May 19, 2014

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China | Liquor

Pernod Ricard (RI FP)

Hangover

+ Excess inventory

Given high channel and customer inventories, we believe sales of premium liquors by Pernod Ricard will not recover before 2016, but even then, we think China will not regain its place as the growth engine of PR sales.

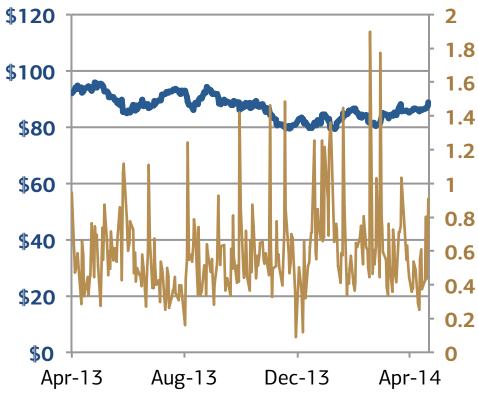
+ Price shock

We believe the dampening effect of anti-corruption campaigns will last for at least two years. The campaigns provided a price shock that reduced the value of high inventories, which will now make their way to the market. Furthermore, we think that the bars and karaokes that drove sales of brown spirits were a bubble phenomenon and not a permanent feature of the Chinese landscape.

+ Valuation

We remain negative on Pernod Ricard's sales in China, and estimate a drop of 23.8% and 17.1% in FY 2014 and FY 2015, respectively. We initiate with a price target of EUR 70.1, derived from a DCF model with a WACC of 6.8%, and give PR a SELL recommendation.

Pernod Ricard (RI FP) one-year share price in EUR (blue) and volume (gold, in mln shares)



Source: Bloomberg, May 19, 2014

Pernod Ricard (RI FP)

Price	EUR 88.94
Rating	**SELL**
Price target	**EUR 70.1**
Difference	**21%**
Market Cap	EUR 23.6 bln
Simple Moving Avg.	0.501 mln
P/E	20.03x

Source: Bloomberg, May 19, 2014

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Pernod Ricard (RI FP)

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Summary

PR sales in China deteriorated in FY 2014 Q3, but our checks indicate that actual sales may be even worse.

Pernod Ricard's sales in China deteriorated in FY 2014 Q3, and our checks with distributors indicate that the company's actual sales may be even worse than reported, as government sweeps on nightclubs and prostitution industry continue to chill the industry. The rebate-driven incentive policy has encouraged channel stuffing among top-level distributors, and the price catalyst provided by the campaigns will mean that they gradually dump what amounts to over a year in inventories. Added to "social inventories," held by end buyers, we believe this indicates a very gloomy outlook for 2014.

Days of inventory, including work in progress, increased to 497 in FY 2013 and stayed at this level through FY 2014 H1. Inventories in the channel is above 60 days in China

Rather than temporary restraints on the premium liquor industry, we see the anti-corruption and anti-prostitution campaigns as catalysts for the drop price across China's liquor industry. The price shock exposed high levels of inventory in channels. Furthermore, Pernod Ricard (PR) is beset with fierce competition and counterfeits, which further undermine its pricing power.

Company description

Created in 1975 by the merger of Pernod and Ricard, the group is one of the world's leading producers and distributors of spirits and wines, with global revenue reaching EUR 8.6 bln in FY 2013. Recent company acquisitions include Seagram (2001), Allied Domecq (2005) and Vin & Sprit (2008). Now PR offers 14 major liquor and Champagne brands and four premium wine brands.

Table 1. Brand portfolio

Top 14 strategic brands	2012/2013 volumes in mln of 9-litre cases
Absolut	11.6
Ballantine's	5.9
Chivas Regal	4.9
Ricard	4.6
Jameson	4.3
Havana Club	3.9
Malibu	3.7
Beefeater	2.6

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Martell	2
Kahlúa	1.6
The Glenlivet	1
Mumm	0.6
Perrier-Jouët	0.2
Royal Salute	0.2
Sub-total	47.1
Premium wines	
Jacob's Creek	6.6
Brancott Estate	1.9
Campo Viejo	1.9
Graffigna	0.3
Sub-total	10.7

