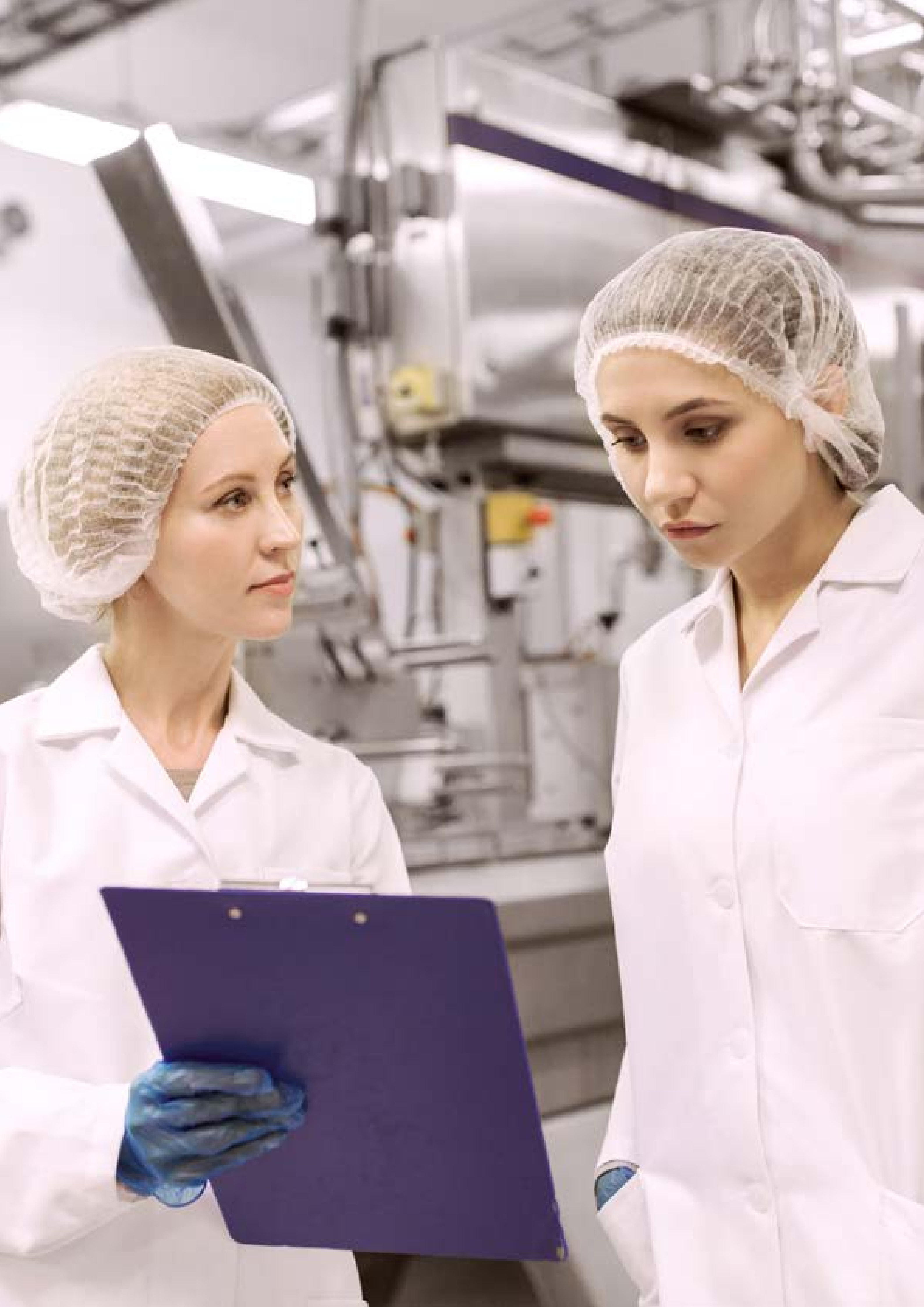
Grant Thornton
An instinct for growth™

Boosting the balance sheet in your food and beverage business

Maximising opportunity in a time of uncertainty



Foreword

The food and beverage (F&B) manufacturing sector contributes an estimated £28.2 billion in value and 400,000 jobs to the UK economy. A further £100 billion in value and 4 million jobs are generated by the supply chain.[1] This is a testament to the important role the sector plays in the British economy.

