Food for thought

JANUARY 2019

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InFocus with John Hood, Invest Northern Ireland

John Hood is Director of Food and Drink at Invest Northern Ireland where he leads a team that works with more than 200 businesses across the region, helping them grow, innovate and develop by providing financial and advisory support.

Q How significant is the food and beverage sector to the Northern Ireland economy?

A Very significant. Food and drink is our largest manufacturing sector, representing around a quarter of manufacturing output, a quarter of manufacturing employment and a quarter of manufacturing exports.

From an economic development perspective and in terms of the geographical spread, it's more than just the figures. If you look at the constituents within the supply chain: the producer, the primary farmer, the processor, the retailer and the consumer, it is probably the only area of economic development that touches everyone in Northern Ireland to a greater or lesser extent.

Q What is the level of interest from firms seeking to export to Great Britain or the Republic of Ireland, compared to elsewhere in the world?

A To put it into context, at the minute, we only sell three per cent of our produce outside of the European Union (EU) and no matter what way you look at it, there are some limitations to the amount of product that we have.

The second issue is there are a lot of opportunities in the food and beverage sector around the world, but we don't yet have a large enough range of companies to fully avail of all the opportunities.

When you consider other markets it's not just about selling. You need to understand the relationship, whether you deal with a retailer directly or through a distributor. You need to understand what the price point is and crucially, make sure you have an export health certificate, which may have been negotiated at an EU, UK or Northern Ireland level.

Logistically, have you someone on the ground if there are issues? Selling into outside markets is more complicated and complex than people think. Our job is to try and simplify that. I think it's about managing the expectations of firms and encouraging them to test themselves out in the near-shore markets such as Great Britain and Republic of Ireland.

The Great British market as we sit today is still a net importer of food and beverage by approximately £24 billion a year, so there will be a lot of opportunities to sell into it when the UK exits the EU, under whatever terms.

Ultimately, the pure, natural quality of our food and beverages will sell anywhere in the world. But, we have got to make sure we match the opportunity with the capability and capacity of our companies.

Q How do you compare the levels of support from Invest NI to similar agencies in the Republic of Ireland or Great Britain?

A The levels of support are governed across the EU so anything that is done has to be consistent with European guidelines on regional aid. If you look at what we do in food and beverage, we have a dedicated business development team whose job it is to promote the pure and natural quality of Northern Irish food and drink and to help facilitate sales.

We provide R&D support to companies seeking to engage in innovative research. Across innovation, there's a range of support, whether that be a design programme for branding or innovation vouchers to deal with particular production issues.

We've got a skills growth programme to make sure the companies have the skills that they need to be as efficient and effective as possible.

The things that other regions offer, Invest NI will offer as well to our companies and we have to encourage firms to make maximum use of those services. Across Ireland food and beverage is a key area of focus which may mean that our local companies receive more dedicated attention than might be the case in Great Britain.

No matter how much investment we put in as a government, the companies will be putting in more than we are. That's the purpose of our job, to de-risk it and make them feel more comfortable making that investment. If a company is ambitious, wants to be innovative, improve its efficiency and productivity and the skills of its people, we will work alongside them.

Q What practical things are Northern Irish food and beverage clients doing in anticipation of Brexit?

A One of the biggest challenges around the exit from the European Union has been uncertainty. That said, Great Britain remains our largest market so even in the worst-case scenario, our largest market will remain open and still present opportunities.

The other thing is that we have seen companies stockpiling, whether it be raw or packaging materials. Others have taken space in other jurisdictions because they have been required by their suppliers to have some kind of facility within the EU, that will allow them to continue to supply.

From an Invest NI perspective, we have a range of products and solutions available including a self-assessment online tool to try and allow companies to understand some of those issues that are likely to be of greatest concern to them.

There is support available from consultancy advice and guidance on how to deal with Brexit up to a maximum of £50,000 and specialist advice on issues such as customs, tariffs and taxation.

Q What thing would you do (if you had the power) to transform the sector in Northern Ireland?