Source: Company data

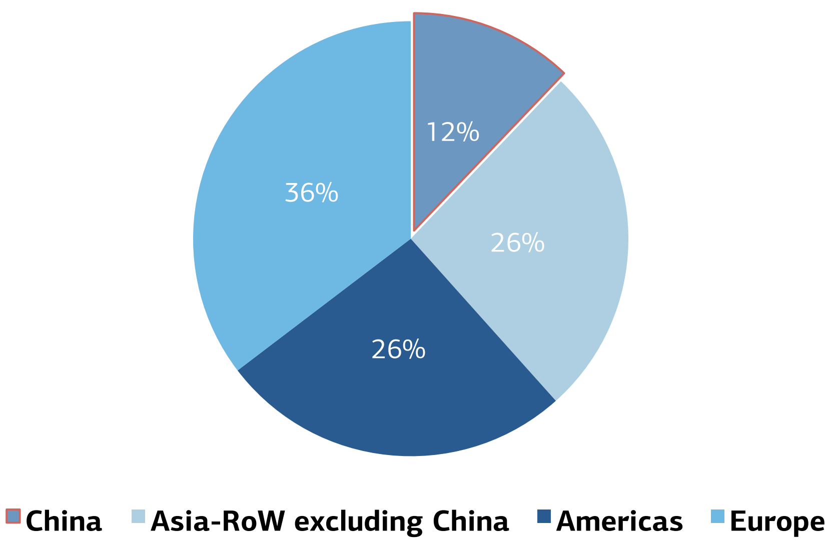
Asia-RoW is currently PR's most important region, contributing to 40% of its total revenue in FY 2013, and representing about 46% of the group's profit from recurring operations.

In recent years, the whole region has seen double-digit growth, mainly fueled by China, PR's second largest market behind the US.

We estimate that China accounts for about 12% of PR's total revenue.

PR's net sales and profit in China increased by 27x and 50x, respectively, from 2002 to 2012. Based on the company data, we estimate that China accounts for about 30.8% of Asia-ROW's revenue or ~12% of PR's total revenue.

Chart 1. Revenue by region



Source: Company data, J Capital Research estimates

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PR's sales in China are driven by whiskey and cognac.

Pernod Ricard's sales in China are driven by cognac and whiskey, though the company also sells important amounts of vodka, champagne and wine in the Chinese market.

Table 2. PR's main product portfolio in China

Product categories	Brand name	Price range (RMB per 70-75cl)
Cognac	Martell	473-25,078
Whiskey	Chivas	225-2,499
	Royal Salute	1,026-2,480
	Ballantines	85-2,695
Vodka	Absolut	85-409
Champagne	Mumm	427-733
	Perrier Jouet	538-728
Wine	Jacob Creek	89-236

Source: IWSR, Yesmywine, J Capital Research

Pernod Ricard operates in China through three tiers of distributors, including 7 tier-1 wholesalers, 340 tier-2 wholesalers and more than 600 tier-3 wholesalers. The distribution structure allows the company to sell its products in 423 cities, including four tier cities.

The Chinese liquor market

On-trade channels represent about 55% of PR's sales in China.

China is a market dominated by local white spirits, accounting for over 99% of total spirit consumption. Western spirits are sold mainly through modern on-trade channels, including nightclubs, Family KTVs, bars and clubs. According to PR's most recent company data, on-trade channels represent about 55% of its total sales in China, while off-trade and other channels, including e-commerce, account for the rest.

Anti-corruption

After the global financial crisis in 2009, Western spirits experienced three years of consecutive growth in China. Cognac, especially, maintained double-digit growth from 2010 and overtook whiskey as the most-consumed Western liquor in China.

