



Rabobank

Spirits Quarterly Q1 2015

The flavour of growth in global spirits

Europe Demand for spirits across Europe has been mixed, with several major companies reporting declining sales in key markets, while there are some signs of stabilisation in southern Europe

Scotch suppliers are seeing a decline in export demand, which has led Diageo to defer plans to expand production capacity, while aged rum is showing positive performance

China Continued consumer migration away from the luxury segment of the Chinese spirits market is affecting both foreign and domestic players

E-commerce continues to grow share of spirits sales in China, supported in part by aggressive pricing, and is driving fundamental changes in the market

United States The US market continues to show signs of premiumisation and volume growth, though growth rates are slowing

The vodka segment sees ongoing pricing pressure, and while key brands show dynamic growth, flavoured vodkas appear to be losing share to flavoured whiskies

India The Indian spirits market appears to have returned to growth mode, delivering important gains in volume and average pricing

Brazil Cachaça sales in Brazil returned to growth across measured channels in 2014, supported by greater innovation, favourable weather and, of course, the World Cup.

Bar Talk Discussions with the bar manager of the Yani Lounge Bar in Shanghai point to trends among millennial consumers in that market

Regional outlooks

Europe

Mixed messages

The financial results of the major spirits companies in Europe are giving mixed messages. In its Q1 2014/15 numbers, Pernod reported a 1% decline in Europe, with a drop in sales in Poland and Germany especially. However, the company also reported a return to growth in Spain for the first time since 2008, indicating that the spirits market in southern Europe continues to stabilise. Gruppo Campari reported modest growth of 0.8% in Europe (excluding Italy) in their Q3 financials, with a significant decline in sales in Germany, but a solid performance in Central and Eastern European markets. Italy posted growth of 4.2%, on the back of good sales for both Campari Soda and Crodino.

Bottoms up: Difficult times for Scotch

After the shake-up caused by the Scottish independence referendum in early September, Scotch producers are facing another hurdle as export figures for 2014 are showing signs of a slowdown in the sector. Over the past years, Scotch has been one of the rising stars of the spirits category, registering a CAGR of nearly 7% (in value terms) between 2008 and 2013. However, Scotch exports totalled GBP 2.81 billion for first three quarters of 2014, signifying a drop of 8.6% compared to the same period a year earlier (see Figure 1). The decline was driven mainly by subdued demand in some of the core markets for Scotch. Seven out of the top-ten export markets declined compared to last year, most notably the US and Singapore (which is the main entry port for Scotch exports to China).

While the recent slowdown in Scotch exports does not yet represent a long-term trend and may well still turn around, declining shipments to the US and other markets are a concern and could be an indication that the Scotch industry is battling structural challenges. Besides the strong British pound, Chinese anti-extravagance measures and the lingering effects of the

global economic slowdown on spirits consumption, Scotch seems to be losing share to other, more innovative spirits categories, including bourbon, Irish whiskey, rum and gin. Diageo's recent announcement to delay plans for expanding the company's production capacity in Scotland suggests that at least some companies see the recent slowdown as more structural than temporary.

However, it is not all bad news. France, the number one market for Scotch in volume terms, showed modest growth. India, a notoriously difficult market for foreign spirits due to high taxation, also showed that demand for foreign (brown) spirits continues to increase, as Scotch exports to the country increased by 20%. Furthermore, exports of single malt Scotch were up 17% (YOY) in Q3 2014, indicating that consumers are still trading up in the Scotch category.

Beware the tropic thunder: Rum on the rise

One category that appears set to capture share from Scotch is dark rum. High-quality aged sipping rums are winning over consumers in the UK, Benelux, France, the Nordics and Eastern Europe, as they look to change up Scotch or gin consumption on the back of the current premiumisation trend. However, rum is also growing outside of the super-premium category, with Diageo's president in Europe dubbing Captain Morgan as the growth driver in Europe on a recent call. With brands like Kraken, Sailor Jerry and Bacardi Oakhart becoming increasingly popular, Europe is all set to face some more Dark 'N Stormy winter weather.

Outlook

With the all-important holiday season just behind us, spirits companies are eagerly awaiting the results from the last quarter of 2014. The past months have shown some signs of stabilisation in the European spirits sector, but as the mixed results of the major spirits companies show, we are not out of the woods yet. Scotch companies will continue to face the challenge of drawing in new customers to keep up their impressive growth, whereas the rum category might well be more content with what could be in store for them this year.