A It goes back to encouraging firms to make the investment that will make businesses as efficient as possible. That's the one thing. If you begin to focus more on the profitability rather than the turnover, whether that be through investment in physical capital, human capital or through identifying markets that potentially give a better return, Northern Ireland could be transformed.

If we could turn companies that are making 1.5 to two per cent profit into companies that are making eight to nine per cent profit, it will be transformational.

Ultimately, I believe we have the pure, natural quality products that would sell anywhere in the world. We've got to make sure that we manufacture them to the highest standards that we can, to the best of our ability and sell where we get the maximum return.

Food for Thought at Grant Thornton agri-food dinner

Grant Thornton's Agri-Food team were delighted to host an engaging discussion on the future of the agri-food industry at a special dinner in Cliff Townhouse. The guest speaker on the evening was the renowned Stephen Twaddell. Stephen shared his experience from across the globe working with global multinational FMCG companies and more recently with rapidly scaling food and beverage companies.

During the course of the evening a range of themes were examined with the 20 strong senior executives in attendance from across Ireland.

"We were delighted to host a range of clients and industry leaders across the sector and the island of Ireland. The conversations on the night were really engaging and sharing of knowledge was powerful. This a key sector for us as a firm and evenings like this with leading speakers like Stephen really benefit us all, in our journey to service this."
Sasha Kerins

Media commentary on the agri-food industry has been dominated by the challenges being posed by Brexit of late. The evenings proceedings kicked off by looking at the opportunities facing the industry and there was a resounding positive mood from all stakeholders. While the macro economic climate may be challenging at present, we were reminded that when it comes to food and beverages – everyone has to eat. The discussion ensued to cover topics such as the rising population, increases in affluence amongst the emerging middle class and the transition towards a westernised diet.

These trends present many opportunities for Irish food and beverage companies to grow and scale. However, finding solutions to consumer demands, continuously innovating to stay ahead of these demands and doing so in a cost effective manner are key to capitalising on the opportunities.

The life-cycle of consumers trends seems to be shortening. In less than five years we have the emergence, rapid growth, maturation and perhaps even the decline of a donut trend in Ireland. Entering and exiting consumer categories at the right time is fundamental to succeeding. Functional foods seem to be an exception to the boom-bust cycle experienced by other food trends.

Millennials interest in healthy lifestyles and food provenance is elongating the lifecycle of functional foods. Ireland's dominance in the infant formula sector was cited as an example that could be followed for other age categories in the development of specialist functional foods.

It is not just what consumers are eating that is changing, how we consume food is also changing. Convenience for 'on-the-go' snacking was identified as a key requirement for today's busy consumer. The emergence of forecourt food parlours was discussed and Ireland was identified as a global leader in this space. The emergence of electric vehicles will in time put pressure on fossil fuel providers and so their business model is changing to offer consumers food on-the-go. The transition away from fossil fuels is being driven by environmental pressures, which the agri-food sector is as exposed to as the transport sector.

Origin Green and Ireland's sustainability credentials were universally recognised as the best in the world. In Origin Green Bord Bia have created a universal brand for Irish producers to market their sustainability credentials. Our temperate climate, year round rainfall and abundance of grassland provide the ideal conditions for sustainable farming. However, it was acknowledged that competitors across the globe have recognised the value of Origin Green and are working to develop their own sustainability story. The need to continuously improve and to align the greening of Common Agricultural Policy (CAP) to public policy in order to stay ahead of the competitive set was discussed.

"In my view food and drink is the best business - its central to our daily existence and as a consequence it really matters to us all. If you want to do something meaningful and make a real difference to how we all live our lives its a fabulous place to be."
Stephen Twaddell

The opportunities and evolution of agri-food Mergers and Acquisitions (M&A) was a topic that generated a lively discussion. Agri-food has seen some of the biggest and highest profile mergers in the last 24 months. Bayer's $63 billion merger with Monsanto with has established a global powerhouse in the agri and crop science sector. The $13.7 billion acquisition of Whole Foods Markets by Amazon will create a digital platform and physical supply chain to enable Whole Foods to revolutionise how it sells and distributes its products. The motivations for merging or acquiring a business need to be clear and agreed by all stakeholders. Two out three M&A fail to achieve their desired objectives. The need for a transition/integration plan prior to a deal being done was identified as a key success factor in M&A.

