



ValueX Vail, June 2017

Becele S.A. (Cuervo)

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Overview

❖ **Becle S.A. de CV (Jose Cuervo)**

❖ **Country: Mexico**

❖ **Sector: global spirits**



❖ **For now only listed in Mexico. (Ticker: CUERVO) IPO: Jan 2017 @ MXN 34**

❖ **Current price: MXN 31.5 / # shares: 3'654 (mil)**

❖ **Market cap: MXN 118'755'000 (mil) = Approx USD 6.5bn**

❖ **Free float: 13% (includes 2% held by Temasek via IPO)**

❖ **Credit Rating: BBB+ (Fitch) / Employees: 5500**

Key Investment Points

- ❖ Market leader in one of the fastest growing spirits categories
- ❖ Business model in evolution
 - ∅ Higher and more stable margins
 - ∅ More diversification and lower risk
 - ∅ Direct distribution network to leverage new categories/brands
- ❖ Competitive advantages – vertical integration
- ❖ Attractive structural growth story
- ❖ Trades at 20% discount to global peers for valid reasons.
- ❖ Several of reasons for discount are about to disappear.
- ❖ “Reinvestment Moat”- winning with growth

Cuervo Product Portfolio

- ◆ **58% Tequila** Jose Cuervo: 37% / 1800: 12% (premium / others 9% e.g. Centenario (ultra premium), Maestro Dobel (premium))
- ◆ **6% Irish Whiskey** Bushmills
- ◆ **4% Rum** Kraken
- ◆ **11% Other alcoholic** Vodka: Hangar 1 & Three Olives
Bourbon Whiskey: Stranahan's and TINCUP from CO (!)
Gin: Boodles
- ◆ **8% Ready served** Golden Margarita, Paloma Sparkling, Kraken Cola etc.
- ◆ **7% Non-alcoholic** Sangrita, Energy drink "B:oot", Margarita Mix

Recognizable Brands



Global Spirits Market

Global mkt share per category			2009-2015 CAGR per category		
	Volume	Value		Volume	Value
Baijiu	38.7%	27.0%	Irish Whiskey	9.8%	12.0%
Vodka	15.2%	15.1%	Baiju	7.5%	3.1%
Whisky	12.5%	22.1%	US Whiskey	5.5%	8.8%
Shochu / Soju	7.6%	4.1%	Tequila	4.0%	7.0%
Brandy	6.1%	8.0%	Cognac	3.2%	8.0%
Rum	4.5%	5.6%	Scotch Whisky	1.3%	3.9%
Tequila	0.9%	2.4%	Gin	1.1%	6.5%
Others	14.6%	15.6%	Rum	0.1%	3.7%
Total	100.0%	100.0%	Vodka	-0.3%	5.6%
Source: IWSR		271.7bn	Total	3.2%	4.6%

Break down by geographies		
	Volume	Value
China	38.7%	28.5%
India	10.1%	6.4%
Russia	8.1%	4.6%
US	6.8%	16.4%
South Korea	4.5%	1.7%
Japan	3.9%	3.9%
Mexico	1.0%	1.2%
Others	26.9%	37.3%
Total	100.0%	100.0%
Source: IWSR		271.7bn

Interesting factoid: Diageo was the world's largest distiller until being overtaken by China's [Kweichow Moutai](#) on 9 April 2017

US Spirits

US Market share per category '15		
	Volume	Value
Vodka	33.7%	28.0%
US Whiskey	12.6%	13.3%
Rum	10.4%	9.1%
Canadian Whiskey	10.2%	9.7%
Liqueur	8.5%	8.2%
Tequila	7.2%	9.8%
Gin	4.7%	3.9%
Others	12.7%	18.2%
Total	100%	100%

US CAGR per category '09 - '15		
	Volume	Value
Irish Whiskey	17.9%	19.4%
Canadian Whiskey	5.7%	8.8%
Tequila	5.3%	7.8%
Cognac	5.1%	7.4%
US Whiskey	4.5%	8.2%
Vodka	3.3%	4.6%
Scotch Whiskey	0.3%	7.1%
Rum	-0.4%	1.8%
Others	-0.9%	0.9%
Total	2.5%	5.1%

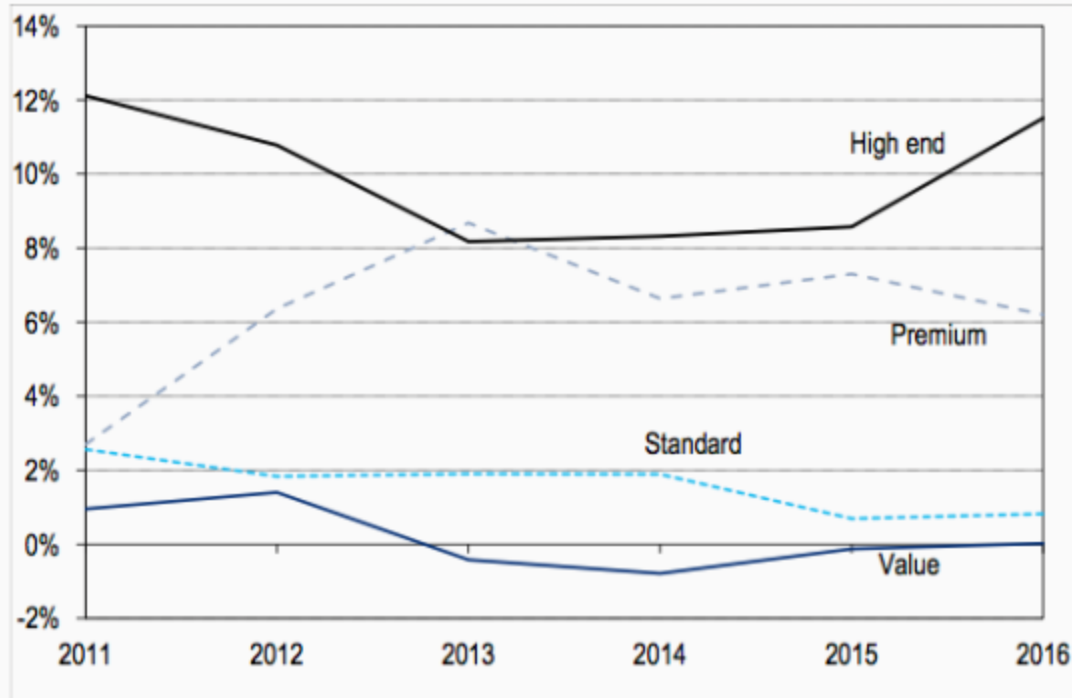
Source: ISWR

During past 3 yrs growth in US Spirits has consistently come from three categories:

1. **US/Canadian Whiskey:** across all price points but mainly premium. Growth slowed from double digits to mid/high single digits. Irish Whiskey strong but still small.
2. **Tequila:** across all price points but mostly (ultra) premium. No sign of slowdown.
3. **Cognac:** continues to grow (also Brandy to lesser extend). No sign of slowdown

US Spirits

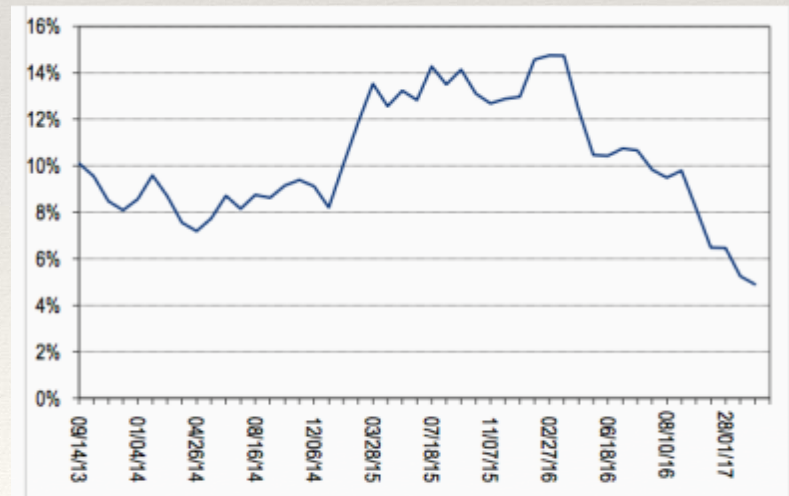
Growth by Price Segment



Source: DISCUS, Citi Research

- Growth in US Spirits was mostly powered by premium and ultra-premium brands.
- Some give back during past 6 months after torrid growth

Growth of Super Premium Brands (Nielsen)



Source: Citi

US Spirits – Market Shares (Value)

	2010	2015	Market share change (bps)
Diageo	24.9%	20.7%	-414
Beam Suntory	8.3%	8.6%	25
Pernod Ricard	8.7%	7.7%	-101
Bacardi	8.9%	7.4%	-148
Brown Forman	5.2%	5.5%	30
Sazerac	4.9%	7.3%	243
Heaven Hill	3.3%	3.6%	35
Moet Hennessy	3.1%	3.6%	50
Cuervo/ Proximo	1.5%	3.4%	189
Campani	2.7%	3.1%	46
Patron	2.7%	2.9%	18
Constellation	3.0%	2.7%	-31
E&J Gallo	1.6%	2.6%	100
Tito's (Fifth Generation)	0.3%	1.8%	149
William Grant	1.2%	1.7%	47
Rémy	1.3%	1.4%	10
Stoli group	1.4%	1.1%	-27
Edrington	0.6%	0.8%	22
Luxco	0.9%	0.7%	-19
McCormick	1.0%	0.6%	-31
Infinium	0.7%	0.6%	-13
Russian Standard	0.1%	0.2%	3

**Cuervo second
largest share gainer
between '10 - '15
+189bps**

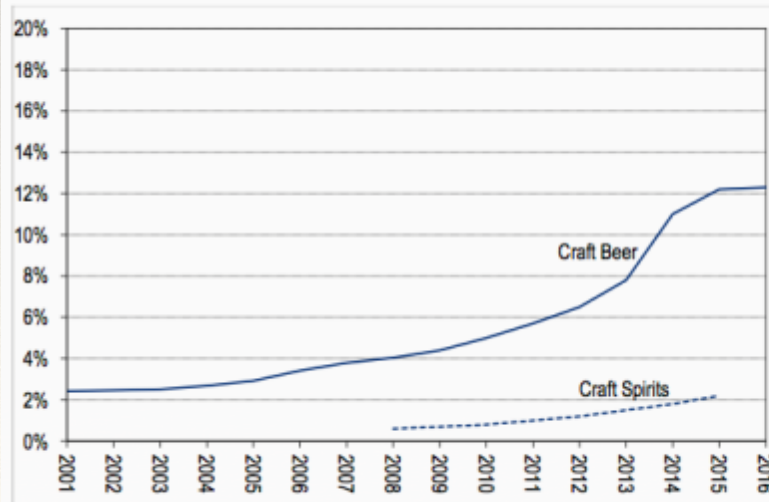
Source: IWSR, Citi Research

US Spirits Market Share by Group

	2010	2011	2012	2013	2014	2015	2010-15 chg (bps)
Big-5 Players	55.9%	55.0%	55.3%	54.2%	51.0%	49.8%	-608
Diageo	24.9%	24.3%	24.1%	23.7%	21.0%	20.7%	-414
Beam	8.3%	8.3%	9.4%	9.2%	9.2%	8.6%	25
Pernod	8.7%	8.6%	8.4%	8.1%	7.8%	7.7%	-101
Bacardi	8.9%	8.6%	8.1%	7.9%	7.6%	7.4%	-148
Brown Forman	5.2%	5.2%	5.4%	5.3%	5.4%	5.5%	30
Second tier players ★	26.0%	26.9%	27.6%	29.0%	32.8%	34.8%	878
Third tier players	17.0%	16.7%	15.5%	14.8%	13.7%	12.4%	-460
Craft	1.1%	1.4%	1.6%	2.0%	2.5%	3.0%	190
Total	100%	100%	100%	100%	100%	100%	0

Note: (1) Second tier players includes Sazerac, Heaven Hill, MH, Proximo, Campari, Patron, Constellation, E&J Gallo, WM Grant, Rémy, Tito's, Edrington. (2) c140bps of Diageo's share loss is explained by loss of Cuervo distribution in 2014. Conversely Proximo (and 2nd tier players aggregate market share) is boosted by the same amount in 2014. Source: ISWR, Citi Research