Figure 1: Scotch exports for Jan-Oct 2014

	Value in GBP million	YOY change
US	571	-10.9%
France	373.1	2.2%
Taiwan	165.5	45.0%
Singapore	157.6	-41.1%
Spain	133.9	-7.5%
South Africa	121.5	-12.8%
Germany	118.3	-16.4%
South Korea	90.4	-7.3%
UAE	89.6	27.1%
Brazil	69.3	-17.5%

Source: HMRC, 2014

China

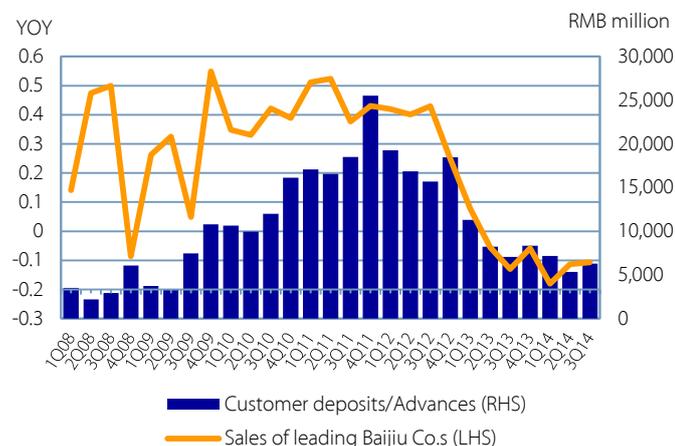
Continuing weak performances

All the listed Baijiu companies in China have released their Q1 through Q3 2014 results, with a 22% decline in total net profit and an 11% decline in sales for the industry (see Figure 2). The SG&A remained high, as manufacturers still struggled to adjust their business models. Advances from customers, a leading indicator measuring distributor confidence and market sentiment, continued to decrease, with a decline of 11% YOY. There is still no sign of a turnaround in demand for the industry as a whole, and there are differences in the trends for wines compared to spirits and for domestic versus foreign players. Pernod Ricard's recent results suggest that its shipments to China rose 4%, while its overall revenues declined by 9% due to a shift to less premium products. We do see that the destocking of wine is close to over, but spirits are still suffering from a downward cycle and the impact of e-commerce, which has caused a price war. Foreign spirits brands will continue to destock and reduce receivables over the next six months before finally stabilising. They will also be focusing on introducing more value-oriented products in order to grab market share in the mass market—given weakness in demand in the higher priced segments of the market.

Trading down

Gross margins of the overall Baijiu industry declined from 34.4% in 2013 to 31.3% between Q1 and Q3 2014, reflecting consumers' shift away from luxury baijiu in favour of low-price products with lower margins. Wuliangye, the second-largest baijiu company in China, recently announced yet another reduction on the ex-factory price of its core 52 degree product (52% alcohol content) to RMB 509/500 ml bottle, from RMB 609/500 ml, just after an announcement that its ex-factory price was cut by 16% to RMB 609/500 ml bottle in late May 2014. Another premium brand, Guojiao 1573, finally played down to the market and cut its ex-factory price by 18% after observing slow movement in products and a high inventory level. As retail

Figure 2: Sales momentum of leading baijiu companies and declining customer advances



Source: Bloomberg, Rabobank, 2014

prices of high-end products have continued to fall, this is having negative implications on 2nd and 3rd-tier brands, as they are being forced to focus on the mass market, where retail prices of below RMB 200 are more acceptable.

Destructive price wars among e-commerce players

11 November, or '1111' jokingly referred to as the Bachelors'/Bachelorettes' Festival in China, has become a major promotional event for e-commerce and for marketers of alcoholic products. Just one week before the Festival, some major alcoholic verticals, such as Jiuxian.com, or other horizontal platforms like Tmall.com, had already initiated aggressive promotions for a number of major brands, such as Moutai and Wuliangye, by offering discounts in the range of 20% to 30% to ex-factory prices. The online spirits market value has almost doubled every year over the last three years and is estimated to contribute 1.5% of the total market in 2014. E-commerce is forcing traditional channels to change. Layers of distributors will have to be streamlined and manufacturers will need to focus on high-value products to stand out in mass market. Some of the major distillers are rushing to establish their own websites for direct selling to brush up their brand images. For small brands, many are introducing their products on established horizontal platforms such as Alibaba.com and JD.com.

