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Wine business insights from the leading wine investment bank

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WINE IN A DOWNTURN

Vic Motto

News headlines today are dominated by global economic concerns, a major credit crunch, tumbling stock markets and sagging sales with consumers trading down.   So, what's ahead for wine in this challenging environment?

"Histories make men wise" said Francis Bacon. Wine's history is long and complex (even Noah had a vineyard), so a look back may be instructive.

Wine in Previous Downturns

The U.S. had major economic downturns each of the last 4 decades: in 1973, 1982, 1991 and 2001. Circumstances were quite different for the wine industry in each of these downturns. The industry's response was also different each time, in some cases finding opportunities in the midst of chaos.

2001

The country was gripped in fear after September 11. Markets tumbled, consumer confidence crashed, travel halted, people stayed home – but wine got sold nevertheless. It was harder to sell wine, and the uncertainty made it seem even worse. In retrospect, as bad as it seemed, it wasn't as profound for the wine business as it felt at the time. Optimism quickly returned and wine sales growth continued.

1991

The 1991 downturn was *very* hard on the wine industry. The downturn followed a spike in oil prices, a crash in real estate values and banks were in crisis. The biggest wine industry bank called-in loans from all but their best customers. Capital was just not available. At the same time, we were rapidly losing vineyards to phylloxera, so the need for capital was very high. Furthermore, the industry was not on the best financial footing going into the downturn. At that time, over half of the wineries were operating at a loss.

Inventories were in oversupply from the huge 1989 vintage, which was widely panned for poor quality, and the 1991 vintage was even larger – a glut. Price cuts to sell the oversupply were widespread and created even larger losses, exacerbating the financial problems.

Then an amazing thing happened: during the inevitable economic recovery, 7 of the next 9 wine vintages were substantially below normal in size and of much higher quality. Wine prices skyrocketed, new records were set every year and the industry became an overnight financial success - stimulating even more growth.

1982

Another real estate crash followed the savings and loan debacle – another government-facilitated housing bubble burst (sound familiar?) plus the 1979 energy crisis. The prime rate hit 22% and a standard mortgage was 17%.

High interest rates caused a run on the dollar, making the currencies of other countries correspondingly cheaper – and their wines as well. We were predicted to be drowned in what was called, "a sea of wine" from Europe. California was struggling with a major oversupply from the immense 1982 vintage. The demise of the industry was predicted by many, including many industry insiders.

In response, some enterprising vintners created "*fighting varietals*" to *fight* back the imports, forgoing generic names for *varietal* names at close to generic price points. They bottled very good quality premium varietals and sold them at 2 for $7 in floor stacks. This category grew to 20 million cases in just 5 years, launching the "wine boom" and forever changing California's image as a jug wine producer.

1973

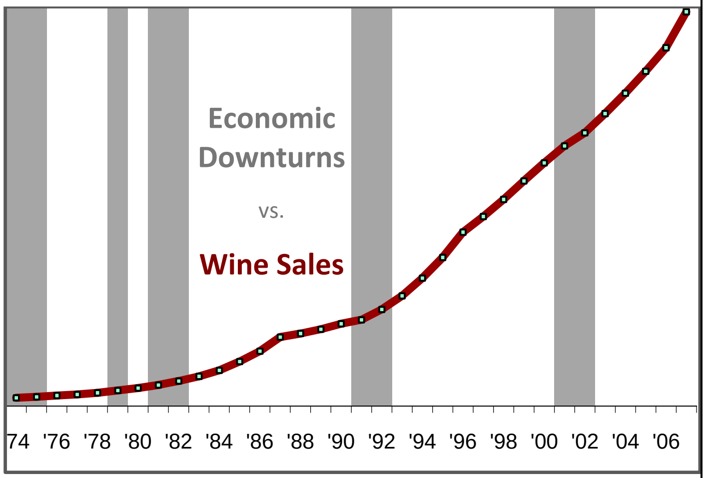
The 1973 *energy crisis* had record oil prices (sound familiar?) with lines going on for blocks at gas stations, double digit inflation, wage and price controls. On top of that, California had the biggest frost in history in 1972, all but wiping out the vintage and grape prices went through the floor nevertheless.

