# Regional analysis
# Beer industry

## Strong profitability and cash flow profile

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# Industry highlights

Bloomberg Adria

While it may seem that traditional industries producing non-discretionary consumer products such as beer have not had a turbulent last couple of years, that is definitely not the case and beer producers across the region also had its own set of challenges arising from the global pandemic and novel industry trends. In this report, we are going through the business performance, strategy and market positioning of the largest beer players, and we are not looking into craft beer industry given the magnitude of their business model difference and financial results.

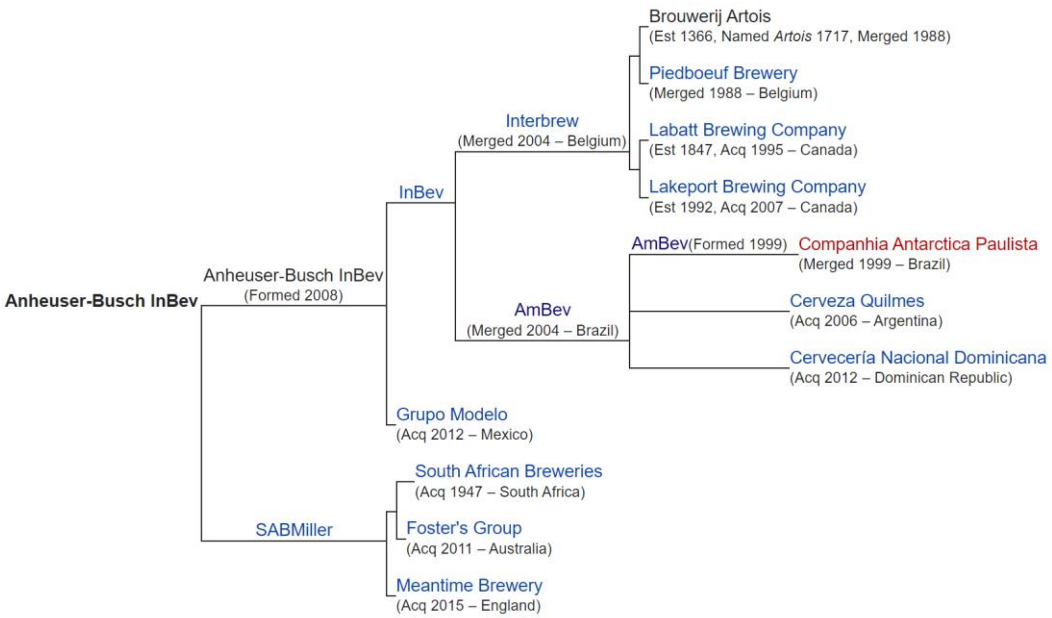
Before we jump to the present-day challenges, in order to understand current developments, it is important to display certain historical characteristics, which differentiate the beer industry from other consumer product industries. **Beer industry is one of the most globally consolidated industries in terms of market share driven primarily by one simple explanation; beer is a low-priced, bulky product that needs to be produced geographically near the end-consumer in order to benefit from low logistics cost and enjoy favourable unit economics.** With that being said, beer industry consolidation was under way as long as the industry exists. Take for example AB InBev - the exhibit on the right perfectly highlights a number of mergers and acquisitions taken place in the last couple of decades, which resulted in the creation of the largest beer producer in the world, both in terms of volume and sales. In fact, **6 out of 9 companies from our list of regional breweries are subsidiaries or joint ventures of global conglomerates such as Molson Coors, Heineken, Carlsberg and Coca Cola**. In order to penetrate international markets, large beer producers had a choice between making a greenfield or brownfield investment. Due to the strong local brands already being embedded in the local cultures and drinking habits, their decision-making process was quite obvious and brownfield investments were supported by the presence of local beer brands alongside brewery plants. The financial implications of such decisions and whether that was the right choice will be discussed later, within the peer comparison section of the report.

