed to verify positive results. Given the industry's improved processing and distribution methods, too often test results are only available after a product reaches the shelves or is consumed. Pathogen testing "can take three to seven days for many products", says Dr Ted Labuza, professor

Case study:

FXA Group

FXA Group, a three-year-old enterprise software development company headquartered in Asia, is focused on speeding up the traceability process by moving it online. FXA's Internet-based technology platform enables stakeholders throughout the food industry to manage and exchange essential data electronically on the safety, quality, and origin of food products at any point across the entire supply chain, from farm to table.

Compiling this information electronically does more than improve food safety. The data in FXA's product tracing system can also help companies manage production flows and track retail activity, thus helping firms reduce expensive stock, co-ordinate orders and shipments, and manage inventories. "It's an enterprise resource planning tool for the entire industry," says James Thomson, FXA's CEO.

> "It's an enterprise resource planning tool for the entire industry."
>
> **James Thomson**
> CEO, FXA

It is also a tool that will enable, for instance, farmers to distinguish their products from those of their competitors. Food producers have long differentiated and branded products with attributes such as taste, texture, nutritional content, cultivation techniques, and origin. What this software means for retailers is that they can utilise traceability solutions to add another branding element to their product mix. "Historically, success for the manufacturers and the retailers was mainly a matter of marketing, branding and taste. In the future, it may also be about proving a product's history – and having the data trail to prove it," says Mr Thomson.

of Food, Science and Nutrition at the University of Minnesota. “We ultimately need to do this in minutes.”

Solutions to the problem are now emerging through the marriage of biotechnology and the food and drink industry, an area where private equity, with its wide-ranging portfolio of investments and expertise in technology, can again play a particularly useful cross-fertilising role.

Tracing paper

Traceability is another key area. When the European Commission receives confirmation that a food or drink poses a serious health risk, its Rapid Alert System requires all member countries to recall or withdraw the tainted food from their markets immediately. What makes those recalls possible is traceability, a verifiable method of delineating a product’s history as it moves from the grower to the retailer and customer.

Historically, where traceability information has been documented, it has usually been done on paper. In the event of a food contamination recall, that has meant placing a series of phone calls, faxes and emails up and down the product supply chain to find the information needed to withdraw affected products off the shelves or back from consumers’ cupboards.

Since the greatest threat to public safety in the event of a recall is that traceability information is not timely, new standards and laws are forcing the food industry to collect and manage huge amounts of information – and to be able to access it immediately in the event of an emergency.

Extending fresh shelf life

Another area stimulating innovation is the search for packaging technology that makes fresh foods safer without a loss of quality. “Older purification techniques such as high temperature pasteurisation usually left fresh foods with a cooked taste,” says the University of Minnesota’s Dr Labuza. “A key innovation is to keep foods safe while preserving the original character and taste.”

The search for new kinds of packaging to extend fresh ready meals’ shelf lives without degradation of quality or nutrition is the focus of attention at MicVac AB, a three-year-old start up from Sweden which is backed by 3i. The company has developed a new patented technology that allows food producers to provide fresh pasteurised and vacuum-packed goods with a shelf life of typically four to five weeks when chilled.

The key to the process is a new valve designed by MicVac that allows food to be packaged, pasteurised and vacuum-packed using microwave technology. The shorter cooking and pasteurisation time of five to ten minutes results in less change in the taste and physical characteristics of the food itself as well as an increased retention of nutrients.

“Consumers today continue to buy ready meals more because of convenience than pleasure,” says Dr Olle Olofsson, MicVac’s chief of research. “Our innovation could accelerate the trend towards wider acceptance of ready-to-eat meals, particularly outside the UK where sales growth has been slower than forecast.”

The international potential of MicVac’s technology made the firm’s choice of partner critical. “Our funding was cross-border and symbolised a belief in the international significance of the technology. It was as important psychologically as financially,” says Dr Joel Haamer, MicVac’s founder. “Working with a global venture capital firm opened doors for us to markets far beyond Sweden.”