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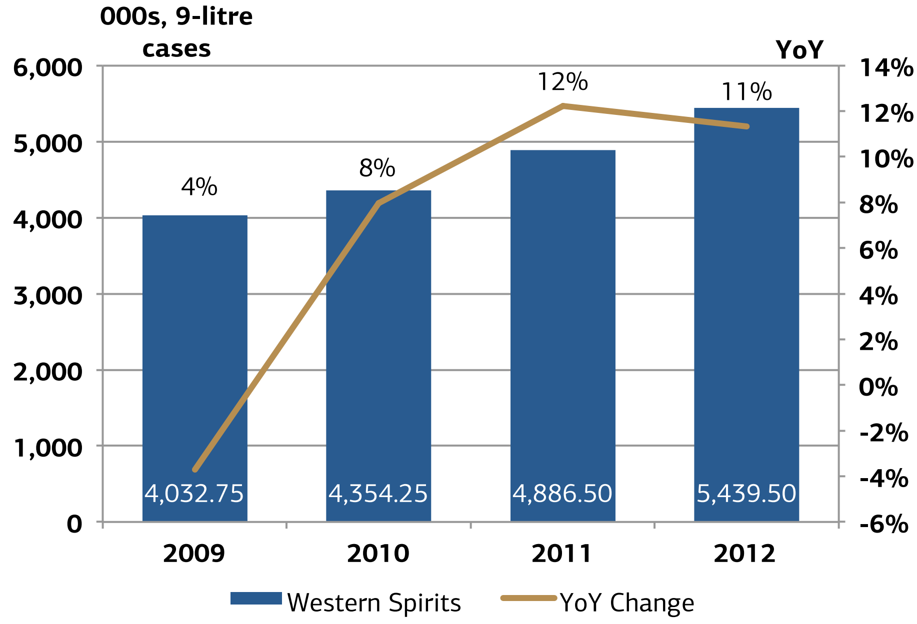
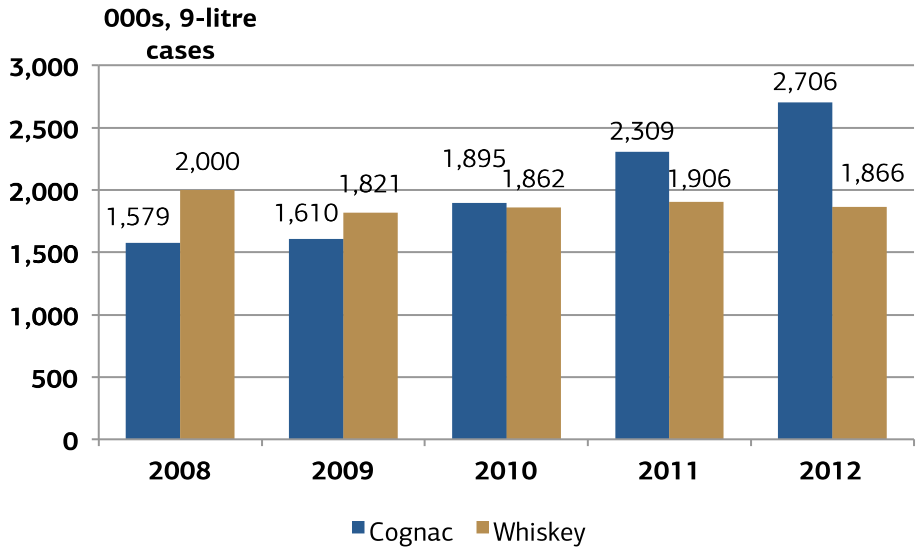
Chart 2. Consumption of Western spirits in China



Source: IWSR

Chart 3. Consumption of cognac and whiskey



Source: IWSR

Prices and demand of liquor have been falling due to China's anti-corruption campaign.

However, the campaign against corruption and lavishness in late 2012 dampened China's liquor sector. Demand dropped and, as a result, prices did too. The market price of the fabled white liquor Moutai, which reached a peak of RMB 2,300 per bottle at the end of 2011, fell below RMB 800 per bottle in April 2013. The consumption and price of Western spirits, including cognac and whiskey, also fell.

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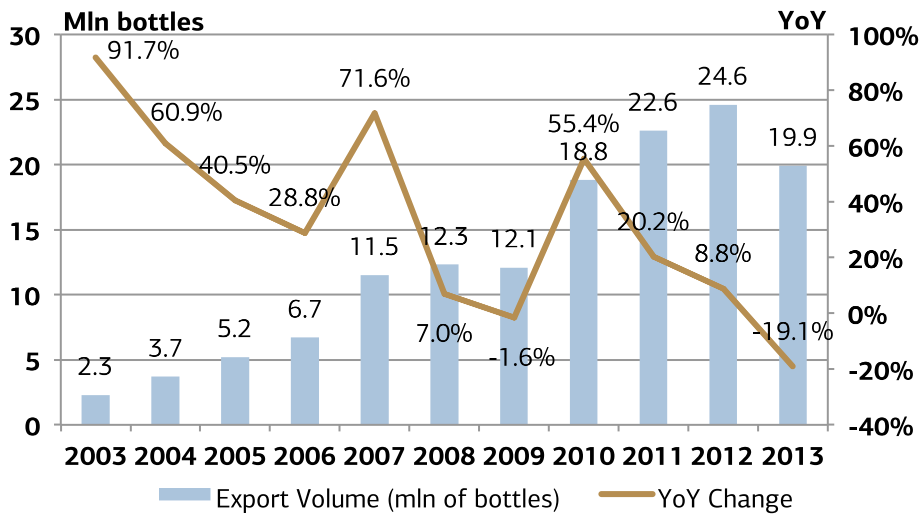
Data from the BNIC shows that France's cognac exports to China fell in 2013, by 19.1% YoY, to 19.9 million bottles. Direct exports of Scotch whiskey declined about 28.7% YoY, to GBP 51 mln in 2013, pulling China out of the Scotch Whiskey Association's top 20 export markets for whiskey.

