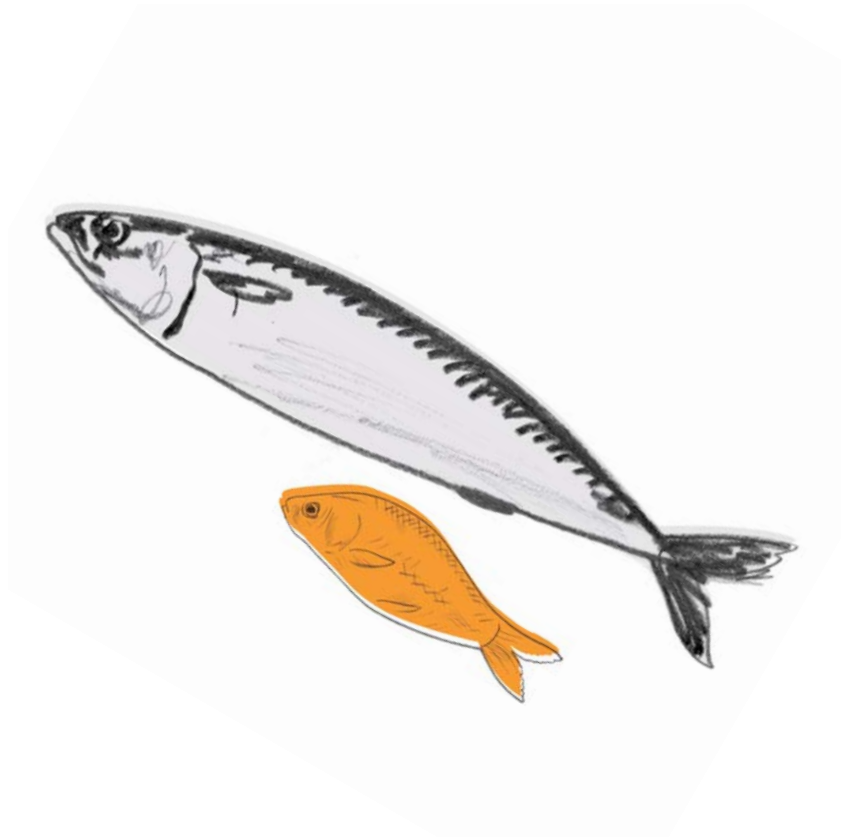


# Eat or be eaten: is consolidation the future?

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Food Consolidation Index 2008



In association with

<b>Contents</b>		<b>Page</b>
1	Consolidation set to continue	03
2	Pressures driving consolidation	04
3	How did we do last time and what does it mean for the 2008 index?	08
4	The Food Sector Consolidation Index 2008	09
4.1	Bakery	10
4.2	Confectionery	11
4.3	Dairy	12
4.4	Delicatessen	14
4.5	Dry grocery	15
4.6	Frozen food	17
4.7	Fruit and vegetables	18
4.8	Meat, fish and poultry	19
4.9	Soft drinks	20
	Appendix I	21
	Appendix II	21
	Appendix III	22
	Acknowledgements	23
	Contacts	23

# 1 Consolidation set to continue

**In 2006 we published our first Food Consolidation Index. Its purpose was to stimulate discussion and strategic thinking, which might help our clients and others in the food industry to position their businesses in order to take advantage of the market trend towards consolidation.**

In an industry where four retailers control nearly 80% of UK sales and the basic market size as measured in calories is essentially static, consolidation has been inevitable – especially taking into account the ever-changing pattern of consumer demand. As a direct result, the dilemma of food manufacturers has been how to survive and grow in an environment where the customer is continually demanding price reductions. The common strategies employed have been innovation through new product development and acquisition.

Since our first report there has certainly been an increase in the level of consolidation: around 450 company failures and over 260 acquisitions. This compares with around 150 receiverships and over 200 deals in the previous two years. However, 2007 heralded a new and uncertain era with the sudden and dramatic rise in raw material prices and the fallout from the sub-prime crisis. And it is hard to see this trend abating.

Two years ago our four-level approach tried to identify those sectors where we expected consolidation to be most marked. For example, we anticipated that snacks would be one of six sectors “with a very high level of consolidation” – and so it turned out. Hardly had the report been issued when Golden Wonder was bought out of insolvency by Tayto (NI): the two-year period ended with Just Crisps being acquired, also by Tayto (NI). In total, 66% of the company failures that we have recorded over the last two years occurred in these six “high consolidation” categories, which together represent 35% of all grocery sales.

In this latest report we have once again tried to identify those sectors where there is the probability of a greater level of consolidation activity.

Yet perhaps there is a ‘wild card’ which may produce some real surprises. Already we have seen a large number of food companies report a drop in 2007 profits. This is because of the inevitable time lag between the impact of raw material increases and getting retailers to accept such increases. And as inflationary pressures persist, the continued stretching of balance sheets during uncertain credit conditions may well be the driving force for restructuring and consolidation across many sectors.

How companies position themselves will continue to be a determining factor as to whether they can cope with the new realities, but it seems certain that consolidation will gain pace.



# 2 Pressures driving consolidation

**In the next two to three years, we anticipate an unprecedented level of consolidation in the UK food and drinks industry. By consolidation, we mean the process by which the number of companies operating in a segment is reduced. This process may occur via mergers, acquisitions, or company failures.**

This unprecedented level of consolidation activity is being driven mainly by the convergence of five particular trends:

- 1 Raw material cost increases
- 2 Retailer pressures
- 3 Cross-border expansion
- 4 Tighter availability of finance
- 5 Portfolio adjustments

Inevitably, these forces will impact on some segments more than others. In particular, we believe the following four sectors (shown in order of size) will feel the impact particularly heavily:

- 1 Meat, fish and poultry
- 2 Fruit and vegetables
- 3 Bread and morning goods
- 4 Specialist soft drinks

## **Raw material cost increases**

For much of the past decade, low and relatively stable commodity prices have helped create an environment in which food prices have been remarkably stable. This changed dramatically in 2007.

According to the Office for National Statistics (ONS), in the 12 months to December 2007 food prices rose by 5.5% and now food inflation is a major contributor to overall inflation.

Within food overall, certain sectors, which are perhaps characterised by being closer to basic foodstuffs, have seen even higher levels of inflation: ONS statistics show that the prices of butter and eggs rose by 30% and bread and milk by about 15% in 2007.

Importantly, these are all sectors where own label is a dominant force. Already, many food processors – despite achieving some increases – have faced delays in passing on the full impact of the successive price increases that they are having to pay to their suppliers. For some companies this may be little more than a short-term difficulty; for others the reduced profitability is more problematic and even terminal.

