# Strategies of Survival and Success for F&F Middle Market Suppliers

## Should you dance with the big boys or have your own party?

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For many middle market flavor and fragrance companies, the landscape is rapidly changing. During the last decade, the industry has seen significant consolidation with the larger flavor and fragrance houses becoming ever more dominant. Gone are the days when the industry was fragmented, with many middle market firms sharing the majority of the worldwide flavor and fragrance market. Today, the largest five firms in the industry—Givaudan, Firmenich, IFF, Symrise and Takasago—supply 57.5% of the $20 billion worldwide flavor and fragrance market. The next five firms—Sensient, Mane, T Hasegewa, Frutarom and Robertet—share another 11.2% of the market[a]. In recent years, these "big boys" have acquired and consolidated many middle market firms with specialized industry experience, and access to clients and technologies to round out their own portfolios. Names such as Manheimer, Noville, Shaw Mudge, Intercontinental Fragrances and Wessel Fragrances have disappeared, just to mention a few.

At the same time, the giant consumer packaged goods (CPG) companies have consolidated their sourcing under increasing cost pressures and acquisition and merger activity in their own industry. As in the automobile industry, core supplier lists have become commonplace. The number of companies supplying flavors and fragrances to these giants have been reduced to just a handful of well-heeled suppliers that can offer in-depth product development and market research, afford to cut prices every year to pass on the economic benefits of scale, afford to "pay (an upfront entrance fee) to play," and offer the worldwide manufacturing and service presence required. Usually, the only chance for a true middle market supplier to survive these pressures is to leverage proprietary technologies. However, many of the big players have well-funded technology efforts, marketing budgets and long-term time horizons (for payback) that cannot be replicated by smaller firms.

Not a pretty picture—if a company doesn't have the financial resources to invest in people, technologies and multiple worldwide production facilities. How do companies position strategically in this environment to survive long term and/or build an organization that can sell at an attractive price later?

If a middle market company is still on a core supplier list of one of the giant CPGs, chances are that it won't be there much longer, unless the supplier provides a key technology that cannot (yet) be replicated by the big boys. The middle market company might still be able to compete on service and turnaround times, but that will only go so far. Such suppliers shouldn't forever count on historical relationships with key purchasing personnel at customer companies to survive the economic pressure and politics of larger organizations. People move within organizations and—even if their key relationship remains as a purchasing decision-maker—they might not be able to fend off key strategic initiatives from corporate.

If a middle market supplier is not on one of these core lists, it shouldn't compete to be included—unless it possesses a "killer" technology. Such suppliers shouldn't pick a battle that is costly and has a low chance of success. Even larger middle market flavor and fragrance companies with superior financial resources have made a conscientious decision not to compete for business with these giants. It is just not feasible without an edge.

Even if a supplier isn't on a core supplier list and has no aspirations to be there, doing business as usual and hoping that there will be enough crumbs falling off the table from the big boys is going to be increasingly ineffective. The top companies in the industry are also focusing

[a] *Based on 2007 numbers as calculated by Leffingwell & Associates (www.leffingwell.com). The numbers include essential oils and aroma chemicals. Leffingwell acknowledges that the numbers may include some double counting of essential oils and aroma chemicals.*

on the private label and other bigger national accounts that may not (yet) have core supplier lists. While it's true that with all the recent acquisitions and consolidations customers can become disgruntled and look for new suppliers, counting on this attrition as a business strategy can be dangerous. In addition, the big boys are aware of the issue and are setting up "shops within the shop" that are geared toward providing appropriate service levels for a new set of smaller customers.

How can mid-market suppliers respond to these forces?

## Internal Growth Strategy

How can middle market suppliers then grow a business that caters to a saturated market with single-digit growth rates in end products? Companies must define who they are and what they want to be, then position themselves strategically and pursue the core business strategy.

