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Venturing In Food and Agribusiness

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Abstract

The food and agribusiness industries of Australia and New Zealand are economically important, diverse, largely inaccessible to public capital markets and entering the threshold of fundamental change.

Australia may have abandoned its "riding on the sheep's back" rhetoric, but the investment community at large has yet to fully appreciated the difference between Agriculture and Agribusiness. Agribusiness refers to the industry or activity that is involved in the transfer of primary products, such as wheat and wool, to manufactured goods or services - value adding. Agriculture is the production of the previously mentioned commodities.

The economic credentials of the food and agribusiness sectors highlight the important levers of change that will generate investment opportunities, and demonstrate the case for venture capital to these industries

Industry Snapshot

The diversity of the food and agribusiness industries is exemplified at the macro-level where, in the Australian case, the ABS classifies the industry into 17 sub-sectors each ranging in turnovers of between $240 million to $10 billion per annum (1995/96). Sector performance in terms of growth is also widely diverse, with annual compound growth rates varying from -4.3% to 12.7% in the 1990/91 to 1995/96 period. At the micro-level, the Australian and New Zealand food and agribusiness industries comprised approximately 6,500 separate enterprises ranging in size up to $5.5 billion in sales (The New Zealand Dairy Board). Such diversity means that successful investors must set about acquiring extensive and detailed knowledge and analysis.

The food and agribusiness industries of the Australian and New Zealand economies had sales equivalent to $68.9 billion in 1995/96. This represented approximately 12% of those countries' combined GDPs. During the five year period 1990/91 to 1995/96, the Australian and New Zealand food and agribusiness industries exhibited a compound annual growth rate of 6.0%, clearly outperforming GDP.

Approximately 32.6 per cent ($22.5 billion) of the industry's turnover is exported, predominantly to Asia. Despite the region's well documented economic predicament, growth of exports continues to be approximately twice that of domestic growth.

In addition, food and agribusiness is Australasia's largest manufacturing industry (28.5 per cent of total) and largest manufacturing exporter (34 per cent of total). Underpinning this strong industry position is the fact that Australia and New Zealand are internationally competitive sources of food and agribusiness products. This competitive advantage is characterised by climate, space and terrain, as well as proximity to population dense markets throughout Asia, which are significantly less suited to the production of the types of meat, dairy, fibre, grain and vegetable products for which demand is accelerating. In the international dairy industry alone, Australia and New Zealand are ranked in the top two exporters on the world market (excluding inter-EU trade) in the cheese, butter and skim milk markets and in the top four players in the whole milk powder market.

The investor's difficulty in accessing and extracting returns from this diverse set of opportunities is exacerbated by the public market/private market split. Only approximately 30 per cent of the Australian industry turnover is represented on domestic public equity markets. Indeed, 50 per cent of that industry's turnover is in the hands of private, unlisted or statutory bodies.

Sources of Opportunity - Levers of Change

Opportunities for investors are likely to arise principally, but not exclusively, as a result of changes taking place within the industry. The nature of these change factors will impact differently on various industry sectors and enterprise types. The investor then will need to adapt itself - its deal structure and investment process - to a variety of situations.

(i) Domestic Deregulation and Industry Rationalisation

The removal of entry barriers to markets such as wool, dairy and domestic grains should increase the efficiency of these industries and create a greater market focus. With heightened competition, opportunities are likely to arise for venture capitalists in the expected rationalisation of any over-capacity and under performing industry sectors.

An increasing awareness of competition policy among governments has seen these sectors at least commence the process of deregulation. In the wool sector, the dismantling of the reserve price scheme was accepted as policy several years ago, but unfortunately the legacy of the stockpile remains to be progressively unwound. As this occurs and the supply overhang is eroded, value added service providers are gradually appearing to introduce innovative trading and risk management products, enhance the quality and reliability of the product, and improve the efficiency of the wool storage and handling services.

(ii) Enterprise Restructuring

Changes to co-operative legislation, the Australian Stock Exchange's listing rules, the review of preferential tax arrangements provided to cooperatives and government agendas are helping stimulate enterprise restructuring. Value recognition, enhancement and realisation stemming from a heightened emphasis on achieving economic returns on assets employed, and a better utilisation of human capital should stimulate the value adding activities of many significant but under performing enterprises.

Namoi Cotton Capital Restructure

The Australian cotton industry is relatively young, and therefore does not suffer from many of the structural industry inefficiencies which impact upon traditionally regulated industries in Australia such as dairy, sugar, wheat and wool. However, in 1994 the limitations of Namoi Cotton Cooperative's capital structure created a number of issues that directly impeded its ability to compete in an increasingly competitive domestic and international market, primarily:

Namoi Cotton had no access to outside equity capital. The only sources of funding for business growth opportunities were capital retained or injected by co-operative members or additional borrowing; and

The status of Namoi Cotton was such that its members, as holders of equity capital, had no basis to recognise the intrinsic value of their investment in Namoi Cotton.