The evidence from the UN Food and Agriculture Organization (FAO), Department for Environment, Food and Rural Affairs (DEFRA) and the National Farmers Union (NFU) is that we may well be facing a paradigm shift. This move away from an era of cheap food is driven by the twin pressures of bio fuels and the phenomenal economic growth of China and India, with 2.5 billion people being increasingly able

to emulate the dietary patterns of richer nations.

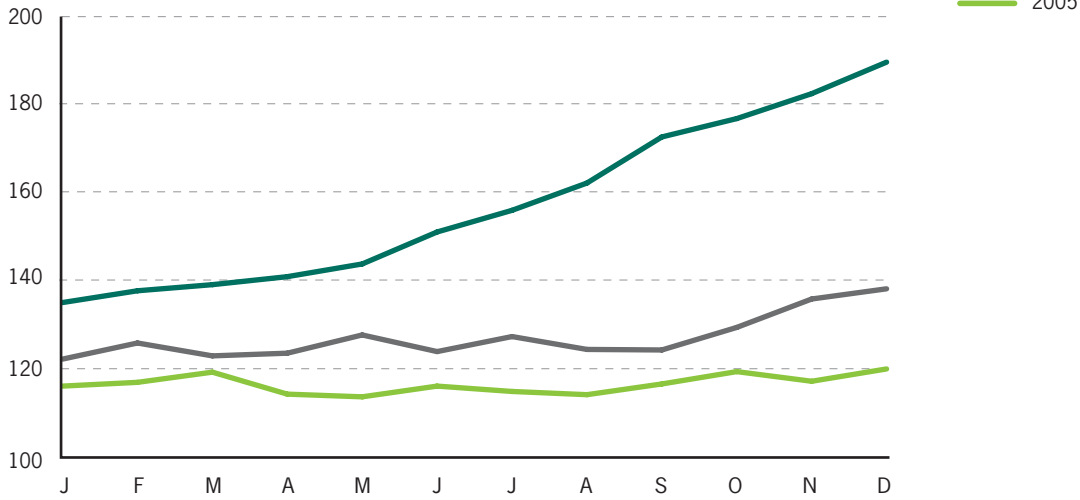
The EU has already abandoned set aside, and with crude oil at over \$130 per barrel US farmers are not going to quickly abandon growing corn for ethanol. In 2007 it is estimated that 30% of the US grain crop went into ethanol and as the acreage farmed was virtually static this meant, in effect, reduced production of grain for human consumption and a consequent reduction in buffer stocks.

This is no longer a national problem but quickly becomes a global one as wheat supplies reduce and the price of flour virtually doubles, and other commodities follow suit. We are already seeing some countries place restrictions on the export of basic foodstuffs in order to prioritise the demand from their domestic markets.

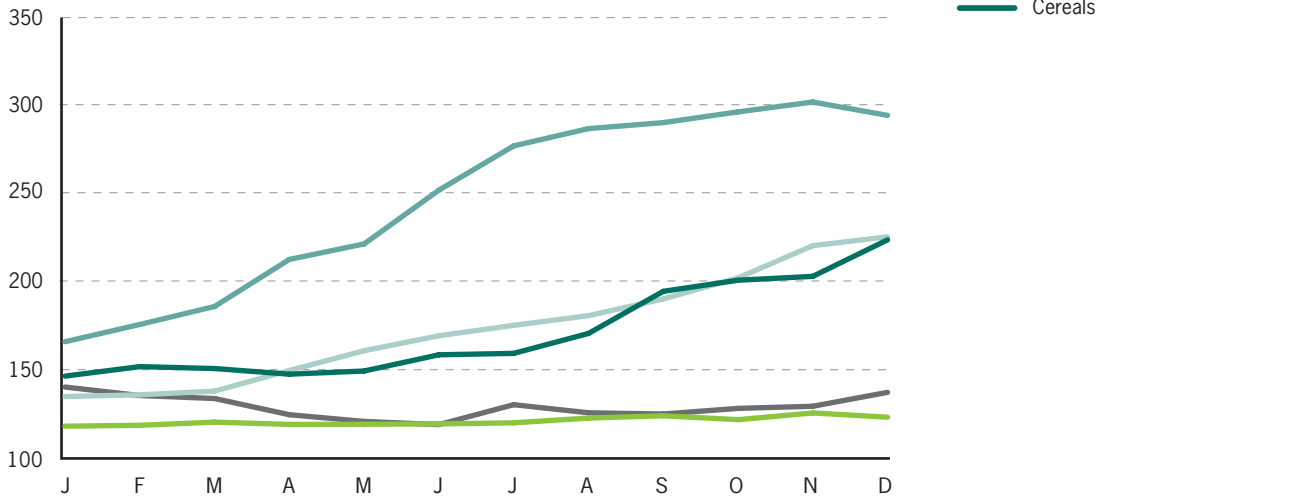
A further dimension to the global picture of food supply is climate change. Australia, once a major exporter of meat, grain and dairy products to the UK, provides an example of this with their sustained drought. As the Hunter River system becomes drier there are fears that wine production could be significantly affected, and some growers of sub-tropical foodstuffs are moving from southern Queensland, where there is also a growing water shortage, to further north.

It is hard to see how these major global changes, which are increasingly attracting the attention of national governments, will not affect the UK food industry and, as a result, contribute to its restructuring.

**Rising food prices 2005–2007**  
1998–2000 = 100\*



**2007 price rises by food types**  
1998–2000 = 100\*



Source: UN Food and Agriculture Organisation (FAO)  
\* Changes in food prices are indexed against the average for 1998–2000

### Retailer pressures

The need for operational simplicity and reduced complexity has served to provide a remorseless pressure on retailers to reduce their number of suppliers.

For companies, some of which rely on one retailer for well over 50% of their business, this is close to a business version of Russian roulette. For the

winner in a ‘shoot-out’ it probably means more sales and volume but lower % margins, while for the loser it can all too often mean oblivion. However, as the Office of Fair Trading (OFT) has recently concluded, while this may not be in the interests of the unsuccessful company and their staff, it does help to keep prices down and is, therefore, in the public’s best interest.

Given the raw material pricing pressures, it may well be that major retailers will emulate the actions of M&S several years ago and actively encourage supplier rationalisation. Certainly, at least in their public statements, retailers such as Asda have adopted a very forceful stance:

“I don’t think it is acceptable to say that if you demonstrate [as a supplier] costs have gone up, we will accept increases. I think our vendors have to do their own restructuring so they are not passing on cost price increases. It is no way acceptable to put prices up, particularly in 2008. Value will be a key issue. It is going to be a difficult year for consumers.”

