THE GLOBE AND MAIL

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Package deal

Think Starbucks makes its own breakfast sandwiches? Think again. Many are made in factories and supplied by Premium Brands, a Vancouver-based rollup that has quietly become the fastest-growing packaged foods supplier in North America

CORY DAWSON

LUCY HYSLOP

George Paleologou is having no truck with my suggestion of a taste test. I'm trying to coax the president and CEO of Premium Brands Holdings Corp.—which has grown from a venerable Vancouver bacon and pork seller into a $2.1-billion-a-year North American prepared foods conglomerate—to sample a few of his company's offerings. Perhaps a nibble of kolbassa sausage from Piller's Fine Foods of Waterloo, Ontario, or a slice of Italian Wine salami created by nearby Freybe Gourmet Foods, while also trying to correctly pronounce the name of its thinly sliced smoked pork: schinkenspeck.

Consumers may not be familiar with Premium Brands' corporate name, but you almost certainly have bitten into some of the offerings of its 41 (and counting) major brands—especially if you've reached for packaged deli meat, bacon, cooked kebabs, jerky, burger patties or meat snacks. Or maybe you've dined out on steak or seafood at one of the half dozen restaurant chains the company supplies, including The Keg and Boston Pizza.

Then there's Starbucks, the corporate customer that has excited investors the most in recent years, helping to propel Premium Brands' share price to a fourfold gain since early 2015. More and more North Americans are now grabbing breakfast sandwiches on the go, and when Premium Brands acquired Seattle-based prepared food provider SK Food Group in 2010, it segued into a contract to be a major supplier of breakfast sandwiches and wraps to the coffee colossus. Premium Brands' sandwich sales spiked from $50.9 million that year to $156.8 million in 2011, and they've been soaring ever since—to almost $460 million in 2016.

Sitting in his office in suburban Richmond, British Columbia, in a neat, open-collared checked shirt and the executive's de rigueur partially clear-rimmed glasses, Paleologou is unfailingly, almost obsessively modest. He declines to share meat slivers with me because doting on some samples wouldn't be fair to other companies under his umbrella. Besides, "I never seek attention," the greying, svelte 57-year-old says calmly. Instead, he says, the focus should be on his acquired brands, their 6,300 employees and management teams left mostly intact. "Ultimately," he says, drumming his desk with his finger for emphasis, "we're only as good as the person on the line."

As for Starbucks, Paleologou tries to shut down discussion immediately, as he does in quarterly earnings calls with financial analysts. He doesn't talk about relationships with specific customers.

It takes a lot more coaxing—with Paleologou and executives of partner companies—to get a clearer picture of the unique expansion strategy he's pursued for almost two decades. Paleologou has been Premium Brands' president since 2001. He recognized early on that many consumers were tired of mass-produced low-quality foods and that there would be a return to quality at a higher price. He also realized that such an approach is hard to standardize and scale, so the key was to keep the brands' small centres of innovation.

The result is an exceedingly rare corporate phenomenon in North America: a rollup that actually works, and one that hasn't been felled while crossing the line from ambition to hubris.

Paleologou is originally from Cyprus. His family moved to Canada in 1975, after Turkey invaded the island nation and it was partitioned between ethnic Greeks and Turks. The family settled in the Vancouver suburb of Coquitlam, where a teenage Paleologou began cooking steaks at a local restaurant. "I loved it," Paleologou says enthusiastically, adding that the wages later helped fund his business administration degree at Simon Fraser University. "That was the beginning of my passion for food."

After graduating in 1982, Paleologou joined KPMG at its office in New Westminster, first articling as a chartered accountant and then becoming a manager. Five years later, he joined one of the firm's largest clients, Fletcher's Fine Foods. He quickly rose to become CFO of the hog and meat processor, founded in 1917 in front of the Fletcher family's house in South Vancouver.

The job gave Paleologou a window into what he soon concluded was a promising yet overlooked segment of the North American food business. In the early 1990s, he watched many local, often family-run companies that made good-quality products go under or be acquired and then disappear. He became convinced there was a better way to do things than multinationals buying up talent only to consolidate and kill their entrepreneurial spirit.

Paleologou developed a sophisticated palate as well. He says food is a passion for him; he devours academic and mainstream publications on the subject. He hands me a copy of The Big Fat Surprise: Why Butter, Meat & Cheese Belong in a Healthy Diet, the bestseller by U.S. investigative journalist Nina Teicholz. "It reads like a novel," he says.

