Predictions for Wine Industry M&A in 2018

Success of the premium wine segment should drive much of the activity

By Cody Jennings

Wine industry transaction volume was notably down in 2017 compared to the previous two years, particularly among marquee brands. However, many of the fundamental dynamics that fueled the heightened levels of investment in 2015 and 2016 were still present in 2017, including a diverse pool of active buyers, which drove competitive valuations across a range of winery assets.

Overall, wine companies that have been active over the past few years maintained their appetites for new opportunities in 2017. Constellation Brands, E. & J. Gallo Winery and Vintage Wine Estates all completed acquisitions for the third year in a row.

Additionally, mid-sized wineries looking to build scale generated healthy demand for production assets, with some pursuing standalone winery facilities and vineyard opportunities in order to bolster capacity and sourcing strategies. Overseas investors continued to show high interest in U.S. assets, with Maisons & Domaines Henriot and LVMH Group becoming the latest in a growing trend of French wine companies to invest in the U.S. wine industry.

Outside of a select few private equity firms, financially motivated buyers continued to focus primarily on the agricultural aspects of the industry, with multiple institutional investment firms acquiring large-scale vineyards.

Looking toward 2018, the ongoing success of the premium wine segment is likely to play a central role in mergers and acquisitions (M&A) activity, with suppliers using an acquisition strategy to quickly shift the center of gravity toward portfolios that produce wine priced $15 to $20 per bottle. Additionally, continued consolidation among wholesalers and retailers is putting pressure on suppliers—especially mid-sized wine companies—to expand portfolios in order to stay relevant in the marketplace. Interrelatedly, many of those suppliers will fulfill that need by venturing into "emerging" geographic wine regions, whose relatively lower input costs offer greater potential to scale brands with higher gross margins. Lastly, ongoing consolidation of major production and vineyard assets by large wine companies (particularly in areas of limited supply, such as Napa and Sonoma) will have a trickledown effect as smaller and mid-sized wineries scramble to replace and/or secure increasingly scarce grape resources.

KEY POINTS

An executive with Zepponi & Co., a wine industry mergers and acquisitions firm, discusses likely activity for 2018.

Producers are shifting their portfolios toward wines in the $15-$20 category and need to secure quality grape supplies for the fast-growing demand.

In response to the quickening pace of consolidation in the wholesale and retail tiers, mid-sized wine companies are feeling compelled to add wineries and brands to stay relevant.

In the absence of any major market disruptions, 2018 will likely see similar to slightly increased deal activity, as the "hangover" effect from 2016's M&A binge begins to wear off. However, a number of industry-specific and macro uncertainties could negatively impact this momentum in the near term. First, there are preliminary signs that the double-digit growth in the premium segments across all beverage alcohol categories is beginning to wane. Additionally, the current expansion cycle of the U.S. economy is getting "long in the tooth" from a historical perspective. The current expansion in the economy marks the third-longest cycle since World War II (see "U.S. Business Cycle Expansions" on page 144). Based on past experience, buyers seem to associate greater risk the farther the economy moves into an expansion cycle. Lastly, there are growing political and economic uncertainties in the United States and abroad. While it is too early to say what effect the presidential administration will have on the U.S. economy, the implications of proposed federal tax reform (particularly a corporate tax rate cut), as well as changes in trade policy, have the potential to significantly influence the M&A landscape in 2018 and beyond.

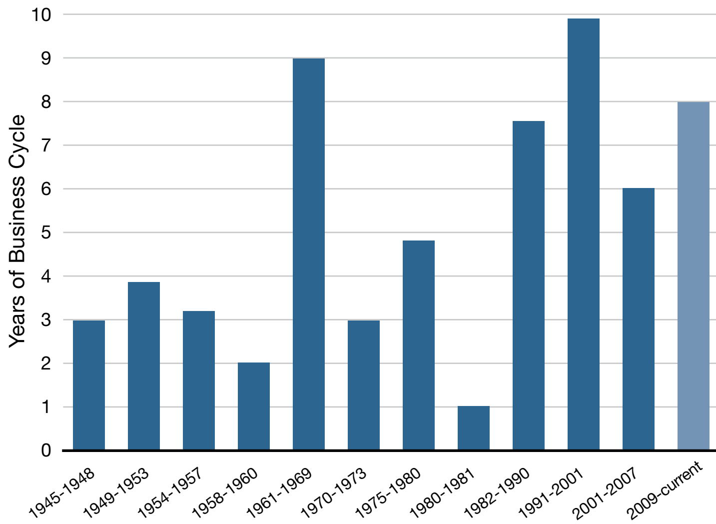
As of press time, it is still unclear exactly what effect the October 2017 wildfires will have on Northern California's wine industry. In terms of ordinary business, the disruption to supply appears to be minimal, however, the impact on human resources and tourism crucial to many wineries is a new challenge that will likely reverberate through the region throughout the coming months and years. From an investment perspective, there will likely be a short-term recess in M&A activity as businesses and their employees focus on recovery, which may extend into the first quarter of 2018.

