WINE BUSINESS
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Robert Nicholson: Master of Mergers and Acquisitions

by Robert Joseph

International Wine Associates (IWV) is an investment advisory and corporate development firm based in the California wine country that offers worldwide services to leading wine industry players. Robert Joseph spoke to Robert Nicholson, the man behind IWV, about where the wine industry is going next.

Wine Business: How did you get started in this business?
Robert Nicholson: After 18 years of working for corporate wine companies such as Seagram and Eschenauer, I established International Wine Associates (IWA) in 1990. Our first major merger and acquisitions (M&A) deal closed in 1993 when we were engaged by IDV – instead of the investment bank that had previously done most California wine industry transactions! – to move various Napa Valley assets that included selling St. Helena's famous Greystone Building to The Culinary Institute of America. It was an interesting transaction that brought America's most prestigious cooking school to the Napa Valley. Since then our business has expanded to include corporate finance, strategy planning and project management work for numerous small family owned and large multinational wine companies as well as various banks. We have been lucky enough to have completed wine industry transactions with a combined value of over US$750m (€557m) since 1993, over US$200m since 9/11 and over US$85m in the last 12 months.

Wine Business: What are the most interesting deals you've been involved with to date?
Robert Nicholson: All of our deals are fascinating because of the colorful personalities we work for and with. Over the years we have worked on the buy side with major multinationals such as Fortune Brands in their 1998 $100 million (€75m) acquisition of Geyser Peak and on the sell side for numerous family owned wine companies.

Wine Business: Internationally?
Robert Nicholson: In 1993 we worked on an interesting project when we were retained by Ross Wilson, who was running SA Brewing at the time, and Jose Fernandez, who was running their local operation and now manages all of Constellation's American wine business. Ross had just completed assembling the most superb collection of Australian winery assets, including Penfolds, Lindemans, Seppelts, Wynns and more, that later became known as Southcorp. Ross wanted us to review all major US winery acquisition opportunities and the project included detailed financial analysis of over 25 American wineries, including Beringer, Robert Mondavi and Stimson Lane. Unfortunately, SA Brewing was not a pure wine player at the time and Ross decided to invest in an underperforming water heating manufacturing company that ended up being a poor investment. However, Ross is one of Australia's all time larger-than-life businessmen who was fascinating and the project allowed IWA to evaluate the financial performance of all the major US wine companies.

Wine Business: And in Europe?
Robert Nicholson: Another classic project was working for the European Bank with ING Baring on a $65m debt and equity due diligence (dd) project for the collective refinancing of Domaine Boyar, the largest

Bulgarian wine company. In addition to managing all the strategic, production and financial work, we were engaged to review the local financials that had been prepared by the Sofia office of a major accounting firm, which we had to re-do completely in order for it to make sense to the banks. The investment was for building one new winery, upgrading three other wineries and working capital inventory financing. None of the funds were designated to an improvement of the vineyards, which is where the investment was most needed, because no investment had been made in the vineyards since the 1980s

Wine Business: Is there a pattern to many of these purchases?
Robert Nicholson: In a rapidly consolidating global wine industry, where the four largest wine companies worldwide have only a 6% market share, most buyers have a clear idea of what they need to acquire to build their portfolio. Compared to beer where the top four have a 26% market share, or soft drinks where they have a 78%, they know that the sky is open. For example, they might need a Pinot Noir brand, or more specifically, a Russian River Pinot Noir producer. We categorize buyers into six distinct groups:

• multinationals (global in focus)
• major wine companies (global or regional in focus)
• large independent wineries (regional in focus)
• small independent wineries (local and sometimes regional in focus)
• financial institutions
• high net worth groups or individuals

We work more often for the sellers.

Wine Business: Isn't it difficult to value the potential of brands to grow in new markets?
Robert Nicholson: Part of every valuation is the "growth" component, which is usually the most difficult to quantify because the seller's view of what his company or brand can become may be different from what an acquirer thinks is possible.

Wine Business: How do you value a brand like Red Truck or Cardinal Zin?
Robert Nicholson: We value brands on the basis of their terminal value, the present day value of their future cash flows, multiples of EBIT or EBITDA or revenues of historical transactions, which are used to check if the terminal value is in the range of acceptable norms. We also use asset value that is based on the brand inventory, bulk wine and case goods, net realizable value plus the goodwill value.

