

## Company Focus

19 June 2008 | 64 pages

# San Miguel Brewery (SMB.PS)

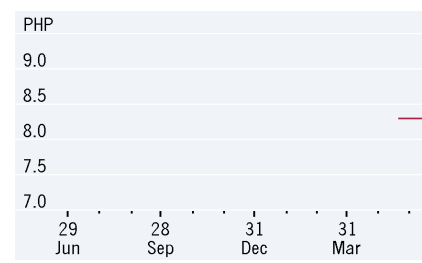
 Initiation of coverage 

## Initiating at Buy: The Philippines' Beer Power House

- Initiating at Buy** — We initiate coverage on the shares of San Miguel Brewery, the Philippines' largest manufacturer and distributor of beer (100% of revenue), at Buy / Medium Risk (1M) with a target price of P10.3. Our target P/E multiple of 15.3x (based on average '08E-'09E EPS) is at 15% discount to global peers, with Philippine country and illiquidity risks offset by a dominant leadership in the local market, higher returns, and yield with similar growth profile.
- Our rationales** — 1) Good defensive choice amid Asian market volatility, with superior yield, stable growth, strong cash flow. 2) One of world's most efficient beer business models with 3-year ('05-'07) average ROE of 46%, reaching 59% by 2010E on 13% EPS CAGR ('07-'10E). 3) Current P/E valuation at 13x '08E with dividend yield of 6.8% looks attractive; we see 29% expected total return.
- Strategic strengths** — Monopoly seems untouchable, with local competitor Asia Brewery becoming even more minor; San Miguel's 468-dealership network to help boost market share (93% currently) further. We see profitability upside despite market maturity on better product mix, while alliance with Kirin Brewery and established returned glass bottle system reduce cost pressures.
- Weathering tough macro environment** — We forecast Philippines' real GDP growth at 6% in '08E~'09E. A more robust rural economy with stronger soft-commodity business could help expand the customer base and boost volumes, partially offsetting weaker urban consumer sentiment amid high inflation.
- Key risks** — Limited share liquidity, higher costs, adverse weather, labor issues.

|                              |                         |
|------------------------------|-------------------------|
| <b>Buy/Medium Risk</b>       | <b>1M</b>               |
| Price (19 Jun 08)            | P8.40                   |
| Target price                 | P10.30                  |
| Expected share price return  | 22.6%                   |
| Expected dividend yield      | 6.8%                    |
| <b>Expected total return</b> | <b>29.4%</b>            |
| Market Cap                   | P129,448M<br>US\$2,935M |

### Price Performance (RIC: SMB.PS, BB: SMB PM)



### Statistical Abstract

| Year to | Net Profit | Diluted EPS | EPS growth | P/E  | P/B | ROE  | Yield |
|---------|------------|-------------|------------|------|-----|------|-------|
| 31 Dec  | (PB)       | (P)         | (%)        | (x)  | (x) | (%)  | (%)   |
| 2006A   | 7          | 0.46        | 14.4       | 18.2 | 8.4 | 46.1 | 5.5   |
| 2007A   | 8          | 0.52        | 13.3       | 16.1 | 8.4 | 51.3 | 4.4   |
| 2008E   | 10         | 0.64        | 22.1       | 13.2 | 7.6 | 60.8 | 6.8   |
| 2009E   | 11         | 0.70        | 10.0       | 12.0 | 7.1 | 61.5 | 7.4   |
| 2010E   | 11         | 0.75        | 6.3        | 11.3 | 6.7 | 61.3 | 8.0   |

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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| Fiscal year end 31-Dec                   | 2006      | 2007      | 2008E      | 2009E      | 2010E      |
|--|-----------|-----------|------------|------------|------------|
| <b>Valuation Ratios</b>                  |           |           |            |            |            |
| P/E adjusted (x)                         | 18.2      | 16.1      | 13.2       | 12.0       | 11.3       |
| EV/EBITDA adjusted (x)                   | 9.6       | 8.7       | 7.1        | 7.0        | 6.6        |
| P/BV (x)                                 | 8.4       | 8.4       | 7.6        | 7.1        | 6.7        |
| Dividend yield (%)                       | 5.5       | 4.4       | 6.8        | 7.4        | 8.0        |
| <b>Per Share Data (P)</b>                |           |           |            |            |            |
| EPS adjusted                             | 0.46      | 0.52      | 0.64       | 0.70       | 0.75       |
| EPS reported                             | 0.46      | 0.52      | 0.64       | 0.70       | 0.75       |
| BVPS                                     | 1.00      | 1.00      | 1.10       | 1.18       | 1.26       |
| DPS                                      | 0.46      | 0.37      | 0.57       | 0.63       | 0.67       |
| <b>Profit &amp; Loss (PB)</b>            |           |           |            |            |            |
| Net sales                                | 41        | 44        | 52         | 55         | 58         |
| Operating expenses                       | -29       | -32       | -37        | -39        | -42        |
| <b>EBIT</b>                              | <b>11</b> | <b>12</b> | <b>15</b>  | <b>15</b>  | <b>16</b>  |
| Net interest expense                     | 0         | 0         | 0          | 0          | 0          |
| Non-operating/exceptionals               | 0         | 0         | 0          | 0          | 0          |
| <b>Pre-tax profit</b>                    | <b>11</b> | <b>12</b> | <b>15</b>  | <b>15</b>  | <b>16</b>  |
| Tax                                      | -4        | -4        | -5         | -5         | -5         |
| Extraord./Min.Int./Pref.div.             | 0         | 0         | 0          | 0          | 0          |
| <b>Reported net income</b>               | <b>7</b>  | <b>8</b>  | <b>10</b>  | <b>11</b>  | <b>11</b>  |
| Adjusted earnings                        | 7         | 8         | 10         | 11         | 11         |
| Adjusted EBITDA                          | 13        | 14        | 17         | 17         | 18         |
| <b>Growth Rates (%)</b>                  |           |           |            |            |            |
| Sales                                    | -1.0      | 8.8       | 16.9       | 6.3        | 6.3        |
| EBIT adjusted                            | 21.4      | 9.5       | 22.0       | 2.8        | 6.3        |
| EBITDA adjusted                          | 18.3      | 8.5       | 21.5       | 1.1        | 4.7        |
| EPS adjusted                             | 14.4      | 13.3      | 22.1       | 10.0       | 6.3        |
| <b>Cash Flow (PB)</b>                    |           |           |            |            |            |
| <b>Operating cash flow</b>               | <b>9</b>  | <b>12</b> | <b>9</b>   | <b>12</b>  | <b>13</b>  |
| Depreciation/amortization                | 2         | 2         | 2          | 2          | 2          |
| Net working capital                      | -5        | -2        | -2         | 0          | 0          |
| <b>Investing cash flow</b>               | <b>-1</b> | <b>-2</b> | <b>-1</b>  | <b>-1</b>  | <b>-1</b>  |
| Capital expenditure                      | -1        | -2        | -1         | -1         | -1         |
| Acquisitions/disposals                   | 0         | 0         | 0          | 0          | 0          |
| <b>Financing cash flow</b>               | <b>-7</b> | <b>-6</b> | <b>-10</b> | <b>-10</b> | <b>-10</b> |
| Borrowings                               | 0         | 0         | 0          | 0          | 0          |
| Dividends paid                           | -7        | -6        | -9         | -10        | -10        |
| <b>Change in cash</b>                    | <b>0</b>  | <b>4</b>  | <b>-2</b>  | <b>1</b>   | <b>1</b>   |
| <b>Balance Sheet (PB)</b>                |           |           |            |            |            |
| <b>Total assets</b>                      | <b>21</b> | <b>23</b> | <b>22</b>  | <b>24</b>  | <b>26</b>  |
| Cash & cash equivalent                   | 1         | 5         | 3          | 5          | 6          |
| Accounts receivable                      | 5         | 4         | 6          | 6          | 7          |
| Net fixed assets                         | 6         | 6         | 5          | 5          | 4          |
| <b>Total liabilities</b>                 | <b>5</b>  | <b>7</b>  | <b>5</b>   | <b>6</b>   | <b>6</b>   |
| Accounts payable                         | 3         | 4         | 4          | 5          | 5          |
| Total Debt                               | 0         | 0         | 0          | 0          | 0          |
| <b>Shareholders' funds</b>               | <b>16</b> | <b>15</b> | <b>17</b>  | <b>18</b>  | <b>19</b>  |
| <b>Profitability/Solvency Ratios (%)</b> |           |           |            |            |            |
| EBITDA margin adjusted                   | 31.6      | 31.5      | 32.8       | 31.2       | 30.7       |
| ROE adjusted                             | 46.1      | 51.3      | 60.8       | 61.5       | 61.3       |
| ROIC adjusted                            | 78.2      | 114.6     | 148.6      | 129.9      | 140.0      |
| Net debt to equity                       | -6.2      | -34.3     | -18.7      | -25.1      | -29.6      |
| Total debt to capital                    | 0.0       | 0.0       | 0.0        | 0.0        | 0.0        |

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## Investment Thesis

We initiate coverage on San Miguel Brewery shares with a Buy / Medium Risk (1M) rating and a target price of P10.3, based on on a target P/E of 15.3x average 2008E-2009E EPS. The stock was listed on May 12<sup>th</sup> with IPO pricing at P8.0, and thus has only a short trading history. We believe the stock could offer an attractive defensive shelter against global macro volatility and Asian stock market fluctuations given its superior dividend yield, stable growth, and superior returns in its core business. San Miguel Brewery is one of world's most cost-efficient beer business models, despite a relatively tepid long-run growth outlook in its mature market. Current valuations appear attractive even after discounting its poor share liquidity. We believe the shares' offer the following merits:

### 1) A defensive choice

There is an old saying on Wall Street that when the going gets tough, the tough get eating, smoking and drinking – referring to investors' preference for defensive stocks during a downturn. Given recent Asian equity market volatility, we continue to focus our attention on defensive stocks, defined as companies that on a relative basis have higher exposure to sales less vulnerable to any economic downturn – for example, offering products or services that are essential for consumers, even during a recession. Often times, stocks with these defensive characteristics generate strong operational cash flow with a limited future capex burden. Thus, without any key re-investment in the future, management opts to pay decent dividends, resulting in attractive yields. These stocks tend to see strong investor support during downturns such as the current one.

We view San Miguel Brewery as defensive stock and relatively more appealing in Asia consumer space given the following characteristics:

- Alcoholic beverage business defensive amid hard times
- High yields: 2008E dividend yield at 6.8%, FCF yield at 6.3%
- Low beta (SMC having a beta of 0.6x)

In short, San Miguel Brewery appears relatively more immune to external global macro volatility while offering stable growth, improving earnings quality, lofty ROEs, superior yields, and strong cash flows.

For comparison purposes, other defensive options in the Asia consumer universe include:

Figure 1. Defensive Plays in the Asia Consumer Sector - Recommendation Snapshot

| Sector   | Cntry     | Company          | RIC       | Rating | Turnovr* | CCY | Price   | Mcap    | P/E  |      | P/B  |      | EV/EBITDA |      | ROE  |      | Yield | OPCAGR | EPSCAGR | EBITDA CAGR |     | PEG |
|----------|-----------|------------------|-----------|--------|----------|-----|---------|---------|------|------|------|------|-----------|------|------|------|-------|--------|---------|-------------|-----|-----|
| Name     |           | Name             |           |        | (US\$m)  |     | 17-Jun  | (US\$m) | 08   | 09   | 08   | 09   | 08        | 09   | 08   | 09   | 08    | 07-09  | 07-09   | 07-09       | 08  | 08  |
| Food     | China     | China Yurun      | 1068.HK   | 1L     | 15       | HKD | 12      | 2,363   | 20.1 | 16.9 | 3.7  | 3.1  | 16.5      | 13.9 | 20%  | 20%  | 1%    | 20%    | 20%     | 20%         | 20% | 0.8 |
| HPC      | India     | Hindustan Unilev | HLL.BO    | 1L     | 2        | INR | 236     | 12,005  | 24.8 | 21.0 | 18.4 | 17.6 | 21.7      | 18.1 | 76%  | 86%  | 4%    | 20%    | 20%     | 20%         | 20% | 1.1 |
| Tobacco  | India     | ITC              | ITC.BO    | 1L     | 0        | INR | 203     | 17,835  | 21.4 | 17.5 | 5.7  | 4.8  | 14.1      | 11.3 | 28%  | 30%  | 2%    | 23%    | 23%     | 23%         | 23% | 0.8 |
| HPC      | Indonesia | Unilever Indon   | UNVR.JK   | 1L     | 1        | IDR | 6,750   | 5,536   | 22.7 | 20.0 | 17.7 | 15.9 | 15.4      | 13.6 | 81%  | 84%  | 4%    | 13%    | 13%     | 13%         | 13% | 1.5 |
| Tobacco  | Indonesia | Gudang Garam     | GGRM.JK   | 1L     | 0        | IDR | 7,250   | 1,499   | 8.1  | 7.2  | 0.9  | 0.9  | 4.8       | 4.2  | 12%  | 12%  | 5%    | 10%    | 10%     | 10%         | 10% | 0.7 |
| Beverage | Korea     | Hite Brewery     | 000140.KS | 1M     | 10       | KRW | 113,500 | 2,306   | 14.2 | 12.9 | 1.7  | 1.5  | 7.0       | 6.3  | 13%  | 12%  | 1%    | 8%     | 8%      | 8%          | 8%  | 1.6 |
| Food     | Korea     | CJ Cheil Jedang  | 097950.KS | 1M     | 7        | KRW | 268,500 | 2,902   | 18.3 | 14.8 | 3.2  | 2.6  | 8.3       | 7.6  | 23%  | 24%  | 1%    | 15%    | 15%     | 15%         | 15% | 1.0 |
| Tobacco  | Korea     | KT&G             | 033780.KS | 1L     | 32       | KRW | 89,500  | 12,071  | 16.4 | 14.9 | 3.4  | 3.1  | 10.8      | 10.2 | 24%  | 24%  | 3%    | 11%    | 11%     | 11%         | 11% | 1.4 |
| Tobacco  | Malaysia  | BAT              | BATO.KL   | 1L     | 2        | MYR | 43      | 3,807   | 14.9 | 13.2 | 20.8 | 16.8 | 10.5      | 9.4  | 177% | 141% | 8%    | 11%    | 11%     | 11%         | 11% | 1.2 |

Source: Company Reports and Citi Investment Research estimates. \* 0 for monthly average turn over is rounded off below US\$ 0.5 million on the trading day. \*\*CJ Cheil Jedang's EPS CAGR and OP CAGR based in FY07 to FY09 due to no historical numbers in FY06 \*\*\* EV/EBITDA is calculated on the basis of [Market cap+Average (Long term debt+Short term debt)+Average (Provision)-Average (Cash)-Average (Total Financial Assets)+Minority interest+Preferred equity]/ [EBIT+Depre+Amort] \*\*\*\*Calendar Year

## 2) One of the world's most cost-efficient beer business models

San Miguel Brewery had eight brands and 93% market share in 2006-2007. We forecast 13% net earnings CAGR ('07-'10E). SMB's key competitive strength is its 468 exclusive dealers forming a powerful marketing network. The company aims to gain further market share by targeting areas (around 20% of the geographic footprint) where its minor competitor Asia Brewery has 7%+ market share. The beer market in the Philippines is saturated, with limited volume growth that moves cyclically with GDP growth or sub-par GDP growth. Therefore volume sensitivity upon price hikes appears fairly strong. The company has a certain degree of pricing power with its monopolistic positioning, passing excise tax hikes or cost pressures onto product prices. We perceive overall room for ASP growth is limited given the pricing sensitivity of Philippine consumers.

However, we believe group profitability will be bolstered in 2008 with an average 9% product price increase offsetting pressures from higher raw materials and malt prices. Incremental sales of high-margin, low-end beer Red Horse, on the back of a robust rural economy, should remain as a sustainable angle for margin upside, along with continued focus on expanding premium beer demand. The group's strategic alliance with Kirin Brewery and established returned glass bottle system should continue to be major factors keeping San Miguel's operating margin profile at above 28% versus global peers average at 15% despite San Miguel's much cheaper selling prices. Continuing efforts to reduce other costs, e.g. labor and outsourcing, should also help in maintaining an efficient cost structure. We keep our operating margin forecasts conservative in 2009E and beyond, looking for a modest decline given we have reflected a meager 3% product price increase in 2009E and 2011E when the government plans to increase excise taxes by 8% each.

We believe the company can continue to improve its superior ROE, at 52% in 2007, to 59% by 2010E vs. global average 18%, with higher asset turnover, zero interest cost burden, no affiliate risk, and monopoly benefits. We look for 13% net earnings CAGR ('07E-'10E) with improving earnings quality and a reduced gap between fundamental vs. reported earnings following spin-off from the parent group. Any potential future merger with the parent's overseas beer & beverage businesses could bring upside to earnings.

### **3) Valuations remain fairly attractive despite limited share liquidity**

Current P/E valuation at 13x 2008E and EV/EBITDA of 7.1x 2008E with dividend yield of 6.8% appears attractive. There is 29.4% Expected Total Return based on our P10.3 target price and dividend forecasts. The stock's superior ROE, dividend yield, and globally well known brand profile should deserve a premium vs. global peers with similar earnings growth at EPS CAGR ('07-'10E) at 13%; however, we ascribe a 15% discount vs. the global peer group average of 18x, for a 15.3x target multiple, given poor share liquidity with only 5% of total outstanding shares offered for public trading, Philippine country-specific risks, greater weather risks given single-market exposure, plus mounting inflation risks impacting more negatively on price-sensitive domestic consumers.

# Company Background

## Company Description

San Miguel Brewery (SMB) is the largest manufacturer and distributor of beer in the Philippines, with 93% market share. Revenue derives 100% from beer sales, with 99.2% coming from the domestic market, and the small remainder from overseas sales. The company produces eight brands of all pasteurized beer with a 6-12 month shelf life. On 1 October 2007, parent San Miguel Corp. (SMC) spun off the San Miguel beer division as 100%-owned San Miguel Brewery Inc. We expect Kirin Brewery, which owns 20% of San Miguel Corp., could aim to increase its stakes in SMB as a strategic global partner for the group, and SMC could reduce its stakes by up to 50%, maintaining a level to keep its managerial control.

## Group Background

San Miguel Corp was incorporated in 1890. The group has four key operational areas:

- Alcoholic and non-alcoholic beverages
- Food and agribusiness, e.g. poultry, hogs and animal feeds
- Packaging
- Property

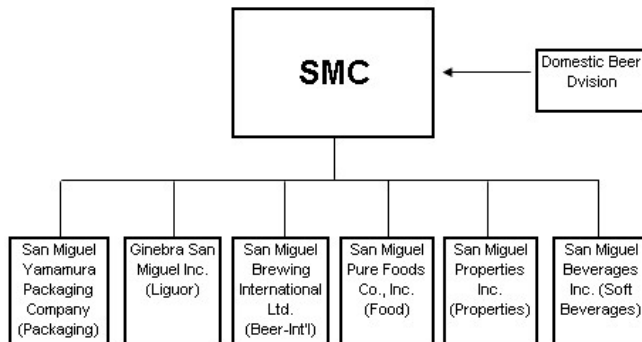
SMC currently plans to expand into new businesses such as mining and power. The group has gone through an expansionary phase across its main operational areas in Asia through acquisitions and has divested some assets which management saw as non-strategic fits and as generating less desirable returns, e.g. Coca Cola bottling and an Australia-based food manufacturer, National Food. Most recently, the group is exploring opportunities in new businesses in the local Philippine market to drive future growth. SMC has already established legal vehicles for the mining and power businesses, although there are no operating businesses at the moment.

Mr. Eduardo M. Cojuangco, Jr. is the Chairman and Chief Executive Officer of SMC. As of February 2008, the shareholding structure of SMC is as follows:

- CIIF (Coconut Industry Investment Fund) companies (24.8%)
- Kirin Brewery Co. Ltd. (20.0%)
- SMC Retirement Plan (16.0%)
- ECJ (Eduardo Cojuanco Jr.) companies (15.5%)
- SM Investment Corp. (10.8%)
- PCD Nominee Corporation (5.2%)
- Others (7.9%).

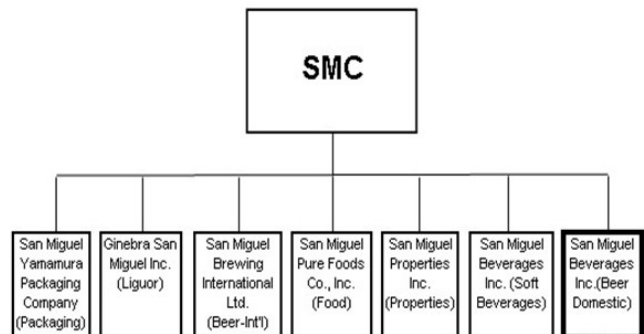
Post spin off, the parent company still maintains operational and management control of SMB. However, the group is open to attracting any strategic partner, e.g. Kirin Brewery, to cooperate in decisions on corporate strategy and operational strength improvement. There are four listed companies related to beer businesses within the group: SMB, parent company San Miguel Corp., San Miguel HK, and PT Delta Jakarta Tbk.

**Figure 2. Corporate Structure (Before Beer Spin-off)**



Source: Company, Citi Investment Research

**Figure 3. Corporate Structure (After Beer Spin-off)**



Source: Company, Citi Investment Research

## Business Model

SMB has a simple and straightforward business model generating earnings via manufacturing and distributing beer in one market, the Philippines. The profitability of the business is driven by variables including:

- volume growth-driven fixed-cost leverage
- ASP growth via price increases or product mix changes
- cost efficiency in manufacturing, distribution and marketing

Given no affiliates ownership, non-operational profit generation is limited except for interest or foreign exchange-related income. Return on capital is largely driven by asset turnover upside (with limited capacity increase expected over the next three years), working capital management improvement, scale of dividend payouts or re-investment. Key entry barriers include initial capital intensity required by beer manufacturing facilities, distribution power with exclusive dealer network, local stickiness in taste/brands, and established system on high retrieval and reutilization of returned bottles.



## Brand Mix

SMB's eight brands can be segmented by retail pricing brackets as Super Premium, Premium, Standard, and Economy; these account for 0.1%, 11%, 81% and 8% of total sales respectively. Non-alcoholic drinks account for less than 1% of sales. Reinvestment in brands has been relatively more rigorous vs. other peers in Asia to cope with changing consumption patterns and demographics, e.g. bi-polarization, well being (focus on health), and convenience.

**Figure 4. Brand Portfolio – Before & After Price Increase as of April 2008**

| Segmentation  | Brand/Product        | Description  | Target Market  | Volume                             | Packaging                         | Before Price(p) | Cur.rent Price(P) |
|---------------|----------------------|--|--|------------------------------------|-----------------------------------|-----------------|-------------------|
| Super Premium | San Miguel Super Dry | First & only Dry beer in local market, light amber lager with strong aromatic hop                    | Males, aged 22-44 in higher socio-economic groups        | 330ml<br>330ml                     | Bottle<br>Can                     | 21.3            | 25                |
|               | Cerveza Negra        | dark lager with a balance of bitterness  | men and women aged 25~44 in higher socio-economic groups | 330ml                              | Bottle                            | 21.3            | 25                |
| Premium       | San Mig Strong Ice   | ice-filtered beer with higher alcohol content<br>Alcohol content: 6.3%                               | men aged 18-24   | 330ml<br>330ml                     | Bottle<br>Can                     | 18.4            | 24                |
|               | San Mig Light        | light/low-calorie beer   | men and women aged 18-34 in higher socio-economic groups | 330ml<br>330ml<br>15L<br>30L       | Bottle<br>Can<br>Keg<br>Keg       | 18.4            | 22                |
| Standard      | Pale Pilsen          | pale golden lager with a clean, hoppy finish<br>a medium body, with a distinct bitter hop character. | all socio-economic groups aged 24 - 44.                  | 320ml<br>1000ml<br>330ml<br>1500ml | Bottle<br>Bottle<br>Can<br>Bottle | 18              | 19                |
|               | Red Horse            | high-alcohol beer tied to rock music and sports<br>Alcohol content: 6.7%                             | men aged 18~24 in middle and lower socio-economic groups | 330ml<br>500ml<br>1000ml<br>330 ml | Bottle<br>Bottle<br>Bottle<br>Can | 15.5            | 18                |
| Economy       | Gold Eagle           | low-priced beer. It has a pale amber hue and is moderately light-bodied                              | men aged 24-44 in middle and lower socio-economic groups | 320ml<br>750ml<br>1000ml           | Bottle<br>Bottle<br>Bottle        | 14              | 15                |
| Non-Alcoholic | Cali                 | non-alcoholic malt-based beverages with fruit flavours   | more health conscious socio-economic groups              | 330ml<br>330ml                     | Bottle<br>Can                     | 15.5            | 18                |

Source: Company, Citi Investment Research Note: San Miguel Light also comes in volume unit of 50L, and Pale Pilsen is also available in 15L, 30L, and 50L.

