



THE FOOD AND DRINK REPORT

INTRODUCTION

Welcome to our review of the food and drink sector in the UK over the last year.

To say it has been a challenging year may be an understatement. Pressures on consumer spending, price wars among the supermarkets, poor commodity harvests and rising input prices have been just some of the challenges. Food and drink companies could be forgiven for feeling like the 'squeezed middle'.

Our review focuses on the key issues and challenges facing the sector, how the sector has responded and what may be in store over the next year.

We look at the general economic backdrop, which continues to be incredibly tough and provides no shortage of challenges for the food and drink sector. We also look at some of the key indicators of economic performance - economic growth, consumer spending and unemployment - and their impact on the sector.

Despite the strong economic headwinds, the sector has continued to provide merger and acquisition opportunities in 2012, with a healthy increase in deal activity over the last 18 months. We provide an insight into the drivers of corporate deals and give our views on what the sector can expect in the next few years.

The Government has gone some way to incentivise companies to invest and a number of changes in legislation provide real cash saving opportunities for companies in the sector. We highlight a number of areas where food and drink companies may benefit.

We also look at the issues around security of supply - a topic that is rising fast on the boardroom agenda. We examine the sustainability challenges faced by companies in the sector and how attitudes and actions vary widely in response.

And finally, we analyse some of the latest sector dynamics that will provide both challenges and opportunities for food and drink companies in 2013.

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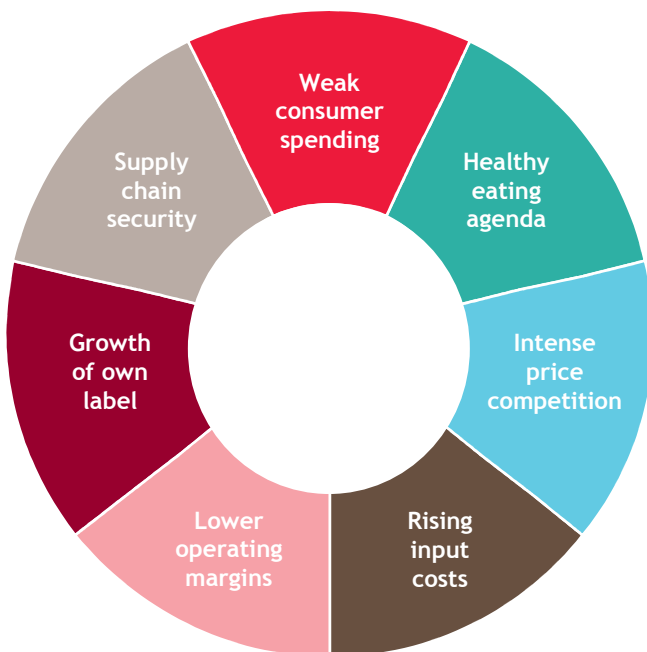
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BOARDROOM AGENDA

The food and drink sector is an important component of the UK economy. In the last 12 months, the UK Government has outlined how it sees the sector being a key contributor to growth of the economy over the next few years. The sector represents approximately 15% of the UK's total manufacturing base and is estimated to directly employ up to 400,000 people.



Despite this backdrop, food and drink companies face a set of challenges as wide and complex as those in any other part of the British economy. Domestically, the sector is subject to significant consumer demands at no extra price and converging commercial and regulatory pressures. On a global stage, concerns surrounding climate change, food security and resilient supply chains have brought the sector into focus.

Few would disagree that 2012 has been a tough year for the sector. Research by OC&C Strategy Consultants revealed that average operating margins across the largest 150 food and drink companies have fallen to a 14 year low of just 5.8%. With the pressures on pricing driven by the retailers and weak consumer spending, together with rises in the price of many key inputs, it is not difficult to see why.

Despite the challenges, there is good news. Many food companies continue to invest in innovation, developing new income streams through product development and category investment. Food and drink businesses have continued to drive cost savings from the supply chain and, in many respects, lead the way in delivering sustainability initiatives aimed at lowering operating costs and reducing waste in its many forms. Furthermore, recent deal activity indicates the UK food and drink sector offers opportunities for mergers and acquisitions - the number of deals in the food and drink industry has recently risen to its highest level since the global financial crisis started in 2008.



BOARDROOM AGENDA

The Food & Drink Sector 2012 - a year to remember?

It may have been a memorable year for some but probably not for the right reasons - the sector has continued to experience very tough trading conditions.

