

**The New Pepsi Challenge:
Would you rather be an Exclusive Distributor or the Brand Owner?
September 1, 2010**

Earlier this year, PepsiCo acquired 100% control of its two largest franchised bottlers, PBG and Pepsi Americas, paying \$7.8 billion for the remaining interests it did not already own. Prior to the acquisitions, Pepsi owned 33% and 43%, respectively, of its two largest franchised bottlers. The Coca-Cola Company then announced the proposed purchase of CCE's North American operations, its 34%-owned largest bottler, for \$12 billion (mostly by assuming a big chunk of CCE's existing debt). Coke's deal is expected to close by the end of 2010.

Combined with the prior formation of ABInBev and MillerCoors, the beverage industry has dramatically changed in the past two years. As a result, the value of distribution rights has been re-affirmed and the strategic role of the exclusive distributor has escalated.

Road to Market

Pepsi now owns an estimated 80% of its North American distribution and Coke soon will control an estimated 86% of its distribution system (including direct sales through Coca-Cola's fountain syrup jobber system, which may account for a third of the 86% estimate). As a result, the recent billion dollar mega-bottler acquisitions will allow Pepsi and Coke to cut costs, be more flexible on pricing, and offer mega-retailers better and more uniform deals. These two leading brand owners also will have greater freedom to go to market via 1) central warehouse delivery (a serious prohibition in an all exclusive franchise system) or 2) the traditional direct store delivery method.

Over the past decade new beverage products have proliferated and some key mega-retailer customers have demanded centralized warehouse deliver of franchised beverages. Nonetheless, we continue to believe that the DSD method remains far superior for delivering the most products to the most consumers at the lowest cost. Thus, in this new environment, competing brand owners seeking to "piggy back" on the established Pepsi and Coke distribution networks likely will incur additional costs (like royalty payments) and other hurdles in order to gain *access to the marketplace*.

The vertical consolidations by Pepsi and Coke will allow these lead brand owners to *profit from future attempts by other brand owners to gain access to the*

marketplace through the Pepsi and Coke systems. In the U.S., independent distributors with exclusive and perpetual rights to sell and distribute trademarked brands historically have represented a brand owner's sole *access to the marketplace*. For decades this road to market has been an efficient means of distribution for beverages of all makes. The lead franchisors now are about to capitalize on the indispensable position of the exclusive distributor in the beverage marketplace.

In recent years non-traditional or so-called "alternative beverages" produced by emerging companies have accounted for a large part of soft drink industry growth. Traditional carbonated soft drink volume has been soft. The road to market for many new and innovative products was made possible by "piggy backing" on the established Pepsi, Coke, and beer distribution systems that have been in place for generations. By acquiring the vast majority of their respective distribution systems, the lead soft drink brand owners will now increase their options for acquiring future growth (i.e., buying out a competing brand owner seeking distribution) and protecting their own portfolio of brands, while creating new challenges for the smaller competitors.

The changing dynamics of beverage distribution and the battle over managing and gaining *access to the marketplace* will continue to guide strategic decisions for dominant and secondary brand owners and distributors. From soft drink companies buying bottlers to brewers attempting to increase their ownership of distributors, change in beverage distribution has never been so quick and defining. It is clear that "*access to the marketplace*" will be a challenge and a very valuable asset at the same time.

Through distributor acquisitions, Coke, Pepsi, and the major breweries achieve the following immediate benefits:

- manage pricing promotion and brand "investment" decisions
- get closer to the consumer to understand trends
- ability to react to consumer trends more quickly, changing out shelves/inventory and adjusting pricing accordingly
- reduce # of people (i.e., sales people, distributor management team) ... don't need a brand owner salesman calling on a distributor
- less politics (i.e., do not need to deal with family issues or sensitivity of distributor relations)

Beverage Distribution Alternatives

The lead brand owners' current shift to (a) acquiring distribution assets and (b) potentially influencing *access to the marketplace* may set limits for some market

players – direct and indirect competitors as well as bottler/distributor “partners.” However, neither Pepsi nor Coke’s vertical integrations fundamentally will restrict the availability and distribution of alternative beverages. When considering the total refreshment beverage market of alcoholic and non-alcoholic beverages, the majority of markets throughout the U.S. will have at least the following four major distribution networks available to brand owners – Pepsi, Coke, ABInBev, and MillerCoors.

