Constellation Brands, April 2008[1]

On April 3, 2008, Constellation Brands, Inc. ('CBI;' *Ticker: STZ*) reported its fiscal year 2008 results. Despite reporting a loss of $610 million, CBI generated positive free cash flow; moreover, the company was confident of generating strong free cash flow for the following year as well; and, earnings guidance for 2009 was positive, beating the consensus estimate among analysts.

The loss was attributable to writedowns resulting from goodwill impairment related to CBI's Australian and UK wine businesses and the reversal of a tax-related allowance. Bob Ryder, Chief Financial Officer of CBI pointed out, "These are non-cash, non-recurring charges to earnings and do not impact the company's free cash flow, debt covenants, or future operations." Rob Sands, President and CEO was even more optimistic: "We exceeded our comparable earnings per share (EPS) estimate for the year, and generated record free cash flow. I am confident in our ability to continue to execute our strategy, profitably grow our business, and generate strong cash flow."[2]

With approximately 217 million shares outstanding and a share price of $19.72 at the end of the day, the company's equity was worth a little over $4.3 billion. CBI's shares had trended upwards in the days prior to this announcement, ending 12% higher than the price a week before. Despite this uptick, the stock was 25% below the high that it had achieved during the past year.

Constellation Brands

Constellation Brands produces and sells 250 brands of alcoholic beverages across 150 countries. Its product portfolio consists of wines, beers, and spirits. Founded in 1945, the company is the world's largest producer of wines in the world, and the largest beverage alcohol supplier in the US. It is a leading producer and exporter of wines from Australia and New Zealand, and wholesaler of wine in the UK. Well-known wine brands include Robert Mondavi, Clos du Bois, Arbor Mist, Blackstone, Nobilo, Hardys, Banrock Station, Inniskillin, Jackson-Triggs, and Ravenswood, to name just a few. CBI imports and markets in the US beer brands such as Corona, Modelo Especial, St. Pauli Girl, and Tsingtao via a joint venture with Mexico's Groupo Modelo (called Crown Imports).

In 2008 (the company's fiscal year ends in February), CBI reported $3,773 million in net sales, comprising $3,017 million from branded wine, $414 million from spirits, and $342 million from their wholesale (and other) sales. Gross margin (i.e., revenue minus cost of goods sold as percent sales) was 34%, and operating margin from wines and spirits[3] (i.e., operating

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[1] *This case was developed by Professor Anant K. Sundaram of the Tuck School of Business at Dartmouth College as a basis for class discussion. Any errors of fact or interpretation are those of the casewriter. © May 2008.*

[2] 'Comparable' EPS is a non-GAAP metric reported by CBI with a view to make year-on-year financial comparisons easier. It is explained in more detail in the next section.

[3] Operating income is from wines and spirits sales only, and does *not* include $258 million in pre-tax earnings from the beer joint venture with Groupo Modelo or other joint ventures.

income before interest and taxes as percent sales) 13%. To put these numbers into perspective, the gross margin and operating margin for a typical firm in the S&P 500 index of stocks are 40% and 18%, respectively. Reported net income (according to GAAP) for CBI in 2008 was *negative* $610 million (compared to *positive* $320 million in 2007), reflecting the non-cash writedowns of goodwill and intangible assets of $822 million associated with CBI's businesses in Australia and the UK, and a $52 million deferred tax asset valuation allowance. *Exhibit 1* shows CBI's key financials for fiscal years 2006, 2007, and 2008.

The company has grown organically and through a series of acquisitions. Some of the firm's larger recent acquisitions include winemakers BRL Hardy Limited of Australia for $1.2 billion in 2003, Robert Mondavi Corp. of the US for $1.4 billion in 2004, and Vincor of Canada for $1.4 billion in 2006. In 2007, CBI announced the purchase of SVEDKA Vodka, the purchase of Fortune Brands' US wine business, as well as a $500 million share repurchase. As a result, CBI's total debt more than tripled from under $1.4 billion in 2001 to $5.3 billion presently.

Given the aggressive growth by acquisitions, comparing year-on-year financials was a challenge, not only because of the difficulties in distinguishing between organic and acquisition-led growth, but also because of the many inevitable one-time charges. As a result, Constellation also disclosed "comparable" non-GAAP financials to enable easier comparisons on numbers from one year to the next. See *Exhibit 2*.[4] (This exhibit also shows segment data for the company.)

