OAKTREE INSIGHTS

SEPTEMBER 2021

# FOOD AND BEVERAGE INVESTMENT: FINDING THE SPECIAL (SITUATIONS) SAUCE

333 S. GRAND AVE 28TH FLOOR, LOS ANGELES, CA 90071 | (213) 830-6300 | OAKTREECAPITAL.COM

# FOOD AND BEVERAGE INVESTMENT: FINDING THE SPECIAL (SITUATIONS) SAUCE

Executing complex investments in the food and beverage industry can be like cooking a complicated meal: it requires sourcing, preparation, technique and, above all, experience. This industry – which represents over 5% of U.S. GDP[1] and roughly 10% of global economic activity[2] – has gone through a volatile last 18 months, with unprecedented shifts in demand. Many companies benefited during this period, as locked-down consumers hoarded packaged foods or rediscovered the joy of cooking, but some businesses – particularly those with exposure to the restaurant industry – struggled to keep pace with the dramatic transformation in eating habits.

The reopening of the U.S. economy is well underway, but the process is proving messy for most industries, including food and beverage. Companies are facing supply chain constraints, such as transportation logjams, labor shortages, and spikes in input costs. Food-related businesses also face significant uncertainty: no one knows which pandemic dining trends will stick and which, like the run on sourdough starters, will recede.

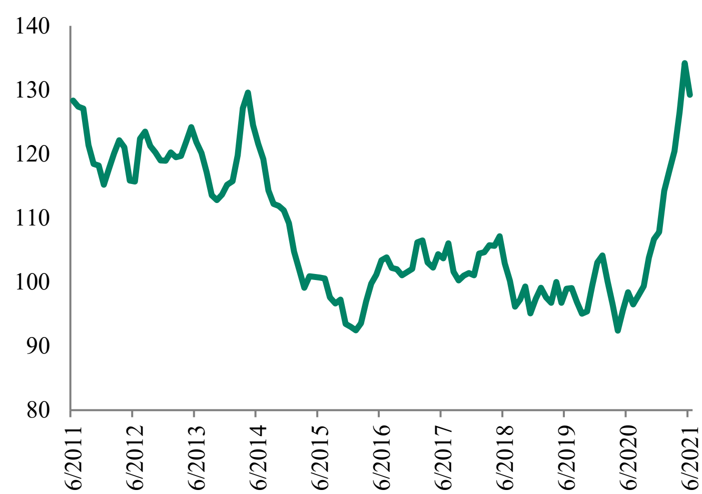
**Unfortunately, many companies have to navigate this environment under the weight of heavy debt burdens accumulated in the years preceding the Covid-19 crisis.**

These trends could create a large opportunity set for special situations investors. Such investors normally target middle-market businesses that don't have easy access to financing but do have valuable assets – like a state-of-the-art processing plant or a popular product in a rapidly growing segment. This investment style also usually involves gaining control or influence over companies seeking capital to address unique – often complex – challenges. For example, a special situations team might have provided rescue financing to a company handling a Covid-19-induced plant closure, and they might now offer capital and operational support to a firm seeking to capture market share as the pandemic ends.

**Historically, many special situations investors have avoided the food and beverage industry, likely because of its vulnerability to exogenous factors – most notably commodity price shifts.** Concern about input costs is particularly elevated now, as agricultural prices have risen by over 30% in the last 12 months to the highest level in a decade (see Figure 1). An investor may worry that companies with substantial leverage will struggle to service or roll over debt if they're unable to pass on a significant portion of rising costs to consumers.

Wariness about investing in the industry could reduce competition for attractive opportunities, potentially enabling willing investors to generate private-equity-like returns while keeping risk under control. **But to achieve this, we believe it helps for investors to possess a specific skill set – a "special sauce."** The key ingredients are tough to come by, in our opinion, but that's what makes them so valuable.

*Figure 1: Food Price Index*




*Source: International Monetary Fund Food Price Index*
*Note: 2016 = 100; includes cereal, vegetable oils, meat, seafood, sugar, and other food price indices*

## INGREDIENT #1: INDUSTRY EXPERTISE

Special situations investors often have to move quickly, as they're normally creating solutions for companies undergoing temporary dislocation or seeking to take advantage of fleeting opportunities. **Having extensive knowledge of an industry like food and beverage can give one a first-mover advantage, smoothing the entire investment process from sourcing to exit.**

First, investors with significant experience in a sector will likely have a well-developed network that can keep them abreast of industry trends and company-specific developments. Such investors may therefore be able to identify attractive deals and secure a company's support before third-party advisors have been engaged and many competitors are even aware that an opportunity exists. Experienced investors will also likely be able to speak the industry's language, potentially making it easier for them to gain management teams' trust and build successful partnerships.

