After The (Natural) Gold Rush

A Green Circle White Paper

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Valuations for growth-stage food and bev companies are coming down. Years from now some may (or may not) blame Covid-19 for not only killing Expo West 2020, but perhaps also for bursting the valuation bubble that had formed for natural food & bev businesses. However, that would be no more accurate than it would be to blame the events of 9/11 for starting the bear market nineteen years ago.

Historical trends and cycles in markets are often useful in providing context for the current environment, or even for future projections. From March of 2000 until October of 2002 the markets "retraced" much of their huge gains made in the late nineties. A brutal and extended bear market occurred, with the events of 9/11 sandwiched right in the middle of it all. With 9/11 almost two decades behind us it is easy to think that those events caused the bear market, but they did not. This is important: By September 10, 2001 the S&P 500 had already pulled back by more than 28% from its high. 9/11 was an *accelerant* to the bear market, not a catalyst.

Through the entire duration of the bear market the S&P 500 went from a high of 1527 to a low of 777. It got cut in half. The Nasdaq, always considered to be more volatile and higher in both risk and potential return, went from a high of 5049 to a low, in October 2002, of 1114 and lost approximately 78% of its value. The conventional view at that time was that the internet had been over-hyped, advertising revenue models didn't work online, and the web would never live up to the commercial promise it seemed to hold in the late nineties. Barry Diller disagreed, but I'll (green) circle back to him later.

For several years in a row now most of the biggest CPG companies that make food or beverages have lost market share. They have lost share to smaller upstarts making natural or organic and/or otherwise innovative and healthier versions of food products made in those same categories by legacy brands. However, in recent years, the landscape has changed significantly in other key ways. When Vitaminwater and SoBe bubbled up and took on big soda, and Bear Naked stripped away the unhealthy ingredients found in some granolas, and Krave made people jones for jerky again and Sir Kensington's turned ketchup upside down (forgive me, but my kids won't listen to dad jokes anymore) they were disrupting big categories and had modest competition from other "better-for-you" startups. Consider that today few major food or beverage categories only have one or two better-for-you brands chipping away at the leaders. Does the world still desperately need another natural ready-to-drink tea now? A healthier chip to snack on? Is there only one natural baby food?… The fact is that the revolution in attitudes about food and nutrition is accelerating, not slowing down (have you noticed the word "vegan" pop up anywhere in marketing lately??). Sodium benzoate and potassium sorbate are being exposed a la HFCS and Area 51. Yet, in each of those categories there are no longer one or two bold ground-breakers feasting on the scraps; now there are dozens scrambling for those crumbs of lost market share—and that makes for less attractive market opportunities, and fewer attractive companies on which to place a bet.

There has been a change (to say the least) in the way that Americans and consumers all around the world view food and nutrition. Over the last five years or so there had been an acceleration in investment (and thus, in valuation) in natural and specialty food and beverage companies. It was exuberant, and perhaps irrationally so—until last year. In 2019 it began "retracing," somewhat substantially, but quietly. On May 5, 2020 Carol Ryan published an article in the Wall Street Journal entitled, "Disruptive Food Brands Get a Taste of Their Own Medicine," wherein she explained: "Funding for these kinds of businesses is drying up. World-wide, the number of venture capital investments in consumer brands fell 26% in the first quarter of 2020 compared with the same period of last year, PitchBook data shows. Even before the crisis, investors had moved on to other hot sectors such as health care and software. Last year, venture capitalists handed over 54% less cash to consumer brands than in 2018, according to data tracked by Goldman Sachs." That is essentially a reversal from what we had seen in the prior three to five years, but, notably, more in line with historical norms for early-stage venture investing.

When I was raising the first capital for my natural soda company startup in 2006 most venture investors wouldn't look at Consumer deals. Of those who would, many would still not consider beverages. Technology was in vogue then (and has been ever since) and healthcare and cleantech were receiving a lot of attention, and money. However, it only takes a few 10X revenue exits like Vitaminwater (where early-stage investors generated returns of perhaps 50X or even 100X their initial capital) to get the attention of Wall St. Just a few years ago I remember reading somewhere that the number of VC firms that had invested in food & bev had grown that year to around 250 firms—from roughly only 50 the year before. They saw the returns being earned by investing in the space and they jumped in. And when everyone else is doing cannon balls into the pool you know what time it is, don't you? Yes. It's time to dry off and go get a margarita or three.

For the last several years valuation multiples on early-stage food and bev companies that generate anywhere from a few million dollars in annual revenues to as much as a few tens of millions, grew significantly. My office routinely got calls from CEOs of such companies who expected to raise growth capital at three, six, or even ten times…. revenues. Some got it, and that skewed expectations. Those companies, in a capital-intensive industry wherein it is hard to generate healthy gross margins prior to achieving substantial scale, often throw off little, or no, positive cashflow. That can be okay if there is a robust environment for venture capital investing in the space which provides support for those valuations, and while strategic investors remain interested in acquiring such companies once they achieve scale (irrespective of EBITDA margins). Should those factors change, or reverse, valuations will invariably come down of course. It began last year.

We have expected that for some time. I am not claiming to be a market timer or to be able to predict the future (insert Trump joke here if you lean left) but rather, simply an observer of the fact that all markets tend to go in cycles. However, just because valuations come back down to earth doesn't mean that an industry will die. Covid-19 has disrupted the economy and markets, but it won't be the end of American prosperity any more than 9/11 was, or Reagan getting shot, or the Iraq War, or the financial crisis of 2008, or the crash of '87 or Justin Bieber or fidget spinners.

For investors, allow me to remind you about what Barry Diller did after the internet bubble burst. He took his company, Interactive Corp., and went on a buying spree. Travel sites, dating sites, Diller went shopping. He was bargain hunting. You can see their building on the west side highway in Manhattan, across from Chelsea Piers. You'll know it when you see the coolest office building you've ever seen in Manhattan. It has frosted white windows and a unique, twisted shape all adding up to something akin to a sailing ship about to jump over the highway and head off down the Hudson and into the Atlantic for an adventure. Oh, and as we all know, the internet worked out okay. Despite all the turmoil, and the Nasdaq imploding, and countless bankruptcies, solid companies prevailed. Fortunes were made by investors with the fortitude to invest when the negative noise around them was overly hyped.

In the coming months and years valuations may come down further and access to capital may be tougher for early-stage companies. It's not the end of the world; it's merely evolution. It may be incumbent upon responsible CEOs to start thinking about bottom line performance, even at the expense of topline growth. Maybe it makes sense to get lean, to focus on margin improvement more than marketing or new allocations for slotting. Maybe it's also a time to go back to basics. If so, here are a few things to consider: A business is supposed to turn a profit someday. Having something unique and defensible can be valuable. In CPG businesses execution (and hard work) are the keys, not which photos get posted to Instagram….

For investors, this may be an opportunity. Don't sell into a correction; buy the dip. A pullback in valuations doesn't necessarily imply anything about the health or long-term opportunity in the sector. The natural products industry is vibrant and coming of age. No sane entrepreneur would launch a food brand today and say, "Hmm, let's load it up with chemical preservatives and HFCS in order to save a few pennies." The Natural and Vegan brands are still winning, even if they may still have to play a little defense every now and then. Burger King sells plant-based burgers for goodness sake. Tides still rise and fall in waves.