Pace University
DigitalCommons@Pace

Case Studies | Lubin School of Business

7-1-2005

Whistling Bird Winery

Armand Gilinsky
Sonoma State University

Raymond H. Lopez
Pace University

Follow this and additional works at: http://digitalcommons.pace.edu/business_cases

Recommended Citation
Gilinsky, Armand and Lopez, Raymond H., "Whistling Bird Winery" (2005). *Case Studies.* Paper 7.
http://digitalcommons.pace.edu/business_cases/7

This Article is brought to you for free and open access by the Lubin School of Business at DigitalCommons@Pace. It has been accepted for inclusion in Case Studies by an authorized administrator of DigitalCommons@Pace. For more information, please contact rracelis@pace.edu.

Case Studies

No. 29 July 2005

Whistling Bird Winery

by

Armand Gilinsky, Jr., Ph.D.
Professor of Business Administration
Sonoma State University

and

Raymond H. Lopez, Ph.D.
Professor of Finance
Lubin School of Business
Pace University

Whistling Bird Winery

by

Armand Gilinsky, Jr., Ph.D.

and

Raymond H. Lopez, Ph.D.

Armand Gilinsky, Jr., Ph.D. is Professor of Business Administration at Sonoma State University.

Raymond H. Lopez, Ph.D. is Professor of Finance at the Lubin School of Business, Pace University.

ACKNOWLEDGEMENTS

The authors gratefully acknowledge Drs. William Welty and Rita Silverman for their direction, inspiration and support in sparking our interest in case research and case writing. We also thank the North American Case Research Association for the valuable assistance received at its annual conference and workshop. Especially for this case, we thank the track chair, Dr. Jonathan Welch for his guidance and support of this effort. Finally, we thank Marie Loprieno and Gail Weldon for their editorial and document preparation assistance.

The case was also tested for its academic integrity and usefulness as a learning tool through the format of a colloquium held under the auspices of the Center for Applied Research within the Lubin School of Business of Pace University. The authors thank Dr. Michael Szenberg, Director of the Center, Dr. Surendra K. Kaushik, Associate Director and Diana Ward, Assistant Director, for their efforts on our behalf.

ABSTRACT

The Whistling Bird Winery has experienced above-industry-average growth in new revenues over the past five years. Although operating with a heavy debt position, the firm, owned and managed by Laurie Johnson, has developed award winning premium table wines that have been enthusiastically accepted by consumers in the northeastern United States.

The firm currently has expansion plans that include grape growing land, expanding capacity at its winery, and increasing its fledgling retail operations. Laurie has quickly realized that private equity funding is her only viable option and is evaluating her position at the winery, from both an owner and a manager perspective. With the cost of equity capital quite expensive, is her current expansion proposal worthwhile?

WHISTLING BIRD WINERY

> "The supply of grapes crushed in the 2002 harvest was an all time record and it followed a very good 2001 harvest. Quality is excellent – yet thousands of acres of vines are being pulled up across California with replanting of fruit trees. Mondavi recently announced a reduction of 10 percent of their workforce due to a reduced demand for wines selling above $25.00 per bottle at retail and a projected quarterly operating loss for the first time since they became a public company (1993). How are things going for you on the East Coast?" (1)

Laurie Johnson had trouble responding to the information she had just heard from her cousin, Wayne Rodgers, during a telephone conversation in May 2003. She had recently prepared a business plan for expansion of her Whistling Bird Winery located in Cutchogue on the North Fork of Long Island. Her plans included the purchase of grape growing acreage as well as expansion of the winery and construction of a retail store, new tasting room and renovation of a special events facility. The cost of these initiatives was estimated at $2.4 million and would take approximately a year to complete. His information created a surge of uncertainty concerning not only these plans but also the outlook for her current wine producing activities.

COMPANY HISTORY

Laurie Johnson and her brother Fred grew up on a 35 acre potato farm on the North Fork of Long Island. Owned by her parents, the farm barely provided for family living expenses. While her father John plowed the fields, her mother Patti Anne taught fourth grade at a nearby public school.

The experience of growing up on a farm had a very different impact on the adult lifestyles of the children. Laurie loved the land. She enjoyed walking the fields with her Dad and seeing the animals that lived on the land, especially the birds nesting in the tall oaks on the periphery of the family property.

For her brother Fred the experience was quite different. An avid reader and athlete, he could not wait to leave the farm for college. With a full athletic scholarship to Yale, Fred thrived in what he thought was a "big city" (New Haven, Connecticut) and then went on to Columbia University for an MBA with a strong emphasis on finance.

Laurie attended the agricultural school at Cornell University. She worked during the summer at small wineries in the Finger Lakes region of New York State. Upon graduation in 1985, she was offered an assistant winemaker position at the Glenora Winery in Hammondsport, NY. For three years she experienced all aspects of the wine making process and saw a chance to combine her love for the land with a career path in this industry.

A few years later her parents announced to their children that they were ready to retire and move to Sedona, Arizona. They "sold" their farm to Laurie and Fred in 1988 and headed west.

In January of 1989, Laurie and Fred each unexpectedly inherited $3 million upon the death of an uncle. They had very different uses for these funds. Laurie paid off her student loans and immediately embarked upon a long held plan to convert the potato fields to the growing of wine grapes. Fred paid off his loans and started a financial consulting firm for private equity investors in Manhattan. Although they spoke often on the phone, Fred had not been out to the farm for more than three years. Laurie would occasionally meet him in Manhattan for dinner.

During the spring of l989, Laurie implemented the planting of 20 acres of grape vines on the property and named her new business Whistling Bird Vineyards. By the fall of 1994, her first harvest was completed with the grapes crushed at a local winery.

Production was 60 tons of grapes, which resulted in 5,000 cases of bottled wine. Within six months, they were all sold locally to restaurants, catering firms and local business for gifts and promotions. Her revenue was just over $250,000 and her business was on its way.

Whistling Bird wines (merlot and chardonnay) were well received in the local marketplace. As demand grew for her products, Laurie decided to operate her own winery. There was a small winery on six acres of land just east of her vineyards. She had been speaking with the owner and sensed that he was ready to retire and move south. After only three meetings, they agreed upon terms of a sale and in the fall of 1996 Laurie was the proud owner of a winery. With an investment of $2.2 million, financed with a mortgage from a local Long Island bank, she was ready to oversee her first wine production in the fall of 1997. With expanded acres producing quality grapes and grape purchases from other vineyards, the renamed Whistling Bird Winery generated just over $1 ½ million in revenue.

Over the next five years through 2002, the Whistling Bird Winery expanded in the local wine markets. Product acceptance was translated into growing net revenues (Exhibit 1). Although operating expenses grew rapidly, Laurie felt that this spending was needed to meet competition and solidify her products with wholesalers, retailers and the final consumer. The building blocks for sustained growth, with commensurate operating efficiencies, were achieved by 2002.