Consumer preference for higher priced wines

By far the most influential factor driving M&A activity in today's environment is the growth disparity between wines priced above and below the $10-per-bottle mark. Consumption trends continue to bode well for higher priced wines, possibly at the expense of lower priced wines. This trend is part of a greater consumer migration toward "premium" goods that has reshaped the beverage alcohol landscape. Based on 52-week Nielsen scan data, sales volume grew 7.3% for bottles priced $10 and up, while the segment priced less than $10 per bottle dropped 2.2% (see "U.S. Wine Year-Over-Year Growth by Price Segment").

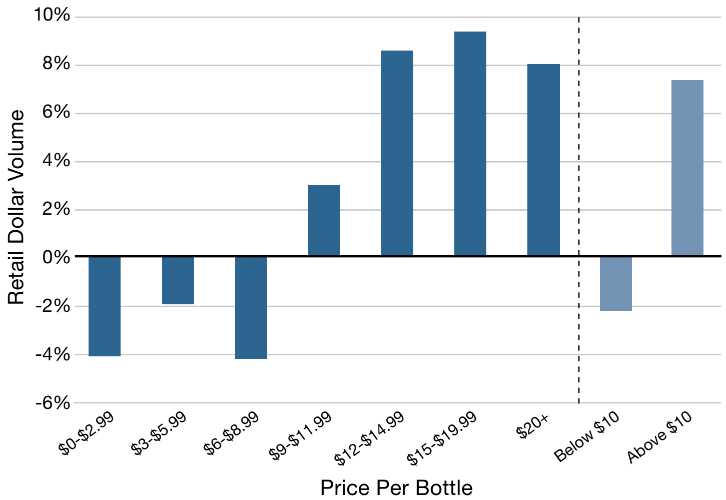
For many wine companies heavily invested in the latter segment, the past several years have been a race to "premiumize" their portfolios. In the intensely competitive sub-$10 per bottle price segment, it is difficult to increase the price of existing brands. Furthermore, developing a new, higher priced brand from the ground up requires significant marketing capital and can take years. As a result, many wine companies opt to pursue an acquisition strategy as a means to tap into the growth of the premium wine sector.

U.S. BUSINESS CYCLE EXPANSIONS



Source: National Bureau of Economic Research.

U.S. WINE YEAR-OVER-YEAR GROWTH BY PRICE SEGMENT



Source: AC Nielsen Food/Liquor, 52 weeks ended Oct. 7, 2017.

Constellation Brands has been a prime example of this strategy. It has strung together numerous premium brand acquisitions in recent years, including Meiomi, The Prisoner, Charles Smith and, most recently, Schrader Cellars in June 2017. The latter is a boutique Napa Valley luxury brand best known for its Cabernet Sauvignon wines that are priced above $200 per bottle and produced from the famed To Kalon Vineyard in Oakville, Calif. Constellation already owned a significant portion of To Kalon Vineyard, which it had acquired as part of its prior purchase of Robert Mondavi Winery in 2004. The New York-based conglomerate also has utilized a similar strategy in beer and spirits, notably acquiring craft whiskey maker High West Distillery and craft brewer Ballast Point, as well as additional brands in both beverage categories. All of the company's acquisitions over the past several years share a common theme: Each has been positioned squarely in the "premium" price segment of their respective beverage categories.

E. & J. Gallo Winery also buttressed its premium asset portfolio in 2017 with the blockbuster acquisition of Stagecoach Vineyard in the Atlas Peak appellation. This acquisition sent reverberations throughout the wine industry, particularly among the more than 90 high-end wineries that sourced grapes from the prestigious vineyard. Gallo itself was already a major customer of Stagecoach as a result of its prior acquisition of the Orin Swift wine portfolio, which it had acquired a year earlier. With the Stagecoach acquisition, Gallo now controls a sizeable portion of the very high-end Napa grape market, giving it the singular ability to scale its most luxury priced brands.