The F&B sector is a global showcase for the best of British branding and creativity. It's not limited to the established names like Warburtons and Tetley either – newer brands such as Tyrells, Joe & Sephs and Pukka Herbs are also becoming internationally recognised brands.

However, despite the successes, the sector faces economic and regulatory uncertainty. Brexit is a major factor, but advancements in technology and evolving consumer habits and tastes are also continuing to disrupt the status quo.

In the current environment it is more important than ever for F&B businesses to boost their balance sheets. We estimate there is a further £7.3 billion of cash that F&B companies could access by managing their working capital better.

Whether it is cost reduction, access to finance or greater flexibility to invest for growth, better management of the balance sheet has a number of key benefits and in this report we consider why working capital matters.

Many F&B companies are making six to seven-digit savings by taking advantage of the government's tax reliefs for research and development projects. However, not all are aware of the scale of the opportunity. We also discuss how firms can take full advantage of the current regime.

I hope that the insights that follow provide a source of inspiration as you plan for a prosperous 2018 and beyond.

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[1]Food and Drink Federation (2017). Our Industry in Pictures [online]. Available at https://www.fdf.org.uk/statsataglance.aspx

Creating room for growth – why working capital matters

Working capital is often overlooked when businesses are searching for ways to boost their performance, in place of technology, big data and innovation.

Unlocking cash from your balance sheet not only provides protection in leaner times, but allows you to take advantage of new technologies and ideas too. Working capital, when combined with the right planning and long term outlook, is a strategic lever that can be used to improve your cost base and profitability.

The macroeconomic challenges we are facing should make working capital a strategic focus for all UK corporates. F&B businesses are more closely tied to consumer confidence than most and often rely on complex and global supply chains, so the sector has a strong vested interest in this area.

To gain a better understanding of the current situation, we analysed the year-end working capital position of 3,081 UK businesses and published the findings in our 2017 UK Working Capital Study.

The study looked at performance by company size and industry, including 290 companies from the F&B sector with a revenue of at least £100 million. Below we look at this sample in more detail and discuss the benefits that can be realised by improving working capital. We hope this gives you inspiration for any planned or future working capital projects, or at the very least provides some 'food for thought'.

A £7.3 billion prize

F&B companies have delivered a 6% improvement in working capital year-on-year in 2017. This equates to £1.2 billion in additional cash – double the average industry improvement across the UK (3% improvement was seen across all businesses in our UK Working Capital Study). This trend shows that the sector is ahead of the pack when it comes to working capital optimisation and suggests a more focused approach to the management of cash.

As a general trend, the top performing and median companies are improving year-on-year, but the performance gap between them and the bottom quartile companies is increasing. The businesses that are not focusing on improving working capital are in danger of falling further behind their peers who are getting it right.

There is a lot of potential for improvement within the sector. We estimate that F&B companies could access £7.3 billion of cash by raising their working capital performance to the median standard.

Sustainable working capital improvement has proved to be more elusive. Only 10% of F&B firms improved their working capital performance for three consecutive years. This is in line with the overall average which saw 11% of companies reach this target. A mere 5% managed four years' consecutive improvement.

Collections performance improved for the first time in three years, driven mainly by the small and medium corporates. There was also good news in terms of Days Inventory Outstanding (DIO), with the downward trend continuing and reaching its second lowest point in the past five years. This trend could be influenced by the increased use of supply chain finance and invoice discounting by many of the large corporates and retailers, resulting in improvements in collections performance.

Balancing supply with demand is always challenging in a sector with perishables and fast-moving product categories. The continued improvement in DIO shows that businesses are getting better at maintaining their optimum stock levels.

Benchmarking the industry

UK corporates	UK F&B businesses
3% Year-on-year improvement in working capital	**6%** Year-on-year improvement in working capital
£8.8 BN Additional cash flow generated	**£1.2 BN** Additional cash flow generated
£136 BN Cash still tied up in working capital on company balance sheets	**£7.3 BN** Cash still tied up in working capital on F&B company balance sheets
11% Have improved their working capital position over three consecutive years	**10%** Have improved their working capital position over three consecutive years

Source: Grant Thornton (2017). UK Working Capital Study [online].
Available at http://www.grantthornton.co.uk/globalassets/w1.-member-firms/united-kingdom/pdf/publication/uk-working-capital-study.pdf

Opportunities for improvement

If you want to see results quickly, early payments are a good place to start. Check whether you are paying suppliers early. For example if the contract states payment on 60 day terms and you are regularly paying them after 55 because this falls in line with your payment runs, this can be easily addressed.