Private equity funding also allowed flexibility to help deal with the typically long period of time needed to validate MicVac’s technology. “Process changes in the food and drink industry can take a long time to be adopted by processors and retailers. The complications of scientific testing, recipe reformulations and customer acceptance evaluations all mean that an investor has got to be there for the long term,” says Dr Haamer.

> “Our funding was cross-border and symbolised a belief in the international significance of the technology.”
>
> **Dr Joel Haamer**
> Founder, MicVac

II. The role of private equity and venture capital: Exploiting consolidation

"There is a tremendous opportunity to unlock the full value of the European food and drink sector."

Olivier Le Gall
Investment director, 3i France

2 Food Sector Insights: Analysis and Opinions on Merger and Acquisition Activity 2002/2003, PricewaterhouseCoopers, 2003

3 A Wholesale Shift in European Groceries, Javier Castrillo, Jose Manuel Martinez, and Dieter Messner, The McKinsey Quarterly, 2003, Number 1

4 Making a Meal of Europe's Food and Drink Business, Peter Freedman, The McKinsey Quarterly, 2000, Number 1

Identifying growth opportunities and fostering innovation plays to one set of the private equity industry's strengths. Realising value in existing companies and assets is another, and once again the food and drink industry provides plenty of opportunities.

The food industry has not seen the reduction in mergers and acquisitions activity typical of many other sectors. According to PricewaterhouseCoopers, the volume of food M&A activity across Europe has remained relatively constant over the last few years, reaching 374 transactions totalling €12.8bn in 2002[2].

Stability in the overall number disguises a shift in deal-making activity away from the UK to continental Europe. In France, M&A activity in the food sector has been gradually rising since 1998. With a disclosed deal value totalling €5.7bn in 2002, France easily surpassed the UK's €1.6bn figure as the market with the highest value of deals last year.

With less room for organic growth, consolidation is the name of the game for food companies. Firms such as Switzerland's Nestlé, the world's largest food company, have busied themselves acquiring both small and large concerns over recent years.

More consolidation is certain. Retailing aside, Europe's food and drink industry remains extremely fragmented. According to McKinsey and Co, a consultancy, the top ten food and drink producers in Europe's largest countries still account for only about 14% of the market—a low level compared with industries such as grocery retailing (42%) and pharmaceuticals (35%).

While the UK has experienced the most consolidation, the rest of Europe is dominated by small and medium-sized enterprises (SMEs), often family-owned. In Italy and Spain, 88% and 86% of the food and drink companies respectively are small companies with less than 50 employees.

"I believe there is a tremendous opportunity for both corporates and private equity companies to work together to unlock the full value of the European food and drink sector," says Olivier Le Gall, 3i's investment director in Nantes, France.

Wholesale change

McKinsey's research points to specific consolidation opportunities in Europe's wholesale food and drink market[3]. On the demand side, growth comes mainly from two sources: independent grocery stores, which are too small to buy direct from producers and, in particular, food service operators that cater to consumers when they don't eat at home, such as institutional catering enterprises, hotels, restaurants and cafes.

Consumption of food and drink in places other than homes rose from about 32% of total European consumption in 1995 to 35% in 2000, and is forecast to approach 38% by 2005, according to McKinsey. This change is boosting wholesale demand from the food service segment by four to five percent a year across Europe, compared to retail growth in demand of one to two percent.

Professor Hughes at Imperial College predicts that the current blurring of lines between conventional supermarkets and food service operators such as takeout and fast food outlets will end. "By 2010 retail food stores and food service operators will be one and the same," he says. "The era of women as shopping and cooking mules is over."

On the supply side there are two types of wholesalers. First are the cash and carry operations where customers select and take away their purchases themselves. Delivery wholesalers, by contrast, deliver products directly to their customers, usually midsize or large food service enterprises and increasingly independent stores. The market remains greatly fragmented, particularly in Italy and Spain. Each EU country has hundreds, sometimes thousands, of suppliers – mostly small, unsophisticated local companies selling a limited range of products.

