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Suiza Foods Corporation: best management strategy in the fluid milk industry

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Abstract

Suiza Foods has rapidly grown to become the largest company in the U.S. fluid milk industry. This teaching case is designed to familiarize students with the challenges which confront Suiza in its quest for further growth and, in turn, high profitability. Interviews with top executives describe the history of Suiza as well as the rationale behind Suiza's strategies. Information is presented on both economic and financial trends so as to allow the student to assess Suiza's past, present and future performance.

Keywords: Fluid milk; Strategy; Mergers and acquisitions

1. Introduction

From its founding in late 1993, Suiza Foods has grown to be the nation's largest fluid milk bottler in only seven years. This case is the story about how such rapid growth has been achieved. It is designed to help students understand both the forces propelling Suiza forward as well as the challenges which lie ahead for Suiza and the bottled milk industry as a whole.

The fluid milk business is characterized by declining per capita demand. As shown in Exhibit 1, competing beverages such as carbonated soft drinks and bottled water are gaining market share at the expense of fluid milk. *Milk Industry Magazine* editor Barbara Martin knew that growing a fluid milk business was difficult. Thus the first question she asked Mr. Gregg Engles, Chairman of the Board of $6 billion Suiza Foods Corporation, concerned the challenge of maintaining up-to-date plant and equipment. Mr. Engles responded, "Running a business is not about next quarter's results. Our managers know you have to invest back

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Exhibit 1
United States fluid beverage consumption trends. Per capita consumption per year, all persons, gallons*

Year	All fluid milk	Bottled water	Carbonated soft drinks	Fruit juice	All alcohol
	(gal./person)	(gal./person)	(gal./person)	(gal./person)	(gal./person)
1977	29.0	1.3	33.0	6.5	26.1
1987	26.3	5.7	41.9	7.9	28.0
1997	24.0	13.1	53.0	9.2	25.2

* Source: Putnam and Allhouse (1999).

into the business to be successful in the long run. In 1999, we invested $186 million in new facilities and new equipment."

Barbara next asked Gregg about the toughest challenge facing Suiza. Gregg responded, "At the start, time itself was our toughest challenge. Once you get an acquisition started, you cannot slow down. Further, we knew we had to keep moving quickly to obtain sustainable advantage. Now we have nearly ninety processing facilities. Our strategy is to modernize the best plants and close the inefficient plants."

Changing the subject to an always difficult area, Barbara asked Gregg about people management. He responded with the following complex and insightful answer. "In our case we need the best people in management positions to be sure they do not make things more complicated than they need to be. We need managers who stick to our fundamental business model. This is to adequately manage the business while consolidating with speed. We must manage our really rapid growth well so that the stock market maintains confidence in us. So we made a very early decision that good company management required a very decentralized model. This means we have some inconsistency now. That is ok because we want to win the consolidation battle. You cannot do both at the same time with the [low] margin structure we have in dairy."

2. Fluid milk bottling history

The concept of a nationwide fluid milk company is not new. Both branded and private label companies have done business on a nationwide basis. Two examples of successful private label companies would include the bottling businesses of The Kroger Company and of Safeway Inc. Both sell almost all of their milk production through their respective retail outlets. As such the driver of success comes largely from cost minimization in the production and delivery of products to retail. In this vertically integrated structure, the bottling operation is totally dependent upon the success of the retail operation. Thus when Safeway experienced its 1986 restructuring and withdrew from several retail markets, dairy operations were reduced substantially as a result.

Other multiregional milk bottling companies such as Borden, Carnation, Foremost and Knudsen have historically existed totally apart from any retail ownership. This type of business structure is quite different from the private label approach. First, because shelf space is not assured, a significant amount of resources must be devoted to sales and marketing. Second, this substantially expands the varieties and types of dairy products manufactured and in turn raises operating costs. Third, nonretail customers such as schools, restaurants, and home delivery play an important role.

