Beverage market update

Industry Consulting Team | Q4 2022

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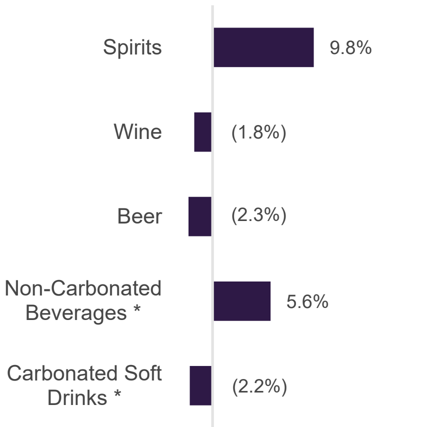
Highlights

- LTM ended 3Q'22 total Beverage category is observing mixed results; certain categories face steep comps YoY leading to areas of soft volume, meanwhile price increases and premiumization continue forward
- The return from off-premise consumption back to on-premise continues; total consumer expenditures have flattened at 0.3% while consumer expenditures on-premise are up nearly 37% through LTM 3Q'22
- Only the spirits category still shows volume growth while beer and wine are experiencing modest declines; Non-Carbonated Beverages (NCBs) are the only non-alcoholic segment continuing to grow volume

Table 1

Total Beverage Industry Volume LTM September 2022 vs. 2021 *



* CSD & NCB data as of Q2 22

Table 2

US Spirit Industry Volume YoY LTM September 2022 vs. 2021

2022 Industry Trends & Observations [1]

BEER: After a tough start for the first 6 months of the year, beer volumes (total US production plus imports) improved through the summer months. While still down through LTM 3Q'22, the decline moderated to negative (2.3%) through the period. In a theme being observed throughout much of the Beverage universe, despite softer volume, beer pricing is up with the average price of a 24/12oz case equivalent increasing +6% YoY per bw166 metrics. As a result, despite volumes declining, beer revenues are likely up low single digits. Imports continue to drive industry growth producing 4.6% volume gains YTD and 2.9% for the LTM period. Mexican imports continue to perform well and drive import segment growth gaining 10% on an LTM basis and more than 11% YTD YoY. In contrast, key domestic producers like Anheuser-Busch InBev (ABI) saw volumes decline (1.9%) LTM with Molson Coors (MC) down (3.0%) for the same period. Even the strong seltzer segment has slowed significantly with much of the YoY growth stagnated to some initial indications of total volume declines in across the segment. Overall, the beer segment is still well above pre-COVID levels and pricing in the category has continued to climb in addition to ongoing premiumization. While positive for beer, the category continues to lose volume share to spirit producers with no current signs of that trend slowing.

SPIRITS: Through the LTM period ending 3Q'22, the spirits sector continued to show its strength over other bev-alc categories with YoY volume growth of 9.8%. Within spirits, Ready-to-Drink (RTD) or canned cocktails remain on their rocket-ship growth trajectory and are becoming a powerful force within the category. RTD volumes gained ~60% through LTM ending 3Q'22 accounting for just under 30% of the total category growth. And the RTD category is becoming far more developed and is no longer vodka-based seltzers, as whiskey, tequila and other agave-based cocktails have emerged and seeing strong signs of success. On the theme of agave, core tequila and mezcals spirits continue to be another growth engine within spirits attributing more than 20% of the total spirits category's growth. Total tequila and mezcal added volume of nearly 20% LTM with YTD trends gaining strength with volumes climbing +22% YoY. Whiskey has maintained solid volume growth at +5.0%. Whiskey is already the largest segment in terms of revenue and is projected to become the largest volume category by FYE 22 surpassing vodka. Other spirits segments demonstrated mixed results with vodka declining (3.6%), gin gaining +11.7%, and rum declining (8.7%).

WINE: Total wine volumes decreased (1.8%) YoY through LTM 3Q'22, led again by sparkling wines. Sparkling wine has snapped back from international supply chain problems that were experienced heavily during COVID periods and gained 12.3% through LTM period ending 3Q'22. Table wines were flat showing mixed results between domestic and imports. Domestic table wines gained nearly 1%, while imported table wines declined (1.6%) during the same period. Table wines still set the tone for the category making up nearly 80% of total wine sales.

