
Chestnut Foods (B)

In early March 2014, stock performance at Minneapolis-based Chestnut Foods (Chestnut) had failed to meet expectations for several years running (see **Exhibit 1**), and now the company was facing the arrival to the board of Rollo van Muur, a high-profile activist investor. Just over a month before, van Muur had quietly and unexpectedly purchased 10% of the company and had asserted his right to two seats on the board.

CEO Moss Thornton was highly concerned about van Muur's arrival and his impact on the company's long-term viability. Over the past months, CFO Brenda Pedersen had advocated two strategic initiatives: a \$1 billion investment in company growth in the Instruments division and the adoption of a more progressive corporate identity. Van Muur had made it very public that he was strongly opposed to additional investment in the Instruments division and in fact had recommended that the Instruments division be sold off "to keep the focus where it belongs."

Next week would be the board's first meeting with van Muur. In preparation for the meeting, Thornton had gathered select members of the executive team to solicit their perspectives on the future of the Instruments division, and the arguments to be made to save it.

The Company

Chestnut Foods began in north Minneapolis in 1887, when 22-year-old Otto Chestnut (born Otto Kestenbaum in Bavaria) opened a bakery that made lye rolls and pretzels, and then stumbled into success as a supplier of sandwiches to the St. Paul, Minneapolis, & Manitoba Railway. Six years later, on a trip to Chicago to visit the Columbian Exposition, Chestnut happened to come upon the Maxwell Street Market, a vibrant melting-pot community of merchants of eastern European descent. At the market, he had a chance meeting with Lem Vigoda and George Maszk, founders of V&M Classic Foods, which provided a range of meat and fish products as well as preserves and condiments. Through them he witnessed a nascent ad hoc distribution system to neighborhood groceries in the rapidly growing city. A vision of wholesale food production and distribution struck him, and he returned to Minneapolis determined to realize it.

By 1920, as regional grocery chains had begun to materialize, Chestnut, since joined by his sons Thomas and Andrew, had purchased V&M Classic Foods among other food businesses. Their plan was for the expanded Chestnut to stock the regional grocery chains across the upper Midwest, while also continuing to supply railroad dining cars and, beginning in 1921, a Chestnut chain of automats in Chicago and Detroit. Otto Chestnut died in 1927 at age 62, but the company was well positioned to weather the Great Depression; in 1935, the Chestnut brothers sold the automat division to Horn & Hardart, then used the proceeds to purchase farmland in Florida and central California. In the postwar period, as the supermarket model emerged, Chestnut grew with it, both

This case was prepared by Michael J. Schill, Professor of Business Administration, Frank Briceno (MBA '18), and Donald Stevenson, Gist Learning LLC. The individuals and entities in this case are fictitious. It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation. Copyright © 2021 by the University of Virginia Darden School Foundation, Charlottesville, VA. All rights reserved. To order copies, send an email to sales@dardenbusinesspublishing.com. No part of this publication may be reproduced, stored in a retrieval system, used in a spreadsheet, or transmitted in any form or by any means—electronic, mechanical, photocopying, recording, or otherwise—without the permission of the Darden School Foundation. Our goal is to publish materials of the highest quality, so please submit any errata to editorial@dardenbusinesspublishing.com.

organically and through acquisition, going public in 1979. By 2013, the company was valued at \$1.8 billion, with annual profits of more than \$130 million.

Chestnut sought to “provide hearty sustenance that gets you where you’re going.” The firm had two main business segments: Food Products, which produced a broad range of fresh, prepackaged, and processed foods for retail and food services, and Instruments, which delivered systems and specialized equipment used in the processing and packaging of food products. Instruments provided a variety of quality control and automation services used within the company. The company took increasing pride in the high quality of its manufacturing process and believed it to be an important differentiator among both investors and consumers.

In recent years, Chestnut’s shares had failed to keep pace with either the overall stock market or industry indexes for foods or machinery (see **Exhibit 1**). The company’s credit rating with Standard & Poor’s had recently declined one notch to A–. Securities analysts had remarked on the firm’s lackluster earnings growth, pointing to increasing competition in the food industry due to shifting demands. One prominent Wall Street analyst noted on his blog, “Chestnut has become as vulnerable to a hostile takeover as a vacant umbrella on a hot beach.”