Immediately after those woes set in, came both the highly touted 1974 vintage – now legendary, and then the 1976 Paris Tasting that put California on the map for making world class wines – which changed the wine world forever.

Wine Sales in Economic Downturns

Each economic slowdown comes about for different reasons and impacts the economy in different ways. History has shown us that wine is affected more by industry factors such as weather, grape gluts, phylloxera epidemics and regulatory trade barriers, than by economic activity.

A close look at the correlation between wine demand and economic indicators including gross domestic product, disposable income, unemployment, and other variables reveals that wine sales growth bears almost no relationship to changes in the general economy. In fact, the chart below clearly shows that wine sales have grown throughout recent economic downturns.



California wine U.S. Revenue vs. Economic Downturns

It's evident that wine can be successfully marketed – even during economic turmoil. Indeed, wine may be the most under-marketed major consumer good in the U.S. – in good times or bad. Advertising and promotion budgets for wine are much smaller than for other consumer goods.

The profound impact of major wine publicity events such as the film *Sideways* and the *French Paradox* broadcasts on *60 Minutes* clearly demonstrate that wine sales are affected more by marketing (in this case, publicity) than by changes in the economy.

In the U.S., wine has another marketing advantage, with rapidly growing numbers of wine consumers, while still having the largest untapped market of any major beverage. Ten years ago only 1 out of 4 Americans drank wine. Today it's 1 out of 3 and still growing.

The Wine Industry Today-

Wine is one of the few pure organic growth industries in the U.S. Not only is wine growing more reliably than most goods, but the consumer base is growing as well. Wine revenues have grown at 3 to 5 times the rate of the general economy since the 1980's. The number of wine consumers has grown to unprecedented levels, adding 25 million new wine consumers in the last 6 years alone.

Nevertheless, there are still challenges today from the current downturn. The restaurant trade is already hit hard and tourism will likely drop further. The wine sales decline from the initial shock hit hard. However, that shock period is no more predictive of what happens next than were the sales trends that occurred before the shock.

Everything changes, people adjust and business goes on. So, this is the perfect time to review and reinforce your business strategy and to do the right things going forward that will position you for even greater success during the recovery and inevitable boom.

Proactive vintners are also implementing non-critical cost-saving measures, seeking new revenue sources, deferring selected capital expenditures, and recapitalizing their debt and equity structures. Sales and marketing efforts are being refocused on the best markets and customers, plus new channels of distribution. This is the time to re-set the stage for future growth and profitability.

Unlike mature industries like automobiles and other durable goods, wine is a growth industry with a long, strong track record of growth. This foundation cushions wines from the heavy blows inflicted on more mature industries in downturns.

There will be blood; but just nicks and cuts relative to other industries. We'll be back on track soon. This is like the winter dormancy before the spring growth.

It's *still* a great time to be in the wine business.

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HOW WILL THE CREDIT CRISIS AFFECT WINE?

Carol Collison

When the history of the current economic downturn is written, it will say that in September of 2008, the U.S. banking system nearly collapsed. The failure of Lehman Brothers was the *"emperor has no clothes"* moment when the world recognized what had been hiding in plain sight: that the slow incursion of Wall Street into U.S. lending markets had created an unsustainable credit bubble. As it turns out, a basic rule of business had not been suspended or hedged: If you make foolish loans, you lose money.

Everyone who watches the news or reads the paper knows the results of this disaster on U.S. consumer credit markets: falling residential values and severe contractions in the availability of home, auto, and credit card financing. The eye of the storm has however, moved on to the commercial credit markets, which since August, 2008 have been largely frozen.

