Understand the Value of Your Wholesale Malt Beverage Distributorship

Timothy R. Lee, ASA
Tim joined Mercer Capital in 1994 and currently serves as a senior vice president and is a member of the firm's board of directors. Mercer Capital is a business valuation and investment banking firm serving a national and international clientele.

Tim has broad industry experience providing corporate valuation and investment banking services to hundreds of companies in an array of industries. Noteworthy industry experience includes, but is not limited to, beer wholesalers, computer hardware, computer software and consulting, construction, food services, general and specialty contracting, distribution companies, financial services, food processing and retail, heavy equipment, manufacturing, technology companies, trucking & transportation, and forest products.

Tim provides valuation and corporate advisory services for purposes including mergers and acquisitions, employee stock ownership plans, profit sharing plans, estate and gift tax planning and compliance matters, limited and general partnerships, corporate planning and reorganizations.

Tim has extensive experience in working with both sellers and buyers in merger and acquisition advisory engagements. He has assisted clients through all phases of the transaction process, from conducting strategic alternatives analyses to determine if selling is indeed the best option, to structuring, negotiating, and closing transactions.

In addition, Tim provides litigation support in cases involving dissenting shareholder rights, marital dissolution, tax matters, and other shareholder conflicts.

About Mercer Capital

Mercer Capital's business valuation services are provided for a wide variety of needs, including corporate valuation services, tax compliance, litigation support, financial statement reporting compliance, and employee stock ownership plans. Clients range from public to private, from smaller companies to large multi-nationals in a broad range of industries as well as numerous governmental agencies.

In addition, Mercer Capital provides investment banking and corporate advisory services including sell-side and buy-side merger & acquisition representation, fairness opinions, solvency opinions, business interest and securities valuation, and board presentations, among others.
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lee@mercercapital.com

Introduction
The financial landscape is littered with rules of thumb pertaining to the value of privately owned businesses. Perhaps in no other industry is the rule of thumb concept more prevalent than in beer distribution. Why is this so? After all, beer distributors are typically street wise and business savvy. They increasingly employ skilled professionals at all levels of their organizations and the evolving disciplines of their trade are largely mandated by sophisticated, international breweries. Wet your finger, raise it to the wind and prophetically proclaim that three dollars per case, or five dollars, or whatever, is the value of the business. While attractive in its simplicity, this mindset is breaking under the need of distributors to know more about the value of their businesses. Indeed, given the scrutiny of the IRS, the control of the breweries, the evolution of product mix, and the wide ranging concerns of shareholders, it is critical that value be determined and articulated in a credible fashion. The purpose of this article is to provide insight into the situational (when and why) and analytical (how) aspects of valuing beer distributorships. We begin with a primer on some important valuation concepts.

The When and the Why of Business Valuation
Most business owners, and particularly principals of beer distributorships, are consumed with day-to-day activities. Many fail to acknowledge that life (and business) cycle events do happen to them, their partners and their families and that these events will require that their businesses be valued. Alternatively, some business owners use business valuation as an essential tool for creating ownership stability and assessing management performance. Mercer Capital professionals have spoken for years about the “things that happen to you” and the “things you make happen”.

The following table depicts the circumstances under which the vast majority of valuation exercises are undertaken. As can be seen, some are positive and some are unpleasant.

<table>
<thead>
<tr>
<th>Ownership Transfer Matrix</th>
<th>Partial Sale/Transfer</th>
<th>Total Sale/Transfer</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Things That You Make Happen (Voluntary, Legacy Path)</strong></td>
<td>ESOP</td>
<td>Sale of Business</td>
</tr>
<tr>
<td></td>
<td>Outside Investor(s)</td>
<td>Stock-for-Stock Exchange</td>
</tr>
<tr>
<td></td>
<td>Sales to Insiders/Relatives</td>
<td>w/Public Company</td>
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<tr>
<td></td>
<td>Combination Merger/Cash Out</td>
<td>Stock Cash Sale to Public Co.</td>
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<td></td>
<td>Going Public</td>
<td>Installment Sale to</td>
</tr>
<tr>
<td></td>
<td>Gifting Programs</td>
<td>Relatives/Insiders</td>
</tr>
<tr>
<td></td>
<td>Buy-Sell Agreements</td>
<td>ESOP/Management Buyout</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Buy-Sell Agreements</td>
</tr>
<tr>
<td><strong>Things That Happen To You (Involuntary, Lifestyle Path)</strong></td>
<td>Divorce</td>
<td>Death</td>
</tr>
<tr>
<td></td>
<td>Forced Restructuring</td>
<td>Divorce</td>
</tr>
<tr>
<td></td>
<td>Shareholder Disputes</td>
<td>Forced Restructuring</td>
</tr>
<tr>
<td></td>
<td>Buy-Sell Agreements</td>
<td>Bankruptcy</td>
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</tbody>
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Chances are you recognize some of your history in the events above. Hopefully, you are planning for those events that are inevitable and seeking to positively influence those events over which you have control.

