Food Securities:

Where Wall Street meets Main Street

BY STEVEN S. VICKNER

Capital market imperatives can have as much impact on agricultural producers as the weather or commodity prices. Agriculturalists need to understand that when Wall Street coughs, Main Street ought to try the chicken soup.

Like it or not, developments in global equity capital markets affect the well being of domestic agricultural producers and the rural communities in which they live. Publicly-held behemoths like ConAgra, Sysco, Kroger, and McDonald's, in their quest to maximize shareholder wealth, routinely make decisions to gain the favorable opinion of Wall Street investment bankers. While closing a rural agricultural processing plant, or sourcing raw commodity inputs from abroad, may help bolster a food company's faltering stock price, these strategies may also adversely affect local farm production and marketing practices.

These changes need not always be harmful. Divestments in one geographic area may be offset by expansion in another. Moreover, nothing precludes residents of rural communities from becoming shareholders in publicly-held food companies and earning economic rents through capital gains and dividends.

The study of securities markets is neither new nor novel, but carefully reviewing the financial data of publicly-held food, beverage, and tobacco companies may yield new insights into the direction, magnitude, and speed of structural change during an era of increased agricultural industrialization. For example, the relative price of securities is often an indicator of impending merger and acquisition (M&A) activity. Observers may deduce corporate secrets on the adoption of just-in-time supply-chain management (SCM) by analyzing a firm's inventory activity.

The former addresses the pressing issue of consolidation; the latter sheds light on the challenges faced by agricultural producers regarding production, harvest, and marketing decisions. Addi-

Don't Need a Weatherman to Know Which Way the Wind Blows: A good financial analyst, however, might be helpful. Agriculture and rural communities increasingly play on a global stage, and the winds of change in capital markets are felt ever more keenly on Main Street.

photo courtesy ArtToday.com

tionally, knowledge of publicly-held food companies, such as Archer Daniels Midland (ADM) and ConAgra, may help us anticipate the strategic decision-making of those huge, influential, privately-held agribusinesses, like Cargill, for which little data exists. The argument that changes in the structure of the food industry is related to corporate financial management strategies is gaining popularity too (Cotterill). Ultimately, this invaluable and very public source of clues may help indicate what's next for agricultural producers.

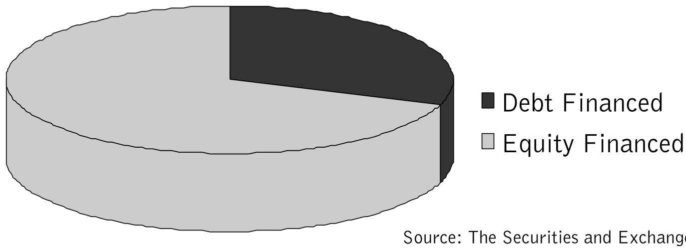
Keeping Up With the (Dow) Joneses

The food and beverage industry has a relatively short history of raising capital in equity markets (Wheeler). While trading on the New York Stock Exchange began in 1792, the earliest publicly-traded food and beverage companies include Coca Cola (1919), Postum Cereal (1922), Kraft Cheese (1926), Borden (1927), General Mills (1928), Beatrice Foods (1929), and Armour & Company (1930).

In 1997, 70 percent of the publicly-held food industry's $722 billion total asset base was financed with common and preferred stock (Figure 1). The remaining 30 percent was financed with debt capital, such as corporate bonds and bank notes. In the last two decades, this mix of financing has remained relatively constant in the food industry, but recently the percentage of equity financing has ticked upward for food manufacturers. The implication for the entire food system is that equity markets matter.

In a sector where the investing public owns nearly three-fourths of the industry asset base, it is no longer sufficient for a food company to exceed its own past performance or that of a narrowly defined peer group. Food and non-food companies with similar capital and risk structures compete for the same financial resources. Thus, a firm's cost of capital equals the risk-free rate plus the return that must be provided to keep the shareholder from investing money in a similarly risky stock — food or non-food. Once this fundamental principle is understood, it becomes clear that publicly-held food companies do not operate in a vacuum influenced only by other food companies, farm policies, and agricultural commodity prices. Management practices, such as M&A and SCM strategies, implemented by publicly-held non-food companies cannot be ignored. Otherwise, the food industry will fall behind the others and lose access to investors' capital.

Figure 1. In 1997, Seventy Percent of the Publicly-Held Food Industry's $722 Billion Total Asset Base was Financed with Equity Capital



Source: The Securities and Exchange Commission's EDGAR database and Standard & Poor's COMPUSTAT North America database.

