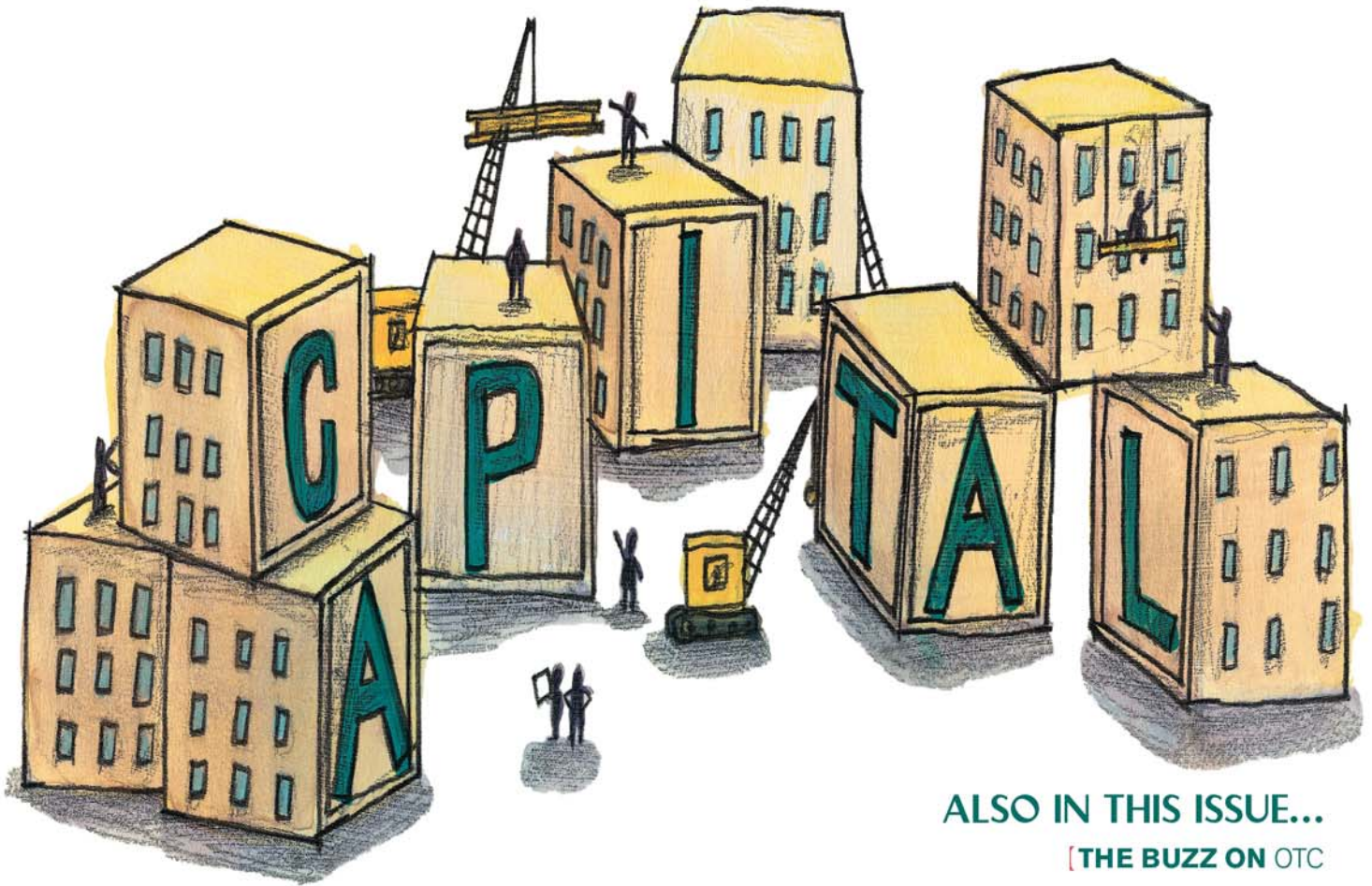




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SHOW ME THE MONEY!