## SWOT Analysis

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Figure 5. SWOT Analysis

|   |  |
|---|--|
| <b>Strengths</b><br>Sustainable distribution power<br>Globally strong brand strength<br>Sourcing cost advantage with Kirin              | <b>Weaknesses</b><br>Saturated industry volume growth<br>Group-related corporate governance risks<br>Limited upside in pricing |
| <b>Opportunities</b><br>Market share gains, albeit a high base<br>Expansion into beverage & overseas beer<br>Cost reduction initiatives | <b>Threats</b><br>Raw material input cost hikes<br>Vagaries of adverse weather factors<br>Weaker-than-expected economic growth |

Source: Citi Investment Research

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## Earnings Prospects

### Key Assumptions Highlights

We forecast 13% net earnings CAGR ('07E-'10E) and operating profit CAGR of 10% on net sales CAGR of 11% and volume CAGR of 4.5%. We project operating margin to rise 90bps yoy in 2008E and modestly drop from 2009E as we have reflected excise tax hikes (8% increase in 2009E and 2011E respectively) but have not reflected price hikes fully (our ASP growth assumption for 2009E and onwards is 3%) to be conservative amid a more aggressive inflationary environment discouraging the company from increasing product prices.

The company does not have any affiliates, therefore we have not included any major non-operational gains or losses. The remainder of net earnings CAGR apart from operating profit growth would come from expected lower effective tax rates, with rates falling to 30% from 2009 vs. 35% currently. Historical numbers in 2004-2006 are on a pro forma adjusted basis provided by the company in its prospectus as if the company had been operating under the spin-off structure from the parent group. Key assumptions in our 2008E earnings forecasts are as below:

- **Volume growth:** 7.0% for the industry and 7.2% for the company with market share assumed to increase by 20bps per annum until 2012E vs. 93% currently. We have reflected better-than-expected volume growth in 1Q08 at 18% yoy and market share gains as we see room for additional improved execution despite mature industry dynamics and a high base from monopolistic positioning of the company. Volume in April is off by a high single-digit decline post product price increases. The key driver for the volume growth is increasing demand from a broadening market among rural consumers for low-end products on the back of a booming commodity business.
- **ASP growth:** 9% to reflect raw material input cost hikes and minimal 3% increase from 2009E, below our inflation rates forecast to be conservative. We would see downside if the company decides not to raise prices in view of domestic consumers' high price sensitivity, while we would see upside if the company decides to raise prices more than what we've assumed to fully transfer the impact from tax hikes or cost pressures.
- **Excise tax rates:** No change in 2008E. We have incorporated an 8% increase in excise tax rate in 2009E and another 8% increase in 2011E in line with announced government plans. (Details on excise tax for the representative SKUs are as below.)

- **Gross margins:** We forecast GPM to move up to 49.5%, up 140bps yoy, with price hikes (due to some pass-through of higher costs into higher product prices), improving production efficiency and better product mix helped by incremental sales increase in high-margin low-end product Red Horse. Note that Red Horse carries higher gross margins vs. more premium products with cheaper raw material costs due to less malt requirement and lower excise taxes. Note malt content of Red Horse is 30% less than the most popular regular brand Pale Pilsen. One noticeable trend in historical GP margins is a big leap from 44.3% in 2005 to 49.0% in 2006, which was mainly driven by ASP increases in 2005 and 2006 of 11% each post excise tax hikes of 18% in 2005.
- **Malt cost assumption:** We have assumed unit malt cost (Peso/Kg) could be up by 20% in 2008E amid global commodity price volatility, which would lead to a loss of about 100bps in gross margins if other factors remain unchanged as malt cost takes 4.8% of net sales. We have assumed an average unit malt cost at US\$498/MT for 2008E based on the company's contracted terms despite surging malt prices recently.
- **Packaging costs minimal:** 98% of company revenue is derived from products sold in returnable glass bottles. Depreciation costs for glass bottles take up 1.4% of net sales. Losses from broken glass bottles have been minimal. Sales from canned beer have increased to a meager 2% over the past 15 years, thus the company does not expect any abrupt demand shift to non-glass bottle packaged beer over the next couple of years. When consumers buy a small-size bottle of beer (320ml, 330ml), they deposit P1.5 and they get this back when they return the bottle. For medium-size (500ml) and large-size (750ml) bottles, the deposit is P2.25 and P4.5 respectively.
- **Operating margins:** We forecast a modest decline in SG&A costs, with not much of change in A&P spending (combined A&P costs under selling and general administrative expense) vs. a low base at 3.2% of net sales in 2007. We believe the cost structure of the company is already quite efficient despite attempts to sustain innovation and further pursue cost-cutting initiatives, e.g. some modest decline in labor costs. We have incorporated royalty costs as percentage of net sales at 2%; fee for shares service as percentage of sales at 0.5%; and rental cost as percentage of sales at 0.4% paid to the parent group since its spin off from July 2007. Note historical figures have been already adjusted to reflect these factors on a pro-forma basis.
- **Interest income:** We forecast the company's net cash position to sustain at P3bn-P5bn from 2008E onwards.
- **Effective tax rate:** We forecast SMB's effective tax rate to fall to 30% from current 35% in 2009E in line with the government's announced plan.
- **Capex:** We do not expect the company should budget for any capacity increase until 2012E or beyond. The current 15 million hector liter capacity with utilization rate at 80% could digest volume growth we've forecast till 2012E. Capex stands at P1.3bn in 2008E with P700mn earmarked for repair and maintenance of equipment and the rest for other costs in line with historical capex of P1.2~2.0bn from 2004-2006. We do not expect any more

factory extension. But the company will focus more on rebalancing capacity in terms of their beer producing capacity and packaging capacity. By rebalancing between factories, the company plans to improve capacity by 20% without limited out-of-pocket expense.

- **Working capital as percentage of sales:** We have not factored in any major change in the current working capital structure.
- **Dividends:** We have assumed a dividend payout ratio of 90% vs. 100% assumed for pro-forma numbers by the company in 2004-2006 to be more conservative. We assume DPS at P0.57 for 2008E.

**Figure 6. Earnings Forecasts**

| Peso in Billions | 2004   | 2005   | 2006   | 2007   | 2008E  | 2009E  | 2010E  | 2011E  | 2012E  | 2013E  |
|------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Net Sales        | 37.367 | 40.978 | 40.565 | 44.139 | 51.590 | 54.849 | 58.313 | 61.997 | 65.772 | 69.778 |
| Gross profit     | 17.068 | 18.170 | 19.878 | 21.212 | 25.537 | 26.986 | 28.690 | 30.378 | 32.228 | 34.191 |
| Operating Profit | 8.875  | 9.234  | 11.212 | 12.273 | 14.976 | 15.397 | 16.370 | 17.474 | 18.632 | 19.767 |
| Recurring Profit | 8.881  | 9.455  | 11.270 | 12.321 | 15.126 | 15.450 | 16.423 | 17.527 | 18.685 | 19.820 |
| Net Profit       | 6.040  | 6.406  | 7.326  | 8.011  | 9.835  | 10.815 | 11.496 | 12.269 | 13.079 | 13.874 |
| Margins (%)      |        |        |        |        |        |        |        |        |        |        |
| GPM              | 45.7   | 44.3   | 49.0   | 48.1   | 49.5   | 49.2   | 49.2   | 49.0   | 49.0   | 49.0   |
| OPM              | 23.8   | 22.5   | 27.6   | 27.8   | 29.0   | 28.1   | 28.1   | 28.2   | 28.3   | 28.3   |

Source: Company, Citi Investment Research estimates

**Figure 7. Key Assumptions**

|                                  | 2004   | 2005   | 2006   | 2007   | 2008E  | 2009E  | 2010E  | 2011E  | 2012E  | 2013E   |
|----------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------|
| Net Sales (P Bils.)              | 37.367 | 40.978 | 40.565 | 44.139 | 51.590 | 54.849 | 58.313 | 61.997 | 65.772 | 69.778  |
| Sales growth (%)                 |        | 9.7    | -1.0   | 8.8    | 16.9   | 6.3    | 6.3    | 6.3    | 6.1    | 6.1     |
| Capacity (MI hl)                 | 15.1   | 15.1   | 15.1   | 15.1   | 15.1   | 15.1   | 15.1   | 15.1   | 15.1   | 15.1    |
| Utilization Rate (%)             | 89.5   | 87.3   | 79.2   | 85.2   | 91.4   | 94.3   | 97.4   | 100.5  | 103.5  | 106.6   |
| Industry Volume growth (%)       |        | -2.4   | -9.3   | 7.4    | 7.0    | 3.0    | 3.0    | 3.0    | 3.0    | 3.0     |
| Volume growth- SMB (%)           |        | -2.4   | -9.3   | 7.6    | 7.2    | 3.2    | 3.2    | 3.2    | 3.0    | 3.0     |
| M/S (%)                          | 93.0   | 93.0   | 93.0   | 93.2   | 93.4   | 93.6   | 93.8   | 94.0   | 94.0   | 94.0    |
| Net ASP (Peso per hl)            | 2,766  | 3,109  | 3,392  | 3,430  | 3,738  | 3,850  | 3,966  | 4,085  | 4,207  | 4,334   |
| GP Margin (%)                    | 45.7   | 44.3   | 49.0   | 48.1   | 49.5   | 49.2   | 49.2   | 49.0   | 49.0   | 49.0    |
| Malt cost as % of net sales      | 6.2%   | 5.9%   | 5.1%   | 4.5%   | 4.8%   | 5.1%   | 5.2%   | 5.3%   | 5.4%   | 5.5%    |
| Corn cost as % of net sales      | 3.0%   | 2.5%   | 2.7%   | 2.9%   | 3.0%   | 3.2%   | 3.3%   | 3.4%   | 3.6%   | 3.8%    |
| Malt price (Peso per kg)         | 18.1   | 20.6   | 19.7   | 17.9   | 21.4   | 23.6   | 24.8   | 26.0   | 27.3   | 28.7    |
| Corn price (Peso per kg)         | 11.9   | 11.8   | 15.6   | 16.7   | 20.1   | 22.1   | 24.3   | 26.7   | 29.4   | 32.3    |
| OP Margin                        | 23.8   | 22.5   | 27.6   | 27.8   | 29.0   | 28.1   | 28.1   | 28.2   | 28.3   | 28.3    |
| A&P Spending as % of net sales   | 3.2%   | 3.0%   | 3.1%   | 3.2%   | 3.2%   | 3.3%   | 3.3%   | 3.3%   | 3.3%   | 3.3%    |
| Interest income (P Mills.)       | 3      | 3      | 3      | 39     | 140    | 44     | 44     | 44     | 44     | 44      |
| Capex (P Bils.)                  | 2.019  | 1.712  | 1.244  | 1.839  | 1.300  | 1.300  | 1.300  | 1.300  | 1.300  | 1.300   |
| Dividends (P Bils.)              | 6.040  | 6.406  | 7.326  | 5.707  | 8.784  | 9.632  | 10.325 | 10.633 | 11.250 | 11.250  |
| Dividend Payout (%)              | 100    | 100    | 100    | 71     | 89     | 89     | 90     | 87     | 86     | 81      |
| Net Debt(cash) (P Bils.)         | -0.996 | -0.994 | -0.978 | -5.262 | -3.176 | -4.565 | -5.730 | -7.255 | -8.859 | -11.181 |
| No. of outstanding Shares (Mil.) | 15,882 | 15,882 | 15,882 | 15,333 | 15,410 | 15,410 | 15,410 | 15,410 | 15,410 | 15,410  |

Source: Company, Citi Investment Research estimates

**Figure 8. Excise Tax Profile by Brands and SKUs**

| Product       | Equivalent Case | Per Liter |
|---------------|-----------------|-----------|
| PP320         | 101.99          | 13.28     |
| PP1000        | 101.99          | 13.28     |
| PP Cans       | 135.48          | 17.64     |
| PP KEG (50 L) | 101.99          | 13.28     |
| PP KEG (30 L) | 101.99          | 13.28     |
| RH330         | 68.58           | 8.93      |
| RH500         | 68.58           | 8.93      |
| RH 1000       | 68.58           | 8.93      |
| RH Cans       | 135.48          | 17.64     |
| GE320         | 68.58           | 8.93      |
| GE750 (12s)   | 68.58           | 8.93      |
| GE 1000       | 68.58           | 8.93      |
| SML Bottle    | 135.48          | 17.64     |
| SML Cans      | 135.48          | 17.64     |
| SML Draft 50L | 135.48          | 17.64     |
| SML Draft 30L | 135.48          | 17.64     |
| SML Draft 15L | 135.48          | 17.64     |
| SD Bottle     | 101.99          | 13.28     |
| SD Cans       | 135.48          | 17.64     |
| CN            | 101.99          | 13.28     |
| S-ICE         | 135.48          | 17.64     |
| S-ICE Cans    | 135.48          | 17.64     |

Source: San Miguel Corporation

## Earnings Quality Enhancement

One of the key discount factors on the parent group, San Miguel Corp., has been risks on the quality of earnings amid earnings volatility on restructuring charges from asset acquisitions and/or gains through disposal. SMC has been highly acquisitive and the usefulness of historically reported earnings to predict future earnings has been diminished, increasing the overall equity risk premium on the stock. We see this issue as less of risk for SMB going forward, and expect little gap between fundamental earnings and reported earnings.

In an inflationary environment, there could be more room for deterioration in earnings quality; however, we believe SMB should offer earnings quality improvement over the next three years.

Our economist forecasts that the Philippines will face a tougher inflation environment with higher oil prices and commodity price hikes. At a time of high inflation, the company could drive its growth via inflation of inventory or asset prices which could improve the scale of earnings growth, but also lead to deterioration in the overall quality of earnings. However, some companies could achieve improvement of earnings quality via revenue growth by market share increases and more proactive cost cutting. We believe the company could drive real growth amid a high-inflation landscape via expanding market share, albeit from a high base, and stronger earnings growth initiatives coming from global brand strength, operational efficiencies, pricing leadership increases, etc. This earnings quality enhancement should persist as a key positive factor. We summarize key rationales in our belief on the strong earnings quality profile of SMB:

1. SMB earnings are more repeatable through sales growth and cost cutting, therefore they could be more predictable.
2. SMB earnings are relatively more controllable amid macro volatility including inflationary pressures, input cost hikes, forex rate fluctuations.
3. Room for manipulating account receivables is limited.

The key trend to monitor is the gap between operational cash flow versus earnings. Theoretically, quality of earnings would be higher the larger the positive gap. It is true that it is challenging and even rare to consistently report a positive gap between operational cash flow and EPS, which should involve smart capital allocation decisions with an optimal net debt to equity ratio. The gap should be monitored also from the context of industry and macro cyclical dynamics or any sizable investment under way for stronger and sustainable future growth.

## Competitive Position

We highlight the competitive position of SMB from three main angles: 1) distribution power, 2) brand strength, and 3) sourcing cost advantage.

### Distribution Power Is Key; Exclusive Dealers System

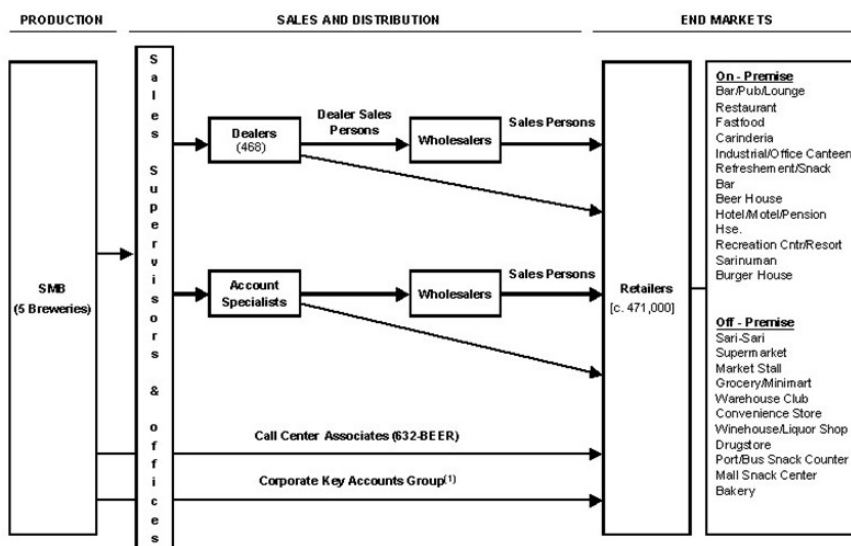
Our belief in the sustainable distribution strength of SMB is based on both our ground checks of dealers and on extensive scale of coverage that actual penetration numbers are showing. SMB has 49 sales offices nationwide (of which 44 of these are company-owned) covering 471,000 on-premise and off-premise outlets nationwide. The company has 468 exclusive dealers and more than 9,000 wholesalers, according to the company's operational staffs which enable the company to have already reached economies of scale forming a powerful marketing network with designated geographical coverage. The company's distribution process is simplified from factory to sales offices, then to dealers, then to wholesalers and finally to retailers (on premise such as restaurants and off-premise such as sari-sari stores, which are small-scale local Mom & Pop stores selling basic food and household products over the counter). According to the company, out of total sales, off-premise takes 70-80% of total sales and then the remaining 20-30% is taken by on-premise channels. Out of total off-premise channel sales, sari-sari store take 90%.

There are two types of dealers – those who source beer through SMB sales offices and those who directly source beer from the SMB factories. Dealers' own distribution mix by channel is roughly 50% to Retail (both on- and off-premise) and 50% to Wholesale. Currently, the numbers of dealers are considered as optimal level. Thus SMB won't increase the number for the time being and actually would try to reduce number of dealers giving greater mandate to cover larger territory. In order to become a dealer, you need to achieve a license for distribution of alcoholic beverages from the government. The business model of the dealer is that they take products from sales offices of SMB and add dealer margin, which is roughly at 6% of shipment price to wholesaler post excise tax and VAT. They take rental, personnel and transportation costs required for distribution of the products to wholesalers or to retailers.

It is quite challenging to establish a dealer network. Therefore, it has become a significant entry barrier for SMB, especially against MNCs trying to make inroads into the local market. In order to maintain operational efficiency within this exclusive dealer network, the company set up a system called Dealer Performance Assessment, which evaluates dealers' performance on volume sales, customer service, carrying volume, etc.



Figure 9. Sales and Distribution



(1) SMC's CKAG division will provide targeted sales and distribution services to SMB on an arm's length basis.

Source: Company Prospectus

By distribution channels, the Philippines shows a high portion of exposure to off-premise channel at 77% of total beer sales nationwide vs. 26~73% in other Asian countries. 90% of off-premise sales are from Sari-Sari stores which should require more localized experience and expertise in securing motor vehicles etc. With the mass consumer segment accounting for the majority of beer consumption in the Philippines, Sari-Sari stores remain the undisputed primary channel for the entire channel sales, serving as social gathering places, which are also popular as many offer credit to regular customers.

In addition to this, SMB has strategic locations for its breweries (i.e. two in Luzon, the most economically and politically important island in the Philippines, two in Visayas, and one in Mindanao. Note Luzon, Visayas, Mindanao are the three major island groups in the Philippines). Proximity of breweries and sales offices to consumer markets helps ensure product availability and freshness, minimizing costs as well.

The strategic locations of factories and sales offices also help the company to have developed established a returnable bottle system. 98% of its beer sales used returnable glass bottles during 2006-2007. These returnable glass bottles are used up to 60 cycles over a span of 10 years or six times a year. With a high retrieval rate of 95% achieved under the system, bottle usage is maximized before bottles are replaced. The existing system for returnable glass bottles could continue to be an important factor to buffer negative impact if any packing costs rise.

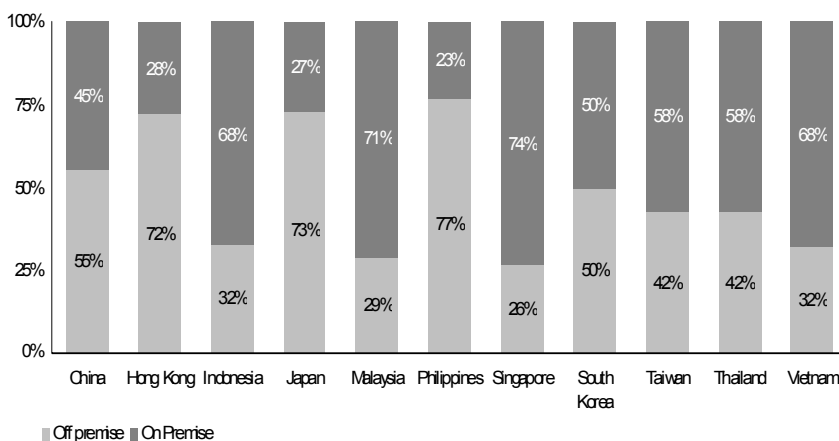
In this environment, distribution strength could act as even stronger competitive strength to keep MNCs from attempting to penetrate into the market.

Figure 10. Outlet Universe in the Philippines for Beer (2006)

| Channel                       | Number         | % share        |
|-------------------------------|----------------|----------------|
| <b>Off-Premise</b>            |                |                |
| Convenience stores            | 1,008          | 0.23%          |
| Supermarkets                  | 80             | 0.02%          |
| Warehouse clubs.              | 31             | 0.01%          |
| Gas stations                  | 200            | 0.05%          |
| Sari-Sari stores              | 350,000        | 79.55%         |
| Other retail                  | 220            | 0.05%          |
| <b>Off-Premise total</b>      | <b>351,539</b> | <b>79.90%</b>  |
| <b>On-Premise</b>             |                |                |
| Hotels                        | 3,655          | 0.83%          |
| Restaurants, cafes, fast food | 68,400         | 15.55%         |
| Clubs, kiosks, others         | 16,400         | 3.73%          |
| <b>On-Premise total</b>       | <b>88,455</b>  | <b>20.10%</b>  |
| <b>Total</b>                  | <b>439,994</b> | <b>100.00%</b> |

Source: Euro Monitor

Figure 11. On-Premise vs. Off-Premise



Source: Company Prospectus, Canadean

## Sourcing Cost Advantage

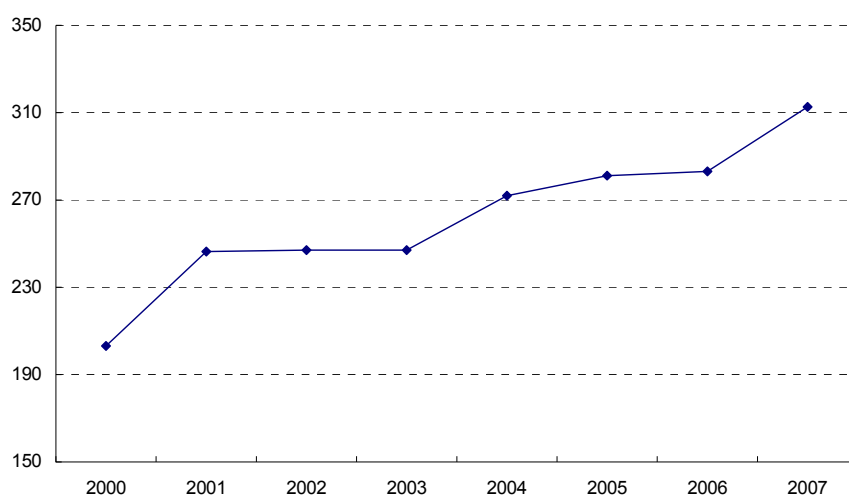
Volatile raw material prices have emerged as an increasing threat amid an overall tougher global commodity supply. In this environment, San Miguel Brewery has managed to avoid any significant margin erosion for the past two years. Gross margins rose by 470bps in 2006 and 50bps in 2007E helped by sizable price hikes and peso strength – but another important factor has been more favorable raw material input costs as they purchase a key raw material, malt, in cooperation with strategic partner Kirin Brewery and its affiliate, Australian brewer Lion Nathan (46% owned by Kirin Brewery). For annual contracts, SMB enters into price negotiations with major suppliers in Australia and China together with these partners using high-volume orders to their advantage. Kirin usually uses 180K tons of malt annually for beer sold domestically, and the combined beer output of Lion Nathan and San Miguel, which both use Australian malt, is comparable to Kirin's domestic production level.

