EDISON

Flavours and fragrances

Identifying opportunities in a highly rated market

Consumer

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The massive sector re-rating over the past three years reflects the industry's many attractive qualities – 3.5% annual structural growth, significant barriers to entry and high cash conversion rates. However, at current valuations, stock selection is of increased importance. In addition, although stretched valuations mean fewer opportunities for transformational M&A deals, we expect continued consolidation.

Attractive investment qualities…

Investor interest has been driven by the sector's numerous defensive qualities. Barriers to entry include investment in R&D, regulatory expertise and the fact that established companies are locked into their customers' supply chains. Typically, the vital active flavours and fragrances (F&F) ingredient consists of merely 1-5% of a customer's overall cost. An additional bonus is that, through these customers, the F&F industry is able to expand geographically without committing capital, hence high ROCE and cash conversion rates.

…but stretched valuations mean higher risk

At current valuations, there is not much room for disappointment. The key question is whether the sector's high margins are sustainable. This is particularly pertinent when compared to the lower returns of their own sophisticated customers. Furthermore, across the sector, recent results suggest that the market may not continue growing at the same rate, particularly in mature economies. Inevitably, the winners will need to gain market share and diversify into complementary products.

A consolidating $18bn dollar market[1]

M&A has long been a feature of this industry, with the result that two-thirds of the market is now dominated by four players (Givaudan, IFF, Symrise and the privately owned Firmenich). Highly rated paper provides an opportunity to purchase growth and some companies are continuing their acquisition strategies (eg Kerry, Frutarom). The biggest challenge will be finding willing sellers at competitive prices.

On relative valuation, a few opportunities remain

Among the large companies, we note that IFF trades at a c 15% discount to its direct peers, which seems unwarranted given its high-quality business model. DSM and Naturex are potential turnaround plays and, among the smaller companies, Treatt trades 20% below our fair value of 190p. The three stevia-related companies in this report (GLG, Evolva and PureCircle) are at valuations that reflect their earlier stage of product development.

[1] Source: IFF. Not all companies featured in this report are pure play.

Companies in this report

Givaudan (GIVN VX)
Symrise (SY1 GR)
IFF (IFF US)
DSM (DSM NA)
Croda (CRDA LN)
Kerry Group (KYG ID)
Robertet (RBT FP)
Frutarom (FRUT IT)
Treatt (TET LN)*
Naturex (NRX FP)
GLG Life Tech (GLG CN)*
PureCircle (PURE LN)
Evolva (EVE SW)*

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Exhibit 1: A snapshot of global F&F companies