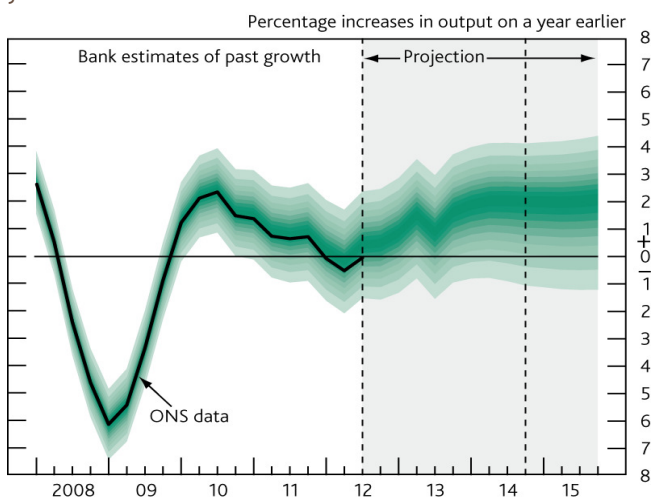
As the downturn in the economy continued, consumer spending remained weak in the UK. With such a fragile state of affairs this only intensified the competition amongst supermarkets to maintain promotional activity, fight price wars and deliver key price points across a wide range of food and drink categories. Consumers have become increasingly price sensitive in the current environment and this is a key driver as the supermarket multiples battle to maintain customer loyalty in order to protect and grow their revenues.

In-store promotions and price points remained a key feature in supermarket strategies. This is an area which has become increasingly important to younger customers and parents in particular. Visibility has increased around this aspect with the help of smart phones and dedicated websites that allow consumers to check prices of the large retailers at the touch of a button or screen.

The economic backdrop - implications for the sector?

Overall, the outlook for the UK economy remains highly uncertain. Inevitably, the backdrop of weak growth, increasing costs of living and pressures on employment will all continue to feature heavily in consumers' minds as they make spending decisions.

Bank of England forecasts predict that overall growth will be broadly flat in 2012 and the bounce back in 2013 will be weaker than previously anticipated. Many businesses are now re-setting growth expectations for the next few years and settling into the frame of mind that lower growth rates will be the norm for at least the next couple of years.



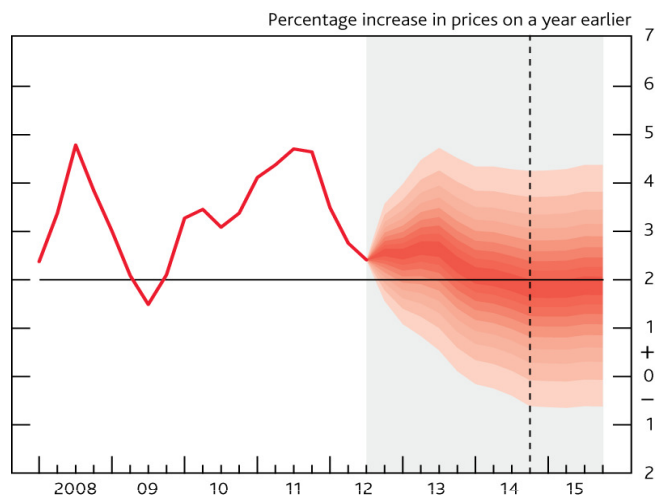
Source: Bank of England - Inflation Report (November 2012)

Unemployment - remained high by historic levels

The number of unemployed in the UK stood at over 2.5 million in October 2012 according to official government statistics. Although this fell since the start of 2012, unemployment remains around its highest level for over 15 years. A weak employment market will continue to depress consumer spending across all categories as households take a cautious stance.

Inflation - stubbornly high

Inflation, as measured by the Consumer Price Index (CPI), stands at 2.7% having been above 4.0% at the turn of 2012. This is a reflection of lower energy prices and a broader-based weakening in other pricing pressures. Latest predictions from the Bank of England indicate that short-term upward pressures remain and inflation will remain above the government's 2% target in the medium term.



Source: Bank of England - Inflation Report (November 2012)

The reduction in inflation since its recent peak at 5.2% in September 2011 should help consumer confidence levels. However, the reality is that the retail prices of many food products, driven by supermarket promotions and price cuts, have not experienced inflation anywhere near the levels reflected by the CPI, indicating less potential benefit for spending in the sector. The pressure to maintain low prices and meet consumer expectations has meant that the price of food in supermarkets after accounting for promotions has risen by much less than wider inflation, a mere 1.6% since July 2011.

