2017 SPIRITS INDUSTRY MERGERS & ACQUISITION

Year in Review

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Mergers and acquisition activity in the spirits industry remained robust in 2017. Buoyed by healthy employment figures, low interest rates and record stock market performance, 2017 was the eighth consecutive year of economic expansion in the U.S. Against this favorable macro-economic backdrop, the spirits industry exhibited positive growth trends for the year. For the 52-week period ended October 7, 2017, Nielsen market data showed overall spirits dollar volume growth of 1.6%. However, the more telling storyline was the growth in the Premium ($15-$25 per 750ml) and Ultra (>$25 per 750ml) price categories. Year-over-year dollar growth for the Premium and Ultra categories was 4.5% and 5.9%, respectively (see Figure 1). This trend towards "premiumization" is consistent with other beverage alcohol categories as craft beer and premium wines continue to outpace lower priced offerings. In an effort by spirits companies to capitalize on these growth trends, there was an abundance of M&A activity in 2017.

FIGURE 1
Nielsen Dollar Growth by Pricing Category (52-weeks ended October 7, 2017)

HOLLYWOOD BLOCKBUSTER – STRONG M&A ACTIVITY IN 2017

There were several well publicized transactions in the last year with one deal in particular garnering substantial media coverage – **Diageo's** acquisition of **Casamigos**. Aside from being co-founded by international celebrity George Clooney, this transaction turned heads with a reported purchase price approaching $1 billion. Squarely positioned as a lifestyle focused, luxury priced tequila, Casamigos was reportedly on pace to sell 170,000 cases in 2017. By all metrics, this acquisition set a new bar for the price paid relative to case production. While an extreme example, this transaction is indicative of where large producers were focusing their M&A strategy in 2017 — luxury priced products.

The year began with the announcement that **Pernod Ricard** had closed on a majority stake investment in the acclaimed West Virginia-based bourbon producer **Smooth Ambler**. On the heels of this transaction it was announced that **Remy Cointreau** finalized their first foray into the domestic whiskey space with the acquisition of single malt producer **Westland Distillery** in Seattle. Additional new entrants into the domestic whiskey space included **SPI Group** with their acquisition of highly sought after **Kentucky Owl Bourbon**, as well as French luxury conglomerate **LVMH** purchasing **Woodinville Whiskey**.

After making a splash in 2016 with the acquisition of whiskey producer **High West**, **Constellation** continued to fortify its domestic whiskey portfolio with a minority investment in Virginia-based **Catoctin Creek Distillery**. **Deutsch Family Wine & Spirits**

FIGURE 2
Notable Spirits Industry Transactions Closed in 2017

TARGET	ACQUIRER	CATEGORY *motivation*
Smooth Ambler	Pernod Ricard	Luxury American Whiskey *Category Expansion*
Sipsmith	Beam Suntory	Luxury Gin *Luxury Expansion*
Westland Distillery	Rémy Cointreau	Luxury Single Malt Whiskey *Category Expansion*
East Tennessee Distillery Facility	Sazerac	Facility *Production*
Catoctin Creek Distilling	Constellation Brands	Luxury American Whiskey *Luxury Expansion*
Kentucky Owl Bourbon	SPI Group	Luxury American Whiskey *Category Expansion*
Bulldog Gin	Gruppo Campari	Premium Gin *Category Expansion*
Bittermens	Sazerac	Premium Bitters *Category Expansion*
Tuthilltown Spirits	William Grant & Sons	Facility *Production*
Del Maguey	Pernod Ricard	Luxury Mezcal *Category Expansion*
Casamigos	Diageo	Luxury Tequila *Luxury Expansion*
Teeling Whiskey Co.	Bacardi	Luxury Irish Whiskey *Category Expansion*
Woodinville Whiskey	LVMH	Luxury American Whiskey *Category Expansion*
Carolans and Irish Mist	Heaven Hills	Premium Irish Liqueur *Category Expansion*
Bib & Tuckers and Masterson's	Deutsch Family Wine & Spirits	Luxury American Whiskey *Luxury Expansion*
Germain-Robin	E&J Gallo	Luxury Brandy *Luxury Expansion*

added to its existing whiskey portfolio with the acquisitions of luxury priced **Bib & Tucker** and **Masterson's** brands. The past year also saw investments in distilleries to help support growth with **Sazerac's** purchase of a distillery in East Tennessee and **William Grant & Sons** acquisition of the **Tuthilltown Distillery**, which produces its acclaimed Hudson Whiskey brand.

