Valuation & Transaction Advisory Considerations for Wholesale Beverage Distributors

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MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

How This White Paper Applies to You

Business Owners

Understanding valuation has never been more critical. This paper reveals the intricacies of valuation and how it relates to big-picture decision making. Understanding value today, as well as planning for tomorrow's value driven events, is essential to optimizing the wealth that is your business. The anchors for the measurement of investment return are based on valuation. The go/no-go for mergers, brand transactions, facility development, distribution policy, and other important attributes of management and ownership can be evaluated using the principals of valuation and corporate finance. Valuation is vital to the design and maintenance of your buy-sell agreement and to the assessment of differing business strategies as you cycle through the events of ownership. Don't find yourself saying "if I had only known." Know your value (as well as that of your neighbors and competitors), and, more importantly learn from the valuation process while educating your advisor about your business and family wealth priorities.

Attorneys

Understanding how value is defined and how value definitions reconcile to the realities of the wholesaler industry is vital when assisting your clients in any ownership succession plan or legal dispute. There is a unique hierarchy of valuation considerations in the beverage wholesaler industry. With respect to litigated matters, each state has specific value-defining statutes and judicial guidance that must be properly addressed in the valuation. Our experience as valuation practitioners informs us that most business appraisers don't understand the wholesaler industry, and most industry pundits don't understand the nuances and technicalities regarding valuation standards, levels of value, and corporate finance. Enhancing your knowledge about valuation gives you the power to examine and question the credibility of valuation approaches, methods, and procedures for tax purposes or for expert opinion purposes in disputed matters. We bring considerable skills and experience to forming opinions and to reviewing the work of others. We are often requested to assist in overcoming impasses in buy-sell disputes and finding workable solutions to valuation disputes. This paper provides important valuation frameworks that can assist you in understanding your client's unique needs and circumstances and can help frame the scope of services you may request on your client's behalf.

CFOs, Board Members, Lenders, & Other Capital Providers

Valuation is the core discipline of wealth maintenance and a precursor to any strategic decision. The information in this paper can assist lenders who serve the strategic needs of their clients by funding the capital needs of businesses and their owners. CFOs that serve as their owners' primary financial sounding board will also benefit from a more thorough discussion of valuation practice and theory. Board members and family office advisors also require informed and timely perspectives about the value of any business entrusted to their care.

About Mercer Capital & the Author

Timothy R. Lee, ASA, began his valuation career in 1994. He is the managing director of Mercer Capital's corporate valuation practice and is a member of the firm's board of directors.

Mercer Capital is a business valuation, transaction advisory, and litigation support firm serving the corporate and individual needs of a global clientele. Tim is an accredited senior appraiser (ASA) in the American Society of Appraisers and a member of the National Beer Wholesalers Association. He has contributed educational content to the ASA and other professional and trade organizations including the National Beer Wholesalers Association, the ESOP Association, the Financial Consulting Group, and Business Valuation Resources.

Tim has authored numerous articles on business valuation and is co-author of A Reviewer's Handbook to Business Valuation published by Wiley & Sons. Tim is a frequent speaker on valuation-related topics to a variety of professional, trade, and educational groups.

He has wide ranging industry experience gained from providing services in over a thousand engagements in an array of industries. His clients have included business entities, business owners, trust and estate planning attorneys, federal judges, independent fiduciaries, and the Internal Revenue Service (among others). He offers litigation and expert witness testimony services for purposes of shareholder actions, corporate damages, and marital dissolution.

Mercer Capital's services span the life cycle needs of businesses and their owners including trust and estate valuation, strategic buy-side and sell-side M&A services, ESOP-related transactions and plan-year valuation services, financial statement reporting, buy-sell agreement planning and dispute resolution services, as well as consulting expertise and expert witness testimony for corporate and personal litigation matters.

Tim works with many clients whose businesses serve as the primary conduit through which branded products and services are delivered to end-sellers and consumers. Countless projects have given him a keen awareness of the operational practicalities and corporate complexities of mid-stream business models such as beverage distribution. He specializes in translating the functional business realities of his clients' businesses to the language of corporate finance and business valuation. Understanding brand-mandated operational and financial requirements for beverage wholesalers, dealerships, distributorships, and franchisees is vital to proper valuation.

A Personal Message from the Tim Lee

My first real pay check came from popping popcorn in the concession operations of the double-A Memphis Chicks (the team depicted on the baseball poster in episodes of Seinfeld). Little did I know that of the dozen or more of my football teammates recruited in a bulk hiring campaign by the club, a few of us would go on to assume supervisory roles and spend several years working in food & beverage (well, mostly beverage).

At Tim McCarver stadium, we would regularly sell 100+ kegs to a crowd of 7,500 on quarter beer night (by my math that's a solid six-pack or more per core drinker). It was this early experience that taught me painful lessons about the weight and bulk of a half barrel, and how a clean draft line and a cold tap meant more beer in the cup than foam in the drain of a rolling Perlick dispenser. The delivery guys who peddled our stadium made out like bandits and used our backs to do it!

Few if any of the financial advisors that want your business have ever poured a beer for a consumer and even fewer have done anything close to the heavy lifting that takes place in your operations. While these experiences cost me a few years starting my professional career, they provided perspectives that have paid me back in the service of many beverage wholesalers. Now with nearly 25 years of professional experience, I sincerely ask you could to consider letting the financial expertise and industry experience of Mercer Capital work for you.

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Table of Contents

Introduction

The purpose of this white paper is to provide insight into the situational (when and why) and analytical (how) aspects of valuing alcoholic beverage distributorships.

The focus is primarily on malt beverage distributorships. However, many aspects of the content relate to other beverage categories including wine & spirits, soft drinks, fruit juices, dairy, water, energy, and other niche categories. While the beverage distribution industry is ubiquitous in the American marketplace, consolidation trends and evolution in each tier of the industry, as well as significant changes in consumer behavior, are creating a greater need for skill and discipline in the analysis and valuation of industry participants.

Based on our experience, valuation practitioners with random periodic exposure to the beverage space, as well as industry veterans who lack a foundation in corporate finance, are not equipped to reconcile the practical trends of the industry with the functional tenants of financial valuation. Over the last decade there has developed an increasing need and benefit for wholesalers to understand financial valuation in order to promote informed decisions regarding family wealth management, to rationalize merger and acquisition activities using tools long familiar to other brand centric wholesalers and franchisees, and to promote operational and ownership continuity. In addition, commencing with the 2018 tax year, we have a new paradigm in tax rates and rules that are rebalancing the decision-making equations of financial valuation. Given the scrutiny of the IRS, the concerns and controls of the breweries and other suppliers, the evolution of category mix, and the wide-ranging interests of owners, it is critical that valuations be determined and articulated in a credible fashion.

Summary Industry Overview

The valuation or transaction of an alcoholic beverage wholesaler and its respective distribution rights is a unique and challenging exercise for many reasons. Beverage wholesalers (also referred to as distributors) occupy the middle tier of a three-tier system of operators in the industry. Distilling, brewing, winemaking, and importing concerns represent the top tier of the industry and are referred to as "suppliers." Suppliers produce various categories of beverage products, which under a post-prohibition regulatory system, are sold to state licensed merchant wholesalers. Wholesalers, who are typically exclusive in their respective geographic territories, provide a variety of logistical and developmental services for suppliers by selling and delivering alcoholic beverages to the bottom tier of the industry where consumers make their direct retail purchases. Each valuation is a distinct exercise because of state-by state variations in three tier laws, licensing, excise taxation, supplier affiliations, and other factors. Additional valuation complexities may result from franchise laws that serve to insulate wholesalers from the potential manipulation of the system by the supplier tier.

Figure 1: Three-Tier Regulatory System

Malt Beverage Industry Dash Board

Brewery Market Share Over Time

The following charts depict the general softness in volume trend over the past decade as well as the significant erosion of core domestic volume share and the combined growth of craft and import products. On a combined basis, MillerCoors and AB-InBev have surrendered a net 8% in volume share since 2006. In the context of flat to declining industry volume, this share has gone directly to import, craft, and other product categories. The variations in brand and category mix are significant factors when valuing malt beverage wholesalers. Big winners in the great shift include regional craft products and the Constellation brands.

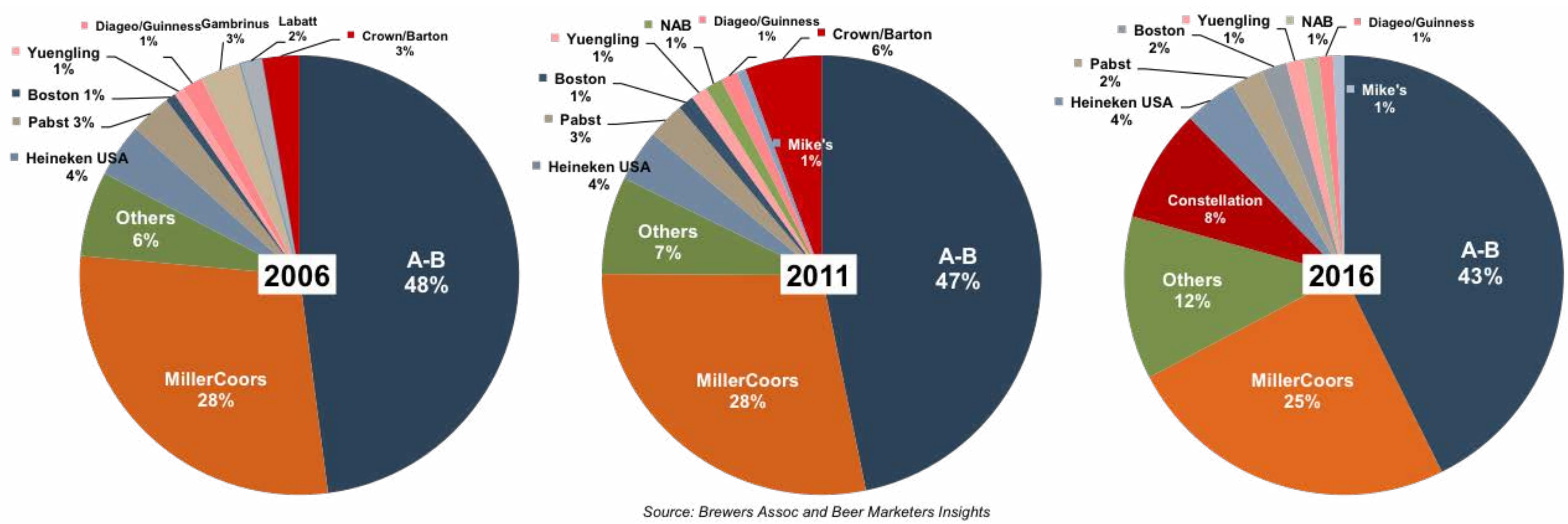
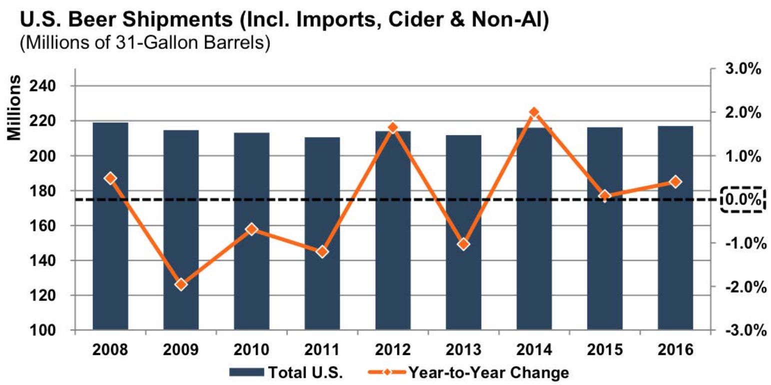


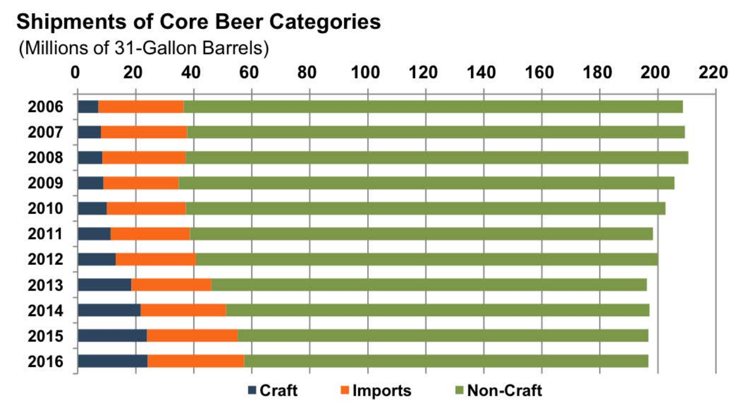
Figure 2: Ten-Year Trend in Market Share Among Major Beer Suppliers / Breweries / Brands

Malt Beverage Industry Dash Board



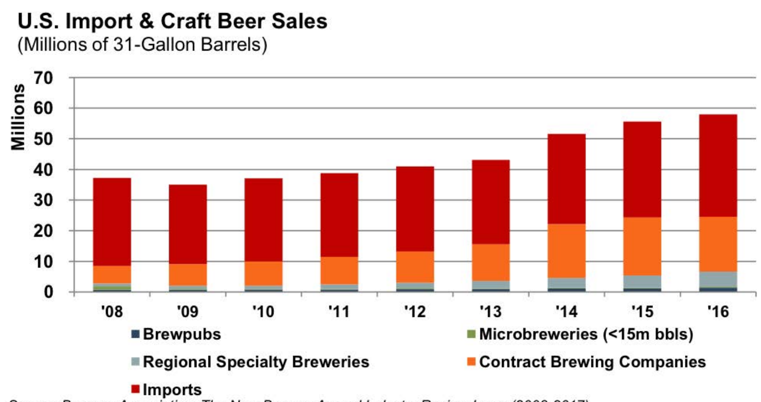
Source: Brewers Association: The New Brewer, Annual Industry Review Issue (2008-2017)

Figure 3: Multi-Year Trend in Total U.S. Malt Beverage Shipments



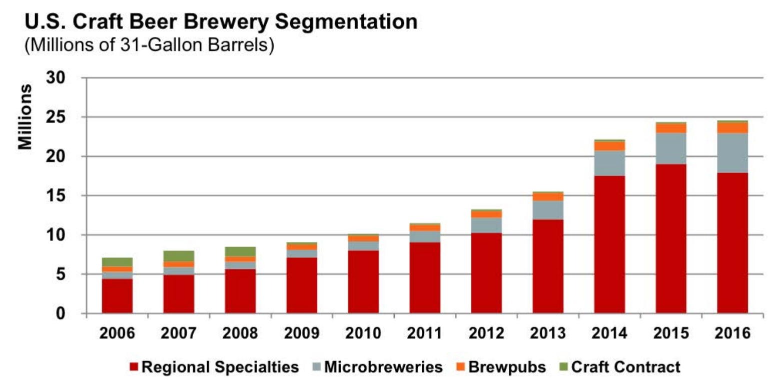
Source: Brewers Association: Annual Industry Review Issues (2008-2017)

Figure 4: Multi-Year Trend in Malt Shipment by Category



Source: Brewers Association: The New Brewer, Annual Industry Review Issue (2008-2017)

Figure 5: Multi-Year Trend in Total U.S. Shipments of Craft & Import



Source: Brewers Association: The New Brewer, Annual Industry Review Issue (2008-2017)

Figure 6: Multi-Year Trend in U.S. Shipments of Craft

When and Why You Need Valuation and Transaction Advisory Assistance

Principals of beer distributorships are consumed with the day-to-day activities of their business. Many fail to realize that life (and business) cycle events will happen to them, their partners and their families, and that these life events will require that their businesses be valued. Alternatively, some principals use business valuation as an essential tool for creating ownership stability, assessing management performance, and for strategic planning in an era on continuing consolidation. Mercer Capital professionals continuously educate clients about the "things that happen to you" and the "things you make happen." Figure 7 depicts the circumstances under which the vast majority of valuation and transaction exercises are undertaken.

