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A Flat Beer Market?

The beer industry in the U.S. actually started out as groups of local breweries in the colonial days, with the number of breweries growing steadily until the 1870s when industrial scale production was introduced. The number of breweries reached a record level in 1873 but then declined as brewers took advantage of new technology, especially in packaging, and created larger and more efficient plants. The industry output took a plunge during the Prohibition years but quickly regained momentum after repeal. Nationally advertised beers became prominent in the 50s and 60s while the number of breweries decreased due to shutdown of smaller local brands. Industry consolidation accelerated in the ensuing two decades, forcing smaller companies to go out of business or be acquired. Two momentous merger activities happened in 2008, changing the industry landscape. In June of 2008, SABMiller, the world's then largest brewing company headquartered in London, received approval from U.S. antitrust authorities to proceed with a joint venture with MolsonCoors, creating a new company SABMillerCoors, accounting for 30% of U.S. sales with 150 brands. In November of the same year, a $52B deal was completed, in which the largest U.S. brewer Anheuser-Busch was acquired by the Belgian brewer InBev, surpassing SABMillerCoors as the new largest brewer in the world. At that time, Anheuser-Busch alone had more than 200 brands and accounted for about 50% of total U.S. sales. These significant mergers changed the U.S. beer industry into a duopoly with the two conglomerates taking up about 80% of total sales. The third and fourth companies, Modelo and Heineken, were brewers of imported beers who produced and sold famous brands worldwide, accounted for roughly 10% of sales in the U.S. Modelo, the brewer of Corona, exports 6 of its brands to more than 170 countries including the U.S., where it's distributed by Crown Imports; Heineken also has great international presence with its 125 breweries in 70 countries. The U.S. beer industry became highly concentrated with top 4 firms accounting for roughly 90% of the total market. Interestingly, all 4 firms are owned by foreign-based multinational corporations: ABI (Belgium), SABMillerCoors (UK), Modelo (Mexico), and Heineken (Netherlands). ABI has a 50% non-conrolling stake in Modelo and is now seeking to acquire the rest (Ascher 3).

The opportunity for a combined firm to take advantage of synergies, economies of scale, and increased market share motivates firms to merge and acquire others. The new joint company is able to reduce distribution and overhead costs and redundant employment. Take ABI for example, InBev's acquisition of AB was motivated, at least in part, by the hope of gaining access to AB's distribution channels and increasing the firm's market share. Simultaneously, this merger also provided opportunity to reduce costs. The new parent company was able to shut down AB International and transfer its foreign beer operations and investments to InBev. Both parties expected to save $1.5B by 2011 and aimed to reduce its debt to income ratio by 50% in 5 years. The joint company restructured internally, revising pay system and eliminating some employee benefits, and exercised its added market powers in purchasing advertising; ABI was expected to increase profits by $350-$370M annually (8). Three years after the InBev deal, the integration-related cost-saving plan ended; the original projection of slashing $1.5B was upped to $2.5B throughout the newly combined company; the number of AB workers in St. Louis alone fell 15% between 2007 and 2009; ABI noted in November 2011's earnings report that it had save $195M in the first 9 months of 2011 with $75M more needed by the year end to reach its company-wide 3-year goal (Frankel). SABMiller also exemplifies similar benefits in its merger as the parties were expecting to save $500M in future annual costs. According to SABMiller's fourth quarter report in 2011, "cumulative cost savings have risen to $219M, bringing the company's combined synergies and cost savings to $765M, achieving the goal of $750M in total savings a full year earlier than planned"; a 32.5% change in 4th quarter net underlying income change was also revealed, which adds to a 2.7% change in 2011 financial year; the full year profit also increased by 2.7% to $1.12B (MillerCoors). Moreover, not only did these consolidation activities result in more effective and efficient businesses, the transactions also enabled both companies to gain greater access to emerging foreign markets and increase their shares in the world market (Ascher 9).

Brewing methods have remained static for the past few centuries; however, new technological advancements have increased production efficiency and quality.