**Defining the “Value” of a Business Ownership Interest**
Experts in communication suggest that most of what we say to one another is flavored by why, when and how we say it. The literal content is sometimes the least significant element of what we are communicating. To many folks, the value of a business is a universal and singular concept. Well, nothing could be farther from reality when it comes to valuing a specific business ownership interest.

The exercise of valuing a business ownership interest requires a strict definition of “value” which is almost always dictated by the when and why circumstances for which the valuation is being performed. Once these aspects are defined, an analytical framework for determining value is then developed. The following concepts are vital to understanding what is meant by “value” and are essential in defining an engagement with a valuation professional.

**Standard of Value**
The standard of value is the identification of the type of value being used in a specific engagement. The proper identification of the standard of value is the cornerstone of every valuation. In many of the scenarios depicted in the preceding table, the standard of value is dictated by law. In other cases, the standard may be selected by the parties such as business partners creating a buy/sell agreement. So, what are the most common standards of value?

*Fair Market Value* is the most common standard of value used in business appraisals. Fair market value is defined in a variety of professional standards, government regulations, and court cases. For example, as defined by the American Society of Appraisers, fair market value is “the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.”

Often appraisers will confer with legal counsel on the appropriate standard of value for a valuation if such is not otherwise defined. Ultimately, the standard of value is a legal concept which may be the topic of hot debate under adversarial circumstances.

Many business owners often pragmatically observe that fair market value has little to do with the real world where buyers and sellers are very specific people who are individually motivated, uniquely informed, and are using something other than pure cash to transact.

*Investment Value* is the value to a specific investor based on their particular investment requirements and opportunities. The value produced would reflect the knowledge, expectations, synergies, and economies of scale of the particular investor. Investment value is often used when valuation or investment banking professionals are advising their clients as to the merits of executing a specific transaction such as buying or selling a specific business or asset. Investment value answers the questions – what’s it worth to them? Or what’s it worth to me?

*Fair Value* has two distinct definitions. It can be defined as the statutory standard of value applicable to cases involving dissenting minority shareholders with respect to corporate reorganizations or recapitalizations covered by the various state statutes. It may also have a specific meaning for divorce or under the securities laws of each state.
Fair value is also commonly used in financial reporting. The definition in this context is outside the scope of this article; however, you may hear the term used when discussing your financial statements with your accountants and auditors.

So why all the minutiae about the standard of value? The standard of value is the predicate for another critical defining element of value – the level of value.

**Level of Value**

Does it make a difference in value per share if I own 10% or 75% of a privately held business? You bet it does. The former is a minority interest and does not enjoy the prerogatives of control which the latter does. How does this affect value per share? Well, the minority owner is relegated to bearing witness to a process over which they have no control or discretion. They cannot control compensation or distributions and they certainly cannot dictate the strategic direction or operational management of the business. Thus, the fair market value per share of a minority owner is likely worth less per share than the shares of a 75% owner.

To add further insult to injury, a minority owner in a private business has no ready market in which to sell their interest. Minority ownership in a publicly traded company enjoys near instantaneous liquidity given that such interests can be traded on organized and regulated exchanges and converted to cash. The unique uncertainties related to the timing and favorability of converting a private, minority ownership interest to cash gives rise to a valuation discount (marketability) which further distances the minority owner’s per share value from that of a controlling owner’s value per share.

The following chart provides a hierarchical perspective of the various levels of value. In most cases a valuation is developed at one level of value and then converted to another level of value by way of a discount or premium. Knowing when to apply such adjustments and quantifying the size of these adjustments is no simple matter.
So what does all this have to do with buying, storing, selling and delivering beer! Good question – apology given for the devilish details of the valuation science. A word of caution though, defining the standard and level of value are big money issues! A lack of basic knowledge will leave you short of the required vocabulary and understanding needed to comprehend the context with which the value of a business interest is developed.