	FRACTIONAL Sale or Transfer of Ownership	**TOTAL OR MAJORITY** Sale, Transfer, or Acquisition
PROACTIVE Voluntary, Planned Events & Reasons	• Bank Financing & Capital Raising • Trust & Estate Planning • Supplier Continuity Requirements • Stock Transactions with Family or Management (Buy-In or Sell-Out) • Buy-Sell Agreement Implementation, Updating, & Execution • Joint Venture or Partial Merger • Brand Realignment Transactions • Transaction Fairness Concerns & Board Fiduciary Issues	• Sale of Territory, Rights, or Total Business to Outsiders • Sale to Family • Trust & Estate Planning • Purchase of Territory or Rights from Neighbors or Competitors • Recapitalization Activities such as an S Election or a Tax-Free Reorganization/Exchange • Transaction Financing & Bank Loan Underwriting • Buy-Sell Agreement Implementation, Updating, & Execution • Transaction Fairness Concerns & Board Fiduciary Issues
REACTIVE Involuntary, Inevitable and/or Inconvenient Events & Reasons	• Gift & Estate Tax Compliance (Death & Taxes) • Supplier Enforcement of Ownership for Designated Successor • Stock Transactions with Family or Management (Buy-In or Sell-Out) • Buy-Sell Execution & Value Disputes • Shareholder Oppression & Value Disputes • Divorce & Equitable Distribution • Corporate Litigation & Business Damage Cases • Transaction Fairness Concerns & Board Fiduciary Issues • Dissenting Shareholder Actions	• Gift & Estate Tax Compliance (Death & Taxes) • Supplier Termination • Buy-Sell Agreement Implementation, Updating, & Execution • Transaction Fairness Concerns & • Board Fiduciary Issues

Figure 7: The Business Valuation and Transaction Matrix

Unless you've managed to avoid the human condition, you probably recognize some history (and some predictability) in Figure 7. Hopefully, you are planning for those events that are inevitable and seeking to positively influence those events over which you have some control.

The Rule of Thumb in Beverage / Beer Wholesaler Valuations & Transactions

The rule of thumb approach for valuation is second nature to distributorship owners and industry advisors. In the malt beverage distribution space, the rule of thumb has evolved from the top-line orientation of case volume to the gross profit line, which better differentiates distributors on the basis of the gross margin and profits that extend from the category composition of sales (core domestic, import, craft, FMBs, NA, etc.).

Typical Rules of Thumb Using Gross Profit and EBITDA

While gross profit multiples enjoy widespread use as a convenient reference for industry insiders, larger wholesalers and investors who employ sophisticated consolidation strategies and high levels of debt to finance their activities have pushed the valuation focus from gross profit to earnings before interest, taxes, depreciation, and amortization (EBITDA). EBITDA is often referred to as gross cash flow and represents the maximal expression of discretionary business cash flow:

- **Before** the decisions and necessities of capital structure are considered (the "I" for interest)
- **Before** the government gets paid (the "T" for taxes)
- **Before** the cost of capital assets (the "D" for depreciation)
- **Before** the cost of intangible assets/distribution rights (the "A" for amortization)

Notwithstanding the protests of Warren Buffet, EBITDA in tandem with the multiple thereof is the most referenced valuation expression for non-financial businesses in the investment banking and valuation environment. Duly noted, EBITDA has limitations and consistency issues, particularly when it comes to differentiating value between distributorships that are tenants in their warehouses (and fleet) and owners of all the capital assets used in the business.

It is extremely important to know what the respective rule of thumb is valuing. It's also important to note that many rules of thumbs (if not all) are observations or consequences and not devices or inputs in the valuation process. At the risk of getting ahead of ourselves, if we value a distributorship using a discounted cash flow model, we get a valuation that typically reflects the total value of the operating assets of the business. We refer to this as the total enterprise value (TEV). TEV includes every operating asset of the business from handheld digital devices to the inventory and fleet, and most importantly, the brand distribution rights.

Alternatively, if we attempt to value a distributorship by way of a gross profit multiple (using a unique multiple for each respective brand supplier and/or category of product) we are estimating the value of the distribution rights. Accordingly, to derive the TEV we must add the value of the fleet assets, the rolling stock, the inventory, all other furniture and fixtures, and the warehouse & offices to the value of the broad distribution rights. Finally, and not inconsequentially, when a valuation is expressing the value of the business equity (stock value, LLC member units, etc.) the total interest bearing debt of the business must be subtracted. Depending on other factors in the valuation, dispute or transaction, the equity value for certain ownership interests may be subject to additional adjustments such as valuation discounts for minority interests (again, we are getting ahead of ourselves!).

Figures 8 and 9 provide a graphical reconciliation of reported accounting measures with the valuations of TEV and the respective asset categories that comprise most wholesalers.

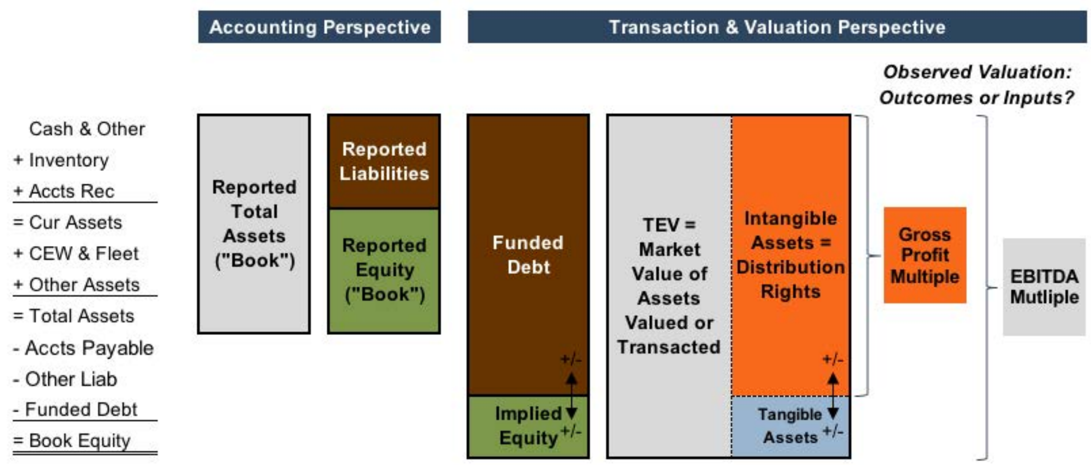


Figure 8: Differentiating between the Value of the Enterprise and the Value of Distribution Rights

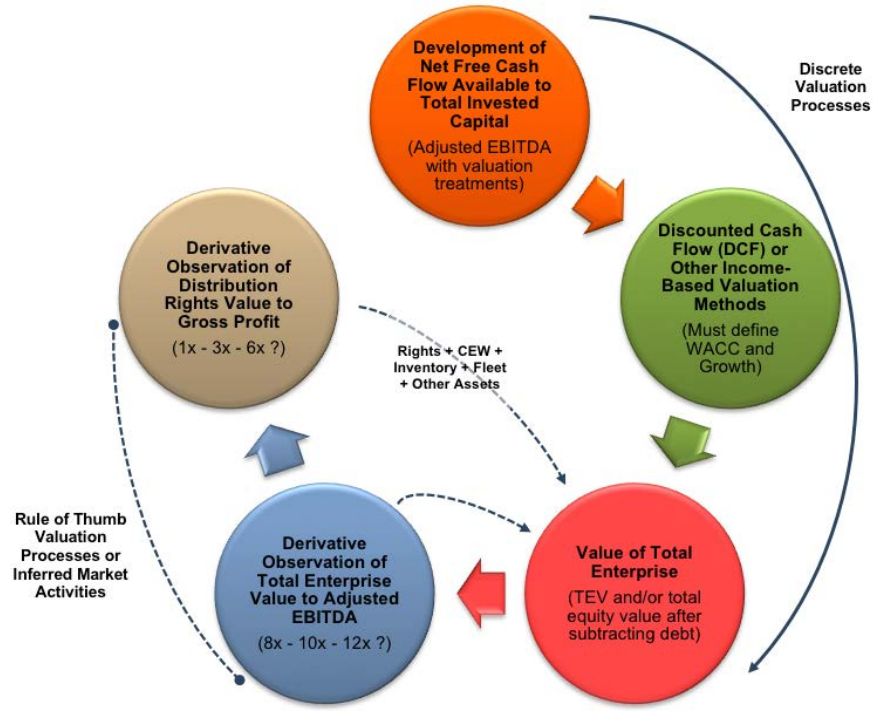


Figure 9: Distinguishing between Discrete Valuation Inputs/Processes & Valuation Rules of Thumb

Potential Shortcomings of Adjusting and Applying Rules of Thumb

In recent years, I have witnessed multiple applications of rules of thumb for various purposes. **Unfortunately, the procedural applications of market-based, rule-of-thumb evidence (i.e. gross profit and/or EBITDA multiples) relied on adjustments that were not explained in such a way as to be convincing or necessarily proper**, albeit relying on an intuitive appeal that might appear reasonable at first glance. For example, I have reviewed valuation reports that relied on a range of multipliers that were adjusted using the market share of the subject wholesaler (a sliding scale of sorts). The intuitive suggestion for adjusting the multiples being that the higher the market share (or volume size) of a particular wholesaler's house, the higher the applicable multiple of gross profit or EBITDA. The premise implies that larger wholesalers and/or wholesalers with significant account density and large delivery drops achieve higher profits through greater efficiency – this is the basic concept of scale. This seems logically correct. However, while analysis of empirical data from public companies generally promotes the notion of valuation being positively correlated to size, the complexities of beverage wholesaling are not so accommodating. At educational sessions during a recent beer wholesaler conference I heard more than one experienced trade veteran state that size and financial performance are not highly correlated. This would contradict, in my opinion, the underlying logic for a shared-based adjustment of market transaction data.

This highlights a recurring issue with any rule of thumb – **only by chance will a specific wholesaler be average with respect to logistical, demographic, and operational attributes as to render the average rule of thumb reasonably accurate for valuation purposes**. For the majority of wholesalers, an adjustment to an average multiple based on something measurable (but not necessarily relevant) such as market share, implies a science that may have no grounding in data and may simply be conjecture. **Without reconciling to measurable financial benchmarks, one could question the intersection of market share and market multiples** and one could also question the increment and relationship of adjustments applied to the multiples.

Only reasonable reconciliation to the core financial ingredients of valuation (profitability, growth, risk, etc.) can render such adjustments a reasonable chance of imparting a reliable answer. This reconciliation process is the essence of what business appraisers refer to as the fundamental adjustment, which is used to adjust market data for purposes of application in the valuation of a particular company. The exact procedures for quantifying such adjustments are beyond the scope of this white paper. However, this author is recognized for such expertise and has provided certified continuing professional education to peers on the topic. **Ultimately, the adjustment of gross profit and EBITDA multiples may be reasonable if the adjustments can be reconciled using comparative financial analysis between a reasonable known base of peer data and the subject wholesaler**.

It is concerning to see a market approach that relies solely on undocumented transaction activity and which lacks the financial and operational detail usually reported for many industries in well-known transaction databases or in the public market place. **With sufficient financial and functional data about the parties to the referenced transactions one can make reasonable and well-considered assertions about if and/or how such data might be adjusted for use in the valuation of a wholesaler with different attributes**. But such supporting data is scarce and the substitution for missing data relies on financial information from various benchmarking sources. Consequently, **I do not foreclose on the concept of a rule-based market method, but I do acknowledge a significant burden on valuations practitioners and transaction advisors to justify their positions**. One caveat to the reasonable consideration of, relevance of, and acceptability of a rule of thumb for valuation purposes relates to the timing and activity of deals that may have been considered or consummated by the subject wholesaler and/or their neighboring distributors. In such cases, it's often possible to reconcile a rule of thumb used as a basis for negotiating a deal to relevant financial facts and expectations. In fact, these are the very circumstances that may differentiate the skill and thoroughness of one advisor from another.

Rules of Thumb Examples

It is no secret that the legacy rule of thumb for the valuing the brand distribution rights of the major domestic brewers ranges from 2x to 4x gross profit, which happens to reconcile to EBITDA multiples ranging from high-single turns (say 8x-10x) to the high teens and beyond (16x and more). That is a considerable range. There are noteworthy outliers to this range based on product category and brand supplier (Crown, Heineken, craft, energy, etc.). However, which EBITDA are we referring to – the lower standalone legacy margin or the higher pro forma margin that may include efficiencies from optimization or consolidation? Even more confusing, a wholesaler's brand and category portfolio is often averaged together to characterize a whole-house rule of thumb for this MillerCoors house or that AB InBev house.

What is not so well understood is that industry transactions occur across a wide universe of circumstances and involve vastly different strategies and motivations. Answering the questions "Who did what? With whom? For how much?" is vital when attempting to rely on market transactions that may be altogether differently motivated and subject to differing valuation standards and definitions (for example as a function of law with respect to divorce or shareholder disputes). Deferring this important framework for a subsequent discussion – let's reconcile a preliminary set of industry norms with a related rule of thumb.

We'll start with an example based on reasonable norms prior to the 2018 change in corporate and personal income tax rates. The scenario shown in Figure 10 could be characterized as a reasonable market value example at the low end of the range (or below) of deals cited by industry players. [A caution to readers – all examples herein are for illustration purposes only, and just as emphasized in this discussion, you can't apply these examples directly to your specific circumstances. The underlying analysis and math is necessarily dense.]

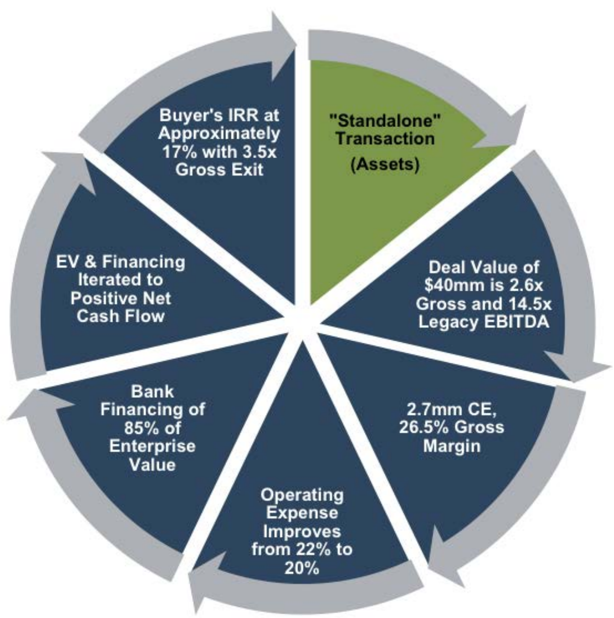


Figure 10: "Standalone" value of a distributorship whose assets are transacted with an approved, non-contiguous buyer

The feasibility of this example relates to the balance between the valuation achieved by the seller and the internal rate of return (IRR) achieved by the buyer based on typical financing terms available to industry participants.

