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**BERINGER WINE ESTATES HOLDINGS, INC. 1997**

**by**

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## INTRODUCTION

*The real challenge is to retain the culture of the organization in a changing and accelerating environment in the marketplace. My job is to keep the good things rolling and revise things that need revising. I don't want people to lose their passion for the things that have made this company a success.<sup>1</sup>*

Walter T. Klenz, Chairman & CEO, Beringer Wine Estates.

Peter Scott walked into his new office at the Napa, California corporate headquarters of Beringer Wine Estates Holdings (“Beringer”) on Monday morning, June 1, 1997, and found a note from his new boss, CEO Walter T. Klenz. The note read: “Welcome, Pete, to Beringer and to the beginning of a new career path in the world of publicly-traded corporations!” It directed him to a meeting with other senior managers, the Board of Directors, and key investors of the privately held firm.<sup>2</sup>

Klenz opened the meeting by stating its primary objective: “We are all here to prepare a business plan that will result in Beringer Wine Estates becoming a publicly-held company.” He turned to Peter Scott and said “we will all be working on the details, Pete, but your responsibility is to coordinate and control this effort.”

Earlier in the spring, the board had set a target for the new issue—Fall 1997. Since, typically, most companies’ Initial Public Offerings (IPOs) were not well received by the equity markets and their investors during the end-of-year holiday season, Scott’s window for a successful offering was probably only a maximum of four months.<sup>3</sup>

The top management team believed that Beringer’s operations had achieved a sustainable growth rate in revenues of more than of 10 percent per annum. [See **Exhibits 1–3** for Beringer’s consolidated income statements and operating data.] The value of Beringer’s brand portfolio was substantial and continued to grow as it expanded product offerings up the premium wine price scale. The wine business was capital intensive. Therefore, in order to sustain and increase growth, access to a broad range of financial sources of capital would be a critical element in achieving Beringer’s strategic goals. Its current capital structure reflected over \$200 million of residual long-term debt from a leveraged buyout (LBO) in 1996. [See **Exhibits 4 and 5** for Beringer’s consolidated balance sheets and statements of cash flow.] The team felt that reducing the combined risk of high operating and financial leverage and at the same time expanding capital choices could enhance revenue growth prospects to above 15 percent per year. An IPO would also reward patient investors by providing them with liquidity and an exit route for their holdings in Beringer.

Scott and his management team worked diligently throughout the summer of 1997 to implement his board’s directives. One critical component of the IPO process was the choice of an investment banker. Although there were a number of interviews, this decision resulted in

one of the easiest for Scott. Beringer's current owners, Texas Pacific Group (TPG), had worked on a number of deals with Goldman Sachs over the years. In addition, another winery, the Robert Mondavi Company, had gone public approximately four years earlier and the lead underwriter was Goldman Sachs. Everyone at Beringer felt comfortable with Goldman Sachs—the Mondavi issue had been well accepted by the investment community and Goldman Sachs understood the wine business. It seemed a natural fit.<sup>4</sup>

With Goldman Sachs announced as the underwriter and internal progress being made throughout the firm, at its August meeting Beringer's board had asked Scott, "Are you ready? Can we take Beringer public before the holidays?" After a brief pause, Scott's reply was in the affirmative.

Some critical questions needed to be addressed by both Beringer management and Goldman Sachs. What would be the size of the issue in dollars? How many shares would be issued to the public and in what price range? How could TPG keep voting control of the ownership of the business? What would be the use of proceeds from a successful offering? How much stock must be sold in order to create an efficient market environment for the shares and the shareholders? What should be the target capital structure of the firm after the IPO?

After Goldman Sachs had been selected as the lead underwriter, some of these questions began to be answered, at least on a preliminary basis. A target of approximately \$100 million was selected to meet financing needs of the firm and efficiency and liquidity needs of the investment market. With an initial target price range of \$21 to \$23 per share, a 5 million-share offering was discussed at length. The net proceeds would enable the firm to refinance some of the most expensive and confining components of its current capital structure, the preferred stock and the subordinated note. [See **Exhibit 6** for characteristics of Beringer's financial structure.] The firm's debt/total capital ratio would also move towards a more manageable and efficient range of 60-65 percent from its current levels in excess of 75 percent, on a book value basis.<sup>5</sup> Finally, current equity holders of Beringer were interested in maintaining voting control of the company after any IPO. Therefore, it was decided that only Class B shares would be sold to the public.

Current equity holders of Beringer were interested in maintaining voting control of the firm. There were two classes of common stock created at the time of the Nestlé buyout. Class A shares had 20 votes each while Class B shares had one vote each. It was decided that only Class B shares would be sold to the public.