In a fast moving products sector, looking at your stock optimisation and differentiated replenishment strategies and parameters based on a supply chain segmentation can also have a short term impact.

It is no surprise that one of the two quick wins concern inventory. Almost half (£3.5 billion) of the additional cash we predict could be released comes from inventory. This brings in the broader issue of demand – a key area for F&B businesses.[2]

Demand planning is a big issue for most businesses. The challenge is finding the right balance, as there are associated risks with holding either too much or too little stock. The general tendency, however, is to overestimate demand due to fear of missing out on sales. A common result is that firms end up taking a hit on surplus stock.

These problems are perhaps more acute in F&B given its sensitivity to consumer spending trends as well as the short life nature of some of the raw materials and finished goods. Looking at base demand versus promotional and seasonal drivers for demand could help businesses more accurately predict their requirements and create an informed plan.

As a result, forecasting demand with greater accuracy and planning accordingly should have a positive knock-on impact on working capital as well as the bottom line through stock write-off avoidance. Here, the power of both internal and external collaboration is often overlooked.

Working on a more collegiate basis can support complex international supply chains to understand demand and smooth incoming peaks. Through collaboration, suppliers can regulate their production schedule and help with on time delivery and cost of production, in addition to reducing lead times.

Diageo take this so seriously that they decided to create a special unit within their central finance department to analyse spikes and determine how they were generated. Demand analysts constantly review forecasts and revise them to reduce bias. Ageing is an important part of the manufacturing process for a number of its leading products (especially whisky), so Diageo has to plan effectively for the long term to avoid both chronic under and oversupply.

Internally, there must be effective communication between all the functions that influence demand. Everyone involved must understand the importance of demand planning to the business. For example, if the marketing team is planning a new campaign that will increase sales volumes of certain product lines, they should be giving purchasing departments an early heads up so they can prepare accordingly.

[2]Grant Thornton (2017). UK Working Capital Study [online]. Available at http://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/publication/uk-working-capital-study.pdf

F&B companies must be wary of the 'bullwhip effect', where you see greater fluctuations in inventory volumes further down the supply chain in response to relatively small changes in customer demand. Businesses can better manage their demand by dedicating time and resource to identifying the root causes of sales spikes and dips and discerning between trends, fads and anomalies.

Although Britain's top 10 supermarkets have faced criticism for how they treat suppliers, Aldi is bucking the trend.[3] From September 2017, the German supermarket chain has shortened its payment terms from 33 to 14 days for annual transactions of up to £250,000[4]. The move, which applies to suppliers of fresh produce, among other products, was one of several initiatives to support its supply base. These include ensuring suppliers do not make any financial commitments without prior assurances on cost and volumes; keeping buying patterns stable throughout the year; and not running 'buy one get one free' or multibuy promotions.

Getting started: technology as an enabler, not the solution

Technologies like big data analysis and automation are valuable tools for businesses looking to manage their working capital more effectively. It's a mistake, however, to turn to technology before you have the right processes and communication channels embedded across the organisation.

Our research shows that companies are fairly adept at improving their working capital on a year-to-year basis, often when there's an urgent need to release cash back into the business. The fact that just one in every 10 businesses has been able to do so for three consecutive years suggests that the majority are not yet thinking beyond the quick wins to unlock cash on consistent basis.

Warburtons: working with suppliers to keep inventory in check

As Britain's largest bakery brand, Warburtons prides itself on not resting on its laurels – the business is always seeking to innovate and this applies to the way it does business, as well as the products it makes.

All Warburtons' products are fresh so they have relatively little capital tied up in finished stock. Watching the inflow of raw ingredients is therefore a key priority to ensure inventory levels are kept under control. The company has an interesting arrangement in place to manage its most important ingredient – wheat.

Warburtons hand selects its wheat suppliers – they have been working with the same British and Canadian farmers for over 15 years. However, they only take ownership of the wheat once it has been to the millers and ground into flour. This keeps them in complete control of the quality while allowing them to meet demand with a limited amount of flour in stock.

"Working capital is important to us for a number of reasons," explains Finance & IT Director, Andrew Light. "As a family business, we don't want to be highly leveraged, so tightly managing our working capital ensures we can sensibly manage our overall level of debt. Plus, we know that trading conditions can change pretty quickly so we always need to be prepared to operate in a tougher market."

