The funding environment for Prepared Consumer Foods in 2015

FOOD AND DRINK
INDUSTRY
IRELAND

Our vision for the PCF sector

By 2025, the PCF sector will:

- **have led the future growth of the overall Irish food industry;**
- **deliver products that are recognised by consumers globally as innovative, safe, sustainably produced and of the highest-quality;**
- **have developed into a dynamic sector based on talent, finance, research capability and government support;**
- **be recognised as among the most advanced, efficient and sustainable PCF sectors globally.**

1. Introduction

In February 2014 Minister Simon Coveney established the Prepared Consumer Foods (PCF) Strategy Group to identify the actions needed to maximise the contribution of the PCF sector to the wider agri-food economy. The resulting strategy document 'A 10-Year Vision for Prepared Consumers Foods (PCF)' now provides a robust starting point and an ambitious roadmap showing how the sector can lead the Irish food industry's future growth.

The strategy group also highlighted a number of barriers to growth which need to be addressed if the sector is to realise its vision (opposite) and achieve its growth potential (Table I). Access to finance was singled out as a high priority issue in this regard. The strategy document identifies a "market failure in finance from financial institutions, venture capital and shortcomings in state-supported funds".

This report presents the results of a case study based examination into access to finance among a representative sample of PCF companies in Ireland. This report accompanies the 2014 strategy document and its call for the creation of a €500 million PCF sector-specific fund through the Irish Strategic Investment Fund (ISIF).

It provides an insight into the current funding environment and the supply and demand side-issues related to bank and non-bank finance for PCF companies. It highlights how a market failure in access to finance has developed over the last five to 10 years and explores how a lack of capital has thwarted planned investment and undermined the competitiveness of the sector.

The report also looks to the future and identifies the type of investments that would be made if a sector-specific fund – with appropriate terms and conditions – were established. This includes information on potential draw-down over a three year period and the estimated impact such investments would likely have in terms of job creation, export growth and company turnover.

Table I – PCF growth targets – 'A 10 year vision for prepared consumer foods'

PCF	2011(*2013)	2025
Employment	20,600	28,100
Gross Output	€4.06bn	€6.87bn
Exports	€2.145bn*	€3.74bn
Domestic Sales	€1.915bn* (40% domestic market share)	€3.12bn (50% domestic market share)
Imports	€2.867bn* (60% domestic market share)	€3.02bn (50% domestic market share)

Source: *CSO Census of Industrial Production (industrial units employing three or more)*

2. Executive summary

- In 2015, Irish PCF companies face a prohibitive funding environment which undermines their ability to achieve growth and scale.
- The Irish PCF sector has an embedded over-reliance on bank lending -particularly lending of a short-term nature.
- The case study companies reported experiencing “zero appetite for risk” among commercial lenders – resulting in high cost bank loans and onerous conditionality.
- The cost of credit in Ireland remains above that in other eurozone countries making it difficult for Irish companies to compete on the international stage.
- Equity finance – as an alterative source of finance - is not an option for most PCF companies as investors are deterred by the high capital costs and the low long term returns on offer.
- The current funding deadlock has forced companies to scale back their ambition, postpone and - in some cases - completely abandon planned investment.
- There is strong demand for a more flexible funding environment that incentivises ambition and empowers businesses to think strategically about the medium to long-term growth of their business.
- All case study companies had growth strategies in place and plans to expand their business in the next three years. All were confident that with the right investment their business had potential to boost turnover, exports and employment numbers.
- There is strong demand within the PCF sector for an agri-food fund facilitated by the Irish Strategic Investment Fund (ISIF) – our 26 PCF companies surveyed have a funding requirement of €144 million alone.

3. Approach and methodology

The report used a case study approach to asses the current funding environment for PCF companies. The case studies involved detailed interviews at senior executive level. A standard interview questionnaire was developed (see Annex I) and the companies were also asked to provide detailed financial and other investment indicators.