Begging your indulgence, we offer a word of advice concerning who you choose to value your business. Beer distribution, like many industries, has given rise to many niche consultants who sometimes practice valuation without the requisite command of how value is defined for a given circumstance and correspondingly how such value should be developed. Industry knowledge and valuation knowledge are not synonymous.

**Approaches to Values (With Relevance to Beer Distributors)**

There are three general approaches to determining business value – cost, income, and market. Under each approach there are specific ways to determine value that are commonly referred to as methods. As a general rule every valuation should consider these approaches. Ultimately, the conclusion of value will reflect consideration of one or more of these approaches (and perhaps various underlying methods) as being most indicative of value for the subject ownership interest.

**The Cost Approach**

This approach is rooted in determining the value of the assets and liabilities. The aggregate value of the assets, net of the liabilities of the business, is indicative of the value of the equity in the business.

The net asset value method is, in simple terms, a balance sheet approach to value. Book value (or adjusted book value as "net asset value" is sometimes referred to) is a primary benchmark for value in many asset intensive companies such as manufacturing concerns or real estate holding entities. While usually disregarded for purposes of direct valuation relevance to a beer wholesaler, a proper investigation of the quality and fair market value of the assets will tell an experienced appraiser a lot about the assets and their capacity to generate future earnings for the business. Typical asset adjustments include marking fixed assets from book value to market value, writing off non-performing receivables and obsolete inventory, and marking financial assets such as stocks and bonds to current (as of date) market value.

The quality and value of assets may be suggestive of the capacity to store, sell and deliver beer. These are important considerations when developing models and assumptions in the income approach. An informed valuation expert with a good working knowledge of the business model will investigate the future needs of the business with regard to delivery and pre-sell fleets, the warehouse, the offices and other assets required to conduct business. Balance sheet investigation also promotes an awareness of potential adjustments to the income statement which then directly affect the income approach. Often we encounter assets which are remote at best to the continuing operations of a beer distributor. We typically segregate the value of these assets from the core value of the beer distributorship. In this way we can provide potentially important planning information to the owners regarding non-business assets owned under the umbrella of their beer business.

A business may also have intangible assets which may or may not be recorded on the balance sheet. Of particular interest to a beer distributor is an intangible asset known as distribution rights. The value of any intangible asset relates to its ability to generate earnings and cash flow. As such, the accounting book value of distribution rights is not directly relevant when developing net asset value. Given that distribution rights are typically one of the most significant business assets of a beer distributor, whether reflected on the books or not, the income approach (which is discussed below) is the most relied upon approach when valuing a beer distributorship.
Nevertheless, the message concerning net asset value is not to sell this method short in its ability to reveal information that could be significant to the valuation. For example, if your primary brewery supplier has you on notice to expand and improve the physical plant, those capital expenditures represent a call for capital. The value of your five million case operation could be quite different than your neighbor’s who finished his/her capital investments several years ago and has ten or more years of growth capacity before the next major capital outlay. These differing circumstances can lead to materially different valuations for otherwise identical distributors.

The Income Approach
Methods under the income approach are wide ranging but typically fall into one of two categories: 1) single period capitalization of income; or 2) discounted future benefits. Simply put, the value of a business is directly related to the present value of all future cash flows or earnings that the business can reasonably be expected to produce. Now we get to the meat of valuation. The mechanics of an income method require an expression of future cash flows or earnings, a growth rate in cash flows or earnings and an appropriate discount rate with which to determine the present value of future cash flows or earnings.

The most common method used under the income approach is a single period capitalization model. Ultimately, this method is simply an algebraic simplification of its more detailed counterpart – the discounted future benefits method. As opposed to a detailed projection of future earnings, the analyst expresses a base level of annual earnings and then determines a multiplier appropriate to that earnings expression. The most familiar form of this approach is the P/E method which is the primary valuation metric observed in the public securities market. Once the challenge of determining the base earnings measure (i.e., net income, EBITDA) is met, investors then quantify their appetite to invest in that annual earnings performance by way of an earnings multiplier.

