The View *from* Burgundy

DECEMBER 2004

Requiem for a Brewer

Later in 2004, Molson Breweries, a grand old Canadian company, proposed to merge with Coors. There were a lot of things wrong with the plan, especially the price. And the timing was very suspect – Molson had just made an atrociously bad acquisition in Brazil that had cost it 20% of the whole corporation's value. Again, David Vanderwood, assisted by Michael Hatcher, analyzed the capital allocation follies of one of Canada's oldest companies and found them badly wanting. And we showed convincingly why the price Molson was receiving was inadequate. The terms of the deal were somewhat improved for Molson shareholders, after a large number of large shareholders (including Burgundy) demanded it. Today, Molson's, which merged on roughly an equal basis with Coors, contributes over 70% of the combined company's cash flow. But in a company controlled by a dual class share structure, as Molson was, a foolish controlling shareholder cannot be gainsaid.

Appended to The View from Burgundy *was a discussion of our February 2004 issue entitled "The Eighth Wonder" that resulted from conversations with Dick Currie, the Chairman of BCE. Dick, of course, had one of Canada's most distinguished careers as President and CEO of Loblaw for 25 years. Dick took issue with one of our points in our analysis of BCE – the Yellow Pages spinout. He felt that there were good and compelling reasons that it had not been such a bad deal for shareholders as we had indicated. While we did not necessarily agree with Dick's points all down the line, we offered him a chance to have his say, based on his distinguished record of service to Canadian shareholders. We had never offered this courtesy before and may never again, unless it is to someone of Mr. Currie's stature.*

Richard Rooney, 2007

In early 2002, Molson Inc., one of Canada's grand old companies, appeared to have shaken off a history of poor decisions and positioned itself for a bright future. Under the leadership of Dan O'Neill, a tough former executive of Heinz Foods, Molson had pulled off a classic turnaround, cutting costs and focusing on both its core brewing business and its core brands in the brewery. The share price had performed very well over the previous three years, after more than a decade in the doldrums. Pleased with the market's response to their company's rising earnings in recent years, Molson management began to cast about for a way to continue to grow earnings at a rapid rate.

So there was much anticipation when Molson announced a bold new initiative in Brazil. The company paid $1 billion for Kaiser, that country's second largest brewer. Mr. O'Neill had some background in Brazil, and many analysts expected that Molson might be on the verge of finding a reasonable adjunct to its phenomenally profitable Canadian brewing operations.

Two years later, Kaiser was bleeding cash and losing $100 million per year. Its market share had fallen from 18% at the time of the acquisition to only 10%. The controlling shareholders, their confidence shaken by yet another in a long series of disastrous diversification initiatives, were attempting to merge their company with a U.S. regional beer business, Adolph Coors Company (Coors).

In this issue of *The View*, we will examine the latest pratfall in Molson's history. While it is modestly instructive on a stand-alone basis, we would also like to draw some broader conclusions about diversification

from this sad tale. We will conclude by giving a shareholder's view of how management should invest the cash flow from a superior business.

Brazil – What Went Wrong?

The Brazilian beer market is dominated by InBev with a remarkable 68% market share. InBev distributes its product through the Pepsi bottlers in Brazil, who run one of the two distribution systems capable of reaching one million points of sale in that huge country. The only other such system is run by the Coca-Cola bottlers, and the beer they have always distributed is Kaiser. They distributed it because they owned the brewery.

At the time of Molson's Kaiser purchase, the Coke bottlers were having a tough time, squeezing marginal profits out of their system, with incentives mainly centred around increasing volumes. Beer was a bit of an afterthought for these distributors, but as long as it was a profitable afterthought, Kaiser looked like it had a secure place on the distributors' trucks, even though it accounted for less than 5% of the Coke bottlers' revenues. Kaiser also appeared to have a regional stronghold in the Sao Paulo market, Brazil's largest, where market share was apparently over 30%. In a product where loyalties are usually deep and long lasting, that could be a big advantage. Finally, to secure the continued support of the bottlers, they received part of their selling price for the Kaiser business in Molson stock, which they were not allowed to sell for at least two years.

