WHITE PAPER

Banking the Wine Industry: Why Your Business Model Matters to Your Financing Options

As an industry segment, commercial banks perform a crucial role in our economy by providing an effective source of capital to corporations looking to finance their cash conversion cycle, growth aspirations, or fixed asset investments. It's no surprise then, as commercial bankers, we are often asked the question, "What do you look for when considering a loan for a winery?" In answer, the approach for any good banker (or investor) should be similar.

Whether analyzing a winery, food company, service provider, or logistics company, proper risk assessment requires a solid grasp on the overall industry in which any prospective customer competes and the business model it has adopted. This exercise includes an analysis of historical and projected financial performance and an assessment of whether the management team can successfully create and sustain a competitive advantage for the business.

What we learn from the business model

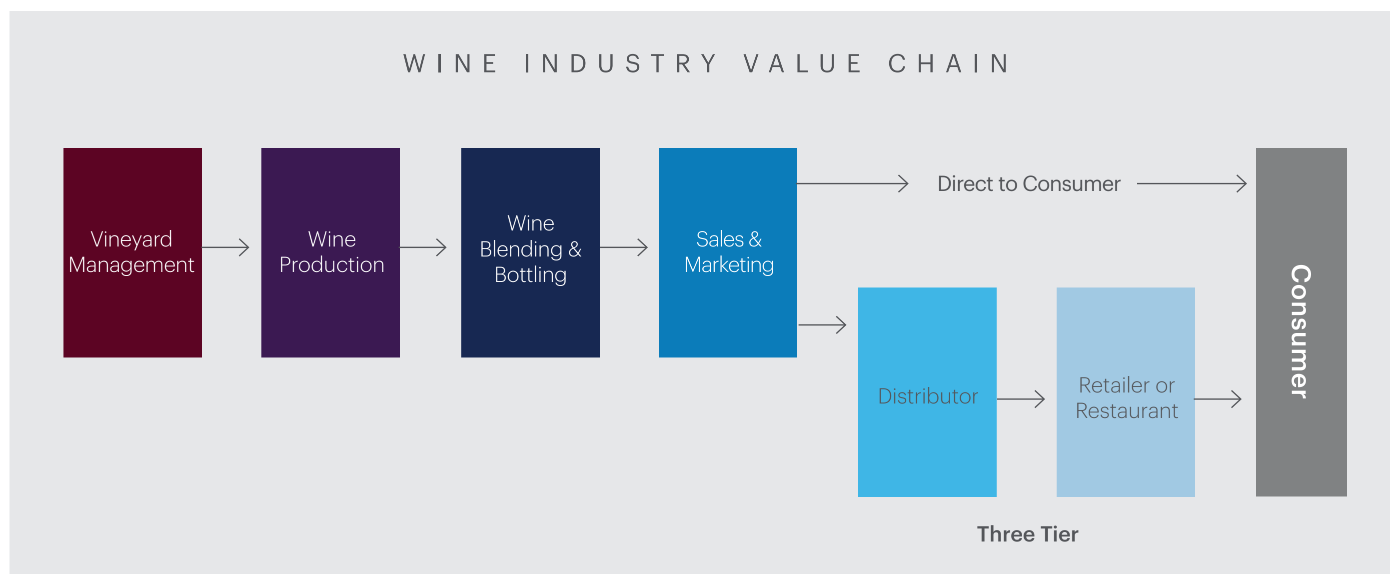
There are a handful of business models within the wine industry that can be used to compete successfully, and the capital needs of these varying models can be vastly different. For example, a company selling $10 per bottle unoaked chardonnay through wholesale markets nationwide will have very different needs than a company selling $150 per bottle cabernet sauvignon through purely DTC (direct to customer) channels. As commercial bankers, we would expect to see widely different gross profit margins and possibly very different fixed assets on the company's balance sheet. The amount of debt (leverage) each company can withstand might also be different.

A good way to start identifying business models in any industry is to first sketch a rough outline of the industry *from the perspective of the consumer*. In the wine industry, we look at the value of the industry in terms of how much money consumers spend on wine annually ($69.5 billion in the U.S. in 2018, of which roughly $46.8 billion is spent purchasing domestic wine[1]), and then we divide that total value into market segments, such as type of wine and price per bottle, in order to better understand what consumers are purchasing. This gives us immediate perspective on a company's target market as well as its position within the overall wine industry in the U.S.

