High valuations do not stop flavors and fragrances deals

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Persistently high valuation multiples have done little to stymie M&A in the growing flavors and fragrances (F&F) market. One of 2018's biggest chemical deals—IFF's $7.1-billion acquisition of Frutarom—catapulted IFF into a near-tie with Givaudan for the largest F&F company by sales. That deal's EBITDA valuation multiple of 24 times (x) was indicative of a sector with extremely high valuations, even by the standards of an historically high-priced chemicals M&A market.

It was indicative of other trends, too: Frutarom was the most acquisitive chemical company of 2017, according to *CW* estimates. The company announced 11 acquisitions in 2017 alone. These transactions were largely about acquiring market access, according to Eric Sabelhaus, vice president with investment bank Grace Matthews (Milwaukee, Wisconsin). "There are lots of local tastes and preferences," Sabelhaus says. "It is hard, for example, for a US company to go into Israel or Asia and understand consumer preferences, so they go and acquire a company that has an established product portfolio." Frutarom acquired companies in nine different countries in 2017, Sabelhaus notes. "They are trying to buy their way into those markets, and that is representative of M&A in this space as a whole." In acquiring Fruatarom, IFF obtained access to these markets, often via regional customers that the larger company had previously lacked.

Access to markets and technologies, often—though not always—on the part of larger F&F producers such as IFF and Frutarom, are the key M&A drivers in the sector. "Capturing market share is not usually a motivating factor in the F&F industry," says Marifaith Hackett, director/specialty chemicals with IHS Markit. Extending a company's geographic reach is often a key consideration in deals, Hackett says. Other key drivers include "extending into adjacent businesses such as cosmetic ingredients and probiotics," acquiring new natural ingredients, and gaining access to medium-sized and regional customers, she adds.

"It boils down to buy versus build," Sabelhaus says. Building a business in a new market or geography is especially difficult in the F&F industry due to differing regional preferences, as well as the fact that it can be almost impossible to replace a given product in a customer formulation. Qualification and certification requirements are stringent, and even more so in the fast-growing natural products market. "There is almost an emotional attachment to the taste or smell of something…it is a lot less risky to acquire an established book of business that already has a loyal customer base and products," Sabelhaus says.

These unique dynamics feed into the high valuations. "While flavors and fragrances constitute only a small portion of a typical finished product, they play a 'mission-critical' role as taste and smell are key in influencing customers when selecting a brand," Grace Matthews says. "As a result, manufacturers in the $25-billion F&F industry command higher margins relative to almost all other specialty chemical sectors."

Gross profit margins for many producers approach 40%, and growth is generally consistent as well as strong, according to IHS Markit. "The leading F&F companies are consistently good performers, with steady sales growth and strong profitability year after year," Hackett says.

Some buyers more than others

While the F&F industry has a strong growth profile, it can be tough terrain for private equity firms. "At higher levels of valuation, it makes it more challenging [to get a return on investment]," says Jack Norris, managing director with private equity firm SK Capital (New York). Simply relying on market growth, even when market growth is strong, may not work, he adds.

Hackett notes that private equity has been active in the F&F ingredients space, but not very active in F&F compositions. Pinova, which is was acquired by major producer Symrise in 2016, was previously owned by private equity firm TorQuest Partners (Toronto, Ontario, Canada), she notes. Unlike makers of F&F compositions, F&F ingredient producers "can be compared to specialty chemical producers," she adds. This makes it easier for private equity buyers to understand these businesses. F&F composition makers, by contrast, "are hard to evaluate," she says.

SK Capital has made acquisitions in food ingredients, in particular. The firm currently owns Niacet (Niagara Falls, New York), a maker of organic salts for the food and pharma markets. In October, SK Capital sold AEB Group (Brescia, Italy), a producer of specialty flavor ingredients for the wine and beer market, to Apax Partners (London, United Kingdom), another private equity firm.

A clear view on how to grow a business is critical in the high-valuation environment of F&F, according to Norris. "You need to have a view…it could be organic or inorganic growth, it could be a market that hasn't been looked at or a product or geographic expansion," Norris says. "The buy-and-hold model is challenging in this sector because of the entry multiples." In the case of Niacet, this entails commercializing new natural products, as well as sourcing a key raw material from an existing SK Capital portfolio company. "As we've grown as a firm…we can in a sense act like a strategic buyer with synergies, but we're buying the companies separately," Norris says.

Barriers to entry in F&F are still high, however, for any new market participant. "If you put things on a spectrum where you have commodity chemicals on one side and very specialty-type chemicals on the other, F&F would fall very far on the specialty end," Sabelhaus says. Technical expertise is highly valued, and regulatory compliance can be a significant issue as many products made by the F&F industry come into contact with the human body. "The business is fairly opaque to outsiders—by design, no doubt—and any new entrant to the F&F industry would have to expect a fairly sharp learning curve," Hackett says. "New entrants tend to start out small." These new entrants are often founded by individuals with pre-existing knowledge and contacts in the industry.

Private equity may have to pick its spots warily, but the major F&F players look set to be acquisitive for the foreseeable future. “Frutarom is off the table, but I wouldn’t be surprised if IFF continues some of that [acquisitive] approach,” Sabelhaus says. Givaudan, which acquired rival Naturex in September, is also expected to pursue more deals. “Targeted acquisitions that address specific strategic goals seem to have a good track record of success,” Hackett says.