TERENCE TSE

# Buying I Scream Ice Cream

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"Should I stay or should I go?" by The Clash are the lyrics and tune that kept on ringing in Jean-Pierre Denault's head when he was examining a rare acquisition opportunity in April 2010. He was the founder-owner of Sacred Heart, a privately held manufacturer of ice cream. The company in questions was Sino-Japan Tobacco, one of the largest tobacco manufacturers in the world, which had recently announced plans for strategic re-organisation that would result in the divestiture of its food business. This plan would enable Sino-Japan Tobacco to refocus on their core business in tobacco, as well as the higher margin pharmaceutical division. A part of the food business the Asian company wanted to sell off was the Europe-based I Scream Ice Cream. At a quick glance, the acquisition of I Scream Ice Cream would double the size of Sacred Heart in terms of revenue and enable it to better exploit the distribution channels. While it was not expected that there would be a contested bid for I Scream Ice Cream, the possibility could not be discounted.

## The Ice Cream Industry and Market

The ice cream industry was occupied by many brands that were owned by both large and small firms. In general, the market could be split into two categories: impulse ice cream and take-home ice cream. Impulse ice cream was often packaged in single servings and purchased for immediate consumption, while take-home ice cream was primarily intended for consumption at home. Both Sacred Heart and I Scream Ice Cream belonged squarely in the latter category. While the ice cream markets were quite sizable – €1.6 billion in France, €3 billion in Germany, €1.7 billion in Italy and £1.3 billion in the UK in 2009[1] – they were marked by relatively low growth. One of the reasons for this was that ice cream is often seen as an unhealthy and low in nutritional value. As a result, there were a number of new innovations that attempted to make up for the lost market of traditional ice cream. They included ice cream smoothies, and gluten-free or low-calorie, real-fruit ice cream.

Despite relatively low growth, the ice cream market remained promising because it was considered an affordable indulgence for many. This is best captured by the founder of a Covent Garden-based artisan ice cream business when he said that ice cream is about paying "£2 for 10 minutes of pleasure". Such affordability allowed the ice cream business to hold up rather well in the current economic downturn. While consumers continued to demand these indulgent and hedonistic products, the trend was shifting towards 'lighter', healthier and more 'natural' products.

While the ice cream business was resilient to economic changes, it was highly dependent on warm weather. As a result, with increasing ownership of home freezers and combined fridge-freezers, take-home

[1] Ice cream: A pan-European overview - France, Germany, Italy, Spain and UK, September 2009, *Mintel Oxygen*

ice cream had been growing at a slow but steady pace. Also, the growing importance of consumers living in one and two-person households was driving demand for take-home ice creams, even though they had to be offered in smaller pack formats.

While there were many ice cream brands in the market (most of which were owned by large food conglomerates), smaller brands, local players and artisan ice cream (for instance, in China and Italy) had not only fragmented the market but also intensified the competition between brands. Of the different ways that manufacturers used to compete more effectively, 'premiumisation' – the act of upgrading the brand to 'luxury' status – had enabled some companies to obtain higher profit margins and strengthen their brands. One of these high-end ice cream manufacturers was Sacred Heart Ice Cream.

**Sacred Heart**

Sacred Heart was founded in 1988 to produce and market take-home artisan ice cream. Before that, Jean-Pierre Denault had failed for the second time to enter a business school and worked in a series of jobs in the insurance and retail industries. As he realised that his latest job would soon come to an end, a friend opened an ice cream scoop shop in a relatively unfashionable part of Paris and introduced him to ice cream making. While the shop did not survive for long, the method and process of making ice cream later became the core recipes for Sacred Heart.

The company began with selling three flavours – vanilla, coffee and chocolate - in specialty food stores and taking up a little shelf space in high-end department stores. The company was known to be using top quality ingredients for its ice cream and subsequently expanded the range of flavours. Sacred Heart also exported its products to Japan, the Middle East, and most recently, China. Sales outside Europe were made through partnered wholesalers, on whom the company still relies today.

