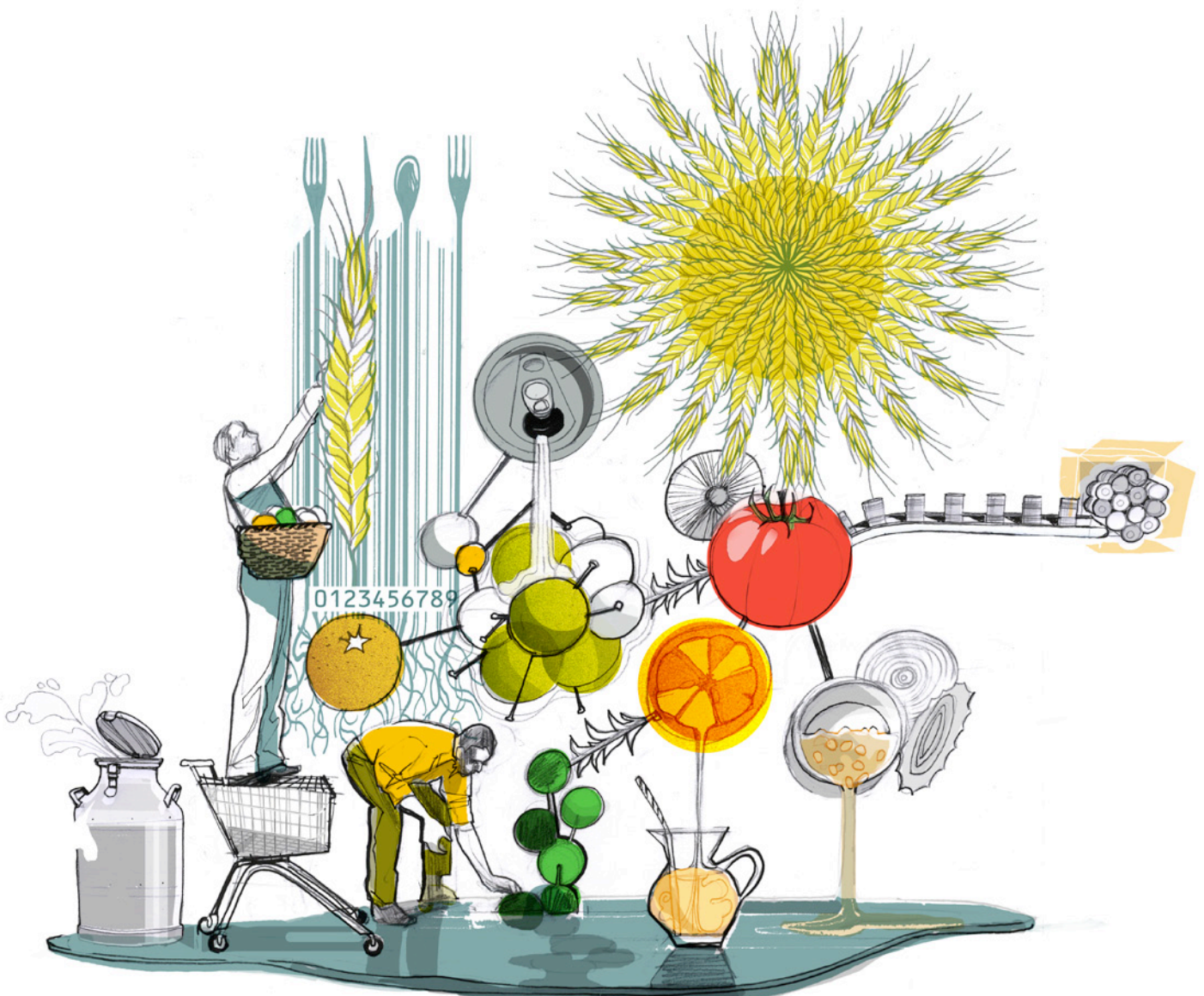


Managing through uncertainty: Food and beverage industry in transition

Wary consumers and rising prices challenge executives around the globe



The global food and beverage industry suffered during the recession and the global malaise that followed. And while measured growth again appears to be the norm in many markets, challenges persist. High commodity prices continue to impact profitability. Consumer spending remains sluggish and limits the ability of food and beverage companies to raise their prices.

Introduction

Not surprisingly, *Managing Through Uncertainty* — a Grant Thornton International Business Report (IBR) 2011 food and beverage sector focus — finds privately held businesses (PHBs) in the food and beverage (F&B) sector are less confident than those in other sectors about their economic prospects. But there is good news: optimism within the sector is increasing. Emerging consumer trends offer new revenue and profit opportunities, and a large balance of F&B companies anticipate revenue growth and improved profits over the next year.

Furthermore, while consumer spending generally remains soft, there is increased demand for home-cooking products and budget friendly, private label brands. Changing attitudes toward healthy eating and the importance of sustainability have supported markets for healthy, organic, natural and green products, especially when these foods are marketed in well defined ways to appropriate consumers. A significant number of consumers are still willing to pay for high-end and gourmet products.

F&B companies are racing to capitalise on these trends with many looking to expand — possibly through mergers and acquisitions (M&A) activity. F&B firms in recent years have focused intensely on cost reduction and improved operational efficiency; with most *internal* gains in profitability already captured, companies are now looking for growth *externally* through M&A. At the same time, size matters more than ever in the F&B sector; small and midmarket companies are increasingly dependent on suppliers and channel partners for innovation, while larger companies enjoy the financial scale necessary for new product development and technology investments.

Managing Through Uncertainty examines global data on the industry — financials, trends, and constraints — and offers perspectives on these issues from Grant Thornton specialists around the world.

Contents

- 3 Introduction
- 4 Cautious optimism among F&B businesses
- 6 Revenues and profits likely to increase
- 9 Employment remains sluggish
- 10 F&B companies react to consumer and market trends
- 13 Product development tops strategic priorities
- 15 Obtaining finance still poses challenges
- 16 Companies dealing with constraints of regulations
- 17 Call to action
- 18 About the Grant Thornton International Business Report

Cautious optimism among F&B businesses

Only +10 per cent of businesses in the F&B sector are optimistic about their respective countries' economic outlook this year (i.e. companies that are optimistic outnumber those that are pessimistic by 10 percentage points). This balance is substantially lower than the overall IBR findings across all industry sectors, at +28 per cent. However, the 2011 F&B findings are marginally higher than 2010 (+7 per cent).

Piyush Patodia, client service director, Grant Thornton India, noted that the overall business environment in India is strong: "In any developing economy on the path to economic prosperity, F&B expenditure is one of the first to burgeon. The Indian

consumer is not just consuming more, but also experimenting with hitherto exotic tastes, throwing open a huge opportunity to numerous foreign F&B companies and concepts. Rising disposable income has especially been beneficial to the foodservice industry, with concepts that are unique and well-priced being the top performers." But he added that "the environment is still challenging due to sourcing and supply chain management issues: input and commodity prices are increasing and Indian F&B companies still have limited ability to pass these on to consumers through higher prices."

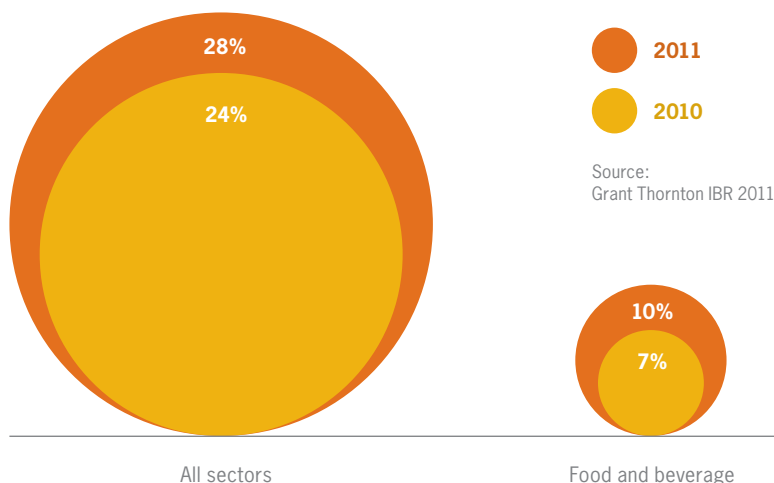
In Canada, the view is similarly optimistic. "I don't believe the Canadian manufacturing sector, and

"In any developing economy on the path to economic prosperity, F&B expenditure is one of the first to burgeon. The Indian consumer is not just consuming more, but also experimenting with hitherto exotic tastes, throwing open a huge opportunity to numerous foreign F&B companies and concepts."