For example, well-connected investors might learn from their network of plant-efficiency experts that a particular company is struggling with capacity issues or input costs. The investors might immediately know the right people to contact and be able to quickly devise potential solutions to tackle the company's problems. When seeking to act swiftly and effectively, it helps to start from third base.

Closely following a sector can also enable investors to locate overlooked niches. This is particularly useful in an industry like food and beverage that includes a wide variety of products and services – everything from cold beverages to the cold-storage network itself. A specialist may be able to identify ignored segments in which companies have sound businesses but too little scale or too much leverage. Limited competition among investors in these areas may allow teams targeting these niches to invest at relatively low valuation multiples even when the potential upside is substantial.

Additionally, such expertise may allow investors to conduct due diligence and other preparatory measures more quickly than generalists because the specialists may: (1) already have the target company on their radar; (2) know precisely which sector-specific criteria to prioritize; (3) and be able to swiftly spot both warning signs and often overlooked sources of value.

Industry knowledge can also potentially help investors better assess risks and opportunities stemming from Environmental, Social and Governance (ESG) considerations. The food and beverage industry has long faced questions about sustainability, safety and labor issues. To properly evaluate these matters, investors increasingly need to construct their own risk-assessment tools, which are far easier to produce when a team has on-the-ground experience.

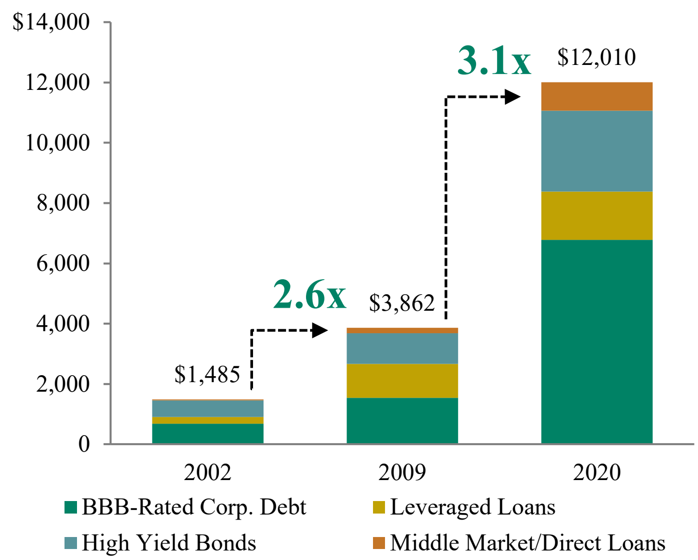
## INGREDIENT #2: ACCESS TO DEAL FLOW

Special situations investors should be able to identify potentially attractive opportunities when markets are under pressure but also at other stages of the cycle, including when the economy is humming along. **By maintaining an extensive network within an industry, investors are more likely to enjoy a healthy deal pipeline in a broad range of environments, including a unique one like investors face today.**

Food and beverage companies have always been vulnerable to unpredictable forces that can generate temporary dislocation, such as safety concerns, regulatory changes, and commodity price volatility. However, situations arising from these issues are made far more challenging if a company has to handle them while servicing a large debt load.

**The amount of low-rated global debt has tripled in the last decade (see Figure 2).** Mergers and acquisitions that occurred across sectors in the years leading up to the pandemic featured aggressive earnings adjustments, which made the debt taken on to support these deals appear sustainable, often falsely so, shrinking the margin for error (see Figure 3). And competition among private equity sponsors for M&A targets enabled companies to borrow at historically high multiples of earnings.[3]

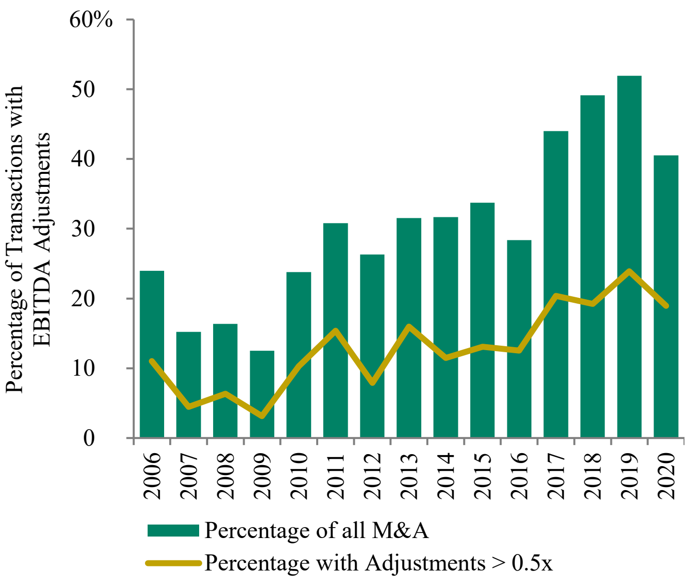
*Figure 2: Amount of Low-Rated Global Corporate Debt*




