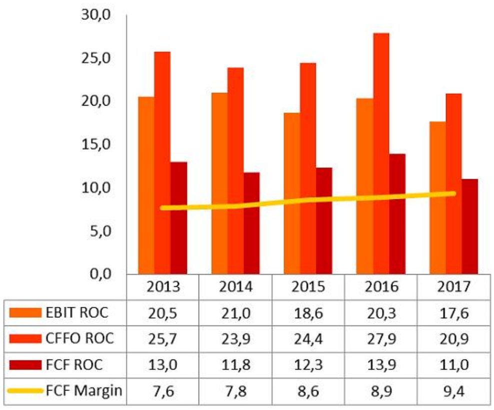
Thoughts on Heineken

Heineken has, I believe, the characteristics of a classic Buffett stock. The high quality businesses I look for have a strong balance sheet, a history of consistently high return on invested capital (ROC) and strong cash flows, where large amounts of “free” cash flow are generated.

The net debt relative to EBITDA over the last 5 years fluctuated between 2.5 and 2.9 and here is an outline of the ROC and the free cash flow margin of Heineken.



	2013	2014	2015	2016	2017
EBIT ROC	20,5	21,0	18,6	20,3	17,6
CFFO ROC	25,7	23,9	24,4	27,9	20,9
FCF ROC	13,0	11,8	12,3	13,9	11,0
FCF Margin	7,6	7,8	8,6	8,9	9,4

A family owned business

Heineken is a family-owned business. In the latest annual report of EXOR, John Elkann wrote about the importance of family control:

There are a number of characteristics of family-owned businesses which give them enduring strength:

- They tend to be prudent in how they are run, particularly in relation to financial matters, which means they remain robust when they face downturns, crises and unexpected events;
- They have the patience not to act when action is unnecessary and resist the pressure to do so.
- They are aware of changes in the world and are able to adapt when those changes require it;
- They have strong cultures, clearly defined purposes and a sense of responsibility. Their cultures, rather than pay, help them to retain talent and to grow leaders internally.

In his 2017 Investor Letter, Thomas Russo, the Managing Member Gardner Russo & Gardner LLC and General Partner Semper Vic Partners, describes 3 occasions of how the protection of the Heineken family voting control of the public company, Heineken N.V., has enabled the Heineken Leadership team to make right long term decisions. It is a wonderful Investor Letter by Thomas Russo and I encourage you to read it.

The first precedent happened when Heineken leadership passed on the buy of Brazil's second biggest brewer, Schincariol, as they felt the value Kirin paid, over $4 billion, tremendously exaggerated the business. Heineken got specific “Wall Street Heat” for their “failing”. After four years, and for a simple $1.1 billion, Heineken bought the then cash losing business from Kirin.

Second, Heineken competitor SABMiller ended up in the awkward position of being a takeover target of AB InBev. SABMiller decided to launch a hostile takeover of its own targetting Heineken. The Heineken family “just said no.”

Third, Heineken invested heavily to increase market awareness in Vietnam. As they repositioned their Heineken and Tiger brands to create a new price tier at the high end of Vietnam’s beer market, Heineken risked short term declines in market profitability and once again “Wall Street Heat”. In the end, Tiger’s repositioning has resulted in accelerated growth of both repositioned brands and increased profitability.

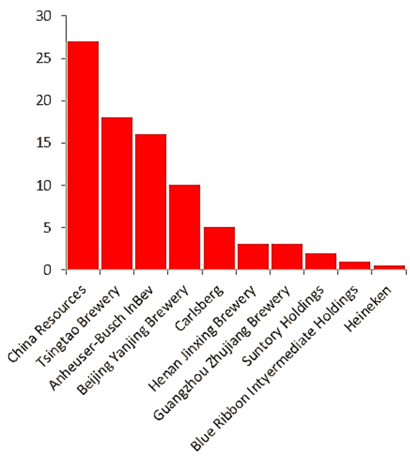
In the Fall 2018 Investment Newsletter of Graham & Doddsville, you will find an interesting interview with the New York Investment Firm Tweedy Browne. One of the questions asked was related to Heineken. The question was: “You are long Unilever and Nestle, right?”

And here is the answer. Yes, as well as Heineken. They’ve almost become semi-permanent holdings. We have owned them for 15-20 years. They have durable competitive advantages that have allowed them to compound our estimate of their underlying intrinsic values at an attractive and predictable rate. It’s a very tax efficient way to invest. We’ll sometimes trade around their estimated intrinsic value, meaning we’ll trim the position if the stock price moves ahead of intrinsic value and add to the position if the stock price drops below. These companies also give us exposure to faster growing parts of the world. When growing middle classes around the globe get more discretionary income, they want a better beverage and a better food product. These companies are serving that demand, which is growing all the time.