As we witness in the public markets, some companies have low P/Es and some have high P/Es. The P/E ratio articulates the risk and growth factors that investors believe underlie the earnings measure. Value is negatively correlated to risk and positively correlated to expected growth.

A cautionary message - your valuation should clearly articulate the observations, assumptions, adjustments and empirical data upon which the income method was based. If your valuation provider cannot develop and report their analyses in a manner that you sufficiently understand, get help or get a new advisor. You may not agree 100% with the conclusion; that is not the appraiser’s job. But you should comprehend the math and recognize your business in the report.

Beer distributorships are typically valued using either a P/E method or a DFB method. Circumstances may dictate that one or the other or both are appropriate. Regardless of the method used, income methods generally involve an adjustment process to historical earnings which eliminate the impact of non-recurring or unusual events (income and expenses). Such events can either be directly adjusted in the event that current or recent earnings are being used in a P/E method or implicitly neutralized in a discounted future benefits or cash flow (DCF) method by way of revenue, margin and/or growth rates used to develop the projection. For example, adjustments may be applied to place rents at market rates, to reduce or increase compensation to peer measures, or to capture changes in capital structure as such changes can impact earnings performance. In either a single period method or a projection method such as DFB of DCF, earnings expectations must reflect a reasonable pattern for future performance. These projections may be the product of management or may be developed by the appraiser with feedback from management as to the assumptions. In times of unusual pricing policies and circumstances, such as the need for fleet and warehouse investments and price wars, a DCF approach may be important to the overall analysis.
Having determined the earnings or cash flow measure, the analyst must develop a P/E ratio and/or a discount rate which is appropriate to the measure being valued and reflective of the expected growth and risk of the investment. Suffice it to say that the discount rate is generally developed by way of observing broad market returns on similar investments. Remember that using a time-value-of-money concept, the higher the discount rate, the lower the resulting valuation related to the income stream. The discount rate in its totality is a measure of risk. Economically, it represents the return available to an investor in an equally risky alternative investment. In essence, the value of your beer distributorship is the value of an equally risky investment foregone. As noted, this article is not the forum for the entirety of the valuation science. The mastery of these concepts, both analytically and artistically, is the reason you hire professionals.

The Market Approach

The market approach is a general way of determining value by using one or more methods that compare the subject to similar businesses, business ownership interests, securities or intangible assets that have been sold.

Market methods include comparison of the subject interest with transactions involving similar investments in publicly traded guideline companies and sales involving controlling interests in public or private guideline companies. Consideration of prior transactions in interests of a valuation subject is also a method under the market approach.

Typically, the absence of reporting and the irregularity of such transactions offer limited perspective on value for any given assignment. Beer distributors are generally prohibited from going public. Transactions within ownership groups have either been infrequent or involve territories and revenue mixes that are not comparable. Particular care and devil’s advocacy must be applied when using this method to assure that it does not value your apple grove on the basis of orange grove deals.

Other Considerations in Valuing Beer Distributorships

Neither Anheuser-Busch’s nor SAB-Miller’s (nor Molson Coors) P/E ratio is directly relevant to the value of your beer distributorship. They are manufacturers and you are their distribution channel. However, many of their underlying risk factors and fundamentals are worthy of consideration when assessing the risk profile and future growth of the malt beverage industry.

Our experience and research suggest the following aspects of a distributor’s business model and territory must be understood to develop the assumptions that underpin a credible valuation:

Consolidation. Consolidation is a multi-headed monster that can either kill you or kill for you. The plot in this story appears to be empire growth or death. We have witnessed significant consolidation at all levels of the beer industry – at the brewery level, at the distribution (territory) level, between brewery houses, at the retail level, and horizontally with alternative products. Traditional market share is breaking down as distributors seek better turnkey product choices to address a growing diversity of consumer preferences. Every distributor faces one side or the other (and maybe a mix of both) of these trends. Market leaders are under attack while smaller market participants are seeking efficiencies of scale and probing for the right bundle of product choice (malternatives, spirits, wine, water, energy). The birth and continuing evolution of the “all-other” house is indicative of virtually all of these pressures.