Borden was the largest of these independent bottlers. Not satisfied with the pace of growth in the fluid milk business, Borden diversified into the chemicals business plus a wide array of other nondairy food businesses. The diversification strategy pursued was to purchase small regional food brands and grow them into national brands. This strategy resulted in the purchase of almost 80 different food companies. However, Borden was unable to grow this wide array of businesses against dominant firms in each category. For example, Frito Lay in the salty snack business and Kraft in the cheese business proved to be too strong. Eventually KKR purchased Borden and sold the Borden dairy businesses (Deveny & Hwang, 1994).

Southland Corporation's dairy operations, which hold an historic tie to the present day Suiza Foods, existed as a hybrid of both the private label and the brand approach. Southland entered the dairy processing and convenience store business almost by accident. The company began with the ice business before widespread home refrigeration. A natural opportunity led Southland to begin selling milk and other perishable items out of its ice houses. Also they began home delivery of milk with their ice. This early combination eventually led to both the creation of the 7-Eleven convenience stores and to a milk bottling business. With Southland's own 7-Eleven Stores serving as a primary sales outlet, this bottling business had the advantage of a large captive sales base totaling over 7,000 domestic convenience stores. The widespread locations of these stores placed "small stop" dairy delivery trucks in many geographies, thus creating a competitive advantage in making additional deliveries to other smaller dairy customers such as restaurants, schools, and other food service accounts.

3. The Suiza story

Barbara was also able to interview Tex Beshears, a former member of the Suiza Board of Directors. Tex came from the Southland Corporation where he managed 28 milk plants. Tex gladly explained his background. "When I started in 1980, our wholesale milk sales were $400 million. By the time I stepped down in 1988, our sales were $800 million. I took a company 70% dependent on 7-Eleven store volume and grew it to the point where it was only 30% dependent on 7-Eleven store volume. This size put our dairy processing volume below that of Borden, Carnation, Knudsen and Foremost. However we were still in the top ten among U.S. firms."

When combined with his down to earth personality, this size put Tex in the position to hold national office at the Milk Industry Foundation, an industry trade association. When Southland did a management-led leveraged buyout, the support processing operations were spun off, leaving Tex without a job. He poured all his energies into his Vice Chairmanship and later Chairman position at MIF. The national travel and relations with the nation's top dairy firm owners gave him a network which was to become crucial to the birth and growth of Suiza Foods.

Tex stated that the birth of Suiza took place when he was fortunate enough to meet Gregg Engles. Engles relates that early meeting and the birth of Suiza as follows. "Tex had a simple concept. It was to gain market share through acquisitions in the ice and milk processing industry, then use this share to gain savings from economies of scale. The idea was simple and, if you look at other food industries such as soft drinks, cookies, soup, and meat, you cannot deny its success. We did have to move quickly to obtain sustainable advantage, to get big and grow."

According to Tex, "When we made our first offer for Suiza Dairy in Puerto Rico, it was rejected due to a higher competing bid from dairy giant Dean Foods. However, a year later the owners of Suiza came back to us. Their deal with Dean had fallen through due to a disagreement over price. We moved quickly to acquire Suiza. Today it is still one of our top performing divisions and Hector Nevares, whose family owned the original Suiza, is on our Board of Directors."

From 1995 through the year 2000, Engles, Beshears and Tracy Noll (the former controller of the Southland dairy operations) pursued an aggressive growth strategy. Exhibit 2 shows the rapid growth experienced by Suiza. Return on assets has ranged between 4.69% and 20.07%. Using a Dupont analysis, one can see that this has been achieved by the employment of a relatively high but constant level of leverage (defined as assets to equity). The assets to equity ratio has ranged from a low of 3.46% in 1994 to 1998s high of 4.60%. Net income divided by assets has exhibited higher variability.

As Beshears explains, "We sought to acquire businesses owned and run by the best people in the industry. With our purchases of Swiss Dairy (9/96) and Model Dairy (12/96) people in the industry really began to take notice of us. When we made these acquisitions we kept existing ownership in place as management. You can bet that word spread across the industry that bottling business owners could turn to Suiza if they sought to get more than simply the net value of their assets out of the business." Although not shown in Exhibit 2, Suiza's sales are forecast to be over $6 billion in 2000. That is a lot of growth from a company that did not come into being until late 1993! Today Suiza Foods Corporation is an American company with global aspirations. Its fast growth has not slowed.

