



LINSELL TRAIN

A Little of What you Fancy

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As holders of Diageo and Brown-Forman, we believe that premium spirits (broadly defined by the drinks industry as litre bottles retailing at over \$15) hold a uniquely valuable place in the global spirits market. At an estimated 3.1bn cases per year this market presents a sizeable opportunity, but its very fragmented nature makes it difficult to compare volumes and values across the whole world: China, as one might expect, is an enormous consumer of spirits – but it's mostly baijiu, a white spirit unique to the region. And the world's largest spirit by volume isn't a household name you're likely to order next time you go to the pub – in fact it's Jinro soju, a Korean clear distilled spirit which shifted 61.4m cases last year, almost exclusively in its own domestic market. The four largest quoted spirits companies by volume, and mainly offering premium products, have only a combined 9% share of volume and 22% of value, with the rest accounted for by a whole host of local brands operating in specific territories.

Premium spirits are our tippie of choice for a number of reasons. Firstly, they are under-penetrated globally and there remains a considerable opportunity as the world shifts from local spirits to western liquors. As history has demonstrated in locations like Japan, rapidly westernising countries tend to switch from local spirits to scotches and other brown spirits, so a large-scale conversion to such beverages in China alone would be very exciting. Secondly, we like the fact that many are impressively pedigreed, ranking amongst the strongest brands in the world and commanding intense loyalty from generations of consumers. At 138 and 147 years old, Jack Daniels and Johnnie Walker are more popular than ever and have even become cultural icons in their own right – with a Jack in hand one can follow in the footsteps of the likes of Frank Sinatra, Mötley Crüe or the Rolling Stones. Thirdly, we like these spirits' strong differentiation, particularly whiskeys and other brown liquors with distinctive flavours and provenances – the taste of Johnnie Walker and Captain Morgan, for example, can't be easily recreated by another distiller. And lastly, we identify an upward trajectory as premium western spirits increase in popularity in many countries. Exports of Scotch whisky increased 11% year-on-year in value terms and 9% in volume terms, while North American whiskeys and bourbons accounted for more than 50% of the total growth in the US spirits market in 2013. Exports of American whiskey grew 5% in value (\$957m in 2012 to \$1bn in 2013) and in America itself, volume sales of all kinds of whisk(e)ys were up 6% to 52.7m cases.

So it was with some interest that we learned of Suntory's recent bid to purchase Beam Inc, maker of Jim Beam, Maker's Mark, Teacher's and Courvoisier, amongst others. No method of valuation is perfect, but to our minds a non-market transaction such as this offers a useful comparison for our holdings because it demonstrates the value placed on a company by a businessperson purchasing 100%, or at least a significant chunk, of the whole thing. We presume that such a buyer will be an industry insider with a long term view and an informed understanding of the value of the asset – very helpful to us as investors taking a decade-long (or even longer) view of our holdings. Of course, the price of Beam reflects the inclusion of an acquisition premium not attached to, say, Diageo, which is a less likely target for acquisition, but nevertheless viewing the figures side by side is informative to say the least.

At \$83.30 per share Suntory was happy to pay a 25% premium for Beam's brands, a figure which provoked some thought – and provided not a little comfort – about the value of our own spirits holdings. At a \$16bn total purchase price (including assumption of \$2bn debt), the transaction puts Beam on 6.3x sales, which suggests to us that Diageo's current valuation of 5x sales is an undervaluation. In our view Diageo has all the advantages of Beam – it's heavily weighted towards brown spirits and enjoys good positions in key markets and categories, particularly whisky – but also boasts a far superior brand stable. Although Jim Beam is undeniably a valuable piece of brand equity, it is also Beam's only product with sales of over 5m cases per year; Diageo, on the other hand, last year sold a whopping 26m cases of Smirnoff, 20m cases of Johnnie Walker and more than 10m of Captain Morgan whilst also holding the #1 positions in liqueurs (Baileys), Canadian whisky (Crown Royal) and gin (Gordons; the company also owns super-premium Tanqueray). And that's without even mentioning Guinness, the only global stout brand and as such a unique and very important asset. If Diageo were valued at 6.3x sales, a £25 share price could be justified – that's

37% upside.

Elsewhere, we like Brown-Forman primarily because of its ownership of Jack Daniels: a 7% increase in sales to 11m cases in 2013 demonstrates the considerable value and growing appeal of the brand. Its other brands are Finlandia vodka, with not too shabby sales of 3.2m cases last year, Canadian Mist whisky (1.6m cases) and Southern Comfort liqueur, which despite suffering a little from cyclicalities in US liqueur drinking habits, still managed to sell a respectable 1.9m cases. At \$80 a share (6x sales) Brown-Forman by no means looks cheap, but as shares currently change hands on the same multiple as Beam, I would argue that we are getting much the better deal in having access to Jack Daniels instead of Jim Beam.

So what will drive growth in premium spirits profits in the future? Pernod-Ricard reports that between 2000 and 2010 sale volumes of their premium spirits grew 2.1% per annum, while super premium volumes grew 4.8% - a tangible demonstration of the impact of premiumisation. Brown-Forman reported underlying sales growth of 18% in their super-premium whiskey brands, most notably 27% growth in sales of Woodford Reserve, which is priced between \$30-40 in the US. Diageo is also well placed to ride this wave, with its core strength in premium liquors (more than 60% of revenues), and a smaller 'reserve' or 'super premium' category (that's the likes of Johnnie Walker Blue, which retails at £145 per bottle, Zacapa rum at £50 per bottle or Tanqueray Ten at £30 per bottle) which is also gaining momentum, recently doubling in size to 10% of sales.