*Sources: Bloomberg Barclays, Credit Suisse, ICE BofA, Preqin, Cliffwater, Refinitiv*[4]

Many food and beverage companies borrowed heavily during this period to invest in new brands, expand distribution channels, and become more vertically integrated, among other goals. Today, pre-pandemic acquisitions may no longer make sense, and capital structures might appear far less sustainable than they did in February 2020. To paraphrase Warren Buffett, the challenges and uncertainty created by the Covid-19 crisis are likely to show who's been swimming naked.

*Figure 3: EBITDA Adjustments in M&A Deals*




*Source: S&P Global LCD, as of December 31, 2020*

**At the same time, we believe the pandemic has created new opportunities for companies in this industry by altering consumer habits and accelerating trends, such as the shift toward delivery services.** Middle-market companies will likely need financial flexibility to grow and compete in the radically altered post-pandemic landscape. This means companies may increasingly require <u>both</u> creative financing <u>and</u> organizational transformation as they correct past mistakes and position themselves for future growth.

Investors who have an established reputation within the industry could have superior access to deal flow because management teams or other potential partners may seek them out or welcome their arrival. Such investors might be able to buy at lower multiples or extract better protections than others. That's because companies may make concessions in exchange for certainty of execution and the comfort of knowing they're working with partners who have a track record of delivering exceptional results while abiding by ethical standards widely considered high. Investors with such reputations might then have the luxury of being selective, deploying capital only when risk can be controlled.

## Ingredient #3: Skill in Structuring

**When investing in an industry that is highly exposed to exogenous forces, special situations experts should be able to structure solutions that provide substantial downside protection while also affording the company sufficient flexibility to handle whatever situation it currently faces.**

A wide, flexible investment mandate can provide a huge advantage. The ability to consider everything from structured equity to direct equity to private loans to distressed debt can help investors craft solutions that address a business's unique challenges. And a bigger toolkit provides more options for risk control.

Take, for example, a publicly traded snack company with valuable brands, strong growth potential, and significant market share that has a weak stock price and an unsustainable capital structure due to poorly executed acquisitions. Investors might help the company reduce its immediate cash needs and pay off expensive debt by providing new financing that allows interest to initially be paid in kind (i.e., in the form of additional debt). These investors might also seek to buy warrants at a hefty discount to gain more influence over the company and the ability to participate in its potential recovery. To increase the likelihood that this turnaround will occur and further control for risk, the investors might insist on being given seats on the company's board of directors and the ability to appoint an operating officer (including the chief operating officer) from the investors' deep talent bench.

Each special situation is, by definition, unique. But we believe investors with sector knowledge and structuring experience will be better positioned to know which industry-specific pitfalls to watch out for and how to contractually protect against them.

## Ingredient #4: Operational Know-How

Simply providing capital has rarely been sufficient to achieve above average performance when investing in complex situations in the food and beverage industry. This will likely remain true in the uncertain post-pandemic world. **We believe investors must be able to both fix problems in a company's capital structure and employ private-equity-style management techniques to improve operations while encouraging organic and inorganic growth.**

Once again, industry expertise can be an advantage. Investors with a long track record in the sector may be able to quickly identify a company's weak points and have internal resources available to rapidly address them.

Consider a fast-growing organic food firm that is suffering from operational issues and struggling to integrate an acquired business. An experienced investment team staffed with dedicated operations professionals would likely do more than reduce the business's leverage: it might also insert some of its own team members into the company. These operations experts could design an extensive plan to create value by, for example, optimizing the product mix, improving logistics, expanding access to supply-chain data, or locating new customers.

Having a large pool of talented operations professionals and seasoned executives to draw from may also help investors speed up improvements at portfolio companies. First, investors with this resource don't have to spend time trying to locate candidates who are well suited for management positions or board seats. And established trust between investors, operations experts and executives can potentially help control for one form of risk – negative surprises stemming from management. This dynamic can give investors the confidence they need to be aggressive when tackling complex, pressing challenges.

