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DAILY

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Grokking Distributor Consolidation

Dear Client:

For veteran distributor lawyer Drew Jaglom of New York City's Tannenbaum Helpern Syracuse & Hirschtritt, who presented at NBWA last week on structuring transactions, it's not if consolidation will continue to happen, but when.

Fielding an audience question on mega-deal rumors, Drew, who has repped everyone from Manhattan Beer to the private equity firm that just bought a stake in Southern Tier, said he "wouldn't lose much sleep" on an ABI/SAB deal, as the MillerCoors JV likely wouldn't go to ABI due to antitrust concerns. So he doubts that would have a big effect on distributors.

But: "If you had a Heineken acquisition - that's kinda a long shot but in today's world who the hell knows - even in the states where there's protection against a move, there's still pressure to consolidate," Drew said. So "there will be deals over time," though "it may take a long time." Case in point: "MillerCoors is how old now? They're working their way through the country and slowly getting the consolidations they want. It does take a while. But it does mean there will be deals: it's just, how long and at what price?"

Indeed, buyers and sellers seek different things and can value the same things differently. And of course laws are complicated and differ state by state. Suppliers can throw a wrench into a distributor deals too. Drew and Phil laid it all out for their rapt, 7:30 a.m. audience.

STRUCTURING DEALS: VALUING THE BIZ FROM DIFFERENT ANGLES. "Once you're at the table, you gotta determine how to value the business," said fellow lawyer Philip J. Morgeson of Cincinnati-based Morgeson Law Office. Of course, both the buyer and seller need the same understanding of which financial records that are going to apply. "Because there is a lot of deviation among the seller trying to maximize the purchase price and the purchaser's ... resistance to some of those adjustments."

Of course, he's seen a lot . "If you're going to be coming into an operation, EBITA is the best way to evaluate the potential for the purchaser," he said. "What I always tell the seller [is], you want to normalize the EBITA as much as possible. ... Usually it's pretty interesting to see what people can slide into their corporate documents. It's pretty rare that you're going to drive a benefit from admitting you're using company funds to finance your $5,000/month [special hobby] -- but this is it, this is the one, so you might as well take advantage of it. But it also makes my job more interesting. It's my favorite part, is going into these EBITA and finding some of the 'non recurring' expenses."

"In a deal where you're buying the business, EBITA is really what your starting point is," said Drew. But if you're buying a brand, "you're probably going to start with gross profit, but you still need to find out incremental costs. People use rules of thumb: 3 to 5 times gross profits, 10 times EBITA - maybe yes, maybe no . Because you've gotta factor in, when you're valuing a business, things like growth rates, things like the changes that will occur in the cost structure, post-deal. And those are all going to affect price." His advice: "Do a discounted cash flow analysis, then turn that into an EBITA multiple or GP multiple and see if it makes sense ... you do a DCF and you get an 8 times GP multiple when the brand's been trading at 3-5, and you've done something wrong. ... it's a reality check. But what you're buying at the end of the day is cash flow."

And remember: "Usually smaller brands have disproportionately smaller incremental costs," said Drew, "which means the smaller brand usually [fetches] a higher multiple ... plus they're often growing more."

TRICKS OF TRADE: CAVEATS. Among the list of things to consider when structuring a transaction, both lawyers advised potential dealmakers to get specialized help, on financing and beyond. Drew gave an example why. "I was involved with representing the private equity firm that just bought that interest in Southern Tier in upstate New York. They had their regular M&A lawyers down South doing the transaction, and I helped with all the regulatory and distribution issues -- so when they were trying to look at all the distributing contracts and figure out what they were going to need to do to rationalize the distribution network... We had some issues," because " when you're dealing with a private equity buyer, they've probably got a lot of investments. And those may include retail. That may create some tied house problems in some states, so you gotta figure out how to deal with that." In other words, it's complicated.

Other caveats include weighing suppliers' potential objections to deals. "You don't want to go down this path unless you're fairly confident that you're going to be able to secure the supplier approval necessary ; or upon the seller, look at my state law, how strong can I get trying to press the issue with suppliers," said Phil. "Price is important but it doesn't dictate everything. Certainly [there are] situations where slightly lower purchase price may be a more appealing offer if it means I can avoid doing battle with suppliers."

Sometimes it's a "game of chicken..... Lots of times I've told my clients, 'I feel pretty good they're going to cave at the last second,'" said Phil, only to end up obsessing over his email every two minutes the days before closing. "Suppliers are very good at sending out those last-second approval letters," he said.

ALLOCATING THE VALUE OF BRANDS. The chicken game is a good point to ask: What happens when a brand gets pulled out of a deal?

Three minus one does not always equal two. "Imagine you've got a selling distributor with 10 brands, all equal -- gross profits, sales; each brand is same," Drew painted a hypothetical scenario. "Each brand contributes $1 million of gross profits. So you've got $10 million worth of gross profits. And operating expenses of $8 million, so your operating profit, EBITA, is $2m. Lose one of those brands [i.e., supplier doesn't approve the transaction], <u>and you just lost half the cash flow on the deal</u> . Lose two of them and you've lost all of it and it doesn't make sense to do it anymore. ... <u>You can lose a brand and lose a lot more of cash flow than you're expecting</u> - one way to deal with it is you've gotta get a certain percentage of EBITA or GP contributed for the deal if it's gonna close. Another way to deal is with it is price adjustments."

This is an interesting concept and one in which I admit I never really considered before. Supplier relations are indeed important, which is why it surprises me to still see some distributors even today remain very introverted. Those circle-the-wagons days are over. Get out there outside your market, press the flesh, meet the people. Relationships matter not just within markets with retailers, but outside of markets with suppliers (and potential suppliers).

AND FINALLY, IT'S A FAMILY AFFAIR. Perhaps one of the many reasons we don't see the rate of consolidation tick up even faster is because distributorships are generational businesses - "usually someone who has been in the business for several generations. There's an emotional attachment," said the two. "If people treated their distributorships like their stock portfolio, they'd sell a lot quicker." Though "I've never had a single person call me after a transaction and say, 'I really wish I didn't sell,'" said Phil.

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Until tomorrow, Harry

"Life is full of obstacle illusions."

- Grant Frazier

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