Global market review of Tequila – forecasts to 2013

2008 edition

Just-drinks

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*Prices correct at time of publication.

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A note about cases…

All references and data quoted in ‘cases’ in this report represents nine-litre cases unless otherwise stated.

Chapter 1 History and product characteristics

Distilled spirits in Mexico date back to the days of the Spanish conquistadors. The indigenous Aztecs drank a drink called Pulque, fermented from the sap of the agave plant (called maguey). Agave had been cultivated in Mexico since pre-historic times. Agave is a water-retaining plant that grows chiefly in the dry climates of Mexico.

The Spanish found Pulque fairly unpalatable and sought to improve it through distillation, a spirit that was termed mezcal. Eventually the process was refined. Under traditional production methods, the fermented ‘must’ is obtained from the heart of the blue agave plant, which is typically the size of a large pineapple but can grow much larger. This heart is heated in a stone furnace. The sap is then extracted from the pulp in a mill, fermented with yeast in a tank, and then double distilled in a copper still (known as alambiques). It is then sometimes aged for a period in oak barrels.

Prior to the latter part of the 19th century, most agave spirits were un-aged and uncoloured. Eventually, several distillers began ageing it using a local wood known as encino for tanks and barrels or, if finances permitted, they purchased used whiskey barrels from Kentucky. These used barrels imparted the ageing Tequila with a hint of oak and some colour.

It was gradually determined that the best blue agave is grown in and around Tequila, a town near Guadalajara, the capital of the western Mexican state of Jalisco. This high-quality blue agave grows at an altitude of 1,500 to over 2,000 metres and takes eight to ten years to ripen and be ready for harvesting.

The Spanish influence was not over. The Spanish government, in 1785, banned Mexican liquors to protect the home industry but ten years later recognised that this prohibition was unenforceable and granted a number of families the right to make Tequila. One of these licenses, for example, was extended to José María Guadalupe Cuervo, which was to become and still is the leading Tequila maker. Cenobio Sauza, founded his own distillery in 1873; Tequila Sauza became Cuervo’s great rival.

Chapter 2 Size of market

Tequila has been displaying high volume growth across a broad spectrum of international markets. Between 2002 and 2006, Tequila displayed average annual volume growth of xxx% to reach xxxxm nine-litre cases, according to The IWSR. This represents an increase of around 5m cases over the period. Preliminary indications are that this growth actually accelerated in 2007.

Table 1: Global Tequila consumption, 2002, 2005-2013 ('000s nine-litre cases)

2002	2005	2006	2007	2008
xxxxxxxxx	xxxxxxxxx	xxxxxxxxx	xxxxxxxxx	xxxxxxxxx

2009	2010	2011	2012	2013
xxxxxxxxx	xxxxxxxxx	xxxxxxxxx	xxxxxxxxx	xxxxxxxxx

Source: The IWSR, *just-drinks*

That growth has been impressively broad-based. Some xx out of the top xx global Tequila markets (including travel retail) posted gains over the five-year (2002-2006) period.

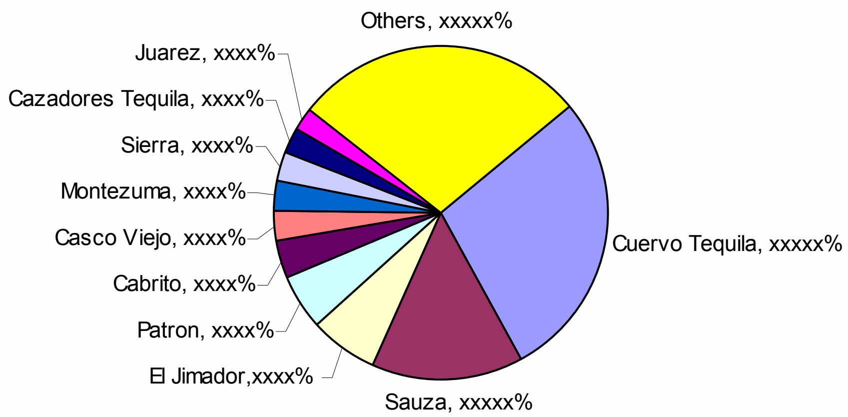
While the potential for international development is vast, the volume (today around xx%) will remain centred in the US and Mexico for the foreseeable future. The gulf between the US and Mexican markets, at around xxxxm and xm cases, respectively, and the third-largest market Germany, at xxxxxxx cases is vast. *"So while the rest of the world will undoubtedly experience fantastic growth, it's going to be even more exponential in percentage terms. But in volume terms it is still going to be relatively small compared to the US and Mexico for some time,"* says Sauza senior brand director Andy Floor.

