Drinking Less, Drinking Better

What does it really mean to say that consumers are "drinking less, but drinking better"? It is an important observation for us, given we have a number of our investments in premium alcoholic beverage brand owners (e.g. Diageo, Remy Cointreau and Brown-Forman). So in this piece I wanted to dig a bit deeper and put some numbers to the phrase by exploring global changes in alcohol consumption and consumer habits. And hopefully, I'd like to leave you with some quantified optimism about why our efforts to increase the percentage of premium (and extending to out and out luxury) international alcohol brands in our portfolios are a positive move to address these changes, take advantage of opportunities around the world, boost margins over time and lock in the considerable pricing power of our portfolio companies' collections of unique and compelling beverage brands.

Perhaps the best place to start is with those changes in alcohol consumption. We observe two complementary and increasingly converging trends: firstly the decrease in absolute alcohol consumption in developed markets, and secondly the global growth in premium branded alcohol, especially spirits. The trend towards drinking less has been going on for some time - in the UK alone, alcohol consumption per adult dropped 10% between 1990 and 2017 and in the USA, 2019 polling showed that 40% of drinking-age adults drink less than they did five years ago. And the upheavals brought about by Covid shutdowns only seem to have accelerated these trends. Much of this seems to be driven by what seem to be permanent generational shifts - the influence of younger, more health-conscious consumers who are less likely to drink to excess is instrumental in changing broader societal behaviours – as well as the never before seen availability of information about brands driving an increased emphasis on being selective and prioritising provenance, heritage and authenticity when choosing what (and how much) to consume.

I should note that on a global basis the picture is somewhat different: total alcohol consumed per year increased 70% between 1990 and 2017, driven exclusively by low and middle-income countries including Vietnam, India and China. Yet even this isn't necessarily indicative of newly excessive alcohol consumption in these geographies – often the increase reflects locals trading up from unmeasurable "informal alcohol" (i.e. home brewed or distilled drinks) consumption to measurable branded beverage consumption, or even previous non-drinkers moving to enjoy one or two branded drinks. Either way, in most cases the alcohol consumed in such countries skews heavily to local beverages and brands, many of which have a phenomenal reach in just one geography – e.g. Korea's Jinro soju, which has managed to retain its spot as the biggest spirits brand by volume in the world. But Lindsell Train prefers to participate in the smaller, but higher priced and faster growing segment of "international branded spirits" – itself still worth an estimated $200bn according to the International Wines and Spirits Record (ISWR) and Remy Cointreau.

A very important aspect of the rationale for investing in this smaller and more rarefied category is the fact that alcohol brands with a premium or luxury positioning tend to be highly differentiated, with a greater ability to increase prices over time than a "value" or mass market brand – even in downturns or periods of turbulence. Over time, these inflation-busting protective qualities usually result in considerable value creation: in January this year, against a backdrop of a sharp increase in input cost prices, Diageo reported increased operating profit margins – crucially, driven by price increases rather than cost savings – and indicated an expectation of operating profit growth of between 6 and 9% to 2025. Such an outlook would not be possible without a portfolio of beverages enjoying substantial pricing power.

Within international spirits, there are clear trends towards premiumisation and indicators that consumers are willing to "trade up" the beverages they drink. "Premium" spirits (definitions of this term vary, but for clarity I'm using the word to refer to those priced over $50 for a 750ml bottle, all the way up to the heady heights of $1000+ bottles) account for just 9% of the total international spirits market, but have enjoyed an 8% p.a. compound growth rate between 2010 and 2020, compared with +4% for the whole international spirits market. And the IWSR Drinks Market Analysis predicts that these trends will continue, with vastly divergent growth rates of international branded spirits at the very top and bottom end of the market - 750ml bottles priced $200+ are expected to grow just over 9% annually until 2025, unlike "value brands" (c.$10 per bottle) which are expected to grow just 0.8% over the same period. This trend correlates to the aforementioned generational shift towards consumers drinking less - if you're having one or two rather than four or five, you are likely to be happy to spend more on a higher quality tipple, and to be more interested in seeking out information about what constitutes the best brand. And given that there really is a perceptible difference in flavour and experience when drinking a more premium beverage, it's likely that drinkers who've made the jump to the better stuff will continue to drink it.