**Figure 12. SMB Malt Input Price Trend - Annual Average**

|                           | 2000   | 2001   | 2002   | 2003   | 2004   | 2005   | 2006   | 2007   |
|---------------------------|--------|--------|--------|--------|--------|--------|--------|--------|
| USD/MT*                   | 203.41 | 246.28 | 247.07 | 247.21 | 272.05 | 280.83 | 283.34 | 312.36 |
| % Growth over Prev. Yr.   | -      | 21.1%  | 0.3%   | 0.1%   | 10.0%  | 3.2%   | 0.9%   | 10.2%  |
| FOREX                     | 44.19  | 50.99  | 51.60  | 54.20  | 56.04  | 55.08  | 51.31  | 46.15  |
| % Increase from Prev. Yr. | -      | 15.4%  | 1.2%   | 5.0%   | 3.4%   | -1.7%  | -6.8%  | -10.1% |
| P/Kg                      | 10.71  | 14.70  | 14.43  | 15.08  | 18.07  | 20.62  | 19.67  | 17.86  |
| % Growth over Prev. Yr.   | -      | 37.3%  | -1.8%  | 4.5%   | 19.8%  | 14.1%  | -4.6%  | -9.2%  |

Source: Company, Citi Investment Research

**Figure 13. SMB Malt Input Price Trend (USD/MT)**



Source: San Miguel Corporation

Figure 14. International Malt Price Trend



Source: Citi Investment Research, Customs and Tariff Bureau, Ministry of Finance Japan

### Brand Strength – Taste Rocks!

San Miguel Brewery established its “San Miguel” brand 117 years ago when a man named Enrique Barretto opened La Fabrica de Cerveza de San Miguel translated as the San Miguel Brewery. San Miguel was not only named after the patron saint of brews, Saint Michael, but also San Miguel was the district where Barretto built his brewery. One of key factors determining the taste of San Miguel Brewery beer is its unique yeast.

Our research on online beer reviews shows the most popular comment about San Miguel Beer is “It is very good and cheap!” The way people describe the taste is not bitter but not too light, and many think it has a smooth, mild, and refreshing taste. Some drinkers differentiate the taste of the beer produced in Philippines vs. elsewhere, e.g. in China. It might not be the recipe which could make some subtle differences but the flavor of ingredients or the quality of the water. Each San Miguel factory has its own deep well water except for one in Polo brewery. Deep well water accessibility is one of the biggest considerations when SMB finds a candidate territory for a factory. The brand also benefits from its mixed Latin and Asian heritage, which tends to put it on the same league with the likes of Corona Extra, Mexico’s leading export brand. All these factors have helped boost San Miguel as a local beer that has also gained a loyal following outside its home country.

All San Miguel beer is pasteurized, and the company currently does not have a plan to move into non-pasteurized beer given they find it not so cost efficient relative to any revenue or brand equity benefits. One of key merits for non-pasteurized beer is better freshness, but the company believes that most beer is consumed within 2~3 month after ex-factory, and they see non-pasteurized beer with shorter shelf life (2-4 months) is not practically considered by consumers as more fresh than pasteurized beer (6-12 months).

We believe the taste of the beer remains a sustainable competitive edge for generating brand loyalty from new customers and driving stickiness to brand from existing customers. In the meantime, the company has continued to investing in its brands. In May 2007, San Miguel decided to renovate the look of its major flagship brand, Pale Pilsan, in the local market with a gold paper label around the bottle vs. the old bottle with printed label. There was no change in retail pricing. This initiative is also meant to bring consistency to the look of the bottle across Asian markets. Plus, the company has continued to develop convenience pack formats to meet faster-paced lifestyles and to address various outing activities. In terms of new product development, the company has plans to launch new brands focusing on the premium pricing category, which is more profitable with higher retail prices on on-premise and off-premise.

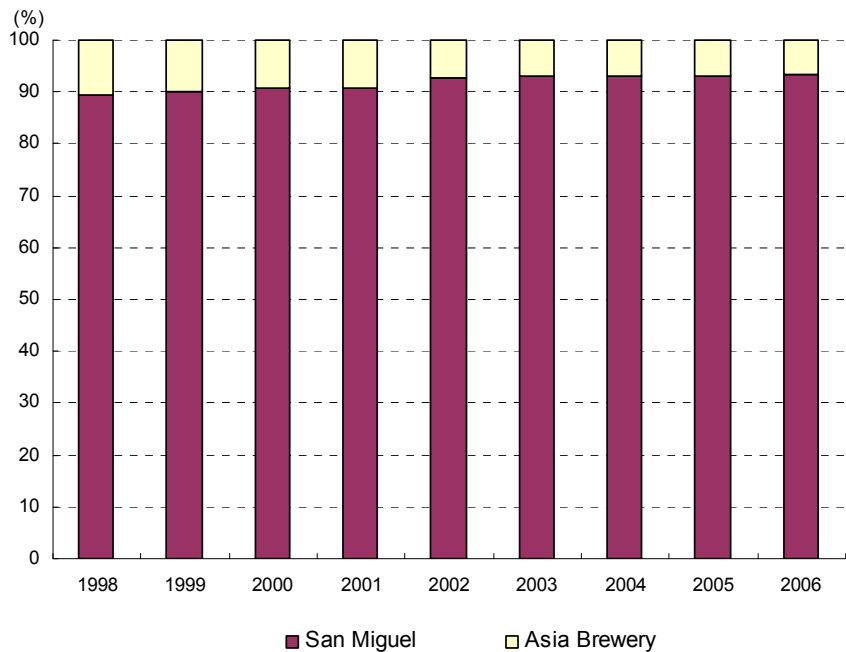
## Corporate Strategy

### Market Share Gains; How to Move Up From 93%?

The company has continued to expand its market share from 89% in 1998 to 93% in 2006 without any single year of decline. Its main local competitor, Asia Brewery, has remained as a minor player shedding its market share gradually, while MNCs have not been successful in penetrating the market, mainly due to lack of distribution network and less competitive pricing. We expect the company to maintain its extremely strong monopolistic position in the Philippines beer market driven by its competitive strengths: the most scaleable distribution network, brand strength, and efficient cost structure enabling favorable working capital cycle. The company targets market share as high as 95% over the next three years or so, though we believe this could be a challenging task.

The key strategy to gain further market share from a high base is a systematic approach to target its competitors, mainly Asia Brewery with more than 7% market share. The geographic markets where Asia Brewery has some strength above their nationwide market share at 7% account for around 20% of total nationwide coverage. We estimate a 1 ppts increase in market share in those areas could lead to about 20bps increase in nationwide market share. Plus, the company continues to enhance support for small-scale retail outlets in terms of shortening delivery lead time and inventory management, which should improve already strong distribution power. For creating new demand, the company is trying to cope with bi-polarization, focusing on both super-premium brands, high-alcohol beer and cheaper economy brands. For the high-alcohol beer segment, the company aspires to gain market share from other hard liquor alternatives in the market.

Figure 15. San Miguel vs. Asia Brewery Market Share Trend



Source: Canadean, Company

## Expansion Potential into Beverages and Overseas Beer Markets

Long-term growth upside for San Miguel Brewery could come from potential integration of overseas beer business and non-alcoholic beverage business which currently are owned by the parent company. Overseas beer business accounted for 7% of SMC revenues and 20% of beer revenues in 2006. Any potential merger with the parent group's beer/beverage assets could offer extra growth longer-term.

We believe the parent company may try to divest its beverage and overseas beer businesses at some time in order to:

- Create better operational synergy within beverage businesses in the group
- Fund other new investments

Note the group has gone through similar restructuring in its packaging business. In May 2006, the Securities Exchange Commission has approved the merger of San Miguel's composite, glass and aluminum can packaging units under San Miguel Packaging Specialist, Inc. The rationale was maximization of synergies in the packaging business. In February 2007, the company announced to consolidate its food businesses, Magnolia, Monterey Foods Corp and San Migueel Foods Inc., under San Miguel Purefoods Co Inc to rationalize corporate structure.

## Overseas Beer Business

San Miguel Corp has a total of six overseas affiliates; two in China, one in Hong Kong, one in Vietnam, one in Indonesia, and one in Thailand. Of these, five have manufacturing capacity – the exception is Hong Kong which is supplied from China. We think this was a sensible move given the HK market is fairly mature with limited growth. Profitability wise, affiliates in China and Indonesia are already profitable and affiliates in HK, Indonesia and Vietnam are nearing a breakeven point, while the affiliate in Thailand has just started and thus it could take a while to contribute to earnings.

- **HK** – The company has shut down its HK facility and transferred it to Foshan Brewery in China in order to reduce production and transportation costs. We view this move as sensible to take better advantage of higher growth opportunities in the China market.
- **China** – Key two popular brands are Blue Star and Dragon apart from its main Pale Pilsen brand. Blue Star beer takes almost 96% of total sales around Bada Baoding area in Northern China. The key strategy is to build brand awareness via its standard and economy brands to keep improving economies of scale.
- **Vietnam** – Volume is not yet big enough to generate profits; however, the market growth dynamic seems fairly attractive, thus the group aspires to set itself as an important industry player with distribution strength and competitive pricing and brand equity improvement.
- **Indonesia** – PT Delta sells major brand Anker Bir (PT Delta's best selling brand), Anker Stout, San Miguel, Carlsberg, Kuda Putih, Sodaku, and Sodaku Ice Brands. The company has been aggressively marketing, building distribution expanding coverage, and seeking better sources for merchandising materials.
- **Thailand** – This is a more mature market with a tough competitive environment. The company would like to leverage the maturity of the market to drive consumer demand to trade up for higher-priced higher-margin products.

## Non-Alcoholic Beverage Business

San Miguel used to be a JV partner of Coca-Cola, owning a 65% stake in Coca Cola Bottlers Philippines, but it divested this stake for US\$590 million in December 2006 after disagreements over operational and strategic direction with Coca Cola. This deal included "non-compete" clauses which prevent San Miguel from competing with Coca-Cola for five years in the manufacture and sale of carbonated soft drinks, sports drinks, energy drinks and flavored water. The deal terms also prohibit San Miguel group from producing non-alcoholic beverages for itself or for competitors of Coca-Cola anywhere in the world for three years and in the Philippines for five years. San Miguel will also provide human resource services to Coca-Cola for up to 18 months to allow Coca-Cola's management to assume control of the bottler. In order to execute these deal terms as more strongly binding in our view, the payment term is rather complex and longer term. Coca-Cola paid San Miguel group US\$370 million and deposited US\$100 million in escrow to be disbursed upon resolution of the



purchase price adjustment, and 18 months after the closing, Coca-Cola will pay US\$20 million, while on the fifth year, Coca-Cola will pay San Miguel roughly US\$100 million.

In developing its own non-alcoholic beverage business within the group, San Miguel has launched its own water product in plastic bottles under the Magnolia Pure Water brand and has developed juice brands under its new beverage company San Miguel Beverages, Inc. It entered the non-carbo beverage industry with the launching of tea and juice drinks under Magnolia brand with Magnolia Fruit Drink and Magnolia Health tea selling at P5.00 per 250ml bottle. The industry outlook on carbonated drinks market is not so bright in our view, with tougher competition to unfold with Pepsi Co ready to increase capacity and with Coca-Cola becoming more aggressive in marketing to defend its share. Therefore, we expect there could be limited gains that San Miguel could generate in the carbonated drinks market, and in any event, expansion in this segment would likely dilute overall returns on its beverage businesses.

### Pricing Tactics

The group enjoys a monopolistic position in the industry, which confers price leadership power and has reduced the importance of competition in pricing decisions. Nonetheless, pricing remains challenging given significant consumer price sensitivity. We see two main tactics in terms of boosting prices:

1. **Cost-driven and tax-driven pricing** – The company has benefited from cooperative sourcing with its global partners – Kirin and Lion Nathan – and via discussions and information sharing, it has not seen much negative impact on gross margins in 2007 despite a surge in malt costs. However, given the scale of incremental rises in malt costs, the company increased its prices from April 2008E at an average rate of 9%. Plus, we expect an excise tax increase by 8% in 2009E and another 8% in 2011E vs. previous fixed excise tax amount, which we forecast the company would most likely transfer onto retail pricing. We have assumed a minimum 3% price increase per annum in line with inflation rate from 2009E, to take a conservative approach.

Figure 16. Price Increases, Excise Taxes and Average Selling Price vs. Inflation

|   | 1997   | 1998   | 1999   | 2000   | 2001   | 2002  | 2003  | 2004   | 2005   | 2006   | 2007   | 1Q08  |
|---|--------|--------|--------|--------|--------|-------|-------|--------|--------|--------|--------|-------|
| <b>SMB Beer Volume Growth (%)</b>           | 2.3    | -3.9   | -1.2   | -3.4   | -3.0   | 4.0   | 11.6  | 15.6   | -2.3   | -9.2   | 7.7    | 18    |
| Price Level - Pale Pilsen 320mL (P/cs)      | 210.0  | 220.0  | 240.0  | 252.0  | 262.0  | 262.0 | 262.0 | 282.0  | 322.0  | 352.0  | 352.0  | 352.0 |
| <b>Increase vs. previous year (%)</b>       | 10.5   | 4.8    | 9.1    | 5.0    | 4.0    | -     | -     | 7.6    | 14.2   | 9.3    | -      | -     |
| Amt of Price Inc. (P/cs)                    | 20.0   | 10.0   | 20.0   | 12.0   | 10.0   | No PI | No PI | 20.0   | 40.0   | 30.0   | No PI  | No PI |
| Timing- The month to start price increase   | Mar    | Feb    | Apr    | Mar    | Apr    | -     | -     | Mar    | Feb    | Mar    | -      | -     |
| Lagged Time period vs. previous hikes       | 15-mo. | 11-mo. | 14-mo. | 11-mo. | 13-mo. | -     | -     | 35-mo. | 11-mo. | 13-mo. | 22-mo. | -     |
| Excise Taxes (P/cs)                         | 65.33  | 65.27  | 64.52  | 71.16  | 69.32  | 68.23 | 67.07 | 67.45  | 79.37  | 78.82  | 84.24  | 85.29 |
| <b>% Increase vs. previous year</b>         | 13.6   | -0.1   | -1.1   | 10.3   | -2.6   | -1.6  | -1.7  | 0.6    | 17.7   | -0.7   | 6.9    | -     |
| <b>Average Selling Price Increase (%)</b>   | -      | 12.7   | 6.9    | 6.1    | 2.3    | 1.4   | 2.1   | 4.6    | 10.8   | 11.3   | 0.5    | -     |
| <b>Inflation (%)</b>                        | 6.0    | 9.7    | 6.7    | 4.3    | 6.1    | 3.1   | 3.4   | 6.0    | 7.7    | 6.3    | 2.8    | 6.4   |
| <b>GDP (%)</b>                              | 5.2    | -0.6   | 3.4    | 4.4    | 4.5    | 3.1   | 5.0   | 6.4    | 4.9    | 5.4    | 6.9    | NA    |
| Price Index - Pale Pilsen 320 ml (1997=100) | 100.0  | 104.8  | 114.3  | 120.0  | 124.8  | 124.8 | 124.8 | 134.3  | 153.3  | 167.6  | 167.6  | 167.6 |
| Change (%)                                  | -      | 4.8    | 9.1    | 5.0    | 4.0    | 0.0   | 0.0   | 7.6    | 14.2   | 9.3    | 0.0    | 0.0   |
| Consumer Price Index (1997=100)             | 100.0  | 110.3  | 115.7  | 121.1  | 129.7  | 133.8 | 138.6 | 146.6  | 159.2  | 170.3  | 175.1  | -     |
| Inflation Rate (1997=100)                   | -      | 10.3   | 4.9    | 4.6    | 7.1    | 3.2   | 3.6   | 5.8    | 8.6    | 7.0    | 2.8    | -     |

Source: Company, Citi Investment Research

2. **Product mix driven pricing** – This is all about managing target markets more proactively. The company will continue to focus more on higher premium sales but without neglecting boosting lower-end sales to capture growing bi-polarization of its consumer markets.

The company plans to continue to increase sales from the premium/super-premium pricing segment, which accounts for 11% of total sales vs. standard & economy at 89%. At the same time, the company would continue to drive lower-margin hard liquor product sales higher (e.g. Red Horse) in order not to lose out market share in the lower-end segment. We have observed Red Horse almost took 50% of revenue in 1Q08. We believe consumer pricing sensitivity is higher in the Philippine beverage market compared with other more developed Asian beverage markets, and there's some truth to the perception that pricing strategies are determined less by companies and more by local macroeconomics. However, we believe San Miguel Brewery at least is trying to employ a smarter segmented pricing to serve each bracket's consumer better. The company appears trying harder on recognizing niche angles in retail pricing bracket, distribution reach, and profitability.

## Cost Reduction Initiatives

One of key attributors to improve earnings quality is a variety of cost initiatives. This includes processing improvement, utility consumption optimization, better packaging efficiency, lowering sourcing cost amid tougher commodity price volatilities, rationalization in SKUs and brands. The company has its own internal benchmark system in which five factories benchmark each other, considering monthly comparison reports on product quality index, packaging quality index, etc. This is helping to improve processing at limited cost.

On raw material costs, the company has not only tried to secure lower malt prices in cooperative negotiations with its global partners, but at the same time tried to improve yield on malt production via technology upgrades.

Transportation cost is another area that the company seeks to improve amid higher oil prices environment. Third-party logistics are cheaper vs. using own internal resources, and third-party logistics as a percentage of total transportation required stands at 70%, which the company targets to improve to 90%.

In terms of packaging efficiency, the company is considering to gradually churn out any non-profitable SKU (Stock Keeping Unit) to better manage product-design or volume-driven pricing.

Advertisement & Promotional cost as a percentage of sales under selling and general administrative expense is already at efficient level of 3.2% of net sales in 2007, much lower vs. its regional peers, e.g. Hite Brewery at 10% based on our 2008E estimates. However, the company continues to endeavor to keep costs under control and improve allocation efficiency in budgeting for marketing activities.

### **Strengthening Global Partnership with Kirin**

Kirin Brewery enjoys 37% market share in the US\$18.9bn beer market in Japan (2006) and has expanded into wine, soft drinks and pharmaceuticals. In order to seek further growth outside of the home market, Kirin has been quite aggressive in acquisitions. Kirin holds a 20% stake in San Miguel Corp and holds three out of 15 board seats at SMC.

Reuters has reported that Kirin has previously said it was open to raising its stake in San Miguel given the opportunity when the Philippine government release its stake. Kirin's strategic angle to raise its stakes in SMC is about driving higher growth. We believe Kirin could also try to take part in higher stakes in San Miguel Brewery directly, apart from its investment increase in the parent company. If this materializes, it could enhance already friendly partnership between the two groups, which should help better sourcing, cooperative marketing, new product development and distribution in global markets. On the new product development front, Kirin has been quite active in chasing trends on new beer categories, e.g. entry to "third type" beer, which tastes like beer but is cheaper with limited alcohol and other lower-malt beers which are made from ingredients that exempt them from higher taxes on alcohol products. Kirin's product Nodogoshi Nama became a hit and the company now has the top market share in the segment, surpassing Sapporo Holdings Ltd, which pioneered the new category. Kirin's product innovation could help San Miguel's future reinvestment strategy in their own brands.

# Financials

## Income Statement

Our historical numbers are on a pro-forma basis to facilitate an apples-to-apples comparison. Note also that GP margin improvement in 2006 is attributable to price hikes in 2005 with a time lagged effect and positive benefits from product mix improvement and stronger cost initiatives to cut processing and sourcing costs.

**Figure 17. Income Statement**

| (y/e Dec, php Bil)             | 2004          | 2005          | 2006          | 2007          | 2008E         | 2009E         | 2010E         | 2011E         | 2012E         | 2013E         |
|--------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Gross sales                    | 49.324        | 54.091        | 54.519        | 59.323        | 69.337        | 75.911        | 80.706        | 88.283        | 93.660        | 99.364        |
| Alcohol tax                    | (11.957)      | (13.113)      | (13.954)      | (15.184)      | (17.747)      | (21.062)      | (22.392)      | (26.287)      | (27.887)      | (29.586)      |
| <b>Net sales</b>               | <b>37.367</b> | <b>40.978</b> | <b>40.565</b> | <b>44.139</b> | <b>51.590</b> | <b>54.849</b> | <b>58.313</b> | <b>61.997</b> | <b>65.772</b> | <b>69.778</b> |
| COGS                           | (20.299)      | (22.808)      | (20.687)      | (22.927)      | (26.053)      | (27.863)      | (29.623)      | (31.618)      | (33.544)      | (35.587)      |
| <b>Gross profit</b>            | <b>17.068</b> | <b>18.170</b> | <b>19.878</b> | <b>21.212</b> | <b>25.537</b> | <b>26.986</b> | <b>28.690</b> | <b>30.378</b> | <b>32.228</b> | <b>34.191</b> |
| SG&A                           | (8.193)       | (8.936)       | (8.666)       | (8.939)       | (10.561)      | (11.588)      | (12.320)      | (12.904)      | (13.597)      | (14.425)      |
| EBITDA                         | 10.397        | 10.846        | 12.833        | 13.925        | 16.913        | 17.093        | 17.900        | 18.888        | 19.962        | 21.034        |
| Depreciation                   | (1.522)       | (1.612)       | (1.621)       | (1.652)       | (1.936)       | (1.695)       | (1.530)       | (1.414)       | (1.330)       | (1.268)       |
| <b>EBIT</b>                    | <b>8.875</b>  | <b>9.234</b>  | <b>11.212</b> | <b>12.273</b> | <b>14.976</b> | <b>15.397</b> | <b>16.370</b> | <b>17.474</b> | <b>18.632</b> | <b>19.767</b> |
| Net interest income /(expense) | 0.003         | 0.003         | 0.003         | 0.039         | 0.140         | 0.044         | 0.044         | 0.044         | 0.044         | 0.044         |
| Non-op income /(expense)       | 0.003         | 0.218         | 0.055         | 0.009         | 0.009         | 0.009         | 0.009         | 0.009         | 0.009         | 0.009         |
| Exceptionals                   | -             | -             | -             | -             | -             | -             | -             | -             | -             | -             |
| PBT                            | 8.881         | 9.455         | 11.270        | 12.321        | 15.126        | 15.450        | 16.423        | 17.527        | 18.685        | 19.820        |
| Tax                            | (2.841)       | (3.049)       | (3.944)       | (4.310)       | (5.291)       | (4.635)       | (4.927)       | (5.258)       | (5.605)       | (5.946)       |
| <b>PAT</b>                     | <b>6.040</b>  | <b>6.406</b>  | <b>7.326</b>  | <b>8.011</b>  | <b>9.835</b>  | <b>10.815</b> | <b>11.496</b> | <b>12.269</b> | <b>13.079</b> | <b>13.874</b> |
| Dividends                      | (6.040)       | (6.406)       | (7.326)       | (5.707)       | (8.784)       | (9.632)       | (10.325)      | (10.633)      | (11.250)      | (11.250)      |
| Retained                       | -             | -             | -             | 2.304         | 1.051         | 1.184         | 1.171         | 1.636         | 1.830         | 2.624         |
| <b>Key data</b>                |               |               |               |               |               |               |               |               |               |               |
| Gross margin                   | 45.7%         | 44.3%         | 49.0%         | 48.1%         | 49.5%         | 49.2%         | 49.2%         | 49.0%         | 49.0%         | 49.0%         |
| Operating margin               | 23.8%         | 22.5%         | 27.6%         | 27.8%         | 29.0%         | 28.1%         | 28.1%         | 28.2%         | 28.3%         | 28.3%         |
| EBITDA margin                  | 27.8%         | 26.5%         | 31.6%         | 31.5%         | 32.8%         | 31.2%         | 30.7%         | 30.5%         | 30.3%         | 30.1%         |
| Dividend cover                 | 1.0           | 1.0           | 1.0           | 1.4           | 1.1           | 1.1           | 1.1           | 1.2           | 1.2           | 1.2           |
| Effective tax rate             | 32%           | 32%           | 35%           | 35%           | 35%           | 30%           | 30%           | 30%           | 30%           | 30%           |
| <b>Key drivers</b>             |               |               |               |               |               |               |               |               |               |               |
| Beer volume growth             | -             | -2%           | -9%           | 8%            | 7%            | 3%            | 3%            | 3%            | 3%            | 3%            |
| Price growth                   | -             | 12%           | 9%            | 1%            | 9%            | 3%            | 3%            | 3%            | 3%            | 3%            |
| Alcohol tax                    | 32%           | 32%           | 34%           | 34%           | 34%           | 38%           | 38%           | 42%           | 42%           | 42%           |
| EBITDA per hl (PhP)            | 770           | 823           | 1,073         | 1,082         | 1,226         | 1,200         | 1,217         | 1,244         | 1,277         | 1,306         |
| Gross margin                   | 45.7%         | 44.3%         | 49.0%         | 48.1%         | 49.5%         | 49.2%         | 49.2%         | 49.0%         | 49.0%         | 49.0%         |
| Capex                          | (2.019)       | (1.712)       | (1.244)       | (1.839)       | (1.300)       | (1.300)       | (1.300)       | (1.300)       | (1.300)       | (1.300)       |

Source: Citi Investment Research estimates

## Balance Sheet

The company has enjoyed a net cash position and should retain a healthy balance sheet with strong operational cash streams. Capital allocation strategy on the company appears more conservative than its parent company, maintaining a net cash position instead of gearing up the balance sheet to an optimal level.

