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Tracking the Trends in the Global Beverage Market

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Small brands playing a disruptive role across beverage segments and markets

The (true) value of a unicorn

An increasing number of emerging brands are being acquired for USD 1bn or more (i.e. unicorns). In spite of the high valuations, a number of them have experienced short-term setbacks. Which is the greater risk: potentially overpaying for a brand or not responding to an evolving consumer?

Spreading the Kicking Horse love

In May 2017, Lavazza acquired Kicking Horse, a fast-growing, premium, organic, fair-trade coffee brand. It may not have been a billion-dollar deal, but it was an attractive price—and there will likely be many more deals like it to come.

Potential for collaboration in Dutch beer

As in other developed markets, Dutch craft brewers see rising demand, even as overall beer sales fall. While this is clearly eating into sales of major brewers, it is also opening up opportunities for collaboration.

Major changes coming in Japanese beer

As seen in many other developed markets, beer consumption is falling in Japan. Unlike other markets, there has been no shift to more premium beer in the process. This may be about to change.

The (true) value of a unicorn

Beverage companies have been actively making bolt-on acquisitions of small start-up companies showing good growth. An increasing number of these small, new companies are being acquired for USD 1bn or more (often referred to as 'unicorns'). In spite of the high valuations, a number of them have experienced short-term setbacks. Are beverage companies overpaying for small, high-growth brands? Perhaps in some cases—but the risks of potentially overpaying are probably justified.

Beverage industry in flux

In 2015, we published a report entitled *Dude, Where's My Consumer?*, in which we looked at the rapid consumer shift away from established brands in favour of more niche, premium brands. We encouraged companies that were losing market share to innovative new brands to consider acquisitions as a means of adjusting their portfolios to meet evolving consumer demand. We spurred them to 'buy small… or pay high': acquire companies at an earlier-than-normal stage of their life cycle in order to avoid paying overly hefty prices.

Investing in emerging brands requires an appetite for risk

M&A activities always entail a certain level of risk, but the level of risk involved in acquiring emerging brands is particularly elevated, as their success is less consolidated. In spite of the inherent risks, we believe that acquiring emerging brands can be a viable growth strategy.

In 2016, Constellation Brands acquired The Prisoner wine brand from Huneeus Vintners for USD 285m. It is interesting to note, though, that Huneeus had acquired the brand six years earlier, for only USD 40m—it sold The Prisoner to Constellation for seven times what it had initially paid for it. Arguably, Constellation could have

bought seven small wine brands like The Prisoner back in 2010—and even if only one had become a success, Constellation would still have come out ahead.

Clearly this is an oversimplification of the issue, but it points to the opportunities in investing earlier in the growth phase.

Buy small... AND pay high

The importance of M&A for beverage companies in the current environment cannot be overstated, and investing in emerging brands clearly justifies accepting some higher tolerance for risk. But over the past 18 months, the beverage industry has seen a number of acquisitions of emerging beverage companies with valuations of USD 1bn or more; It seems that in the current market, even when you 'buy small', you still 'pay high'. We think it is worth looking at this trend in more depth by reviewing four such deals from the past 18 months.

Ballast Point. In November 2015, Constellation Brands announced the acquisition of craft brewer Ballast Point for USD 1bn. Although still quite small (Ballast Point was selling 4m cases per year), the brewer was still a very attractive asset in many ways, in that it was growing at an extremely fast pace (2015 revenue was double that of 2014) and generated extremely high margins (Ballast Point typically retails for at least 50% more than other craft beers). According to Constellation's press release, Ballast Point was on track to generate USD 115m in sales in 2015, making the valuation approximately 8.7 times revenue.

Bai. In November 2016, Dr Pepper Snapple Group (DPSG) acquired Bai, a fast-growing brand of low-calorie, enhanced water that uses natural flavourings and sweeteners. The purchase cost DPSG USD 1.7bn, which, by our estimates, represents 6.8 times 2016 revenue, or 5.5 times revenue when factoring in the estimated USD 400m tax benefit.

BrewDog. In April 2017, TSG Consumer Partners, a private-equity investor out of San Francisco, acquired a 22% stake in Scottish craft brewer BrewDog for GBP 213m, implying a total value of GBP 1bn. BrewDog is the largest craft brewer in the UK and was growing at a 54% CAGR. Revenue in 2016 was approximately GBP 71m, putting the TSG valuation at approximately 14 times revenue.

