

# Separating fact from fiction in today's winery market

Recently, the news media has focused on the troubles facing the wine industry as a result of the current economic recession. The outside world's perception is that the wine industry is about to be inundated by a wave of despair in the form of bankruptcies, short sales and foreclosures. As we know, perception does not always match reality. As such, it is important to separate perception from reality in assessing the current market environment for winery transactions.

**Market realities.** The wine industry is navigating through incredibly challenging economic times. Gone are the days of wine club waiting lists and retailer allocations for \$100-plus bottles of wine. Wineries that specialize in such luxury priced wines are being forced to incorporate creative marketing solutions in order to adjust to this new market reality. At the same time, wineries producing at retail price points in the range of \$25 per bottle and below are thriving as a result of the consumer trading down to lower price points in search of value. While some bankruptcy reorganizations and foreclosures will occur, the magnitude of wineries succumbing to such dire consequences has been grossly overstated.

**Current transactional environment.** Although the number of recent winery transactions has been few and far between, beneath the surface there are signs of mounting activity. This buildup in activity is attributable to growing interest from buyers in three categories of winery assets: marquee wine brands, winery assets that have a significant cash flow component and winery assets that will ultimately trade at a discounted value because they lack meaningful cash flow.

**Marquee wine brands.** A marquee wine brand that is strongly identified with a particular varietal category (e.g., cabernet sauvignon or zinfandel), retail price point and quality – even if it is struggling with interim lapses in financial performance – continues to attract interest among strategic purchasers. In relation to other winery assets, the “brand equity” of marquee wine brands has a greater resiliency to economic down cycles. As a result, marquee wine brands are

better able to preserve their value and marketability during market downturns.

**Winery assets with positive cash flow.** A winery investment that has a significant cash flow

component will always have a buyer where the purchase price is based on a required return on investment.

The strength of a winery's cash flow can be gauged by analyzing its earnings before interest, taxes, depreciation and amortization (EBITDA). Common ways to value the stream of cash flow include

applying a multiple to EBITDA or performing a discounted cash flow analysis. In the current environment, negotiant brands and custom winery service providers are examples of business models that typically fall within this category of winery assets.

**Winery assets trading at a discount.** The third area in which market activity is building up is where assets will be sold at a discount in order to compensate for their inability to cash flow or demonstrate strong brand equity. The one factor that is helping to mitigate this undercurrent is where the winery asset has a strong aesthetic appeal to lifestyle purchasers. However, assets that require more hands-on business responsibility are less appealing to a lifestyle purchaser.

**What is prompting market activity?** There are three factors that are creating a buildup in market activity: wineries that are experiencing severe financial stress, wineries that have a vacuum in core management necessary to navigate the present landscape and wineries that are experiencing “owner fatigue.”

**Wineries experiencing financial stress.** Those wineries that are experiencing financial stress are primarily challenged with being under-capitalized and over-burdened with debt service obligations. The best tonic for these wineries is an infusion of equity – not additional debt. However, raising equity capital in the current environment is extremely difficult, particularly if a winery is seeking a minority interest infusion of equity capital. There are a few wine industry specialists who are focused on assisting wineries confronting these challenges, but a winery's cash flow limitations may prove to be an insurmount-

able barrier to closing a transaction.

**Wineries lacking core management.** In difficult economic times, proficient management becomes an even more valuable and rare commodity. Some wineries are having difficulty because they lack a management team that can effectively deal with current economic problems. These wineries typically have some component of financial stress or negative sales trends that are compounded by a vacuum in key managerial positions, such as sales and marketing or financial management.

**Wineries experiencing “owner fatigue.”** In part, “owner fatigue” is the result of not having a viable succession plan in place. We have encountered a few instances where owners, who perform key management roles due to financial necessity, lack the drive, energy and stamina necessary to prevail through the downward cycle of this economy. Consequently, these winery owners are seeking a transaction despite the fact that today's environment may not be an optimal time to sell their business.

**What to expect for the balance of 2010.** While we believe that the current market environment has created opportunities for buyers, we do not subscribe to the despair prophesized and fueled by the perceptions of outsiders.

With that said, the winery transaction environment will continue to pose challenges for sellers with weak brands and unprofitable business models. We anticipate the volume of transactions will increase in the second half of 2010 as the expectation gap between buyers and sellers continues to shrink.

The industry should expect to see a few significant brand transactions close in 2010 at attractive prices in spite of current economic forces, which should provide momentum for more transaction activity in 2011.

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Zepponi & Company is the leading provider of mergers & acquisitions, valuation and transactional advisory services to the wine industry. Headquartered in Sonoma County, Zepponi & Company focuses exclusively on winery and vineyard transactions globally.



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