

BSVI – CONSTELLATION BRANDS

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COMPANY OVERVIEW

Constellation Brands, Inc. is a prominent beverage alcohol company with a diverse portfolio of beer, wine, and spirits. Established in 1945, it has grown into a global enterprise with operations in various regions, including North America, Europe, and Asia.

Constellation Brands operates within three key business divisions:

Beer Division: Focused on brewing and marketing a wide range of beer brands, including iconic names such as Corona, Modelo Especial, and Pacifico. This division has a strong presence in the global beer market, targeting diverse consumer preferences.

Wine and Spirits Division: Engaged in the production and marketing of high-quality wines and spirits. The portfolio includes renowned brands like Robert Mondavi, Meiomi, and Svedka Vodka. This division caters to the growing demand for premium and craft beverages.

Canopy Growth Corporation: Constellation Brands has a strategic investment in Canopy Growth, a leading cannabis company. This reflects Constellation's forward-looking approach to emerging markets and consumer trends.

In addition to its core business divisions, Constellation Brands is committed to corporate responsibility and sustainability. The company actively engages in initiatives related to environmental conservation, social responsibility, and community development.

The international presence of Constellation Brands extends to multiple countries, contributing to its status

as a global leader in the beverage alcohol industry. As consumer preferences evolve, Constellation Brands continues to innovate and adapt, ensuring a strong position in the dynamic and competitive market. The market was severely impacted by COVID-19, which forced stores to suspend operations or shorten operating hours during states of emergency.

GAMING MACHINES MARKET: Japan's gaming machine market shrank for the seventh consecutive year to 564 billion yen (down 16.1% from the previous year). This was due to diminishing investment appetite for gaming machines at halls and performance of machines with gambling restraints. Next fiscal year (ending March 2022), we expect some demand for new machines replacing older types but believe the situation will remain harsh.

ESPORTS MARKET: In 2021, we expect the market to grow to 1.08 billion U.S. dollars (up 14.5% from the previous year) owing to increased sponsorship and media rights fees, primarily in China. The future remains unclear due to the prolonged COVID-19 pandemic, but the growth of live broadcasts has resulted in an increase of viewers.

FIVE FORCES ANALYSIS

Customer Power: Medium

The power of customers in the alcoholic beverage industry, in which Constellation Brands operates, can be considered medium. Customers have the ability to choose from a wide variety of alcoholic beverages, and their preferences are influenced by factors such as taste, brand, and marketing. The quality and appeal of Constellation Brands' products play a significant role in customer decision-making. However, customer loyalty can also be influenced by brand reputation and product consistency, which may reduce their willingness to switch to alternative brands.

2. Supplier Power: Medium-Low

The supplier power in the alcoholic beverage industry is generally medium to low. While there may be limited external suppliers for certain raw materials and technologies used in beverage production, Constellation Brands has the flexibility to source materials from various suppliers. The primary ingredients for alcoholic beverages, such as grapes for

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wine or grains for beer, are commodities that can be obtained from multiple sources. However, there may be some dependency on suppliers for specialized items like specific types of barrels, packaging materials, and equipment. The supplier power may also be influenced by the economic context, as changes in the economy can affect the cost and availability of resources.

3. Threat of New Entrants: Medium-Low

The threat of new entrants to the alcoholic beverage industry is relatively low. Entry barriers are high due to the substantial capital investment required for establishing production facilities, distribution networks, and compliance with industry regulations. Additionally, building a brand and gaining consumer trust in a highly competitive market can be challenging. Constellation Brands has a strong presence in the industry, which requires significant resources, expertise, and time to replicate. The industry also has regulatory requirements related to licensing, labeling, and safety, which further deter new entrants.

4. Threat of Substitution: Low

The threat of substitution in the alcoholic beverage industry can be considered medium. While there are no direct substitutes for alcoholic beverages, consumers may choose alternative beverages or non-alcoholic options based on their preferences and occasions. The level of threat may vary based on consumer preferences and trends.

