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Beverage Market Buzz

Reflections on Strategic Developments in Beverages

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Contents

Summary

As we move into the month of August, we thought it would be worthwhile to take a moment to reflect on a few of the most intriguing beverage developments we've witnessed over the past month:

I Got You Babe – ABI Acquires Remaining Stake of Swish (Babe Wines)

- Is non-beer the path to growth for big beer?
- New strategies/packages/formulations/mindsets are needed to reach young consumers.
- Babe is a red alert for the wine industry…
- … as lines continue to blur between all alcohol categories.

From IPO to M&A – ABI Has Many Deleveraging Levers to Pull

- ABI's decision to pull back from the Asia IPO and then announce the sale of CUB highlights the great optionality that comes with a global empire.
- We think the CUB announcement sheds new light on the value/risk of the SAB deal – and that achieving scale through M&A in beer is as attractive as ever.

Jollibee Steps Onto the World Coffee Stage With Coffee Bean & Tea Leaf Acquisition

- Significant global investment is driving consolidation in the coffee shop landscape…
- … as well as a convergence between quick-service retail and coffee shops.
- This is part of an out-of-home coffee revolution taking place from China to Brazil to the US.

I Got You Babe (Wine)

AB InBev Acquires Babe Wines

On June 28 (OK: technically not July, but close enough!), ABI acquired the remaining stake in Babe Wines that it didn't already own, completing a process that started in March. While the brands in the Babe portfolio are still relatively small, this marks ABI's biggest move yet into the wine industry. We think this move is interesting on a couple of different levels, and it really got us thinking…

Could Brewers Make a Comeback in the US?

We have been talking about the changes in consumer preferences and the negative impact on established flagship brands for a number of years (see our 2015 report, *Dude, Where's My Consumer?*). Within the beverage alcohol industry, beer was among the first categories to be hit by these trends – and arguably the most adversely affected. Beer has been losing share of alcohol consumption to wine and spirits since the turn of the millennium – and within beer, large brands have ceded additional share to craft brewers. Large brewers – including many large craft brewers – have clearly been on the back foot for the past few years.

Given the difficult times that beer has seen in the US market recently, brewers such as ABI have been investing heavily in understanding consumer trends (watch out for the upcoming episode of our *Liquid Assets* podcast, in which we interview ZX Ventures). We believe that some of the most meaningful innovation in beverage alcohol in the coming years will likely come from the large brewers – and mainly out of sheer necessity. Adding innovative new brands like Babe Rosé is part of the process that is helping to make brewers into much more viable competitors – even if the brands are not in the beer category.

However, as an aside, while we think that branching into new categories like seltzer and canned wine is an important strategy for brewers, we are most certainly not discounting the potential for beer to return to growth in this market. The growth of brands such as Corona and Michelob Ultra makes it clear that the consumer has not rejected beer – they are just looking for more relevant styles and brands. In fact, our analyst Jim Watson has argued that the current white space and pent-up demand for strong, new beer brands in above-premium mainstream lager has made this one of the most attractive opportunities to invest in the US beer market in recent memory (read Jim's report, *Who Can Rescue Mainstream Beer?*).

'Babe' Is a Lesson in Building Brands for Millennials…

With the acquisition, ABI gets much more than just a brand; it brings in greater insights as to how to connect with younger consumers (a critical skill set required to bring beer back to growth). In our view, so much of what Babe has implemented (a well-differentiated product, a well-defined personality, ongoing and creative communication, a focus on penetrating alternative distribution channels, etc.) serves almost as a tutorial as to how to build a brand in today's market. Whether this brand will reach its stated goal (i.e. to become the Bud Light of wine) or if it is just a fad remains to be seen, but it has certainly connected with consumers and created an outsized impact in a short amount of time.

… and the US Wine Industry Should Be Paying Attention

It could easily be tempting for the wine industry to ignore this deal – it's a small brand, and no one is waiting around for the reviews of the latest vintage of Babe Rosé – but we believe it should serve as a wake-up call for wine companies.

The growth rate of US wine sales is slowing, mainly because the wine industry connects very well with boomers and Gen X, but appears to be losing traction with millennials. Babe has shown itself to be adept at connecting with millennials, and it will have strong access to the convenience channel, which has been outpacing other channels for off-premise wine sales in recent years. Wine companies should look to learn from the Babe brand… or they may find themselves ceding market share to a new breed of competitors.

Traditional Category Definitions Continue to Lose Relevance

Finally, while we see the ABI/Babe deal as having some strategic implications for the beer and wine industries in particular, it is also worth noting that it is another example of the broader trend of category blurring – an issue that we have written about a number of times in the past (see our report, *Blurring Category Lines*). With Coca-Cola Amatil rumored to be looking at Pernod Ricard's wine assets, Coca-Cola making a huge bet on coffee with the Costa acquisition, and wine companies increasingly expanding into spirits, traditional category definitions are becoming less meaningful.

