Expansion or Diversification?

Abstract

One of the main objectives of any company is to make money for the shareholders. A sign of prosperity is sustained profitability. Hence, pursuing profits is an ongoing effort by a company's management and directors. When all avenues for business expansion schemes. Carlsberg Brewery Malaysia Bhd. (Carlsberg) is such a company. It has sustained profitability for ever nearly 40 years in the Malaysian beer and stout market. It serves as an excellent model for the study of business expansion schemes, as part of a corporate finance curriculum. The case study of Carlsberg is in itself interesting because it is full of irony. On one hand, Carlsberg operates in a 'sun-set industry' with no more scope for expansion because of the ever increasing excise duties, taxes and other costs, restricted market target groups, the socially undesirable/unacceptable nature of the products, high advertising costs and the associated social responsibility that comes with it. On the other hand, Carlsberg and other competitors have succeeded to remain profitable and cash rich, with consumption on the rise in spite of the ever increasing prices, and contribute substantially to the Government's tax revenue. In discussing on the issue of expansion on diversification, such company has to face the business reality behind Malaysia's halal premise, the understanding behind 'sin taxes' and other related social and ethical issues.

DIVERSIFICATION FOR SUSTAINED PROFIT

David Ross returned to his office at 12.00 noon, after a heavy morning of monthly business meetings. On the way back to his office, all he could think of was what his boss, Robert Stanley, had said to him.

David had been working for 3 years as a consultant with ABC Consulting Sdn. Bhd., after graduating from university. The consulting firm specialized in business turnarounds and had been successful in reviving a number of distressed businesses in the past decade. At this month's meeting, the Mr. Stanley had lamented that, although their overall business remained profitable, too much time was taken to resolve cases and, because they dealt with business turnarounds, the firm's cash inflow had become irregular. To be sustainable, Mr. Stanley had suggested that the firm ought to start looking into proposing schemes to cash-rich firms that wanted to expand, diversify or venture into profitable business. David was given the task of pioneering such a move, with full support from the firm.

David, anxious to strengthen his mark in the firm, readily took up the challenge. He remembered he had read somewhere that the beer and stout industry was at crossroad because of the high excise duties. He began his research on the industry and come up with some preliminary findings.

A CASH-RICH COMPANY

There were three very profitable beer companies in Malaysia, supported by a non-Muslim population of 8 million, approximately one-third of its total. One of them, a marked leader with more than a 50% share of the beer and stout market, was Carlsberg Brewery Malaysia Berhad (Carlsberg).

Carlsberg had been incorporated in 1969. Two years after that, it began brewing Carlsberg Green Label beer market in innovation, quality and product launches and campaigns. The Carlsberg brand became a part of everyday life for the beer drinking community and held no less than 12 products of beer, stout and shandy. Carlsberg was 51% owned by the Carlsberg Group of Denmark and listed on the Main Board of Bursa Malaysia. It locally marketed its products via a 100% subsidiary in Carlsberg Malaysia Sdn. Bhd.

Since it began its operations, the prudently-managed company was able to enjoy sustainable profits. They increased from RM14 million in 1997 to RM138 million in 1999. Even when profits started to decline, the company was still able to maintain respectable RM76 million in 2008. The company's share price averaged between RM5.00-RM6.00 per share over the last ten years in the Malaysian stock market until 2007, despite the 2005 stock split (shareholders give 2 shares in exchange for 1) from RM1.00 To RM0.50 per share. The share price fell in 2008 but it was still able to secure a reasonable RM3.50 per share.

Carlsberg rewarded its shareholders well. Although its profits fluctuated over the years, the company was able to keep a stable dividend yield policy. For example, its profits after tax changed from RM138 million in 1999 to RM76 million in 2008, while its dividend from RM109 million to RM79 million in the same period. It indicated that, while its retained earnings plummeted from RM29million to a negative RM3 million in those ten years (it began to report negative retained earnings since 2002), its dividend payments had exceeded its net profits over seven straight years.

Furthermore, by Carlsberg's calculations, if an investor had invested RM1,000 in 1971 and an additional RM500 in 1972 (at RM1 per share), as at 31 December 2008, the shares would be worth a market value of RM121,500 with accumulative dividends of RM191,381. Depositing the same amount with a bank that paid an average interest of 5%, would make a pale comparison as the returns, if compounded annually, would estimate RM9,281 by end 2008.

