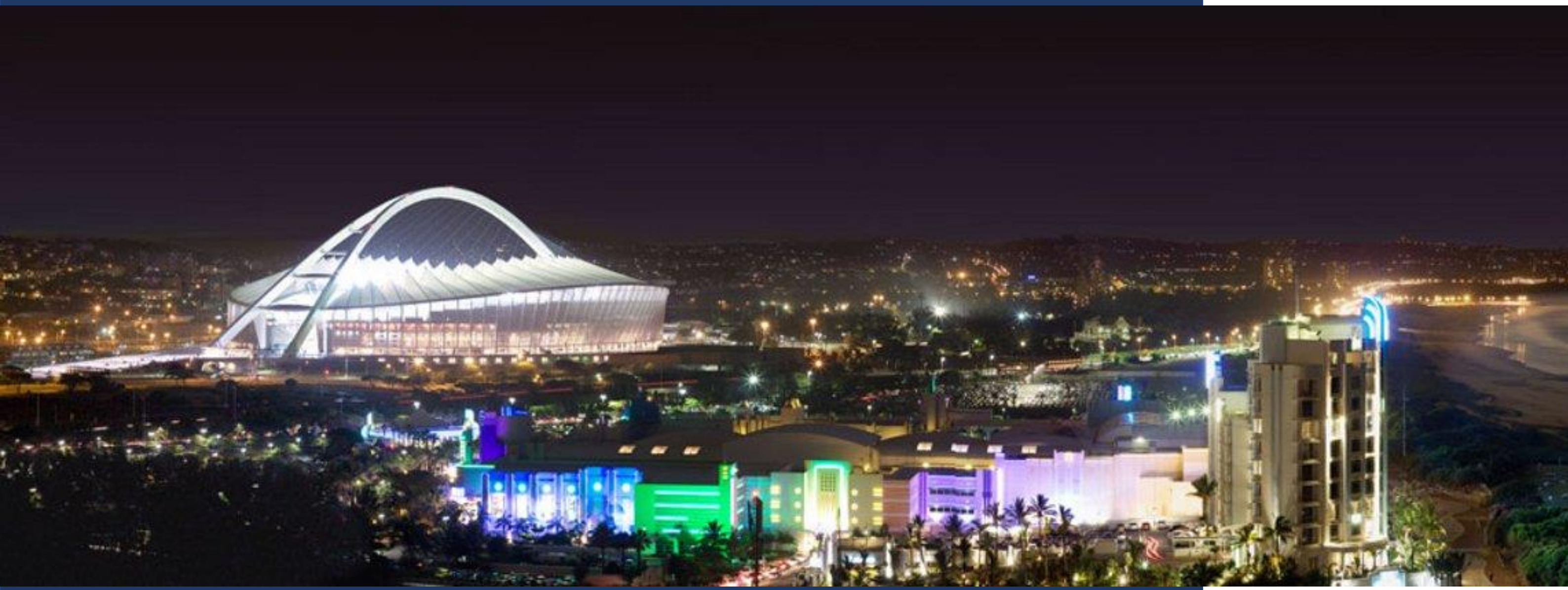

Report to AB InBev Board

MAY 2016

TEAM UKZN

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The CFO Case Study Competition

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SECTION A: EXECUTIVE SUMMARY

1. Terms of reference

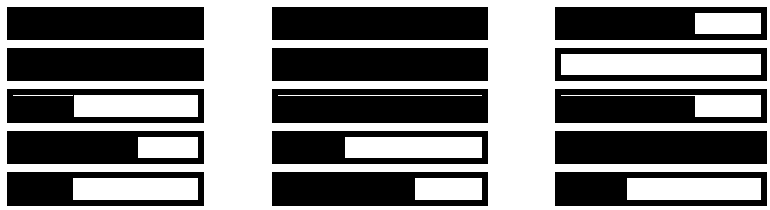
AB InBev is the global leader in beer brewing. As part of their corporate strategy, the Board of Directors have been actively investigating the acquisition of their biggest competitor, SABMiller. As part of this acquisition, AB InBev has commissioned this report to evaluate and prioritise the issues it faces and provide a recommended course of action.

2. Prioritisation of issues

The issues raised by the Board have been prioritised on the basis of urgency, impact on the company and ethical implications. The prioritisation has been based on the SWOT analysis presented in Appendix A. The order of priority is listed below:

Urgency *Impact* *Ethical implications*

1. Direct entry into Nigeria
2. Deal funding strategy
3. Integration
4. Environmental hazard: China
5. Downstream supply chain strategy



3. Key Recommendations

The key recommendations for each issue, in order of priority, are detailed below.

	Issue	**Recommendations**
1	Direct Entry into Nigeria	• Forgo Foreign Direct investment • Invest in SABMiller Shares
2	Deal Funding Strategy	• Preference Equity: US$50bn • Bridging Loan: US$5.5bn • Ordinary Equity: US$44.5bn • Sale of Financial Assets: US$0.2bn • Long Term Bonds: US$5bn • Cash: US$0.3bn
3	Integration	• Implement improvements to Integration Project initiatives • Implement developed initiatives to take advantage of Revenue synergies
4	Environmental Hazards: China	• Accept responsibility and rectify situation • Develop in-house policies to prevent re-occurrence
5	Down Stream Supply Chain Strategy	• Implement combination of suggested strategies • Commence marketing strategies for consumers to apply pressure to retail outlets to stock products

SECTION B: DETAILED REPORT

4. Detailed Findings and Recommendations:

4.1 Africa Direct Entry via Nigeria

Issue
AB InBev has two mutually exclusive options available with regards to entering the African market. It can either continue with the SABMiller merger thereby gaining access to a well-established network on the continent or they can alternatively obtain a foothold via a foreign direct investment into Nigeria.
A quantitative and qualitative analysis will be performed to obtain an understanding of which alternative would be most favourable to AB InBev.

Analysis
Quantitative Analysis:

The decision of entering the Nigerian market as a foreign direct investment (FDI) or by purchasing the 100% stake in SABMiller will be quantified as follows:

- Foreign Direct Investment (FDI): Net Present Value Capital Budgeting
- 100% stake in SABMiller: Black-Scholes Option Pricing Model

The FDI project will include the purchase of the requisite land, buildings and machinery.

