

PRIVATE EQUITY INVESTMENT COMMITTEE PAPER ON SOGRAPE, SGPS, S.A.

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A Project carried out on the Master in Finance Program, under the supervision of:

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Abstract

This work project aims to study a private equity deal using a Leverage Buyout Model of the Portuguese private equity Sogrape, operating in the wine sector. In this specific part is define how much is Sogrape worth and how will be their initial capital structure. The starting point was the market and company analysis where it was concluded it is needed to take advantage of Sogrape's positioning as a leader in the Portuguese market, promoting consolidation through an acquisition and empower the company positioning as a distributor. Regarding the international markets, part of the strategy involves to change the route-to-market in USA, a key market to this sector. In the other market clusters as growth platforms and mature markets, the plan involves the promotion of sales through an increase in marketing expenses as well as focusing on the segments that is expected to face a higher growth rate in the following years and where Sogrape holds more competitive advantages such as light wines. After this analysis, a valuation of Sogrape and Esporão was needed. Knowing the drawbacks of a Discounted Cash Flow valuation a valuation based on multiple was realized. To have the most complete multiple analysis we not only consider Sogrape most comparable companies multiples but also how much the market is currently paying looking for the last transactions multiples. Reaching a value for Sogrape value it was then possible to calculate how much equity and debt would be needed to buy Sogrape bearing in mind all the debt covenants (Leverage Amount, Interest and Cash Cover ratios) and expected cash generation.

Keywords (up to four): Private Equity, Valuation, Multiples

PERSONAL REFLECTION ON THE THESIS

Thesis Skill Development

Team Work: If you want to go fast go alone. If you want to go far, go together. For me with this thesis I learnt what it really means. Knowing that each people have different skills and they can be complement was a prof that together someone can reach different levels than alone.

Development of skills: being part of a team helped me not only to develop my interpersonal skills such as speaking and listening but also my leadership and motivating skills.

Knowing myself: Working for a set of goals under deadlines sometimes presented unique opportunities to deal with situations that we were not used to deal with. By doing this, skills that were previously less developed became, in a way, more exercised.

Masters Skill Development

Attention to detail: With this master I realized that small numbers and the way they are calculated can have very large repercussions on projects. Consequently, I attention to detail is crucial for a successful career in the world of finance.

Communication: This master taught me that technical components can only be greatly enhanced if in one hand the people involved in the work are in agreement and aligned and if each one can transmit their ideas in a clear and rationale way.

Problem Solving: The tight deadlines that we faced during our first year of master and most recently doing the final project forced me to be practical and to find fast solutions to the problems that we faced during this period.

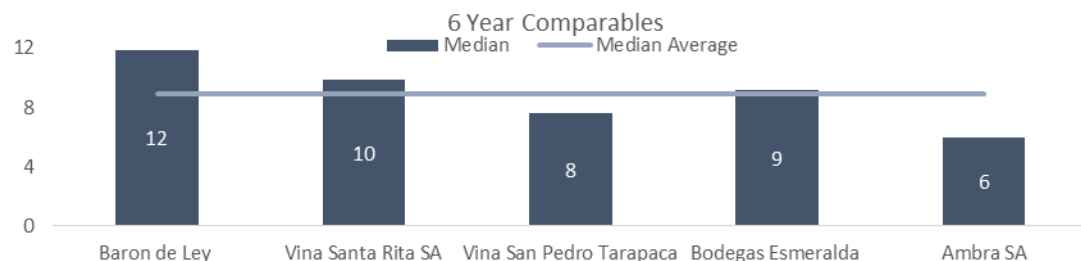
VALUATION

In order to estimate Sogrape's Enterprise Value three valuation methodologies were used

PEER ANALYSIS

Trading Comps: This analysis was performed comparing the 5 closest 4 companies taking into account not only their respective similar core business with Sogrape but also their Geography localization and EBITDA values .

The EV/EBITDA is considered a reliable multiple because it does not take into account the capital structure and taxation of the companies. With this criteria a median multiple of **8.6x** EBITDA was achieved.