BOARDROOM AGENDA

Consumer spending - still fragile

Overall, the outlook for the UK economy remains highly uncertain. Inevitably, a backdrop of weak growth, increasing costs of living and pressures on employment will all continue to feature heavily in consumers' minds as they make spending decisions. Recent concerns expressed by the Bank of England over the possibility of a sharp fall in growth in the final quarter of 2012 will only weaken consumer confidence further.

Pressures on the sector likely to continue

As retailers drive competition around pricing, they exert significant pressure on food and drink suppliers to drive down product costs and support their aggressive pricing strategies, be it through promotional support, rebates and over-riders or reduced supply prices.

At the other end of the supply chain increasing input costs in key ingredients are squeezing margins further for farmers, food manufacturers and processors. Poor weather and climactic conditions have devastated harvests of food commodities in many regions, leading to price hikes in commodities on global markets. Oil prices are again tracking upwards adding further costs to transport and delivery. Food and drink companies can often find it difficult to pass on increased input costs, either in absolute terms or as quickly as prices impact their businesses.

BDO OPINION

“ Many businesses have exploited the challenges, invested in new product development, built strong partnerships with customers and responded to the demands in managing the supply chain. Food companies need to balance the desire to deliver short term opportunities with the investment and innovation needed to ensure longer term success.

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BOARDROOM AGENDA

Pricing pressures have impacted branded products, own label and food service suppliers alike. And size does not always make a difference, with a number of examples of food companies with strong and well established brands whose businesses have been adversely impacted after flexing muscles over customer pricing. It was widely reported that a de-listing of various Premier Foods brands following price increases to Tesco in 2011 cost the supplier in excess of £10 million in lost profits.

The convergence of these issues has put immense pressure on food and drink businesses, impacting the profitability achieved in the sector. Businesses have responded with a careful look at the supply chain - operational improvements have driven down costs and improved competitiveness but some costs are less easy to manage. Passing on the increasing costs of commodities and other inputs often proves a challenge as the large retailers and food service customers maintain a great deal of bargaining power in many food supply relationships.

The effectiveness in which food companies have tackled these issues is mixed. Many businesses have exploited the challenges, invested in new product development, built strong partnerships with customers and responded to the challenges in managing the supply chain. The position for others is less rosy, particularly where constraints exist around funding to support investment and dependence on key customers and own label offerings leave them vulnerable to the wider trading pressures.

BDO OPINION

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Food and drink companies face a set of challenges as wide and complex as those in any other part of the British economy. The performance of the sector has been impacted by the convergence of weak consumer spending, intense price competition and volatility in key input prices. It has been a tough year for many and the outlook remains uncertain.

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LEGISLATION AND TAX

There are few areas of tax that have been overlooked in the Government's quest to increase tax take and reduce the deficit. Despite this, opportunities remain for food and drink companies to reduce their exposure to tax and save cash.

Product development - exploiting R&D and patent box opportunities

Where companies develop new products, or indeed amend existing products and technologies used in the business, then the first tax consideration should be whether or not an enhanced Research & Development ('R&D') relief is available. This equates to 225% of the qualifying expenditure being allowed as a tax deduction for SMEs and 130% for large companies (this can be in the form of an equivalent 'above the line' credit for large companies from April 2013). For loss making companies there is a repayable credit. This credit was previously limited to SMEs but with effect from April 2013 will also be available to large companies. Companies that have previously dismissed claims on the basis that there was no immediate cash benefit need to reconsider in 2013.

Examples of projects that should qualify for R&D tax relief include:

- Adapting recipes to achieve the required taste with less salt content
- Developing packaging to increase the shelf life or quality of a product.

Also from 1 April 2013, companies that receive qualifying patent income can elect for 10% tax to apply to profits attributable to this income. This includes not just income from the sale of patents and licence fees, but also income from product sales incorporating a qualifying patent. With an increasing number of companies registering patents over production technology and know-how, there are some significant potential benefits available from this lower tax regime.

It is worth noting that seemingly straightforward processes are on public record as being subject to patent including:

- Method of preparing potato chips
- Method of icing a small biscuit
- A meat based food product and method of manufacture.

Capital investment - encouraging green investment

Whilst many in the sector operate in a capital constrained environment, there is potential for 100% capital allowances when businesses invest in environmentally friendly plant (www.eca.gov.uk). There are three separate streams of expenditure - the two that are particularly relevant to this sector are plant & machinery which result in either energy savings or water conservation. Given recent decreases in the standard rates of capital allowances, there is an added incentive to install these types of technologies which should result in both cash tax savings and potential operating cash savings through increased efficiencies. In addition, loss making companies may be able to surrender the allowances for a tax credit of 19% of the surrendered loss.