**Figure 18. Balance Sheet**

| (y/e Dec, php Bil)                     | 2004          | 2005          | 2006          | 2007          | 2008E         | 2009E         | 2010E         | 2011E         | 2012E         | 2013E         |
|--|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Stocks                                 | 3.795         | 3.169         | 3.202         | 2.447         | 2.860         | 3.041         | 3.233         | 3.437         | 3.646         | 3.868         |
| Debtors & Others                       | 2.455         | 5.203         | 5.161         | 3.856         | 5.967         | 6.344         | 6.745         | 7.171         | 7.608         | 8.071         |
| Cash & Cash Equivalents                | 0.996         | 0.994         | 0.978         | 5.262         | 3.176         | 4.565         | 5.730         | 7.255         | 8.859         | 11.181        |
| <b>Current Assets</b>                  | <b>7.246</b>  | <b>9.366</b>  | <b>9.341</b>  | <b>11.565</b> | <b>12.003</b> | <b>13.950</b> | <b>15.708</b> | <b>17.863</b> | <b>20.113</b> | <b>23.121</b> |
| PP&E                                   | 6.130         | 6.017         | 5.660         | 5.616         | 4.980         | 4.584         | 4.354         | 4.241         | 4.211         | 4.243         |
| Associates                             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             |
| Investments                            | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             |
| Others                                 | 5.274         | 5.553         | 5.664         | 5.427         | 5.437         | 5.442         | 5.452         | 5.462         | 5.472         | 5.478         |
| <b>Fixed Assets</b>                    | <b>11.404</b> | <b>11.570</b> | <b>11.324</b> | <b>11.043</b> | <b>10.417</b> | <b>10.026</b> | <b>9.806</b>  | <b>9.703</b>  | <b>9.683</b>  | <b>9.721</b>  |
| Creditors                              | -2.768        | -2.795        | -3.473        | -4.070        | -4.374        | -4.678        | -4.973        | -5.308        | -5.631        | -5.974        |
| Others                                 | 0             | -2.252        | -1.305        | -3.202        | -1.042        | -1.115        | -1.185        | -1.265        | -1.342        | -1.423        |
| Short term debt                        | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             |
| <b>Current Liabilities</b>             | <b>-2.768</b> | <b>-5.047</b> | <b>-4.778</b> | <b>-7.272</b> | <b>-5.416</b> | <b>-5.792</b> | <b>-6.158</b> | <b>-6.573</b> | <b>-6.973</b> | <b>-7.398</b> |
| Provisions & others                    | 0             | -0.007        | -0.005        | 0             | 0             | 0             | 0             | 0             | 0             | 0             |
| Long term debt                         | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             |
| <b>Total Assets net of liabilities</b> | <b>15.882</b> | <b>15.882</b> | <b>15.882</b> | <b>15.336</b> | <b>17.004</b> | <b>18.184</b> | <b>19.356</b> | <b>20.992</b> | <b>22.823</b> | <b>25.444</b> |
| Equity                                 | 15.882        | 15.882        | 15.882        | 15.333        | 17.000        | 18.183        | 19.354        | 20.990        | 22.820        | 25.444        |
| Minorities                             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             |
| <b>Total</b>                           | <b>15.882</b> | <b>15.882</b> | <b>15.882</b> | <b>15.333</b> | <b>17.000</b> | <b>18.183</b> | <b>19.354</b> | <b>20.990</b> | <b>22.820</b> | <b>25.444</b> |

### Key Data

|                           |        |        |        |        |        |        |        |        |        |         |
|---------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------|
| Debt % equity             | -6%    | -6%    | -6%    | -34%   | -19%   | -25%   | -30%   | -35%   | -39%   | -44%    |
| Working capital % sales   | 9%     | 8%     | 9%     | -2%    | 7%     | 7%     | 7%     | 7%     | 7%     | 7%      |
| ROE                       | 38%    | 40%    | 46%    | 52%    | 58%    | 59%    | 59%    | 58%    | 57%    | 55%     |
| Net debt / (cash) Bil php | -0.996 | -0.994 | -0.978 | -5.262 | -3.176 | -4.565 | -5.730 | -7.255 | -8.859 | -11.181 |

Source: Citi Investment Research estimates

## Cash Flow Statement

We are not forecasting any abrupt change in working capital and capex. We have assumed a constant 90% dividend payout ration from 2008E onwards.

**Figure 19. Cash Flow Statement**

| (y/e Dec, php Bil)             | 2004         | 2005          | 2006          | 2007E         | 2008E         | 2009E         | 2010E         | 2011E         | 2012E         | 2013E         |
|--------------------------------|--------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| PAT excl Minorities            | 8.881        | 9.455         | 11.270        | 12.321        | 9.835         | 10.815        | 11.496        | 12.269        | 13.079        | 13.874        |
| Depreciation / amortisation    | 1.522        | 1.612         | 1.621         | 1.652         | 1.936         | 1.695         | 1.530         | 1.414         | 1.330         | 1.268         |
| Working capital                | -1.448       | -3.099        | -4.666        | -2.418        | -2.400        | -0.254        | -0.297        | -0.295        | -0.323        | -0.342        |
| Provisions / other             | 0.110        | 0.143         | 0.322         | 0.220         | -0.009        | -0.009        | -0.009        | -0.009        | -0.009        | -0.009        |
| <b>Operating cashflow</b>      | <b>9.065</b> | <b>8.111</b>  | <b>8.547</b>  | <b>11.775</b> | <b>9.362</b>  | <b>12.248</b> | <b>12.720</b> | <b>13.378</b> | <b>14.077</b> | <b>14.790</b> |
| Capex                          | -2.019       | -1.712        | -1.244        | -1.839        | -1.300        | -1.300        | -1.300        | -1.300        | -1.300        | -1.300        |
| Dividends                      | -6.040       | -6.406        | -7.326        | -5.707        | -8.784        | -9.632        | -10.325       | -10.633       | -11.250       | -11.250       |
| <b>Free cashflow</b>           | <b>1.006</b> | <b>-0.007</b> | <b>-0.023</b> | <b>4.229</b>  | <b>-0.722</b> | <b>1.316</b>  | <b>1.094</b>  | <b>1.445</b>  | <b>1.528</b>  | <b>2.240</b>  |
| M&A                            | 0            | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             |
| Investments                    | 0            | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             | 0             |
| Share issues / (repos)         | 0            | 0             | 0             | 0             | 0.616         | 0             | 0             | 0             | 0             | 0             |
| Others                         | -0.676       | 0.005         | 0.007         | 0.055         | -1.980        | 0.072         | 0.070         | 0.080         | 0.077         | 0.082         |
| <b>(Inc) / dec in net debt</b> | <b>0.330</b> | <b>-0.002</b> | <b>-0.016</b> | <b>4.284</b>  | <b>-2.086</b> | <b>1.389</b>  | <b>1.165</b>  | <b>1.525</b>  | <b>1.605</b>  | <b>2.322</b>  |

### Key Data

|                            |     |     |     |     |     |     |     |     |     |     |
|----------------------------|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|
| Capex % cash profit        | 22% | 21% | 15% | 16% | 14% | 11% | 10% | 10% | 9%  | 9%  |
| Divi % cash profit         | 67% | 79% | 86% | 48% | 94% | 79% | 81% | 79% | 80% | 76% |
| Operating cashflow % sales | 24% | 20% | 21% | 27% | 18% | 22% | 22% | 22% | 21% | 21% |

Source: Citi Investment Research estimates

## Valuations

### P/E and EV/EBITDA Analysis

Our target price of P10.3 is based on a P/E multiple of 15.3x 2008E-09E average EPS. Our target multiple is at 15% discount to global peers. San Miguel Brewery offers dominant leadership in the local market, higher ROE and dividend yield; however, we think these are offset by a modestly lower EPS growth profile ('07-'10E EPS CAGR at 13% vs. global average at 16%) as well as overall Philippine country and equity market risks and share illiquidity risks. In addition, peers have a relatively greater scale of non-operational expenses, which makes their P/E appear higher.

We have opted to use P/E as our main methodology as it is the most commonly used valuation tool in the Philippines equity market, and the company does not have any substantial non-operating income.

### EV/EBITDA Analysis

We believe a useful methodology to value beer breweries on a global basis is EV/EBITDA since many global peers have sizable affiliate income contributing to the bottom line and losses and gains via corporate restructuring. At our target price of P10.3, the shares would trade at a 2008E EV/EBITDA of 9.5x and 2009E EV/EBITDA of 9.3x, broadly in line with global major beer peers' average. We think this is reasonable, as San Miguel's relative weaknesses such as concentration in just one geographic market, risks of investing in the Philippine equity market, and the stock's poor liquidity are offset by superior ROE generation, higher yield with similar EBITDA growth prospects (EBITDA CAGR ('07-'10E of 9.0%), and brand strength.

### DCF Analysis

Our DCF analysis supports our target price of P10.3. We assume a fair WACC of 10.8% with 6% risk-free rate, equity risk premium of 8% (higher than what we could give for other stocks at an average of 6% given this stock's poorer liquidity), beta at 0.6x, terminal multiple at 13x on a five-year DCF model. We generally do not use DCF as our most favored valuation methodology in the sector given the number of inputs to be assumed on a subjective bias. There is no magic rule for selecting the terminal multiple to get the value of the company's free cash flows beyond year 5 of our DCF model; however, given our terminal value portion takes 66% of our total DCF value, we would not see 13x terminal value multiple as too aggressive to make our DCF value as distorted yardstick to value the stock.

### EV/hl (Hector Liter) Analysis

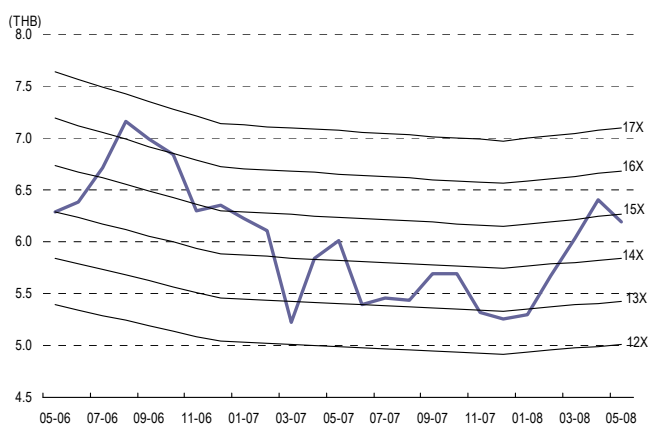
One valuation tool for beer businesses from an operational value creation perspective is EV/hector liter, which is EV divided by total production volume of the year. The stock is currently trading at EV/hl at US\$229 while generating EBITDA/hl at US\$25 in 2007, which is at a 17% discount to its global peers' average (ex China) on 29% lower EBITDA generating power.

Figure 20. EV & EBITDA/mhl

| Mil USD, mhl<br>Yr of Volume | Company                  | Volume | 2007<br>EV | 2007<br>EBITDA | 2007<br>EV/hi | 2007<br>EBITDA/hi |
|------------------------------|--------------------------|--------|------------|----------------|---------------|-------------------|
| 2007                         | Hite Brewery             | 10.7   | 2,159      | 323            | 202           | 30                |
| 2007                         | Tsingtao Brewery*        | 51.4   | 3,573      | 222            | 70            | 4                 |
| 2007                         | Heineken NV              | 111.9  | 29,326     | 3,710          | 262           | 33                |
| 2007                         | Foster's Group Ltd       | 10.3   | 11,779     | 1,069          | NA            | NA                |
| 2007                         | Asahi Breweries Ltd      | 23.8   | 8,987      | 1,124          | 377           | 47                |
| 2007                         | Kirin Breweries Ltd      | 23.4   | 8,825      | 1,717          | 378           | 73                |
| 2007                         | Molson Coors Brewing*    | 49.3   | 12,214     | 1,098          | 248           | 22                |
| 2007                         | SABMiller                | 216.0  | 42,064     | 4,459          | 195           | 21                |
| 2007                         | Ambev                    | 142.9  | 45,088     | 4,461          | 315           | 31                |
| 2007                         | Beijing Yanjing Brewery* | 39.8   | 2,666      | 147            | 67            | 4                 |
| 2007                         | San Miguel Brewery       | 12.9   | 2,943      | 324            | 229           | 25                |
| Average                      |                          |        |            |                | 234           | 29                |
| Average-ex<br>China          |                          |        |            |                | 276           | 35                |

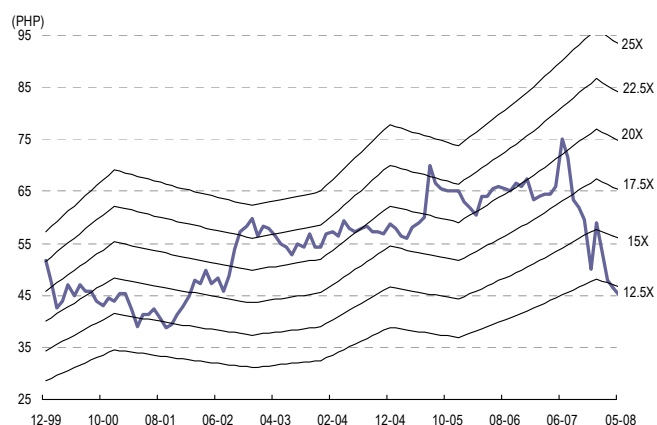
Source: Citi Investment Research estimates

Figure 21. Thai Beverage Trailing PE Band



Source: Citi Investment Research

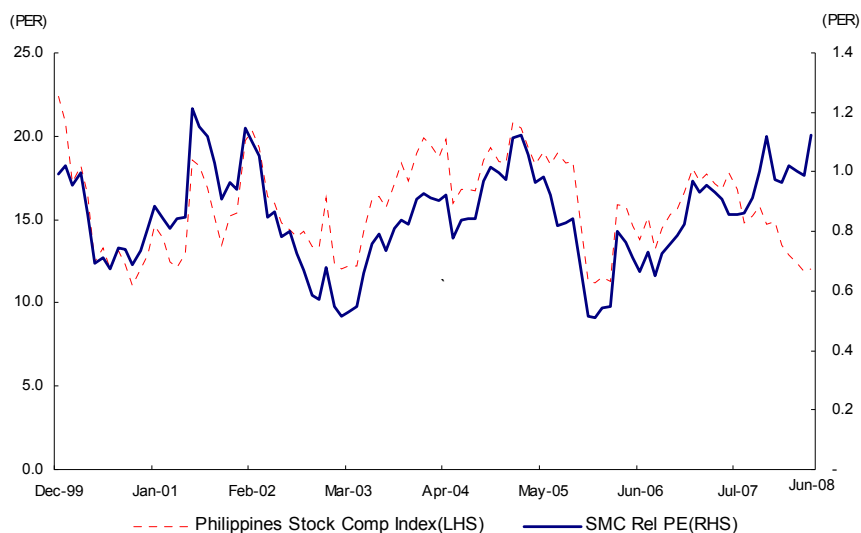
Figure 22. SMC Trailing PE Band



Source: Citi Investment Research



Figure 23. Philippines Stock Comp Index vs. SMC PE - Trailing Basis



Source: Citi Investment Research, Datastream

Appendix-Figure 24. Beer Brewers – Global Comparisons

| Company                        | Description                              | RIC         | Rating | Ccy | Price   | Mkt Cap | P/E         |             | EV/EBITDA  |            | P/B        |            | Yield       | EPS CAGR     | EBITDA CAGR | ROE        |            |
|--------------------------------|--|-------------|--------|-----|---------|---------|-------------|-------------|------------|------------|------------|------------|-------------|--------------|-------------|------------|------------|
|                                |  |             |        |     |         |         | 08          | 09          | 08         | 09         | 08         | 09         |             |              |             | 08         | 09         |
| <b>Beer</b>                    |  |             |        |     |         |         |             |             |            |            |            |            |             |              |             |            |            |
| Foster's Group Ltd             | Beer 46%, Wine 54%                       | FGL.AX      | 1M     | AUD | 5       | 9,771   | 14.5        | 13.5        | 9.9        | 9.3        | 2.3        | 2.2        | 4.9%        | 5.7%         | 4.6%        | 16%        | 17%        |
| Lion Nathan Ltd                | Beer 91.8%, Wine & spirits 8.1% etc      | LNN.AX      | 2L     | AUD | 9       | 4,610   | 17.9        | 16.0        | 10.5       | 9.7        | 6.6        | 5.9        | 4.6%        | 6.7%         | 8.7%        | 36%        | 39%        |
| Beijing Yanjing Brewery*       | Beer 97%, Spring Water 1%, Tea Bev 2%    | 000729.SZ   | NA     | CNY | 14      | 2,302   | 29.9        | 23.7        | 18.7       | 16.0       | 2.2        | 2.2        | 1.2%        | 28.2%        | NA          | 8%         | 11%        |
| Carlsberg AS B                 | Beer 100.0%                              | CARLB.CO    | 2M     | DKK | 500     | 4,415   | 16.5        | 13.7        | 7.1        | 6.3        | 2.2        | 1.9        | 1.1%        | 15.9%        | 8.9%        | 14%        | 15%        |
| Royal UNIBREW A/S*             | Beer 100.0%                              | RBREW.CO    | NA     | DKK | 550     | 673     | 14.8        | 11.4        | 8.9        | 7.7        | 2.5        | 2.1        | 1.8%        | 37.0%        | 32.9%       | 17%        | 20%        |
| Heineken NV                    | Beer 100%                                | HEIN.AS     | 1L     | EUR | 35      | 26,532  | 12.8        | 11.7        | 6.2        | 5.6        | 2.5        | 2.2        | 2.4%        | 12.1%        | 8.3%        | 20%        | 20%        |
| SABMiller                      | Brewery 79%, Other beverages 21%         | SAB.L       | 2M     | GBP | 12      | 35,339  | 15.7        | 13.8        | 9.3        | 8.9        | 2.0        | 1.9        | 2.6%        | 12.1%        | 3.0%        | 13%        | 14%        |
| Kingway Brewery Holdings*      | Sales of beer 100.0%                     | 0124.HK     | NA     | HKD | 1       | 227     | NA          | 41.6        | 8.5        | 6.4        | 0.6        | 0.6        | 0.2%        | NA           | NA          | 0%         | 2%         |
| Tsingtao Brewery*              | Beer 100%                                | 0168.HK     | NA     | HKD | 19      | 1,585   | 27.3        | 21.4        | 16.1       | 13.2       | 3.8        | 3.4        | 2.3%        | 38.0%        | 16.3%       | 14%        | 16%        |
| Asahi Breweries Ltd            | Beer 70%, Whiskey/Brandy/etc 11% Others  | 2502.T      | 1M     | JPY | 1,975   | 8,623   | 17.9        | 15.7        | 6.1        | 5.5        | 1.7        | 1.5        | 1.1%        | 15.2%        | 8.1%        | 10%        | 10%        |
| Kirin Holdings Co. Ltd         | Beer 63.8%, Soft drinks 23.6% Others     | 2503.T      | 3L     | JPY | 1,692   | 14,928  | 28.5        | 25.0        | 4.2        | 3.6        | 1.5        | 1.4        | 1.4%        | -1.5%        | 4.4%        | 5%         | 6%         |
| Sapporo Holdings Ltd*          | beer 75.0%,beverages 13.5% etc           | 2501.T      | NA     | JPY | 764     | 2,769   | 23.8        | 56.4        | 13.6       | 13.3       | 2.3        | 2.2        | 0.9%        | -2.0%        | 3.0%        | 9%         | 5%         |
| Hite Brewery                   | Beer 100%                                | 000140.KS   | 1M     | KRW | 113,500 | 2,306   | 14.2        | 12.9        | 7.0        | 6.3        | 1.7        | 1.5        | 1.1%        | 16.6%        | 5.8%        | 13%        | 12%        |
| Grupo Modelo S.A.B. de C.V     | Beer 100.0%                              | GMODELOC.MX | 3L     | MXN | 52      | 3,290   | 18.9        | 17.0        | 7.6        | 7.1        | 2.7        | 2.6        | 3.9%        | 5.1%         | 4.4%        | 15%        | 16%        |
| Guinness Anchor Bhd*           | BEER 100.0%                              | GUMS.KL     | NA     | MYR | 5       | 489     | 12.6        | 12.2        | 8.7        | 8.3        | 3.9        | 3.7        | 8.4%        | 4.8%         | 2.9%        | 29%        | 29%        |
| Asia Pacific Breweries Ltd*    | BREWERIES 99.8%,OTHERS 0.2%              | APBB.SI     | NA     | SGD | 13      | 2,465   | 21.7        | NA          | NA         | NA         | NA         | NA         | 2.2%        | NA           | NA          | NA         | NA         |
| Thai Beverage                  | Beers & Spirits 100.0%                   | TBEV.SI     | 3L     | SGD | 0.25    | 4,575   | 12.2        | 12.0        | 7.2        | 7.0        | 2.3        | 2.1        | 4.1%        | 8.1%         | 4.1%        | 20%        | 18%        |
| Anadolu Efes Biracilik ve Malt | Beer brewing 91.8%,Soft drinks 8.2%      | AEFES.IS    | 1M     | TRY | 11.90   | 4,299   | 13.5        | 9.5         | 7.7        | 6.1        | 2.6        | 2.3        | 2.1%        | 22.9%        | 18.4%       | 20%        | 26%        |
| Ambev                          | Beer/ Soft Drinks 100%                   | ABV         | 1M     | USD | 68      | 19,851  | 23.6        | 20.2        | 8.7        | 7.8        | 4.1        | 4.2        | 3.1%        | 20.3%        | 12.7%       | 18%        | 21%        |
| Baltika Brewery*               | Beer 100.0%                              | PKBA.RTS    | NA     | USD | 44      | 6,600   | 12.6        | 9.7         | 6.5        | 5.9        | 3.3        | 3.1        | 5.0%        | 13.6%        | -3.6%       | 33%        | 38%        |
| Boston Beer Co.*               | Beer 100.0%                              | SAM.N       | NA     | USD | 40      | 560     | 22.2        | 18.9        | 9.2        | 7.6        | 3.6        | 3.0        | 0.0%        | 6.8%         | NA          | 16%        | 18%        |
| Fomento de Construcciones y    | Beer 30.0%,Soft drinks 40.1%,Other 29.9% | FMX.N       | 1M     | USD | 44      | 37,976  | 18.3        | 16.2        | 7.4        | 6.8        | 2.4        | 2.1        | 1.4%        | 15.3%        | 11.1%       | 14%        | 14%        |
| Molson Coors Brewing*          | Malt beverages 100%                      | TAP         | NA     | USD | 55      | 8,412   | 15.7        | 14.5        | 9.7        | 8.9        | 1.1        | 1.1        | 1.4%        | 16.1%        | 7.6%        | 9%         | 8%         |
| <b>Average</b>                 |  |             |        |     |         |         | <b>18.2</b> | <b>18.2</b> | <b>9.0</b> | <b>8.1</b> | <b>3.1</b> | <b>3.0</b> | <b>2.5%</b> | <b>14.3%</b> | <b>8.4%</b> | <b>18%</b> | <b>20%</b> |

Source: Citi Investment Research estimates. \*Based on IBES Consensus data \*\*Calendar Year

