2018 SPIRITS INDUSTRY MERGERS & ACQUISITIONS

Year in Review

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Mergers and acquisitions (M&A) activity in the spirits industry remained healthy in 2018. Driven by a U.S. economy that continues to outperform expectations, there was strong interest from various buyers to partner with, or acquire, several spirits producers. As predicted in last year's M&A retrospective, the continued growth of premium-priced products, combined with concerns of independently owned producers accessing the increasingly challenging distribution channel, led to numerous investments and partnerships during the year. This activity took place as the spirits industry continued to exhibit relatively positive growth trends.

For the 52-week period ending on October 6, 2018, Nielsen market data showed overall spirits dollar volume growth of 1.3 percent, somewhat lower than last year's growth rate of 1.6 percent for the same period. Growth in the industry continued to be driven by 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 4.4 percent and 5.1 percent, respectively (see Figure 1). This trend towards "premiumization" is consistent with last year albeit at a slightly lower rate of growth. Overall, higher priced offerings in the spirits industry continue to experience solid growth trends which has led to consistent investment interest in the space.

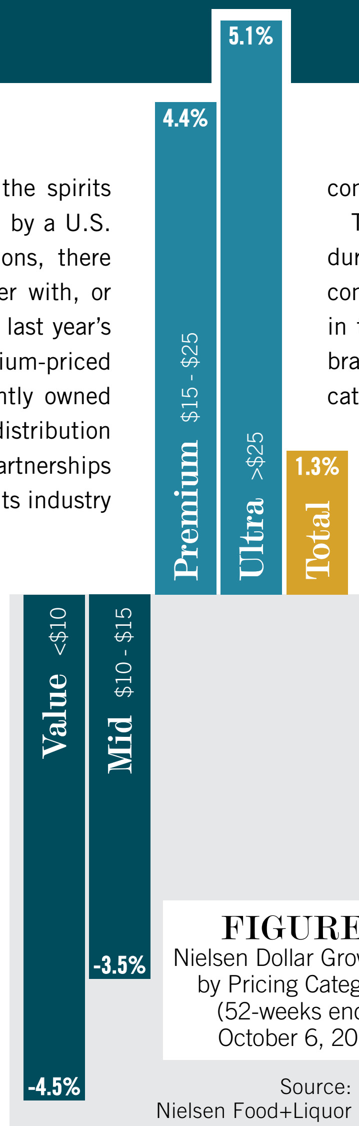


FIGURE 1
Nielsen Dollar Growth by Pricing Category (52-weeks ended October 6, 2018)

Source: Nielsen Food+Liquor

The drivers of M&A activity in 2017 remained relevant during this past year. In general, larger suppliers continued to seek out brands to fill "white space" voids in their portfolios. That is, these suppliers are seeking brands that address a weakness in a specific product category (e.g., tequila or gin), or pricing tier (e.g., ultra-priced whiskey or premium rum). Suppliers remained incentivized to fill these portfolio gaps as they continue to work with the "new world order" of distribution. With two distributor groups, Southern Wine & Spirits and RNDC/Breakthru, controlling over 55 percent of the U.S. wine and spirits market, the pressure is on for suppliers to carry products that are attractive to the retail partners. Lastly, new craft spirits producers continued to emerge during the year, providing an ever expanding amount of product choices for consumers. These choices continue to erode market share of large "legacy" brands forcing suppliers to continue to monitor, and invest in, smaller "upstart" craft spirits producers. As a result of these trends, M&A activity in 2018 remained active and consisted of some high profile transactions, many minority investments, and the introduction of a few interesting new buyers.

MAS TEQUILA! PATRON ACQUISITION HEADLINES 2018 M&A ACTIVITY

One year after the head-turning announcement that George Clooney's Casamigos brand would be acquired by Diageo for approximately $1 billion, 2018 started out with an even larger tequila acquisition. In late January, **Bacardi** stated their intention to acquire the remaining interest of the largest ultra-priced tequila brand — **Patron Spirits** — at an enterprise value of over $5 billion. Bacardi had purchased a 30 percent stake in the brand in 2008, but decided it was now ready to make a deeper commitment to the category. This comes as little surprise due to the fact that Patron was nearing case sales of almost 3 million and is squarely positioned in the ever popular ultra-priced tequila category. Demand for ultra-priced tequila has continued to outperform all other spirits categories in Nielsen data with dollar volume increasing by 13.3 percent for the 52-week period ended October 6, 2018. While this is certainly the marquee transaction for the year, it is indicative of where M&A activity remained focused in 2018 — premium and ultra-priced products (see Figure 2).