Competitive Rivalry: High

The competitive rivalry in the alcoholic beverage industry is high. There are numerous brands and companies competing for consumer spending, and consumers often have a wide range of options to choose from. Brand loyalty is not as strong in this industry as it is in some other consumer goods sectors. Therefore, companies like Constellation Brands must continually innovate, market effectively, and produce high-quality products to stay competitive. The availability of a variety of alcoholic beverage options, from wine and beer to spirits, contributes to intense competition. Additionally, changing consumer preferences and trends can create a dynamic and competitive landscape.

BUSINESS ANALYSIS

Business Definition: Constellation Brands is a company that delivers value to its customers through the production and distribution of alcoholic beverages, including wine, beer, and spirits. It generates most of its value from the creation and sale of a wide range of

alcoholic beverage brands, both in physical form and through digital channels. The company targets consumers who are of legal drinking age and have an interest in a variety of alcoholic beverage options. While the primary geographic focus is North America, Constellation Brands also has a presence in other parts of the world, including Europe and the Asia-Pacific region.

Consumer Segment: The average consumer of Constellation Brands' products is typically of legal drinking age, which varies by country. The gender distribution among consumers varies by product and region, with certain products and regions showing a more balanced gender distribution. Consumers' income levels can vary, as Constellation Brands offers a wide range of products at different price points to cater to a diverse consumer base.

Profit Logic: Constellation Brands generates the majority of its revenues from the sale of alcoholic beverages (wine, beer, and spirits). The company also engages in activities related to the production and distribution of these products. It may operate its own production facilities, import, and distribute alcoholic beverages, and engage in marketing and brand promotion. The primary costs are related to production, marketing, distribution, and the workforce. The company may also benefit from economies of scale and technological innovation in production and distribution processes.

Value Proposition: Constellation Brands not only offers a broad selection of alcoholic beverages but also provides consumers with a premium experience. The company's value proposition includes producing high-quality and diverse alcoholic beverage products, building strong brand recognition, and offering unique and enjoyable experiences for its customers.

ACTIVITY SYSTEM:

Content Production: The primary activity of Constellation Brands is the production of alcoholic beverage products, which includes wine, beer, and spirits. These products are available in various brands and variants to cater to different consumer preferences.

Distribution and Marketing: Constellation Brands engages in the distribution and marketing of its alcoholic beverages to reach consumers through retail outlets, restaurants, bars, and online sales channels.

Production of Amusement Equipment: While not a core business activity, Constellation Brands may

engage in promotional activities and merchandise production related to its beverage brands. This could include items like branded glassware, apparel, or promotional events.

Other Businesses: Constellation Brands may diversify its offerings by creating events, such as wine tastings or beer festivals, or venturing into entertainment, like producing movies related to the alcoholic beverage industry.

STRUCTURE: The primary and secondary activities of Constellation Brands are interconnected and share some structural synergies:

Content Production and Distribution: The core activities of producing alcoholic beverages and distributing them are closely related. The company leverages its production facilities, supply chain, and distribution networks to ensure that its products reach consumers effectively. The scale of production and distribution operations can create cost efficiencies and competitive advantages.

Brand Development: Constellation Brands focuses on building and nurturing its various beverage brands. This involves not only creating the products but also marketing and promoting them to establish brand recognition. The synergy between brand development and content production is evident, as the success of one activity directly impacts the other.

Marketing and Promotion: The company's promotional activities, such as events, merchandise, and entertainment, align with its core content production. These efforts are aimed at enhancing brand image and customer engagement.

Customer Loyalty: Constellation Brands aims to cultivate customer loyalty by offering a range of products and experiences related to its alcoholic beverages. This synergy strengthens the connection between consumers and the brand, fostering repeat business.

GOVERNANCE AND RISKS: Constellation Brands' governance and risk management strategies are crucial in a highly competitive and dynamic industry:

Customer-Centric Approach: The company's focus on customer satisfaction is essential in retaining a loyal consumer base. Failing to meet customer expectations could lead to a loss of market share, as consumers have a variety of options within the alcoholic beverage industry.

