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Wine Industry
Accountants and Consultants

The Family Wine Business Journal

ARE YOU READY FOR CHANGE?

Elaine Chan

In our last issue, we began a discussion of management succession in a family-owned and family-run winery. We considered selecting a group of candidates, preparing those candidates, and reviewing and evaluating them. In this issue, we consider how and when you should choose a successor.

Once you have a group of well-prepared and motivated candidates, how do you select the new leader? Hopefully, when the time comes, the decision will be fairly obvious: your successor will be the apparently best qualified. The decision becomes a difficult one to make if *all* of the candidates are similarly prepared and qualified, and it can be emotionally difficult if they are all close family members.

Most of you probably assume that *you* must make the decision. In most cases, *you* should have the honor and duty of selecting your successor, because you can decide what is best for both your business *and* your family. You know what and who it takes to run your business. Much like selecting the initial group of candidates, selecting your ultimate successor will often come down to intangible qualities that are important to you and your winery. Your successor is capable and shares your vision and passion for the business.

If your company has an outside board of directors, you might refer the decision to the board. An outside board is often established to provide guidance to management and can help select successors to management. It may be appropriate to have the outside board make the final selection because of its objectivity. Although the board could ultimately select a non-family member, remember that we are determining a *management* successor, not an ownership successor. Further, the board could be given the power to make this decision only if you do not or cannot make the decision, or if no family member is interested or available to succeed to the management of the business.

In addition to deciding *who* will be your successor, you need to think about the *timing* of when all of this should happen. Deciding *when* to make the transition may be more difficult than deciding *who* your successor will be. Turning over the reins often conjures up thoughts of finality and thoughts not of giving up control, but of losing control. When is the right time to give up something you have created and helped to grow?

The timing of the transition requires something like a simultaneous equation, because at least two unknowns must be discovered at the same time: your successor must be ready, and you must be ready. Whether your successor is "ready" will depend on how motivated, prepared and experienced he or she is. Your successor

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WINERY VALUATIONS

Mike Fisher

At one time or another everyone has wondered "How much is my winery worth?" In most instances curiosity would not justify a formal valuation. However, at times it may be necessary. Winery valuations are used for a wide range of purposes such as transfers of ownership, gifts, estate planning, financing, litigation, etc.

Determining the value of a winery is more of an art than a science. The term "fair market value" is defined as the price at which the property would change hands between a willing buyer and willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of the relevant facts. This value can vary substantially depending on an individual's perspective.

This perspective is influenced by the individual's perception of the future for the wine industry and for the winery being valued. This perspective can be clouded by the romance of the product. Lifestyle issues also come into play.

How are the risks assessed and quantified?

The methods used to determine value fall principally into three categories.

- Comparable Winery Sales (If the other guy paid that, mine must be worth it too.)

  Having a number of wineries similar to yours which recently changed hands would give you a good indication of value. Unfortunately, few wineries are selling in today's market. Of those that do sell there may be major differences in size, wine pricing, facility, maturity, profitability, etc. If by coincidence these factors do match up, the sales information may not be available because most sales are private transactions. When using comparable sales, all of these factors are taken into account and valuation adjustments are made to reflect the differences.

- Computations Based on Earnings (The boring accountant's approach.)

Use of current earnings assumes future earnings will be similar, because future earnings, not current earnings, determine value. Many wineries do not have current earnings and earnings may be possible only in the distant future. If earnings are projected into the future, how realistic are the assumptions? Given future earnings, which capitalization rate or price/earnings ratio should be used? This capitalization rate is a function of the basic cost of money and the risk involved with achieving the projected earnings. Not only must the valuator project the future, he must assess the risk involved with that projection.

- Valuation of Specific Assets Based on Cost and/or Replacement Value (The intuitive piece-by-piece approach.)

What are the specific assets such as inventory, equipment, facility, vineyard, etc. worth? Inventory can be valued at net realizable value, equipment based on replacement of similar type and age, facility on type of construction, age and capacity, and vineyard based on market value of similar acreage. What about goodwill? You can't buy or value 10,000 gallons or 20 acres of goodwill. This method does not allow differentiation between profitable and unprofitable wineries, and gives the valuator little information to determine goodwill, if it exists.

How does a valuator reconcile that a non-profitable winery recently sold for a price much greater than the value of the specific assets? Based on the comparable sales method, its value is \$5 million; the earnings method gives no value; and the specific assets method determines a value of \$3 million. What is the call?

The use of all three methods with subjective weighting of each is the key to determining fair market value of a winery. Obviously the weighting is critical.

The value determined by these methods assumes a complete transfer of ownership. When a less than 50 percent ownership interest is valued it may be discounted because of lack of control. The owner of a minority interest has no say in management, distribution of earnings or input in the planning of the business. Generally, in these circumstances the value of this minority interest will be discounted, anywhere from 30 to 50 percent depending on the circumstances.

When valuing the shares of a closely held company, a lack of marketability discount may also be applicable. Even though the value of the total business will be realized upon sale, sale of individual shares may be more difficult. This lack of marketability discount can range from 20 to 40 percent.

For example, if a 20 percent minority

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THE WORKING BOARD

Vic Motto

Few family-owned wineries have an active board of directors. Also, when they *do* meet they often do not make decisions that are in the best interests of the company. Why? Because they don't address the right issues, and also because they typically just rubber-stamp the decisions of the owners.

The boards of family-owned wineries are usually made up of some combination of owners, key managers, advisors, friends or relatives. They all have two things in common. First, each has their own agenda *and* a built-in conflict of interest. Second, all of their knowledge and experience is already *available* to the company without having them on the board. You don't *need* them on your board. The owners can discuss business at a shareholders' meeting; managers at a management meeting. Advisors are hired and paid for their advice. If you want advice from friends and relatives, you can invite them over for dinner.