Technological developments have focused on refining brewing processes and packaging and distribution processes. Developments such as more efficient boiling systems and inventory management software systems used in warehouses have helped to provide the consumers with lower-cost beer (“The Beer Industry”). Moreover, advancements in refrigeration in railroad and pasteurization enabled companies to ship longer distances with larger-scale production reducing unit costs of transportation. Progress in commercial and home refrigeration, bottling and canning machinery, and highways all contributed to industry growth. The advancement of TV and national broadcasting also helped to expand the beer market through extensive advertising. Large firms were further advantaged since they were able to spread the cost over a large production volume and deliver nationwide. At the same time, their larger size also enabled them to invest in new machinery, improving their production efficiency (Ascher 27-8).

According to the latest data in Brewers Almanac series, the volume of U.S. production has steadily declined by 4% from a peak of 203.7M barrels (1990) to 194.2M barrels (2010). 2011 trade data showed the total annual beer production in the U.S. to be approximately 200M barrels, generating about $100B in revenue. (6). While total beer production is decreasing, craft beer production has seen growths and has begun to cut into the big brewers’ market shares. The U.S. beer market in general is mature and stagnant; the market growth is propelled by a large number of small craft beer breweries who cumulatively produce 10-11M barrels annually (7). Despite increases in total volume of craft beer, it remains a small sector controlling only 5.7% of total U.S. beer market by volume in 2011, achieving $8.7B, just over 9%, of total beer sales in 2011. Over the years, many craft beer firms have entered the market and failed, but still others have survived and thrived and expanded to larger entities (7). Not only are craft brewers a newer and faster growing part of the industry, they are also by far the largest in number (about 2,000 breweries). However, they are generally small and local and consist of only about 5-6% of U.S. sales. A smaller number of traditional breweries (about 20) are grander in size and produce the majority of U.S. beer quantity-wise. The large traditional breweries may also be active in the craft beer sector through internal growth and acquisitions. ABI, for example, wholly owns Shock Top and Goose Island, its craft-like beer brands.

Entry barriers in the traditional brewing sector are extremely high. It costs hundreds of millions of dollars to construct new, large-scale traditional breweries capable of producing 7M or more barrels annually; by contrast, small craft breweries can be started with as little as $150,000 in the U.S. (28). The two largest companies, ABI and Miller, has a combined annual capacity of at least 154M barrels; AB has 12 plants with estimated total capacity of 80-88M barrels; Miller has 8 plants with estimated capacity of 74-86 M barrels (28). Not only are plant construction costs high but maintaining a large-scale modern brewery is also very costly. ABI, for example, invested more than $1B to modernize its brewing processes, upgrade systems to reduce environmental impacts, and install equipment for new products and innovations in 2012 (28). These large and established firms have advantages over others since they have already built a customer base and can afford to spend larger sums on advertisement in order to attract new consumers and maintain customer loyalty, making it harder for new entrants to capture market shares ("The Beer Industry"). Moreover, the distribution of alcohol is heavily regulated in the U.S., further hindering new entrants into the industry. There are 2 types of regulatory settings: open states, where brewers are allowed to sell beer directly to independent distributors, and control states, where companies market their products to state liquor control boards through a warehousing system and then to state liquor stores ("The Beer Industry"). For those operating in open states, the network of distributors is crucial; therefore recent mergers in the distributor sector serves as further challenges. From 1980 to 2010, the number of distributors in the U.S. declined from nearly 5,000 to about 2,000 (Ascher 9). Rising costs and the need for scale and broader portfolios pushed distributors to consolidate, reducing the number of wholesalers. About 60% in number and 89% in volume of the distributors generally handled either Miller/Coors or AB but not both. AB not only has contracts with about 500 distributors but also owns more than a dozen distributorships as well as holding minority shares in others. The majority of AB distributors are "tied houses" and handled AB brands exclusively; in 2008, however, AB began revising its contracts to allow distributors in its network to take on other clients (10). In this setting, small craft brewers have struggled to gain access to the market as larger wholesalers acquired many medium-sized "all-other" distributors and some smaller ones dropped out of business. However, the recent successes of craft brewers have attracted the attention of independent distributors, many of whom are moving toward multiple clients including craft brewers. Craft brewers sold an estimated 13M barrels in 2012 and taking a 6.5% sales share by volume and 10.2% by dollars in 2012; growth of the craft brewing sector in 2012 was 15% by volume and 17% by dollars ("Craft Brewing"). Craft brewer retail dollar value in 2012 was estimated at $10.2B, up from $8.7B in 2011; additionally, the Brewers Association reported 409 brewery openings and 43 closings in 2012 as of March 2013 ("Craft Brewing"). As the craft brewers struggle to build distribution networks, more independent distributors are beginning to carry their products (Ascher 10). The dominance of non-price competition, especially advertising, in the beer industry proves to be another barrier for new entries. National brewers have more advantages since they are able to achieve economies of scale in advertising through bulk media purchases and umbrella brand marketing whereas local craft brewers spend more than twice that amount on marketing and advertising per barrel (28).

