BRYAN, GARNIER & CO

INDEPENDENT RESEARCH UPDATE

24th September 2015

Food & Beverages

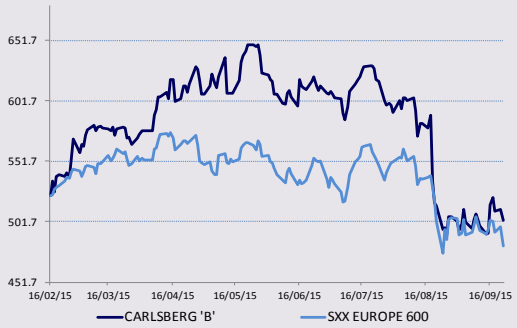
Carlsberg

Strong in the West, but where is it going?

Fair Value DKK519 vs. DKK629 (price DKK502.50) **NEUTRAL**

Bloomberg	CARLB DC
Reuters	CARCb.CO
12-month High / Low (DKK)	648.5 / 451.5
Market capitalisation (DKKm)	78,143
Enterprise Value (BG estimates DKKm)	136,636
Avg. 6m daily volume ('000 shares)	395.8
Free Float	69.7%
3y EPS CAGR	-1.4%
Gearing (12/14)	74%
Dividend yield (12/15e)	1.35%

YE December	12/14	12/15e	12/16e	12/17e
Revenue (DKKm)	64,506	65,151	66,448	67,872
EBIT (DKKm)	8,458	7,863	8,561	9,185
Basic EPS (DKK)	28.85	28.33	32.15	35.66
Diluted EPS (DKK)	35.92	27.52	31.14	34.44
EV/Sales	2.17x	2.10x	2.00x	1.89x
EV/EBITDA	11.2x	11.2x	10.3x	9.5x
EV/EBIT	16.6x	17.4x	15.5x	14.0x
P/E	14.0x	18.3x	16.1x	14.6x
ROCE	5.3	5.2	5.6	6.1



On the back of the further weakness in the Russian rouble and the Russian macro economic outlook, we have reduced our earnings forecasts and are now expecting a declining EBIT by respectively 4% and 10% for 2015 and 2016. As a result of our review, we have lowered our price target by 17% to DKK519 (from DKK629).

- In 2014, China accounted for 9% of group revenue and the company has embarked on a dual strategy of building domestic operations in the West and selling nationally Carlsberg/Tuborg.

- In China, Carlsberg ranks fifth with a 6% share of sales volumes and value, but it is the leader in its operating provinces. The company has a share of around 50% in its Western core provinces (including a 30% share in Yunnan, 60% share in Xingjiang and 85% in Chongqing). Operationally, the biggest challenge is to integrate the recently-acquired Chongqing business (60% owned) which is being put on the same platform as Carlsberg group for IT, procurement and payrolls, enabling it to run the business more efficiently.

- Currently, Carlsberg's new CEO, Cees 't Hart, is reviewing all operations and putting in place a new strategic plan for the company, which will also determine if and how the company could be part of the further consolidation of the Chinese beer market.

- With Western European operations in 2015 expected to be flattish (good summer months compensating for a poor spring and tough comps), Asian growth (China and India) is balancing the deteriorating situation in Eastern Europe (macro-economic and destocking) and hence we expect only a slight organic decline of 0.3% in the 2015 EBIT. However, with the unfavourable currency translations, we are expecting a decline in reported EBIT of 7% to DKK7,863m. On top of this, there is a higher cost of debt (4% vs 3.3%) and a higher tax rate (28% vs 26.1%) and, as a result, we are expecting adjusted net profit to be down 23% to DKK4,211m from DKK5,496m in 2014.

