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Deep Dive Series

Constellation Brands, Inc.

“So a quality business walks into a bar…”

TITAN

Deep Dive Series

TICKER: STZ

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“So a quality business walks into a bar…”

Meet Constellation Brands, Inc.

Whether you prefer beer, wine or spirits, chances are you've consumed a beverage from the Constellation Brands (“STZ”) portfolio. From Corona Extra and Modelo Especial beer to SVEDKA vodka and Mondavi wines, Constellation's portfolio of 80+ premium consumer brands has immense reach and consumption.

Paradigm

When you find a business that buys commodities and consistently turns them into enduring brands on a massive scale, you've found a gem of a long-term investment.

Buffett: “Buy commodities, sell brands has long been a formula for business success. When we bought See's Candies, we didn't know the power of a good brand. Over time we just discovered that we could raise prices 10% a year and no one cared. Learning that changed Berkshire.”

OPERATIONAL FACTS

Industry	Alcoholic beverages
HQ	New York
CEO	Robert Sands (11 yr)

Core products

Beer, wine, spirits including Corona, Modelo, SVEDKA

How this co. makes money

Selling its products primarily to wholesalers nationwide

VALUATION

Price	$233.02
Market Cap	$45 billion
’19E P/E	21.5x
’17A ROIC (Tangible)	25%

As of 6/15/18. '19E and '17A refer to calendar year

Elevator Summary

Constellation Brands is a high-quality compounder, with distribution advantages and brand value that are hard to replicate. As the #1 multi-category supplier of alcoholic beverages in the U.S., Constellation has built an enduring portfolio of beverage brands with wide-reaching scale that we believe will provide a long runway for revenue growth.

Constellation also has impressive pricing power. Its push toward premiumization, or bringing more high-end brands into the beverage portfolio, is driving higher prices and market share. We believe pricing power with a low fixed cost base will drive terrific unit economics for the company.

When you put it all together, our research indicates that STZ will continue to acquire strong beverage brands, expand its distribution and margins, and generate positive shareholder value. Led by a family-run operating team with the right incentives, STZ deserves to be a staple in the Titan portfolio.

“Buy commodities, sell brands has long been a formula for business success. When we bought See's Candies, we didn't know the power of a good brand."

WARREN BUFFETT

What does Constellation Brands do?

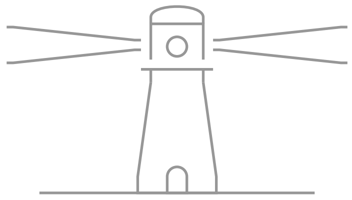
Constellation Brands is the largest multi-category beverage alcohol supplier in the U.S. with leading market shares in the beer, wine and spirits markets.

The company was actually founded as a wine business and grew through acquisitions to reach #2 share in the U.S. wine market by revenue. Then, in June 2013, STZ entered the beer business at scale when it acquired the U.S. business of Mexico's Groupo Modelo. As part of the deal STZ acquired a state-of-the-art brewery in Mexico and the exclusive rights to manufacture and market Modelo's brands, including Corona Extra and Modelo Especial, to the U.S. market.

Today STZ is the #3 player in the U.S. beer market by unit volume (behind Anheuser-Busch and Molson Coors) and the #1 beer importer, representing half of all imports into the U.S. The company also has leading market shares in the wine and spirits markets.

The beer business consists of mostly their Mexican beer portfolio and craft beers. This segment is the most critical to our thesis (versus the wine & spirits segments in which STZ has fewer competitive advantages and levers for growth, in our view). Hence, STZ's beer business will be the focus of our deep dive.

Source: Constellation Brands CAGNY Conference Investor Presentation, 2/21/2018.



BUSINESS CASE

STZ's beer business, driven primarily by its Modelo and Corona brands, is a crown jewel asset. It has a number of competitive advantages that we believe create a wide moat and make STZ a high-quality long-term investment.

1. Scaled distribution and manufacturing networks
2. Brand value across a deep product portfolio
3. Industry tailwinds and economic resilience
4. Pricing power from premiumization strategy
5. Robust and improving unit economics
6. Family-operated business with the right incentives

Advantage #1: Scaled distribution and manufacturing networks

The beer industry is highly concentrated, with the top 11 brewers in the U.S. making up over 90% of all U.S. beer volume. This means only a handful of brewers control almost all of the distribution (e.g. shelf space).

