August 2021

SUMMARY

Coca-Cola FEMSA is the largest Coca-Cola bottler in the world, with operations across Latin America and generating 11% of global Coca-Cola company sales volume. Bottlers have historically been well insulated from recession. Consumer thirst for Coca-Cola rarely changes, even in the face of challenging economic environments. The pandemic was a different story as lockdowns shifted sales away from more profitable products, pressuring both average selling prices and overall profitability. But bottlers quickly adapted and as a result, FEMSA's volumes have already exceeded pre-pandemic levels. The continued reopening of local economies should drive additional volume back to more profitable segments as consumption normalizes. Longer term, rising consumer incomes, higher margin products, and expanded distribution should drive growth for emerging market bottlers. We believe these businesses deserve to trade at a premium to their developed market peers given their superior competitive positioning, greater growth potential, and structurally higher profitability. Despite these advantages, investors can accumulate shares of KOF today at around 7x EBITDA relative to recent transactions valued at nearly 12x EBITDA. We don't expect that discount to remain as Latin American economies reopen in the coming quarters.

OUR INTRO TO BOTTLERS

Broyhill has followed the bottling industry for the better part of the last decade, beginning with our 2012 investment in Coca-Cola Hellenic. A few years later, we established a position in Coca-Cola FEMSA, but we have been on the sidelines since 2016. In the five years leading up to 2020, while the S&P 500 gained north of 80% cumulatively, Coca-Cola FEMSA declined 16.5% (including dividends) as the stock's valuation sunk from a 2016 high of 12x EV/EBITDA to recent lows near 6x EBITDA.

In the fourth quarter of last year, with shares were trading at historically low valuations, we began building positions in Fomento Economico Mexicano (FEMSA) and Coca-Cola FEMSA (NYSE: KOF). We continued buying through the first half of 2021. FEMSA (NYSE: FMX), headquartered in Monterrey, Mexico, operates the third-largest convenience store chain in the world (second only to Japan's Seven Eleven Holdings and Family Mart). As of year-end 2020, the company had a total network of nearly 20,000 small-format Oxxo stores, making its retail segment, which accounts for 56% of LTM sales, FEMSA's most important business. The company's controlling stake in Coca-Cola FEMSA makes up another 37% of LTM sales, and its 15% economic stake in Heineken rounds out the portfolio. While there is a lot to like about the largest network of convenience stores in Mexico, particularly the optionality provided by ecommerce and global payments, this letter will outline our Coca-Cola FEMSA investment thesis, given our greater direct and indirect exposure to the company.

A BRIEF INDUSTRY OVERVIEW

Coca-Cola has sat at the top of the global beverage supply chain for a generation. Although the positioning along that chain has shifted over the years, one thing has not changed–the secret sauce of the Coca-Cola company. The soft drink's recipe, known as the concentrate, dictates the exact proportion of ingredients to produce that indistinguishable flavor. It's the real thing. It's not a coincidence that most of the value in the beverage supply chain accrues to the secret sauce. To maximize its economics, Coca-Cola has sold most of the distribution rights to bottlers around the world, which operate under long-term agreements and provide packaging, sales, and distribution of Coca-Cola's products.

The Coca-Cola Company generates return on capital about twice the level of its bottlers, and as a result, investors have shown strong preference for the *owners* over the *distributors* of the secret sauce. Bottling is far more operational and capital intensive. Capital expenditures typically make up about 6-8% of sales for bottlers versus 3-5% of sales at Coca-Cola. Notably, we think that bottlers have put this capital to good use and have generating positive returns and extending the industry's long-term growth runway.

So, despite their lower pecking order on the Coca-Cola totem pole, bottlers remain an essential ingredient in the largest non-alcoholic beverage system in the world. That scale is why the system has operating leverage, increased purchasing power, optimized production efficiency, and the ability to spread large, fixed costs across highly fragmented distribution networks.

Nowhere is that scale clearer than in Latin America, where market share and profitability are highest. While the region constitutes little more than 10% of sales, LatAm makes up north of 20% of Coca-Cola's operating profits.

A PASSPORT TO REFRESHMENT

Coca-Cola has nearly 225 independent bottling partners globally, providing global reach with local focus. All of these bottlers contribute to the global system, selling nearly 2 billion servings each day. But demographics are destiny with regard to long-term growth potential. As such, emerging markets offer upside to consumption relative to more established markets.

Within emerging markets, Latin America remains a key region for the Coca-Cola System, making up nearly 30% of global volume. Mexico and Brazil are the most valuable markets, with $52B in sales or nearly 60% of total soft drinks sales in the market. Strong growth in LatAm has resulted in consumption per capita among the highest in the world. In Mexico, for example, consumption is almost twice as high as in the US.