Piyush Patodia
Client service director, Grant Thornton India

Figure 1: Outlook for the economy over the next 12 months: 2011

Average percentage balance of businesses indicating optimism against those indicating pessimism.



in particular the F&B sector, has been hit as hard as in other parts of the world,” said Jim Menzies, global food and beverage industry leader, Grant Thornton Canada. “A transition has started — companies are coming out of survival mode and moving into a cautious expansionary mode. In terms of the overall business environment, companies are starting to hire. They are expanding some of their existing lines of business, they are adding capacity, and they are entering new lines of business.” Canadian F&B companies are also entering emerging markets, Menzies added, looking beyond Canada’s dominant trading partner, the United States.

The outlook is far more restrained in Ireland, a country still struggling through economic crisis. “We are in a very tough economic environment at the moment,” said Ciara Jackson, head of food and beverage, Grant Thornton Ireland. She points to a banking crisis that has required support from the International Monetary Fund and the European Union, along with high unemployment and energy costs: “Here in Ireland, in Grant Thornton, we are calling that the ‘new normal.’”

But despite the challenging environment, there are positives in Ireland for the F&B sector. The agrifood sector is viewed by many economic commentators as one of the key rescue engines of the Irish economy. The government has produced a vision for the sector (Food Harvest 2020), and the current minister for agriculture, fisheries, and food is a vocal and passionate advocate for the sector. Areas of particular focus include sustainability/green initiatives, as well as increased foreign direct investment, especially for expansions and new capacity to produce infant

formula. Ireland produces 16 per cent of the world’s infant formula, and the industry aims to increase that to 20 per cent by 2020.

The UK faces challenges similar to those in Ireland. “It’s quite a gloomy outlook at the moment for a lot of the UK, and especially for some companies operating in the food sector,” said Trefor Griffith, head of food and beverage for Grant Thornton UK. Rising costs for nearly all imported input products, along with an inability to pass along all those costs to

consumers, has constrained the F&B sector. The UK unemployment rate rose to 7.9 per cent in July 2011, with more than 2.5 million people out of work.¹ In March 2011, consumer spending was at a 16-year low; on a like-for-like basis, sales were 3.5 per cent lower than the previous year.² Added Griffith: “As well as having to deal with cost pressures, companies are having to adjust to changing

consumer behaviour. The reduced purse has led to consumers adopting a far more prudent approach to their shopping habits, and, specifically, they are buying smaller quantities of food more often. This has led to a strategy of the large retailers, which are very dominant in the UK, moving toward convenience store formats — rather than large out-of-town stores with lots of non-food items as well.”

In the United States, Dexter Manning, national food and beverage practice leader, Grant Thornton US, said the mature F&B industry, “is in very good shape.” Weak companies were stress tested during the recession, and many either went out of business or were acquired. The result, he said, is a stronger industry that has improved productivity through initiatives such as lean manufacturing and deployment of new technologies.

“Over the last 12 months, mergers

and acquisitions have been up, and a lot of capital that had been on the sidelines is back in the play,” said Manning. “We are seeing F&B companies spend on capital improvements where they had not in the past two or three years — a loosening of spending for planned future growth. The overall business climate for F&B companies moved in a very positive direction during the first half of 2011, in contrast to the turmoil in global markets and the government sector. However, the global credit crisis, especially at the government level, continues to contribute to business uncertainty and consumer fears, which could reverse some of the gains made during the early part of 2011 in the United States.”

South Africa’s F&B market is similarly strong. Receipts across the South African F&B industry increased to R9.1 billion in Q2 2011, up 3.2 per cent from a year ago.³ Elsewhere on the African continent, consumer incomes are increasing due to rising oil and commodity profits. Higher incomes, in turn, drive higher rates of consumption.

“What we are seeing, coming out of South Africa, is further development of the F&B industry in different countries,” said Ian Scott, managing partner, Grant Thornton Cape Town, South Africa. “Some South African businesses are moving into other African countries and taking over market share.”

But, similarly, quite a lot of new plants are being erected. Africa has a large number of farmers and, going forward, should be able to supply more food to the rest of the world than it does today.” Export growth, increased local consumption, and improved prosperity make the continent attractive for F&B investment.



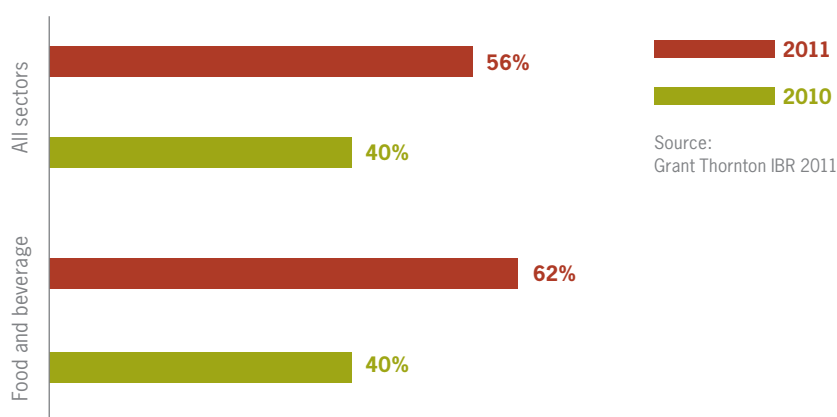
¹ Larry Elliott, “Unemployment Rises above 2.5M Milestone,” The Guardian, Sept. 14, 2011.

² British Retail Consortium

³ “Food, beverages industry income down,” Mail & Guardian, Aug. 22, 2011.

Revenues and profits likely to increase

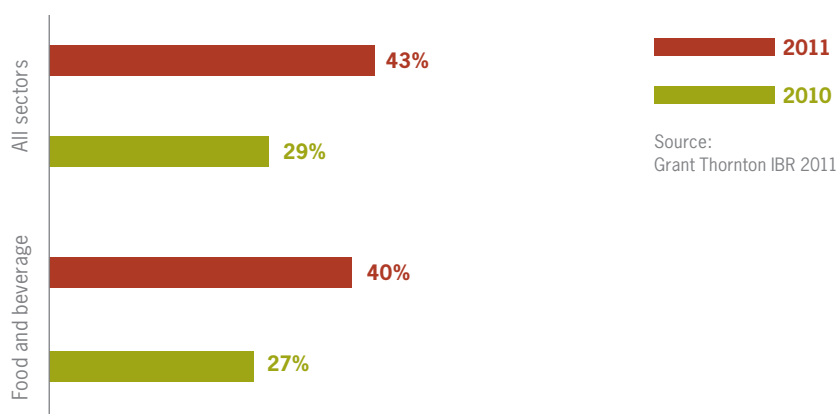
Figure 2: Revenue expectations over the next 12 months: 2011
Balance percentage of businesses



“There is a consensus in our market that while companies do expect revenues to increase over the next few years ...there will be greater pressure on profitability as a result of increasing input costs in Australia — especially as it appears that we are on the way to a carbon tax here.”

Tony Pititto
Industry leader food and beverage, Grant Thornton Australia

Figure 3: Profitability expectations over the next 12 months: 2011
Balance percentage of businesses



A balance of +62 per cent of businesses in the F&B sector expect revenue to increase in 2011 — a sharp increase from expectations in 2010 (+40 per cent), and higher than the average across all sectors (+56 per cent). Similarly, the balance of F&B businesses expecting improved profits in 2011 is +40 per cent — up from +27 per cent in 2010, and comparable to the all-sectors average of +43 per cent.