Floor adds: *"There are green shoots of growth everywhere: Japan, Russia, Australia. There is some really interesting growth stuff in emerging Asian markets as well – in India and the Philippines. Tequila will benefit as consumers in those markets start to engage with more Western brands."*

Chapter 3 Industry structure

Greater multinational involvement

Figure 1: Global Tequila market by brand, 2006 % share of volume



Source: The IWSR, *just-drinks*

The positive outlook for Tequila has encouraged some industry heavyweights to invest in the category. Beam Global's acquisition of the Sauza brand from Allied Domecq (via Pernod Ricard) in 2005 and Brown-Forman's acquisition of Herradura at the beginning of 2007 were the two biggest splashes, involving the second- and fourth-largest Tequila houses, respectively. Brown-Forman supplemented that Herradura deal by acquiring the remaining portion of the global trademark for the Don Eduardo super-premium Tequila brand from the Orendain family, which it had previously been operating as a joint venture.

With the sale of Herradura, only Jose Cuervo of the leading producers will remain Mexican-owned (it is distributed globally by Diageo). Sauza, the number two producer, is controlled by Fortune Brands.

There have been a number of other smaller but potentially significant deals. In January 2008, Heaven Hill Distilleries, the US's largest independent family-owned spirits supplier, entered into a joint venture with Tierra de Agaves, the Mexican spirits company founded by Francisco Beckmann and sons, former co-owner of Jose Cuervo. The partnership involves joint ownership of the

Chapter 4 Premiumisation trends

The plentiful supply has also encouraged suppliers to move from xx% agave products to xxx%, which is helping to raise quality perceptions. More Tequila suppliers are also putting down larger inventories for ageing – a sign of confidence in the future demand for high-end Tequila.

The greater availability of supply has helped fuel the growing connoisseur market for super-and ultra-premium aged Tequilas in Mexico and the US. According to Sauza senior brand director Andy Floor this is helping to alter consumer perceptions of Tequila. *"The vast majority of people enter the category drinking cheap Tequila as shots at bars and end up with terrible hangovers. But consumers are beginning to realise that it doesn't have to be this way. You can enjoy it in any variety of Tequila drinks – it doesn't have to be just a shot or Margarita.*

"Consumers are also starting to recognise that Tequila embodies many of the quality aspects of other high-end spirits – the variety and ageing of single malt, the demarcated production controls of Champagne, the romantic heritage of Cognac and mixability of rum and vodka. And underlying that, it has real attitude, real personality. That's what really puts Tequila aside from the other categories."

Much of this premiumisation has been led by the success of the Patrón brand in the US. McDonnell explains that the high price is one of the keys to the brand's success. US consumers are in the mood to trade up and there is a greater interest in connoisseur offerings and a willingness to pay more for them. As ever, there is also an element of badge-drinking associated with fashionable high-end brands such as Patrón. *"The price is not a deterrent to purchasing; it's a benefit, quite honestly. For many consumers it makes it more aspirational and attractive: US$xx for a bottle of Patrón is still an affordable luxury."*

According to McDonnell, Patrón's success is also tied into the greater desire on the part of consumers to trial different products. *"Patrón happens to be in the right place at the right time, when people are experimenting. Twenty years ago, people predominantly tended to stick with one brand. Today it's based on*

Chapter 5 Diverse usage

One of the real growth drivers has been Tequila's diversity. In most markets it is consumed as shots. The salt and lime ritual accompanying the shot has certainly been a major element in the brand's popularity – particularly among younger consumers.

Tequila also provides the basis for the Margarita cocktail. Made with Tequila, tangy limes and salt (or not), it's been a favourite for decades. It is today the most popular cocktail in the US, accounting for approximately xx% of all mixed drinks sold in the on-trade, according to the Distilled Spirits Council of the US (DISCUS). As the US cocktail culture emerges other Tequila-based cocktails are also emerging such as the Mexican Mojito (a traditional mojito made with Tequila instead of rum) or the Paloma (grapefruit soda, Hornitos Plata and limes).

Beam Global has taken this increasingly diverse usage into consideration with its re-launch of Sauza Hornitos. In conjunction with that launch, Hornitos has introduced its 'Sip, Shoot and Savor' strategy, in direct response to an evolving category and consumer demand for a Hornitos variant for all consumption occasions. Sip, Shoot, and Savor educates consumers on the diversity of Tequila, where Hornitos Plata is versatile enough for mixed drinks, Hornitos Reposado can be enjoyed as a shot, and can be savoured as you would a Scotch or Cognac.

It is good news for the overall category. The more usage occasions that Tequila can tap into the greater the prospects for overall growth. Sauza's Floor says: *"In the past, consumers engaged with Tequila in a very limited format and very limited way. And now they're starting to realise that Tequila doesn't have to be challenging, doesn't have to be horrible. Consumers are drinking Tequila in a vast, basically increased number of formats and occasions than they ever have before. And it's not just about shots or Margaritas anymore. So people are looking and they're trying different brands, different variants, different styles for different occasions."*

This greater consumer willingness to experiment will be encouraged with enhanced marketing by the Tequila companies. Floor says: *"Tequila has been*

Chapter 6 Inventory issue

Supply restored

A big reason for the acceleration of growth since 2002 has been the restoration of agave supply. Now there is more than enough supply to meet international demand.

