



## THE BENEFITS OF CONSOLIDATION

September 2010

### CONSOLIDATION AND CONCERNS

The purpose of this “IBG update” is to discuss our view of the current state of consolidation. We will also discuss several concerns we have and the potential impact they could have on the three-tier system. We travel the country visiting distributors, work with suppliers, speak at events, work retail and listen to all points of view. We do not profess to have all the answers and certainly can’t accurately predict the future. What we can do is present an educated, experienced, independent view that we hope stimulates creative insight that results in positive change.

**Current state of Distributor Consolidation:** Distributor consolidation has slowed in the past year. Most people predicted that due to tax changes coming in January, 2011 that consolidation would gain momentum. This is not occurring. We think there are several reasons the pace has slowed.

1. **Profits:** Beer distributors as a whole are currently experiencing solid profitability. This is due to the fact that beer prices have increased, discounting is not bad, distributors are enjoying the rewards of past consolidation and have done a great job managing overall cost. While this dynamic of raising prices while cutting cost has hurt volume, it has not hurt it enough to negatively impact profits. We think very soon our volume declines will begin to erode distributor profitability. Most markets are now duopolies for distributors. While this environment has been good for profits it seems to have taken some of the competitive spirit and passion out of our industry. IBG is a firm believer that competition has been one of the main ingredients that made our industry great. We do not see the level of risk taking or investment necessary to drive future volume growth. Instead of winning, we appear to be trying not to lose.

2. **Prices:** The “value bubble” we talked about in late 2008 still exists. The fact is that selling prices of distributorships peaked in the fall of 2008 and have not come down. What is different is that buyers are no longer willing to pay 2008 prices. There are still a few strategic transactions occurring but the feeding frenzy from buyers willing to chase acquisitions is over. Buyers still pay premium prices but are willing to walk away and take their chances later.
3. **Pressure:** Since the MillerCoors merger, and the flurry of activity that followed, the effort from suppliers to push consolidation has been reduced. ABI has never really tried to implement a distributor consolidation strategy other than getting all their brands to their traditional distributors. Since neither ABI nor MillerCoors currently has the appetite to push their respective distribution systems to consolidate, and profits are good, no one feels the need to change. Simply put, there is no pain.
4. **Partnerships:** More and more IBG is working with distributors who are willing to become partners with other distributors. In fact, we have completed several mergers this year. Partnerships/mergers/J.V.'s are hard to put together and this new trend is slowing down consolidation to a certain degree. There are several reasons for this change in attitude but at the end of the day people seem to think that being a smaller part of something that is 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 good return.

**Consolidation Conclusion:** Consolidation has slowed because profits are good and there is less supplier pressure. Therefore, distributors have no compelling reason to sell. There still exists a value gap of at least 20% between buyers and sellers. Until something bigger than increases in capital gains taxes happens IBG feels we will muddle along with consolidation. However, this slow down in taking cost out of the system by eliminating redundant cost is not without risk. Just because beer distributors are trading water does not mean the world around them is not changing. Other participants in three-tier systems: suppliers, soft drink bottlers, wine/spirits distributors, retailers and others continue to aggressively take redundant cost out of their systems. IBG's fear is that consolidation slows and distributors reduce cost by cutting services and brand building activities. This would slowly destroy the equity value of distribution rights. Our distribution model would then be more expensive than other three-tier systems and not that much different from an execution standpoint. We run the risk of becoming a logistics system not a value-added selling system. If other distribution systems are capable of handling beverages at less cost, even if not as good, products will gravitate to them. In today's economic environment the low cost provider may be viewed differently in the future than in the past. We fear the historical three-tier distributor model that was based on volume growth and brand building is being replaced with a new model of margin growth and make as much money as you can as fast as you can. The suppliers, consumers and retailers of tomorrow could be forced to look outside beer distributors for a lower cost system because distributors would have slowly given up several points of differences.