“There is a consensus in our market that while companies do expect revenues to increase over the next few years,” said Tony Pititto, industry leader food and beverage, Grant Thornton Australia, “there will be greater pressure on profitability as a result of increasing input costs in Australia — especially as it appears that we are on the way to a carbon tax here.” A heavy reliance on private labels by major supermarket chains is also likely to have a negative effect on F&B margins.

Menzies cited a study conducted by Grant Thornton Canada that found that two-thirds of Canadian manufacturing and distribution companies expect revenues to rise in the next 12 months, and half anticipate improved profits as well; only 20 per cent expect profits to go down, and 30 per cent expect them to stay about the same.

India’s Patodia expects F&B profitability in India to either remain stable or possibly dip slightly over the next 12 months due to commodity and input price inflation pressures as well

as increased regulatory environment. The most prominent regulatory change that could have a negative impact on the foodservice industry is an additional service tax, part of the Finance Act 2010 in India, which took effect this year and will impact a large number of restaurants.

Most F&B companies are caught between rising commodity prices and a competitive environment that makes it difficult to pass along those increases to customers. The IBR findings, though, indicate that many F&B companies may finally be able to increase their pricing; a balance of +41 per cent of F&B businesses expected to increase prices in 2011, compared to just +12 per cent in 2010. Across all sectors, +29 per cent of companies expected to raise prices.

Rising commodity prices are affecting food production, selling prices, and profitability. Commodity price increases have been driven globally in part by demand in China and severe weather conditions around the world that limited supplies. In the last six months of 2010, as drought and wildfires ravaged wheat crops in Russia, global wheat prices soared 95 per cent. During this period, corn and soybean prices also climbed 64 per cent and 39 per cent, respectively, as adverse weather conditions in the United States led to smaller than expected harvests.⁴ A range of in country conditions has also impacted commodity prices.

In South Africa, where supermarket chains exert great pricing influence, food

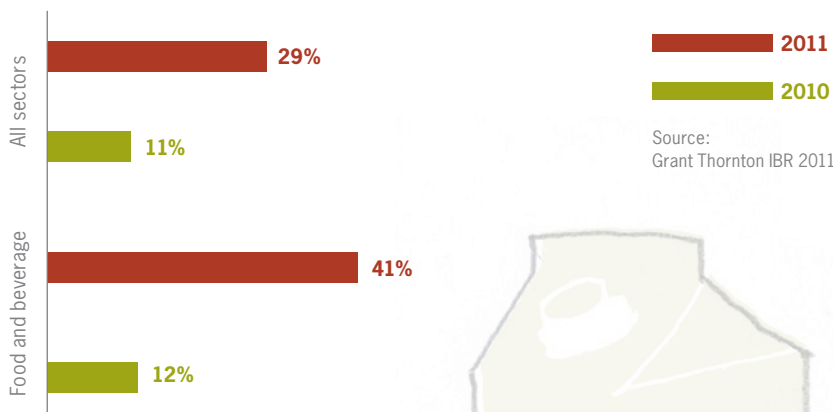
processors have struggled to raise prices. Volatile exchange rates and rising fuel prices have also impacted profitability in the F&B sector.

Natural phenomena were the culprit behind commodity price increases in Australia. After years of drought, the country experienced epic flooding in Queensland in December 2010 and January 2011. The weather's effect was felt on Australia's seasonally adjusted gross domestic product, down 1.2 per cent in Q1 2011 vs. Q4 2010, and agriculture was down 8.9 per cent.⁵ Grant Thornton's Pititto said that some crops were wiped out and that produce, such as bananas, became so expensive that few people purchased them. Food pricing was up 6.1 per cent in Q2 2011 vs. Q2 2010, and fruit prices were up 26.9 per cent.⁶

In the United States, diversion of crops to emerging countries — such as China, India, and Brazil — contributed to commodity price increases. Further, nearly one-third of the corn crop is being diverted for ethanol production, driving shortages within the F&B industry. “Commodity prices, especially corn and wheat, are going to be higher than the historical average for the next several years,” Manning said. “I think that is just inevitable, and people are coming to grips with it.”

In France, the pricing pressure comes from large retailers — such as Carrefour and Groupe Auchan — that dominate consumer food markets and largely control pricing, said Vincent Frambourt, partner at Grant Thornton France. “Commodity prices are really getting high, and companies are not maintaining their margins. We really have a drop down on their profitability. I had a large client that succeeded in increasing prices by five per cent, which is great; but they have a 20 per cent increase on their commodity prices. They cannot maintain their profitability.”

Figure 4: Selling price expectations over the next 12 months: 2011
Balance percentage of businesses



“Commodity prices are really getting high, and companies are not maintaining their margins. We really have a drop down on their profitability.”

Vincent Frambourt
Partner, Grant Thornton France

⁴ “Food & Beverage Industry Snapshot,” Grant Thornton Corporate Finance, Winter 2011 edition.

⁵ Australian Bureau of Statistics, April 2011.

⁶ Australian Bureau of Statistics, July 2011.

Ireland's F&B sector is similarly challenged by a combination of increasingly volatile commodity prices and rising energy costs; at the same time, Ireland's trading volumes with both the UK and the United States have exposed the F&B sector to currency fluctuations.

Commodity prices in India also are going up, said Patodia, affected by insufficient logistics and storage infrastructure and a dependence on import fuels. Those conditions are likely to persist into 2012.

In Canada, rising commodity costs are "the biggest concern right now for most food manufacturers," said Jean-Pierre Haché, senior manager, Raymond Chabot Grant Thornton in Quebec. "Especially those that have to buy exotic raw materials such as fruits, orange juices, and other types of juices from around the world."

Haché said commodity cost pressures are running into a depressed trading partner in the United States and pressure from retailers to keep costs low. Some companies are able to pass on up to half of those costs, while others look to downsize or repackage products for relief. "Instead of selling one litre of orange juice, the package now contains 960 millilitres, and it's the same size package. Customers are buying a price. Some manufacturers, for example, instead of packaging eight products in a package, are now packaging six items for the same or

similar price. Or vice versa — they are upsizing the package, putting more in and raising the price, but higher than the incremental cost. They are playing a lot with the packaging to try to pass on the price point to the consumer."

In the UK, consumers are simply buying less, Griffith said. In June 2011, food volume in the UK decreased by 4.2 per cent, according to the Office for National Statistics — the steepest drop since record-keeping began in 1988.⁷ At the same time, food prices rose 5.8 per cent, the biggest increase in two years. In July, the consumer survey group Which? found that 84 per cent of UK residents are worried about the rising cost of food.⁸

As in most sectors, there is an economic divide between consumer groups reflected in relative value and selling prices, around the world and within individual countries. "We have seen in the United States the average private label brand food products grow every year to a higher percentage of total food purchases," said Manning. "Contrast that with a continued market for organic, natural, and more healthy food. People are willing to pay more for those. It really is a diverging market where some of the high end, more expensive foods are still selling very well, and the private label continues to grow at a pretty good pace."

⁷ James Thompson, "Food Retailers Endure Biggest Slump Since Records Began," *The Independent*, July 22, 2011.

⁸ "Consumers Hit Hard by Rising Cost of Food," *Which?*, July 21, 2011.

"We have seen in the United States the average private-label brand food products grow every year to a higher percentage of total food purchases. Contrast that with a continued market for organic, natural, and more healthy food. People are willing to pay more for those. It really is a diverging market where some of the high end, more expensive foods are still selling very well, and the private label continues to grow at a pretty good pace."