Beringer formally announced its IPO intentions on August 27, 1997. A "road show" was scheduled by Goldman Sachs for the middle two weeks of October. Upon its completion, representatives of the Board of Directors, management, and the underwriters would meet in New York City and, after equity market trading closed down on Monday, October 27<sup>th</sup>, determine final pricing and the number of shares to be sold in the IPO, expected to be released to the markets on Tuesday morning.

## **BERINGER'S HISTORY**

In 1875 two German emigrants, Jacob and Frederick Beringer, purchased property in St. Helena, California, for \$14,500. The following year Jacob began working his new vineyards and started construction of a stone winery building. He employed Chinese laborers to build limestone aging tunnels for his product. In 1880, Frederick opened a store and a wine cellar to accommodate the sale of wine in New York. The Beringer Brothers commenced an education and marketing program to introduce Napa Valley wine to the East Coast market. Their specialty, even in those early years, was premium table wines.

The winery was continuously owned by Beringer family members until 1971, when they sold it to the Nestlé Company. Over the next 25 years, Nestlé hired management to implement an expansion strategy that included purchase and development of extensive acreage positions in prime growing regions of Napa, Sonoma, Lake, Santa Barbara, and San Luis Obispo counties in California. Ownership of these vineyards enabled the firm to control a source of high quality, premium wine grapes at an attractive cost. The operation, renamed Wine World Estates, also acquired and developed a number of California wineries, including Beringer, Meridian Vineyards, and Chateau Souverain.

In a series of sweeping moves overseen by Wine World's winemaker, Myron Nightingale, operations were overhauled, the winery was retooled, vineyards were acquired, long term vineyard leases were negotiated and the company focused on the production and sale of great wines. The winery achieved a reputation for being thorough in its operations rather than taking shortcuts to achieve its objectives.

Results of these initiatives began to bear fruit in the late 1980s. New private reserve wines were winning accolades throughout the industry and, overall, wine quality was rising rapidly. Wine World began to redefine itself as a top-quality producer, slowly but steadily shedding its prior image for making "ordinary wines."

In 1984, Michael Moone spearheaded operations of Wine World and accelerated transformation of the firm. Moone pursued expansion via both acquisitions and start-ups of new brands. Chateau Souverain, located in the Sonoma Valley, was acquired in 1986. Also that year a new brand, Napa Ridge was launched. The Estrella River Winery in Paso Robles was revamped as Meridian Vineyards in 1988.

In 1990, Moone relinquished his CEO position to current chairman Walter Klenz. Klenz had joined Wine World in 1976, first working in marketing and then in financial operations.

In early 1996, Moone reentered the market with a private company named Silverado Partners. Together with dealmaker David Bonderman, who headed the Texas Pacific Group (TPG), a leveraged buyout of Wine World Estates was engineered by Moone. The \$350 million plus deal resulted in the business going back to its roots, with the new name of Beringer Wine Estates.

One of the most important goals of venture capital sponsored leveraged buyouts is an “exit strategy” to realize positive returns on their investment. The principals of TPG had chosen the Beringer operations and completed their acquisition with this goal in mind. In addition to its strong brand recognition in the product marketplace, it was expected that, when a public sale of shares was made, they would be well received by investors, especially those familiar with this industry.

Klenz’s strategic vision for Beringer included internal growth, through brand development, and external growth of the firm’s business through mergers and/or acquisitions. A publicly traded company would create the greatest financial flexibility in order to accomplish its goals as well as to provide liquidity for current owners. This meant preparing the company for life as a public firm.<sup>6</sup> Management information systems needed to be enhanced, accounting, reporting, and control systems needed to be put into place and the firm needed to keep its records on a quarterly basis, to comply with SEC requirements. Doug Walker was hired in 1996 to implement many of these systems, but the final piece of the puzzle was the hiring of a chief financial officer, in order to coordinate these activities as well as to plan for future operations.

Early in June of 1997, Peter F. Scott was brought on board as a senior vice president for finance and operations. Scott had spent seven years with Kendall-Jackson Winery, most recently as senior vice president, finance and administration. He had also spent six years as a management consultant and eight years with a nationally-known public accounting firm. He learned of Beringer’s IPO plans and became intimately involved with their preparation from the outset.

## BERINGER'S FINANCIAL HISTORY

After operating as a wholly owned subsidiary of Nestlé from 1971 through 1995, TPG Partners, L.P. acquired all the then outstanding common stock of Beringer Wine Estates Company in 1996. The total purchase price was approximately \$371 million, which included net cash paid of \$258 million, short-term mezzanine financing provided by the seller of \$96 million, and acquisition costs of \$17 million.