Aside from domestic whiskey, there were several notable brand acquisitions in 2017. Reflecting the increasing popularity of the tequila category, **Pernod Ricard** acquired **Del Maguey**, the leading mezcal brand in the U.S. Mezcal, a small sub-category of tequila, was one of the fastest growing spirits categories in the past year. Premium and Ultra priced gin also attracted attention in 2017. **Beam Suntory** expanded into the Ultra gin category acquiring London-based **Sipsmith**, while **Gruppo Campari** purchased the remaining stake of **Bulldog Gin** after making a minority investment several years earlier. Other transactions of note involving large spirits companies included **Bacardi's** minority investment in rapidly growing Irish whiskey brand **Teeling Whiskey Co.**, **E&J Gallo** betting on luxury brandy with the acquisition of **Germain-Robin**, **Heaven Hill** diversifying its portfolio with the additions of **Carolans** and **Irish Mist** brands, and **Sazerac's** strategic investment in **Bittermens**, a Portland-based premium bitters.

The underlying motivation for the acquisition of these desirable spirits brands in 2017 was to fill "white space" voids in the acquirers' portfolios (Figure 2). The white space can either consist of not having a brand in a specific product category (*e.g.*, tequila or gin), or not having a brand at a certain price tier within a product category (*e.g.*, Ultra-priced whiskey or Premium-priced rum). With this understanding, it is important to acknowledge the factors driving the increasing number of transactions over the last few years. These factors include consumer demand for Premium and Ultra-priced products, a rapidly consolidating distributor and retailer network, and increased pressure from "upstart" craft spirits producers.

PREMIUMIZATION TREND — WHISKEY AND TEQUILA REMAIN HOT

As previously discussed, the Premium and Ultra price categories were the primary drivers of growth in the spirits industry over the past year. Diving deeper into the data reveals that tequila, gin and whiskey were the specific categories that led the growth of higher-priced spirits offerings. For the 52-week period ending October 7, 2017, Nielsen market data showed Ultra-priced tequila, gin and whiskey dollar growth of 13.2%, 12.9% and 10.1%, respectively (Figure 3). Reflecting these trends, there were several acquisitions within these specific product categories in 2017. Conversely, vodka continued its slide with a particular negative trend in the Ultra price segment.

Consumers are demanding luxury products to the detriment of Value and Mid-priced offerings. In order to satisfy the demands of these consumers, retailers are reshuffling their shelf sets to feature higher priced brands. Suppliers without established Premium or Ultra brands face limited options as they seek to remain relevant. They can attempt to raise prices on select brands in their portfolio, launch a new brand, or acquire an existing brand. Anecdotal evidence indicates that the market is less than favorable to those brands increasing price without the ability to deliver on value. Introducing a new label into the market has proven successful for some suppliers, but can be prohibitive for many due to the substantial sales and marketing costs and timeframe required for a successful roll-out. Given the difficulty and risk of the first two options, the acquisition of an established brand becomes an enticing alternative.