Figure 19. Craft volume market share in US beer and spirits



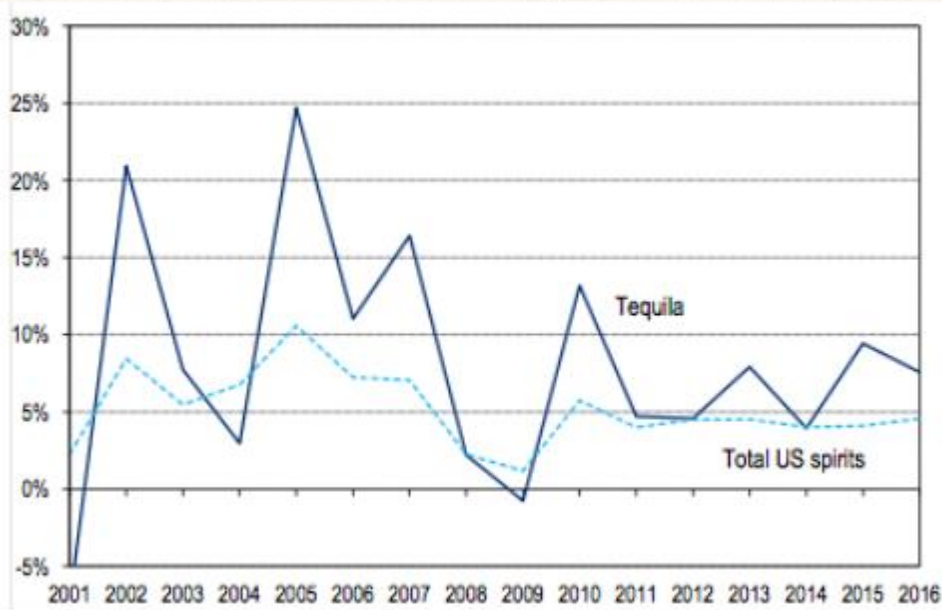
Source: Beer Association, TTb, IWSR, Citi Research

Figure 20. Number of craft breweries and distilleries in the US

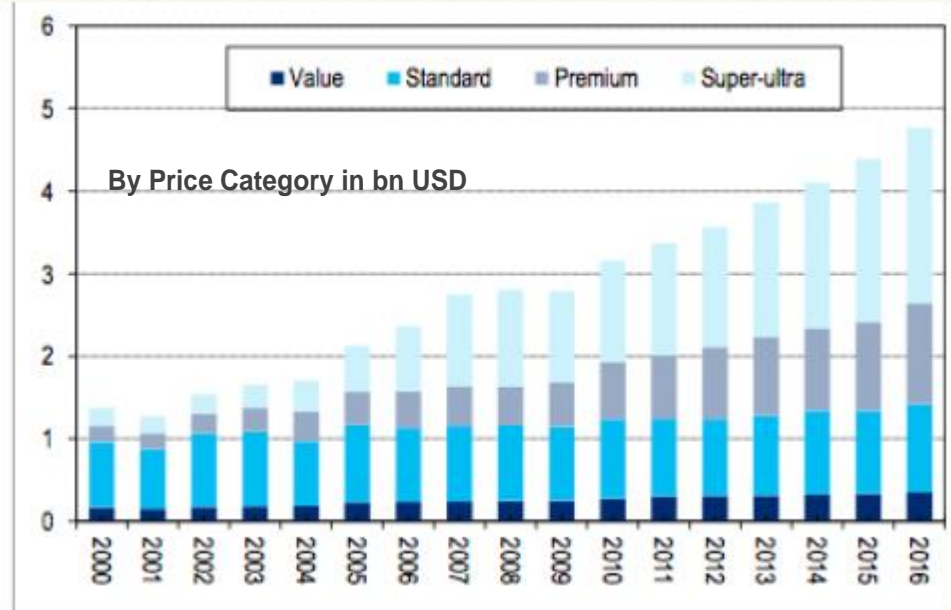


Source: Beer Association, TTb, IWSR, Citi Research

US Tequila Sales

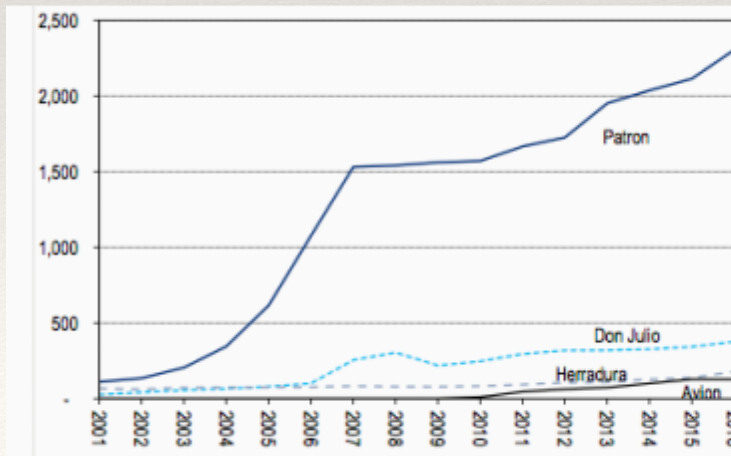


Source: IWSR, Discus (2011-16), Citi Research



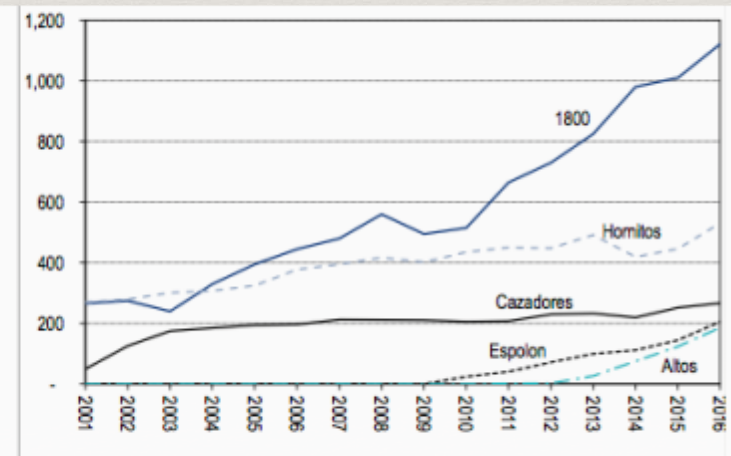
Source: IWSR, Discus (2016), Citi Research

Ultra Premium Brands



Source: IWSR, Citi Research (2016 estimated applying Nielsen growth rate)

Premium Brands



Source: IWSR, Citi Research (2016 estimated applying Nielsen growth rate)

Likely US Trends During Next Years

1. **Broad based growth in US Whiskey, Irish Whisky, Tequila and Cognac**
2. Most growth in Irish Whisky came from Jameson (Pernod) but should broaden to other brands going forward (Cuervo brand: Bushmills)
3. **The next big thing is considered to be high-end Gin and high-end Rum** (Cuervo brands: Boodles, Kraken)
4. Italian aperitifs should continue to grow fast (mostly Campari)
5. Vodka should continue its recent stagnation after many years of strong growth.
6. **Large brands of the 90s and 00s are losing share** (e.g. Smirnoff, Absolute, Captain Morgan). History has shown it hard to turn around a declining brand.
7. **Brands can be scaled up significantly and faster today than 5-10 years ago.**