DESPITE THE CREDIT CRUNCH, CONTRACT MANUFACTURERS STILL HAVE A VARIETY OF OPTIONS FOR FINANCING CAPITAL IMPROVEMENTS, INCLUDING CONTRIBUTIONS BY THEIR BRAND-OWNER PARTNERS.



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Show Me the Money!

Despite the credit crunch, contract manufacturers still have a variety of options for financing capital improvements, including contributions by their brand-owner partners.

by Denise Leathers

Banks and brokerages are failing at rates not seen since the early '80s. The stock market has experienced record losses. And lenders are keeping a tight hold on available capital. You sure picked a fine time to try and finance a plant expansion! But don't despair. Even in these uncertain economic times, contract manufacturers have plenty of options for raising the capital necessary to expand their operations, including, perhaps, their brand-owner partners.

According to Raymond Baribeau, senior director of sales and marketing at St. Hubert, Quebec-based Confab Laboratories, broad improvements to the physical plant – floors, water systems, heating and cooling, etc. – that tend to impact all customers equally typically are paid for by the contract manufacturer itself, as is equipment that's intended to improve performance or increase capacity across the board. But new equipment purchased to manufacture a unique product for a particular customer is a different story.

"Projects that require dedicated, single-use equipment or areas are cropping up more and more," Baribeau says.

"But it's difficult for contract manufacturers to envision purchasing that equipment, which is often very sophisticated and expensive, without some type of commitment from the brand owner." However, he continues, that "commitment" can take several different forms.

Occasionally, a brand owner will pony up cash to use toward the purchase of dedicated equipment. "We have had situations in the past where we asked brand-owner clients to contribute to capital projects specific to the production of their products," reports Margaret Liang, marketing director at W.N. Foods, Hayward, Calif. "In those cases, they directly injected funding for us to acquire specific equipment."

Other times, a brand owner will actually supply the equipment itself, especially if it's sitting idle at another plant. "That's probably the best scenario for both parties since that equipment has probably already been written off by the brand owner," says Steffen Weck, senior managing consultant at Lenexa, Kan.-based Food Business Consulting Inc. However, Weck continues, the issue of capital ownership must be addressed up front. "If the brand owner-contract manufacturer relationship begins to sour," he asks, "who pays to remove the equipment from

the contract manufacturer's facility? Who's responsible for maintenance? And what if someone gets hurt on the equipment? The answers to all of those questions need to be spelled out ahead of time when everyone is still in love with each other."

The Buy-Back Option

One common solution to the ownership problem is to allow the contract manufacturer to purchase equipment supplied by the brand owner over time. That's the approach taken by the company formerly known as Mexi-Snax, now part of Addison, Ill.-based Natural Snacks LLC, when it moved its in-house production operation to a contract manufacturer. "We wanted to use the same equipment so that we could ensure a consistent product," recalls Blair Kellison, former Natural Snacks president, who knew the move would also allow the company to consider a much wider range of contract manufacturers. "But we didn't want to be in the business of owning equipment used in someone else's plant. So we sold it to them over the course of a few years – at a price agreed upon at the start – on a cost-per-case basis. So, the more cases we ordered, the more they paid us until the equipment was paid off."

Another key component of Mexi-Snax's agreement with its contract manufacturer was exclusive use of the equipment it supplied, unless the company approved an exception (which it did do a couple of times for non-competitors). But not all contract manufacturers are as willing to give up valuable space to equipment that's underutilized.

Part of what a contract manufacturer sells is its space, explains Baribeau. "So every square inch has to contribute to the cost of doing business. We don't have the leisure of keeping equipment that doesn't generate production," he says.

Not My Problem...

While some brand owners are happy to contribute in some way to the acquisition of equipment used to manufacture their products, others aren't so willing. "One of the biggest reasons we got out of manufacturing in-house was...to avoid making a huge financial investment in [equipment]," says Michael Season, current Natural Snacks president.

"I expect to share expenses related to energy, labor, raw materials, etc. that cause my contract manufacturer's costs to go up. But if you want to buy a new potato chip maker that allows you to make product more efficiently, that's your business." He adds, "When we spent \$150,000 to redesign our



A MORE PERMANENT SOLUTION

Companies seeking a more significant infusion of capital over the long term may want to consider taking on an equity partner. According to Philip Yates, senior advisor for New York-based Irving Place Capital, equity funds have literally billions of dollars to invest in contract manufacturing, a growing sector that, by definition, needs capital to expand.