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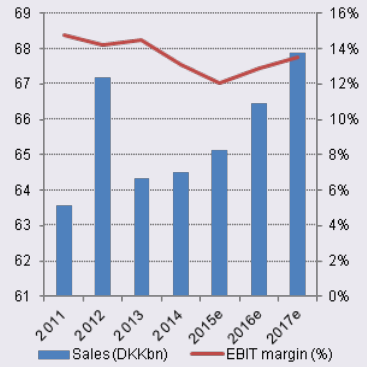
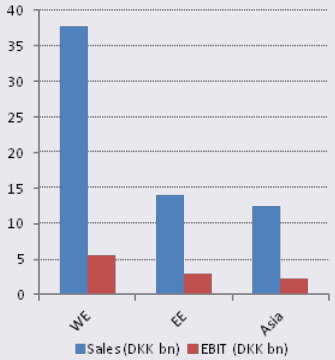




Company description

Carlsberg is the fourth largest brewer in the world, producing 123m hl of beer in 2014 and a further 21m hl of soft drinks (mainly in the Nordic countries). Carlsberg is focused on Europe and Asia. In Europe, the group is the largest brewer in Russia (24% of EBIT), the Nordic countries (15%), Switzerland and France. In Asia (21% of EBIT), the group holds a number two position in Malaysia, and is market leader in Western China and in Vietnam.

Simplified Profit & Loss Account (DKKm)	**2012**	**2013**	**2014**	**2015e**	**2016e**	**2017e**
Revenues	67,201	64,350	64,506	65,151	66,448	67,872
Change (%)	*5.7%*	*-4.2%*	*0.2%*	*1.0%*	*2.0%*	*2.1%*
EBITDA	13,559	13,200	12,561	12,236	12,899	13,497
EBIT	9,568	9,337	8,458	7,863	8,561	9,185
Change (%)	*1.9%*	*-2.4%*	*-9.4%*	*-7.0%*	*8.9%*	*7.3%*
Financial results	(1,772)	(1,506)	(1,191)	(1,401)	(1,238)	(1,061)
Pre-Tax profits	7,796	7,831	7,267	6,462	7,323	8,124
Exceptionals	202	(419)	(989)	(50.0)	(40.0)	(29.6)
Tax	(1,861)	(1,833)	(1,749)	(1,910)	(2,159)	(2,392)
Profits from associates	108	370	408	408	428	450
Minority interests	(638)	(478)	(523)	(575)	(633)	(696)
Net profit	5,607	5,471	4,414	4,335	4,920	5,456
Restated net profit	5,504	5,772	5,496	4,211	4,765	5,270
Change (%)	*5.8%*	*4.9%*	*-4.8%*	*-23.4%*	*13.2%*	*10.6%*
Cash flow Statement (DKKm)						
Operating cash flows	13,822	12,954	12,427	12,186	12,859	13,468
Change in working capital	329	(223)	(799)	82.5	166	182
Capex, net	(5,585)	(5,600)	(5,908)	(3,909)	(3,987)	(4,072)
Financial investments, net	1,100	(2,500)	(1,746)	0.0	0.0	0.0
Dividends	(1,121)	(1,662)	(1,897)	(1,441)	(1,514)	(1,589)
Other	(9,305)	(4,822)	(3,412)	(3,122)	(3,198)	(3,245)
Net debt	NM	NM	NM	NM	NM	NM
Free Cash flow	4,286	2,652	1,557	5,049	5,641	6,124
Balance Sheet (DKKm)						
Shareholders' funds	70,261	67,811	52,437	55,331	58,737	62,603
+Provisions	NM	NM	NM	NM	NM	NM
+Net debt	34,268	36,044	37,039	33,023	28,467	23,483
=Invested Capital	NM	NM	NM	NM	NM	NM
Fixed assets	153,965	152,308	136,983	136,889	137,073	137,409
+ Working Capital	NM	NM	NM	NM	NM	NM
+ Other	9,623	6,950	7,838	7,838	7,838	7,838
=Capital employed	122,064	124,261	117,312	109,820	109,288	108,819
Total Balance sheet	153,965	152,308	136,983	136,889	137,073	137,409
Financial Ratios						
Operating margin	14.24	14.51	13.11	12.07	12.88	13.53
Tax rate	23.27	24.73	26.16	28.00	28.00	28.00
Net margin	8.19	8.97	8.52	6.46	7.17	7.76
ROE (after tax)	7.83	8.51	10.48	7.61	8.11	8.42
ROCE (after tax)	6.01	5.66	5.32	5.16	5.64	6.08
Gearing	51.91	55.40	74.32	63.23	52.04	41.23
Pay out ratio	16.32	22.38	31.20	33.35	30.86	29.22
Number of shares, diluted	153	153	153	153	153	153
Data per Share (DKK)						
EPS	36.76	35.74	28.85	28.33	32.15	35.66
Restated EPS	36.08	37.71	35.92	27.52	31.14	34.44
Change(%)	*6.0%*	*4.5%*	*-4.7%*	*-23.4%*	*13.2%*	*10.6%*
BV	461	445	344	363	385	410
Operating cash flows	90.61	84.62	81.22	79.64	84.04	88.02
FCF	28.10	17.32	10.18	33.00	36.87	40.02
Net dividend	4.32	5.76	6.48	6.80	7.14	7.50

