To what extent has Heineken N.V. realized sufficient financial value for the major stakeholders to be able to guarantee the continuity of the operations?

HEINEKEN

Strategic Finance Report prepared by:

Yusi Chen

Amsterdam, The Netherlands

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Company profile

Established in 1864 by the Heineken family, Heineken has a long heritage as an independent global brewer. Today, Heineken is the No.1brewer in Europe and No.2 brewer in the world with a wide international presence through a global network of distributors and breweries. Heineken is also one of the world's leading brewers in terms of sales volume and profitability. In recent years, the volatile markets and price pressures from local alcoholic drinks brands have posed serious financial challenges to Heineken. As Heineken had a target of increasing its operating margin by 40 basis points per year between 2014 and 2017, the growth of Heineken's operating margin is expected to slow down in coming years. Heineken has to work hard to make its brand as appealing to global customers as before under fierce competition, on the other hand, to optimize its capital investment and finance structure.

1. Strategy and mission

Figure 1. The strategy framework of Heineken N.V.

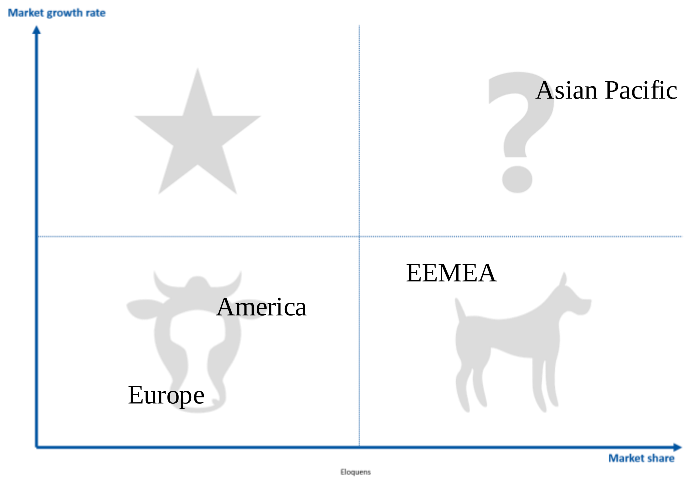
Mission We delight consumers, day in day out, with perfect cider and beer brand experiences.
Strategy the Heineken strategy is built around 4 business priorities for action.
Product Led by the Heineken® brand, the group has a product portfolio of more than 300 international, regional, local and specialty beers and ciders. Operating breweries, malteries, cider plants and other production facilities in more than 70 countries. Principal international brands are Heineken and Amstel, but the group brews and sells more than 170 international premium, regional, local and specialty beers, including Cruzcampo, Tiger, Zywiec, Birra Moretti, Ochota, Murphy's and Star.

Figure 2. The sales performance of consolidated beer volumes in 4 regions

Consolidated beer volumes *(in mhl)*	**4Q17**	Organic growth %	**FY17**	Organic growth %
Heineken N.V.	**56.7**	4.6	**218.0**	3.0
Africa, Middle East & Eastern Europe	**10.6**	7.2	**40.1**	4.8
Americas	**21.8**	4.6	**72.1**	3.3
Asia Pacific	**7.6**	10.6	**27.0**	8.9
Europe	**16.8**	0.6	**78.8**	0.2

According to the sales and sales growth in 4 regions, the BCG matrix is designed like below.

