

Fehr Foods: A Step Forward in Nutresa's Expansion Plan

by

Mariana Ochoa Ramírez

Carlos Esteban Saldarriaga Morales

A thesis submitted in partial fulfillment of
the requirements for the degree of

Master of Financial Management

at the

University EAFIT

Medellin, Colombia

2015

Abstract

*In memory of Mr. Steve Fehr (1950-2015),
a name ever to be remembered with gratitude and respect.*

Keep flying high!

In 2009, Grupo Nutresa, Colombia's largest food company set an ambitious and challenging growth plan for the years to come. Bearing in mind the competitiveness and potential of its business units overseas, since the year 2000 the company defined the internationalization process as a key objective for its business model development and sustainable growth (Grupo Nutresa, Informe anual y de sostenibilidad, 2013). As part of it, the Americas were defined as the strategic region to continue on with its market enlargement and penetration plan.

In 2009, the Investment Banking Firm McColl Partner, LLC (which had recently carried out an investment process for Grupo Nutresa's sister company, Grupo Argos), came into contact with Nutresa suggesting them the acquisition of Fehr Foods, a leading value-priced retail packaged cookie manufacturing company in the U.S.

Known today as Abimar Foods, this acquisition was consistent with the company's previously defined expansion plan to enter the U.S. market. According to Grupo Nutresa Biscuits Business Unit perspective, it was aligned with their management and business policies, and their sales were supported through a local facility (Grupo Nutresa, personal communication, April, 25th, 2015).

The purchasing process was relatively quick and in 2010 Fehr Foods was incorporated to Grupo Nutresa Biscuits Business Unit. About a year later, Mr. 4M, who was the financial manager of the Cookies Business, was designated as Fehr Foods' CEO.

In September 2011, one year after Fehr Foods had been acquired, some concerns on the main financial statements and business performance report arose. There was an important gap between the figures estimated in the valuation exercise and the ones given by Fehr Foods. Additionally, the U.S. economy downturn, an important increase in the price of the main raw materials, and the commercial aggressiveness of the local market competitors, played against the situation, configuring a less encouraging picture. In consequence, the Fehr Foods team realized the challenge they were facing and hence understood they needed to take actions immediately.

Fehr Foods: A Step Forward in Nutresa's Expansion Plan

History of a Young Company

Fehr Foods was founded in 1992, in Abilene, Texas, where its headquarters are still located. Steve Fehr, CEO and majority owner until 2010 formed the company through a purchase of baking assets in Abilene, under chapter 11 of the U.S. Bankruptcy Code. The company started operations with two small capacity ovens and an annual revenue of approximately \$1.5 million, through private investors who financed the assets purchase and funded working capital. Along its development path, two significant plant expansions occurred in 1997 and in 2005, totaling \$4.5 million and \$12.0 million of investment respectively. In the same year of the last investment expansion, Fehr Holdings, Inc., parent company of Fehr Foods, Inc., acquired the assets of Bake-Line LP (later renamed Oktex Baking, LP) in Marietta, Oklahoma, under Chapter 7 of the Bankruptcy Code.

In 2010, the Company produced over 1.5 million pounds of cookies per week with national and international distribution in markets such as Mexico, Panama, and the Caribbean, selling over 80 million pounds of cookies yearly.

In 2010, Fehr Foods Inc. was one of the leading value-priced retail packaged cookie manufacturing companies, with second-tier branded products and high-quality private-label product line. It had highly automated equipment with bulk storage facilities, up-to-date mixing, forming, and packaging equipment, and multiple flexible production lines. It had around 100 customers across the U.S. and distributed its products in dollar stores, wholesale grocery stores, independent food distributors, prisons, and retail grocery segments, reaching more than 20,000 stores.

Cookie Market Overview

In 2009, the United States cookie market generated around \$5 billion in sales, remaining strong despite a recessive global economy and volatile commodity prices. The branded cookie market was concentrated in the hands of a few large players, including Nabisco, Keebler, Little Debbie, and Pepperidge Farm. Kraft Foods' Oreos, Chips Ahoy and Nilla Wafers were the three largest brands. McKee's Little Debbie had had the strongest growth in those years. These national brands were sold through grocery and convenience stores and other channels at premium prices.

