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There's more than price to consider when purchasing a winery asset

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Assessing the value of a wine investment opportunity is the key to a good purchase.

The value of a wine asset exists on many levels. A buyer might begin assessing an investment by considering global economic conditions, the current state of the wine industry, and whether or not a particular asset aligns with their specific investment criteria. On another level, value may be influenced by factors related to an asset's specific characteristics.

The due-diligence process provides an opportunity for a buyer to identify an asset's unseen potential – and possible pitfalls – in order to gain a better understanding of value.

QUALITY OF FINANCIAL INFORMATION

Often the most difficult task in performing a financial review is assessing the reliability of a company's historical financial statements. While most mid-sized businesses do not necessarily need to be audited annually, a buyer would do well to look for at least review-level financials prepared by a reputable accounting firm.

Regardless of the manner in which financial statements are prepared, buyers should perform their own independent investigation to understand how much money the business is making on a normalized basis. Good accounting practices do not necessarily reveal the true profitability of a business. If the owner is heavily involved in the day-to-day operations of the business, find out if that person's contribution is captured in the form of a market-appropriate salary.

Are there any owner discretionary items, such as memberships, entertainment or benefits, which would not be incurred under new ownership? In instances where rent or other property costs are paid to outside parties or a related entity, they should be adjusted to reflect actual market rates. These are just a few examples; each business will have unique revenue and cost adjustments that need to be taken into account in order to obtain an idea of actual cash flow.

SALES TREND INDICATORS

When reviewing sales trends, stagnant or declining sales over the past three or more years are certainly a red flag. However, even positive sales trends may not tell the entire story. For example, a wine brand's gross sales are not the truest indicator of brand strength. Wineries have been under a significant amount of pressure over the past few years to engage in aggressive pricing discounts in order to remain competitive in the three-tier wholesale system.

Once a winery begins an aggressive discount program, it becomes more difficult to terminate the program and rely upon a retailer to sell the wines at regular retail price points. If a brand's price discounting strategy is the dominant force driving sales, then this is typically not a sustainable business model for the brand.

REAL PROPERTY ISSUES

Real estate is a key component of many wine industry transactions.

Inattention to property-related issues may result in delayed closings and increased costs, as well as significant business risk if they are related to a production asset such as a winery or vineyard. Access, boundary, and environmental issues often go unnoticed until a property changes hands, and once uncovered can take significant time and resources to remedy.

It is helpful to know whether the property was previously commercially financed. If so, it is likely that the lender required a more comprehensive review of the real property, including a boundary survey and assessment of potential environmental hazards.

SELLER RESPONSIVENESS

An incidental benefit of the due-diligence process is that it offers buyers an intimate glimpse into how the business is run.

A seller's ability to produce information in a timely manner inspires confidence that the business is being properly managed.

On the other hand, delays in the process can be concerning. A buyer may ask, "Why do they need so much time? Is there something wrong?"

OPEN COMMUNICATION

In every transaction, there will be items which may not be readily apparent to the buyer but are well-known by the seller because they have a material effect on the business. Depending on the sensitivity of such information, disclosure of such items may only be appropriate once the likelihood of consummating a transaction is more certain.

Achieving the right balance of disclosure at the appropriate time is a key component to any successful deal and requires considerable forethought by the seller. As a buyer learns of certain items during the course of due diligence, a seller's willingness to communicate openly will become evident. A lack of appreciation for properly disclosing important information not only strains negotiations but also raises serious questions about the seller's credibility.

Investing quality time in due diligence will shed light on the value of a considered purchase. Communication and quality information flow are necessary in order to evaluate any deal. After satisfying curiosity surrounding value, a buyer can move forward with the knowledge of their investment.

Cody Jennings is a vice president with Santa Rosa-based wine industry transactions firm Zepponi & Company. Prior to joining the firm in 2009, he worked as a financial analyst and business consultant specializing in the wine industry.