In time of crisis – side-show or sword of Damocles?

Potential effects of the economic and financial crisis on the German beverage industry

Author: Meik Forell

The economy of the EU is expected to stagnate in 2012, and it is presumed that the Eurozone will see a recession. More and more European countries are fighting a vicious cycle of excessive debt, structural problems, shrinking economic figures, and radical austerity programs.

Not long ago Spain became the latest, though likely not the last, country to huddle beneath the umbrella of bailouts. In the debate about how to overcome the crisis, hardly a day goes by without new political suggestions. Besides the growth pact and euro bonds, high taxes and compulsory loans for upper income brackets are being discussed in many euro countries.

Previous measures have not been able to calm the capital markets. The European stock markets have been on a roller-coaster course since the beginning of the year. The bottom line is that the Euro STOXX, which represents the European stock market, has dropped by nearly five percent since then.

The crisis has not, however, affected all of the Eurozone countries and sectors of the economy on the old continent equally. The last holdouts today include both Germany and—at a first, superficial glance—the beverage industry.

A robust labor market, rising disposable income, and high consumer confidence: Germany can expect economic growth of one to two percent in 2012, even after forecasts have been lowered. Despite relatively moderate austerity measures at home, new debt was significantly lower than expected, and a balanced national budget is within reach. The OECD even sees Germany as being at the beginning of a prolonged growth period. The capital markets appreciate Germany's position as the exception in the Eurozone. Since the beginning of the year, the German stock index has risen by five percent, bucking the European trend. The large European brewery companies, too, have successfully defied the crisis so far. With the exception of Carlsberg, the "Big Four" have increased their profits in the last fiscal year—some by a significant degree. Market values rose between 13% and 33% in the first six months of this year for SAB Miller, Heineken, and AB InBev. Carlsberg shares, rising by "only" 10%, bring up the rear, though they are still far superior to the broader European market. Breweries are perceived as extremely welcome relative islands of stability in a very stormy and turbulent sea.

Does this imply that the beverage industry, especially breweries, is recession-proof and can look to the near future without worries, especially in Germany? Definitely not!

This industry is indeed much less sensitive to the overall economy, and thus more stable, than other economic sectors. Global beer producers also have wide-ranging portfolios of brandname beverages at various price points, both in industrial nations and in emerging countries. This makes it easier for them to stand up to regional economic recession.

Nevertheless, stability must not be mistaken for immunity. Growth in volume and profits at the "Big Four" are increasingly supported by emergent markets. In Europe, positive results are maintained primarily by efficiency improvement programs and rigid cost and cash management. In some markets that have been strapped by the crisis, such as Greece, even some large brewers have experienced sensitive drops in sales and financial losses in the mid two-digit percentage range. In addition, "German angst" is increasingly spreading too many other European countries. The trend towards discounting and low-cost brands is increasing, and beer is rather consumed at home instead of at restaurants and bars. The primary causes of this trend are surely not to be found in the recent economic and financial crisis. Such trends, however, are certainly strengthened by the high unemployment rate among young people, one of the main target groups for the large brewers' premium beers.

For the less diversified and internationalized German brewers, the crisis is having impacts on various fronts. Sales growth in 2012 will again follow a tradition that has been going on for about two decades: at cumulative 2.2%, however, the domestic drop is more severe than last year. Considering the special German situation, however, these developments probably have little to do with the financial and economic crisis. Exports, in contrast, will be hit particularly hard, which is of special importance as exports have been touted by many, especially recently, as a panacea for the chronically weak growth of the German market. Sales in the financially strapped chief export market of Italy are crumbling, and in the truly emergent growth markets, German brewers have very little presence. Intensifying export activities, however, appears to be more difficult than ever, especially in a time of crisis, due to increasingly protectionist policies in some countries.

The greatest challenges in the domestic market existed even before the crisis, but have intensified continuously. Cost increases in recent years have—unlike the situation in many other countries—been passed along only minimally to the consumer. In an intensively competitive market environment, discounted prices have risen to nearly 70% of sales, and discount pricing has been accompanied by a previously unknown arms race in sales promotions, particularly in recent months. Despite tentative attempts, the timing is conceivably bad for price increases. The raw material and energy markets have taken a breather for the last few months. The significant rise in prices in recent years could continue in the medium to long term, in a muted form, but will be only of limited use as an argument for higher prices, particularly during the crisis. Little support is likely from increased trade due to the activities of the antitrust agency. An across-the-board price increase, especially a successful one, is not likely in the near future, despite sporadic pushes.

Wage increases could be significant in this context. It can be expected that the pilot contract in Bavaria, retroactive to March of this year, will serve as a benchmark for negotiations in other German federal states. With an increase of 2.9% in both 2012 and 2013, cost increases will be significant, particularly for medium-sized brewers, and it will be difficult to compensate for them with increased productivity. Perceptibly stronger government regulation of contract workers will also have an effect. In this area, the German brewers are hit hard by the relative strength of the German economy: Contracts such as these would be inconceivable in other euro countries today. This makes an increase in export activities even more difficult.

Falling sales, limited growth prospects, rising costs, and a constant price trend—conditions will remain tough. The packaging and product mix is no help, either. Rather the opposite: the continued trend toward small packages and the shift from restaurant sales to retail continue to put pressure on profit margins. There is a small glimmer of hope. The low price trend appears to have come to an end in Germany, in contrast to many other European markets.

All of these developments were not triggered by the economic and financial crisis that has lasted, with a brief interruption, since 2008. At most, they have been reinforced in certain areas. One exception is financing.

It would certainly be premature to speak of a credit crunch at the moment. In this time of financial crisis, and with increasing requirements for equity capital and risk hedging at banks under Basel II and, starting in 2013, Basel III, this risk has not been eliminated. Some large brewers have already reacted to this in recent months. Cash flow has been increased disproportionally to profits, using strategic initiatives. Thus the debts accumulated from acquisitions in recent years have been steadily reduced. In parallel, residual debt has been refinanced or converted in a favorable interest rate environment. Bond issues are enjoying increasing popularity. Heineken, for example, issued new bonds in March of this year with a total volume of 1.35 billion euro. The portion of debt financed by bonds is now 28%.

Similar opportunities are not currently available for the relatively small, unlisted German brewers. Quite the opposite: comparatively lower returns internationally, and even losses, are placing even existing financing under pressure in many cases. It is practically inconceivable that additional latitude in financing will be forthcoming. This makes it even more difficult to define and implement successful strategies to find a way out of the growth and margins trap.

In summary, the crisis in its current form does not affect the German beverage industry dramatically, but it reinforces certain areas of the already difficult market conditions. The sector cannot profit from the relative strength of the German economy.

If the crisis should escalate further, things would look a little different. A breakup of the Eurozone would strike the German economy a severe blow. Even the beverage industry, which is relatively independent of the overall economy, would be battered, not only in the export market—due to the expected appreciation of the currency—but also domestically.

This scenario may still not be the most probable, but it cannot be considered completely inconceivable either. Against this background, it is quite surprising that many German breweries, as of today, are barely addressing the crisis strategically, and are practically unprepared for a euro meltdown.

Author:

Meik Forell has many years of experience both in management consulting and the consumer goods industry, most recently as Managing Director in the area of Finance, Human Resources, and IT. In 2009, together with Alle Ypma, he founded the Forell & Ypma partnership for corporate consulting in Hamburg.

Forell & Ypma is a management consultant firm specializing in consumer goods and retail, particularly in the beverage industry.

For further information please check our website www.forell-ypma.com.