The importance of these markets is magnified by strong operators, the largest of which have leveraged increased scale to generate more attractive returns. LatAm bottler profitability ranks among the highest globally despite low revenue per unit case.

Emerging market bottlers, particularly those based in Latin America, have several advantages relative to their developed market peers.

- **Demographics**. As incomes grow, emerging market consumers will buy more ready-to-drink beverages. This more attractive product and pricing mix should drive both volume growth and margin gains for bottlers in the region.

- **Brand Dominance.** Coca-Cola is the undisputed market leader in the region, as the company has leveraged its brand dominance and distribution advantages to monopolize share and thwart competition. For example, in some markets outside of the US, there isn't even an acceptable option "B" for soft drinks. Pepsi is often discounted as much as 30% and sometimes given away with the purchase of a snack.

- **Economies of Scale.** The LatAm region represents the greatest share of global Coca-Cola volume sold. The system's largest and most efficient bottlers are based in the region, which is also one of the most fragmented markets, providing greater benefits to scale, reducing costs per unit, and increasing returns on capital. As Coca-Cola has increasingly relied on a more diversified portfolio mix to drive growth, the scale advantages of LatAm bottlers have enabled them to make sizeable investments in the production, packaging, marketing, and distribution of additional categories, which are often too demanding for smaller operators.

- **Distribution Efficiency.** The complex distribution system in developing markets makes it challenging, if not impossible, for smaller players to generate acceptable returns. The majority of sales in these markets still occur at small mom-and-pop bodegas and roadside stands in sparsely populated regions, making efficient distribution a challenge, providing additional advantages to the incumbents, and encouraging further consolidation.

And last but certainly not least, despite their superior growth opportunities and structurally enhanced profitability, emerging market bottlers trade at record discounts to developed market bottlers. We would argue that these businesses deserve to trade at a premium to their developed market peers given the structural advantages outlined above.

THE OPPORTUNITY

Coca-Cola FEMSA, based in Monterrey, Mexico, is the largest Coca-Cola bottler in the world, led by CEO John Santa Maria. The company is controlled by two strategic investors, FEMSA and Coca-Cola, who own 47% and 28% of the float, respectively.[1]

The company commenced operations in 1979, when a subsidiary of FEMSA acquired sparkling beverage bottlers in Mexico City and the surrounding area. In a series of transactions since 1994, management acquired new territories, brands, and other businesses across Mexico, Argentina, Central America, Colombia, Venezuela, and Brazil.

Bottlers have historically been well insulated from recession. Consumer thirst for Coca-Cola rarely changes, even in the face of challenging economic environments. During the financial crisis, for example, Coca-Cola's volumes in the region were up mid-single-digits in both 2008 and 2009.

The pandemic was a different story as lockdowns prevented consumers from buying "on premise" and "on-the-go" products, pressuring both average selling prices and overall profitability, even as underlying demand remained stable. As consumers took fewer shopping trips and favored cheaper formats, supermarkets and hypermarkets gained share over restaurants and sports venues.

Despite the challenges, the LatAm region was still the best performing market in the Coca-Cola System, and LatAm beverages performed better than other discretionary categories during the pandemic. Mexico's less coercive approach increased mobility relative to more restrictive economies (which has also benefited the region's airports). At the same time, bottlers quickly responded by adapting their portfolios, optimizing their packaging, and gearing their channel mix towards at-home consumption.

As a result, FEMSA's volumes have already exceeded pre-pandemic levels. And the continued reopening of local economies should drive additional volume growth towards the on-trade segment as "on-the-go" consumption normalizes. Although higher commodity prices remain a headwind, the shift in product mix towards higher ticket formats should more than offset input cost inflation, driving higher margins and greater profits for the next several quarters.

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[1] Both FEMSA and Coca-Cola have board representation and hence, substantial influence on the company's strategy. While public shareholder influence is limited by the existing ownership and corporate structure, we believe Coca-Cola FEMSA benefits from these affiliations. The current board includes FEMSA's CEO, Jose Antonio Fernandez and Chairman, Eduardo Padilla Silva, in addition to Coca-Cola's CFO, John Murphy, and President of North America, Jim Leonard Dinkins.

Longer term, we see multiple opportunities for the company to drive growth and multiple ways for shareholders to win.

- Ongoing efforts to develop and consolidate new markets should continue to enhance scale and drive earnings growth.

- FEMSA's leading position in the core Mexican market (where it holds 70% volume share of soft drinks in its territories) should benefit from a rebounding US economy, strengthening its ability to further push mix and pricing.

