Soft Beverages - Europe

Bottled Water Growth To Offset Slowdown In Other Segments, But Impact on Credit Quality Limited For Now

Summary
Rise in bottled water consumption will help compensate for slowing growth in mature segments, supporting revenues. We expect bottled water, which represents 23% of the overall soft drinks market in terms of value, to remain one of the fastest growing beverage categories in terms of volumes in the next five years as consumers move away from high sugar drinks. Volume growth in the water segment will help organic revenue growth for Nestlé S.A. (Aa2 stable) and Danone (Baa1 stable) because both companies are exposed to mature segments which are suffering from declining demand. We also expect the water segment to support revenue growth for soft beverage companies like Coca-Cola HBC AG (CCHBC, parent company of Coca-Cola HBC Finance BV Baa1 stable) and Coca-Cola European Partners plc (CCEP, A3 stable), which faces volume pressure in the carbonated soft drink segment in certain mature markets.

Volume growth will remain driven by emerging markets. Danone is best placed given its established presence in China and Mexico with its Aquadrinks flavoured water business. While just 20% of Nestlé’s water sales are in emerging markets, the company has a dominant presence in the carbonated water segment. We expect Nestle to benefit from the premiumisation trend in China and the expected higher growth in this segment in the US.

Water segment will remain profit dilutive in the near term. This is a very fragmented market with high price competition and a large number of small players including private labels. Also, in countries where there is a reliable potable water supply consumers are reluctant to pay a premium for bottled water. As a result we do not expect margin improvements during the next 12 to 18 months. Nestle’s bottled water margin continues to lag the overall group, despite improvements in recent years. Slowing growth in China will restrict margin improvement in Danone’s water business. CCHBC has the opportunity to improve the profitability of its water business considering its currently much less exposure to the higher-margin carbonated, flavoured and premium segments.

Credit metrics to benefit once profitability improves, but this might take longer than 18 months. Profitability should improve in the longer term as companies’ investments in new and premium products begin to pay off. We expect a move into products other than still water will help companies to increase their price power in the category and their returns, resulting in improved credit quality over time.
Rise in bottled water consumption will help compensate for slowing growth in mature segments, supporting revenue growth

We expect bottled water (including still, carbonated and flavoured water) to remain one of the fastest growing beverage categories in terms of volumes in the next five years. This will help beverage manufacturers offset growth in slowing segments such as carbonated soft drinks. Consumption of carbonated soft drinks and fruit juices is falling because consumers are moving away from high sugar drinks to other beverages which are perceived as being healthier, including water.

Increasing regulation on sugar content by governments, such as the sugar tax on soft drinks announced by the UK government in March 2016 should also support increased bottled water consumption to the detriment of soft drinks.1

Bottled water segment was worth around $183 billion globally in 2015 and represented 46% of the total soft drink sector in terms of volumes, but a much smaller portion in terms of value (23%). 2 This is a fragmented business where the two largest players in volume terms are Nestlé S.A. (Aa2 stable) and Danone (Baa1 stable), followed by The Coca-Cola Company (Aa3 stable) and PepsiCo Inc. (A1 stable) accounted as the aggregation of their different bottlers. The four largest players represented around 26% of the total off trade volumes of bottled water in 2015. We estimate the two European Coca-Cola bottlers to represent a small portion of the total Coca-Cola’s volumes in the water segment. In particular we estimate Coca-Cola HBC AG (CCHBC, parent company of Coca-Cola HBC Finance BV, Baa1 stable) to represent around 19%, while Coca-Cola European Partners plc (CCEP, A3 stable)3 to represent slightly less than 10%.

CCHBC operates mainly in Central and Eastern Europe and recorded total volume of 2.1 billion unit cases in 2015 of which water accounted for around 19%. CCEP operates in Western European markets with 2015 pro forma volumes of approximately 2.5 billion unit cases, of which we estimate water represented around 7%.

Exhibit 1
Nestlé and Danone Are The Largest Global Players

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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Nestlé (Aa2)</td>
<td>#1</td>
<td>92.4</td>
<td>7.9</td>
</tr>
<tr>
<td>Danone (Baa1)</td>
<td>#2</td>
<td>24.9</td>
<td>5.3</td>
</tr>
</tbody>
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Source: Euromonitor (ranking) and companies’ data

As Exhibit 2 shows, Euromonitor forecasts bottled water consumption volume growth of around 5% in the next five years. Along with energy drinks, bottled water will outperform the 1% growth forecast for carbonated soft drinks (CSDs) and 3% growth in non-carbonated soft drinks.
As Exhibit 3 shows, volume growth in the water segment will help organic revenue growth for Danone and Nestlé because both companies are exposed to mature segments which are also suffering from declining demand. Danone is exposed to the dairy sector in Europe, where the market is saturated. For Nestlé the prepared dishes food segment has lost its appeal with consumers, especially in the US. By contrast, water segment organic revenues have been strong.

