Beverages

An Industry Refresher

Given that everyone consumes food and beverages, beverage companies are often recognized as safe and non-cyclical investments that are not overly affected by macroeconomic circumstances. The demand side of this notion is fundamentally true, although it does not mean that the beverages industry is not facing its fair share of disruption today. Constant innovation and evolving consumer preferences shape the beverages industry into one that is competitive and exciting – after all, who does not enjoy sampling a new beverage? Furthermore, global supply chain constraints, high inflation and rising interest rates are forcing beverage companies to be more disciplined in today's business environment. This report provides an analysis of several trends, opportunities and challenges facing beverage companies today, along with commentary on how beverage companies are grappling with these disruptions.

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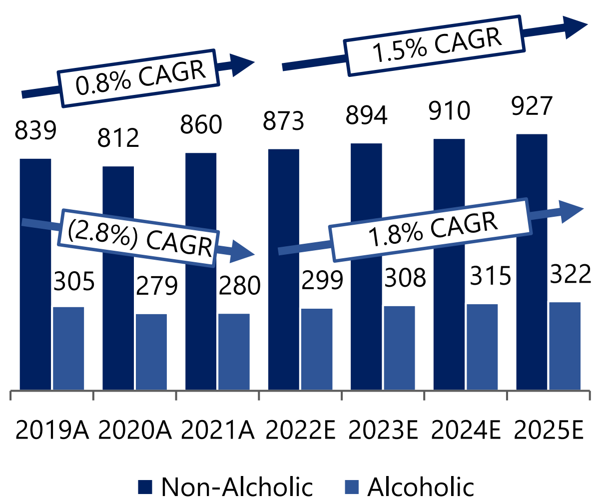
Macroeconomic Environment

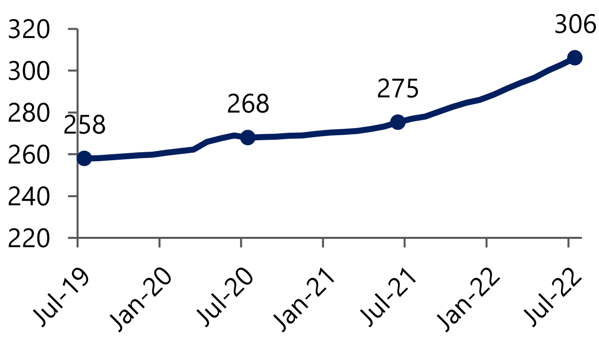
The Covid-19 pandemic shifted beverage purchases from food service establishments such as bars to retail stores, limiting a revenue stream with usually strong margins for most beverage manufacturers. In 2021, consumers started to shift their purchases back to the service industry, which resulted in growth in the latter end of the year. Following a strong first half of 2022, global consumer spending and beverage consumption are expected to decrease in the second half of year, as services industry sales growth from increased accessibility for on-premise sales has been partially overshadowed by shifting consumer choices due to inflation, elevated wholesale and retail inventory levels limiting downstream sales, and a shift towards service-based sales where consumers tend to drink fewer alcoholic beverages when out than they would at home. Sales declines are expected to mostly impact larger alcoholic businesses focused on retail, with smaller companies benefiting from growth in the service industry and a return to selling direct to consumers. Meanwhile, companies with a diversified portfolio of beverages catering to different audiences (e.g., beer and seltzer, caffeinated and non-caffeinated) are likely outperform. However, as the service sector continues to recover and supply chain constraints ease, beverage sales are expected to grow at a faster rate, growing at CAGRs of 1.8% and 1.5% for alcoholic and non-alcoholic beverages respectively from 2022 to 2025.

The main operating costs incurred by beverage companies are the cost of ingredients for beverage production, the cost of packaging materials (such as glass for bottles, aluminum for cans, cardboard for boxes, etc.), and shipping and transportation expenses. Prices for all of these variables have increased significantly in 2022, however margins for alcoholic and non-alcoholic beverage manufacturers have been resilient thus far as these costs have been deflected onto consumers via higher prices. In particular, increased transportation costs elevated commodity prices and increased federal taxes have had a considerable impact on beverage prices this year, with prices in the U.S. food and beverage sector increasing by 10.9% y/y as of July 2022. The extent to which beverage firms will be able to continue bearing cost increases onto consumers is uncertain. Forecasts indicate that persistent inflation will materially affect sales volumes for consumer goods. Firms capable of mitigating costs in other ways will likely seize substantial market share from their competitors. North American beverage firms are better positioned than their European counterparts due to healthier consumer balance sheets.

Global Beverage Consumption (in billion Litres)



Consumer Price Index - Food & Beverages in the U.S. (base year = 1982)



Economic Overview (cont.)

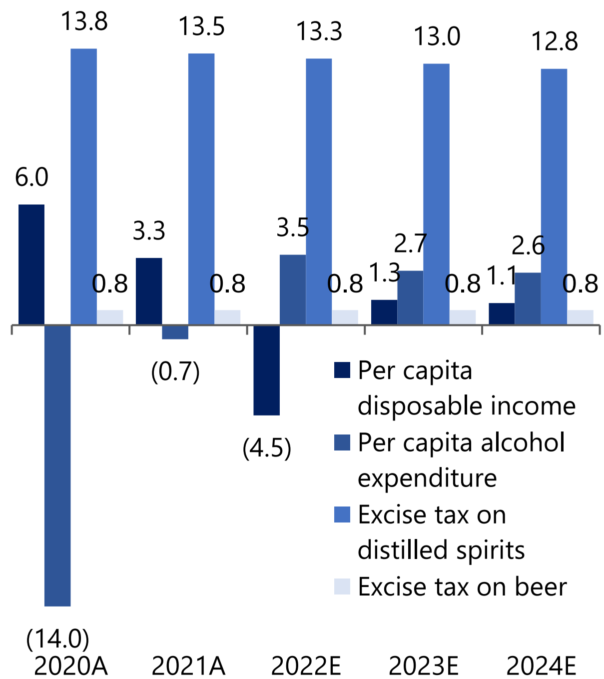
Revenue Drivers

Expenditure on alcohol
Over the past decade, per capita expenditure on alcohol has slowly been rising. The growth is not due to an increase in consumption of alcohol, but rather a change in consumer perceptions as consumers move from cheap beverages such as alcohol to premium beverages. Alcohol consumption will continue to steadily rise as consumption remains an active component of adult life.