Beringer's capital structure on January 1, 1996, was composed of: <sup>7</sup>

<u>Item</u>	<u>Amount</u>	<u>Dollars</u>
Class A Common Stock	938,000 shares	\$ 4.66 million
Class B Common Stock	<u>9,058,590 shares</u>	<u>45.04 million</u>
Total Shares	<u>9,996,590 shares</u>	<u>\$49.70 million</u>
Series A Preferred Stock	300,000 shares	\$27.05 million
Credit Agreement (maximum of \$150 million)		\$86.00 million
Term Loan, Tranche B (secured by all properties)		\$150.00 million
Term Loan, Tranche A (secured by all properties)		\$20.00 million
Senior Subordinated Notes		<u>\$33.24 million</u>
Total Long Term Financing		<u>\$287.00 million</u>

The buying group put together this financing package and utilized financial leverage to the fullest extent possible, given the size of their equity commitment (\$50 million) and the willingness and ability of financial institutions to lend them the remaining funds.

On April 1, 1996, the company acquired the net assets of Chateau St. Jean from Suntory International Corporation. Net cash paid to the seller amounted to \$29.3 million, with acquisition costs of \$1.9 million, for a total purchase price of \$31.2 million.

In order to pay for this acquisition, the company issued 945,000 Class B common shares for a net proceeds of \$4.725 million. Subsequently, in September 1996, the company issued 11,980 Class A shares and 224,380 Class B shares to investors, resulting in net proceeds of \$825,000.

On February 28, 1997 Beringer acquired Stags' Leap Winery, Inc. from Stags' Leap Associates and various individuals. Net cash paid to the sellers amounted to \$19.2 million; with a note due the seller aggregating \$2.85 million. Together with transactions expenses of \$1.15 million the total cost amounted to \$23.2 million.

In March 1997, the company issued 833,334 shares of Class B common stock, resulting in net proceeds of \$4,955,000. It may be observed that the average price at which common stock



(A & B) was sold varied from \$4.97 per share in January 1996, to \$5 per share in April 1996. By September of that year, the price was only \$3.50 per share. Finally, in March of 1997 the average selling price had rebounded to approximately \$5.95 per share. For comparative purposes, book value per share was \$4.17 as of June 30, 1996 and \$3.46 as of June 30, 1997.

### **BERINGER'S STRATEGY IN THE 1990s**

By the late 1990s, Beringer had achieved a leadership position in the premium wine market in the United States. A number of strategies contributed to this position and would continue to be implemented by the firm. "You have to establish some fundamental themes for your company" Klenz remarked, "and you have to be careful you don't have too complex a message." In a 1997 interview published in the *Wine Spectator*, Klenz had remarked:

There's no secret to what drives Beringer Wine Estates. Its wineries focus on wines that consumers like to drink in the styles and prices that are most popular. The challenge is how do you make wines at all these different price points. It's not volume – it's quality we're after. That's what's made us and that's what we're going to focus on.<sup>8</sup>

Beringer marketed a portfolio of six brands of wines from major California premium growing areas across all premium price segments. This multi-brand portfolio provided opportunities for growth at each price point without diluting the value of any individual brand. In addition, this portfolio offered consumers a choice of familiar and appealing products that were differentiated by variety, region, and price, while providing distributors with a broad assortment of brands for their selling efforts. To supplement its domestic brands and to meet the growing U.S. demand for premium wine, Beringer had imported products from a number of countries for more than a quarter century. In recent years they had been working with winemakers in Italy, Chile, and Southern France to produce premium wines designed to compete in the rapidly growing \$ 7 to \$10 a bottle market segment.

High quality products at competitive prices had been central to Beringer's strategy since its days under Nestlé's control. The firm's current team of 14 experienced winemakers produced these wines using high quality premium wine grapes and state-of-the-art equipment in each stage of the winemaking process. For their efforts, the company had achieved considerable acclaim from industry experts. For example, in 1996, eight Beringer brands were included in *Wine Spectator's* "Top 100" wines of the world, more than any other wine company since that survey began in 1988.

Premium variety grapes were among the most important determinants of wine quality and a significant component of product costs. Beringer produced a larger percentage of its grape requirements (excluding White Zinfandel requirements) from premium varietals than most of its competitors. This strategy enabled Beringer to improve its control over grape quality and costs as well as to help assure continuity of grape supply. Grape supply and prices were cyclical, inasmuch as many uncontrollable factors impacted the quantity and quality of grapes produced in any given year.