Figure 25. Global Beer Operational Comps

|                                      |           | CY_2004 | CY_2005 | CY_2006 | CY_2007 |
|--------------------------------------|-----------|---------|---------|---------|---------|
| <b>Hite Brewery (KRW) in Bil</b>     | 000140.KS |         |         |         |         |
| Net sales                            |           | 861     | 853     | 893     | 963     |
| Gross profit                         |           | 436     | 430     | 475     | 527     |
| OP                                   |           | 175     | 134     | 202     | 231     |
| GPM                                  |           | 51%     | 50%     | 53%     | 55%     |
| OPM                                  |           | 20%     | 16%     | 23%     | 24%     |
| <b>Tsingtao Brewery* (HKD)</b>       | 168 HK    |         |         |         |         |
| Net sales                            |           | 8       | 10      | 12      | 14      |
| Gross profit                         |           | 2       | 3       | 4       | 4       |
| OP                                   |           | 0.5     | 0.6     | 0.7     | 1.0     |
| GPM                                  |           | 31%     | 30%     | 31%     | 32%     |
| OPM                                  |           | 7%      | 6%      | 6%      | 8%      |
| <b>Heineken NV (EUR)</b>             | HEIN.AS   |         |         |         |         |
| Net sales                            |           | 10      | 11      | 12      | 13      |
| Gross profit                         |           | 4       | 4       | 5       | 5       |
| OP                                   |           | 1       | 1       | 2       | 2       |
| GPM                                  |           | 39%     | 38%     | 39%     | 39%     |
| OPM                                  |           | 13%     | 13%     | 13%     | 15%     |
| <b>Foster's Group Ltd*(AUD)</b>      | FGL.AX    |         |         |         |         |
| Net sales                            |           | 4       | 4       | 5       | 14      |
| Gross profit                         |           | 2       | 2       | 3       | 6       |
| OP                                   |           | 0.5     | 0.6     | 0.7     | 1.0     |
| GPM                                  |           | 44%     | 50%     | 70%     | 44%     |
| OPM                                  |           | 14%     | 13%     | 14%     | 8%      |
| <b>Asahi Breweries Ltd (JPY)</b>     | 2502.T    |         |         |         |         |
| Net sales                            |           | 1,444   | 1,430   | 1,446   | 1,464   |
| Gross profit                         |           | 466     | 476     | 496     | 503     |
| OP                                   |           | 101     | 90      | 89      | 87      |
| GPM                                  |           | 32%     | 33%     | 34%     | 34%     |
| OPM                                  |           | 7%      | 6%      | 6%      | 6%      |
| <b>Molson Coors Brewing*(USD)</b>    | TAP US    |         |         |         |         |
| Net sales                            |           | 4,306   | 5,507   | 5,845   | 6,191   |
| Gross profit                         |           | 1,564   | 2,200   | 2,364   | 2,488   |
| OP                                   |           | 348     | 422     | 581     | 641     |
| GPM                                  |           | 36%     | 40%     | 40%     | 40%     |
| OPM                                  |           | 8%      | 8%      | 10%     | 10%     |
| <b>SABMiller(GBP)</b>                | SAB.L     |         |         |         |         |
| Net sales                            |           | 13      | 15      | 18      | 21      |
| Gross profit                         |           | 9       | 11      | 13      | 15      |
| OP                                   |           | 2       | 2       | 3       | 3       |
| GPM                                  |           | 70%     | 72%     | 73%     | 73%     |
| OPM                                  |           | 15%     | 17%     | 17%     | 16%     |
| <b>Ambev (USD)</b>                   | ABV       |         |         |         |         |
| Net sales                            |           | 4       | 7       | 8       | 10      |
| Gross profit                         |           | 2       | 4       | 5       | 7       |
| OP                                   |           | 1       | 2       | 3       | 4       |
| GPM                                  |           | 60%     | 64%     | 66%     | 67%     |
| OPM                                  |           | 30%     | 32%     | 35%     | 37%     |
| <b>Beijing Yanjing Brewery*(CNY)</b> | 000729 CH |         |         |         |         |
| Net sales                            |           | 4       | 5       | 5       | 7       |
| Gross profit                         |           | 1       | 1       | 2       | 2       |
| OP                                   |           | 0.4     | 0.4     | 0.5     | 0.6     |
| GPM                                  |           | 30%     | 29%     | 29%     | 29%     |
| OPM                                  |           | 10%     | 9%      | 9%      | 9%      |
| <b>Thai Beverage (SGD)</b>           | TBEV.SI   |         |         |         |         |
| Net sales                            |           | 90      | 92      | 98      | 98      |
| Gross profit                         |           | 31      | 33      | 33      | 35      |
| OP                                   |           | 16      | 17      | 16      | 16      |
| GPM                                  |           | 34%     | 36%     | 34%     | 36%     |
| OPM                                  |           | 18%     | 18%     | 16%     | 16%     |

Source: Citi Investment Research estimates. \*Based on IBES Consensus data \*\*Calendar Year

Appendix-Figure 26. Non Beer Beverage – Global Comparison

| Company                      | Description                                   | RIC Rating | Ccy | Price | Mkt Cap | P/E     |      | EV/EBITDA |      | P/B  |      | Yield | EPS CAGR | EBITDA CAGR | ROE    |     |       |
|------------------------------|---|------------|-----|-------|---------|---------|------|-----------|------|------|------|-------|----------|-------------|--------|-----|-------|
|                              |   |            |     |       |         | 17-Jun  | 08   | 08        | 09   | 08   | 09   |       |          |             | 08     | 09  | 07-09 |
| <b>Soft Drinks</b>           |   |            |     |       |         |         |      |           |      |      |      |       |          |             |        |     |       |
| Coca-Cola Amatil Ltd         | Beverages 100%                                | CCLAX      | 1M  | AUD   | 7       | 4,971   | 13.0 | 11.4      | 8.0  | 7.3  | 3.7  | 3.1   | 5.7%     | 12.7%       | 8.7%   | 28% | 29%   |
| C&C Group                    | Cider 34% , Soft drinks and snacks 29%, etc   | GCC.I      | 2M  | EUR   | 5       | 2,371   | 14.4 | 13.7      | 11.8 | 11.6 | 4.1  | 4.1   | 5.5%     | 3.0%        | 0.5%   | 32% | 29%   |
| Cadbury Schweppes            | Beverages/Confections 100%                    | CBRY.L     | 2M  | GBP   | 6       | 17,074  | 20.7 | 17.8      | 13.3 | 10.8 | 1.4  | 1.3   | 2.5%     | -13.4%      | -17.3% | 6%  | 7%    |
| GSK Consumer*                | White and Brown beverage                      | GLSM.BO    | NA  | INR   | 735     | 721     | 18.4 | 15.8      | 14.3 | 13.1 | 4.7  | 4.0   | 1.9%     | NA          | NA     | 32% | 32%   |
| Tata Tea                     | Tea/Packet Tea 93.2%, Other 6.8%              | TTTE.BO    | 1L  | INR   | 798     | 1,150   | 10.5 | 9.2       | 4.3  | 3.5  | 1.2  | 1.1   | 2.8%     | 24.3%       | 6.1%   | 21% | 12%   |
| Coca-Cola Company*           | Soft Drinks 100%                              | KO         | NA  | USD   | 54      | 125,339 | 17.6 | 16.0      | 14.3 | 13.1 | 5.3  | 4.9   | 2.7%     | 11.7%       | 11.9%  | 32% | 32%   |
| Coca-Cola Enterprises Inc*   | Soft drink bottling 100%                      | CCE        | NA  | USD   | 18      | 8,879   | 12.9 | 11.7      | 7.6  | 7.3  | 1.4  | 1.3   | 1.6%     | 5.9%        | 2.8%   | 12% | 12%   |
| Coca-Cola Femsa SA de CV     | Soft drink 100%                               | KOF        | 2M  | USD   | 57      | 1,533   | 13.9 | 11.3      | 7.4  | 6.4  | 1.9  | 1.7   | 0.8%     | 21.0%       | 14.2%  | 15% | 16%   |
| Embotelladora Andina S.A.    | Soft drink bottler 100%                       | AKOa.N     | 3M  | USD   | 16      | 6,082   | 9.0  | 7.8       | 7.3  | 6.7  | 3.0  | 2.7   | 7.3%     | 22.6%       | 0.2%   | 40% | 36%   |
| PepsiAmericas Inc*           | Beverages 100%                                | PAS        | NA  | USD   | 22      | 2,799   | 12.0 | 10.9      | 8.1  | 7.5  | 1.4  | 1.4   | 2.5%     | 10.3%       | 7.9%   | 12% | 13%   |
| PepsiCo*                     | Pepsico beverages 64%, Frito Lay N.A. 31% etc | PEP        | NA  | USD   | 66      | 104,476 | 17.7 | 15.9      | 11.7 | 10.7 | 6.1  | 5.8   | 2.5%     | 10.5%       | 9.4%   | 35% | 38%   |
| The Pepsi Bottling Group*    | bottled soft drinks 100%                      | PBG        | NA  | USD   | 29      | 6,271   | 12.2 | 11.2      | 7.1  | 6.7  | 2.4  | 2.3   | 2.0%     | 8.2%        | 3.4%   | 20% | 21%   |
| Average                      |   |            |     |       |         |         | 14.3 | 12.7      | 9.6  | 8.7  | 3.1  | 2.8   | 3.2%     | 10.6%       | 4.4%   | 24% | 23%   |
| <b>Dairy Products</b>        |   |            |     |       |         |         |      |           |      |      |      |       |          |             |        |     |       |
| Mengniu Dairy                | Liquid Milk 85%, Ice Cream 11%, Others        | 2319.HK    | 1L  | HKD   | 23      | 4,200   | 24.8 | 17.9      | 12.7 | 9.3  | 4.8  | 3.9   | 0.9%     | 35.0%       | 32.2%  | 21% | 24%   |
| Binggrae                     | Dairy products 56%, Ice Cream/ Others 44%     | 005180.KS  | NA  | KRW   | 35,700  | 337     | 7.7  | NA        | 4.5  | 4.3  | NA   | NA    | 3.2%     | NA          | NA     | 16% | NA    |
| Average                      |   |            |     |       |         |         | 16.3 | 17.9      | 8.6  | 6.8  | 4.8  | 3.9   | 2.0%     | 35.0%       | 32.2%  | 18% | 24%   |
| <b>Wine &amp; Spirits</b>    |   |            |     |       |         |         |      |           |      |      |      |       |          |             |        |     |       |
| Kweichow Moutai*             | Spirits- Maotai 96%, Spirits- Others 4%       | 600519.SS  | NA  | CNY   | 142     | 19,443  | 33.6 | 25.2      | 26.3 | 19.7 | 12.0 | 8.9   | 0.9%     | 36.9%       | NA     | 38% | 37%   |
| Luzhou Laojiao*              | Spirits 98%, Real Estate 1%, Others 1%        | 000568.SZ  | NA  | CNY   | 29      | 5,782   | 27.7 | 20.0      | 28.6 | 20.0 | 11.3 | 8.5   | 2.4%     | 60.5%       | NA     | 46% | 48%   |
| Shanxi Fenjiu*               | White Spirits 100%                            | 600809.SS  | NA  | CNY   | 13      | 809     | 14.3 | 11.6      | 9.3  | 7.6  | 3.6  | 3.0   | 4.1%     | 15.6%       | NA     | 34% | 35%   |
| Wuliangye Yibin*             | Liquors 99%                                   | 000858.SZ  | NA  | CNY   | 17      | 9,199   | 30.0 | 22.5      | 28.7 | 22.6 | 5.4  | 4.5   | 0.0%     | 38.6%       | NA     | 20% | 23%   |
| Yantai Changyu Pioneer Wine* | Wines 74%, Brandy 20%, Tonic Wines 4%, etc    | 000869.SZ  | NA  | CNY   | 71      | 3,594   | 40.2 | 30.7      | 27.4 | 21.0 | 14.0 | 10.7  | 1.8%     | 38.1%       | 24.1%  | 33% | 33%   |
| Davide Campari               | Spirits 70%, Wines 14%, Soft Drinks 14%       | CPRI.MI    | 1M  | EUR   | 6       | 2,583   | 13.0 | 12.1      | 8.8  | 8.0  | 1.7  | 1.5   | 1.9%     | 5.2%        | 3.1%   | 14% | 13%   |
| Pernod-Ricard SA             | Wines Brandy Spirits 100%                     | PERP.PA    | 2L  | EUR   | 69      | 23,464  | 15.6 | 13.7      | 12.9 | 12.2 | 2.0  | 1.8   | 2.0%     | 11.1%       | 15.2%  | 14% | 14%   |
| Diageo PLC                   | Premium Drinks 100%                           | DGE.L      | 2L  | GBP   | 10      | 47,847  | 15.1 | 13.6      | 11.0 | 10.3 | 6.5  | 6.2   | 3.7%     | 11.4%       | 8.9%   | 42% | 46%   |
| United Spirits               | Alcohols/Spirits 100.0%                       | UNSP.BO    | 1L  | INR   | 1,322   | 3,087   | 26.0 | 19.8      | 15.6 | 13.6 | 6.7  | 5.2   | 0.5%     | 36.0%       | 26.9%  | 26% | 28%   |
| Constellation Brands*        | Wines 74%, Beer 20%, Spirits 6%               | STZ        | NA  | USD   | 20      | 3,830   | 11.9 | 10.7      | 10.5 | 9.2  | 1.4  | 1.2   | NA       | 12.1%       | NA     | 12% | 12%   |
| Average                      |   |            |     |       |         |         | 22.7 | 18.0      | 17.9 | 14.4 | 6.4  | 5.2   | 1.9%     | 26.5%       | 15.6%  | 28% | 29%   |
| Total Average                |   |            |     |       |         |         | 17.8 | 16.2      | 12.0 | 10.0 | 4.8  | 3.9   | 2.4%     | 24.0%       | 17.4%  | 23% | 25%   |

Source: Citi Investment Research estimates. \*Based on IBES Consensus data \*\*Calendar Year

## Risks

We assign a Medium Risk rating to the stock, though its short trading history would normally betoken a Speculative rating based on our quantitative risk rating system. However, we believe a Medium Risk is more appropriate given that we expect the stock to trade broadly within the range of its parent company San Miguel Corp and also given the nature of its businesses – a simple beer manufacturer & distributor with a highly predictable earnings stream. The following risk factors could prevent the shares from reaching our target price.

### Illiquidity

The stock has only a short trading history, and the shares available for public trading are limited to only 5% of total outstanding post its IPO. Thus the stock should remain highly illiquid, potentially leading to greater volatility. Plus, recent equity investors' preference lies in more established markets and large-cap stocks, while they have generally been avoiding small countries and small caps, therefore, despite robust fundamentals, the stock could remain out of favor for a while.

### ROE deterioration possible

We forecast the company's ROE could still go up, albeit from a high base, to 59% in 2010E vs. 52% in 2007. However, ROE could deteriorate in the case of any inefficiency in capital allocation, e.g. misguided re-investment or lower dividends.

### Limited pricing power

Local consumers' price sensitivity in the beverage market appears higher vs. other regions in Asia despite SMB's dominant market share. Any abrupt surge in commodity prices or tax hikes to a level that the company could not transfer easily onto product prices could erode overall margins. In order to improve product mix, the company could continue to attempt to launch new products, which could carry cannibalization risks.

### Adverse weather factors

100% of earnings derive from beer, where demand is exposed to the vagaries of the weather. This could have a sizable impact on earnings both on the downside and the upside. Beer sales typically decline in rainy weather, forming a weak seasonality in 3Q, which is the slowest period for sales.

### Country and macro risks

The Philippines faces some country and stock market risks (including a high correlation with US market movements). Also, key events that could adversely affect the company's earnings include macro events such as outbreaks of disease such as avian influenza.

### Management

Management of parent company San Miguel Corp. has made a couple of capital allocation mistakes in its acquisition history, in our view. Moody's and S&P issued warnings of downgrading ratings for SMC in 2007 due to rising risks related to new business areas.

### **Labor union strikes**

The parent company has cut the total number of employees from 35,694 in 1990 to 19,200 currently as part of a massive retrenchment program displacing workers due to closures and mergers apart from downsizing and rationalization. Any similar action taken by San Miguel Brewery could raise similar concerns about labor strikes.

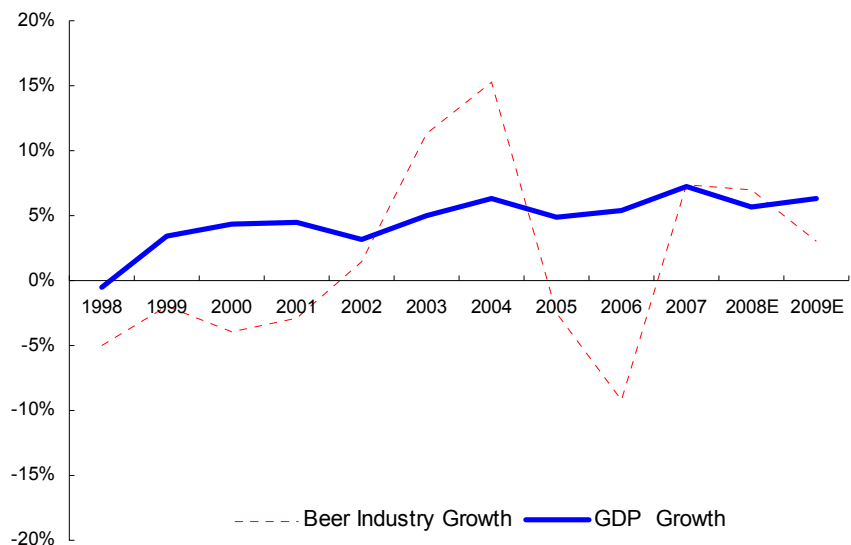
# Industry Outlook

## Volume Growth Fairly Cyclical

The Philippine beer industry is mature with sales volume growth CAGR (2001-2007) at 3.9%. Volume growth in the future is cyclically highly correlated to real GDP growth which our economist forecasts to be at 5-6% in 2008E-2009E. Volume growth has been historically affected by retail pricing moved by raw material costs and tax hikes.

However, longer-term volume growth should show a resilience as beer becomes more like necessity rather than a discretionary good in the local market. Per capita consumption of beer in Philippine stands at 15 liters per person with urban areas at 39 liters per person (taking 35% of total population) and rural areas at 10 liters per person based on press reports (Reuters). Urbanization (with populace moving from rural to urban locations, as well as increased urbanization of formerly small rural communities) could be a key factor driving market volume growth to exceed GDP growth. Overall per capita consumption of beer is not yet declining, but growth is slowing. We assume 3% industry volume growth from 2009E post relatively buoyant growth at 7% in 2008E, with excise taxes taking effect in 2009E and 2011E and causing moderate consumers likely to show near-term resistance on price hikes although it could recover longer term.

Figure 27. Beer Industry vs. GDP Growth (YoY)



Source: Cannadean, Citi Investment Research

## Share Gains Over Other Alcohol Options Not Easy

The company aims to increase the share of beer in the alcoholic beverage market by focusing on specific regions and localities in which hard liquor sales are higher. The company believes its high-alcohol beer (6.8% vs. regular at 5%) Red Horse could take meaningful share from other hard liquor options. However, we remain relatively more cautious on this front given consumers' reason for picking cheaper hard liquor is frequently to feel the effect more quickly, which is not as easy with hard-alcohol beer (with still relatively low alcohol contents on an absolute scale). And major beer reviews on the Internet suggest regional consumers' preference on the taste of hard alcohol beer is poorer vs. its major premium brands. If there are not many cheaper hard liquor options available in the market vs. other countries, we would carry higher conviction in believing the share of high-alcohol beer to take more share in the alcoholic beverage industry; however, we find proliferation of modernized retailing formats carry ample alternatives in hard liquors.

Figure 28. Sales of Beer by Sub-Sector: Total Value

| Ps million              | 2001   |      | 2002   |      | 2003   |      | 2004   |      | 2005   |      | 2006    |      | 2007    |      | 2008E   |      | 2009E   |      | 2010E   |      | 2011E   |      |
|-------------------------|--------|------|--------|------|--------|------|--------|------|--------|------|---------|------|---------|------|---------|------|---------|------|---------|------|---------|------|
| <b>Lager</b>            | 59,125 | 97%  | 63,284 | 97%  | 71,237 | 97%  | 80,530 | 97%  | 91,269 | 97%  | 103,764 | 98%  | 111,942 | 98%  | 119,948 | 98%  | 128,007 | 98%  | 136,061 | 98%  | 143,598 | 98%  |
| ---- Premium lager      | 5,214  | 9%   | 5,557  | 9%   | 5,991  | 8%   | 6,508  | 8%   | 7,113  | 8%   | 7,798   | 7%   | 8,099   | 7%   | 8,432   | 7%   | 8,790   | 7%   | 9,185   | 7%   | 9,612   | 7%   |
| ---- Standard lager     | 52,262 | 86%  | 56,012 | 86%  | 63,297 | 86%  | 71,893 | 87%  | 81,861 | 87%  | 93,510  | 88%  | 101,347 | 88%  | 108,990 | 89%  | 116,669 | 89%  | 124,310 | 90%  | 131,400 | 90%  |
| ---- Economy lager      | 1,649  | 3%   | 1,715  | 3%   | 1,949  | 3%   | 2,129  | 3%   | 2,295  | 2%   | 2,455   | 2%   | 2,496   | 2%   | 2,527   | 2%   | 2,549   | 2%   | 2,566   | 2%   | 2,586   | 2%   |
| <b>Dark beer</b>        | 1,754  | 3%   | 1,846  | 3%   | 2,014  | 3%   | 2,166  | 3%   | 2,339  | 2%   | 2,512   | 2%   | 2,561   | 2%   | 2,617   | 2%   | 2,685   | 2%   | 2,762   | 2%   | 2,850   | 2%   |
| ---- Domestic dark beer | 1,754  | 3%   | 1,846  | 3%   | 2,014  | 3%   | 2,166  | 3%   | 2,339  | 2%   | 2,512   | 2%   | 2,561   | 2%   | 2,617   | 2%   | 2,685   | 2%   | 2,762   | 2%   | 2,850   | 2%   |
| ---- Stout              | 30     | 0%   | 31     | 0%   | 33     | 0%   | 35     | 0%   | 37     | 0%   | 39      | 0%   | 39      | 0%   | 38      | 0%   | 38      | 0%   | 39      | 0%   | 39      | 0%   |
| <b>Beer Total</b>       | 60,908 | 100% | 65,161 | 100% | 73,284 | 100% | 82,730 | 100% | 93,645 | 100% | 106,315 | 100% | 114,541 | 100% | 122,603 | 100% | 130,730 | 100% | 138,861 | 100% | 146,487 | 100% |

Source: Euro monitor

Figure 29. Sales of Beer by Sub-Sector: YoY Volume Growth

| million litres          | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008E | 2009E | 2010E | 2011E |
|-------------------------|------|------|------|------|------|------|-------|-------|-------|-------|
| <b>Lager</b>            | 3%   | 6%   | 7%   | 6%   | 6%   | 5%   | 5%    | 5%    | 4%    | 4%    |
| ---- Premium lager      | 2%   | 4%   | 4%   | 4%   | 3%   | 3%   | 3%    | 2%    | 3%    | 3%    |
| ---- Standard lager     | 4%   | 6%   | 7%   | 7%   | 6%   | 6%   | 5%    | 5%    | 5%    | 4%    |
| ---- Economy lager      | 2%   | 3%   | 2%   | 2%   | 1%   | 1%   | 0%    | 0%    | 0%    | 0%    |
| <b>Dark beer</b>        | 2%   | 4%   | 5%   | 4%   | 3%   | 3%   | 2%    | 2%    | 2%    | 2%    |
| ---- Domestic dark beer | 2%   | 4%   | 5%   | 4%   | 3%   | 3%   | 2%    | 2%    | 2%    | 2%    |
| ---- Stout              | 0%   | 100% | 0%   | 0%   | 0%   | 0%   | 0%    | 0%    | 0%    | 0%    |
| <b>Beer Total</b>       | 3%   | 6%   | 7%   | 6%   | 6%   | 5%   | 5%    | 5%    | 4%    | 4%    |

Source: Euro monitor

**Figure 30. Brand Shares of Beer 2002-2005**

| <b>% total volume</b>                    | <b>Company</b>   | <b>2002</b> | <b>2003</b> | <b>2004</b> | <b>2005</b> |
|--|------------------|-------------|-------------|-------------|-------------|
| San Miguel Pale Pilsen                   | San Miguel Corp  | 61.5        | 59.5        | 58.2        | 56.1        |
| Red Horse Beer                           | San Miguel Corp  | 15.2        | 15.6        | 15.7        | 16.7        |
| San Miguel Light                         | San Miguel Corp  | 5.8         | 6.8         | 7.9         | 9.3         |
| Beer na Beer                             | Asia Brewery Inc | 4.8         | 5.1         | 5.2         | 4.9         |
| Colt 45 Malt Liquor (SABMiller Plc)      | Asia Brewery Inc | 2.1         | 2.2         | 2.5         | 2.7         |
| Gold Eagle                               | San Miguel Corp  | 2.9         | 2.8         | 2.6         | 2.5         |
| San Miguel Super Dry                     | San Miguel Corp  | 1.6         | 1.8         | 2           | 2.2         |
| Cerveza Negra                            | San Miguel Corp  | 1.7         | 1.7         | 1.7         | 1.6         |
| Blue Ice                                 | San Miguel Corp  | 1.3         | 1.5         | 1.6         | 1.4         |
| Stag                                     | Asia Brewery Inc | 0.3         | 0.5         | 0.6         | 0.5         |
| Lone Star (SABMiller Plc)                | Asia Brewery Inc | 0.4         | 0.5         | 0.6         | 0.5         |
| Lone Star Light (SABMiller Plc)          | Asia Brewery Inc | 0.1         | 0.1         | 0.1         | 0.2         |
| Miller Genuine Draft (SABMiller Plc)     | San Miguel Corp  | 0.4         | 0.3         | 0.3         | 0.2         |
| Carlsberg (Carlsberg A/S)                | Asia Brewery Inc | 0.3         | 0.3         | 0.2         | 0.2         |
| Budweiser                                | Asia Brewery Inc | 0.1         | -           | -           | -           |
| Colt 45 Malt Liquor (S & P Co)           | Asia Brewery Inc | -           | -           | -           | -           |
| Lone Star (Pabst Brewing Co)             | Asia Brewery Inc | -           | -           | -           | -           |
| Miller Genuine Draft (Miller Brewing Co) | San Miguel Corp  | -           | -           | -           | -           |
| Others                                   |                  | 1.4         | 1.2         | 0.9         | 1           |
| Total                                    |                  | 100         | 100         | 100         | 100         |

Source: Citi Investment Research, Euromonitor

## Room for ASP Growth Amid Bi-polarization in Demand

The ASP growth outlook is not so positive given pricing sensitivity of consumers in the market; however, product mix improvement should offer some room for hikes. Local consumers feel pressure from continued inflation, and accordingly shift toward products other than beer, in our view. We think this increases demand for value-for-money among price-sensitive consumers, and means some consumers may be more interested in products offering a higher alcohol content at the same price. In the meantime, there is a growing segment of high-end consumers who seek superior quality and sense of exclusiveness, which should continue to provide upside for the premium segment based on product innovations in packaging, taste, added value, e.g. low calorie.