Merging in Heavy Traffic

During the last two decades M&A strategies have been popular means used to increase shareholder value and bring about an efficient allocation of financial resources. The publicly-held food industry has been no exception to this rule. The theory is simple. Eliminate redundant functions and employees through acquisition, and shareholder value is enhanced. Any organizational and marketing synergies, or other economies, are simply icing on the cake. Marauding Wall Street investment banking firms tested this theory in the 1980s, a decade characterized by hostile takeovers (Connor and Geithman). Rogers (2000) found M&As reached a near historical peak (between 550 and 650 deals per annum) for food businesses during this time, and M&A activity in the food sector has accelerated in the last half-decade (between 700 and 800 deals per annum).

Despite potential benefits of economies of scale and scope, industry consolidation through M&A activity naturally concerns policy analysts. Agricultural producers may face fewer buyers and processors for their commodities and possibly lower wholesale prices. Consumers may be confronted with higher retail prices, fewer places to shop, and a less extensive range of products offered in retail outlets.

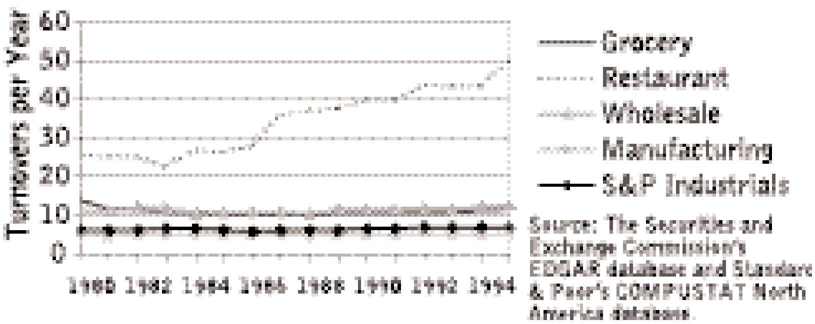
IBP, Incorporated, the nation's largest meat packer, represents a timely case study. Despite being structurally sound, IBP securities have been undervalued for some time, trading at only a fraction of their book value per share. "Over 10 years, the only thing treated worse than their [IBP's] public shareholders have been their cattle," said John McMillin, a food industry analyst at Prudential Securities (Kilman and Sherer). The short list of potential buyers, which included Cargill, ConAgra, ADM, Tyson Foods, and Smithfield Foods, was as much an agribusiness Who's Who as a list of potential suitors. After various failed attempts to purchase IBP (which first included lesser-known Donaldson, Lufkin, & Jenrette, Inc., followed by Tyson, and then Smithfield), on August 27, 2001 the Securities and Exchange Commission (SEC) approved a merger between IBP and the Lasso Acquisition Corporation, a wholly owned subsidiary of Tyson.

A merger of this magnitude will alter the structure of the domestic beef industry and affect livestock producers. Tyson has a long history of managing supply chains using vertical integration and contracting. As a result, Tyson has "privatized" the price discovery function. This puts the writing on the wall for the beef industry, just as it once was for the poultry, hog, and vegetable industries.

Right Turns, Wrong Turns, and Inventory Turns

Financial efficiency refers to a firm's ability to better manage its assets. Inventory turnover, cost of goods sold, and the value of average annual inventories are suitable financial performance metrics to quantify the impact of SCM strategies. Like M&A strategies, just-in-time SCM strategies have also been used by publicly-held food industries as they try to keep pace with non-food manufacturing, wholesaling, and retailing peers. Figure 2 shows trends in inventory turnover from 1980 to 1997. In each sector, both cost of goods sold and value of average annual inventories increased through time. Despite the hype regarding "Efficient Consumer Response" and "Category Leadership" between food manufacturers, wholesalers, and grocers, their trends have been flat. In less than 20 years, inventory turnover in the restaurant sector has almost doubled, increasing from 26 to 45 times per year. Restaurateurs now completely replenish their inventories every 8 days, down from the two weeks' supply maintained in the early 1980s. Grocers and wholesalers replenish inventories approximately monthly, while food manufacturers restock about every 72 days.