Mexico Spirits

Mexico market share per category '15

	Volume	Value
Tequila	36.6%	33.0%
Scotch Whiskey	18.9%	33.1%
Brandy	10.2%	9.1%
Rum	9.8%	7.6%
Vodka	6.0%	5.0%
Liqueur	4.8%	3.7%
Others	13.7%	8.4%
Total	100%	100%

Mexico CAGR per category '09 - '15

	Volume	Value
Whiskey Total	15.5%	19.4%
Mezcal	4.7%	
Tequila	1.8%	16.5%
Liqueur	1.6%	
Rum	0.3%	3.9%
Vodka	-0.8%	5.9%
Brandy	-3.8%	5.8%
Others	-0.8%	1.2%

Source: Company Filings

Background

- ❖ **Cuervo was founded in 1758**, In 1795 Spanish King Carlos IV granted the company the first ever license to produce Tequila (vin de mescal). The company was always owned by the same family over eleven generations (250+yrs).
- ❖ **Tequila is a globally protected denomination of origin. It has to be distilled from the Blue Agave plant which grows in a strictly defined geographical area.** The production also has to follow pre-defined production conditions and traditions.



From Field to Bottle



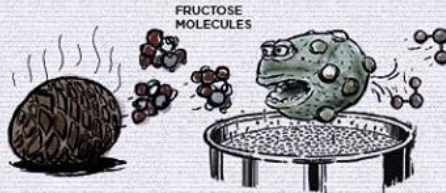
FERMENTATION

THE CONVERSION OF SUGAR TO ALCOHOL



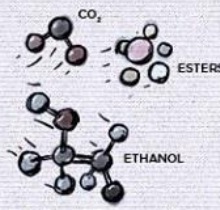
**AGAVE TEQUILANA
WEBER AZUL**

A starchy succulent plant made of a carbohydrate named inulin. This is the mother plant of tequila.



**ROASTING
THE PIÑAS**

Roasting the agave piñas transforms the inulin carbs into fructose. The agave juice is separated from the plant fibers and pumped into vats.



**ETHANOL
RAW ALCOHOL**

A by-product of the yeast's feast is ethanol, along with carbon dioxide and other aromatic compounds that give tequila its flavor and aroma.



**TEQUILA
FINISHED PRODUCT**

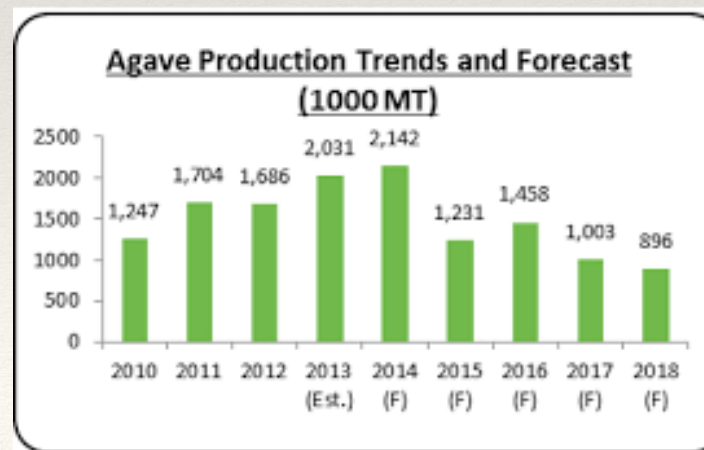
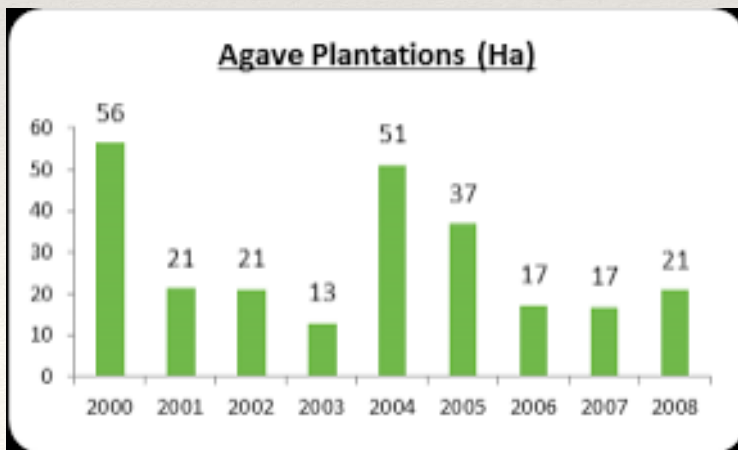
That raw alcohol is then distilled twice, removing impurities. The end result—a fine sipping tequila.

Tequila: Integrated Business Model

- ❖ **Primary input factor:** biggest producer of Blue Agave in Mexico and agreements with independent producers. Planting in place to become **90% self-sufficient within next two years (now 70%)**. Secures the supply chain and shields from price volatility. **Vertical integration provides a strong competitive advantage.**
- ❖ **Distillation and bottling:** fully controls those production stages with five distilleries and five bottling plants in Mexico, the US and Northern Ireland.
- ❖ **Direct distribution to consumer:** owns direct distribution networks in Mexico, US, Canada, UK and Ireland. **90% of global sales are direct distribution.** Mexico second, US ninth largest distribution network for distilled alcoholic beverages by sales value. Prior to 2013 Diageo was US distributor. **Taking over its own US distribution** greatly improved sales and **leverages the distribution** of new (Kraken) or acquired brands (Bushmills).

Agave Production

- **Agave prices** rose from 1 peso per kg in 2011 to 3 pesos early 2015 and 13 pesos today.
- **Demand is surging while production is falling.**
- Agave needs **7+ yrs to mature**. **Low prices for many years have discouraged new planting.**
- Securing the Agave supply chain is crucial for Tequila producers. Producers are very secretive about their Agave suppliers and prices.
- **Cuervo's increasing vertical integration is huge advantage and protects gross margins.**
- Big Tequila producer engage in third party contract farming while smaller producer are struggling.