Company	Description	Key financials	Investment case
Givaudan GIVN VX CHF1,722	**Corporate overview** Founded 250 years ago, Givaudan is the world's leading F&F company, with above 25% market share. Growth has been via consistent organic development and strategic M&A. Acquisitions include FIS (Nestle flavours) in 2002, IBF (US fermentation) in 2003, Quest International in 2007 and Soliance (sustainable cosmetic ingredients) in 2014.	2015e CHFm Mkt cap: 15,900 Net debt: 517 Revenues: 4,343 EBIT: 767 PBT: 694	**Bull** ■ Strong balance sheet, stable cash flow and progressive 3% dividend yield. ■ Ability to continue bolt-on M&A deals. ■ Slowing organic growth compensated by margin accretion, helped by stabilising raw material prices.
	Markets In Flavours (52% sales), end-customers include beverages, savoury, snacks, sweet goods and dairy. In Fragrances (48% sales), customers are in personal, home and laundry care brands, as well as prestige perfumes. In 2014 mature markets (US, Europe, Japan) represented 54% sales. Developing markets (Asia Pacific, Latin America and Eastern Europe) accounted for 46% of annual sales. The sales mix is expected to continue changing as growth in emerging markets outpaces the rest.		**Bear** ■ Weak recent l-f-l growth, particularly in mature markets. ■ Recent weakness in China suggests a market slowdown, as well as increased competition. ■ Strengthening Swiss franc may affect translation, as well as competitive pricing.
	Catalysts		H1 results (17 July), H1 investor conference (27 August).
Symrise SY1 GR €57.95	**Corporate overview** With a market share of 12%, Symrise is the world's fourth largest supplier in the F&F market. The company was founded in 2003 by the merger of Haarmann & Reimer (ex-Bayer) and Dragoco, both based in Holzminden (Germany), with an IPO in 2006. Recent acquisitions include Flavours Direct (UK seasonings) in 2005, Kaden Biochemicals (speciality botanical extracts) in 2006 and Diana Group (natural flavours and pet food) in 2014.	2015e €m Mkt cap: 7,522 Net debt: 1,177 Revenues: 2,614 EBIT: 436 PBT: 386	**Bull** ■ Outpacing the market, with continued solid customer demand. 2020 targets reiterated. ■ Global presence and diversified portfolio leads to continued growth opportunities. ■ Diana acquisition is an entry into pet and baby food.
	Markets The company's 30,000 products are primarily produced from natural raw materials (vanilla, citrus, blossoms, plant or animal materials). Sales mix in 2014 was flavours 54%, scent and care 46%. Mature markets comprised 53% of sales. Emerging markets are expected to grow to more than 50% of group sales by 2020.		**Bear** ■ Volatile raw material costs, particularly natural-based materials (citrus, vanilla) affect margins. ■ USD FX changes could affect US expansion plans. ■ Management reiterated that there is limited margin upside in the business.
	Catalyst		Capital Markets Day (12 June).
IFF IFF US US$119.0	**Corporate overview** With a market share of 16%, IFF is the second largest supplier in the F&F market. It was created from a merger in 1958 and has been listed since 1964. The acquisition in 2000 of Bush Boake Allen made IFF the largest F&F company for many years. IFF acquired Aromor (a private Israeli company) in 2014 and Ottens (US flavours) in 2015.	2015e US$m Mkt cap: 9,605 Net debt: 430 Revenues: 3,116 EBIT: 630 PBT: 580	**Bull** ■ Superior organic growth, as company continues to gain market share, particularly in emerging markets. ■ Strong balance sheet and high returns on capital, with progressive dividend policy. ■ Recent results demonstrated resilience and defensive nature of the business.
	Market In 2014, fragrances (beauty, fabric, home care, fine fragrances, ingredients, personal wash) comprised 53% sales, with flavours (beverages, sweet, dairy, savoury, vanilla, strawberry, FlavourFit) at 47%. Following a $320m investment into emerging markets over the past five years, IFF is the market leader in terms of percentage of sales to emerging markets, which equate to 50% of group revenues.		**Bear** ■ Q1 showed intensifying FX headwinds. ■ Further margin progression is dependent on successful delivery of efficiency measures. ■ After a strong 2014, l-f-l growth is increasingly difficult to achieve.
	Catalyst		NY Investor Conference (2 June).
DSM DSM NA €53.99	**Corporate overview** Royal DSM is a global science-based company active in health, nutrition and materials. Established in 1902, it has undergone numerous transformations. Most recently, it acquired Kensey Nash (US biomedical) and Cargill's (cultures and enzymes) in 2012, Tortuga (Brazilian nutritional supplements) in 2013, and Aland (Hong Kong vitamin C) in 2015. It is also forming a partnership with CVC, with a view to exiting non-core businesses (composite resins).	2015e €m Mkt cap: 9,795 Net debt: 2,230 Revenues: 8,480 EBIT: 609 PBT: 501	**Bull** ■ Continued restructuring, as evidenced by formation of a JV (DPX), where there is IPO potential. ■ If the company can exit its more volatile businesses, a pure-play nutrition company may benefit from high peer group valuation comparisons. ■ More cost-cutting expected.
	Market DSM's global end-markets include food and dietary supplements, personal care, feed, medical devices, automotive, paints, electrical and electronics, life protection, alternative energy and bio-based materials. Nutrition (animal and human) comprises 64% of sales, and performance materials (plastics) comprises 34% sales. In 2014, emerging markets comprised 43% of group sales, compared to 41% the year before.		**Bear** ■ Sluggish western food and beverage markets. ■ US multivitamin market remains weak, and fish oil input costs affect the omega market. ■ Falling cash flows could threaten dividend cover.
	Catalysts		Q2 results (4 August), Q3 results (3 November), Capital