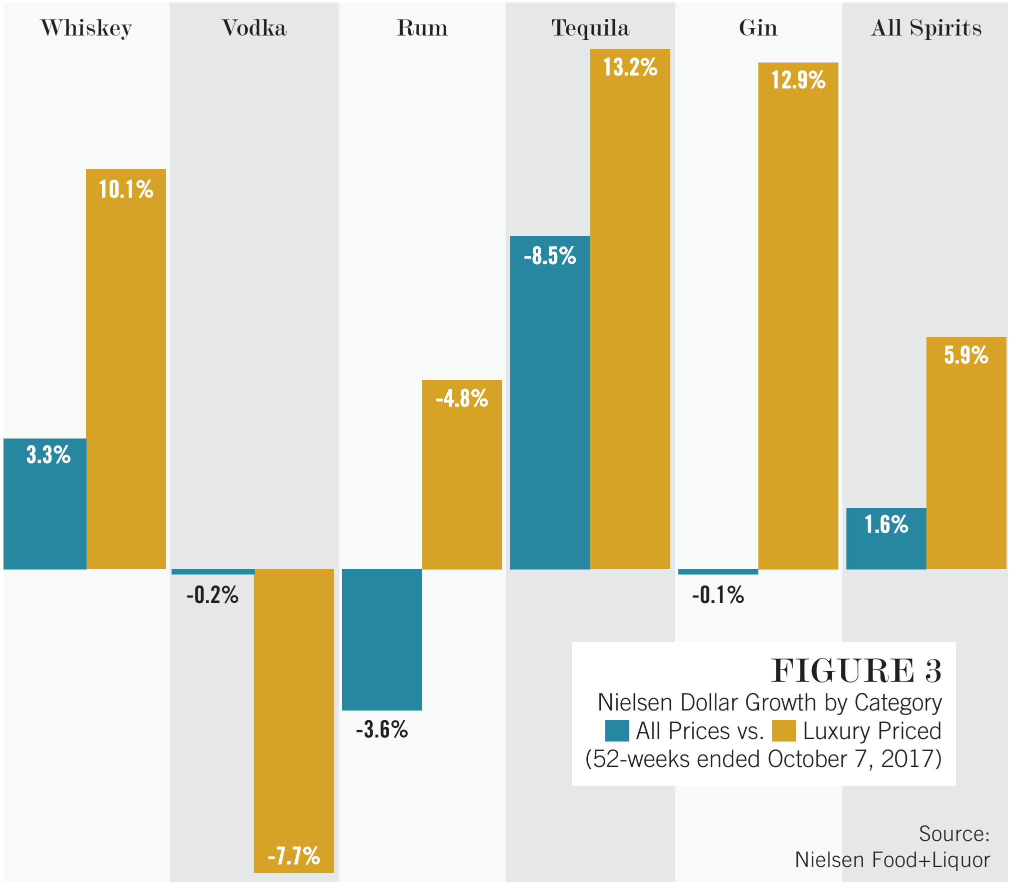


FIGURE 3
Nielsen Dollar Growth by Category
All Prices vs. Luxury Priced
(52-weeks ended October 7, 2017)

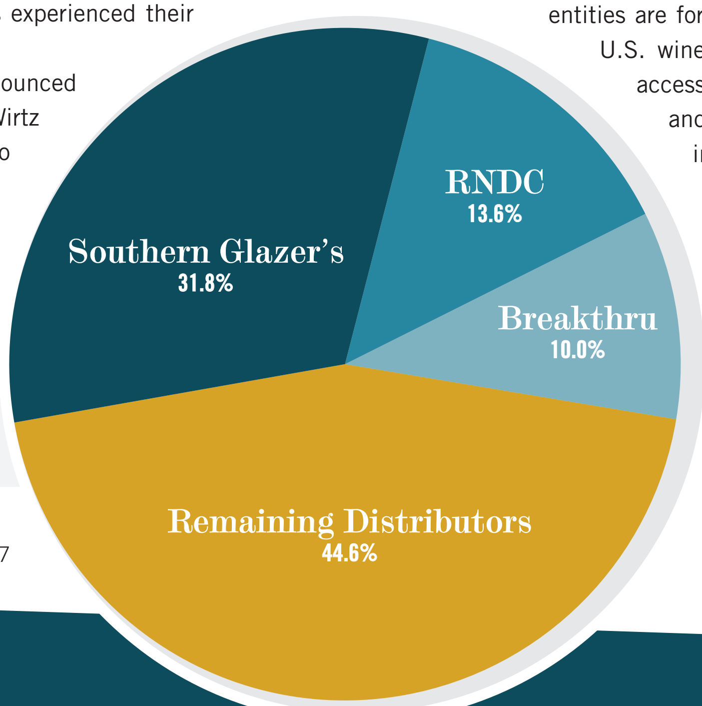
Source:
Nielsen Food+Liquor

NEW WORLD ORDER — WHOLESALER CONSOLIDATION

The past few years have seen several significant mergers between some of the country's largest wholesalers. As the distribution funnel continues to narrow due to the growing number of producers and dwindling amount of independent wholesalers and retailers, spirits companies are finding it increasingly difficult to secure access to the marketplace for their products. In response to a number of large grocery store mergers, including Safeway-Albertsons and Royal Ahold-Delhaize, wholesalers experienced their own wave of M&A activity.

At the end 2015, it was announced that Charmer Sunbelt Group and Wirtz Beverage Group were merging to create Breakthru Beverage. The new group has coverage in over 16 markets and combined revenue of over $5 billion, representing almost 10% of the U.S. wine and spirits market by dollar volume. Following this announcement, Southern Wine & Spirits and Glazer's, two of the largest wine and spirits wholesalers, surprised the industry by announcing their intent to combine operations. The Southern Glazer's merger provided the wholesaler with a dominant, near-national footprint and combined revenue of over $15 billion. In response to the Southern Glazer's merger, it was recently announced that Breakthru Beverage and RNDC intend to merge in 2018. Assuming this transaction closes, these combinations may forever change the wholesaler landscape, as two entities are forecasted to control over 55% of the U.S. wine and spirits market (Figure 4). As access to retailers becomes more limited, and competition among wholesalers increases exponentially, many in the industry foresee additional M&A activity at the wholesaler level in order to address competition challenges posed by the newly established distributor duopoly.

