Grant Thornton

Food for thought

Food & beverage industry CEO survey | September 2011

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Foreword

Our survey of food and beverage CEOs reveals an industry in relatively healthy shape but on the cusp of substantial change. There is broad optimism about the future, tempered with a realisation that mergers and acquisitions are likely to refashion the industry landscape.

The research supports our view that the industry is at risk of fragmenting. There is evidence that smaller companies are already struggling. With less to spend on R&D and product innovation than their larger competitors, they are becoming less profitable and are vulnerable to being taken over.

Larger companies, with deeper pockets, can more readily afford to promote their brands and sustain premium pricing. Supermarkets, on the other hand, are continuing to introduce competitively priced, private label products. As a result, smaller companies are being squeezed; unable to compete either on brand exposure or price.

Until now they have been partially shielded from this market dynamic by robust consumer demand and relatively stable input costs. Those moderating influences no longer apply.

We therefore expect the pace of industry restructuring to accelerate. Ultimately, we expect to see a more concentrated industry landscape, dominated by large brands and supermarkets, but with room for agile, niche players.

Those companies determined to reinvent themselves can certainly succeed, despite the gathering headwinds. They will have to factor into their plans industry-wide impacts such as the Government's carbon scheme, rising costs of electricity, water, labour and raw materials, and for some, the high Australian dollar. In the face of all this, they will have to maintain their investment in new product development.

Some companies are rising to the challenge. They are showing how to survive and thrive by innovating and embracing new routes to market. A small group is pioneering online promotion and sales. Some are striking new customer and supplier agreements to reduce their reliance on the powerful supermarkets. And yet others are contemplating strategic alliances and acquisitions to build market presence in carefully defined niches.

To warrant the optimism expressed by the industry as a whole, more food and beverage companies will need to follow this lead. We hope this survey serves to remind industry participants that they must tighten cost controls, free up cash for innovation and review their strategies as a matter of priority.

Tony Pititto

Industry Leader – Food & Beverage
Grant Thornton Australia Ltd

About this report

Grant Thornton's food and beverage industry CEO survey, Food for Thought, was produced in collaboration with Monash University and the Australian Food and Grocery Council (AFGC). We canvassed the views of CEOs of Australian food and beverage manufacturers on important issues facing the industry including:

- current and future performance
- product innovation and investment
- supply chain management
- mergers and acquisitions; and
- future strategies.

We are grateful to those companies who responded, representing over $14.4 billion in sales. We would like to thank the team at the AFGC, including Kate Carnell and Tony Maher, for their support in developing and promoting the survey. We would also like to recognise Dr. Lawrence Dooley of Monash University for his significant contribution to the survey process.

Key findings

Despite the negative sentiment surrounding general economic conditions, the Australian food and beverage industry appears optimistic about future opportunities.

There is a clear view that mergers and acquisitions will be used strategically to strengthen financial positions.

The level of concentration along the supply chain and its affects on future profits is a clear concern for those companies outside the top quartile of return on assets.

Whilst investment is expected to occur within existing production facilities, no significant investment in new facilities is expected. It is perhaps not surprising then that funding for future growth strategies will be largely made from internal and existing debt facilities.

- CEOs have an optimistic business outlook. 91% expect total sales to increase over the next two years.
- The outlook for employment within industry is positive. 79% of CEOs expect employee numbers to either increase or remain the same in the next two years.
- Companies have been in savings mode with 82% of respondents expecting to fund future revenue growth through either internally generated funds or existing debt lines.
- A focus on the expansion of existing production facilities and cost control will continue. 70% expect production volume in Australia to increase over the next two years. 94% expect per unit manufacturing costs to rise across all inputs.
- 83% of respondents believe that power distribution along the supply chain was too concentrated. Only 15% did not believe that future profits would be under pressure as a result of private label/home branded products.
- 69% view strengthening customer relationships and enhancing product innovation as the main drivers of improved profitability. Relationship building still requires further work with 39% not improving their relationships with their top three customers over the past year.
- Companies with strong brands and the ability to launch numerous new products appear more profitable. They typically spend between 1% and 5% of sales on product development.
- On balance, CEOs expect M&A activity to continue with only 25% not considering M&A activity over the next two years.

Background

At a glance

This food and beverage industry benchmarking survey sought the views of CEOs on important operations and strategy issues including:

- Financial performance
- Industry competitiveness
- Supply chain strategy
- Technological innovation
- Government regulations
- Future outlook

Our findings offer an independent perspective of the current economic and regulatory environment impacting the food and beverage industry.

Industry snapshot

According to Australian Food Statistics, the food and beverage industry is the largest retail and manufacturing sector in Australia. The industry has gradually increased its workforce over the past few years to 226,750 in 2010.

The dollar value of both Australia's food imports and exports has remained constant over the past few years.

Total unprocessed and processed food imports were $10.9 billion in 2010 compared to $11.0 billion in 2009.

Total exports of these categories were $24.3 billion in 2010 compared to $25.4 billion in 2009.

