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Fixed Income Analysis

CONSTELLATION BRANDS INCORPORATED

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Company Overview

Constellation Brands (STZ) is an international producer and marketer of beer, wine, and spirits with operations in the U.S., Mexico, New Zealand, and Italy with consumer-connected brands like Corona Extra, Modelo Especial, the Robert Mondavi Brand Family, Kim Crawford, Meiomi, The Prisoner Wine Company, High West, Casa Noble, and Mi CAMPO. In the U.S., Constellation is one of the top growth contributors at retail among beverage alcohol suppliers and is the third-largest beer company in the U.S. and continues to strengthen its leadership position as the #1 high-end beer supplier and the #1 share gainer across the U.S. beer market. Within wine and spirits, Constellation is making solid progress in refining its brand portfolio to shift to a higher-end-focused business to deliver net sales growth. Constellation conducts its business through entities they wholly own as well as through a variety of joint ventures and other entities.

Industry:	Food and Beverage
Bond Name	STZ 5.00% 2026
Credit Rating (Moody's)/Outlook	Baa3/Stable
Maturity	February 2nd, 2026
Issue Size	US$500 Mn
Rank	Sr. Unsecured
Current Price (June 05, 2023)	US$100.12
Yield to Maturity	4.95%
Yield to Worst (@ call on 02/02/2024)	4.80%
Recommendation	**MARKETWEIGHT**

Financial Summary (US$)					
	2019	2020	2021	2022	2023
Revenue	8.12 Bn	8.34 Bn	8.61 Bn	8.82 Bn	9.45 Bn
EBITDA	2.86 Bn	2.60 Bn	3.19 Bn	2.76 Bn	3.34 Bn
Total Assets	29.23 Bn	27.32 Bn	27.10 Bn	25.86 Bn	24.66 Bn
Total Equity	12.84 Bn	12.47 Bn	13.93 Bn	12.05 Bn	8.73 Bn
Financial Ratios					
EBITDA Margin (%)	35.23%	31.12%	37.02%	31.33%	35.32%
Debt/EBITDA	4.76x	4.91x	3.44x	3.96x	3.88x
Interest Coverage	7.54x	6.06x	8.26x	7.75x	8.38x

Executive Summary

The **STZ 5.00% 2026** note gives investors exposure to one of the leading American food and beverage sector players, through the upmarket alcoholic beverages segment. The Company has seen consistent growth in sales over the past five years as it has focused more on its high-end market offerings which also produce greater profit margins. The Company's primary segment is its best-in-class beer portfolio with nearly 40% operating margins. These notes were issued in February 2023 in order to repay existing debt and fund general corporate activities. While Constellation as a company has performed well over the years, these notes do currently trade above par and at a yield just above expectation based on the market pricing relative to its peer group with similar credit metrics. **As a result, we've assigned a MARKETWEIGHT recommendation to these notes.**

STZ Credit Rating

Rating Summary: On January 30th, 2023, Moody's assigned a **'Baa3'** rating to the senior unsecured notes offered by Constellation Brands, Inc. The proceeds will be used for general corporate purposes including repaying a portion of the delayed draw term loan due in 2025 (unrated) that was utilized to help fund the $1.5 billion consideration related to the conversion of the super-voting Class B common stock to Class A common stock. The Company's Baa3 senior unsecured ratings and stable rating outlook are not affected because the refinancing is leverage neutral and extends the maturity of a portion of its debt. The buyout related to the stock conversion was leveraging, although Moody's expects that Constellation will reduce total debt over the next two years. The Company also favourably reduced its leverage target after the conversion announcement.

Ratings Rational:

Constellation's Baa3 ratings reflect the meaningful scale, good product diversification, and Moody's expectation for strong organic growth. Constellation's products include an extensive portfolio of premium wine, spirits, and imported beers, all in segments that are growing faster than their broader categories. Constellation is the third-largest beer company in the United States and the largest imported beer company in the country. Moody's expects Constellation's portfolio of premium imported Mexican beers will continue to grow faster organically than the overall US beer market. Following the divesture of certain wine assets, Moody's expects the premium wine and spirits business to see better than industry average growth as well. Constellation's credit profile reflects its franchise strength and diversity with a presence in all three alcohol categories, as well as its strong cash flow and solid profitability. These strengths are balanced by its track record of debt-financed acquisitions, commitment to return significant cash to shareholders and large capital spending requirements resulting from its growing Mexican beer business. There is also some geographic and category concentration risk.

