

Sleeman overpriced, analyst says:

Veritas' Peter Holden

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Veritas Investment Research is an independent firm with a habit of telling investors to sell market favourites like Nortel Networks Corp., Bombardier Inc. and Royal Group Technologies Ltd. long before the rest of the Street catches on and the stocks sink.

And now, **Veritas** has put Sleeman Breweries Ltd. in its sights.

Analyst **Peter Holden** calculates that Sleeman (ALE/TSX), which closed yesterday at \$15.23, just shy of its 52-week high, is really worth between \$2.50 and \$4.

Only one of the nine other analysts following the Guelph, Ont.-based brewery recommends selling the stock.

That analyst -- CIBC World Markets' Michael Van Aelst -- has a target price of \$14.50. David Hartley of First Associates Investments is the most bullish, pegging the company at \$18, according to Bloomberg.

Chief executive John Sleeman and the company that bears his name are "caught between the rock of stagnant markets and the hard place of increasing costs," **Mr. Holden** said.

Sleeman controls about 5% to 6% of the domestic beer market, one which has grown little over the past 10 years, the analyst said in a research report. Cumulative growth over the past decade was 1.5%, leaving domestic beer sales hovering around 19.6 million hectolitres a year.

With brewing heavyweights Molson Inc. and Labatt claiming about 90% of the domestic market and imports growing in popularity, **Mr. Holden** said "it seems unlikely that [Sleeman] will break out of the 5% to 6% band in the foreseeable future."

"Just staying in that band will likely entail significant pain for Sleeman," he added.

With market conditions weak, margins need to be strong. But Sleeman's margins don't look attractive to **Mr. Holden**.

A case of Sleeman Honey Brown Lager, for example, now costs about \$36, which is 50% more than so-called value-priced cases of beer at \$24. A case of \$36 beer works out to revenue of \$4.39 per litre, for net revenue after taxes and other costs of \$2.17. Net revenue of a case of \$24 beer works out to about 86 cents of net revenue per litre, which barely covers the costs of goods sold.

The Sleeman Honey Brown net revenue numbers "would be great for business if it wasn't for the damn customers," the analyst said. Customers are opting for imports and "value-priced" beer instead.

Additionally, unit revenue growth has been about 5% a year, but costs per hectolitre have shot up about 7% a year and EBITDA hasn't budged, **Mr. Holden** said. "Shouldn't revenues rise faster than costs?"

The next problem is with Sleeman's cash flow. Sleeman's "aggressive program of stretching accounts payable has been a significant source of cash," he said. Payables were stretched to 90 days in 2003 from 50 days in 2000.

"Obviously, trade creditors do need to be paid at some point. We suspect that Sleeman has reached that point."

Further, the company's free cash flows between 2001 and 2003 averaged negative \$1.7-million, after accounts payable gains and acquisitions are ignored, the analyst calculated.

Free cash flow at Unibroue, the Quebec-based brewer Sleeman acquired in 2004, also left **Mr. Holden** shaking his head. The \$40-million Sleeman paid for Unibroue is about 40 times free cash flow, an unreasonable amount given the flat domestic market, he said. That cash flow might also drop off in the future because Unibroue makes "super-premium" beers that are marketed as beer brewed by Quebecois for Quebecois. Having Unibroue under control of an Ontario-based company may sour some consumers on the product.

At best, Sleeman is fully valued now if -- and only if -- all the "cold winds of change blowing over Molson and Labatt manage to miss Sleeman," **Mr. Holden** said.

But if Sleeman increases its ratio of value-priced beer from 40% of production to 50%, and all other factors remain constant, free cash flow will become negative after five years. If that's the case, the net present value of the five years of positive cash flow is \$2.50 a share.

If the company cranked its value-priced beer production up to 50% and reduced total costs by 1% a year, then Sleeman's net present value is \$3.83, the analyst said.

But if that's the case, why is the stock trading so high?

Market rumours say Mr. Sleeman has been "flogging" the company for \$500-million, **Mr. Holden** said. The analyst has no idea who would pay that price for the brewery, noting other players could build their own brewery at that price. **Mr. Holden** declined to pinpoint where he heard the rumour.