10/5/2010

First Beverage Group

Has your game plan evolved along with the rest of the industry?

"Has your game plan evolved along with the rest of the industry?"

By: First Beverage Group

William Anderson, Chairman & CEO
First Beverage Group

Sean McLaren, Managing Director
First Beverage Financial

Joth Ricci, Managing Director of Operations
First Beverage Capital

John O'Connor, Managing Director
First Beverage Financial

Historical Recap of Value Added Proposition of the Second Tier and the Changing Landscape of 2010 The second tier has long been known for its stability based on reliable cash flows and steady growth in the beer industry. It is also marked by its remarkable value proposition as an extremely reliable route to market for all sizes of suppliers and brand profiles. This business model has proven over the years to develop and grow brands that would otherwise not be able to get to market and prosper. While at times unheralded, beer distributors are consistently successful brand champions. The second tier also serves as a political force and as a result provides unusual strength to the beer industry overall. Highly philanthropic, beer distributors serve an effective role as community leaders and employers in their individual territories.

The beer distribution industry, however, is facing unprecedented times. Despite historical stability, beer distributors are now faced with many new sets of challenges in how business is conducted. These challenges are made manifest as a result of two chief changes to the first and second tiers. First, new players and new capital are entering at the supplier level, including new ownership at ABI, Heineken-FEMSA, the MillerCoors JV and Pabst. New capital has also entered the craft beer segment through the recent acquisitions by NAB of Pyramid and Magic Hat and the recent acquisition of Anchor Steam by the Griffin Group. Second, new players and new capital have entered the second tier, including Warren Buffett's acquisition of Empire Distributors, Byron Trott's possible acquisition of 70% of City Beverage, and Chesterman Co.'s proposed acquisition of two AB wholesalers in Iowa. Each of these developments will set the stage for interesting times ahead, particularly as they are set against a historic drop in volumes, aggressive price competition from wine and spirits, a severe decline in core premium brands, the unknown Costco challenges to regulation in Washington State, and the continued wave of bad news from the worst recession in our lifetime.

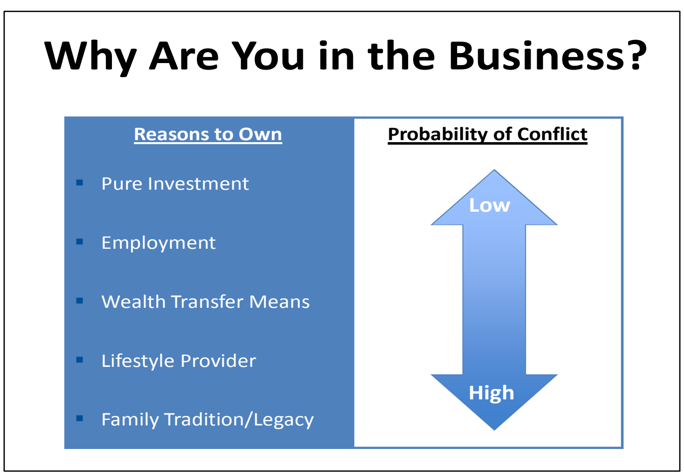
These challenges provide each of us with the opportunity to look at things differently. There has never really been a time when the industry was able to sit still. It has always been forced to evolve. As 2010 presents a new set of challenges for the years ahead, however, it has forced us to evaluate the real game changers for your business today and for the future with more focus and renewed discipline. Whether you are addressing the transfer of your business to a second or third generation of family members, or whether you are considering a sale of your business or a purchase of a contiguous distributor, we strongly recommend looking at your ownership structure and governance and assessing your capital structure and what your company's day-to-day operational needs are in order to remain competitive. This White Paper addresses these key areas and some proposed solutions and strategies.

As we travel the country and have the opportunity to look at the beverage distribution business from various angles, there are several key themes and traits we see in all successful distributors in how they are addressing a rapidly changing business environment: (1) They have strong management in place with a team of identifiable, professional leaders; (2) They uphold a brand-building mentality in everything they do; (3) They maintain unparalleled customer and supplier business relationships; (4) They have developed highly-capable internal systems that are transferrable to other operations or to an expanded business model; and (5) They are appropriately structured and capitalized for the future.