On Wall Street there was some enthusiasm for the arrival of van Muur. In recent weeks the stock was up 12%. Several research analysts saw great potential in his impact on the company and expected there to be wholesale changes in corporate strategy and leadership at Chestnut. Other analysts were apprehensive about the short-term nature of van Muur’s horizon and, like Thornton, shared concern over his long-term impact on the company. Analysts estimated the equity beta for Chestnut at 0.90. Chestnut’s debt totaled \$0.46 billion.

Instruments division

Since its earliest days amid the bustling flour mills and rail lines of Minneapolis, Chestnut’s management had maintained a shared value that technology, properly harnessed, could improve quality and efficiency across production processes, and over the years, the company had developed a strong expertise in food process instruments. The success of companies such as Toledo Scale, founded in Toledo in 1901 before merging to become Columbus, Ohio–based, Swiss-owned Mettler-Toledo in 1989, was not lost on Otto Chestnut himself, although thoughts of such diversification were repeatedly deferred. Yet as a more cyclical and diverse industry (with products providing advanced capabilities to utilities, military and aerospace programs, and industrial and residential applications in addition to food production), precision instruments seemed to complement the food industry and to present opportunities for growth overseas. In 1991, Chestnut capitalized on an opportunity to purchase Consolidated Automation Systems, a medium-sized food-processing-instrument equipment company based in Thunder Bay, Ontario, and the Instruments division was born. This proved very successful and was followed by the purchase in 1997 of Redhawk Laboratories, a small manufacturer of food filtration material using computer-controlled precision equipment, based in Troy, New York.

Although 20% of the division’s revenue was derived internally from the Chestnut Food Products division, the Instruments division produced equipment and automation support for a wide range of food producers in North America. Demand, much of it from overseas, was strong, but required substantial investments in R&D and fixed assets. Instruments division sales had increased by nearly 20% in 2013. Segment NOPAT¹ was \$46 million, and net assets were \$600 million. Based on the marginal tax rate of 37%, the expected return on capital for the division over the foreseeable future was 7.7%.¹ **Exhibit 2** provides financial data for the Instruments division.

¹ This figure was calculated as net operating profit after tax (NOPAT) divided by net assets: \$46 million (1 – 37% tax rate) / \$600 million.

The Instruments division was currently comprised of five business units: ConTech, Packaging, LST, Redhawk, and SafetySure (see **Table 1**).

Table 1. Instruments division units.

Product Group	Group Description
ConTech	Designs and produces specialized fittings and tubing that conform to the exacting hygiene standards common in food industry plants. This product belonged to Chestnut's oldest line of product equipment, with heritage in the company's Consolidated Automation acquisition years ago.
Packaging	Manufactures packaging machines for producing airless food service pouches for liquid sauces, dressings, and condiments in sizes from 6 ounces to 5 gallons.
LST	Designs and markets software products for automated food packaging technology.
Redhawk	Produces filter products that use a patented cylindrical filtration media in which food solids are deposited on the interior surface of the screen and filtered fluid exits the outlet.
SafetySure	Creates software solutions that integrate components of the food processing processes to monitor machine safety and durability.

Source: Created by author.

