description:

Quilmes Industrial (Quinsa) is a very high quality business with excellent returns on capital. Its stock sells at a cheap price and a change of control is going to occur.

Quinsa is the dominant beer brewer in several South American countries. Its beer brands account for 79% of the market in Argentina, which is the company's main market (I will tackle Argentina issues in the Q&A). Quinsa also controls 97% of the market in Bolivia, 95% in Paraguay and 98% in Uruguay. One of the hallmarks of a great business is very little competition and as the Nielsen figures indicate, Quinsa's competitors have not been very successful going up against the company. To make matter worse for the competition, Quinsa acquired the operations of the #2 competitor in its markets two years ago and thereby increased its lead in Argentina, Paraguay and Uruguay. Also as a result of that transaction, AmBev became a large shareholder of Quinsa. AmBev will not be doing business in Quinsa's markets except through its interest in Quinsa. This removes the threat of a competitor entering from neighboring Brazil.

What are the competitive advantages that allow Quinsa to maintain its monopoly-like position?

Quinsa is the lowest cost producer.

The company produces a greater volume of beer than any other local competitor so it reaps advantages from economies of scale. Its facilities operate at higher capacity utilization rates so fixed costs are spread over large quantities. It purchases more bottles, more crown-tops and other inputs than its competitors so it has an advantage in buying inputs cheaply (interesting note: Quinsa owns the farms that produce much of the barley and its developed barley strains account for nearly all the barley produced in Argentina). Quinsa's cost of goods sold per liter is among the lowest in the world, let alone the lowest in its markets (Quinsa manages to make a 54%-56% gross margin on net revenue of only $0.345 per liter. For comparison, Anheuser-Busch gets net revenue of $0.94 per liter but its gross margin is only 40%). This discourages foreign competitors from entering the market as they are unlikely to be able to match prices.

Quinsa has strong brands.

The phrase "strong brands" can be an over-applied investment banking sales pitch but in this case Quinsa's brands are a true source of durable competitive advantage. Beer is a product that consumers choose by brand instead of price (the next time you order a beer at a bar or a restaurant, notice if you even look at the price before you order). Quinsa has ingrained its Quilmes brand in the minds of millions of beer drinkers in Argentina with countless television commercials, billboard displays, radio spots and other advertisements over much of the modern part of its 100+ year history. These advertisements are a Pavlovian bombardment of positive associations for the Quilmes brand: beautiful people, parties, soccer, music, national pride, etc.

Additionally, millions of these beer drinkers have had dozens of positive experiences over their lifetime drinking Quilmes beer. If you add to this mix the chemical reinforcement properties of alcohol, the result is a population with a deep-rooted affinity for Quilmes. This "share of mind" is the same thing that Buffett describes as Coca-Cola's most valuable intangible asset. It is very difficult for a competitor to replicate this because they'd first have to spend years advertising to build up the necessary number of positive image associations in people's minds. And they'd have to spend years trying to associate their brand with millions of positive taste experiences. Quinsa has already been "training" its population for decades.

Besides the obstacle of time, the competitors have the obstacle of money. Quinsa's competitors would have to spend a disproportionately large amount of their budget on advertising to match Quinsa. Quinsa spends over $55 mil per year on advertising. This amount is more than the local beer revenue of many of its competitors. Quinsa has also locked up certain key sponsorships such as the national soccer team and popular club teams.

Quinsa dominates the channels of distribution.

Quinsa's beer is available at over 440,000 points of sale. Many of these points of sale are either covered by the company directly or serviced through independent distributors. There are 800 of these distributors and Quinsa has exclusive arrangements with nearly all to sell only Quinsa products. Quinsa happens to also be the largest Pepsi bottler in a few of its countries so its negotiating power with distributors is compounded. As a result of its overwhelming market share, Quinsa is able to spread its volume over several geographically-dispersed distribution centers whereas competitors can support only one. This creates a cost advantage in transportation expense.

The comprehensive coverage provided by the numerous points of sale means that Quinsa's beers are nearly always readily available, a key in developing favorable consumer consumption patterns. Whenever a customer wants a Quilmes, one is available. When I visited Argentina, sometimes a 2nd beer choice was simply not available.

Enough qualitative stuff, numbers please.