Dexter Manning
National food and beverage practice leader, Grant Thornton US

Employment remains sluggish

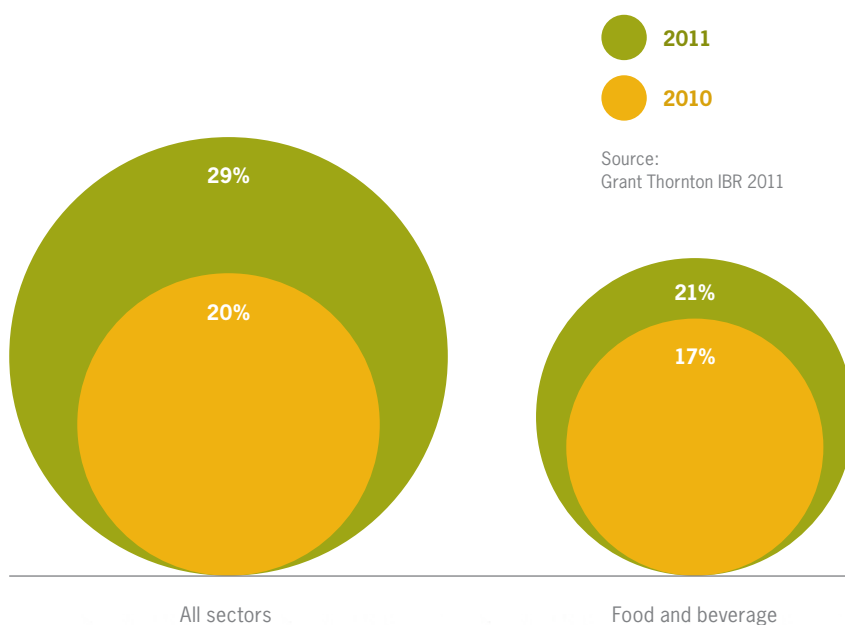
Although F&B businesses anticipate growth in revenue and profits, there is no consensus that improved conditions will translate into widespread workforce expansion. A balance of +21 per cent of businesses in the sector expect to add workers in 2011 — up from +17 per cent in 2010, but below the all sectors average of +29 per cent.

Even in countries where Grant Thornton partners were most optimistic about the F&B sector, few expected to see significant hiring.

The UK is representative of the employment future for the F&B sector. Employment in the UK industry will continue to contract as companies adopt more automated processes to reduce costs. It is predicted that there will be a loss of 27,000 jobs (decrease of six per cent) between 2007 and 2017. The UK is also forecast to recruit high-skill level roles (eg managers, senior officials, technical roles) to approximately 50% of current levels, which is an issue for the industry in terms of being able to afford talent.⁹

To address these issues the Food and Drink Skills Council has launched a Skills Action Plan with the aim of creating 50,000 apprenticeship training opportunities in companies within agriculture and primary production; food and drink manufacturing and processing; food retail; and hospitality and catering.

Figure 5: Employment
Balance percentage of businesses expecting to add workers.



Source:
Grant Thornton IBR 2011



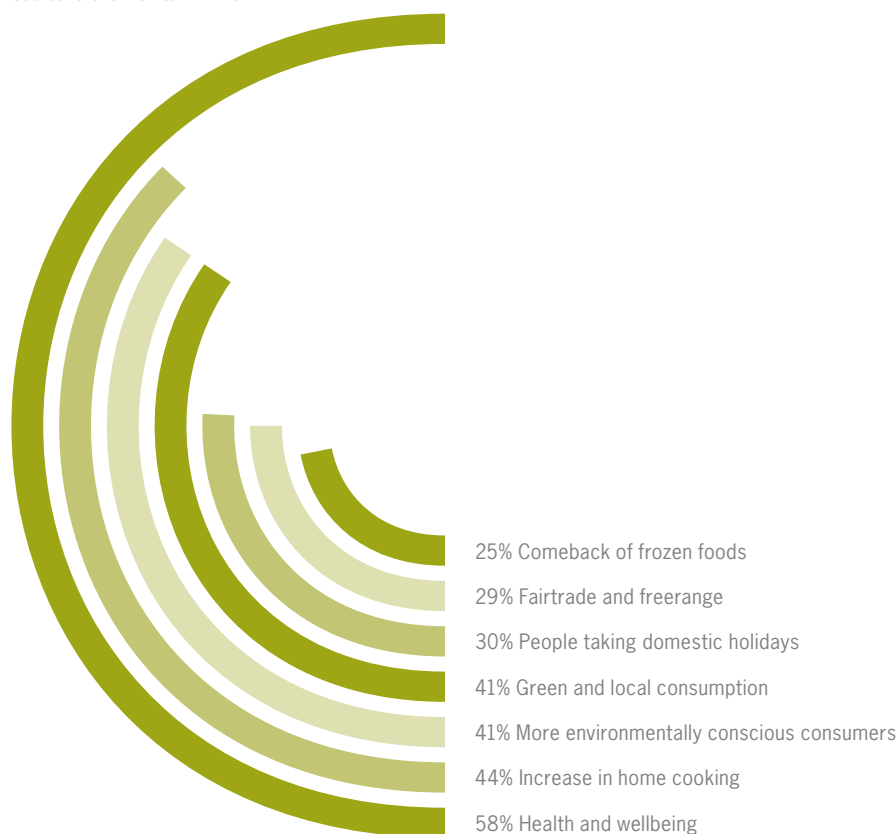
⁹ The Food and Drink Manufacturing & Processing Industry 2010," UK Food and Drink Sector Skills Council.

F&B companies react to consumer and market trends

Figure 6: Which of the following consumer trends offer the greatest opportunity for your business?

Average percentage of businesses rating trend 4 or 5 on a scale of 1 to 5, where 1 is not an opportunity and 5 is a significant opportunity

Source: Grant Thornton IBR 2011



Four consumer trends offer the greatest opportunities to F&B businesses:

1. Health and wellbeing (58 per cent rated it either 4 or 5 on a scale of 1 to 5, where 1 is “not an opportunity” and 5 is a “significant opportunity”)
2. In-home cooking (44 per cent rated it either 4 or 5)
3. More environmentally conscious consumers (41 per cent rated it either 4 or 5)
4. Green and local consumption (41 per cent rated it either 4 or 5)

In response to these trends, a majority of F&B businesses are working on strategies to introduce more healthy eating products (54 per cent), diversify product ranges (53 per cent), and find new retail/customer outlets (52 per cent).

However, these trends and business strategies vary dramatically from country to country.

Health trends and healthy foods

Many consumers — whether by choice or physicians’ orders — are pursuing healthier lifestyles and healthier food consumption in the form of reduced fat, fewer calories, lower sodium, more fibre, increased nutrients, etc. In countries with aging populations, such as in the United States where many baby boomers are entering retirement, healthy foods are even more popular.

“We have a wave of demographics in the United States that is going to be driving the health food market and healthier foods over the next several years,” said Manning. “So that is a very,

very important segment, and more and more F&B companies are spending on R&D to take normal food and enhance it with vitamins or with other substances that will promote health.”

In-home cooking

In the UK it is a case of the “haves” and “have nots,” said Griffith. Consumers who have retained employment are often better off due to low interest rates and reduced mortgage commitments, while many other consumers are struggling to make ends meet, stress that is reflected in their food shopping habits. The consumers who have fared better may still be concerned about their futures, constraining their spending even as they seek quality foods, especially groceries; those F&B companies that offer quality branded products are faring better.

“All the supermarkets have done pretty well with their high quality, private label products. People are trading up. They cannot afford to go out and eat as many times as they would have in the past. They are eating more at home, which is partly because of the cost and partly because of the celebrity chef culture in the UK,” added Griffith.

“Instead of going to eat out on a Friday night, they are cooking nice meals in the home,” Griffith said. “They will end up buying products of higher quality in the supermarket or in niche high end retailers, either in the form of ingredients for a recipe or a quality, ready meal.”

Natural or organic foods

Global organic food sales were \$54.9 billion in 2009, up from \$18 billion in 2000, according to Organic Monitor estimates; 2009 was the first period in years in which sales of organics experienced only single-digit growth. The countries with the largest organic markets were the United States, Germany, and France.¹⁰ US sales of organic food and beverages have grown from \$1 billion in 1990 to \$26.7 billion in 2010. From 2009 to 2010 — when the US economy was at its worst — sales of organic foods grew 7.7 per cent.¹¹

In Ireland, quality and value continue to be important buying criteria, said Jackson, and people are willing to pay for premium products as long as the benefits of those goods are clearly communicated. She said willingness to spend on more expensive items seems to be focused on healthier products, while organic products have become less fashionable. “Unless the organic products are priced well, there is not so much interest in buying them.”