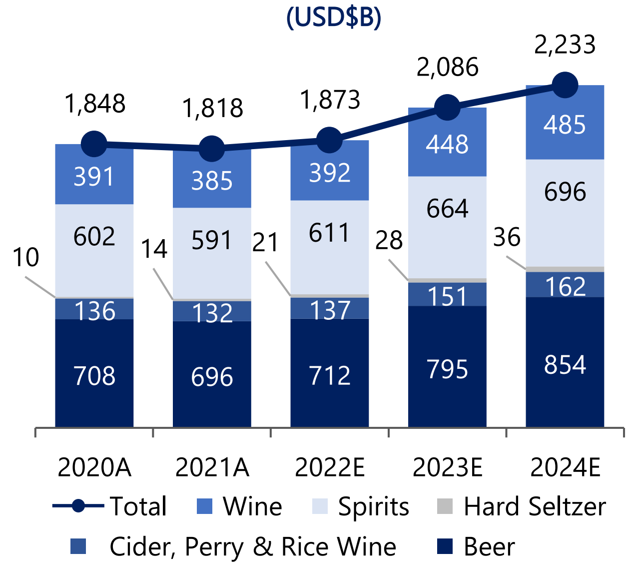
Excise tax on distilled spirits and beers
The price of alcohol is influenced by federal and provincial taxes. Distillers claim an 80% taxation rate, although Statistics Canada estimates it to be in the 20-30% range. Brewers allege that beverages are taxed at a rate of 47 percent, while the Canadian government estimates a rate of 16 to 18 percent. The most important policy tools for decreasing the consumption of alcohol are prices and taxes. Higher alcohol prices are closely linked to decreased alcohol consumption. Due to inflation, the tax on beer and distilled sprites is expected to decline.

Disposable income
The ability of a person to acquire goods or services is determined by per capita disposable income. Disposable income can be described as an individual's after-tax and savings capital. Disposable income impacts revenue as it dictates the amount individuals are willing to spend on unessential items. When there is fewer disposable cash, unnecessary items are among the first to be cut to minimize spending. In 2020 at the beginning of the Covid-19 Pandemic, there was a slight decrease followed by an increase in disposable income as the government issued stimulus payments and tax breaks. Following the predicted correction in 2022, disposable income levels will progressively rise. As normal activity gradually resumes, the economy is likely to start a phase of steady recovery. Overall economic growth will contribute to an increase in per capita disposable income.

Y/y Change for Selected Beverages Revenue Drivers in the U.S. (%)

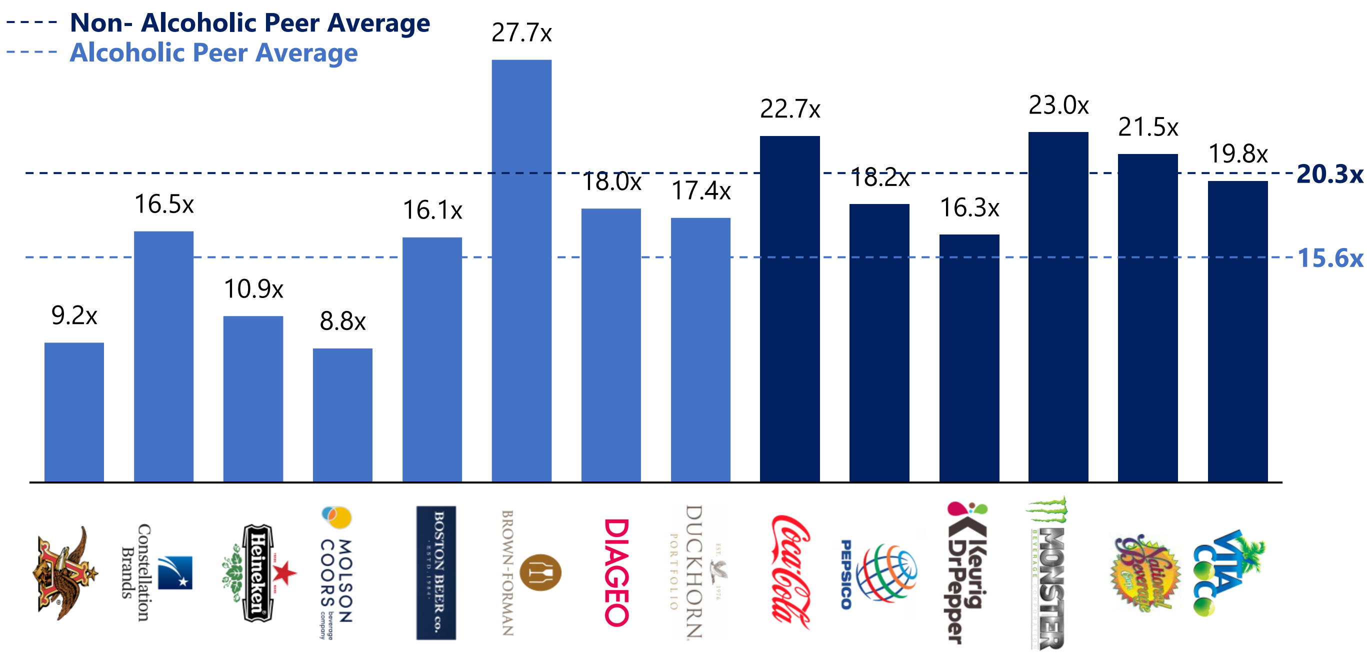


U.S. Total Addressable Market by Subsector (USD$B)