In total 26 PCF companies participated*. The participating companies can be divided into three groups; small (turnover less than €10 million), medium (€10-50 million turnover) and large (€50 million plus turnover). The sample is representative of the PCF sector. It includes companies manufacturing in a range of PCF sub-sectors; cooked meats, non-alcoholic beverages, dairy-based products, breakfast cereals, ready-made meals, confectionery, baked goods, snack foods, soups and sauces, value-added seafood and value-added fruit and vegetables.

A profile of the case study companies is presented in Table II.

* PCF is defined in the strategy document ‘A 10 Year Vision for Prepared Consumer Foods (PCF)’ as any company producing value-added food and beverages and selling domestically or internationally to grocery or convenience retail, foodservice or other food companies. The sector includes prepared consumer foods, ingredients, value-added seafood, value-added horticulture and non-alcoholic beverages.

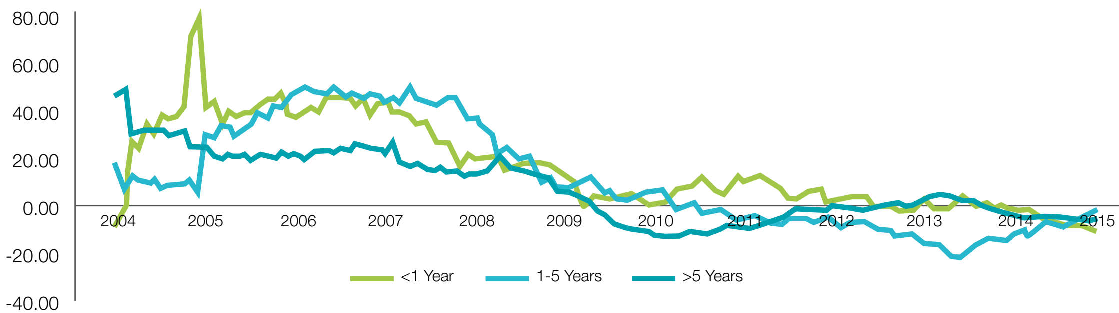
Table II – A profile of case study companies

Company	Turnover			2015 Funding Environment					Demand
	<€10m	€10-50	€50+	Very Prohibitive	Prohibitive	Neutral	Attractive	Very Attractive	
Company A			•	•					€50m
Company B		•		•					€1.5m
Company C			•		•				€6m
Company D			•	•					€8m
Company E		•				•			€8m
Company F	•					•			€100k
Company G		•					•		N/A
Company H		•		•					€9m
Company I	•			•					€2m
Company J	•				•				N/A
Company K	•								N/A
Company L			•	•					€45m
Company M		•		•					N/A
Company N		•							N/A
Company O		•				•			€2m
Company P		•			•				€6m
Company Q			•	•					N/A
Company R		•			•				N/A
Company S		•				•			N/A
Company T	•			•					€500K
Company U		•			•				€1m
Company V	•			•					€500K
Company W		•				•			N/A
Company X		•			•				€1m
Company Y		•				•			€3m
Company Z			•			•			N/A
Total	**19%**	**54%**	**27%**	**35%**	**23%**	**35%**	**8%**	**0%**	**€144.1m**

4. The context – macro data

Enterprise access to finance has become a central policy issue in recent years. Despite state interventions, the funding gridlock created by the financial crisis remains. An embedded over-reliance on bank lending, a lack of alternative sources of finance, and shortcomings in state-supported funds have created a prohibitive funding environment for many Irish businesses.

