



CBV INSIGHTS

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VALUATION IN THE BREWERY INDUSTRY

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INTRODUCTION

The brewery industry is one of the oldest industries in Canada. When assessing the value of breweries, there are several business considerations unique to the industry that are important to understand. Although it is largely agreed that the industry is “mature” in terms of its life cycle, the brewery industry continues to evolve via forces such as growing craft beverage demand, shifts in consumer demand preferences, and increased focus on sustainable and innovative packaging solutions. This article will highlight, discuss, and explore several topics unique to the brewery industry, with an emphasis on how these topics can affect brewery valuation. There are many situations which may require the valuation of a brewery business. The presence of special interest purchasers (“SIPs”)* is a very real possibility, as existing breweries may look to consolidate and achieve synergies, given these unique industry characteristics.

This article addresses special topics unique and fundamental to the brewery industry and then discusses how these topics would be relevant to an assessment of value from the lens of a Chartered Business Valuator (“CBV”). A discussion of specific valuation approaches and methodologies used by CBVs to value breweries are outside the scope of this article, however there are multiple valuation approaches that should be considered when conducting a formal valuation of a brewery, given it is a capital-intensive and asset-heavy business. Value at its core, however, is forward looking in nature, and this article will focus on the importance of having a robust understanding of the underlying business fundamentals of a brewery business and that business’ ability to generate cash flow in the future.



Catalina Miranda, CBV, Vice-President, Regulatory & Standards, CBV Institute, sits down with Spencer Gunning, CBV, to chat about valuation in the brewery industry.

* Special interest purchasers are defined as entities or individuals that are willing to pay a premium or higher price for a company due to reasons that include potential post-acquisition synergies or strategic advantages through the combination of the business or asset with existing resources. SIPs are usually willing to justify paying above otherwise fair market price because of the inherent incremental value they expect to generate.



INDUSTRY TRENDS & THE IMPORTANCE OF MARKET POSITIONING

The brewery industry in Canada has undergone several significant trends in recent years, including growing demand for craft beverages, a significant shift in market share towards ready-to-drink (“RTD”) and low-alcohol and non-alcoholic options, and an increased focus on sustainable brewing and packaging practices. Industry participants that have a strong ability to adapt to ever-shifting consumer trends and government regulations will be better-positioned to defend and potentially increase market share. When valuing a company in the brewing industry, understanding how the company has positioned itself to adapt to factors such as the above, is essential in properly assessing the ability of the company to generate cash flow in the future. This is likely seen via innovation in product offerings beyond traditional beer, whether it be innovation within craft beer or ventures into other RTD beverages such as spirit- or seltzer-based mixed beverages.

Craft beer has become increasingly popular as a share of total beer consumption in Canada, with a growing number of microbreweries and brewpubs opening across the country in the last nine years. According to trade association Beer Canada, the number of breweries per 100,000 legal drinking age adults in Canada almost tripled from 1.4 in 2012 to 4.0 in 2020.^{1,2} However, beer consumption per capita (based on the legal drinking age population) has fallen from 83.4 litres in 2012 down to 69.3 litres in 2020, a 16.9% decrease over same the period.^{1,2} The stark increase in breweries relative to the decline of beer consumption in Canada frames a compelling picture of future market consolidation, as fighting to earn market share is set to become increasingly difficult in an already competitive segment.

Another significant trend directly affecting the brewery industry is the rise of RTD and low-alcohol and non-alcoholic beer beverages as a total percentage of alcohol consumption. Consumers are prioritizing taste in flavored malt and spirit-based beverages and at the same time, becoming much more mindful of their alcohol and caloric consumption. According to a report by Statistics Canada, Canadians bought \$2.1 billion worth of ciders and coolers (both RTD-type beverages) between April 1, 2021 and March 31, 2022, up 13.5% from the previous fiscal year.³ In contrast, while Canadians bought four times as much beer, \$9.1 billion worth, beer sales were down 0.7% from the previous fiscal year.⁴ A report compiled by J.P. Morgan with data from Euromonitor forecasts that RTD, cider and pre-mixed cocktails will continue to grow in popularity, at a global 2019-2025 CAGR sales volume growth rate of 8.5%,⁵ a stark contrast in comparison to the decreasing beer consumption trends mentioned above.