Exhibit 3 shows Suiza Foods in its present structure as of January 1, 2000. As can be seen, Suiza now consists of thirty different companies. This exhibit gives the names of Suiza's various divisions as well as the companies which make up these divisions. In addition to these companies, most of which are important local brand names, Suiza also owns several names with national, or nearly national, recognition. These names include Borden's, Meadow Gold, and Foremost (all of which came with the Southern Foods acquisition) and International Delight, a brand acquired along with Morningstar in 1997. Regarding the Borden name, Suiza owns the right to use this name for fluid milk, while Dairy Farmers of America owns the right to use this name for cheese.

4. Acquisition and marketing

Barbara was curious about the mechanics of a Suiza acquisition and so she sought out Tracy Noll, Suiza's Director of Development. Tracy originally grew up on a farm in

Exhibit 2 Financial performance summary for Suiza Foods*

	1999	1998	1997	1996	1995	1994
Total revenue	$4,481,999	$3,320,940	$1,795,868	$1,207,565	$1,014,926	$891,165
Cost of sales	$3,487,075	$2,557,908	$1,381,084	$970,796	$813,091	$710,175
Gross profit	$994,924	$763,032	$414,784	$236,769	$201,835	$180,990
Expenses & adjustments	$885,193	$631,426	$386,020	$190,108	$195,584	$164,599
Net income (after taxes)	$109,731	$131,606	$28,764	$46,661	$5,251	$16,391
Total assets (at year end)	$2,658,922	$3,013,783	$1,403,462	$833,624	$484,852	$443,307
Shareholder equity (at year end)	$583,972	$655,771	$359,310	$213,854	$111,909	$127,954
Net income/total assets (%)	4.13%	4.37%	2.05%	5.60%	1.08%	3.70%
Total assets/shareholder equity	4.55	4.60	3.91	3.90	4.33	3.46
Net income/shareholder equity (%)	18.79%	20.07%	8.00%	21.82%	4.69%	12.81%
Average common shares, diluted	42,858,492	41,965,564	31,348,591	24,491,899	20,935,161	22,761,925
Share price						
Year ending	12/31/99	12/31/98	12/31/97	12/31/96	n.a.	n.a.
Average	$36.39	$52.00	$38.63	$17.00	n.a.	n.a.
High	$50.25	$67.00	$62.50	$20.75	n.a.	n.a.
Low	$29.63	$25.69	$19.25	$14.25	n.a.	n.a.

* All dollar figures are in thousands, except for share prices.

Source: Suiza Foods (1996, 1997, 1998, 1999)

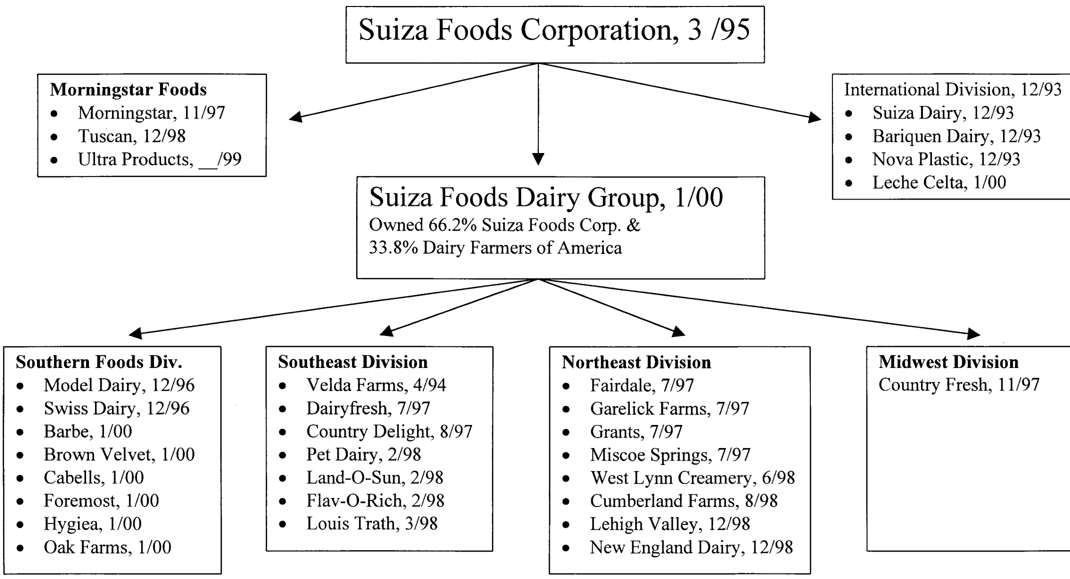

Exhibit 3. Company organization chart, suiza foods corporation.