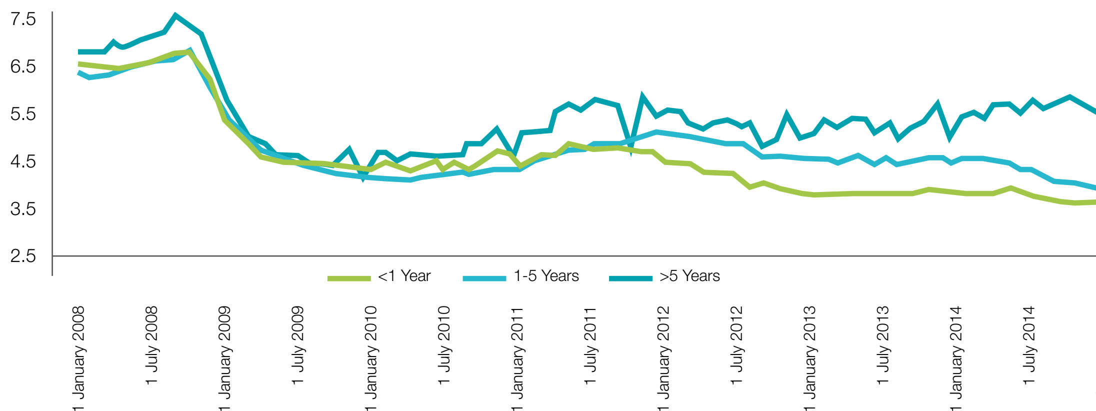
Chart I – Lending to Irish Non-Financial Corporations – % Year-on-Year Change 2004-2015



***Source:** Irish Central Bank*

Bank lending –the primary source of external finance for Irish companies – dropped significantly during the crisis and has continued to fall despite the recent economic recovery (Chart I). Since Q3 2013 there has been a further decline in longer term loans to non-financial corporations which indicates a declining investment focus.

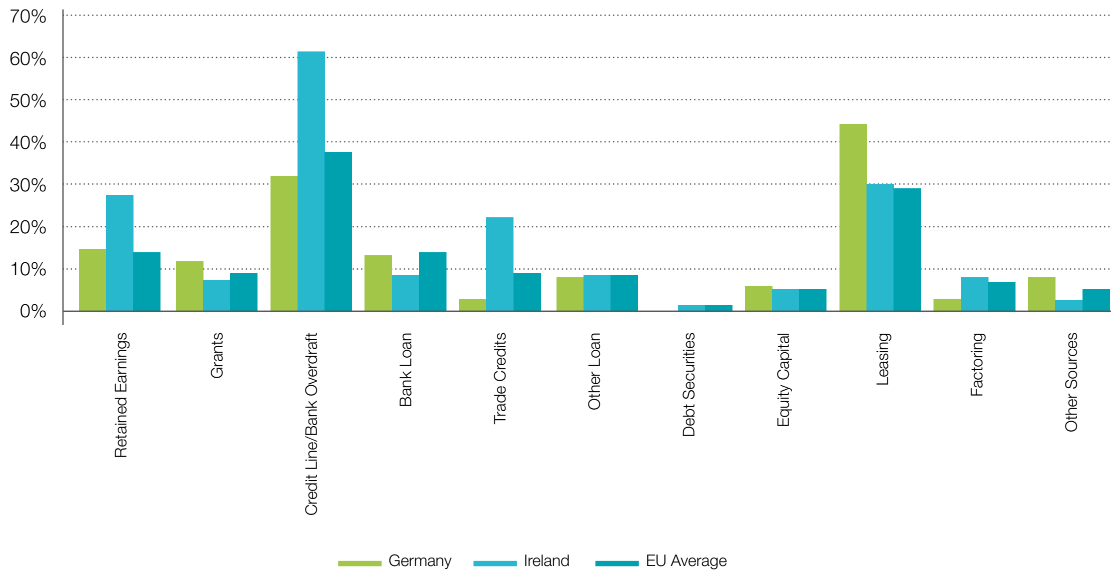
Chart II – Interest rates on loans to non-financial corporations up to €1 million (3mma)



***Source:** Irish Central Bank*

The cost of credit for SMEs is a major contributing factor to this prohibitive funding environment. In February 2015 the cost of credit in Ireland remains above that in other competitor eurozone countries (Chart II). The weighted average interest rate on new loan agreements to NFCs was 170 basis points higher than the equivalent eurozone rate. In the last two years Irish banks have introduced a range of new fees on commercial loans. In the past the absence of such fees could partially explain the interest rates differential. This is no longer the case.