On the other side, smaller manufacturers had experienced either significant consolidation or closures over the last few years. Certain market participants, such as Archway Cookies (which filed for bankruptcy in 2008), was squeezed out of the market due to volatile raw material costs and increased competition. As a result of this turmoil, smaller manufacturers had moved away from the lowest-price model towards the high volume, private-label market.

Fehr Foods was nonetheless able to achieve its outstanding performance by lowering its price point below those of other brands, while keeping it higher than the private-label products. This dynamics created a quality value-priced segment that appealed to cash-strapped consumers.

Such an approach favored Fehr Foods to an extremely attractive growing segment of the overall cookie market, becoming a competitive option to serve many markets and customers who could not meet volume requirements for a full line of private-label items. Specifically, those who competed in quality with national brands but were sold at lower prices.

While the overall cookie market had been relatively flat for the last six years, branded value-priced cookies and private-label cookies grew significantly. Fehr Foods

products acted as an alternative for customers who could not afford their own private-label brand and were incurring extra costs associated with such products. The economic downturn had favored dollar stores and discount retailers at the expense of retail grocery stores and wholesale grocery distributors.

In terms of market drivers, households with children consumed on average 20% more cookies than households without children. This population segment had increased from 34.7 million in 1997 to 36.8 million in 2007. On the other hand, Hispanic population was much more likely to buy and eat cookies than other ethnic groups. The Hispanic population reached 45.4 million in 2008 and was forecasted to grow by 13% between 2008 and 2013, representing thus the fastest growing ethnic group in the United States. (McColl Partners, 2010)

Fehr Foods Products and Brands

Three main cookie categories were covered by Fehr Foods product portfolio: wire cut, rotary, and sandwich cookies. The first product line, wire cut cookies, included chocolate chip, oatmeal, iced oatmeal, coconut macaroon and sugar. Its sales represented approximately the 33% of total revenues in 2010.

The second product line included almond windmills, coconut bars, big country cookie, animal crackers, chip delights, butter bites, moon cookies, butter cookies, and graham meal. It represented approximately the 20% of total revenues for the same year.

The third one included a variety of sandwich Crème Cookies with vanilla, chocolate, peanut butter, lemon, strawberry, and fudge flavors. It accounted approximately for the 46 % of the total sales. These last two product categories were produced under own brands and private labels.

The remaining 1% was represented on products manufactured by third parties. In terms of brands, Fehr Foods had Lil' Dutch Maid, Sun Valley, and Tru-Blu, which represented 78.7%, 0.1%, and 1.3% of fiscal 2010 sales, respectively. On the other hand, private-label Brands accounted the other 19.4%.

Manufacturing Facilities Overview

Fehr Foods has two production facilities: one in Abilene, Texas with 150,000 ft², and the other in Marietta, Oklahoma with 164,000 ft², reaching together a weekly installed capacity of 2.7 million pounds of cookies in 2010. Its production capabilities can be understood through three main processes: bulk storage units with automated ingredient handling for flour, granulated sugar, and high fructose corn sweetener; automated mixing and packaging equipment; and multiple production lines used to simultaneously produce three categories of cookies.

Abilene Facility

In 2010, Abilene facility employed more than 270 individuals and included a 122,000 ft² production facility and 25,000 ft² warehouse with 13 overhead dock doors, eight-hour shifts, five days a week, for 120 hours a week per line. It contained five production lines ranging from 150 to 220 feet (oven length).

Marietta Facility

In 2010, Marietta employed 66 individuals and included a 100,000 ft² production facility, a 60,000 ft² warehouse with 15 overhead dock doors and 4,000 ft² maintenance facilities. It operated two lines at approximately 33% of capacity in aggregate, under ten-hour shifts, typically four days a week, for 40 hours per week per line.

Fehr Foods Market Approach

The pool of Fehr Foods clients can be grouped in five segments: dollar store, wholesale grocery, independent food distributor, prison, and retail grocery. In the following sections these categories will be explained taking into account its impact in sales and particularities.

Dollar Stores

This segment accounted for 52% of total revenues in 2010. The significant economic downturn drove frugal consumers to more value-priced shopping options. Households with annual incomes less than \$25,000, are more likely to shop at these stores. Lower income households eat an average of 8.3 packages of cookies per month compared to 6.7 packages of cookies per month for households with incomes greater than \$100,000 per year. Over 50% of consumers report shopping at dollar stores once a month, while 46% purchase at food products stores.