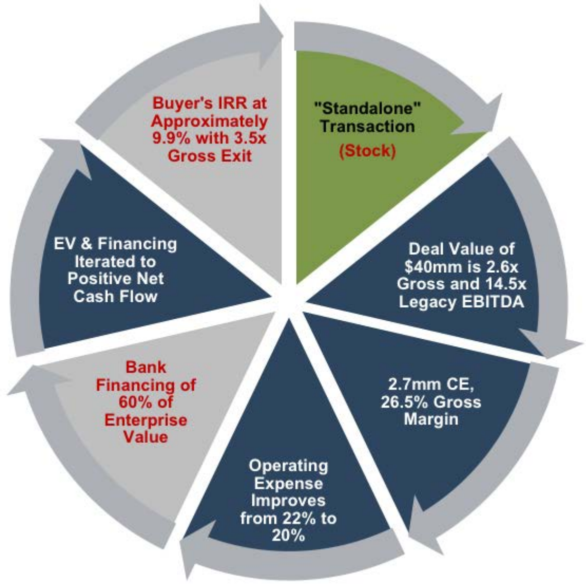


Figure 11: "Standalone" example of a distributorship whose stock is transacted within a family unit using the same valuation achievable in a sale of assets to a neighbor (Figure 10)

In this case, the buyer does not enjoy the significant tax advantages that accompany a purchase of enterprise assets (namely the tax amortization shelter for distribution rights). This situation may limit the amount of debt that can be serviced and it significantly reduces the buyer's IRR. Family units that operate under this framework for ownership succession are condemning the next generation of ownership to reduced returns and predisposing that generation to a sale rather than continuing family ownership.

Figure 11 holds everything constant except the transaction is a cross-purchase of stock that lacks certain tax treatments that enhance financial returns in asset structured transactions. This example illustrates a classic issue resulting from a next-generation family equity manager purchasing stock using an enterprise value more easily financed by an outside purchaser of the business assets. Admittedly, there is a complicated model underlying these mechanics and expectations; but note the reduced IRR (10% versus 17%) and lower debt funding capacity (60% versus 85%) when holding the core deal terms and IRR modeling constant.

In plain and simple terms – it's more expensive and compromising for a buyer to consolidate equity ownership at a valuation similar to the M&A market for beer wholesaler assets. Buying the family out at the likely deal valuation available from a neighboring wholesaler can be problematic. If a buyer has a reasonable benchmark for equity return on the order of 12% cost of equity capital, the "Standalone" stock transaction actually throws off a net present value (NPV) deficit (which is corporate finance speak for the deal being unfavorable). This is because the IRR measured on the out-of-pocket achieves only a 10% return, which is likely below an acceptable hurdle rate. With some combination of reduced out-of-pocket equity and higher debt capacity, a buyer might achieve a more reasonable outcome, but will still not enjoy the same investment return as the buyer modeled in Figure

10. This suggests the next-generation buyer would be better off re examining the deal. Such a deal is not necessarily the situation mom and dad may intend for the next generation and it certainly may not be palatable for an internal management buyout.

Taking the same seller summarized in Figures 10 and 11, what are the reasonable post-acquisition realities for a neighboring buyer and what are the buyer's returns using typical financing assumptions? Note in Figure 12 that a typical strategic buyer can pay more, finance more at the bank, and realize a better return on the investment. We note that ***all*** the scenarios summarized here assume that today's buyer exits in 15 years at 3.5x gross.

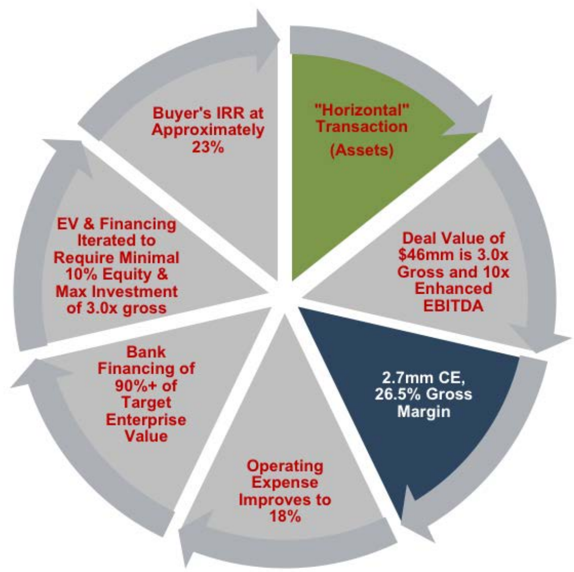


Figure 12: Example of a "Contiguous" or "Horizontal" transaction (neighbor buying neighbor) using the typical asset-based structure

In this example the deal value is approximately 15% higher ($46 mm / 3.0x gross / 10x enhanced EBITDA) than the Standalone example in Figures 10 & 11. CE volume and gross margin are unchanged compared to Figures 10 & 11. Importantly though, the combination of the two territories allows for expense reductions that increased cash flow and allow for better financing capacity. Versus the "Standalone" asset deal in Figure 10, the buyer's IRR increases to 23% (or more). Maybe this suggests the seller could ask for more and the buyer has greater capacity to pay more and still achieve an acceptable return on the investment! Refer to Figure 13 to see how high we can go and still get a deal done.

What can a buyer pay if we push the valuation in Figure 12 as high as possible while still delivering a 17% investment return to the buyer? Figure 13 shows the summary. Everything is held constant except the total deal value and the corresponding gross profit multiple. Remember, we are pushing the valuation as high as possible while still delivering a 17% IRR to the buyer. As summarized in the graphic, the deal value is $54 million and the implied valuation of the distribution rights is 3.5x gross profit and the implied value of the business is 11.4x EBITDA. These figures correspond to the type of figures you and your wholesaler colleagues have become accustom to hearing from industry advisors in recent years.

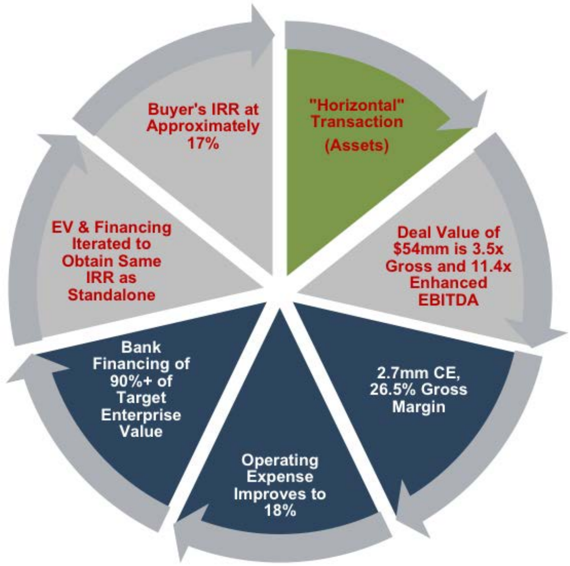


Figure 13: Example of a "Contiguous" or "Horizontal" transaction (neighbor buying neighbor) using the typical asset-based structure.

In this example the deal value is approximately 35% higher ($54 mm / 3.5x gross / 11.4x enhanced EBITDA) than the Standalone example in Figures 10 & 11. Absent a unique portfolio, highly convenient territory logistics, and unusually strong demographics, this deal is now probably near its peak.

These examples are necessarily dense with underlying assumptions. **The implications from this analysis are that rules of thumb can a dangerous thing in the hands of the uninitiated, and the resulting valuations from their use can impart a wide variety of financial outcomes for buyers and sellers based on the facts and circumstances of the transaction**. There are countless variations of modeling to capture the uniqueness of any market pairing of buyers and sellers. The tools and skills to model outcomes are not universal among valuation or industry advisors.

These examples relate valuation multiples to the operational scale of the business and certain financial norms in the industry. Additionally, the valuation and rate of return disparities in these examples highlight a critical need to define the valuation carefully. Defining value under the proper standard, level, and premise of value is critical to the task. This is because the value of your business and the value of a pro rata ownership interest in it could be wide ranging based on the facts, circumstances, and purpose of the valuation.

Defining the Value of a Business Ownership Interest

The value of a business interest can be several different values at a moment in time and the value difference can be substantial. We realize this notion sounds preposterous but stay with us – this matters.

The exercise of valuing a business ownership interest requires a strict definition of "value" which is almost always dictated by the *when*, *where*, and *why* circumstances for which the valuation is being performed. Once these aspects are defined, an analytical framework for determining value is then defined. The following concepts are vital to understanding what is meant by "value" and are essential in defining an engagement with a valuation professional in the hypothetical environment of fair market value, the accounting and legal environments of fair value, and the strategic investment value environment of mergers and acquisitions.

Standard of Value

The standard of value is "the identification of the type of value being used in a specific engagement" *(American Society of Appraisers Business Valuation Standards)*. The proper identification of the standard of value is the cornerstone of every valuation. In many of the valuation events listed in the Business Ownership Matrix (Figure 7), the standard of value is dictated by state statute, judicial guidance from precedent court cases, the tax code, and/or by contract. In the circumstance of creating or interpreting a buy-sell agreement, the standard of value (and other important value defining attributes) may be intentionally agreed to by the undersigning parties. So, what are the most common standards of value?

Fair Market Value

Fair market value is defined as follows:

> 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. *(American Society of Appraisers Business Valuation Standards)*

The willing seller and the willing buyer are hypothetical parties. Each is assumed to be well informed about the subject interest and the market context in which it might be transacted.

Fair market value is similarly defined in various sections of the Internal Revenue Code, related regulations and interpretations, including Revenue Ruling 59 60, Section 20.2031-1(b) of the Estate Tax Regulations, and Section 25.2512.1 of the Gift Tax Regulations.

Fair market value is the most common standard of value used in business appraisals. Often appraisers will confer with legal counsel on the appropriate standard of value for a valuation if such is not otherwise clearly defined. Ultimately, the standard of value is a legal concept which may be the topic of significant debate under adversarial circumstances.

With respect to the alcoholic beverage distribution industry and business valuation, the development and communication of "fair market value" requires an awareness of the market conditions under which wholesalers typically transact and the general conditions that transfers of ownership interests are subject to. The bilateral buyer/seller framework of fair market value contrasts with the triangular reality of the wholesaler industry, which is complicated by wholesalers' requirements to obtain consents from their respective suppliers for ownership transfers and transactions.

Many business owners pragmatically observe that fair market value has little to do with the real world where buyers and sellers are very specific investors who are individually motivated, uniquely informed, and are using something other than pure cash to transact. This is a particularly important consideration given the relatively closed ranks of the beer/beverage wholesaler industry and the complexities of adhering to supplier mandates concerning the ownership of a distributorship and the merger and acquisition protocols of the industry.

Investment Value (Strategic Value)

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. *(American Society of Appraisers Business Valuation Standards)*

Investment value, also referred to as "strategic value" or "value to the owner," is often used when valuation or investment banking professionals are advising their clients on the merits of executing a specific transaction such as buying or selling a specific business or asset. Investment value answers the question – what is the asset or enterprise worth to a specific party based on investor-specific considerations?

Strategic value is higher than fair market value. However, fair market value can be informed by strategic considerations under a variety of circumstances. When strategic events are foreseeable, planned, or imminent, then fair market value may be informed by the reasonable certainty and/or timing of a strategic transaction. For example, it might reasonable to assert that fair market value, under the premise of a going concern, might be $40 million (refer to Figure 10), but strategic value for the same wholesaler could be much higher, say $54 million (refer to Figure 13), based on selling the business to another wholesaler who is motivated beyond the objectives and purely financial motivations of a hypothetical investor. The beverage wholesaling industry is consolidating, and it may be reasonable to assume that an eventual strategic exit value could be available to any owner with the capacity and patience to wait for it. That is not to say that when a strategic exit is planned (or reasonable to expect) that the two values will converge. If such an exit is five, ten, or more years in the future, there can be a meaningful difference between fair market value and investment/strategic value. The complexity of these considerations may be compounded when valuing minority interest positions in a business versus a controlling interest.

Strategic value is also identified as a "**level of value**" that is arrayed above the traditional financial controlling level of value under fair market value (refer to Figure 14). Additionally, the "**premise of value**" is another important value defining attribute. Both the level and premise of value are integral to the understanding of the standard of value, and each is discussed in a subsequent section of this paper.

One could argue that in the instance of a consolidating industry such as beer/beverage wholesaling, there is an inherit option value that increases fair market value if fair market value is determined without any direct or indirect consideration of the possibility of a favorable strategic exit value. A controlling owner can sell the company, and a minority owner can piggyback an eventual favorable opportunity to exit. This is where the premise of value becomes an important attribute to consider. The "premise of value" is discussed in a subsequent section of this report and is particularly interesting when examined in the context of the beverage wholesaler industry.

In the context of the potential bridge between fair market value and investment value, there is another definition of value that is worth mentioning. **Intrinsic value** is "the value that an investor considers, on the basis of an evaluation or available facts, to be the true or real value that will become the market value when other investors reach the same conclusion" *(American Society of Appraisers Business Valuation Standards).* When the term applies to options, it is the difference between the exercise price or strike price of an option and the market value of the underlying security.

Fair Value in Legal Matters

In legal matters, fair value is a statutory standard of value (inclusive of any relevant judicial guidance) applicable to cases involving dissenting or oppressed shareholders and/or with respect to corporate reorganizations or recapitalizations. Fair value may also have a specific and differentiated meaning for divorce under the laws of each state. In litigation proceedings, case venue and jurisdiction dictate.

Fair value frameworks will typically reconcile to a single or hybrid definition of value under the standard of fair market value or investment value. Legal counsel determines the value-defining elements as part of the engagement agreement with the valuation expert. **In situations where there is ambiguity and/or support for more than one interpretation of fair value or fair market value, legal counsel may request the appraiser render opinions using more than one definition of value**. This enables an expert to have the necessary opinions that fit the respective needs or findings of the court, maintains the prerogative of counsel to argue the question of value definition without the fear their expert's work will be disregarded, and allows the court to make determinations from a wealth of analyses underlying the expert's report. The intricacies of this topic are the substance of entire books in the valuation profession. Suffice it say, this can be a significant issue in litigation matters.

Fair Value for Financial Reporting Purposes

The Financial Accounting Standards Board (FASB) functionally introduced the discipline of fair value measurement for accounting purposes with a series of pronouncements dating to the early 2000s. The changes were intended to impart greater financial transparency and consistency in an accounting universe steeped in historical cost disciplines and to enhance the accuracy and timeliness of information provided to users of financial statements whether they be lending institutions, investors in publicly traded securities, or individual owners of closely held businesses.

We will not delve into the details of the many and evolving pronouncements, statements, and codifications in this area. However, it's important for beverage wholesalers to understand that in the language of financial accounting, **brand distribution rights** are characterized as **indefinite-lived intangible assets** and their recording on financial statements under Generally Accepted Accounting Principles (GAAP) and for federal income tax purposes is a vital aspect of the M&A discipline and tax compliance. The amortization of acquired brand distribution rights (sometimes improperly labeled "goodwill") has long been the topic of financial and strategic education in the beverage wholesaler space.

Using the disciplines mandated for fair value measurement, the tax benefits associated with the amortization feature are required to be recognized as a contributing attribute to the fair value of brand rights. In mildly technical terms, this means the present value (i.e., time value of money) of the future taxes saved from amortization (expensing rights purchases over time for tax purposes) is an element of the fair value of the brand rights. Knowingly or not, wholesalers witness and recognize this concept in the varied gross profit multiples assigned to differing suppliers and categories. The translation of tax benefits in fair value accounting to that of fair market value determination seems credible given the longstanding representations of noteworthy advisors in the industry who represent that the amortization tax shelter influences market valuations for distribution rights.

When the acquisition of a wholesaler occurs, the aggregate value paid for the enterprise assets is required to be allocated to the various assets purchased (CEW, fleet, inventory, and brand rights). In some cases, the line item value of each brand right may seem self-evident using the transaction terms and documentation. However, the sum-product mentality of brand multipliers and brand gross profits does not necessarily provide an accurate depiction of fair value for each brand or for the portfolio as a whole. If alternatively, a transaction is negotiated using a stated **total enterprise value (TEV or EV)** or an EBITDA multiple, there will be a specific exercise required to allocate the total enterprise value to the assets in the transaction. In the financial reporting universe, this exercise is called a **purchase price allocation (PPA)** and it's a required report that your accountant or CFO should request if your financial statements are developed using GAAP.