We have seen houses on every side of this trend, some are crying, some are facing the challenge, and some are dangerously confident these trends won’t catch them due to their territories and market strength. Even the sanctity of the three-tier system is under attack. It is vital that your valuation reflect an awareness and balanced consideration of just how these trends will affect you. We cannot know with perfect foresight what will happen in the future, but we do know what are likely reasonable expectations.
Competition. Perhaps this is simply an extension of the consolidation concept, but competitive concerns run deeper. Domestic brewery houses, with the current exception of their light beer labels, are slowly losing market share to craft and import products. Beverage choice is fracturing traditional concepts of just who the consumers are and what they want. While beer is still king of both volume and dollar generation, its market share is being reduced on multiple fronts and per capita consumption continues its long running decline. The growth of imports, coffee, spirits, wine and energy drinks (among others) represents both a serious threat and a potential opportunity. The risk and growth aspects of these trends to your brewer and to your territory must be adequately understood and incorporated in your valuation.

Growth. Revenue growth is largely demographically driven. Age, employment, education, income and other factors vary from territory to territory and have differing implications for your business based on your brewery affiliations and product diversity. Domestic label growth is relatively stagnant at 1%-2% annually. Margins cycle with price competition and market share plays. The industry is mature and earnings growth is modest in the current environment. Growth assumptions are critical to your valuation. Relatively small changes in growth expectations can swing the conclusion of value in a significant fashion. Experienced financial professionals are best equipped to reconcile the multitude of concerns into an all encompassing perception of growth.

It is important to understand that growth assumptions on an industry-wide level (say 1%-2%) are not the same as a growth rate assumption required to determine the value of a given level of your cash flow (i.e. EBITDA, earnings, etc.) Make sure your appraisal properly identifies what aspect of the income statement is being analyzed for growth. We frequently see significant confusion in this critical area of analysis and valuation.

Final Thoughts
Mercer Capital has long promoted the concept of managing your business as if it were being prepared to sell. In this fashion you promote the efficiencies, goals and disciplines that will maximize your value. Most beer distributors have little choice but to contractually define their successors and to actively plan for the successor’s direct involvement in ownership. Brewers define the business model for their distribution channels and there is relatively little room for a truly unique approach. Despite attempts to homogenize the operational and ownership structures of their distributors, our experience is that each valuation is truly unique given the purpose for the valuation and the circumstances of the distributor.

Mercer Capital has valued many distributors over the years and we have witnessed many of the hardships and successes in the industry. We hope this information, which admittedly only scratches the surface, helps you better shop for business valuation services and understand valuation mechanics. We encourage you to extend your business dialogue to include valuation – sooner or later a valuation is going to happen. Proactive planning and valuation services can alleviate the potential for a negative surprise which could make worse an already stressful time in your personal and business life. Perhaps Yogi Berra wasn’t specifically commenting on valuation, but his advice is nonetheless sage: “You got to be careful if you don’t know where you’re going, because you might not get there.”
SIDEBAR

What to Look for in a Business Appraiser

Q: Are business valuation professionals required to be licensed?
A: No!

Q: What credentials help me identify who the better practitioners might be?
A: There are a number of professional societies that promulgate credentials for valuation (financial) professions. Each has differing requirements and may subject their members to different requirements, training and skill. Among the more recognizable professional credentials and organizations are:

- ASA (American Society of Appraisers)
- ABV (American Institute of Certified Public Accountants)
- CBA (Institute of Business Appraisers)
- CVA (Nat’l. Assn. of Certified Valuation Analysts)
- CFA (Chartered Financial Analyst Institute)

Q: Are there practice standards and valuation requirements that dictate how a valuation is developed and how it is documented?
A: Yes, but they may vary by professional society and they may vary based upon the scope of work for the specific engagement. More detail can be found by consulting the Uniform Standard of Professional Appraisal Practice (USPAP) and the Business Valuation Standards of the American Society of Appraisers. In many instances where the brewery is required to approve your transaction or transfer, the review process may bring to light poor or unacceptable appraisal work.

Q: Aren’t all business appraisals the same thing?
A: No. There is no restriction on what one can represent to be a “business appraisal.” However, if a practitioner has defined the final report product as compliant with USPAP and/or recognizes specific professional society standards, then you have a benchmark by which the work can be judged. Ultimately, you should inquire about the standards under which your valuation service provider is bound for a given engagement and such standards should be specifically defined in the engagement letter. Given the potential disparities in quality and requirements, it is no wonder that appraisal and investment banking services have wide-ranging fee structures.