AB INBEV'S STRATEGIC REPORT

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Introduction

Alcoholic beverages are a part of celebrations and a sign of happiness. When enjoyed responsibly, they bring people closer together, creating a sense of joy. There is always time for celebration, resulting in breweries having multiple opportunities in the market. Anheuser-Busch InBev (AB InBev) is a global leading beer brewer, operating in 25 countries across six geographical zones.

Based in Leuven, Belgium, AB InBev had a primary listing on the Euronext Brussels Stock Exchange and a secondary listing on the New York Stock Exchange (NYSE). As for global beer market share, in terms of revenue (2015), AB InBev led with 20.8% market share. AB InBev ranked first in beer sales in several markets. AB InBev has had a large history of mergers and acquisitions, assisting with growth. Over the past 12 years, AB InBev have acquired over 100 breweries. AB InBev arose through consecutive mergers of three international brewing groups: Interbrew from Belgium, AmBev from Brazil and Anheuser-Busch from the USA.

Due to AB InBev's absence from the African market, the acquisition of SABMiller has been considered with a final offer of US$105.5 billion which SABMiller has accepted. SABMiller established itself as Castle Brewery in 1895 and listed on the Johannesburg Stock Exchange (JSE) two years later. After their relocation to London, UK, SABMiller received a primary listing on the London Stock Exchange (LSE) and a secondary listing on the JSE. By 2015, SABMiller operated in 62 countries worldwide across Africa (16 countries), Asia Pacific (seven, including Australia), Europe (25 countries), Latin America (11 countries) and North America (three countries). SABMiller produced more than 200 beer brands and was one of Coca-Cola's largest bottlers. SAB's growth strategy revolves around investing in a broad range of markets and not only breweries.

The benefits of the merger would not be immediate, given the significant financial outlay to acquire SABMiller. However, Newco could save costs through its combined distribution operations. This report will be analysing various issues and scenarios that AB InBev face.

Prioritisation of Issues (in order of importance):

1. **Africa Direct Entry via Nigeria**

We feel this scenario is of utmost importance to AB InBev. AB InBev currently do not have a presence in Africa, it is vital for their growth that they take necessary action to grow into this region. This is the failsafe in case the deal with SABMiller does not go through.

2. **Deal Funding Strategy and Group Financial Performance**

To the finance the deal, AB InBev would have to do it by way of debt or equity, as there were insufficient levels of cash. The impact of such a large cost on the cash levels and short term of AB InBev will need to be analysed. It is vital that AB InBev set clear financial objectives to overcome the initial impact of the deal.

3. **Integration, Synergies and Execution Risk**

SABMiller is the single biggest acquisition that AB InBev has ever undertaken, resulting in the revised planning horizon of 4 years, rather than 2 years. This is an important issue to be addressed. The benefits of the cost synergies achieved need to be analysed while taking the execution risk into consideration.

4. **B2B and Downstream Supply Chain Strategy in Southern Africa**

AB InBev must be wary of the ever-growing buyer power of supermarkets and wholesalers. The high level of buyer power, inaccurate sales forecast, and lack of adequate shelf space and high cost of servicing supermarket customers are all problems which need to be solved and analysed by AB InBev.

5. **Environmental Hazard in China**

AB InBev have experienced troubles regarding their project in China as there have been waste materials discarded in a nearby river, causing harm to the wildlife and polluting the water. This is of a lower priority in the regard that the other issues, need more urgent addressing, however as AB InBev already operate in China they should be able to come up with appropriate solutions that keep their product and brand environmentally friendly.

Africa Direct Entry Via Nigeria

AB InBev is looking at moving into Nigeria as the first step of a venture into Africa. The venture of AB InBev into Africa via Nigeria has the potential to be a ground-breaking move for the company into an extremely profitable market. For the Foreign Direct Investment (FDI) into Nigeria to be prosperous, every key problem must be identified, analysed and solved with clear strategic guidance.

Problems facing AB InBev in Nigeria:

- Establishing a strong foundation in Nigeria from which the brand can prosper
- Declining worth of the Nigerian market

The main problem facing AB InBev in the pursuit of a successful entry into Nigeria is a strong foundation from which the brand can become prosperous. Before AB InBev enters the Nigerian market, an initial groundwork worth $100M will be laid down to form the pillars of their marketing and competitive strategy to win market share from rivals. This will form the foundation of the brand before the actual selling of alcoholic drinks begin, if done incorrectly a weak groundwork could be the downfall of AB InBev's entry into the Nigerian market.