Recent Debate

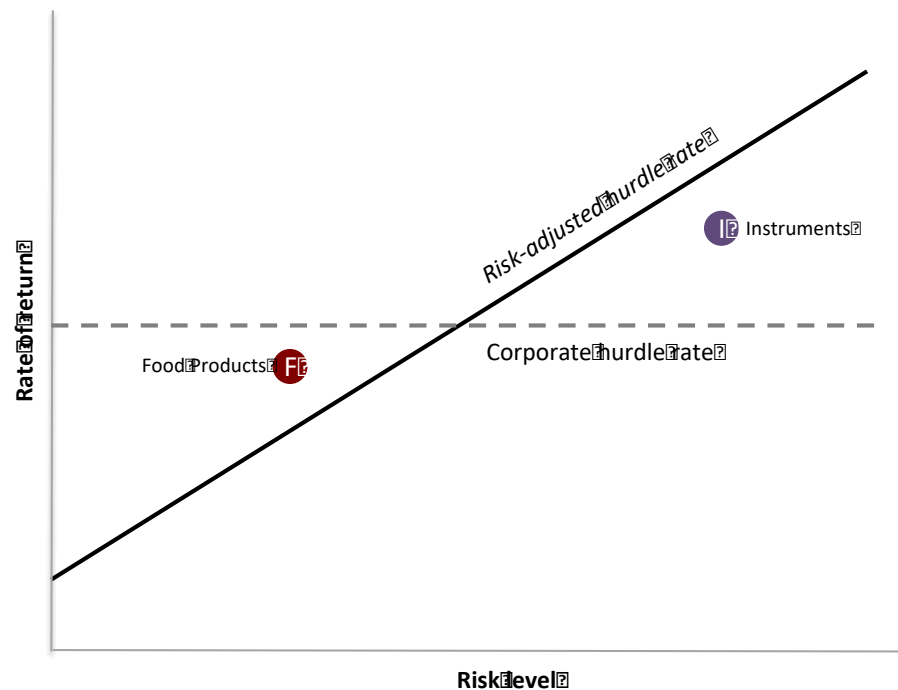
Thornton was aware of the wide range of views held by his management team. Rob Suchecki, VP of Instruments, was ardent in his opposition to the influence of van Muur. He forcefully emphasized how Instruments was growing like gangbusters and that van Muur's views did not reflect the positive outlook of most investors. Suchecki maintained that it was imperative that management protect the company from all short-term-oriented activist investors. He noted that not only were all the product groups in the Instruments division growing but they were also all profitable. He argued that the Instruments division deserved greater funding, not less. **Exhibit 3** contains the profit and loss statement for each product group within the Instruments division. There was mostly agreement that the recent historical performance for each business unit was also reflective of the prospective performance.

Claire Meyer, VP of Food Products, tended to be sympathetic to van Muur and acknowledged that the Instruments division was underperforming. To emphasize her point, she pulled out from her purse a napkin with a diagram she had used at a previous dinner meeting with Suchecki (see **Figure 1**). This infuriated Suchecki, who claimed she was simply turf building for her division. The underperformance claim seemed inappropriate when it was noted that every product group in the Instruments division maintained higher margins than the Food Products division. Meyer upheld that van Muur was simply responding to the risk-return tradeoffs of the two divisions. Lower returns for Food Products was fully satisfactory to investors since the risk exposure of her division was much lower than that of Instruments.

What puzzled Thornton even more was the disparity of opinion among business unit managers within the Instruments division. Emily Li, longtime manager for ConTech, largely sided with Suchecki, expressing concern about calls for disinvestment from a flagship product. She explained that not only was ConTech generating margins above 20% for investors, but it also provided additional benefits to the Food Products division by supplying direct manufacturing product. Li suggested that the Instruments division provided a distinctive

feature among food companies that she believed was a key competitive advantage for Chestnut in the marketplace. Because of this, she thought ConTech would be worth supporting in the company even if the margins were near zero. She was convinced that Chestnut would be better off overall if Pederson's plan were realized, and capital investment was made to support additional growth opportunities and strengthen all five Instruments division business units.

Figure 1. Meyer's diagram of constant versus risk-adjusted hurdle rates.



Source: Created by author.

Maggie Flax, manager of the Redhawk unit, was quick to counter that the profit and loss statement generally reflected the gains provided to other parts of the business. “Much of what allows us to fairly compare margins across units is our care at Chestnut in appropriately gauging proper transfer prices. I think we need to be careful about arguing for additional benefit.”

Michael Johansen, manager for LST, in contrast, sided with Meyer. Johansen believed that his product was being handicapped within the Chestnut portfolio. He believed that LST would attract more investment dollars and more product exposure if it became an independent company, or at least became part of a business software company. Johansen said with a raised eyebrow, “Providing hearty sustenance,” is not the tagline you want when trying to attract the brightest software minds and software dollars.”

Alfredo Torres, manager for SafetySure, emphasized that margin comparisons were only half the story. He argued for the importance of considering the asset investment requirements of each product category. He claimed that his area required much less company investment than was needed for other products. As such, the economics were very different across products. Li responded that the company had never allocated assets across the product groups for good reason—because too much of the assets were shared and the variation in asset usage was minimal. Torres countered by quoting van Muur—“The only performance metric that matters is returns on the invested capital. My patience gets thin when businesses can’t deliver sufficient RONA or when

economic profit is negative”—and then added that if this group didn’t adjust for invested capital, van Muur would.²

Thornton’s Response

Following the discussion, Thornton’s assistant, Ben Frantz, had gathered related data: a summary of prevailing capital market data (**Exhibit 4**) and some financial data on comparable companies for the Instruments division (**Exhibit 5**). Following up on the suggestion of Torres, Thornton had also asked his assistant to do his best to allocate the division balance sheet items by product. Frantz’s effort at such an allocation is provided in **Exhibit 6**.

