Appetizing Investing in Unbranded Food Manufacturers

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The food industry is rich with investment opportunities, many of which are in unbranded food. Changes in consumer preferences are creating growth companies in an industry with stable, long-term demand. Furthermore, with market volatility leaving investors uneasy of cyclical industries, food becomes an appetizing option because it is more market agnostic. For investors looking at the many opportunities in food, the key to success is to identify the companies with sustainable and valuable long-term differentiation.

Without brand equity, food manufacturers need competitive advantages to ensure the strong margins and growth that investors desire. In many respects, unbranded food companies are merely a category of specialty manufacturing—they can have competitive advantages that arise from many attributes—and this similarity makes unbranded food a great fit with generalist private equity firms.

Differentiation among unbranded food manufacturers generally falls into several categories:

1. **Production or Delivery Differentiation** – First and foremost, attractive food manufacturers almost always have valuable, relatively unique, and difficult to replicate advantages in their production or delivery. For example:

   - a salsa manufacturer with a strong geographic advantage near fresh ingredients;
   - a marinade and condiments company with differentiated product development, unique manufacturing techniques, and highly efficient, short-run production; and
   - numerous companies with highly differentiated and valuable food safety protocols in categories which demand it.

   On the distribution side, many route-based companies that can deliver quickly, safely and reliably offer great service models that drive strong margins.

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2. **Loyal Customers with High Switching Costs** – The uniqueness of the food manufacturer is typically reflected in the loyalty of its customers. These customers may be retailers (i.e., store brands) foodservice operators, and/or other food manufacturers, but the high perceived switching costs create loyalty and drive higher margins. The most loyal customers will not have regular, competitive RFPs every year, nor will they split the business between competing suppliers. Some of the customers will rely on the manufacturer for innovation; the customer is essentially outsourcing its R&D and/or category management. In other cases, the food manufacturer may be the only player in the market capable of providing its product or service at the quality level demanded by the customer. The company's financial performance reflects this uniqueness.

3. **End Market Trends** – If a company has great differentiation and loyal customers, the end market will drive growth and valuation multiple. Often, the end market becomes the most critical ingredient for driving investor demand. Is the category on trend? Looking beyond obvious opportunities such as private label healthy snacks, how else are end markets shifting in a way that generates more demand for the unbranded food manufacturer? While better-for-you is certainly in favor, other trends may create opportunities in indulgent categories such as snack pies, cakes or doughnuts.

4. **EBITDA Evidence** – The company's income statements should reflect its competitive attributes. Like a great brand, a great unbranded food investment can have terrific margins. However, great brands typically have strong gross margins, while the unbranded businesses are more usually defined by their EBITDA margins. If an unbranded food company has EBITDA margins of greater than 15%, such margins are uncommon and an obvious sign of real differentiation—the stars are aligning for investment! EBITDA margins above 10% are still quite good and worth investigating further. Below 10% requires some explanation; it may indicate commodity pressure or the opportunity to improve the business, though opportunities certainly exist at all margin levels.

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The unbranded food world has many companies that demonstrate the above attributes and more. Better yet, these opportunities are often privately-owned and provide private equity with additional value-creation opportunities as the first institutional capital. In many cases, the unbranded food companies have every reason to trade at premium valuations consistent with branded food.

David Houser is an investment banker at Lincoln International, specializing in mergers & acquisitions advisory services for the consumer industry. David has more than 25 years of investment banking experience, which ranges from transformational growth brands to leading private label companies. He has represented leading consumer-focused private equity investors and partnered with founders of high-growth private companies. He has advised on a number of cross-border transactions involving Chinese and other foreign strategic acquirers.

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