Wine Business: The South African Kumala brand was a major element in the purchase of Western Wines by the Canadian Vincor and the subsequent purchase of Vincor by Constellation. Do you think the current Kumala performance in the United States justified the purchase?
Robert Nicholson: Yes, Kumala was a key component in Vincor's acquisition of Western Wines. They believed Kumala would give them UK market access for their other products. However, Vincor overpaid for Western. On the other hand, while Kumala may have been one of a few important reasons for Constellation's acquisition of Vincor, I do not believe that it was the most important component. It was access to the Canadian wine market through Vincor's 25% market share there that Constellation wanted. Constellation has not yet focused their considerable strength on building Kumala in the USA. This may change with Gallo's introduction of Sebeka from the Swartland cooperative.

Wine Business: How important is land in the deals you are doing?
Robert Nicholson: Land is a critical element in high quality winery deals and relates back specifically to the importance of the estate vineyards to maintain the estate integrity and quality of the specific opportunity.

Wine Business: How big a factor is distribution?
Robert Nicholson: Distribution is a key component in any acquisition and will always impact valuations. At a time when the global wholesale and retail network is quickly consolidating, the relative strength that a

brand can bring to a buyer, or the access to a new market sector that it offers, will influence the value a buyer is willing to pay. The synergy in the wholesaler network is also a key valuation driver in the States. Often acquisitions are driven by the market access that the opportunity can bring to the buyer.

Wine Business: You have brokered a number of interesting deals including the recent sale of Bonny Doon's Big House Red. Considering the price it achieved, it wasn't a huge brand in volume or value terms. What makes a brand like that attractive to purchasers?

Robert Nicholson: Bonny Doon's Big House sold over 200,000 cases in 2005. It is the best tasting, highest priced generic blended red wine in the United States. At the time of the acquisition the brand was highly profitable, had a strong following with consumers who were looking for a reasonably priced alternative to the corporate generics and had distribution in an upscale group of restaurants and off-sale retail accounts throughout the country. The fact that Big House can be scaled to a much larger volume, at a high retail price in its category, with higher than normal margins, made it an attractive brand to many buyers.

Wine Business: Some of the prices that have been paid for wine companies in recent years seem to make little sense in terms of potential earnings. Can you explain the rationale behind some of these purchases

Robert Nicholson: Certain buyers can extract value, where others cannot. Constellation was reportedly able to absorb Robert Mondavi, for which they paid 15.5 times forward EBITDA, and pay for the acquisition within five years with one third to be paid from Robert Mondavi's cash flow under Constellation ownership, one third by increasing the sales of Robert Mondavi wines in Britain and one third from consolidation synergies through staff reductions and other savings. Foster's acquisition of Beringer, a 12 times forward EBITDA, gave them access to the world's largest wine market and a strong wholesaler network, which subsequently enabled Fosters to acquire Southcorp at 14.9 times forward EBITDA.

Wine Business: The US has not been good at exporting its wines. Might this be an issue if the American market was to one day become less profitable than it is today?

Robert Nicholson: US wine exports, of which 95% come from California, totalled US$895m (€665m) for 404.5 million liters in 2006, an increase of 30% in value and 4% in volume over 2005. In Europe, where USA ships more than 50% of its overseas sales, exports surged by 48% in value. Wine exports to Canada grew by 29%. According to British retail statistics, US wines grew by 8% in value off-premise and 18% on-trade. Apparently, the off sale growth was larger than that of any other country and equals a market share of 16%, only slightly below France at 16.4% and the market leader Australia at 22.3%, but with volume growth of only 4% in 2006. California wine exports have grown in value from US$219m in 1995 to nearly US$800m in 2006.

Wine Business: The last few years has seen a plethora of "critter" brands riding on Yellow Tail's coat tails. How many of these have long term value?

Robert Nicholson: Probably not very many have sustainable value. However, 10 million cases in the USA alone make Yellow Tail pretty special! My thought is these brands have served the industry and consumer well. They have brought a more light hearted approach to wine marketing and made the product more approachable.

Wine Business: Philip Bowman, when he was heading Allied Domecq, once said he thought public ownership was inappropriate for the wine business, because of the length of time establishing vineyards, difficulties in changing direction and the vagaries of weather, which are incompatible with the needs of shareholders. What do you think?

Robert Nicholson: The model Bowman referred to is the "old" style. Most public wine companies are now quickly shedding most of their non-core assets such as vineyards, unless they are core to the estate concept of the brand. Some wineries, for instance, move them off the balance sheet to financial institutions and then lease the assets back.