Chart 4. Cognac exports to China

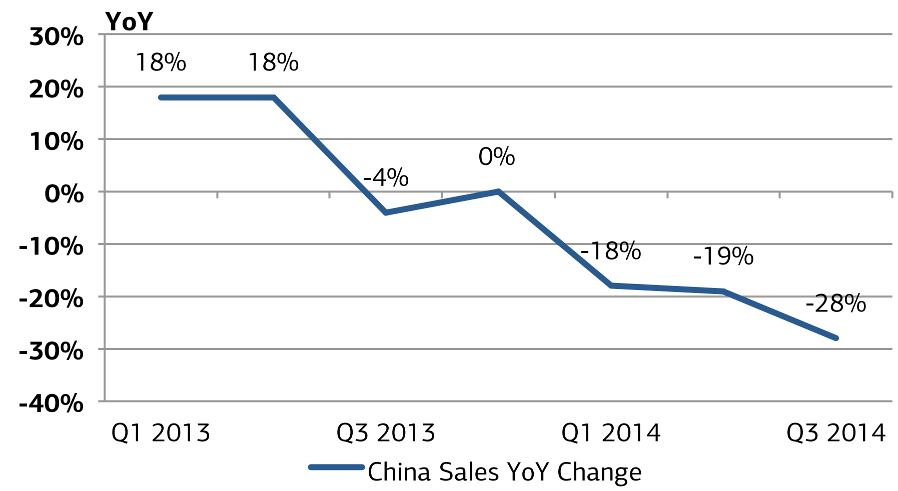


Source: BNIC, J Capital Research

PR's sales in Asia fell 8.7% YoY due to the poor performance in China.

As the market leader of both cognac and whiskey in China, Pernod Ricard was hard hit. On April 24, 2014, PR reported FY 2014 Q3 sales of EUR 1,616 mln, down by 7.2% YoY. Asia-RoW sales were EUR 690 mln, representing an 8.7% YoY drop, mainly due to the poor performance in China. Organic sales dropped by 21% YoY in 9M, falling further down in Q3 to -28% YoY, and shipments and depletion went down by 19% YoY and 14% YoY, respectively.

Chart 5. Quarterly organic sales in China: YoY



Source: Company data

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A bad beginning in 2014

About 30% of full-year sales in China's liquor industry are generated in the first quarter of each year. This year, sales were down.

The first quarter of every calendar year is important for liquor sales in China: about 30% of full-year sales are generated during the New Year and the Spring Festival, while the Mid-Autumn Festival and the October 1 National Day holiday account for another 20%.

Due to a slowing macro economy and the continuing impact from the anti-corruption campaign, this Spring Festival was no festival at all for distributors. Gift demand, the largest driver of off-trade sales, and which we estimate at about 20% of PR's total sales, shrank by over 50% during this Spring Festival. Distributors told us that sales of liquors of over RMB 1,000, which are mainly used for gifting, suffered the most, while brands such as Chivas, with prices of RMB 200-800 were still being sold.

To understand the actual sales of liquor in calendar year Q1, we checked with distributors of different tier levels in Beijing, Shanghai and Guangzhou province, where about 50% of Western liquor are consumed, and found that sales in the channel might have been even worse than the 28% YoY decline reported by the company in April 2014. According to our check, in Q1 sales dropped by 30-50% YoY and premium liquors suffered the most.

The distributors with worst performance saw their revenue down by over two-thirds in CY 2013, which continued to decrease in early 2014. Many chose to quit the liquor business. We visited a building that used to have 10 distributors, of which only two were still in business; they don't sell and Western liquor brands, except for wines.

Liquor pays the bill for anti-prostitution

China's recent crackdown on prostitution, which started in February 2014 in the Guangdong city of Dongguan, has now expanded across the entire country and is targeting directly entertainment locations such as nightclubs.

Consumption of Western liquors, especially high-end cognac such as PR's Martell, was especially high in nightclubs, as both Chinese businessmen and government officials frequent them. According to the announcement published by the Ministry of Public Security of China,[1] there were 2,410 places in Dongguan offering prostitution services that were required to suspend business. Not surprisingly,

[1] http://www.mps.gov.cn/n16/n1237/n1342/n803715/4005634.html

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when we tried to check liquors sales in nightclubs and bars, we found locked doors and nervous staff.