Whereas high entry barriers and duopolistic environment severely limits competition in the traditional brewing industry, price and advertising remain important in brand rivalries. Domestic beers may be separated according to price (e.g. popular or discount brands) with imports and prestigious crafts priced above premiums and super-premiums (25). However, as taste differences may be indistinguishable to ordinary consumers, some traditional beers may be sold as premiums at a higher price; Budweiser, sold in the premium category at premium price is an example (25). An example of price competition is between Miller and AB back when Miller introduced the Lowenbrau in 1974. It was a U.S.-brewed beer with foreign cache; Miller stressed its German name and heritage to create the allusion that it was an import and priced it as a super-premium (below price of imports) in order to compete with AB's Michelob; it substantially cut into Michelob's market and AB filed a complaint with the FTC, which made Miller to clarify in the label that the beer is a product of the USA (25). Once threatened by upscale imports and upstart craft brews, duopolists ABI and SABMiller now seek to utilize variety to their advantage, competing with each other in creating products with the best taste, most interesting packaging, and most alluring brand image; and like other successful duopolists, ABI and SABMiller have relaxed price competition (Pearlstein). Furthermore, discounting in the beer industry is not a good long-run strategy because while it might bring additional sales it loses revenue for the brewer and distributor and sustained low prices also cheapens the brand image; this leads advertising to be the stronger influence as evidenced by the brewers' spending approximately 10% of their revenues on advertisement (25).

The mega brewers' switch to focus on variety further escalates competition in the craft beer sector. In 2011, overall U.S. beer sales were down by an estimate of 1.3% by volume while craft brewing saw a growth of 13% by volume. Despite the relative small market share held by craft brewers, some mere 5-6% in volume, they deliver higher profit margins and attract consumer spending. With traditional beer sales stagnant in developed markets, craft beer is the sector that has actually seen growth (6.5% in sales by volume while traditional beer sales have been flat), inducing the mega breweries to tap into this market by launching beers that approximate the craft taste profile (Blue Moon by Coors), purchasing stakes in some craft breweries (MillerCoors in Terrapin Beer Company), or outright acquiring craft brewers (AB and Goose Island Brewing). These big brewers even housed these specialty brands in newly created divisions to distance them from their billon-dollar household brands (AB's Green Valley Brewery and MillerCoors's Tenth & Blake Beer Company). The mega producers' actions, however, have sparked outrage in the craft brewing community, who see these beers as "imitators, donning a craft beer costume – bold label designs and quirky names – in an attempt to deceive customers" (Wilson). In the easy-to-enter and creative craft beer market, price competition is relatively minor as non-price competition, especially product differentiation, dominates the industry. The 2,000+ craft brewers in the U.S. compete fiercely against each other and big brewers to create unique products by varying the color, flavor, strength, ingredients, production method, history, or origin of the beer. Moreover, brewers innovate by producing low carbohydrate beer (ABI's Budweiser Select) or using creative ingredients (Miller Chill is a light lager that is brewed with salt and lime).