Let's start with this question: Why do you own this company? There are typically many reasons to own a company. So, why do you own yours? This may seem a strange question to many, but planning and management is often driven by how this question is answered by senior management. Every entrepreneur has his or her own motivations, but there are five primary reasons we see in this industry:

(1) **Pure Investment**: This reason is often characterized by limited emotional ties and a primary desire to build wealth. Day-to-day operations are often run by a professional management team. Optimizing long-term and short-term profitability drives the business decisions. The least amount of conflict occurs in this structure.

(2) **The Business as a Means to Family Employment Opportunities:** Multiple family members are active in the day-to-day operations of the business. Several of the members use this business as their primary means of income and many times they have not yet created significant wealth. They continue to need the job. Duplicating this job safety is not likely to occur unless your family owns the business.



(3) **An Effective Means to Transfer Wealth:** The business is a mechanism to transfer wealth over time from one generation to the next. Quite often the parents have created significant wealth outside the business that has been generated from the historical business cash flows. Such wealth can be transferred through a series of gifts and/or sales to the next generation.

(4) **Lifestyle**: The owners enjoy running the business and the "perks" of being a prominent business person in the community. He/she enjoys giving back and staying active in the community. Owning the business offers significant free cash flow that allows lifestyle perks (e.g. travel, vacation homes, etc.)

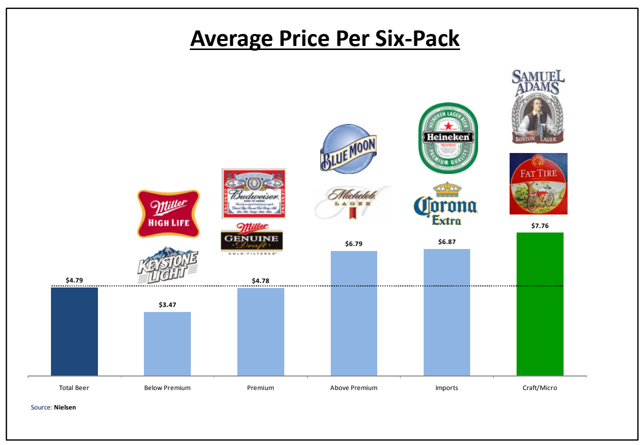
(5) **Family Tradition**: The business is a family legacy. Maximizing profitability is not as important as maintaining the family's prominent position in the community.

The bottom line is that the business stakeholders must communicate their reasons for continuing to stay in the business, and ideally the reasons on a go-forward basis should be aligned. Also, as time evolves and our industry becomes more competitive, wholesalers will likely have to adjust away from "lifestyle" choices to more disciplined "pure investment" motivations.

So why does your plan need to change?

Increasing Competitive Landscape We all understand that this industry has been competitive since 1933, but over the last few years it has seen monumental changes, coupled with competition on multiple fronts. Gone are the days of Bud, Miller and Coors houses competing for simple BEER market share.

Bud houses now see a more formidable competitor in a combined MillerCoors house often armed with several significant imports, alternative alcoholic and non-alcoholic beverages. In the same vein, the MillerCoors houses are now watching their Bud competitors aggressively pursue portfolio additions with micros, imports and non-alcs at a faster rate than ever before. All of this is a response to several macro consumer trends that include the "graying of America" resulting in per capita consumption decline as the increased competition for share of stomach grows. The share of stomach battle is leading to an increased trend in promiscuous brand swapping. Eroding consumer loyalty seems to be en vogue, especially in the key 21to 29 year old age group. This trend puts continued pressure on some of the mega brands while micro, wine and spirits consumption grows at a faster rate than that of premium beer in several regions around the country.



Overall portfolio margins are under pressure for several reasons, in part due to share growth and attention placed by large-format stores on driving larger pack size choices and brand trade-down, thus resulting in less gross profit for the same number of cases.

As a result of all these macro changes, a third or fourth distributor may emerge and succeed in some major markets by building on basic and historical industry principles: local expertise by local people building a local brand. This emerging trend is a direct result of consolidation and marketplace pressures not adjusting well to increased portfolio and retailer demands.

The opportunities from highly profitable yet high-maintenance brands could be missed by larger distributors due to mismanaged portfolio implementation, but this doesn't have to be the case. Existing wholesalers who address the changing portfolio landscape will be able to add new brand families and capture a greater share of the overall market.