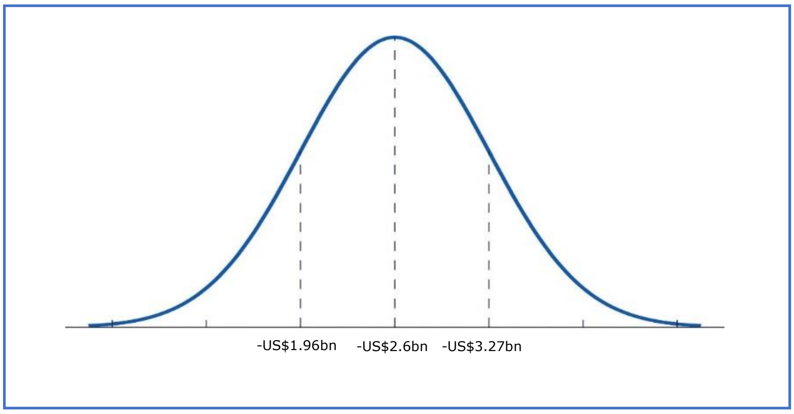
The FDI decision is favourable if the NPV analysis results in a positive figure as this would indicate that the project is going to increase the value of the firm as it generates returns in excess of the required return.

The Black-Scholes model is favourable if a positive amount is calculated, as this shows that the equity of SABMiller is positive after the 5 years (indicating that the option to sell the equity in the future is positive).

Results

In terms of the capital budgeting performed in Appendix 2.1, the NPV of the FDI is -US$2.61bn
A sense check is performed below in order to calculate a range of values (based on one standard deviation on either side of the valuation) as the exchange rates for Y1 to Y5 are challenging to predict.

Figure 1.1: Normal Distribution Curve



The option to sell the equity of SABMiller in an equivalent five-year period, using the Black-Scholes Price Valuation Model (Appendix 2.2) is *US$ 10.51 million*, thus indicating *a positive put option*.

Qualitative Analysis:
Negative (FDI):

- There are already established competitors in Nigeria such as Nigerian Breweries, Guinness Nigeria and SAB Miller. These companies have an established market share and an understanding of the cultural, political and economic landscape of the country. Whilst AB InBev has paid for several marketing studies, there is no guarantee that such campaigns will work and that marketing firms will deliver on the promised contracts.

- The country has a turbulent economic and cultural environment. The government has a great deal of influence over businesses by creating and enforcing stringent regulations, while the Afro-centric nature of the country may result in AB InBev's presence being viewed with hostility as it is a foreign company. This will make conducting business in Nigeria difficult.

- Whilst a feasibility study has been commissioned to identify whether there are appropriate brewery facilities, transport links and a reasonably skilled labour force, there would still be a need to build relationships and become familiar with the economic landscape and business practices.

- The commissioned study, which produced the market share and forecasted data about the batches of drink sales, indicates that whilst AB InBev market share will grow over the next five years, it will still be 10% below Heineken (Nigerian Breweries Plc, Consolidated Breweries). This shows that even with AB InBev's significant investment, the growth opportunities in the area are limited.

- The advantages resulting from the FDI over AB InBev's competitors will only last for 5 years due to new advances in brewing technologies. The initial foothold created will only be worthwhile if AB InBev expands with other FDI's in other African countries for an amount of US$ 2 billion.

- The African continent is a complex business environment, so what could work in Nigeria may not work in other African countries. This will entail more research studies and marketing campaigns should AB InBev seek to expand further into the African continent.

Positive (FDI):

- Nigeria is one of the most populous countries in the world and second largest beer consumption market on the African continent which would provide a growing demand and customer base for AB InBev.

- There is evidence that this business model can work as shown by the various multinational companies already operating with subsidiaries within the Nigerian market.

- The core values on which the market strategy is based encompasses sustainability with three key pillars: a growing world, a cleaner world and a healthier world. These are all noble goals that may carry public favour given that the issues of scarce resources and healthy living are currently very topical. This might get them the market they need and in turn, increase the market share. The initiative to ensure that an increase in no or lower alcohol beer products sold will also improve the public image of the company.

Positives (SABMiller)

- SABMiller is already an established entity within the Nigerian market with 18,6% of the market share. Therefore, there are no start up risks related to entry into the Nigerian market. Furthermore, SABMiller also has a presence throughout the continent, which removes the risk of expanding into Africa.

- SABMiller has a knowledge of the both the market conditions within Nigeria and the African continent. Through this investment, AB InBev will gain the business acumen that SABMiller has acquired through its numerous years of business in the African market.

- SABMiller has established infrastructure and an existing value chain with established supplier relationships. This will benefit AB InBev as they will not have to develop these relationships.

- SABMiller has established brands within the market, which AB InBev can leverage its international products off, thus boosting the profile of its flagship brands. This links to recommendations made in section 4.3.

- A merger of AB InBev and SABMiller will ensure that the number of competitors in the market does not increase. This will allow SABMiller to be more profitable.

- The bilateral tax treaty between Nigeria and Belgium will benefit AB InBev as its head office is located in Belgium (i.e. the company is resident there and consequently taxed on worldwide income). However, the taxable income generated by the FDI will also be taxed in Nigeria. Therefore, the company will be able to reduce its tax liability in Belgium by the foreign tax paid in Nigeria.

- The FDI option only gives AB InBev exposure to the Nigerian market for 5 years and expansion into Africa is dependent on the success of those 5 years, as the expansion is dependent on the capital reserves generated from the Nigerian operations.

Conclusion:
The quantitative analysis has indicated that there will be a negative return should AB InBev decide to enter the Nigerian market on its own. Furthermore, the adverse qualitative analysis outweighs the positive.

Recommendation:
Based on the quantitative and qualitative analysis, AB InBev should continue with the SABMiller merger rather than pursue an FDI into Nigeria.

4.2: Deal Funding Strategy and Group Financial Performance

Issue:

Given the recommendation to purchase SABMiller, AB InBev must determine an appropriate strategy to fund the US$105.5 billion needed to buy out the SABMiller shareholders. This strategy needs to take AB InBev's current cash position, credit rating and key financial objectives into account.

Analysis:

When determining the most appropriate funding strategy, one must consider the impact of the strategy on return, financial risk, control, signalling and flexibility.

Whilst it would be most advantageous to utilise internally generated funds to fund the deal, AB InBev needs to be wary of this, given the impact this will have on the *liquidity position* of the entity.

With a current ratio of 0.67:1, AB InBev needs to be cautious about placing undue strain on its liquidity position, as this may have negative consequences for the company going forward. Given the company's liquidity status, a conservative decision of utilising as minimal cash reserves as possible to fund the acquisition should be followed. Thus, it is recommended that US$300 million is raised in this manner.

However, the company does have an option to sell investments in financial assets. In certain cases, this may be required by competition authorities, as explained in Section 4.3. AB InBev should consider divesting of its investments in companies that are not related to its core operations. However, as AB InBev only has approximately US$500 million invested in associates and securities, it is estimated that only US$200 million can be raised in this manner.