Many corporate powerhouses have in the past acquired their innovation to get closer to the consumer trends and to grow their business. However, the industry is evolving and in-house or company sponsored incubator programmes are replacing traditional M&A. Examples of how Unilever acquired Ben and Jerry's ice-cream or Coca Cola bought Innocent Smoothies were contrasted against the development and success of Hop House 13 by Diageo.

For companies looking to M&A as an exit strategy the importance of a strong EBITDA was discussed. Companies looking to sell their business must also be mindful of the impact the sector they operate in will have on the value of their business. Businesses operating in value add will inevitably attract higher multiples than those trading in commodities. Across multiple sectors succession planning or lack thereof is a catalyst for M&A activity and it was universally agreed that agri-food is no exception.

A significant number of family owned small and medium sized businesses with no succession plans remain in place and this will stimulate continued M&A activity in the sector for the foreseeable future.

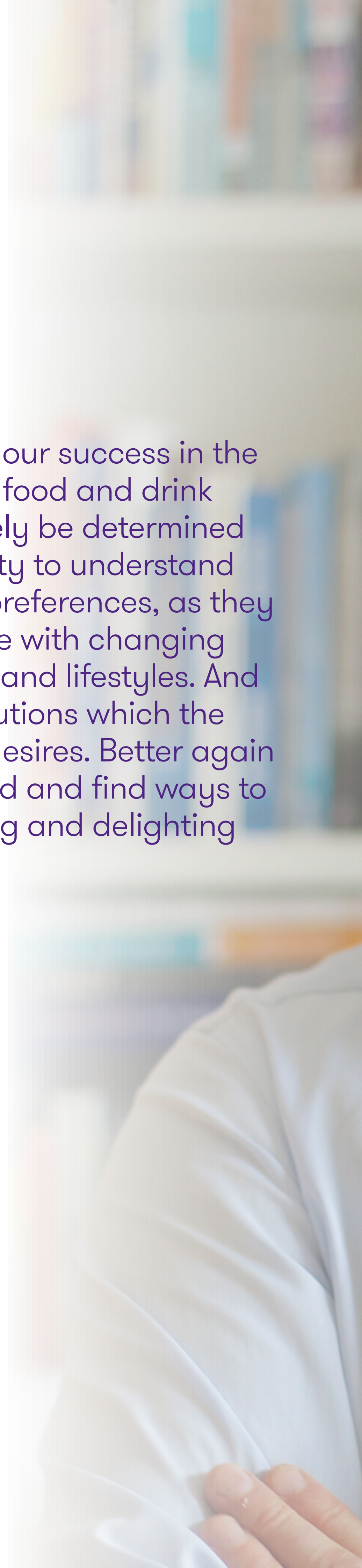
One of the challenges with succession planning is identifying, attracting and retaining good talent into the industry. The agri-food sector is now competing with technology giants like Google and Facebook for the best talent. It was felt that there is a body of work to be done throughout the sector to improve the image of careers in agri-food to graduates. Today graduates are no longer choosing companies that simply pay the best. They want the best work life balance and a sense of purpose.

The agri-food sector has a fantastic story to tell and can offer graduates a balanced and attractive career however, how the sector communicates the opportunities needs to be modernised. Attracting people who want to work in the industry and have a passion for it is fundamental to driving growth. Agri-food companies need to attract people with an entrepreneurial spirit, people who want to do something better than it's already done.

This entrepreneurial mind-set is a key driver of growth. Growing and scaling food businesses is challenging. The dominance of a small number of retailers presents a very competitive environment in which small and medium sized businesses must compete. Many of these companies succeed in getting their products onto retailer shelves, the challenge comes in getting their products to move off these shelves.