Source: Company Data; Bryan, Garnier & Co ests.

1. Increasing importance of China

Carlsberg has been active in China since 1995, owning the Huizhou brewery in the Guangdong province, which serves mainly the Hong Kong market. Carlsberg initiated its West China strategy in 2003 through investing in local breweries in Western China. The acquisitions of the Kunming and Dali breweries in the Yunnan province (in 2003) were followed by purchases of a 33% stake in the Lhasa Brewery in Tibet (in 2004), a 30% stake in the Lan-zhou Huanghe Brewery in the Gansu province (in 2004), a 50% direct stake and a 30% stake in their holding company in the Wusu/Xinjiang Brewery Group in two stages (2004 and 2006), a greenfield brewery in Qinghai (2005) and one in Ningxia (2006).

Over the last few years, the company's strategy has been to increases its presence in its subsidiaries through step-up acquisitions. In 2008, the company became the second largest shareholder in the Chongqing Brewery (with the acquisition of Scottish & Newcastle it gained a 19.5% stake and Chongqing Brewery Group held a 34.5% stake) and increased its stake to 29.7% in 2010. In 2013, Carlsberg increased its stake in Chongqing to 60%. And, in 2014, the group increased its stake in the Llasa Brewery to 50% (from 33%) (but which is still an associated company as Carlsberg has no management control.). In October 2014, Carlsberg bought the full control of the "Eastern Assets" of the Chongqing Beer Group Assets Management Co. The deal was initially valued at RMB1.56bn (USD253m) and concerns the breweries located in the eastern provinces of Jiangsu, Anhui and Zhejiang, which have a combined annual capacity of about 12m hl.

Furthermore, Carlsberg has agreed with Xinjiang Hops that it can increase its stake in the Wusu/Xinjiang Brewery Group from 65% to 100%. This transaction, which still needs government approval, is expected to close before the end of 2015.

In Yunnan, the company is building a new brewery to come on stream by the end of this year and which replaces the one in Dali (was in the middle of the city). The new brewery will have an initial capacity of 5m hl but can be expanded to 10m hl.