When determining how the remainder of the deal will be funded, the Board must consider its key financial objectives, namely:

- Grow dividends annually by 10%;
- Deliver Total Shareholder Returns (TSR) of 14% annually; and
- Keep gearing below 40%.

Currently, shareholder returns for AB InBev are estimated to be 18.37%, while gearing is calculated at 61.94%. Dividends per share have increased by approximately 7% year-on-year.

In traditional capital structure theories (such as the pecking order theory and the trade-off theory), the raising of debt is considered preferable to issuing equity. However, as gearing is very *high* in comparison to the target, the case must be made for issuing more equity than debt, to reduce the financial leverage of AB InBev. A leveraged buy-out would increase the financial risk of AB InBev, which may result in the predicted credit downgrade. This would make it more difficult to obtain financing for future expansion, which would be detrimental to AB InBev's corporate strategy.

In addition, debt financing is currently risky for AB InBev, due to the credit rating concerns that it is currently experiencing.

However, debt cannot be completely disregarded, as issuing too much equity will result in inappropriate signals being sent to the market. Already, the share price has not reacted positively to the merger announcement (only increasing by 1.8% instead of the 25% anticipated). Thus, it would be reckless for the Board to issue an excessive amount of equity.

In addition, the raising of debt assists shareholders in managing the agency problem. Raising more debt forces the Board to maximise returns and minimise the use of capital. Thus, the raising of debt can assist the shareholders in encouraging the Board to meet the financial objectives that have been set.

It is suggested that the split between debt and equity should be 40% debt and 60% equity. This translates to:

- Debt: US$42 billion
- Equity: US$63 billion

This split will result in a post-merger gearing ratio of 56.2%, and an estimated TSR of 13.15% (see Appendix 3). Thus, the recommended capital structure will assist Newco in meeting two of its financial objectives, as the gearing has decreased, and the TSR is more in line with the company's objectives.

To raise the necessary debt financing, a split between bonds and a short-term bridging loan is suggested. This is because an adverse credit rating will make our bonds less attractive to investors and more expensive to AB InBev. The bridging loan, which will be repaid over the first 5 years of the merger, will be replaced with long-term bonds. These bonds can be issued at a lower interest rate, as the Board can take advantage of the increased financial stability post-merger.

A straight issue of ordinary equity may not be viewed as appropriate by current shareholders, as certain shareholders may lose their portion of control, should they be unable to take up the additional shares.

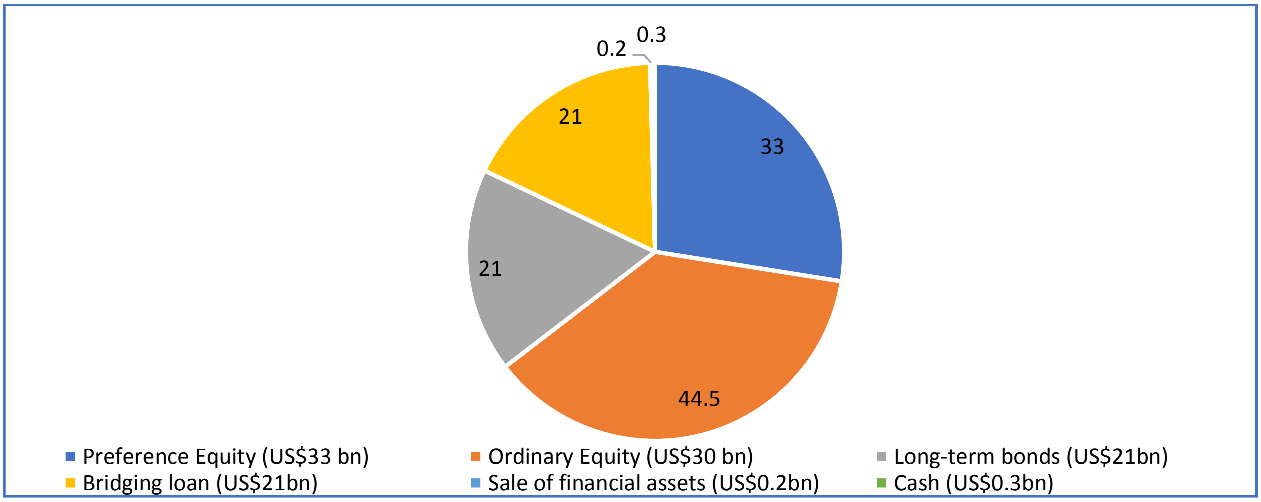
Thus, it is suggested that the issue of equity be apportioned into an issue of preference shares (approximately 52%), convertible after 10 years into ordinary shares, and with a coupon rate of 5% of the issue price; and an issue of ordinary shares (approximately 48%). The issue of ordinary shares would commence with a rights issue, after which, shares will be offered to the public in countries where Newco will be listed. The price for the ordinary shares should be consistent with the current market value of AB InBev's shares.

The financial objective related to dividend growth should be revised downward to support this acquisition. This is in line with the Board's strategy to prioritise acquisitions over dividend pay-outs. In addition, there is precedent to support this recommendation as AB InBev made reduced dividends to support its merger in 2008.

Recommendation:

- AB InBev should finance the US$105.5billion cash offer as follows:

Figure 2.1: Deal funding strategy



- The Board should revise its dividend growth policy to 2%, in response to the increased level of equity it has raised.

4.3: Integration, Synergies and Execution Risk

Issue:

Shareholders are concerned that the value of the purchase price is too high, and that the value of synergies are less than the premium paid.

As calculated in Appendix 4; the value of the premium paid to SABMiller shareholders is approximately US$6.5 billion. This indicates that, should all the synergistic benefits materialise, AB InBev did not overpay for the shares:

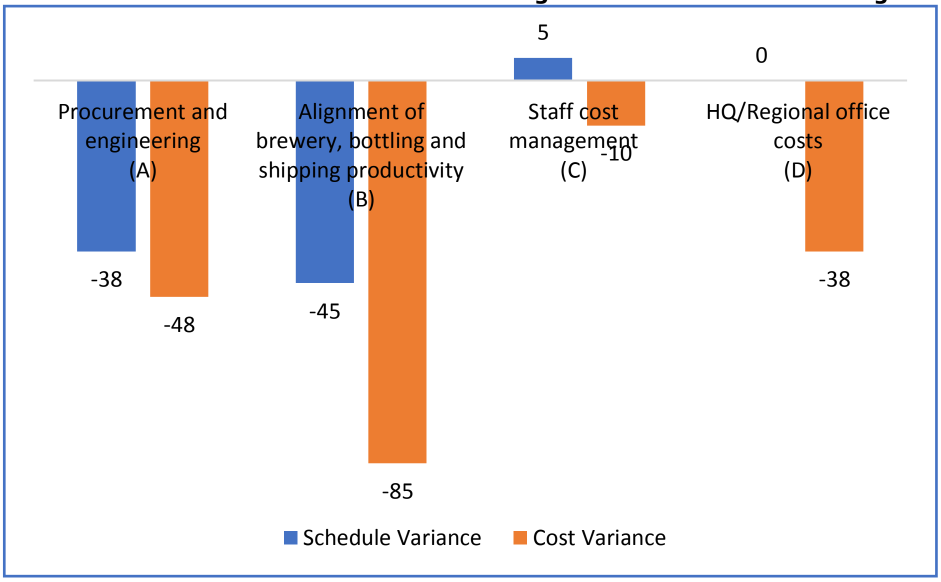
	US$ Bn
Total value of the synergistic benefits:	7.421
Total premium paid:	6.5
Value of synergistic benefits not paid to SABMiller shareholders	0.921

