Will 500 West Coast Wineries Sell?

What the wine mergers and acquisitions market *really* looks like

By Carol Collison

There is a widely held perception in the wine industry that merger and acquisitions (M&A) activity is currently quite robust, and that selling their wineries is how owners will exit the business.

In a report published by Silicon Valley Bank earlier this year ("Ownership Transitions in the Wine Industry"), more than 10% of the winery owners surveyed were "strongly considering" a sale in the next five years. Will 500 West Coast wineries actually be sold in the next five years? The short answer is no. For a variety of reasons, the 10% who are thinking about selling today will result in 2% who actually do.

It is true that there is currently a strong level of transaction activity in the wine industry. However, most sales have been of vineyards and the occasional winery facility. These are real estate sales transactions, which sometimes get erroneously conflated with M&A. The winery merger and acquisition market (meaning the sale of a wine company and/or associated brand[s] as going concerns) is quite different, with activity levels currently slow to normal.

It is difficult to see perfectly what happens in the wine industry M&A market, since there are so many small operations, and many transactions are not publicized. However, a review of the data about West Coast wineries collected by Wines Vines Analytics from 2005 through September 2014 provides a clear and remarkably consistent picture. (Included in the many interesting facts in this data, used for the Wines & Vines Directory/Buyer's Guide and other services, is the ownership of the winery, for most entries.) On average, there are approximately 20 M&A transactions a year. There are some basic microeconomic principles that can explain why, although there are 500 winery owners who currently want to sell their wine company and/or brands, there are only 100 who will.

Fantasy Island

Some of these 500 "sellers" are sellers only if someone knocks on their door and offers them a ridiculous sum of money. The problem with this plan: It almost never happens. In the real world, the sale of a wine company occurs after the owner decides to pursue a sale, hires a professional advisor who establishes a realistic asking price and then conducts a complicated, lengthy and expensive preparation, marketing and negotiation process. Wineries owned by this kind of daydreamer will not, therefore, be sold in the next five years.

Human nature

A growing area of economics applies cognitive psychology to the study of human behavior in the marketplace. "Behavioral economics" is establishing that the theoretical economic agent maximizing his or her return does not exist, and that humans are more complicated and "buggy" and often make decisions that don't pencil out. Empirical studies in this field have shown that people have a tendency to dramatically discount the value of gains in the future and overvalue immediate gains. People are more motivated by the fear of losing than by the hope of winning. People prefer the status quo over a better alternative. In sum, given the choice between a possible large future payday at the end of an expensive and difficult sale process that results in a winery owner having to change their whole life or continuing to run their business and live in their house on the vineyard, most winery owners will choose the latter.

So a large number of the folks who checked "yes" to a future sale in the Ownership Transition Survey will never begin the process. What will happen with those that do?

Two for the price of one

The winery merger and acquisitions market is in a state of permanent disequilibrium. That is to say, there are no simple mechanisms by which the large number of wineries for sale (the supply) will be cleared by price adjustments or adjustments in demand as there are in markets for less complicated items such as commodities or consumer goods. For example, there are many reasons why a winery owner will not accept a lower price in order to get a deal done. Some are similar to what we find in the residential real estate market, such as the amount of debt on the winery or the desire to preserve equity or obtain a reasonable return on an investment that has been held for many years (if not generations). In the absence of urgency created by outside forces (e.g. a bank or partners demanding repayment), many of the sellers who actually go to market will not obtain their price and therefore will not sell.

Buyer's remorse

Even when buyers and sellers come to an initial agreement on price, a significant portion of deals will fail during subsequent contract negotiations and due diligence. This is because the stakes are high for individuals and companies acquiring an operating winery: Millions of dollars will be invested and borrowed; organizational reputation is at risk for the company and for the managers making the decision; and for most buyers, there are opportunity costs (meaning that the purchase of one wine company will preclude pursuing other future opportunities that might be a better fit). Having agreed to pay something near the seller's price, even the most sophisticated buyer begins to worry that he has made a mistake. No matter how well prepared the seller's offering, the typical due diligence and contract negotiation process leaves ample opportunity for the buyer to get spooked and walk away.

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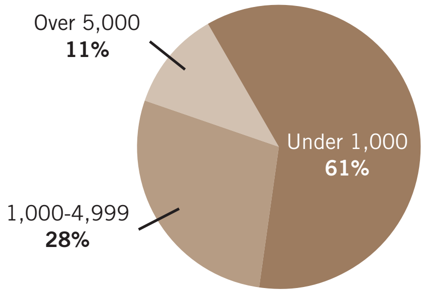
Winery Closures by Production Size (cases)



Wines Vines Analytics. West Coast, 2005-September 2014

What's behind the Northwest land grab

The Pacific Northwest has become a hotbed of wine property sales as vineyard acreage in Washington has reached 45,000, and acreage in Oregon has reached 25,000. Average revenue per acre in both states is more than $5,000 per acre, yet property values have remained mostly lower than for California land with similar wine quality potential.