The firm's balance sheets (Exhibit 2) and statement of cash flows (Exhibit 3) reflected the efforts made by Laurie and her management team as well as the challenges of this business. Most significant was the rapid and continuing expansion of inventories as premium red wines required longer lives in the oak barrels. These growing inventories were financed with a rapidly expanding line of credit from a local bank. However, that bank was nearing its lending limit to any one borrower. Either a larger bank would be needed within the year or another perhaps more permanent financing source would be

needed. Page Hopkins, Laurie's accountant and financial manager, had recently been exploring a number of options with North Fork Bancorp.

THE WINE INDUSTRY ON LONG ISLAND

From humble beginnings in 1973, the Long Island Wine Industry had developed steadily with growing numbers of vineyards, wineries, acreage and production of quality wine products. It currently (2003) produced a broad variety of varietals from cabernet sauvignon and merlot to chardonnay, cabernet franc and shiraz. All actions of current winery owners pointed to continued growth and expansion into the 21st century.

Grape growing and wine production were located primarily on the eastern end of Long Island which juts more than 100 miles into the Atlantic Ocean, parallel to the coast lines of Connecticut and Rhode Island. It is a maritime region with a unique combination of climate, soil characteristics and growing conditions ideal for quality wine production. Bays bordering the North and South Forks insulate the vineyards and trap moist warm air. Along with rich sandy glacial soil, this combination creates the perfect environment for growing grapes. Growing seasons are quite long (an average of approximately 200 days) and relatively mild winters have encouraged the planting of Europe's noble vinifera grapes on almost all acres planted. The growing region encompasses both Nassau and Suffolk Counties with the majority of wineries and vineyards located at the East End on the North and South Forks.

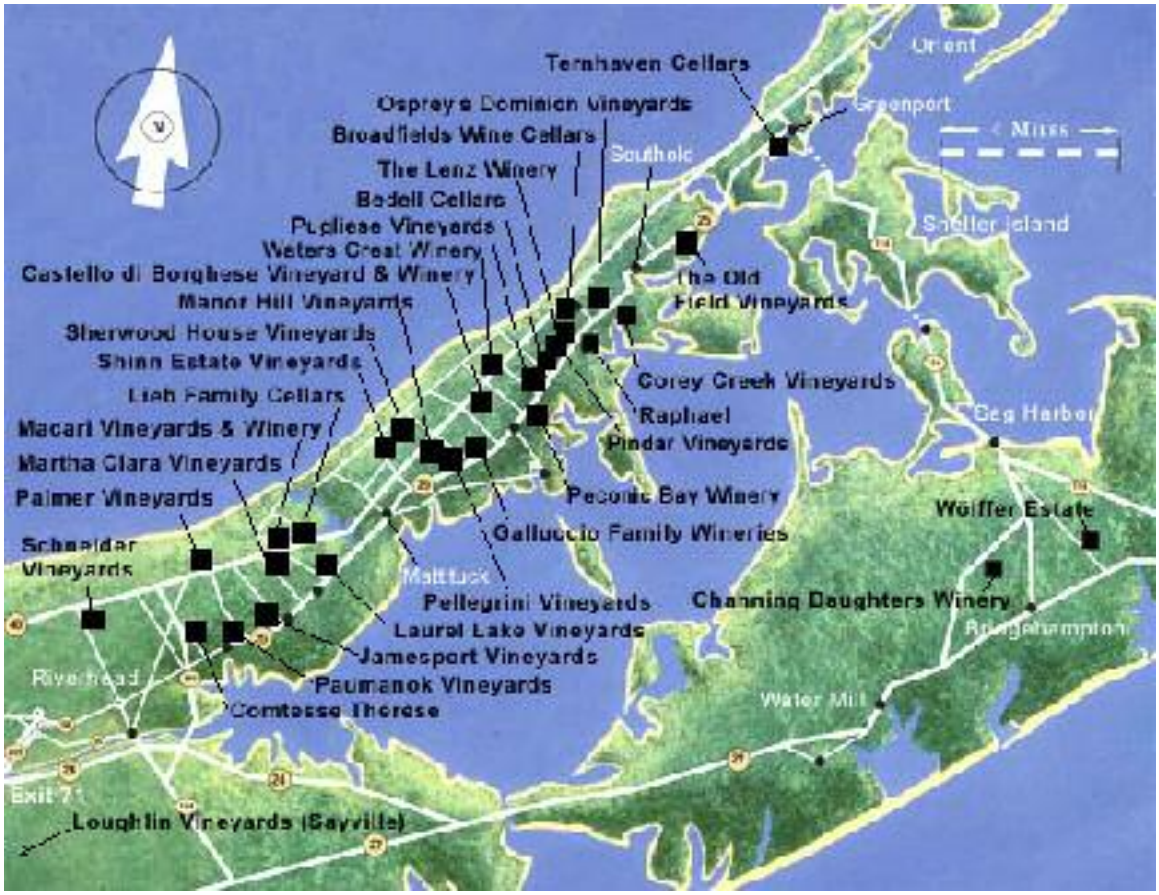
Long Island wines were sold primarily in the New York Metropolitan Region. Products were found at most vineyards and in local wine retail stores, as well as in a broad variety of restaurants and catering establishments. As quality had been enhanced with higher ratings by wine magazines and in national taste testings, the market broadened up and down the East Coast. It was not surprising that large regional distributors had in recent years shown a growing interest in carrying these wines, and it was expected that these patterns of geographic growth would continue. A few wineries already distributed in Florida, California and elsewhere and it was expected that this trend would accelerate as knowledge spread of the rising quality of Long Island wines.

Long Island Wine country was becoming increasingly respected as an important premium wine producing region. There were currently three appellations (American Viticulture Areas) approved by the Bureau of Alcohol, Tobacco and Firearms (BATF) – the North Fork of Long Island, The Hamptons and, as of April 2001, Long Island AVA. This latest designation allowed for further expansion beyond the two Forks of Long Island's East End, while at the same time protecting the overall integrity of the regions wines. [(2)]

LONG ISLAND WINE COUNTRY – THE EARLY YEARS

How did it all begin? A small band of hesitant artisans and amateurs started the industry in converted barns and potato fields some 30 years ago seeking a simpler agrarian lifestyle, or so they thought. In less than a third of a century, the profile of Long Island Wine Country had morphed to that of self-assured professionals backed by deep-pocketed investors who were also seeking a different lifestyle as owners of Napa Valley-like showcase wineries making prize winning and sought-after wines. While world class wines might be some years away, the money, the talent and the will to make them were all in place. It seemed just a matter of time according to winery owners and operators.