Beringer either owned or controlled through long-term leases approximately 9,400 acres in California's prime wine growing regions of Napa, Sonoma, Lake, Santa Barbara, and San Luis Obispo counties. In crop year 1996, approximately 23.4 percent of overall grape requirements were grown on its owned or controlled vineyards. When White Zinfandel requirements were excluded from the calculations, 48 percent of requirements were supplied by owned or controlled vineyards. To meet requirements for White Zinfandel, the company strategy was to purchase grapes or bulk wine, primarily through long-term contracts.

Simultaneously, during the 1990s a number of major trends emerged in the California wine industry. These trends included: consolidation of the industry's "three-tier" distribution network (winery-wholesaler/distributor-retailer), consumers' "trading up" from inexpensive jug wines to premium priced varietal wines such as Chardonnay, Merlot, and Cabernet Sauvignon, and the development of "second-label wines" at moderate price points by many producers.

In response, Beringer purchased Chateau St. Jean and Stags' Leap wineries. By acquiring these attractively positioned wineries, Beringer was able to immediately diversify its brand portfolio and achieve operating efficiencies by integrating sales, marketing, and administrative functions. Beringer also believed that its professional management could improve wine quality and increase productivity at the acquired wineries, resulting in increasing sales and profitability. Management expected to continue to evaluate acquisition candidates and make strategic winery acquisitions on a highly selective basis.

The firm's wineries and product brands were of varying sizes, with products at different price points. "Pieces of the business can grow at varying rates," said Klensz, "and we do want to focus on growth because the market rewards growth. But you can't take a broad-brush approach and say we're going to grow all the brands by 10 percent...it's the \$7 to \$10 [price] range that's Beringer's focus." Because it was incrementally less costly and time-consuming to expand a winery's production than to start a new brand, prospects for growth at its larger wineries, Meridian and Napa Ridge, was apparent. At Beringer's smaller wineries, such as St. Jean and Souverain, the emphasis was to "drive their reputations," rather than volume.<sup>9</sup>

Consumer marketing had also become an integral component of Beringer's strategy. It used sophisticated marketing techniques more typical of consumer packaged goods companies than of wine producers. These techniques included product branding, advertising, product publicity, and packaging initiatives in consumer marketing, as well as extensive trade marketing targeted at the second and third tier wholesale/distribution and retail channels.

By 1997, Beringer had achieved exceptional depth and experience in both the wine and branded consumer packaged goods industries. The average tenure of the company's senior management in the wine industry was 19 years while their average tenure at Beringer was 14 years. The team had produced an exceptional record of performance in recent years and expected to continue and even enhance operating effectiveness in the future.

## DIRECT COMPETITION

There were hundreds of wine producers operating in the United States in the 1990s. Most were relatively small operations, located primarily in California. There were approximately 1,500 wineries in operation, yet the top 20 produced almost 90 percent of all American wines. Of the larger firms, probably the most well-known was the E&J Gallo Wine Company, which had recently established a premium varietal winery, Gallo of Sonoma. [See **Exhibit 7** for a list of the top 20 brands of U.S. domestic table wine producers.]

Consolidation among wineries began to accelerate, as smaller wineries decided to sell to larger ones in order to achieve greater economies of scale in marketing and economies of scope in gaining access to distribution channels. The “consolidators” were generally public firms that were able to offer predominantly family-run wine businesses a means to greater liquidity of their investment in a larger, more diversified operation. Concurrently, the attractiveness of California’s wine industry to entrepreneurs continued unabated as new, small operations were started each year.

A handful of U.S. wineries had completed or were known to be in the process of offering their stock to the public as a means of raising capital and achieving greater investment valuation and liquidity. Most prominent among the public wineries was the Robert Mondavi Corporation, which had a portfolio of brands similar to Beringer’s. By 1997, Mondavi had been public for approximately four years. Canandaigua Wine Company, another publicly held business, was by contrast a much larger, more diversified beverage producer than either Beringer or Mondavi, following a strategy of expansion in the wine business that was primarily facilitated by mergers and/or acquisitions. [See **Exhibit 8** for comparative company product portfolios.]

### *The Robert Mondavi Corporation*

The Robert Mondavi Company was founded in 1966 by its eponymous owner and winemaker, Robert Mondavi, to produce quality premium table wines that would compete with the finest wines in the world. Its strategy was to sell its wines across all principal price segments of the premium wine market. The company also sold wine under importing and marketing agreements with other business entities.<sup>10</sup> Recent financial data for Robert Mondavi are shown in **Exhibits 9–12**.

