The Flavor & Fragrance Industry: Selling Out or Holding On?

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Companies in the specialty chemical and the flavor and fragrance industries are concentrated in Northern New Jersey and upstate New York. These firms make food taste better, shampoos smell nicer, and provide the fragrance ingredients to perfume, air freshener and candles. In total, it's a $20 billion market worldwide, according to Leffingwell & Associates.

Many originated as importers of essential oils in New York City, but eventually left the city as they grew bigger and the smell of mixing essential oils and, later, aroma chemicals became unsustainable in the city.

Today, the market is forcing these companies to compete with overseas competition, deal with consolidation among their customers and manage economies of scale where the larger firms have the advantage. Middle-market suppliers can only succeed by either selling out or holding on and continuing to grow their companies. The status quo won't work in today's market.

Like in other specialty chemical industries, the flavor and fragrance industry has consolidated to an extent where the top five/ten players control 59 percent/71 percent of the market, respectively. Their customers, the big consumer goods companies such as P&G, Unilever, Kraft, etc, which have consolidated and bought brands themselves, are only selecting a few suppliers as "core suppliers" and eliminating all others.

Core suppliers need to have an international manufacturing footprint and invest significantly in consumer goods research in order to make new consumer product introduction proposals. These suppliers must also have the R&D to find new technologies for delivering a fragrance that lasts longer and other innovations. Core suppliers are expected to pass through improvements in production costs and even make up-front payments for the privilege to participate—a tall order for a mid-market supplier.

Years of no product defects, a record of on-time deliveries, excellent customer service, creativity and quick response times are marginalized. In addition, an increasing amount of regulations on production and ingredient usage/registration, as well as headwinds from the last economic downturn, have made life even more difficult for many middle-market suppliers. For many suppliers that survived the last wave of consolidation and then the economic downturn, the question has become, "Where do we go from here?" The economy seems to be rebounding and sales have, in many cases, started to increase. For many entrepreneurs, this will set the stage for either selling out soon or positioning the company for long-term growth.

Like most strategic decisions, it is all about focus. Even in these very competitive markets, there is a place for a mid-market supplier. A supplier just has to choose its battlefield. Don't try to compete where you are at a disadvantage and have little chance of success like the core supplier lists. Think about what your company does best and what it excels in. Look at what your middle-market competitors are doing and then decide what product lines and customers to focus on. Sometimes suppliers have found that they can create a "firm within the firm," catering to different customers requiring different services and product quantities. However, boundaries tend to get blurred and a supplier might end up providing Cadillac service to Buick customers.

In some industries, it has become practice to divest a "book of business," which involves customer/sale relationships and product formulas without fixed assets that do not fit a supplier's strategic objective anymore. Through a closely controlled process, such a sale can be executed with confidentiality. Ultimately, it will provide a supplier with capital that it can invest in other areas of focus. Once a supplier has determined its long-term strategy, implemented its focus and streamlined its assets, the question becomes, "Where does growth come from when the end-markets [consumer products] do not show much promise?"

A middle-market supplier may decide to try to invent a proprietary technology to protect it from market forces. Technologies are risky business. Yes, they might provide a competitive advantage but really groundbreaking technologies take a lot of time and effort to develop. Not everything that looks promising in the beginning lives up to its expectations. Even with a patent protection, a technology can be costly to defend should someone else with significant financial resources

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want to use it. While tempting, focusing growth on developing technologies requires a large R&D budget (to develop several simultaneously) and usually a long time to pay off.

A middle-market supplier may also focus on areas that grow more rapidly than the overall market. Natural, Organic, and Health are examples of fast-growing categories. Developing expertise in these areas early has a good chance to outrun a bigger competitor which has hierarchies that impede quick decision-making.

The biggest strength for a middle-market supplier is from within. In many corporate transactions where we represented the seller, the buyer (typically a large strategic acquirer) was surprised at the turnover, even among the large customers. That is exactly a middle-market supplier's core strength. We all know the customer that ordered $1,000 worth of product in year one, $50,000 the next year—and before you know it—$100,000 or more. It is important for suppliers to constantly mine its customer list for these "diamonds in the rough" and allocate a sales person to ride the growth curve with these customers as long as possible.

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Unfortunately, this customer might eventually be bought or graduate to such dreaded habits as core supplier lists. However, aggressively unearthing new prospects is the key competitive advantage of a middle-market supplier while the sales force of a larger organization is usually focused on "serving" existing customers. It is not easy and will take some time to create and foster the right sales mentality and incentive structure for your sales force, but it will pay off.

Growth may also come externally by acquiring a "book of business" or even an entire organization. Facilities can be consolidated to eliminate costly, unused capacity. A supplier may also decide to venture abroad and acquire a small business on another continent. Acquiring businesses, even domestically, requires a lot of thought, experience and preparation. A supplier would want to look around, study several businesses and evaluate alternatives. Developing your options requires a lot of time, effort and expertise. It is usually wise to outsource this special service to a professional firm which brings the expertise of how to source and structure deals, address complex shareholder situations and negotiate with different cultures.

In most cases, an entrepreneur is growing his business to ultimately build wealth and eventually sell it for a nice payday. When focusing on a business strategy, many suppliers are well advised to build a company that is not only a lifestyle company (supporting the owner through dividends) but can be built into something a larger company might eventually want to acquire.

Should an entrepreneur decide to engage in a corporate transaction, it is critical for the entrepreneur to have a full understanding of each step of the transaction process and then to properly prepare for each one. Preparing for a transaction takes time and, therefore, should be initiated early in the process. Taking the right steps early on can mean all the difference. Poor preparation leads to delays, higher transaction costs and bad results, whereas proper preparation minimizes distraction, reduces risks and increases the likelihood of achieving your goals.

Actually, the first step in preparing for a corporate transaction is recognizing that you cannot handle the transaction alone, particularly since you still need to keep an eye on operating your business. It is important to pick your transaction team, both internally and externally, and then to work with your team to develop the proper business strategy that evaluates all your options. ■

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