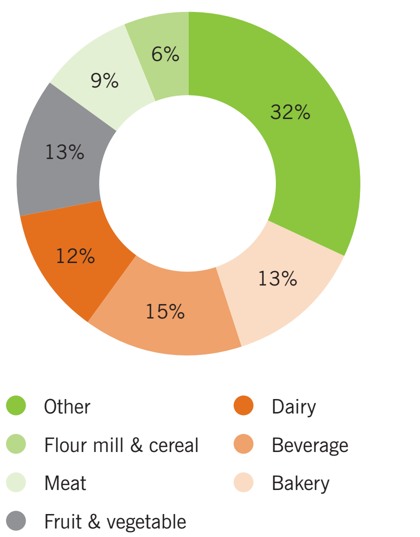
The participants

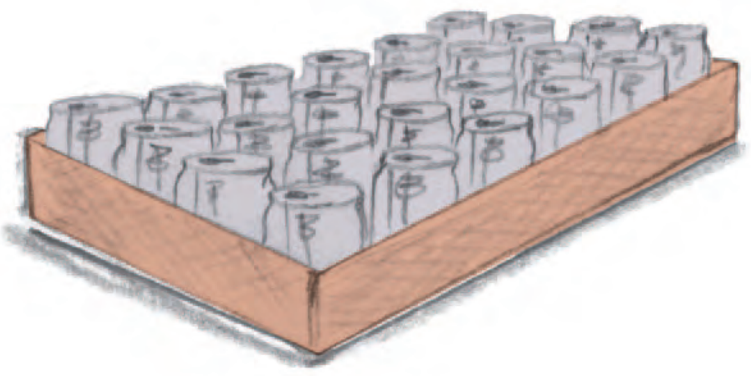
Eighty-two CEOs participated in the survey. These industry leaders represent companies that had combined estimated total annual sales of $14.4 billion in 2011. They provide work for over 50,000 Australians.

Key characteristics of participants:

- Median annual sales of $100 Million
- Median average weekly wages of $850 per employee
- 75% of total production volume in Australia
- Median EBITDA return on total assets is 10%
- Majority export less than 5% of sales
- Invest between 1% and 2.5% of sales revenue in product development

Survey participants' main business





Operations

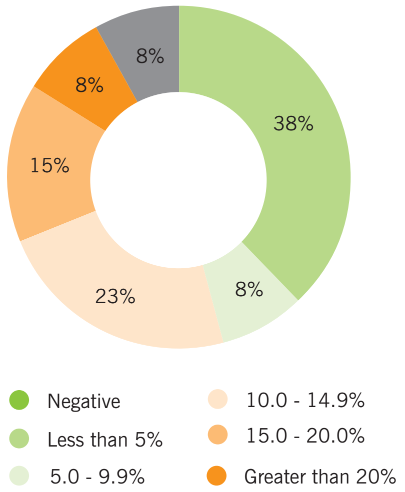
Financial performance

A number of metrics were used to examine operations.

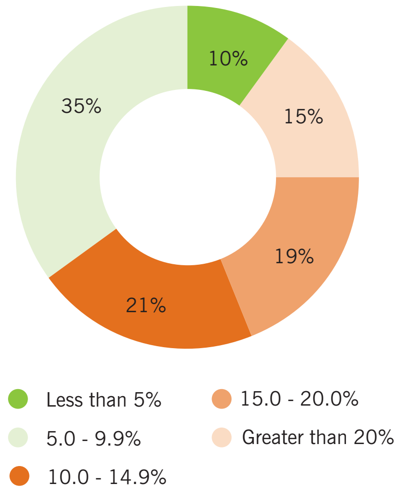
Overall, small companies (less than $25 million in total annual sales) have lower returns. Almost half of these small companies had a return on total assets below 5%.

Two primary drivers were identified by CEOs to increase profitability over the next two years. They are stronger relationships with customers and product innovation. Only 7% will reduce the size of their workforce to increase profitability.

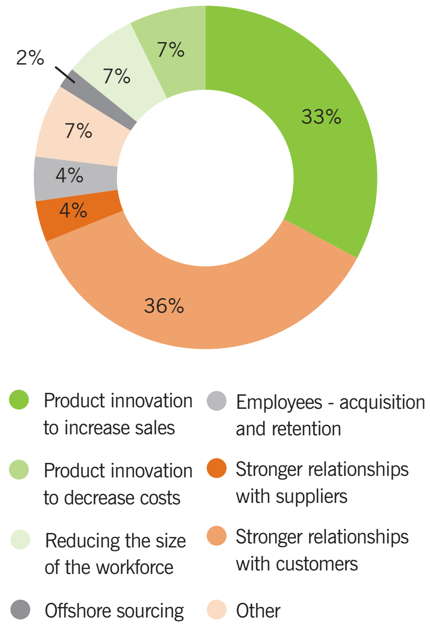
'Less than $25 million sales' return on total assets (EBITDA / Total Assets) during fiscal year 2011



'More than $25 million sales' return on total assets (EBITDA / Total Assets) during fiscal year 2011



What will be the main driver to increasing the groups's profitability over the next two years?



Manufacturing costs

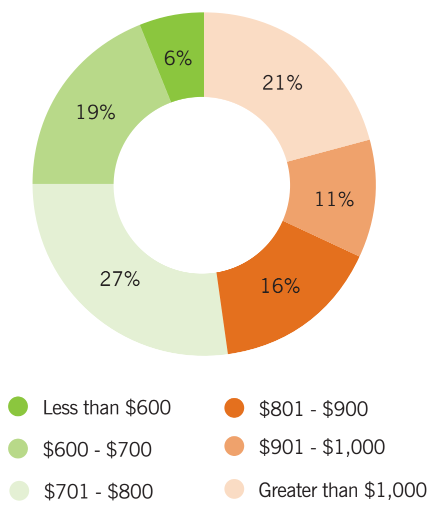
Raw materials and direct labour per unit manufacturing cost components varied significantly across all companies. Outside of these two inputs, other costs (i.e. packaging, transport, utilities, IT, marketing and compliance) are for the most part each below 5% of total sales.