Several speakers at the 23rd Wine Industry Financial Symposium described the current economic levers affecting vineyard purchases, and Josh Grace, managing director of International Wine Associates, noted 13 significant vineyard deals in the Northwest since October 2010–dominated by California wineries as the buyers.

Size of the industry

With Oregon approaching 600 wineries and 25,000 planted acres that produce 3.3 million cases of wine annually, Grace noted that wine grape growers have to compete for space with farmers of blueberries, hazelnuts and hops for craft breweries, all of which are very popular.

Washington has 680 bonded and virtual wineries, according to Wines Vines Analytics, and Grace estimated there are 45,000 planted acres producing 13 million cases of wine per year. There, apples, cherries and hops are alternative lucrative crops. Washington has not quite twice as much acreage as Oregon but four times the output due to yields of 4 to 5 tons per acre compared to Oregon's 2 to 2.5 tons per acre.

Grape production in Oregon and Washington is similar in size to several of California's coastal counties. Sonoma has about 60,000 acres planted to wine grapes, while Monterey and Napa counties each report about 45,000 acres.

The number of planted acres in Oregon grew by 25% between 2011 and 2012, according to survey results from Southern Oregon University, and Grace speculated that the rapid growth would continue in the near future. The yield disparity between Oregon and Washington vineyards is generally offset by the increased value per ton of Oregon grapes, of which 80% are Pinot Noir. Washington averages $1,110 per ton for a revenue per acre of $5,550, compared to Oregon's average of $2,500 per ton and $5,625 per acre.

Even though Oregon commands high prices, buying vineyard property there is a very attractive option compared to buying in noted California Pinot Noir regions such as the Russian River and Anderson Valley AVAs. Washington has had a wider range of vineyard prices from low to high compared to Oregon because of greater differences in growing conditions and more diverse planting of varieties.

Even at a high selling price of $75,000 to $80,000 per acre in top Oregon AVAs and Washington's Walla Walla and Red Mountain AVAs, the states have a long way to go before commanding the prices paid for top California vineyards.

Grace said that Cabernet Sauvignon wines from Walla Walla average slightly higher in *Wine Spectator* ratings than those from Napa, and the Walla Walla bottles sell at about half the price.

Not surprisingly, producers from California and France are looking to Oregon because of the high quality vineyards, good water supply and attractive pricing relative to California and Burgundy for planted vineyards. Planted Oregon Pinot Noir vineyards are currently selling for half the price per acre of Russian River vineyards, for example.

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While Washington has had comparatively fewer investments from outside the state thus far, it has seen a few large transactions.

The state has significant amounts of unplanted land with water at prices that are very attractive ($10,000-$15,000 per acre for bare land). Large vineyards can sell for $25,000-$30,000 per acre and produce wines of excellent quality in the $10-$14 retail category.

Duckhorn, Gallo, Cakebread Cellars and Crimson Wine Group are all making wine in Washington now, and according to Grace others will join them soon.

The symposium, designed to bring together lenders and decision-makers in the wine business, was held Sept. 22-23 at the Marriott Napa Valley.

John Mackie, the managing partner of law firm Carle, Mackie, Power & Ross, moderated a panel that included Grace, Matthew Franklin, principal at Zepponi & Co., and vineyard appraiser Tony Correia of the Correia Co.

California mergers and acquisitions

Franklin with Zepponi & Co. provided an overview of the situation in California. He began with a reminder of who's buying vineyards and wineries now:

Strategic buyers are public and privately held companies already in the wine business looking to build their portfolio, expand geographically and leverage their existing infrastructure to make opportunistic buys. Financial buyers include private-equity firms and institutional investors seeking to generate adequate return, given the level of risk over a finite period, and lifestyle buyers such as wealthy individuals and foreign investors are seeking

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Econ 101

There are a number of structural issues in the wine industry that create further obstacles for owners wanting to sell their company. Among these are low barriers to entry, especially with the market acceptance of negociant and virtual brands. This creates competition, which drives profitability down and leads to many unsuccessful efforts. Furthermore, buyers can then ask: Why should I buy your failure when I can create my own? Another structural element: capital intensiveness. When added to low profitability in many instances, the investment required to acquire Chateau John Doe in relation to the returns is prohibitive for many potential buyers.

Finally, lifestyle buyers are a bigger part of the winery M&A market than they are in, for example, the technology industry. These buyers want to create Chateau Me, which limits the market for some types of brands irrespective of profitability.

So what will happen to those sellers that will be unable to find a buyer in the next five years? The data from *Wines & Vines* tells the story. On average, almost 100 wineries shut their doors every year. In the end, we find that the U.S. wine industry reflects the vibrancy and risk-taking entrepreneurialism of the American culture. It's creative destruction on steroids.