It is imperative that companies consider this at the capital investment planning stage as if products are not included on the list of energy saving technologies, even if they are to be added at a later date, it is the time of purchase which is relevant. As such, this is not just a tax issue. Procurement departments should be aware of the rules and potential cash flow savings, to ensure best results can be obtained.

There are also enhanced capital allowances available on R&D capital spend. The enhanced rates provide 100% first year capital allowances and are available on capital expenditure on buildings.

Businesses with smaller capital spend should also ensure they plan the timing of expenditure to maximise the benefit of the temporary ten-fold increase in the Annual Investment Allowance to £250,000 from 1 January 2013 for the next two years.

A high profile current project is the development of Arla Foods' £150 million super-dairy near Aylesbury.

The company note on their website that:

"Arla is aiming for the dairy to be the first zero carbon milk processing facility in the world and, throughout the design stage, the potential impact of the dairy on the environment has been evaluated. Going forward Arla is committed to utilising the best available construction techniques, advanced process technologies and cutting edge renewable energy opportunities."



LEGISLATION AND TAX

People - reducing the total wage bill

The sector remains relatively labour-intensive, which means rewarding employees in a tax efficient manner can result in large cash savings.

Salary sacrifice for pensions provides an opportunity to offer additional workplace benefits to employees whilst enabling the company to benefit from employers NIC savings of 13.8%. As an increasing number of employees will come within the pensions net with the introduction of auto-enrolment from October 2012, this may be an ideal time for companies who have not yet implemented salary sacrifice in this area to consider introduction. Dependent on the size of the workforce the implementation costs of introducing salary sacrifice schemes for pensions can be outweighed by tax savings over a very short period.

Additional methods of reducing employers NIC can arise for subsistence payments which are salary sacrificed. This would typically be relevant where food companies have large numbers of mobile staff, usually where they have their own fleet of delivery vehicles, who are away from their permanent place of business for more than five hours a day. In such circumstances it is possible for employees to salary sacrifice an element of pay for a tax and NIC free subsistence allowance (which is benchmarked by HMRC - £5 per day for over five hours away from the permanent location and £10 per day for ten hours). These arrangements are typically structured in a way which allows companies to offer increases in net pay to employees whilst achieving employment cost and NIC savings for the company.

Depreciation in stock

Food and drink companies Mars and William Grant successfully argued a number of years ago that depreciation included in the value of year end closing stock should not be added back for tax purposes. This enables a one off tax deduction to be claimed in year one for depreciation included in a company's closing stock valuation. Where businesses maintain a relatively stable level of stock this one-off benefit never reverses.

VAT liabilities - understand your position and that of your customer

Over the last few years the food and drink sector has been one of the most active in terms of VAT issues and opportunities. This is not surprising given that the legislation covering the production and supply of food and drink items is one of the most complicated due to the way it is drafted and the various conditions that apply. As a result, there has been various litigation in the sector, with both taxpayers and HMRC taking cases to determine what the VAT liability of products should be. In some cases this has led to significant refunds of VAT for the taxpayer, but HMRC has also been successful in a number of cases (mainly where they have successfully argued that sales do not qualify to be zero-rated).

In the 2012 Budget, HMRC introduced changes to the VAT treatment of certain products. It is clear that the sector will continue to be heavily impacted by VAT matters, especially if HMRC continue with their drive to address 'borderline anomalies'.

Currently the key matters to consider are:

- Review the VAT liability of your products: given the various litigation, it is advisable to review your products regularly to ensure that the correct VAT liability is being applied. Although many of the cases and changes relate to retail sales (eg sale of hot takeaway food) there have also been some amendments which impact manufacturers (for example, the Budget changes to sports nutrition drinks).
- Understand your customer's position: in light of the recent changes, many retailers have seen their products become standard rated for VAT purposes. Where the retailer is unable to increase the price for such products, to effectively pass this VAT charge on to the end consumer, it leads to a reduced margin. The impact for manufacturers who sell direct to retailers is that they could start to see push back from retailers.
- Be prepared for further challenge: if HMRC is on a drive to increase VAT revenue, it is reasonable to assume that they will review the zero-rating legislation and seek to reduce its application. Compared to the rest of Europe, the UK has very favourable zero-rating rules and it has been suggested by many that the scope of the zero-rating provisions will be narrowed in the future. Businesses should continue to monitor developments in this area in order to properly prepare for any changes.