Outside Boards:

There *is* a board structure that can work. An outside, independent, working board of directors can make a *real* difference for many family-owned wineries, especially those with plans for multi-generation succession. These wineries face many changes and challenges. A properly structured board can help lead a winery through these changes. Every generation must survive and prosper in its own time; and the times are profoundly different for each generation. The right board will help see to it that the winery continues, grows, prospers, and operates in a business-like way. And today, a successful family winery needs all of the professionalism it can get.

A board is not a substitute for a strong CEO with vision and leadership. The ideal board will challenge and support the CEO, diffuse and arbitrate disagreements, and make sure that the company has appropriate long-range plans. They will also make sure that the winery sets a proper course and stays on track, or adjusts as needed. This includes making concrete realistic plans for management succession.

Criteria for Directors:

A board of directors is no substitute for good managers and good advisors. The winery must already have a stable organization structure, good management and good professional advisors. Once these are in place you are ready for a few (not more than five) good men and women with the following attributes:

- Decision-makers with proven ability, who are active in business
- Problem-solvers with good judgment who appreciate the value of action and reasonable risk
- People who are strong in your weak areas, and who are *not* from the wine industry
- Competent leaders, with high integrity and "sharp eyes"
- Completely independent from your company; no possible conflict of interest

Meetings That Work:

Meetings should be regular, not much more or less than quarterly, and scheduled well in advance. The setting and atmosphere should be private and business-like, *not* social. Mornings are best. The board should set their own agenda, ask their own questions, and stick to a short list of high priorities. Their mission is to optimize the long-range potential of your winery, and help you avoid mistakes. They need materials in advance, but don't overwhelm them with minutiae. Give them the facts and the questions in the advance material. Don't waste valuable meeting time poring over facts. Meetings are for making decisions . . . *important* decisions.

We're in an era of economic restructuring and scarce resources. Your market is demanding more quality, value and service. No winery will survive if it cannot adapt to these changes and use them to its advantage. A working board of qualified outside directors can be your added edge for survival.

WINERY VALUATIONS

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interest of a closely held winery were valued the conclusion could be:

Total value of winery - assume complete sale	$ 5,000,000
Interest to be valued	x 20%
Total Value - 20% Interest	1,000,000
Discount for minority interest @ 35%	(350,000)
Value - Discounted for Minority Interest	650,000
Discount for lack of marketability at 25%	(162,500)
Value of Discounted 20% Interest	$ 487,500

These discounts may be used when transferring shares among family members and also for valuation purposes at death when the estate owns less than a majority interest.

Generally, valuations are not done frequently but understanding the process is helpful when the need arises.

ARE YOU READY FOR CHANGE?
continued

is probably already making substantial contributions to the winery; he or she is experienced in the critical areas of the business; and he or she displays appropriate managerial and decision-making abilities.

In the eyes of some winery owners, however, the successor may never be "ready," despite completing all of the preparation and other requirements the owner has laid out. You cannot expect your successor to be a carbon-copy of you. You can only hope that you have done a good job in preparing your successor, and that he or she will lead the business forward and help the winery continue to grow and succeed.

The more difficult of the two unknowns is whether you are ready. Are you ready to let someone else run your business? Most owners who are willing to give up control have decided on what they want to do when the transition is completed, whether or not it is related to the wine industry in general or to their winery or vineyard in particular. These owners have decided that it is time to pass the baton, so that their business and everyone concerned can move on. These owners have made plans for themselves.

On the flip-side, owners who are not ready or do not want to lose control are usually still very involved in the day-to-day affairs and the details of running their winery. Although the candidates may be involved in the winery, the owners have not yet thought about making plans for themselves. Most likely, questions exist which need to be asked and resolved. Many of these unasked questions probably revolve around future financial security. Although management succession can and, at least initially, should be considered separately from ownership control, owners need to feel comfortable with their financial well-being before anything can be given up. Other questions revolve around what they want to retire to, i.e., what are they going to do when they get up each morning. Until they feel that they can survive without the winery, it will be difficult for them to accept that the winery can survive under their successor.

These two unknowns are like moving targets. At any given moment, the successor may be ready, while the owner may not be, or vice versa. As time goes on, individuals change, causing difficulty in determining the optimum time for transition. As blood and business families expand, new strengths, qualities and needs are brought to the table; while one candidate may seem to be the obvious successor, new circumstances may warrant that another candidate be selected.

Change is inevitable, and although we cannot control the unknowable future, there are benefits to planning the overall circumstances and timing of the transition and keeping them flexible. First, having an overall plan sets a timetable for both you and the candidates. Goals are set. Everyone is encouraged to do whatever individual planning and preparation are necessary. Second, having an overall plan provides an element of certainty not only for your family members but also for all of your employees. Everyone can expect change at a particular time or over a specific time period. By making flexible plans, options are kept open and choices are available. The goal is to transfer the leadership role in the least disruptive way possible to minimize the conflict that can destroy both family and business harmony. Everyone should know what is supposed to happen so that the business can go on.

Once you have a plan to help your business continue, you need to make sure that you execute and monitor the plan. Keep your plan in motion. Don't make inertia a part of your business. Modify the details as necessary, but keep the overall goal in focus: your winery shall continue as a family business.

After the management succession issues have been considered, you need to deal with transferring ownership control of the winery, the subject of our next issue. ✻

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The **Family Wine Business** *Journal*

AGENDA
Business Continuation Planning
Management Succession
Ownership Succession
Identification and Separation of Family and Business Goals
Estate Planning
Estate Taxes
Retirement Planning
Financing and Funding Issues
Business Valuations

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