**What is also unique and quite peculiar to the beer industry is the relationship between beer producers. In certain markets they do not compete against each other, instead they cooperate**. AB InBev and Molson Coors are the two largest beer producers in terms of market share in the USA, where they fiercely compete against each other. However, **Zagrebačka pivovara (a subsidiary of Molson Coors), in our markets has a licence for brewing and bottling AB InBev's beer brands such as Stella Artois, Becks, Corona and Leffe**. In Serbia, Carlsberg has a licence for brewing and distributing AB InBev's Budweiser beer.

***Trends***

**Global COVID-19 pandemic has only accelerated the inevitable, which is a shift towards aluminum can packaging.** Normally, the beer industry has additional packaging-related manufacturing complexities. Since the sale of their products occurs through two different streams, being on-premise (HoReCa) and off-premise (supermarkets, convenience stores), manufacturing of products had to be adjusted accordingly. On-premise channel favours glass-bottled beer, while the off-premise channel favours aluminum can beer. Pandemic-related shift of beer consumption from on-premise to off-premise channel, for obvious reasons, was accompanied by the higher demand for aluminum can packaging.

## AB InBev transformation




Source: Wikipedia

# Industry highlights

Aluminum cans have many benefits compared to glass-bottled beer. **For retailers, it means easier handling, with lower risk of breakage, lower occupation of shelf space and lower electricity costs in order to cool the beer. For producers, cans offer more advertising space to distinguish their brand with attractive designs, and lower transport costs due to cans being lighter than glass bottles. In general, for society, aluminum is a preferred form of packaging due to its natural characteristics allowing indefinite recycling**. Given the accelerated shift towards aluminum packaging, Zagrebačka pivovara (Cervesia) has invested EUR 8.5m in a new assembly line for filling 40.000 0.5l cans per hour, which represents a capacity increase of 4x compared to previous levels. In addition, it allows packaging in sleek cans, as well as packaging in formats of 8-12 multipacks, instead of traditional 4-6 multipacks. All of which comes from the needs and requirements of retailers, following consumer habits.

Supply chain bottlenecks driven by COVID-19 have resulted in increased prices of aluminum, which was additionally fuelled by the Russian aggression in Ukraine and related sanctions towards Russia, which accounts for ~6% of global aluminum capacity.

Release of COVID-19 measures which went viral across EU and US has influenced a recovery of HoReCa and healthier sales split for beer producers, however, again there was a huge demand shift in favour of glass bottles at the expense of beer producers, that had another cost spike fuelled by both demand and supply side (rise of energy costs and, hence production costs). On the supply side, i.e., rising production costs across all industries has resulted in higher input-costs for beer producers as well, with increased prices for key raw materials such as malt, barley and hops. The real impact of cost-inflation is only to be seen going forward, in their 2022 annual reports, which are yet to be published.

**Another thing distinguishing off-premise from on-premise channel is the distribution model. On-premise channels are usually organized through a three-tier distribution model, encompassing beer producer, distributor and HoReCa.** Despite having a middleman in placement of their products towards HoReCa due to complex logistics, beer producers are able to obtain better margins at the expense of end consumer, who is willing to pay higher prices for out-of-home consumption. Vertical integration of beer producers is a rare case. In the Adria region we have an example of Pivara Skopje, and Cervesia with an incomplete vertical integration via ownership of Tia Partner. Tia Partner currently operates only in certain parts of Croatia, thus Cervesia/Zagrebačka pivovara is forced to sell to other distributors such as Roto dinamic. Looking at standalone financial statements of Tia Partner, it is obvious why vertical integration is rare in the industry. Distribution is a low-margin business, often unprofitable without a certain scale. In fact, Tia Partner has not delivered profit in the last two years, while in the pre-pandemic period they had profitable years, however, with low single-digit returns on invested capital. That is not to say that the distribution industry does not offer the potential of healthy returns on invested capital, however, it does require significant investments in order to reach the scale necessary to produce such returns. As an example, Roto dinamic as a market leader in Croatia has achieved 20% ROIC in 2021, despite the still on-going pandemic-related difficulties. Distributors have ample negotiating power against HoReCa due to HoReCa's high fragmentation.