In terms of industry profitability, we believe it could still improve based on the monopoly structure of San Miguel Brewery. MNCs have already been ousted from the market mainly due to lack of distribution base. A major local competitor, Asia Brewery, should remain positioned as a minor player

## Market Attractiveness from a Global M&A Context

We've borrowed insights from our European beer sector analyst, Phillip Morrissey, to gauge the Philippine market's attractiveness in a global M&A context. We believe San Miguel could be positioned with a partnership with Kirin Brewery as more of a consolidator rather than being consolidated; however, we do not see any big M&A angle on the company in the near future, although we could foresee a few possible though unlikely consolidation possibilities. The table below highlights global beer consolidation potentials and previous beer transaction multiples sourced from our European beer team.



Figure 31. Consolidation Possibilities in Global Beer

|    | SABMiller       | Heineken | Carlsberg | Mol. Coors |
|----|-----------------|----------|-----------|------------|
| 1  | SABMiller       | ○        |           | ●          |
| 2  | Heineken        | ○        |           | ○          |
| 3  | Carlsberg       |          |           |            |
| 4  | Molson Coors    | ●        | ○         |            |
| 5  | Modelo          |          |           |            |
| 6  | Tsingtao        |          |           |            |
| 7  | FEMSA           | ●        | ●         |            |
| 8  | Kirin           | ○        | ○         |            |
| 9  | Beijing Yanjing | ●        | ○         | ○          |
| 10 | Asahi           | ○        | ○         |            |
| 11 | Guinness        | ○        | ○         | ○          |
| 12 | San Miguel      | ○        | ○         | ○          |
| 13 | Anadolu Efes    | ●        | ●         | ○          |
| 14 | Jinxiang        | ○        | ○         | ○          |
| 15 | Radeberger      |          | ●         | ●          |
| 16 | Polar           | ●        | ●         |            |
| 17 | Castel          | ●        |           |            |
| 18 | Zhujiang        |          |           |            |
| 19 | Suntory         |          |           |            |
| 20 | Schincariol     | ●        | ○         |            |
| 21 | Chongqing       |          |           | ●          |
| 22 | Mahou           | ●        |           | ○          |
| 23 | Fosters         | ○        | ●         | ○          |
| 24 | Hite            | ○        | ○         |            |
| 25 | Thai Bev        | ●        | ●         | ●          |
| 26 | Sapporo         |          |           |            |
| 27 | Obolon          | ●        | ●         | ○          |
| 28 | Boon Rawd       | ●        | ●         | ●          |
| 29 | Pabst / S&P     | ○        |           | ○          |
| 30 | Bitburger       |          | ●         | ●          |
| 31 | Grupo Damm      | ○        |           | ●          |
| 32 | GBC Kingway     |          | ●         |            |
| 33 | Oettinger       |          | ●         | ●          |
| 34 | Cerv. Regional  | ○        | ○         |            |
| 35 | Warsteiner      |          | ●         | ●          |
| 36 | Krombacher      |          | ●         | ●          |
| 37 | Bavaria NV      |          |           | ○          |

Key:

|   |                       |
|---|-----------------------|
| ● | Possible              |
| ○ | Possible but Unlikely |
|   | Unlikely              |

Source: Citi Investment Research

Figure 32. Some Beer Transaction Multiples as of March 2008

| Date Announced | Acquiror                     | Target                                      | Stake Acquired | Implied Enterprise Value (US\$ m) | Enterprise Value / |              |               |               |
|----------------|------------------------------|---|----------------|-----------------------------------|--------------------|--------------|---------------|---------------|
|                |                              |   |                |                                   | Sales              | EBITDA       | EBITA         |               |
| 1-08           | Carlsberg / Heineken         | Scottish & Newcastle                        | 100.0          | \$ 21,225                         | 2.6 x              | 14.9 x       | 19.1 x        |               |
| 11-07          | SABMiller                    | Grolsch                                     | 100.0          | 1,333                             | 3.2                | 16.0         | 33.8          |               |
| 8-06           | Sapporo                      | Sleeman                                     | 100.0          | 345                               | 1.9                | 12.8         | 17.8          |               |
| 4-06           | AmBev                        | Quinsa (BAC Stake)                          | 34.5           | 3,893                             | 4.1                | 10.1         | 13.6          |               |
| 4-06           | Scottish & Newcastle         | Foster's (Europe & CIS)                     | 100.0          | 540                               | NM                 | 20.6         | 20.6          |               |
|                | Efes Breweries International | Krasny Vostok                               | 92.3           | 390                               | NA                 | NA           | NA            |               |
| 1-06           | Baltika                      | Yarpivo / Vena / Pikra Minorities           | NM             | 1,450                             | NA                 | NA           | NA            |               |
| 1-06           | FEMSA                        | Kaiser                                      | 68.0           | 418                               | 1.7                | NA           | NA            |               |
| 8-05           | Heineken                     | Ivan Taranov (PIT)                          | 100.0          | 420                               | 2.0                | 11.1         | NA            |               |
| 7-05           | SABMiller                    | Bavaria                                     | 71.8           | 7,804                             | 3.9                | 10.1         | 13.4          |               |
| 7-05           | Heineken                     | Stepan Razin                                | 100.0          | 120                               | 1.7                | NA           | NA            |               |
| 5-04           | FEMSA                        | FEMSA                                       | 30.0           | 4,411                             | 2.3                | 7.7          | 9.3           |               |
| 3-04           | AmBev                        | Labbatt, FEMSA Cerveza, Labbatt USA         | NM             | 7,300                             | 3.0                | 11.5         | 16.3          |               |
| 3-04           | Interbrew                    | AmBev                                       | 57.4           | 22,495                            | 3.8                | 12.7         | 17.4          |               |
| 2-04           | Dr. Oetker                   | Brau und Brunnen                            | 61.7           | 836                               | 1.1                | 6.1          | 19.8          |               |
| 1-04           | Carlsberg                    | Holsten                                     | 100.0          | 549                               | 1.0                | 9.1          | NM            |               |
| 12-03          | Radeberger                   | Hofbrau                                     | 50.0           | 147                               | NA                 | NA           | NA            |               |
| 9-03           | Interbrew                    | Spaten / Dincklacker                        | 100.0          | 537                               | 1.3                | 8.9          | NA            |               |
| 9-03           | Interbrew                    | Apatinska Pivara                            | 100.0          | 256                               | NA                 | 6.3          | 8.1           |               |
| 9-03           | Interbrew                    | Lion Diversified Holdings (China Beer Ops.) | 100.0          | 274                               | NA                 | 9.1          | NA            |               |
| 6-03           | SABMiller                    | Harbin Brewery Group                        | 29.6           | 390                               | 2.7                | 9.9          | 14.4          |               |
| 5-03           | SABMiller                    | Peroni                                      | 60.0           | 647                               | 1.1                | 12.6         | NA            |               |
| 5-03           | Scottish & Newcastle         | Central de Cervejas / Luso                  | NM             | 886                               | NA                 | 11.4         | NA            |               |
| 5-03           | Heineken                     | BBAG  | 100.0          | 2,131                             | 1.7                | 10.2         | 23.9          |               |
| 1-03           | BAC                          | Quilmes                                     | 15.0           | 1,046                             | 2.2                | 11.3         | NM            |               |
| 1-03           | Heineken                     | CCU (IRSA)                                  | 31.0           | 1,404                             | 2.9                | 12.6         | 26.8          |               |
| 12-02          | Bavaria SA                   | Backus & Johnston                           | 12.3           | 2,993                             | 5.5                | 16.4         | 23.0          |               |
| 11-02          | Interbrew                    | Gilde Brauerei                              | 100.0          | 478                               | 1.8                | 8.6          | NA            |               |
| 9-02           | Heineken                     | FIFCO - Florida Bebidas / COCECA            | 25.0           | 916                               | 7.0                | 16.6         | 19.9          |               |
| 9-02           | Heineken                     | Al-Ahram Bev Co                             | 100.0          | 378                               | 4.1                | 10.9         | 13.8          |               |
| 5-02           | SAB                          | Miller                                      | 100.0          | 4,993                             | 1.0                | 8.8          | 11.3          |               |
| 7-02           | Bavaria SA                   | Backus & Johnston                           | 12.2           | 2,414                             | 4.9                | 15.4         | 22.6          |               |
| 5-02           | AmBev                        | Quilmes                                     | 37.5           | 1,579                             | 3.4                | 14.5         | NM            |               |
| 3-02           | Molson Inc                   | Kaiser                                      | 100.0          | 765                               | 2.3                | 12.0         | NA            |               |
| 2-02           | Scottish & Newcastle         | Hartwall                                    | 100.0          | 1,982                             | 2.8                | 10.1         | 14.0          |               |
| 2-02           | Heineken                     | Bravo International                         | 100.0          | 400                               | 3.1                | 13.4         | 19.1          |               |
| 12-01          | Kirin                        | San Miguel                                  | 15.0           | 3,790                             | 1.4                | 11.2         | 18.1          |               |
| 12-01          | Adolph Coors                 | Carling                                     | 100.0          | 1,727                             | 1.0                | 7.9          | 15.8          |               |
| 11-01          | Bavaria SA                   | Cerveceria Nacional                         | 91.5           | 343                               | 2.3                | 11.5         | 21.1          |               |
| 11-01          | SAB                          | Cerveceria Hondureña SA                     | 97.1           | 549                               | 2.1                | 9.7          | 12.1          |               |
| 8-01           | Interbrew                    | Beck & Co.                                  | 99.8           | 1,510                             | 2.0                | 13.0         | NA            |               |
|                |                              |   |                | <b>Mean</b>                       | <b>\$ 2,462</b>    | <b>2.8 x</b> | <b>12.0 x</b> | <b>19.4 x</b> |
|                |                              |   |                | <b>Median</b>                     | <b>886</b>         | <b>2.3</b>   | <b>11.4</b>   | <b>19.1</b>   |

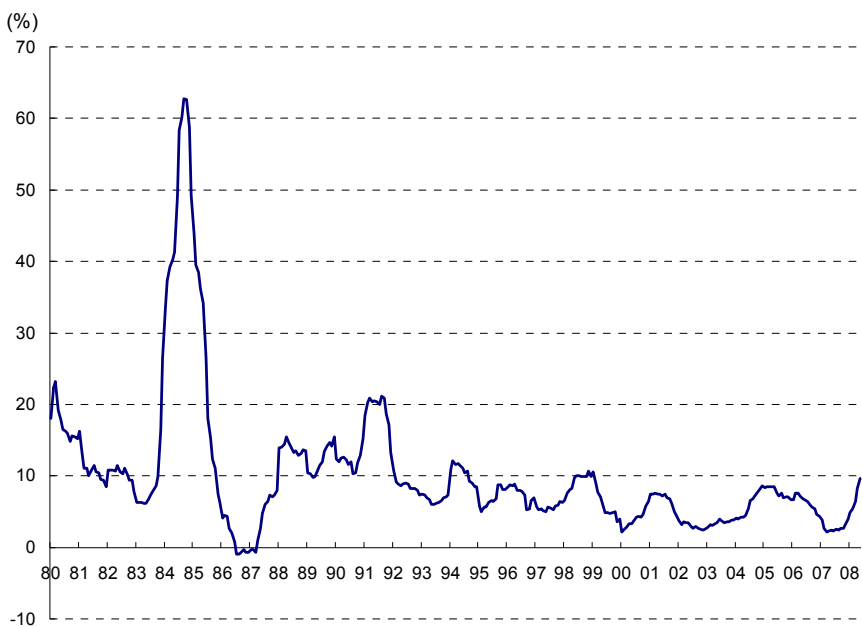
Source: Citi Investment Research

# Macro Landscape

## Spending Outlook Becoming More Cautious

Our economist, Jun Trinidad has become more bearish on the overall economic outlook for the Philippines since a couple of months ago. His key reasons for becoming more cautious are mainly due to shifting of consumer sentiment towards the negative and growing constraints on household budgets for spending amid a more aggressive inflationary pressures during the next 1-2 years. CPI yoy increase is already hitting 10% levels in May. We have revised down our real GDP growth of 5.6%-6.3% in 2008E-2009E in April vs. 6.5%-7.5% till March 2008.

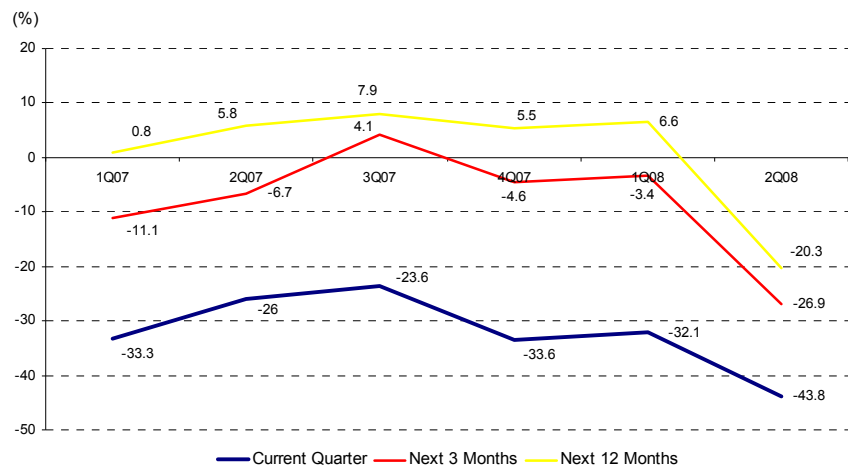
Figure 33. CPI Inflation Rate



Source: Citi

Consumer confidence slipped in Q2 2008 with an impact of oil price increase and global rice crisis during the survey period. The overall consumer confidence index (CI), dropped to -43.8 percent, down by 11.7 index points qoq and by 17.8 index points yoy. The index indicated that respondents with negative outlook outnumbered respondents with positive outlook by about 4 for every 10 respondents in Q2 2008.

Figure 34. Consumer Confidence Index (Overall Consumer Outlook Index) Trend



Source: Citi, Department of Economic Statistics of Philippines

\*The overall consumer confidence index is determined by the average of the 3 measures, namely, outlook on macroeconomic condition, family financial situation and family income. A positive CI indicates that respondents with a favorable view outnumber those with an unfavorable view while a negative index means the reverse. Moreover, a zero percent index indicates an equal number of respondents with positive and negative views.

### Peso Strength to Reverse for a While

Strong domestic growth has sustained local currency strength against the USD from late 2005 till most recently in March 2008. However, growing inflation risks impacting negatively on domestic private consumption has resulted in reversing this peso strength trend. We have revised up our forecast for an average rate of PHD/USD to 41.5 in 2008 and 39.3 in 2009 in June vs. 37.7 in 2008 vs. 40.8 as of March 7th 2008. We still see upside risks in our current assumption for 2009.

Figure 35. Historical Peso/USD Rate



Source: Citi

Figure 36. Forecasts on Peso/USD Rate

|                               | Spot Rate (June 6) | 2Q08  | 3Q08  | 4Q08  | 1Q09  |
|-------------------------------|--------------------|-------|-------|-------|-------|
| Peso Per US\$*                | 44.15              | 44.50 | 43.85 | 42.00 | 41.85 |
| BSP Overnight Borrowing Rate% | 5.00               | 5.25  | 5.75  | 5.75  | 5.75  |
| Three-Month Rate %*           | 6.00               | 5.50  | 6.00  | 5.75  | 5.50  |
| 5-Year Bond Yield %*          | 8.489              | 8.25  | 7.50  | 7.00  | 6.50  |

Source: Citi estimates, Bloomberg-PDEX

## Longer-Term Economic Outlook Solid

From a broader and longer-term picture perspective, we view the Philippines as currently at the turnaround stage economically in the context of political stabilization post ousting of the Estrada government in 1998 and Gloria Arroyo taking over in 2001 and being elected as a president in 2004. The current government's term is expiring in 2010.

The key for economic growth is improvement in the investment cycle driven by the government's expansionary fiscal spending policy via decompressing infrastructure budget with a cash flow funded through privatization of utilities, e.g. power generation/transmission and financial holdings such as stakes in San Miguel Corp. President Arroyo said she will accelerate the sale of government-held assets to reduce the nation's budget deficit. Since 2005, the government has consistently exceeded its privatization initial target every year. In 2005, about P2.3 billion of P8.3 billion in privatization proceeds went to the national coffers after the government sold real estate properties in Japan and

its shares in Philippine National Bank to airline and tobacco magnate Lucio Tan.

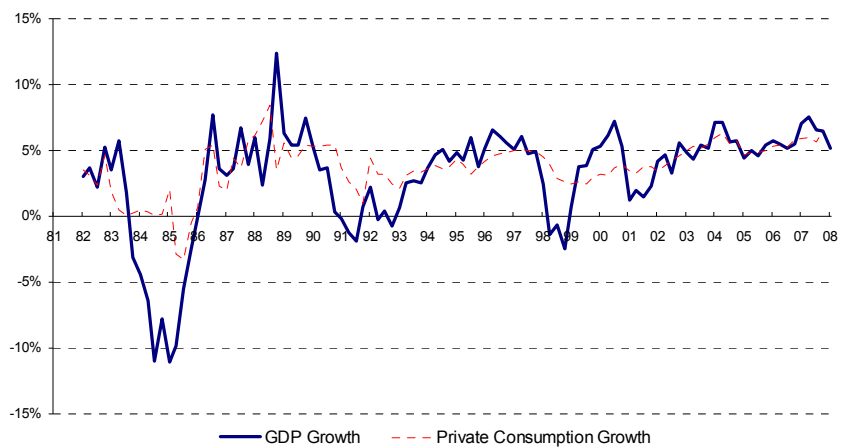
The government has identified P80billion worth of assets as up for disposition in 2008 (according to *Business World*, 19 October 2007) to prepare to compensate for any slips in tax collection that would threaten its balanced budget goal. Key assets lined up for disposition include:

- 24% Holdings in San Miguel Corp.
- Holdings in Philippine National Oil Co.- Exploration Corp (PNOC-EC) in the middle of a privatization process
- Food Terminal Inc.
- the New Bilibid Prison property
- the Fujimi property in Japan

Regarding the government's efforts to divest SMC shares, it's worthwhile mentioning that the government has been saying this publicly and to the rating agencies every year for about 15 years now. However, the reason they have not been divested is that the court case and potential monetization proceeds are now in the Supreme Court as to related issues, and no party seems to know when this will be actually resolved.

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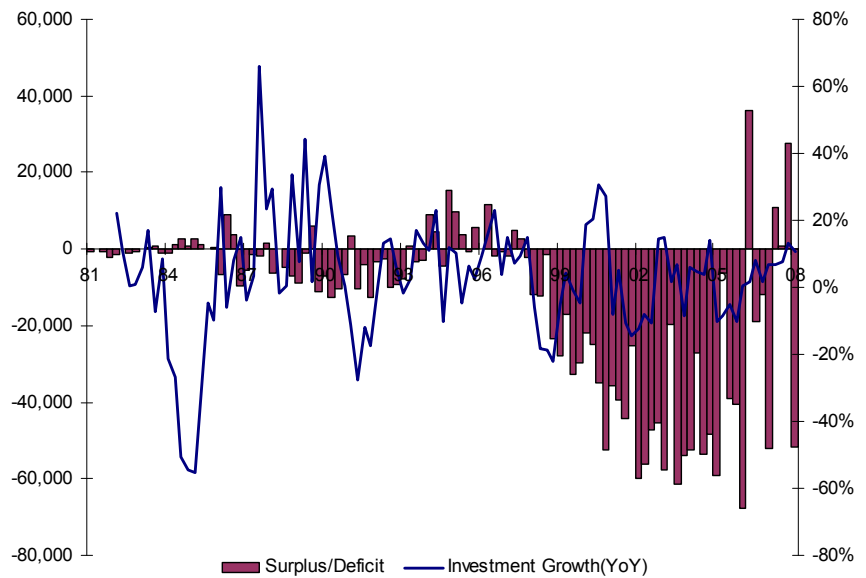
**Figure 37. GDP vs. Private Consumption Growth**



Source: Citi

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Figure 38. Fiscal Surplus/Deficit (LHS) vs. Investment (RHS)

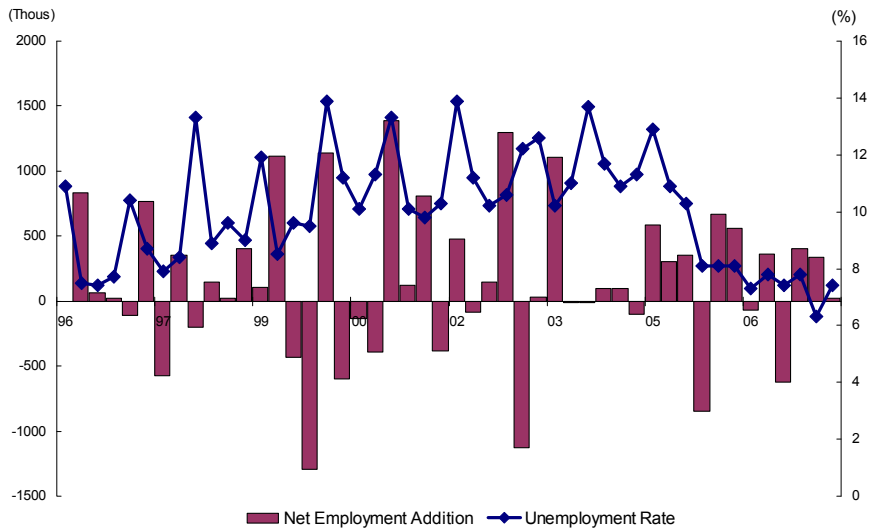


Source: Citi

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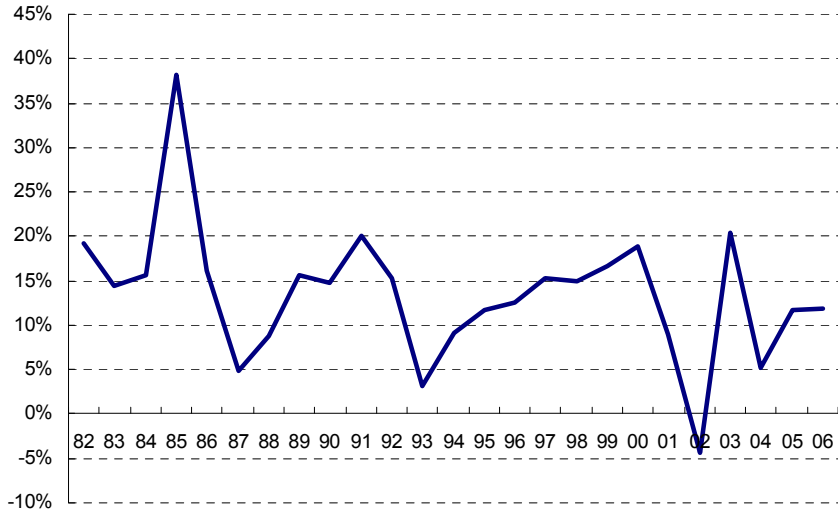
More aggressive government fiscal spending on investment should ultimately lead to more upbeat job generation and foreign direct investment. We believe consumers' disposable income growth outlook should remain sanguine despite the global macro slowdown.

