A Work Project, presented as part of the requirements for the Award of a Masters Degree in Finance from Nova School of Business and Economics

Anheuser-Busch InBev acquisition of Oriental Brewery

Tomás Neves Ferrão Relvas, 752

A Project carried out under the supervision of

José Neves de Almeida

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Section A. Case Study

It is August 2013, in two weeks time the Board meets to decide on whether to go forward with the acquisition of Oriental Brewery (OB). Alan Johnson[1] is the Head of Corporate Development at AB InBev, the World's largest brewer, and is in charge of presenting the case to the Board.

Oriental Brewery was AB InBev's South Korean unit, sold in 2009 to KKR and Affinity Equity Partners in a transaction with an embedded Call Option that gave the company the right to reacquire the asset between July 2014 and July 2015 at a pre-agreed multiple of 11.0x EBITDA. The Board has mentioned concerns regarding the early exercise (acquisition of the asset ahead of the exercise period) of the Call Option as it sees value in keeping it until maturity, so as to see how market conditions evolve. Given that AB InBev is still financially stretched due to the $20bn acquisition of Grupo Modelo in 2012, Alan needs to consider leverage issues that may arise as well as asset pricing concerns.

AB InBev background

AB InBev has a long history of acquisitions. The company was founded in 2004 under the name InBev, following the merger of Belgium's Interbrew and Brazil's Ambev (Companhia de Bebidas das Américas). This merger between Europe's and South America's largest brewers created, at the time, the number one global brewer with around 12% share in the global beer market.

The merger was expected to generate synergies of €280m (c.$350m) over the coming years, through a combination of technical, procurement and other general and administrative cost

[1] Alan Johnson is a fictitious name with the intent of not disclosing the identity of the actual individual holding the described role

savings, as well as commercial (revenue) synergies such as the cross-licensing of existing brands. The new entity's flagship global brands included Interbrew's *Stella Artois* and *Beck's*, as well as Ambev's *Brahma*.

In July 2008, the company went through yet another significant undertaking by acquiring industry giant Anheuser-Bush (AB). This $52bn acquisition was the largest ever in the industry to date and created an undisputed No 1 global brewer with a global beer market share of around 20%. The newly formed AB InBev now owned brands such as *Budweiser*, *Bud Light* and *Corona* from Anheuser-Busch, as well as InBev's *Stella Artois*, *Beck's* and *Brahma* brands.

The acquisition had a very strong rationale and significant synergistic potential. There would be minimal geographic overlap between the two companies, as well as possibility for cross-selling brands in different markets, leading to higher revenues. For example, *Budweiser*, No 1 brand in the United States, could now enjoy an established global distribution channel. In addition, InBev has long had a strong reputation for financial control and sets the industry standard in cost minimization and supply chain optimization[2]. By applying these standards, there was potential to improve AB's margins via cost reduction, as well as combined R&D. The World's No 1 had further strengthened its purchasing power through the ability to better negotiate long term pricing agreements with suppliers. The merger was expected to realize $1.5bn in synergies over the next 3 years – $1.0bn from AB and $0.5bn from InBev.

[2] The company is known for its World class efficiency and financial discipline, with a number of group-wide cost efficiency programmes in place, such as the Zero Base Budgeting and the Voyager Plant Optimisation. These measures have resulted in increased Normalised EBITDA margins evolution from 21.3% in 2003 (based on Interbrew's margin) to 34.6% in 2007

The transaction was financed with both debt and equity, including $45bn in bank debt[3] as well a $9.8bn rights issue, implying that over 80% of the deal was debt financed. One of the company's major concerns with the deal was its commitment to maintaining an investment grade profile, based on credit rating agencies' metrics. To do so, it committed to a rapid de-leveraging of its Balance Sheet to a target 2.0x leverage[4] through strong cash flow generation, enhanced focus on working capital improvements, a more flexible dividend policy throughout the first two to three years following the acquisition[5] and a series of asset disposals. According to a company announcement:

> *"Financing of the transaction has been structured for rapid repayment of a significant portion of the credit facilities through anticipated asset disposals and capital markets issuances"*

Post-merger asset disposals

At the end of 2008, AB InBev's leverage reached 4.7x[6], higher than any other brewer. The following year, the company set itself to executing $7bn in assets divestitures. In doing this, it tried to ensure divestments had minimal operational impact by setting up agreements with the buyer, in addition to favouring divesting to Private Equity firms over competitors. Over the course of the year, AB InBev completed $9.4bn in divestitures.

[3] The debt component of the financing consisted of: Term A Bridge to DCM (12+12mo.) of $12.0bn; Term B 1 year Bridge on Disposals of $7.0bn; Term C 3 year Bullet Bank Loan of $13.0bn; Term D 5 year Bullet Bank Loan (incl. $1.0bn RCF) of $13.0bn

[4] Leverage ratio measured as Net debt/EBITDA

[5] InBev's dividend policy at the time of acquisition implied an aggregate dividend of at least 25% of the Company's consolidated profit attributable to equity holders. Nevertheless, at time of merger, it issued a statement warning shareholders that *"the dividends to be paid in the first two to three years after the closing of the Acquisition may be lower than the 25% threshold"* (InBev Analyst Meeting, October 2008)

[6] PF leverage estimate to simulate the effect of the merger as if it had occurred on 1 January 2008

These included, for example, its Labatt business in the US, sold to KPS Capital Partners. One of its key divestitures to a competitor involved the sale of its 27% stake in Tsingtao, China's second largest brewer, to a consortium including Asahi, who paid $667m for a 19.9% stake and private investor Chen Fashu, who paid $235m for a 7% stake.

Among its major disposals at the time was the sale of Oriental Brewery, its South Korean unit, to KKR. The deal was announced in May 2009 and completed two months later. In addition to AB InBev's stake in Tsingtao, this represented one of the company's main gateways into Asia, the World's fastest growing beer market at the time. Therefore, it was not in the company's long-term interest to dispose of such a strategic asset. However, due to the need to de-lever and repay some of its debt, the company was forced to go through with the sale of OB. The transaction was completed for an equity value of $1.8bn and included several covenants, such as an embedded Call Option and an Earn-Out agreement.

KKR's post crisis situation

Founded in 1976, KKR is a multinational Private Equity firm, based in the US. The firm is one of the largest and most renowned PE firms in the World, having established itself in the 1980's leveraged buyout hype, which it pioneered.

In 2007, the worst global financial crisis since the 1930's took place, the so called subprime crisis. It originated from the US housing bubble and soon affected US financial institutions (e.g. Lehman Brothers went bankrupt, Bank of America acquired Meryl Lynch) and quickly spread to the rest of the World, sending developed economies into recession. In Europe, it triggered the debt crisis forcing overleveraged countries such as Greece, Ireland or Portugal to ask for bailouts from international organisations.

