Perils of a Grand Old Brand

Scarce growth prospects in Canada inspired Molson CEO Dan O'Neill to invade Brazil, where the beer business is as chaotic as Carnival. Anyone got a hangover cure?

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For anyone who follows Canada's largest brewer, it's hard to be dispassionate about Dan O'Neill. The Molson boss is either the guy who whipped a fat company into shape, or the American-trained carpetbagger who's slowly destroying a great Canadian institution; a leader who has culled mediocre performers, or a control freak who has caused talented people to flee; the visionary responsible for doubling Molson's operating profit, or a reckless CEO squandering a fortune on a South American misadventure. It all depends on whom you ask.

If you ask O'Neill, though, he's simply driven, and maybe a little bit misunderstood. "Am I a hard guy to work for?" he asks. "I'm really demanding on myself to deliver to shareholders. And my expectations for everyone are really high." As long as Molson is meeting its business plan, he says, "I'm really easy to work for, you know?" Which can only mean that for the past year, O'Neill has been a miserable guy to be around.

His tenure at Molson is a study in how quickly an executive can lose his hero status. O'Neill, a 51-year-old who has spent his life selling ketchup, soup and other consumer goods, joined the brewer in 1999 as chief operating officer (accepting a $2-million signing bonus and one million stock options), then immediately did all the right things. He closed breweries and sacked workers in a $150-million cost-cutting scheme, and fired Molson's long-time ad agency to shake up a lame marketing effort.

Elevated to CEO a year later, O'Neill completed the sale of the company's controlling stake in the Montreal Canadiens, to the delight of shareholders who had questioned Molson's attachment to a beloved, but money-losing, hockey team. The move sent a loud message to an impatient Bay Street. Sentimentality was out; for a change, Molson was being run by a hard-ass, and better still, a hard-ass with a pinpoint focus on selling beer and making money. He killed ailing brands like Old Vienna Light to save money. The stock, at $13 when O'Neill arrived, got up to almost $40 in little more than three years. He was sitting on a personal stake of some $25 million in stock and options by March, 2002. That's when he blew it.

On March 18, 2002, facing a home market with few growth prospects--indeed, facing portents that Molson's market share might even shrink--O'Neill took a fateful leap into the global league of the beer business, where he must play against a handful of European and American behemoths. Molson spent $1.14 billion to acquire Cervejarias Kaiser Brasil SA, the second-largest brewer in Brazil, then passed 20% of the operation to Heineken. O'Neill thought it a coup: Now he had control of Kaiser, the world's 13th-largest beer brand, and a nearly 18% share of a large, developing market. Brazil has the brew-loving demographics--half the population is under 29--that Canada lacks, and would give Molson the growth it desired. In theory.

So what has gone wrong? Everything. Molson's market share has crumbled to 12.1%, and the brewer has fallen to No. 3. Kaiser's sales volume fell 23% in the fiscal third quarter, a crucial selling period that coincides with the beginning of Brazilian summer. "It has been a disaster, basically," says Keith Graham, a fund manager at AGF Management Ltd. who has followed the company for years and who owns the stock in his mutual fund.

Worse yet, O'Neill's two biggest enemies--AmBev, the dominant brewer in Brazil, and Interbrew, parent of Labatt Brewing Co. Ltd. in Canada--agreed in March to a stunning $11.4-billion (U.S.) merger. Once the deal is completed, Molson will be competing against the world's biggest brewer, a company eight times its own size by volume, in both its main markets.

That's a headache O'Neill doesn't need. Kaiser's woes had already forced him to issue a profit warning in January, and to commit to spending "about a week a month" in Brazil trying to fix the problems. He has replaced the marketing director and scrapped part of the old sales structure. In its place, he has hired more

than 1,200 new salespeople and outfitted them with motorcycles so they can flit from one watering hole to the next, their Kaiser-branded wheels serving as moving billboards. The Brazilian beer war, O'Neill says, will be won in the trenches--"door to door, bar to bar."

Then he set out to change the beer itself. Kaiser, which accounts for most of Molson's Brazilian sales, was a tired discount brand, so the company relaunched it in February with a new taste, and revamped packaging and advertising. "All you would have to do is walk the streets in any of the cities and you would say, 'Wow, I'm starting to see your new beer already,'" O'Neill says as he prepares for another flight from Montreal to S{Isaquo}o Paulo. "But we have to demonstrate the success for anyone to buy into that."

At least he's realistic enough to know that people won't believe it's a turnaround until they see it. **Michael Palmer**, president of **Veritas Investment Research Corp**., thinks Kaiser is irreparable under Molson's watch. Selling beer in Brazil "is a business they don't understand. They have already been hammered," he says. "They're facing a dominant competitor [AmBev] with 65% of the market." At stake is O'Neill's legacy, and perhaps his job too. **Palmer** predicts the demise of both the experiment and the CEO: "I don't think they will be there two years from now," he says. "And I would be surprised if Dan is still at Molson by the end of the fiscal year"--next March.