Innovation, in the form of flavoured whiskeys and vodkas – black cherry, vanilla and green apple are all recently spotted variants – is also a key strategy for both Brown-Forman and Diageo. With 770,000 cases sold last year, Jack Daniels Tennessee Honey accounts for 7% of Jack Daniels overall sales and is part of a fast growing sub-category: in the wider industry flavoured whiskey accounted for 75% of growth in the overall whiskey category and 42% of growth in the bourbon category. These sweeter offerings appear to be additive rather than cannibalistic, as Brown-Forman see uptake primarily from new consumers – some previously whiskey-averse men, but in particular women and young people who have not traditionally been the target demographic for whiskey products.

Emerging markets will become ever more important as the world's taste turns from local spirits to aspirational, premium branded offerings. Compared with the Russians' yearly consumption of 2.3 cases of spirits per capita (it may not be a surprise that most of this is vodka, at 1.6 cases per person) and the Americans' 0.8 cases, spirits consumption in, say, Africa looks to be merely in its infancy – Ghana and Nigeria consume only 2.4 and 0.3 litres respectively. Ten years ago, less than one third of Brown-Forman's sales came from outside the US. Today international sales have grown to 59% of total revenues and emerging market sales are now just under 25% of total. In nine years Diageo has gone from less than 30% of sales in emerging markets to over 40%, spending £3bn on strategic local player acquisitions (Mey Icki in Turkey and Ypioca in Brazil) to gain access to a local distribution network and create long-term opportunities for Diageo's international premium brands.

Africa is an important emerging market for Diageo. Its revenues from this region have grown to £1.5bn per annum including Guinness (13% of the global total) and should continue to increase at pace as the company tempts consumers away from local brands with a range of aspirational offerings. African drinkers can 'sample' brands such as Johnnie Walker Red in small 20cl bottles or opt for cheaper labels, such as Smirnoff 1818 or Jebel gin which cost less than \$10 per bottle but still offer Diageo better margins than beer. Though less easy to operate in than Africa, India is another exciting market: in 2012 Indians drank a total of 156m cases of whisky in 2012 – that's the same amount as the rest of the world put together! However, operating here is very difficult: traditional Indian whisky tastes very different from foreign whisky as it is distilled from molasses rather than barley, plus a prohibitive 100% import duty on spirits and a powerful incumbent in Bangalore native United Spirits (holder of the #1 and #3 products by volume) mean that overseas brands are at a significant disadvantage.

Of the foreign companies selling into India, Diageo is undoubtedly the best positioned. Its 30% controlling stake in United Spirits not only gives it a way to participate in the popularity of local Indian brands, but also allows it to use United Spirits' distribution channels to market its own premium spirits to aspirational drinkers who are beginning to upgrade. In recent years Johnnie Walker and Captain Morgan have attained respectable market positions, with net sales of the former growing 87% in 2013. Though lacking Diageo's obvious advantage in the region, Brown-Forman has also managed to build a fairly good market position with Jack Daniels by marketing to wealthy young Indians in cities via rock concert and motorcycle event sponsorship. It has also had some success with Finlandia vodka, which is now the number 2 imported vodka (Pernod-Ricard's Absolut is number 1).

So could we see any more Beam-type deals in the future? Given the extreme fragmentation within the spirits industry as a whole and the local/premium split, further consolidation within the industry would be a welcome opportunity for companies to take some position-securing share: with total sales of 26m cases per year Brown-Forman has a mere 1% share of the global spirits market by volume and Diageo 5% with 165m cases. Realistically, though, consolidation is unlikely to happen on a grand scale. Tight control by the family ownership of several brands – Brown-Forman, Bacardi, Jose Cuervo and Remy immediately spring to mind – has historically limited large transactions and the current lineup of spirits companies by volume stands at Diageo in #1 place, followed by Pernod Ricard at #2, Suntory (with Beam) at #3 and Brown-Forman in fourth place.

However, smaller brand acquisitions will almost certainly take place on the periphery: at US\$16.7bn market cap and with around 70% family ownership Brown-Forman is likely too small and inflexible to participate in any large-scale acquisitions, but does have an obvious space in its portfolio for a quality cognac. Diageo lacks a key tequila, cognac and bourbon product, and their failed 2012 bid for family-owned Jose Cuervo demonstrates an appetite for acquisition in at least one of those categories. It's also worth noting that Diageo explored the possibility of its own bid for Beam in 2012. Bacardi's stable of wonderful assets (Grey Goose, Bombay Sapphire, Dewar's and of course its namesake Bacardi rum, the biggest selling rum in the world at 20m cases per year) is a tempting prospect for a bigger spirits group, but its private family ownership will determine if and when any transaction could take place.

To sum up: whether or not any significant transactions do take place, in our view premium spirits companies are uniquely powerful brands with a huge amount of global potential. As the saying goes – a little of what you fancy does do you good, and we think that participating in the rising value of premium spirits brands will do us very well indeed.

Madeline Wright, Deputy Portfolio Manager

Lindsell Train Ltd

Sources: IWRS, via Brown-Forman; Euromonitor; Wall Street Journal; Business Insider; The Spirits Business; Diageo; Brown-Forman; Pernod-Ricard; Nielsen; World Health Organisation; Washington Post; Goldman Sachs; Business Standard

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Lindsell Train Limited
66 Buckingham Gate
London
SW1E 6AU
UNITED KINGDOM

Tel. 020 7808 1210
Fax. 020 7808 1229
www.LindsellTrain.comInfo@lindselltrain.com

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