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Liquid Lunch

Changing Consumer Preferences are Transforming the Beverage Industry

RaboResearch
Food & Agribusiness
far.rabobank.com

Stephen Rannekleiv
Global Strategist – Beverages
+1 (212) 8086823

For a full list of authors, see back page

Table of Contents

How changing consumer preferences are transforming the beverage industry

Consumers are becoming more educated and affluent, which is affecting what they consume, how they consume, and where they consume. These changes are altering the competitive context that beverage companies are facing today in many important ways.

In this issue of Liquid Lunch, we look at some of the important changes in consumption patterns around the world and explore the various implications for beverage companies.

Among these, we include the following:

The rise of craft beer shows just how slow brewers were to respond to changing preferences. Large brewers have made numerous acquisitions of craft brewers in an attempt to react, which is an important start, but Constellation's investment in Canopy shows how far they are now willing to go to respond to the demands of their consumers.

Changing consumer habits, such as preloading, are creating a drag on the traditional on-premise, which creates challenges for many brewers… but also some opportunities.

Drizly data suggests that beer underperforms wine and spirits among its users. This provides some insights as to which e-commerce channels will be most important for different alcoholic beverage segments.

US wine consumers are eagerly seeking packaging formats that permit single-serve or allow quality to be preserved. The wine industry must find viable alternatives to the 750ml bottle that are cost-effective, while maintaining a premium image, or risk ceding share to beer and spirits over time.

Small, premium, and craft spirits have been performing extremely well in some mature markets. How much more can premium gin grow? And will the success of craft whiskey in the US ultimately create some pricing pressure in that segment? There are some signs that these pressures are already starting.

Soft drink sales are falling in Indonesia. This is partly explained by challenges in the economy, but may also be a reflection of deeper changes in consumer demand.

These are some of the issues and topics we have been exploring in our research, and we use this opportunity to briefly share some views and perspectives. As always, we welcome your comments and questions.

Beer

Consumer preferences are changing… and brewers are following

by Jim Watson

Following the consumer

Consumer trends in beer and across beverages change continuously, but only gradually, while corporate reactions come in waves of M&A, and fits and starts of line extensions to key brands. Not every company can drive new consumption patterns with a corporate strategy—and in a world of outsourced innovation, it is more necessary than ever to aggressively follow the consumer. This reality is being faced by companies across the beverage spectrum—but given the challenges many major brewers have faced in recent years, it provides some particularly excellent examples.

Brewers look beyond lager…

The biggest global brewers are all looking outside of the traditional beer category—with the long, slow decline of macro beer as a backdrop. In the US, the market share of the top five beer brands by volume was 54.8% in 2008 and has fallen about 1ppt per year, to 45.7% in 2016. The trend continues, with ABI volume in North America down 4% through the first nine months of 2017.

Macro beer in the US (and globally) left a near infinite amount of white space across the rest of the beer flavour spectrum. Craft beer rushed in to fill this space, and has diligently worked to expand the number and styles of beer that consumers will accept and even search out. When you thought a 20% abv beer pushed the limits as far as possible, a slew of new styles—from sours to NEIPAs—expand the borders even further. For several years now, we've watched as large brewers have been aggressively acquiring craft brewers in an attempt to reposition their portfolios in line with consumer demand.

But the idea of a brewer investing in the potential of cannabis-infused beverages was not on our radar.

… and beyond beer

Constellation surprised the beer world in late October by purchasing a 9.9% stake in Canopy Growth, a publicly traded cannabis producer in Canada. This is the first move by a major beverage company in the cannabis industry and an early step in potentially opening up a significant new avenue of expansion. For now, Canopy makes the majority of its profit in medical marijuana in Canada. The deal with Constellation offers strength to enter the US if/when marijuana use is made legal at the federal level. The partnership also provides a platform for developing and helping to distribute cannabis-infused (likely non-alcoholic) beverages.

Much has been made of the legalisation of consumer marijuana use across the US, mainly in terms of the potentially negative impact on beer. Are beer and cannabis use correlated? Substitutes? The data on this topic is very poor and perhaps overly dependent on readers' college consumption habits.