Company	Description	Key financials	Investment case
			Markets Day (4 November).
Croda CRDA LN £29.25	**Corporate overview** Croda is a UK speciality chemicals business, with a focus on developing and delivering innovative ingredients sustainably. It was founded in 1925 and floated in 1964. Recent acquisitions include Sederma (skincare) in 1997 and ICI's Uniqema business (manufacturing) in 2006.	2015e £m Mkt cap: 3,971 Net debt: 184 Revenues: 1,087 EBIT: 267 PBT: 253	**Bull** ■ Company is returning to stronger organic growth after a period of disappointing figures. ■ Investments over the past five years have left the company with a stronger platform for growth. Croda's cost base is showing signs of deflation. ■ Strong balance sheet and potential return of capital.
	Markets The business is split into three core segments: Personal Care (35% of sales), Life Sciences (20% of sales), Performance Technologies (34% of sales) and Industrial Chemicals (11% of sales). Geographically, Croda is consolidating its position in Western Europe (37% of sales), expanding in North America (26% of sales) and expanding in Emerging Markets (37% of group sales).		**Bear** ■ Subdued demand in Europe, which is a core element of sales. ■ Limited order book visibility. ■ Valuation distorted by bid speculation.
	Catalysts		Interim results (21 July), Q3 update (5 November).
Kerry Group KYG ID €68.00	**Corporate overview** Kerry was founded in 1972 and floated on the Dublin stock exchange in 1986. Since 2000, the company has made 150 acquisitions, with a particular focus on the food ingredients market. The company is undergoing a €350m corporate restructuring (Kerry Connect). After a relatively quiet two-year M&A period, the company is now looking at new acquisition opportunities.	2015e €m Mkt cap: 11,959 Net debt: 891 Revenues: 5,937 EBIT: 671 PBT: 606	**Bull** ■ Company aims to continue making accretive acquisitions. This is aided by an attractive corporate tax rate. ■ Recent disposals mean that the consumer business has been almost fully repositioned. ■ Key markets showing some recent improvement, with particular growth in emerging markets.
	Markets Ingredients and Flavours (savoury, dairy, beverage, cereal, pharma, regional technologies) comprise 75% of sales, with consumer foods as the remaining business. EMEA accounts for 38% of sales, Americas for 44% and Asia Pacific comprises 18% of group sales. The company aims to grow its emerging market revenues from 25% of group total in 2014 to 30% by 2017.		**Bear** ■ Potential increased tax regulation would have a significant adverse impact on results. ■ Cash conversion much lower in 2014 due to increased WC and one-off opening of R&D centre. ■ Organic growth profile remains lower than F&F peer group.
	Catalyst		Deutsche Bank Conference (9 June), H1 results (6 August).
Robertet RBT FP €212.00	**Corporate overview** Created in 1850, Robertet is a leading player in natural ingredients, with approximately 3% of the global F&F market. The company listed in Paris in 1992.	2013a €m Mkt cap: 507 Net debt: 27 Revenues: 390 EBIT: 39 PBT: 39	**Bull** ■ High-end established perfume and natural aromatics business. ■ Possible M&A target by larger corporations seeking to enter the higher-end spectrum of F&F.
	Markets Robertet's principal activities are the production and distribution of aromatic products. Sales are 45% food flavouring, 35% for perfumes and 20% for natural aromatic product industry. The group operates in Asia (15% sales), the US (31%), South America (8%), the Middle East (7%) and Europe (39%).		**Bear** ■ Family-controlled business, with lack of liquidity and very little information in the stock market. ■ Lack of scale. Continuous investment required to keep pace with larger competitors. ■ Slower growth, due to mature market exposure.
	Catalyst		N/A
Frutarom FRUT IT ILS15,200	**Corporate overview** Established in 1933, Frutarom is a flavours business based in Israel, with listings in Tel Aviv (since 1996) and London (since 2006). The company is highly acquisitive and since 1990 it has acquired 39 businesses globally (and 5 already in 2015). Its major shareholder (37%) is ICC Industries, a New York-based holding company.	2015e US$m Mkt cap: 2,300 Net debt: 168 Revenues: 853 EBIT: 130 PBT: 125	**Bull** ■ Deal pipeline remains strong. Company benefits from efficient tax structure. ■ Strong revenue guidance, largely driven by acquisitions. ■ Private label, mid-sized customers proving to be a strong market for natural and healthy solutions.
	Markets Frutarom operates in two divisions: Flavours comprises 72% of group sales (flavours, savoury solutions, seasonings and food systems) and Fine Ingredients accounts for 20% of sales (natural flavour extracts, functional food ingredients, speciality oils, citrus and aroma chemicals). In 2014 Western Europe comprised 34% of group sales (from 51% in 2010) and emerging markets accounted for 46% of group sales (vs 27% in 2010).		**Bear** ■ Acquisitions inherently difficult to model and forecast. ■ Execution and integration risk associated with M&A. ■ Investors may be disappointed if company is unable to source competitively priced deals.