An interesting recent trend is the growth of premium and super-premium fuelling entire spirits categories, e.g. tequila in the US as shown in the chart below.

US Tequila Rise in volumes 2002 to 2020	
Total	+209%
High End	+663%
Super Premium	+1330%

Super Premium accounts for 23% of tequila volumes in the USA

Source: 'Tequile Olé!', Distilled Spirits Council of the United States, February 2021

Such growth indicates that it's not mass market tequila shots driving the boom but rather exquisitely crafted Palomas and complex fine sipping tequilas served over ice or even neat. The global rise of interest in cocktails – itself another indicator of consumer tastes turning towards quality over quantity – has been kind to tequila, with the 2021 Bacardi Global Brand Ambassador Survey placing it as the top trending spirit for 62% of global bartenders (rising to 76% in the US) and tequila-based cocktails now ranking 4 of 30 in popularity. We recognise that trends and "booms" have long been a feature of the spirits market, but arguably the combination of demographic behavioural changes and the increased emphasis on truly differentiated flavours as well as heritage and provenance might make shifts like this more durable than in previous years. So we were impressed with our Global portfolio holding Brown-Forman's 20% growth in tequila volumes in 2021; and despite raised eyebrows at the 2017 Casamigos purchase price of $1bn, we're pleased that Diageo owns this super-premium tequila and has managed to grow case sales from just 170,000 in 2017 to 1m in 2020. And even more importantly, I did happen to notice in the course of my, er, extensive research that Casamigos has now been immortalised by Claridge's in a new cocktail named – what else? – "The George".

As an aside, the quality cocktail boom and especially the growth in tequila has also been good news for our investee company Remy Cointreau's eponymous Cointreau. Invented in 1849, Cointreau is the global #1 premium orange liqueur and the biggest brand within the company's Liqueurs & Spirits division, which means it accounts for a not insignificant c.12% of the company's total revenues. It's a distinctive beverage and a key component of more than 500 cocktails – most famously the tequila-based Margarita - with almost no credible alternatives, unless one opts for a significantly lower quality substitute. So in our view, Cointreau's enviable 50% revenue growth between 2020 and 2021 is an indication that even spirits and liqueurs used for mixing can be beneficiaries of the broader global "drinking better" trend – but only if they possess the same unique positioning and flavour profile, heritage, quality and brand resonance as Cointreau.

While I'm on the subject of Remy Cointreau, I'd be remiss not to mention that its 73% of revenues from cognac offer considerable protection: its centuries-old brand, already standing for heritage, history and superior flavour, is burnished and supported by a vertically integrated production process which ensures control over terroir and quality, and also necessitates considerable eau de vie stocks to be 'laid down' years in advance. And the skew to cognac also makes Remy Cointreau particularly well positioned to benefit from the strong premiumisation trends within the category itself, and the significant headroom for this premiumisation to happen. The USA is the world's largest market for cognac, accounting for 55% of all exports (by definition, cognac must be produced in Cognac!) but with a very pronounced skew to younger, and therefore lower priced, iterations of the beverage. In 2019:

- 73% of cognac bottles sold in North America were VS ("very special", i.e. aged for a minimum of two years)
- 25% were VSOP ("very superior old pale", aged for over four years)
- And just 2% were XO ("extra old", aged at least six years).

Globally, VSOP and above accounts for 46% of the total cognac market so the USA is lagging behind – and, we think, likely due to catch up! With a clear skew to premium, nearly all of Rémy's cognac falls within the VSOP+ segment so the company should benefit as the broad spectrum premiumisation trends lift the average quality and value of cognac consumed in the USA.