How will this crisis affect the ability of wineries to obtain financing? After all, the wine industry is a uniquely capital intensive business, requiring substantial investment to finance large amounts of needed land, facilities, equipment, inventory and working capital.

The answer is mixed. The four major sources of credit – the Farm Credit System, large banks, community banks, and Wall Street – are each affected differently.

How We Got Here: The Rise of Wall Street

Over the last decade, the role of banks in U.S. commercial lending declined significantly, as Wall Street's share increased. Annual reports on the large commercial loan market issued jointly by the agencies responsible for regulatory oversight of the US banking system demonstrate that between 2000 and 2008 the share of large commercial loan transactions held by non-bank organizations (securitized pools, hedge funds, insurance companies and pension funds: aka "Wall Street") nearly *tripled*, rising from 7% to 20%. Conversely, the share of regulated U.S. institutions fell from 48% to 41%. The balance of large loan commitments are held by Foreign Banking Offices, which also lost market share to Wall Street.

So what? Some might argue that Wall Street earned that market share by being more competitive in loan pricing and structure (collateral, covenants, and repayment terms.) Indeed, as anyone involved in business lending during this period can attest, loan rate spreads fell, and terms eased, whether you did business with Wall Street directly or not.

The problem is that Wall Street is very new to the business of commercial lending – as recently as 1994 no investment bank had a syndicated loan underwriting department. U.S. banks and their regulators, on the other hand, had been seared by the fires of a number of economic declines and credit melt-downs since the Great Depression, when the bank regulatory framework had been put into place.

Traditional U.S. banking structures, policies and procedures exist for a reason: to minimize bad loans. By 2008, Wall Street's share of weak credits far outstripped their share of commitments. With only 20% of the commitments, Wall Street was responsible for 43% of troubled loans in the 2008.

Credit Default Swaps: The Emperor's New Clothes

In their annual reports, regulators point out that although there are high levels of criticized debt, the numbers do not include the effects of "hedging or other techniques". In other words, there were a lot of shaky loans being made, but even the regulators could not quantify whether and how the storied "credit default swaps" would work to mitigate the risks of loan losses.

The basic idea behind a credit default swap is this: when a lender makes or buys a loan or corporate bond that lender is making a bet that the borrower can pay the loan back. But if the lender buys a default swap on the debt from somebody else, say Lehman Brothers, he is effectively switching his position and betting that the borrower will *default* on the loan. When the dust settles on the current economic crisis, we're likely to find that once all the bankruptcies, defaults on swap obligations, cross-cancelling bets, etc. wash through, these credit default swaps will have largely been a mirage. The same institutions that made the shaky loans will have taken significant losses on their bad credit bets.

But while the Federal Reserve and its regulatory cohorts were watching these trends, they did not step in. After all, they and the American taxpayer they represent, were *not responsible* for the lending practices of Wall Street. Or so they thought.

To Wall Street, and the industries that relied heavily on their cheap and easy money, the current economic downturn feels like Armageddon. Commercial mortgage-backed security issuance, as an example, dropped from $236 billion in 2007 to $12 billion in 2008, with essentially no new activity at all after June, 2008.

The wine industry however, will escape most of the carnage of the commercial credit contraction. Why? *Because Wall Street money never made its way to the industry in any significant measure*, and as a part of agriculture, the wine business is served by a uniquely diversified set of lenders, most of which remain relatively unscathed by the crisis.

Farm Credit System

A major source of stability in wine industry lending market is the Farm Credit System, which provides one-third of all ag lending in the country. Farm Credit supplies substantial capital directly to the wine industry and indirectly by being a major partner in loan "participations" or "syndications" with other lenders.

The Farm Credit Administration was formed by Franklin Roosevelt in 1933 to improve the nation's delivery of lending to agriculture, and has evolved over the years into a robust network of institutions, surviving its own near-Armageddon in the '80's.