Products were sold through a global network of over 200 leading distributors in the U.S. and 90 countries around the world. These distributors then resold the product to restaurants and retail outlets. Substantial portions of Robert Mondavi’s wine sales were concentrated in California and, to a lesser extent, in New York, New Jersey, Texas, Pennsylvania, Florida, and Massachusetts. Export sales accounted for approximately 8 percent of net revenues, with major markets in Canada, Europe, and Asia. Several international joint ventures allowed the company to market wines from Italy, France, and Chile, as well as those from California vineyards.

Robert Mondavi had been expanding its holdings of prime wine producing acreage over the years, to a current level (1997) of over 5,000 acres. In addition, it had solidified excellent long-term relationships with grape-growing partners.

For more than three decades, the Robert Mondavi name had been synonymous with winegrowing excellence, marketing innovation and environmental integrity. Together, these translated into extraordinary brand equity for Robert Mondavi and its principal wine products. Brand strength and the firm's ability to maintain and build on its strength have been among the Robert Mondavi Corporation's most important assets and considered key to its continued success.

In the 1990s there had been a proliferation of wine brands and expectations were that this trend would continue into the foreseeable future. In this environment, only brands with a clear, quality image and strong consumer franchise were likely to succeed and grow in market share and profitability. The brands in the Robert Mondavi portfolio had precisely these characteristics. Each of the firm's nine brands had a distinct personality, served a defined market niche, and leveraged Robert Mondavi's global reputation, distributor network, and infrastructure.

From a marketing perspective, the Robert Mondavi portfolio served the broad spectrum of consumer demand. There were brands that appealed to the first-time wine drinker as well as to the experienced oenophile (wine connoisseur). Brands were sold at supermarkets and club stores as well as fine wine shops and restaurants. Brands were created for every day enjoyment of consumers, as well as for "special occasions."

The company had a clear formula for its current success and future competitiveness in the wine market. It obtained the finest grapes available, maintained state-of-the-art production facilities, and utilized innovative marketing strategies. A powerful distribution network resulted in growing acceptance of Robert Mondavi's well-defined brands in the competitive market environment of the 1990s.

### *Canandaigua Wine Company, Inc.*

Canandaigua Wine and its subsidiaries operated in the alcoholic beverage industry. The firm was a producer and supplier of wines, an importer and producer of beers and distilled spirits, and a producer and supplier of grape juice concentrate in the United States. It maintained a portfolio of more than 125 national and regional brands of beverage alcohol, which were distributed by over 1,400 wholesalers throughout the United States and selected international markets. Its beverage alcohol brands were marketed in five general categories: table wines, sparkling wines, dessert wines, imported beer, and distilled spirits.<sup>11</sup> Recent financial data for Canandaigua are shown in **Exhibits 13–16**.

Internal growth in support of the firm's brands had been supplemented by an active acquisition strategy over the last five years. In October 1993, Canandaigua acquired all of the tangible and intangible assets of Vintners International Company, Inc. and Hammondsport winery for a purchase price of \$148.9 million. Vintners was the fifth largest supplier of wine in

the United States, owning two of the country's most highly-recognized brands, Paul Masson and Taylor California Cellars.

In August 1995, Canandaigua acquired the Inglenook and Almaden brands, the fifth and sixth largest selling table wines in the United States, a grape juice concentrate business and wineries in Madera and Escondido, California, from Heublein, Inc. The company also acquired Belaire Creek Cellars, Chateau La Salle and Charles Le Franc table wines, Le Domaine champagnes, and Almaden, Hartley, and Jacques Bonet brandy. The aggregate consideration for these brands and properties was \$130.6 million in cash and options to purchase 600,000 shares of Class A common stock; 200,000 exercisable at \$30 per share; and 400,000 exercisable at \$35 per share, at any time up to August 5, 1996. All of these options expired unexercised, on August 5, 1996.

In September 1995, Canandaigua, through a wholly-owned subsidiary, Barton Incorporated, acquired certain assets of United Distillers Glenmore, Inc., and certain of its North American affiliates. Included in this transaction were rights to the Fleischmann's, Sköl, Mr. Boston, Canadian LTD, Old Thompson, Kentucky Tavern, Chi-Chi's, Glenmore, and di Amore distilled spirits brands. In addition, the deal included the U.S. rights to InverHouse, Schenley, and El Toro distilled spirits brands, along with inventories and other assets. The aggregate consideration for these acquired brands and other assets was \$141.78 million, plus assumption of certain current liabilities.