Figure 3. BCG Matrix Evaluation for Market Share in 4 regions



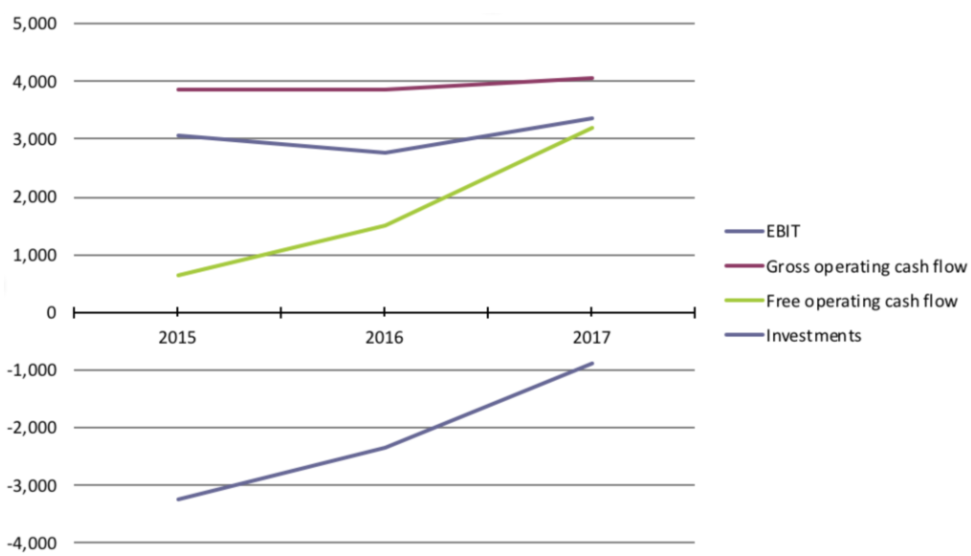
2. Estimation of the originally invested capital

In 2017, €28,769 billion has been invested in Heineken, there has seen a small increase compare to 2016 and 2015, and big jump compare to 2014. 39% of total capital have been invested in net PPE by 2017, a noticeable increase by 5%. Other operating assets still kept at a high and stable level. (the details see Appendix 1)

3. NOPLAT and FOCF

NOPLAT in 2017 significantly increased by 22% due to a substantial growth in net sales, as high as € 2 billion more sales are achieved by 2017. The Free operating cash flow in 2017 almost doubled the figure in 2016, which turned out to be more than € 3 billion. (the details see Appendix 2)

Figure 4. The trend of EBIT versus investment, FOCF and GOCF from 2015 to 2017



Illustrated by the chart at the above, the EBIT maintained at a stable and high level, around € 4 billion created. The substantial reduces in investment from 2015 to 2017 contributed to a rapid growing of FOCF. Heineken N.V. is blessed with large amount of free cash.

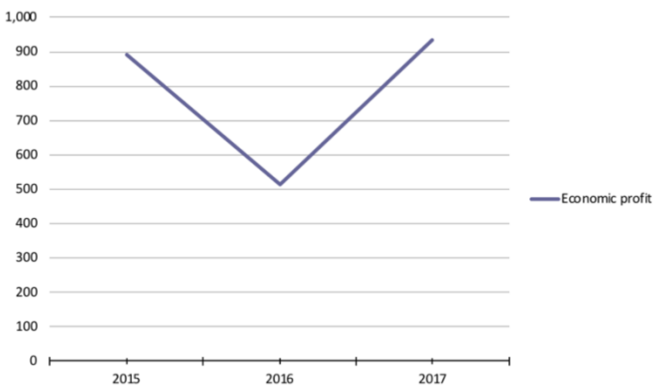
4. Estimation of WACC

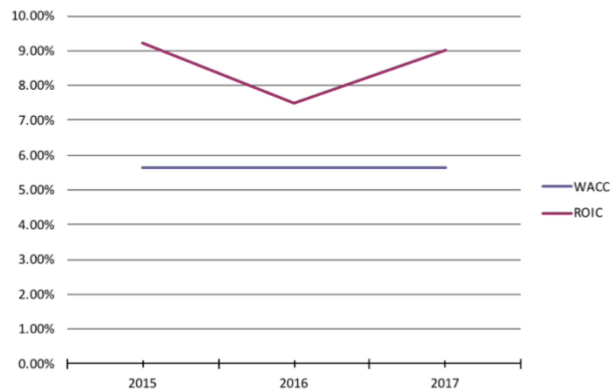
According to gurufocus.com, on the day of June 3rd, Heineken N.V.'s weighted average cost of capital is 5.62%. [1]

5. Estimation of the EVA

The economic profit of Heineken N.V experienced a V-shaped movement from 2015 to 2017, with 2016 hit the bottom and then rebound to the level of 2015 by 2017, with € 933 million economic profit has been created. The ROIC presents by 9.24%, 7.51% and 9.01% from 2015 to 2017 respectively, which were all much higher than the WACC estimated at 5.62%. Heineken N.V thus proved to continually create value for shareholders.

