Premium Brands

A Bright Future by Learning from Our Past

Once in a while, as time allows, I reflect on how far our company has come over the past fifteen years and am truly humbled. From our modest beginnings in western Canada, we have evolved into one of Canada's largest food companies and one of North America's largest sandwich companies. We now have over 6,700 employees, 49 facilities and sales across Canada and the U.S. How did this happen? Was it planned or did it happen by accident? Furthermore, how did we deliver to our shareholders an annual compounded return in excess of 28% over the past fifteen years while operating in a mature, highly competitive industry dominated by billion-dollar multinational food conglomerates with seemingly unlimited resources?

Over the coming paragraphs I hope to answer these questions by sharing with you some of the history of our company and the key lessons, events and decisions (right or wrong) that shaped the way we think and how we manage our company and our shareholders' capital. I then want to provide you with a roadmap of what lies ahead for us as we ourselves become a multi-billion-dollar food conglomerate.

My career in the food business began at a western Canada based pork commodity company called Fletcher's. At the time Fletcher's operated four facilities: two hog processing facilities, one in Red Deer, Alberta and the other in Langley, BC; and two mainstream processed meats facilities, one in south Vancouver and the other just south of Seattle. The Red Deer facility processed 4,000 hogs per day and sold pork globally while the Langley facility processed 800 hogs per day and catered to niche ethnic markets in BC's lower mainland. The Red Deer facility, which was much larger and more efficient than the Langley facility, constantly struggled to make money as pricing for its products was determined by global balances or imbalances in the supply and demand for its commodity pork products. Comparatively, the Langley facility always made money as it produced specialized products for niche markets.

At some point, as part of a strategy to improve the competitiveness of the Red Deer plant, we decided to expand its scale and invest in state-of-the-art processing equipment. In conjunction with this, we accepted an offer from a local businessman to sell the Langley operation. We then proceeded to spend $40 million on the Red Deer plant and while the project came in on time and on budget the operation's financial results continued to be underwhelming. We achieved the expected efficiency and product quality gains, however, we were still producing commodity, non-differentiated products that were being sold at prices determined by factors beyond our control.

In retrospect, we should have sold the Red Deer facility and kept the Langley facility, i.e. we should have sold the commodity focused business that was a price taker and instead dedicated our capital and efforts to the niche focused business that was a price setter. This was one of my first real world business lessons, namely the importance of selling differentiated products at fair prices and margins rather than being a price taker and subject to forces outside our control. To this day this hard lesson is at the core of every capital allocation decision we make.

My next “Red Deer” lesson was in regard to making sure individual management teams control their destiny. The Red Deer facility was mandated as the exclusive supplier of fresh pork to all our downstream value added businesses. The strategy behind this was to reduce our commodity risk exposure by value-adding the Red Deer operation’s products. What we did not see at that time was how this strategy hindered innovation and did not necessarily result in the optimization of revenue and margins. The Red Deer operation, given that it had a captive customer, had no incentive to invest in product innovation or to ensure that it was finding the most valuable markets for its products. Similarly, our downstream businesses had no incentive to invest in the global supply chain knowledge and relationships that can often result in unique procurement, product differentiation and product innovation opportunities. Today, one of the strengths of our business is the sophisticated global and local supply networks that we have worked with our various businesses to develop. These networks have helped to drive product innovation, enhanced the depth of our portfolio of products and brands, and diversified supply chain risk.

The third lesson I learned from our Red Deer plant experience was to avoid battles that you are unlikely to win. The Red Deer operation competed in a universe that included very large global players with broad networks of production facilities. We, on the other hand, were trying to compete in this global market with a single facility located in the northwest corner of Canada. Correspondingly, any efforts by us to build close customer relationships or provide new product solutions to customers were generally unsuccessful when, all too often, we would get caught in the crossfire of these much larger companies fighting for market share. Based on this lesson, we have often decided to pass on potential deals – I am sometimes prouder of the deals that we have passed on than I am of the ones we have completed.

The foundation of what has today become Premium Brands was set in 2001 when we sold the Red Deer facility and exited the commodity pork business. Since then every investment decision we have made has incorporated the above lessons.