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**Andy Bond**  
Asda CEO

“I don’t think it is acceptable to say that if you demonstrate [as a supplier] costs have gone up, we will accept increases. I think our vendors have to do their own restructuring so they are not passing on cost price increases. It is no way acceptable to put prices up, particularly in 2008. Value will be a key issue. It is going to be a difficult year for consumers.” Andy Bond, Asda CEO.

Alternatively, companies may take the initiative. Following the stunning rise in wheat prices analysts have questioned whether Associated British Foods (ABF) will stay in the bread market. As for the other major miller RHM, now part of Premier Foods, their new parent’s recent share price trends reflect concerns among some analysts about the structure of their balance sheet.

With many raw material prices continuing to rise in 2008, it seems inevitable that UK food suppliers will continue to feel pressure and this could well drive further consolidation.

### **Cross-border expansion**

A feature in the sale of UK food companies in recent years has been the ever increasing foreign buyer. In some cases the attraction has been the brands – such as Vijay Mallya’s UB Group purchasing Whyte & Mackay; Bakkavor’s takeover of Geest; Singapore Food Industries ownership of Covent Garden Soup; and Heinz’s sale of HP Foods to Danone and Linda McCartney to Hain Celestial.

But the driving feature for many acquirers has been gaining access to new markets, thereby spreading customer concentration and creating opportunities for cross-selling and, thus, potentially further consolidation.

Some major food companies have announced recently their intentions to expand into new markets, such as Bakkavor and Greencore’s move into the USA and IAWS’s merger with Hiestand to create the 2.3 billion euro revenue group ARYZTA.

### **Tighter availability of finance**

In 2007, Inter Link – the cake sector’s major consolidator – came unstuck and was sold out of receivership. At the same time a new consolidator, Finsbury Food, gained momentum.

Both companies also highlight the role AIM-listed companies increasingly play in the food industry. Built through acquisition, they are perhaps reminiscent of Hazlewoods, Hillsdown and Perkins in past years. For shareholders who get into such companies at the early stages they can prove highly lucrative investments. But the availability of credit has, in the past, been a key factor in maintaining the acquisition momentum. One cannot help but wonder what impact the current credit environment could have on them and on their ability to continue to drive consolidation.

Both local and global factors seem overall to point to a further increase in

the rate of consolidation in the coming years. Potentially stretched balance sheets, reduced credit availability, rapidly rising raw material prices, and the trade’s desire to reduce price increases all point to an environment that may, for the weak, mean forced sales and, for the strong, unusual buying opportunities.

### **Portfolio adjustments**

Government statistics point to an apparent paradox: an increasing number of us are obese yet we are, on average, eating fewer calories than 50 years ago. The demise of many of the heavy industries coupled with a more sedentary lifestyle mean that we need to reduce our average food intake faster than we actually have done.

The food industry ultimately provides the energy intake we all need to function. As the UK population is growing only marginally, we are at best in a static industry when expressed as calories consumed. Certainly experience suggests that for every growth sector there is just as likely to be a contracting sector (eg white meat has grown while red meat has declined).

However, food is about much more than just calories. It is also about self expression and pleasure. The success of companies in aligning themselves to the ever-changing dynamics of society, the changing age profile, social patterns and experiences, will also be a key factor in defining whether a company is growing or contracting.

Understanding these dynamics is not easy. All too often, a perceived mega-trend such as the 'High Protein Atkins Diet' turns out to be little more than a passing fad. Yet even without becoming a vegetarian or an earth-baby, a lot more of us are eating more vegetarian ("I like pasta") and organic ("it tastes better") foods.

Against this complexity it is inevitable that all major food companies are constantly rearranging their product portfolios. At a global level, for example, many analysts have noted that relative to its major competitors, Unilever and Kraft, Nestlé has generally achieved a higher level of internal growth partly by successfully focusing on growth sectors and growth countries.

Nelson Pelz, an active American investor, has criticised Heinz, Kraft and most recently, Cadbury, in part for their poor growth record and their perceived failure to focus on the right sectors. So easy in retrospect, but so challenging looking forward.

Portfolio adjustment is undoubtedly one of the key drivers of consolidation. Larger companies often seek to adjust their business portfolio and extend their presence to new markets and add growth segments and products. This has certainly driven an increased level of cross-border food industry mergers at a European level as companies seek to strengthen their position in particular sectors. We expect to see this trend strengthen in the coming years.

It is often said that innovation is harder in large companies. Consequently, as Pepsi showed in the snack market, it is often easier in the food sector to find good propositions in small companies, acquire them, and then drive them first nationally and then even globally. This certainly has been a feature of recent years and it is hard to see this trend abating.

#### **How will these factors impact consolidation?**

Our view, as explained in more detail in the next section, is that consolidation will be most marked in those sectors where:

- Retailer own label dominates and several companies supply the same retailer with similar products. It is hard to see why retailers will not force rationalisation so as to reduce their input costs. We see this impacting in particular on the fresh fruit and vegetables sector and fresh meat
- Global raw material markets have seen substantial and sustained price increases and, consequently, suppliers struggle either to obtain supply or to pass on the appropriate price increase. This scenario has a particular resonance in bread and morning goods, and ambient cakes

- Health considerations either create downward pressure on volume (eg crisps over the last two years) or create rapidly growing niche companies, which offer a convenient nutritious product with perceived growth potential. This could well impact on other soft drinks and some segments within the snacking market

That said, major surprises as a result of the credit environment – and potential strategic moves by governments regarding raw material supply – seem unavoidable and could impact all sectors.

For managers, aligning their company's portfolio to meet ever-changing consumer needs is never easy. To do this in the coming two years, in a market context which faces the prospect of major potential disruptions, will be even harder and thus acceleration in the rate of consolidation seems the most likely outcome.

# 3 How did we do last time and what does it mean for the 2008 index?

**With at least 450 failures and over 260 mergers in the past three years, the UK food sector has, as we predicted, continued to consolidate.**

What is of particular note is that whereas the annual rate of mergers was broadly stable, the rate of failures trebled between 2005 and 2007. This suggests that as we moved from the benign economic conditions and the relaxed credit environment of the mid-decade, so companies felt the pressure. Looking ahead, we would expect this pressure to have a continued impact in the coming years as banks and their customers respond to the sub-prime debacle.

Within sectors, it is interesting to look at those sectors where we forecasted either a very high or a very low level of activity.

Of these predictions it seems with 20:20 hindsight we got it broadly right, with two possible exceptions.