Figure 5. The trend of Economic profit and WACC vs. ROIC from 2015 to 2017





6. Financial performance and financial health

If we take a look at the financial performance KPIs, the change in performance was mixed. The ROIC and asset turnover in 2017 were slightly lower than those of 2015, whereas the EBIT margin was slightly higher. Regarding financial health, the ICR ratio turned down and Debt-to-EBITDA went up, though not substantially, it shows a negative trend. In the chart of ROIC breakdown, the figures in 2017 were very close to those of 2015. (see details of ROIC tree at Appendix 3)

Figure 6. The financial performance and financial health KPIs from 2015 to 2017

Financial performance KPI	2015	2016	2017
ROIC	9.2%	7.5%	9.0%
EBIT margin	14.70%	13.20%	15.20%
Asset turnover	0.85	0.77	0.8

Financial health KPI	2015	2016	2017
Interest coverage ratio	7.46	6.58	7.16
Debt-to-EBITDA	2.58	2.83	2.88

[1] The WACC is changing day by day. The calculation of WACC is based on the following formula.

WACC = E / (E + D) * Cost of Equity + D / (E + D) * Cost of Debt * (1 - Tax Rate)

Figure 7. EBIT margin changes from 2015 and 2017

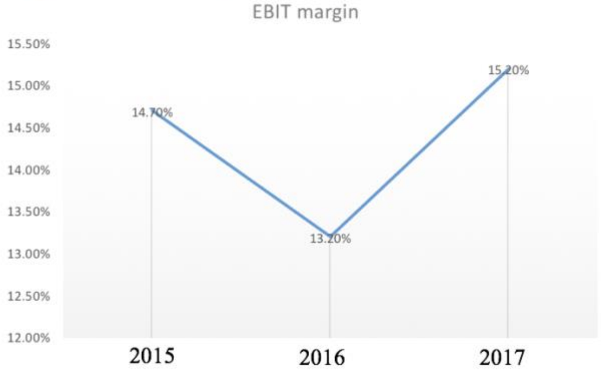
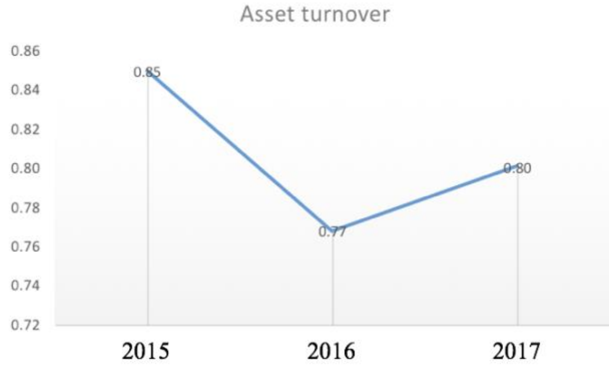


Figure 8. Asset turnover changes from 2015 to 2017



7. The value of the assets

In order to process valuation model of Heineken N.V. 3 scenarios are made as follows:

Scenario 1- fast growing

The FOCF in 2017 was € 3,181 million, the forecasted FOCF is projected to grow by 2 % constantly since that. The market value of operations would be FOCF 2017/(WACC-2%) = 87,869. The market value of Equity would be 73,621. Then the P/E ratio will be 34.2, and Market-to-book ratio will be 5.1, almost double the figure of 2 peers in the industry, for Anheuser-Busch InBev by 2.6, and Carlsberg by 2.46.

Figure 9. The valuation model of Heineken N.V. based on scenario 1

Market value of operations		Invested capital (in millions of €)	
FOCF	87,869	Debt	14,248
		Equity	73,621
Total	**87,869**		**87,869**

Scenario 2- maintaining

The FOCF in 2017 was € 3,181 million, the forecasted FOCF is projected to have no growth since that. The market value of operations would be FOCF 2017/WACC = 56,599. The market value of Equity would be 42.351. Then the P/E ratio will be19.7, and Market-to-book ratio will be 2.9, a bit higher than 2 peers in the industry, for Anheuser-Busch InBev by 2.6, and Carlsberg by 2.46.