Company	Description	Key financials	Investment case
	Catalyst		NA
Treatt TET LN £1.52	**Corporate overview**		**Bull**
	Treatt began trading in essential oils in 1886, and expanded gradually over a century into other areas (chemical sales, contract compounding and distillation). The company listed on LSE in 1989. In 2007, it acquired Earthoil (organic oils in the US and Kenya).	2015e £m Mkt cap: 78 Net debt: 9 Revenues: 84 EBIT: N/A PBT: 8	■ Strong acceleration in operating performance. ■ Clearly defined strategy already bearing fruit. ■ Good medium-term earnings visibility through a combination of growth and self-help cost savings.
	Markets		**Bear**
	Treatt provides innovative ingredient solutions from its manufacturing bases in Europe, North America and Africa, principally for the flavours and fragrance industries, and multinational consumer goods companies, with particular emphasis on the beverage sector. Revenues by geography are UK 13%, Europe 27%, Americas 37% and RoW 23%.		■ Uncertainty and execution risk over two to three years relating to UK head office and plant relocation. ■ Products are relatively low on the F&F value chain, so higher valuation may not be justified. ■ Volatile commodity prices, specifically orange oil.
	Catalyst		FY results (8 December 2015)
Naturex NRX FP €63.00	**Corporate overview**		**Bull**
	Naturex was established in 1992 and is the global leader in speciality plant-based natural ingredients. It listed in Paris in 1996. Since 2002, it has been highly acquisitive, and in May 2014 it doubled its food and beverage business in the US with the acquisition of Vegetable Juices Inc.	2015e €m Mkt cap: 579 Net debt: 151 Revenues:369 EBIT: 32 PBT: 26	■ Departure of the chairman (and former CEO) and his son (CFO) should lead to fresh strategy and potential further realignment of shareholder and management interests. ■ Has been perceived as a potential bid target, especially after Diana (its key peer) was acquired by Symrise in 2014. ■ Leading niche position in natural ingredients.
	Markets		**Bear**
	Naturex produces and sells 100% natural vegetable ingredients, extracts, pigments and antioxidants. Food & Beverage comprise 65% of group revenues, while nutrition and health comprise 30%, Personal care accounts for 2% and toll manufacturing 3%. Geographic sales: Asia Pacific 13%, EMEA 43% and Americas 44%. Emerging markets in total comprise 19% of group revenue.		■ Investor confidence has been eroded from past track record and may take time to recover. ■ Disappointing Food & Beverage Q1 sales, especially in Europe. ■ Negative organic growth affects the ability to return operating margins to historical levels.
	Catalyst		2020 strategic plan (30 June).
GLG Life Tech GLG CN C$0.35	**Corporate overview**		**Bull**
	GLG Life Tech is a TSX-listed vertically integrated supplier of stevia-derived extracts primarily for use as low-calorie, high-intensity sweeteners (HIS) in the food and beverage industries. It sources stevia in China and processes extracts at its China-based facilities. In 2014 it began to produce Luo Han Guo (LHG) extracts, which we expect will account for c 25% of 2015 sales.	2015e C$m Mkt cap: 13 Net debt: 94.9 Revenue: 47.4 EBIT: (3.6) PBT: (16.5)	■ Proprietary stevia leaf (H3, H4, Super RA, "RebC Gold") should increase extract yields and drive efficiency and market share gains. ■ Reputation boosted by FDA GRAS letters of no objection for multiple stevia and LHG extracts. ■ Increasing consumer interest for naturally sourced low-calorie sweeteners should fuel double-digit, long-term industry growth.
	Markets		**Bear**
	More than 90% of 2014 revenue consisted of stevia extract sales. 58% of 2014 revenue was sold to China-based customers, with 42% to international customers (mostly developed markets). In Q115, international customers accounted for 82% of revenue, driven by LHG growth. We assume GLG will secure 15% of the global stevia market by 2020 (the market value of which we estimate will exceed US$500m by then).		■ High leverage ratio, with majority of $107m Q115 net debt due within 12 months and under negotiation with creditors for refinancing. ■ Operating losses between 2011-14 largely due to industry overcapacity; we do not anticipate return to consistently positive EBITDA before 2016. ■ Dependence on commodity (stevia) market prices.
	Catalyst		Q2 results (August 2015).
PureCircle PURE LN £4.28	**Corporate overview**		**Bull**
	Incorporated in 2001, PureCircle is an investment holding company and one of the largest producers of high-purity stevia ingredients for the global food and beverage industry. In 2012, it entered a JV with Coca-Cola to investigate new forms of stevia. It is currently expanding its production capacity (expected in 2017).	2015e £m Mkt cap: 727 Net debt: 53 Revenues: 133 EBIT: 21 PBT: 12	■ Market leader (75% of market) in stevia, which is rapidly becoming a mainstream calorie-reducing natural sweetener. ■ Recent equity funding enables significant expansion, which is a constraint on other players.