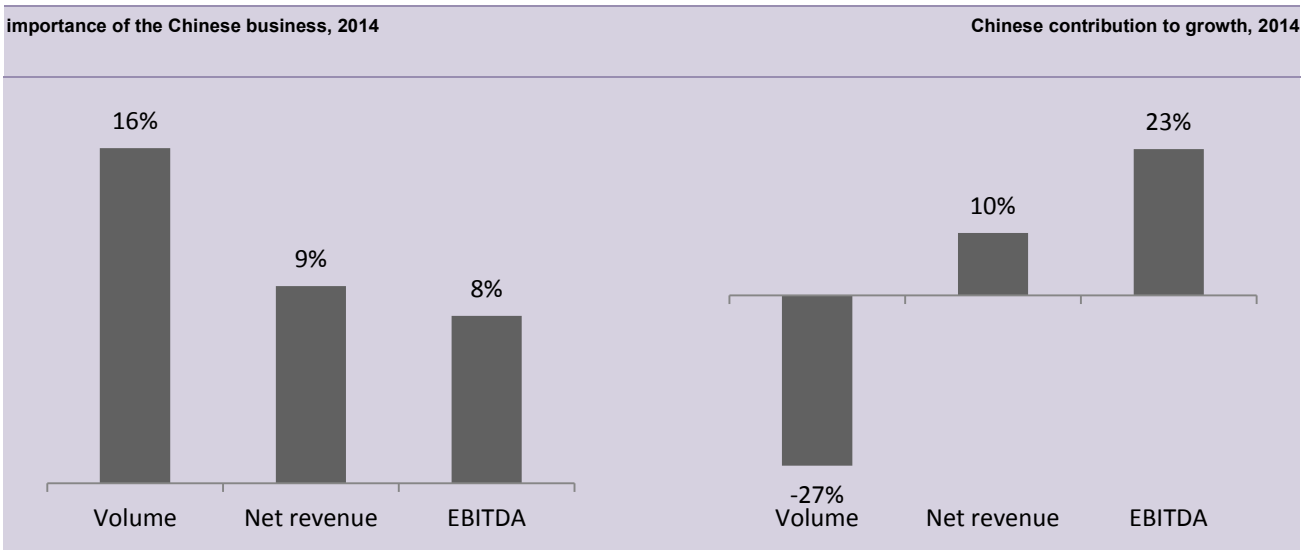
Carlsberg has a 50% share in its core Western provinces

Carlsberg currently (2014) ranks fifth with a 6% share of sales volumes and value, but is the leader in its operating provinces. The company has a share of around 50% in its Western core provinces (including a 30% share in Yunnan, 60% share in Xingjiang and 85% in Chongqing). It currently has 47 breweries in China.

China is 9% of group revenues

In China, Carlsberg's revenue for 2014 was around DKK6.1bn (that is from the Xinjiang, Yunnan, Chongqing and Guangdong assets) on which it has an operating margin of around 10%. According to our calculations, China contributed in 2014 16% of volume, 9% of net revenue and 8% of EBITDA. It contributed 27% to the decline of the group's volume, 10% to the organic growth in revenue and 23% to the organic growth in EBITDA. However, in 2015, it will be one of the few areas in growth and we estimate that, including the DKK0.5bn of the acquired eastern assets of Chongqing, organic growth and currency appreciation, China could realise DKK7.6bn of revenues and an EBIT of DKK660m (including the DKK100m loss for the acquired Chongqing assets).