Opening up further to foreign investment in the baijiu sector

The revised Catalogue for the Guidance of Foreign Investment Industries 2014 reveals that the National Development and Reform Commission (NDRC) is further opening the China market to foreign investment, and foreign investors are now allowed to take majority control of domestic baijiu distillers with a long history, whereas the previous version does not permit such investments. The domestic baijiu industry is highly fragmented and the top-four distillers only account for 15.4% of the whole industry value. The ongoing industry downturn is gradually weeding out many small brands and offers an opportunity for market leaders to consolidate. The reform of state-owned companies has once again been raised on the government's agenda. In the past, baijiu distillers were heavily controlled by local governments, as they are major tax revenue contributors locally. The relaxed investment guide also presents opportunities for international strategic investors who are interested in gaining a foothold in the domestic spirits sector.

Flavoured alcoholic beverages (FAB) are a rising star

The market size of FAB is expected to reach USD 500 million this year. The millennial generation (born between the 1980s and 1990s) prefers products that are trendy and have personality, and are boosting FAB as a sub-category. In Japan, FAB's market share in total alcoholic drinks grew from 0% to 30% over the past 30 years, taking market share away from beer. Currently, Rio and Bacardi each possess one-third of the market in China, but many new entrants are taking a share from the growing pie.

Strategically, this may fit in with China's current market trend of catering to genuine consumer demand for subcategories with sustainable growth and engaging the millennial generation.

Outlook

Looking forward to the next quarter, the 1st-tier domestic baijiu manufacturers are expected to slow their shipments to preserve the stability of prices of their leading premium products. The seasonally increased demand from New Year's Day and the Chinese New Year in Q1/2015, will likely see retail prices stabilising at the current level in view of the competition from e-commerce. Lower tier brands will have to focus on products with good price/quality to grab the mass market. There is no sign of an immediate turnaround, and the market will probably only begin to stabilise towards late Q1 2015.

United States

Ongoing growth, but a slowing pace

The good news out of the US is that the spirits market continues to grow and value growth continues to outpace volumes. Even the on-premise category, which has been the soft spot of the spirits market, appears to be showing signs of improvement.

While the overall trends in the US market remain positive, it should be noted that the ongoing premiumisation trends (particularly in whiskey) and the success of several new key product innovations, which have helped drive the success of the market, have masked some of the underlying challenges. Volume growth remains positive, but there has been a marked slowdown in the rate of growth in 2014. The US market is currently experiencing its slowest rate of volume growth since the recession (see Figures 3 and 4).

Figure 3: Volume growth of spirits sales in control states by category, Jan-Oct 2013 vs 2014

	Jan-Oct 2014	Jan-Oct 2013	Pct Change
Domestic whiskey	4,686,526	4,539,515	3.2%
Total Scotch	961,172	969,772	-0.9%
Canadian whiskey	3,329,889	3,384,246	-1.6%
Irish whiskey	361,700	328,447	10.1%
Other imported whiskey	1,943	1,377	41.1%
Gin	1,829,663	1,873,230	-2.3%
Vodka classic domestic	7,815,664	7,618,797	2.6%
Vodka classic imported	3,083,042	3,001,767	2.7%
Vodka flavoured domestic	1,487,890	1,443,076	3.1%
Vodka flavoured imported	1,187,932	1,253,391	-5.2%
Vodka	13,574,528	13,317,031	1.9%
Rum aged dark	87,079	71,563	21.7%
Flavoured rum	2,375,961	2,372,588	0.1%
Rum Gld	554,647	570,807	-2.8%
Rum Lt	1,557,166	1,576,784	-1.2%
Rum	4,574,853	4,591,742	-0.4%
Brandy/Cognac	1,663,205	1,557,777	6.8%
Tequila	1,890,407	1,819,833	3.9%
Whiskey-based liqueurs/ cordials	1,468,610	1,023,792	43.4%
Total Spirits	38,662,973	37,862,361	2.1%