Factors That Could Lead to an Upgrade or Downgrade of the Rating:

The stable outlook reflects the Company's strong profitability, good liquidity, and Moody's expectation that it will deleverage to around or below its updated target of 3.0x net debt/EBITDA (based on the Company's calculation) over the next 12-18 months. Debt to EBITDA was elevated to the 3.5x to 4.0x range following the $1.5 billion cost of converting super-voting B shares to common stock. Moody's expects that Constellation's alcoholic beverage portfolio will continue to experience positive operating momentum driven by its premium brands and favourable category trends and that sizeable, planned share buybacks would be reduced in the event of operating difficulty or leveraged acquisitions.

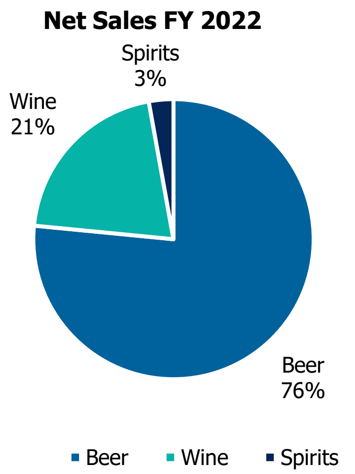
An **upgrade** could occur if the Company sustains strong operating profit growth, stable or improving financial metrics and demonstrates conservative financial policies. While greater geographic diversity would be difficult to achieve in its beer business, profitable diversification that helps to reduce the Company's reliance on Mexican beer could also support an upgrade. Absent significantly greater scale and diversity, an upgrade would require debt/EBITDA approaching 3x.

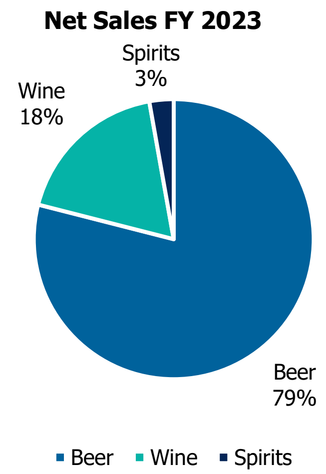
A **downgrade** could occur if operating performance or liquidity weakens, EBITDA margins are sustained below 20%, or debt/EBITDA is sustained above 4x. In addition, supply issues related to the brewery capacity in Mexico, or further large debt-financed acquisitions or shareholder returns could also lead to a downgrade.

Business Overview

Constellation's business is segmented as follows:

- **Beer**
- **Wine**
- **Corporate Operations and Othe**r
- **Canopy**





Beer

Constellation is the #1 brewer and seller of imported beer in the U.S. market and is the leader in the high-end segment of the U.S. beer market, which includes the imported, craft, and ABA categories. Constellation has the exclusive right to import, market, and sell the following Mexican brands in all 50 states of the U.S. Its Brands in the segment include:

- Corona Brand Family
- Modelo Brand Family
- Victoria Brand Family
- Pacifico Brand Family

Notable achievements in the U.S. in the segment include the following:

(i) Constellation has nine of the 15 top-selling imported beer brands,
(ii) Modelo Especial is the best-selling imported beer and second best-selling beer overall,
(iii) Corona Extra is the second-largest imported beer and fourth best-selling beer overall, and
(iv) Pacifico is the fastest-growing major beer brand.

Wine and Spirits

Constellation is a leading, higher-end wine and spirits company in the U.S. market, with a portfolio that includes higher-margin, higher-growth wine and spirits brands. The wine portfolio is supported by grapes purchased from independent growers, primarily in the U.S. and New Zealand, and vineyard holdings in the U.S., New Zealand, and Italy. Constellation's wine and spirits are primarily marketed in the U.S. and sold in Canada, New Zealand, and other major world markets. In the U.S. Constellation has seven of the 100 top-selling higher-end wine brands, with Meiomi and Kim Crawford achieving the fourth and eighth spots, respectively. Its portfolio of wine and spirits brands include:

- Wine Brands – Cook's California Champagne, Mount Veeder, Kim Crawford, Ruffino, Meiomi and SIMI
- Wine Portfolio of Brands – My Favorite Neighbor, Robert Mondavi Winery, Schrader and The Prisoner Wine Company
- Spirits Brands – Casa Noble, Mi CAMPO, Copper & Kings, Nelson's Green Brier, High West and SVEDKA

Corporate Operations and Other

The Corporate Operations and Other segment includes traditional corporate-related items including costs of executive management, corporate development, corporate finance, corporate growth and strategy, human resources, internal audit, investor relations, IT, legal, and public relations, as well as investments made through Constellation's corporate venture capital function.