Fig. 1: The weight of the Chinese business for Carlsberg



Source: Company, Bryan, Garnier & Co estimates

1.1. Strategic priorities

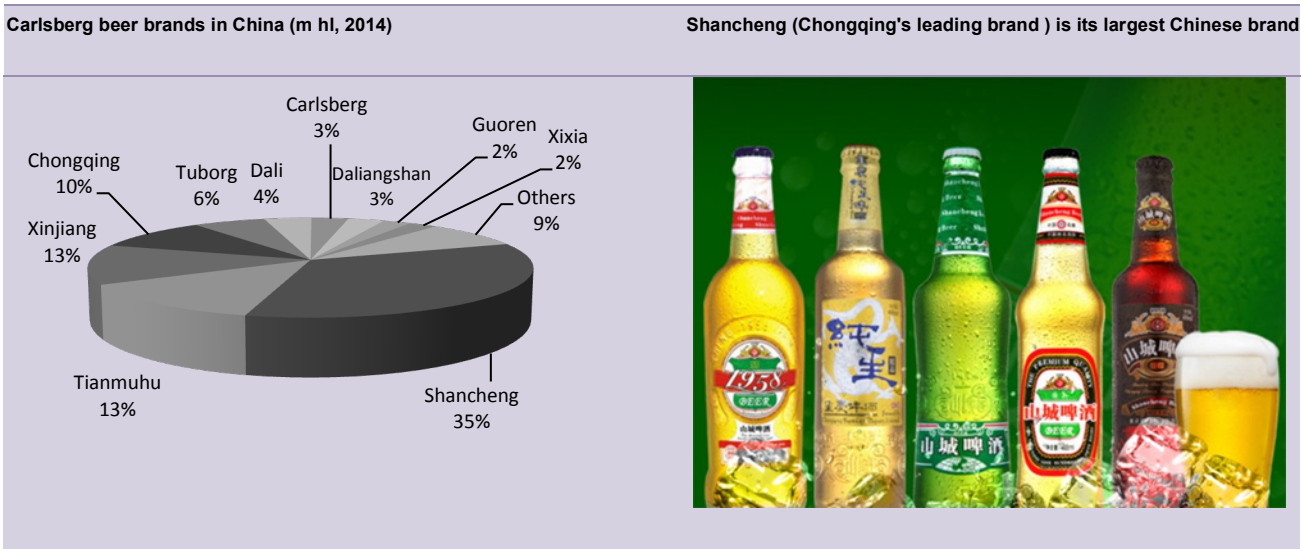
Building local power brands

According to the former CEO, Jorgen Buhl Rasmussen, Carlsberg's strategy in China is based on making the local power brands more attractive, more premium and on top of that sell its international brands Carlsberg, Tuborg and 1664. Because of the preference of lighter tasting beers, the company has introduced sub-brands Carlsberg Chill (for the night life) and Carlsberg Green (for the dining occasion).

Increasing sales of its international brands Carlsberg and Tuborg

In general, Carlsberg is already widely distributed in China (with a separate distribution and sales force, although recently in some provinces, e.g. Xingjiang. the sales team is integrated with the local businesses), but the group believes it has further room for increasing the distribution of Tuborg. Selling respectively 1.4m hl and 2.4m hl, Carlsberg and Tuborg brands make up in total 9% of the company's China volumes and 14% of its consolidated China volumes.

Fig. 2: Carlsberg's China brand portfolio



Source: Canadean, Bryan, Garnier & Co estimates

Also on the East coast are the recently acquired footholds in the eastern provinces of Jiangsu, Anhui and Zhejiang, where the company is losing money (DKK100m on revenues of DKK500m). One of the main reasons for this is the capacity utilisation of less than 50% and selling mainly in the low mainstream segment. The eastern provinces are being integrated into the Carlsberg Group and marketing efforts will be on the local brands to improve volumes and up the mix.

However, for the group's profitability, it is more important to focus on Chongqing, Yunnan and Xinjiang where the company continues to strengthen its local brands and build premium brands. In these areas, competition is fierce. In the North West, Carlsberg's main competitor is Yanjing whereas in the South it has AB InBev and CR Snow as the main competitors, both of which have deep pockets to improve their foothold.

Integrating Chongqing

In Chongqing, Carlsberg's 80% share of the market should shield it from increased competition and give it a base to move into neighbouring provinces. Although Carlsberg owns only 60% of Chongqing Brewery the focus is on putting it on the same platform as the Carlsberg Group for IT, procurement and payrolls, enabling it to run the business more efficiently. Brand wise, the company is now shifting to improving brand positions and introducing Carlsberg/Tuborg.

1.2. M&A – everything on hold

Currently, Carlsberg has put a stop to all M&A as its new CEO, Cees 't Hart, settles in and prepares his strategic plan for the company (expected to be communicated in Q2 2016). Still we believe that if the opportunity arrives to clean up its structures in China, the company would act. Moving forward, we can see some closer cooperation between Carlsberg and Tsingtao but also notice that the blind spots in CR Snow's imperium are corresponding to Carlsberg's geographies.