What we do know from beer data and marijuana surveys in the US is that marijuana users and beer drinkers look a lot alike demographically, skewing male, younger, and with lower levels of education. The ability for Constellation to speak to its core consumer with a wholly new and innovative product could significantly shake up the beverage market.

Filling the gaps in consumer demand

The ability to move into the gap between latent consumer demand and available products is a formula for growth in beverages—and Constellation has followed this path successfully before, with its Mexican import portfolio.

When Constellation acquired the Modelo portfolio in 2013, most of the volume was generated by Corona sold in a bottle. The consumer demand was clearly there for more, and by expanding the availability of Corona through draft and can, pushing hard behind Modelo Especial, and introducing Pacifico to a wider market, Constellation grew its volume share in the US, from 6.4% in 2013 to 8.5% in 2016. To view it another way: Between 2013 and 2016, Constellation Brands grew its beer sales in the US by 42%, according to IRI data, while sales for ABI and Molson Coors have grown by 5% and 2%, respectively.

What other consumer demand already exists that consumer brands are not meeting?

So, beer that isn't beer—does this ring a bell? Consider the wonderfully aggressive goal that ABI laid out in 2016—to move 20% of global beer volumes to no-alcohol or low-alcohol by 2025. ABI has touted the success of its Jupiler 0.0% brand in Europe and of Brahma 0.0%, which has 70% of the non-alcoholic beer market in Brazil.

The number of consumers looking for low or non-alcoholic products, for a variety of reasons, is growing, and interest in the category is higher among younger consumers. But the need has not always been easily met by brewers. It's not that non-alcoholic beers have not existed, but a combination of new brewing techniques and a marketing effort to renovate the category gives brewers a new license to take advantage of this need-state.

Following the consumer to new lands

Sometimes the changing consumer landscape is less a reflection of changing consumer trends than the speed at which companies are changing business models to find the consumer. What is a beer company if it is not selling beer to consumers? Perhaps it is a company with the vision and the common sense to follow the consumer to new lands.

Where to go for a beer? Important changes in on-premise trends

by Francois Sonneville

Traditional on-premise under pressure

Despite Europe and North America coming out of a recession, beer consumption in the on-trade is under pressure. According to GlobalData, out-of-home consumption in the two regions declined from

17.4bn litres to 16.7bn litres over the past five years, and the volume share of on-trade has fallen from 33.4% to 31.7%.

Pre-loading steals occasions

An important reason for the decline is the change that is taking place in the pattern of consumption. Young consumers are pre-loading at home before an evening out: a trend driven by the large price difference between off-trade and on-trade. As a result, less alcohol is consumed once a bar or restaurant is visited. Pre-loading is particularly popular in the UK, where 60% of consumers admit to it, and some consumers drink more than 25% of their total alcohol intake before they leave home.

As friends meet at home before going out, the on-trade experience of visiting a bar or pub is also valued less. Part of the social aspect of on-trade has moved towards off-trade residential drinking, something made much easier to organise because many young people spend a lot of time communicating with each other online.

Brewpubs buck the downward trend

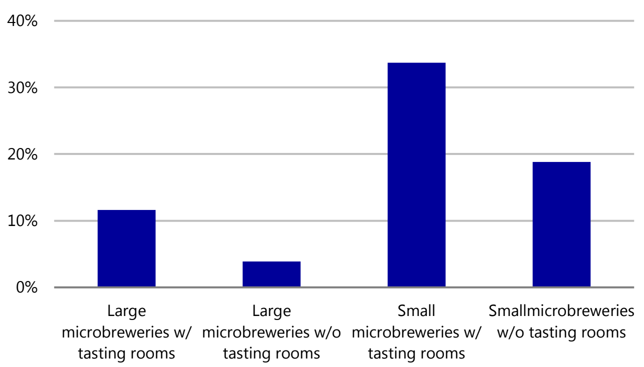
While the traditional on-trade is suffering from lower consumer interest, establishments that produce beer on-premise are seeing a massive increase in attention. Young consumers are much more interested in learning about the production processes than their parents. They also value locally produced goods, both from a quality and a sustainability viewpoint. According to the Brewers Association, in the US, 9.4% of craft beer sales occurred at the brewery in 2016, up from 7% in 2015. The volume shipped by brewpubs (establishments that sell at least 25% of their beer on-site) grew by 17%, which makes it the second-fastest growing segment, after microbreweries. Meanwhile, within microbreweries, those with tasting rooms substantially outperformed counterparts without a tasting room (*see Figure 1*).