The wheels began to come off the new Molson subsidiary when a new Coke executive took over in Brazil and revolutionized bottler economics overnight. He replaced the old, volume-driven incentive system with a new profit-driven one that offered much better payouts to the distributors. All of a sudden, it made a lot more sense to stock the truck entirely with Coke products than to throw on a few cases of Kaiser beer. Even worse, it developed that the putative 30% market share in Sao Paulo was illusory and represented simply a lot of transhipment from that city to other regions in Brazil. Finally, to complete a very ugly picture, the third-place brewery in Brazil introduced an aggressive and highly successful marketing campaign that led to big increases in market share for its products.

Unloved by its distributors and consumers, Kaiser fell to the back of the pack in the Brazilian beer market. Perhaps the most painful aspect of its dilemma was the lack of any alternatives – remember, only two distribution systems are set up to reach all of Brazil, and building a separate system for Kaiser would be uneconomic. And the collapse in profits precluded an aggressive marketing spend to fight off the competition.

What is the moral of this nasty story? Well, clearly Molson did not do an adequate job of assessing the risks of this acquisition. Strong and committed distribution is essential to the success of any business, and the structure of the deal obviously did not secure this for Kaiser. The extreme power of the distributors does not appear to have been given enough weight. Mr. O'Neill, who had done a good job of focusing and trimming fat at Molson, was clearly outside his "circle of competence" in emerging market acquisitions.

The Bigger Issue

But to us, Molson's Brazilian misadventure is a symptom of a larger problem at that organization. As owners since 1786 of a brewery with huge market share in the world's most profitable beer market, normal compounding would indicate that the Molson family should own the entire planet Earth. Instead, through repeated failed diversification initiatives, the company has interrupted the compounding equation over and over again.

How should Molson think about diversification? Well, to us, diversification is desirable in the presence of a significant probability of permanent capital loss. A smart business manager or portfolio manager will

always seek to own a number of risky businesses rather than just one. By the same token, owning a highly reliable business with well-protected cash flows reduces the necessity to diversify and in fact gives a strong incentive to concentrate and focus on that business. Corporate America has been reading from this playbook since the early 1980s, especially in areas like consumer branded products, food and beverages. Warren Buffett is the exemplar of someone using the same strategy in the portfolio investment world.

With a great business like Molson's Canadian beer business, time is on your side. You can wait for fat pitches and you never have to swing. The money generated from your business doesn't have to burn a hole in your pocket; you can simply distribute it to shareholders. But let's say you decide that the opportunities for profitable growth are too limited in your small national market. Stella Artois (InBev), SAB and Heineken are examples of companies that came to that conclusion. These companies have shown that breaking into mature beer markets is extremely expensive, though given patience and willingness to absorb either a hefty local acquisition premium or ongoing losses for long periods, it can be done. A riskier strategy is to buy brewers in emerging markets. But with that strategy comes the possibility of permanent capital loss.

Role Playing

Let's look at Molson's position in 2002. We assume they have three alternatives for a $1 billion investment: first, a share buyback; second, purchase of a single emerging market brewery business; and third, purchase of three emerging market breweries with similar risk profiles. We include a fourth column showing purchase of 10 emerging market businesses, not because we feel that is an option with $1 billion, but because it illustrates the risk profile of the strategies pursued by InBev and Heineken. The example is illustrative only and is somewhat simplified.

RISK PROFILE FOR MOLSON'S ALTERNATIVES

Outcome	Probability	A Share Buyback	B One Emerging Market	C Three Emerging Markets	D Ten Emerging Markets
Downside	20%	(5%)	(50%)	(17%)	(2%)
Most Likely	60%	10%	15%	19%	19%
Upside	20%	25%	100%	57%	41%
Expected Return		**10%**	**19%**	**19%**	**19%**

Examining the share repurchase option in Column A leads to a couple of key observations. First, the expected return from the share repurchase is significantly lower than the emerging market strategies. Second, the risk of absolute capital loss is also much smaller (we suspect that over any reasonable time frame it approximates zero, but we're a conservative bunch).

