An Alternative to Venture Capital in the Food and Beverage Industry

By Dave Kauppi, President MidMarket Capital, John Blackington, Managing Partner GBS Growth Partners and Steve Hasselbeck Practice Leader Food and Beverage MMC

If you are an entrepreneur with a small food or beverage company looking to take it to the next level, this article should be of particular interest to you. Your natural inclination may be to seek venture capital or private equity to fund your growth, but that might not be the best path for you to take. We have created a hybrid M&A model designed to bring the appropriate capital resources to you entrepreneurs. It allows the entrepreneur to bring in smart money and to maintain control. We have taken the experiences of a beverage industry veteran, a food industry veteran and an investment banker and crafted a model that both large industry players and the small business owners are embracing.

I recently connected with two old college mates from the Wharton Business School. We are in what we like to call, the early autumn of our careers after pursuing quite different paths initially. John Blackington is a partner in Growth Partners, a consulting firm that advises food and beverage companies in all aspects of product introduction and market growth. You might say that it has been his life's work with his initial introduction to the industry as a Coke Route driver during his college summer breaks. After graduation, Coke hired John as a management trainee in the sales and marketing discipline. John grew his career at Coke and over the next 25 years held various positions in sales, marketing, and business development. John's entrepreneurial spirit prevailed and he left Coke to consult with early stage food and beverage companies on new product introductions and strategic partnerships.

Steve Hasselbeck is now a food industry consultant after spending 27 years with the various companies that were rolled up into ConAgra. His experience was in managing products and channels. Steve is familiar with almost every functional area within a large food company. He has seen the introduction and the failed introduction of many food industry products.

John's experience at Coke and Steve's experience at ConAgra led them to the conclusion that new product introductions were most efficiently and cost effectively the purview of the smaller, nimble, low overhead company and not the food and beverage giants.

Dave Kauppi is now the president of MidMarket Capital, a M&A firm specializing in smaller technology based companies. Dave got the high tech bug early in his business life and pursued a career in high tech sales and marketing. Dave sold or managed in computer services, hardware, software, datacom, computer leasing and of course, a Dot Com. After several experiences of rapid accent followed by an even more rapid decent as technologies and markets changed, Dave decided to pursue an investment banking practice to help technology companies.

Dave, John, and Steve stayed in touch over the years and would share business ideas. In a recent discussion, John was describing the dynamics he saw with new product introductions in the food and beverage industry. He observed that most of the blockbuster products were the result of an

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entrepreneurial effort from an early stage company bootstrapping its growth in a very cost conscious lean environment. The big companies, with all their seeming advantages experienced a high failure rate in new product introductions and the losses resulting from this art of capturing the fickle consumer were substantial. When we contacted Steve, he confirmed that this was also his experience. Don't get us wrong. There were hundreds of failures from the start-ups as well. However, the failure for the edgy little start-up resulted in losses in the $1 - $5 million range. The same result from an industry giant was often in the $100 million to $250 million range.

For every Hansen Natural or Red Bull, there are literally hundreds of companies that either flame out or never reach a critical mass beyond a loyal local market. It seems like the mentality of these smaller business owners is, using the example of the popular TV show, Deal or No Deal, to hold out for the $1 million briefcase. What about that logical contestant that objectively weighs the facts and the odds and cashes out for $280,000?

As we discussed the dynamics of this market, we were drawn to a merger and acquisition model commonly used in the technology industry that we felt could also be applied to the food and beverage industry. Cisco Systems, the giant networking company, is a serial acquirer of companies. They do a tremendous amount of R&D and organic product development. They recognize, however, that they cannot possibly capture all the new developments in this rapidly changing field through internal development alone.
Cisco seeks out investments in promising, small, technology companies and this approach has been a key element in their market dominance. They bring what we refer to as smart money to the high tech entrepreneur. They purchase a minority stake in the early stage company with a call option on acquiring the remainder at a later date with an agreed-upon valuation multiple. This structure is a brilliantly elegant method to dramatically enhance the risk reward profile of new product introduction. Here is why:

For the Entrepreneur: (Just substitute in your food or beverage industry giant's name that is in your category for Cisco below)