Figure 39. Net Employment Addition (LHS) vs. Unemployment (RHS)



Source: Citi

Figure 40. Household Disposable Income Growth (YoY)



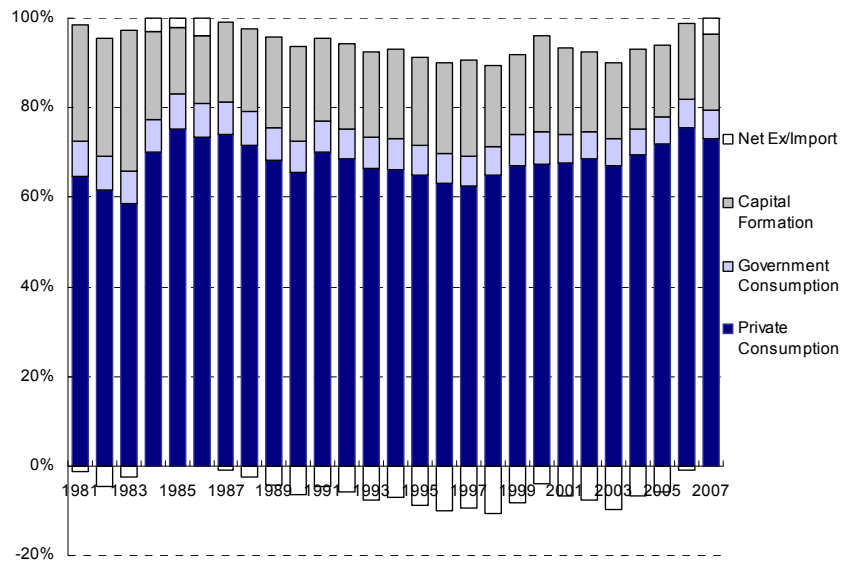
Source: Citi

Personal consumption accounts for roughly 75% of GDP out of over 90% of GDP coming from domestic demand with limited net export contribution. Consumer sentiment recently appears vulnerable to oil price hikes anticipating any major pass-through; we think this could hit harder on durable goods, and we do not think this would largely impact on non-durable goods demand, which is offset by upside in disposable income growth outlook, and continued



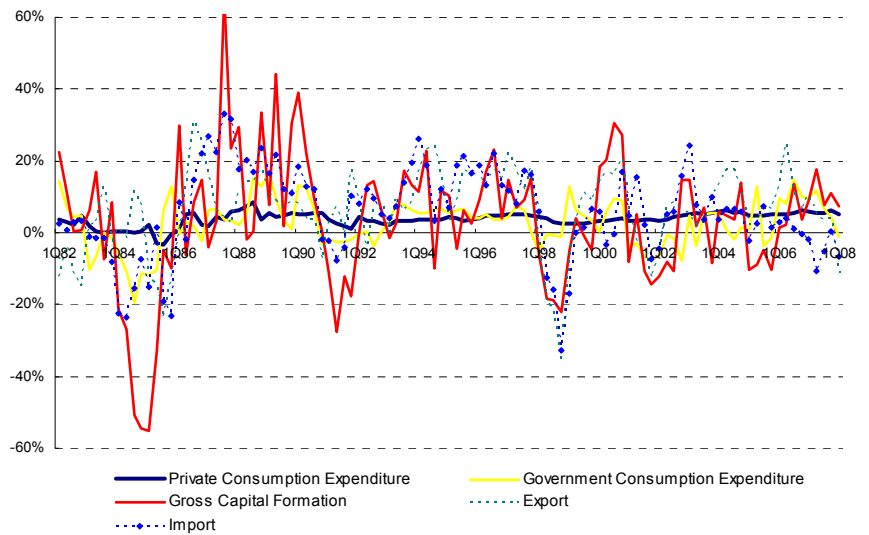
government aid on strengthening health/social safety net. Income distribution of the society is as skewed to the high end as everywhere else in Asia, and high-end consumers have shown consistent purchases of discretionary durable good items. We expect the savings rate to remain low on the back of robust willingness to spend amid a growing economy and healthy disposable income growth outlook. One risk is that the inflation rate could go much higher amid higher oil prices and commodity price hikes.

**Figure 41. Historical GDP Breakdowns**



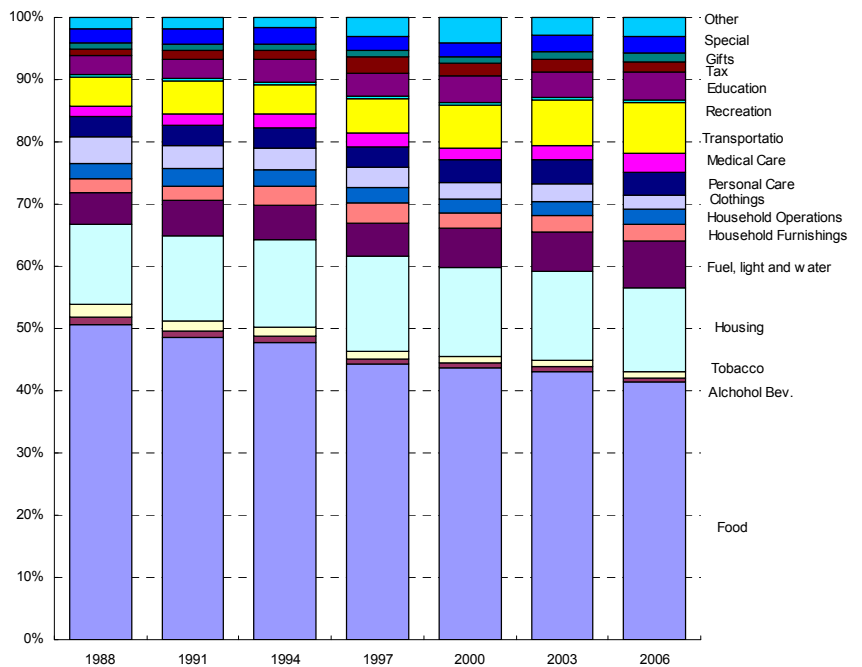
Source: Citi

Figure 42. GDP Components – Growth Trend (YoY %)



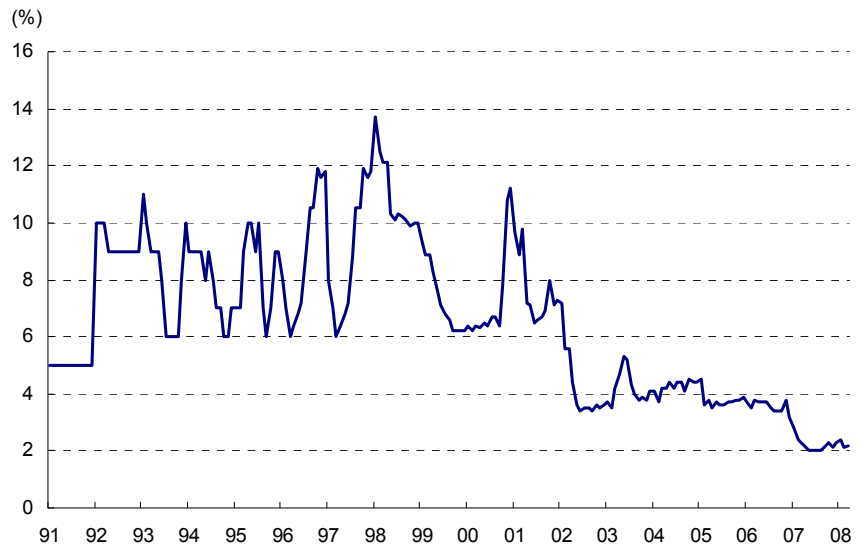
Source: Citi

Figure 43. Historical Household Expenditure Breakdowns



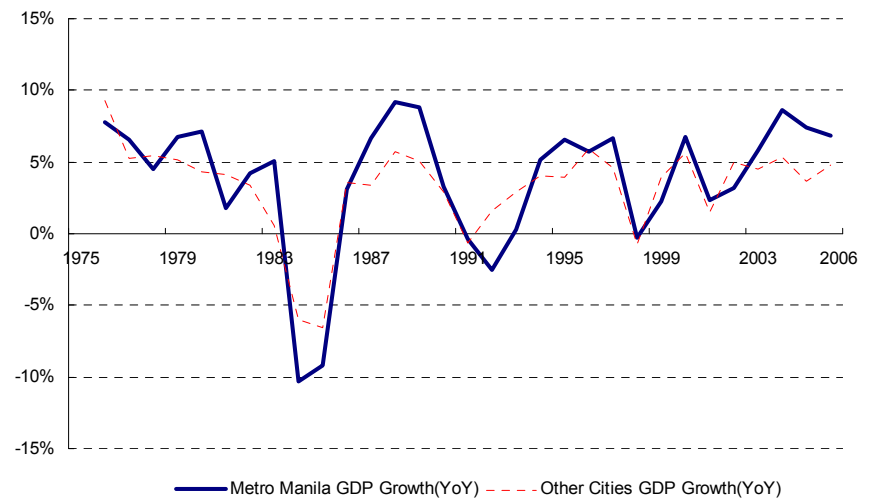
Source: Citi

Figure 44. Savings Ratio



Source: Citi

Figure 45. Metro Manila vs. Other Cities GDP Growth (%)



Source: Citi

Figure 46. Macro Snapshot

|   | 1996     | 1997     | 1998     | 1999     | 2000     | 2001     | 2002     | 2003     | 2004     | 2005     | 2006     | 2007     | 2008E    | 2009E    |
|---|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| <b>GDP Growth (Real) (%)</b>                    |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| Global  | 4.1      | 4.2      | 2.7      | 3.8      | 4.8      | 2.5      | 3.1      | 4        | 5.3      | 4.8      | 5.4      | 3.9      | 3        | 2.8      |
| US  | 3.7      | 4.5      | 4.2      | 4.5      | 3.7      | 0.8      | 1.6      | 2.5      | 3.6      | 3.1      | 2.9      | 2.2      | 1.3      | 1.4      |
| China   | 10.0     | 9.3      | 7.8      | 7.6      | 8.4      | 8.3      | 9.1      | 10.0     | 10.1     | 10.2     | 11.1     | 11.9     | 9.8      | 9.7      |
| Korea   | 7.0      | 4.7      | (6.9)    | 9.5      | 8.5      | 3.8      | 7.0      | 3.1      | 4.7      | 4.2      | 5.0      | 5.0      | 4.2      | 4        |
| HK  | 6.5      | 5.1      | (5.5)    | 4.0      | 10.0     | 0.6      | 1.8      | 3.2      | 8.6      | 7.5      | 6.9      | 6.4      | 4.8      | 4.6      |
| India   | 7.8      | 4.8      | 6.5      | 6.0      | 4.4      | 5.8      | 3.8      | 8.5      | 7.5      | 9.0      | 9.4      | 8.7      | 7.7      | 8.3      |
| Singapore                                       | 7.8      | 8.3      | (1.4)    | 7.2      | 10.1     | (2.4)    | 4.2      | 3.1      | 8.8      | 6.4      | 7.9      | 7.7      | 5.6      | 6.3      |
| Thailand  | 5.9      | (1.4)    | (10.5)   | 4.4      | 4.8      | 2.2      | 5.3      | 7.1      | 6.3      | 4.5      | 5.0      | 4.8      | 5.1      | 5.5      |
| Malaysia  | 10.0     | 7.3      | (7.4)    | 6.1      | 8.9      | 0.3      | 4.4      | 5.5      | 7.2      | 5.2      | 5.9      | 6.3      | 5.3      | 5.8      |
| Indonesia                                       | 7.8      | 4.7      | (13.1)   | 0.8      | 4.9      | 3.6      | 4.5      | 4.8      | 5.0      | 5.7      | 5.5      | 6.3      | 6        | 6.3      |
| Vietnam   | 9.3      | 8.2      | 5.8      | 4.8      | 6.8      | 6.9      | 7.1      | 7.3      | 7.8      | 8.4      | 8.2      | 8.5      | 6.7      | 6.4      |
| Pakistan  | n/a      | n/a      | n/a      | n/a      | n/a      | 2.0      | 3.1      | 4.7      | 7.5      | 9.0      | 6.6      | 5.6      | 6.3      | 6.4      |
| Philippines                                     | 5.8      | 5.2      | (0.6)    | 3.4      | 6.0      | 1.8      | 4.4      | 4.9      | 6.4      | 4.9      | 5.4      | 7.3      | 5.6      | 6.3      |
| <b>Private Consumption Growth (Nominal) (%)</b> |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| US  | 5.7      | 5.5      | 6.0      | 6.9      | 7.3      | 4.7      | 4.2      | 4.8      | 6.4      | 6.3      | 5.9      | n/a      | n/a      | n/a      |
| China   | 19.7     | 8.7      | 6.3      | 6.9      | 9.4      | 7.3      | 6.8      | 8.1      | 12.3     | 11.6     | 12.6     | 16.4     | 10.8     | 10.20    |
| Korea   | 13.3     | 9.5      | (7.7)    | 15.1     | 13.6     | 10.0     | 11.0     | 2.1      | 3.2      | 6.3      | 6.4      | 7.1      | 3.0      | 3.40     |
| HK  | 9.2      | 10.4     | (4.5)    | (3.9)    | 1.2      | 1.1      | (4.4)    | (3.8)    | 6.7      | 4.8      | 6.9      | 11.8     | 6.1      | 3.80     |
| India   | 17.9     | 8.9      | 16.2     | 12.6     | 6.9      | 9.2      | 5.5      | 10.7     | 9.1      | 10.7     | 12.7     | 12.6     | 6.0      | 6.00     |
| Singapore                                       | 7.6      | 7.5      | (5.6)    | 7.1      | 14.4     | 3.7      | 4.9      | 1.0      | 5.7      | 3.8      | 3.5      | 10.5     | 4.5      | 4.60     |
| Thailand  | 11.4     | 4.3      | (3.2)    | 3.6      | 6.5      | 6.4      | 6.1      | 8.5      | 9.6      | 9.2      | 8.2      | 3.7      | 2.90     | 3.79     |
| Malaysia  | 9.6      | 9.4      | (7.9)    | 6.2      | 16.2     | 3.6      | 5.9      | 8.1      | 11.8     | 12.0     | 10.6     | 14.7     | 8.20     | 7.10     |
| Indonesia                                       | 18.7     | 16.6     | 67.3     | 25.5     | 5.4      | 21.3     | 18.5     | 11.4     | 11.7     | 16.5     | 17.2     | 20.0     | 5.35     | 5.84     |
| Vietnam   | 20.2     | 11.1     | 13.7     | 7.3      | 6.9      | 6.3      | 11.7     | 16.5     | 14.5     | 14.5     | 15.0     | 16.5     | 7.70     | 7.00     |
| Pakistan  | n/a      | n/a      | n/a      | n/a      | 11.3     | 3.7      | 8.1      | 16.2     | 19.5     | 14.5     | 13.9     | n/a      | n/a      | n/a      |
| Philippines                                     | 13.0     | 10.4     | 12.4     | 9.2      | 8.0      | 9.8      | 7.3      | 8.6      | 12.0     | 12.7     | 12.0     | 9.2      | 5.80     | 5.80     |
| <b>Inflation Rate (%)</b>                       |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| US  | n/a      | n/a      | n/a      | n/a      | n/a      | 2.4      | 1.9      | 3.3      | 3.4      | 2.5      | 4.1      | 3.1      | 2.9      | 2.8      |
| China   | 8.3      | 2.8      | (0.8)    | (1.4)    | 0.4      | 0.7      | (0.8)    | 1.2      | 3.9      | 1.8      | 1.5      | 4.8      | 7.4      | 5.7      |
| Korea   | 4.9      | 4.4      | 7.5      | 0.8      | 2.3      | 4.1      | 2.8      | 3.5      | 3.6      | 2.8      | 2.2      | 2.5      | 4        | 3        |
| HK  | 6.3      | 5.8      | 2.8      | (4.0)    | (3.7)    | (1.6)    | (3.0)    | (2.6)    | (0.4)    | 0.9      | 2.0      | 2.0      | 4        | 4.8      |
| India   | 4.6      | 4.4      | 5.9      | 3.3      | 7.1      | 3.6      | 3.4      | 5.5      | 6.5      | 4.4      | 5.3      | 4.5      | 6        | 4.5      |
| Singapore                                       | 1.4      | 2.0      | (0.3)    | 0.0      | 1.3      | 1.0      | (0.4)    | 0.5      | 1.7      | 0.5      | 1.0      | 2.1      | 6.2      | 2.6      |
| Thailand  | 5.9      | 5.6      | 8.1      | 0.2      | 1.6      | 1.7      | 0.6      | 1.8      | 2.8      | 4.5      | 4.7      | 2.3      | 7.6      | 6.7      |
| Malaysia  | 3.4      | 2.7      | 5.3      | 2.7      | 1.6      | 1.4      | 1.7      | 1.2      | 1.4      | 3.1      | 3.6      | 2.0      | 2.9      | 2.5      |
| Indonesia                                       | 8.4      | 6.2      | 58.0     | 20.8     | 3.8      | 11.5     | 11.8     | 6.8      | 6.1      | 10.5     | 13.1     | 6.4      | 9.5      | 7.5      |
| Vietnam   | 5.5      | 3.2      | 7.7      | 4.3      | (1.6)    | (0.3)    | 3.9      | 3.2      | 7.7      | 8.3      | 7.5      | 8.4      | 21.6     | 10.8     |
| Pakistan  | n/a      | n/a      | n/a      | n/a      | n/a      | 4.4      | 3.5      | 3.1      | 4.6      | 9.3      | 7.9      | 11.9     | 15.7     | 6.8      |
| Philippines                                     | 9.0      | 5.9      | 9.7      | 6.7      | 4.3      | 6.1      | 2.5      | 3.5      | 6.0      | 7.7      | 6.3      | 2.8      | 8.3      | 6.3      |
| <b>Disposable Income Growth (%)</b>             |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| China   | 5.0      | 7.9      | 3.9      | 4.4      | 2.5      | 4.2      | 5.9      | 0.9      | 5.2      | 6.0      | n/a      | n/a      | n/a      | n/a      |
| Korea   | 12.2     | 8.4      | 6.9      | 1.4      | 5.2      | 5.3      | 9.0      | 8.4      | 8.0      | 7.7      | 6.8      | 7.1      | n/a      | n/a      |
| HK  | 12.5     | 12.2     | (6.8)    | (0.0)    | 3.5      | (0.7)    | (0.7)    | (3.0)    | 4.7      | 4.1      | 1.5      | 6.3      | n/a      | n/a      |
| India   | 16.9     | 11.6     | 14.1     | 10.1     | 5.1      | 5.1      | 10.5     | 8.0      | 8.1      | 0.0      | 15.9     | 7.9      | n/a      | n/a      |
| Singapore                                       | 13.2     | 9.7      | 2.3      | 2.5      | 7.9      | 5.9      | 4.5      | 8.5      | 6.1      | —        | 8.6      | 4.8      | n/a      | n/a      |
| Thailand  | 7.2      | 1.9      | 2.0      | 0.5      | 6.6      | 3.6      | 4.4      | 6.8      | 9.4      | 7.9      | 5.7      | n/a      | n/a      | n/a      |
| Malaysia  | 16.3     | 11.5     | 3.1      | 6.2      | 13.0     | 3.8      | 8.1      | 5.7      | 7.0      | 8.7      | 4.5      | 6.0      | n/a      | n/a      |
| <b>Unemployment Rate (%)</b>                    |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| US  | n/a      | n/a      | n/a      | n/a      | n/a      | n/a      | 6        | 5.7      | 5.4      | 4.9      | 4.5      | 4.6      | n/a      | n/a      |
| China   | 3.0      | 3.1      | 3.1      | 3.1      | 3.1      | 3.6      | 4.0      | 4.3      | 4.2      | 4.2      | 4.1      | 4.0      | 4        | 4.1      |
| Korea   | 2.1      | 2.6      | 7.0      | 6.4      | 4.4      | 4.0      | 3.3      | 3.6      | 3.7      | 3.7      | 3.5      | 3.2      | 3.3      | 3.4      |
| HK  | 2.8      | 2.2      | 4.4      | 6.3      | 5.0      | 5.1      | 7.3      | 7.9      | 6.8      | 5.5      | 4.8      | 4.0      | 3.5      | 3.775    |
| Singapore                                       | 1.6      | 1.4      | 2.5      | 2.8      | 2.7      | 2.7      | 3.6      | 4.0      | 3.4      | 3.1      | 2.6      | 2.1      | 2.2      | 1.8      |
| Thailand  | 1.5      | 1.5      | 4.4      | 4.2      | 3.6      | 3.3      | 2.4      | 2.2      | 2.1      | 1.9      | 1.5      | 1.4      | n/a      | n/a      |
| Malaysia  | 2.5      | 2.5      | 3.2      | 3.4      | 3.1      | 3.7      | 3.5      | 3.6      | 3.6      | 3.6      | 3.5      | 3.4      | 3.4      | 3.3      |
| Indonesia                                       | 4.9      | 4.7      | 5.5      | 6.4      | 6.1      | 8.1      | 9.1      | 9.5      | 9.9      | 10.3     | 10.3     | 9.1      | 9        | 8.2      |
| Vietnam   | 5.9      | 6.0      | 6.9      | 6.7      | 6.4      | 6.3      | 6.0      | 5.8      | 5.6      | 5.3      | 4.8      | 4.6      | 4.5      | 4.5      |
| Pakistan  | n/a      | n/a      | n/a      | n/a      | n/a      | 9.9      | 9.8      | 9.8      | 9.7      | 9.7      | 8.0      | 8.3      | n/a      | n/a      |
| Philippines                                     | 8.4      | 8.9      | 10.3     | 9.9      | 11.7     | 10.9     | 11.5     | 11.5     | 11.9     | 11.2     | 11.0     | 10.0     | 9        | 8        |
| <b>Household Liabilities/Disposable Income</b>  |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| China   | n/a      | n/a      | 1%       | 2%       | 7%       | 11%      | 17%      | 24%      | 29%      | 33%      | n/a      | n/a      | n/a      | n/a      |
| Korea   | 63%      | 71%      | 57%      | 66%      | 78%      | 95%      | 112%     | 105%     | 103%     | 104%     | 107%     | 107%     | n/a      | n/a      |
| HK  | 54%      | 61%      | 70%      | 72%      | 72%      | 75%      | 75%      | 74%      | 70%      | 69%      | 75%      | 75%      | n/a      | n/a      |
| India   | 2%       | 3%       | 3%       | 3%       | 4%       | 5%       | 5%       | 7%       | 8%       | 11%      | n/a      | n/a      | n/a      | n/a      |
| Singapore                                       | 118%     | 126%     | 147%     | 157%     | 159%     | 158%     | 155%     | 149%     | 138%     | 141%     | n/a      | n/a      | n/a      | n/a      |
| Thailand  | 47%      | 42%      | 39%      | 35%      | 31%      | 30%      | 34%      | 40%      | 42%      | 45%      | n/a      | n/a      | n/a      | n/a      |
| Malaysia  | 68%      | 80%      | 74%      | 71%      | 71%      | 79%      | 84%      | 90%      | 96%      | 102%     | n/a      | n/a      | n/a      | n/a      |
| <b>Local Currency/ USD Rate</b>                 |          |          |          |          |          |          |          |          |          |          |          |          |          |          |
| China (RMB)                                     | 8.3      | 8.3      | 8.3      | 8.3      | 8.3      | 8.3      | 8.3      | 8.3      | 8.3      | 8.2      | 8.0      | 7.6      | 6.70     | 6.30     |
| Korea (KRW)                                     | 804.8    | 951.1    | 1,398.9  | 1,189.5  | 1,131.0  | 1,291.0  | 1,251.0  | 1,192.0  | 1,145.0  | 1,024.0  | 956.0    | 929.3    | 1020.00  | 980.00   |
| HK (HKD)  | 7.7      | 7.7      | 7.7      | 7.8      | 7.8      | 7.8      | 7.8      | 7.8      | 7.8      | 7.8      | 7.8      | 7.8      | 7.78     | 7.76     |
| India (INR)                                     | 35.5     | 37.2     | 42.2     | 43.4     | 45.7     | 48.0     | 48.3     | 45.9     | 45.0     | 44.3     | 44.9     | 40.2     | 40.00    | 37.00    |
| Singapore (SGD)                                 | 1.4      | 1.5      | 1.7      | 1.7      | 1.7      | 1.8      | 1.8      | 1.7      | 1.7      | 1.7      | 1.6      | 1.5      | 1.33     | 1.25     |
| Thailand (THB)                                  | 25.3     | 31.3     | 41.3     | 37.8     | 40.1     | 44.4     | 43.0     | 41.5     | 40.2     | 40.2     | 37.9     | 34.6     | 34.25    | 33.50    |
| Malaysia (MYR)                                  | 2.5      | 2.8      | 3.9      | 3.8      | 3.8      | 3.8      | 3.8      | 3.8      | 3.8      | 3.8      | 3.7      | 3.4      | 3.10     | 2.90     |
| Indonesia (IDR)                                 | 2,347.3  | 2,951.8  | 9,974.2  | 7,847.0  | 8,389.0  | 10,247.0 | 9,315.0  | 8,573.0  | 8,936.0  | 9,711.0  | 9,167.0  | 9139.5   | 9237.00  | 9280.00  |
| Vietnam (VND)                                   | 11,032.6 | 11,683.3 | 13,268.0 | 13,927.0 | 14,174.0 | 14,808.0 | 15,270.0 | 15,513.0 | 15,732.0 | 15,855.0 | 15,985.0 | 16,076.0 | 17168.38 | 17636.16 |
| Pakistan (PKR)                                  | n/a      | n/a      | n/a      | n/a      | n/a      | 58.4     | 61.4     | 58.5     | 57.6     | 59.4     | 59.9     | 67.0     | n/a      | n/a      |
| Philippines (PHP)                               | 26.2     | 29.5     | 40.9     | 39.1     | 44.2     | 51.0     | 51.6     | 54.2     | 56.0     | 55.1     | 51.6     | 46.1     | 39.50    | 37.00    |