Canopy Segment

In 2017, Constellation acquired a 35.7% stake in Canadian company, Canopy Growth, which was later consolidated into another US-based entity called Canopy USA. Canopy Growth Corporation was a Canada-based cannabis and consumer packaged goods (CPG) company. The principal activities of the Company are the production, distribution and sale of a diverse range of cannabis and cannabinoid-based products for both adult use and medical purposes. The creation of Canopy USA will help it reduce costs and tap into the U.S. market, which is projected to be more than $50 billion by 2026. Following the news, Constellation expressed the intention to convert its existing common shares in Canopy into new exchangeable shares, which it said will protect shareholder value while retaining its interest in Canopy through non-voting and non-participating shares. Constellation has essentially positioned itself to exercise influence, but not control in Canopy, with its financial results accounted for under the equity method.

Industry Analysis

US Food, Beverage and Tobacco Industry Outlook[1]

The outlook for fast-moving consumer goods (FMCG) and restaurant companies is neutral, with the outlook for consumer products, agribusiness and protein subsectors deteriorating. Most FMCG and US restaurant companies have had stronger operating positions since the pandemic started and sufficient rating headroom, which should help them face external pressures, such as moderating consumer spending driven by changes in savings, employment and real wages. Fitch expects sales growth to moderate after high inflationary pricing and demand recovery in 2022 particularly for sectors that were more negatively affected within the away-from-home channels. However, issuers can leverage their brands, breadth of portfolios and diverse channels combined with cost initiatives to help support stable EBITDA and leverage in 2023. The deteriorating outlook for agribusiness and protein reflects Fitch's expectation that EBITDA could moderate in 2023 following cyclical peak levels in 2022 but remain above mid-cycle levels.

Global Grains, Oils and meals[2]

The grains price index is expected to fall by 10% in 2023 and a further 8% in 2024, following a 21% increase in 2022. The oils and meals price index is expected to decline by 14% in 2023 and 2% in 2024. The forecast assumes that there are no further disruptions from the war in Ukraine, while goods harvests in major grain-producing countries—such as Australia, Canada, Russia, and the United States—contribute to lower prices.

In 2023, wheat prices are expected to be 17% lower and maize prices 15% lower than in 2022, amid weak global demand (excluding China, which may see a pickup in demand for maize in animal feed). At the same time, falling crude oil prices should reduce demand for maize in ethanol production. Brazil is set for a record-breaking grain harvest in 2023 as a result of favourable weather. Similarly, better-than-expected grain harvests in Australia, Canada, Kazakhstan, and Russia in the 2022 production season are likely to lead to higher stock-to-use ratios for 2023. In addition, planting intention surveys from the United States indicate sizable increases in maize and wheat acreage, which may put additional downward pressure on 2023 prices.

Overall, a neutral expectation for fast-moving consumer goods, which includes beverages and spirits, in the United States, combined with expectations for softening input prices, such as grain and meal for alcohol production, bodes well for maintenance and improvement in the operating results of Constellation brands through 2023 and 2024.