The economic meltdown took a very hard toll on Private Equity firms who saw their invested companies experience financial distress and an inability to invest the cash they had raised in their funds during the boom years due to a lack of 1) solid assets to invest in; 2) available credit. During the pre-crisis period LBO firms raised as much as $507bn in cash from investors and were at this point struggling to find good investments and secure debt financing in order to meet their funds' return hurdles.

In 2008, KKR recorded the largest loss in its history, with a net loss of $1.2bn. One year before, the firm had raised its first Asia fund, a $4bn regional fund, and was now struggling to find good investments to deploy its investors' cash and achieve appropriate returns.

The 2009 asset disposal

On May 7th 2009, AB InBev and KKR announced they had entered an agreement to sell AB InBev's South Korean unit Oriental Brewery for a total consideration of $1.8bn. This was, at the time, the largest leveraged buyout since the start of the year.

The transaction resulted from a fairly quick arrangement given how keen both parties were to complete the transaction. It implied an estimated EV/EBITDA LTM multiple of 8.8x[7]. **Table 1** shows the sources of funds used in the transaction that include $750m in equity and $1,050m in debt[8], of which $300m in vendor financing provided by AB InBev[9].

[7] EV/EBITDA LTM is a common metric used in transactions and refers to Enterprise Value over Earnings Before Interest, Taxes, Depreciation and Amortisation in the Last Twelve Months

[8] Bank financing includes both USD and KRW denominated loans. Bank loans pay LIBOR +600bps of interest, coming down to LIBOR +350bps pa after the third year and LIBOR +400bps flat upfront-fee. USD denominated funding has been syndicated by Calyon, Nomura, Natixis, ING, JP Morgan, WestLB, Development Bank of Singapore and United Overseas Bank; KRW denominated funding has been provided by Korea Development Bank, Hana Bank, Standard Chartered Bank, HSBC, Korea Exchange Bank, Shinhan Capital, SMBC and National Federation of Fisheries Cooperatives

[9] Vendor financing pays LIBOR +800bps, stepping down to LIBOR +700bps after the first year

Sources ($m)		Uses ($m)	
Equity	750	Equity consideration	1,800
Debt	1,050		
Vendor financing	300		
Bank loans	750		
Total	1,800	Total	1,800

Table 1. Sources and Uses of Funds in OB acquisition by KKR

The deal managed to get debt financing in the height of the global financial and economic crisis, when credit was considered to be frozen. However it came at a cost: a debt stake of about 58% of total consideration, compared to 75% in the leveraged buyout's boom years. As KKR's Asia head Joseph Bae said upon announcement, the firm's "large" equity commitment and the "high asset quality" helped secure debt financing. "The Oriental deal doesn't necessarily mean the market is reopening for buyouts, but it shows that with the right asset, the right buyer, a fairly priced deal and some creativity on structuring, there's debt available".

Despite the large equity stake in the investment, vendor financing and the quality of the asset with No 2 position in its domestic beer market, bank loans were syndicated to spread default risk. In addition, KKR contracted loans in both USD and KRW to minimize currency exposure, given market uncertainty.

Besides the vendor financing provided by AB InBev, the deal had some specific covenants. The first of these was a Call-Option that gave AB InBev the right to buy back Oriental Brewery for a pre-agreed multiple of 11.0x EV/EBITDA LTM between July 2014 and July 2015. Only after this period expired, and in case AB InBev had not exercised its option by then, was KKR allowed to market its asset to other potential acquirers.

The second option embedded in the deal was an Earn-Out agreement between the two parties in which KKR committed to share part of the returns it was to make from the sale of the asset with AB InBev. These returns were measured using two metrics: Internal Rate of Return (IRR) and Money Multiple (MM). In the event that KKR was to have a return higher than a pre-determined hurdle in these metrics, it was contractually obliged to "share" this excess return with the vendor, AB InBev[10]. This is often called an "anti-embarrassment" clause for the vendor, in a sense that it prevents the acquirer from buying the asset at a low price to then sell it for a large profit.

These agreements between the two parties – i.e. vendor financing, call option, earn-out – were valuable to both. AB InBev would be able to re-acquire its South Korean unit with a strategic role in its long-term expansion into Asia, with no competition. In addition, the earn-out agreement allowed it to "save face" in case the acquirer was able to generate very high returns from this deal – besides profiting from said returns. In what regards KKR, it would be able to secure financing to complete the deal, which without the provided vendor financing would have been complicated – if not impossible. Furthermore, it benefited from a contractual double-digit exit multiple agreement, which was considered a reasonable price, bearing in mind market conditions at the time.

On July 7th 2009, shortly after the deal was announced, KKR sold 50% of its equity stake to Affinity Equity Partners, for $400m[11]. Affinity Equity Partners is a Hong-Kong based Private Equity firm investing in Asian companies. By doing so, KKR would be co-

[10] The Earn-Out agreement was based on a hurdle IRR of 35% and hurdle MM of 3.0x. In the event that the acquirer's returns exceeded these values it would be obliged to make a payment equivalent to 15% of the "excess return" to the seller. Given that these two hurdle rates could originate different levels of "excess return", the maximum between the two would be considered the Earn-Out value

[11] Affinity Equity Partners also assumed 50% of the debt burden from the transaction

managing its investment in Oriental Brewery. The goal behind this sale was twofold: on the one hand, KKR immediately profited from its investment and returned some cash to its investors. On the other hand, KKR welcomed Affinity into the partnership as it was keen to enjoy the latter's expertise in the field both due to its experience and to the proximity that its Seoul office offered OB's management team.

Oriental Brewery and the South Korean beer market

Oriental Brewery is one of South Korea's largest brewers. Founded in 1952 by the industrial conglomerate Doosan, it was acquired in 1998 by the Belgium brewer Interbrew to be then integrated in 2004 into InBev, after the merger between Interbrew and Ambev.

The company, currently operated by KKR and Affinity, owns the country's most popular beer – *Cass*. In addition to it, its portfolio includes *Cass Light*, *Cass Fresh*, *Cafri* and *Budweiser* as well as *Golden Lager*. These brands are produced, imported and marketed in South Korea based on an agreement between the company (and its owners) and AB InBev that grants it exclusive rights in the country. Along with Hite, Oriental Brewery's main competitor, they control about 95% of the South Korean beer market, in volume terms. In **Figure 1** the evolution of this duopoly's market share is shown and OB's dominance over the last 4 years becomes evident.