The land of the North Fork, where most of the wineries were located was flat to slightly rolling, planted not only with grapes but also with potatoes, sod and fruit trees. Craggy oaks shaded the villages of Greenport, Southold and Cutchogue, small and quaint with 200-year-old houses and 100-year-old churches and plaques to show where the old Pilgrim stocks used to stand on the village green. The water is never more than a few miles away, with Long Island Sound to the North and Peconic Bay and The Atlantic Ocean to the South.[3]



THE LAST FIVE YEARS – A MATURING WINE PRODUCING REGION

In 1999, Long Island had 20 wineries, 26 wine producers and 25 vineyards that did not have their own wine-making ability. They either sold their grapes to other wineries or contracted with other wineries to produce their wine.(4) A sure sign of the maturing of the industry on Long Island came with the announcement of a custom-crush facility to be constructed in Mattituck. It would cater to independent vineyard owners and grape buyers that lack their own wine-making facilities.(5)

Russell Hearn, the winemaker at Pellegrini Vineyards, planned this venture along with investors Mark Lieb, a Connecticut money manager and owner of the 50-acre Lieb Vineyard, and Bernard Sussman, also a money manager and an associate of Lieb. The partners expected to fund 40 to 50 percent of the new winery with equity and borrow the remainder from a Long Island bank.

"The primary purpose of this venture is to make wines for a number of small and large producers which choose not to, or are unable to, build their own wineries," Hearn has said. "Our service would allow someone to have small amounts of wine made and bring in their own consultant (winemaker) to set the style. A number of wineries that offered custom services in the past are approaching their maximum." Moreover, grape land under commercial production may double in the next two decades, further expanding the customer base. (6)

BEVERAGE CONSUMPTION IN THE UNITED STATES

The volume of alcoholic and non-alcoholic beverages consumed by Americans had been growing modestly over the last seven years. By far, the largest category was soft drinks, which in 2002 was almost double the next largest category – coffee. The consumption of wine, produced domestically as well as imports, had grown steadily over the same period, but its volume was significantly smaller, less than 4 percent of soft drink volume in 2002 (see Exhibit 4).

In terms of growth in consumption, the wine industry performed better than most other beverage categories. It had expanded by 2.8 percent per year since 1996, trailing only bottled water at 10.8 percent per year and cider (beverage alcohol) at 8.8 percent per year. Overall beverage consumption has been growing at only 1.8 percent per year.

On a per capita basis, wine consumption also performed quite well in recent years (Exhibit 5). It had risen steadily from 1.8 gallons per person per year in 1996 to just over 2.0 gallons in 2002. Once again the bottled water category has experienced the greatest growth in recent years, while soft drinks were still, by far, the largest beverage market segment (over 31 percent of total industry consumption).

Wine tends to be a relatively more expensive beverage as it places quite a bit higher in performance when retail sales are measured. In Exhibit 6, it may be observed that the expenditures for wine placed it as the fourth largest market segment, trailing only soft

drinks, beer and distilled spirits. Bottled water sales were again the fastest growing segment at 12 percent per year, while wine sales were in second place at 8.2 percent per year. Overall industry growth in retail sales was 4.3 percent over the same seven-year period.

WINE INDUSTRY CHARACTERISTICS

Total wine consumption in the United States reached an all time high in 2002. At 595 million gallons, it exceeded the record consumption of 587 million gallons reached in 1986 (see Exhibit 7). From those peak years in the mid-1980s, total consumption as well as per capita consumption trended down for more than a decade. Since the early 1990s growth has resumed and record consumption and sales are being observed, especially in the major market segment, table wine. Table wine in the 1980s represented between 82 and 84 percent of consumption. In response to changing tastes and preferences of the consumer, it exceeded 89 percent in 2002.

Wine sales in the United States over the last decade show clearly that table wine is winning over consumer's choice. Dessert wines declined from 1991 through 1997 (Exhibit 8) and have since experienced renewed growth. Sparkling wine (champagne) sales also declined in the early 1990s and have stayed at lower levels except for a spike in 1999.

Also reflecting the changing tastes and preferences of the American consumer were the growth performances of table wine sales by color. In the 1980s white wines accounted for more than one-half of all wines consumed in the United States, with a peak market share of 62 percent reached in 1985 (Exhibit 9). Since the early 1990s, the red wine segment has been the growth driver of the industry, more than tripling its consumption by 2002 to a market share of 39 percent. The white wine segment grew much more slowly throughout the 1990s. More recently, consumption growth has accelerated, yet has not reached the levels of 1985. Finally, the rosé/blush category peaked in the early 1990s, then generally trended downward at a slow pace since those years.

It should be remembered that the red wine category includes wines that are more expensive to produce, due to aging requirements. Therefore, they generally sell for higher prices at both wholesale and retail levels. The result has been that revenues from red wine sales at wineries as well as distributors and retailers have grown faster and are now substantially higher than those of either the white or rosé/blush market segments.

COMPETITIVE CHARACTERISTICS OF THE WINE INDUSTRY

Since the 1960s there has been a substantial increase in the number of firms producing wine products in the United States. From hundreds of companies in the 1960s and 1970s, the number exceeded 1,800 wineries in the late 1990s.[(7)] Most were relatively small and located primarily in California. In the last few years, the twenty largest firms produced approximately 90 percent of all American wines by volume and 85 percent by value at wholesale.

The competitive structure of the industry could be classified into three groups – stand alone wineries, both public and private and conglomerate or multi industry firms primarily public. The largest publicly traded winery was Robert Mondavi along with Chalone, a much smaller firm. The privately held firms were led by E&J Gallo, the industry giant, along with Kendall Jackson, The Wine Group and more than one thousand small to medium size wineries. The largest concentration was in California although in early 2003 every one of the 50 states had at least one winery!

The final group of competitors was composed of large multi-industry firms. They included Allied Domecq, Brown Forman (Wine Estates Division), Foster's (Beringer Blass), Constellation Brands (Canandaigua Division), Diageo (Chateau and Estates Division), Fortune Brands, Louis Vuitton Moet Hennesey (LVMH) and UST (formally know as U.S. Tobacco).

In addition to domestic competition, a growing percentage of the wine consuming marketplace had been gained by imports. In addition to the traditional "Old World" supplies from France, Italy, Germany, Spain and Portugal, a new group of countries had experienced growing acceptance of their wine production. Australia, Chile and Argentina (the "New World" suppliers) increased their market share in the last decade with quality wines at very competitive prices.

Consolidation among wineries began to accelerate in the early 1990s as larger producers decided to purchase smaller ones in order to achieve greater economies of scale in marketing and economies of scope in gaining access to more varied channels of distribution. These larger wineries could then become more effective in negotiating favorable selling terms with the small number of large regional distributors. The "consolidators" were generally public firms that were able to offer predominantly family-run wine businesses, a means to greater liquidity of their investment in larger more diversified firms. Concurrently, the attractiveness of wine production across the United States resulted in a growing number of entrepreneurs purchasing or starting new small operations.

The wine industry was capital intensive. In addition to land and vineyards, a fully integrated firm needed investments in crushing facilities, fermentation tanks, barrels for aging their product and warehouses to store the bottled and cased wine. Ownership was not essential for any of these activities. However, in order to control quality and quantity of production, these investments became essential as a firm developed its brands and expanded its markets.

Business risks were also substantial. Weather conditions could affect the quality and quantity of grape production. Insect damage and disease could affect the grape vines. Replanting of new vines required four to five years before commercial quantities of grapes could be expected and another two to three years for maximum sustained output.

