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Learning to deal:
What toll will rising commodity costs take on the food industry?

By David Houser, Managing Director, Lincoln International

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During discussions with food industry executives, Lincoln International, a Chicago-based independent mid-market investment bank, now hears one question more than any other: "With the increases in commodity costs, can deals get done?"

Make no mistake, we are in a period of big price increases in food commodities, and these increases have an impact on merger and acquisition activity that is impossible to ignore. In the food industry, the increases are pervasive — corn, dairy, wheat, beef, etc. Name a commodity, and chances are its price is increasing.

Can deals get done in this environment? Fortunately (for those of us who rely on deal activity), the answer is "yes." From our firsthand experience, food deals still are getting done and at attractive valuations. At Lincoln International, we expect to complete a record number of completed food transactions during 2008.

This does not imply that the deal environment is the same as it was 12 months ago. It is not. We might not see the early 2007 level of liquidity and resulting valuations for many years to come. However, compared to a longer time frame, merger and acquisition activity and valuations (both in and out of the food industry) remain good. Deals get done, albeit with some challenges.

With respect to commodity costs, there are current challenges in the food industry for both the food processor and the food investment banker. For the food processor, the challenge relates to the uncertainty and a seemingly impossible task of implementing price increases at the same rate of cost increases.

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Companies that are passing along those increases also are maintaining their margins. Other companies, not able to get price increases, are facing rapid margin declines.

For the food investment banker, the increases in commodity costs also create difficulty. As background, uncertainty can be the bane of an investment banker's existence. Uncertainty often is a deal killer. In periods of uncertainty, buyers and sellers typically have a different view of future margins, different view of future profitability and, not surprisingly, a different view of current valuations.

In today's food market, the impact of commodity costs often relates to one key question, "Is the food processor successful at implementing price increases with its customers?"

We hear different answers almost daily. Some processors assure us that (pick one) Wal-Mart, Kroger, Food Lion, etc., will never agree to a price increase. For this type of company, a deal is a long shot (and, in this environment, their long-term viability is questionable). Buyers will realize the company, unable to get price increases, is under tremendous margin pressure. Unless the company is sold in a lender-driven or distressed sale, a deal is unlikely.

Other processors show us calendars of the almost constant implementation of price increases. For these companies, buyers remain interested because the long term outlook is more favorable (any margin declines are temporary) and the company has demonstrated that is has something unique that gives it negotiating power with its customers. In the current market, these are the companies getting sold at premium valuations. **RFF**

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