An article (in 2009) focused on a comparison between Carlsberg and Guinness Anchor Bhd (GAB), its main competitor, where Maybank Investment Bank analysts had reported GAB's 2008 fourth quarter net profit's dramatis increase of 41% to RM27.39million from a year earlier, while Carlsberg's 2008 second quarter net profits fell 21.7% to RM12.88 million.Analysts saw GAB's gradual gain in market share to eventually dominate the Malaysian Brewery Industry.However, Carlsberg Manager Director, Soren Holm Jasen, had been quoted as saying that their latest result were similar to what they had achieved in the previous year and that they were on track and confidence of achieving favourable earnings for that coming year. He further added that the newly acquired Carlsberg Singapore would boost the company's earnings by 40% to 50%.

Carlsberg's accumulated funds prior to 2002 had been invested in money markets, overseas investments and share buybacks. In September 1999, Carlsberg had repurchased its own shares through KLSE (now Bursa Malaysia) at a cost of RM12 million and held in the company as treasury shares. It had been at the company's April 2007 Annual General Meeting (AGM) that the shareholders give the mandate for the company to repurchase up to 10% of its issued and pay-up capital, inclusive of 2.33 million shares in it treasury stock. In addition, Carlsberg had also invested in overseas ventures. In 2006, the company invested RM29 million in Carlsberg Distribution Taiwan Ltd, and in 2008, RM0.9 million in Lion Brewery (Ceylon) Ltd. In September 2009, it acquired 1 million shares, representing 100% equity capital, from Carlberg Singapore Pte Ltd, at a cost of RM370 million.

AT CROSSROADS

Operationally, a typical beer company in Malaysia would incur excise duties and taxes that accounted for more than half of the costs. They included excise duties ad valorem tax (49.6%), sales distribution and administration (19.1%), raw materials and packing cost (13.1%), employee cost (5.5%), depreciation (2.2%), and corporation tax (2.6%).

As reported in The Star on 29 July 2009, the beer and stout was facing though times ahead, pending on the hike in excise duties and taxes. Malaysia's excise duties were on gradual increase, and currently highest in Asia and second highest in the world. Table 1 below provides the illustration on the increasing duties and tax.

Table 1 The effect of excise duties on the consumption per capita of beer and stout in Malaysia

	2002	2003	2004	2005	2006	2007	2008
Per capita consumption (in litres)	22	22	23	21	20	20	21
Excise duties (RM/litre)	4	5	6	7	7	7	7

Note: (1) Per capita consumption is based on individuals of the average age of 20+ years in the Muslim population. (2) Source: *Star on line* dated 29 July 2009.

It had been estimated that an increase in excise duties and taxes between 5% and 25% would reduce per capita consumption further by 7% to 21%. All points indicated that the Malaysian beer and stout market had reached saturated point, the excise duties and taxes being the limiting factor. The same sentiments were shared by Carlsberg's competitor, GAB.

FOREIGN BEER

There is an influx of cheap foreign beer in the market and it may be costing the country up to RM250mil in lost taxes annually.

Industry sources claim that beer with high alcohol content from Thailand, the Philippines, China and Europe have flooded the market and are being sold at almost half the price of locally-produced beer at coffeeshops, convenience stores, medical halls and even some established supermarkets here.

The low prices and easy availability have made the brew attractive to all beer consumers, particularly the lower income group, such as labourers and migrant workers. It is learnt that consumers are switching from locally-produced beer to compounded hard liquor because of the high price of local beer due to high excise duties.

The sources cited reports and analysis, which estimated that the uncollected duty from cheap imported beer to be around RM250mil while the total tax evasion from all alcoholic beverages could be as high as RM1bil.

The report noted that while tax losses from beer smuggling in Malaysia are lower compared to smuggling of other liquors in terms of the amount of duty paid, the sheer volume of illicit beer makes up for its lower profit margins.

Another source pointed out that imported beer should logically cost more than locally produced beer if legally brought into the country as the import tax alone would be about RM5 per litre. Moreover, importers should pay a higher excise duty on beer with higher alcohol content.

The sources also questioned how foreign beer, despite having almost twice the alcohol content of locally-brewed beer, could be sold for as low as RM4.29 per 330ml can or RM7 per 550ml can (in some places, it’s only RM5) compared to premium imported beer brands that were priced from RM9 per bottle.