1. The involvement of Cisco – resources, market presence, brand, distribution capability is a self fulfilling prophecy to your product's success.
2. For the same level of dilution that an entrepreneur would get from a VC, angel investor or private equity group, the entrepreneur gets the performance leverage of "smart money." See #1.
3. The entrepreneur gets to grow his business with Cisco's support at a far more rapid pace than he could alone. He is more likely to establish the critical mass needed for market leadership within his industry's brief window of opportunity.
4. He gets an exit strategy with an established valuation metric while the buyer helps him make his exit much more lucrative.
5. As an old Wharton professor used to ask, "What would you rather have, all of a grape or part of a watermelon?" That sums it up pretty well. The involvement of Cisco gives the product a much better probability of growing significantly. The entrepreneur will own a meaningful portion of a far bigger asset.

For the Large Company Investor:

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1. Create access to a large funnel of developing technology and products.
2. Creates a very nimble, market sensitive, product development or R&D arm.
3. Minor resource allocation to the autonomous operator during his "skunk works" market proving development stage.
4. Diversify their product development portfolio – because this approach provides for a relatively small investment in a greater number of opportunities fueled by the entrepreneurial spirit, they greatly improve the probability of creating a winner.
5. By investing early and getting an equity position in a small company and favorable valuation metrics on the call option, they pay a fraction of the market price to what they would have to pay if they acquired the company once the product had proven successful.

Dean Foods utilized this model successfully with their investment in White Wave, the producer of the market leading Silk Brand of organic Soy milk products. Dean Foods acquired a 25% equity stake in White Wave in 1999 for $4 million. While allowing this entrepreneurial firm to operate autonomously, they backed them with leverage and a modest level of capital resources. Sales exploded and Dean exercised their call option on the remaining 75% equity in White Way in 2004 for $224 million. Sales for White Way were projected to hit $420 million in 2005.

Given today's valuation metrics for a company with White Way's growth rate and profitability, their market cap is about $1.26 Billion, or 3 times trailing 12 months revenue. Dean invested $5million initially, gave them access to their leverage, and exercised their call option for $224 million. Their effective acquisition price totaling $229 million represents an 82% discount to White Wave's 2005 market cap.

Dean Foods is reaping additional benefits. This acquisition was the catalyst for several additional investments in the specialty/gourmet end of the milk industry. These acquisitions have transformed Dean Foods from a low margin milk producer into a Wall Street standout with a growing stable of high margin, high growth brands.

Dean's profits have tripled in four years and the stock price has doubled since 2000, far outpacing the food industry average. This success has triggered the aggressive introduction of new products and new channels of distribution. Not bad for a $5 million bet on a new product in 1999. Wait, let's not forget about our entrepreneur. His total proceeds of $229 million are a fantastic 5- year result for a little company with 1999 sales of under $20 million.

MidMarket Capital has created this model combining the food and beverage industry experience with the investment banking experience to structure these successful transactions. MMC can either represent the small entrepreneurial firm looking for the "smart money" investment with the appropriate growth partner or the large industry player looking to enhance their new product strategy with this creative approach. This model has successfully served the technology industry through periods of outstanding growth and market value creation. Many of the same dynamics are present in the food and beverage industry and these same transaction stru7ctures can be similarly employed to create value.

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MidMarketCapital,Inc.

MidMarket Capital, Inc., MMC is an M&A Advisory firm specializing in providing corporate finance and business broker services to entrepreneurs and middle market corporate clients in the food, beverage, and select niche markets. The firm counsels clients in the areas of mergers, acquisitions and divestitures, private placements of debt and equity, valuations, corporate growth and turnarounds. Dave began Mergers and Acquisitions practice after a twenty-year career within the financial and information technology industries. Steve brings a broad background including new item introductions, trade and customer marketing strategy, pricing, and distribution for traditional grocery retailers as well as the alternate or non-traditional grocery accounts. John started GBS, a beverage industry consulting firm after a 25 year career with Coca Cola. Contact Dave Kauppi at (630) 325-0123, davekauppi@midmarkcap.com or Steve Hasselbeck (630) 415-6577 shasselbeck@midmarkcap.com or John Blackington (214) 215-4444 http://www.midmarkcap.com