In the fall of the year, usually late September to early November, depending on the weather, grapes were picked and carefully brought from the fields to the crushing facility. There is only one crop per year and crushing takes from one to two months. Consequently, the investment in this facility stands idle at least 10 months of the year. Since all the grapes in a region mature at approximately the same time, there is no way to rent out crushing capacity to other wineries at other times of the year.

After crushing, the juice is pumped into the fermentation tanks. These stainless steel vessels are temperature controlled to balance the heat generated by the natural fermentation process. Fermentation takes only a few weeks after the crush, so this investment is also idle more than 85 percent of the time.

From the fermentation tanks, the wine is pumped into oak barrels for aging. These barrels are quite expensive, currently costing $600 to $700 each. Due to quality concerns, they are used for only four or five years, at which time their value is negligible (some are cut in half and sold as planters). A barrel aging facility is a large open space that also must be climate controlled. During the aging process, some wine is lost due to evaporation through the porous oak barrel. Every two weeks each barrel is refilled up to 3 inches from its top. For premium red wines that are in barrels for two years or longer, about 5 percent of the original wine will be lost.

WINE PRODUCTION IN THE UNITED STATES

The internal structure of the wine industry in America has been undergoing fundamental changes over the last quarter century. In terms of product, the most significant developments were observed in the table wine category. This is the largest segment of production and value of shipments, amounting to more than 85 percent in the last decade. These products have been responding to changes in the tastes and preferences of consumers for higher quality premium wines.

Grapes used in the production of table wines are of varying quality. Varietals are delicate thin-skinned grapes whose vines usually take approximately four years to begin bearing fruit. As defined by the Bureau of Alcohol, Tobacco, and Firearms truth in labeling standards, one variety – the name of a single grape – must be used if not less than 75 percent of the wine was derived from grapes of that variety, the entire 75 percent of which was grown in the labeled appellation of origin. Appellation denoted that "at least 75 percent of a wine's volume was derived from fruit or agricultural products and grown in place or region indicated."[8] To develop the typical varietal characteristics that result in enhanced flavor, taste and finish could take another two to three years after the four years it takes newly planted vines to bear fruit. These additional growing periods, in the pursuit of enhanced quality and value, increase both investment levels and operating expenses.

Table wines are defined as those with 7 to 14 percent alcohol content by volume and are traditionally consumed with food. In contrast, other wine products such as sparkling wine (champagnes), wine coolers, pop wines and fortified wines are typically consumed as stand-alone beverages. Table wines that retail for less than $3.00 per 750 ml. bottle are generally considered to be generic or "jug" wines, while those selling for more than $3.00 per bottle are considered premium wines.

Premium wines generally have a vintage date on their labels. This designation signifies that the product was made with at least 95 percent of grapes harvested, crushed and fermented in the calendar year shown on the label and used grapes from an appellation of origin (i.e., Napa Valley, Sonoma Valley, etc. in California; North Fork, the Hamptons and Long Island AVA on Long Island). Within the premium wine category, a number of market segments have emerged based on retail price points. Popular premium wines generally sell for $3.00 to $7.00 per bottle, while super premium wines retail for $7.00 to $14.00. The ultra premium category sells for $14.00 to $20.00 per bottle, while any retail price above $20.00 per bottle is considered to be luxury premium.

LAURIE'S DECISION

After her conversation with cousin Wayne, Laurie set up a meeting with her operations manager, Dan Henning, and her accountant, Page Hopkins. She also invited the director of the Long Island Wine Council, Nanette Hansen, to get a broader perspective of local conditions. More than a few hours were spent on the website of the Wine Institute headquartered in San Francisco.

The meeting began with Laurie presenting her ideas for expansion. "There is an opportunity to purchase additional grape producing acreage across the road from the vineyard, 28 acres for $900,000. We have been farming over one-half of that land and purchasing its grapes for more than six years in order to supplement and/or complement our own production. Grape quality has been uniformly excellent and we have approached Mr. O'Reilly on more than one occasion about a possible sale. This is an opportunity that we cannot afford to pass up. It will provide us with increasing supplies of premium grapes for our merlot brands and also open a new market, petite shiraz. With expanded winery capacity in place for the 2004 harvest, we should easily meet our newly revised sales goals. We will be able to have ownership and control of our grape supplies for the foreseeable future.

Our winery also needs expansion and I have estimates of between $800,000 and $900,000 for that work. It will require two fermentation tanks as well as some barrel aging space. The tasting room at the far end of that building also needs expansion since we have observed consistent overcrowding even on week days in the fall. That would cost another $250,000.

Finally, many of the other wineries on the North Fork have facilities for special events (weddings, birthday parties, anniversaries, business meetings, etc.). By constructing a building for these activities, we could generate another source of revenues and cash flows. For the design I have in mind, the cost would be $450,000.

Dan supported Laurie's plans. "The winery is operating at 100 percent capacity and I still had to ship some grapes from last year's harvest over to the custom crush facility in Mattituck. [9] I'd like to bring all our production back here under our complete control."

Page had a number of questions concerning the cost estimates of each expenditure category, but was also interested in the perspective of Nanette representing a broader industry analysis. Nanette was prepared for those questions.

"At the Long Island Wine Institute, our prime focus is the local producers and their markets. I can't tell you much about conditions in California such as how long the "glut" of grapes will last, but we have studied the markets extensively in the East."

On the supply side, acreage planted in grapes and production of premium wines have grown steadily over the past six years, through the harvest of 2002. A long, hot growing season last year was ideal for grape growing, resulting in small flavor-packed grapes. It was the third great vintage in a row for the North Fork.

Only six inches of rain fell from mid-April to the beginning of September, 10 inches below normal. Stretches of relatively intense heat caused vines to temporarily "shut down" growth, limiting progress of the growing cycle and reducing the size of the fruit. The resultant small berries caused by this "stressing," if able to ripen correctly, made for a more concentrated and flavorful wine. More color was produced from the increased skin-

to-juice ratio. Previous premium vintages of 1993, 1995 and 1997 came from very similar hot, dry summer growing seasons.

In 2001 an almost perfect balance between rainfall and temperatures produced a spectacular harvest. Low rainfall, warm temperatures and an extended growing season combined to produce fully ripe, healthy grapes and one of the East End's best vintages ever. This followed a 2000 vintage that produced a number of award-winning whites and reds in local and national competitions. These wines from the 2000 vintage were a turning point for recognition of the region.

A final point to be made on the supply side is related to the changing composition of vineyard and winery ownership, especially on the North Fork. Over the last few years, a number of new owners have come into the area. They have brought a new respect for the land and the grape growing process. In addition, they have contributed strong financial support to both vineyards and wineries." (Exhibits 10 and 11.) [(10)]

"On the demand side of the market for Long Island wines, a major segment is event driven – celebrations of either a personal or business nature. For many local wineries, this represents 40 percent or more of their revenues and any weakness in pricing or volume will be felt quickly on cash inflows."