There are at least two additional factors that could complicate the analysis of CBI's value. In 2007, the company formed a joint venture called Crown Imports, to market imported beer in the US. Prior to this, Constellation had consolidated its revenue from imported beer sales as a part of its overall sales. From 2008 and on, the company booked the impact of imported beer revenue as income in the form of "equity earnings in joint ventures" (EEJV). The implication of this change was a drastic reduction in net sales and a substantial increase in reported EEJV. The second complication, and one that caused valuation uncertainty, arose from a buyout option for Groupo Modelo in the year 2017 − there was uncertainty as to the whether the joint venture would continue past the 10th year, depending on the course of action Modelo would pursue at that time.

Current Business Challenges

In the immediate future, Constellation faced a number of business challenges: a trend among US wine distributors to operate with lower inventory levels, Australian wine over-supply, and weakness in the UK market. Increasing consolidation and improved supply chain efficiencies among distributors implied that wine inventory in the distribution channel would be lowered by perhaps 25% - 30%, thereby temporarily impacting US wine sales negatively. In addition, the UK wine market was seeing an influx of low-cost Australian wines for private

[4] Many analysts also, therefore, focused on a revenue metric known as "constant currency organic revenue growth," i.e., the rate of growth in existing businesses assuming the value of the US dollar stayed constant. The considerable depreciation of the US dollar against other major currencies in the prior few years had led to a positive impact on the net income of many US exporters, thereby boosting their US dollar reported profits for reasons that, the market believed, may have more to do with favorable currency movements rather than effective strategy execution.

label brands (as well as duty increases), leading to tremendous pricing (and hence, profit margin) pressures there.

Analysts noted that, compared to other consumer products, the wine industry had low branding and pricing power. Wholesalers and retailers insulated the wine producer from the consumer. Wholesalers derived their power thanks to a plethora of state laws that regulated and protected wine distribution. The industry is characterized by high capital − especially working capital − intensity and cyclicality resulting from agricultural price swings. Entry barriers in wine production are low, thereby attracting low marginal cost players during times of low grape prices, making it difficult to increase margins. On the flip side, low pricing power meant that the effects of high grape prices could not be passed on to the consumer.

Valuation Implications and Assumptions

In order to address these challenges, Constellation would need to improve operating efficiencies, tighten working capital and capital expenditure, shift to higher margin brands, undertake better brand-building, and expand into new markets. Such developments in the company's financial and operating fundamentals − as well as the volatility of its stock price − rendered the valuation of CBI a somewhat demanding undertaking.

Revenue growth rates for the next several years are forecasted to be 3% to 5% per year for wines, and 4% to 6% per year for spirits. EEJV is expected to grow at 4% to 6% per year. Cost of goods sold (including depreciation charges) during the forecast period is expected to be 66%, and SGA expenses (including depreciation charges), 22% of sales. Working capital is expected to be 53% of sales and Capital Expenditure 4% of sales during the forecast period. Given their generally long-lived nature, fixed assets in CBI's businesses depreciate on average over 20 years.

Long-run growth rate in free cash flows would be determined by the long-run assumed return on invested capital (ROIC) and a "Re-investment Rate", which, in turn, is a function of operating profits and net capital investments in the last forecast period.[5] ROIC in the long run could be assumed to be 11% to 13%. (Capital markets data relevant to CBI, and for the US financial markets, are shown in *Exhibit 3*.)

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[5] Specifically, Reinvestment Rate = [Capex − Depreciation + Change in Net Working Capital]÷[EBIT×(1−t)]. For details, see *Sundaram (2005) "Terminal Values in Corporate Valuation."* The tax rate is estimated to be 36% during the forecast period.

