Value Creation in the Beer Sector Through M&A Activities

At the Table or on the Menu?

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The global top-four brewers are leading the consolidation in the beer sector. Between 2000 and 2009, they tripled their combined market share and quadrupled their volume. This resulted in economies of scale and increased profitability. The EBIT margins of the top four significantly outperformed the market, but acquisitions multiples are steep and there is debate whether the acquisition strategy actually creates value. A comparison of ROCE developments reveals that, despite an initial unfavourable reaction, acquisitions over the past decade have led to value creation.

Introduction

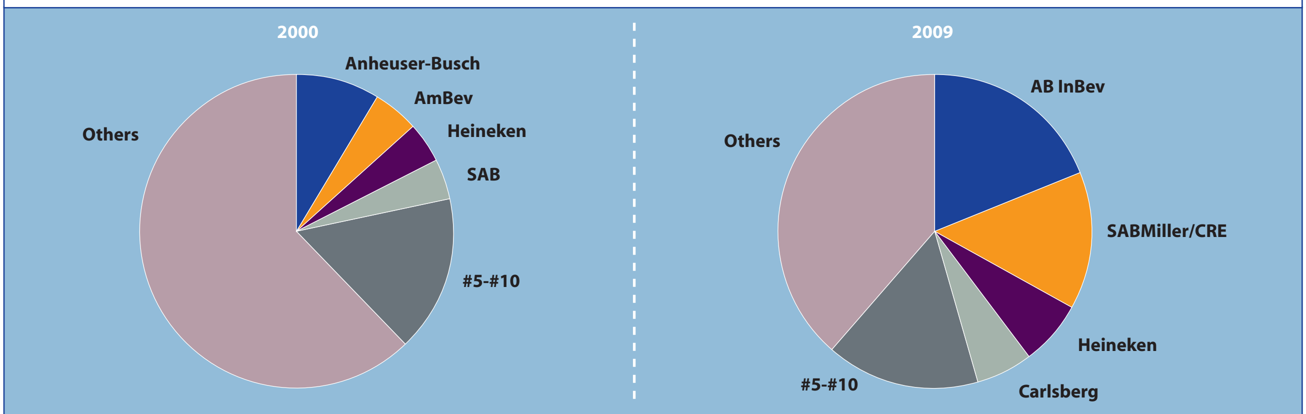
The global beer market has changed considerably over the past 10 years. Global beer consumption has risen 3.3 percent annually, driven by a rapid rise in consumption in Asia, eastern Europe, South America and Africa on the back of increased disposable incomes. In mature markets volume growth has been negligible. The major international brewers have reacted to these changes by entering emerging markets and consolidating in developed markets. As a result, the competitive landscape has changed. In 2000, the top-10 brewers accounted for 38 percent of the global beer volume. By 2009, this percentage had increased to 61 (*see Figure 1*).

But what is perhaps more striking is the emergence of a clear top four. In 2000, the difference in volume between the number four, SAB, and number five, Interbrew, was under 1 percent. In 2009, the volume of the number four, Carlsberg, was almost twice that of number five, Tsingtao.

The strategies of the top-four brewers have similarities. By making acquisitions, they are all growing their volumes to benefit from economies of scale and from a global distribution platform that enables a portfolio approach. The growth of the top four is unlikely to come to an end in the near future. As the CEO of one of the market leaders points out: "You're either at the table or on the menu". With multiples for acquisitions looking steep and rising, brewers outside the top four will find it increasingly difficult to decide which course is best for them.

Figure 1: Market Shares of Global Brewers, 2000 vs. 2009

percent



Source: Euromonitor, 2010

[1] The peer group comprises Anadolu, APB, Asahi, Beijing Yanjing, Boston Beer, CCU, Chongqing, Damm, Duvel, Hite, Kingway, Kirin, Kulmbacher, Modelo, Molson Coors, Royal Unibrew, San Miguel, Sapporo, Tsingtao and UB. It should be noted that there are many cross-holdings between the top four and the peer group, but all companies are operating as independent entities.

[2] In this equation, return equals the estimated stand-alone revenue of the target company plus the estimated synergy of the acquisition; the invested capital equals the acquisition price and the WACC equals the required return on the additional capital.

Strong Volume Growth Through Acquisitions

Over the past decade, the current top-four brewers, AB InBev, SABMiller, Heineken and Carlsberg, have emerged as the dominating international companies in the sector. In 2000, these four companies combined sold 192 million hectolitres of beer. By 2009, their total sales had risen to 756 million hectolitres. As the total global beer market grew from 1,372 million hectolitres to 1,836 million hectolitres during this period, the top four outperformed the market by 360 percent (*see Figure 2*).

