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COMPANY INTERVIEW

Leading Brands, Inc. (LBIX)

This is a TWST interview with ***RALPH D. MCRAE****, CEO of Leading Brands, Inc.*

SECTOR: BEVERAGES – SOFT DRINKS

(ACU605) TWST: We would like to begin with a brief historical sketch of Leading Brands and a picture of things as they are now.

Mr. McRae: The company started off in the late 1980s and funded Clearly Canadian, which was one of the first new-age beverage companies. It received about a $24 million net return on its investment, and then proceeded to use those proceeds to expand its business in a variety of different interests related to the soft drink business. I became involved in the company in 1996 as part of a turnaround to try to focus it more on the premium, non-preservative-type products that were becoming more in fashion, like Snapple. Today, we are a fully integrated bottling and distribution company. We run our business based on a model that we call the Integrated Distribution System, where we take products from the conception stage to the design of the bottles and the creation of the liquids, to the marketing campaigns around them, and then we launch the products.

TWST: Is there anybody else doing it that way?

Mr. McRae: Not that I am aware of. Most of the companies have to contract out most of the functions that I have just described to you, which results in a loss of cash and flexibility about when you can launch the product and how you can control the ramp-up of the brand. So we think that gives us a distinct advantage. We primarily started off doing that in Canada, and in 2003 we moved down into the United States. We have been focusing lately on a product that we developed in the fall of last year called TrueBlue, which is a blueberry-based juice product. We think we have a chance to be the leader in that category across North America.

TWST: The types of drinks that you described have become very popular. Does that mean you have to be very fast on your feet?

Mr. McRae: You have to be, but you can't sacrifice a good appreciation of the market, good design and good liquids just to be quick. Once we conceive our product, we can push it out the door in six to eight weeks. Our process normally takes a little longer than that, but it often involves refining our product. In this TrueBlue blueberry brand, our product has fewer calories than most cranberry juices. In a period when everyone is focused on obesity and schools are shutting carbonated soft drinks out of their doors, products like that have an appeal. You want to create as many unique selling points as possible. That drink didn't formulate itself overnight. That took us many months to get these formulations proper, with reduced sweeteners.

TWST: What are the main things on your agenda for the next two or three years?

Mr. McRae: We want to continue to expand our product base in the US. We have very good, solid, across-the-board distribution in Canada, but the US market in beverages is about 20 times as large. We have had an extremely good success rate in introducing products to large-scale retailers. Some of the most recent ones, Albertson's and Safeway, got good pickup in those brands and we are getting great sell-through. If we can just repeat that over and over again, things should be fine for us.

TWST: How difficult is the struggle for shelf space?

Mr. McRae: It can be a pricey one. First of all, you have to have a product that is desired by the retailer. If you don't have that, you are not going to get in the door. Once you get there, there is a debate that goes back and forth about how much it costs you to get the shelf space, by way of "listing" or "slotting" fees. You want to make sure that you pay for something that you can get a good return on. Sometimes that's a negotiation, and sometimes that's a process of saying no for a while until someone see a product somewhere else and asks you for it. So that's an expensive process, but as we build up this business over the next couple of years in the US, a lot of those upfront costs will start to be subsumed in the throughput that we will have coming out of stores where we already have those listing and slotting fees paid.

TWST: What is the general outlook?

Mr. McRae: The general outlook that you get from trade and people who do studies on these sorts of things, is that carbonated soft drink sales are in a pretty steady decline. This has occurred for 15 years or so, with a 2% to 3% decline against an increasing population growth. These types of products that we are in have grown into the double digits in the past, but the reason that they are going a little slower now is because the size of the market is so much bigger. We are seeing most of that carbonated soft drink trend being picked up by these products and bottled waters.

The only problem that you get with bottled water is that you can't create enough product differentiation there in order to sustain the margins that you want in this business, and that's why we chose this premium business. You can have a higher percentage gross profit margin on your products, which allows you to do more things. With a private-label carbonated soft drink company, you have a commodity price-driven cost-related product and you don't have much control over your margins.

TWST: How big a part does water play in your portfolio?

Mr. McRae: We don't sell much in the way of water with the exception of two things. We have our own spring site outside of Vancouver. It is a 22-acre site that we own, and we have several million gallons worth of capacity out of there. We also license Fiji Water, which has been a fast growing water in North America in the last couple of years. We had some more success on that here, and that is perceived to be a premium product.

TWST: What's the reason for the success of Fiji? How have you managed to differentiate it?