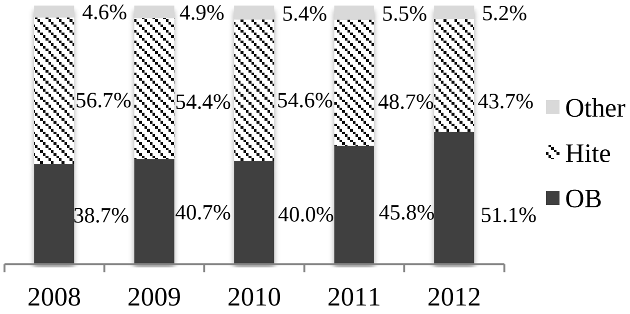


Figure 1. Top players in South Korea beer market

Under KKR and Affinity's tutelage, Oriental Brewery has seen its market share grow from c.40% to over 50%. This dominance was driven not only by a strong strategy from the management team, but also by a lacklustre performance on Hite's end.

Oriental Brewery has benefited from a distracted competitor. Hite has been suffering from integration problems post the acquisition of Jinro, the World's largest Soju[12] producer (even though the acquisition was completed in 2005, only in 2011 did the Fair Trade Commission allow for integration of its marketing and sales strategies). The lack of cultural integration has led to a decrease in synergies from the merger. Given the strength of its Workers Union, it has had trouble letting go of employees (which is one of the most common – though extreme – forms of cost cutting), thus limiting the potential to improve margins.

As OB managed to focus efforts on its *Cass* brand – with variations such as *Cass Light* and *Cass Red* that appeal to the younger generation, comprising almost half of the country's beer consumption – to drive consumer preference, Hite's flagship brands have been losing traction with the Korean consumer.

Beer market growth in South Korea is expected to be driven not only by volumes but mostly through pricing. Volume growth over the next years will be modest with an annualized growth over the next 5 years[13] of 2.7%, as depicted in **Figure 2**. Revenue growth is expected to be largely driven by pricing, which can boost market revenue growth to reach 4-5.5% annually over the next 5 years. This is pushed by a premiumisation of the beer market, as consumers become ever more aware of the different brands and start

[12] Soju is an alcoholic beverage based on ethanol and water and was in 2010 considered the most popular alcoholic beverage in South Korea

[13] Refers to CAGR 2013-18E

favouring those that offer a more premium flavour – such as OB's *Premier OB* and AB InBev's *Beck's* or *Corona*.

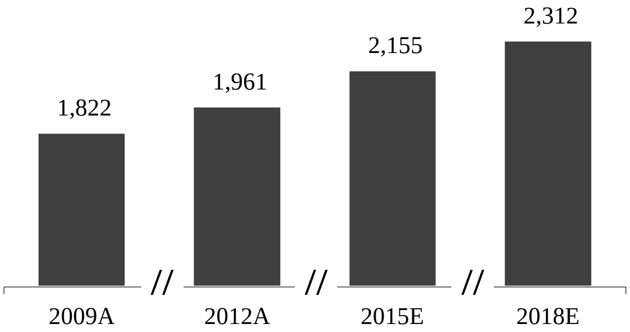


Figure 2. South Korea beer volumes (million L)

This consolidated market is also under pressure from potential entrants, such as Lotte. Lotte is a Japanese/South Korean conglomerate with strong presence in non-alcoholic beverages and liquor that has long wished to enter the beer business in this market. In fact, it was one of the frontrunners for the acquisition of Oriental Brewery, when, in 2009, it was surpassed by KKR and Affinity. Although Lotte has historically focused on beer imports (e.g. brands such as *Asahi* and *L*) it has been vocal regarding its interest to expand in South Korea.

AB InBev recent developments

On June 29th 2012 AB InBev announced yet another transformational acquisition: Grupo Modelo. The company has acquired the 50% stake it did not already own of the Mexican brewer for $20.1bn in cash. This gave the World's largest brewer full control over the *Corona* brand – US's largest imported beer by volume – and a leadership position in Mexico, the World's No 3 largest beer profit pool, behind the US and Brazil.

The acquisition of the remainder of Grupo Modelo represented a major push towards building presence in the faster growth emerging markets. In addition, its global distribution channels will provide meaningful opportunities to push the *Corona* brand outside the US and Mexico markets, along with potential cost savings of c.$600m annually.

The acquisition price represents an EV/EBITDA LTM multiple of 12.9x, above a historical average of 12.3x for similar deals since 2005. This comes to show the greater appetite for brewing stocks and their higher valuations since the financial crisis. Completed two months ago, in June 2013, synergies arising from the acquisition are expected to amount to $1bn annually, which corresponds to 15.6% of the target company's sales[14]. AB InBev is known to be able to cut cots and improve working capital requirements of the targets it acquires, thus benefiting not only from improved margins but also increased cash flow generation. Working capital benefits from the acquisition are expected to reach $500m annually.

After this acquisition, AB InBev has began to look again at other potential targets and continued to focus on its growth strategy. In April 2012, AB InBev's subsidiary Ambev gained control of Cerveza Nacional Dominicana through a strategic alliance with E. León Jimenes S.A. by contributing Ambev Dominicana along with a cash payment of $1.0bn, representing an EV/EBITDA LTM multiple of c.13.0x.

The acquisition of Grupo Modelo resulted in yet another increase in leverage, which had been coming down since the 2008 acquisition of Anheuser-Busch, as shown in **Figure 3**. The company is still committed to reaching its 2.0x leverage target.

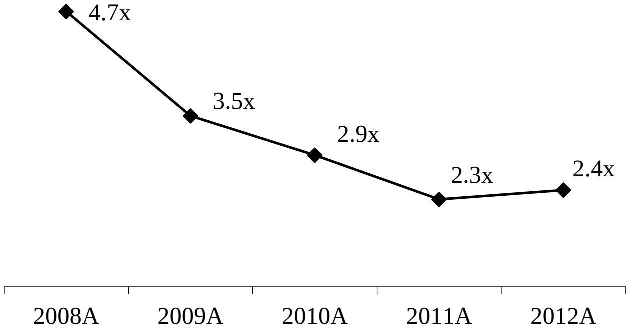


Figure 3. AB InBev historical leverage

[14] Run-rate synergies as % of target company sales is a common metric used to compare potential synergistic value creation between different transactions

AB InBev's financial control and ability to reduce leverage is something very well received by credit rating agencies. In fact, after the announcement of the acquisition of Modelo Moody's upgraded the company's outlook to positive, since it trusts in AB InBev's cash flow generation ability and the opportunity that this acquisition represents, despite a temporary increase in leverage[15].

At the moment AB InBev has nearly $7bn in cash and short-term investments and around $4.5bn of its $8bn credit facilities still available. This comes to show the amount of liquidity the company has available to fund its activities and potential investments.