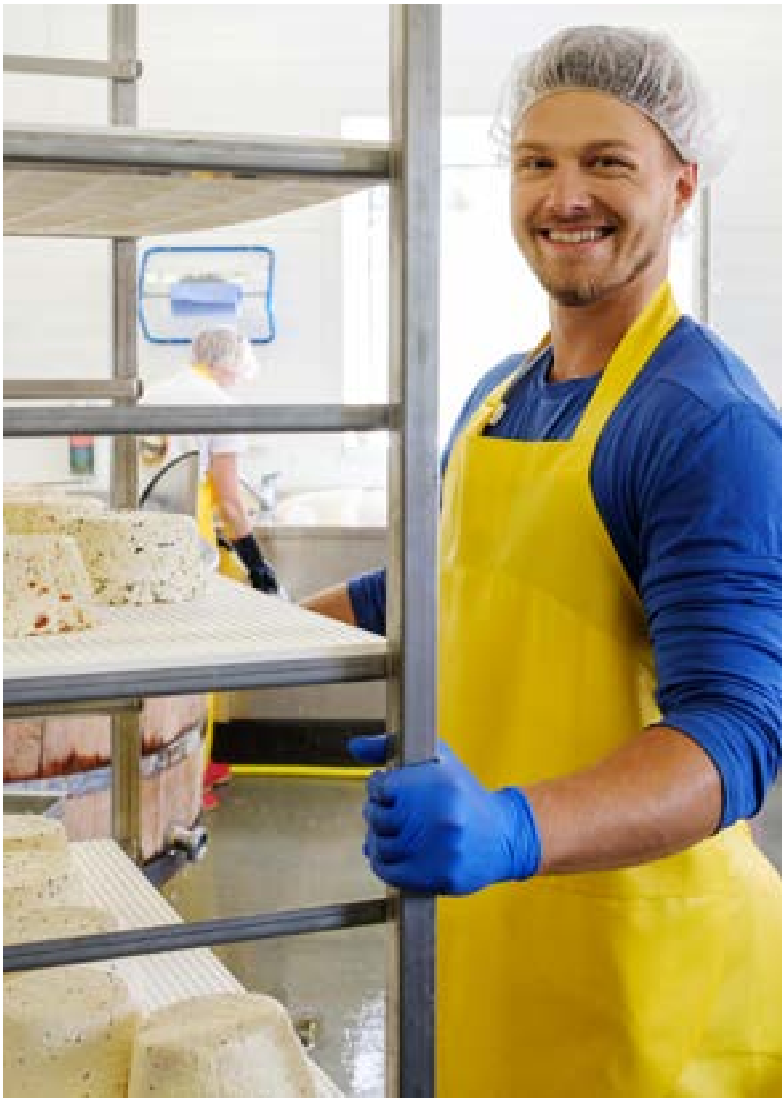
[3] The Sunday Times (2017). Supermarkets charge suppliers to be on shelf [online]. Available at https://www.thetimes.co.uk/article/supermarkets-charge-suppliers-to-be-on-shelf-dkzpgpw6n
[4] Fresh Produce Journal (2017). Aldi cuts small suppliers' payment terms to 14 days [online]. Available at http://www.fruitnet.com/fpj/pdf/173247

Checklist: key questions

Making working capital a strategic priority for the business will pay off in the longer term. The positive impact can be seen not just on available cash, but also on your cost base, credit rating, shareholder value, and ultimately profitability.

If that sounds like a compelling list of reasons to get started, here are some key questions you may wish to consider:

1 Is working capital part of your strategic plan?
2 Do you know what good looks like with consideration to your sector, size and your current performance?
3 Have you identified the 'quick wins' and acted on them?
4 Have you taken steps to embed standardised processes and controls that can improve working capital in areas such as payment policies, proactive collections, and inventory segmentation?
5 Have you developed and implemented metrics that allow you to regularly track working capital performance in a way that can be understood by those who can influence day-to-day performance?
6 Does every relevant department understand the importance of demand management and how it can help the business improve in this area?
7 How can you improve transparency within your supply chain to produce more accurate forecasts?
8 Are you pushing the boundaries of best practices by using more sophisticated tools such as big data analytics in your inventory processes or supply chain finance within your supplier base?



Making innovation pay – R&D in food and beverage

It's time to rethink R&D

Rapid macroeconomic, environmental, technological and social change ensures that the F&B sector never stands still. The way we grow, manufacture, store and consume food is constantly evolving thanks to private sector investment in research and development (R&D).