Wisconsin. He first entered the commercial agribusiness sector through the Master Mix division of Central Soya. He then worked for the Southland Corporation, parent company of 7-Eleven Stores. Tracy held the position of Manager of Corporate Accounting, a position which gave him a thorough understanding of a wide ranging empire which included 11,000 stores worldwide, an oil refinery, an ice business, and 28 milk processing plants.

Noll explained the mechanics of a Suiza acquisition as follows. “Each owner has their own motivation to sell. For one it may be estate planning needs. For another ownership may be split up among several family members, some wanting to stay in business and others having no active interest. Our basic program has been to pay a multiple of cash flow, normally 5 to 7 times EBITDA (earnings before interest, taxes, depreciation and amortization). Once we acquire an operation in an area, then we seek other complimentary acquisitions which allow us to realize economies in distribution and manufacturing from consolidation.”

To manage fast growth, Suiza’s upper management has had to make a succession of important decisions on key personnel. To be sure these are the right decisions, one fundamental Suiza philosophy is to leave the local management team in place whenever possible. As Tex Beshears, states, “local management knows the customers, the employees, and the dairy farmers.”

Joining forces with Southern Foods brought top quality experienced managers into Suiza, especially Pete Schenkel who was President of Southern Foods. Gregg considers the appointment of Schenkel as President of the newly formed Suiza Dairy Foods Group to be one the best decisions he has ever had to made. “When you make a management change at that level it is very tough. However, within the day, I knew I had made the right decision,” says Gregg.

4.1. Acquisition economics

From the proprietary bottling plant owner's point of view, several external changes can motivate a sale. On the sales side, the consolidation of grocery retailers and proliferation of chain restaurants both contribute to reduce the number of available customers. Even though the same amount of milk may be consumed, customer bargaining power increases. Sometimes even when a proprietary bottler wholesales milk at a competitive price, an account can still be lost to an out-of-area bottler taking that business as part of a larger multiregional sales relationship.

On the milk supply side, pressures also encouraged proprietary bottlers to sell. The advent of the 1985 Food and Agricultural Adjustment Act brought about continued declining milk prices, a whole herd buyout, and thus the liquidation of cow numbers in many areas. Price volatility was the eventual result and in the late eighties a surplus of milk bottling capacity made it very tough for bottlers to pass on frequent price increases to buyers. Although today's buyers are used to fast changing prices, in the late eighties a lot of equity was lost, leaving surviving bottling plant owners cautious about future risks to their equity.

From Suiza's perspective, when competing plants are acquired in a single area and brought into coordinated management, important savings result. A study of fluid bottlers by Erba et al. (1997) illustrates why this is true. Regarding economies of plant size, each 1% increase in processing plant *capacity* results in a 0.094% drop in bottling cost (p.37). Also in regard to the plant, each 1% increase in plant *size* results in an 0.081% drop in bottling cost (p. 37). Regarding economies from densification in the *delivery* of milk, each 1% reduction in route miles results in a 0.29% reduction in delivery costs (p. 59). Also regarding deliveries, each 1% reduction in the number of delivery stops results in an 0.11% drop in delivery cost (p. 59).

According to Noll, "Local management can best run the respective operations. For this reason we have headquarters here in Dallas handle financing, procurement, legal, banking and insurance. However, the local operations handle sales, human resources, and operations. Plus, we never force any operation to do it 'the headquarters way.' We have target-based bonus compensation plans in each operation to further encourage local management to drive for efficiency."

4.2. Product development

At present fluid milk products are considered relatively generic and are sold with little fanfare or excitement. The cause for this is likely two fold. First, many consumers perceive milk as a homogeneous, interchangeable product. Second, generic advertising, funded by producers, reinforces this conception. The net result is that 67% of all retail milk is sold under private label supermarket brands, creating a category with little excitement (International Dairy Foods Association, 1999).