On prepared salads we had expected a very high level of mergers or failures. This didn't happen but the acquisition by Bakkavor of Hitchin Foods in 2005 for £44m was highly significant and, together with their acquisition of Exotic Farm Products in 2007, gave Bakkavor effectively clear domination of this sector.

Hot drinks turned out to be much more exciting than we predicted, with Apeejay Surrendra buying Typhoo Tea from Premier, and a high level of failures and several small mergers. In a sector undergoing significant innovation in terms of retail offerings, we probably underestimated the knock-on effect on the attitudes of consumers, manufacturers and retailers.

On eggs, our thanks go to the OFT for maintaining our prediction!

Looking forward, those sectors where we predict a very high level of consolidation are somewhat different from our last report. We still expect a lot of activity in Fruit and vegetables as well

as in Meat, fish and poultry. However, in other sectors where last time we predicted a very high level of consolidation, we have concluded that the job is partly done and there will be a 'pause for breath', so we have dropped their ranking.

At the other end of the scale, last time we saw 10 sectors with a low level of consolidation activity and 8 of them remain in the same category. The fact that breakfast cereals have rocketed to an anticipated high level of activity, and hot beverages have also moved up, highlights the fact that as markets change and evolve, so the likelihood of their structure changing also increases.

## Review of 2005 predictions

Very high level of consolidation activity		Low level of consolidation activity	
Fruit and vegetables	✓	Chilled pot desserts	✓
Meat, fish and poultry	✓	Hot beverages	?
Snacks and crisps	✓	Canned produce	✓
Frozen savoury	✓	Cereals	✓
Prepared salads	?	Canned pies, meats and soups	✓
Frozen desserts	✓	Butter and spreads	✓
		Eggs	✓
		Sugar and sweeteners	✓
		Preserves	✓
		Squashes	✓

# 4 The Food Sector Consolidation Index 2008

Category	Value £	Yr on Yr % change	Index	
Meat, fish and poultry	9.3bn	5.2	Very high	
Fruit and vegetables	7.9bn	6.6		
Bread and morning goods (including in-store bakery)	2.8bn	9.1		
Other soft drinks	200m		High	
Chocolate confectionery	3.0bn	6.8		
Milk	2.9bn	10.1		
Cheese	2.1bn	3.0		
Snacks and crisps	1.9bn	4.6		
Cereals	1.7bn	5.4		
Biscuits and crackers	1.7bn	3.2		
Chilled ready meals	1.7bn	1.6		
Ambient cakes	1.0bn	5.7		
Sandwiches	931m	7.2		
Frozen vegetables (including chips/potato products)	844m	6.0		
Water	609m	-5.8		Moderate
Chilled pies, quiches and pasties	5.2bn	4.3		
Carbonates	2.0bn	1.1		
Fruit juices/drinks	1.9bn	5.4		
Hot beverages	1.4bn	3.5		
Sugar confectionery	1.2bn	5.3		
Frozen savoury	1.1bn	-0.3		
Prepared salads	866m	4.0		
Ice cream	702m	-4.4		
Cooking sauces	547m	6.4		
Frozen desserts	270m	0.5		
Fresh cakes	148m	12.0		
Chilled pot desserts (yoghurts/fromage frais)	1.8bn	4.3	Low	
Canned pies, meats and soups	1.2bn	3.5		
Canned fruit, veg and pasta	1.0bn	3.4		
Butter and spreads	963m	6.6		
Eggs	632m	19.0		
Rice and pasta	501m	12.4		
Squashes	433m	-6.5		
Preserves	279m	6.7		
Sugar and sweeteners	264m	2.1		

Source: ACNielsen Scantrack

	Sales £m	Share	Yr on Yr Value Sales Change
Total food	62,773	100%	5.3%
Total bakery (including in-store bakery)	4,245	6.8%	7.9%
Total confectionery	6,078	9.7%	5.9%
Total dairy	8,283	13.2%	6.9%
Total delicatessen	7,842	12.5%	4.0%
Total dry grocery	9,291	14.8%	4.8%
Total frozen food	2,919	4.7%	0.5%
Total fruit and vegetables	8,788	14.0%	6.3%
Total meat, fish and poultry	9,259	14.7%	5.2%
Total soft drinks	6,068	9.7%	2.8%

This table sets out the size and trends of each category for the 12 months ended 31 December 2007.

# 4.1 Bakery

## Sector snapshot

Bakery	£4,245m	+7.9%
Bread and morning goods		Very high
Ambient cakes		High
Fresh cakes		Moderate

A sector with an exceptionally high level of both failures and mergers. Overall it represents 7% of retail food sales but accounted for 17% of failures and 13% of mergers.

With wheat reaching ever-higher prices it is hard to see this action diminishing. Rumours about ABF reviewing its strategy in this sector are rife, and clearly the City has concerns whether Premier's recent acquisition of RHM was 'a deal too far' in the current market context.

How this will all pan out is hard to predict but a continued high level of consolidation activity in this sector seems inevitable.

## Bread and morning goods

Consolidation rating: very high

Rationale:

- The sector has seen major structural change, most notably with the acquisition of RHM by Premier, the successful expansion of Warburtons, and consolidation activity by the likes of Canada Bread Company
- There was also a significant number of failures among smaller players in the sector
- Massive increases in wheat prices have brought heavy cost pressures to the sector. These pressures have been felt especially heavily in the large plant bakeries
- We anticipate a continuation of the trend of a significant number of failures among smaller players in the sector

## Ambient cakes

Consolidation rating: high

Rationale:

- The sector continues to experience flat/declining volumes and this situation looks likely to get worse in the face of healthy eating pressures
- In addition, cost increases driven principally by the price of wheat will continue to put margins under pressure
- In 2007, the previous main consolidator in the sector, Inter Link, failed and was taken over by McCambridge, while Finsbury Food emerged as the new consolidator
- In these circumstances, we would envisage a significant number of company failures and, perhaps, a number of mergers

## Fresh cakes

Consolidation rating: moderate

Rationale:

- This sector has proved more dynamic than we anticipated and has shown significant volume growth
- Some quite significant deal making occurred with, for example, the acquisition by Bakkavor of Laurens Patisserie and Rye Valley Patisserie. Risk Capital Partners, the owners of Patisserie Valerie, acquired Druckers
- It is difficult to envisage a lot of further deals in the next couple of years
- If sector growth continues to be positive, some smaller players may become attractive to potential acquirers



## 4.2 Confectionery

Sector snapshot		
<b>Confectionery</b>	<b>£6,078m</b>	<b>+5.9%</b>
Snacks and crisps		High
Sugar confectionery		Moderate
Chocolate confectionery		High

Overall, this is an area which perhaps will find life tough in an era where health is becoming ever more important. However, countering this will be the continued growth of snacking and eating on the hoof.