Although major CPG companies have expressed growing interest in contract manufacturing, says Yates, the industry still is very fragmented, with few companies large enough to offer the kind of complete supply chain solutions required by the biggest players. “That’s one of the reasons we decided to focus on this area,” he explains.

Typically, an equity partner “buys” a stake in an existing company, providing the cash necessary to make an array of improvements, including the acquisition of other businesses. In exchange, the original owner agrees to share decision-making with its new partner. “The original owner still runs the company on a day-to-day basis,” explains Yates, “but now he has a partner that can provide not just capital but additional contacts and resources to help build and expand the business.”

Like the original owners, “The equity partner’s goal is to drive returns for its investors by growing the business and, as a result, the value of their investment,” he continues. “Taking on an equity partner is a big decision that requires a lot of discussion,” Yates says. “But given the current financial situation, it may be a good solution for some contract manufacturers.”

packaging earlier this year, none of our contract manufacturer partners offered to help pay for it.” And that was OK with Season “because we handle expenses related to sales and marketing. But manufacturing is their job.”

However, Season recognizes that he’ll probably end up contributing to that equipment purchase in the form of a price increase. “It’s just like when I pass my cost increases along to retailers, who then pass them on to consumers,” he says.

Since a de facto contribution is often inevitable, many brand owners actually prefer to enter into some sort of formal agreement that promises them something in return – whether exclusivity, lower prices or some other benefit. For example, says Baribeau, “During the time the equipment is being paid for, the price could be adjusted up to cover costs. Then, once the equipment is paid for, some price relief would be considered.”

For that sort of agreement to work, however, the brand owner has to guarantee a certain amount of volume over a certain amount of time – a relatively painless way for them to contribute to new equipment purchases without having to hand over any cash on the front end. How does it work?

Hodgkins, Ill.-based Arro Corp. recently installed bulk handling equipment “that not only helped reduce our labor costs but also saved our customers money on ingredients since they can now buy in bulk,” reports director of sales Tim McNicholas. “We paid for the equipment ourselves and then built the cost into our prices. Our brand-owner customers then committed to a certain volume figure that will allow us to recoup the money over time.”

The company takes the same approach to construction of dedicated storage and assembly rooms. “We put into the agreement a term of so many years, and we work the cost of the capital into the price of the project, so they pay for it over the life of the contract,” says McNicholas, who calls the arrangement a win-win. “We get guaranteed business and they get the benefit of a dedicated room without the upfront expenditure of capital.”

Financing Up-Front Expenses

Although new equipment often pays for itself after a couple of years of service, where do contract manufacturers get the money to pay for it initially? “Contract manufacturers that are flush with capital may opt to pay for it them-



A **2007 study** by the Equipment Leasing & Financing Association (ELFA), Washington, D.C., reveals that **approximately 55 percent** or \$650 billion of the **\$1.2 trillion** invested in equipment each year is **financed**.

selves,” and then build the cost into their price structure, answers Weck. “But that scenario is becoming less common” as companies facing an uncertain credit market look to preserve capital.

In fact, a 2007 study by the Equipment Leasing & Financing Association (ELFA), Washington, D.C., reveals that approximately 55 percent or \$650 billion of the \$1.2 trillion invested in equipment each year is financed in some way, whether through a lease, a loan or a line of credit. But it’s the former that really seems tailor-made for contract manufacturers, whose survival often depends on their ability to change gears quickly in order to accommodate the needs of new customers.

Not surprisingly, an ELFA survey found that eight of every 10 U.S. companies lease at least some of their equipment. “Most companies aren’t as concerned about owning a piece of equipment as they are about tapping that equipment’s productive capacity,” says Ralph Petta, ELFA’s vice president of research and industry services. “They just want to use it to make money, not count it among their assets.” He adds, “It’s a great way for companies to access equipment they might not have been able to otherwise because of issues with cash flow.”