***Focus, focus and focus:*** Suppliers need to determine their key strengths and expertise, focusing on the product lines of flavors and fragrances at which they excel. Although historically most companies in the industry have produced both flavors and fragrances—and sometimes ingredients as well—today it is difficult to find a compelling reason why this should continue. Flavor and fragrance suppliers market to different customers, requiring different expertise and creative talent, and there are increasingly divergent regulatory and manufacturing requirements. Although a case can be made for cross-fertilization between perfumers and flavorists, it mostly benefits organizations with large perfumery and flavor divisions. There are numerous examples of middle market firms that have divested one or the other, including Belmay and CPL Aromas, both of which sold their flavor activities to Frutarom. Or, most recently, Hagelin & Co., which sold its fragrance business to CPL Aromas. Even a company as big as Mastertaste, a division of the Kerry Group that was formed several years ago in part through the acquisition of Manheimer and AFF International, recently divested its fragrance activities to Symrise to focus on its core flavor and ingredients business[b]. (Full disclosure: the authors have been advisors to a number of American and European companies in the flavor and fragrance industry, including Noville, AFF, Intercontinental Fragrances and Mastertaste/Kerry Group.) Companies can sell just a "book of business," i.e., client list, formulas, etc., and invest the money in the part of their business that constitutes its strength and presents the most growth opportunities. (See **Buying a Book of Business** on Page 42.) It is better to be focused than to try to be everything to everybody. If one day a supplier wishes to be acquired by one of the big boys for a big multiple, it is crucial to remember that the top companies prefer to buy product expertise and technologies in areas they do not have, as opposed to just another couple of million

[b] *The division has been renamed Kerry Ingredients & Flavours.*

dollars of sales spread throughout all sorts of product lines and geographies.

***Technology:*** Investing in technology is expensive, requires considerable time and offers no guarantees. There are a number of middle market firms that have invested in technologies for many years and have succeeded in developing leading technologies that helped them sell their flavors and fragrances to the large CPGs—more so in flavors than in fragrances. Those new to this game should be aware that, while there might be opportunities, this strategy is risky and will take time to pay off.

***Developing an aggressive sales effort:*** In general, this is a company's best defense (and offense) and an area in which mid-market suppliers can absolutely excel. Most of the larger companies have account representatives who service existing clients but are relatively slow in generating new clients. Middle market companies are nimbler and hungrier. They can build a sales force that has a "go get 'em" personality. This might be different from the way a company used to run its sales efforts, and in some cases the owner-CEO is also the vice president of sales. Building an effective sales force might present a new mind-set, but it is time, effort and capital well spent. It can be useful to hire a consultant to help implement the right structure, training and incentives for the sales force. Independent sales representatives who do not work exclusively for the company are a double-edged sword and usually don't pay off in the long term. Middle market companies need to remember that they are building a long-term strategy, not a quick fix.

Organizations should focus on tomorrow's large customers and ride up the growth curve with them and their products. Everyone can cite an example of a customer that orders a few pounds one year, then the next year a few hundred pounds, and then before long has become one of a supplier's largest customers. These diamonds in the rough can be found by going through existing sales records, researching clients' potential flavor and fragrance needs, and dedicating an incentivized salesperson to service them. It takes time to build up an effective sales force and to turn it into a key strategic asset. But it pays off in terms of sales growth and, ultimately, when a company wishes to sell. The good news is that with all the consolidation going on—not to mention the troubled economy—there is talent available. Organizations should be flexible to accommodate personal needs and location. A good sales person is on the road with (potential) customers, not in the back office.

Suppliers should stay aware that their largest clients may eventually adapt such dreaded habits as competitive bidding and core supplier lists. When this happens, middle market companies may eventually lose out to the big boys. This is understandably hard, but in some cases inevitable. However, middle market suppliers' strength lies in being able to embrace constant change. The sales force must be able to constantly unearth the next diamond in the rough. It is a constant rejuvenation process, not a static privilege.

In some of the transactions we have personally advised on, the buyers (some of the big boys) were astonished to see that, unlike their own top accounts, some of the middle market companies' biggest and most rapidly growing accounts had only been served for a few years and that there seemed to be constant change in the composition of the top 20 accounts. That is exactly the point. There is a window of time in the life of every customer where a supplier is the right fit. Understanding that is the difference between middle market companies that are proactive and those that are reactive.

***Grow with areas of rapid changes:*** Organic, natural health foods as well as fragrance suspension in public spaces are examples of long-term trends and areas of rapid growth. Obviously, there are many more. Suppliers should focus on one that can profit from their existing expertise and try to build traction. It is always easier to gain new customers in growing markets than to take market share away from a competitor. If a company can become an expert in a growing market, it will attract financing for additional investments into its area of expertise. In addition, the company will become a sought-after acquisition target. Many of the private equity firms that have considered investing in flavor and fragrance companies fell in love with the cash flow that flavor and fragrance businesses generate, but had a difficult time getting their arms around a stable or slow-growing top line. Suppliers need to give investors something to dream about.