**Unlike on-premise, off-premise is usually characterized by the two-tier distribution model, that is, beer producers selling directly to retailers.** Despite not having middleman, retail offers lower margins for beer producers due to lower prices for off-premise purchases, frequent promotions, and highly consolidated market share of retailers, thus impacting negotiating power. Nevertheless, beer producers are able to achieve much higher margins with retailers than other consumer staple businesses due to their supremacy and oligopolized industry in which 2-3 producers often control 70-80% of the market share.

# Peer comparison



We have focused our peer analysis on two largest companies from each country of the region based on sales criteria, with the exception of Slovenia where second largest brewery has a sales amount below EUR 1m, thus below the necessary threshold for the sake of comparability.

**On average, our peers got hit by COVID-19 resulting in a 13% sales decrease. For non-discretionary consumer staples business, double-digit sales decline, followed by the 5pp median EBIT decline can be considered as annus horribilis**. All the companies from the list have material exposure to the on-premise channel, which was one of the worst positioned business streams during COVID-19. Companies from Croatia, Cervesia and Heineken Hrvatska have, on average, suffered the most in the region due to their significant exposure to tourism activity. The pandemic year has not just affected their volumes due to less arrivals, but also their pricing. Tourism is virtually an export industry which allows them to charge higher prices due to greater purchasing power of tourists coming predominantly from countries such as Germany, Austria, Netherlands and Italy. Effect of operating leverage working against them, i.e., allocation of fixed costs onto a lower volume level, together with negative pricing effect, has manifested in EBIT margin decline of almost 4pp in case of Cervesia, and up to 8.8pp in case of Heineken Hrvatska. **In the following year after COVID-19, all the companies from the list displayed healthy growth rates and a successful recovery. Although, cumulative sales amount has lacked the one achieved in 2019** for the obvious reasons of still largely present COVID-19 measures in certain periods of the year.

**Breweries from Serbia are the only ones from the list whose recovery in 2021 resulted with sales numbers above the ones achieved in the pre-pandemic year.** Volumes in 2021 were definitely lower in all the countries of the region since COVID-19 measures were still active, however, it seems like that higher prices in Serbia managed to offset the negative volume effect, which then resulted in higher sales number. On top of increased sales, Carlsberg Srbija managed to increase their margins as well. More surprising is the fact that Carlsberg Srbija managed to achieve higher yoy margins in 2020, despite the 7.8% sales decline primarily due to savings generated on cost of services and cost of employees.

**Net debt/EBITDA indicator implies that peers in general have an excess of cash and, thus, low indebtedness.** If we look at other credit indicators, the conclusion remains the same. However, 6 out of 9 selected companies are majority owned by global conglomerates such as Heineken, Carlsberg and Molson Coors, with cash pooling arrangements set in place, i.e., a central cash/treasury management function whose task is to move cash around between group's subsidiaries based on operational requirements. Even when that is not the case, **every transaction related to receiving or extending loans, acquiring or divesting a business/segment needs to be in line with group policy and approved by the group treasury department**. On a consolidated level, these conglomerates have quite exorbitant debt levels with net debt/ EBITDA indicators exceeding 2x, thus, local Management often has its hands tied in terms of decision making related to external financing.