“If you go to a bank for a loan,” explains Ken Turner, senior vice president and national sales manager at Superior, Colo.-based Key Equipment Finance, “they usually require a down payment. But leasing offers 100-percent financing, which means no money upfront.” In addition, he says, monthly payments on an equipment lease are typically lower than those for an equipment loan because payments are based on the value of the machinery minus what it’s worth at the end of the lease term.

When a lease runs out – typically after five to 10 years – lessees have three options: They can surrender the equipment to the leasing company; they can purchase the equipment for its current value; or they can renew the lease for as

long or as short a term as they’d like. Most leasing companies also are willing to accommodate companies that want to upgrade or add a new piece of machinery before the original lease is up.

“It’s a very flexible financing tool that also keeps you from getting stuck with old equipment” – an important consideration among manufacturers not interested in entering the equipment resale business, Turner says.

Credit Crunch?

“Some [lending institutions] have scaled back or ceased operation altogether in certain ‘challenged’ sectors – like homebuilding and transportation,” answers Turner. “So, yes, it may be more difficult to find companies who want to lend in those spaces, and if they do, it’s going to be more expensive.” However, he continues, “We still see retail as a very viable sector.”

Like many other segments, it’s been performing below expectations. In fact, October represented retail’s worst month in more than 39 years. But food, drug and mass merchandise outlets haven’t been as impacted by the consumers’ unwillingness to spend money as retailers that sell more discretionary items such as electronics, furniture and cars. “People aren’t making decisions to buy less cereal or toothpaste or OTC drugs,” Turner says.

Still, a combination of tighter credit and manufacturer uncertainty probably led to the 14.5 percent decrease in new business originations (i.e. leases and loans) in August 2008 vs. August 2007, according to ELFA’s monthly leasing and financing index. Up until then, reports Petta, the number of new loans had increased steadily from month to month and year to year.

However, “We don’t see it as a trend,” Turner says, pointing to the fact that year-to-date new business volume is up 2.5 percent – a rather remarkable achievement given the market’s volatility of late. “What we are seeing,

THE CLOCK IS TICKING...

Some contract manufacturers have put off the purchase of new equipment until the economy gets back on track. But waiting until 2009 could end up costing them, says Ken Turner, senior vice president and national sales manager at Superior, Colo.-based Key Equipment Finance.

Passed earlier this year, "The Economic Stimulus Act includes a couple of provisions intended to encourage the acquisition of equipment in 2008," he explains. The first, known as accelerated bonus depreciation, allows companies that purchase equipment before the end of the year to take an additional 50 percent depreciation on the equipment on the 2008 taxes. The second, which falls under section 179 of the IRS code, increases the amount a small business can write off on equipment purchases made through the end of the year.

though, is companies holding onto their equipment longer – whether it's owned or leased. And that's simply a factor of uncertainty about the future," not necessarily a lack of

affordable credit. "If orders are down," he explains, "they're thinking maybe it's not the best time to go out and buy new equipment. Businesses are being cautious."

Sooner or later, however, most contract manufacturers will need to procure new equipment. "You need to establish a relationship today with a bank or leasing company or whoever's giving you credit so that if and when you need it in the future, it's ready to go," Weck answers. "The worst thing you can do is wait until a brand owner comes to you with a sure thing and then flip through the yellow pages to find a leasing company that has no idea who you are – your track record, your credit-worthiness, etc."

Once a contract manufacturer has secured access to capital, Weck suggests they find a way to communicate that fact to potential brand-owner customers that may be looking for a partner with deep pockets. "Contract manufacturers need to promote the fact that even if they don't have needed equipment right now, they have access to capital that will allow them to put in a half-million dollar line if they need to." Unfortunately, he continues, the question of capital doesn't always come up until late in the process when each party finally learns the other is unwilling or unable to finance needed equipment.

That's why good communication is so critical when it comes to the question of capital. There are lots of different ways for contract manufacturers and brand owners to work together to get the equipment they need, Petta says. "But it's very important that both parties know what they're getting into and ask lots of questions before they sign on the dotted line." ■

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