Chart III – Sources of finance for NFCs in Q2 and Q3 2014



Source: *European Central Bank Survey*

These problems are exacerbated by the fact that Irish firms – particularly SMEs - are more reliant on commercial banks than almost all other European countries (Chart III). A 2014 report by InterTradeIreland noted that 90% of SME lending is through bank loans. This is a cause of concern as it is likely to increase the vulnerability of the real economy to shocks to the banking sector.

Equity finance – frequently proposed as an alternative to bank lending is largely unutilised as a source of investment capital. Only 6% of total SME funding is through equity financing. According to the European Central Bank's 2014 SAFE survey, nearly 70% of Irish SMEs say that equity finance is not relevant to their firm.

Access to finance data at a sectoral level is limited. However, available evidence suggests that this over-reliance on bank lending and the prohibitive funding environment is acutely felt by Irish PCF companies. Equity finance – for example - is not an option for most PCF companies. Potential investors are deterred by the high capital costs and low long term returns on offer. As an illustration – only four of 750 companies to participate in Enterprise Ireland's 2012 Seed & Venture Capital Programme were in the food sector – and none could be classed as PCF.

5. Case study findings

1. A prohibitive funding environment in 2015

Most of the case study companies reported significant challenges accessing suitable finance for investment, irrespective of size. The severity of the funding challenge increased with company size.

Fifteen out of 26 respondents felt that the current funding environment was either prohibitive or totally prohibitive in terms of encouraging investment in their own business. Nine companies considered the environment to be neutral. Two companies considered the current funding environment to be attractive. All companies agreed that the funding environment for their business had deteriorated in the last five to ten years.

2. An over-reliance on bank lending

The case study interviews confirmed reports that the Irish PCF sector has an over-reliance on bank lending and particularly funding of a short-term nature. While this is a problem across Irish manufacturing – it appears to be particularly acute within the PCF sector.

All bar one cited bank loans and retained earnings as their main source of finance when it comes to financing investment.

A small number of companies relied solely on internal funds to fund investment in their business. Most of the companies in this group were generally satisfied with the funding environment and had no immediate need to go to the banks to fund expansion.

Small and medium sized companies stressed the importance of state-supports and business expansion grants to grow their business. Enterprise Ireland, Local Enterprise Boards (LEOs) and Údarás na Gaeltachta were all mentioned in this regard. Significant levels of state funding from such institutions were not available to large companies due to current EU state-aid rules.

Use of equity financing was limited. A few companies availed of the now retired business expansion scheme (BES) and its successor, the Employer and Investment Incentive Scheme (EIIS). Only one company had experience using equity financing outside the BES/EIIS framework. VC funding was not mentioned by any companies as a source of funding.

In a few cases owner contributions were also used – but the total sum was minimal.

3. A market failure in bank lending

Most case study companies reported having had significant challenges dealing with Irish banks. High interest rates, onerous terms and conditions, red tape and additional fees were all cited as contributing factors to a prohibitive bank lending environment. For a few companies the situation had deteriorated further in the last three years. Many companies considered Irish banks to be risk averse and thus unwilling to give food companies sufficient leeway when it came to lending.

“It took eight months of negotiations and legal fees before we could draw down the loan. And even then it was only half of what we were looking for.”

CEO, a medium-sized PCF Company

4. Zero appetite for risk among banks

For one medium-sized company employing 100 people, this fear of risk was plainly visible when it applied for a loan to help build a new factory last year. While ultimately successful in their request, it took eight months of intense negotiation and legal fees before the facility could actually be drawn down – and then at a disproportionately high cost. A second company also noted how they were required to pay a facility fee and a commitment fee.

Another company had a similar experience. The company employs 150 people across two locations and has an annual turnover of €30million. A strong brand and a unique product have helped the company achieve year-on year growth of 10% over the last four years. A year ago they sought a loan of €1.5 million to implement an expansion plan that would see their exports increase by 25%. They were however only able to secure part of the funding they needed and thus had to curtail their expansion. They are now looking to continue their planned expansion but have no appetite to engage with the same bank again on the same terms. In their analysis - the cost was "astronomical' and the associated fees a major disincentive to going down that route again in such a short space of time.