Figure 2. Inventory Turnover Rate by Industry



These trends have far-reaching implications for the way business is conducted across the food system, especially in perishable commodities. Food consumed away from home makes up nearly half of all domestic consumer food expenditures (roughly $339 billion in 1997, according to recent USDA-ERS data), and the trend of consuming food away from home is unlikely to reverse in the near future. Publicly-held restaurant sales hover near $56 billion annually — roughly 17 percent of all food away from home expenditures. While restaurateurs' just-in-time SCM practices reflect in part the response to the consumer's demand for fresher foods, to a larger extent these strategies reflect the investment banker's reluctance to tie up productive capital in slow-moving inventories. However, unlike a tire company supplying an automobile manufacturer, the lettuce grower may not simply be able to store the product until the next production run requires it. The tire manufacturer has only foregone the return of the capital tied up in the tires and incurred a storage cost. The lettuce grower loses that plus the future sale of the output if it spoils.

Since larger privately-held restaurants and restaurant chains must attempt to emulate the SCM strategies of publicly-held restaurants, the effect of closely managed inventories on agricultural producers may be even more dramatic. Additionally, by transplanting the restaurant industry's SCM initiatives in the grocery, wholesaling, and manufacturing sectors, it is not unreasonable to expect higher inventory turnovers in those sectors in the coming years, moving the burden and risk of perishable inventory ownership further up the supply chain and thus continuing to transform the structure of the consumer food marketing channel.

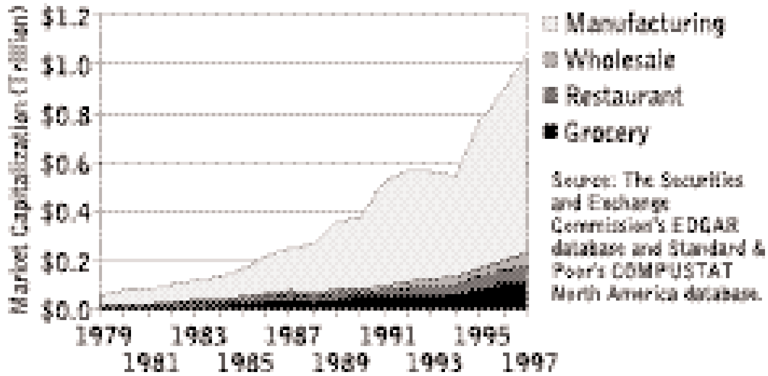
Warning: Cash Cow Crossing

The fundamental business objective in a publicly-held company is to maximize shareholder wealth. Hence, CEOs are frequently evaluated on their ability to grow market capitalization (the product of stock price and shares outstanding). While there are many metrics available for measuring wealth creation, growth in market capitalization is perhaps the most popular.

Figure 3 shows that total market capitalization grew from $54 billion in 1979 to $1.03 trillion in 1997 (a 17 percent compound rate) for all 994 publicly-held food companies traded on North American securities exchanges. This rate of growth in food sector wealth is consistent with other estimates found in the financial industry. For the nine years ending in 1997, the Fidelity Select Food and Agriculture mutual fund, which represents a broad portfolio of publicly-held food and beverage manufacturers, wholesalers, and retailers, maintained a compounded annual growth rate of 18 percent.

Like wealth creation, the importance of corporate dividend policy in the food industry is underscored by its vast exposure in equity capital markets. Maintaining a compounded annual growth rate of nearly 10 percent from 1979 to 1997, combined preferred and common stock dividends rose to $17 billion annually in the food industry by 1997. This continual multi-billion dollar redistribution of funds, in the form of capital gains and dividends, is seldom reported or mentioned in mainstream food industry research (Sexton).

Figure 3. Total Market Capitalization in the Food Industry Grew at a Compounded Annual Growth Rate of 17 Percent from $54 Billion in 1979 to $1.03 Trillion in 1997



Agriculture's Role in the Food Industry: Peering into the Future

The Securities Exchange Act of 1934 created the SEC and charged it with the task of increasing transparency in the financial reporting of publicly-held companies. This was accomplished through documents such as quarterly (10-Q) and annual (10-K) filings, along with information regarding M&A activity. Some of the financial performance metrics based on this data, either viewed at the company or industry level, represent concurrent and occasionally leading indicators of structural change in the food industry. Consolidation trends can often be linked to the relative prices of securities and SCM strategies to inventory turnover statistics. Classes of financial statistics not considered here, such as liquidity, profitability, and other financial efficiency and market-based measures, provide additional useful clues to other areas related to structural change in the industry. Careful study of the developments in global securities markets and the data collected on publicly-held food, beverage, and tobacco companies may improve our ability to gauge what challenges agricultural producers will face in future years.

For More Information

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