In the late 1990s, Sacred Heart had a range of 12 flavours and started to experiment with new ice cream products that emphasised 'mouth feel', that is, with big chunks of chocolate, fruit and nuts. For several years, Sacred Heart was seen as the choice for not only those who were health-conscious but also those who were affluent and fashionable. Nevertheless, with more and more products that ranged from traditional full-fat ice cream to smoothies flooding the market as well as the availability of viable alternatives such as water-based frozen desserts, the company had gradually lost its ability to differentiate itself from its competitors. The company's income statements and balance sheets are shown in Exhibits 1 and 2, respectively.

Recently, the company narrowed its range to concentrate on the best-selling flavours. Operationally, this translated into simplification of production and streamlined supply chain. As a consequent, the new structure enabled Sacred Heart to approach inventory and brand management with greater ease, allowing it to be more effective in managing inventory compared to its rivals.

Even though the company had been fairly profitable, its small size was gradually seen as a competitive disadvantage. Compounded with this problem was the fact that almost all the products that Sacred Heart sold were full-fat ice cream. In this competitive environment, while the company's sales would remain fairly stable;, there would be very little remarkable growth as consumers were becoming exposed to more and more choices within the market. The company was also under pressure from new ice cream-like products and desserts created by non-traditional ice cream manufacturers and large food conglomerates. A list of competitors and the selected information about these firms are shown in exhibit 3.

Viewing the brand as one of the most important ways to distinguish the company from other competitors, Denault had long decided that Sacred Heart Ice Cream would not move down-market by selling products at lower prices. Whilst this helped preserve the operating margins, this decision also led the company to becoming stuck in the low-growth market of luxury take-home ice cream. Even though the company could continue to operate as such, its long-term survival might be put into question as competitors continued to grow in size and to apply competitive pressure.

**I Scream Ice Cream**

I Scream Ice Cream had been a success because it sold, in addition to full-fat ice cream, innovative ice creams that were different such as yogurt, low-fat and fruit-based ice creams and smoothies, all of which appealed to an increasingly sizable population of health-conscious consumers in Europe. The recent income statement and balance sheet information are shown in exhibits 4 and 5.

Founded in Germany some 20 years ago, I Scream Ice Cream was initially a regional success; with enormous media coverage, it turned into a national premium ice cream manufacturer. Since its inception, the company stressed an image of the maker of 'healthy' ice cream (the slogan was "I scream 4 Gesundheit [the German word for health]"). Such success had drawn the attention of Sino-Japan Tobacco, which at the time was seeking to develop beyond its core offerings of cigarettes and tobacco-related products. The company eventually acquired I Scream Ice Cream and injected capital to promote rapid expansion. More importantly, the new parent provided the necessary funding for the company to develop innovative and healthy/healthier ice cream products. At the same time, Sino-Japan Tobacco tried to exploit the same distribution channels for its tobacco products to expand I Scream Ice Cream's sales, thus achieving economies of scale and bargaining power. It also transferred several senior managers from Japan to oversee the product development and the operation of the ice cream company.

While the company came up with some innovative products (not least because of various quirky elements imported from Japan), its sales were below expectations. This was partially the result of failing to exploit the same channels for products as initially planned. In the last few years, I Scream Ice Cream changed its strategy to distribute through a retailing network that it had established in various countries. Revenue had improved substantially as a consequence. In 2009, the board of Sino-Japan Tobacco concluded that the food business division did not fit its strategy and had decided to sell the business in the context of a broader re-organisation.

I Scream Ice Cream spotted the growing market segment of healthy alternatives to full-fat ice cream early on and capitalised upon it. It first tapped the market by offering ice cream with less than half the fat of regular ice cream without compromising the flavour. Sales of such low-fat ice cream had grown substantially over the years. Even in the midst of an increasing number of ice cream manufacturers offering low-fat products, sales of the company had been growing, despite no longer being as stellar as it once was.