Niche players with a perceived health story have attracted the interest of several companies and this, together with rationalisation of the sugar confectionery sector by Tangerine, has led to a high level of deals in the past years.

The health story will almost certainly continue to resonate, though following the Monkhill deal at the start of 2008 we expect consolidation in sugar confectionery to slow down.

The big news in April 2008 was the planned merger of Mars and Wrigley. This, together with the demerger of Snapple and the emergence of Cadbury as a chocolate confectionery company, will almost certainly precipitate the much-vaunted next round of global confectionery consolidation as Nestlé and Kraft seek to respond to the emergence of a new global giant.

### Snacks and crisps

Consolidation rating: high

Rationale:

- A lot of rationalisation has taken place in this sector in recent years, driven notably by Tayto (NI) who have acquired Golden Wonder, Real Crisps and, most recently, Redmill. In addition, United Biscuits acquired a number of Golden Wonder's brands
- Both Glisten and Zetar have been active in this sector, buying companies such as Dormen Foods and Salamanda
- Deals around healthier/premium snacks are likely to continue to take place
- The big unknown in the sector is whether the new owners of UB will seek to increase their focus on biscuits by offloading their snacks business

### Sugar confectionery

Consolidation rating: moderate

Rationale:

- Tangerine has clearly made its mark as a consolidator in this sector, with a number of deals in the period under review and the acquisition of Monkhill from Cadburys at the beginning of 2008
- The pace of further consolidation in the sector seems likely to be slower in the next couple of years

### Chocolate confectionery

Consolidation rating: high

Rationale:

- A significant number of both acquisitions and company failures occurred in the period under review
- The most notable acquisition during the period under review was the purchase by Cadbury of Green & Black's
- Further consolidation activity at the smaller end of the sector seems likely

Following the Mars/Wrigley merger a major deal involving Cadbury seems a distinct possibility.



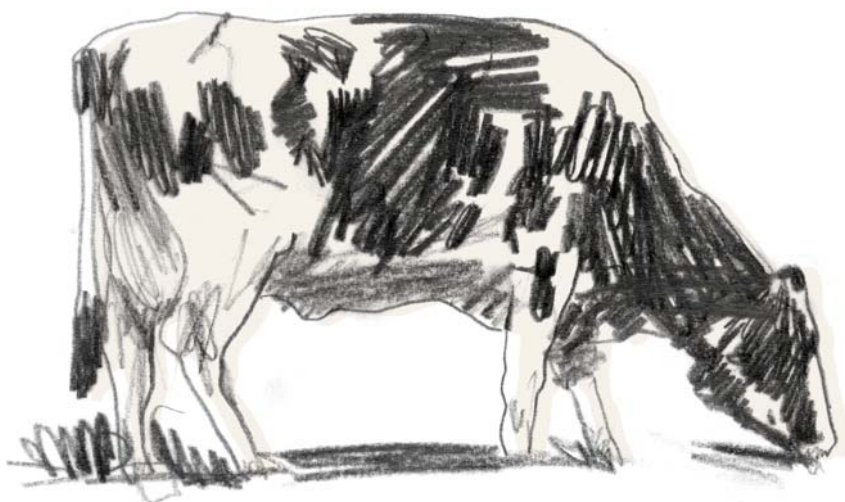
## 4.3 Dairy

Sector snapshot		
<b>Dairy</b>	<b>£8,283m</b>	<b>+6.9%</b>
Milk		High
Cheese		High
Chilled pot desserts		Low
Butter and spreads		Low
Eggs		Low

No other sector has attracted the attention of the OFT as consistently or as profoundly as the Dairy sector. In the last five years, of the 60 referrals of food deals to the OFT, 18 have been in the Dairy sector and of three actually referred to the Competition Commission, two have been in this sector. Thus, consolidation in Scotland (Wiseman's acquisition of Scottish Milk Dairies) and in the egg sector (the merger of Deans and Stonegate) was overruled by the Competition Commission. Attempts to improve the returns to farmers by a co-ordinated effort to raise prices led to major fines.

Only the merger of Milk Link and First Milk failed for commercial reasons and nothing to do with the OFT.

Yet, as shown in a recent study by a group of Oxford academics, the reality remains that returns to farmers are inadequate and the case for further consolidation is strong. The imponderable, which will certainly impact on any commercial decision, is whether the OFT will permit it and, therefore, we have concluded that this significant element of uncertainty and potential cost will reduce the likelihood of consolidation in the coming years.



### **Milk**

Consolidation rating: high

Rationale:

- Significant retailer-driven consolidation has already occurred in this sector, but pressures for consolidation remain
- The recently aborted merger of Milk Link and First Milk is indicative of both the appetite for such consolidation and the difficulty in achieving it
- At a smaller level, there has continued to be a rationalisation of the home delivery milk sector, with Dairy Crest making acquisitions such as Arla's Express Dairies depots
- However, the ability to undertake significant merger and acquisition activity appears to be constrained by the likelihood of intervention by the competition authorities

### **Cheese**

Consolidation rating: high

Rationale:

- In 2006, First Milk acquired Dairy Crest's retailer-brand cheese operation
- The last year has seen major cost pressures on UK cheese producers due to massive milk price increases. These were mostly passed on to customers
- If further such increases occur and are not able to be passed on to customers, then major pressures will come to bear on UK producers
- In those circumstances, we would anticipate company failures, especially among the smaller, more marginal players
- Increasingly this seems to be an industry which is consolidating at a pan-European level, with both Arla and Lactalis having been active in this regard

### **Chilled pot desserts**

Consolidation rating: low

Rationale:

- There has been little in the way of mergers or company failures in this sector over the last two or three years
- The presence of big players, such as Danone, Nestlé and Muller, brings a degree of stability to the supply base
- It is possible that some smaller, innovative players could be acquired

### **Butter and spreads**

Consolidation rating: low

Rationale:

- The sector is already fairly well consolidated
- Butter is supplied to the multiple retailers by a small number of international players
- The spreads sector is dominated by two branded players and, given the level of capital investment required, there are a limited number of own label suppliers
- The scope for further consolidation appears fairly limited

### **Eggs**

Consolidation rating: low

Rationale:

- There was only one important piece of activity during the period under review – the attempted merger of Deans Foods and Stonegate to form Noble Foods
- This merger was overturned by the Competition Commission
- We envisage little further activity in the sector over the next couple of years, with the possible exception of a few regional players combining

## 4.4 Delicatessen

Sector snapshot		
<b>Delicatessen</b>	<b>£7,842m</b>	<b>+4.0%</b>
Chilled ready meals		High
Sandwiches		High
Chilled pies, quiches and pastries		Moderate

Few failures and some strategic mergers would sum up this area over the past few years. Both sandwiches and chilled ready meals have seen a steady level of mergers and this seems likely to continue, and possibly accelerate, as retailers exert their buying power to resist price rises, especially on sandwiches following bread price rises.

