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Key Performance Metrics and Other Factors for Food Manufacturers to Focus Upon to Maximize Shareholder Value in Advance of a Transaction

Tully & Holland is often asked by owners of food manufacturing companies – "What is it that I should be doing now to prepare and position my business in the best light possible prior to a potential sale process in 2-3 years?"

Listed below are the ten factors that we see most often affecting the price that buyers, strategic or financial, are willing to pay:

1. Consistent sales and EBITDA growth (year-to-year)
2. Revenues > $25 million (or recognizable scale within sector)
3. A proven management team
4. Excess capacity sufficient to support projected growth
5. Loyal, high quality customers without customer concentration risk
6. No vendor concentration risk
7. Proven ability to innovate and acquire new customers
8. Proven successful resource allocation
9. A strategy and a documented plan for future growth
10. Clean corporate documents & quality financial statements

A few comments on each of these factors may offer some additional clarification.

Consistent revenue and EBITDA year-to-year growth is clear enough, but implicit in this is the ability to demonstrate off-shelf movement that confirms high repeat-purchase rates from a loyal customer base. Within certain limits, attractive revenue trends will sometimes trump EBITDA growth for strategic buyers who may be more interested in purchasing contribution cash flows, without assuming the fixed costs of the seller. Gross margins and EBITDA margins of greater than or equal to 40% and 10%, respectively, should be sought. If one had to choose, gross margins are probably more important than EBITDA margins, though these numbers are affected by whether the business is doing its own manufacturing or hiring a contract manufacturer. Contract manufacturer fixed costs and profit margins are often lower than self-manufactured margins. In addition, it is very important to be able to demonstrate the impact of scale on margins. For example, what is the impact on unit costs and gross margin of producing one million cases vs. 100,000 cases?

Achieving **revenue of $25 million** is perceived by strategic buyers as an important milestone. Strategic buyers today are loathe to assume the risk of launching new products, particularly public companies that are beholden to Wall Street for hitting quarterly earnings targets. They much prefer that entrepreneurs assume this risk, and pay them handsomely for what they've created. $25 million in revenue represents an attractive milestone because the target business has likely demonstrated that it provides a product of value to a loyal, diversified customer base.

It is important to build a business that will have appeal to both financial and strategic buyers. As a seller it is ideal to have alternatives, and financial buyers provide alternatives and competition that often result in a premium sale price. For financial buyers, the development of **a proven management team** is particularly important. They do not want to run a business if something were to happen to its manager, and having a "second in command" and other seasoned managers protects against this risk. Conversely, strategic buyers may have little interest in the current management team. Business owners should be prepared for this reality and be ready to reward key managers in a unique way should the sale to a strategic buyer take place.

For a company that does its own manufacturing, having too much capacity may not be a good thing. Often times buyers are not be willing to compensate for capital investments made to create excess capacity. Instead, business owners interested in selling need to have enough **manufacturing capacity** to fulfill three years of projected growth, but no more than that. It is important to avoid over investment in this area.

Sophisticated buyers will closely scrutinize your **customer mix and profile**. Sellers should seek to immediately diversify customer mix and minimize any risk of customer concentration. It is one of the first questions buyers ask today in an environment of retailer consolidation across all channels – food, drug, mass merchandisers, etc. Stickiness of customers is also very important to buyers, and is exemplified by year-to-year customer retention. A clear, concise explanation for the loss of any significant customer is helpful; e.g. a customer was acquired and the buyer chose to award the business to another pre-existing vendor.

Business owners interested in selling should want to sell their business to a sophisticated buyer. Sophisticated buyers recognize value when they see it, and a business is more likely prosper under their ownership. A sophisticated buyer will also recognize quality when they see it, particularly the quality of a business' customers. In this regard, businesses should minimize their exposure to large customers like Wal-Mart and Club stores to a proportion no greater than the national ACV that these customers represent.

Minimization of risk is important to buyers. If the perceived risk of a business is low, they are inclined to place a greater value on the business. One source of risk is **vendor risk**; being overly reliant on only one source of glass, corrugated, rare organic ingredients, etc. In this area, operators should strive to build a network of redundant suppliers; each capable of supplying the business with what it needs in sufficient quantities and at prices comparable to those of other current suppliers.

Another differentiator between a high quality company and an average company is its ability to **innovate and acquire new customers**. Innovation can come from various sources. The obvious is product innovation founded on unique insight into marketplace conditions, unmet consumer needs, and the ability to develop high quality products ahead of one's competition. Another less obvious source of innovation is found in the field with one's sales force. We have seen many successful companies out-innovate their competitors with "me-too" products via a "take no prisoners attitude" and aggressive distribution programs that result in geographic expansion and greater shelf space allocation. It is important to have examples of such innovation to present to interested buyers. It is a quality differentiator.

Proven successful resource allocation is important. What does this mean? Operators should not attempt to spread their company too thin by creating too many different businesses, brands, or product lines. The result that we often see is weakness and lack of sustainability in peripheral business initiatives. Many buyers will actually assume that they will discontinue these initiatives post-closing and, as a result, sellers are not likely to be compensated for the investment they've made in them. Conversely, operators should attempt to create barriers to entry wherever possible. Being first to market may represent a barrier, but perhaps the best is the creation of a brand that defines the category. Intellectual property, aside from the trademark protection provided by one's brand, is relatively rare in the food industry and usually unimportant.

It is important for business owners to have **a strategy and a documented plan for future growth** based on a clear definition of the market the business operates in, an understanding of their position within the market, and a well-defined set of action steps and resource requirements necessary to achieve their financial objectives. Being able to articulate an investment thesis based on a strategy and plan is crucial for owners to effectively sell their business to sophisticated investors. As part of this process, operators should seek to build their business consistent with the anticipated needs of the most likely strategic buyers; e.g. logistical, IT, quality, safety, HR, etc.

Finally, business owners should be sufficiently organized to be able to present **clean corporate documents and quality financial statements** (an audit is recommended) to potential buyers. Solid, scalable information systems capable of generating the information necessary to manage and grow the business are vital. Important to the sale process will be the assembly of a well experienced team of advisors, including an accountant and a corporate attorney experienced in mergers & acquisitions. Clear, undisputed ownership of all assets is fundamental. Human resource and environmental issues, should any exist, need to be resolved well in advance of initiating a sale process. All "funny business," like licensing or unusual lease arrangements with family members, should be avoided. While adjustments to EBITDA for owner's discretionary items are common, and almost always expected, they are to be minimized ideally three years prior to a selling event. Having a list of addbacks as long as one's arm not does bolster the credibility of one's selling story. In summary, the seller of a food manufacturing company needs to be thoroughly prepared for the significant time and resources that sophisticated buyers will devote to the due diligence of their prospective investment.