



A Spirited Debate

Structural changes in alcohol consumption

May 8, 2024

GQG Research

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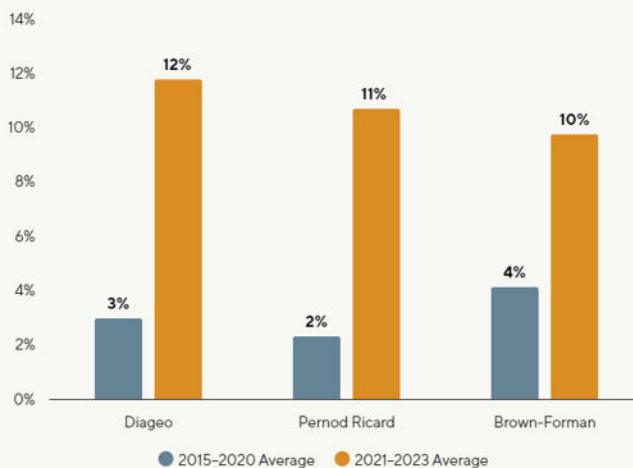
Key Takeaways

- > The alcoholic beverage industry is facing meaningful changes, and we believe the current cyclicality may be hiding deeper structural issues
- > Consumer tastes are changing, with young adults in the US drinking less—driven primarily by health concerns—which may have a lasting effect on volumes as this cohort ages
- > Certain brands may have priced too aggressively in recent years, opening a price gap that will be difficult to close and lastly, heavily skewed consumption, GLP-1s, and regulatory risks may be underappreciated reasons for caution

The pandemic-induced alcohol super-cycle has left the industry dealing with a hangover that producers are struggling to work through. After sales skyrocketed in 2021-2022 due to lockdowns, shifting consumer spend, and price increases, 2023 was a challenging year marked by weaker volumes that left investors wondering, is this a temporary headache or a warning sign of deeper structural change? We think there is a compelling case for the latter, and hence we are being very selective within the sector, especially in developed markets. Beer shipments faced their worst year since 1999, while spirits are looking wobbly after having leaned excessively on price and mix to support moderating volumes.¹ Despite relying on price/mix to drive growth, spirits continue to trade at near-market multiples. Therefore, we think that investors needed to expect higher growth from higher-multiple stocks. Here, we revisit the topic of slowing growth and multiple risk as it relates to alcoholic beverages, and specifically spirits.

Organic Sales Growth Has Been Unsustainably High

Current Cyclicalty is Hiding Structural Issues



Source: Bloomberg as of 3/18/2024. Sorted by market capitalization, data calendarized.

Multiple Compression Risk: Parallels to Tobacco

The multiple risk concerns are not without precedent. We see a clear parallel to tobacco stocks, which de-rated significantly around 2017. Interestingly, investors had previously been comfortable with the similar tobacco model of relying on price/mix, despite falling volumes. Global cigarette volumes, ex-China, have been declining since 2008, but the de-rating in tobacco only occurred in 2017 – nine years later – on the back of increased regulatory scrutiny and accelerating volume declines from reduced risk products.² We believe spirits face similar risks. Notably, there are important pricing power advantages in tobacco, which still could not save the category. First, the average selling price for a pack of cigarettes is much lower than that of alcohol, meaning that buyers are less sensitive to an illustrative 10% price increase due to the lower absolute change in price. Relatedly, we think large spirit distillers may have increased prices too aggressively in recent years, thus accidentally promoting trade-downs. For example, a bottle of Casamigos Blanco is now priced around \$50 in New York, relative to Espolon Blanco, another 100% agave offering, at \$25. There are no such savings to be found when trading down in tobacco given the average pack costs roughly \$10 in the US, and therefore savings from downtrading will be comparatively small. This is a structural issue because consumers who trade down may never go back to the \$50 bottle, given the broadly similar quality and attributes of these products.

Forward Multiples Over Time

Could Alcohol Go the Way of Tobacco?

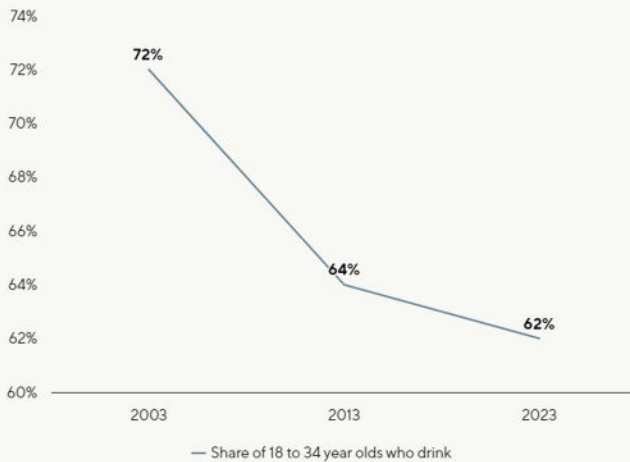


Source: Bloomberg as of 3/15/24. Note: Average FY2 multiples (i.e. 2025 consensus for latest data points). Spirits includes Diageo, Pernod Ricard, Brown Forman; Beer includes Anheuser-Busch, Molson Coors, Heineken; Tobacco includes Altria, British American Tobacco, and Philip Morris.