Professionally, every other year, Paleologou heads to Anuga, the world's largest food fair, held in Cologne, Germany. Personally, he and his wife, Joelle, recently bought a 22-acre organic farm on Vancouver Island. "I've never been one who just accepted answers—I've always had to do my own homework, especially on the provenance of food."

All this talk about food authenticity brings Paleologou to the "cheese story"—which I've been told he's eager to tell. "At one point in my career, I met with a fellow who was running a business in the U.S. but used to manage the cheese division of a large multinational company," he says. Paleologou asked him why he left such a high-level job. "'George,' he says, 'I got tired of having to take the cheese out of the cheese.' Now that's an amazing line."

The line stuck. Fletcher's began to expand in the mid-1990s, and by 2000, it was operating 14 plants under several brand names. That year, it changed its name to Premium Brands. In 2001, Paleologou was appointed president under Fred Knoedler, who had been in the food processing business since the early 1960s, and remained CEO and chair. Paleologou and CFO Will Kalutycz put together a deal to buy the control block of the company from the Saskatchewan Wheat Pool, selling some of Fletcher's old commodity (read: slaughter) business beforehand.

The plan was to appeal to consumers who, like Paleologou, were becoming more fastidious about what they ate. He also wanted to retain respected local brands and their managers. "I realized back then that the true innovators in the space were the little guys," he says—the Davids, rather than the Goliaths. "The big guys were trying to drive their quarterly results. They're producing chemical cocktails."

This sends Paleologou off on a sharp tangent about "Frankenfoods." Why does some bread have 45 ingredients in it, when it should only have four? Why is sugar often the second-largest ingredient in a hot dog?

"So the idea was to back the Davids in the space, but let's not rationalize them and basically impose our culture on them," he says, getting back to business. Premium Brands would be like a "big brother," buying firms and providing capital. "Let's invest in companies that are doing good things. Let's empower them and then they'll grow," he says.

Across the Canada–U.S. border in the pastoral town of Ferndale, Washington (population 12,710), I meet Stephen Bates, one of Premium Brands' early Davids. Dressed in a white lab coat, hairnet and blue hard hat, the 61-year-old president of Hempler's Foods Group walks me past racks of pepper-encrusted bacon at the company's 60,000-square-foot meat factory. He and Paleologou met in 1987, when Bates was director of the U.S. division of Fletcher's.

Hempler's started its life as a small meat-and-sausage provider in 1934. When the company approached Paleologou in 2006, it was still family-owned, with 18 employees and a 6,000-square-foot factory that produced about 2,000 pounds of bacon a week. Now, its much larger Ferndale plant ships 200,000 pounds a week, and Hempler's workforce has expanded to 230.

As Bates shows me around, we meet founder Hans Hempler's 80-year-old son, Dick, who still owns 30% of the company and pops into the office almost daily. Bates lauds Paleologou for building brands that are "measurably better" over the long term, "but which you have to be patient about."

The trouble is that Bay Street has never had much patience for anything. Back in the early 2000s, many investors just didn't understand Paleologou's obsession with food quality or his plan for keeping brands intact. "We were talking about focusing on the new food trends, focusing on protein and not sugar," he says. "They had trouble getting their heads around the strategy."

Premium Brands' share price sagged and then basically moved sideways for years. Factoring in changes in corporate structure, the price declined from a peak of $28.25 in 1999 to below $10 in 2003. It then bounced around that price for a decade, and didn't climb back above $20 until late 2013. In some ways, however, the lack of enthusiasm on the Street imposed a helpful discipline on Premium Brands. The company kept growing by acquisition, but it did so without raising huge sums from stock or bond issues.

And expand Premium Brands did, not just in the meat business, but also into food distribution and seafood. In 2007, the company bought Calgary-based meat and fish distributor Centennial Foodservice for $84.7 million. The following year, Paleologou was named Premium Brands CEO after Knoedler passed away.

By 2014, Paleologou had concluded more than 40 deals, and Premium Brands' revenues had soared to $1.2 billion from $274 million in 2001. The company was earning small but consistent profits, and its long-term debt was a modest $211 million. Yet Bay Street still wasn't impressed. Premium Brands' share price hovered at just over $20.