It's an exciting time for food innovation as modern technology enables both new scientific breakthroughs and makes more products and processes commercially viable. These innovations are coming from businesses of all sizes across the world as the barriers to entry shrink by the day.

The government wants the UK to be the global 'go-to' place for such innovation.[5] A series of tax reliefs for the R&D work undertaken by British based companies is one of the key incentives it has put in place.

There is a common misconception in the business community that only the most experimental, cutting-edge projects can be put forward for tax relief. In reality, the tax definition of what constitutes R&D activity is much broader than you might expect. It doesn't always have to involve white coats and secret test labs. It doesn't even have to be happening in the R&D department. It can apply in many other areas of your organisation, such as IT and manufacturing.

The available tax relief can be worth up to 26% of the total project expenditure.[6] Though claiming it isn't always straightforward, it pays for F&B businesses to think differently about R&D.

Understanding R&D tax reliefs

R&D tax relief essentially means cash back into the business – either by saving corporation tax payable or by exchanging tax losses for a valuable cash repayment.

SMEs with less than 500 staff and a turnover of under €100 million, or a balance sheet total under €86 million, can:

- deduct an extra 130% of their qualifying costs from their yearly profit. Once added to the normal 100% deduction, this results in a total deduction of 230%;
- claim a tax credit worth up to 14.5% of the surrenderable loss if they are loss making.

Larger companies can claim for a Research and Development Expenditure Credit worth 12% of the qualifying R&D expenditure.[7]

The Patent Box tax relief allows UK companies to benefit from a lower corporation tax rate on profits earned from patented inventions. Where a company holds qualifying patents, or have an exclusive license to use others' technology, any profits derived from the qualifying intellectual property are taxed at an effective rate of 10% (subject to meeting the application criteria).

Note that there are currently two schemes in place as the old one is transitioned over to the 'new scheme' with more stringent requirements which came into force on 1 July 2016.

[5] Ping Chan, S (2016). 'Britain gets R&D boost as Theresa May unveils plans to make UK 'global go-to place' for innovation', The Telegraph, 21 November 2016 [online]. Available at http://www.telegraph.co.uk/business/2016/11/21/britain-gets-rd-boost-as-theresa-may-unveils-plans-to-make-uk-gl/
[6] Grant Thornton (2015). Innovation in the Food and Beverage sector: Serving up tax savings.
[7] UK Government (2017). Research and Development (R&D) tax reliefs [online]. Available at https://www.gov.uk/guidance/corporation-tax-research-and-development-rd-relief

R&D in numbers

33%

Maximum relief of qualifying R&D spend

£3.8bn

Returned to UK companies (a 20% increase from the previous year)

21,865 SMES

Received tax relief totalling £1.3 billion

£1.5bn

Total tax relief that 4,390 large companies benefitted from

£28.2bn

Contributed by the sector to the UK economy despite 75 claims being made in the Food and Accommodation sector, representing 16% of the total R&D claims[8]

Source: Grant Thornton (2015). Innovation in the Food and Beverage sector: Serving up tax savings.

The examples below help to demonstrate the breadth of activity which can be put forward for tax relief.

1. Ingredients, products and processes

Food companies are responding to changes such as new food labelling regulations and a new breed of health-conscious consumer by reformulating their products. They are also putting more effort into understanding how their processes affect ingredients as they go through production.

Many of the modifications firms make in the interests of their customers can attract R&D tax incentives. Getting the right viscosity for pasteurised mayonnaise, inventing gluten free recipes, or finding a way to reduce the amount of saturated fats in pizza without compromising taste can all count (see the case study below).

Our own benchmarking suggests that 1% to 4% of the total staff costs for a business with a test kitchen facility would represent eligible R&D work. Any resulting proof of concept recipe that moves to production could qualify for a further 1% to 2.5% relief out of the total staff cost to reflect the challenges in 'scaling up' a new product.

R&D in action

A 9% refund for healthier pizzas

A large-scale pizza kitchen wanted to reduce the hydrogenated fat and calorie content of their slimmer's branded pizzas. Reducing the calorific content and the amount of hydrogenated fat was straightforward, the problem was the detrimental impact this had on the taste.

Finding a recipe with fewer calories but the same great taste required an extensive period of R&D with many different ingredient combinations. By claiming R&D tax relief, the business was able to get back 9% of its investment in the new pizza.

