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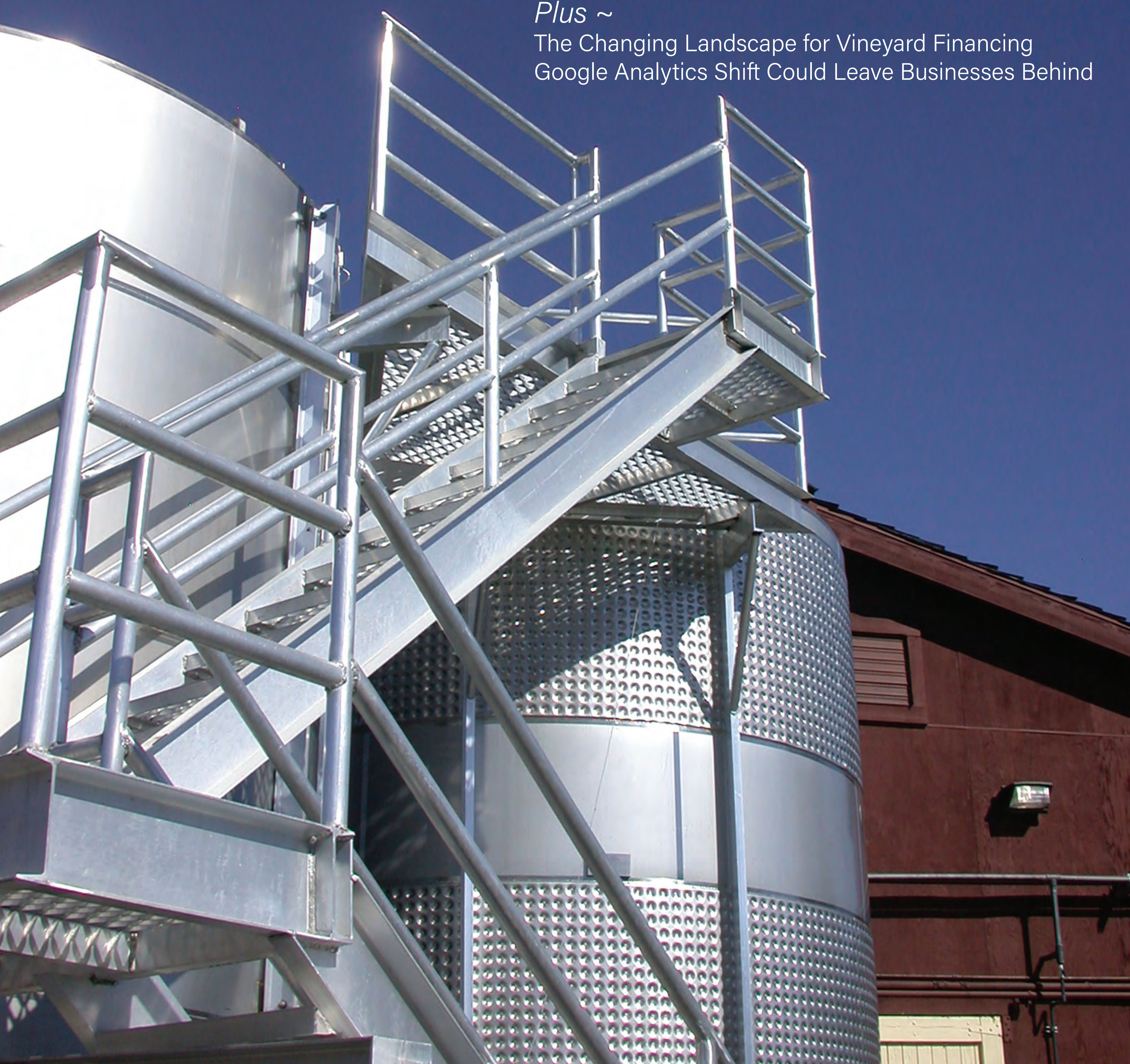

Navigating an Uncertain Economy in the Wine Sector

Sophia McDonald

Sophia McDonald is a wine and food writer based in Oregon's Willamette Valley. She also writes for *SevenFifty Daily*, *Wine Enthusiast*, *The Drop* and several other publications.