It took a humble sandwich to get investors really excited.

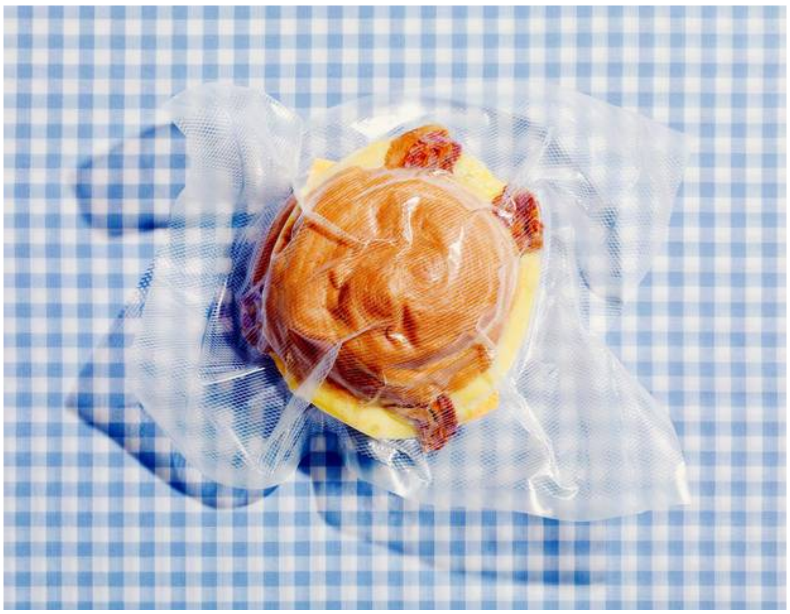
In early 2015, news stories noted that Starbucks' sales of grab-and-go breakfast sandwiches were soaring, and Premium Brands was one of its leading suppliers. Premium Brands' share price took off, soon climbing above $30, and it has kept going ever since (see chart on right).

But the investor enthusiasm about the Starbucks contract has put Paleologou in an awkward position. He says he's "not allowed to talk about it specifically as part of our agreement with them."

What Paleologou can do is describe Premium Brands' sandwich business in general. It accounted for 22% of the company's sales in 2016, and analysts estimate that at least half of that was from Starbucks. Paleologou says he expects to hit $1 billion in sales in the category within five years. As of early last fall, Premium Brands had five sandwich plants: two small ones in Canada, in Montreal and Edmonton, and three much larger factories, in Columbus (Ohio), Reno (Nevada) and Phoenix.

In the brightly lit Reno and Columbus factories, dozens of employees in white coats, hairnets and gloves assemble sandwiches on conveyor belts. Staff at the start of the line lay out bottom slices of bread or buns; others add, say, meat or egg patties, and then condiments and tops. Some sandwiches are packaged individually with logos of brand partners or private-label customers, while others are loaded in batches of a dozen or so in clear plastic bags, which are then put in large cardboard boxes for shipping.

But you won't see Premium Brands' name on sample sandwiches in Starbucks display cases. Clients like that don't want to advertise that the sandwiches are made in factories. As Paleologou explains, some quick-service restaurants face a sandwich hurdle: Profit margins are narrow, and they can't afford the labour to make sandwiches from scratch.



Cory Dawson

In November, Premium Brands acquired three more U.S. companies for a total of $200 million. Two of them are sandwich makers: Minnesota's Buddy's Kitchen Inc., which has two plants in the state, and California-based Raybern Foods, a national supplier of heat-and-serve sandwiches to Walmart and other retail chains, which has a factory in Tupelo, Mississippi.

Investment analysts who track Premium Brands are mostly bullish, and much of that optimism is based on Starbucks and the surging North American demand for food on the go. But they have also come to appreciate Paleologou's strategy for buying and nurturing brands. "Over time, Premium Brands has demonstrated that they buy something and develop the expertise in that field rather than plunging into multimillion-dollar deals where they don't know much about the acquired business and the related market," says ***Dimitry Khmelnitsky***, an analyst with Toronto-based ***Veritas Investment Research Corp***.