[8] Grant Thornton research for FDF commissioned report 2017 – http://www.fdf.org.uk/publicgeneral/FDF-Economic-contribution-Full-report.pdf

2. Packaging development

The way a product is packaged has a huge effect on the overall customer experience. No-one likes a dry sandwich or a flat lemonade! More food and drink companies are committed to reducing their environmental impact, so what happens to that box or can after the contents have been enjoyed matters too.

Some of the biggest changes in the way we eat result from the industry discovering new ways to store and preserve food – take the microwaveable meal, for example. The R&D value in the development of different types of packaging for health, safety, or sustainability reasons should not be underestimated (see the case study opposite).

3. Manufacturing

Businesses often fail to consider the opportunities for R&D tax relief in the manufacturing process.

R&D doesn't stop once the product or packaging has gone into manufacturing. Activities including integrating automation and robotics, increasing the efficiency of the manufacturing process and reducing energy from manufacturing can fall under the scope for tax relief. The same goes for continuous improvement projects, as long as these are technical in nature.

R&D in action

An 8% refund on new packaging

Sandwich packaging normally uses waxed paper to make sure the inside surface stays clean and hygienic. The downside is that it is not suitable for recycling. A large sandwich manufacturer wanted to change this by developing a new, recyclable material to replace the wax.

Following extensive testing, the company realised that their new material 'wicked' moisture away from the sandwiches, so 'wet' fillings would dry out over time. Though the sandwiches were still edible, the wicking effect had made them dry and unappetising.

It took a further period of R&D to land on the right combination of materials that allowed the packaging to be recycled but also limited the rate at which the sandwich dried out.

The project represented a £1 million investment for the business, and as it qualified for R&D relief the tax benefit was £80,000, a saving of 8%.

Joining the dots

It's not just gaps in understanding of which projects can qualify as R&D that prevent firms from submitting a claim. F&B businesses are often geographically distributed, with operations spread over a number of sites, making it harder to stay on top of who is doing what.

It's a story we often hear from our clients. For example, a leading international producer of convenience foods had grown so quickly through acquisitions in both headcount and number of locations that each site had slightly different ways of working.

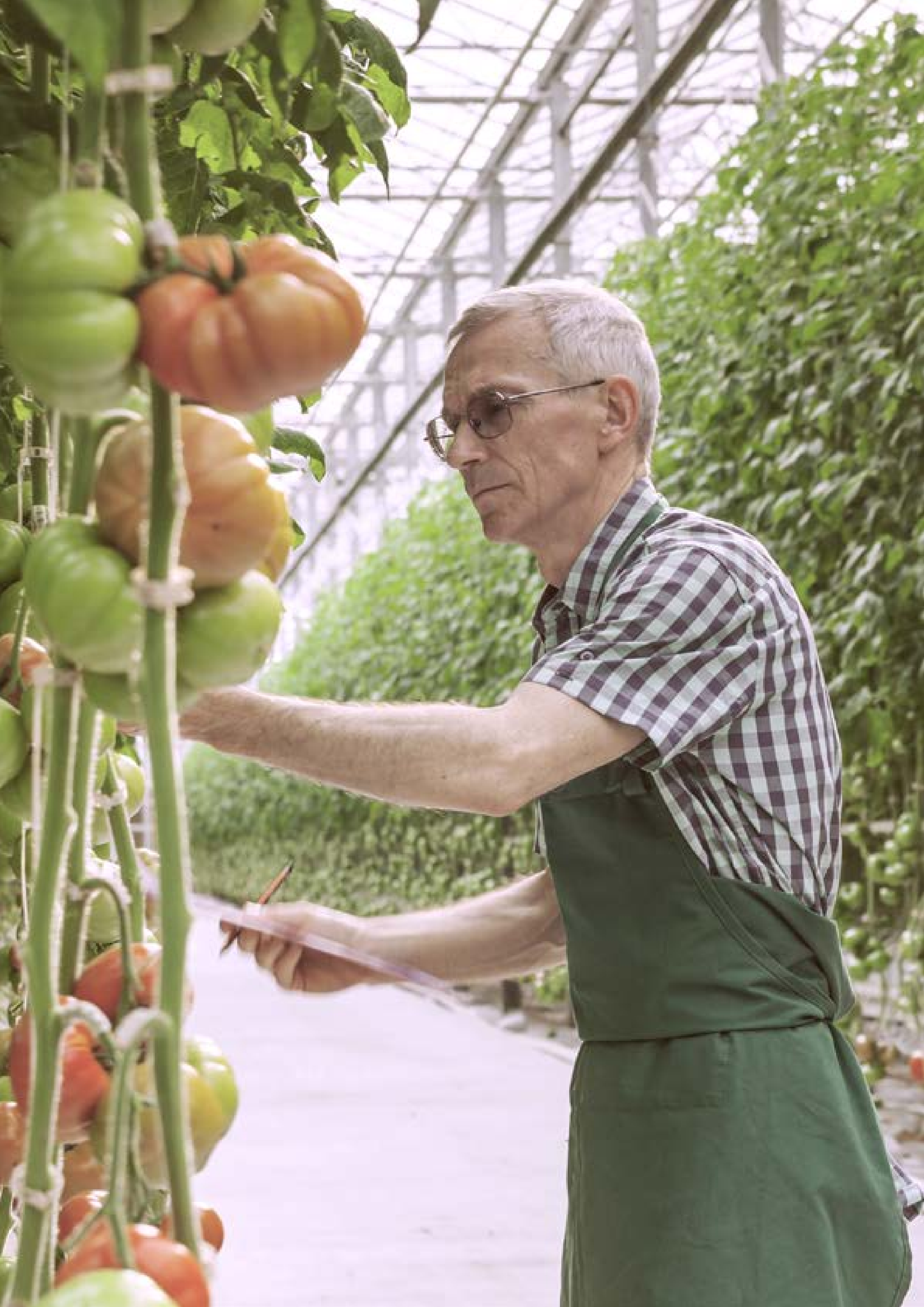
The solution is to adopt a holistic approach to assessing the R&D merit of projects that can be easily replicated across the business. Some steps you might consider include:

