NEW PRODUCTS, TRENDS, AND INNOVATION

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POUCH PROFITS

How an innovative package reinvigorated malternatives - and gave this little iguana a home.

ENERGY DRINK CONTROVERSY: BEVNET'S COLUMNISTS WEIGH IN

CHANNEL CHECK: YEAR IN REVIEW

Strategics

Private Equity

and Timing

The Blurring Lines

By Michael Burgmaier

As an investment banker with Silverwood Partner working in the healthy/active living consumer packaged goods (CPG) space, I've often said that the joke about investors is true – they enter the room walking backwards with their eye on the exit. Perhaps entrepreneurs and founders should, as well. Unless you are building a company to comfortably live off of cash flows, you will need to sell your company at some time. In addition, your investors will also need liquidity at some point. For most companies, your options can include dividends from cash flow, being bought out, going public, or selling the company.

Most people I meet in the beverage space have started their company with one objective in mind: to grow enough to sell to a large strategic buyer like Coke or Pepsi – and for a lot of money.

Today, however, the role of the strategic is changing. These companies don't only participate as exit options. More often, in fact, they are providing investment capital to help build companies. A sale is often considered as a potential result, but it can take a while.

Why is this happening?

In 2006, Glaceau (VitaminWater) had sales of approximately $355 million and in March 2007, the company was acquired by Coca-Cola from its founders and investors, including the Tata Group, for $4.1 billion in cash. Will that happen again? Monster Energy rumors aside, it's not likely. Strategics still acquire, but their preferred method is evolving, and lately it seems to be through investing with a path to acquisition, sometimes called the "two-step" deal. It's starting to become a well-troden road with increasing corporate traffic: Coke with Honest Tea and Zico, Pepsi with O.N.E., Hershey with mix1, Dean Foods with White Wave (Silk) and more.

Large food corporations like General Mills are doing this now too. Over the last two years, our direct conversations with strategics in regards to investing in earlier-stage food and beverage companies have increased dramatically. We frequently talk to and advise both companies looking to gain investment capital or sell, and also large corporations on their strategy and plans to set up official investment arms or incubators like Coca Cola's Venturing and Emerging Brands (VEB) group.

We know that strategics want fast-growth, big-potential, on-trend brands to be a part of their larger brand portfolio. And they know that innovation happens quicker and can be more adept outside of the large strategic. But if there are increasing opportunities to get strategics involved early on, there are also new, important questions that complicate decision-making for entrepreneurs and investors.

TWO-STEP STRATEGIC BEVERAGE DEALS

TARGET	STRATEGIC	OUTCOME
Honest Tea	Coca Cola (VEB)	Investment & Acquisition
Bossa Nova	Coca Cola	Investment; Decided to not acquire
Sweet Leaf	Nestle Waters	Investment & Acquisition
Zico	Coco Cola (VEB)	Investment & Acquisition
O.N.E.	Pepsi Co	Investments & Majority Acquisition
mix1	Hershey	Investment & Acquisition
White Wave (Silk)	Dean Foods	Investment & Acquisition

We consistently get these questions from beverage entrepreneurs about strategics:

- When should I talk to a strategic?
- Am I too small and too early?
- Can I trust the strategic?
- Should I talk to just venture capital firms (VCs) when I want to raise capital, or strategics as well? And which do I talk to first?
- What information do I have to share before the strategic will sign a non-disclosure agreement (NDA)?
- Should I be worried about talking to a strategic – won't they just learn from me and do what I am doing on their own?
- If I do a deal with a strategic, how do I structure it? How do I protect my company? What terms can I expect? What can I push for?

These are all complicated questions and ones that we deal with on a daily basis on behalf of our clients. But they fall into two main groups: (1) When to talk with strategics; and (2) What can and should a deal with a strategic look like.

WHEN TO TALK WITH STRATEGICS

We recently embarked on a capital raise for a client where the client initially believed they were too small to talk with strategics. As we talk with the likes of Coke, Pepsi and Nestle on a near-daily basis, we knew otherwise. Sure enough, more than one leading strategic demonstrated strong, genuine interest in our client.

The question of company size and stage of development needed to have reached should be in order to talk with strategics will vary somewhat with the strategic you're talking about; in general, as little as $5 million in sales (trailing-12 month or genuine run-rate) can garner true interest. And if the ramp to $5 million happens quickly, talking with investors on that ride before $5 million is reached can be a good idea (and can even lead to an early term sheet).