International groups - financing and foreign exchange

Where food and drink companies have an international presence, then the financing of these companies can be restructured to take advantage of the finance company partial exemption. This effectively reduces the tax on interest income to a quarter of the headline UK corporate tax rate. This legislation was implemented from 1 January 2013.

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MERGER & ACQUISITIONS REVIEW

The food and drink sector has been the key driving force in helping the UK economy reach a three-year record in terms of M&A “mega deals” (defined as deals over £1bn in value). 2012 saw 39 deals over £1bn announced, compared to 34 in 2011.

Research by Experian has revealed that food and drink manufacturing is the most active sector in terms of megadeals, accounting for 15.4% of transactions announced but it is not just megadeals. According to Oghma Partners, overall transaction levels in the food and drink sector were at their highest levels since 2007 - before the financial crisis hit.

However, whilst the announced transactions clearly indicate the appetite for large scale inorganic growth, the poor macroeconomic environment means businesses remain reluctant to pursue transformational M&A.

The appetite is there - but the valuations are not

The continuing economic uncertainty means that many deals are stalling as buyers and sellers fail to come to an agreement on the valuation of assets. Buyers are anticipating low valuations on assets, but sellers are reluctant to re-evaluate their price expectations where businesses are continuing to deliver strong economic returns.

Case Study I

BRIGHT FOOD'S ACQUISITION OF WEETABIX

Deal background: State-owned Shanghai-based Bright Food took a majority stake in Weetabix for £720m in May 2012. The acquisition formed part of Bright Food's continued march on a string of western household names.

Lion Capital, the buy-out group which purchased Weetabix in 2004, invested a longer period of time negotiating and building strategic value with Bright Food. A trend we are seeing across all transactions.

What does this mean for the industry? The acquisition by Bright Food of such an iconic British brand was the cause of much criticism.

However, whether welcomed or not, the deal is one of a growing number that exemplifies the global power shift from the west to the east. The acquisition highlights how the emerging powerhouses are looking to capitalise on the success of old - but highly iconic - brands. There are many Asian and Latin American companies that have plenty of capital, but lack the experience and gravitas of brands. Acquiring brands is an easy way to gain access to western consumers - something they would find near-impossible with a self-built brand of their own.

Such deals are set to become more commonplace as cash rich emerging market food companies become increasingly desperate to acquire western brands demanded by Asian consumers.

Case Study II

KELLOGG'S ACQUISITION OF PRINGLES

Deal background: In February 2012, the Kellogg Company purchased the Pringles snack brand in a lightning \$2.72bn deal. The deal saw Kellogg boost its standing to no. 2 in the worldwide savoury snack market and highlighted the trend for consolidation.

What does this mean for the industry? The deal was symptomatic of a growing trend amongst businesses to divest assets which fail to form a part of the core strategic direction of the company. In this case, Procter & Gamble were able to use the proceeds of the sale to concentrate entirely on health and wellbeing. Kellogg's availability of cash meant the transaction could be completed in lightning quick time.

The purchase was not just advantageous to Procter & Gamble (it had been attempting to sell the Pringles brand for years). Kellogg's saw its share price jump by 5% immediately after the announcement was made. Proof enough that the purchase had been received well by the market.

Consolidation continued at pace in 2012

Industry consolidation showed no real signs of slowing down in 2012 with companies seeking to build their market share by buying up rivals' brands and business units. Nestle furthered its desire to push into the health and wellbeing market with its purchase of the Pfizer Infant Nutrition business, whilst Kellogg's forwarded its plans to delve deeper into the global snack food business when it bought the Pringles brand from Procter & Gamble in February.

Such deals not only provide companies with increased market share but help them achieve economies of scale from a wider portfolio which are both increasingly vital in a world where retailers have a significant grip on the market and consumers have ever-diversifying tastes.

In addition, large corporate buyers are looking to spread their exposure to fluctuating exchange rates and commodity prices as well as rationalise distribution networks.

Lower risk bolt-ons remained an attractive option

Smaller, bolt-on acquisitions remain an attractive option for companies who want to enter into new markets, enrich their product portfolio, or expand their customer base without the risk of a major change in strategic direction. In 2012 a number of Premier Foods' brands were snapped up by separate companies in a range of smaller acquisitions.

MERGER & ACQUISITIONS REVIEW

Private Equity - is it losing its appetite?