| Company name | Sales EUR in millions | | | Sales growth % | | | EBITDA margin % | | | EBIT margin % | | | ROE % | | | ROIC % | | | Net debt/EBITDA | | | CCC in days | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2019 | 2020 | 2021 | 2019 | 2020 | 2021 | 2019 | 2020 | 2021 | 2019 | 2020 | 2021 | 2019 | 2020 | 2021 | 2019 | 2020 | 2021 | 2019 | 2020 | 2021 | 2019 | 2020 | 2021 |
| Cervesia | 202.4 | 174.1 | 195.1 | 4.9 | (14.0) | 12.1 | 29.9 | 26.8 | 27.3 | 22.0 | 18.2 | 19.8 | 11.8 | 7.9 | 9.4 | 11.8 | 7.9 | 9.4 | (0.7) | (1.5) | (1.1) | (52.1) | (126.0) | (144.2) |
| Heineken Hrvatska | 83.9 | 66.0 | 81.9 | (9.0) | (21.3) | 24.0 | 22.9 | 18.0 | 23.1 | 11.9 | 3.1 | 12.1 | 14.8 | 2.5 | 15.2 | 12.5 | 2.5 | 12.9 | 0.3 | 0.9 | 0.0 | 27.9 | 48.9 | 50.1 |
| Pivovarna Laško Union | 156.5 | 145.6 | 165.6 | 2.2 | (7.0) | 13.7 | 28.5 | 22.1 | 19.6 | 21.3 | 14.1 | 13.3 | 34.8 | 25.0 | 29.8 | 9.0 | 6.8 | 8.0 | 2.5 | 2.3 | 2.5 | (43.0) | (91.0) | (84.0) |
| Heineken Srbija | 96.7 | 91.0 | 102.8 | 5.2 | (5.9) | 13.0 | 24.2 | 20.7 | 21.5 | 16.2 | 11.8 | 13.5 | 28.1 | 15.3 | 21.9 | 25.4 | 14.7 | 21.8 | (0.5) | (0.5) | (0.6) | 9.3 | (2.2) | 17.2 |
| Carlsberg Srbija | 93.6 | 86.3 | 99.5 | 5.6 | (7.8) | 15.3 | 11.3 | 13.5 | 14.3 | 2.4 | 4.2 | 6.5 | 3.0 | 5.6 | 12.3 | 2.7 | 5.5 | 12.1 | (0.1) | (0.4) | (0.8) | 153.2 | 6.8 | 6.7 |
| Prilepska Pivarnica | 30.1 | 26.0 | 26.9 | 0.7 | (13.6) | 3.5 | 10.5 | 16.0 | 14.2 | (0.0) | 4.6 | 4.7 | 1.0 | 4.0 | 4.3 | (0.0) | 3.2 | 3.4 | (3.5) | (0.7) | (3.9) | 103.1 | 128.4 | 126.4 |
| Pivara Skopje | 86.4 | 73.2 | 80.1 | 27.3 | (15.3) | 9.4 | 25.6 | 26.8 | 27.8 | 20.9 | 20.4 | 22.1 | 24.1 | 17.6 | 23.3 | 32.2 | 27.3 | 31.9 | (0.1) | (0.2) | 0.1 | (18.2) | (35.0) | (33.8) |
| Banjalučka pivara | 23.8 | 20.5 | 20.0 | 3.2 | (14.1) | (2.3) | 16.1 | 24.1 | 18.3 | 3.4 | 8.9 | 1.8 | (0.5) | 5.1 | (3.0) | 1.6 | 4.7 | 0.7 | 3.1 | 2.1 | 3.7 | 86.6 | 99.9 | 122.4 |
| Sarajevska pivara | 15.5 | 11.6 | 11.7 | (13.5) | (25.0) | 0.4 | 16.5 | 22.1 | 24.0 | 4.6 | 6.6 | 12.2 | 0.1 | 0.1 | 0.1 | 1.5 | 1.6 | 3.2 | 3.2 | 2.6 | 1.9 | 73.9 | 133.7 | 104.4 |
| **Average** | **87.7** | **77.1** | **87.1** | **3.0** | **(12.0)** | **12.9** | **20.6** | **21.1** | **21.1** | **11.4** | **10.2** | **11.8** | **13.0** | **9.2** | **12.6** | **10.7** | **8.3** | **11.5** | **0.5** | **0.5** | **0.2** | **37.9** | **18.2** | **18.4** |
| **Median** | **86.4** | **73.2** | **81.9** | **3.2** | **(14.0)** | **12.1** | **22.9** | **22.1** | **21.5** | **11.9** | **8.9** | **12.2** | **11.8** | **5.6** | **12.3** | **9.0** | **5.5** | **9.4** | **(0.1)** | **(0.2)** | **0.0** | **27.9** | **6.8** | **17.2** |