Under the traditional interpretation of the fair market value standard, investors are hypothetical parties and not industry players. Under fair value, value is determined using the financial perspective of the most likely universe of buyers, who are referred to as **market participants**. Market participants are imbued as having motivations that are typical of the industry. The goal of fair value is to represent an asset's value at the valuation at which it would likely transact between market participants (and not the lesser value between purely financial, hypothetical investors). Accordingly, the fair value of brand distribution rights is more akin to strategic value but may not necessarily be the highest value that the highest bidder might pay.

Not only are PPAs vital to the process of purchase accounting, so too is the annual or periodic test for impairment. If your financial statements include a significant intangible asset balance and there is an unfavorable change in the market value for such assets, your accountant may require an **impairment test**. An impairment test includes an analysis to determine if a previously recorded asset value is impaired. If impairment is indicated, an additional analysis quantifies the adjusted value and the corresponding impairment charge required to restate the value of the asset.

Level of Value

Is the value of a 25% equity ownership different than a 75% equity ownership? The answer lies in the eyes of the beholder and is influenced by the facts and circumstances of each specific transaction, transfer, or dispute. Obviously, this is just another way to say "it depends." Defining this aspect of valuation can be a big money issue for owners, the IRS, and other stakeholders. Questions that affect the answer include:

- Is the valuation for federal tax compliance?
- Is the valuation for loan underwriting to be used by a lending institution?
- Is it for a divorce matter – which state? What is fair value for equitable distribution?
- Is it for other litigation purposes?
- Is it for strategic planning or for an event in the marketplace?
- Is it for a supplier termination or denial of transfer?
- Is the applicable standard of value fair value or fair market value?
- Is the valuation pursuant to the operation of a buy-sell agreement? What are the defining elements of the buy-sell agreement?
- Is the valuation for a portion of the brand rights, the entire brand portfolio, or for the enterprise as whole?
- Should the ownership interests of a designated equity (or successor) wholesaler or manger be valued as a minority or controlling interest equivalent?

Staying with the preceding example of ownership, a 25% interest is generally valued as a **minority interest** and does not enjoy the **prerogatives of control** that a 75% or 100% owner does. How does this affect value per share? Minority owners have limited or no discretion over the operational or strategic management of a business. A minority owner cannot control compensation or distributions and they cannot unilaterally dictate the strategic direction or operational management of the business or modify the capital structure of the balance sheet. Thus, the fair market value per share for a minority owner is generally worth less per share than the shares of a 50%+ owner.

Owners in privately held businesses generally have no ready market in which to sell their interests. 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 uncertainties related to the timing and favorability of converting a private, minority ownership interest into cash gives rise to valuation discounts (for lack of control and lack of marketability) which differentiate the minority owner's per share value from that of a controlling owner's per share value. Valuation discounts are expressed as a percentage and applied sequentially to the relevant level of value used in the initial calculation of value.

Figure 14 provides a hierarchical perspective of the various levels of value. In many cases, a valuation may be directly developed at one level of value and then converted to another level of value by way of a discount or premium. Knowing when valuation discounts and/or premiums are appropriate and quantifying the magnitude of these adjustments is no simple matter.

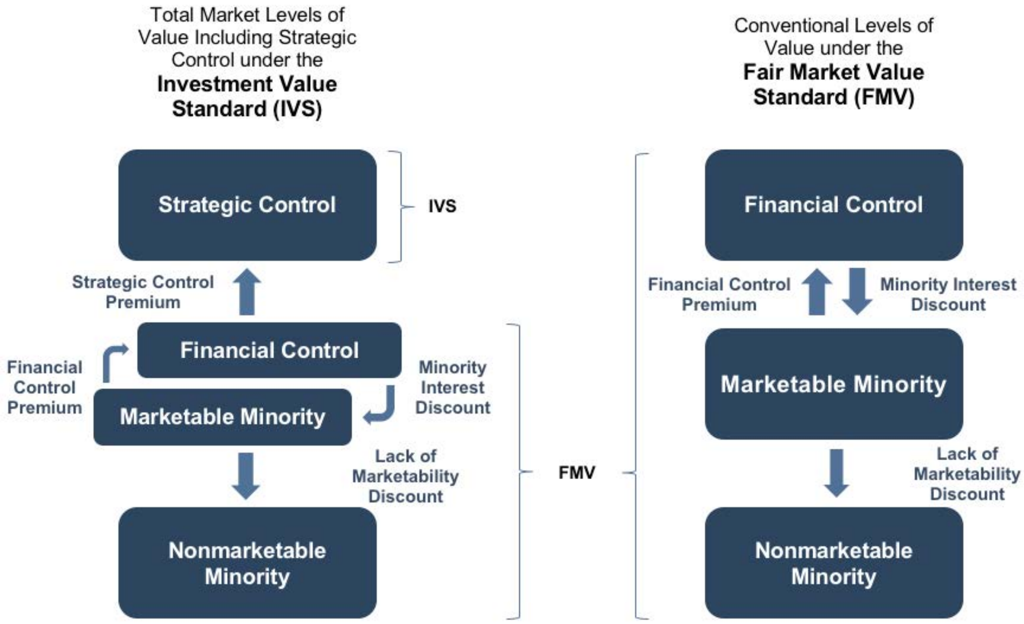


Figure 14: Business Valuation Levels of Value and Total Market Levels of Value

Defining the Levels of Value

Valuation professionals generally recognize three "levels" of value applicable to a business or business ownership interest. The levels of value are described as:

- **Controlling interest basis** (levels) refers to the value of the enterprise as a whole [or pro rata ownership interests therein]. The controlling interest level of value is considered to include two components, the **financial control level** and the **strategic control level**.

- **Marketable minority interest basis (level)** refers to the value of a minority interest, lacking control, but enjoying the benefit of liquidity as if it were freely tradable in an active market. The marketable minority level of value is also on an enterprise level of value, meaning that it is developed based on 100% of the expected cash flows of the enterprise.

- **Nonmarketable minority interest basis (level)** refers to the value of a minority interest, lacking both control and market liquidity.

Figure 14 includes the conventional three levels of value under the standard of fair market value (right). The total market place for businesses and ownership interests includes the investment standard of value (left portion of Figure 14). Value here is based on the industry and/or other investor-specific attributes that exist for certain investors. Business appraisers may differ on the financial and operational attributes of hypothetical investors when industry facts and circumstances dictate that parties in the most likely transactions are either pre-existing market participants and/or are parties who would be transacting in a market where specific, supplier-approved investors are prevalent, if not universally mandated.

Valuation Discounts

In trust and estate valuation, or other valuation settings where the standard of fair market value applies, valuation discounts for lack of control often range from approximately 5% to 25% (and the range can extend beyond this) and are supported by the facts and circumstances of the subject ownership interest, the business entity, the composition of ownership, and many other factors. Some valuations place reliance of change of control data captured in *Mergerstat Review* as a justification for the minority interest discount applied in an appraisal of a beverage wholesaler. We do not believe such data is directly relevant but it does support the notion that minority interests are potentially less valuable than controlling interests. The size of valuation discounts and premiums depends on the undiscounted value and upon the specific facts and circumstances of the business and its ownership at the time of the valuation.

Determining the Appropriate Level of Value

Some business appraisers initially develop their valuation indications at the marketable minority level and then apply valuation discounts or premiums to arrive at a nonmarketable minority or control level of value. We'll discuss this process, and we'll explain why we typically do not follow this approach for alcoholic beverage wholesalers.

Valuing Directly at the Marketable Level of Value

When valuing an equity interest in a wholesaler as opposed to valuing the enterprise as a whole, there can be options in both practice and theory as to which level of value the initial direct methodology results in. After directly valuing at the marketable minority level of value, the final level of value can be obtained by applying a discount for lack of marketability and/or a premium for control depending on the required final level of value for the conclusion. If an appraiser applies the typical income and expense adjustments but makes no adjustments to recast the business to an optimized state of profitability and does not otherwise employ controlling interest treatments, the resulting initial value often represents value at the marketable minority interest level of value. This is reinforced in part by the concept of using empirical data (i.e., Ibbotson, et al.) from the public markets that reflects financial returns to investors in minority ownership positions over time. Minority shares in private companies such as beverage wholesalers may not enjoy a ready market and can, therefore, be described as lacking marketability.

While we do not foreclose on the potential for using such an approach, but we have generally found that valuations that attempt to initially calculate value directly at the marketable minority interest level of value fall well short of rendering values that make sense in the context of the real marketplace for beverage wholesalers. A thorough understanding of the rules of thumb can be helpful in highlighting the significant disparities we often see. It's important to recognize the mistakes of business appraisers who do understand the specifics of the beverage distribution industry and who mistakenly attempt to transplant methods from other industries. While there are some very small and unprofitable wholesalers, not many are limited to 6x EBITDA or their book value as might be more typical of certain small, family owned businesses. In fact, data from lenders and other beverage industry stakeholders reference very wide-ranging multiples depending on whether legacy, low-margin EBITDA measures are used (i.e. 16x EBITDA) or if adjusted, optimized, post-transaction margins are used (i.e. 8x EBITDA or more).

Preference for Valuing Enterprises at the Controlling Interest Level of Value

In recent years, particularly with the increase in wholesaler valuations, we prefer to value wholesalers at the enterprise level of value using a controlling interest basis. When appropriate, we then sequentially apply a minority discount and then a lack of marketability discount to derive value at the nonmarketable minority interest level of value. In this fashion we can more directly compare the undiscounted control value to rules of thumb, regional transaction data, and even the brand or territory M&A activities of the subject wholesaler.

There is a certain intellectual bankruptcy with valuations that, despite their use of traditional valuation techniques, result in control values that are one-third or less of a credible market value of a wholesaler. We have seen numerous cases of this in recent years. This does not mean that we don't periodically encounter an economically challenged wholesaler with a justifiably low value. It's just the exception and not the rule.

Level of Value	Direct vs. Indirect Valuation	Comments
Strategic Control	Direct only via market-based evidence and/or advisory assistance based on specific buyer-seller combination efficiencies and income-based models such as DCF / IRR / MIRR / NPV	Does not represent fair market value unless specific facts and circumstances support that a strategic event was likely or reasonable to occur within a known or logical timeframe. Sometimes strategic control value is useful to know given the owner's option to achieve a potentially favorable valuation outcome/exit.
Financial Controlling Interest	Direct using income methods and/or market-based evidence when properly supported	The majority of experienced practitioners employ income methods to develop a direct indication of value at the control level.
Marketable Minority Interest	Indirect by applying discount for lack of control (DLOC) to direct initial financial control value; Direct using income capitalization	Direct initial method typically flawed in application due to improper risk assessment for cost of equity, lack of income adjustments, and failure to consider capital structure. Quantification of DLOC must consider facts and circumstances and be reasonable in relation to the value to which it is applied.
Nonmarketable Minority	Indirect by applying discount for lack of marketability (DLOM) to a marketable minority indication of value; Direct if transactions in the subject interests are available and relevant	Quantification of DLOM must be specific to the subject and the entity and consider varying methods of support. Quantification of DLOM must consider facts and circumstances and be reasonable in relation to the value to which it is applied.

Figure 15: Total Market Levels of Value and Direct versus Indirect Valuation Methodology

Premise of Value

The *International Glossary of Business Valuation Terms* defines the premise of value as "an assumption regarding the most likely set of transaction circumstances that may be applicable to the subject valuation."

> **Going concern value** is "the value of a business enterprise that is expected to continue to operate into the future. The intangible elements of going concern value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place." *(American Society of Appraisers Business Valuation Standards)*
>
> **Liquidation value** is "the net amount that would be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either 'orderly' or 'forced'." An orderly liquidation premise contemplates that the subject company's assets are sold over a reasonable period of time to maximize proceeds received." *(American Society of Appraisers Business Valuation Standards)* In contrast, a forced liquidation premise contemplates that the subject company's assets are sold as quickly as possible, such as at auction.

In general, the standard of fair market value assumes that a business is and will remain an independent going concern for the foreseeable future. Conversely, the premise of liquidation denotes a lack of business goodwill and intuitively suggests that assets will be transacted individually or collectively at an aggregate value that is lower than the enterprise value of a business that can successfully exploit the assets for commercial purposes.

As with other special attributes of the beverage distribution world, the premise of value may require careful consideration. The breakup value or piecemeal sale of brand rights to the highest bidder may result in brand valuations well in excess of the brand portfolio of a going concern. This is contrary to the normal connotation of liquidation value representing a value concession (i.e., the never ending liquidation event at your local furniture store). Transactions of brands in isolation are typically done for purposes of brand realignment. Many such deals represent horse trading exercises to consolidate a supplier's brands (or allied brands) under a single distribution house in the territory and are deemed mutually beneficial to the participating wholesalers and their suppliers.

Reconciling Business Valuation Levels of Value to the Wholesaler Transaction Hierarchy

The levels of value and the premise of value relate primarily to the valuation of equity interests. In the real world of mergers & acquisitions of mid-market businesses, transactions and transaction values are quantified in relation to assets or enterprise values. In the beer wholesaler world, multiples of gross profit typically relate to brand distribution rights and multiples of EBITDA are intended to express the value of a wholesaler's total asset base, inclusive of tangible assets like inventory, rolling stock, and real property (refer to Figure 8).

For market transaction valuations (and capital returns analyses) on behalf of a buyer or a seller, deal consideration is based on an enterprise concept and is typically quantified at the strategic level of value (which may be a range concept that is distilled to a single point estimate in the bid/ask process of a transaction). This simply means we are talking about real buyers and sellers with specific motivations who are reasonably informed by industry trends and by the relevant characteristics of the brands, the territories, and the accounts doing real deals.

Beverage Distribution / Wholesaler Transaction Hierarchy

The transaction market for beverage wholesalers is similar in character to the broader M&A marketplace. The transaction hierarchy of beverage distributors and the respective level of value perspectives are shown in the fourth column of Figure 16a and summarized as follows:

- **Standalone value/transaction** – relates to the total value of a wholesaler as an independent going concern, whose business operations are reasonably optimized with respect to sales mix and operating efficiency. This mostly equates to the financial controlling interest level of value under fair market value and is the lowest value on the hierarchy of transactions for beverage distributors.

- **Horizontal value/transaction** – relates to the value of a wholesaler as a targeted acquisition of a neighboring wholesaler who will enjoy certain efficiencies that increase the buyer's pro forma profit margin. In M&A speak, we describe the effect on expenses using the term operating leverage in that a portion of the target's standalone expense burden can be eliminated and the buyer's existing (mostly fixed) expense burden can service the higher volume of the combined business. This type of transaction is the most common in the industry and is also referred to as a contiguous transaction. It is arguably equated to the upper spectrum of financial control value (FMV) and/or the lower spectrum of strategic control value.

- **Vertical value/transaction** – describes a strategic event where the buyer's and seller's territories (footprints) overlap in whole or part and the buyer expects to achieve incrementally higher back office efficiencies in addition to potentially significant expense savings in the labor intensive selling, warehouse, and delivery operations of the combined business. In such situations, the buyer and seller already drop product at the same accounts. Some industry advisors describe this transaction type as being synergistic.

- **Brand Realignment or Liquidation value** – describes an event where brands are piecemealed to and/or exchanged with potentially multiple in-territory or near-by wholesalers who will experience minimal incremental expense to service the brands. The term golden cases is used to describe brands transacted under such scenarios because a significant portion of the gross profit of an acquired brand will translate to the buyer's EBITDA.

The alcoholic beverage distribution industry is unique, and virtually all market activity reflects some measure of strategic value because supplier-approved investors (buyers) are almost exclusively pre-existing industry participants. Accordingly, sellers expect (if not demand) to benefit from the efficiencies of industry consolidation and brand realignment. Most industry transactions are conventional "horizontal" acquisitions whereby an existing wholesaler expands by acquiring a contiguous neighboring wholesaler.