In addition to the much-publicized Patron announcement, there was a flurry of other high-profile transactions that closed, or were announced, in the beginning of the year. **Proximo**, the U.S. subsidiary of Casa Cuervo, acquired the fast growing, approximately 250,000 case, premium-priced Canadian whisky brand **Pendleton** for $205 million. Shortly thereafter, it was announced that **Constellation Brands** made minority investments in the Louisville-based, ultra-priced brandy producer **Copper & Kings** as well as the ultra-priced rum brand **Real McCoy**. These brands further strengthen Constellation's craft spirits portfolio that includes several previous investments including High West Distillery, Bardstown Bourbon Company,

FIGURE 2
Notable Spirits Industry Transactions Closed in 2018

TARGET	ACQUIRER	CATEGORY
Pendleton Whisky	Proximo	Premium Canadian Whisky
Copper & Kings	Constellation Brands	Ultra-Premium Brandy
Real McCoy	Constellation Brands	Ultra-Premium Rum
Martin Miller's	Grupo Diego Zamora	Ultra-Premium Gin
Patron Spirits	Bacardi	Ultra-Premium Tequila
Dead Man's Fingers	Halewood International	Ultra-Premium Rum
Puerto de Indias	H.I.G. Capital	Ultra-Premium Gin
Belsazar	Diageo	Ultra-Premium Vermouth
Denizen	Hotaling & Co.	Premium Rum
Casa Dragones	BDT Capital Partners	Ultra-Premium Tequila
Niche Drinks	Luxco	Irish Spirits Portfolio
Atom Brands	ZX Ventures	Spirits Portfolio
Piedre Almos	Diageo	Ultra-Premium Mezcal
Laws Whiskey House	First Beverage Ventures	Ultra-Premium American Whiskey
Gin Sul	Mast-Jägermeister	Ultra-Premium Gin
Wyoming Whiskey	Edrington	Ultra-Premium American Whiskey
Westward Whiskey	Diageo	Ultra-Premium Single Malt Whiskey
Distillery No. 209	Vintage Wine Estates	Ultra-Premium Gin
Multiple Diageo Brands	Sazerac	Spirits Portfolio

Catoctin Creek Distilling, and Nelson's Green Brier Distillery.

Additional early M&A activity included another ultra-priced rum acquisition with the announcement that **Halewood International** would acquire **Dead Man's Fingers**. Spain's **Grupo Diego Zamora**, which acquired Texas-based Yellow Rose Distilling in 2017, continued its portfolio diversification with a majority investment in the approximately 100,000 case ultra-priced **Martin Miller's Gin** brand. Another ultra-priced gin brand, Spain's **Puerto de Indias**, received a significant investment from international private equity firm **H.I.G. Capital**. This was followed by the announcement that **Hotaling & Co.**, formerly known as Anchor Distilling, took a minority stake in yet another premium-priced rum brand named **Denizen Rum**. Rounding out early M&A activity was an additional private equity deal with **BDT Capital Partners** making a "significant" investment in acclaimed ultra-priced tequila brand **Casa Dragones**, as well as **Luxco**'s enhanced partnership with Ireland-based **Niche Drinks**, producers of St. Brendan's Irish Cream and The Quiet Man Irish Whiskey. Finally there was the announcement that **ZX Ventures** had acquired **Atom Group**, a UK-based spirits, eCommerce and import business.