Not surprisingly, 94% of CEOs expect per unit manufacturing costs to increase over the next two years. Electricity and gas costs are expected to increase significantly; over 60% of participants believe these costs will increase by more than 5%. 65% of respondents believe government regulations are a significant cost burden.

Employment and future production

Over 67% of respondents employed at least 100 employees with a median weekly wage of approximately $850 per employee. Direct labour costs are expected to remain constant, as 84% of CEOs believe this cost will not increase by more than 5% over the next two years. Encouragingly, 57% of CEOs expect domestic employment to increase over the next two years while only 21% of respondents do not.

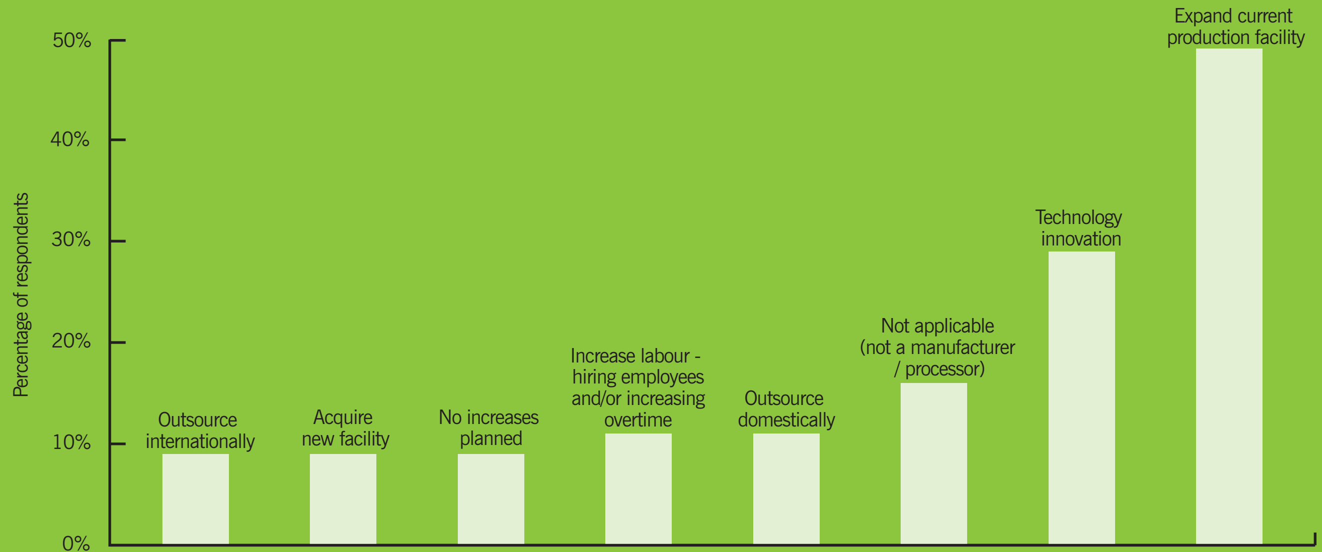
Average weekly wage (excluding overtime and allowances) per non-salaried employee for the fiscal year 2011



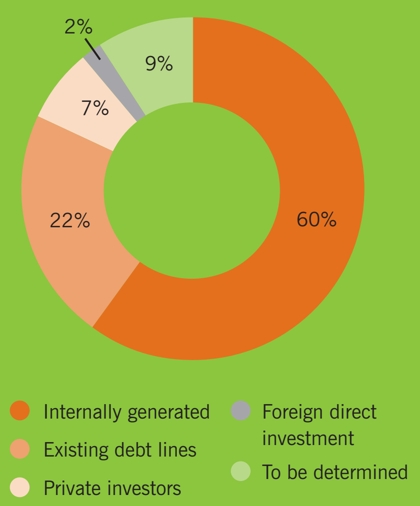
Cost pressure is expected to continue in the short term as additional regulatory costs are addressed.

Investments will be made by most companies through expansion of current facilities and technology innovation.

To increase production over the next two years, the group will most likely take the following actions:
NOTE: Respondents were allowed multiple answers for this question.



The main source to fund revenue growth over the next two years:



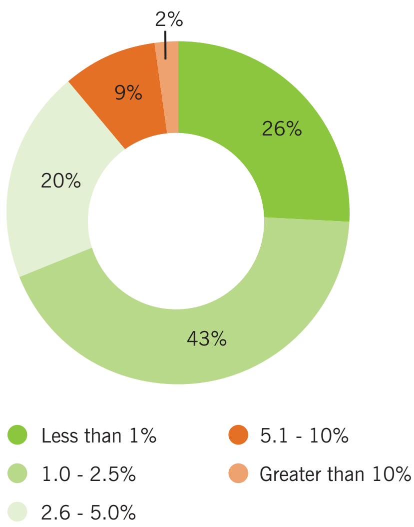
CEOs plan to fund future growth internally or by using existing debt facilities.