***Adjusting service and production:*** If a supplier is good, it can turn and deliver most of its orders in 48 hours—okay, 72 hours. The big boys will have a much more difficult time. And so, mid-market companies should be able to secure customers that truly value this quick service and, hopefully, will pay for it. Mid-market suppliers' organization, order-taking, production, shipping and administration need to be optimized for the kind of customers and order sizes they are taking. If they are shipping small quantities, they cannot afford designing custom products. If they specialize in custom products, their whole organization needs to be different in every way, from client service to sampling to order intake to processing to billing—not just creative effort. Once a supplier reaches a certain size (full production), bar coding and automated production and sampling equipment require a lot of structure, but might be wise long-term investments; meanwhile, other production technologies, such as spray drying, might lend themselves more to outsourcing. Suppliers must adjust their organizations to the kind of customers and order sizes they want to focus on. While suppliers may commit to a wider spectrum, they must do it profitably. These organizations need less costly processes for certain customers. They cannot get sidetracked by what else they can do to fill up their facilities: Taking in marginal business generates more overhead and clogs processes. When making decisions, suppliers must be mindful that lower margin business takes time from everyone in the organization, not just production. The benefits of taking in lower margin business to fill up a facility can be very deceptive and, even more importantly, can take companies' eyes off the ball.

***Barriers to entry:*** Here comes the good news. The days are gone when perfumers or flavorists could launch a new company based on their experience, a few (potential) client relationships and minimal capital. Today, regulatory compliance alone requires substantial investment in people and systems, in effect creating a barrier to entry. For a flavor and fragrance company to be viable and profitable, it needs scale with at least $5 million to $10 million in sales. These economic realities have made it increasingly difficult to start a new flavor and fragrance company and have helped to protect some of the smaller companies that are already in business.

## External Growth Strategy

Having defined and determined an internal growth strategy, suppliers may consider reorganizing their assets and/or buying a business to accelerate the achievement of long-term objectives.

***Reorganizing assets:*** After a company defines its strategy and niche, it may be wise to consider selling some of its business to focus on core product lines and customers. Throughout the past couple of years, it has become more common practice to package less strategically important accounts and sell them as a book of business, as mentioned earlier. Suppliers don't have to sell any tangible assets, just the customer list and formulas. This can be done in a structured auction to get the best price, the most qualified buyer and to preserve confidentiality until a deal is done. If done right, the seller can control the information flow and avoid any rumors that may become dangerous to its reputation and spook customers and, possibly, employees. The big boys have been divesting accounts for which they are not appropriately set up to serve. For a multibillion dollar flavor and fragrance company, it usually does not make sense to service $10,000 customers who require multiple products, production runs and complex formulas. For smaller, middle market suppliers, these customers might present attractive entrees and business opportunities that can be actively mined by a salesperson and, hopefully, grown. By divesting business lines or customer accounts that are not a core focus, flavor and fragrance suppliers can raise some capital that can be invested in the pursuit of the core business strategy. However, companies have to choose their timing well to mitigate the initial negative impact on overhead cost absorption, i.e. it makes more sense to do this if the company operates close to full capacity and can free up production capacity for the core strategy, as opposed to taking on a new, larger facility.

***Buying a book of business:*** Many times middle market clients ask, "Does it make sense to buy one of these packages, or books of business, being made available by the big boys?"[c] That depends. First of all, not

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[c] *More recently, even middle market companies have started realigning their businesses and selling accounts.*

all of these packages are alike. Some include only very small accounts; others include some larger accounts. Middle market suppliers might consider buying such a package of accounts if it provides them with an opportunity to more actively service and develop some of the larger accounts being sold. For the small stuff alone, it might not be worth it if the buyer is just taking orders and hoping that the customers order again next year. The important point is to obtain accounts that can be mined. While a few early book of business transactions had been done on a royalty basis, today's are most likely to require upfront payment. Buyers must make sure they know what they are buying and research the top names to assess their business potential.