Source: Company financial statements, Bloomberg Adria analysis

Bloomberg Adria

***What is the proper return on invested capital for Cervesia?***

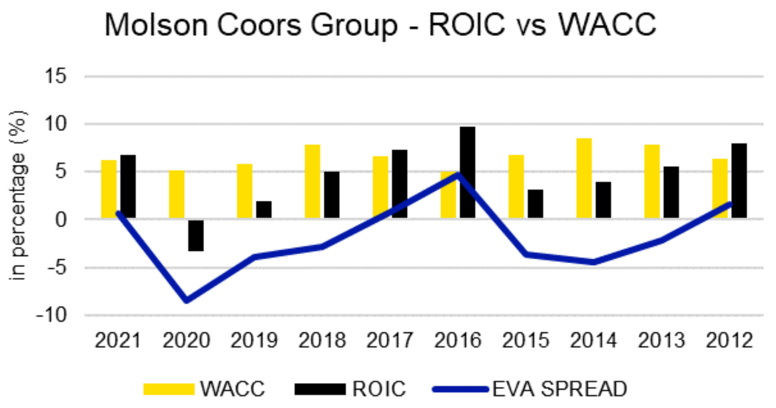
Some financial analysts argue that goodwill should be excluded from the ROIC calculation because it has nothing to do with the underlying business and capital invested in it. While there is some truth in that, we argue that goodwill, as a result of acquisition (i.e. premium paid over net book value), augments market share and without an increased market share, margins of the underlying business would not be the same, and therefore, should be adjusted. However, quantifying the adjustment of the effect on margins is an almost impossible task**. We believe goodwill should not be excluded from the ROIC calculation. Also, it serves as a great yardstick to gauge the Management's capital allocation skills.**

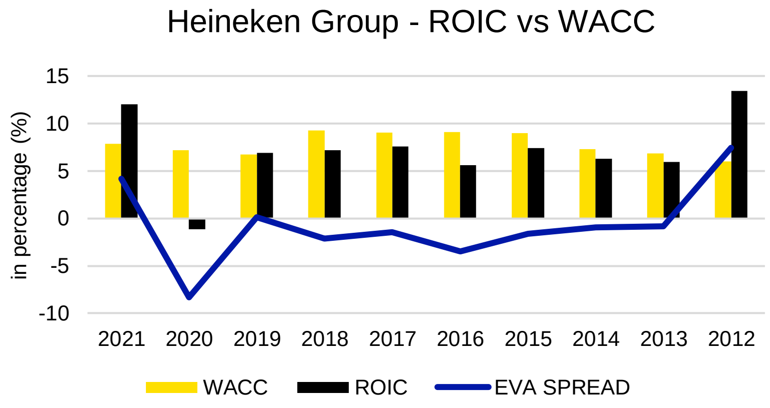
Having said that, an average return on invested capital of 9.7% for the period 2019-2021 means that Cervesia is barely covering its weighted average cost of capital and, thus, not creating any additional economic value. Have a look at charts showing comparison of ROIC with WACC, on a group level for Heineken and Molson Coors. Here you have a great business with global domination in one of the most beloved consumer products, double-digit market share in their respective markets, with high-teen EBIT margins and inventory turnovers of several times a year (8-10x in case of Molson Coors). **Still, they deliver returns on invested capital below 10% a year. The math doesn't sound right, but the answer lies in the expensive acquisitions they were making over their lifetime in order to achieve global domination**. It serves as a great example that acquisitions are more often than not a money incinerating activity, whose returns on capital are generally below the cost of capital, thus destroying in lieu of creating economic value for the company. In the case of both Heineken and Molson Coors, goodwill represents over a quarter of their invested capital.