Making the most of the trend

The success of tasting rooms could have a negative influence on mainstream beers, national and regional craft brands, and other beverage categories. Consumers who visit a tasting room are very interested in the production process and primarily drink beer that is made on the premises. Guest beer sales are struggling in tasting rooms, as this is not what consumers come for.

Mainstream brewers are starting to discover that "if you can't beat them, you should join them". Goose Island is currently opening brewhouses in major cities, and Paulaner has been so successful with its Bräuhaus concept across the globe that it is opening franchises in China. The volumes sold in tasting rooms might not immediately move the needle for major brewers, but it is important to remember that brands are built in the on-trade. The tasting room experience is another way for brewers to premiumise their brands.

Figure 1: Sales growth in the US by brewer type, 2016



Source: Brewers Association 2017

The Drizly consumer... and what this tells us about the future of e-commerce

by Bourcard Nesin

Boston-based start-up Drizly is processing more digital alcohol sales than any other company. In August 2017, the company started publishing sales and demographic data from its online sales—a space where little information has been available. The data yields some surprises that point to potential winners and losers in on-demand alcohol delivery.

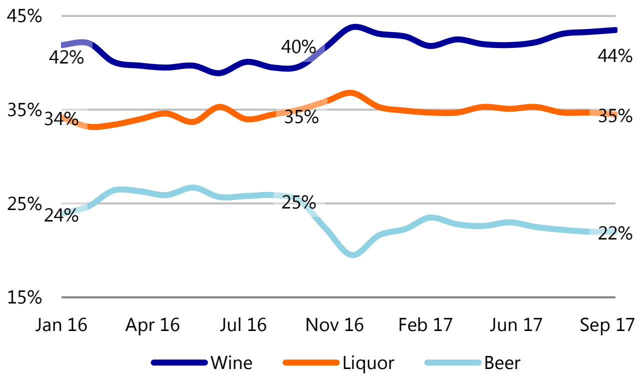
Drizly users' map to m-commerce

Drizly, a predominantly mobile platform, has similar demographics to all mobile sales: overwhelmingly millennial and higher-income. Drizly operates almost exclusively in high-density urban areas, which have a disproportionately high share of young, wealthy consumers, further driving its skewed demographics. The typical Drizly consumer is different from the typical online grocery consumer, who has more proportionate representation across income and age groups.

The inversion of wine and beer consumption

According to bw166, beer is the most popular alcoholic beverage in the US—drinking up nearly 50% of sales—followed by spirits (~30%) and wine (~20%). On Drizly, the share of sales attributed to beer and wine are inverted (*see Figure 2*).

Figure 2: Share of sales via Drizly by major category, Jan 2016-Sep 2017



Source: Drizly 2017

A number of factors likely contribute to Drizly's young users choosing wine and spirits over beer:

1. Drizly's consumers (urban and higher-income) naturally over-index on wine and, to a lesser extent, spirits.
2. Beer is more widely available than other choices, reducing the convenience premium of delivery.
3. The pricing premium for beer on Drizly (29% to 30%) is much higher than for wine (9% to 14%) and spirits (12% to 14%), according to Rabobank estimates.

Implications for suppliers vary by segment

The Drizly data supports a theory we have been forming for some time: On-demand delivery apps like Drizly will not be the primary long-term drivers of online beer sales. In the future, we believe online grocery will be the most important channel for beer sales.

We feel consumers are more likely to see value in purchase beer alongside other groceries than pay a

USD 5 delivery fee for a product available at the corner store. Drizly and its numerous competitors (Minibar, Saucey, etc.) will be most relevant to spirits brands, who have limited retail outlets and few alternative avenues for online sales.