"There has been a weakening in the last two years in business spending for events. While volume has held up reasonably well , the price points have deteriorated – medium priced product ($10-15/bottle) has been substituted for premium wines ($25/bottle and up). Corporate and business budgets have been tightened and it is unlikely that this trend will be reversed in the next few years.

"Will the Long Island wine industry be adversely affected by these national trends in cost containment? Will the regional extent of our markets shelter us from these slowdowns in demand?"

"The market for Long Island wine has expanded from the New York metropolitan region, north to Boston and south to Philadelphia, Baltimore and Washington, D.C. Especially in New York City, the financial services industry has experienced some of the largest declines in employment as well as reductions in salaries and bonuses."

"Special events volume has slowed with cost containment at parties of all kinds, as well as restaurants. The reason overall volume and revenues have been rising is expansion of the geographic market for Long Island wines on the east coast and growth westward through New York, Pennsylvania, Maryland and Virginia. This geographic expansion may be able to counter the local trend toward lower prices. From conversations with our members, the next few years are likely to be quite challenging for the industry on the East End."

"One final statistic I picked up in reading a *Business Week* article last year concerns the consumption profile of wine drinkers in the United States. Whereas in many European

countries such as France, Germany, Italy and Spain, wine is almost a necessity with meals – this is not the case here in the United States. Just over 10 percent of American adults account for 86 percent of wine consumed annually! We have not yet been successful at stimulating wine consumption to broader segments of the population. Until this occurs, your market strategy should be directed towards those consumers already drinking wine on a regular basis." (11)

Laurie thanked everyone for sharing their ideas and expertise with her. Her plans totaled $2.4 million. She would have to prioritize each item and defend these expenditures when making a formal proposal for financing. In preliminary negotiations with a Long Island bank, they had a lending limit for a business her size of $3 million for fixed assets. They were also financing a small percentage of her inventory through a revolving line of credit. Anything above those levels would have to be sourced by some form of equity, meaning that Laurie would no longer own all of the Whistling Bird Winery!

Laurie decided it was time to make another phone call, this time to her brother Fred. Although he hadn't visited the North Fork in years, he had been to the Hamptons each summer driving his BMW to his family's summer home on the beach.

"Fred, how has your business and career been going this last year? I heard about all the reductions in financial services employment – have you been affected? My firm has maintained its competitiveness in these uncertain times," replied Fred. We are also diversifying our clients' portfolios from real estate and annuities into private and public equity positions. If you know of any interesting investment opportunities, we would gladly examine the financial data."

Somewhat surprised, Laurie responded, "Fred, right here at The Whistling Bird Winery, we have a financial proposal. We need an equity investment of approximately $2 million. Although the equity in the business is low, I will not be willing to give up control."

"Send me your financial statements," replied Fred, "and I'll contact you in two weeks with a proposal. The amount you are looking for is well within the range of my clients."

"Thanks Fred," said Laurie. "I'll fax you the data tomorrow."

TWO WEEKS LATER

"Laurie, this is your brother. I received your materials and have a proposal for an investment of $2 million. Can we meet for lunch this Wednesday and I'll present the details. I also would like my wife to be at our meeting. Liz Anne has been an equity strategist for a large investment banking firm in Manhattan and I think she can provide some insight into the workings of the private equity market. She would also like to visit the winery."

Laurie agreed and the three met for a long lunch at the Old Mill House in Peconic. After the salad, Fred presented details of his $2 million proposal to Laurie.

"Although investment returns are low these days for fixed income instruments, venture capital is still expensive. I could offer you a 10 year note with interest at 6 percent, with warrants attached. They would provide the investor with potential capital gains up to their required return of between 20 and 25 percent per year. These warrants would be exercisable for the next five years into company stock at $1 per share. The note would also be amortized from year 6 through year 10."

"Those seem to be expensive terms, Fred, especially since the book value of my common stock is almost $4 per share as of year end 2002. I will have to speak with my accountant concerning these warrants, especially the number needed to be attached to this note so that the required rate of return will be realized by your investor. By the way, who is this investor and when can I meet him?"

"Laurie, you have known him all your life!"

ONE MORE MEETING

After receiving her brother's proposal, which included a fixed income instrument and warrants to purchase shares in the firm, Laurie met again with Dan and Page.

"I can't believe how expensive this funding could be even under the lowest cost presentation," said Laurie. "With my most optimistic forecast of earnings growth for Whistling Bird Winery and his 'cheapest' financing alternative, I could lose more than one-half ownership in the company. I surely do not want that to happen!"

Dan reiterated his desire for purchasing the vineyards across the road and expanding winery capacity. "This property has been owned by the O'Reilly family for 55 years. We may never get an opportunity to purchase it again if it is bought by another winery. We have managed it for the last six years and know the quality of grape production."

Page listened attentively to the two operating managers and had clearly planned her ideas for this meeting. An integral component of her presentation was a summary of an appraisal report that had been prepared for the Whistling Bird by a local firm specializing in wine industry asset valuations on Long Island (Appendix A). It showed quite clearly that the current value of the firm's two largest asset categories was considerably higher than their book values ($8,698 million vs. book values of $6,037 million). Adding the difference of $2,661 million to the firm's equity value would surely enhance Laurie's bargaining position in negotiating for new funds.

Page also summarized and prioritized the three components of the Whistling Bird expansion plans. "It seems to me that the highest priority at this time is the land purchase," said Page. "We can produce larger volumes of wine, if the market so

demands, at the new custom crush facility. By postponing the other projects, Laurie, you would reduce the volume of funds needed from your brother and, consequently, the dilution in your ownership position. If you really want to spend the entire $2.4 million in the next year, remember the Class B common stock on the balance sheet."

After the meeting ended, Laurie walked slowly back to her office. Almost there, she turned, walked out of the building and proceeded towards the vineyard. Past the old oak trees with the birds in the branches, she walked all the way down to the shore of Peconic Bay. Sitting on a large rock near the shore, she spent the next hour considering her alternatives. She knew that when she got back to the office, Dan and Page would be waiting for her decision.

ENDNOTES

1. Murphy, Dean E., "California Grape Rush of 90s Withers as Prices Collapse," *New York Times* (May 25, 2003).

2. To put this information in perspective, the California wine industry has been in business for more than 200 years and currently has 86 AVA's. (www.wineinstitute.org).

3. "On the North Fork, Dreams of Napa," *New York Times* (July 26, 2000):1.

4. Hamm, Steve, and Sandra, Dallas, "A Wine Region That's Aging Beautifully, *Business Week* (November 23, 1999).

5. There are nine of these facilities in the wine country in California.

6. Walzer, Robert, "Hearn pressing for $2M winery," *Long Island Business News* (October 1, 1999): 5A.

7. The Wine Institute, www.wineinstitute.org.

8. Title 27, Part 4 of the Code of Federal Regulations, Bureau of Alcohol, Tobacco and Firearms, Regulatory Agency, United States Department of the Treasury.