Tequila supply, however, could come under pressure in the next couple of years. Last year, the Jalisco government's Rural Development Secretariat has forecast that the supply of agave would plummet by the end of this decade after the present glut works itself out, indicating another Tequila supply crisis looms.

Tequila is distilled from the fermented juices of blue agave plants in Mexico. The high agave prices at the beginning of the decade drove many growers to plant agave and attracted many speculators into the industry. It takes between five and eight years for an agave plant to mature. The heavy plantings in the early 2000s are now mature or maturing. Agave also continues to arrive from outside of the designated growing area – from San Luis Potosi and Zacatecas – which are not part of the authorised agave-growing or Tequila-producing regions – and this has exacerbated the situation.

The present over-supply has led to falling agave prices, from a high of around MXNxx (US$xxxx) per kilo in the late 1990s to around MXNx (US$xxxx) per kilo last year. For some growers, it is simply not worth the cost of harvesting. There have even been instances of farmers burning their agave fields.

Many are returning to traditional cash crops – particularly corn. This is encouraged because demand and prices for corn are rising due to the growth in biofuels such as ethanol. Corn production in Jalisco was up an estimated xx% in 2007. This raises the possibility of future shortages. It is estimated that xxxxx% less agave was planted in 2007 compared to 2006. Agave supply is also being hit this year by disease in the fields, partly due to farmers caring less for the plants after prices dropped.

The leading producers have taken measures to secure their own supply through long-term contracts. Sauza senior brand director Andy Floor says:

Chapter 7 Key markets

Mexico

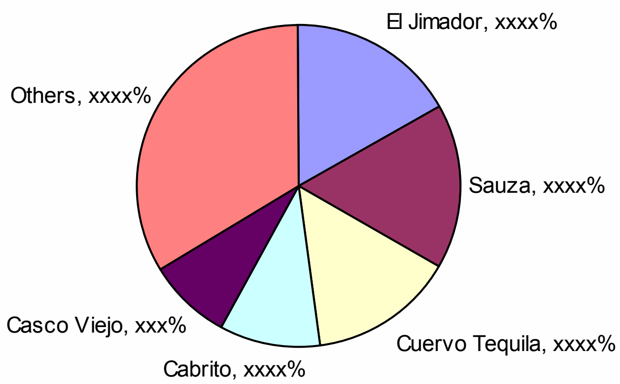
Table 2: Tequila consumption in Mexico, 2002, 2005-2013 ('000s nine-litre cases)

2002	2005	2006	2007	2008
xxxxxxx	xxxxxxxx	xxxxxxxx	xxxxxxxx	xxxxxxxx

2009	2010	2011	2012	2013
xxxxxxxx	xxxxxxxx	xxxxxxxx	xxxxxxxx	xxxxxxxx

Source: The IWSR, *just-drinks*

Figure 2: Mexican Tequila market by brand, 2006 % share of volume



Source: The IWSR, *just-drinks*

Tequila is the largest spirits category in Mexico with approximately a xx% market share, compared to xx% for brandy and xx% for rum in 2006, according to The IWSR. Tequila continues to gain greater acceptance as a premium spirit in Mexico, as it becomes more popular across a broader spectrum of consumers, including women.

Chapter 8 Company profiles

Cuervo (Diageo)

Table 12: Leading markets for Cuervo Tequila, 2006 (consumption '000s nine-litre cases and % share total sales)

Country	Volume 2006	Share of total sales
US	xxxxxxx	xxxx%
Mexico	xxxxxxx	xxxx%
Greece	xxxxx	xxx%
Canada	xxxx	xxx%
Brazil	xxxx	xxx%
Others	xxxxx	xxxx%
Total	**xxxxxxx**	**xxxxx%**

Source: The IWSR, *just-drinks*

Jose Cuervo is the world's leading Tequila marketer with a xxxx% share of the global market (2006), around double that of its nearest competitor Sauza, according to The IWSR estimates.

Diageo holds the distribution rights for the Cuervo brand in the US until 2013. There, Cuervo, which dominates the standard sector, has been under some pressure of late from the growth of the premium-and-above Tequilas. Diageo reported that Jose Cuervo volume in the US decreased x% in the fiscal first half year to December 31 2007. Net sales decreased x% as price increases were implemented.

Jose Cuervo director Bevin Gove concedes that Cuervo has been hit by the increased demand for super- and ultra-premium Tequilas. She explains that the company is fighting back with a number of new super- and ultra-premium Tequila introductions including; Jose Cuervo Platino (a recently introduced ultra-premium silver Tequila), Jose Cuervo Tradicional, Jose Cuervo Black as well as with the xxxx and Gran Centenario Tequila portfolios.