FREE KIC NO. 55 MAY 10

IS THERE METHOD IN THE MAGNERS?

In September 2006 on a visit to the Bulmer's factory in Clonmel I had the opportunity to have lunch with the Chief Executive Maurice Pratt. That pleasant lunch gave me the idea for Opinion piece 12 "Magners Magic".
Earlier this week I attended the C&C annual results presentation and I met John Dunsmore the new Chief Executive. That meeting made me realise that it was time to revisit my old opinion piece and talk about the dramatic events that have taken place at the company.

I would love to be able to report back that my 2006 analysis had been accurate but unfortunately that is not the case. Back then I wrote "*I think that the analyst community may still be underestimating just how big this brand might be.*" In fact it turns out that I was the one overestimating the strength of the Magners brand.
It is at moments like this that I think of Warren Buffett's humorous remark that he is an "air-oholic" and he needs a phone helpline to call every time he has the urge to buy an airline. In other words he feels that he needs help to fight against the urge to buy airlines because they will inevitably lose him money and he should have learned from his disastrous investment in US Air.
In my case I need a "spare capacity-oholic" phone helpline because sometimes I have the habit of believing that spare capacity will get used. (I should have learned from my days of visiting Japanese companies that I have described in other opinion pieces.)

In my 2006 Opinion Piece I mentioned that C&C felt they needed to increase cider capacity from 200m litres to 500m litres. I had my "spare capacity-oholic" moment and said that I thought that they might need the capacity. I must have been on the cider when I wrote that because in 2008 they sold 176m litres. In other words they did not need any additional capacity.

I was wrong in a number of ways. First of all I overestimated the potential size of the premium cider market in the UK. Secondly I overestimated the market share that Heineken would achieve with their "Bulmers" brand. Thirdly I underestimated the importance of distribution (in particular the way pubs are owned and controlled) and fourthly I was wrong to think that Magners could become anywhere as near a dominant brand as Bulmers in Ireland.
In particular I think the biggest single mistake I made was underestimating the competition. As the following pictures show the biggest competitor responded to the Magners success with a copycat marketing campaign:

Magners – Packaging 2007 vs 2008 (Limited Change)

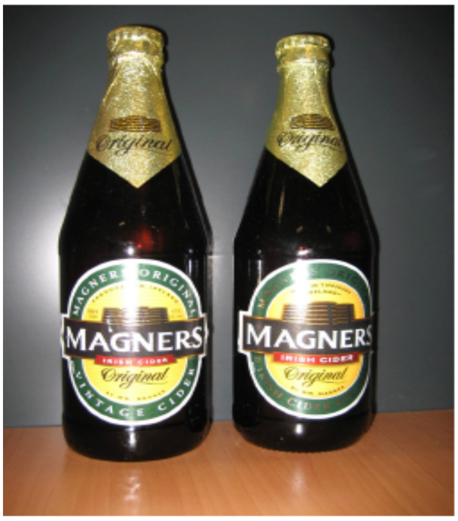
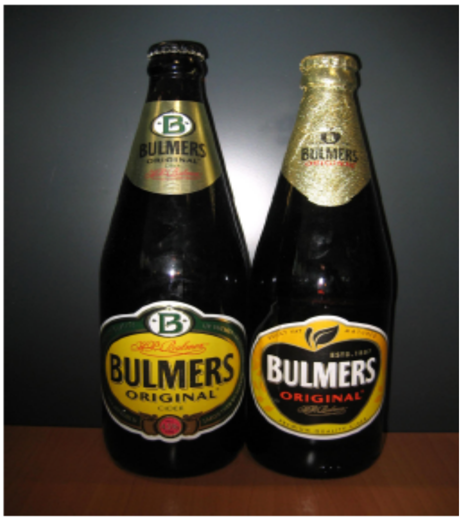
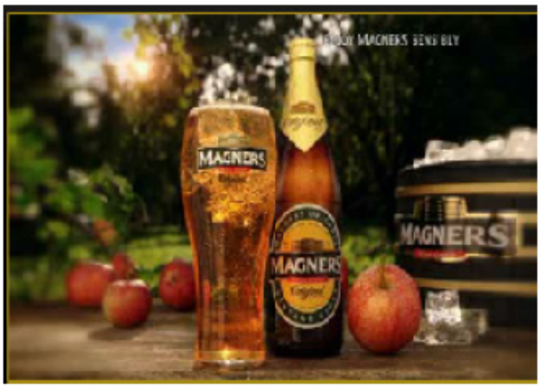


Figure 38. Bulmers – Packaging 2007 vs 2008 (Significant Change)

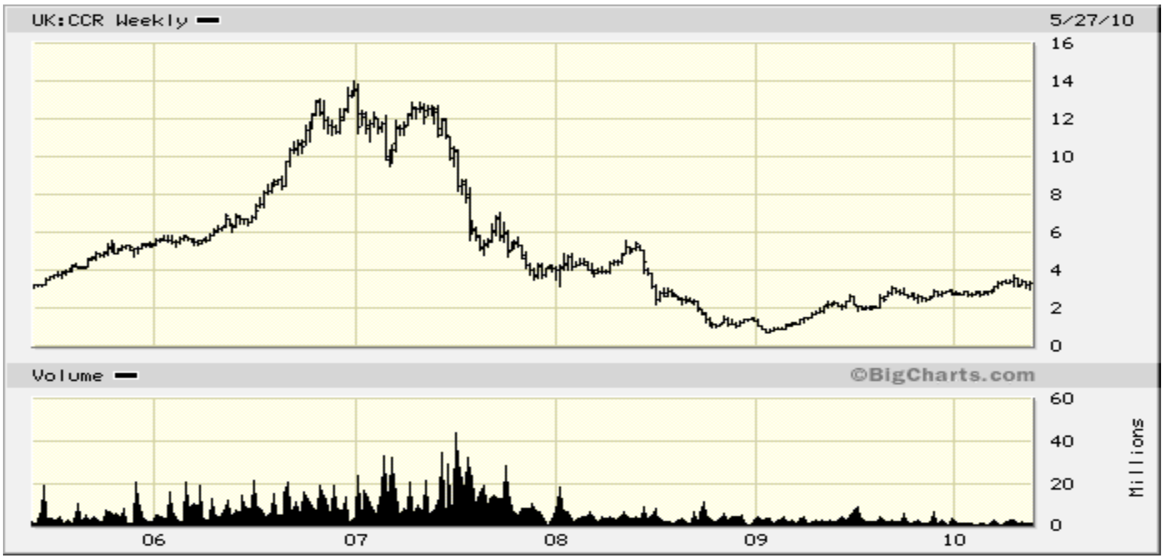


This copycat approach combined with good distribution and cheaper pricing meant that instead of growing volumes Magners began to see volumes decline.

There are only two things that I can claim to have got right. First of all I believed that “Bulmers” would remain the dominant cider brand in Ireland and secondly I believed that cider was not a fad and was likely to keep on growing.



I was therefore wrong to say that C&C was a buy at €10 and it was painful to watch the share price fall from a peak of €14 at the end of 2006 to a low of €0.75 in early 2009:



I never sold my shares because even though I realised that I had overestimated the potential of Magners I still believed that it was a good brand and the drop from €12 to €4 seemed to happen in what felt like a very short space of time. At €4 I felt I had the comfort of knowing that Bulmers in Ireland remained a dominant player and a cash generating machine. I felt that Bulmers alone was worth at least €500m because it was generating operating profits of at least €50m. I felt that the stock market was once again going through that process of going from one extreme to another. It was going from extreme optimism to extreme pessimism. I hoped that ultimately a new realism would recognise the continuing strengths that I still believed in.
I did not see the scale of the economic crisis that was about to hit Ireland in 2008 because that knocked volumes in the Irish market and ultimately led to the share price falling below €1.

I did not know what to think in November 2008 when a whole new management team was put in place. I was comforted by the fact that they were the people that had caused so many of the problems for Magners by boosting the Bulmers brand in the UK. Little did I think that they would engage in a whirlwind of activity that has significantly changed the overall structure of the business.

As I mentioned at the beginning I recently met the new Chief Executive for the first time. He brought us up to date with his thinking at the annual results presentation. I listened closely to his analysis and I am once again making a judgement call that the new team’s strategy of buying more cider exposure and getting into lager is a reasonable one. I am also making a judgement call that they got a good price for the sale of their spirits brands.
I believe that cider remains an excellent business and I think Bulmers in Ireland will remain a dominant brand. I think Magners will stabilise and the new Gaymers brands will generate an acceptable return.
I hope Tennents will throw off plenty of cash and with a little bit of support will remain the dominant lager in Scotland.
Even if I am still being optimistic I think the scale of any disappointment should not be anything like what happened in the last few years.
I think management will be in a position to increase the dividend and hopefully I will start to get a decent yield on my shares.

Management still believe that there is a major opportunity to sell cider internationally. I think it is sensible to exclude this from the current discussion.
In four years time I might end up writing another opinion piece on how Magners succeeded or failed to take off in international markets but at least I will be able to celebrate or drown my sorrow with a pint bottle of Bulmers.

In conclusion I just want to say that when I bought the shares at €2.54 in November 2004 I think I would not have been too upset if I had known the shares would be trading at €3.20 in 2010 (paying a reasonable dividend along the way). It is only because they went to €14 in 2006 that I have a sense of disappointment. Long term investing sure can be a bit of a roller coaster!


John Dunsmore