Regulatory Compliance: Given the industry's heavy regulation, adherence to local and international laws is

vital. Any non-compliance could result in legal and financial repercussions that may harm the business's reputation and operations.

Market Flexibility: The alcoholic beverage market can be influenced by changing consumer preferences, economic conditions, and health-related trends. Constellation Brands must stay agile and responsive to these market dynamics to remain competitive.

Competition: The company operates in a highly competitive environment with numerous rivals. Maintaining a strong market position requires continuous innovation, marketing efforts, and customer engagement to stand out in the crowded marketplace.

Synergies and Diversification: Constellation Brands can capitalize on the synergies between its primary and secondary activities to mitigate risks and explore new revenue streams. Diversification into related businesses, such as events and entertainment, can offer additional opportunities while managing risk.

achievements and developments throughout the entire business but then, what is made on the other activities is entirely related to the main product: the video game.

COMPETITIVE ANALYSIS

Novelty: Constellation Brands operates in the alcoholic beverage industry, which is generally characterized by traditional products and production methods. While there may not be significant "new" activities in terms of product innovation, the company can still find ways to differentiate itself in the market. This can be achieved through:

Product Variety: Introducing new and innovative variations of existing alcoholic beverage products or launching entirely new product lines can capture consumer interest and differentiate the brand.

Marketing and Branding: Utilizing novel marketing strategies, storytelling, and branding initiatives to create unique and memorable experiences around their products.

Lock-In: Constellation Brands can retain customers through the following means:

Brand Loyalty: By maintaining high-quality standards and ensuring consistent product quality across their portfolio.

Consumer Engagement, through events, tastings, and immersive experiences to foster a sense of connection and loyalty to the brand.

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Promotions and Loyalty Programs: Implementing customer loyalty programs and promotions can incentivize repeat purchases and customer retention.

Complementarities: Constellation Brands can create more value by embracing complementarities, particularly in the context of Environmental, Social, and Governance (ESG) initiatives. This includes:

Sustainability: Investing in sustainable practices in the production, packaging, and distribution of alcoholic beverages can align with environmental and social responsibility goals, which can appeal to conscious consumers and regulatory requirements.

Corporate Responsibility: Participating in social initiatives, philanthropy, and community engagement to build a positive brand image and generate goodwill.

Intellectual Property: Protecting and leveraging intellectual property, such as unique product names, branding, and labels, can add value and recognition to their products.

PEST ANALYSIS

Political Factors:

Government Resource Allocation and Time Scale: the alcoholic beverage industry is subject to government regulations and policies related to the production, distribution, and sale of alcohol, and so is the company. For example, the introduction of more stringent regulations or changes in licensing requirements can affect the company's operations.

Taxation Policies: Taxation policies can have a significant impact on Constellation Brands. High taxes on alcoholic beverages can increase the cost of production and potentially reduce consumer demand. Tax policies that promote responsible drinking may be beneficial to the company, while increases in alcohol taxes could reduce profitability.

Economic Factors:

Inflation Rate: Inflation can affect the company's cost structure, including the price of raw materials, packaging, and transportation, therefore eroding profit margins.

Exchange Rate: As a global company, Constellation Brands may be exposed to fluctuations in exchange rates, particularly if it imports or exports alcoholic beverages.

Economic Cycles: The performance of Constellation Brands is closely tied to economic cycles. During economic downturns, consumers may cut back on discretionary spending, including alcohol consumption. Economic growth can boost consumer confidence and increase demand for premium alcoholic beverages.

Social Factors:

Education Level: The education level in the regions where Constellation Brands operates can influence consumer preferences and consumption patterns. High education levels may lead to a more discerning consumer base, potentially favoring premium and craft beverages.

Technology Factors:

Intellectual Property Rights and Patents Protection: Strong safeguards for intellectual property rights and patents can be advantageous for Constellation Brands, especially in areas such as branding, packaging, and unique production methods. These protections can encourage the company to invest in research and development.