***Establishing an international presence:*** This is another strategic question that comes up frequently. Buying a small flavor and fragrance company abroad is not easy. It involves a different culture, legal system and business practices. Most of the transactions have been done between US and European firms. While emerging countries such as China, India, Vietnam, Russia, Brazil and others might offer promising growth potential, the cultures in these countries are very different. As recently as 10 to 20 years ago, private property rights didn't exist in some of these countries. Sometimes it is difficult to tell what a company is really buying. The most important assets—talented people—can be difficult to retain. In fact, they may open a competing business next door. There are also additional regulatory and political risks overseas buyers will face. In the emerging countries, it is usually better for companies to start their own operations with local personnel trained at the home base, or to buy part of an operation from a European/North American competitor with European/North American-trained key personnel who can operate in a local environment. Sometimes, such operations become available because of the streamlining of duplicate operations following a consolidation/merger.

In more saturated markets, buying an established flavor and fragrance company might be a good alternative to a green-field effort. Suppliers will have to invest money upfront to buy a company, costs offset by having an established business, a local team and fewer startup losses. However, before embarking on a purchasing spree abroad, companies mustn't forget the most important thing: having a good reason to go abroad other than just buying sales. Usually, one or several of a supplier's most important customers will require them to become local abroad. In this case, with existing international sales/customers, companies can bring more than just money to the table. They can fill an existing facility and make it imminently more profitable, i.e. making money from day one by adding sales, flavor/fragrance know-how and existing programs to market to local customers. Suppliers shouldn't just buy a local company for size, assuming that they can run the company more efficiently.

If a supplier is considering expanding internationally, it should start early—as soon as the possibility of entering a certain region becomes more than remote. Companies want time to be on their side. If they buy under time pressure, they will usually make costly mistakes. Suppliers need to know the country/region very well and develop options from that knowledge. There is value in knowing what not to do. Potential buyers need to have developed several scenarios for investments/acquisitions/joint ventures before really knowing the best choices. It will take time to open doors and get comfortable with one another. Also, not everything is available when companies want it to be, no matter what price they are willing to pay. Companies are usually dealing with one or more complex ownership transition issues, different interests among owners/owner groups, and different agendas between owners and CEOs and other key personnel that the buyer must retain to make the acquisition successful. It requires time to develop several situations simultaneously. They will all have their different challenges. In order to successfully develop options and navigate them, buyers will want to hire a consultant/investment banker to run a systematic effort (acquisition program) and advise them in navigating the best options. It is also a time issue: CEOs cannot focus on running their organizations and undertake the time-intensive effort of locating, contacting and pursuing multiple foreign acquisition targets simultaneously. Buyers want their advisors to work exclusively for them. And they want someone who has gone through this process before and already has multiple relationships in the industry—not pay for someone's learning curve.

Some business owners believe it will be enough to connect into the deal flow by working with several intermediaries who bring opportunities on a situation-by-situation basis. However, under this system potential buyers will only see opportunities that are available and sometimes widely shopped. Such buyers will be forced to make decisions on a situation-by-situation basis, rather than developing proprietary scenarios and comparing/negotiating several opportunities at a given point in time. Usually, the effort and money spent up front will pay off in terms of quality of opportunities and, in turn, the success of the investment. Companies cannot be penny-wise and dollar foolish.

In every situation, once the initial introductions have been made, it will still take a lot of time to bond and feel comfortable with the local talent who remain after the acquisition to run the foreign subsidiary. One shouldn't hope to insert home-trained personnel and expect them to run the foreign business successfully. There is a graveyard of situations where this has led to disaster, especially if one brings in a new CEO and vice president of sales who has minimum background in the local culture. Those who do will pay twice to get it right.

## Executing a Corporate Transaction

If a flavor and fragrance supplier's strategy involves a corporate transaction, it will need to work with someone who has done deals in the industry and who knows what can be negotiated and what cannot—especially when negotiating terms with a big boy, or a company in a foreign country. Mistakes can be costly. The following are some of the topics that regularly come up in a corporate transaction in one form or another.

***Understanding the process:*** Whether a supplier is selling, buying or undertaking a joint venture, it is important to have a full understanding of each step of the transaction process—from preparing or reviewing the initial description of the business to initial management meetings to preliminary due diligence to negotiating a letter of intent and, eventually, completing formal transaction agreements.