On top of goodwill, there are other particularities that need to be assessed in order to have a clear picture of the financial performance of Cervesia's business. Their annual report was signed off by the auditor with qualified opinion, which means that certain accounting treatments are not in line with IFRS/IAS. In the case of Cervesia, it is their treatment of useful life of PP&E that is not in line with IAS 16. According to auditors, their equity is understated by ~ EUR 17m and profit before tax is understated as well in the amount of ~ EUR 55k in 2021. These adjustments result with the adjusted ROE and ROIC of 9%, which is better than Molson Coors group ROIC, therefore Croatian subsidiary is positively contributing to consolidated accounts. The same thing can be said for both Heineken Hrvatska and Heineken Srbija, which means that **doing business in the Adria region is lucrative for world's largest breweries. As for why is that the case, there are many eventual factors influencing such as lower effective income tax rate, difference in market share, lower product diversification resulting in lower invested capital, greater exposure to on-premise channel with higher margins, lower consolidation of retailers affecting their bargaining power, etc.**

| EUR in millions | Cervesia | Molson Coors Group | Heineken Group |
|---|---|---|---|
| Invested capital | 327 | 20,349 | 39,129 |
| Goodwill | 268 | 5,404 | 11,810 |
| **Goodwill as % of invested capital** | **81.8%** | **26.6%** | **30.2%** |