Technology and innovation

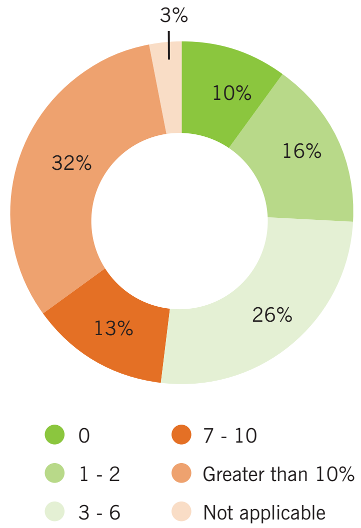
Investment in product development is integral to product innovation. Almost 74% of CEOs are investing more than 1% of sales towards new product development, with 11% investing more than 5%.

Reducing the time taken from conception to launch is a major challenge across the industry. However, larger companies tend to handle this better than their smaller competitors. 45% of respondents have launched more than six new products during the past year and 70% of these had turnover greater than $100 million.

Annual group investment in new product development as a percentage of sales during fiscal year 2011



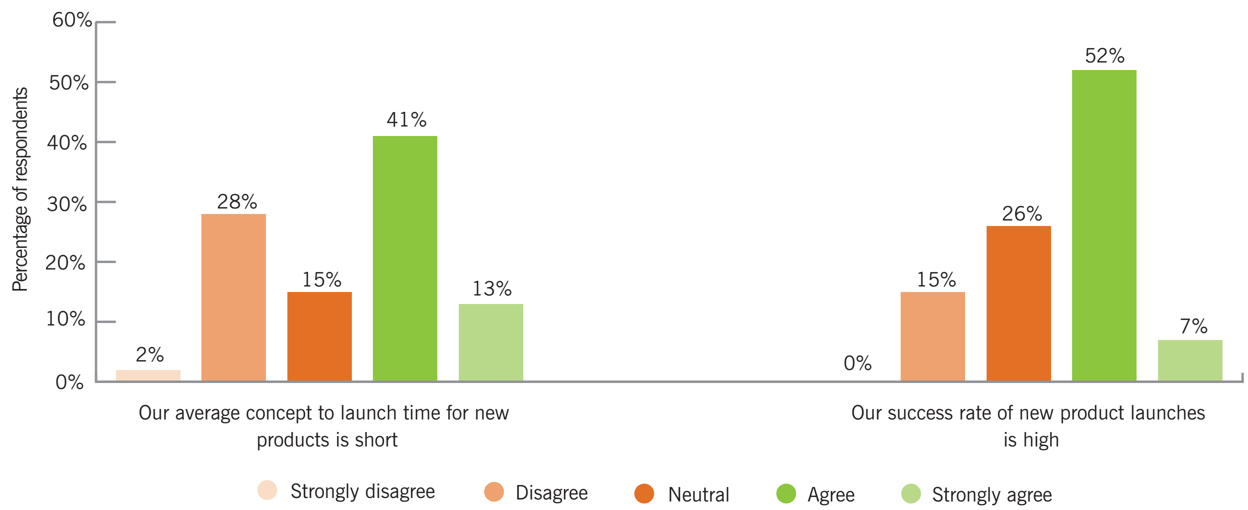
Number of new products launched by the group during the fiscal year 2011 (excluding rebranded items and imported products)



The amount of product development expenditure does not vary based on company size. However, those companies that invest more in product development tend to be more sophisticated with the use of cross-functional teams and a higher level of senior management commitment to the process.

This is also less of an issue for those that spend more than 2.5% of sales on product development. This seems to imply that unless companies are prepared to seriously invest in the product development process with the use of cross-functional teams and senior management time, then the chances of success will be lower.

In relation to the group's product development process:



Strategy

Mergers and acquisitions

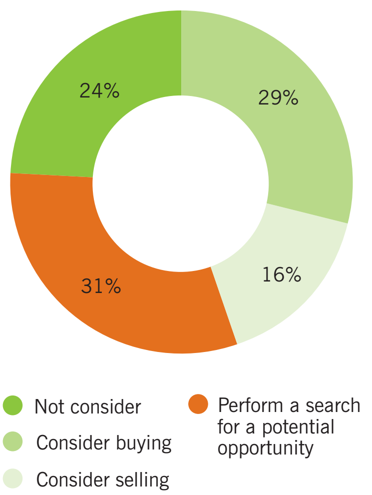
The trend toward industry consolidation is expected to continue.

Only 15% of CEOs believe mergers and acquisitions are not strategically important for their growth; however company size plays an important role here. Just 40% of small companies believe mergers and acquisitions are strategically important compared to 61% of larger companies.

It appears companies have been saving. 76% of companies will consider M&A activity over the next two years, with 20% not having sufficient capital or access to capital to complete an acquisition.

The challenge to integrate a new company is significant as only 28% of those who completed a recent merger considered it successful. Interestingly, none of the small companies surveyed are considering acquisitions, compared to 37% of larger companies. 30% of small companies will consider selling, compared to just 12% of larger companies.

In relation to mergers and acquisitions, over the next two years companies will:



Social media

The influence of social media is growing. With the launch of multiple social networking sites over the past decade and their acceptance by consumers, 59% of CEOs have integrated social media into their business strategy.

Company size seems to matter when achieving social media success. 50% of companies with annual sales greater than $500 million have obtained significant success compared to only 30% of companies with less than $25 million of annual sales.

Relationships with customers and suppliers

Strong customer relationships are one of the main drivers of increased profitability. The current industry trend is towards less reliance on supermarkets and the survey shows that relationships have not improved over the last 12 months.

