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CONSOLIDATION AND CONCERNS

The purpose of this “IBG update” is to discuss our view of the current state of consolidation and issues concerning the direction of our traditional three-tier business model. We travel the country visiting distributors and suppliers, speaking at events, working retail and listening to all points of view. We have completed more buy/sell/merge transactions than anyone in the beer industry. We do not profess to have all the answers but feel we can present an educated, experienced, independent view that stimulates thought.

Current State of Consolidation: Distributor consolidation has slowed. Below are several reasons consolidation is not moving as rapidly as in the past. IBG has always believed that it takes both pain and pleasure to accomplish consolidation and there is no real pain at present at this time.

1. **Profits:** Beer distributors are currently experiencing solid profitability. This is primarily because beer prices have increased, discounting is under control, the industry is enjoying the rewards of past consolidation at the distributor and supplier level and everyone has done a great job managing cost. Most markets are now duopolies at both levels. This symbiotic environment has been good for profits and industry value. However, spirited competition is one of the main ingredients that makes anything better and we do not see the level of competition required to cause the risk-taking necessary to drive improved growth and profits in the future. Instead of working to win consumers, a significant amount of our industry’s volume appears to be trying not to lose very many. Contrast the big suppliers with the craft suppliers and you see the impact of competition. Craft people are very passionate, aggressive, creative and innovative and they are generating excitement and growth. Large suppliers appear most concerned about capturing synergies and reducing cost. Competition creates growth, growth creates profit and profit creates value.
2. **Prices:** The “value bubble” we talked about in late 2008 still exists. Selling prices of distributorships have not come down. In fact, in certain situations values have risen. In the

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past MC wholesalers were guaranteed approval of whatever brands were available because most ABI wholesalers were encouraged to be exclusive. Now, primarily driven by competition from ABI distributors, brand prices often escalate to very high levels. However, brand prices should not be confused with the value of a total business. From a cost to service standpoint they are two entirely different scenarios. While buyers and banks are cautious, they both continue to support premium prices. There are fewer sellers because distributors are making a lot of money and more buyers because interest rates are low. This makes it a sellers market. IBG has spoken with banks, distributors, suppliers and other transaction companies and it is our conclusion prices are likely to remain high for the next 18 months unless something significant occurs. With the buy/sell/merge process required by certain supplier contracts it takes a lot of time and experience to obtain a price that maximizes value for the seller and at the same time works for banks and buyers.

3. **Pressure:** Since the MillerCoors merger, and the flurry of legal activity that followed, their success at consolidation appears to be slowing. ABI has never really tried to implement a distributor consolidation strategy other than getting all their brands to their traditional network. They have recently stated they want more consolidation and are willing to identify distributors they want to be buyers but will not directly tell anyone they want them to sell. Since ABI does not have the appetite to encourage sellers, and MC is less aggressive, few distributors feel the need to change. Major suppliers have been focused on taking cost out of their own systems but will eventually get back to reducing redundant cost through consolidations.
4. **Partnerships:** More and more IBG is working with distributors who are willing to consider becoming partners with other distributors. In fact, we have completed several mergers recently. Partnerships/mergers/J.V.'s are hard to put together and frequently leads to one selling to the other. This process is slowing down consolidation to a certain degree. There are several reasons for this change in attitude but people seem to think that being a smaller part of something bigger and more profitable is better than leaving the industry. Another cause is the fact that once you sell out there is no real place to invest your money safely or with a better return.

Consolidation Conclusion: Consolidation has slowed because profits are good and there is little supplier pressure. At this moment distributors have no compelling reason to sell and no safer place to invest their wealth. There still exists a price gap of at least 20% between buyers and sellers with sellers having the upper hand. Buyers are able to pay premium prices because of low borrowing cost. Until something big happens IBG feels the pace of consolidation will continue to be slow. This slow down in taking cost out of the system is not without risk to the equity value of distributorships. Just because someone wants to continue

the status quo does not mean the world around them is not changing. Other participants in D.S.D. systems: suppliers, soft drink bottlers, wine/spirits distributors, retailers and others continue to aggressively look for ways to improve their business. IBG's fear is that consolidation continues its slow pace and distributors reduce cost by cutting services and brand building activities. This would slowly erode the value-added benefits of beer distributors and eventually the equity value of distribution rights.