Pititto indicated a similar dynamic in Australia since the financial crisis of 2008-2009. “The organic products were the first to feel the pain of the financial crisis. While they are still growing, the biggest issue here is that there really are no defined standards as to what makes something ‘organic.’ It is very confusing.”

South Africa’s Scott said organics represent a buying segment only at the top of a highly stratified food-buying population. Approximately 5 million of the wealthiest consumers will buy organic products and fuel growth in the category, while about 35 million others are focused on buying basic food items. But reports of contaminated foods from China have contributed to broader interest in organic foods: “It’s made a lot of people aware of what they are eating, and when they can afford to they may choose organic.”

Sustainability

Haché said Quebec is at the forefront of a sustainable industry, with regulatory mandates such as the imposition of a cap-and-trade scheme

on carbon emissions. “Quebec is in an enviable position because all of our electricity is hydroelectricity, which has very low emissions. Other Canadian provinces and US states use fossil fuels, which emit a lot of carbon — not even counting the transportation of the goods through all the different warehouses and distribution centres. So a lot of our food companies are starting to look at using carbon footprinting as a marketing tool.”

Haché highlighted the example of a company that retained Grant Thornton to certify emission reductions at a US plant — utilising those carbon reductions to offset emissions of factories in Canada, thereby enabling it to potentially market certain products with “carbon neutral” branding. “That is very new. No one that I know of is

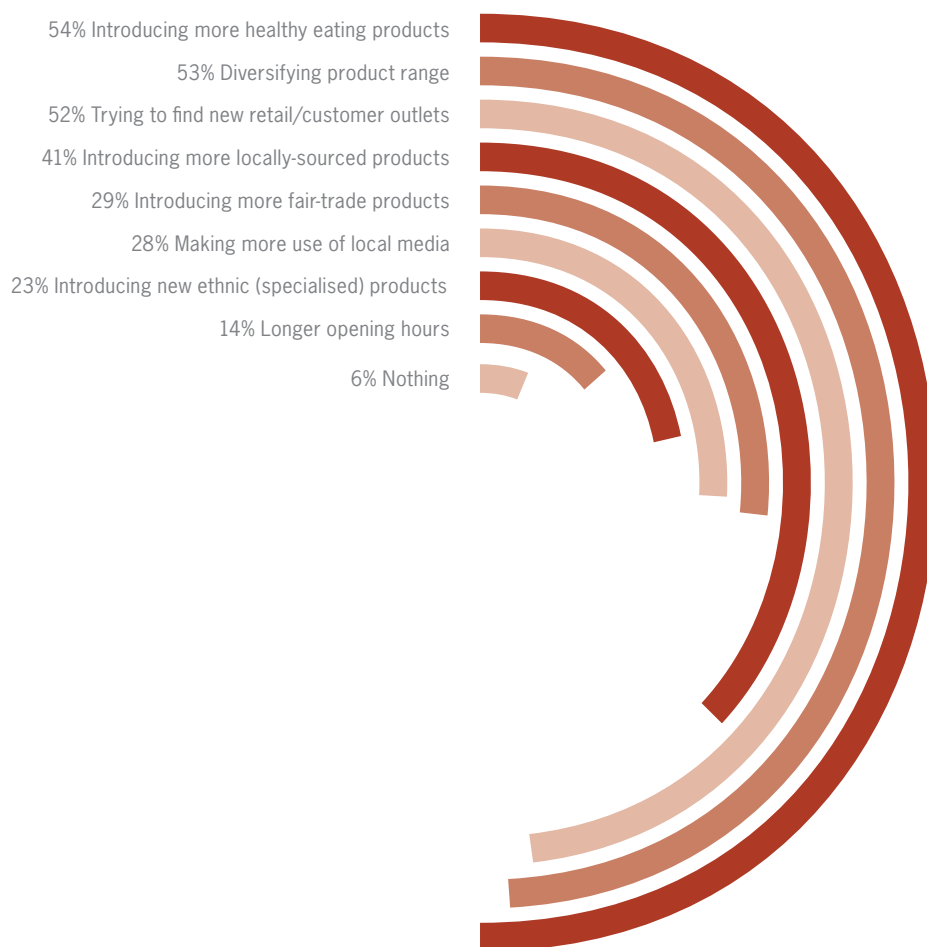
marketing yet in Canada or even in the United States that their products are carbon neutral. But I see a lot of the larger corporations at least thinking about it. If there is one area of potential growth that may be a niche today and mainstream tomorrow, it would be carbon certification, or emission certification and reduction certification.”

Bord Bia, the Irish Food Board, in collaboration with the Carbon Trust in the UK, are working toward having a leadership position for Irish beef through a carbon-footprint calculation model that confirms the natural advantages of grass-based production, noted Jackson.

Markets for green products are not as advanced in the United States as in other parts of the world, but Manning anticipates growth in the category as more companies perform sustainability reporting.

Figure 7: Which of the following are you doing in reaction to social and demographic changes in your customer base? Percentage of businesses

Source: Grant Thornton IBR 2011



¹⁰ H. and Kilcher, L., The World of Organic Agriculture: Statistics & Emerging Trends 2011, IFOAM, Bonn, and FiBL, 2011.

¹¹ Organic Trade Association's 2011 Organic Industry Survey, Organic Trade Association, April 2011.

Localisation

To some extent green/sustainability, local foods, and organic and natural foods overlap — food grown locally and organically without synthetic fertilizers is considered to be greener than non-organic agribusiness product shipped in from out of state. And this creates questions for the industry. For example, does a wine imported by air have a bigger carbon footprint than a wine trucked across the country? Which one is greener? Is local always greener? F&B businesses, large and small, are rushing to sort through the issues.

In the United States, a movement toward localised foods is underway — from consumers buying in local markets to restaurateurs establishing agreements with local farmers. Even superstores like Walmart are trying to integrate local food and beverage items. The challenge for many firms, processor and retailer alike, is that their supply chains were not designed to support localisation. They are now asking: “How can we localise and also save money?”

The localisation movement also is strong in Quebec, said Haché. As in the United States, there is a resurgence of local farmers’ markets, and rumours that Walmart will test localised waters. “They’re actually setting up warehouses and new logistics to be able to gather all these commodities so that they could buy them locally and put them in the stores locally,” Haché said. Similar plans are underway at other grocers, he noted. “There is a pretty strong push toward localisation. And I think one reason is that they know that the fuel cost is much lower.”

Haché’s Canadian colleague Menzies agreed, but also noted the beginning of a decidedly non-local trend in Canada; companies are now more likely to explore market opportunities in places like Mexico, India, China, and South America — countries that in the past have relied heavily on food imports from the United States. “The belief, whether it is right or wrong, is that the US market will not grow significantly, and that historical reliance is just not as strong as it may have been in the past,” Menzies said. “That is causing some of our

Canadian F&B companies to really look seriously at going to other countries with their products.”

In India, localisation is the rule rather than the exception, in part because of its still-developing logistics infrastructure. The two basic food trends, according to Grant Thornton’s Patodia, are localisation and ethnic foods, simply because India is such a diverse country with so many different cuisines and preferences. “It’s often said that you move a hundred kilometres and the cuisine changes — its texture, its colour, its taste as well. From that perspective,

“The belief, whether it is right or wrong, is that the US market will not grow significantly, and that historical reliance is just not as strong as it may have been in the past. That is causing some of our Canadian F&B companies to really look seriously at going to other countries with their products.”

Jim Menzies
Global food and beverage industry leader,
Grant Thornton Canada

localisation and ethnic foods become an important success factor.”

Private labelling

Consumers still suffering from the recession have tightened their belts, forgoing higher priced food items and shifting to more in-home consumption. They are also saving money by purchasing private label foods instead of advertised brands. Generic foods used

to be packaged and promoted as cut-rate substitutes; now many private label products mimic manufacturer brands in both quality and appearance.