A further company meanwhile had plans to build two new production lines to keep up with demand and achieve greater efficiencies. However they found the collateral requirement to be significantly disproportionate to the loan offering and the repayment terms too inflexible. They ultimately decided to place their planned investment on hold.

"We have been forced to put our investment on hold until more appropriate funding becomes available."

Six companies interviewed felt that the size of funding on offer from Irish banks was simply too small. For example, a large company employing over 500 people has ambitions to become a world player in their category. Over the last five years the business has lost significant ground to a UK-based competitor in both export and domestic markets. They now need to invest in their business to build a broader product portfolio and increased productivity. In their analysis this requires an investment of at least €35 million over the next five years. They have also put their investment on hold until more appropriate funding becomes available.

Overall, there was general agreement that the cost, terms and conditions associated with bank lending had deteriorated in the last five to 10 years. The term "market failure" was used by two respondents when describing the current state of play. While companies did acknowledge the need for financial institutions to avoid reckless lending – there was widespread feeling that the banks had overcorrected.

“The funding deadlock has forced us to scale back our ambition and rethink what is possible for an Irish food company.”

CEO, a medium-sized PCF Company

5. Equity finance not an option for PCF companies

Use of equity finance to fuel investment was limited. A few companies did avail of the now retired Business Expansion scheme and its successor, the Employer & Investment Incentive Scheme (EIIS).

A large and well-established company explained how they used the old BES scheme several years ago in combination with a bank loan to upgrade their plant and purchase new technology. Their use of the BES scheme was regarded as a success even if it involved a considerable amount of red-tape. They noted that they would now not qualify as the company had grown too large and any future expansion would need an alternative source of funding.

For another company, the EIIS and BES schemes were both utilised to help develop their business. In the last two years they have found the cost of involvement to be too high. They also had issues with the structure and some of the restrictions imposed by the scheme i.e. how the funding is used. Overall, they felt the EIIS scheme had inherent flaws that discouraged investment in food companies with low margins. They are hoping that recent changes in Budget 2015 will iron out some of these issues.

For many case-study companies EIIS was simply not an option as they did not qualify due to their size, location and/or investment intentions.

“The sector is seen as being high risk and at the mercy of volatile raw material costs, pressured margins and rapidly shifting consumer buying trends”.

Of those companies reviewed, only one had experience using equity to finance large-scale investment outside the BES/EIIS framework. The company explained how this was a last resort and the decision was made when the company was highly leveraged and needed to make a strategic acquisition to remain competitive. The acquisition was ultimately successful and the arrangement brokered with the third party enabled the company to refinance its debt and build market share in new export markets. The company did concede that the arrangement – while successful – was a last resort and ideally they would not have had to go down this costly route.

When asked why more PCF companies did not go down the equity route, the company said that the option was probably not available to most companies: “We were able to attract equity investment only because we had a strong and established brand and a good relationship with the third party”. A number of companies noted that the sector is not viewed favourably by investors. As one company stated, “the sector is seen as being high risk and at the mercy of volatile raw material costs, pressured margins and rapidly shifting consumer buying trends”.

“We could be the next Irish food multinational. But without investment we risk losing business at home and abroad.”

CEO, a large PCF company

6. Shortcomings in state aid

All case study companies availed of state support in some form in the last three years to help expand their business. Enterprise Ireland (EI) and the Local Enterprise Offices (LEOs) were identified as the key providers. A range of grants and support measures were recorded.

The small and medium-sized companies emphasised the ongoing importance of state-aid to their business. For most respondents in this cohort – the investment would not have occurred had they not had state support.

One company noted how EI invested preference shares in their business and helped upskill their management team through their various leadership for growth programmes. Four of the small companies interviewed noted their reliance on support from their LEO. It was noted that this is a competitive process and the amount varied annually. All four expressed concern that the funding might not be available next year.

Another company was extremely grateful to one organisation which provided them with support to build their existing factory and get their business off the ground. However the company is no longer in receipt of funding from this organisation but needs capital to build two new production lines to keep up with demand. Their only option appears to be a high-cost bank loan.