Source: Bloomberg, Bloomberg Adria analysis

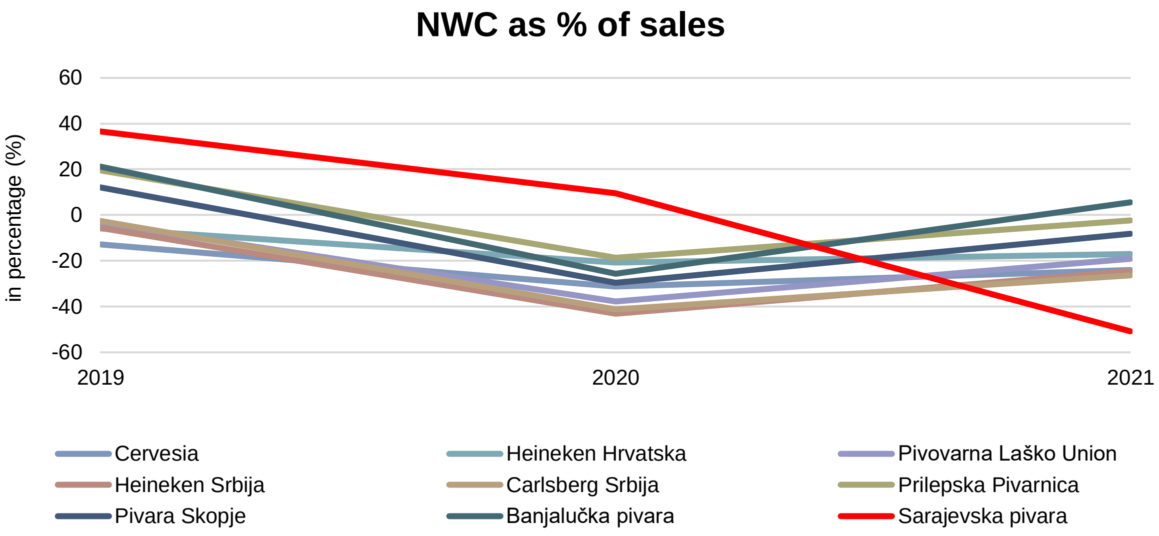


# Peer comparison

Pivara Skopje can be considered as an outlier on the peer list since it has the most specific ownership structure, the widest portfolio of products and the most dominant market position. **Pivara Skopje is a joint venture between Heineken and Coca-Cola HBC. Thanks to the ownership structure, Pivara Skopje has the most powerful basket of brands including both Coca-Cola brands such as Coca-Cola, Fanta, Sprite, Fuze tea, and Heineken owned brands such as Heineken, Amstel, Birra Moretti and Laško**. That powerful combination is combined with premium spirit brands such as Macallan, The Famous Grouse, Brugal and local beer brand Skopsko. **Considering the portfolio of products, it doesn't come as a surprise the fact that Pivara Skopje has achieved the highest return on invested capital of 32% in 2021**. Unlike many players in the region, Pivara Skopje distributes their own products independently. Given the size of their brands portfolio and over 10 distribution centers throughout Macedonia, it is probably the largest beverage distributor in the country, allowing it to achieve economies of scale effects discussed previously in the report and additionally improving their margin profile. **Another reason for such an outstanding ROIC percentage is definitely their negotiating position, which allows them to achieve a negative cash conversion cycle. Their net working capital is negative, thus lowering their invested capital amount**. Driving their negative net working capital is the average days payable of 107 days, alongside swift cash collection (28 days) and successful just-in-time inventory management (45 days of inventory). It makes them a rare example in the region, alongside Cervesia and Laško Union with negative CCC. In the case of Cervesia, the average days payable to suppliers amounts to 220 days. Nothing explains better their bargaining power over suppliers than those outrageously high AP days.

**Pivovarna Laško Union has the largest share of sales generated from foreign markets, averaging 30% over the past 3 years**. However, the majority of foreign market sales are towards group companies. That perfectly throws light on the second largest sales amount, despite the fact that Pivovarna Laško Union comes from the second least populated country of the region. Also, Slovenia having the highest economic standard in the region allows Laško Union to achieve the highest sales per unit amount on the 70% of sales generated domestically, which is another reason for Laško Union being the second largest brewery in the Adria region, in terms of sales.




Source: Company financial statements, Bloomberg Adria analysis

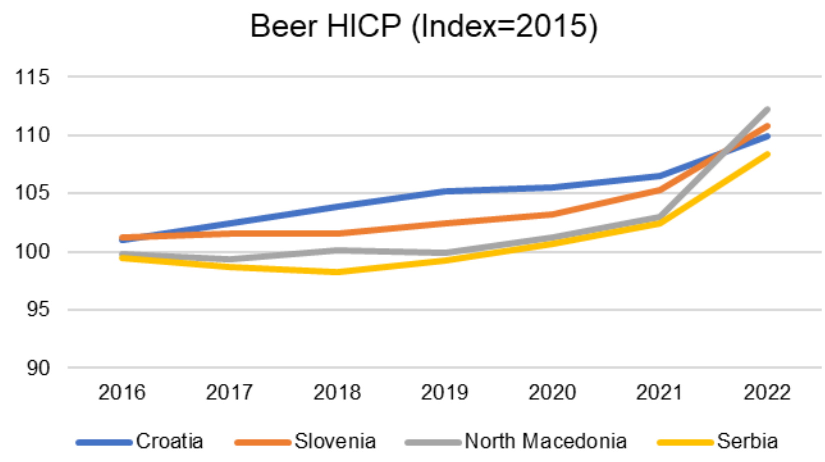
**B&H market is being dominated by imported beer from Croatia (Molson Coors BH – a subsidiary of Cervesia/Zagrebačka pivovara), Slovenia and Serbia. Therefore, Banjalučka and Sarajevska pivara are displaying mixed performance, with financial indicators being below the peer average. Sarajevska has been struggling financially over the last couple of years mainly due to exaggerated debt levels, with interest expense eating a significant portion of their operating profit**. With regards to NWC as % of sales, Sarajevska pivara has the lowest net working capital amount driven largely by the tax liability within other payables. However, their CCC is the highest among peer group, thus indicating poor working capital management practice. In general, average NWC as % of sales is negative (-5.6%) at year-end 2021 for the peer group, demonstrating prudent working capital management skills and potent position of beer producers compared to suppliers and customers.

