PE Firms Scarf Down Food Deals

But Will Some Investments Bite Back?

By Lauren Pepiciello and Megan Spillane

The branded food industry has seen a significant increase in activity as of late. With deals ranging from franchise restaurants to packaged supermarket foods, private equity firms have been taking advantage of the steady cash flow stemming from a strong consumer market.

After **Parthenon Capital**, which acquired Atkins Nutritionals Inc. at the height of the no-carb craze in October 2003, lost big when the company was forced to file for bankruptcy in early August, many investors became somewhat wary of a similar situation. That's why, in an industry where investors are constantly making bets on which companies they think will flourish, executives are trying to focus more of their efforts on doing deals with companies that have proven brands and a relatively long history. There is virtually no risk that any of the products offered by TB Corp. (Taco Bueno), which has been around since 1967, Papa John's International Inc., which was founded in 1985 or Hill & Valley Inc. baked goods, which was founded in 1987, can be mistaken for fads. **Palladium Capital Partners**, **Milestone Capital Management LLC** and **Circle Peak Capital LLC** acquired these companies, respectively, in late August.

Regardless of the risks involved, the food sector is a good market right now. Consumers are spending, and given the fact that there are more two-income households than ever before, people have more money to eat out, as well as less time to prepare food in their homes.

Branded Packaged Foods

Private equity investors have often turned to branded food products, ranging from staple supermarket items like Tropicana orange juice to diet conscious products like Gardenburgers because of the level of stability they can provide.

"It's a sector that offers some protection over a broad economic cycle, and there have been some very successful investments in the food sector that haven't been trendy concepts that involve more traditional buyout characteristics—decent purchase price, management possibilities, and expanding distribution and branding," said **R. Adam Smith**, a managing partner at Circle Peak.

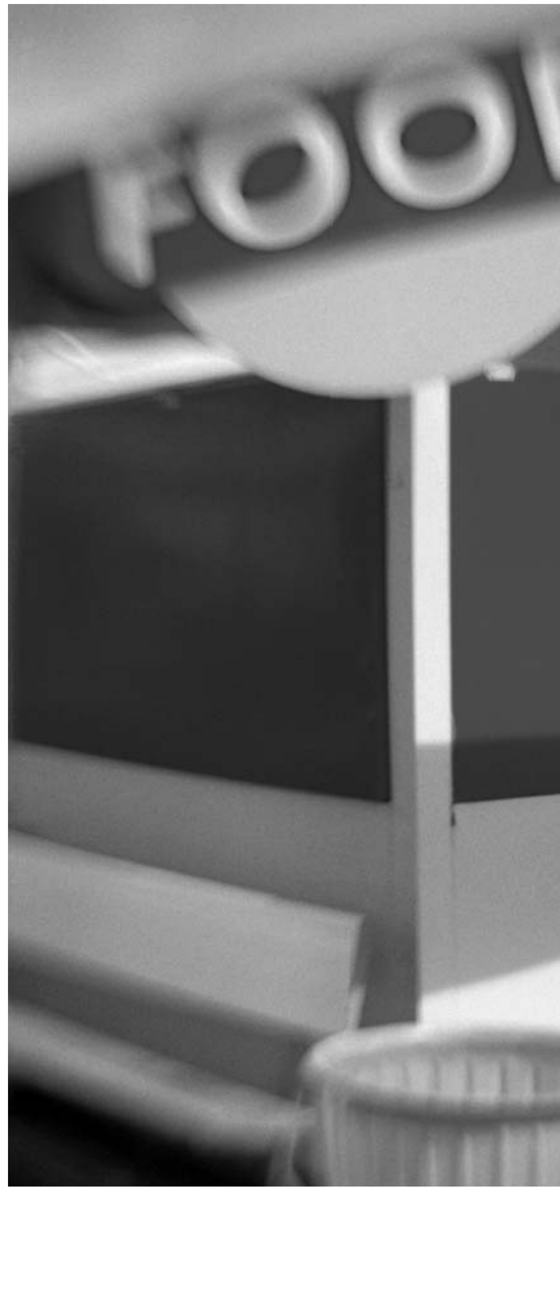
Circle Peak plans to focus on branding and distribution expansion as it attempts to grow its newly acquired platform company, Hill & Valley Inc.—a manufacturer of sugar free and no-sugar-added baked goods sold in supermarkets nationwide under the Hill & Valley brand name and other private labels.