Consolidation in this type of landscape brings significant rewards. McKinsey analysed potential consolidation in the production of beer, confectionery, spirits and yogurt categories across Europe[4]. They found that the category leader in any national market typically earned margins up to twice those of competitors half its size. "Even a modest increase in concentration could easily add a percentage point to the category's overall profitability, generating economies of scale in almost every function, from sourcing and manufacturing, to customer management, marketing and administration," says Peter Freedman, a McKinsey director in London.

Branding together

Alongside consolidation, the disposal of non-strategic and less successful brands from giants such as Nestlé and Danone has also been a major source of private equity deal flow. Unilever alone is more than halfway to reducing the 1600 brands it owned in 1995 to 400 brands by 2004.

This rash of divestment of brands from the largest players brings a number of opportunities for private equity. Under-performing brands can be revitalised through stronger management and a keener focus on profitability and growth. And using buy-and-build strategies, private equity investors can help pull together numerous smaller companies, cross-sell to existing buyers, discover new distribution channels and thus create new markets.

Buy-outs and buy-ins of family-owned businesses are also seen as a growth area for private equity, particularly in France, Germany, Italy and Spain. "Baby-boomers are set to retire soon, and inheritance planning is motivating many to begin looking at exit strategies," says Pablo Gallo, 3i's investment director in Spain. "The coming years present a significant opportunity for private, family-owned firms as consolidation and a rationalisation of industry structure takes place on the continent."

Divestors are also becoming increasingly innovative, employing complex and creative sales structures to make deals. Examples include the 'split sale', in which businesses or brands are parceled off to more than one buyer where each is prepared to pay a strategic premium for the piece they can exact the best synergies from. Sellers are also more prepared to maintain a stake in the business being sold and thereby share any future uplift in value.

"The coming years present a significant opportunity for private, family-owned firms."

Pablo Gallo
Investment director, 3i Spain

Bite-sized

Number of food and drink companies, 2001	
Italy	6,800
Germany	6,035
France	3,604
Spain	3,040
UK	2,319

Average number of employees per company	
Ireland	69.0
Finland	21.2
Germany	19.4
Spain	14.6
Portugal	13.3
Belgium	11.1
France	9.0
Italy	6.3
EU Average	14.1

Source: CIAA 2002 Annual Report and Eurostat

Figure 4

Beverage trends

"The juice market is still fragmented in Europe and I believe further consolidation will take place."

Menno Antal
Investment director, 3i Netherlands

Food and drink get lumped together but they are dissimilar in significant respects.

"The beverages industry is very different from the food sector," says Nick Barton from Stamford Partners, a specialist investment banking and strategy consulting firm focusing on the food and drink industry. "There are fewer players in beverages, particularly spirits, beers and soft drinks. It's a space dominated by multinationals and there are few opportunities beyond occasional substantial trade deals. It's a tough spot for private equity today."

New products do create growth spurts. Cadbury Schweppes, for example, has seen sales of its diet Dr Pepper grow by 4% in the US, despite its overall market share declining. The company is also pinning its hopes on Snapple-a-day, a diet version of its popular uncarbonated soft drink. But sustaining sales in year two of a new product has become a real struggle, as the novelty wears off and the initial marketing blitz fades.

Any growth in the soft drink industry is now more likely to be down to price rises, rather than increased unit sales.

Price rises are not on the horizon in the wine industry, where improving technology, growing techniques and marketing have resulted in an explosion in the range of wines available to consumers. The improved growing techniques have led to a glut of wine on the market. And hiking grape quality has led to branding wars as low-end wines catch up with the quality of mid-range varieties. The effect has also led to a series of price wars.