Fruit-based ice cream and smoothies were more recent inventions. Although this product segment once enjoyed the highest EBIT margin within the company, it was no longer as popular as it used to be and sales of such products had been levelling off in the previous two years. Growth in this segment was likely to be slow. In contrast, yoghurt-based ice cream provided a more promising future. In 2009, supported by an extensive marketing campaign, I Scream Ice Cream introduced a range of yoghurt-based ice-cream products containing vitamins and antioxidants. It emphasised the use of only the freshest organic ingredients and the best chocolate, fruit and nut pieces to provide the "ultimate mouth feel". Given the health-conscious image and the luxury ingredients, I Scream Ice Cream was able to increase the sales of this segment by 44% in 2010.

**Valuing I Scream Ice Cream**

To Jean-Pierre Denault, I Scream Ice Cream represented a superb acquisition candidate. Working with his team, they developed financial projections based on forecasts of each of I Scream Ice Cream's four main product segments, as shown in exhibit 6. As part of the plan after the acquisition, full-fat ice cream would be wound down within the year that followed, as it had been planned that I Scream Ice Cream would be marketed as the healthy choice and exiting the full-fat ice cream segment would only reinforce this image. With regards to the corporate overhead, it was highly probable that they would conform to historical averages in the near future.

Jean-Pierre Denault and his team also produced a forecast of the balance sheet items, which are shown in exhibit 7. After some discussions with experts, it was agreed that the target debt ratio ought to be

20%. As the current credit markets had tightened up after the financial crisis, the degree of leverage expected implied a cost of debt of 9.50%. At the same time, the risk-free rate was 3.00%, with the market risk premium being 8.00%. It was also assumed that the tax rate would be 40%. After examining I Scream Ice Cream's value using the above presented base case assumptions, it would be necessary to consider the sources of possible synergies. Even though all these represented hard work, Jean-Pierre Denault understood that only with all these estimates and calculations in hand, he ought to be able to decide whether he should stay or he should go.

**Exhibit 1** **Sacred Heart historical income statements (in 000s)**

| | 2008 | 2009 | 2010 |
|---|---|---|---|
| Revenue | € 45,033 | € 46,941 | € 49,059 |
| Cost of goods sold | 22,721 | 23,307 | 24,812 |
| Gross profit | 22,312 | 23,634 | 24,247 |
| Selling, general & administration | 6,323 | 6,574 | 6,612 |
| EBITDA | 15,989 | 17,060 | 17,635 |
| Depreciation & amortisation | 1,410 | 1,469 | 1,573 |
| EBIT | 14,579 | 15,591 | 16,062 |
| Interest expenses (income) | 1,261 | 890 | 1,024 |
| EBT | 13,319 | 14,701 | 15,037 |
| Taxes | 5,423 | 6,418 | 6,271 |
| Net profit | € 7,896 | € 8,283 | € 8,766 |

**Exhibit 2** **Sacred Heart historical balance sheets (in 000s)**

| | 2008 | 2009 | 2010 |
|---|---|---|---|
| *Assets* | | | |
| Cash & cash equivalents | € 9,547 | € 6,788 | € 5,902 |
| Accounts receivable | 4,701 | 5,122 | 5,864 |
| Inventory | 2,198 | 3,028 | 3,206 |
| Other current assets | 3,396 | 3,989 | 3,759 |
| Total current assets | 19,842 | 18,927 | 18,731 |
| Property, plant & equipment | 9,739 | 10,042 | 11,078 |
| Trademarks & other intangibles | 1,283 | 2,455 | 2,872 |
| Goodwill | 850 | 2,370 | 2,483 |
| Other assets | 596 | 616 | 650 |
| Total fixed assets | 12,468 | 15,483 | 17,083 |
| Total assets | € 32,310 | € 34,409 | € 35,814 |
| *Liabilities & Shareholders' Equity* | | | |
| Accounts payable | € 3,142 | € 3,838 | € 4,002 |
| Other current liabilities | 2,987 | 3,053 | 3,211 |
| Total current liabilities | 6,129 | 6,891 | 7,213 |
| Long-term debt | 5,633 | 6,001 | 6,675 |
| Other long-term obligations | 1,189 | 1,027 | 784 |
| Total long-term obligations | 6,822 | 7,028 | 7,459 |
| Shareholders' equity | 19,359 | 20,490 | 21,142 |
| Total liabilities & shareholders' equity | € 32,310 | € 34,409 | € 35,814 |