Concerns For The Traditional Three-Tier Model: There are many potential events outside a distributor's control that could have a dramatic influence on how the three-tier model looks in the future.

1. **Structural:** We believe that the beer distribution system is better than other systems in terms of its ability to sell, deliver, nurture and care for products. Beer distributors are and have always been more consistent at merchandising, pull-up, rotation, local events, local marketing and overall service. However, in the past few years several distributors have been moving away from being value-added and becoming more like low cost logistics companies. IBG sees markets where distributors are losing their ability to add value because they have so many sku's they can't do any of them justice. Some are becoming businesses living on past performance that are being paid for something they no longer provide. Logistics companies do not get paid beer distributor margins. Brand builders, creative local marketers and the best service providers do. As an industry, are we reducing cost at just the wrong time in just the wrong way? As the middle of the three-tier system are distributors earning the margin they are paid or are they becoming replenishment systems? Are suppliers and retailers looking at the relationship between distributor performance and distribution margin? We realize that many distributors are still brand builders that provide great service but a chain is no stronger than its weakest link.
2. **Supplier Consolidation:** Craft suppliers will consolidate at an accelerating rate in order to gain distributor/retailer influence, and to improve their overall financial performance. In a declining industry you must reduce cost and grow revenue if you want to improve profitability. Once major suppliers have captured all the savings within their direct sphere of influence they will be forced to look at areas they may not have focused on in the past to grow profits. Craft brands and distributor margins could become attractive targets. If/when big suppliers go after distributor margins and craft brands it will cause consolidation for both to accelerate.
3. **Competitive Systems:** Warren Buffet (Berkshire Hathaway) owns McClane Trucking, Burlington Northern Railroad and Empire Distributing. We do not think these events are unrelated. IBG thinks some very smart people are trying to figure out a more efficient method of getting bulky beverages from supplier to consumer. Coke and Pepsi are looking to add anything, except competitive soft drinks to their trucks in order to improve

bottler profitability. If you are Pepsi would you rather share warehousing and delivery with beer or a competitive soft drink? Several craft brewers are looking to self distribute or adjust franchise laws so they can change distributors more easily. Ask yourself why and then calculate the amount of time your salespeople have per week, per account, per sku to “sell and develop” a brand. Retailers, specifically 7-11 and Costco, are constantly seeking changes to beverage distribution. Keep in mind that ABI, MC, and Pabst all have extensive experience with direct sales, either here or abroad. We are not suggesting that they would go direct, only that they know how. Our three-tier model has more competition than most realize.

Three-Tier Conclusions: The current direction of our three-tier model concerns IBG. We see some distributors and suppliers raising prices, cutting service and working less at brand building. Are distributors slowly destroying the equity value of their businesses by being less “value-added” to suppliers and retailers? When was the last time you attended a meeting about value-added service and how long since you met to discuss cutting cost? IBG is all for reducing cost but some of the savings should be reinvested in growing equity value. If we become too self oriented we could face drastic changes rather than gradual adjustments. IBG totally believes the three-tier distribution model is better than any other system and has proven its value. We need an honest self appraisal about what we offer for the future. The historical three-tier business model may not be broken but it could use a tune-up.

SUMMARY: We believe if distributor profits remain high consolidation will remain slow. Prices for distribution rights have never been higher but if volume continues to creep lower, profits decline or interest rates begin to rise the price of distribution rights will most likely go down. Supplier consolidation is gaining momentum, particularly at the Craft/Import level, and this will add friction to our industry as winners and losers are redefined. IBG believes we are in the calm before the storm in terms of consolidation at the craft supplier and distributor levels. We fear that our traditional three-tier model may be forced to make sudden and dramatic changes rather than voluntarily adjusting. A status quo strategy is becoming more and more risky. We believe distributors in the future will be much larger, sell more beer but make less per case. If you are not prepared to buy and get much larger or do not see yourself in the industry long-term you should carefully examine your options. Prices, interest rates and taxes are optimal for sellers and buyers are available. History tells us this window of opportunity will not last forever.

IBG is the leader in beer industry consolidation. If you are considering a buy/sell/merge transaction give us a call. We work hard to get results for our clients. References are available upon request.

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