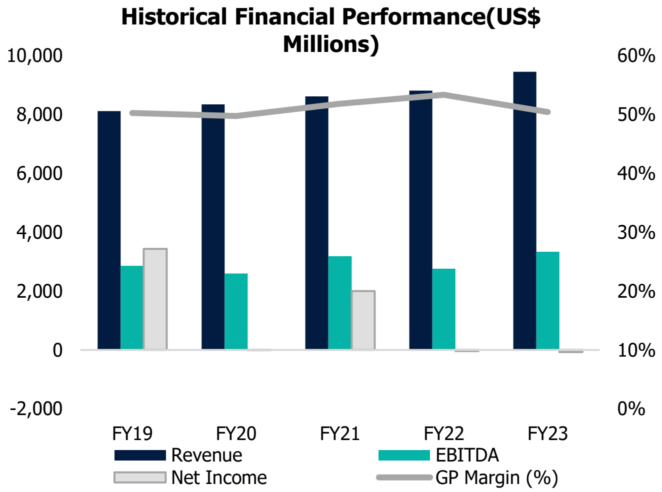
[1] Fitch – US and EMEA Food, Beverage, Tobacco and Consumer Outlook 2023
[2] World Bank – Commodity Markets Outlook, April 2023

Financial Performance

All items are in US$ unless otherwise stated.

Financial year ended February 28, 2023

The Company reported revenues of $9.45 billion for the financial year ended February 28, 2023 (FY 2023), representing a 7.16% increase year-over-year (YoY). The growth in revenue was attributable to an 11% increase in beer segment sales to $7.47 billion, which offset a 5% decline in wine segment sales to $1.72 billion. Growth in beer sales was largely due to growth within the Mexican beer portfolio. The cost of goods sold grew 13.86% to $4.68 billion as a result of higher materials costs, including aluminum, glass, malt, cartons, lumber, corn, and steel, driven by inflation and supply chain constraints. As a result, gross profit remained fairly flat YoY at $4.77 billion, compared to $4.71 billion in FY 2022. Invariably, with the cost of sales increasing at a faster pace than revenue, the gross profit margin decreased to 50.5% for FY 2023 compared with 53.4% for FY 2022.



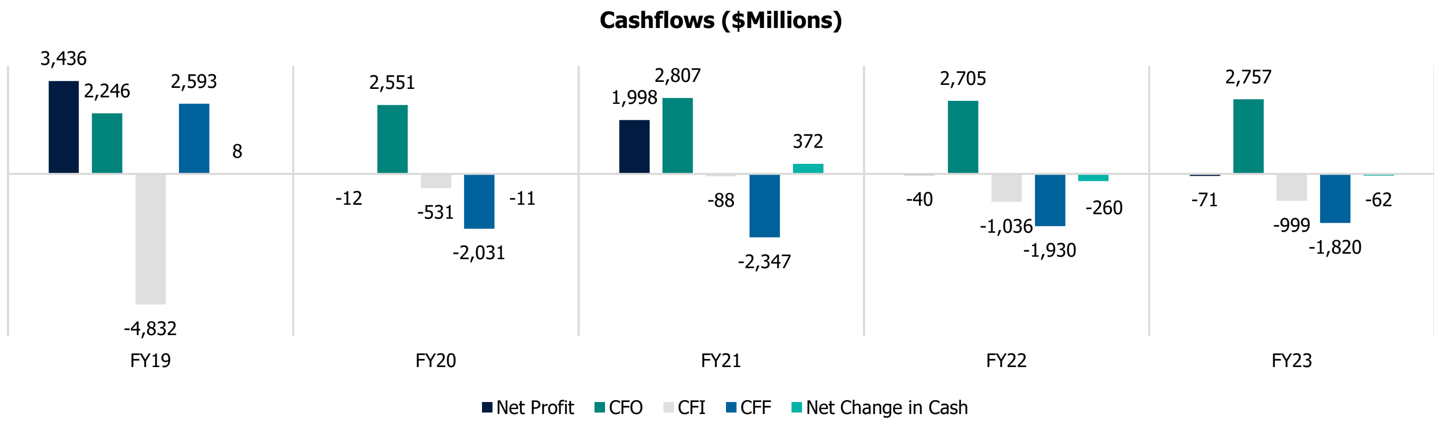
Selling, General and Administrative expenses grew 12.66% during the year to $1.93 billion, largely resulting from an 11% increase of these expenses in the beer segment due to $54.7 million of higher marketing spend and $47.8 million of increased general and administrative expenses. The higher marketing spend was driven by increased sports-related partnerships and planned investments to support the growth of the Mexican beer portfolio, while the increase in general and administrative expenses was driven by increased compensation and benefits related to the Mexican beer portfolio. Selling, general, and administrative expenses as a percentage of net sales increased to 20.4% for FY 2023 as compared with 19.4% for FY 2022.