However, to realise all the synergistic benefits, the Board of Newco will have to analyse their current integration projects, as well as their cost and revenue synergies.

Integration projects: costs and cost synergies:
Analysis:

Utilising an Earned Value Analysis Model, the schedule variance and cost variance have been determined for initiatives, as displayed in Figure 4.3.1 (see Appendix 4 for a detailed calculation of these indicators):

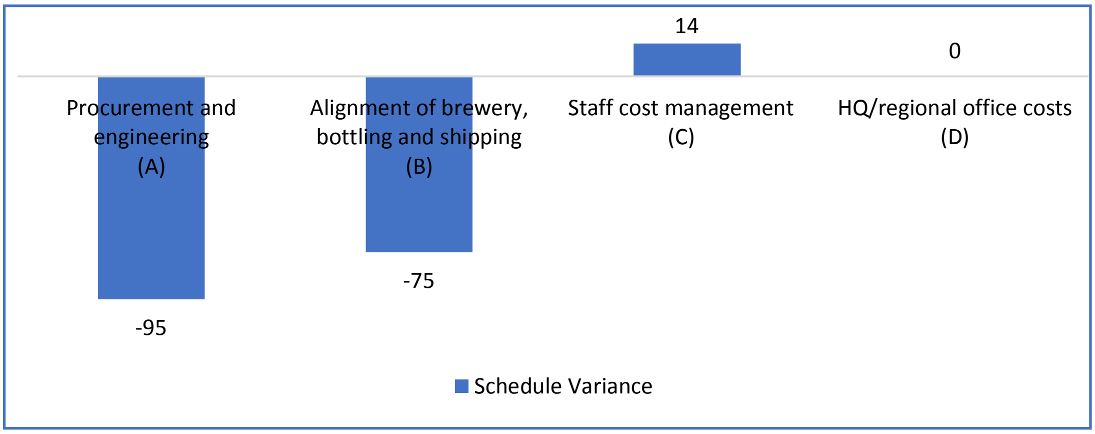
Figure 4.3.1: Schedule and cost variance of integration costs for each strategic initiative



It has been noted that, given the estimations at 31 October 2018, initiatives A and B will be behind schedule, whilst initiative C will be ahead of schedule and initiative D will be on schedule. All initiatives will be more than anticipated.

The expected cost synergies for each project have been analysed below:

Figure 4.3.2: Schedule variance of cost synergies of each strategic initiative



From both figures 4.3.1 and 4.3.2, it is noted that integration initiatives A and B are the least successful. The Board will need to devote resources to investigate the reasons for and reverse the negative cost and schedule variances.

The negative variances are outlined as follows:

Table 4.3.1: Understanding the cause of the negative variances

Strategic Initiative	Understanding
Procurement and engineering (A)	The likely cause for the negative variance is the scope of the project. SABMiller's operations were *decentralised*, and it will require a significant amount of resources to centralise this network. Implementing a JIT system with a Centralised Procurement Division (CPD) will result in operating inefficiencies as the global CPD will expose Newco to language and cultural barriers which will cause difficulties in resolving supplier issues. In addition, with a completely centralised procurement division, Newco cannot take advantage of *region specific knowledge*, and enhanced *supplier relations*, as the division may be located on a different continent to its suppliers.
Alignment of brewery, bottling and shipping (B)	Business process re-engineering requires a complete redesign of an entity's business processes. With an entity as large and complex as Newco, this will take a substantial amount of time, given that Newco is redesigning all aspects of its value chain. It would thus be expected that the *planning horizon should exceed four years*, in order to ensure appropriate implementation of new processes. However, the *synergistic benefits from implementing this project will exceed the 4-year horizon* envisaged by the Board, given that the new processes will be in effect for many years to come.
Staff cost management (C)	No concerns have been noted as this initiative does not appear to be materially behind schedule however, the ethical concerns surrounding this initiative are dealt with in Section 5.
HQ/Regional Costs (D)	The costs of running the SABMiller HQ while the company is in the process of collapsing the operation is expected to be a lot higher than originally anticipated. Newco will require a strategy that reduces these costs.

Recommendations:

Management needs to review each of their strategic initiatives; **identify the bottleneck** (both in terms of cost and time) and **adjust their strategy** to improve the time and spending efficiencies of the initiatives.
In the table below, recommendations are made that could assist the Newco's Board in meeting its targets, as well as the potential financial implications of each approach.

Table 4.3.2: Recommended approaches to reduce bottleneck of each strategy

	Recommended approach	Financial implications
A	Adjust the strategy to centralise procurement *per region* (i.e. the African region, Asian region, North and South American region etc.). This will allow for Newco to take advantage of *exploiting stronger bargaining power*, however, it also reduces the concerns highlighted in Table 4.3.1	May result in a slight reduction in bargaining power, but will also reduce the risk of a JIT system failure and will enhance supplier relations.
B	Newco should re-evaluate its timeline for the implementation of this project.	Costs will be incurred over a longer timeframe; however, synergistic benefits will be experienced over a longer period.
C	This strategy does not require a change in approach, as it appears to be meeting its targets.	N/A
D	Enter into a sale and short-term leaseback arrangement for the sale of the HQ in London with a real estate investment firm. The real estate investment firm will be able to take advantage of economies of scale, thus, will result in lower costs for Newco.	Provides short term liquidity whilst allowing for time to conclude outstanding matters.

Revenue synergies:

Analysis and Recommendations:
AB InBev has identified five revenue synergies from its acquisition of SABMiller. However, it needs to develop strategic initiatives to take advantage of these synergies.

1.