In addition to significant portfolio changes, supplier requirements also continue to evolve and this will create an increased need for greater business sophistication for large and small distributors alike. There is an old saying in this business that growth solves all ills. We don't disagree with that, but we believe there are several other areas of your business that need to be taken as seriously as growth drivers. We look at five areas of opportunity that will result in a better operation and improved profitability for your company without selling another case:

(1) **Automate your data reporting**: As your portfolio increases, supplier demands for information will increase. If you are still manually entering numbers into a spreadsheet for a supplier, you are well behind the times and you are costing yourself thousands of dollars in administrative expenses. Data reporting, survey recaps and depletion reporting should be automated and in real time. Web-based reporting is a great way to minimize your administrative requirements and treat the supplier as a business partner.

(2) **Train and invest in your people**: Every year you probably have a resolution about increased training for your employees. It usually comes up as a "must do" and moves to a "should have done" by the end of the year. This is a very people-intensive business and the demands on your employees as a result of supplier and retailer requirements are not decreasing. A focus on consistent employee training is a must. And the new training that is required is not on how to sell a brand but is a more sophisticated training regimen that addresses customer support, team building, and problem solving. Improving your employees' abilities will immediately and tangibly improve your overall business performance.

(3) **Keep up with the speed of execution**: The world is moving faster than at any time in our history. Along with technology, the needs of our industry are changing faster than ever. Speed of execution and ability to react to customer and supplier needs will set your business apart. Having systems set up so that you can respond immediately will avoid a situation in which you lose valuable dollars because you were not ready to meet the demand. This is also critical when managing multiple supplier requirements. Your team's ability to execute and move to the next priority quickly can mean the difference in getting or losing the extra handle, gaining that important lobby display or keeping your best salesperson.

(4) **Manage a more complex portfolio:** Along with speed of execution comes the constant rotation of seasonal inventory, special packs, new programs, etc. These programs should be embraced by good operators as they will drive incremental dollars when properly planned for and managed correctly. Your willingness to execute and maintain flexibility is critical to capturing new consumers.

(5) **Take control of your business:** No longer should the distributor wait for the supplier to set the planning meeting or bring new ideas to the table. Distributors should be planning their portfolio business a minimum of 120 days ahead of the selling period. This will allow for balancing the new portfolio requirements and margin requirements, and most importantly proactively involving your key suppliers in your business planning process. This is a great opportunity to get ahead of the cycle and plan for business needs that collectively drive business and make everyone in the system a better operator.

Next we ask…do you have the people to pull this off?

Management & Personnel As the complexity of being a great operator continues to increase, the requirements on your management team will evolve as well. The shift from "hitting case numbers" to "managing a business unit" is not accomplished overnight and takes a skill that may or may not exist in your organization today. There are three areas that we suggest each distributor look at in evaluating the people side of your business: professional management needs, existing family members and specialized areas of expertise.

Professional Management We are seeing many distributors move to a "professional management" strategy as they acknowledge the need to bring in non-family, professional managers to run key segments of the business. Evaluating your needs and going through a quality search is critical. In addition, we suggest taking the time to evaluate your current management team and conduct a succession planning forum semi-annually to assist you in identifying your leadership gaps and opportunities. This disciplined process will help you determine the development needs of your existing team and identify key weaknesses in your organization. In some cases the next right hire will be a person from outside the industry who brings a fresh perspective; in other cases it may be a well-known person within the industry who brings a high level of credibility and supplier management knowledge.

Family Members We understand this is a touchy subject. We understand that family member issues are a reality in most distributorships around the country. New family business members should be required to gain working experience in other outside businesses first, before they are allowed to join the family business. Having a younger member spend up to five years outside of the family business affords great perspective and will allow them to bring new ideas and more confidence to your business. We also strongly recommend that any family member who wants to grow with the company be required to do every single job in the company. If the long-term succession plan is for that person to run the business, he or she must be intimately familiar with all areas of operation. And, as an important side note, they should be held just as accountable as anyone else; you will be doing them and your employees an immeasurable favor.

Critical Positions Finally, we suggest looking at key areas of emphasis for your business and seeking out expertise in those areas. The need for expert knowledge as the portfolio and business changes is critical. A few positions to look at as you change your business model include:

(1) Craft & Import Brand Manager: This often requires a different person than you may have in your organization. Look to on-premise accounts or to the outside marketplace for that expert.

(2) Non-Alc Brand Manager: The business language and volume requirements of non-alcs are very different from those of beer or wine. Having a liaison for those suppliers is critical to the success of your business and the development of those brands in the marketplace.