The food and drink sector has traditionally been popular with private equity firms: the stable cash flows, together with strong brand portfolios, make the sector particularly attractive in an underperforming economy.

On the surface, it appears that private equity funding in the sector is continuing to flourish with a number of big ticket deals announced in 2012. Lion Capital bought UK-firm Cumbrian Seafoods, Montagu Private Equity bought Dairy Crest's French business and Pacific Equity Partners acquired Nestle's Australian ice cream business.

However, despite these deals, it is the high profile private equity sales to trade buyers which have been more prevalent in the headlines this year: Blackstone and PAI partners sold half of United Biscuits, whilst Lion Capital - in one of the most controversial deals of the year - sold the much loved British Weetabix brand to Chinese firm Bright Food.

Indeed over the course of 2012, financial buyers only accounted for 15% of transactions by deal volume. These volumes indicate private equity companies are holding onto their food and drink company assets for longer than they may be used to and extracting as much value as they can from their assets - a trend mirrored across all private equity-backed manufacturing businesses.

So, whilst private equity's tastes towards food and drink companies may have altered, there is still plenty of interest amongst private equity firms for food and drink businesses.



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2013: THE TOP THREE TRENDS FOR FOOD & DRINK M&A

- 1. The private equity market kicks into life:** After holding onto assets since the start of the downturn, we should start to see private equity companies seeking to sell investments they have been holding - particularly if the economic situation begins to improve but it will not just be the sale of companies. The continuing investment attractiveness of the food and drink sector to private equity companies, coupled with a more confident market, should see private equity companies gaining a renewed appetite for the sector.
- 2. Increasing raw material cost volatility will continue to drive consolidation:** Food manufacturers realise that the volatility of raw materials input costs is here to stay - at least for the medium term. They will continue to consolidate in order to achieve increased bargaining power and economies of scale.
- 3. Emerging markets will continue their drive for western brands:** The Weetabix acquisition by Bright Food is the most high profile purchase of a western brand by an emerging market business, and is likely to be the start of a trend by cash rich emerging market food and drink companies to enrich their brand portfolios. Deals will not just be reserved for Chinese companies. Other emerging economies such as Brazil and India will also be looking to make buys, particularly for global food categories such as ambient grocery.

SUSTAINABILITY



The critical role that the food and drink sector plays in the UK economy is one of our national success stories. The sector contributes growth, supports many hundreds of thousands of jobs and delivers exports that the UK economy is seeking.

Of course, the sector also sits as a major part of the retail supply chain and is subject to greater levels of corporate and consumer scrutiny than any other group of suppliers. This drive for quality and resource efficiency combines with the role of delivering food security and social wellbeing to place the sector in a unique position.

Without electing to be at the middle of a political focus, the collective leadership of the food and drink industry find themselves at the very centre of the sustainability agenda. If the situation feels complex and challenging it is because, more than any other part of the economy, all sustainability roads ultimately lead to food & drink.

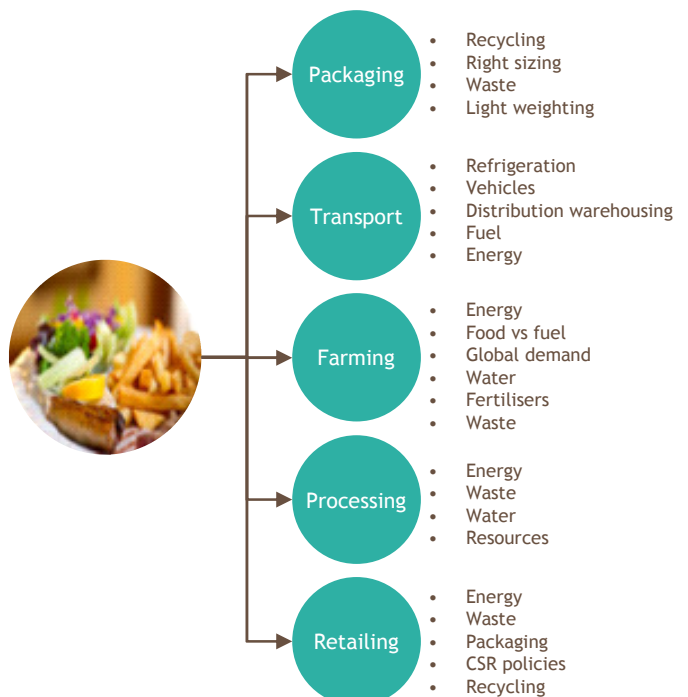
Some of the issues on the agenda are, of course, global in nature and beyond the direct influence of any one company no matter how large. With these big structural challenges, the only intelligent response is to understand the context in which change is happening and then put in place appropriate adaptations to the business as usual approach.