In 2009, the 756 million hectolitres sold by the top four represented a market share of 41.2 percent. This was considerably more than the 14.0 percent market share they had in 2000. However, the top four have not gained significantly at the expense of their present competitors. The market share of the 25 mergers and acquisitions (M&A) made by the top four over the past decade was 25.8 percent in 2000. This means that, in today's form, the top four would have had a 39.8 percent share of the market in 2000 and that their organic market share growth over the past decade amounts to less than 1.5 percent.

Outperforming on Margins

The top-four brewers have not used their economies of scale to reduce prices, which most likely would have led to organic market share growth, but instead they have focused on improving their margins. This becomes evident when comparing the margins of the top-four brewers over the past decade with those of a constructed peer group[1]. So as not to distort the comparison, the peer group has been selected to most closely resemble the top four. By doing so, the differences in acquisition strategies become a major determinant of the performance of both groups. The selected peer group is made up of 20 listed major brewers.

Apart from obvious differences in company size, the characteristics of the top four and the peer group are fairly similar. Both groups have just over 60 percent sales exposure to emerging markets, although the peer group has more exposure to Asia, especially China, and the top four to South America and eastern Europe. Furthermore, both groups are exposed to highly concentrated (and therefore profitable) markets, as well as to highly fragmented ones. Overall, the HHI index, which is a measure of the size of companies in relation to the industry and an indicator of the amount of competition among them, is similar for the top four and the peer group. Finally, the overall product mix is the same. Although some of the companies in the peer group are only active in specialty beers or craft beers, the top four carry these in their portfolios, too, and both groups have virtually the same overall exposure to premium beers.

Gross Margin

Two things become clear when looking at the unweighted average gross margins of both groups (*see Figure 3*). Firstly, the gross margin of the top four is substantially higher than that of the peer group as a larger company size results in greater buying and selling power. Secondly, as the volume of the top four versus the peer group grew over the past decade, so too did the difference in gross margin.

EBIT Margin

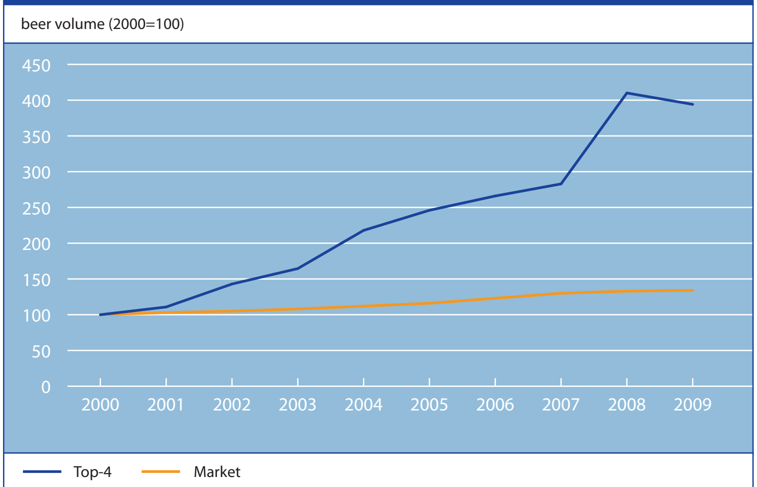
The top four also performed better on EBIT margins. Between 2001 and 2009, the EBIT margin of the top four grew by 360 basis points, whereas the EBIT margin of the peer group showed a 160 basis point decline. The top four outperformed the peer group by more than 500 basis points as its sales volumes increased. This is hardly surprising. While the cost of goods sold (COGS) have a predominantly variable character, the overhead costs are mainly fixed, and, as the sales volume of the top four increased, their overhead costs per litre declined.

The top four outperformed the peer group on margins as their volumes grew. However, the acquisitions that fuelled this growth did require additional capital investment — improved profitability is not a guarantee for value creation.