Finally, we believe fixing operational problems and creating long-term value requires an active approach to ESG matters. Regulatory, health, and safety issues are major considerations at many food and beverage companies because of the nature of their products. In our opinion, addressing these concerns goes beyond simply monitoring them or providing guidance on appropriate ESG benchmarks; investors should be able to offer a playbook that shows management how to improve these metrics.

## PUTTING IT ALL TOGETHER

Oaktree's special situations team, whose members have an average of 20 years of experience, believes there isn't one recipe for investment success – in food and beverage or any other industry. **But we think possessing all of the above ingredients better positions investors to take advantage of opportunities in any market environment, including one characterized by tremendous uncertainty.**

No one knows exactly what the post-pandemic economy will look like or what special situations it will create for food-related companies. It's tough to sketch out the shape of the new restaurant-industry normal; it's impossible to know how workers' breakfast and lunch habits will change if hybrid and remote working persists; and, of course, no one has any clue what will happen with inflation. But we think a few assumptions about the industry are likely safe bets: consumer tastes will continue to evolve, ill-advised acquisitions will weigh on performance, and the appetite for creative solutions to complex challenges will remain very healthy.

## JORDON KRUSE

*Managing Director and Co-Portfolio Manager*

Mr. Kruse is a managing director and co-portfolio manager of the Special Situations Group. He is responsible for management of the strategy and all of its investing activities. Prior to joining Oaktree in 2001, Mr. Kruse was an attorney at the law firm of Kirkland & Ellis where his practice focused on mergers and acquisitions, corporate finance and private equity. Mr. Kruse currently serves on the boards of directors of Caerus Oil & Gas, Strawn Petroleum Holdings, Crossroads Building Supply, and Bus Patrol, Inc. He previously served as a director of numerous former investments in a broad range of industries. In addition, Mr. Kruse serves on the Board of Trustees of The Children's Bureau of Los Angeles, the Board of Directors of the Los Angeles Food Bank, the Board of Trustees of The College Foundation of the University of Virginia, and the Law Board of the Northwestern University Pritzker School of Law. Mr. Kruse received a B.A. degree in history and government from the University of Virginia and a J.D. from the Northwestern University School of Law where he was a member of the Order of the Coif and served as a Note and Comment Editor of the Law Review. Mr. Kruse is a member of the State Bar of Illinois.

## MATT WILSON

*Managing Director and Co-Portfolio Manager*

Mr. Wilson is a managing director and co-portfolio manager of the Special Situations Group. He is responsible for management of the strategy and all of its investing activities. Prior to joining Oaktree in 2007, Mr. Wilson worked at H.I.G. Capital, LLC, where he was a founding member of Bayside Capital, Inc., a firm focused on special situations and credit-oriented investments. Previously, he worked at J.H. Whitney & Co., in its middle market buyout group. Mr. Wilson began his career in the Investment Banking division at Merrill Lynch & Co. He currently serves as Chairman of the Board of Directors of Agro Merchants and Boardriders, and on the board of Glam Squad. Mr. Wilson previously served on the boards of AdvancePierre Foods, Billabong International, Diamond Foods and the Bridge Direct. He is also the previous Chairman of the Board of Trustees and currently serves on the Board of Directors of The Children's Bureau of Los Angeles. Additionally, Mr. Wilson serves on the Board of Trustees of The Chadwick School. He earned a B.A. degree with distinction in economics and history from the University of Virginia and an M.B.A. from the Harvard Business School.

## ZACH SEREBRENIK

*Managing Director and Assistant Portfolio Manager*

Mr. Serebrenik is a managing director and assistant portfolio manager for Oaktree's Special Situations Group. Prior to joining the firm in 2008, Mr. Serebrenik spent two years at Dune Capital Management LP as an analyst in the Special Situations group, where his responsibilities included sourcing, due diligence, financial modeling and monitoring investments. Prior thereto, Mr. Serebrenik was an associate in the Private Equity group at Soros Fund Management. Before that, he spent over two years at Goldman, Sachs & Co. as an analyst in the Mergers & Strategic Advisory group. Mr. Serebrenik currently serves on the boards of Blue Ribbon Partners, City Brewing, and SunOpta. He previously served on the board of Agro Merchants. Mr. Serebrenik graduated with highest honors from The University of Texas at Austin with a B.B.A. degree in business honors and finance.

## ENDNOTES

[1] U.S. Department of Agriculture, as of 2019.

[2] World Bank, as of 2018.

[3] Refinitiv, as of March 31, 2021.

[4] Bloomberg Barclays, Credit Suisse, and ICE BofA data as of July 31, 2021; Preqin and Cliffwater data as of December 31, 2019; middle-market loan data from Refinitiv as of September 30, 2020.

## NOTES AND DISCLAIMERS