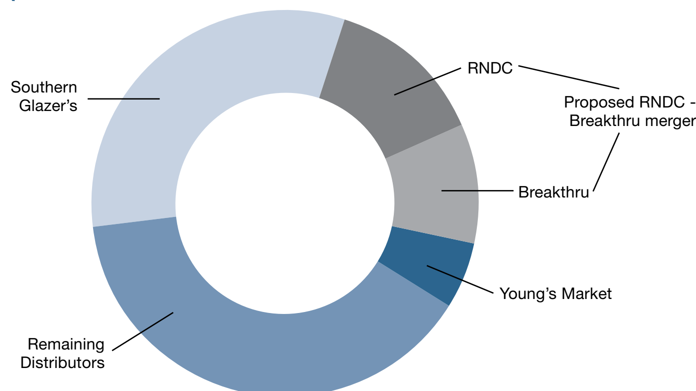
In a lesser publicized but similarly telling transaction, Gallo in August acquired Mendocino-based luxury brandy producer Germain-Robin. Established in 1982, Germain-Robin was one of the pioneers of the niche luxury-priced U.S. brandy market and today produces brandy products aged up to 30 years that retail for up to $120 per bottle. Gallo is no stranger to the brandy category, with its market-leading E. & J. brand accounting for more than 40% of total U.S. brandy dollar volume in retail channels. Its purchase of Germain Robin will allow Gallo to quickly migrate into the higher priced and more profitable brandy segment.

Using acquisitions as a means to premiumize portfolios is not a phenomenon limited to the largest wine companies. Silver Oak Cellars, one of Napa's most iconic brands, along with a consortium of outside investors, purchased Napa cult wine producer Ovid in early 2017. Silver Oak produces approximately 100,000 cases per year of wine priced between $75 and $125 per bottle. Its purchase of Ovid further upgrades its high-end wine portfolio with an approximately $285-per-bottle luxury wine brand that sources grapes for its 2,000 cases from 15 acres of accompanying Pritchard Hill estate vineyards.

The effect of wholesaler consolidation

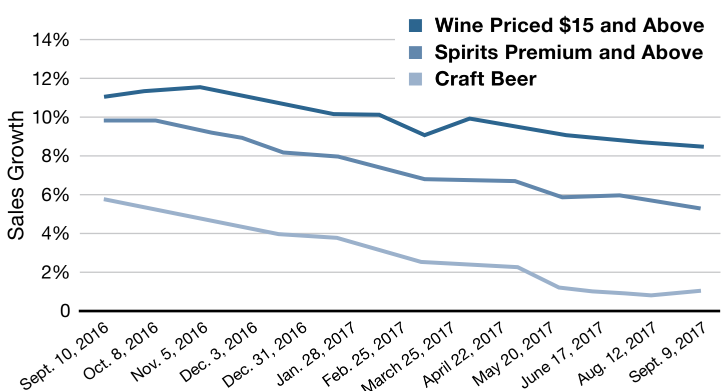
Looking downstream in the U.S. wine supply chain, machinations within the three-tier distribution system continue to result in an ever-narrowing route to market

TOP U.S. SPIRITS AND WINE WHOLESALERS (PERCENTAGE OF MARKET SHARE BY SALES DOLLARS)



Source: Shanken Impact Spirits Report 2017.

FOUR-WEEK ROLLING YEAR-OVER-YEAR DOLLAR GROWTH



Source: Nielsen Food/Liquor, Rolling 52-week periods from Sept. 10, 2016, through Nov. 4, 2017.

for wine producers. While a number of business models in the wine industry have been able to leverage the recent surge in direct-to-consumer sales, the reality today is that a clear majority of wine volume is sold through wholesale channels. Since 1995, the number of U.S. wineries has grown from approximately 1,800 to 9,200; however, the number of U.S. wine and spirits distributors has compressed from approximately 3,000 to 1,200 over the same time period. In recent years, the pace of consolidation among wholesalers has snowballed as a result of a series of mega mergers. Beginning in early 2016, Charmer Sunbelt and Wirtz Beverage merged to create Breakthru Beverage, which, once completed, accounted for approximately 10% of U.S. wine and spirits sales dollars. Shortly thereafter, two of the industry's largest distributors, Southern Wine and Spirits and Glazer's, combined to form Southern Glazer's, whose combined footprint accounts for almost one-third of total U.S. market share. In response to the Southern Glazer's merger, Republic National Distributing Co. (RNDC) and Breakthru Beverage, the second- and third-ranked distributors, respectively, recently announced their intention to merge. Assuming the deal closes, the top two distributors would account for more than half of total U.S. wine and spirits sales, with the next-largest (Young's Market) accounting for approximately 5.5%. (See "Top U.S. Spirits and Wine Wholesalers").