Synergy:	**Growing our global brand**
Initiative:	"Act Global, Think Local"
Description:	Newco should use its global brand and philosophies, but *develop a local iteration* of its products, that is suited to the preferences of the local market.
How synergy will be achieved:	Newco will be able to take advantage of its global brands and philosophies; but develop a beer that is Afro-centric, thus, utilising its global image, but creating a product that focuses on the preferences of Africans.
Cost implications:	High start-up costs, as Newco will have to invest in research and development of new product, and initial marketing. However, they can draw on the expertise of SABMiller.

2.

Synergy:	**Cross sales of SABMiller brands (Castle and Castle Light)**
Initiative:	"Taking Castle to the World"
Description:	Newco should implement the following strategies: a) A *price penetration* policy; where Newco sells the Castle and Castle Light beers at a price cheaper than local beers when they enter the European and American markets and increase the price as support for the brand grows. Furthermore, current Newco products should be used to leverage the Castle brands in these new markets. b) Highlight the Castle brands in the 'Smart Drinking Goals' campaign in these regions.
How synergy will be achieved:	Newco will enter these markets at a price lower than the competition. Combined with a marketing push, this will promote the Castle brand above other foreign brands in the region. It will be advantageous to export the Castle brands from South Africa as the weaker Rand will assist in lowering prices. This synergy is risky as the beer industry is very region-specific.
Cost implications:	Newco will experience a short-term reduction of profits to implement its pricing penetration policy.

3.

Synergy:	**Elevating the core**
Initiative:	"Elevating the Core"
Description:	In line with our recommendation in Section 4.5, Newco must enter into agreements to be the *sole distributor of alcoholic beverages* at major sporting and other social gatherings.
How synergy will be achieved:	Newco will have an opportunity to market its products and brands at sporting events to a wide customer base, which will increase its market share.
Cost implications:	Negotiating contracts of this nature is costly, as the competition from other suppliers will be fierce.

4.	Synergy:	**Developing the near beer segment**
	Initiative:	"Diversifying Product Horizons"
	Description:	There are a number of initiatives Newco should invest in: a) Acquire the licence to bottle and distribute MillerCoors brands (particularly Miller) outside of the US. b) Target 20% of the product range to be low- and no-alcohol alternatives to beer. c) Expand on SABMiller's interest in bottling Coca-Cola (non-alcoholic) beverages in Middle Eastern countries. d) As a long-term strategy, acquire craft beer breweries in developed regions (This is a long-term strategy).
	How synergy will be achieved:	a) By acquiring the licence to bottle Miller out of the US, Newco will be able to expand on its product range and eliminate the threat of increased competition from a merger between MillerCoors and another brand. b) Consumers are becoming more health conscious, and this initiative will supply this growing trend. The initiative will also fit into the "Smart Drinking Goals" marketing campaign. c) This will give Newco an opportunity to invest in markets previously untapped by AB InBev and other breweries. d) Mainstream breweries have saturated the market in the developed world, thus, in order to continue expanding in these regions, Newco must invest in these niche markets.
	Cost implications:	These strategies require considerable investment.

5.	Synergy:	**Premiumising and invigorating beer**
	Initiative:	"Smart Drinking Goals"
	Description:	The Smart Drinking Goals initiative is in its design stage. By promoting a shift in social norms regarding alcohol abuse and developing products that have reduced alcohol, Newco will be an industry leader. This will result in benefits for both AB InBev and SABMiller portions of Newco.
	Cost implications:	The investigation and design of the strategy will require a significant initial investment, and the piloting of the project will also require a continual investment.

<u>Stakeholder management:</u>

Analysis:
There are many stakeholders who are very interested in the outcome of this merger. The Board of AB InBev (and Newco, once the company is established) must take great care in managing its relationships with these stakeholders, to ensure a successful merger.

The relevant stakeholders are considered below:

1. **Competition authorities in countries that Newco operates**
   Due their respective sizes, the merger between SABMiller and AB InBev will likely raise the concern of anti-competitive authorities. The Boards of Ab InBev and SABMiller must take steps to ensure that all concerns raised are addressed, so as to avoid the cancellation of the merger.

2. **South African government**
   Should the South African government not approve the merger, AB InBev will incur a high cancellation premium (US$3 billion), and neither company will acquire synergistic benefits. Given that the government has a large stake in this merger (they stand to lose ZAR15.68 billion), the Board has a responsibility to address the concerns raised.

   In addition, the South African government will impose a requirement that Newco spends US$5 million over the next 5 years. Newco should pre-empt this requirement by pledging US$5 million to supporting the development of local suppliers. This could be a CSR initiative for the company (see Section 5).

3. **Suppliers of Newco in South Africa**
   The suppliers of Newco are concerned that the prices of their products will decrease because of Newco's improved bargaining power. They have formed an industry body to counteract this effect.
   Through negotiation and mediation programmes, Newco should attempt to gain a good working relationship with the suppliers. Newco should insist that decisions reached must benefit all parties concerned.
   Should an agreement with the bargaining council not be forthcoming and as a long-term solution to these concerns, Newco should consider vertical integration by purchasing key suppliers in the South African market.

4. **Consulting firms**
   Consulting firm EVA and software giant SAP are unsure about the status of the merger agreement. The Board should prioritise the finalisation of the agreement as outlined in Section 4.1, and inform these stakeholders as soon as possible, to limit delays to the BPR as recommended in Recommendation B under Integration Projects. As highlighted above, the BPR strategy will take longer than the expected 4-year horizon to implement, and thus, delays to this process should be minimised.

Recommendations:

To respond to concerns raised by various stakeholders, Newco should:
- Reassure the South African tax authorities that effective management of the African region (as discussed in Recommendation A of Integration Projects) will remain in South Africa.
- Pledge US$5 million over 5 years to support the development of South African suppliers.
- Engage with the bargaining council of suppliers and attempt to find common ground, with the goal of creating a good working relationship.
- As a long-term strategy to the bargaining council, consider vertical integration, to gain control of this area of the value chain.
- Divest of all non-core operations (i.e. not involved in the production of beer) in countries where authorities have raised concern over anti-competitive behaviour.
- In countries where all operations are core, attempt to enter into licencing agreements with divested breweries to bottle and distribute their products in other regions where these products are sold.
- Inform all stakeholders of the decision made in Section 4.1, so that projects resulting from the merger can commence as soon as possible.
- Through reliable media outlets, keep shareholders informed of all material aspects of the merger, and the status of the synergistic benefits.

4.4: Environmental hazard in China

Issue:
AB InBev are constructing their largest brewery facility in China, however the contracted construction firm has been found to be illegally disposing of waste into a nearby river, affecting the eco system. This has led to a delay in construction and rising media attention, which potentially damages AB InBev's reputation in China.

Analysis:
Despite Li Wang's insistence that this is a minor issue, the incorrect disposal of the waste has serious ramifications for AB InBev's operations in China. A delay in construction and therefore production will affect AB InBev's total output in China allowing competitors an opportunity to capture more of the market.

