

Food and beverage sector analysis



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This study covers the time period of January 1, 2006 through June 30, 2009. We used data for the 17 public food and beverage corporations traded on the London Stock Exchange. The data consists of closing prices on February 12, 2009, common share outstanding, PE and book value of PBIT, total revenue, operating income, equity and long term debt. The source for the closing price data is Financial Times. (www. ft. com) The book value and share outstanding data came from a manual review of the data from the annual reports of each firm. Because of the inconsistent fiscal year in the UK listed corporations, Y-0 was identified as the fiscal year which is the nearest year to present. For instance, Y-0 stands for fiscal year from July 1, 2008 to June 30, 2009. Y-1 stands for the previous year of Y-0 and Y-2 stands for the previous year of Y-1. Among the 17 corporations, three firms recorded negative equity in Y-0. Therefore, those three firms were excluded from the study.

To evaluate the investment strategy, we compare the share performance using two financial ratios: PE and ROE. To study the business operation perspective, operation profit margin and gearing will be examined.

Furthermore, weighted averages of those figures were calculated in order to retrieve the industry level ratios, which were based on the market valuation.

Investment Perspective

It is discovered that portfolios of low price-earning (P/E) ratio stocks have higher returns than do high P/E portfolio (Basu, 1977) Rational long term investors usually choose firms with higher ROE and lower PE ratio.(Banz, 1983)

In the UK food and beverage industry, the weighted average PE was 23.05 on February 12, 2010, which could be acceptable. The maximum PE is 148.98 and the minimum is 4.85.

The ROE has increased steadily from 33.51% in Y-2 to 41.56% in Y-0. The maximum ROE in Y-0 is 62.56% and the minimum is 10.43%.

The maximum ratio was contributed by DIAGEO which is the leading beverage manufacturer worldwide. The firm also has PE ratio 15.66 which is a little lower than the industry level. Therefore, DIAGEO could be a valuable investment target for the rational investors. However, other business indicators need to be further studied.

Business Perspective

Understanding the investment strategy by PE and ROE, it is turned to the business perspective. To evaluate the business operation, we employed operating profit margin and gearing.

In the UK food and beverage industry, the operating profit margin has decreased steadily from 17.63% in Y-2 to 17.14% in Y-0. The maximum ratio in Y-0 is 51.25% and the minimum is 4.13%. Unilever, the world leading food manufacturer, records 17.69% as the operating profit margin while other firms in food sub-sector can only generate profits which were under 10% of their sales.

The gearing has increased steadily from 34% in Y-2 to 42.74% in Y-0 which is a little higher. The maximum gearing in Y-0 is 70.51% and the minimum is 14.36%.

It seems that the development of whole industry depends on the long term debt. For instance, DIAGEO records thick profit margin which could be the main reason the firm could finance the business by lending. Contrarily, lending could enhance the cash flow which could ensure the higher profit margin. However, higher gearing means higher interest payment which might cause trouble to the cash flow.

Non Financial perspective

One of the primary goals of geographic diversification is to reduce the companies' exposure of any particular country and region. So their group revenue and growth are balanced out in the face of an economic slowdown or a political turmoil. The group business risks are being hedged against many countries and regions. So the shareholders can be reassured of a relatively less volatile year end profits and stable overall growth under normal circumstances.

One of the long term benefits of geographic diversification is the companies tend to develop or expand their business in the emerging markets. The growth of the emerging markets can help to make up the slow down or saturation in the developed western economies. So long term sustainable growth can be derived from the synergy of both types of markets.

A PESTEL analysis for contemporary and emerging issues both directly and indirectly impact all companies within this sector.

Political

Governments under increasing pressure to regulate the advertising of certain products such as soft drinks and confectionery. But promotions through advertising are crucial to generate revenue for those types of products.

Economical

Rising energy costs, increasing oil and gas prices can directly impact on the production and transportation costs within the food and beverage industry.