Five of the large companies interviewed found current state aid to be insufficient and stressed the need to reform current EU state aid rules to allow Irish business compete on the international stage.

Three large companies noted how state supports during the 1980s and 1990s had been instrumental to their development and transition from a medium-sized company to a large-sized company. Two of these companies claimed that without state support they would not have broken through into the large company cohort.

7. A barrier to growth

A number of companies reviewed could point to a specific occasion when a lack of funding cost them business and/ or forced them to abandon/postpone a planned investment. For a number of companies the funding deadlock has generated a malaise within the industry which discourages entrepreneurship and ambition. For one company the situation has become extremely frustrating:

“We are an established company with potential to be the next Irish food multinational, but we simply cannot access funding of sufficient scale to break into this group.”

Company B’s ambitions are more modest. They want to increase production efficiency and grow market share in the UK. However, the funding environment has forced them to repeatedly rethink their growth strategy and scale back their ambition. Another company compared the current deadlock to that of a weight – artificially holding back the growth of their company and the wider PCF sector.

6. Recommendations

A flexible funding environment

All case study companies stressed the need for a more flexible funding environment that incentivises ambition and empowers businesses to think strategically about the medium to long-term growth of their business.

While a number of companies singled out bank lending reform as a potential solution, most agreed that the sector needed to break free from its unsustainable overreliance on commercial lending altogether.

One company stressed the need for a suite of funding options that would allow companies spread their risk. This request was echoed by another company who compared the Irish funding environment to that in the United States where food companies have a greater selection of funding sources at their disposable.

“There is a serious demand for capital in this sector and a fund could help shake things up, but the last thing we need is another fund offering the same onerous terms and conditions - inaccessible to companies who need capital the most.”

All companies welcomed the idea of an agri-food fund facilitated by the Irish Strategic Investment Fund (ISIF). Companies felt that the proposed fund could help remove the deadlock and inject much needed competitiveness into the lending environment. However they were adamant that such a fund would have to be designed in consultation with industry to ensure drawdown. For another company the fund would need to be flexible to accommodate companies of varying size with different investment intentions.

Opportunities for growth - potential drawdown

Most case study companies had growth strategies in place and/or plans to expand their business in the next three years.

For some companies their investment strategy focused on volume growth in export markets. Others identified an opportunities to increase margins by upgrading their facilities, investing in lean efficiency and buying in new technologies. For a few companies a partnership and/or a strategic acquisition was identified as an effective way to achieve scale and capture export market share.

All were confident that with the right investment their business had potential to boost turnover, exports and employment numbers.

A number of companies reviewed have just concluded a phase of expansion and expressed no immediate demand for capital. However all of the companies in this situation supported the development of a fund, noting that its availability could help fuel investment down the line. Two companies in this group said they might avail of the fund if there was an opportunity for strategic acquisition.

The following examples provide a snapshot of the sector's potential for growth.

Example 1:

A large company employing over 500 people in two separate Irish locations. The company has a strong track record in the area of long-term investment. They now want to implement a carefully planned three year growth strategy that would see turnover increase by 100%, exports by 100% and employees by 50%. In their analysis – an investment of €30 million into their business would be sufficient. The funds would be used in a number of areas. However capacity expansion and the purchase of new technologies to build production efficiency are high priorities on their list. If funding was available and the opportunity arose they would also consider strategic acquisition.

Example 2:

A medium-sized company based in the midlands. Their premium products have great potential to meet a growing trend among European consumers. A fund would give them the means to increase turnover by 40%, exports by 60% and employment by 10% over the next thee years. If the fund offered business friendly rates they would draw down €8 million over three years.

Example 3:

A large company employing 400 people. They secured most of their funding through continental banks via an international shareholder. However if the fund offered attractive terms they would draw down €6 million over a three year period. They noted that the option of drawing down from an Irish food fund would provide financial flexibility and reduce their funding costs. Their current growth strategy would see turnover increase by €40million in seven years.