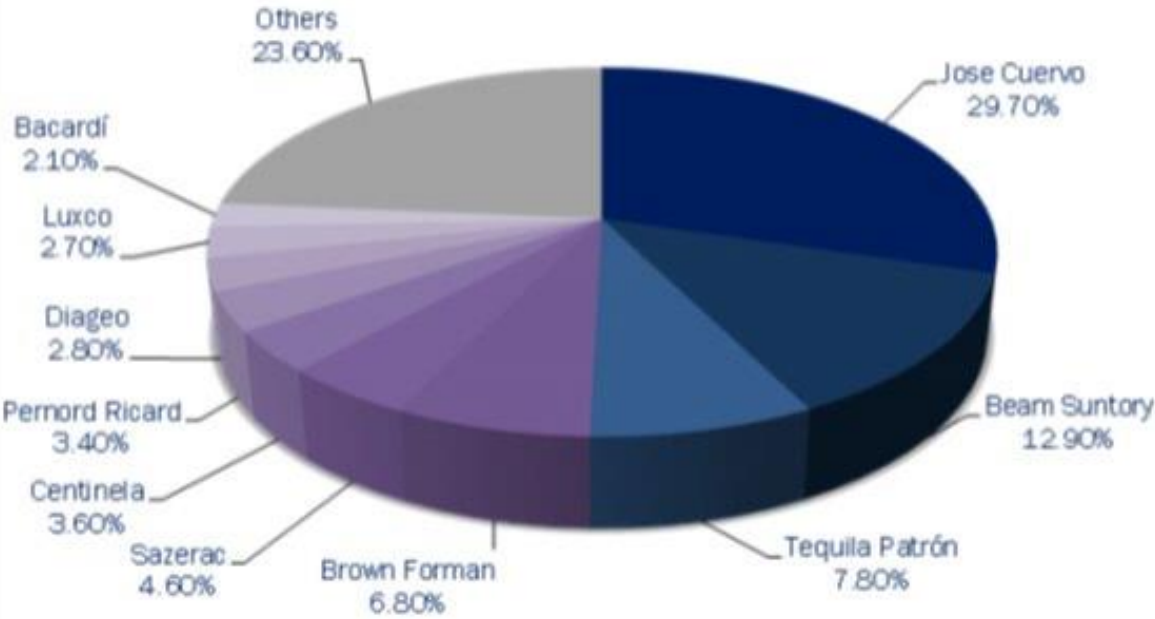
Recent Developments

- 2007: - Proximo Spirits Distribution established
- acquisition of Three Olives Vodka brand.
- 2010: acquisition of Hangar 1 Vodka & Stranahan's Whiskey
- 2011: acquisition of Boodles Gin
- 2013: fended off take-over by Diageo, cancelled US distribution with Diageo, Proximo takes over US distribution
- 2015: exchanges brands with Diageo. Cuervo's stake in Don Julio for Old Bushmills Distillery
- 2016: launches Ready-to-Drink beverages Jose Cuervo Especial Paloma (Sparkling Margarita) and Kraken Cola (Rum & Coke)
- 2017: IPO, doubling capacity of Bushmills Distillery

Market Share and Competition

Global Tequila Market Share

Total Size of the Market = 28.2mm (9L. bases)
2015 Volume %



Source: Company Filings

Market share by producer

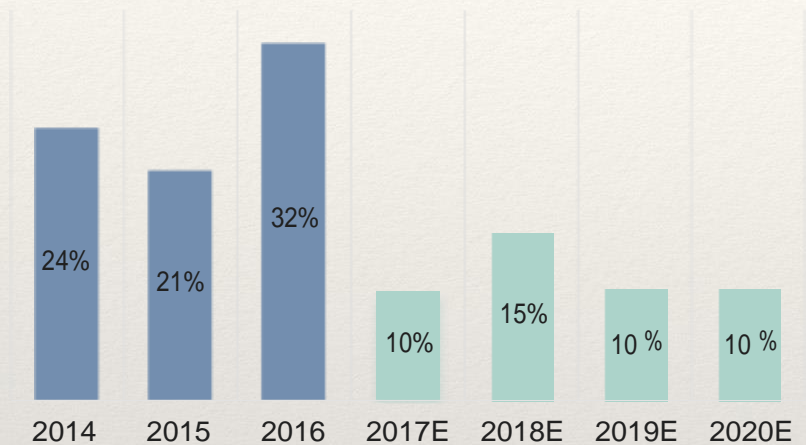
Market share by brands

	(9Lc MM)	% Participación
Cuervo	5.8	20.5%
Sauza	2.5	9.0%
Patron	2.2	7.6%
1800	1.3	4.4%
Gran Centenario	1.2	4.1%
El Jimador	1.1	4.0%
Cabrero	0.9	3.2%
Juarez	0.8	2.7%
Don Julio	0.7	2.4%
100 Años	0.7	2.4%

Source: Company Filings

Revenue Growth

ANNUAL REV GROWTH IN %

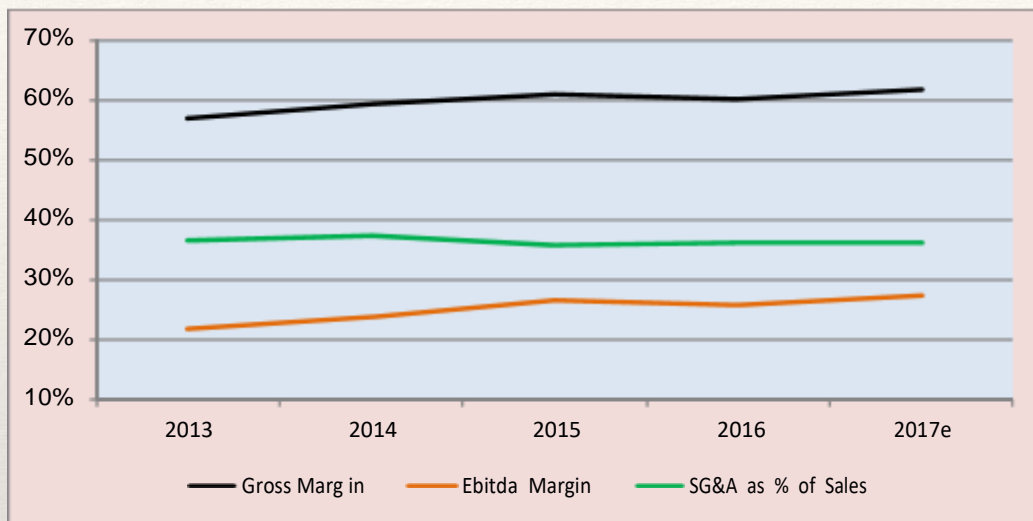


In Value	2014	2015	2016	3yr CAGR	Category size
Tequila	23.5%	13.0%	20.3%	19%	58%
Bushmills			58.6%		6%
Rum	48.2%	40.5%	40.8%	43%	4%
Others	46.7%	24.3%	28.5%	33%	26%
US	32.9%	26.9%	28.5%	29%	64%
Mexico	12.6%	-4.4%	10.4%	6%	20%
RoW	15.3%	62.5%	26.4%	33%	16%