Consumer price sensitivity and the need to discount in order to penetrate the market were discussed. Access to funding to allow for this investment was also cited as a challenge. The days of scalable food businesses having a single funding stream are gone. Today businesses must explore opportunities through traditional banks, angel investors, venture capitalists, state bodies and even crowd funding. Success is not guaranteed by sufficient funding. Businesses must still understand and satisfy the consumer. Failure often proceeds success and the successful food businesses we see on our supermarket shelves have often brought unsuccessful products to market in the past. The secret to success is understanding and being close to the consumer.

The active and engaging discussion throughout the evening was able to draw on Stephen Twaddell's vast experience but also on the experiences of all attendees. Opportunities and challenges were discussed at length. The evening started and finished in the same vein – consumers will dictate success and opportunities lie in understanding the consumer.



"'The key to our success in the business of food and drink will ultimately be determined by our ability to understand consumer preferences, as they evolve in line with changing behaviours and lifestyles. And find the solutions which the consumer desires. Better again to get ahead and find ways to keep exciting and delighting them!"

Stephen Twaddell

Knowledge Development Box (KDB)

Finance Act 2015 introduced the Knowledge Development Box (KDB) with the first deadline for making a claim now passed. Companies with a 31 December 2016 year-end had until 31 December 2018 to make a successful claim. The broad objective of the KDB is to promote innovation and provide an incentive whereby profits arising from patented inventions, copyrighted software and certain other specific asset classes can effectively be taxed at a reduced rate of 6.25%.

Any royalty or other sum in respect of the use of a qualifying asset or income reasonably attributable to a qualifying asset, can benefit from the reduced rate. Broadly, the relief is linked to the qualifying Research and Development (R&D) expenditure incurred by the Irish company as a proportion of its overall global R&D expenditure, thereby making the KDB very attractive to companies that carry on a significant element of their R&D activities in Ireland.

The KDB is also attractive to large groups that are capable of isolating individual qualifying assets, the R&D for which is carried on in Ireland.

What is a qualifying asset?

For the purposes of the KDB, a qualifying asset is copyrighted software, certain patented inventions, plant breeders' rights, protection certificates for medicinal products and plant protection certificates. A qualifying patent must have been granted following substantive examination for novelty and inventive steps and have undergone a search by the patent office in relation to the invention, with a search report duly prepared. Transition arrangements apply for unexamined patents which were certified before 1 January 2017. Small and Medium Enterprises (SMEs) benefit from an expansion of the definition of Intellectual Property (IP) to include inventions that are certified by the Controller of Patents, Designs and Trademarks as being novel, non-obvious and useful.

For the purposes of the KDB relief, SMEs are companies with annual income from IP **not exceeding** €7.5 million and group turnover **not exceeding** €50 million.

What income qualifies for the relief?

The following income generated from the qualifying assets qualifies for the relief:

- royalty income;
- licence fee income; and
- where a sales price includes an amount which is attributable to a qualifying asset, a portion of the income from those sales calculated on a just and reasonable basis.

How does the relief work?

The mechanics of the KDB relief are to allow a tax deduction of 50% of the qualifying profits from the R&D activities, thereby resulting in an effective tax rate of 6.25%.

In arriving at the qualifying profits figure, there is a calculation required which broadly looks at the percentage of the R&D activities carried on by the Irish company, including third party outsourced costs ('qualifying expenditure'), as a proportion of the overall expenditure incurred on the qualifying asset (including acquisition costs and outsourcing costs, both group and third party).

The formula can be summarised as follows:

$$\frac{QE+UE}{OE} \times QA$$

QE = Qualifying Expenditure on qualifying asset
UE = Uplift Expenditure (see below)
OE = Overall Expenditure on qualifying asset
QA = profit from relevant Qualifying Asset

How is qualifying expenditure and overall expenditure defined?

Qualifying expenditure is expenditure incurred by the company, wholly and exclusively in the carrying on of R&D activities in an EU member state, the consequences of which lead to the development, improvement or creation of the qualifying asset.