For wine, on-demand delivery apps are an important online channel, but operate alongside numerous e-commerce alternatives, such as online grocery, direct-to-consumer sales, dedicated online retailers (Wine.com), and wine clubs. In short, the online channel most likely to drive future sales will vary from category to category, and investment decisions behind those channels must vary accordingly.

Wine

Un-supersize me: the search for the holy grail of alternative wine packaging

by Stephen Rannekleiv

In the US market, changing consumer dynamics are driving increasing demand for alternative packaging formats for wine. The traditional 750ml bottle is the dominant format, making up 50% of wines sold, while an additional 30% of wines are sold in glass formats larger than 750ml.

The limitations of the 750ml bottle

The traditional wine bottle is part of wine's identity and status, but in today's market, it also has several drawbacks. It holds five servings of a product that begins to deteriorate once it is open. At a time when the size of the average US household is shrinking and consumers are generally seeking to drink 'less, but better', consumers often have to think twice about whether or not to open a bottle, knowing that much of it will go to waste.

Alternative formats gaining share

The shortcomings of the 750ml format can be seen by the growth rates of alternative formats. Nielsen data shows that, in 2016, while the value of total wine sales in the off-premise grew 5.6%, wine in Tetra Pak grew 21%, 3-litre bag-in-box grew 13%, and wine in cans grew 100% (*see Figure 3*).

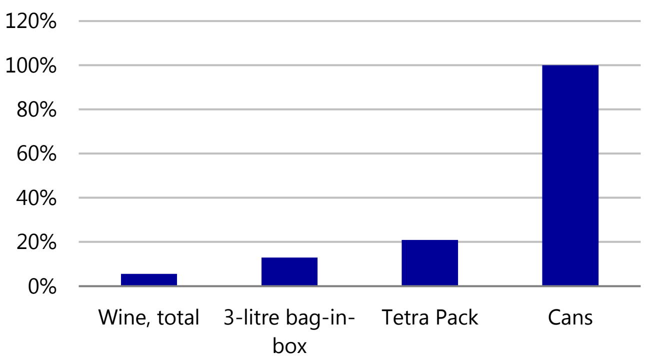
Alternative formats that resolve the waste problem (or preserve quality) are growing quickly, but remain a relatively small percentage of overall wine sales. A key limitation for these formats is that they lack the premium image of the traditional glass bottle. Many brand owners are reluctant to put premium brands into a bag-in-box or can format for fear of downgrading the brand's value in the eyes of the consumer. (Even craft brewers have been reticent to move from bottles to cans for fear it would undermine their brand's premium positioning.) This lack of a premium image for these formats has been a critical shortcoming that has created a barrier for their use in the wine industry.

While alternative packaging formats have generally been stealing share from glass formats, glass manufacturers have also been providing alternatives, such as the .187ml and the .375ml bottles. While the .375ml format remains a very small part of the market, recent data from Nielsen suggests that this format is also growing by double digits (+22%). This format is likely a better option in terms of preserving a brand's premium image, but has some cost disadvantages relative to some of the other alternatives.

The holy grail: single-serve, premium, and cost-effective

The growth of alternative packaging formats suggests offering alternatives to the traditional .750ml bottle may create new growth opportunities for the industry. There will likely not be one solution for the industry, as different formats may work better with different brands, depending on how they are positioned. Wineries and packaging companies—particularly glass companies—must continue to explore alternative formats until the holy grail is found: a packaging format that is single-serve (or preserves shelf life once opened), premium, and cost-effective in order to meet changing consumer preferences. Failure to find the right alternatives may ultimately create limitations on wine's ability to compete with beer and spirits... and perhaps marijuana.