These, then, are the realities of the wine mergers and acquisitions market:

Because it is such a personally and organizationally complicated effort, for most owners, the sale of their winery will always be "two to five" years out. For others, the first (or even second) sale effort will not achieve a satisfactory result. For those owners, the solution will be the quiet liquidation of the brand and the separate sale of the real estate assets. Often, the owners will retain and continue to operate the business.

Nevertheless, a successful sale transaction is the single-largest contributor to a winery owner's return on investment. For many, the effort required to find a buyer will be well worth it. Notwithstanding the old canard about large fortunes being turned to small ones in the wine business, the reverse has also been true. Fortunes have been made, and many more will be in the years to come. W&V

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SIGNIFICANT PACIFIC NORTHWEST TRANSACTIONS

1987 Maison Drouhin of Burgundy created Domaine Drouhin Oregon

1990 Chalone Vineyard invested in Canoe Ridge Vineyard in Washington

1991 Gary and Nancy Andrus of Pine Ridge Vineyards (now the Crimson Wine Group) started Archery Summit in Oregon

1995 Col Solare, a joint venture between Marchese Antinori and Ste. Michelle Wine Estates, founded in Washington

2001 Lion Nathan bought Argyle Winery in Oregon

2001 Vincor bought Hogue Cellars in Washington (Vincor later was acquired by Constellation Brands)

2001 Constellation acquired Columbia and Covey Run wineries in Washington

2005 Crimson Wine Group bought Double Canyon Vineyards in Washington

2006 Ste. Michelle bought Erath Winery in Oregon

2008 Ascentia Wine Estates bought Washington's Columbia and Covey Run

2008 Bill Foley bought into Three Rivers Winery in Washington

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intangible lifestyle benefits, though financial returns are important.

Vineyard prices on the rise

Finally, appraiser Correia spoke about California vineyards and land. He first noted that the value of California wine grapes grew from about $200 million in 1973 to $3.25 billion in 2013, and with the growth, vineyards prices have followed.

In Napa County specifically, grape prices rose from $1,500 per ton in 1995 to $5,500 in 2013, Correia said, even as tonnage has almost doubled.

Cabernet Sauvignon has increasingly dominated Napa. Its harvest rose by 92% since 1995, even as Chardonnay dropped 22%.

One result is that even secondary vineyard land has increased in value from $50,000 per acre in 1995 to $100,000-$200,000 now, and the price for prime vineyard sites located in top mid-valley AVAs is approaching $300,000. "A few are pushing $450,000 (per acre)," Correia said. "That's still a bargain compared to the best of Bordeaux and Burgundy, however!"

Even outlying land across the mountains from Napa Valley but still in Napa County can go for $50,000 per acre.

For his part, however, Correia said he fears some growers are planting Cabernet in unsuitable soil, which could compromise Napa's reputation for quality. "We've never seen a serious decline in value in Napa, in prices of grapes or land, unlike the disasters that have occurred in other parts of the state," he said.

Prices are lower in Sonoma County, but top Pinot Noir land near the coast can cost $125,000—up from $25,000 in 1995. "Pinot is driving the bus in Sonoma," Correia said, adding that the same is also true in Monterey—especially in the Santa Lucia Highlands.

In Monterey County, where growers compete for space with vegetable farmers, land has risen from $10,000 to $40,000 per acre, while in San Luis Obispo and Santa Barbara counties, the prices have risen from about $12,000 per acre to more than $50,000 in some areas.

Lodi has stayed relatively stable (from $12,000 to $20,000 per acre), but in Fresno and Madera counties, demand for land to plant nut orchards has grown from less than $5,000 per acre to more than $25,000 if the land has water.

Correia concluded his talk with an emphasis on the importance of water. "There's plenty of water in California, but politics can create problems." With new regulations signed, he warned growers to deal with water issues now.

—Paul Franson

2010

Banfi acquired Pacfic Rim Winemakers in Washington

2012

E. & J. Gallo Winery acquired Columbia and Covey Run in Washington

2013

Jackson Family Wines acquired Gran Moraine/Zena Crown Vineyards in Oregon

Precept Wine Brands acquired Yamhela Vineyard in Oregon

Jackson Family Wines acquired Solena Estate winery in Oregon

Jackson Family Wines acquired Maple Grove Vineyard

Louis Jadot acquired Resonance Vineyard in Oregon

Duckhorn Vineyards acquired Longwind Vineyard in Washington

2014

Elk Cove Vineyards acquired Goodrich Vineyard in Oregon

Jackson Family Wines acquired Gran Moraine/ Zena Crown Vineyards in Oregon

Allan Brothers Inc. acquired Sagemoor Vineyards in Washington

Foley Family Wines acquired Four Graces winery in Oregon

Ste. Michelle Wine Estates acquired Willakia Vineyard in Oregon