Company	Description	Key financials	Investment case
			■ Long-term growth opportunity of 30% CAGR.
	Markets		**Bear**
	PureCircle estimates that the stevia market will grow from $250m in 2014 to a multi-billion dollar market within a few years. The group's markets are based in the Americas (75% sales), EMEA (10% sales) and Asia Pacific (15% sales).		■ Early days for the stevia market, resulting in a lack of visibility with short-term order flow. ■ Given the higher demand, Chinese leaf prices have risen considerably (75% of variable costs). ■ Significant fixed costs – very operationally geared.
	Catalysts		FY15 results (September 2015)
Evolva	**Corporate overview**		**Bull**
EVE SW CHF1.79	Evolva was founded in 2004 to commercialise its yeast technology platform and listed in 2009. Evolva acquired Allylix in December 2014 to strengthen its position as a leader in high-tech fermentation.	2015e CHFm Mkt cap: 586 Net cash: 58.4 Revenues: 15.7 EBIT: (26.4) PBT: (21.2)	■ Evolva and its partner Cargill will be launching the better-tasting stevia sweeteners (RebD and RebM) in 2016. ■ There is increasing demand for natural sweeteners. ■ Evolva has collaborations with Ajinomoto, BASF, Cargill, IFF, L'Oréal, Roquette and Takasago.
	Markets		**Bear**
	The company develops ways of producing nutritional and consumer products using yeast fermentation. It launched resveratrol and vanillin (with IFF) in 2014 and is in the process of launching nootkatone and valencene. In 2016, Evolva aims to launch a range of stevia sweeteners with its partner Cargill, primarily for use in beverages.		■ The company is still loss-making and is expected to require additional financing, which might be dilutive. ■ Scaling up from lab to commercial production can be challenging and a source of delays. ■ The field of high tech fermentation is a new area, and its potential is yet to be proven.
	Catalysts		Finalisation of a JV with Cargill to co-commercialise stevia sweeteners in H215. Stevia and saffron launches (2016).