Source: Citi estimates

Figure 47. Asia Consumer Demographics & Macro Data

|   | Philippines | Thailand | Malaysia | Vietnam | Indonesia | India     | China     | HK      | Korea   | Taiwan  | Singapore | Japan     |
|---|-------------|----------|----------|---------|-----------|-----------|-----------|---------|---------|---------|-----------|-----------|
| Population (Mil.)                           | 91          | 67       | 27       | 86      | 235       | 1,110     | 1,323     | 7       | 49      | 23      | 4         | 127       |
| Urban Population as % of total              | 64          | 22       | 69       | 27      | 50        | 29        | 42        | 100     | 69      | n/a     | 100       | 66        |
| Population aged 14+ as % of total           | n/a         | n/a      | 68       | 71      | 72        | 68        | 79        | 86      | 82      | 81      | 81        | 86        |
| Female as % of total                        | 50          | 51       | 50       | 50      | 50        | 49        | 49        | 50      | 50      | 49      | 52        | 51        |
| Working Population (Mil.)                   | 56          | 46       | 17       | 58      | 145       | 713       | 949       | 5       | 35      | 16      | 3         | 83        |
| Female as % of total                        | 40          | n/a      | 36       | 48      | 38        | 28        | 44        | 47      | 41      | 43      | 40        | 41        |
| Population Growth Rate                      | 2           | 1        | 2        | 1       | 1         | 1         | 1         | 1       | 1       | 0       | 0         | 0         |
| Birth Rate (Per 1000 people) (2005 Data)    | 25          | 14       | 23       | 17      | 20        | 23        | 14        | 7       | 10      | 13      | 9         | 9         |
| Per Capita GDP (constant 2000 US\$)         | 1,626       | 3,720    | 6,866    | 835     | 1,925     | 1,082     | 2,534     | 29,849  | 20,013  | 16,790  | 34,337    | 37,303    |
| Total GDP (constant 2000 US\$ mil)          | 144,320     | 245,521  | 186,709  | 71,127  | 433,001   | 1,167,563 | 3,377,294 | 206,731 | 969,753 | 383,121 | 161,382   | 4,766,547 |
| Private Consumption (% of Total GDP)        | 69          | 53       | 46       | 62      | 63        | 55        | 36        | 60      | 54      | 59      | 40        | 55        |
| Public Consumption (% of Total GDP)         | 10          | 13       | 12       | 6       | 8         | 10        | 14        | 8       | 15      | 12      | 10        | 17        |
| Investment (% of Total GDP)                 | 15          | 27       | 21       | 36      | 25        | 37        | 42        | 21      | 29      | 21      | 23        | 16        |
| Export(+) (% of Total GDP)                  | 41          | 73       | 110      | n/a     | 29        | 21        | n/a       | 207     | 46      | 74      | 231       | 16        |
| Imports(-) (% of Total GDP)                 | 42          | 66       | 89       | n/a     | 25        | 24        | n/a       | 197     | 45      | 66      | 202       | 11        |
| Overseas Spending (USD bil)                 | n/a         | n/a      | 4        | n/a     | 4         | 6         | 22        | 13      | 15      | n/a     | 10        | 38        |
| as % of Private Consumption                 | n/a         | n/a      | 0.05     | n/a     | 0.01      | 0.01      | 0.02      | 0.1     | 0.03    | n/a     | 0.16      | 0.01      |
| Cost of living Survey index (as of June 07) | n/a         | n/a      | n/a      | n/a     | n/a       | n/a       | 96        | 119     | 122     | 86      | 100       | 122       |
| Cost of living Survey index (as of 06)      | n/a         | n/a      | 69       | 85      | 82        | 80        | 95        | 116     | 122     | 87      | 92        | 119       |

Source: Citi

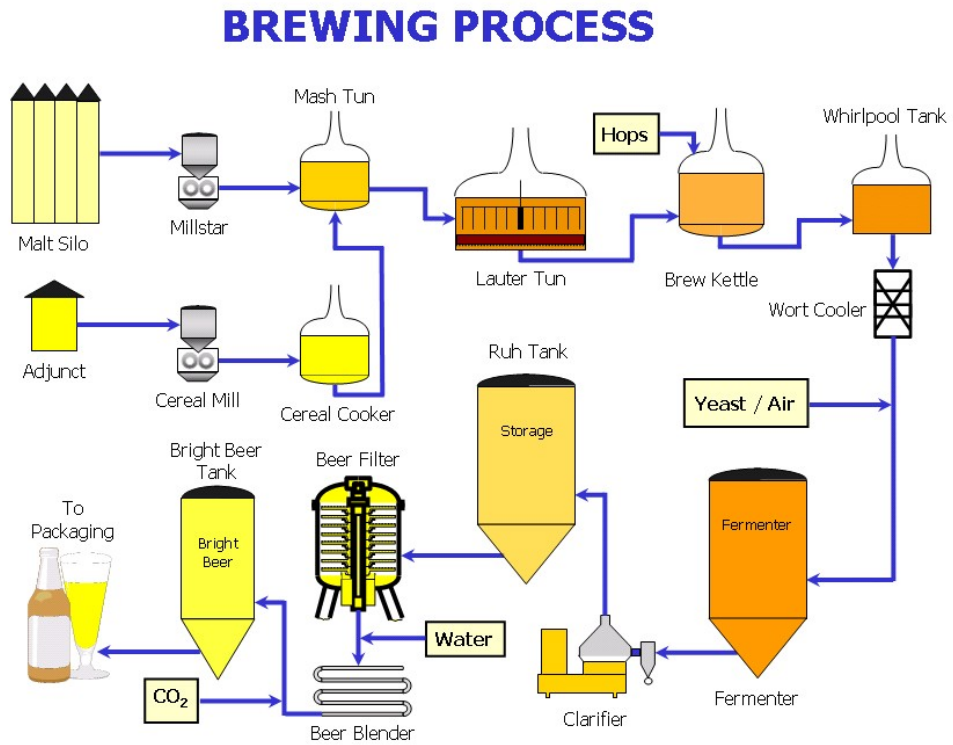
Figure 48. Asia Consumer Major Products Market – Figures as of 2007

|   | Philippines | Thailand | Malaysia | Vietnam | Indonesia | India | China  | HK    | Korea  | Taiwan | Singapore | Japan  |
|---|-------------|----------|----------|---------|-----------|-------|--------|-------|--------|--------|-----------|--------|
| <b>Retail Market (US\$Bn &amp; % of Retail Mkt)</b>   |             |          |          |         |           |       |        |       |        |        |           |        |
| Retailing   | 45          | 46       | 22       | 19      | 88        | 201   | 639    | 29    | 176    | 73     | 15        | 989    |
| Grocery retailers (%)                                 | 56          | 61       | 25       | 59      | 69        | 64    | 46     | 24    | 35     | 42     | 27        | 32     |
| Non-grocery retailers (%)                             | 43          | 36       | 64       | 41      | 30        | 36    | 53     | 75    | 42     | 54     | 68        | 59     |
| Non-store retailing (%)                               | 2           | 2        | 11       | 0       | 1         | 1     | 1      | 1     | 23     | 4      | 5         | 9      |
| <b>Consumer Products Market Size (US\$ Mil)</b>       |             |          |          |         |           |       |        |       |        |        |           |        |
| Confectionery   | 1,442       | 891      | 561      | 545     | 2,549     | 2,661 | 15,579 | 454   | 2,895  | 1,452  | 312       | 19,952 |
| Sweet Confectionery & Gum                             | 603         | 275      | 230      | 202     | 1,267     | 898   | 6,774  | 262   | 1,217  | 556    | 136       | 7,305  |
| Biscuits  | 329         | 115      | 175      | 186     | 521       | 1,353 | 3,142  | 112   | 933    | 250    | 110       | 3,564  |
| Sweet and savoury snacks                              | 510         | 501      | 155      | 157     | 760       | 410   | 5,663  | 80    | 745    | 646    | 66        | 9,084  |
| Noodles   | 472         | 339      | 174      | 290     | 1,321     | 280   | 7,021  | 131   | 2,248  | 446    | 34        | 9,968  |
| Beverages – non Alcohol                               |             |          |          |         |           |       |        |       |        |        |           |        |
| Carbonated Drinks                                     | 1,752       | 948      | 218      | 48      | 369       | 860   | 4,434  | 260   | 1,020  | 360    | 88        | 4,555  |
| Tea   | 66          | 116      | 42       | 6       | 561       | 6     | 5,005  | 476   | 146    | 825    | 34        | 11,255 |
| Bottled water   | 1274        | 256      | 50       | 41      | 1,010     | 499   | 3,607  | 238   | 676    | 438    | 20        | 3,072  |
| Beverages – Alcoholic                                 |             |          |          |         |           |       |        |       |        |        |           |        |
| Beer  | 1,440       | 2,395    | 179      | 504     | 231       | 1584  | 16,312 | 228   | 3,982  | 1,039  | 176       | 19,872 |
| Spirits   | 795         | 2,113    | 100      | 21      | 6         | 8574  | 16,591 | 73    | 1,796  | 843    | 27        | 6,404  |
| Wine  | 68          | 116      | 67       | 31      | 8         | 60    | 3,465  | 133   | 1,374  | 556    | 109       | 5,531  |
| Dairy Beverage  | 795         | 619      | 447      | 408     | 1,293     | 4,566 | 13,624 | 391   | 3,185  | 889    | 130       | 9,259  |
| Ice Cream   | 164         | 261      | 133      | 62      | 237       | 297   | 4,394  | 119   | 1,950  | 155    | 69        | 4,274  |
| Cosmetics & Toiletries                                | 1,862       | 2,363    | 973      | 517     | 1,649     | 4,677 | 14,296 | 1,166 | 6,610  | 2,731  | 596       | 30,500 |
| Colour cosmetics                                      | 79          | 251      | 100      | 16      | 140       | 183   | 1,411  | 145   | 902    | 355    | 78        | 5,926  |
| Fragrances  | 121         | 86       | 64       | 15      | 87        | 93    | 361    | 85    | 331    | 187    | 109       | 505    |
| Skin care   | 452         | 884      | 261      | 51      | 262       | 540   | 5,258  | 524   | 2,704  | 1,337  | 187       | 13,081 |
| Others  | 1,210       | 1,142    | 548      | 436     | 1,160     | 3,861 | 7,266  | 413   | 2,674  | 853    | 221       | 10,988 |
| Home & Personal Care                                  | 867         | 685      | 376      | 361     | 787       | 2310  | 5,209  | 168   | 1,242  | 455    | 95        | 7,458  |
| Cigarette   | 2,721       | 1,958    | 1,649    | 1,554   | 7,973     | 3,592 | 70,693 | 571   | 10,533 | 3,499  | 861       | 35,281 |
| Cigarette (Bn Stick)                                  | 95          | na       | 17       | 81      | 153       | 97    | 1,949  | 3     | 86     | n/a    | 2         | 273    |
| <b>Consumer Product Penetration per Capita (US\$)</b> |             |          |          |         |           |       |        |       |        |        |           |        |
| Confectionery/Total                                   | 16          | 153      | 21       | 6       | 10        | 2     | 11     | 62    | 59     | 62     | 69        | 154    |
| Sweet Confectionery & Gum                             | 7           | 4        | 8        | 2       | 5         | 1     | 5      | 37    | 25     | 25     | 30        | 57     |
| Biscuits  | 4           | 2        | 6        | 2       | 2         | 1     | 2      | 16    | 19     | 11     | 24        | 28     |
| Sweet and savoury snacks                              | 6           | 8        | 6        | 2       | 3         | 0     | 4      | 11    | 15     | 28     | 15        | 71     |
| Noodles   | 5           | 5        | 6        | 3       | 6         | 0     | 5      | 19    | 46     | 20     | 8         | 78     |
| Beverages – non Alcohol                               |             |          |          |         |           |       |        |       |        |        |           |        |
| Carbonated Drinks                                     | 19          | 14       | 8        | 1       | 2         | 1     | 3      | 37    | 21     | 16     | 20        | 36     |
| Tea   | 1           | 2        | 2        | 0       | 2         | 0     | 4      | 68    | 3      | 36     | 8         | 88     |
| Bottled water   | 14          | 4        | 2        | 0       | 4         | 0     | 3      | 34    | 14     | 19     | 4         | 24     |
| Beverages – Alcoholic                                 |             |          |          |         |           |       |        |       |        |        |           |        |
| Beer  | 16          | 36       | 7        | 6       | 1         | 1     | 12     | 33    | 81     | 46     | 39        | 156    |
| Spirits   | 9           | 32       | 4        | 0       | 0         | 8     | 13     | 10    | 37     | 37     | 6         | 50     |
| Wine  | 1           | 2        | 2        | 0       | 0         | 0     | 3      | 19    | 28     | 25     | 24        | 43     |
| Dairy Beverage  | 9           | 9        | 16       | 5       | 6         | 4     | 10     | 56    | 65     | 39     | 29        | 73     |
| Ice Cream   | 2           | 4        | 5        | 1       | 1         | 0     | 3      | 17    | 40     | 7      | 15        | 34     |
| Cosmetics & Toiletries                                | 20          | 36       | 36       | 6       | 7         | 4     | 11     | 167   | 135    | 120    | 133       | 239    |
| Colour cosmetics                                      | 1           | 4        | 4        | 0       | 1         | 0     | 1      | 21    | 18     | 16     | 17        | 46     |
| Fragrances  | 1           | 1        | 2        | 0       | 0         | 0     | 0      | 12    | 7      | 8      | 24        | 4      |
| Skin care   | 5           | 13       | 10       | 1       | 1         | 0     | 4      | 75    | 55     | 59     | 42        | 103    |
| Others  | 13          | 17       | 20       | 5       | 5         | 3     | 5      | 59    | 55     | 38     | 49        | 86     |
| Home & Personal Care                                  | 10          | 10       | 15       | 4       | 4         | 2     | 4      | 24    | 26     | 20     | 22        | 58     |
| Cigarette   | 32          | 29       | 64       | 18      | 36        | 3     | 54     | 81    | 218    | 153    | 196       | 277    |
| Cigarette (pack)                                      | 56          | na       | 33       | 48      | 34        | 4     | 74     | 20    | 89     | n/a    | 28        | 107    |

Source: Citi Investment Research estimates, Euro Monitor \* Cost of Living Index is by Mercer Human Resources with New York as 100 \*\* 0 for penetration per capita is rounded off

# Appendix I: Beer Brewing Process

Figure 49. Brewing Process Diagram

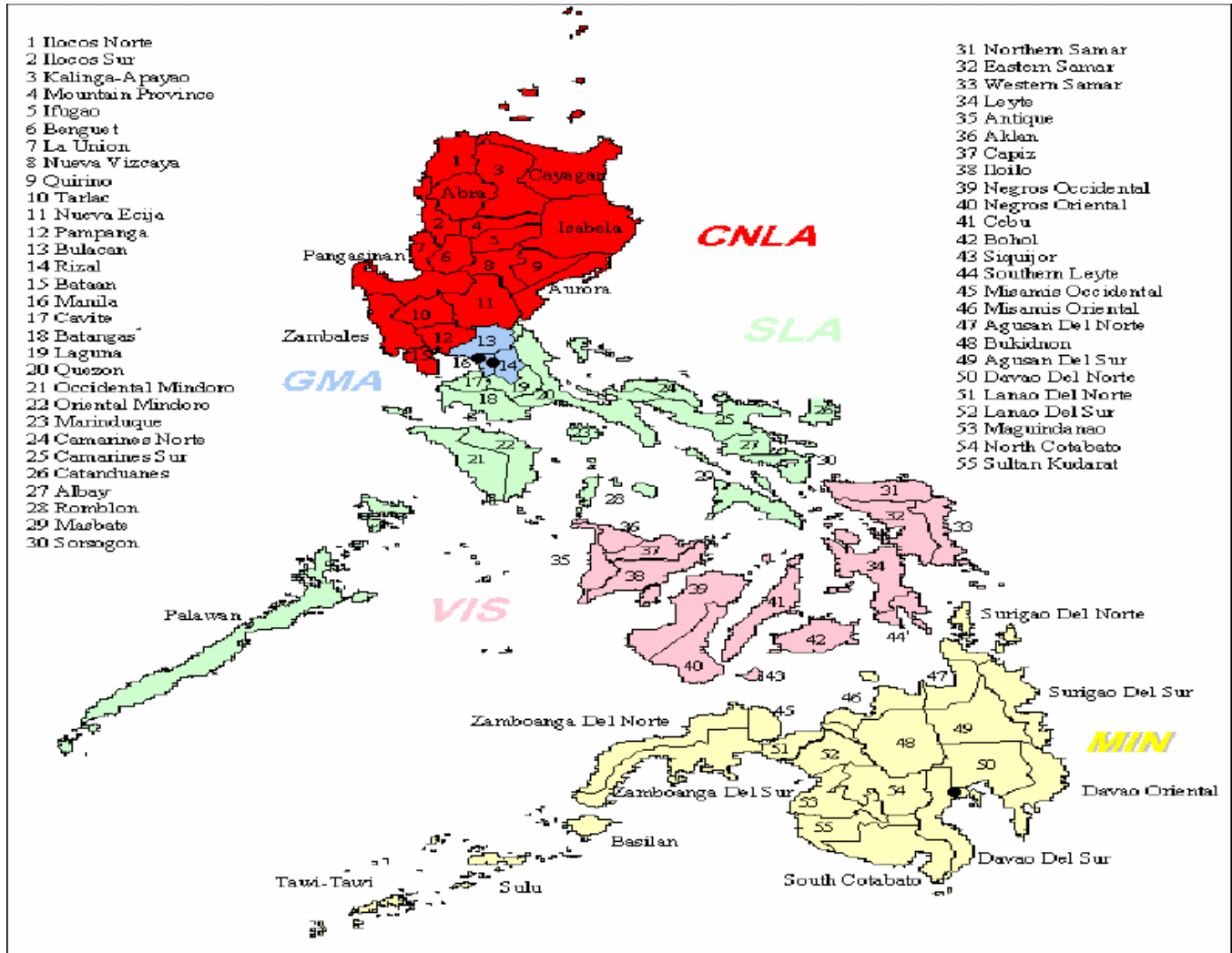


Source: San Miguel Brewery

## Appendix II: Geographical Coverage

The chart below features the geographical coverage of sales territory of SMB. The company has five breweries: two in Luzon (San Fernando: 5.5 mn hl, Polo:3.1 mn hl); two in Visayas (Bacolod:1.0mn hl, Madaue:3.4mn hl) and one in Mindanao (Davao:2.1mn hl).

Figure 50. Geographical Coverage of SMB Sales Territories: GMA South & North, Central North Luzon, South Luzon, Visayas, Mindanao



Source: San Miguel Brewery



## San Miguel Brewery

### Company description

San Miguel Brewery (SMB) is the largest manufacturer and distributor of beer in the Philippines with 93% market share. Revenue derives 100% from beer sales, with 99.2% coming from the domestic market, and the small remainder from overseas sales. The company produces eight brands of all pasteurized beer with a 6-12 month shelf life. On 1 October 2007, parent San Miguel Corp. (SMC) spun off the San Miguel beer division as 100%-owned San Miguel Brewery Inc.

### Investment strategy

We rate San Miguel Brewery shares as Buy / Medium Risk (1M) with a target price of P10.3. Key rationales for our buying stance are 1) Good defensive choice amid Asian market volatility, with superior yield, stable growth, strong cash flow. 2) One of world's most efficient beer business models with 3-year ('05-'07) average ROE of 46%, reaching 59% by 2010E on 13% EPS CAGR ('07-'10E). 3) Current P/E valuation at 13x '08E with dividend yield of 6.9% looks attractive. San Miguel's strategic strengths include that its monopoly seems untouchable, with local competitor Asia Brewery becoming even more minor, while San Miguel's 468-dealership network should help boost market share (93% currently) further. We see profitability upside despite market maturity on better product mix, while alliance with Kirin Brewery and established returned glass bottle system reduce cost pressures.

### Valuation

Our target price of P10.3 is based on a P/E multiple of 15.3x 2008E-09E average EPS. Our target multiple is at 15% discount to global peers. San Miguel Brewery offers dominant leadership in the local market, higher ROE and dividend yield; however, we think these are offset by a modestly lower EPS growth profile ('07-'10E EPS CAGR at 13% vs. global average at 16%) as well as overall Philippine country and equity market risks and share illiquidity risks. In addition, peers have a relatively greater scale of non-operational expenses, which makes their P/E appear higher. We have opted to use P/E as our main methodology as it is the most commonly used valuation tool in the Philippines equity market, and the company does not have any substantial non-operating income.

### Risks

We assign a Medium Risk rating to the stock, though its short trading history would normally betoken a Speculative rating based on our quantitative risk rating system. However, we believe a Medium Risk is more appropriate given that we expect the stock to trade broadly within the range of its parent company San Miguel Corp and also given the nature of its businesses – a

simple beer manufacturer & distributor with a highly predictable earnings stream. The following risk factors could prevent the shares from reaching our target price: (1) Share volatility due to short trading history and very small free float of only 5%; (2) ROE could deteriorate in the case of any inefficiency in capital allocation; (3) Limited pricing power given consumer price sensitivity; (4) vulnerability to weather; (5) Country and macro risks; (6) Any capital allocation missteps by management; (6) any labor problems.





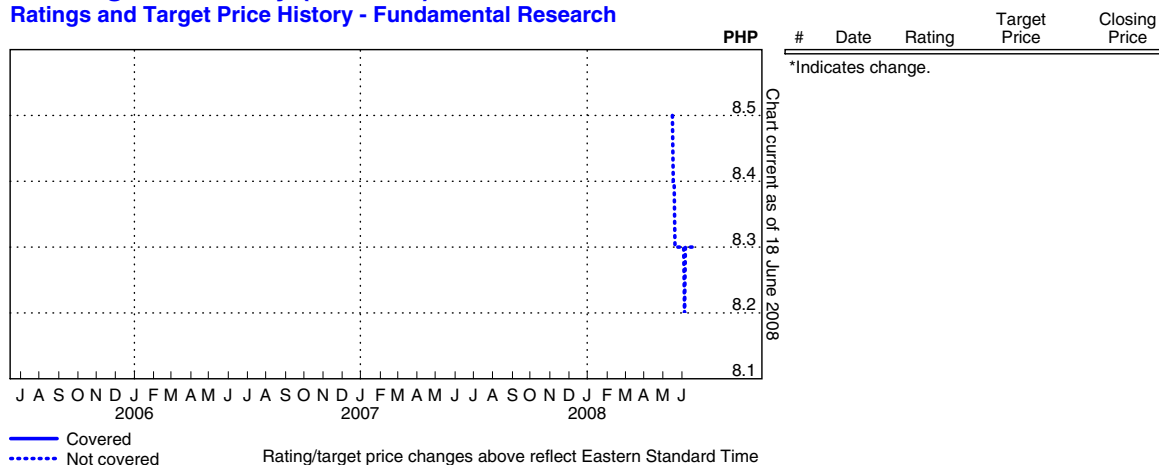
# Appendix A-1

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### San Miguel Brewery (SMB.PS) Ratings and Target Price History - Fundamental Research



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## San Miguel Brewery (SMB.PS)

19 June 2008

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