**Exhibit 3** **Selected data on public ice cream and dessert companies (in 000s except otherwise stated)**

| | Market capitalisation | Net debt | Equity beta | LTM revenue | LTM net earnings | EBITDA margin | EBIT margin | Net profit margin |
|---|---|---|---|---|---|---|---|---|
| Glace Doree | 25,402 | 14,088 | 1.19 | 50,901 | 8,292 | 36.0% | 32.7% | 16.3% |
| Gelatalia | 18,116 | 9,287 | 1.21 | 26,271 | 3,044 | 31.9% | 26.8% | 11.6% |
| Green Farm Organic | 326,693 | 174,367 | 1.49 | 364,478 | 70,044 | 36.1% | 33.8% | 19.2% |
| Fat Cow Ice Cream | 44,524 | (235) | 0.99 | 46,188 | 7,586 | 32.1% | 29.1% | 16.4% |
| Morimoto Dessert Creation | 283,456 | 101,108 | 1.07 | 248,306 | 33,234 | 33.0% | 27.4% | 13.4% |
| Winkelmann | 143,206,021 | 9,011,000 | 0.62 | 49,267,345 | 5,635,000 | 36.2% | 15.0% | 11.4% |
| Mount Pitman | 30,040 | 23,017 | 1.33 | 54,670 | 10,036 | 34.8% | 29.3% | 18.4% |
| Fast Luxury Food | 219,213 | 160,201 | 1.87 | 193,236 | 38,834 | 38.5% | 34.7% | 20.1% |

**Exhibit 4** **I Scream Ice Cream historical income statements (in 000s)**

| | 2008 | 2009 | 2010 |
|---|---|---|---|
| Revenue | € 39,823 | € 41,098 | € 43,777 |
| Cost of goods sold | 15,754 | 16,734 | 17,435 |
| Gross profit | 24,069 | 24,364 | 26,342 |
| Selling, general & administration | 10,010 | 10,534 | 10,998 |
| EBITDA | 14,059 | 13,830 | 15,344 |
| Depreciation & amortisation | 1,540 | 1,600 | 1,901 |
| EBIT | 12,519 | 12,230 | 13,443 |
| Interest expenses (income) | - | - | - |
| EBT | 12,519 | 12,230 | 13,443 |
| Taxes | 4,812 | 5,234 | 5,687 |
| Net profit | € 7,707 | € 6,996 | € 7,756 |

**Exhibit 5** **I Scream Ice Cream historical balance sheets (in 000s)**

| | 2008 | 2009 | 2010 |
|---|---|---|---|
| *Assets* | | | |
| Cash & cash equivalents | € 1,121 | € 896 | € 1,001 |
| Accounts receivable | 5,523 | 5,731 | 6,899 |
| Inventory | 2,071 | 2,164 | 2,630 |
| Other current assets | 1,562 | 2,162 | 2,790 |
| Total current assets | 10,277 | 10,953 | 13,320 |
| | | | |
| Property, plant & equipment | 8,618 | 8,890 | 10,011 |
| Trademarks & other intangibles | 5,111 | 5,567 | 5,732 |
| Other assets | 1,131 | 2,377 | 2,832 |
| Total fixed assets | 14,860 | 16,834 | 18,575 |
| | | | |
| Total assets | € 25,137 | € 27,787 | € 31,895 |
| | | | |
| *Liabilities & Shareholders' Equity* | | | |
| Accounts payable | € 2,568 | € 2,951 | € 3,753 |
| Other current liabilities | 2,608 | 2,914 | 3,309 |
| Total current liabilities | 5,176 | 5,865 | 7,062 |
| | | | |
| Long-term debt | - | - | - |
| Other long-term obligations | 1,953 | 2,314 | 2,489 |
| Total long-term obligations | 1,953 | 2,314 | 2,489 |
| | | | |
| Shareholders' equity | 18,008 | 19,608 | 22,344 |
| | | | |
| Total liabilities & shareholders' equity | € 25,137 | € 27,787 | € 31,895 |