Mr. McRae: Fiji has a unique bottle and is a unique tasting product. It contains about 83 parts per million of silica. That gives it a very velvety texture, and it doesn't taste like other water. Fiji has also been very good in getting high profile people like athletes and movie stars to take a look at that product and use it. So they get it into magazines and have had a very good adoption rate just by people seeing it. It is similar to the Starbucks trend. Fifteen years ago, nobody dreamed of paying $3 for a cup of coffee, but they do now.

TWST: What problems or challenges could arise for your company?

Mr. McRae: The biggest one that we face right now is the increased cost of oil, gas and petrochemicals. They are pervasive in whatever we do because our bottles are made out of plastic, which is derived from petrochemicals. Our raw materials come in on trucks that are fueled by gasoline and our plants are fueled with natural gas. So we have to recognize that these costs are coming out, defer them wherever we can, and then pass them along. That is an advantage to having premium products. It gives you an ability to have some pricing control where you are pretty much stuck if you have a commodity.

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TWST: Your company places great emphasis on efficiency in logistics. That must help you to keep the cost down of moving your products.

Mr. McRae: It does. It is a volume-related equation in that when you have developed freight lanes that you use over and over again, you can work on getting the prices down of those products that we are having challenges going into new market with in the United States. For example, if we ship from Vancouver to St. Louis for the first time, we probably don't do it the most efficient way, but as we continue to do that and develop relationships with haulers that pull along that route, we will get more efficient and our costs will go down. If you end up experiencing upfront average costs that are higher than you would want, those things will come down, which is what we are doing.

I don't think we are unique in that field. We produce a lot of beverages for other people and also have a lot of volume. This company produces and distributes about $200 million a year, with an equivalent wholesale value of goods, but our revenues are around $40 million. Why is that? We do things on a contract basis for a lot of people, which gives us the experience and the people on the staff, so that they can understand how to do that for us. Those other people have to go and rely on third-party brokers to do that for them.

TWST: Are you interested in acquiring and merging?

Mr. McRae: Not at this point. We have a lot on our plate right now. There is a lot of stuff that we can do with the plans that we have developed. Our company is like a biotech company in a lot of ways in that we have a lot of items and brands in the pipeline. Some of them will be big and some might not be. We had a product called Pez Juices that we just discontinued last month because we were putting more effort into it than we were getting return. We had some moderate successes, but when we have one that is a big success, they can generate some pretty incredible returns very quickly. Our existing business allows us to generate cash flow that supports the development and growth of this brand. For a price, you can buy a stock for today, get an existing business and free upside on some of these brands that we have, and that's what we think is of significant value here.

TWST: What about things like wine coolers and vodka-based drinks? Have you ever thought much about those?

Mr. McRae: It is a different distribution system for us, particularly in Canada. We are one of the primary bottlers for one of those companies, but they do all the marketing and distribution with the liquor outlets that we don't. It is just a different group of people that you have to deal with and we are not experts in that area. I think we focus best on what we think we are good at.

TWST: What would you reasonably expect your company to look like in about three years?

Mr. McRae: If the trends that we are seeing in the brands we have now are any indication, we will be a bigger version of ourselves. If the growth comes from where we think it will, we will be selling a lot of blueberry juice as a percentage of our sales from where we are today. One of the nice things about our model is that we can handle a lot more incremental growth without a significant increase in our overhead costs.

We try to get ourselves to a point where that then takes more gross profit dollars and we put some down to the bottom line. We are at that inflection point now where we don't need much more in the way of upside growth in order to give us a pretty good return. So we've got to see the growth and the brands come out. We've got to do it profitably and control our cost, but if we do all of that, we will be at the point of making that turn. Two or three years from now, I think you will see a company that could be 1 or 2 times bigger than we are today, with most of that added gross profits going straight to cash flow and an ultimate bottom line.

TWST: What are your feelings about your stock price?

Mr. McRae: Anybody who runs a company has a little better view on what's going on than when people just call and ask questions. But if you look at what the value of our base business is today and the cash it throws off, it is undervalued at its current price. I hate to speculate what it might be worth, but it's worth something significantly more than it is today. You get the free ride on the brands. I think that the market is waiting for us to have a success. The market sometimes prices our competitors too high based on seeing some of the brands they put out to promote, without a prospect of them getting much of a return on the business. We try to sell our products in the places where they are going to actually be bought by consumers and give us a contribution and make money. So we try to do things in a very practical way to get the business driving a good bottom line and generating cash flow, because at the end of the day, that's what we are here for.