## **THE BEVERAGE INDUSTRY IN THE UNITED STATES**

Consumption of beverages purchased by consumers in the U.S. had grown steadily, yet unspectacularly, in the 1990s. Total annual consumption per capita expanded from 154.3 gallons in 1991 to over 164.5 gallons in 1996. By far the largest beverage category was soft drinks. At a level of 54.2 gallons per capita in 1996, soft drinks represented 31.4 percent of total beverage spending at retail. They also represented one of the few categories that were growing in both absolute and relative terms in the 1990s. Soft drinks' absolute growth of 6.4 gallons per capita in the 1990s was by far the largest in any single beverage consumption category. On a relative basis, their annual growth rate of 2.7 percent was second only to the 4.9 percent growth rate in the bottled water category. Bottled water nevertheless owned a market share just over one-fifth as large as that of soft drinks. [Exhibit 17.]

### ***U.S. Wine Consumption***

Wine consumption per capita remained fairly steady in the 1990s, fluctuating only slightly between 1.7 and 1.9 gallons per capita. [Exhibit 18.] After rising steadily in the late 1970s and through most of the 1980s, absolute and relative growth had slowed considerably in the last decade. On the basis of retail spending, however, the wine market represented 6.1 percent of the beverage industry. Although this was down from the 6.5 percent levels of the early 1990s, it showed how these higher value products ranked in importance at the retail level. [Exhibit 19.]

Major segments in the wine industry included the following broad categories: table, fortified, vermouth, sparkling, coolers, and ciders. The largest category, by consumption, was table wines, representing an 81.6 percent market share in 1996, up steadily from 79.4 percent in 1993. Domestically produced wines represented the largest segment of the market. In 1993, 85.7 percent of all wine categories were produced domestically, with the remainder being imported. With imports rising at a rate of almost 13 percent per year between 1993 and 1996, their share had grown from 14.3 percent of the market to 18.8 percent over this four-year period. [Exhibit 20.]

Wine shipments into the wholesale distribution channel trended downward from 1985 levels of 244 million cases to the 189 million case level in 1993. Since that time, however, there had been a reversal, with shipments reaching 213 million cases in 1996 and an estimated 220 million for calendar 1997. Sparkling wines, coolers, and other wine categories reached their peak of consumer acceptance as far back as 1987 and have since been declining fairly steadily to a range of only approximately one-third those lofty levels. [Exhibit 21.]

California table wine shipments had grown continuously from 43.4 percent of the industry in 1985 to 63.2 percent in 1996. Wine production from other U.S. states had grown by almost 80 percent since 1985, yet still accounted for only 5 percent of U.S. shipments in 1996. Jug wines made up almost 85 percent of California table wine shipments in 1985. This trend has been down for most of the last decade, until a low of approximately 56 percent was reached in 1993. Even with an upturn in shipments over the last three years, this percentage continued downward, reaching 51 percent in 1996.

The growth segment of the California table wine industry may be found in the various “premium” categories defined below. Revenues at the wholesale level show even stronger growth in the premium categories, implying that prices have been robust, resulting in faster growth in revenues than in shipments.

### ***U.S. Wine Production***

The internal structure of the wine industry in the United States had been undergoing fundamental changes in terms of product, especially in the table wine category. As the largest segment of production and value of shipments at over 80 percent in 1996, these products have been responding to changes in the tastes and preferences of consumers for higher quality, premium wines. [Exhibits 22.]

The grapes used to produce table wine are of varying quality. *Varietals* are delicate, thin-skinned grapes whose vines usually take approximately four years to begin bearing fruit. As defined by the Bureau of Alcohol, Tobacco and Firearms truth-in-labeling standards, one variety—the name of a single grape — may be used if not less than 75 percent of the wine was derived from grapes of that variety, the entire 75 percent of which was grown in the labeled appellation of origin. Appellation denoted that “...at least 75 percent of a wine’s volume was derived from fruit or agricultural products and grown in place or region indicated...”<sup>12</sup> To develop the typical varietal characteristics that result in enhanced flavor, taste, and finish could take another 2-3 years. These additional growing periods increased both investment costs and product quality.

“*Table*” wines are those with 7-14 percent alcohol content by volume and are traditionally consumed with food. This is in contrast to other wine products such as sparkling wines (champagnes), wine coolers, pop wines, and fortified wines, which are typically consumed as stand-alone beverages. Table wines that retail at less than \$3.00 per 750 ml. bottle are generally considered to be generic or “*jug*” wines, while those selling for more than \$3.00 per bottle are considered premium wines.

*Premium* wines generally have a vintage date on their labels. This means that the product was made with at least 95 percent of grapes harvested, crushed, and fermented in the calendar year shown on the label and used grapes from an appellation of origin. (i.e., Napa Valley, Sonoma Valley, Central Coast, etc.). Within the premium table wine category, a number of market segments have emerged, based on retail price points. *Popular premium* wines generally fall into the \$3.00 - \$7.00 per bottle range, while *super premium* wines retail for \$7.00 - \$14.00. The *ultra premium* category sells for \$14.00 - \$20.00 per bottle. Any retail price above \$20.00 per bottle is considered *luxury premium*. [Exhibit 23.]