9. A custom crush facility provides winemaking services for vineyards that do not have a winery and wineries that do not have sufficient capacity or expertise to make certain wines. A custom crush facility can take in harvested grapes and return wine that has been bottled, labeled and packaged for sale. It also offers laboratory and technical services. Premium Wine Group, located in Mattituck and serving numerous North Fork vineyards and wineries is such a facility.

10. Lynn, Jane Bryant, "2002 Harvest Report," *The Wine Press* (October, 2002).

11. Himelstein, Linda, "This Merlot's For You," *Business Week* (September 30, 2002): 65-68.

EXHIBIT 1
Whistling Bird Winery
Income Statements
(in thousands)

	2002	2001	2000	1999	1998
Net Sales	$4,924	$4,477	$3,906	$3,315	$2,764
Cost of Goods Sold	3,242	2,866	2,495	2,108	1,626
Gross Profit	$1,682	$1,611	$1,411	$1,207	$1,138
Operating Expenses					
Marketing & Advertising	132	119	106	92	81
Selling & Administration	850	738	647	520	326
Total Operating Expenses	982	857	753	612	407
Operating Income (EBIT)	$700	$754	$658	$595	$731
Interest Expense	342	297	269	257	236
Net Income Before Taxes	$358	$457	$389	$338	$495
Provision for Income Taxes	143	183	256	135	198
Net Income (Loss)	$215	$274	$233	$203	$297
EPS	.30	.39	.33	.29	.42
Number of Cases Sold	55,000	53,146	49,531	44,527	38,777
Price per case received by company	$87.52	$84.24	$78.86	$74.45	$71.28

Notes: Prime + 2 ½% on average balance for line of credit.
Long term debt (mortgage) at 7 ½%.
Federal and State income tax rate of 40%.

EXHIBIT 2
Whistling Bird Winery
Balance Sheets
(in thousands)

	2002	2001	2000	1999	1998
Assets					
Current Assets					
Cash	$222	$199	$210	$197	$191
Accounts Receivable	244	252	268	245	214
Inventories	2981	2581	2335	1985	1750
Prepaid and Other Expenses	44	40	42	38	37
Total Current Assets	$3,491	$3,072	$2,855	$2,465	$2,192
Property, Plant and Equipment	3253	128	2992	2921	2801
Less: Accumulated Depreciation and Amortization	197	174	167	174	197
Net Property, Plant and Equipment	3,056	2,954	2,825	2,785	2,687
Other Assets (net)	15	14	15	14	12
Total Assets	$6,562	$6,040	$5,695	$5,264	$4,891
Liabilities and Capital					
Current Liabilities					
Accounts Payable	$271	$233	$198	$177	$155
Accrued Expenses	244	202	176	154	137
Line of Credit (bank)	1166	909	869	689	514
LTD (current portion)	30	30	30	30	30
Total Current Liabilities	$1711	$1374	$1273	$1050	$836
Long Term Debt					
Mortgage	2,080	2,110	2,140	2,165	2,209
Equity					
Class A Common	1510	1510	1510	1510	1510
Class B Common	0	0	0	0	0
Retained Earnings (Loss)	1261	1046	772	539	336
Total Equity	$2,771	$2,556	$2,282	$2,049	$1,846
Total Liabilities and Equity	$6,562	$6,040	$5,695	$5,264	$4,891

Notes: Class A Common Stock—10 votes; Class B Common Stock—1 vote.
Currently outstanding: 710,000 Class A shares; 0 Class B Shares
Effective Corporate Taxes (Federal and State) at 40%.

EXHIBIT 3
Whistling Bird Winery
Statement of Cash Flows
(in thousands)

	2002	2001	2000	1999
Cash Flows From Operating Activities				
Net Income	$215	$274	$233	$203
Depreciation	23	7	31	22
Increase in Receivables (net)	8	16	(23)	(31)
Increase in Inventories	(400)	(246)	(350)	(235)
Increase in Prepaid and Other Expenses	(4)	2	(4)	(1)
Increase in Accounts Payable	38	35	21	22
Increase in Accrued Expenses	42	26	22	17
Net Cash Provided (used) by Operating Activities	$(78)	$114	$(70)	$(3)
Cash Flows From Investing Activities				
Purchase of Property,Plant&Equipment	$(125)	$(136)	$(71)	$(120)
Other Assets (net)	(1)	1	(1)	(2)
Net Cash Used for Investing Activities	$(126)	$(135)	$(72)	$(122)
Cash Flows From Financing Activities				
Increase (decrease) from Bank Line of Credit	$257	$40	$180	$175
Increase (decrease) in Long Term Debt (Current Portion)	0	0	0	0
Increase (decrease) in Mortgage	(30)	(30)	(25)	(44)
Net Cash Provided (used) in Financing Activities	$227	$10	$155	$131
Net Income in Cash	23	(11)	13	6
Cash at the Beginning of the Year	199	210	197	191
Cash at the End of the Year	222	199	210	197

EXHIBIT 4
United States Beverage Consumption
(millions of gallons)

Beverage Category	2002P	2001	2000	1999	1998	1997	1996
Soft Drinks	15,153	15,023	14,925	14,895	14,820	14,385	13,940
Coffee	7,700	7,710	7,700	7,750	7,800	7,854	7,901
Milk	6,950	6,910	6,885	6,918	6,880	6,890	6,924
Beer	6,353	6,241	6,202	6,136	6,002	5,922	5,898
Bottled Water	6,000	5,400	4,950	4,570	4,070	3,730	3,100
Tea	1,940	1,910	1,870	1,850	1,825	1,788	1,744
Juices	1,830	1,790	1,750	1,720	1,710	1,702	1,692
Powdered Drinks	1,320	1,340	1,350	1,370	1,360	1,365	1,358
Wine	**586**	**557**	**552**	**538**	**519**	**512**	**497**
Distilled Spirits	365	357	354	343	334	320	329
Cider (Beverage Alcohol)	10	11	10	10	9	7	6
Totals	48,277	47,249	46,548	46,101	45,329	44,485	43,389

Notes: P = Preliminary
Totals may not add up due to rounding

Source: Adams Wine Handbook 1999, 2003

EXHIBIT 5
United States Beverage Consumption
(gallons per person)

Beverage Category	2002P	2001	2000	1999	1998	1997	1996
Soft Drinks	52.5	52.7	52.9	53.4	53.7	52.8	51.7
Coffee	26.9	27.0	27.3	27.8	28.3	28.8	29.3
Milk	24.1	24.2	24.4	24.8	24.9	25.7	25.7
Beer	22.0	21.9	22.0	22.0	21.8	21.7	21.9
Bottled Water	20.8	18.9	17.5	16.4	14.8	13.7	11.5
Tea	6.7	6.7	6.6	6.6	6.6	6.6	6.5
Juices	6.3	6.3	6.2	6.2	6.2	6.2	6.3
Powdered Drinks	4.6	4.7	4.8	4.9	4.9	5.0	5.0
Wine	**2.0**	**2.0**	**2.0**	**1.9**	**1.9**	**1.9**	**1.8**
Distilled Spirits	1.3	1.3	1.3	1.2	1.2	1.2	1.2
Cider (Beverage Alcohol)	.03	.04	.04	.04	.03	.03	.02
Totals	**167.4**	**165.6**	**164.9**	**165.2**	**164.3**	**163.2**	**161.1**