Outsourcing costs incurred in relation to a person who is not a member of the group/company and is engaged to carry on R&D activities on behalf of that company, will be treated as if it were expenditure incurred by the company. However, any group outsourcing costs are specifically excluded as qualifying expenditure.

Overall expenditure refers to the company's overall expenditure on R&D in respect of the qualifying asset, including all outsourced costs (including to group companies) together with any acquisition costs incurred by the company in relation to the qualifying asset (either from a group company or a third party).

It should be noted that in establishing the amount of tax relief each year under the KDB, the expenditure figures, both qualifying and overall, will include amounts of historic expenditure. The rules in relation to this key aspect are set out at the end of this page.

The exclusion of group outsourcing costs and acquisition costs will dilute the benefit of the KDB for many multinational corporations. To partially mitigate this, there is a provision for an uplift in the amount of qualifying expenditure.

What is 'uplift expenditure'?

An additional 'uplift expenditure' is allowed to increase the qualifying expenditure on the qualifying asset. The uplift expenditure is the lower of:

- 30% of the qualifying expenditure; or
- the aggregate of the acquisition costs and group outsourcing costs.

How does this calculation appear in my corporation tax return?

The 6.25% rate will not appear on the face of the corporation tax return. The KDB qualifying activities are treated as a separate specified trade. The profits of this specified trade should be calculated separately from the other activities of the company. The relief is obtained in the form of an additional trading expense against the profits of the specified trade, which will equal 50% of the qualifying profits (12.5% x 50% = 6.25%).

What happens if I have a number of qualifying assets but it is not possible for me to identify the overall income and expenditure on each qualifying asset?

Owing to the interlinked nature of many qualifying assets, it is not always possible to identify the breakdown of income and expenditure on each asset. This scenario is overcome using the 'family of assets' approach. A family of assets permits the smallest grouping of identifiable qualifying assets for which income and expenditure is reasonably identifiable to utilise the KDB, as if the 'family of assets' was one qualifying asset.

What happens if I have not started trading, but have incurred expenses relating to qualified assets?

Any pre-trading expenditure which is qualifying expenditure shall be deemed to have been incurred in the first accounting period of the company, therefore allowing the expenditure.

When is it effective?

The relief is available to companies for accounting periods beginning **on or after 1 January 2016 and before 31 December 2020**.

How many years of expenditure are included in the formula?

For accounting periods beginning on or after 1 January 2016 but on or before 31 December 2019:

- acquisition costs shall include both current costs and historic costs incurred prior to 1 January 2016;
- group outsourcing costs include costs incurred prior to 1 January 2016 and where such costs relate to more than one qualifying asset, those costs shall be apportioned on a just and reasonable basis; and
- qualifying expenditure (as referenced above) incurred during the three years prior to the year in which the first claim is made, together with the current year (restricted). However, periods prior to that may be included where there is sufficient supporting documentation.

For accounting periods beginning on or after 1 January 2020:

- acquisition costs shall include costs incurred prior to 1 January 2016;
- group outsourcing costs include costs incurred prior to 1 January 2016 and where such costs relate to more than one qualifying asset, those costs shall be apportioned on a just and reasonable basis; and
- qualifying expenditure may include any amount incurred prior to 1 January 2016 where there is sufficient documentation.

What documentation must I have?

