



Consolidation Quagmire

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Wholesaler consolidation is in a quagmire. The entire industry recognizes the need for, and potential benefits of consolidation. However, forces seemingly beyond any single entity's control are impeding the process and the delays may prove costly for all parties. Suppliers are questioning the performance and effectiveness of newly formed multi-brand wholesalers, and multi-brand wholesalers are struggling to perform and be effective. The low hanging fruit was picked in the last few years and what's left are the difficult choices. You can't blame any one supplier. The facts are that in each market the disapproving suppliers feel they are "doing what is right for their brands". One might blame wholesalers but the old problems of emotions and egos appear to be diminishing. In most cases wholesalers have accepted the realities of their situation and are trying to accommodate their supplier's request. You can blame the consultants, banks, or lawyers, but their interests are in closing, not conflict. There is no simple answer for the current pause. The purpose of this article is to create a dialogue that encourages the industry to discuss the current situation. Hopefully, this will lead to solutions that help the consolidation process accelerate to a pace that will lead to a more competitive environment.

Everyone agrees that consolidation creates significant savings. In short the math works. Consolidation creates a potential pot of money for the acquiring wholesaler. Unfortunately, this pot of money too often goes to the bank and not the marketplace. You have suppliers being shown pro formas that demonstrate financial success; but, when the acquiring wholesaler tries to improve retail performance, they realize the money is spoken for. This causes a major disconnect between suppliers and consolidated wholesalers. I understand both the supplier frustration and wholesaler confusion. The suppliers' sales departments were told bigger would be better so their expectations are very high. Wholesalers are shocked by what IBG calls the "Triangle of Terror". Banks with their ratios and restrictive covenants are on one leg of the triangle, suppliers' high expectations are on another leg and aggressive competition and demanding retailers are on the third leg. Should any one of the three sides get too aggressive, the whole structure can collapse. What can happen is ***everyone pulling toward their own self-interest and the wholesaler is slowly torn apart***. As an industry we expect consolidation to create bigger, better performing and more profitable wholesalers, and it can. However, consolidation can fail if not done correctly. In other words it's not what we are doing, it's the way we are doing it. What are a few options that should and should not be considered?

What Should Be Done?

Different Forms of Financing – The wholesale beer business is consolidating on the private debt of wholesalers. Wholesalers are absorbing the debt that goes with being more competitive. I am suggesting that for anyone except the high share system there needs to be a serious look at alternative forms of financing consolidations. Things that come to mind are suppliers co-signing notes with acquiring wholesalers in order to reduce the up front loan covenants and ratios required by lenders. Suppliers might want to take an equity position in wholesalers where legal. Acquiring wholesalers should strongly consider mergers or partnerships, even if they prefer not to. Selling wholesalers should be willing to finance part of the transactions especially in cases where they are obtaining an aggressive price. There are other methods but the point is to help the acquiring wholesaler so he is able to focus on retail performance from day one and not have loan repayment as his number one priority.

Subsidizing the Acquiring Wholesaler – This raises the eyebrows of suppliers. The immediate response is “Why should we help when this makes business sense for the wholesaler?” or “If I help a multi-brand house I am helping my competitor!” These are easy to state but are they really valid when you consider the potential problems associated with not consolidating fast enough? It could be a case of pay now or pay more later. ***The reality for low share suppliers and wholesalers is that they are codependent.*** Consolidation should be a long-term investment for both the supplier and wholesaler. The performance issues raised are normally in the early years. We have already established that the expectations of suppliers and banks are for immediate results, and we can do a better job of pre-planning and early transition. Most suppliers place extensive demands on the acquiring wholesaler before they approve. They use the approval process as a tool to get their wish list of demands integrated into the new entity. I often agree with what they are requesting. In most cases what they demand is necessary for the wholesaler to be competitive and to protect their interest in a multi-brand environment. Most suppliers know what is necessary to succeed with their brands at the wholesale level, but they need to use their knowledge to **assist, not assassinate**, the acquiring wholesaler. What I am suggesting is more support upfront from all suppliers. This can come in the form of POS, manpower, in-store marketing, short-term margin assistance, better credit terms, better discount splits, etc. The list of ways and the amount a supplier can subsidize is virtually endless. The point is to collectively assist up front and allow the new wholesaler to focus more on retail performance. My opinion and experience is that when a consolidated wholesaler gets past the first 6 to 12 months, their performance improves, share of market stabilizes and a high share competitor no longer has an unfair advantage. Consolidation can accomplish its objective. Share growth, profitability and retail performance eventually improve dramatically. One of the keys seems to be assistance up front.