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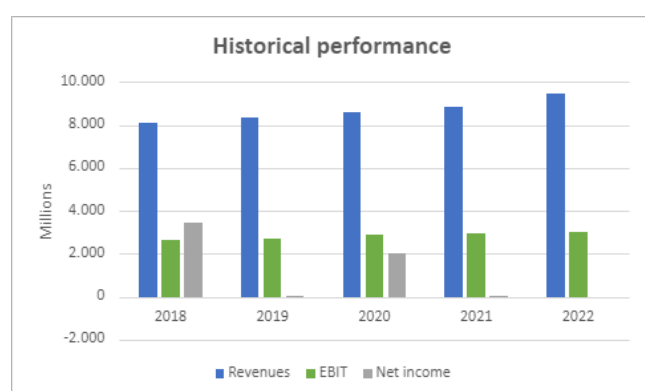
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GROWTH PATH

Income statement: In the last 4 years, Constellation Brands has experienced a compound growth rate of around 3.8% in revenue as well as operating profit (EBIT), although growth accelerated to 7.2% in the last fiscal year (2022). However, growth has been very uneven across its business segments. While the beer business segment has seen annual revenue growth of close to 10%, the wine and spirits business segment has seen an annual decline of close to that figure. The operating margin remained at around 32% throughout the period. Net profit, on the other hand, has been erratic, mainly due to reported losses on unconsolidated investments. Specifically, these losses derive from its shareholding and creditor participation in the Canopy subsidiary, a company dedicated to the sale of cannabis.



Balance sheet: Regarding the company's core operating assets, the most notable variation in recent years is seen in PP&E, due to a higher CAPEX investment than historically. In addition, the capital productivity of working capital has improved slightly, as the collection period to customers and days of inventory have decreased and the payment period to suppliers has been

extended. Non-core assets have decreased significantly due to impairments in equity method investments and securities measured at fair value, which are related to the subsidiary Canopy. On the liabilities side of the balance sheet there have been no changes of particular note, only a notable increase in short-term borrowings in the last financial year to 12% of total revenues.

RATIO ANALYSIS

Profitability ratios: Constellation Brands' operating profitability remained strong during the analyzed period, as its stably increasing revenues corresponded to a similarly increasing gross profit, EBITDA, and operating profit, reflected in its mostly unchanging ratios that surpass those of the competitors. Although not improving these in the past years, the company maintained its profitability in its core operations.

Constellation Brands' return on assets suffered, however, due to unprofitable unconsolidated investments that made its net income volatile and even negative in 2022. The impact of unsuccessful investments was further amplified in its return on equity. These two ratios lagged behind competitors' whose performance was not hindered by similar unprofitable investments and produced mostly positive returns on both assets and equity.

	PROFITABILITY RATIOS				
	2018	2019	2020	2021	2022
Gross profit margin	51%	52%	52%	52%	51%
EBITDA margin	36%	37%	37%	37%	36%
Operating profit margin	30%	26%	32%	26%	30%
Return on Assets	15%	0.1%	8%	0.004%	-0.2%
Return on Equity	33%	0.2%	15%	0.01%	-0.4%
Return on Invested Capital	10%	11%	11%	11%	11%

Efficiency ratios: Total asset turnover increased over time, fueled by a steady increase in revenues and a steady decrease in total assets, mostly attributable to decreasing non-core investments. The same increasing trend is observed in its fixed asset turnover due to the increasing revenues, suggesting an improvement in the company's ability to use its assets efficiently, however, it remained below the average of its competitors. This improving trend also appears in the operating cycle that shortened compared to the one

observed in 2018, driven by improving inventory periods and a steady accounts receivable period. Although there seems to be an improving trend in these ratios, in the past 3 years the operating cycle once again increased, which may lead to a reversal to the previous levels.