**Exhibit 6** **I Scream Ice Cream income statement projections in the next 5 years (in 000s)**

| | | 2011 | | 2012 | | 2013 | | 2014 | | 2015 |
|---|---|---|---|---|---|---|---|---|---|---|
| *Yoghurt-based ice cream* | | | | | | | | | | |
| Revenue | € | 21,037 | € | 22,987 | € | 24,001 | € | 24,282 | € | 25,237 |
| Cost of goods sold | | 8,934 | | 9,245 | | 9,995 | | 10,786 | | 11,023 |
| *Fruit-based ice cream/smoothie* | | | | | | | | | | |
| Revenue | | 8,989 | | 9,823 | | 10,257 | | 10,999 | | 11,548 |
| Cost of goods sold | | 2,902 | | 3,154 | | 3,876 | | 4,903 | | 5,234 |
| *Low-fat ice cream* | | | | | | | | | | |
| Revenue | | 11,302 | | 12,545 | | 13,434 | | 14,289 | | 15,353 |
| Cost of goods sold | | 3,945 | | 4,294 | | 4,889 | | 6,001 | | 6,989 |
| *Full-fat ice cream* | | | | | | | | | | |
| Revenue | | 3,123 | | - | | - | | - | | - |
| Cost of goods sold | | 903 | | - | | - | | - | | - |
| Sales, general and administration | | 11,999 | | 12,483 | | 13,023 | | 13,444 | | 14,010 |
| Estimated capital expenditures | | 2,412 | | 2,580 | | 2,669 | | 2,853 | | 2,987 |
| Estimated depreciation | | 1,568 | | 1,897 | | 1,805 | | 2,242 | | 838 |

**Exhibit 7** **I Scream Ice Cream balance sheet projections in the next 5 years (in 000s)**

| | | 2011 | | 2012 | | 2013 | | 2014 | | 2015 |
|---|---|---|---|---|---|---|---|---|---|---|
| *Assets* | | | | | | | | | | |
| Cash & cash equivalents | € | 1,021 | € | 993 | € | 1,010 | € | 979 | € | 1,026 |
| Accounts receivable | | 7,214 | | 7,826 | | 8,802 | | 9,946 | | 11,010 |
| Inventory | | 2,978 | | 3,331 | | 4,056 | | 4,305 | | 4,934 |
| Other current assets | | 2,895 | | 2,953 | | 3,201 | | 3,444 | | 3,477 |
| Total current assets | | 14,108 | | 15,103 | | 17,069 | | 18,674 | | 20,447 |
| Property, plant & equipment | | 11,485 | | 12,329 | | 13,012 | | 13,876 | | 14,487 |
| Trademarks & other intangibles | | 6,132 | | 6,132 | | 6,132 | | 6,132 | | 6,132 |
| Other assets | | 2,832 | | 2,832 | | 2,832 | | 2,832 | | 2,832 |
| Total fixed assets | | 20,449 | | 21,293 | | 21,976 | | 22,840 | | 23,451 |
| Total assets | € | 34,557 | € | 36,396 | € | 39,045 | € | 41,514 | € | 43,898 |
| *Liabilities* | | | | | | | | | | |
| Accounts payable | € | 3,844 | € | 3,988 | € | 5,001 | € | 5,432 | € | 5,977 |
| Other current liabilities | | 3,501 | | 3,645 | | 3,735 | | 3,920 | | 4,079 |
| Total current liabilities | | 7,345 | | 7,633 | | 8,736 | | 9,352 | | 10,056 |
| Other long-term obligations | € | 2,489 | € | 2,489 | € | 2,489 | € | 2,489 | € | 2,489 |