Distribution is very sticky in the beverage industry due to the complexity of delivery & inventory logistics which can create headaches for local wholesalers if changed. Wholesalers tend to focus on finding brands that sell well and then promote those brands' products to continue to fuel their own growth.

Consumers also tend to establish local preferences, making it less ideal for regional wholesalers to change or cancel their distribution contracts with suppliers and risk losing those customers. This stickiness creates a high barrier to entry for new entrants, benefitting the scaled incumbents like Constellation.

With such wide scale, Constellation can expand its sales of new beer brands that it acquires by simply placing them in the same distribution channels as its existing brands. This is another benefit for STZ versus its smaller peers who have to try to win new distribution contracts for every new brand they develop.

Lastly, STZ's manufacturing and logistics network also has major cost advantages. By in-housing its glass bottling operations at its own facilities and shifting to cheaper forms of glass & aluminum over time, the company is reducing its manufacturing costs and improving its delivery times to customers, driving higher gross profit margins.

Advantage #2: Brand value across a deep product portfolio

Brands are incredibly important in the alcoholic beverage industry. Like toothpaste and chewing gum, beer occupies a person's "share of mouth." This precious real estate is highly personal and, as a result, taste and perception tend to matter much more than, say, price.

Colgate and Wrigley's are great examples of companies with brand moats. Most consumers don't opt for the cheaper, generic drug store alternative when it comes to their taste buds. Constellation's beer brands have a similarly strong affinity with its core customer demographic.

Not every beer brand has enduring brand value: it is expensive and time-consuming to build such brands, and most companies cannot pull it off.

Over the past few decades, Constellation has invested billions of dollars into marketing and distribution to gain a pathway to consumer's mouths. The company won exclusive import agreements with the suppliers of its most popular Mexican beers, Corona and Modelo. It also spent hefty sums acquiring other beer brands to complement those flagship products.

By combining marketing firepower and thoughtful distribution tactics, STZ has turned great-tasting beers into world-class brands. This brand value is what has allowed the company to maintain a consistent share of mouth amongst consumers for years, and we don't anticipate that changing any time soon.

Advantage #3: Industry tailwinds and economic resilience

From a secular growth perspective, the alcoholic beverage industry is extremely attractive. It consistently grows dollar sales at above-GDP rates even through difficult recessions, due to the resilient nature of alcoholic beverage consumption.

For Constellation, beer is most critical to its organic growth. The beer industry has seen a huge increase in demand for Mexican beers in the U.S. from 2009-present. Since the end of the last recession, Mexican beers have grown volumes by 4–5% per year, compared to domestic beers declining by 4% per year.

These market share gains by Mexican and other imported beers are being driving by a shift in consumer preferences to more craft-like beers, versus traditional domestic light beers. These craft-like beers offer more nuanced tastes and rebellious brand images that resonate better with the growing generation of millennial drinkers. We think this is a major tailwind for Constellation because its beer portfolio is primarily Mexican and imported beers.

Contrast this with its competitors Anheuser-Busch and Molson Coors. These peers have historically built their scale via the success of traditional beer brands like Coors Light, Bud Light, Busch Light, and Budweiser. However, times are changing, as the domestic light beer category loses share to Mexican light beers that Constellation owns, such as Modelo Especial, Corona Extra, and Pacifico. We think this trend will continue to benefit STZ.

Advantage #4: Pricing power from premiumization strategy

Consumers are looking for premium alcohol products to meet their shifting taste preferences. Over the past five years, the wine industry has seen sales of $11+ wines grow at 13% annually, compared to <$11 wines growing only 2%. A similar shift is happening in the beer & spirits markets.

Constellation is adapting to consumers' tastes and preferences by offering premium wine and spirits to consumers like millennials who wish to break away from mainstream products. For example, the company is working on acquiring wines that sell from $225–250.