(3) HR Manager: This position is not a paper pusher, and he or she needs to be a critical member of management for any business that has over 125 employees. This person can lead training, succession planning, compensation optimization, healthcare and other critical efforts. Ultimately, this person is all about driving greater performance. Over 70% of your expenses are your people. We suggest that you put the appropriate resources behind that investment.

The Ownership Structure Your business structure needs to be designed to meet your planned and unplanned goals. This is another topic that gets put off year after year. We recently spoke with a tax expert who could not understand what unique circumstances might exist that would drive a private business owner to remain a C-corporation. His comment to us was, "Barring a very unique circumstance, most of these privately held businesses should have converted to an S-corporation or LLC many years ago." You and your tax advisors should discuss ownership structure as part of your annual planning process. Entity structures can be generally categorized as pass-through (Partnership, LLC, S-corporations) vs. taxable (C-corporation) entities. Most structures (other than a sole proprietorship) are designed to protect you from personal liability. The primary advantage of a pass-through entity is the single layer

Ownership Structure

	Sole Proprietor	C-Corp	S-Corp	Limited liability Company (LLC)
Personal Liability Protection	No	Yes	Yes	Yes
Management	Full control	Shareholders elect directors who manage business	Shareholders elect directors who manage business	Members can set structure as they choose
Taxable Entity	No	Yes	No	No
Pass-Through Tax Treatment	Yes	No	Yes	Yes
Double Taxation	No	Yes, if income distributed as dividends	No	No
Transferability of ownership	No	Stock easily sold, but asset sale double taxed	Stock easily sold and still get step-up … assets sale not double taxed	Can structure in operating agreement

Note: Above items are for general guidance only. Expert tax advice should always be sought to ensure structure fits your specific circumstance.

of tax. C-corporations are taxed at the legal entity level and then the distributions are taxed again when paid to the owners in the form of dividends. We still run into circumstances whereby the owner is taking a very large salary (and paying 1.45% to the government for Medicare contributions) to avoid the double tax of a distribution. In many cases people have simply not asked the pertinent questions of their tax advisors and for one reason or another the tax advisor has not brought the issue up. LLCs typically offer tremendous flexibility for those wishing to buy other businesses or sell their existing business. We can't tell you the number of times we have run into people who did not think they would ever sell the business, but something occurred and now they are either trying to sell stock (which does not allow for tax write-offs that increase the price) or are facing double taxation as they sell assets.

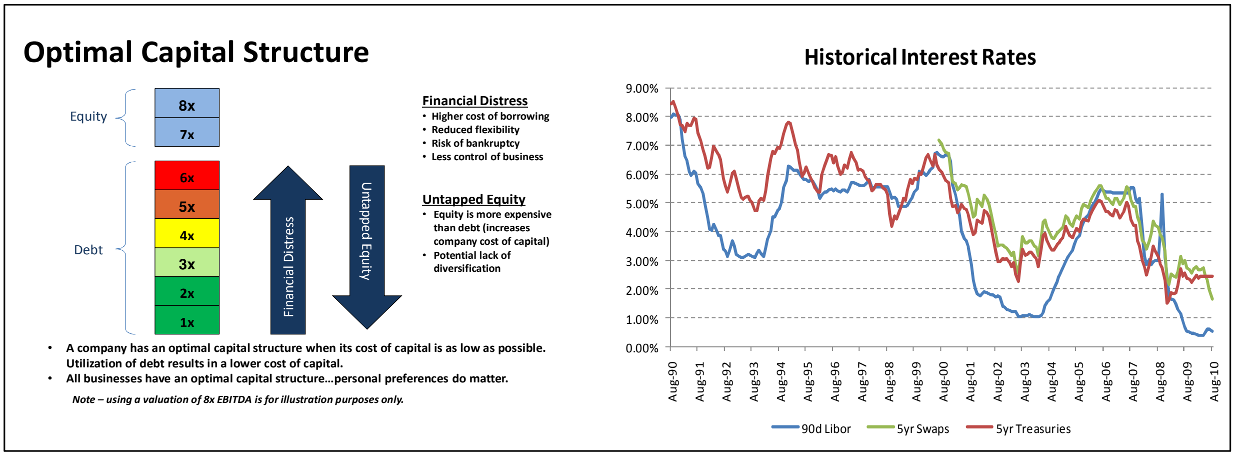
Are you protecting your wealth? As the beer distribution industry is set to go through large systematic changes, so too is the tax structure in this country set to undergo major changes, including likely rate hikes. While nothing is certain, most tax experts agree that tax rates will increase over the next several years to address our swelling federal and state deficits. Capital gains taxes are slated to increase by 5% next year and possibly higher in subsequent years. The threat of increased taxes and the growing uncertainties surrounding our tax system generally make it imperative that beer distributors and their families consult with independent, well-qualified tax experts on a regular and consistent basis. Preparation will maximize your wealth in future years, and you can never prepare too early or too often. Every family business in this industry faces generational transfer issues in the years ahead; the coming changes in federal and state taxes make the need for early planning more important than ever.