## THE ECONOMIC ENVIRONMENT IN 1997

The United States’ economy continued its extraordinary performance during 1997.<sup>13</sup> [See **Exhibit 24** for data from selected financial markets from June – September 1997.] Growth in the gross domestic product extended gains that began with the end of the last recession, officially dated as March 1991. Unemployment continued a long-term decline, personal, national income grew robustly, and inflation at both the producer and consumer levels was historically low and continuing to decline. In international markets the U.S. dollar remained strong, especially against Asian currencies that linked their currencies to the dollar.

Alan Greenspan, chairman of the Federal Reserve, expressed a bit of skepticism toward this performance. He stated that the U.S. economy was on an “unsustainable track.” This opinion resulted in fear of an interest rate increase to slow down economic activity and prevent a flair-up in inflation.

Financial markets are not only reflective of activities in the U.S., but also of international conditions. Problems started to materialize in Asia during the summer months of 1997. A collapse of financial markets in Thailand, followed by those in Singapore, Malaysia, and Indonesia resulted from the bursting of real estate and stock market bubbles in those countries. Trophy buildings were being constructed on a speculative basis and financed with long-term bank lending. Commercial banks in these nations funded these assets with short-term foreign borrowings, many denominated in dollars and other hard currencies. When real estate and stock prices collapsed, the result was a full-fledged banking crisis as financial institutions’ collateral went up in smoke.

Investors all headed for the exits at the same time, desperately seeking to convert their local currency holdings into dollars. The result was a collapse of these currencies and an ever-stronger dollar than might have been warranted by the exceptional performance of the U.S. economy.

This cashing in of local currencies inevitably led to dramatic decreases in domestic money supplies. As the credit-worthiness of almost every company and bank in the region came into question, their ability to borrow abroad was seriously impaired that a general liquidity crisis occurred, and the malaise began to spread.

As these same elements unexpectedly appeared in South Korea, the world's eleventh largest economy, the world received a stern financial wake-up call. A deep and prolonged recession in Asia now appeared quite probable. Worries also spread that this "Asian Flu" could extend into Japan, the world's second largest economy. If this occurred, could the "Goldilocks economy" of the West fall prey to these Asian ills?

### **THE FINANCIAL ENVIRONMENT IN 1997**

Financial markets in the United States performed reasonably well throughout the summer and early fall of 1997. Valuations were quite high, historically, with the S & P 500 trading between 24 and 26 times, trailing earnings in early October. Late in the third week of that month, just as the Beringer road show was ending, the equity markets in the U.S. commenced a precipitous decline. On Thursday and Friday, October 23 and 24, the DJIA declined by 320 points. The following Monday a decline of 554 Dow points took place, "the largest single numerical drop in the history of the DJIA."<sup>14</sup>

From an all time high of 8259 on August 6, when the DJIA market capitalization stood at \$1.94 trillion, as of Monday evening, October 26, the market cap was \$1.54 trillion, a decline of 20.8 percent. For Monday's trading alone, \$129 billion of value disappeared, representing a decline of 6.6 percent. Over these three days the bond markets were also affected by a "flight to quality." The 30-year Treasury yield declined from 6.42 percent on October 22 to close at 6.13 percent on October 27.

Equity strategists at leading financial institutions had a variety of interpretations and opinions concerning these violent swings in security prices. "It could go down thirty percent or forty percent" from this year's market peaks warned Barton Biggs, chief global strategist at Morgan Stanley, Dean Witter Discover, in a conference call to clients and on television appearances. Ralph Acampora, technical analyst at Prudential Securities and a bull, pulled in his horns. He became "temporally negative" on the stock market and warned his firm's sales force of a "nasty market correction" to come.

A Barrons Roundtable regular, Jim Rogers, shuttling between a Peter Jennings interview on ABC and another on-camera session with CNBC that eventful evening, opined that the sell off "could be the beginning of a major bear market, the Big Kahuna itself" that would send financial asset prices crashing around the world.<sup>15</sup>

In contrast, Edward Kerschner, head of Paine Weber's investment policy committee, told clients that if market prices fell another 5 percent from their closing levels on Monday, October 27, "it would be a compelling buying opportunity." His models showed that the markets were 5 percent undervalued. "If prices become 10 percent undervalued, it's time to buy."