Casamigos. In June 2017, Diageo announced that it would acquire Casamigos—a super-premium tequila brand founded by George Clooney and two other high-profile friends—for USD 1bn. The deal is structured, with an initial up-front payment of USD 700m and an additional USD 300m to be paid in subsequent years, based on performance targets. Clearly, this is a fast-growing brand (created in 2013 and selling 120,000 cases by 2016), and it is well-positioned in the fast-growing US super-premium tequila market. By our estimates, Casamigos' 2016 revenue was likely around USD 30m to USD 35m, which would put the sales price at approximately 20 times previous-year revenue.

Long-term growth prospects drive valuations

The valuations of the previously-noted acquisitions, measured as a factor of revenues, show significant variations from one case to another, but all are quite high when compared to some of the well-established, publicly-traded beverage companies. The valuations of the targets in these cases ranged from 6.8 times revenue to up to 20 times revenue. Valuations for most of the established peers (market cap/revenue) ranged from 2.6 to 5.4 times revenue *(see Table 1)*. The high valuations for these targets have been driven by aggressive competition among beverage companies for brands that can deliver strong, long-term growth.

Table 1: Market cap/revenue for selected companies and recent acquisitions (estimated), 2017

Company	*Market cap/revenue (trailing)*
Constellation Brands	5.1
AB InBev	4.5
Diageo	5.4
Pernod Ricard	3.6
Becle SA de CV (Cuervo)	4.8
DPSG	2.6
Coca-Cola	4.6
Highlighted acquisitions	
- Ballast Point	8.7
- Bai (pre-tax benefit)	6.8
- BrewDog	14.1
- Casamigos	20

Source: company financial data, Bloomberg, public sources 2017

Short-term results can be challenging

While the focus of these brands has been to deliver long-term growth, the short-term results have seen challenges.

- DPSG has had to lower guidance for Bai brand-revenue growth, from its initial estimates of 80% to 90% annual growth in 2017 down to 40% to 50%, as the company admitted it may have been 'overzealous' when it comes to expectations for Bai innovation growth.

- In June 2017, Constellation Brands recorded an USD 87m non-cash impairment charge to the trademark of Ballast Point due to the recent soft performance of the brand.
- While data on Casamigos' performance is not yet available, Diageo's stock price dropped 2% in the days following the announcement, as investors appeared to feel the company overpaid for the acquisition.

Are valuations getting too frothy? Hard to generalise

Given the high prices that were paid for these acquisitions and the near-term challenges some have encountered in the integration process, are beverage companies paying too high a price for emerging brands? Even though the prices for some of these brands were quite high, and companies have had some hiccups, generalisations are not accurate, as the prospects for each of these acquisitions are quite different. In our view, some were well worth the full valuation, while others will be more challenged to meet their targets.

In the case of the Bai acquisition, the financial and strategic risk from not making the acquisition (losing the brand from its distribution portfolio) justified DPSG's willingness to put in a strong bid for the brand. The valuation (as a multiple of revenue) appears within reason of industry standards (particularly when tax benefits are included), even if growth has not fully met initial expectations.

At 20 times revenue, the Casamigos acquisition will have the highest hurdle to achieving a reasonable return on invested capital—in our view, not impossible, but with little room for error. By our estimates, the brand will need to grow 50% per year for the next four years in order to bring the valuation down to a level more in line with industry standards.

Fundamental story remains valid

In the current market, there are plenty of eager buyers for on-trend brands in growth mode, and this is keeping upward pressure on valuations. An increasing number of small brands are being acquired for aggressive multiples. These high valuations, coupled with the short-term challenges that often arise in the integration process, will potentially create a longer-than-expected time horizon for these brands to achieve profitability. While the risks are clear—and some of the acquirers may eventually reach the conclusion in hindsight that they overpaid for one brand or another—we believe the fundamental driver behind these acquisitions remains valid: The consumer is changing, and beverage companies must adjust their portfolios of brands accordingly. The risks of slightly overpaying often pale in comparison to the risks of being left with a stale portfolio of brands that no longer resonate with the current consumer.

This is a cursory look at a very complex issue, but one we will continue to explore in future research.

Coffee

Coffee consolidation moves into the third wave

In our recent report, *Coffee Consolidation Accelerates*, we describe how the emergence of JAB is increasing pressure on not just brand owners, but the entire coffee value chain when it comes to pursuing further integration. While not at the scale of the previously-mentioned >USD 1bn deals—Lavazza bought an 80% stake of Kicking Horse in May 2017, in a deal which valued the company at USD 160m—the pattern is the same: the desire to find high-growth companies in premium segments and the willingness to pay up for it.