1.3. Outlook for Chinese profits

For 2014, we estimate Carlsberg's China revenues of DKK6.1bn and EBIT of DKK610m and, with the organic growth, currency appreciation and the acquisition of the eastern assets of Chongqing, we expect the Chinese operations to contribute DKK7.6bn to net revenues and DKK660m (including the DKK100m loss for the acquired Chongqing assets) to EBIT. According to our estimates, the company is making roughly the same margin on the Carlsberg/Tuborg package (more on Carlsberg but Tuborg was launched only three years ago in China) as on the other businesses.

2. Updating forecasts for the Carlsberg Group

Disappointing first half

On 19th August, Carlsberg published pretty bad profit numbers for the second quarter of 2015 (and that is putting it mildly) with operating profit down 19% to DKK2,922m which was 11% below consensus of DKK3,265m. On the back of the weaker results in both Western and Eastern Europe, the company revised its 2015 organic operating profit guidance down to a slight decline vs previously mid-to-high single-digit growth and is now expecting a slightly less negative impact from currencies at DKK300m vs previously DKK400m. Following these results, we have already lowered our 2015 operating profit forecast by 8% to DKK8,878m (a 4% decline on 2014) and adjusted net profit by 5% to DKK4,720m which is a 14% decline on 2014.

Western Europe rebound in H2

The biggest miss and shock came from the Western European business where net revenues were down 2%, which was actually slightly ahead of expectations, but operating profit fell by 18%. In terms of revenue, H1 was up due to relatively high comps with last year's good weather and the Football World Cup and this year the weather was bad. With that background, a 2% decline in net revenues in Q2 (1% volume and 1% price/mix) was a good performance (the Western European market was down 2-3%). However, comps are getting easier with last year's Q3 having bad weather (and volumes flat at Carlsberg in a market down 3%), so for the full year we are expecting an organic net revenue decline of only 0.5% (implying 1.5% growth in H2). The bad weather and negative price mix was one of the reasons for the H1 profit drop of 7% (-18% in Q2), but the main reason was the shortfall in anticipated cost savings because of widespread execution problems, which, as we understand it, has mainly to do with wanting to do too much (for the Carlsberg organisation) in too short a period of time. Indeed, while most supply chain managers were still busy implementing BSP1 (comprehensive set of standardised business processes and an integrated supply chain), other subsequent changes (i.e. relocation of bottling lines) happened so fast resulting in a lack of savings and in some cases doubling costs. However, some of these savings should come through in the second half of the year which leads us now to look for a flat Western European margin in 2015 (down 100bp in H1). We still believe that the company is on track to deliver a 250bp margin improvement (basis 2012) but are now expecting the company to hit that target by 2019 instead of the original guidance of 2017.

Eastern Europe from bad to worse

Although the Russian market declined by 9%, Carlsberg's Eastern European volumes were down by 18% in the first half because of the further decline in the Ukrainian market as well as the market-driven need for further inventory reductions at distributors in Russia (a consequence of the significant slow-down of the economy and consequent decline of the beer market as well as the rapid channel shift from traditional trade to modern trade). With the further deteriorating economic situation, we expect underlying volumes in Russia to be 12% in the second half (on top of the 6-7% decline last year). And although stock levels are now at the level they are supposed to be, the negative spiral of declining expectations is unlikely to offer some temporary relief. So, for the full year, we are expecting volumes in Eastern Europe to be down by 15%. This should result in a margin contraction of 510bps, which is slightly better than the H1 contraction of 530bps. For the years ahead, forecasts are extremely difficult to make, given the uncertainties on the economic and political front. However, we assume that the Russian beer market continues to decline in 2016 by 3% before stabilising at that level. Profit wise, we would expect, in that scenario, to see some improvement in margin next year to 16.6% from 15.9% and a tick-up to the 17% level in the years afterwards.