Moving on to the single emerging market acquisition strategy, we see a much higher expected return, offset by a very much higher risk of a 50% absolute permanent capital loss. This is by far the highest risk investment strategy of the four shown here.

Finally, we show the risk profile of buying three emerging market businesses with risk profiles similar to the individual business in Column B. Due to the multiplicative nature of probabilities, you can see that the risk of absolute permanent capital loss is significantly reduced. With 10 such markets, this probability becomes small indeed while the expected return remains the same. This is the whole point of diversification.

This simple example shows why InBev and Heineken have been able to execute their growth strategies

successfully and become large multinational beer businesses. By owning large diversified buckets of emerging market brewers, the risk posed by serious problems in any one market is substantially reduced. It also shows that Molson management quite deliberately risked severe capital loss with one, large emerging market speculation. In the case of the Kaiser acquisition, the permanent capital loss appears to be more like 90%. That would mean that fully 20% of Molson's value was wasted in Brazil.

Déjà Vu

If the Molson saga seems vaguely and uncomfortably familiar, it may be because its duopoly partner, Labatt, acted amazingly similar in the early 1990s. In their case, the misadventure occurred in Mexico, and the amount risked was also 20% of Labatt's value. Within months of purchasing 22% of Femsa, a severe monetary crisis caused the investment to fall in value by almost 50%. A shaken Board and management sold out to InBev a few months later. In retrospect, Labatt was sold at far too low a price, and the strong, reliable cash flows from their Canadian asset have allowed InBev to finance many more acquisitions. Clearly, a very high market share position in a phenomenally profitable beer market like Canada's should not be given up lightly or cheaply.

This brings us to the Molson proposal to merge with Coors. We believe that the price being discussed is far too low. If it proceeds under the last terms discussed, shareholders will have received another value-subtracting blow at least rivalling the one they suffered in Brazil. Having purchased Molson shares in the aftermath of the Brazilian debacle, when we felt that the Canadian assets were no longer being appropriately valued by the market, we now find that they are not appropriately valued by management and the controlling shareholders either.

The basic problem is that the price being discussed does not reflect the superior profitability of Molson's Canadian operations. The mysterious decision to focus on EBITDA (earnings before interest, taxes, depreciation and amortization) is the culprit. EBITDA is supposed to be a measure of cash flow generation capacity, and on that basis Coors makes the point that its stock trades at 6.6 times EBITDA and Molson will be merging at 9.6 times EBITDA. Sounds like a fat premium, doesn't it?

Alas, this number is never very meaningful (Charlie Munger referred to it as "bull---- earnings" at last year's Berkshire Hathaway annual meeting) and in the current context it is horribly misleading. Molson's beer business is vastly more profitable than Coors' beer business. The differentiating factor is the depreciation expense. If this (very real and burdensome) charge is treated appropriately as an expense, you can see that measured by EBIT (earnings before interest and taxes), a much more stringent and meaningful measure of free cash flow, Molson is merging at a discount to Coors. A company with profits per hectolitre almost four times those of its merger partner, merging at a discount! This makes no sense at all. Coors paid a 30% higher EBIT multiple to acquire Carling's U.K. business, a far less valuable property.

TRANSACTION DETAILS

	Molson[1]	Coors[2]	Carling UK Acquisition[3]
EBITDA Multiple[4]	9.6 x	6.6 x	8.0 x
EBIT Multiple[5]	10.3 x	11.7 x	13.5 x
Depreciation/ EBITDA	8%	43%	43%
Core Market Share	43%	11%	21%

So on its merits, we believe that Coors and Molson should go back to the drawing board to come up with a new formula, one that reflects Molson's superior economics. Molson should be valued at least in line with Carling, one would think. If the deal goes through at current prices, it will be largely because of the unbridled and undeserved power wielded through

the egregious dualclass voting structure. But don't get us started on that again.