For example, we are familiar with concerns relating to climate change and the apparent increase in extreme weather events such as droughts and floods. Whether or not one accepts that climate change is a factor in the changing pattern of weather, the impact in terms of economic uncertainty and concern around food production are beyond doubt; just ask the insurance industry or those at the frontline of farming and food production in marginal environments.

These uncertainties are set against the back drop of competition for land from biofuels, an increasing human population and the rise of a prosperous middle class in emerging markets. This new consumer base has led not only to rising demand for food but also to changes in the nature of demand, partly reflected in an increased consumption of protein. Not only are costs being driven up as a consequence of this change, but increased pressure is being placed on a delicate resource balance. For those tempted to dismiss this shift as insignificant, consider the fact that it takes up to 16 pounds of grain and as much as 800 gallons of water to produce one pound of beef.

In the same way, the global demand for fresh water which comprises less than 3% of all the Earth's water is 'mission critical' to future food & drink supply. Water conservation, pollution control and a balanced water supply have rapidly risen up the agenda. Even in the UK recent studies by the Environment Agency identified that 12 of the 23 UK water company areas are officially classified as facing serious water stress.

These and other global pressures demand new thinking and the active management of adaptation and change. Proactively addressing risk and creating corporate conditions where innovation can thrive will be critical in dealing with big global challenges. For example, one major supermarket has identified concerns that the water resources in Spain will not be adequate to grow oranges in the medium term and is protecting its supply chain by entering into forward agreements with producers in South Africa for approximately four years time. This form of 'soft' vertical integration allows the South African producers to invest with confidence whilst the supermarket anticipates a competitive advantage in the medium term.



SUSTAINABILITY

On a more local level, the manufacturing and processing of food and drink has historically focused on delivering efficiencies into its processes. Driven by cost, the influence of its customer base and the need to operate successfully in a competitive marketplace, many organisations have become very lean and effective.

The rising cost of energy, waste disposal and water are the most obvious catalysts for improved efficiency but, increasingly, the corporate agendas of the major food retailers are also exerting an influence. For some in the supply chain this can feel like a case of 'we have made a promise and now you're going to keep it'. The good news is that despite the pressures exerted by these commercial drivers and changes to legislation (for example, in packaging and waste recovery) there is an ability for organisations to directly influence the agenda and create some positive outcomes.

Traditional energy, waste and water efficiency programmes are moving towards a focus on investment and opportunity with the adoption of energy security and price hedging strategies. These renewable energy and energy-from-waste projects are taking advantage of interim market incentives such as Feed in Tariffs, the Renewable Heat Incentive and the link between food and drink waste streams and anaerobic digestion plants.

Not only can this focus have direct business benefits but it is also being actively encouraged by the major food retailers. The retailers, and others at the top of the supply chain, recognise that improved energy security in the supply chains will ultimately play out in future pricing as fossil fuel and grid energy prices not only rise, but are at increasing risk of grid supply issues.

Take for example Barfoot Energy, part of the successful Barfoots Group that has been farming in the South of England for many years. Producing high quality sweetcorn and other products for retailers such as Sainsburys, Waitrose and Tesco is good business, but it does generate a lot of process waste from husks and leaves. As Julian Marks, Managing Director of Barfoots explains, "Composting didn't work and landfilling is both out of line with Barfoots' environmental commitments and just far too expensive".

The solution was to develop an on-site energy plant that uses the waste material as its feedstock. Anaerobic digestion plants of this type are relatively common in Germany, but have only recently become part of the UK renewable energy landscape. Barfoots completed their development in 2010, making them something of an early adopter. They have entirely removed their waste problem, and saved a lot of money. Finance Director, Nick Lake said they have also "considerably reduced the number of tractor movements associated with the farm and generated 300% of the power we need - which improves energy security while also creating revenue".

Their innovative approach to a waste management challenge has put Barfoots in a position to provide services to farmers and landowners wanting to develop anaerobic digestion projects elsewhere. It has allowed them to deepen relationships with customers who are increasingly looking to their supply chain to help deliver corporate sustainability commitments and brand values while also managing costs.

As the food retailers at the head of the chain look to manufacturers and processors to create innovation and drive in change, so are the manufacturers and processors looking to their supply chains to identify areas of future risk and opportunity.

