PROPER BREWERY DUE DILIGENCE A KEY TO ACQUISITION SUCCESS

Some of the most talked about beer industry stories in the last few years relate to brewery transactions. It's clearly big news when the likes of Anheuser-Busch InBev, MolsonCoors and Heineken make strategic acquisitions.

In a more recent trend, private equity companies have made deals with craft breweries, and brewery groups such as Canarchy Craft Brewery Collective and Artisanal Brewing Ventures have formed to find synergies and strengthen their competitive positions.

Many industry experts expect more brewery deals as leaders look for growth or owners seek to retire.

Those who follow the industry learn of these transactions once the final *ts* are crossed and *is* are
Those involved, however, have a deep understanding of the often long and demanding journey t
leads the parties from the initial interest stage to a closed deal.

Due diligence, which has several meanings but most commonly involves a comprehensive appraisal of a business being acquired, is an early and important step in that process. When breweries are involved it can pose unique challenges.

This piece lays out some common brewery due diligence objectives as told by industry experts who have conducted many of these exercises.

Understand the objective

The team performing the appraisal – whether part of the buyer's operation or an outside firm – should start with a clear idea of the task at hand.

Preliminary due diligence occurs before a deal is reached. Prospective buyers usually have access to a restricted set of data about the brewery for sale. They use that information to make an investment decision and, when appropriate, determine an offer price.

Detailed due diligence is typically conducted after the buyer has reached a tentative purchase agreement with the seller. It permits the buyer to confirm assumptions made during the preliminary stage. The time allotted is limited, and the exercise requires high degrees of confidentiality, sensitivity and expertise. As a result, everyone must be on the same page and focused on what matters most.

Once a due diligence team is formed initial meetings lay out the scope of work, roles and responsibilities and timeline to help keep the effort on track.

In addition to diligence areas common to all industries (e.g. legal, tax matters, insurance, environmental, etc.) comprehensive brewery due diligence can include a range of reviews, such as:

- **Technical** – evaluation of all aspects of the brewery operations, including condition, capability and capacity of the plant, as well as operating effectiveness, maintenance and quality management systems
- **Supply chain** – review of how the flow of goods – from sourcing materials through in-process inventory to shipping finished products – is managed
- **Distribution and regulatory** – quality of distributor relationships and potential regulatory challenges in markets served
- **Sales and marketing** – review of product/SKU mix, performance trends, value proposition and brand strength
- **Management and processes** – assessment of talent, structure and operational processes and controls
- **Financial** – quality of earnings

Although team members divide up responsibilities according to their areas of expertise, they often share thoughts and observations with each other. These regular conversations can reinforce findings or lead to new questions.

Quantify the risks

"The object is to put a value on any risks identified through due diligence," said Paul Woodhouse, head of the financial services practice for First Key. "That effort will help the buyer make a well-informed decision. And the due diligence report often serves as a roadmap for how the buyer can improve perform after the deal is closed."

The first step in identifying potential risks is to gather as much information about the brewery involved as possible. The team does this by reviewing reports and other data the seller has submitted to the buyer.

Where possible, the initial data capture is followed up by a site visit. There, the team can observe brewery operations firsthand, speak with select members of management and review additional performance reports.

Teams should adhere closely to any ground rules set by the buyer or seller. The walkthrough may take place before the purchase is made public so all involved must be careful to not raise any concerns or disrupt operations.

Dr. Hugo Patiño, First Key's director of technical services, said team members can glean important information by observing the brewery's practices while also digging deeper into key trends. "Sometimes we'll see something in the data that points to, say, inconsistent yields or productivity. Then we'll see in person how certain practices or the use of space may be contributing to those trends. We can then have a conversation with management or the buyer about it to explore means for improvement."

The costs and benefits on improvement of each of the gaps or opportunities found are detailed in the final report to the buyer.

Examine quality of earnings

All of the areas assessed during due diligence have some impact on a brewery's bottom line. Inefficiencies in brewing and packaging operations can lead to unexpectedly high operating costs, and poor quality control can be a risk to brand reputation, sales volumes, and revenue.

As a result, one of the most important items of a final due diligence report is the quality of earnings review. In short, this is a detailed analysis of each component of the brewery's revenue and expenses.

Financial experts on the due diligence team will review the brewery's historical financial performance over a three- to five-year period. The goal is to provide commentary on the underlying performance drivers, explain key trends and fluctuations in revenues and expenses, and make adjustments for unusual or non-recurring items – such as discontinued product sales or one-time costs. The normalization adjustments identified are explained and presented in an "adjusted earnings report", which is considered more relevant for risk analysis and deal pricing.

"These 'normalized' earnings, when combined with the due diligence team's broader findings, provide the buyer with a much clearer view of the brewery being purchased," said Woodhouse, a chartered professional accountant.

Help the buyer

Through proper due diligence the buyer will have a greater comfort level with the investment being made.

Though it's a time-honored practice, due diligence may still pose a unique challenge to those involved in the sale of a brewery.

“Private equity or venture capital firms will likely have the skill set needed to gain a firm grasp of the targeted brewery’s financial performance, but they may not understand the operations side as well,” said Dr. Heather Pilkington, executive director at First Key. “On the other hand, brewery owners targeting other breweries may know the operations side well but may have never performed a comprehensive due diligence exercise.”

Based on current trends, more breweries and investors may find themselves in need of this important skill set and should ensure they pull together a strong team for due diligence work.

By Michael Tysarczyk