Figure 3: Sales growth of wine in the US by package type, 2016



Source: Nielsen 2017

Spirits

Premium gin has been hot! How much runway does it still have?

by Maria Castroviejo

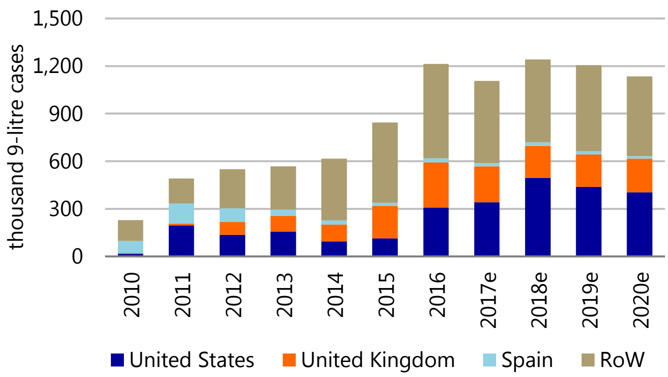
Premium gin has been gaining popularity in the last decade, particularly in the US, UK, and Spain *(see Figure 4)*. Gin fits well with contemporary consumer preferences: It is mixable, resonates as 'natural' with its botanic ingredients and as 'authentic' with small-batch, boutique brands. It is also a very suitable premium cocktail ingredient, which helps in today's market.

At the same time, premium gin has several attributes that also make it attractive from the supply side. It has attractive margins; limited fixed-asset requirements; short time-to-market, versatility, and differentiation opportunities (such as origin, ingredients, and flavours); and relatively low entry barriers (compared to spirits that require ageing). These qualities, among others, have attracted capital that has further supported category growth with new products and players.

Explosion of new competitors in premium plus

In 2012, the top five players in the premium-and-above gin segment accounted for over 90% of total sales. All five are international spirits companies who remain important players in the category, generating (70%) of the new volumes gained by the segment between 2012 and 2016. However, other players have grown even faster: The aggregated total volumes sold by players ranked six and below rose 300% in only four years.

Figure 4: Additional sales volumes of premium-and-above gin in the global market, 2010-2020e



Source: IWSR 2017

Not everything small is craft

While small brands have generated important growth, it is important to note that not all of these are necessarily in the hands of craft distillers. Some are large international spirits companies with a small position in premium gin (e.g. Remy Cointreau with The Botanist), others are established mid-sized domestic/regional producers (e.g. Cognac Ferrand, Gonzalez Byass, etc.), others are merchants (e.g. Berry Brothers), while some are, of course, craft distillers. Many of these craft distillers are actually focused on producing whisky, but leverage their distilling capacity to make gin in order to generate income while the whisky ages.

Sales—and competition—to rise

Global sales of premium-and-above gin are likely to see further growth as the trend expands to other markets, and consumers continue to trade up from standard to premium gin in the US and UK. But some of the more established markets are showing some early signs of saturation. Even if volumes are still growing and tier-2 names are gaining share, these markets are beginning to look overly crowded and fragmented. With limited capacity and shelf space, distributors, on-trade operators, and off-trade retailers are forced to make choices.

Spain, which was at the forefront of the premium gin revolution, provides an interesting case study as to where trends are likely to go in other markets. For several years, the number of gin brands was increasing, and all gained volume—the rising tide lifted all boats. In recent times, the largest brands have still been losing volumes, but an increasing number of small brands are also suffering from declining sales, despite overall volume growth in the market.

Time for strategic reviews

Low-scale craft producers who can be profitable with stable, local revenues (such as direct sales and visitor-related revenues) and who do not need external funding will be able to maintain their position—although growth perspectives may be limited in an increasingly crowded market.

For all other players, to secure existing market positions and benefit from future growth, quality and identity are a must, but not enough. Brands need access to domestic and international distribution, and eventually funding, in order to scale up production. It is time to evaluate possibilities for securing these under the current conditions. If the best alternative is to look at third parties (joining larger groups, selling the brand, giving exclusive agreements, or finding funding providers), earlier movers will have an advantage in an increasingly crowded arena.

The success of craft spirits in the US… and the rising risk of pricing pressure

by Stephen Rannekleiv

Craft spirits see rapid growth

At the end of October, the ACSA, Park Street Imports, and the IWSR launched the second annual Craft Spirits Economic Briefing. The report highlighted the ongoing growth of craft spirits and the justified optimism of the sector. Sales of craft spirits grew 25% over the previous year and have now captured 3.8% share of value of the total market. Like craft beer, craft spirits are effectively tapping into the rising consumer demand for small, local, authentic brands. We have also watched as the craft spirits industry has quickly made important strides in improving product quality and marketing.