Farmers are under price pressure from the cost of fuel in machinery and transport, fertilisers and herbicides (which need lots of energy to make them), the regulatory impacts of run-off into rivers and water aquifers, and the cost of feed for livestock. Transport and logistics organisations are under significant pressure from fuel prices and the cost of operating and maintaining refrigerated buildings and vehicles, and the cost of raw materials and commodity prices around hydrocarbon-based packaging materials such as plastic are driving rapid change.

Across the sector as a whole the delivery of resource efficiency and active management of supply chains translates into compelling market positioning, both with increasingly aware consumers and the major food retailers. Investment in a commercially aligned sustainability programme is a win-win; not only in terms of ongoing operational efficiency but also with respect to brand and reputation leverage.

All of this translates into the need for the food and drink sector to ensure that corporate strategy is directly informed by relevant sustainability issues; not to be green or to gain superficial brand benefit but in order to future proof their organisations.

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WHERE NEXT FOR THE FOOD & DRINK SECTOR?

The strong economic headwinds mean it's likely to remain a challenging environment in the year ahead. The depressed level of consumer spending, intense price competition between retailers and rising costs in the supply chain will continue to be key factors driving financial performance in the sector. But it's not all doom and gloom. Opportunities exist to benefit from maintaining close customer relationships, new product/brand development, expanding into new markets and acquisitive growth.

We highlight 10 key areas we believe will be areas of focus for the food and drink sector in 2013.

1

CONSUMER SPENDING - GOING NOWHERE FAST: Consumer spending is set to remain flat in real terms amid a backdrop of weak economic indicators impacting consumer confidence. With the food and drink market unlikely to grow much beyond inflationary levels, the challenge for companies will be taking a larger share of the cake.

2

CONTINUED PRESSURE ON OPERATING MARGINS: Increasing raw material and operating costs are likely to remain a feature of the supply chain. In addition, the markets for commodities remain exposed to significant volatility. There will be a greater importance than ever on manufacturers to run their production as efficiently as possible to protect operating margins.

3

CUSTOMER RELATIONSHIPS - MORE IMPORTANT THAN EVER: As competition remains fierce amongst retailers, suppliers will need to intently focus on their customer relationships. Working with customers to focus on value added products, promotional opportunities and new product development across portfolios will be key to delivering sales growth and robust margins.

4

THE RISE AND RISE OF OWN LABEL PRODUCTS: The last few years have seen continued growth in own label products. Own label product sales now exceed one third of all food and drink sales, a trend that many predict will continue as cost conscious consumers continue to hunt for value. Understanding how own label supply fits into the wider corporate strategy will be critical.

5

CONSOLIDATION IN THE SECTOR: A reasonably healthy flow of M&A activity in the last 18 months is expected to continue, driven by the opportunity to deliver operating synergies, improve cost competitiveness and provide access to new products/customers. Inevitably, corporate failures in the sector will also present an opportunity to pick up businesses and assets at an attractive price.

6

UNREST IN THE SUPPLY CHAIN: There is increasing evidence of unrest in many parts of the supply chain. Following on from the dairy farmer protests in 2012 there could well be further actions from producers looking to get what they perceive to be a fair price from processors and retailers. Pressures are most likely to come from the farming and agricultural parts of the supply chain.

WHERE NEXT FOR THE FOOD & DRINK SECTOR?

7

INNOVATION AND NEW PRODUCT DEVELOPMENT: Innovation and new product development will provide opportunities to stand out from the crowd and take market share. A focus on refreshing existing brands and developing exciting new products will be particularly important in protecting market share against a backdrop of more consumers switching to own label alternatives.

8

GROWTH INTO NEW MARKETS: The level of exports by UK food companies remains at a low level. Whilst accessing emerging markets can seem daunting, there is evidence that early movers are doing well. A large number of foreign food businesses have already invested in well known UK brands, such as China's Bright Food investment in Weetabix.

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SUSTAINABILITY IN THE SUPPLY CHAIN: The issues surrounding sustainability are only going to escalate up the boardroom agenda. Placing sustainability at the heart of corporate strategy will help create competitive advantage and future-proof the business from sustainability risks in the medium to long term.

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FOOD LABELLING GETS THE GREEN LIGHT: The recent wide-scale adoption of the traffic light food labelling system will bring the health aspects of food and drink products into sharp focus. Food and drink companies may need to review their product formulations and increase the focus on healthier alternatives. Anticipating changes in consumer demand and buying preferences will generate opportunities for businesses looking to appeal to more health-conscious consumers.



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