Wine Business: Given their famous hunger for cash returns, how much appeal do you think wine businesses have for private equity investors?
Robert Nicholson: As the US wine market continues to show strong growth, we are seeing increased interest from private equity groups. Well run super and ultra premium wineries can provide strong returns. The US is the strongest wine market in the world with the largest upside for continued growth. Wall Street is no longer blind to this fact.

Wine Business: Many observers would say that Napa Valley land is overpriced, which in turn has led to an average price for Napa Valley Cabernet of $50 per bottle. Are these prices sustainable?
Robert Nicholson: Large crops in 2005 and 2006 produced an excess of Cabernet Sauvignon that now gives the consumer an opportunity to enjoy $15-20 bottles of generic Napa Cabernet. However, in 2003 Francis Ford Coppola purchased a Rutherford vineyard from the estate of JJ Cohen, co-founder of MGM Studios, in a deal that represents the highest price ever paid for vineyard land in California, or the New World, at $350,000 an acre (€650,000 per hectare). Coppola stated "Our goal is to become America's great wine estate, equivalent to a Bordeaux 'first growth', and we have the land and grapes necessary to do so". With land in Pauillac now selling for over $600-750,000 an acre for the classified growths, we think that Napa still has a long way to go!

Wine Business: The New World has been far quicker to move into public ownership of wine businesses. Do you see investors taking an interest in Europe where, by US standards, land and businesses might seem cheap?
Robert Nicholson: Most major European wineries are family owned and have not needed to go to public markets to raise funds to finance their growth. We envisage the emergence of five or six global wine multinationals, who will own assets in most major wine producing regions of the world. All will be participants in the European wine industry. The majors will be followed by a few strong regional companies, who will focus their resources in their own region of origin, but compete throughout the all major markets with the multinationals.

Wine Business: Europe is loosening up some of its more restrictive wine laws. Will this make investment there more attractive?
Robert Nicholson: Yes, the international wine companies will all want to invest in Europe. Indian investors, in the shape of UB, have recently bought the sparkling wine firm of Bouvet Ladubay in the Loire – after failing to secure Taittinger – and there are rumors of similar interest from potential Chinese buyers in the west.

Wine Business: You have predicted that the US will become the biggest wine market in the world by 2008.
Robert Nicholson: In 2005, the USA ranked third in volume of wine consumed behind France and Italy. By 2010, Vinexpo IWSR project that the USA will grow to become larger than both the UK and France combined.

Wine Business: Are you confident about those figures?
Robert Nicholson: Yes, because I am very optimistic about the American consumer's future interest in wine. A recent survey published by Wine Market Council shows that the number of core wine drinkers, that is those who enjoy wine at least weekly, has increased by 32% in the last 24 months. This statistic is particularly encouraging because core wine drinkers, while still only 17.4% of the US population, or 45.2 million people, consume 87% of the wine purchased and have a per capita consumption of over 60 liters per year. There are an additional 44.7 million marginal wine drinkers, who enjoy wine at least quarterly, that consume 13% of the volume. Then there are the 69.7 million beer and spirits drinkers who don't yet consume wine, but who will in the future. In addition, the survey also revealed the Millennial generation, currently aged 28 and younger, is drinking more wine than previous generations. This important demographic group of 70 million Americans is a key to the continued expansion of the wine market. We may not have enough wine to supply them if they all turn out to be core consumers!

Wine Business: Most of the M&A has been at the production or brand-owning level. What do you expect to happen to distributors?

Robert Nicholson: Consolidation at the wholesaler distributor level in the USA has been driven by Southern, Charmer/Sunbelt and a few others. These major companies now have wholesalers in most of the key markets in the States. This expansion has generally been secured through acquiring other wholesale distributors.

Wine Business: Yellow Tail's American distributor owns a large slice of that brand. Would you advise other would-be exporters to the US to make equity sharing deals?

Robert Nicholson: Yes. Other than for prestigious, well-known, limited production wineries, it is unrealistic of exporters to the American market to assume their partners will open the market for their brands and provide access to the complicated 50 state whole-sale network without having secured some permanency to the relationship with the brand owners that they represent.

Wine Business: Can the three-tier system survive?

Robert Nicholson: The fact is that the three-tier system is legally mandated and will survive in some form. However, there will be further challenges and the system will be slowly eroded. Twenty years ago, only four states allowed for legal, regulated direct-to-consumer wine shipments. Although 33 states now allow such shipments from out of state wineries, just 12 allow retailers to do the same. Currently the Supreme Court, Federal Trade Commission, state alcohol regulators and state legislators have joined consumers to help update the laws originally designed to entrench monopolies.