That comment is both a compliment for Premium Brands and a shot at one of the biggest and most disastrous corporate rollups ever: Valeant Pharmaceuticals International Inc. Under J. Michael Pearson, a management consultant who took over as CEO in 2008, Valeant went on a takeover binge and its share price soared, briefly pushing it past Royal Bank of Canada in the summer of 2015 to become the largest company on the TSX by market capitalization. But Valeant's share price then skidded by more than 90%, crumbling under the weight of $30 billion (U.S.) in long-term debt and accusations of aggressive accounting and price gouging.

Khmelnitsky was the first analyst to blow the whistle on Valeant, slapping a sell recommendation on the company in July 2014. Yes, Premium Brands is a rollup, too, but he says "it is diametrically opposite in terms of how it is doing business." There is none of the "slash and burn" approach that Pearson employed when he took over companies—firing executives, cutting R&D and raising prices.

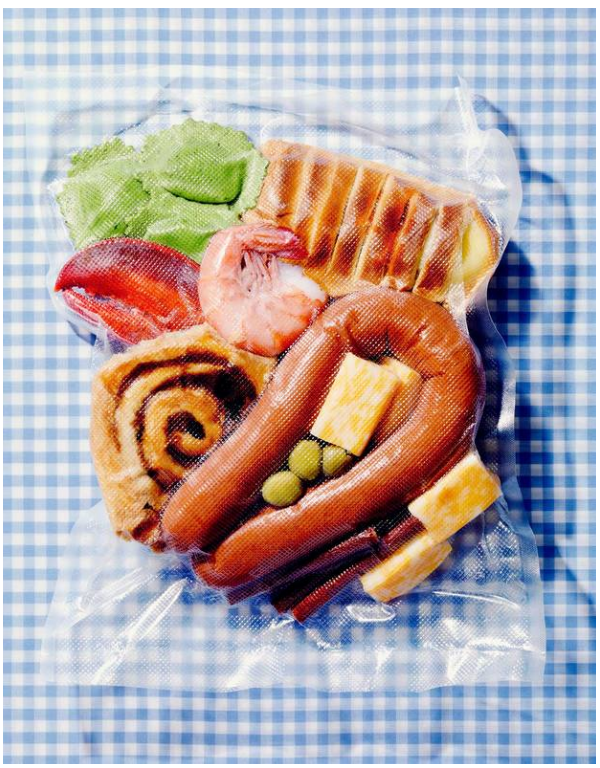
Paleologou has also avoided mistakes that another ill-fated rollup, Toronto-based MDC Partners Inc., made as it bought up dozens of firms in the advertising and communications sector. The company's share price on the Nasdaq exchange soared from less than $3 (U.S.) in 2009 to more than $28 (U.S.) in 2015. Like Paleologou, MDC founder, chair and CEO Miles Nadal had talked about leaving acquired companies and management intact.

But the ride ended in early 2015 as analysts and investors took a closer look at MDC's shaky financials—it had only earned a profit one year in the previous 10. The company also became embroiled in a scandal. In April 2015, MDC announced that it had been subpoenaed by the U.S. Securities and Exchange Commission over its accounting practices and Nadal's expenses.

There was also an elephant in the room: Nadal's massive ego and pay package. Although MDC was a mid-sized company, he was one of the highest-paid executives in Canada for years, collecting $16.8 million (U.S.) in 2014. In July 2015, Nadal resigned, and MDC shares later declined to below $10 (U.S.).

"Shin-ken-shpeck": I finally have my salami tasting and pronunciation lesson at the Langley, British Columbia, head office of another family-run business, Freybe Gourmet Foods. A whiff of garlic fills the air as Sven Freybe—as in "buy me," says the president and CEO, quoting the family slogan—picks up slices of cervelat, chorizo and other European meats and takes a sniff of each. "It's a longtime habit," he says, before enthusing about "rich flavours" and "tanginess."

Peering down from the wall behind him are portraits of his ancestors, including "Sausage Meister" Johann Carl, who founded the company in Stettin (then in Prussia, now Poland) in 1844, and Ulrich, who ran the company with his brother, Walter, out of an East Vancouver garage just over a century later. "Obviously, when you sell your business, there is a part of you that is emotionally hurt and saddened," says Freybe, 45, the sixth generation of the family to run the company.



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But by 2012, he says, the family realized they needed money to modernize. The company was not struggling, but costs, ranging from complying with federal regulations to shipping into the United States, were rising. "It's a capital-intensive business," he says. They also felt that the company would grow more with the right partner than by taking out a bank loan. So Freybe approached Premium Brands. In March, 2013, the company bought Freybe Gourmet Foods for $55 million.