The secondary problem is the declining worth of the Nigerian market which can be seen in their decreasing worth of currency in comparison to the US (Appendix 7). The amount of profit AB InBev is making per batch is decreasing year-on-year as the market becomes less profitable for AB InBev.

Recommendations

For a strong foundation to be built between AB InBev and the Nigerian people, AB InBev will get involved in Corporate Social Responsibility (CSR) projects. These projects will benefit the people of Nigeria, creating a trusting relationship between the AB InBev brand and the people as well as reinforcing AB InBev's marketing focus of 'A better world'. By creating a positive reputation more consumers will buy their products, allowing AB InBev to reach their forecasted market share and potentially exceed it. Reallocating funds ($15 million) from digital marketing like YouTube, which many Nigerians do not have access to, and using it for a project like a feeding scheme for needy children not only creates a connection to the youth, who will one day use our product, but also the parents who feel indebted to the brand. Even the wealthy who will not directly feel the effect of the CSR programs will see the benefits for the country and will consciously or subconsciously develop a positive association with the brand. Market research will be a crucial part of this and AB InBev must use marketing tools like questionnaires, personal interviews and social media to know more about the target market. A SWOT analysis (Appendix 1) could also show the potential of the product before AB InBev even establishes a foundation to see the worth of doing so. Regarding the declining worth of the Nigerian market as shown in Appendix 7 Nigeria's market is becoming less profitable over the years to an overseas company like AB InBev, the recommended course of action is for AB InBev to increase their selling price for batches by 15% annually to keep profitable within the declining Nigerian market.

Deal Funding Strategy and Group Financial Performance

Management's objectives

1) Grow Dividends per share by 10% year on year
2) Deliver Total shareholders Returns of 14% year on year
3) Keep Gearing below 40%

To meet management's objectives, we would need to look at the way the deal structure will influence the achievement of the objectives.

Data for Assumptions

We are using the financials as presented at the respective year ends (AB InBev- Dec, SAB-March) this is in line with the public presentations used by the AB InBev board to present the transactions to shareholders. All reported numbers were in USD.

The funding of the acquisition.

The purchase price was agreed on at $105.5bn. AB InBev, we would need to structure the acquisition price in such a way that the group still meets its hurdles. Based on all of our calculations, we would recommend that the board issues shares to fund the transaction, this will meet all of the objectives, as shown in our calculations.

Issuing shares to fund the transaction

We are using the share price at "today" which we assume to be $111. To entice shareholders to buy shares, we believe that the shares should be issued at a discount to the trading price and have assumed a 5% discount. (This is in line with other companies that issue shares to fund a transaction, the discount will vary)

AB InBev needs $105.5bn to fund the transaction. We have netted off the cash available as at June 2015 which was $6.8bn. Also, we have netted off the cash in SAB which was $965m. Overall, the group would need $97.7bn using our suggested discount of 5%, which would mean an issue price of $105.5 per share.

Gearing

The board would like to keep the Gearing ratio at 40%. It is essential to strike a balance between how much interest needs to be paid if you fund the transaction through debt and what this does to other ratios. We look at three importantratios(Appendix 3).

Interest cover

An important consideration would be the ability of the company to pay the interest on new debt, i.e. the extent to which the operating profit covers the net interest cost. A reasonable ratio will vary across industries; a low ratio leaves little margin for error. We have assumed that the group will achieve the cost savings in our calculations.

If the transaction is funded entirely through shares, we estimated an interest cover of 11.7x including the savings. This is a very comfortable level and in line with the group's ratio before the transaction as shown in the Appendix 2.

If we assume shares of 20% and debt of 80 %, this will still allow for a gearing ratio below 40% as shown in the tables below. However, the interest cover will decline to 7.3x as shown above. We have used an interest charge of 6.10% on the debt portion and a tax rate of 20% in line with the group' s tax rate.

To meet the 40% gearing requirement, the best option would be to finance the entire transaction through the issue of shares. This would keep the gearing at 24%, as mentioned a blend of 20% debt /Equity would see a ratio of 35% but interest cover will decline.

The third ratio to consider would be to look at the net debt/equity which will be at a reasonable level of 31% if the group issues shares to pay for the transaction.