Consequently, operating income grew 21.92% to $2.84 billion, on the back of a 6% increase in beer segment operating income to $2.86 billion. Beer segment operating income offset operating losses in the wine and spirits segment of $17.6 million and losses in the corporate operations segment of $39.4 million. The increase in Beer operating income was largely attributable to the favourable pricing impact, and strong shipment volume growth within the Mexican beer portfolio. The decrease in Wine and Spirits' operating income was primarily due to the decline in branded wine and spirits shipment volume and the 2022 divestitures of various wine brands. The increase in operating loss for the "corporate operations and other" segment is largely due to FY 2023 Digital Business Acceleration investments and increased compensation and benefits.

The Company booked a loss from unconsolidated investments of $2.04 billion, a 24.51% higher loss than recorded in FY 2022. This loss is associated with its investment in Canopy and is composed of an impairment of the Canopy equity method investment, an unrealized loss in the fair value of shares held in Canopy and a share of losses from Canopy's results. The impairment of $1.06 billion is the result of the Canopy equity method investment, with the carrying value of $1.70 billion being written down to its estimated fair value of $634.8 million following the determination that this impairment was non-temporary as a result of the following factors: the period of time for which the fair value had been less than the carrying value and the uncertainty surrounding Canopy's stock price recovering in the near-term; Canopy recording a significant impairment of goodwill related to its cannabis operations during its three months ended June 30, 2022; and the uncertainty of U.S. federal cannabis permissibility. Additionally, $45.9 million was recorded for fair value losses on stock held in Canopy, while a $949.3 million loss was attributed to Constellation's equity in losses from Canopy's results.

EBITDA grew 20.82% to $3.34 billion compared to $2.76 billion in FY 2022 in line with greater operating profits, while the EBITDA margin grew to 35.32% at the end of FY 2023 compared to 31.33% for FY 2022. As a result of growth in EBITDA, major debt servicing metrics such as Interest coverage and Total Debt to EBITDA improved in the 2023 financial year. The interest coverage ratio grew to 8.38x from 7.75x in FY 2022, while total debt to EBITDA improved to 4.53x from 4.67x at the end of FY 2022. Interest expense increased by $42.3 million to $398.7 million in FY 2023, driven by higher average borrowings of approximately $775 million and approximately 20 basis points of higher weighted average interest rates. The provision for income taxes increased to $422.1 million for FY 2023 from $309.4 million for FY 2022. As a result, the Net loss attributable to shareholders increased to $71.0 million for FY 2023 compared to a net loss of $40.4 million in FY 2022.

Cash Flows



Cash provided by operating activities

Cash flow provided by operating activities was $2.76 billion for the year ended February 28, 2023, a 1.90% increase from the $2.71 billion in cash provided by operating activities in FY 2022. Cash Flow from operating activities are significantly higher than the net loss of $71.0 million made in FY 2023 as a result of the impact of the Canopy investment on Net Income. The loss from unconsolidated investments of $2.04 billion, included in net income, consists of the $1.06 billion impairment of the Canopy Equity Method Investment and an additional $971.8 million equity in the losses made by Canopy in the period. These non-cash adjustments, related to Canopy, account for most of the discrepancy between net income and cash flow provided by operations.

Cash used in investing activities

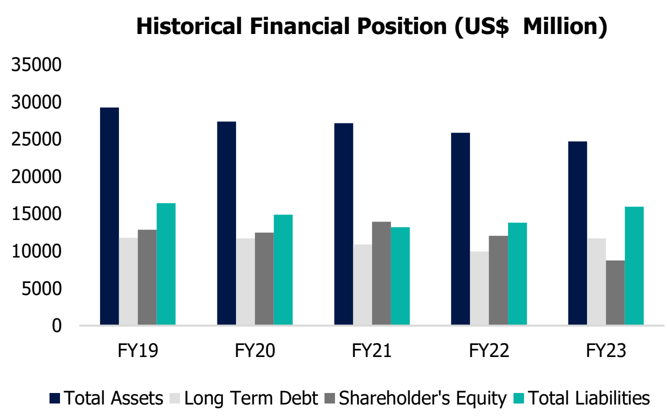
Net cash used in investing activities for FY 2023 decreased to $999.4 million from $1.04 billion in FY 2022. This decrease of $36.4 million was primarily due to $92.1 million of higher proceeds from the sale of businesses, driven by the October 2022 Wine Divestiture, and $16.4 million less cash used in business acquisitions, partially offset by $74.4 million from the sale of an investment made through our corporate venture capital function in Fiscal 2022.