Furthermore, AB InBev could face fines and penalties imposed by the Chinese government due to their non-compliance with environmental policies. This may impact future investment opportunities in the country.
AB InBev is at risk of losing its standing in the Chinese community and damaging its reputation globally due to the illegal dumping. This reputational damage could affect the company's position as the world leader in the brewing industry.

Recommendations:
- AB InBev should immediately undertake to investigate the cause of the illegal dumping. Should the contractor be at fault, ensure that no further work is awarded to that contractor.
- In addition, AB InBev must rehabilitate the environment that was damaged by the hazardous waste.
- Issue a media statement condemning the inappropriate disposal of hazardous waste and reassuring the Chinese community that the company is committed to operating in an environmentally-friendly and sustainable manner.
- Engage in dialogue with the protestors through mediation channels, to ensure that AB InBev addresses their concerns.
- Ensure that construction of the plant resumes as soon as possible after addressing the concerns of the relevant stakeholders.
- Furthermore, AB InBev should re-evaluate its in-house processes relating to contractor selection to only hire contractors that abide to sound operating standards.
- AB InBev should develop an in-house global operating standards policy which must be met prior to making use of any suppliers worldwide.

4.5: B2B and Downstream Supply Chain Management in Southern Africa

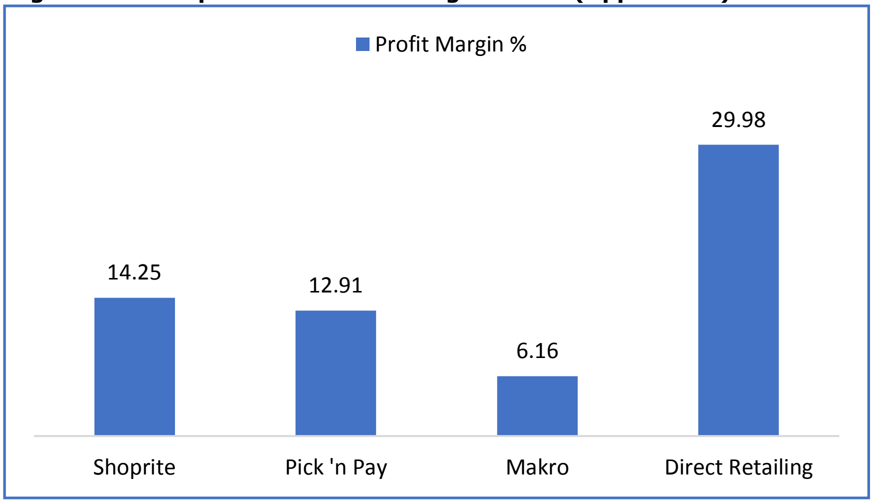
Issue
To maximise the synergistic benefits from the creation of Newco for AB InBev shareholders, the issue of downstream supply chain management needs to be addressed quickly and in the right manner to ensure continued success.

Retail space is vital for the success of Newco. Several strategies have been proposed to deal with retailers' reticence to sell Newco's products.

Analysis:

1. **Stop selling to the least profitable retailer.**

   Figure 5.1: Comparison of Profit Margin Ratios (Appendix 5)



   As shown, the retailer with the lowest profit margin is Makro.

   Advantages:
   - This would streamline operations and allow Newco to focus on its more profitable customers, which will improve the profitability on these clients.

   Disadvantages:
   - By not supplying directly to the customer, they may decide not to stock Newco's products. Thus, Newco will lose out on potential revenue.
   - Furthermore, Newco receives the greatest revenue from Makro, thus Newco's revenue would be adversely affected by this decision.

2. **Persuade the supermarkets to reduce the number of cost generating activities.**

   This would take the form of reducing the number of purchase orders, standard deliveries and rush deliveries.

   Advantages
   - This would reduce the cost to Newco, thus allowing it to be more generous with discounts, which benefits the retailers.

   Disadvantages
   - Retailers may not want to reduce their cost generating activities owing to their own established purchasing policies or the additional administration.

3. **Venture into direct retailing.**

   Advantages
   - Increased revenue since Newco can retail at a price similar to that of the other retailers.
   - No competition for retail space as Newco will own the space and use it to primarily market its own products.
   - Newco can sell products below the retail price of our competitors as the middle man will be removed.

Disadvantages
- Newco has no experience in retail as it is primarily a manufacturer.
- Competition with the other big retailers who already have a loyal customer base as well as prime locations and specialised knowledge in retail.
- The risk of slow-moving stock is transferred onto Newco, rather than other retailers.
- Newco will only be selling a limited range of products, whereas general retailers sell many products, making it more convenient for customers.
- Newco will require capital to fund the start-up. This may be difficult to acquire due to the take-over (the share price is not responding to the take-over and thus raising equity may not work. In addition, AB InBev is currently avoiding raising debt finance).

4. Introduce new technologies to reduce the cost of cost generating activities.

This would entail rolling out an ERP system that integrates Newco with their customers to streamline the value chain.

Advantages
- Newco will save on its cost generating activities as orders will automatically be uploaded to the system. These cost savings can be passed on to customers, making Newco a more attractive supplier.

Disadvantages:
- The system will be expensive to implement due to ancillary costs.
- This would require buy in from all of Newco's customers to be effective.

Recommendations:

We recommend both a direct and indirect solution to this issue:

Direct
An integrated approach should be used:
- Firstly, supermarkets should be approached and encouraged to reduce cost generating activities. A *hierarchical discount structure* should be introduced that rewards customers for ordering larger quantities within normal delivery times. *Additional delivery fees* should be implemented for rushed orders over a certain limit agreed upon with the customer. We recommend *no more than 0.3%* of the prior month's sales volume (which is the average of rushed orders for the three supermarkets) should be allowed as rushed orders before the higher delivery fee is charged.
- Secondly, management should start with the due diligence process and discussions with customers for the implementation of an ERP. We recommend an *off the shelf ERP*, such as SAP, (already being considered within Section 4.3) This will allow for the reduction in both cost of orders and time taken to fulfil orders.
- Thirdly, should the previous two recommendations not produce the desired effect, Newco should cease selling to the lowest performing customer (Makro- Appendix 5). This will allow it to streamline its sales operations to the other retailers and its wholesalers.
- Lastly, Newco (as a long-term option) should plan to open its own retail outlet. Newco must investigate the sustainability of this option as it requires significant investment.

Indirect
Newco will need to secure a greater bargaining power with its customers, to ensure that the above strategies are effective. The merger will increase bargaining power, as this has consolidated the two largest brewers and, with our recommendation of acquiring the license to bottle Miller (Section 4.3), will establish Newco as the primary beer supplier within the South African market.