According to **Scott Becker**, a founder and managing partner of **Northstar Capital LLC** who served in the M&A division of General Mills Inc. during the 1980s, profits can often be made in the sector over time even without needing considerable growth of the brand name. "Traditionally levering up food companies has proven to be successful because of the consistency that you can expect in margin over time, especially if it's a branded established product," Becker said. "There is a degree of comfort in terms of the amount of leverage put on a food transaction that can be sustained without much growth on a debt pay-down platform because of the stability of cash flow."

Still, investment opportunities within the sector come with changing trends, and, as evidenced by the Atkins collapse, the fine line between a new trend and a fleeting fad can often be hard to decipher.

"There is a continuous evolution of food consumer trends and product development that offer investors different entry points into the food sector, so there are always a lot of opportunities that occur as trends change," Smith said.

Neal Aronson, managing director of **Roark Capital LLC ,** maintained that the often trendy diet food industry typically goes through five-to-six-year cycles, which allows more than enough time for some investments, like **Invus Group's** Weight Watchers International Inc. deal, to be fully realized. New York-based Invus bought Weight Watchers, which distributes branded frozen food products and snack foods, in addition to providing weight loss services, in 1999 from H.J. Heinz Co. for $735 million. The buyout shop, which is the U.S. extension of **Artal Luxembourg SA**, took the company public



with the help of **Credit Suisse First Boston** on Nov. 15, 2001 in one of the most profitable IPOs of the year. Invus netted a 13x equity return on its investment.

Despite American consumers' obsession with healthy trends and fads, packaged food deals are taking place in other niches as well. **Monomoy Capital Partners LLC** recently completed its first investment since the firm's founding in March, 2005 with its purchase of Awrey Bakeries Inc. Monomoy completed the deal alongside **Hilco Equity Managaement LLC**. Awrey, which filed for Chapter 11 bankruptcy in February, produces and sells frozen pastries, doughnuts, cakes and other sweets and breads to distributors and retail outlets in the U.S. and Canada.

In other packaged food news, Cadbury Schweppe's is rumored to be considering a sale of its European soft drink division, which includes products like Orangina and Schweppe's ginger ale, tonic water, seltzer and club soda. Cadbury hired **Goldman Sachs** to auction off the division, and a number of Private Equity firms including the **Carlyle Group** are rumored to be interested.

Restaurants and Franchises

Many private equity executives who have invested in the restaurant/franchise sector are not surprised by the recent upturn in restaurant deals—mainly because many of them recognize that this aspect of the food industry is driven by a cyclical interest.

According to Aronson, whose firm specializes in franchise investments, namely Carvel, Cinnabon, and most recently McAlister's Deli, the excitement over restaurant deals "comes in waves."

"There are periods of one, two or three years when private equity investors have been very excited about the restaurant industry, and then there will be a period of three or fours years when many investors hate the restaurant industry," said Aronson. "There has been an increased level of activity in the restaurant industry in the last 12 to 24 months, and that's exciting."

Lawrence Golub, founder and president of **Golub Capital**, which has just completed its eighth restaurant investment in the past two years, said that around 2002, in particular, few people would touch a restaurant deal.

"I think that today you are seeing a significant number of sellers who either acquired restaurant businesses in the 1999-2000 time frame, rode them through the downturn in the restaurant industry in 2001- 2002 and see the current environment with good performance as an opportunity to sell," said Golub.