Dividend

AB InBev would like to grow the dividend per share by 10% year on year. Theoretically, a company would typically grow dividends in line with the earnings, so if earnings increase by 10%, then the dividend would increase by the same amount. However, in some instances, a company can opt to increase the dividend at a greater rate, or it may opt to pay a lesserdividend and keep the cash to expand. For this exercise, we would assume that management would like to deliver on its promise to grow the dividend by 10%. This could also compensate for any volatility in share price during the corporate action.

We note that AB InBev has a payout ratio of 1.7, this has varied over the years depending on the acquisitions.

Based on our calculations, including synergies, the new operating profit will increase by 16%. However, if the group opts to finance the entire acquisition through shares, this will result in a significant increase in the denominator, which will result in a lower dividend per share given the increased base.

Management can still increase last year's dividend, by increasing the payout ratio from 1.7 to 1.55, this will result in DPS growing by 10%. This will not strain cash flow as a significant portion of this is covered by the synergies. Also, the base business going forward should be able to grow earnings underlying profits which will further support the increased pay-out ratio.(Appendix 4).

Return on shareholder's funds: Target 14%

Two ratios can be used in this instance. If we look purely at the return based on the share price movement including dividends divided by the price in the previous period, the total return will be 4% using "today" ($111+DPS 3.68/$110) as the measure and 9% using the price that shareholders could apply for new shares ($105.50) on our suggested discount. However, share prices are very unpredictable and not something that management can control as even if the business is doing exceptionally well, external factors could result in a lower price which would mean that the ratio cannot be met.

We, therefore, believe the group should also take the Return on shareholders' funds ratio into account which is more internally focused and will look at the balance sheet structure and the way the transaction will impact the profits and returns. If we assume that the transactionis funded through shares and that the cost savings are realized, the return would be 16% in line with the strategy. (Income after interest and tax including savings 14.964/ Average shareholder's funds (93807)= 16%)

Integration, Synergies and Execution Risk

AB InBev wishes for the potential costs synergies of any acquisition of SAB Miller to be identified and quantified. Since this is the largest acquisition done by AB InBev, the planning horizon will be done over four years. Although since the deal was announced the anticipated reaction that AB InBev thought of the market as well as the world would have, has not happened. Some investors seem to feel that AB InBev overpaid for this deal and many others feel that the acquisition was too large and complex to realise the envisaged synergies. AB InBev has decided to envisage these synergies over 4 years which many feel is still too short a time.

Problems facing AB InBev in relating to Integration, Synergies and Execution Risk:

- Below expected market share price
- Higher than planned costs as well as unexpected time frames to integrate SAB Miller

The main problem facing AB InBev is the well below expected share price of the company after the deal was announced, instead of an expected 25% share increase the company's share price only rose by 1.8%. Following such a massive undertaking AB InBev would expect their share price to rise accommodating all their new assets but this share price not rising, due to investors not being confident in the deal, undervalues the deal AB InBev has done. With AB InBev having such a large share of the alcoholic beverages industry but a lower than expected share price, the risk could end up not being worth the reward for the company and board members.

Another problem facing AB InBev is the costs this integration project might take versus what was budgeted for. For the procurement and engineering: raw materials and packaging integration process the amount budgeted for was $80 Million but it is now expected to cost $2 Billion which is 2500% more than expected on top of that, midway through the project only 2.5% of the project will be complete opposed to the 50% that was scheduled.

Recommendations:

For the AB InBev board to increase their market share to what they expected they need to return investor confidence in the acquisition. This cannot be done quickly and the two key factors are a smooth integration and higher than anticipated profits for the company early on in the joint venture. If both of those happen, investors will feel that the company is undervalued which will lead to a share price increase. To make sure that the integration of the companies goes smoothly, AB InBev must allow more time to realise the envisaged synergies. Four years is not a long enough time for such an undertaking and a period of 8 years would be more appropriate and stop any rushed work as well as benefit AB InBev in the long term.

B2B and Downstream Supply Chain Strategy in Southern Africa

AB InBev faces various challenges regarding their supply chain strategy. The supermarkets and wholesalers are at the forefront of downstream supply chain developments, growing their technical expertise and buying power.