The four major beverage distribution networks now in place will continue to compete aggressively with comparable assets and financial resources to offer beverages to retail customers nationwide. Additional beverage distribution resources also will be available through expanding mega-retailer delivery systems, and by food wholesalers like McLane Company. Thus, existing and emerging alternative beverages will enjoy significant competition for their brands and numerous choices for distribution of their brands, especially among independently-owned bottlers and beer distributors seeking to expand their portfolios beyond the products offered by their principal franchisor.

Furthermore, in light of the heavy capital investment in distribution, it would come as no surprise to us if Pepsi or Coke were to “re-franchise” its entire U.S. distribution system in three to five years “to create the next generation of high return opportunities.” The future re-birth of franchised distribution could be similar to current Coke and Pepsi systems outside the U.S. – distribution systems owned and operated by large, independent bottlers (though ideally without public ownership of bottlers that may conflict with the interests of the franchisor).

Through the future “re-franchising” and selling off the bottling facilities and/or franchise territories it owns, Coke and Pepsi could write new distributor agreements with its new business partners and raise a large amount of capital when needed. *This is what Coke did in 1986 when it gave birth to CCE.* The soft drink leaders also then could choose whether or not to participate via equity investments in new, large, privately-owned U.S. anchor bottlers who would be more closely aligned with (a) the demands of a diverse marketplace increasingly dominated by mega-retailers, and (b) the interests of the franchisor.

Value of “Golden Cases”

Ironically, in the two recently closed Pepsi mega-bottler acquisitions the shoe was on the other foot as Dr Pepper Snapple Group (“DPS”), the third-ranking brand owner in the soft drink industry, actually strengthened its *access to the marketplace*. As it turned out, the two mega-bottlers that Pepsi sought to acquire also were licensed franchisees of DPS for a small but significant percentage of their total volume. If DPS were to disapprove the transfer of its brands to the

buyer, the loss of the incremental profit contribution to PepsiCo would have reduced value significantly, likely killing the deals.

DPS showed the muscle and value of incremental “Golden Cases” by entering into a 20-year renewable “Distribution Agreement” with PepsiCo that gave Pepsi the right to hang on to these “Golden Cases” in perpetuity so long as Pepsi abides by the terms of the Distribution Agreement. *Pepsi paid \$900 million to DPS for the exclusive perpetual rights to the DPS brands in the exclusive territories of the two mega-bottlers it purchased.* In essence, Pepsi paid twice for the DPS franchise rights of the two bottlers.... demonstrating the valuable nature of “Golden Cases” and their calculated worth.

DPS gained leverage in this arrangement because it retained termination rights. Also, Pepsi must adhere to DPS performance provisions AND maintain a Chinese wall of confidentiality between its Pepsi and non-Pepsi business. The Pepsi-DPS Distribution Agreement also potentially lays the foundation for similar arrangements in the beer industry, by showing that a competitor may handle another brand owner’s brands on an exclusive, perpetual basis without conflict – an interesting twist in distribution. Also, a “Golden Case” payment by Coke to DPS may be in the offing as a result of the pending acquisition by Coke of CCE – perhaps in excess of one billion dollars – since CCE handles a greater volume of DPS products in its territory compared to the two Pepsi mega-bottlers.

Financial and Economic Rationale

Brand owners recognize that the cash flow of distributors is stable and predictable. Brand owners may be motivated to acquire distributors because they view a distributor as an extension of the brand owner. The stability, predictability, and inter-dependence of brand owner and distributor reflects a low cost of capital. Therefore, significant prices are being offered for the stable, predictable cash flows of distributors. In fact, the blue-ribbon investment bankers who rendered the fairness opinions of value in the two Pepsi mega-bottler deals calculated a cost of capital in the range of 7-8%, which is a low hurdle rate compared to the risk-adjusted return on investment of most industries in the U.S. and reflects the relatively safe and stable nature of beverage distribution.