Not dissimilar to many industries across the globe, sustainable practices are becoming increasingly important in the brewing industry, as both consumers and regulators continue to place pressure on brewers to minimize waste and environmental impact of the production and packaging of their products. In June 2022, the Government of Canada began officially rolling out a ban on single-use plastic products, including most notably, a ban on the manufacturing, import, export, and sale of plastic ring carriers.⁶ These plastic ring carriers are the most commonly found packaging method for beverages in a 6-pack type format but have been mandated to be replaced by alternative packaging methods. Brewing industry participants that are well-capitalized with access to capital are going to be best positioned to react to these types of significant changes in government regulation, as it is capital intensive to purchase, sell, and re-configure packaging capabilities to comply with such drastic and important changes. Not only is such a change significant from a capital expenditure point of view, it also affects product margin as brewers will be forced to find other, likely more cost-intensive, packaging alternatives on a per unit basis.

We observe these prominent industry trends because they can affect a subject company’s position within the brewery industry, and its risk profile, which would impact the valuation both qualitatively and quantitatively. A CBV will assess such factors when determining an appropriate discount rate to apply to future cash flows as part of the valuation or pricing analysis. Breweries that are able to continuously innovate with new products in response to shifting consumer tastes are much more likely to be able to defend and/or grow their revenues. Continuously shrinking beer consumption and increased RTD and low/no-alcohol demand warrants a broader portfolio of products if breweries want to increase their potential consumer base, and a business that can do so will only inevitably have a much greater chance of continuing to generate cash flow in the future.

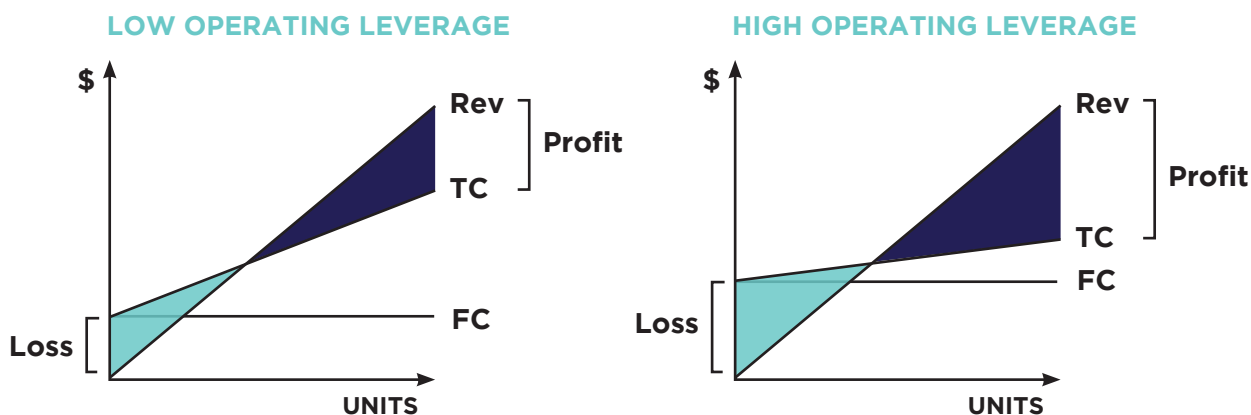


OPERATING LEVERAGE & THE VALUE OF CONTRACT BREWING

OPERATING LEVERAGE DEFINITION

The concept of operating leverage is relatively well-known among those familiar with manufacturing companies. Essentially, operating leverage is the measure of the proportion of fixed operating costs of a company in relation to its variable operating costs.⁷ The degree of operating leverage impacts profitability. Small to medium sized breweries have a high degree of operating leverage because they have a high proportion of fixed costs (e.g. the building and the specialized brewing equipment) relative to variable costs (e.g. containers and ingredients). Once fixed costs are recouped by initial beer sales, the relatively low variable cost to produce each unit of beer becomes a small hurdle to overcome in generating positive cash flow. Quickly, the brewery begins to benefit from greater incremental profits on a per unit basis. This is further illustrated in Figure 1 (FC = fixed costs, TC = total costs, Rev = revenue), which holds variable per unit costs constant for illustrative purposes.