Source: NABC, 2014

Pricing pressure in key categories

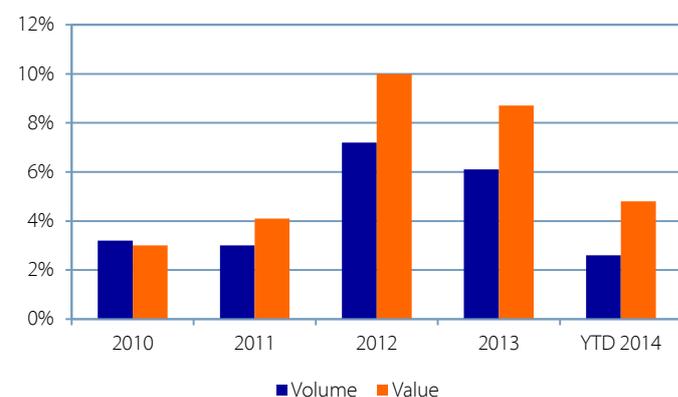
Beyond slowing growth, in spite of the improving overall average value, pricing is still challenging in many individual categories. The positive trends seen in sales of super-premium bourbons, single malt Scotch whiskeys and several ultra-premium vodka brands have helped keep average prices on the rise, even as pricing pressure mounts in other segments. Pricing in the premium vodka segment in particular remains intense, with Diageo entering the fray and becoming notably more aggressive in its pricing of Smirnoff. Not all of the category pricing pressure in the market is reflected in IRI or Nielsen data, as discounts are often provided via mail-in coupons or other rebates that are not picked up by scanner data. Given the soft trends in many other major global markets, spirits companies appear to be looking to the US to drive sales growth, which is helping to create pricing pressure in categories that do not have supply constraints.

Tito's and New Amsterdam drive domestic vodka growth

In recent years, imported vodka brands had the upper hand in driving growth of the vodka segment, but current NABCA data suggests that domestic vodka (including both flavoured and unflavoured) grew 2.7% in the first ten months of 2014, while imported vodka grew only 0.4% during the same period. This phenomenon is more than a consumer shift in favour of domestic versus imported, as it appears to be the result of two separate trends: Growth of specific domestic vodka brands and flavoured whiskey taking share from flavoured vodka.

In 2014, two domestic vodka brands have clearly outperformed: Tito's Handmade and New Amsterdam. During the first ten months of 2014, these two brands added more than 240,000 cases of growth in control states, while the total growth of domestic vodka category was less than 200,000 cases. These two brands are taking share from other domestic vodka brands but also appear to be stealing share from imported vodkas. Tito's pricing is similar to Absolut, which has seen volume pressure that coincides with Tito's growth.

Figure 4: US off-premise spirits consumption growth rates by volume and value



Source: IRI, 2014

Flavoured whiskies taking share from flavoured vodka

In addition to the strength of these two domestic vodka brands, imported vodkas seem to face another major challenge: flavoured whiskies. Flavoured whiskies (or whiskey-based liqueurs/cordials) have been the hottest growth segment in the US spirits market and have generated more than half of the spirits segment volume growth to date in 2014. Flavoured whiskey growth appears to be taking market share from flavoured vodkas, as NABCA reports that imported flavoured vodka has fallen by more than 5% YTD.

Outlook

The 2014 holiday season and the start of the calendar year 2015 have seen continued, moderate growth of the spirits categories. The super-premium and flavoured American whiskey trends show no signs of slowing any time soon, while vodka's volume growth will likely be largely driven by intense pricing.

In terms of categories that may drive growth in the future, we believe that Cognac and brandy hold interesting potential. Cognac has seen some renewed growth in the US market but still seems to struggle to gain broader acceptance in the mainstream markets. The brandy/Cognac category appears to have all of the elements that should make it successful in the US market—ability to drive premiumisation through perceptible quality differences and a flavour profile that lends itself to mixability/cocktails/ flavour pairings. The category has not yet cracked the code for greater success, but many key elements seem to exist.

India

Market update

Typically, the second quarter of the fiscal year is lean period for the Indian spirits industry. However, this year turned out to be different for Diageo-owned United Spirits, with a 5.8% total volume increase, its first in nearly five consecutive quarters. With Pernod Ricard India showing an even stronger double-digit performance, overall volumes in the market improved. Coming on the back of ~4% volume growth in Q1 2015, this marks a return to growth for the Indian spirits sector. The structural shift

from a volume-based to a value-based business model continues, with all major spirit companies focused on transitioning customers to the premium category. In 2013, despite volume growth of only ~3%, value increased by 9%. Similarly, in Q2 2014/15 volume growth of ~6% returned a strong double-digit value growth.