“There is a lot of work being done in product innovation and new product development, but mainly for the purposes of meeting private label demand by the supermarkets,” said Pititto. “What we have here in Australia is that two chains predominantly control two-thirds of all food spending at the retail level. They have significant power in terms of what gets on the shelves.” Private labels in Australia have grown from about 10 per cent to approximately 25 per cent; supermarkets are now aiming for 40 per cent. And while other trends, such as healthy foods, ethnic foods, and localisation are important, “that is not what is keeping the manufacturers or the processors awake at the moment. It is clearly about ensuring that they are on the supermarket shelves.”

“Store labels have been successful, and it is more profitable for the supermarkets,” said Griffith in the UK, “so they are obviously still promoting those as much as they can.” For example, retailer Tesco has successfully offered a range of private label products at different price points. But this trend raises some issues for F&B manufacturers. First, production of private label goods is less profitable than the sale of branded goods, Griffith noted. Second, retailers tend to concentrate their private label production to fewer suppliers. So some F&B producers will benefit from growth in private labelling, but others will suffer.

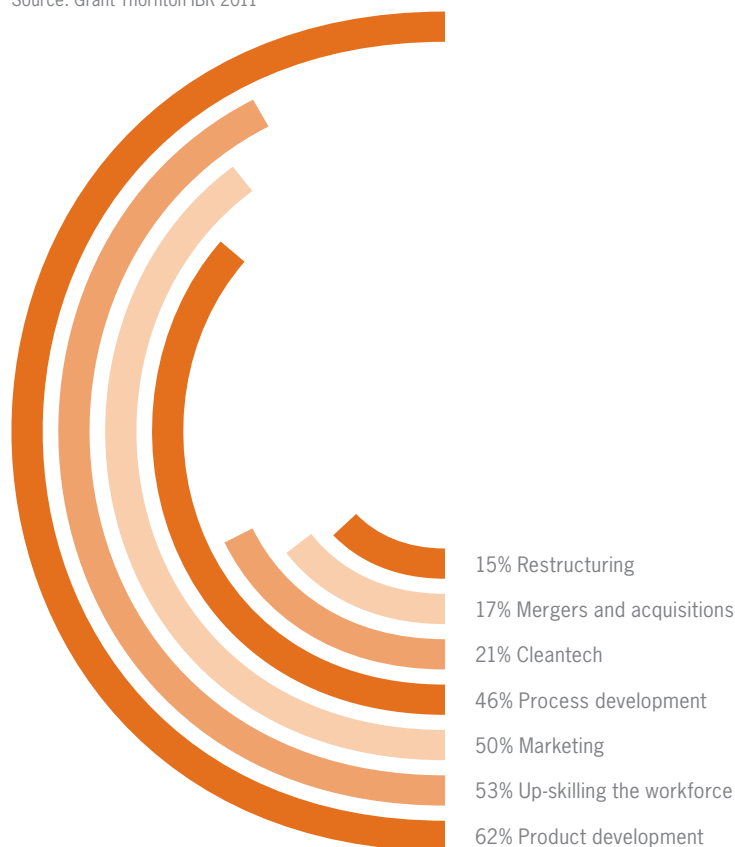
Private labelling has not yet taken hold in India, despite efforts of department store chains, said Patodia. “The trend has yet to see any traction in India, since the value proposition for such products is not yet clearly defined.”

Product development tops strategic priorities

Figure 8: What are your priorities for investment over the next 12 months?

Percentage of businesses

Source: Grant Thornton IBR 2011



Half or more of food and beverage companies ranked product development (62 per cent), up-skilling the workforce (53 per cent), and marketing (50 per cent) as key priorities for investment over the next 12 months.

Product development/R&D is a priority for food and beverage businesses in Ireland, said Jackson, “because of the recession and a challenging cash management/working capital environment, they’re not spending as much as they would have done a few years ago, and they never probably spent as much as they ideally should have.” She said that while there are some notable exceptions, it is not uncommon to see R&D investments of less than one-half of one per cent of sales — much lower than investment rates in other

countries. “It’s a huge differential. We are trying to educate our clients of the importance of intervention to stay competitive.”

Jackson has observed a rising level of collaboration between government, industry and academia. The emphasis, she noted, is to develop new functional and technical ingredients, as well as products that have health and/or nutritional benefits — helping companies develop a model that offers premium product at a premium price.

“Because we are a developed economy and a small open economy, we can’t compete on the mass production, commoditised playing field, so we need to really focus on the premium and value-add products,” Jackson added.

Product development in the UK is focused on evolving consumer tastes, labelling requirements, smaller portion sizes, recycling, and cost reduction, said Griffith of Grant Thornton UK. But R&D funding has been pinched, first by the recession and then by rising commodity costs. “There is not a ready tap of money to use to sort out any one issue. It is very tough. They have got to be looking at how they make profit, how they satisfy shareholders in the short term, or how to stay afloat in the short term. New product development — which can take six months, a year, two years or longer — is something that is getting tough, but remains necessary to ensure listings on already competitive supermarket shelves. While difficult, this often provides an opportunity for innovative companies to gain shelf space and market share.”

Menzies said that in recent times, product development has not been a major priority among F&B companies in Canada — but the sector is changing. “While companies have been in survival mode, many of them have been somewhat reactive, and have not necessarily had that big picture approach. And product development is one of those areas where you need to be looking at the big picture, and spending and investing. When you are going through some tough economic times, it is hard to do that. Canadian companies are now getting back into investing money and resources in product development, process improvements, new machinery, etc.”

Much lower on the sector’s global priority list is M&A activity (17 per cent), though it is increasing in many countries. Last year, although the number of announced F&B transactions remained significantly below 2007 levels, it was higher than in the previous two years.

“There are businesses that are struggling and banks are not supporting them, but if you are looking at M&A activity, especially at the larger end, there is money available. And the outlook, in terms of consolidation, is probably strong, which is partly driven by the need to consolidate due to cost issues.”

Trefor Griffith
Head of food and beverage, Grant Thornton UK

The number of global food and beverage transactions rose 13 per cent from 255 in 2009 to 289 in 2010. The value of deals also rose sharply, from approximately \$22bn in 2009 to \$38bn in 2010, up almost 42 per cent.¹²

The big issue is availability of capital to drive deals, said Griffith. “There are businesses that are struggling and banks are not supporting them, but if you are looking at M&A activity, especially at the larger end, there is money available. And the outlook, in terms of consolidation, is probably strong, which is partly driven by the need to consolidate due to cost issues.” Large and medium-sized corporations see the current market as an opportunity to grow via acquisition — easier than growing organically — and diversify their product range and customer base. Overseas buyers, especially those from the developing world, see acquisition as a way to enter the UK market and as a way to take the UK’s higher F&B standards out to their markets.

“There is going to have to be some industry consolidation here in Ireland and possibly between Ireland and the UK in order to be competitive and to develop scale,” said Jackson. “That is definitely a challenge for a lot of our clients, particularly small- and medium-sized enterprises.”