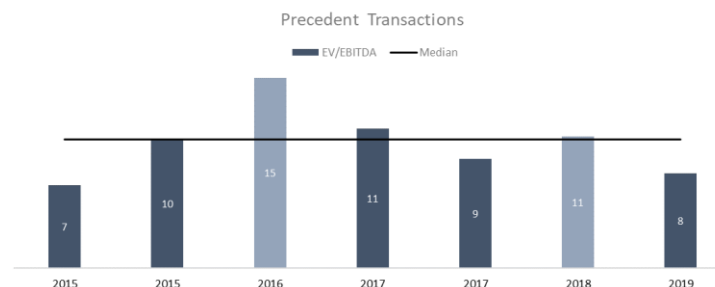


6 Year Industry Comps: Being aware that the Trailing 12 months EBITDA can suffer from business cycles fluctuation it was decided to compute the average of this multiple since 2014. With this analysis, an Average and Median Multiple of **8.95x** and **8.98x** EBITDA , respectively, were obtained.

FOOTBALL FIELD

Football Field: Bearing in mind all the aforementioned multiple analysis and assuming that Sogrape multiple is above the 75th percentile (not only because in terms of revenues compared to the other global players but also in terms of EBITDA) one ends up with an entry multiple of **10.9x** the 2019 Forecasted EBITDA.

PRECEDENT TRANSACTIONS

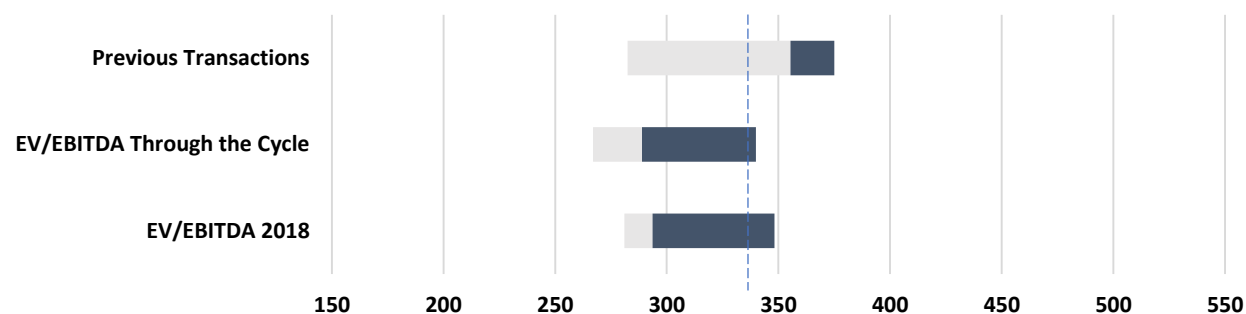


Precedent Transactions: Another analysis based on precedent transactions was performed, as it shows what the market is currently paying, on average, for comparable transactions. It was decided to only consider the transactions that happened during the last 4years and the ones where the target companies were companies very similar to Sogrape. The market is currently paying a **10.41x** median EBITDA multiple.

DCF

Exit Multiple	10.9
Terminal Value (TV)	€572m
Discounted TV	€451m
EV	€471m

Discounted Cash Flow: Knowing that that the terminal value would represent the majority of EV Value and it is sensible to the WACC and the assumed perpetual growth rate, it was decided to calculate the DCF through the **Exit Multiple Method** leading to a final value of **€471 million**. The **exit multiple in 2025** was assumed to be the same as the **entry multiple in 2019**.



Given an entry EBITDA Multiple of 10.9x Sogrape's EV is estimated to be worth €444 million

CAPITAL STRUCTURE: SOURCES AND USES

Capital Structure was calculated maximizing debt amount taking into account its covenant's

USES

As mentioned, Sogrape Multiple will be around 11x its EBITDA meaning that its **Enterprise Value (EV)** would be worth **€444 million (€407 millions for Equity and €37 millions for Net Debt)**.

Moreover, it will be necessary to incur in **transaction and due diligence costs**, which are assumed to be 6% of the Sogrape's Enterprise Value (**€27 million**). As such, to replace the current capital structure, a **€471million** investment will be required.

SOURCES

Debt: Taking into account Sogrape business it was decided to fund the borrowed amount with a **term B loan** of €88 million. This amount was calculated taking into account not only its respective covenant's (**Cash Cover > 1.5x/1.7x, Interest Cover > 2, Net Debt around 5-6x EBITDA**) but also the cash expected **cash generation** throughout the investment period. Having a negative 5 year Euribor of -0.19% on November (Bloomberg) and a 5% margin (advised by Nuno Caetano, Head of European Trading at Invesco) their final cost is 5% since the threshold for the interest cost cannot be negative.

Equity: The remaining amount of €356 million needed to acquire the company will be financed with equity. This equity will be divided into two levels:

- **Sweet Equity:** Due to the actual management group experience in the industry and being aware that they are the ones who best know Sogrape it was decided to invite all the management group to remain at the company. To ensure that the interests are aligned it is expected that they will invest €8m (Two times of the board's 2018 salary) for 20% of ordinary shares.
- **Institutional Strip:** Composed by the remaining part of the ordinary shares (€33 million for 80%) and by a Fixed Return Instrument to fund the remaining € 315 million to acquire the company. The last one will be rewarded with 5 % of interest (advised by Nuno Caetano) that will be paid with the principal at maturity (in 10 years).

Name	Position	Estimated Annual Salary	Annual Salary %	Sweet Equity	Share of Ordinary Shares (20%)	Share of Total Equity
Fernando da Cunha Guedes	Chief Executive Officer	1.226.240	30,00%	2.459.248	6%	1,20%
Francisco Valadares do Souto	Vice-President	1.021.867	25,00%	2.049.373	5%	1,00%
Bernardo José Brito e Faro	Chief Financial Officer (CFO)	1.021.867	25,00%	2.049.373	5%	1,00%
Raquel Filipe Seabra	Chief Innovation Officer (CIO)	817.494	20,00%	1.639.499	4%	0,80%
		4.087.468	100%	8.197.494	20%	4,00%

RELEVANT NUMBERS

Enterprise Value	444
Fees - 6%	27
Total Uses	471

Sogrape Acquisition

	Amount	x EBITDA	%
Senior debt			
Term Loan B	115	2.8x	24%
Total debt	115	2.8x	24%
Fixed Return Instrument	315	7.7x	67%
Ordinary Equity	41	1.0x	9%
Sweet Equity	8		
Institutional Investor	33		
Total Equity	356	8.7x	76%
Total sources	471	11.5x	

Esporão Acquisition

It was decided to fund the acquisition amount solely with borrowed money from the same bank with the same type of debt and maturity increasing **Term Loan B** amount to **€214 million** in 2021.

Term Loan B	214	35%
Total Debt	214	35%
FRI	347	58%
Ordinary Equity	41	7%
Total Equity	420	65%

With the new capital structure Sogrape will almost double its financial leverage ratio from 0.22 in 2019 to 0.43 in 2021

LBO MODEL: INVESTMENT CASE VERSUS BANK CASE

An LBO Model is now a key tool to analyze how well Sogrape is capable to face its debt obligations

KEY INPUTS

The **inputs** that were needed to calculate the LBO are the following:

- The main assumptions already mentioned in the **Operating Model**: Revenue growth, EBITDA and EBIT Margins, Tax and Net Working Capital.
- The **Enterprise Value (€444.4 millions)** using an entry EBITDA multiple of 10.9x.
- The **Capital Structure of the acquisition**: 76% with Equity and 24% with Debt.

The **Key Outputs** of the LBO model are as follows:

- The **cash flow dynamics and key credit statistics** for the business during its investment period that will be presented in this section. In this section not only the investment scenario will be presented but also the bank case scenario.
- **The breakdown of the different drivers of returns** and the **returns generated by the investment** which will be presented in the next section.

For the **bank case** the following adjustments were made to the investment case:

- **Revenue growth**: for each year the growth rate would decrease by 10% of what is expected
- **EBITDA Margin** would decrease 5% of what is expected by the fund throughout the investment period
- **The percentage of Maintenance Capex as percentage of sales** would increase by 0.5%

COMPARISON

Investment Case	2020	2021	2022	2023	2024	2025	2026
Cash	46.0	62.9	81.9	107.2	136.9	172.9	1.8
Cash Flow	46.0	16.9	19.1	25.3	29.7	35.9	(171.0)
Cash Cover	8.0x	1.6x	1.8x	2.4x	2.8x	3.4x	-16.0x
Interest Cover	7.9x	6.1x	7.0x	7.7x	8.5x	9.5x	10.2x
Net Debt / EBITDA	1.5x	2.3x	1.8x	1.3x	0.8x	0.4x	0.0x

Bank Case	2020	2021	2022	2023	2024	2025	2026
Cash	43.3	56.1	70.2	89.8	112.9	141.0	(38.9)
Cash Flow	43.3	12.8	14.1	19.6	23.1	28.1	(179.9)
Cash Cover	7.5x	1.2x	1.3x	1.8x	2.2x	2.6x	-16.8x
Interest Cover	7.5x	5.6x	6.4x	7.0x	7.6x	8.4x	9.0x
Net Debt / EBITDA	1.7x	2.6x	2.1x	1.7x	1.2x	0.8x	0.4x

When comparing the **investment case scenario** with **the bank case scenario** it is verified that when the bank case is used the **cash cover covenant** is violated in 2021 and 2021(lower than 1.5/1.7).

Although the cash flow in the investment case is always greater than in the bank case, the **remaining covenants** (Interest Cover > 2 and Net Debt/ EBITDA < 6x) are satisfied in both the investment case and bank case.

Finally, remember that having **a bullet payment in 2025**, will naturally deteriorate Sogrape cash flows and consequently their compliance with covenants leading to **a negative cash cover covenant in both scenarios**. In the **investment case scenario** **their impact is null** since the negative cash flow generated in the year is lower than the amount that Sogrape has accumulated in Cash Balance (€ 173 millions).

If the forecasted projections are materialized the covenants proposed will be satisfied in the vast majority of the years analyze

DUE DILIGENCE – COMMERCIAL

Commercial Synergies are of the utmost importance, particularly assessing the impact of the pursued strategy and shifts in assumptions

COMMERCIAL	Market			
	Growth	<ul style="list-style-type: none"> Verify growth rate assumptions for each geographical market cluster, with focus on Portugal and the USA Verify trends analysis for each geographical market cluster, confirming development and growth rate assumptions of each market segment 		
	Market Structure	<p>Conduct in-depth market environment analysis in Portugal, verifying major competitors and stakeholders across value chain and confirming:</p> <ol style="list-style-type: none"> Distributor Dynamics: Assessing Sogrape Distribuição's actual power in the distribution market, both on and off trade, as opposed to PrimeDrinks and Viborel; differences in margins, reach and quantity loss on revenue side due to low bargaining power. Product Dynamics: Assessing the competitive advantages of Sogrape Brands, materializing their value based on current consumer demand and market trends. Production Dynamics: Assessing the competitive advantages of different production regions, particularly, the difference in costs per liter in Alentejo, Douro and Lisboa. 	<p>Conduct in-depth market environment analysis in the USA, verifying major competitors and stakeholders across value chain and confirming:</p> <ol style="list-style-type: none"> Distributor Dynamics, <ol style="list-style-type: none"> quantifying: the increase in revenues due to higher reach of national distributors; the change in commercial margins between national and regional distributors Product Dynamics, verifying that: Whispering Angel is, in fact, a solid benchmark for Mateus Rosé; <ol style="list-style-type: none"> Premium Wines will, in fact, be the most appropriate entry point to specific states; General Wines will not shift beyond previsions Overall Market Impact of trade wars; 	<p>Conduct in depth analysis in every non target geographical market cluster, identifying:</p> <ol style="list-style-type: none"> Unmet opportunities in specific markets and clusters Overall Market impact of current developments such as Brexit in the UK, payment instability in Brazil and Angola, among others.
	B&B Target			
Esporão Wines	<ul style="list-style-type: none"> Verify performance in 2018 and monitor performance in 2019, adjusting valuation in accordance Conduct further analysis on revenue breakdown, materializing market origins Assess cultural outlook of the company in order to ensure optimized integration, identifying potential problematic areas in the process <ul style="list-style-type: none"> Assess cost synergies value and probability Assess willingness to sell a family business to a competitor 			
Prime Drinks	<ul style="list-style-type: none"> Assess cultural outlook of the company in order to ensure optimized integration with Sogrape Distribuição, identifying potential problematic areas in the process Assess the revenue synergies from a joint venture between Sogrape Distribuição and PrimeDrinks from a quantity and price perspective both on and off trade. 			

DUE DILIGENCE – OTHERS

The remaining areas to DD are also paramount in the assessment of the deal

		Market
Legal & HR	Legislation	<ul style="list-style-type: none"> Review current legislation in operating markets regarding every aspect of the supply chain Analyse Legislative expectations in operating markets, particularly in Portugal regarding the future of Government Grants
	Legal Standpoint	<ul style="list-style-type: none"> Analyse Sogrape’s current legal standpoint identifying legal actions against or by Sogrape, as well as their possible outcomes and impacts Analyse legal aspects of intended actions including competition legislation in the acquisition of Esporão and PrimeDrinks, labour law in the firing of employees from Sogrape Distribuição, Evaton and PrimeDrinks and, finally, contracts with current distributors in the USA that will have to be emended to fit the proposed strategy
		Legal
	Integration After Merger	<ul style="list-style-type: none"> Analyse changes in human resources with merger with Esporão and PrimeDrinks, particularly ability to fire employees and reduce payroll costs Analyse best practices in integrating the different teams of Esporão Wines and Sogrape Brands as well as PrimeDrinks and Sogrape Distribuição
Tax	Tax Code Changes	<ul style="list-style-type: none"> Analyse expected changes in the overall tax code, particularly the effect of a possible tax increase on alcoholic beverages in every market
	Tax Optimization	<ul style="list-style-type: none"> Verify that Sogrape is following a tax optimizing strategy, readjusting where possible
Board	Fit & Incentives	<ul style="list-style-type: none"> Will: Determine if current Management team is aligned and in agreement with proposed strategic changes, as well as best strategy to incentivize performance Skill: Determine if current Management team has the right skills to enforce desired strategy, particularly regarding the acquisition and integration of Esporão, as well as USA expansion Filling Gap: Identify new managers to meet requirements that current managers will have difficulty applying
Reports	Reported Intel	<ul style="list-style-type: none"> Analyse the accuracy of currently provided financial information in the annual reports, particularly the current, 2018, gap in cash flows from financing activities
	Non Reported Intel	<ul style="list-style-type: none"> Obtain information regarding currently assumed aspects such as second level revenue breakdown and COGS breakdown, as well as stake in Liberty UK
Valuation & Exit	Valuation	<ul style="list-style-type: none"> Adjust valuation based on DD outcome
	Exit	<ul style="list-style-type: none"> Conduct in-depth analysis of potential buyers

APPENDIX : VALUATION

Peer Company's

Company	Business Description	EV/T12M_EBITDA	EV/Sales	Country	EBITDA (€ m)
Baron de Ley	Company's main activities include farming, production, ageing and sale of red, white and pink wines	11.01	3.70	Spain	31
Vina Santa Rita SA	Company principally engaged in the production and distribution of wine	10.38	1.45	Chile	26
Vina San Pedro Tarapaca	Holding company engaged in the production, packaging and export of wine. Produces and commercializes wine	13.11	1.41	Chile	28
Bodegas Esmeralda	Company primarily engaged in the production, distribution and export of wine	8.60	1.64	Argentina	21
Ambra SA	Engaged in the production, import and distribution of wines and non-alcoholic beverages	6.32	0.87	Poland	16

6 Year Industry Comps

Company	2014	2015	2016	2017	2018	2019
Baron de Ley	12.42	15.50	11.85	11.27	10.95	11.01
Vina Santa Rita SA	9.81	9.53	7.88	9.85	12.47	10.38
Vina San Pedro Tarapaca	7.14	6.77	6.17	8.01	10.59	13.11
Bodegas Esmeralda	5.62	10.86	9.79	11.22	4.69	8.60
Ambra SA	7.55	5.97	6.03	5.75	5.03	6.32

Precedent Transactions

Buyer	Buyer Country	Target	Target Country	Year	EV/EBITDA
CEP IV Bubble Sarl	Luxembourg	Bodegas Bilbainas SA	Spain	2019	7.68
Jiangsu Yanghe Distillery Co Ltd	China	Vina San Pedro Tarapaca SA	Chile	2018	10.60
CCU Inversiones SA	Chile	Vina San Pedro Tarapaca SA	Chile	2017	8.86
Vintage China Fund LP	China	Australian Vintage Ltd	Australia	2017	11.20
Grands Crus Investissements SAS	France	AdVini SA	France	2016	15.43
Terroirs Distillers SAS	France	Louis Royer SAS	France	2015	10.41
Ducde SA	Spain	Bodegas Bilbainas SA	Spain	2015	6.75