Global beer market

Since the financial crisis, global brewers – AB InBev included – have been shifting their focus towards high growth emerging markets rather than developed economies. Grupo Modelo was a major step AB InBev took towards increasing its exposure to emerging economies. These markets, namely in Asia, South America and Africa, are expected to experience higher growth rates in volume terms, as is depicted in **Figure 4**'s estimates**.**

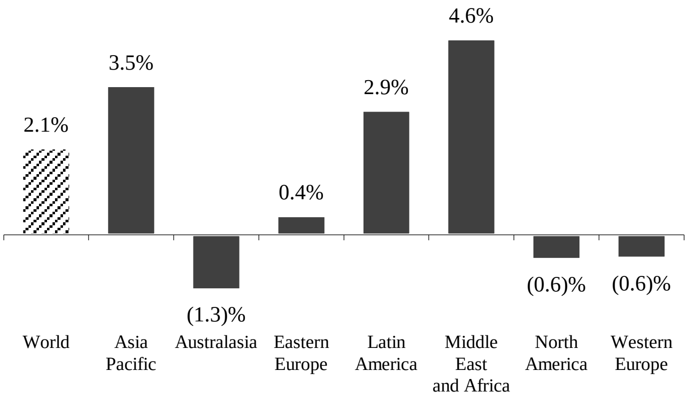


Figure 4. Beer market volume CAGR 2013-18E by major region

[15] Based on Moody's Investors Service report released on June 29, 2012 "Moody's affirms A3/P-2 ratings of AB InBev after Modelo acquisition announcement; outlook positive"

Besides focusing their efforts on organic growth in emerging markets, M&A activity around targets in these regions has been increasing. Valuations of these targets have been climbing since the global financial meltdown and the EV/EBITDA LTM multiple of selected key transactions since 2011 averages 13.5x[16]. In addition, it is interesting to see how emerging market beer companies are being traded at higher multiples when compared to global brewers[17]. As of the end of July 2013, these averaged 13.1x EV/EBITDA 2013, compared to 10.3x of global brewers.

These factors come to prove the optimism in the beer market and especially around a potential market consolidation, in which global brewers look for ways to improve growth that has been lagging in developed markets.

KKR and Affinity today

The current economic scenario for Private Equity firms, such as KKR and Affinity Equity Partners, is very different from what it was 4 years ago, upon the acquisition of Oriental Brewery. Debt availability into these types of riskier investments has regained its strength, particularly in the US.

KKR completed raising its second Asia fund at the start of July. Fund raising for this $6bn fund has been supported by a strong track record from KKR’s first Asia fund, which was fully subscribed and includes investments such as Intelligence, a Japanese recruitment group, sold for a fivefold return as well as Oriental Brewery, expected to create at least 4x initial invested capital returns.

[16] Refer to Appendix III – Selected precedent transactions. Excludes Hartwall/Royal Unibrew (target based in Finland) and Foster’s/SABMiller (target based in Australia)

[17] Refer to Appendix IV – Peer trading valuation multiples

By contrast, Affinity Equity Partners has been under some pressure from investors. It is currently in the process of raising its fourth APAC fund, Affinity Asia Pacific Fund IV but, as opposed to KKR who has been supported by a stellar track record in its previous fund, Affinity's APAC fund III, a $2.8bn fund in which Oriental Brewery is included, has had a mixed track record. OB is its largest and best performing asset, though investments outside South Korea have been underperforming. Therefore, its fund raising efforts have so far yielded a quantum of $1.5bn at first close, from a target of $3.8bn. It is thus looking to cristalyse well performing investments and return cash to its investors, in an attempt to boost confidence and secure funding for its fourth fund.

Dynamics of a potential early exercise of the Call Option

Alan has been thinking of whether it would make sense for AB InBev to exercise its option early, before the pre-established period from July 2014 to July 2015. He knows that the company looks at potential investments in two ways – strategically and financially. The first focuses on the fit between AB InBev and the target, bearing in mind economic conditions, the company's M&A "fire-power", the potential synergy creation and the fit of the target in its short and long-term strategy. As for financial considerations, the company analyses how much value can be extracted from the target and looks at three major financial metrics: ROIC, NPV and Accretion/Dilution analysis – the latter dictates in part market reaction. Finally it also needs to consider leverage implications arising from the acquisition and how this may affect reaching its target.

Assuming the acquisition of OB does make sense for AB InBev at the moment, Alan needs to think of what could trigger KKR and Affinity into being willing to sell their asset ahead of the Option's exercise period, in order to present a structured plan to the Board in a few weeks time. Strategically, the firms would be able to cash in immediately and return some of this cash to investors. In addition, by selling the asset immediately they reduce the risk of potential competition from a dormant competitor – Hite – and potential entry – Lotte. On the other hand, given that the price of the sale to AB InBev is based on a fixed EV/EBITDA LTM multiple and EBITDA is expected to keep rising, the longer they hold the asset, the greater the cash amount they will get for Oriental Brewery – although this does not necessarily imply a higher IRR.

There were certainly a lot of different perspectives to consider in such a deal, in particular because by exercising the option early “everything becomes negotiable”.

Conclusion

Alan Johnson has gone over a very broad list of targets in Emerging Markets. However, he keeps reaching the conclusion that Oriental Brewery would be the logical acquisition. And so the question remains: should AB InBev exercise its Option early and acquire OB now?

When presenting to the Board in two weeks, Alan will need to focus on two different issues: Why AB InBev should go forward with the acquisition at the moment, instead of waiting for the exercise period as there is value in optionality; and how AB InBev could present the case to the Private Equity firms to compel them to accept this early exercise. It is thus necessary to understand the strategic and financial rationale for all parties involved in order to present a potential structured deal. Seems like a lot of work for only two weeks.

Section B. Discussion Topics

Case Study key takeaways

1. *Leverage* Importance of leverage in companies and its main drawbacks

2. *Private Equity* How Private Equity firms look at value creation and investment analysis

3. *M&A* Asset disposals and valuation issues

4. *Derivatives* Importance of the use of options and other financial instruments in Corporate Finance and how these create value in transactions

Potential discussion questions

Corporate financial decision-making

- What are the consequences of over leverage in a company? How has it affected AB InBev's strategic decisions over the past 5 years?
- What are the main concerns of the Board at the moment and how can they be mitigated?

2009 asset disposal

- Why did KKR allow for a Call Option and Earn-Out agreement to be embedded in the original deal? Why did AB InBev concede a vendor loan?

The current deal

- Why would the Private Equity firms be willing to sell early?
- Why would AB InBev want to buy back its asset early (or at all)?
- How much should AB InBev be willing to pay for the asset? Please focus on
    - How much is Oriental Brewery worth to AB InBev?
    - Would this be an accretive acquisition?
    - Calculate the returns for the Private Equity firms – both IRR and MM

Section C. Discussion Note

AB InBev's asset disposal, in 2009, marked an important milestone in its history. It was part of its de-leveraging program, after the 2008 merger with Anheuser-Busch. This transaction came in the midst of the global financial crisis, which created difficulties in finding a buyer, as well as in securing a reasonable value for the asset.