This type of acquisition is slightly newer in the coffee world, which does not have the same track record of small deals at such significant valuations as other beverage categories do. Unlike Bai (eight years old at acquisition) and Casamigos (four years), Kicking Horse is 20 years old, giving it a deeper track record and a more stable base to build from. Premium brands such as Kicking Horse are becoming more relevant to consumers, and the larger players realise this, recognising the need to add new brands to build out a true brand portfolio.

Why the high multiples? Brands with great equity, the right credentials, and room to grow can be difficult to find on the market. As consolidation heats up, it puts pressure on brand owners to move quickly. Entering growth segments—in this case, premium, organic, fair-trade coffee—is often best done by acquiring a smaller brand that has proven consumer acceptance. The high multiples also mainly reflect revenue synergies, as opposed to cost synergies. The point is to combine a powerful brand with a powerful distribution system and conquer new markets. As Elana Rosenfeld, the founder/CEO of Kicking Horse, said of the deal: "I think there is tremendous opportunity for us to be worldwide and to really be spreading that Kicking Horse love."

Global brands—especially outside of Starbucks and Nestlé—are less developed in coffee than in many of the other beverage categories. We expect a continuation of the consolidation trend (especially in terms of acquiring third-wave roasters with strong consumer connections), but we

see deals on the scope of Bai/BrewDog/Casamigos unlikely over the near term. After all, George Clooney is already in the coffee-brand world… and Nestlé's got him!

Beer

The rise of craft creates potential for collaboration in the Dutch beer industry

Over the past decade, per capita beer consumption in the Netherlands has followed a similar pattern to the rest of Western Europe. Consumption per capita has fallen, from 73 litres to 63 litres, but spending on beer has increased, from EUR 320 to EUR 382 per person *(see Figure 1)*. Dutch consumers have also started to drink 'less, but better beer'. The declining beer consumption is putting some pressure on brewery capacity utilisation in the Netherlands. Total consumption in 2016 was around 200m litres lower than it was in 2006.

At the same time, the number of breweries in the Netherlands has increased sharply, rising from 90 to 110 between 2007 and 2012. In 2016, this number reached 290, and now, there are some 370 breweries in the country. Over 90% of these breweries are microbreweries with fewer than five employees. There are also more than 100 brewers in the Netherlands who do not have their own brewery and who hire capacity. Both microbrewers and so-called 'gypsy brewers' are seeing their volumes grow fast. Around half of them are members of CRAFT, an industry association for independent brewers, which last year saw a 50% increase in volume among its members. The volume losses have mainly impacted the major Dutch brewers.

The ten largest Dutch brewers (which include Heineken, Bavaria, Asahi, and AB InBev) are organised in Nederlandse Brouwers. They operate 18 breweries in the country and account for more than 95% of Dutch beer production. The 175 CRAFT members, by contrast, operate 116 breweries and account for a mere 2% of production (59 CRAFT members are gypsy brewers). Capacity utilisation among CRAFT breweries is a healthy 77%. With microbrewers growing and major brewers suffering from volume declines, we see growing opportunities for collaboration between the two groups.

The most obvious opportunity for collaboration to explore would be for gypsy brewers to outsource production to those larger brewers who have excess capacity. While this appears to be an obvious opportunity, potential for collaboration will be somewhat limited, given that large brewers are ill-equipped to produce the very small batches required by these companies.

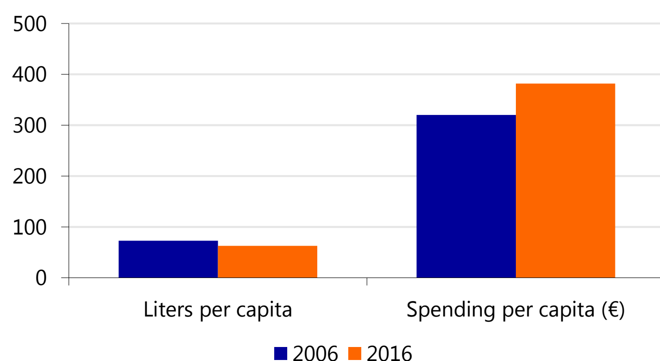
In sales, however, the opportunities to cooperate are interesting. Heineken operates a craft-beer platform, Beerwulf, which also sells independent craft beers. As the choice for the consumer increases and the life cycle for many products becomes shorter, distribution is becoming increasingly important. Apart from intelligence on consumer preferences (which has already resulted in major brewers starting craft breweries on their premises), new insights can also help to spot tomorrow's winners, and enter into partnerships and joint ventures that are mutually beneficial.