Wholesale Grocery Distributors

It represented 15.6% of Fehr Foods sales in 2010. It sells more than two-thirds of all cookies and cookie bars in the United States but have recently lost market share to mass merchandisers, such as Wal-Mart, dollar stores, and drugstores.

Independent Food Distributors

In 2010, it represented 13.7% of total revenues.

Prison Business

It accounted for 11.6% of 2010 sales. In this segment, each single business must be won in an annual bidding process. Contracts are adjusted for consumer price index rates.

Retail Grocery Stores

In this segment, consumers traditionally buy cookies as part of their regular shopping habits or as an indulgence purchase. Although cookies have long shelf life, consumers generally limit the amount of cookies of their purchase per store visit in order to limit the amount of cookies in the household expenses. This segment accounted for 5.6% of the 2010 fiscal year Fehr Foods sales.

Miscellaneous and Other

It accounted for 1.6% of 2010 Fehr Foods sales. It includes vending services, school districts, and other customers who do not fall into one of the five categories previously explained.

International Customers

It accounted for 10.3% of its sales in 2010. The largest market outside the United States is Mexico, due to its proximity to Laredo and El Paso.

Business Performance

As a market leader in the value-priced wholesale cookie sector, Fehr Foods business model allowed it to have a stable cash flow by selling products in high volume as a value-priced alternative to the significantly more expensive national brands. In addition, very competitive acquisition costs compared to the industry could be reached through a variety of risk management financial coverage instruments (futures, options, and OTC structured derivatives).

Its price strategy was aimed to access all economic levels across North America, based on FOB Abilene costs. The final selling price was directly influenced by the raw material commodity market changes, freights, payment terms, marketing allowances, program costs, and volume. Given the ability to manage its costs, the company was able to

remain flexible as consumer demand trends fluctuated over time, allowing them to commit toward 12 months or longer as the dollar store segment requires.

As additional operational advantages, low labor costs are possible due to manufacturing locations in Abilene and Marietta. Access to both Atlantic and Pacific coasts, as well as its close proximity to Mexico, gave Fehr Foods an optimal location for distribution channels.

The aforementioned key elements were reflected on its financial performance. This was how Fehr Foods increased net revenue and adjusted EBITDA from \$47.0 million and \$3.9 million in fiscal year 2008 to \$62.7 million and \$10.0 million in fiscal year 2010, representing CAGRs of 15.5% and 60.4%, respectively. (McColl Partners, 2010)

What was the reality of Fehr Foods in September 2011?

In September 2011, the United States economy had not yet been recovered, as it was expected, from the worst economic crisis since the Great Depression of 1929. “We have learned that the recession was even deeper and the recovery weaker than we had previously thought (...)” said Ben S. Bernanke, Federal Reserve’s Chairman with a sense of realism at the end of the summer of 2011 at the Economic Club in Minnesota Luncheon. (Bernanke, 2011).

The three economic pillars of any economy were not definitely at the level they were before the downturn. The unemployment rate was still at a considerable level of 9.1%, close to the highest rate of 10% reached on September 2009. (Bureau of Labor Statistics, 2011). The economic growth was not very encouraging either, as the growth rate of GDP was 1% for Q3, 2011. (Bernanke, 2011). Finally, the inflation had picked up significantly with an increase at the price index for personal consumption expenditures at an annual rate of about 3 to 3.5%, compared with an average of less than 1 to 1.5% over the preceding two years. (Bernanke, 2011). These were the circumstances that framed the future of Fehr

Foods. And under such a macroeconomic landscape, Grupo Nutresa would take the path that will define the destiny of the company.

From the primary raw materials perspective, the situation was also difficult since commodities prices were near to their historical maximums bringing complexity to Fehr Food's operation, which margins were highly correlated to raw materials behavior. In September 2011, for example, sugar prices were 89% higher compared to the levels reached in January 2009. These prices were above the assumptions used on valuation of the company back in March 2010. Wheat prices were not much different.

In brief, the two main commodities had increased their prices in significant amounts: 89% for sugar and 65% for wheat. This situation posed a challenge for the business management, since the increase in the raw material prices directly affected the cost of the final goods but could not be automatically transferred to the final customers as a means to remain competitive.