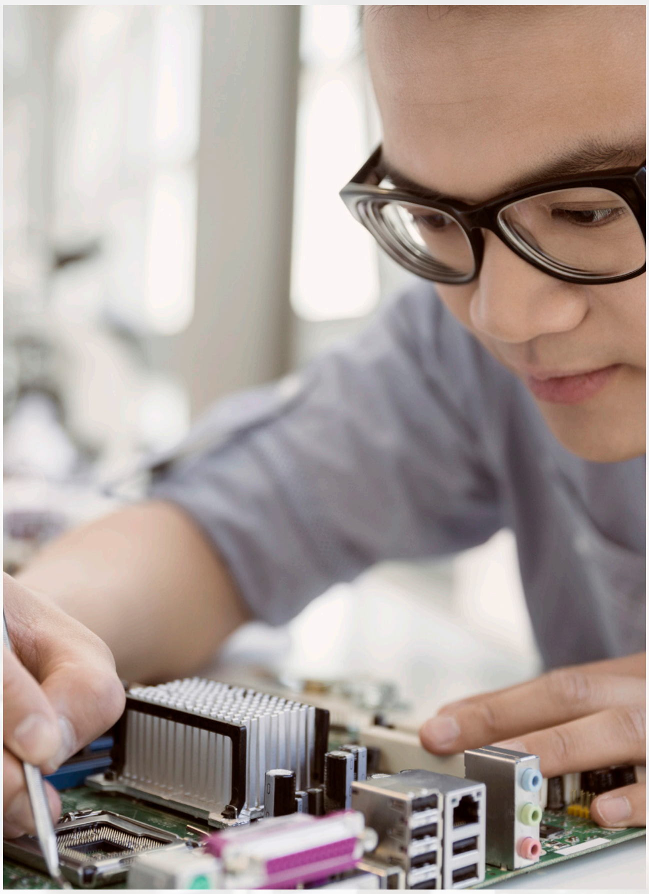
A company must have records available which track:

- overall income from the qualifying asset;
- qualifying expenditure on qualifying assets; and
- overall expenditure on the qualifying asset.

The company must also show how such expenditures and income are linked to the qualifying asset.

Other provisions:

- the KDB provisions should have no impact on claiming capital allowances on IP under S.291A;
- the KDB may impact on cash refund claims made under the R&D tax credit regime. Broadly, the R&D tax credit is calculated as if the KDB regime was not in place. This should only present a cashflow timing issue;
- should there be a trading loss in respect of a qualifying asset in an accounting period, 50% of the loss will be available for offset in the normal manner; and
- if a company is subject to transfer pricing rules, the apportionment and application of all qualifying income and qualifying expenditure must be in line with transfer pricing rules. For smaller companies, income and expenses should be apportioned on a just and reasonable basis.



Impact of Brexit on M&A activity in the agri-food sector in Ireland

As the 29 March deadline is fast-approaching and the deal/no-deal scenario in relation to the operation of the border between Ireland and the UK, we consider the impact this had on M&A activity in the Irish agri-food sector in the past 12 months and how it will continue to impact in 2019 and beyond.

The agri-food sector trade is quite diverse and is broken down into 24 categories identified and agreed by the Department of Agriculture, Food and the Marine and the Central Statistics Office. These categories include the obvious items such as beef, dairy, animal feedstuffs, fruit and vegetables and live animals. It also includes such items as forestry, animal hides and skins.

On an overall basis, between 2009 and 2017 agri-foods exports increased by 74% from €7.8 billion to €13.6 billion. Exports to the UK during this period increased by 40% with exports to the rest of the EU increasing by 68%.

The most significant export growth has been seen in exports to non-EU destinations, increasing by in excess of 162%.

In recent times the level of M&A activity between companies within the agri-food sector has followed a similar trend with an increase in activity between Irish and non-EU headquartered companies.

Despite the growth in trade in new markets, the UK remains a critically important trading partner for the Irish agri-food sector with almost 40% of exports in 2017 going to the UK. Total value of these exports was €5.2 billion. This represented an increase of 7% in value terms when compared to 2016. It should be noted that the overall proportion of exports going to the UK is slightly lower than in 2016.

The UK also has a significant reliance on the Irish market with the value of their agri-food imports into Ireland being at €4.1 billion in 2017.

The agri-food sector is also a key employer accounting for approximately 8% of total employment in Ireland in 2017.

Much has been written recently on the potential impact of Brexit on the Irish agri-food sector and the general consensus is that the impact will be negative both from an Irish and UK perspective. Agri-food is particularly vulnerable given its exposure to the UK market compared to other sectors of the Irish economy. The challenges surrounding the treatment of the future EU-UK trading relationship, with specific reference to Ireland, together with the impact of the significant drop in the value of sterling against the euro has created difficulties for each sub-group within the agri-food sector which is exposed to the UK market.