According to IBISWorld, profit margins for the industry have declined at an annualized rate of 11.4% over the time period of 2005-2010 and margins are expected to tighten to 11.6% by 2017, due to price competition among the major brewers as well as lower-margin craft brewers cutting into the market shares. Furthermore, government belt-tightening can also lead to tax increases, further affecting profits; however such activities are expected at the state or local level rather than nationally. IBISWorld also reported that growth and volatility in input prices is expected to ease over the next 5 years and limited price competition between the major producers, resulting in some improvement in profitability. Profit levels are expected to grow to 4.4% of industry revenue with an anticipated profit of $1.23B in 2015; as craft brewers generate competition there will be fewer entries in the next few years and so annualized growth is projected at 2.7% in 2015. The smaller number of entrants will decrease industry expenditure and boost the aggregate profit margin (Kaczanowska 7). ABI boasted a profit margin of 32% of revenue, significantly higher than the industry average of 26%; this higher margin is also attributable to media deflation, which allowed the company to purchase more advertising at lower costs ("The Beer Industry"). ABI is also expecting significant opportunities to expand profit margins in the domestic Mexican business with the approved Modelo deal (Petroff). SABMiller reported an unexpected 0.3 percentage point increase in organic profit margins in 2012's first half and stated that gains in Latin America and Africa offset European declines and the acquisition of Foster's Group Ltd. increased profitability (Fletcher). On Forbes Magazine's ranking of the world's largest public companies, ABI placed 76 with profits of $7.2 B and SABMiller placed 188 with profits of $4.3 B according to values calculated in 2013 ("The Word's").

The most recent havoc in the market comes from ABI's acquisition of the remaining 50% of Modelo for $20.1B. Crucial for ABI's international growth, the

Modelo deal with solidifies ABI's presence in emerging markets in Mexico and other Latin American countries. In January 2013, the Department of Justice filed an antitrust lawsuit in order to block the deal, arguing that it would substantially lessen market competition and give ABI too much control in the U.S. beer market, potentially creating a monopoly with limited choices and rising prices. In response, ABI proposed to divest Modelo's entire U.S business to Constellation Brands, Inc. including its 50% stake in Crown Imports (the company that imports Corona into the U.S.), the rights to Corona and other Modelo brands, and Modelo's newest, most technologically advanced brewery located close to the U.S.-Mexico border (United States). This is to sustain competition in the beer market by ensuring that Constellation is able to compete using Modelo brand beers independent of relationship to ABI or Modelo. This transfer of brewing assets and the perpetual ownership of Modelo brands necessarily result in the purchasing company taking the place of Modelo as a competitor in the U.S. market (Wyatt). Constellation, one of the world's largest wine companies who already co-owns Crown with Modelo, will pay $2.9B for perpetual and exclusive licenses of Modelo beer brands in the U.S. and $1.85B for full control of Crown (Reilly).

There also have been ongoing rumors regarding a potential merger of ABI and SABMiller since the Modelo deal. I don't think the government will approve such deals unless serious concessions are made to maintain competition in the U.S. market, as was the case of ABI and Modelo; such might be that SABMiller's U.S. operations are to be sold off to another company, independent of SABMiller and

ABI, who then essentially takes the place of SABMiller and maintain the competitive environment. Apart from spinning off SABMiller's U.S. business to another company as prerequisite for the merger, I also think that as long as there is some type of price control, a combined ABI and SABMiller won't be as bad because there's competition from craft brewers and wine/spirits sector to sustain innovation in the industry and price will be under regulation so consumer prices will not skyrocket (Prices did rise after the 2008 mergers, but most of it was in accordance with the rising prices of input prices. This shows that having a duopoly did not significantly affect prices). It might even be possible that the growing craft brewery sales will prompt traditional brewers to cut prices in order to remain competitive in the general market. While ABI and SABMiller may benefit from merging due to their complementary global footsteps, the deal would not only be highly complex and expensive but would also involve antitrust issues. Although the merging of these two beer conglomerates may not appear too substantial in cost saving in the U.S. due to their already grand sizes and utilization of economies of scale, from a global perspective it would be profitable for them to gain greater world market shares, particularly as internal competition (craft beer) and external competition (wine/spirits) as well as consumer behavior cause beer sales in the saturated North America and Western Europe markets to stall. Because of that, the emerging markets in Asia (China and India), Latin America (Mexico and Brazil), Africa (South Africa, Ethiopia, and Nigeria), and Eastern Europe (Czech Republic and Russia) prove to be very lucrative. As a remedy, I think the U.S. government can disincentivize mega mergers by imposing higher taxes on products by these joint companies and effectively reduce their profit margins in order to discourage such behavior.

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