Cash used in financing activities

Cash flow used in financing activities was $1.82 billion for FY 2023, compared to $1.93 billion cash used in 2022. Proceed from the issuance of debt amounting to 2.0 billion offset $1.5 billion in cash used to repay class B convertible stockholders which were eliminated in November 2022 pursuant to a reclassification.

Financial Position, Liquidity and Solvency

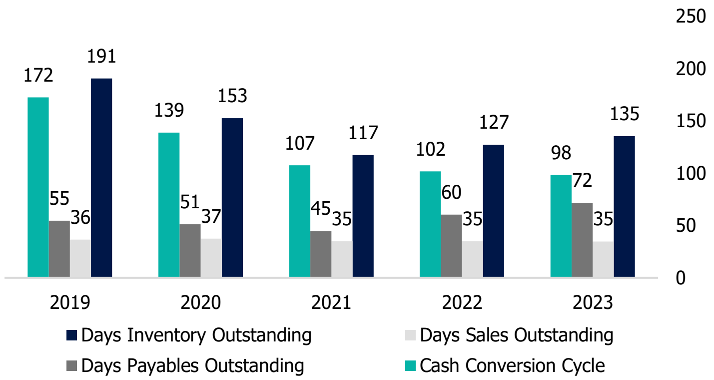
At the end of February 2023, the Company had total assets amounting to $24.66 billion, funded by total liabilities of $15.93 billion and shareholder's equity of $8.73 billion. Total assets fell 4.62% YoY as a result of a 75.33% decrease in the carrying value of its equity method investment in Canopy from $2.69 billion to $663.3 million. Liabilities grew 15.36% as a result of an 18.95% increase in long-term debt to $11.29 billion. Shareholder's equity fell 27.51% due to a 14.90% drop in retained earnings to $12.34 billion and a 40.56% increase in Treasury stock to $5.86 billion.



Liquidity, as measured by the current ratio, had worsened in FY 2023, with an outturn of 1.18x, compared to the 2022 year-end result of 1.23x, mainly due to faster growth in current liabilities relative to the overall growth in current assets driven by an increase in short term borrowings to $1.17 billion. Constellation historically does not keep large cash balances, instead, the Company draws down on its available line of credit or raises new debt to finance short-term liquidity needs. As a result, the Company's cash ratio has remained at a very low level of 0.05x at the end of FY 2023, down from 0.07x at the end of FY 2022.

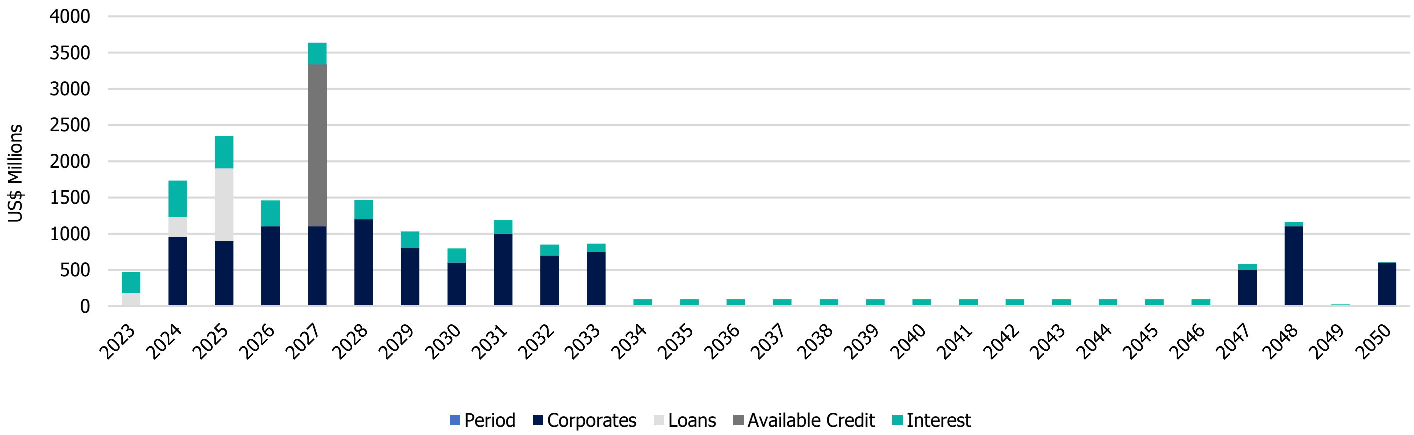
The company saw an improvement in the cash conversion cycle from 102 days in FY 2022 to 98 days as at February 28, 2023, due to a slowing in the pace of inventory turnover. At the end of FY 2023 Constellation's days' sales outstanding stood at 35 days, in line with the end of FY 2022. The days of outstanding inventory were slightly worse at 135 days compared to 127 days in FY 2022. The days of accounts payable outstanding increased to 72 days from 60 days, suggesting payables are being settled in a longer time frame.