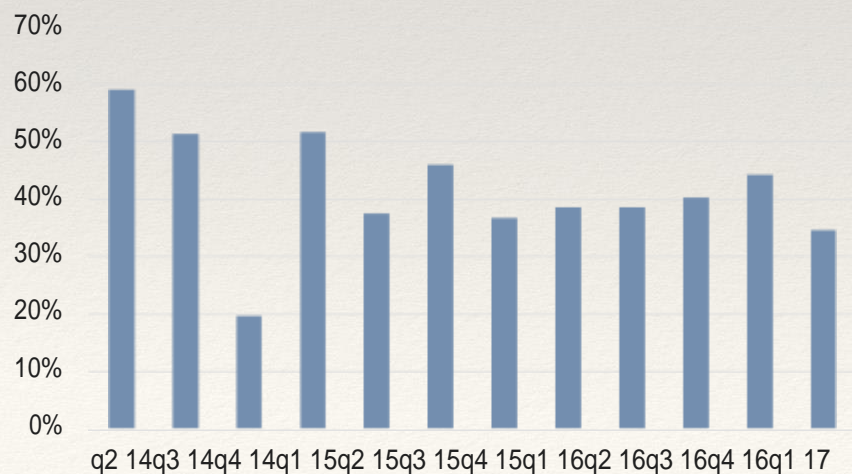
In Volume	2014	2015	2016	3yr CAGR
Tequila	4.7%	2.2%	5.7%	4%
Bushmills			40.7%	
Rum	40.2%	14.6%	18.4%	24%
Others	21.6%	9.0%	8.0%	13%
US	30.3%	6.4%	8.0%	14%
Mexico	11.8%	0.1%	5.7%	6%
RoW	7.8%	21.5%	6.6%	12%

- ∅ Strong growth has been a combination of **solid volume trends combined with a improved product mix** towards premium and ultra premium products.
- ∅ **US volume greatly improved after taking over US distribution from Diageo in 2013** which also opened up opportunities to use US distribution network to introduce new brands (e.g. Kraken Rum) or to acquire existing brands which can leverage off Cuervo's distribution platform e.g. Bushmills, or craft brands

Margins



Cogs as % of sales, quarterly



- Gross margins are improving and stable despite a surge in Algave prices. A result of the increasing vertical supply chain integration.
- Gross margin improvements the main cause for Ebitda margins improvements as SG&A as a % of sales stayed constant.
- Now directly owned distribution network combined with new brands and categories should lead to increased operating margins..

Valuation

	EV/Ebitda	EV/Ebitda	Ebitda	Gross				EPS Growth		Cash Conv.	Aging Inv.
	2017	2018	Margin	Margin	P/E '17	P/E '18	DY	2017	2018	FCF/EBITDA	% of sales
Diageo	16.3	15.4	33.8%	60%	21.8	20.6	2.7%	19%	6%	50%	35%
Brown Forman	19.5	18.3	35.1%	67%	27.1	24.9	1.5%	-1%	9%		
Pernod Ricard	15.2	14.1	29.3%	62%	20.2	18.6	1.8%	9%	9%	35%	50%
Campari	15.5	14.0	22.0%	57%	23.5	21.1	1.2%	27%	12%	55%	18%
Remy	18.6	16.5	21.4%	63%	30.6	26.8	1.6%	18%	14%	40%	105%
Average	17.0	15.7	28.3%	62%	24.6	22.4	1.8%	14%	10%	45%	52%
Cuervo	14.1	11.8	27.3%	62%	27.9	21.8	2.3%	25%	15%	50%	15%
Difference	-17%	-24%									
									Heineken	30-40%	
									ABI	40-50-%	
									Unilever	below 50%	
									Nestle	60%	

Stock price (mxn)	31
Market cap (mil)	113,274
EV	103,377
4yr avg ROE	13.5%
P/S	4.23
4yr sales growth	21.7%
4yr Ebitda growth	28.8%
5yr avg Ebitda margin	25.0%

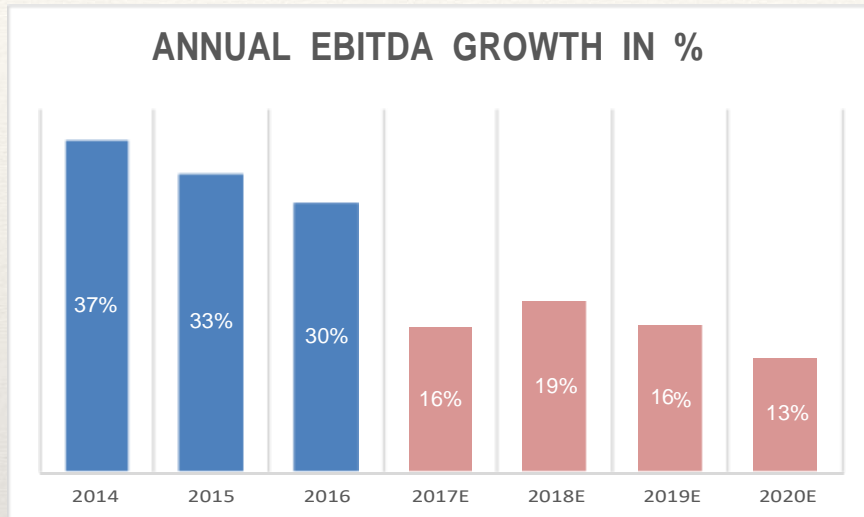
Reasons for Current Discount

- ❖ Historic volatility in gross margins due to Agave price volatility
- ❖ Lack of diversification
- ❖ Family control, small float
- ❖ FX volatility
- ❖ Mexican only listing, so far not included in any major index
- ❖ Some political uncertainty around Mexico's relationship with the US

What will reduce discount?

- ❖ Increasing vertical integration in Tequila will drive margin improvements
- ❖ Direct distribution asset can be leveraged for new brands. E.g. Cuervo product family has 82% of sales within Nafta, Bushmills only 30%
- ❖ More diversified portfolio over time (organic/M&A)
- ❖ Optionality with some of the smaller brands recently acquired
- ❖ Continued outperformance of peers
- ❖ Political uncertainty should subside, IPO hangover dissipate
- ❖ Inclusion in Mexican stock index S&P/BMV IPC likely in Oct '17

What is it worth?



