

FOCUS: VINEYARD MANAGEMENT

Wine Industry

Will rebound by consumers alter wine M&A landscape?

Anticipated rebound in wine consumer, acquisition spending could expand pool of M&A buyers in 2011

GUEST CONTRIBUTORS

MARIO ZEPPONI, MATT FRANKLIN AND CODY JENNINGS



There are indicators that our economy is crawling out of its deep recession. Employment data is getting incrementally better, corporate profitability is on the rise, merger and acquisition activity is increasing on Wall Street and there are rumors abounding that 2011 wine sales are off to the strongest start that many wineries have seen in years. If this market trend continues, it will be a sign of good things to come in the wine industry's merger and acquisition marketplace.

There is much anticipation within both the wine industry and greater financial markets that 2011 will see a noticeable increase in dollars being spent both at the consumer level and in acquisition activity. In anticipation of such activity, it is appropriate to explore the widely varying motivations, expectations and investment time horizons of the five groups of historically active acquirers in the wine industry:

1. publicly traded beverage and consumer companies;
2. privately owned wine companies;

3. private-equity firms;
4. financial investors; and
5. lifestyle purchasers.

The economic woes of the past few years have shifted the dynamics of the merger and acquisition marketplace. In the absence of a traditionally strong presence from publicly traded beverage companies, privately owned wine companies have become the focus of buy-side activity for standalone brands as well as wineries. Additionally, savvy financial investors and private-equity companies remain active in their pursuit for cash-flow-positive investments in the wine industry, although to varying degrees of success.

If 2011 brings increased acquisitions in the industry, it is likely that we will see the return of two noticeably absent buyer types: the lifestyle investor and the publicly traded beverage company.

Publicly traded companies

Since 2008, there has been a noticeable absence of winery acquisitions by publicly traded beverage and consumer companies. This absence is not by coincidence. Publicly traded companies have had to engage in a wholesale analysis of the profitability of each of their consumer divisions during this economic downturn. In particular, there is greater pressure to shift attention to products that have higher gross margins and profitability, in some cases at the expense of marginally producing brands and products.

Wine brands and investments typically fall into the "marginally producing" category because:

1. they are asset intensive and, as a result, tie up working capital,
2. require building inventory sometimes for two or three years before being able to sell the product, and
3. their profit margins typically do not fare well in comparison to the profit margins of other beverage products, such as distilled spirits and sports drinks.

In contrast to the consolidation frenzy that has gradually reshaped the wine industry over the past two decades, the profile of publicly-traded beverage companies as of late has come to resemble that of a seller more so than an active buyer in the marketplace. Among other things, the recent sale

of Fetzer and Bonterra by Brown-Forman, Diageo's divestiture of core and noncore winery brands and real property assets, and the highly anticipated demerger and sale of Fosters' winery assets, have all set the tone of the current market environment. One notable exception to this trend was the acquisition of Fetzer and Bonterra by a foreign publicly-traded wine company, Concha Y Toro, out of Chile.

There is an expectation that a new wave of consolidation in the wine industry is on the horizon. Regardless of who ends up driving activity, as the economy continues to improve, there is a strong likelihood of a resurgence of publicly traded beverage companies as active buyers in the marketplace. This transition is likely to occur within the next 18 to 24 months.

Two candidates likely to jump back into the market sooner, rather than later, are Constellation Brands, which is heavily invested in winery brands and assets, and Crimson Wine Group, a subsidiary of Leucadia Corp., whose brands include Pine Ridge Vineyards, Archery Summit Winery and Chamisal Vineyards.

Privately owned wine companies

The most active purchasers of standalone wine brands, as well as fully integrated wineries, have been privately owned wine companies. Privately owned wine companies are better suited from both a strategic and efficiency standpoint to maximize the value of winery acquisitions. Some of the more active entities in this arena have been Foley Family Wines, Huneus Vintners, Purple Wine Co. and Delicato Family Vineyards.

Privately owned wine companies have a window of opportunity to expand through acquisitions, while their deeper-pocket, publicly traded counterparts remain relatively dormant. There are no discernible wine brand retail price points that are driving their purchase activities.

Rather, privately owned wine companies have been opportunistic and strategic in their acquisitions, focusing on factors

Continued on next page

such as cash flow from operations, varietal and geographical gaps in their portfolios and sales and distribution channel efficiencies. So far, standalone wine brands have attracted the greatest attention from privately owned wine companies, particularly if they produce positive cash flow. Additionally, marquee wine brands, even those with substantial real property assets, have remained a high priority for these types of buyers.