Management with Equity Interest – It has become increasingly clear that **the management of a consolidated wholesaler is critical.** IBG firmly believes that one of the best ways to ensure consistent, qualified and aggressive management is to allow the person running the day-to-day operation to acquire an equity stake in the business. This is difficult for most wholesalers to grasp even though they recognize the need. Businesses that have had exclusive family ownership for years are hard to change. However, the most successful consolidations are the ones that have strong managers, and the ones that struggle have weak managers. This is true of any business but

it is absolutely essential in consolidation. It should be noted that the high share system requires equity ownership for its day-to-day manager. If this industry is to attract the kind of talent necessary to successfully operate these complicated businesses we need to offer more than money. In the future we all must recognize this dynamic and begin to devise methods of finding and retaining talented management. Anyone who has dealt with the problem and opportunities associated with a newly consolidated multi-brand wholesaler will agree that the person in charge deserves more than a paycheck.

What Shouldn't Be Done?

Stop Consolidation – Certainly not an option I like, but one we are currently experiencing either by accident or design. This approach ignores IBG's belief that if you are at a 2 to 1 share disadvantage you probably can't be competitive at store level. In fact, we do not believe that if before or after consolidation a wholesaler has less than half the share of its nearest competitor, they can effectively compete. The brand mix, percent of profit pool, and overall financial condition can change this for a short period of time but it eventually hold true. If suppliers want reasonably competitive retail performance, as most contracts require, they will need to be prepared to support or assist low share wholesalers consolidated or not. Without economies of scale similar to their largest competitors they will not be able to overcome their financial disadvantage. In my opinion, the disproportionate share advantage held in the convenience store segment by the high share system is one of the by-products of not consolidating fast enough. Wholesalers will spend money to be competitive. I have seen many spend into bankruptcy and the day before they filed for bankruptcy someone demanded more effort and investment. In the low share scenario failure is only a function of time. Stopping or even slowing consolidation while the high share wholesaler grows only makes the competitive imbalance worse.

Lower The Selling Price – Bankers and Suppliers almost always want this course of action. It's not hard to determine why. Banks want less risk and Suppliers care most about the amount of money the buyer has moving forward and not the amount the seller leaves the business with. The years of equity building spent by a wholesaler can be ignored or forgotten in an instant. There is some quantitative data to suggest that prices are no longer going up. A review of IBG's closed transactions shows that prices have stabilized and some selling wholesalers may even be willing to reduce their expectations slightly. However, in today's slow economy, being a beer wholesaler is still a pretty good investment. There are still more buyers than sellers so don't expect prices to come down significantly any time soon. State laws often make it difficult to terminate even a horrible wholesaler. So, if someone does not get what they think is a good price, they simply stay in business. Often they under service the market in order to survive. A strong competitor generally approves of this approach. Again, while consolidation waits the high share wholesaler gets stronger.

Deny the Problem – Currently, suppliers to a large degree and wholesalers to a lesser degree seem to be happy with what I refer to as portfolio realignment and extensive evaluation. MBC wants Pilsner Uriquel and Foster with its wholesalers, CBC wants Molson consolidated in its network and the same is true of Interbrew, Heineken, Barton, etc. Everyone wants their brands in one house and this is understandable. The problem is that while everyone evaluates and consolidates portfolios the competition is getting stronger. The high share wholesaler's share of

market and share of margin pool continues to grow. Low share wholesalers and suppliers may be winning some battles with each other but the high share system and number one supplier is winning the war. The longer we discuss options the tougher it is to be competitive. ***We are not operating in a competitive void.*** This is not to imply that the high share system does not have its problems because it does. But they seem to have a consistent and subsidizing approach to consolidating. The low share portion of the industry can't afford to wait any longer. We can deny that the high share wholesalers are providing significantly better service, that their investments in technology do not matter and that their capital expenditures will not really help but, this denial will not change the fact that they are getting bigger and better at a faster pace than everyone else. ***There is an answer.*** Create a multi-brand wholesaler with enough share of market to be competitive. Give them assistance from all their suppliers upfront and a debt structure that facilitates retail performance. With their portfolio advantage, and highly motivated management, they can be more than competitive. If some suppliers and non-consolidated low share wholesalers continue to focus on their own selfish interests or deny their disadvantages we will end up with the high share system as a well-financed and dynamic 3-tier system, and everyone else could be in some form of direct shipping/three-tier system. For the sake of discussion let's call it a 2½-tier system. In this scenario the high share system wins. Most low share suppliers will struggle to reach all consumer channels. These suppliers' brands could become commodities or niche products. The wholesalers in a 2½-tier system would become less necessary, less valuable, and non-exclusive.

In conclusion, let me state that IBG respects the supplier's right to choose who they want to enter long-term relationships with. We respect the sellers right to get a fair price for years of hard work and the buyers right to continuing success. But the current slow down mixed with self-seeking and inconsistency needs to be addressed. ***You can wait too long.*** In fact, in some states, we have already waited too long. Consolidation is not black or white. However, the economics are black and white and the simple reality is one group of wholesalers is pulling away in share of market, profitability and service.