Year on year raising raw material costs, e. g. wheat, corn, soy beans, cocoa beans. The prices of those commodities can directly impact the producers' costs across many product ranges. Raising labour costs by regulatory requirements can directly impact the costs of production within this sector, e. g. China and US have all increased their minimum wage requirements.

A few major player in this industry all suffer from weak employee productivity hence management needs to find solutions to address this industry specific problem.

Social

Changing consumer preferences and increasing health consciousness require constant innovation for new products to meet the healthy eating trend in order to maintain long term sustainable growth.

Advocates of fair trade have also increased the operating costs across the industry. Companies have changed some of their practices to work more closely with smallholder farms and local farmers. This initiative would

inevitably increasing production and raw material costs but the increased costs must be carefully weighed against the consequences of failure in public relations and public image. E. g. Cadbury is committed to making its leading Dairy Milk brand Fair trade by supporting small cocoa farmers in Ghana. Unilever is offering 5, 000 small farmers guaranteed markets, access to finance and technical assistance to grow black soybeans in Indonesia.

Technological

Companies in sector have to compete on investment in technologies to create new competitive advantage in areas of: internal processes (more efficient production methods), distribution networks (better meet the needs of large retailers without incremental costs) and innovation (new products to lead the market or social trends).

Environmental

Increasing concerns to reduce carbon emissions can significantly increase production and distribution costs. Companies have to invest in new technologies to comply with the new environmental regulations and satisfy various pressure groups. E. g. Cadbury have started working closely with farmers, discovering in the process that relatively simple changes in herd management can trim emissions of CO₂ gases.

Legal

Pressures derived from increasingly stringent food safety regulations across the world. The consequences would range from increased production costs to large sums of fines if failed to comply with various regulators and national

laws. The massive milk power scandal in China has affected many domestic and foreign companies in both financial terms and public confidence.

Most eminent of barriers to Entry into Food and Beverage Industry

1 Regulatory requirements for food safety compliance demand larger initial investments in plants and procedures (staff training) to meet food safety standards. E. g. the FDA in the US has extensive compliance requirements for food safety so companies wish to enter the US market have to make high initial investment to satisfy the FDA regulations before their products are allowed to enter the US market.

The F&B companies are operating in many countries so they have to meet the relevant regulations of every single country they choose to enter.

2 Economies of scales is one the most significant barriers to entry in this sector, the major players are constantly seeking for global economies of scale and operation synergies through organic expansion and mergers and acquisitions. The scales of operations are also transferred into the bargaining power against their buyers and suppliers. Lower costs in raw materials offers larger firms a cost advantage over its competitors. Larger retail chains are dominant in most markets worldwide but only equally large food and beverage companies are more able to secure contracts and negotiate better deals with those mega chains in order to achieve significant market share and market power for the whole range of their products.

3 Massive advertising expenditure and promotion campaigns also deter small player enter the primary market of food and beverage products.

Effective advertising in this sector can generate high sales volumes and create brand awareness and ultimately secure large share of the market and also restrict the power and retailers.

Conclusion

The Food and Beverage industry is complex and dynamic due to its diversification and globalisation to ensure that all major industry players maintain a sustainable competitive advantage each company has to invest a substantial amount in research and development. This will enable the launching of innovative products and services that will meet customers who have ever changing needs.

As most of the companies operate globally this allows risk to be either business or financial to be diversified away as various portfolios attain various returns. This allows the spreading of systematic risk which can not be diversified away across various national boundaries.

As part of a forward thinking strategic perspective it is highly essential for all players as Ansoff model shows that when a company has existing products expansion is essential and can be achieved by either market penetration, or new product development for new products. In the case of a new market then existing products can go through some market development, and if new products it will be by diversification.

As part of increasing the resource base the companies have the ability to form alliances, synergies, or even mergers and acquisitions, to take advantage of the full economies of scale and scope.

Therefore upon the basis of the financial, internal and external analysis a rational investor would find the food and beverage industry as a suitable choice to invest equity in.