Our first deal

Empowered with the lessons learned from our commodity pork business, we began to look to invest in food businesses that were producing differentiated branded food products. The first of these was Grimm’s Fine Foods, a premium European deli meats company based in Richmond, BC. The business was being managed by brothers Rick and Heinz Grimm, sons of one of the original founders of the business. Rick and Heinz were looking for some help for a variety of reasons including the business was in need of capital to support its continued growth.

We were delighted at the opportunity of partnering with Rick and Heinz. Not only did Grimm’s have all of the key competitive strengths we were looking for, including a strong family heritage, a market leading premium brand, an entrepreneurial culture and a razor sharp focus on current consumer trends, but we were also very confident that we could empower its management team to take what was a good relatively small business and turn it into a much larger great business. Furthermore, the Grimm’s family were upstanding citizens in the community with a great reputation for producing high quality, authentic German style sausages and other deli style products. This was at a time when consumers were just beginning to have doubts about the mainstream food industry and were starting to read and question the large ingredient lists, which included various preservatives, artificial colors and unpronounceable chemicals, on the products being sold by the national and international consumer packaged goods companies.

We worked with Heinz and Rick to address certain weaknesses in their business while helping them build on their strengths. What happened next is nothing short of remarkable. The combination of Grimm’s competitive strengths with our resources was a major success with the returns generated on this investment far exceeding even those of our best case scenarios. Today Grimm’s continues to be a leading deli brand generating strong growth rates and margins. Although Heinz has since retired, Rick continues to be involved in the business alongside a strong entrepreneurial management team, almost all of whom have spent most of their careers at Grimm’s and fully understand and appreciate its entrepreneurial and dynamic culture.

Our second deal

The second deal in our journey of transitioning away from commodity products and toward value added and branded products was Harvest Meats. Similar to Grimm's, Harvest has also turned out to be a fabulous investment for our shareholders. One of the key reasons for this is the strong leadership of Kenn Propp, Harvest's CEO and the great grandson of Harvest's founder, Alexander Propp, along with the talented management team he has built. Kenn approached us to partner with him for two very typical reasons: his partner at the time, Walter Bauer, was looking to retire and Kenn needed capital to help support the continued growth of his business. Having admired and enjoyed Harvest's signature bacon and farmer double smoked sausage products for years, we jumped at the opportunity to invest in what was then a small but very well run business.

Since joining Premium Brands, Kenn and his team have grown Harvest's branded business by over tenfold while expanding its production facility in Yorkton, SK from 30,000 square feet to 160,000 square feet. Today, Harvest is the leading premium processed meats brand in western Canada and a key supplier to its sister company, Ferndale, WA based Hempler's. Harvest is a true Canadian success story and a testament to the resilience, perseverance and dedication of Kenn Propp and his management team. Our shareholders have many reasons to thank Kenn and his team as our return on this investment also far exceeded even our best case scenarios.

Harvest Meats is celebrating its 90th anniversary this year. Ninety years of dedication, hard work and passion in producing best-in-class products exemplifies the spirit and culture that we value so highly and make every possible effort to preserve when a new business joins our family. After all, these are the values that lead to their success as a private company.

Lessons learned

The Grimm's and Harvest transactions helped us to refine, in general, our acquisition strategy and, in particular, the core of our strategy, namely providing successful food entrepreneurs with customized ownership solutions that meet their liquidity and estate planning needs; then giving them access to the resources they need to strengthen and accelerate growth in their business. These transactions also validated our earlier lesson of empowering existing management teams to run their business, rather than mandating top down strategies, and taught us a new lesson on the merits of preserving a business' culture and institutional knowledge at all costs.

Furthermore, our partnership with Harvest re-enforced the importance of long-term patient investing. After they completed their first plant expansion, Harvest ran into some challenges and as a result limped along for a while. We did not panic. Management had a clear vision and plan, product quality was not being compromised and the expansion itself was best in class. After a few years, we began to see some promising green shoots. These soon became a forest and the sky cleared. The Harvest brand is now a household name and their products not only lead a variety of premium categories, but in many cases define them. I often hear about how large mainstream players can't figure out how this little known Saskatchewan based company could come out of nowhere and suddenly be everywhere.