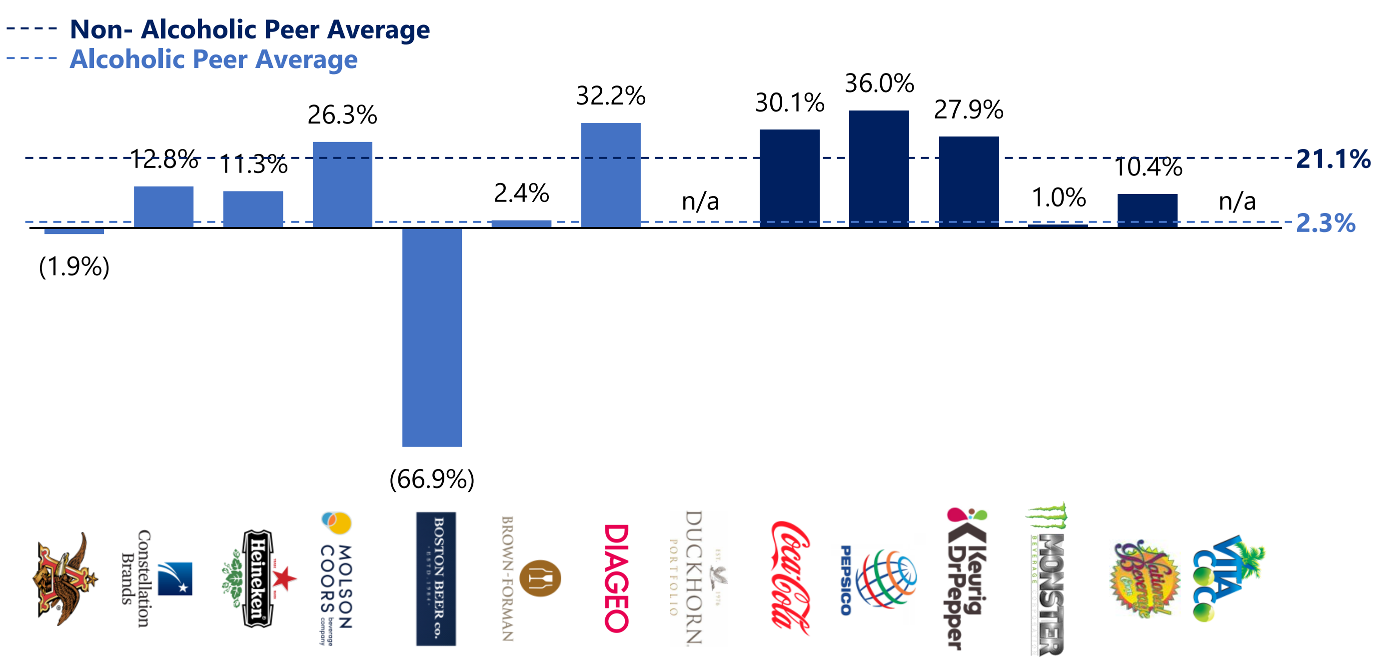


Peer Benchmarking – Trading Performance

Forward EV/EBITDA

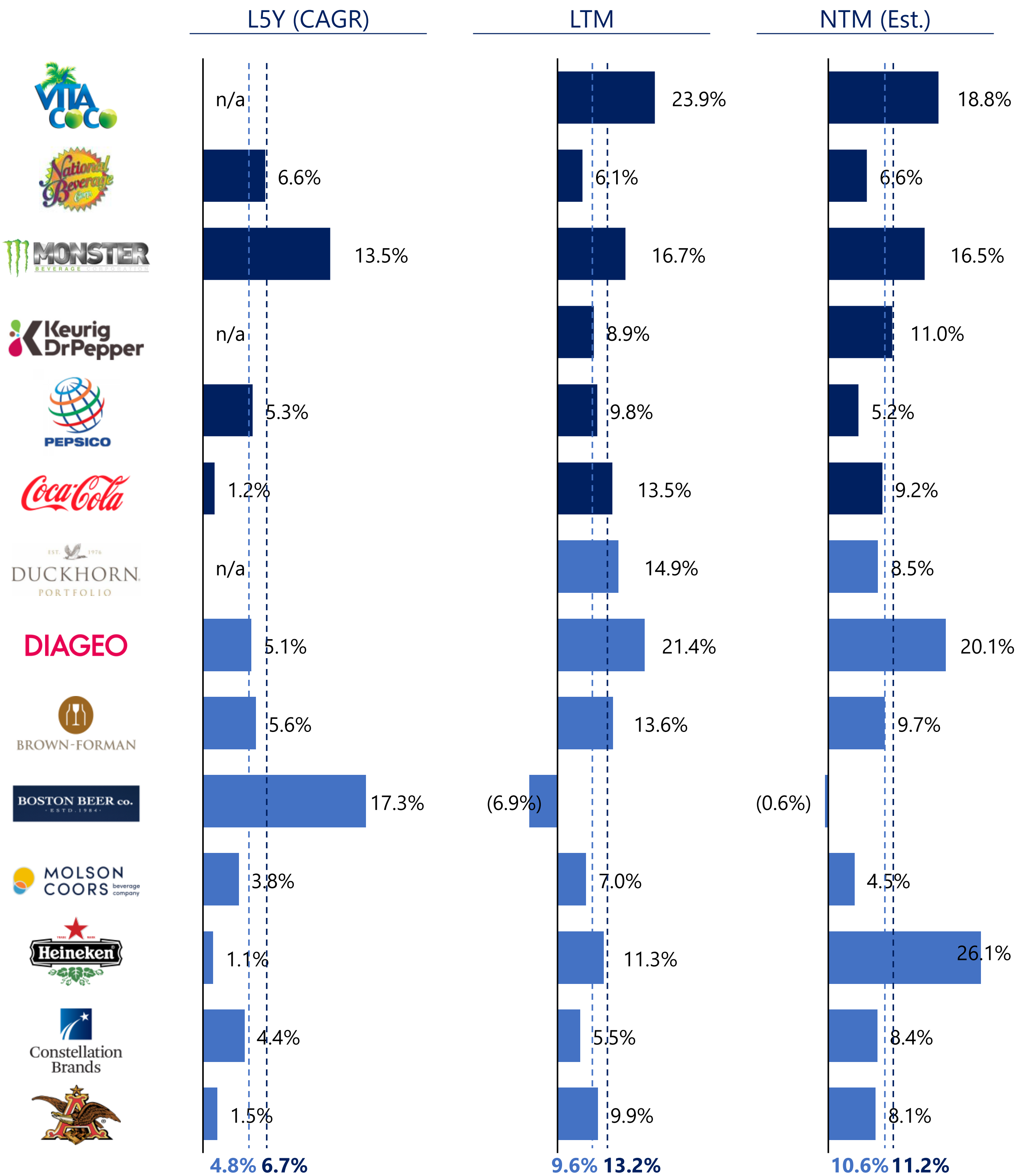


Share Price Performance (L18M)