Consolidation at the wholesale level has encouraged a similar dynamic at wine supplier and retailer levels, putting pressure to implement more simplified sales strategies so products have access to the market. Larger retailers prefer to work with larger wholesalers in order to leverage operational efficiencies and simplify the supply chain. Retailers in general also face pressure to rationalize the number of wine products they carry, as increased demand for craft spirits and craft beer has resulted in dwindling shelf space historically reserved for wine. Not surprisingly, during the past three years the number of wine SKUs monitored within retail scan channels has decreased (see "Number of Active Wine SKUs in U.S. Food and Liquor Channels"). Additionally, larger wine companies that have better, more robust representation of specific appellations and varietals under one ownership umbrella have become more attractive to larger distributors looking to expand their own portfolios. The inherent implication of all these changes is that smaller manufacturers are the ones most susceptible to losing placements in retail accounts.

In response to the quickening pace of consolidation, mid-sized wine companies are feeling increasingly compelled to expand their portfolios in order to stay relevant with distributors. Falling into this category was WX Brands' (formerly known as Winery Exchange) April 2017 purchase of the Bread & Butter wine brand. At the time of its acquisition, Bread & Butter was one of the fastest growing brands in the wine industry, reaching annual sales of approximately 170,000 cases in just over three years. WX Brands also acquired the Jamieson Ranch Vineyard family of brands, which added a further 80,000 cases to the company's branded wine business.

Santa Rosa-based Vintage Wine Estates, which over the past five years has amassed a collection of wineries and brands through acquisitions, expanded its geographic footprint in 2016 and 2017 with the purchases of Firesteed Cellars in Oregon, Buried Cane in Washington state and Clayhouse Wines in Paso Robles, Calif. The Buried Cane and Clayhouse Wines transactions were part of a strategic partnership with Washington's Middleton family. Vintage Wine Estates also won a bid in early 2017 to acquire the well-known Cameron Hughes negociant brand out of bankruptcy. These brand acquisitions bring Vintage's total acquisition tally to more than a dozen within the past five years, which put it on pace to sell close to 1.5 million cases by the end of 2017.

Geographic expansion continues to be a central theme for many mid-sized acquirers. Private equity-backed Duckhorn Vineyards, which made a foray into Washington in 2014 with its Canvasback label, looked south in 2017 in acquiring the Pinot Noir-focused Calera Wine Co. in Monterey County (see related story on page 132). This purchase represents the company's first organic acquisition, as well as first foray into the Central Coast. Additionally, Jackson Family Wines, which has been heavily investing in Oregon, expanded its holdings in the Central Coast with the acquisition of Brewer Clifton, a 100% estate producer of Sta. Rita Hills Pinot Noir and Chardonnay.

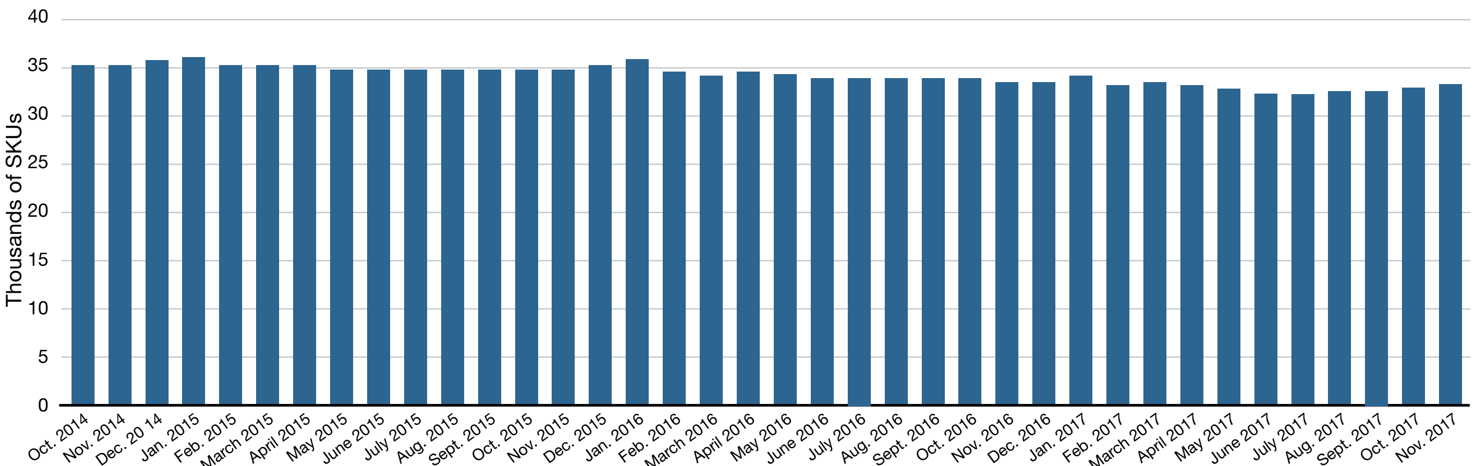
The success of emerging wine regions in recent years is particularly compelling from an M&A perspective. It has created acquisition opportunities for a broader range of buyers who are able rationalize more favorable sourcing economics and relatively lower regulatory constraints from these emerging regions in comparison with other wine regions such as Sonoma and Napa.