Editor's Note: *At the time of publication, news broke that the FDIC had taken control of Silicon Valley Bank and its assets, freezing accounts for many wine-related businesses. For now, the long-term implications are unknown.* Wine Business Monthly *will continue to cover the news both online and in print. The article that follows was written prior to the SVB reports and looks at the landscape for vineyard-related loans, business dealings and the health of the industry.*

There was a time in the not-too-distant past when interest rates were historically low and options for acquiring capital to buy a vineyard, open a winery or merge with another firm were high. Today, the financial picture is very different; wine businesses are facing higher interest rates among other challenges. Ed Adams, vice president of the corporate banking group for American AgCredit, summed it up this way, "Rising interest rates, inflation, pandemic distortions in wine sales an ambiguous economy, and the recent closure of Silicon Valley Bank are creating a challenging operating environment for both wineries and growers."

Rising interest rates have made it more difficult to quality for a loan or refinance, said Jeff Clark with the Craft Beverage Group at LiveOak Bank.

"In many cases, the interest expense to borrow has more than doubled in less than a year. This also increases refinance risk for existing borrowers. You may be facing a higher debt service, when you refinance, if your previous interest rate was fixed more than a year ago," Clark said.

"From a financing standpoint, higher interest rates are posing challenges to all borrowers in today's current economic climate—particularly if they have variable-rate financing in place," Adams said. "Operating lines of credit are priced off variable rate (Prime Rate or SOFR) as the underlying index, and both are higher than fixed-rate terms currently, given the inverted yield curve."

Higher interest rates aren't the only challenge facing wine businesses. According to the International Monetary Fund[1], inflation was around 3.5 percent annually from 2017 to 2019. It was 8.8 percent in 2022. Though inflation is slowing, it is still expected to be high, with rates projected at 6.6 percent in 2023 and 4.3 percent in 2024.

Many proposed winery and vineyard acquisitions are priced higher than historic cash flow is able to support.

"Banks are cash flow lenders and want the winery or vineyard to be able to service the debt with a cushion," Clark said. "Any intangible value above the appraised value of the assets can be problematic for a lender and may require a higher equity injection. Projection-based deals are more difficult to finance in this environment and require contractual-based sources of revenue to support assumptions."

In addition, the wine industry has struggled to pass on increasing costs to consumers. Clark noted, "This reduces margins and cash flow available for debt service. There is no lack of substitute product in the adult beverage space, which makes it hard to increase prices without risking losing a customer to a lower-priced wine or alternative alcohol beverage."

Pandemic hangovers continue to confound many wineries. "COVID ended up benefiting most wine businesses; but as we come out of COVID, the results are more divergent," said Erik McLaughlin, CEO of Metis LLC. "While the industry is generally flat from a macro perspective, individual wine businesses tend to be either growing or shrinking. It's no longer a rising tide for all, but quickly becoming an environment of winners and losers."

In addition to problems with demand, many firms are facing supply challenges.

Adams noted that wineries on the North Coast are coming off of three years of short harvests.

"Some wineries didn't have a 2020 harvest and, as a result, have no vintage offerings for that year. Those vintage releases are currently impacting cash flow and financial results. Less capitalized wineries or operations unable to strategize around these shortfalls are now feeling cash flow issues," Adams said.

The federal government's Paycheck Protection Program (PPP) loans helped some wineries bridge cash flow challenges from these low harvests, but for most people, those funds are long gone.

The U.S. is not technically in a recession. The economy posted small gains in both Q3 and Q4 2022[2], but high inflation, and the uncertainty brought by the Ukraine war, continued supply chain challenges and other factors mean a recession is still possible. The job market continues to be strong, with unemployment at the significantly low rate of 3.6 percent in mid-March. This is helping parlay recession fears. However, consumer confidence has fallen the last two months[3]. All of this has left consumers and business owners nervous about the near-term future of the economy.

Business Still Being Conducted

It's not all doom and gloom, though. Both inflation and interest rates seem to have stopped their precipitous climb, which is good news for everyone.

"Now that interest rates have more or less stabilized, albeit at a higher level than they were a year ago, the market is beginning to 'price in' the higher cost of capital and get back to business," McLaughlin said. "Buyers and investors are getting more comfortable with rates and tweaking their business plans and investment objectives to incorporate more debt service out of cash flow. In certain niche markets where values remain strong, the higher cost of capital can be offset with anticipated continued appreciation of underlying asset value."

Adams had good news to report from American AgCredit.

"We are still closing new loans for capital projects, equipment purchases and acquisitions. The cost of capital is a bit higher, but credit availability is still strong to support good projects for borrowers that have well thought out business plans," Adams said.

The real estate market in California's wine country has not taken a nosedive in response to rising interest rates and a fragile economy.