Exhibit 1

Constellation Brands: Financials for 2006 – 2008

(US$ millions, unless otherwise mentioned; Fiscal Year-end is February)

	2006	***2007***	***2008***
Net Sales	4603.4	5216.4	3773.0
Of which, Wines	*3235.4*	*3843.4*	*3017.0*
*Of which, Beer, Spirits & Other**	*1368.0*	*1373.0*	*756.0*
Cost of Goods Sold	3278.9	3692.5	2491.5
SG&A	612.4	768.8	807.3
Of which, Depreciation & Amortization	*128.1*	*131.7*	*154.7*
Other Costs	46.1	1.1	18.7
Other Operating Income (incl. EEJV)	0.8	49.9	257.9
Interest Expense	189.7	268.7	341.8
Impairment of Goodwill/Intangibles	--	--	807.3
Earnings before Taxes	477.3	535.3	(435.7)
Provision for Taxes	152.0	203.4	(174.9)
Net Income	325.3	331.9	(610.6)
Assets			
Cash & Short Term Investments	10.9	33.5	20.5
Accounts Receivable	771.9	881.1	731.6
Inventories	1704.4	1948.1	2179.5
Other Current Assets	213.7	160.7	217.2
TOTAL CURRENT ASSETS	2700.9	3023.3	3148.8
Net Property Plant & Equipment	1425.3	1750.2	2035.0
Goodwill	2193.6	3083.9	3121.0
Net Intangible Assets	883.9	1135.4	1198.0
Other Assets	196.9	445.4	504.9
TOTAL ASSETS	7400.6	9438.2	10007.7
Liabilities			
Accounts Payable	312.8	376.1	349.4
Notes Payable to Banks	79.9	153.3	379.5
Current Maturities of LTD	214.1	317.3	229.3
Other Current Liabilities	691.3	744.4	760.1
TOTAL CURRENT LIABILITIES	1298.1	1591.1	1718.3
Long Term Debt	2515.8	3714.9	4648.7
Deferred Income Taxes	371.2	474.1	538.0
Other Long Term Liabilities	240.3	240.6	333.9
Equity	2975.2	3417.5	2768.8
TOTAL LIABILITIES + EQUITY	7400.6	9438.2	10007.7

Source: SEC Filings, Annual Reports, Company website.

** Because of the Crown Imports joint venture, beer revenues disappear in 2008. The income impact of beer sales is reported under EEJV.*

Exhibit 2

Constellation Brands: Comparable Financials for 2004-2008, and Segment Data for 2006-2008

(US$ millions, unless otherwise mentioned)

Panel A: Comparable Financials

	2004	*2005*	*2006*	*2007*	*2008*
Reported Results					
Net Sales	3552.4	4087.6	4603.4	5216.4	3773.0
Operating Income*	487.4	567.9	666.1	748.9	(98.8)
Net Income	220.4	276.5	325.3	331.9	(613.3)
Diluted Earnings Per Share	1.03	1.19	1.36	1.38	(2.83)
Comparable Results					
Net Sales	3552.4	4087.6	4603.4	5216.4	3773.0
Operating Income*	558.9	626.7	760.0	895.3	818.8
Net Income	266.5	314.1	379.8	403.3	321.0
Diluted Earnings Per Share	1.25	1.35	1.59	1.68	1.44

Source: Company website. Comparable financials result from adjustments for factors that, in the management's judgment, reflect one-off items such as acquisition-related costs, restructuring charges, facility rationalization costs, inventory revaluation, and so forth.

** 'Operating Income' in 2007 and 2008 includes EEJV.*

Panel B: Segment Data

	2006	*2007*	*2008*
CBI Wines Segment			
Net Sales	3235.4	3843.4	3358.8
Operating Income	530.4	629.9	558.4
CBI Spirits Segment			
Net Sales	324.5	329.4	414.2
Operating Income	73.4	65.5	72.0
CBI Beer Segment			
Net Sales	1043.5	1043.6	Not Avail.
Operating Income	219.2	208.1	Not Avail.

Source: Company website.

Exhibit 3

Constellation Brands: Capital Markets and Competitor Data
(US$ millions, unless otherwise mentioned)

Panel A

	Data for April 2008
CBI Credit Rating	BB–
CBI Equity Beta @ 55% Debt/Capital*	1.27
CBI Size Premium	0.79%
CBI Value Premium	0.79%
Estimate of US Market Risk Premium in 2008	5.00%
US Government 30-Year T-bond Yield	4.60%
'A' Spread Over 30-Year T-bond Yield	220 bp
'BB–' Spread Over 30-Year T-bond Yield	340 bp
Average Annual S&P500 Return (1900-2007)	11.20%
Average Annual S&P500 Return (1996-2007)	9.79%

Source: Bloomberg, Ibbotson Associates, finance.yahoo.com. At a 55% debt-to-capital ratio and 36% tax rate, the equity beta of 1.27 implies an asset beta of 0.71.