EFFICIENCY RATIOS					
	2018	2019	2020	2021	2022
Total Asset Turnover Ratio	0.34	0.32	0.35	0.37	0.41
Fixed Asset Turnover Ratio	0.50	0.51	0.52	0.52	0.54
Accounts Receivable Turnover Ratio	10.00	9.75	10.44	10.47	10.5
Accounts Payable Turnover Ratio	6.5	6.86	8.05	6.17	4.98
Inventory Turnover Ratio	1.88	2.3	3.08	2.93	2.64
Operating Cycle	230.62	196.15	153.65	159.43	172.88

Liquidity ratios: The company's current and quick ratio increased from 2018 to 2020, then declined in the next two years, finally returning to its approximate original level in 2022. The ratios' trajectories were mainly driven by changing liabilities, specifically short-term borrowings, maturities of long-term debts, and accounts payable, that first decreased, and then subsequently increased in 2021 and 2022.

Although the company has enough current assets to cover its short-term obligations, inventories make up a large portion of its current assets that may not be so easily turned into cash and could thus lead to liquidity problems.

These ratios are below the competitors' average, however, there is significant variation in their ratios, with many having comparable levels of liquidity

LIQUIDITY RATIOS					
	2018	2019	2020	2021	2022
Current Ratio	1.16	1.51	2.40	1.23	1.1
Quick Ratio	0.49	0.91	1.38	0.65	0.5

Solvency ratios: Compared to its competitors, Constellation Brands operates with relatively higher levels of debt. The increasing debt to equity ratio in the past three years was driven by stock repurchases, that significantly decreased equity levels compared to liabilities. Despite this, both interest and debt service coverage ratios remain very high, which ensures that the company does not need to face any solvency issues. This high level of financial solidity is a common trend across the industry and is in line with the company's main competitors.

SOLVENCY RATIOS					
	2018	2019	2020	2021	2022
Debt to Equity Ratio	1.16	1.08	0.84	1.01	1.63
Interest Coverage Ratio	7.09	6.34	7.25	7.61	7.18
Debt Service Coverage Ratio	1.08	1.54	6.73	1.81	1.81
Debt to Asset Ratio	0.50	0.49	0.42	0.44	0.55

Conclusion: it is evident that the company is exceptionally robust, as demonstrated by its solid balance sheet and the absence of any concerning factors. The likelihood of the company going bankrupt in the next decade is exceedingly low. Furthermore, the substantial cash reserves provide opportunities for future acquisitions or investments, which can further enhance revenue generation.

Over the past decade, the company has consistently achieved commendable growth rates in both revenues and profits. Considering the projected growth of the industry, the foundations for successful investments are undeniably in place. However, an important aspect that remains to be addressed is whether the company's current valuation accurately reflects its true worth, as analyzed by the finance division below.

COMPANY VALUATION

(under the finance division)

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THE GROWTH RATE

Growth Rate:

The growth rate of revenues was obtained using both the historical growth rate, and the future plans of the company, which led to consider a growth rate of around 7-8% annually for the five next years. This optimistic projection is supported by a phase of aggressive growth and expansion in the company's beer segment, which accounts for approximately 80% of its business. The upcoming construction of a new plant in Veracruz is a pivotal factor in this growth, as it is expected to substantially increase production capacity and distribution efficiency.

As this important growth will be limited in time, the terminal growth rate is projected at 4.5%, closely aligning with the forecasted growth of the US GDP and the specific dynamics of the beer industry considering the mature nature of the market and the company's established position within it.

Marginal Tax Rate:

Constellation Brands Inc. has experienced an unusually high marginal tax rate, exceeding 100% in the last few years. However, according to the last financial statements, this rate is expected to normalize to around 19-21% in the coming years, which is what has been used to calculate the net operating profit after taxes.

Capital Expenditures:

A significant component of the forecast is the capital expenditure related to the company's expansion in Mexico. With an additional investment of \$4.0 to \$4.5

billion over the next three years, this expansion is a substantial financial commitment. While these investments will have a negative effect on the free cash flow in the short run, they are expected to lead to a sustaining growth as well as a deeper market penetration in the long run.

WACC

Cost of Equity:

To compute the cost of equity, we will begin by using a risk-free rate. In our case, as the company presents all its financial statements in US dollars, we will opt for a risk-free rate that reflects the returns on a risk-free security in the US. Assuming the US is risk-free, we will refer to the yield of a 10-year US Treasury bond, specifically 4.57%.