A second strategy to implement is an increased marketing campaign which will increase customer demand. If customers are demanding Newco's product, the retailers will be forced to purchase Newco's stock.

This strategy may have a limited life span, owing to the government's proposed ban on alcohol advertising (Appendix 1), therefore, we also recommend introducing competitions and sport related sponsorships (such as getting sole brewer distribution rights to sport stadiums) to attract new consumers and reward loyalty to existing consumers (as discussed in Section 4.3).

While these strategies may be costly, the improved consumer base will apply the necessary pressure on retailers to purchase Newco's products.

5. Ethical issues

5.1 Investment in Nigeria:

Issue:

The company is embarking on a marketing campaign in Nigeria; this has ethical ramifications, as it could encourage vulnerable members of society to abuse alcohol.

As part of its advertising campaign, the company has paid US$10 million to an industry body to campaign for industry self-regulation in Nigeria. Self-regulation will not be in the best interests of the community, as companies like Newco may favour profits over the best interests of the Nigerian people.

Recommendations:

The company must collaborate with advertising agencies and social media platforms to ensure that content promoting alcohol is only distributed to age appropriate individuals.

The Board should work in partnership with the Nigerian government to determine reasonable regulation of the industry, rather than promote self-regulation.

The Board should partner with the Nigerian government to promote good drinking habit education in Nigerian schools.

5.2 Integration, Synergies and Execution Risk

Issue:

To maximise cost synergies, Newco is having to reduce the number of staff it employs. This has potential ethical ramifications, as these individuals will be unemployed, which will affect their livelihoods.

In addition, due to its increased bargaining power, Newco may try to disadvantage its suppliers by negotiating prices for materials that are too low to sustain the suppliers.

Recommendations:

The merger will not see a reduction in unskilled and semi-skilled labour, as the company is targeting higher earning individuals (as Newco wishes to expand into Africa, it would seem counterproductive to reduce unskilled/semi-skilled labour, as these employees will contribute to this expansion).

Newco should assist retrenched employees by negotiating fair retrenchment packages.

Newco must ensure that it engages with its suppliers in an equitable manner, so as to avoid disadvantaging the. In addition, Newco must pre-empt the South African government's requirements by pledging investment into communities where suppliers operate.

5.3 Environmental hazard in China:

Issue:

A contractor of the company has damaged the environment through hazardous waste disposal. This will have detrimental consequences on the ecosystem and the surrounding communities that rely on the river for water. In addition, the contractor is insisting that the issue is minor, and should not be pursued.

Recommendation:

In the interest of sound corporate governance, AB InBev should disregard the contractor's advice, as they have an ethical obligation to the act on the allegations.

The Board should immediately make arrangements to rehabilitate the affected area. In addition, the Board should consider engaging in upliftment initiatives in areas affected by the pollution.

The Board should issue a statement condemning all acts of environmental degradation and inform the public that the matter is being pursued.

APPENDICIES

Appendix 1: SWOT Analysis

AB InBev	
Strengths - **Good at picking the merger targets** - **Long history** - **Global Leader in beer industry**	**Weaknesses** - Have not diversified - Estimates of share price increase due to merger incorrect-shows management may be overselling merger
Opportunities - **Expansion into craft beer market** - **The merger with SABMiller represents entry into the African Market** - **Policy of mergers increases the bargaining power of AB InBev**	**Threats** - Perception of beer (Unhealthy, young people moving away from drinking beer) - Competition Commission/ Anti-Trust laws - Trade union action based on SABMiller retrenching staff - Merger not producing perceived value for shareholders

SABMiller	
Strengths - **Successful with most past mergers** - **Willing to take risks:** **- Gone into Africa and purchased unestablished breweries and allowed organic growth to develop the brand** **- Entered the Russian market and stayed even when operations became difficult and thus benefitted when the business became profitable** - **Market leader in the developing world (especially Africa)** - **Has license to produce other world leading brands such as Heineken**	**Weaknesses** - Has not successfully entered Nigeria, Africa's biggest/2nd biggest economy
Opportunities - **Expansion of Coca-Cola bottling into the middle east**	**Threats** - Perception of beer (Unhealthy, young people moving away from drinking beer) - Competition from other alcohol companies such as Distell (Linked to point above) - Regulations on advertising throughout the world - Increase in 'sin' tax- places greater burden on consumers (and govt loves targeting this for increases every year)

Appendix 2: Quantitative Analysis of FDI and SABMiller Acquisition

2.1: Capital Budgeting

The analysis will be presented as follows:
Initial CFs (Y0) (Assumption: Time of the SABMiller offer is Y0)
Operational CFs (Y1-4)
Closing CFs (Y5)

Net Present Value Analysis:

		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
	Ref	NGN Bn	NGN Bn	NGN Bn	NGN Bn	NGN Bn	NGN Bn
Initial cash flows:							
Land and buildings		(70)					
Machinery		(70)					
Marketing study	A	-					
Initial marketing ground work	A	-					
Initial investigation	A	-					
Reverse breakup fee	B	(2100)					
Working capital	C	(2)					
Operational cash flows:	*						
Revenue from batches sold	D	-	300,3	473,1	993,4	904,0	547,6
Cost to produce & sell batches	E	-	(39,1)	(64,6)	(142,2)	(132,5)	(86)
Special packaging	F	-	(36,7)	(57,9)	(121,6)	(110,6)	(67)
Training and development costs	G	-	(31,3)	(12,8)	-	-	-
Income tax expense	H	-	(46,5)	(82,7)	(180,7)	(163,5)	(109,1)
Closing cash flows:							
Recovery of working capital							2
Sale of land and buildings	J						28
Sale of Machinery	J						56
Total		(2,242)	146,6	255,1	549	497,4	371,4
		CF_0	CF_1	CF_2	CF_3	CF_4	CF_5
Discount rate	L	10%					
NPV	M	(915)					

This is equivalent to - US$2,61bn (-NGN915bn/NGN350.00)

References:

(A) The following costs represent sunk costs and are therefore, irrelevant.

- Marketing study: US$ 101m
- Initial investigation on local infrastructure and resources: US$ 500k

(B) At this point an offer has already been made to SAB Miller. However, as the FDI precludes AB InBev from purchasing SABMiller, the reverse breakup fee of US$6billion will be incurred

This amount will need to be converted to Nigerian Naira:
= US$ 6bn x NGN 350= NGN 2100bn

***Assumptions for Operational Cash Flows:**
It was assumed that all amounts given in the scenario are as at Y0 when the exchange rate is as follows: NGN 350 per US$1. Therefore, expected increases in amounts are reflected from Y1 onwards. It is also assumed that all cash flows occur at year end.