The deal was negotiated quickly, given time constraints on both sides: AB InBev was "desperate" to dispose of the asset and get cash to pay down its debt burden, while KKR and Affinity were "sitting on piles of cash" from investors with no solid investment to make. Therefore, both parties agreed to terms that they might otherwise prefer not to include in such deal. These included the $300m vendor financing provided by AB InBev, as well as the Call-Option an Earn-Out agreement that put a cap on the Private Equity firms' returns, if it were to be exercised. However, these terms were necessary for the deal to go forward at the time and ended up shaping the situation that both parties are currently in.

AB InBev rationale

AB InBev, as any corporate, analyses investment opportunities under two different perspectives: strategically and financially. The first aims to assess whether it makes strategic sense to go forward with an investment whereas the latter analyses several financial metrics that help quantify how beneficial such investment is. These metrics include, but are not limited to, ROIC and NPV.

Oriental Brewery is a solid asset that has been performing very well in the past years under KKR and Affinity ownership and there is very little doubt in the market that AB InBev will indeed want to reacquire the asset. Besides being No 1 in its domestic market and exhibiting a continuously growing market share, AB InBev may leverage off of its strategic positioning in order to penetrate the broader Asian market.

The real question lies on why AB InBev would be interested in exercising the option early. Firstly, it would gain control of the asset sooner, allowing it to exploit both cost and revenue synergies. In addition, AB InBev will be able to pay a lower quantum for it. Since its acquisition price is pegged to its EBITDA LTM, and this metric is expected to keep increasing, the longer it waits the higher the acquisition price.

On the other hand, the Board's concerns do make sense and there is indeed value in optionality. There is less exposure to FX risk and increased competition (from the "awakening" of a dormant Hite or the entrance of Lotte). These risks would make AB InBev better off by waiting to then make a more informed decision after these concerns have played out in the market. Furthermore, by going through with the acquisition, AB InBev will in fact be actively choosing to delay reaching its leverage target of 2.0x, which may send a negative message to the markets. However, it is important to bear in mind that credit rating agencies seem to assimilate positively AB InBev's strategic acquisitions given the company's financial control ability and strong cash flow generation. In the end the decision cannot rely solely on the strategic rationale but also on its financial sense.

KKR and Affinity rationale

In order to build a compelling argument to the Board it is necessary to understand why the firms would be interested in going forward with an early exercise of the option.

In general terms, both firms benefit from cashing in immediately and distributing returns to its investors. They become less exposed to the volatility and uncertainty in the South

Korean beer market, as well as the potential entry of new competitors or the renewed focus of Hite – the latter's internal problems have been one of success factors of Oriental Brewery's brands in its domestic market and the extraordinary gain in market share. On the other hand, the longer KKR and Affinity wait, the larger the quantum amount they will get for OB, given the call-option agreement, which could give them an incentive to delay the transaction. However, this does not imply a higher IRR, as will be shown later on.

In the end, it all comes down to the timing of the transaction. KKR has just successfully raised a second Asia fund, however, Affinity, currently raising another APAC fund, is having more difficulties in luring investors. It is in need of crystallising returns in order to show good results after a historically patchy track record. Since the firms have been 50/50 partners throughout OB ownership, their internal politics will come into play in what comes to the final decision.

How KKR and Affinity look at returns

When assessing how much to pay for an asset we need to think of how much the seller stands to make in order to be able to make a reasonable offer and move forward with negotiations. By running an LBO model we are able to estimate their potential returns. Calculations are based on Oriental Brewery's historical financial statements in **Appendix II** and assume that all the available generated cash flow is used to repay debt[18].

By assuming an exit in December 2013 at 11.0x LTM EBITDA, the Private Equity firms are expected to make around 48.5% IRR and an impressive 5.9x MM. These values are pre-earn-out agreement, thus will be brought down once KKR and Affinity make the cash

[18] Cash available to repay debt is affected by a minimum operating cash level of 2% of sales as well as theoretically assumed 20% of total generated cash being trapped and thus not readily available for debt repayment, since it is an emerging economy

payment to AB InBev. **Table 2** and **Table 3** show the range of possible returns for the Private Equity firms, based on the exit date and the exit multiple.

Table 2. Internal Rate of Return

		Exit year			
		2012	2013	2014	2015
Exit Multiple	10.0x	47.7%	44.8%	40.7%	39.1%
	10.5x	50.3%	46.7%	42.1%	40.2%
	11.0x	52.8%	48.5%	43.4%	41.3%
	11.8x	56.6%	51.1%	45.5%	42.9%
	12.3x	58.9%	52.7%	46.7%	43.8%

Table 3. Money Multiple

		Exit year			
		2012	2013	2014	2015
Exit Multiple	10.0x	3.9x	5.3x	6.5x	8.5x
	10.5x	4.2x	5.6x	6.9x	9.0x
	11.0x	4.4x	5.9x	7.3x	9.4x
	11.8x	4.8x	6.4x	7.9x	10.2x
	12.3x	5.1x	6.7x	8.2x	10.6x

The Earn-Out agreement embedded in the deal stipulated that 15% of the maximum excess value between IRR and MM[19] would be paid out to AB InBev, as exemplified in **Table 4**. This opens room to further negotiation between the involved parties given that, even if the two were to agree on the 11.0x EBITDA LTM price, it is necessary to consider whether this refers to a pre or post Earn-Out payment to AB InBev, as in **Table 5**.

Table 4. Earn-Out value ($m)

		Exit year			
		2012	2013	2014	2015
Exit Multiple	10.0x	103	258	399	624
	10.5x	131	293	440	675
	11.0x	159	328	481	725
	11.8x	204	384	546	806
	12.3x	232	419	587	857

Table 5. Exit multiple post Earn-Out

		Exit year			
		2012	2013	2014	2015
Exit Multiple	10.0x	9.7x	9.4x	9.3x	9.1x
	10.5x	10.1x	9.9x	9.7x	9.5x
	11.0x	10.6x	10.3x	10.1x	9.9x
	11.8x	11.3x	11.0x	10.8x	10.6x
	12.3x	11.7x	11.4x	11.2x	11.0x

How much is OB worth to AB InBev

Oriental Brewery has been a unit of AB InBev in the past, which gives the company an informational advantage when compared to an external buyer. This may prove very helpful in accessing the synergistic potential of the target and the transaction, allowing for a more accurate prediction of synergies and value creation potential.

[19] Refers to 15% of the excess value above the hurdles of 35% IRR and 3.0x MM. Of these, the maximum quantum between the two is paid out to AB InBev

Synergistic value is expected to be created from both cost and revenue. Cost synergies, are expected to originate from procurement cost reductions, centralization of management and improved efficiency in distribution channels. Even though margins are already high – 2012 EBITDA margin of 33.4% – there is room for improvement. Besides cost reduction, Working Capital requirements are deemed to have the potential for enhancement. AB InBev, as the World's largest brewer has an improved negotiating capacity with both suppliers and clients that a local brewer like OB does not, thus leading to more beneficial NWC requirements. Finally, revenue is expected to increase by pushing other global brands into the South Korean market, such as Corona. Leverage concerns can also be mitigated since the impact of this acquisition adds only 0.3x leverage to the company[20].