But how that $5 million sales figure was achieved is also critical: sell-in vs. sell-through, sell-through velocities, distribution white space, success in natural vs. conventional, brand extendibility… in short – do you have a convincing story to move from $5 million to $300 million, $500 million and potentially $1 billion in sales? (For more information, see my previous articles "Numbers Rule" from the Feb. 2012 *BevNET* Magazine and "Capital Market Success" from Sept. 2011)

Your own objectives also matter. Are you talking to a strategic because you want to get on that path to sell today (and/or with that specific strategic investor) or do you just want to assess longer-term interest? Either way, the dialogue itself can lead to valuable learning and create positive external results. For example, talking to strategics can enhance opportunities with raising institutional capital.

Earlier this year, we identified the hole in the market for a client's product with strategics and contacted the most likely eventual buyer. Our thesis that the strategic would like and eventually want this brand proved true, even though our client was much smaller than most companies the strategic would normally think about investing. The interest became real: We exchanged NDAs and held five in-person meetings. We were told exactly what we needed to create for them to buy, and this interest helped garner interest from financial investors. The result: Close to $5 million raised and a company on its way with a strong financial partner, lots of free and valuable advice from the strategic and a long-term buyer keeping tabs on progress and perhaps ready to pounce when the timing and size are right.

As strategics are willing to come in early,and provide valuable feedback to help prime the pump for longer-term interest, we now often include contacting a carefully-selected group of strategics with a carefully-crafted message as a part of our capital-raising process for clients.

WHAT SHOULD A DEAL LOOK LIKE?

Remember, though: a strategic will want to invest in a company because they hope to eventually buy all of it. They don't want to invest, add value and then wake up to read the Wall Street Journal that you've sold to someone else.

The issue here becomes how to creatively structure rights for a strategic to buy you that do not overly hurt the company and its shareholders. But how do you, as the company, structure such a deal to provide the best eventual outcome for you and your shareholders? You are setting up a deal that may have a great outcome, but if it's structured poorly, you may be doing nothing more than setting up a relatively "free look" at your company for the strategic, with little down-side for them – and potential risk for you.

Face it, when you sign a deal with one strategic and it is public (or becomes generally known to 'those that know') you are also likely limiting your exit pool. If you do a deal with BigCo A and they have a right of first refusal (i.e. they can match any deal that another company puts forward to buy your company), why would BigCo B spend time to conduct due diligence on your company and put an offer forward? All they are doing is setting the price and market for BigCo A. In this case, you have limited your options – and, likely, your shareholder returns as well. As with any deal, the terms matter. Some of the more important terms and issues to consider when doing a deal with a strategic include:

Approval Rights (Negative Covenants) and Governance:

- Does the strategic as an investor get the right to block certain items, such as the company raising additional capital?
- Will the terms and structure of your deal potentially inhibit or help your ability to raise capital from outside sources in the future?
- Can you take on debt above a certain amount or change the strategic direction of the business?
- Will the rights granted to the strategic investor align management and the investor on long-term goals?
- Will the strategic get a board seat? How many seats? Who from the strategic will be on the board? What if the person from the strategic who did the deal leaves the company or changes roles? How can that impact you?

Value Add:

- Is the strategic bringing in money or more than just money?
- What will they assist with? Distribution? R&D? Marketing? COGS reductions? Supply-chain?
- How will you ensure that the value-add occurs?
- What does the strategic get for the value add?

The Path to (and rights regarding) Acquisition:

- Does the strategic get a Right of First Refusal? If not, what other means can you employ to grant this "need" to the strategic?
- How do the rights and deal structure impact your goal to maximize the exit value while the strategic wants to minimize it?
- How does the acquisition work?
- Are the "triggers" which turn on the acquisition time-based, financial-based or a combination?
- If certain triggers or milestones are met, does the mechanism involve a Call (the strategic "calls" the remaining stock to acquire) or a Put (the company "puts" the rest of the stock to the strategic)?
- What if there is no acquisition due to milestones not met or other issues? How do you disentangle the deal, the ownership, any value add (distribution) and move forward with as little damage as possible?

Each of these questions and issues aforementioned are probably each worth their own article and require good thought, preparation and careful negotiations. Our advice is simple: get a good advisor and deal counsel – in other words, have your own deal team.

These questions and issues are complex, but when the rewards can be immense, they should be. The opportunities have never been better for younger and smaller food and beverage companies to engage and partner with strategic investors and buyers. When we run a process (to either raise capital or sell), we thoroughly examine both potential strategics and financials (private equity). Our relationships with both help the process and open doors. When you think about your company's longer-term (and near-term) options, don't be too quick to discount or eliminate the strategic path – if you do so, you may be eliminating the best potential option, limiting competition for your deal and potentially reducing your longer-term options.