In two years time, companies plan to reduce their percentage of sales to supermarkets. Most companies (72%) agree that supermarket private label/ home branded products will have a major impact on their future strategy and profitability. As companies endeavour to shift sales away from supermarkets, these companies will be looking to replace them with greater online sales.

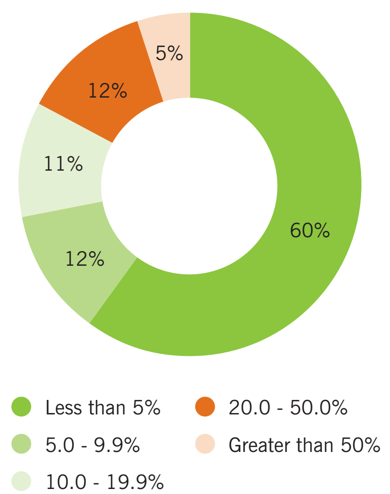
There is a difference in strategy however, when comparing the smaller companies to the larger companies. Larger companies plan to sell a larger percentage of total sales online.

Currently, 25% of large companies sell online, which represents, on average, 8% of total sales. In two years time, 33% of large companies expect to have online sales representing, on average, 16% of their total sales. 15% of small companies currently sell online. For those that do it represents, on average, only 1% of total sales. In two years time, only 10% of small companies plan to sell online. For these companies it will represent, on average, 3% of sales.

Exports

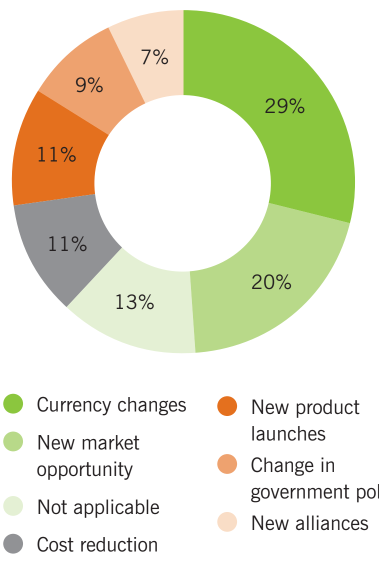
Most companies are not exporting and do not plan to export in the future. This study shows small companies export less as a percentage of sales than larger companies. 79% of small companies export less than 5% of total sales, compared to 60% for the entire population. In addition, no small company exports more than 20% of its total sales.

What is the group's percentage of estimated export sales for fiscal year 2011?



As the Australian dollar continues to strengthen, the attractiveness of export markets for food and beverage companies reduces.

What factor will have the greatest impact on the future Australian export strategy?



Power distribution

The majority of companies believe that power is too concentrated within the supply chain. This issue appears to have a greater impact on small companies as the majority strongly agree with this sentiment.

A greater proportion of small companies believe their future profits will be negatively impacted by the continued launch of private label/home brand products by supermarkets. The trend of private label/home brands is expected to grow in the near future.

Power distribution along the supply chain is too concentrated.

	Total population	Less than $25 million sales	Superior performers
Strongly agree	48%	80%	62%
Agree	35%	20%	13%
Neutral	17%	0%	25%
Disagree	0%	0%	0%
Strongly disagree	0%	0%	0%

Our profits will be under pressure as a result of home brands in the next two years.

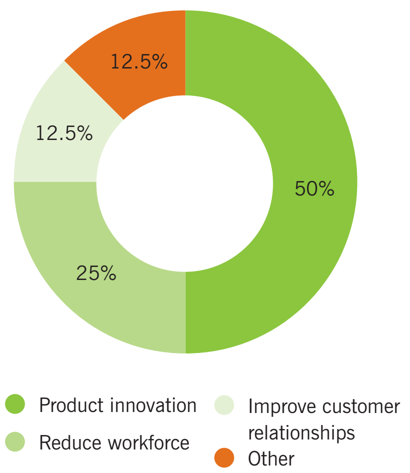
	Total population	Less than $25 million sales	Superior performers
Strongly agree	26%	30%	25%
Agree	41%	40%	50%
Neutral	17%	30%	13%
Disagree	11%	0%	12%
Strongly disagree	4%	0%	0%

Benchmarking superior performance

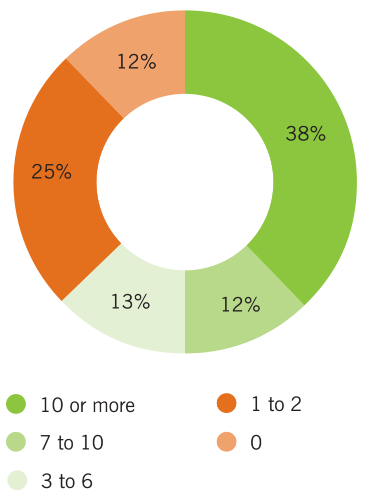
The characteristics for superior performance were reviewed for those companies in the top quartile of return on total assets (i.e. EBITA/Total Assets). These companies had a return of greater than 20% and display the following characteristics:

