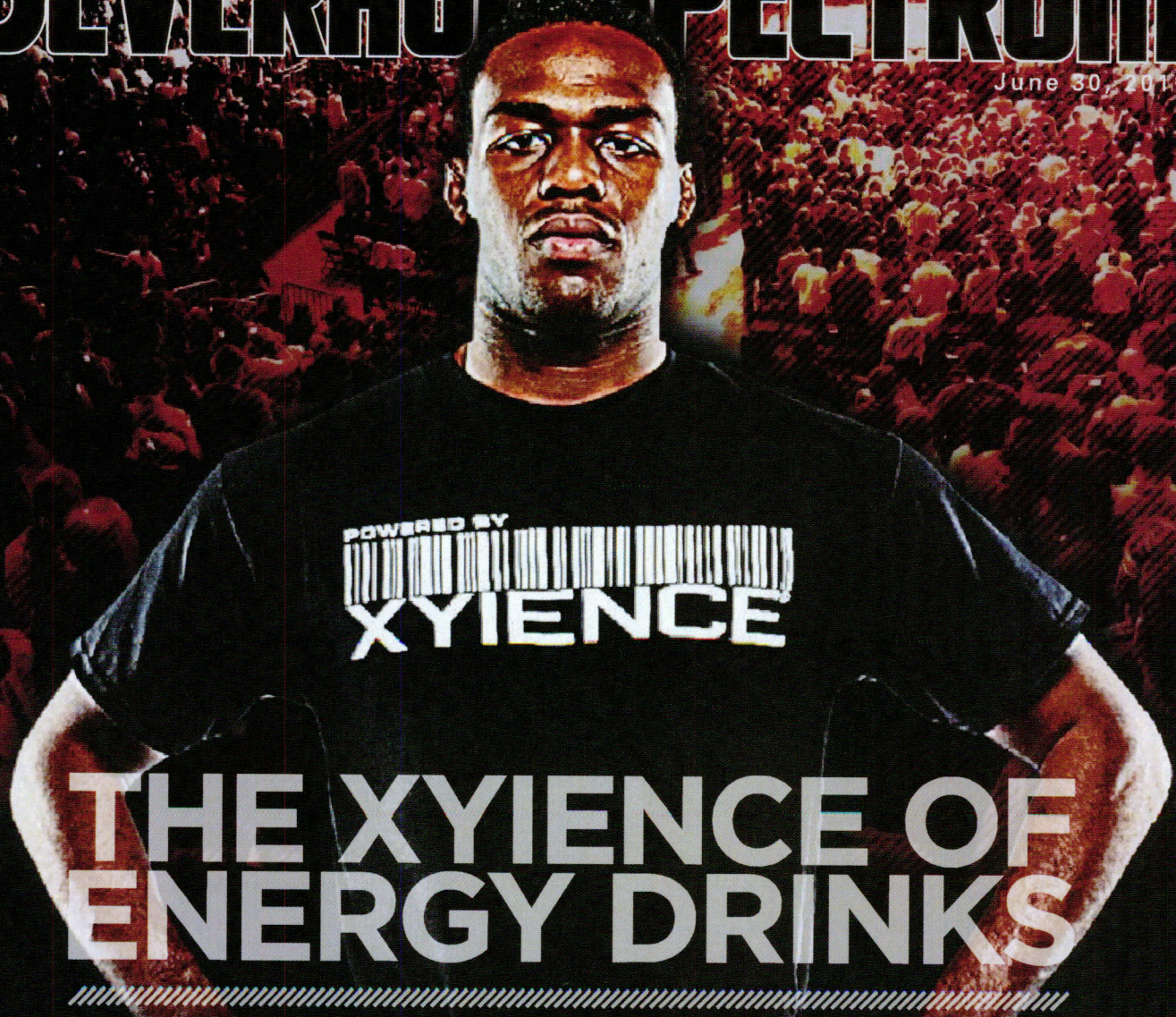


NEW PRODUCTS, TRENDS & INNOVATION

# BEVERAGE SPECTRUM

June 30, 2011



## THE XYIENCE OF ENERGY DRINKS

Riding UFC, Category Consolidation, zero-cal Xenergy is a knockout

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# HOW TO MONETIZE INNOVATION

## INSIGHTS FROM THE STRATEGICS

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As an investment banker advising consumer-focused companies, I see many business plans from innovative food and beverage companies looking to sell their company. To successfully sell a company, in fact, I've found that innovation is often an essential component to make it attractive to a large strategic buyer. Innovation is a broad term, of course, and when it comes to food and beverage companies, it can take many forms: novel ingredients; supply-chain advantages; science-based functionality; breakthrough packaging; or unique branding, marketing, social media and/or messaging. It can include products with new usage occasions, that utilize new distribution channels or have unique merchandising. Knowing the scope, it's important to think about what matters to the strategic investor and what delivers the return for the entrepreneur.

To see what those large strategic investors are thinking, I spoke with some friends at eight of them. (To understand the size, the average 2010 revenues among them were near \$40 billion). All asked that I not attribute thoughts to any specific company, but taken together, they provide some very interesting insights, particularly when it comes to trying to gauge how entrepreneurial beverage companies should align themselves as they try to grow and attract attention from potential acquirers. So here's what I learned:

### MITIGATE RISK

Inevitably, large beverage companies have to innovate. To do so, they will either invest or acquire, or else build internally. Because big companies tend to be risk-averse, they tend to be slow. On the other hand, smaller companies, with smaller staffs and limited decision-makers, can act quickly and use that nimbleness to their advantage. So the larger the risk to be taken, the more likely it will originate externally. But here's the rub: to eventually get acquired, over time, companies must minimize those risks. For example, if a product uses less-common ingredients or complex molecules, this can raise questions: Are they safe? Have they been tested? How do they interplay with other ingredients? Smaller companies can often get away with things (ingredients, packag-

ing, claims, marketing) that will make a larger strategic uneasy. Simply put, because they are large, the scrutiny microscope (and the legal department) gets bigger. Take the risk early, but, even if you can't put it into practice right away due to budgetary or size constraints, you should know how to mitigate those risks by the time you want to sell.

