



Financing Healthy Living

by John LeClaire, David Thibodeau and Steve Adams

Market observers generally believe nutraceutical companies enjoy favorable demographics. Their target demographic market continues to expand as aging baby boomers and other consumers around the world increasingly focus on healthy living, self-care and alternatives to traditional medicine. While the market for nutraceuticals is estimated at approximately \$20 billion, it is also quite fragmented with more than 750 companies participating. Only a handful of companies in the sector have annual sales in excess of \$100 million.

Therefore, there are exciting opportunities for companies in the nutraceutical industry that can accelerate growth and gain scale. For that, however, capital is usually required. The question then becomes where can ambitious companies find this capital.

One option is to consider public markets, which can be an excellent source of capital for nutraceutical companies with the right characteristics. Undertaking an initial public offering (IPO) is both exciting and tiresome. However, once public, the company would have an acquisition currency—its stock—to fuel growth and provide shareholder liquidity. Key characteristics needed for an emerging growth company to access the public markets include a sustainable market position, and revenue and earnings growth rates that are higher than those of its peers. Additionally, the company would need to target a market capitalization of at least \$200 million (based on current price/earnings multiples of approximately 13 times) to be attractive and to meet liquidity requirements of institutional investors.

On the downside, by electing to go public, a company would bear the costs and public performance pressures that are part of the post Sarbanes-Oxley landscape. Also, like many other sectors, the public markets do not favor the nutraceutical sector in the current market environment. Stock prices are under pressure, with market leaders NBTY Inc. and Schiff Nutrition suffering declines of 45 percent and 30 percent, respectively, compared to their respective most recent 52-week highs, and the 2004 Herbalife offering being the last major IPO of note.

While the public equity markets are presently problematic for financing growth, some companies reinvest their own profits or turn to the debt markets for this purpose. Since 2007, credit in many sectors has been tight, but it is available to growing, stable nutraceutical companies with predictable cash flows, probably at the level of two- to three-times EBITDA (earnings before interest, taxes, depreciation and amortization). With barriers to entry lower in the nutraceutical industry than in some other industries, lenders to the nutraceutical industry tend to take a cautious view, and this caution is amplified in the current credit market. Further, some companies are reluctant or ill-suited to take on debt in any event.

Private equity markets provide a third and often promising source of financing for growth, particularly in the current market environment. Private equity firms have capital to deploy and many specialize in consumer products (e.g., TSG, MidOcean, Catterton, Carlyle, TA Associates). Private equity firms come in a range of styles and approaches, and private equity financing structures cover a range of alternatives. A threshold choice for a company considering private equity financing is whether to sell a minority stake, thereby retaining control, or a majority stake. In either case taking “chips off the table” while retaining a “second bite at the

apple” via a retained interest (sometimes referred to as a “rollover” interest) and/or growth capital on the balance sheet can be an appealing alternative for an entrepreneur who is ready to take on a partner and who is poised to build toward a future liquidity event.

Private equity financing multiples tend to vary widely and information on private equity transactions is sometimes hard to corroborate. Generally, current multiples in the industry for private equity financings are in the range of six- to eight-times EBITDA, slightly lower than in previous years. (Private equity-led take private transactions are very rare in the nutraceutical sector, in part reflecting the time, expense and financing required to complete them.) Negotiation of valuation in private equity financing transactions reflects company performance and outlook, competitive dynamics and target returns of the investors, among other factors.

The mergers and acquisitions (M&A) market affords yet another source of liquidity and opportunity. For smaller organizations needing capital and distribution channels to grow, combining with a larger company can be a winning strategy. For a larger organization, increasing market share and accessing new categories through acquisitions is very attractive. Transactions continue apace, such as Plethico Pharmaceuticals’ purchase of Natrol and NBTY’s recent purchase of Leiner out of bankruptcy for \$371 million plus the assumption of certain liabilities. Although the pace of M&A transactions slowed a bit in 2007, there were still more than 25 transactions in the sector as compared with approximately 35 transactions in 2006. Since the beginning of 2005, average M&A multiples in the broader nutraceutical sector have been approximately 1.3-times revenues and 9.4-times EBITDA. Industry commentators expect consolidation in the industry to continue.

Regardless of how an entrepreneur chooses to finance his business, certain structural ideas are useful to keep in mind. Generally, doing business in an LLC or other tax pass through structure for tax purposes can create flexibility and tax advantages, such as a write up of the purchase price for tax purposes (and corresponding deductions for a purchaser, possibly justifying a higher price), the ability to use retained earnings to build up owners’ tax basis, the ability to pass-through earnings to owners with a single level of taxation, and the ability to offer employees tax-enhanced equity participation in the business in the form of profits interests. Possible tax rate changes following the 2008 election could affect these benefits. Tight management systems, a clean regulatory score card and ability to build and deliver reliable projections will greatly enhance the prospects for a successful financing. And, of course, careful selection of a financing partner and knowledge of the pros and cons of the various financing alternatives are critical.

Those nutraceutical companies that understand the pros and cons of the various alternatives and make wise choices will position themselves to be consolidators and growers in a growing sector. □

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