Figure 1 – Low vs. High Operating Leverage



BREWERY EFFICIENCY & OVERHEAD ALLOCATION

For example, “Brewing Company A” utilizes its labour force and capital assets in the form of an annual schedule in shifts to brew and package product. This schedule creates a predictable, fixed cost structure; this structure is also commonly referred to as manufacturing overhead, and can oftentimes include other largely predictable pieces such as utilities, maintenance expenses, etc. If “Brewing Company A” can become more efficient in producing *more* units per shift, via (i) less plant downtime, (ii) increased capacity via capital expenditure, (iii) proficiency in the labour force, or in most cases, (iv) some combination of these, the company will be able to “spread” this fixed manufacturing overhead over *more* product, reducing the total cost per *unit* of manufacturing overhead. This is the basic premise of overhead allocation in a manufacturing business and is important to understand when analysing the value of efficiency and capacity to a brewing business.

From a valuation perspective, management’s intent surrounding the company’s operating leverage and overhead allocation rate demonstrates strong competence and industry knowledge and will inherently assist in generating positive cash flow and creating underlying value for their brewery. Manufacturing expertise is important when it comes to being able to create value in a brewery business, as any earnings- or cash flow-based valuation method that a CBV applies will result in a higher valuation if there is either (i) a path to increased cash flow or (ii) increased confidence around existing cash flow.



THE VALUE OF CONTRACT BREWING

Now that we understand operating leverage and overhead allocation as they relate to the profitability of a brewery, we can conclude that generally speaking, greater utilization of production volume as a percentage of total capacity, equates to greater profit margins. In many cases, the path of least resistance to attaining more volume is via contract brewing for a third-party beverage company. Specifically, if a brewery can “tuck-in” contract brewing volume, using their pre-existing fixed cost structure, this assists in further driving profitability across the entire business via enhanced overhead allocation.

Given the contractual nature of this revenue, the margins are often lower than true owned volume, but come with greater certainty of volume and thereby, revenue (via annual minimum requirements). Additionally valuable, contract manufacturing revenue almost always comes with little to no working capital strain, given no need for finished goods warehousing, and raw material oftentimes being provided by the customer.

Contract brewing can bring significant value to a brewery if executed upon properly. Understanding and analyzing either (i) the current state and proportion of contract brewing present in a brewery business, or (ii) the potential to add in contract brewing revenue to a brewery business, can be extremely helpful in depicting and identifying value within a brewery. Contracted revenue generally carries less risk than traditional revenue segments given the greater certainty around volumes, and as a result a lower discount rate would be applied to the resulting cash flow. Qualitative factors such as this are critical in determining the appropriate discount rate and can instill more assurance in a business’ ability to continue to generate said cash flow, inevitably assisting in increasing valuation.

WHY A VALUATION SHOULD FACTOR FOR EFFICIENCY & OPERATING LEVERAGE

Regardless of the purpose of the valuation, any stakeholder will want to understand how efficiency and operating leverage have been reflected in the valuation of their business. A solid understanding of historical efficiency as well as opportunities for improvement will better enable business owners to strategize how to potentially create value in the future. There can be a significant financial benefit if a brewery business is able to enhance their ability to increase sales and production in a high operating leverage environment, as the increased profitability should translate to an increased valuation.

The concepts of efficiency and operating leverage also come into play when considering strategic or synergistic buyers. Other craft brewers or larger mainstream brewers may be considering the acquisition for competitive or other strategic reasons. In relation to operating leverage, CBVs may consider a scenario in which synergies could arise from optimizing the target and the acquirers’ combined manufacturing capacity. Identifying synergies can be significantly accretive to cash flow and deal value, leading to higher valuations and ultimately, enhancing shareholder value.





GOVERNMENT REGULATION & TAXATION

Breweries operate in a heavily regulated environment. As a result, it is crucial that an understanding of the ever-changing regulatory and political landscape remains current. Elections come and go, and breweries are subject to changing policy at both the federal and provincial level; these changes can warrant shifting taxation structures and while some changes may be minor, some changes can be significant, in some cases affecting the profitability of operations.