While recognising the constraints of its then current structure, the directors of Namoi Cotton also recognised the strong marketing benefits associated with the co-operative structure of Namoi Cotton. The directors wanted to retain grower control of the entity through its co-operative structure whilst solving the above issues.

The introduction of Co-operative Capital Unit ("CCU") provisions in the co-operatives legislation and recent changes to ASX policy have permitted Namoi Cotton to undertake this restructure, satisfying key capital raising and value recognition objectives, whilst retaining co-operative status and grower control.

The resultant structure employs two classes of capital:

Grower Shares allow the members of Namoi Cotton to retain control of the entity; while

The value of the underlying business is recognised through the value of Namoi Capital Stock, which are to be listed on the ASX to provide liquidity to existing grower shareholders and to provide a means to access new capital from third party investors.

As a result of the restructure and ASX listing, significant value has been released to the grower shareholders of Namoi Cotton. Prior to the restructure, one co-operative share was tradeable amongst its members at $2.70. At the time of listing we estimated the value released for each equivalent co-operative share to be, on average, approximately $9.60, represented by one grower share of $0.20 and approximately 11.75 Namoi Capital Stock units at an underwritten market value of $0.80 each. Namoi is currently trading at approximately $0.78 per share.

The Namoi Cotton restructure is a catalyst for a venture capitalists positioning in the food and agribusiness sector to access like-kind opportunities, particularly in providing equity capital over the period between the acceptance by members of the limitations inherent in their co-operative and the date of its restructuring.

(iii) Technology, Biotechnology and Innovation

The application of new technologies and techniques should not only serve to transform ingredients into more highly specialised and refined food products but also stimulate markets in services, technology and intellectual property.

Innovation Produces Shareholder Value

Between 1989 and 1996, innovations in technology, techniques and product forms produced outstanding capital gains for entrepreneurs in the food industry.

Pasta House and The Kettle Chip Company were both founded by entrepreneurs in 1989 and both sold to major food companies in 1996.

Pasta House introduced fresh chilled pasta and sauces to the Australian market around 1989. While initial capitalisation is not clear, it is inferred from publicised reports to be no more than $2 million. By 1992, the business had been built to a sales turnover of the order of $17 million. In that year, Pacific Dunlop acquired a 75 per cent interest in Pasta House for a sum reported in accounts to be $9 million.

By 1995, sales had been built to around $40 million and the two founders sold their remaining 25 per cent stake to Pacific Dunlop for $25 million. Pacific Dunlop, in turn, sold 100 per cent of Pasta House to Pillsbury for $100 million in January 1996.

The Kettle Chip Company was formed in 1989 by five entrepreneurs, who introduced to the Australian market an American method of batch-cooking potatoes (in the healthiest oil) as soon as they were sliced. The labour intensity of hand cooking pushed costs up 20 per cent but produced a product of distinctive flavour and bite.

By 1996, in a market dominated by the major multi-nationals, Smiths and Frito Lay, sales had been built to approximately $20 million. The Company slowly built by its founders, with "no exposure", was sold to Arnott's in August 1996 for $26 million.

As the company's net assets were of the order of $3 million, it is understood that the original investors in the business received well over $20 million for "goodwill".

(iv) Growth of Export Demand

Australia and New Zealand export food and agri-products to most countries in the world. Although one quarter of Australia's exports are to the USA, UK and New Zealand, Asia is still the dominant market for food and agribusiness exports from Australia and New Zealand.

The Asian food market, valued at more than 20 times the size of Australia's domestic food market, is growing particularly rapidly. It is expected that by the year 2000, Asian consumers will spend (compared with their present levels) an additional $213 billion per annum on food.

The potential opportunities for Australian exports to Asia are significant. Australia currently supplies less than 10 per cent of Asia's food imports, and the Australian Bureau of Agricultural and Resource Economics has forecast that food and beverage exports to Asia will increase an estimated 174 per cent from 1995/96 to 2010.

Notwithstanding the recent regional financial and currency problems, the Asian economies are expected to continue to provide a sustainable platform for growth in the food and agribusiness sectors well into the next century.

(v) Market Access and Trade Liberalisation

The Uruguay round of GATT may result in the twin benefits of increased market access (eg. to Japan) coupled with a reduction in subsidised competition (eg. European dairy), facilitating export opportunities and the establishment of offshore branches of Australasian enterprises.