This new campaign has quickly spread to other cities. We were told local governments in Beijing, Shanghai and Guangzhou have also been targeting entertainment venues such as nightclubs, clubs and bars. Consequently, liquors sales, highly dependent on night entertainment locations, have been suffering a lot nationwide.

We believe about 50% of PR's total sales in China are conducted in nightclubs, all of which have been heavily hit by China's anti-prostitution campaign.

The China Market Research Group estimates that sales of brandy were hit as much as 50% since February. Having a market share of 47% in cognac sales, Pernod Ricard should be feeling the drastic deterioration of its business in China. Based on our research and checks with distributors and owners of entertainment venues, actual sales of Pernod Ricard through nightclubs—such as adult-oriented KTVs—represent over 50% of their total sales in China, rather than the 20% reported by the company. In fact, in some cities, these establishments could account for over 70% of the company's sales. We believe that, after the campaign spreads to other cities in Q2, Pernod Ricard will see its Q4 2014 sales drop even further, especially its Martell brand cognac, which is mainly sold through these establishments.

Rebate-driven sales among Tier 1 distributors

Inventory in the channel remains a problem that the company needs to solve in the near future. Inventory days for PR rose to 497 at end of June 2013 and stayed at that level at the end of 2013. Reported inventory includes works-in-progress, but we believe the increase of inventory days was driven by inventory of finished products not just in China, but also in the US, Thailand, Poland and including some travel retails.

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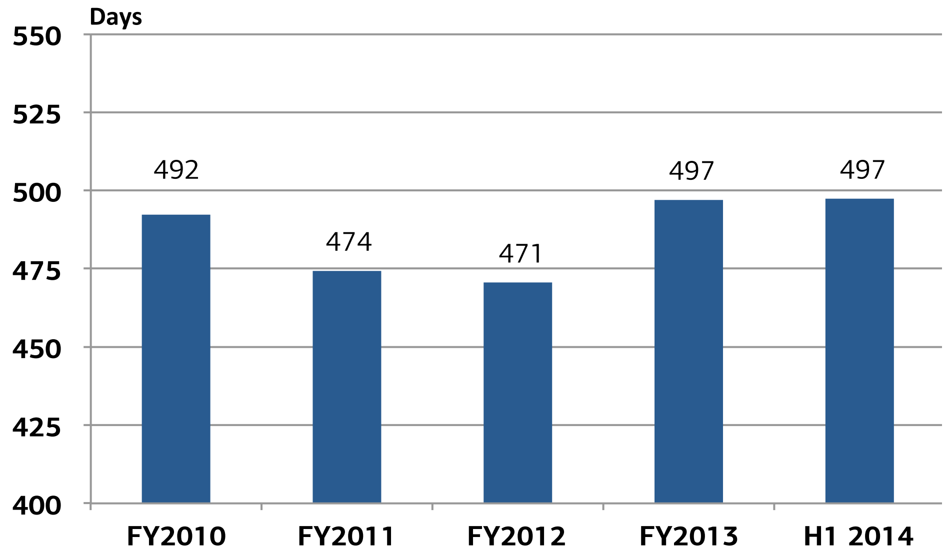
Chart 6. Inventory days



Source: Company data, J Capital Research

Pernod's rebate policy is leading to an accumulation of inventory in the channel, especially by tier 1 distributors.

PR's management indicated that the company's current inventory level is above 60 days in China and we think that tier 1 distributors are accounting for the inventory in the channel.

PR sets sales targets for its distributors and provides remarkable rebates if they can achieve their targets. According to distributors in the business, the gross margin of selling Western spirits is only about 8%, which is not very attractive. The larger part of their profits from selling Western spirits comes from the rebates provided by PR after ordering a certain amount of liquor, which are not necessarily sold to consumers, but which PR records as sales. Indeed, we were told that the amount they receive through rebates exceeds what they earn from selling spirits, though we did not obtain the details of how PR pays the incentives to its distributors.

So, PR has been generating sales by making tier 1 distributors stock liquor. Additionally, in the past years, people were betting on the continuous increase of liquor prices, including cognac and whiskey, so a lot of Western liquors were stocked in the channel. However, in line with the slowdown of China's economy, liquors' selling prices have been gradually decreasing and sales have tumbled significantly. Low tier distributors are now unwilling to increase their existing inventories, they just want to sell them. For those distributors who still have regular downstream customers, they are now making orders to their upper suppliers only after achieving sales.

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Thus, either Pernod Ricard will see mounting liquor in its bonded zones or tier 1 distributors will hold inventories only for incentives. But neither is sustainable, and the high dependence on tier 1 distributors will make PR passive once they refuse to get more stocks, since these distributors also sell other brands of liquor.