Perhaps nothing symbolises the growth potential of small brands in the current market more than the rise of Tito's Vodka at the expense of its larger, more established rivals. Tito's has risen from obscurity and in the course of just a few years is now rivalling (or perhaps surpassing) core Smirnoff volumes (excluding flavoured extensions), with IWSR estimating it should surpass total Smirnoff sales in the US by 2020.

With fragmentation comes pricing pressure

While we see great potential for craft spirits in the US, given their resonance with emerging consumer demand, we are also watching signs of emerging pricing pressure that typically come with a more fragmented market like the highly fragmented wine industry—bw166 estimates 125,000 active SKUs in the US, and price increases are notoriously difficult to implement for all but the most elite brands.

Vodka: the first battleground of pricing pressure

At the moment, signs of pricing erosion are most evident in the vodka segment, as large competitors attempt to stem the flow of share losses to new, fast-growing competitors such as Tito's. As Bob Kunze-Concewitz , CEO of Gruppo Campari, alluded to in their most recent earnings call, the vodka segment in the US is becoming very competitive. We have seen supermarket flyers advertising Smirnoff—which normally retails for USD 10.99/bottle—on sale for less than USD 3.50/bottle after volume discounts and mail-in rebates. And while this is an extreme example, it signifies a broader trend that goes beyond one brand and is creating profitability challenges for the category. Pricing pressure has been noted in the vodka category for a number of years, but the rapid rise of Tito's seems to be increasing the intensity of this challenge.

Rising risk of pricing pressure in craft whiskey

While pricing pressure has been most palpable in the vodka segment, we believe it also could soon begin to be felt more materially in the super-premium end of the US whiskey space. Unlike brewers, who can quickly adjust production levels to current demand, adjusting whiskey production to market demand is a process that requires several years due to the ageing process. Based on the recent growth trajectory of craft whiskey coming into the market, along with the growing number of craft distillers who are laying down whiskey for ageing, our models suggest that the volume of craft whiskey available for sale in the US could easily double the volumes available in 2016 by 2020.

The average US craft whiskey retails for USD 42.54/750ml bottle, according to IWSR. This is the high end of the super-premium category, which we estimate at roughly 3% of the total American whiskey market (*see Figure 5*).

We believe that, to date, craft distillers have been highly effective at bringing new consumers into the super-premium segment, but as new distillers continue to enter the market and increasing volumes of aged craft whiskey come available for sale, the fight for shelf space and consumer attention will become more competitive. Craft distillers may find it increasingly difficult to continue growing sales without resorting to some element of price promotion.

Brown Forman CEO Paul Varga noted in the most recent earnings call that "there are a lot of new entrants in the market", and price increases for their brands are "just a little more difficult today than they were three or four years ago". If production of craft whiskey continues along current trends, pricing in the super-premium segment may become even more challenging. Craft distillers with aggressive expansion plans may wish to begin thinking through how they plan to respond should pressure on pricing become more intense, as pricing moves can have long-term implications for the positioning and profitability of the brand.

Soft drinks

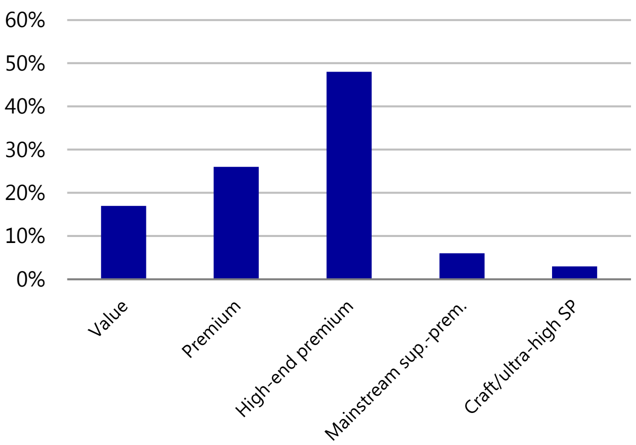
Freshly squeezed: sugary soft drinks under pressure in Indonesia