Quinsa trades at 5.98x 2005E EBITDA. The multiple of 2004 EBITDA is 6.75x. The 2005 estimate is a forecast from a valuation report commissioned to justify the price offered by InBev to AmBev shareholders, so there was an incentive to skew the value of AmBev's stake in Quinsa lower. This estimate has EBITDA growing by 12.9% in 2005 despite the fact that EBITDA grew by 48% last year (even with a 32% increase in advertising spending in Argentina). Quinsa is on pace to surpass the forecasted EBITDA, as it grew by 28% in the first quarter of 2005 (Quinsa does not publish quarterly results but you can find it if you dig into the filings for AmBev). Winter here is summer down there so 1Q 05 is one of the 2 key selling periods. The calculations I present here are based on the conservative EBITDA forecast minus certain items I subtract to adjust things to US GAAP.

EBITDA has limitations of course but in this case it may be the most important metric because it is the key variable in a takeover formula that I will explain later. Also, because of the importance of this EBITDA-driven takeover formula I believe the company is currently overspending on capex (i.e. EBITDA-capex may understate the cash flow generation ability of the company). It trades at 9.19x 2004 EBITDA-Capex and 9.18x 2005E. I am using actual capex, not maintenance capex and not making any adjustments for overspend. The EBIT multiples are 9.88x 2004 and 8.07x 2005E.

The company's blended income tax rate is 34.5%. However the company has $196 million of accumulated tax loss carryforwards so the cash paid for income tax has been materially lower. Even at a full tax rate, the valuation multiples are very reasonable for a company with 60% pretax returns on tangible capital and high double digit cash flow growth rates. Quinsa's high return on capital is not apparent at first glance because the financials are prepared according to Luxembourg GAAP, which does certain strange things like recording treasury stock as an asset as opposed to a reduction of shareholders' equity. You have to make some adjustments to get a clear picture of the true economic return on capital.

For those of you who want comps, these are the 2005 EBITDA multiples for some other global brewers. These are Morgan Stanley's figures.

AmBev $30.02 per share 9.3x
Anheuser-Busch $46.54 10.4x
Fomento Economico Mexicano $57.59 6.5x
Grupo Modelo $31.10 8.6x
Heineken $31.50 7.0x
SABMiller $15.30 7.1x

Change of Control

When AmBev exchanged its operations in Argentina, Paraguay and Uruguay for a stake in Quinsa in 2003, it entered into a put/call agreement with Quinsa's controlling shareholder. The agreement gives the controlling shareholder the right to sell its stake to AmBev at a price determined by a formula in Schedule 1.04 of the agreement. This put right is exercisable annually. The next exercise date is in April 2006. If the put is not exercised in the next few years then AmBev has a call option to purchase the shares at the formula price. When there is a put and a call struck at the same price it is bound to be exercised by one of the parties.

The formula is not simple enough to include in this write-up but it essentially values LQU at the greater of (1) 8x EBITDA and (2) the trailing EBITDA multiple for AmBev. It then applies some discounts to determine the number of AmBev shares that would be issued for LQU shares. According to my calculations, the formula would have produced a sale price of $48.25 per share of LQU if the put had been exercised in April 2005. Applying the various discount factors would have left a price of $38 realizable in the form of AmBev shares. As I mentioned earlier, EBITDA for 2005 could be substantially higher than last year so if the other variables remain the same then the put price could be higher at the exercise date in April 2006.

Why should we care if 55% of the voting power is put to AmBev? The European Union adopted the Takeover Directive in March 2004 to harmonize takeover laws. It specifies mandatory bid requirements to be adopted by member states for acquisitions of companies in the EU. If an acquirer obtains voting control of a target, the acquirer must follow with an offer for the remaining public shares. The offer must be made at an "equitable price", which is defined as the highest price paid by the acquirer for any shares within the last 12 months (EU members can make this as short as 6 months). If control of Quinsa transfers to AmBev at $38 per share for example then laws implementing the Takeover Directive would require a mandatory offer to minority shareholders at $38 per share.