NON-ALCOHOLIC: Total Non-Alcoholic beverages (NAs) delivered mixed results through 2Q'22 with challenging comps as they cycle off big volume quarters. Additionally, CO^2 shortages have challenged the industry creating disruption in production and impacting volume sales. Total CSDs declined (2.2%). Keurig Dr. Pepper (KDP) led in CSDs and was flat for the period, ahead of The Coca-Cola Company's and PepsiCo's (0.6%) and (6.0%) declines; respectively. Despite volume challenges, CSD pricing has observed large gains with total category revenue increasing 11.0% YoY, led by Coca-Cola and KDP with 14.1% and 11.9% gains, respectively. Within NCBs, energy led the sector adding +5% volume growth, followed by plain bottled water increasing volume by 4.1%. Enhanced / flavored waters were flat with sports drinks, juices, and teas all declining.

Beverage Sectors In-Focus

M&A CHARGES ON DESPITE RISING INTEREST RATES: M&A activity has continued at a fever pitch across the bev-alc sector despite one of the most accelerated rising rate environments the US has seen. At the start of 2022, the Federal Funds Rate was at near zero levels with the targeted range between 0.00% and 0.25%. Then in March, the Federal Reserve began increasing interest rates in an effort to curb rising inflationary pressures. From mid-March we've watched rates rise at a historic pace from 0.00% - 0.25% to 3.75% - 4.00% at the most recent Fed meeting on November 2. At the same time, while the cost of capital has increased, we've continued to watch the M&A environment across bev-alcohol accelerate and in a lot of cases at very high to near record setting valuations. So, what's driving all this activity and why are buyers willing to defy academic analysis and pay the aggressive multiples being observed in today's market despite the dramatic shifts in interest rates? We unpack these questions and more in two areas where we see the most significant M&A activity; beer distribution and spirit producers / brand companies.

1: Unless otherwise noted, LTM, YTD and YoY statistics throughout the newsletter reflect data through 3Q'22

TRUIST

Sources: bw166, Beer Institute, DISCUS, Beverage Digest, Brewers Association, Nielsen, CGA, Footprint Intelligence

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Table 3

US Wine Industry YoY LTM September 2022 vs. 2021

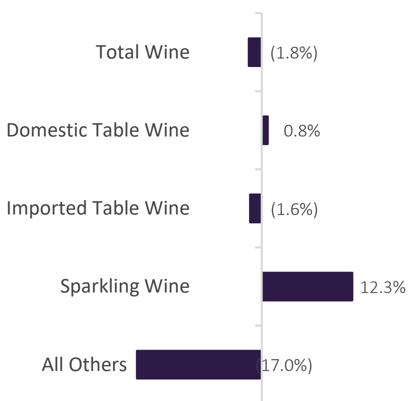
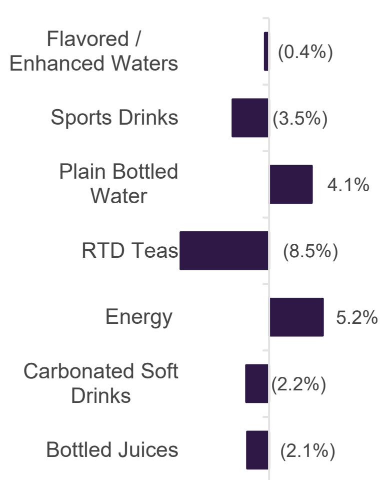


Table 4

Total Non-Alcoholic Beverages YoY LTM 2022 vs. 2021 Volume Trends *



* CSD & NCB data as of Q2 22

Beverage Sectors In-Focus (Continued)

BEER DISTRIBUTION: Consolidation and M&A in beer distribution has been going on for years as scale and operating efficiencies have become paramount in an increasingly complex industry. M&A slowed initially during the early COVID period given obvious uncertainties, but distributors soon found themselves operating at record or near record levels, and M&A has returned in a big way. Low rates, in conjunction with increasing margins due to the perfect combination of velocity and premiumization from imports and seltzers, provided consolidating wholesalers the ability to be aggressive with acquisition valuations; therefore, increasing competition and multiples.