Launching new premium products with higher prices increases the average selling price for STZ's product portfolio. This "premiumization" strategy reinforces the company's pricing power and creates pure incremental profits (because it brings in more revenue without any additional costs). The result is higher margins and earnings per share. The growing consumer demand for higher-end alcoholic beverages doesn't appear to be going away anytime soon. Thus, we're confident this premiumization strategy will be a key sales and margin driver for STZ for the foreseeable future.

Advantage #5: Robust and improving unit economics

Given its brand value and distribution efficiencies, it's no wonder that Constellation's EBITDA margins are high, around 33%. These are higher than some of the most time-tested, globally-scaled consumer brands such as Coca-Cola (31%). To understand how well STZ converts its EBITDA (earnings before interest, taxes, depreciation & amortization) to free cash flow, we need to understand its capital spending (commonly known as "capex").

The business's capital intensity has been elevated over the past few years, with an average of ~13% of sales spent on capex. However, most of this spending has gone towards growth initiatives such as expanding its owned glass supply for its beer bottles, simplifying its packaging operations, and enhancing its logistics network. These growth spending initiatives are all temporary from a spending perspective, but should benefit long-term margins and free cash flow conversion.

So while STZ's free cash flow conversion (FCF) from net earnings has optically been only ~45% over the past three years, when we look under the hood, we see the quality of earnings being artificially weighed down by growth investments in the near term. As growth investments are completed over the next few years, its FCF conversion should improve materially, driving cash earnings and hopefully the stock's price-to-FCF multiple higher as well.

Finally, as a sanity check, note that STZ's returns on tangible invested capital are around 25%. These are tremendous economic returns for a consumer beverage business.

Advantage #6: Family-operated business with the right incentives

Constellation has been operated by the Sands family since the mid 20th century. In 1945, Marvin Sands founded the company (then called “Canandaigua Industries”) by selling bulk wine to bottlers in the eastern U.S. The company went public in 1973, and Marvin’s son Richard took over as CEO in 1996.

In 2000, the company changed its name to Constellation Brands to reflect the wide ranging scope of its beverage brands. In 2007, Marvin Sands handed the reins over to his brother Rob (current CEO) and became Chairman instead.

The Sands family has had a terrific history of shrewd operating experience and smart acquisitions at Constellation. They also have a significant ownership stake in the business (both Rob and Richard own ~3%), reflecting the alignment between their incentives and shareholders’.

With a strong history of execution plus alignment of incentives, we’re confident that senior management at STZ will continue to create value for shareholders.

WHAT ARE THE RISKS?

Shift in consumer preferences

Like any consumer business, alcoholic beverages are subject to shifts in consumer tastes. The generational shift from baby boomers to millennials has brought in a new wave of drinkers with a greater affinity for imported and craft beers than the traditional domestic light beers that their parents grew up on, which has benefitted STZ to date.

Growth assumptions for the next few years are heavily tied to STZ realizing consumer trends in its Mexican beer segment. However, if consumer preferences shift to some other type of beverage that Constellation isn't well positioned to produce, it would be negative for STZ's sales and earnings.

Competitive dynamics in beer industry

There has been a competitive response to STZ taking market share in beer. Many of the large, mature beer brewers like Heineken, Molson Coors and Anheuser-Busch have slashed prices on their beer brands in order to maintain market share amidst the consumer taste shift from domestic light beers to imported beers. Cutting prices is bad for profit margins (because a bottle of beer generates fewer dollars of sales but still requires the same amount of fixed costs to produce).

If STZ's competitors continue to cut prices in a desperate attempt to maintain market share, domestic light beer prices may fall low enough to entice consumers to choose the Bud Lights and Coors Lights of the world over Corona and Modelo (even if they prefer to drink the Mexican imports).

Fortunately, the trend towards premiumization of beers seems like a consistent one amongst the millennial generation, which we believe should more than offset most pricing headwinds from competitors.

Return on marketing investments

In any business where brand value creates a wide moat, there is existential risk that the brand loses its luster with consumers at some point. STZ spends significant money on marketing investments in order to promote new brands and maintain "share of mouth" for existing brands.

To date, these investments have paid off handsomely, but there is a risk that new marketing campaigns may not materialize as profitably. Hence it's important to keep an eye on which beers & other beverages consumers are drinking most frequently at your next barbecue.

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