### Chilled ready meals

Consolidation rating: high

Rationale:

- The sector has had buoyant volumes and severe price pressures from the multiple retailers
- With the trend to convenient meals and the high retailer own label participation, this picture looks set to continue
- In the period under review, many of the acquisitions which took place were conducted by larger players to add niche products to their range
- Over the next couple of years, we envisage a high degree of consolidation, principally via acquisitions, as suppliers try to cope with retail pressure rather than company failures

### Sandwiches

Consolidation rating: high

Rationale:

- Positive value growth in the sector has been driven by innovation and premiumisation
- The significant number of company failures and deals during the period under review reflects the large number of smaller regional/local players in the sector
- Cost-reducing mergers are likely to occur in the sector over the next couple of years, along with a number of further failures among smaller regional/local players

### Chilled pies, quiches and pasties

Consolidation rating: moderate

Rationale:

- Some premiumisation has occurred in this sector, which has shown an overall downward volume trend in recent years
- One notable acquisition in the sector was that of George Adams by Tulip, the Danish meat producer
- The sector is already well structured so we would envisage limited consolidation activity in the next couple of years

# 4.5 Dry grocery

Sector snapshot		
<b>Dry grocery</b>	<b>£9,291m</b>	<b>+4.8%</b>
Cooking aids		High
Home baking		Moderate
Biscuits and crackers		High
Cooking sauces		Moderate
Rice and pasta		Low
Hot beverages		Moderate
Canned fruit, veg and pasta		Low
Cereals		High
Canned pies, meats and soups		Low
Sugar and sweeteners		Low
Preserves		Low

This was an area in which we predicted a low level of consolidation and overall, this was indeed the case. However, one area proved much more active than we expected and this was hot drinks. The sale by Premier Foods of Tetley to Tata, and significant consolidation of smaller niche players, suggests that the interest generated by retailing initiatives (Starbucks, Costa coffee etc) is having its effect on the grocery sector. This seems likely to continue and we have therefore predicted more consolidation in this sub-sector.

By contrast, the merger of RHM and Premier has really consolidated the dry grocery sector and we anticipate even less activity in this sector overall.



## Cooking aids

Consolidation rating: high

Rationale:

- In the period under review, a number of deals occurred that were MBI spin-offs and a larger number that were strategic purchases by larger players
- The strategic purchases included Heinz's acquisition of Pride oils, and Princes' acquisition of Cookeen, Spry and Mazola from Unilever
- With many attractive consolidation opportunities remaining, we envisage a significant number of further acquisitions over the next couple of years

## Home baking

Consolidation rating: moderate

Rationale:

- Acquisition activity in the sector increased during the period under review
- Premier acquired McDougalls as part of the RHM deal; Whitworths changed hands between private equity owners; Premier acquired various brands (Angel Delight, Birds Custard, Dream Topping from Kraft, Dr Oetker bought SuperCook; and General Mills bought Saxby

## Biscuits and crackers

Consolidation rating: high

Rationale:

- The ownership structure of the sector makes it fairly likely that there will be change over the next few years. Both United Biscuits and Burtons are owned by private equity and Fox's Biscuits is part of Northern Foods which has made major divestments in recent years
- The sector is subject to major wheat-driven price pressures, which will squeeze margins
- We believe that a degree of ownership change is likely, and this could include consolidation at a European or other international level

## Cooking sauces

Consolidation rating: moderate

Rationale:

- In the period under review, a number of acquisitions occurred, and no failures
- ABF bought Patak's, Premier gained Sharwood's as part of the RHM deal; Santa Maria acquired Discovery Foods; and Symington's was sold to private equity
- This is an attractive sector but the limited number of targets for any potential acquirer is likely to constrain the amount of activity

### Rice and pasta

Consolidation rating: low

Rationale:

- This category is already well structured and there has been almost no activity, either mergers or failures, over the last few years
- We see little likelihood of this changing over the next couple of years unless shortages of rice force vertical integration

### Hot beverages

Consolidation rating: moderate

Rationale:

- This sector is already fairly well consolidated, with a stable ownership structure
- The one deal of note in the period was the sale by Premier Foods of Typhoo Tea to Apeejay
- We believe there will be very little consolidation in this sector over the next couple of years

### Canned fruit, veg and pasta

Consolidation rating: low

Rationale:

- The sector is already well consolidated
- We see little prospect of further consolidation over the next couple of years

### Cereals

Consolidation rating: high

Rationale:

- The ownership structure in this sector appears relatively unstable, with Weetabix and Dailycer owned by private equity, and Jordans owned 20% by ABF
- The recent acquisition of Dorset Cereals, which has recently been bought out of private equity ownership by Wellness Foods, only serves to underscore this point
- Big Bear, the owner of Fox's Confectionery, bought Quaker's Sugar Puffs business in 2006
- We believe further ownership change, including potential consolidation, is likely over the next couple of years

### Canned pies, meats and soups

Consolidation rating: low

Rationale:

- The sector is already well consolidated
- One significant piece of recent activity was the 2006 acquisition by Premier of the Campbell's soup business (Premier also previously acquired Batchelors in 2002, prior to our last report)
- Another important development was the sale by Heinz of their European canned fish business (including brands such as John West) to a buyer backed by Lehman Brothers
- We see little prospect of significant further consolidation over the next couple of years

### Sugar and sweeteners

Consolidation rating: low

Rationale:

- This sector is already highly consolidated and there has been minimal consolidation activity, either by merger or failure, over recent years. In addition, the EU sugar reforms have impacted on the major companies in the sector
- In 2005, The Real Good Food Company acquired Napier Brown, the third-largest sugar processor
- We envisage this pattern continuing over the next couple of years

### Preserves

Consolidation rating: low

Rationale:

- The Premier takeover of RHM led to the merger of the Robertson's and Chivers Hartley businesses, and Rowse was acquired by Wellness Foods
- We see little prospect of significant further consolidation in this already well-consolidated sector over the next couple of years

## 4.6 Frozen food

Sector snapshot		
<b>Frozen food</b>	<b>£2,919m</b>	<b>+0.5%</b>
Frozen savoury		Moderate
Frozen desserts		Moderate
Ice cream		Moderate
Frozen veg		High

In our last review we predicted that there would be a high level of consolidation in the frozen food sector. In fact, the reality has exceeded our expectations.