Cash Conversion Cycle (Days)



The company's interest coverage ratio has increased from 7.75x to 8.38x, largely due to EBITDA growing at a greater rate of 20.82% YoY than the increase in interest expense of 11.87%. Interest expense grew due to additional debt issued during the year. As shown by the debt distribution schedule, the company has principal payments due in most years leading to 2033. The immediate notes due in 2024 and 2025 can be covered by current assets and Constellation's access to a $2.7 billion line of credit maturing in 2027, while the Company's credit metrics support the ability to refinance through issuing new notes.

Debt Distribution Schedule; Future Loans and Principal (Corporates) Payments Due



STZ CREDIT METRICS					
Credit Metrics	**FY 2019**	**FY 2020**	**FY 2021**	**FY 2022**	**FY 2023**
US$ Millions	**3/31/2019**	**3/31/2020**	**3/31/2021**	**3/31/2022**	**3/31/2023**
Total Debt	13,616.50	12,744.80	10,982.20	10,954.20	12,960.10
Short-Term Debt	1,856.70	1,050.40	98.00	1,008.70	1,256.20
Long Term Debt	11,759.80	11,694.40	10,884.20	9,945.50	11,703.90
Total Debt/Equity	106.07%	102.17%	78.84%	90.92%	148.39%
Total Debt/Capital	51.47%	50.54%	44.09%	47.62%	59.74%
Total Debt/Total Assets	46.58%	46.64%	40.52%	42.37%	52.55%
Interest Expense	379.1	428.7	385.7	356.4	398.7
Interest Coverage	7.54x	6.06x	8.27x	7.75x	8.38x

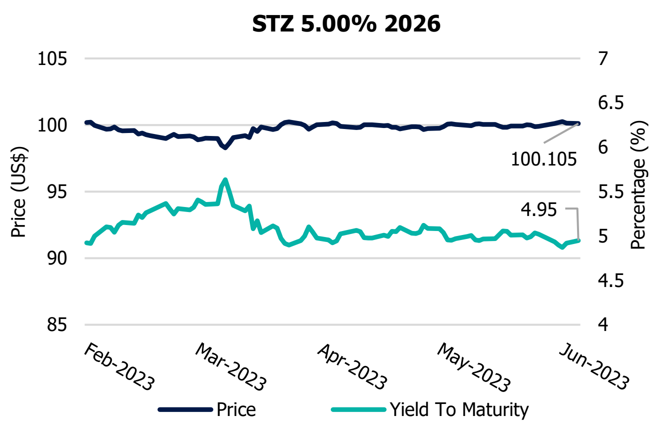
Relative Valuation and Spread Analysis

In evaluating a bond, its spread to certain benchmarks can be compared to historical or typical values. The spread of the bond is the difference between its yield and the yield of the benchmark. There are three main yield spreads evaluated, the G-Spread, I-Spread and Z-Spread.

The G-spread is the spread to the yield of US treasuries; in this case, it is the difference in yield between this bond and a US government bond maturing in May 2024.

The I-Spread is the bond's spread over the benchmark USD Secured Overnight Financing Rate (SOFR) Curve. The SOFR curve has replaced the London Interbank Overnight Rate (LIBOR) as the benchmark for pricing derivatives such as swaps. A swap is an agreement where one party receives a stream of interest payments in exchange for paying a different stream of interest payments to the other.

