FOOD MANUFACTURING

March 2021

Introduction

- **Food Manufacturing is seen as a resilient industry with limited volatility, low correlation to GDP cycles, and support from the non-discretionary need to eat. However, factors such as the ability to pass-through costs, supermarket/customer concentration, packaging, animal welfare, the shift to online, and the twin trends of both indulgence and healthier eating mean that this sector is not without complexity; as such it attracts both specialist PE firms and specialist Direct Lending partners.**
- **Food Manufacturing is a core investment sector for Pemberton. Over the last four years we have made 12 investments across Europe in this sector and deployed €1.5bn of capital.**

Our recent investments

- **Project Cookie:** €100m (Second Lien) to support a leading European manufacturer of private-label sweet biscuits.
- **Projects Galatea & Life:** £180m Term Loan B ('TLB') + €170m TLB add-on to support the creation of a leading European multi-protein business.
- **Project Artisan:** €204m (€154m TLB + €50m acquisition and capex facilities ('ACF') to support the buyout of a leading manufacturer of private label premium processed meat in the Dutch, Belgian and German markets.
- **Project Carus:** £69m TLB + £40m ACF to support the buyout of a leading UK manufacturer of private-label and branded dry pet food.
- **Project Paris:** €87m HoldCo payment in kind (PIK) to support the buyout of a leading Dutch company producing spreads, dips, meal solutions and bites.
- **Project Ava:** £40m TLB + £10m ACF to support the creation of a leading UK healthy snack manufacturer.

Covid-19 impact

The Food Manufacturing sector has experienced both challenges and benefits as a result of the Covid-19 outbreak, with discreet factory closures due to outbreaks amongst the workforce, foodservice shutdowns (e.g. restaurants, hotels) and delayed product introductions happening concurrently with surges in demand for staple products in both physical stores and online delivery services.

Online booms as foodservice falls - We observed a shift in demand from the foodservice channel to the physical retail and online channels for at-home consumption.

For example, **online food sales in the UK saw the greatest increase of any category, growing by 79.3% over 2020**[1] to account for 11% of the UK market, compared with c.5% in 2019. UK foodservice, on the other hand, is forecast to have declined by 57.8% year-on-year as part of a near £200bn drop in spend during 2020[2].

Such declines in foodservice sales across the UK and Europe were largely due to the hospitality sector being forced by governments to either shut down or operate at significantly reduced capacity for a large part of 2020. This has continued for at least the first few months of 2021.

1. Ecommerce grew by 46% in 2020, its strongest growth for more than a decade, but overall retail sales fell by a record 1.9%. (InternetRetailing)
2. UK British Lifestyles 2020 (mintel.com)

We observed that for the Food Manufacturing sector companies we invested in during the pandemic, **those with <15% exposure to foodservice saw a positive Covid-19 impact**, mostly driven by increased retail sales that more than offset any reduced activity in foodservice. Whilst the majority of our investments in the sector have limited foodservice exposure, those with higher exposure and without this channel mix hedge have felt the negative impact at revenue level, although some adjustments to their cost base and marketing spend slightly reduced the impact on EBITDA.

Consumers treating themselves - Consumer habits have also evolved during the pandemic, with increased spending on premium foods, indulgence products, localised food purchasing and more home cooking. **In the UK, 34% of people are indulging in more treats**[3], and overall spending on food in January 2021 was higher than levels in February 2020[4]. Curtailing of social lives and a shift to homeworking led to an extra £440m spent on sausages, burgers and chicken to cook at home.

These trends were evidenced in the resilient top line performance of our portfolio companies operating in product categories including meat & fish processing, ambient food, snacks & chocolate and ready meals. For example, one of Pemberton's portfolio companies producing artisanal meats saw a 7% EBITDA uplift, driven by increased consumer expenditure on specific premium products in supermarkets.

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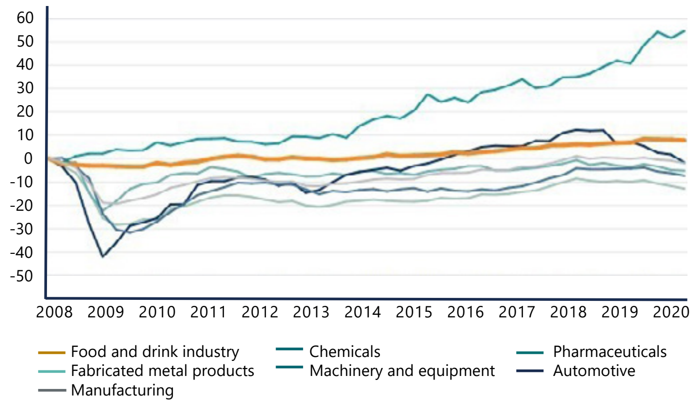
Long-term resilience - The overall food and drink manufacturing industry remained relatively resilient throughout 2020, with production volumes in the EU remaining broadly stable after c. 1% growth p.a. over the last few years. **Our portfolio of food companies experienced a weighted average revenue increase of 9.3%** during YTD-20 vs. PY, with some of this growth driven by acquisitions[5].