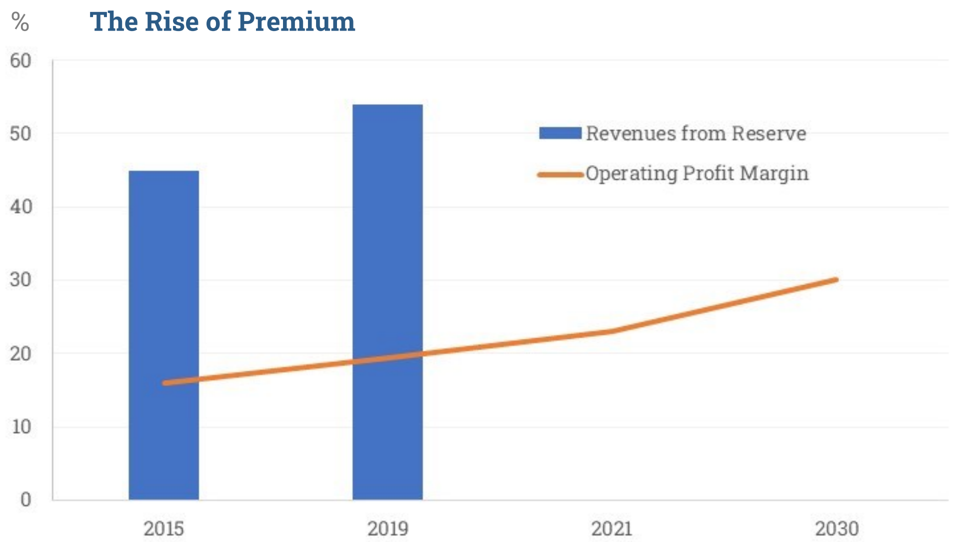
This leads neatly onto a subject inextricably linked with premium, luxury and indeed the cognac category: China. While absolute alcohol consumption is rising rather than falling in China (up just over 4% between 2010 and 2017), a much more compelling trend is the ever increasing interest – and the enormous opportunity – in premium and especially Western premium beverages. At present the Chinese white spirit Baijiu accounts for 96% of all alcohol consumed in China, leaving Western spirits with a tiny 4% share. However of that 4%, cognac is the biggest with 3% (Scotch whisky takes the final 1%) – so it's no wonder that China as a geography is so important to Remy Cointreau. Asia Pacific is 29% of the company's revenues, and it's safe to assume that China makes up a big portion of this, especially as cognac consumption patterns in China are almost opposite to those in the USA: 88% of bottles sold into the region are VSOP or XO, with the lower priced VS accounting for only 12% of shipments. So between the USA's scope to upgrade its cognacs and China's existing taste for fine cognac but low overall market penetration, we see a host of global opportunities for Remy Cointreau. And elsewhere in China perhaps the growth of scotch and the premiumisation within the baijiu category will benefit Diageo, which owns China's biggest Scotch brand (Johnnie Walker) and was the first of the Western spirits companies to enter the region with a stake in exclusive baijiu house Shui Jing Fang. According to Diageo's CEO, the company's current 5% of revenues from China could well double in the coming years.

The final trend to mention is the growth of low and no alcohol offerings in both the beer and spirits categories, targeting not only the teetotal but the growing cohort of consumers looking to cut down on their alcohol consumption but not their drinking occasions. This "low and no" beverage category remains very small as a percentage of total beverage alcohol, e.g. in the US it's just 0.5% (and non or low alcoholic spirits are even smaller at 0.1%), but nevertheless it has increased substantially in recent years. According to the ISWR, sales of these products in ten key global markets have grown from $7.8bn in 2018 to nearly $10bn in 2021, and even more rapid growth is predicted for the category – ISWR forecasts an increase of 34% between 2022 and 2025. We're pleased to see our portfolio companies tapping into this trend with various new products, some of which are already showing substantial growth and considerable promise. Within non-alcoholic beer, Heineken has now committed 10% of the Heineken brand marketing budget to Heineken 0.0, making this a strategically significant offering – and also the company's fastest growing product, already available in 95 markets.