Additionally, there has been an evolution of major consolidators who are now large businesses capable of pursuing deals worth hundreds of millions of dollars. These consolidators have emerged as a result of acquisitions, organic volume growth, pricing increases and operational efficiencies. A perfect example is The Reyes Group. Starting out as a Schlitz distributor in Spartanburg, SC, through a consistent string of acquisitions and focus on operational efficiencies, Reyes now sells more than 300 million case equivalents and recently announced a cluster of acquisitions including DET Distributing (Nashville), Capital Wright Distributing (Austin) and Paradise Beverage (Hawaii); combined these represent an estimated $2 billion in acquisition value all within a 60-day window from Sept. through Oct. this year. Also, the entry from outside capital sources such as family offices has introduced deep pocketed parties who have historically not participated in the equity stack within beer distribution. Departing from historical views, both Anheuser Busch and MolsonCoors have shown a willingness to allow outside capital to have an increasing role in the beer distribution system. With more capital coming into the industry, it's less likely to see meaningful downward pressure on valuations.

It is critical to note in the context of premium valuations that not all assets are equal. Deals which have garnered super premiums in the space contain common themes such as strong portfolio diversity, which have included on trend suppliers like Constellation, Boston Beer, and Mark Anthony Brands (the latter two have softened slightly but still represent significant contributors of elevated margins and dollars). Other common factors include larger operations in growing population centers with healthy demographic trends. Absent some or all these elements the likelihood of obtaining a super premium valuation decreases.

While multiple driving forces within beer distribution will keep valuations high in the industry, the simple fact remains that the cost of capital continues to increase, and buyers will need to adapt to this higher cost environment. Post acquisition synergies will be a crucial element to de-levering the combined business or a distributor will simply need to rely more heavily on their own free cash flow going into a deal with less synergy accretion. For example, a fully financed $150MM acquisition would carry an additional +$5MM interest burden when considering the 3.75% increase in the Fed Funds Rate experienced thus far in 2022. The incremental cost will have an impact on a distributor's ability to reduce debt and de-leverage post acquisition, placing incremental strain on free cash flows and elevating the importance of synergies and operational efficiencies. Adding another factor of complexity, tax law changes now limit the amount of interest that can be expensed each year. In a rising rate environment, this becomes even more important as distributors leverage up to complete an acquisition. Overall, we see an increasingly complex environment for M&A with buyers needing to evaluate more on each acquisition, but the inertia and strength of the industry will keep values high to stable.

SPIRIT PRODUCERS & BRAND COMPANIES: M&A in spirits has also been tremendous in FY22, which is not surprising given the continued strength and growth being observed in spirits as compared to beer and wine. Also not surprising, the two areas where transaction activity has been more pronounced are agave and American whiskey, which have driven much of the growth across the sector; especially in the higher pricing tiers of the industry. Across spirits, capital is coming in from all directions: private equity, family offices, strategic players, etc., as sustained growth in the industry and ongoing strength towards organic premiumization and less reliance on pricing increases have drawn the attention of many forms of capital and as a result valuations have pressed higher.

Inventory matters, especially in brown spirits. Given the demand growth in American whiskey, supply chains have been stressed particularly on longer-aged products. As a result, producers have faced challenges keeping aged stated brands on store shelves. With companies struggling to keep their own brands supplied, they've been reluctant to acquire other brands at a premium without their own inventory to supply growth. Those with inventory can push for a premium, those without maybe less so. A perfect example, Campari just recently announced the majority share acquisition of Wilderness Trail, a branded and contract whiskey producer based in KY, valuing the business at $600MM (10.5x Est. FY22 Rev. and +16x Est. FY22 EBTIDA) a very high multiple, but it was also announced that Wilderness Trail had inventory with a book value of $24MM as of 9/30/22. In a market where aged goods are limited, having the inventory to support projected growth becomes an important factor.

Strategics are also very active, particularly in the white-hot agave and American whiskey sectors. The Campari/Wilderness deal will be one of the headlining transactions of the year, but they also took a minority position in flavored whiskey brand Howler Head in Aug '22. Others have been active as well; EJ Gallo has been quickly expanding their spirits division taking a minority share in Horse Soldier Bourbon and acquiring Casa Komos group of super premium tequila and mezcal brands. Diageo made several agave-based additions with 21 Seeds and Lone River Ranch Water while just recently announcing the acquisition of Texas-based whiskey company Balcones Distilling. In early FY22, Heaven Hill acquired the Sampson & Surrey group of brands including Widow Jane, FEW Spirits, Tequila Ocho and Vago line of mezcals. Thus far 2022's themes are clear: agave-based brands and American whiskies are on trend, especially in the premium / super premium price point, and buyers are actively looking for the right targets to bring onboard.

TRUIST

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