For purposes of bridging the gap between the vocabulary of the business valuation world and the real world of beverage distribution, we offer the following progression of graphics, which synthesize the primary value defining elements (standard, level, and premise of value) with the beverage industry transaction hierarchy.

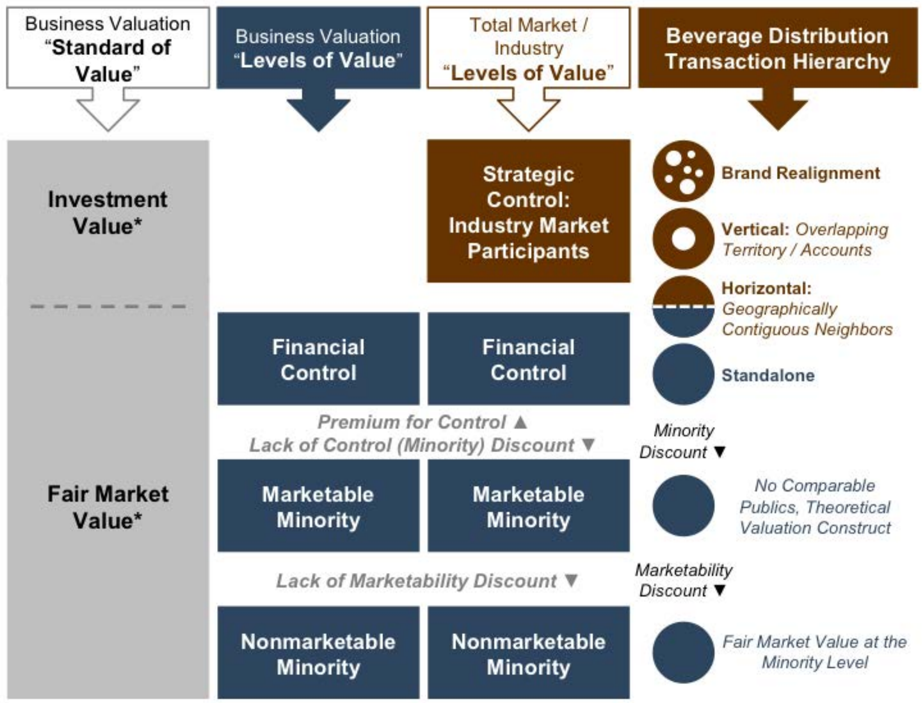


Figure 16a: Relating Business Valuation Levels of Value to the Wholesaler Transaction Hierarchy

Figure 16b relates the beverage industry's transaction hierarchy (column two) to the underlying financial progression of operating efficiencies and synergies that result from differing types of business combinations (columns three and four).

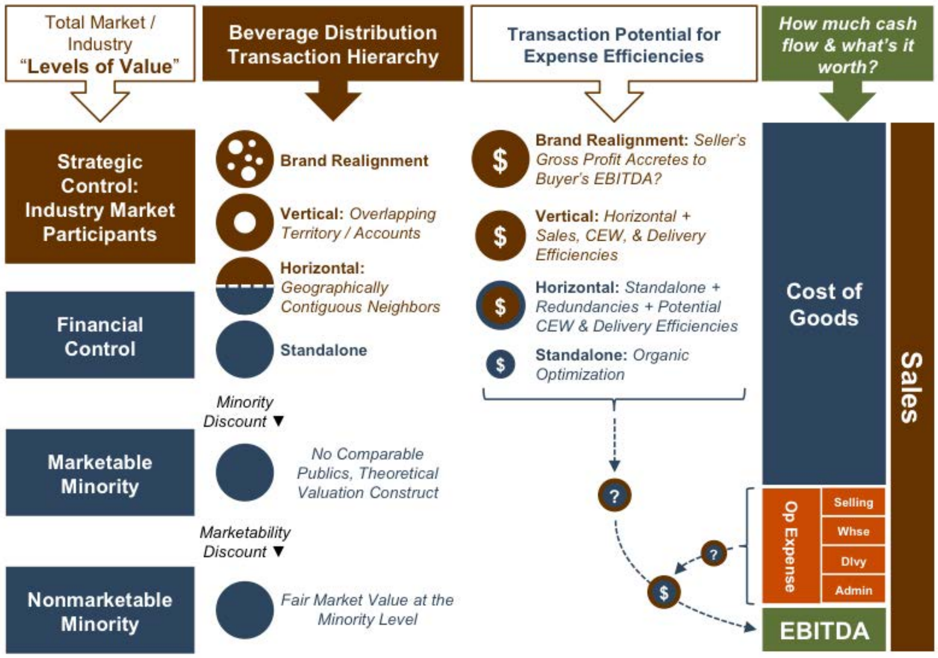


Figure 16b: The Wholesaler Transaction Hierarchy with Relevance to Valuation Economics

The higher the transaction on the hierarchy, the more operating expense can be squeezed out of the buyer's pro forma combined operation, which relative to a constant multiple of EBITDA increases the value of the transaction and the potential return to investors.

The phenomenon of operating leverage is a common motivation for business combinations in virtually all industries. The operational similarity of most beverage wholesalers makes the rebalancing of expenses a relatively straightforward study, the results of which appear to correlate closely with the transaction multiples (whether on gross profit or cash flow).

Summary Comments on Defining Valuations

So what does all this have to do with buying, storing, selling, picking, and delivering beer! Good question – apologies for the painful technicalities of the valuation science. The answer comes in the form of a cautionary message: defining the standard, level, and premise of value can be big a money issue! **Experts and advisors who lack the ability to reconcile the unique attributes of the beverage industry to the necessary standards, approaches, methods, and procedures of the valuation world could expose you to compliance repercussions with the IRS and to adverse outcomes in litigation matters where reporting requirements and expert knowledge are paramount**. In the real world where you might be asking yourself "should I stay or should I go" – a lack of basic corporate finance skills can result in poorly informed strategic planning. Industry knowledge and valuation knowledge are not synonymous – you need both.

Anatomy of a Beverage/Beer Wholesaler

The operating structures of beer wholesalers are highly regimented and relatively homogeneous across the industry. The organization and function of staff, the departmentalization of expense, the logistical realities of moving beer into and out of the warehouse, and the delivery of product to the final retail account are universal concerns of wholesalers and distributors in numerous industries. Differences in territory logistics and demographics require wholesalers to adapt their operations and/or product portfolios to the needs of the accounts (consumers) in their markets. The financial chart of expense accounts for a typical beer distributor provides the best platform for understanding the investment requirements and operational functions of the business model and promotes an understanding of how the operating expense structure of a wholesaler might change under differing types of transaction scenarios (refer to columns 3 and 4 of Figure 16b).

Departmental Expenses and Labor Mix

The departmental expense margins for the typical beer wholesaler are presented on the left in Figure 17. The total departmental labor expense margin is shown on the right.

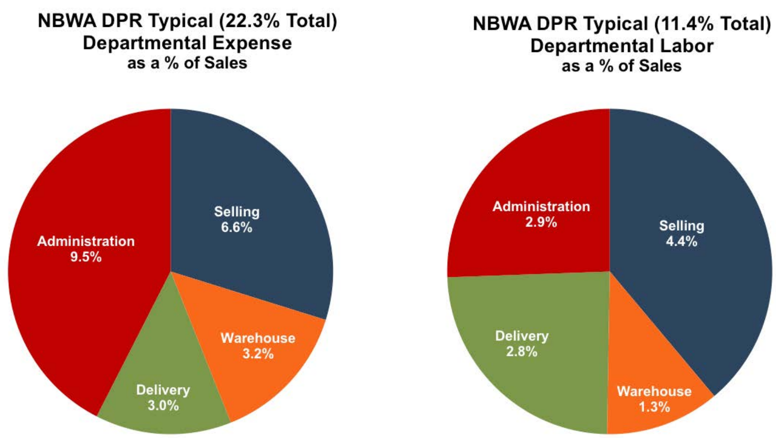


Figure 17: Department & Labor Expense Margins (Typical Beer Wholesaler)

The departmental expense margins for the typical high performing beer wholesaler are presented on the left in Figure 18. The total departmental labor expense margin is shown on the right.

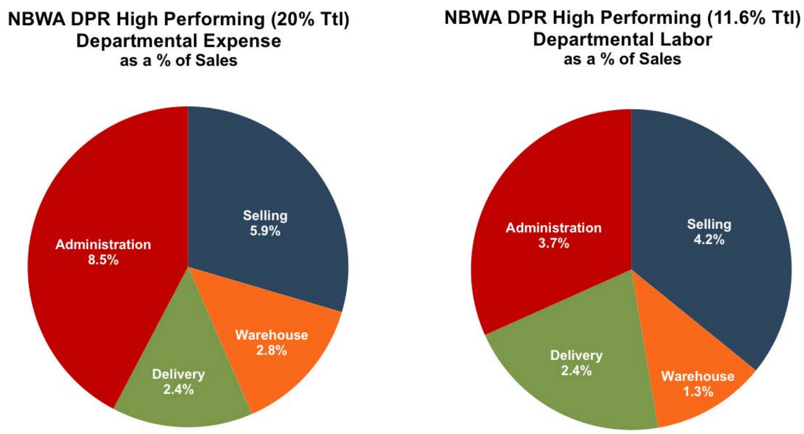


Figure 18: Department & Labor Expense Margins (High Performing Beer Wholesaler)

The total portion of operating expense associated with labor and benefits for typical and high performing wholesalers is presented in Figure 19. Reducing these expenses can be a significant driver of margin enhancement. A buyer's profit margins and cash flows are increased by the extent to which these expenses are reduced in a consolidating transaction.

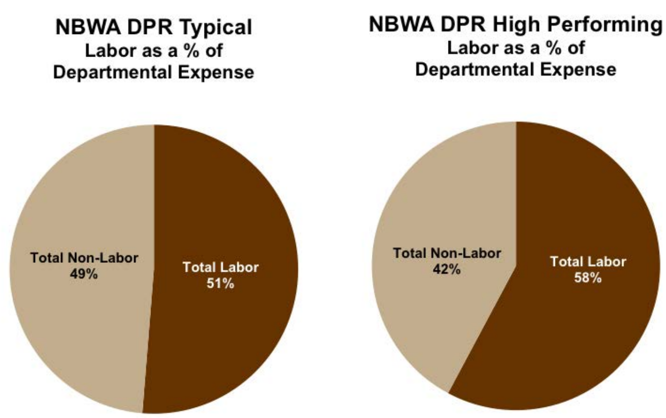


Figure 19: Total Labor as a % of Departmental Expenses

Selling Expenses

While the sales models of individual distributors can vary, the predominant model is referred to as "pre-sell." Under the pre-sell model, a distributor's sales representatives regularly call/visit their assigned retail accounts (both on- and off-premise accounts) to assess inventory needs and to inform accounts of product promotions, introduce and/or position products, and provide other account support services. Account orders are coordinated for delivery. Selling expenses typically represent 5%-7% of a distributor's sales. Labor costs constitute approximately 65%-70% of the sales department.

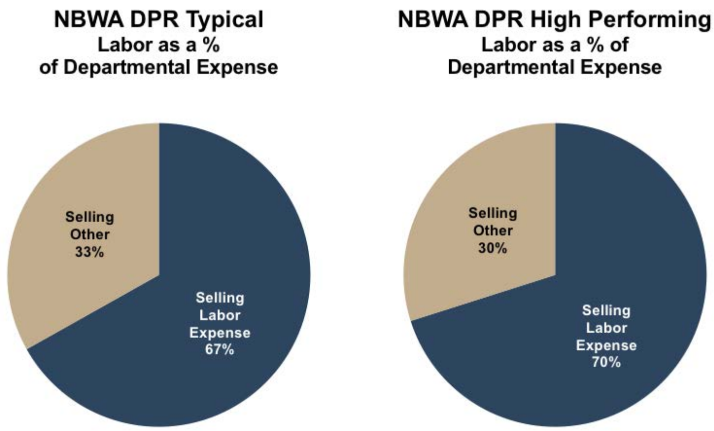


Figure 20: Total Labor as a % of Selling Expenses

Warehouse Expenses

The primary fixed assets include a controlled environmental warehouse (CEW) and a sales & delivery fleet. Additionally, warehousing systems and rolling stock are vital aspects of the inventory handling process. Warehouse design can be a significant influencer of inventory receiving efficiency, order picking, and order fulfillment. Procedurally, beer arrives in bulk from suppliers, is strategically placed into inventory, and gets picked and staged for loading into delivery vehicles. Warehousing expenses typically represent approximately 3% of a distributor's sales. Labor costs typically represent 40%-50% of total warehousing costs.

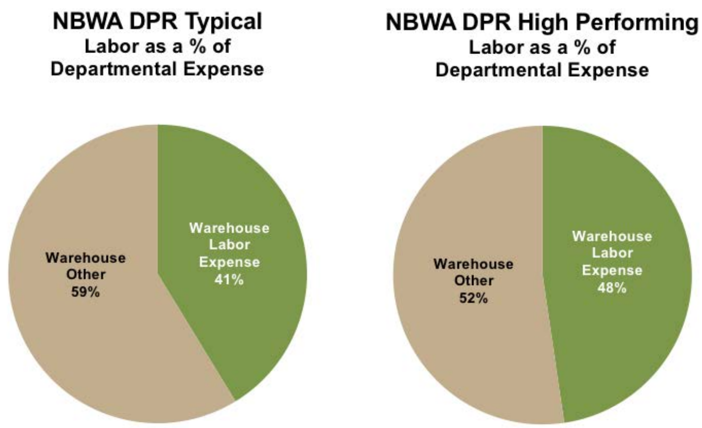


Figure 21: Total Labor as a % of Warehouse Expenses

CEW Tenant or Owner

CEW Tenant or Owner. Ownership of the warehouse can be a significant consideration in the valuation and transaction of a wholesaler. In many horizontal transactions, either the seller's or the buyer's warehouse will be retired. Logistical factors and the physical condition and capacity of warehousing typically influence match making in consolidating markets.

For a seller that is a tenant in its warehouse, a transaction often leaves the seller's family with a large empty building. Unfortunately, the configuration of CEWs is often highly purpose-specific to the requirements of the beer wholesaling business. There may be other expensive material handling assets that may have no home in the wake of a sale. Thankfully, many such assets generally have some demand in secondary markets (racking, rolling stock, etc.).

Despite the inconvenient prospect of legacy assets being excluded from a transaction, the economics of that transaction should reward (in some measure) the seller for the incremental profit being delivered to the buyer, which may include some portion of amounts previously charged to the business for rent. For financial valuation purposes, the use of EBITDA plus rent/lease expense (EBITDAR/L) should be used to assess the valuation against market-based cash flow multiples and common sense. Of course, in the case where a seller's CEW is not leased or purchased by the buyer, there will still be occupancy burden to integrate the seller's volume into the buyer's warehouse. We know from experience and by deduction, that enterprise transactions often reflect a mix of 80-90% distribution rights and 10 20% hard tangible assets. The recoverable value of excluded assets is part of the overall valuation and transaction equation even if the assets are not included in the LOI. The timing and liquidation values achieved for excluded assets have to be taken into consideration when assessing deal consideration. For example, if you're the seller and one of your motivations for selling is the avoidance of a new $5 million warehouse mandated by your supplier, you might expect the multiples of your transaction to reflect the buyer's burden to deal with a near-term capital investment (or one already made by the buyer in anticipation of a deal). Conversely, if the seller has a relatively shiny, high capacity CEW that allows the buyer to avoid their own investment to expand or replace their legacy warehouse, expect the value of your warehouse and the multiple on your deal to consider that.