Notes: P = Preliminary
Totals may not add up due to rounding

Sources: Adams Wine Handbook, 1999, 2003
Statistical Abstract of the United States

EXHIBIT 6
Retail Sales and Share of Retail Dollar by Beverage
($ Millions)
1996-2002

Beverage Category	2002	2001	2000	1999	1998	1997	1996
Soft Drinks	$75,915	$74,700	$73,100	$70,980	$68,913	$66,171	$63,455
Beer	74,400	69,940	67,400	63,850	59,811	56,398	53,010
Distilled Spirits	42,150	39,502	37,317	35,770	34,014	33,600	33,328
Milk	18,765	18,400	17,700	17,495	17,153	17,166	17,181
Juices	14,360	14,000	13,400	13,140	13,066	13,002	12,920
Wine	**20,530**	**19,020**	**18,120**	**16,600**	**14,535**	**13,718**	**12,848**
Coffee	8,150	8,040	8,050	8,165	8,112	8,050	7,972
Bottled Water	7,100	6,210	5,545	5,120	4,480	4,070	3,600
Tea	1,340	1,300	1,280	1,265	1,252	1,225	1,195
Powdered Drinks	860	870	880	888	885	887	885
Totals	$263,570	$251,982	$242,792	$233,273	$222,221	$214,287	$206,394

Source: Adams Wine Yearbook, 1999, 2003

EXHIBIT 7
Wine Consumption in the
United States
1980 – 2002

Years	Total Wine (millions of gallons) [1]	Total Wine (per capita) [3]	Total Table Wine (millions of gallons) [2]	Total Table Wine (per capita) [3]
2002	595	2.06	532	1.84
2001	561	1.96	503	1.76
2000	558	1.97	498	1.76
1999	551	2.02	482	1.76
1998	526	1.95	466	1.72
1997	520	1.94	461	1.72
1996	505	1.90	443	1.67
1995	469	1.79	408	1.56
1994	459	1.77	395	1.52
1993	449	1.74	381	1.48
1992	476	1.87	405	1.59
1991	466	1.85	394	1.56
1990	509	2.05	423	1.70
1989	524	2.11	432	1.74
1988	551	2.24	457	1.86
1987	581	2.39	481	1.98
1986	587	2.43	487	2.02
1985	580	2.43	378	1.58
1984	555	2.34	401	1.69
1983	528	2.25	402	1.71
1982	514	2.22	397	1.71
1981	506	2.20	387	1.68
1980	480	2.11	360	1.58

Notes: [1] All wine types including sparkling wine, dessert wine, vermouth, other special natural and table wines.
[2] Table wines include all still wines not over 14 percent alcohol content.
[3] Per capita consumption based on the resident population of the U.S.

Source: The Wine Institute, http://www.wineinstitute.org,,
Gomberg, Fredrikson & Associates.

EXHIBIT 8
Wine Sales in the United States
Domestic Shipments and Foreign Producers
Entering U.S. Distribution Channels
1991 – 2002
(in millions of gallons)

Year	Table Wine [1]	Dessert Wine [2]	Champagne Sparkling Wine	Total Wine	Total Retail Value (in Billions)
2002	532	37	27	595	$21.1
2001	503	34	25	561	19.8
2000	499	32	28	558	19.0
1999	475	31	37	543	18.1
1998	466	31	29	526	17.0
1997	461	29	29	519	16.1
1996	439	31	29	500	14.3
1995	404	30	30	464	12.2
1994	394	33	31	458	11.5
1993	381	35	33	449	11.0
1992	405	37	33	476	11.4
1991	394	39	33	466	10.9

Notes: (1) Includes all still wines not over 14 percent alcohol; excludes Canadian Coolers (made from malt).
(2) Includes all still wines over 14 percent alcohol.

Source: The Wine Institute, http://www.wineinstitute.org.

EXHIBIT 9
U.S. Table Wine Market [1]
Color Mix Profile
(in millions of nine-liter case shipments)

Year	Red	White [2]	Rosé/Blush [3]	Totals [4]
2002	88	91	33	212
2001	81	84	33	198
2000	79	81	34	194
1999	74	74	38	185
1998	66	74	38	178
1997	61	76	39	176
1996	55	74	38	167
1995	46	71	39	156
1994	41	71	39	150
1993	36	68	38	143
1992	36	69	42	147
1991	26	67	40	133
1990	25	68	44	136
1985	33	99	27	159
1980	41	80	30	151
1975	36	27	21	83
1970	28	14	14	56

Notes: [1] Consumption of Domestic and Imported Wine.
[2] Includes white wine produced from white grapes only.
[3] Includes all wines labeled "rose" or "blush" and all wines labeled "white" produced from red grapes.
[4] Addition of columns may not agree due to rounding.

Source: "The U.S. Wine Market", Impact Databank, Review and Forecast", 1998, 2001, 2003

EXHIBIT 10
Long Island Wine Industry Statistics
(Select Years)

Year	Number of Vineyards	Number of Wineries	Planted Acres	Total Acres Owned	Value Per Acre	Wine Production (Cases)
2002	52	29	3000	4000		500,000
2000		21	2200	2800	25,000	400,000
1999		21	2100			
1998		21				200,000
1996	40			1800		
1995		23	1,055			200,000
1989		14				
1987		12				
1985	16	7	600			
1984	12	4	700			
1975		1				
1973	1		17		4000	

Source: Various Issues of the Following Publications:
The Wine Press, Underground Wine Journal, Wine East, Long Island Business News, and Newsday.

EXHIBIT 11
Selected Values of Vineyards and Wineries on Long Island
(Select Years)

Year	Name	Location	Winery Capacity (cases)	Total Acres	Estimated Value
2001	Gristina	Cutchogue		82.5	$5,200,000
2001	Raphael	Peconic	10,000	70	6,000.000
2000	Bedell Cellars	Cutchogue	8,000	50	5,000,000
	Pindar Vineyards		80,000	42.5	
	LeClos Thirese (Theresa's Field)			40	400,000
1999	Hargrave	Cutchogue	6-8,000	84	4,000,000
1999	Laurel Lake Vineyards	Laurel	5,500	23	2,000,000
1999	Corey Creek	Southold	4,000	30	2,500,000
1999	Peconic Bay Vineyards	Cutchogue		35	2,200,000
1999	Bidwell Vineyards	Cutchogue	15,000	34	2,900,000
1997	Laurel Lake Vineyards	Laurel		23	3,000,000
1997	Manor Hill Vineyards	Cutchogue		65	1,800,000
1993	Dzugas-Smith Vineyards	Cutchogue		29	245,000

Sources: Various issues of the following pulications:
The Wine Press, Underground Wine Journal,
Wine East, Long Island Business News, and Newsday

Appendix A

Report of the Appraisal of Assets
of the Whistling Bird Winery

In response to the request of Ms. Laurie Johnson, sole owner of the Whistling Bird Winery, we hereby enclose our estimates of current market values for the firm's wine inventory as well as its fixed asset position. Our personnel have carefully examined your inventories, land, winery building and equipment and compared it with current market values that we have observed over the last six months. We are pleased to report to you that the quality of your inventory is excellent and your assets are in top operating condition.