David Ashcraft, broker and founder of Vintroux Real Estate, said he's still seeing plenty of interest in both wineries and vineyards in Napa and Sonoma, and noted that"Wineries are continuing to plan for the future and lock down sources of fruit."

Land planted to high-end Cabernet Sauvignon (in Napa) and Pinot Noir (in Sonoma) continues to be in high demand as do vineyards with Sauvignon Blanc.

For premium vineyards, higher interest rates seem to be causing a leveling-off in demand, Ashcraft said. For vineyards with average to lower than average fruit, he is seeing prices go down slightly.

"One of the things that's helpful is that grape prices are still strong. You see a spiral effect; in that you have both higher interest rates and the grape prices have gone down, but that's not what we're seeing right now," Ashcraft said.

Information on demand for wineries is harder to come by, but Ashcraft's sense is that there's a similar trend. Wine brands that are quality-oriented are in a good location and are profitable, are seeing no appreciable decline in values. Wineries that are producing lower-quality wines, aren't in prime areas or aren't profitable are going down in value although there does still seem to be demand for them.

"Lifestyle buyers are a different category, and that's definitely taking a bit more of a hit," Ashcraft said.

Clark does caution that "Inflation, coupled with supply chain disruptions, has created problems for construction loans. Projects are coming in over budget, sometimes significantly so. Banks are increasing contingency reserves and are being more conservative, with some banks choosing not to provide construction financing at this time."

Adams mentioned that real estate transactions are taking longer to close with a 45- to 60-day average.

And McLaughlin noted that higher interest rates are making it harder to finance vineyard-only projects.

"Vineyard financing for operators who have internal use for grapes remains doable, but stand-alone vineyards are experiencing margin squeeze between inflation of operational costs and inputs and higher cost of capital that they are having a difficult time recapturing in higher grape prices," McLaughlin said.

Burnish Your Business Plan and Credentials

In this less-than-ideal marketplace, lenders are getting pickier about with whom they work.

"Strong operators, delivering growth with good cash flow, are not difficult to finance," McLaughlin said, whereas those lacking strong wine industry credentials and cash flow may have a harder time finding partners.

What can wine brands do to make themselves look more appealing to lenders? Good bookkeeping and accounting give lenders confidence in a company's ability to service their debt, according to McLaughlin. Additionally, make sure the company's financial documents are in order and cost accounting is accurate.

"Lenders are particularly attracted to strong margins at the moment as well, as much or more as growth," he added. "Some wineries seek growth at the expense of margin—often producing a bigger business that makes the same amount of money. More modest growth, while maintaining margin, will position operators to be most attractive to lenders."

Depending on the project, it may benefit brands to think outside the box, at least a little, when seeking lending partners, Clark noted. For example, in order to get loan payments to fit with the company's cash flow now that interest rates are higher, lenders may require the borrower to reduce the principal. If borrowers can't do that, a government-guaranteed option, such as a Small Business Administration or USDA loan, might be a better fit (although with the caveat that these programs are predicated on cash flow as well).

"For borrowers seeking financing for vineyard purchases or longer-term capital projects, we encourage those applying for new loans—or those that have existing variable-rate loans—to consider fixed-rate options," Adams said. "We also recommend shorter terms and pre-payment flexibility."

Clark cautioned that banks tend to have varying appetites for different types of credit. Depending on the need, it might make sense to reach out to a different partner.

"For example, if you need working capital to expand and grow, seek out a lender that specializes in that area," Clark said. His advice is to look for a bank with plenty of experience in the wine industry He said many banks have dipped their toe into the wine lending space only to vacate during difficult times, leaving borrowers in a bad spot.

"Borrowers need to be strategic when applying for and structuring loans," Clark added. "Use permanent assets for long-term debt collateral. Use your current assets for working capital collateral purposes only. Maintain sufficient liquidity for a working capital cushion."

Adams added that creating a strong business plan with a solid set of financial projections is critical for anyone seeking additional debt for capital projects or acquisitions. The projections should show an adequate ability for the borrower to cover the debt service on an annual basis and clearly demonstrate contingency plans.

Adams encourages businesses to think of their lender as more than just a source of money. Some offer their partners value-added services, such as access to agricultural economists and industry analysts who can help them make their business and business plan even stronger.

Now may not seem like the ideal time to be looking for investment in a business, but with interest rates stabilizing and inflation on a downward trajectory, things are looking up. Plus, depending on your needs and the strength of the company, it may be the perfect moment to approach a lender.

Clark leaves owners with this sage advice, "Raise capital when you don't need it. When you need it, it's probably not available." **WBM**

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