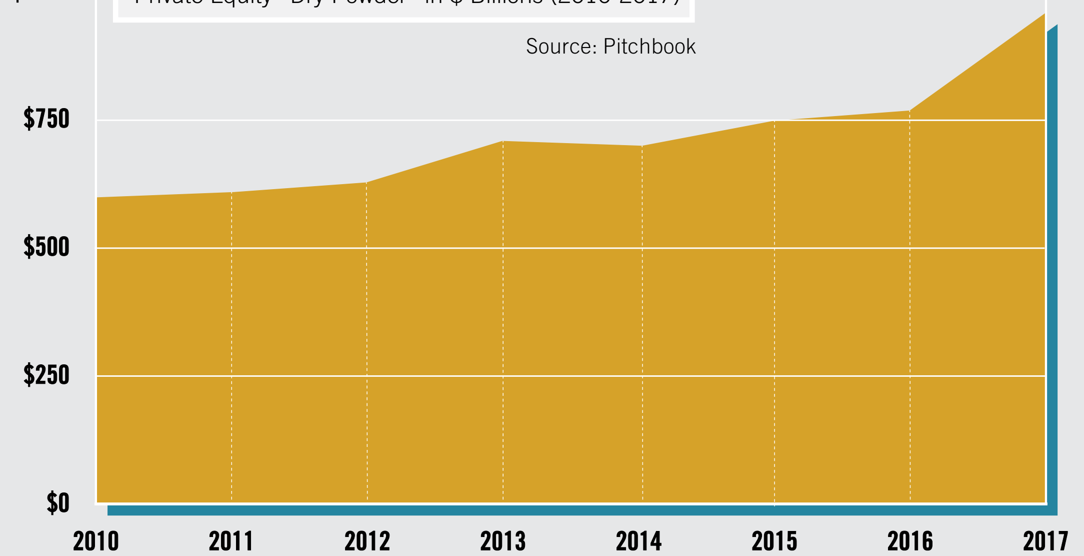
M&A activity throughout the year was also heavily influenced by **Diageo**, the largest spirits company in the world. One year removed from its aforementioned $1 billion tequila deal, Diageo was involved in four transactions in 2018 that reiterated their commitment to higher-end brands. The first was the full acquisition of Germany-based **Belsazar**, an ultra-priced vermouth brand. This brand was the first to "graduate" from Diageo's venture arm Distill Ventures. The second was the acquisition of the Oaxaca-based, ultra-priced **Piedre Almas Mezcal** brand. Diageo's most recent investment, another ultra-priced play, was a minority investment in Portland, Oregon-based **Westward Whiskey**. This investment is of particular note in that Westward is a leading American single malt whiskey brand, an emerging category that continues to garner acclaim within the world of whiskey aficionados.

Finally, Diageo announced in November that they were selling off numerous sub-Premium brands to Sazerac for $550 million. Sazerac, the Louisiana-based owner of Buffalo Trace bourbon, has been steadily adding to its portfolio over the years including the recent addition of Southern Comfort. This transaction includes 19 brands, highlighted by Seagrams's VO whiskey, Peligroso tequila, Myers's rum, Romana Sambuca, Popov vodka, Yukon Jack whiskey and Goldschlager schnapps. Diageo said the deal will allow it to focus on the faster-growing premium-priced drinks in its U.S. portfolio, which include new brands like Casamigos alongside its core whiskey and vodka lines.

Additional transactions announced included two additional ultra-priced whiskey and ultra-priced gin investments. During the summer, **First Beverage Ventures** announced taking a minority stake in Colorado-based **Laws Whiskey House**. This was followed by **Mast-Jagermeister** making a "strategic investment" in Germany-based **Gin Sul**. In September, Scotland-based **Edrington** made a majority investment in **Wyoming Whiskey**. For Edrington, producer of acclaimed scotch brands Macallan, Highland Park, Glenrothes, Cutty Sark and The Famous Grouse, this is its first foray into the American whiskey category. Lastly, it was announced in November that **Vintage Wine Estates** acquired the San Francisco-based **Distillery No. 209**, which gained popularity for its ultra-priced No. 209 gin.

While acknowledging that 2018 was another busy year for spirits industry M&A activity, it is important to take a step back and review these deals to tease out relevant trends or observations. The diverse nature of these transactions provides some interesting insights. These include private equity firms lighting a fuse, rum emerging from the shadows, vodka struggling to remain relevant, and a beverage alcohol Goliath jumping into the fray.

FIGURE 3
Private Equity "Dry Powder" in $ Billions (2010-2017)



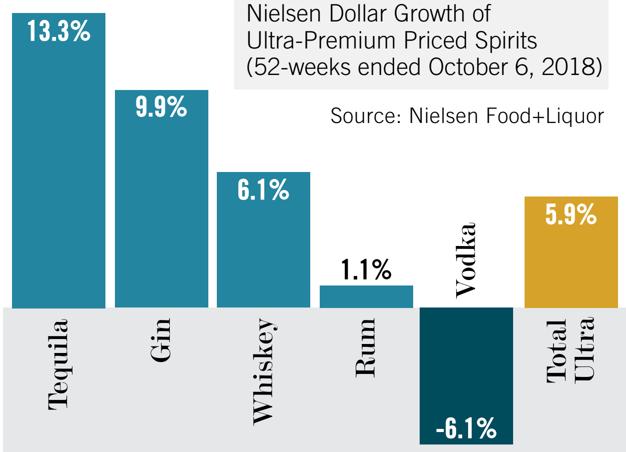
PRIVATE EQUITY LIGHTING "DRY POWDER"

2018 marks the first year in recent history that multiple private equity firms set their sights on the spirits industry. During the year there were three private equity backed investments made by H.I.G. Capital, BDT Capital Partners, and First Beverage Ventures. Private equity firms, which make their money buying and selling companies in a span of five to seven years, have a long history of investing in other beverage alcohol categories. The craft beer boom in the middle of this decade saw numerous high profile transactions take place with many of the largest consumer focused firms investing in the space. Additionally, there has been a recent wave of investments in the wine industry that has produced billions of dollars of transactions. It may be easy to point at the growth in the premium-priced segments of those industries, or recent high profile acquisitions by strategic buyers, but that is not the whole story.