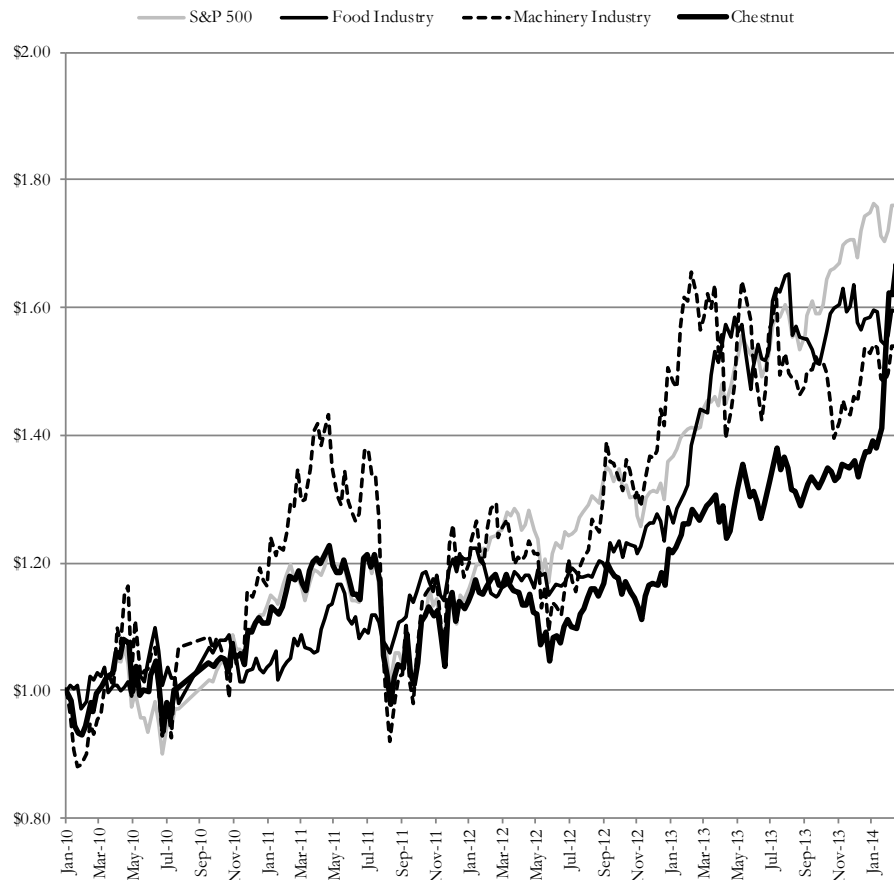
Thornton appreciated that good leadership depended less on what he wanted the outcome to be than on what outcome was best for the company. Van Muur’s arrival was a catalyst for change, but he was unsure how to respond. How he could ensure that the change was for the better?

² Economic profit considered that business profit was only really positive if it covered the cost of the capital used to generate it. One common measure of economic profit was NOPAT: Net Assets \times Cost of Capital. RONA = return on net assets.

Exhibit 1

Chestnut Foods (B)

Value of \$1.00 Invested from January 2010 to March 2014
(weekly adjusted close)



Data sources: Yahoo! Finance and author data.

Exhibit 2

Chestnut Foods (B)

Financial Statements for the Instruments Division
(in millions of US dollars)

Statement of Income

	2012	2013
Revenue	320	383
Cost of sales	<u>169</u>	<u>210</u>
Gross profit	151	173
Research and development	23	24
Selling, general, and administrative expenses	58	62
Corporate expenses	<u>12</u>	<u>14</u>
Operating profit	58	73

Statement of Financial Position

<u>Assets</u>	2012	2013
Property, plant, and equipment	275	359
Intangible assets ⁽¹⁾	75	90
Long-term receivables	19	23
Inventories	90	110
Trade and other receivables	<u>104</u>	<u>127</u>
Total assets	563	709
<u>Current division liabilities</u>		
Trade and other payables	98	109
Net assets	465	600

⁽¹⁾ Represents capitalized R&D expenses

Source: Author analysis.