Looking forward, beverage companies will likely be defined less by the category of products they produce (e.g. beer, wine, soft drinks) and more by the type of consumer they target, their route to market, or perhaps the type of occasion where they are most effective. Beverage companies should be thinking differently about how they define themselves and about how they build their competitive positioning moving forward.

Big Brewer M&A in the Spotlight

July also saw AB InBev demonstrate its ability to negotiate deals on a much larger scale…

ABI Hits the Brakes on an IPO…

On Friday, July 12, AB InBev announced that it had decided not to move forward with the IPO of its Asian unit, Budweiser Brewing Company APAC Ltd. The brewer had been hoping to raise as much as USD 9.8bn from the process, which it was going to use to pay down the heavy debt burden it incurred from the SABMiller acquisition. ABI said the decision was made as a result of "several factors, including the prevailing market conditions," as it became clear it would not achieve the pricing it was hoping for.

The decision to pull back on the IPO was disappointing to investors, and ABI shares fell by 3% on the day of the announcement.

… and Follows With a Surprise

One week later, on July 19, AB InBev announced the sale of its Australian unit, Carlton United Breweries (CUB), to Asahi for AUD 16bn (approximately USD 11.3bn). Although ABI had clearly had this in the works for some time, it was not a move the markets had anticipated. CUB is a large operation, but Australia is a mature, slow-growing market that offers ABI little growth. Once again, the company indicated that the proceeds from the sale would be used to help deleverage its balance sheet, allowing ABI to focus its resources on faster-growing markets.

Perspectives on Brewery M&A

Both the retracted IPO and the sale of CUB have elicited a new round of conversations about both ABI's acquisition of SABMiller and M&A among brewers in general.

On the one hand, the obvious question that gets raised in retrospect is: "Did ABI pay too much for SABMiller?" Given that the reduction in debt is taking longer than expected, it might be easy to conclude that this was indeed the case. Beyond the value paid, some in the industry might point out that big beer brands are declining in many markets and that M&A focused on large flagship beer brands may not be the ideal path for growth.

While valid questions can be raised about the ABI/SABMiller deal, we think the two moves that ABI made this month also highlight a very important point: The acquisitions it has made, and the scale it has achieved, give ABI management a wide range of levers it can pull to help create value for shareholders. So, even though many mature markets are seeing fragmentation due to the decline of flagship brands and the rise of craft and import brands, our beer analyst, François Sonneville, has been looking at the long-term strategic value that brewers are deriving from M&A. Keep an eye out for more on this issue!

Out-of-Home Coffee Revolution

On July 24, Philippine-based fast-food giant Jollibee Foods Corporation (JFC) acquired the multi-national coffee store chain Coffee Bean & Tea Leaf for USD 350m. As Sudip Sinha, our analyst in Singapore, recently wrote, this is a transformational move for JFC, giving the operator a much stronger footprint in Southeast Asia, as well as a stronger presence in North America (read Sudip's article, *Jollibee Makes a Splash With Coffee*).

The move by Jollibee is an important one, but should be viewed in the broader context of the wider transformation of the coffee sector in recent years; perhaps no beverage category that we track is undergoing as much radical transformation as out-of-home coffee (OOHC), a process we've been following for several years. We've looked at the shift to OOHC and the evolution of format preferences in Southeast Asia (read our report, *Yuan More Coffee?*). We've also looked at the growing demand for premium coffee in markets like Brazil and how that is driving changes in OOHC (read our report, *Brazil's Robust Coffee Consumption*). More recently, we've looked at a number of disruptive trends in China – perhaps the market in which change is occurring faster than anywhere else – and concluded that it is 'never too late' (see our appropriately-titled report, *Chinese Coffee: It's Never Too Late to Start Investing*) to invest in that market.

After looking at the trends on a market-by-market basis in the past few years, our team has more recently reflected on the emerging global themes in this space. Our analyst Jim Watson, working closely with the rest of the beverage team, identifies three key drivers of change in the OOHC space globally: First, the evolution of the coffee shops themselves, including the growing value of a good food strategy, increased competition from QSRs, and more. Second, the team flags the increasing focus on offering the consumer greater convenience, along with the myriad ways that operators are harnessing technology to reach that goal. Finally, they highlight the way in which the premiumization trend is driving important changes at every level of the industry.

We believe the report will have value for anyone looking to understand the radical changes in OOHC, as seen in the recent rise of Luckin (read the entire report, *Out-of-Home Coffee Delivers Growth*). It will also help put the recent JFC acquisition in perspective, relative to the broader changes occurring in the market.

Imprint

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