Other issues affecting Western liquor consumption

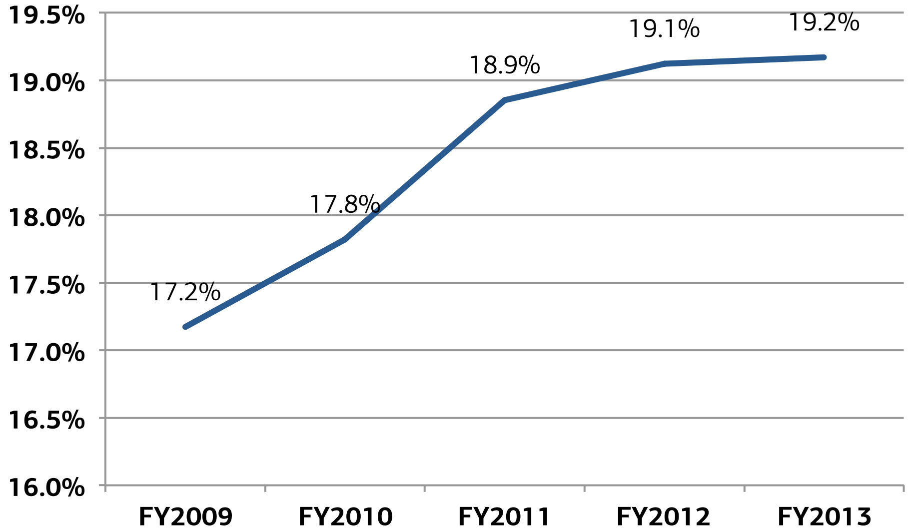
Competition

Competition in the low and middle ranks of Western spirits had intensified.

Because high-end liquor consumption has been constrained by the government actions, competition in the low and middle ranks of Western spirits, where prices range from RMB 100-500 per bottle (70cl), has intensified. At bars, Family KTVs, and clubs, where real consumption still exists, Pernod Ricard is competing fiercely with Diageo. In those locations, normally one of the two brands “monopolize” sales by arranging for its products to be used as staples and to be displayed in better locations.

To achieve these arrangements, the companies may use dirty methods, such as lump-sum payments or rebates. For example, a bar may buy 1,000 bottles for RMB 250 each bottle. This is what is recorded in the invoice. Then the company may return to the bars RMB 100 for each bottle. So the bar is really paying RMB 150, which is beneath market's fair value. We believe this promotion strategy may have driven up PR’s total A&P expenses. In FY 2013, PR’ A&P expenses reached EUR 1.6 bln, about 19.2% of its total revenue and higher than Diageo’s 11.5%.

Chart 7. A&P expenses as % of total sales



Source: Company data, J Capital Research

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Although Pernod Ricard still has the largest share of whiskey in China, it has been gradually pushed out by Diageo at some night venues in a few cities. In Beijing, for instance, Diageo has been very successful in capturing most popular bars and clubs.

Fake Sales

Estimates indicate that about 40-50% of all Western liquor sold in China is fake.

As liquor boomed in the past years, so did counterfeit spirits. Our checks with bar owners and distributors show that fake liquor is a big issue affecting real liquor sales. It is very hard to have an accurate number about the quantity of fake liquors in circulation, but according to people in the liquor business, a conservative estimate is that about 40-50% of the total Western liquor sold in China is fake.

Many Western spirits are shipped in bulk and bottled in China, so it is easy for people to collect empty bottles of genuine spirits and refill them with cheap alcohol. Due to their very low cost, fake liquor is very attractive to Chinese entertainment venues including bars, nightclubs, and clubs; these establishments widen their margins by selling fakes as originals. We were informed that even famous clubs in Beijing are selling fakes. As a result liquor sales for companies such as PR are lower than they should be.

Product substitution

To some extent, product substitution is affecting Pernod.

Bar owners and distributors informed us that beers and champagne are becoming increasingly popular in establishments such as Family-KTVs, bars and clubs. In these places people are drinking less and less cognac and whiskey, which we believe is a signal that consumers are becoming more aware of China's fake liquor problems. Only in establishments such as adult-oriented KTVs are cognac and whiskey still the most consumed spirits.

Increase of wine sales

Not everything is grim for PR. Its wine business has been doing well, especially its Jacobs Creek, an Australian brand, which accounts for over 90% of imported PR wines by volume in China. Sales have had double-digit growth in the past few years and have not been impacted much by the government's anti-corruption and anti-prostitution campaigns, according to our checks.