Exhibit 3

Chestnut Foods (B)

Instruments Division Profit and Loss by Product Line
(in millions of US dollars)

	ConTech	Packaging	LST	Redhawk	SafetySure
Revenue	114.9	95.8	68.9	53.6	49.8
Cost of sales	<u>59.9</u>	<u>51.5</u>	<u>39.9</u>	<u>31.5</u>	<u>27.3</u>
Gross profit	55.1	44.3	29.0	22.1	22.5
Research and development	7.4	5.8	4.4	3.0	3.4
Selling and marketing	18.3	15.2	11.5	8.7	8.4
Corporate expenses ⁽¹⁾	<u>4.2</u>	<u>3.5</u>	<u>2.5</u>	<u>2.0</u>	<u>1.8</u>
Operating profit	25.1	19.9	10.6	8.5	8.9

⁽¹⁾ These corporate expenses are allocated to products by revenue.

Source: Author analysis.

Exhibit 4

Chestnut Foods (B)

Capital Market Data, February 28, 2014

	<u>Yield</u>
30-Day Treasury Bill	0.0%
10-Year Treasury Bond	2.7%
10-Year Corporate Bonds of Industrial Companies	
AAA	2.7%
AA	2.8%
A+	3.1%
A	3.2%
A-	3.4%
BBB+	3.7%
BBB	4.0%
BBB-	4.5%
BB+	5.7%
BB	6.4%
BB-	6.4%
B+	6.7%
B	8.3%
B-	8.9%
Historical Market Risk Premium	
Equity Market Index Less Government Debt	6.0%

Data sources: Bloomberg, author estimates.

Exhibit 5

Chestnut Foods (B)

Financial Data for Industry Comparables, February 2014
(figures reported as specified in millions of US dollars)

Panel A: Precision Instruments

	Badger Meter	Dresser-Rand	Flowserve	Honeywell	IDEX	Measurement Specialities	Mettler-Toledo	Wendell Instruments
Year End	Dec-13	Dec-13	Dec-13	Dec-13	Dec-13	Mar-13	Dec-13	Dec-13
<u>Income Statement</u>								
Total Revenue	334	3,033	4,955	39,055	2,024	347	2,379	277
Gross Profit	117	785	1,688	10,691	875	142	1,282	102
Operating Income	39	361	732	5,501	399	41	448	42
Net Income	25	168	486	3,924	255	34	306	26
<u>Balance Sheet</u>								
Cash	7	190	364	8,016	440	36	112	9
Receivables	50	727	1,155	8,006	253	58	467	47
Inventory	61	716	1,061	4,293	231	56	210	29
Other Current Assets	9	102	267	849	67	7	125	18
Total Current Assets	127	1,736	2,847	21,164	991	157	914	103
Net PP&E	76	472	716	5,278	213	64	514	57
Goodwill	45	928	1,108	13,046	1,349	154	456	49
Other Intangibles	57	479	161	2,514	311	56	114	15
Other Long-Term Assets	10	123	205	3,433	22	14	154	9
Total Assets	316	3,738	5,037	45,435	2,888	446	2,153	233
Accounts Pay. & Acc. Exp.	7	656	1,006	8,654	257	43	373	31
Short-Term Debt	70	40	73	2,028	2	0	17	-
Long-Term Debt	-	1,247	1,128	6,809	772	98	401	-
Other Long-Term Liabilities	42	493	953	10,198	284	23	426	104
Total Equity	197	1,301	1,877	17,746	1,573	280	935	98
<u>Capital Markets</u>								
Equity Beta	1.06	1.40	1.30	1.25	1.15	1.35	1.10	0.52
S&P Bond Rating	BBB*	BB	BBB-	A	BBB	BBB*	A*	NA
Market Value of Equity	723	4,549	10,767	74,330	5,933	944	7,154	230

* Identifies bond ratings that are estimated by author.

Note: PP&E = Property, plant, and equipment; Accounts Pay. & Acc. Exp. = Accounts Payable and Accrued Expenses.