A Customs Department official, who declined to be named, said beer pricing was not regulated by the department. (Source: Star on line dated 17 October 2013)

BEER IN SOUTHEAST ASIA

Southeast Asia is currently experiencing one of the fastest growth rates in beer consumption in the world, according to a study by market researcher Euromonitor (Source: Asean Lifestyle dated 6 March 2015). Why? Mainly because it’s so hot, say those who enjoy a cold beer to wash down spicy food at stalls and open-air restaurants between Bangkok and Manila.

The main reason why Southeast Asia’s citizen are gulping more booze is the growth in the number of young people with higher disposable income in recent years. There is a clear correlation between the consumption of beer and economic dynamics, let alone Western influence through the growing influx of tourists, Western-style restaurants and international beer brands. All this lets Southeast Asian people turn away from their traditional distillates, be it rice whiskey in Thailand, arrack in Indonesia or various sugar cane or coconut brews elsewhere.

The survey also found that beer is increasingly being consumed in times of prosperity, while people were seeking solace in cheap domestic liquor during harder times in the past.

Asia overtook Europe and the Americas in beer consumption already in 2007. In 2011, the continent drank 67 billion liters of beer, against 57 billion in the Americas and 51 billion in Europe, according to the latest available figures by Euromonitor. The survey predicts that beer consumption is expected to grow 4.8 per cent in the Asia-Pacific region each year up to 2016.

The top beer-drinking nation in ASEAN is Vietnam. Vietnamese drinkers downed 2.6 billion liters of beer in 2011, followed by Thailand with 1.8 billion liters and the Philippines with 1.6 billion liters, nearly double the total amount of beer consumed in Indonesia (236.4 million liters), Malaysia (171.4 million), Cambodia (136.3 million), Laos (134.3 million), Singapore (108.2 million) and Myanmar (30.4 million). No figures were available for Brunei where no alcohol is officially sold, but certain restaurants in the small Chinese quarter in Bandar Seri Begawan would serve booze in tea cups upon request at unknown volumes.

San Miguel Corporation, which produces San Miguel beer, the most popular beer in the Philippines, has a business history of 125 years (Source: Inquirer.net dated 23 September 2015). It is the country's largest conglomerate in terms of asset size. The group now has interests in several industries, locally and overseas, from energy to telecommunications with consolidated revenues of $20 billion annually.

AN OPPORTUNITY

David reckoned that the major beer industry players were worried about the industry's future direction, having recognized that there was not much of prospect for expansion in the market itself. Diversification appeared to be a promising alternative for such companies like Carlsberg & GAB. David considered the types of products he felt he should purpose for Carlsberg to diversify into. The strength of Carlsberg laid in it brewery operations and it bottling and marketing forces. An alternative was seen in the bottling and marketing the non-alcoholic beverages where the company could tap into a much larger market in Malaysia.

After looking at the Carlsberg's and GAB's 2014 annual reports, David felt confident that he could sell the idea of manufacturing sparkling grape juice under a "halal" brand to Carlsberg. David was equally aware that Guinness had successfully launched the non-alcoholic 'Guinness Maltase' many years ago. He also considered a route map to list the new company in Bursa Malaysia within the shortest time frame.

Armed with research, David estimated that a carbonated beverage operation, under a wholly owned subsidiary, would require an investment of RM200 million, where the internal rate of return would be a likely 12%.

Required:

a. From your analysis of the case, identify and elaborate **THREE (3)** pertinent issues.

(15 marks)

b. Identify and thoroughly discuss **THREE (3)** business strategies should Carlsberg adopt when entering new markets.

(15 marks)

c. Assess and contrast the strength and weakness, opportunity and threat of a beverage company similar to Carlsberg doing business in Malaysia.

(20 marks)

d. To expand in new markets, funding is a critical factor for its success. Discuss the company's funding ability. If not internally available sufficiently, analyse and propose other sources can the company tap into.

(15 marks)

e. Assuming you are David, what would you recommend to Carlsberg in terms of dealing with increasing competition, country risk and new product reception?

(20 marks)

f. The challenge for David is convincing Carlsberg whether it is viable and the market is receptive for marketing a 'halal' soft drink owned by a beer company. What are the alternative businesses that David can propose assuming that Carlsberg is willing to go for expansion strategy? What internal and external changes do you think need to be considered? What business model needs to be used to make it viable? You need to quote examples of other 'sinful' companies that have followed this path.

(15 marks)