A review of Third Quarter 2008 financial statements of the Federal Farm Credit Banks Funding Corporation demonstrates only moderate affects from the credit crisis. System banks had some exposure to capital markets losses, through mark-to-market write downs on investments, however in spite of the significant increase in these losses during the third quarter ($743 million) net income remained strongly positive. There are clearly signs of trouble ahead: delinquent loans are rising even before the significant commodity price declines of the fourth quarter 2008, with more to come in 2009. However the system is prudently increasing its provision for loan losses, which doubled over the same period in 2007.

Farm Credit's ongoing ability to raise capital appears to have largely weathered the credit crisis. The system is funded primarily through the issuance of Farm Credit Investment Bonds. Farm credit institutions are government sponsored enterprises, like Fannie Mae and Freddie Mac. That's the good news – and the bad news, given recent headlines.

However, in spite of (or perhaps because of) the U.S. government's takeover of the aforementioned institutions, issuance of bonds remained steady throughout the third, and into the fourth quarter of 2008. Market appetite appears to be propelled by the general flight to safety.

Although the spread between these bonds and like-term treasuries has increased significantly, the coupon rates have remained stable. In fact, bonds issued in November '08 had a slightly lower rate than those issued in '07. Also, system banks appear to have successfully issued equity capital during the third quarter, although activity was down significantly and the cost of funds was higher. Overall, the ability of Farm Credit to continue "business-as-usual" lending remains strong.

Commercial Banks

U.S. regulated banks provide approximately half of all loans to agriculture, and are the key source of wine industry capital. In spite of the numerous bank failures to date and the decimation of financial stock values, there will not be any major changes in banks lending to the wine business.

First and most importantly, while Wall Street's source of funds for lending is (was?) the sale of securities, and Farm Credit's is primarily the sale of bonds, banks lend out their depositor's money. With the exception of a few tense moments at the depths of the crisis, after the failure of IndyMac Bank and before the FDIC increased deposit insurance levels (when mattresses were beginning to look like a reasonable option), the disaster in the Stock Market and on Wall Street in fact *eased* the competitive landscape for banks in attracting deposits. People and institutions are withdrawing from securities and holding cash. Thus the rush by non-bank lenders (e.g. Goldman Sachs and GMAC) to convert themselves into bank holding companies.

Secondly, the banks that are failing, (e.g., IndyMac, Washington Mutual) are the banks that chased the securitized mortgage lending market, and ended up on the wrong end of the branch when Wall Street stopped buying their risky mortgage loans. These are not the banks that lend to agriculture.

Community Banks

Community banks, those with total assets of $1 billion or less, provide the majority of bank lending to agriculture (59%). These banks have a negligible exposure to the markets at the heart of the current melt-down. According to the FDIC, these banks hold only 9% of U.S. bank residential mortgages, 1% of credit cards, and have zero exposure to the derivatives market (e.g. interest rate and credit default swaps.) And the mortgage lending they did was higher-quality: community banks account for only 2% of total residential mortgage charge-offs through the third quarter of 2008.

This is not to say that there are no headwinds. Community banks' risk exposure is concentrated in commercial real estate and farm lending, and the spreading economic downturn will lead to increases in problem loans. Ironically however, the fix for the current crisis, TARP funds, (Troubled Asset Relief Program) are providing community banks with a source of capital they would not otherwise have had, namely U.S. government investment. These funds will provide a buffer in community banks' capital base that will allow them to absorb the loan losses that are likely to occur in '09 and '10. That means less of an impact on their capacity to make new loans.

Large Banks

In the ranks of large banks, while some have fallen or are in trouble, those that lend to the wine industry are among the strongest. The top three U.S. Bank lenders to agriculture are Bank of America, Wells Fargo, and Bank of the West.

The first two are sufficiently strong to be utilizing the current crisis to grab market share. The third, Bank of the West, is a wholly owned subsidiary of BNP Paribas. It was the conservative BNP that was the first major institution to point out that there was trouble in the mortgage backed securities market when, in August 2007, it halted trading in those securities. And the rest is history.