With your firm's growing emphasis on the production of premium red wines (merlot and cabernet sauvignon), our appraisal estimates that 30 percent of wine in barrels by volume has been stored for more than two years, resulting in a doubling of its book value at the time fermentation was completed in early 2001. Another 40 percent, also red wine, mostly from the 2002 harvest has been in barrels for 14 months. Remaining wine volumes are a mixture of younger reds and white chardonnay. We conclude that as of November 2003 the value of inventory, if sold in the local wholesale market, would result in receipts of $4.65 million.

In a separate analysis of property, plant and equipment, our real estate expert on current market conditions estimates the value of company owned land at $1,088,000 or $32,000 per acre on the 34 acres under cultivation by Whistling Bird. This in contrast to $720,000, which is the current book value of this land on an historical cost basis.

The remaining $2,336,000 of depreciated book value of the winery plant and equipment has also increased in value since its original purchase. Its current value is $2.96 million according to our appraiser.

In summary, upon a sale of these two major asset categories, it is estimated that they would bring into the firm a total of $8,698,000, or $2,661,000 more than their current book value of $6,037,000. This additional value could be added to the firm's equity account of $2,771,000 at year end 2002, bringing its total up to $5,432,000

Summary Data

Asset	Book Value December 31, 2002	Adjusted Market Values November 30, 2003
Land – 34 planted acres	$720,000	$1,088,000
Plant & Equipment	2,336,000	2,960,000
Inventory	2,981,000	4,650,000
Totals	$6,037,000	$8,698,000
Less: Liabilities	3,266,000	3,266,000
Equity Value	$2,771,000	$5,432,000
Equity Value Per Share (710,000 shares outstanding)	$3.90	$7.65

It was a pleasure to provide you with the above data. If there is any additional information or clarification you may require, do not hesitate to contact us.

Respectfully submitted,

Sharon Brown, President
East End Associates
November 24, 2003.

Appendix B

Laurie Johnson's Position with Projections

Laurie has projected capital expenditures of $2.4 million for expansion of Whistling Bird Winery operations. She had taken them to her local bank along with her business plans for the next five years. Those projections included two scenarios, a revenue growth rate of 15 percent expected over the forecast period with enhanced operating efficiencies and expanded profit margins.

The bank officer was skeptical of her optimistic expectations, especially after speaking with a number of other wine operators in the area. Their final proposal was for only a $400,000 term loan with a small increase in the revolving line of credit to $3 million. Their implications and position were clear – the firm needed larger equity capital to sustain its growth plans. While the longer term outlook for the industry was quite favorable, they were quite cautious about business over the next two years (2004 and 2005).

Laurie realized that permanent capital was needed to support her growth initiatives. However, she was not able to add to her personal investment in the business. Her husband David, a professor of history at Stony Brook University, also believed that too large a percentage of the family's assets were already in the business.

Appendix C

Liz Anne Johnson's Private Equity Guidelines

Fred's wife Liz Anne had worked with Fred on guidelines his firm would use for their new venture into private equity and she shared this information with Laurie.

Stage One (start ups, "seed deals")
Outside capital flows into the firm for the first time with funds being spent on organizing operations. The first products and/or services show evidence of interest on the part of potential customers. The firm is in operation for less than a year and risks are quite high.

Expected Rate of Return 45-55%

Stage Two
The firm is producing products or supplying services, thus generating revenues. Accounts receivable and inventories are growing, customer relations are being established and strengthened.

Expected Rate of Return 35-40%

Stage Three
Company revenues are growing and the firm is profitable on a cash flow and net income basis. Funds are needed to expand capacity, expand market segments or facilitate an acquisition.

Expected Rate of Return 20-30%

Bridge Financing
The firm expects to go public with an IPO in 6 to 12 months. A deal is structured so that funds from the IPO would repay the supplier of the bridge financing in whole or in part along with their required return.

Expected Rate of Return 15-25%

Buyout or Acquisition Financing
Current or a new management team buys another firm. Depending on the expertise of management and the characteristics of the business, a deal of one to three years is usually structured.

Expected Rate of Return 25-35%

The following check list is generally required to be completed for any of the above proposals:

- General Business Plan with Goals
- Growth Prospects
- Plan for Achieving Goals
- Amount of Financing Desired and How It Will be Used
- Description and Background of Key Managers
- Pro Forma Statements: Balance Sheets, Income Statements, Statements of Cash Flows
- Detailed Financial Projections of Revenues, Cash Flows, Gross Margins, Inventory Turnover and Management
- Capital Expenditure Budgets
- Expected Rates of Return on Assets, Investments and Equity

Appendix D

Fred Johnson's Position with Projections

Fred had some questions concerning the timing of the expenditures outlined in Laurie's proposal. He was also concerned about the "grape glut" and its impact on product pricing. In addition, the economic outlook in the near term did not seem to be either clearly defined or strong. Therefore, his expectations were for average annual growth rates in revenues of between 5 and 10 percent in contrast to Laurie's 15 to 20 percent. He did, however, agree that enhanced efficiencies could generate faster growth in net income than the growth in revenues.

With respect to Laurie's overriding concerns over control, Fred quite understood. Perhaps the last thing on his mind was to have to take over the operations of Whistling Bird Winery. He approached this deal strictly from a financial point of view. Fred was looking for a viable and profitable investment of $2 million that would fit nicely into his portfolio. A current return of 6 percent, with a total expected return of 20 percent over at least a five year holding period, was quite acceptable to him. While he might have expected a 25 percent total return on an investment with this risk a few years ago, equity risk premiums had been trending downward. Thus a 20 percent return would meet his current portfolio needs.

Fred had received a copy of the report from East End Associates and understood their higher estimate of Whistling Bird's asset position. Yet he was still quite concerned about the lack of liquidity of this investment and its impact on the cost of capital. Although he was confident of being repaid his $2 million at the end of five years, as well as receiving his interest payments each year, the capital gain component of his total return was quite uncertain.

This investment would definitely have a buy-and-hold profile. Selling a private equity investment is traditionally accomplished through an initial public offering or an acquisition by another firm years after the venture has developed into a viable, competitive and profitable business. In evaluating his potential position in Whistling Bird, he did not realistically see either of these scenarios occurring in the foreseeable future. His only hope for monetizing his investment would be to sell his shares back to Laurie at a reasonable value or try to sell them to another private investor.