In order to assess the true value of Oriental Brewery, several methods have been used. Valuation was run off OB's Operating model[21], in **Appendix V**. By conducting an Analysis at Various Prices (AVP), where we compare OB's value computed through a DCF[22], trading and transaction multiples[23], as in **Appendix VI,** Oriental Brewery's value to AB InBev lies between $6.0-6.5bn. This represents an LTM multiple of 12.9-13.9x, above the 11.0x agreed in the call-option agreement. Such negotiation, where "everything is on the table", will benefit from a wide window of opportunity for AB InBev. This will focus not only on the 11.0x pre-agreed in the Call option, but also taking into account the Earn-Out discount factor.

[20] Based on PF 2013E EBITDA, a funding gap of $5.1bn fully debt financed, given an acquisition price of 11.8x EV/EBITDA LTM

[21] Topline growth driven by the expected increase in beer volumes in South Korea, appreciation of OB's market share and improvement in pricing and product mix; run-rate pre-tax synergies amounts to 8% of OB's 2013E sales, reaching $118m, phased in over 3 years

[22] DCF assumes a WACC of 8% and a TGR of 3%

[23] Trading comparable companies include brewers depicted in **Appendix IV** (range of 11.2-12.2x LTM and 9.5-10.5x NTM); Selected peer transactions ranging from 11.8-12.8x LTM

Call-Option value

The Call Option embedded in the transaction cannot be accurately priced using quantitative methods as it is expected that EBITDA keeps growing. As the acquisition price is pegged to a multiple of this metric, the longer we wait to exercise, the higher the cash amount we will have to pay for the asset. Thus, every day we are maximizing the option value, as tomorrow to cost of acquiring OB will be higher. However, the Option does bear value.

Upon the 2009 agreement, it granted a "safe" acquisition multiple in an industry that AB InBev expected to improve considerably. As an example, by comparing the option's 11.0x multiple to the industry's recent emerging market average of 13.5x, we see that, for an exercise in Dec-2014, the difference in value amounts to about $1.4bn[24].

AB InBev financial analysis

The acquisition is EPS accretive from year 1 and has a 7.9% ROIC in year 1 rising up to over 11% in year 4, as depicted in **Table 6**, proving that it does make financial sense.

Table 6. EPS accretion/dilution and ROIC analysis[25]

	2014E	2015E	2016E	2017E
EPS accretion/(dilution)	2.0%	2.8%	3.1%	3.1%
ROIC @ Dec-2013	7.9%	9.9%	10.7%	11.1%
ROIC @ Dec-2014	-	8.5%	9.2%	9.6%

By comparing ROIC of an acquisition occurring in Dec-2013[26] versus Dec-2014[27] it is possible to argue the viability of an acquisition now rather than waiting. Even though year 1 ROIC is higher for an acquisition in Dec-2014, from year 2 onwards we are better off by acquiring OB in Dec-2013.

[24] EV difference between a price of 11.0x and 13.5x based on EBITDA LTM of $546m; Ignores Earn-Out
[25] Assumes a year end acquisition, 100% debt financed at an interest rate of 5%
[26] Assumes a pre-earn-out acquisition multiple of 11.8x
[27] Assumes a pre-earn-out acquisition multiple of 11.0x EBITDA LTM as per the Call-Option agreement

Appendixes

Appendix I – AB InBev historical and projected selected financial statements[29]

($m)	2009A	2010A	2011A	2012A	2013E	2014E	2015E
Revenue	36,758	36,297	39,046	39,758	44,092	45,988	47,873
EBITDA	**13,036**	**13,869**	**15,357**	**15,511**	**17,152**	**18,625**	**19,484**
D&A	2,789	2,704	2,750	2,746	2,866	2,989	3,112
EBIT	**10,247**	**11,165**	**12,607**	**12,765**	**14,286**	**15,636**	**16,373**
Non-recurring items	1,321	(268)	(278)	(32)	-	-	-
Net interest expense	(4,419)	(3,736)	(3,137)	(2,366)	(2,034)	(1,558)	(1,234)
Income from associates	513	521	623	624	692	722	751
Profit Before Taxes	**7,662**	**7,682**	**9,815**	**10,991**	**12,944**	**14,800**	**15,889**
Income tax expense	(1,786)	(1,920)	(1,856)	(1,680)	(1,978)	(2,262)	(2,429)
Net income	**5,876**	**5,762**	**7,959**	**9,311**	**10,965**	**12,537**	**13,461**
Minority interests	(1,264)	(1,736)	(2,104)	(2,165)	(2,550)	(2,915)	(3,130)
Exceptionals	(686)	1,014	594	41	-	-	-
Net income to shareholders beia[28]	**3,926**	**5,040**	**6,449**	**7,187**	**8,415**	**9,622**	**10,331**
Basic EPS beia	2.48	3.17	4.04	4.49	5.26	6.01	6.46
Diluted EPS beia	2.46	3.13	4.00	4.41	5.17	5.91	6.35
Other headline items							
Net debt	45,403	40,383	34,845	37,290	38,321	38,323	39,517
Capital expenditures	1,386	2,123	3,256	3,089	3,551	3,638	3,822
Working capital	-	(7,357)	(8,328)	(10,409)	(11,694)	(11,881)	(12,039)

Source: *Company Reports, Analyst Research, Author Analysis*

Appendix II – Oriental Brewery historical financial statements

Income statement[30]

($m)	2009A	2010A	2011A	2012A
Revenue	639.6	790.6	968.9	1,118.1
COGS	(271.7)	(348.4)	(420.7)	(471.2)
Gross profit	**367.9**	**442.2**	**548.2**	**647.0**
SG&A	(214.1)	(247.2)	(291.5)	(320.4)
Other income	4.4	13.9	7.2	5.2
Other expenses	(25.1)	(128.0)	(20.2)	(8.1)
Operating profit	**133.2**	**81.0**	**243.7**	**323.6**
Interest income	10.0	9.3	9.2	8.8
Interest expense	(4.0)	(106.8)	(73.4)	(54.8)
Profit before taxes	**139.2**	**(16.6)**	**179.6**	**277.6**
Income tax expense	(39.8)	16.5	(59.6)	(73.3)
Net income	**99.4**	**(0.1)**	**120.0**	**204.4**

Source: *Company Reports*

[28] The term 'Beia' stands for 'Before exceptional items and amortization'

[29] Estimates based on broker consensus as of Aug-2013

[30] All items translated from KRW to USD at the average exchange rate for the respective year

Balance sheet[31]

($m)	2009A	2010A	2011A	2012A
ASSETS				
Current assets				
Cash and cash equivalents	108.4	152.5	151.4	158.0
Current held-to-maturity financial assets	0.2	0.2	0.0	0.1
Trade and other receivables	177.5	195.7	220.8	228.6
Inventories	44.8	48.0	60.3	70.3
Other current assets	2.7	2.6	2.3	2.4
Total current assets	**333.4**	**399.1**	**434.8**	**459.4**
Non-current assets				
Held-to-maturity financial assets	2.1	0.1	0.2	0.1
Long-term deposits	17.5	0.0	0.0	0.0
Long-term trade and other receivables	30.1	55.2	46.3	42.8
PPE	571.6	583.2	618.2	615.0
Investment property	1.0	15.6	10.8	5.2
Intangible assets	1,074.1	1,273.8	1,330.5	1,308.3
Other non-current assets	8.5	1.7	1.3	1.0
Total non-current assets	**1,704.9**	**1,929.5**	**2,007.2**	**1,972.3**
Total assets	**2,038.3**	**2,328.7**	**2,442.0**	**2,431.7**
EQUITY & LIABILITIES				
Current liabilities				
Short-term borrowings	30.2	56.7	29.3	90.3
Derivative liabilities	1.2	0.1	1.9	2.4
Trade payables	20.7	50.2	83.4	72.6
Other payables	58.7	48.9	67.0	70.7
Accrued expenses	2.0	18.6	20.0	15.0
Guarantee deposits received	18.3	19.3	21.4	21.1
Current portion of long-term borrowings	25.9	-	-	28.5
Other current liabilities	138.4	124.3	256.9	212.1
Total current liabilities	**295.2**	**318.1**	**480.0**	**512.9**
Non-current liabilities				
Long-term borrowings	952.3	1,104.5	893.2	663.6
Provision for sales return	-	0.8	0.5	0.5
Long-term payables	14.0	0.0	-	-
Derivative liabilities	10.0	-	-	-
Defined benefit liabilities	9.7	14.9	21.7	28.1
Deferred income tax liabilities	50.3	86.8	94.5	88.3
Total non-current liabilities	**1,036.3**	**1,207.0**	**1,009.9**	**780.4**
Total Liabilities	**1,331.5**	**1,525.1**	**1,489.9**	**1,293.3**
Equity				
Common shares	73.3	81.2	84.8	83.4
Capital surplus	659.9	729.5	761.2	748.7
Capital adjustments	(0.7)	-	-	-
Retained earnings	(25.6)	(7.2)	106.1	306.4
Total Equity	**706.8**	**803.6**	**952.1**	**1,138.4**
Total Equity & Liabilities	**2,038.3**	**2,328.7**	**2,442.0**	**2,431.7**

Source: *Company Reports*

[31] All items translated from KRW to USD at the year-end exchange rate for the respective year

Cash Flow statement[32]

($m)	2009A	2010A	2011A	2012A
Cash flows from operating activities				
Profit (loss) for the period	99.4	(0.1)	120.0	204.4
Adjustments for:				
Depreciation & amortization	54.9	63.9	55.8	46.7
Retirement benefits	5.4	8.7	9.7	9.8
Income tax expense (benefit)	-	(16.5)	59.6	73.3
Gain of foreign currency translation	-	(0.1)	(0.2)	(0.1)
Gain on sale of PPE	(0.7)	(5.0)	(1.4)	(0.7)
Other losses	3.6	85.4	17.6	6.8
Interest expense	28.8	106.8	73.4	54.8
Interest income	-	(9.3)	(9.2)	(8.8)
Change in assets and liabilities:				
Net trade receivables/(payables)	(4.6)	35.7	20.2	(18.5)
Net other receivables/(payables)	(20.6)	(5.8)	14.3	6.9
Net advance payments/(receipts)	-	(0.2)	0.7	(0.1)
Prepaid expenses	(1.0)	1.3	(0.2)	(0.3)
Derivative assets	-	(9.8)	(0.1)	(0.7)
Inventories	7.8	(1.5)	(10.2)	(11.0)
Other current assets	1.7	2.0	0.1	0.2
Long-term trade receivables	-	4.7	9.6	5.6
Guarantee deposits received	(1.2)	(1.0)	1.9	0.1
Accrued expenses	0.5	1.5	1.8	(0.2)
Withholdings	25.7	(31.4)	83.6	(47.1)
Other current liabilities	10.0	0.0	0.9	(0.9)
Provision for loss on sales return	-	0.3	(0.3)	(0.0)
Payment of retirement benefits	(9.0)	(5.8)	(12.1)	(6.1)
Cash generated from operating activities	**200.7**	**223.9**	**435.4**	**313.8**
Interest received	-	1.9	1.9	2.4
Interest paid	-	(77.7)	(68.8)	(57.5)
Income taxes payable	(2.0)	(32.3)	(11.0)	(69.7)
Net cash from operating activities	**198.7**	**115.7**	**357.6**	**189.1**
Cash flows from investing activities				
Net proceeds from sale/(acquisition) of financial assets	-	0.0	0.0	(0.0)
Net decrease/(increase) in loans to employees	0.6	0.6	1.3	0.8
Net decrease/(increase) in key money deposits	(0.6)	(0.6)	3.6	(1.2)
Net proceeds from sale/(acquisition) of PPE	(17.2)	(21.4)	(59.3)	(47.3)
Net proceeds from sale/(acquisition) of intangible assets	(0.0)	(1.7)	(1.8)	(1.6)
Acquisition of consolidated entities	(1,710.1)	-	-	-
Other,net	(0.2)	(0.0)	0.0	0.0
Net cash used in investing activities	**(1,727.5)**	**(23.1)**	**(56.1)**	**(49.4)**
Cash flows from financing activities				
Net increase/(repayment) in short-term borrowings	(17.1)	19.3	(29.9)	61.5
Net increase/(repayment) in long-term borrowings	971.7	(82.2)	(279.2)	(192.2)
Proceeds from issuance of common stock	-	3.6	-	-
Other, net	94.9	(0.4)	0.0	(0.0)
Net cash used in financing activities	**1,049.6**	**(59.7)**	**(309.2)**	**(130.7)**
Effect of exchange rate fluctuations on cash held	-	0.0	(0.1)	0.1
Cash and cash equivalents at beginning of period	706.9	227.6	260.6	252.8
Change in cash and cash equivalents	**(479.2)**	**32.9**	**(7.7)**	**9.1**
Cash and cash equivalents at end of period	227.6	260.6	252.8	261.9

Source: *Company Reports*

[32] All items translated from KRW to USD at the average exchange rate for the respective year