Conclusion

The Molson saga shows the ongoing effects that misunderstanding diversification can have on a business. Molson really did not need to diversify at all – it was driven to do so by arbitrary earnings growth targets developed by management (and cheered on by shortsighted, short-term oriented shareholders). The growth targets were inappropriate for a slow-growing, but very profitable business. Now Molson proposes to double down its Brazilian error by making a fundamental valuation mistake in its merger negotiations. A brief reality check is revealing – if Molson had used the $1 billion to buy back stock in 2002, and then merged at 13.5 times EBIT, the share price would be $61 by our estimation – a far cry from current levels.

Since 1980, Molson has been grappling with a thorny problem: If you own a powerful, cash-generating, low-growth business, what should your strategy be? How can you open up new growth avenues while intelligently diversifying risk? We would suggest the following checklist:

1. If you own a great business and you can profitably invest in it, then that is the best use of the cash it generates. Such investment can take the form either of spending on marketing, production efficiencies, new facilities, or buying back the company's stock. Investing in operations you know best, and in a stock whose intrinsic value you understand, should be the first priority of any management of a great business. It may appear to be lower return, but it is almost invariably lower risk as well.
2. If there are almost identical businesses that can be tucked under existing operations and skill sets, then acquiring these businesses is the next best use of cash, assuming those businesses are available at a sensible price.
3. If the company has advanced skills in managing acquisitions or organic growth in the same industry in foreign countries, then that is a perfectly viable use for the shareholders' money.
4. If the company wishes to build these acquisition or operations skills, then management should start slow and perhaps in minority positions, never risking very large amounts of shareholder capital.
5. Investing in unrelated businesses is almost invariably an error.

The history of the Molson companies is a long list of violations of all these common sense precepts. Too bad – with a heavyweight business in a great industry, and intelligent capital allocation, Molson could have been a contender.

Reasonable People Can Disagree

In the aftermath of our *The View* entitled "The Eighth Wonder," we received a visit from Dick Currie, the chairman of BCE and former president of Loblaw. Dick had some concerns that our recounting of the events surrounding the divestiture of BCE's Yellow Pages business left out certain information that he considered critical to the final decision. While it is not uncommon for us to be contacted in the aftermath of an issue of *The View*, we have hitherto not allowed anyone to respond to our remarks in this forum. But in view of the long and inordinately distinguished career he put together as President of Loblaw, we decided to make an exception for Dick Currie. We are willing to extend a similar platform to anyone who puts together a 20-year record of shareholder value creation like he had at Loblaw. Those with lesser track records need not apply.

So, what were Dick's concerns with our analysis? They chiefly revolved around three issues. One was lack of credit given for the very sophisticated tax planning that resulted in BCE not having to write a huge cheque on the disposition. Another issue was the forecast growth rate for the Yellow Pages business. As

our readers will recall, we had forecast a modest rate of growth going forward. Mr. Currie takes issue with this estimate, and feels that looking to the U.S., where trends are more advanced, would give rise to a much more conservative forecast that would essentially call for a modest annual decline in the business going forward. Factoring such a decline into our methodology would reduce our estimate of the value of the business substantially.

Finally, Mr. Currie pointed out that the divestiture was made under substantial time pressure since BCE was buying back the 20% of Bell Canada's operations that were sold to SBC by another management team some years before. Management feared a ratings downgrade for its debt if cash came from a debt issuance rather than a sale of assets.

We note Dick's arguments while not necessarily agreeing with all of them. Certainly the performance of the Yellow Pages units would indicate that BCE shareholders left a large sum of money on the table. But we understand that an executive as dedicated to shareholders' interests as Mr. Currie would feel that he needed to tell his side of the story, so we have offered him this courtesy. As shareholders of BCE, in part because of our confidence in him and CEO Michael Sabia, we wish him well.

Endnotes

1. Statistics are for Molson's Canadian brewing business only in fiscal 2004, under the overly conservative assumption that the other unprofitable assets are worth nothing.
2. On "a last 12 months" basis.
3. Based on fiscal 2002, the year of the Carling acquisition.
4. Total value of the company's equity plus debt divided by EBITDA.
5. Total value of the company's equity plus debt divided by EBIT.

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