M&A activity

Pre-Brexit, the agri-food sector would have been expected to be a key sector to generate M&A activity, particularly between Ireland and the UK. Coming from reasonably buoyant M&A activity in 2016 and 2017 between Ireland and the UK, where deals included the acquisition by Nomad Foods Limited of Green Isle Foods Limited, Henderson Foodservice Limited's acquisition of Barbarrie Duckling Limited and Promise Gluten Free being acquired by Mayfair Equity Partners LLP, the approach in 2018 has been more cautious.

We are aware that many companies within Ireland are adopting a 'wait and see' approach when it comes to M&A activity until there is some certainty around Brexit and how it will operate. Some companies have bought opportunistically or strategically, but in general we have seen a cautious approach when it comes to trade deals.

While there has been a notable slow-down in M&A activity between Irish and UK agri-food companies, Irish companies have begun to take steps to protect themselves where they have exposure to UK suppliers and markets. Within the agri-foods sector the most significant impact of Brexit is likely to be the imposition of tariffs which will ultimately result in higher prices for consumers. Irish agri-food companies are considering the actions they need to take in order to protect themselves from the potentially adverse impacts of Brexit. The latest example of this is where it was recently mentioned in the media that Musgraves have switched from UK suppliers to EU based suppliers in order to minimise higher consumer prices due to potential tariffs. We are aware of other Irish agri-food companies adopting a similar approach.

Outside of the Brexit zone, within the last 12 months Irish agri-food companies have been involved in a number of significant deals with international companies, both on the buy-side and sell-side. While these deals may not be as a direct consequence of Brexit, there is continued consolidation within the food ingredients sector. Heading the charge were Kerry Group plc who acquired Fleischmann's Vinegar Company, Sias Food Company, Zhejiang Hangman Food Technologies Co. and Ganeden along with its recently announced agreement to acquire Ariake USA, the North American Business of Ariake Japan Co. for a consideration expected to be in the region of €325 million.

Sources: Mergermarket, Department of Agriculture, Food and the Marine, Central Statistics Office, Bord Bia

Other significant transactions worthy of mention, in the produce sector, were the acquisition by Total Produce of a 45% stake in Dole Food Company Inc. for €240 million and the acquisition of Fyffes plc by Sumitomo Corporation for €716 million.

What will 2019 bring?

In 2018, M&A activity within the agri-food sector has seen some very significant transactions on a world-wide basis. However, the approach of Irish companies to M&A in the UK market has been cautious with companies looking to implement measures which will protect their sector rather than considering growth/expansion into an uncertain market. With the introduction of tariffs between Ireland and the UK being the most likely and hardest hitting impact, many Irish agri-food companies are looking at measures which will ensure that customers will not face higher prices and ultimately put more pressure on their own margins.

With continued uncertainty around the Brexit negotiations and the potential impacts for Irish/EU and UK trade it is difficult to be definitive in relation to the 2019 M&A prospects but it is likely that the cautious approach will continue in the short-term. Despite the uncertainty, for those companies who may be considering a future sale, now may be the time to consider what pre-transaction activities can be undertaken which will enhance value in the future. The starting point may be to understand the key components of the business, how they impact on or contribute to value and ultimately how exit value can be enhanced. Typical areas to consider include margin analysis and maximisation, key contractual arrangements and strong management.

We believe that international deals within the agri-food sector will see some level of increase in 2019. From a UK perspective, a negotiated Brexit deal is likely to see more deal activity subsequently, but until that is the case, we do not expect the volume of Irish/UK transactions to pick-up.

We are Grant Thornton

At Grant Thornton we work with over 200 Irish agri-food businesses across the entire value chain. Our dedicated agri-food team has a wealth of national and international experience in the agri-food sector providing bespoke professional services to companies of all sizes. If you require further information on any topics or would like to discuss other professional services matters, contact our agri-food team or visit our website **here**.

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