It is expected that a number of co-operatives may be encouraged to restructure their capital base in order to access funding required to support international expansion opportunities.

Given the market opportunity, favourable conditions and the correct financial structure, the industry must look beyond 'shipping commodities' and apply the focus and discipline to develop brands and customer loyalty.

(vi) Supply Chain Management

Vertical integration and market globalisation should not only remove inefficiencies but also serve to improve quality through greater customer focus and harmonisation of supply chain activities.

The Meat Supply Chain

The meat sector has consistently under-performed other food and agribusiness industries, in part due to significant supply chain problems. As supermarkets now supply the greatest proportion of retail meat sales, conditions exist to re-configure the supply chain to better serve the requirements of more significant and sophisticated businesses and their customers.

The potential benefits of this re-engineering of the protein supply system include:

- enhanced product quality;
- enhanced product safety;
- brand integrity;
- increased product yield;
- reduced capital requirements and operational expenses.

This re-engineering involves new methods of product storage and transport, proprietary software for system management, and documented processes and standards to enable central cutting plants to replace retail butchers. Potentially this process will sell, lease or franchise intellectual property and provide high returns on capital. Leading international retailers have committed to beginning this process.

(vii) Change in Domestic Demand

Changing demographics and consumer demand are opening up new opportunities and new markets. These changing demand patterns are largely a result of the shifting workforce patterns and the cultural diversity within Australia and New Zealand.

Domestic consumers are favouring:

- less time in preparing meals;
- access to fresh and frozen prepared food at all hours; and
- greater variety and quality of foods.

In response to these changing trends, numerous product opportunities exist in the food and beverage processing industries including pre prepared meals, ready prepared vegetables, microwave meals and a larger range of flavours and products.

Accessing Opportunities and Value in the Food and Agribusiness Industries

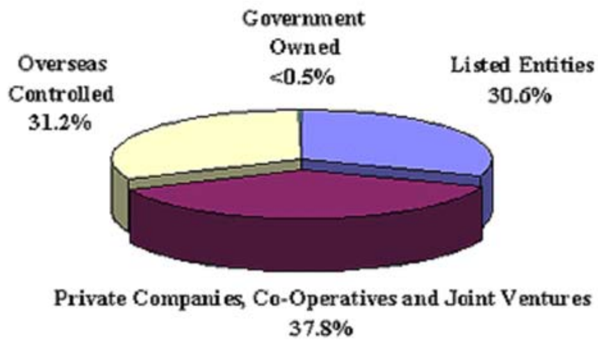
Historically, public access to investments in the Australian and New Zealand food and agribusiness industries has been difficult due to:

- the presence of large multinational food corporations;
- the relatively small number of the medium sized food and agribusiness companies listed on the Australian and New Zealand stock exchanges; and
- the substantial private, co-operative and government ownership of entities within the food and agribusiness industries.

In relation to the food and beverage sectors, this is illustrated in Figure 1.

Figure 1 Breakdown of the Food and Agribusiness Industries

Total Sales Value: $41 billion



Source: Food Management Journal, December 1997. Top 200 Food & Beverage Manufacturing Industries.

What is required to access these opportunities is a focused and disciplined investment vehicle, specialising in food and agribusiness. The Food and Agribusiness Investment Fund ("FAIF") is the only specialist venture capital fund investing in the food and agribusiness industries. FAIF aims to provide investors with access to these future opportunities within the industry by investing in the sectors, which are otherwise inaccessible for traditional Australian and New Zealand investment vehicles.

FAIF is managed by Gresham Rabo Management Limited ("GRML"). This is a joint venture between Rabobank, the world's leading specialist food and agribusiness bank, and Gresham Partners, a prominent Australian investment house with extensive experience in the food and agribusiness sectors. The Manager and its related entities have a strong market presence in servicing private companies, farm co-operatives and unlisted companies and government authorities in the food and agribusiness industries. The accumulated expertise is a result of Rabo Australia Limited's banking activities and Gresham Partners' corporate advisory and investment activities in these industries.

Investment Criteria

FAIF's investments will be made across a variety of structures including companies, co-operatives, joint ventures and other unlisted vehicles.

The Investee Entity should, in the Manager's opinion, exhibit most of the following characteristics:

- participate in an industry sector demonstrating sustainable growth, which is driven by either an internationally competitive cost structure and/or rapid growth in the underlying level of demand;
- participate in an industry sector whose underlying profitability is growing or is poised for growth, due to industry rationalisation from deregulation and/or market forces, including innovation;
- be an entity capable of outperforming sectoral volume and profitability growth based on measurable sustainable quality and/or cost competitive advantages;
- be an entity possessing enterprise strength demonstrated across most of the following areas: management capability, financial health, technical capacity, market position, information systems and absence of legal or contractual contingent liabilities;
- be an entity that is likely to benefit from equity injection and FAIF's participation in achieving its potential.