Source: Bloomberg consensus, Edison Investment Research estimates

Valuation

Exhibit 2: F&F peer group valuations

Company	Market cap	P/E (x)			EV/EBITDA (x)			Yield (%)		
	(m)	2015e	2016e	2017e	2015e	2016e	2017e	2015e	2016e	2017e
Givaudan	CHF15,900	25.6	23.0	21.6	16.2	15.3	14.4	3.1	3.3	3.6
Symrise	€7,522	25.7	23.5	21.5	15.0	14.1	13.1	1.6	1.7	1.9
IFF	US$9,605	21.9	20.0	18.0	14.3	13.3	12.2	1.6	1.8	2.0
DSM	€9,795	20.6	18.2	15.9	10.8	10.5	9.8	3.2	3.3	3.4
Croda	£3,971	21.7	20.3	19.2	13.6	12.7	12.0	2.4	2.5	2.6
Kerry Group	€11,959	22.5	20.4	18.4	16.5	15.3	14.1	0.7	0.8	0.9
Robertet	€507	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Frutarom	US$2,300	23.4	21.1	19.0	15.3	13.9	11.9	0.7	0.8	1.4
Treatt	£78	13.9	13.1	12.6	9.0	8.4	8.0	2.8	3.0	3.2
Naturex	€579	35.0	25.4	19.9	14.9	13.0	11.2	0.2	0.2	0.2
GLG Life Tech	CAD 13	N/A	N/A	N/A	N/A	N/A	N/A	0	0	0
PureCircle	£727	84.8	34.7	20.7	40.6	23.0	15.1	0	0	0
Evolva	CHF 586	N/A	N/A	N/A	N/A	N/A	N/A	0	0	0

Source: Bloomberg consensus. Note: Prices as at 29 May 2015.

Relative valuation provides opportunities

Given its many attractive investment qualities, the sector has experienced significant multiple expansion over the past few years. From the valuation table above, we observe a few notable outliers:

- IFF trades at a c 15% P/E discount to its direct peers (Givaudan and Symrise), which seems unwarranted given its very strong business profile.

- DSM appears potentially attractive as a turnaround play and, should the company be successful in realigning it business, we expect its valuation to more closely track the sector.
- Treatt continues to trade at a significant discount to the sector and 20% below our fair value of 190p.
- Stevia companies (PureCircle, Evolva and GLG) have far greater growth potential, but are clearly at the more speculative end of the spectrum.

F&F transaction multiples

Exhibit 3: F&F selected transaction multiples

Year	Buyer	Target	Value	EV/EBITDA (x)	EV/Sales (x)
2006	Croda	Uniqema	£410m	8.4	0.6
2006	Givaudan	Quest (ICI)	£1.2bn	16.9	2.1
2010	DSM	Martek	€790m	8.2	2.1
2011	Dupont	Danisco	US$6.3bn	12.1	2.3
2011	Kerry	Cargill Flavours	US$230m	N/A	1.2
2011	Cargill	Provimi	€1.5bn	11.6	1.1
2012	DSM	Ocean Nutrition Canada	C$540m	9.8	2.8
2012	DSM	Tortuga	€440m	7.8	1.2
2013	Symrise	Belmay	US$100m	9.0	1.7
2013	Naturex	Vegetable Juices	US$90m	12.0	2.1
2014	ADM	Wild	€2.3bn	14.2*	2.3
2014	Frutarom	Montana Food	US$35m	N/A	0.7
2014	Symrise	Diana	€1.3bn	14.5	3.0
2015	Frutarom	Sonarome	US$28.6m	N/A	2.4
2015	IFF	Ottens	US$190m	N/A	3.0

Source: Company reports, Edison Investment Research estimates. Note: *2015 forward estimated EV/EBITDA.

The F&F sector has been consolidating for decades, with the result that four main players now comprise two-thirds of the market. While anti-trust and valuation issues may prevent mergers in the top four, we expect them individually to continue looking at ways to gain market share (as well as diversify into complementary products) through continued bolt-on acquisitions.

In terms of transaction prices, 2014 witnessed a few large and extremely expensive acquisitions, notably Wild and Diana, which sold for over 14x EV/EBITDA. The challenge for buyers of strategic assets will be to find willing sellers at competitive prices.

The valuations seem more compelling among the smaller transactions, although this may also reflect the quality of the acquired assets. We note that Frutarom has already acquired five small businesses in 2015 and tends to pay c 1-2x EV/Sales and c 7x EV/EBITDA, which is considerably lower than the high-profile deals last year.