PGIM FIXED INCOME

All the Credit® Episode 42

Transcript

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Female Voice: You're listening to *All the Credit®*, a monthly podcast series brought to you by PGIM Fixed Income, an active global fixed income investment manager. And now, your co-hosts, Senior Portfolio Manager, Mike Collins, and Portfolio Manager, Alyssa Davis.

Alyssa Davis, Co-host and U.S. Investment Grade Corporate Bond Portfolio Manager: Hello, and welcome to *All the Credit®*. I'm Alyssa Davis.

Mike Collins, CFA, Host and Senior Portfolio Manager, Multi-sector Strategies: And I'm Mike Collins.

Alyssa: And we're two of the many investment professionals at PGIM Fixed Income, and your hosts of *All the Credit®*. Considering we're in the heart of summer, we decided to keep things light for this episode. Today, we will focus on the industry trends occurring in the alcoholic beverage of choice for many consumers during these dog days of summer–beer. First, we will take a brief look at the composition of the beer market following active M&A consolidation. We will discuss market share dynamics for beer and explore competing products in adjacent categories. For most of the discussion, we will focus on trends in growth, pricing, and margins for the biggest brewers while considering potential impacts of consumers trading down in the current macro environment. And to wrap up, we'll end with a brief discussion on portfolio positioning in the sector. So, a full episode today. And here to educate us on the beer market is one of PGIM Fixed Income's credit research analysts, Elitza Fleischman, who's making her inaugural appearance on the podcast. Elitza is a Credit Analyst for PGIM Fixed Income's U.S. Investment Grade Credit Research team. She covers the U.S. and non-U.S. consumer and retail sectors. Prior to joining PGIM in 2008, she worked at Credit Suisse on the Leveraged Finance Research team, where she covered the media sector. And earlier at Credit Suisse, she was in the Investment Banking Division, where she focused on the retail sector. She received a BS in Accounting from Saint Peter's College, and an MBA in Finance from NYU, Stern School of Business. Elitza also holds the Certified Public Accountant (CPA) designation. Elitza, Mike, and I are here to give you all the credit. Welcome to your first episode of *All the Credit®*, Elitza.

Elitza Fleischman, CPA, U.S. Investment Grade Credit Research Analyst: Thank you for having me. I'm excited to participate in my first podcast.

Mike: Well, I'm excited about the topic. I think this is a great idea to talk about beer, as Alyssa said, in the middle of summer here. And 30 years ago, or so, Elitza, I was also a consumer products and beverage analyst. And wow, a lot has changed. In fact, I can't even really keep track of who owns who and who's selling what. There's been a lot of consolidation, a lot of M&A, a lot of brands trading hands over the last few years and even decades. Why don't you just set the stage for the audience to remind everybody and educate me as well on who the big players are, what has changed, what are the kind of latest market shares, etcetera?

Elitza: You're right, Mike. The beer industry has gone through significant cross-border consolidation. In 2004, InBev was formed by a merger of Interbrew, a Belgian-based brewer, and AmBev, a Brazilian-based brewer. And in 2008, the group acquired Anheuser-Busch for 52 billion in order to expand to the U.S. market. Later, in 2012, the group acquired the remaining 50% it did not own of Grupo Modelo, which is a Mexican brewer, and the maker of the Corona beer, for 20 billion. Lastly, in 2016, Anheuser-Busch InBev acquired its largest rival, SABMiller, for 78 billion British pounds. The merger was called Megabrew, and as a result of consolidation activity, today, Anheuser-Busch controls more than a third of the global beer profit pool. ABI's competitors have also benefited from ABI's consolidation activity, as the company has had to sell assets in order to appease regulators and to reduce debt. Notably, Constellation Brands purchased Grupo Modelo's U.S. assets, which allowed it to become a significant player in U.S. beer and in a very attractive category, namely Mexican imports.

Alyssa: Thank you for that perspective, Elitza. Let's shift our discussion to focus on current market shares, not only by brewer but also by brand. How have these evolved over time, and what are some of the more recent trends in the market?

Elitza: So globally, Anheuser-Busch is the largest brewer. It controls approximately 26% of beer volumes, which is well ahead of its nearest competitors, Heineken and Carlsberg, with 14% and 7% respectively. In the U.S. market, Anheuser-Busch and Molson Coors control the majority of beer volumes, albeit their market shares have been declining as a result of the decreasing popularity of mainstream beers and increasing popularity of exports, craft brews, and hard seltzers. As for brands, here in the U.S., we're all aware of a relatively recent marketing campaign gone awry for one of the more well-known brands of light beer. The impacts on that brand have been tremendous, with volumes for the brand down in the mid to high 20% range, and volumes for its overall U.S. business down in the low to mid-double digit range. This has benefited competitors. One of the major takeaways from this event is that diversification is an important consideration for credit quality, as it allows a company to offset weak performance in one area with stronger performance in other areas of the business.