Beer manufacturers, on the whole, are faring better, thanks partly to consumers' increasing willingness to pay for premium beers. In Germany most new product development is within the booming beer-mix market. So far most beer-mixes have been beer plus lemonade or cola, but other recipes are now entering the market, including the mixture of beer and other alcoholic drinks. Most of the new beer-mixes are launched as totally new products, rather than line extensions.

The fruit juice market is also looking healthy, not least because it is more fragmented than most other beverage categories. The European market was valued at €16bn in 2001 and is forecast by Datamonitor to grow to €19.2bn by 2006. Germany is Europe's largest market at the moment, accounting for 29% of juice sales, but its market share will be eaten away by other, faster-growing markets such as Italy and the UK. Packaging innovations, notably in the area of ambient juices, also point to growth potential.

"The juice market is currently full of opportunity. This is due to the combination of continuous packaging innovations and the trend towards natural ingredients and health. Furthermore, the market is still fragmented in Europe and I believe further consolidation will take place," says Menno Antal, investment director at 3i Benelux.

Case study:

Refresco Holdings

Refresco Holdings, a four-year old company headquartered in the Netherlands, has grown rapidly to become one of Europe's leading fruit juice and soft drink manufacturers.

The company has employed a buy and build strategy, acquiring a series of strong national fruit juice and soft drinks manufacturers and then integrating them in a European network. A large proportion of the company's products are private label, but it also includes branded products and contract manufacturing.

Through nine production sites throughout the region, Refresco now has a production capacity of over five million litres per day. It runs 51 production lines featuring a variety of pack types and sizes, including cartons, cans, asceptic PET and glass. International sourcing and the combined means of production enable Refresco to offer lowest-cost production with high reliability in terms of both produce quality and speed of delivery.

"Cost efficiency, innovation, quality and the assurance to deliver in time are the focus points for Refresco," says managing director, Frans Barèl.

Refresco's extensive product portfolio, differentiated packing and filling possibilities, combined with its European-wide presence and local and regional strength, has also made it a compelling partner for many European food retailers.

"Our expected growth in turnover is based on our proven, successful strategy to anticipate market developments, such as the growth and consolidation activities of our clients," says Mr Barèl.

Agents of change

"The demand for quality, fair price, and food safety is increasing."

Keith Ellis
Global head of the food and drink sector, 3i

Private equity and venture capital firms are well known for their ability to affect change within the area of technology transfer – in effect, commercialising innovation. They also have a significant role further along the development cycle, where they offer large corporates the opportunity both to acquire innovative companies that deliver immediate value to the purchaser, and to exit non-core businesses.

Indeed, if there is any criticism of the private equity industry's participation in the food and beverages sector, it is that it needs to engage more pro-actively in dialogue with larger corporates. "Private equity and venture capital firms need to be a little less reactive, moving from transactions that are, for instance, generated by divestments of brands, to proactive deals," says Steffen Andersen, a director at KPMG's corporate finance practice. In particular, they need to open more conversations with leaders in the areas still dominated by fragmentation, particularly on the continent.

This dialogue between corporates and private equity firms is especially important given the evolving nature of the industry. Horizontal consolidation of firms in all segments of the industry is being promoted by the economies of scale that come with business-to-business e-commerce, forward contracting and the purchasing power of large retailers.

The old market for food and drink products was a relatively friendly and democratic place. Anyone with a product to sell could enter and market it to willing consumers, or, as a fall back, to government programmes that fed hungry people. But in this emergent environment of contracts and consolidation, the market is being de-democratised. "It is getting harder to enter without a contract, a strategic alliance, or a personal relationship between buyer and seller," says Dr Jean Kinsey, professor of Applied Economics at the University of Minnesota and the co-director of the Food Industry Center.

Companies are also using new information technologies, trying out new ownership and management styles, and contracting in new global markets. Says Dr Kinsey: "The supply chain is now really a demand/supply web with food consumption at the centre, where point-of-sale information about consumer demand heavily influences what is produced and when it is delivered." That supply chain involves many non-food firms that provide services and products, from software and data analysts, to engineers of food packaging, to biological and physical scientists who redesign food itself.