Danone’s dairy segment’s organic revenue growth has slowed to 0.6% in 2015 from 4.6% in 2011. However the company has revamped its dairy category and revenue growth rose 2.6% in the first half of 2016. We expect dairy performance will continue to improve towards the 2020 annual growth target set by the company of 3%-5%. However growth in water will remain stronger in the next 12-18 months. Water now represents 21.3% of Danone’s sales, up from 16.7% in 2011.

Nestlé is the market leader in the bottled water segment. The company reported 6.7% organic revenue growth in 2015 in the category, versus the overall group average of 4.2%, which has fallen slightly from its historical level of 5%-6%. This is due to some difficulties in selected markets but also to a slowdown in its prepared dishes segment and more recently in the milk and ice cream divisions. Nestlé’s water segment growth rate has been lower than Danone’s in the past because Danone has been more successful in reshaping its brand portfolio proactively. However we expect that water will continue to be one of the faster growing categories for Nestlé in the next 12-18 months. Water represents 8.6% of Nestlé’s revenues, up from 7.8% in 2011.

We also expect the water segment to support revenue growth for soft beverage companies like CCHBC and CCEP which faces volume pressure in CSD in certain mature markets, where demand is depressed by health concerns about sugar content. CSD volumes
represented around 69% of CCHBC’s total volumes, but grew just 2% in 2015 in contrast with growth of 4.7% in the water category. Water represented around 19% of total volumes and 10% of CCHBC’s revenues in 2015 and we expect its contribution will continue to steadily increase in the coming years. Volume growth will mainly be supported by energy drinks, which have become increasingly popular with consumers in the past five years, and rose 6.6% in 2015. CCHBC expects to double its revenues from energy drinks by 2020.

We do not expect concerns about water scarcity or the waste created by disposable water bottles to slow the segment’s growth. Instead we would expect increasing demand to support packaging innovation to reduce the product’s environmental impact. Also, bottled water production consumes less water than the production of other beverages, such as beer, where, for example, Heineken reports to consume 3.7 hectolitres of water to produce 1hl of its beverages.

**Volume growth will remain driven by emerging markets**

As Exhibit 4 shows, we expect bottled water volume growth to remain strongest in emerging markets, with growth in the Middle East and Africa the highest, albeit from a low base. Among mature markets the US is expected to grow more than Europe.

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Asian and Latin American countries will also remain large markets. In China, demand is being fueled by concerns about the quality of public water supplies, but we expect volume growth to slow to mid-single digits from double-digit growth in recent years as economic growth slows down. According to Euromonitor, most growth will come from customers trading up to vitamin and mineral enhanced “functional” and carbonated water, segments it expects to grow faster than the still bottled water segment.

Distrust of public water supply also fuels demand in Mexico, which has the highest per capita consumption of bottled water in the world, at 80%. Despite slowing volume growth in Brazil in 2015 due to the economic slowdown, Euromonitor forecasts continued bottled water sales growth, but at a slower pace. In terms of value, the market will remain healthy because the unit price rose sharply in 2015 due to water shortages in many regions of the country.

Typically in developed countries, tap water meets drinking water quality standards, so bottled water volume growth in Europe will be driven more by the ongoing success of flavoured water. In the US, the move away from carbonated soft drinks resulted in sales of bottled water reaching new highs in 2015. This was further supported by ongoing premiumisation with customers searching for higher quality products. We expect both trends to continue.

Danone is the company best placed to benefit from rising consumption in emerging markets, given its established presence in China and Mexico with its Aquadrinks flavoured water business. Aquadrinks revenues grew 25% between 2010 and 2014. This was driven by its Mizone brand in China, which rose 44% in the same period, allowing the company to improve price and mix. However, volume growth rate in China started to slow since mid 2015, hitting Danone’s profitability because Aquadrinks in China are sold at higher prices than in other countries. Danone is now reducing inventories at distributor level and adapting its cost base in order to protect the category’s operating margin.
While only 20% of Nestlé’s water sales are in emerging markets, it is the market leader in the US and in the carbonated water segment globally. This is growing more rapidly than still water in both China and the US. Euromonitor forecasts that carbonated water sales in the US will grow faster than the global average, at 4% versus 1% in the next five years. The US is included in its North America division which represented 54% of Nestle’s total CHF7.6 billion water segment sales in 2015. Nestlé will also benefit from the expanding presence of its premium international sparkling brands such as Perrier and San Pellegrino. These represent 18% of its total water revenues, but these premium brands have stronger price potential, being sold for four times more than Nestlé’s still water brand. Premium brands also have more potential to increase international sales, because higher selling prices cover the additional transportation costs.

**Water segment to stay profit dilutive in the next 12-18 months**

We expect bottled water to be a key driver of increased volumes and revenues for Danone, Nestlé, CCHBC and CCEP.