### THERE IS ROOM FOR THE SIMPLE AND THE COMPLEX

Strategics are looking for and will pay for both. Not every innovation needs to be, say, a relaxation beverage with 12 ingredients you can't pronounce. Simple innovations can be big: think coconut water (one ingredient), Honest Tea (low-calorie tea in a bottle), Coca-Cola's fridge pack for cans (consumer s use more, so buy more). Every strategic I spoke with believes there is room left for these simple innovations, but interestingly, many strategics say that the simple can often be the most difficult for them to spot. For example, several pointed out that just three years ago, coconut water was not identified through internal strategic planning sessions.

### EARLY IN DEVELOPMENT CAN WORK, BUT HAVE PROOF

Strategics are clearly open to investing or buying earlier-stage (under \$25MM sales – sometimes even as low as \$5MM) beverage companies these days. Part of the reason is that they want to ride the innovation wave, instead of coming in after (“let's avoid the \$4.1 billion for Glaceau...”). But early needs to come with proof points: same-store sales, deep consumer insight – clear traction in the marketplace. Many strategics are willing to partner and test those ideas before buying.

### FIT

Make sure your innovation aligns with your strategic buyer. Often the biggest questions asked by a strategic center on whether the company is an appropriate fit: is it the right size (both current size and eventual potential brand sale potential) and is the timing right (for the strategic and the growth company). Innovation alone is not sufficient, but it is a required element together with other aspects like business model and management team – it must all come together – and must fit with the large company's view of the world, capabilities and strategic direction.

### DON'T FORGET THE BOTTOM LINE

Innovation is just as important for the top line as well as the bottom line. One strategic said, “many younger companies forget that all areas of the P&L are on the table.” In other words, if you have an innovation that might save money or increase efficiency, it might be just as valuable than one that increases revenue. Strategics want to drive overall company success, not just one brand's top line.

### TAKE TIME AND FOCUS

One strategic advised that entrepreneurs take time to grow their brand. “Consumers don't want innovation forced on them;

## » SOME EXAMPLES OF INNOVATION TYPES

### PACKAGING

Plant-based bottles; Eco-Shaped bottles; Fridge Packs; Sportstastic; refrigerated almond milk



### DEMOGRAPHIC

Tampico and Rowland Coffee (Latino Market)

### HEALTH/ WELLNESS

Good Belly (probiotics)

### SIMPLICITY/AUTHENTICITY

Honest Tea; Coconut Water (Zico; O.N.E); VitaminWater

### PROCESS DELIVERY

5-Hour Energy; Activate (caps)

### INGREDIENTS

Acai (Sambazon; Zola); Chia (Mamma Chia)

### SUPPLY CHAIN ADVANTAGES

Coconut water; Acai

### SCIENCE-BASED FUNCTIONALITY

Function Drinks; FRS; Nawgan

### USAGE OCCASION

Muscle Milk (protein)

### MARKETING - CHANNEL

5-Hour Energy; Mona Vie

### COMPLEX

Relaxation drinks



instead, they want to be part of ‘discovering’ the innovation.” In doing so, the so-called “early adopters” become brand ambassadors and entrepreneurs have the time to perfect their idea over time. One investor told me that “nothing on Day One will ever end up being the final proposition. You need to invest time and energy to learn, tweak and change... otherwise, the chances of failure grow quickly.”

### STAY AWAY FROM THE EDGE

Both breakthrough innovations and a slight tweak may be tough for strategics. The breakthrough edge of the spectrum can raise questions (and hence, risk) such as: Is the innovation just “too much”? Is it safe? Is it sustainable over the long-term? And something small may not be enough to move the needle. A happy medium may be the best approach. “Consumers move gradually, but it’s tough to be on either side of the spectrum...being too far out there on the pioneering -edge innovation can sometime pose too much risk for a larger buyer.”

### HAVE A CLEAR POINT OF DIFFERENTIATION IN THE MARKETPLACE

There is no innovation in “me too.” You need to set yourself apart, know and own your target consumer and show that you can scale with your differentiation. A name like Honest Tea has elegant simplicity and broad permission to move in new directions. Such “must-have” names alone can be enough, they told me.

Beyond a good name, however, these big beverage companies are looking for innovations in many areas. They’re looking for healthy beverages in growing markets, like products that can play to fast-growing demographics like the Latino community, packaging innovations, process-delivery innovations and technology innovations. Some established categories mentioned where strategics thought there was still room to grow include tea, lemonade, functional beverages and natural sweeteners. Also, more innovation for the mainstream is needed, both with innovative products that don’t come with a required premium price and speak to the masses, and products with the taste and messaging to help move people away from sugar-laden products –innovations that can help with larger cultural issues.

In the end, my friends spoke about how the magic of innovation comes from the interplay of taste, feel, messaging, functionality, brand and ingredients – but they also said that there’s little magic without cash generation, same-store sales growth and execution. There are just no economics and no exit for companies lacking the last three characteristics. And innovation can take time: As one strategic noted, most entrepreneurs create a product for their community (friends, social networks, family, peers) and as they start to expand the brand beyond that universe, they need to keep it true its original mission (what it started out to be) but continually innovate and evolve so the appeal becomes broad enough for a larger audience. To get there, it’s all about execution.

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