Paradoxically, investments in the distribution side of the beverage business always have generated a lower return on capital than investments in “pure” franchising (which consists mainly of tax deductible marketing expenditures). This conclusion is supported by the underperformance of PepsiCo’s stock price relative to the S&P 500 in the months following its announcement of the mega-bottler acquisitions. Nonetheless, a franchisor’s pursuit of distribution assets in the well-developed U.S. beverage industry is perfectly rational economic

behavior, because the lower returns available from distribution still exceed the 7-8% minimum returns required by the franchisor's shareholders.

In most of the world outside the U.S. (where Coke generates most of its profits) the locally-owned, independent, exclusive franchise system publicly advocated by Coke is in full swing. The vertical integration of franchisor and franchisee that we presently are witnessing in the U.S. may simply signify that Coke and Pepsi have run out of high yielding investment opportunities in the "pure" franchising business in this country. However, owning their respective distribution systems for now and therefore having the ability to manage *access to the marketplace* along with low levels of business risk provide huge future returns. Furthermore, on-going annual capital expenditure requirements are low compared to the cash flow generated, especially for bolt-on brands or "Golden Cases."

In our opinion there is no doubt that the senior management of Coke and Pepsi fully understand the edict and requirement of maximizing "Return on Investment" and "Value Creation" for its shareholders. Therefore, as noted above, 3-5 years from now we very well may see a return to a franchise system in the U.S. built around different market dynamics that create "the next generation of high return opportunities."

Outlook For Independent Exclusive Distributors

Independent exclusive distributors – whether soft drink or beer – undoubtedly will encounter hurdles in a turbulent and uncertain future in the months and years ahead. Nevertheless, so long as there remains a mandate for a dynamic 3-tier system for soft drinks and beer, we conclude the following:

- No one can force an exclusive franchised bottler or distributor holding a valid franchise contract to sell his/her business. The industry's margin pool split will remain intact because the principal brand owners realize that distributors must operate near current gross profit levels to remain competitive and deliver value-added services to large and small retailers.
- The independent distribution platform for soft drinks and beer is an extremely valuable asset for all brand owners that use it, and to risk altering the existing franchise or 3-tier system risks permanently damaging the equity of the major brand owners.
- The outlook for growth, profitability, and re-investment in the beverage distribution business remains positive for strategic buyers as they continue to squeeze out redundancies through the acquisition of willing sellers.

- Brand franchise *exclusivity* and *perpetuity* are conveyed by the binding distribution agreements that exist between brand owners and exclusive distributors. These contracts will continue to support the premium value that buyers are willing to pay for beverage distribution rights.
- Opportunities exist for independent bottlers and beer distributors holding exclusive franchise contracts to create enterprise value through strategic partnerships and acquisition of “Golden Cases,” as the beverage industry continues to re-align brands and re-make itself.

For the exclusive bottlers and beer distributors who remain independently owned, now is the time to assess strategic options and brand acquisition opportunities to increase overall enterprise value. An exclusive beer or soft drink distributorship remains an enviable and valuable business to own. Brand owners hold the same view.

Ippolito Christon & Co. provides valuation and transaction services to bottlers and distributors of beer, wine, and spirits nationwide. Prior to co-founding Ippolito/Christon in 1986, Mr. Christon managed a group at Coca-Cola USA analyzing, structuring, and negotiating the transfer of ownership of Coca-Cola bottlers. In addition, he served as a director of several transferred bottlers. Ippolito/Christon is recognized nationally as an expert on the value of beverage distribution rights. In 2006, Mr. Christon was engaged by The Coca-Cola Bottlers' Association to provide expert witness consultation in the litigation between Independent Bottlers vs. The Coca-Cola Company and CCE. At issue was the potential harm that central warehouse delivery could cause to brand values.

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