Private equity firms are sitting on a record amount of "dry powder." Dry powder refers to the amount of capital that has been committed to firms by their investment partners that has yet to be deployed. Pitchbook reports that at the end of 2017 dry powder reached almost $1 trillion, the highest amount in the industry's history (see Figure 3). These firms are incentivized to invest this money in a timely manner in order to provide the desired economic returns for their partners. With so much money available, these firms need to find industries in which to make some investments. This leads us back to the recent deals completed by these types of firms in 2018. It would not be surprising to see more investment in the industry in light of the recent high-profile, high-dollar, acquisitions that have taken place in the last few years. Private equity may be wise to place some bets in the industry in that the rewards can be substantial upon a successful exit.

FIGURE 4
Nielsen Dollar Growth of Ultra-Premium Priced Spirits (52-weeks ended October 6, 2018)

Source: Nielsen Food+Liquor



YO-HO-HO, AND A BOTTLE OF RUM

Consistent with 2017, there were several transactions during the year that involved ultra-priced tequila, whiskey, and gin brands. The reasoning behind these deals is clear — these are the categories that have continued to outperform the overall spirits market. For the 52-week period ending October 6, 2018, Nielsen market data showed ultra-priced tequila, gin and whiskey dollar growth of 13.3 percent, 9.9 percent and 6.1 percent, respectively (see Figure 4). This same data shows that ultra-priced rum grew by a mere 1.1 percent, yet there were surprisingly three ultra-priced rum investments during the year. On reflection though, these transactions make sense if one considers product supply and consumer trends.

The recent boom in American whiskey and tequila has left producers scrambling to keep up with demand. Due to this demand, pricing of aged whiskey has nearly tripled in the last few years. Even more detrimental is the shortage of agave, the key ingredient to make tequila. Tequila Matchmaker reports that agave shortages have increased agave pricing to nearly 25 pesos per kilo versus 2016 pricing of approximately 4 pesos per kilo, a significant price increase. In contrast, anecdotal evidence suggests that the supply of current, and aged, rums continues to remain relatively stable. If suppliers believe that rum will follow a similar trajectory of other spirits products, that is, higher priced "craft" offerings, then the rum category could be the next segment to reach critical mass. If that is the case, then these investments may prove to be very fruitful.

TITO'S PROPPING UP STRUGGLING VODKA CATEGORY

In reviewing the transaction activity for 2018 it was surprising to note that there were no transactions involving vodka brands. While the pace of investments in this category has slowed over the last few years, this is the first year for some time that a vodka brand was not acquired. This is of particular interest in that vodka is the second largest spirits category based on Nielsen data. That being said, review of recent market data suggests that this category is facing some serious headwinds which may be leading some to question the vodka category's growth prospects.

For the 52-week period ending October 6, 2018, Nielsen market data reveals that the vodka category is down 0.2 percent. While that may not appear to be a significant decline, digging into the data suggest a different story. Across all pricing tiers, except for premium-priced, the category is declining by 5 percent or more. The premium-priced vodka category is the only tier that continues to grow, having increased 9.8 percent year-over-year. While that appears to be positive, the data reveals that the growth in that category is strictly driven by Tito's. Tito's, which represents nearly 50 percent of the premium-priced category, continues to outpace every other spirits brand of its size by growing an impressive 25.3 percent during the year (see Figure 5). Tito's has now become the largest single spirits brand across all spirits categories tracked by Nielsen — an amazing feat for an independently owned brand. If Tito's is removed from the data set then it shows that the total vodka category would have declined by 4.3 percent in the last 52-week period ended October 6, 2018. These figures suggest that investors are being prudent in not committing resources in this struggling category.