TWST: Would you tell us about the backgrounds and the expertise of yourself and a couple of your colleagues?

Mr. McRae: I have been running this business since 1996. I have been in this business for 10 years. Before that, I was trained as a lawyer and did business restructuring work in Canada and abroad. Our Chief Operating Officer ran his own private business successfully for almost 20 years, joined us about seven years ago and has been a great addition. The fellow who runs our sales out of Montreal was with a very large food company for many years; he has been with us now for about six years. Our CFO came from one of the large Pepsi bottlers that was acquired here several years ago by Pepsi Bottling Group, and she brings a lot of experience in that regard.

As we go down the ranks, there are some very talented people in plant management and logistics, and we have regional sales people all around North America. We try to have those people relatively senior in the company so that they can actually go and manage something. They are not on the street selling products day to day, but they are out there managing business relationships and getting large listings, and we think we get the best return from that type of plan.

TWST: Will you be able to grow the top line without having to add too many employees?

Mr. McRae: That's our hope. You like to think you could grow without adding much, but it always seems like somebody needs to hire somebody else. We run this business seasonally from about 200 to 250 employees. If we had had 10 or 15 more, we'd probably be able to double our sales. So you can see where the leverage comes in that. Nobody has asked me whether or not we've got plant capacity and the answer to that is yes, particularly in the winter when some of these products have a lot of volume. So we are looking to balance those things off, as well.

TWST: Do you see any need to improve the company's capital structure?

Mr. McRae: It is always nice to have more cash, but we know that we can manage where we are now. We are putting money into growing working capital, and we also have a bit of long-term debt. We pay that off in regular increments, so the money goes out too. But I really don't have a plan right now to raise more capital, I don't think we need to. We come out of the winter period early on in February with pretty good cash flows to gear up for the spring and summer, and that works well for us. So we will start to see a lot of increases in sales over the early part of the new year. We will be generating cash to support that growth, so I think we will be fine.

TWST: Do you spend much time telling the company's story to the investment community?

Mr. McRae: Not as much as I probably should, and not as much as some people would like me to. We've started to make an effort here in the last few months. We want to let the results speak for themselves. You can go out and get other people excited about something, but we're not going to be successful unless the financial results show us where we have gone, not where we are going. I don't think that the stock will respond significantly one way or the other.

We want to show results and let those speak for themselves. We don't forecast; we don't go out on a limb trying to predict what sales are going to be next quarter. We just want to carry out the things we are doing and what we think will get in the way of new business. People can figure that out from there. So we think that a good financial report is beneficial, and we hope to have those coming out.

TWST: What would be the two or three best reasons for the long-term investor to take a very good look at Leading Brands?

Mr. McRae: We have a strong core business and it provides us internally generated cash flow to grow for years to come. I think we have proven that we can create some very good brands that have potential. The question is, how are those accepted by consumers and how do we execute on those? The most important thing is that we spent the last eight or nine years hiring some very good people here who now have a lot of experience and understand how we want to go to market and do business. Those are two different things. One is having great people, but the other is having everybody on the same page and knowing how we want to get to market and do that profitably.

TWST: What are things going to be like for companies like yours down the road?

Mr. McRae: We are looking for some sustained higher petrochemical, oil and gas prices. This is here to stay. You might see oil down to $50 and you might see it up to $75 or $80, but you are going to need to see something fundamental before you see oil prices down to historical lows again. As a consequence of that, we have some systemic inflation that is coming in this economy, and it will need to be dealt with. People who are highly levered are going to have an issue, but we are not. People that cannot pass on price increases because they are highly competitive or have a commodity product are going to have a problem. We don't see ourselves in that position.

If you have products that have unique selling points, you can create new demand for them. We believe we have some pricing flexibility and that's why we are here and doing this. However, the price increases have started. They are being passed along to everybody in the industry. There was a period when there were absolute shortages in materials. Those have now corrected themselves, but there are issues like this that people are going to have to become accustomed to and do it, and you are going to have problems.

TWST: Is there anything that you would like to add to what we have talked about, particularly with regard to your strategies and your long-term objectives?

Mr. McRae: We come in to work every day and try to make incremental gains in our business in reducing costs, doing things more efficiently and getting new business. For us, getting that new business is the real key. We have been at this for a while now. We think we know how to do it well. You can't just blithely go about trying to sell products out there and hope something sticks, you've got to do it intelligently. You've got to have a strategy, and we think we do. If investors can find a brand of ours that they like that they think has potential, then there is some great upside, and that's why they should watch us.

TWST: Thank you. (MC)

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