To determine the equity risk premium, we will employ an implied equity risk premium method. Given that 97% of Constellation's revenues come from the US and computing the risk premium for all other countries is considered negligible—especially since Canada, responsible for the remaining 2% of revenues, is equally rated—the equity risk premium is established at 5.71%.

Lastly, to derive the Beta, we will utilize a bottom-up procedure by employing comparable companies from the sector. After deleveraging, we will compute an arithmetic average. Accounting for the capital structure of the company, we will lever the beta using the book values of both debt and equity, resulting in a final beta of 1.43. Employing the CAPM model, we arrive at a conclusive equity value of 12.75%.

Cost of Debt:

We initiate the computation of the cost of debt using the same risk-free rate assumed for the cost of equity. Given our assumption that the US is risk-free, we omit any associated country risk from the cost of debt calculation. Finally, we employ a synthetic ratings approach to determine the company risk. With Constellation Brands holding a Moody's rating of Baa3, we compare it to the prices of all rated bonds in the US economy, particularly those with the same rating. Our findings indicate that the average company risk for this rating is two percent. Summing the company risk and the risk-free rate leads us to a final cost of equity of 6.57%

Final WACC

To arrive at the final discount rate, we calculate a weighted average of the market values of both debt and equity. To determine the market values, we use the simple market capitalization for equity. For debt, we estimate the market value by considering the interest the company pays and the book value. After computing these values, we obtain a final Weighted Average Cost of Capital (WACC) of 10.69%.

DISCOUNTED CASH FLOW MODEL

Given these unlevered free cash flow projections, a terminal growth rate of 4.5%, and a weighted average cost of capital of 10.69%, we find an enterprise value of approximately \$38.276 billion. To determine the equity value, we subtracted the company's net debt from this enterprise value. The calculation led to an equity value of \$26.597 billion. Given the total number of outstanding shares, this translates into an implied share price of \$154.

MULTIPLE ANALYSIS

- 1) **EV/Revenue: 47.03-127.60\$ (sweet spot: 55.00\$)**
- 2) **EV/EBITDA: 115.13-193.80\$**
- 3) **EV/EBIT: 149.73-281.98\$**

The above-mentioned price ranges slightly hint at an overvaluation of the target company. Though, the results must be taken with a caveat. Due to Constellation Brands' rare standing in the market as international alcoholic beverage conglomerate with most revenues derived from its beer brands, the deal multiple selection (even when undertaken with the utmost care) did not allow for very good peers. Moreover, lots of the precedent transactions were done by industrial buyers, which, at least based on financial theory, can buy at higher prices due to the ability to make use of synergies. While these concerns must be kept in mind, it is notable that the above-mentioned limited data issues do not appear when selecting suitable trading multiples. This is of particular interest as trading multiples point towards a clear overvaluation, too.

Lastly, the difference in the EV/EBITDA and EV/EBIT valuation is striking. One potential explanation is the targets low D&A or, in other words, the minute difference between EBITDA's and EBIT's value.

Precedent Transactions Selection

Starting from all the transactions of large businesses (>100m\$) in the alcoholic beverage market for which data is available and that have taken place in the last five years, the following exclusionary criteria have been used (the reasoning can be found in brackets):

- Exclusion of spirits companies (higher margins)
- Exclusion of wholesalers (different business model)
- Exclusion of malt manufacturers (different business model)
- Exclusion of share repurchases (different financial logic)
- Exclusion of majority purchases (can make use of synergies)
- Exclusion of firms mainly active in 3rd world countries (different business environment)

Through these companies five comparable transactions have been found. The chosen sample consists of 2 financial and 3 industrial buyers as well as 1 private and 4 public targets. The targets equity value ranges between 520m\$ and 59.5bn\$. 4 breweries and 1 winery made the target list.

Trading Multiple Selection

The selection of trading multiples was based on three criteria: market in which the business operates, overall business size, and akin operating margins in recent times. This way five suitable companies were picked.

CONCLUSION

Since both the Discounted Cash Flow Method and the trading multiples valuation hint at price higher than the fair value. We will say that the stock is overvalued.