Properly organizing your governance structure is as important as your operating processes and metrics. Too many times people have thought their business was too small to worry about things such as a Board of Directors or a strategic operating committee. Yet when the time comes when they have the opportunity to grow their business, they are viewed by their primary supplier as being "too small minded" or "unsophisticated". Or something happens to the majority owner, and people are arguing over how to proceed without that person. If you have any desire to grow or simply improve the performance of your organization, then you should definitely have a structured, highly detailed governance plan. Not only will it add disciplined structure and likely bring new ideas into the business, but it will protect you when things don't go as everyone originally planned. Clearly laying out the ownership rights of both the majority and minority owners is critical.

A relatively easy way to jumpstart a new governance system is to add outside, independent members to your Board of Directors. Ideally, these members will be outspoken and not hesitant to express ideas that shake up your family's more conventional thinking. They should bring in ideas from outside the business and add valuable insights from their own business experiences. They should also be nominated based on specific skill sets, e.g., legal, mergers & acquisitions, marketing, business governance, and supplier relations. Outside Board members should also serve as impartial mediators between the different constituencies inside your family business.

Capital structure Textbook finance asserts that every company has an "optimal" capital structure. This capital structure includes debt and equity. Beer distributorships are the perfect type of businesses for debt. They have stable and reliable cash flows with which to service even the highest levels of debt.

If you have no debt, you may be missing opportunities to increase your shareholder value. Debt on your books may allow you to redeploy capital if your personal net worth is not diversified outside the beer business. Furthermore, senior debt rates are at all time lows, as shown in the table below.



If you have no debt and you borrow at low levels of leverage, your all-in cost of debt will be around 4% for five-year, fixed-rate money. It will be less than 2.5% if you get floating rate debt. Using debt to diversify your net worth makes sense. If you borrow money from the business and redeploy the proceeds into alternative investments, you don't need much in terms of returns in those investments to increase shareholder value. We are NOT telling you that you can calculate your optimal capital structure. We ARE telling you, however, that your business has an optimal capital structure and it includes a certain amount of debt.

Staying on the topic of debt, the tables below illustrate a common misconception in the beer business (for illustration purposes, we assume that a beer wholesaler will sell for 8.0x EBITDA, however, this multiple will vary with EVERY deal). Many wholesalers believe that if you can finance 100% of an acquisition with senior debt, it must be a good deal. Conversely, if you need more than what senior debt will provide, it must not be a good deal. As seen in the first chart below, by paying what amounts to 12.0x EBITDA for an acquisition (and having it completely financed by a bank) may decrease shareholder value. In the second chart, we assume that the wholesaler pays what amounts to be 7.5x EBITDA (the wholesaler in this example has too much leverage to use senior debt to finance the entire acquisition). In this example, the wholesaler may pass on a good deal because they do not tap into other sources of capital.

If I can finance it 100% with senior debt it must be a good deal!

Also, goes by "how can I destroy equity?"

	Current	Purchase	Post-Deal	Variance
EBITDA	$ 3.0	$ 1.0	$ 4.0	
Company Value Multiple	8.0x	12.0x	8.0x	
Company Value/Price	24.0	12.0	32.0	
Capital Structure:				
Debt	-	12.0	12.0	
Equity	24.0	-	20.0	(4.0)
Leverage (Debt/EBITDA)	0.0x		3.0x	

This is a simple loan for banks to make.

The banks will let you overpay and destroy equity if you want to.

If I can't finance it 100% with senior debt it must be a bad deal!