However, while bottled water volumes will increase, companies will continue to struggle to improve the segment’s profitability and we do not expect it to contribute to margin improvements during the next 12 to 18 months. This is a very fragmented market, with a large number of small players including private labels, resulting in very high price competition. Also, in countries where there is a reliable potable water supply, it is seen more as a commodity with consumers reluctant to paying a premium for bottled water.

As a result, margins for bottled water tend to be lower than other food and beverage products and dilute overall group margins. Nestlé’s 2015 reported operating margin in the water segment was 10.8% versus 15.1% at group level. Its focus on efficiency gains and brand investment has resulted in profit improvement in its water division of above the group average in the past five years, of 280 basis points, but the gap in margins remains. Growth in its water segment will probably not help Nestlé improve its group operating margin, which remains lower than its peers. However, we acknowledge that the premium sparkling segment, where Nestlé is leader, carries stronger margin than average.

Danone’s group operating margin has been squeezed by the weak performance of its fresh dairy division, but its water segment margin remained overall flat until 2014. It is not far from the group level, at 12.7% versus 13.5% respectively on average in 2011-2015. Danone has reshuffled its water portfolio in recent years and increased contribution of flavored and speciality waters, which are sold at higher prices. This also allowed the company to record higher margins than Nestlé in this segment (see Exhibit 5).

However slowing growth in China was a drag on Danone’s margins in 2015 and the first half of 2016 and we expect that weaker performance in China will continue to weigh on Danone’s water segment margin for the next 12 to 18 months, making difficult to restore it to previous levels.

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**Exhibit 5**

Danone’s Water Business is More Profitable than Nestlé’s

Reported Operating margin 2011-2015

![Graph showing operational margin comparison between Nestlé and Danone](image-url)
CCHBC’s water business is dilutive both in terms of revenue per case and operating margin. CCHBC has the opportunity to improve the profitability of its water business considering its currently much less exposure to the higher-margin carbonated, flavoured and premium segments.

Credit metrics to benefit once profitability improves, but this might take longer than 18 months

While we do not expect margin improvement in the next 12-18 months, profitability should improve in the longer term as companies’ investments in new and premium products begin to pay off. A shift towards more innovative products and away from still water will help companies to increase their price power and their returns, and this should help improve credit quality over time.

Nestlé and CCHBC are both investing in expanding their brand portfolios to increase value by moving towards new products with higher margins. Nestlé is investing in functional water and in its premium brands to strengthen profit growth and further improve an already above-average cash flow generation. This will help the company to improve its Moody’s adjusted retained cash flow (RCF) to net debt ratio which, at 30.8% at the end of 2015, is currently at the lower end of our guidance to maintain the rating, of above 30%. The weak RCF to net debt ratio, however, is in line with our expectation and is the result of its CHF8 billion share buyback programme completed last year.

CCHBC will find it more difficult to grow its water business, given its current focus on still water in the mainstream segment. However, innovation in packaging including single servings and the introduction of functional and flavoured water should help the company to improve its margins over the next two to three years. Its strategy targets an EBIT margin improvement to 11% by 2020 from 7.5% currently. CCHBC’s EBIT margin is lower than other Coca-Cola bottlers, at 7.4% on a Moody’s adjusted basis versus 10.2% on average for rated Coca-Cola bottlers. Among other triggers we indicate that an improvement in the company’s EBITA margin towards 8%, currently also at 7.4%, could lead to a rating upgrade.

Slowing growth in China will continue to weigh on Danone’s profitability at least through the end of 2016. However strong growth in other developing markets will help offset this: Danone’s water revenues for outside Europe, excluding China, rose 12% in the first half of 2016. Danone continues to invest in its Aquadrinks business in emerging markets and in innovation in its still water segment (e.g. packaging). This should improve its profitability on the back of expected strong volume growth outside China and should help the company achieve its long term revenue annual growth target of 7%-10% in the water segment by 2020.
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Sector Comment: Soft Beverage Manufacturers - UK - Impact of Sugar Levy Will Be Limited but May Set Precedent, 18 March 2016

Credit Opinions:

» Nestlé S.A., 6 April 2016
» Danone: Update Following Acquisition of WhiteWave Foods Co, 12 September 2016
» Coca-Cola HBC AG, 20 November 2015
» Coca-Cola European Partners plc, 17 June 2016

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Endnotes

1 See “Soft Beverage Manufactures - UK - Impact of Sugar Levy Will Be Limited but May Set Precedent,” published 18 March 2016

2 Source Euromonitor

3 The new European bottler that was formed through the merger of Coca-Cola Enterprises, Inc. (CCE, A3, stable), Coca-Cola Iberian Partners, S.A. (CCIP, not rated) and Coca-Cola Erfrischungsgetränke GmbH (CCEG, not rated)

4 Source: Heineken’s Sustainability report 2015. Data represents hectoliter of water per hectoliter of beer, cider and soft drinks.

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