- 63% of respondents were in fast moving consumer goods
- 75% had more than 100 employees
- The median average weekly wage in 2011 was $800 per employee and median sales revenue was $100 million
- 63% are privately owned and have production volumes in excess of 75% in Australia
- They are not export focused with export sales not exceeding 10%
- 88% of companies sold through supermarkets and for these companies, on average, 61% of their total sales are in this channel
- Only 38% sold online but for these companies their online sales were an average of 34% of sales
- Input costs, excluding raw materials, direct labour and packing, represent less than 5% of sales revenue
- All companies expect sales to increase over the next two years but only 38% will increase export sales
- Whilst all companies believe collaboration with customers and suppliers is important, only 38% say relationships with customers have improved
- 75% of companies believe supermarket home brands will have a major impact on strategy in the next two years and will experience pressure on profits as a result of home brand sales
- Only 38% believe mergers and acquisitions will be important in future strategy and, in fact, 50% are not considering any M&A activity

Strategy used to increase profitability over the next two years

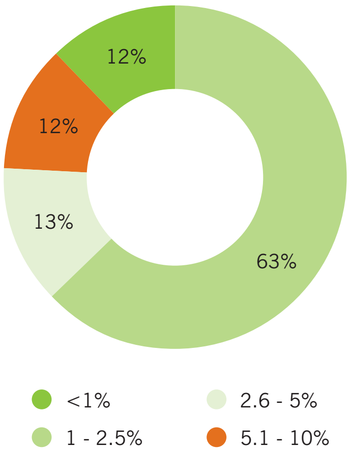


New products launched in 2011

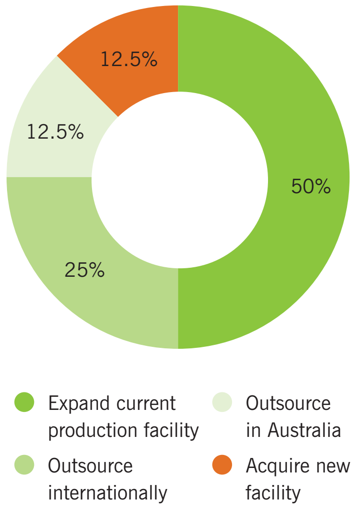


These companies in the top quartile of return on assets expect to increase profitability over the next two years by focusing on product innovation and to a lesser extent reducing the current workforce.

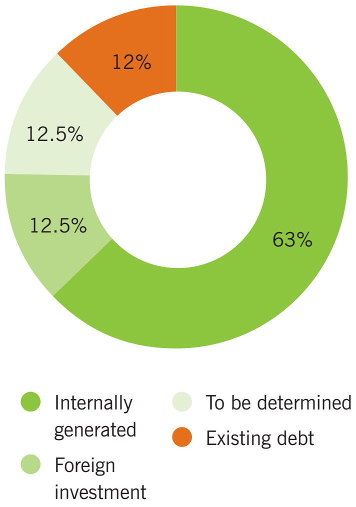
Product and Development Expenditure as a percentage of sales



To increase production over the next two years



Funding growth



The companies that generated superior performance are clearly focused on product innovation. 88% invested more than 1% in research and development and 50% launched more than six products in 2011. 50% of companies will use product innovation to increase future sales.

Production is expected to increase over the next two years, with 88% of companies planning to increase Australian production volumes. However, investment in new production facilities is not expected as 50% plan to increase production through existing production facilities whilst 25% plan to outsource internationally.

Given then that investment in new facilities and M&A activity are not high on the agenda of the superior performers it is not surprising that future growth will be funded largely from existing resources.

Sub-sector analysis

This section outlines the key findings by sub-sector for where there were a statistically valid number of responses.

Summary key metrics

- Beverage and Malt has the highest return on assets, with Fruit and Vegetable showing a lower median in comparison.
- Meat and Meat Products is showing the lowest investment in new product development and the lowest number of product launches.
- Salaries are consistent across the sub-sectors, being in the range of $701-900 per week per employee.

Median Sub-sector Responses	All Responses	Bakery	Beverage & Malt	Dairy	Fruit & Vegetable	Meat & Meat Product	Flour Mill, Cereal, & Other (incl. Confectionary & sugars)
Return on Assets	10-14.9%	10-14.9%	15-20%	10-14.9%	5-9.9%	10-14.9%	10-14.9%
Investment in new product development	1-2.5%	1-2.5%	1-2.5%	1-2.5%	1-2.5%	<1%	1-2.5%
New Product Launches	3-6	7-10	3-6	3-6	3-6	1-2	7-10
Average Weekly Wage	$801-900	$701-800	$801-900	$801-900	$701-800	$701-800	$801-900

Better than median   Below median

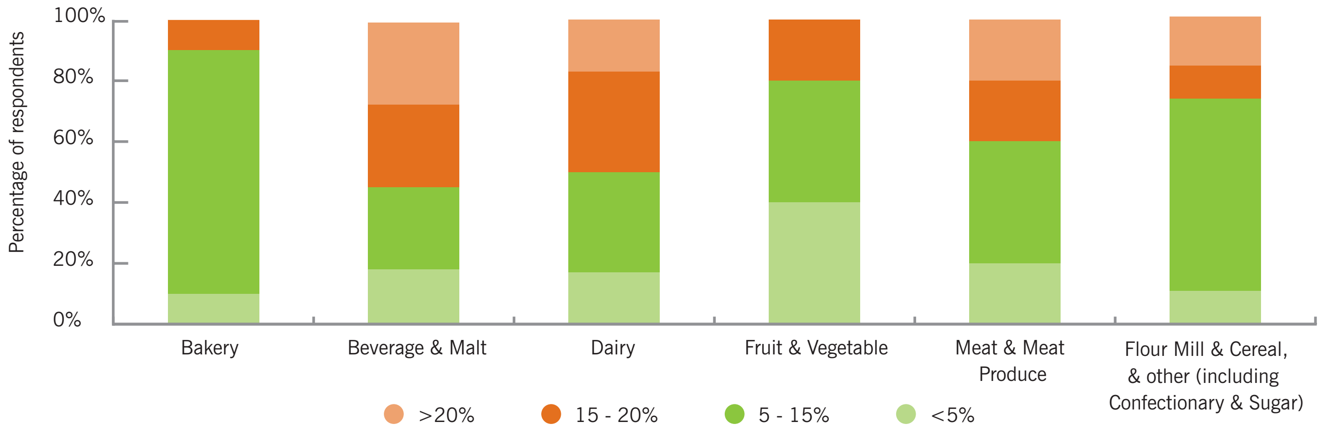
Strategies to improve profitability (over the next two years)