The passion, resilience and work ethic necessary for a small specialty food business to succeed in an industry dominated by large multi-national competitors cannot be taught at business school or imposed from a corporate board room. Over the course of my career I have witnessed far too many examples of smaller food companies being acquired by large food conglomerates who then, through the process of rationalization, consolidation and cost cutting, destroy the very fabric of what made these small companies successful in the first place. The too often misplaced focus on costs instead of value, on assets instead of people and hierarchy instead of culture, are the reasons why so many past acquisitions in the food industry have failed. Correspondingly, our intense focus on the opposite of each of these factors is the primary reason why we have been able to meet our targeted investment returns. We have never had the integration of an acquisition go wrong for one simple reason, we do not integrate businesses. Rather, as I mentioned earlier, we empower their management teams by giving them access to our resources and then allow them to choose which, if any, of these resources can be used to help their business grow and prosper.

Since our acquisition of Harvest, we have executed many more transactions following the principles and strategies described above. Additional examples include our investments in two US based businesses, Hempler's and SK Food Group, both of which have generated amazing sales growth under the Premium Brands umbrella. Some Canadian examples include Piller's, Freybe, Centennial Foodservice, C&C Packing and Expresco Foods, all of which came with best-in-class management teams, strong entrepreneurial driven cultures and values that fit with ours.

Financing growth

Our primary goal is to create shareholder value over the long term. We are passionate about guarding against short term thinking and try to make every decision based on the long-term best interests of our shareholders. This not only applies to how we deploy capital but also how we raise capital. Over the last eight years our primary financing sources have been senior debt and convertible debentures. The convertible debentures have been our equity strategy since our ultimate objective is to have them converted to equity. Hence we are effectively raising equity at up to a 65% premium to our share price versus the discount associated with a traditional equity offering. To date we have completed eight convertible debenture offerings resulting in net proceeds of approximately $654 million. Four of these issuances have been fully converted, a fifth is expected to be fully converted shortly, a sixth is well into the money and is expected to be fully converted in early 2019 and the remaining two are recent offerings.

We estimate that our convertible debenture financing strategy has, by minimizing dilution, created almost $20 per share in value for our long-term shareholders.

Over the past ten years we have raised some capital through the direct issuance of shares, however, until recently this has been limited to the issuance of shares to entrepreneurs in conjunction with the acquisition of their companies. We are big believers in the principle of management having "skin in the game" and do this to further align the interests of management with those of our shareholders. In fact, one of the most common regrets that I hear from entrepreneurs that we have partnered with is that they wished they had taken a larger portion of their proceeds in Premium Brands shares when they sold us their business.

The road forward / long term thinking / our "why"

I firmly believe that the road ahead is going to get even more exciting. Our growth platforms are exceptionally well positioned to continue to grow and create value for our shareholders while our management teams are now contemplating global strategies instead of just North American ones. I know that this is a fairly grand statement that could be misinterpreted as promotional or overreaching but I have met with many talented food entrepreneurs who are running solid family owned businesses outside of North America that are facing the same issues that our current partners encountered prior to joining us. These include family succession, access to capital, liquidity, consolidation of their customer base and changing consumer tastes.

As I have outlined above, we can offer these entrepreneurs ownership solutions without them having to fear rationalization, bureaucratic decision making and the loss of their family legacy, which in many cases goes back multiple generations. Furthermore, the entrepreneurs we have partnered with over the years are discovering additional overseas opportunities by leveraging our global supply chain networks to cultivate new relationships and partnerships.

In terms of North America, we are continuing to see an increasing number of acquisition opportunities as our story becomes better known, particularly in the U.S. We consider it both an honor and a privilege that an increasing number of talented and successful food entrepreneurs from across Canada and the U.S. consider us as their acquirer of choice. The combination of our unique culture, focus on long-term value creation and respect for the legacy of the businesses and entrepreneurs we partner with differentiates us from most, if not all, other major food companies in North America. It is for these reasons that the pace of our acquisitions activity has been accelerating and our pipeline of potential opportunities remains very robust.