Value Through Acquisitions

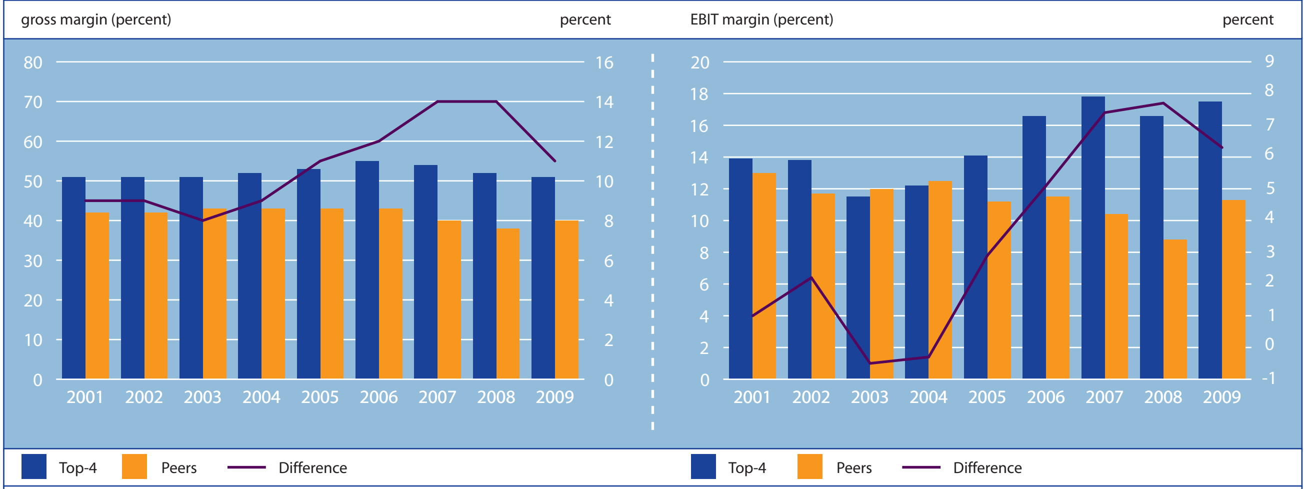
The most common method for analysing the value creation of an acquisition is the comparison between the return on capital employed (ROCE) and the weighted average cost of capital (WACC)[2].

Figure 2: Volume Development, 2000-2009



Source: Euromonitor, 2010

Figure 3: Gross Margin* and EBIT Margin in the Brewing Sector, 2001-2009



*Gross margin information not available for all companies; figures are unweighted averages of companies that do report detailed COGS.

Source: Rabobank 2010, based on Bloomberg

While this method is good for predicting whether an acquisition will create value in the future, it is less useful for evaluating if it has indeed been successful. There are two key reasons for this. First, companies seldom continue to report the acquisition in a stand-alone format. After year one, results are consolidated. This makes sense, as existing and acquired operations are usually integrated and splitting the result is no longer possible. Second, the development of the profitability of a company over a longer period is not only a result of the acquisition itself, but also of market trends, which would have had an impact on the company regardless of the acquisition.

Between 2001 and 2009, the ROCE of the top four was on average slightly above that of the peer group, but the absolute level decreased by 2.5 percent, whereas the peer group witnessed a decline of only 1.6 percent. The breakdown of the ROCE shows an interesting development. The top four increased their EBIT margin, but this was more than offset by a decline in asset turn. The peer group, on the other hand, kept the asset turn virtually flat, but saw its EBIT margin decline (*see Figure 4*).

In terms of year-on-year change in ROCEs, both groups had four years during which they outperformed the other group. The four years of underperformance for the top four coincided with the years during which their increase in average assets was the greatest. The six major M&A transactions of the top four over the past decade show that the negative effects dominated in the year of an acquisition and the year that followed. The benefits of an acquisition which resulted in margin improvement only became visible in the years thereafter.

It is important to take timing into consideration. Between 2001 and 2007, the ROCE of the top four outperformed that of the peer group by 270 basis points. In 2008 and 2009, however, this was reversed as AB InBev, Heineken and Carlsberg all made significant acquisitions. The ROCE of the top four is expected to show a strong recovery over the coming years as the positive effects of these acquisitions come through. The 1H 2010 results already showed an improvement in the ROCE, virtually erasing all the underperformance of the last two years. When all the advantages of the latest acquisitions have materialised, the ROCE development of the top four will be superior to that of the peer group.

