CREDO WEALTH

Celebrating year end with a shot of tequila

Cyclicality is a feature of many industries. In businesses such as mining, oil and gas, automobiles and airlines, the extrapolation of current demand trends leads in turn to over or under-supply, until the cycle eventually starts swinging the other way. Whilst some industries are driven by global economic conditions, others are fuelled by their own specific factors. One such, less well-known example, is agave production.

Resembling a large wild pineapple with long triangular leaves, the agave plant is used in the production of tequila. Similar to the geographic restrictions relating to the production of champagne or Scotch Whisky, tequila can only be distilled from the blue agave plant grown in specific parts of Mexico. The plant has a very long life-cycle, taking approximately seven years to reach full maturity. Agave is prone to shortages and gluts and therefore extreme price swings. The assumption that current high prices will continue into the future, typically encourages farmers to sow more plants, leading to an excess of supply seven years later.

Tequila is one of the fastest growing products in the spirits category globally. It currently represents only about 1% of global alcohol volumes, as compared with 14% for vodka and 9% for whiskey. The relative under penetration means that there is still a long run way for growth in our view. There are two categories of tequila: 100% tequila is the premium product and uses purely agave sugars, whereas 50/50 tequila (the mass market offering) is only required to use 50% agave sugar. Over the past few years, the premium segment has been growing faster than the mass market product. The resulting acceleration in demand growth alongside the long agave life cycles has led to acute price volatility over the past two decades. Prices have ranged from low single digit pesos per kilo to over 25 pesos in 2019.

Becle, S.A.B. de C.V. (Becle) is the premier global player in the tequila industry with approximately a 30% market share and owns leading brand Jose Cuervo. The company has been controlled by the Beckman family for eleven generations (they still own 85% of the shares) and listed in 2017. As much as c.60% of the company's revenue is generated through the sale of tequila, whilst the remaining 30% generated from Irish Whiskey, ready mixed drinks and other spirits.

Recently, Becle's profit margin has fallen dramatically, caused largely by the extreme spike in agave prices. Although management could have chosen to raise prices substantially in order to protect margins in the near term, they did not. Rather than sacrifice volume growth and market share, the company chose to maintain its leading position. We believe that this was the right strategy for the business as well as shareholders over the long term. Having experienced several agave cycles since 1795, we believe that the Beckman family have the experience necessary to steer the company through this more difficult period. However, the market fixated on the immediate impact with the company falling to a P/E valuation of around 16 times in 2018, having previously traded in a range of 25-29 times before.

Although there is currently an undersupply of agave, it is possible to track the volumes of plants sown in any one year. This gives a high degree of visibility as to the available supply both currently and going forward. As is typical of a cyclical industry and of history, high prices in recent years appear to have encouraged more planting. Therefore, we estimate that the price of agave will normalise over time as the volume of plants sown has substantially outstripped projected volume growth. This should result in a significant margin improvement for Becle. Having maintained its market share, the company (and thus shareholders) should significantly benefit as tequila volumes continue to grow. ▶

Not only is Becle likely to benefit from a fall in agave prices, the company is also taking steps to increase the level of vertical integration. Companies which are vertically integrated have control over the supply of their input products. This allows better management of planting and means that in times of tight supply the company is less impacted by rising wholesale costs. Furthermore, overall expenses are lower, as the cost of agave will reflect the absolute cost of production as opposed to including a margin for the original producer. Reducing the reliance on buying agave from third parties should therefore provide a further benefit to margins over the long term. Although the company missed its targets for increasing integration in 2018, this was caused by the rapid growth of the tequila category. However, we believe that management took the right decisions to maintain market share by using third party agave and expect that the company will reap the rewards going forward.

One of the challenges of investing in cyclical industries is timing. When the main driver is the global economic cycle, predicting changes in demand growth can be difficult. However, that is not the case in this instance. There is good visibility of the supply of agave and demand growth for tequila has also been accelerating. At the same time, we were presented with the opportunity to buy shares in the company when it was trading at a substantial discount to peers.

We originally bought a position in Becle in the Credo Global Equity Fund in 2018. Whilst performance so far has been pleasing, we believe that further upside lies ahead.

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