For example, the Government of Canada began rolling out a ban on single-use plastic products in June 2022, and while this change was announced in advance (giving producers time to prepare), not all regulatory changes provide so much lead time. Any brewery business that sells product in plastic ring carriers is now faced with a looming change that requires machinery investment, packaging line re-configuration, and potentially higher unit costs as these businesses will be forced to find a more sustainable packaging replacement.

From a taxation perspective, breweries in Canada face two separate points of taxation; one being at the federal level, known as excise tax, and the second being provincially, known as provincial markup. From a valuation perspective it is important to understand how both taxation mechanisms work, as excise tax is based on incremental levels of *production* volume, whereas provincial markup varies province to province in terms of structure and is based on sales volume. Some provincial markup structures opt for a percentage-based approach based on sales totals, whereas others opt for an incremental step system, where the markup rate per litre increases as sales volumes increase.

As one can imagine, analysis and understanding of taxation both federally and provincially needs to be kept in mind as breweries look to grow or potentially merge, as tax implications can significantly alter profitability and margins. As an example, federal excise tax has just been recently amended and effective April 1st, 2023, will increase on a per hectolitre basis across all alcohol levels of beer.⁸ On beer containing more than 2.5 % alcohol by volume, the rate 0 to 2,000 hectolitres is \$3.701 per hectolitre; if a brewery is to make one incremental hectolitre, that rate jumps to \$7.402 for any incremental volume up to 5,000 hectolitres.

CAPITAL REQUIREMENTS & CYCLICALITY

It likely comes as no surprise that operating, maintaining, and growing a brewery is a relatively capital-intensive endeavour. While there are of course ways to “bootstrap” and remain lean in terms of minimizing packaging capability and brewing assets, capital requirements pose a large barrier to entry for new market entrants. In a survey conducted by MNP between November 2021 and February 2022, 50% of Alberta craft breweries cited access to capital and financing as the primary challenge they face with respect to growth and profitability.⁹ This barrier to entry has simultaneously been a key catalyst in the growth of asset-light, brand-focused businesses that rely on contract brewing agreements with full-service breweries for their production. The degree of access to cost-effective capital is an important factor to be wary of when evaluating a brewery business, as a strong balance sheet with financing flexibility will always prove advantageous to adapt to the ever-changing dynamics of the industry.

In North America, beverage alcohol is a cyclical business with a “peak” season spanning spring-summer and a “shoulder” season spanning fall-winter. As a result of this, breweries will have ebbs and flows on their working capital requirements. An experienced management team will understand the peaks and valleys of demand, and thereby, periods in which the business is able to generate excess cash flow. It is quite common for breweries of various sizes to burn cash in the shoulder season, via the combination of a dip in sales and a pre-emptive inventory build for the peak season, and rely upon increased periods of demand in peak season to generate their fiscal year’s cash. Breweries must be diligent in managing their inventory, receivables, and payables throughout the year as working capital can easily become stressed by seasonal fluctuations. It is common practice for breweries to use a revolving debt facility to assist in smoothing working capital, as this provides a relatively low cost of capital option for easing the effects of seasonality.



CONCLUSION

Breweries are subject to unique considerations that can significantly affect their cash flows and value. The topics that have been discussed in this article are not exhaustive but do represent some of the more crucial factors that should be considered in any robust valuation or deal pricing exercise. Although a mature industry in classical terms, the brewery industry continues to change quickly via a combination of shifting trends in consumer demand and evolving government and regulatory changes. The boom of craft beer and innovation has spurred significant growth in Canadian microbreweries and brewpubs, placing market share pressure on all participants given continually declining beer consumption trends. With more breweries emerging and less volume to get a piece of, this picture of inevitable market consolidation continues to be painted; CBV's are being called upon as financial advisors for strategic transactions in the brewery space, and this article can hopefully provide guidance as to where to start. While quantitative analysis will always be crucial, business valuation is about so much more than strictly numbers, and a well-informed qualitative understanding will greatly assist in providing a robust and thorough valuation conclusion.

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