Finally, Abby Joseph Cohen, strategist at Goldman Sachs and a prominent stock market bull for most of the 1990s, published the following commentary at the close of trading Friday, October 24. “Despite the Asian troubles, the United States’ economic and profit outlook remains solid.” With Asian markets disrupted, the U.S. should prove a safe haven for investment money.

As a result of the further, extraordinary decline on Monday, October 27, she actually boosted her allocation to stocks in Goldman’s model portfolio from 60 percent to 65 percent. “I was calm and confident because everything in my work indicated that the economy was going great from the standpoint of jobs, profit growth and muted inflation pressures. It was just one of those classic moments when emotion caused the market to become disoriented from economic reality.”<sup>16</sup>

### **PETER SCOTT’S DILEMMA**

The meeting on the Monday evening of October 27<sup>th</sup> was anything but upbeat. The DJIA had finished the day down over 550 points due to lingering fears from the Asian financial crisis. How would these events affect Beringer’s decision? Should it go ahead with the offering and risk disenfranchising new shareholders if stock prices continued to decline? Or should it follow the suggestions of Goldman Sachs, as it had been doing for the past few months?

Although the IPO market in recent months had shown continued strength and receptivity for many types of companies, Peter Scott remembered two charts prepared for him by the underwriters [**Exhibit 25 and 26**]. They showed clearly how volatile the IPO markets could be. Although considered quite strong at the moment, they could cool off very quickly for an extended period of time. Postponing the issue could mean waiting for perhaps another three to six months or more, which could adversely affect strategic initiatives planned for the next year.

Postponement of the IPO for any appreciable length of time would also generate other concerns that would have to be addressed by the Beringer management team. In private board meetings a few scenarios had been proposed and “played out” for the next four years. They included various assumptions concerning company growth rates and their financial statement implications.

Going through Peter’s mind was the possibility of using debt sparingly, only enough to keep Beringer’s current debt/equity ratios roughly constant. A 10 percent growth in revenues could be achieved, just by keeping the firm’s market share unchanged. A 15 percent growth rate could be achieved if the firm utilized internally generated cash flow, increased its use of debt, and utilized its equity at book value for one or more strategic acquisitions.

In another board meeting, there was a discussion of the impact of a successful IPO on the weighted average cost of capital (WACC) of Beringer and how the reduced cost of equity could enhance prospects for external growth in the years ahead.

Back in the boardroom at Goldman Sachs, executives were monitoring market sentiment and discussing investor reactions to current circumstances. Based upon indications of interest

being kept by underwriters during the road show, the issue was sure to be oversubscribed. In fact, based on preliminary indications of potential demand, the target price range had been increased the previous week to \$23 to \$26 per share.<sup>17</sup> Before the stock market swoon on Monday, the range had been raised once more, to \$26 to \$28 per share. Klenz asked everyone at the meeting — particularly Peter Scott—to voice an opinion.

## ENDNOTES

<sup>1</sup> Laube, James, "Going Public," *Wine Spectator*, December 31, 1997-January 15, 1998, pp. 112-134

<sup>2</sup> Interview with Peter F. Scott.

<sup>3</sup> Interview with Peter F. Scott

<sup>4</sup>The prime motivation for the public offering of shares of Robert Mondavi was to settle a family dispute revolving around operating strategy in the wine business between the Mondavi brothers; Peter, who kept the family business (Charles Krug Winery) and Robert, who started the Robert Mondavi Company.

<sup>5</sup> "Beringer's IPO: Big Demand May Boost Price – Again," *The Wine Enthusiast*, October 27, 1997.

<sup>6</sup>Interview with Walter Klenz.

<sup>7</sup> Beringer Wine Estates Holdings, Inc. *Prospectus*, October 28, 1997: 49, 50.

<sup>8</sup> Laube, J. *op. cit.*

<sup>9</sup> Laube, J., *op. cit.*

<sup>10</sup> The Robert Mondavi Corporation *Annual Report*, 1997.

<sup>11</sup> The Canandaigua Wine Company *Annual Report*, 1997.

<sup>12</sup> Title 27 Part 4 of the Code of Federal Regulations. Bureau of Alcohol, Tobacco and Firearms, Regulatory Agency, United States Department of the Treasury.

<sup>13</sup> *Bloomberg Personal*, April 1988: 70-73.

<sup>14</sup> Browing, E. S., "Not Even the Bulls See a Fast Recovery," Heard on the Street, *Wall Street Journal*, October 28, 1997: C-1.

<sup>15</sup> Laing, Jonathan R., "Abby Says Relax," *Barrons*, February 23, 1998: 31.

<sup>16</sup>Laing, *op. cit.*

<sup>17</sup> "Beringer's IPO Priced," *The Wine Enthusiast*, October 28, 1997.