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WINE INDUSTRY BUSINESS JOURNAL: Guest Contributor: Wine industry faces new landscape in 'credit crunch'

Guest Contributor
By Simon Inman

The effects of the "credit crunch" will be felt just as much by the wine industry as any other sector. Fortunately, the industry as a whole seems to be in far better shape overall than many others. As a result the impacts may not be as dramatic. Nonetheless, some changes are inevitable.

For a start, lenders are bound to be more circumspect and cautious in assessing credit risks.

It is disingenuous to assume that merely because the federal government is making funds available to the banking sector that banks will merely lend the money "willy-nilly." At a time of economic uncertainty, lenders will want to make sure they are making good credit decisions on their borrowers. So what should we expect?

• For real estate backed loans, lower loan-to-value ratios

• For growers looking for crop loans or other vineyard development finance, more scrutiny of grape contracts to ensure that the wineries are well-run and well-financed

• For wineries, tighter financial covenants concentrating on optimizing cash flows and inventory depletions

• Less competition among banks as the more marginal, opportunistic lenders retreat from the market

• Higher interest rates, since the recent cuts by the Fed will not have much impact until the volatility in the LIBOR market recedes; even then, we are unlikely to see a return to the wafer-thin margins that were available in the run-up to the crisis. At the moment, anything linked to a prime rate may be a pretty good deal.

So does this mean that there will still be finance available for the wine industry? In short, the answer is yes. At each stage of any economic cycle there is always opportunity as well as risk. While fortune may favor the brave, it is more likely to favor the prudent, well-managed and well-informed. Just as there are opportunities for wineries to take advantage of the current situation, so there are lenders with long-term commitments to the industry and less exposure to the credit problems of other banks who will be anxious to add quality credits to their portfolio.

The wine industry has always been conservatively financed, perhaps due in part to the long-term nature of almost everything it involves: from the time it takes for vineyards to reach maturity, to the time spent aging wine in barrels made from 50-year-old trees. It is therefore interesting to see two new sources of finance appear on the horizon recently: private-equity investors and mezzanine debt providers.

Private-equity investors have generally had relatively short-term horizons in part due to the structure of private-equity funds that reward quicker realizations. The longer it takes to realize an investment typically the lower the overall return and the higher the risk. Furthermore, because of the need to achieve realizations, private-equity investors tend to like to be in control.

The prospect of finding investors to take a minority stake in a winery to finance long-term development plans seems remote. There may be private-equity investors out there who like and understand the industry and who will have long-term horizons, but there will not be many. Since nothing seems to happen quickly in the wine industry, it will be interesting to see how long the current interest of private equity in the wine industry lasts.

Mezzanine finance, on the other hand, seems like the very antithesis of the wine industry. Mezzanine debt sits between traditional bank finance and equity capital; it is less secure than bank debt and therefore attracts a hefty premium on the interest rate. As additional compensation for the risk, mezzanine lenders often also look for a share in any increase in the equity value of the business in the form of warrants. Either way, the finance is expensive and typically relatively short-term in its nature, with most being in the 5-to-7-year maturity range. For larger, high-growth businesses with strong

positive cash flows, mezzanine finance can provide a useful tool to expand the capital base of the business beyond where a traditional lender may be prepared. That can occur without the need to raise additional equity capital, which dilutes the ownership and which is even more expensive.

Given the capital-intensive, long-term nature of the wine industry, it is hard to imagine that there will be a lot of demand for mezzanine finance. Nonetheless, there will be some opportunities for those businesses looking for short-term capital perhaps on the way to an imminent liquidity event.

Private-equity investors are very familiar with the valuable role that mezzanine finance can play generally in their transactions, and it would not be surprising to see private-equity and mezzanine debt investors alongside each other in larger transactions.

The wine industry has become part of mainstream America in the last 20 years, and wine is not about to disappear from the dinner table anytime soon.

This growing maturity ensures that finance will continue to be available to the industry in the long term even if it may be tough to find in the short term.

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