There is a need for partners who understand these myriad market changes and who can help integrate food and drink companies into the fabric of the new food economy. The marriage of food science and biotechnology will provide some answers, and the integration of information technology and the food supply chain will provide others.

For private equity and venture capital firms, it means there is plenty of opportunity to help. "The demand for quality, fair price, and food safety is increasing," says Mr Ellis at 3i. "The winners will be the companies that are knowledgeable, well networked and flexible. These companies will be well placed to innovate and adopt a seamless approach to product development, packaging and marketing."

We would like to thank the following people for their contribution to this report:

Steffen Andersen, KPMG, UK
Frans Barèl, Refresco, Netherlands
Nick Barton, Stamford Partners, UK
Pablo Cervera, Atlas Ventures, Spain
Adrian Davis, PricewaterhouseCoopers, UK
Peter Freedman, McKinsey and Co., UK
Antonio Garcia de Blas, Calidalia.com, Spain
Dr Joel Haamer, MicVac, Sweden
Chris Hale, Travers Smith Braithwaite, UK
Per Harkjaer, Toms, Denmark
Peel Holroyd, Peel Holroyd and Associates, UK
Dr David Hughes, Imperial College, UK
Dr Jean Kinsey, University of Minnesota, USA
Dr Ted Labuza, University of Minnesota, USA
Jan Little, International Flavors and Fragances, USA
Marc Mathenz, Henderson Global Investors, UK
David Mathews, KPMG, UK
Dr Olle Olofsson, MicVac, Sweden
Adrian Parton, Matrix Microscience, UK
Paul Simmonds, Glisten PLC, UK
John Spayne, Lehman Brothers, UK
Neil Sutton, PricewaterhouseCoopers, UK
Patrick Terrien, Le Cordon Bleu, France
James Thomson, FXA Group, Thailand
Mark Twine, KPMG, UK

3i food and drink industry team

Country	Name	Role	Email	Telephone
Denmark	Thomas Riis Knudsen	investment executive	thomas_riis@3i.com	00 45 (0) 33 47 67 04
France	Stephane Franchaud	investment director	stephane_franchaud@3i.com	00 33 (0) 147 15 11 00
	Jeremy Gould	investment director	jeremy_gould@3i.com	00 33 (0) 437 48 30 30
	Olivier Le Gall	investment director	olivier_legall@3i.com	00 33 (0) 251 17 33 00
Germany	Thomas Atzwanger	investment manager	thomas_atzwanger@3i.com	00 49 (0) 89 54 86 22 42
	Olaf Bruns	investment director	olaf_bruns@3i.com	00 49 (0) 69 71 00 00 55
	Andre Deloch	investment manager	andre_deloch@3i.com	00 49 (0) 211 95 44 40
Italy	Walter Comelli	investment director	walter_comelli@3i.com	00 39 (0) 49 87 75 715
Netherlands	Menno Antal	investment director	menno_antal@3i.com	00 31 (0) 20 305 7458
Spain	Pablo Gallo	investment director	pablo_gallo@3i.com	00 34 (0) 93 439 1991
UK	Keith Ellis	F&D global head	keith_ellis@3i.com	00 44 (0) 121 609 3844
	Paul Cannings	local director	paul_cannings@3i.com	00 44 (0) 207 975 3169
	John Kernohan	investment manager	john_kernohan@3i.com	00 44 (0) 1132 430 511
	Judith Fine	portfolio administrator	judith_fine@3i.com	00 44 (0) 121 609 3898

This report was produced in co-operation with the Economist Intelligence Unit. Design and production by Infoconomy.
To provide feedback on this report, please email mark_sallows@3i.com

www.3i.com

For more information about
3i sector reports, email
mark_sallows@3i.com