China

Until recently, Heineken, the world's No. 2 brewer, had struggled to compete with the dominant players in China's premium lager market such as Anheuser-Busch InBev and Carlsberg. The Dutch group had a 0.5 percent share of the China market by volume in 2017 (data from research firm Euromonitor International), while AB Inbev had 16.1 percent. The Budweiser maker is by far the leading foreign brewer in the world's biggest beer market and CR Beer had more than a quarter share.

Interestingly enough, China Resources bought the 49 per cent stake in Snow Breweries from SABMiller, its previous foreign partner. SABMiller sold its Snow stake to get regulatory clearance to merge with AB InBev in 2016, creating the world's largest beer company.



On 3 August 2018, Heineken N.V. announced that it has signed non-binding agreements with China Resources Enterprise, Limited ('CRE') and China Resources Beer (Holdings) Co. Ltd. ('CR Beer') to create a long-term strategic partnership for Mainland China, Hong Kong and Macau (together 'China'). In the context of this partnership, Heineken will become CRE's 40% minority partner in holding company CRH (Beer) Limited ('CBL'), which controls CR Beer. The companies are conducting due diligence and will need anti-trust approval from China. The transaction is expected to complete by year-end.

"We very much look forward to joining forces with CRE and CR Beer, the undisputed market leader in China. CR Beer is everywhere in the country, but they lack an international premium beer, making the Chinese group's distribution network and Heineken's brands a good match. They have what we don't have and we have what they don't have, so it's a win-win situation. Consumers switch to alternatives such as wine, meaning growth can only come from selling higher-end brews as tastes shift towards the premium end of the market. We believe that our strong Heineken® brand and marketing capabilities, combined with CR Beer's deep understanding of the local market, its scale and best-in-class distribution network will create a winning combination in the growing premium beer segment in China." – Quote Heineken CEO Jean-François van Boxmeer.

As part of the strategic partnership, Heineken China's current operations will be combined with CR Beer's operations and Heineken will license the Heineken® brand in China to CR Beer on a long-term basis.

Together, Heineken, CRE and CR Beer are perfectly positioned to win in the rapidly growing premium beer segment in China.

China's beer market, the world's largest beer market by volume, is now the second largest premium beer market globally and is forecast to be the biggest contributor to premium volume growth in the next five years, driven by its rapidly growing middle class. Profitability of the Chinese beer market is expected to improve significantly, driven by premiumisation, demand for international beer brands and cost optimisation. In increasing middle class means disposable incomes in China are growing faster than in most developed markets and, coupled with urbanization, creates new opportunities for socialising and consuming higher-end beers. Younger consumers in particular, are interested in trying new beer styles. Wheat beer and stout have recorded very strong growth over the past five years. While growth has now become more restrained it remains in double digits."

"We are very excited about this partnership and see immense potential in the combined strengths of CR Beer and Heineken. With Heineken's long heritage and world-class iconic brand portfolio, along with our leading presence and deep understanding of China, we believe we can win together in this new era of the Chinese beer market, in which the premium segment will become increasingly important. In Heineken we have found the perfect partner to achieve our ambitions in China and - as an international partner - to support us in growing our business outside China." – Quote Chen Lang, Chairman of CRE.

The combination of Heineken and CR Beer in China is expected to be highly complementary. CR Beer has a best-in-class route to market network, a wide brewery footprint and a deep understanding of the Chinese market. Heineken has proven premium brand building capabilities and a world-class international brand portfolio, led by the iconic Heineken® brand for which it has built strong equity over the years in China. Heineken, CRE and CR Beer are convinced that their strategic partnership will drive growth for their businesses. The partnership will enable CRE to advance its premiumisation strategy and it will help Heineken to significantly expand availability of the Heineken® brand in China to fully leverage the brand's potential.

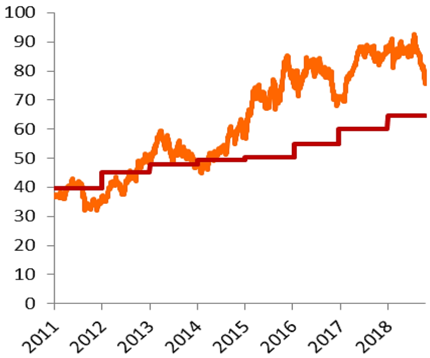
Under the strategic partnership agreement, Heineken will be CRE's exclusive partner for international premium lager beers in China. Heineken and CR Beer will investigate which other premium brands from Heineken's portfolio can be licensed to CR Beer in China. Heineken and CRE will also investigate if the Dutch brewer's global presence and marketing capabilities can be leveraged to support and accelerate the international growth of the locally popular CR Beer's Snow® brand and its other Chinese brands to become the Chinese beers of choice. “This (deal) will help accelerate CR Beer’s Snow beer high-end strategy and achieve its goal to take a leading position in the premium market within 5-10 years.” – Quote CR Beer’s Chief Executive Hou Xiaohai. Snow accounts for about 90 percent of CR Beer’s total beer sales volumes but is almost exclusively sold in China.

How to value Heineken?

The only thing I try to do when valuing high quality stocks like Heineken is applying a very conservative multiple of the company’s cash flow in light of prevailing interest rates.

It seems as if the Federal Reserve officials, despite the vocal critics of the central bank's actions by President Donald Trump, remain convinced that continuing to gradually increase interest rates is the best formula to preserve a steady economy. There might even be a period where the Fed will need to go beyond normalization of rates and into a more restrictive stance.

Nevertheless, given this interest rate environment I do believe that a multiple of 10 times 3 year average operational cash flow per share is reasonable, which happens to be the equivalent of a P/E ratio of 19.



As of today the stock trades well above this multiple (red line). As you can see, there was a great window of opportunity in 2011-2012 to buy into this wonderful company.

For a value investor a P/E multiple of 19 might seem too high. The current interest rate environment is, I believe, very favorable for stock market valuations. Warren Buffett recently (once again) explained that when interest rates rise to high levels such as in the early 1980s, it makes higher equity valuation multiples much less attractive to investors: "When we had 15 percent short-term rates in 1982, it was silly to pay 20 times earnings for stocks."

The buying price, I believe, is a very personal matter. Perhaps you want to buy as cheap as possible, but then there is a risk that Mr. Market doesn’t offer you this low buying price and you will not be able to buy into this wonderful company. Or perhaps you believe the current price is right, but if the markets crash after you bought the stock, you probably would regret you bought the stock @ such a high price.

In his 2017 Investor Letter, Thomas Russo points out that if you want to buy, the Heineken Holding N.V. stock (HEIO.AS) might turn out to be the better alternative.

"Ironically, for over 30 years, Heineken Holding N.V. shares have often traded at a discount to the operating company shares which they control. The discount has exceeded 15 percent, in some instances, even though every share of Heineken Holding N.V. economically represents a share of the more expensive public company holding." – Quote Thomas Russo.

And finally, Alexander. The 34-year-old Alexander de Carvalho, the eldest son of Charlene and Michel de Carvalho and the favorite grandchild of Freddy Heineken, studied at Harvard. There he was not only praised as one of the 'brightest stars', he was also known as 'excessively flamboyant'. He kicked it among other things to join the very exclusive Porcellian Club, whose ballotage is so strict that once even Franklin D. Roosevelt, who would later become president of the United States, was refused. Will Alexander once become the new CEO? Time will tell…

Cordially,

Peter

Peter Coenen
Founder & CEO of The Value Firm®
21 October 2018

The Heineken Leadership Team

18 October 2018

Jean-François van Boxmeer, Chairman Executive Board / CEO

Jean-François van Boxmeer was born on 12 September 1961 in Elsene, Belgium. He received a master's degree in Economics from the Facultés universitaires Notre-Dame de la Paix in Namur, Belgium in 1984. In 2001, appointed member of the Executive Board and from 1 October 2005 Chairman of the Executive Board/CEO. Joined HEINEKEN in 1984 and held various management positions in Rwanda (Sales & Marketing Manager), Democratic Republic of Congo (General Manager), Poland (Managing Director), and Italy (Managing Director). Executive Board responsibility for HEINEKEN Regions and Global functions: Human Resources, Corporate Relations, Supply Chain, Commerce, Legal Affairs, Strategy, Internal Audit and Company Secretary.

Jean-François van Boxmeer
Chairman Executive Board / CEO

Laurence Debroux
Member Executive Board / CFO

From left to right: Marc Busain - President Americas, Dolf van den Brink -President Asia Pacific, Marc Gross - Chief Supply Chain Officer, Blanca Juti - Global Corporate Affairs Officer.

Drom left to right: Jan Derck van Karnebeek - Chief Commercial Officer, Roland Pirmez - President Africa Middle East and Eastern Europe, Stefan Orlowski - President Europe, Chris Van Steenbergen - Chief Human Resources Officer.