Appendix III – Selected precedent transactions

Date	Target	Acquirer	EV/EBITDA LTM	Synergies % target sales
Jul-13	Hartwall	Royal Unibrew	8.8x	na
Jul-12	APB	Heineken	17.1x	1.7%
Jun-12	Grupo Modelo	AB InBev	12.9x	15.6%
Apr-12	Starbev	MolsonCoors	11.0x	5.0%
Apr-12	Cerveza Nacional Dominicana	Ambev	13.0x	na
Aug-11	Foster's	SABMiller	13.4x	na
Jan-10	FEMSA	Heineken	9.6x	5.9%
Jun-08	Anheuser-Busch	InBev	12.4x	13.5%
Jun-08	SABMiller	MolsonCoors	JV	7.1%
Oct-07	S&N	Carlsberg	13.9x	6.2%
Oct-07	S&N	Heineken	12.9x	4.9%
Jul-04	Coors	Molson	10.4x	9.4%
Mar-04	Ambev	Interbrew	11.7x	6.7%
Average			**12.3x**	**7.6%**
Median			**12.7x**	**6.5%**

Source: *Company Reports, Press Releases*

Appendix IV – Peer trading valuation multiples

Company	EV	Market	Share	EV/Sales		EV/EBITDA		EV/EBIT	
	($m)	cap	price	2013	2014	2013	2014	2013	2014
AB InBev	202,374	154,469	96.1	5.1x	4.1x	13.0x	10.5x	15.9x	12.6x
Global brewers									
SABMiller	95,912	78,272	48.8	4.1x	3.7x	17.0x	13.4x	19.8x	15.6x
Heineken	57,950	40,384	70.1	2.4x	2.1x	11.1x	9.2x	15.1x	13.1x
Carlsberg	21,894	15,223	98.9	1.8x	1.7x	9.0x	8.1x	12.7x	11.2x
Kirin	24,087	14,236	14.8	1.0x	1.0x	7.0x	7.3x	13.6x	14.4x
Asahi	15,265	12,287	25.4	0.8x	0.9x	7.7x	7.9x	12.2x	12.1x
MCBC	13,009	8,037	50.1	3.3x	2.9x	10.2x	9.0x	13.2x	11.9x
Emerging markets brewers									
AmBev	118,101	118,000	7.5	7.5x	6.9x	15.5x	14.1x	17.4x	15.9x
Thaibev	13,884	10,644	0.4	2.6x	2.4x	15.9x	14.0x	18.6x	16.7x
Efes	10,247	8,139	13.7	2.9x	1.9x	14.3x	10.1x	23.6x	15.5x
CCU	4,859	4,286	13.3	2.2x	2.0x	9.9x	9.2x	13.0x	12.0x
Beijing Yanjing	2,629	2,730	1.0	1.3x	1.0x	10.1x	7.0x	23.0x	11.7x
Global soft drinks									
Coca Cola	198,323	177,681	40.1	4.1x	4.0x	15.0x	13.7x	17.6x	16.3x
PepsiCo	152,257	128,837	83.5	2.3x	2.2x	12.3x	11.0x	15.7x	13.9x
DPS	12,082	9,515	46.7	2.0x	1.9x	9.2x	8.9x	11.2x	10.6x
Global spirits									
Diageo	92,931	78,175	31.1	5.4x	5.0x	14.4x	14.6x	15.9x	16.2x
Pernod Ricard	43,125	31,530	118.8	3.8x	3.6x	13.0x	12.6x	14.0x	13.6x
Brown Forman	16,399	15,613	72.5	4.3x	3.8x	17.3x	14.7x	18.3x	15.5x
Suntory	11,375	10,839	35.1	1.0x	0.9x	8.6x	7.2x	16.8x	13.2x

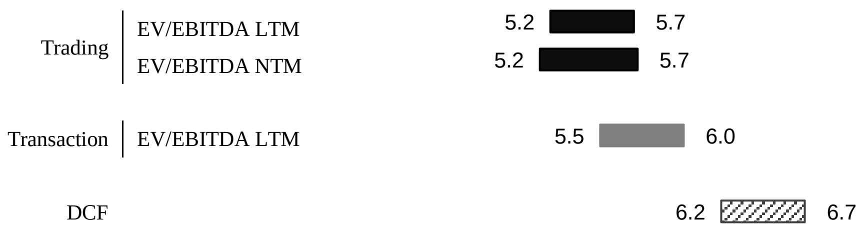
Source: *Factset Research Systems ad of July 31, 2013 (assessed on October20, 2014)*

Appendix V – Oriental Brewery Operating model

(YE Dec, $m)	2012A	2013E	2014E	2015E	2016E	2017E	2018E
Sales	1,118	1,285	1,473	1,682	1,761	1,838	1,915
% growth	*15.4%*	*15.0%*	*14.6%*	*14.2%*	*4.7%*	*4.4%*	*4.2%*
COGS	(471)	(521)	(596)	(681)	(741)	(774)	(806)
% margin	*42%*	*41%*	*41%*	*41%*	*42%*	*42%*	*42%*
Gross profit	647	765	876	1,001	1,019	1,064	1,109
% margin	*57.9%*	*59.5%*	*59.5%*	*59.5%*	*57.9%*	*57.9%*	*57.9%*
SG&A	(274)	(298)	(342)	(390)	(408)	(426)	(444)
% margin	24.5%	23.2%	23.2%	23.2%	23.2%	23.2%	23.2%
Net synergies	**-**	**-**	**12**	**65**	**118**	**118**	**118**
% margin	*0.0%*	*0.0%*	*0.8%*	*3.9%*	*6.7%*	*6.4%*	*6.2%*
EBITDA	373	467	546	675	729	756	782
% margin	*33.4%*	*36.3%*	*37.1%*	*40.2%*	*41.4%*	*41.1%*	*40.9%*
D&A	47	54	62	70	74	77	80
% margin	*4.2%*	*4.2%*	*4.2%*	*4.2%*	*4.2%*	*4.2%*	*4.2%*
EBIT	327	413	485	605	655	679	702
% margin	*29.2%*	*32.1%*	*32.9%*	*36.0%*	*37.2%*	*36.9%*	*36.7%*
Capex	(50)	(57)	(66)	(75)	(79)	(82)	(86)
% margin	*4.5%*	*4.5%*	*4.5%*	*4.5%*	*4.5%*	*4.5%*	*4.5%*
∆ NWC	(37)	(41)	(46)	(52)	(20)	(19)	(19)
% margin	*(3.3)%*	*(3.2)%*	*(3.2)%*	*(3.1)%*	*(1.1)%*	*(1.0)%*	*(1.0)%*

Source: *Company Reports, Author Analysis*

Appendix VI – Oriental Brewery's Analysis at various prices ($bn)



EV	**4.0**	**5.0**	**6.0**	**7.0**	**8.0**
EV/EBITDA LTM	8.6x	10.7x	12.9x	15.0x	17.1x
EV/EBITDA NTM	7.4x	9.3x	11.2x	13.0x	14.9x
Net debt	0.7	0.7	0.7	0.7	0.7
Equity value	3.3	4.3	5.3	6.3	7.3

Source: *Author Analysis*

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