Conclusions

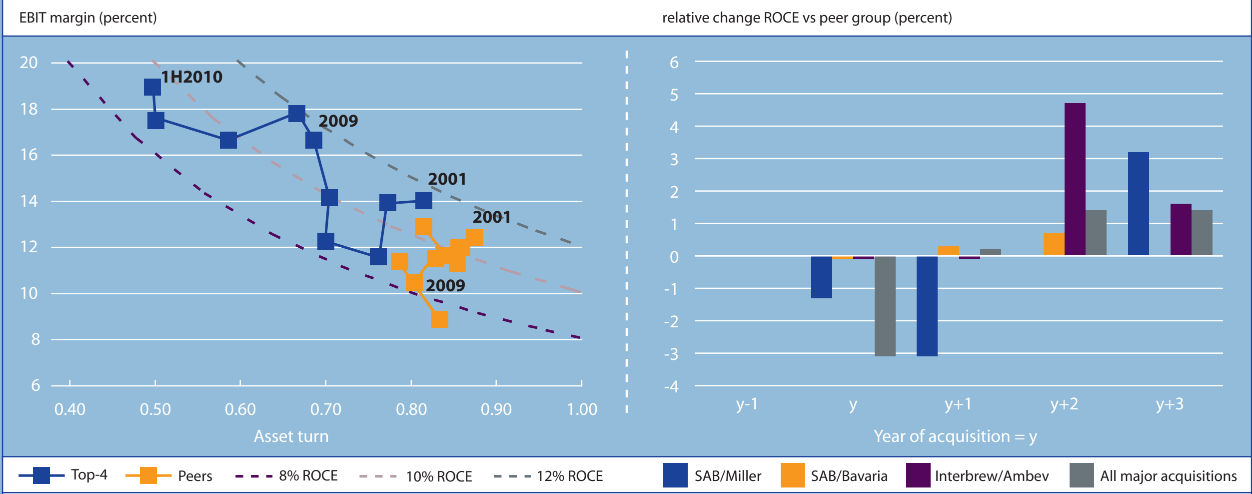
Over the past decade, the brewing industry has seen rapid consolidation, led by AB InBev, SABMiller, Heineken and Carlsberg. These top-four brewers have seen their combined market share triple and their volume almost quadruple. The advantages of increased scale have led to improved profitability and the margin development of the top four has been superior to that of the market.

During the acquisitive period, the top-four brewers outperformed the market significantly on gross margin and EBIT margin. Despite this superior operating performance, the value creation of acquisitions has been questioned. Critics have highlighted the high multiples in the beer sector and, outside the top four, many brewers remain unconvinced that acquisitions can add value at today's prices. The discussion is not helped by the fact that it is difficult to measure the value creation of an individual acquisition, especially over a period of several years.

There are two ways to create value.

- A company creates value when its ROCE exceeds its WACC. WACC includes the costs of both equity and debt.
- If a company is creating value, a growth strategy will enhance value creation when the absolute EBIT is growing faster than the additional capital employed required for that growth.
- The ROCE is measured as the operating result divided by the capital employed (ROCE = EBIT / CE), which can be rewritten as: ROCE = (EBIT / Revenues) * (Revenues / CE), or ROCE = EBIT-margin * asset turn
- A company creates value with a growth strategy if it improves either its operating margins or its asset turnover, as long as one is not offset by a negative influence on the other.

Figure 4: Value Creation (ROCE) and the Impact of Acquisitions in the Brewing Sector, 2001-2010



Source: Rabobank 2010, based on Bloomberg

At first glance, it may appear that the acquisitions of the top four did not add value. However, a closer look at the year-to-year developments, reveals that between 2001 and 2007 the performance of the top four was superior to that of the peer group.

It is also evident that during the year of the acquisition and the year that followed, the asset turn is under pressure while margin improvements have not yet fully materialised. Therefore, the first published results after an acquisition present the worst possible picture. This implies that in our analysis, the results of 2008 and 2009 show the top four at their most difficult time. The observations between 2001 and 2007 show that the acquisition strategy of the top four did not only improve margins, but also created value. This is contradicted by the data for 2008 and 2009, but judging by the pattern of ROCE development in the past and the 1H 2010 results, it is too early to evaluate the latest acquisitions at that moment in time.

Whether or not an acquisition adds value will always depend on the characteristics of the individual transaction. Some acquisitions are great while others are poor; some acquisitions work for one party while they would not have worked for another. Still, disregarding acquisitions in general for fear of destroying value is unjustified. Despite initial pressure on ROCE from M&A activity, the top-four brewers have managed to outperform the peer group in the longer run — indicating that for the top four, it has been better to be at the table than on the menu.

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This report has been published in line with Rabobank's long-term commitment to international food and agribusiness. It is one of a series of publications undertaken by the global department of Food & Agribusiness Research and Advisory.

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