- Nearly all respondents are consistent in wanting to develop closer relationships with their customers.
- Product innovation to increase sales was the next most consistent theme.
- The Bakery sub-sector also sees employee acquisition and retention as a critical success factor.

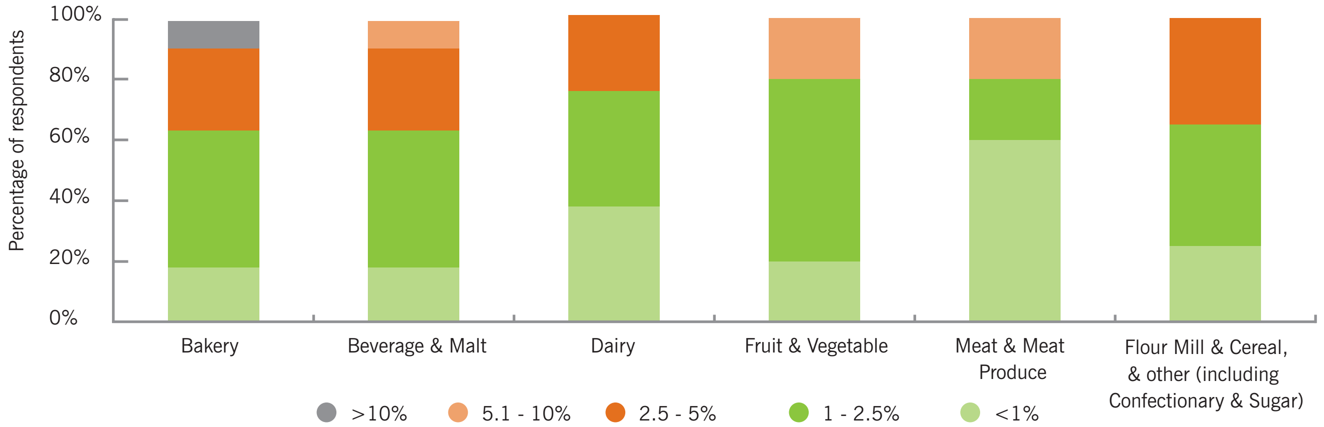
Average sub-sector responses	All responses	Bakery	Beverage & Malt	Dairy	Fruit & Vegetable	Meat & Meat Product	Flour Mill, Cereal, & Other (incl. confectionary & sugars)
Stronger relationships with customers	✓		✓	✓	✓	✓	✓
Product innovation to increase sales	✓	✓	✓		✓		✓
Employee acquisition and retention		✓					

Return on assets

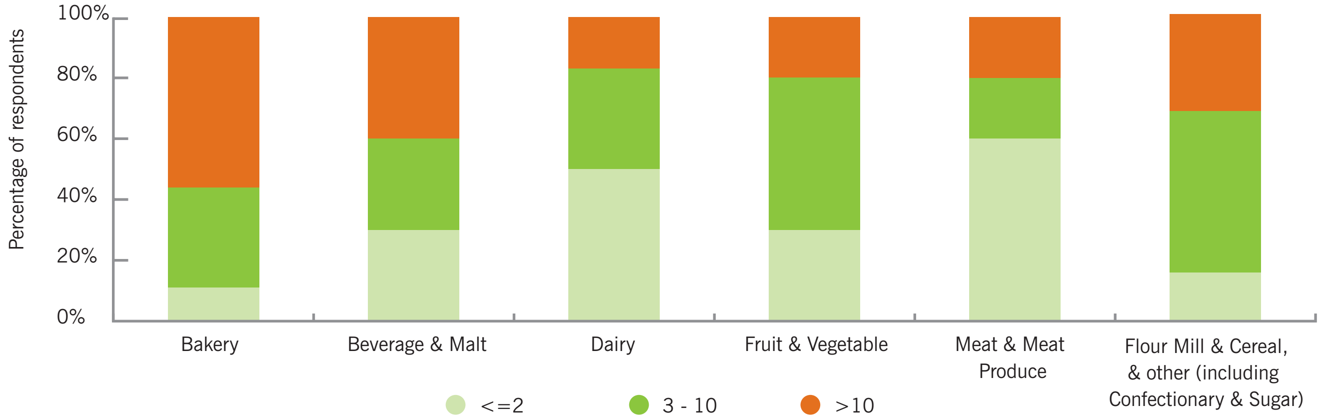
(EBITDA/Total Assets for financial year ended 30 June 2011)



Investment in new product development by sub-sector (as percentage of sales for financial year ended 30 June 2011)



New product launches by sub-sector (last financial year)



Bakery and Product Manufacturing

This sub-sector is exhibiting consistent return on assets with 80% of respondents delivering returns between 5% and 15% for the last financial year.