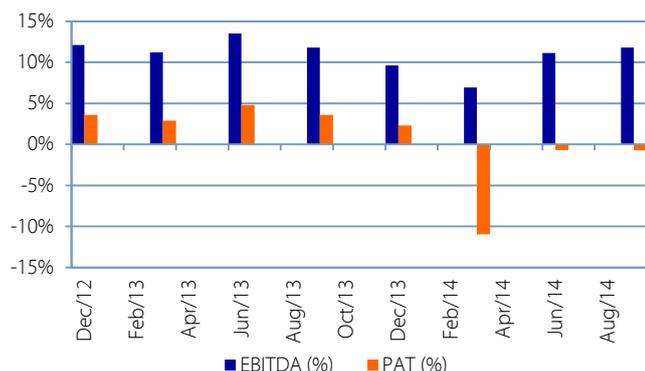
On the margin front, the operational environment remains challenging (see Figure 5). Duty hikes by state governments, less-than-expected price hikes by state government, regulatory changes in Tamil Nadu, a temporary control order on recycled bottle use, and now the announcement of a gradual implementation of a complete ban on sales of alcohol in Kerala highlight the tough domestic operating scenario. For spirit companies, a decline in sugar production and expected delays to the start of the sugar season, coupled with overall strong demand for molasses, resulted in ENA price increases during Q3 2014/15 (see Figure 6).

Outlook: Battle over, war begins

A delayed start to the cane crushing season is likely to postpone any softening of ENA prices. Furthermore, despite the fact that overall ethanol blending remains below 2% in 2013/14, the now mandated 10% blending requirement will keep ENA prices high. Capacity increases for grain-based molasses will likely ease pricing pressure in the medium term. Importantly, as elections would be over by the start of FY16, the industry is expecting price hikes across several states to help with margin recovery.

On the corporate front, Diageo has now completed the process to acquire a majority stake in United Spirits—the leading Indian spirits company. Its main rival in India, French spirit company, Pernod Ricard, has managed to acquire 50% of the market value despite contributing merely ~10% of the industry volumes. Transforming United Spirits from a volume-based business to a value-based business will remain the main long-term challenge for Diageo. The company has outlined a 14-power brand strategy, including a few from the Diageo stable, to build a value-based business in India. As part of the strategy, Diageo has already indicated its intention to exit low-margin markets in favour of a franchise model. The low-value brands strategy will likely see franchisees selling regular and below-category brands, while keeping the premium line for the company.

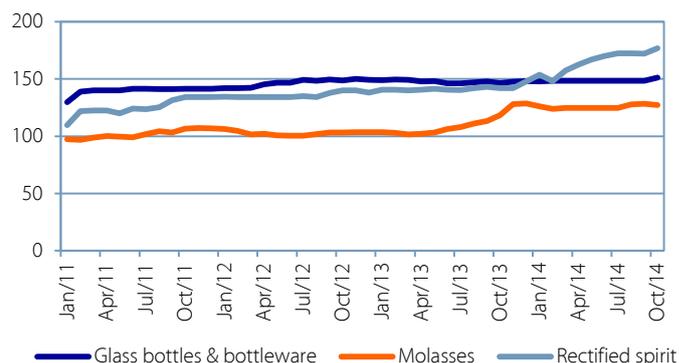
Figure 5: Listed distillers' quarterly margins, Dec 2012-Sep 2014



Source: Company data, 2014

Figure 6: Wholesale price index, Jan 2011-Oct 2014

Index, 2004-05 = 100



Source: Reserve Bank of India, 2014

Brazil

Cachaça: Back on track

According to AC Nielsen, cachaça sales in Brazil are on track to record 5.9% growth in volume and 14% in value in the audited retail channels in 2014. More diversification and innovation across brands have helped drive sales in recent months. Hot and dry weather has also favoured the beverages category throughout the year, as the exceptional drought affecting large parts of the country contributed to more consumption at home during evenings and weekends. The World Cup and the additional public holidays it brought along contributed to the positive performance of cachaça sales in 2014.

In terms of inflation, a weaker real, high taxes and underlying price pressures are all pushing food and drink prices higher. The sub index for prices in all food and drink categories has advanced an alarming 30 points since January 2012. However, the wine and spirits sub index is tracking the overall IPCA index at around 19 points higher than in January 2012 (see Figure 7).

Outlook

A weaker economy, expected to grow just 0.3% in 2014 and 1% in 2015, has the market forecasting weaker consumption through the Christmas and Carnival season compared to last year. Once again, the weather will play a huge role, as most Brazilians take their holiday during the next three months. However, a weakening economy remains a concern for growth potential in all categories along the spirits spectrum.