Figure 10. The valuation model of Heineken N.V. based on scenario 2

Market value of operations		Invested capital (in millions of €)	
FOCF	56,599	Debt	14,248
		Equity	42,351
Total	**56,599**		**56,599**

Scenario 3- moderate growing

Take the averaged FOCF from 2015 to 2017, that is 1,778. The forecasted FOCF is projected to grow by 2 % constantly since that. The market value of operations would be FOCF on average /(WACC-2%) = 49,128. The market value of Equity would be 42.351. Then the P/E ratio will be16.2, and Market-to-book ratio will be 2.4, lower than 2 peers in the industry, for Anheuser-Busch InBev by 2.6, and Carlsberg by 2.46.

Figure 11. The valuation model of Heineken N.V. based on scenario 3

Market value of operations		Invested capital (in millions of €)	
FOCF	49,128	Debt	14,248
		Equity	34,880
Total	**49,128**		**49,128**

8. Final analysis

The financial performance of Heineken has been maintained at a satisfactory level attributed to a higher ROIC, asset turnover and lower operating expenses. The financial figures like interest coverage ratio and Debt-to-EBITDA multiples show that Heineken N.V. is a financially healthy company in the past 3 years. Heineken has enough operating capacity to pay its interest expenses and current debt obligations, there is no signals of distress, however there is no room for more debt financing.

Based on the assumption of the 3 financial scenarios, the P/E ranges from 16.2 to 34.2, considering the P/E ratio of another 2 benchmarking brewery giants-- Carlsberg at 94.29 and Anheuser-Busch InBev at 25.2, investors of Heineken are projected to have some moderate earnings growth in the future, and the value of Heineken is either overvalued or undervalued.

MEMO

Analysis of Heineken N.V. value creation for operations continuity

Executive Board of Heineken N.V.
Tweede Weteringplantsoen 21
1017 ZD Amsterdam
Netherlands

June 23, 2018

Dear Executive Board Members,

With this report, I would like to present you with the financial performance of Heineken N.V. as such to evaluate its ability to create value for shareholders and ensure operations continuity. Generally speaking, 2017 for Heineken is a blessed year, it made a big progress in operations improvement and expenditure restructuring. The financial figures all show that Heineken is a steadily growing company creating values for shareholders. Not only its success lies in economic terms, but also are its efforts in social and environmental sustainability cheerful.

Strong top-line and bottom-line performance

Heineken has maintained its revenue growth for the 5^{th} consecutive year, from € 19,203 million by 2013 to € 21,908 million by 2017. Particularly in 2017, driven by strong sales, € 1,200 million more revenue were achieved. On the bottom-line side, € 2,247 million of net profit had been made compared to € 2,098 million last year. The outcome in 2017 successfully achieved one of the four commitments of Heineken made: deliver top line growth.

Robust value creation ability

The return on invested capital of Heineken in recent 3 years (on average 8.57%) has successfully sustained higher than WACC (5.62%). By 2017 alone, Heineken has brought about € 933 million economic profit, it is a company creating value to shareholders.

Improved operations

The operating margin of Heineken N.V. increased by 2% in recently 2 years, it means that Heineken's operating expenses in relation to total revenue has decreased by 2%, the cost-cutting efforts made in 2017 is proved to be effective. Besides, Heineken was more quickly to turn over its asset through sales. The asset turnover of Heineken by 2017 implies that Heineken was generating € 0.8 revenue per € 1 of capital invested, seeing an improvement compared to 2016 (ratio: 0.77).

Healthy finance

The interest coverage ratio of Heineken in 2017 was kept at a safe level of 7.16, much higher than the alarming threshold of 2. Its EBIT is more than enough to cover interest expenses, there is no signals of distress. Debt-to-EBITDA multiples has been kept at 2.88, Heineken has sufficient income to pay its current debt obligations.

<u>Moderate market valuation</u>
Based on the assumption of the 3 financial scenarios, the P/E ranges from 16.2 to 34.2, considering the P/E ratio of another 2 benchmarking brewery giants-- Carlsberg at 94.29 and Anheuser-Busch InBev at 25.2, investors of Heineken are projected to have a moderate earnings growth in the future, and the value of Heineken is neither overvalued nor undervalued.

<u>Sustainable business for future</u>
Heineken N.V. has made good progress to reach the majority of the 2020 SDGs commitments. Among 15 social and environment commitments, 9 commitments were kept on track by 2017. Highlighted achievements are 41% reduction in carbon emission from production, 42% of raw materials sourced are from local regions, and 29% decrease in water consumption in breweries since 2008.