The Brazilian and Canadian markets are as different as the countries' climates. In Brazilian supermarkets, beer is cheap and profit margins are thin--a can of Kaiser retails for about 0.9 reals, or about 40 cents (Canadian). Molson brewed more beer in Brazil than in Canada in fiscal 2003, yet earned just 7% of its profit there (before interest and taxes). It earned almost nothing in Brazil in the first nine months of fiscal 2004.

To make money in Brazil, you have to be successful in selling to the thousands of tiny bars and restaurants that dot Brazil's vast cities, where drinkers prefer tankard-sized 600-millilitre bottles, and margins are fatter. There are about one million places to buy beer in Brazil, compared with about 50,000 in Canada. In that fact lies both an opportunity and a complex problem. How do you get your suds to so many places?

Molson bought Kaiser from a group of Brazilian Coke bottlers, and continues to rely on their fleet of trucks to distribute its beer. It's the only practical way to do it, yet the arrangement is also the source of many of Kaiser's problems, says David Hartley, an analyst at First Associates Investments Inc. "The distribution guys are not salespeople. They're truck drivers. They're dropping off product and not really trying to sell it," he says. The Coke distributors make more money selling their own products than Kaiser. If they're going to push anything, it's cola.

The lack of devoted sales staff had another effect: Public consciousness of the Kaiser brand fell because of weak promotion at retail sites. O'Neill knows it, too. "You have to own the point of sale," he says. "If you go into a bar. . .you [have to see] posters of Kaiser up and a special price, and on the tabletops you have one of those little triangular tents and it says TRY THIS NEW KAISER.. . .Those are the types of controls you need to have."

Molson didn't have them. The company had provided refrigerated display cases, yet the bartenders wouldn't necessarily stock them with Kaiser. "There was competitive product in the

coolers we owned," says O'Neill, sounding surprised. The Coke bottlers couldn't fix these problems, perhaps because they typically did their business over the phone, "rather than doing the motorcycle and going street to street to street."

When asked what he wishes he had known two years ago about Brazil, O'Neill responds with a long silence, then finally says, "The effectiveness of the selling organization we purchased." (**Palmer** says the trouble should have been obvious: "If the Coke bottlers really thought it was such a good business, why exactly were they selling it?")

The mess was worst in S{Isaquo}o Paulo, which accounts for some 30% of the national market. Kaiser's volume plunged 31% in the region in just nine months, which is why O'Neill has concentrated more than half of the sales staff there--650 people. They visit the bars, pitch Kaiser to the barmen, hand out Kaiser-branded bottle openers and posters; the Coke guys drop off the cases later. Jason Bilodeau, an analyst at UBS Securities Canada Inc., has seen the operation, and said in a recent report that he found the new staff "highly competent and motivated. We would be surprised if these efforts did not have a positive impact on Kaiser's volume performance over the coming quarters."

"We needed the feet on the street," says O'Neill. "Quite honestly, we might have done it a little faster, but when you're in a new market, you need time to understand what's happening. We're being judged in Canada pretty harshly. But I don't know what acquisition anywhere in the world in the beer industry has paid out the next day."

Sales might improve, but whether Molson can ever sell enough in Brazil to justify its investment there is another question. The new staff is expensive, and Molson will be fighting for a long time to get back to the volumes it had two years ago. Kaiser will need to increase sales by 20% this year just to make up for ground it lost last year, Hartley of First Associates says. And Brazilian beer consumption, favourable demographics aside, is no longer growing so quickly--2.6% a year this decade, according to Molson's projections. That means Kaiser will have to recover by stealing market share from a much larger competitor, AmBev, and a hungrier one, Schincariol, which recently displaced Kaiser in the No. 2 spot.

Schincariol's recent success is a huge irritant for O'Neill. Schincariol itself reinvented its flagship brand late last year, rechristening it Nova Schin. Kaiser was flattened by its competitor's aggressive sales pitch. "Outdoor, TV, newspaper, with lots of different commercials--they spent a huge amount of money on production," O'Neill says. "The amount of money, yes, caught me by surprise."

But there's a twist, one that is a reminder that Brazil is not as orderly a place to do business as Canada. O'Neill charges that Schincariol, a private company, could never afford a massive marketing push if not for its clever evasion of the taxman. "If you add the taxes being paid by the beer industry excluding Schin, it's 100% of the taxes. The size of that campaign would have been very difficult to have otherwise."