This **resilience is evidenced further by looking back to the 2008-09 financial crisis, when production only fell by c. 1% over the two years**. Since 2008, only the Pharmaceuticals sector has displayed a greater resilience to economic shocks, having been by far the highest growth sector in the EU.

Volume of production in the EU manufacturing industry (% change relative to the first quarter of 2008)



Source: Eurostat (STS).

In this context, Pemberton has remained very active in the food sector since the Covid-19 outbreak and has used its sector expertise to strategically invest in companies displaying resilience and positioned to benefit from the current environment. We have completed a total of six transactions since February 2020.

Beyond Covid-19 – Key investment drivers and themes

M&A drives loan demand - Acquisitions are typically a key growth pillar for most food companies to complement the slower organic growth potential in what is a relatively mature market. Across our food manufacturing portfolio, our strongest companies continued to invest in M&A activity in 2020. Since our initial investment, **7 of our 12 portfolio companies in this sector have made one or more acquisitions**, typically allowing them to broaden their product offering or expand geographically whilst realizing synergies via cross-selling and cost rationalisation. For example, Pemberton recently supported Project Galatea to become an international multiprotein food group and a leading processor and supplier of seafood and pork.

In order to provide flexibility for our portfolio companies to execute their growth strategy via acquisitions and capex investment programmes in their production sites, Pemberton usually provides sizeable committed ACF facilities as part of our financing packages.

Production and supply chain efficiencies - Achieving production efficiencies through improving manufacturing processes, including via the modernisation of production lines and automation, is also key in the industry, particularly in order to maintain margins that can come under pressure from retailers and increases in labour and raw material costs. The latter has been a key focus point

3. COVID-19 Study - European_Food_Behaviours_Report.pdf (eitfood.eu)

4. UK consumer spending falls sharply as lockdown bites (ft.com)

5. YTD-20 Pemberton portfolio data refers to trading from January 20 to September-December 20 (depending on data availability and with the exception of one company where this refers to January to July 20).

since the Brexit vote for most UK companies importing raw materials from the EU and relying on EU workers.

Whilst the trade deal between the EU and the UK avoided the introduction of tariffs on goods, the additional administrative burden might create some disruptions for those companies with weaker procurement and supply chain functions.

> Consumers are often more attracted to small brands that possess healthy, natural credentials or authenticity that the major brands cannot deliver in the same way.

Cost pass-through agreements are typically a feature in most trading relationships in the industry. However those companies with efficient production processes and procurement and supply chain functions are best positioned to achieve margin improvements over time. Companies manufacturing branded or differentiated private-label products also have better pricing power, which typically contributes to higher margins relative to competitors.

Shift in consumer preferences - The industry has started to see a generational shift in what consumers are looking for when it comes to food, and is seeking to address specific needs around health, lifestyle, the environment or products that provide a specific value proposition. We have seen all our recently invested portfolio companies responding to this shift through New Product Development ('NDP'), launching alternative food products, or developing their brands to highlight their high-quality or healthy, natural credentials. **We have seen companies spending up to 3% of net sales on NPD** to this effect. Competitive advantage now goes beyond just pricing.

Consumers are often more attracted to small brands that possess healthy, natural credentials or authenticity that the major brands cannot deliver in the same way. In response to these trends, many major food players use M&A and venture capital to acquire up-and-coming players before they become a larger threat.

Increasing focus on ESG – ESG continues to be a core focus for our portfolio companies in this industry. We observe increased efforts to achieve sustainability via reduced packaging, improved animal welfare, responsible procurement, resource efficiency, and food safety & quality measures.

For example, Project Galatea has strong ESG credentials as the largest producer of high-welfare antibiotic-free pork globally. Overall pigs processed receive 70% fewer antibiotics than the industry average and own breeding farms are antibiotic-free. It has 100% responsibly-sourced seafood (founding member of the 'Sustainable Seafood Coalition'), earning the company various awards and accreditation and is focused on ending animal cruelty globally as a member of the Global Animal Partnership. The company has also reduced carbon emissions by c.40% since 2016 and continues to set stretching targets for further improvement.

Opportunities ahead

With Covid-19 restrictions continuing through 2021, we expect companies with exposure to the right sales channels and product categories to continue to perform well and execute their growth strategies. For those with significant exposure to foodservice, we anticipate rebounds in sales later this year as hospitality reopens.

Focus on health and the environment, the use of online channels and consumers seeking products with particular value propositions are all trends we expect to stay. We will watch the evolution of these consumer preferences as they create opportunities for further growth in this sector.

We believe Food Manufacturing will continue to present attractive investment opportunities for Pemberton, and we will continue to support our portfolio companies and core PE relationships in this sector.

Spotlight on Project Galatea

Animal welfare/procurement

- 100% responsibly sourced seafood
- 19% reduction in soy usage since 2015
- Vegetarian feed for all pigs

Resource efficiency

- Carbon emissions reduced by 38% in the pork business since 2016 and 42% in seafood since 2016
- 83% landfill avoidance in 2019 in pork, 68% reduction in landfill since 2016
- 38% reduction in water usage in pork business since 2016, 12% reduction in seafood since 2018

Contact us

These are our thoughts based on our view of the market. We would love to hear your opinions, so please feel free to contact us with your questions or comments.

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