Mr. 4M arrives to Fehr Foods

Having to lead and manage the company amid those difficult times, and shortly three months after his designation as Fehr Food's CEO in July 2011, was also a challenge for Mr. 4M. Upon his arrival, the unavoidable and expected cultural shock took place, for it was not easy for a family-owned Texan company, traditionally led by its American owner, to welcome the new 33 years-old Colombian CEO.

But Mr. 4M was willing to accomplish the mission he was designated for. In his mind, he was determined to act always based on a principle of profound respect and understanding for the local culture. For this same reason, however, the expected brain drain took place a few months later, when the CFO and the sourcing leader both decided to leave the company; forcing Mr. 4M to either hire local talent or bring it from Colombia.

Consequently, many areas of the company had to face diverse challenges. Fehr Foods had an important employee's turnover of around 75% that needed to be addressed to bring stability to the operation. Furthermore, the concentration of the 15% of the total sales in one single customer, for instance, would surely increase the risk of unexpected sell losses in such a competitive value price market.

On the financial side, there were also alerts that called Mr. 4M's attention. Even though sales for the first three quarters of 2011 were increasing as expected after applying the initial tactics, the aforementioned pressure from the raw materials side was affecting the COGS in a great deal and was lowering the EBITDA margin. All these challenges needed to be addressed at some point; it would be Mr. 4M's call to decide which battle he should fight first to achieve the turnover of the business that Grupo Nutresa was expecting.

Mr. 4M's assignment from Nutresa's Board

In 2010, when Nutresa decided to proceed with the acquisition and buy the 100% of Fehr Foods for USD 82.7 million (Grupo Nutresa, Información relevante, 2010), goals to be pursued and achieved in the following five years were set, looking forward to assure the return over the investment and a value generation for the company's shareholders.

Grupo Nutresa's expectation for all its business units was to generate a minimum EBITDA margin of 12% along with a sustainable growth in sales, contributing thus with the "Multilatina Vision" of that time, meant to double the 2005 sales by 2010 and triple them by 2015. (Grupo Nutresa, Strategic Framework, 2015)

In short, and in this context, the aim of Mr. 4M and his team was to assure that in 2015 the company's valuation would meet that of 2010, as well as to assure the expected ROI to the shareholders. In this sense, Nutresa leadership is expecting to generate net revenue of \$83 million by 2020.

Which would the best way to follow?

As mentioned before, the economic panorama and challenging goals were the main concerns of Mr. 4M. Thanks to the first diagnosis he anticipated while working side by side with Mr. Fehr, some months before his official designation as CEO, he was able to consider three possible ways to redirect the performance of the company.

First of all, there was a clear guidance from Grupo Nutresa leadership to assure an EBITDA margin ranging from 12% to 14% in all of its business units. This goal in Fehr Foods was translated in USD 7.7 million for 2011 while, according to preliminary estimates, Fehr Foods EBITDA could be around USD 4.8 million. As corrective action, the option was to apply a general non-profitable client basis depuration. This meant to stop selling to those whose average margin did not guarantee the EBITDA policy. Additionally, it would be necessary to avoid any kind of investment in terms of portfolio extension through new packaging formats or sizes.

In this strategy, the company growth would be sacrificed against a better financial performance, assuring the EBITDA goal but embracing the possibility of losing a good position in the market. Moreover, there was a potential risk of not recovering those clients once the economic cycle would change on their favor.

Secondly, as Grupo Nutresa strategic guidelines encouraged a high commercial aggressiveness without any reputational risk, the next tactic was to improve the sales performance. This would be achieved by increasing the client's pool and strengthening the value price segment, taking advantage of the established commercial networks and the knowledge of its competitiveness differential in the dollar stores segments.

These stores were showing significant growths and interesting opportunities during the last two years. Nevertheless, this plan could expose the company into a non-healthy

financial performance, given that the required margin was not being guaranteed through better prices and the commodities market continued with an upward trend.

Finally, and having differentiated marketing strategies for its production efficiency ratio compared to other similar players, Fehr Foods' third way was to bet in terms of profitability improvements, leveraging cost reductions, and guaranteeing acceptable margin levels without significant price increases.