In the last three years, all the major food manufacturers who had dominated this sector have followed the example of Nestlé and exited this sector. Unilever sold to Permira, Heinz sold to Hain Celestial, Christian Salvesen sold to Pinguin, and Oriental Express, a spin off from UB, went into liquidation. Then at the start of 2008 Foodvest combined the old UB business Youngs with the old Nestlé business Findus, though because of corporate history the UK Findus business was not part of this larger European deal.

As a result of this high level of activity it is tempting to say 'job done' and certainly the level of consolidation in the coming years will be less frenetic. However, with so much of the market held by VCs or other financial institutions, and perhaps the level of investment by Birds Eye in extolling the virtues of frozen food set to decline, one cannot but feel that the fundamental space pressures on this sector will remain and further portfolio rearrangement will emerge towards the end of this decade.

### Frozen savoury

Consolidation rating: moderate

Rationale:

- Major consolidation has already taken place in the sector, with Heinz and Unilever exiting and various operations being merged
- After a significant decline in sector volumes and values, the sector seems currently to be in a period of relative stability

- Space constraints in supermarkets and the high presence of retailer own label will continue to make this a tough sector in which to operate
- Some smaller players are likely to suffer and there are still some modest opportunities for consolidation

### Frozen desserts

Consolidation rating: moderate

Rationale:

- After a period of decline, sector volumes have flattened out and some product premiumisation has occurred
- Premier sold off the RHM frozen foods operation while Country Style has been acting as a consolidator in the sector
- Retailer own label constitutes two-thirds of sales in the sector, making this a tough sector in which to operate
- We believe there is the likelihood of a few company failures and a few mergers

### Ice cream

Consolidation rating: moderate

Rationale:

- The significant decline of the sector looks set to continue due to concerns about health/obesity and the ever-increasing diversity of foods available for children
- Future milk price increases pose the risk of further cost pressures for the sector's producers

- The sector has seen a lot of consolidation in recent years
- Richmond Foods, which had acted as a major consolidator in the sector, was bought by Oaktree Capital Management, who already owned Roncadin, a significant ice cream business in Germany
- Hill Station, already a small player in the sector, acquired Loseley and Granelli
- Smaller brands are likely to be squeezed in a sector dominated by major brands, and own label players are also likely to be under pressure
- We therefore anticipate a few company failures and the possibility of a few minor mergers

### Frozen veg

Consolidation rating: high

Rationale:

- Sector volumes are likely to remain static at best
- The market sector is around 75% supermarket own label, meaning that many suppliers will be under heavy pressure due to the threat of business being re-allocated away from them
- In 2007, Pinguin acquired Christian Salvesen's frozen foods business and Padley Vegetables
- We anticipate some further consolidation among own label suppliers, most probably through company failures
- It is also possible that there will be some further consolidation at a European level

## 4.7 Fruit and vegetables

### Sector snapshot

<b>Fruit and vegetables</b>	<b>£8,788m</b>	<b>+6.3%</b>
Fruit and vegetables		Very high
Prepared salads		Moderate

Another area high in company failures. In a sector accounting for 14% of all food sales it generated 23% of all failures and 11% of the mergers. It is hard to see these pressures abating.

Looking at it from the retailers' perspective, it is still an area where they have a large number of suppliers, and consolidation of their business with a smaller number is an obvious way of resisting the inflationary pressures, which are so significantly impacted on all raw materials. Indeed, we understand Tesco have already begun to look at this option and almost certainly other retailers will have had similar thoughts.

The one area where consolidation may be less marked is in prepared vegetables. With the acquisition of Hitchin Foods and Exotic Farm Products, Bakkavor extended its domination of this sub-sector and the real question is whether any other consolidator can emerge to tackle their domination.

### Fruit and vegetables

Consolidation rating: very high

Rationale:

- The sector's volume is likely to continue to grow due to the positive health perceptions surrounding the sector
- The major retailers continue to want to see consolidation in this still very fragmented sector and want suppliers who can provide all-year-round supply of their products
- There is an ongoing movement in favour of multi-product suppliers, only very partially offset by the retailers' wish to maintain local suppliers for environmental and provenance reasons
- There are still some significant takeover/merger opportunities as well as a high likelihood of the failure of many smaller players
- The increasing demand for organic produce may result in some larger mainstream suppliers in this sector seeking to acquire organic producers to strengthen their portfolio

### Prepared salads

Consolidation rating: moderate

Rationale:

- Bakkavor owns multiple operations in this sector, and has been further strengthened, and they now clearly totally dominate this sector
- As a consequence, there is now relatively limited scope for further consolidation in the sector
- We would, therefore, anticipate a few smaller company failures and possibly one or two modest acquisitions



## 4.8 Meat, fish and poultry

### Sector snapshot

<b>Meat, fish and poultry</b>	<b>£9,259m</b>	<b>+5.2%</b>
Meat, fish and poultry		Very high

This was one of the three sectors where we saw an exceptionally high level of company failures. Indeed, 42% of the failures which we have been able to classify impacted on this sector which accounts for just 15% of the food trade. By contrast, its share of the mergers taking place (18%) was broadly in line with expectations.

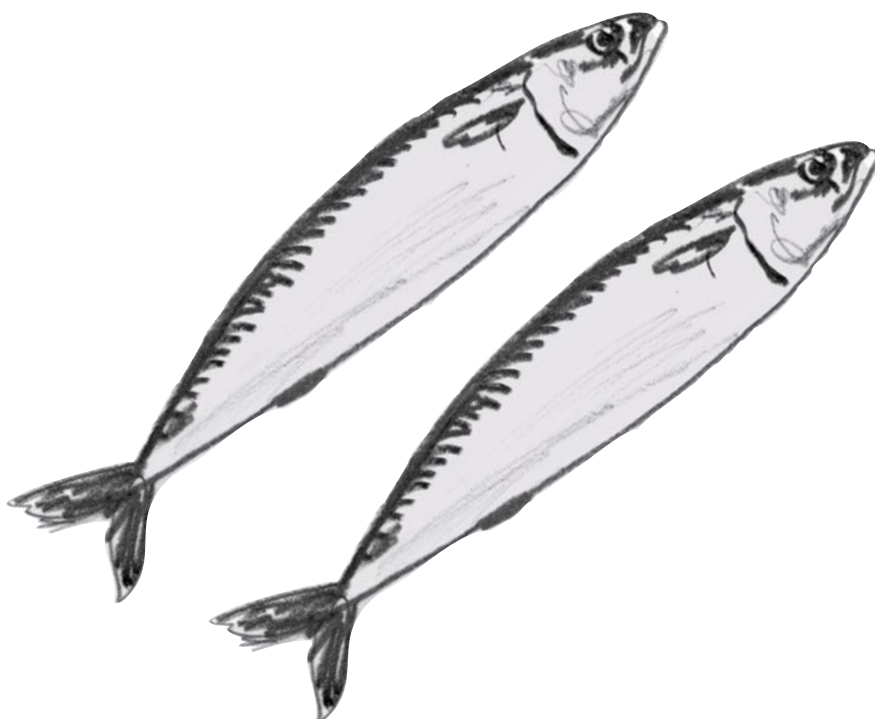
Looking ahead, it is hard to see this pattern changing, with smaller suppliers continuing to be squeezed out and failing and larger suppliers operating on tight margins but using scale to survive. The recent agreement for the sale of Grampian to Vion may well result in Vion selling off various parts of Grampian to other meat processors.