- ❖ Ebitda Cagr over past 3yrs: 33%
- ❖ Assuming Ebitda grows by $\frac{1}{2}$: 16% Cagr over next 3yrs (Q1 Ebitda growth already 34%yoy)
- ❖ Assuming trades at peer multiples
- ❖ Stock price should be closer to 40 by end of this year and closer to 50 by end of next year. However, noisy year might provide opportunities.

Risks

- ❖ Recession in any of its major markets
- ❖ Competitive pressures (craft, new entrants into premium tequila category)
- ❖ Changing consumer preferences
- ❖ Natural disasters affecting the Agave planting
- ❖ Excessive foreign exchange fluctuations
- ❖ Unsuccessful M&A
- ❖ Family control

Annex: What to expect from this year

- ❖ Tough comparables due to demand surge in US/Canada before price hikes effective Jan 1, '17
- ❖ Imbalances in Algave market, suspended 3rd party purchases for during Q1 to help balance market, will need to purchase again during next quarters which will weigh somewhat on margins
- ❖ Recent strength in Mex Peso will weigh on net income
- ❖ Q2 overhang from price hikes will have been absorbed.
- ❖ Underlying product trends remain strong
- ❖ New M&A of scaleable premium brands to be expected until the end of 2017 into 2018.

Annex: ...and beyond

- ❖ **Bushmills should become a more important factor** as early success shows the investments in marketing/distribution are starting to pay-off. Production capacity is currently being doubled.
- ❖ Also smaller brands such as **TINCUP Whiskey** show promising signs, grew triple digits over last year.
- ❖ **The opening of the Chinese market.** In June 2013, the ban on importation of premium (100% blue agave) tequila into China was lifted following a state visit to Mexico by President Xi Jinping. 2015 Tequila exports to China only 0.5mm litres (US 151mm). So far little success.

Annex: Casa Amigos

- Sold last week for \$1bn to Diageo (\$700m cash and \$300m earn out over 10 years). Last year shipped 140'000 cases, this year expects to ship 170'000 cases. Diageo is buying growth in premium Tequila.
- Price category: Premium (retail \$45-55)
- **The multiple Diageo is paying looks very high**, 20x 2016 sales (Citi estimates: \$37), excluding the earn-out. This compares to typical craft (high) acquisition multiples of 8-10x sales. (Campari paid c3.5x sales for *Grand Marnier*)
- The equivalent Cuervo brand would be 1800 which ships 1'167'000 cases and grew volume double digits over the past few years. Even in Q1 after a 13% price increase it showed a 9% increase yoy
- 1800 represents 12% of Cuervo's volume.

Annex: Staples – No Bargain

Attractive relative valuation might not be enough in the shorter term as staples look expensive in absolute and relative terms. However, Cuervo's structural growth profile, operational improvements and competitive advantages suggest a bright outlook beyond the current market cycle.