Source: [1] Gomberg-Fredrickson Report, December 2018

The value chain — a key component of the business model

Now that we are armed with an overview of the industry, we next turn to identifying the industry value chain. A value chain (also referred to as a supply chain) follows the life cycle of a product or service and identifies each major step in the process where value is added. Let's take a high-level look at a wine industry value chain.



Each step above offers a distinct opportunity to add value to a bottle of wine, and as anyone in the industry knows, each part of the value chain equation has numerous variables that go into making that part successful. When any company enters into business, it first identifies which market segment(s) it wants to target. Then the company should understand what drives purchasing behaviors in that segment in order to assess which parts of the value chain are most important to compete profitably and, therefore, successfully. The parts of the value chain that are most important to the business are those the company will want to fully control. Other components can potentially be outsourced.

For example, if a company wants to sell red and white still wine at prices over $25 per bottle, it's important to control a larger portion of the value chain because quality of wine becomes more important, as does branding/marketing. Yet if a company is focused on selling all types of wine around $10 per bottle, usually we find that their consumers are less picky about the quality and perhaps more focused on the branding and packaging. This means that it might not be as necessary to control the earlier stages in the value chain and instead focus on purchasing bulk wine or grapes from third parties and creating a specific blend to achieve the desired flavor profile, then subsequently focusing more time and investment on branding and marketing.

Financing needs by business model

The types of loans a bank considers most appropriate for a company are usually driven by the types of assets being financed, with significant consideration given to the profitability and cash flow generated by the business.

A vertically integrated winery, one which owns as much of the value chain as is legally allowed under the three-tier distribution system (shown in the chart above), usually owns or leases its vineyards (real estate assets), has its own wine-making facilities (real estate and equipment assets in addition to the actual wine inventory), and also invests in a sales and marketing team that usually spans both DTC and wholesale channels. This is an asset-heavy business model and requires significant capital. Financing needs from a bank might involve a shorter-term line of credit to support the working capital needs of the business, and there might also be a need for longer-term loans to support the investment in real estate and equipment assets.

Conversely, at the opposite end of the business model spectrum, a virtual winery does not own any of its own vineyard or wine-making assets, and instead owns just the branded wine inventory. Financing from a bank in this case would focus on a line of credit for working capital.

The more vertically integrated a winery, the more control it has over its assets and, therefore, the more debt it can support.

Financial expectations by business model

Financial results, in particular the amount of debt (leverage) a company can support as well as the company's profit ratios, will be driven by the business model.

Banks measure the amount of leverage of each company through various ratios, and these ratios are heavily scrutinized by bank regulators as a key indicator of risk. Most companies utilizing bank debt are accustomed to having a financial covenant measuring leverage.

The more vertically integrated a winery, the more control it has over its assets and, therefore, the more debt it can support (assuming sufficient cash flow). As such, there is usually greater tolerance from banks to see slightly higher leverage ratios. The closer a winery is to the virtual end of the spectrum, the less control it usually has over the value chain. In this case, lower overall leverage would be expected.

Banks also pay close attention to a winery's profitability and understand that key differences in ratios, depending on the business model, are to be expected. For example, a large winery selling over 100,000 cases of wine a year through wholesale channels will likely have gross profit margins in the 40-60% range. Yet a small winery selling fewer than 20,000 cases a year through DTC channels should be able to deliver gross profit margins in the 60-80%+ range.

Profitability also depends on ongoing investment in assets needed for the company to continue to compete successfully. After all, barrels need to be routinely replaced and presses and tanks eventually need to be upgraded. Banks monitor profitability and cash flow through financial covenants like minimum profitability requirements as well as debt service coverage ratios (the measurement of a company's annual cash flow relative to its annual debt payment obligations).

We can help

At Union Bank, our Wine Industry Services team is proud to support companies spanning the entire value chain. From growers to producers, bottling companies to distributors, our team understands there is no one-size-fits-all set of rules for what to expect in a company's financial results. Our job is to understand your business given the competitive context and then determine the types of financing appropriate for your company's unique situation.

Three tips to better help your bankers help your business

1. Know your business model and the types of assets your company owns and controls.
2. Ensure you're investing in the right components of the value chain in view of your primary consumer target.
3. Take the time to help your bankers better understand the valid reasons why your financial results might differ from competitors.

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