Shifting Demographic Trends

Share of US 18- to-34-Year-Olds Who Drink

Steady Decline in Young Adults Drinking



Source: Gallup Polls.

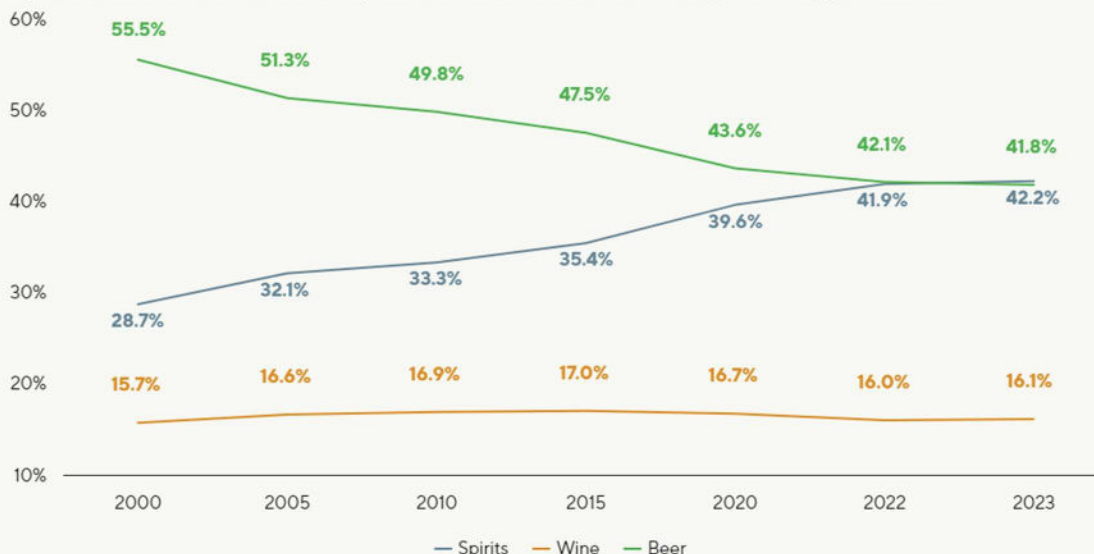
The decline in alcohol volumes is well known and even producers will admit that people drink less but better over time, industry parlance for positive mix. However, there are now a host of potential reasons for accelerated volume declines, such as demographic factors, changing tastes and increased awareness of negative health impacts. Gallup polls have found that 18- to 34-year-olds in the US have become increasingly less likely to drink alcohol, with the percent who drink having fallen from 72% two decades ago to 62% in 2023. Further, they found that the percentage of young adults saying they ever drink, that they drank in the past week, or that they sometimes drink more than they should are all lower today. Said differently, fewer young adults are drinking, they drink less frequently, and when they do, they consume less. Health concerns appear to be a driving factor, with 52% now believing that even moderate drinking is unhealthy, up from 34% five years ago. This belief is likely to be structural and may accelerate volume declines, given that our understanding of the health impacts is only likely to increase, driving further aversion from this cohort and future potential consumers.

Beer: Back to 1999 (Volumes)

In addition to there being fewer drinkers, people are drinking differently. There has been an ongoing trend away from beer and towards spirits in the US. This share of consumption gain partially explains the difference in multiples between beer and spirits. However, the shift away from beer seems to be accelerating, with US beer shipments falling more than 5% in the first nine months of 2023. Full year shipments are expected to hit their lowest level since 1999, according to industry tracker Beer Marketer's Insights.¹ While traditional beer sales are flat-to-declining, non-alcoholic beer sales are on the rise, having averaged ~30% growth in dollar-terms annually in the US over the past four years, according to NielsenIQ.³

US Market Share By Supplier Revenue (%)

Spirits Gained 13 Points of Market Share by Volume Since 2000 - Each Point Worth \$890M in Supplier Revenue



Source: Distilled Spirits Council of the US.

Spirits: Growth Engine is Stalling

Despite the share gains and price/mix benefits in spirits, there is also reason for caution. Distillers may have increased prices too aggressively in key categories. For example, the tequila category, a key growth driver in recent years, is broadening out, with sales increasingly driven by lower-price point offerings, as opposed to the super-premium. This may foreshadow the end of the super-premium tequila boom, in which case distillers will be left looking for the next leg of growth. Even beyond tequila, weak consumer demand for high end premium and super-premium priced liquors was cited by the Distilled Spirits Council of the US as the key factor behind slow US spirits sales last year. Total spirit sales in 2023 were largely flat, and increases were driven by the lower-end categories with a notable decline in super-premium (see chart below). The US market is particularly important because it represents an outsized share of profits due to the higher average prices and margins compared to other countries, hence the focus on it in this report. At Diageo, for example, the US represents 40% of sales but almost 60% of EBIT, given the country's 38% margin is materially higher than the Group margin of 27%. Hence, a pullback in US premiumization raises questions about whether distillers' primary growth engine is stalling.