Note: 12 month forward P/E relative to MSCI World

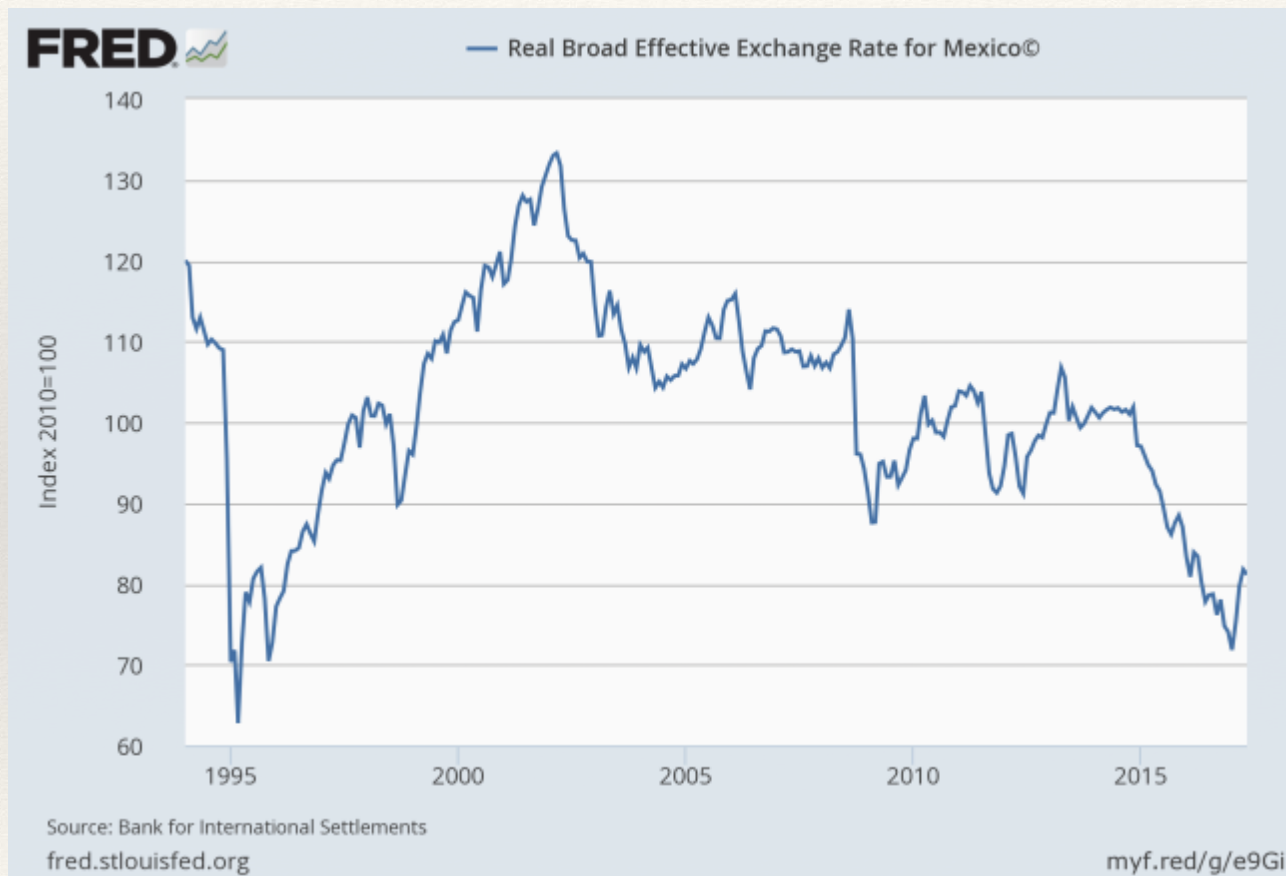
Source: DataStream



Note: 12 month forward P/E

Source: DataStream

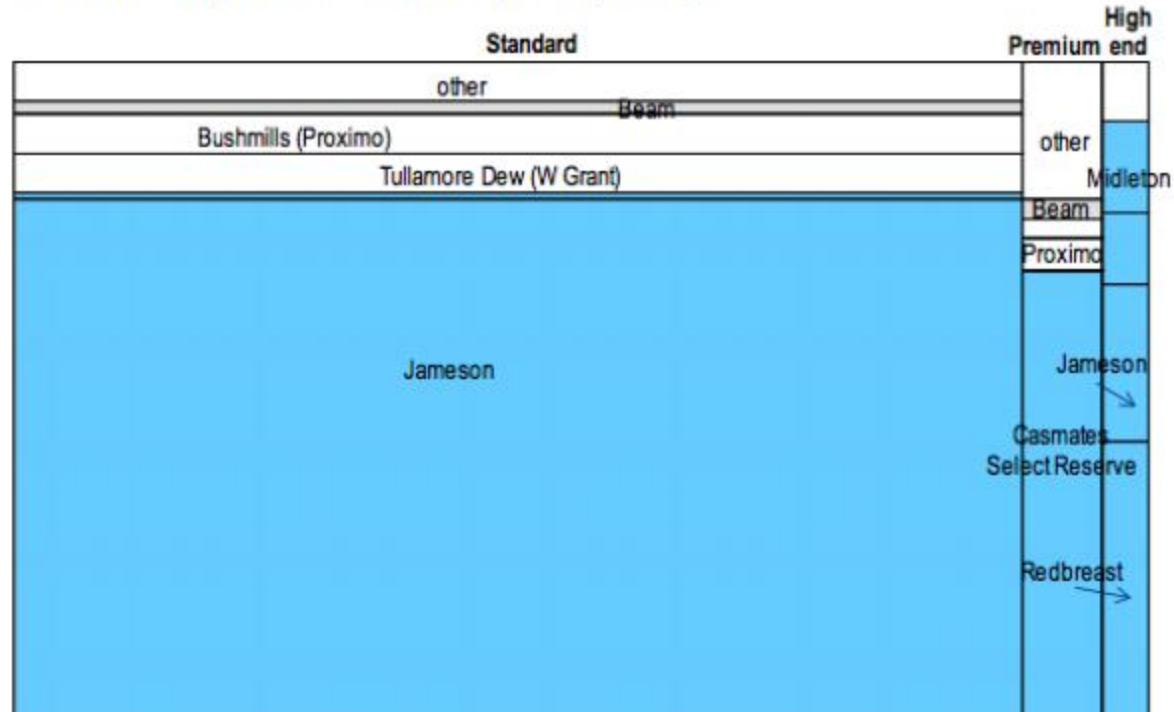
Annex: MXN Real Exchange Rate



Annex: Irish Whiskey – Market Share

Irish whiskey

Irish whiskey market shares (value, 2015)

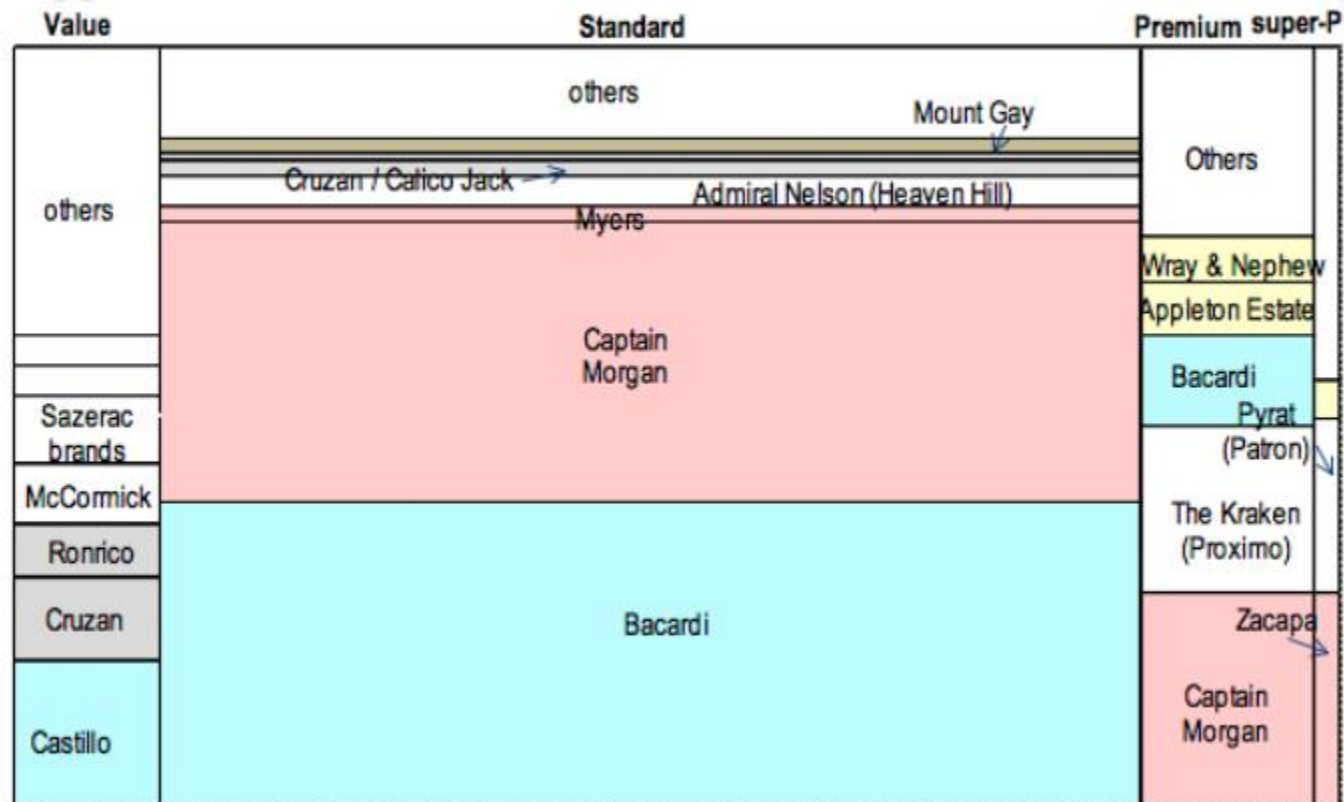


Source: IWSR, Citi research

Annex: Rum – Market Share

Rum

Rum market shares (value, 2015)



Source: IWSR, Citi research

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