"There is a real consumer barrier because most consumers see milk as being basically the same," Suiza Chief Marketing Officer Mike Hogan says. "People don't come to the milk category expecting something new." (Clark, p. 40) Hogan, a former Frito Lay marketing executive, is leading Suiza's effort to introduce new dairy products. Under his leadership

Exhibit 4
New fluid milk product concepts

Product name	Maker	Target market	Product packaging	Product test and flavors
Fitmilk	Suiza	Athletes/diet concious	114 oz., easy to poor, plastic smart jug	Fat free with 67% more calcium than regular milk
Kidsmilk	Suiza	Children	114 oz., easy to poor, plastic smart jug	2% milkfat, 67% more calcium, 50% more of 11 vitamins
Lifemilk	Suiza	Over 40	114 oz., easy to poor, plastic smart jug.	1 % milkfat with 67% more calcium
Chugs	Dean's	Children & on the go consumers	8 oz, pints, & quarts plastic.	Chocolate milk, whole, 2% and nonfat milk.

Suiza has begun to roll out entirely new fluid milk products such as lifemilk, fitmilk and kidsmilk. Exhibit 4 describes these products along with Dean's new fluid product called Chugs. With Chugs, Dean's is trying to develop a product aimed at the on-the-go consumer whereas Suiza is seeking to develop new milk categories. Both efforts are critical to the long term success of the fluid milk industry.

4.3. Milk supply strategy

Fluid milk is generally a perishable product. In order to minimize returned product and maximize quality, farm fresh milk is a crucial requirement. Furthermore, this supply must be obtained in an economical fashion. In order to do this, some milk bottlers maintain field staff, producer payroll clerks, trucking fleets, and manufacturing facilities. Such companies maintain very close relationships with their independent shippers (i.e., dairy farmers who do not belong to a cooperative). Such companies may invest heavily in facilities capable of processing surplus milk. This surplus is created when a company's regular retail, school, and food service customers do not need all the milk produced by farmers. This practice, called balancing, can be very costly. An alternative to running a direct shipper system is to procure milk from a full service cooperative.

Suiza has formed a joint venture with the Nation's largest milk cooperative, Dairy Farmers of America (DFA). Exhibit 3 shows that DFA owns 33.8% of the Suiza Foods' Fluid Dairy Group. DFA is headquartered in Kansas City and has a membership of over 25,000 dairymen. With a total milk supply of almost 40 billion pounds per year, Exhibit 5 shows that DFA is more than three times larger than the number two cooperative in the nation, Land O'Lakes. By itself, DFA accounts for 25% of the nation's total milk supply.

Gary Hanman, DFA President, gives the following reasons for working closely with Suiza Foods and other bottlers:

> By owning the Borden cheese label and participating in 11 joint ventures with bottlers including the nation's largest, Suiza Foods, our members have greater market security and an opportunity to capture income from the retail market. Joint ventures offer another protection against losing control of our industry and becoming fully integrated like the hog and poultry business (*DFA Leader,* January 2000, p. 1.).

Exhibit 5
Changing structure of U.S. milk cooperatives*

1997		1998		1999	
Cooperative	Annual milk	Cooperative	Annual milk	Cooperative	Annual milk
	(Bil. Lbs.)		(Bil. Lbs.)		(Bil. Lbs.)
Mid America	17.2	DFA	31.5	DFA	39.7
AMPI	11.8	Land O'Lakes	12.2	Land O'Lakes	12.3
MMI	7.0	CMP	6.8	Calif. Dairies	11.7
CMP	6.5	Foremost	5.4	Northwest Dairy	5.4
Foremost Farms	5.6	Family Dairies	5.3	Dairylea	5.3
Farmer's Union	5.4	Darigold	5.0	Family Diaries	5.2
Darigold	5.0	Dairylea	4.9	Foremost	5.2
Dairylea	4.5	AMPI	4.4	AMPI	3.7
Land O'Lakes	4.2	DCCA,	4.2	Manitowoc	3.7
DCCA	4.0	Manitowoc	3.5	Michigan Milk	3.0

* Sources: Koinski (1999), Mowery (1998), and Hoard's (1997).