The problems facing AB InBev include:

- High level of buying power
- Inaccurate sales forecast
- Lack of adequate shelf space
- High cost of servicing some major supermarket customers in Africa

Recommendations

The acquisition of SABMiller will assist with bargaining power. Newco will reap the benefits from this tie up as the financial might and reputations of the two companies will help gain control over the wholesalers and supermarkets. As mentioned earlier, the cost of acquiring SABMiller is incomparable to previous acquisitions. This will need to be carefully considered by AB InBev. Ideally, the benefits from the acquisition should be greater than costs incurred. AB InBev should stop selling to the least profitable supermarkets as this is time consuming and will hinder their progress. If these supermarkets wish to sell Newco's products they should buy them through wholesalers. AB InBev should persuade supermarkets to reduce the number of cost generating activities. An alternative option for Newco would be to venture into direct retailing. This is where the acquisition of SABMiller would prove most beneficial as cost synergies will be achieved. Direct retailing is expected to generate larger sales revenue and profits than the top 3 supermarkets combined (Appendix 5 and 6). By venturing into direct retailing, Newco also eliminate costs such as making a sales visit or processing a purchase order. Issues such as lack of adequate shelf space are also eliminated. In this day and age, there is always the opportunity to keep up to date with the latest advancements in technology and use this to reduce the cost of cost generating activities.

Barriers to entry would be a liquor licence to sell directly to the public, which we believe the group would be able to achieve. In our view, given that they manufacture their own product this forward integration, gives Newco a competitive advantage as it owns the product, and will more likely sell more volume than other retail outlets, and will not be affected by new entrants as it owns the entire supply chain. Furthermore, Newco will not be vulnerable to buying power of suppliers, or the threat of substitutes as the combined brands are so strong and the group can opt not to sell rival brands in its stores.

The gross profit margin in direct retailing is higher at 31%, since all the costs are eliminated, the operating margin will be higher. This will yield a higher operating profit and should result in the estimated synergies of $2,450m being achieved.

Environmental Hazard in China

The opening of AB InBev's largest brewery facilities in the world in China has been halted due to protests regarding the manner at which the waste throughout the construction of this facility has been discarded. Because of this, the wildlife and some water sources have been affected. This environmental issue has attracted attention from the media as well as protestors who have delayed the opening of the facility. This is a matter of medium priority to AB InBev in comparison to its other issues as the facility has already been constructed and rehabilitation of the surrounding environment can be done after the facility has been opened.

Recommendations:

Seeing that the Chief Project Engineer of this facility, Li Wang, admits that some of the waste was not discarded in a suitable manner, it is in AB InBev's best interest to commit to rehabilitating the environment surrounding the facility. This will not only prove that AB InBev is accountable for its inexcusable actions but is also environmentally conscious considering the environmental issues China is facing. Environmental rehabilitation can include the expansion of AB InBev's watershed restoration and conservation initiatives in China. By doing so, AB InBev will be making up for the water pollution it caused during the construction of the Putian Brewery. This will require less funding than a totally new concept or initiative as AB InBev has already implemented their "Cleaner World" initiative in China.

Environmental rehabilitation, however, may not please the media and protestors as it may seem like a way for AB InBev to protect its reputation rather than the desired delay of the opening of the facility. AB InBev must ensure that the benefitting communities of its water conservation initiatives are experiencing a positive change in the availability of clean water.

Ethical Issues

Integration, Synergies and Execution Risk

The acquisition of SABMiller by AB InBev is an opportunity for AB InBev to minimise costs by consolidating the business functions of both AB InBev and SABMiller which may result in the reduction of the total staff positions of the combined entities. Managers will therefore sit with the uncomfortable decision of firing employees.

B2B and Downstream Supply Chain Strategy in Southern Africa

Through the reduction of cost generating activities and reverting to selling products directly to the public, AB InBev faces the ethical issue of making alcohol more accessible to the underage population. Countries in Southern Africa, especially South Africa, are plagued with the problem of underage drinking and the negative effects thereof. AB InBev will be faced with the decision of making alcohol readily available to this population and as a result fuelling this problem, causing there to be questions about AB InBev's ethicality.

Environmental Hazard in China

The environmental hazard created by AB InBev in China through the construction of its Putian Brewery is a major ethical issue that AB InBev is faced with. All efforts made by AB InBev to rectify this situation may be questioned as being reactionary rather than environmentally conscious as AB InBev did indeed cause the problem. The question of whether it is ethical or not for AB InBev implement rehabilitation initiatives as opposed to answering as to why the hazard was created in the first place, may be the basis of the public's view of AB InBev's ethicality.