I think that this is an attractive situation even without the possibility of a mandatory bid. AmBev and Quinsa's controlling shareholder have demonstrated an interest in increasing their ownership percentages through share purchases and company buybacks. In August 2004, the company purchased 41% of the float through a tender offer. So far in 2005, the company has purchased another 4% of the float through open-market share repurchases as high as $24.96 per share and as recently as June 15. Also, page 21 of the recently filed Form 20-F mentions that the board has been considering a transaction involving a buyout of the minority shares. The company has been so eager to buy up shares that when it ran into a constraint created by Luxembourg law (a company cannot continue buybacks if it depletes certain treasury stock reserves) it decided to go through the hassle of changing its fiscal year twice, creating two stub periods, and holding several annual/special meetings in order to approve the necessary reserves. It's worth mentioning that this little technicality, which has been keeping Quinsa out of the stock market for the last few weeks, will end a few days from now. On July 15, 2005 there is a special meeting to get the flexibility to resume the share repurchase program and authorize certain dividend payments.

Incidentally, Luxembourg law does not give acquirers minority squeeze-out rights so the controlling shareholders cannot force a going private transaction (a Luxembourg lawyer explained the rationale to me this way: "if you are the owner of shares then why should anyone have the right to take those shares away from you at a price you don't want?").

Other dynamics and catalysts

Quinsa is a great business with rapidly growing cash flow and it is available at a cheap price. These core factors are enough to produce an attractive investment on their own. As a bonus, there are several additional factors converging together that could make this a really great opportunity.

The put option formula creates an incentive for the controlling shareholder to maximize EBITDA and reduce shares outstanding. The controlling shareholder knows that it will be parting with its stake in Quinsa, which it has held for generations, so they are motivated to optimize the inputs in the put option formula.

To maximize EBITDA, the company has recently been raising prices at a healthy pace. Since the execution of the put/call agreement, Quinsa raised beer prices in its primary market by 10% in March 2003, and then another 10% in September 2003. Prices were raised again in 2004, with the most recent increase (8% on a consolidated average in December 2004) not yet fully reflected in the trailing numbers. Run-of-the-mill businesses cannot withstand large price increases like this but with a wide-moat business like Quinsa you can raise prices without losing volume. Quinsa's volumes have actually been increasing despite the price hikes (2002: 7.619

mil hectoliters of beer, 2003: 9.921 mil hectoliters, 2004: 10.396 mil hectoliters – remember, though that in 2003 Quinsa made an acquisition). As the volumes have gone up, cost of goods sold per hectoliter have fallen (down 10% in 2003, down 2% in 2004). Equally impressive is the decline in administrative and general expense on an absolute basis even though revenues have grown substantially – the controlling shareholder is very serious about maximizing EBITDA. A wide-moat business like Quinsa has enormous latent earnings power that is not reflected in the income statement until management decides to start raising prices. The put option has been a catalyst for Quinsa to flex its pricing muscle.

Because the put option formula does not penalize for capex spending, the company has begun to ramp up capital investments. The capacity of a malting plant in Argentina is being doubled for $27 mil, a new bottle facility in Paraguay is being built for $10 mil and a new soft drinks production line is being added for $10 mil. These investments should facilitate higher revenue, higher EBITDA and ultimately, a higher sale price for shareholders.

The impending change of control has also encouraged the company to continue doing the right things in returning capital to shareholders and deploying excess cash. Last year Quinsa purchased several minority interests in key operating subsidiaries, which will increase the proportionate EBITDA credited in the formula. The company has also done the previously mentioned share buybacks and after July 15, 2005 it will have the power to buy the equivalent of 11%-13% of the current float.

I like the fact that the people piloting the ship have been passing up opportunities to exercise their put option at a price that is much higher than the publicly-traded price today. The put was likely not exercised last year because of the anticipated price increases and other EBITDA-maximization efforts. EBITDA ended up growing 48% in 2004. I believe that the anticipated effect of price increases and EBITDA growth is the main reason that the put was not exercised in April of this year. I do not mind the deferral of the change of control if insiders think that EBITDA is going to increase at a pace sufficient to compensate for passing on a massive premium today.

catalyst:

Investor recognition of a great business.
Resumption of buybacks on July 15th.
Change of control at a large premium, as early as April 2006.
Controlling shareholders may offer to take the company private before then.
Recent price increases and future increases will begin to demonstrate the company's true earnings power.