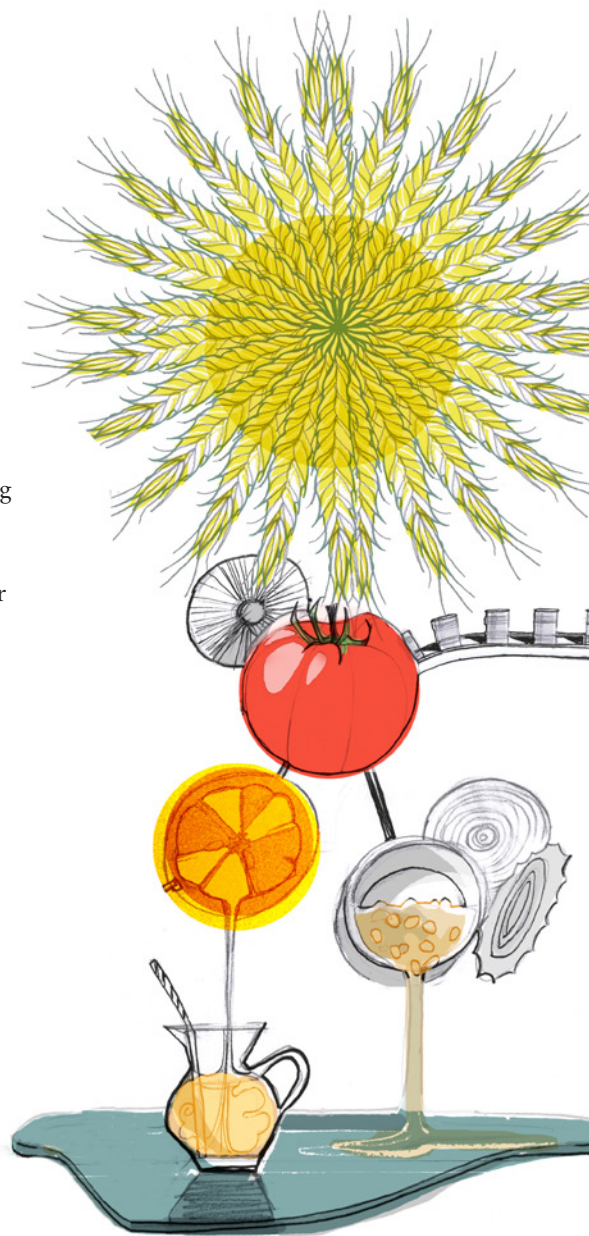
“Right now in Australia we are seeing a lot of overseas corporations that are endeavouring to buy up assets in F&B, whether that is land holdings or whether that’s commodities such as grain or wheat,” said Grant Thornton’s Pititto. “It is happening in the beef, beer, and sugar industries, to name a few. There is going to be greater M&A activity from overseas corporations buying into the Australian market.”

Frambourt said that large F&B companies in France are still structured around brands. As it gets more difficult to create or develop brands, they are looking to M&A as a means to expand their portfolios.

M&A activity will increase in Canada, according to Menzies of Canada — not just in the F&B sector, but across all industries. The need for M&A consulting and due diligence

is increasing, along with demand for services to assist with cross-border tax issues, setting up tax structures in other countries, and transfer pricing issues. “All of those areas will increase over the next few years as mergers and acquisitions continue on the uptick.”

“In Canada, many companies do have cash and access to financing,” said Menzies. “I think that’s one of the reasons that the M&A market is a little healthier here than one would expect. I also believe that there is a belief that, since some companies really struggled through the economic recession, current valuations might be lower than what they would normally be. Many believe there are bargains out there as a result of that.”



¹²“Food & Beverage Industry Snapshot,” Grant Thornton Corporate Finance, Winter 2011 edition.

Obtaining finance still poses challenges

One-third of businesses in the F&B sector expect finance to become more accessible, the same as in 2010, and only 18 per cent of F&B businesses expect finance to become less accessible in the year ahead, an improvement over 2010 findings. Nonetheless, obtaining finance in many countries still poses challenges for F&B businesses; 24 per cent rated a shortage of long term finance as a meaningful constraint (rated either 4 or 5 on a scale of 1 to 5, where 1 is “not a constraint” and 5 is a “major constraint”).

“Finance is a challenge here at the moment, given our banking collapse and economic crisis,” said Jackson in Ireland, “and there is a lot of nervousness about approaching the banks because people are fearing a negative response.”

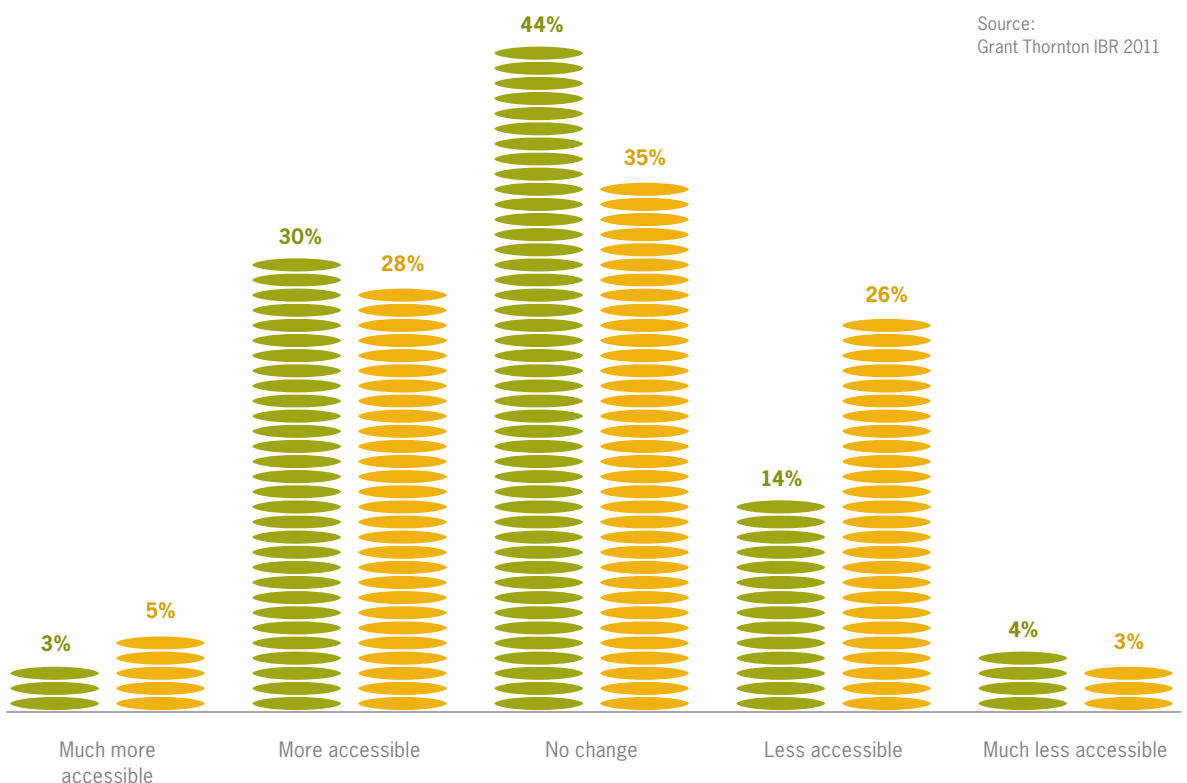
In Australia, Grant Thornton conducted a study that indicated F&B companies are planning to invest in capacity, such as expanding manufacturing lines. “But surprisingly, over 80 per cent of those companies

expanding facilities or building new plants said they would be financing internally or with existing debt lines,” said Pititto, “perhaps expressing lack of confidence in the availability of capital at reasonable terms and the fact that companies have been in savings mode since the global financial crisis.”

Patodia in India said midmarket F&B companies tend to focus on private equity to raise capital for expansion, given the size and nature of their businesses. “There is a need for finance for a lot of companies because of the way the industry wants to expand in India over the next three to five years. So, altogether, companies are looking at raising finances, and I don’t think they are shying away from debt as such. Obviously, they would like to minimise the interest costs and, therefore, look at how they can get the best deal domestically or in international markets. The key issue when raising debt or equity is the current scale of the local F&B companies — most of them are regional or category specific, and this typically proves to be a hindrance in scaling up.”

Figure 9: Accessibility of finance

Percentage of businesses expecting finance to be more or less accessible in the coming 12 months



Companies dealing with constraints of regulations

More than access to capital, F&B companies cite regulation and red tape as their most pressing constraint; 34 per cent rated it either 4 or 5 on a scale of 1 to 5, where 1 is “not a constraint” and 5 is a “major constraint.” That alone signified a positive change in the industry; a year ago, the highest-rated constraint was a shortage of orders (39 per cent, down this year to a second-place 27 per cent).