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Table 3. Consumption of wines

000s 9-littre cases	2008	2009	2010	2011	2012
Michel Lynch	2	3.3	4	4.5	5.3
Louis Latour	3	2	3	3.3	3.3
Campo Viejo	1	0.5	0.5	0.5	0.5
Jacobs Creek	77	95	120	156	195
Wyndham Estate	6.5	7	8	9	9
Brancott	0	1	1	1.1	1.1
Total	89.5	108.8	136.5	174.4	214.1
YoY Change	na	21.5%	25.5%	27.7%	22.8%

Source: IWSR, J Capital Research

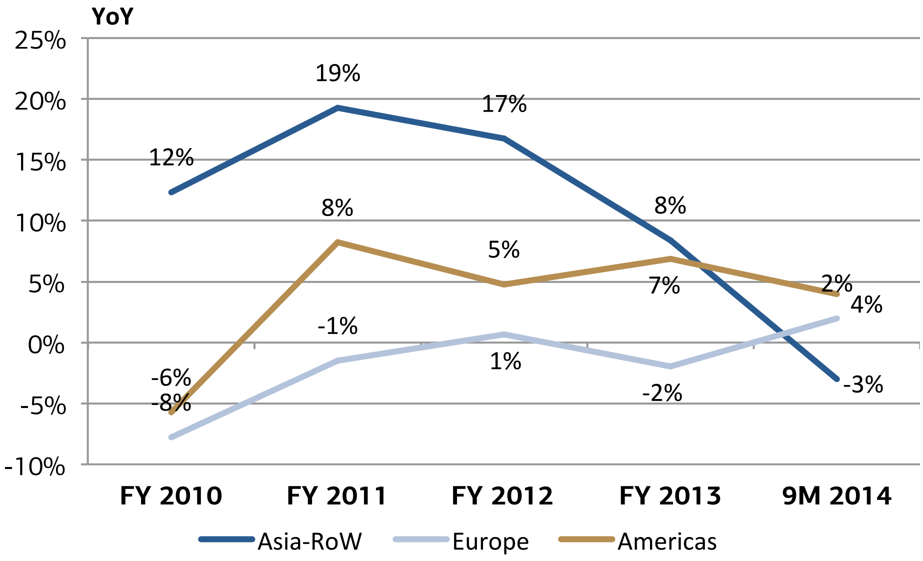
Though Pernod's wine business has been doing well in China, it accounts for less than 3% of its total revenue.

However, according to our estimates, PR's wine business in China contributes with less than 3% of its total revenue in the China market. Therefore, even a strong increase in wine sales would not be able compensate for the loss of revenue from the decrease of cognac and whiskey sales.

Things are better outside of China

PR has had a better performance in other regions. While Asia-RoW went down 3% in 9M FY 2014, Europe and Americas have seen their sales increased by 4% and 2% YoY, respectively. Sales accelerated in 2014 Q3, especially in emerging markets.

Chart 8. YoY sales growth rate



Source: Company data

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Table 4. Organic sales growth in 9M 2014

9M 2014 sales growth	Including China	Excluding China
Emerging markets	-1%	7%
Asia/RoW	-3%	5%

Source: Company data

Improving leverage ratio, but higher than peers

As of December 31, 2013, Pernod Ricard's net debt stood at EUR 8.8 bln. Despite an improvement of Pernod's leverage ratio from nearly 150% as of June 2009 to 75.8% at the end of 2013, its Net Debt/EBITDA remains the highest one when compared to its peers.

Table 5. Comparable

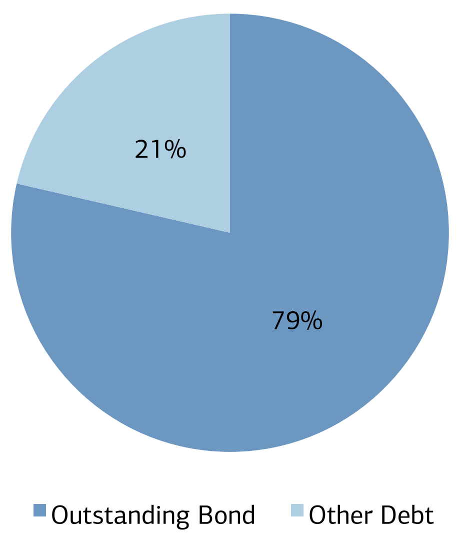
2014 H1	Net Debt to Equity	Net Debt / EBITDA (x)	EBITDA/Interest Expenses (x)
Pernod Ricard	75.8%	2.96	6.52
Diageo	108.3%	1.94	9.4
Remy Cointreau	27.7%	1.08	10.59

Source: Company data, Bloomberg, J Capital Research

At the end of 2013, nearly 80% of PR's total borrowings were from bond issuance.