In all of our investments FAIF seeks significant, although not necessarily a controlling, participation in the Company's management and the opportunity to exit within the order of five years.

For early stage, innovation based enterprises we will seek products or processes which have passed at least through the early prototype stage and which are adequately protected by patents, copyrights or trade secret agreements.

Investment Size

The equity investments in Investee Entities will typically be significant minority interests of between 5 per cent and 25 per cent of the value of the economic entity, and which justify FAIF being represented on the board of the Investee Entity in a fashion, which allows FAIF to add value to the strategic and financial development of the business.

Target Investment Return

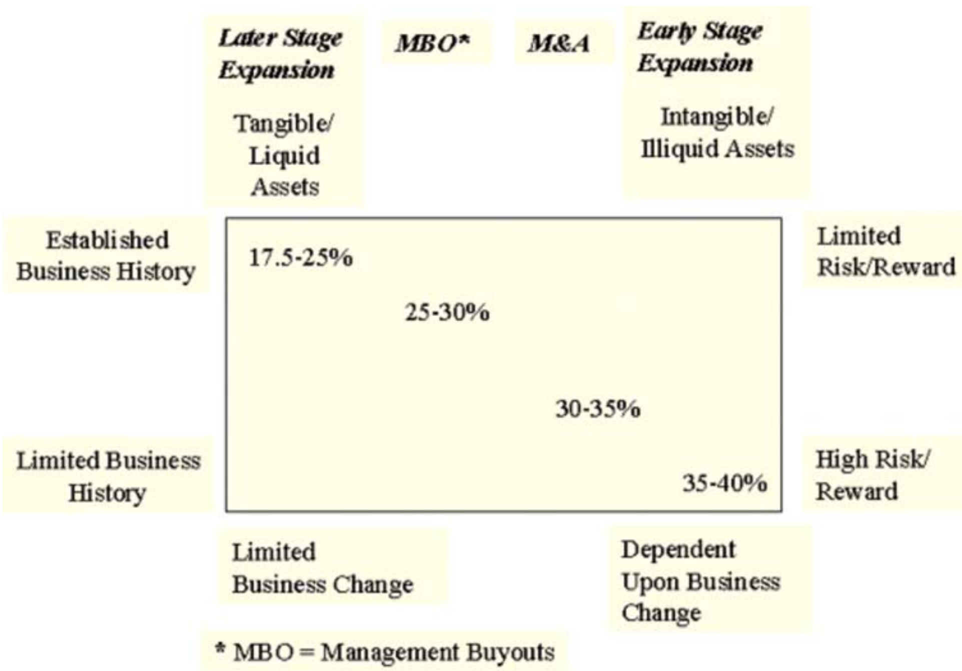
FAIF is targeting to achieve a return over a five-year period of 125 per cent of the average pre-tax return on the Food and Household Accumulation Index for listed equities during the five-year period.

The actual return the Fund makes is dependent upon the portfolio of investments it makes and how well it assesses the expected risks and returns. This is reflected in the following analysis. Risk and hence, return, will be a function of company specific risk and investment category risk.

Company specific risk in a venture is likely to be a function of the degree of established trading history, the degree of prospective change and the degree of tangibility/liquidity in assets.

Investment category risk will be a function of the stage of the business expansion. Aligning investment categories to generic risk, we can identify the following ranges of target returns for broad investment categories, where position within the range is determined by degrees of tangibility/liquidity of assets.

Figure 2: Range of Target Returns for Investment Categories



The lower end of the range, 17.5 per cent is an estimate of where 125 per cent of the Food and Household Goods Accumulation Index might eventuate over the next five years. At this end of the scale would be well-established businesses, in sound markets, which take advantage of restructuring opportunities. Alternatively, at the opposite end of the scale, are businesses with little track record, introducing new technology in deregulating markets. Thus 35 to 40 per cent represents the accumulated risks in the business, products and markets.

Exit Strategy

A clear perspective of the likely exit strategy/ies is required at the stage of investment. Typically, FAIF would wish to see the potential for either a trade sale or IPO exit within a three to five year time frame. Lack of suitability for either of these significantly reduces the attraction of the investment. Regular review of exit timing and outstanding issues to be addressed will take place from the time of investment.

Management incentives are linked to the performance of the investment at the time of exit. An important task of the Manager will be to review trade sale opportunities as well as the appetite of the local (or international) IPO markets.

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