One big attraction of the deal, Freybe says, was Paleologou's "respect for family businesses." But maintaining and nurturing brands doesn't mean the acquired firm simply keeps operating as before. As part of the acquisition, Premium Brands sold Freybe's deli meats factory in nearby Abbotsford to a limited partnership, and then leased the plant back. Freybe and his 50 employees now concentrate on innovation, sales and marketing.

By allowing acquired companies to keep their brand identities, Premium Brands has also accomplished something very rare for a Canadian consumer products company: It has established a large presence in the United States. Shoppers Drug Mart, Canadian Tire and Loblaws are among many big names that have tried and failed to do that.

"Premium Brands has developed a niche for acquiring differentiated and specialized brands with good management, strong entrepreneurial culture and sustainable operations," says Wendy Evans, founder and president of Evans & Co. Consultants Inc. in Toronto, who has advised on cross-border expansion, marketing and management for three decades. The company has combined those brands with an "efficient marketing and distribution enterprise, which has allowed them to gain entry into leading retailers."

Just about the only concerns analysts have about Premium Brands are valuation and its share price climbing too quickly. Yet even at the recent $103, the shares were trading at a relatively modest 20 times forecast earnings for 2018.

Khmelnitsky says the company remains the "acquirer of choice" for small Canadian and U.S. food brands, in large part because of its collaborative approach. So a lot of Premium Brands' growth will depend not just on Paleologou's financial acumen, but on his ability to bond personally with his brand partners.

Paleologou is well aware of that. "Basically, we're big enough in Canada now, so we're focusing on the U.S.," he says. But, he adds, "Our size doesn't mean we're going to change our values, or that we'll forget what got us here in the first place."

It's only when Paleologou talks about Premium Brands' free cash flow per share that his modest armour is pierced a smidgen. Pointing to the increase from 78 cents in 2004 to $4.56 in 2017, he gushes: "That's tremendous."

But then he quickly returns to form. This is not a stock promotion story, Paleologou says, "it's companies doing really good things in the food space and getting rewarded for it."

Keeping the cheese, in other words, in the cheese.

The Premium Brands empire

Deli meats
Direct Plus (Calgary)
Fletcher's (Ferndale, Wash.)
Freybe (Langley, B.C.)
Grimm's Fine Foods (Langley, B.C.)
Harvest Meats (Yorkton, Sask.)
Hempler's (Ferndale, Wash.)
Isernio's (Kent, Wash.)
Made-Rite (Langley, B.C.)
McSweeney's (Langley, B.C.)
Piller's (Waterloo, Ont.)
SJ Fine Foods (Saskatoon)

Sandwiches and other prepared foods
Bread Garden (Delta, B.C.)
Creekside Custom Foods

(Delta, B.C.)
Deli Chef (Laval, Que.)
HQ Fine Foods (Edmonton)
Hygaard (Edmonton)
Oven Pride (Seattle)
Quality Fast Foods (Edmonton)
SK Food Group (Seattle)

Bread and baked goods
Audrey's Patisserie (Langley, B.C.)
Island City Baking (Richmond, B.C.)
Stuyver's Bake Studio (Langley, B.C.)

Salads, fresh pasta and sauces
Conte Foods (Burnaby, B.C.)
Duso's (Coquitlam, B.C.)
Gourmet Chef (Langley, B.C.)
Larosa Foods (Burnaby, B.C.)

Foodservice, retail and specialty retail
B&C (Saanichton, B.C.)
C&C (Montreal)
C2C Premium Seafood (Richmond, B.C.)
Centennial Foodservice (Calgary)
Diana's Seafood (Scarborough)
Eleven Food Group (Calgary)
Hub City Fisheries (Nanaimo, B.C.)
Interprovincial Meat Sales (Dartmouth, N.S.)
Maximum Seafood (Vaughan, Ont.)
Ocean Miracle (Vaughan, Ont.)
Premier Meats (Montreal)
Premium Brands Distribution (Surrey, B.C.)

Halal foods
Shahir (Richmond, B.C.)
Wescadia (Richmond, B.C.)

Concession snacks and beverages
Harlan Fairbanks (Winnipeg and Seattle)
Multi-National Foods (Calgary)