Also, goes by "I passed on a good deal"

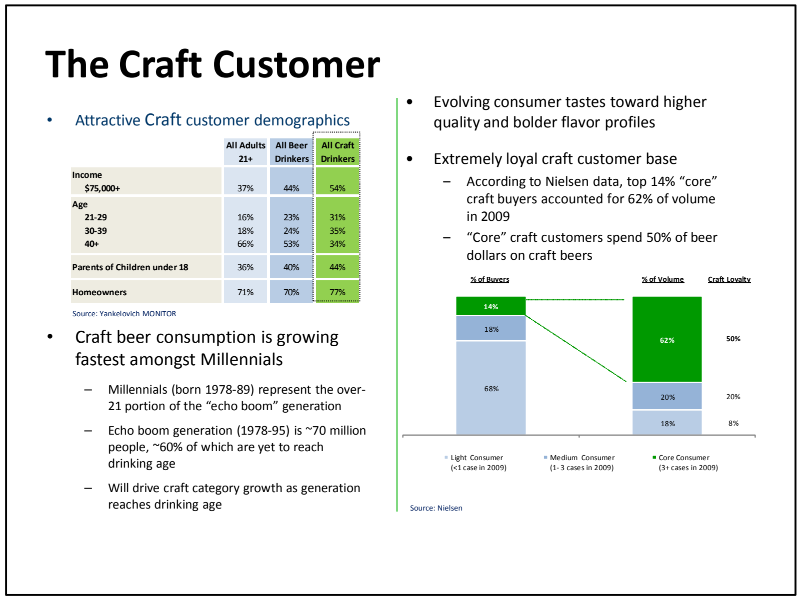
	Current	Purchase	Post-Deal	Variance
EBITDA	$ 3.0	$ 2.5	$ 5.5	
Company Value Multiple	8.0x	7.5x	8.0x	
Company Value/Price	24.0	18.8	44.0	
Capital Structure:				
Debt	15.0	18.8	33.8	
Equity	9.0	-	10.3	1.3
Leverage (Debt/EBITDA)	5.0x		6.1x	

The banks will not allow leverage levels this high regardless of the incremental equity generated.

A creative capital structure can get you the deal.

To summarize, use your balance sheet to diversify and grow your personal net worth. In addition, if an acquisition doesn't make sense, don't assume that if you use other people's money it will make it right. On the other hand, if a deal makes sense, find the capital to get it done.

G**rowth drivers** in the beer business are different today than they were in the past. In the past, what was probably your only major supplier would come out with new brands that would provide supplemental growth for your already growing brands. Nowadays, your workhorse brands aren't growing as consistently and new brand introductions aren't having the impact as those in the past. Crafts are the new growth engine for beer wholesalers. Distributors are adapting and getting aggressive about courting craft brands to put in their warehouse. If you think that you can sit back and wait for these brands to find you, you open the door for your competitor to get there first. Small suppliers need to know that their brands will be fairly represented in your market, and they will go with what they consider their best option, regardless of what brands you already have. As we mentioned earlier, the option of a smaller, more focused network looms in many markets and will create a nice opportunity for smaller brands if you don't get your plan together first.



Another key growth driver is how you want to operate your business for the future. We used to hear about a certain threshold of case volume that would determine if you were a buyer or seller. Although that talk has dissipated, cost pressures are here and are here to stay. As an industry, distributors have done an adequate job of becoming more efficient at countering these pressures. These cost pressures, however, are not going away. If you don't have a considerable amount of discretionary cash flow, cost pressures may force you to look at other alternatives to maintain your family's legacy in the beer business. These alternatives include finding other brands (which may be wine, spirits, or non-alcs), mergers, JV's, or shared services. We recommend that you establish right now whether you are a buyer or a seller for the future. You should also immediately consider what other steps are necessary for you to grow and manage intelligently in this new environment. Considering—and answering—these questions now will assist you in setting up your options for the future and gaining the adequate assistance to make sure you are successful.

William Anderson, Chairman & CEO **First Beverage Group**	**(310) 481-5101**	**bill@firstbev.com**
Sean McLaren, Managing Director **First Beverage Financial**	**(404) 442-8760**	**sean@firstbev.com**
John O'Connor, Managing Director **First Beverage Financial**	**(636) 733-7537**	**joconnor@firstbev.com**
Joth Ricci, Managing Director of Operations **First Beverage Capital**	**(503) 341-5648**	**joth@firstbev.com**

First Beverage Group
11100 Santa Monica Blvd., Suite 850
Los Angeles, CA 90025
Main (310) 481 – 5100
Fax (310) 481 – 0833

www.firstbev.com