This could be achieved by reducing its flexibility on the portfolio, eliminating non-profitable SKUs and investing in terms of technology to reach better production ratios. However, this could cause a lack of differentiation in the market and allow other competitors to easily present the same offer.

Exhibit 1 - Historical and Projected Financials of Fehr Foods in May 2010 (\$ in thousands). (McColl Partners, 2010)

	<i>For the Fiscal Years Ended and Ending the Last Saturday in February</i>					
	2008(A)	2009(A)	2010(A)	2011(B)	2012(P)	2013(P)
Net Revenue	\$46,963	\$60,592	\$62,665	\$62,193	\$67,336	\$72,498
<i>% Growth</i>	<i>n/a</i>	<i>29.0%</i>	<i>3.4%</i>	<i>(0.8%)</i>	<i>8.3%</i>	<i>7.7%</i>
Cost of Goods Sold	34,374	44,196	41,335	40,366	42,983	46,206
Gross Profit	\$12,589	\$16,396	\$21,330	\$21,828	\$24,353	\$26,292
<i>Gross Margin</i>	<i>26.8%</i>	<i>27.1%</i>	<i>34.0%</i>	<i>35.1%</i>	<i>36.2%</i>	<i>36.3%</i>
Operating Expenses ⁽¹⁾	10,668	12,509	13,510	13,138	13,210	13,762
Unadjusted EBITDA	\$1,921	\$3,888	\$7,821	\$8,690	\$11,144	\$12,530
<i>Unadjusted EBITDA Margin</i>	<i>4.1%</i>	<i>6.4%</i>	<i>12.5%</i>	<i>14.0%</i>	<i>16.5%</i>	<i>17.3%</i>
Adjustments and Synergies ⁽²⁾	1,959	2,198	2,156	1,425	-	-
Adjusted EBITDA	\$3,880	\$6,086	\$9,977	\$10,115	\$11,144	\$12,530
<i>Adjusted EBITDA Margin</i>	<i>8.3%</i>	<i>10.0%</i>	<i>15.9%</i>	<i>16.3%</i>	<i>16.5%</i>	<i>17.3%</i>
Total Capital Expenditures	\$642	\$311	\$852	\$585	\$634	\$682
<i>% of Net Revenue</i>	<i>1.4%</i>	<i>0.5%</i>	<i>1.4%</i>	<i>0.9%</i>	<i>0.9%</i>	<i>0.9%</i>

Footnotes:

(1) Excludes depreciation.

(2) Income statement adjustments include extraordinary costs incurred, non-recurring expenses, and potential synergies.

References

- Bernanke, Ben S. "*The U.S. Economic Outlook.*" Speech given at the Economic Club of Minnesota Luncheon, Minneapolis, Minnesota. September 8, 2011. Retrieved from Board of Governors of the Federal Reserve System website:
<http://www.federalreserve.gov/newsevents/speech/bernanke20110908a.htm> (visited July 26, 2015)
- Bureau of Labor Statistics, U.S. Department of Labor, *The Economics Daily*, Unemployment in September 2011. Retrieved from
http://www.bls.gov/opub/ted/2011/ted_20111011.htm (visited July 15, 2015).
- Condley. (2013). *Financial Statements and Independent Auditor's Report 2011 & 2012*. Abilene, Texas.
- Condley. (2014). *Financial Statements and Independent Auditor's Report 2012 & 2013*. Abilene, Texas.
- Grupo Nutresa. (2010). *Información Relevante*. Retrieved from
<http://www.gruponutresa.com/sites/default/files/101-%20Septiembre%2023%202010%20-%20Inversi%C3%B3n.doc>
- Grupo Nutresa. (2013). *Informe Anual y de Sostenibilidad 2013* [Annual Report and Sustainability Report FY 2013]. Retrieved from:
http://www.gruponutresa.com/sites/default/files/1_informe_anual_y_de_sostenibilidad_2013_-_grupo_nutresa_-_esp.pdf
- Grupo Nutresa. (2015). *Strategic Framework*. Retrieved from
<http://www.gruponutresa.com/en/content/strategic-framework-0> (visited August 3, 2015)

McColl Partners. (2010). McColl Partners Investment Bankers. Charlotte, North Carolina:

McColl Partners Investment Bankers.