In fact, *Buyouts* only recorded a total of two successfully completed restaurant transactions in 2002. Morton's Chicago Steakhouses was acquired by **Castle Harlan Inc.** in the third quarter of that year for $171.9 million, and, on a much larger scale, Burger King was acquired by **Texas Pacific Group** and Goldman Sachs in the fourth quarter for $1.5 billion. Though other food deals took place during 2002, the restaurant sector saw little activity.

Many factors have led to the upturns and downturns in this sector, an important one being the overall economic and consumer trends that tend to pave the way to success in this sector. This was most evident in 2001 with the economic situation following Sept. 11, 2001.

"In 2001 and 2002 there was a confluence of factors. The recession led to reductions in consumer spending and that combined with post 9/11 travel contractions, which had a particular impact on restaurant concepts tied to tourist destinations," said Golub. "That double whammy led to an industry-wide profit contraction."

Now that the economy has bounced back and a period of relatively consistent growth in the restaurant/ franchise sector has surfaced, many investors have started to regain their once muted interest in the sector.

But even though this resurrected interest has begun take hold of the private equity world, there are still concerns that go along with this, according to Aronson.

"There is a difference between a trend and a fad," said Aronson. "What attracts people to the food and restaurant industries is intellectually making a bet that a certain trend will continue."

Aronson added that in cases where what is thought to be a trend turns into a fad, you can end up with a disastrous situation, like the one Parthenon found themselves in with the Atkins deal.

"There is a reason why investors have fallen in and out of love with the restaurant industry over time, and that is because sometimes these consumer trends people have bet on through a restaurant chain have worked and some have not," said Aronson. ❖

Circle Peak Acquires Hill & Valley

In light of the Atkins Nutritionals Inc. collapse, one might think that buyout shops would be hesitant to invest in a diet food product. But neither the carb catastrophe nor the recent increase in Splenda sweetened products kept **Circle Peak Capital Partners** from acquiring **Hill & Valley Inc.**, a longtime producer and distributor of sugar-free and no-sugar-added baked goods.

No financial terms were revealed, but **Fifth Third Bank** of Chicago provided senior debt and **Prism Mezzanine**, a division of Chicago's **Prism Capital Corp.**, provided mezzanine financing.

Hill & Valley's products are stocked in the in-store bakery sections of 20% to 30% of grocery stores nationwide. According to **R. Adam Smith**, Circle Peak's founder and managing partner, the company's established product and customer base particularly appealed to the PE firm.

"They've been in business for almost 20 years and it's one of the oldest producers of these low sugar products—primarily for diabetics—but as consumers have looked for lower sugar alternatives, particularly in the dessert category, the core customers have evolved beyond diabetics to include non-diabetic healthy customers, and that core product capability is very exciting for us," Smith said.

In addition to reaching out to a wider array of customers, Circle Peak plans to grow the company by penetrating the natural and specialty store market, targeting restaurants and other food service categories and pursuing smaller add-on acquisitions to complement and expand the product line.

Circle Peak will continue to support Hill & Valley's current president, **Scott Florence**, but the firm does plan to add a member of its own team to the company's management. **Brian Gustaitis**, a senior executive at Circle Peak, will join the Hill & Valley board.

Gustaitis has over 25 years of consumer goods experience and food expertise, as he previously served in senior management positions at Tetley USA Inc. and Pepperidge Farm Inc. Most recently, Gustaitis served as President and COO of Kozy Shack Enterprises, a manufacturer and marketer of refrigerated pudding, where he engineered a successful financial turnaround.

"Brian's involvement will bring over twenty years of consumer goods and food expertise to the company's benefit," Smith said.

Hill & Valley was advised by **RSM EquiCo**, a division of **H&R Block**, who initiated the sale to Circle Peak. "There was an initial phase of discussions with a broad range of parties and we quickly settled to exclusivity in the first quarter," Smith said.

Circle Peak was represented by **Akin Gump Strauss Hauer & Feld LLP** and used in house operating advisors **Robert W. Kraft** and **Doris Zelinsky**. The purchase was made using the Circle Peak's latest unspecified fund. —*M.E.S.*