Delivery Expenses

Delivery vehicles vary based on route type, retail accounts, delivery frequency, and products. Small and large truck & trailer (bulk) combinations, box trucks, mini vans, merchandising vehicles, and other vehicle types are employed to sell beer and get it delivered to retail accounts.

Beer distribution is referred to as a direct store distribution (DSD) model. In fact, the laws of most states require that all alcoholic beverages be delivered by the distributor to the final retail point of sale, which significantly limits retailers from using their own central warehousing and fleet infrastructures. Wholesaler delivery and merchandising personnel are actively involved in keeping store shelves properly stocked, inventory rotated for product freshness and store merchandising optimized (through coordination with the retailer). Delivery expenses typically represent approximately 3% of a distributor's sales. Labor costs represent 80%-90% of total delivery expenses.

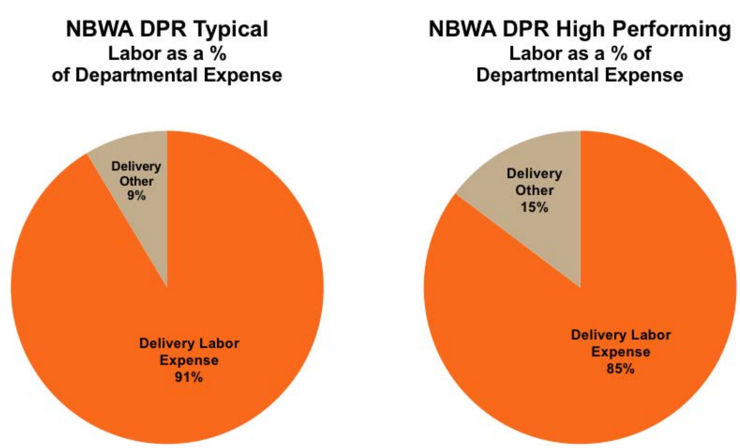


Figure 22: Total Labor as a % of Delivery Expenses

Administration Expenses

Administration includes senior management oversight and covers all expenses not directly allocated to selling, warehouse, and delivery departments. Administration expenses typically represent 8%-10% of a distributor's sales. Labor (including benefits) represents 30%-40% of total administrative expenses.

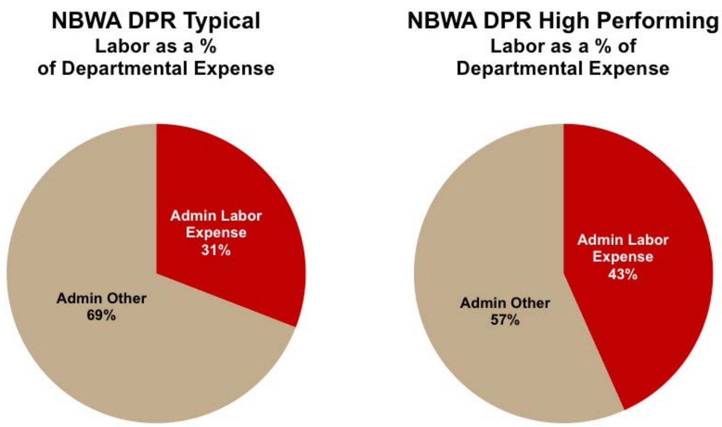


Figure 23: Total Labor as a % of Administration Expenses

Industry Expenses & the Long-Term Health of the Three-Tier System

In recent years, some of the industry's noteworthy advisors have cautioned wholesalers about the balancing of operational efficiency with the value-added role of brand development on behalf of their suppliers. While beer industry volumes have been flat for many years, pricing strategies and category mix have fueled favorable profitability for many wholesalers. But wholesalers are not perceived by many suppliers as the most effective partners in brand building. Also, beer's share of the market has eroded with the increased share of other beverage categories in key demographics. If wholesalers define their role as one of pure mid stream logistical necessity, then the operating efficiencies of the average wholesaler appear lower than the captive distribution costs of many big boxes retailers and wholesale clubs, who deliver a greater portion of their gross profit to EBITDA. If beer is to compete more aggressively on price with wine and spirits, wholesalers' profits could get squeezed unless the system as a whole improves on operational execution. Wholesaler consolidation in the beverage industry appears a pure play on operating leverage. The forces of disruption in retail, in the supplier ranks, and elsewhere are not likely to leave the three-tier system unchallenged.

Valuing Beverage Distributors

When You Need a Valuation or Valuation Consulting

Valuations and Financial Analysis for Transactions

Valuations and financial analysis for transactions encompass a refined and scenario-specific set of disciplines and frameworks. A valuation process should enhance a buyer's understanding of the cash flows and corresponding returns that result from paying a certain amount and employing a certain mix of purchase consideration and capital structure. For sellers or prospective sellers, valuations and exit scenarios can be modeled to assist in studying exit timing (sell now versus sell later) and for assessing the adequacy of deal consideration. Setting expectations and/or defining deal limitations are critical to good transaction discipline.

Sophisticated investors examine the returns associated with purchase consideration, financing, and prospective cash flows in order to develop term sheets and letters of intent, which may be distilled into a list of gross profit multiples or some other simplified format when presented to the seller. Rather than continuing with the financially vague concept of gross profit multiples, we encourage buyers and sellers to adopt the same corporate finance disciplines to assess value as it relates to the target, the existing platform business, and the combined enterprise. As an example at the end of this paper, we'll show how a merger/transaction plays out using some core financial disciplines.

In the Trust & Estate Environment and in Litigation Settings

In the trust & estate environment and in litigation settings, the rules and the standards for due diligence and work product are strenuous and subject to a high level of scrutiny. The continuity planning required by many brand suppliers is often satisfied by ownership succession or estate planning strategies that rely heavy on formal business valuations. Many wholesalers are not aware that business appraisals are subject to significant development and documentation requirements when they are rendered by a professional who is credentialed by the American Society of Appraisers, AICPA, or other legitimate professional society. Credentialed business appraisers are also required to adhere to the Uniform Standards of Professional Appraisal Practice (USPAP). Beware that many valuations (most in our experience) performed by industry advisors and some inexperienced business appraisers do not meet the requirements of being labeled an appraisal under the requirements of the business valuation standards of many professional appraisal societies.

Industry or Valuation Expert

We have observed a wide variety of work products from differing providers. There are a number of niche consulting providers that may have industry awareness, but lack the credentials, training, and independence to render valuation services befitting of enterprises that range in value from a few million to hundreds of millions of dollars. Industry experts are frequently guilty of a lack of awareness concerning the use and verification of unreported market data and for the misapplication of valuation models. As might be expected, business valuation practitioners are often guilty of shoehorning beverage distributors into their generic business valuation templates resulting in flawed valuation conclusions. Mercer Capital's qualifications in the formal valuation/appraisal universe are well established. And, given the benefit of many beverage industry projects over time and our commitment to following the industry, we have accumulated significant industry experience.

A valuation can be many things and can be approached using different variations of core methodology. The total business enterprise value (assets) of a wholesaler could be determined as the sum of its parts with each part being valued with asset-specific methods. For example, the multi-period excess earning method (MPEEM) could be used to value core intangible assets like distribution rights, which can be added to the reported balances of working capital assets and the appraised or estimated values of hard assets like CEW and fleet. Alternatively, the enterprise value of the business can be determined by capitalizing or discounting the cash flows of the business. With a known or estimated enterprise value, the implied value of the distribution rights is obtained by subtracting the working capital assets and the appraised or estimated values of hard assets. The latter of these methods is most common in business valuation. A more casual approach to valuing distribution rights might employ a rule of thumb for gross profit, which might be adjusted by the practitioner using various judgmental or quasi-analytical techniques. As mentioned throughout this paper, the use of gross profit multiples poses significant challenges and generally requires a parallel method that helps ground the valuation in financially sound methods.

Approaches to Valuation

There are three general approaches to determining business value – cost, income, and market. Under each approach there are specific methods. Within the methods there are numerous underlying procedures, which are often very important to end result.

As a general rule, valuation standards dictate that all three valuation approaches be considered. Ultimately, the initial 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 interest.

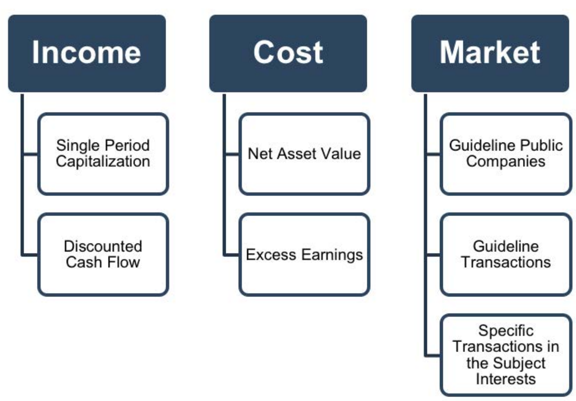


Figure 24: Valuation Approaches and Methods

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.

Net Asset Value Method

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 of 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 beverage 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. We often encounter assets which are remote at best to the continuing operations of a beer distributor. We typically segregate the value of these non-operating 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 beverage distributors is the 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. Because 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. Some valuators will elect to adjust the net carrying amounts of intangible assets to their respective market values and to add the value of any legacy rights that were never recorded on the balance sheet. The methods for achieving this require elements and application of the market and income approaches.

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 three-million-case operation could be quite different than your neighbor who finished his/her capital investments several years ago and has 10 or 20 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 varied but typically fall into one of two categories: 1) single period capitalization of free cash flow (SPC); or 2) a discounted future cash flow model (DCF). Simply put, the value of a business is directly related to the present value of all future cash flows that the business is reasonably expected to produce. The mechanics of an income method require an expression of future cash flows (annually), a growth rate in cash flows, and an appropriate discount rate with which to determine the present value of future cash flows.

Single Period Capitalization Model

The most common method used under the income approach is a single period capitalization model (SPC). Ultimately, this method is simply an algebraic simplification of its more detailed DCF counterpart. As opposed to a detailed projection of future cash flow, the analyst expresses a base level of annual net cash flow and then determines an appropriate multiplier. The most familiar expression of the SPC method is the P/E ratio, which is the primary valuation metric observed in the public securities market. 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 is based. If your valuation provider cannot develop and report their analyses in a manner that you sufficiently understand, get clarification or get a new advisor. You may not agree 100% with the conclusion. But you should comprehend the math and recognize your business in the report.

Discounted Cash Flow Method

Beer distributorships are frequently valued using the DCF method. In some situations, the use of a DCF is unnecessary because DCFs allow for the modeling of future periods during which some change or trend in the business model reaches a mature stage. Accordingly, a projection period of three or five years is typically employed so that sales trends, margin changes, and expense ratios can attain their stabilized norms. Beyond the discrete projection period, it is assumed that the business will achieve a constant level of performance. In circumstances where no near-term changes in the business model or capital structure are expected, an SPC method may suffice. Whether a DCF or an SPC is employed, clear and compelling support is required for all procedural treatments and assumptions.

The terminal period of a DCF model encompasses a single period capitalization that essentially values the cash flows from the last year of the projection into perpetuity. The terminal value of many DCFs actually represents the majority of value for most wholesalers, which should not be a surprise because the aggregate present value of "forever after" should be higher than the present value of a few years of cash flow. The following is a progression of simple formulas which culminate in the DCF formula.

$$\textbf{\textit{Single Period Capitalization Value}}(\textbf{\textit{SPC}}\$) = \textit{Cash Flow}(CF\$) \div \textit{Capitalzation Rate}(CR\%)$$

$$\textbf{\textit{Capitalization Rate}}(\textbf{\textit{CR}}\%) = \textit{Cost of Capital}(R\%) - \textit{Assumed Growth Rate of Cash Flow}(G\%)$$

$$\textbf{\textit{Capitalization Factor}}(\textbf{\textit{CF}}\%) = \frac{1}{\textit{Capitalization Rate}(CR\%)}$$

$$\textbf{\textit{DCF Value}} = \underbrace{\frac{CF_1}{(1+R)^1} + \frac{CF_2}{(1+R)^2} + \frac{CF_n}{(1+R)^n}}_{\substack{\textit{Discrete Projection Employed} \\ \textit{Until Cash Flow is Stabilized}}} + \frac{SPC_{\textit{Terminal}}}{(1+R)^n}$$

As can be seen above, the first equation for the SPC is also the formula used in the terminal value calculation of the DCF. For the sake of simplicity, if the growth rate in cash flow during each period is the same as the single growth rate used in an SPC, then the DCF method is not necessary and an SPC could be employed to derive the same or similar value.

If growth rates are assumed constant, the only reason for using a DCF in lieu of an SPC would be to consider significant inflows or outflows that affect cash flow in the foreseeable periods. These would include the building of a new warehouse or some other irregular, capital intensive event.

A DCF may also be used to gradually change the operating effectiveness of a business based on peer margins or other data that might be reasonable to employ in the valuation. Applying the adjustments over time could be more reasonable in the context of a going concern and may be less risky to assume over time rather than instantaneously as implied by an earnings or margin adjustment employed in an SCP method.

In cases where there is no dynamic trend necessitating a multi-year projection, the income method could just as well be a single period model. This makes sense when growth and margins are stable and unusual inflows or outflows are minimal. Circumstances may dictate that both a DCF and an SPC can be useful.

Adjustments

Regardless of the method used, income methods generally involve adjustments to historical earnings which eliminate the impact of non-recurring or unusual events (income and expenses) and reflect cash flow as would be expected by either a hypothetical financial investor or a strategic investor. Such events can either be directly adjusted in the event that current or recent earnings are being used in a SPC method or implicitly neutralized in a discounted future benefits or cash flow method (DCF) by way of revenue, margin and/or growth rates used in the projection. For example, adjustments may be applied to place rents at market rates, to reduce or increase compensation, or to capture changes in capital structure because such changes can impact earnings performance.

In either a single period method or a projection method, cash flow expectations must reflect a reasonable pattern for future performance. These projections may be the product of management or may be developed by the analyst with feedback from management and/or guidance from peer data. In times of unusual pricing policies and circumstances, such as the need for fleet and warehouse investments and during price wars, a DCF approach may be important to the overall analysis.

Discount Rate

Having determined the cash flow measure, the analyst must develop a discount rate that is appropriate to the cash flow measure being valued and that is reflective of the expected growth and risk of the investment. The discount rate is generally developed by way of observing broad market returns on similar investments. Remember that using the time-value-of-money concept, the higher the discount rate, the lower the resulting valuation related to the income stream. The discount rate 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 a beverage distributorship is the value of an equally risky, alternative foregone investment.

Risk

A fundamental issue with the theory of economic valuation for beverage wholesalers, particularly alcoholic beverage distributors, is that three tier laws have a substantial impact on risk assessment. Identifying the return of the investment that is foregone is not so easy. I suggest that the 15% equity discount rate seen in many valuations appears too high. If such a discount rate persisted (and it did) in valuations before the financial crisis when long-term government bond yields were 200 basis points higher than today, why then would a constant equity premium (which has arguably declined in the past decade) not put a reasonable discount rate for many wholesalers at 13% or lower?

As a mid-stream asset in the vertical array of the three tiers, volume throughput does not vary with the volatility of returns in the broad financial markets. In financial market terminology, this means that many wholesaling enterprises may not be as volatile in their returns as those of the respective supply and retail tiers, where there are more variables affecting financial returns. This would mitigate the equity risk premiums typically applied by unknowing industry experts who are unfamiliar with important pricing theories in corporate finance as well as inexperienced business appraisers who, failing to locate industry data to the contrary, use a build-up process that implies a market-neutral beta and use a size premium that may not square with common sense and informed judgment. Only in rare instances have I witnessed other experts attempt to address this fundamental issue. There are tools and methods of informed judgment available to sufficiently skilled valuation experts to deal with this important factor. This paper, while detailed, does not cover all aspects of the valuation science in depth. The mastery of these concepts is the reason you hire experienced professionals.