US Spirits Premiumization Stalls

Sales Driven by Lower-Tier Offerings



Source: Distilled Spirits Council of the US.



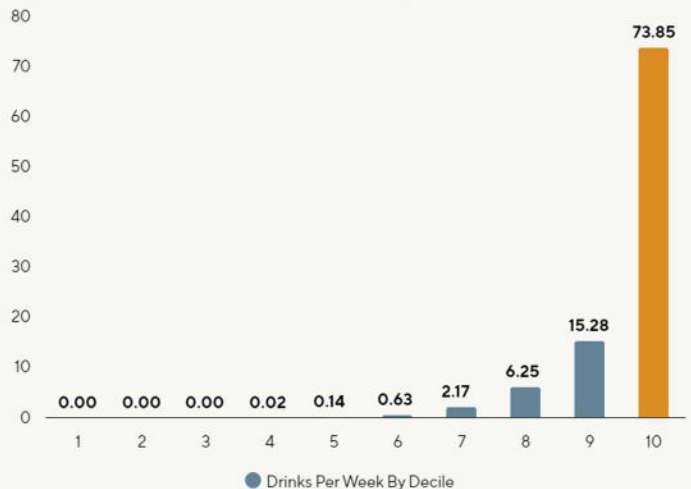
Skewed Consumption and Potential GLP-1 Risk

Further, an underappreciated risk is that alcohol consumption is heavily skewed by the right-tail of heavy drinkers. A study by the National Institute of Health (NIH) and economist Philip J. Cook, revealed that 60 percent of Americans aged 18 and over consume half a drink or less a week, while the top 10% of drinkers, who consume 74 drinks per week, account for more than half of all alcohol consumed in the U.S.⁴ There is a clear concentration risk in this segment of drinkers, and according to Cook, "...the heaviest drinkers are of greatly disproportionate importance to the sales and profitability of the alcoholic beverage industry. If the top decile could be induced to curb their consumption to that of the next lower group (the ninth decile) then total ethanol sales would fall by 60%." Additionally, although not yet present in the numbers, GLP-1s may compound this issue. GLP-1s have been shown to reduce alcohol consumption in animals, and a study recently published in *Nature* claims to provide, "initial real-world evidence of reduced alcohol consumption in people with obesity taking Semaglutide or Tirzepatide medications".⁵ Although we are in the early innings of

understanding (never mind mass producing and distributing) GLP-1s, this could present another headwind to alcohol consumption over the long-term.

Drinks Per Week By Decile

Top Decile Accounts for ~50% of US Alcohol Consumption



Source: Paying the Tab, by Philip J. Cook.

Regulatory Headwinds Reinforce Tobacco Parallels

Regulatory Threats on the Horizon

Labelling Restrictions Reminiscent of Tobacco

By The Irish Times

22 May 2023

Ireland set to become first country with mandatory health warnings on alcohol

Display of information on dangers of drinking will be require from 2026

Source: Clipping of The Irish Times headline detailing the new labelling laws. TheIrishTimes.com, May 22, 2023.

Lastly, new regulatory announcements in Ireland are an unprecedented negative for the industry. Ireland will soon become the first country in the world to mandate comprehensive health labelling on alcoholic drinks. Starting in 2026, all alcoholic drinks' labels will need to state risks of cancer and liver disease associated with consuming the products, along with calorie count, grams of alcohol, and dangers of drinking while pregnant. Coldiretti, Italy's biggest farmers' association, described the "terrifying" warnings as a "direct attack", per the Guardian.⁶ Labelling restrictions are tobacco-esque and don't bode well for future developments. Conceptually, the end-state of alcohol packaging resembling cigarettes', with prominent health labelling, would be especially negative from a price/mix perspective given the brand appeal of certain alcoholic categories. For example, picture super-premium spirits without the branding. Circling back to the tobacco parallel, increased regulatory scrutiny precipitated the de-rating, and these regulations show that alcohol is not immune to negative regulatory developments.

Summary

In summary, alcoholic beverages are faced with the potential for accelerated demand destruction, slowing premiumization, right-tail risks from heavy drinkers and GLP-1s, and increased regulations. As investors, we are looking for asymmetric upside opportunities, and we think the market may be too complacent on the outlook for spirits, which is reflected in their near-market multiples despite the litany of risks presented above and the clear parallels to tobacco. With that said, we continue to look for selective opportunities as there are always some who can figure out ways to grow.

END NOTES

¹"Beer Faced Declines in 2023.", NACS, January 2, 2024.

²"Does the Drink Industry Have an ESG Alcohol Problem?", Jefferies, March 2021.

³Black, Aaron. "Sobriety Is In, and Nonalcoholic Beer Sales Are Soaring.", Wall Street Journal, October 12, 2023.

⁴Haden, Jeff. "How much do the top 10 percent drink?", Inc., October 7, 2014.

⁵Quddos, F., Hubshman, Z., Tegge, A. et al. "Semaglutide and Tirzepatide reduce alcohol consumption in individuals with obesity", Nature, Sci Rep 13, November 28, 2023.

⁶"Ireland to introduce world-first alcohol health labelling policy", The Guardian, May 2023.

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