## Future Concerns for Industry

- 1. Structural:** We know that the current beer distribution system is better than other systems in terms of its ability to nurture and care for products. Beer distributors are more consistent at merchandising, pull-up, delivery, local events, local marketing and overall service. Beer distributors are a fixture in most markets. But, other beverages have lower cost distribution systems. While some can't handle beer very well they are trying to learn. The current situation with Costco in the state of Washington is frightening because they are trying to make it a consumer issue. If they succeed, and IBG is concerned, look out for others to do the same thing. Put yourself in the consumer's position. If they can buy beer \$1.00 per case cheaper just by letting Costco buy direct why would they not be willing to give them a chance? IBG understands and supports the industries arguments. But, are we pricing our products too aggressively? Are we reducing service at just the wrong time in just the wrong way? Retailers are constantly looking for ways to reduce their cost in order to better accommodate their shoppers.
- 2. Supplier Consolidation:** Suppliers will consolidate at an accelerating rate in order to gain distributor/retailer influence and economies of scale. They clearly recognize the need to reduce their cost in a declining industry if they are to improve their profitability. Once they have captured all the savings within their direct sphere of influence they will eventually be forced to look at other areas to grow profits. Distributor margins could become an attractive target. This will be simplified if distributors are only replenishment systems. Our industry needs to collectively start investing more in the future. Raising prices while reducing cost is a great short-term way to make money. However, we believe that more money must be invested in growth and less removed for other purposes. IBG believes you will see some suppliers seek unique distribution combinations in the not to distant future.
- 3. Consumers:** Throughout this paper we have expressed our concern about the direction and cost of our distribution system. We are very concerned about our core consumers and their ability to purchase beer in sufficient amounts and at the price points necessary for our industry to grow. Never forget that a substantial majority of our volume is purchased by people making less that \$75,000 a year. At some point our consumers will say "No Mas". Not because they want to but because they have no choice. As an industry are we putting our own short-term interest ahead of our customers? This approach rarely works and always costs more than it is worth. IBG believes our industry needs to look past quarterly or monthly profit and loss statements.
- 4. 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 someone is trying to figure out a more efficient method of getting bulky beverages from supplier to consumer. Coke and Pepsi currently control the majority of their distribution and are looking to add anything, except competitive soft drinks to their trucks in order to improve bottler profitability. Ask yourself, if you are Pepsi would you rather share warehousing and delivery with Budweiser or a competitive soft drink? Currently soft drink bottlers cost of distribution is 15% of sales and beer is

20% of sales on average. Soft Drinks make \$.04 on the dollar and beer distributors \$.08 on the dollar in 2008 and probably more in 2009. Do the math of annual savings on 21 billion cases a year. Wine/Spirits distributors and beer do not seem to integrate very well at this time. But, we better keep an eye on them. 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. This was not true 3 years ago. Be creative at lowering cost and pass some of those savings on to your consumers. Use increased profits to improve retail service because if you don't someone else might.

**Industry Concerns Conclusions:** The direction of our three-tier model concerns IBG. We see our industry raising prices, slowing its effort to reduce redundant cost while cutting service and brand building. Have we become too self focused? Are we destroying the equity value of brand distribution rights? IBG feels that at this time our industry appears unwilling to give enough back to our consumers and retailers. The cost of our great product and services can get so expensive that our customers may seek drastic changes. Remember, selling anything starts with the customer not with the provider. We meet with and discuss other distribution systems and are aware of their interest in selling and delivering beer. The beer three-tier model is the best but sometimes people can't afford the best.

**SUMMARY:** Distributor consolidation has slowed at a time when other distribution systems are consolidating and becoming more efficient. We believe if distributor profits begin to decline consolidation will quickly pickup. Supplier consolidation is gaining momentum, particularly at the Craft/Import level, and this will only add friction to our industry as winners and losers are redefined. IBG believes we are in the calm before the storm. We think that our beer distribution model will change faster moving forward than it has in the past. We hope these few pages create thoughtful discussion about how to improve the beer business in your area.

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. We have more references than anyone because we have been at it longer than anyone.

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