

Cash flow analysis benefits successful brands

(Second of two parts)

Our previous article explored the asset valuation method as a means for determining a brand's value. This article focuses on the cash-flow analysis method as a tool for measuring a brand's value based on its operating performance and future income potential.

The asset valuation method places emphasis on the value of a brand's tangible assets, which consist mainly of its cased goods and bulk wine. The cash-flow analysis method incorporates two commonly used valuation techniques: the income approach and the market approach.

Cash-flow analysis attempts to translate current and future prospective cash flows into a current value for the brand, using "discount rates" (income approach) and "market multiples" (market approach).

Successful wine brands tend to benefit from the cash flow analysis method, as the resulting value generally exceeds the sum of its components under the asset valuation approach. Cased goods and bulk wine inventories are a source of potential income in the short term, but contribute little toward the staying power of a brand.

It is the "intangible assets" – brand uniqueness, established sales channels, direct sales, wine club memberships and the capacity to maintain a high level of wine quality – that contribute to a brand's perceived value on a "going concern" basis. This is the underlying premise behind a cash flow analysis valuation.

However, before using the cash flow valuation method for valuing a brand, the winery's financial statements should be reviewed and, where appropriate, restated in order to provide an accurate representation of the true financial performance of the brand.

Regardless of the financial metric used to value a brand, certain financial statement adjustments may be necessary or appropriate. In general, the types of adjustments most commonly applied in a winery brand valuation fall into the categories shown in the chart below.

The ultimate goal of adjusting the financial statements is to present a financial picture that best depicts the normal operating performance of a brand in adherence to wine industry standards. Once the income stream of the brand

has been adjusted, as described above, the cash flow valuation method can be applied to the brand using the income and market approaches.

The income approach relies on the economic principle of present value – that an asset's worth is equal to the expected future benefits of ownership discounted to reflect the time value of money and the risk associated with the investment opportunity. By definition, present value requires two main assumptions: an income stream and an appropriate discount rate.

As discussed above, the income stream should be adjusted (via any appropriate adjustments to the financial statements) to reflect the true financial performance of the brand. Typically, the income stream is projected out for three to five years. Anticipated returns beyond this time period should be aggregated by estimating cash-out value – that is, the present value of future cash flows beyond the projected time period – and discounting this amount to present value terms.

The exact discount rate applied under the income approach is a subjective matter. The applicable discount rate depends largely on required rates of return for similar investments and risks associated with the cash flows of the brand.

The benefit of using the income approach is that it takes into consideration the future earnings growth of the brand and allows for flexibility to perform scenario analysis by adjusting the income stream and discount rate. The drawback of the income approach is that it relies heavily on estimated financial projections and is sensitive to changes in assumptions, such as the discount rate and growth rates.

While heavy emphasis is often given to the income approach, actual market transaction data often provides persuasive empirical evidence of value.

This information is the basis of the market approach.

Similar to looking at market comparisons when valuing real estate, the market approach uses comparable wine industry transactions to determine brand value.

The process of quantifying value under the market approach involves calculating a value multiple, such as price-to-revenue or price-

to-EBITDA (earnings before interest, taxes, depreciation and amortization). These value multipliers are then adjusted and applied to the subject brand's revenue or EBITDA to reach an estimate of value.

Valuation multipliers can also be applied to

other financial statement metrics such as gross margin, EBIT (earnings before interest and taxes) and net income.

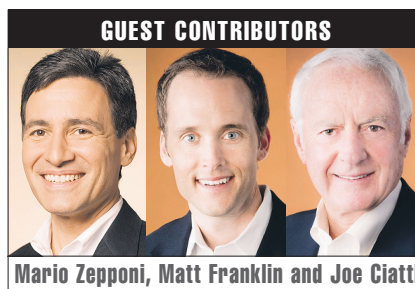
One of the biggest hurdles faced when using the market approach is finding sufficient market data that is relevant for comparative purposes. A significant amount of winery transactions occur between privately held companies, which means detailed financial statement data may be unavailable or unreliable.

Often, reported transactions do not accurately reflect financial information and valuation considerations. Additionally, market conditions surrounding older transactions may not be appropriate for comparison in the current economic environment.

Unlike the asset valuation method discussed in our previous article, the cash flow analysis method provides a better framework for assessing value for brands with strong cash flows and recognizable franchises because it captures both the tangible and intangible components of a brand.

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Type of Adjustment

- Accounting adjustments
- Non-recurring / extraordinary events
- Owner-related adjustments
- Non-brand or unrelated items

Example

- Use of LIFO for inventory costing
- Abnormal bulk wine losses
- Excessive owner compensation
- Income from investment securities