And within non-alcoholic spirits, in 2016 Diageo took a minority stake in Seedlip through its Distil Ventures accelerator – and in 2019 this increased to a majority position following 270% year-on-year volume growth and a distribution footprint spanning 7500 locations in 25 countries. Perhaps expertise gained from this investment has carried across to other business segments – in December

2020 Diageo launched a non-alcoholic Gordons, swiftly followed by Tanqueray in January 2021. But Seedlip arguably remains the original "no and low" spirit with a growing brand recognition and resonance – as of 2021, Drinks International now features a Non-Alcoholic Spirits category in its Brands Report, and reports that "Seedlip is by far the dominant name, accounting for a whopping 77% of [the surveyed] bars' first choices". In some ways this brand is an expression of both the lower alcohol consumption and the premiumisation trends, encapsulated in its pricing alone: compare its current retail price of £26 with Gordon's Gin's price of £15.50. And when you consider that the UK tax burden means that duty on a standard bottle of spirits is over £8, whilst none is charged on beverages less than 1.2% ABV (alcohol by volume), the returns profile of these offerings starts to look very enticing.

So how else do we see all this translating into our portfolios? Just as we look to increase the premium element of our portfolios, we think it makes sense for spirits owners to look to boost the revenues from premium and above brands within their portfolios, and we welcome this trend across the whole industry. We have been encouraged to see Diageo actively take its percentage of revenues from Reserve (i.e. its highest end brands) from 5% in 2011 to 31% in 2021, and in between 2015 and 2019 Remy Cointreau increased its revenue from its most premium bottles from 45% to 54%. In both cases this is a huge overweight to premium given that the category accounts for just 9% of the entire global international spirits market. And this shift upwards has already been reflected in Remy Cointreau's operating profit margin growth from 16% in 2015 to 23% in 2021 – and we see no reason why the company shouldn't achieve or exceed its predicted 2030 margin of 30%.



RÉMY COINTREAU

Source: Rémy Cointreau Annual Report 2020/2021

Elsewhere we are encouraged by Brown-Forman's increased attention to its portfolio of Premium Bourbons such as Woodford Reserve, whose 18% volume growth in 2021 made it the fastest growing single brand in the company's entire stable. Brown-Forman's investment activities and resource allocation also indicate that internally its Premium Bourbons are viewed as an opportunity: an extra $125m of capex was approved last year to expand bourbon-making capacity in Kentucky (this is distinct from Jack Daniels, which as a Tennessee Whiskey is exclusively produced in that state). We watch Heineken's progress with Heineken 0.0 and Diageo's progress with Seedlip with considerable interest, and at the same time continue to build our position in Fever Tree, which constructed the premium mixer category from zero and today holds a 45% market share in all UK mixers - whilst also adding considerable revenues from Europe and the US. In 2021 Fever Tree tonic and ginger beer became the #1 sellers in their respective categories in the US, which we hope heralds the creation of the premium mixer category in that geography and offers the chance to benefit from both the shift to higher quality mixers and alcohol and the rise of occasional and full-time non-drinkers.

And finally, we look with reassurance at the portion of truly rare, truly unique and uniquely valuable brands at the very highest end of our portfolio companies' collections - Remy Cointreau's Louis XIII cognac or Diageo's limited edition Johnnie Walkers. We want more exposure to premium and luxury, and we believe that these beverages are a fantastic way to get exactly that. But don't just take my word for it – I'll leave you with a quote from the ex-Global Executive Director of Louis XIII, Ludovic du Plessis:

"Louis XIII is beyond the cognac market, it's a luxury category by itself, which is growing in volume and value. We not only compete with other wine and spirit brands but with luxury brands such as Berluti, Chanel or Hermes."

Which makes Louis XIII - and the other fine luxury beverage brands in our investee companies' stables – exactly the kinds of rare and increasingly valuable assets we're delighted to own in our portfolios. We hope to benefit from their unparalleled pricing power and scarcity value for years to come.

Cheers!

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