# Outlook

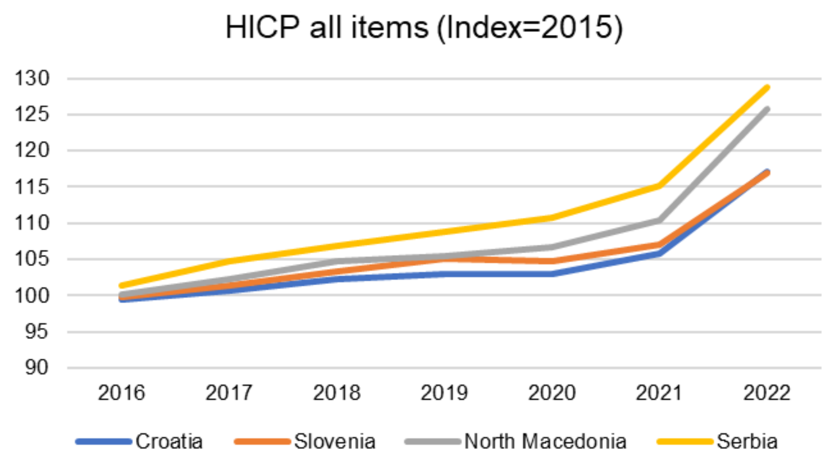
**Unfavourable macroeconomic environment by means of rising interest rates, high inflation and consequently decline of real disposable income will inevitably affect financial performance of beer producers.**

**Recessionary environments result in adverse changes of product mix and placement mix of beer producers. Consumers tend to lean towards lower priced beer and towards off-premise purchases. Both activities result in margin decline since both lower priced beer and off-premise sale have lower gross margin.** People reduce their go-out activities to bars and restaurants, there are less gatherings in the form of barbecues and celebrations - all of which results in a decrease of on-premise sales. To some extent, on-premise sales are replaced with off-premise sales, but not completely. Furthermore, beer producers such as Cervesia and Heineken Hrvatska with significant exposure to Croatian tourism will face additional challenge with tourism activity not expected to grow at the same momentum as in 2022 i.e. post-COVID rebound, and a stagnation is more likely a base scenario. **That is not to say that the decline of financial performance will be double-digit. We project at most a 1-2pp decline in margins over the course of 2023.**

Let's not forget the base effect as well, since 2022 will be an important year for beer producers. Notwithstanding the fact that we have not yet seen the numbers for 2022, high inflation and producers' ability to transfer the cost-inflation to consumers (exhibit shows that beer producers were quite successful in passing over the inflation onto the beer prices), together with warm weather, strong tourism activity and World Cup in football, have inevitably resulted in a pleasing financial performance.




Source: Eurostat, Bloomberg Adria analysis




Source: Eurostat, Bloomberg Adria analysis

# Outlook

As for the long-term, we are convinced that the beer industry in the Adria region will keep the status-quo in the following 5 years. Subsidiaries of global producers dominate the market and hardly anything could materially change that in the future.

While the **increase in economic standard tends to be followed by increased consumption of craft beers**, which we are witnessing in the western countries **– we, surprisingly, think this may positively affect legacy players. They have the economic power to either invest in craft breweries and marketing activities to build craft beer brands, or to acquire a rising craft beer producer.** As an example, Molson Coors group already has a craft beer division, alongside 10 craft breweries in the Americas and 7 craft breweries in Europe. **Therefore, consumers' shift towards more premium beers will - in our opinion - positively impact breweries' margins in the long-term.**

Moreover, some players in the region still have an untapped potential of portfolio expansion and diversification with other alcoholic and non-alcoholic beverages such as soft drinks, hard seltzers, ciders and spirits. Products portfolio extension can further increase their volumes and pricing power, thus impacting top and bottom-line P&L.

**Rising market share of discount retailers and their preference for private label products should not have a material adverse impact for beer producers, despite the fact that our region has relatively lower economic standard compared to the western countries. Data shows that beer has the lowest share of sales among the private label categories.** Those numbers act as a scarecrow for retailers investing in private labels.

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