Exhibit 6 presents reasons, from both the Suiza and the DFA perspective, why this joint venture will be successful. From Suiza's perspective, the cooperative provides the traditional services such as milk supply balancing, transportation, quality control and milk producer relations. Looking forward, Suiza is growing quickly and when acquiring new plants, it is important that a secure milk supply be available. DFA, with its members located in 42 states, is positioned to provide this supply. Finally, DFA provides capital to Suiza and this in turn makes possible moves such as the Southern Foods merger.

The Suiza–DFA relationship reflects an understanding by dairy farmers that they must take responsibility for marketing their own products. The venture is also viewed as a chance to make money and a chance to obtain a secure home for raw milk. DFA does not play a direct role in company management. In a sense, the relationship is an ordinary producer–handler relationship. As Tex Beshears puts it, "they need to keep us competitive in terms of raw milk cost."

Exhibit 6
Suiza: Foods and Dairy Farmer of America each gain different things from their joint venture

Dairy Farmers of America gains because:	Suiza Foods gains because:
Suiza eliminates the need to invest capital in money-losing manufacturing plants. (A common cooperative paradigm of the past.)	DFA provides traditional cooperative services such as supply balancing, transportation, quality control, and producer relations.
Suiza provides a guaranteed outlet for milk.	DFA can quickly provide milk supply to new plants and/or new locations.
Suiza provides a non-confrontational outlet for milk.	DFA provides financial capital.
Suiza offers a vertical integration opportunity whereby profits can be earned further up the marketing chain.	

From DFA's point of view, the Suiza relationship reflects a major strategy change compared to the traditional role of a full-service milk cooperative. Historically such cooperatives would maintain costly balancing plants that manufactured butter, powder and/or cheese. These price sensitive commodities could be profitable in times of short milk supply or in times when the plant they were made in could be used to withhold milk from a thirsty market and thus result in processors paying raw milk premiums to the cooperative. However, the reduced role of the government's dairy price support program has made such generic dairy products harder to sell due to increased price volatility. Also, strong-arm bargaining tactics created adversarial relationships between cooperatives and their commercial milk processors.

Today DFA's relationship with Suiza provides a guaranteed outlet for milk and does so in a nonconfrontational manner. This new view of milk marketing has allowed DFA to grow without building milk plants. Also, it gives the cooperative a chance to earn profits from commercial sales. Many foresee future deregulation of the dairy industry. Should this result, DFA's joint venture with Suiza will provide a strong foothold in the commercial market.

5. Suiza today

Today Suiza Foods Corporation consists of the Fluid Group, Morningstar Foods, Suiza Dairy in Puerto Rico, and Leche Celta in Spain. Suiza's growth has required considerable capital, including substantial debt. In order for Suiza's strategy of acquisition and densification to succeed, sufficient savings must occur. Further, Suiza must be able to develop a national marketing presence in order to positively impact the demand for milk. Just as Suiza begins its new marketing strategy with kidsmilk, fitmilk and lifemilk, New England dairy farmers are raising concerns about Suiza's possible monopoly power in milk acquisition.

As Barbara reflected on all her interviews and the fluid milk situation in general, she recognized that fluid milk processing plants were not being sold by their original owners because those original owners were making too much money. The same could be said of dairy farmers. In fact, Exhibit 7 shows that both the number of milk bottling plants and the

Exhibit 7
Number of U.S. fluid milk bottling plants and number of U.S. dairy farms

Year	Fluid milk bottling plants*	Dairy farms**
	(#)	(#)
1940	9,950	4,663,413
1950	8,195	3,681,627
1959	5,571	1,836,785
1969	2,473	568,237
1978	1,215	312,095
1987	674	202,068
1997	448	116,874

* Source: USDA and California, various years.

** Source: U.S. census of agriculture, various years.

number of dairy farmers have continuously declined over the years. Such tremendous structural change had causes far beyond any strategy pursued by Suiza. Thus, for Suiza's future success, a key question concerned whether an expansion strategy could succeed in such an environment?

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