Mike: Yeah, so while we're talking about this, and you mentioned kind of waning sales among traditional, high-volume brands, how have the trends been, really, Elitza, over the years, beer relative to, let's say, wine and hard liquor? And my sense is, I have a bunch of children in their 20s, and it doesn't seem like they drink as much beer as they will, like maybe a vodka and seltzer or something like that. And then you also have those hard seltzers, which obviously were really, really popular a few years ago. I don't know if that's changed, and we have all these new-age prepackaged cocktails that seem popular. It just seems like there's constant shifts going on in consumer demand for the different competing products, if you will. How has that changed, and how do you see that going forward?

Elitza: So globally, beer retains the number one share in total beverage alcohol with about 41% market share, while spirits are second at around 35%, and wine is around 20%. However, in the U.S., beer has been losing market share since the 2000s, when it accounted for over half of all alcohol sales, while spirits has been the main beneficiary, and wine has stayed relatively unchanged. In addition, craft breweries, which are characterized by their small scale and often independent production, have gained market share from mainstream beer, as have imported beers and hard seltzers, albeit the latter is currently experiencing declining volumes after explosive growth. Another interesting trend we have observed is the blurring of the lines between products made by the alcoholic, non-alcoholic beverage producers, and even tobacco companies. For example, hard seltzers, which are typically made by brewers, compete with canned cocktails and canned wine, which are typically made by spirits and wine companies. And lastly, non-alcoholic beverage companies enter the hard seltzer market in partnership with brewers.

Mike: You mentioned non-alcoholic beer, has that moved the needle for these companies?

Elitza: So non-alcoholic beer is currently only around 5% of the total U.S. beer market. However, it is growing faster than the overall beer market, and brewers have developed offerings that cater to that segment of the consumer. Should that continue to increase its market penetration as expected, it could help partially impede some of the decline in mainstream beer.

Alyssa: Elitza, if we think back to the pandemic, were brewers a beneficiary when everyone was in lockdown? And were there any impacts on the industry from the global supply chain disruptions that we experienced during that time period? And now that we're fully reopened and the service economy remains robust, how do sales and profits look at these brewers compared to pre-COVID levels?

Elitza: During the pandemic, sales of beer declined initially as bars and restaurants were closed, and some countries took measures to limit the sale and production of alcohol. However, sales rebounded after a couple of quarters as consumers simply switched to gathering at home, and some of the aforementioned restrictions on alcohol were lifted. Currently, beer sales are higher than pre-COVID levels due to price increases and premiumization. However, margins have not recovered to pre-COVID levels as price increases have not been enough to fully offset inflation and FX headwinds. Going forward in 2024, as raw materials such as barley and aluminum have declined, and as companies' more expensive hedges roll off, we would expect margins to improve.

Mike: You were talking about COVID, and that was a very unique type of recession, of course, with the lockdowns. But right now, everybody's focused on the next recession, and there are a lot of pretty high expectations for a recession sometime in the next 12 months or so. How typically, Elitza–I mean, the kind of conventional wisdom is when there's a recession, people don't stop drinking beer. Maybe they just down trade, and instead of going out to bars and drinking cognacs, they stay at home drinking beer. So how does that actually work? Is there enough experience from your perspective in past recessions? And what would you expect over the next year or two if we do have a kind of a big global slowdown?

Elitza: Overall, beer is an affordable luxury, especially in developed markets. And compared to spirits, as you mentioned, the beer is much cheaper than having a cocktail at the bar. That being said, we could see some consumers down trade to less expensive beers and drink at home, which could have negative implications for margins. And in emerging markets, consumers could also switch to illegally brewed beer as budgets there are more significantly impacted by the cost of food and beverages. But I would say in a relatively shallow recession, we shouldn't see much of an impact to brewer sales and profitability and cost takeouts, such as reduced marketing, or offering consumers returnable bottles in emerging markets could be used as levers as needed. Overall, we see the beer industry as relatively recession resistant.

Mike: That's always been, I think, the traditional view there. So that's good to hear. To really wrap up on the fundamentals, your job, Elitza, is to analyze these companies, not just from a business perspective, but their ability and willingness to pay back their debt. Alyssa, you're one of the leaders in managing the bonds within this sector, so how are we positioned today relative to our benchmarks, whether they're corporate portfolios or even the multi-sector portfolios that I jointly co-manage?

Alyssa: Sure, Mike. We have been positioned in the sector with an overweight versus the benchmarks. Specifically, that's really driven by our overweight to the largest brewer in the investment grade corporate index, which is Anheuser-Busch. In fact, due to their outstanding debt profile, which is more heavily weighted to longer maturities, Anheuser-Busch is even larger in the long-duration benchmarks. That company continues to work towards further deleveraging of their balance sheet and has further ratings upside potential. We also have a less significant overweight to Constellation Brands, another big brewer in the index, and an underweight to Molson Coors.

Alyssa: Well, that wraps it up for today. Thank you, Elitza, for joining us today. And thank you, Mike Collins, for hosting with me. And many thanks to all our listeners for tuning in to this latest episode of *All the Credit*®. You can see all of our thought leadership on our website at PGIMFixedIncome.com and catch our latest hard-hitting research on The Bond Blog. Thank you for listening.

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