In the United States, the Food Safety Modernisation Act (FSMA) became law in January 2011. It shifts the regulatory focus on the US food supply from contamination *response* to contamination *prevention*. F&B manufacturer reaction to FSMA has been varied; according to a survey of US companies by Grant Thornton US and *Food Processing* magazine, 51 per cent of companies reported that FSMA would affect them positively, while 20 per cent said it would have a negative effect.¹³

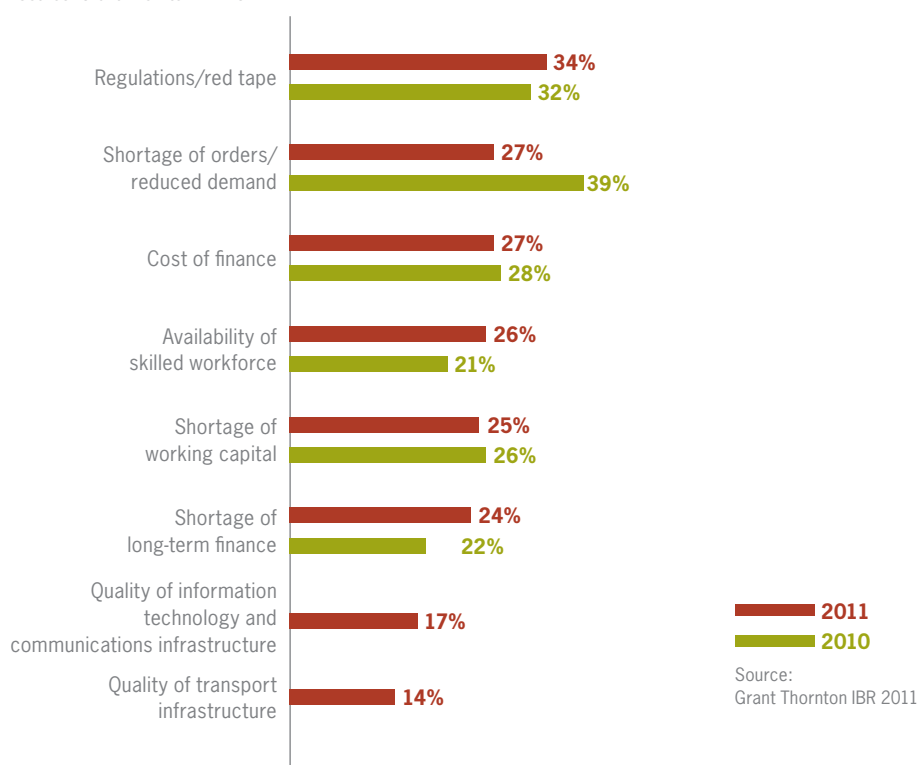
Regulations can be a major obstacle in India, particularly the restriction on foreign direct investment in multi-brand retailing, which has prohibited large supermarket chains like Walmart or Tesco from entering India, said Patodia. A change in this restriction could represent a seismic shift in India’s organised retail sector, which currently accounts for only 4 per cent of market share.¹⁴

In France, the most recent regulatory change impacting the F&B segment is a new tax on soft drinks (sodas).

Figure 10: Constraints on expansion

Average percentage of businesses rating constraint 4 or 5 on a scale of 1 to 5 where 1 is not a constraint and 5 is a major constraint

Source: Grant Thornton IBR 2011



The tax will take effect in 2012, and caught many in the industry by surprise, said Frambourt. “We already know that our government is very imaginative, having created a tax on tobacco and things like that. Of course, they did tax alcohol. But now I do not know where they will stop.” The Irish government is also considering introducing a “fizzy drinks tax” to help fight obesity, said Jackson. Speculation is rife that Ireland will follow Denmark’s lead and introduce a “fat tax,” under which products with a high level of saturated

fats are subject to additional taxes.

“I think I am right in saying the UK food industry is probably affected more by EU regulations than UK regulations,” said Griffith. There is a strong feeling within the UK industry that the UK tends to adhere more strictly to regulations than other countries, added Griffith. Small companies find the regulatory environment — including labelling — particularly difficult.

¹³ Fast Facts on Food Processing, Grant Thornton US, September 2011.

¹⁴ K.T. Chacko, “No Need to Fear FDI in Retail,” Hindu Business Line, Aug. 23, 2011.

Call to action

“Managing Through Uncertainty,” the Grant Thornton International Business Report 2011 food and beverage sector focus, highlights emerging trends and their impact on food and beverage companies worldwide. How will *your* organisation respond to these new challenges and opportunities?



- **Productivity improvement and operating-cost reductions:** Rising commodity costs — coupled with customer resistance to price increases — make productivity improvements and cost control vital to success. Does your company have the internal resources and insight to evaluate processes in search of efficiency improvements? Have you comprehensively reviewed your cost structure and cost-drivers for savings opportunities?
- **Mergers, acquisitions and divestitures:** Food and beverage companies are once again looking to grow through acquisition. Coming out of the economic downturn, F&B companies have seen a number of attractive acquisition opportunities, creating a sharp upswing in M&A activity. Are you able to identify target acquisitions that will fit well with your company? Does your company have the internal expertise to identify M&A opportunities, and then to conduct effective due diligence? Can you find financing to support acquisitions?
- **Regulatory compliance:** F&B companies face an increasingly complex set of regulations around the world, along with emerging sustainability standards. Is your entire firm aware of the regulations it will face tomorrow — and next year? Does your company have the ability to monitor, measure, and document compliance?
- **Innovation and quality:** Consumers want innovation, improved quality, and lower prices — a trio of demands that small, midmarket, and even larger F&B companies often find difficult to address. Can your company develop supplier relationships to leverage the power of partners for new product development expertise? Can you leverage these supplier relationships to enhance your technological and operational performance?
- **Country-specific changes:** The global trends cited in this report affect individual companies and individual countries in unique ways, challenging F&B executives to stay abreast of trends that impact their bottom lines. Is your company ready to identify and respond to trends *on its own*?

Any company can benefit from a fresh set of eyes to help address challenges and manage *all* of their new opportunities efficiently and effectively. As one of the world’s leading organisation of independently owned and managed accounting and consulting firms — with more than 2,500 partners in over 100 countries providing assurance, tax and advisory services — Grant Thornton is ready to help.

About the Grant Thornton International Business Report





The IBR is a quarterly survey of the views of senior executives in privately held businesses (PHBs) all over the world. Launched in 1992 in nine European countries, the report now surveys over 11,000 PHBs per year in 39 economies providing insights on the economic and commercial issues affecting a sector often described as the “engine” of the world’s economy. In the food and beverage sector, 513 businesses were interviewed between November 2010 and May 2011, 48 per cent from manufacture of food products; 16 per cent from manufacture of beverages; 16 per cent from retail sales of food, beverage and tobacco in specialised stores; 12 per cent from food and beverage service activities and 8 per cent from other food and beverage.

To find out more about IBR and to obtain copies of reports and summaries please visit: www.internationalbusinessreport.com. The site also allows users to complete the survey and benchmark their results against all other respondents by territory, industry sector, and size of business.

Global contacts

Global leader and Canada

Jim Menzies
T +1 416 360-5008
E jim.menzies@ca.gt.com

Jean-Pierre Haché
T +1 514 390-4267
E hache.jean-pierre@rcgt.com

Australia

Tony Pititto
T +61 (3) 8663 6000
E tony.pititto@au.gt.com

Brazil

Fabio Silva
T +55 (11) 3886-8976
E fabiosilva@br.gt.com

France

Vincent Frambourt
T +33 6 16 58 19 61
E vincent.frambourt@fr.gt.com

Germany

Kai Bartels
T +49 (40) 4321 862 8613
E kai.bartels@wkgt.com

India

Piyush Patodia
T +91 (11) 4278 7070
E piyush.patodia@in.gt.com

Ireland

Patrick Burke
T +353 (0) 1 6805 650
E patrick.burke@ie.gt.com

Ciara Jackson
T +353 (1) 6805 640
E ciara.jackson@ie.gt.com

South Africa

Ian Scott
T +27 (0) 21 417 8792
E ian.scott@za.gt.com

United Kingdom

Trefor Griffith
T +44 (0) 207 728 2537
E trefor.a.griffith@uk.gt.com

United States

Dexter Manning
T +1 404 475-0061
E dexter.manning@us.gt.com

Vietnam

Bill Hutchison
T +84 (8) 3910 9102
E bill.hutchison@vn.gt.com



www.gti.org

© 2011 Grant Thornton International Ltd. All rights reserved.
Grant Thornton International Ltd (Grant Thornton International)
and the member firms are not a worldwide partnership.
Services are delivered independently by the member firms.