Preparing for and working through the due diligence process will take a lot more time and effort than some might realize. As sellers, gathering and organizing material takes time. They need to prepare for site visits and interviews. Decisions will need to be made regarding disclosure of information and access to personnel. Sellers should be prepared to provide whatever material might be reasonably requested. Most importantly, sellers should know the story they want to tell and present it in a flattering way, but make sure they do a full and fair disclosure. They should anticipate questions, know the answers, and not let the buyer hear or learn about bad news from anyone except the seller. Trying to hide bad news or to avoid tough questions is unrealistic and usually does not work.

***Don't enter into a non-binding letter of intent (LOI) casually:*** A buyer's initial analysis and due diligence investigation of a potential acquisition is its best and perhaps only real opportunity to learn about what they are buying and to determine if it is the right opportunity. Buyers must be sure to request everything they will need to see and make sure they understand how that information is presented relative to the business they are buying.

Both sides of a deal should make sure they are ready before moving to an LOI. These should only be signed after both sides have made the basic decision to do the deal. While LOIs are generally non-binding, it is very difficult to change the terms of a deal after an LOI is signed. The due diligence investigation that is done after the LOI is signed, while comprehensive, is intended only to be confirmatory in nature. Many buyers try to renegotiate the deal after their confirmatory due diligence by saying they found something they did not bargain for. Right or wrong, it always creates tensions, might jeopardize the deal and leaves a bad taste. The time for negotiating substantial deal terms is before the LOI. In addition, while LOIs are generally non-binding, sellers will be expected to stop shopping the business during the term of the LOI under a binding standstill provision contained in the LOI.

***Prepare for the deal and assemble a team early:*** Sellers will need to pick their transition team early on. Owners cannot manage this process entirely alone; they will need support from members of the management team, including those in the company responsible for finance, sales, operations and human resources. If one anticipates any tension between the need to bring the right people into the deal and the need to keep the deal secret, those issues must be worked through early in the process. In fact, this point in the process might be the best time to put in place appropriate secrecy, retention and/or noncompete agreements. Also, sellers shouldn't wait too long to bring in the outside team, such as financial and legal advisors. Waiting to put the transaction team in place until the middle of the process will not serve one's best interests.

Sellers must also consider what customers and vendors will need to be told about the deal. Deciding if, when and how to introduce the buyer to core customers and suppliers is an extremely sensitive matter, particularly if buyer and seller are competitors. Going through this process may be unavoidable, but selecting the right time and manner to handle it is absolutely mandatory.

***Understanding legal terms one can negotiate:*** In terms of the legal agreement between a buyer and a seller, it is critical to understand where the lines of liability are drawn. The legal agreements will include a wide range of representations and warranties required of the parties, mostly from the seller. Those representations and warranties will cover not only basic matters, such as the ownership and condition of the assets being sold or bought, but also about the overall history, condition and liabilities of the company as a whole. In many cases, buyers are not willing to assume the liabilities of a company—except, perhaps, for certain financial debt and trade payables and the like. In all cases, the buyer will want the seller to give representations as to what those liabilities are, whether or not the buyer will be assuming those liabilities. Buyers need to be concerned with not only the liabilities they agree to assume, but also the liabilities they do not intend to assume, such as obligations of the seller imposed on the buyer as the successor to the business.

Typically, sellers are asked to remain responsible for unassumed liabilities that are known, but also for preclosing liabilities that are not known, even where the seller has no knowledge of the events or circumstances giving rise to such liabilities. From the seller's perspective, some of these issues can be mitigated by negotiating certain limits and caps on liability into the deal. However, these are all sensitive and difficult issues.

***Understanding what one wants, personally:*** As part of any transaction, sellers will need to decide what they want their role to be post-closing. Do they want an ongoing role in the company, to break away and maybe start a new business, or perhaps just retire? In any event, sellers should expect to be called upon to provide some kind of noncompete and nonsolicitation agreement for at least some period of time post-closing.

Once a decision has been made on a sound and sustainable business strategy, follow-through must occur. If it includes a corporate transaction or more, a good advisor who knows the industry is crucial, can help develop multiple options, and advise on selecting and executing an actual transaction.

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