Major structural changes brewing in Japanese beer

The Japanese beer market has been struggling to grow volumes for more than a decade. From 2002 to 2016, the Japanese beer market shed 15.5m hectolitres of volume and is now 21.5% lower than 2002 levels.

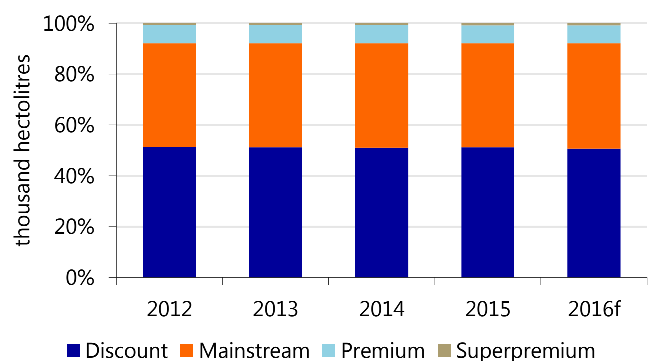
In other developed markets, a fall in overall market volumes has corresponded with a growth in the premium and craft-beer segments. However, craft and premium beer remain a niche segment in the Japanese beer market *(see Figure 2)*.

Figure 1: Dutch beer consumption in litres per capita and spending per capita), 2006 vs. 2016



Source: GlobalData 2017

Figure 2: Japanese beer market by price segment (thousand hectolitres, 2012-2016f



Source: Canadean 2016

This is almost entirely driven by a regressive taxation regime, which penalises beer with higher malt content with the highest tax rate. Ironically, the taxation act refers to this type of product as 'beer'. A product with lower malt content is 'near-beer', or happoshu, with a third, beer-flavoured beverages category brewed with malt alternatives, or a mix of happoshu and malt alternatives.

For Japanese tax officials, unlike sake or shōchū, beer remains a foreign luxury product with little connection to domestic culture and history. Thus, products classified as beer are taxed at JPY 220,000/litre, while sake is taxed at JPY 120,000/litre. In addition, the average sake has triple the volume of alcohol (15%) compared to the average beer (5%), which makes the tax regime extremely inefficient from a consumer perspective. Unsurprisingly, therefore, the share of cheaper happoshu and beer-flavoured beverages is greater than that of mainstream beer.

A major structural shift underway

However, things appear to be changing, as the government has approved major reforms to liquor taxation and classification in its 2017 tax reform bill. The two key provisions of the reform, which will run in three stages until October 2026, are the unification of tax rates for beer and near-beer like liquor (at JPY 155,000/litre by 2026) and a change to the malt-ratio definition, including the expansion of ingredients allowed in beer *(see Table 2)*.

The proposed reform also abolishes the third category (beer-flavoured beverages), while the changes in product definition and permitted ingredients will allow craft beer brewed with exotic ingredients and with malt content below 67% to be classified in the same category as mainstream beer—not in the cheaper (and poorly-perceived) happoshu category.

Tax reforms also offer international brewers a potential opening in the tough Japanese market, which has remained off-limits owing to its ingredient and tax regulations. Understandably, therefore, the big 5 domestic brewers are expected to refocus their new product-development strategy on premium and craft lines. These changes could add further incentives for international M&A, as domestic brewers race to bring premium beer brands to the Japanese consumer.

As a result of these changes, we are looking at a major structural shift in the Japanese beer market.

Table 2: Japanese 2017 tax reforms – beer-related tax (JPY/litre)

Category	Present	Proposed revision		
		Phase 1 October 2020	*Phase 2 October 2023*	*Phase 3 October 2026*
Carbonated alcoholic beverages (abv under 10%)	220,000	200,000	181,000	155,000
Malt content 25%–50%	178,125	167,125	155,000	-
Malt content under 25%	134,250	134,250	134,250	-
New genre/beer-flavoured beverages	-	-	134,250	-
Other carbonated alcoholic beverages (abv under 10%)				
New genre/beer-flavoured beverages	80,000	108,000	-	-
Alcoholic beverages that do not contain hops or certain ingredients that add bitter flavour	80,000	80,000	80,000	100,000

Source: Japanese Ministry of Finance 2017

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