- **Take stock.** An internal audit/review can help you understand what the business is already doing and which areas might need the most attention.
- **Identify your stakeholders.** R&D can cover a lot of separate business areas and functions. Get early buy in from relevant colleagues and look at processes to keep information and communication flowing between departments.
- **Find a process that works.** It could be as simple as an email checklist (see Is R&D relevant to your business opposite), or you might want to bring in a collaboration or project management tool. The method doesn't matter as much as ensuring that it is easy enough to be applied consistently throughout the relevant parts of the organisation. Automate where possible.
- **Seek out the right expertise.** Navigating the complexities of the constantly evolving UK tax system requires specialist knowledge.

Checklist: is R&D relevant to your business?

The existing government tax regime has a broader view of what constitutes R&D than you might think. If the answer to any of the following questions is 'yes', you may be entitled to claim relief.

1. Do you develop new food products?
2. Do you invest in new technology or science to create/maintain competitive advantage?
3. Have you changed or modified your products or processes in the last two years (including your IT systems)?
4. Have you undertaken studies to understand ingredient interactions, find healthier alternatives, or to optimise the shelf life of a product?
5. Have you developed new or innovative forms of packaging?
6. Did you face technical challenges and difficulties in either developing new tools and technologies or integrating new and legacy technology?
7. Did you undertake any R&D projects that were unsuccessful?



About Grant Thornton

Grant Thornton is one of the world's leading organisations of independent assurance, tax and advisory firms. We help dynamic organisations unlock their potential for growth by providing meaningful, forward looking advice.

We believe that today's world is all about connecting across businesses and industries, between public and private. And we have a track record of making that happen. Working with dynamic growing businesses is in our DNA. We provide advice to more than 40,000 dynamic organisations across the public and private sector, and working with them excites us because we know they help a vibrant economy to thrive.

At Grant Thornton, we know the food and beverage industry inside-out. Our advice is drawn from people who have worked in the industry themselves so we're able to offer advice that we know works. Our clients often tell us that our sector knowledge is the best there is. On top of this, we work with the Food and Drink Federation to share our insights, expertise and know-how with their members. All the thinking you get from us is built on this knowledge, so you can make the best choices to grow your business.

Grant Thornton is one of the few firms that can advise you across the whole supply chain. We work with over 500 food and beverage businesses – from agri producers' through to bars and restaurants. There is nothing we like more than bringing people together and creating new opportunities for you to meet potential suppliers and customers. All this means you will get a solution that works in the real world, not just the boardroom.

To talk to us about boosting your balance sheet, please contact one of our experts.

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