(C) It was assumed that the working capital investment took place at the beginning of Y1 and therefore falls under Y0 cash flows.

(D) NGN286,050 x 1000 000 batches x $(1.05)^n$

(E) NGN35,600 x 1000 000 batches x $(1.10)^n$
It is assumed that the value of these costs was provided at Y0 and increase by 10% p.a

(F) It has been assumed that the special packaging costs is US$100 per batch because this appears reasonable with the number of batches produced/sold each year together with the costs relating to producing and selling each batch.
This amount will need to be converted to Nigerian Naira**:** US$ 100 x NGN 350= NGN 35,000

NGN35,000 x 1000 000 batches x $(1.05)^n$

(G) Percentage of the production and selling costs (excluding the cost of special packaging)
Y1: 80% x NGN39,160,000,000 = NGN31,328,000,000
Y2: 20% x NGN64,614,000 = NGN12,922,800

(H) Income tax expense cash outflows relating to operating expenses:

		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
	Ref	**NGN Bn**	**NGN Bn**	**NGN Bn**	**NGN Bn**	**NGN Bn**	**NGN Bn**
Revenue from batches sold	**C**	-	300,4	473,1	993,4	904	547,6
Cost of production and selling batches	**D**	-	(39,2)	(64,6)	(142)	(132,5)	(86)
Special packaging	**E**	-	(36,8)	(57,9)	(121,6)	(110,6)	(67)
Training and development costs	**F**	-	(31,3)	(12,8)	-	-	-
Tax allowable depreciation	**I**	-	(7)	(7)	(7)	(7)	(42)
Disposal of land and buildings	**J**	-	-	-	-	-	28
Disposal of machinery	**J**	-	-	-	-	-	56
Taxable cash flows		-	186	330,7	722,7	653,9	436,6
Income Tax (25%)	**K**	-	(46,5)	(82,7)	(180,7)	(163,5)	(109,2)

(I) Y1-4: 10% x NGN 70bn= NGN7bn
Y5:(Balancing adjustment) =NGN 70bn-NGN28bn(Y1-4) =NGN42bn

(J) Land and buildings: 80% x NGN70bn= NGN56bn
Machinery: Given

(K) The current annual corporate tax rate of Nigeria will be used as the evaluation is concerned with cash flows being generated in Nigeria and is assumed to remain unchanged for the next five years.

2.2 Black Scholes Option Model

For the valuation of a company using the Black-Scholes Model, it is appropriate to substitute the Share price with the total assets of the company and the Strike Price with the Face Value of Debt of the company.

S= Total value of Assets: US$44 911m
E= Total face value of Debt: US$20 556
σ= Annualised Volatility (Std Deviation): 25%
r= Risk free rate: 15%
t= Years to Maturity: 5

Put Option Price: US$10.51m

Appendix 3: Ratio Analysis

Gearing ratio: AB InBev (all figures quoted in US$ million)
Debt: 61 085 + 27 208 = 88 293
Equity: 54 257
Gearing ratio: 61.94%

Gearing ratio: Newco (all figures quoted in US$ million)
Debt: 88 293 (AB InBev) + 20 556 (SABMiller) + 42 000 (Raised for merger) = 150 849
Equity: 54 257 (AB InBev) + 63 000 (Issued for merger) = 117 257
Gearing Ratio: 56.3%

Total shareholder return post-merger (all figures quoted in US$ million)

Profit: AB InBev		11 302
Profit: SABMiller		3 557
Cost synergy		2 450
Revenue synergy		210
Interest from raising of debt	$(42\ 000 \times 6.1\% \times (1-18\%))$	(2 101)
Adjusted profit		15 418
Adjusted equity		117 257
Adjusted shareholder return		**13.15%**

Appendix 4: Synergistic Benefits and Costs

4.1 Synergistic Benefits

Value of the synergistic benefits per annum:

	US$ million
Revenue synergies (160 + 11 + 20 + 15 + 4)	210
Cost synergies (226.8 + 1 700.4 + 448 + 74.8)	2 450
Total	2 660

Net Present value of synergistic benefits:

	Y_0	Y_1	Y_2	Y_3	Y_4
	US$ mill	US$ mill	US$ mill	US$ mill	US$ mill
Total synergy		2 660	2 660	2 660	2 660
Cost of integration project	(290)	(290)	(290)	(290)	
	(290)	2 370	2 370	2 370	2 660
	CF_0	CF_1	CF_2	CF_3	CF_4
Discount rate = AB InBev WACC = 10%					
Net present value = US$7 420.66 million					

Quantification of cost to implement Revenue Synergies have not been considered.

	US$
SABMiller average market capitalisation for 2015 year (approximate)	99 billion
AB InBev offer price	105.5 billion
Premium offered to SABMiller shareholders	6.5 billion

4.2 Earned Value Analysis

In this report, the EVA model has been used to assess the integration projects resulting from the merger between AB InBev and SABMiller.

The calculation of key indicators is as follows:

Variable	Explanation	Formula
BCWS or Planned Value	Amount of work supposed to be complete	BAC × 50% (as the project is 50% complete by Oct 2018)
Schedule Variance (SV)	Schedule status of the project	BCWP – BCWS
Cost Variance (CV)	Cost status of the project	BCWP – ACWP

A positive CV indicates a project is under budget, while a negative CV indicates the project is overbudget.
A positive SV indicates a project is ahead of schedule, while a negative SV indicates a project is behind schedule.
The key indicators are thus calculated as follows:

	Strategic Initiative	BAC	BCWS	BCWP	ACWP	SV	CV
A	Procurement and engineering	80	40	2	50	-38	-48
B	Alignment of brewery, bottling and shipping productivity	120	60	15	100	-45	-85
C	Staff cost management	70	35	40	50	5	-10
D	HQ/Regional Office Costs	20	10	10	48	0	-38

Appendix 5: Calculation of Profit Margin for various retail outlets:

	Shoprite	**Pick 'n Pay**	**Makro**	**Direct Retailing**
	US$m	US$m	US$m	US$m
Revenue	580	240	1080	7000
Gross Profit	116	48	216	2170
Discounts	(17.4)	(4.8)	(86.4)	-
Sales Visits	(0.0822)	(0.10275)	(1.4933)	-
Purchase Orders	(0.8732)	(0.03848)	(1.1248)	-
Standard Deliveries	(2.34)	(7.155)	(13.545)	(1.125)
Rushed Deliveries	(0.45325)	(0.1295)	(10.2305)	(0.1295)
Damaged Goods	(12.18)	(4.8)	(36.72)	(70)
Profit	82.67	30.97427	66.4864	2098.7455
Profit Margin (%)	14.25	12.91	6.16	29.98