The rest of the brewing industry--primarily Molson and AmBev--is lobbying the government to crack down. In any event, UBS's Bilodeau says that now the relaunch campaign is largely over, Nova Schin's appeal is already starting to fade.

Unfortunately, the same could be said of some of Molson's major brands in Canada. The industry's duopolistic dinosaurs--Labatt and Molson--have slugged it out for decades, so consumed with beating each other that they've failed to fend off the rise of more nimble competitors. In 1998, Molson said that it and Labatt owned about 92% of the Canadian beer market. Last year, their share was 87%.

The interlopers: international beer giants and microbrewers. Between 1993 and 2002, sales of imported beer in Canada jumped almost fourfold--from 500,000 hectolitres to 1.9 million (a hectolitre is the equivalent of about a dozen cases of 24). Domestic beer sales grew only marginally in that time, and an increasing chunk went to small brewers that emphasized quality over volume. Sleeman Breweries Ltd. emerged as a third force in Canadian beer, doubling its revenue in just five years.

O'Neill was able to defy gravity for a few years by cutting costs and jacking up prices to offset falling sales of some brands. He raised Molson's profit from about $250 million to $500 million before interest and taxes. But the black mark on his record is market share. While Molson's piece of Canada has dropped only a little bit, to 43.4%, an ever-increasing portion of that share comes not from beers it owns, but from those it distributes through partnerships, such as Coors Light and Heineken.

Research by **Veritas's Palmer** shows that Molson's owned brands, such as Canadian, commanded 35.7% market share in 1999, O'Neill's first year with the company. Today, they have shrunk to 28.6%, while Molson's rented brands increased from 9.3% to 14.8%. The Coors deal--in which Molson is a 49.9% partner with Coors Brewing Co.--has become especially critical to Molson's bottom line. Coors Light has about 8% of the national market. "If Coors ever walks on that agreement, [Molson's] stock is down $5 the next day," says **Palmer**. But Molson says the deal is secure for at least five years because sales are meeting performance targets negotiated with Coors.

Things got bad enough for Molson's key brands last summer that O'Neill dumped Michael Downey, president of the brewer's operations in Ontario and Western Canada. Likewise Sean Moffitt, who was vice-president of marketing for Molson Canadian. But O'Neill refuses to discuss exactly what happened. This much is clear: He blamed them for a weak advertising effort. After some memorable ad campaigns--such as the famous "rant" ad with Joe Canadian, the first big campaign on O'Neill's watch--Molson's marketing floundered during last year's prime beer-drinking months. This was especially true for Canadian, the No. 1 beer in English Canada. "We went probably eight, nine months without the equity advertising critical for a major beer brand," he says.

The overarching fact here is that mainstream brands like Canadian and Labatt Blue are in a slow decline. Tastes are changing. Canadians of legal drinking age consume on average about 14 litres of wine a year, up from about 11 litres a decade ago. Meanwhile, beer consumption has dropped to about 92 litres per person, from 98. In the beer market that remains, the majors have been getting squeezed by the microbrews and other so-called super-premium beers, brands that appeal to drinkers, mostly urbanites, willing to pay a higher price for what they perceive to be better taste. Super-premiums now command about 12% of the market, which is a problem for O'Neill, and not merely because it means fewer people are drinking Molson Canadian. Unlike Labatt, whose Interbrew parent owns the rights to high-cachet brews such as Stella Artois and Beck's, Molson doesn't have a strong super-premium to call its own, and must rely on international brands such as Heineken or Corona, for which it is merely the importer and distributor.

These arrangements are profitable; **Palmer** estimates that the so-called partner brands (including Coors Light) constitute about 30% of Molson's earnings before interest, taxes, depreciation and amortization. The problem is, they're not forever. The Heineken deal gives Molson the exclusive right to import and distribute the Dutch beer until 2012. But the distribution agreement for Corona, which is the top super-premium import in the country, comes up for renewal in 2006, and doesn't cover the four western provinces.

The need to have a top-flight beer has led to plenty of speculation that Molson will some day buy Sleeman. "The strategic logic of their owning Sleeman is very high," says AGF's Graham. Not

only would it give Molson the power to fight Labatt in the premium market, it would help make Molson's breweries more efficient, because today they are running at just 75% capacity (rising to 85% in the summer).

In the here and now, O'Neill has tried to fill the super-premium gap by importing Bavaria and pitching it as an upscale lager. It's nothing if not ballsy marketing. Bavaria--for which Molson paid almost $100 million (U.S.) in 2000 as a prelude to the Kaiser deal--is viewed as inferior beer in Brazil, and the price is heavily discounted to garner what sales it has. In Canada, it has captured 0.3% of the market.