Growth Considerations

It's worth observing that beverage wholesalers transact at relatively high multiples of cash flow. High valuation multiples are the result of low risk and/or high growth. Everyone knows that growth in the beverage industry is modest from a volume perspective. But cash flow can change as a result of category mix, with craft and trending FMBs, among other products, contributing to growth rates in gross profit and operating income. The combined effect of pricing, volume, category mix, and expense control can drive cash flow growth rates at a healthy pace, albeit lower than the rate of growth seen in certain private equity investments or the tech sector.

Ultimately, the regulatory and contractual protections of the middle tier contribute to an abnormally low risk profile that is difficult to develop using the conventional tools of the valuation trade. A 15% cost of equity, in my view, is not representative of the prevailing market risk for most wholesalers, and it does not explain the types of valuations common in the transaction environment. Modest growth is an industry reality; the only way to derive multiples that reconcile to the market is by way of a comparatively low cost of equity capital and the employment of debt that reflects the high financial leverage employed in beverage industry transactions. Again, at the risk of over-simplification, the weighted average cost of capital (WACC) in the middle tier is typically less than 10% and in some transaction structures could be argued to be as low as 5%. WACCs at these low levels help explain the valuation realities of the marketplace for the last 10+ years.

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 wholesaler investment (control or minority) 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 detailed reporting and the irregularity of such transactions offer limited perspective on value for any given assignment. Beer distributors are generally prohibited from issuing stock in the public markets. 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

Trends in the public securities markets and M&A valuations may not be directly relevant to the value of your beer distributorship. The top and bottom tiers of the industry are manufacturers and retailers; wholesale distributors are mid-stream business models which have a specific function that is different than selling goods to consumers or converting raw materials to finished goods. This is not to say that markets and economic trends don't influence wholesaler performance by virtue of the mix of premium to sub-premium, the share dynamics of craft and import products, and the pricing strategies that go into certain products and packages. Numerous underlying risk factors and fundamentals are worthy of consideration when assessing the risk profile and future growth of the malt beverage industry. However, the nuances and timing of these trends are different at the wholesaler tier of the industry. Since the repeal of prohibition, three tier laws have intentionally constrained the vertical diversification of the industry. This in turn, implies a limitation of the extent to which trends in the supplier and retail tiers affect the middle tier.

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. Grow your empire or capitulate to the selected consolidator in your market. We have witnessed significant consolidation in each of the three tiers. Traditional market share is being reallocated as suppliers and distributors build portfolios that respond to the growing diversity of consumer preferences. And emerging market participants are seeking efficiencies of scale and probing for the right mix of offerings.

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 threatened. It is vital that your valuation reflect an awareness and balanced consideration of just how these trends might affect you. We cannot know with perfect foresight what will happen in the future, but we can form reasonable expectations sufficient for you to study alternatives among varying strategies. Should you stay or should you go?

Secondary Liquidity

Secondary liquidity is an emerging topic of interest. If you were an early and aggressive adopter in the consolidation game, you might now be guessing what your exit event will be 10 or 15 years down the road. Selling 15 or 20 million cases of volume to a neighbor is not nearly as automatic a prospect as it was when you had three million CE. The entry of large pools of capital and the nature of partnering with large sophisticated mangers of capital will be interesting to witness. Mercer Capital works for a broad range of family office and alternative investors and we understand that managing capital and selling beer are very different things. In recent years the knock on the door has been louder by private equity groups and industry outsiders looking for strong cash flowing businesses that feature favorable investment duration. How suppliers plan to deal with this issue over the long run is an interesting discussion.

"How big can mega become as the ABI/SABMiller combination continues to mature and legacy market shares continue to fragment" is an intriguing, even existential question for beer wholesalers. Will disruptions in consumer retail and logistics evolve to where the role of the middle tier becomes outmoded and vertical re-integration of the alcoholic beverage industry becomes a reality? If the enterprise revenue multiple of the entire beer wholesaler tier is about 1x, then 200 million barrels of volume could be absorbed in a middle-tier ending industry reorganization that is not terribly different than the $100 billion merger value between ABI and SABMiller. Once upon a time, there were three wholesalers in every territory that mirrored the three core domestic brewery concerns. Today, we have a global brewer with an aggregate 75% of U.S. volume share. What's next?

Competition

Perhaps this is simply an extension of the consolidation concept, but competitive concerns run deeper. Domestic brewery houses 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 strong in both volume and dollar share, its overall market share is being reduced on multiple fronts and per capita consumption continues its long running decline. The growth of imports, craft, coffee, spirits, wine and energy drinks (among others) represents both a serious threat and an ongoing opportunity. The risk and growth aspects of these trends must be adequately understood and incorporated in your valuation.

Growth

There is not much volume growth in the beer industry. The market share pie is being re-sliced, and one brand's loss may be another's gain. 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 brand growth is stagnant or declining. Craft and import growth may be helping offset the slide in legacy domestic product. Margins cycle with price competition and market share plays. The industry is mature and profit growth is generally modest.

Real growth at the gross profit and EBITDA levels is dependent on mix and efficiency. For some wholesalers, despite modest volume growth, the gentrification of mix has helped drive profits. However, many small-market wholesalers have not enjoyed the craft and import trends, leaving them with profit growth that is limited to expense optimization, pricing, and demographics. Most recently, brewers delivered a stern message to wholesalers that malt pricing strategies were not helping category share because many popular wine and spirits products deliver similar alcohol content at a lower retail price point. Dietary misconceptions have also driven a wedge in gender balance with beer largely missing out on a promising female demographic. Caloric and carbohydrate density actually favors beer, which is a little-known fact to a largely under-served female consumer.

Growth assumptions are critical to all valuations. A small 1% growth rate implies that you've probably weeded out waste and optimized your system, leaving limited headroom for margin growth. On average, we know that many wholesalers have not achieved this because their SWD&A expenses are still more than 22% of sales. In a fully optimized wholesaler, some industry advisors believe 18%-19% is easily attainable, and in certain business combinations significantly lower. If we limit revenue growth to a portion of the annual price change in the industry and we add the growth associated with improving from a 22% expense base to a 19% expense base over a three-year period, then operating profits will increase on the order of 22% per year and nearly double by the third year. If after a multiple year period of expense reduction, operating growth is limited to 1.5% for the next 20 years, then a reasonable perpetual growth rate against a legacy profit base would be on the order of 4%-5% and not the uniform 1%-2% so often employed. If the expenses are adjusted in year one of a projection model and then profits are forecasted for a DCF, a lower growth rate might be called for. Accordingly, the assumed growth rate in a valuation depends on the wholesaler and the territory and it must be quantified in the context of the margin assumed for the cash flows.

Another troubling and fundamental issue we see in valuations is the equating of top-line and industry growth rates with the growth rates for cash flow. As previously noted, unless the cash flows are already optimized, the use of industry volume or revenue growth as a proxy for a wholesaler's cash flow and profit growth could be a mistake that renders the concept of operating leverage meaningless in an industry where consolidation activities are the quintessential example of growth through efficiency. The differences in legacy multiples and pro forma multiples that are referred to in industry circles directly support the expectations of the industry and of the lenders who willingly lend significant capital into beverage wholesaler transactions.

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 expression of growth.

Valuation Discounts

When valuing an ownership interest in the stock of a distributorship, discounts for lack of control and lack of marketability may need to be considered.

Lack of Control (Minority Interest) Discount

At the risk of oversimplification, equity ownership interests representing less than voting control of the subject entity's capital base are considered non-controlling (or minority) interests. As such, a discount for lack of control (DLOC) may be applied to reflect that the owner of such an interest either cannot (or has limited ability to) influence the operational management and strategic direction of the business.

Valuation practitioners frequently derive DLOCs from M&A control premiums documented in certain annual financial publications. Control premium data comes from publicly disclosed M&A deals where the transaction value of the acquired business is higher than the pre-acquisition value of the target (and thus an implied premium for the change of control.) At best these observations are anecdotal to the beverage distribution industry, but they provide perspective concerning appraisal treatments commonly cited and employed and they support the notion that the economics of control may be superior to those of minority owners.

The implied range of DLOCs relating to the respective range of control premiums is approximately 20% to 30%. However, a sizable consensus of valuation professionals recognizes that the published M&A control data represents the strategic activity of predominately large, publicly traded enterprises. Accordingly, the observed control premiums and implied DLOCs must be tempered for inferences on discounts applicable to relatively small closely held businesses such as most beverage wholesalers (small size being relative to large publicly traded businesses).

For purposes of the DLOC for many beer wholesalers, we tend to apply smaller discounts than cited or derived from various studies. The reasons can vary from one appraisal to the next. Most importantly, any DLOC must be appropriate to the base control valuation to which it is applied. There may be valid reasons for no discount or for discounts lower or higher than the 10%-20% often employed. It is widely acknowledged in the valuation profession that differences between the financial control and marketable minority levels of value are often narrow in the context of fair market value (refer to the left portion of the graphic in Figure 14). A lower DLOC may also be reasonable if there is the potential for "minority" investors to piggy back future strategic events.

Lack of Marketability (Marketability) Discount

Marketability relates to the liquidity of an investment relative to a comparable and actively traded alternative. A rational investor will pay less for a nonmarketable interest than an otherwise comparable interest that is freely tradable in a public market. This differential in value is commonly referred to as a marketability discount, or discount for lack of marketability (DLOM), and is typically stated as a percentage of the marketable value of the subject interest.

DLOMs can be estimated using a variety of approaches and methods. Within the market approach, benchmark analysis considers data from (1) restricted stock transactions, (2) pre-IPO studies, and (3) decisions rendered in court cases. Methods within the income approach are generally rooted either in option pricing theory or discounted cash flow analysis.

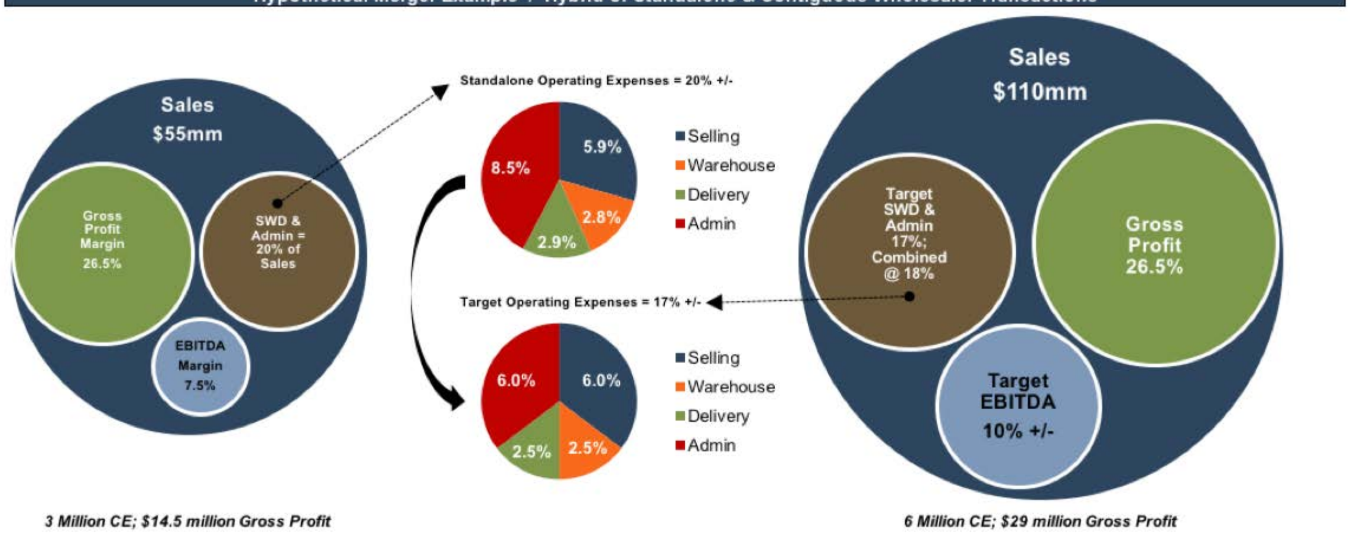
There are more than two dozen published methods to derive discounts for lack of marketability, and hundreds of reviews of them. In 2009, the Internal Revenue Service developed a guide for IRS staff to evaluate marketability discounts; the guide was released to the public in 2011. The Discount for Lack of Marketability Job Aid for IRS Professionals (the IRS Job Aid) reviewed and categorized eighteen of these methods. Consistent with the preceding discussion of the DLOC, DLOMs for malt beverage distributorships can vary for numerous reasons.

Conventions for the range of DLOMs derive from various studies regarding transactions of restricted stocks in publicly traded companies that have freely traded and unrestricted securities. The difference between the restricted stock valuations and the freely traded public issue represent a proxy for the DLOM. The typical range cited by practitioners if from 25% to 45% but can vary based on facts and circumstances. Restrictive provisions, low or no shareholder distributions, ownership mandates of suppliers, exit scenarios and exit timing, and many other finite considerations can suggest a higher or lower discount. Rather than relying on the generic range of the restricted stock studies, Mercer Capital typically employs a qualitative tool and a quantitative tool to support the concluded discount. For profitable, high distribution paying distributorships DLOMs can range from 20%-30%, but DLOMs outside this range are not unusual. Each specific DLOM must be supported by specific facts and circumstances.

Example of a Hypothetical Merger

In the following graphic we depict a hypothetical merger/sale where a standalone 3 million CE wholesaler combines or sells out to a similar sized buyer/partner. With a fixed EBITDA multiple and enhanced margins, the implied gross profit multiple jumps for the target and the combined entity. This explains the value premium that makes the typical horizontal consolidation an accretive event. Another important analytical perspective: a healthy buyer under the scenario could finance almost the entire target valuation of $55 million, could generate positive annual cash flows on the acquired business, and earn a 20%+ internal rate of return assuming a future exit in 15 years at 3.5x gross profit. The buy-side NPV in this example approaches eight digits (using a 12% hurdle rate) and an even a more stringent assessment using a modified IRR with a 10% reinvestment rate exceeds 20%. Estimate your buyer's capacity based on what the deal could do for them on a pro forma basis. Know your seller's valuation as a target in order to prevent overpaying as well as to assess downside risks under differing future scenarios.