The Effect on the Wine Industry

The credit crisis which started on Wall Street has caused a major economic downturn that will affect the wine industry in ways that are not entirely clear yet, but will certainly require the sort of management responses that are typical for these cycles, such as inventory management, increased sales efforts, and cost controls. Some in the wine industry will have to rethink their business models to accommodate the new credit environment, with increasing due diligence processes, and fewer speculative deals financed.

Although the wine industry will not face some of the challenges as other sectors of the economy with respect to credit availability, it will still be more difficult for grape growers and wineries to obtain financing. In its simplest terms, the supply/demand equation just shifted with the evaporation of the securitized loan market.

In the past six months what was a buyers' market for money has become a sellers' market. As a result, the wine industry can expect increased interest rates, increased collateral requirements, lower advance rates, the return of personal guarantees, and other changes in terms to reflect both the increased risks in the market, the increased cost of funds for lenders, reduced competition and the increased scrutiny that regulators will bring to lender's loan activities.

The good news: the system is working.

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FINDING THE RIGHT WINERY BUYER

Scott Becker

The most important factor in getting the highest price for a winery is finding the right buyer –the one who will pay the most for the business. But how does a buyer ultimately determine what price to pay? There is a systematic way to approach this question that provides insight into how buyers value a wine business.

The most important, but often overlooked, exercise for finding the right buyer is evaluating the full potential of the business. What is the highest and best use of the business assets? What makes the brand(s) unique? How can the business improve going forward? These are questions to be answered before looking to the "market" for indications of value.

Business Plan

The answers to these questions should be documented in a business plan that shows the projected results of pursuing the optimum business plan for the assets. This may be a change in current direction.

These changes however, must be supported by some evidence that the new assumptions are reasonable. For example, if sales are projected to increase, where specifically is the source of that growth and what resources are needed to realize that growth? Also, if that is the true potential, why has it not yet been realized and what are the risks going forward? The assumptions used must be credible and well-supported.

After looking at the business in this critical way, then look at the business through a buyer's eyes. Of course, "beauty is in the eye of the beholder" and in business, value is in the eye of the beholder. In other words, the value of a wine business depends in large part on the specific buyer.

Each potential buyer will utilize the assets differently. A buyer's plan for the assets determines the price that buyer is willing to pay. The business will be most valuable to the buyer who believes they can scale the business the most and can realize the most synergy from the transaction. Synergies include cost savings from production, distribution, or marketing plus increased revenues from improved marketing and sales. The challenge is to show each specific buyer how they can maximize their return and minimize their risks. This is key because, in short, the buyer who will pay the most is the one who can do the most with the assets.

Asset Mix

Selling a business is very different from selling a brand. A significant portion of the value may be in vineyard properties or other hard assets, or just in the brand and inventory. Buyers look at these assets very differently. For example, a strategic buyer like another wine company might be looking for a bolt-on brand to fill a gap in its portfolio. Meanwhile, a financial buyer such as a private equity firm might be looking for a stand-alone business with considerable real-estate holdings to borrow against. Different assets attract different kinds of buyers.

Evaluating Buyers

The sale process includes a due diligence period designed for the buyer to examine the seller. However, this is also an opportunity for the seller to evaluate the buyer. While price is clearly a significant factor in finding the right buyer, it is not the only consideration. The buyer's philosophy and other non-price contractual terms such as non-compete clauses are also important. The diligence period provides the opportunity to fully evaluate the potential buyer and assess their suitability.

The sale process is best described in Shakespeare's terms – in that deals always "die a thousand deaths" before they're done. In other words, the process is always unpredictable. You cannot easily identify the best buyer in advance. There are always surprises. Buyers come and go. The key to surviving the ups and downs of the sale process is preparation (the topic of another article). Preparation allows you to operate with speed once a buyer is interested.

Finding the right buyer is more art than science. But spending time thinking about each buyer and how each might view the business always yields useful insights. In the end, these insights help identify the best buyer and ultimately result in a successful transaction.

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