### Meat, fish and poultry

Consolidation rating: very high

Rationale:

- As before our previous report, commodity prices have impacted heavily on this sector in the last few years
- The result has been a large number of takeovers and a much larger number of company failures
- Large numbers of undifferentiated suppliers remain in each of the sub-sectors of this area and commodity price pressures remain acute, especially from imported poultry. We therefore anticipate considerable further consolidation in the sector over the next couple of years
- At the time of writing, Bernard Matthews was in turnaround mode, indicating that it is not just the smaller players that may be affected by the toughness of the sector



# 4.9 Soft drinks

Sector snapshot		
<b>Soft drinks</b>	<b>£6,068m</b>	<b>+2.8%</b>
Fruit juices		Moderate
Squashes		Low
Carbonates		Moderate
Water		High
Other soft drinks		Very high

What stands out in this sector is that, with the exception of smoothies, all sectors have seen a volume decline in the past 12 months. This may prove a catalyst to consolidation, but so far this has not been apparent and structurally, with the possible exception of water, this is a fairly consolidated sector. So on balance we see a low level of activity, unless the volume decline places increasing pressure on the marginal players.

## Fruit juices

Consolidation rating: moderate

Rationale:

- The modest number of acquisitions in the period under review (for example, Pepsi's acquisition of PJ Smoothies) were all strategic in nature
- This is a sector which, overall, is likely to benefit from healthy eating trends and this is reflected in the strong growth rates already shown by smoothies and pure juices
- At the same time, fruit drinks volumes have shown decline
- We envisage a limited number of further strategic acquisitions in the growing sectors and, perhaps, a few failures in the declining fruit drinks sector

## Squashes

Consolidation rating: low

Rationale:

- This is a declining sector in terms of both volume and value and has seen little innovation
- It is already fairly well consolidated and we envisage little structural change occurring in the sector over the next couple of years

## Carbonates

Consolidation rating: moderate

Rationale:

- The sector is largely static in volume and value terms and, while dominated by big global players, also includes national and regional players
- In the period under review, there were significant numbers of both mergers and company failures at the smaller end of the market
- For example, Cott Beverages bought Macaw and Nichols bought Cariel Soft Drinks and Panda Soft Drinks
- We anticipate a reduced level of consolidation activity at the smaller end of the market
- The possibility of a larger deal involving Britvic remains

## Water

Consolidation rating: high

Rationale:

- The sector has already experienced volume and value decline and is facing an increasingly negative PR climate
- The most significant deal in the sector was the acquisition by AG Barr of the Strathmore business from Constellation Brands
- The number of failures increased sharply towards the end of the period under review and we would anticipate this trend continuing over the next couple of years, with failures or mergers occurring among the smaller players

## Other soft drinks

Consolidation rating: very high

Rationale:

- This sector includes sports drinks, mixers, energy drinks and dairy drinks
- The sector currently has a very high level of innovation and, consequently, significant consumer interest
- The sector is currently composed of a large number of smaller players
- This combination of factors suggests the likelihood of a number of failures and considerable interest in acquisitions over the next couple of years

# Appendix I



## Further information

Axis is a specialist consumer research and consulting business. Its aim is to help food and drinks businesses survive and thrive with the UK's grocery multiple retailers.

It works with clients to improve their effectiveness in areas essential for success with the multiple retailers, especially:

- consumer understanding and category development
- new product development
- supplier/retailer relationship management.

Axis does this by providing both consultancy support and a full range of qualitative and quantitative consumer research techniques.

It is comprised of a multi-disciplined team with extensive food and drinks industry experience. The team comprises essentially two types of people:

- Consultants
  - Client-side experience (typically 10–15 years) in marketing, sales and category management
  - They lead all client relationships and projects
- Consumer researchers
  - Minimum of 10 years' agency experience
  - Major agency backgrounds
  - They execute all consumer research projects.

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# Appendix II



## Further information

Solalex Associates focuses exclusively on strategic management in the food industry.

Clients are able to benefit directly from Hugh Thomas's wide experience as:

- a senior corporate manager. Hugh was previously a global senior vice-president with Nestlé in Switzerland and subsequently executive director of the consumer foods division of a FTSE 100 company
- a highly experienced deal maker and adviser. Hugh was the retained adviser on food M&A to a major accounting company and has been the principal on over 25 acquisitions and disposals
- an entrepreneur financing and controlling SMEs. Currently Hugh owns two food companies and is launching a range of healthy food products under the Colin Jackson name.

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# Appendix III



## Further information

Market conditions are always changing. Barclays Commercial Bank Food and Drink team can provide a range of solutions to help your business prepare for that.

Our unique industry-focused proposition allows our team to build up an in-depth understanding of both the day-to-day challenges, as well as the longer-term opportunities your businesses face. As we are immersed in the food and drink sector and are the leading bank in the sector, we understand your market and can deliver bespoke banking solutions that deliver results. By thinking ahead, we'll help you face any storm.

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## ACNielsen

ACNielsen provides measurement and analysis of market-place dynamics and consumer attitudes and behaviour to help companies understand competitive performance, to uncover new opportunities and to raise the profitability of their marketing and sales campaigns.

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We are also grateful to a range of food industry contacts whose off-the-record advice and observations helped greatly.

# Contacts

## Further information

Grant Thornton has a strong track-record of providing advisory services to dynamic food and drink businesses. These services include corporate finance, project finance, business planning, tax and audit. Our specialist partners have acted for numerous food and agribusiness companies in the capacity of financial advisors, administrators, accountants, auditors and receivers.

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