Hypothetical Merger Example / Hybrid of Standalone & Contiguous Wholesaler Transactions



Independent Standalone

		Measures
Case Equivalent Volume		3,000,000
Sales @ Per CE	$18.33	$55,000,000
Gross Margin	26.5%	$14,575,000
Adj. EBITDA %	7.5%	$4,125,000
TEV @ EBITDA	10.0x	$41,250,000
Rights Allocatior	90%	$37,125,000
Implied Net WC & Fixed Assets		$4,125,000
Rights ÷ Gross Profit		**2.5**

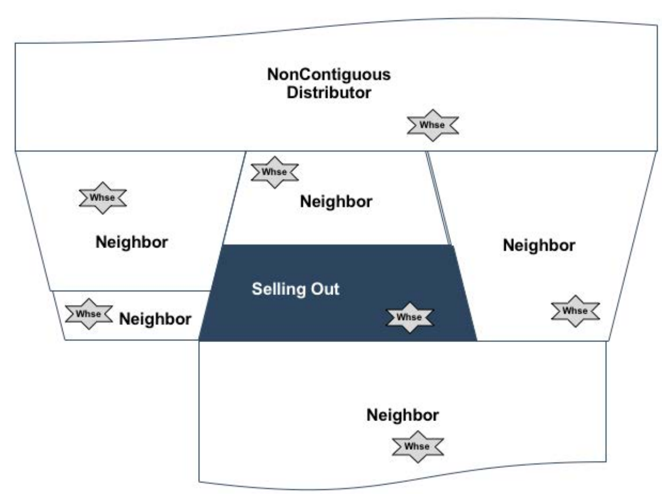
Contiguous Wholesaler Transaction - Combination of Equals

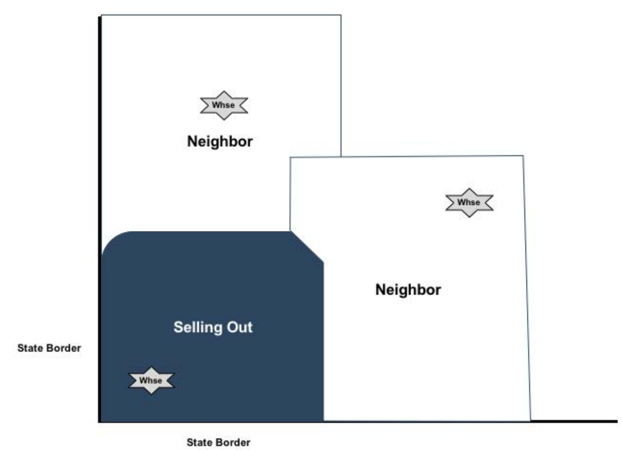
		Measures
Case Equivalent Volume		6,000,000
Sales @ Per CE	$18.33	$110,000,000
Gross Margin	26.5%	$29,150,000
Adj. EBITDA %	10.0%	$11,000,000
TEV @ EBITDA	10.0x	$110,000,000
Rights Allocatior	90%	$99,000,000
Implied Net WC & Fixed Assets		$11,000,000
Rights ÷ Gross Profit		**3.4**

Territory Geography and Competition Can Influence What You Pay or Receive in a Transaction

Sellers with different territories can face fundamentally different logistical and other realities that can influence the degree of interest or competition in the market. One seller has a potentially favorable circumstance of numerous contiguous distributorships. The other has inherently limited options that could influence a lower than typical outcome in a sale. An analysis of like-branded neighboring houses, as well as an understanding of the competitive footprint of other houses in the same territory, is critical to estimating reasonable expectations. It always helps to make a long list of criterion for assessment regarding the sale or acquisition of brands and/or territory. Despite the inherent difficulty of the science, common sense and reasonable judgment as a buyer or seller can help your advisor craft reasonable bid/ask valuation assessments. These questions should be addressed to both buyer and sellers in transactions.

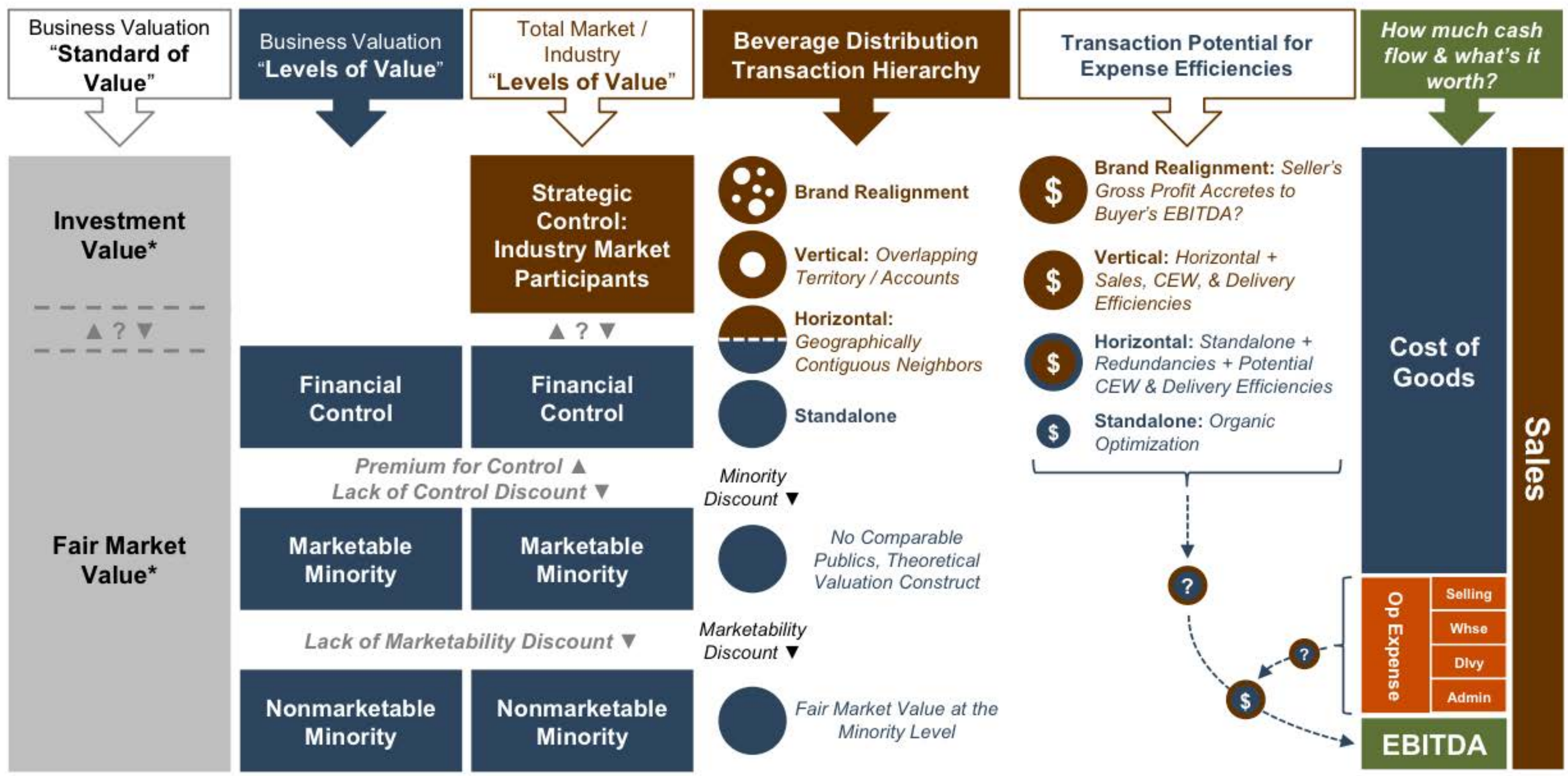
- Composition and age of ownership? Prior CEW projects and the estimated influence on financing and operating capacity?
- Interstate/ Highway / Surface thoroughfares?
- Supplier signals, precedence, & preference?
- Age, capacity, and location of CEW?
- Assessment of labor productivity?
- Competitive footprints and brand realignment potential?
- Sequential and jigsaw consolidation considerations and potential (sell now, grow, sell later)?
- Potential financial and family complications resulting from a transaction?
- Merge versus sell?
- Prior brand transactions and estimated influence on financing capacity?
- Geographic distribution of accounts and CE drop volumes and distances?
- Location of core population centers, retail outlets, major employers, etc.?
- SWD&A efficiencies and opportunities?





Industry Transaction Hierarchy & Business Valuation

Defining Value for Dispute Resolution, M&A, Financing, Estates, & Ownership Continuity



Final Thoughts

Mercer Capital has long promoted the concept of managing your business as if it were being prepared to transact. Doing so allows you to promote the efficiencies, goals, and disciplines that maximize 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 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 hardships and successes in the industry. We hope this information, which admittedly only scratches the surface, helps you to understand some core valuation mechanics and to better shop for valuation and transaction services.

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."**

About Mercer Capital

Mercer Capital is a full-service business valuation and financial advisory firm. We offer a broad range of services, including corporate valuation, financial institution valuation, financial reporting valuation, gift and estate tax valuation, M&A advisory, fairness opinions, ESOP and ERISA valuation services, and litigation and expert testimony consulting. We have provided thousands of valuation opinions for corporations of all sizes in a wide variety of industries. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement.

Specifically, Mercer Capital provides beverage wholesalers and distributors across the nation with corporate valuation, transaction advisory, financial reporting valuation, and related services.

For over 35 years, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world.

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Why You Need a

Valuation of Your Beer Distributorship

There are many reasons, one of which is the new tax law

The alcoholic beverage distribution industry is complex and evolving with influences arising from multi-tier consolidation and category integration, as well as from changes in consumer behavior and disruptions in retail product channels. Complicating matters, historical rules of thumb crafted over decades under the prior tax code must now be reinterpreted for a new reality.

Lower tax rates generally contribute to higher valuations – but some new rules and limitations require careful assessment to determine their effect on investor returns and financing options. Participating in the valuation process and equipping yourself with a current valuation will give you the updated understanding necessary for your next business decision.

Mercer Capital has worked with middle tier operators for over 25 years. Our knowledge of the beverage industry extends from serving clients across the three tiers and other related industry verticals. We provide business valuation and financial advisory services for shareholder disputes, divorce, trust & estate planning, transaction assistance, tax reorganizations, among other purposes. Mercer Capital can help you navigate the complications and opportunities arising from the new tax law in order to plan for and respond to the next event in your business.

You need a valuation if...

You want to know what your business is worth under the new tax law.

Understanding your business' value under the new tax law empowers you to properly position yourself for the future.

The new lower tax rates may yield higher valuations – which is good news for some but problematic for others. Whether the wholesaler transaction markets will affirm the higher valuations has yet to be revealed, and some recent trends in industry volume could actually signal reduced valuations.

Interestingly, some early financial modeling suggests that strategic deals require careful assessment to determine the impact on investment returns. The new tax rules and rates could be problematic for internal family transfers and for sales between family owners and their non-family successors.

Between a changing industry and changing tax code, obtaining a fresh valuation is paramount to best position yourself and your business for tomorrow.

You need a valuation if...

You've never had a real business valuation.

Manage your business with a robust understanding of the asset you own and operate, and plan well for continuity, expansion, or exiting.

Imagine if Schwab or Fidelity determined that you really didn't need your account statement or any real timely understanding of your assets. Sounds absurd for sure, but not knowing your valuation represents the same unacceptable risk and absurdity.

Success in the business world is largely measured by the change in value. Measurement between two points in time is the essence of investment return. Yes, we sell valuation services. And, yes, you should use valuation services regularly enough to measure and assess your investment returns over time. This need is in addition to any specific valuation requirements you might encounter in the cycle of owning your distributorship (taxes, death, divorce, deals, etc.).

You owe it to yourself and to your family to "mark" your asset's value to its market value on a regular basis.

You need a valuation if...

Your previous valuation is out of date and/or it addressed a purpose disconnected from the current need.

Gain an understanding of corporate finance in order to maximize your business' potential.

Worse, you never saw it because "it" served a static need and its development did nothing to stretch your understanding of corporate finance and its relevance to your business or your family continuity strategy.

One size does not fit all. A mistake in defining the moving parts and a failure to understand the dynamics of those parts as a business machine often lead to flawed valuations that will not win the day.

Mercer Capital strives to deliver advisory services that attend to your immediate need while also highlighting the bigger picture of your distributorship and its fit in the greater scheme of the industry's evolution and wholesaler consolidation.

You need a valuation if...

Your "expert" has no way to explain and reconcile the myriad of value definitions.

Get informed and understand all the angles of your transaction or dispute.

This can be a huge issue in transaction negotiations, dispute resolution, and tax compliance. We have encountered numerous business valuation practitioners who have attempted to apply vague, generic, and uninformed business valuation methodologies to the valuation of beverage distributors. In fact, appraisers have begged our advice and structural guidance many times over the years.

Methodologies that work for many businesses can also work for beer, wine & spirit, and NA wholesalers, but the valuation modeling assumptions and procedural treatments for the middle tier of the beverage industry are unique. Does your industry guru understand the technicalities of the valuation world? Does your valuation analyst have a real clue about the beverage industry? Mercer Capital provides expertise both as a leading national valuation firm and an experienced industry veteran.


Valuation practitioners with limited exposure to the space or industry veterans without corporate finance expertise are not equipped to handle your needs

You need a valuation if...

Your last valuation relied on rules of thumb.

Rely on an expert who is both an industry and a valuation expert.

Did your last valuation rely on rules of thumb such as gross profit multiples and/or EBITDA multiples? Did it employ unwarranted averaging techniques and fail to consider reasonable adjustments? Worse, was there some artificial science used to adjust a rule of thumb based on market share or size?

If you are lucky, and your distributorship is average in every way (territory, demographics, portfolio, mix, CEW, etc.), then the answer might be reasonable. If you are among the majority of wholesalers whose house profile differs from some peer norm, your result is likely flawed, lacks the substance and discipline of sound corporate finance, and fails to cover the reporting requirements of a legitimate business valuation. A professional with both industry experience and a deep financial bench assures that the technicalities get covered with real industry relevance to your circumstance and need.

You need a valuation if...

Your buy-sell agreement has outdated pricing requirements & funding needs.

Outdated buy-sell agreements are at risk of being fundamentally misaligned from the industry and new tax rates.

You may know that the combined effects of growth in average gross profit per case and average brand rights valuations have contributed significantly to valuations in the wholesaler space. Changes in mix and margin, diversification of category offerings, liberalization of licensing rules and market channels, affordable and abundant financing, favorable tax laws, the willing compromise of buyers' return on investment, enhanced operational performance in the industry, and other factors have contributed to significant brand value appreciation over the last 10-15 years. However, will this trend continue under new signs of post-craft maturity and category mix?

Formula-based updates and grafting from prior valuations with outdated rules of thumb are not the making of a sound valuation today, particularly in the paradigm of the new tax code.

Mercer Capital & Timothy R. Lee

Beverage-Related Valuation Experience

Timothy R. Lee, ASA
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Timothy Lee, ASA, Managing Director of Mercer Capital's corporate valuation practice, has been an associate member of the National Beer Wholesalers Association since 2008, attending annual conventions and tradeshows and providing financial and valuation-themed educational sessions to NBWA members. Additionally, Tim has presented to business valuation professionals on the topic of valuing alcoholic beverage distributors for purposes of continuing education.

He has provided valuations and related advisory services for purposes of marital dissolution, ownership and management succession, trust & estate planning, brand acquisitions, purchase price allocation, asset impairment, shareholder oppression and other ownership disputes, celebrity endorsement, recapitalizations, mergers & acquisitions, and financial underwriting. His work has been accepted by brewery concerns, which exercise significant discretionary control over the ownership and business activities of the wholesale tier.

Tim's national beverage-related experience extends to producers and suppliers of non-alcoholic products as well as to wine and spirit importers and wholesalers. He also has experience in the valuation of consumer goods companies, food wholesalers, and hospitality enterprises.

Tim has performed services for wholesaler entities, individual owners, legal and financial representatives, lending institutions, and the Internal Revenue Service. He relies upon a deep bench of over 20 valuation professionals. Contact him to discuss your need in confidence.


Our team has both
deep industry experience
and sophisticated
valuation and transaction
advisory expertise

MERCER CAPITAL

Beverage-Related Valuation & Transaction Experience

Mercer Capital has extensive experience valuing alcoholic beverage distributors and other concerns in the beverage industry for over 25 years.

Services Available

- Distribution rights & intangible asset valuation
- Trust & estate valuations
- Valuations for continuity planning purposes
- Transaction advisory, fairness & solvency opinions
- Litigation support for marital dissolutions & shareholder disputes
- Buy-sell agreement design & dispute resolution
- Strategy assessments
- Board & shareholder education
- Financing assistance & underwriting
- Quality of earnings assessments

Industry Segments

- Beer wholesaler distributorships
- Wine & spirits wholesalers & distributorships
- Breweries
- Retail channels
- Non-alcoholic beverage production & distributorships

The professionals of Mercer Capital understand your industry. We are also one of the largest and most respected valuation firms in the nation. Let us help you the next time you require valuation services.

www.mercercapital.com

800.769.0967