Product innovation was strong with nearly 40% of respondents spending over 2.5% of revenues on product development. Significantly, more than 50% of respondents launched more than ten new products in last financial year. Interestingly though, 43% were neutral on the success rate of their new product launches.

M&A will continue to be strong with 71% looking for potential acquisition opportunities. 86% are expected to use internal revenue and existing debt lines to fund growth.

If there is a concern for profitability in the next two years, then it is in relation to electricity and gas input costs. 43% are expecting these costs to increase by over 10%, much greater than the expected increases in other costs and overheads.

Beverage and Malt Manufacturing

Another sub-sector exhibiting strong returns is Beverage and Malt Manufacturing with 55% of respondents showing a return on assets of over 15% last year. 27% of this group are reporting returns of over 20%.

Product innovation was strong in this sub-sector with nearly 40% of companies investing more than 2.5% of revenue on product development. This level of investment led these companies to launch over ten new products last year. However, the success of these new product launches was questionable with 55% of respondents remaining neutral or negative about the result.

Over the next two years, there were strong sentiments from 77% of respondents in this sub-sector that they would be expanding their local production facility. 66% were actively looking for acquisitions. Electricity and transportation costs are expected to increase by over 10% over the same period.

Dairy Product Manufacturing

Return on assets in this sub-sector was evenly spread with 50% of respondents achieving returns of over 15%.

Product innovation is slightly lower in this sub-sector with the majority (75%) of respondents investing less than 2.5% in new product development. This is reflected in the actual number of new product launches, with 50% of companies launching less than three new products last year.

Only a small number of companies sold their products online. Interestingly, however, these companies' online sales represented 35% of their total sales.

Fruit and Vegetable Processing

Return on assets in this sub-sector is comparatively lower than other sub-sectors with no Fruit and Vegetable respondents exceeding returns of 20% and 40% of respondents achieving less than 5% returns.

As might be expected, 80% of the respondents noted themselves as family owned businesses. In order to increase production capacity over the next two years, they are looking to expand their existing facilities (29%) and use advances in technology (43%). Internal funds will be used to fund this expansion (82%).

To improve profitability they are looking equally to stronger relationships with customers (29%) and product innovation (29%).

Meat and Meat Product Manufacturing

This sub-sector is showing high returns with 80% of respondents showing returns of over 5%.

Most respondents (60%) noted that they were investing less than 1% into new product development and launching less than two new products a year.

For those that sold to supermarkets, this channel represented, on average, 41% of their total sales. This is expected to drop to 28% over the next two years. No company in this sub-sector reported online sales. Given this response, it is not surprising that none plan to invest in building this channel in the next two years.

Flour, Mill, Cereal and Other (including Sugar and Confectionary)

In this very diverse sub-sector 63% of respondents were showing a return on assets of between 5% and 15%.

The majority (65%) of respondents are investing between 1% and 5% of their sales revenue into new product development. This is resulting in 32% launching over ten new products a year. Surprisingly, there was an even split between those that agreed these new product launches were a success and those that were neutral or disagreed. The time to launch new products was noted as a concern for 20% of the respondents.

Over the next two years, this sub-sector is expected to maintain profitability through product innovation to increase sales (40%) and creating stronger relationships with customers (27%).

Cost increases of over 10% are expected in electricity, gas and transportation.

About Grant Thornton

Grant Thornton Australia is a member firm of Grant Thornton International – one of the world's leading networks of independently owned and managed accounting and consulting firms. We have significant experience in the food and beverage industry.

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We offer advice on all aspects of your business from merger and acquisition advisory, capital raising, valuation services, audit and assurance, Sarbanes Oxley compliance, tax compliance and research and development tax credits and businesses transformation and integration services.

If you want to know more, please contact us…

Tony Pititto
National Industry Leader – Food & Beverage
T + 61 3 8663 6204
E tony.pititto@au.gt.com

Andrew Newman
Partner – Audit & Assurance
T + 61 7 3222 0308
E andrew.newman@au.gt.com

Andrew Archer
Partner – Audit & Assurance
T +61 2 8297 2528
E andrew.archer@au.gt.com

Geoff Lloyd
Partner - Tax
T + 61 8 8372 6676
E geoff.lloyd@au.gt.com

Kim Hayman
Partner – Privately Held Business
T +61 8 9480 2096
E kim.hayman@au.gt.com

Adelaide

Level 1
67 Greenhill Road
WAYVILLE SA 5034
T +61 8 8372 6666
F +61 8 8372 6677
E info.sa@au.gt.com

Brisbane

Ground Floor
Grant Thornton House
King George Square
102 Adelaide Street
BRISBANE QLD 4000
T +61 7 3222 0200
F +61 7 3222 0444
E info.qld@au.gt.com

Melbourne

Level 2
215 Spring Street
MELBOURNE VIC 3000
T +61 3 8663 6000
F +61 3 8663 6333
E info.vic@au.gt.com

Perth

Level 1
10 Kings Park Road
WEST PERTH WA 6005
T +61 8 9480 2000
F +61 8 9322 7787
E info.wa@au.gt.com

Sydney

Level 17
383 Kent Street
SYDNEY NSW 2000
T +61 2 8297 2400
F +61 2 9299 4445
E info.nsw@au.gt.com

Grant Thornton

www.grantthornton.com.au