FIGURE 5
Nielsen Dollar Growth of Vodka by Pricing Category (52-weeks ended October 6, 2018)

Source: Nielsen Food+Liquor

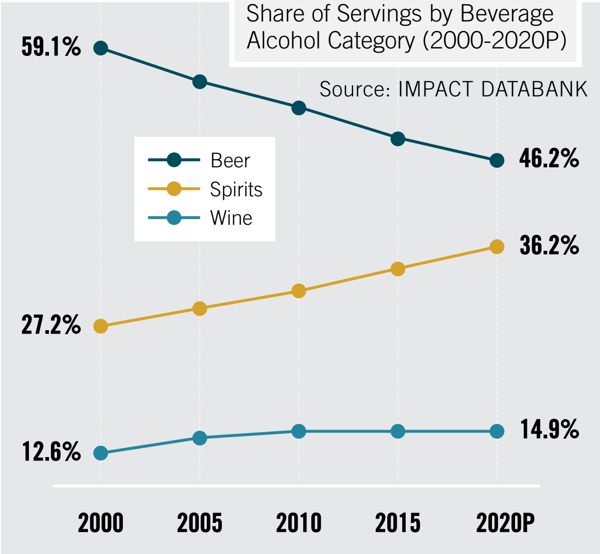
BEER BEHEMOTH ENTERS THE RING

In April, an announcement was made that ZX Ventures acquired the Atom Group, a UK-based spirits, eCommerce, and import business. This deal may have gone slightly unnoticed in the craft spirits industry, but is important in that ZX Ventures is the "global growth and innovation team" of Anheuser-Busch InBev (AB InBev). AB InBev is one of the world's largest, and most influential, consumer product companies — this deal marks their first foray into the spirits category. In a letter to wholesalers to discuss the transaction, an AB InBev executive wrote that the deal meets two of the company's strategic initiatives: "gain share of throat and lead category development." This investment should come as little surprise as AB InBev has been struggling over the last few years due to changing consumer preferences.

Over the last three years, AB InBev has witnessed their stock price decline by almost half. This is significant in light of how well the overall stock market has performed during the same period. Historic and projected consumption data spells out very clearly the monumental task the company faces to "right the ship." AB InBev has fallen victim to a shift away from mass-market beers. Beer, still the largest beverage alcohol category, is projected by IMPACT Databank to account for 46.2 percent of share of servings in the U.S. beverage alcohol category in 2020. This projection is a far cry from the share the category held in 2000 when beer represented 59.1 percent. The beneficiary of this change in consumer preference has been the spirits industry. Spirits share is projected to grow from 27.2 percent in 2000 to 36.2 percent in 2020 (see Figure 6). These industry dynamics have left AB InBev looking for solutions to their "share of throat" problem.

Part of the solution is the Atom Group investment, but AB InBev has also recently partnered with Beam Suntory to cross-promote their flagship brands across bars and retailers throughout the U.S., as well as launching Budweiser

FIGURE 6
Share of Servings by Beverage Alcohol Category (2000-2020P)



Reserve Copper Lager, a limited-edition beer aged in Jim Beam bourbon barrel staves. With a strong history of growing through acquisition, it will be interesting to monitor the impact of having another international drinks giant playing in the spirits space.

PEAK SPIRITS M&A ACTIVITY?

Assuming the economy continues to outperform expectations, it is fair to assume there will be continued M&A activity in the spirits industry in 2019. The drivers of activity in 2018 will remain relevant in the new year and will be bolstered by the entry of deep-pocketed buyers including AB InBev and private equity firms. That being said, there are a few factors that may present challenges to the continuation of the frantic pace of M&A activity in the industry.

With the amount of high-profile transactions occurring recently, there is anecdotal evidence that some large strategics are taking time to "digest" these acquisitions. Many "white spaces" of their portfolios have now been filled which could result in a decreased appetite to acquire additional brands in the near term. Additionally, some of these same buyers are being pulled into the emerging cannabis industry. Constellation, which recently made a multi-billion dollar bet on Canopy Growth, has publicly stated they will curb their M&A activity over the next year as they manage their expanding debt load. Other large spirits companies, Diageo and Pernod Ricard, have been rumored to be interested in the category as well. These companies have been very active over the last several years — combine that with additional interest in cannabis, and 2019 may be a year where these large players reduce their M&A activity in the spirits category.

In an effort to curb inflation, the Federal Reserve has been steadily increasing interest rates over the last year. This increase has an impact on all M&A activity by making acquisition financing more expensive and may lead buyers to become more selective with their investment dollars. Increased financing costs, combined with a softening in year-over-year dollar sales growth in the industry, leads to a less attractive investment thesis than in previous years. It's too early to announce the peak of spirits industry M&A activity, but the aforementioned factors may provide some headwinds for 2019 and beyond.

Kevin O'Brien is a Sr. Vice President with Zepponi & Company, a leading beverage alcohol M&A firm. Dedicated to the beverage alcohol industry, Kevin has presented on various accounting and finance related topics for the American Craft Spirits Association, American Distilling Institute, Brewers Association, and Oregon Wine Board. Kevin will be providing additional insight into M&A activity during his presentation at the American Craft Spirits Association convention in February 2019.