by Sudip Sinha

What started as a trickle seems to have turned into a tide. The growth in the Indonesian soft drinks market has quickly fizzled out. Most notably, the booming double-digit growth which characterised the Indonesian RTD tea segment has gone into reverse since the second half of 2016. Since then, Nielsen data suggests that all major beverage categories have shown volume decline, with only water and coffee showing positive value growth (*see Figure 6*).

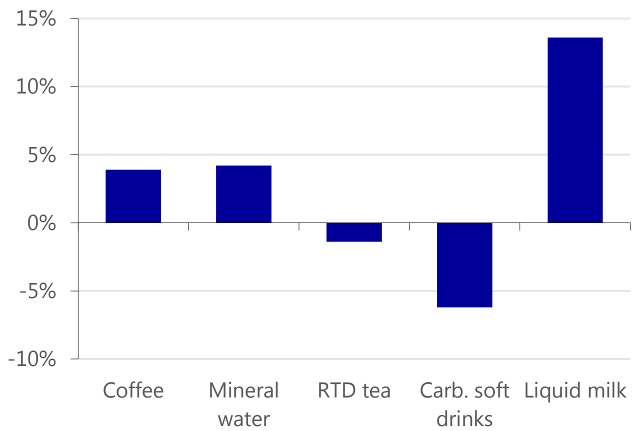
While the market slowdown is well-established, the reasons for the slowdown are less clear. Lower purchasing power for the consumer has been frequently cited as one of the main drivers. There is some truth in this, as the labour absorption rate in Indonesia fell by ~21% in 1H 2017 against 1H 2016 (see Table 1). General trade has grown slower than the

Figure 5: Share of American whiskey sales volumes in the US by price segment, , 2016



Source: DISCUS, IWSR, Rabobank 2017

Figure 6: Indonesian beverage category growth: 52-week MAT, August 2017



Source: Nielsen 2017

modern trade channel, which also partly validates this theory.

On the other hand, the average wage rate has continued to climb higher, which is puzzling. While consumption is being held back, household saving has increased, which might indicate that consumers are deferring expenditure.

In addition, the debate around sugar has created a perception of avoiding or reducing unhealthy products in the diet, which might explain the recent decline in sugar-sweetened beverages.

Table 1: Indonesian labour absorption (thousand), 2016 vs. 2017

	2016	*2017*	*Growth %*
Q1	327.1	194.1	-40.6%
Q2	354.7	345.3	-2.7%
1H	681.8	539.4	-20.9%

Source: BKPM Indonesia 2017

Thus far, companies have taken the obvious route of increasing prices to manage margin, but at the expense of volume. World sugar output is predicted to erase the deficit of the previous two years and therefore foretells a benign raw material environment in the near term. However, if the trend is a more structural indication of changes in consumer preference, this could have an impact on portfolio mix, as well as sugar demand, in the future.

Imprint

RaboResearch
Food & Agribusiness
far.rabobank.com

Food & Agribusiness Global Beverages Sector Team

Stephen Rannekleiv, Global Strategist – Beverages
stephen.rannekleiv@rabobank.com, +1 (212) 808-6823

Jim Watson, Senior Analyst – US
james.watson@rabobank.com, +1 (212) 916-7943

Bourcard Nesin, Analyst – US
bourcard.nesin@rabobank.com, +1 (212) 808-6846

Francois Sonneville, Senior Analyst – UK
francois.sonneville@rabobank.com, +44 (20) 7809 3811

Maria Castroviejo, Senior Analyst – Netherlands
maria.castroviejo@rabobank.com, +31 (30) 712 3811

Sudip Sinha, Senior Analyst – Singapore
sudip.sinha@rabobank.com, +65 6230 6772

Macy Fu, Analyst – China
macy.fu@rabobank.com, +86 (21) 2893 4620

Banking for Food