Appendices

Appendix 1: SWOT ANALYSIS OF AB InBev

Strengths

1. AB InBev has efficient production lines at its manufacturing facilities worldwide
2. The company offers quality products (beverages) which gives it the ability to maintain a good reputation
3. AB InBev has extensive business knowledge and experience since is a company merged from multiple breweries.
4. AB InBev has many skilled employees to drive the business forward.
5. The company has a great number of shareholders which can serve as a support for the company
6. AB InBev produces 4 of the world's top ten selling beers, creating a powerful revenue for the company

Weaknesses

1. AB InBev is challenged with the managing and the distribution of beverages to the many regions it supplies as well as meeting the demand in the market
2. AB InBev puts its financial house at risk through the issuance of $55 million worth of bonds to finance the merger with SABMiller.
3. Due to the fact that AB InBev is a global entity there may be conflict between management and unions which could be a concern.
4. The company relies mainly on wholesalers and they run the risk of not selling enough products.

Opportunities

1. The rise in online purchasing of consumers could be an opportunity for AB InBev to create a platform for online sales.
2. The recent growth in craft beer is an opportunity for AB InBev to expand their craft beer range.
3. Through the acquisition of SABMiller, AB InBev can expand into the non-alcoholic beverage market as SAB Miller has a 57% shareholding of Coca Cola Beverages Africa.
4. AB InBev can do some extensive marketing during the Rio Summer Olympics of 2016 to increase revenue.

<u>Threats</u>

1. Many governments view alcohol consumption as a major moral issue which can threaten the sales and entry of AB InBev into new countries.
2. Legal issues that involve underage issues may affect AB InBev's strong reputation
3. The global alcohol consumption is slightly declining and could impact AB InBev's sales.
4. The rise in health awareness could affect AB InBev's sales as consumers change from alcoholic to non-alcoholic beverages.
5. The increase in sin-tax could force many consumers to stop purchasing alcoholic beverages which will negatively affect AB InBev's sales.

Appendix 2: Interest Cover

Interest cover					
net interest divided by operating profit					
Before funding	**AB INBEV**	**SAB**	**NEWCO**	Include savings of $2450 after tax	3063
net interest	-1319	-637	-1956		
operating profit	15308	4459.2	19767.2	Operating profit after savings	22830
Interest cover	**11.6**	**7.0**	**10.1**	Interest cover including savings	**11.7**

