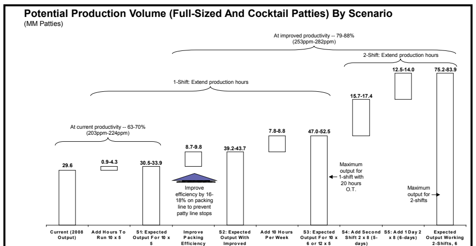
Operational Due Diligence Of Family-Owned Branded Ethnic Foods Manufacturer: Assessing Operational Scalability To Support Targeted Growth

The Challenge: A mid-market private equity firm was in exclusive negotiations with FoodCo, a family-owned branded frozen ethnic foods manufacturer operating out of the Northeast. The PE firm's investment thesis was to grow the company 2-3 times its current size by: (1) introducing more sophisticated and professional business practices; (2) expanding nationally through retail and food service channels; and (3) expanding into new products, customers, and channels – organically or through acquisitions. To better understand operational realities and determine requirements for growth, the PE firm asked Gotham to conduct an operational due diligence focused on: determining the throughput potential of the current plant/reality checking management who believed that the plant was running at capacity; identifying potential co-packers in the event plant can not meet growth requirements; assessing plant equipment and capex requirements; evaluating food safety practices; and conducting an overall assessment of management, processes, and systems to establish potential cost reduction opportunities.

The Partnership:

<u>Analysis</u>: As a starting point, Gotham visited the plant to interview managers, observe the manufacturing operations, and collect operational data. We quickly established that the company's owner was singularly driving operational decision-making, and that operational data and processes were non-existent. To generate this missing data, Gotham undertook a number of bottom-up efforts to build the required fact base, including: (1) observing the manufacturing operations and collecting data to map the manufacturing process and establish cycle times, labor requirements, waste, and downtime; (2) reviewing financial statements and assumptions; (3) collecting available paper records, spreadsheets, etc., on production, sales, purchasing, quality, assets, and cost data; and (4) interviewing operational personnel and leveraging our own knowledge to fill remaining data gaps. We then built a bottom-up operating cost model incorporating labor, material, overhead, and distribution costs, and throughput.



	Current (2008 Output)	Add Hours To Run 10 x 5	S1: Expected Output For 10 x 5	Improve Packing Efficiency	S2: Expected Output With Improved Productivity	Add 10 Hours Per Week	S3: Expected Output For 10 x 6 or 12 x 5	S4: Add Second Shift 2 x 8 (5-days)	S5: Add 1 Day 2 x 8 (6-days)	Expected Output Working 2-Shifts, 6 Days/Week
Production Hours	38.8-43.2	44.5	44.5	44.5	44.5	53.4	53.4	71.2	85.4	85.4
Cocktail	4.8-5.4	5.5	5.5	5.5	5.5	6.6	6.6	8.8	10.6	10.6
Total	43.6-48.6	50	50	50	50	60	60	80	96	96

Simultaneously, the Gotham team undertook various approaches to answer the PE firm's due diligence questions:

- To understand **plant capacity and current utilization**, we analyzed each production process and storage area in detail and created several improvement scenarios for increasing capacity
- To pin down **capex requirements**, we reviewed each key piece of equipment with engineering to pin down age, condition, breakdown history, spare parts, and replacement cost/lead times
- To assess availability **of co-pack options**, we identified 25 potentially capable co-packers and contacted them to discuss viability and requirements
- To establish **supply chain requirements** of national expansion, we evaluated potential warehousing options (including a new company-owned warehouse and 3rd party warehouses) and freight cost implications
- To assess **food safety**, we reviewed quality and HAACP processes and Department of Agriculture inspector non-compliance reports for the past several years.

<u>Findings</u>: Key findings from our due diligence assessment includes:

- **Throughput Enhancement Potential:** With improved labor efficiency of packing lines (requiring labor discipline and productivity reporting/metrics) and addition of run hours, existing facility would be capable of production 2.5-2.8x current volume
- **Capex Requirements**: No major near-term capex requirements as existing equipment in fairly good condition
- **Co-Pack Options:** 5-6 viable and interested co-packers exist; leveraging this outsourcing would require segmenting the production process and investing in equipment
- **Cost Reduction Opportunity:** In addition to labor productivity enhancements, other potential cost savings opportunity include: transition away from a production-quota-based compensation structure for legacy employees; vendor consolidation and provision of clear specifications to capture purchasing savings; fill weight controls to reduce material waste; and renegotiation of freight rates.

Overall, FoodCo offered significant opportunity to reduce cost and improve throughput by establishing disciplined, well-defined processes, addressing critical gaps in the planning (MRP) system, enhancing reporting/tracking metrics for productivity, waste, and quality, and strengthening personnel in key functions (e.g., purchasing and inventory management).

The Outcome: Gotham's operational due diligence indicated that with the improvement noted above, FoodCo's current operations should be able to meet the PE firm's growth objectives without any significant investment and with a 16-17.5% reduction in cost per case. We provided a road map for improving operations and the PE firm is in the process of closing the deal.