With the new economic team for the re-elected president announced, the market's attention for the next three months will focus on the actual measures that will be announced now that new government has officially taken office. A divided congress will make passing new policy harder and slower, despite the urgency in addressing fiscal imbalances.

Bar Talk

The Yani Lounge Bar in Shanghai is the only five-star bar on dianping.com, China's largest restaurant review website. We recently sat down with the bar manager of the Yani Lounge Bar to discuss trends in the Chinese market. Below are some key takeaways.

Bar Trends: "Consumers prefer speakeasy bars with soothing music and characteristic decoration. Most of the consumers range between the ages of 25 to 30 years old. They are looking for places to relax and chat."

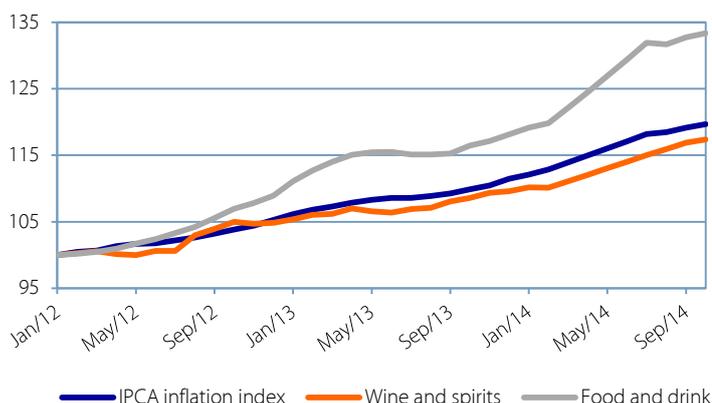
Single Malt Whiskey Preferences: "In these last two years, single malt whiskies have become popular among consumers in Shanghai, taking the place of blended whiskey. In terms of flavours, consumers each have their own tastes."

New Trends in Cocktail Bars: "In Shanghai, consumers have become more independent. They love to try specialty products with culture. Instead of being persuasive, consumers have their own ideas about brand and taste."

Other trends: "While the anti-corruption activities continue, consumers have been driven from club to bars. Bars attract consumers by offering unique taste and special décor instead of pure promotion. Some consumers come to a bar for its famous bartender."

Figure 7: Indexed inflation for Brazil, 2012-2014

Index, Jan 2010 = 100



Source: Sicobe Receita Federal, Rabobank, 2014

Rabobank currency forecasts

USD Crosses	12-Jan	1m	3m	6m	9m	12m
JPY	118.9	120.0	122.0	123.0	124.0	125.0
EUR	1.18	1.19	1.19	1.18	1.17	1.15
GBP	1.51	1.53	1.53	1.52	1.52	1.52
CNY	6.20	6.23	6.30	6.40	6.30	6.25
ZAR	11.50	11.80	11.85	11.85	11.90	12.00
MXN	14.6	15.0	14.7	14.5	14.3	14.2
BRL	2.63	2.70	2.75	2.80	2.85	2.90

Source: Rabobank Financial Markets Research, Jan 2015

Rabobank quarterly average price forecasts

Commodity	Unit	Q4'14f	Q1'15f	Q2'15f	Q3'15f	Q4'15f
Wheat	USc/bu	525	520	530	550	560
Corn	USc/bu	360	360	370	380	360
Sugar	USc/lb	16.2	16.5	16.8	17.0	17.5

Source: Rabobank Agri Commodities Markets Research Outlook 2015, Dec 2014

GDP forecasts

Country	2013	2014	2015f
US	2.2	2.25	2.5
Eurozone	-0.7	0.75	1.25
UK	1.7	3	2.75
Japan	1.5	0.25	1
Netherlands	-0.7	0.75	1.5

Source: Rabobank Economic Research Department Global Economic Outlook, Dec 2014

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Rabobank Food & Agribusiness Research and Advisory Beverages Global Sector Team Analysts

China – Katharine Song

Katharine.song@rabobank.com

China – Sandy Chen

sandy.chen@rabobank.com

India – Sudip Sinha

sudip.sinha@rabobank.com

Australia – Marc Soccio

marc.soccio@rabobank.com

EU – Francois Sonnevile

francois.sonneville@rabobank.com

US – Ross Colbert (Global Strategist)

ross.colbert@rabobank.com

Brazil – Andres Padilla

andres.padilla@rabobank.com

EU – Elena Saputo

elena.saputo@rabobank.com

US – Stephen Rannekleiv

stephen.rannekleiv@rabobank.com

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