Asia was and is the bright spot

Asia was the bright spot in the first half, delivering 34% higher revenues and 29% higher EBIT. Net revenue grew organically by 9% (volumes +5%) with reported net revenue growth of 38% due to strong currencies and the Chongqing Eastern Assets acquisition. The price/mix continued to develop favourably at +4%. Price/mix growth was helped by Tuborg which continued its very strong performance in Asia and increased volumes by 66%, as it almost doubled its volumes in China and grew 50% in India. The Indian business was also the country operation that performed the strongest, delivering 43% organic volume growth in a market growing slightly. In China, volumes grew by 1% organically, significantly outperforming the Chinese market which declined by a mid single-digit percentage. Volumes grew 12% in reported terms due to the consolidation of Chongqing Eastern Assets. The Chinese price/mix improved by 4% driven by a healthy mix development. Going into the second half of the year, we are expecting a somewhat bleaker picture for the Chinese organic volume development as the easy comps in North West China (bad weather) disappear and the beer category is increasingly affected by the ant-extravaganza measures of the government. Nevertheless, we are expecting organic revenue growth of 7% and organic operating profit growth of 11%

Adjusted net profit to be down 23%

We expect organic EBIT to decline by 0.3% as the decline in Eastern Europe is balanced by the increase in Asia (Western Europe is expected to be flattish). However, with the unfavourable currency translations, we are expecting a decline in EBIT by 7% to DKK7,863m. On top of this, there is a higher overall cost of debt (4% vs 3.3%) and a higher tax rate (28% vs 26.1%) and, as a result, we are expecting adjusted net profit to be down 23% to DKK4,211m from DKK5,496m.

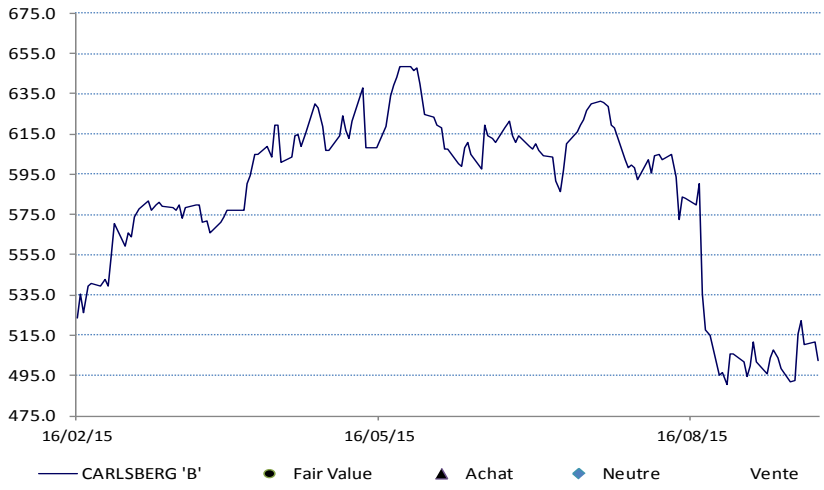
Fig. 3: Results outlook Carlsberg by division