Key supply assets in high demand

Vineyard values remain high in premium winegrowing regions—as do the level of vineyard transaction activity, due to intensifying competition for quality grape sources corresponding with premiumization trends. Favorable lending conditions and several years of strong industry growth have made vineyard acquisitions a more viable and attractive option for mid-sized wineries looking to control supply and mitigate increasing supply costs. As a result, the number of strategic buyers of vineyard assets has increased in recent years, with each successive acquisition by a strategic buyer having the compounding effect of reducing available supply.

In certain cases, the acquisition of a key supply asset can have a disruptive and rever-

NUMBER OF ACTIVE WINE SKUS IN U.S. FOOD AND LIQUOR CHANNELS



Source: Nielsen Food/Liquor, four-week periods from Oct. 11, 2014, through Nov. 4, 2017.

berating effect on M&A activity. Gallo's acquisition of Stagecoach Vineyard in early 2017 was notable not only for its size, but because of its potential impact on the ultra-premium Bordeaux-variety grape market. Though Gallo has committed to honor all existing contracts with the more than 90 wineries that had been sourcing fruit from Stagecoach, as those contracts run out, Gallo will most likely utilize the grapes to grow its own brands. Given the extremely limited supply of comparable vineyards, the outgoing wineries will be forced to become more aggressive in securing replacement fruit, which will likely lead many to pursue an acquisition strategy in order to lock in long-term supply. Anecdotal evidence of Napa vineyard transaction activity immediately prior to and following the Stagecoach announcement suggest that the market impact of this dynamic may be significant in terms of vineyard pricing.

Larger wine companies that have better, more robust representation of specific appellations and varietals have become more attractive to larger distributors.

Wineries also face competition from investors outside the industry, as the long-term track record and future growth prospects for U.S. premium wine pose a compelling investment rationale for agricultural investment firms that typically operate on 10- to 20-year timeframes. Within the past 12 to 24 months, the industry has seen an increase in the number of institutional investment funds making acquisitions of premium vineyards, notably in premium winegrowing areas such as the Oak Knoll and Oakville AVAs in the Napa Valley, as well as in Sonoma County, Santa Barbara County and Oregon. This trend is likely to continue as each of these investment groups seek bolt-on acquisitions in order to achieve greater economies of scale.

What does this mean for 2018?

Momentum continues to be strong for wine industry M&A activity, thanks to a healthy economy and a sustained period of growth in premium U.S. wine consumption. However, there are growing concerns that the wine industry (and greater beverage alcohol sector) may be experiencing the beginnings of a change in consumer behavior. Recent Nielsen scan data reporting among the fastest growing beverage alcohol categories (premium wine, premium spirits and craft beer) show tapering growth in the past six to 12 months (see "Rolling Year-Over-Year Dollar Growth"). Additionally, while the U.S. wine market remains the largest in the world and continues to grow in total consumption, per-capita intake in the United States has slowed significantly since 2010. If these cautionary signs persist into 2018, then this may create a dampening of the high investor confidence which has characterized the current M&A cycle. Regardless of what happens in 2018, consolidation momentum within downstream sales channels is unlikely to change in the near future, and barring any major disruptive antitrust, legislative or technological advances, its effects will likely continue to be a driving factor of deal activity in the coming years.

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