Unlike their public beverage company rivals, privately owned wineries can afford to make acquisitions that are based on long-term acquisition potential and efficiencies. Publicly traded companies are under tremendous pressure to generate shareholder value now, whereas privately owned wineries will not place a premium on shareholder value to the detriment of long-term growth.

Private-equity firms

In some respects, the historical acquisition pattern of private-equity firms mirrors that of publicly traded beverage companies. G.I. Partners' acquisition of Duckhorn and GESD Capital's acquisition of Ascentia Wine Estates are the most notable winery transactions that involved private-equity investors. Unfortunately, these acquisitions are also representative of the valuation high watermark for winery transactions. Nonetheless, one should not confuse this observation with an expectation that private-equity firms will remain on the sidelines while merger and acquisition activity picks up in the wine industry.

There is evidence that private-equity firms are prepared to re-enter the transaction environment in the wine industry. In September 2010, private equity giant Cerberus drew considerable attention when it submitted an unsolicited bid to acquire Foster's Group. Furthermore, before the announcement on the sale of Fetzer and Bonterra, rumors circulated about the prospect of private-equity financing being lined up in order to launch an acquisition effort.

It is widely believed that private-equity firms will play a significant role in the event of a sale of Foster's or other wine divisions of publicly traded beverage companies due to the sheer size of capital that will be

required to acquire such assets.

In today's environment, there is a tremendous opportunity for experienced and proficient management teams to align themselves with private-equity financing in order to create formidable wine companies. Such strategic marriages of operating expertise with capital resources have the potential to drastically change the competitive landscape over the next five years.

The major obstacle confronting these would-be wine conglomerates, however, is the relatively short holding period required with private-equity money. Although there are some exceptions, private-equity firms usually look for a five- to seven-year time horizon on a return of their invested capital.

Financial investors

The attraction of financial investors to the wine industry is predicated upon their ability to realize acceptable rates of return on their invested capital. Financial investors are typically focused on "passive" investments, such as vineyards or winery assets where key management figures are already in place.

Overall, the examples of financial investors who pursue management-intensive investments, such as wineries, are far and few between because of the corresponding increase in risk associated with such investments. The Vincaft Group, which might be considered a hybrid between a financial investor and a wine industry-focused private-equity venture, stands out as one of the few exceptions. It acquired high-end pinot noir producer Kosta Browne in 2009 and continues to be active in its search for further complementary winery acquisitions.

By contrast, a number of agricultural investment companies have successfully entered the wine industry by focusing on "passive" investment opportunities that involve building strong vineyard portfolios and establishing long-term relationships with key industry grape buyers.

On average, financial investors are looking for investment opportunities that provide a return on invested capital that is between eight percent and ten percent. However, their expectations for making an investment in the wine industry ini-

tially start in the range of twelve percent or more.

Lifestyle investors

Perhaps the greatest risk to market values of vineyard and winery assets is the lack of activity among lifestyle investors. This is particularly evident in the absence of transactions involving vineyards that do not have long-term grape contracts or where the motivations for a transaction are not centered upon vineyard economics.

A lifestyle purchase that is predicated upon a startup business venture is very problematic in today's economic environment. Such startup business propositions are exceptionally difficult to scale in circumstances where:

1. the vineyards do not have grape contracts that can support the value of the investment, or
2. an associated wine brand is misaligned with consumer preferences.

Both of these challenges have been exacerbated in recent years by wine consumers' demonstrated preference for trading down in value to retail price points that are substantially less than \$25 per standard 750-milliliter bottle.

Despite the uncertainties described above, history has shown that there exists a certain lifestyle demand factor in the wine industry that has helped buoy market values for these types of assets. When the lifestyle investor becomes comfortable enough to return to the marketplace, market values for winery assets will be in better balance.

•••

Zepponi & Company (www.zepponi.com) is a leading provider of merger and acquisition, valuation and transactional advisory services to the global wine industry. Headquartered in Santa Rosa, Zepponi & Company professionals specialize in advising on ultrapremium and luxury brands, estate wineries and vineyards, such as Chalk Hill Estate, Four Vines, Black Stallion, Kuleto Estate and Murphy-Goode Estate. The principals collectively share over 75 years of wine industry experience and completed \$900 million in transactions.