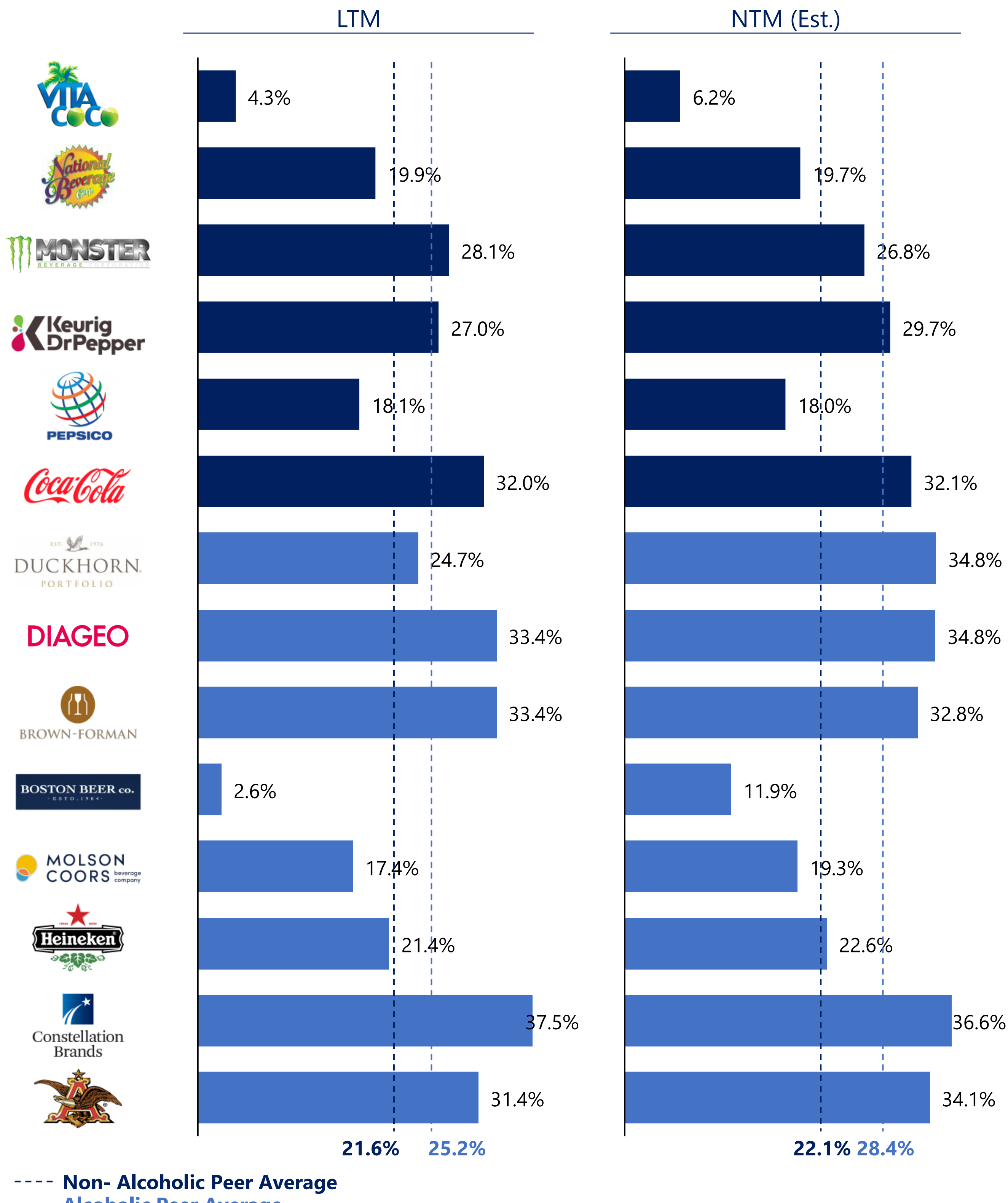
Source: S&P Capital IQ (market data as of August 19th, 2022)

Peer Benchmarking – Sales Growth



---- **Non- Alcoholic Peer Average**
---- **Alcoholic Peer Average**

Peer Benchmarking – EBITDA Margins



Source: S&P Capital IQ (financial information as of August 19th, 2022)

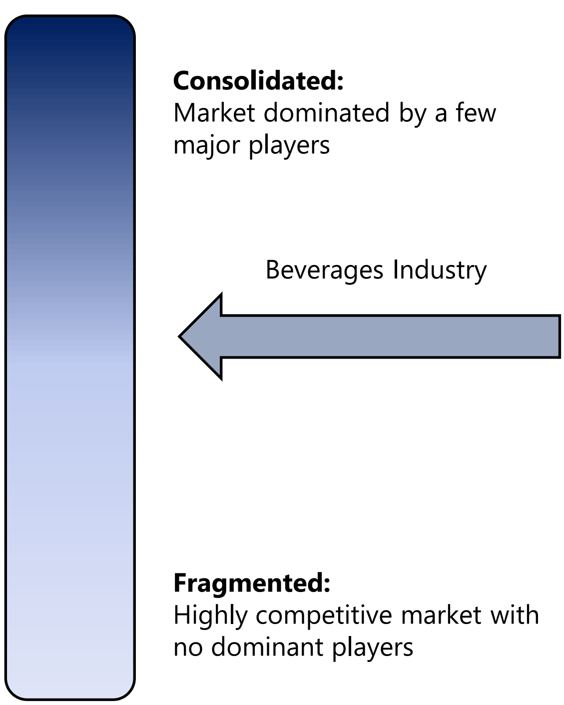
Industry Dynamics

Competition

The beverage industry is highly competitive, especially in an environment of rising prices, aesthetic packaging, and the development of new products, flavors and marketing campaigns. Additionally, brands must compete with a wide range of drinks produced by a relatively large number of companies, many of which have substantial financial, marketing and distribution resources.

Not only that, but new competitors must meet consumer demands for low prices, appealing packaging, and tasty products. Not to mention that major companies like Coca Cola and Anheuser Busch already have a sizable portion of the non-alcoholic and alcoholic beverage sectors under their control.

However, the energy, health, and "functional" beverage industries, which is a rapidly growing category, has fewer major players than the traditional soft drink or alcoholic beverage industry. While there may be lots of competition, many small beverage companies try to compete there. Local craft brewers are also becoming more and more well-liked among younger people, bringing many new players in the market.



Key Trends

Each year, more and more consumers are being drawn to the health benefits of functional beverages. As people become more concerned with their health and fitness, the demand for zero-calorie, zero-sugar, and low-carb beverages has risen drastically across North America. Not only that, but beverages hold the biggest opportunity for flavor innovation. In fact, in the United States, consumers prefer flavored water more than any other drink. Manufacturers are investing huge amounts of resources to extend their product lines to keep up with the latest flavors and categories. That is exactly why there has been rapid growth in the introduction of new products such as Bubly's line of flavored water.

Furthermore, now more than ever, we are seeing companies like Sobe, Snapple, Arizona and Fuse, among many others, market their products as "functional" energy beverages, or as having "functional" effects, by adding supplements to their drinks.

Additionally, in the North American alcohol market, there is a growing preference for low alcohol by volume beverages. This surge in demand for low-ABV beverages can be seen specifically among millennials and baby boomers. Like the non-alcoholic beverage market, this surge can be seen a result of consumers' growing interest in fitness and health.

In coming years, the market for low-alcohol beverages will grow as a result of the ongoing trend for mindful drinking and young people's propensity towards sensible drinking practices. The rise in the market may be attributed to growing awareness of the negative effects of high-alcohol beverages and the quick substitution of those products with lower alcohol content. The millennial generation's declining alcohol usage and growing preference for hard seltzers over the various flavors of low ABV drinks on the market will certainly boost the market's momentum.

The low-ABV market was valued at USD$1.27 billion in 2021 and is projected to reach USD$2.02 billion by 2030, growing at a CAGR of 5.7% from 2022 to 2030.

Source: IBISWorld, equity research

Industry Dynamics (cont.)

Major Players

In North America, the alcoholic beverage market is highly fragmented, with a variety of key players such as Anheuser-Busch, Molson Coors, Heineken, Constellation Brands and Diageo plc. Additionally, the alcoholic beverages market is segmented into beer; wine, brandy and spirits. Players such as Heineken and Anheuser-Bush hold a much higher presence in the manufacturing of beer, whereas Diageo plc are a much larger player in the manufacturing of brandy and spirts.

Non-Alcoholic Industry Players

Similar to its alcoholic peers, the market for non-alcoholic beverages is also relatively fragmented. Some key players in this space include Coca-Cola, PepsiCo, Keurig Dr Pepper, and Monster. In certain spaces such as soda manufacturing, Coco-cola and PepsiCo are dominant players. In other areas, such as the growing space for natural beverages or energy drinks, The Vita Coco Company and Monster may hold a higher presence.

Rising Stars

Owned by Vital Pharmaceuticals Inc, Bang Energy is a sports nutrition company that produces ready-to-drink performance-enhancing beverages. The company attributes most of its growth to its effective influencer strategy, where generating sales comes equally as important as building their brand awareness. By partnering with influencers across various social media platforms such as TikTok, Bang's strategy is to create highly personalized content geared towards Gen Z consumers.

In 2020, Bang Energy was the fastest growing energy drink on the market. Since then, the company has remained closely behind its key competitors, Red Bull and Monster Energy. Additionally, Bang Energy's USD$1.2 billion in sales in 2021 marked a 9.1% increase over the same period the year prior.

In August 2022, Keurig Dr Pepper announced it is in talks to potentially acquire Vital Pharmaceuticals.

Celsius Holdings is currently one of the most popular energy drink manufacturers attracting investor interest (NASDAQ:CELH). Due to its breakthrough growth which has occurred over the Covid-19 pandemic. Celsius has found major success in the direct-to-consumer channel. The stock even increased by nearly 1,000% last year.

In a rapidly growing energy drink industry, Celsius has been able to differentiate itself from other beverage companies through its creative marketing strategies and advertising techniques. Like Bang, this includes a high presence on a variety of social media platforms through its partnerships with various content creators and influencers.

The company has continued to grow after the pandemic, with revenue growing 159.4% y/y in the last twelve months.

Source: S&P Capital IQ, company filings

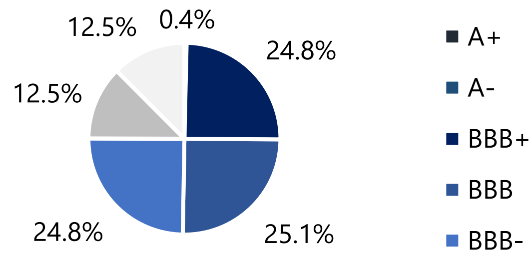
Capital Markets Environment

Capital Markets Activity

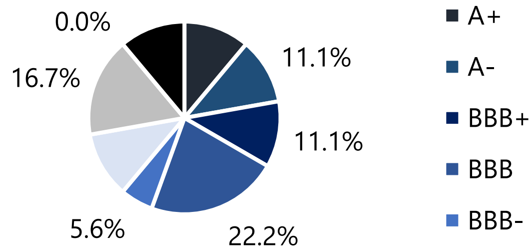
While increasing consumer caution, high operating costs, and interest rate hikes have reduced financial flexibility for beverage companies, it is expected that this will not materially affect the credit quality of alcoholic and non-alcoholic beverage producers. Most firms ended 2021 with substantially more cash on their balance sheets than ever before, so this liquidity can ease the impacts of cost pressures on margins. Excluding firms with significant exposure to the Russia-Ukraine conflict, credit grade upgrades have exceeded downgrades every month this year. Companies in EMEA have a worse credit outlook due to high volatility in European capital markets and top-line challenges driven by plummeting consumer confidence. These variables are less extreme in the Americas. Globally, producers of high-end spirits and healthy non-alcoholic beverages have the best credit outlook, due to a combination of high margins and healthy demand growth for these beverage categories. However generally speaking, deleveraging is not a high priority for most firms in the industry currently.

As central banks have adopted hawkish monetary tightening mandates, debt issuances have fallen since 2021 and activity is expected to remain slow this year. Like in most industries, firms in the beverage industry will need to allocate capital more conservatively as interest rates rise and they will be more hesitant to issue more debt. Equity markets are practically shut down in nearly all sectors including beverages, and this will likely continue into the next year as investor sentiment has dropped. Consequently, many firms in this space that do not want to issue new debt have started carving out non-core and underperforming brands in order to preserve capital for the operations of their high-performing assets. These cost-oriented divestitures are expected to remain a popular way for beverage companies to inject themselves with capital in 2023, and financial sponsors are generally seeking to acquire these types of assets, keeping beverage company valuations somewhat afloat in private markets.

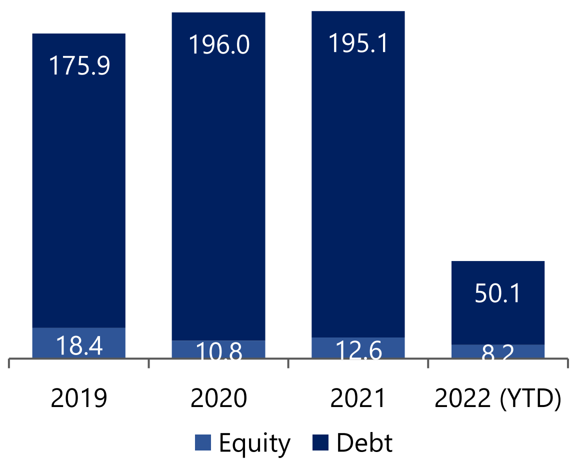
Alcoholic Industry Credit Grades



Non-Alcoholic Industry Credit Grades



Beverages Industry Issuances Total Transaction Value (USD$B)

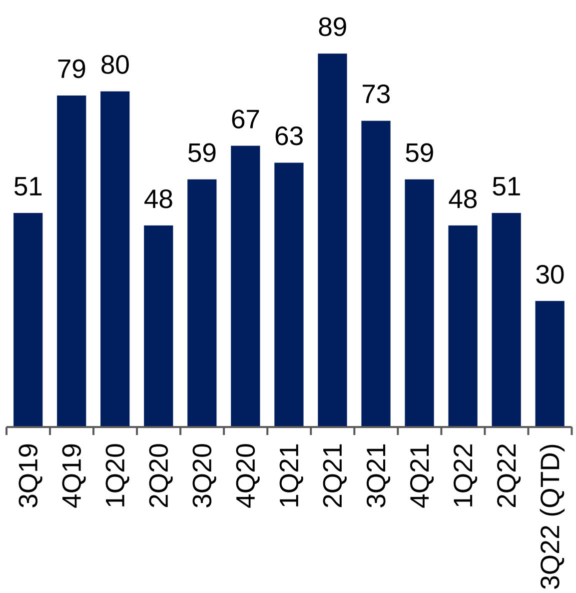


Source: S&P Global Ratings, Fitch Ratings, S&P Capital IQ

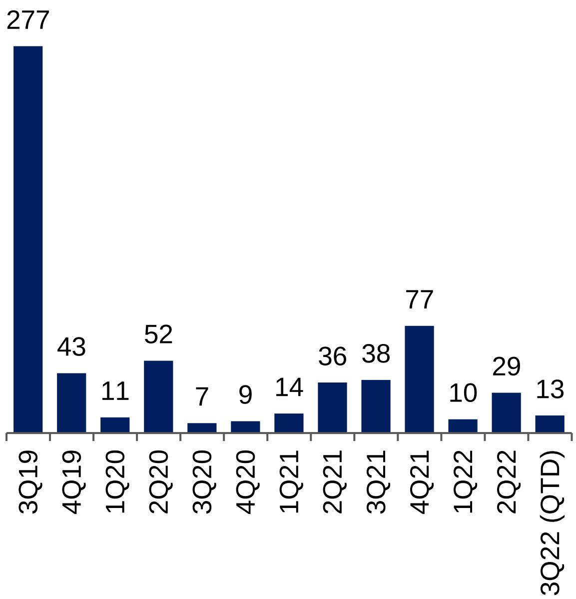
Capital Markets Environment (cont.)

M&A Environment

Beverages Industry Number of Announced Deals



Beverages Industry M&A Total Transaction Value (USD$B)



Even compared to a robust 2021, M&A activity has been energetic this year in the beverages space, and the consumer sector remains one of the most active sectors globally. Many large players in this sector have emerged from the pandemic with plenty of cash on their balance sheets, and they are utilizing this liquidity to seize tuck-in growth opportunities. Furthermore, other beverage producers who were hit harder by pandemic restrictions are now looking to recapitalize or exit entirely.

Premium alcoholic beverages and healthy beverages remain the most attractive acquisition targets currently, due to shifting consumer preferences and increasing attention paid to healthy living. In particular, producers of high-end spirits are popular acquisition targets as firms look to enter this quickly growing product category.

In response to supply chain constraints, larger beverage companies have recently made it a priority to carve out non-core and niche brands, in order to consolidate manufacturing resources to protect the overall profitability of their most successful brands. Such divestitures will drive a large portion of M&A volumes for the foreseeable future as managers must be more conservative in their capital allocation.

USD$3.7 trillion cash and equivalents held by S&P 500 companies at the end of 2021

USD$948.9 billion dry powder held by U.S. private equity firms as of June 2022

Private equity sponsors have increasingly enjoyed lower valuations and abundant beverage acquisition opportunities due to corporate divestitures. 40% of divestitures this year have been acquired by private equity sponsors or their portfolio companies. With nearly USD$949 billion in dry powder as of June 2022, it is likely that private equity will have a growing presence in the consumer sector throughout 2022.

Source: S&P Capital IQ, PwC, Bain & Co, PitchBook

Capital Markets Environment (cont.)

Case #1: Monster Acquires CANarchy

Monster Beverage has acquired CANarchy Craft Brewery Collective for $330 million

On January 13th, 2022, Monster Beverage Corporation entered an agreement to acquire CANarchy Craft Brewery Collective LLC for USD$330 million (2.5x FY2021 revenue) in cash.

Following the transaction close on February 17th, Monster received ownership of all of CANarchy's craft beer and hard seltzer brands, including Cigar City (Jai Alai IPA and Florida Man IPA), Oskar Blues (Dale's Pale Ale and Wild Basin Hard Seltzer), Deep Ellum (Dallas Blonde and Deep Ellum IPA), Perrin Brewing (Black Ale), Squatters (Hop Rising Double IPA and Juicy IPA) and Wasatch (Apricot Hefeweizen).

After much discussion over recent years, this transaction served as a springboard for Monster to enter the alcoholic beverages industry with full infrastructure and manufacturing capabilities. It is likely that Monster will utilize CANarchy's capabilities to experiment with innovation of new products in the future, fitting with the recent industry blurring of the lines between non-alcohol and alcohol. Monster clarified that its focus in alcohol is unlikely to include the core Monster brand name but will probably involve growing smaller existing brands or developing new brands over time.

Monster now possesses full economic control over future expansion into alcohol vs. other potential partnership options where it would have needed to theoretically split the economics. Current CANarchy U.S. distribution is 50% through the Molson Coors system, 30% AB InBev, and 20% independent.

Case #2: Diageo Acquires 21Seeds

Diageo has acquired 21Seeds for £123 million

On March 31st, 2022, Diageo plc acquired 100% of 21Seeds Inc, a craft-infused tequila producer, for £123 million. The transaction included a £62 million up-front consideration in cash, as well as a £61 million contingent consideration linked to performance-based targets. No additional transaction details were publicly disclosed.

Founded in 2019, 21Seeds is currently in the growth stage and should benefit from access to Diageo's marketing resources and connections in retail and distribution. The 21Seeds tequila portfolio includes three fruit-infused tequila varieties; Cucumber Jalapeno, Grapefruit Hibiscus and Valencia Orange.

This transaction enables Diageo to deepen its presence in the U.S. flavoured tequila market, which is currently growing at a rate of 20% per year, over three times as fast as total spirits. Over the last few years, many beverage producers have sought to enter spirits manufacturing, which is growing at a faster rate than any other alcohol category.

The 21Seeds acquisition also reflects a broader industry trend toward beverage premiumization, as consumer preferences have shifted toward higher-end alcoholic beverages in recent years. While the flavoured tequila category is growing 20% per year, the super-premium flavoured tequila category is growing at a rate 65% per year in the U.S..

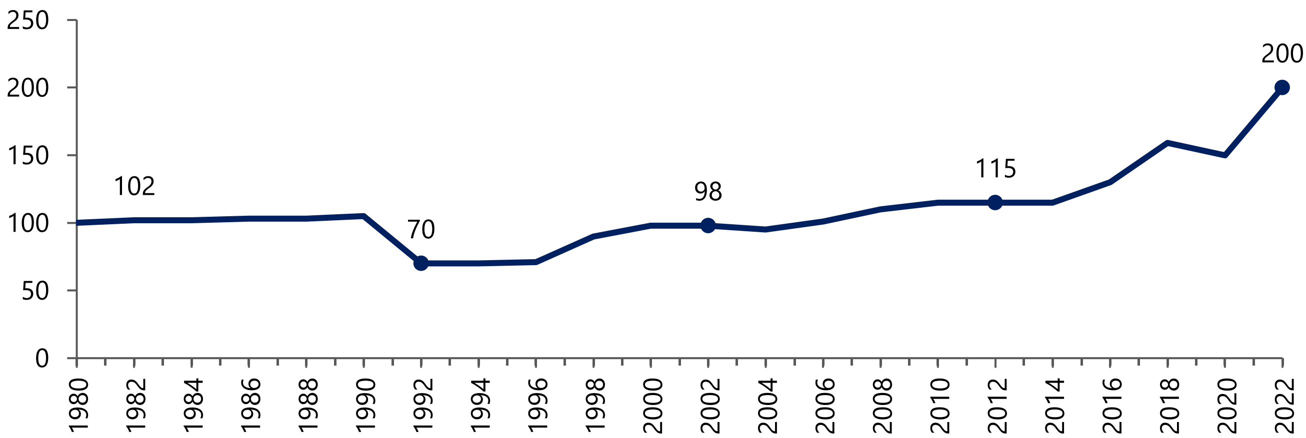
Source: ISWR, company press releases

Industry Outlook (Headwinds)

Price of Fruits

In 2022, the price of fruits is expected to rise at a rate of 6.4%, which can potentially lower the profit margin for non-alcoholic drinks. Factors that contribute to the increased price of fruits include coronavirus. Covid-19 has inhibited the production of beverages due to supply chain disruptions and shortages. Additionally, the conflict in Ukraine has raised the index price. The war in Ukraine and sanctions against Russia has led in a massive decline in the supply of major staple foods. The FAO reported that the global Food Price Index (FPI) has increased 12.6% in March 2022.

Price of Fruit Index (base year = 1980)



FDA Health Regulations

There are rising public concerns with sugar-sweetened beverages. Studies from the National Library of Medicine stated that there is a connection between carbonated soft drinks and cardiovascular health problems. As a result, major players like Coca-Cola and PepsiCo, which control 34% of the global soft drink market, will have to re-evaluate their product portfolios. Since most products in this industry contain sugary contents, major players will have to shift towards product alternatives that match the FDA standards. The FDA proposed rule in 2022 may modify limitations for certain nutrients like sodium and sugar, which calls out the need for product reformulation. This serves as a challenge since most products that have high sugar and sodium are key revenue drivers.

International Conflict

Western countries, like the United States, impose sanctions on Russia for invading Ukraine and starting a war. Sanctions on Russia have impacted trade exports and food production. Russia plays a key role in the international sphere, exporting $407 billion in total products in 2019. Russia also makes up 18% of wheat and 11% of barley, essential for beer production. The 30.9% drop in exports in 2022 from Russia will affect the U.S. and Canadian imports of barley and wheat. In addition, the Biden administration has blocked vodka imports to the United States. Russia exports approximately USD$149 million of vodka in 2019. The relationship between Russia and Western countries is tarnished, negatively affecting the international supply chain.

Source: IBISWorld, IMF, National Library of Medicine

Industry Outlook (Tailwinds)

Socioeconomic Factors

Projected world population in 2050 accounts for 10 billion people. Canada's population is expected to grow by 6.3% over the next 5 years, which presents opportunities for industry leaders like PepsiCo and Coca-Cola to position themselves as global leaders. The projected distribution of the target age group for the alcoholic sector accounts for 57.5% in 2050. Health-conscious consumers are rapidly increasing, as 95% are more compelled to purchase healthier alternatives. As a result, demand for the non-alcoholic sector will increase significantly, especially to active millennials and baby boomers

Emergence of the Middle Class

The growth of the middle class in the 21th century is projected to rise significantly over the next 15 years. In 2030, North America, Europe and Asia-Pacific are projected to have the biggest middle-class population. United States and Canada are among the countries that have a good trading relationship with Europe and Asia. Coca Cola's top exporters in 2020, include Poland, China and Japan. This presents an opportunity for key players in the industry to develop appropriate market segmentation to capture the immense revenue potential of the emerging middle class.

Conclusion

The Covid-19 pandemic has severely disrupted the beverage industry, leading to a decrease in on-premise alcohol sales and per-capita disposable income. The rise of inflation by 3.9% showcased a drop in consumer confidence, which has caused people to eliminate alcoholic or fruit beverages that are not considered a necessity. Despite the effects of the global pandemic, the North American beverage sector has proven to exemplify resilience. Diageo, Molson Coors and Heineken are among the alcoholic industry players to facilitate innovation. Dominating players in the non-alcoholic sector, like Coca-Cola, PepsiCo and Keurig Dr Pepper will stay competitive because of their strong brand presence used to create a top-of-mind awareness to the public. This industry is positioned to grow for the next decade, due to macroeconomic trends that are catered towards the major players in this industry and companies on the rise. Compared to popular companies like Coca Cola and PepsiCo, Vita Coco will experience the biggest growth rate in the next twelve months. Companies that have introduced or implemented products with health benefits reap the most success in the future. Consumer preference have shifted towards products with an abundance of nutrients. This trend has inspired Amazon to introduce functional energy beverages. In addition, companies are investing a huge amount of resources to extend lines of various flavours. The demand for low-ABV beverages is surging, strengthening the alcoholic sector. As a result, between 2022-2025, this industry will experience a growth rate of 14.77% and total revenue of USD$353 billion.

Comparable Company Analysis

Alcoholic Beverages Peers

Comparable Company Analysis - Alcoholic Beverages Peers Data as of August 19th, 2022 at market close. Dollars in USD$B unless otherwise stated.					EV/Sales (x)		EV/EBITDA (x)		P/E (x)	
Company	**Price (USD$)**	**Mkt Cap**	**Net Debt**	**TEV**	**LTM**	**NTM**	**LTM**	**NTM**	**LTM**	**NTM**
Anheuser-Busch InBev SA/NV (ENXTBR:ABI)	52.58	104.3	76.1	188.1	3.5	3.1	10.6	9.2	28.7	16.0
Constellation Brands, Inc. (NYSE:STZ)	251.69	47.1	10.9	58.3	6.4	6.1	20.8	16.5	39.1	22.2
Heineken N.V. (ENXTAM:HEIA)	96.47	55.5	15.5	71.6	3.2	2.5	13.6	10.9	16.7	18.9
Molson Coors Beverage Company (NYSE:TAP)	56.09	12.2	6.5	18.9	1.8	1.7	9.9	8.8	16.7	13.8
The Boston Beer Company, Inc. (NYSE:SAM)	368.58	4.5	net cash	4.4	2.3	2.1	69.9	16.1	NM	33.3
Brown-Forman Corporation (NYSE:BF.B)	77.66	36.9	1.5	38.4	9.8	9.4	28.4	27.7	44.6	39.5
Diageo plc (LSE:DGE)	46.78	106.5	17.4	125.5	6.9	6.3	18.7	18.0	28.3	23.1
The Duckhorn Portfolio, Inc. (NYSE:NAPA)	19.17	2.2	0.2	2.4	6.7	6.1	27.3	17.4	36.3	27.2
High	**368.58**	**106.5**	**76.1**	**188.1**	**9.8**	**9.4**	**69.9**	**27.7**	**44.6**	**39.5**
Low	**19.17**	**2.2**	**net cash**	**2.4**	**0.8**	**0.7**	**9.9**	**-**	**16.7**	**-**
Mean	**120.3**	**41.5**	**14.2**	**56.9**	**4.6**	**4.2**	**24.0**	**13.8**	**30.2**	**21.6**
Median	**77.66**	**36.9**	**6.5**	**38.4**	**3.5**	**3.1**	**18.7**	**16.1**	**30.1**	**22.2**

Non-Alcoholic Beverages Peers

Comparable Company Analysis - Non-Alcoholic Beverages Peers Data as of August 19th, 2022 at market close. Dollars in USD$B unless otherwise stated.					EV/Sales (x)		EV/EBITDA (x)		P/E (x)	
Company	**Price (USD$)**	**Mkt Cap**	**Net Debt**	**TEV**	**LTM**	**NTM**	**LTM**	**NTM**	**LTM**	**NTM**
The Coca-Cola Company (NYSE:KO)	65.17	270.3	31.2	303.3	7.3	7.1	20.2	21.9	28.4	25.1
PepsiCo, Inc. (NasdaqGS:PEP)	180.17	240.0	33.6	273.7	3.3	3.2	17.1	17.7	26.2	25.1
Keurig Dr Pepper Inc. (NasdaqGS:KDP)	39.96	55.2	12.7	68.0	5.1	4.7	18.2	15.9	25.7	21.9
Monster Beverage (NasdaqGS:MNST)	90.59	49.3	net cash	46.9	7.8	6.9	27.5	23.8	40.9	34.0
National Beverage Corp. (NasdaqGS:FIZZ)	55.66	4.3	net cash	4.3	3.7	3.6	19.6	20.1	30.8	29.4
The Vita Coco Company (NasdaqGS:COCO)	15.23	0.8	0.0	0.9	2.1	1.8	48.6	19.8	66.7	31.5
High	**180.17**	**270.3**	**33.6**	**303.3**	**7.8**	**7.1**	**48.6**	**23.8**	**66.7**	**34.0**
Low	**15.23**	**0.8**	**net cash**	**0.9**	**2.1**	**1.8**	**17.1**	**15.9**	**25.7**	**21.9**
Mean	**74.46**	**103.3**	**12.5**	**116.1**	**4.9**	**4.5**	**25.2**	**19.9**	**36.4**	**27.8**
Median	**60.42**	**52.3**	**6.4**	**57.4**	**4.4**	**4.2**	**19.9**	**20.0**	**29.6**	**27.3**

Source: S&P Capital IQ, company filings