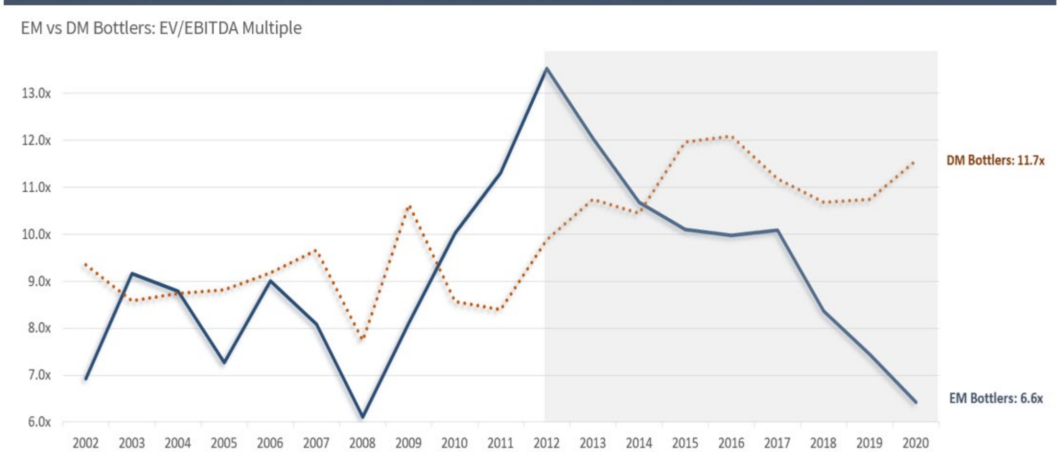
- Brazil, where FEMSA accounts for nearly half of the country's volume, offers significant upside potential, as per capita consumption ranks among the worst in the region.

- A shift towards higher priced products and higher margin offerings should improve sales and profit per unit, enhancing total company operating margins. FEMSA's pipeline of product innovation includes new formulations, bottles, sizes, and packaging.

- The consensus underappreciates the long-term growth potential of new offerings. In July, FEMSA updated its existing framework with Coca-Cola allowing the distribution of new categories. A renewed distribution agreement with Heineken in Brazil also provided greater flexibility to produce and distribute complementary beverages. The company's recently announced acquisition of Brazilian brewer Therezopolis demonstrates management's enthusiasm for expanding its alcoholic beverage and paves the way for FEMSA to become a total beverage company.

- The expansion of FEMSA's portfolio to include alcoholic beverages should boost overall company volumes and profitability. Alcohol sales are almost entirely complementary to FEMSA's existing business as there is little overlap between the selling beers and selling soft drinks. Additional volume drives operational efficiencies and increases the density of delivery routes, driving further benefits to scale and margin gains.

EMERGING MARKET BOTTLERS HAVE DERATED RELATIVE TO DEVELOPED MARKET PEERS



Source: Bloomberg historical data

BOTTOM LINE

We believe investors should reward predictable, non-cyclical businesses with defensive product mixes and economies of scale with premium valuations, as steady top-line growth can drive meaningful long-term margin expansion when costs are largely fixed.[2] FEMSA is the largest Coca-Cola bottler on the planet with excellent corporate governance, strong leadership, and a pristine balance sheet, yet the company trades at a similar valuation to dying department stores.

Investors can accumulate shares of FEMSA today around 7x EBITDA, a valuation near historical lows on both an absolute and relative basis. At current levels, we think the odds of permanent capital loss are unusually low, given the company's structural advantages, competitive positioning, and long-term growth opportunities. Conversely, a re-rating towards a more normal valuation range, could represent significant upside.

We note that Coca-Cola Europacific Partners recently bid ~ 12x EBITDA for Coca Cola Amatil (the leading bottler in Australia), in line with where bottlers have transacted over the past decade. Applying that same multiple to FEMSA's TTM EBITDA, would put the stock about 75% higher. Using our base case assumptions for earnings 3-5 years out would imply a valuation about twice as high. We don't expect today's prices to remain around current levels for long, particularly as Latin American economies reopen in the coming quarters.

[2] We assume roughly 25% of COGS and 75% of operating expenses are fixed.

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Broyhill Asset Management is a boutique investment firm, initially established as a family office in 1980 and guided by a disciplined value orientation. Founded in the foothills of North Carolina's Blue Ridge Mountains, we operate outside of the fray and invest with a rational, objective, long-term perspective.

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Performance is calculated using time-weighted rates of returns, net of fees. Since these platforms report returns to Broyhill gross of fees, in order to report net returns, a 1.5% annual management fee has been subtracted from gross reported returns. This methodology has also been applied to the extracted attribution returns. Average position size is calculated from the average capital invested divided by the average portfolio capital in fully invested accounts.

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