In conclusion, the performance of Heineken N.V. in 2017 is successful with regard to its commitment of long-term value creation. Its 4 priorities of actions: deliver top-line growth, drive end2end performance, Brew a Better World, and engage and development people, have been implemented in line with its mission. In the future, Heineken should continue to strive for superior top line growth while working on improving operating profit margin.

I would like to congratulate to your great job done in 2017, and I wish Heineken will achieve another year of progress for your exciting brewery business in 2018.

Sincerely,

Yusi Chen
Full-time MBA candidate
Nyenrode Business University

Appendix

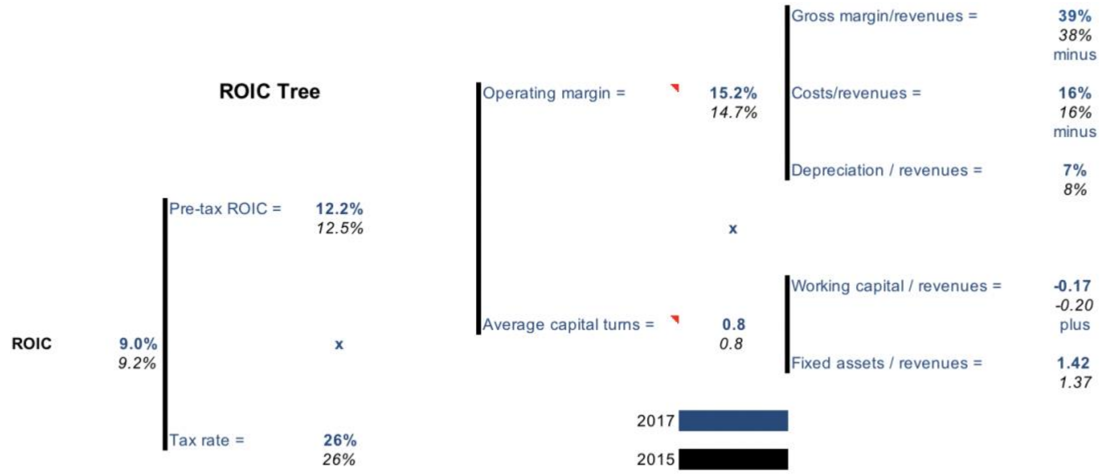
1.Total investor funds of Heineken from 2014 to 2017

In millions of €	2014	2015	2016	2017
Current assets	6,086	5,914	8,137	8,248
Non-interest-bearing current liabilities	10,208	10,589	11,813	12,265
Investment in (operating) working capital	**-4,122**	**-4,675**	**-3,676**	**-4,017**
Net property, plant, and equipment	8,718	9,552	9,232	11,117
Other operating assets	20,026	22,248	21,952	21,669
Investment in fixed and other operating assets	**28,744**	**31,800**	**31,184**	**32,786**
Investment in operating assets	**24,622**	**27,125**	**27,508**	**28,769**
Total investor funds	**24,622**	**27,125**	**27,508**	**28,769**

2.Free operating cash flow of Heineken from 2015 to 2017

In millions of €	2015		2016		2017	
Net sales	**20,922**		**20,838**		**22,029**	
Cost of sales	12,931		13,003		13,540	
Selling, general and admin. expenses	3,322		3,263		3,550	
Depreciation, amortization and impairments	1,594		1,817		1,587	
Operating earnings before interest, and taxes	**3,075**		**2,755**		**3,352**	
Taxes on EBITA (26%)	801		718		873	
Net operating profit less adjusted tax	**2,274**		**2,037**		**2,479**	
NOPLAT	**2,274**		**2,037**		**2,479**	
Depreciation, amortization and impairments	1,594		1,817		1,587 +	
Gross operating cash flow		**3,868**		**3,854**		**4,066**
(Dis)investment in operating assets:						
(Increase - / decrease +) in operating working capital	553		-999		341	
Purchase of PPE (minus proceeds of sale of PPE)	-1,555		-1,641		-1,509	
(Increase - / decrease +) in other operating assets	-2,222		296		283	
Total operating (dis)investment		**-3,224**		**-2,344**		**-885**
Free operating cash flow		**644**		**1,510**		**3,181**

3. ROIC tree of Heineken 2017 vs. 2015



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