	FY2013	FY2014		FY2015e		FY2016e	
DKKm	Published	Published	% Incr.	New	% Incr.	New	% Incr.
Net sales	64350	64506	0.2%	65151	1.0%	66448	2.0%
North & Western Europe	37393	37762	1.0%	38321	1.5%	38798	1.2%
Eastern Europe	17711	14100	-20.4%	10684	-24.2%	10221	-4.3%
Asia	9063	12491	37.8%	15988	28.0%	17268	8.0%
Non allocated	183	153	-16.4%	158	3.0%	162	3.0%
Operating profit	9723	9230	-5.1%	8521	-7.7%	9249	8.5%
North & Western Europe	5183	5470	5.5%	5551	1.5%	5892	6.1%
Eastern Europe	4127	2962	-28.2%	1698	-42.7%	1470	-13.5%
Asia	1882	2195	16.6%	2682	22.2%	3311	23.5%
Non allocated	-1330	-1282	-3.6%	-1295	1.0%	-1308	1.0%
Other	-139	-115		-115		-115	
Special items	-435	-1353	211.0%	-300	-77.8%	-300	0.0%
Operating profit margin	15.1%	14.3%	-5.3%	13.1%	-8.6%	13.9%	6.4%
North & Western Europe	13.9%	14.5%	4.5%	14.5%	0.0%	15.2%	4.8%
Eastern Europe	23.3%	21.0%	-9.8%	15.9%	-24.3%	14.4%	-9.5%
Asia	20.8%	17.6%	-15.4%	16.8%	-4.6%	19.2%	14.3%
Net interest	-1506	-1191	-20.9%	-1401	17.7%	-1238	-11.7%
PBT	7782	6686	-14.1%	6820	2.0%	7712	13.1%
Tax	-1833	-1749	-4.6%	-1910	9.2%	-2159	13.1%
Minority interests	-478	-523	9.4%	-575	10.0%	-633	10.0%
Net profit - published	5471	4414	-19.3%	4335	-1.8%	4920	13.5%
Net profit - adjusted	5772	5496	-4.8%	4211	-23.4%	4765	13.2%
Number of fully diluted shares	153.1	153.0	0.0%	153.0	0.0%	153.0	0.0%
Diluted EPS - Published	35.7	28.8	-19.3%	28.3	-1.8%	32.2	13.5%
Diluted EPS - adjusted	37.7	35.9	-4.7%	27.5	-23.4%	31.1	13.2%
Net dividend (DKK)	5.8	6.5	12.5%	6.8	5.0%	7.1	5.0%

Source: Company Data; Bryan, Garnier & Co estimates.

Price Chart and Rating History

Carlsberg



Ratings		
Date	**Ratings**	**Price**
05/05/15	NEUTRAL	DKK619

Target Price	
Date	**Target price**
19/08/15	DKK629
05/05/15	DKK634

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Bryan Garnier stock rating system

For the purposes of this Report, the Bryan Garnier stock rating system is defined as follows:

Stock rating

BUY — Positive opinion for a stock where we expect a favourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential upside based on valuation), but also takes into account a number of elements including a SWOT analysis, positive momentum, technical aspects and the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

NEUTRAL — Opinion recommending not to trade in a stock short-term, neither as a BUYER or a SELLER, due to a specific set of factors. This view is intended to be temporary. It may reflect different situations, but in particular those where a fair value shows no significant potential or where an upcoming binary event constitutes a high-risk that is difficult to quantify. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

SELL — Negative opinion for a stock where we expect an unfavourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential downside based on valuation), but also takes into account a number of elements including a SWOT analysis, positive momentum, technical aspects and the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

Distribution of stock ratings

BUY ratings 64.3% NEUTRAL ratings 31.3% SELL ratings 4.3%

Research Disclosure Legend

1	Bryan Garnier shareholding in Issuer	Bryan Garnier & Co Limited or another company in its group (together, the "Bryan Garnier Group") has a shareholding that, individually or combined, exceeds 5% of the paid up and issued share capital of a company that is the subject of this Report (the "Issuer").	No
2	Issuer shareholding in Bryan Garnier	The Issuer has a shareholding that exceeds 5% of the paid up and issued share capital of one or more members of the Bryan Garnier Group.	No
3	Financial interest	A member of the Bryan Garnier Group holds one or more financial interests in relation to the Issuer which are significant in relation to this report	No
4	Market maker or liquidity provider	A member of the Bryan Garnier Group is a market maker or liquidity provider in the securities of the Issuer or in any related derivatives.	No
5	Lead/co-lead manager	In the past twelve months, a member of the Bryan Garnier Group has been lead manager or co-lead manager of one or more publicly disclosed offers of securities of the Issuer or in any related derivatives.	No
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7	Research agreement	A member of the Bryan Garnier Group is party to an agreement with the Issuer relating to the production of this Report.	No
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