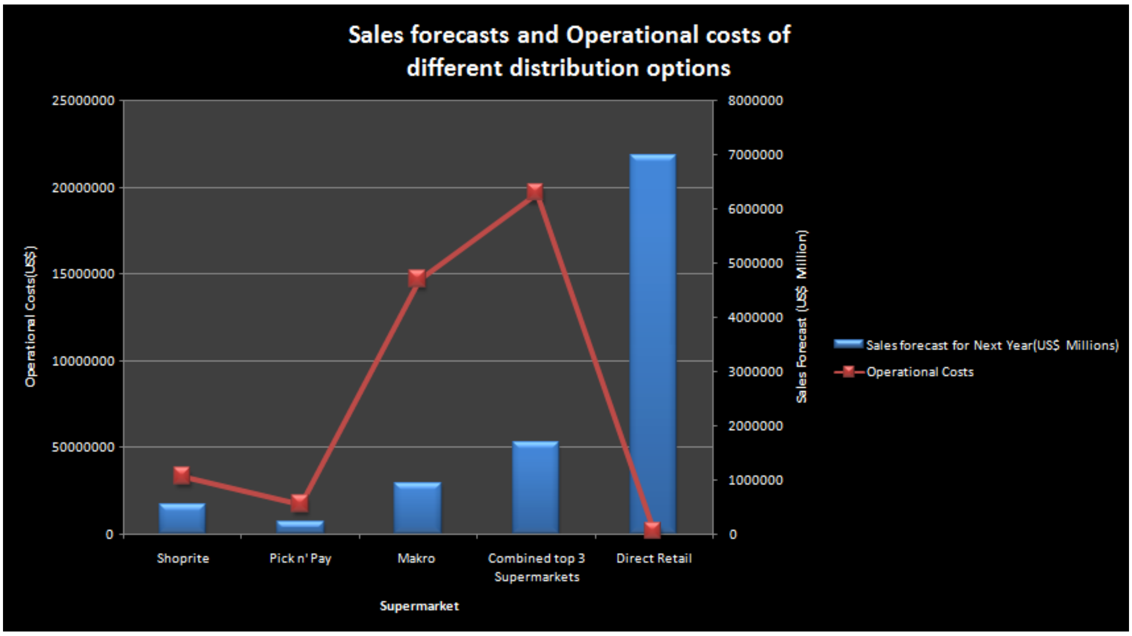
Appendix 3: Gearing

Assume 100% shares issued	**AB INBEV**	**SAB**	**NEWCO**	**Assume 80%**	**AB INBEV**	**SAB**	**new debt**	**new equity**	**NEWCO**
Gearing									
net debt/total equity-net debt	42724	11579	54303		42724	11579	19547		73850
Equity			230852	Equity	99785	33332		78188	211305
ratio			**24%**	**ratio**					**35%**

Appendix 4: Dividend

	Before Transaction ABINBEV	**SAB**	**Newco**	**savings**	**Newco Including savings**	**% Earnings Uplift**
Earnings	**9215**	**3298.242**	**12513.24**	**2450**	**14963.24**	
Less minorities				2058	**14571.24**	**16%**
dividends						
shares in issue						
Shares in issue before transaction	1665					
Issue for acquisition	**927**					
new shares after acquisition	**2592**					
Earnings per share before acquisition	**5.54**					
Earnings on new shares					**5.62**	**2%**
						Dividend Uplift
Dividend per share	3.25				**3.31**	2%
Dividend cover	1.70				**1.70**	
Pay-out ratio	0.59				0.59	
change cover	0				**1.57**	
new dividend per share					**3.58**	**10.2%**
Dividend $ at 1.55 cover	5411.25				**9281.0**	
Dividend $ at 1.7 cover					**8571.3**	

Appendix 5: Graph Showing Sales Forecasts and Operational costs of different distribution options



Appendix 6: Revenue and profits of supermarkets vs direct retail

	Shoprite	Pick n' Pay	Makro	Direct Retail
Sales Revenue (Before discounts and returns)(US$ Million)	580	240	1,080	7000
Damaged products returned(% of Sales revenue)	2.1	2	3.4	0
Revenue after damaged products taken into consideration	567 820 000	235 200 000	1 043 280 000	7 000 000 000
Average Discount given (%)	3	2	8	0
Revenue after average discount (%) taken into consideration	550 785 400	230 496 000	959 817 600	7 000 000 000
Number of Sales Visits	120	150	2180	0
Revenue after sales visit taken into consideration	550 676 200	230 393 250	958 324 300	7 000 000 000
Number of purchase orders processed	5900	260	7600	0
Revenue after purchase orders taken into consideration	549 803 000	230 354 770	957 199 500	7 000 000 000
Number of standard delivieries made	1040	3180	6020	500
Revenue after standard deliveries taken into consideration	547 463 000	223 199 770	943 654 500	6 998 875 000
Number of 'rush' deliveries made	70	20	1580	20
Revenue after rush deliveries taken into consideration	547 009 750	223 070 270	933 424 000	6 998 745 500
Final Profit	547 009 750	223 070 270	933 424 000	6 998 745 500

Appendix 7: Predicted profits of AB InBev in Nigeria

Year	1	2	3	4	5
Cost of producing and selling each batch(NGN)(Increasing 10% per annum)	35,600	39,160	43,076	47,384	52,122
Selling price per batch(NGN)(Increasing 5% per nnum)	288,503	302,928.15	318,074.56	333,978.29	350,677.20
Exchange Rate (NGN/US$)	NGN395/US$	NGN445/US$	NGN502/US$	NGN566/US$	NGN638/US$
Cost of producing and selling each batch(US$)	101.71	88	85.81	83.72	81.7
Selling price per batch(US$)	730.39	680.74	633.61	590.07	549.65
Batches produced/sold	1,000,000	1,500,000	3,000,000	2,600,000	1,500,000
Profit(US$)(per batch)	628.68	592.74	547.8	506.35	467.95
Profit(US$)	628,680,000	889,110,000	1,643,400,000	1,316,510,000	701,925,000