Despite Molson's problems, Graham, a keen value investor, says the company's Canadian operation is worth at least $40 a share, which is why he jumped in and bought some when the stock fell to about $30 on January's Brazil-induced profit warning. What Molson needs, says Graham, is some stability and a deeper management team. "I think Dan O'Neill has been trying to do too much by himself," he says. "He's been trying to run Brazil, fix Brazil, fix Canada, run marketing, do acquisitions--he's kind of tried to be a one-man band."

O'Neill may be well qualified to fix Brazil, because he is fluent in Portuguese and spent four years in the country working for consumer-products company S.C. Johnson. In March, Molson effectively admitted that O'Neill needed more help when it hired Kevin Boyce as chief operating officer, a position that has been vacant since O'Neill moved up to the CEO's office. Boyce, the former CEO of Unilever Canada and more recently the head of that company's cosmetics division, is seen by some Molson-watchers as an eventual successor to O'Neill in the chief executive job.

David Vanderwood, a senior vice-president at Burgundy Asset Management Ltd., a Molson shareholder, has a view close to Graham's: There's such a steep "Brazil discount" on the shares that investors have ignored the value of its leading position in Canada, where brewers' margins are better than almost anywhere else in the world. "They may have overpaid [for Kaiser]--we think they did," he says. But "if they get half of what they paid for it, it might be worth between $3.50 and $4" a share.

But that depends, in part, on whether the Coke bottlers stay with Molson. As much as they've been part of the Kaiser headache, Molson would be sunk without them, forced to find a new distributor--or worse, forced to go to the expense of building its own fleet to serve a massive nation of beer-drinkers. Molson's most important distributor, Coca-Cola FEMSA, can walk in 2006 in the critical S{lsaquo}o Paulo region, though the brewer says FEMSA would have to pay a stiff financial penalty.

The key is for O'Neill to make sure that Kaiser is a self-sustaining operation--in other words, to prevent it from sucking from the teat of Molson's Canadian cash cow. Graham suggests the company should be broken into two: The domestic operation could be turned into an income trust, to minimize corporate taxes and maximize dividends to shareholders, with Kaiser and the small American operation rolled into a "Molson International" stock. Hartley, the First Associates analyst, has calculated Molson Canada would be worth at least $42 a share as an income trust.

O'Neill has heard the income-trust talk and crunched the numbers for that scenario. He says he can do better for shareholders by keeping the company in its present form. He's as convinced today as he was in

2002 of the potential of Brazil, and points to Interbrew's deal with AmBev as proof that he's not the only one who sees it.

"I had a large number of shareholders e-mail me, you know, saying, 'Well, your acquisition was confirmed--just have the courage to remain in there,'" he says. "It's 20 million hectolitres of beer in this country [Canada] only, and you're competing for that. But Brazil has 84 million."

If he's wrong about Kaiser's future, though, takeover talk will start. Heineken, the world's fourth-largest brewer and Molson's minority partner in Brazil, is at the head of any list of potential buyers. As of March, its known stake in Molson is 1.1 million shares, or less than 1%.

But the company can't be bought without the blessing of the Molson family, which has voting control. And while there's little to indicate they would sell, the company is, by O'Neill's own admission, at a disadvantage playing against giants like Interbrew. Molson is just the 15th-largest brewer in the world. If its destiny is truly to compete globally, its low rank can be blamed on earlier management teams, who wasted time and resources diversifying into not only professional sports, but also hardware stores, chemicals and broadcasting.

"When you look at the big brewers," O'Neill reflects, "you say Heineken--they were in a little tiny country [the Netherlands], right? They recognized this need to get out many years before we recognized it. You look at Interbrew, same thing--they're in Belgium, and they go out," he says. "We just took too long to get out. So we're chasing the big guys."

But will Molson destroy itself in the process of "getting out" of Canada? "There are people who really believe that, yeah, as soon as Brazil starts coming, there will be a big upside," says O'Neill. He sounds convinced, but admits there isn't much time left to prove it. "We probably have another solid 12 months before we sort of rethink what we did."

Strained Brew

Molson's challenge is a tale of two hemispheres

Canada

Molson's home market is mature. What's more, a growing share of suds sales is migrating from stalwart brands like Canadian to imports and super-premium brews. In this category, Molson has to rely on "rented" beers like Coors Light, which has 8% of the national market.

United States

Outside of Brazil, Molson's only significant international venture is in the U.S.--also in partnership with Coors--but the operation is small and unprofitable. Molson Canadian is becoming more popular, but the other brands sold stateside, Molson Golden and Molson Ice, face declining sales.

Brazil

The market is much bigger than Canada's, and growing faster.
But Molson's Kaiser and Bavaria labels are struggling to compete with entrenched local brewer AmBev, which recently merged with Belgian-based Interbrew--which also owns Molson's other archrival, Labatt