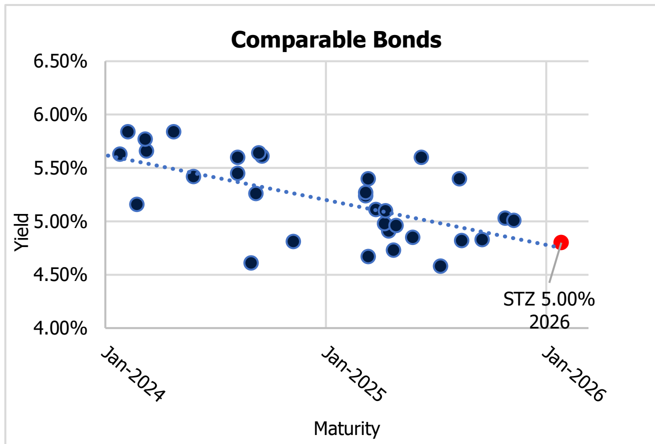
The Z-Spread is the bond's spread over the entire US zero coupon treasury yield curve; it is the amount basis points above the treasury curve that is needed to discount the bond's future cash flows to its current market price. Generally, tighter spreads, indicate less risk as investors are pricing the bond closer to the benchmark (risk-free rates).



STZ 5.00% 2026:
This bond is trading at a G-Spread, I-Spread and Z-spread of -58 bps, -44 bps and -53 bps respectively. These measures are all below their 4-month averages indicating a tightening of the spreads to the benchmarks in that time. Narrower spreads suggest that investors demand a yield relatively closer to the benchmark, implying that the bond has become much more favorable in the open market. However, this may be more indicative of the movement in the yield on the benchmark than the STZ note as Bloomberg benchmarks the note against a one-year US treasury note. When compared to the benchmark US three-year treasury note, the spread comes in at 72 basis points.

	Spread	Low	Range	High	Avg	+/- bps
1) Spreads to Curves (RV)			◆ Avg ● Now			
2) Spread-Bench	31	28		150	104	-73
3) G-Spread	-58	-69		148	79	-137
4) I-Spread	-44	-54		170	86	-130
5) Z-Spread	-53	-64		166	81	-134

The bond has a liquidity score of 90 (100 being the most liquid) relative to its sector which has a median liquidity score of 50, likely due to heightened trading activity following the recent issuance of these notes. This bond has a short duration of 2.5 years which exposes investors to less interest rate risk.



Compared to a selection of corporate bonds from other food and beverage manufacturers with similar credit ratings, the STZ 5.00% 2026 bond trades just above the expected yield of 4.75% based on the line of best fit derived from the yields of the peer group. As such, when taking into consideration the key driving factors affecting the outlook of the company, the bonds are effectively fairly priced at a yield of 4.80%

Recommendation
Despite the overall loss made, on an unadjusted basis, in FY 2023, STZ has overperformed despite inflationary issues and tighter economic conditions as is seen by earnings beats in three of its prior four quarters. Prospects do appear to be better for company performance into 2023 as commodity prices are projected to continue to fall as evidenced by consensus estimates of higher adjusted net income for FY 2024. The prospects for improved company performance seem to be reflected in the STZ 5.00% 2026 notes, with the bonds trading at a higher price than the issue price earlier this year. Given the pricing relative to its peer group, we have the opinion that these notes are approximately fairly priced at current levels and offer minimal upside relative to other instruments issued by corporations with similar creditworthiness. At issue in February this year, the bond represented a spread over the US 3-year treasury of 110 basis points; this has narrowed to 72 basis points since. Additionally, the ICE BofA BBB US corporate spread over US treasuries is 173-bps, much higher than the 72-bps spread of these notes are lower than would be expected based solely on its rating (note that it is important to take into account industry-specific and other factors in assessing the relative pricing). On balance, we recommend that investors **MARKETWEIGHT** the STZ 5.00% 2026 bonds in their portfolio.

Definitions:
Sell = REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO
UNDERWEIGHT = REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 5% FOR THIS PARTICULAR ASSET
MARKETWEIGHT/HOLD = EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO
OVERWEIGHT/BUY = EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO