Irish Dairy Sector
Charting a Course for Growth
Structuring funding for expansion and protecting against downside risks
2018 in the Rear-view Mirror

While not quite Charles Dickens, “It was the best of times, it was the worst of times”, 2018 was certainly an eventful year in the Irish dairy industry. Milk production volumes continued to grow in Ireland, though global production levels meant that milk prices probably didn’t fall as much as might have been expected at the beginning of the year.

To meet the continued growth in farm level milk production, Irish processors continued their trend of making significant capital investments in order to process the increased milk volumes. During 2018 Aurivo, Arrabawn and Tipperary Co-Operative all announced large capital expenditure programmes aimed at increasing milk processing capacity, diversifying product ranges and meeting increased customer demand.

Other corporate events of particular note in the year included Glanbia Cheese’s announcement of its plans to build a mozzarella cheese manufacturing facility in Portlaoise, at a cost of c.€130m. Glanbia Cheese, which is a joint venture between Glanbia plc and Leprino Foods, expects the new facility to commence production in 2020.

2018 also saw the announcement of the merger between Lakeland Dairies and Lacpatrick, making it reportedly the second largest dairy processor on the island with more than 3,200 suppliers and a milk pool of 1.8 billion litres. The proposed merger remains subject to approval from Irish and UK competition authorities, with a formal decision expected in March.

These investments came against the backdrop of what was a challenging market for many Irish dairy processors in 2018 – a year in which the weather was to be a defining factor. A long and harsh winter in the early part of the year led to fodder shortages and increased levels of feed use. The spring then segued into an uncharacteristically hot and dry Irish summer, which impeded grass growth. In addition to impacting milk yields during this period, the inability to harvest silage for the winter ahead also created fodder reserve issues for farmers heading into the winter months of 2018.

The farm-level impact of these weather effects was not insignificant in 2018, and co-ops sought to support farm level incomes with its dairy prices and other support initiatives. In this regard 2018 also saw the launch of the second MilkFlex Fund (from Finance Ireland, Ireland Strategic Investment Fund and Rabobank), as a follow up to the initial fund which was solely available to dairy farmer suppliers of Glanbia Ireland. This new fund will make flexible capex financing available to dairy suppliers of a number of dairy processors.
2019 – A year of Continued Growth & Investment

Seasoned practitioners in the Irish dairy industry will well be aware that in any five year cycle there will be a mix of the good, the bad and the ugly. Years that farmers would rather forget, are offset by very strong years, and it is the longer term trends that need to be considered when it comes to investment planning.

Continued growth and investment is therefore expected in the year ahead. In January Glanbia Ireland announced its alliance with Dutch dairy firm Royal A-Ware, to create mozzarella cheese for the Continental European market. In February, Carbery Group announced its plans to invest €78m in a new manufacturing facility which will see it increase production capacity and diversify its cheese product range. It is also strongly anticipated that other major processors in the industry will make or announce further largescale investments over the course of the next year, to meet the core milk processing demands of suppliers and to diversify product suites and geographic markets. In this regard Glanbia plc recently announced its acquisition of a non-dairy ingredient solutions business in the US, and signalled its appetite and capacity to make further significant acquisitions.

Market Headwinds

This growth and continued investment is likely to be in the face of stiff market headwinds. A clear and present challenge on the horizon is Brexit, and its potential implications for future trading with the UK and supply chains generally. The preparedness of the industry to a hard, or no-deal Brexit remains to be seen and tested. Glanbia has been on the front foot in this regard, recently announcing that it is stockpiling and engaging contract manufacturers in the UK in order to insulate itself from supply chain disruption.

The on-going international trade disputes between the US and China has potentially negative implications for all Irish exporting sectors, as a global rise in protectionist policies and an imposition of trade tariffs on exports from EU into the US or China could significantly impede Irish exporters’ growth in these markets. For the dairy industry, the impact of this could be acutely felt given the importance of these markets to Irish dairy exporters.

The volatility of global dairy commodity markets and the geo-political influences on global supply and demand will continue unabated; however this is the new reality with which Irish dairy processors are now accustomed to.
How will this Growth be funded?

The financing of this growth will remain a key area of focus and attention for dairy processors, their executive management teams, governing boards and members.

As an industry dominated by co-operative corporate structures, the raising of new equity, or member capital, can be challenging and politically sensitive amongst members, particularly in times of depressed farm incomes, or amongst dry-members. Accordingly investments in this sector tend to be substantially debt financed.

The removal of the EU milk quota in April 2015 heralded a new era for the Irish dairy industry on the global stage. It has also been the catalyst for significant capital investment in the industry in recent years. As a consequence, non-working capital related debt is more elevated on co-op balance sheets now than has been the case historically. Similarly, increases in milk volumes from dairy farmers, the volatility of global commodity prices and the increasing regularity of weather effects, has seen working capital funding requirements swing significantly too.

Stretching relationships
Irish co-ops typically benefit from strong and established bank club relationships. Notwithstanding the low margin nature of the industry, bank lenders take comfort from the strong asset composition of co-op balance sheets, staple nature of many of their food products, the high industry barriers to entry, and the strategic importance of the sector in Ireland generally. While traditional banks have generally been very supportive of co-ops in the Irish dairy sector, their ability to provide ‘flexible’ financing becomes more limited when balance sheet leverage rises above 3.5x EBITDA for a sustained period of time; banks will accept periodic spikes in leverage relating to specific and approved investments, but struggle with sustained high leverage. In such instances, financial covenants from banks tend to get more numerous in number and covenant headroom gets tighter. Flexibility of drawdown on new capex/acquisition facilities gets more limited, with banks tending to focus more on capital repayment and balance sheet deleveraging.

Co-ops will therefore need to take particular care when raising new debt facilities to support their growth plans in 2019. Key objectives should include obtaining optimal financing terms, minimising debt-related risks (default risk, refinance risk, liquidity risk), and maximising business flexibility in the context of the unique requirements of a co-op’s various stakeholders - management, board and members.

Areas of Structuring & Negotiation focus:
In the context of structuring the appropriate debt facilities for growth, co-ops should therefore give careful consideration to:
• the sustainability of free cash flow available for debt servicing (FCADS), and debt repayment profiles, so as to minimise default risk;
• the negotiation of borrower-friendly financial covenant definitions and maximising of headroom over appropriate bank case projections;
• the extent to which capex/acquisition facilities are committed, and flexibility of drawdown on these facilities (including for example, conditions precedent to draw-down, reporting and oversight requirements on construction projects etc);
• sizing of working capital financing lines, and mix of committed and uncommitted facilities in order to ensure availability of funding when it is most needed; and
• the availing of favourable credit markets to lock in long term funding and manage refinancing risk.

For further information on this topic please see the Deloitte article “Raising Finance – 5 Critical Success Factors to consider...”

Considering Alternative & Complimentary Financing Structures
There can be a reluctance on the part of Irish co-ops to disrupt existing bank club relationships. As the funding needs for the industry and individual co-ops grow, it is important however that co-ops be aware of the breadth of funding options available in the market, as the scale of funding required by a co-op may necessitate the introduction of a new bank or group of lenders into a club. Also, while a bank may wish to support a co-op from a relationship perspective, even as its leverage rises above 3.5x, the financial terms provided by the bank may impose heightened financial risk on the balance sheet of the co-op (e.g. covenant headroom too tight, capital repayment profile too steep, working capital facilities to low etc) thereby storing up problems for the co-op down the line.
Consequently, a consideration of the full range of financing options in the market will give a co-op, and its governing board, confidence that it is putting in place the optimal financing package for its stakeholders. These options need not be at the expense of established banking relationships, but could be considered in conjunction and alongside those lenders. Such alternative funding structures and options could include:

- junior forms of debt capital (mezzanine, 2nd lien), or hybrid equity instruments, which boost the capital base of a co-op;
- structured working capital facilities, such as supplier financing, stock financing and off balance trade receivables financing and securitisation, as a means of unlocking value which can be used to reduce balance sheet leverage;
- committed long term funding from the likes of the European Investment Bank and ISIF as a means of spreading refinance risk; and
- making investments and acquisitions through joint venture arrangements and ring-fenced special purpose vehicles, as a strategy for growth while maintaining core group leverage at corporate facility type levels and minimising the amount of shareholder/member capital at risk.

Great Expectations
Creating a platform for Scale and Product Diversification

Irish dairy processors, ingredients solutions providers and brand owners now operate on the global stage. These companies compete and trade with some of the biggest corporate giants in the world. Many of these global competitors have access to equity markets through public listings or have track records of accessing debt capital markets and structured funding products from banks.

Increasing scale, diversification into higher margin products and efficacy of capital allocation are likely to remain key agenda items at board levels in dairy-Ireland. Accordingly, and in order for corporate leaders in this market to execute on these strategies and to continue to deliver on stakeholders’ great expectations, the structuring of debt financing packages, which mitigate risks and maximise business flexibility will be the platform for the continued growth, defence, and creation of value in the Irish dairy industry.

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