2017

2017 was another active year and finished with a flurry of transactions. Our Sandwich Group growth platform was particularly busy having completed and commissioned a new 212,000 square foot sandwich production facility in Phoenix, AZ and closed two very strategic acquisitions: Buddy's Kitchen and Raybern. All of these initiatives help to diversify the Group's manufacturing footprint, provide much needed capacity and, in the case of the acquisitions, expand its presence into new distribution channels while providing it with a leading retail brand.

We were particularly pleased with the opportunity to partner with Dave Smith, President and CEO of Minneapolis based Buddy's Kitchens. Since joining Buddy's Kitchen in 2007 Dave has grown it over fourfold by refocusing it on being a provider of culinary meal solutions to the airlines and convenience store chains. Furthermore, he has created a culture and a set of values within Buddy's Kitchen that perfectly mirror ours.

During the second half of 2017 we also completed two smaller but key transactions in Ontario, namely Leadbetter Foods and Skilcor. Both companies came with great legacies of entrepreneurially driven success and growth against all odds. Deborah Kinzinger at Skilcor and Phil Leadbetter both built their businesses by producing differentiated branded protein products that reflect the passion and values of their founders. We are privileged that both of them chose us to partner with and look forward to working with them to help take their businesses to the next level in their development.

No discussion about artisanship is complete without mentioning our new bakery joint venture in San Francisco with Pascal Rigo and Nicolas Bernadi, two of the most passionate, creative and innovative entrepreneurs in the food space. Early in their careers Pascal and Nicolas built La Boulange into a very successful combination artisan bakery and small regional coffee chain that they then sold to a much larger multi-national chain.

In conjunction with the sale of their business, Nicolas and Pascal took on the role of overseeing the acquiring chain's food innovation initiatives. While they were very successful in this role, and introduced an amazing array of new products that drove a significant amount of growth, they missed the entrepreneurial nature of running a smaller business and decided to exit the corporate world to found San Francisco based Shaw Bakers.

When the opportunity was presented to us to partner with Pascal and Nicolas we jumped on it. It was an easy sell for us as our Shaw Baker partnership is the perfect vehicle for combining Pascal's and Nicolas' passion for innovation, food craftsmanship and artisanship with our ability to provide capital, capacity and scale. Artisanship combined with scale is the holy grail of today's food universe as consumers turn away from the traditional food chain and the preservatives, artificial colors and unpronounceable chemicals associated with industrial food production.

Conclusion

Last year I warned our shareholders not to expect another 80% jump in our stock price, at least not in the short term. We did, however, manage to deliver a 52% return this past year and, correspondingly, I once again caution you not to expect these types of returns every year. As we always have, we will continue to manage our business for the long term and not for short term financial results. Our long-term objective is to generate a compounded annual return for our shareholders of 15% by investing in stable, well-run specialty food businesses with solid growth opportunities and attractive risk profiles. When our share price far exceeds this objective, it does not change the way we run our business or the risks we are willing to take.

Over the next few years we are confident that we will continue to deliver strong top and bottom line growth driven by the execution of our business plan and our willingness to only take calculated risks in areas of the food space that we know well. This way, if anything does go wrong, and it usually does, we can respond quickly and effectively.

We are very excited by what lies ahead and by the opportunities we are seeing, both for organic and acquisitions related growth. In terms of organic growth, never in my 30 years in this industry have I seen such an array of opportunities. Consumers are voting with their wallets and choosing to buy local and regional brands instead of national ones. This is creating significant opportunities for insurgent companies, such as our specialty food businesses, at the expense of large consumer packaged goods companies that each quarter are struggling to grow their sales. We are winning the hearts of consumers by producing food with integrity, quality and great community and social values; and correspondingly, retailers are dedicating an increasing amount of shelf space to our products and brands.

I would once again like to thank our employees for their dedication and hard work. I am privileged to work with such a talented group of passionate and entrepreneurial people. We are very lucky to be the employer of choice for our great workforce and will continue to lead the industry in all employee related metrics including diversity, inclusivity, retention and sponsorship of charitable causes and community events.

Finally, thank you to all of our shareholders for your support and belief in our vision.

George Paleologou
President and CEO