Exhibit 5 (continued)

Panel B: Information Technology and Software

	ACI	Amdocs	Citrix	Compuware	Jack Henry	Manhattan Associates	MICROS	Oracle	Symantec
Year End	Dec-13	Sep-13	Dec-13	Mar-13	Jun-13	Dec-13	Jun-13	May-13	Mar-13
<u>Income Statement</u>									
Total Revenue	865	3,346	2,918	724	1,108	415	1,268	37,180	6,906
Gross Profit	521	1,179	2,514	528	461	233	664	22,739	5,800
Operating Income	140	482	381	58	251	101	231	14,432	1,183
Net Income	64	412	340	(17)	168	67	171	10,925	755
<u>Balance Sheet</u>									
Cash	95	1,326	735	90	128	133	634	32,216	4,747
Receivables	206	678	655	430	237	71	241	6,875	1,031
Inventory	-	-	14	-	-	-	49	240	24
Other Current Assets	135	277	159	74	91	15	60	2,361	614
Total Current Assets	436	2,282	1,563	593	456	219	984	41,692	6,416
Net PP&E	57	276	339	302	301	14	44	3,053	1,122
Goodwill	669	1,818	1,769	722	533	62	433	27,343	5,841
Other Intangibles	429	157	510	117	289	-	70	6,640	977
Other Long-term Assets	90	393	1,032	239	93	2	57	3,084	152
Total Assets	1,682	4,926	5,212	1,973	1,672	298	1,589	81,812	14,508
Accounts Pay. & Acc. Exp.	92	361	336	115	78	43	181	2,270	756
Short-Term Debt	-	-	-	-	-	-	-	-	-
Long-Term Debt	714	1	-	18	-	-	-	18,493	2,094
Other Long-Term Liabilities	331	1,289	1,556	842	579	73	290	15,904	6,182
Total Equity	545	3,275	3,320	998	1,016	182	1,118	45,145	5,476
<u>Capital Markets</u>									
Equity Beta	0.81	0.85	1.00	0.95	0.85	0.85	1.05	0.95	1.00
S&P Bond Rating	BB*	NA	NA	NA	NA	NA	NA	A+	BBB-
Market Value of Equity	2,344	6,768	10,044	2,105	4,650	2,517	4,142	167,070	14,076

* Identifies bond ratings that are estimated by author.

Note: PP&E = Property, plant, and equipment; Accounts Pay. & Acc. Exp. = Accounts Payable and Accrued Expenses.

Exhibit 5 (continued)

Precision Instruments

Badger Meter	Water meters for municipal water utilities; pipeline flow measurement for food and beverage, pharmaceutical, utility, and HVAC industries.
Dresser-Rand	Rotating equipment for oil, gas, and petrochemical industries.
Flowserve	Pumps, valves, seals, and boiler systems for petroleum, chemical, water, mining, pharmaceutical, and other industries.
Honeywell	Electric controls, surveillance, monitoring, and associated software for defense, air traffic control, utilities, and industry.
IDEX	Pumps, flow measurement for food, chemical, industrial, and energy industries; pumps, air compressors, and optical components for health, scientific, defense, and aerospace applications.
Measurement Specialties	Equipment sensors for vehicle, medical, home appliance, aerospace, and industrial applications.
Mettler-Toledo	Weighing, chemical, and assorted laboratory instruments for food retail, industrial, and scientific research applications.
Wendell Instruments	Control and monitoring instrumentation for fast-food restaurants; young company.

Information Technology and Software

ACI Worldwide	Business software products and services that facilitate electronic payments, particularly among financial institutions and retailers.
Amdocs Ltd	Business software and products for the global communications, media, and entertainment industry.
Citrix	Infrastructure access software for business, government, and educational institutions.
Compuware	Software products and professional services for the software testing, implementation, and systems management.
J. Henry and Associates	Integrated computer systems and services for financial institutions.
Manhattan Associates	Business software for supply chain commerce for retailers, wholesalers, manufacturers, and government.
MICROS Systems	Information solutions for hotels, restaurants, and other hospitality businesses.
Oracle	Database and middleware software, applications software, and hardware systems, particularly for computer server and storage products.
Symantec	Software and services for security, storage, and systems management.

Data sources: S&P Capital IQ, Bloomberg, Yahoo! Finance, Value Line, and author estimates.

Exhibit 6

Chestnut Foods (B)

Balance Sheet Allocations of Net Assets by Product Group

	ConTech	Packaging	LST	Redhawk	SafetySure
Property, plant, and equipment	44%	22%	12%	15%	7%
Intangible assets	24%	20%	24%	14%	18%
Long-term receivables	100%	0%	0%	0%	0%
Inventories	41%	23%	16%	13%	7%
Trade and other receivables	37%	25%	13%	13%	12%
Trade and other payables	27%	23%	18%	21%	11%

Source: Author analysis.