The issuing of bonds remains the main borrowing source for Pernod Ricard and can lead to an increase of its outstanding debt in the future. At end of 2013, nearly 80% of its total borrowings were from bond issuance, including the EUR 850 mln bond issued in March 2014. With strong free cash flow generation, we think the company has no liquidity risk.

Chart 9. Debt structure



Source: Company data, J Capital Research estimates

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Table 6. Outstanding bonds

Nominal value	Coupon rate	Issue date	Maturity
GBP 250 million	6.63%	12.06.2002	12.06.2014
EUR 800 million	7.00%	15.06.2009	15.01.2015
EUR 850 million	2.00%	20.03.2014	22.06.2020
EUR 1,200 million	4.88%	18.03.2010	18.03.2016
EUR 1,000 million	5.00%	15.03.2011	15.03.2017
USD 1,000 million	5.75%	07.04.2011	07.04.2021
USD 1,500 million	4.45%	25.10.2011	15.01.2022
USD 850 million	2.95%	12.01.2012	15.01.2017
USD 800 million	4.25%	12.01.2012	15.07.2022
USD 850 million	5.50%	12.01.2012	15.01.2042

Source: Company data

Valuation

Contrary to what PR's management expects, we believe the China business will not see strong growth, and that will bring down sales of the entire group.

We estimate future sales by summing geographic regions. Although management remains confident about the mid and long-term growth potential in China, we think a strong growth won't come back and this will drag down the sales of the entire group. For China, we arrived at our estimates based on our channel checks. We believe consumption in night entertainment establishments and gift demand will continue to suffer, as the impact of anti-corruption move will persist, and consumption from real demand is still relatively low and facing fierce competition. For our basic scenario, we estimate the China market will decrease by 23.8% in 2014 and 6.4% for the group as a whole.

Table 7. Sales estimates

In Eur mln	FY 2014E	FY 2015E	FY 2016E	FY 2017E	FY 2018E	FY 2019E	FY 2020E
Sales from China	856	710	671	662	675	697	719
YoY Change	-23.8%	-17.1%	-5.5%	-1.3%	2.0%	3.2%	3.2%

Source: Company data, J Capital Research estimates

Table 8. Bull and bear scenarios

Scenario	Bear	Base	Bull
YoY rate in China	-30%	-17%	5%
Total net revenue in FY 2015 (EUR mln)	7,997	8,092	8,228
Price Target (EUR per share)	63.8	70.1	80.4

Source: Company data, J Capital Research estimates

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Our price target of EUR 70.1 per share is derived from a DCF valuation method based on a WACC of 6.8%.

Table 9. Terminal value and DFC valuation

Valuation	
Terminal value	
Terminal growth rate	2.0%
Terminal WACC	6.8%
Estimated terminal free cash flow (In EUR mln)	1,445
NPV of terminal value (as at 2020) (In EUR mln)	29,886
NPV of terminal value (as at 2014) (In EUR mln)	19,768
DCF valuation	
NPV of Forecasts (In EUR mln)	7,635
NPV of terminal value (In EUR mln)	19,768
Enterprise value (In EUR mln)	27,404
Net debt (In EUR mln)	8,809
Equity value (In EUR mln)	18,595
Number of shares (millions)	265
Price target (In EUR)	70.1

Source: J Capital Research estimates

WACC	
Risk free rate	1.9%
Market risk premium	9.9%
Equity beta	0.70
Cost of equity	8.9%
Cost of debt (pre-tax)	5.6%
Cost of debt (after tax)	4.3%
Target debt weight	44.9%
Target equity weight	55.1%
Tax rate	22.9%
WACC	6.8%
Terminal growth	1.0%

Sensitivity analysis	WACC				
Terminal Growth Rate	5.8%	6.3%	6.8%	7.3%	7.8%
1.0%	74.7	64.8	56.7	49.8	44.0
+1.5%	84.1	72.3	62.8	54.8	48.1
+2.0%	96.0	81.6	70.1	60.7	53.0
+2.5%	111.5	93.2	79.1	67.9	58.7
+3.0%	132.5	108.3	90.4	76.6	65.7

Source: Company data, J Capital Research estimates, Bloomberg

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Risks

- Acceleration of growth in other emerging markets.
- Stimulus in China leading to renewed liquor sales.
- Stronger than expected increase of demand in China.

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