FIGURE 4
Wine & Spirits Distributor
Market Share – 2017



Source:
Shanken Impact Spirits Report 2017

The impact of these wholesaler mergers on large spirits companies is substantial. Distributors now have significant leverage over their supplier partners. This is of particular concern for the spirits industry in that the largest suppliers are less concentrated than their beer and wine competitors. In 2016, the top-3 spirits suppliers accounted for approximately 40% of the U.S. market. In comparison, the beer industry is the most "top-heavy" with the top-3 suppliers controlling approximately 78% of the market and the top-3 largest wine suppliers control about 51% of the market. Due to the fractured nature of the spirits industry, these large suppliers have less influence with their distributors and, therefore, must find ways to keep their distributors focused on their portfolios.

In general, larger retailers prefer to work with larger wholesalers in order to better integrate and simplify their supply chain and forecast demand. Additionally, retailers continue to rationalize their product SKU selections in order to optimize use of shelf space. Distillers with products that do not meet specified margin or sales velocity rates are ever more susceptible to losing placements. Wholesalers are likely to respond by focusing on those products that meet retailer expectations to the detriment of those that do not. Add these challenges to the steady increase in private label brands and continued growth of craft beer and premium wine, and it becomes clear that there are major headwinds facing suppliers in the three-tier wholesale system. As a result, larger suppliers will find it necessary to continue to add strong brands to their portfolios in order to maintain relevance and mindshare with their wholesale partners.

THE UPSTARTS – RISE OF CRAFT SPIRITS PRODUCERS

The increased demand for Premium and Ultra-priced products, as well as consumers' affinity to "buy local," has allowed craft spirits producers to capitalize on the growth of the spirits industry over the last several years. The Craft Spirits Data Project Report, published in October 2017, provides substantial insight into the growth of the craft spirits industry. For context's sake, the publication defines a craft producer as those whose distilled spirits are produced in the U.S., have not removed more than 750,000 proof gallons from bond, market themselves as craft, and are not openly controlled by a large supplier.

Using this definition, the Craft Spirits Data Project Report shows that a number of craft spirit producers grew from 280 in 2011 to 1,439 in 2016, an increase of over 400%. With price points that tend to fall in the Premium to Ultra price range, craft spirits are clearly a contributor to the eroding market share of larger suppliers. As evidence, craft spirits retail sales by dollar value have increased from $800 million in 2011 to $3 billion in 2016, an increase of approximately 275% - far outpacing the growth of the overall spirits industry. Additionally, in 2016 craft spirits sales represented almost 4% of the total U.S. spirits industry by value, a far cry from the approximately 1% of value share in 2011.

While the growth of the craft spirits industry is encouraging, it is also becoming more difficult to sustain. With the noted increase in power of the consolidating distributor network, it is now exponentially more difficult for craft producers to get access to the market. There is continued evidence of craft producers attempting to expand outside of their home markets with limited success. Without "boots on the ground", as well as the full support of distributor partners, expanding outside of core markets is an uphill battle. Due to these challenges, many acclaimed, luxury priced brands have sought, and will continue to seek, strategic partners that will provide the necessary muscle to navigate the rough seas of distribution.

The past few years have seen large suppliers either acquire craft producers outright, or make minority investments that are accompanied by sales and marketing agreements. Minority investments have been viewed as being mutually beneficial for both parties in that large suppliers are able to fill a "white space" in their portfolio, while the craft producer is able to leverage the distribution prowess of their partner to grow its brand. As the amount of entrants into the craft spirits industry continues to grow, it is expected that more of these types of minority investments will occur in the future.

CONCLUSION – WILL MARKET TRENDS CONTINUE IN 2018?

Barring any negative swings in the U.S. economy, the industry growth trends in 2017 are likely to carry forward into 2018 since there does not appear to be any slowdown in the consumer's seemingly insatiable appetite for higher quality spirits. This push toward premiumization will likely translate into continued acquisitions of Premium and Ultra-priced spirits brands. As the proliferation of higher quality spirits brands grows, the pressing issue of concern for independently owned producers will be access to the retail marketplace. These concerns are bound to spur further M&A sales activity in 2018, as well as the consummation of sales and marketing alliances with larger spirits companies that can secure a sales footprint for independent brands. AS M

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