Example 4:

A medium sized company employing 150 people in the midlands. The company has a range of premium products with a clear USP within their category. They now plan to capitalise on this in the UK where competitors have been slow to catch up. In the next two years they plan to increase exports to the UK alone by 25%. An investment of €5 million would help them with new product development (NPD), capacity expansion and the purchase of new technologies. More would be needed if they were to go down the road of strategic acquisition or partnership – which is highly possible and could provide a shortcut to other profitable export markets.

Example 5:

A large company with 300 employees and a strong brand. They recently managed to get their cost-base at the correct level and are now on a growth trajectory. They are also excited about the launch of a new product for export markets in Q1 this year. Their main issue at the moment is demand. They are under immense pressure and need to build capacity expansion. In their analysis, an investment of €50 million over a three year period will enable them to increase turnover by 25%, exports by 100% and jobs by 25%.

Example 6:

A large company employing over 500 people - – has ambitions to become a world player in their category. Over the last five years the business has lost significant ground to a UK-based competitor in both export and domestic markets. They now need to invest in their business to build a broader product portfolio and increased productivity. In their analysis this requires an investment of at least €35 million over the next five years. The funds would be used to build a new factory, strategic acquisition and the upgrade of the existing plants. They have put their investment on hold until more appropriate funding becomes available.

Example 7:

A small family-run business which is about to break into the medium-sized cohort. Last year they invested €5 million into their business which should see turnover increase by €5million, exports increase by €3million and create 50 new jobs over the next 3 years. On this basis their drawn down would be limited to €100k.

Example 8:

An export focused medium-sized company based in the south east of Ireland. The company employs over 150 people in the region and has had continuous growth over the last few years. A strategic acquisition in 2013 has paid off and now the company is looking to break into the large cohort. In their analysis this would require an investment of €6-9 million over the next three years. If executed – the investment should see the creation of 40 additional jobs, a 30% increase in turnover and a 30% increase in exports.

Annex I – financial survey questionnaire for case studies

1. **Overall, how do you rate the funding environment in terms of encouraging investment in your organisation?**

   - 1 (totally prohibitive) 2 (prohibitive), 3 (neutral) 4 (attractive) 5 (very attractive)

2. **What are the main sources your company uses to finance investment?**

   a. Internal funds/Retained earnings
   b. Trade credit
   c. Borrowed from banks
   d. Borrowed from non-bank financial institutions/funds
   e. Owner's contribution
   f. Equity
   g. EIIS or BES
   h. Other (please specify)

3. **Would you say that the availability of these types of finance have improved, remained unchanged or deteriorated for your firm over the past five to 10 years?**

4. **How are the terms and conditions of funding available to your firm? For each of the following items, could you please indicate whether they were increased, remained unchanged or were decreased the past 6 months?**

   a. Level of interest rates
   b. Level of the cost of financing other than interest rates
   c. available size of funding
   d. available maturity of funding
   e. collateral requirements
   f. other

5. **How did the funding environment affect your planed investment? Positive, negative**

6. **How should conditions attached to funding/finance change to make investments viable?**

   eg.

   - lower interest rate @ -1% to -3% below current banking interest rates
   - longer repayment period (e.g. five to seven years/ seven to 10 years)

- If funding is made available at the correct conditions, what sorts of investment would your organisation likely make?
- plant renewal
- capacity expansion
- product and process innovation technology to improve productivity
- Development of new sales markets development
- Strategic acquisition
- other

7. **What would your likely total investment in terms of drawdown of loans be over a three year period? Please give an approximate figure.**
8. **Estimate the impact of this investment over the next five years in terms of:**
   - Turnover
   - Exports
   - Job creation
9. **Please provide any more additional relevant information**

FDII is the main trade association for the food and drink industry in Ireland. It represents the interests of over 150 food and drink manufacturers and suppliers which account for over 85% of the market in four main categories; Prepared Consumer Foods, Beverages, Dairy and Meat. FDII is committed to ensuring an environment exists that is conducive to the success and further growth of the food and drink industry in Ireland. FDII provides leadership and direction on a number of key strategic issues, including the economic importance and reputation of the sector, competitiveness, innovation, trade, skills, regulation and general food chain policy.

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